

## 2.6 KEY FACTORS AFFECTING BUDGET OUTCOMES

The 2001-02 Budget estimates are predicated on assumptions and judgements influenced by the information available at the time of their preparation. In practice, both revenues and expenses will be subject to change from budget, and the size of changes will inevitably increase over the forward estimates period.

Actual revenues and expenses and the timing thereof will be influenced by:

- ◆ the economic environment and general influences that have indefinite timing and/or a magnitude that has not been established, notably those related to technological change;
- ◆ policy delivery, new policy developments and service delivery pressures;
- ◆ regulatory outcomes;
- ◆ Commonwealth Government policy, most notably around taxation and revenue support to the States; and
- ◆ the possible realisation of contingent liabilities.

Management of the State's finances requires giving consideration to uncertain future developments, both external to the State's control and in respect of new policy. The flexibility to respond to changes in circumstances as they occur, rather than overly restrictive adherence to a set of targets for their own sake, is critical to effective budget management and the formulation of fiscal strategy. The impact of possible changes on budget aggregates can be favourable in some circumstances and adverse in others.

Some contingency funding is provided in the Budget. The *Treasurer's Advance* is for contingencies such as those associated with natural disasters and the costs of unanticipated policy responses that may be required in the budget year. A separate Treasurer's Advance is provided for capital works.

## ECONOMIC PARAMETERS

There are two sources of uncertainty associated with the economic parameters and their bearing on the Budget. First, the forecasts for 2001-02 and parameters thereafter will be subject to forecasting errors. The economic parameters from 2002-03 abstract from cyclical factors over the estimates period, reflecting expectations for average economic performance over the current decade due to the difficulty in accurately predicting cyclical variations more than a short period ahead. Second, the relationship and timing between some revenue and expense items and economic factors can be unpredictable. Therefore, even if economic outcomes were identical to those assumed for budgeting purposes, total revenues and expenses may still vary from the Budget, all other factors being unchanged.

Variations between Budget estimates and actual outcomes from time to time are unavoidable. Revenues from contracts and conveyance duty and other transaction based taxes are particularly volatile and difficult to forecast. Some revenue items may have had an inadvertent bias in past Budgets. Most notably, in the past there appears to have been on average a conservative bias in the profit estimates for PTEs, which flows through to the Budget via dividend and tax equivalent payments.<sup>1</sup>

A useful way to illustrate the scope for Budget outcomes to be affected by changes in the economic environment is to consider the consequences of different economic scenarios for the Budget.

### Examples of Alternative Economic Scenarios and Budget Impacts

Three scenarios are explored for the purposes of illustrating the potential for changes in the economy to affect the Budget year's outcomes: a *higher growth* scenario, a *lower growth* scenario, and a *severe recession* scenario. The economic scenarios should not be interpreted as likely possible outcomes for the economy or as confidence intervals around the Budget estimates.

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<sup>1</sup> Section 9.5 provides details.

**Table 2.7: Illustrative Economic Scenarios, 2001-02**

	<i>Budget Economic Forecasts</i> %	<i>Alternative Scenarios</i>		
		<i>Higher Growth</i> %	<i>Lower Growth</i> %	<i>Severe Recession</i> %
Gross State Product	2 ¾	3¾	1	-1½
Employment (NSW)	¾	1¾	¼	-½
Wages	3½	4	3¼	2
CPI	2¼	2½	2	1½
Mortgage interest rates	6¼	6½	5½	4¾

In the *higher growth* scenario a slightly stronger labour market than the 2001-02 Budget forecast accompanies better output growth of 3¾ percent, putting modest upward pressure on prices. Confidence and investor sentiment would be expected to improve.

In the *lower growth* scenario, output and employment undergo relatively subdued growth of 1 percent and ¼ percent respectively putting downward pressure on interest rates. Wages and prices are slightly lower than the 2001-02 Budget forecast and business and consumer confidence is assumed to be lower.

The *severe recession* scenario is the most extreme. Under this scenario a prolonged downturn in the United States is assumed to have flow-on effects to the Australian economy. Consumer confidence and business investment would be hard hit and output declines by 1½ percent. In line with this, labour market conditions would deteriorate and interest rates fall.

Budget scenarios corresponding to each economic scenario have been derived. For each scenario, Table 2.8 shows the deviations from the Budget result assuming *no* explicit policy response to changed economic conditions by State and Federal Governments.

**Table 2.8: Illustrative Alternative Budget Outcomes, 2001-02**

	<i>Change on Budget Estimate</i>		
	<i>Higher Growth</i> \$m	<i>Lower Growth</i> \$m	<i>Severe Recession</i> \$m
<b>GFS Budget Result</b>	<b>360</b>	<b>(-) 435</b>	<b>(-) 970</b>
GFS Revenues	365	(-) 445	(-) 995
Tax	325	(-) 380	(-) 825
Non-tax	40	(-) 65	(-)170
GFS Expenses	5	(-) 10	(-) 25

The projected Budget outcome is a Budget Surplus of \$368 million. However, under the higher growth scenario the outcome could be a higher Budget Surplus of about \$730 million (an improvement of around \$360 million), while under the lower growth scenario the outcome could be a Budget Deficit of about \$70 million (a deterioration of around \$435 million).

In all scenarios, the Budget result is primarily driven by changes in revenues. In the short term, expenses are relatively insensitive to changes in economic parameters largely because growth in public sector wages (the largest component of expenses) is 'locked in' through wage agreements for the Budget year and beyond and major program changes are difficult to achieve in a short time frame.

In contrast, revenue items such as payroll tax and stamp duty can be quite sensitive to economic factors. Both employment levels and wage rates affect payroll tax. Stamp duties, including contracts and conveyances, are affected by changes in transaction volumes and confidence. Note also that while the state of the economy will impact on GST collections, this will not flow through to the NSW Budget because *Budget Balancing Assistance* will be adjusted.

Revenues under the higher growth scenario are higher in line with higher output growth, a stronger labour market, improved confidence and stable interest rates. Consistent with the fall in confidence under the lower growth scenario, transaction based tax revenues decline.

Under the more extreme severe recession scenario the Budget outcome deteriorates by over \$970 million, and with no policy adjustments a Budget Deficit of about \$600 million results.

## **TECHNOLOGICAL DEVELOPMENTS**

The potential costs or benefits of technological developments cannot be readily quantified. Technological developments will often affect the Budget over a longer period than that covered by the forward estimates. Examples include:

- ◆ New technology and the associated increased mobility of capital and greater exploitation of tax loopholes have the potential to erode NSW tax revenue.
- ◆ There is the potential to improve the quality of service delivery and/or reduce the cost per unit of service delivery, as new technologies are applied in key service areas such as education and health. However, new technologies could also produce unanticipated changes in service demand patterns, especially in the health sector, which have the potential to affect expenses.

## **CHANGES IN THE POLICY ENVIRONMENT**

Apart from possible changes to the macroeconomic environment, Budget outcomes may depend on any or a combination of the following:

- ◆ The cost of implementing a new policy or maintaining an existing policy may be different from that assumed in the Budget estimates – for example, due to different take-up rates or subsequent refinements to cost estimates.
- ◆ Delays in implementation or the need for additional government funding may arise, such as weather-related delays to capital works, or the occurrence of natural disasters.
- ◆ Policies will be fine-tuned or changed and new policies will inevitably be introduced over the forward estimates period.
- ◆ Changes in the regulatory environment at the State and Federal level can affect the prices and costs of government provided services such as transport, electricity and water.

### **Policy Delivery Assumptions**

The Budget is framed on a ‘no policy change’ basis – ie, it assumes that expenditure and revenue policies prevailing at the time of the Budget (including any new policies announced up until and in the Budget) are carried into the forward estimates period. Therefore a subsequent change in policy would affect the Budget year and forward estimates.

Funding for the Treasurer’s Advance provides a contingency for unforeseen demand and increased cost pressures in each of the forward years.

Demographic and social changes and other external factors can have a substantial impact on demand and hence the cost of maintaining existing policies, in particular in the health, community services, criminal justice and education sectors.

The forward estimates make allowances for such costs where possible, and in some areas to a greater extent than in previous Budgets. For example, since the commencement of the Government Action Plan for Health in 1999-2000, the forward estimates of the Department of Health have included guaranteed growth funding to meet projected increases in activity. In the welfare area, the forward estimates have been revised in 2001-02 Budget to meet expected growth in foster care expenditure.

However, some of the changes in demand are difficult to predict. For example, the demand for public health services will be affected by the usage of private health insurance which in turn is influenced by Commonwealth Government policy.

Additionally, the impact of policy changes in one area can have unpredictable consequences for other interconnected areas. For example, the increase in police numbers will have flow-on costs for other parts of the criminal justice system. While an allowance has been made for these kinds of flow-ons in the forward estimates, the size of these flow-on costs may turn out to be different from those assumed.

In regard to liabilities associated with superannuation schemes and other employee benefits and insurance schemes, measures of such liabilities depend on actuarial estimates that rely on policy assumptions regarding public sector wage growth and non-policy assumptions regarding inflation and fund earnings. Therefore actuarial estimates are subject to change, which can influence the size of funding contributions required from the Budget.

## **Capital Works**

In past years, budgeted capital outlays have tended to exceed actual capital outlays to a small degree.

In part agencies expectations of the capital works they would complete were over-optimistic with insufficient allowance for unavoidable circumstances such as bad weather and other factors which delayed spending. While every effort is made to account for these effects, the impact of such factors cannot be accurately forecast.

The forward year estimates assume that the size of the “discretionary” component of the capital program (ie. that component which is not funded through dedicated revenue sources) will remain relatively constant in real terms. This means in effect that the forward estimates contain an allowance for new projects yet to be identified or approved.

## **PRICING AND REGULATION OF UTILITIES**

Potential adjustments to the Budget (adverse or favourable) could arise from price determinations by the Independent Pricing and Regulatory Tribunal (IPART). IPART is expected to provide pricing determinations with effect in 2001-02 in respect of public transport fares (affecting the State Rail Authority and State Transit Authority). This determination could influence the level of Budget subsidies required.

IPART reviews may also impact on revenues from financial distributions. IPART recently released a review of the Rail Infrastructure Corporation's (RIC) asset values affecting the maximum permitted return on assets. The impact of this review on profitability is currently being assessed by RIC.

IPART has established electricity retail prices until June 2004 for those customers choosing not to enter the contestable retail market. From 1 January 2002, all electricity customers are scheduled to be able to choose their retail electricity supplier. However, competition could reduce margins earned by Government owned electricity retailers, thereby putting pressure on financial distributions.

## **POLICY CHANGES IN OTHER JURISDICTIONS**

Changes in Commonwealth Government policies can affect the States in a variety of ways. The impacts on the Budget can be direct, such as through changes in Commonwealth grants, conditions associated with tied grants, and changes in Commonwealth tax policy. The impact of most such changes cannot readily be quantified in advance, but could be quite significant.

Commonwealth Government policy can also have indirect impacts. For example, a change in migration policy, tariff policy, or Australian commitments to international agreements could have flow-on effects to the NSW Budget.

In addition, Commonwealth policy changes can alter the incentive for individuals to use State Government services - e.g. pricing and/or changes to eligibility requirements or waiting list criteria for some social services - can significantly change the patterns of demand and usage, and therefore the costs faced by States.

Policy changes in other States can flow through to the NSW Budget. For instance, different tax regimes may apply to border regions in order to minimise tax revenue leakages between States or policy changes may affect Commonwealth Grants Commission relativities. New South Wales has also closely monitored changes in other States' tax regimes for highly mobile tax bases such as financial transactions. Apart from taxation, cross-border charging arrangements by other States for some services can also lead to variations in the demand for or cost of services provided by New South Wales.

## COMMONWEALTH TAX REFORMS

Not all costs and forgone revenues have been recognised in the Commonwealth's *Budget Balancing Assistance* payments to the States associated with national tax reform. Furthermore, the costs agencies are incurring to comply with the GST on an ongoing basis may vary from those provided for in the forward estimates.

## CONTINGENT LIABILITIES

The Budget can be affected by a wide variety of contingent liabilities, defined as costs the Government will have to face or otherwise respond to if a particular event occurs. These may arise from:

- ◆ disputes including claims for compensation and litigation;
- ◆ State guarantees under statute;
- ◆ other guarantees provided to facilitate the provision of certain services and the construction of infrastructure assets; and
- ◆ developments where the Government intervenes in the public interest, despite there being no legal obligation for the Government to do so.

The main contingent liabilities of the General Government and State Sectors, both quantifiable and unquantifiable, are identified in the *Consolidated Financial Statements of the New South Wales Total State Sector* published in the second quarter of each calendar year.

Note 19 in the 1999-2000 Statements identifies \$754 million worth of quantifiable contingent liabilities in the General Government Sector as at 30 June 2000, as well as a number of other unquantifiable contingent liabilities.

The Government may also face contingent liabilities associated with private sector infrastructure projects which are detailed in Chapter 9 of this Budget Paper to satisfy Loan Council reporting requirements. Some of these liabilities are also noted in the *Consolidated Financial Statements of the New South Wales Total State Sector*.

Other additional contingent liabilities which are not identified in either the *Consolidated Financial Statements* or Loan Council reporting requirements may arise from contractual obligations, guarantee arrangements or claims in connection with land development, forestry/environmental programs and native title. For example, the State is required to meet 25 percent of compensation costs when native title is forcibly extinguished. The potential size of these liabilities has not been quantified.

Additional unquantifiable contingent liabilities may also arise throughout the course of the year. For instance, the Government may undertake to provide financial assistance to victims of drought or flood or to those suffering significant adverse impacts as a consequence of financial or other mismanagement of public or private entities.