# HOW WILL WE FUND OUR SERVICES?

# 5

Over the next 40 years, the people of New South Wales will need services and infrastructure to support their longer lives and growing standard of living. To fund these, the NSW Government must establish a stable and sustainable revenue base that anticipates changing conditions and growing demands.

We expect revenue growth to slow. Over the next 40 years it is projected to average 4.7 per cent a year, in line with projected GSP growth.[1] This is, however, lower than average annual revenue growth since 1996-97 of 5.7 per cent.[2]

The composition of revenue is also expected to change over the next 40 years. Growth in Commonwealth grants (including GST payments) is expected to average only 4.2 per cent a year, below nominal GSP growth. This will see a decline in Commonwealth payments from 41 per cent of state revenue in 2014-15, to 32 per cent by 2055-56.

There is a subsequent proportional rise in state taxes, which are expected to grow at 5.4 per cent a year. They are projected to reach 48 per cent of total state revenue in 2055-56. That is up from 38 per cent in 2014-15.

With this compositional change, we expect New South Wales' total revenue to be more volatile, making state budgeting more challenging.

Ageing contributes to lower revenue growth. Without ageing, average revenue growth would be 5.2 per cent a year. The ageing population affects revenue growth by lowering transfer duty, land tax and payroll tax revenues. Ageing reduces house price growth and participation because of a smaller traditional working age population share.[3]

In this Report, the budget and forward estimates from the 2015-16 Half-Yearly Review inform the first four years of the revenue projections. Beyond 2018-19, we project forward on a 'no policy change' basis. This means current policy settings, such as tax rates, thresholds and indexation arrangements are assumed to continue throughout the projection period. The long-run equilibrium projections 'look through' the inevitable property and other economic cycles that will occur over the next 40 years.

**To be able to fund services over the next 40 years, the NSW Government must establish a stable and sustainable revenue base that anticipates changing conditions and growing demands.**

**Ageing reduces house price growth and participation because of a smaller working age population share.**

1 Unless stated otherwise, 'revenue' refers to general government revenue, excluding interest, consistent with the definition of the fiscal gap in Chapter Six

2 1996-97 was the first year that the NSW Budget adopted accrual accounting

3 Guest, R., Swift, R., 2010. Population ageing and house prices in Australia. Australian Economic Review. vol. 43, pp. 240–253

# HOW WILL WE FUND OUR SERVICES?

**FOR THE PERIOD 2014-15 TO 2055-56, REVENUE IS EXPECTED TO GROW BY**

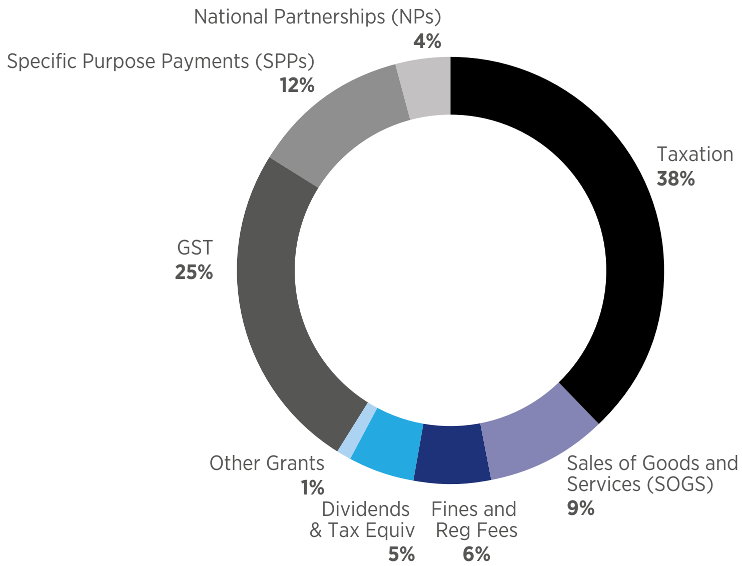
# 4.7%

**in line with growth in nominal GSP.**

## 5.1 Revenue trends and outlook

In 2014-15, general government revenue, excluding interest, was $69 billion. State taxation accounted for $26 billion, with GST and other Commonwealth payments adding another $28 billion (Chart 5.1).

### Chart 5.1 Revenue sources in 2014-15 (share of total revenue)

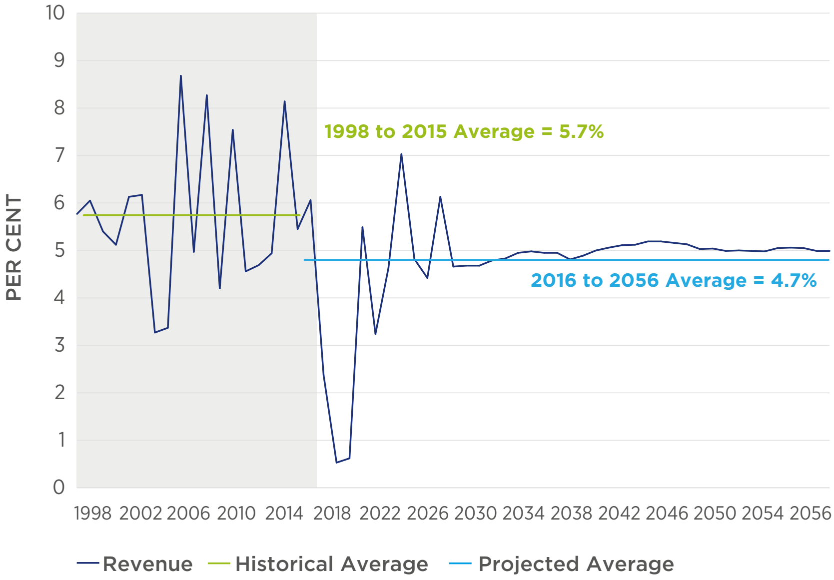



*Source: NSW Treasury*

Revenue growth is expected to be lower than the historical average. From 1996-97 to 2014-15, revenue rose by an average of 5.7 per cent each year (Chart 5.2). That is 0.4 percentage points above the 5.3 per cent average growth in nominal GSP over that period. But as set out in the 2015-16 Half Yearly Review, state revenue growth over the four years to 2018-19 is projected to average 2.6 per cent a year. After this initial sharp decline, growth is expected to recover somewhat.

For the period 2019-20 to 2055-56, revenue is expected to grow by 5.0 per cent a year, which is 0.2 percentage points above the 4.8 per cent average growth in nominal GSP.

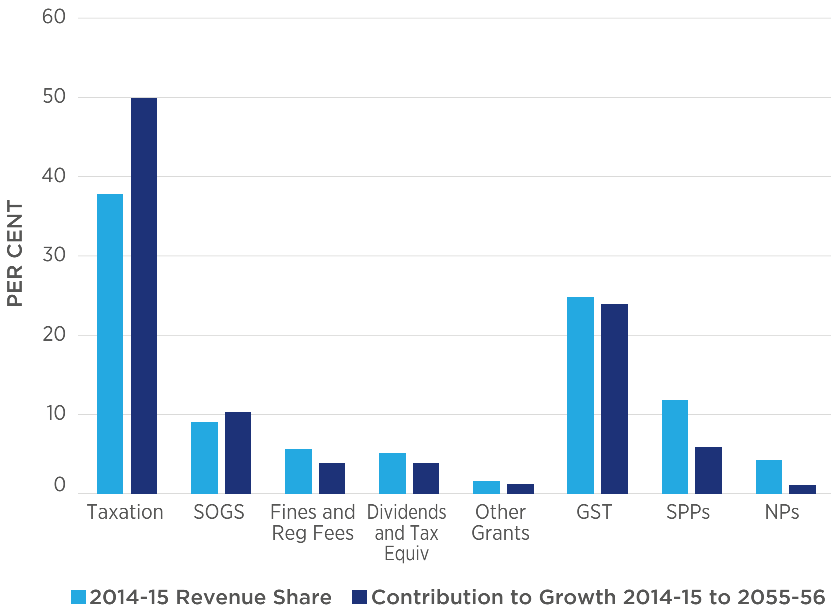
### Chart 5.2 Revenue growth is expected to average 4.7 per cent a year over the projection period[4]




*Source: NSW Treasury*

The average revenue growth of 4.7 per cent a year over the projection period reflects a combination of faster growth in states taxes and slower growth in Commonwealth payments. Payments from the Commonwealth are expected to grow at an average of 4.2 per cent a year. In contrast, state taxation revenues are expected to grow by around 5.4 per cent per year, mainly reflecting strong growth in transfer duties and payroll tax (Chart 5.3).

### Chart 5.3 Revenue shares and contribution to growth by source



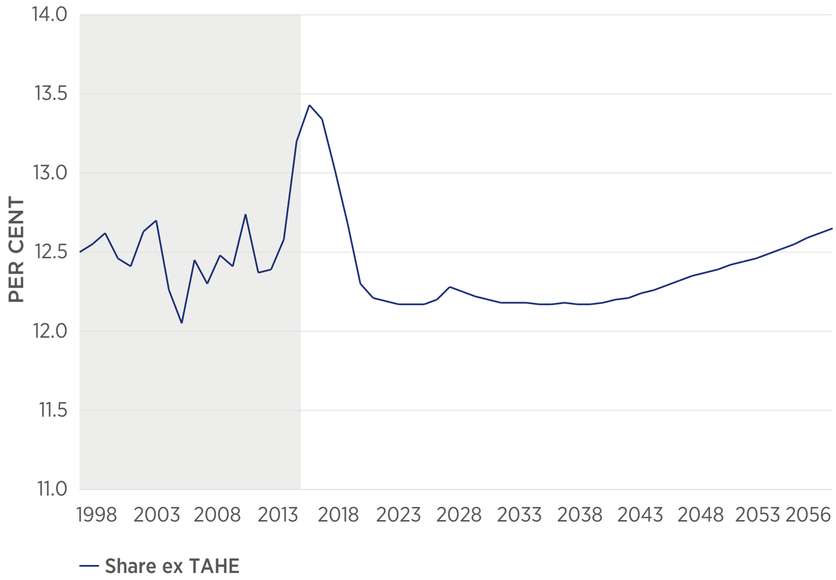

*Source: NSW Treasury*

4 Adjustments have been made to exclude the impact of Commonwealth fiscal stimulus over the years 2009 to 2013

Ageing contributes to the slowing of revenue growth through its impact on workforce participation and hence economic growth. Without ageing, revenue growth would be 5.2 per cent a year over the projection period, which is higher than nominal GSP growth, consistent with past trends.

Historically, revenue as a share of GSP has averaged around 12.5 per cent, with a cyclical peak in 2014-15 driven by strong GST and transfer duty revenue growth. Chart 5.4 shows that revenue as a share of GSP is expected to fall below the historical average in the short-term. This is because of lower growth in GST payments and transfer duty, expiring Commonwealth National Partnerships, and changes in dividends following the long-term lease of the electricity networks. Over the long-term, ageing and Commonwealth funding arrangements will act as a restraint on revenue growth, with strong state taxation growth expected to gradually increase revenues as a share of GSP in the latter half of the projection period.

### Chart 5.4 Revenue as a share of GSP[5]

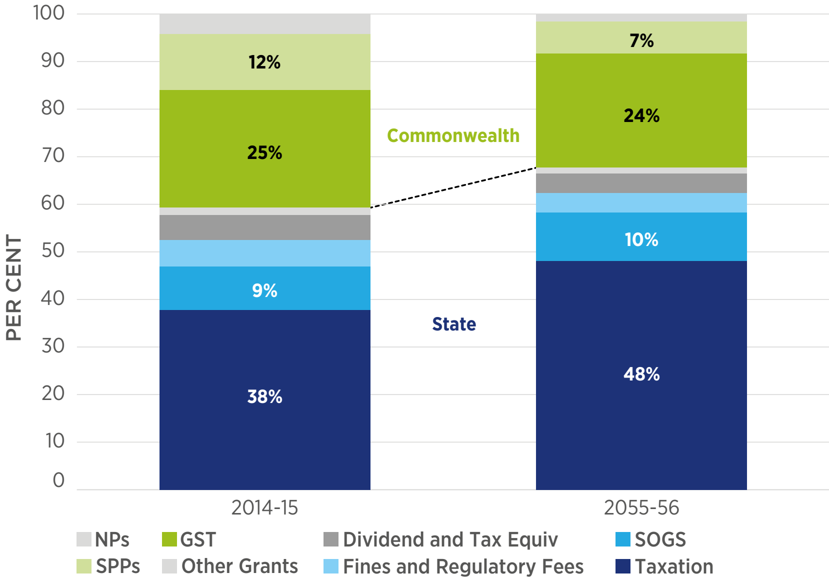



*Source: NSW Treasury*

Chart 5.5 shows how the composition of New South Wales' revenue base changes over time. The share of revenue sourced from the Commonwealth is projected to fall from 41 per cent in 2014-15 to 32 per cent in 2055-56, offset by an increasing reliance on state taxation.

5 To enable a comparison with historical data, Chart 5.4 excludes fee for service payments made under the TAHE

### Chart 5.5 New South Wales will become increasingly reliant on state taxation




*Source: NSW Treasury*

## 5.2 State taxation

State tax revenue comes from several sources, each of which are subject to different pressures, some of which are more volatile than others.

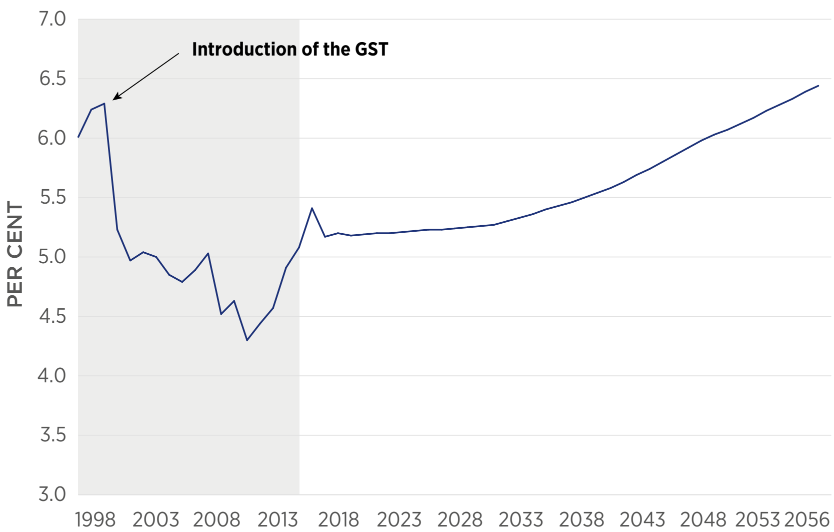
Overall, state taxation revenue is projected to increase by an average of 5.4 per cent a year to 2055-56. This leads to state taxes increasing from $26 billion to $221 billion in nominal terms, and $26 billion to $85.5 billion in real terms. State taxation fell from over 6.0 per cent of GSP in the late 1990s, to a low of 4.3 per cent in 2010-11 (Chart 5.6). This decline was largely due to the introduction of the GST in 2000, which coincided with the abolition of certain state taxes.

Strong tax revenue growth over the last four years has lifted the state taxation share to 5.4 per cent of GSP in 2015-16. State taxation as a percentage of GSP is then projected to rise gradually over the projection period.

**STATE TAXATION REVENUE IS PROJECTED TO INCREASE BY AN AVERAGE OF**

**5.4%**

### Chart 5.6 State taxation as a share of GSP




*Source: NSW Treasury*

The growing reliance on state taxation for revenue means that the way the state levies its taxes will be increasingly important, for both revenue and economic growth (see Box 5.1).

### Box 5.1

### The efficiency of the NSW tax base[6]

NSW tax revenue is projected to become increasingly reliant on what are relatively inefficient transaction taxes, in particular property transfer duty.

Taxes can impose economic costs on New South Wales if they change the decisions of firms and consumers. Taxes imposed on transactions, such as transfer duty or insurance taxes, are relatively inefficient, because people react to them by moving home less often and buying less insurance. Over and above the revenue generated, the state-wide economic cost for every million dollars of transfer duty revenue is estimated to be around $800,000.

Taxes whose economic burden falls primarily on labour, such as payroll tax, have intermediate efficiency. While individual firms' demand for labour is relatively responsive to real wages, most people in the workforce do not change the hours that they work as real wages change. The economic cost of payroll tax is estimated to be around $350,000 for every extra one million dollars of revenue it generates.

Taxes on unimproved land values are more efficient, because the quantity of land does not change in response to the taxes. They also provide no disincentive to make improvements to the land. The economic cost of NSW land tax is estimated to be around $90,000 for every million dollars of revenue it generates.

Without policy change, rising house prices will result in effective rates of transfer duty increasing over time. This will lead to a higher share of NSW tax revenue from transfer duty.

## Land-based taxation

Land-based taxation, which includes transfer duty, land tax and insurance duty, grew on average by 8.2 per cent a year over the last 10 years. Its share of total revenue has increased from 12.8 per cent in 2005-06 to 15.6 per cent in 2014-15.

We are becoming increasingly dependent on transfer duty, which is expected to grow at 6.4 per cent a year over the projection period, compared to total land taxes, which grow at 6.3 per cent. But the high average growth rate will not be steady. Year-on-year growth in transfer duty revenue, which depends largely on property transactions, has varied between negative 32 per cent and positive 39 per cent over the last 10 years. As well as being volatile, transfer duty is also relatively inefficient, and its growth as a share of the economy may affect economic growth.

Land tax is expected to grow in line with housing prices and population, averaging 6.3 per cent growth annually over the projection period. Insurance duty grows with the value of housing and vehicle stocks. It is projected to grow by 4.8 per cent a year.

The NSW Government plans to bring the state into line with other mainland states and abolish the current Emergency Services Levy (ESL). The introduction of a property-based levy will provide a fairer and simpler way to fund fire and emergency services, as well as improving the affordability of property insurance. Commencing on 1 July 2017, an Emergency Services Property Levy (ESPL) will replace the existing levy.

6 All estimates from NSW Treasury

## Income-based taxes

Income-based taxes include payroll, motor vehicle, gambling and private health insurance taxes. They are driven by income levels, although other factors can also play a role. Revenue from this group of taxes is expected to grow by 4.7 per cent a year to 2055-56. The ageing population has a negative impact on the growth of income-based tax revenue over the projection period, as the share of the traditional working age population falls.

Payroll tax is the largest component of tax revenue, at 11 per cent of total revenue. It is currently collected from employers whose payrolls exceed $750,000 a year and is projected to grow in line with total wages paid at 5.0 per cent a year.

Motor vehicle and vehicle weight taxes are assumed to grow broadly in line with overall economic activity. Combined, these revenues are expected to grow at an annual average rate of 4.6 per cent to 2055-56.

Hotel and club gaming revenue is projected to grow more slowly than it has previously. Growth in gaming slowed since the GFC. This decline appears to be structural. Moreover, recent innovations in gambling and betting — with internet gaming now making cross-jurisdictional betting possible — may further erode these revenues[7]. As a result, long-term projections have declined to 3.3 per cent a year on average, below previous projections.

The Health Insurance Levy is applied to private health insurance policies. It is expected to grow by an average of 4.4 per cent a year over the projection period. The two drivers of this revenue are demographic factors, including ageing, and insurance coverage. As the population moves through life stages, health insurance take-up increases. People are most likely to hold health insurance in their late 50s and early 60s, as the likelihood of making a claim increases. Looking ahead, health insurance coverage rates are anticipated to rise slightly, from 36 to 38 per cent, because we expect that people taking up private health insurance now are less likely to give it up as they age.

## Other taxes

Other taxes are relatively small and include the Parking Space Levy, pollution control licences and the Waste and Environment Levy. We generally assume these will increase with consumer price inflation.

**Hotel and club gaming revenue is projected to grow more slowly than it has previously. Growth in gaming slowed since the GFC.**

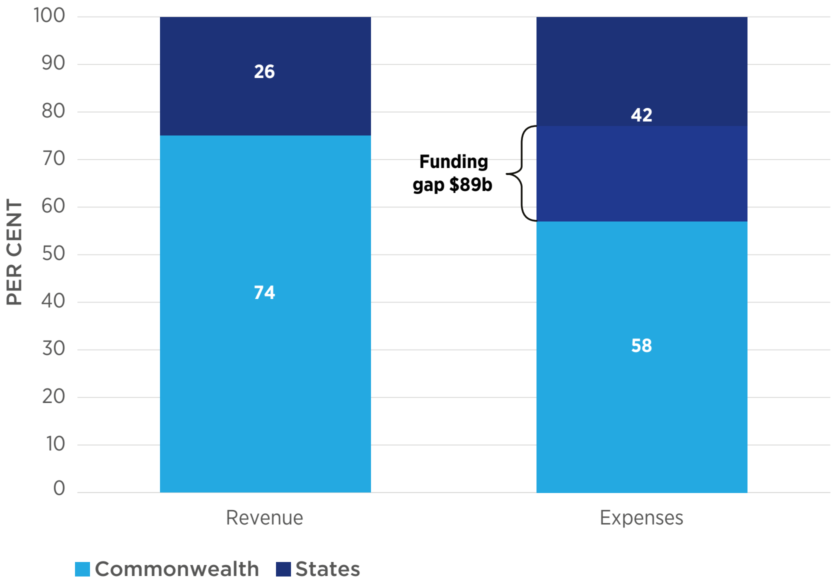
7 Productivity Commission, 2010. Gambling (Report no. 50). PC Canberra

## 5.3 Revenue from the Commonwealth

The revenue New South Wales receives from the Commonwealth Government is the State's largest source of funds, marginally higher than state taxes. In 2014-15, it was $28 billion, equal to 41 per cent of revenue. That figure includes $17 billion from GST and $11 billion for payments tied to certain state-delivered services. The most significant of the latter group is health, at $5 billion.

These revenue payments are necessary because there is a mismatch between the Commonwealth's capacity to raise revenue and the responsibility of states and territories to deliver services and infrastructure. The resulting funding gap totalled $89 billion for all states in 2014-15 (Chart 5.7).

### Chart 5.7 Federal-State funding and expenditure gap, 2014-15




*Source: ABS Government Finance Statistics, cat no. 5512.0, 2016, Canberra*

**NSW's GST revenue is projected to grow more slowly than the growth in the national GST pool, averaging around 4.7 per cent annually over the projection period.**

### Distributing the GST

While GST is a Commonwealth tax, the revenue is distributed to states and territories to use as they see fit. The distribution of these funds among the states is not based on population alone. Rather, it is determined by the Commonwealth Government, which takes into account each state's ability to raise revenue and deliver a nationally average standard of service and infrastructure.[8]

Historically, the GST revenue collected in New South Wales has exceeded the revenue returned by the Commonwealth, with the difference being provided to the other states and territories. How much GST revenue New South Wales will receive in the future depends on size of the GST pool, NSW's population share and the per capita share the Commonwealth decides to provide to New South Wales citizens.

As set out in the 2015 Commonwealth Intergenerational Report, the GST is projected to grow by around 5.2 per cent a year on average to 2055-56. That is in line with nominal GDP growth. However, NSW's share of the national GST pool is expected to decline. This is partly because our population growth is projected to be below the national average (Chapter One), but more importantly because our per person funding ratio is expected to decline to 2019-20.

8 This is termed 'relativity' and is calculated by the Commonwealth Grants Commission

Historically, NSW's per person GST funding has averaged around 90 cents per dollar in the national GST pool. This rate peaked at 98 cents in 2014-15 as Western Australia and Queensland experienced strong mineral royalty revenue growth from the mining boom. That drove their ratio down to historically low levels — to 30 cents in the dollar for Western Australia. The fading mining boom and the recent strong transfer duty growth, mean NSW's per person funding is projected to fall to around 80 cents in the dollar of the national pool by 2019-20. After that, it is expected to gradually rise to its long-run average — of around 90 cents — by 2024-25, and then to remain constant.

As a result, NSW's GST revenue is projected to grow more slowly than the growth in the national GST pool, averaging around 4.7 per cent annually over the projection period. If, however, the GST were to change structurally over the next 40 years — as it did during the GFC — lowering both consumption and GST revenues, then these projections could change significantly.

### Other Commonwealth Payments: Specific Purpose Payments (SPPs) and National Partnerships (NPs)

New South Wales currently receives around 16 per cent of its revenue from other Commonwealth payments, through Specific Purpose Payments (12 per cent) and National Partnerships (4 per cent). SPPs fund essential services such as hospitals and schools, while NPs are tied to specific programs or projects, such as the delivery of essential vaccines or the upgrade of the Pacific Highway. The share of revenue from these programs is expected to fall to around 8 per cent in 2055-56, primarily driven by the expiry of NPs and relatively low indexation rates for Commonwealth health and education funding.

#### *Specific Purpose Payments*

Specific Purpose Payments (SPPs) make up the greatest share of other Commonwealth funding, and are projected to grow by an average of around 3.3 per cent a year to 2055-56. This results in SPPs falling as a share of total revenue from 12 per cent in 2014-15, to 7 per cent in 2055-56. The slower growth in SPPs results from the escalation formulae set out in Commonwealth agreements. It also includes the recent 2016 COAG health funding agreement.

The annual average growth rates in individual SPPs over the projection period are as follows:

- **Health**: 3.8 per cent
- **Education**: 3.7 per cent
- **Skills and workforce development**: 1.0 per cent
- **Housing**: 0.9 per cent

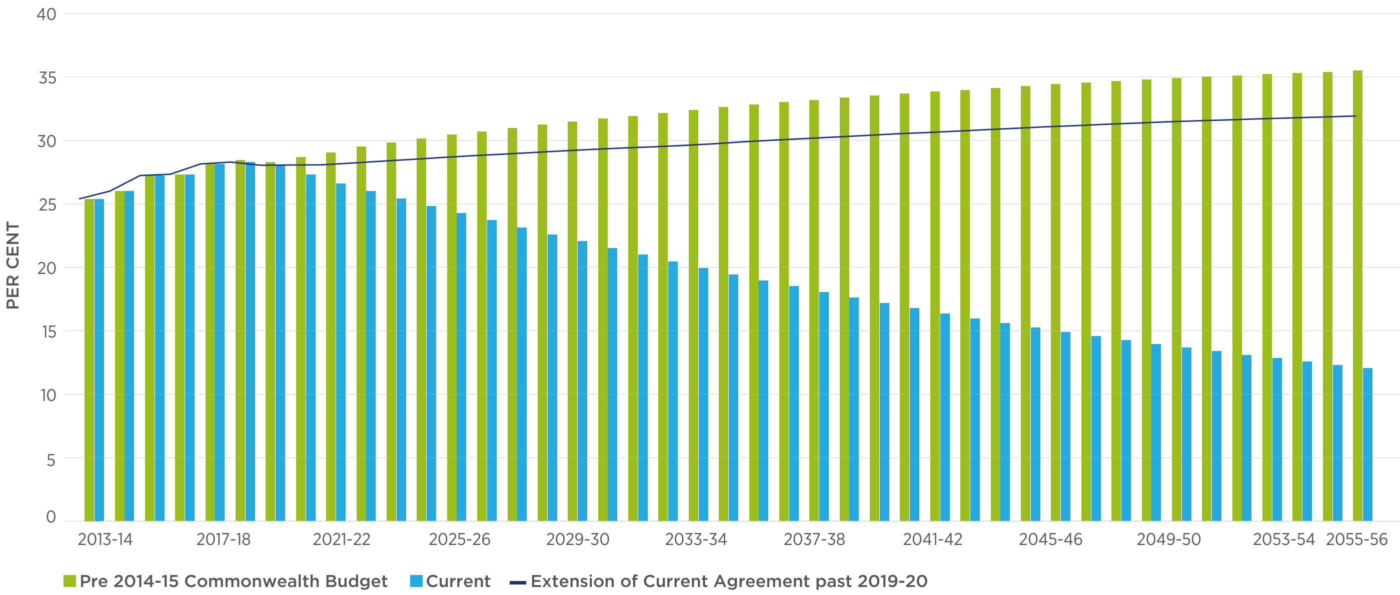
Health is the largest SPP, representing 60 per cent of SPP revenue in 2014-15. The 2014-15 Commonwealth Budget signalled that from 2017-18 the indexation of health funding for hospitals would no longer keep up with actual increases in hospital expenses, which are expected to increase by 6.2 per cent on average over the projection period. That decision would have meant that from 2017-18, Commonwealth health funding increases would be limited to growth in population and consumer price inflation — averaging around 3.5 per cent a year — leading to a long-term decline in the Commonwealth share of the state's health funding.

**Health is the largest SPP, representing 60 per cent of SPP revenue in 2014-15.**

**The recent agreement between the Commonwealth and the states has temporarily increased funding for the three years to 2019-20, bringing it back in line with growth in hospital expenses.**

The recent agreement between the Commonwealth and the states has temporarily increased funding for the three years to 2019-20, bringing it back in line with growth in hospital expenses. Our projections are based on existing Commonwealth policy, so that after 2019-20, Commonwealth health funding is again expected to grow, in line with population and consumer price inflation. NSW's share of the health budget is therefore projected to increase from 74 per cent in 2014-15 to 88 per cent by 2055-56 (Chart 5.8), with a commensurate decline in the Commonwealth share. Should the current three year agreement be extended beyond 2019-20, the Commonwealth share of health funding is projected to reach 32 per cent by 2055-56, just below pre-2014-15 Commonwealth Budget funding projections.

**Chart 5.8 Declining Commonwealth health funding share**




*Source: NSW Treasury*

Education represents 20 per cent of SPP funding. The indexation arrangements for the education SPP have also recently changed. From 2019-20, education SPP funding will grow by the projected rate of growth of the NSW student population plus consumer price inflation. This change from the previous Gonski formula means indexation is expected to fall from 5.3 per cent to 3.7 per cent a year.

### *National Partnerships*

National Partnerships (NPs) are time-limited Commonwealth grants that are tied to specific programs outside the SPP framework. Examples include transport infrastructure projects, universal access to early childhood education and essential vaccines.

While most NP programs are time-limited, some are ongoing. Of those, the most significant is that on Land Transport Infrastructure Projects, which relate to road projects, like the Pacific Highway upgrade. We have assumed that this particular NP will follow historical trends and grow proportionally in line with the NSW transport capital budget. Actual future allocations will, however, be sensitive to future Commonwealth decisions.

The remaining ongoing NPs are projected to either remain flat or grow with consumer price inflation in line with historical trends. Where the Commonwealth has not yet made decisions about expiring NPs, the modelling assumes they will end. This results in NPs growing by only 2.3 per cent per year over the projection period.

## 5.4 Other revenue

States levy mineral royalties on the extraction of a mineral resource. Currently, 87 per cent of this is thermal coal. Mineral volumes are projected to grow by 1.2 per cent a year in the long term, in line with estimates from the Commonwealth Department of Industry, Innovation and Science.[9]

With the thermal coal price assumed to grow with the consumer price inflation minus any change in the terms of trade, royalty revenue is expected to increase at an annual average of 4.2 per cent over the projection period.

Dividends and tax-equivalent payments from the NSW public trading enterprise (PTE) sector are based on business data to 2020-21 and then escalated in line with nominal GSP. The projections reflect the effects due to the long-term lease of the electricity assets. Average growth in dividends and tax equivalent payments is projected to be 4.1 per cent a year.

Sales of Goods and Services (SOGS) include rents, entry fees, tolls and hospital patient fees. In the past, governments have increased the government services that attract charges and some existing fees have been escalated at rates above CPI. As a result, SOGS revenue has grown by around 6 per cent a year since 1996-97.

Consistent with the 'no policy change' assumption, we have escalated SOGS revenue by CPI and population growth. In some cases however, we have used a more appropriate volume or price escalator. For example, patient fees are escalated with private health insurance coverage and health inflation. In total, SOGS revenue is expected to grow at an average rate of 5.0 per cent a year over the projection period. The slower projected growth compared to historical rates reduces the overall rate of revenue growth by 0.1 percentage points over the next 40 years.

**SALES OF GOODS AND SERVICES**

▲ 5%

**a year on average over the projected period.**

9 Office of the Chief Economist, 2014. Australian Energy Projections 2049-50