

REPORT
OF THE
TREASURER

TO THE
NSW PARLIAMENT

ON THE REVIEW
OF THE

FISCAL RESPONSIBILITY ACT 2005

10 June 2011

REPORT OF THE TREASURER TO PARLIAMENT ON REVIEW OF THE *FISCAL RESPONSIBILITY ACT 2005*

The *Fiscal Responsibility Act 2005* (FRA) sets targets and principles for the conduct of fiscal policy. The Act was assented to on 16 June 2005.

Section 25 of the Act states:

25 Review of Act

- (1) The Treasurer is to review this Act to determine whether the policy objectives of the Act remain valid and whether the terms of the Act remain appropriate for securing those objectives.
- (2) The review is to be undertaken as soon as possible after the period of 5 years from the date of assent to this Act.
- (3) A report of the outcome of the review is to be tabled in each House of Parliament within 12 months after the end of the period of 5 years.

A review of the Act has been made in accordance with Section 25 and is attached.

The policy objective of the Act, *maintaining financial results that are fiscally sustainable in the medium and long term*,¹ remains valid and the Government is committed to this objective. However, the review finds that many targets and principles have not been met. There has been no attempt to return to the unmet targets, nor has there been acknowledgement of the departure from principles and provision of the reasons, the remedies, and the time frame to return to them, as required under the Act.

The departure from the key net debt and net financial liability targets means that the state has less of a balance sheet buffer to absorb financial risks or shocks, thus threatening the long-term sustainability of the state's finances.

On 29 March 2011 the Government established a Financial Audit, including in its terms of reference a review of the State's fiscal strategy and legislation. The Audit's advice will inform any proposed revisions to the *Fiscal Responsibility Act*. These are expected to be submitted to Parliament later in 2011.

¹ FRA, Section 3(1)

I. Background²

The *Fiscal Responsibility Act 2005* (FRA) sets targets and principles for the conduct of fiscal policy. It is part of the suite of legislation setting rules and standards of performance and transparency for State financial management including:

- *Public Authorities (Financial Arrangements) Act 1987*;
- *Public Finance and Audit Act 1983*; and
- *State Owned Corporations Act 1989*.

The FRA is the successor to the *General Government Debt Elimination Act 1995* (GGDEA), and is similar in scope and language. Its aim is to provide a sustainable medium-term framework for state finances, as needed to ensure ongoing service delivery.

The GGDEA was enacted after the financial stress and rising debt that accompanied the economic recession of in the early 1990s. New South Wales narrowly avoided the credit rating downgrades imposed on several other States at that time. This underscored the need for a medium-term policy framework to reduce the risk of repeating this experience. By writing this into legislation, the Government was signalling a commitment to fiscal discipline in a multi-year framework.

In the GGDEA and FRA, this framework includes quantitative targets, policy principles and reporting requirements. The 2005-06 Budget Papers compare the two, with the main differences being:

- The focus of the GGDEA was to eliminate General Government (GG) net debt (by 2020), while the aim in the FRA is to limit its growth (by setting a debt-to-GDP ceiling). The FRA widens the fiscal framework by adding a similar constraint on net financial liabilities.
- The GGDEA sought to constrain the annual fiscal outcome (net lending, being the sum of the current and capital balances), while the FRA limits this constraint to the current balance (the operating result).

These changes in emphasis reflected the view that by the mid-2000s the GGDEA was largely on track to achieve its principal objective – GG net debt had declined from over 7 per cent of GSP in 1995 to 1 per cent by 2004. It was considered that a prohibition on debt was not optimal from a financial management standpoint and was impeding the response to infrastructure requirements.

The legislative review also noted that New South Wales was unique among Australian states in taking the net lending balance rather than the operating balance as the budget bottom line, and interstate performance comparisons suffered unfairly as a result. The FRA changed the emphasis to the operating balance, with Fiscal principle No 1 stating that the budget should be framed so as to achieve a net operating result for the GG sector that is consistent with the fiscal targets.

² Unless otherwise indicated, this analysis relies on fiscal and economic information as at the 2010-11 Half Yearly Review.

Fiscal Responsibility Act – Statutory five year review

Reflecting the concern raised by intergenerational studies, the FRA added a further requirement for annual reporting on the impact of Budget measures on long-run sustainability.

The table below provides a summary of the FRA targets and principles, and of performance against them, including for the General Government Sector (GGS).

A	Fiscal Target	Progress Indicator	Assessment
	GG net financial liabilities		Not met
	GG net debt		Not met
	State unfunded superannuation liabilities		On track, but target not yet met
B	Fiscal Principles	Progress Indicator	Assessment
1	Keep budget in surplus	GG net operating Result	Not met
2	Constrain costs and expenses	Growth in net cost of services and expenses	Not met
3	Manage public sector employee costs	Public sector Employee costs	Not met
4	Evaluation of capital expenditure proposals	Stability of capital project budgets	Not met
5	Manage finances with view to long term fiscal pressures	The long-term fiscal gap	Partially met
6	GG net worth	GG net worth	Substantially Met
7	Superannuation Liabilities	State unfunded superannuation liabilities	Met
8	Total asset management	Best practice in asset Maintenance and management	Met
9	Prudent risk management	Financial risks including NFL, debt, contingent liabilities, assets	Partially met
10	Tax restraint	Impact of tax policy measures	Met
C	Departures	Indicator	Assessment
	Manage temporary departures from the principles	Principles may be departed from, but any departure should be temporary	Not met

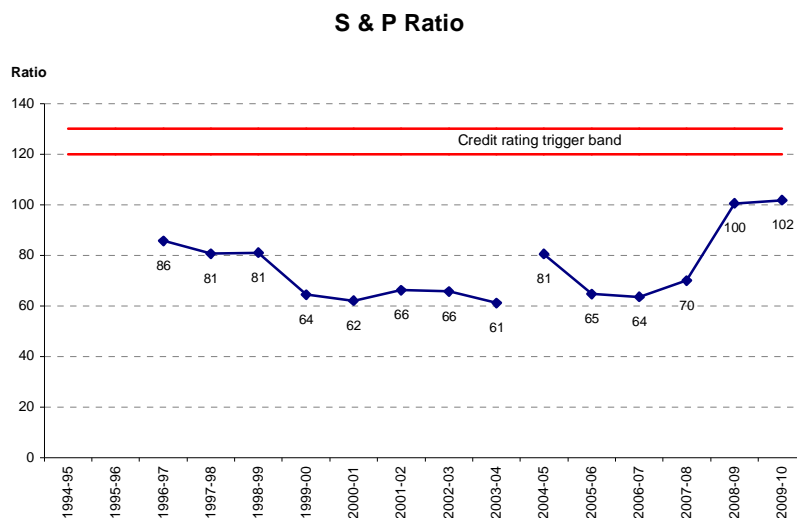
II. Performance under the FRA

The declared purpose of the FRA is:

to provide the framework for the conduct of New South Wales fiscal policy, with a view to maintaining financial results that are fiscally sustainable in the medium and long term. Fiscal sustainability requires that the Government be able to manage financial risks and financial shocks in future periods without having to introduce significant and economically or socially destabilising expenditure or revenue adjustments in those future periods³

Fiscal performance in the five years to 2009-10 deteriorated with both net debt and net financial liabilities increasing. Independent analysis of the performance over that time by credit rating agencies saw the state retain its triple-A credit rating, though on a number of measures that the agencies employ, there is little room for further deterioration.

Standard and Poor’s measure of the state’s net debt and unfunded superannuation liabilities, for example, as shown below, is approaching a band which could see the state’s credit rating reviewed. The State’s fiscal flexibility has been reduced considerably.



Series break in 2004-05 as a result of the adoption of Australian Equivalents to International Financial Reporting Standards

The next section discusses performance against the targets and principles set out in the FRA.

³ FRA, Section 3(1)

A. Performance against targets

The fiscal targets are set out in Part 2 of the Act. These include medium and long term targets for GG net financial liabilities and net debt, and a long-term target for total state unfunded superannuation.

GG Net Financial Liabilities (NFL)

Medium term: to reduce the level of general government net financial liabilities as a proportion of gross state product to 7.5 per cent or less by 30 June 2010

Long term: to reduce the level of general government net financial liabilities as a proportion of gross state product to 6 per cent or less by 30 June 2015

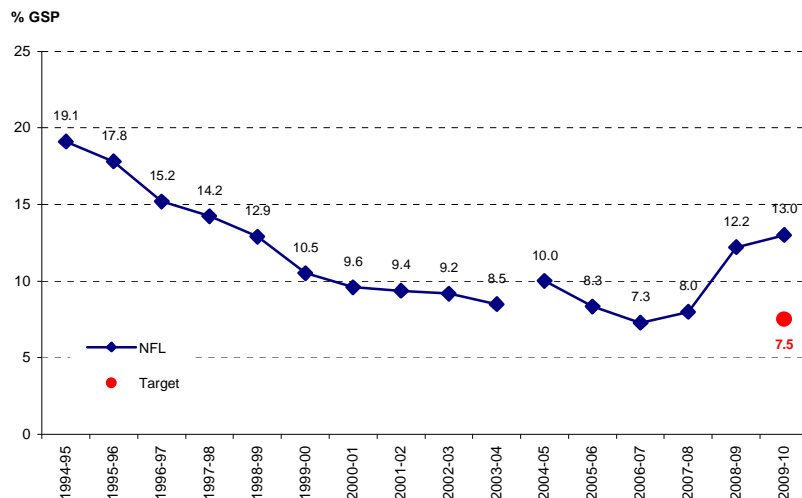
Assessment: Not met

These targets were selected partly with a view to locking in progress that had been made during the preceding decade (the ratio of NFL to GSP declined from 19.1 per cent in 1994-95 to 8.5 per cent in 2003-04) and maintaining a trend improvement. The FRA legislated that the NFL to GSP ratio be reduced to 7.5 per cent by 2010 and below 6 per cent by June 2015. The ratio fell to 8.3 per cent in 2005-06 and 7.3 per cent in 2006-07.

The ratio moved higher in following years, and was 13.0 per cent (5.5 percentage points above the medium-term target) in 2009-10. The 2010-11 Budget attributed this overshoot to the increased capital program, the cyclical downturn in revenue associated with the global financial crisis, and the impact of the crisis on unfunded superannuation liabilities.

The December 2010 Half Yearly Review projected a ratio of 11.1 per cent in 2013-14 (5.1 percentage points above the FRA long-term target set for 2014-15). Since then, the fiscal outlook has deteriorated substantially.

GG Net Financial Liabilities



Series break in 2004-05 as a result of the adoption of Australian Equivalents to International Financial Reporting Standards

Fiscal Responsibility Act – Statutory five year review

GG Net Debt

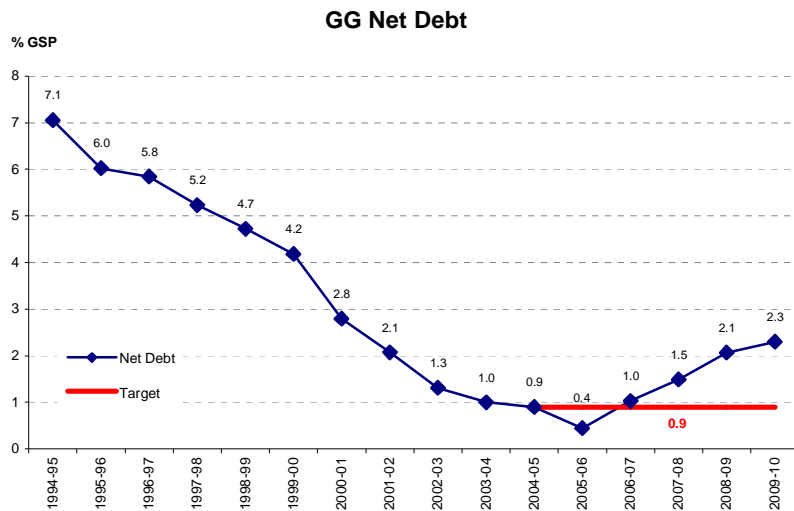
Medium term to maintain underlying general government net debt as a proportion of gross state product at or below its level as at 30 June 2005, unless an increase is required in net debt to reduce one or more components of general government net financial liabilities

Long term: (same as medium term target)

Assessment: Not met

Under the FRA, the ratio is to be held at or below its June 2005 level, both in the medium and long term.

The ratio declined to 0.4 per cent at June 2006. The ratio rose steadily thereafter reaching 2.3 per cent (1.4 percentage points above target) at June 2010. This overshoot was driven by the increased capital program and the cyclical downturn in revenue associated with the global financial crisis.



Unfunded superannuation liabilities

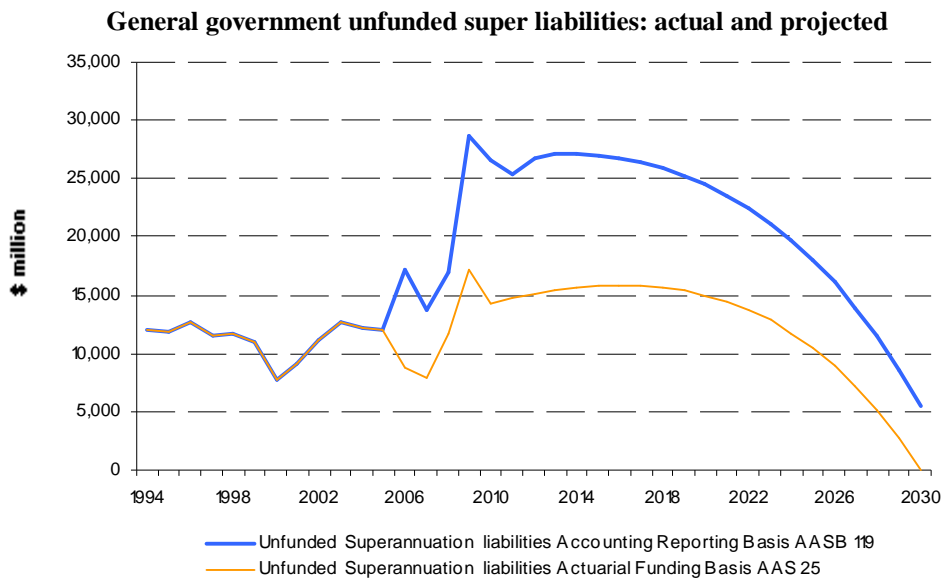
Long term: to eliminate total state sector unfunded superannuation liabilities by 30 June 2030.

Assessment: On track, but target not yet met

The FRA target is to eliminate total state unfunded superannuation liabilities by 2030.

The shift from the actuarial AAS 25 standard to the mark-to-market AASB 119 standard in 2005-06 had a large impact on the assessed liability. However, the target is measured against the AAS 25 standard as that is the basis of the funding program.

The assumptions underlying liability and asset estimates are revised on an ongoing basis and are subject to detailed assessment every three years. The most recent triennial actuarial review was completed in late 2009. The 2010-11 Budget states that while the GFC has slowed progress, the downward trend in net unfunded liabilities is continuing. Use of the proceeds of the Lotteries transaction and the new triennial funding plan are designed to ensure full funding by 2030.



Source: 2010-11 Budget, Chapter 7. Over 95 per cent of total state unfunded liabilities are in the GG sector.

B. Performance against principles

The FRA sets out ten fiscal principles, some of which are quantitative while others are concerned with processes and policies.

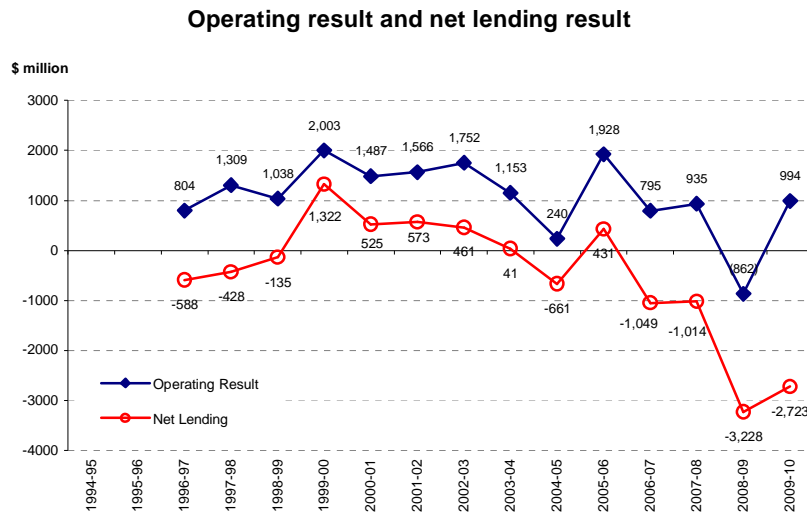
1. Keeping the budget and forward estimates in surplus

Fiscal principle No 1 is that the budget should be framed so as to achieve a net operating result for the general government sector that is a surplus consistent with the fiscal targets.

Assessment: Not met

During the first 5 years of the FRA, the net lending result was in deficit in four out of five years, while the operating result was in surplus in four out of five (the exception being the GFC-impacted 2008-09 result).

The size of the operating surplus was insufficient to achieve the net debt targets (page 6).



2. Constrained growth in net cost of services and expenses

(1) Fiscal principle No 2 is that growth in net cost of services and expenses of the general government sector is to be managed in accordance with the objective of prudently managing State finances.

(2) For the purposes of this section, the average annual growth in net cost of services and expenses of the general government sector on a GFS basis is to be calculated for:

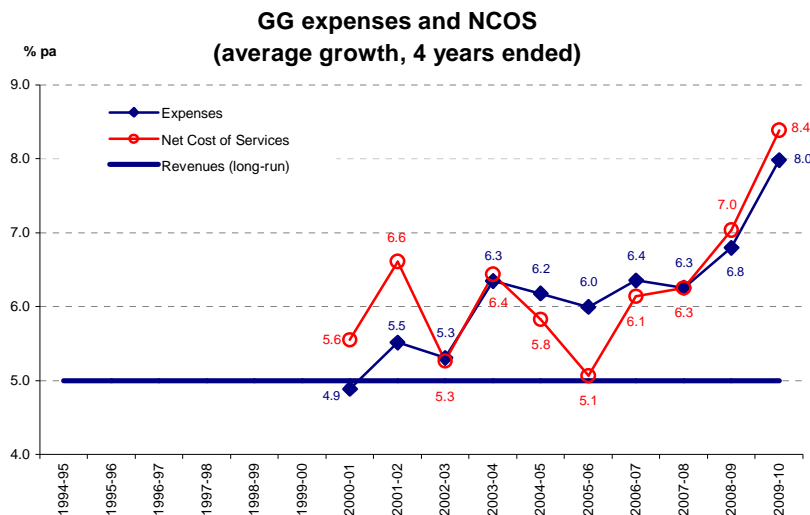
- (a) the 4-year period ending with, and inclusive of, the financial year prior to the budget year, and
- (b) the 4-year budget and forward estimates period commencing with the budget year.

(3) For each of the 4-year periods referred to in subsection (2), the average annual growth in net cost of services and expenses is to be kept at or below long-term average revenue growth. An assessment of past and prospective long-term average revenue growth is to be reported each year in the budget.

Assessment: Not met

The FRA constrains NCOS and expenses to grow at long-term revenue growth over 4 year periods. These constraints are prospective (average growth over the Budget and forward estimates) and retrospective (average growth over the four years preceding the Budget).

Through the FRA period the long-term revenue growth parameter was estimated at about 5 per cent. During this period (through 2009-10), four-year retrospective expense growth averaged around 6.7 per cent per annum, and NCOS growth averaged around 6.6 per cent per annum. On both measures, growth was about 1½ percentage points above long-term revenue growth. The expense growth rates trended upward over the period.



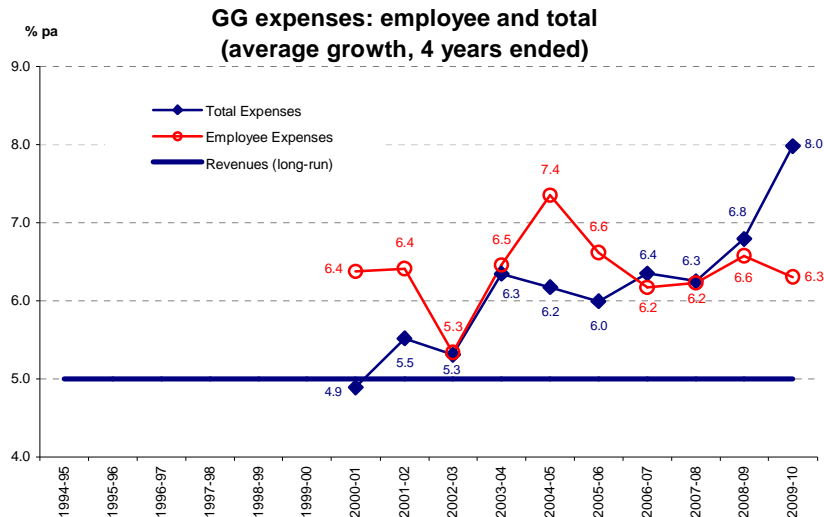
3. Managing public sector employee costs

(1) Fiscal principle No 3 is that government policy with respect to negotiating rates of pay and related conditions of employment of general government sector employees is to be consistent with the fiscal targets.

(2) In negotiating rates of pay for employees, public trading enterprises are to take into account conditions in their industry and the government's policy for negotiating rates of pay and related conditions of employment of general government sector employees

Assessment: Not met

In September 2007 a wages policy was introduced with the aim to ensure that Fiscal Principle No 3 was achieved. The policy was that future wage increases be limited to a net cost of 2.5 per cent per annum, with any additional increases above 2.5 per cent per annum tied to negotiated employee related cost savings and reforms. State Owned Corporations were also covered by this policy.



While cost offsets above 2.5 per cent have been identified in current wage agreements, not all of those savings have been delivered. This lack of sufficient offsets will have contributed (along with employment growth and bracket creep) to total GG employee costs increasing by an average 6.3 per cent per annum in the four years to 2009-10.

4. Evaluation of capital expenditure proposals

Fiscal principle No 4 is that capital expenditure proposals are to be evaluated in accordance with government procurement policy requirements.

Assessment: Not met

This principle is intended primarily to measure performance against TPP04-1, *NSW Government Procurement Policy*, which lays out a code of practice (including the Gateway Review process) for the general government sector. The Gateway Review process assesses projects against seven criteria: service delivery, affordability - value for money, sustainability, governance, risk management, stakeholder management and change management.

Strategic and Business Case Gateway Reviews assess project planning and identify alternatives for projects over \$10 million. Reviews covered 80 per cent of projects in both the 2008-09 and 2009-10 Budgets, up from 67 per cent in 2007-08. Analysis of construction projects commenced before and after the introduction of procurement reforms (including Gateway Business Case Reviews and enhanced Treasury monitoring) indicate a reduction in the order of 50 per cent in cost over runs.

However, there have been major decisions made where the business case assessment has not been properly applied. These include the now-abandoned CBD Metro and the previously proposed Parramatta to Epping Rail Line.

5. Managing State finances with a view to long-term fiscal pressures

(1) Fiscal principle No 5 is that the budget should be framed taking into account the anticipated future fiscal gap likely to develop as a result of increased spending pressures associated with the ageing of the population and other long-term trends.

(2) An assessment of long-term fiscal gaps is to be presented in the 2006-2007 budget papers and is to be updated in the budget papers in conjunction with the 5-yearly review of this Act.

(3) An assessment of the impact of budget measures in respect of expenses and revenue on long-term fiscal gaps is to be presented in the annual budget papers.

Assessment: Partially met

This principle addresses long-term fiscal sustainability concerns, as reviewed first in the Australian Treasury's 2002-03 Intergenerational Report and subsequently in the NSW 2006-07 Budget.

This reporting components of the principle appear to have been complied with.

- Budget Paper 6 of the 2006-07 Budget is a detailed assessment of the long-term fiscal gap, as required under the FRA;
- An updated study of the fiscal gap is expected to be completed in the 2011-12 Budget; and
- Each successive budget has assessed the impact of its measures on the long-term fiscal gap. As a result the long-term gap estimate has risen from 3.4 per cent (2005-06) to 3.5 per cent (2006-07 and 2007-08), 3.9 per cent (2008-09 budget), 4.3 per cent (2009-10 budget) and 4.9 per cent (2010-11 budget).

While reporting has complied with the Act, the increase in the fiscal gap over the past five years does not comply with principle, which was to ensure budget measures strengthened rather than weakened capacity to meet long-run fiscal challenges.

6. Maintaining or increasing general government sector net worth

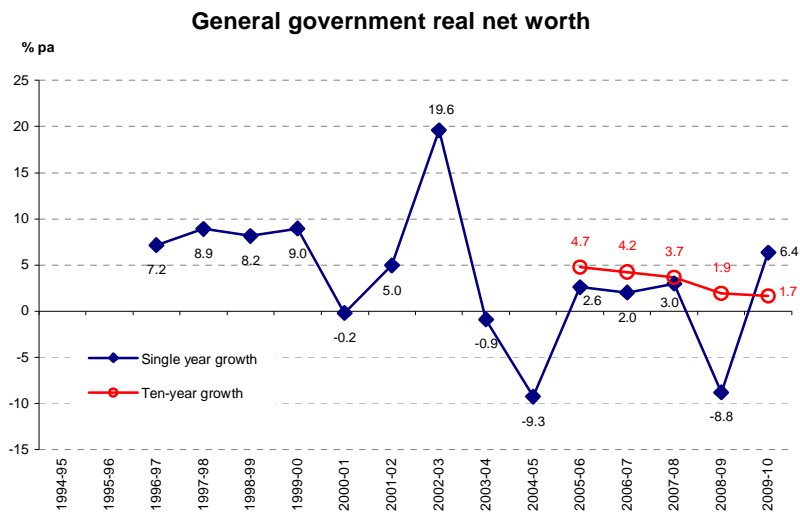
(1) Fiscal principle No 6 is that general government sector net worth should at least be maintained in real terms from year to year.

(2) Measures taken to implement this fiscal principle are to be identified and subject to progress reports in the annual budget papers.

Assessment: Substantially met

Net worth is equivalent to net assets, and therefore is affected (like its components, including unfunded superannuation) by changes in accounting standards and parameters and, when measured in real terms, by volatility in the price deflator. For instance, real net worth increased 19.6 per cent in 2002-03, fell by 9.2 per cent in 2004-05 and fell by 8.8 per cent in 2008-09.

Progress against this principle was not reported on the legislated “year to year” basis, but in terms of ten year average growth. On that basis, growth in real net worth has been positive.



7. Funding employer superannuation liabilities

(1) Fiscal principle No 7 is that employer superannuation liabilities are to be managed and funded so as to eliminate total state sector unfunded superannuation liabilities by 30 June 2030 and that the manner of management and funding of these liabilities is to be subject to periodic review.

(2) Measures taken to implement this fiscal principle are to be identified and subject to progress reports in the annual budget papers.

Assessment: Met

The principle is an elaboration of the long-term fiscal target, and annual FRA progress reports cross reference the report against the target.

The annual budget chapter on liability management (Chapter 7 in the 2010-11 Budget) provides detailed analysis of policy and performance.

Progress against the FRA target and the principle has been consistent with the legislation, although year-to-year performance, particularly following the adoption of AASB 119, reflects fluctuations in asset markets. The objective of the Government's funding plan is for sufficient but not excessive employer contributions to be made over time to meet the target. The funding plan undergoes triennial reviews to ensure it remains on target.

Changes to accounting standards and parameters result in substantial divergences between the funding plan projections and recorded estimates of unfunded superannuation liability. The volatility of the liability estimates using current accounting standards, reflecting asset market fluctuations across the cycle, is a major source of volatility in the broader fiscal aggregates, particularly net financial liabilities. This has led to adverse findings by the Auditor General.

8. Total asset management

(1) Fiscal principle No 8 is that government agencies must align their physical asset management practices (on a whole-of-life basis) with their service delivery priorities and strategies.

(2) Measures taken to implement this fiscal principle are to be identified and subject to progress reports in the annual budget papers.

Assessment: Met

The main measure of performance against this principle has been the TAM (Total Asset Management) Plan coverage rate across GG agencies, which was 96 per cent in 2009-10. The principal reporting document since the 2005-06 Budget is the annual *Infrastructure Statement* (formerly *State Asset Acquisition Program*). This includes a review of TAM policy developments and performance.

9. Prudent risk management

- (1) Fiscal principle No 9 is that financial risk is to be managed prudently on the basis of sound risk management principles.
- (2) For the purposes of this section, the management of financial risk comprises the following:
 - (a) maintaining total state sector net financial liabilities at prudent levels,
 - (b) managing risks associated with contingent liabilities,
 - (c) managing risks associated with the total state sector's debt and financial assets, including commercial risks arising from the ownership of public trading enterprises.
- (3) Measures taken to implement this fiscal principle are to be identified and subject to progress reports in the annual budget papers.

Assessment: Partially Met

Responsibility for compliance with this principle is diversified. Analysis in the annual FRA progress reports has generally been to list the guidelines and processes put in place to manage risk. These include the Financial Management Framework, the Commercial Policy Framework, the TAM Guidelines, the Working with Government guidelines, and Internal Audit and Risk Management Policy. In addition, the Liability Management chapter in the budget generally includes a section on financial liability and risk management. Risks associated with TCorp operations are managed by the TCorp Board, and exposures are shown in their annual report. While the Budget no longer contains a table of contingent liabilities, these (as well as risk exposures) are detailed in the audited annual *Report on State Finances*.

Decisions by the former government associated with the generation trader transactions have markedly altered the financial risk profile of the NSW Budget. New risks to the Budget include the risk of constructing and developing the major Cobbora coal mine; potential support for the generators for liabilities that could arise under the generation trader contracts; the generation trader proceeds being less than book value for at least Eraring Energy; and the loss of dividends and tax equivalents from Eraring Energy and Delta Energy compared to the level of net proceeds.

10. Tax restraint

(1) Fiscal principle No 10 is that any adjustments to legislated tax rates, thresholds and bases are to be made with the maximum possible restraint having regard to the effect of these adjustments on the overall level of tax revenue, and policies should be pursued that are consistent with a reasonable degree of predictability and stability of tax rates, thresholds and bases for future years.

(2) The estimated impact of proposed tax policy changes in the year of implementation and, where different, in a full year, is to be reported in the budget papers.

Assessment: Met

The annual FRA progress reports have summarised performance against this principle in terms of the net effect on the annual tax burden (in the budget year) of cumulative tax policy changes since the Act came into force. This was estimated to be a reduction of \$1.5 billion for 2008-09, \$1.2 billion for 2009-10, and \$1.6 billion for 2010-11. The revenues chapter in each budget contains details on all tax policy changes including their estimated impact.

C. Application of the principles and departures from them

Under Section 9 of the Act, “the Government should aim to pursue its policy objectives in accordance with these principles.”

(2) Those principles may be departed from in the presentation and implementation of the budget, but any departure should be temporary.

(3) The Treasurer is to include in the budget papers a statement containing the following:

- (a) the reasons for the departure,
- (b) the approach to be taken to enable a return to the principles,
- (c) the time frame within which a return to the principles should occur.

Assessment: Not met

There have been a number of years when performance departed from one or more of the principles, as identified above. Only once (in 2006-07) did the Budget include a formal statement acknowledging the departure and giving the reasons, the remedies, and the timeframe to return to the principles, as required under the Act.