

1.2 BUDGET POLICY STATEMENT

BACKGROUND

The General Government Debt Elimination Act requires the Treasurer to prepare a Budget Policy Statement as part of each year's Budget Papers. The Statement is to include information on the following matters -

- an assessment of progress achieved against the fiscal targets and fiscal principles set out in the Act;
- projection of the ability to achieve fiscal targets in the future and to progress the achievement of fiscal principles; and
- 3-year projections of all relevant economic and financial variables.

This Section of Budget Paper No. 2 provides the Budget Policy Statement for the 1998-99 Budget.

ASSESSMENT OF PROGRESS ACHIEVED AGAINST THE FISCAL TARGETS AND FISCAL PRINCIPLES AND PROJECTED POSITION

Principle no. 1 - adherence to fiscal targets

- **Past Trends**

As far back as consistent information is readily available, New South Wales has generally been running deficits on a General Government Sector basis.

Over the 25-year period to 1995-96, only one surplus was recorded - in 1988-89. That year's surplus of almost \$600 million was the result of a massive increase in stamp duty revenue from the Sydney property boom at that time.

After 1988-89, the Budget result deteriorated rapidly as current outlays increased substantially and the boom in the Sydney property market reversed. The deficit peaked in 1991-92 at over \$1.6 billion (refer to Table 1.6 in Section 1.3 for details).

In 1996-97 a surplus of \$90 million was recorded, following the Government's commitment to expenditure restraint and debt reduction under the General Government Debt Elimination Act.

The projections in last year's Budget Papers showed the *Budget Sector* result to be broadly in balance in 1997-98, with moderate surpluses in the following years. (On a *General Government Sector* basis, the forecast was for a deficit of \$279 million.)

Since then, additional pressures have arisen on the Budget. These pressures include the High Court's decision in the s90 case (which resulted in a once-off reduction in revenue of \$346 million) and the provision of additional funding to address urgent needs in the health, transport and community services areas.

Offsetting these adverse factors, taxation revenue grew strongly in 1997-98, particularly reflecting the buoyant conditions in certain parts of the Sydney property market.

The expected underlying *Budget Sector* result for 1997-98 is now a deficit of \$359 million - a \$386 million deterioration from the Budget-time forecast of a \$27 million surplus, but broadly consistent with the \$315 million deficit forecast in the Mid-Year Budget Review. (On a *General Government Sector* basis, the 1997-98 result is now forecast to be a deficit of \$416 million.)

- **Policy and Prospects**

The *short term fiscal target* set out in the Act is to achieve a sustainable surplus for the General Government Sector within three years from the commencement of the Act (i.e. by 1998-99).

For 1998-99 and later years, the projections in the following table indicate that the short-term fiscal target will be met.

Table 1.1: Budget Results, 1996-97 to 2001-02

	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02
	\$m	\$m	\$m	\$m	\$m	\$m
Budget Sector (a)	208	(359)	28	n.a.	n.a.	n.a.
General Government Sector	90	(416)	45	215	450	952

(a) On an "underlying" basis as previously defined.

In particular, the projections show a strong growth in General Government Sector surpluses in later years. This growth in surpluses reflects a number of factors.

First, the projections reflect a continuation over the forward estimates period of the restraint in current outlays growth evident in 1998-99.

Between 1998-99 and 2001-02, current receipts are forecast to increase by over \$2.4 billion in total or around 3¼ per cent per year on average, reflecting the nominal growth in the economy. Current outlays over the same period are forecast to increase by nearly \$1.4 billion in total or around 2.0 per cent per year on average.

Secondly, the General Government Sector results for 1996-97 to 2000-01 include the impact of large net expenditures on the Olympics and Homebush Bay facilities and the costs of Government services to be provided in support of the Games (transport, security, etc.). These years represent the peak years of Budget impact from these projects. The substantial increases in the surpluses after 1998-99 reflect, in part, the completion of major venue construction. The improvement from 2000-01 to 2001-02 in the forecast surplus also reflects the inclusion in the earlier year of substantial Government service costs for the Olympics.

Finally, it is important to understand the difference between targets and projections - the former would represent a committed position to be achieved; the latter simply represent the best available estimates of the future Budget position given the continuation of current expenditure and revenue policies.

The *medium term fiscal target* is to reduce the level of net debt to a sustainable level. This is defined as the level of net debt at which the Budget can absorb the full adverse impact of an economic cycle without the need for significant corrective action.

At present, the interest bill on General Government Sector debt is around \$1.5 billion. This will decrease substantially in 1998-99 with the use of the TAB sale proceeds to pay off debt and the replacement of Commonwealth loans, raised when interest rates were higher, with lower coupon borrowings.

Nevertheless, interest costs in 1998-99 will still consume over 5 per cent of Budget receipts (equivalent to the amount to be spent on Police services). Reducing debt - and hence interest costs - will decrease the exposure of the Budget to economic downturns and free resources for service provision and/or a lower tax burden.

A comprehensive analysis is being undertaken to assess the implications of the Act's fiscal targets and general macroeconomic conditions for the State's Budget. The Act and its fiscal targets imply a need for the Budget strategy to take into account influences, such as those associated with the business cycle and with changing social and demographic factors, that have a longer term focus than that implied by the current forward estimates timeframe.

The impact of the business cycle on both revenue and outlays means that in any year the Budget outcome is influenced by the position in the cycle. Therefore, it is necessary to consider Budget outcomes in "cycle-adjusted" terms. A long-term Budget model which simulates the impact of economic growth, population growth, business cycles, expenditure and revenue strategies on government finances is being developed to define a range of feasible scenarios for achieving the medium and long term targets.

The *long-term fiscal target* is to eliminate net debt in the general government sector by 2020.

Principle no. 2 - maintaining or increasing General Government Sector net worth

- **Past Trends**

Net worth is defined as *total assets less total liabilities*.

As at 30 June 1997, the net worth of the *Budget Sector* was \$23.0 billion. For the *General Government Sector*, the net worth at the same date was \$24.8 billion. The latter is forecast to increase to \$27.0 billion as at 30 June 1998.

Trends in the net worth of the Budget Sector (and more recently, the General Government Sector) are set out in the following table.

Table 1.2: Trends in Net Worth

30 June	Assets	Liabilities	Net Worth
	\$m	\$m	\$m
Budget Sector -			
1992	56,416	32,795	23,621
1993	57,685	35,155	22,530
1994	59,755	35,068	24,687
1995	61,742	35,985	25,757
1996	54,950 (a)	35,855	19,095
1997	58,725	35,772	22,953
General Government Sector -			
1996	61,471	39,969	21,503
1997	64,044	39,222	24,822
1998	65,192	38,238	26,954
1999	66,626	37,741	28,885

(a) Reduction is due to the transfer of regional roads to local councils (\$6,179m) and downward adjustments of asset values by some agencies (\$2,742m).

- **Policy and Prospects**

The principle is to at least maintain the net worth of the General Government Sector in real terms. The 1998-99 Budget is forecast to result in an increase in the net worth of the Sector to 30 June 1999 of nearly \$2.0 billion.

Given the projected GFS-based surpluses for 1999-2000 and later years, the roundly \$2¾ billion of asset acquisitions each year (maintaining or adding to the asset base) and the move to full funding of accruing superannuation liabilities, it can be assumed that net worth will continue to increase in the future.

Principle no. 3 - funding employer superannuation contributions

- **Past Trends**

Until 1992, employer superannuation liabilities were mainly funded on a *pay as you go* basis, which resulted in a build-up in unfunded superannuation liabilities. Since 1992, a number of measures were implemented to gradually phase-in full funding of superannuation liabilities. Two of the most important initiatives were –

- the State Authorities Superannuation Scheme (SASS), a defined benefit superannuation scheme, was closed to new entrants. It was replaced by the First State Superannuation Scheme (FSS), which is a more flexible, less costly and fully funded scheme.

- a long-term funding plan for General Government Budget-dependent agencies (ie those receiving a direct Budget appropriation) was introduced, designed to extinguish unfunded liabilities by 2045. A requirement was also placed on non Budget-dependent agencies to fully fund accruing current service superannuation liabilities and to extinguish any past service unfunded liabilities over a period no longer than 30 years.

Trends in the level of unfunded superannuation liability for the Budget Sector (and more recently, the General Government Sector) are set out in the following table.

Table 1.3: Unfunded Superannuation Liabilities

As at 30 June	Unfunded Superannuation Liability
\$m	
Budget Sector -	
1992	11,319
1993	12,431
1994	12,250
1995	12,687
1996	13,654
1997	12,430
General Government Sector -	
1997	12,336
1998	12,311
1999	11,488

The increase in unfunded liability as at 30 June 1996 was partly due to actuarial factors and partly due to the Crown assuming the unfunded superannuation liabilities of various Government Trading Enterprises and State Owned Corporations as part of the corporatisation process, rather than any deterioration in the underlying position.

The \$1.2 billion decrease in unfunded superannuation liabilities as at 30 June 1997 mainly resulted from adjustments to employer superannuation accounts in 1996-97. These adjustments included the distribution to employer accounts of tax credits and the allocation of funds held in the State Superannuation Scheme Contributors' Reserve. The reduction would have been greater had it not been for the Crown assuming additional unfunded liabilities from non Budget Sector agencies, as it did for the previous year.

The bulk of the forecast reduction in unfunded liabilities as at 30 June 1999 is due to the anticipated distribution of remaining funds held in the State Superannuation Scheme Contributors' Reserve (see Section 7.6).

- **Policy and Prospects**

It is important that the same policy of restraint that applies to debt applies to other non-debt liabilities.

Of the total non-debt liabilities of the General Government Budget-dependent agencies as at 30 June 1997 (approximately \$18.8 billion), around 66 per cent related to unfunded superannuation liabilities.

The principle under the Act requires that -

- accruing current service superannuation liabilities should be fully funded for non Budget-dependent agencies (ie those not receiving direct Budget appropriations) and be fully funded for Budget-dependent agencies by 2020; and
- there should be phased-in funding to eliminate existing past service unfunded liabilities.

The initiatives taken to reduce unfunded superannuation liabilities will result in the smoothing out of superannuation payments. Otherwise, employer payments would consume a disproportionately high level of Budget outlays in future decades.

In accordance with Principle No. 3, this Budget continues the practice of fully funding each year's superannuation expense in the First State Superannuation Scheme, phasing-in full funding of other accruing current service superannuation liabilities and moving to address past service unfunded liabilities.

Based on latest actuarial assessments, the accruing liability is being funded to a substantial extent and will be fully funded on an ongoing basis by the year 2020. Similarly, the total superannuation liabilities will be fully funded by the year 2045.

Non Budget-dependent agencies are required to fully fund each year's superannuation expense and, where they have past service unfunded liabilities, they are required to fully fund these liabilities by no later than 2022.

Principle no. 4 - asset maintenance

- **Past Trends**

It is only in recent years that there has been a proper appreciation of the need to develop a formal asset maintenance policy. In the past such a policy was not in place due to the lack of adequate information on assets. This in turn resulted in a bias towards the acquisition of further assets at the expense of proper asset maintenance.

The introduction of accrual accounting in the Budget Sector has largely rectified the information deficiency.

- **Policy and Prospects**

Under the asset management policy, agencies are required to develop asset maintenance plans which identify all assets, set out a maintenance program for each asset or grouping of assets, identify any deferred maintenance requirements and establish a funding plan.

Asset maintenance plans for most Budget Sector agencies have now been prepared and reviewed by Treasury and the Department of Public Works and Services. In many cases these reviews have indicated the need for further work to be done to bring the plans to the standard that would allow them to be used as an input to the Budget decision-making process.

Once finalised, these plans will be submitted to the Budget Committee of Cabinet in the second half of 1998 for consideration. The result of this process will be the endorsement of an asset maintenance program and the broad commitment by Government of funding. It needs to be acknowledged that this will absorb some of the funding that may previously have gone into new capital projects. However, it is clearly inappropriate to expand the capital stock to the exclusion of adequate maintenance of existing assets.

Principle no. 5 - constrained growth in net cost of services and outlays

- **Past Trends**

Over the longer term, there has been a trend of significant real growth in States' Budget outlays. Over the two decades to 1994-95, New South Wales own purpose outlays in the General Government Sector grew by 2.6 per cent per year in real terms. This compares with a slightly lower growth rate of 2.3 per cent per year for the six States combined.

- **Policy and Prospects**

The main strategy for achieving the objective of reducing debt and eliminating the Budget deficit is through restraint of Budget outlays.

The principle is to keep the growth in net cost of services and outlays below the growth in inflation and population (i.e. zero real growth in per capita terms). In respect of capital outlays, the principle is to be applied over a 3 to 5 year period to allow for the impact of large projects, such as the Olympics.

Budgets have traditionally reflected cash transactions, with outlays defined as cash payments less cash user charges.

With the introduction of accrual accounting into the Budget Sector, the Budget is now able to measure the *net cost of services*, i.e. total expenses less user charges.

Accordingly, the commitment to restraint of the net cost of services is an important extension of the policy of fiscal restraint.

In 1998-99, current outlays are forecast to grow by 2.6 per cent, a real per capita increase of only 0.2 per cent. Net cost of services is projected to decrease by 1.7 per cent in nominal terms, a real per capita decrease of 4.0 per cent.

Capital outlays will fall by 10.8 per cent in 1998-99 in nominal terms. This represents a real per capita decrease of 12.8 per cent. This fall is largely the result of a reduction in expenditure by the Olympic Co-ordination Authority and an increase in negative capital outlays from asset sales.

Principle no. 6 - prudent risk management

- **Policy and Prospects**

There are risks that are centrally identified and managed, and others that are the direct responsibility of individual agencies. Regardless of where the risk arises, it is vital that there is a comprehensive framework in place for identifying, assessing and addressing risk.

To assist agencies in developing these frameworks, Treasury released a Risk Management and Internal Control Toolkit in September 1997. This self-assessment guide assists agencies in identifying areas within their operations where risks are not being adequately managed. Once any risk management gaps have been identified, strategies included within the Toolkit can be employed to assist in mitigating these risks.

Complementary to the Statement of Best Practice for Internal Control and Audit, the Toolkit focuses on the operational areas of the agency rather than just financial areas. It is the core business areas that need to be addressed to ensure that community expectations are met.

At the level of the whole General Government Sector, risk management involves seeking to reduce debt and other liabilities and to manage them in a prudent manner. Financial risks for the Sector are centralised in the main, with Treasury Corporation managing total debt and relatively limited powers conferred on agencies for the management of financial assets.

Principle no. 7 - tax restraint

- **Past Trends**

Over the last recession and consequent deterioration in the Budget, there was substantial recourse to tax increases to keep the Budget deficit under control.

This experience was shared by most other States and as a result, while taxes in New South Wales increased in absolute terms, the tax burden relative to other States did not.

Table 1.4: Trends in Tax Levels

Year	Policy Induced Tax Changes (a)	Index of Tax Burden in NSW relative to the National Average (d)
	\$m	
1989-90	200	n.a.
1990-91	310	n.a.
1991-92	80	n.a.
1992-93	240	103.2
1993-94	100	101.8
1994-95	(40)	104.6
1995-96	10	103.3
1996-97	180 (b)	104.2
1997-98	280 (b) (c)	n.a.
1998-99	(110) (b)	n.a.

- (a) Net effect on the year shown of all tax changes, whether announced in that year or in previous years.
- (b) Includes impact of tax increases introduced to fund the Fiscal Contribution Payments to the Commonwealth.
- (c) Excludes the one-off loss from abolishing business franchise fees and replacement by Commonwealth safety net taxes.
- (d) The latest Commonwealth Grants Commission data issued is for the period 1992-93 to 1996-97.

- **Policy and Prospects**

This principle requires that the level of taxes should be constrained to the maximum extent possible and that policies should be pursued that give a reasonable degree of predicability about the level and stability of tax rates for future years.

The existing tax system is narrowly-based, generally regressive and relatively inefficient. New South Wales will continue to seek to achieve meaningful reform of Commonwealth-State financial relations in order to provide a more appropriate revenue structure for the State.

The Government recognises the need to balance the call on taxpayers to fund Budget outlays. The 1995-96 and 1996-97 Budgets achieved the financial targets set by the Government without recourse to tax rate increases. (In fact, the 1996-97 Budget exempted refinancing of existing loans from loan security duty as from 1 July 1996.)

Subsequent to the 1996-97 New South Wales Budget being presented, it was determined at the 1996 Premiers' Conference that the States would make Fiscal Contribution Payments over a three year period (totalling \$530 million for New South Wales) to assist the Commonwealth in meeting its deficit reduction targets. To fund those payments, New South Wales was obliged to introduce a number of temporary tax increases - in land tax, payroll tax and stamp duty on motor vehicle transfers.

In the 1997-98 Budget, it was necessary to introduce a targeted tax package to fund the cost of a number of emerging needs, particularly in the health and public transport areas.

There are no new taxes in the 1998-99 Budget. Four tax concessions are being introduced - the staged removal of the levy on motor vehicle registrations, increases in concessions for first home purchases, the introduction of indexation of the land tax threshold for investors and a change in the land tax indexation provision for owner-occupied residences. The 3 per cent and 5 per cent stamp duty rates on motor vehicle registrations will be maintained. Details are shown in Chapter 3 of this Budget Paper.

Overall tax receipts are only estimated to increase by an average of 4.2 per cent in the years 1998-99, 1999-2000, 2000-01 and 2001-02. This rate broadly reflects the growth in the economy in nominal terms over the period and the impact of tax changes in this Budget.

The intention is for future Budgets to maintain the position of tax restraint and, if possible and consistent with the overall fiscal targets, to achieve further targeted tax relief.

While it is important for taxpayers in the State to have a degree of certainty as to the *level* of taxes they will face in the future, the *efficiency* and *equity* of taxes are equally relevant. It is important for the nation, at all levels of government, to address the issue of tax reform. This issue is discussed in Chapter 5 of this Budget Paper.

ECONOMIC AND FINANCIAL VARIABLES

The General Government Debt Elimination Act also requires the Treasurer to include 3-year projections of all relevant economic and financial variables in the Budget Papers.

The following table sets out key economic and financial variables relevant to the Budget. More detailed data and discussion are contained in Section 1.3 (in relation to Budget aggregates) and in Chapter 2 (in relation to economic conditions and forecasts).

Table 1.5: Economic and Financial Variables

Variable	1997-98	1998-99	1999-2000	2000-01	2001-02
NSW real GSP growth (%)	3½	3	3¾	4¼	2½
NSW employment growth (%)	½	1½	2	2½	1½
NSW unemployment rate (%)	7¾	7¼	7¼	7¼	7¼
Sydney CPI (%)	0	2¼	2¾	3½	2½
10 Year bond rate (%)	6	6¼	7	8½	8
General Government Sector -					
Surplus (\$m)	(416)	45	215	450	952
Net debt (% of GSP)	5.4	5.2	4.8	4.3	3.7
Debt costs (% of Budget receipts)	6.2	5.1	5.1	4.2	3.8
Real growth in current outlays (%)	4.0	1.2	(-) 0.6	(-) 0.2	(-) 0.7
Real growth in capital outlays (%)	3.2	(-) 12.0	1.6	0.6	(-) 4.2
Real growth in receipts (%)	1.8	1.21	0.3	0.8	0.6
Employment (March) (000)	238.2	n.a.	n.a.	n.a.	n.a.

