GOVERNMENT RESPONSE TO THE REPORT OF THE NSW FINANCIAL AUDIT 2011

The NSW Liberal National Government is getting on with the job of fixing the problems facing NSW - to rebuild the state's financial position and to provide transparency and accountability.

The report of the Financial Audit (The Lambert Report) provides a comprehensive analysis of the state of NSW finances and detailed a range of systemic failures in the financial management and fiscal leadership of New South Wales.

The Lambert Report was considered in the course of developing the September 2011 State Budget, NSW 2021 and in the preparation of the Expenditure and Management Audit (Schott Report).

The Lambert Report identifies eight elements of a reform package for NSW:

1. Fiscal sustainability, improved financial management, budget control and accountability
2. Revenue reform
3. Implementation of an Economic Development Strategy
4. Reformed service provision
5. Reformed Asset and Capital Project Management
6. Improved workforce management and wages policy
7. Improved balance sheet management
8. Improved PTE performance

These eight elements have helped shape the Government's decisions to date.

To the extent that the specific Lambert Report recommendations were not adopted in the Budget or reflected in NSW 2021 or the Schott report, the Government has no plans to adopt them.

[ends]

NSW Financial Audit 2011

Volume 1

Part A: Setting the Scene

Part B: Financial System, Projections and Sustainability

Volume 2

Part C: Policy, Financial and Economic Reform

September 2011

NSW Financial Audit 2011

Report Part A:

Setting the Scene

Report Part B:

Financial System, Projections and Sustainability

September 2011

NSW Treasury

Governor Macquarie Tower

1 Farrer Place

SYDNEY NSW 2000

Website: www.treasury.nsw.gov.au

NSW Financial Audit set includes:

Volume 1 – Part A: Setting the Scene

Part B: Financial System, Projections and Sustainability

Volume 2 – Part C: Policy, Financial and Economic Reform

NSW FINANCIAL AUDIT 2011

Contents

PART B: FINANCIAL SYSTEM, PROJECTIONS AND SUSTAINABILITY

FOREWORD AND TERMS OF REFERENCE

The new Liberal National Party Government, elected in March 2011, has established a Financial Audit, undertaken by the Acting Secretary of the NSW Treasury. This Financial Audit follows on Financial Audits undertaken in 1988 and 2006.

The Financial Audit which has produced this report commenced in April 2011 with the following Terms of Reference:

A review of the NSW public sector financial system and position, identifying and reporting on the following:

1. The State of the NSW balance sheet, including on-budget and off-budget assets and liabilities
2. The long-term sustainability of the NSW Budget position, including the underlying cost and revenue drivers
3. Weaknesses in financial controls and financial risk management frameworks
4. Wasted expenditure that has built up over 14 years of Labor government including program and infrastructure cost overruns and areas of less effective programs and infrastructure provision
5. Opportunities to strengthen the NSW financial position.

The Government also announced an Expenditure and Management Audit which is examining public sector management and service delivery through the use of case studies, benchmarking and agency program analysis.

The Financial Audit has been supported by a secretariat and drawn on the advice and assistance of a number of Treasury officers and others whose assistance is gratefully acknowledged and who are identified below. In addition, the Financial Audit has consulted with Director-Generals in the general government sector; ministers in each administrative and policy cluster; and the chairs and managing directors of all state owned corporations (SOCs).

The contribution of the following persons are gratefully acknowledged. Any errors of fact or presentation are mine alone.

Michael Lambert

Secretariat staff

Sue Power, Kitsa Papadopoulos, Kerrie Mangan, Jimmy Zhang, Agata Molenda.

Contributing Treasury officers

Mark Ronsisvalle, Kevin Cosgriff, Caralee McLeish, Stephen Brady, Matthew Roberts, Richard Timbs, Anne Ellison, Joshua Shrubb, Bruce Freeland, Elizabeth Stratford, Ann Tsuei, Chen Chou, Kosmas Stergiou, Louis Kastoun, Julian Cornelius, Bruce Freeland, Ross Edwards, Michael Warlters, Richard Cox, Nin Rejante, Peter Horn, John Diller, David Thorp, Mark Pellowe, Jenny-Lea Charlier, Narayan Mukkavilli, Ziggi Lejins, Peter Regan, Danny Graham, Colin Campbell, Glenn Grimshaw, Dominic Schuster, Rebecca Bishop.

Other contributors

Jane Bridge, Sarah Lambert, Nigel Stokes.

EXECUTIVE SUMMARY

The purpose of the Financial Audit is to assess the financial position and underlying expenditure and revenue trends for the NSW public sector and to develop strategies aimed at creating a sustainable financial position to provide the means of delivering, on an ongoing basis, quality public goods and services.

The report focuses on the previous ten years of government and financial performance and identifies major deficiencies in public administration and financial management and a program of reform to rectify these. The Government has already begun this process in various areas, including a revised wages policy, displaced employees policy, the establishment of Infrastructure NSW, the establishment of a Public Service Commission and the development of a State Plan.

This report has been prepared in the context of a deteriorating financial position for the State, with risk to the State's AAA credit rating, and evidence of failures in project selection, program evaluation, financial management, transparency and accountability. All these and other matters are addressed in this report, with a comprehensive eight part reform strategy proposed.

The key objectives that have underpinned the preparation of this report are as follows:

- Achieving a fiscally sustainable position
- Budget control and accountability
- Improved economic performance
- Efficient, equitable and simple taxation system
- Efficient and effective provision of services and infrastructure
- Improved resource management and expenditure control.

Part A of the report provides a description and explanation of the financial position and the underlying financial trends. Part B undertakes a more detailed analysis of the financial position and outlook, as well as the financial system and decision making process. It also identifies deficiencies which have contributed to deterioration in the State's financial position and proposes a sustainable fiscal target. Part C sets out a program of economic and financial reform aimed at achieving a sustainable financial position and delivering on service and infrastructure provision.

An overview of the NSW public sector

The NSW public sector can be divided into two broad sectors:

- the general government sector
- The public trading and financial enterprises sector.

The general government sector is broadly the Budget-funded part of government, though there are agencies in the sector that are in part or wholly self-funded. Agencies in the general government sector are generally characterised as providing non-market goods and services, be they pure public goods (law and order), merit goods (education, welfare services, environmental services and health) or of a regulatory nature (safety and licensing), as well as providing grants and concessions to the community. The goods and services are generally provided on a universal basis with a zero or limited charge.

In contrast, the public trading and financial enterprises sector provides services which are or can be charged for. These include entities in the water, energy, port services and public transport sectors, as well as certain entities which are engaged in competitive markets such as Landcom and Forests NSW. Within this sector there are budget-dependent non-commercial public trading enterprises such as public transport and public housing, which are an important part of the Budget process.

The main focus of this report is the general government sector and the non-commercial public trading enterprises sector. Nevertheless, the commercial public trading enterprises are also considered because their performance impacts on budget revenue, total state sector debt and on the economy in general.

The key metrics of the total state sector and its components are as follows:

Table 1 Key aggregates for the state sector

	General government sector	Public trading enterprise sector	Public financial enterprises
2010-11 Half-Yearly Review			
Total Expenses	$56 billion	$20 billion	$4 billion
Total Revenue	$57 billion	$20 billion	$4 billion
Capital Expenditure	$8 billion	$9 billion	$0
Total Assets	$238 billion	$127 billion	$65 billion
Employment (a)	344,000	42,000	

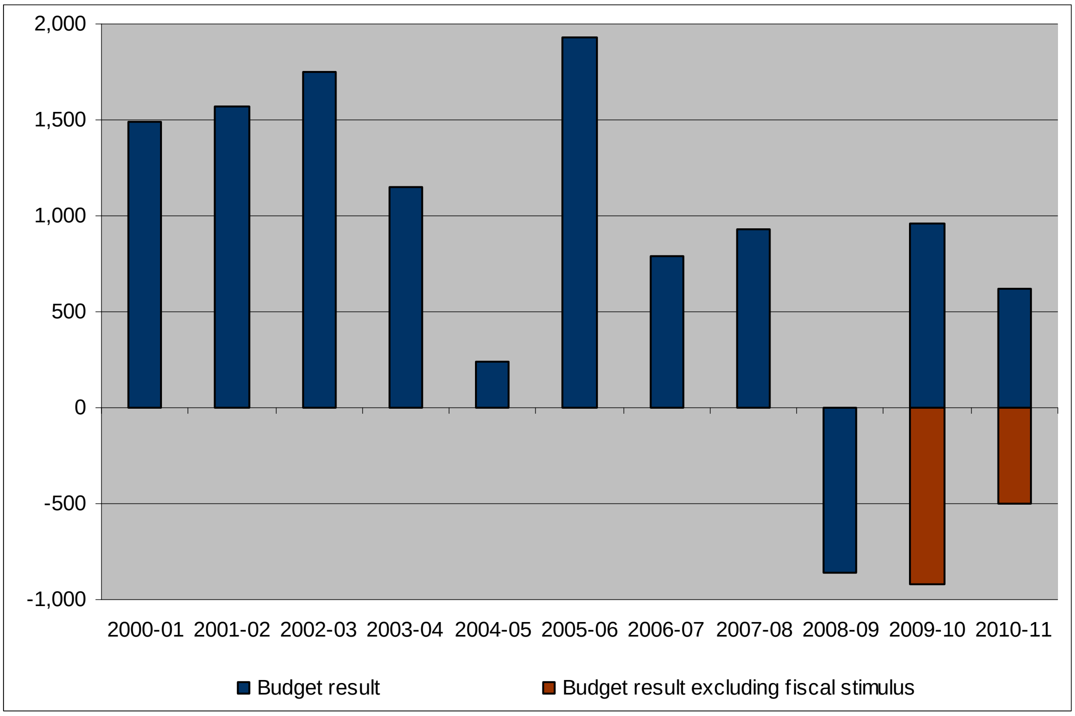
(a) Rounded estimates using NSW DPC 2009-10 Workforce Profile (v2010.11.02) Table 8 Size of Workforce. PFEs are not separately identified in the workforce profile collection. PFE employee numbers are captured within the public trading enterprise sector.

Is there a problem?

After a considerable period of fiscal restraint, there has been a marked deterioration in the State's financial position since broadly 2005-06, which has produced an unsustainable financial trend. Thus the short answer is that yes, there is a problem, and that is an unsustainable fiscal trend, which requires corrective action.

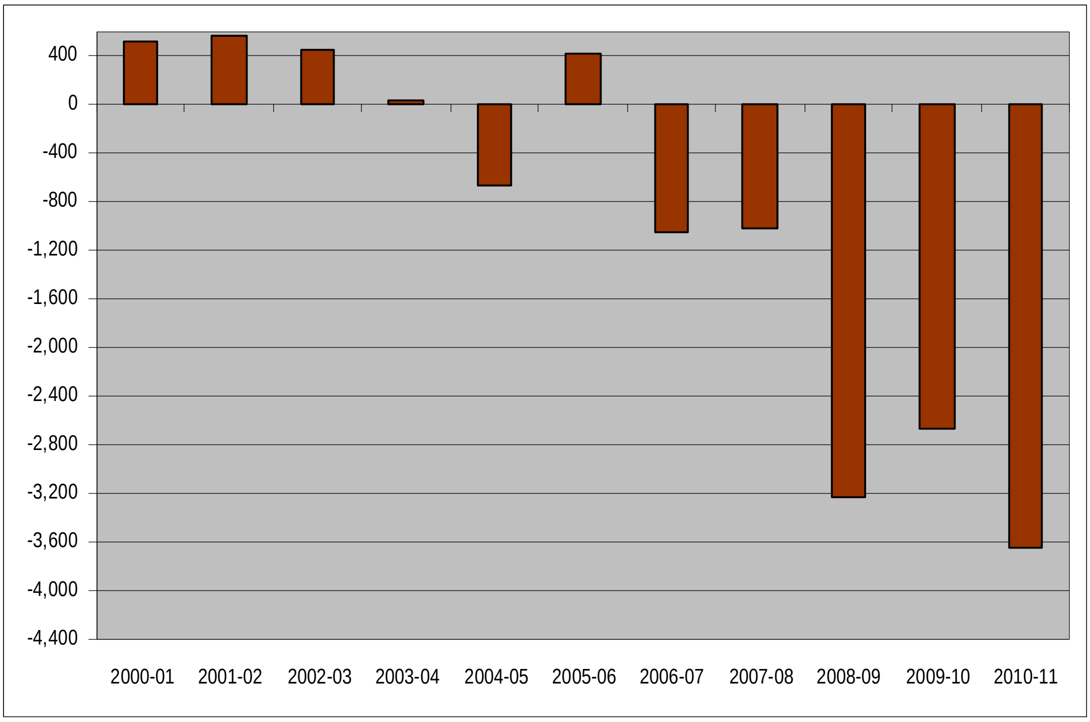
The deterioration in the Budget result (called the net operating result) since 2005-06 is shown in Figure 1, noting that the deterioration has been partly masked in 2009-10 and 2010-11 by the Commonwealth's economic stimulus.

Figure 1 Budget results 2000-01 to 2010-11



It must be noted that the Budget is presented on an accrual basis, which means that it does not include capital expenditure. Instead it includes a depreciation charge to reflect the use of capital assets. In order to obtain a comprehensive measure of the call of the NSW public sector on financial markets it is necessary to look at the net lending/borrowing requirement which measures the net demand for funding of the budget and the capital program. The deterioration in the net borrowing requirement is the most significant fiscal challenge facing the State and is presented below in Figure 2.

Figure 2 Net lending results 2000-01 to 2010-11



What has caused the deteriorating financial position

The deterioration in the financial position is the product of:

- underlying recurrent expenditure growing more rapidly than revenue
- a ratcheting effect of above-budget revenue producing decisions to increase expenditure. This increases the underlying cost base which is not reversed in years when actual revenue is less than budgeted
- the recent acceleration in capital grants to fund the Metropolitan Transport Plan, which is projected to continue for 20 years into the future at between $2 billion to $3 billion a year in constant dollar terms
- the increasing resort to borrowings to fund the escalating general government capital expenditure program and hence the rise in debt servicing costs.

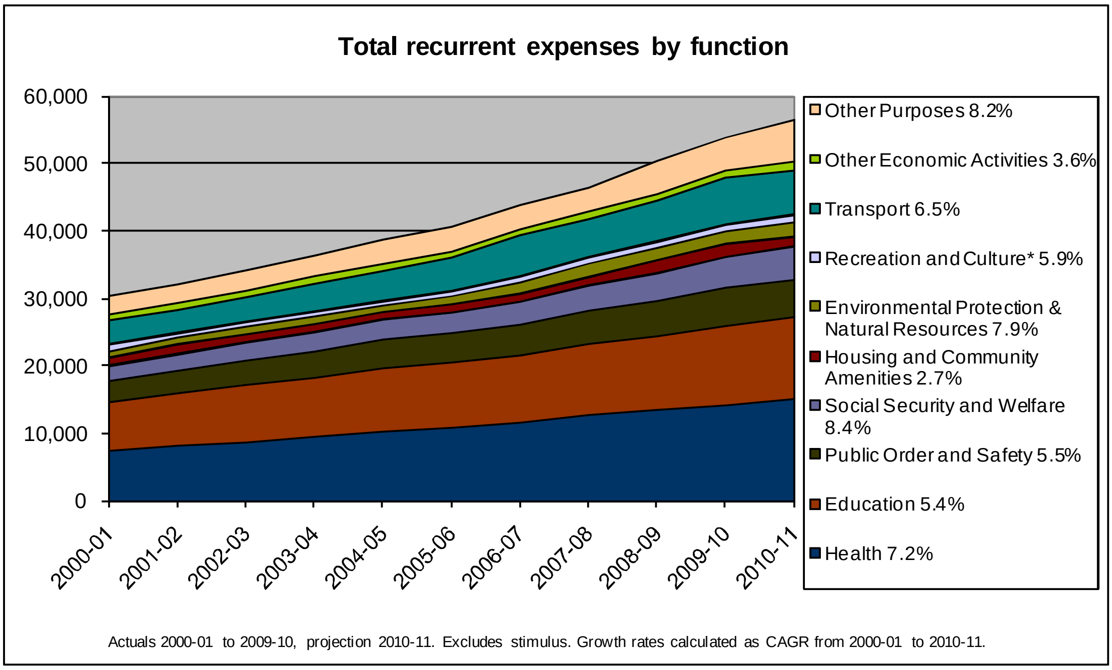
The key causal factor is recurrent expenditure which has grown consistently faster than revenue, reflecting a lack of fiscal discipline, eliminating the large budget surplus that was previously used to fund the general government capital program.

Expenditure has grown over the last ten years at an average annual rate of 6.2 per cent (excluding Commonwealth stimulus), in excess of revenue growth of 5.6 per cent per annum (excluding Commonwealth stimulus) and the long term trend revenue growth of 5.2%. This may not appear to be particularly alarming but it needs to be recognised that with expenditure at $56 billion, a 0.5 per cent gap between revenue and expenditure in year one is $300 million and by year five has compounded to $1.8 billion. Growth in recurrent expenditure has been strongest in social security and welfare, environmental protection, health and transport, as can be seen from Figure 3.

The key factors underlying recurrent expenditure growth are:

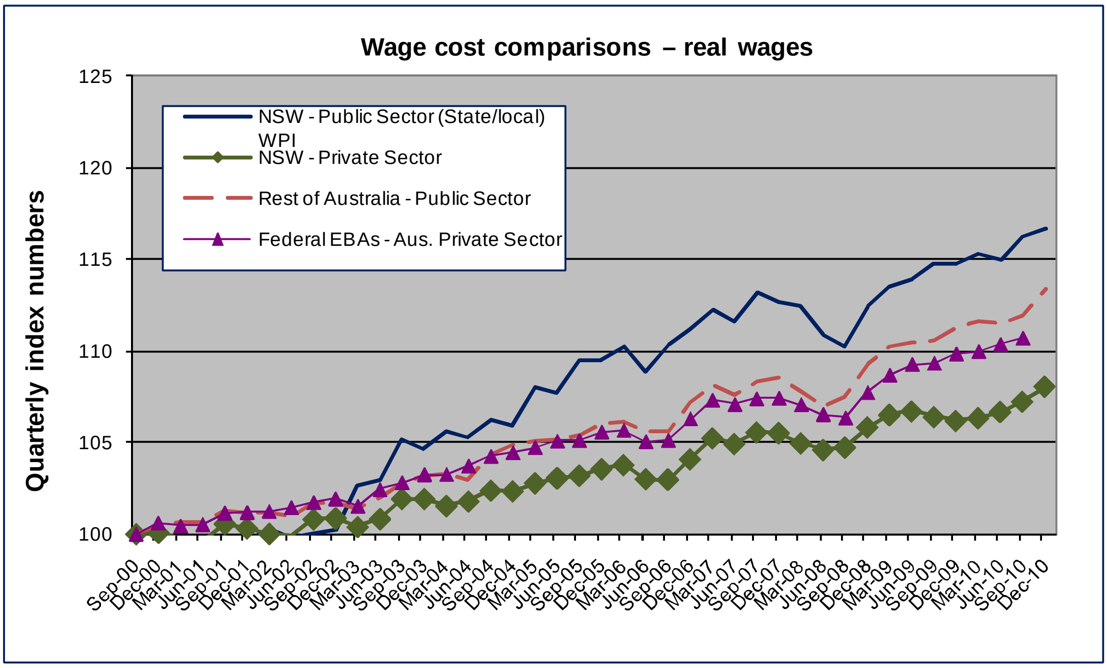
- growth in the cost of inputs (mainly employee costs)
- the large Metropolitan Transport Plan which is funded, appropriately, by capital grants from the Budget
- substantial expenditure decisions being made outside the Budget context and a general breakdown in budget compliance and control
- increased demand for services in certain areas reflecting population growth and demographic shifts (such as changes between regions, requiring additional infrastructure, and ageing)
- changes in policy, such as changes in school class sizes, changes in bail laws and sentencing laws, and the size of the police force
- service enhancements
- Commonwealth funding for new initiatives, requiring matching state funding.

Figure 3 Recurrent expenditure growth trend by policy area for NSW general government sector



Employee cost is not only the largest component of expenses but has been growing at 6.7 per cent per annum. This reflects wages growth as well as employment growth of 1.8 per cent per annum and salary drift – the tendency for there to be an upward shift in the seniority structure of the public sector. What is noticeable is that wages in the NSW public sector have grown significantly faster than for the NSW private sector or the public sector in other jurisdictions, as can be seen from Figure 4.

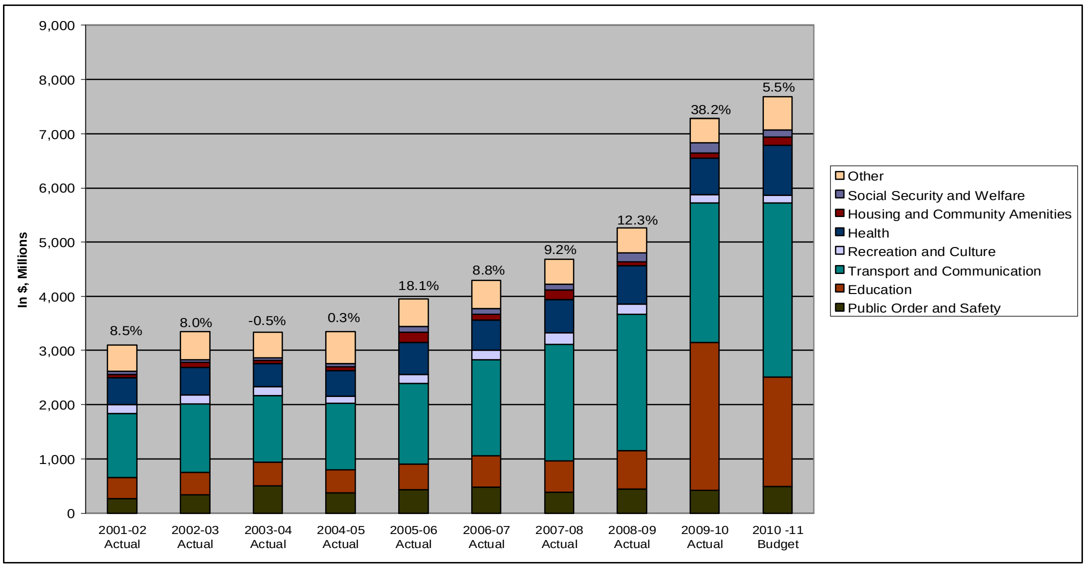
Figure 4 Comparison of real wage increases: NSW public sector[1] versus private sector and public sector in rest of Australia



Second, the general government capital program has strongly increased over the last ten years, averaging 10.4 per cent per annum, with expenditure accelerating from 2005-06 at an average annual growth rate of 14.9 per cent per annum. The major components of the program are transport, education and health.

[1] Information not available for post December 2010; Federal EBAs – Aus. Private Sector information not available post September 2010.

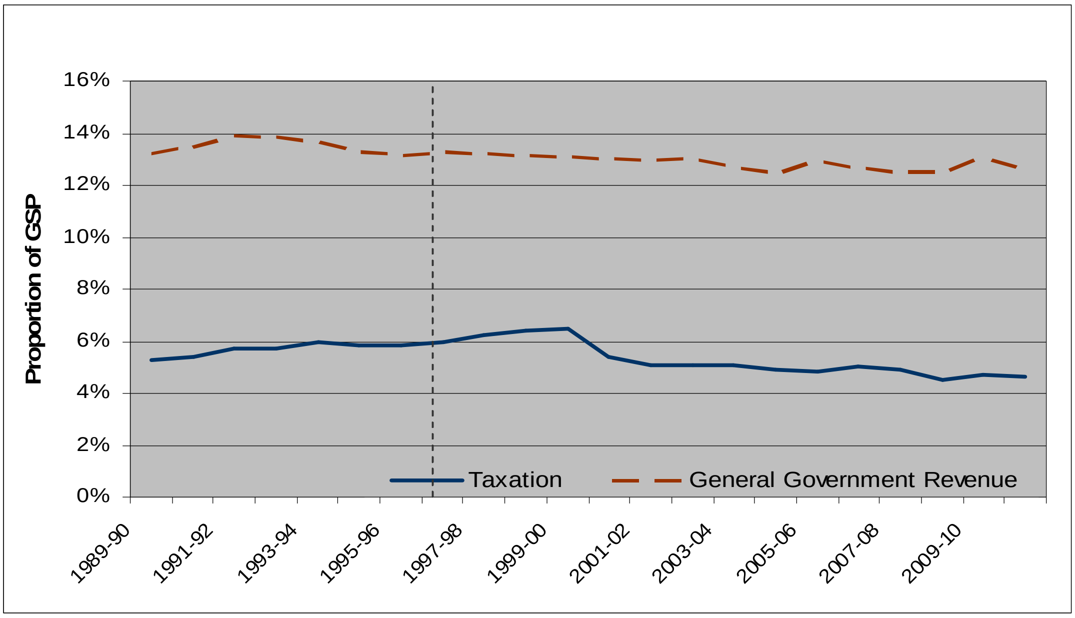
Figure 5 General government sector capital program by policy area



The boost in 2009-10 in part reflects the Commonwealth economic stimulus package.

Third, and less significant in the short to medium term but very significant over the long term, is the decline in the State's revenue base as measured relative to Gross State Product. The trends for general revenue and taxation as a proportion of GSP are shown below in Figure 6. The sharp drop in 2000-01 reflects the introduction of GST and the concurrent abolition of a number of State taxes. Over the period 1991-92 to 2010-11, revenue as a proportion of GSP has declined from 13.9% to 12.6%. This raises issues about the ability of the State's revenue base to adequately fund recurrent and capital expenditure growth.

Figure 6 Trend in general government taxation and revenue as % of GSP



Why did the Budget and Capital Program systems not avoid this problem developing?

While the financial deterioration reflects expenditure growing faster than revenue, the key question is why was this allowed to happen? Why didn't the Budget system act to keep expenditure at a more sustainable level? This reflects a failure in the application of the Budget process and a failure of financial leadership of the State.

While the Budget architecture is generally sound, there has been poor governance and accountability in this area. In addition, the actual process followed in recent years has been less than ideal and has produced a less than fully effective approach to expenditure control. The key weaknesses are as follows:

- the State Plans, which set out the Government's priorities, have not been aligned with the Budget process and fiscal strategy
- absence of a medium to longer term fiscal strategy, with the result that when actual revenue exceeded budgeted revenue there was a tendency to increase expenditure, producing a ratcheting effect in respect to expenditure. This was clearly not matched by downward adjustments in expenditure in years when actual revenue fell below budgeted revenue
- there are limited processes within agencies or centrally for the systematic evaluation of programs
- decisions on new policies and programs have not been evidence based. A clear example is the Solar Bonus Scheme

- the performance of agencies in managing their budgets has not been considered in the overall budget decision making process, with no sanctions for poor performance
- agency budgets and forward estimates often include unrealistic assumptions about expenditure control and the achievement of savings, requiring Treasury to make central contingency provisions. This has created a culture that "budgets do not matter" and that any budget overrun will be centrally funded
- agencies are not able to carry forward savings from one year to the next, encouraging end of year spend-ups
- the Cabinet Committee responsible for the Budget has operated in past years on an around-the-year basis, meaning that often expenditure proposals have been assessed outside the Budget context
- there have been inadequate systems in place to hold CEOs and ministers accountable for financial performance
- the Treasurer's Advance has been used routinely to fund budget overruns and enhancements rather than, as designed, to fund genuine unforeseeable and uncontrollable contingencies.

This has produced the deteriorating Budget result such that revenue is not even covering recurrent expenditure. Compounding that problem has been the acceleration in the capital program which, given the ever-decreasing budget surplus, has required more and more of the capital program to be funded by debt, building up debt servicing costs.

However, this deteriorating situation was not highlighted as an issue because the focus of the Budget shifted from the total lending/borrowing result to a narrower concept: the operating result, which excludes capital expenditure and its funding requirements. This would not have been a problem if the capital expenditure had been revenue generating. However, not only was the general government capital expenditure not revenue generating, but in a significant number of cases it was misdirected.

Once again, as with the Budget, there was not an obvious problem with the capital program architecture which included 10-year Total Asset Management Plans, State Infrastructure Strategies and the NSW Procurement Framework, the latter setting out evaluation gateways through which capital projects should pass. The problem was a lack of clear accountability and that the system was only partially applied. In particular:

- the business cases for a significant number of major projects have not been supported by robust business plans
- the Gateway system was not applied in a number of cases (particularly large projects) with no formal cost-benefit analysis undertaken
- a significant number of projects that were subject to cost-benefit analysis and which demonstrated costs greater than benefits were nevertheless approved,

including over $1 billion in road projects, including the Berry bypass project on the Princes Highway, and the Parramatta to Epping Rail Line

- there has been too narrow a focus on capital expenditure solutions and inadequate assessment of alternatives such as demand management. For example, in the transport area a major problem with rail and road is peak hour demand. Increasing capacity is very expensive and may not be effective because greater capacity can increase demand. An alternative is economic pricing that encourages users to use transport in off-peak periods or, where not possible, to contribute to the costs associated with peak hour use.

What is the position with commercial public trading enterprises?

There is a sound commercial policy framework in place for the commercial public trading enterprise sector, particularly for state owned corporations (SOCs). This involves appropriate capital structures and financial distribution policies, reporting and monitoring arrangements, the approval of business strategies and policies for ensuring full competitive neutrality.

While financial performance has improved since the commercial policy framework has been in place, nevertheless there is room for further governance, financial and operating performance improvement. Over the years there have been some departures from what would be considered best practice and there is now a need for reforms including:

- ensuring a consistent, best practice approach to governance
- enhanced accountability for business performance
- improved organisational structures (in a number of cases).

What is the financial outlook and what are the requirements for a sustainable financial position?

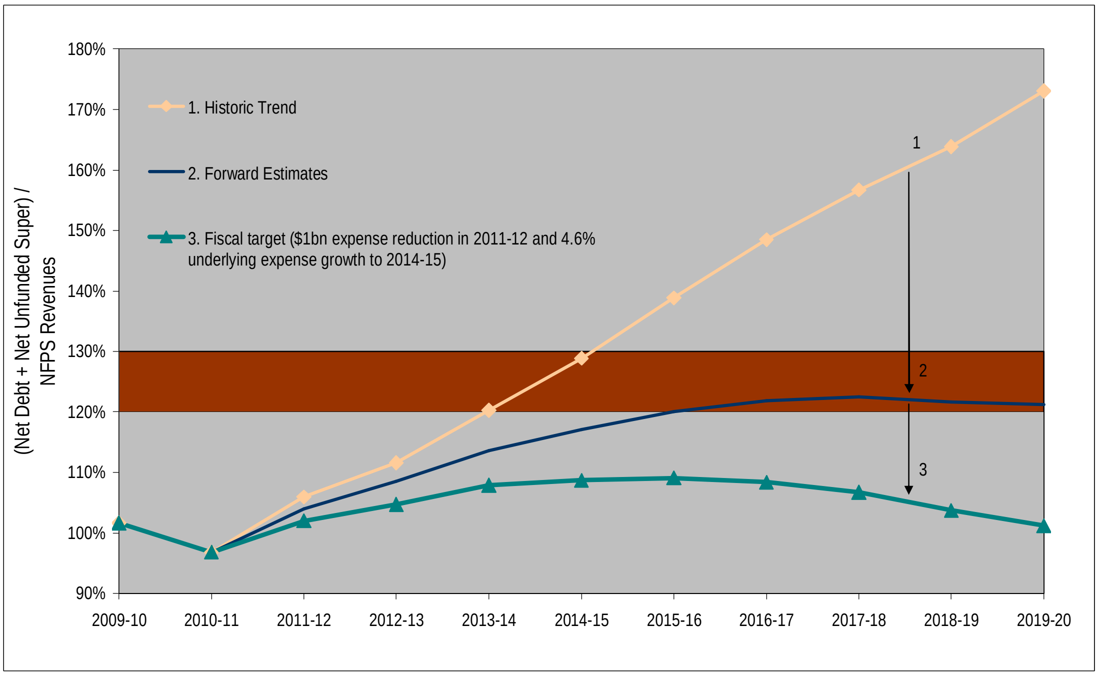
A number of scenarios have been projected over a 10-year horizon, each having the same revenue projections but with differing expenditure scenarios. These are the:

- historic trend scenario – general government expenditure growing at the historic growth of 6.6 per cent per annum
- forward estimates scenario – expenditure growing in line with the growth rate in the forward estimates to 2014-15, which is 4.9 per cent per annum and thereafter growing in line with the trend growth rate of revenue of 5.2 per cent per annum
- fiscal sustainability scenario - setting expenditure at a level that achieves an appropriate mix of budget funding and debt funding for the general government capital program and establishing and maintaining an appropriate balance sheet buffer to allow for external shocks.

The red bar in Figure 7 shows the trigger point at which a review for a possible downgrade for the State’s AAA credit rating will occur, which is where net debt and unfunded superannuation liabilities are between 120% and 130% of total state revenue. Based on the experience of the recent GFC and the recession of the early 1990s, it is desirable to have a buffer of around 20% to 30% to allow the State's balance sheet to absorb cyclical economic or financial shocks without the need to resort to expenditure cuts or tax increases. Hence a sustainable target is to maintain net debt and unfunded superannuation liabilities at or below 100% of total state revenue.

As can be seen in Figure 7 below, neither of the first two scenarios delivers a sustainable fiscal position. The reason is that a large net borrowing requirement has been built up over time. It is necessary to address this and to then keep expenditure growth at or below the trend growth in revenue. This is done under the sustainability scenario where there is a significant reduction in recurrent expenditure and then expenditure is kept at or below trend revenue growth.

Figure 7 Financial projections under a range of scenarios



Fiscal sustainability has three core requirements:

- ensuring that the Government's expenditure and revenue policy settings are not threatened by an untenable budget position in which debt grows faster than the ability to service it
- ensuring a stable tax base that does not require recourse to increasing taxes that would threaten the competiveness of the State as a place to undertake business
- achieving intergenerational sustainability through maintaining and improving the service potential of the infrastructures stock and having an equitable distribution of the costs borne by current and future users.

As noted above, it is proposed that the overarching fiscal target is to achieve and then maintain, for the total state sector, the ratio of net debt and net superannuation liabilities at or below 100 per cent of total revenue. This has been set to be consistent with the retention by the State of its AAA credit rating, together with a suitable buffer to allow the absorption of economic cycles and economic or financial crisis without the need to adjust expenditure or tax rates. The Government is at liberty to target a lower credit rating but would then still need to put in place fiscal targets that will sustain that position. A deteriorating fiscal position, which was what the Government inherited, is not capable of sustaining any credit rating, much less a AAA credit rating. The key priority is to reverse the deterioration and maintain a sustainable financial position.

The merits of the proposed fiscal target are that such a target maintains debt at levels that are sustainable; provides a buffer to absorb external economic and financial shocks without the need for recourse to tax increases or expenditure cuts; and provides the capacity to fund the State's priorities without spiralling debt servicing costs squeezing out programs.

It should be noted that consideration was given to having zero debt over a ten year rolling horizon, as advocated in the Victorian Independent Review of State Finances. However, it was concluded that this would require an unnecessarily severe adjustment to expenditure and/or taxes and would create intergenerational equity issues.

How can the fiscal target be achieved?

To achieve the adjustment from the current financial trajectory to the fiscal target requires three key steps to be taken:

1. eliminating the expenditure drift whereby expenditure growth has exceeded trend revenue growth
2. fully achieving the projected efficiency savings set out in the forward estimates plan and the whole-of-government corporate services plan
3. achieving fundamental reform and prioritising expenditure to save between \$1.0 billion and \$1.5 billion per annum.

The outcome of these steps will be the generation of a budget surplus of sufficient size to keep the net lending deficit at a sustainable level of about \$1.5 billion per annum. This in turn requires achieving consistent budget surpluses of the order of \$200 million to \$500 million per annum. If the size of the general government capital program were to increase from current and projected levels, this would require a corresponding increase in the budget result to maintain the target cap on the net lending deficit.

These steps require a major change in behaviour, accountability and a different approach to how the Budget and the capital program are managed. There are eight key elements to the reform program.

An economic and financial reform program

The eight key elements of the proposed financial reform program recommended by the Financial Audit, together with the linkages to the key objectives set out earlier, is presented schematically in Figure 8.

Table 2 Overview of the Economic and Fiscal Reform Program

Strategies	Objectives					
	Achieving a fiscally sustainable position	Budget control and accountability	Improved economic performance	Efficient, equitable and simple tax system	Efficient and effective provision of services and infrastructure	Improved resource management and expenditure control
Fiscal sustainability and improved financial management, control and accountability	√	√	√			
Revenue reform	√		√	√		
An economic development strategy	√		√			
Reforming service delivery	√	√	√		√	√
Improving asset management and prioritisation and effectiveness of capital expenditure	√		√		√	√
Workforce management and wages policy	√	√				√
Balance sheet management	√					√
Improved state owned corporation governance and performance	√		√		√	√

An overview of the key components of each reform strategy, together with the rationale for the reform is presented below. Full details are set out in Part C.

Table 3 Key elements of the reform

Reform area	Key elements	Rationale for reform
Fiscal sustainability and financial management, budget control and accountability	§ Implement a Medium Term Fiscal Strategy based on a sustainable fiscal position within which each budget is framed. § Revise the *Fiscal Responsibility Act* to reflect the Medium Term Fiscal Strategy. § Establish at the commencement of each budget cycle a Budget Policy Statement that sets out the key financial aggregate targets which are in accord with the medium term fiscal sustainability target. § Integrate the State Plan with the Budget process through the preparation at the commencement of each budget cycle of a Statement of Priorities, which is required to be considered with the Budget Policy Statement. § Improve budget compliance through greater accountability and effective incentives and sanctions for budget compliance. § Focus all resource allocation decisions in the Budget cycle. § Strengthen financial and risk management, reporting and accountability. § Enhance the role and effectiveness of the Public Accounts Committee and the Auditor General. § Prepare full business cases and design an approach to program evaluation for all expenditure proposals and existing programs. § Implement output budgeting in a hierarchy of models that reflect the circumstances of individual agencies.	Fiscal deterioration does not reflect poor budget systems, but rather poor accountability and poor adherence to the systems, a lack of budget discipline, and a failure to adhere to a Medium Term Fiscal Strategy. Fiscal sustainability is the bedrock for the provision of services and infrastructure, maintaining business and consumer confidence and providing access to financial markets on excellent terms to meet the financing requirements of the State.

Reform area	Key elements	Rationale for reform
Revenue reform	§ The preferred approach is to develop a multi-lateral reform package for the consideration of all states and the Commonwealth based on the principles of efficiency, equity, transparency and revenue neutrality. § As a fall-back, develop a NSW reform package based on the same principles which seeks to reduce and eliminate, over time, inefficient taxes and expand efficient taxes, all on a revenue-neutral basis. § Explore greater employment of user charges, including road-use charges, both to recover costs and to more effectively manage demand. § Review all NSW user charges to ensure there is a more appropriate user contribution as distinct from taxpayer contribution. § Undertake an assessment of all tax expenditure and concessions to pare back those that are poorly targeted. § Seek to improve the approach to the negotiation, arrangements and renewal of National Agreements and National Partnerships, ensuring consistency with the Intergovernmental Agreement on Federal Financial Relations.	State revenue in general does not have strong growth characteristics, with tax revenue falling as a proportion of gross state product (GSP). It is also very volatile, which makes budget planning challenging. The State relies on a number of taxes which are imposed on narrow transaction bases that create substantial economic costs for the community, over and above the revenue generated. What is required is reform of the tax system, in a revenue neutral manner, that achieves a better growth profile and lower volatility and, importantly, lower economic cost for the community. There is also significant capacity to achieve a more appropriate, higher level of user contributions. In reality the choice facing government in many areas is between user contribution and tax payer contribution. At present, the weighting is excessively in favour of the user at the expense of the taxpayer.
An economic development strategy	The core elements of an economic development strategy are: § Efficient and effective provision of human services to support productivity and participation in employment. § Public investment in timely and effective social and economic infrastructure. § More efficient government businesses.	States have neither the responsibility nor the capacity to undertake a macroeconomic role, seeking to influence the aggregate level of economic activity. However, through the supply side of the economy by microeconomic reform, States can influence the economic performance of the state economy, particularly its productivity. Improved economic performance enhances the wellbeing of the State’s

Reform area	Key elements	Rationale for reform
	§ Effective, efficient evidence based regulation, including land use planning. § More efficient taxes. § More competitive domestic market. § An effective industry and trade policy that is consistent with a dynamic and adaptable economy. § Adjustment of the NSW economy in an efficient and effective manner to a low-carbon world. § Ensuring the workforce has the right mix of skills and flexibility.	citizens and has beneficial feedback effects into state revenue, as well as containing demand for social services, so assisting the State's financial position.
Improved service provision	§ Commit to six key principles in respect of service delivery: 1. proactive and innovative service delivery 2. devolution of service delivery to those closest to clients 3. good governance including separation of the purchaser and provider roles 4. efficient provision and pricing of services 5. regular reviews of effectiveness 6. transparency with respect to performance. § Application of benchmarks to assess the performance of government-funded service provision. § Establishing and maintaining a rolling efficiency review program, managed by Treasury and reporting to the Expenditure Review Committee of Cabinet. § Implementation of corporate and shared services savings across the general government sector. § Devolution of service provision to the local level. § Improved governance for service provision agencies, including greater	The need to address the structural deficit in the Budget and the large and growing net borrowing requirement while avoiding increases in the tax burden requires that the efficiency and effectiveness of all programs is under regular review. The objective is to realise savings that can be used to fund higher priority services. Beyond addressing the structural deficit it is essential to make fiscal room to address the Government's priorities, as set out in the State Plan.

Reform area	Key elements	Rationale for reform
	use of separation of purchasing/funding from service provision roles and the creation of contestability in service provision, contracting with non-government organisations (NGOs) and the private sector. § Establishment of an independent and transparent program evaluation process across the general government and non-commercial PTE sectors, through the creation of the Independent Evaluation Office. § Addressing as a priority identified ineffective, poorly targeted programs.	
Reformed asset and capital project management process	§ Infrastructure NSW to undertake an infrastructure audit as a first priority and to provide an independent review of the planning and appraisal of capital projects. § Ensure that all agencies have Total Asset Management Plans and that there is a direct linkage from these to the State Infrastructure Strategy. § Preparation of business plans and full application of cost-benefit analysis for all significant capital projects. § Full assessment of alternatives to capital expenditure, including better use of existing assets and more effective demand management. § Clear process for the prioritisation of capital projects.	There is evidence of poorly conceived, prioritised and implemented capital projects. Need to ensure that: all capital expenditure is subject to a rigorous process of assessment against alternatives, including non-capital solutions; full economic appraisal of projects; comprehensive planning and prioritisation; and effective implementation of projects on time and on budget. The systems are in place to do this but have, in the past, not been effectively employed.
Improved workforce management and wages policy	§ An effective wages policy that restrains wages growth and seeks genuine labour productivity and work practices reforms. § A more commercial approach to displaced employees is also essential § Effective performance management system that recognises and rewards	Employee remuneration accounts for about 50 per cent of total recurrent expenditure and is a major driver of increased costs. Workforce inflexibility creates difficulties for CEOs in managing operations and costs.

Reform area	Key elements	Rationale for reform
	good performance and sanctions and rectifies poor performance. § Greater workforce flexibility and extension of contractual employment to provide appropriate workforce flexibility. § Improved, proactive workforce planning to plan and adapt to such developments as the retirement of the 'baby boomers'.	
Improved balance sheet management	§ Identify and sell/lease non-core assets that would be better operating in the private sector. § Further investigate ways to more effectively manage the assets on the State's balance sheet in order to free up funding for superannuation liabilities and new, high priority infrastructure. § Assess the approach to valuation of superannuation liabilities. § Review options with respect to the fund management function which is at present spread over a number of public sector financial agencies. § Rationalise superannuation administration function. § Achieve improved property management. § Addressing with the Commonwealth the issue of funding of university superannuation liabilities.	Seeking to improve the management of the State's assets and liabilities, disposing of non-core assets and managing assets more effectively.
Improved public trading enterprise (PTE) performance	§ Developing and applying improved performance measures and seeking to achieve improved performance in line with best practice. § Improved governance arrangements for PTEs. § Selective structural reform of SOCs.	Improved PTE performance means prices that are lower than they otherwise would be, as well as a larger return to the Budget in the form of dividends and taxes.

KEY FINDINGS AND RECOMMENDATIONS

Key findings

1. The architecture for both the Budget system and the capital program process are sound, though there has been inadequate attention to incentives and accountability.
2. Over the last four to five years there has been a breakdown in the disciplined application of the Budget and capital program processes and hence a deterioration in the State's financial position.
3. Key problems with the Budget approach have been identified and include: a lack of application of a medium term fiscal strategy; absence of wages restraint; no rigorous program evaluation; and a lack of budget discipline, reflecting a lack of accountability for financial management.
4. Effective financial management, control and accountability needs to be established. This would include a medium term fiscal strategy based on achieving and maintaining fiscal sustainability; ensuring resources are allocated in accordance with the State's priorities; ensuring all material resource decisions are made in the Budget process; and achieving full budget compliance and control.
5. The capital program has grown very substantially in recent years and that growth has been associated with: poor capital program planning; a lack of prioritisation of projects; a failure to assess alternatives to capital expenditure such as effective demand management; and an absence of rigorous capital program appraisal.
6. While it has not been possible to undertake an audit of the infrastructure position, there is no evidence of general under-expenditure on infrastructure.
7. There is a major capital program planned in the transport area, in the order of $50 billion over ten years. However, this program has not been assembled through a disciplined capital planning and appraisal process and there has been inadequate consideration given to alternatives to capital expenditure such as effective demand management. A full evaluation of the State's longer term infrastructure plan, including the transport plan, should occur before commitment to any new major capital projects.
8. There has been a lack of focus by governments on the State's net lending/borrowing requirement. This needs to be re-established as the principal fiscal target.
9. In contrast to the situation found at the time of the 1988 Audit, the position of the commercial public trading enterprises sector is sound. However, there is significant capacity to improve financial performance and there has been a deterioration in governance arrangements. Both need to be addressed.

10. Associated with the deterioration in the Budget position and the strong growth in the capital program, there has been a deterioration in the State's balance sheet which, if not corrected, will lead to an unsustainable financial position and result in the loss of the State's AAA credit rating. Acceptance of a lower credit rating is not a solution, even if the cost of an additional $1 billion over the forward estimates period were accepted as the consequence of a downgrade from AAA to AA+. The current trend is unsustainable and needs to be reversed regardless of the targeted credit rating.
11. There are significant opportunities to improve the management of the State's balance sheet, including the sale or lease of non-core assets and improved funds management.
12. Service delivery can be made more efficient and effective by ongoing evaluation of programs as well as program reform driven by the principles of proactive and innovative service provision, devolution of service provision, efficient and effective service delivery and pricing, good governance, including the separation of purchaser and provider, and transparency.
13. The revenue base of the State, particularly the tax base, is in the main narrowly based, volatile and economically inefficient. There are substantial opportunities to reform the tax base to achieve greater efficiency, equity and simplicity.
14. There is a pressing need for a State Economic Development Strategy to act as a framework for state policy, seeking to ensure a consistent and appropriate approach that will improve the economic performance of the State.

Recommendations

12. Fiscal sustainability and improved financial management, control and accountability

The Financial Audit recommends:	
Budget decision making	
12.1	A Cabinet-approved Budget Policy Statement be made at the beginning of each budget process that is consistent with fiscal sustainability targets and sets key financial targets over the forward estimates period.
12.2	An annual Statement of Priorities that identifies priority areas for funding be approved by Cabinet at the commencement of each Budget process, consistent with the Budget Policy Statement and aligned to the NSW State Plan, with the priorities guiding resource allocation decisions through the annual budget process.
12.3	Making the Net Lending Result, rather than the Budget Result, the principal focus in setting the fiscal strategy and for ongoing budget management purposes, with the Net Operating Balance retained as the measure of the Budget Result to ensure comparability with other states and territories.
12.4	Establishment of a non-commercial PTE sector comprising those PTEs that are funded through operating subsidies and/or capital grants from the Budget, as well as internal revenue sources. The sector should have a specific financial management framework, including the requirement that no debt is allocated to it.
12.5	All new (recurrent and capital) expenditure proposals be supported by robust business cases based upon improved corporate and medium-term planning, with business cases associated with major infrastructure projects reviewed by Infrastructure NSW.
12.6	Savings targets be risk assessed jointly by Treasury and the relevant agency, and the risk-weighted savings be reflected in the agencies' budgets and forward estimates.
12.7	Maintenance of effort proposals be restricted to genuinely unforeseeable and extraordinary issues or those that arise from approved formula-driven arrangements.
12.8	All key budget framework documents be published, along with the annual budget strategy, business cases for approved programs or projects, the outcomes of program reviews and details of key processes, such as the Budget process.
12.9	The State invest in developing the skills necessary to support the new financial management framework with the Public Service Commissioner (PSC) playing a key role in facilitating the development of sector-wide skills.
Improved budget compliance	
12.10	Ministers and CEOs have formal performance agreements with – and be held accountable by – the Premier, with a formal funding agreement with Ministers and CEOs signed at the end of the Budget process.
12.11	Budget compliance is made a key and mandatory element of CEO performance agreements, with performance sanctions for budget overruns, with portfolio ministers not permitted to direct agency CEOs to exceed budget without renegotiation of their funding agreement or, in urgent cases, confirmation from the Premier and Treasurer.
12.12	The portfolio minister, not the Treasurer, be required (with Budget Committee approval) to seek an additional appropriation from Parliament, if Budget supplementation is required outside the 'exigencies of government' due to either an inability of the agency to manage within the approved budget or to fund new programs outside of the Budget process.

The Financial Audit recommends:	
12.13	All Cabinet Minutes be considered by the Government only if submitted with a Treasury-endorsed Financial Impact Statement.
12.14	Treasury Administrative Controls be tightened by curtailing the Treasurer's Advance and limiting its use to genuine contingencies.
12.15	Allowing the rollover of funds across years if approved by Parliament via a Special Appropriation Bill.
12.16	The cluster Minister be the Budget holder for the cluster, with the only exceptions being: § where there is a second departmental cluster that is not strategically aligned with the principal department § independent bodies such as ICAC. with the cluster Minister and the principal department CEO being responsible for achieving strategic alignment within the cluster and responsible for all cluster proposals made to Cabinet.
Output-based budgeting	
12.17	Implementation of an output-based budgeting model, building on the service group information currently in the Budget Papers and customised to individual agencies with a formal 'Statement of Service Outputs', signed by the Minister and the CEO based on services specified in terms of quantity, quality, cost and timeliness.
Financial and risk management in agencies	
12.18	Development of a comprehensive whole-of-government compliance framework to support the NSW financial management framework, providing specific guidance to agencies on governance processes, the internal control environment, systems, procedures and management, and financial reporting.
12.19	The Financial Management Framework include a new financial management framework for general government non-budget-dependent agencies, to bring about consistency with budget-dependent agencies in the application of net cost of services tolerances, capital authorisation limits and introducing consistent disciplines to permit greater scrutiny and control such as a requirement to produce Statements of Business Intent.
12.20	The *Public Finance and Audit Act 1983* be amended to reflect the revised approach to financial management, including: defining the roles and responsibilities of key parties (e.g. the CFO); mandating key elements of the management cycle such as strategic planning, risk management and attestation of compliance; defining performance in terms of outcomes, outputs and financial compliance; and requiring annual reports to be tabled in Parliament within three months of the end of financial year (by 2013).
12.21	Requiring CFOs, CEOs and Ministers to sign off on financial reports provided to Treasury, including financial projections for the balance of the year, with such certifications provided every six months, that is accompanying half year and end of financial year returns.
12.22	Reporting financial measures and departmental key performance indicators in agency corporate and business plans, performance reports and annual reports.
12.23	Responsibility for compliance with the Budget be cascaded to the CFO and all staff in agencies with budget control responsibilities through performance agreements.
12.24	A comprehensive reporting framework be agreed between Treasury and agencies that includes both financial and non-financial metrics for programs (including service (output) metrics and FTE numbers).

The Financial Audit recommends:	
12.25	The Public Service Commission, with the assistance of the Department of Premier and Cabinet and Treasury, take the lead in developing and implementing a strategy to build risk management capability across the sector.
The Auditor-General	
12.26	The Auditor-General's powers be enhanced by: § increasing powers of the AG to access Cabinet documents § providing the AG with explicit power to undertake compliance audits § expanding the AG's role in the audit of entities not directly controlled by a statutory body, department or minister § empowering the AG to audit the Legislature § permitting the AG to choose not to audit dormant agencies.
12.27	The Auditor-General's accountability be enhanced by: § requiring the AG to comply with Australian Accounting Standards § making the AG directly accountable to the Public Accounts Committee (PAC) § requiring the AG to include agency comments in any report to Parliament § requiring the review of the Audit Office to be provided directly to the PAC rather than to the AG for on-passing to the PAC § reducing the number of days an agency has to respond to a performance audit report.
The Public Accounts Committee	
12.28	The PAC's role and effectiveness be enhanced by: § reviewing the PAC structure and membership § making the AG directly accountable to the PAC (refer to recommendation 12.27) § strengthening procedures for government responses to the PAC's recommendations § enhancing the PAC's capabilities § improving the PAC performance reporting process.
The Fiscal Responsibility Act	
12.29	Amending the *Fiscal Responsibility Act* to make the fiscal sustainability target that net financial liabilities for both the total state sector not exceed total revenue, with the target phased in over the period to 2019-20 and thereafter maintained.

13. Revenue reform

The Financial Audit recommends:	
13.1	The NSW Government seek the support of all Australian governments in the reform of state and territory taxation on a revenue neutral basis aimed at improving its economic efficiency, and growth characteristics and reducing revenue volatility.
As part of a multilateral or unilateral reform process, consideration be given to the following reforms:	
13.2	Abolition of the emergency services levy on insurance companies and imposition of a property levy on rateable property with a public consultation process used to identify the most effective way of allocating this property levy across properties.

The Financial Audit recommends:	
13.3	Abolition of insurance duty and the health insurance levy and fund by lowering the payroll tax threshold.
13.4	If recommendation 13.3 is not implemented, removal of general insurance tax concessions and applying a single flat rate of 4.5 per cent to all insurance other than life insurance. The new rate would apply to general insurance, third party motor vehicle insurance, marine and cargo insurance, WorkCover premiums and health insurance.
13.5	Abolition of transfer duty and imposition of a 'Stamp Duty Replacement Tax' (SDRT) on land value.
13.6	Abolition of indexation of the land tax threshold, using the additional revenue generated by bracket creep each year to gradually reduce the 2 per cent top tax rate towards the base 1.6 per cent rate. The objective is to have a single flat rate of tax applying to all investment and business land[2] and in the long run, consider merging the land tax and the SDRT (if implemented).
13.7	Preparation of a discussion paper on a business cash flow tax, examining its potential for lower transaction and efficiency costs than payroll tax and also examining the compliance and enforcement implications that might arise if different states set different rates for a business cash flow tax.
13.8	Abolition of the indexation of the payroll tax threshold as a first priority, followed by reducing the threshold to a suitable economic level, with a corresponding reduction in the tax rate.
13.9	Increase reliance on road pricing as a source of revenue, using any additional revenue to reduce vehicle taxes. § In the short-term, introducing consistent tolling across all currently untolled sections of the Sydney Orbital Network with tolling reflecting the distance travelled, and incorporate a congestion price that varies by location and time of day. § In the medium-term, renegotiating existing toll concessions, to ensure consistent tolling across all of the Sydney Orbital Network with tolling reflecting the distance travelled, and incorporate a congestion price that varies by location and time of day. In the longer term, introduce a state-wide system of road pricing, with a base fee per kilometre for road use and a congestion supplement in congested areas that varies by time of day and location. Studies to implement such a system should begin immediately.
13.10	Consider means of accelerating reforms of heavy vehicle road pricing, including unilateral implementation of state-wide road usage prices for heavy vehicles operating in NSW.
13.11	Launch a feasibility study for the introduction of a state-wide system of road pricing, including a base element per kilometre, and a congestion charge element which varies by location and time of day. In the long run, use road pricing to eliminate all vehicle taxes and to fund improvements in roads and public transport.
13.12	Investigate mining industry interest in a potential revision of royalties, to provide companies that develop new mines with a choice between the existing royalties regime or an efficient resource rent tax.
13.13	Review the level of royalties for minerals subject to fixed dollar fees per tonne and provide for regular indexation of those tax rates.

[2] Starting from the current land tax threshold of $387,000, with annual inflation of 2.5 per cent the additional revenue generated from bracket creep (relative to current revenue forecasts), would be sufficient to abolish the 2 per cent top rate by 2018-19.

The Financial Audit recommends:	
13.14	Investigate Council of Australian Governments (COAG) interest in a process of constitutional reform to remove the constitutional prohibition on state excise taxes.
Tax reform process	
13.15	If major tax reforms are pursued, a consultative process be used to refine the reform details. This process would include issuing a Green Paper to set out the main options for public consultation, followed by a White Paper that sets out the Government's favoured options and invite comment on technical details. Draft legislation should be issued for comment before introduction into Parliament.
User charges	
13.16	Commission IPART to conduct a review of all NSW user charges that appear in the Budget as general government revenue, as well as mineral royalties that are not *ad valorem*. The review should: § identify principles for setting user charges, including efficiency considerations such as the management of demand and capacity § identify equity considerations which may suggest alternative levels for user charges § benchmark all user charges against these principles § identify instances where user charges should include a premium to reflect any external costs imposed on others, such as pollution under the 'polluter-pays' principle § suggest a mechanism for the regular centralised review and revision of user charges.
13.17	Phase in an adjustment of RailCorp fares to those allowed under the IPART determination in order to provide an appropriate level of user contribution as distinct from tax payer funding.
13.18	Review of the zonal structure of public transport fares, including the number and size of zones and the extent to which fares reflect distance travelled and set out and maintain a target level of user contributions to efficient operating costs.
13.19	Implementation of co-payments for a range of non-hospital services such as dental, community health and ambulance services, with appropriate concessions for low income earners.
Tax expenditures and concessions	
13.20	Removal of tax concessions for clubs, applying the same tax rates as for hotels.
13.21	Imposition of land tax on primary producers, with provisions for a gradual transition.
13.22	Investigate imposing payroll tax on hospitals, when national reforms of health funding are finalised, in order to ensure competitive neutrality.
National Partnerships	
13.23	Supporting the implementation of the recommendations of the Heads of Treasuries review of National Partnerships.

14. An Economic Development Strategy

The Financial Audit recommends:	
An Economic Development Strategy	
14.1	The preparation and promulgation of an Economic Development Strategy through a Green Paper process to be led by the Treasurer.

The Financial Audit recommends:	
Specific economic reform initiatives.	
14.2	The review of the *Environmental Planning and Assessment Act 1979* and associated regulations, focusing on incorporating economic principles, reducing uncertainty, promoting flexible land use zones and amending anti-competitive planning regulations that do not take into account market preferences.
14.3	A review and update be undertaken of the Metropolitan Plan as a matter of urgency to provide the necessary basis for a new Transport Plan as well as for broader Sydney region planning. This review should give proper weight to the role that market forces play in influencing the location of investment in housing and business.
14.4	A timely replacement for Part 3A of the *Environmental Planning and Assessment Act 1979* be implemented as a matter of priority with clear, economically sound principles for identifying state-significant projects and a transparent and independent decision making process.
14.5	A coordinated approval process be introduced for all projects above a certain scale – and involving multiple agency approvals – that draws upon approaches adopted in other jurisdictions, including the South-East Queensland Growth Management Initiative.
14.6	Noting the risk of continuing the rate pegging system, the State explores with IPART options to provide councils with greater financial flexibility.
14.7	High priority be given to regulatory reform and broadening of its scope to address gaps identified, including (but not limited to): § systematic review of significant new or existing primary legislation that currently have no statutory provision for periodic reviews (of the type mandated by the *Subordinate Legislation Act*) § systematic review of significant new or existing regulation in non-legislative forms § incorporating in the *Guide to Better Regulation* clearer guidance on the conduct of cost-benefit analysis of regulations § examining the scope to improve and make more transparent the process for selecting areas for future targeted reviews and improving dialogue with business and consumer groups. Further, that these tasks be undertaken by the newly established Microeconomic Reform Unit within Treasury under the supervision of an advisory board which will be responsible for formulating a microeconomic reform and competition policy agenda (encompassing the above tasks) and reporting periodically against that agenda to an appropriate Cabinet committee.
14.8	The application to industry assistance programs of a more consistent economically based process to assess and prioritise Government's initiatives for industry assistance on an *ex ante* basis (including stricter compliance with existing guidance on the preparation of business cases, the application of comprehensive cost-benefit analysis, rigorous value for money and public interest tests) and undertake systematic independent *ex post* evaluation of existing programs.
14.9	The State seek to ensure the Commonwealth takes primary responsibility for climate change mitigation and associated income support policies, with any state mitigation programs being complementary to Commonwealth programs. In turn, the NSW Greenhouse Gas Abatement Scheme (GGAS) be terminated with the introduction of a national carbon tax and/or emission trading scheme with Commonwealth compensation arrangements sought for GGAS participants.
14.10	NSW recommit to the existing Interstate Investment Cooperation Agreement which expires in September 2011.

The Financial Audit recommends:	
14.11	In support of human capital development, priority be given to Vocational Education and Training (VET) reforms including increasing contestability and productivity improvements to make TAFE more competitive with private providers.

15. Reforming service delivery

The Financial Audit recommends:	
Principles for effective service delivery	
15.1	The following principles be adopted across government for guiding service delivery policy, planning and operations: § proactive and innovative rather than reactive service delivery, with a focus on prevention and early intervention § devolution of service delivery decision making to as close as possible to the level of interface with clients § good governance, including separation of the purchasing from the provider functions to provide a focus on the needs of the client uncompromised by the interests of the service provider and to allow for contestability in service provision § a focus on continuous improvement in efficiency § regular evaluations being undertaken on the effectiveness and appropriateness of programs § transparency with respect to performance.
15.2	The Government undertakes a pilot study on implementing an appropriate charge on capital for budget-dependent agencies. The outcomes of this pilot study would be evaluated by Government to determine the appropriateness of implementing a capital charging framework across relevant government departments
Benchmarking	
15.3	Performance benchmarks be established for general government and non-commercial public trading enterprise sector agencies to provide the information base to facilitate an assessment of efficiency and effectiveness in service provision.
Proactive and innovative service delivery	
15.4	Central agencies promote full assessment of proactive and innovative approaches in the human services, health and justice areas. Where there is compelling evidence for the effectiveness and efficiency of proposed proactive and innovative programs, they should be brought to the attention of Cabinet and the Expenditure Review Committee of Cabinet.
15.5	The NSW Government assess the feasibility of a trial of social impact bonds in a number of areas including preventing juvenile reoffending and reducing entry to out of home care.
15.6	Treasury and relevant agencies identify a small number of areas in which application of behavioural economics could result in more effective programs and work with relevant parties to examine the potential for pilot program reforms.
Devolution	
15.7	Noting the Better Schools devolution trial in the schools area, all government agencies be required to investigate and report back to the Expenditure Review Committee of Cabinet on opportunities for further devolution of service delivery.

The Financial Audit recommends:	
15.8	A full review of the spatial delivery of services both within metropolitan areas and regional locations be undertaken by a Taskforce led by the central agencies with a view to: § achieving multi agency co-location of services § rationalisation of the spatial location of specialist facilities such as police stations, schools, hospitals, research stations to achieve the most efficient and effective provision of services, with greater use of alternative technology to provide assistance and information to the community.
Good governance	
15.9	The Central Agencies work with government departments to investigate opportunities to utilise purchaser-provider arrangements for delivery of government services at better value to the State.
15.10	The Central Agencies establish a Task Force to review opportunities to improve the contracting and governance frameworks for service delivery purchased from the private or NGO sectors, including but not limited to: § implementation of performance-based contracting § increasing accountability, transparency and performance monitoring § streamlining contract management and administration arrangements, including minimising 'red tape' and establishing 'centres of excellence' in grants administration and contracts management across government.
15.11	RailCorp, the State Transit Authority (STA) and the Roads and Traffic Authority (RTA) be corporatised with high quality, commercial boards established under a commercial charter, with arms length service delivery agreements with the Department of Transport, based on phasing out inefficiency costs in the provision of services.
Efficiency	
15.12	All government departments continue investigating opportunities for market testing and contracting with the private sector and NGOs for services.
15.13	General government sector-wide efficiency dividends be replaced with a more targeted approach to agency savings, with the Expenditure Review Directorate of Treasury having responsibility for working with agencies on a rolling program of agency efficiency evaluation, reporting to the Expenditure Review Committee of Cabinet.
15.14	Appropriate line-agency Project Management Offices and a NSW Treasury Central Program Management Office be established to drive effective monitoring and delivery of agency-specific and whole-of-government reforms and initiatives.
15.15	The establishment of central corporate and shared services businesses within clusters, noting the plan to establish six such businesses, with a consistent approach to systems and an appropriate governance structure featuring a single commercial board of suitably experienced independents oversighting all six businesses. The board would be responsible for driving efficiency improvements and benchmarking against best practice, including possible further consolidation of the businesses.

The Financial Audit recommends:	
Effectiveness	
15.16	The establishment of a new policy framework to drive NSW Government program evaluation which includes an Independent Evaluation Office with the following features: § a Board of Governance reporting directly to the Premier that is comprised of a majority of independent members to support independence of the Office § responsibility to undertake, contract and support rigorous evaluation of Government programs § responsibility to assist with and analyse development of enhanced rigorous evaluation capacity within agencies, including the ability to effectively contract independent program evaluation § powers under legislation to require agencies to provide necessary program information § establishment legislation that mandates that the Independent Evaluation Office provides guidance to promote transparency and public evidence on the performance of government programs.
15.17	Introduction of cost-benefit analysis requirements and guidelines for all new recurrent projects and programs, including the delineation of an evaluation process that is undertaken within a defined period of establishment.
Transparency	
15.18	Treasury to review current program information of general government agencies and work with general government agencies to develop comprehensive program information.
15.19	Treasury to establish a direct link to program information held by agencies as well as financial information in general and access to agency program information be made available to the other central agencies and to the Independent Evaluation Office.
15.20	The development of a suite of benchmark performance information for general government, non-commercial public trading enterprise sector agencies and major programs.
15.21	The IEO set out in its annual report the work undertaken in program evaluation and provide a commentary on the state of development of program evaluation.
Agency-specific	
15.22	NSW Health to accelerate benchmarking to reduce cost variation, targeting best practice cost, and expansion of activity-based funding as a tool to improve the efficiency of health service through purchaser-provider arrangements.
15.23	NSW Health to work with Local Health Districts (LHDs) to undertake a service review with the aim of implementing service realignments and re-configurations that will improve cost effectiveness, safety and sustainability of services by consolidating and networking services where clinically appropriate.
15.24	An Independent Re-configuration Board be established to advise the Minister for Health on contested proposals for health service changes proposed for LHDs to improve services.
15.25	NSW Health to support LHDs in developing integrated plans to meet health needs of local communities. These should include purchaser-provider arrangements with local private hospitals, primary health care services and Medicare Locals.
15.26	NSW Health to market test non-clinical services such as food, linen, security, facility management and maintenance to ascertain where contracting out of these services can improve cost effectiveness and efficiency within the health system.

The Financial Audit recommends:	
15.27	NSW Health to ensure that plans to increase the autonomy of LHDs are accompanied by: § strong accountabilities to ensure performance incentives drive value for money and budget discipline § strong information and research systems to support benchmarking, evaluation and dissemination of best practice § strategies to build clinical leadership at a local level and purchasing and strategic capacity at a head office level § limited use of ministerial and departmental direction on service delivery and development matters, with more decisions made by LHDs § networking efforts across LHDs to achieve economies of scale.
15.28	The Department of Family and Community Services (FaCS) to reform the Out of Home Care (OOHC) purchaser-provider model to significantly expand purchasing from the NGO sector of OOHC (outplacement of children at risk) placements and deliver a lower average cost than currently achieved in NSW. This requires improved contracting practices and capabilities within FaCS and could be achieved by the already established taskforce to drive reforms and engage with NGOs and other involved parties.
15.29	FaCS to review the policy settings and child protection data in other jurisdictions to assess why the number of children in OOHC in NSW is higher than in other jurisdictions. This review should also assess the appropriateness of the balance of resources between family support services and child protection services and effectiveness of family support services.
15.30	The roll-out of individualised funding in FaCS for disability services be accelerated following a review of implementation in other jurisdictions. The scope for a broader roll-out of individualised funding across other human services areas, including Health, should also be investigated.
15.31	Full contestability be implemented for RTA and RailCorp maintenance operations and other suitable inputs to private providers to achieve better value for money.
15.32	Noting the proposed franchising of ferry operations, together with increased contestability, consideration be given to implementation of contestability of whole transport operations through franchising, once current major inefficiencies have been removed.
15.33	Planning Reform Fees and Development Assessment Fees charged by the Department of Planning and Investment (DPI) be banked as Crown receipts, with DPI being fully funded from the Budget to improve accountability and transparency.
15.34	A comprehensive review of planning fees be undertaken as part of the upcoming review of the *Environmental Planning and Assessment Act 1979*.
15.35	A CEO Committee, reporting to Cabinet, be established to oversee the Government's Murray Darling Basin Plan.
15.36	A full assessment of all energy renewable programs be conducted in relation to cost-benefits and their relevance in the context of contemporary Commonwealth policy direction such as the proposed introduction of a carbon tax.
15.37	Cessation of the police authorised strength concept, allowing the Police Commissioner greater authority and flexibility to determine matters of staffing structure and deployment to meet current needs and resources.
15.38	NSW Police implement reforms to increase flexibility in police rostering, allowing better capacity to better match resources with demand across the Local Area Commands.

The Financial Audit recommends:	
15.39	The Police Death and Disability Scheme and associated other equivalent schemes be the subject of major reform to make it affordable, equitable and provide the appropriate incentives to return police to work in as timely a manner as possible, modelled on the successful programs in other jurisdictions.
15.40	Review existing governance arrangements across art, sport and recreation entities with a view to rationalising the number of individual agencies and governing trust boards to maximise shared service arrangements and improve resource allocation.
15.41	Develop and implement purchaser-provider arrangements between Arts NSW and cultural institutions, with an in-built system of integrated planning and budgeting.
15.42	Implement the proposed changes to the Government's User Charges for Special Events, developed through an inter-agency working group in 2010.
15.43	IPART undertake a full review of all concessions and community service obligations (CSOs) and develop an economic framework for the assessment of concession programs.

16. Improving asset management and prioritisation and effectiveness of capital expenditure

The Financial Audit recommends:	
Improved effectiveness and prioritisation of capital expenditure	
16.1	The following priorities be established for Infrastructure NSW: § undertake an audit of the existing infrastructure asset stock, including future demands and the identification of key gaps § revise the State Infrastructure Strategy to provide a 10- to 20-year context of key emerging service deficiencies and community priorities § develop/update a 10-year Infrastructure Plan, including total capital expenditure estimates by sector, through the review and prioritisation of agencies' Total Asset Management plans § review agencies' project evaluations to facilitate prioritisation of funding and the development of five-year agency infrastructure plans (aligned to budget estimates) § co-ordinate planning between sectors to facilitate efficient and timely project delivery § ensure compliance for all significant capital projects with the Gateway process set out in the State's Procurement Policy.
16.2	The option of the use of a privately funded projects (PFP) approach for infrastructure projects can be considered once a project has been fully evaluated and endorsed, with the choice of a PFP approach based on achieving value for money and appropriate risk allocation.
16.3	A rigorous contractor capability assessment be undertaken for all significant capital projects, including PFPs, to ensure its selected contractor has the full capability to undertake the role.
16.4	Noting the circumstances under which a PFP should be considered (refer to section 8.2) and that PFPs can be effective approach for managing major project risk and cost, consideration be given to refining the availability model to substitute to an appropriate extent public sector for private sector debt at the end of the construction stage.
16.5	Require that any draft asset or reliability standards that will have a material impact on state capital expenditure be the subject of a full cost-benefit analysis by Infrastructure NSW, with the agency responsible for setting the standard required to have full regard to the cost-benefit analysis.

The Financial Audit recommends:	
16.6	Infrastructure NSW to work with the Department of Transport on the development of the state's Transport Master Plan, having full regard to the revised Metropolitan Strategy. This should include a full review of the North West Sector rail project to ensure it is assessed in a holistic manner having full regard to the total system wide implications of the project.
16.7	Full consideration should be given to using the private sector to design, construct, maintain and possibly operate the North West Rail line.
16.8	Re-affirm that agencies' Total Asset Management Strategies include plans to appropriately rationalise their asset bases.
16.9	Direct the Department of Transport, in consultation with Infrastructure NSW and IPART, to develop strategies and supporting analysis for the application of appropriate pricing signals across the Transport network, with an objective of reducing peak congestion and increase utilisation in off-peak periods.
16.10	Require as a precondition of funding that all material capital projects have undertaken the Gateway assessment.

17. Workforce management and wages policy

The Financial Audit recommends:	
17.1	Noting that the recent wages policy reform is consistent with the policy that applied previously but addresses the deficiencies that made it not fully effective and so should assist in maintaining suitable public sector wages restraint.
17.2	The Public Service Commission consider options to decentralise bargaining for the Crown Salaries Award, taking into account possible adverse impacts on workforce mobility.
17.3	The Department of Premier and Cabinet amends the *NSW Public Sector Wages Policy 2011* to include a provision that additional staff ratios, workforce management policies and death and disability benefits should not be included in industrial instruments.
17.4	The Public Service Commission review the *Public Sector Employment and Management Act 2002* and other relevant employment legislation to support the application of the new *Managing Excess Employees Policy* across the entire public sector and not just the core public service.
17.5	The Public Service Commission introduce new performance management arrangements to: § link salary more closely to the level of employee performance § improve processes to ensure that jobs are matched with employee capabilities § improve processes to recognise and reward good performance § simplify processes for managing poor performance § standardise performance review processes across agencies for executive and non-executive employees § reinforce the distinction between redundancy and redeployment and performance management.
17.6	The Public Service Commission introduce new workforce management arrangements to: § appoint employees to a substantive remuneration level rather than a specific position § extend employment contracts to senior officers below the Senior Executive Service § require all agencies to prepare detailed workforce management plans and better monitor movements in workforce composition § ensure managers have flexibility to direct resources to areas of service need.

The Financial Audit recommends:	
17.7	The Department of Premier and Cabinet review the integrity of workforce profile data and improve governance arrangements to: § make the data more accessible across the sector § improve processes to rectify data quality issues.
17.8	The Public Service Commission conduct a detailed review of employment conditions to identify and quantify reform opportunities across the sector. This should include: § a cross-jurisdictional review of award entitlements and salaries for individual employee groups § a cross-jurisdictional review of employment conditions included in state-based legislation, including a comparison with National Employment Standards covered in the *Fair Work Act*.

18. Balance sheet management

The Financial Audit recommends:	
Sale or lease or restructure of businesses	
18.1	All proceeds from the sale or lease of income generating businesses be used in a financially sustainable manner either by retirement of debt, funding net superannuation liability or investing in financial assets, with only any excess above retention value and income generated used as a funding source.
18.2	Having regard to the findings of the Judicial Review into the Electricity Transactions, proceed with the long-term lease or sale of the generator businesses, including those subject to GenTrader agreements and the sale or long term lease of the network businesses rather than the merger of the distributors.
18.3	The State prepare a broad development plan for the Cobbora coal mine, allowing appropriate commercial flexibility while defining the requirements of the GenTraders as core customers, then seek proposals from the private sector for the divestment of the mine site and its development and operation.
18.4	Enter into discussions with the two other shareholding governments, the Commonwealth and Victoria, with a view to obtaining agreement to the sale of Snowy Hydro.
18.5	IPART establish a suitable price path and undertake a review of the regulatory instruments for Sydney's bulk water supply market and, following that, undertake a long term lease or sale of Sydney Desalination Plant Pty Ltd.
18.6	Investigate transferring Sydney Catchment Authority, a bulk water supplier to Sydney Water Corporation, into Sydney Water Corporation, subject to retaining full transparency in respect to the costs of each component of the business.
18.7	Separate the Forests NSW plantation business from the Department of Primary Industries, then corporatise and execute a long term lease of the business.
18.8	Establish a light-handed regulatory regime for NSW Ports, including greater pricing autonomy, consultation with users on proposed pricing changes and provision for regulator intervention if there is evidence of port businesses misusing market power.
18.9	The role and strategic direction of each port be established within an overall state ports strategy.
18.10	Seabed and channels be vested in the port corporations or provided for under a long-term lease and the current channel charge payable to NSW Maritime be removed.

The Financial Audit recommends:	
18.11	Subject to achieving recommendations 18.7, 18.8 and 18.9, long-term leases be established for each of the ports, with the private sector assuming the lessee role.
Property management	
18.12	All new office accommodation over 1,000m^2 achieve a maximum space utilisation of 14m^2/person unless the agency can demonstrate a clear service delivery requirement for higher space utilisation, to be approved by the Government Asset Management Committee.
18.13	State Property Authority publish an annual table of agency space utilisation performance.
18.14	Where an agency determines that it must exceed the 14m^2/person target for operational reasons, a business case be submitted to the Government Asset Management Committee for approval.
18.15	All car parks, depots, warehouses and motor registries be assessed to determine the benefits of vesting these assets to the State Property Authority (SPA).
18.16	The State Property Authority, in consultation with the NSW Police Force, develop a business case to determine the costs, benefits and any other implications (particularly maintenance costs) for the vesting of the entire Police property portfolio (including operational property) and make recommendations to the Expenditure Review Committee.
18.17	The current review of the *State Property Authority Act 2006* includes review of any parts of the Act that may impede vesting of operational property to SPA (particularly in relation to Crown Land).
18.18	An assessment be undertaken of the rationale of the in house property management function within SPA relative to the full property management function being outsourced to the private sector.
18.19	SPA review selected major SPA owned assets to identify opportunities for the disposal of more property.
18.20	Establishment of a task force to identify potential relocation opportunities and develop business cases for consideration by Government. The task force should include membership from the Department of Premier and Cabinet, NSW Treasury, Department of Finance and Services and the Department of Planning.
Infrastructure Fund	
18.21	A full review be undertaken of the option of establishing the NSW Infrastructure Fund, under the management of Treasury Corporation, with the transfer of suitable infrastructure assets to the fund as a means of funding net superannuation liabilities and new income generating infrastructure assets.
Funds management	
18.22	A Treasurer's direction be issued under Section 9 of the *Public Finance and Audit Act 1987* requiring all general government agencies to undertake new investments through Treasury Corporation.
18.23	The Judges Pension Scheme, the Parliamentary Contributory Superannuation Scheme and the defined benefit component of the Energy Industries Superannuation Scheme (EISS) be consolidated into the State Superannuation Scheme, with the accumulation component of EISS transferred to First State Super.
18.24	Undertake a review involving the Compensation Authorities, Treasury and NSW Treasury Corporation to seek to establish a central, professional investment function.

The Financial Audit recommends:	
18.25	In the event that there is a desire to have greater strategic input to the risk-return trade-off decision in respect to State Super investments, consider the option of transferring the investment function of the State Superannuation Trustee Corporation to NSW Treasury Corporation, with an external, independent Investment Committee established to oversee the investment function. This function would be subject to a statement of risk-return objectives established by the Treasurer.
Liability Management	
18.26	Confirm the Government's commitment to achieve full funding of superannuation liabilities by 2030.
18.27	Representation be made at the highest level to the Australian and International Accounting Standards Boards to have accounting standard AASB119 reflect the underlying financial position with respect to unfunded superannuation liabilities.
18.28	Noting that the liability for the Work Cover scheme is correctly recognised in the Total State Sector Financial Statement.
18.29	Noting that the liability for superannuation in the Total State Sector Financial Statements reflects the unfunded liability in respect to employment service to the present time but does not reflect future service liability.
18.30	Noting that the Total State Sector Financial Statements will need to record a contingent liability arising from the electricity sale transaction in regard to Availability Liquidated Damages which is estimated at $360 million in present value terms.
18.31	Noting that the State is under no obligation to guarantee or support the financial position of Reliance Rail, the counter party in the Waratah Rail contract, but prudence would support developing contingency plans that have regard to the risk of insolvency of the credit wrappers or the failure of Reliance Rail to draw down the next tranche of debt, which is due in February 2012.
18.32	Noting that there is an unfunded liability in respect to NSW-based universities' superannuation liabilities, which is substantially a Commonwealth liability but has not been formally recognised as such by the Commonwealth. The State, as a matter of urgency, should seek to have the Commonwealth agree to an independent actuarial review of the university superannuation liability as a matter of urgency in order to resolve the distribution of liabilities between the Commonwealth and NSW.
Other balance sheet matters	
18.33	Noting the substantial negative impact of the proposed carbon tax on the value of the state owned generators and seek agreement with the Commonwealth on suitable compensation.
18.34	A full strategic and financial evaluation be undertaken of the proposal to transfer the major part of public housing assets to community housing trusts

19. Improved state owned corporation governance and performance

The Financial Audit recommends:	
Governance	
19.1	An annual meeting between the shareholders and the chair and CEO of each SOC be held to review past year performance, discuss and agree on major initiatives and strategic directions for businesses and approve the Statement of Corporate Intent.

The Financial Audit recommends:	
19.2	Establishment of a revised board appointment process which is merit-based, transparent, addresses the specific skills and experience requirements of each board and allows for board input through the chair.
19.3	All SOCs be subject to the *Corporations Act* through the operation of the Company SOC provisions of the *SOC Act*.
19.4	Centralisation of governance provisions for SOCs in the *SOC Act* and removal from enabling legislation (including objectives of SOCs, provisions for issuing directions, the size and composition of boards and roles and responsibilities of shareholder and portfolio ministers), updating the *SOC Act* to reflect best practice.
19.5	Establish a transparent process for requiring SOCs to take into account state policies. This approach should reflect the Queensland approach that seeks the advice of the SOC on the commercial implications of requirements before the approval of the shareholding minister is sought to its imposition.
19.6	A Register of Directions be maintained by Treasury in addition to publication in the Government Gazette as provided in Section 20P(5) of the *SOC Act*.
19.7	Businesses be compensated for non-commercial activities that they are directed to undertake, subject to funding approval through the annual budget process.
19.8	The costs to SOCs of meeting all non-commercial directions be disclosed in annual reports and Treasury's financial performance evaluation is adjusted in line with the costs of these activities.
19.9	The approach to CEO and board remuneration be reviewed with CEO remuneration more closely linked to performance and the appropriate quantum of board remuneration based on businesses of comparable risk, complexity, scale and profitability.
SOC performance	
19.10	An equity hurdle rate be established and maintained for each SOC, reflecting its risk characteristics.
19.11	Treasury implement a consistent approach to analysing SOC performance and shareholder returns, with a standardised template applied to all SOCs/PTEs.
19.12	Return on invested capital be used as the primary performance evaluation measure for commercial PTEs including SOCs.
19.13	For regulated SOCs, capital expenditure and operating expenditure forecasts be explicitly compared with those allowed by the regulator.
19.14	SOCs/PTEs be required to provide scenario analysis as part of their Corporate Plan and Statement of Corporate Intent/Statement of Business Intent forecasts.
19.15	Annual indicative valuations of the equity in each SOC/PTE be prepared based on 10-year forecasts and provided in Statement of Corporate Intent (SCI) documentation. These forecasts should initially be prepared by Treasury then later by SOCs/PTEs.
19.16	Performance information be published in an Annual Portfolio Report of SOCs, prepared by Treasury, so as to strengthen accountability and incentives. This could include key performance metrics relevant to other stakeholders to indicate factors influencing pricing, service standards and financial returns to government.
Compliance with COAG Requirements	
19.17	The NSW Government should undertake a review to ensure all SOCs fully comply with the *Competition and Infrastructure Reform Agreement* and *Competition Principles Agreement.*

PART A: SETTING THE SCENE

Part A sets the institutional and factual scene for the report, providing an explanation of the structure of the public sector in NSW and of budget and capital program trends.

An outline is also provided of the State balance sheet and the general government balance sheet. The balance sheet represents the accumulation of previous decisions with respect to revenue, expenditure and financings and provides a potential buffer to absorb external economic and financial shocks without the need to adjust expenditure and taxation parameters.

Various fiscal targets have applied over the years in NSW and the outcome against each of these is reported in Chapter 5.

Finally, a broad outline of the performance of the State economy is provided in Chapter 6. The State Government is not able to manage the macro or aggregate demand and production performance of the State economy but is able to influence its performance through micro economic policy, directed at improving the functioning of markets and increasing productivity. In turn, a healthy economy will generate additional revenue and reduce the demand for social services, hence assisting State financial performance.

1 OVERVIEW OF THE NSW PUBLIC SECTOR

Key points

- The total state sector comprises:
  - the general government sector
  - the public trading enterprise sector
  - the public financial enterprise sector.
- The classification of entities into these sectors is determined by the activities undertaken and sources of funding used to finance this activity. The Australian Bureau of Statistics Government Finance Statistics (GFS) framework is used to determine the sectoral classification of entities.
- The general government sector undertakes policy, regulatory and provision of services functions. These usually relate to merit or public goods with broadly universal access and funding mainly from the Budget.
- In NSW, the general government sector agencies are arranged into nine clusters of broadly aligned agencies.
- The key areas of the general government sector in terms of recurrent expenditure are health, education, public order and transport, which broadly account for 70 per cent of total expenditure.
- In terms of capital expenditure, the main category is transport, which accounts for 50 per cent of all general government capital expenditure. Health and education account for a further 26 per cent.
- Over the past 10 years, budget revenue has increased at an average of 5.6 per cent per annum but has been quite volatile. General government expenditure has increased by 6.2 per cent per annum over the same period, but by 6.4 per cent per annum since 2005-06.
- The public trading enterprise (PTE) sector incorporates commercial PTEs (which includes State owned corporations) and non-commercial PTEs.
- The commercial PTE sector is a significant contributor to State Budget general government revenues, generating a forecast $5.6 billion in dividends and tax equivalent payments and government guarantee fees in 2010-11.
- The commercial PTE sector is also responsible for an increasing share of total state borrowings and capital expenditure.

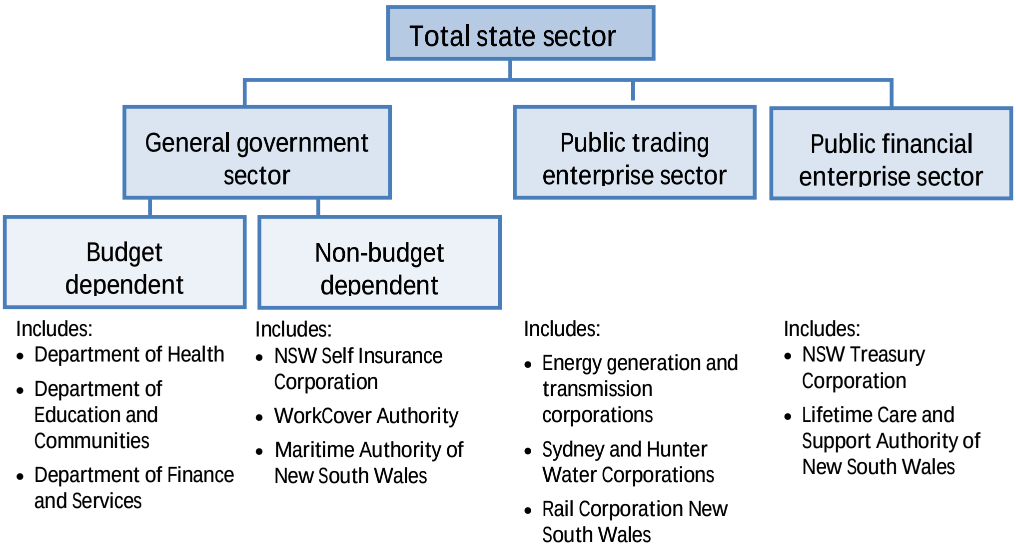
- State owned corporations (SOCs) are commercial PTEs that operate under a governance framework that seeks to establish independence from government and impose private sector incentives and disciplines.
- The capital program consists of both the general government program, which is budget-funded, and the PTE sector program. It is important to distinguish between the commercial and non-commercial PTE sectors, with the former funded by a combination of profits and borrowings while the latter is in the main funded by capital grants from the Budget.
- The total state capital program in 2010-11 is estimated at $16.6 billion, consisting of $7.7 billion for the general government sector and $8.9 billion for the PTE sector ($3.3 billion for non-commercial PTEs and $5.6 billion for commercial PTEs).

1.1 Overview of the total state sector

Total state sector

The structure of the total state sector as it relates to NSW Government entities is presented below.

Figure 1.1.1 Structure of the total state sector



General government sector

Agencies in the general government sector are fully included in the Budget and operate under Treasury's Financial Management Framework. All the financial transactions of this sector make up the budget result (as well as the other fiscal aggregates for the general government sector).

The distinction between budget and non-budget agencies is not a Government Finance Statistics (GFS) concept but is adopted by Treasury to reflect which agencies receive a direct appropriation from the Consolidated Fund.

The characteristics of the goods and services of general government agencies are:

- generally non-market in nature being a pure public good (e.g. law and order) or a merit good (e.g. cultural institutions, education and health), regulatory in nature (e.g. safety or licensing authorities), public policy (Premier and Cabinet, Treasury) or provide services to the public sector (Department of Finance and Services)
- provided on a universal basis, focusing on equity and accessibility. Access is often free (e.g. public education and hospitals) or at a heavily subsidised price (e.g. public transport and entry to cultural institutions and national parks have user contributions but overall, the services are heavily subsidised).

Some agencies provide services primarily to other general government agencies (e.g. Businesslink).

PTE sector

The PTE sector[1] comprises two distinct sub-sectors:

- commercial PTEs, which are government-controlled entities that are self-funded from user charges and have a commercial charter
- non-commercial PTEs, which are government controlled entities where the general government sector provides operating subsidies and capital grants.

Commercial entities operate under Treasury's Commercial Policy Framework. This aims to replicate disciplines and incentives that lead private sector businesses towards efficient commercial practices. The commercial agencies in this sector generally pay dividends and tax equivalent payments to the general government sector, in accordance with normal commercial principles.

Commercial PTEs receive most of their income from customers. They are able to finance their operations and capital expenditure from own-source revenue and borrowings. Commercial PTEs cover government businesses in sectors including electricity, water, ports and property. These include State owned corporations governed by the *State Owned Corporations Act 1989.* The Government represents the people of NSW as shareholder of these businesses and so expects an appropriate return on its investment. This return is used to fund core government services.

Non-commercial PTEs receive budget funding to meet policy objectives agreed with the Government when revenue is insufficient to meet operating expenses or capital expenditure. Non-commercial PTEs include government businesses in transport (excluding ports) and social housing.

[1] The PTE sector is also referred to by the ABS as the 'Public Non-Financial Corporation Sector'.

PFE sector

Public financial enterprises[2] (PFEs) are government-controlled entities that perform financial functions, or accept demand, time or savings deposits, or have the authority to incur liabilities and acquire financial assets in the market on their own account.

The major NSW PFEs are NSW Treasury Corporation, the state's central borrowing and investment authority, and the Lifetime Care and Support Authority, which provides treatment, rehabilitation and attendant care services to people severely injured in motor accidents.

Key aggregates and classification of agencies

Below are the key economic aggregates for the key parts of the overall state sector.

Table 1.1.1 Key aggregates of the state sector

	General Government Sector	Public Trading Enterprise Sector	Public Financial Enterprises
2010-11 Half-Yearly Review			
Total expenses	$56 billion	$20 billion	$4 billion
Total revenue	$57 billion	$20 billion	$4 billion
Capital expenditure	$8 billion	$9 billion	$0
Total assets	$238 billion	$127 billion	$65 billion
Employment [(a)]	344,000	42,000	

(a) Rounded estimates using NSW DPC 2009-10 Workforce Profile (v2010.11.02) Table 8 Size of Workforce. PFEs are not separately identified in the workforce profile collection. PFE employee numbers are captured within the public trading enterprise sector.

2 The PFE sector is also referred to by the ABS as the 'Public Financial Corporation Sector'.

The following table outlines the classification of significant entities within the NSW state sector, by ABS and funding category.

Table 1.1.2 Schedule of agencies by classification

	General government	Public trading enterprises – commercial	Public trading enterprises – non-commercial	Public financial enterprises
Aboriginal Housing Office	•			
Art Gallery of New South Wales	•			
Attorney General and Justice, Department of	•			
Audit Office of New South Wales	•			
Ausgrid		•		
Australian Museum	•			
Barangaroo Delivery Authority	•			
Board of Studies, Office of the	•			
Cancer Institute NSW	•			
Casino, Liquor and Gaming Control Authority	•			
Catchment Management Authorities	•			
Centennial Park and Moore Park Trust	•			
City West Housing Pty Limited			•	
Cobbora Holding Company Pty Ltd		•		
Community Relations Commission of New South Wales	•			
Compensation Authorities Staff Division	•			
Country Rail Infrastructure Authority			•	
Crime Commission, New South Wales	•			
Crown Finance Entity	•			
Delta Electricity		•		
Education and Communities, Department of	•			
Electoral Commission, New South Wales	•			
Electricity Tariff Equalisation Ministerial Corporation	•			
Endeavour Energy		•		
Environmental Trust	•			
Eraring Energy		•		
Essential Energy		•		
Events New South Wales Pty Limited	•			
Fair Trading Administration Corporation				•
Family and Community Services, Department of	•			
FANMAC Trusts				•
Film and Television Office, New South Wales	•			
Finance and Services, Department of	•			
Fire and Rescue, New South Wales	•			
Food Authority, NSW	•			
Forests NSW		•		
Health Care Complaints Commission	•			
Health, Department of	•			
Historic Houses Trust of New South Wales	•			
Home Care Service of New South Wales	•			
Home Purchase Assistance Fund	•			
Hunter Development Corporation	•			
Hunter Region Sporting Venues Authority		•		
Hunter Water Corporation		•		
Illawarra Venues Authority		•		

	General government	Public trading enterprises – commercial	Public trading enterprises – non-commercial	Public financial enterprises
Independent Commission Against Corruption	•			
Independent Pricing and Regulatory Tribunal	•			
Independent Transport Safety and Reliability Regulator	•			
Information and Privacy Commission	•			
Judicial Commission of New South Wales	•			
Land and Housing Corporation, New South Wales			•	
Landcom		•		
Legal Aid Commission of New South Wales	•			
Legislature, The	•			
Liability Management Ministerial Corporation	•			
Lifetime Care and Support Authority of New South Wales				•
Long Service Corporation	•			
Luna Park Reserve Trust	•			
Macquarie Generation		•		
Maritime Authority of New South Wales	•			
Minister Administering the Environmental Planning and Assessment Act	•			
Motor Accidents Authority	•			
Museum of Applied Arts and Sciences	•			
Natural Resources Commission	•			
Newcastle Port Corporation		•		
NSW Businesslink Pty Limited	•			
NSW Trustee and Guardian	•			
Ombudsman's Office	•			
Parramatta Stadium Trust		•		
Planning and Infrastructure, Department of	•			
Police and Emergency Services, Ministry for	•			
Police Force, NSW	•			
Police Integrity Commission	•			
Port Kembla Port Corporation		•		
Premier and Cabinet, Department of	•			
Primary Industries, Department of	•			
Public Prosecutions, Office of the Director of	•			
Public Transport Ticketing Corporation			•	
Rail Corporation New South Wales			•	
Redfern-Waterloo Authority	•			
Rental Bond Board	•			
Residual Business Management Corporation		•		
Roads and Traffic Authority of New South Wales	•			
Royal Botanic Gardens and Domain Trust	•			
Rural Assistance Authority, New South Wales	•			
Rural Fire Service, Department of	•			
Self Insurance Corporation, New South Wales	•			
State Emergency Service	•			
State Library of New South Wales	•			
State Property Authority	•			
State Records Authority	•			
State Transit Authority			•	

	General government	Public trading enterprises – commercial	Public trading enterprises – non-commercial	Public financial enterprises
State Water Corporation		•		
Superannuation Administration Corporation	•			
Sydney Catchment Authority		•		
Sydney Cricket and Sports Ground Trust		•		
Sydney Ferries			•	
Sydney Harbour Foreshore Authority		•		
Sydney Metropolitan Development Authority	•			
Sydney Olympic Park Authority	•			
Sydney Opera House Trust		•		
Sydney Ports Corporation		•		
Sydney Water Corporation		•		
Teacher Housing Authority			•	
Trade and Investment, Regional Infrastructure and Services, Department of	•			
TransGrid		•		
Transport Construction Authority			•	
Transport Safety Investigations, Office of	•			
Transport, Department of	•			
Treasury Corporation, NSW				•
Treasury, The	•			
Waste Assets Management Corporation		•		
Western Sydney Parklands Trust	•			
WorkCover Authority	•			
Workers' Compensation (Dust Diseases) Board	•			
Zoological Parks Board		•		

SAS Trustee Corporation is not included in the above table because it is not a controlled entity of the NSW Government. Its board has a fiduciary duty to members of the superannuation schemes. Accordingly, its assets and liabilities are not included in the state's financial statements. However, the value of its net liabilities is included in the financial statements of the Crown Finance Entity.

Local government

Local government is not constitutionally independent of the State Government. However, amendments to the NSW *Local Government Act 1993* introduced significant reforms in the 1990s which were designed to improve the financial independence of councils and support microeconomic reform of local government businesses.

Notwithstanding these improvements, local government finances still represent some risks for the State Government, which will need to be managed going forward:

- unlike in the other large states (Victoria, Queensland, Western Australia), local rate pegging remains in effect in NSW. While the recent delegation to the Independent Pricing and Regulatory Tribunal (IPART) of the rate pegging function improves the likelihood of the rate peg more accurately reflecting councils' cost base, the adequacy of the rate peg will ultimately depend on how IPART administers this responsibility

- the audit of council infrastructure backlogs commissioned by the Government raises the issue of how councils will fund these backlogs as well as meet future infrastructure needs. The Government's election commitments include a proposal for a capped interest rate subsidy. However, this may bear no relation to the capital funding needs of individual councils.

To help address these issues, the Government could consider, among other things:

- designing the interest rate subsidy (or any other form of assistance to councils) in ways that minimise or appropriately manage consequent risks to the state – e.g. through adequate specification of eligibility criteria, allowable purposes, repayment terms and other conditions under which assistance is provided to councils
- ensuring sufficient flexibility with respect to local rate setting, providing greater ability for councils to impose a special levy (as opposed to normal rates) to fund any infrastructure backlogs
- encouraging councils with sufficient debt serving capacity to judiciously use borrowings to fund their infrastructure needs, as opposed to the 'zero debt' strategy currently practised by some councils. This is likely to result in more efficient use of available capital funding resources
- providing greater flexibility to councils to vary their rates, noting that rigid application of rate pegging to a core index is unsustainable in the long run.

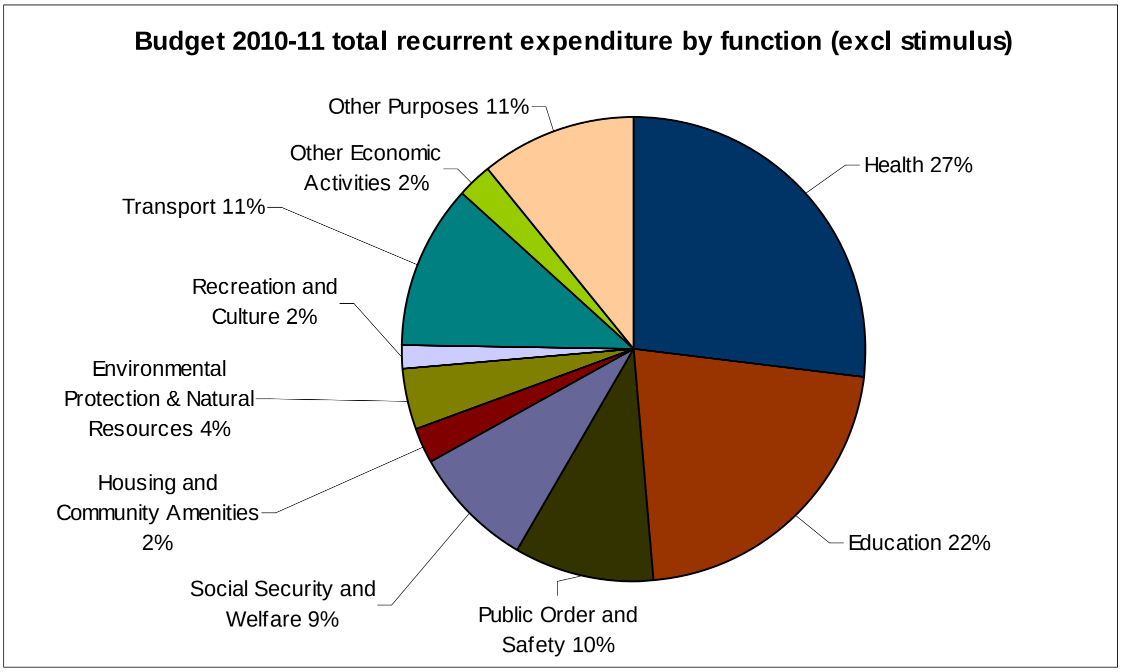
1.2 General government sector

Overview of the general government sector

The general government sector provides services and infrastructure in such areas as health, education, community and disability services, police and justice, environment services and roads as well as subsidies for public transport services. Some agencies have purely a regulatory function (e.g. IPART) or provide services primarily to other general government agencies (e.g. Businesslink).

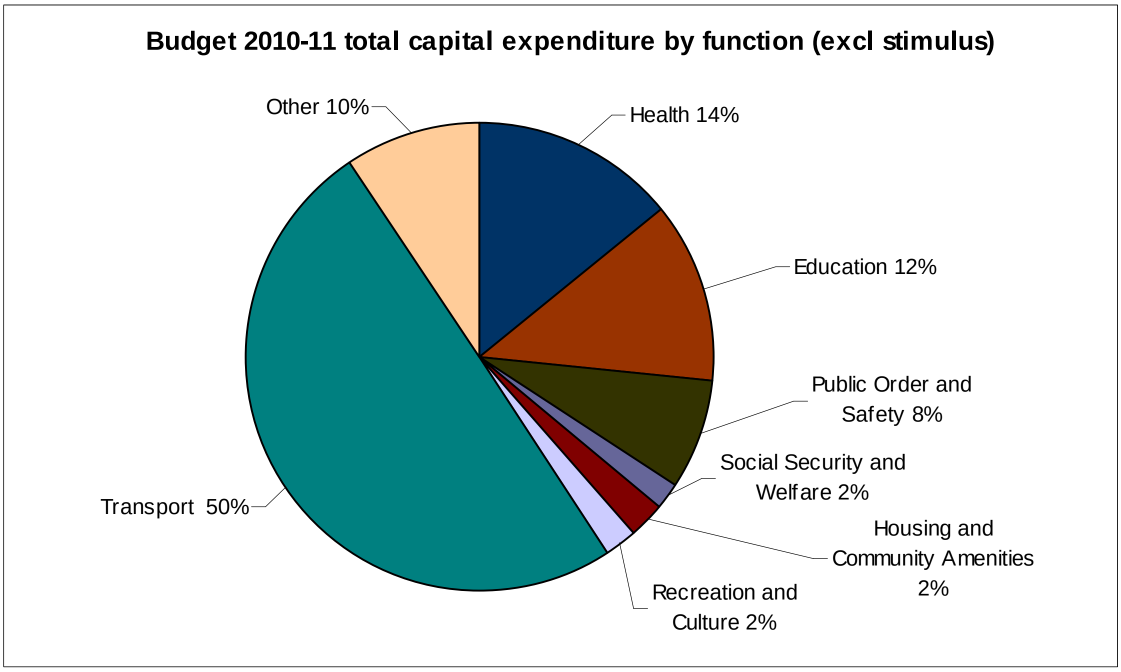
The share of recurrent expenditure in the 2010-11 Budget across major functional areas is shown in Figure 1.2.1below. Expenditure shown in the transport sector includes recurrent and capital grants from Transport NSW to RailCorp, which is a non-commercial public trading enterprise largely dependent on budget funding for recurrent and capital expenditure.

Figure 1.2.1 Total general government recurrent expenditure by function 2010-11



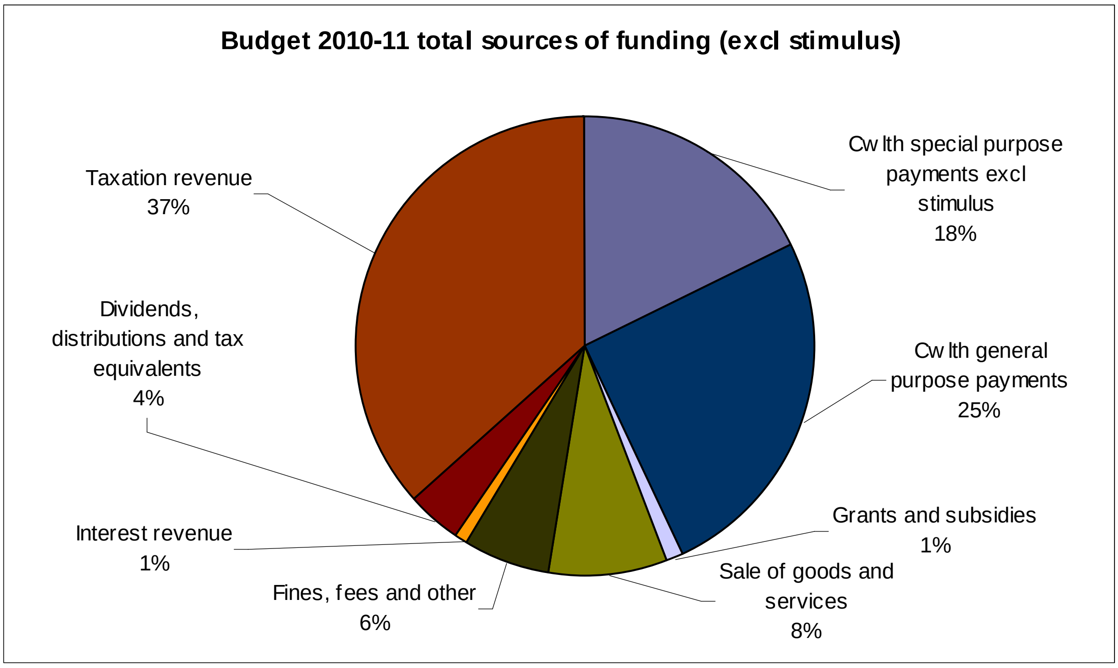
The breakdown of capital expenditure in the 2010-11 Budget across major functional areas is shown in Figure 1.2.2 below.

Figure 1.2.2 Total general government capital expenditure by function 2010-11



Major sources of funding for the sector are shown in Figure 1.2.3 below. Overall, about 43 per cent of funds are provided by payments from the Commonwealth, about 37 per cent by state taxes and the remainder is mainly from the sale of goods and services, contributions from PTEs, and fines, fees and other revenues.

Figure 1.2.3 Total general government sources of funding 2010-11



Agencies in the general government sector generally share some common features:

- most recurrent expenses are for labour-intensive services that are delivered by professionals, including teachers, nurses, social workers and police officers
- service levels tend to grow at a rate greater than the general population, with expenditure growth commonly at least equal to overall economic growth, as community expectations rise. A key driver for most agencies is policy choices by government, including for increased eligibility and for service enhancements, as community expectations grow with prosperity
- many services are provided on a universal basis, focusing on equity and accessibility rather than need. Access is often free (e.g. public education and hospitals) or at a heavily subsidised price (e.g. public transport and entry to cultural institutions and national parks).

The functions of general government agencies can be broadly categorised into a few high-level categories:

- policy – including governance-related activities, support for the functions of ministers and Parliament and provision of policy advice
- regulation – covering the spectrum of regulatory activities including licensing and permits and direct regulation backed by legislative sanctions, including associated monitoring, compliance and administrative activities

- service provision – including services provided to other parts or levels of government, the non-government organisation sector, private sector and general public. Services may be provided directly by government agencies, in partnership with others, or government may fund service provision by third parties
- transfer payments – some agencies also provide payments to specific members of the community based on certain policy requirements.

The appropriate delivery mechanism and funding and pricing model for each function depends on its categorisation. For example, policy functions are normally provided by government agencies and are normally fully funded through the Budget. Regulatory services are normally provided by government, sometimes in partnership with NGOs or private contractors, and full or partial cost recovery may be appropriate depending on whether the benefit of the regulatory action accrues to identifiable private parties or is a public good.

Delivery of functions categorised as service provision may be, at least in principle, contestable. Research or market testing may be required to determine whether the service is best provided by government or by other parties. Where services are contestable, but provided by government, funding and pricing should be consistent with competitive neutrality principles. Fees for contestable services available from non-government providers should generally be set at market rates or to deliver a commercial return. Where government involvement is required to build a market, partial cost recovery may be the appropriate model. Funding to meet any Community Service Obligation required by government should be provided transparently.

The structure of the general government sector

On 3 April 2011 the Government announced through an administrative order the agency structure for the general government sector (which has subsequently been modified in various ways). The order attributed responsibility for Acts to Ministers and outlined the configuration of newly identified Principal Departments and Divisions of the Government Service into nine clusters as follows:

- Attorney General and Justice
- Education and Communities
- Family and Community Services
- Finance and Services
- Health
- Premier and Cabinet
- Trade and Investment, Regional Infrastructure and Services
- Transport
- Treasury.

All the clusters, excluding Treasury, encompass further Public Service Divisions and all clusters, except Attorney General and Justice, include Non-Public Service Divisions. For example, Education and Communities includes the Office of the Board of Studies and Institute of Sport, public and non-public service divisions respectively. The groupings of Principal Departments and Divisions are referred to as clusters.

The grouping of material general government sector entities in clusters is shown in Table 1.2.1 below (the Principal Department for each cluster is in bold type).

Table 1.2.1 General government clusters

Attorney General and Justice	
Department of Attorney General and Justice	Ministry for Police and Emergency Services
NSW Trustee and Guardian	NSW Police Force
Department of Rural Fire Service	Office of the Director of Public Prosecutions
Fire and Rescue NSW	State Emergency Service
Information and Privacy Commission	Legal Aid Commission of NSW
Judicial Commission of NSW	NSW Crime Commission
Education and Communities	
Department of Education and Communities	Office of the Board of Studies
Sydney Olympic Park Authority	Community Relations Commission of NSW
Family and Community Services	
Department of Family and Community Services	
Aboriginal Housing Office	NSW Businesslink Pty Limited
Home Purchase Assistance Fund	Home Care Service Division
Finance and Services	
Department of Finance and Services	Compensation Authorities Staff Division
Crown Leaseholds Entity	Motor Accidents Authority
State Property Authority	WorkCover Authority
State Records Authority	Workers' Compensation (Dust Diseases) Board
Minister Administering the Environmental Planning and Assessment Act	Building and Construction Industry Long Service Payments Corporation
Rental Bond Board	Superannuation Administration Corporation
Health	
Department of Health	
Cancer Institute	Health Care Complaints Commission
Premier and Cabinet	
Department of Premier and Cabinet	
The Legislature	Department of Planning and Infrastructure
Electoral Commission NSW	Royal Botanic Gardens and Domain Trust
Audit Office of NSW	Centennial Park and Moore Park Trust
Police Integrity Commission	Historic Houses Trust of NSW
Independent Pricing and Regulatory Tribunal	Luna Park Reserve Trust
Internal Audit Bureau	Western Sydney Parklands Trust
Ombudsman's Office	Hunter Development Corporation
Independent Commission Against Corruption	Barangaroo Delivery Authority
Natural Resources Commission	Redfern-Waterloo Authority
Environmental Trust	Sydney Metropolitan Development Authority

Trade and Investment, Regional Infrastructure and Services	
Department of Trade and Investment, Regional Infrastructure and Services	Department of Primary Industries
Art Gallery of NSW	NSW Rural Assistance Authority
Australian Museum	NSW Food Authority
Casino, Liquor and Gaming Control Authority	Catchment Management Authorities
Museum of Applied Arts and Sciences	Events NSW Pty Limited
NSW Film and Television Office (Screen NSW)	State Library of NSW
Transport	
Department of Transport	
Independent Transport Safety and Regulator	Office of Transport Safety Investigations
Maritime Authority of NSW	Roads and Traffic Authority
Treasury	
The Treasury	
Crown Finance Entity	Liability Management Ministerial Corporation
Electricity Tariff Equalisation Ministerial Corporation	NSW Self Insurance Corporation

The lead minister for the Principal Department acts as the coordinating minister for each cluster and other ministers may hold specific portfolio responsibilities within the cluster. The Principal Department, Public Service and Non-Public Service Divisions of the clusters all have nominated Departmental and Divisional Heads.

In general, appropriations will be provided to the cluster minister who will then allocate funding to individual ministers and hence to agencies in the cluster, an exception being Premier and Cabinet, where there are two sub-clusters, Premier and Cabinet and Planning and Infrastructure. Where there are independent bodies such as the Judicial Commission and ICAC, there will be a separate appropriation to these bodies to preserve their independent status.

The cluster minister and the respective Director General for the cluster are responsible for achieving strategic alignment within the cluster through working with the other ministers and the CEOs in the clusters to achieve a consistent strategic direction.

Financial controls

Agencies in the general government sector mainly operate under Treasury's Financial Management Framework. The key financial controls that apply to them are:

- net cost of service limits for recurrent expenditure, which require agencies to manage to an approved net expenditure figure (total expenditure less agency own-source revenue, subject to some minor adjustments). This gives agencies an incentive to enhance revenue as they are free to spend above-forecast revenue but must make up for any revenue shortfall. However, a potential perverse incentive of this net approach is that it could encourage agencies to under-forecast their revenue, to provide some headroom for over-expenditure
- asset authorisation limits for capital expenditure, which require agencies to manage to an approved gross expenditure figure for capital projects. This is not a net control, so it does not create an incentive to maximise sales of departmental assets. An agency retains 50 per cent of the net proceeds of asset sales with the balance transferred to the Consolidated Fund unless the

agency has an explicit agreement to retain a higher amount (e.g. Health retains 100 per cent). This provides an incentive for active asset management.

As noted in the previous section, the general government sector includes both budget-dependent and non-budget-dependent agencies. The great majority of expenditure is undertaken by budget-dependent agencies. Some budget-dependent agencies, especially NSW Health, also have significant own-source revenues, and in some cases units within budget-dependent agencies operate on a quasi-commercial basis.

Non-budget-dependent agencies

All agencies are also subject to the legislative framework for the management of public funds. This framework includes the *Public Finance and Audit Act 1983*, the *Public Authorities (Financial Arrangements) Act 1987*, and the *Fiscal Responsibility Act 2005*.

The financial controls on non-budget-dependent agencies are in practice generally less defined than for other agencies. Non-budget-dependent agencies rely largely on own-source revenue to fund their activities, and the net cost of service control provides only limited scrutiny over self-funded expenditure. At the same time, these agencies are not subject to the commercial disciplines imposed by the Commercial Management Framework on agencies outside the general government sector.

By requiring non-budget-dependent agencies to prepare a Statement of Business Intent, transparency of expenditure would be enhanced. Extending the requirement for transparent reporting to non-budget-dependent business units within agencies the pricing rationale for services/cost recovery and any cross-subsidisation would also become transparent.

1.3 Public trading enterprises sector

Types of government business

The generic term ‘government business’ includes:

- public trading enterprises (or Public Non-Financial Corporations under ABS classifications)
- public financial enterprises (or Public Financial Corporations under ABS classifications)
- general government businesses (or General Government agencies under ABS classifications), which are non-budget-dependent and operate under the Commercial Policy Framework.

The public trading enterprise (PTE) sector comprises a range of government businesses providing major economic services. This includes State owned corporations (SOCs) which are governed by the *State Owned Corporations Act 1989* and the Commercial Policy Framework.

A distinction is made between commercial and non-commercial PTEs. The former comprises SOCs and a range of other government-owned entities that operate on a commercial basis and are generally self-supporting. Commercial PTEs that are not

SOCs generally comply with similar commercial policies as SOCs, such as competitive neutrality measures and dividends, but do not have independent boards.

Commercial PTEs receive the majority of their income from user charges. They are able to finance their operations and capital expenditure from retained earnings and borrowings. The commercial PTE sector covers government businesses in a range of sectors, including electricity, water, ports and property.

The SOC framework was introduced in 1989 by the Greiner Government in response to the 1988 Commission of Audit. This regime was put in place by the *State Owned Corporations Act 1989*, subsequently significantly amended in 1995 and is supported by a range of policies administered by Treasury. Continued observance of these policies is a requirement of the *COAG Competition Principles Agreement 2007*.

Fifteen SOCs operate under the SOC framework, including businesses in the energy generation (3) and distribution and transmission sectors (4), urban water (2), bulk water (1), ports (3), land development (1) and superannuation administration (1). All SOCs are statutory corporations, established under enabling legislation, although the *State Owned Corporations Act 1989* makes provision for company SOCs established under the *Corporations Act 2001*.

The non-commercial PTE sector comprises businesses in the transport sector, such as State Transit, Sydney Ferries, CityRail and transport infrastructure delivery entities, and the social housing sector. Non-commercial PTEs receive budget funding to meet social policy objectives agreed with the Government where revenue is insufficient to meet operating expenses or capital expenditure. These PTEs do not at this stage fall under the SOC governance framework as they are not primarily supported by user charges.

In addition to non-commercial PTEs, there are a number of general government business units that seek to operate on a commercial basis, such as the Redfern-Waterloo Authority.

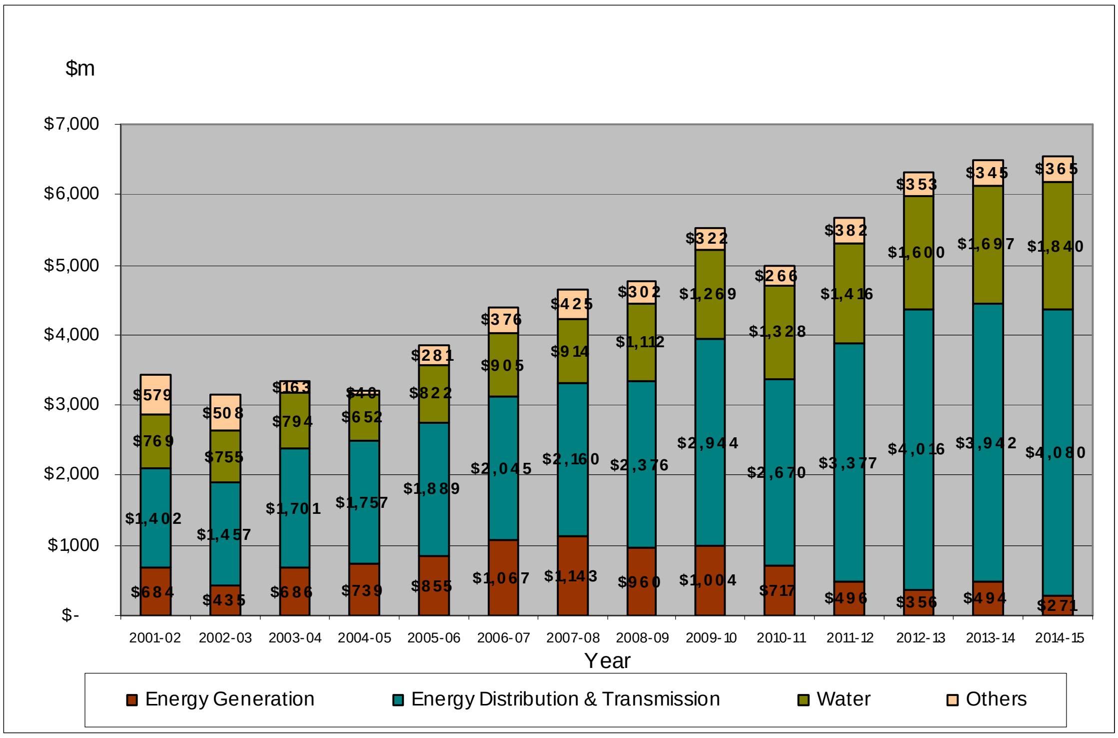
Attachment A at the end of this subsection includes a list of government businesses.

Financial overview

Prior to the corporatisation and commercialisation reforms of the 1980s and early 1990s, the commercial PTE sector had a general history of operating deficits and a mixture of commercial and non-commercial functions, including regulatory functions, and a general lack of transparency. The corporatisation and commercialisation reforms have delivered a turnaround in financial performance through full separation of commercial and non-commercial functions, the establishment of competitive neutrality principles and full transparency.

In 2010-11, the commercial PTE sector is projected to deliver an operating surplus of $5 billion and payments to government of $5.6 billion (comprising dividends of $4.5 billion including the special dividend of $3.4 billion, tax equivalent payments of $630 million and government guarantee fee payments of $435 million). Figure 1.3.1 shows the operating surplus of the commercial PTE sector over 2001-02 to 2014-15.

Figure 1.3.1 Commercial PTE sector operating surplus (earnings before interest, tax, depreciation and amortisation – EBITDA) 2001-02 to 2014-15

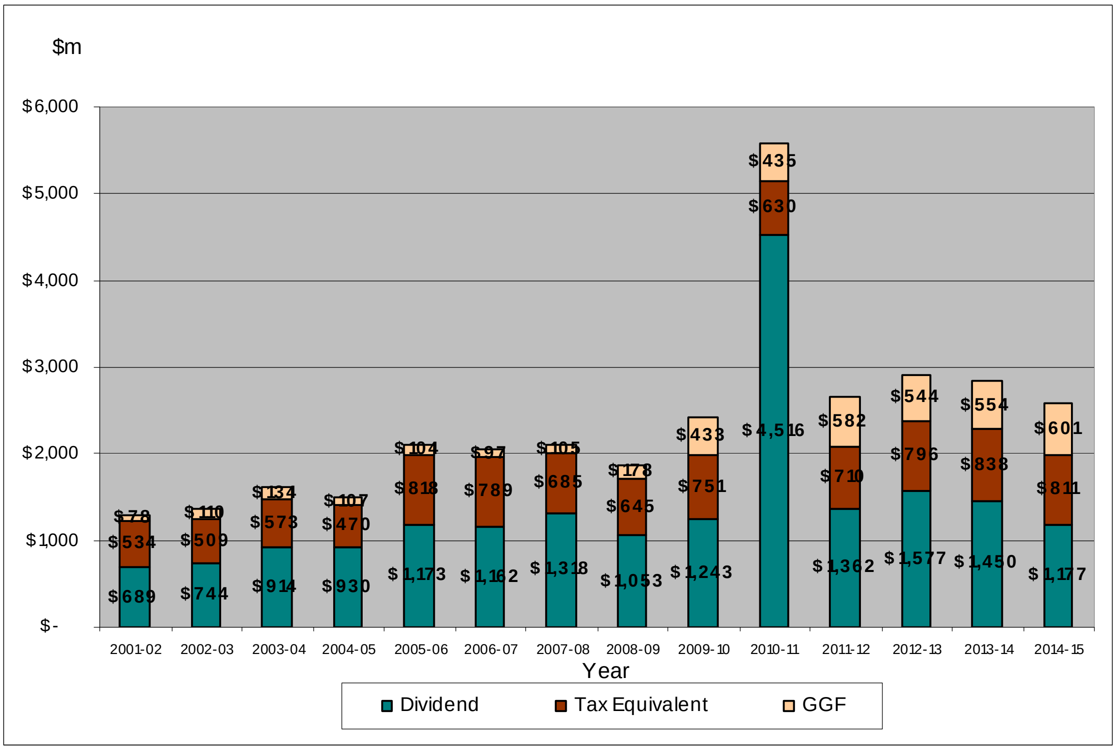


Over the four years 2011-12 to 2014-15, the commercial PTE sector is projected to generate an operating surplus of $25 billion, delivering dividends, tax equivalent and government guarantee fee payments of around $11 billion to the government. Projected electricity generation EBITDA falls from 2010-11 due largely to the sale of the output from Eraring Energy and from Delta Electricity's western power stations through the GenTrader contracts. Forecast EBITDA from the distribution businesses drops due to the sale of their retail arms, associated transaction and stranded costs and, in the case of Essential Energy, the associated crystallisation of hedge losses into its operating results.

The Government represents the people of NSW as shareholder of commercial PTE businesses and expects an appropriate return on its investment. This return is then used to fund core government services. If government businesses earn less than would be delivered by similar commercial businesses, this means lower revenues to government and higher contributions by taxpayers to fund a given level of services. For energy and water businesses that are price-regulated, fair returns are set by the regulators and the businesses should achieve these regulated returns.

The book value of the Government's equity investment in the commercial PTE sector is forecast at $25.8 billion in June 2011 and is forecast to grow to $29.1 billion by June 2015. Figure 1.3.2 and Table 1.3.1 show the expected returns to the Government from this investment in commercial PTEs.

Figure 1.3.2 Commercial PTEs dividends, tax equivalent and government guarantee fee payments 2001-02 to 2014-15



Note: 2010-11 dividends include a special dividend of $3,406 million from the energy sale.

The four years from 2011-12 to 2014-15 include adjustments to the energy SOC distribution forecasts for retention value modelling undertaken for the electricity transactions and assumed funding of the Solar Bonus Scheme.

Tax equivalent payments and government guarantee fees are designed to place PTEs on the same basis as private sector equivalents and are not a return on investment. Tax equivalent payments are received by the State under the National Tax Equivalent Regime. Government guarantee fees bridge the cost differential between debt raised at the State's AAA credit rating and businesses' individual ratings. Guarantee fee revenue is forecast at $630 million in 2010-11. Higher government guarantee fees reflect increased borrowing to fund capital expenditure.

Together, dividends, tax equivalent payments and government guarantee fees from commercial PTEs are projected to be 3.9 per cent of general government revenues by 2014-15. These payments are a stable stream which helps to fund other government services. However, they are below what would be expected by a commercial shareholder, as discussed in Chapter 9.

The non-commercial PTE sector obtains significant budget funding for both operating and capital expenditure and hence does not contribute to general government revenues. Budget funding represents a contribution by taxpayers to the services provided by these businesses. To the extent that this sector improves its efficiency or generates higher revenues from user charges, it contributes to the State's fiscal position and credit ratings metrics.

Table 1.3.1 Dividends, income tax equivalents and government guarantee fee by sector

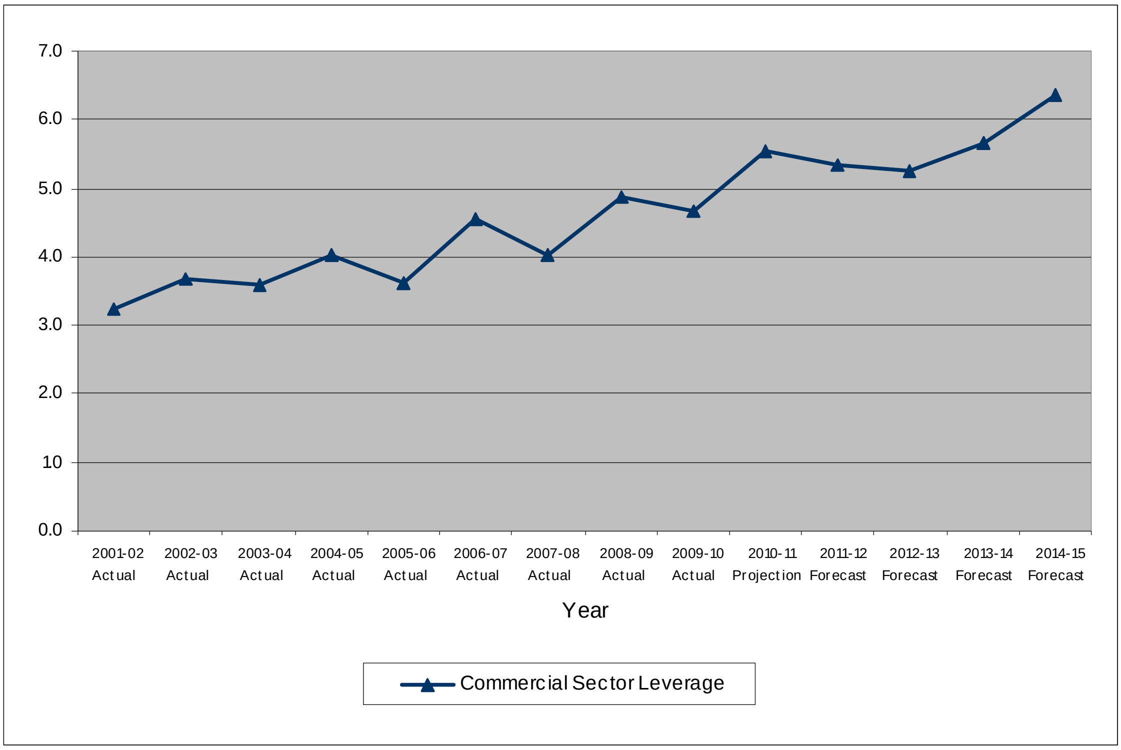
($m)	2001-02 Actual	2002-03 Actual	2003-04 Actual	2004-05 Actual	2005-06 Actual	2006-07 Actual	2007-08 Actual	2008-09 Actual	2009-10 Actual	2010-11 Budget	2010-11 Revised	2011-12 Forward Estimates	2012-13	2013-14	2014-15
Dividends															
Electricity generation	246	205	234	311	303	426	509	270	291	215	172	293	275	185	-52
Electricity distribution and transmission	157	226	366	251	455	392	464	426	575	461	538	634	827	731	670
Distribution (special dividend from sale)	-	-	-	-	-	-	-	-	-	-	3,406	-	-	-	-
Water	172	173	169	170	253	200	231	262	300	296	287	311	333	355	372
Property and resources	48	85	76	120	87	65	46	43	61	38	43	59	67	68	72
Financial sector	45	39	46	49	46	46	43	50	12	51	63	47	53	57	57
Ports sector	21	16	22	28	28	33	25	2	3	9	7	17	21	53	59
Total, Dividends	689	744	914	930	1,173	1,162	1,318	1,053	1,243	1,070	4,516	1,362	1,577	1,450	1,177
Income Tax Equivalents															
Electricity generation	128	113	123	121	209	208	270	215	236	165	137	122	102	129	79
Electricity distribution and transmission	153	168	234	164	296	331	205	244	324	251	288	363	435	415	399
Water	182	127	113	70	230	171	108	109	136	150	109	128	172	191	222
Property and resources	39	65	56	43	26	23	18	14	21	18	25	29	34	37	39
Financial sector	13	18	18	20	21	17	25	24	-7	27	34	20	23	24	24
Ports sector	18	19	28	52	36	39	59	38	41	21	38	47	30	41	48
Total, Tax Equivalents	534	509	573	470	818	789	685	645	751	635	630	710	796	838	811
Government Guarantee Fee															
Electricity generation	31	48	56	40	31	23	19	27	62	66	49	28	24	20	20
Electricity distribution and transmission	32	45	51	52	51	51	58	97	238	315	236	342	337	357	292
Water	7	9	18	8	15	17	24	48	122	147	140	194	169	165	177
Property and resources	6	6	7	5	4	3	2	3	6	6	4	8	6	4	4
Financial sector	1	1	1	1	0	0	0	0	1	5	0	0	0	0	0
Ports sector	1	2	2	2	2	2	2	2	5	6	6	10	9	8	8
Total, Government Guarantee Fee	78	110	134	107	104	97	105	178	433	544	435	582	544	554	601
Total, Dividends, Income Tax Equivalent and Government Guarantee Fee	**1,300**	**1,363**	**1,621**	**1,507**	**2,095**	**2,048**	**2,108**	**1,876**	**2,428**	**2,249**	**5,582**	**2,653**	**2,917**	**2,842**	**2,589**

The PTE sector is responsible for an increasing share of state sector borrowings, with 82 per cent of commercial PTE capital expenditure in the regulated sector (water and electricity distribution and transmission). This is supported by regulated revenues which ensure that sufficient revenue is available in the future to service the increased debt associated with the expanded capital program.

The relationship between total PTE sector debt and earnings before interest, tax, depreciation and amortisation (EBITDA) is shown in Figure 1.3.3. The figure forecasts a stabilisation in debt relative to earnings for 2011-12 to 2012-13 before the upward trend resumes. The upward trend reflects the substantial increases in capital expenditure which have had to be funded by increased debt. Gross debt was $11 billion in 2001-02 and is projected to increase to $41 billion in 2014-15. However, EBITDA is projected to increase from $3 billion in 2001-02 to $6 billion in 2014-15.

Gross debt increased during the period 3.7 times, while EBITDA increased only 2 times. This increased leverage from 3.2 in 2001-02 to 6.4 in 2014-15.

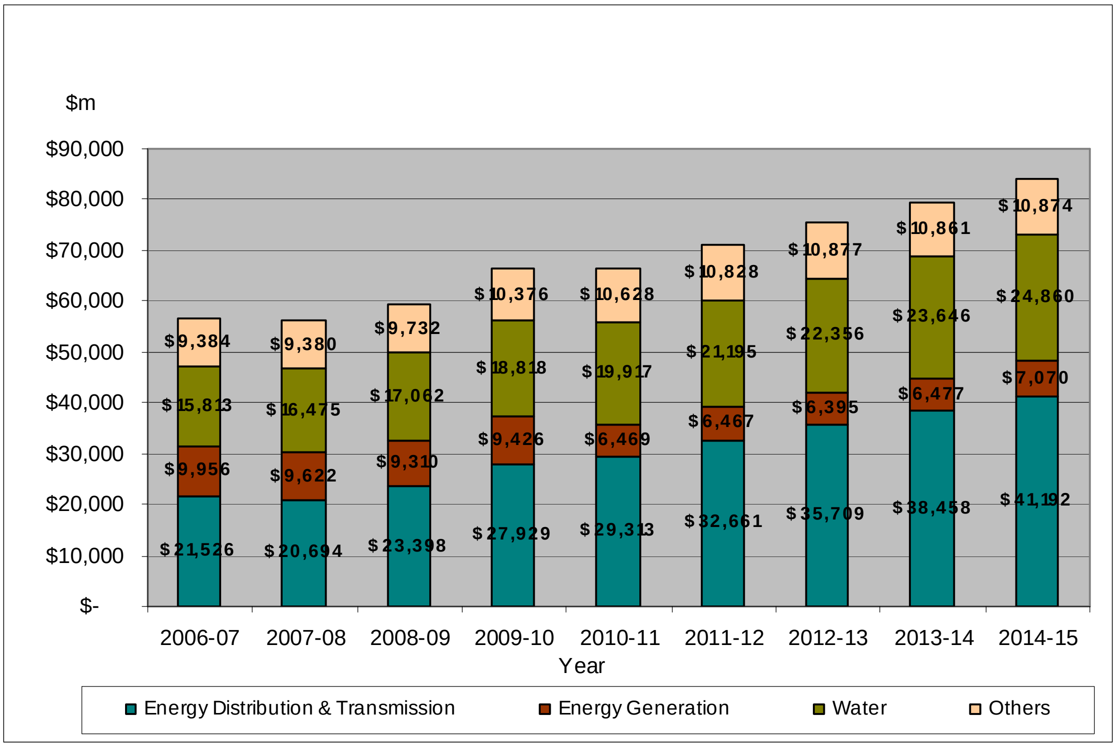
Figure 1.3.3 Leverage (total debt / EBITDA)



While leverage is an indicator of the ability of a business to service debt, it is more important to assess each business's sustainable capital structure than growth in debt or earnings over a period. Large investments generate increased EBITDA over a long period, matching the life of the assets and in some cases businesses have been re-geared to bring debt to commercially appropriate levels. Spikes in leverage are appropriate in these contexts.

As shown in Figure 1.3.4, total commercial sector assets were $57 billion in 2006-07 and are projected to be $84 billion by 2014-15, an increase of 48 per cent. Major investments in energy distribution and transmission will result in assets increasing by 91 per cent and water assets increasing by 57 per cent over this nine-year period.

Figure 1.3.4 Total assets commercial PTE sector, 2006-07 to 2014-15



Attachment A

Business type	Business name
Commercial PTE (State owned corporation)	Ausgrid (formerly EnergyAustralia)
Commercial PTE (State owned corporation)	Delta Electricity
Commercial PTE (State owned corporation)	Endeavour Energy (formerly Integral Energy)
Commercial PTE (State owned corporation)	Eraring Energy
Commercial PTE (State owned corporation)	Essential Energy (formerly Country Energy)
Commercial PTE (State owned corporation)	Hunter Water Corporation
Commercial PTE (State owned corporation)	Landcom
Commercial PTE (State owned corporation)	Macquarie Generation
Commercial PTE (State owned corporation)	Newcastle Port Corporation
Commercial PTE (State owned corporation)	Port Kembla Port Corporation
Commercial PTE (State owned corporation)	State Water Corporation
Commercial PTE (State owned corporation)	Superannuation Administration Corporation (Pillar)
Commercial PTE (State owned corporation)	Sydney Ports Corporation
Commercial PTE (State owned corporation)	Sydney Water Corporation
Commercial PTE (State owned corporation)	Transgrid
Commercial PTE	Forests NSW
Commercial PTE	Sydney Catchment Authority
Commercial PTE	Sydney Cricket Ground and Sports Ground Trust
Commercial PTE	Sydney Ferries
Commercial PTE	Sydney Harbour Foreshore Authority
Commercial PTE	Hunter Region Sporting Venues Authority
Commercial PTE	Illawarra Venues Authority
Commercial PTE	Parramatta Stadium Trust
Commercial PTE	Sydney Opera House
Commercial PTE	Zoological Parks Board
Non-commercial PTE	City West Housing Pty Ltd
Non-commercial PTE	Department of Housing – Land and Housing Corporation
Non-commercial PTE	Teacher Housing Authority
Non-commercial PTE	Country Rail Infrastructure Authority
Non-commercial PTE	Public Transport Ticketing Corporation
Non-commercial PTE	Rail Corporation NSW
Non-commercial PTE	State Transit Authority

Business type	Business name
Non-commercial PTE	Transport Construction Authority
Commercial business, general government non-budget-dependent (GG NBD)	Aboriginal Housing Office
Business commercial business (GG NBD)	Hunter Development Corporation
Commercial business (GG NBD)	Maritime Authority of NSW
Commercial business (GG NBD)	NSW Self Insurance Corporation
Commercial business (GG NBD)	NSW Trustee and Guardian
Commercial business (GG NBD)	Redfern-Waterloo Authority
Commercial business (GG NBD)	State Property Authority
Commercial business (GG NBD/Business Unit)	NSW Businesslink Pty Ltd
Public financial enterprise	NSW Treasury Corporation
Public financial enterprise	Fair Trading Administration Corporation
Public financial enterprise	Lifetime Care and Support Authority of NSW

1.4 The state capital program

Overview

The state sector capital program provides the assets and infrastructure to meet the service delivery needs of the people of NSW. The program ranges from the construction of major infrastructure such as roads (e.g. the Pacific Highway upgrade), railways (e.g. the South West Rail Link) and hospitals (e.g. the Liverpool Hospital redevelopment) to the acquisition and maintenance of minor plant and equipment.

The capital program, provides for the construction, acquisition and upgrading of the State's physical assets. It therefore plays a key role in the growth and development of the state economy by providing the basic infrastructure required by industry for urban and rural development and by providing the social infrastructure essential for the efficient and effective delivery of community services.

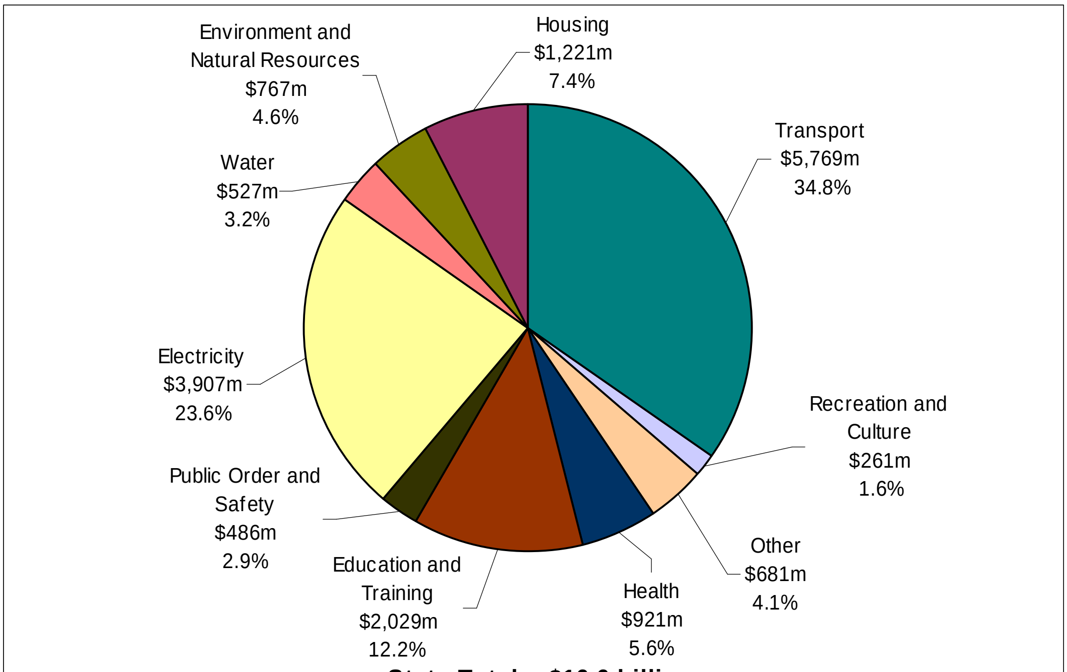
The capital program is delivered by the general government sector, which is budget-funded, and the PTE sector, which has both commercial and non-commercial components. The State's fiscal outcomes and its credit rating are significantly affected by PTE capital expenditure, productivity and profitability. The PTE sector accounts for a significant proportion of capital expenditure by the State. In 2010-11, the general government sector accounted for 44 per cent of the program, while the PTE sector accounted for 56 per cent.

In the general government sector, assets include diverse items such as roads, hospitals, schools, prisons, national parks, sporting venues, art collections and other cultural institutions. This contrasts with the PTE sector that broadly provides economic infrastructure such as rail, water and electricity.

In 2010-11, the total state sector capital program is estimated at $16.6 billion, which is $277 million or 1.5 per cent more than 2009-10 actual expenditure.

Capital expenditure in the four largest policy areas of transport, electricity, education and housing will total $12.9 billion or around 78 per cent of the State's estimated infrastructure spending in 2010-11.

Figure 1.4.1 Total state sector infrastructure investment 2010-11 by policy area*



* The policy areas are based on the Australian Bureau of Statistics' system of Government Finance Statistics (GFS). GFS policy areas do not always align with individual agency infrastructure investment budgets as an agency can provide a range of services that are classified into more than one GFS policy area.

General government sector capital program

General government sector capital investment in 2010-11 is expected to be $7.7 billion, which is $406.9 million or 5.5 per cent greater than 2009-10 actual expenditure. Major investments in 2010-11 include:

- $2.8 billion for roads, including $809.6 million to continue work on the Pacific Highway north of Hexham; $345 million for work on the Hume Highway; and $340 million to continue work on the Hunter Expressway
- $2 billion for Education and Training, including $1.2 billion for Primary Schools and Secondary Schools under the Building the Education Revolution program; $800 million on 60 major school projects, 35 major TAFE projects and school and TAFE minor works, such as security fencing and upgrades of toilets, sewers and roofs

- $917.8 million for NSW Health for investment in hospital upgrades, medical equipment, health technology programs, information and communication technology, regional cancer centres, improved mental health facilities, ambulance infrastructure and other new health projects
- $222 million for acquisition of 300 new growth buses for the State Transit Authority (STA) and private operators
- $160.3 million for custodial services infrastructure, including a new facility at Nowra and increasing inmate capacity by 250 at Cessnock
- $79.3 million to expand the range of accommodation and support models available to people with a disability
- $69.8 million for planning, construction and refurbishment of police stations at 20 locations.

Public trading enterprise capital program

Total PTE sector capital expenditure in 2010-11 is expected to be $8.9 billion, down from $9 billion in 2009-10. The slight decline in expenditure largely results from:

- a decrease of $672 million in the social housing sector as part of the wind down of the Commonwealth Government's Nation Building – Economic Stimulus Plan
- a decrease of $402 million by Sydney Water, reflecting the completion of the desalination plant.

Table 1.4.1 compares actual 2009-10 expenditure with forecast 2010-11 expenditure for the non-commercial and commercial components of the PTE sector.

Table 1.4.1 PTE sector capital expenditure

Public trading enterprise sector capital expenditure	2009-10 Actual ($m)	2010-11 Est ($m)	Variation $	Variation %
Non-commercial PTE	3,891.0	3,340.8	-550.2	-14.1
Commercial PTE	5,139.7	5,560.0	420.3	8.2
Total – public trading enterprise sector	**9,030.7**	**8,900.8**	**-129**	**-1.4**

Major investments in 2010-11 include:

- $3.9 billion in the electricity sector, including programs of work for the distribution and transmission networks and at power stations
- $2.1 billion for rail projects, including $303.9 million for work on the Rail Clearways program, $278 million for the South West Rail Link and $145 million towards the acquisition of Outer Suburban Rail Carriages – Tranche 3

- $1.1 billion for social housing, including $538.3 million for the completion of 4,690 social housing dwellings under Stage 2 of the Nation Building – Economic Stimulus Plan and $232.7 million for the improvement of existing social housing dwellings
- $914.7 million by Sydney Water and Hunter Water for water and sewerage projects
- $346.2 million for port projects, including $168.7 million towards the construction of a third container terminal at Port Botany.

PTE capital expenditure is largely funded through a combination of debt and funds retained in the businesses.

Funding the state capital program

Infrastructure is ultimately funded by either taxes or user charges. Debt financing can only be used to bridge any timing mismatch between capital expenditure and the receipt of funds from these sources.

The general government infrastructure program is funded from a combination of sources including:

- operating cash flows
- borrowings
- revenue from asset sales and/or
- Commonwealth Government funding.

Since the general government sector mainly provides essential public services that are typically not income-producing, there is limited ability to recover costs through user charges. An exception is user charges on certain roads. Similarly, the ability to use borrowing to fund capital expenditure is limited because the payment of principal and interest restricts future funding of services.

The funding sources for the actual 2009-10 and estimated 2010-11 general government capital program is shown in Table 1.4.2 which highlights the importance of the net operating result and depreciation as funding sources and the significant increase in net debt between the two years.

Table 1.4.2 General government sector capital program 2009-10 and 2010-11 – source of funds

Source of funds	2009-10 Actual ($m)	2010-11 Estimate ($m)
Net operating balance (surplus net of depreciation)	3,764	3,819
Asset sales	671	560
Increase in net debt	1,256	1,853
Accruals/provisions/other	1,586	1,445
Total - general government capital program	**7,277**	**7,677**

Commercial PTEs fund their infrastructure programs from a combination of debt and internally generated cash. In particular, in the electricity and water PTE sectors, there is scope for commercial investments that can be repaid through user charges. While commercial investments are repaid through increased revenues and efficiencies, the total level of debt financing is limited by the investment risks similar to any commercial business.

Non-commercial PTEs rely on a combination of debt and capital grants from the State Budget to finance their infrastructure programs. Given the lack of capacity of non-commercial PTEs to carry debt, much of their infrastructure program is funded by the Budget. Capital grants in the non-commercial PTE sector are mainly for the provision of social housing and rail infrastructure.

Table 1.4.3 compares the funding sources for the 2009-10 actual and 2010-11 estimated PTE capital program. The major variations broadly relate to a 52 per cent reduction in the net operating balance and a 73 per cent increase in net debt. The sharp fall in the PTE sector net operating balance between 2009-10 and 2010-11 results from:

- a one-off, non-cash transfer of housing stock from the NSW Land and Housing Corporation to the Aboriginal Housing Office and community housing providers
- the large increase in the electricity network capital program in recent years, which has necessitated increased resort to borrowings until such time as profits build up to a sufficient level to refinance an appropriate portion of the debt.

Table 1.4.3 PTE sector capital program 2009-10 and 2010-11 – source of funds

Source of funds	2009-10 Actual ($m)	2010-11 Estimate ($m)
Net operating balance (surplus net of depreciation)	5,804	2,617
Asset sales	370	467
Increase in net debt	2,907	5,039
Accruals/provisions/other	-51	778
Total - PTE capital program	**9,031**	**8,901**

Privately financed projects (PFPs)

During the ten years to 2009-10, $90.48 billion in capital was procured by government agencies, 46 per cent ($41.4 billion) by general government agencies and 56 per cent ($49.0 billion) by the PTE sector.

One of the procurement options available to government is privately financed projects (PFPs). In the 10 years to 2009-10, 10.9 per cent of capital procurement, totalling $9.9 billion, was spent through 19 PFPs. Traditional and alliancing procurement methods were used for the balance of capital procurement.

Approval of PFPs

Agencies make infrastructure project submissions to Government in compliance with their designated functions and in accordance with the state capital program. When a project is approved for delivery by the PFP method, the private sector is invited to bid to design, construct, finance, operate and maintain[3] an approved project for an agreed term. The bidder demonstrating the best value for money proposal will, following successful negotiations, be contracted to proceed with the project.

PFPs have the potential to provide value for money outcomes relative to traditional procurement methods if projects have some or all of the following attributes:

- scale – projects with a total contract value of $50 million or more
- measurable outputs – the services required should be capable of specification in terms of measurable outputs that can be translated to a performance contract
- non-core activities – significant non-core services and support activities that currently divert management and skilled staff in the public sector
- innovation – the project is of sufficient complexity to encourage innovative approaches (in terms of design and technology) that can deliver value for money
- whole-of-life optimisation potential – the project involves significant maintenance and operating costs that can be better handled by the private sector
- technology – scope for cost savings and improved services through new technology
- risk allocation – capacity to allocate appropriate levels of risk to the private sector
- complexity – complexity and other features that encourage innovative solutions
- market appetite – a real business opportunity that will attract a number of proponents involves bid costs, for both government and the private sector. PFPs require government and bidders to obtain advice from a series of professional advisors, such as accountants, banks, builders, lawyers, engineers and quantity surveyors. According to the *Benchmarking Study into Alliancing*[4], government can save time and money by pursuing PFPs. The value of PFPs may be less clear for the private sector, and these engagement costs can be significant, but they gain the advantage of having an informed client.

---

[3] As applicable to particular projects.

[4] *In Pursuit of Additional Value – a Benchmarking Study into Alliancing in the Australian Public Sector*, Department of Treasury and Finance, Victoria, and Evans and Peck and University of Melbourne, October 2009, p.19.

In striving to achieve value for money in PFP procurement, the Government places much attention upon risk allocation, with risks transferred to the private sector that it is better equipped to deal with than government.

As market conditions and risk appetite change, the PFP model needs to adapt as well. Recent adverse changes in international financial markets have had significant effects on the PFP market, and the model has changed in response.

Section 7.4 provides further information about PFPs in NSW. Table 1.4.4 overviews all PFPs undertaken by the NSW Government.

Table 1.4.4 PFPs undertaken by the NSW Government

Policy area	Project	Value[1] $m	Commencement date	Completion date	Ongoing contractual arrangement
Transport/ Tollways	Sydney Harbour Tunnel	670	January 1988	August 1992	30-years concession Maintenance and operational services
Transport/ Tollways	Cross City Tunnel	680	January 2003	August 2005 (opened for the traffic)	Until 18 December 2035 Maintenance and operational services
Transport/ Tollways	Lane Cove Tunnel	1100	December 2003	March 2007 (opened for the traffic)	Until 9 January 2037 Maintenance and operational services
Transport/ Tollways	Eastern Distributor	700	August 1997	December 1999 (opened for the traffic)	48-years concession Maintenance and operational services
Transport/ Tollways	M2 Motorway + M2 Motorway Widening	644 (initial project) 550 (M2 widening)	1994 (initial project) January 2011 (M2 widening)	May 1997 (initial project) Under construction: M2 Widening – expected late 2012	Until 2046 Maintenance and operational services
Transport/ Tollways	M5 Motorway + M5 Motorway Widening + M5 Moorebank Avenue Interchange	315 (initial project) 65 (M5 widening) 32 (Moorebank)	1991 (initial project) 1993 (M5 widening) April 2002 (Moorebank)	October 1992 (initial project) 1995 (M5 widening) January 2003 (Moorebank)	Until 2023 Maintenance and operational services
Transport/ Tollways	M7 Motorway (Westlink)	1850	July 2003	February 2007	Until 14 February 2037 Maintenance and repair
Transport/ Rail	New Southern Railway	716	June 1995	July 2000	30-years concession Maintenance and operational services
Transport/ Rail	Replacement of RailCorp's Electric Passenger Rollingstock	2400	December 2006	Under construction 1st train expected mid-2011 78th train expected mid-2014	Until 30 July 2043 (or 30 years after the 69th train) Maintenance, cleaning, repair and refurbishment of the trains to ensure 72 trains available to RailCorp for timetabled service each day
Transport	Chatswood Transport Interchange	157	June 2005	December 2008	50-years concession Maintenance and operational services

Table 1.4.4 PFPs undertaken by the NSW Government

Policy area	Project	Value[1] $m	Commencement date	Completion date	Ongoing contractual arrangement
Transport	Parramatta Transport Interchange	67.5	March 2004	February 2006	25-years licence Maintenance and operational services
Transport/ Light Rail	Pyrmont Ultimo Light Rail + Lilyfield Extension	84 (initial project) 21 (Lilyfield extension)	November 1995 (initial project) November 1999 (Lilyfield extension)	July 1997 (operations commenced) August 2000 (Lilyfield extension finished)	30.5-years concession Maintenance and repair services
Education	New Schools Project	87	March 2003	January 2004 (four schools) January 2005 (five schools)	Until 31 December 2032 Maintenance and provision of selected services
Education	New Schools Project 2	131	December 2005	February 2010	Until 31 December 2035 Maintenance and provision of selected services
Energy	Colongra Gas Pipeline and Storage Facility	90	February 2008	November 2009	20-years concession Maintenance and operational services
Energy	Mini Hydro Schemes	52	1994	Various	
Health	Bathurst, Orange & Associated Health Services	256	December 2007	March 2011	Until 21 December 2035 Hospital facilities management and delivery of ancillary non-clinical services
Health	Hawkesbury Hospital	47	December 1994	August 1996	20-years concession Maintenance and provision of selected services
Health	Liverpool Hospital Car Park	6	1993	October 1994	25-years concession Maintenance and operational services
Health	Newcastle Community Health Centre	24	September 2005	March 2007	20-years concession Maintenance and operational services
Health	Newcastle Mater Hospital Redevelopment	131	November 2005	June 2009	Until 30 November 2033 Hospital facilities management and delivery of ancillary non-clinical services

Table 1.4.4 PFPs undertaken by the NSW Government

Policy area	Project	Value[1] $m	Commencement date	Completion date	Ongoing contractual arrangement
Health	Royal North Shore Hospital Redevelopment – Stage 2	587.5	October 2008	The Community Health facility was completed in March 2011 Under construction: Acute hospital facility – December 2012 Douglas Building Refurbishment – October 2013 New Car Park facilities – July 2014	Until 22 October 2036: 1) Hospital facilities management and delivery of ancillary non-clinical services 2) Management and operation of the car park facilities 3) Operation of the retail premises
Health	Randwick Hospital Car Park	23	July 1997	June 1998	20-years concession Maintenance and operational services
Health	St George Hospital Car Park	12	1998	June 2000	25-years concession Maintenance and operational services
Health and Justice	Long Bay Prison and Forensic Hospitals	126	January 2006	December 2008	Until 4 October 2034 Maintenance and provision of selected services
Social Housing	Bonnyrigg Living Communities Project	733	December 2006	1st stage was competed in June 2010 Under construction: 17 stages more over a 9-year period until 2020	Until 28 February 2037 Maintenance of the existing, new and refurbished public housing and delivery of tenancy, relocation, communication, consultation, community renewal and other services to public housing tenants and other community members.
Sydney Olympic Venues	Olympic Stadium	620	January 1997	June 1999	Until 31 January 2031 Maintenance and operational services
Sydney Olympic Venues	Olympic Village	445	April 1997	May 2000	n/a
Sydney Olympic Venues	Sydney Super Dome	277	October 1997	November 1999	Until 31 January 2031 Maintenance and operational services
Water and Sewerage	Blue Mountains Sewage Transfer Tunnel	80	November 1993	June 1996	35-years concession Maintenance and operational services

Table 1.4.4 PFPs undertaken by the NSW Government

Policy area	Project	Value[1] $m	Commencement date	Completion date	Ongoing contractual arrangement
Water and Sewerage	Illawarra/ Woronora Water Treatment Plants	174	December 1994	December 1996 (Illawarra) April 1997 (Woronora)	25-years concession Maintenance and operational services
Water and Sewerage	Macarthur Water Treatment Plant	125	September 1993	September 1995	25-years concession Maintenance and operational services
Water and Sewerage	Prospect Water Treatment Plant	200	September 1993	June 1996	25-years concession Maintenance and operational services
Water and Sewerage	Rosehill Camellia Recycled Water Project	100	November 2009	Under construction Expected July 2011	Until July 2031 Maintenance of recycled water treatment plant and associated distribution assets providing Sydney Water Corporation will purchase a minimum volume of 10.5 mega-litres per day
Water and Sewerage	St Mary's Biosolid Vermiculture Plant	2	2000	2001	
Other	Sydney Opera House Car Park	40	1990	March 1993	Until 13 March 2043 Maintenance and operational services

1.5 The State's credit rating assessment

Summary analysis

Given the State's ongoing infrastructure funding task as well as its exposure to the economic cycle, the fiscal strategy is dependent on continued reliable access to domestic and international capital markets. The availability and cost of this access depends partly on credit rating agency assessments of the State's financial sustainability and risk. The credit rating criteria applicable to NSW includes:

- *A strong and supportive federal fiscal system*

  State finances are rated higher in Australia than elsewhere due in part to the supportive federal fiscal system, the predictability of revenue and expenditure power sharing and the implicit guarantee of the Commonwealth for state debt. It is in NSW's interest, from a rating perspective, to protect and strengthen an equitable and efficient federal fiscal system.

- *A strong, growing and diversified State economy*

  State finances are enhanced by a robust and broad-based economy. Policies that promote soundly based economic growth and diversification in turn will contribute to sound finances and a favourable credit rating outlook.

- *A track record of good budget and infrastructure program management, meeting targets, limiting risks, comprehensive reporting and strong political support*

  The strength of NSW budget and infrastructure program management must be sustained and enhanced.

- *Capacity and commitment to meet financial obligations if necessary by adjusting taxes, trimming or postponing expenses, and accumulating financial balances to draw on in adversity*

  The Budget process needs to assign priorities and set policy options, facilitating orderly adjustment in response to fiscal pressures. Cyclically above trend revenues, and any net proceeds from asset transactions, should be used to strengthen the balance sheet.

- *Keeping debt within sustainable limits in relation to revenues and the economy, with long maturities, diversified counterparties and limited exchange rate exposure*

  Fiscal policy must ensure outcomes, including debt, are consistent with the target. State financial liabilities and assets must be managed professionally to protect and improve liquidity and control risk.

What needs to be recognised is that a credit rating is prepared for the purposes of assisting lenders to assess credit risk. While a high credit rating will facilitate access to capital markets on favourable terms, this is not the only factor to consider in developing a financial management strategy. Rather than being the driver of the financial management strategy, a high credit rating should be regarded as an outcome from a suitable financial management strategy. In particular, it needs to be acknowledged that the retention of a AAA credit rating, which NSW currently has, is not under the full control of the State. If the Commonwealth were, for example to lose its AAA credit rating, it is most likely that all states with such a rating would also suffer a downgrade simply because of the importance attached to the Commonwealth-State financial relationship in the credit rating process.

The credit rating process

The credit rating process is a core aspect of NSW fiscal management.

The credit rating is a guide to investors as to the quality of debt being offered or traded, and its appropriate price (yield). Many institutional fund managers operate under mandates precluding assets rated below AAA. When a credit rating is lowered, the market narrows, and investors demand an interest rate premium. Even a single-tick downgrade can add substantially to the interest burden for taxpayers in a jurisdiction with large public debt, and can hinder access to credit markets in periods of stress. The credit rating may be viewed as a judgement on the economic and financial management of the issuer, and thus a downgrade may affect business sentiment and the investment climate.

Current ratings for NSW are:

Agency	Rating/Outlook	Scope
Moody’s	Aaa/Stable	TCorp long-term bonds
S&P	AAA/Stable	Issuer credit rating
Fitch	AA+	Foreign currency long-term debt

Credit ratings may be either solicited (i.e. contracted by the issuer) or unsolicited (i.e. initiated by a credit rating agency in response to demand from investors). Further, international regulators now require rating agencies to disclose this information. For example, S&P ratings for the Commonwealth Government (and most major governments internationally) are unsolicited.

The State’s central borrowing agency, TCorp, secures ratings for its issued debt from two internationally recognised agencies. These are Moody’s and S&P, and each receives an annual fee from TCorp for services.

A third company, Fitch Ratings Ltd. (Fitch), issues unsolicited ratings for the State. Fitch’s foreign currency rating for NSW is limited by its rating for the sovereign (Australia is AA+). While there is no contractual arrangement, established practice is for NSW Treasury and TCorp to provide Fitch with periodic briefings and information on request, and for Fitch to send its draft opinions to Treasury for correction of factual errors or inadvertent release of confidential information before issuing.

Moody's and S&P issue ratings for all Australian states. Fitch rates NSW, South Australia and Queensland. All three agencies have offices in Sydney, although the Moody's analyst for the Australian states is based in New York.

The rating cycle normally includes one or two meetings (after the Budget and the Half-Yearly Review respectively), plus special meetings and phone and email correspondence as appropriate.

At the major annual (post-Budget) meetings, the two designated rating agencies are briefed by the Treasury Secretary and Executive and the TCorp Chief Executive Officer and Chief Financial Officer. The meetings include a session with the NSW Treasurer and advisors, and a courtesy visit to the Premier. While the agenda reflects issues of the day, it invariably includes a review of current and projected fiscal performance, public enterprise sector developments and the TCorp funding program.

Normal practice is for rating agencies to issue a formal Credit Opinion followed by a full Credit Review toward the end of the calendar year, plus brief public comments on Budget day. However, they may issue announcements at any time, particularly if they believe there has been a material change to the outlook.

NSW government businesses are required to borrow through TCorp. This gives them a financial advantage, compared with private sector businesses, because they are able to borrow at interest rates based on the credit rating of the State of NSW. To achieve competitive neutrality, the Government imposes a risk-related guarantee fee on borrowings by government businesses. This reflects the cost they would face if required to borrow as a standalone entity. The Government contracts with one of the rating agencies (currently Moody's, which was selected by tender) to issue private standalone credit ratings which are used to set the level of the guarantee fee.

Under current legislation, NSW local governments cannot borrow through TCorp. However, they are unrestricted in borrowing from Australian institutions in Australian dollars. Lending institutions may require them to secure an investment-grade rating from a recognised credit rating agency.

History of NSW's credit rating

NSW has been rated AAA throughout its rating history, although it has twice faced a risk of downgrade. Moody's placed the State on credit watch in 1991, at a time when all Australian states were under pressure from the recession and financial management issues. S&P placed the State on negative outlook in 2008 following the failure of the electricity privatisation legislation. The State returned to AAA/Stable in June 2009.

The rating agencies recognise that performance is affected by the business cycle and other special factors and they may show some tolerance for temporary underperformance. What they look for is a clear plan and credible commitment to restore fiscal performance in the medium term. For example, when South Australia's outlook deteriorated sharply in 2009, S&P refrained from downgrading the state because, in its opinion, South Australia had a credible plan to restore performance:

> *The stable outlook reflects our expectation that South Australia will continue to manage its finances prudently during the current economic downturn. Although the state has exceeded the non-financial public sector net financial liabilities trigger set by Standard & Poor's, South Australia's metrics remain consistent with an 'AAA'. The forecast peak in net financial liabilities is only temporary, and Standard & Poor's believes that this ratio will decrease in the medium term, as projected by the government. The savings measures announced by the government will support the state's operating position and thereby reduce South Australia's need to borrow additional funds.*
>
> (S&P, 28 August 2009)[5]

In Queensland's case, by contrast, Moody's immediately downgraded the state in May 2009 when its budget announced a large debt-financed increase in infrastructure works spending. Moody's commented:

> *As a result, the state is expected to produce a series of very large recurring deficits. The widening budget gaps and the resulting additional borrowing that is being projected place the state on a debt trajectory that is no longer consistent with AAA debt metrics.*
>
> *The lack of a medium-term plan to restore budgetary performance and financial flexibility also contributes to the rating downgrade. Moody's anticipates the introduction of some measures to dampen the negative budget and debt trends, but the impact of such measures is unlikely to lead to a material shift in the negative trajectories.*
>
> (Moody's, 20 May 2009)[6]

Credit rating agency methodologies and assessment

Since their coverage of sub-sovereigns (state, regional and local governments) is global, rating agencies seek to apply standard methodologies for all such entities. These are documented in:

§ Moody's Investor Service, *Rating Methodology: Regional and Local Governments Outside the US* (May 2008)

§ Standard & Poor's, *Methodology for Rating International Local and Regional Government*s (20 September 2010).

These documents set out the standard multi-factor scorecard framework used in the annual rating review. In addition, each rating agency has selected one key balance sheet metric for special emphasis.

---

[5] Standard & Poor's, *Ratings Direct on the Direct Credit Portal – South Australia (State of).* August 2009, p.3.

[6] Moody's Investor Service, *Rating Action: Queensland (State of) Australia, Moody's Lowers Queensland's Rating to Aa1.* May 2009, p.1.

Both S&P and Moody's put special emphasis on a key balance sheet metric:

S&P: $\dfrac{\text{NFPS Net Debt + NFPS Net Unfunded Super}}{\text{NFPS Revenues}}$

Moody's: $\dfrac{\text{GG Gross Debt + Non-Commercial PTE Gross Debt}}{\text{GG Revenues}}$

S&P sets trigger band limits for this metric to remain consistent with a AAA credit rating. These bands differ among states (refer table below), reflecting their relative risk profiles, including the volatility of revenues. This 'risk profile' represents all other factors covered in their annual scorecard assessment. S&P has set the trigger band at 120-130 per cent for NSW.

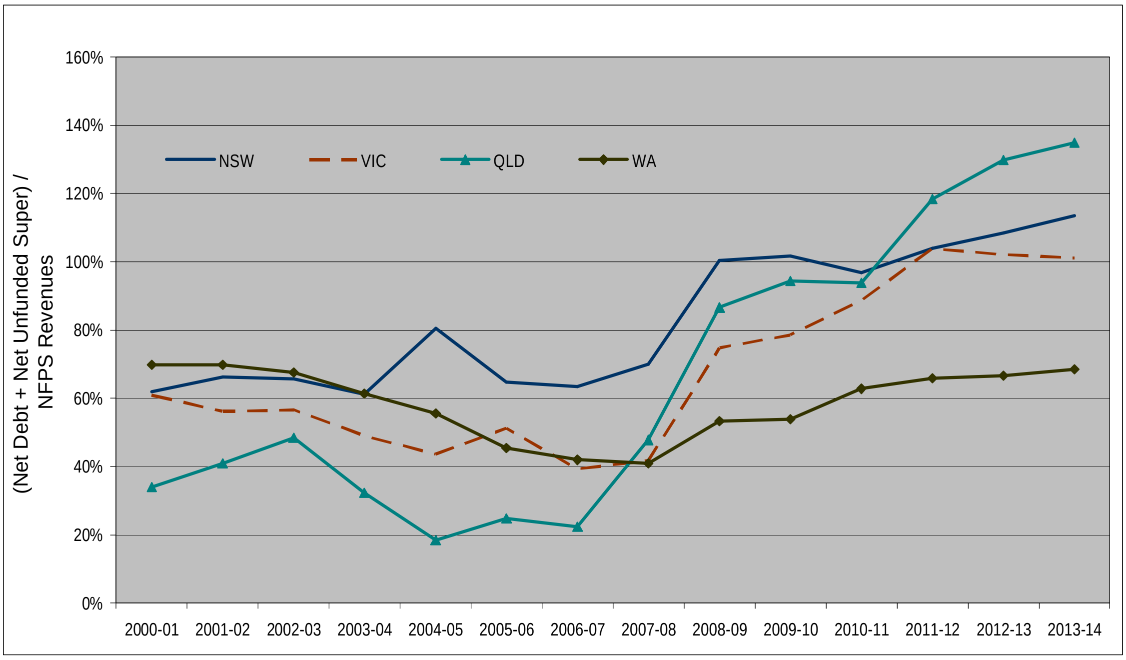
Table 1.5.1 S&P trigger bands for Australian jurisdictions

S&P Trigger Bands (percent of revenue)		
	Lower Bound	Upper Bound
NSW	120	130
Vic	130	140
Qld	100	110
WA	90	100
SA	80	90
Tas	60	70
ACT	100	120

Performance of the major states on the S&P metric (with projections to 2013-14 based on their Half-Yearly Reviews) is shown in the chart below.

Figure 1.5.1 S&P ratio – interstate comparison

(Ratio of net debt + net financial liabilities to revenues in the non-financial public sector)

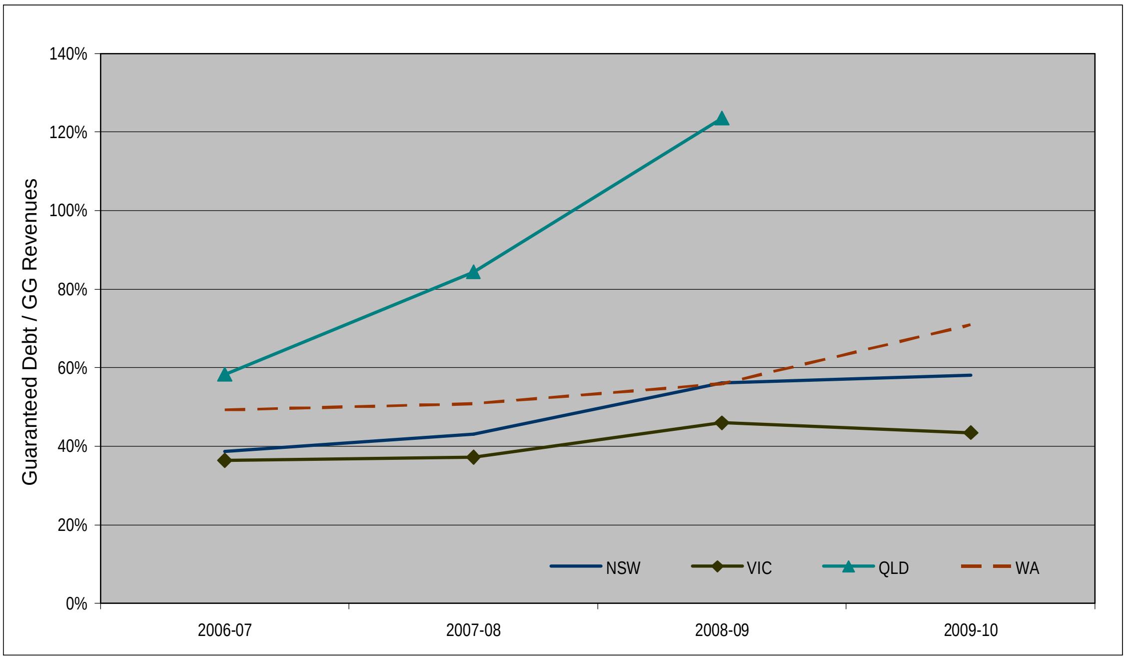


S&P is currently in the process of revising its trigger band methodology, which dates from early 2009 (prior to their current global semi-sovereign methodology).

Moody's has not set formal target bands for its metric, but has said informally that the NSW ratio should not be allowed to exceed 60-70 per cent.

Performance of major states against the Moody's metric (based on the latest Moody's credit reviews for each state, which do not include projections) is shown below.

Figure 1.5.2 Moody's ratio for major jurisdictions
(Ratio of state non-commercial debt to general government revenues)



The two metrics can send diverging signals when the structure of the balance sheet changes.

The S&P metric gives equal weight to net debt and net unfunded superannuation. Moody's views debt as a 'harder' contractual constraint, compared to unfunded super liabilities, which governments can alter by changing policies. Therefore an increase in net debt that was offset by a reduction in unfunded super would be neutral for the S&P ratio, but would cause a deterioration in the Moody's ratio.

A second difference is in debt classification. The Moody's metric distinguishes between commercial (self-supporting) debt (which is netted out) and non-commercial (taxpayer-supported) debt. The S&P metric does not make this distinction. Therefore debt to expand commercial services (such as water) would not affect the Moody's ratio but it would raise the S&P metric.

Scorecard framework

While the key metrics described above provide a snapshot of fiscal performance, both S&P and Moody's use a multifactor 'scorecard' framework in conducting their annual rating reviews. The scorecards are used to assess and weight a range of political, economic and fiscal factors that, in their view, are systematically related to credit performance. S&P uses the scorecard to set the target band for its metric. The main analytical categories of the two agencies (reordered for comparability) are:

Standard & Poor's	Moody's
Institutional framework (national)	Institutional framework Operating environment
Economy	Economic fundamentals
Financial management	Governance and management
Budgetary flexibility Budgetary performance	Financial position and performance
Debt burden Liquidity Contingent liabilities	Debt profile

Each of these scorecard categories is summarised below.

Institutional framework (and operating environment)

The 'Operating Environment' is the national economic and political context within which the State operates. Factors scored include:

- predictability, stability, responsiveness of state revenue powers and spending responsibilities
- fiscal flexibility of states to make their own revenue and spending decisions
- fiscal adequacy, being the adequacy of revenue sources and whether the state faces an unfunded borrowing requirement after normal transfers and own-revenue generation.

Economy

The economic assessment aims to measure how economic factors are likely to impact on a state's revenue generation capability and spending needs, and ultimately its ability to service debt in the medium to long term.

Governance and financial management

This assessment rates a government's general track record for budgeting and infrastructure programs, timely legislative support, and good investment and debt management policies. Key measures include:

- fiscal management that typically meets or exceeds fiscal targets
- investment and debt management that is conservative and avoids risks
- institutional capacity: clearly defined rules and procedures and orderly processes
- financial reporting that is transparent, timely, detailed and audited

- budgeting that is fully consolidated with formalised processes, timely approval and few revisions
- long-term capital and financial planning that is prudent, detailed and consistent with ongoing political commitment
- revenue and expenditure are accurately forecast, and robustly controlled
- government entities (PTEs) exist only for sound purposes, with transparent board and CEO selection processes, and entity costs fully covered by own sources plus contractually agreed service fees
- political and managerial strength (large government majority, cross-party consensus, strong government management team)
- external risks clearly managed with plans to deal with stress scenarios and clear willingness to reduce public services rather than compromise financial viability.

Financial position, performance and flexibility

The aim is to determine if recurring revenues will cover ongoing operating and infrastructure spending and debt service commitments and to assess the flexibility of financial management in terms of the ability to adjust to external shocks. Factors assessed include: ability and willingness to adjust taxes and spending when needed to restore the fiscal balance; taxing powers, and their effective exercise; competence in tax collection; fiscal transfers (how predictable and untied); expenditure growth drivers (including demography); limits on flexibility imposed by national government; and liquidity (the cushion provided by cash balances and external sources of liquidity).

Debt and liquidity

A government debt profile is developed covering the amount of debt, the burden it poses, its structure and composition, past trends and future requirements. Factors include:

- level of debt relative to government revenues and to economic output
- debt structure (alignment of repayments with revenue generation, and refinancing risk)
- reliance on short maturities and corresponding exposure to market risk
- foreign currency risk exposure and risk management
- consolidation of off-balance-sheet items and debt-like instruments (including PPPs)
- contingent liabilities.

S&P’s current global methodology considers unfunded pension (and other) liabilities to be less significant than debt because their magnitude is less certain, and states can change the liability by changing parameters (retirement age, indexation provisions and so on). Its key metric for the Australian states (the so-called S&P ratio), however, gives equal weight to unfunded super and net debt (S&P indicates this is under review).

The rating agency scorecards quantify each of these factors, apply weights, and consolidate this information into an aggregate rating scale. While the process is systematic, it is qualitative as well as quantitative. It relies on the judgement of a panel of assessors representing the agency's global scope to avoid a bias for one geographical region or institutional system over another.

2 BUDGET STRUCTURE AND TRENDS

Key points

- § Total revenue grew at an average annual rate of 5.6 per cent in the 10 years to 2010-11, excluding the contribution of the Commonwealth Government's Economic Stimulus Plan. Tax revenue grew at 4.2 per cent, Commonwealth grants grew at 6.9 per cent and all remaining revenue sources combined grew at 6.9 per cent.
- § NSW is heavily dependent on Commonwealth funding, which accounts for 45 per cent of the State's total general government revenue.
- § State taxes account for another 36 per cent of general government revenue and approximately 40 per cent of state taxes are narrowly based and economically inefficient.
- § Total expenses grew at an average annual rate of 6.2 per cent per annum over the last 10 years to 2010-11, excluding the effect of the Economic Stimulus Plan.
- § Employee costs are a major component and a major cost driver, constituting 49 per cent of total expenditure and growing at an average of 6.5 per cent per annum. This reflects growth in wages, employment and grade shift.
- § The highest growth has been experienced in the areas of health, social security and welfare, environmental protection and natural resources, and transport.
- § Policy has been a significant cost driver in particular areas, especially regarding reduced class sizes in education; amended laws on sentencing; increased police numbers; increased standards for reliability and customer service; decisions on tolling and rail charges in the transport area; and various initiatives regarding social security and welfare.
- § There has been a significant deterioration in the budget results (net operating balance) in the last 10 years, reflecting the fact that the annual growth in expenses of 6.2 per cent has exceeded the annual growth in revenues of 5.6 per cent.
- § The deterioration in the net lending results has been more significant, reflecting the deterioration in budget results and the significant growth in the general government sector capital program.
- § An increasing proportion of the general government capital program is funded by debt rather than operating surpluses and asset sales.

- In seven of the last 10 budgets, the actual budget outcome has been better than forecast, due to higher than budgeted revenue. However, this has produced a 'ratcheting up' effect, where higher revenue leads to increased expenditure.

2.1 Budget trends

Key concepts

Budget result

The budget result (net operating balance) reports the difference between the full cost of general government service delivery in the financial year, and the revenues earned during the year to fund those services.

The budget result is measured on a full accrual basis, in accordance with Australian Accounting Standards. This means that revenues and expenses are recognised when they are earned and incurred, respectively, rather than when cash is received or paid. For example, the budget result includes the full cost of employing public servants in the financial year; that is, their cash salary, plus accruing benefits such as superannuation, long service leave and annual leave.

The budget result does not include capital expenditure undertaken during the financial year but it does include a charge for depreciation, which represents the estimated loss of value (through wear and tear) of the full stock of physical assets owned by general government agencies.

Net lending result

A second key aggregate is the net lending result, which reports on the net impact of the general government sector's recurrent and capital activities, and their impact on the balance sheet (net financial liabilities). The net lending result is the sum of the net operating result before depreciation, and net capital expenditure (i.e. expenditure after asset sales).

A net lending deficit (i.e. net borrowings) means that funds generated from operations (the budget result before depreciation) plus asset sales are insufficient to fully fund the capital expenditure program, and the difference must be funded by borrowings.

While the net lending result reports on the impact of both operating and capital activities during the year, it is still based on accrual principles; for example, it includes non-cash accruing superannuation and leave entitlements.

Cash surplus/deficit

The cash surplus/deficit reports on the cash impact of both operating and capital activities during the year.

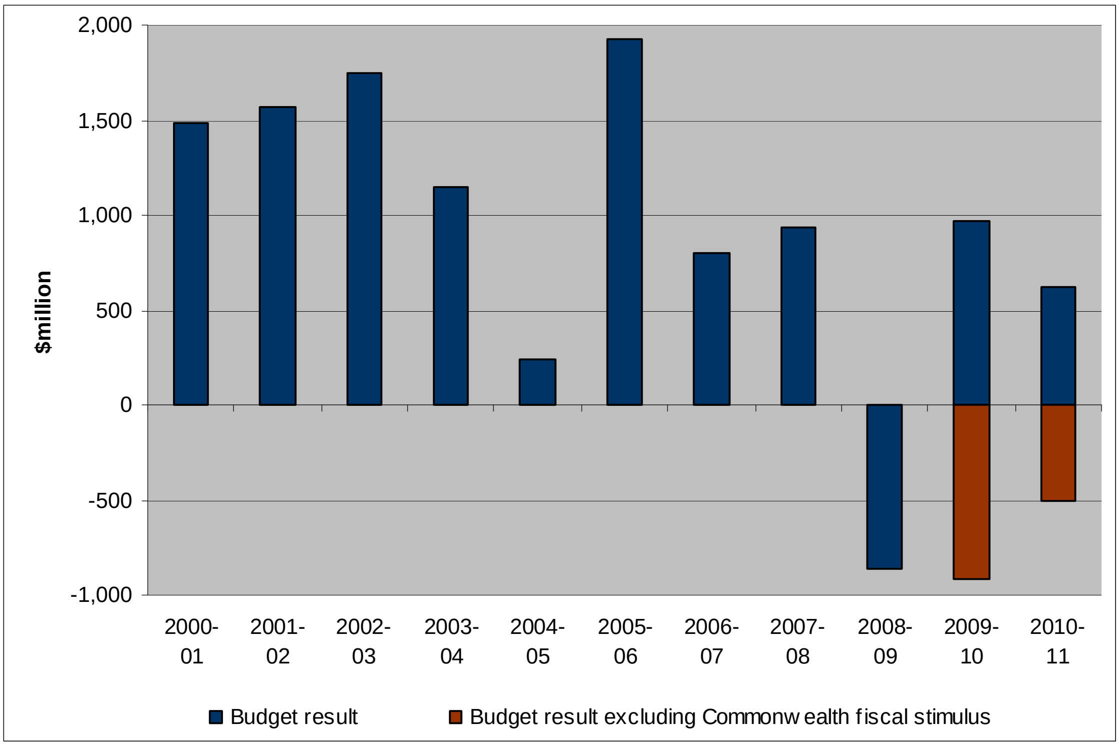
Budget results 2000-01 to 2010-11

There has been a progressive deterioration in the budget result (net operating balance) in the last 10 years, as shown in Figure 2.1.1.

The budget results for 2009-10 and 2010-11 have been positively affected by the Commonwealth Government's Economic Stimulus Plan. The grants provided to NSW for upgrading school buildings are treated as revenue in the operating statement but will be expensed progressively as a depreciation charge over the useful lives of the assets acquired.

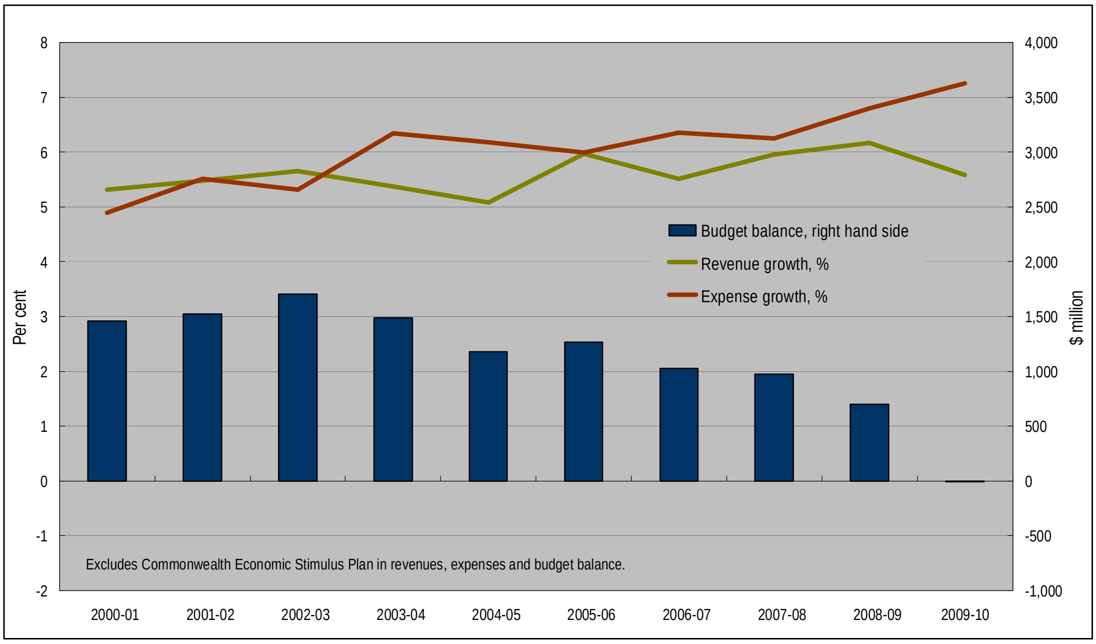
Without the impact of the Economic Stimulus Plan, the budget results would be $1.9 billion lower in 2009-10 and $1.1 billion lower in 2010-11. Figure 2.1.1 also presents the Budget for 2009-10 and 2010-11, excluding the impact of the Economic Stimulus Plan.

Figure 2.1.1 Budget results 2000-01 to 2010-11



The deterioration of the budget results is due to the growth in general government expenses exceeding revenue growth. In particular, there is an increasing gap between average expense growth and revenue growth from 2005-06, as shown in Figure 2.1.2.

Figure 2.1.2 Four-year growth rates and average budget balance



In the 10 years to 2010-11, expenditure growth (excluding the impact of the Economic Stimulus Plan) averaged 6.1 per cent per annum, compared with revenue growth (excluding the impact of the Economic Stimulus Plan) of 5.5 per cent per annum. In the five years to 2010-11, this gap has widened, with expenditure growth increasing to over 6.4 per cent per annum while revenue growth slowed to 5.2 per cent.

Revenue structure and trends

Total general government revenue grew at an average annual rate of 5.6 per cent in the 10 years to 2010-11 (excluding the impact of the Economic Stimulus Plan), exactly matching the growth of gross state product (GSP) over the same period.

Taxation revenue has grown more slowly than GSP – at an average annual rate of 4.2 per cent – while other revenue sources have grown faster than GSP, including royalties (19.2 per cent), sales of goods and services (6.9 per cent), and Commonwealth grants (6.9 per cent).

NSW is heavily dependent on Commonwealth funding, which now accounts for 45 per cent of total general government sector revenue.

A detailed analysis of revenue structure and trends is set out in Section 2.2, Revenue structure and trends.

Expenditure structure and trends

Since 2001-02, NSW expenses have grown at an average annual rate of 6.2 per cent – 0.3 per cent per annum above the growth in revenues (0.6 per cent excluding the impact of the Economic Stimulus Plan).

Employee costs, which account for 49 per cent of total expenses, have increased at an annual average rate of 6.5 per cent. This reflects growth in real wages, increasing employee numbers, and an increase in average job grading.

Government policy has been a significant cost driver in some areas, such as reduced class sizes, changed sentencing laws, increased police numbers and decisions on rail charges in the transport sector.

On a functional basis, trend growth has been highest in the areas of health (7.2 per cent), social services (8.4 per cent), and environmental protection and natural resources (7.9 per cent). Other areas have shown slower growth in expenses, including education (5.4 per cent) and public order and safety (5.5 per cent).

A detailed analysis of expenditure structure and trends is set out in Section 2.3, Expenditure structure and trends.

Budget variations

On average over the last 10 years, revenues have been $1.8 billion per annum above the budget forecast.

On average, taxation revenue has been $512 million per annum above the budget forecast. Taxation, particularly transfer duty, is strongly influenced by economic conditions. It is inherently difficult to predict turning points, so revenue forecasts tend to display a conservative bias. The sustained economic strength of the last 10 years has resulted in higher than budgeted revenues over this period.

On average, Commonwealth grants have been $515 million per annum above the budget forecast. This is mainly due to significant policy decisions made by the Commonwealth Government, including an additional roads grant of $960 million in 2005-06, and a total of $2.5 billion of additional revenue in 2008-09, which included Commonwealth of Australian Governments (COAG) -related funding, the First Home Owner Grant, additional special-purpose payments and road grants.

On average, expenses have been $1.3 billion per annum above the budget forecast. There is a positive correlation between above-budget growth in revenues and subsequent above-budget growth in expenses. In specific circumstances there has been a very direct correlation; for example, additional Commonwealth grants and additional own-sourced agency revenues result in equivalent additional expenses.

The Government has made an explicit decision to apply unbudgeted revenues to strengthen the State’s balance sheet. For example, in 2006-07 a one-off grant of $960 million was made to the Transport Infrastructure Development Corporation to repay debt.

More generally, unbudgeted revenue has led to weaker fiscal discipline, including:

§ consistent budget overruns in key service delivery areas including health, education and the police service, which have been funded by additional revenue rather than addressed through remedial action to limit expenditure

§ the routine tabling of supplementary appropriation bills, which have been used to fund a range of ad hoc spending decisions outside the budget process, in addition to funding budget overruns.

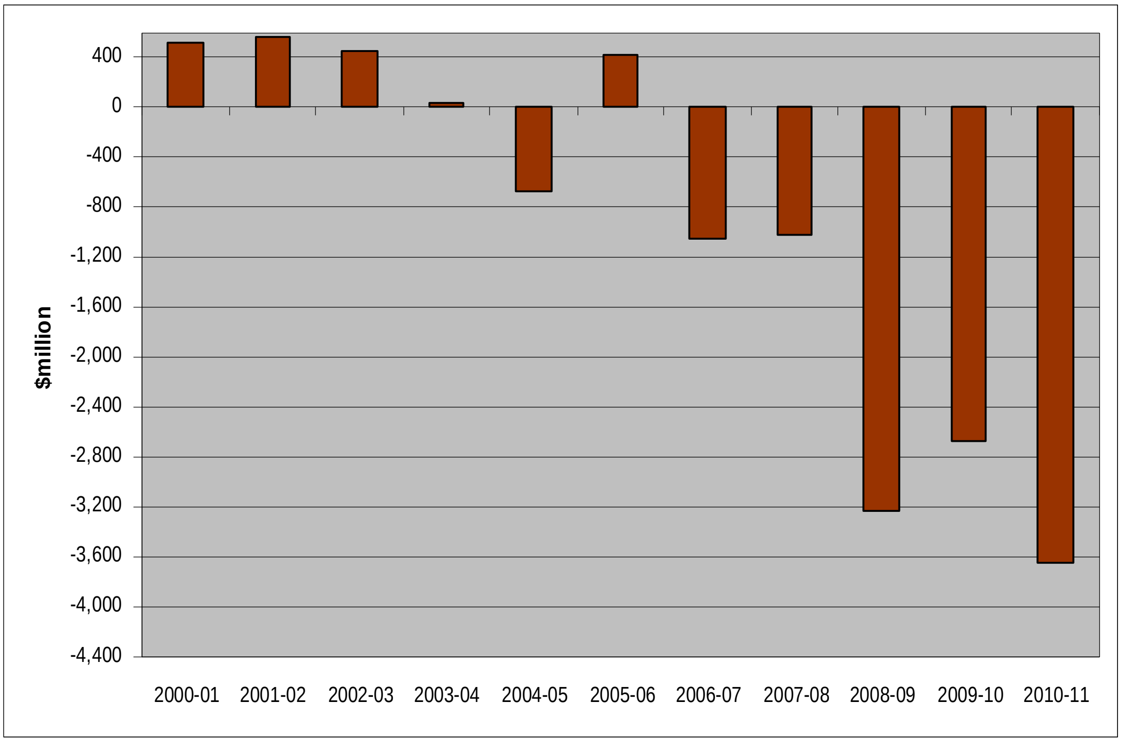
A detailed analysis of budget variations is set out in Section 2.4, Budget variations.

Net lending results 2000-01 to 2010-11

The net lending result has deteriorated over the last 10 years, particularly since 2006-07, with an ongoing increase in net borrowing requirements.

The net lending result is not significantly affected by the Economic Stimulus Plan, because Commonwealth funding is broadly offset by capital grants to Housing NSW and capital expenditure in the Department of Education.

Figure 2.1.3 Net lending results 2000-01 to 2010-11 ($m)

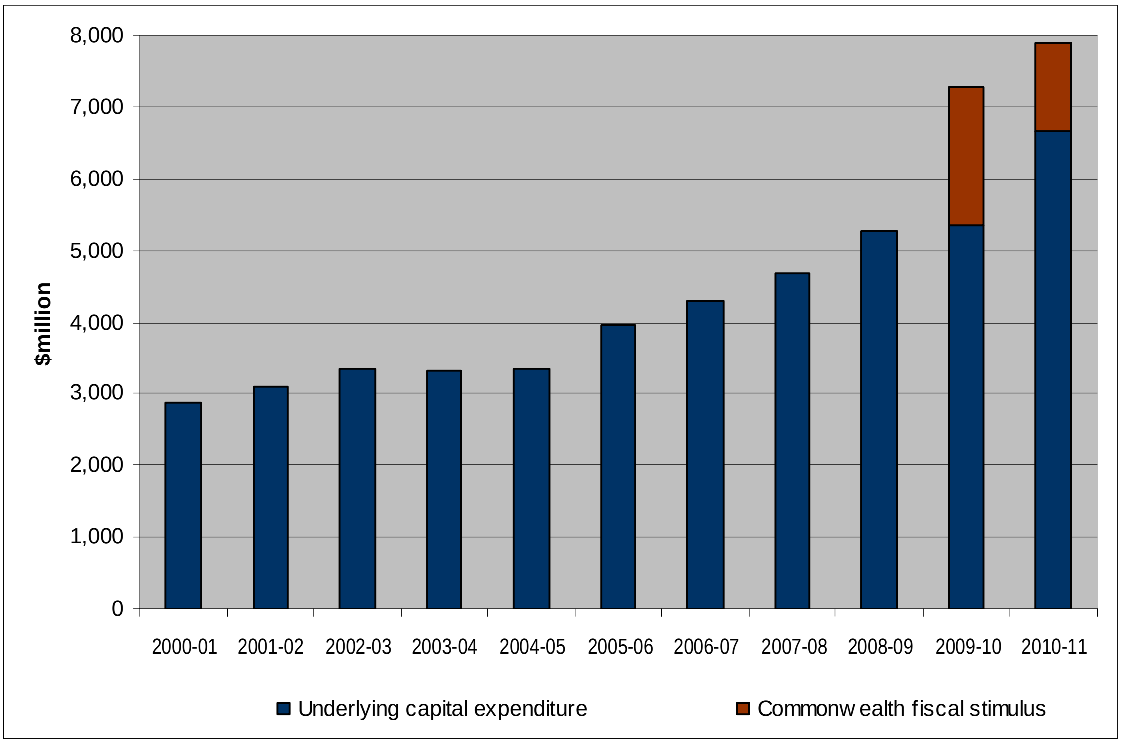


The deterioration in the net lending result reflects:

§ the significant deterioration in budget results and

§ the significant escalation in general government capital expenditure, especially since 2005-06, as shown in Figure 2.1.4.

Figure 2.1.4 General government capital expenditure 2000-01 to 2010-11 ($m)



Since 2001-02, the State's general government capital expenditure has increased by an average annual growth rate of 10.6 per cent.

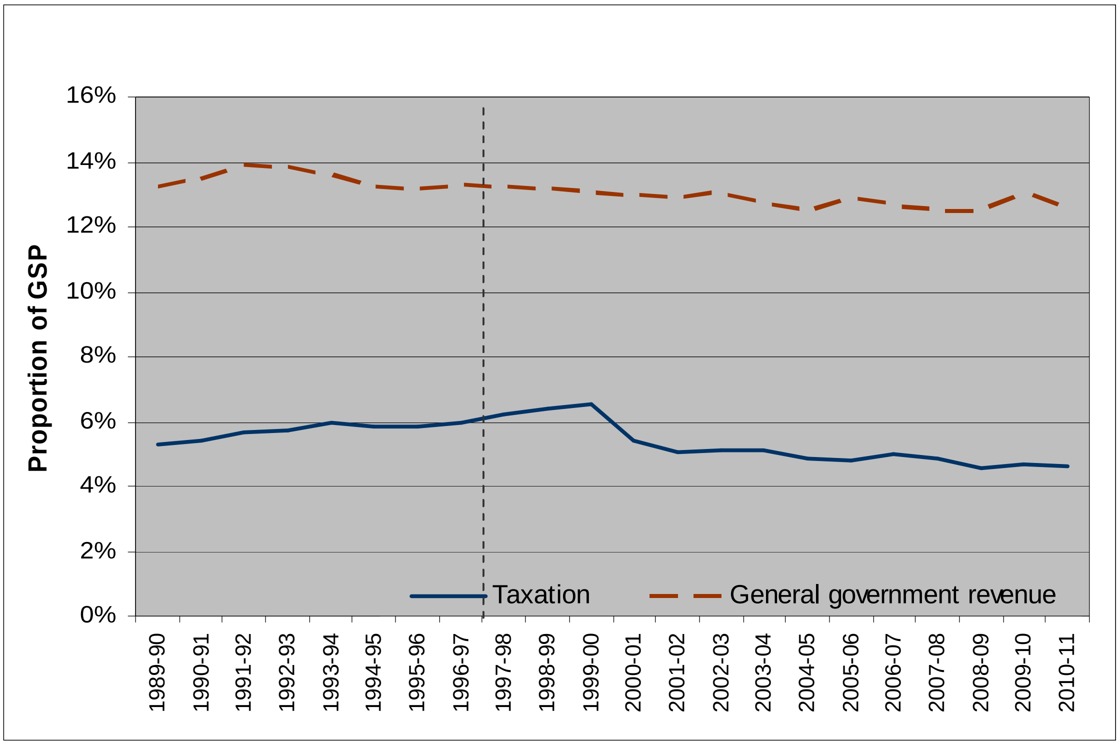
The general government capital program has accelerated significantly since 2005-06, even after allowing for the impact of the Commonwealth Economic Stimulus Plan. This growth has occurred across a range of functional areas including health, education and transport.

A detailed analysis of general government capital expenditure trends is set out in Section 3.2, Drivers of capital demand.

2.2 Revenue structure and trends

Over the long term, general government revenue has declined as a proportion of gross state product (GSP), from 13.9 per cent in 1991-92 to 12.6 per cent forecast for 2010-11. State taxation revenue declined significantly in 2000-01, when the GST was introduced and a number of state taxes were abolished. Since then, tax revenue has continued to decline as a proportion of GSP, as shown in Figure 2.2.1, which is largely due to policy choices.

Figure 2.2.1 NSW revenue as a proportion of gross state product (GSP)



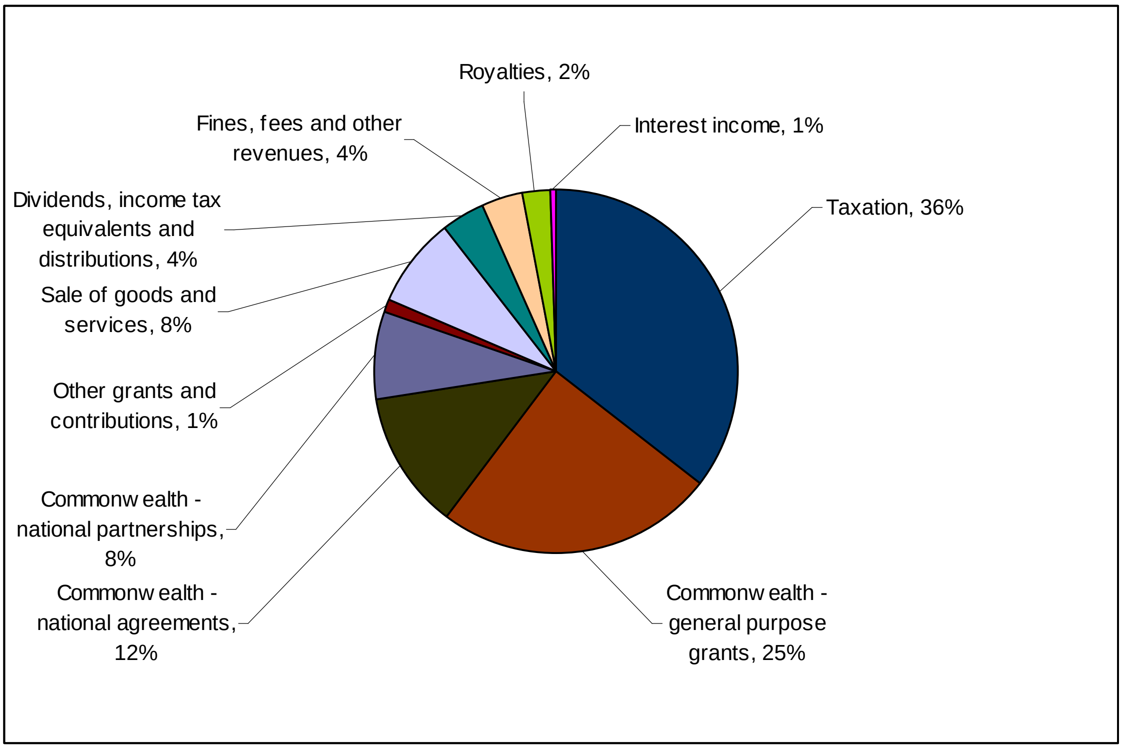
Notes: Underlying general government revenue excludes revenue received under the Commonwealth Government's Economic Stimulus Plan. Revenue figures prior to 1996-97 are from the Australian Bureau of Statistics.

Revenue structure

Like other states and territories, NSW is heavily dependent on Commonwealth funding, which accounts for approximately 45 per cent of total state revenue. Of this, 25 percentage points comprise untied general purpose payments (reflecting the NSW share of GST) and the balance represents Specific Purpose Payments.

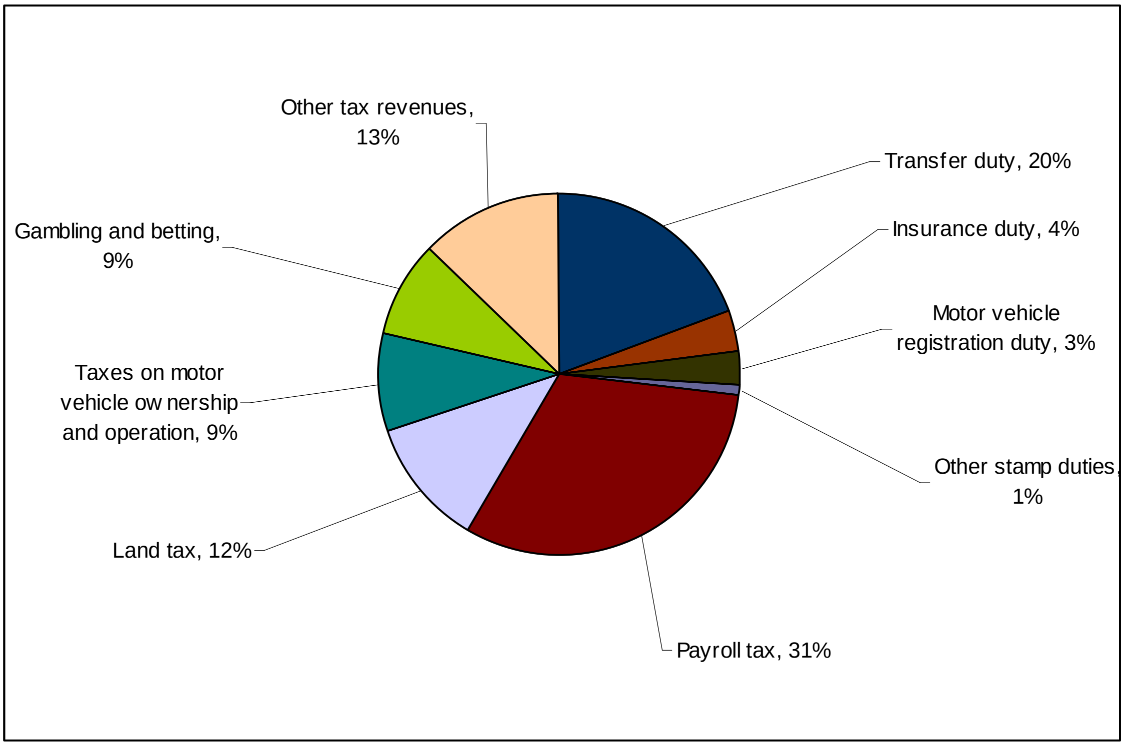
The balance of the State's revenue – 55 per cent of the total – is own-source revenue, of which the largest component, 35 percentage points, is state taxation. The other key elements of own-source revenue are sales of goods and services (8 percentage points), fines and regulatory fees (6 percentage points) and dividends and distributions from public trading enterprises (4 percentage points).

Figure 2.2.2 NSW general government revenue, 2010-11



State taxation can be divided into two broad categories: taxes levied on broad-based economic aggregates, which are relatively efficient; and taxes levied on narrowly based transactions, which are relatively inefficient. As shown in Figure 2.2.3, approximately 58 per cent of state taxes are relatively efficient taxes based on broad economic aggregates, namely payroll taxes, land tax and annual vehicle registration taxes. The remaining taxes include the most inefficient state taxes: the various stamp duties on property, insurance, and transfers of new and used vehicles. As these transactions represent narrow sections of economic activity, taxing them significantly distorts economic activity. Although gambling taxes are based on transactions and levied on a narrow area of activity, they are an efficient means of capturing ‘rents’ (excess profits) arising from regulatory restrictions on competition, which have been introduced in part to combat the negative externalities of gambling.

Figure 2.2.3 Composition of NSW tax revenue, 2010-11



Revenue trends

In the past 10 years, state revenue has grown at an average annual rate of 5.6 per cent (excluding the impact of the Commonwealth Economic Stimulus Plan), which is lower than the 5.9 per cent growth in GSP over the same period.

Taxation revenue has grown at an average annual rate of 4.2 per cent, while other revenue sources have grown faster than GSP. In declining order, average annual growth rates for the broad revenue classes shown in Figure 2.2.4 are: royalties at 19.2 per cent; sales of goods and services at 6.9 per cent; and Commonwealth grants at 6.9 per cent. Details for the period 2001-02 to 2010-11 are shown in Table 2.2.1.

Table 2.2.1 NSW general government revenue

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Average annual growth %
Taxation	13,210	14,146	15,018	15,300	15,902	17,697	18,554	17,885	19,124	20,185	4.2
Commonwealth grants											
General purpose	9,952	9,931	9,939	10,181	10,720	10,938	11,942	11,974	13,419	13,922	5.2
National Agreement	5,081	5,295	5,554	6,010	7,320	6,813	7,586	6,573	6,555	6,861	4.2
National Partnership	-	-	-	-	-	-	-	3,145	6,345	4,479	19.4[a]
Sale of goods and services	2,485	2,685	2,714	2,804	3,037	3,306	3,663	4,024	4,357	4,660	6.9
Interest income	282	440	862	1,050	1,298	1,314	454	416	313	421	-1.1
Dividends, income tax equivalents and distributions	1,308	1,276	1,614	1,508	1,837	1,951	2,320	2,029	2,322	2,122	5.7
Royalties	216	235	233	396	504	489	574	1279	985	1,275	19.2
Fines, fees and licences	432	448	475	549	570	510	578	644	736	780	3.9
Other grants and contributions	37	564	371	506	456	450	557	602	669	649	21.0
Other state revenues	825	1,047	873	778	990	1,230	1,205	1,099	1,517	1,330	4.9
Total general government revenue	**33,828**	**36,067**	**37,653**	**39,084**	**42,634**	**44,697**	**47,434**	**49,669**	**56,342**	**56,685**	**5.9**

(a) Growth rate calculated for three years

The effects of the recent economic slowdown can be seen in Figure 2.2.4, with taxation revenue falling in 2008-09 and Commonwealth grants temporarily increasing in 2009-10.

Figure 2.2.4 NSW general government revenue, 2001-02 to 2010-11

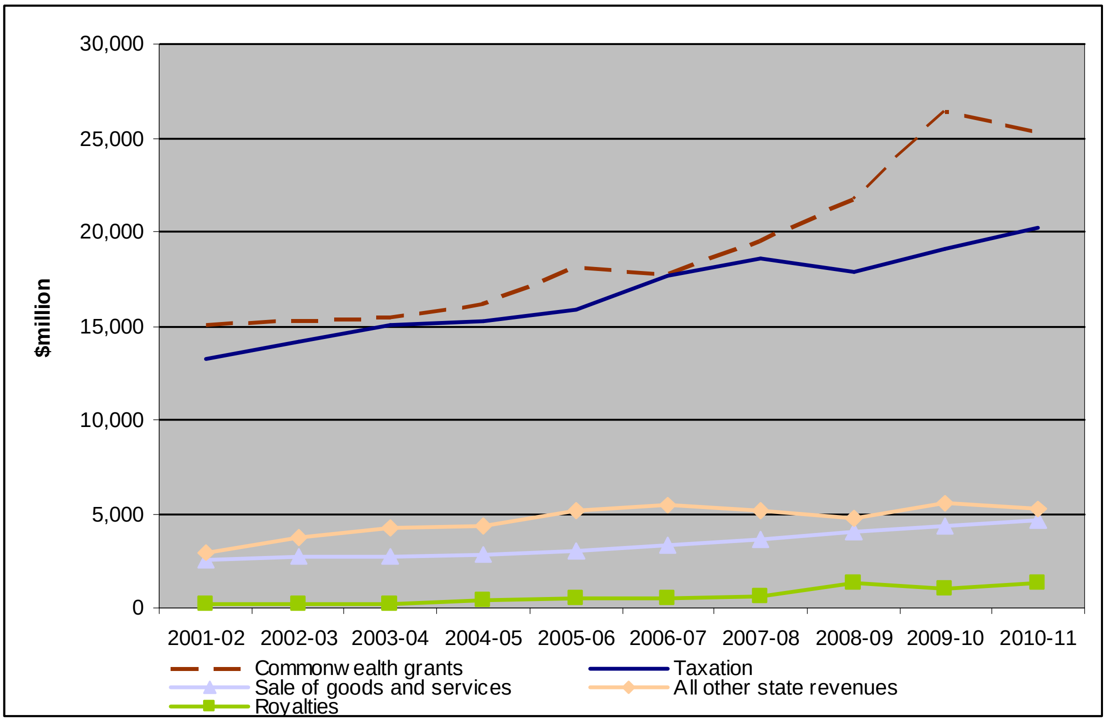


Table 2.2.2 reports state tax revenues since 2001-02. The largest source of tax revenue – payroll tax – has grown at an average annual rate of 5.2 per cent in this period. This growth rate is lower than GSP growth (5.9 per cent), reflecting reduced payroll tax rates and increased payroll tax thresholds.

The second largest revenue source – stamp duties – has grown at an average annual rate of 1.6 per cent. This slow growth is almost entirely due to the abolition of minor stamp duties as part of a package of tax reforms agreed upon when the GST was introduced. As a result of confining attention to stamp duties on real estate, motor vehicles and insurance contracts, revenue has grown at an average annual rate of 5.2 per cent. Transfer duty is the most volatile element of tax revenue (in absolute dollar terms), and its growth rate fluctuates widely with the property market cycle.

The recent weakness in property markets does not extend to land values, with revenue from land tax growing at an average annual rate of 9.6 per cent over the decade.

Taxes on motor vehicle ownership have grown at the same rate as GSP (5.9 per cent per annum). Gambling revenue has grown more slowly (3.9 per cent per annum), in part reflecting a real decline in racing revenue as a result of increased competition from interstate betting. Other tax revenues have grown by 5.1 per cent per annum, with increased parking space levies and waste and environment levies making notable contributions to this growth.

Table 2.2.2 NSW tax revenue

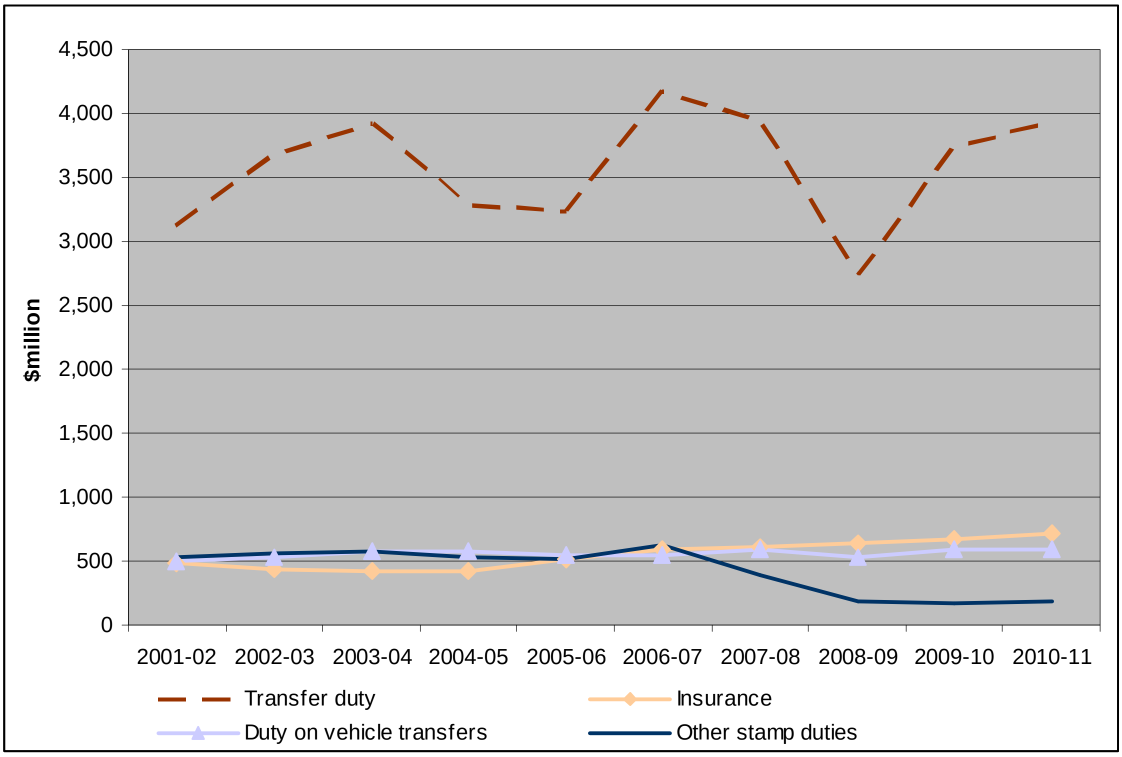
	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Average annual growth %
Stamp duties											
Transfer duty	3,119	3,677	3,918	3,282	3,237	4,166	3,938	2,736	3,739	3,945	5.7
Insurance	487	442	423	423	523	598	610	646	678	715	5.5
Motor vehicle transfers	497	534	581	570	548	554	600	537	587	590	2.4
Other stamp duties	536	567	580	531	518	632	387	187	172	193	-18.6
Total stamp duties	**4,639**	**5,221**	**5,502**	**4,806**	**4,826**	**5,950**	**5,535**	**4,106**	**5,176**	**5,443**	**1.6**
Payroll tax	**4,021**	**4,123**	**4,356**	**4,835**	**5,184**	**5,661**	**6,205**	**6,356**	**6,138**	**6,329**	**4.7**
Land tax	**1,001**	**1,136**	**1,355**	**1,646**	**1,717**	**2,036**	**1,937**	**2,252**	**2,296**	**2,328**	**9.6**
Taxes on motor vehicle ownership and operation											
Weight tax	816	881	948	1,003	1,057	1,114	1,186	1,229	1,312	1,475	6.7
Vehicle registration and transfer fees	208	221	233	244	257	-268	281	285	307	236	1.8
Other motor vehicle taxes	17	20	23	25	26	28	31	32	35	36	8.5
Total motor vehicle	**1,041**	**1,122**	**1,203**	**1,272**	**1,341**	**874**	**1,498**	**1,547**	**1,654**	**1,748**	**5.9**
Gambling and betting											
Racing	142	145	150	157	150	153	147	159	164	165	1.8
Club gaming device duty	404	414	435	500	569	661	609	636	640	688	5.4
Hotel gaming device duty	319	338	358	395	417	447	407	410	425	460	3.6
Lotteries and lotto	256	277	278	281	283	284	300	308	349	305	1.8
Casino	80	80	81	88	92	98	97	100	116	149	6.2
Other gambling and betting	8	8	8	9	8	8	8	11	11	12	4.7
Total gambling	**1,209**	**1,262**	**1,310**	**1,429**	**1,519**	**1,652**	**1,569**	**1,624**	**1,706**	**1,779**	**3.9**
Other revenues											
Health insurance levy	94	96	98	102	108	119	125	133	141	145	4.9
Insurance protection tax	65	67	68	68	68	67	68	67	66	69	4.9
Emergency services contributions	350	368	382	420	454	479	521	572	554	672	8.1
Parking space levy	41	45	48	46	45	50	49	50	101	95	7.6
Waste and environment levy	78	90	95	104	118	154	222	245	295	374	16.6
Government guarantee of debt	93	115	129	109	105	97	106	179	443	400	10.9

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Average annual growth %
Private transport operators levy	6	6	9	10	11	16	15	16	14	22	8.9
Pollution control licences	43	327	36	44	44	42	51	46	46	50	4.9
Other	535	173	435	422	373	516	668	706	508	732	-1.5
Total other revenues	**1,299**	**1,282**	**1,291**	**1,314**	**1,315**	**1,524**	**1,810**	**1,999**	**2,155**	**2,559**	**5.1**
Total tax revenue	**13,210**	**14,146**	**15,018**	**15,301**	**15,902**	**17,697**	**18,554**	**17,885**	**19,124**	**20,185**	**4.2**

State taxes

Stamp duties

Figure 2.2.5 Stamp duty revenue



Stamp duty revenue is dominated by transfer duties on real properties, with the other forms of duties making relatively modest contributions.

Transfer duty

Stamp duty is levied on transfers of real property. The residential property market accounts for around three-quarters of transfer duty revenue, with the remaining quarter coming from non-residential property and business transfers. Within the residential market, owner-occupiers accounted for 57 per cent of housing finance approvals in the 10 years ending December 2010, and of these, around 14 percentage points were first home buyers.

Revenue from transfer duty grew at an average annual growth rate of 5.7 per cent in the 10 years to 2010-11[1]. In both absolute dollar terms and percentage terms, transfer duty was the most volatile source of tax revenue: its annual fluctuations ranged between -37.6 per cent and +36.7 per cent during this period.

The following factors are the main drivers of transfer duty growth and the sources of its volatility:

- Market prices of properties tend to drive the long-term trend growth in revenue.
- The number of property sales is more volatile than market prices and is a major source of volatility in revenue. Over the past 10 years, housing building approvals (a measure of new home construction) averaged around 0.7 per cent of the housing stock and around 8.2 per cent of annual transfers.
- Changes in support for first home buyers (e.g. increased Commonwealth support for first home buyers in the Economic Stimulus Plan) have driven changes in the composition of market activity, but this does not have a major direct effect on revenue since most first home buyers pay little or no transfer duty.

Policy-based rate changes have not been a major driver of revenue growth. The highest marginal rate of 7 per cent for properties valued over $3 million was introduced in 2004. Ad valorem fees for registration of land title, introduced in 2010-11 and soon to be repealed, are classified in the Budget as part of transfer duty revenue. They account for $68 million (1.7 per cent) of forecast revenue in 2010-11.

Insurance duty

Insurance duty is imposed on general insurance premiums, such as household, travel and mortgage insurance, and certain types of commercial insurance, including public liability insurance. There are numerous concessions and exemptions.

Insurance duty revenue has grown at an average annual rate of 5.5 per cent over the past 10 years. The revenue base is determined by the level of insurance premiums and insurance take-up rates, which in turn are linked to state final demand and state economic growth.

Policy changes have also affected the growth rate of insurance duties. The standard rate was reduced from 10 per cent to 5 per cent from 1 August 2002, then increased to 9 per cent from 1 September 2005.

The Emergency Services Levy, which is discussed later in this section, is a tax imposed on insurance policies to fund NSW fire and emergency services. The problem with this approach is that it discourages people from taking out insurance policies.

Stamp duty on vehicle transfers

Duty on vehicle transfers is paid when a vehicle is registered in NSW for the first time (i.e. new vehicles and second-hand interstate purchases) and when registration is

[1] As a highly volatile revenue source, growth rates for stamp duty are particularly affected by the base year. Using 2001-02 as the base year, the nine-year average growth rate is 2.6 per cent.

transferred from one owner to another. Duty rates for passenger vehicles are 3 per cent for vehicles valued up to $45,000 and a marginal rate of 5 per cent on vehicles valued at more than $45,000. Non-passenger vehicles are subject to the higher marginal rate. A flat fee is also charged to cover the administrative costs of transferring registration.

Revenue from vehicle registration duty has grown at an average annual growth rate of 2.4 per cent over the past 10 years. The revenue drivers are registration prices, new and used car sales, and bracket creep. For forecasting purposes, registration prices are assumed to grow in line with the forecasts of Sydney's consumer price index (CPI). The number of vehicle sales is linked to overall economic activity. In 2009-10, approximately 55 per cent of revenue from stamp duty on vehicle transfers was raised from new vehicles and about 63 per cent of transactions related to passenger vehicles.

The only policy change during the past 10 years was the abolition of stamp duty on caravan and camper trailer transfers, from 1 July 2009. This was not a major source of revenue; its abolition cost $14 million in revenue in 2009-10 (2.4 per cent of vehicle duty revenue).

Other stamp duties

Other stamp duties include duties on loan securities, share transfers, financial institutions, hiring arrangements and leases. Revenue from these other stamp duties has declined over the last 10 years at an average annual rate of -18.6 per cent. The majority of this decline occurred in 2000-01, 2007-08 and 2008-09.

The main drivers of the revenue decline were the abolition of certain stamp duties as part of the agreement with the Commonwealth on the introduction of the GST. The following duties have been abolished:

- the financial institutions duty and the duty on quoted marketable securities, from 1 July 2000
- the vendor duty, from 2 August 2005
- the hire of goods duty, from 1 January 2007
- the duty on mortgages for the purpose of owner-occupied housing, from 1 September 2007
- the duty on mortgages for the purpose of investment housing, from 1 July 2008
- the duty on lease instruments, from 1 January 2008[2].

Other duties due to be abolished from 1 July 2012, are:

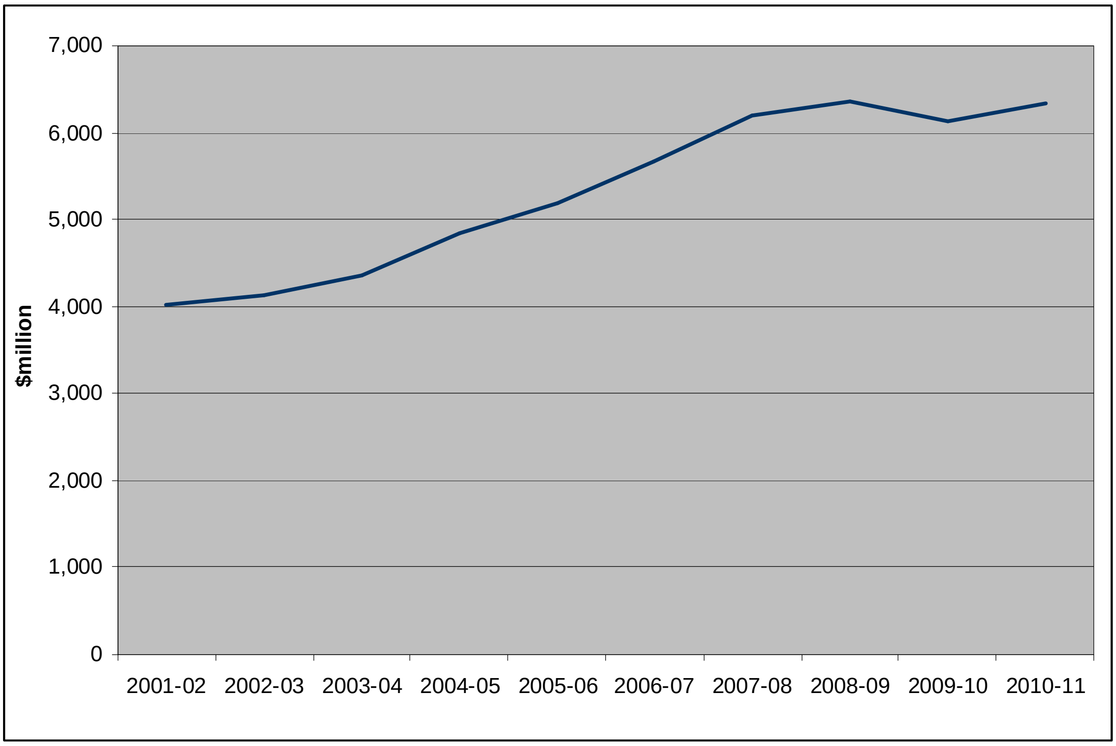
- the non-real business property duty, abolition of which will cost an estimated $110 million in 2012-13, $116 million in 2013-14 and $122 million in 2014-15
- the mortgages and loan security duty, abolition of which will cost an estimated $127 million in 2012-13, $137 million in 2013-14 and $143 million in 2014-15

[2] Other taxes abolished as part of the package of reforms introducing the GST were the accommodation levy (or 'bed tax'), from 1 July 2000 and the debits tax, from 1 January 2001.

§ the off-market share transfer duty, abolition of which will cost an estimated $50 million in 2012-13, $53 million in 2013-14 and $54 million in 2014-15.

Payroll tax

Figure 2.2.6 Payroll tax revenue



Payroll tax is based on the total wages paid by employers. The tax rate is 5.45 per cent for payrolls above the tax-free threshold of $658,000. The threshold is indexed annually, based on changes in the Sydney CPI.

The threshold introduces an artificial distinction between large and small firms, and indexation preserves this distortion over time. Less than 10 per cent of firms pay payroll tax, yet these firms employ around 80 per cent of NSW workers. The proportion of employers and employees in the tax base has stayed roughly constant over the past 10 years. Removing indexation would generate significant economic gains and increase growth in payroll tax revenue.

Payroll tax revenue has grown at an average rate of 4.7 per cent over the past 10 years. The key economic drivers of payroll tax revenue are total employment and average wages.

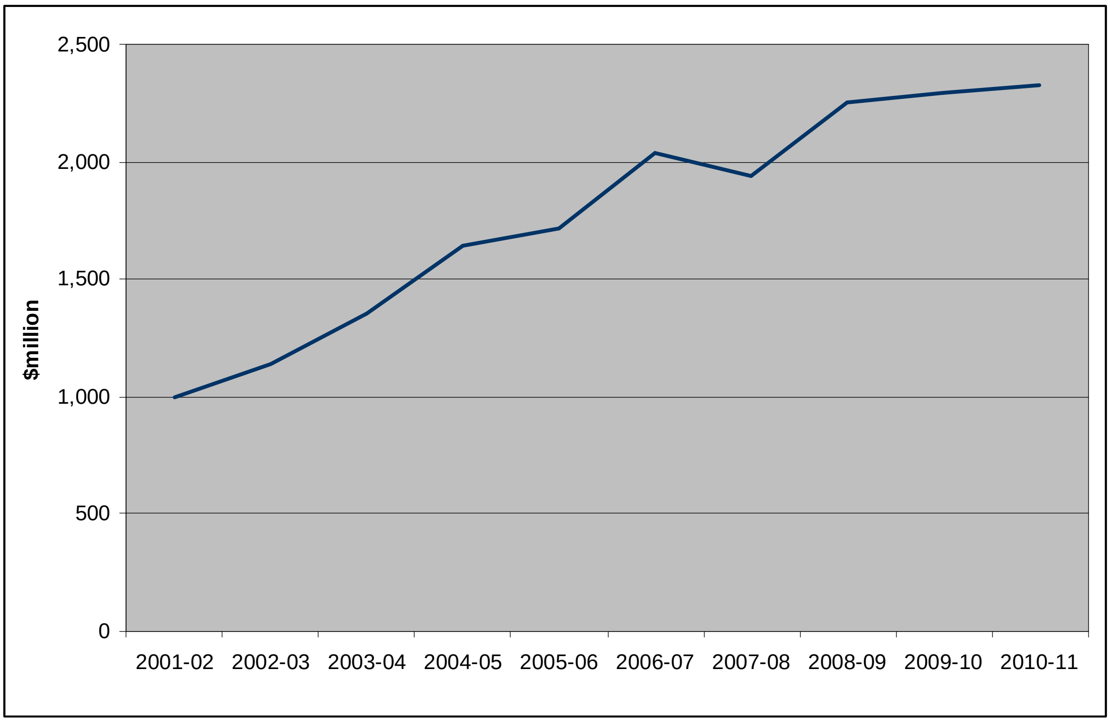
Payroll tax revenue is also influenced by policy changes, most notably changes in the payroll tax rate and threshold. In recent years, the payroll tax rate has decreased eight times, from a high of 6.85 per cent in 1999 to the current tax rate of 5.45 per cent. Payroll tax exemptions (which narrow the tax base) have not increased significantly over the past 10 years.

Table 2.2.3 Payroll tax changes

Period	Threshold	Rate (%)
1 January 2001	600,000	6.20
1 July 2002	600,000	6.00
1 January 2009	623,000 (from 1 July 2008)	5.75
1 January 2010	638,000 (from 1 July 2009)	5.65
1 July 2010	658,000 (from 1 July 2010)	5.50
1 January 2011	$658,000 (from 1 July 2010 to 30 June 2011)	5.45

Land tax

Figure 2.2.7 Land tax revenue



Land tax is levied on aggregate holdings of business and investment properties. A rate of 1.6 per cent applies for landholdings valued above the tax-free threshold of $387,000, and 2.0 per cent for landholdings valued at more than $2.366 million. These thresholds are indexed to movements in average land values.

Land tax revenue has grown at an annualised rate of 9.6 per cent over the past 10 years. The key economic driver of land tax revenue is land values. While specific taxpayers or liable land parcels vary each year, the overall physical size of the tax base remains relatively stable. Movements in commercial and industrial land values are relatively more important: for the 2010 land tax year, residential properties comprised 62 per cent of taxable properties, but raised 36 per cent of land tax revenue.

Land values can be relatively volatile. In the 10 years to 1 July 2010, annual changes in land values ranged between 0.7 per cent and 23.3 per cent. The subsequent volatility in tax revenue is reduced by using a three-year average of land values to determine the tax base.

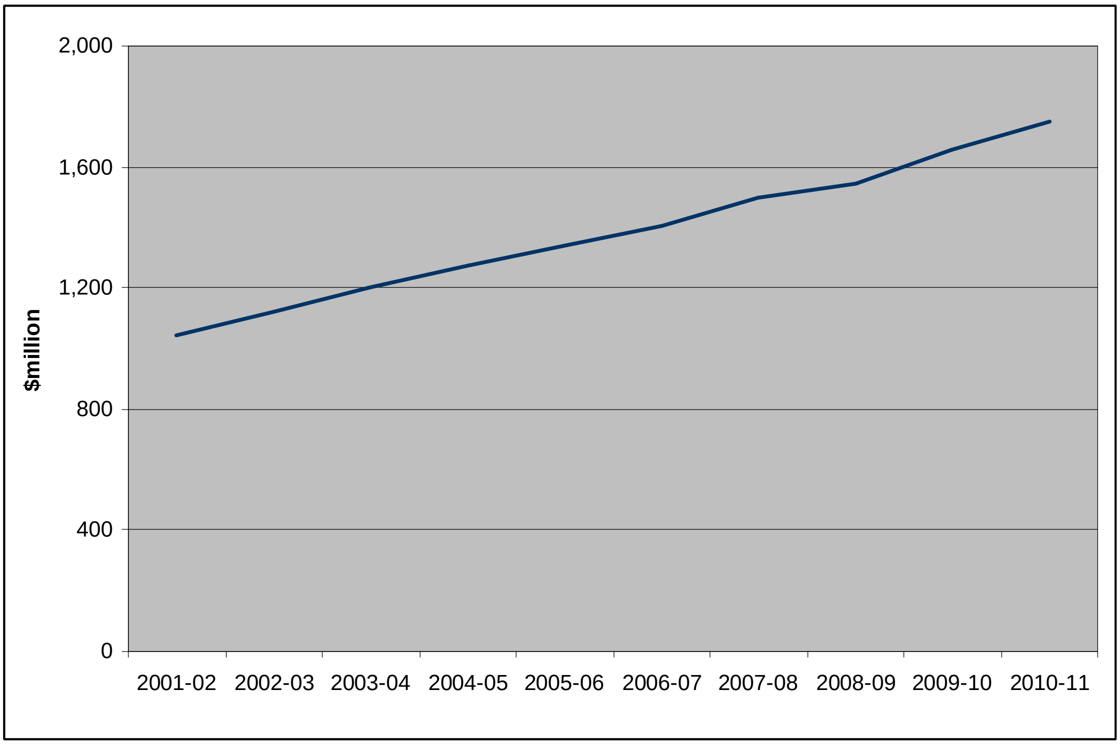
Policy changes have also been a source of revenue fluctuations. The tax threshold is indexed annually to movements in average land values. The average tax rate was lowered in the 2005 land tax year, increased in 2006, lowered in 2008 and increased in 2009.

Table 2.2.4 Land tax changes

Land tax year	Tax Rates	Tax threshold
2002	1.70	$220,000
2003	1.70	$261,000
2004	1.70	$317,000
2005	0.40 $1,600 + 0.60% $2,200 + 1.4%	$0–$400,000 $400,001–$500,000 Over $500,000
2006	1.7	$352,000
2007	1.7	$352,000
2008	1.6	$359,000
2009	1.60 2.0	$368,000 Over $2,250,000
2010	1.6 2.0	$376,000 Over $2,299,000
2011	1.6 2.0	$387,000 Over $2,366,000

Taxes on motor vehicle ownership

Figure 2.2.8 Revenue from taxes on motor vehicle ownership



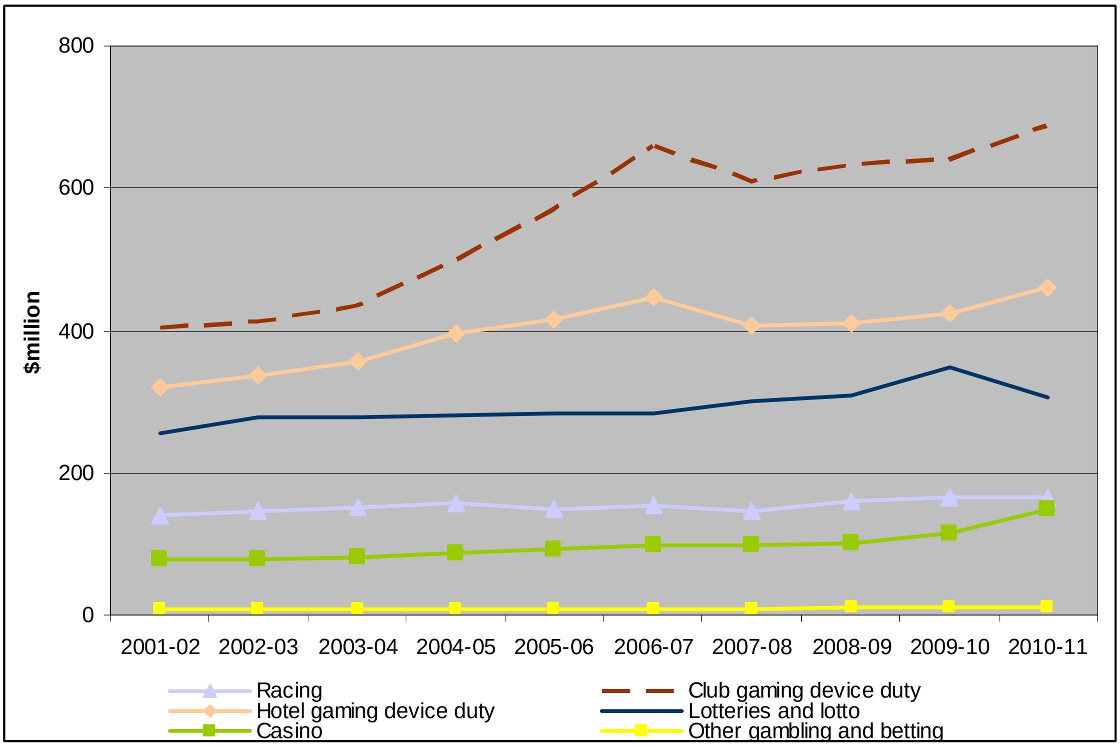
Annual motor vehicle taxes include weight tax, registration fees and other taxes. The Budget also groups the administrative fees for vehicle transfers with these taxes. Weight tax accounts for approximately 80 per cent of this revenue source. Stamp duty on transfers of vehicle ownership is separately classified in the Budget and is discussed above with other stamp duties.

On average, motor vehicle tax revenue has grown at 5.9 per cent over the past 10 years. Main drivers of this trend are the steady growth in vehicle stock and indexation of taxes in line with changes in the Sydney CPI. Between 30 June 2001 and 30 June 2010, the number of motor vehicles registered in NSW grew at an average annual rate of 2.4 per cent. Weight tax is indexed on 1 January each year and other fees and taxes are indexed on 1 July each year.

There have been only minor policy changes over the past decade. In 2005, apprentices were granted a $100 rebate for car registration and in 2007-08, further concessions were introduced for new apprentices hired that year. The weight tax was increased on 8 August 2010 as part of the Metropolitan Transport Plan, resulting in an estimated additional $41 million revenue in 2010-11, according to budget forecasts.

Gambling taxes

Figure 2.2.9 Gambling taxes revenue



Racing

The betting tax rate is 19.11 per cent of the TAB's gross commissions (player loss) on totalisators.

Betting tax revenue has grown at 1.8 per cent per annum over the past 10 years, failing to match the rate of GSP growth or inflation. Declining real revenues from betting reflect increased competition from online gambling, and other gambling and entertainment forms.

Club and hotel gaming devices (poker machines)

Duties are levied on club net gaming revenue, or player loss. Progressive rates are based on annual gaming profits. Hotels pay higher rates than clubs.

Table 2.2.5 Club and hotel gaming duty rates (%)

	Up to $200,000	$200,001 to $1 million	$1 million to $5 million	$5 million to $10 million	$10 million to $20 million	Above $20 million
Clubs	0	10	21	26	29	30.9
Hotels	0	33	36	50	50	50

Revenue from club gaming devices has grown at an average annual rate of 5.4 per cent over the past decade, while for hotels the growth rate has been 3.6 per cent. The main driver of growth in revenue is household disposable income. The different rates of growth reflect increased tax rates for clubs and hotels being phased in over seven years, starting in 2003-04. The hotel tax rates were phased in more rapidly, and were increased further than the rates applying to clubs. Gaming revenue was also adversely affected by smoking prohibitions introduced in 2006.

Lotteries

Lotteries are taxed at 66.1 per cent of player loss. Lotteries revenue has grown at an average annual rate of 1.8 per cent over the past 10 years. The main driver of growth is disposable income. A moratorium on the introduction of new games has constrained the growth of lotteries revenue.

Casino

Star City Casino is the only licensed casino in NSW, and pays tax pursuant to commercial agreements updated in 2007, as part of its exclusive licence. The tax rates vary over time and in accordance with the revenue generated by the casino from gaming devices and table games. In 2010-11, the minimum tax rate was 14.41 per cent and the maximum tax rate was 38.91 per cent.

Casino revenue has grown by 6.2 per cent per annum over the past 10 years. Much of this growth occurred since 2007, when tax rates were increased and more table games were permitted. Since 2007, budget treatment of casino revenue has also included annual amounts of $8.3 million, representing amortisation of upfront payments of the $100 million the casino paid for its exclusive licence.

Other gambling

Other gambling revenue is dominated by Keno, a networked game akin to bingo. Revenue from ‘other gambling’ has grown at an average annual rate of 4.7 per cent over the past 10 years.

Other taxes

Insurance taxes

The Health Insurance Levy, Insurance Protection Tax and Emergency Services Levy are expected to provide a combined total of $886 million in revenue for 2010-11.

The Health Insurance Levy is paid by NSW health insurers, based on health fund membership, at the rate of $1.24 per individual member per week and $2.48 per family membership per week. These rates are increased annually based on movements in the Sydney CPI and average weekly earnings. Insurance tax revenue has grown at an average annual rate of 4.9 per cent over the past 10 years, reflecting inflation and increased take-up of health insurance.

The Insurance Protection Tax is a tax on NSW insurers. It was introduced in 2001 to repay government debt incurred in responding to the collapse of the HIH group of insurance companies. These annual debt repayments are apportioned between the insurers based on their market shares. The debt is expected to be paid out during 2010-11 and the tax has been abolished, effective 1 July 2011.

The Emergency Services Levy is paid by insurers, and covers 73.7 per cent of the cost of providing NSW fire and emergency services. Growth in revenue from this levy of 8.1 per cent has been driven by the cost of providing emergency services.

Parking Space Levy

The Parking Space Levy is charged on off-street commercial and office parking spaces. Zone 1 includes Sydney, North Sydney and Milsons Point business districts and Zone 2 includes St Leonards, Chatswood, Parramatta and Bondi Junction business districts. Annual rates are currently $2,040 in Zone 1 and $720 in Zone 2.

Revenue growth has been 7.6 per cent per annum over the past 10 years, and is almost entirely due to changes in the tax rates. The number of liable spaces has not changed significantly during the period.

Remaining taxes

Taxes not already covered include the Waste and Environment Levy, the Government Guarantee of Debt, the Private Transport Operators Levy, Pollution Control Licences and other taxes. Combined, these remaining taxes have grown at an average annual rate of 3.5 per cent. Since 2006-07, significant increases in the Waste and Environment Levy have been driven by policy-based changes to the rates and the areas in which the levy applies.

State revenue other than taxes

Table 2.2.6 NSW revenue other than taxes

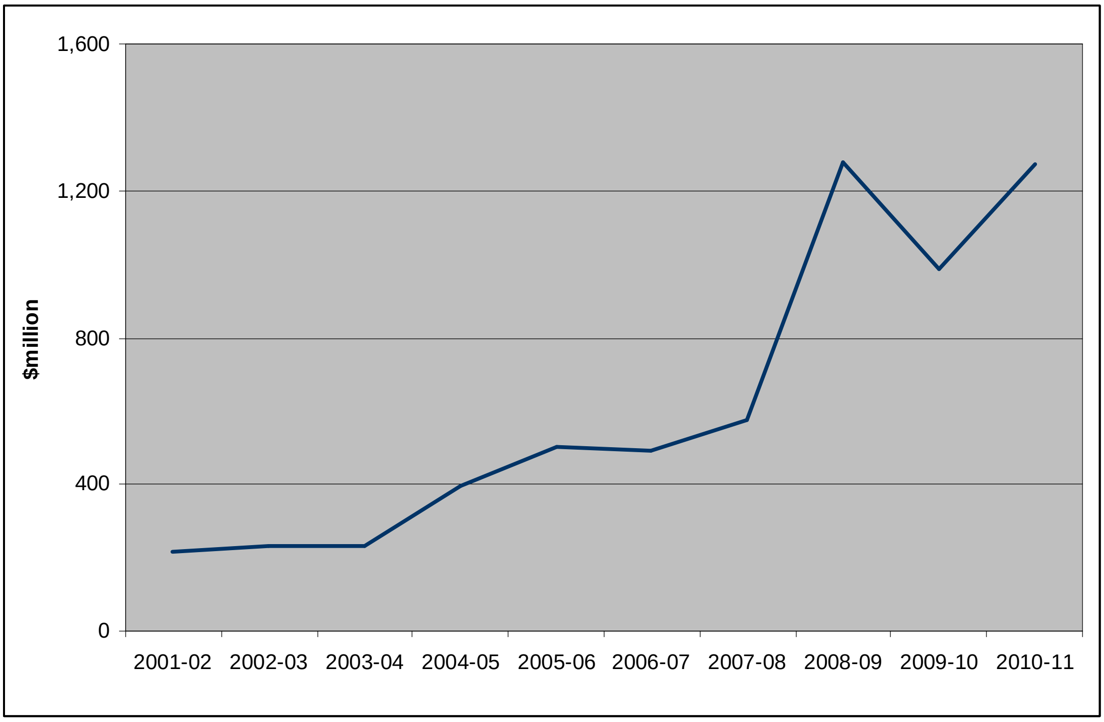
	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Ave. annual growth %
Royalties	**216**	**235**	**233**	**396**	**504**	**489**	**574**	**1,279**	**985**	**1,345**	19.2
Fines, fees and licences	**432**	**448**	**475**	**549**	**570**	**510**	**578**	**644**	**736**	**780**	3.9
Sales of goods and services											
Fees for service	87	98	101	120	194	285	345	444	590	654	23.3
Patient fees	532	609	610	290	316	352	426	428	464	540	1.1
Veterans' affairs	246	245	266	264	313	316	296	290	284	314	3.1
Court fees	128	134	137	148	167	173	191	215	223	235	7.3
Rents and leases	129	111	109	142	147	154	180	207	227	221	3.5
Land titles fees	107	112	117	120	123	119	138	140	163	161	5.8
Miscellaneous services	63	66	71	90	97	115	126	136	149	148	6.9
Road tolls – RTA	66	79	68	75	77	89	98	136	138	138	9.7
Plate fees – RTA	40	51	53	54	58	67	73	75	82	87	12.4
Administration charge – education	45	44	62	69	74	71	72	75	72	74	5.6
Reinsurance and other recoveries	29	51	14	60	35	52	29	185	-87	42	7.5
Crown Land leases	-7	-8	-10	-6	18	25	13	46	42	39	N/A
Entry fees	17	21	19	28	27	28	33	39	35	39	8.4
Operating revenue	81	201	134	23	25	28	34	39	39	33	-10.5
Income from water operations	43	40	45				23	22	25	26	-4.3
State fleet sales				3	4	6	7	7	8	8	N/A
Motor vehicle third-party payments – health	29	31	28	29	29						N/A
Other sales of goods and services											
Department of Health	28	29	30	427	428	490	566	605	814	837	40.4
Department of Education and Training	62	90	87	92	97	110	135	147	157	162	15.5
Department of Services, Technology and Administration		17	14	12	76	100	109	112	120	113	N/A
Roads and Traffic Authority	80	90	97	99	120	108	85	71	73	87	1.4
NSW Self Insurance Corporation	4	4	8	11	11	18	18	23	53	61	33.4

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Ave. annual growth %
All other agencies	28	29	30	427	428	490	566	605	814	837	-1.0
Total, sales of goods and services	2,485	2,685	2,714	2,804	3,037	3,306	3,663	4,024	4,357	4,660	6.9
Dividends and income tax equivalents	1,308	1,276	1,614	1,508	1,836	1,951	2,320	2,029	2,322	2,122	5.7
Interest revenue	282	440	862	1,050	1,298	1,314	454	416	313	421	-1.1
Grants and contributions	37	564	371	506	456	450	557	602	669	649	21.0
Other state revenue	825	1,047	873	780	991	1,229	1,206	1,100	1,516	1,330	4.9
Total state revenue other than taxes	5,585	6,695	7,142	7,593	8,692	9,249	9,351	10,093	10,898	11,237	6.9

Revenue from sources other than taxes or Commonwealth grants accounts for 19 per cent of state revenue, and has grown at an average annual rate of 6.9 per cent over the last decade.

Royalties

Figure 2.2.10 Mineral royalties revenue



Royalties have grown at an average annual rate of 19.2 per cent over the past 10 years. The revenue source is dominated by coal royalties, which currently represent around 95 per cent of all royalties.

The main economic drivers of the growth in coal royalties are:

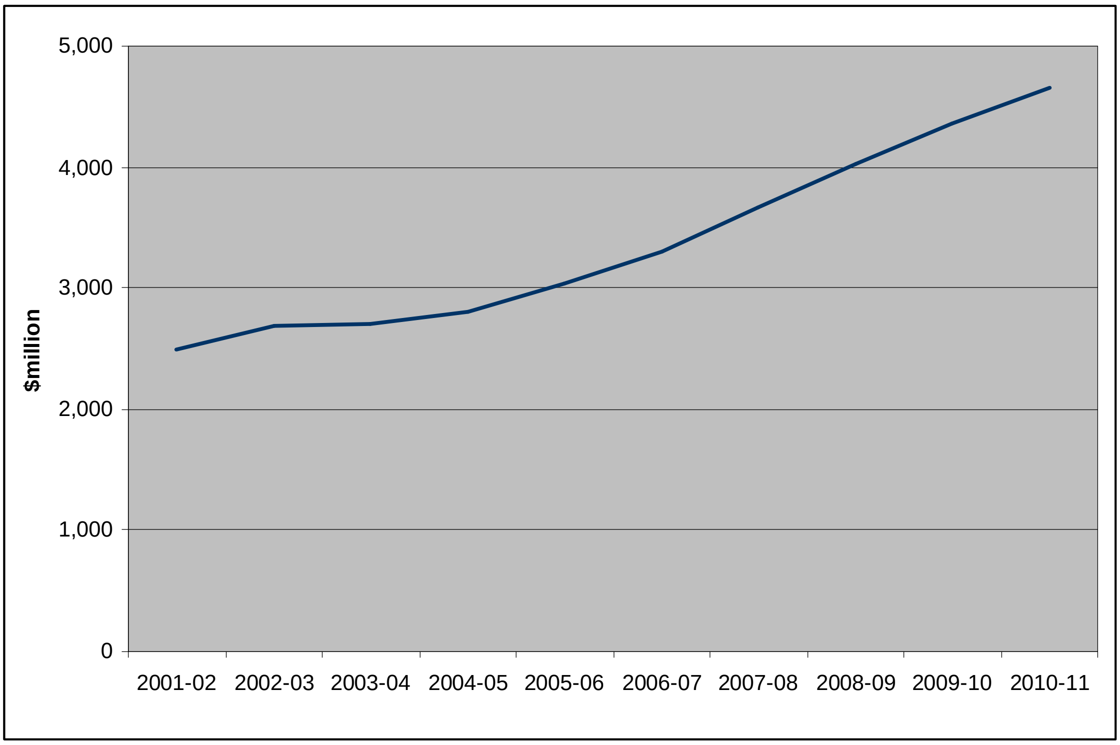
- the production capacity of NSW mines
- the export capacity of ports at Newcastle and Port Kembla
- contract prices for coal (written in $US) and
- the US dollar exchange rate.

Appreciation of the Australian dollar results in lower royalty revenue.

Royalty rates have also increased over the past decade. Prior to 2004, royalties were paid at $1.70 per tonne. From 2004, royalties were paid at the rate of 8 per cent of the value of production (i.e. total revenue less allowable deductions) for coal from open cut mines, 7 per cent for underground mines and 6 per cent for deep underground mines (i.e. deeper than 400 metres). These different rates are designed to take account of differences in the cost of extraction. From 2008, these rates were increased to 8.2 per cent, 7.2 per cent and 6.2 per cent respectively. In the absence of these policy changes, royalties would currently provide less than $400 million revenue.

Sales of goods and services

Figure 2.2.11 Revenue from sales of goods and services



Sales of goods and services have grown at an average annual rate of 6.9 per cent over the past decade. This revenue source includes more than 900 small revenue items that cannot be easily classified. The Budget groups some of the major categories (such as rents and leases) across government agencies, but approximately 40 per cent (by revenue) of the revenue items are agency-specific and are grouped by agency under the heading ‘Other sales of goods and services’ in Table 2.2.6.

Fees for service

Revenue from fees for service has grown at an average annual rate of 23.3 per cent over the past 10 years. A large part of this increase is attributable to general government agencies that absorbed employees from the non-general government sector with the introduction of Work Choices in 2005-06, thereby incurring additional employee expenses. General government agencies receive reimbursements – categorised as 'fees for service' – from the non-general government agencies. Examples include the transfer of staff from the Land and Housing Corporation to the Department of Human Services (incurring $215 million in fees for service in 2010-11), from the Mine Subsistence Board and Forestry Commission to the Department of Industry and Investment (incurring $51 million in fees for service in 2008-09); and from the Office of the Protective Commissioner to the Department of Justice and Attorney-General (incurring $33 million in fees for service in 2008-09). These revenues are balanced by expense items in the accounts of the relevant non-general government agencies.

Patient fees

The low rate of growth in patient fees (averaging 1.1 per cent per annum over the last decade) reflects a changed accounting treatment of $400 million in certain hospital charges, which were classified as patient fees until 2004-05 and were subsequently reclassified as 'other sales of goods and services'.

Since 2004-05, the average annual growth rate for patient fees has been 10.9 per cent. Drivers of revenue growth are a growing population and an ageing population. Most fee rates are indexed to inflation.

Veterans' affairs

The Department of Health receives revenue from the Commonwealth for the provision of services for veterans. These revenues have grown at an average annual rate of 3.1 per cent over the past decade.

Court fees

Court fees currently provide around $235 million in revenue, and have grown at an average annual rate of 7.3 per cent over the past decade.

Rents and leases

Revenue from rents and leases totalling $221 million is currently received by 35 government agencies, of which the greatest revenues are received by the Aboriginal Housing Office, the State Property Authority, NSW Maritime, and the Roads and Traffic Authority.

Revenue from rents and leases has grown at an average annual rate of 3.5 per cent over the past 10 years. Rents and leases revenue dropped significantly in 2001-02, associated with the dissolution of the Olympic Co-ordination Authority and the transfer of the Sydney Harbour Foreshore Authority to the public trading enterprise sector. Since 2001-02, rents have grown at an average annual rate of 6.2 per cent. Part of the increase is due to rent reviews in lease agreements, which typically take into account increases in the CPI. Significant rental revenue increases have been seen for:

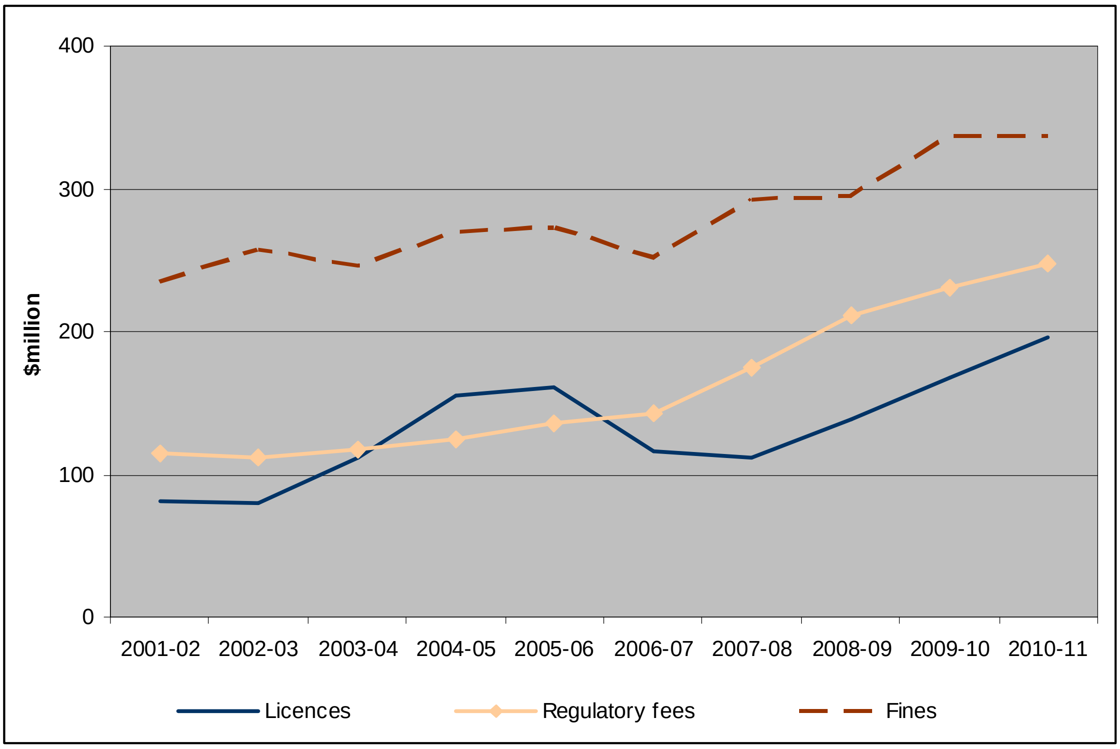
- the Aboriginal Housing Office, reflecting a significant increase in residential properties held
- the Department of Environment, Climate Change and Water, reflecting a strategy of increasing own-source revenues such as renting premises in parks
- the State Property Authority, reflecting its establishment in 2007-08 as a central body to own and manage government office spaces
- the Sydney Olympic Park Authority, reflecting the development of sites and new rental income.

Other sales of goods and services

Within the classification of agency-specific ‘other sales of goods and services’, the largest single agency is the Department of Health, with expected revenues of $837 million in 2010-11. An increase in these sales in 2003-04 reflected changed accounting treatment of hospital charges, which had previously been classified as ‘patient fees’.

Fines, regulatory fees and licences

Figure 2.2.12 Revenue from fines, regulatory fees and licences



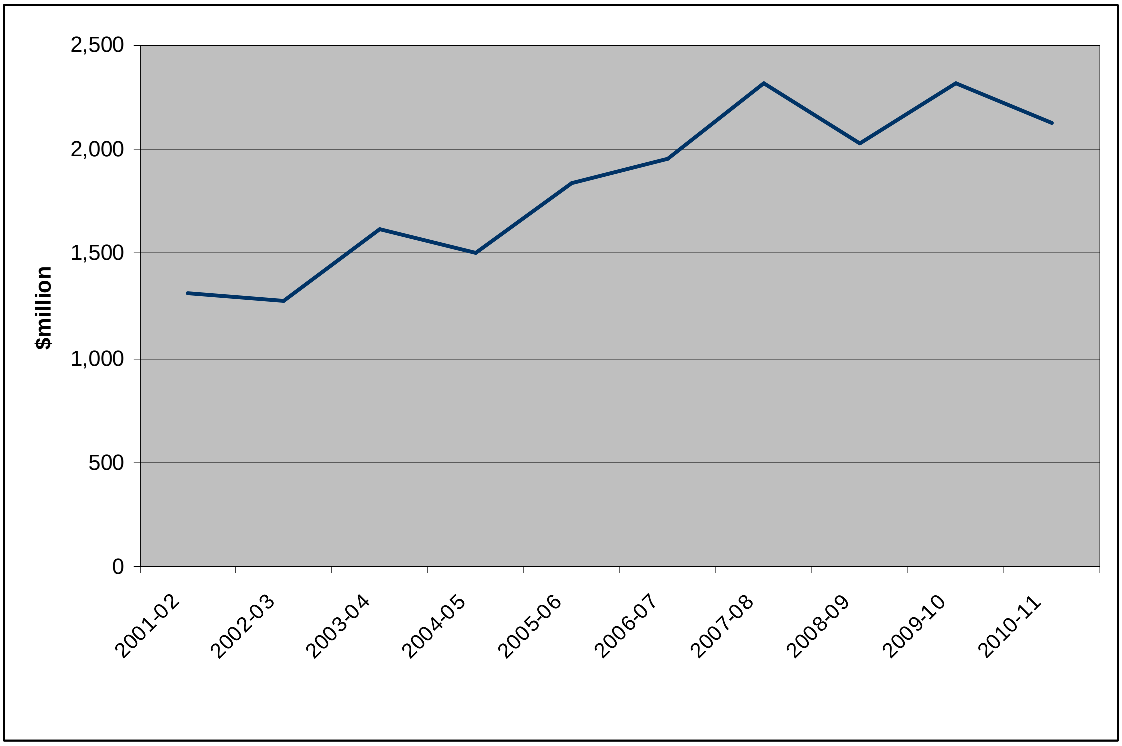
Fines revenue has grown at an average annual rate of 1.2 per cent over the past 10 years. Over 90 per cent of fines are motor traffic fines, so key drivers of revenue change are the number of vehicles in NSW, the number of speed cameras, tolerance limits, education campaigns and the levels at which fines are set.

Revenue from regulatory fees has grown at an average annual rate of 9.8 per cent over the past 10 years. These fees include boat registrations, security industry fees, NSW fisheries fees and motor vehicle dealers' fees. Most fees are charged annually and exhibit fairly stable growth rates, linked to the growth of the underlying economic activities to which the fees apply. The largest single change has been an increase in mining exploration fees since 2008, associated with a move to auctioning exploration licences.

Licence revenue has grown at an average annual rate of 3.6 per cent over the past 10 years. More than 85 per cent of revenue is from drivers' licences. The underlying driver of revenue growth is population growth. A renewal pattern of three- and five-year drivers' licences means revenue growth moves in a cyclical pattern.

Dividends and income tax equivalents

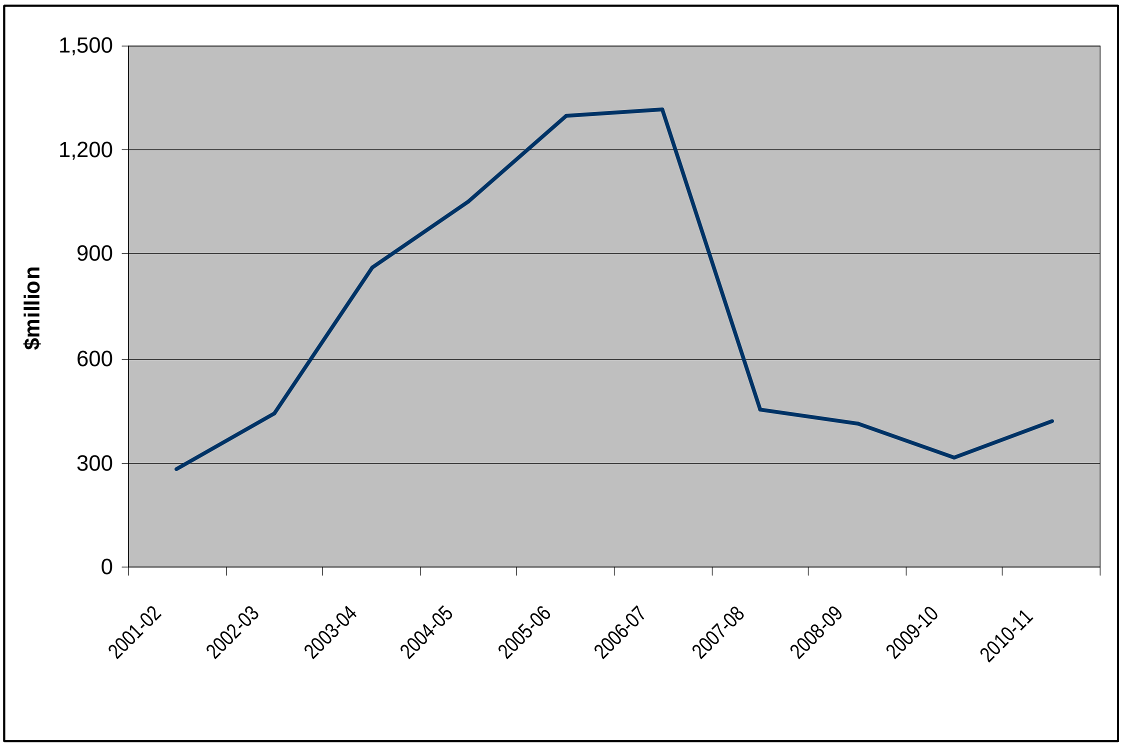
Figure 2.2.13 Revenue from dividends and tax equivalent payments



Dividends and tax equivalent revenue have grown at an average annual rate of 5.7 per cent over the past 10 years. Dividends give the Government a commercially appropriate return on its investment in commercial businesses. Dividends are determined individually for each business, taking into account operational requirements and investment programs. Paying income tax equivalents places these businesses on a similar footing to private sector companies. Revenue growth is driven by the profitability of the underlying businesses. Sales of trading enterprises remove these sources of revenue but are offset in terms of reduced debt interest when the proceeds are used to repay debt or reduce the level of recourse to debt.

Interest income

Figure 2.2.14 Interest income



Interest income comprises returns on managed bond investments (including investments with NSW Treasury Corporation) and interest on bank deposits. Interest income fluctuates with the level of funds invested and market rates of return.

A decline in investment income in 2007-08 largely reflected a reduced level of invested funds following the transfer of approximately $7.2 billion from the General Government Liability Management Fund to the State Super Fund.

Grants and contributions

Grants and contributions are made to general government agencies by a number of public trading enterprises and other sources. The vast bulk of these (98 per cent of ‘other grants’ revenue in 2010-11) are received by two agencies: the Department of Education and Training, and the Department of Environment, Climate Change and Water. Growth in revenue in the form of grants and contributions has averaged 21 per cent per annum since 2001-02, but much of this growth reflects accounting changes in 2002-03, particularly for the Department of Education (see below). Since 2002-03, annual growth in this revenue source has averaged 1.8 per cent.

Contributions to the Department of Education are expected to provide $345 million in 2010-11. These contributions reflect school revenues received, for example, from parents and citizens associations. These items were included in the Budget for the first time in 2002-03, when schools’ balance sheets were brought within the general government accounts.

Grants to the Department of Environment, Climate Change and Water are expected to amount to $230 million in 2010-11. These grants include both capital and recurrent grants to the Climate Change Fund, which replaced the Energy Savings Fund and the Water Savings Fund in 2007. The main sources of funds for the Climate Change Fund are annual contributions from water and electricity providers.

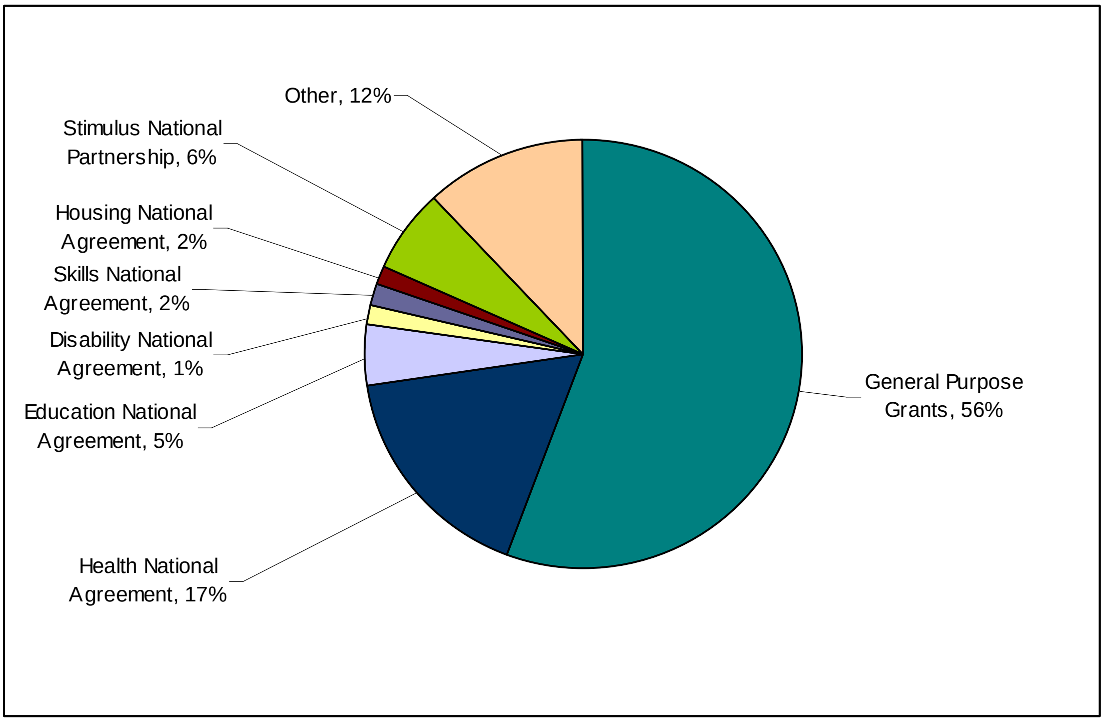
Commonwealth grants

Table 2.2.7 Commonwealth grants to NSW

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Average annual growth %
General-purpose grants	**9,952**	**9,931**	**9,939**	**10,181**	**10,720**	**10,938**	**11,942**	**11,974**	**13,419**	**13,922**	5.2
National Agreements	**5,081**	**5,295**	**5,554**	**6,010**	**7,320**	**6,813**	**7,586**	**6,573**	**6,555**	**6,861**	4.2
National Partnerships	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**3,145**	**6,345**	**4,479**	12.5[a]
Total Commonwealth grants revenue	**15,033**	**15,226**	**15,493**	**16,192**	**18,040**	**17,750**	**19,529**	**21,691**	**26,320**	**25,504**	**6.0**

(a) Growth rate calculated for two years

Figure 2.2.15 Commonwealth grants to NSW



Commonwealth Government general-purpose grants

Average annual growth of Commonwealth general-purpose payments in the decade to 2010-11 was 5.2 per cent, as shown in Table 2.2.7. GST revenue payments accounted for the vast majority of these grants and grew by 6.7 per cent per annum on average, as shown in Table 2.2.8.

Table 2.2.8 Commonwealth general-purpose grants to NSW

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Average annual growth %
GST revenue payments[(a)]	8,132	9,080	9,667	9,884	10,362	10,938	11,916	11844	13,478	13,912	6.7
Budget Balancing Assistance payments[(b)]	1,577	599	69	0	30	0	0	118	52	0	N/A
National Competition Policy payments	243	252	204	233	292	0	26	0	0	0	N/A
Compensation for GST deferral	-	-	-	64	37	0	0	0	0	0	N/A
Snowy Hydro Limited tax compensation	-	-	-	-	-	-	-	13	11	30	53.8[(d)]
Repayments to the Commonwealth[(c)]	-	-	-	-	-	-	-	-1	-121	-19	N/A
Total general-purpose payments	**9,952**	**9,931**	**9,939**	**10,181**	**10,720**	**10,938**	**11,942**	**11,974**	**13,419**	**13,922**	**5.2**

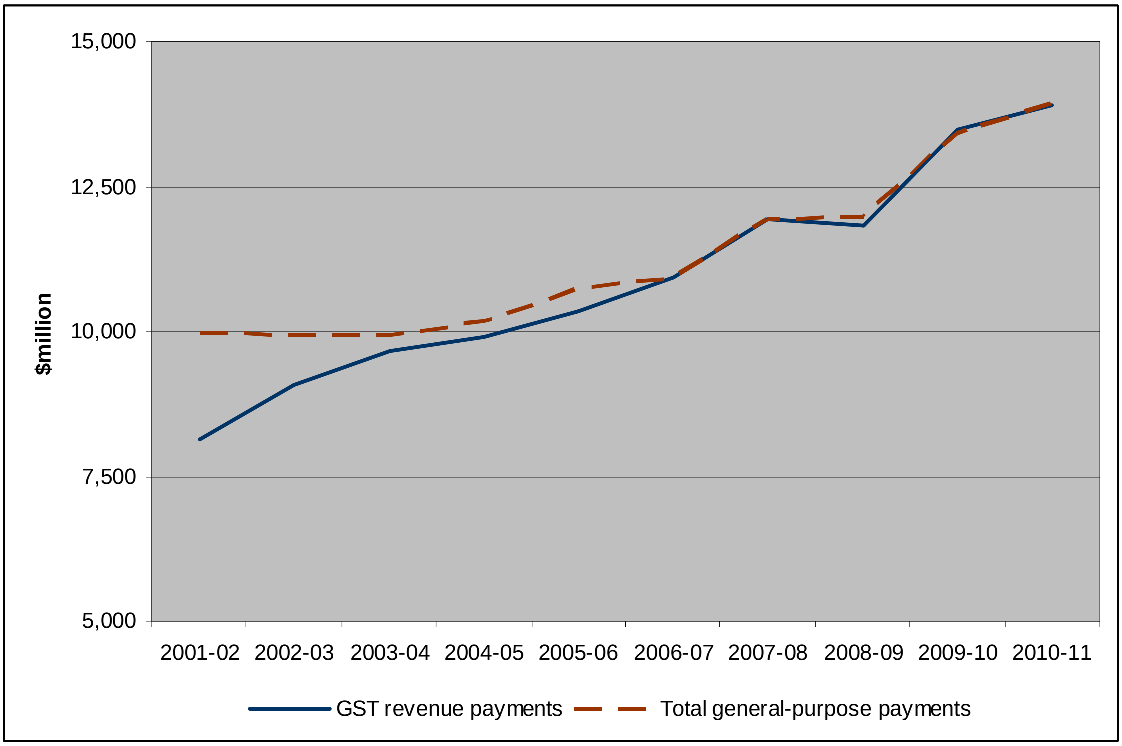
(a) The 2010-11 figures include repayment by NSW of $142.2 million in GST revenue overpaid by the Commonwealth in 2009-10.

(b) This includes a residual adjustment amount of $30 million paid in 2005-06 in respect of 2004-05. Residual adjustment amounts were paid by the Commonwealth to the states to ensure that all states received appropriate payments as they moved off or onto the Budget Balancing Assistance scheme.

(c) Repayments in 2009-10 comprised $87.6 million in GST deferral compensation overpayments and $33.7 million of savings in NSW cellar-door subsidy payments, which the states agreed to pay to the Commonwealth when it introduced (in its 2004-05 Budget) a national wine equalisation tax, producer rebate and reduced State cellar-door subsidy payments. The 2010-11 repayment related to Snowy Hydro Limited tax compensation overpayments.

(d) Growth rate calculated for two years.

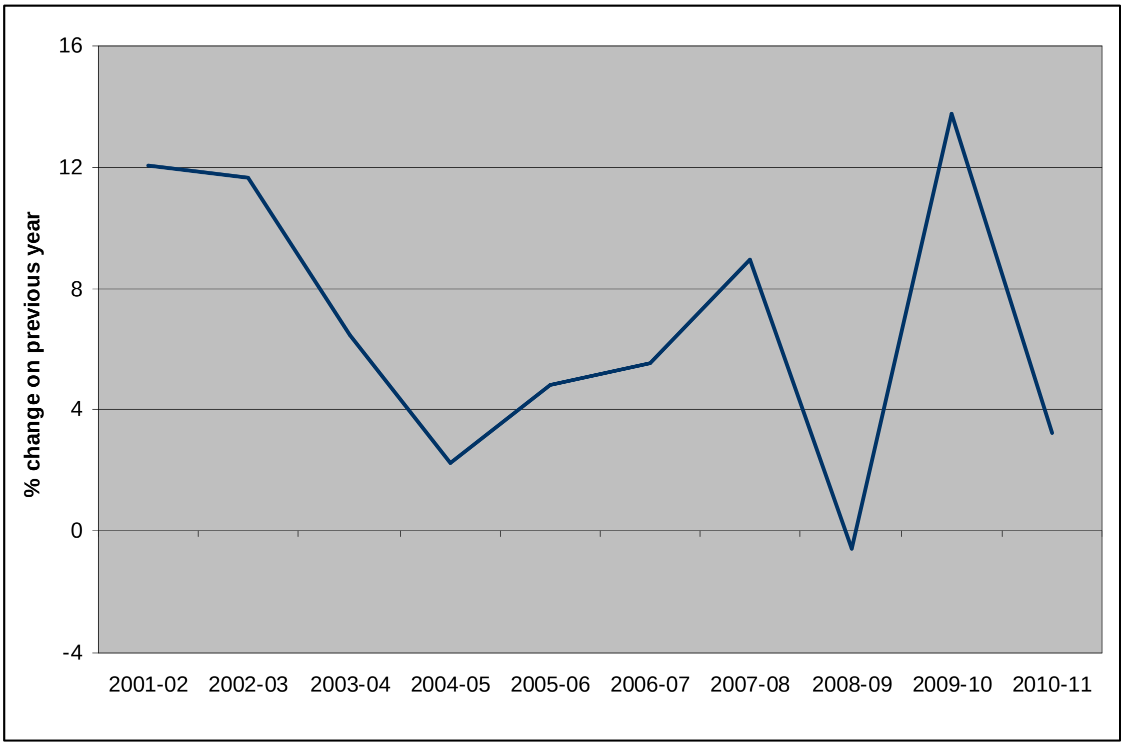
Figure 2.2.16 Commonwealth general-purpose payments to NSW ($ millions)



GST revenue payments

Based on current estimates for 2011-12 revenue, GST revenue payments to NSW will have grown at an annual average rate of 6.7 per cent over the 10 years to 2011-12. However, year-on-year growth has been quite variable, ranging from a 0.6 per cent decline in 2008-09 to 13.8 per cent growth in 2009-10, as shown in Figure 2.2.17.

Figure 2.2.17 Annual growth in NSW GST revenue (% change on previous year)



GST revenue in any year is affected by three factors:

- the total GST pool, which reflects total GST tax collections in Australia
- NSW GST per capita relativity (i.e. the per capita payment for NSW), which is recommended by the Commonwealth Grants Commission (CGC) and determined by the Commonwealth Treasurer
- NSW population, which together with NSW GST relativity determines the NSW share of the total GST pool.

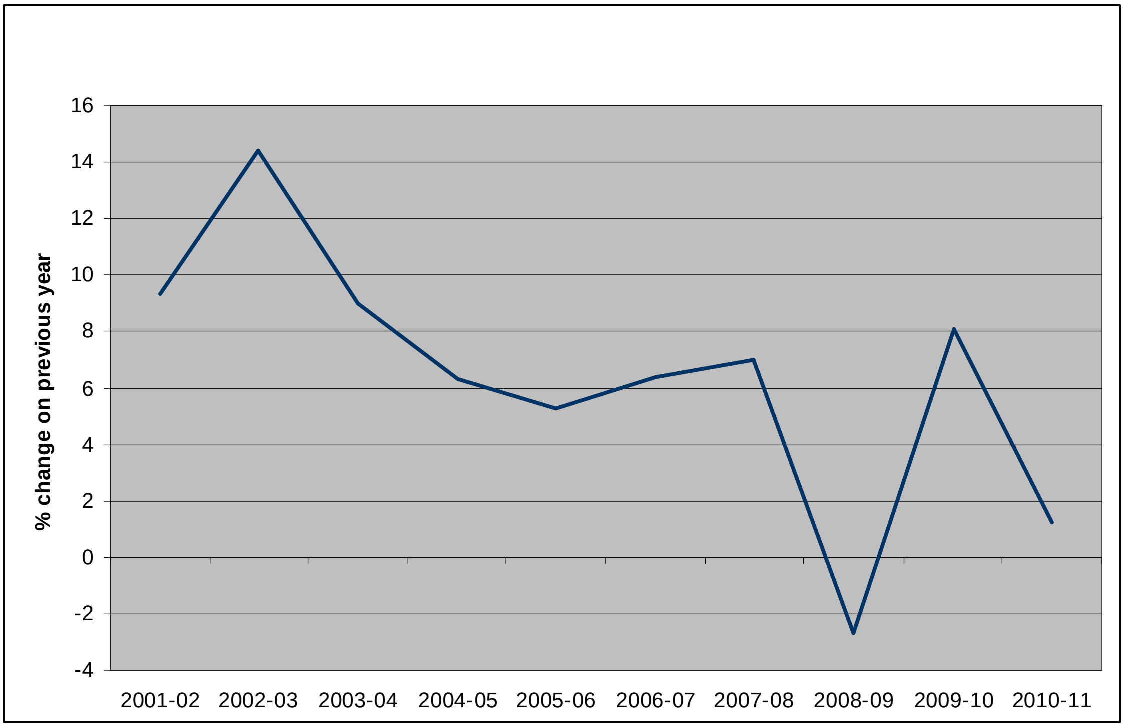
Total GST revenue pool

Table 2.2.9 shows the GST pool underlying annual GST payments to the states for the years 2001-02 to 2010-11. Average annual growth for the period was 6.3 per cent; however, year-on-year growth is again quite variable, moving within a range of -2.7 per cent in 2008-09 and 14.4 per cent in 2002-03, as shown in Figure 2.2.18.

Table 2.2.9 GST pool

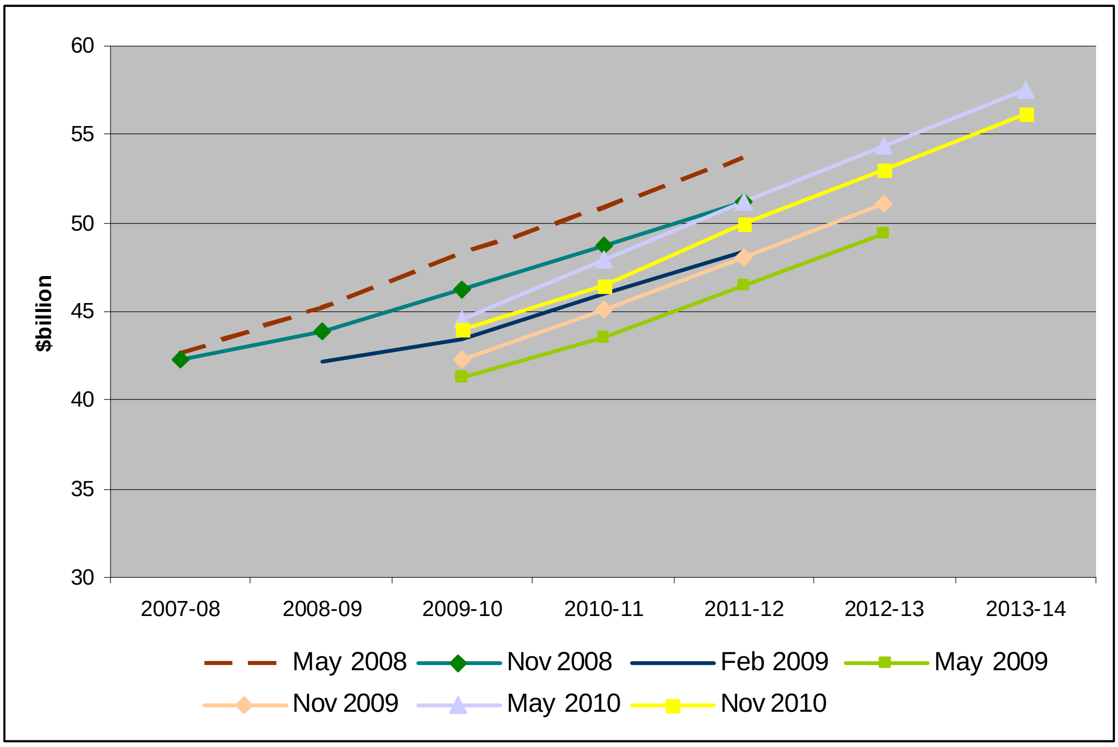
	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Average annual growth %
Total GST pool	26,632	30,479	33,219	35,323	37,182	39,552	42,330	41,189	44,529	45,063	6.3

Figure 2.2.18 Annual growth in the GST pool



Forecasts of the GST pool have been subject to substantial revision. Figure 2.2.19 shows Commonwealth Government forecasts of the GST pool through successive budgets, starting with the Commonwealth's 2008-09 Budget (May 2008) and ending with its 2010-11 Mid-Year Economic and Fiscal Outlook.

Figure 2.2.19 Commonwealth revisions to GST pool forecasts



GST is a broad-based Commonwealth tax of 10 per cent on most goods, services and other items sold or consumed in Australia. GST is also charged on new housing purchases. The cost of GST is borne by the final consumer. Generally, businesses and other organisations registered for GST will include GST in the price of sales charged to their customers, and claim credits for the GST included in the price of their business purchases. The final consumer cannot claim GST credits.

The major exemptions from GST are most basic foods, some education courses, and some medical and healthcare products and services.

As a tax ultimately falling on final consumption and new housing, the main influences on revenue derived from the GST are those that influence consumption incurring GST, and dwelling investment.

Policy changes have so far not been a major influence on total GST revenue. Changes to the GST rate and base require the agreement of Commonwealth and state governments. Changes in the GST treatment of certain goods and transactions have had minor impacts on GST revenue.

NSW's GST relativity

State GST revenue-sharing relativities are recommended by the CGC and are ultimately determined by the Commonwealth Treasurer.

The CGC recommends state GST shares using the principle of horizontal fiscal equalisation (HFE). The CGC defines HFE as giving each state the fiscal capacity to provide the national average standard of services and infrastructure, assuming it imposes state taxes at national average rates and operates at national average levels of efficiency.

HFE seeks to compensate states for non-policy influenced factors (or ‘disabilities’) that reduce their capacity to raise revenue relative to a notional national average, or increase their cost of providing services and infrastructure relative to a notional national average. These disabilities reflect characteristics of:

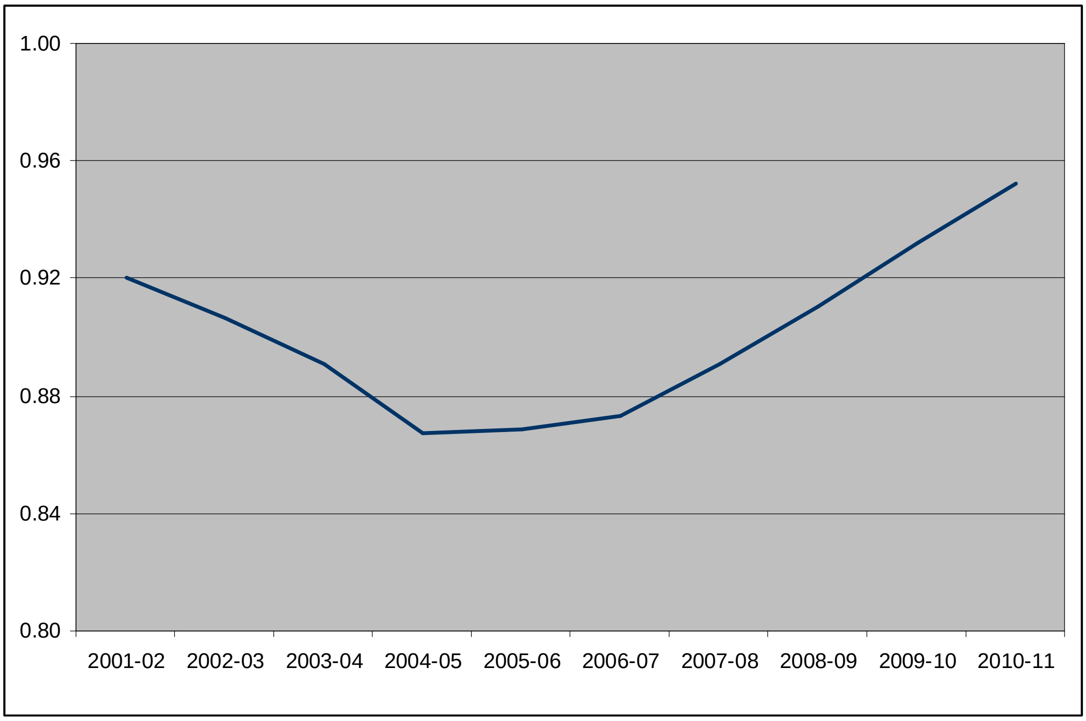
- the economy (e.g. higher wage costs affect spending, while lower land values affect land tax revenue)
- geography (e.g. land area and population dispersion affect the cost of providing services, and lack of mineral resources affects the ability to raise revenue from mining royalties
- demography (e.g. a higher proportion of aged people in the population affects provision of healthcare services).

Every five or six years, the CGC reviews the underlying methodology it uses to assess states’ relative capacities to raise revenue and provide services, based on terms of reference provided by the Commonwealth. The last review report was delivered in 2010. Between reviews, the CGC updates the GST relativities annually, using data from the previous three years.

On 30 March 2011, the Commonwealth Government announced a review of GST distribution. The review will be conducted by Nick Greiner, John Brumby and Bruce Carter, assisted by a Heads of Treasuries’ Advisory Committee and a small Secretariat within the Commonwealth Treasury. The review will provide a final report by August or September 2012 for consideration by COAG, which will make a final decision on the new arrangements by the end of 2013.

NSW’s GST relativity from 2001-02 to 2010-11 is shown in Figure 2.2.20. The CGC’s assessments are combined in one figure: the relativity. The Australian average revenue-raising capacity and spending need is given a value of one. A relativity greater than one means a state has below average capacity to raise revenue and/or above average costs of providing services, and therefore needs above average per capita levels of GST revenue. A relativity lower than one means a state has above average capacity to raise revenue and/or below average costs of providing services, and therefore needs below average per capita levels of GST revenue.

Figure 2.2.20 NSW's GST relativity



NSW's GST relativity is currently at its highest level since the GST was introduced, and indeed since relativities were first applied to Commonwealth grants in 1982-83. NSW's GST relativity has always been below one, so it has always received less than its population share of the GST pool.

NSW's share of GST payments has increased in recent years, mainly due to the increase in the capacity of states like Western Australia and Queensland to raise their own revenues, as a result of the resources boom. The resources boom has increased those states' capacities to raise revenue from mining royalties and other taxes such as payroll tax, property transfer duty and land tax, reflecting increases in employment, wages, property market activity and land prices associated with the boom.

Earlier in the last decade, NSW's share of GST payments declined, largely reflecting the state's increased capacity to raise its own revenue from property transfer duty and land tax, as a result of the property market boom.

Population

A state's GST relativity is applied to its population to produce its 'adjusted population'. A state's adjusted population as a share of total Australian adjusted population produces the state's share of the GST revenue pool[3].

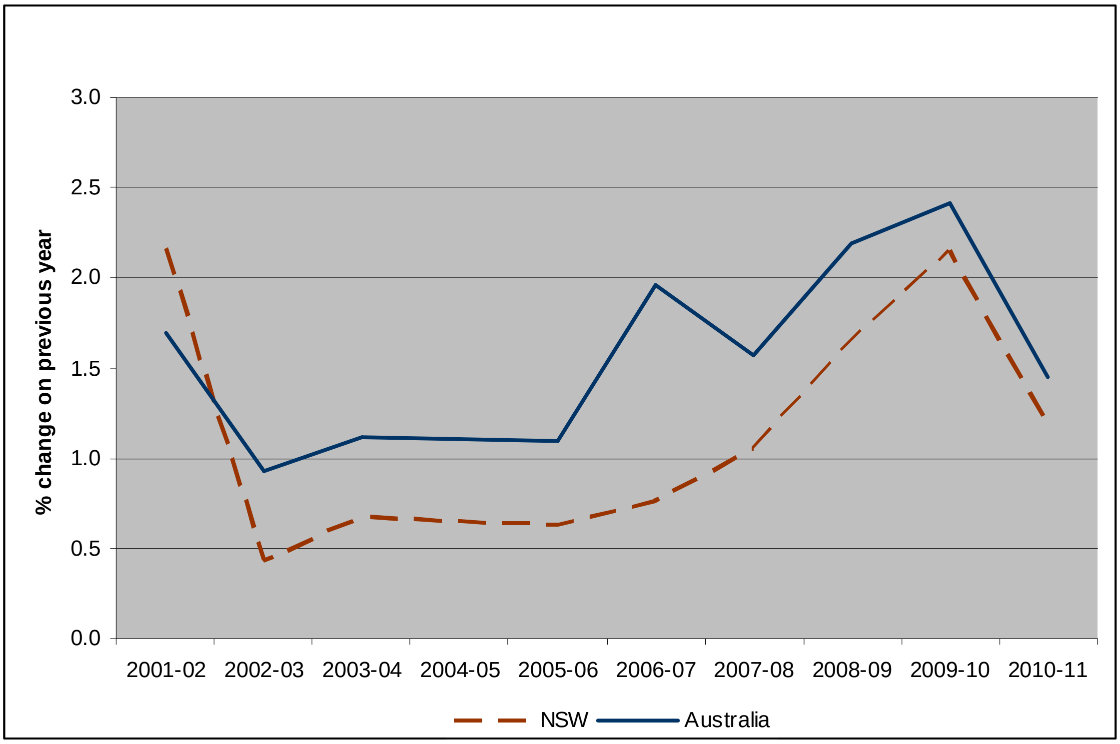
Relative population growth therefore affects state GST shares directly – as well as indirectly, through the assessment of needs for spending on physical and financial

[3] Until 2007-08, a state's adjusted population share was applied to a total pool of GST and Commonwealth Health Care Grants (HCGs). The state's HCG payments, which were determined separately from CGC and GST processes, were then deducted from its share of the total pool, to produce the state's GST payments. In that way, state HCG payments did not affect the state's GST relativity, but did impact on the GST payments a state received, since the higher its HCGs the lower its GST payments.

assets. All other things being equal, a state with below-Australian-average population growth and a declining share of the total Australian population will receive a declining share of the GST pool.

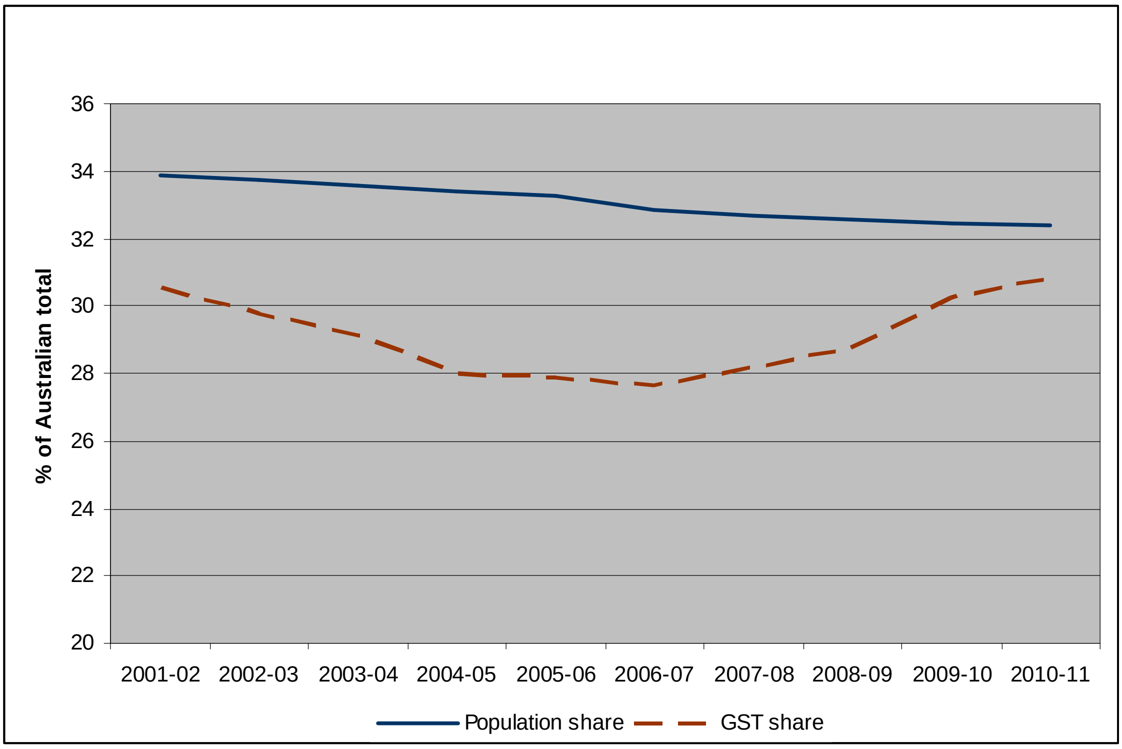
NSW annual population growth rates compared to the average Australian population growth rate are shown in Figure 2.2.21, based on the population figures used to distribute GST. On average, the NSW population growth rate over the 10 years to 2010-11 has been 0.5 percentage points below the Australian average. Please note the population figures used to determine GST shares in the relevant year are estimates for the December quarter.

Figure 2.2.21 NSW and Australian population growth



The combination of NSW's GST relativity and its population share produce NSW's share of GST revenue. Figure 2.2.22 shows NSW's GST share compared to its population share over the last decade.

Figure 2.2.22 NSW GST and population shares



Budget Balancing Assistance payments

Budget Balancing Assistance (BBA) payments were paid in accordance with the Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations concluded between the Commonwealth and states in June 1999 (the 1999 IGA).

The Commonwealth paid BBA payments to meet its guarantee under the IGA that in the transition to new Commonwealth-State financial arrangements associated with the introduction of the GST, the states would be no worse off financially than they would have been under the old arrangements. Associated with the introduction of the GST and the Commonwealth paying GST revenue to the states, the states agreed to forgo certain other Commonwealth payments, abolish certain state taxes and take on new spending. This transition period expired in 2008-09.

The need for BBA was assessed by calculating a guaranteed minimum amount (GMA) for all states, which was effectively an estimation of the revenues states lost by giving up other revenue sources and taking on new spending under the IGA. Where a state's GMA exceeded its GST revenue payment in a particular year, Commonwealth BBA payments made up the difference.

By 2004-05, all states' GST payments exceeded their GMAs. However, due to declining GST revenue in 2008-09 in the cyclical downturn accompanying the global financial crisis, NSW (as well as South Australia, Tasmania and the Northern Territory) still required BBA payments in that year. A further payment in 2009-10 was required after final data for 2008-09 indicated the need for higher BBA payments than originally estimated.

National Competition Policy payments

National Competition Policy (NCP) payments were paid in accordance with the Intergovernmental Agreement to Implement National Competition Policy and Related Reforms, concluded between the Commonwealth and states at the April 1995 COAG meeting (the 1995 IGA).

The payments commenced in July 1997 and were conditional on states reviewing competition-restricting legislation; applying competitive neutrality to government business activities; and introducing specific reforms in electricity, gas, water and road transport. NCP payments ended in 2005-06, though previously suspended payments were finalised in 2007-08.

At its 10 February 2006 meeting, COAG agreed to a new national reform agenda comprising human capital, competition and regulatory reform streams. COAG agreed that, if funding is needed to ensure the costs and benefits of reform are shared fairly, the Commonwealth Government would provide funding to the states on a case-by-case basis once specific implementation plans were developed.

Other Commonwealth Government payments

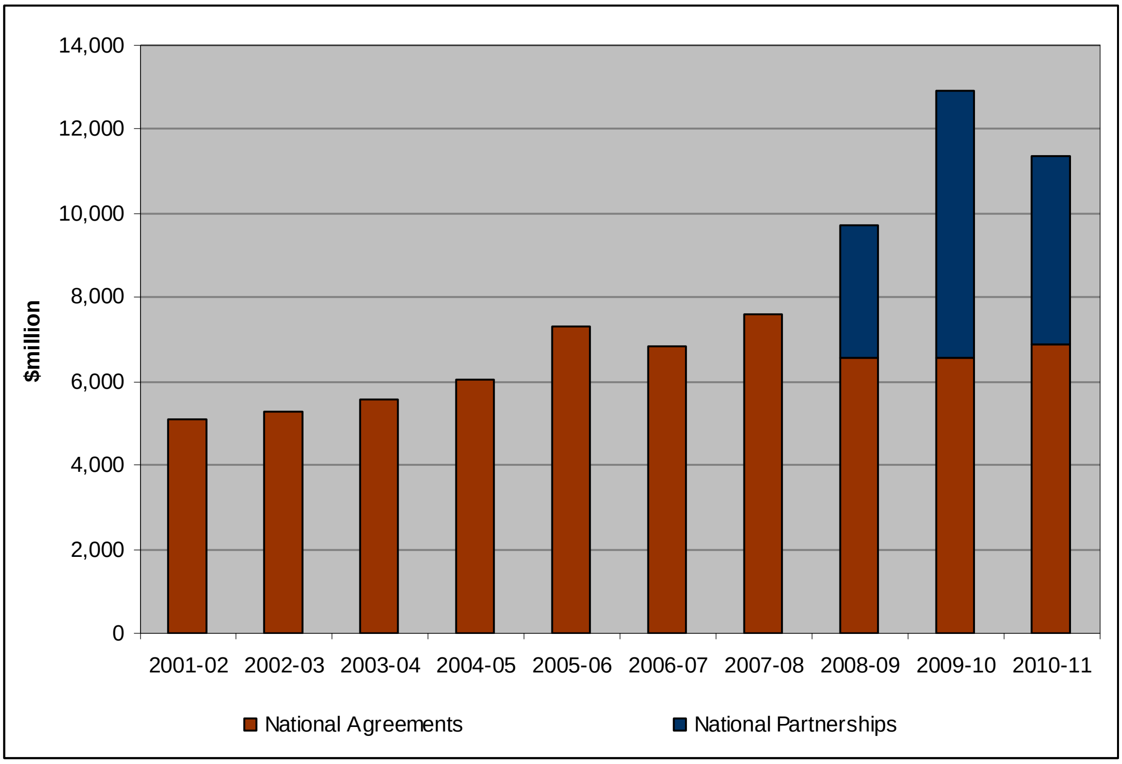
Table 2.2.10 National Agreements and National Partnerships

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	Average annual growth %
Specific Purpose Payments/National Agreements											
Health	2,495	2,727	2,791	2,985	3,090	3,279	3,702	3,871	3,714	3,951	5.2%
Education	780	726	705	783	942	983	1,043	1,020	1,106	1,170	7.8%
Disability (including Home and Community Care)	356	374	421	434	461	494	566	613	654	729	8.7%
Skills	347	363	370	384	363	427	415	430	439	443	3.7%
Housing	374	373	347	350	354	364	361	370	384	388	0.3%
Other	728	732	920	1,074	2,110	1,265	1,498	268	259	181	-11.3%
National Partnerships											
Health (including Health and Hospitals Network)								429	250	555	13.7%
Education								294	437	430	20.9%
Transport								922	1,277	727	-11.2%
Stimulus and Nation Building								666	3,428	2,188	81.2%
Other								833	953	579	-16.6%
Total	5,081	5,295	5,554	6,010	7,320	6,813	7,586	9,718	12,900	11,340	9.6%

Historically, the Commonwealth Government has provided Specific Purpose Payments (SPPs) to NSW, with the funds to be spent on particular functions. In 2008, COAG agreed to consolidate the majority of these payments into two broad streams: National

Agreements (NAs) and National Partnerships (NPs). Table 2.2.10 reports SPPs up to 2007-08, and reports NAs and NPs separately for subsequent years.

Figure 2.2.23 National Agreements and National Partnerships ($ millions)



NAs set out policy objectives in six service delivery areas: healthcare, education, skills and workforce development, disabilities, affordable housing and national Indigenous reform. NPs are time-limited arrangements that focus on delivering specific outputs or projects in areas of nationally significant reform, or achieving service delivery improvements.

The main drivers of NA and NP revenue change over the past 10 years have been:

- demographics (e.g. student numbers, number of people with disabilities, and state population)
- Commonwealth election commitments (e.g. the Investing in our Schools Program and the Digital Education Revolution)
- major Commonwealth programs (e.g. the Economic Stimulus Plan, the Building Australia Fund and the Natural Heritage Trust
- indexation rates for the various funding agreements. The 1995 IGA states that base funding for each national SPP will be provided on an ongoing basis, and indexed on 1 July 2010 and each year thereafter by a growth factor. See Table 2.2.11 for the most recent agreements.

Table 2.2.11 Major National Agreements

SPP National Agreement	Growth factor
Affordable housing	§ Wage Cost Index 1 - Safety-net wage adjustment: 75% - All groups CPI: 25%
Healthcare	§ Health-specific cost index - Australian Institute of Health and Welfare Health price index § Growth in population estimates weighted for hospital utilisation § Technology factor - Productivity Commission-derived index of technology growth
Education	§ Growth in average government schools recurrent cost § Growth in full-time equivalent enrolment in government schools
Disability services	§ Rolling five-year average of year-on-year growth in nominal gross domestic product (GDP)
Skills and workforce development	§ Wage Cost Index 1 (85%) + Wage Cost Index 6 (15%)

The issue of expiring NPs is a significant policy and financial risk for the states. NPs worth $1 billion to NSW are due to expire by the end of 2012. NPs may involve funding an increase in capacity (e.g. more teachers) and can raise community expectations of higher levels of service, making it difficult to remove these services when an NP expires. States need certainty regarding the future of these expiring NPs.

Treasurers, through the Ministerial Council for Federal Financial Relations (MCFFR) under Clause A4 b(vii) of the 1995 IGA, have a role in assessing whether expiring NPs should be converted into existing or new SPPs, or general revenue assistance.

It was agreed at the 7 April 2011 MCFFR that by September each year, state and territory Treasurers will formally advise the Commonwealth Treasurer of their views regarding NPs in terms of whether funding should continue – and if so, in what form – for consideration in the Commonwealth Budget process.

However, ultimate funding decisions regarding the continuation of NPs lie with the Commonwealth. Table 2.2.12 lists soon-to-expire NPs.

Table 2.2.12 Expiring National Partnerships

National Partnership	Expiry date	Review date	Commonwealth funding to NSW ($m)
NPs expiring 2010-11			
Local Government and Regional Development	30/06/2011	30/11/2010	3.3
Pre-Apprenticeship Training	30/06/2011	None specified	4.3
Home and Community Care (deemed an NP)	30/06/2011	Planned on expiry	378.8
National Bowel Cancer Screening Program (deemed an NP)	30/06/2011	None scheduled	1.4
Total expiring in 2010-11			378.8
NPs expiring 2011-12			
Elective Surgery Waiting Lists Reduction Plan	30/06/2012	None specified	56.1
Certain Concessions for Pensioners and Seniors Card Holders	30/06/2012	2011-12	513.5
E-Health	30/06/2012	30/06/2011	35.5
Productivity Places NP	30/06/2012	30/06/2010	419.8
Total expiring in 2011-12			**1024.9**
NPs expiring 2012-13			
Fort Street High School Noise Insulation	31/07/2012	01/07/2010	14.5
Essential Vaccines	31/12/2012	None	525.9
Literacy and Numeracy	31/12/2012	None	136.0
Remote Indigenous Public Internet Access	30/06/2013	31/12/2011	0.1
Early Childhood Education	30/06/2013	None	278.6
Homelessness	30/06/2013	31/12/2011	140.4
Hospital and Health Workforce Reform	30/06/2013	31/07/2011	353.8
Natural Disaster Resilience	30/06/2013	31/12/2012	25.7
Digital Education Revolution	30/06/2013	30/06/2011	259.6
Digital Regions Initiative	30/06/2013	30/12/2012	11.4
Seamless National Economy	30/06/2013	31/12/2011	144.1
Total expiring in 2012-13			**1890.1**

National Partnership	Expiry date	Review date	Commonwealth funding to NSW ($m)
NPs expiring 2013-14			
Improving Teacher Quality	31/12/2013	None	142.2
Youth Attainment and Transitions	31/12/2013	None	38.3
Indigenous Early Childhood Development	30/06/2014	None	101.7
Legal Assistance Services	30/06/2014	30/06/2013	304.8
National Quality Agenda for Early Childhood Education and Care	30/06/2014	30/12/2014	35.4
Total expiring in 2013-14			**622.4**

2.3 Expenditure structure and trends

Expenditure trends and drivers

Total general government expenses for 2010-11 are forecast to be in the order of $56 billion. Expenses have increased on average by 6.2 per cent per annum over the last 10 years to 2010-11, compared to a projected average of 3.3 per cent per annum over the next three years to 2013-14[4]. Over the period to 2010-11, the weighted average consumer price index (CPI) for Sydney has increased by about 2.7 per cent per annum.

The most significant drivers of real expense growth have been the direct or indirect effects of government policy decisions, for example:

- wage increases significantly higher than the private sector
- high-cost employee benefits such as the Police Death and Disability Scheme
- growth in workforce to deliver new or enhanced services, or to build and maintain new infrastructure
- indirect costs of policy positions, such as the increase in custodial costs resulting from criminal justice policy settings.

The impact of population growth and ageing is relatively small in the short to medium term. NSW's population is growing at only about 1 per cent per year, and the impact of ageing on some services (estimated at 0.5 per cent per annum for health, for example) is partly offset by slowing growth in services for young people (such as school education).

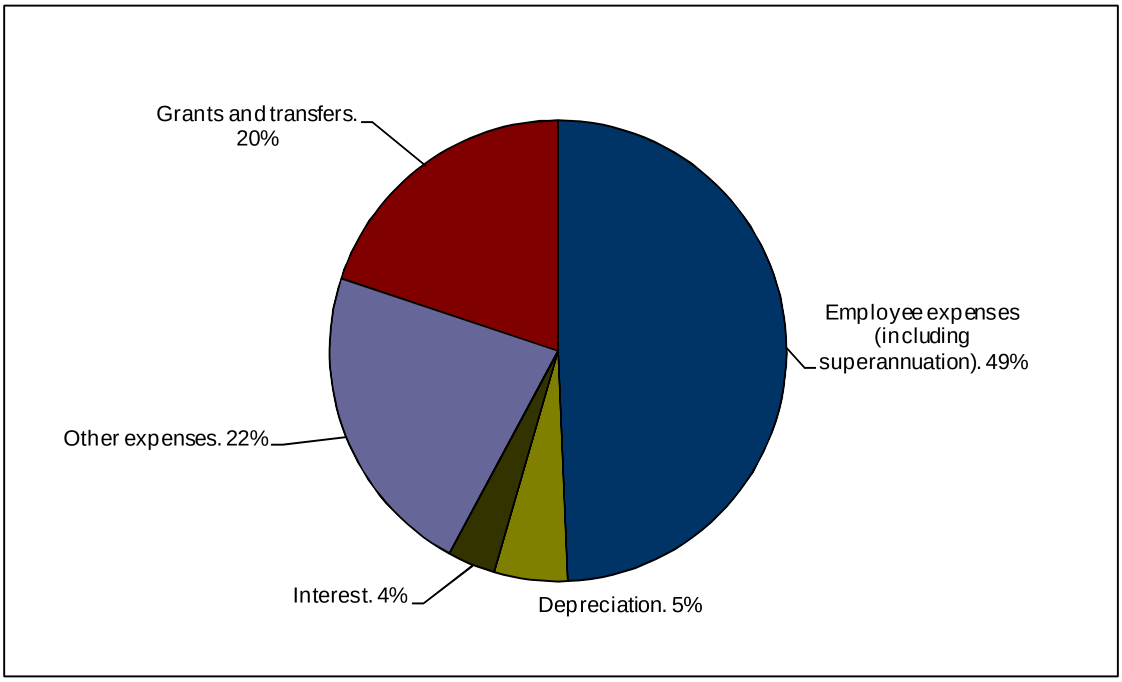
Expenses have also increased due to uncontrolled employee structure drift; that is, a relative shift over time in the proportion of employees at higher salary grades.

[4] Half-Yearly Review expenditure forecasts, 2011-12 to 2013-14.

Expenditure by input type

Employee-related costs account for just under 50 per cent of total expenses, and ‘other expenses’ account for a further 22 per cent. Grants and other transfers are 20 per cent of total expenses, including capital grants. Capital grants to non-commercial public trading enterprises, principally in the transport area, represent 4 per cent of total expenses. Interest currently accounts for approximately 4 per cent of total expenses, which is the highest it has been since 2000-01.

Figure 2.3.1 Total general government recurrent expenses by category (excluding stimulus), 2010-11

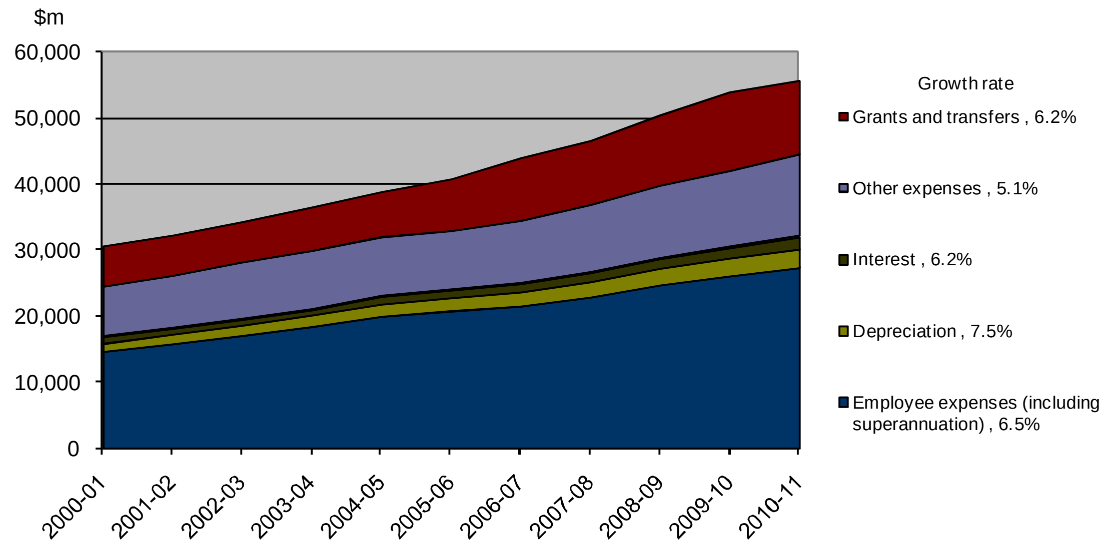


Over the past 10 years, employee-related expenses have been the largest driver of expenditure growth, increasing by 6.5 per cent per annum.

The high rate of growth in depreciation (7.5 per cent) reflects the growth of the capital program, but continues to represent a relatively small share of total expenses.

Interest expenses in the general government sector grew by 6.2 per cent per annum, largely reflecting the increase in net debt in recent years. Total interest expenses in the sector have grown by over $1 billion per annum, from the $0.8 billion low of 2003-04 to the almost $2 billion projection for 2010-11.

Figure 2.3.2 Growth in total general government recurrent expenses by category

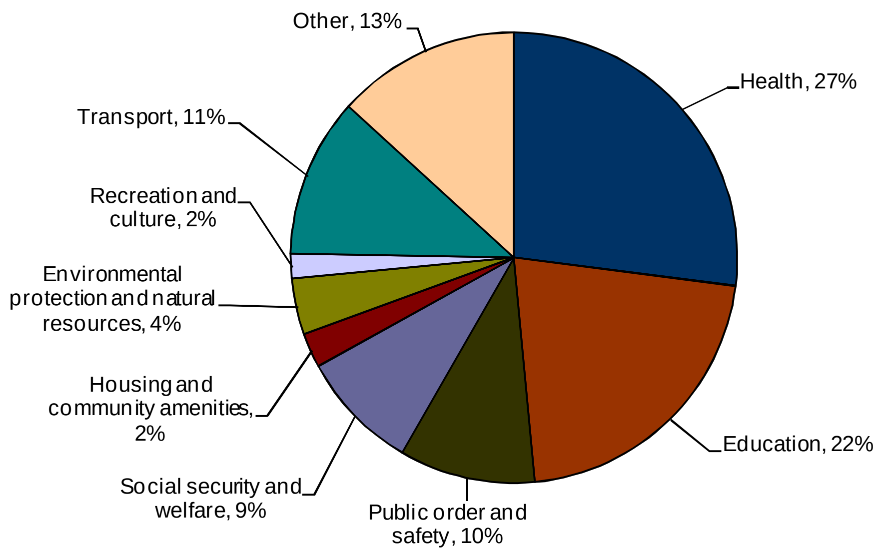


Actuals 2000-01 to 2009-10, projection 2010-11. Stimulus not excluded. Growth rates calculated as Compound Annual Growth Rate (CAGR) from 2000-01 to 2010-11.

Expenditure by function

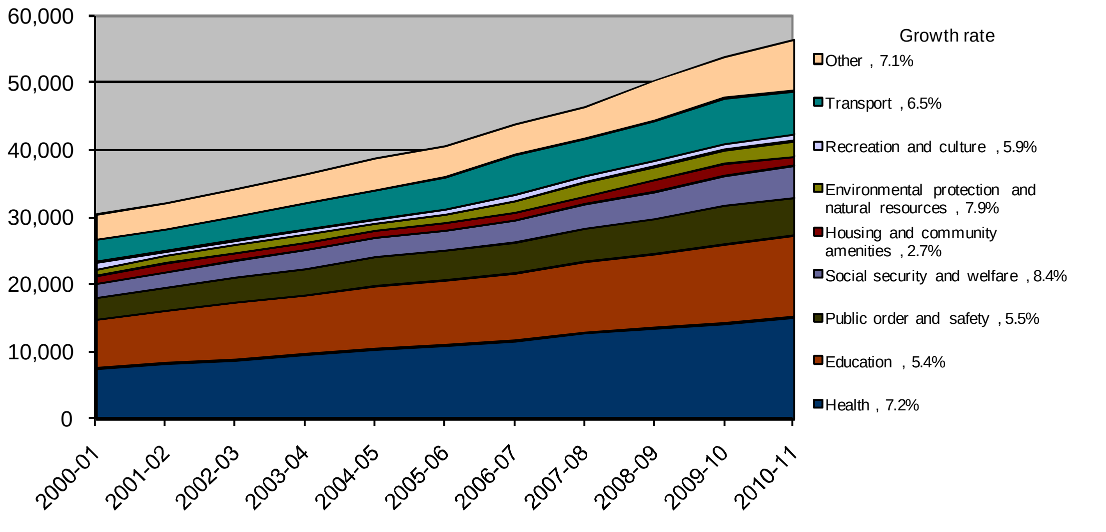
The share of general government expenditure by policy sector is shown below in Figure 2.3.3. The top four areas – health, education, transport, and public order and safety – account for about 70 per cent of total expenditure.

Figure 2.3.3 Total general government recurrent expenses by function (excluding stimulus), 2010-11



On a functional basis, trend growth has been highest in health (7.2 per cent), social services (8.4 per cent), and environmental protection and natural resources (7.9 per cent).

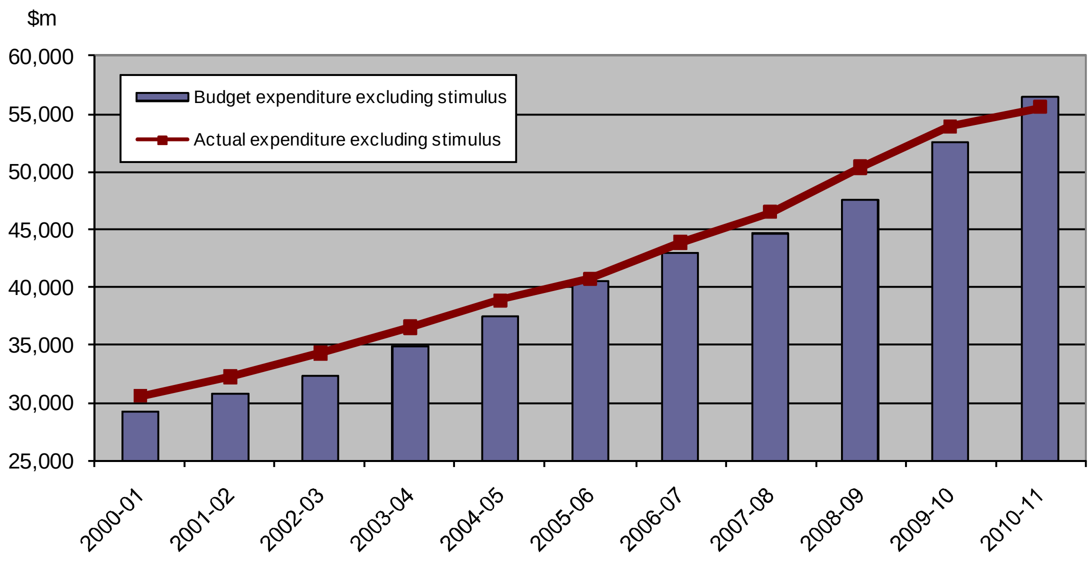
Figure 2.3.4 Growth in total general government recurrent expenses by function



Actuals 2000-01 to 2009-10, Budget 2010-11. Excludes stimulus. Growth rates calculated as Compound Annual Growth Rate (CAGR) from 2000-01 to 2010-11

Actual expenditure growth over the period has consistently exceeded budgeted growth. In each year from 2000-01, actual expenditure has exceeded the published budget by an average of $1.3 billion or 3.3 per cent over budget.

Figure 2.3.5 Deviation between actual and budget recurrent expenditure



Actuals 2000-01 to 2009-10, projection 2010-11. Excludes stimulus.

This expenditure slip (which includes government-approved variations) has undermined the benefits from efficiency dividends that were introduced for all agencies in 2005-06.

While many savings measures have been successful, savings in one part of an agency are frequently offset by increases in costs in other areas of the agency's operations.

Employee-related expenditure drivers

Employee-related expenses are not only the largest component of total expenses; they have also grown on average by 6.5 per cent per annum over the last 10 years to 2010-11.

Growth in employee-related expenses is the major challenge facing government in managing state finances and providing state services, given that frontline services such as education, healthcare and policing are labour intensive.

In dollar terms, employee expenses in 2010-11 are projected to be[5]:

- $24.6 billion (excluding superannuation)
- $27.7 billion (including superannuation).

Every 1 per cent increase in employee-related expenses costs the Budget $277 million per year.

The underlying growth in employee-related expenses can be explained by three key factors:

1. Wages growth (the price of labour) – increases in rates of pay and benefits
2. Workforce size (the quantity of labour) – growth in absolute employee numbers
3. Grade composition – grade creep has led to higher costs for the same level of output.

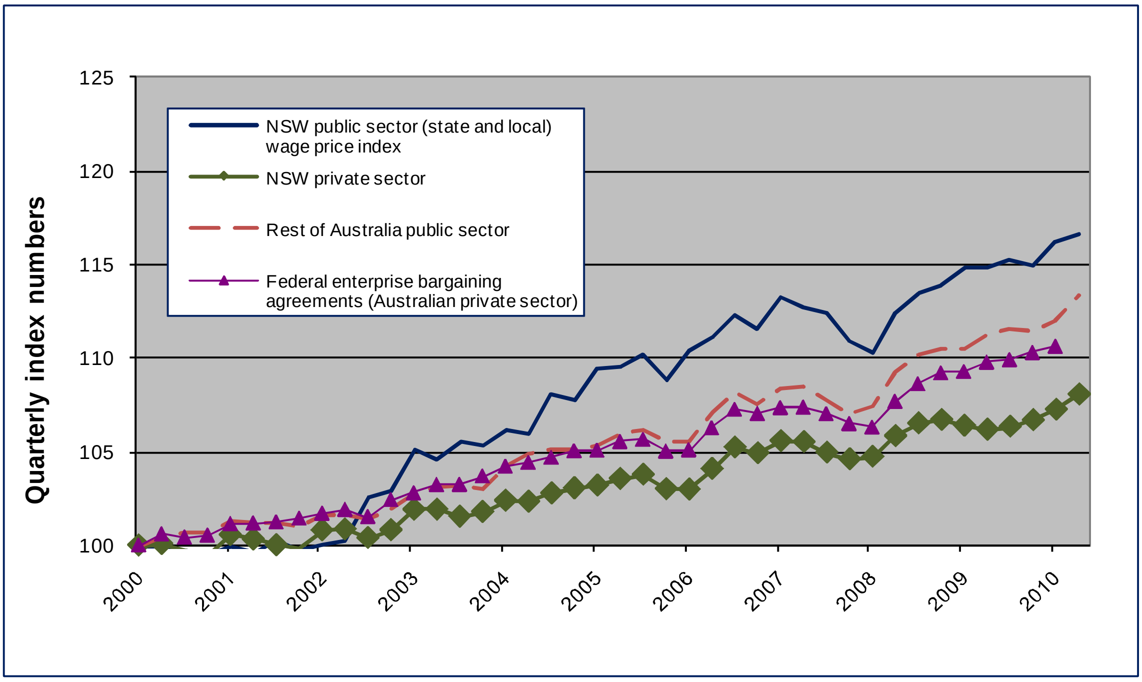
Each of these components has had a significant impact on the growth in expenditure.

Wages growth

For some time, public sector employees in NSW have received wage increases well above other employee groups, as shown in Figure 2.3.6.

[5] Based on the 2010-11 Half-Yearly Review.

Figure 2.3.6 Comparison of real wage increases in the NSW public sector[6]



Since 2000, NSW public sector wage growth has exceeded that of the NSW private sector by about 7.9 per cent, and the public sector in the rest of Australia by about 2.9 per cent. If private sector wage increases had applied in the past 10 years, forecast employee-related expenses would be approximately $2 billion lower in 2010-11.

The NSW Public Sector Wages Policy 2011 provides for wage increases of 2.5 per cent per annum, and increases above this amount must be funded by employee-related cost savings. The Government, recognising the failure to achieve sufficient savings to fully offset previous wage increases above 2.5 per cent, has announced reforms to improve compliance with the policy by requiring:

- any wage increases above 2.5 per cent per annum to be paid only after employee-related cost savings have been achieved and
- the Industrial Relations Commission to give effect to the Government's policy.

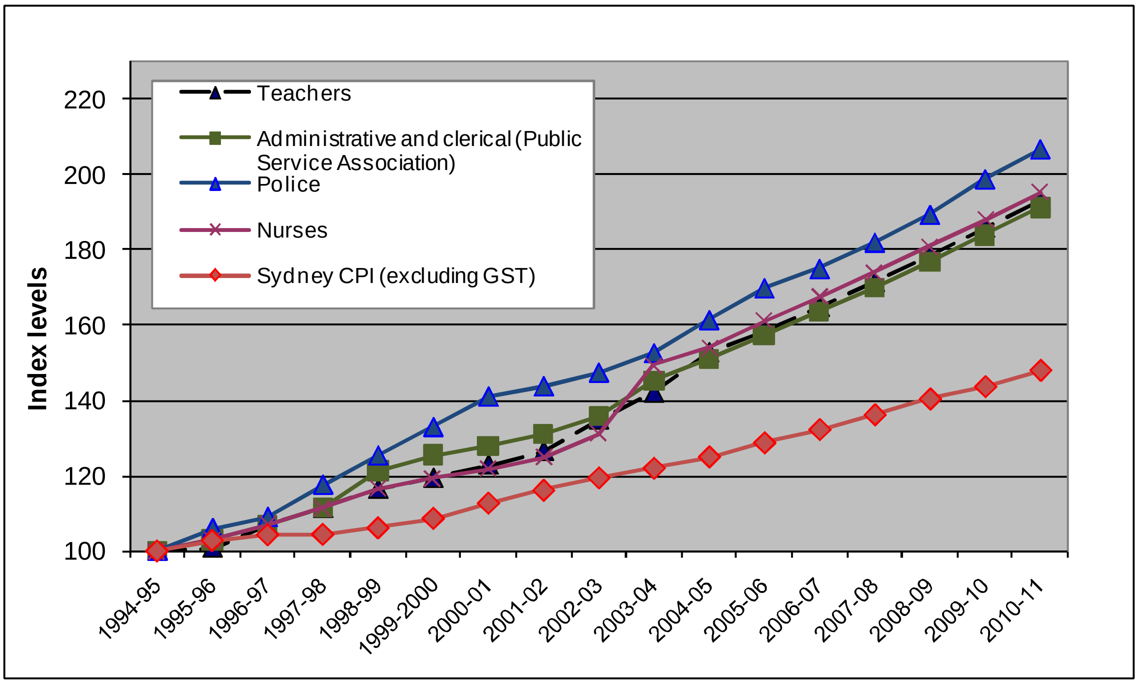
A number of major employee groups (e.g. police, teachers and nurses) have received wage increases (or other negotiated increases in employee-related expenses)[7] above 2.5 per cent without offsets being identified.

Wage restraint is necessary to restore parity and provide scope for the Government to improve services and deliver infrastructure requirements.

6 Information not available for post-December 2010; post-September 2010 information not available for Federal enterprise bargaining agreements (Australian private sector).

7 Including a commitment for an additional 1,400 nurses.

Figure 2.3.7 Wage increases by major employee groups since 1994-95[8]

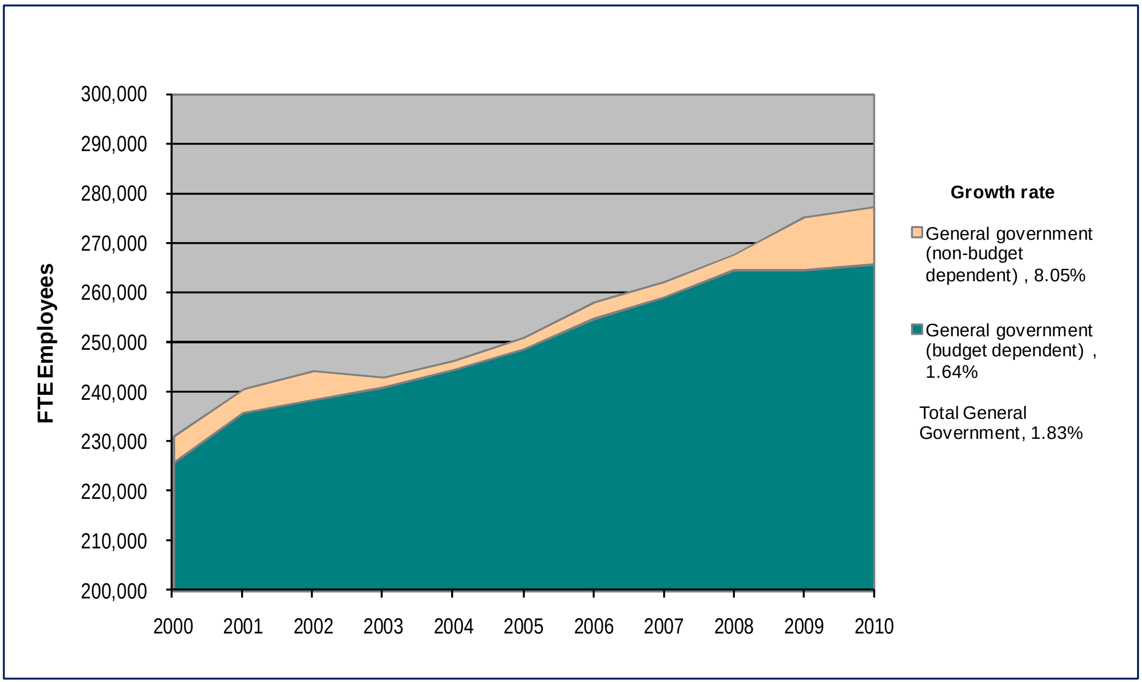


Workforce size

The NSW general government sector employed 277,332 full-time equivalent (FTE) employees on average during the 2009-10 year[9]. General government employee numbers have grown on average by around 1.8 per cent per annum over the last 10 years. In absolute terms, this is an additional 46,094 employees. The majority of these employees provide services in the areas of health, education, and public order and safety.

8 June 2011 quarter Sydney CPI is an estimate only.
9 Source: NSW Workforce Profile 2010, Table 1.

Figure 2.3.8 In-year average general government FTE employees[10]



The growth in the general government workforce is mainly due to Government policy choices made in response to rising community expectations for services. Many of the subsequent reforms and initiatives require a boost in staff numbers to ensure effective implementation. Some of these policy decisions can have far-reaching consequences; for example, an increase in the authorised strength of police officers not only increases police numbers, but also has flow-on effects to other government services such as the court system and corrective systems, in turn requiring additional employees in those functions. Further, the incentives underlying the Death and Disability (D&D) Scheme and workers compensation (as it relates to police) produce a significant loss of active police capabilities. In recent years, the net effect of increased police numbers plus the impact of police D&D and workers compensation claims has been a decline in policing numbers.

Another example is the recent wage agreement with nurses, which includes a wage rise and a workforce increase of 1,400 additional nurses, producing a compound effect on the State's employee-related expenses.

Grade composition shift

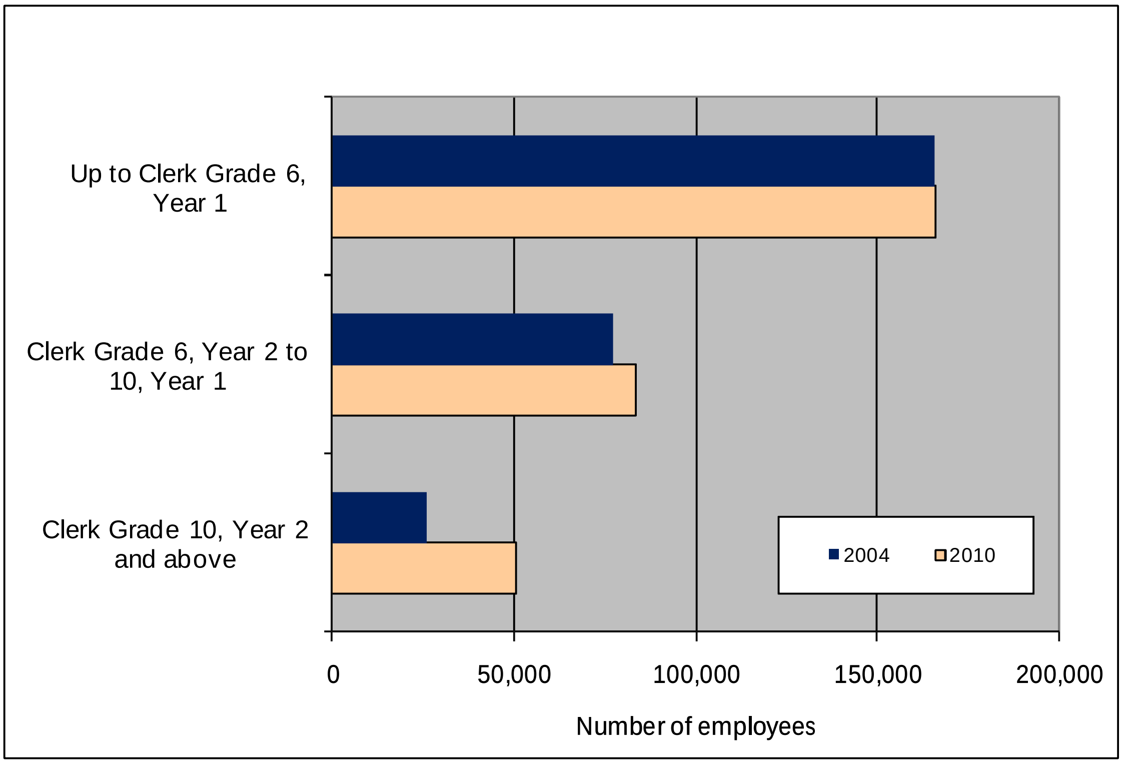
A public sector grade structure with an increasing proportion of higher graded employees will result in higher salary costs for the same level of output. Higher salary costs leads to higher annual and long service leave liabilities, especially for employees who remain in government employment for many years.

A significant part of the increase in employee-related expenses can be attributed to changes in workforce composition. Between 2004 and 2010, the number of employees at Grade 10, Year 2 equivalent and above (i.e. with salaries above $95,319 at current

10 Source: Department of Premier and Cabinet NSW Public Sector Workforce: Profile 2000-10 Snapshot tables. This graph denotes number of FTE employees during the financial year. Data is not available for 2011.

rates) increased by 94 per cent, as shown in Figure 2.3.9. The number of staff at lower levels was largely unchanged over this period.

Figure 2.3.9 Change in workforce composition 2004 to 2010[11]



Changes in the workforce profile may partly reflect strategy by the public sector to retain highly skilled functions while outsourcing lower skilled work. However, some movements in workforce composition are more likely to reflect inadequate job evaluation, with staff automatically progressing through the employment grades based on the length of their tenure.

Policy expenditure drivers

State and Commonwealth Government policy decisions have been key drivers of expenditure growth in the past 10 years.

Commonwealth policy decisions can impact state expenditure in a number of ways. In some cases, Commonwealth funding passes through state agencies, leading to an increase in expenditure offset by an increase in state revenue. However, in many cases agreements with the Commonwealth must be matched in some way by state funding, which has a net impact on the budget result. Some Commonwealth policy decisions also affect the State less directly – the State may bear the cost of operating and maintaining assets funded by Commonwealth infrastructure funding, or the risk of cost increases in jointly funded projects.

[11] Data not available prior to 2004.

State policy choices have influenced expenditure growth in many ways, including decisions to:

- expand eligibility for services provided (expanding eligibility for special education services)
- enhance the quality of services provided (improving on-time running of trains)
- increase inputs rather than focusing on outcomes (reducing the student to teacher ratio).

Specific examples of policy decisions that have influenced the expenditure trend are discussed later in this section, grouped according to policy area.

It is impossible to accurately break down expenditure growth according to demand, policy and other parameters. This is due to a number of factors including inadequate data and the subjectivity associated with categorising expenditure as 'demand', 'policy' and 'other parameters'. For example, an increase in the number of children with low-spectrum disabilities eligible for special education support may be attributed to changes in the interpretation of eligibility criteria, or to increases in the population of children now recognised as having disabilities. Similarly, there is no clear line between improvement of existing services as new technologies and interventions are developed, and policy commitment to new, enhanced services.

Health

Health represents the State's largest policy area in terms of recurrent expenditure, accounting for around $15.2 billion or 27 per cent of the total general government sector expenditure in 2010-11. Health expenditure has nearly doubled since 2001-02 ($8.3 billion) and has had an average growth of 7.2 per cent per annum over the last 10 years.

Key cost drivers in this area are employee-related expense growth, policy choices to fund expansion in services, and external factors such as population growth and ageing. Policy decisions have been affected by factors including increasing community expectations for health services, and technological advancements that have enabled the provision of additional services.

Factors contributing to the growth in health expenditure over the past 10 years include:

- increases in service capacity (including growth in hospital bed capacity) to meet demand for emergency and elective surgery and enhanced mental health services
- increases in Commonwealth funding contributions, particularly since 2008, through higher rates of growth in Specific Purpose Payments (SPPs) and new National Partnership (NP) payments for service enhancements in elective surgery, emergency departments and sub-acute care
- enhancements to improve the quality and scope of services, including funding in recent years to implement the recommendations of the *Final Report of the Special Commission of Inquiry Acute Care Services in NSW Public Hospitals*

(Garling, 2008), including the $485 million Caring Together: The Health Action Plan.

In response to high rates of expenditure growth and budget overruns, the 2009-10 Budget introduced a formula-based approach to growth funding for NSW Health. The formula provides for 5.4 per cent per annum growth in NSW Health's net cost of services. In addition to the funding delivered by the formula, NSW Health can keep all the revenues and efficiency savings it achieves as well as 100 per cent of all asset sale proceeds, with Commonwealth NP payments and enhancements on top of growth funding. The funding formula assumes that NSW Health will achieve a 1 per cent efficiency dividend, which, like other agency efficiency dividends, will increase to 1.5 per cent in 2011-12 and 2012-13. Depending on the level of efficiency achieved by NSW Health, the funding model provides capacity to meet cost and demand pressures of at least 6.4 per cent to 6.9 per cent. This can accommodate underlying demographic growth factors for population (1 per cent) and ageing (0.5 per cent), wage and price inflation, and the impact of new technology and service enhancements on health expenditure.

Education

Education represents the second largest policy area for recurrent expenditure, accounting for around $12.2 billion or 22 per cent of total general government sector expenditure in 2010-11. The compound annual growth rate (CAGR) of Education's total expenses has averaged 5.4 per cent per annum over the last 10 years, largely driven by cost escalation and changes in Commonwealth and state policy parameters. Key policy drivers include:

- Reduced class sizes, through a reduction in student to teacher ratios, implemented from 2003. This represents the most significant state education policy direction related cost over the last decade. Smaller class sizes require a greater number of teachers, which has led to the employment of an additional 1,500 teachers at an estimated cost of $155 million per annum. Furthermore, large capital and recurrent expenditure is required for additional classrooms and demountable classrooms. Despite this, there is no evidence the policy decision has led to better education outcomes, and no evidence either in Australia or internationally of a positive relationship between smaller class sizes and better educational outcomes.
- Additional Commonwealth SPPs and NP initiatives include:
  - Building the Education Revolution (BER) to upgrade school infrastructure as part of the Commonwealth Government's 2008 Stimulus package.
  - The Digital Education Revolution, to support a staged rollout of student computers in high schools.
  - Funding to enhance TAFE facilities.
  - The $46.4 million Smarter Schools NPs covering low-socioeconomic status schools, improving teacher quality, literacy and numeracy.

  - The Productivity Places NP, which is part of the Commonwealth Government's Skilling Australia for the Future initiative, aimed at reducing skills shortages and increasing the productivity of industry and enterprises.

The status of a number of Commonwealth NPs is unclear beyond their current funding arrangements. NSW is exposed to a funding risk associated with potential pressure for the State to continue funding some aspects of terminating NP programs.

Public order and safety

Public order and safety represents around $5.6 billion or 10 per cent of total general government sector expenditure in 2010-11. NSW has pursued policy and legislative changes over the past 10 years, which have contributed to a CAGR of 5.5 per cent over that period. Some of the major changes and drivers include:

- Bail laws were tightened between 2003 and 2010, to include:
  - the introduction of a stringent test for granting bail to persons accused of murder and persons who are 'repeat serious personal violence offenders'
  - a presumption against bail for 'repeat property offenders'
  - a presumption against bail for other offences including certain firearms, drug, terrorism and riot offences.

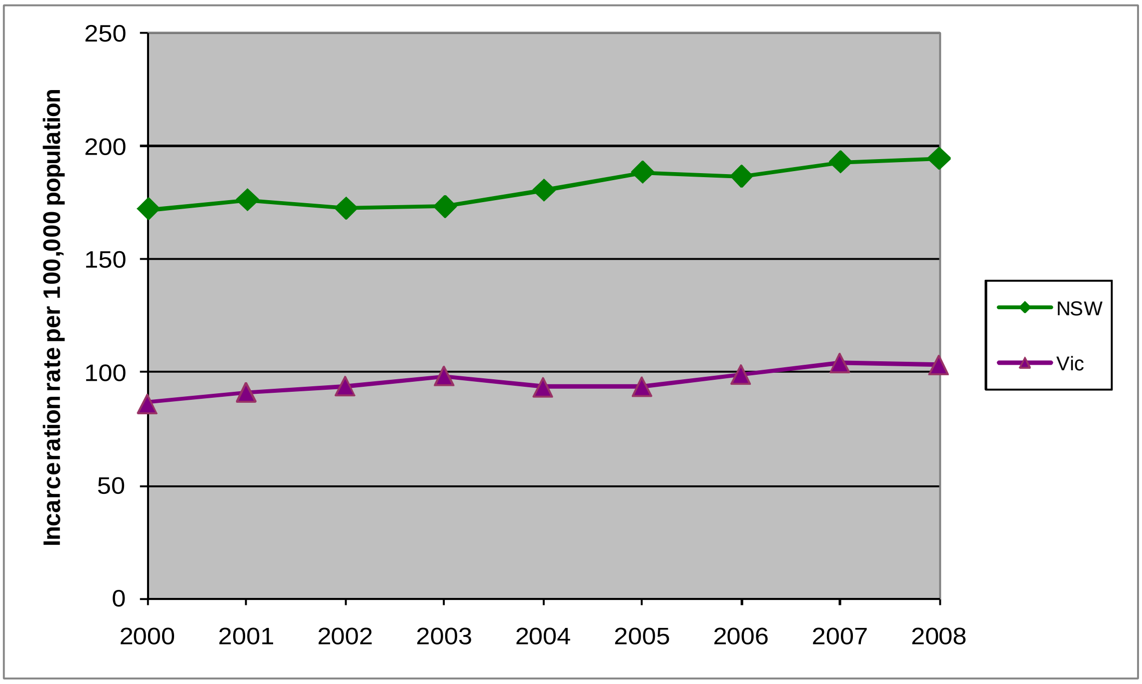
  The changes have contributed to higher imprisonment rates, especially for relatively minor offences for which a non-custodial sentence would have sufficed (as shown in Figure 2.3.10), with 52.7 per cent of all NSW inmates held in minimum security prisons.

- The commitment to increase authorised police strength will increase police numbers by 600 by the end of 2010-11, costing approximately $63.8 million per annum recurrent, and about $4 million capital. However, the number of calls for assistance has been relatively stable in recent years and reported crime rates are generally stable or falling. Over the past five years the NSW Police budget has experienced significant overruns. This is mainly due to NSW Police's inability to achieve efficiency dividends and award offsets while maintaining and increasing authorised strength. These strength commitments have largely limited savings measures to back-office expenditure, which is in the order of 5 to 10 per cent of the annual NSW Police budget.

- The NSW Police Death and Disability (D&D) Scheme provides compensation payments to injured officers, and has contributed to the growth in NSW Police expenditure over recent years. The cost of claims through the scheme reached $168 million in 2009-10, and workers compensation insurance premiums increased from $59 million in 2004-05 to $86 million in 2009-10[12]. The D&D Scheme provides incentives for officers to lodge partial and permanent incapacity claims and receive a lump sum payment, which are maximised the earlier the officer leaves the service.

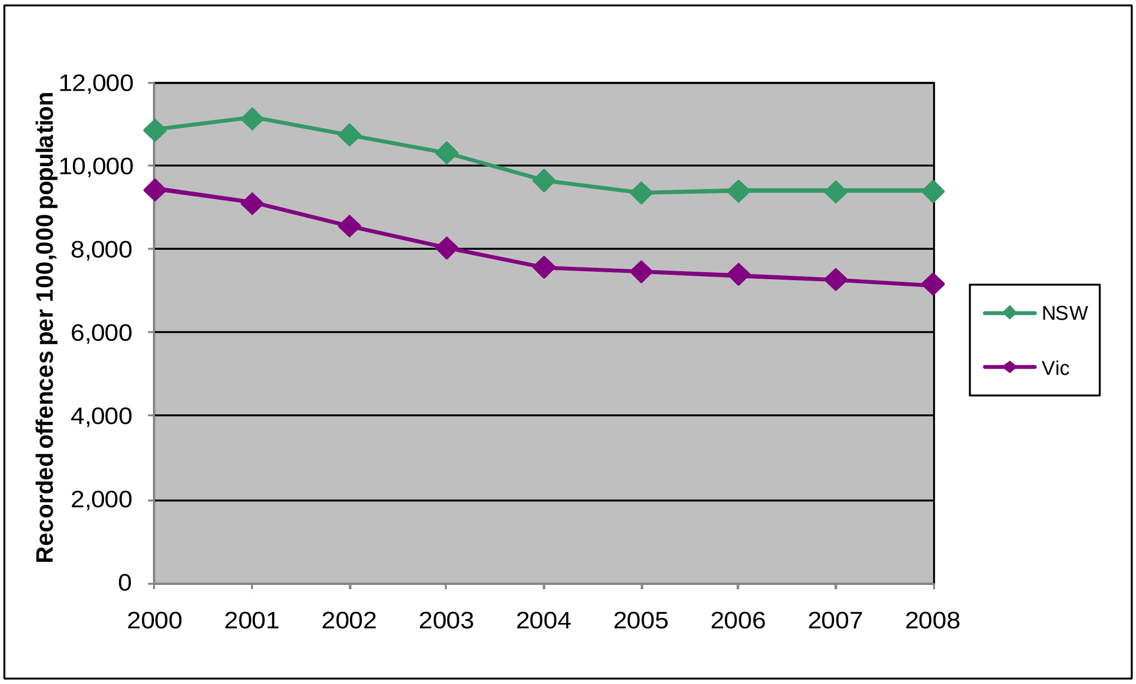
[12] Source: NSW Police management accounts.

Figure 2.3.10 Incarceration rate (per 100,000 population)[13]



The above figure shows that the NSW incarceration rate is approximately double that of Victoria, and is increasing at a CAGR of about 2 per cent per annum. However, in 2008 the NSW crime rate was less than 25 per cent higher than Victoria's, and is declining in line with Victoria's (as shown in Figure 2.3.11). This suggests that NSW's increased incarceration rate is caused by policy and legislative changes.

Figure 2.3.11 Number of recorded total offences (per 100,000 population)[14]



[13] Source: KPMG 2010, *NSW Treasury/ DJAG Initial Scan of Expenditure Final Report*.
[14] Ibid.

Social security and welfare

Social security and welfare represents around $4.9 billion or 9 per cent of total general government sector expenditure in 2010-11 and is largely delivered by the Department of Family and Community Services. The CAGR of social security and welfare expenditure in the past 10 years averaged around 8.4 per cent per annum. Apart from wage expenditure growth, key cost drivers include:

- NSW government policy changes such as the five-year, $750 million[15] Keep Them Safe: A shared approach to child wellbeing policy, which commenced in 2009-10; and the Stronger Together new direction for disability services, which required $1.3 billion[16] expenditure over the five years from 2006-07 to 2010-11. A further $2 billion will be provided over the next five years (2011-12 to 2015-16) for the recently approved next phase, 'Stronger Together 2'.
- The growth of non-government organisation (NGO) grants. The average growth of NGO grants (which is related to NGO award and overhead costs increases) is around 7.5 to 9 per cent per annum.

Housing and associated amenities

Expenditure on housing and associated amenities represented around 2 per cent of total general government expenditure in 2010-11. Approximately two-thirds of the total 2010-11 budget for housing and associated amenities related to funding social housing and homelessness initiatives under the Housing Policy and Assistance Program.

Increased expenditure in recent years largely reflects increased funding under the National Affordable Housing Agreement and a number of time-limited initiatives announced in 2008 as part of COAG and the Commonwealth Government's Economic Stimulus Plan, including:

- the Nation Building – Economic Stimulus Plan ($1.9 billion over four years to 2011-12) and the Social Housing NP ($130 million over the two years to 2009-10) to increase the supply of new social housing
- Remote Indigenous Housing NPs ($396 million over 10 years).

Environmental protection and natural resources

Environmental protection and natural resources represents around $2.3 billion or 4 per cent of total general government sector expenditure in 2010-11. The CAGR of total expenses in this area has averaged 7.9 per cent per annum over the last 10 years. A major cost driver in this policy area is grant expenditure associated with various environmental programs. Environmental-related grants expenditure was projected to be $225 million in 2010-11, an increase of 9 per cent per annum on average since 2000-01. Key components of grant expenditure include:

- Grants from the Climate Change Fund, which received contributions from utility providers of around $180 million in 2010-11. The fund was established in July

---

[15] Source: *Budget Papers 2010-11*, BP3 page 6-5. Note that the program funding is provided to several departments, including NSW Health and NSW Police.

[16] Source: *Budget Papers 2010-11*, BP3 page 6-8.

2007 to help business, households, schools, communities and government save water and energy and reduce greenhouse gas emissions.

- Programs funded from one-third of the Waste and Environment Levy, totalling $135.4 million in 2010-11, up from $73.9 million in 2006-07. The Waste and Environment Levy is essentially an environmental tax generated from waste disposal by the municipal, commercial and industrial, building, and demolition sectors.
- Programs funded by Commonwealth contributions. For example, since 2007-08, NSW has received over $158 million for the Caring for Our Country program, to deliver natural resource management projects on private and public lands.

Transport

Transport represents around $6.4 billion or 11 per cent of total general government sector expenditure in 2010-11. The CAGR of transport total expenses has averaged 6.5 per cent per annum since 2000-01, largely due to growth in wages and staff numbers and grants to RailCorp. RailCorp is a non-commercial public trading enterprise that receives recurrent and capital funding mainly through grants from the general government sector; fare revenue provides only about 20 per cent of total RailCorp funding.

The following policy choices have contributed to recurrent transport expenditure growth:

- Increased focus on reliability and customer service has contributed to the 24 per cent increase in RailCorp infrastructure maintenance expenditure from $835 million in 2006-07 to a projected $1.03 billion in 2010-11. Maintenance expenditure is also driven by network expansion and enhancements, new rolling stock and enhancements to the existing fleet.
- The RailCorp Easy Access program, driven by the Commonwealth *Disability Discrimination Act*, has in recent years resulted in the installation of lifts and other access initiatives across the rail network. The installations will result in significant ongoing recurrent maintenance costs in future years.

Policy decisions also influence revenue collections. RailCorp has advised that not following the Independent Pricing and Regulatory Tribunal (IPART) CityRail price path will result in a revenue reduction of $65 million per annum from 2011-12. RailCorp has advised that revenue may be further reduced by $15 million per annum due to a recent proposal to cap fare increases according to CPI.

Increases in Roads and Traffic Authority (RTA) revenue and capital expenditure have also contributed to recurrent expenditure growth. Growth in weight tax revenues in recent years (approximately 5.5 per cent CAGR for period 2004-05 to 2009-10) has resulted in an increase in RTA expenditure. The RTA receives approximately $1.4 billion in funding from the Motor Vehicle Weight Tax.

RTA capital expenditure grew from $1.6 billion in 2006-07 to $2.6 billion in 2010-11, an increase of 60 per cent. As a result, depreciation and amortisation (which account for

$962 million of the total budget), has increased by 11 per cent over the same period. Increased Commonwealth funding for roads has largely been directed toward new capital projects rather than meeting network maintenance costs. This increases pressure on the state-funded component of the RTA's budget for maintenance expenditure in coming years.

Other economic activities

Total expenditure for the industry and investment area is around $1 billion, with a CAGR of 5 per cent for the period from 2006-07 to 2009-10. Apart from wages, grants are the other major cost driver within the former industry and investment policy area, driven by both Commonwealth and state policy decisions. The key grants are outlined below:

- The Advancing Australian Agriculture (AAA) grant represents around half of all grants (approximately $250 million per annum). It is 90 per cent Commonwealth funded and the remainder is funded by NSW.
- Drought assistance provided by the NSW Government has reached over $530 million since 2002-03. Total drought assistance in NSW, including funds provided by the Commonwealth Government, has reached over $1.8 billion since 2002. The current scheme does not encourage efficient farming and with increasingly extreme weather events, the scheme is likely to continue to grow, albeit in a cyclical pattern.
- There are various ad hoc grants relating to one-off policy decisions (e.g. investment supporting V8 supercar races at Sydney Olympic Park); the expansion of parks and reserves for conservation through the buyout of industry land and marine parks (e.g. Brigalow Belt South and Nandewar structural adjustment package, and the River Red Gum structural adjustment package in the Riverina); and sustainable natural resource management through industry buybacks (e.g. $5 million in commercial fishing licenses).

Other expenditure drivers

As discussed above, the major drivers of expenditure growth over the past 10 years have been wages growth and government policy decisions. Employee-related expenses have grown on average by 6.5 per cent per annum over the last decade. As employee-related expenses (including superannuation) comprise about 49 per cent of total general government expenses, the impact of this factor on aggregate general government expenditure growth is estimated at approximately 3 per cent per annum.

The impact of external factors such as demographic change and non-wage inflation, while often cited, in most cases has a relatively small impact on a year-to-year basis, but can be significant in the longer term.

Population

Population growth increases the cost of maintaining existing services for most general government agencies, as the size of the target group receiving the services is at least partly driven by total population. However, over the period 30 June 2001 to 30 June

2009, the NSW population grew more slowly than that of Australia as a whole, with a compound annual growth rate of about 1 per cent per annum[17].

Some agencies provide services targeted to specific sub-groups of the population that may be growing faster or slower than the population overall. For example, health services are used more by older people, so an ageing population increases demand for these services. However, the impact of this factor remains small compared to other factors. For example, according to Productivity Commission analysis of health expenditure growth over the period 1992-93 to 2002-03, population growth and ageing contributed just 1.2 per cent and 0.6 per cent respectively to the total real growth of 5.3 per cent per annum[18].

Faster-than-average growth in the target groups for some services is at least partly offset by slower-than-average growth in the target groups for other services. For example, the population of NSW children aged 4 to 14 – the major target group for school education – only grew by about 0.7 per cent per annum over the period 2001 to 2009. In recent years, this low growth has been compounded by a drop in the proportion of children attending public versus private schools – nationally, the share of students attending public schools fell from 72 per cent in 1993 to 66 per cent in 2009)[19].

In many cases, the impact of population growth is swamped by other factors driving demand for services. For example, the daily average population of people aged 10 to 17 years in juvenile detention rose from 216.5 to 361.3[20] from 2001-02 to 2008-09, mainly as a result of government policy, not because of an increase in the juvenile population.

Non-wage inflation

The main impact of inflation on expenditure growth occurs through wage increases; however, inflation also drives increases in the cost of other inputs. The impact of these increases falls largely in the 'other expenses' and 'grants and transfers' categories, as shown in Figure 2.3.1. These expense categories represent about 42 per cent of total general government expenses. Non-wage inflation has contributed to growth in these costs at an average rate of about 2.7 per cent per annum in Sydney over the period from December 2001 to December 2010[21]. The impact of this factor on aggregate general government expenditure growth is therefore estimated to be in the order of 1 per cent per annum.

Economic cycle

The economic cycle impacts on expenditure growth, partly through cyclical variations in revenue, and partly through cyclical changes in the need for some services. Over time, if cycle-driven expenditure growth is balanced by effective reduction in expenditure growth at appropriate points in the cycle, the net effect on long-term trends should be

---

[17] Australian Bureau of Statistics 1338.1 *NSW State and Regional Indicators*, December 2010.
[18] Productivity Commission 2005, *Impacts of Advances in Medical Technology in Australia*, Research Report, Melbourne, p.55
[19] Australian Bureau of Statistics 4221, *Schools Australia* 2009.
[20] Productivity Commission 2011, *Report on Government Services 2011*, Table 15A.170.
[21] Australian Bureau of Statistics 6401.0 *Consumer Price Index, Australia*, March 2011.

zero. The challenge for government is to achieve this though the evidence indicates there is a 'ratcheting up' effect taking place, as expenditure is increased in an economic downswing but is not fully eliminated in the upswing.

Other external factors

A range of other external factors such as climate conditions may also impact on expenditure growth. Where these factors are material, the impact is usually realised through policy choices, as discussed above.

2.4 Budget variations

Overview of budget result variations between 2001-02 and 2010-11

Actual budget results were better than original budgets in all years. with the exception of 2004-05, 2008-09 and 2010-11.

Positive budget variations ranged from $127 million in 2003-04 to $2 billion in 2009-10.

The 2008-09 result was $1.1 billion below budget, and the 2010-11 result is currently expected to be broadly in line with the current Budget.

Revenue collections have been the main cause of budget variations over the last 10 years. Over this period, revenues were on average $1.8 billion or 4.4 per cent over budget forecasts.

The key underlying driver of revenue variations over the period has been the difficulty in forecasting stamp duty on property transfers (transfer duty). Transfer duty is strongly influenced by economic conditions (particularly interest rates and changing rate expectations) and turning points are difficult to predict. Budget forecasts over the last 10 years have tended to underestimate revenues in periods of strong economic activity. Conversely, revenues have been overestimated in times of economic slowdown.

GST collections in recent years have also experienced large budget variations, driven principally by the impact of the GFC and the switch to higher savings rates by households.

Expenses for the last 10 years were on average $1.3 billion or 3.3 per cent over budget forecasts.

Strong revenue outcomes have flowed through to expenditure in key service delivery areas such as health, education and police. Consistent budget overruns were driven by a combination of higher employee costs due to various award decisions and actuarial valuations of the Police Death and Disability Scheme, higher demand for services and higher program spending flowing from Commonwealth funding decisions or own-source revenues.

In addition, a major source of expense variations since 2006-07 has been year-end decisions to use higher than budgeted revenues to make late, one-off capital grants to the rail sector, to fund various infrastructure projects. These grant payments were considered prudent as they reduced pressures on future budgets.

Finally, it should be recognised that the large negative budget variation in 2008-09 was the outcome of a number of unbudgeted events, including:

- the global financial crisis (GFC) and its negative impacts on state taxes and GST revenues
- the Commonwealth Government's Economic Stimulus Plan in response to the GFC and
- COAG reforms to Commonwealth-State financial relations.

In short, the negative impacts of the GFC were offset in part by other Commonwealth actions.

Table 2.4.1 Summary of budget forecasts versus actual budget results, 2005-06 to 2009-10

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	10-year average
Original budget	1,256	1,299	1,026	836	303	-700	40	268	-990	773	
Actual result	1,566	1,752	1,153	240	1,928	795	935	-862	994	621	
Variance	*310*	*453*	*127*	*-596*	*+1,625*	*+1,495*	*+895*	*-1,130*	*1,984*	*-152*	
* Revenue variation											
– $ million	+1,997	+2,390	+1,415	+775	+1,821	+2,544	+2,786	+1,753	+3,376	-987	+1,787
– %	6.3%	7.1%	3.9%	2.0%	4.5%	6.0%	6.2%	3.7%	6.4%	-1.7%	4.4%
* Expense variation											
– $ million	+1,687	+1,937	+1,289	+1,372	+195	+1,049	+1,891	+2,882	+1,392	-835	+1,286
– %	5.5%	6.0%	3.7%	3.7%	0.5%	2.4%	4.2%	6.0%	2.6%	-1.5%	3.3%

Revenue variations

The table below summarises the main revenue variations for the 10 years to 2010-11.

Table 2.4.2 Summary revenue variations

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	10-year Average
Taxation:											
– Stamp duty on property transfers	969	957	543	-598	-372	913	243	-1,068	1,009	-6	259
– Other taxes	157	333	285	385	14	73	758	420	109	-3	253
GST grants	291	54	-100	177	45	-8	16	-1,046	798	-905	-68
Other Commonwealth grants	277	119	100	254	1,199	134	732	2,469	483	67	583
Other grants	-6	390	-2	151	172	-15	107	149	25	4	98
Sales of goods and services	212	228	133	109	211	336	231	398	468	76	240
Interest	-154	-149	214	272	327	400	-327	-137	-74	96	47
Dividends and tax equivalents – other sectors	180	81	94	-162	-49	330	264	39	24	43	84
Other dividends and distributions	-22	-20	24	0	-20	-43	292	-21	80	26	30
Fines, fees and other:											
– Mining royalties	1	10	1	96	91	-12	94	359	-56	-493	9
– other	92	387	123	91	205	436	376	193	511	105	252
Total revenue	**1,997**	**2,390**	**1,415**	**775**	**1,821**	**2,544**	**2,786**	**1,753**	**3,376**	**-987**	**1,787**

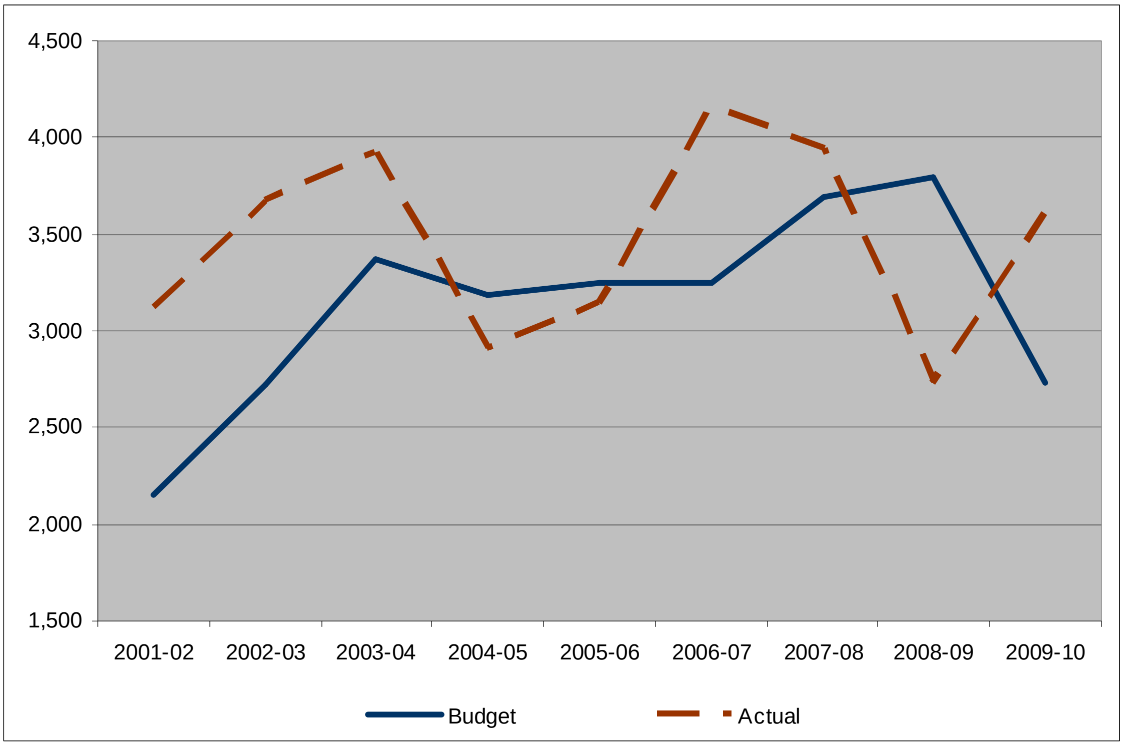
Overview

Generally speaking, actual revenues have exceeded budget forecasts in aggregate over the course of the 10-year period. However, there have been significant differences in the cause of these variations over time.

Transfer duty is very volatile and difficult to forecast. It is driven by the number of transactions and the value of the properties. Interest rates and changing interest rate expectations can have significant effects on these variables.

Transfer duty budget forecasts typically are not as volatile as the actual outcomes and turning points are difficult to track. Forecasts typically underestimate the strength of the cycle, although forecast errors do not have a systematic bias in either direction.

Figure 2.4.1 Transfer duty: budget verses actual

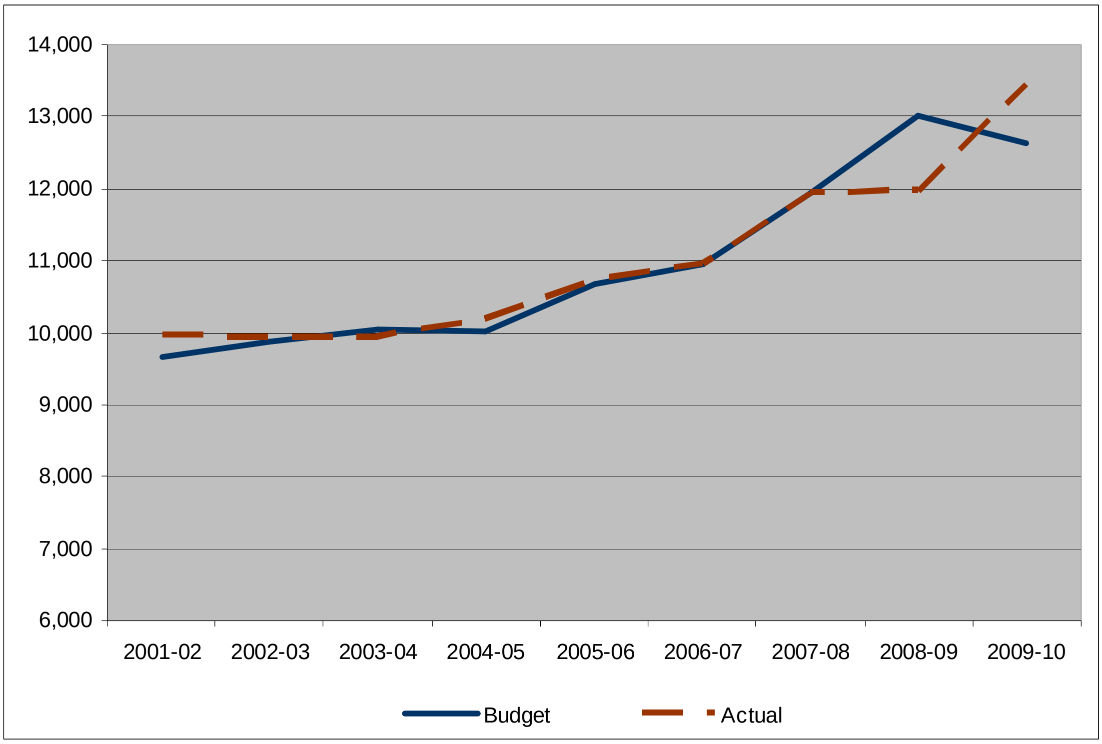


A review of NSW revenue forecasts prepared by Econtech in May 2008 found that “despite the seemingly large errors, NSW Budget estimates outperform the average errors achieved across the other states and territories and specifically the larger states”.

Forecast errors in other taxes reflect a number of factors in other stamp duties, payroll tax and land tax. Mortgage duty (to be abolished from 1 July 2012) tends to reflect the transfer duty cycle. Payroll tax does not appear to display a systematic bias, but reflects unexpected movements in employment and wages. Land tax appears to have been underestimated over most of the period. Major reasons for the underestimation have been larger than expected outcomes from Office of State Revenue (OSR) compliance activities, and changes in the timing of processing land tax assessments. For example, a number of land tax assessments are typically carried over from one year to the next. Changes to the number of carried-over assessments between years can affect land tax outcomes.

GST actual results have generally been close to budget forecasts, except for the last few years, when GST collections were affected by the impact of the GFC and the increased savings ratio. There does not appear to be any systematic bias. These forecasts are typically based on Commonwealth forecasts for the GST pool, which are usually updated in the Commonwealth Budget and Commonwealth Mid-Year Economic and Fiscal Outlook. NSW revises these estimates periodically during the course of the year, based on monthly GST data.

Figure 2.4.2 GST: budget verses actual



Other Commonwealth grants appear to have been systematically underestimated over the past 10 years. This appears to reflect changes in grant timing at the Commonwealth's discretion and additional grants paid by the Commonwealth due to changes in Commonwealth policy.

Mineral royalties have largely been on track, with no systematic bias. Policy changes and the effects of weaker economic conditions have negatively affected royalties in the past few years.

Forecast errors in most revenue streams do not appear to reflect systematic bias; rather, they appear to reflect a number of one-off factors, revenue volatility and the difficulty of forecasting turning points. The exception is other Commonwealth grants, where changes in the timing of Commonwealth grants and changes to Commonwealth policy appear to be responsible for the regular underestimation of other Commonwealth grants.

More detailed analysis

There are a large number of material variations across certain years and for individual revenue sources. Many of these are one-off variations relating to timing issues; involve reclassifications of data; or are driven by Commonwealth funding decisions.

The key underlying drivers of revenue volatility over the last 10 years are:

- taxation revenues, especially stamp duty on property transfers
- mining royalties (since 2008-09)
- GST grants (since 2008-09).

These revenues are subject to volatility and forecasting difficulties as they ultimately depend on broader economic conditions, both domestic and international.

Taxation

Stamp duty on property transfers

Stamp duty on property transfers is the largest single component of stamp duty revenues and is the most volatile revenue source collected by the State.

In the early 2000s, revenue outcomes were positive in relation to budget forecasts, due to continuing low interest rates, and strong investor interest in the property market caused by nervousness about share markets.

Revenues were below budget forecasts in 2004-05 and 2005-06 because of weaker than expected property markets, partly due to uncertainty about interest rates.

Increased transfer duty collections in 2006-07 were mainly from high value commercial property sales, with nearly half of the additional revenue coming from one single transaction.

The 2007-08 increases were due to stronger than expected activity across all property markets.

The $1.1 billion shortfall in 2008-09 was predominantly due to the poor economic climate associated with the GFC, while the strong collections in 2009-10 reflected an earlier than expected recovery from the 2008-09 slowdown.

Land tax

Each year, land tax revenue varies from budget expectations, primarily because of variations in the timing of assessments issued by the OSR and in the revenue yield from compliance activity.

Revenues in 2006-07 and 2007-08 were higher than budgeted because of faster assessment processing, which cleared a backlog of assessments carried over from previous years. The 2008 mini-Budget introduced a higher marginal tax rate on taxable land holdings valued at over $2.25 million, which accounted for an estimated $170 million positive revenue variation in 2008-09.

Payroll tax

Variations in payroll tax revenue reflect differences between actual and expected growth of employment and wages. For instance, there were stronger than expected labour market outcomes in 2006-07 and 2007-08, followed by weaker outcomes in 2008-09 and 2009-10 in the wake of the GFC.

GST grants

Until 2008-09, GST grant revenues were broadly in line with budget forecasts.

This pattern changed dramatically in 2008-09, with a $1 billion negative variation reflecting the unexpected magnitude of the economic slowdown associated with the GFC. Since then, GST grant revenues have been volatile, with a faster than anticipated economic recovery in 2009-10 resulting in over $1 billion in additional revenue. In contrast, the current outlook for 2010-11 revenue looks very negative due to weaker consumption and housing growth.

Mining royalties

Royalty variations primarily reflect differences between actual and expected contract prices and volumes of export coal, as well as variation from the anticipated exchange rate between the Australian and US dollars.

As with GST grants, mining royalties were relatively stable up until the late 2000s; however, this has changed since 2008-09. In 2008-09 mining royalties were $359 million over budget due to a combination of higher coal prices, favourable exchange rates and the 2008 mini-Budget decision to increase coal royalty rates by 1.2 percentage points.

In contrast, royalties are now expected to be below budget forecasts by over $400 million in 2010-11, largely due to the strong Australian dollar.

Expense variations

The table below summarises the main expense variations for the 10 years to 2010-11.

Table 2.4.3 Summary expense variations

	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	10-year average
Employee-related	1,360	1,316	1,065	765	691	569	451	965	348	-374	716
Superannuation	-3	165	-73	409	-297	25	-5	145	43	32	44
Depreciation	144	375	136	131	40	56	38	11	-146	-130	66
Interest	-14	43	-7	405	290	264	-21	28	122	-82	103
Other operating	-347	-349	-390	-806	-1,136	-1,037	243	89	164	-108	-368
Grants and subsidies:											
– Recurrent	121	419	532	428	385	-9	556	562	-287	262	297
– Capital	427	-29	27	41	221	1,177	627	1,082	1,148	-436	429
Total expenses	**1,687**	**1,937**	**1,289**	**1,372**	**195**	**1,049**	**1,891**	**2,882**	**1,392**	**-835**	**1,286**

As with revenue, a number of expense variations appear to obscure rather than clarify the main underlying reasons for systematic underestimation of expenses over the last 10 years.

After allowing for these one-off transactions, the key underlying sources of expense variance over the last 10 years were:

- a consistent pattern of spending overruns in several key service delivery agencies, including NSW Health, the Department of Education and Training, NSW Police, and the Roads and Traffic Authority
- the impact of tort law reforms on SICorp workers compensation and public liability claims expenses
- special capital grants payments to the rail and housing sectors.

NSW Health

NSW Health expenses have been over budget in most years; however, with the rebasing of NSW Health's budget in 2008-09 and the introduction of a new health growth funding model, the agency has been on budget since 2009-10. While expenditure variations have been concentrated in employee-related expenses, there were also significant variations in other operating expenses. The main drivers of expense overruns were:

- various changes over the 10-year period to awards covering nurses, visiting medical officers, career medical officers, staff specialists, medical radiation scientists, other health occupations and employee entitlements
- unbudgeted expenditure in a range of areas due to overspends by Area Health Services and
- the reclassification of capital expenditure to expenses.

Some higher than budgeted expenditure increases were funded by additional Commonwealth programs (especially under the new COAG reforms) and by internally generated revenues.

Department of Education and Training

Department of Education and Training expenses were over budget every year for the past decade. As with NSW Health, overruns were greater in the early 2000s, 2007-08, 2008-09 and 2010-11. Expenditure variations were concentrated in employee-related and other operating expenses, with the relative proportions varying significantly between different years. Overall, the main drivers of expense overruns were:

- teacher award changes
- additional student enrolments
- Commonwealth program funding
- expenditure driven by higher own-source revenues (e.g. TAFE fees)
- non-achievement of budgeted savings (mainly in 2010-11).

NSW Police

NSW Police expense variations have been steadily growing over the last 10 years, escalating noticeably since 2004-05. Variations are heavily concentrated in employee-related expenses. The main driver of expense overruns since 2006-07 was a series of major revisions to Death and Disability (D&D) Scheme liabilities based on actuarial valuations. Other drivers include:

- the additional cost of new recruits in 2005-06 and 2006-07
- the cost of retaining higher police numbers in 2008-09 and later years
- one-off events like the saturation policing of beaches after the Cronulla riots in December 2005, and security provisions for the 2007 Asia-Pacific Economic Cooperation conference.

Roads and Traffic Authority (RTA)

RTA expenses were over budget in all years except for a minor negative variation in 2005-06. Budget variations were greater in the early 2000s, and 2007-08 to 2009-10. Variances were scattered over a number of expenditure items including employee-related expenses, other operating expenses, depreciation, and recurrent and capital grants. The main drivers of expense variations have been:

- depreciation changes in the early 2000s due to changing accounting treatments, road cost indexes and asset revaluation reviews
- increased expenditure on road safety, traffic and transport programs
- additional road maintenance work, reflected in recent years by higher recurrent grants to local councils for road repairs due to flood damage
- programs funded from increases in motor vehicle taxes, and Commonwealth and other grants
- reclassification of capital to expenses
- revised accounting arrangements for the Sydney Harbour Tunnel
- unbudgeted non-cash capital grants (including $401 million in 2009-10) due to transferring RTA roads to the local government sector following implementation of the NSW Roads Classification Review.

NSW Self Insurance Corporation (SICorp)

SICorp expense variations have been volatile over the last 10 years due to a combination of legislative reforms and actuarial assessments of insurance liabilities.

In 2001-02, expenses were more than $500 million above budget forecasts, mainly due to significant increases in public liability insurance. The increasing budget exposure to insurance risks led to government legislative reforms in workers compensation and tort law.

These reforms were so successful in controlling insurance claims and liabilities that over the three-year period from 2005-06 to 2007-08, actual expenses were significantly lower than budget forecasts. These outcomes were also influenced by more effective claims management.

Following this period, expenses returned to above budget forecasts because of higher claims payments and the actuarial forecasts for outstanding liabilities relating to NSW Police workers compensation.

The outcome for 2010-11 is currently expected to be below budget forecasts due to new actuarial studies that have revised down liabilities associated with workers compensation and the Police D&D Scheme.

Capital grant payments

Capital grants variations have been significant in all years since 2006-07. Decisions to make late grant payments to the rail or housing sectors were often influenced by stronger than expected year-end budget positions. The major variations in this period are detailed below:

- 2006-07 – A one-off payment of $960 million to the Transport Infrastructure Development Corporation to repay debt.
- 2007-08 – The combination of a $390 million payment to the Transport Infrastructure Development Corporation to provide additional funding for the Epping to Chatswood line, and a $150 million bring-forward payment to RailCorp.
- 2008-09 – A combination of increases in the First Home Owner Grant due to the Commonwealth Government's First Home Owners Boost Scheme ($413 million); a $280 million grant to repay RailCorp debt; and a $220 million bring-forward payment to Housing NSW.
- 2009-10 – The combination of a $350 million payment to the Transport Infrastructure Development Corporation to provide additional funding for the South West Rail Link; and a non-cash capital grant of $401 million by the RTA due to roads being transferred to local councils, following implementation of the NSW Roads Reclassification Review.

2.5 Budget and forward estimates for 2010-11

Variances in budget estimates during 2010-11

Since the release of the 2010-11 Budget there have been two major revisions to the estimates: in the Half-Yearly Review (as a legislative requirement), and in March 2011, to brief the incoming Government. Changes in revenues, expenses and the budget result over this period are summarised in the following table.

Table 2.5.1 Headline budget aggregates

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
Revenues				
– 2010-11 Budget	57,669	59,962	62,196	64,025
– Half-Yearly Review	56,535	60,030	62,260	64,019
– March estimates	56,731	59,147	61,372	63,611
Four-year budget variation				
– $ million				-2,991
– %				-1.2%
Expenses				
– 2010-11 Budget	56,896	59,077	61,334	63,397
– Half-Yearly Review	56,369	59,855	61,828	63,890
– March estimates	56,366	58,943	61,777	64,804
Four-year budget variation				
- $ million				+1,186
- %				+0.5%
Budget result				
– 2010-11 Budget	773	885	863	628
– Half-Yearly Review	167	176	432	129
– March estimates	365	204	-405	-1,193
Four-year budget variation				
– $ million				-4,178

The budget result is the difference between two very large aggregates, making it very sensitive to small changes in gross flows. For example, over the four years to 2013-14, expenses have increased by 0.5 per cent while revenues have fallen by 1.2 per cent. The combined impact of these movements has resulted in the aggregate four-year budget result moving from a surplus of $3.1 billion to a deficit of $1.0 billion.

The March estimates show a progressive deterioration in the budget position, with revenues in 2013-14 0.6 per cent lower and expenses 2.2 per cent higher, resulting in a turnaround in the budget result from a surplus of $628 million to a deficit of $1,193 million.

Rail grants were prepaid in the 2010-11 Budget, to reduce the size of the projected deficit in 2013-14, the latter reflecting the growth of the capital program associated with the Metropolitan Transport Plan. The effect of these payments was removed from the March 2011 estimates, to provide a clearer representation of budget trends. The following table shows budget results excluding these 'rail smoothing' payments.

Table 2.5.2 Budget results excluding rail smoothing

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
2010-11 Budget	773	1,470	1,163	228
Half-Yearly Review	167	1,061	732	-571
March estimates	365	204	-405	-1,193
Total variation				
– Since 2010-11 Budget	-408	-1,266	-1,568	-1,421
– Since Half-Yearly Review	198	-857	-1,137	-622

After excluding the impacts of rail smoothing grants, the downward revisions to the budget result show a greater level of consistency, reflecting movements in underlying budget finances.

Conceptual basis of the Half-Yearly Review

The revised Budget and forward estimates are produced on a no-policy-change basis; that is, the estimates reflect existing policy including:

- NSW Health net cost of services increasing annually by 5.4 per cent in accordance with the agency's growth funding formula
- education expenses, reflecting projected growth in student numbers in line with established student to teacher ratios
- expansion in disability services under the Stronger Together 2 package, which may result in an increased proportion of the population being serviced
- the volume of services delivered by agencies without agreed funding agreements remaining static
- indexation of agency spending in line with the consumer price index (CPI) and wages policy (under existing wages policy, wage growth of 2.5 per cent is funded and all wage increases above 2.5 per cent must be offset by employee-related savings)
- agency efficiency dividends of 1 to 1.5 per cent per annum in discretionary spending, with NSW Health retaining any savings.

Process for developing Half-Yearly Review and March estimates

The Half-Yearly Review took the 2010-11 Budget as a starting point. Adjustments were made to reflect:

- the impact of any government decisions on agency spending or revenues in general
- approved changes to agency budgets reflecting unavoidable cost and demand increases (the latter needing to be specifically approved), or changes in the timing of program delivery consistent with unchanged policy outcomes

- adjustments to revenues reflecting changes in the economic environment
- changes in risks, with risk provisions being reviewed to ensure budget aggregates reflect likely expected outcomes.

The March estimates were developed in a similar manner (based on the Half-Yearly Review estimates) although changes in risk provisions were done more on an exception basis rather than through a systematic review, which will be undertaken later in the budget cycle.

Outlined below are separate reconciliations for the movement in revenues and expenses between the Budget and the Half-Yearly Review, and between the Half-Yearly Review and the March estimates.

Revenue variations

2010-11 Budget to Half-Yearly Review

The following table summarises the revenue variations between the 2010-11 Budget and the Half-Yearly Review.

Table 2.5.3 Revenue variations in the period from 2010-11 Budget to the Half-Yearly Review

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
2010-11 Budget	**57,669**	**59,962**	**62,196**	**64,025**
Transfer duty	-274	-285	-169	-77
Payroll tax	82	72	78	91
Land tax	-	80	90	95
GST grants	-437	-191	-151	-139
	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
Commonwealth transport grants	-204	240	9	-71
Business regulation NP	-	-64	-80	-
Financial distributions and government guarantee fees	-47	114	-89	-370
Mining royalties	-332	64	151	145
Fines – speeding and red light cameras	-97	-122	-2	28
SICorp premiums and investment income	55	85	101	118
Revenues associated with maintenance of effort	-	110	64	114
Other	120	-35	62	60
Half-Yearly Review	**56,535**	**60,030**	**62,260**	**64,019**
Total variation	-1,134	68	64	-6

Explanations

Transfer duty	Receipts were lower in 2010-11, reflecting the greater than expected impact of interest rate increases, and a more subdued property market now expected over the forward estimates period.
Payroll tax	This source brought in higher revenue over the projection period, reflecting stronger than expected employment growth in 2010-11, with flow-on impacts over forward estimates period.
Land tax	The variations were due to higher than previously expected land valuations in June 2011.
GST grants	Variations were due to the Commonwealth Government's downward revision of national GST pool estimates, and a refund in 2010-11 of overpayments made in 2009-10.
Commonwealth transport grants	Variations were mainly due to timing differences in National Partnership (NP) payments, including payment by Commonwealth of funds for the Holbrook Bypass in June 2010 instead of July. There is also a predicted increase in revenue in 2011-12 as a result of re-profiling Commonwealth-funded road projects.
Business Regulation NP	The variation reflects loss of revenues associated with NSW not participating in nationally uniform occupation health and safety reforms.
Financial distributions and Government guarantee fees	Variations were due to adjustments driven mainly by the alignment of dividend forecasts with retention value analysis conducted on the energy corporations, with consistent forecasts being applied across the sector – including forecasts regarding the timing of emission reduction proposals.
Mining royalties	There was a reduction in 2010-11, reflecting the impact of lower than expected volumes due to supply chain constraints at Newcastle and a higher exchange rate reducing Australian dollar values. Increases in the forward estimates period reflect continued strengthening in spot prices, with a slower return to longer term price levels and a weaker than previously forecast exchange rate over the forward estimates period.
Fines	Fines brought in lower revenues, reflecting delays installing safety and red light cameras, and a lower volume of fines per camera due to awareness campaigns.
SICorp revenues	Variations were due to higher premiums from public trading enterprises and expected higher returns on financial assets.
Maintenance of effort adjustments	Variations mainly reflect an increase in hospital charges.

Half-Yearly Review to March 2011 estimates

The following table summarises the revenue variations between the Half-Yearly Review and March 2011 estimates.

Table 2.5.4 Revenue variations in the period from the Half-Yearly Review to March 2011

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
Half-Yearly Review	**56,535**	**60,030**	**62,260**	**64,019**
Transfer duty	240	-80	-217	-223
Payroll tax	-79	-103	-66	-63
Government guarantee fees	-90	-53	-23	-29
Climate Change Fund Levy	4	68	252	279
Speeding fines	-19	-80	-106	-86
Other taxes	24	33	16	24
Mining royalties	-91	-70	40	72
GST	-185	-370	-224	-84
Other Commonwealth grants	148	111	-75	-29
Financial distributions				
– Electricity	9	-269	-440	-276
– Other	26	-1	22	47
Agency revenues	92	-26	-42	-45
Interest revenue				
– Electricity	46	25	25	25
– Other	47	-12	-34	-26
Other changes	24	-56	-16	6
March 2011 estimate	**56,731**	**59,147**	**61,372**	**63,611**
Total variation	196	-883	-888	-408

Explanations

Transfer duty	Revenue in 2010-11 was artificially boosted by payments associated with the electricity transaction. Forward year revenues have been revised down due to expected interest rate increases in 2011-12 and projected reduced transaction volumes.
Payroll tax	Revenue is lower over the projection period due to slower expected growth in aggregate hours worked, despite firm employment growth.
Government guarantee fees	Variations reflect the use of more accurate methodology to assess fees, and changes in credit rating margins.

Climate Change Fund levy	Variations reflect the former Government's decision to continue the Climate Change Fund Levy at $150 million in 2011-12 and $250 million thereafter, to pay costs associated with the Solar Bonus Scheme.
Speed camera fines	Revenues have been revised down due to a slower than expected roll-out of safety cameras and the increased visibility of mobile speed cameras, resulting in lower fines per camera.
Mining royalties	Revenues have been revised down due to export coal volumes being constrained more than expected by supply chain issues at Newcastle.
GST	Revenues have been revised down due to weaker than expected collections for the year to date, with a flow-on effect into future years. Lower than expected Commonwealth Grants Commission relativities following the 2011 Relativities Update Report will further slow the growth in GST revenues.
Financial distributions	Dividends and tax equivalent payments from the electricity sector are lower due to the impact of the electricity transaction. This is offset by lower interest expenses.

Expenses variation

2010-11 Budget to Half-Yearly Review

The following table summarises the expense variation between the 2010-11 Budget and the Half-Yearly Review.

Table 2.5.5 Expense variations in the period from the 2010-11 Budget to the Half-Yearly Review

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
2010-11 Budget	**56,896**	**59,077**	**61,334**	**63,397**
Department of Education				
– Agency expenses	90	105	105	105
– Offset to provisions	-90	-105	-105	-105
Department of Human Services				
– Agency expenses	-	82	218	326
– Offset to provisions	-	-119	-251	-371
NSW Police				
– Agency expenses	111	142	70	45
– Offset to provisions	-57	-45	-45	-45

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
Corrective Services				
– Agency expenses	90	-	-	-
– Offset to provisions	-90	-	-	-
SICorp	-96	134	173	204
Barangaroo Tunnel	33	53	10	-
Bus contracts	55	-	-	-
Rail prepayment	-350	-	-	-
Rail smoothing	-	300	-	-300
Commonwealth funding	10	105	32	68
Natural disasters (RTA)	68	-	-	-
Interest	-36	37	96	128
Treasurer's Advance	-120	-	-	-
Maintenance of effort	-	44	5	182
Other changes in provisions	-376	-56	26	-34
Other	231	101	160	290
Half-Yearly Review	**56,369**	**59,855**	**61,828**	**63,890**
Total variation	-527	778	494	493

Explanations

Department of Education	Expenses were higher, associated with failure to deliver efficiency dividends and wages offsets.
Department of Human Services	Variations reflect the cost of Stronger Together 2 disabilities funding package.
Police	Variations reflect higher D&D Scheme expenses; a shortfall in efficiency and wages offsets; DNA testing backlog costs; and costs associated with a new regulatory model for the security industry.
Corrective Services	Expenses are higher due to a shortfall against Way Forward reforms, efficiency dividends and wage offsets.
SICorp	Higher costs associated with the D&D Scheme are offset by favourable actuarial adjustment in 2010-11.
Bus contracts	Variations reflect increased operating costs for an integrated network plan, costs of additional buses and falling patronage.
Rail prepayment	Variations reflect the decision to bring forward payment to the Transport Construction Authority to 2009-10, to offset a timing change in Commonwealth road grants.

Rail smoothing	Variations are due to changed timing for rail capital grants, as a result of managing budget aggregates.
Commonwealth funding	Variations reflect additional expenses funded by Commonwealth grants (not necessarily in the same year as payments are received).
Natural disasters	Variations mainly reflect payments to local government to compensate for repairs to roads damaged during 2009-10, principally by flooding.
Interest	Higher expenses reflect a worsening in budget position and associated additional borrowings.
Treasurer's Advance	Variation reflects the use of Treasurers Advance to offset unbudgeted expenses.
Maintenance of effort	Figures represent variations between 'approved' changes to agency budgets for continuation of existing policy.
Other changes in provisions	A full review of Budget provisions was undertaken as part of the Half-Yearly Review, resulting in decreased expenses in all years excluding 2012-13.

Half-Yearly Review to March 2011 estimates

The following table summarises the expense variations between the Half-Yearly Review and the March 2011 estimates.

Table 2.5.6 Expense variations for the period from the Half-Yearly Review to March 2011

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
Half-Yearly Review	**56,369**	**59,855**	**61,828**	**63,890**
Solar Bonus Scheme	112	68	252	279
Rail capital grants	0	-885	-300	700
State election costs	-	39	6	6
Transport fare deferral	23	23	0	0
Interest				
– Electricity	-14	-183	-194	-205
– Other [(a)]	-40	-43	60	145
Other changes	-83	70	125	-11
March 2011 estimate	**56,366**	**58,943**	**61,777**	**64,804**
Total variation	-2	-911	-51	914

(a) After adjusting for changes in the timing of rail capital grants

Explanations

Solar Bonus Scheme	This variation reflects additional Climate Change Fund expenses associated with Solar Bonus Scheme payments to distributors.
Rail capital grants	Prepaid rail capital grants have been removed to expose underlying trends.
State election costs	Variations reflect the former Government's decision to change the basis for reimbursing eligible candidates, groups and parties for the cost of election campaigns.
Transport fares deferral	Variations reflect the former Government's decision to defer an increase in transport fares until 2012.
Interest	The reduction in expenses is due to the positive impact of the cash proceeds from the electricity transaction, offset by the cost of additional borrowings associated with worse than forecast budget results. The estimate also reflects the impact of changes to the timing of rail capital grants.

3 TRENDS IN THE STATE CAPITAL PROGRAM

Key points

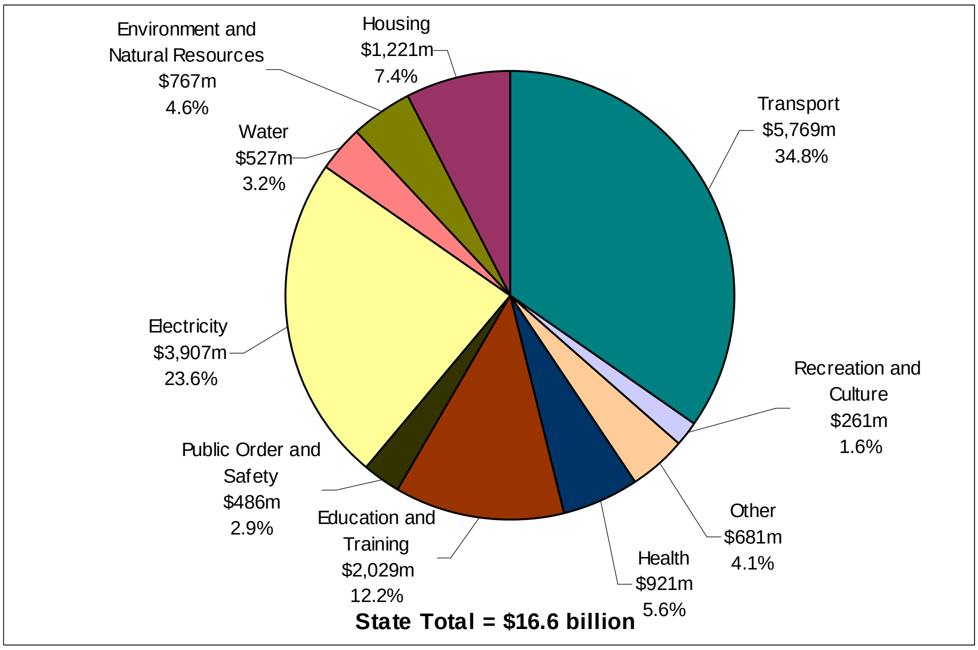
- Over the 10 years to 2010-11, the total state capital program grew at an average rate of 12 per cent per annum and 17.6 per cent per annum between 2005-06 and 2008-09. Over that time, the proportion of the program funded from debt has increased.
- Over the 10 years to 2010-11, the general government capital program's average growth rate was 10.4 per cent per annum. Debt required to fund the program is heavily influenced by net operating surpluses and the size of the program, with both factors contributing to an increase in debt. Debt funding has averaged over $2 billion per annum.
- Over the 10 years to 2010-11, the public trading enterprise (PTE) capital program's average growth rate was 13.5 per cent per annum.
- The key drivers of the capital program are growth in the population and shifts in population between regions; ageing of the population which increases the requirements for hospital care investments; technological change; the renewal requirements of ageing infrastructure; and community expectations concerning the quality of infrastructure.
- There is no evidence of under-spending on infrastructure in NSW, based on total private and public sector expenditure trends and comparing the State with other jurisdictions. However, it has not been possible to undertake an audit of the infrastructure stock.

3.1 State capital program

In 2010-11, the total state sector capital program is estimated at $16.6 billion, which is $277 million or 1.5 per cent greater than 2009-10 actual expenditure.

Capital expenditure in the four largest policy areas of transport, electricity, education and housing will total $12.9 billion or around 78 per cent of the State's estimated capital spending in 2010-11 (see Figure 3.1.1).

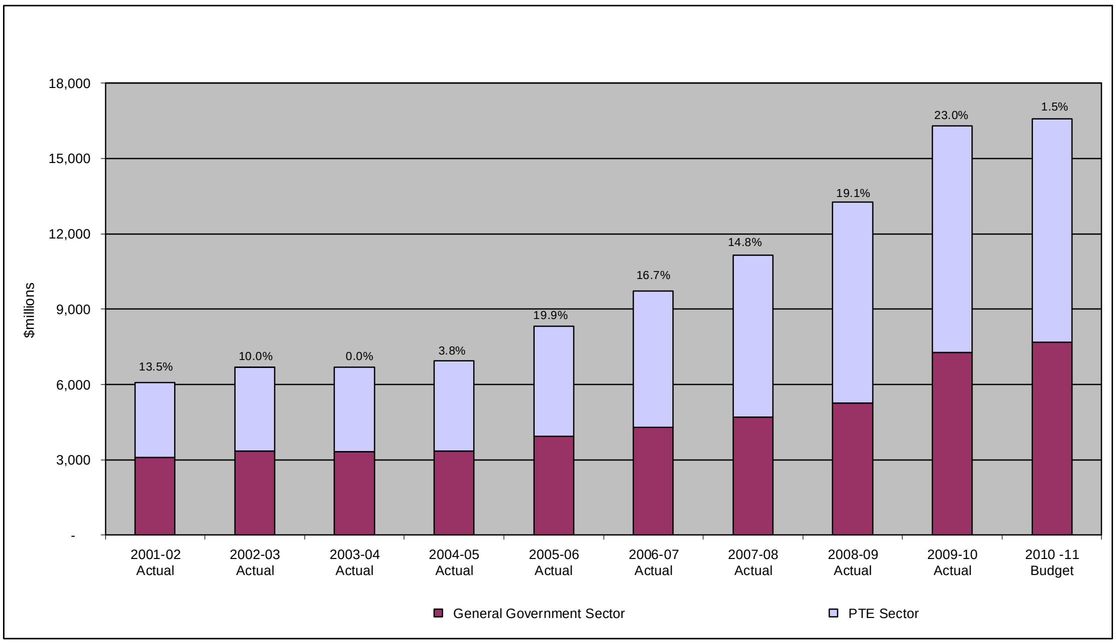
Figure 3.1.1 Total state sector capital investment 2010-11 by policy area*



* The policy areas are based on the Australian Bureau of Statistics' system of Government Finance Statistics (GFS). GFS policy areas do not always align with individual agency capital investment budgets as an agency can provide a range of services that are classified into more than one GFS policy area.

The average growth rate from 2001-02 to 2010-11 for the State's capital investment program was 12 per cent per annum (see Figure 3.1.2). Over that period most policy areas experienced an average annual growth rate above inflation. Growth in the general government sector averaged 10.4 per cent per annum, while growth in the PTE sector averaged 13.5 per cent per annum.

Figure 3.1.2 Trends in the total state capital program



Growth in real terms was broadly maintained over the period 2001-02 to 2004-05, with average growth of 6.7 per cent per annum. However, from 2005-06 to 2008-09, the average annual growth rate was 17.6 per cent per annum, reflecting major increases in spending in the education, health, social security and welfare, electricity and transport and communication policy areas.

Capital spending in 2009-10 was $3 billion or 23 per cent greater than 2008-09. The major increase in the 2009-10 program reflected increased spending of $3.1 billion funded from the Australian Government's economic stimulus and nation building packages.

Over the past decade, the largest increases occurred in the following policy areas.

- **Education** (average growth rate of 21 per cent per annum). In the period to 2008-09, the average annual increase was 11 per cent which was broadly in line with the total capital investment program growth trend. Between 2008-09 and 2009-10, spending on the education policy area grew by 289 per cent. The major component of this large increase was funding of $1.8 billion provided by the Australian Government for education and training under the economic stimulus package.

- **Fuel and energy** (average growth rate of 15 per cent per annum). There is no consistent trend in growth in this policy sector, with movements in capital expenditure reflecting spending on distribution systems, transmission networks and upgrades of existing generation capacity. There has been a particular focus on the upgrading of capacity, reliability and output of assets.

  Major increases in electricity spending occurred between 2005-06 and 2008-09, with average annual growth of 26 per cent. The increase in expenditure reflects major upgrades to transmission lines, new or upgraded electricity zone substations and upgrades to power stations.

- **Transport and communication** (average growth rate of 13 per cent per annum). A substantial increase in the program between 2001-02 and 2002-03 of 30 per cent reflected expenditure on the Parramatta Rail Link and additional funding over four years from 2001 in response to the findings of the Special Commission of Inquiry into the Glenbrook Rail accident.

  Sustained increases averaging 17 per cent per annum have occurred since 2004-05. Spending on roads and rail increased by 15 per cent per annum and 17 per cent per annum respectively, over the period. The additional roads spending reflected major network upgrades including orbital roads projects, the upgrade of Old Windsor Road and Windsor Road and major highway and freeway upgrades. Major rail spending was directed toward the Epping to Chatswood Rail project, the Rail Clearways program, the South West Rail link and major investments in rolling stock and station upgrades.

- **Housing and community amenities** (average annual growth rate of 10 per cent per annum). The major growth in spending in this policy was over the period 2006-07 to 2009-10 which saw average annual growth of 18 per cent. The major driver of additional expenditure over that period was expenditure associated with the 2006 Metropolitan Water Plan and the construction of the Desalination Plant.

The growth in the 2010-11 capital program is estimated to be a modest 1.5 per cent. While NSW's spending on the Commonwealth Government's Nation Building – Economic Stimulus Plan is trending downwards, the program also provides for the Metropolitan Transport Plan. This is a 10-year $50.5 billion plan, announced in February 2010 that includes a package of transport infrastructure for Sydney, the Illawarra and Newcastle.

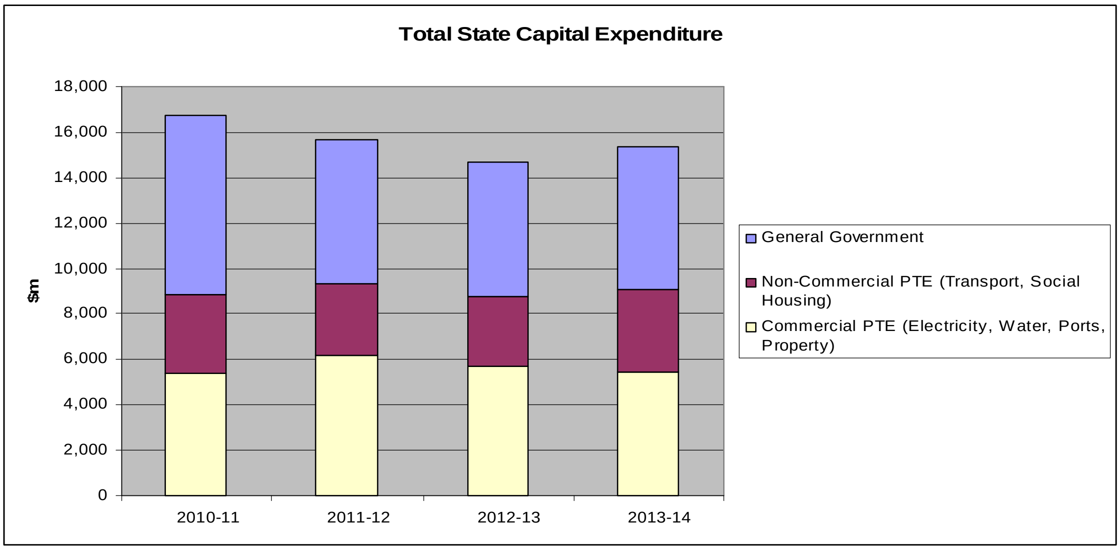
In 2001-02, general government spending was 49 per cent of the capital program, with the PTE sector accounting for the remaining 51 per cent (see Figure 3.1.2). Spending by the PTE sector gradually increased to 60.3 per cent of the total state sector capital program in 2008-09. The movement was driven by large spending increases, mostly in the policy areas of housing and community amenity, fuel and energy and transport and communication.

PTE sector spending fell as a proportion of total state sector spending to 55.4 per cent in 2009-10, falling again to 53.7 per cent in 2010-11. The change in proportions between the sectors is largely due to:

- increased spending by the general government sector, mostly on education, road and health projects
- reduced expenditure in the PTE sector, largely due to the completion of significant projects in the housing, water and electricity businesses.

Figure 3.1.3 outlines total state capital expenditure over the period 2010-11 to 2013-14. Over that period, the total state capital program is expected to total $62.5 billion, which is $12.2 billion or 24 per cent above the investment of $50.3 billion in the previous four years to 2009-10. The increase comprises an additional $5 billion in the general government sector and an additional $7.2 billion in the PTE sector.

Figure 3.1.3 Total state capital expenditure 2010-11 to 2013-14



The main drivers of total state sector capital expenditure over the period to 2013-14 are:

- a $22.9 billion transport program, including funding for the North West Rail Link and significant highway upgrades
- $17.5 billion for electricity networks to ensure a reliable electricity supply that meets growing demand in NSW. Spending will mostly be on distribution systems and the transmission network
- $4.7 billion for water and sewerage, in particular works to service urban development and recycled water projects
- $3.6 billion for education including the Building the Education Revolution program
- $3.3 billion for health and major hospital redevelopments and upgrades
- $2.7 billion for housing, mostly on new social housing dwellings under the Commonwealth Government's Nation Building – Economic Stimulus Plan.

The State's capital program to 2013-14 will be partly funded by projected operating surpluses of $30.7 billion and an increase in net debt of $24.4 billion.

The State's capital program is ultimately funded by either taxes or user charges. In 2001-02, the program was funded entirely from sources other than debt. At that time, there were sufficient funds from other sources, most notably net operating surpluses, to fund the program. The influence of the global financial crisis was most keenly felt during 2009 and 2010 when reduced revenues and operating margins required increased debt to fund the program.

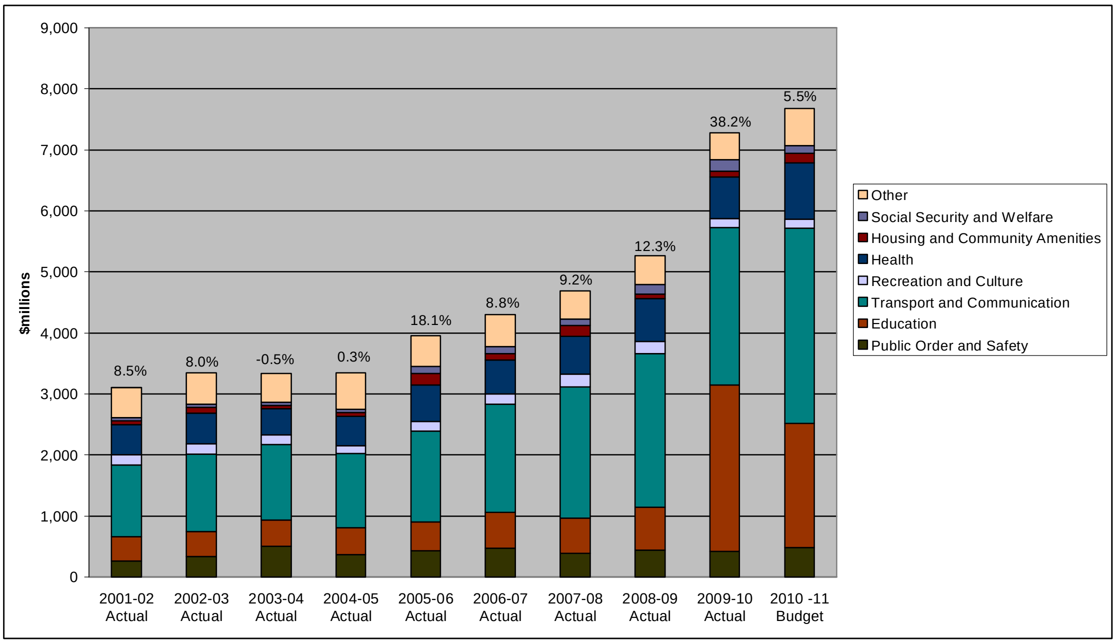
By 2010-11, around 41.6 per cent of the total state sector program was funded from debt. The proportion of the program funded from debt has broadly increased since 2006-07, with the major increases being in the PTE sector. The increase since 2006-07 is consistent with the significant increases in the commercial PTE sector program, particularly in the water and electricity sectors.

General government sector capital program

Between 2001-02 and 2010-11, the average annual growth rate for the general government capital program was 10.4 per cent.

As shown in Figure 3.1.4, there were relatively consistent annual increases between 2004-05 and 2008-09, leading to a large increase of 38.2 per cent in 2009-10 followed by a smaller increase of 5.5 per cent in 2010-11. The variations across these two years are largely accounted for by the gearing up in 2009-10 and winding back in 2010-11 of funding provided to NSW under the Commonwealth Government's Economic Stimulus Plan.

Figure 3.1.4 General government capital program by policy area 2001-02 to 2010-11



The most substantial annual increases occurred after 2004-05, with average annual growth being 14.9 per cent. This reflects major spending increases in the education, health and transport and communication policy areas, as follows:

§ **Education** (average growth rate of 29 per cent per annum since 2004-05). The major component of the substantial increase is funding of $1.8 billion provided by the Commonwealth Government for education and training under the economic stimulus package. Spending in this policy area is driven by population growth in Sydney and regional areas, the movement of families within regional areas and the changing total number of students. The investment in education infrastructure provides for new schools and TAFE institutes, the upgrade of existing facilities and the expansion of new technologies into the learning environment.

- **Health** (average growth rate of 12 per cent per annum since 2004-05). Growth over this period reflects major spending to upgrade existing hospitals and construct new hospitals as well as major investments in patient and clinical information systems. A key driver of spending in this policy area is an ageing and growing population and the availability of new technologies. This generates increasing demand for funding for new infrastructure, facilities, information systems and health and medical technologies.
- **Transport and communication** (average increase of 18 per cent per annum since 2004-05). Over this period there has been significant enhancement of the roads budget, particularly driven by growth in the economy and population in outer urban and regional areas, the need to reinforce the capacity of the core established network and the need to increase capacity on major highways. Major projects that have responded to the drivers include the Western Sydney Orbital, highway upgrades and the widening of major arterial roads.
- **Housing and community amenities** (average increase of 13 per cent per annum since 2004-05). Expenditure in this policy area is directed toward reducing the concentration of social disadvantage in public housing estates, providing increased housing for Indigenous Australians and more appropriate social housing for older people. The growth in expenditure is mostly driven by the need to accommodate increasing numbers of people with complex health needs and disabilities and an investment in social housing provided under the Commonwealth Government's Economic Stimulus Plan.

  Demographic changes also influence spending in this policy area, including the increased proportion of smaller households, the ageing population and population shift to the metropolitan and coastal areas of the State.

In the four years to 2013-14, general government sector capital expenditure is expected to total $26.5 billion. This is an increase of $607 million or 2.3 per cent over the 2010-11 Budget estimate.

The main components of the program to 2013-14 are:

- major spending on highways, most notably the Pacific Highway, the Hunter Expressway and the Great Western Highway
- education funding for the Building the Education Revolution program
- the redevelopment of Liverpool, Orange/Bloomfield and Royal North Shore Hospitals and the upgrade of Nepean Hospital.

Over the period 2001-02 to 2010-11, there are no consistent trends in the funding of the general government capital program. The funding profile is highly dependent on the net operating balance. Broadly, the net operating balance varies in line with:

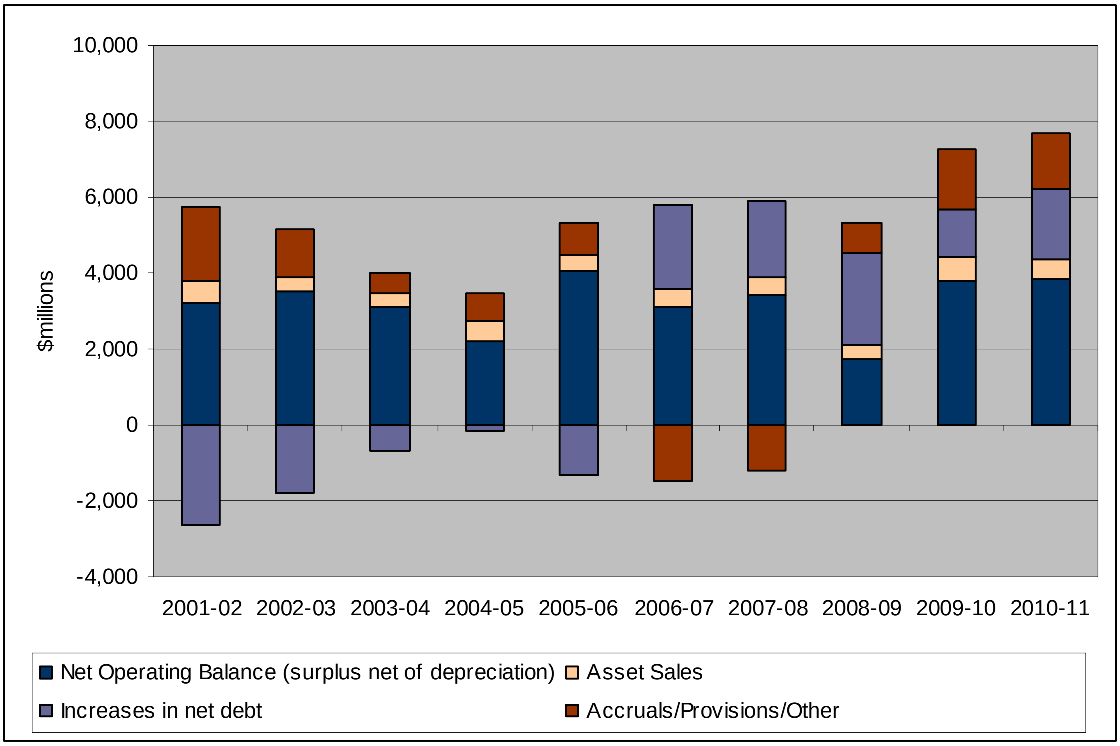
- variations in the economy that impact revenues, such as payroll tax and transfer duty
- COAG reforms to state/federal financial relations

§ the global financial crisis which negatively impacted state taxes and GST revenues, particularly in 2008-09

§ spending initiatives.

This necessarily means that the debt-funded component of the program is affected by both variations in the net operating balance and increases in the size of the program. Further, as the capital program began to trend upward after 2004-05, so did net debt. The one exception is 2005-06, where the impact on net debt was mitigated by a large net operating balance that resulted from revenue significantly exceeding budget.

Figure 3.1.5 Trends in general government capital program funding 2001-02 to 2010-11



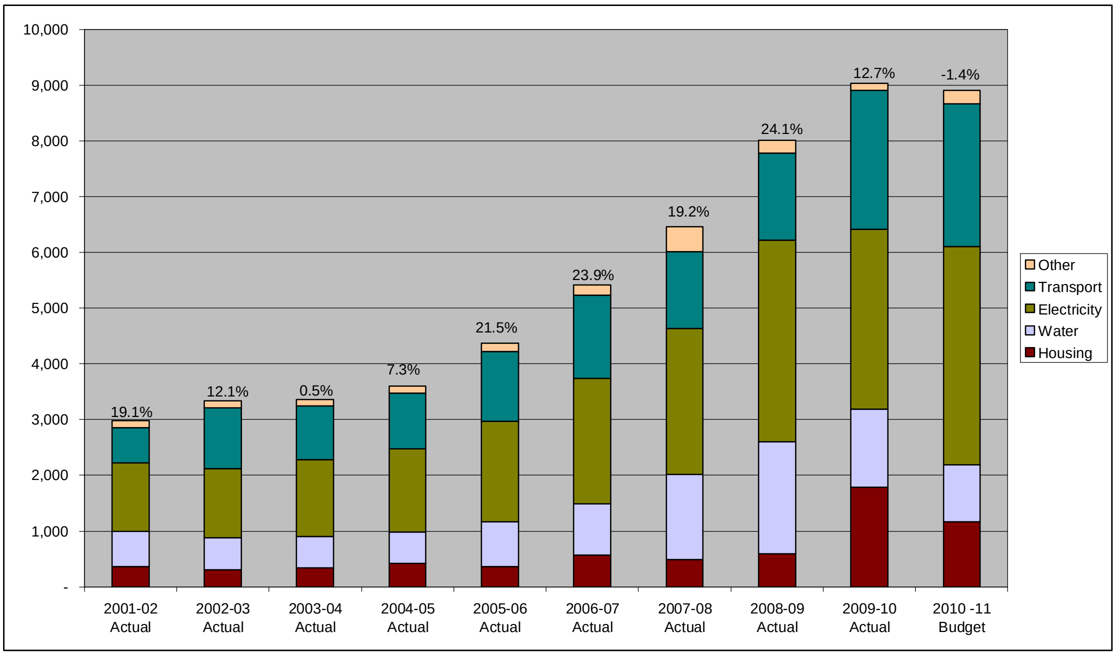
The main source of funds is the operating surplus, which in 2001-02 was sufficient to fund the entire general government sector capital program and contribute to a reduction in net debt. The trend of operating surpluses fully funding the capital program reversed in 2006-07, when debt was increased to fund the program, primarily because the operating surplus declined by 23.5 per cent compared to the previous year. The main reason for the large decrease in the operating surplus between 2005-06 and 2006-07 was increased expenditure particularly in the transport, health and social security and welfare policy areas.

Since 2006-07, debt funding of the general government sector capital program has averaged $2.2 billion per annum. The debt-funded portion is projected to decline to $1.9 billion in 2010-11, driven by a higher operating surplus, mainly due to the positive impact of the Commonwealth Government's Economic Stimulus Plan.

Public trading enterprise capital program

The average annual growth rate in the PTE capital program over the decade from 2001-02 to 2010-11 was 13.5 per cent, with the largest increase being between 2007-08 and 2008-09.

Figure 3.1.6 PTE sector capital program by policy area 2001-02 to 2010-11



Investment in the PTE sector tends to be in large projects, such as the Sydney Desalination Plant and major capacity improvements to Sydney's rail system. The fluctuating nature of these investments is reflected in the strong growth between 2005-06 and 2009-10. The average annual increase in the capital program over that period was 16.3 per cent. This largely reflects major investment in infrastructure, particularly in the following policy areas.

- **Water** (average growth rate of 10 per cent per annum). The construction of the $1.8 billion Sydney Desalination Project, which provides water security for the Sydney region. The main drivers of spending in this policy area include new water infrastructure to service a growing population, renewal of existing water supply and expenditure to meet modern-day dam safety standards.
- **Fuel and energy** (average growth rate of 15 per cent per annum). Increased spending in this area reflects expenditure on electricity distribution and transmission networks and power stations. The major drivers of expenditure are the growth in customer numbers, increasing summer peak demand, the need for increased capacity and replacement or refurbishment of ageing assets.
- **Transport and communication** (average growth rate of 17 per cent per annum, predominantly in the rail sector). There has been major spending on rolling stock acquisition, projects that increase the capacity of the rail network and enhancements to power supplies, signalling and safety upgrades. Projects that increased capacity include the Cronulla branch rail line duplication and the

Chatswood to Epping Rail Line. The overall demand for transport is driven by growth in the economy and population.

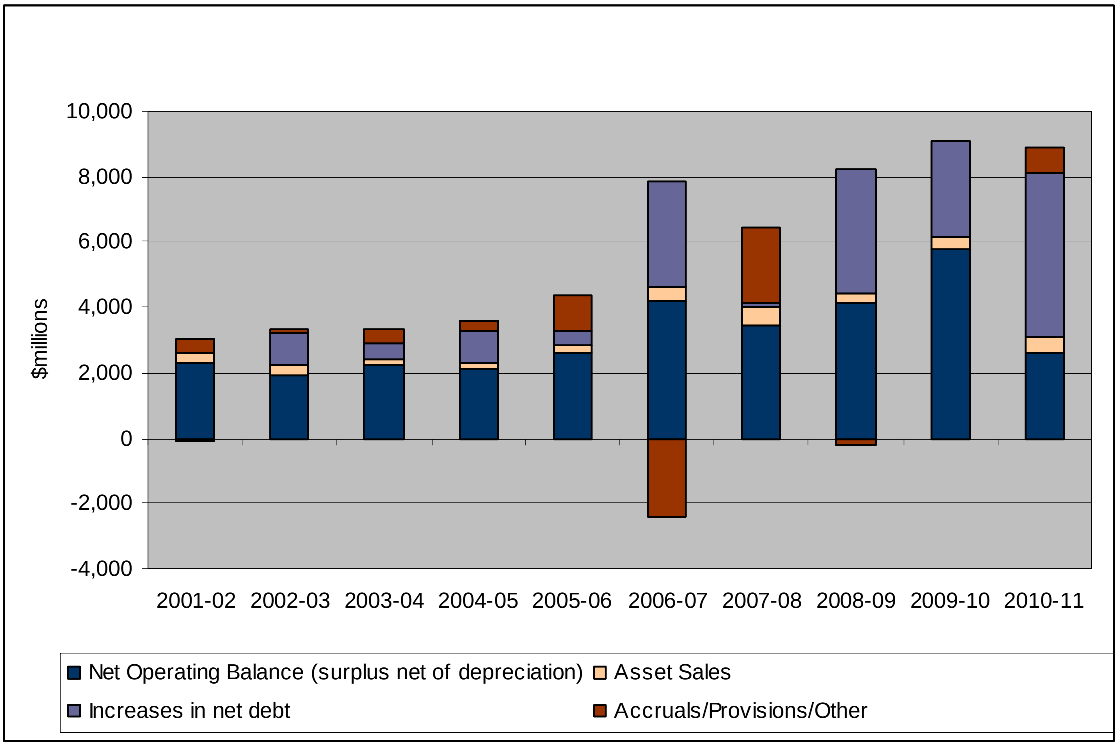
In 2010-11, the PTE capital program is $130 million less than in 2009-10. This is not unexpected given the substantial capital program over the preceding five years and the winding down of the Nation Building – Economic Stimulus Plan funding for social housing. Over the longer term, PTE capital expenditure will return to trend growth levels.

In the four years to 2013-14, capital expenditure in the public trading enterprise sector is expected to total $36 billion. This is $361 million less than the estimate published in the 2010-11 Budget. The main components of the program are:

- spending on major rail projects as part of the 10-year Metropolitan Transport Plan (as announced in August 2010) and further work on the South West Rail Link consistent with announced project delivery in 2016
- energy sector spending on distribution systems, transmission networks and upgrades of existing generation capacity
- spending by water agencies, particularly on growth works to service urban development and works that provide a secure and sustainable water supply.

Similar to the general government sector capital program, the PTE sector program is mostly funded from net operating balances and increases in net debt. The net operating balance shows moderate volatility between 2001-02 and 2010-11. Over the years 2001-02 to 2004-05, the net operating balance averaged $2.2 billion. There was a sharp increase in 2005-06 to $4.2 billion and a further significant increase again in 2009-10 to $4.8 billion. In 2010-11, the net operating balance fell to $2.6 billion.

Figure 3.1.7 Trends in PTE sector capital program funding 2001-02 to 2010-11



In 2001-02, the operating balance was sufficient to fund the capital program and contribute to a reduction in debt. Since that time there have been increases in debt to fund the PTE capital program. The average annual growth in net debt between 2002-03 and 2010-11 was 23 per cent.

3.2 Drivers of capital demand

The NSW capital program essentially provides the enabling infrastructure that allows the Government to deliver goods and services and grow the economy. As outlined in this section, there are a range of factors that drive the need for capital projects in NSW.

Population growth and distribution

The NSW population is projected to grow from about 7 million in 2008 to 7.6 million in 2018. Sydney (including the Central Coast) is expected to account for 70 per cent of this growth; North Coast, 10 per cent; Hunter, 8 per cent; Illawarra, 6 per cent; South East, 4 per cent; and inland areas, 2 per cent.

Over the five years from 2001 to 2006, the population of the North Coast region increased by over 6 per cent, making it the fastest growing region in NSW during that period. Total growth over the 10 years to 2018 is expected to be 10.5 per cent.

The Central Coast is estimated to grow by around 12 per cent between 2008 and 2018, the largest increase of the State Capital Strategy regions.

Sydney's Greater Metropolitan Region (GMR) encompasses only 2.2 per cent of the total NSW landmass but has 75 per cent of its population. Further, population growth in the Sydney GMR, which has remained reasonably steady since 1981, will place further pressure on existing urban areas. Growth rates in the coastal regions outside the Sydney GMR have declined, although they are still the fastest growing populations in NSW. Population growth in inland NSW has remained low. While some inland regions (Murrumbidgee, Murray and the Central West) are expected to experience modest population growth to 2036, others (Northern and North-Western regions) are expected to experience population decline.

The growing spread of the population is fuelling greater capital demand in coastal and new urban areas, in particular for expanded transport, health, education and police services.

Ageing and longevity

NSW continues to experience a fundamental change in its demographic structure, with increasing life expectancy and declining birth rates. The ageing population is placing growing demands on infrastructure such as hospitals and community services. Health spending on those over 65 years of age is around four times higher than spending on those under 65.

According to the 2006 Census, about 906,000 people in NSW were aged 65 years and older, representing 13.8 per cent of the State’s population. It is estimated the number of people aged 65 years and older will increase to 1.3 million in 2018, representing 17.4 per cent of the State’s population.

Capital expenditure will be required to accommodate the changing structural dimensions of the population. Health, social housing and transport services will experience increasing demand as the population ages, while other areas such as schools and prisons will experience reduced demand.

Technological change

Technological developments are changing the ways in which services are delivered by the Government. The effect is particularly evident in the health, education and justice sectors, where new technology improves service delivery while concurrently driving demand for more capital expenditure.

In education, the State's Connected Classrooms Program connects two or more schools through videoconferencing equipment and shared interactive whiteboards. Real-time interaction empowers students to engage in discussion and active learning.

Advances in medical diagnostic and treatment technologies continue to place growing demands on health capital expenditure. These new technologies allow for greater home and community care, particularly in cancer-related illnesses.

Industrial and commercial developments

Capital expenditure on ports, rail and roads is supporting economic growth and greater trade volumes. Providing efficient transport networks and intermodal links is crucial to industrial growth and development. For example, expansion of the coal sector in the

Hunter Valley and Gunnedah Basin will require expanded capital and logistical support. Over $35 million of works have commenced at the Port of Newcastle.

Container trade through Port Botany has been increasing at an average of 10 per cent per annum over the past five years and future average growth is projected to be 5.7 per cent per annum. In response, the Government, with the private sector, is spending $1 billion on expanding Port Botany.

The Government is also developing an intermodal logistics facility at Enfield to encourage the movement of more containers on rail and to improve the distribution of goods throughout the Sydney metropolitan area.

There are also shifts occurring toward knowledge-based activities. This includes industries such as pharmaceuticals, information and communications technology and advanced manufacturing. Many of these activities are located in business parks, away from older industrial areas, and require new supporting capital.

The Government continues to seek to ensure that there is adequate supply of appropriate, well-serviced and well-located land zoned for industrial and commercial use. In 2007, an action plan was released for Sydney's employment lands, catering for at least 125,000 jobs over 25 years. An example is the 929-hectare Western Sydney Employment Hub at the intersection of the M4 and M7 Motorways, which provides for around 36,000 jobs.

Capital renewal

Significant capital renewal requirements will continue over the next decade.

Renewal demands are particularly evident in public transport, electricity transmission and distribution, public housing, water and sewerage, and major roads and bridges in country areas. New building and safety standards and increasing demand are placing further pressures on the renewal costs of public housing.

The Government has set priorities for renewal and revitalisation of capital in strategic locations such as the Greater Homebush precinct, South Sydney and the Newcastle waterfront. Extensive renewal of transport capital is also occurring. Older buses and rail cars are being refurbished or replaced with modern, air-conditioned buses and rail cars.

Environmental issues

Capital planning over the next decade and beyond will be affected by the development of abatement policies to minimise greenhouse gas emissions and by adaptation of measures to address the possible impacts of climate change.

The Commonwealth Government has committed to introducing a carbon price mechanism as early as 1 July 2012 and proposes to present the necessary legislation to Parliament in 2011.

The impacts of climate change will vary by location and policy responses will need to vary with them. Climate change adaptation should be approached from a risk management perspective. Treasury has added a section to the Economic Appraisal

Guidelines to provide guidance to agencies on appropriate decision-making frameworks to consider and respond to these risks. Efforts should be targeted to being ready to respond to impacts as they become clearer, rather than undertaking potentially expensive and unnecessary or counterproductive action in the short term.

Cost pressures

The Australian economy is performing close to full capacity, with record levels of output and near full employment. Demand from developing nations such as China and India for NSW's mineral and energy products is at record levels. The consequences of economic success include increased costs for skilled labour and raw materials. This has led to increases in the cost of construction outpacing the consumer price index (CPI). Industry analysts expect construction costs to increase at faster rates than CPI over the medium term.

In Sydney, continued urban development and increased densities have led to greater complexities and costs in delivering new infrastructure. For example, new transport infrastructure requires higher standards of noise mitigation and increased use of tunnelling. While saving on land acquisition, tunnelling is a significantly higher cost construction method.

In response to escalating construction costs, the government has developed clearer planning strategies, clearer project definition and increased coordination in order to achieve 'value for money' outcomes. Despite the proactive approach, major construction capital in the coming decade is likely to cost more, in real terms, than it did in the past.

These demand drivers affect major policy areas in different ways, leading to the introduction of area-specific policy initiatives and projects. Across the total state sector capital program, population growth and distribution is the dominant demand driver.

Policy areas with significant demand drivers include:

- **Transport**. The Metropolitan Transport Plan has been developed to address growth in the population, particularly in outer urban and regional areas, and links land-use planning and the transport network. This major 10-year plan was announced in February 2010. It sets the strategic outlook for transport and incorporates a 10-year package of transport infrastructure for Sydney, the Illawarra and Newcastle. The plan focuses on increasing capacity and improving both reliability and safety. The plan is subject to a major review by the incoming Government.
- **Electricity networks**. Increased investment in electricity distribution networks is being undertaken to accommodate growth in demand, the need for replacement or refurbishment and the need to accommodate even faster increases in peak demand. The growth in demand results from:
  - a growth in customer numbers that requires new infrastructure particularly in north-west and south-west Sydney and the north coast of NSW

- Ø increasing summer peak demand, largely arising from the improved affordability of residential air conditioning.

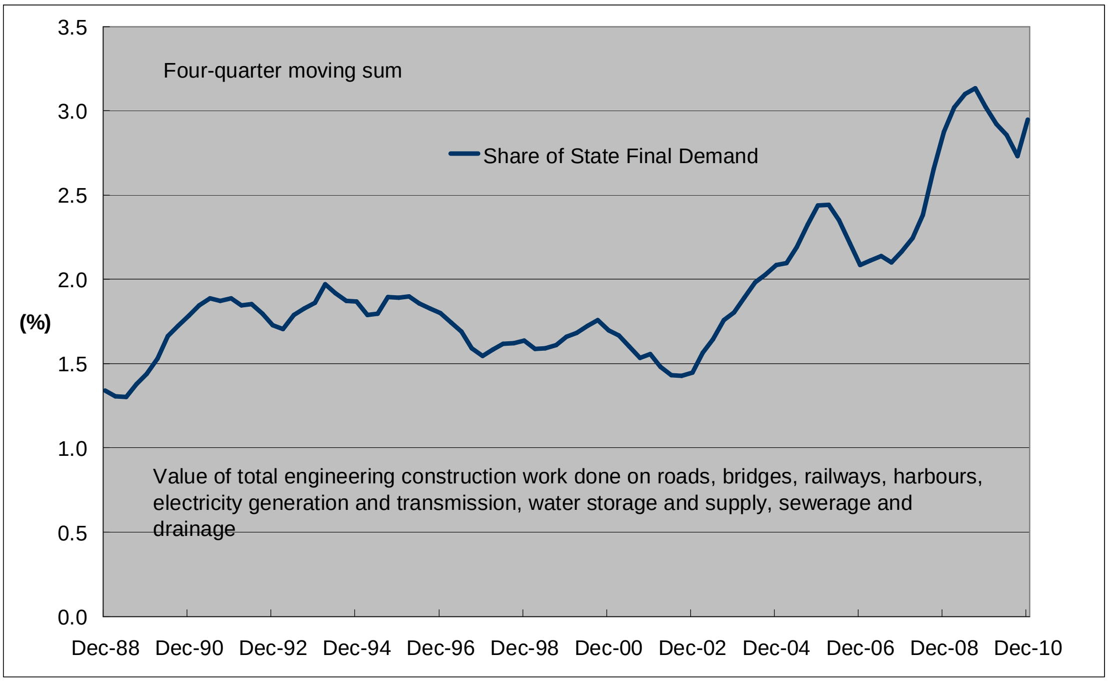
- § **Education**. Investment in education capital expenditure is driven by the ongoing growth of the population in Sydney and NSW and the movement of families within residential areas. Government policy that sets maximum class sizes also drives the level of capital required. Looking forward, student numbers are forecast to increase gradually in the medium to longer term. New schools will need to be provided, while existing schools may need to expand or scale down. School investment is also driven by the Government's commitment that education is accessible to all students, with facilities suitable for educating and supporting students with a range of special needs and geographic, economic, social or cultural disadvantage. A commitment to expand new technologies into school classrooms and into TAFE institutes also drives capital investment.
- § **Housing**. Social housing investment is influenced by policy initiatives to accommodate increasing numbers of people with complex health needs and disabilities. Demographic changes are also important, including the increased proportion of smaller households, the ageing population and population shifts to the metropolitan and coastal areas of the State.
- § **Health**. In the health sector, pressure from an ageing and growing population, rising community expectations and availability of new health technologies generates increasing demand for funding for new infrastructure, facilities, information systems and health and medical technologies.
- § **Justice**. Increasing demand for correctional accommodation is largely driven by growing numbers of inmates in both adult and juvenile facilities, which is influenced by Government policies regarding, for example, the number of police, sentencing and remand laws. Appropriate accommodation is also required to deliver assessment, monitoring, intervention and rehabilitation programs for offenders in the community. The services provided by criminal justice agencies are often interdependent. The key results and capital needs of one agency can be influenced by the performance of other agencies as a person moves through the criminal justice system.

3.3 Adequacy of infrastructure expenditure

There has not been the opportunity or time to undertake an assessment of the adequacy of the State's infrastructure and to assess whether there is a gap that needs to be addressed. It is recommended that such an audit be undertaken by Infrastructure NSW (INSW).

While not an adequate substitute for a complete audit, it is possible to assess whether there has been underspending on infrastructure in NSW by looking at engineering and construction activity trends in categories relevant to infrastructure, as derived from ABS information. This approach enables the inclusion of both public (state and Commonwealth) and private sector infrastructure expenditure. However, the key limitation is that it considers the flow of infrastructure expenditure, not the stock.

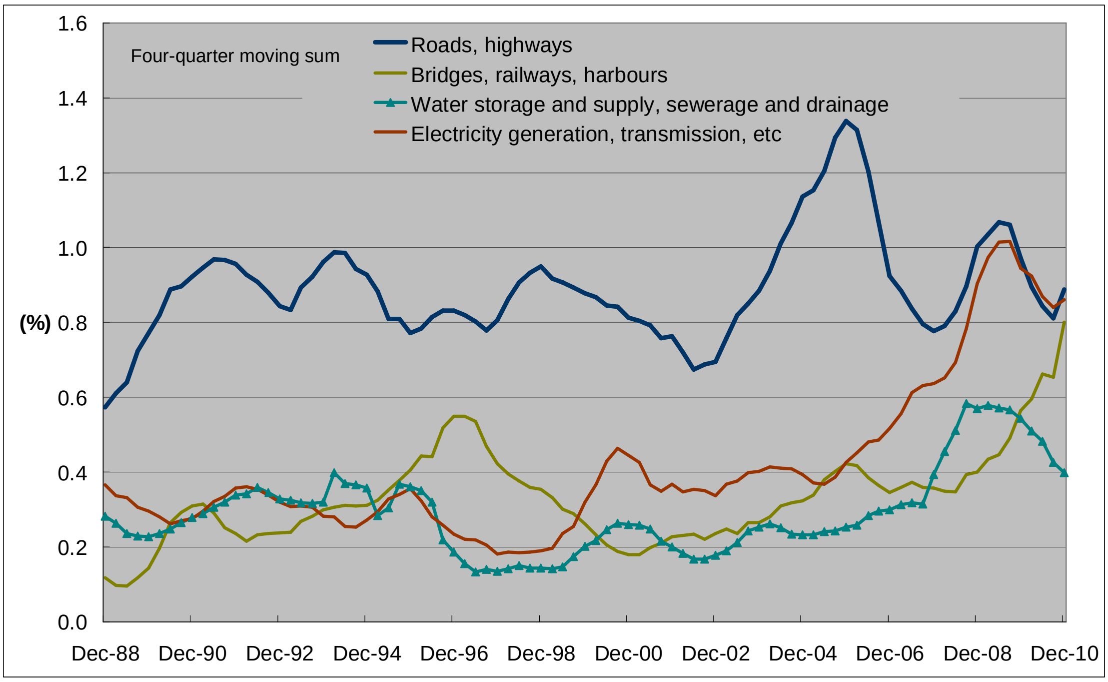
Figure 3.3.1 Infrastructure expenditure as a percentage of state final demand



Source: ABS 8620.0 Engineering Construction Activity, and ABS 5206.0 Australian National Accounts.

As can be seen from Figure 3.3.1, total infrastructure spending in NSW as a share of state final demand varied between 1.5 per cent and 2 per cent for most of the 1990s and the 2000s before rising above 2 per cent from 2005 (though with a dip from 1997 to 2002). The dip appears to be explained by an initial slowing in investment in capital expenditure on water storage and supply, and electricity generation and transmission, followed by a slowing in investment in bridges and railways and then in investment roads and highways. This is shown in Figure 3.3.2 below.

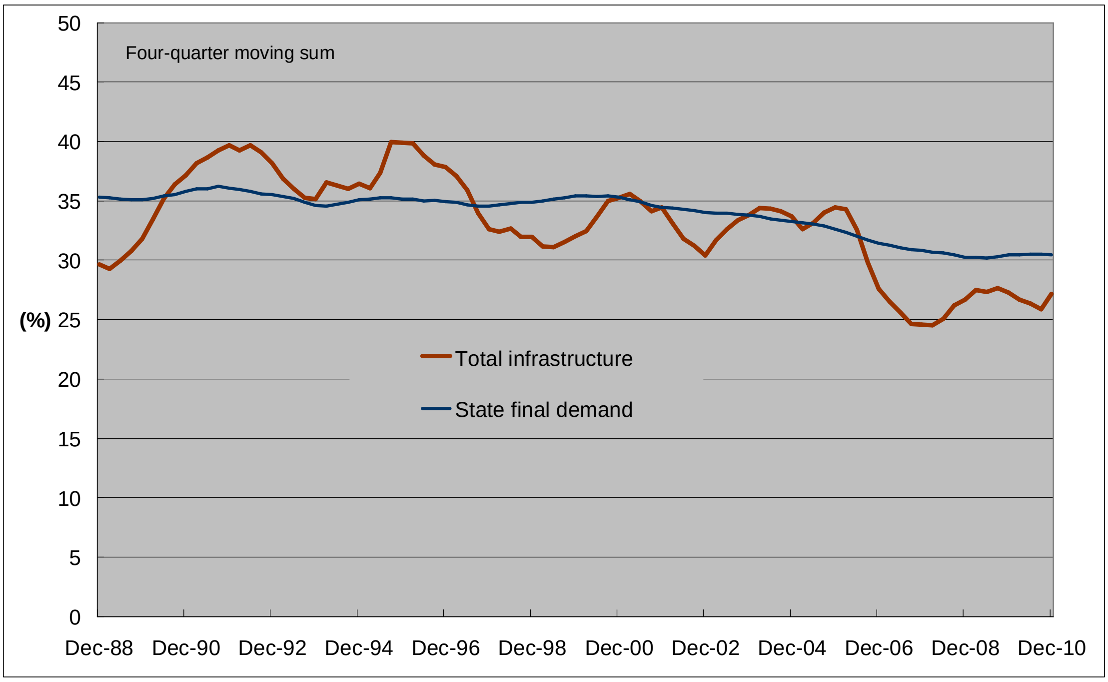
Figure 3.3.2 Trends by category of infrastructure expenditure as a percentage of state final demand



Source: ABS 8620.0 Engineering Construction Activity, and ABS 5206.0 Australian National Accounts.

It is also useful to consider NSW's share of national infrastructure expenditure, which is shown below in Figure 3.3.3. For the period up to 2006 NSW's share of national infrastructure expenditure was broadly in line with NSW's share of national domestic demand, apart from a brief dip in about 1997.

Figure 3.3.3 NSW share of national infrastructure expenditure and domestic final demand



Source: ABS 8620.0 Engineering Construction Activity, and ABS 5206.0 Australian National Accounts.

From 2006 onwards, NSW's share of national infrastructure has fallen significantly. This reflects the very large increase in infrastructure expenditure associated with the resources boom as well as a surge in infrastructure expenditure in Queensland. A significant part of the more recent fall in the NSW share was in water infrastructure which appears to reflect the relative lumpiness in major water projects around the nation.

4 THE STATE BALANCE SHEET

Key points

- The State's net financial liabilities have risen from $50.7 billion (13.8 per cent of gross state product, GSP) at June 2006 to $86.3 billion (20.8 per cent of GSP) as projected at June 2011.
- State net debt has risen from $9.8 billion (2.7 per cent of GSP) at June 2006 to $35.7 billion (8.6 per cent of GSP) as projected at June 2011.
- Recent business transactions involving lotteries, waste services and the electricity sector reduced total state net debt and net financial liabilities by over $5 billion.
- General government sector net financial liabilities have risen from $27.5 billion (7.5 per cent of GSP) at June 2006 to $48.7 billion (11.7 per cent of GSP) as projected at June 2011.
- General government sector net debt has risen from -$3.8 billion (-1.0 per cent of GSP) at June 2006 to $9.2 billion (2.2 per cent of GSP) as projected at June 2011.
- A major driver explaining the increases in net debt and net financial liabilities is the large capital program in both the general government and non-financial corporations sectors.
- The major balance sheet issues to address are the impacts of the proposed carbon tax on the value of State owned generators; putting in place appropriate mechanisms to address any issues that flow out of the Reliance Rail contract; obtaining Commonwealth funding for university superannuation liabilities; the treatment of the public housing assets; and the appropriate method for valuing superannuation liabilities.

4.1 Non-financial total state sector balance sheet

Structure of the non-financial total state balance sheet

In broad terms, the non-financial total state balance sheet identifies and values the sector's assets and liabilities, and hence its net worth. The balance sheet excludes the public financial corporations sector (predominantly NSW Treasury Corporation) to ensure consistency with the approach taken by rating agencies such as Standard and Poor's.

Assets are classified as either financial or non-financial.

Financial assets include both cash (investments, receivables and advances paid, which are projected to total $25.1 billion at June 2011) and equity investments (projected to total $0.2 billion at June 2011).

Non-financial assets are the physical assets of the sector such as public schools, hospitals, police stations and roads and are projected to total $250.0 billion at June 2011.

Liabilities reflect the financial obligations of the total state sector. They comprise borrowings, advances received, payables, unfunded superannuation and other employee provisions, insurance obligations and other liabilities (projected to total $112.7 billion at June 2011).

Net worth is total assets less total liabilities and is projected to be $162.6 billion at June 2011.

The key balance sheet measures of financial strength or weakness are net debt and net financial liabilities.

Net debt comprises borrowings, advances received and deposits held, less cash and cash equivalent assets, financial assets and advances paid (loans for policy purposes, such as housing, transport or rural assistance). Prior to the introduction of full accrual accounting, the level of net debt was the most widely used indicator of the strength of state finances. Net debt is projected to be $35.7 billion at June 2011.

Net financial liabilities comprise net debt, unfunded superannuation and other employee provisions, insurance obligations and other liabilities, net of receivables and other financial assets. Credit rating agencies and other financial analysts increasingly focus on net financial liabilities as a comprehensive measure of the State's financial position. Net financial liabilities are projected to be $86.3 billion at June 2011.

The State's non-financial sector balance sheet for 2009-10 and 2010-11 is shown in Table 4.1.1.

Table 4.1.1 Non-financial state sector balance sheet

	2009-10 $m	2010-11 $m
ASSETS		
Financial assets		
Cash and cash equivalent assets	5,670	9,545
Receivables	6,660	6,106
Financial assets at fair value	7,407	9,001
Advances paid	438	486
Deferred tax equivalents	0	0
Equity		
Investments in other public sector entities	-1,005	-1,031
Investments in associates	1,240	1,187
Other	0	0
Total financial assets	**20,410**	**25,294**
Non-financial assets		
Inventories	1,367	1,445
Forestry stock and other biological assets	669	669
Assets classified as held for sale	258	221
Investment properties	1,007	1,006
Property, plant and equipment		
Land and buildings	104,440	108,460
Plant and equipment	12,110	12,640
Infrastructure systems	118,283	121,127
Intangibles	2,619	2,901
Other	1,475	1,534
Total non-financial assets	**242,226**	**250,004**
TOTAL ASSETS	**262,637**	**275,298**
LIABILITIES		
Deposits held	199	1,504
Payables	7,078	6,114
Liabilities directly associated with assets held for sale	0	0
Borrowings and derivatives at fair value	265	114
Borrowings at amortised cost	45,242	52,252
Advances received	807	812
Employee provisions	12,961	13,125
Superannuation provision	34,535	29,113
Deferred tax equivalent provision	-74	-150
Other provisions	6,232	6,146
Other	3,760	3,621
Total liabilities	**111,005**	**112,652**
NET ASSETS	**151,632**	**162,646**
NET WORTH		
Accumulated funds	63,150	70,517
Reserves	88,481	92,128
TOTAL NET WORTH	**151,632**	**162,646**
Net debt	**32,998**	**35,650**
Net financial liabilities	**89,590**	**86,327**

Trends in non-financial total state sector balance sheet

An analysis of the level and movements in the three key balance sheet measures since June 2006 has been undertaken, as summarised in Table 4.1.2.

Table 4.1.2 Non-financial state sector balance sheet – key measures

	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011	5 Yr Change
Net debt							
- $billion	9.8	20.6	22.6	28.9	33.0	35.7	+25.8
- % GSP	2.7%	5.4%	5.8%	7.3%	8.2%	8.6%	+5.9%
Net financial liabilities							
- $billion	50.7	51.6	58.1	80.4	89.6	86.3	+35.6
- % GSP	13.8%	13.7%	14.9%	20.4%	22.3%	20.8%	+7.0%
Net worth							
- $billion	127.5	136.6	146.9	140.6	151.6	162.6	+35.1
- % GSP	34.7%	36.2%	37.6%	35.6%	37.7%	39.2%	+4.5%

Net debt

Net debt is expected to be $35.7 billion at June 2011. This represents an increase of $25.8 billion over the five years since June 2006. Net debt as a percentage of GSP is expected to increase from 2.7 per cent in June 2006 to 8.6 per cent in June 2011. The large increase in net debt in 2007 was largely due to a one-off cash payment of $7.2 billion[1] from the General Government Liability Management Fund (GGLMF) to the SAS Trustee Corporation (State Super).

The GGLMF was a non-superannuation investment fund established to accumulate Crown employer superannuation contributions before eventually transferring accumulated funds as a lump sum to State Super. As the funds were placed in superannuation assets, the transfer did not result in any change in net financial liability.

The change in net debt over the period is due to a number of factors:

- cumulative cash deficits covering both operating and capital expenditure ($23.1 billion increase). Cash deficits have been driven by the large capital programs in both the general government and public trading enterprise (PTE) sectors. Over the five years to 2010-11, capital expenditure in the general government sector was $27.2 billion and $36.9 billion in the PTE sector
- the above mentioned one-off payment to State Superannuation Fund in 2006-07
- business transactions involving lotteries, waste services and the electricity sector ($5.5 billion decrease)
- finance lease acquisitions ($2.2 billion increase)
- other technical accounting transactions mainly involving valuations and reclassifications of specific financial assets and liabilities ($0.7 billion increase).

[1] According to the Budget Papers and State Accounts, the GGLMF had $5.3 billion in deposits at the end of June 2006. $7.2 billion was paid to State Super during 2007.

Net financial liabilities

Net financial liabilities are expected to be $86.3 billion at June 2011. This represents an increase of $35.6 billion over the five years since June 2006. Net financial liabilities as a percentage of GSP are expected to increase from 13.8 per cent in June 2006 to 20.8 per cent in June 2011.

The change in net financial liabilities over the period is due to a number of factors:

- cumulative negative net lending results ($28.1 billion increase)
- business transactions involving lotteries, waste services and the electricity sector ($5.5 billion decrease)
- net superannuation actuarial losses over the period ($11.4 billion increase)
- other technical accounting transactions mainly involving valuations and reclassifications of specific financial assets and liabilities ($1.6 billion increase).

Net worth

Net worth is expected to be $162.6 billion at June 2011. This represents an increase of $35.1 billion over the five years since June 2006. Net worth as a percentage of GSP is expected to increase from 34.7 per cent in June 2006 to 39.2 per cent in June 2011.

The change in net worth over the period is due to a number of factors:

- net impact of accounting operating results ($8.7 billion increase)
- superannuation gains/(losses) ($11.4 billion decrease)
- positive physical asset valuations ($37.9 billion increase)
- other technical accounting transactions mainly involving adjustments to accumulated funds and reserves ($0.1 billion decrease).

4.2 General government sector balance sheet

Structure of the general government balance sheet

In broad terms, the structure of the general government sector balance sheet mirrors the total state sector. The only major difference is that the general government sector records an equity investment in the net assets of the public non-financial corporation and public financial corporation sectors. This results in the net worth of the general government and total state sector being equal.

General government financial assets are projected to total $107.7 billion at June 2011, including $79.6 billion of equity investments in other sectors.

Non-financial assets are projected to total $133.4 billion.

Liabilities are projected to total $77.9 billion.

Net worth is projected to be $163.2 billion.

The key balance sheet measures of financial strength or weakness are net debt and net financial liabilities.

General government sector net debt is projected to be $9.2 billion at June 2011.

Net financial liabilities are projected to be $48.7 billion.

Table 4.2.1 General government balance sheet

	2009-10 $m	2010-11 $m
ASSETS		
Financial assets		
Cash and cash equivalent assets	3,123	8,081
Receivables	6,203	6,093
Tax equivalents receivable	286	199
Financial assets at fair value	6,598	7,457
Advances paid	904	937
Deferred tax equivalents	5,734	5,275
Equity		
Investments in other public sector entities	78,473	78,441
Investments in associates	1,155	1,187
Other	0	0
Total financial assets	**102,476**	**107,671**
Non-financial assets		
Inventories	282	284
Forestry stock and other biological assets	7	7
Assets classified as held for sale	114	156
Investment properties	258	254
Property, plant and equipment		
Land and buildings	56,742	60,401
Plant and equipment	7,983	8,458
Infrastructure systems	58,254	61,291
Intangibles	1,238	1,390
Other	1,103	1,207
Total non-financial assets	**125,980**	**133,447**
TOTAL ASSETS	**228,457**	**241,118**
LIABILITIES		
Deposits held	78	1,423
Payables	3,683	3,762
Tax equivalents payable	19	15
Liabilities directly associated with assets held for sale		
Borrowings and derivatives at fair value	24	16
Borrowings at amortised cost	19,060	23,380
Advances received	807	812
Employee provisions	10,929	11,087
Superannuation provision	32,726	27,869
Deferred tax equivalent provision	795	834
Other provisions	5,718	5,813
Other	3,031	2,904
TOTAL LIABILITIES	**76,869**	**77,915**
NET ASSETS	151,588	163,203
NET WORTH		
Accumulated funds	24,922	33,242
Reserves	126,666	129,961
TOTAL NET WORTH	**151,588**	**163,203**
Net debt	**9,345**	**9,156**
Net financial liabilities	**52,866**	**48,685**

Trends in the general government balance sheet

An analysis of the level and movements in the three key balance sheet measures since June 2006 has been undertaken. Table 4.2.2 below summarises the outcomes of this analysis.

Table 4.2.2 General government balance sheet – key measures

	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011	5 Yr Change
Net debt							
- $billion	-3.8	3.6	5.7	8.2	9.3	9.2	+13.0
- % GSP	-1.0%	1.0%	1.4%	2.1%	2.3%	2.2%	+3.2%
Net financial liabilities							
- $billion	27.5	25.7	30.4	48.2	52.9	48.7	+21.2
- % GSP	7.5%	6.8%	7.8%	12.2%	13.2%	11.7%	+4.2%
Net worth							
- $billion	127.5	136.6	146.9	140.6	151.6	163.2	+35.7
- % GSP	34.7%	36.2%	37.6%	35.6%	37.7%	39.4%	+4.7%

Net debt

Net debt is expected to be $9.2 billion at June 2011. This represents an increase of $13.0 billion over the five years since June 2006. Net debt as a percentage of GSP is expected to increase from -1.0 per cent in June 2006 to 2.2 per cent in June 2011. The turnaround between 2006 and 2007 is largely explained by a one-off cash payment of $7.2 billion from the General Government Liability Management Fund to State Super (see more detailed explanation in total state sector commentary).

The change in net debt over the period is due to a number of factors:

- cumulative cash deficits covering both operating and capital expenditure ($7.9 billion increase). Cash deficits have been driven by the large capital program in the general government. Over the five years to 2010-11 capital expenditure in the general government sector was $27.2 billion
- a one-off payment to State Superannuation Fund in 2006-07 ($5.3 billion increase
- various business transactions including lotteries, waste services and the electricity sector ($2.9 billion decrease)
- capital returns from the non-financial corporations sector ($0.6 billion decrease)
- finance lease acquisitions ($1.6 billion increase)
- other technical accounting transactions mainly involving valuations and reclassifications of specific financial assets and liabilities ($1.7 billion increase).

Net financial liabilities

Net financial liabilities are expected to be $48.7 billion at June 2011. This represents an increase of $21.2 billion over the five years since June 2006. Net financial liabilities as a percentage of GSP are expected to increase from 7.5 per cent in June 2006 to 11.7 per cent in June 2011.

The change in net financial liabilities over the period is due to a number of factors:

- cumulative negative net lending results ($11.6 billion increase)
- various business transactions including lotteries, waste services and the electricity sector ($2.9 billion decrease)
- capital returns from the non-financial corporations sector ($0.6 billion decrease)
- net superannuation actuarial losses over the period ($9.6 billion increase)
- other technical accounting transactions mainly involving valuations and reclassifications of specific financial assets and liabilities ($3.5 billion increase).

Net worth

Net worth is expected to be $163.2 billion at June 2011. This represents an increase of $35.7 billion over the five years since June 2006. Net worth as a percentage of GSP is expected to increase from 34.7 per cent in June 2006 to 39.4 per cent in June 2011.

The change in net worth over the period is due to a number of factors:

- net impact of accounting operating result ($5.3 billion increase)
- superannuation gains/(losses) ($9.6 billion decrease)
- positive physical asset valuations ($25.8 billion increase)
- a net gain on equity investments in the PTE and public financial enterprise (PFE) sectors ($10.6 billion increase)
- other technical accounting transactions mainly involving adjustments to accumulated funds and reserves ($3.6 billion increase).

Superannuation assets and liabilities

Table 4.2.3 Superannuation assets and liabilities

Unfunded liability estimates measure the difference between the total gross value of superannuation liabilities and the value of invested super scheme assets[2].

Liabilities represent the present value of the defined benefit obligation at the end of the reporting period. Estimation of the present value requires the selection of a discount rate (i.e. the rate used to estimate the value today of a future cash flow).

The accounting standard under which these liabilities are reported (AASB 119) requires the use of a discount rate based on the Commonwealth long-term bond rate. As this bond rate is subject to ongoing change, the reported value of these liabilities is subject to ongoing volatility from year to year.

---

[2] These estimates include all State Super schemes covered by the Crown (i.e. most general government schemes) plus the Judges Pension Scheme and the Parliamentary Contributory Super Scheme.

In the period from 2006 to 2011, the reported value of superannuation liabilities increased by $10,288 million. The level of reported liabilities remained largely unchanged from 2006 to 2008 before increasing in the two years to 2010 and then falling in 2011. These changes are shown in Table 4.2.3.

Table 4.2.3 Superannuation assets and liabilities

Date (30 June)	2006 $m	2007 $m	2008 $m	2009 $m	2010 $m	2011 (est) $m	2006-11
Current unfunded superannuation liabilities*	-	902	978	1,057	1,330	1,363	1,363
Non-current unfunded superannuation liabilities	22,929	13,520	16,529	27,374	30,129	25,867	2,938
Total unfunded superannuation liabilities (AASB 119)	22,929	14,422	17,507	28,432	31,459	27,231	4,302
Total superannuation liabilities (AASB 119)	40,069	41,068	41,084	48,492	52,977	50,357	10,288
Scheme assets	17,140	26,645	23,576	20,060	21,518	23,126	5,986
Total unfunded superannuation liabilities (AASB 119)	22,929	14,422	17,507	28,432	31,459	27,231	4,302

Source: Crown Annual Reports – 2005-06 to 2009-10. FIS/TOES report February 2011 for 2010-11. * Current liabilities are defined as being equal to standard employer contributions.

A major underlying factor is an ongoing increase in liabilities as entitlements accrue to scheme members who are still in the workforce. These entitlements are expected to peak in the next few years as more ‘baby boomers’ retire and as the scheme matures.

However, as Table 4.2.4 below shows, ongoing changes in actuarial gains and losses were the largest single source of variation in the liability over these time periods. These changes are largely due to changes in discount rates and the adoption of Mercer Triennial Review demographic updates.

Table 4.2.4 Crown superannuation liabilities ($m)

Date (30 June)	2007 $m	2008 $m	2009 $m	2010 $m	2011 est $m
Gross liability – opening value (30 June the previous year)	40,069	41,068	41,084	48,492	52,977
Current service costs	652	621	587	652	626
Interest expense/unwinding of discount rates	2,319	2,559	2,622	2,658	2,672
Employee contributions	355	383	348	340	341
Other items	33			47	-14
Benefit payments	-637	-2,627	-2,706	-2,256	-3,007
Actuarial gains and losses	-1,724	-920	6,558	3,043	-3,238
Gross liability closing value (30 June)	41,068	41,084	48,492	52,977	50,357

Of these two factors (member entitlements and actuarial issues), the change in discount rates is the major cause of volatility in estimated liabilities and variation in the value of actuarial gains and losses from year to year[3]. Table 4.2.5 compares changes in discount rates with actuarial gains and losses reported for each year since 2006.

Table 4.2.5 Movement in actuarial gains and losses and liability discount rate

Date (30 June)	2007 $m	2008 $m	2009 $m	2010 $m	2011 est $m
Actuarial gains and losses	-1,724	-920	6,558	3,043	-3,238
Discount rate (based on 10-year Commonwealth Government bond rates at June 30 each year)	6.4%	6.55%	5.59%	5.17%	5.83%

Actuarial gains and losses are also be affected by underlying changes in forecast member demographics and incomes as well as timing differences. However, the volatility in liabilities due to the use of changing bond discount rates under AASB 119 makes it difficult to judge underlying liability trends from published reports. Notably, the forecast actuarial gain and loss estimate for 2011 (-$3,238 million) exceeds the fall in liabilities forecast for 2011 (from $52,977 million to $50,357 million, i.e. a decline of $2,620 million).

The sensitivity of superannuation liability estimates to changing discount rates under AASB 119 is shown in Table 4.2.6 below.

3 For State Super, the impact of the discount rate change was $2,410 million in 2010 and $4,825 million in 2009.

Table 4.2.6 Liability valuation AASB 119 bond discount rate sensitivity

Movement in discount rate	Government bond rate (per annum)	Gross liability $million	Difference in gross liability to base case $million
%			
+1.00	4.75%	65,427	6,854
+0.75	5.00%	63,613	5,040
+0.50	5.25%	61,823	3,250
+0.25	5.50%	60,125	1,552
Base case	5.75%*	58,573	0.0
-0.25	6.00%	57,039	-1,535
-0.50	6.25%	55,580	-2,993
-0.75	6.50%	54,192	-4,381
-1.00	6.75%	52,920	-5,653

* Current Treasury forecast for Commonwealth 10-year bond rate.

From 2006 to 2011, the value of superannuation scheme assets has increased by $5,986 million, which represents an underlying reduction of $1,189 million after taking into account a ‘one-off’ General Government Liability Management Fund (GGLMF) contribution of $7.2 million to State Super in 2007.

This transfer, combined with an earnings rate of 15.2 per cent for State Super during the year, led to an increase in asset values from $17,140 million to $26,645 million for that year. Asset values then declined to $20,060 million by 2009, due to negative investment returns in the wake of the global financial crisis (-7.2% in 2008 and -10.4% in 2009 for State Super). With improved earnings realised in 2010 and forecast for the current year, asset values are now forecast to rise to $23,126 million by the end of 2011.

Table 4.2.7 Crown superannuation assets

Date (30 June)	2007 $m	2008 $m	2009 $m	2010 $m	2011 est $m
Fair value (opening – 30 June the previous year)	17,140	26,645	23,576	20,060	21,518
Expected return	1,527	2,015	1,872	1,681	1,793
Actuarial gains/losses*	1,412	-3,770	-4,061	135.0	1,158
Other cashflows	-355			-64	-43
Contributions by employers	7,208	930	1,032	1,621	1,365
Contributions by fund members	355	383	348	340	341
Benefits paid	-637	-2,627	-2,706	-2,256	-3,007
Fair value (closing – 30 June)	26,645	23,576	20,060	21,518	23,126

* Actuarial gains/losses incorporate the difference between expected investment returns (based on an expected return of (8.6%) and realised investment returns (forecast to be 14.1% for 2011). The difference (outperformance of 5.5%) is included in the value of actuarial gains and losses for assets. The large actuarial losses in 2008 and 2009 reflect the scale of investment losses during those years.

4.3 Balance sheet issues

This section examines a number of balance sheet issues both with respect to the total state and general government balance sheet.

WorkCover

The WorkCover-related balance sheet issue is whether the liability for the WorkCover Scheme is correctly recognised in the Total State Sector Financial Statements.

The WorkCover Authority (WCA) is consolidated in the Total State Sector Financial Statements because it is a controlled entity of the NSW Government. WCA is responsible for the regulation of the Nominal Insurer and Insurance Funds (the Scheme).

However, the 'NSW WorkCover Scheme' (the Scheme) is not consolidated because it is not a controlled entity. The clear intent of the legislation (in Second Reading Speeches), the legislation itself (including the 2003 amendments) and Australian accounting standards support that neither the Government nor the WCA controls the Scheme.

The legislation states that the scheme is a statutory trust held on trust for the benefit of workers and employees (paraphrasing section 154D(2)). Further, the State, the Nominal Insurer and the WCA have no liability to meet any deficit in the scheme and have no beneficial interest in any surplus (paraphrasing section 154D(6)).

Similarly, accounting standards state that a government does not control another entity where it cannot benefit from the resources, for example, where it acts as a trustee or where it merely has the power to regulate (paraphrasing AASB 127 Consolidation and Separate Financial Statements para Aus 17.2).

The above view has been supported by three written opinions from the NSW Solicitor-General, Mr Keith Mason, QC (1996), Mr Michael Sexton, SC (June 1999) and the Acting Crown Advocate, Mr Peter Burman (1998).

Despite the above, the Audit Office for many years qualified the Total State Sector Financial Statements when the WorkCover Scheme was in deficit. The Audit Office last requested Treasury's view on 6 September 2009. Treasury provided its view on 14 September 2009 and the Total State Sector Financial Statements for 2009 and 2010 were not qualified on this issue.

GenTraders' contingent liability for availability liquidated damages

The balance sheet issue here is whether the Total State Sector Financial Statements need to record a liability for availability liquidated damages (ALD) arising from the GenTrader Agreements (GTA).

The rights to sell the electricity produced by the State owned generators were transferred to the private sector during the 2010-11 financial year. The GTAs include monthly targets for contracted availability. Where targets are not reached, the government owners are required to pay liquidated damages to the GenTraders.

Treasury advised the General Purpose Standing Committee No.1 that the 'the expected risk associated with ALDs over the life of the GenTrader contracts … (are)… roughly $360m in net present value terms'.

Ernst and Young advised Treasury that, in accordance with Australian Accounting Standard 137 Provisions para 7.19 'the Owner (and the Total State Sector) will not be able to raise a provision for forecast ALDs payable under the GTA as the extent to which ALDs are payable are dependent on the Owner's future actions'.

Further, they stated: 'a provision can only be raised where an entity has a present obligation (legal or constructive) as a result of a past transaction (AASB 137.14(a))'. AASB 137.19 provides additional guidance and states that 'it is only those obligations arising from past events existing independently of an entity's future actions (that is, the future conduct of its business) that are recognised as provisions'.

As a result, the ALDs are contingent liabilities that are included in the notes to the financial statements, but not liabilities that are recognised on the Statement of Financial Position.

Valuation of electricity generators and the impact of the carbon tax

The Commonwealth's proposed carbon price is expected to significantly reduce the value of NSW-based coal-fired generators. This value impact is yet to be fully reflected in the balance sheets of Macquarie Generation and Delta Electricity.

Only limited information on the carbon pricing scheme has been released by the Commonwealth Government to date. However, based on Commonwealth modelling for the former Carbon Pollution Reduction Scheme (CPRS), the carbon tax will have a substantial negative impact on the value of the NSW-based coal-fired generators.

In the Commonwealth Government's 2008 CPRS White Paper, two of the three modellers estimated a negative impact greater than $5 billion on the black coal generators in the National Electricity Market. While Queensland also has a large portfolio of black coal generators, the majority of black coal electricity generation is in NSW, so the majority of the negative impact will likely be felt in this state.

Treasury expects to see significant downward revisions in the value of the Government's non-GenTrader businesses (Macquarie Generation and Delta Electricity's coastal operations) in the coming year as these businesses incorporate the impact of forecast carbon prices in their balance sheet valuations. In determining the quantum of the impact, these businesses will need to make assumptions about scheme details that have not yet been announced. Valuations may subsequently change where these assumptions are inconsistent with future announced outcomes.

The ultimate magnitude of the value impact will depend on the final detail of the scheme and particularly on the level of compensation available to black coal-fired generators. The 2008 CPRS White Paper proposed an intensity-based assistance scheme that would have seen almost none of the available compensation for generators going to black coal generators, but rather going to brown coal generators in Victoria.

There is no logic for applying the bulk of compensation for the carbon tax identified for the generation industry to brown coal generators. The value of both brown coal and black coal generators will be substantially impacted by the proposed carbon tax and there is no reason for compensation not to be equitably allocated between the two sectors of the same industry.

Water treatment plants

The balance sheet issue here is whether Sydney Water's arrangements with a number of privately-owned water treatment plants should be recognised in the Total State Sector Financial Statements as assets and liabilities.

Sydney Water has service agreements with the operators of four privately-owned water treatment plants. Under these agreements, Sydney Water pays availability charges that recoup the operators' capital and capital servicing costs of the plants.

On the basis of advice from several international accounting firms, Sydney Water regards the arrangements as service agreements and recognises the availability charges as expenses when they occur. It does not recognise any assets or liabilities relating to the agreements.

However, the Audit Office considers that Sydney Water should recognise a liability for future availability charges because it considers that the agreements effectively transfer all of the risks and benefits incident to ownership of the plants to Sydney Water. The Audit Office has issued a qualified opinion on Sydney Water's financial statements for many years for this reason. However, the Audit Office does not qualify the Total State Sector Financial Statements on this issue.

There would appear to be support for Sydney Water's position as independent accounting firms have assessed the risks and rewards of ownership of the plant as lying with the operator rather than with Sydney Water.

Recently, the Macarthur Water Treatment Plant agreement has been renegotiated and the risks and rewards of ownership of the plant have transferred to Sydney Water. Therefore, as from 2010-11, this agreement will be treated as a finance lease. The plant will be recognised as Sydney Water's asset and the future availability charges will be recognised as a liability.

Sydney Water discloses its commitments under all of the agreements.

Reliance Rail privately financed project

In 2006, RailCorp entered into a privately financed project (PFP) contract with the Reliance Rail consortium to finance, design, manufacture, commission and provide 78 eight-car trains. Since then both Moody's and Standard and Poor's downgraded Reliance Rail's credit rating and it is now substantially below investment grade and exposed to deterioration in the financial condition of its financial guarantors. However, trains will start to be delivered in the second half of 2011 and Reliance Rail's financial condition may be substantially different on revised delivery of the trains in 2014.

Importantly, the State is under no obligation to guarantee the financial position of Reliance Rail.

An agreement is in place for a Rollingstock PFP, which incorporates finance leases. The finance leases substantially transfer to RailCorp all the risks and benefits incidental to ownership of the leased item and are capitalised at the commencement of the lease term at the fair value of the leased asset or, if lower, at the present value of the minimum lease payments. The corresponding liability to the lessor is included in the Statement of Financial Position as a finance lease liability. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are capitalised in accordance with the accounting policy on borrowing costs.

RailCorp has signed a contract for a Rollingstock PFP with Reliance Rail which constitutes a finance lease. The Auburn Maintenance Facility (AMF) reached practical completion on 18 June 2010 and therefore an addition to property plant and equipment, representing buildings of $219.3 million (2009: nil) and associated finance lease liability of $219.3 million has been recognised in the financial statements.

The finance lease liability relating to rollingstock sets amounted to $nil at 30 June 2010. These assets and associated finance lease liability will be recognised on completion and delivery of the rollingstock sets.

Reliance Rail under the contract is required to:

- design, manufacture and deliver 626 carriages, together with simulators for training
- design and construct a maintenance facility at Auburn (commissioned 18 June 2010)
- provide through-life support for the trains, the maintenance facility and the simulators over a period of more than 30 years.

Payments for the above will be made via a series of Set Availability Unit Allowances (SAUs) made by RailCorp to Reliance Rail. The SAUs ramp up progressively as each set becomes available for passenger service. The SAU payments are inflated at CPI.

Reliance Rail has advised that the sets will be progressively available for passenger services from late 2011. Overall, the total payments to be made by RailCorp to Reliance Rail, including milestone and completion payments and financing costs, over the term of the project are estimated to be $9,727 million (2009: $9,698 million) in nominal dollars which, together with further ancillary RailCorp costs and retained risk, amount to a total project cost of $3,650 million in net present value as at 30 June 2006. In accordance with the PFP contract, RailCorp is required to make certain milestone payments. These are treated as interest-free advances pending satisfactory completion of the construction of carriages together with two simulators and a maintenance facility.

There is the risk that the directors of Reliance Rail may conclude that the company is not in a financial position to draw down the next tranche of debt that is due to be drawn down in February 2012 or, alternatively, that the monocline insures become insolvent, so eliminating the obligation of the banks to provide the lending facility. It is suggested that the State needs to develop contingency plans to deal with these possibilities and may consider taking a proactive commercial approach to the financing issue.

University superannuation liability

Universities in NSW have a number of employees and pensioner retirees who are long-standing members of NSW public sector defined benefit superannuation schemes.

The main schemes are the SSS pension scheme, closed to new members in 1985, the SASS lump scheme, closed to new members in 1992 and the 3 per cent award-based SANCS scheme, introduced in 1988 and closed in 1992.

These schemes are funded by employers and employees. The estimated value of accrued service is a liability and is funded by a combination of invested assets and ongoing employer funding for remaining liabilities. The difference between the value of the liability and invested assets is known as the 'unfunded liability'.

Prior to 1974, the states and the Commonwealth provided employer funding for universities and colleges of advanced education (CAEs). The portion of recurrent costs paid by NSW at 1 January 1974 was 100/285 of costs for universities and CAEs (although NSW had paid 100 per cent of CAE costs since 1967 and 100 per cent of CAE-teacher college costs up until mid-1973).

In 1974, the Commonwealth took over all funding responsibilities for universities. In 1982, the SSAU scheme was introduced for universities and was funded by 14 per cent employer contributions.

In 1987, the Commonwealth announced that states will be required to pay their share of costs for pre-1974 service and pay superannuation costs in excess of 14 per cent from 1 January 1982. Following the introduction of the 3 per cent award TESS scheme for universities in 1988, the notional university employer contribution rate was raised to 17 per cent.

Commonwealth/state university liability funding negotiations commenced in 1988 and are yet to be concluded, despite numerous attempts by NSW to seek a resolution.

An actuarial review of the university sector in 2008 by Mercer indicated that university employer funding arrangements were unsustainable and funds would soon become depleted. The review also advised that NSW now had some responsibility for the liabilities, amounting to around 20 per cent of the total liability and, depending on the value of past contributions from NSW, potentially 20 per cent of the unfunded liability (around $360 million, from a total unfunded liability of $1.8 billion). However, Mercer made it clear that this was a preliminary forecast and updated detailed actuarial modelling would be required to properly apportion liabilities and assets.

The NSW Audit Office, in their recent report to Parliament, stated that the liability is ultimately the responsibility of the Commonwealth and noted that university management had advised them that their Vice-Chancellors will pursue the issue of outstanding funding with the Commonwealth through the NSW Vice-Chancellors' Committee.

Valuation of net superannuation liability

There are three balance sheet issues related to the State's net superannuation liability: whether the liability in the state accounts is in respect to current or future service liability; the appropriateness of accounting standard AASB 119 for representing the superannuation liability; and the implications of a prospective change in AASB 119 for the state balance sheet.

The first issue is whether the liability for superannuation is correctly recognised in the Total State Sector Financial Statements and whether the liability reflects a liability for future service. The liability for superannuation is recognised in the Total State Sector Financial Statements in accordance with Accounting Standard AASB 119 Employee Benefits. The amount of the defined benefit liability is the net of:

- the present value of the defined benefit obligation at the end of the reporting period and
- the fair value of the plan assets at the end of the reporting period (AASB 119 para 54).

The amount of the defined benefit liability is assessed annually by actuaries. It is based on the expected future payments based on the benefit that employees have earned in return for their service in the current and prior periods (AASB 119 para 50). Therefore, the liability recognised does not reflect future service liability, in accordance with AASB 119.

The second issue is the appropriateness of AASB 119 for valuing the State's superannuation liabilities.

Superannuation liabilities for the Mercer triennial review were estimated in accordance with Australian Accounting Standard 25 Financial Reporting by Superannuation Plans. The AAS 25 methodology uses the long-term fund NSW earning rate to value liabilities and is generally known as the 'actuarial funding basis'. The forecast earning rate used by NSW Treasury is 8.6 per cent after tax.

Before 2005-06, superannuation liabilities in the State Budget were estimated under AAS 25. However, since 2005-06, liabilities for statutory accounting reporting have been estimated under the international accounting standard AASB 119, also known as the reporting standard or reporting basis. This standard was adopted by NSW Treasury in order to avoid an Audit Office qualification.

Under the reporting basis, a floating discount rate is used to estimate the present value of liabilities. This discount rate is based on long-term government bond yields as at 30 June each financial year. As the yield on bonds is generally lower than fund earning rates, the reported value of liabilities under AASB 119 is much higher than the AAS 25 estimate. Ongoing changes to discount rates also lead to substantial variability in reported liability estimates.

The extent of the liability valuation differences and increased AASB 119 volatility is highlighted in the following table based on the Budget Statement 2010-11.

Table 4.3.1 General government sector unfunded superannuation liability forecasts

Year			
June	**AASB 119**	**AAS 25**	**Difference**
Actual	*$m*	*$m*	*$m*
2008	17,624	12,239	5,385
2009	29,423	17,811	11,612

Year			
June	AASB 119	AAS 25	Difference
2010	27,466	14,901	12,565
Forecast			
2011	26,157	15,379	10,778
2012	27,575	15,786	11,789
2013	28,014	16,122	11,892
2014	28,064	16,384	11,680

Budget Papers 2010-11 Budget Statement (Budget Paper No. 2) page 7-21 Table 7.13

NSW Treasury has adopted the actuarial funded basis approach to determine the General Government Sector Funding Plan with a fixed discount rate of 8.6 per cent.

AASB 119 may be appropriate if liabilities are totally unfunded, or funded only by bonds or other interest-based investments. Earnings would then be limited to interest-based returns and relatively high employer contribution rates would be needed to pay member benefits over time.

However, NSW Superannuation schemes are funded by diversified growth asset portfolios, where long-term investment history shows that the average earnings on assets are significantly higher than interest-based portfolios due to the existence of the equity risk premium.

Under the circumstances, using AASB 119 as a guide to funding is inappropriate and gives an inaccurate and misleading measure of NSW's underlying funding status and potential funding requirements. The actuarial funding basis provides a more appropriate basis for funding as it provides a better indication of the level of employer contributions required over time to meet future entitlements.

The third and final issue is the prospective changes in AASB 119 and its impact on the reported state financial position.

The Australian Accounting Standards Board is expected to adopt a revised AASB 119 accounting standard which changes the calculation methodology for net superannuation expense. It is anticipated that the standard will be operative from the 2013-14 financial year.

The revised standard deletes the expected return on superannuation plan assets and changes interest expense from a gross liability to a net liability concept. The forecast Budget impact, based on a bond rate of 5.75 per cent and investment return of 8.60 per cent, is about $780 million per annum. The forecast impact, while changing the headline result, does not change the State's underlying financial position. NSW should consider seeking a revision of the accounting standard applicable to the reporting of net superannuation expense.

Public housing

Public housing assets which are held by the Land and Housing Corporation and include 130,000 residential properties valued at $30 billion are included in the State's balance sheet. There are plans to transfer the majority over time to Community Housing Providers (CHPs). The objectives of such a transfer are to develop the social housing system; diversify social housing delivery and deconcentrate areas of social disadvantage; and transform public housing assets and places.

International experience indicates that appropriate models can encourage third parties to provide affordable housing and produce innovation in the provision of public housing and better client outcomes. At the same time, there are major strategic and financial implications of such a proposal which need careful consideration.

5 TRACKING FISCAL OUTCOMES AGAINST TARGETS

Key points

- NSW met the short- and medium-term targets of the *General Government Debt Elimination Act 1995* through to 2004-05.
- The outcomes for general government net debt as a proportion of gross state product (GSP), and net financial liabilities (NFL) as a proportion of GSP, have exceeded the targets set out in the *Fiscal Responsibility Act 2005*.
- Increased capital spending and a deteriorating operating position are driving the net debt/GSP result, while NFL/GSP outcomes reflect the higher net debt and a higher unfunded superannuation liability.

5.1 Overview

General Government Debt Elimination Act 1995

The *General Government Debt Elimination Act 1995* (the GGDEA), as amended in December 2000, set out the following short-, medium- and long-term targets:

Short term

- To achieve a sustainable surplus budget for the general government sector by 1998-99.

Medium term

- To reduce general government sector net debt to a sustainable level by 30 June 2005. A sustainable level is defined in the GGDEA as a level at which the budget can absorb the full impact of an economic cycle without the need for significant corrective action on the revenue or expenditure side.

Long term

- To eliminate general government net debt by 30 June 2020.
- To eliminate total state sector unfunded superannuation liabilities by 30 June 2030.

The GGDEA short-term target was measured using Government Finance Statistics (GFS) cash estimates for the general government sector. An underlying[1] cash surplus of $381 million was achieved in 1998-99, and underlying cash surpluses averaging $732 million per annum were achieved in the years 1999-00 to 2004-05.

[1] Adjusted for prepayments of superannuation and deposits to the General Government Liability Management Fund.

The medium-term target of a sustainable net debt position was announced as being reached in the 2003-04 Budget. The 2003-04 Budget Paper No. 2 indicated that "…reduced general government net debt…has reached low levels and would appear to be sustainable"[2]. The general government net debt to GSP ratio was reduced from 6.4 per cent on 30 June 1996 to 0.9 per cent by 30 June 2005.

The GGDEA was replaced by the *Fiscal Responsibility Act 2005* (the FRA) from the 2005-06 financial year onwards. The GGDEA's long-term target of reducing general government net debt to zero by 30 June 2020 was replaced by the FRA target of maintaining the underlying general government net debt to GSP ratio at 30 June 2005 levels. The FRA maintains the GGDEA's unfunded superannuation liabilities target.

Fiscal Responsibility Act 2005

The FRA sets out targets to guide government fiscal policy over the medium and long term. The medium term is defined as 30 June 2010 and the long term as 30 June 2015. The targets are:

Medium term

§ To reduce the level of general government NFL as a proportion of GSP to 7.5 per cent or less by 30 June 2010.

§ To maintain underlying general government net debt as a proportion of GSP at or below its level as at 30 June 2005[3], unless an increase in net debt is required to reduce one or more components of general government net financial liabilities.

Long term

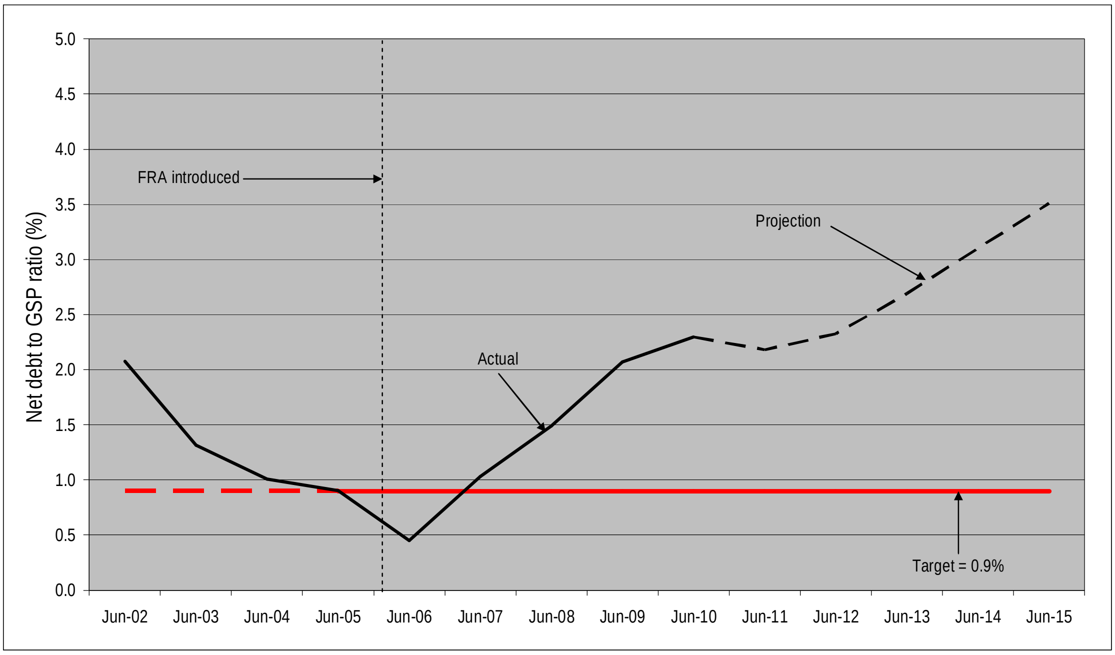
§ To reduce the level of general government NFL as a proportion of GSP to 6 per cent or less by 30 June 2015.

§ To maintain underlying general government net debt as a proportion of GSP at or below 30 June 2005 levels, unless an increase in net debt is required to reduce one or more components of general government net financial liabilities. To eliminate total state sector unfunded superannuation liabilities by 30 June 2030.

The figures below show the evolution of the metrics since the FRA came into force, as well as current projections.

[2] 2003-04 NSW Budget, Budget Paper No. 2, p. 1–5
[3] At 30 June 2005, underlying general government net debt as a proportion of GSP was 0.9 per cent.

Figure 5.1.1 General government net debt to GSP ratio, actual versus target



The net debt to GSP ratio was below the target at June 2006, mainly due to the changed accounting treatment of a Commonwealth road transport grant received in that year. Previously, this grant was accounted for progressively in the years it was expected to be spent (2006-07 to 2009-10); however, under the new Accounting Standards, this grant had to be fully recognised in the year it was received[4]. This had the effect of boosting the net operating balance by $952 million with flow-through effects to the net lending and net debt results.

Since June 2006, the net debt to GSP ratio has exceeded the target each June and has been steadily rising, from 1.0 per cent at June 2007 to 2.3 per cent at June 2010 – 1.4 percentage points above the target. The June 2011 outcome is projected to be 2.2 per cent, with the reduction mainly due to the impact of the electricity transaction. The ratio is projected to continue rising through the forward estimate period, reaching 3.5 per cent by June 2015.

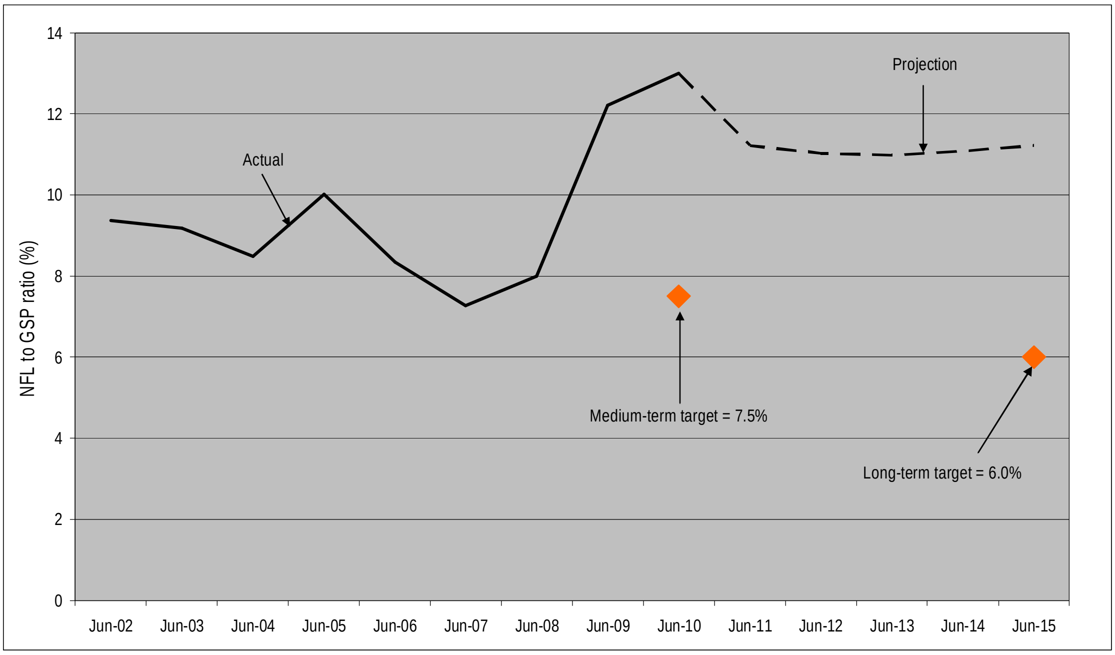
A key reason for the rising net debt to GSP ratio since June 2005 is the expansion of the capital expenditure program. After allowing for the impacts of the Commonwealth Government's Economic Stimulus Plan, general government capital spending rose from $3.3 billion in 2004-05 to $5.4 billion in 2009-10. As noted in earlier chapters, this occurred at the same time the budget surplus was becoming structurally lower, requiring a growing proportion of the higher capital program to be funded by debt.

Looking ahead, the capital program (excluding Economic Stimulus Plan-related capital spending) is expected to remain at high levels and the operating position is projected to deteriorate significantly through the forward estimate period. Both of these factors are expected to contribute to the net debt to GSP ratio continuing to move away from the target.

---

4 See NSW Budget Papers 2008-09, Budget Paper No. 2, pp. 1–3.

Figure 5.1.2 General government NFL to GSP ratio, actual versus target



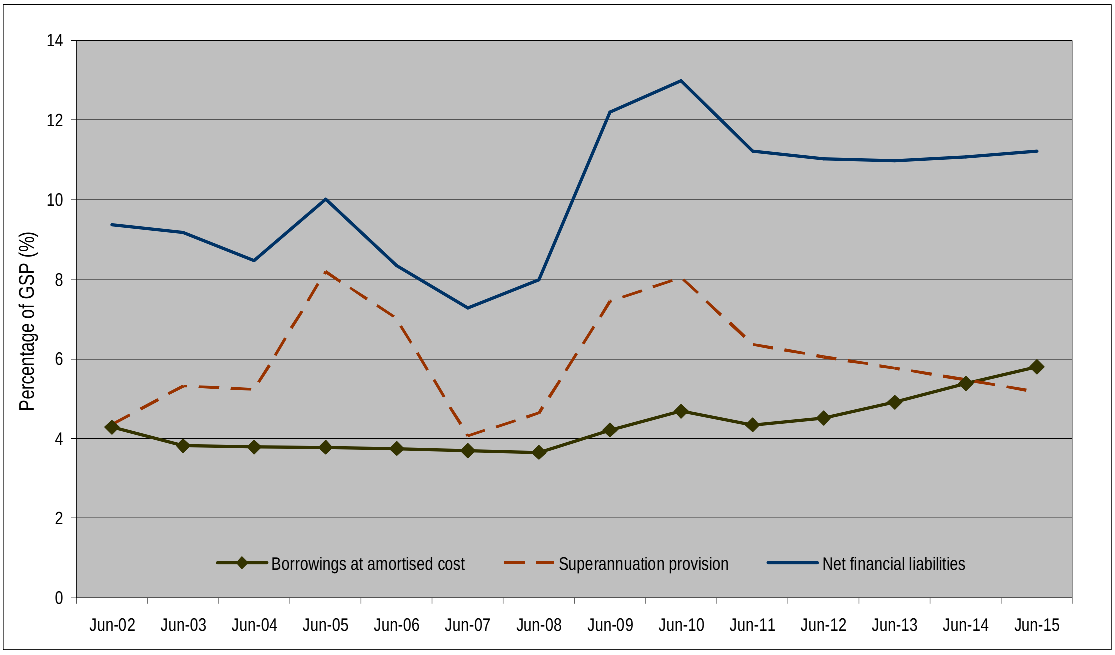
As shown in Figure 5.1.2, though somewhat volatile, the NFL to GSP ratio was declining (on average) between June 2005 and June 2008 and appeared broadly on track to achieve the medium-term target of 7.5 per cent by June 2010. However, the ratio lifted sharply by June 2009; at 13 per cent it was well above the medium-term target level at June 2010; and it is projected to remain considerably above the long-term target level of 6 per cent by June 2015.

As shown in Figure 5.1.3, the key contributor to the NFL to GSP ratio result, especially in the earlier years, was the unfunded superannuation liability, which largely determines both the value of the ratio and its profile. In the years prior to the global financial crisis (GFC), the liability was falling both in absolute terms and as a proportion of GSP, as fund assets were earning high returns, but the discount rate (the 10-year Commonwealth Government bond rate as at 30 June) was also high. These positions reversed when the GFC occurred, leading to a significant increase in the liability.

More recently, as equity markets have improved (and interest rates have again risen) the unfunded superannuation liability has declined, at least in terms of its share of GSP. In absolute terms, the liability is expected to rise moderately to June 2014 before starting to decline thereafter, reflecting actuarial assumptions underpinning the liability estimates. The superannuation liability remains on track to be fully funded by the target date of 30 June 2030.

Despite the fall in unfunded superannuation liabilities, during the forward estimates the NFL to GSP ratio is expected to remain broadly constant. As the figure below shows, this is because the falling share of unfunded superannuation to GSP is being offset by a rising share of debt to GSP.

Figure 5.1.3 Major contributors to the NFL to GSP ratio



An issue taken up in Chapter 12 is whether the current fiscal targets are appropriate. In particular, the expression of fiscal targets as a proportion of GSP does not appear to be the most appropriate metric. The State has limited influence over GSP and more particularly, GSP does not represent the State's fiscal capacity or capability. In fact, there has been a long-term trend of declining state revenue expressed as a proportion of GSP. A more appropriate metric would be to relate the flow of liabilities, budget result, and net lending and borrowing requirement – and the stock, net debt and net financial liabilities – to state revenue.

6 RECENT NSW ECONOMIC PERFORMANCE

Key points

- Growth in NSW's real gross state product (GSP) per capita during the past two decades was tracking fairly similarly to other states until the first phase of the mining boom around 2003-04, but has since lagged behind the 'resource boom' states of Queensland and Western Australia.
- NSW significantly lagged behind Victoria in respect of growth in private business investment per capita over the last decade. NSW also underperformed in private housing investment compared to Victoria, which could be partly linked to government policy.
- The Independent Pricing and Regulatory Tribunal (IPART) found that while productivity growth in NSW industry sectors was slightly less than the Australian average over the past few years, the gap is narrow. NSW was found to have performed well against other states in respect of most productivity indicators.

6.1 NSW output growth performance

The output of an economy is typically measured in three ways: production (measured by value added by producers); expenditure (measured in terms of consumption and investment); and factor income (measured by return on inputs such as wages, rent, and profits). This section discusses NSW's performance mainly in terms of production and expenditure.

NSW has the largest economy of all the Australian states in terms of both output and employment. In 2009-10 (the latest year for which data is available), the size of the NSW economy in real output terms was $401.7 billion, representing approximately 31 per cent of the Australian economy. The next largest economy is Victoria, with an approximately 23 per cent share of the national economy in 2009-10.

The structure of the NSW economy differs from that of other states, with a greater diversity of industry sectors and a relatively larger proportion accounted for by finance, information, and media and telecommunications services; professional, scientific and technical services; and administrative and support services.

During the 1990s, the NSW economy experienced strong growth broadly in line with that of other states and nationally, and maintained this pace until around 2003-04, when the resources boom started. However, in recent years the NSW economy has not grown in real per capita terms[1] as quickly as some other state economies (see Figure 6.1.1 and Table 6.1.1).

Figure 6.1.1 Real GSP per working-age person, NSW versus other states

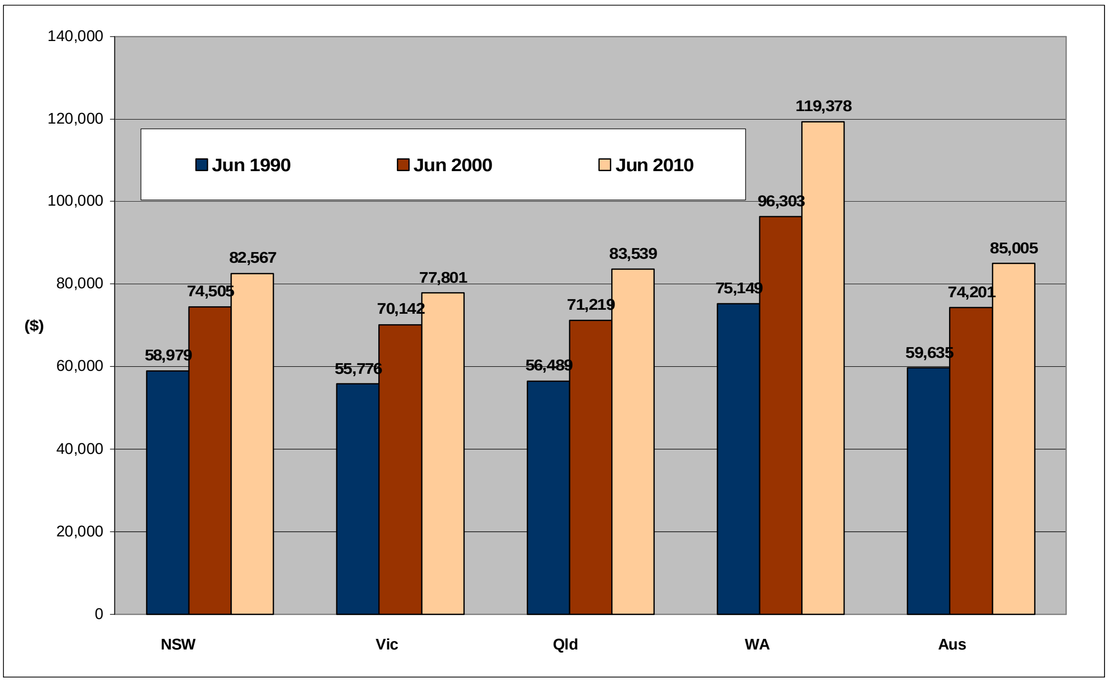


Table 6.1.1 Annualised growth in GSP, household consumption and business investment, NSW and other states (per cent per year, period average)

	Growth in GSP and components per working-age person* (per cent)				
	NSW	**Vic**	**Qld**	**WA**	**Aus**
1990–2010					
Gross state (domestic) product	1.7	1.7	2.0	2.3	1.8
Business investment	4.0	4.8	4.6	5.6	4.7
Household consumption	1.9	1.8	1.8	2.1	1.9
1990–2000					
Gross state (domestic) product	2.4	2.3	2.3	2.5	2.2
Business investment	4.2	4.6	3.1	0.7	3.8
Household consumption	2.2	2.2	1.6	2.0	2.1

1 Per capita throughout this section is defined as per working-age person. A working-age person is defined as a person aged 15 to 64 years. Per capita growth is used because this measure mitigates differences in population growth between states. In recent years, differences in per capita growth between NSW and the national average are explained largely by higher growth in participation and output rates in the 'resource boom' states of Queensland and Western Australia, which were in turn due to growth in mining investment and commodity exports driven by favourable terms of trade.

	Growth in GSP and components per working-age person* (per cent)				
	NSW	Vic	Qld	WA	Aus
2000–2010					
Gross state (domestic) product	1.0	1.0	1.6	2.2	1.4
Business investment	3.9	5.1	6.2	10.8	5.6
Household consumption	1.6	1.4	2.0	2.2	1.7

* A working-age person is defined as a person aged 15 to 64 years.

Sources: Australian Bureau of Statistics publications 3101.0 *Australian Demographic Statistics* and 5220.0 *Australian National Accounts: State Accounts.*

On the production side, the slowdown in NSW relative to other states has been mainly due to NSW having relatively less exposure to the large investment in mining resources as part of the first phase of the mining boom that started in 2003-04. Also, as the bulk (approximately 46 per cent) of Australia's finance and business industry is located in NSW, the industry was disproportionately affected by the global financial crisis (GFC) compared to other Australian states. NSW is structurally more exposed to economic turbulence in the United States and Europe than Queensland and Western Australia, which are more directly exposed to the strong but slowing North Asian economies (particularly China).

Recent NSW performance should also be viewed in the context of the seven-year housing boom from mid-1996 to mid-2003, during which house prices consistently rose faster than average weekly earnings. As NSW housing became less affordable, more people migrated to other states, particularly Queensland. Slower NSW population growth was due partly to this interstate migration, which in turn affected household consumption and dwelling construction. While NSW population growth has improved since the lows of mid-2004, it remains below growth levels in other states.

The end of the housing boom in late 2003 was followed by the resources boom, driven by international demand for minerals and other resources. Apart from coal, NSW has relatively little exposure to these sources of growth, which principally benefit Queensland and Western Australia. The first phase of the resources boom resulted in strong growth in mining investment in the resource-rich states, and also an appreciation of the Australian-dollar exchange rate relative to other major trading currencies. The latter adversely affected the international competitiveness of the NSW manufacturing and services export industries, including the important tourism industry.

NSW has also been more affected by drought – which has been ongoing intermittently since 2002-03 – than other states. This has had an adverse impact on agricultural exports, especially wheat. NSW was declared to be drought-free at the end of 2010. However, agricultural production was affected by floods at the end of 2010, which resulted in crop losses and quality downgrades.

Like all other major economies, the NSW economy was adversely impacted by the GFC and economic downturn abroad. Annual real GSP growth in 2008-09 slowed from

3.4 per cent to 1.1 per cent, although growth rebounded modestly to 1.7 per cent in 2009-10.

6.2 NSW productivity

IPART analysis[2] suggests that although productivity growth in NSW industry sectors has been slightly less than the Australian average over the past six years, the gap is narrow. IPART found that NSW compares favourably with other states on most key measures of productivity. NSW lagged behind other states only in its rate of investment in physical capital, but performed well regarding level of skills and innovation.

Noting that NSW's productivity record occurred in the context of a significant decline in the rate of productivity growth across Australia over the last decade, IPART also made the following findings:

§ There is no sign of NSW underperforming in GSP per capita relative to Victoria and Queensland during the slowdown in Australian productivity since 2003-04, and the modest gap between NSW and the national average is due largely to the strength of economic growth in Western Australia.

§ Out of 14 sectors that recorded rising national labour productivity during the period 2003-04 to 2009-10, NSW outperformed the national average in 10 sectors (including financial and insurance services, wholesale and retail trade, construction, accommodation and food services). However, NSW labour productivity fell significantly in three other sectors (mining; electricity, gas and water; and arts and recreation services).

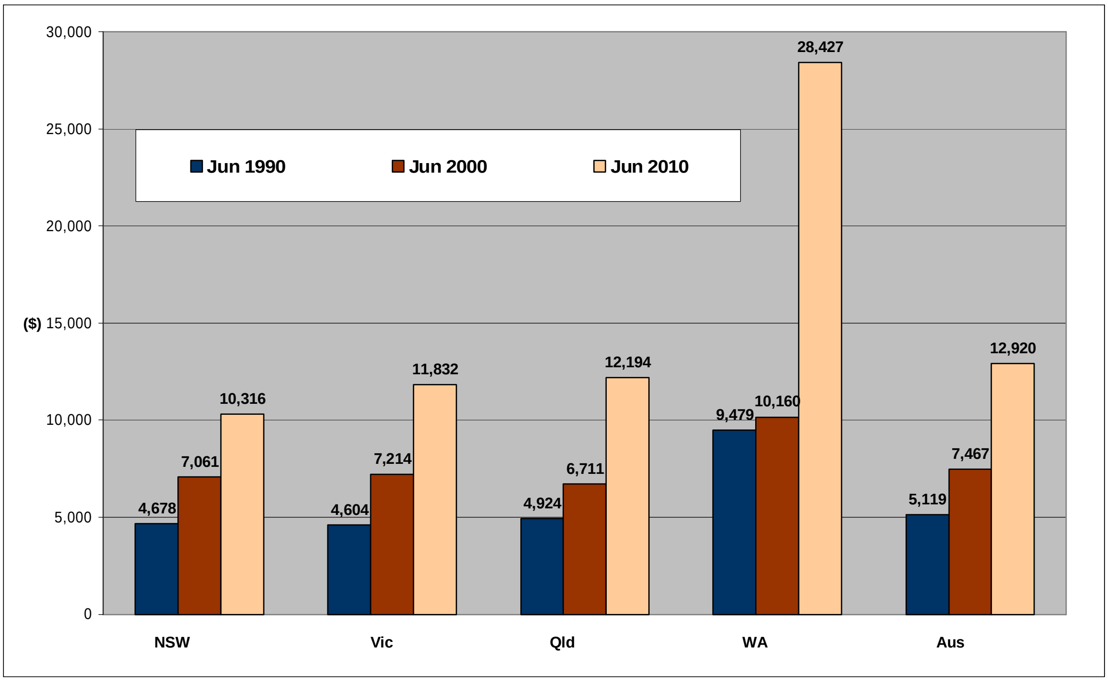
§ In terms of drivers of productivity, NSW went through an era of low investment in physical capital in the 2000s, but this trend is now less evident.

6.3 NSW investment growth

On the expenditure side of the economy, differences in real per capita growth in household consumption between NSW and other states have been relatively minimal over the last few decades. However, in respect of private business investment, NSW has lagged significantly behind other states. The gap in private business investment growth has widened between NSW and other states during the past decade, as shown in Table 6.1.1 and Figure 6.3.1.

2 IPART (2011), *Reform Priorities: Report to the NSW Government*, April 2011, pp.11–12 and Appendix A.

Figure 6.3.1 Real business investment per working-age person, NSW versus other states



This is true even in comparison with Victoria, which, like NSW, is relatively less reliant on the mineral resources investment boom. Part of this underperformance can be explained by the privatisation of the Victorian electricity industry in the late 1990s, which has seen private engineering construction activity grow more strongly in Victoria than in NSW. However, other components of private business investment – including plant and equipment, and commercial and industrial non-residential building – have also grown more quickly in Victoria than in NSW over the last decade.

The largest underperformance in NSW over the past decade has been in housing investment. Since a peak in 1999-2000, private completions of detached dwellings have since fallen by 48.5 per cent across NSW, and private completions of multi-unit dwellings have fallen by 56.8 per cent, as shown in Figure 6.3.2. In contrast, during the same period in other parts of Australia, private completions of detached homes increased by 1.3 per cent while other residential completions rose by 44.3 per cent[3], as shown in Figure 6.3.3.

3 Australian Bureau of Statistics data, Treasury analysis.

Figure 6.3.2 NSW private dwelling approvals versus dwelling completions (quarterly, number, seasonally adjusted)

Beyond keeping a sustainable fiscal position, state governments can do little in terms of macroeconomic policy. To a large extent, states' economic cycles are determined by monetary policy (through the Reserve Bank of Australia), Commonwealth fiscal policy, international demand for goods and services, and the strength of the Australian dollar. However, while states have limited capacity to manage aggregate demand, they may be able to influence the supply side. States are responsible for delivering services relating to the use of land and the regulation of economic activities within their borders – for example, development planning approval processes and regulations that affect housing supply.

The private sector has pointed out that a number of factors – including regulatory restrictions, slow or lengthy development approval processes, and a lack of confidence that planning regulations will not be subject to constant change – have increased uncertainty and added risk premiums to the costs of development activity in NSW.

While there is no single dominant cause of the lack of housing production in NSW, the private sector believes that these factors have contributed to a substantial decline in production in NSW compared to increases in other parts of Australia.

Figure 6.3.3 Completions of private houses and units in NSW and rest of Australia (index 1999-2000 = 100)

6.4 Conclusion

The current resources boom and high exchange rate reflect trends in relative prices in the global economy; however, there is no certainty that these will persist in the long term. Going forward, the NSW economy would be best placed to deal with future uncertainties if its economic policy fundamentals gave it sufficient flexibility to deal with future changes in relative prices and other economic shocks.

Taking into account that private investment is subject to the economic cycle, there is some latitude for the Government to encourage future business investment growth by encouraging competition, reducing the regulatory burden and providing an economic policy framework that allows input and output markets to function as freely as possible, in as many industries as possible.

PART B: FINANCIAL SYSTEM, PROJECTIONS AND SUSTAINABILITY

Part B provides an explanation of how the budget and capital program processes operate, and identifies deficiencies in the current systems.

Complementary to this, Part B provides an overview of the governance arrangements that apply to public trading enterprises and reviews the financial performance of that sector. An assessment of the governance and commercial policy framework is provided.

Chapter 10 includes projections of the medium-term financial outlook under a number of scenarios, followed in Chapter 11 by an assessment of the concept of fiscal sustainability and an identification of the broad gap between the financial projections and what is required to achieve fiscal sustainability.

This analysis leads on to the assessment of what reforms need to be undertaken to restore fiscal sustainability, which is the subject of Part C.

7 OVERVIEW OF THE BUDGET SYSTEM

Key points

- The annual State Budget is the principal mechanism for determining the level of resources to be drawn from the community and how these limited resources will be allocated to specific areas of government activity.
- A typical annual budget cycle commences in September and concludes in June.
- Forward estimates are rolling baseline projections for the budget year, plus the next three years
- Results and Services Plans (RSPs) demonstrate how the provision of general government agency services contributes to planned results and government priorities.
- The current wages policy limits budget funding of wages growth to 2.5 per cent per annum, with additional wage outcomes funded by employee-related cost savings.
- Efficiency dividends have been set for general government agencies to ensure that services are delivered in the most efficient and cost-effective way possible.
- While the budget process architecture is sound, there is a lack of full accountability, and in the last four to five years, significant weaknesses have developed regarding how the process is applied. In particular, budgets have not been developed within a medium-term framework; there has not been a clear statement of priorities; programs have not been systematically evaluated; and budget compliance has been poor, reflecting a lack of accountability for financial management.

7.1 The budgeting and forward estimates process

Overview

The annual State Budget is the principal mechanism for determining the level of resources to be drawn from the community and how these limited resources will be allocated to specific areas of government activity. It represents the financial plan of revenue and current and capital expenditure for government agencies. It includes all agencies – budget-dependent and non-budget dependent – in the general government sector.

The time frame for the State Budget is 12 months in terms of the formal process of parliamentary approval for appropriation of funding, but extends out a further three years in terms of expenditure and revenue estimates. The forward estimates are the rolling baseline projections for all revenues and expenditures for each year of a four-year planning horizon (i.e. the budget year, plus the next three years). After the Budget is passed, the first year of the forward estimates becomes the base for the next year's Budget and another future year is added to the forward estimates.

The Budget is developed within the broader context of the State's fiscal strategy, the details of which are set out in Budget Paper No. 2 each year. The fiscal strategy is designed to manage the State's financial resources in a manner that supports the Government's service delivery objectives. It demonstrates the relationship with the fiscal targets and principles set out in the *Fiscal Responsibility Act 2005*. The fiscal strategy focuses on managing and strengthening the balance sheet and provides a basis for setting major fiscal aggregate targets for the four-year period covered by the Budget.

Roles and responsibilities

The annual budget cycle is an intensive process that normally involves interaction between the Budget Committee of Cabinet[1] (BCC), the Treasurer, ministers, NSW Treasury and agencies.

The BCC is responsible for developing the budget strategy, overseeing the preparation process and monitoring the budget position within the year.

The Treasurer leads Treasury in managing the process on behalf of the BCC. Treasury collects and analyses data and submissions from agencies and makes recommendations to the BCC. Typically, a senior-level officers group (representatives of the Premier's and Treasurer's Offices, Department of Premier and Cabinet and Treasury) reviews funding recommendations before the Treasurer submits them to BCC for decision.

Treasury provides the Treasurer with advice on economic conditions, state revenue projections and fiscal strategy. Treasury also prepares reports for the BCC during the year, to help monitor the budget position.

Ministers and agencies are responsible for service delivery within their Budget. They are invited to make funding submissions through the Budget process. This is to identify additional funding required to maintain current policies and proposed program enhancements. Such proposals must be prioritised and must fit within the overall funding envelope determined by the BCC.

Core components of the budget process

The Budget is framed around government policy and priorities as well as economic and other parameters for the short and medium terms. The core components of the process are set out below.

<u>Setting the fiscal strategy and parameters</u>

The Budget needs to be consistent with the longer term fiscal strategy and the associated fiscal targets used to track the success of implementing the strategy. Where there are deviations from the budget – due to, for example, unexpected surges in

[1] For the 2011-12 Budget, the Expenditure Review Committee of Cabinet (ERC) is the responsible committee, but thereafter the BCC will have this role; the ERC will then have the role of driving the strategy on expenditure savings and providing input on this to the BCC.

revenue that are not expected to be maintained – expenditure discipline should be maintained and the revenue surge should be used to prepare for inevitable adverse circumstances. This can be achieved by paying off debt or bringing forward funding of superannuation liabilities. Where adverse circumstances do arise and are not expected to continue, a short-term increase in liabilities is appropriate.

Setting service delivery and policy priorities

Having a clear view on priorities helps the BCC make trade-offs and choices between the relative merits of agency proposals or proposed revenue adjustments. The NSW State Plan guides priority setting and agencies should seek to develop their own plans around it.

Maintenance of effort proposals

Agencies are expected to fund minor recurrent proposals by restructuring within their funding envelope. Maintenance of effort proposals must demonstrate that additional funding or other budget adjustments are necessary to maintain existing government services and commitments in terms of service nature, availability, eligibility, quantity and quality. These proposals include rollovers or re-profiling of existing programs.

Enhancement of effort proposals

Enhancement of effort proposals deal with new programs or infrastructure projects that enhance effort – generally, these proposals aim to expand service delivery availability, eligibility, quantity or quality. These initiatives are assessed in the context of the Government's service delivery and policy priorities. The proposals must demonstrate a direct link to the NSW State Plan priorities or be critical in nature. Thresholds are also applied, and minor enhancements are expected to be met from within existing resources.

A summary of the budget timetable and process is set out below in Table 7.1.1.

Table 7.1.1 The budget process: major milestones in a typical annual budget cycle

Timing	Activity
September	A budget process advice letter is issued to agencies, to outline the budget process and provide early notification of: § any specific requirements in that year § the process for setting priorities § major decision points and § required agency inputs.
October	Agency allocation letters are issued, summarising current spending authorisations and budget funding. The letter also requests submission of maintenance of effort proposals on a no-policy-change basis, where expenses have increased for extraordinary, unforeseen and uncontrollable reasons. Forward estimates are updated.
November	Agencies submit forward estimates and maintenance of effort proposals to Treasury. Treasury updates the fiscal position based on a review of agency submissions.

Timing	Activity
December	The Half-Yearly Review is prepared on a no-policy-change basis, including provisions for maintenance of effort. The BCC considers the Half-Yearly Review and maintenance of effort provisions, and considers the potential for enhancement of effort (new policy) proposals. Selected agencies are invited to prepare enhancement of effort proposals based on the NSW State Plan and other government priorities. The Half-Yearly Review is released.
February	Enhancement of effort proposals are received from agencies and assessed.
March	Treasury updates the fiscal position. The BCC signs off all budget allocations and decisions. An allocation letter is issued to agencies.
April	Forward estimates are revised. Budget Paper material is received from agencies.
May	The BCC signs off on final estimates.
June	NSW Budget Day. A final allocation letter is issued to agencies, confirming budget allocations.

Instruments and controls in the budget process

Allocation letters

The allocation letter and schedules provide a continuous record of all the changes to an agency's forward estimates allocations. The starting point for each allocation is the agency aggregates set out in the previous letter, followed by adjustments approved since that time. The letter details the approved net cost of services and capital authorisation limits for the Budget and forward estimates period, against which agencies must plan and within which they must manage their operations. Any special conditions on expenditure or funding approvals are also included in the allocation schedules. Allocations are formally updated and issued three times during the budget cycle.

Escalation

Budget aggregates are published in dollars of the year, reflecting the impact of expected inflation over that period.

In the case of budget-dependent agencies, forward estimates data are provided by the agency and held in Treasury's financial information system, in base dollars. Escalation is calculated centrally by Treasury. Different escalation factors are applied to employee-related expenses, other expenses and revenues.

Wages funding policy

Employee-related costs are the largest component of expenses, accounting for close to half of the sector's budgeted expenses. The wage policy, implemented in September 2007, limits budget funding for wages growth to 2.5 per cent per annum, the mid-point of the Reserve Bank of Australia's 2 to 3 per cent target inflation rate.

This policy permits wage outcomes in excess of 2.5 per cent, funded by employee-related cost savings. The last round of awards and agreements resulted in most employees receiving wage increases at or near 4 per cent, with increases above 2.5 per cent offset by proposed employee-related cost savings. The policy has recently been updated and is addressed in Chapter 17.

Efficiency dividends

While all agencies are expected to increase their operating efficiency over time, since 2005-06 general government agencies have been required to return these efficiency gains to the Budget through an annual efficiency dividend. The aim is to develop a culture in which agencies continue to revisit their operations and activities so that services are delivered in the most efficient and cost-effective way possible.

An efficiency dividend of approximately $300 million (around 1 per cent of agency-controllable expenses) has been applied each year across the sector. Efficiency dividends were increased in 2011-12 and 2012-13 to 1.5 per cent in anticipation of savings from agency amalgamations and the Better Services and Value program (details of the program are set out in Chapter 15). Efficiency dividends built into the forward estimates for 2013-14 reverted to the long-term rate of 1 per cent. No efficiency dividend is currently assumed beyond 2013-14.

Contingencies

A contingency fund is held for in-year, unforeseen funding requirements. This fund is known as the Treasurer's Advance and is included in the annual *Budget Appropriation Act*. Treasury monitors the fund and prepares advice to the Treasurer for decisions on funding requests that are received from agencies.

Results and Services Plans

Results and Services Plans (RSPs) are strategic medium-term service delivery and funding plans that link agency funding with the achievement of government priorities through:

- the results an agency is working towards
- the services it delivers to contribute to those results and
- the costs of delivering those services as reflected in the agency's budget.

Most general government agencies are currently required to submit an RSP at least once every four years, at the commencement of each new term of government. RSPs are based on a robust results logic that demonstrates how an agency's services contribute to results, which in turn contribute to government priorities. The results logic is the basis for identifying the agency's service measures and result indicators.

Budget estimates are prepared on an RSP format. Agencies are required to report – following determination of the annual budget allocations – on a service group basis in the Budget Papers. These reports are presented in Budget Paper No. 3. This provides a framework for improving disclosure of agency service delivery performance, and is an annual public presentation of those aspects of an agency's RSP that can be directly linked to the agency's annual budget.

7.2 Risk management

The effective management of risk should be a key activity for all organisations, including those operating in the public sector. In the NSW public sector, risk management is a core component of both the NSW Treasury budget cycle processes (including the Statement of Business Intent, Results and Services Plan, and Total Asset Management Plan) and strategic planning processes (in line with NSW State Plan requirements).

Effectively managing risk involves a number of discrete steps, including:

- identifying risks
- assessing the probability and consequences of each risk
- developing strategies to mitigate each significant risk and
- implementing identified risk management strategies.

Risk should be managed as close as possible to the source of the risk. For example, the risk of failure of an agency's computer network or the risk of employee fraud should be managed at an agency level.

Where a risk is beyond the capacity of an agency to control, or the residual risk after mitigation strategies have been put in place is too great, insurance may be obtained, effectively transferring the risk to another party that is better able to manage it.

Agency risk management

In 2007, the Performance Review Unit of the Department of Premier and Cabinet (DPC) undertook a review of internal audit capacity in the NSW public sector. While the performance review concentrated mainly on internal audit, risk management practices were also covered.

The review identified some issues specifically relating to risk management, for example

- Many organisations needed to improve enterprise risk management to better drive internal controls and priorities for internal audit.
- While organisations were generally found to have a culture of risk management awareness, processes for effective implementation of risk management could be improved.

The review's key recommendation was to strengthen the whole-of-government policy and regulatory framework for governing internal audit and risk management. The review outlined a better practice approach, drawing upon the standards endorsed by professional associations and best practice in the public and private sectors. In particular, the review recommended that Treasury's risk management and internal control policy be updated to align with the Australian Standard for Risk Management AS/NZ 4360[2].

Treasury issued Treasury Policy Paper 09-05, Internal Audit and Risk Management Policy for the NSW Public Sector (the Policy) in August 2009, as a direction to department heads and statutory bodies, addressing the recommendations in DPC's performance review. Unlike previously existing guidelines, the Policy was mandatory.

The Policy sets out a number of corporate governance practices aimed at strengthening the internal control and risk management processes undertaken by NSW public sector departments and statutory bodies. These practices are encapsulated in the following six core requirements:

1. An internal audit function should be established and maintained.
2. An Audit and Risk Committee should be established and maintained.
3. The Audit and Risk Committee should have an independent chair and a majority of independent members. It should have at least three members, and no more than five members.
4. The Audit and Risk Committee should have a charter consistent with the content of the 'model charter', and governance arrangements should be in place to ensure the real and perceived independence of the committee and the rigour and quality of its oversight and monitoring role.
5. An enterprise risk management process appropriate to the department or statutory body should be established and maintained. The process should be consistent with Australian/New Zealand Standard 4360 on risk management.
6. The operation of the internal audit function should be consistent with the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing, and any additional practice requirements set by the Policy.

The department head or governing board of the statutory body is required to annually attest compliance to Treasury and to report this compliance in the annual report.

The Policy provides for the Auditor-General to conduct regular compliance audits on a sample of departments and statutory bodies.

Where a department or statutory body is unable to achieve compliance with the core requirements, an exception must be determined by the portfolio minister.

A recent review of the Policy conducted separately by Treasury and the Audit Office has shown it has widespread support, and has made a material, positive impact on agencies' operations. It is expected that a revised policy will be issued later this year, addressing a number of implementation issues identified by the review. In addition, Treasury has also undertaken to issue separate risk management guidelines.

[2] This standard has recently been superseded by an International Standard ISO 31000:2009.

Insurable risk

In the NSW public sector, insurable risk is mitigated (or managed) through its self-insurance arrangement, the Treasury Managed Fund (TMF). Membership of the TMF is mandatory for all budget-dependent agencies and is available to non-budget dependent agencies by application. The TMF provides a level of coverage that is without peer in the commercial insurance market.

The TMF provides worldwide cover in respect of:

- workers compensation (in accordance with NSW statute)
- liability (including, but not limited to, public liability, products liability, professional indemnity, directors and officers liability, and medical negligence)
- property (providing full replacement cover, both new-for-old and consequential loss)
- motor vehicle insurance
- miscellaneous loss, notably due to employee dishonesty or personal accident, or relating to overseas travel.

Indemnity is unlimited in value (subject to a $300 franchise). The general exclusions are limited to illegal activities, wear and tear, and inherent vice pollution (other than sudden and accidental pollution).

A comprehensive reinsurance program protects this broad range of cover. Property to the value of $127 billion is covered for any one loss of $3 billion, subject to a self-insured retention of $30 million for any one loss. Liability is covered for any one loss of $600 million, subject to a self-insured retention of $25 million. The State Library is the highest value risk covered, at $2.87 billion. Other risks covered include fine arts and contract works.

The TMF structure is based on managing the risk of operational losses (below the self-insured retention levels) and transferring the risk of catastrophic loss to the reinsurance market.

Implementing risk management practices is a fundamental obligation for all TMF member agencies. Agencies are provided incentives to improve their performance by managing their insurable risk prudently. Incentives include the following:

- Benchmark funding for budget agencies. For workers compensation, agency funding is based on comparison with interstate counterparts and industry benchmarks. For motor vehicle insurance, funding is based on comparison with private fleet data. Property, liability and miscellaneous insurance funding is based on the proportion of small claims to large claims, as small claims directly benefit from agency risk management. Agencies that outperform their benchmarks receive surplus funding.
- Workers compensation hindsight premiums. Original premiums are based on claims experience from the two years prior. Hindsight premiums are adjusted after three and five years according to actual experience. Agencies with

improved experience receive the financial benefit of a premium refund, while those with deteriorating performance are required to pay an additional premium.

- Motor vehicle hindsight adjustments. These are applied similarly to workers compensation, based on actual experience 18 months after the start of the fund year.

The TMF is an outsourced arrangement utilising professional claims managers to provide claims management services. Contracts for these services, which are subject to tender every five years, include incentives aligned to those of agencies to support overall TMF improvements.

Aggregate budget risk

The Budget and forward estimates are prepared on a no-policy-change basis; that is, the estimates reflect existing policy. Existing policies include:

- a commitment to provide for increases of 5.4 per cent per annum in the net cost of services for NSW Health, which allows for expansion in services and new hospital openings, but may result in reduced or increased hospital queues depending on demand
- education expenses that reflect projected growth in student numbers in line with established student to teacher ratios
- expansion in disability services under the Stronger Together 2 package, which may see an increase in the proportion of the population serviced
- maintaining at a static level the volume of services delivered by agencies without agreed funding arrangements
- indexation of agency spending in line with consumer price index (CPI) and wages policy (under existing wages policy, wage growth of 2.5 per cent is funded and all wage increases above 2.5 per cent must be offset by employee-related savings)
- agency efficiency dividends of 1 to 1.5 per cent per annum of discretionary spending, with NSW Health retaining any savings
- provisions for risk.

All budget estimates for revenues and expenditure are based on assumptions that may or may not be proven to be accurate. These assumptions can be based on:

- economic variables such as the rate of general inflation or levels of interest rates
- behavioural variables such as the propensity to buy and sell property, enrol children in government schools or take up new programs
- the likely outcome of intergovernmental negotiations or submissions to industrial tribunals
- expected improvements in productivity

- likely rates of construction and tender prices for individual capital projects and
- the propensity of the Government to adjust its service delivery expectations or revenue collections before the next Budget.

Given the above, all budget estimates have a probabilistic distribution reflecting their individual risk characteristics. Because the budget result represents the difference between two large numbers, year-by-year budget results can be volatile. For example, a 1 per cent variance in either revenue or expenditure results in a movement in the budget result of around $600 million which, in many years, is sufficient to move the Budget from being in surplus to being in deficit.

Budget estimates in NSW are based on an approach that attempts to ensure estimates reflect an equal likelihood that the actual outcomes will be higher or lower than the estimate. Despite this approach, the accuracy of aggregate budget estimates will depend on the existence of any systematic bias by forecasters.

Systematic bias can exist in a number of forms. For example, it is generally recognised that revenue estimates reflect a conservative bias – i.e. when revenues are rising sharply, budget estimates are likely to understate revenues. On the other hand, when revenues are falling, budget estimates are likely to overstate revenues. This bias reflects a natural tendency for revenue forecasters to avoid significant year-by-year deviations in estimates based on long-term growth trends. This approach can have significant consequences for budget aggregates where these revenues are large and highly volatile.

On the expenditure side, the predominant bias reflects general optimism – i.e. program managers assume outcomes can be achieved at a lower than actual cost over shorter timeframes than possible, risks can be managed within program budgets, and careful planning will accurately identify and quantify all risks.

At an aggregate level the Budget attempts to neutralise systematic risks in a number of ways. On the revenue side, while estimates are built on a bottom-up basis, they are also reviewed from a top-down perspective to minimise any overall conservative bias.

Systematic bias on the expenditure side of the Budget is managed in a number of ways. In the budget year, a contingency allowance for unexpected expenditure is made in the form of the Treasurer's Advance. The Treasurer's Advance allows for unexpected events requiring additional government expenditure during the course of the financial year, as well as optimism bias in expenditure estimates.

Beyond the budget year, the forward estimates make provision for known risks as well as optimism bias. For example, where programs have been funded for a limited period, the likelihood of the program being renewed is considered and, where prudent, a provision for the rollover of the program is made. More generally, the budget process explicitly attempts to identify expenditure risks based on likely future events. The 2011-12 Budget will, for example, make some allowances for the costs associated with introducing a carbon tax, despite it not being currently legislated.

In addition to provisions for specific risks, the Budget also provides for program costs increasing on a no-policy-change basis faster than these costs are provided for under normal cost escalation. For example, year-by-year changes in the number of children attending government schools or the number of people held in gaol cannot be known with certainty. Rather than increasing agency forward estimates in line with long-term forecasts of client growth – which may or may not occur on a year-by-year basis – the Budget holds a central provision for growth in service costs beyond normal cost escalation. The size of this provision reflects historical maintenance of effort claims by agencies.

7.3 The budget process – an assessment

The basic budget architecture is sound, though accountability arrangements are deficient. There is an administrative structure that ensures the Budget is prepared and approved in a timely manner. There are well-established procedures for ensuring coordination of the budget process, and developing and communicating the policies and guidelines that guide preparation of the budget. There are also well-established procedures that facilitate review, discussion, modification and adoption of a proposed Budget, and there are systems in place to monitor and report budgetary performance.

In particular, the forward estimate system is one of the reasons for Australia's stronger public sector fiscal position compared with many overseas jurisdictions, where the focus is often on one year only.

There has been a State Plan in NSW since 2006, a State Infrastructure Strategy since 2006-07 and fiscal responsibility legislation setting out fiscal principles and targets since 1995. A results logic approach has been established, linking outputs to outcomes throughout the management cycle. The results logic approach has been applied in the areas of planning (which uses Results and Services Plans); budgeting (Budget Paper No. 3 was based on a results logic approach in June 2008); and reporting (many of the better annual reports in the recent Premier's Annual Reports Awards adopted the approach).

However, there are weaknesses that should be addressed to strengthen the budget process. These weaknesses, which have built up especially over the last five or so years, are identified below.

Budget decision making has not been tightly aligned to Government strategy

The State Plan, launched in 2006 and updated in 2010 and 2011, was intended to provide a long-term blueprint for the delivery of services to the people of NSW. While the planning process developed a set of state-wide priorities, it did not consider in detail the resources necessary to deliver on the proposed targets, nor did it establish appropriate mechanisms for re-prioritising activities to priority areas. The absence of a strong link between priorities and available resources limited the usefulness of the State Plan as a tool to guide resource allocation decisions.

Consequently, there has been no consistent alignment of policy and budget decisions to a clearly articulated whole-of-government strategy and priorities. This has favoured resource allocation decision making based on short-term considerations through the annual budget process, inconsistent with a coherent long-term strategy.

Budget decision making has also not reflected the targets and principles in the *Fiscal Responsibility Act 2005*. Instead, budget outcomes have been rationalised within the context of a strategy after key budget decisions are made. In some cases this has required last-minute policy adjustments to expenditure and revenues, to achieve acceptable budget results such as the prepayment of rail capital grants, which occurred in the 2010-11 Budget.

The merits of existing programs are not formally evaluated

Resource allocation decisions made during the annual budget process only focus on new spending proposals. Funding decisions are incremental, and typically deal with around 3 per cent of total expenses.

There is no process for systematically evaluating expenditure on the stock of current programs – either to avoid duplication and overlap; or to identify policies that are ineffective or fail to provide good public value, and which could make way for other policies that yield higher public value outcomes at a lower cost. This issue is addressed further in Chapter 15.

Decisions on new policies and programs have not been evidence-based

Budget proposals have been brought forward without a proper business case. The requirement for agencies to have the Financial Impact Statement (FIS) attached to Cabinet Minutes approved by Treasury has not worked work well, because timelines for submissions are not adhered to, and even when FISs are submitted, they often contain inadequate or incomplete information. As a result, decisions have been made without appropriate evidence of the financial consequences.

Similarly, infrastructure expenditure decisions have been made without a proper analysis of costs, benefits and formal business cases. This decision-making weakness has contributed to poor project selection and a poor delivery record for major infrastructure works, with projects often running over time and over budget.

When considering sectoral issues involving multiple agencies, there is no formal requirement that all agencies affected by the content of a Cabinet Committee submission be consulted, though informal consultation sometimes occurs.

Performance against targets is not considered in budget decision making

Performance information is collected through the budget process and reported in Budget Papers. Despite this, performance targets are seldom used during budget decision making. Agency performance against performance targets is not formally reviewed as part of the budget process.

There are no mechanisms or incentives to ensure that the NSW Government considers performance information when making budget decisions.

Agency budgets and forward estimates are based on unrealistic assumptions

Forward estimates have been developed incrementally and are based on optimistic assumptions, especially with regard to agencies' ability to deliver efficiency dividends and wage offsets. Some agencies have been unable to fully achieve these across-the-board savings targets. As a result, budgets in many instances are unrealistic targets. Supplementation requests have become institutionalised, as agencies cannot manage within the budget originally allocated.

In response, Treasury has created central expense provisions to ensure that budget aggregates remain realistic.

The annual budget process is resource-intensive

The budget cycle occupies a significant part of each financial year, normally commencing in September and extending to June. Treasury and agencies consume extensive resources working on the process, rather than on analysis and decision making.

Each year, ministers and agencies submit numerous maintenance of effort proposals. Effectively, these proposals represent sector-wide risks to the forward estimates, which are currently implicitly assumed by the Treasurer, rather than being managed by agencies within their forward estimates.

Ministers and agencies also submit numerous low-priority enhancement of effort proposals each year. The lack of top-down budget priority setting has resulted in a significant number of ambit funding claims.

Inability to carry forward funding has led to sub-optimal spending decisions

Agency appropriations lapse at the end of the financial year. There is an annual year-end spike in expenditure as agencies rush to spend their budget allocation, sometimes leading to sub-optimal spending decisions.

Budget Committee of Cabinet processes have not functioned as intended

As part of the budget cycle, the Budget Committee of Cabinet (BCC) is charged with setting the budget strategy and key financial targets; reviewing funding proposals and forward estimates; and determining the final budget allocations.

However, in recent years the BCC has effectively operated a continuous, year-round budget process. Proposals have been approved on an ad hoc basis without evaluation against competing priorities or a fiscal strategy, and in some cases despite inadequate financial impact statements and business cases. Submission protocols are often ignored and last-minute proposals accepted. As a result, decisions have been made without an appropriate evidence base.

Systems to measure, monitor and hold ministers and CEOs accountable for performance have been inadequate

Accountabilities and incentives for fiscal discipline have been very weak. Chief Executive Officer (CEO) performance agreements have been between the CEO and the portfolio minister, which encourages CEOs to pursue the priorities of the individual portfolio minister rather than whole-of-government priorities, including fiscal objectives. The ability of CEOs to pursue whole-of-government objectives is also undermined when they are exposed to arbitrary dismissal by portfolio ministers.

There are no formal funding agreements in NSW. Budget compliance is not seen to be a core responsibility of ministers and CEOs. There are also virtually no incentives or sanctions for budget compliance and there is a history of agencies overspending their budgets. In other jurisdictions, CEO performance agreements are between the CEO and the Premier. This encourages CEOs to pursue whole-of-government priorities, including keeping to budget. The establishment of the Public Service Commission is an important step in the right direction, as is the new Government’s decision to have the Premier appoint CEOs on the advice of the Commission.

Further, the Public Accounts Committee and the Estimates Committee have been ineffective in holding ministers and agencies to account.

The Treasurer’s Advance has funded regular budget overruns

The Treasurer’s Advance, which should be used for unforeseeable contingencies, has been used to fund regular budget overruns as well as new programs outside the budget process. The Treasurer’s Advance is routinely exceeded and the Treasurer has annually submitted a supplementary appropriation bill to Parliament towards the end of the financial year.

8 OVERVIEW OF THE CAPITAL PROGRAM SYSTEM

Key points

- The key building blocks for developing the capital program for the general government and non-commercial public trading enterprise (PTE) sectors are:
  1. Rolling 10-year total asset management (TAM) plans prepared by agencies.
  2. The State Infrastructure Strategy (SIS), which assesses agencies' TAM plans to develop a total rolling 10-year capital plan.
  3. Individual project appraisals, developed by agencies and reviewed through the Gateway Review Process (Gateway).
- The key process for commercial PTEs is the Statement of Corporate Intent (SCI) for State owned corporations (SOCs) and the Statement of Business Intent (SBI) for other PTEs. These SCIs and SBIs are evaluated and endorsed by boards and then approved by the shareholding ministers. In addition, the independent regulator reviews the capital program of regulated SOCs as part of the five-yearly review and price path reset.
- Privately financed projects (PFPs) are one available procurement option, which in the 10 years to 2009-19 accounted for 10.9 per cent or $9.9 billion of the capital program. Projects capable of being delivered through a PFP arrangement are assessed in the same way as other projects and, if approved, are then progressed through the PFP process.
- While the capital program process (like the budget process) is sound and represents best practice, its actual application has been poor. There has been a lack of rigour in developing the SIS (particularly regarding the prioritisation of projects) and poor compliance with project appraisal and Gateway processes.

8.1 The capital program process

Overview

The NSW capital program comprises the capital expenditure estimates for the general government and PTE sectors. Total capital expenditure projections are specified over four years in the budget estimates and over a further six years in the SIS.

These total capital expenditure estimates are based on:

- approved amounts of capital expenditure in each year for specific approved projects (as listed in Budget Paper No. 4)
- provisions for future capital works that have not yet been approved (or for capital works in outer future years, even when agencies have not yet identified these works)

- Ø Some provisions are contained within major agencies' forward year capital estimates (for health, education, transport and commercial PTEs) and Treasury also holds a central 'unallocated capital' provision for the collective future needs of agencies (including smaller agencies that have volatile annual capital needs).

These capital expenditure estimates are currently produced by Treasury through the following separate but linked processes:

- § Four-year budget estimates are developed through the annual budget process.
  - Ø Budget-dependent agencies (general government agencies and non-commercial PTEs such as those in the transport sector) submit proposed capital projects and programs for approval by the Budget Committee of Cabinet (BCC).
  - Ø Capital programs for commercial PTEs (which finance their capital expenditure from own-source revenue, borrowings and equity) are agreed between shareholding ministers and the board according to the SCI or SBI process, supported by Treasury review and advice[1]. These commercial PTE capital programs are then included in total state budget estimates, along with the businesses' estimates for debt financing and dividend returns to the general government budget result.
- § Ten-year SIS estimates equal that allowed in the budget forward estimates for the first four years, with the following six years developed as follows:
  - Ø SCI and SBI estimates are prepared for SOCs and other major commercial PTEs.
  - Ø Treasury estimates are developed for major budget-dependent agencies (NSW Health, the Department of Education and Training, NSW Police, the Department of Transport (including all other transport entities) and Housing NSW) based on a review of their TAM submissions (as described in more detail below). Similarly to budget estimates, a combined provision is also estimated for all smaller general government agencies.
  - Ø Total SIS capital estimates are presented to the BCC for approval, along with corresponding fiscal projections developed by Treasury (as described in Chapter 10).

  The SIS provides an estimate of total capital expenditure requirements, but does not necessarily contain all projects listed in agency TAM plans, nor does it constitute a fully populated list of committed projects.

---

[1] Statement of Corporate Intent (SCI) for State owned corporations and Statement of Business Intent (SBI) for other PTEs. The Commercial Policy Framework sets out requirements for PTE capital investment. These requirements are generally required to be consistent with the principles underlying TAM and procurement policy for the general government sector. Capital expenditure programs may be driven by licence conditions or service standards set by the Government. For some major businesses, such as electricity and water networks, proposed capital programs are reviewed by an independent industry regulator, which determines efficient levels of capital expenditure (over a rolling five years), and the allowed price path to fund this and recurrent expenditure. For commercial PTEs operating in competitive markets (such as Landcom, Pillar Administration and Forests NSW), the capital program is part of the business strategy, which is subject to the disciplines of the marketplace.

- The BCC may also determine 10-year capital planning limits for certain agencies or sectors (e.g. the Metropolitan Transport Plan (MTP)).

Budget forward estimates and SIS estimates are updated twice a year, with the Budget and the Half-Year Review. However, SIS estimates are only published every second year (at or near Budget time), when they are included in a report that maps out major infrastructure priorities aligned to other high-level government plans such as the Metropolitan Plan, Regional Strategies and State Plan.

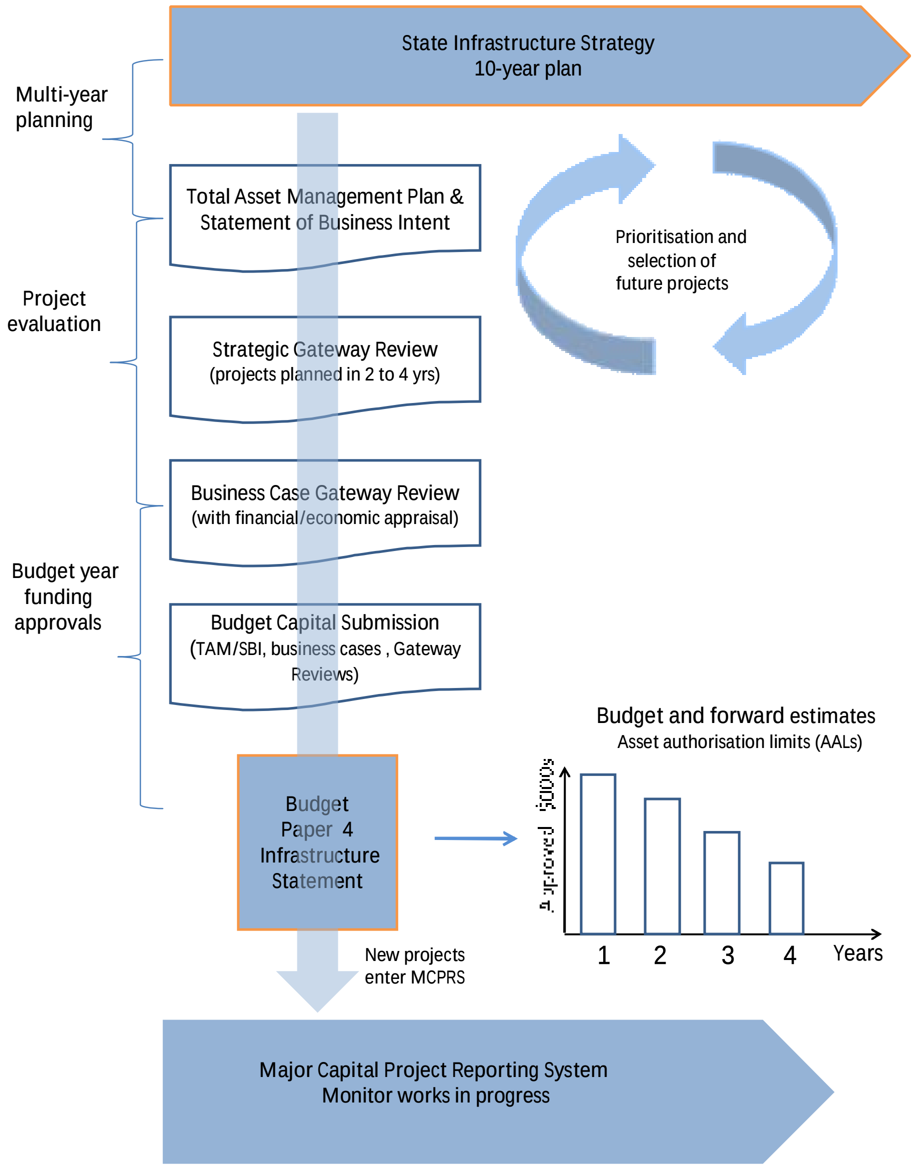
The remainder of this section focuses on the processes for determining the budget-dependent capital program.

Budget capital planning, approval and monitoring processes

Figure 8.1.1 depicts the processes for developing and delivering the State's budget-dependent capital program. This commences with 10-year SIS capital estimates (based on agencies' 10-year TAM plans); proceeds to individual project evaluation requirements, and final project and funding approval by the BCC (for inclusion in Budget Paper No. 4); and ends with the subsequent monitoring of project delivery according to the Major Capital Project Reporting System.

The early stages of capital program development require an iterative process, with plans for forward and outer years of the SIS revised annually in response to ongoing project development and changing priorities and economic circumstances.

Figure 8.1.1 Key elements of the capital program process



The overarching policy frameworks for project planning and approval are the TAM Policy and NSW Procurement Policy, which determine agencies' capital submission requirements for the annual budget process. The BCC agreed to updated TAM requirements to support the development of the SIS in July 2007. These were promulgated through Treasury Circulars TC08-06 and TC08-07, and Treasury Policy Paper TPP08-02 *Total Asset Management (TAM) requirements for updating the NSW State Infrastructure Strategy.*

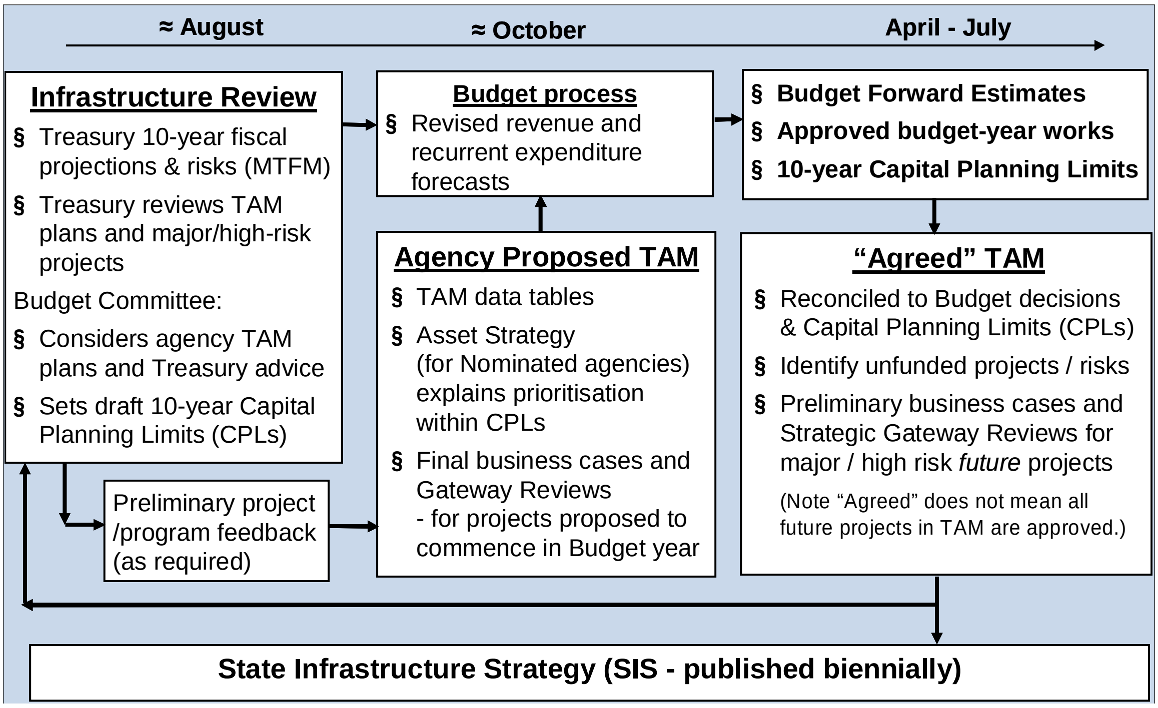
Agency submission requirements and the cyclical annual TAM and budget capital process are depicted in Figure 8.1.2 (drawn from TPP08-02).

The process commences with agencies preparing proposed TAM plans, which have a 10-year rolling time horizon and set out each agency's asset management strategy as well as proposed capital investments over the planning horizon. Agencies also prepare business cases to support projects seeking approval to commence in the budget year or soon after.

Treasury reviews agency TAM plans and business cases, and recommends specific projects and/or total capital expenditure limits for each agency, to be decided by the BCC. The approved capital program is then incorporated in the Budget and 10-year SIS (together with commercial PTE projects and capital expenditure levels approved through the SCI and SBI process).

The start of the budget process is also informed by an Infrastructure Review, which draws on the TAM plans from the previous year's process ('agreed TAM plans' are plans that agencies have modified to be consistent with the previous budget process decisions). The Infrastructure Review is intended to provide a strategic context for the budget process, so that near-term budget decisions can take into account the Government's longer term infrastructure plans and funding requirements, while remaining consistent with fiscal constraints. The Infrastructure Review should prioritise, at a high level, the Government's service objectives. This should result in draft 10-year capital planning limits for major agencies, which can guide agencies' future asset planning and the prioritisation of budget project proposals within available funding.

Figure 8.1.2 Iterative cycle for annual TAM submissions and capital approvals



In practice, the focus to date has been on transport – the timing of the Infrastructure Review from 2008 to 2010 was aligned to the Government's transport planning processes, culminating in the release of the MTP in early 2010.

An important part of the Infrastructure Review is developing 10-year fiscal projections in Treasury's Medium Term Fiscal Model (MTFM), because the sustainability of these projections and the affordability of the SIS are critically dependent on assumptions for agencies' recurrent expenditure growth.

Budget capital submissions

As indicated in Figure 8.1.2, agencies' annual capital budget submissions (whether maintenance of effort or enhancement of effort) should include the following:

- Proposed TAM data tables, showing proposed annual capital expenditure, by project, over at least four years, and ten years for planned projects (or programs of minor works) with a total cost over $10 million.
- An asset strategy (for nominated agencies only), which should explain how the proposed capital projects are prioritised within expected funding levels, to achieve efficient use of all assets and best meet agency service needs. The strategy should balance asset expansion against maintenance requirements; consider alternatives to asset investment, such as demand management policies; and identify how the project aligns with broader government strategies and plans.
- Business cases (including financial impacts and full economic appraisals for projects over $5 million) and Gateway Review reports as required by Procurement Policy, for individual projects seeking final funding approval for the upcoming budget year, and also for major projects in planning stages (especially those planned to commence during the forward estimates period)[2].
    - The required content of business cases (and preliminary business cases) is specified by Treasury guidelines (TPP08-05) and includes the need to identify and objectively evaluate multiple alternative service delivery options, and to develop strategies for managing risks and delivering intended community benefits. Economic appraisals should comply with Treasury guidelines (TPP07-05), and should include all material financial, social, economic and environmental impacts.

[2] For projects seeking approval to commence in the upcoming budget year, the Procurement Policy (as specified in TC08-07 and TC010-13) requires business cases for all projects over $1 million, and a Business Case Gateway Review for projects over $10 million, unless the project is assessed as low risk and Treasury has not requested a Business Case Gateway Review. Risk assessments must be conducted for projects over $1 million and must use the Gateway Project Profile Assessment risk evaluation tool. Preliminary business cases are required for any project over $10 million that is planned to commence in the subsequent three years, along with a Strategic Gateway Review, (unless the project is assessed as low risk and Treasury has not requested a Strategic Gateway Review). Preliminary business cases are also required for projects over $50 million planned to commence in the upcoming five- to 10-year period (once project development expenditure exceeds $1 million), and Strategic Gateway Reviews are required for all projects commencing beyond the budget year and proposed for SIS publication or other public statement.

- Gateway Reviews are short (conducted over two to three days), structured, independent reviews arranged by Treasury, using reviewers from the public and private sectors. The reviews occur at critical decision points (gates) in the planning and procurement process and are designed to assist agencies and Treasury by testing the soundness of the project business case (e.g. to ensure value for money) and the agency's capacity and capability to successfully manage project delivery (in terms of asset delivery – on time and on budget – and achieving intended service benefits). Reviews examine what alternative strategic options have been considered to meet service needs; the social, economic and environmental impacts of the project; the adequacy of project governance (including stakeholder, change and risk management); and weaknesses in the business case and project planning that may need to be addressed.
- The Gateway process applies to all general government agencies, government businesses and any SOCs nominated by Treasury. Treasury Circular 10-13 outlines Gateway Review requirements, and specifies that they apply to the procurement of all construction, goods and services (including information and communications technology), property and accommodation. There are six gates: Strategic, Business Case, Pre-Tender, Tender Evaluation, Pre-Commissioning and Post-Implementation. The Strategic and Business Case gates are mandatory subject to size and risk thresholds (they typically apply to capital projects over $10 million)[2].

These budget submissions are reviewed by Treasury to inform its advice to the Government on spending and funding priorities in the budget process, and to help it estimate required capital provisions for the SIS. Submission and review of supporting information for planned forward year projects facilitates earlier identification of risks and alternative service delivery options, before project planning progresses too far. These submission requirements are also designed to help the Government decide what forward-year projects should be included in the SIS publication (prior to final project approval and inclusion in Budget Paper No. 4).

TAM and Procurement Policy submission requirements apply to all general government agencies and PTEs except SOCs that are not nominated by Treasury as needing to comply[3]. The timing of submission requirements for non-budget dependent agencies is determined by key project decision-making points.

In practice, compliance with submission requirements is variable and Treasury reviews are prioritised according to perceived budget risk.

It is expected that in future, Infrastructure NSW will take the lead role reviewing agency TAM plans and major project proposals.

---

[3] However all SOCs are still required to develop a Strategic Asset Management Plan that is consistent with TAM and Procurement policies, and the board is asked to certify that its asset maintenance policies and processes are adequate and appropriate to manage and control risks associated with physical assets. Budget Committee approval is also required for large (over $100 million), risky or controversial projects, according to the *Guidelines for Assessment of Projects of State Significance (2002)*.

Monitoring project delivery

The capital works program represents planned investment at a point in time. Allocations for individual projects may alter during the course of the financial year depending on a range of factors, including construction schedule adjustments, weather conditions, prices varying from pre-tender estimates, and revisions to the project scope.

Capital expenditure must be managed within the asset acquisition authorisation limits approved by the BCC, which apply to capital expenditure (in the budget year and three forward years) on current works in progress and approved new projects. These authorisation limits apply to all budget-dependent general government agencies with a capital expenditure program, regardless of the specific project funding source (including, for example, assets acquired through finance leases or partly funded through agency asset sales).

The authorisation limits system provides some flexibility for ministers to manage their capital expenditure program within these limits when unforeseen events occur. Ministers may approve variations within capital programs under certain conditions; all other variations require prior approval by the Treasurer.

For budget-dependent PTEs, there are no formal accounting controls on capital expenditure other than through SCIs or SBIs, and the level of budget capital grants provided.

Projects approved by the BCC and published in the Budget Infrastructure Statement are monitored on an ongoing basis by Treasury using the Major Capital Projects Reporting System (MCPRS). The MCPRS is an established tool for monitoring project delivery and implementation, and could support Infrastructure NSW with early identification of risks including delays, impediments and cost variations.

8.2 Privately financed projects

There are broadly two kinds of privately financed projects (PFPs): those for social infrastructure such as hospitals, schools or transport; and those for economic infrastructure such as toll roads. The essential difference between the two types is the level of revenue risk transfer: where the private sector will take the full revenue risk, as in an economic PFP for a toll road, the project is not on the Government's balance sheet[4], whereas social infrastructure PFPs are on the balance sheet.

Value for money is determined by comparing complying bids against the Government's assessed cost of building, financing and operating the project[5], using tools such public sector comparators and net present value analysis.

[4] At the present time (July 2011), it is has been difficult to get the private sector to take full revenue risk on infrastructure projects.

[5] On the same basis as requested of the private sector.

Studies comparing business case estimates to final costs across all Australian states have concluded that significant cost overruns occur when infrastructure is procured through traditional and alliancing methods (average 35 per cent and 55 per cent respectively), whereas PFP procurement resulted in 11.6 per cent average price overrun[6 7 8].

Notwithstanding this low price-overrun advantage, in the decade to 30 June 2010, PFPs were used for less than 11 per cent of infrastructure procurement in NSW. Once a social infrastructure PFP contract is signed, capital expenditure by the private party and state repayment over the term are fixed under a PFP. In contrast, capital expenditure and repayment under alliancing and traditional procurement can be varied relatively easily, allowing for flexibility in accord with volatile budget receipts and expenditures.

Some of the techniques employed in PFPs can be used to improve other procurement outcomes. In particular, three techniques or value drivers used in PFP procurement could assist agencies in their procurements. These are:

1. a detailed and complete project scope prepared by the agency, following extensive stakeholder consultation and needs analysis
2. a detailed risk investigation and risk sharing plan
3. a detailed cost estimate showing how much it would cost the public sector to build and operate the project (public sector comparator)[9].

Contractor capability

Although the PFP model transfers construction risk to the private sector, the ability of the contractors utilised by the PFP company to deliver the underlying project is a key constraint on whether the project is ultimately successful. Significant delays in construction can occur if the contractor underestimates the scale or complexity of the construction task, or fails to manage the program or interface risks effectively – thereby delaying the project asset entering into use and the subsequent public benefit the project was intended to deliver. While this issue is not confined to PFP projects (the same problems can arise in traditional procurement), a particularly vigorous assessment of the capability of PFP counterparties needs to be undertaken, particularly for large-scale or complex projects. This should be addressed in the tender evaluation phase, by placing more emphasis on the contractor's ability to deliver in a range of circumstances.

---

6 *In Pursuit of Additional Value – a Benchmarking Study into Alliancing in the Australian Public Sector*, Department of Treasury and Finance, Victoria, and Evans and Peck and University of Melbourne, October 2009, p.19.

7 *Performance of PFPs and Traditional Procurement in Australia*, Report to Infrastructure Partnerships Australia, The Allen Consulting Group, November 2007, p.1.

8 These studies showed that large cost overruns associated with alliancing procurement occurred particularly in Queensland, and that NSW cost overruns were lower.

9 These additional information sources will better inform the investment decision.

Project selection

Projects, whether they are intended to be financed by PFP or not, should all be evaluated on the basis of cost-benefit. Only once a project has been assessed as suitable for proceeding should the range of financing options be considered. The decision on which projects are undertaken using the PFP model should be driven by the extent to which the project risks can be effectively transferred to the private sector on a value-for-money basis. The Government has tended to be attracted to PFPs involving an income stream (e.g. a toll road) that can help the project deliver on an off-balance-sheet basis, rather than choosing PFPs based on an analysis of whether the public or private sector is better able to manage underlying risks (such as traffic risks) and the economic benefit to the public of the service enabled by the PFP project.

Table 8.2.1 Selected PFPs awarded in NSW

Policy area	Project	Value ($)
Rail	Rail Electric Passenger Rollingstock (under construction)	3.6 billion
Housing	Bonnyrig Living Communities Project (under construction)	733 million
Health	Orange Hospital Redevelopment (completed)	194 million
	Newcastle Mater Hospital Redevelopment (completed)	131 million
	Royal North Shore Hospital Redevelopment (under construction)	950 million
Justice	Long Bay Prison and Forensic Hospitals (completed)	126 million
Education	New Schools Project 2: 10 new schools (completed)	106 million
Energy	Colongra Gas Pipeline (completed)	70 million

Recent developments

The global financial crisis created a significant slowdown in private sector infrastructure financing and substantially altered the terms on which it is provided. Separately, the substantial losses incurred by private sector financiers on a series of Australian toll roads (the Cross City and Lane Cove tunnels in NSW; and the Airport Link and CLEM7 Tunnel in Queensland) have resulted in a dramatic reduction in the level of market risk that can be transferred to the private sector in future projects.

There is still market interest in availability-based PFPs, in which the private sector takes on the construction, cost overrun, maintenance and operation risks on the basis of a series of availability payments. Post-construction, the asset is fully on the Government's balance sheet, with a corresponding liability. The objective of availability-based PFPs is not to take projects off the balance sheet, but to use the private sector to more effectively manage the key risks of major projects.

The value for money of availability PFPs could be improved by replacing some or all of the private sector debt with public sector debt post-construction, therefore minimising debt cost while still retaining the risk transfer benefits of private sector participation. The level of replacement of private by public sector debt and its timing will be dependant on the residual risk exposure of the private sector.

8.3 Assessment of the capital planning system

The capital program process – an assessment

Existing processes and requirements under total asset management (TAM) and Procurement Policy provide a sound framework for planning, evaluating and monitoring agency capital programs. However, the main deficiency is that the process has not been consistently and rigorously applied.

There are several areas that could be improved – these are detailed below.

Review of TAM plans

The State's strategic asset management and prioritisation would benefit from higher profile assessment and feedback on agencies' TAM plans, and a clearer link to budget decisions and forward capital provisions.

Although agencies' TAM plans are formally a part of their budget submissions, in practice they have not been consistently used to inform the Budget, in particular when setting allowances for future new capital works. Aside from transport, agency TAM plans have received relatively little focus or feedback from Treasury and the Budget Committee of Cabinet (BCC). A clearer, more consistent and more visible use of TAM submissions – with improved feedback to agencies – could make agency TAM plans more relevant, thereby encouraging higher quality infrastructure planning and prioritisation within fiscal limits.

Aside from transport, Treasury has not formally communicated to agencies its estimated capital allowances in the State Infrastructure Strategy (SIS) (that is the major agency capital planning limits (CPLs) that were envisaged in Treasury Policy Paper TPP08-02). This is partly due to continued above-budget forecast growth in recurrent expenditure, which adversely impacts the affordability of current SIS estimates, and therefore raises the risk of Treasury prematurely advising agencies of CPLs that subsequently become inconsistent with fiscal targets. This problem would be moderated if the Government committed to certain infrastructure expenditure levels and also to the required level of recurrent expenditure restraint to ensure fiscal sustainability (see Chapter 11) and the policy measures required to achieve this (see Part C).

Review of project business cases

As the Government's investment assurance program, the Gateway Review Process has helped strengthen and improve project business cases. Since 2004, 350 reviews for 515 projects (accounting for $40 billion worth of procurement) have been undertaken. Construction and information and communication technology (ICT) projects contributed to 85 per cent of the total reviews undertaken, and for 61 per cent of the total project value.

Projects reviewed using the Gateway process have been diverse as:

- the Barangaroo redevelopment ($1 billion) and subsequent Headland Park and pedestrian link projects

- RailCorp's Digital Train Radio System ($203 million) and Traction Supply Upgrade Programs ($871 million)
- the Public Transport Ticketing Corporation's electronic ticketing card ($240 million)
- the State Water Corporation's Keepit Dam Safety Upgrade ($117 million)
- NSW Police's Computerised Operational Policing System Modernisation ($74 million)
- the Digital Education Revolution – Student Learning Devices and WiFi Upgrade ($197 million)
- NSW Health's hospital redevelopments in Tamworth ($300 million), Wagga Wagga ($295 million), Bathurst and Orange ($200 million) and Blacktown and Mount Druitt ($200 million).

A 2008 review of the Gateway process[10] confirmed that the NSW process is essentially sound and that there is a real opportunity for the system to drive a government-wide agenda to improve capital projects planning and delivery in NSW. Fully applying the Gateway process could deliver advantages for all levels of government, in particular:

- NSW Treasury – in the initial risk reduction stages of project planning and approval (Strategic Review and Business Case)
- individual agencies – for the entire process
- whole-of-government – at the performance review stage (post project implementation), to inform better practice across all levels of government.

However, publicly funded infrastructure projects have not always been fully developed prior to receiving approval. A significant number of capital budget proposals have not been supported by a proper business case, a robust financial impact statement or a Gateway Review. The quality of business cases is also variable, with agencies sometimes treating economic appraisals as a Treasury compliance exercise. Instead of using evaluations to identify and evaluate optimal service solutions, agencies often conduct evaluations after they have already decided on their preferred project, using 'creative analytics' to produce desirable cost-benefit ratios and secure budget funding.

Some high-profile transport projects have been approved (or even announced without formal Budget Committee approval) before critical operational and financial constraints have been resolved. Often priority is given to new infrastructure options rather than options such as demand management that make more effective use of existing infrastructure and offer greater net benefits to the community.

This has led to projects being prematurely approved, despite being supported by limited financial analysis, little evidence of economic and community merit, or limited evidence of strategic priority. Ultimately, this has resulted in project cost blow-outs and projects being delayed or cancelled following their approval (which in turn creates a perception of failure to deliver).

[10] *Gateway Review Process Refresh Program*, Turner and Townsend, July 2008.

Failure to comply with procurement policy for major projects leads to a poor allocation of limited capital resources and ultimately squeezes available funding for the numerous ongoing capital works required across government, even when these smaller projects are supported by well-developed business cases and offer higher net benefits to the community.

Project delivery monitoring

At an individual project level, agencies should be accountable for delivering projects on time, on budget, and with the intended service and community benefits. Agencies therefore need to develop appropriate monitoring systems to suit their various projects.

Centralised project delivery monitoring, conducted by Treasury or other central agencies, has changed over time, with varying emphasis on its importance and preferred scope or objective. The purpose of central monitoring should be clarified and should focus on holding agencies accountable for delivering projects and services. The role of central agencies (including Infrastructure NSW) should mainly be focused on identifying agencies' systemic failures, to inform intervention and drive improvement in those agencies for future project management. Reporting through the Major Construction Projects Reporting System (MCPRS) and to Cabinet may need to be refined to achieve this focus.

PTE sector capital program

The regulated commercial public trading enterprise (PTE) sector capital program has a significant impact on total state capital expenditure levels and debt financing, which can potentially constrain general government expenditure. However, these PTE investment plans, along with dividend returns to the general government budget, are not proactively managed as part of the annual budget decision-making process. PTE financial plans are developed through Statement of Corporate Intent (SCI) and Statement of Business Intent (SBI) processes, which do not clearly inform the Government of the trade-offs between SCI and SBI targets (such as dividends or debt limits) and other expenditure and revenue choices it is considering in the general government sector.

Conclusion

Existing policies and processes provide a strong foundation for effective capital and asset management. However, more consistent and higher profile application of these policies, and a closer integration with the budget process, are required to deliver improved financial management and investment outcomes for the community.

The establishment of Infrastructure NSW provides an excellent opportunity to address current planning, process and appraisal weaknesses. Infrastructure NSW will have a role in strategic planning, oversight of project appraisal (including feedback to agencies), giving advice on prioritising and monitoring major projects in the general government and PTE sector.

9 PUBLIC TRADING ENTERPRISES SECTOR

Key points

- The commercial policy framework is a governance regime designed to deliver improved performance and accountability, and provide competitive neutrality for government business undertakings.
- The full suite of commercial policies applies to State owned corporations (SOCs), while many specific policies also apply to other public trading enterprises (PTEs).
- The commercial policy framework has promoted improved commercial performance and efficiency in the two decades since it was introduced, but more can be done to improve performance, by engaging shareholding ministers, and improving scrutiny of financial performance and the quality of Boards.
- Shareholders' expectations of government businesses should be in line with performance benchmarks developed with reference to comparable private and public businesses.
- In a context of multiple accountabilities to shareholders and regulators, benefit could be gained from a streamlined performance reporting approach that incorporates key metrics relevant to each stakeholder. This will help boards of directors report transparently against various competing objectives, and may also help the public understand the factors that influence pricing, service standards and financial returns to government.
- Public reporting of government businesses' financial performance provides an incentive for good management, which would partially compensate for the absence of other market disciplines as in equity and debt markets.

9.1 Commercial policy framework

Background to the commercial policy framework

The commercial policy framework is primarily designed as a governance structure for SOCs, although many of its principles, such as competitive neutrality, also apply to businesses operating in the broader PTE sector.

The framework was introduced in 1989 under the Greiner government, in response to the 1988 Commission of Audit. The Commission found that the five main statutory authorities at the time were characterised by operating inefficiencies, excessive debt and debt servicing costs, over investment and poor asset management. The resulting subsidies to these authorities significantly reduced budget funding for core government services.

The Commission recommended reforming the sector by introducing a more commercially focused environment, with underlying principles of:

- clear, non conflicting commercial objectives
- independent boards and management, with managerial authority and autonomy
- effective performance monitoring, and rewards and sanctions to create an incentive to maximise value of the businesses
- a range of competitive neutrality measures to avoid advantaging or disadvantaging businesses relative to their private sector counterparts.

This regime was put in place through the *State Owned Corporations Act 1989* (the *SOC Act*), which was significantly amended in 1995 and is supported by a range of policies administered by Treasury. Continued observance of these policies is a requirement of the Council of Australian Governments (COAG) Competition Principles Agreement 2007.

The SOC model has been in place in NSW for more than two decades. It has proven to be a relatively effective governance structure, imposing private sector disciplines on major government businesses and, in doing so, materially improving their financial performance, contribution to the Budget and service delivery. The SOC model is the core of the commercial policy framework. This section examines the key elements of the framework which have contributed to its successes. Section 9.2 provides benchmark information on SOC performance.

Despite the relative strengths of the SOC model, adherence to it has weakened over time. Section 9.3 assesses the current approach to the commercial sector and Chapter 18 suggests reforms aimed at strengthening the commercial policy framework.

Institutional framework – separation of policy and ownership roles

To ensure different interests are represented and any conflicts are considered openly, a sound practice is to separate advice on policy and regulation for the services provided by SOCs on one hand, from the ownership function on the other. This gives boards of directors clear commercial objectives so they can manage within agreed objectives, and provides benchmarks against which performance can be assessed.

The commercial policy framework in NSW does separate the roles in this way. In common with New Zealand and most Australian states, a shareholder review unit is located within Treasury to maintain links with the policy and fiscal roles. Current arrangements in NSW are as follows:

- The portfolio minister sets quality standards and directions to implement public policy. Under the *SOC Act*[1], the portfolio minister must obtain the Treasurer's agreement for directions, and recompense may be paid by agreement with the Treasurer.

[1] Exceptions are Landcom and the NSW Port Corporations, for which the portfolio minister may issue directions before they are considered by the Treasurer.

- For electricity and water SOCs, operating licences are set by the relevant minister, allowing each entity to operate in NSW and specifying reliability, consumer and environmental standards.
- The Independent Pricing and Regulatory Tribunal (IPART) advises on licence conditions and administers the licensing regime on behalf of the minister.
- For regulated businesses, prices are set by independent regulators (the Australian Energy Regulator for energy transmission and distribution, and IPART for water corporations) to recover the efficient operating costs of providing services under the licences, and provide a fair return on capital. There has been less scrutiny of pricing for non-regulated entities.
- Commercial objectives such as expected returns are approved by shareholders in the Statement of Corporate Intent (SCI) or Statement of Business Intent (SBI). Treasury advises on appropriate returns and monitors performance.
- The capital program is agreed with reference to demand, asset replacement and licensing conditions. Capital expenditure is financed via debt or equity, which may be provided via retained earnings or budget funding. The allowable capital program for the regulated activities of energy and water businesses is set by the independent regulator; for other businesses and non-regulated activities it is set in the SCI and SBI process.

Key elements of the commercial policy framework

Major policies within the commercial policy framework are:

Shareholder role – governance

- Board Appointment Guidelines
- Guidelines for Boards of Government Businesses
- CEO Contract Guidelines
- SOC Indemnity Policy

Shareholder role – performance

- Reporting and Monitoring Policy
- Business Planning – SCI and SBI
- Performance Reporting – quarterly reporting against SCI or SBI
- Capital Structure Policy
- Financial Distribution Policy

Competitive neutrality

- § Government Guarantee Fee
- § Tax Equivalent Regime
- § Social Program Policy

General policy

- § Projects of State Significance (Budget Committee approval of major projects)
- § Financial Appraisal
- § Corporatisation Manual
- § Treasury Management Policy.

Details of key policies

Board governance

The current Guidelines for Boards of Government Businesses set out a framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in government businesses. For SOCs, the board of directors is charged with governance of the entity.

The main recommendations of the guidelines are as follows:

- § Boards should develop, comply with and publish a charter that sets out roles, powers and responsibilities of the board and identifies key stakeholders and the board's responsibilities to each stakeholder. The charter should complement any legislative charter and should be reviewed regularly.
- § Boards should develop and comply with a code of conduct to ensure their integrity and accountability.
- § Boards should require that management report to them on the design and implementation of risk management and internal control systems.
- § Boards should form an audit committee and, in the case of SOCs, a remuneration committee.
- § The majority of board members should be independent rather than executive directors.
- § Directors should not concurrently hold directorships of more than three government boards.
- § Induction and continuing education should be provided to directors to enhance their understanding of the role of boards of government businesses, corporate governance generally and government policy developments.
- § Boards, committees and individual directors should be subject to regular performance evaluation, with frequency and methodology to be disclosed in annual reports.

The guidelines largely mirror standards that are recommended to help private sector businesses minimise risks concerning corporate governance, and optimise board performance and accountability.

SCIs, SBIs and reporting

The Statement of Corporate Intent (SCI) for SOCs and Statement of Business Intent (SBI) for non-SOC government businesses is an annual agreement between the shareholders and the business. The primary purpose of this agreement is to enhance accountability for performance and provide the business with certainty as to the shareholders' expectations for its financial performance.

The SCI or SBI must include:

- the objectives of the business and a summary of its strategic direction
- a description of core business activities
- financial and non-financial performance targets that have been agreed with the shareholders
- an overview of the capital expenditure program containing a brief outline of its nature and purpose and link with business objectives, and a list of new capital projects valued over $50 million or categorised as high-risk projects
- information on social programs and non-commercial activities
- information on major risks, including financial risks
- a statement regarding adherence to the commercial policy framework including the reporting and monitoring policy, accounting policies applied in the accounts, and agreed disclosure obligations
- information that SOCs will include in their Half-Yearly Reports
- any additional representation or commitment required by the shareholders such as adherence to other government requirements.

As an agreement between a government business and its shareholders, the final SCI should be signed by the shareholders, the chair and the chief executive. For businesses that are not SOCs, the SBI should be signed by the shareholders (the Treasurer and the portfolio minister), the chairperson of the board (where applicable) and the chief executive.

Reporting and monitoring policy for government businesses

This policy provides the requirements for information disclosure and communications in business planning, performance monitoring and reporting. It focuses on reporting and monitoring from a shareholder perspective. For government businesses, it is a surrogate mechanism for the accountability disciplines and reporting requirements faced by private sector counterparts.

The policy aims to:

- safeguard the value of government businesses and help ensure appropriate returns from taxpayers' investments

- enhance accountability in the management and control of the businesses and provide clarity on reporting and monitoring requirements
- balance the need for accurate and timely information against any compliance burden, with appropriate private sector best practices and consistency with legislation
- promote cooperation, openness, mutual respect and information sharing between management, boards, the Treasurer, other ministers, regulatory agencies, and NSW Treasury.

Government businesses are required to:

- undertake a corporate planning process including preparing a business plan (in consultation with NSW Treasury) that aligns with the State's budget preparation cycle and is the basis for the annual SCI or SBI
- demonstrate a commitment to achieving financial and non-financial objectives and targets set by the Government when undertaking corporate planning
- sign an SCI or SBI representing an agreement with the Government on the objectives and obligations by which the business will operate over the next 12 months and following years
- provide quarterly reports of performance and other requested information to their relevant minister and NSW Treasury on behalf of the Treasurer
- provide timely disclosure of information that may have a material effect on the value of the business, including information that may influence government decisions or may require the Government to comment
- have in place robust internal procedures for capital projects, and provide information to NSW Treasury on major capital projects including quarterly reports required in this policy.

Capital Structure Policy

The purpose of the Capital Structure Policy is to ensure government businesses are financed by an appropriate mix of debt and equity to encourage efficient, commercial investment decisions and thereby maximise returns to shareholders.

Excessively high or low levels of debt can lead to excessive financial risk or a high cost of capital respectively, discouraging investment in opportunities that may otherwise have added value to the business. Capital structures set on a commercial basis allow for an appropriate return on equity. This ensures that the Government, as a shareholder, earns a rate of return from its equity investment in a government business comparable with equity holders in a private sector firm that has similar risks. A commercially based capital structure therefore minimises distortions in resource allocation between the private and public sectors.

Government businesses assess whether or not a potential investment project will add value to the business, by comparing the expected returns of the investment with the business's cost of capital. If the returns exceed that cost of capital, the project will add value to the business.

The appropriate capital structure for a government business is influenced by a number of factors that may vary between government businesses, including business-specific, industry and economic factors. These factors include:

- the level of capital investment and the appropriate approval of funding
- an acceptable level of financial risk for the business, as indicated by the business's individual credit rating
- debt service criteria, to match the debt market discipline faced by private sector firms
- the capacity to finance approved capital expenditure through internally generated cash flows and debt
- the need to provide sufficient flexibility for contingencies
- shareholders' dividend preferences.

The Capital Structure Policy and the Financial Distribution Policy for Government Businesses are inextricably linked, taking into account shareholders' preference for dividends.

Once the capital structure has been determined it will operate as an influence on dividends. In this way, actual dividend payments are used to maintain the business's capital structure within an approved range.

Setting the capital structure of government businesses to ensure a steady stream of dividends is consistent with private sector practice, where financing decisions are constrained by the likely response of shareholders and their perceived preference for dividends.

Financial Distribution Policy

As shareholder of government businesses, the Government expects an appropriate return on the equity investment in its portfolio of businesses. Financial distributions are the Government's primary means of realising a return from its equity investment.

Financial distributions comprise dividends and capital repayments. Dividends represent a return on the owners' equity investment in a business, while capital repayments involve a return of the owner's equity. Tax equivalent payments and government guarantee fees are not financial distributions as they do not represent either a return on, or a return of, the Government's equity investment in the business.

Dividends are an important source of ongoing funding for health, education and other social services provided through the State Budget. As such, the Government has a strong preference for dividends over capital gains and for a stable stream of dividends from its portfolio of government businesses.

An issue that has been raised in recent times is a concern that distributions from SOCs have led to increases in prices, thus impacting on consumers. This concern is based on a misunderstanding of how prices are set for the great bulk of SOCs that are in the energy and water sectors. SOCs in those sectors are subject to independent price regulation that is based on efficient capital and operating expenditure and has no regard to the level of distributions. Hence distributions are an outcome, not a cause of price setting.

The Financial Distribution Policy applies to all government businesses with the exception of business units of not-for-profit agencies. Exemptions may be permitted in limited exceptional circumstances.

The objectives of the policy are to:

- recognise the opportunity cost associated with the Government's equity investment
- enhance the transparency of, and accountability for, financial performance of government businesses
- ensure these businesses do not enjoy any special advantages over their private sector competitors
- support the initial determination and ongoing maintenance of each business's approved capital structure, in accordance with the Capital Structure Policy for Government Businesses.

Under the Financial Distribution Policy, dividend targets are negotiated annually between the shareholders, the board and the management of each government business, and are agreed in writing in the SCI (for SOCs) or the SBI (for other government businesses).

The policy requires government businesses to negotiate ordinary dividends based on post-tax profits. Ordinary dividends are the returns to shareholders generally sourced from current year earnings or the prior year's retained earnings. They are distinguished from special dividends, which represent additional, one-off dividend payments typically sourced from transactions, such as the sale of major physical assets.

A dividend payout ratio of 70 per cent of post-tax profit is used as a standard reference point based on commercial private sector practice. However, the target dividend payout ratio for individual government businesses may vary from the standard reference point, based on a case-by-case consideration of underlying capital structure and future cash flow requirements, including a contingency for financial flexibility. Businesses with the financial capacity to pay dividends based on payout ratios above 70 per cent are expected to do so.

In determining the annual dividend payment for each business, the cash flow requirements of the business must be recognised and dividend payments must not knowingly place the business at financial risk. On the other hand, a business should not retain any cash or financial investments in excess of its requirements. Such funds should be returned to the shareholders because investment in financial assets is not part of the core operations of government businesses.

Social Program Policy

The Social Program Policy applies to SOCs conducting non-commercial activities that have social objectives. Such programs are generally known as community service obligations (CSOs). The policy aims to separate commercial and non-commercial activities, and ensure a formal contract between the SOC and relevant portfolio minister with regards to delivering CSOs.

The key objectives of the Social Program Policy are to:

- provide a framework for the effective separation of SOCs' commercial and non-commercial activities to give management clear and non-conflicting objectives, thus enabling accountability for commercial performance and the delivery of social programs
- subject SOCs' social expenditure to the budget process, increasing transparency and enhancing Parliamentary accountability
- provide a framework to improve the effectiveness of CSO expenditure by applying appropriate review and evaluation processes.

Government Guarantee Fee Policy

The Government Guarantee Fee Policy for government businesses is designed to improve their competitive neutrality. The fee exposes government businesses to the risk-related cost of debt they would face if they were required to borrow funds based on their stand-alone credit rating. Government businesses can borrow funds at interest rates based on the credit rating of the State of NSW so without this adjustment, they have a financial advantage over private sector businesses.

A guarantee fee is levied on the outstanding debt of government businesses that:

- undertake commercial operations
- have borrowings greater than $1 million
- have a credit rating lower than that of the State of NSW
- are authorities, as defined in the *Public Authorities (Financial Arrangements) Act 1987* or scheduled under any other Act that refers to the Treasurer's role in providing a guarantee.

An annual credit rating is required for government businesses, to assess the ability of the business to meet its future debt obligations without the financial support of the NSW Government.

Guarantee fees are based on:

- the borrowings a business has outstanding in any one financial year
- the guarantee fee rate, which is the difference between the market interest rate for a business of similar risk and the cost of debt obtained from TCorp.

Tax Equivalent Regimes

NSW Government businesses are exempt from Commonwealth taxes under the State and Territories Bodies Provisions of the *Income Tax Assessment Act 1936* (the ITAA). However, to ensure competitive neutrality with private sector competitors and to comply with the National Competition Policy, government businesses must pay Commonwealth income tax equivalent payments as well as state taxes. These income tax equivalent payments are administered under two systems: the National Tax Equivalent Regime (NTER) and the Tax Equivalent Regime (TER).

The NTER is an administrative arrangement under which the relevant Commonwealth income tax laws are notionally applied to state and territory government-owned enterprises that have been nominated by their state or territory for inclusion in the regime. The Australian Taxation Office (ATO) administers the NTER in return for the NTER administration costs being paid for by the states and territories. The states and territories collect the income tax equivalent liabilities from each entity, as determined by the ATO. The NTER is governed by a memorandum of understanding between the Commissioner of Taxation, the Commonwealth, states and territories. The TER is administered by the NSW Office of State Revenue.

The NTER applies to corporatised and non-corporatised government businesses that are nominated by their respect state or territory*.* Government businesses that have been nominated for inclusion in the NTER are nominated because they are sufficiently commercial to comply with the ITAA-based income tax regime.

Government businesses that have not been nominated for inclusion in the NTER but which have not received an exemption from paying tax equivalents are covered by the TER*.* Under the TER, the tax equivalent liability is assessed annually using the prevailing rate of company income tax applied to accounting profits. All NSW government businesses subject to the TER must pay quarterly instalments of the expected annual liability to the NSW Office of State Revenue.

Newly formed government businesses that come under the commercial policy framework are, in the first instance, considered for placement under the NTER. If participation in the NTER is considered inappropriate, the government business is instead subjected to the TER.

A government business may be exempted from both the TER and NTER in exceptional circumstances, to suit the specific situation of the government business. An application for an exemption must be submitted to NSW Treasury for consideration by the Treasurer.

9.2 Benchmarking performance

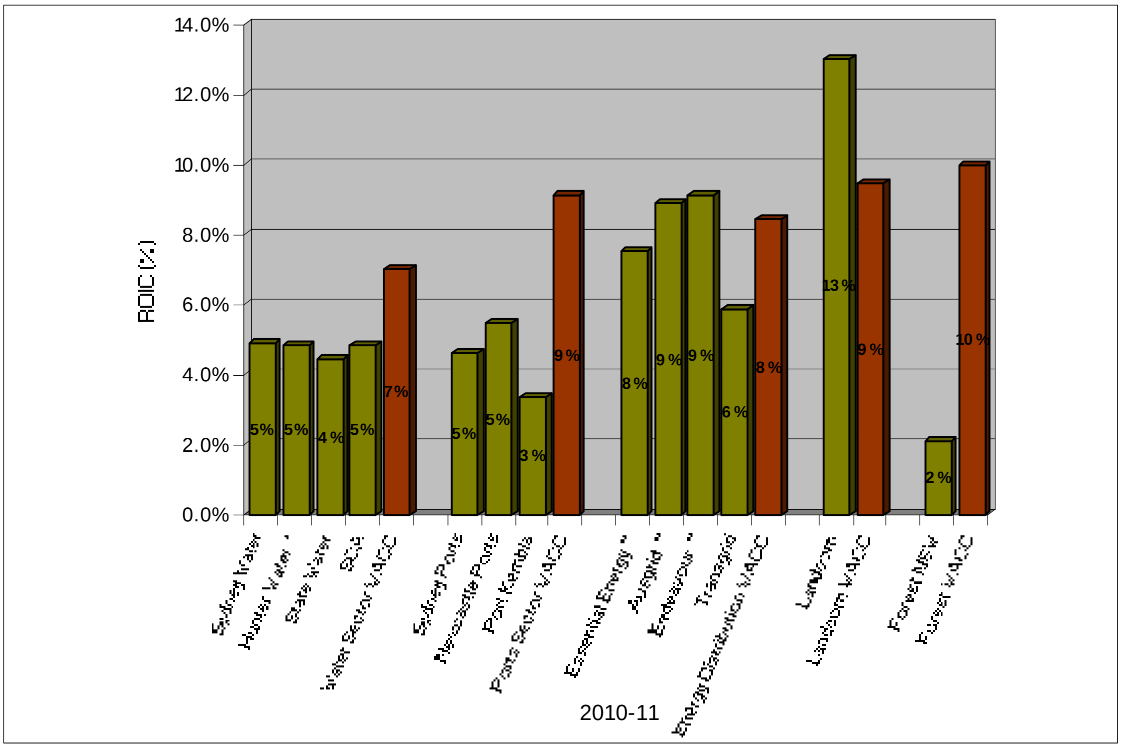
As commercial enterprises in competitive environments, or providing important services to the community and the economy, SOCs are expected to perform at a level that would be achieved by private companies facing similar market conditions. Earnings should be at appropriate levels and these in turn should result in acceptable dividends to shareholders. In the absence of a traded market for shares, benchmarks assist in assessing the adequacy of performance and shareholder returns.

The Government's return on equity includes dividends, retained earnings and capital growth. The return on invested capital (ROIC) is a performance measure that compares after-tax operating profit with invested capital (debt plus equity) and therefore includes dividends, retained earnings and interest (the portion of earnings used to finance debt). ROIC can be compared with the weighted average cost of capital (WACC) for the business, to assess whether the business is generating value for its shareholders.

To assess and improve business performance analysis in NSW, Treasury commissioned the Government Business Performance Assessment and Capital Management Project[2], which developed a methodology for benchmarking ROIC and WACC.

Figure 9.2.1 shows the ROIC for commercial PTEs against estimates of the benchmark WACC for each sector. For regulated businesses in the energy and water sectors, the benchmark WACC is an average of the allowable WACCs set by the respective regulators, on a nominal, post-tax basis. For other sectors, it is an indicative WACC that could be used to evaluate performance, calculated by Ernst & Young based on market comparisons and economic assumptions. Figure 9.2.1 shows that the commercial PTEs' ROIC results do not consistently meet their benchmark WACC. This means there is room for improved financial performance by commercial government businesses. Figure 9.2.2 provides a time series of ROIC for the commercial PTEs.

Figure 9.2.1 Return on invested capital compared with benchmark cost of capital, commercial PTEs, 2010-11



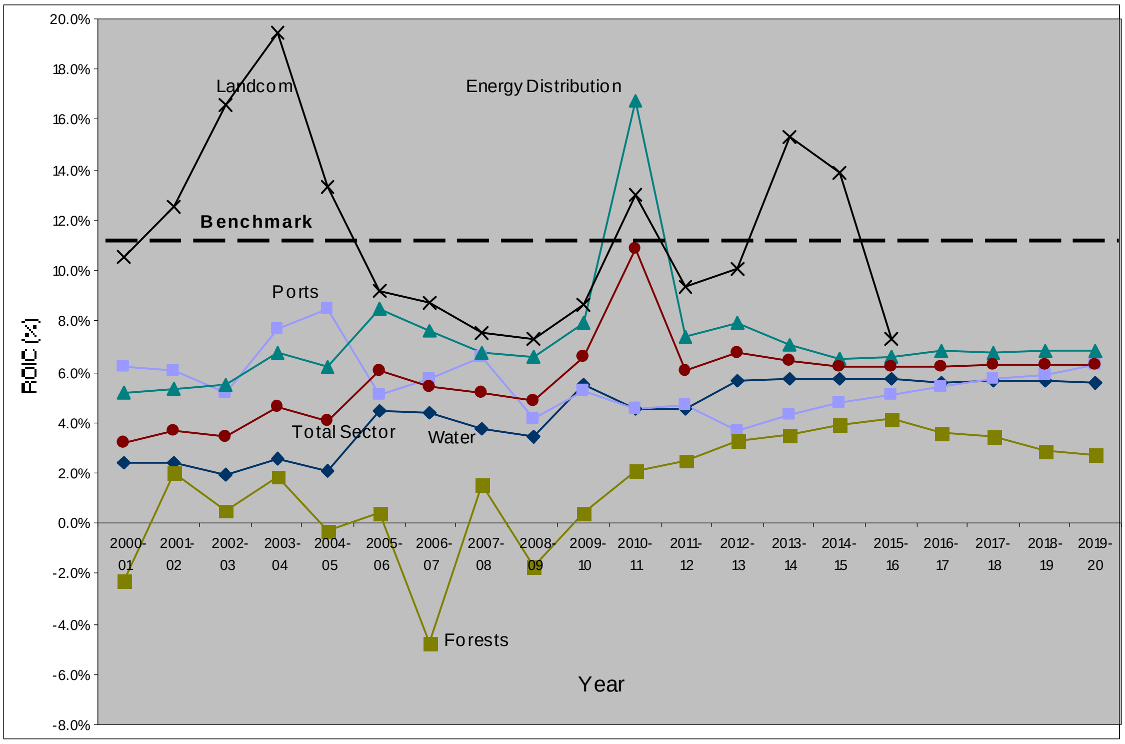
* Hunter Water assets are valued significantly higher than its regulated asset base, so this shows Hunter Water's return on regulated asset base instead of ROIC.

** ROIC for Essential Energy, Ausgrid and Endeavour are for 2009-10 to avoid the impact of retail sales.

*** WACC is a post-tax nominal figure converted from regulated determined WACC for Water and Energy, otherwise as estimated by Ernst & Young.

2 Government Business Performance Assessment and Capital Management Project for NSW Treasury, Ernst & Young, January 2011.

Figure 9.2.2 Return on invested capital of commercial PTEs, 2000-01 to 2019-20



Note: Landcom data is only available until 2015-16.

The project also benchmarked NSW commercial PTEs against their peers, which provides another view of performance. While caution needs to be exercised in interpreting the results where different businesses and operating environments are involved, using ROIC as a benchmark suggests that on average, the performance of businesses in the water, ports and forestry sectors does not compare well with their private sector peers.

For regulated businesses, benchmarking against peers needs to be tempered by analysing them against their regulated returns. By definition, the possibility of outperformance in terms of ROIC is limited for regulated industries, but there is a real prospect of underperformance against regulatory allowances. The focus for regulated businesses should be comparison against their regulated returns. Each business should be required to meet its regulated WACC and to stay within its allowed operating and capital expenditure limits, so as not to erode shareholder value.

Where businesses remain in government ownership, it is imperative that the Government, as shareholder, properly values its equity investment in SOCs and achieves a fair commercial return on that investment. This ensures management is accountable for performance within reasonable commercial expectations. Community preferences for non-commercial activities can be met by explicit payments from the Budget. Ensuring commercial returns is also a competitive neutrality issue, especially for businesses with private sector competitors.

Requiring market-based returns on equity encourages PTEs to consider debt in the way a private business would; that is, as a lower cost source of finance. Higher levels of debt as part of a sustainable capital structure also provide an incentive for improved financial performance against the discipline of obligatory debt repayments.

The Government Business Performance Assessment Project broadly concluded (using forecast 2009-10 data) the following findings:

- **Energy Distribution:** Ausgrid (Energy Australia), Endeavour (Integral) and Essential Energy (Country) outperformed their industry peers on ROIC[3], ROA[4], ROE[5] and dividends, and have higher gearing.
- **Energy Transmission:** Transgrid performed marginally above peers, with lower gearing.
- **Water:** Sydney Water and the Sydney Catchment Authority outperformed their peers; Hunter Water was below average (though this result is skewed by high asset valuations); and State Water was significantly below average. Sydney Water's gearing is above the peer average.
- **Ports:** Port Kembla outperformed its peer group, while Sydney Ports and Newcastle Port were on par with theirs. Dividend payouts were below peer averages. Sydney Ports' gearing was average compared to its peers , but the others are under-geared.
- **Forests NSW:** Forests NSW had strong operational performance but underperformed financially and its gearing of only 10 per cent was low compared to its peers.
- **Landcom:** Landcom displayed strong operational performance with average gearing compared to its peers.

The project also identified agencies that were able to accommodate more debt and therefore provide higher returns to the Government.

Table 9.2.1 PTE capacity for increased debt

Sector	Little capacity for increased debt	Capacity for increased debt (at industry average credit rating)
Energy	Ausgrid Endeavour Energy	Essential Energy Transgrid
Water	Sydney Water Hunter Water State Water	Sydney Catchment Authority
Ports	Sydney Ports	Newcastle Port Kembla
Other	Landcom	Forests

3 ROIC = Return on invested capital = (EBIT minus tax on EBIT) divided by (average total assets, minus average non-interest bearing liabilities).
4 ROA = Return on assets = EBIT divided by average assets.
5 ROE = Return on equity = Operating profit after tax, divided by average equity.

The Government's shareholder role is being strengthened through improved analysis of performance, using tools developed as part of the project. Ernst & Young produced a standardised template for performance evaluation and capital structure monitoring, which is produced by a model that incorporates functionality for sensitivity analysis. This will aid comparability, will drive a consistent approach and is supported by the Financial Audit.

The project includes the following recommendations, which are currently being implemented in Treasury's shareholder monitoring unit.

Table 9.2.2 Recommendations of the *Government Business Performance Assessment Project*

Recommendation	Benefit
Undertake a consistent approach with a standardised template applied to all SOCs and PTEs. While the existing Reporting and Monitoring Policy for Government Businesses outlines the information businesses need to provide, it is less prescriptive on how that information is analysed and conveyed within Treasury.	Consistent performance measurement and standardised outputs.
Explicitly adjust for community service obligations required by the Government. Obligations that were fully or partially unfunded should be accounted for in business analysis, especially when benchmarking their performance.	Ensures SOCs and PTEs can be compared with each other and private sector peers on a like-for-like basis, focusing on commercial operations only.
Focus on Return on Invested Capital (ROIC) as the primary performance evaluation measure.	For evaluating operating performance, ROIC is superior to return on assets (ROA) and return on equity (ROE), which are easily skewed by items and/or financing decisions that do not influence true operating performance. ROIC measures the efficiency with which capital is employed by blending profitability and capital efficiency, expressing operating profit earned per dollar of invested capital. This focuses attention on businesses' true operating performance.
Ensure all capital structure measures are consistent with the measures used by the ratings agency currently reviewing the SOCs and PTEs.	Consistent capital structure monitoring and reporting.

Recommendation	Benefit
Explicitly compare capital expenditure and operating expenditure forecasts with those allowed by the regulator for regulated entities.	Utilises the detailed analysis undertaken by regulatory bodies to ensure that the SOCs and PTEs are achieving efficient operating expenditure and capital expenditure levels. Underperformance against regulatory targets destroys shareholder value.
Track dividends paid as a percentage of equity against industry peers and the return allowed by the regulator.	Better monitoring of dividends paid and dividend payout ratio, to ensure that the Government is achieving a reasonable dividend yield and ROE.
Require SOCs and PTEs to provide scenario analysis as part of their Corporate Plan or Statement of Corporate Intent (SCI) forecasts.	Allows capital structure and dividend payout decisions to be undertaken with information on the potential out-performance and underperformance of the entity over the 10-year forecast horizon.
Prepare annual indicative valuations of the equity in each SOC and PTE, based on the 10-year forecasts provided in the SCI for each asset.	Allows Treasury to track performance of its assets and growth in underlying equity value over time, in a similar way to private sector asset managers. Avoids reliance on the asset carrying values of each SOC and PTE, which may skew ROIC, ROE and ROA statistics. Focuses attention on the reliability, accuracy and consistency of the underlying SCI forecasts, driving more accurate forecasting by SOCs and PTEs.

Aggregate analysis of business performance

IPART's study of historical trends in SOC productivity[6] found that half of the SOCs recorded improvements in labour productivity over the study periods (the longest of which was 13 years), with five achieving increases in total factor productivity, noting that the timing of major capital expansion influences total factor productivity measures. Analysis by NSW Treasury shows that historically, these gains have been shared between consumers, through lower prices and payments to the Government.

In Australia, aggregate analysis of PTE financial performance was conducted by the Productivity Commission and before that, by NSW Treasury. The most recent Productivity Commission Report[7] found that across Australia:

> *Just over half of monitored GTEs* [government trading enterprises] *failed to achieve a return on assets above the risk-free rate of return in 2006-07. This implies that an even greater proportion did not earn a commercial rate of return (which would include a margin for non-diversifiable risk). Twelve GTEs (14 per cent) failed to achieve a positive return on their assets.*

6 Review of the Productivity of State Owned Corporations, Independent Regulatory and Pricing Tribunal, 2010.
7 Productivity Commission 2008, *Financial Performance of Government Trading Enterprises, 2004-05 to 2006-07,* Commission Research Paper, Canberra, July, page v.

The poor financial performance of many GTEs underscores a long-term failure to operate these businesses on a fully commercial basis, in accordance with Competition Policy Agreements.'

Extensive performance information is reported to a range of stakeholders, including the Australian Competition and Consumer Commission (ACCC) and IPART. Any summary performance reporting framework to be developed should be streamlined and should incorporate metrics relevant to each stakeholder. This will help boards manage their performance according to a variety of objectives, and identify trade-offs or competing objectives (e.g. between pricing, service standards and financial returns).

9.3 Assessment of the approach to the commercial sector

The commercial policy framework has been in place in NSW for more than two decades. It has proven to be a relatively effective governance structure, imposing private sector disciplines on major government businesses to materially improve businesses' financial performance (with operating surpluses allowing a steady contribution to government revenues) and service delivery.

The commercial policy framework, with the SOC model as its core, was initially conceived in part as a step in the process towards privatisation. The provision for a company SOC structure under the *SOC Act* was intended to simplify a transfer of businesses to the private sector over time. However, time has shown the SOC model to be a legitimate and enduring corporate governance framework, delivering commercial outcomes where there is a deemed justification for ongoing government ownership.

While the framework is sound, adherence to it has deteriorated. Recent reviews suggest four main departures in NSW:

1. Conflicting and unclear objectives and unclear shareholder expectations.
2. Inconsistent and less than ideal governance arrangements.
3. Less than full autonomy for boards of directors.
4. A monitoring framework that is not robust.

For example:

- Businesses have been required to deliver aspects of government policy without compensation through social program payments. Such activities divert management, obscure businesses' underlying financial performance and weaken the effectiveness of the shareholder's role in performance monitoring.
- A relatively low level of involvement by shareholder ministers in recent years has reduced the focus on businesses' strategic direction and allowed for greater incursion into their activities by portfolio ministers, generating costs that must be met by users or taxpayers generally.
- Conflicting objectives in the *SOC Act* and enabling legislation obscure the underlying commercial expectations of businesses.

- The appointment of directors to boards has not been consistently undertaken in consultation with the Chairs of the relevant boards, nor in accordance with identified skill and experience gaps.

In addition, there is a need to strengthen the focus on performance and enhance accountability for performance.

Reform directions for government businesses

After two decades, it is appropriate to reassess the SOC governance framework to ensure that it supports appropriate commercial outcomes and delivers net benefits in the operations of businesses that remain in government ownership. It is also appropriate to consider whether the performance and governance of commercially orientated government entities that sit outside of the SOC model would be enhanced by their inclusion in the SOC framework.

Treasury has overseen a series of reviews under the Better Services and Value Plan, which included comprehensive reviews of SOC boards and SOC productivity, as well as a program of reviewing the strategic performance of individual SOCs. These reviews have identified a range of recommended reforms for the SOC regime and the operations of individual businesses, which are outlined in Part C. In summary, suggested reforms focus on the following:

- Reforming the SOC governance regime, to enhance the governance framework, reassess the role of shareholder ministers, improve the process for appointing board directors, remove inconsistencies with other legislation, and ensure the provisions of the framework are in accordance with best practice and comparable with private and public sector counterparts.

  In addition to updating the *SOC Act* and governance framework, board members highlighted their desire to have greater interaction and engage more meaningfully on strategic direction and business initiatives.

- Enhancing accountability for business performance, to properly value the Government's equity investment in its SOCs, achieve a fair return on that investment, set a commercial capital structure for each business, implement more transparent and effective shareholder reporting, benchmark businesses against SOC and private sector peers, and appropriately cost non-commercial activities.

  Commercialisation and corporatisation reforms have resulted in more efficient pricing of goods and services by government businesses, with prices increasingly set to recover efficient costs and generate a fair return on capital. An improved accountability framework will improve efficiency and returns to the Government.

- Implementing improved business structures, to improve the accountability and performance of certain businesses and provide options for sale.

10 THE FINANCIAL OUTLOOK

Key points

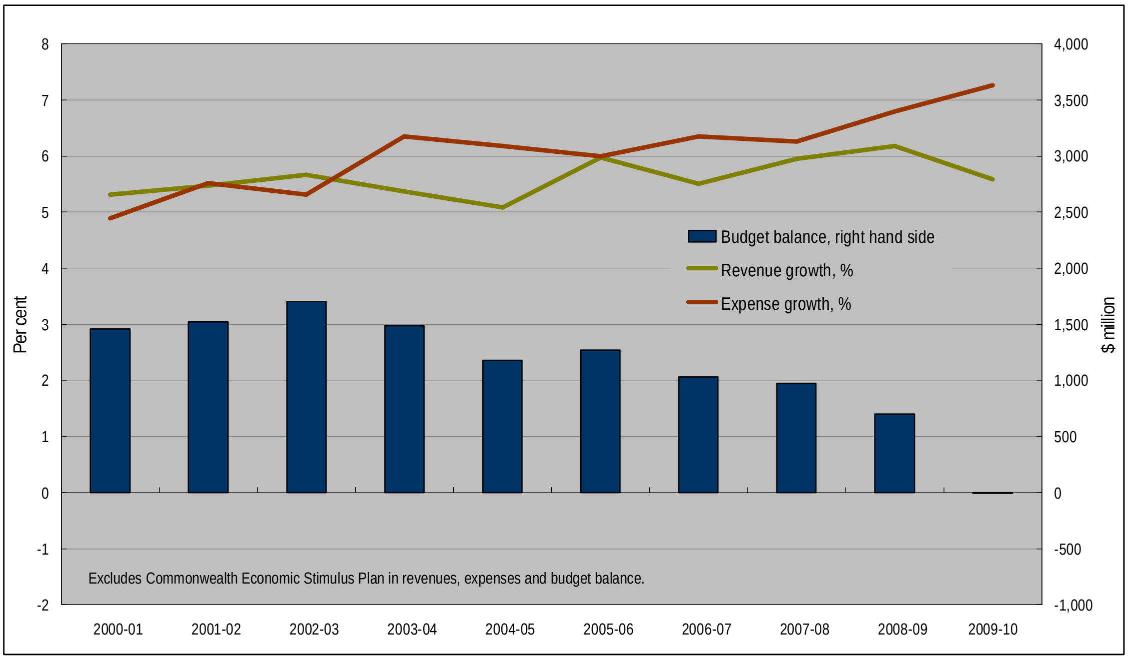
- Growth in general government recurrent expenditure has exceeded revenue growth over much of the last decade, which has reduced the size of budget operating surpluses and, if uncorrected, will lead to a structural deficit.
- The State's capital program has expanded, and borrowings have risen to late-1990s levels, producing a large and continuing call on financial markets and a deterioration of the State's balance sheet.
- Ongoing large structural deficits put in jeopardy the State's ability to address high-priority infrastructure needs and places the State at risk in the event of external financial shocks.
- Fiscal projections are developed for two expenditure scenarios: recurrent expenditure growth of 6.6 per cent per annum, in line with the historic trend; and a lower expenditure scenario as projected in the March 2011 forward estimates, with underlying recurrent expenditure growth of 4.9 per cent over the five years to 2014-15, followed by 5.2 per cent per annum in line with long-term trend revenue growth.
- Both scenarios are unsustainable. Ongoing operating deficits and large net lending deficits meaning that borrowing will be required to fund all new net general government capital spending and partially fund recurrent spending.

10.1 Overview of financial position

Financial position

Since 2005-06, general government recurrent expenditure growth has exceeded revenue growth, leading to progressively lower budget operating surpluses (see Figure 10.1.1, but note the figure reduces year-to-year volatility by focusing on four-year average growth rates and average budget balances). This trend has also been compounded recently by a decline in economic and revenue growth following the 2009 global recession.

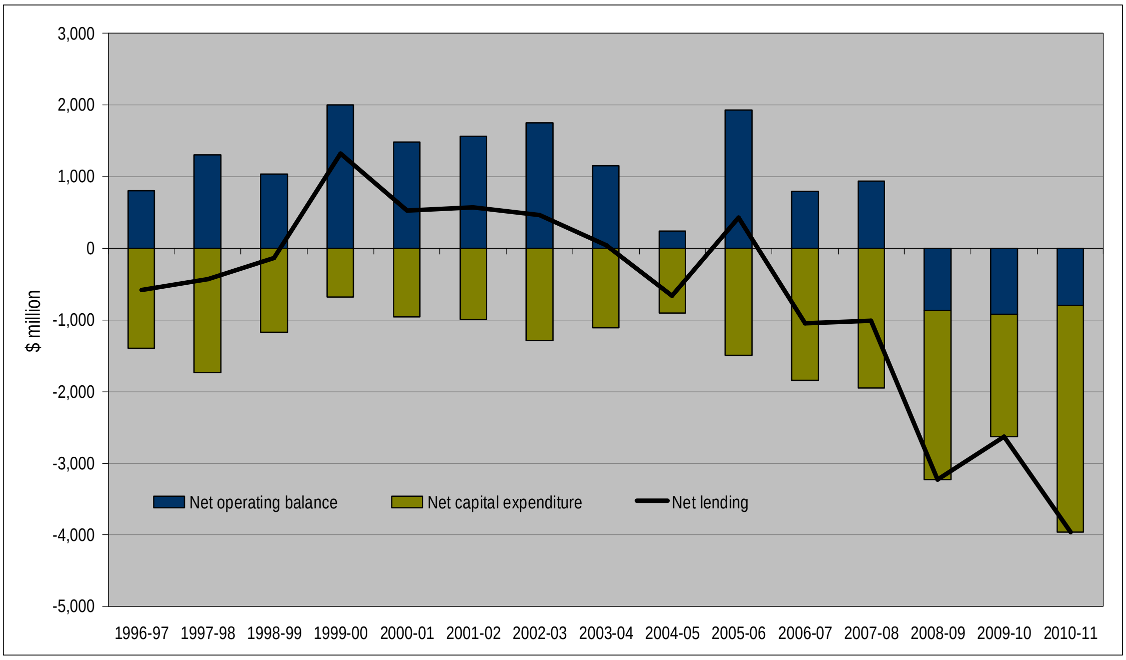
Figure 10.1.1 Four-year average growth rates and general government budget balance



The structural deterioration in budget operating balance and increases in capital expenditure have seen the general government net lending result move from significant surpluses in the five years to 2003-04, to increasing deficits (see the top chart in Figure 10.1.2). This increased borrowing requirement has reversed the previous downward trend in general government net debt. Further, unfunded superannuation liabilities increased sharply during the global financial crisis, substantially adding to financial liabilities in the non-commercial sector (see Figure 10.1.3).

The rapid growth in public trading enterprise (PTE) sector capital expenditure since 2005-06 (particularly in electricity networks and water) has further contributed to a major deterioration in the net lending result for the non-financial public sector, as shown in the bottom chart in Figure 10.1.2. In the four years to 2005-06, total state capital spending grew by an average of 8.2 per cent per year, which was already well in excess of revenue growth. In the four years to 2009-10, this average growth rate lifted further to 12.3 per cent per year.

Figure 10.1.2 General government (top) and non-financial public sector (bottom) financial results, excluding fiscal stimulus ($million)



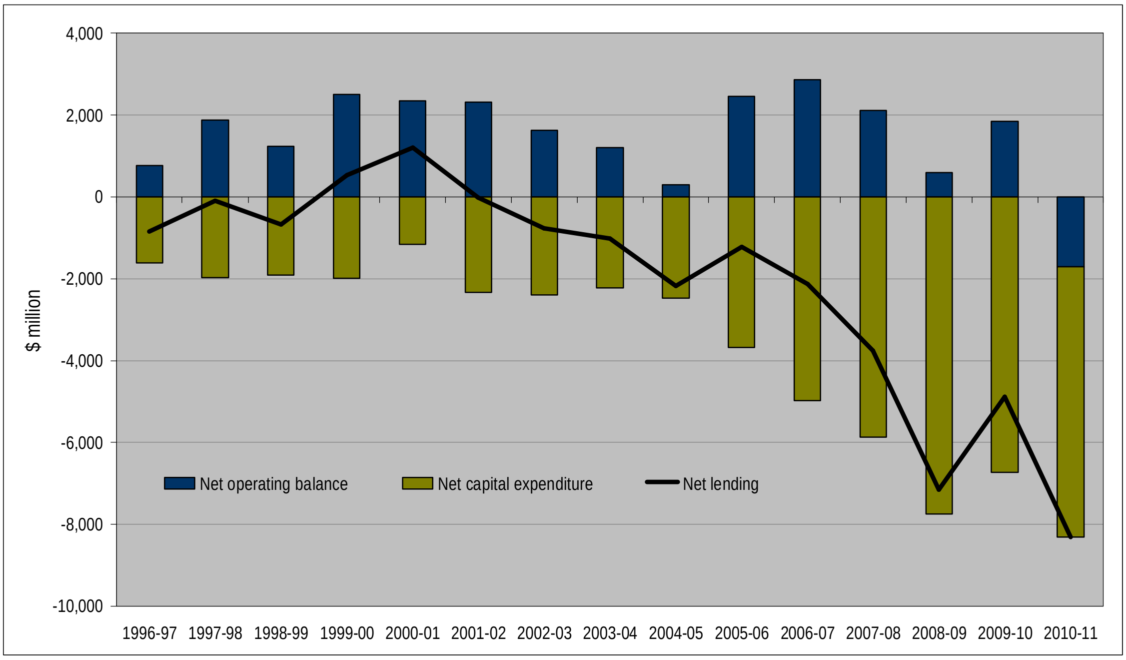
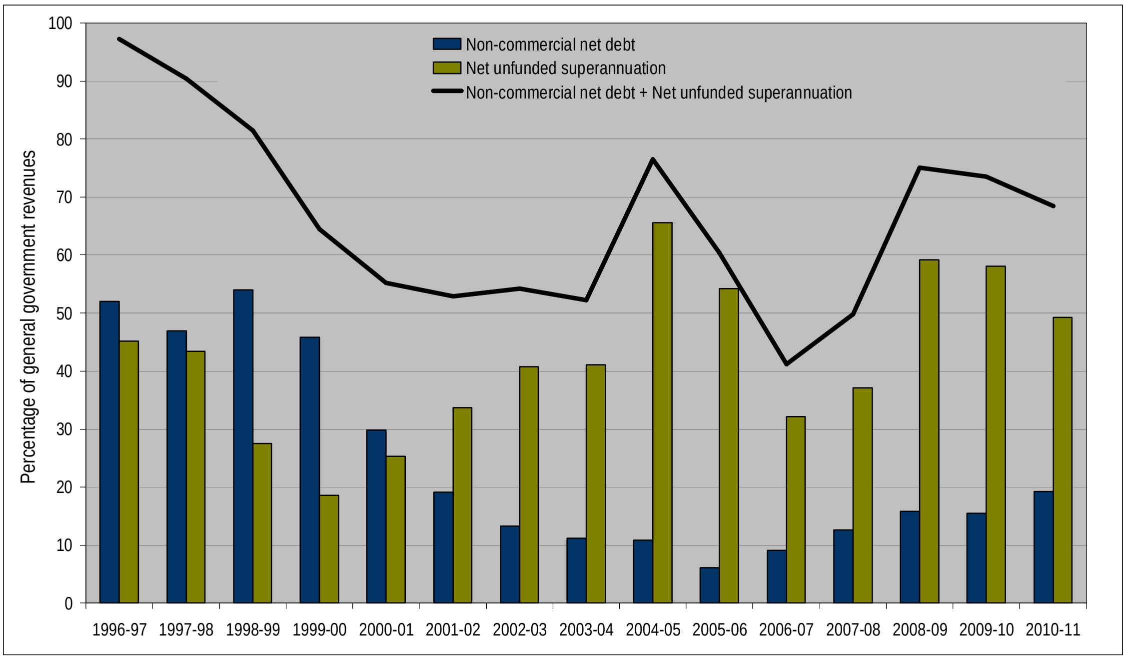
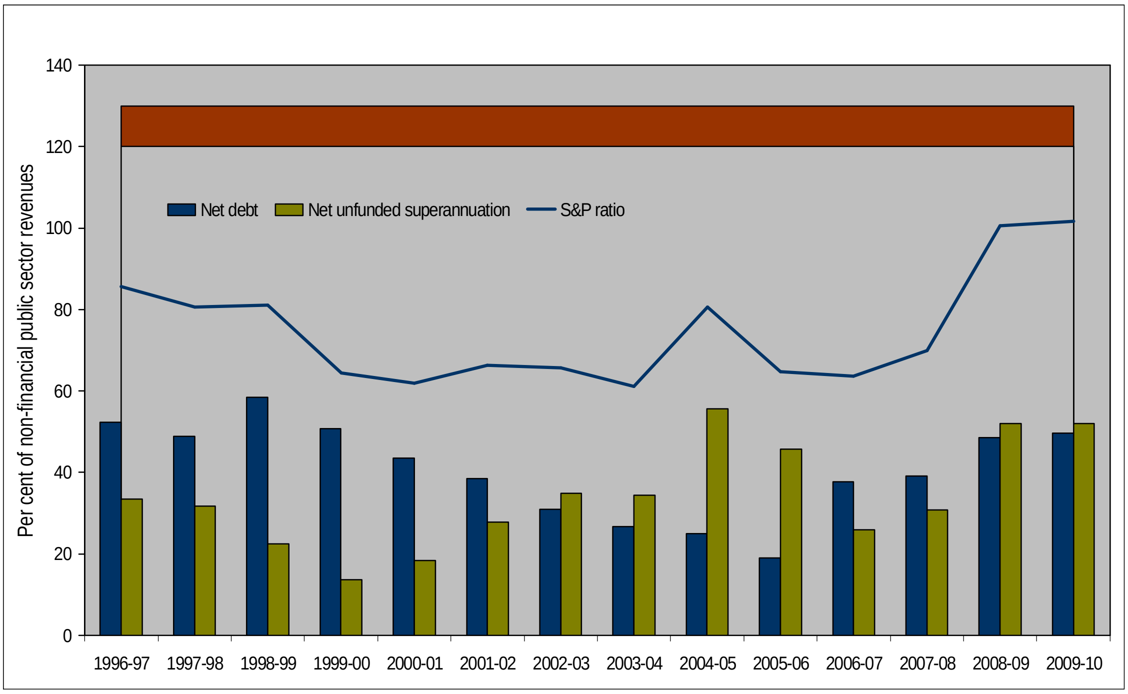


Figure 10.1.3 Non-commercial (general government and non-commercial PTE) net debt and superannuation liabilities



The increase in the State's net borrowing requirement has seen net debt in the non-financial public sector increase; by 2009-10 the non-financial public sector net debt position (as a share of revenues) was back at levels last seen in the late 1990s, as shown in Figure 10.1.4. Current financial liabilities are still at levels consistent with maintaining the AAA credit rating, according to the Standard & Poor's (S&P) metric, though the trend is negative and if maintained without corrective action, would risk a credit downgrade.

Figure 10.1.4 Net debt, unfunded superannuation liabilities and S&P ratio of the non-financial public sector



10.2 Medium-term financial outlook

This section presents fiscal projections for the following two general government expenditure scenarios:

- The historic trend scenario assumes recurrent expenditure will continue to grow at historic rates from 2010-11, growing an average of 6.6% per annum to 2020[1].
- The forward estimates scenario is a draft budget scenario based on March 2011 forward estimates, with underlying recurrent expenditure growth of 4.9 per cent over the five years to 2014-15, then 5.2 per cent per annum (in line with the long-run trend revenue growth rate).

In both scenarios, revenues are equal to March 2011 forward estimates, with underlying annual revenue growth of 4.6 per cent over the five years to 2014-15, followed by growth at the long-term trend rate of 5.2 per cent per annum[2 3].

Figure 10.2.1 shows that even the lowest expenditure scenario, based on draft forward estimates, produces a permanently large general government net lending deficit, which results in continually growing debt as a proportion of revenues in the non-commercial

1 This 6.6% future trend rate is based on projecting historic rates forward for each major agency (adjusting for any abnormalities such as the Commonwealth Economic Stimulus Plan). As some agencies grow faster than others, they make up an increasing proportion of the total and cause the aggregate growth rate to accelerate over time.

2 Both scenarios also have the same assumptions for superannuation liabilities and the commercial PTE sector, the other major components of the S&P ratio.

3 The assumed growth in state taxes over the five years to 2014-15 is 5.2% per annum, in line with the long-run trend rate for total revenues of 5.2% per annum. The underlying average growth rate of total revenues – at 4.6% per annum over the five years to 2014-15, which excludes the cessation of Commonwealth Economic Stimulus Plan payments – is still less than 5.2%, primarily because of the tail-off in other Commonwealth National Partnership payments (e.g. for education and roads). Any increases in this funding will most likely require corresponding increases in expenditure (commonly capital), with no net benefit to net debt.

sector, as shown in Figure 10.2.2. In this scenario, both the level of debt and the rate of increase in that debt are clearly unsustainable.

Figure 10.2.1 General government financial results: forward estimates scenario (underlying results excluding fiscal stimulus revenue and expenditures)

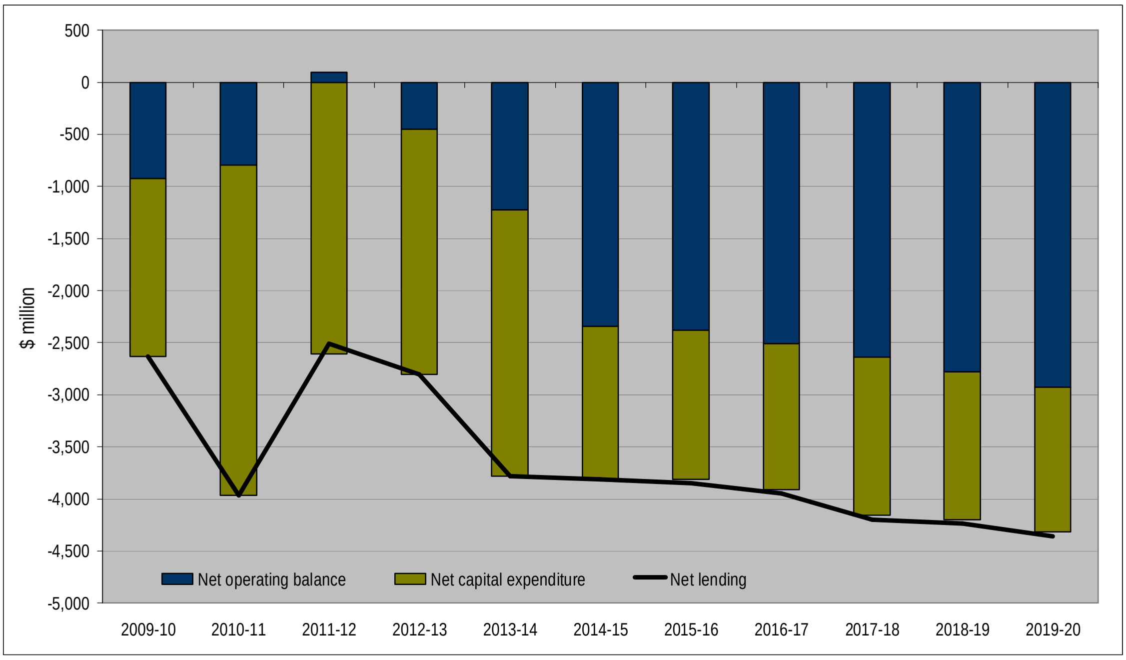
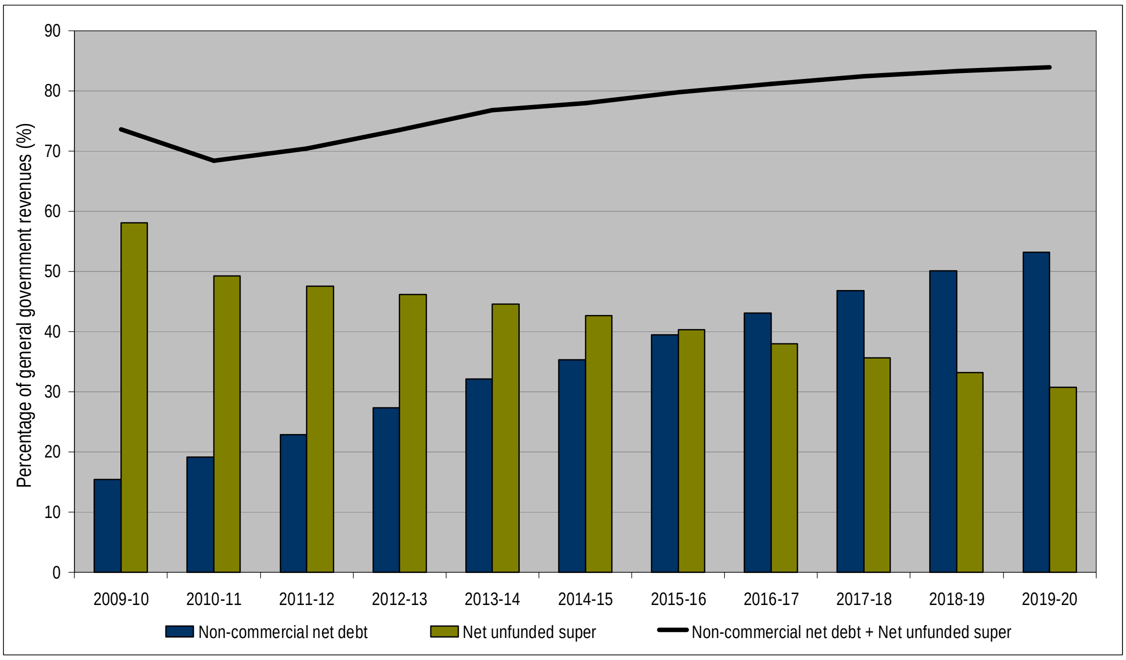


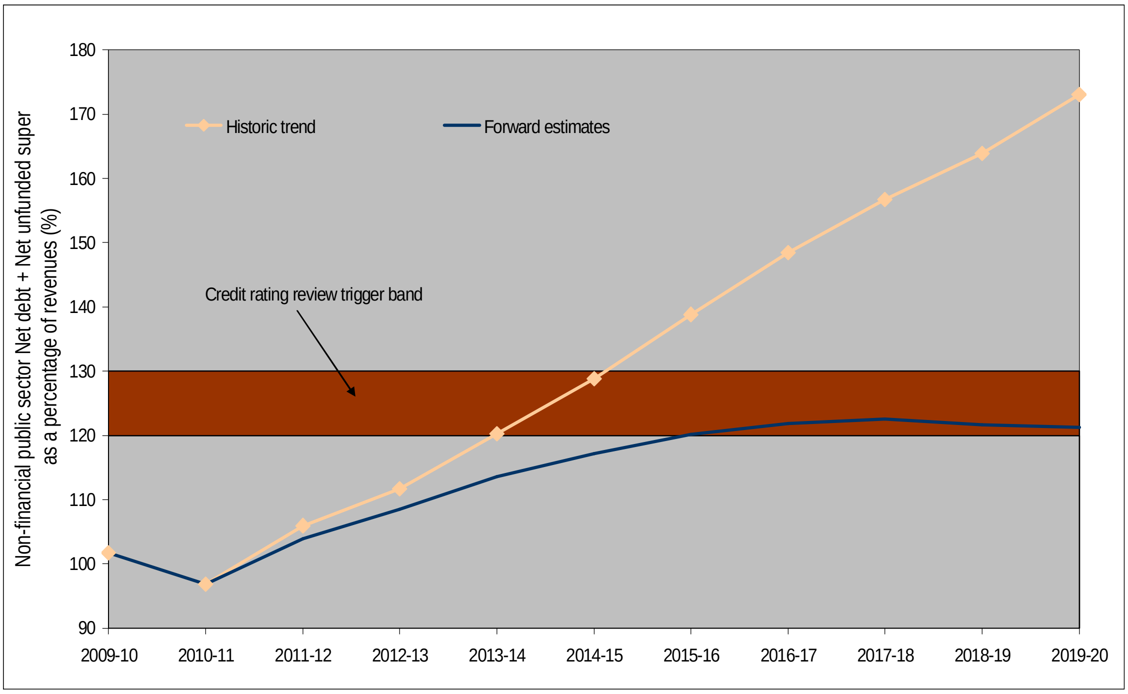
Figure 10.2.2 Non-commercial (general government and non-commercial PTEs) net debt and superannuation liabilities (forward estimates scenario)



The resulting S&P metric for the two expenditure scenarios is plotted in Figure 10.2.3, against the AAA threshold of 120 to 130 per cent. In the forward estimates scenario, rising net debt is eventually offset by declining superannuation liabilities (as shown in Figure 10.2.2), resulting in the S&P metric plateauing towards the end of the decade, but inside the AAA threshold band, leaving no flexibility to absorb fiscal shocks.

Alternatively, if expenditure growth continues its historic trend, rapidly rising general government net debt will quickly result in an unsustainable debt position and the loss of the AAA credit rating.

Figure 10.2.3 S&P metric for varying expenditure growth scenarios



Conclusion

Under the scenarios modelled in this chapter, general government net debt will rise substantially from current levels as a percentage of revenues, and will reach unsustainable levels, threatening the State's AAA credit rating. The State needs to create fiscal 'room' by reducing both the level of recurrent expenditure and its growth rate. Without this action, the Government will not be able to address NSW's infrastructure needs, nor will it be able to place the State's finances in a prudent position to absorb any external economic or financial shocks.

11 REQUIREMENTS FOR A SUSTAINABLE FINANCIAL POSITION

Key points

- A sustainable fiscal position is one that allows for efficient funding and delivery of all state responsibilities, with revenues funding all recurrent costs; and an appropriate level of funding of capital expenditure, such that debt remains at a prudent level. To be deemed prudent, a debt level must not crowd out funding for core responsibilities; it provides ready access – on excellent terms – to debt markets; and must provide a substantial buffer to absorb any economic downturn or external shock.
- Projections based on continuing historic expenditure growth trends or maintaining current policies produce an unsustainable financial position.
- The Government should target stabilising general government net debt as a percentage of revenues by 2014-15. This requires reducing the net lending deficit to approximately $1.5 billion per annum by 2014-15 based on the current projected general government capital program.
- Adhering to these sustainable fiscal targets should provide an adequate balance sheet buffer to accommodate future economic shocks and should ensure the AAA credit rating is maintained.
- This chapter develops a 'fiscal target' scenario consistent with these targets.

11.1 Defining fiscal sustainability

It is easy to define when a fiscal position is unsustainable: when debt is so high that the interest payments on that debt consume a sufficiently large portion of available revenue that service delivery cannot be funded and debt spirals uncontrollably higher. Borrowing to pay interest is clearly an unsustainable position, as some European countries have recently experienced.

There is no suggestion that the State's finances are currently in such a position. Total state interest payments on debt, were 5.3 per cent of revenues in 2009-10, rising to 6.5 per cent in 2013-14. At the general government level, interest payments were 2.9 per cent of revenues in 2009-10. These levels are not considered fiscally unsustainable. Moody's[1], for example, estimates that for AAA rated sovereign entities, "based on empirical observations, …when debt service costs exceed around 10 per cent of revenues, they start exerting pressure on social and political options available to government".

[1] *How far Can Aaa Governments Stretch Their Balance Sheets?*, February 2009, Moody's Investors Service.

This notion of debt affordability, rather than the sustainability of debt levels, is an important one for Australian states, where the dominant role is service provision. An increase in debt would allow for additional infrastructure spending, but given that most general government infrastructure does not generate an economic return, the interest payments on that higher debt will to some extent crowd out spending on other services. For example, a $10 billion infrastructure project that was debt funded and had no financial return to the Government would mean higher interest payments of about $600 million per annum, or around 1 per cent of general government recurrent expenditure. In addition, the project's operating and maintenance cost could add a further $100 million per annum or more in expenses.

A necessary condition for fiscal sustainability is that states do not have sustained operating (budget) deficits. Ongoing borrowing to pay for the whole net capital program and part of recurrent spending leads to an unsustainable debt position. This also means that to achieve fiscal sustainability, states should not have sustained higher expense growth than revenue growth, as this will eventually lead to operating deficits.

The so called golden rule that borrowing should only be undertaken for capital spending is not sufficient to ensure fiscal sustainability. Borrowing for all net capital spending (i.e. having a balanced budget and debt increasing by the amount of net capital spending each year) will also lead to spiralling debt over time, depending on the initial level of debt and the level of the capital spend.

For Australian states, a better definition of fiscal sustainability is one that allows debt to grow, but in line with growth in either gross state product (GSP) or revenues, again depending on the starting point for debt. That would also leave interest payments on debt constant as a share of GSP or revenues (assuming a constant interest rate). The key debt target of the *Fiscal Responsibility Act 2005* (the FRA) was to keep general government net debt constant as a share of GSP. However, it could be argued that in the light of subsequent events – including Standard & Poor's (S&P) issuing its assessment of debt levels consistent with keeping a AAA credit rating – the starting point for debt levels in the FRA (at 0.9 per cent of GSP) was too low.

In early 2009, in an environment of rising Australian state debt, S&P announced that it would put special emphasis on the following key balance sheet metric for the non-financial public sector (NFPS):

$$\frac{\text{NFPS net debt + NFPS net unfunded super}}{\text{NFPS revenues}}$$

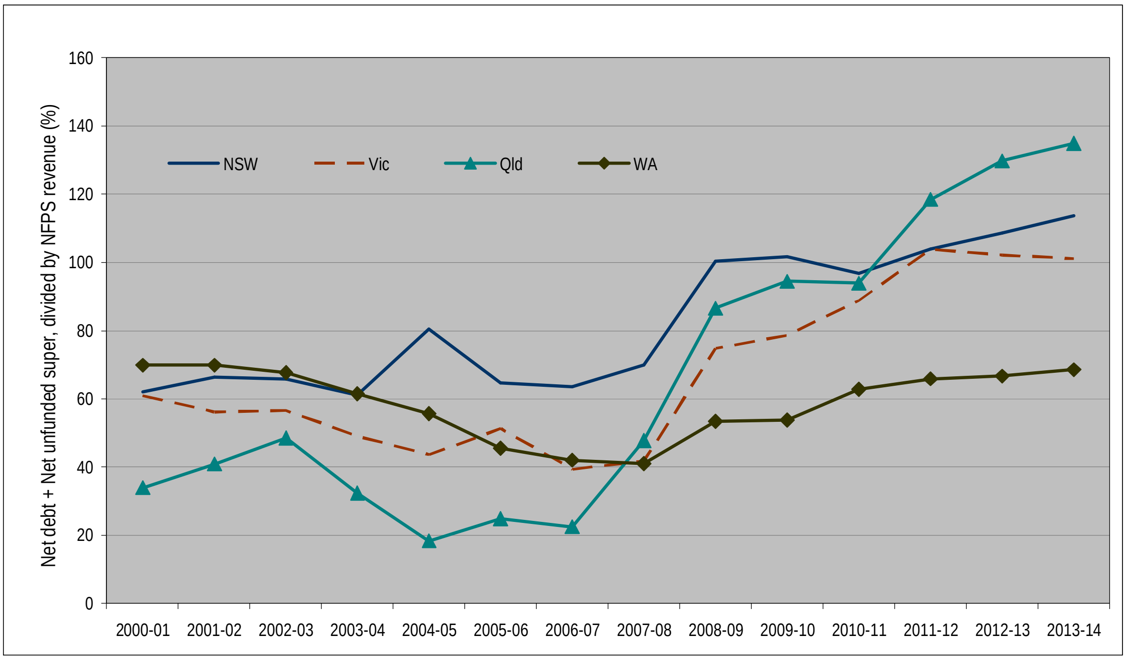
S&P sets trigger band limits for this metric, to remain consistent with a AAA credit rating. These bands differ among the states (as shown in Table 11.1.1 below), reflecting the states' relative risk profiles, including the volatility of revenues. This risk profile represents all other factors covered in the states' annual scorecard assessment. S&P has set the trigger band for NSW at 120 to 130 per cent.

The performance of the major states on the S&P metric (with projections to 2013-14 based on their Half-Yearly Reviews) is shown in Figure 11.1.1.

Table 11.1.1 S&P trigger bands for Australian jurisdictions

S&P trigger bands (per cent of revenue)		
	Lower boundary	Upper boundary
NSW	120	130
Vic	130	140
Qld	100	110
WA	90	100
SA	80	90
Tas	60	70
ACT	100	120

Figure 11.1.1 S&P ratio interstate comparison (ratio of net debt + net unfunded superannuation liabilities to revenues, in the non-financial public sector)

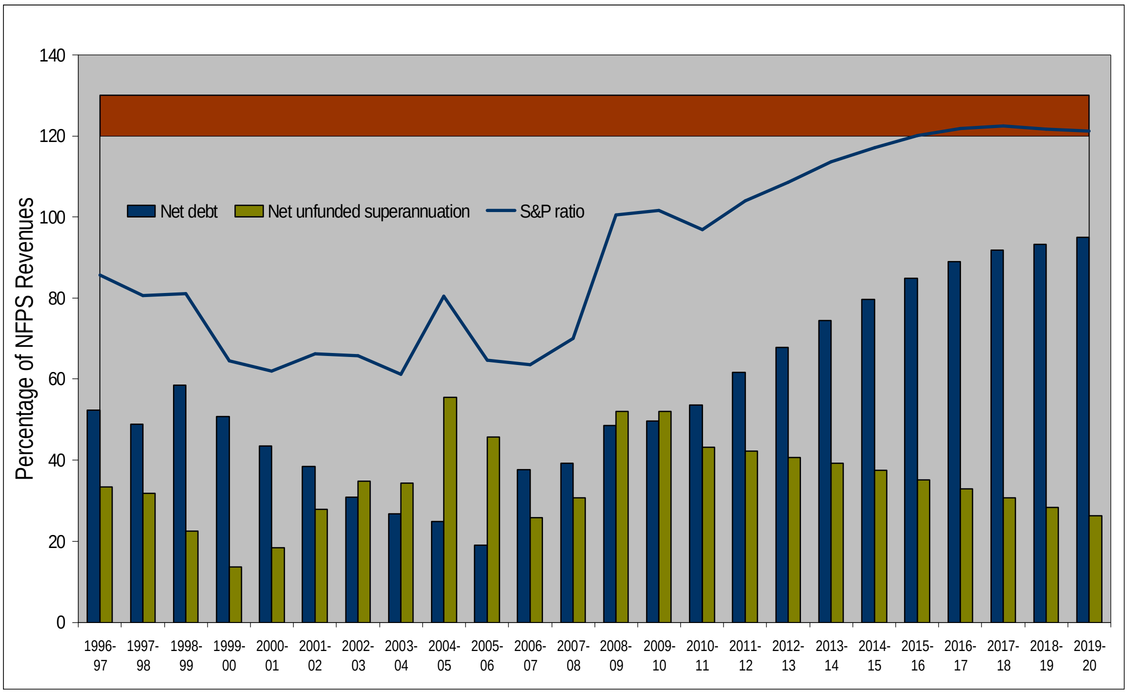


Maintaining a AAA credit rating is an independent signal that the State's finances are of a high standard and viewed as sustainable. A lower credit rating does not necessarily mean the State's finances are unsustainable; however, it would mean a higher interest payment to revenue ratio, and therefore less revenue available for service delivery.

For NSW, there has been a clear deterioration in the S&P metric since around 2005-06. This is partly due to a rise in the net unfunded superannuation liability, as a result of the global economic crisis in 2008-09 and subsequent downturn. However, it also reflects the rise in the net debt component, from less than 20 per cent of non-financial public sector revenues in 2005-06 to nearly 50 per cent of revenues in 2009-10. Based on March 2011 budget estimates, net debt will rise to 80 per cent of revenues by 2014-15 and is projected to increase further to 95 per cent of revenues by 2019-20, if policies do not change.

This projected increase in net debt is partially offset by a decline in net unfunded superannuation liabilities, which creates a plateau in the S&P ratio, as depicted in Figure 11.1.2. The decline in net superannuation liabilities is a result of policy settings, and a cash funding plan aimed at reducing these liabilities to zero by 2030. This avoids the need for large future spending and debt increases when these liabilities come due, but the funding to achieve this contributes partially to the projected medium-term rise in net debt. Unfunded superannuation liabilities and debt are therefore largely interchangeable, which is why the S&P ratio monitors the two in combination.

Figure 11.1.2 S&P ratio – contributions of main components

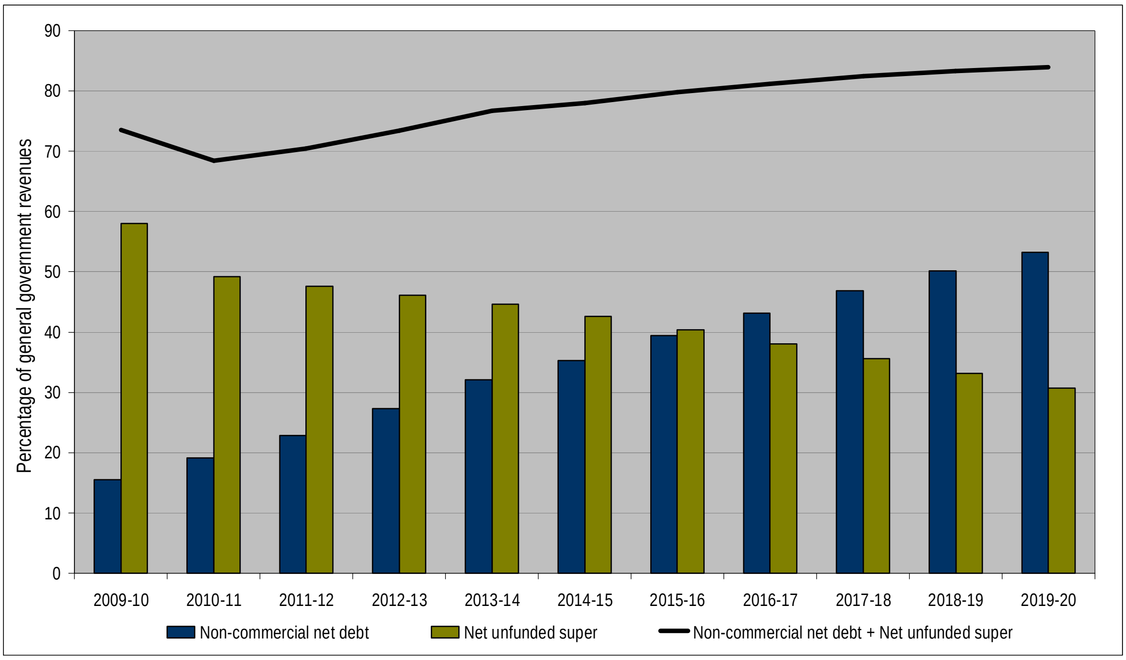


However, despite the offsetting decline in superannuation liabilities, the ongoing increase in debt shown in Figure 11.1.2 could become a concern for ratings agencies, because in time, as net unfunded superannuation liabilities trend towards zero, further reductions will no longer offset continued rises in net debt.

As the S&P ratio is based on the NFPS, increases in net debt are determined by both the public trading enterprise (PTE) and general government sectors. Although high levels of PTE gearing and risk can constrain total NFPS and general government borrowing capacity (in the eyes of ratings agencies), if it is assumed that the commercial PTE sector can ultimately support its debt through user charges, the greatest concern is achieving a sustainable trend in general government net debt, or, more generally, a sustainable trend in all budget-dependent or non-commercial net debt (including any debt in non-commercial PTEs such as transport and housing).

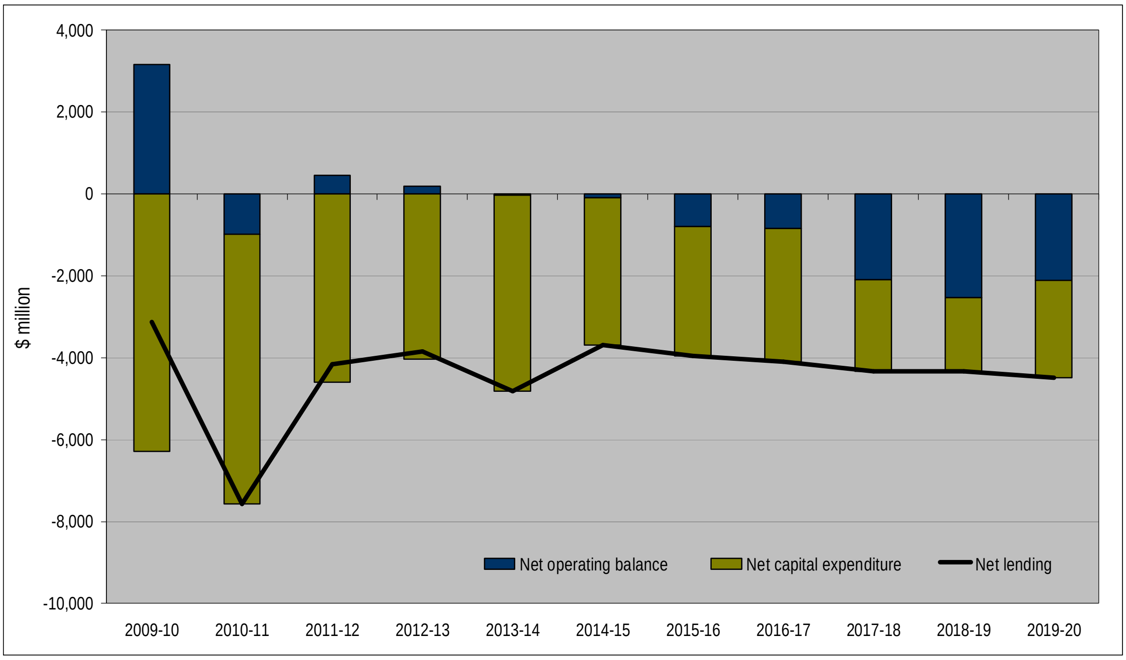
Figure 11.1.3 shows the non-commercial component of the S&P ratio corresponding to the projection in Figure 11.1.2, (i.e. general government and non-commercial PTE net debt plus net unfunded superannuation liabilities, divided by general government revenues), which indicates that non-commercial net debt is following a continually increasing and ultimately unsustainable trend.

Figure 11.1.3 Non-commercial (general government and non-commercial PTE) component of the S&P ratio (forward estimates scenario)



This unsustainable trend in net debt is driven by ongoing net lending deficits in excess of 5 per cent of revenues (see Figure 11.1.4), which reflects the combination of an ongoing operating deficit and the further borrowing requirement for high levels of non-commercial capital expenditure. Given a desire to maintain high infrastructure spending levels and also to keep taxes at competitive levels (to attract business and drive economic and revenue growth), the sustainability of state finances is ultimately determined by a sustainable level of – and trend in – recurrent expenditure growth in the non-commercial sector.

Figure 11.1.4 Non-commercial (general government and non-commercial PTE) net lending and components (forward estimates scenario, including fiscal stimulus)



Requirements for fiscal sustainability

There are three main requirements for fiscal sustainability:

1. The Government's expenditure and revenue policy settings must not be threatened by an untenable Budget position in which debt grows faster than the ability to service it. This can be measured by constraining non-financial public sector net debt and unfunded superannuation liabilities at levels no greater than 100 per cent of revenues[2].
2. A stable tax base must be established – one that does not require recourse to increasing the tax rate, which would threaten the State's competiveness as a place to undertake business. The stability of the tax base can be measured by NSW's tax severity relative to other jurisdictions.
3. Intergenerational sustainability must be established by maintaining and improving the service potential of the infrastructure stock, and equitably distributing the costs borne by current and future users. Sustainability in this area can be assessed by way of periodic infrastructure audits conducted by Infrastructure NSW, as well as by the level of user contributions to funding infrastructure.

[2] Consideration should be given to modifying this target to include liabilities such as long service leave and other liabilities held by SiCorp, and also to measure unfunded superannuation liabilities on a funding basis rather than an accounting basis. See Chapter 12.3 for further discussion.

Recommended fiscal target measures

To ensure state finances are sustainable, the Government should focus on stabilising general government net debt (and related interest costs) as a percentage of revenues, which, for a given infrastructure program, means reducing net borrowing requirements (i.e. improving net lending results from their current level) by controlling the growth in recurrent expenditure.

The time frame for stabilising the growth of debt needs to balance fiscal needs with government service delivery requirements, noting that excessively delayed restraint in expenditure will require more severe adjustments later (and that in the absence of any near-term actions, third parties are likely to be sceptical of forecasts).

On balance, the Government would be well advised to target expenditure control, which would slow the growth in general government (and non-commercial PTE) net debt over the next few years.

The issue that needs to be determined is what financial position needs to be targeted. At present, the implicit target is that required to retain the State's AAA credit rating. The desired credit rating level and required fiscal targets are policy decisions the Government will need to make. Targeting a financial position consistent with retaining the State's AAA credit rating is beneficial because it maintains:

- NSW's assured access to debt markets on the most attractive terms possible
- community and business confidence in the State, which could be adversely affected by a credit rating downgrade.

Nevertheless, the Government needs to make these policy decisions consciously, rather than leaving it as matter of default. If the decision was made to target a lower credit rating, it would still be necessary to put in place a financial strategy that would achieve a sustainable fiscal position consistent with that target.

If the Government wishes to retain the AAA credit rating, it will need to aim for achieving net debt and unfunded superannuation liabilities not greater than total revenue for the total state sector. This in turn will require slowing the growth in general government debt to revenues by reducing net lending deficits to approximately $1.5 billion per annum based on the current projected general government capital program.

Given current projections for unfunded superannuation liabilities and PTE sector net debt, meeting this proposed target of stabilising general government net debt would be consistent with the S&P ratio being at or below 100 per cent by 2019-20. This would put the State's finances on a sustainable path and provide sufficient fiscal flexibility for the ratio to rise temporarily into or near the AAA danger zone of 120 to 130 per cent in the event of likely future economic shocks[3].

Although challenging, these fiscal targets are significantly less demanding than those proposed in the current Independent Review of Victoria's State Finances, which has proposed achieving a zero net debt target for the general government sector over a 10-year rolling period, and having superannuation liabilities fully funded by 2030. While the Victorian proposal has the merit of clarity and simplicity, it is not applicable to NSW for the following reasons:

- From NSW's current starting point, achieving a zero net debt target would require a severe adjustment to expenditure, which would either have very negative impacts on service delivery or would require significant tax increases. Practically speaking, the target is incompatible with the Government's objective of maintaining a high level of general government capital spending and increasing rail capital expenditure over the remainder of the decade.
- From the perspective of intergenerational equity, repaying debt over a 10-year period (which would be necessary to meet a zero net debt target) would mean that the cost of major infrastructure designed to provide benefits over 30 or more years would be funded only by current users.

In order to accommodate NSW general government capital spending, general government net debt is likely to rise over the next decade. This rise is expected to be offset by the decline, as a share of revenues, of unfunded superannuation liabilities and commercial PTE net debt. This combination means that a sustainable financial position could be maintained at the total state level. However, the recent rate of increase in general government debt levels cannot continue.

Restoring an appropriate general government net borrowing position (with net debt growing more in line with trend revenue growth) would halt – but not reverse – the upward move in general government net debt and ensure ongoing sustainability.

---

[3] The large upward move in the S&P ratio in 2008-09, for example, shows the impacts of a slowdown in the state economy and a financial market decline. The ratio increased by over 30 percentage points in that year, with the debt component increasing by over 9 percentage points, while the unfunded superannuation component increased by over 20 percentage points. A recession such as that which occurred in the early 1990s could cause an increase in the ratio of over 15 percentage points on the debt component alone.

11.2 The fiscal gap

Measures to reduce expenditure growth

As explained in Section 11.1, sustainable fiscal targets can help stabilise general government and non-commercial net debt as a share of revenues, and (given current projections for the commercial PTE sector) help achieve a target S&P ratio of 100 per cent by 2019-20.

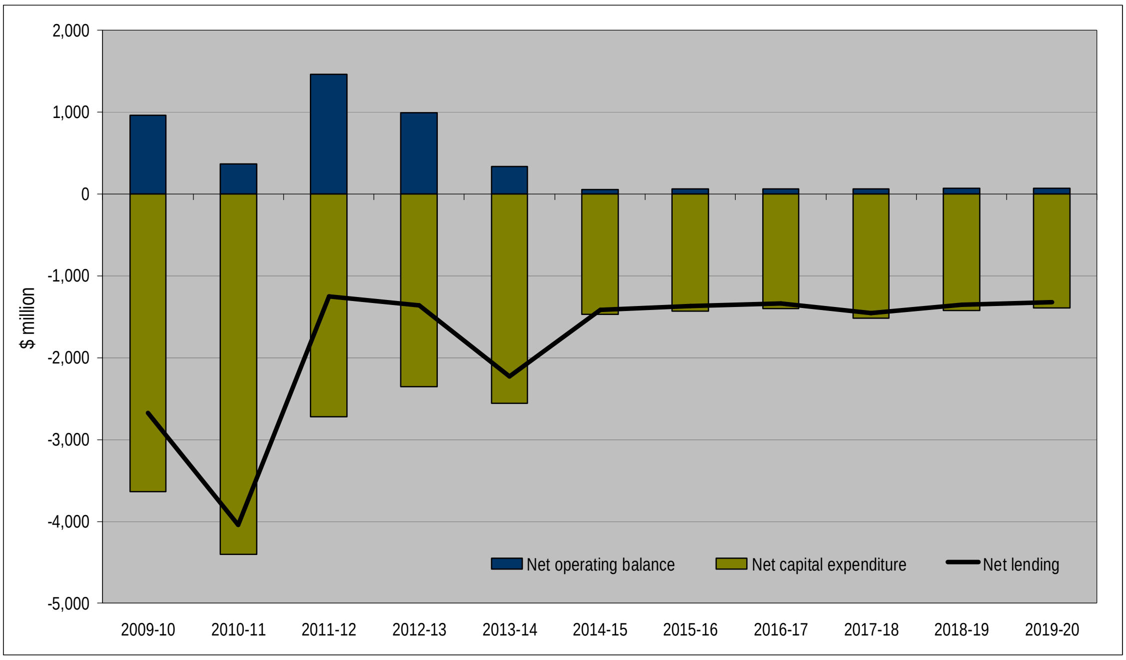
Stabilising general government net debt means focusing on the budget net lending result, which – given current 10-year State Infrastructure Strategy capital expenditure projections and assumed medium-term trend revenue growth – will also provide the targets for achieving sustainable general government recurrent expenditure growth.

To achieve a sustainable fiscal position, the Government must first address the current structural net lending deficit, before bringing general government recurrent expenditure growth in line with or below the trend in revenue growth.

Figure 11.2.1 presents a new fiscal target scenario, in which recurrent expenditure projections are lower than in the forward estimates scenario presented in Chapter 10. These reductions comprise:

- an immediate saving of $1 billion per annum
- recurrent expenditure growth of 4.6 per cent per annum (compared to the unchanged policy rate of 4.9 per cent per annum) until 2014-15, reverting to 5.2 per cent per annum thereafter, in line with trend revenue growth.

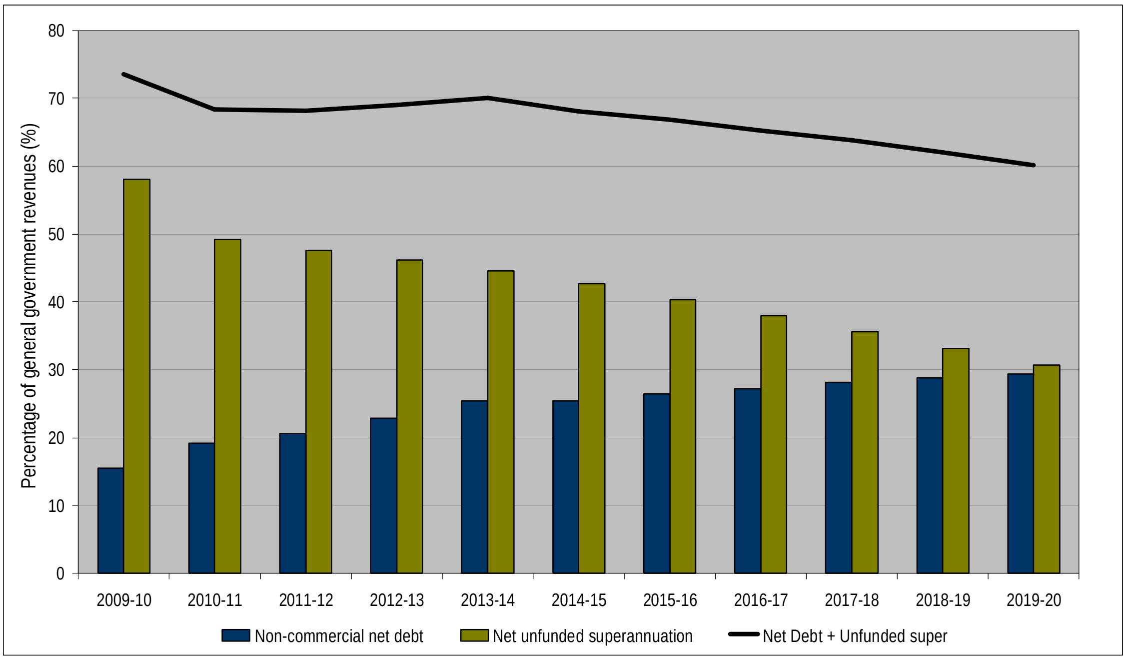
Figure 11.2.1 General government net lending and components (fiscal target scenario)



The fiscal target scenario produces improved net lending results (with deficits reduced to about 1 to 2 per cent of revenues) and net debt projections that, as seen in Figure

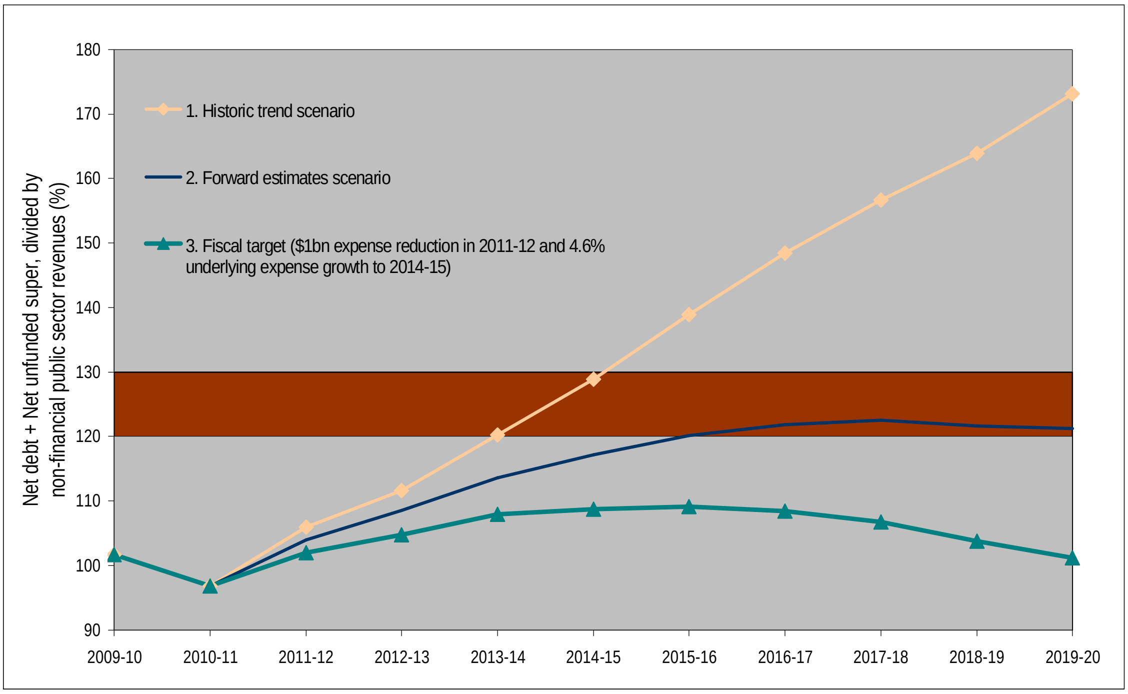
11.2.2, are broadly stabilised as a percentage of revenues. Under the fiscal target scenario these figures will still rise, but will do so at a slowing rate, and will be more than offset by the projection of declining superannuation liabilities.

Figure 11.2.2 Non-commercial (general government and non-commercial PTE) net debt and net unfunded super (fiscal target scenario)



In Figure 11.2.3, the S&P ratio for this fiscal target scenario is shown alongside the previous two scenarios presented in Chapter 10. As illustrated, there are three main steps required to meet a sustainable expenditure target.

Figure 11.2.3 S&P ratio projections with progressive tightening of expenditure control



These three steps are:

1. Bringing expenditure drift under control, by avoiding all discretionary increases that have contributed to recent high recurrent expenditure growth of over 6.5 per cent per annum. This reduces recurrent expenditure growth by about 1 per cent per annum, making it consistent with minimum realistic estimates (assuming no fundamental reforms occur).

    - Separate analysis for the Long Term Fiscal Model found that 0.8 per cent per annum of historic recurrent expenditure growth could be attributed to policy enhancements, and a further 0.2 per cent per annum was due to unexplainable factors (e.g. generally poor budget management).

    - To achieve this lower expenditure growth requires close control of future policy enhancements (through the budget process), and measures to deliver improved budget management.

2. Achievement of savings targets already in the forward estimates and actively prioritising the capital program, to bring total expenditure in line with budget and State Infrastructure Strategy estimates and keep recurrent expenditure growth in line with trend revenue growth.

3. Fundamentally reforming and prioritising service delivery (including program savings), to further reduce recurrent expenditure and meet fiscal targets.

    - Achieve additional expenditure savings through program evaluation. This goes beyond the efficiency savings that have already been pursued and targets cutbacks in poorly designed or functioning programs.

- As fiscal projections also depend on PTE sector performance in respect to dividends, tax and debt, a strong financial management framework will also be required to ensure commercial PTEs meet their current business plan forecasts (as contained in agreed Statements of Corporate Intent and Statements of Business Intent). This is especially important in the electricity network businesses, where planned growth in recurrent or capital expenditures could materially increase business debt levels and the S&P ratio, and thereby add further pressure to general government expenditure targets.

Conclusion

Achieving a sustainable fiscal position, given the current level of the capital program, requires a reduction in the ratio of net financial liabilities to revenue for the total state sector, targeting a reduction to 100 per cent by 2019-20.

To achieve this requires obtaining consistent net lending deficits of the order of $1.5 billion per annum in order to reduce the level of debt funding of the general government sector. This can be combined with asset sales, provided the asset sale proceeds are used in a sustainable manner.

A phase in over the period to 2019-20 is suggested as to phase in over a shorter period would be excessively disruptive in regard to expenditure programs and, or revenue policies.

Achieving the target of 100 per cent provides a buffer of about 20 per cent in which to absorb financial and economic shocks without being forced to resort to program cuts or tax increases. A buffer of about 20 per cent is suggested from the experience of the GFC of 2008-09 and the recession of the early 1990s.

ABBREVIATIONS

AAA	Advancing Australian Agriculture
AAS	Australian Auditing Standards
AASB	Australian Accounting Standards Board
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACHS	Australian Council on Healthcare Standards
ADHC	Ageing, Disability and Home Care
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AG	Attorney-General
AHURI	Australian Housing and Urban Research Institute
AIHW	Australian Institute of Health and Welfare
ALDs	availability liquidated damages
AMF	Auburn Maintenance Facility
APSC	Australian Public Service Commission
ARC	Audit and Risk Committee
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
BBA	budget balancing assistance
BCC	Budget Committee of Cabinet
BI	Business Intelligence
BOCSAR	Bureau of Crime Statistics and Research
BRO	Better Regulation Office
BRS	Better Regulation Statement

BS&V	Better Services and Value
BSGP	Business Sector Growth Plan
BSVP	Better Services and Value Plan
BSVT	Better Services and Value Taskforce
CAEs	Colleges of Advanced Education
CAGR	compound average growth rate
CBD	central business district
CGC	Commonwealth Grants Commission
CHP	Community Housing Provider
CLD	Crown Lands Division
COAG	Council of Australian Governments
CPI	consumer price index
CPL	capital planning limit
CPMO	central project management office
CPRS	Carbon Pollution Reduction Scheme
CREDIT	Court Referral of Eligible Defendants into Treatment
CSI	Centre for Social Impact
CSO	community service obligation
CSS	Corporate and Shared Services
D&D	Death and Disability
DEEWR	Department of Education, Employment and Workplace Relations
DET	Department of Education and Training
DFS	Department of Finance and Services
DHS	Department of Human Services
DII	Department of Industry and Investment

DoT	Department of Transport
DP&I	Department of Planning and Infrastructure
DPC	Department of Premier and Cabinet
DRGs	diagnosis-related groups
DSTA	Department of Services, Technology and Administration
EBA	enterprise bargaining agreement
EBITDA	earnings before interest, tax, depreciation and amortisation
EC	exceptional circumstances
EDS	Economic Development Strategy
EFT	electronic funds transfer
EOIs	expressions of interest
ERC	Expenditure Review Committee
ERM	enterprise risk management
ERP	enterprise resource planning
FaCS	Family and Community Services
FDASD	fetal drug and alcohol spectrum disorder
FEA	Forest Enterprises Australia
FHOG	First Home Owner Grant
FIS	financial information systems
FIS	Financial Impact Statement
FiT	feed-in tariff
Fitch	Fitch Ratings Ltd.
FRA	*Fiscal Responsibility Act 2005*
FTE	full-time equivalent
GAMC	Government Asset Management Committee

GDP	gross domestic product
GFC	global financial crisis
GFS	Government Finance Statistics
GGAS	Greenhouse Gas Abatement Scheme
GGDEA	*General Government Debt Elimination Act 1995*
GGLMF	General Government Liability Management Fund
GGS	general government sector
GMA	guaranteed minimum amount
GMR	Greater Metropolitan Region (of Sydney)
GOC	government owned corporation
GPG	General Purpose Grant
GSP	gross state product
GST	goods and services tax
GTA	GenTrader agreements
GTE	Government Trading Enterprise
HAT	highly accomplished teacher
HEIT	Health Efficiency Improvement Taskforce
HFE	horizontal fiscal equalisation
HOTS	Heads of Treasuries
ICA	Insurance Council of Australia
ICAC	Independent Commission Against Corruption
ICT	information and communication technology
ICU	intensive care unit
IEO	Independent Evaluation Office
IGA	intergovernmental agreement

IHPA	Independent Hospital Pricing Authority
INSW	Infrastructure NSW
IP	implementation plan
IPART	Independent Pricing and Regulatory Tribunal
IRC	Industrial Relations Commission
ITTA	*Income Tax Assessment Act 1997*
KPI	key performance indicator
LEP	local environmental planning
LGA	Local Government Area
LHD	Local Health District
LHN	Local Health Network
LPI	land and property information
LPMA	Land and Property Management Authority
LSL	long service leave
LTFPM	Long Term Fiscal Pressures Model
MCFFR	Ministerial Council for Federal Financial Relations
MCPRS	Major Capital Projects Reporting System
MEE	Managing Excess Employees
MERIT	Magistrates Early Referral into Treatment
MoE	maintenance of effort
Moody’s	Moody’s Investors Service
MRRT	Minerals Resource Rent Tax
MRU	Microeconomic Reform Unit
MTFM	Medium Term Fiscal Model
MTP	Metropolitan Transport Plan

NA	National Agreement
NBF	Nation Building Fund
NCP	National Competition Policy
NFL	net financial liabilities
NFPS	Non-Financial Public Sector
NGO	non-government organisation
NHS	National Health Service
NOW	NSW Office of Water
NP	National Partnership
NPP	National Partnership payment
NSWIC	NSW Infrastructure Corporation
NTER	National Tax Equivalent Regime
OECD	Organisation for Economic Co-operation and Development
OH&S	occupational health and safety
OOHC	out-of-home care
OSR	Office of State Revenue
OTR	on-time running
P&C	Parents and Citizens' Association
PAC	Public Accounts Committee
Pcards	purchasing cards
PFAA	*Public Finance and Audit Act 1983*
PFC	public financial corporation
PFE	public financial enterprise
PFNC	public non-financial corporation
PFPs	privately financed project or privately funded partnership

PISA	Program for International Student Assessment
PMO	program management office
PPP	public private partnership
PSA	Public Service Association
PSC	Public Service Commissioner
PTE	public trading enterprise
RAD	Resource Allocation Directorate
RBA	Reserve Bank of Australia
RET	renewable energy target
RIS	Regulatory Impact Statement
RoA	rest of Australia
ROA	return on assets
ROE	return on equity
ROGS	Report on Government Services
ROIC	return on invested capital
RSP	Results and Services Plan
RSPT	Resource Super Profits Tax
RTA	Roads and Traffic Authority
S&P	Standard and Poor's
SAUs	set availability unit allowances
SBI	Statement of Business Intent
SBS	Solar Bonus Scheme
SCA	Sydney Catchment Authority
SCI	Statement of Corporate Intent
SDRT	Stamp Duty Replacement Tax

SES	Senior Executive Service
SIBs	social impact bonds
SIS	State Infrastructure Strategy
SOC	State owned corporation
SPA	State Property Authority
SPP	Specific Purpose Payment
SSTS	School Student Transport Schemes
ST2	Stronger Together 2
STA	State Transit Authority
TA	Treasurer's Advance
TAFE	Technical and Further Education
TAM	Total Asset Management
TER	tax equivalent regime
TMF	Treasury Managed Fund
TPP	Treasury policy paper
VET	Vocational Education and Training
VFMC	Victorian Funds Management Corporation
WAN	wide area network
WCA	WorkCover Authority
WPI	wage price index

GLOSSARY

Allocative efficiency

An optimal allocation of scarce resources in the economy, such that those resources are directed to end uses that generate the maximum benefit to society. Allocative efficiency pertains to the total economy, where the allocation of resources across the economy results in the production of a combination of goods and services that best accords with the pattern of consumer demands. Should not be confused with 'productive efficiency', where a discrete production unit(s) produces a given level of output of a given good or service at least cost – eg, an 'efficiency dividend' of a government agency typically refers to a 'productive efficiency' context. See also 'market failure' and 'efficiency dividend'.

Appropriation

The funds appropriated by Parliament from the consolidated fund to Ministers for the purposes of funding agency activities (either recurrent or capital).

Budget-dependent agencies

These are general government agencies that receive an appropriation from the Consolidated Fund. This is their predominant funding source (rather than user charges or other revenues).

Budget result

The Budget result represents the difference between expenses and revenues from transactions for the general government sector. This measure is equivalent to the net operating balance adopted in accounting standard AASB 1049 *Whole-of-Government and General Government Sector Financial Reporting*.

Capital expenditure

This is expenditure relating to the acquisition or enhancement of property, plant and equipment (including land and buildings, plant and equipment and infrastructure systems) and intangibles (including computer software and easements).

Cash surplus/(deficit)

Net cash flows from operating activities plus net cash flows from acquisition and disposal of non-financial assets (less distributions paid for the public non-financial corporation [PNFC] and public financial corporation [PFC] sectors).

Commercial Policy Framework

The policy suite that applies a shareholder framework to government businesses and seeks to impose private sector disciplines. Principles include independent boards and management with authority and autonomy, clear commercial objectives, effective performance monitoring and rewards and sanctions to create an incentive to maximise the value of the businesses, and competitive neutrality measures.

Community service obligations

Non-commercial activities that government businesses are directed to undertake by the Government that they would not undertake commercially. These should be costed by the business and reviewed in the State Budget, to rank them against other priorities and for transparency. Funding may be provided from the Budget, and for those that are not reimbursed, Treasury's performance monitoring should be adjusted.

Competitive neutrality

Policies applied to government businesses so that they are not advantaged or disadvantaged relative to their private sector counterparts, due to their ownership by government. Policies include the government guarantee fee and the tax equivalent regime.

Consolidated Fund

The fund is established under s39 of the *Constitution Act 1902*. Public monies collected on behalf of the State form this fund. This includes:

§ taxes, fines, fees collected

§ Australian Government grants and

§ dividends and tax equivalent payments from public trading and public financial enterprises.

Corporate governance

The framework of rules and relationships by which authority is exercised by and controlled in government businesses. For SOCs, the board is charged with governance within the framework set by the State Owned Corporations Act 1989, and for all businesses the Commercial Policy Framework applies.

Cost-benefit analysis

Also referred to as 'benefit-cost analysis' (BCA), pertains to a technique for systematically analysing all the costs and benefits of various options to achieve a given objective. BCA assists in the selection of projects or programs that maximise benefits to the community relative to costs, and helps ensure that decision makers are aware of all likely direct and indirect costs and benefits as well as externalities (to the extent it is possible to quantify these) associated with different options. See also 'Externality'.

Efficiency dividend

The efficiency dividend represents a return to the Budget of gains expected to arise from increased operating efficiency in general government sector agencies.

Externality

The impact of an activity that confers costs (a ‘negative externality’) or benefits (a ‘positive externality’) on a third party that are not fully reflected in prices. Externalities can arise during the production or consumption phases of the activity and may be of an environmental, social or financial nature. See also ‘Market failure’, ‘Allocative efficiency’, ‘Information asymmetry’ and ‘Cost benefit analysis’.

Financial Impact Statement (FIS)

The Financial Impact Statement accompanies Cabinet Minutes and is intended to demonstrate to Cabinet or a Cabinet Committee the financial impact of the proposal being referred for a decision. The Financial Impact Statement includes on-costs to other agencies, offsetting savings and the manner in which it is proposed to fund the initiative.

Financial Management Framework

The NSW Financial Management Framework comprises of a suite of legislation, policies and procedures aimed at maintaining aggregate fiscal discipline, allocating resources in line with the Government’s strategic priorities and using Budget resources efficiently.

Fiscal gap

The fiscal gap is the difference between the base period primary balance as a share of gross state product (GSP) and the primary balance as a share of GSP at the end of the projection period, on a no policy change basis. The primary balance is the gap between spending and revenue excluding interest transactions but including net capital expenditure. A positive gap implies that fiscal pressures will be building over the projection period.

Fiscal Responsibility Act 2005 (NSW)

The Act sets out both medium-term and long-term fiscal targets and principles providing a framework for budgeting in New South Wales.

Forward estimates

The forward estimates are the projected annual position for all revenues and expenditures for each year of a four year planning horizon (ie budget year, plus three out years). Forward estimates are prepared on a no policy change basis, that is, they reflect existing policy.

Full-time equivalent (FTE)

This is the standard measure of staffing in terms of a full-time equivalent number of positions.

Gateway review system

Gateway Reviews are reviews of major procurement projects by independent people at defined decision points (gates) in projects. Gateway is not an audit, a detailed technical review or an inquiry, but a review by experienced 'peers' to provide a 'fresh' view of the project. The NSW Government developed the system to help agencies improve their procurement discipline and to achieve better service results from their procurement activity.

General government sector

This is an ABS classification of agencies that provide public services (such as health, education and police), or perform a regulatory function. General government agencies are funded in the main by taxation (directly or indirectly). Within this sector there are budget dependent and non-budget dependent agencies.

Government Finance Statistics (GFS)

A system of financial reporting developed by the International Monetary Fund and used by the Australian Bureau of Statistics to classify the financial transactions of governments and measure their impact on the rest of the economy.

Gross state product (GSP)

The total market value of final goods and services produced within a state.

Horizontal fiscal equalisation (HFE)

A distribution of GST revenue to State and territory governments such that, after allowing for material factors affecting revenues and expenditures, each jurisdiction should have the fiscal capacity to supply services and associated infrastructure at the same standard, provided each jurisdiction made the same effort to raise revenue from its own sources, operated at the same level of efficiency and maintained the same per capita net financial worth.

Information asymmetry

A situation where one party to a transaction has more or better information than the other(s), creating an imbalance of power that favours the more knowledgeable party in the transaction and resulting in sub-optimal resource allocation. Examples include adverse selection (eg, a more costly or inferior option is selected because the buyer may be unaware of the true cost) or moral hazard (eg, a party to the transaction who is protected from risk behaves differently than if they were exposed to that risk). See also 'Market failure' and 'Allocative efficiency'.

Long term fiscal model

Demographic based model which NSW Treasury has developed to examine the long-run (40 year) impact of ageing of the population on the NSW economy and fiscal position.

Maintenance of effort (MoE)

Maintenance of Effort proposals are proposals to maintain existing Government services in terms of service nature, availability, quantity and quality. It includes proposals to rollover or re-profile existing programs and address extraordinary, unforeseen and uncontrollable circumstances.

Market failure

A situation where allocative efficiency is not attained due to sub-optimal market structures (eg, monopolies) and/or the failure of costs and benefits to be internalised in market prices, thereby sending erroneous signals on which producers and consumers base their decisions. Market failures tend to be associated with information asymmetries, non-competitive markets, externalities or public goods. The claimed existence of a market failure is often used to justify government intervention in that particular market. See also 'Allocative efficiency', 'Externality' and 'Information asymmetry'.

Medium Term Fiscal Model (MTFM)

A NSW Treasury developed model which examines the fiscal position of the state over the next decade. Uses SCI and SBI operating balance and balance sheet information for the PTE sector and for the general government sector uses SIS capital expenditure and assumptions for budget expense and revenue growth.

National Agreement (NA) payments

An Australian Government grant to States and Territories which must be spent in the key service delivery sector (healthcare, schools, skills and workforce development, disability services and affordable housing, and Indigenous reforms) for which it is provided. States are free to allocate the funds within that sector to achieve the mutually agreed objectives specified in the associated National Agreement.

National Partnership payment (NPP)

An Australian Government grant to States and Territories to support the delivery of specified outputs or projects, to facilitate reforms or to reward the delivery of nationally significant reforms. Each NPP is supported by a National Partnership Agreement which defines mutually agreed objectives, outputs and performance benchmarks.

Net cost of services

In agency operating statements this measures the net cost of providing government services. It equals operating expenses less operating revenues, and excludes government contributions.

Net debt

Net debt equals the sum of deposits held, advances received, loans and other borrowings less the sum of cash and deposits, advances paid and investments, loans and placements.

Net financial liabilities (NFL)

This is the total liabilities less financial assets, other than equity in PNFCs and PFCs. It is a more accurate indicator than net debt of a jurisdiction's fiscal position. This is because it is a broader measure than net debt in that it includes significant liabilities other than borrowings (for example, accrued employee liabilities such as superannuation and long service leave entitlements). For the PNFC and PFC sectors, it is equal to negative net financial worth. For the general government sector NFL, excluding the net worth of other sectors results in a purer measure than net financial worth as, in general, the net worth of other sectors of government is backed up by physical assets.

Net lending/(borrowing)

The financing requirement of government, calculated as the net operating balance less the net acquisition of non-financial assets. It also equals transactions in financial assets less transactions in liabilities. A positive result reflects a net lending position and a negative result reflects a net borrowing position.

Net operating balance

This is calculated as revenue from transactions less expenses from transactions.

Net worth

An economic measure of wealth and is equal to total assets less liabilities.

Non-budget dependent general government agencies

These are general government agencies that do not rely on the Consolidated Fund for direct financial support. They predominantly source funds from regulatory and user charges (but may receive budget funding in the form of grants from other general government agencies for certain activities or services).

Non-financial public sector

This is a sub-sector formed by the consolidation of the general government sector and public non-financial corporations (PNFC) sector.

Productivity

A measure of output per unit of input from a production process. In relation to the aggregate economy, measures of productivity may be based on a single input (eg, labour productivity is the ratio of the real value of output to the value of labour input) or all inputs (eg, multifactor productivity or total factor productivity is the ratio of the real value of output to the combined value of labour and capital inputs). Similar measures can also be developed for a discrete production unit, eg, a company or department.

Public financial enterprise (PFE)

An ABS classification of agencies that have one, or more, of the following functions:

- that of a central bank
- the acceptance of demand, time or savings deposits or
- the authority to incur liabilities and acquire financial assets in the market on their own account.

For GFS purposes these are referred to as public financial corporations (PFC).

Privately Financed Projects (PFP)

This involves the creation of an infrastructure asset through private sector financing and private ownership for a concession period (usually long term). The Government may contribute to the project by providing land or capital works, through risk sharing, revenue diversion or purchase of the agreed services.

Public trading enterprise (PTE)

An ABS classification of agencies where user charges represent a significant proportion of revenue and the agency operates with a broadly commercial orientation. For GFS purposes, the ABS refers to these as Public Non-Financial Corporations (PNFC).

Results and Services Plan (RSP)

A service delivery and funding plan prepared by an agency to support decision making by the Cabinet Standing Committee on the Budget. The RSP provides a clear ‘line of sight’ for performance management by setting out the linkages between State Plan priorities, the results that an agency is working towards, the services it delivers to contribute to those results, and the costs of delivering those services as reflected in the agency’s budget.

Royalties

A mineral royalty is the price charged by the Government for the transfer of the right to extract a mineral resource. The prices (royalty rates) for different minerals are prescribed in mining legislation and associated regulations.

Services

These are the ‘end products’ or direct services that are delivered to clients or recipients, the broader community or another government agency. They are expected to contribute to Government priorities.

Service groups

Services that are grouped together on the basis of the results they contribute to, the client group that they serve, common cost drivers or other service measures. There should be a clear ‘line of sight’ between the service groups and the services and activities that are costed and managed as part of internal business planning.

Social capital

Social capital focuses on social relations that have productive benefits. It may be thought of as an ability to interact with other members of society and is associated with better functioning communities and higher individual satisfaction with life.

Social rate of return

The social rate of return of a project is the increase in welfare that results from the project, expressed as a proportion of the cost of the project. For a project with wider social benefits, the social rate of return will typically exceed the private rate of return, or financial rate of return, which is the amount of money returned to the project developer expressed as a proportion of project costs.

Stamp Duty Replacement Tax (SDRT)

This is a tax proposed in Chapter 13 to replace stamp duty on transfers of real estate (ie transfer duty). The proposed tax would be based on land values rather than market values of property, and would be payable annually instead of being paid when properties are bought.

Statement of Business Intent (SBI)

For commercial government businesses that are not State Owned Corporations, an agreement with the Government on the objectives and obligations by which they will operate, encompassing 10 years with a focus on the next 12 months

Statement of Corporate Intent (SCI)

For State Owned Corporations, an agreement with the Government on the objectives and obligations by which they will operate, encompassing 10 years with a focus on the next 12 months

State owned corporation (SOC)

Government businesses which have been established with a governance structure mirroring as far as possible that of a publicly listed company. State owned corporations are scheduled under the *State Owned Corporations Act 1989* (Schedule 5).

Structural deficit

A budget deficit that persists even when revenues are at trend levels. It indicates that government spending is too high for the current revenue base.

Surplus/(deficit)

In Budget Paper No.3 *Budget Estimates* this is the agency accounting result which corresponds to profit or loss in private sector reports. It equals the net cost of services adjusted for government contributions. This is not the same as the budget result or the GFS cash surplus/(deficit).

Total Asset Management (TAM)

An agency's TAM plan sets out its asset expenditure priorities and funding projections over a rolling ten year period, to ensure physical asset management plans are aligned with service priorities and performance targets, and are financially sustainable. TAM covers the acquisition, maintenance, operation and disposal of all physical assets, including land, buildings, infrastructure, plant and equipment, and information technology.

Total expenses

The total amount of expenses incurred in the provision of goods and services, regardless of whether a cash payment is made to meet the expense in the same year. It does not include expenditure on the purchase of assets. It also excludes losses, which are classified as other economic flows.

Total revenues

This is the total amount of revenue due by way of taxation, Australian Government grants and from other sources (excluding asset sales) regardless of whether a cash payment is received. It excludes gains, which are classified as other economic flows.

Total state sector

Represents all agencies and corporations owned and controlled by the NSW Government. It comprises the general government, public trading (also referred to as the public non-financial corporations) and public financial enterprises.

Transfer duty

This is one of the various forms of stamp duty. It is a tax that is levied on purchases of real estate, based on the market value of the property transferred.

Treasurer’s Advance (TA)

The Advance to the Treasurer is an amount included each year within the recurrent and capital appropriations to the Treasurer to meet ordinary expenses that generally could not have been foreseen at Budget time, e.g. a new policy initiative by the Government post-budget.

Vertical fiscal imbalance

The significant mismatch between the States’ and territories’ large spending responsibilities but limited revenue raising options and the Australian Government’s capacity to raise much more revenue than is required for its own spending needs. VFI produces a need for large financial transfers from the Australian to State and territory governments.

Wage offsets

Wages policy provides funding for wage increases and associated costs at 2.5 per cent per year. Increases in wages and conditions greater than 2.5 per cent must be funded by employee-related cost savings. Employee related cost savings that fund increases in wages or conditions above 2.5 per cent per annum are referred to as wage offsets.

Welfare

Economic welfare refers to the overall well-being of society. Measures of economic welfare take account of the amounts that people pay for goods and services, the additional well-being that they receive over and above the price paid (consumer surplus), and any costs (eg pollution, congestion) or benefits they impose on others.

CHART AND TABLE LIST

BIBLIOGRAPHY

Abelson, Peter. *Economic Review of Urban Planning (Progress Report).* January 2011

Alcohol and other Drugs Council of Australia. *Best Practice in the Diversion of Alcohol and Other Drug Offenders: Proceedings of the ADCA Diversion Forum*. Canberra: 1996.

Applied Economics*. An Economic Assessment of Human and Social Capital Interventions, prepared for NSW Treasury*. Sydney: 2011.

Australian Bureau of Statistics. *Australian Demographic Statistics - 3101.0*. Canberra.

Australian Bureau of Statistics. *Australian National Accounts: State Accounts - 5220.0*. Canberra.

Australian Bureau of Statistics. *Australian System of Government Finance Statistics: Concepts, Sources and Methods, Cat No 5514.0*. Canberra: 2005.

Australian Bureau of Statistics. *CGC Relative Fiscal Capacities of the States - 3222.0*, Canberra: 2008.

Australian Bureau of Statistics. *Consumer Price Index - 6401.0.* Canberra: March 2011.

Australian Bureau of Statistics. *Council Rates Revenue 2008-09 - 5212*. Canberra: 2009.

Australian Bureau of Statistics. *Household and Family Projections (Cat. 3236.0, Table 1.2)*. Canberra: 2010.

Australian Bureau of Statistics. *NSW State and Regional Indicators - 1338.1*. Canberra: December 2010.

Australian Bureau of Statistics. *State and Territory Budgets for 2010-11: 5512.0.* Canberra: 2011.

Australian Bureau of Statistics. *Schools Australia 2009 - 4221.* Canberra: 2009.

Australian Bureau of Statistics. *Wage Price Index*. Canberra: March 2011.

Australian Housing and Urban Research Institute. *The Cost-Effectiveness of Homelessness: A First Assessment, Final Report No.119.* June 2008

Aos, Steve et al. *Benefits and Costs Of Prevention And Early Intervention Programs For Youth.* Olympia, Washington: Washington State Institute for Public Policy, 2004.

Audit Office of NSW. *Auditor-General's Report to Parliament 2010: Volume Nine.* Sydney: 2010.

Audit Office of NSW. *Performance Audit Condition of State Roads, Roads and Traffic Authority of NSW.* Sydney: 2006.

Audit Office of NSW. *Performance Audit of Government Investment in V8 Supercar Races at Sydney Olympic Park.* Sydney: 2010.

Audit Office of NSW. *Report to Parliament 2010, Volume 10 – Focusing on Education and Communities: Department of Education and Training*. Sydney: 2010.

Australian Competition and Consumer Commission. *Inquiry into the Competitiveness of Retail Prices for Standard Groceries.* 2008.

Better Regulation Office. *Annual Update on Regulatory Reform 2009-10*. 2010.

BIS Shrapnel. *Forecasting the Distribution of Dedicated Office Employment within Sydney*. Sydney: February 2011.

BIS Shrapnel. *Sydney Commercial Property 2010–2020 Update, Prime Net Commercial Rents 2010.* Sydney: October 2010.

Bureau of Transport and Regional Economics. *Estimating Urban Traffic and Congestion Cost Trends for Australian Cities - Working Paper 71*. 2007.

Bureau of Transport Statistics. 2010.

Bureau of Transport Statistics. *Customised Data Request on Road Volume and Capacity in Sydney*. Sydney: 2011.

Bureau of Transport Statistics. *NSW Transport Household Travel Survey*. Sydney: 2010.

Butler, Tony and Lucas Milner. *NSW Inmate Health Survey.* Sydney: NSW Department of Corrective Services, 2003.

Centre for International Economics. *The Benefits and Costs of Alternative Growth Paths for Sydney: Economic Social and Environmental Impacts.* Sydney: 2010.

COAG National Reform Agenda. *Competition and Infrastructure Reform Agreement.* Canberra: 2007.

Daley, John and Tristan Edis. *Learning the Hard Way: Australia's Policies to Reduce Emissions*. Melbourne: Grattan Institute, April 2011.

Department of Planning*. Local Development Performance Monitoring: 2009–10*. Sydney: January 2011.

Department of Premier and Cabinet. *NSW Public Sector Workforce: Profile 2000-10 Snapshot tables*. Sydney: 2010.

Department of Premier and Cabinet*. Wages Policy and Workforce Management, Section 5.4.6 - Key Reform Issues for Wages Policy in Brief 5.4*.

Department of Premier and Cabinet. *Whole-of-Government Policy for the Application of User Charges for Major and Special Events*. Sydney: December 2003.

Department of Treasury and Finance, Victoria. *In Pursuit of Additional Value – a Benchmarking Study into Alliancing in the Australian Public Sector*. Melbourne: 2009.

Department of Transport. *Updated Transport Submission by NSW Government to Infrastructure Australia: North West Rail – Hills District Line.* Sydney: 2010.

Econtech. Excess *Burden Estimates for Commonwealth taxes*. 2010.

Econtech. *Excess Burden Estimates for State and Council Taxes.* 2011.

Econtech. *Treasury Calculations for Reforms 8 and 9*. 2011.

Ernst & Young. *Government Business Performance Assessment and Capital Management Project for NSW Treasury*. Sydney: January 2011.

Fels, Allan, Stephen Beare and Stephanie Szakiel. *Choice Free Zone*. Canberra: Urban Taskforce Australia, 2008.

Queensland Chamber of Commerce and Industry. *Regulatory Compliance Costs and Other Burdens - A Survey Report.* Brisbane: 1996.

Hoeckel, Kathrin et al. *Learning for Jobs: OECD Reviews of Vocational Education and Training – Australia.* November 2008.

Independent Pricing and Regulatory Tribunal. *Reform Priorities: Report to the NSW Government.* Sydney: April 2011.

Independent Pricing and Regulatory Tribunal. *Review of the Productivity of State-Owned Corporations.* Sydney: 2010.

Independent Transport Safety and Reliability Regulator. *Transport Reliability Report 08-09.* Sydney: 2009.

Independent Pricing and Regulatory Tribunal. *Up-Skilling NSW – How Vocational Education and Training Can Help Overcome Skill Shortages, Improve Labour Market Outcomes and Raise Economic Growth, Australian Census and OECD Data*. Sydney: 2006.

Jensen, Ben. *Investing in Our Teachers, Investing in Our Economy*. Melbourne: Grattan Institute, 2010.

Johnson, Guy, Hellene Gronda, and Sally Coutts. *On the Outside: Pathways in and out of Homelessness.* Melbourne: Australian Scholarly Publishing, 2008.

Leigh, Andrew. *Disconnected*. Sydney: University of New South Wales Press, 2010.

Knight Frank. *Global Real Estate Markets: Annual Review and Outlook 2009-10.* 2010.

KPMG. *DJAG Initial Scan of Expenditure Final Report.* Sydney: 2010.

McDowell, Jim et al. *A Shared Responsibility – Apprenticeships for the 21st Century*, *Final Report by Expert Panel.* Canberra: January 2011.

Metropolitan Transport Authority. *Annual Report 2009-10*. 2010.

Moody's Investors Service. *How Far Can Aaa Governments Stretch Their Balance Sheets.* February 2009.

Moody's Investor Service. *Rating Action: Queensland (State of) Australia, Moody's Lowers Queensland's Rating to Aa1.* May 2009.

NSW Treasury. *Half-Yearly Review of the Budget 2010-11: State Revenue Estimates*. Sydney: 2011.

NSW Treasury. *Half-Yearly-Review Expenditure Forecasts 2011-12 to 2013-14*. Sydney: 2011.

NSW Treasury. *Mid-Year Review 2010-11*. Sydney: 2011.

NSW Treasury. *Budget Papers 2010-11, BP3.* Sydney: 2011.

NSW Treasury. *Budget Papers 2008-09, BP2.* Sydney: 2009.

NSW Treasury. *Budget Papers 2003-04*, BP2. Sydney: 2004.

NSW Treasury. *Treasury Policy Paper TPP08-02.* Sydney: 2008.

NSW Treasury. *Workforce Profile 2010 Table 1*. Sydney: 2010.

NSW Police. *Management accounts*.

RailCorp, *Annual Report 2009-10*. Sydney: 2010.

Parents and Citizens' Association of NSW, 2008.

Property Council of Australia. *Office Market Report: Net effective Rents in Docklands.* February 2011.

Productivity Commission. *Financial Performance of Government Trading Enterprises, 2004-05 to 2006-07, Productivity Commission Research Paper*. Canberra, July 2008.

Productivity Commission. *Performance Benchmarking of Australian Business Regulation: Planning, Zoning and Development Assessment.* Canberra: April 2011.

Productivity Commission. *Productivity Commission Inquiry Report, Government Drought Support.* Canberra: February 2009.

Productivity Commission. *Productivity Report on Government Services 2011: Table 15A.5, 2009-10 data*. Canberra: 2011.

Productivity Commission. *Vocational Education and Training Workforce, Productivity Commission Research Report*. Canberra: April 2011.

Productivity Commission Research Report. *Impacts of Advances in Medical Technology in Australia.* Melbourne: 2005.

Productivity Commission. *Trade and Assistance Review 2009-10.* Canberra: 2011.

Pleace, Nicholas. *Single Homelessness as Social Exclusion: The Unique and the Extreme, Social Policy & Administration.* 1998.

Parliament of NSW. *Industrial Relations Amendment (Public Sector Conditions of Employment) Bill 2011.*

Roads and Traffic Authority. *Travel Speeds in Sydney Metropolitan Area*. Sydney: 2011.

Royal Commission into the NSW Police Service Final Report. Sydney: May 1997.

Sanders, William and June Rivers. *Cumulative and Residual Effects of Teachers on Future Student Academic Achievement.* University of Tennessee, November 1996.

School Student Transport Scheme NSW. November 2008.

Skills Australia. *Skills for Prosperity: A Roadmap for Vocational Education and Training.* Canberra: May 2011.

Smart, Mike. *Value of CityRail Externalities and Optimal Government Subsidy.* Sydney: CRA International: 2008.

Standard & Poor's. *Ratings Direct on the Direct Credit Portal – South Australia (State of).* August 2009.

The Allen Consulting Group. *A Harmonised Payroll Tax System for NSW and Victoria, Estimated Change in the Administrative Burden*. Sydney: 2009.

The Allen Consulting Group. *Report to Infrastructure Partnerships Australia: Performance of PPPs and Traditional Procurement in Australia.* November 2007.

The Audit Office of NSW. *NSW Auditor-General's Report to Parliament 2010: Focusing on Education and Communities, Department of Education and Training, volume 10*. Canberra: 2010.

The Centre for International Economics. *The Benefits and Costs of Alternative Growth Paths for Sydney.* 2011.

The Public Sector Employment and Management (Departments) Order 2011*, Public Sector Employment and Management Act 2002.*

The Treasury. *Australia's Future Tax System - Report to the Treasurer*. Canberra: 2009.

The Treasury. *Commonwealth 2009 Tax Expenditures Statement - Forecast for 2011-12*. Canberra: 2010.

The Economist, 11 November 2010.

Transport for London. *Annual Report and Accounts*. London: 2010.

Turner and Townsend. *Gateway Review Process Refresh Program*. July 2008.

Societe de Transport de Montreal. *Annual Report 2010.* Montreal: 2010.

Urban Taskforce Australia. *Fixing Town Planning Laws, September 2010 - Updated Transport Submission by NSW Government to Infrastructure Australia; M5 East Expansion*. Sydney: 2010.

Usher Review. *A Report to the Minister for Health and Community Services from the Committee established to review Substitute Care Services in NSW*. Sydney: NSW Ministerial Committee, 1992.

Valentine, Kylie and Ilan Katz. *Cost Effectiveness of Early Intervention Programs for Queensland*. Brisbane: Queensland Council of Social Services, 2007.

Wood Inquiry. *Special Commission of Inquiry into Child Protection Services in NSW.* Sydney: 2008.

www.headspace.org.au

www.cityofsydney.nsw.gov.au/AboutSydney/CityResearch/AtAGlance.asp

www.dpc.nsw.gov.au/publications/memos_and_circulars/circulars/2010/c2010-18_staffing_freeze

www.dpmc.gov.au/publications/aga_reform/aga_reform_blueprint/part4.6.cfm

www.dpmc.gov.au/consultation/aga_reform/pdfs/0114%20Australian%20Public%20Service%20Commission.pdf

www.dpc.nsw.gov.au/__data/assets/pdf_file/0020/120737/2010_SnapshotReport_P2011_004.pdf

www.health.nsw.gov.au/pubs/2010/pdf/yellowbook_09.pdf

www.parliament.nsw.gov.au/prod/parlment/nswbills.nsf/0/C78B213F28ABF8DBCA25789A002446D3?Open&shownotes)

www.pc.gov.au/gsp/reports/rogs/2011 (Police data tables)

www.sydney.edu.au/business/__data/assets/pdf_file/0003/99426/NSW_Public_Sector_Pay_Note_1.pdf

NSW Financial Audit 2011

Report Part C:

Policy, Financial and Economic Reform

September 2011

NSW Treasury

Governor Macquarie Tower

1 Farrer Place

SYDNEY NSW 2000

Website: www.treasury.nsw.gov.au

NSW Financial Audit set includes:

Volume 1 – Part A: Setting the Scene

Part B: Financial System, Projections and Sustainability

Volume 2 – Part C: Policy, Financial and Economic Reform

NSW FINANCIAL AUDIT 2011

Contents

PART C: POLICY, FINANCIAL AND ECONOMIC REFORM

PART C: POLICY, FINANCIAL AND ECONOMIC REFORM

Part C sets out a comprehensive reform package that seeks to achieve the following overarching objectives:

- creating a sustainable financial position for the State consistent with retaining the State's high credit rating
- ensuring effective financial management, budget control and accountability
- improving the productivity and performance of the state economy
- achieving a more efficient, equitable and simpler taxation system
- creating the preconditions for an efficient and effective provision of services and infrastructure
- improving resource management and expenditure control

The package of reforms to achieve these objectives consists of eight elements, which are each addressed in dedicated chapters here in Part C.

In summary, the eight elements of the reform package and their rationales are:

1. **Fiscal sustainability and improved financial management, budget control and accountability**

The achievement of a sustainable fiscal position requires not only committing to the required fiscal targets, but of having in place a disciplined approach to financial management and clear accountability for financial management and control.

2. **Revenue reforms**

The State's revenue base is relatively narrow and inefficient. Further, it generates highly volatile revenue which over the longer term, declines as a share of gross state product. It is essential to reform the State's revenue base and in particular to improve the efficiency, equity and simplicity of the taxation system.

3. **Implementation of an Economic Development Strategy**

An Economic Development Strategy is proposed as a framework for informing and guiding the actions of the Government in pursuing economic reform, focusing on efficient and effective service and infrastructure provision; better and more efficient regulation; improved land use planning; a pro-competition approach to markets and policy; ensuring the State has the right mix of skills and flexibility in its workforce; and the efficient and effective adjustment of the State economy to a low carbon world. By improving the performance of the economy, an effective economic development strategy also assists the Budget by increasing revenue and reducing demand for social services.

4. **Reformed service provision**

To achieve fiscal sustainability while delivering on the Government's commitment to providing quality public services requires putting in service provision arrangements based on good governance and to review, on a regular basis, the efficiency, effectiveness and appropriateness of service programs.

5. **Reformed asset and capital project management**

Infrastructure is not an end in itself, but a means to deliver services to the community. In recent years, poor decisions that reflect a lack of good process have been made regarding various infrastructure projects. It is essential that long-term infrastructure plans are established which are based on rigorous appraisal of all alternatives, including demand management and more effective use of existing infrastructure. Further, there should be a sound and transparent process for prioritising scarce resources.

6. **Improved workforce management and wages policy**

Labour is the key resource that underpins service provision in the public sector and it is also the major cost that affects the ability to achieve a sustainable fiscal position. It is essential that there is a wages policy in place that is affordable and which encourages improved labour productivity. Complementary with this is the need for improved workforce flexibility and planning.

7. **Improved balance sheet management**

A strong balance sheet provides a buffer for the State’s finances to absorb external economic and financial shocks without the need to cut service provision or increase taxes.

8. **Improved PTE performance**

A well-performing public trading enterprise (PTE) sector provides its services at an efficient cost, generates contributions to the Budget in the form of dividends and taxes, and avoids excessive debt that could adversely impact on the state financial position.

The linkages from the strategies to the objectives are summarised in the figure below.

Strategies	Objectives					
	Achieving a fiscally sustainable position	**Budget control and accountability**	**Improved economic performance**	**Efficient, equitable and simple tax system**	**Efficient and effective provision of services and infrastructure**	**Improved resource management and expenditure control**
Fiscal sustainability, financial management, control and accountability	√	√	√			
Revenue reform	√		√	√		
Economic development	√		√			
Reforming service delivery	√	√	√		√	√
Improving asset management and prioritisation and effectiveness of capital expenditure	√		√		√	√
Workforce management and wages policy	√	√				√
Balance sheet management	√					√
Improved State Owned Corporation governance and performance	√		√		√	√

12 FISCAL SUSTAINABILITY AND IMPROVED FINANCIAL MANAGEMENT, CONTROL AND ACCOUNTABILITY

Key points

- The Government can achieve more sustainable finances – with stronger fiscal discipline, better allocation of budget resources and more efficient resource use – through reforms designed to improve financial management, control and accountability, including:
  - adopting a Medium Term Fiscal Strategy (MTFS) based on fiscal sustainability, with the *Fiscal Responsibility Act 2005* revised to reflect financial targets in line with this MTFS
  - ensuring resources are allocated in line with the Government's strategic priorities
  - improving budget compliance by devolving authority, and ensuring greater accountability by introducing effective incentives and sanctions for CEOs and ministers in order to encourage good financial management
  - requiring all resource decisions to be made in the budget process at the commencement of each budget cycle.
- Cabinet should approve a Statement of Priorities and a Budget Policy Statement, consistent with the MTFS, to guide resource decisions at the commencement of each budget cycle.
- All spending proposals (capital and recurrent) should be supported by rigorous business cases.
- Formal processes should be implemented to evaluate the effectiveness of current and new programs.
- Administrative controls should be tightened, including by curtailing the Treasurer's Advance for all purposes other than genuine unforeseen and unavoidable circumstances.
- The role and effectiveness of the Public Accounts Committee and the Auditor-General should be enhanced.

12.1 Overview

While the structure or machinery of the Government's budgeting and financial management system is sound, there are significant deficiencies in the areas of accountability, prioritisation and control, as well as a lack of compliance with the requirements of the financial system. In the absence of action to address these deficiencies, it will not be possible to achieve the core requirements of a financial management system, namely:

- maintaining overall fiscal discipline while delivering priority services and infrastructure within a sustainable fiscal policy setting
- allocating resources in line with the Government's strategic priorities
- using budget resources efficiently and effectively.

The core deficiencies in the current governance and accountability framework are as follows:

1. ***The absence of a coherent, longer term policy direction at a whole-of-government level***

   While there have been numerous State Plans in recent years – which in theory provides the necessary longer term, whole-of-government framework – this objective has not been achieved. The State Plans have not acted as the framework for government decision making and the basis on which budget priorities have been set.

2. ***The absence of prioritisation and rigour in decision making regarding resource requirements***

   Decisions are undertaken on an ad hoc basis over the course of each year, often outside of the context of the budget process. When decisions are made outside the budget process, there is limited consideration of the comparative merits of different proposals at a point in time, which creates the potential for deviations from the fiscal strategy.

3. ***A lack of clear accountability for policy and service delivery outcomes and financial management***

   In the past, CEOs have been accountable to their portfolio minister, not to the Government as a whole. CEOs and portfolio ministers have also not been held accountable for performance and financial management, while CFOs have not been fully empowered to undertake their role.

4. ***Siloed decision making with no whole-of-government perspective***

   There has been a fragmented approach to government decision making, with each minister pursuing specific policies and approaches that are not informed by a whole-of-government perspective. Even within groups of portfolios that should have clear strategic alignment – such as in transport, and the broad area of attorney-general, justice, corrective services and police – there has been a lack of coordination, which has undermined effective policy development.

5. ***Poor policy formulation and lack of public participation***

   There has been a lack of disclosure of information and policy options required to stimulate informed public discussion on major issues, and to educate the public on the constraints and issues that need to be taken into account.

6. ***No regular evaluation of the efficiency and effectiveness of government programs***

   Over the last few years, a Better Service and Value process has been developed. This has sought to involve agencies in an assessment of opportunities to improve efficiency within them. Prior to this, agencies had productivity targets but no mechanism in place to help them find the savings and evaluate whether the savings were consistent with the direction of government policy. This process needs to be institutionalised. There is also no process in place for regularly evaluating the effectiveness of new and existing programs.

7. ***Discouragement of 'frank and fearless' public service advice***

   The system in which CEOs were directly accountable to their minister discouraged the giving of independent advice that may have been at variance with the disposition of the particular minister.

8. ***Unrealistic agency budgets and forward estimates***

   There is an inherent conservative bias in the forward estimates of agencies in the sense that it is not appropriate to build into individual agency budgets provisions for risks that may not eventuate. However, in recent years the forward estimates have built in quite unrealistic assumptions. These assumptions included restricting wages growth funding to only 2.5 per cent per annum under institutional circumstances that did not allow this to occur, and that full efficiency savings would occur when the prospect of this occurring was doubtful. This led to a view amongst agencies that the budgets and forward estimates did not matter.

Set out below in Figure 12.1 is a schematic representation of the deficiencies and how the recommendations set out in the report will address these.

Figure 12.1.1 Reforms to the governance and accountability framework

		THE PROBLEM							
		Lack of coherent, whole-of-government policy direction	Absence of clear prioritisation	Lack of clear accountability for policy, service delivery and financial management	Siloed decision making	Poor policy formulation and lack of public participation	No regular evaluation of efficiency and effectiveness of programs	Discouragement of 'frank and fearless' public service advice	Unrealistic agency budgets and forward estimates
SPECIFIC INITIATIVES	***Budget decision making***								
	§ Cabinet-approved Budget Policy Statement to set fiscal position	√	√						
	§ Cabinet-approved Statement of Priorities	√	√		√	√			
	§ Net lending as key budget aggregate and fiscal target	√	√						
	§ Non-commercial PTE sector established			√					
	§ Business cases for all spending proposals					√			√
	§ Targeted productivity savings								√
	§ Risk-assessed saving targets in forward estimates								√
	§ Maintenance of effort restricted			√					√

12 - 4

		THE PROBLEM							
		Lack of coherent, whole-of-government policy direction	Absence of clear prioritisation	Lack of clear accountability for policy, service delivery and financial management	Siloed decision making	Poor policy formulation and lack of public participation	No regular evaluation of efficiency and effectiveness of programs	Discouragement of ‘frank and fearless’ public service advice	Unrealistic agency budgets and forward estimates
SPECIFIC INITIATIVES	§ Formal program evaluation					√	√		
	§ Greater transparency for budget processes					√			
	§ Enhanced financial management skills in the sector			√			√		
	Updated Fiscal Responsibility Act	√							
	Improved budget compliance								
	§ Formal funding agreements			√				√	√
	§ CEOs accountable for budget compliance			√				√	√
	§ Funding decisions only as part of the budget process		√		√	√			
	§ Budget supplementation only with Parliamentary approval			√					
	§ Financial Impact Statements to accompany all Cabinet Minutes					√			
	§ Tightened Treasury administrative controls			√					
	§ Rollover of funds								√

12 - 5

		THE PROBLEM							
		Lack of coherent, whole-of-government policy direction	Absence of clear prioritisation	Lack of clear accountability for policy, service delivery and financial management	Siloed decision making	Poor policy formulation and lack of public participation	No regular evaluation of efficiency and effectiveness of programs	Discouragement of 'frank and fearless' public service advice	Unrealistic agency budgets and forward estimates
SPECIFIC INITIATIVES	§ Devolution of responsibility and accountability								√
	§ Progress agency amalgamations and clarify accountabilities				√				√
	§ Financial Management framework for non-budget-dependent agencies			√					
	Output-based budgeting					√	√		√
	Financial and risk management in agencies								
	§ Financial Management Compliance framework			√					
	§ Updated financial legislation	√	√	√	√	√	√	√	√
	§ Minister, CEO and CFO certification of accuracy of financial information			√					
	§ Financial measures included in top-line departmental KPIs			√					
	§ Responsibility for budget compliance cascaded down through agencies			√					

12 - 6

		THE PROBLEM							
		Lack of coherent, whole-of-government policy direction	Absence of clear prioritisation	Lack of clear accountability for policy, service delivery and financial management	Siloed decision making	Poor policy formulation and lack of public participation	No regular evaluation of efficiency and effectiveness of programs	Discouragement of 'frank and fearless' public service advice	Unrealistic agency budgets and forward estimates
SPECIFIC INITIATIVES	§ Greater transparency of agency operations					√			
	§ Building risk management capability across the sector			√		√	√		
	The Auditor-General								
	§ Enhanced powers			√		√	√		
	§ Enhanced accountability			√		√	√		
	The Public Accounts Committee								
	§ Enhanced role and effectiveness			√		√	√		

12 - 7

12.2 Budget decision making

Although the existing architecture of the core budget processes in NSW is sound, improvements are required in both accountability and in the way it is applied. Specific areas of weakness were identified in Chapter 7 of this report. These weaknesses and issues reflect a lack of clear strategic direction, budget decisions that have been made outside of the formal budget process and decisions that have been ad hoc or not evidence-based.

A package of reforms is proposed below with the objective of imposing greater discipline on the budget process and focusing, as far as practical, all resource decisions through this process.

Proposed reforms to the NSW budget process

The reforms set out below are intended to ensure an improved budget process through:

- strong alignment of policy and budget decisions to a clearly articulated whole-of-government strategy
- mechanisms to focus expenditure on higher priority programs in accordance with government priorities
- making evidence-based decisions about resource allocation
- integration of processes to explicitly link services delivered by agencies to funding
- restricting maintenance of effort proposals for current policies.

A complementary suite of reforms to improve budget compliance and control are described in Section 12.4.

Budget Policy Statement

It is proposed that each year Cabinet approve a Budget Policy Statement consistent with Government's Fiscal Strategy. The Budget Policy Statement should set out the short-term intent of fiscal policy within the context of longer term fiscal objectives in the Medium Term Fiscal Strategy and the Fiscal Responsibility Act, and set targets for key aggregates over the forward estimates period, including:

- net operating balance
- net lending requirement
- net financial liabilities (as a percentage of revenue)
- growth in recurrent expenditure
- capital expenditure.

The Budget Policy Statement should provide a reference point for government, agency heads and Treasury in developing the Budget. Budget Policy targets for balance sheet and operating statement aggregates should determine an 'Affordable Fiscal Envelope'. The difference between the budget and forward estimates forecast and the Affordable

Fiscal Envelope, adjusted for risk, represents the pool available (if any) for funding enhancements, on both the revenue and expenditure sides of the Budget.

All claims against the Enhancement Pool should be based on a rigorous bid process. Agencies should be invited to submit formal proposals to support the delivery of government priorities. Bids should be assessed by the Budget Committee, ranked and selected based on contribution to the NSW State Plan and the Statement of Priorities.

Statement of Priorities

It is proposed that the Government guide budget resource allocation decisions through the articulation of an annual Statement of Priorities. The planning hierarchy for the general government sector should consist of the NSW State Plan, which has a rolling 10-year time horizon, the Statement of Priorities, and agency corporate and business plans. This hierarchy would be fully integrated into the Department of Premier and Cabinet's strategic management cycle and government-wide performance management framework.

The Government should establish an overall strategic direction through a NSW State Plan within the context of a funding envelope that is determined based on the Government's Fiscal Strategy. The NSW State Plan should articulate the State's aspirations and ambitions for its citizens and should be informed by community needs. In contrast to the past, the NSW State Plan needs to have full regard to fiscal sustainability. It should also be reviewed and updated on a regular basis and informed by the targets in the Fiscal Responsibility Act and financial projections.

Within this framework, policy priorities for the next year should be agreed by Cabinet at the commencement of each budget cycle in order to focus the preparation of spending proposals and be incorporated in a Statement of Priorities. The Statement of Priorities should link directly to the NSW State Plan and should articulate the objectives intended to be delivered over the budget year and the rolling forward estimates period. A draft Statement of Priorities should be developed by Cabinet early in the budget cycle (around August) as a guide to agencies and communicated to agencies via ministers and chief executives. Following the receipt of agency policy proposals, the Statement of Priorities may be refined (around November) to take into consideration input from departments and Ministers.

The Statement of Priorities, when finalised, should guide resource allocation and policy across the whole of government and should identify accountabilities and high-level measures of success specific to the upcoming budget cycle. In particular, the Statement of Priorities should be considered by the Budget Committee of Cabinet when assessing budget submissions and ensuring resource allocation within the budget strategy is directed to the key priorities. The Statement of Priorities should specifically include a commitment to the Budget Strategy as the overriding priority for all subsequent budget decisions.

Compliance with the policy priorities in the Statement of Priorities will be crucial to ensure decision making is consistent over time, coherent and aligned with the agreed whole-of-government strategic direction. The Statement of Priorities should also act as a guide to the preparation of the budget papers.

Net lending/borrowing as key aggregate for state finances

The budget result is based on the net operating balance. This is consistent with other Australian states and territories.

The net operating balance is akin to the profit and loss of a private sector company. It measures the difference between the full cost of service delivery during the year and the revenues earned during that year.

The full cost of services is determined by accrual principles. It includes all employee-related costs (cash salary plus accruing superannuation and leave entitlements) and a depreciation expense, to reflect the loss in value of the full stock of assets through wear and tear.

In recent years, budget management practices have focused on the budget result. In the meantime, there has been a significant increase in general government capital expenditure, an increasing proportion of which is now funded by debt.

The general government capital expenditure program principally comprises replacement, enhancement and major periodic maintenance of the stock of core government assets, including schools, hospitals and roads. Capital investment is ongoing, rather than lumpy and significant increases in the program, without concurrent increases in the budget result, are unsustainable.

Accordingly, the more appropriate key aggregate for state finances is the net lending/borrowing result which reflects both operating performance and the full current year impact of the capital program (i.e. includes capital expenditure less assets sales, rather than depreciation) on the State's balance sheet.

Establishment of a non-commercial PTE sector

The public trading enterprise (PTE) sector comprises two distinct sub-sectors:

- commercial PTEs are government-controlled entities that are self-funded from user charges and have a commercial charter
- non-commercial PTEs are government-controlled entities that are provided with significant operating subsidies and capital grants from the Budget.

The non-commercial PTE sector should have its own financial management framework, reflecting the status of entities in this sector as being neither fully commercial nor fully budget-funded.

Business cases for all spending proposals

Budget Committee processes should be highly disciplined. Funding decisions outside the budget process should be kept to the absolute minimum, with the standard practice being that funding decisions should be made:

- as part of the formal budget process to allow the relative ranking of proposals to be considered
- with a proper evidence base (e.g. Financial Impact Statements) to ensure sufficient information is available for informed decision to be taken and
- after normal submission lodgement practice to allow adequate time for the matter to be considered.

In order to ensure the Committee is fully informed about the budget context and the costs and benefits of individual proposals, and to clarify choices in resource allocation, all new policy proposals for both recurrent and capital expenditure above a reasonable expenditure threshold[1] should be supported by 'Business Cases'[2]. These business cases should be formally approved by Budget Committee prior to funding approval.

It is recommended that a two-stage process be followed to consider agency submissions. In the first stage, agencies should be invited to submit bids for new initiatives and enhancement of existing services that require capital and recurrent expenditure over the next year. The bids should be supported by preliminary business cases that describe, at a high level, project rationale, options considered, risks, interdependencies with other projects, timing and success measures and how the proposal impacts the costs and services in the Statement of Service Outputs.

In particular, the 'Preliminary Business Case' should articulate how the proposed project or service:

- aligns with government priorities in the draft Statement of Priorities and NSW State Plan or
- in exceptional circumstances, is justified independently on other grounds.

Only preliminary business cases (above a reasonable materiality threshold) that demonstrably contribute to government priorities and have met the minimum information requirements should be put forward to the Budget Committee.

It is proposed that Budget Committee reviews preliminary business cases (and for relevant capital projects, associated Strategic Gateway review outcomes) for consistency with government priorities, and overall budget strategy, the strength of the department's proposal and the risks associated with program delivery.

1 Materiality thresholds could vary by size: $5 million for agencies above $500 million in net cost of services (NCOS); 1%of NCOS for agencies between $25–500 million; and $250,000 for agencies below $25 million in NCOS.

2 Business cases would be required to meet strict Treasury guidelines. Business case guidelines for recurrent expenditure proposals will need to be developed and issued.

Infrastructure NSW should play a key role in reviewing business cases associated with major infrastructure projects and make recommendations in relation to infrastructure issues.

In the second stage, where preliminary business cases are supported by the Budget Committee, it is proposed that agencies are invited to submit detailed business cases, including robust cost-benefit analysis for evaluation by the Budget Committee. It should be mandatory for business cases to specifically indicate the impacts of the proposal on the measures outlined in the Statement of Service Outputs (see output-based budgeting later in this section). It should also be mandatory for all agencies affected by the submission to be formally consulted.

The Budget Committee should review Treasury advice and make a final resource allocation determination, taking into account the ranking of business cases. In making its determination, the Budget Committee should evaluate business cases based on criteria that include:

- consistency with overall budget strategy
- consistency with the Statement of Priorities
- costs, benefits and feasibility of the agency's proposal
- track record of the agency in program and project delivery (based on advice from the Expenditure Review Committee)
- risks.

Business cases should specifically include an evaluation plan, including the basis for future evaluation and public disclosure of benefits.

Lower ranked but supported proposals which cannot be funded in the current year should be held on a reserve list to be reconsidered for funding in following years.

Business cases approved for funding should be publicly disclosed as part of the Budget each year.

Targeted productivity savings based on efficiency reviews and formal program evaluations

The Better Services and Value (BSV) program has conducted a rolling program of expenditure reviews of most major general government policy areas (except NSW Health, where there is a separate Health Efficiency Improvement Taskforce). There is now a substantial stock of potential efficiency improvements at various stages of detailed planning and implementation.

This should lay the foundation for moving away from across-the-board productivity savings requirements toward a more targeted approach based on opportunities identified by the BSV program, the corporate services program and the implementation of the Program Evaluation Framework (refer to Chapter 15).

Revised approach to formulation of forward estimates

Over recent years there has been a change in the approach to the formulation of the forward estimates. This has reflected a number of factors:

- Increasing concern about the ability of agencies to deliver on productivity savings associated with both efficiency dividends and wages growth above the funded 2.5 per cent per annum. This has led to agency forward estimates reflecting savings being achieved and central provisions being established for the risk associated with this assumption.
- A breakdown in the budget process which has seen agency budget allocations being adjusted on an almost continuous basis, necessitating the establishment of central provisions to ensure the realism of bottom-line budget aggregates.

There will always be a need, as a matter of prudent risk management, for central provisions to be established for contingencies and uncertainties. However, where a matter is under the reasonable control of an agency, the budget and forward allocation should reflect realistic levels of funding. The Government's recent reform to wages policy will assist in this regard. It is proposed that savings targets be risk-assessed jointly by Treasury and the relevant agency and the risk-assessed savings be reflected in the budgets and forward estimates of agencies.

Restrict maintenance of effort proposals

Some agency budgets and forward estimates have become unrealistic because agencies have been unable to fully achieve wage offsets or efficiency dividends in the absence of agreed major reforms. Agency budgets should be re-based to realistic levels reflecting true cost and volume drivers as well as the outcomes of expenditure and program reviews. Thereafter, submissions for additional funding for unchanged policies, other than genuinely unforeseeable and extraordinary issues and from pre-existing formula-driven funding arrangements, should be discouraged.

Formula-driven maintenance of effort (MoE) estimates should be initially derived in real terms (i.e. removing inflation) to reflect:

- maintenance of existing service provision ratios such as
  - student teacher ratios
  - police population ratios, and
- changes in underlying demand such as
  - health demographics
  - prisoner numbers
  - persons with a disability.

The estimates should be based on maintaining existing service provision standards such as hospital waiting periods for both elective surgery and accident and emergency services. These formulae will need to be established and agreed.

MoE estimates should be adjusted for risk adjusted efficiency. Finally, MoE estimates should be adjusted to include nominal inflation in all cost drivers.

MoE should *not* be used to seek funding for service quality improvements (irrespective of whether these represent existing policy or a long-term trend) such as:

- reduced waiting times in hospital accident and emergency departments

- reduced waiting times for respite care in the disabilities sector
- improved programs for special education.

Funding for such service quality improvements should be sought through the enhancement pool.

Formal program evaluation

Formal program evaluation can confirm that allocated funds, both for existing programs and for new initiatives, have been spent as approved and have delivered the intended services and results. The outcomes of formal evaluations also provide an evidence base to support major new policy decisions, program reforms and expansions or the termination of programs during the budget cycle and during Cabinet consideration and decision making.

A clear government policy framework is required to drive rigorous program evaluation, instead of the current ad hoc arrangements where evaluations are sometimes mandated in Cabinet or Budget Committee decisions or otherwise decided by agencies.

The policy framework should define program evaluation requirements, specify the need for evaluation planning within agencies, outline thresholds for evaluation of existing programs and detail mechanisms for incorporating evaluation outcomes in decision making. This framework should be driven by an Independent Evaluation Office (IEO). (refer to Chapter 15). The IEO would promote leadership, rigour and consistency in program evaluation in NSW.

Transparent processes

Greater public oversight encourages the pursuit and development of good policies. Transparency gives citizens information to participate in policy development and evaluate performance and allows them to hold government accountable for its policy choices. Transparency and accountability should promote more efficient delivery by shining a light on decision-making processes. All key budget framework documents and processes should be published along with business cases supporting new initiatives or capital projects.

Analyst and agency capability

The implementation of these reforms will require a strengthening of capabilities in both agencies and Treasury, particularly to support the change to output-based budgeting. In addition to the development and introduction of costing and management systems, cultural, behavioral and attitude change aspects need to be addressed. The Public Service Commissioner should play a key role in facilitating the development of sector-wide financial management skills.

Revised budget process

The key elements of the budget process, reflecting the proposed improvements set out above, are reflected in table 12.2.1.

Table 12.2.1 Budget process steps

Budget process step	Comment
1. Cabinet approves Budget Policy Statement and a Statement of Priorities	§ Cabinet approves a Budget Policy Statement that sets targets for key aggregates over the forward estimates period and a Statement of Priorities to guide resource allocation decisions. § The principal aggregate for target setting purposes is the net lending/borrowing result.
2. Budget Committee, advised by Treasury, establishes draft agency four-year forward estimates and a central funding provision, in the context of the Budget Policy Statement	§ Agency forward estimates would be adjusted for: Ø agreed parameter changes (e.g. school enrolments) Ø specific agreed savings identified through the Better Service and Value reviews and through formal program evaluations Ø revised funding agreements following evaluation of long-term funding pressures on agencies. § A separate central provision pool would also be created, to cover unplanned needs not allowed for in agency forward estimates. To the extent that this provision is not eroded by maintenance of effort proposals, it is available for new policy initiatives.
3. Agencies requested to develop and submit output-based business plans, including high-level enhancement options	§ Business plans should be based on output costs and performance indicators. These plans should improve in time as agencies migrate from level 1 output budgeting status to the appropriate higher level (2 to 4). (refer to section 12.5). § Maintenance of effort proposals should be articulated within the context of output cost variances and should be kept to a minimum. § Ministers are invited to submit enhancement proposals supported by a preliminary business case which, among other things, identifies links with the Statement of Priorities. § The business plans and proposals should be submitted by the budget-holding minister (i.e. responsible for the principal department in the cluster). This minister should be responsible for allocating resources across the cluster in accordance with government priorities.
4. Budget Committee reviews enhancement proposals	§ The Budget Committee reviews preliminary business cases and identifies which proposals should proceed to full business case development.
5. Budget Committee approves agency budgets	§ The Budget Committee approves agency forward estimates, supported by output-based business plans and approved business cases for new proposals.

12.3 The *Fiscal Responsibility Act*

NSW is unique among Australian states in setting its fiscal targets in legislation. The current *Fiscal Responsibility Act 2005* is due to be updated in 2011. The opportunity should be taken to reconsider its purpose, tighten its focus and strengthen its contribution to fiscal sustainability.

Fiscal legislation and other fiscal policy instruments

Fiscal responsibility legislation is one of several means available to government to define and commit to a fiscal policy agenda. This agenda can include:

- the Budget
- policy statements
- constitutional restrictions (e.g. in many states of the United States of America).

The role of fiscal legislation, as distinct from policy statements, is to formally commit a government to policies and performance criteria over a multi-year period (exceeding the full electoral cycle in NSW). It thus provides a considerable degree of transparency to government decision making and makes the Government accountable for the management of the State's finances in accordance with the legislation.

Fiscal legislation and constitutional restrictions are common among American states. They have been an integral part of the European policy under the Maastricht Treaty, aiming (with very limited success) to constrain the fiscal flexibility of signatory states in order to anchor the European Monetary Union. Other sovereigns, including Australia, New Zealand and the US, have enacted national fiscal legislation of greater or lesser comprehensiveness, and with greater or lesser success.

In all other Australian states, fiscal legislation limits itself to defining broad principles of fiscal management and imposing a requirement for the government to periodically set forth its fiscal policies and targets, usually in the annual budget. This preserves the flexibility of governments to alter policy in response to developments, although in practice most jurisdictions maintain continuity in fiscal policy over a run of years.

Fiscal Responsibility Act 2005

The *Fiscal Responsibility Act 2005* (FRA) sets out five fiscal targets and ten principles of fiscal management. It was introduced after a period when NSW total state and general government net debt had been declining both in level terms and as a share of the economy. The debt target of the FRA (shown in figure 12.3.1 was a fairly simplistic one – that general government net debt should remain at end-June 2005 levels as a share of the economy. In other words, that general government net debt could grow from the 30 June 2005 level, but only in line with growth in the economy.

The statutory five-year Review of the Act (tabled by the Treasurer in June 2011) found that while the policy objective (*maintaining financial results that are fiscally sustainable in the medium and long term*) was valid, many of its targets and principles were not met, and the requirement to acknowledge departures and take remedial action was not observed.

The 30 June 2005 level of general government net debt was $2.8 billion or 0.9 per cent of gross state product (GSP). With nominal GSP growth averaging 5.4 per cent from 2004-05 to 2009-10, if the target was met, general government net debt would have risen to $3.7 billion by 2009-10. The actual level of general government net debt was $9.4 billion or 2.3 per cent of GSP in 2009-10. Chapter 5 reviews the performance against the targets of the FRA more fully and (in line with the June 2011 Review) finds that neither the net debt nor the net financial liabilities targets were met.

Figure 12.3.1 Total state and general government net debt as a share of GSP

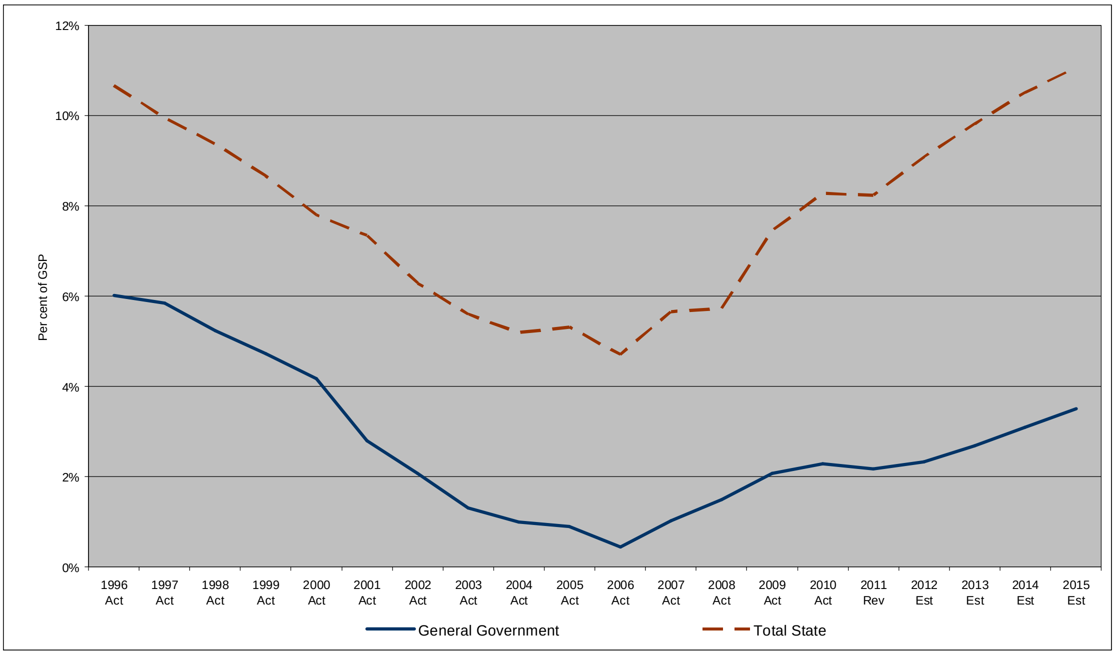


Figure 12.3.1 also shows that total state net debt has risen more sharply since 2006 and is approaching levels as a share of the economy that were evident in the mid-1990s. The bulk of the increase in total state net debt originates from the commercial public trading enterprise (PTE) sector, particularly the energy and water sectors where the return on the assets and debt is regulated. As such, debt of the commercial PTE sector can be viewed as sustainable. However, the lumpiness of increases in debt in the commercial PTE sector needs to be taken into account in the context of the total state balance sheet.

General government net debt has grown since June 2006, but is presently at relatively low levels as a share of the economy. However, given actual and projected growth in commercial net debt and on the basis of no policy change, as well as a large planned general government capital spending program and higher capital grants for rail projects, the growth in general government net debt projected over the forward estimates is becoming unsustainable.

Revised Fiscal Responsibility Act

The recommended main objective of a new FRA is to ensure that the State's finances are sustainable. As indicated earlier, fiscal sustainability needs to satisfy three requirements:

- Expenditure and revenue policy settings that ensure debt grows no faster than the ability to service it. This implies limiting the ratio of net financial liabilities (of which the main components are net debt and unfunded superannuation liabilities) to total revenue.
- A stable tax base and a tax burden (as measured by an index of tax severity relative to other jurisdictions) that does not erode the competitiveness of the State for business.
- Intergenerational sustainability through maintaining and improving the service potential of the infrastructure stock and an equitable distribution of costs between current and future users.

Three key elements need to be met to ensure a sustainable financial position:

- The level of debt must be affordable, that is the cost of servicing the debt must not crowd out funding for core government service delivery.
- Fiscal performance must ensure ready access to debt markets at all times on favourable terms. This means that the targets and principles should be consistent with maintaining a high credit rating.
- The limit for financial liabilities must include a margin that allows the balance sheet to act as a shock absorber in an economic downturn or natural disaster so that core government service delivery is not interrupted.

Both Standard and Poor's (S&P) and Moody's apply multi-factor methodologies in their credit ratings. To be successful, the new FRA needs to commit the Government to high performance across a similarly wide set of targets and principles. The revised FRA should contain a commitment to targets that are similar in scope to, or more comprehensive than, those of the credit ratings agencies. This should in turn constrain rating agency metrics to ranges consistent with a high rating.

Targets in a revised Fiscal Responsibility Act

The revised FRA targets should have the following elements:

- *The denominator for fiscal ratios should be revenues, rather than GSP.*

Revenues are a better measure of the affordability of debt and liabilities than GSP, which is only loosely linked to revenue growth. Revenues are a better benchmark of government performance, since the State has greater influence over revenue than it does over GSP. Finally, revenues avoid the long-run unsustainability of linking fiscal performance to GSP, given that the ratio of revenues to GSP is in trend decline.

- *The balance sheet target should be the ratio of net financial liabilities (NFL) to revenues.*

Net financial liabilities (encompassing net debt, unfunded superannuation and other financial liabilities) is the most comprehensive measure of the State's balance sheet position. Setting a debt target alone, for example, could lead to other financial liabilities being increased (such as unfunded superannuation) in order to meet the debt target. Similarly, it should be set for the total state sector in order to prevent debt substitution between the general government and PTE sectors. However, particular attention needs to be given to the general government sector as it is tax funded and its capital expenditure is non revenue generating, in the main.

- *The NFL target should use actuarial funding estimates for unfunded super.*

The NFL target should be set in ‘underlying’ terms using actuarial funding estimates to measure unfunded superannuation liabilities, rather than headline (AASB 119) estimates. The actuarial estimates provide a more stable and correct measure for performance analysis and for assessing the cash contributions required to fully fund all liabilities by the target date. Nominating an ‘underlying’ measure will not affect official reporting, for which the AASB 119 standard remains mandatory.

- *Elimination of unfunded superannuation by 2030 should be retained as a target.*

The target of fully funding all state superannuation liabilities by June 2030 aligns the profile of financing with obligations, and should be retained. This target also helps anchor the constraints on spending and debt that are consistent with the NFL limits.

- *A debt target should be set for the non-commercial public sector (which given a NFL target would be implied for a given commercial public sector debt).*

It is recommended that the debt target basis be changed from general government net debt (current FRA) to general government and non-commercial PTE debt in the non-financial public sector (NFPS), and capped as a ratio to revenues rather than GSP.

Targeting non-commercial public sector debt rather than total state debt recognises the different nature of debt underwritten by the income stream received by the regulated commercial sector as opposed to budget-dependent sector debt, which must be serviced by the taxpayer out of consolidated funds.

This measure better aligns with metrics used by the credit rating agencies. It is the key metric for Moody’s, and it is an important secondary metric for S&P.

Total public sector debt remains constrained by the limits imposed on NFL and on superannuation.

- *General government net worth should be maintained in real terms.*

The new legislation should continue to require maintenance of general government real net worth, to prevent financing current operations by running down assets, or using asset proceeds for purposes other than improving the balance sheet.

- *The operating statement target should be the fiscal balance.*

The balance sheet targets should be supported by operating targets, as they are in the existing legislation. However, the target should be the net lending result rather than the net operating result. A debt-to-revenue target implicitly imposes the fiscal balance constraint that combined current and net capital spending (i.e. net lending) growth cannot exceed revenue growth.

General government net debt has already increased substantially since 2005-06 and it is certain to rise further to 2014-15 – even with expenditure restraint as set out in the Fiscal Target scenario of Chapter 11. The focus of the new FRA therefore should be on restraining further growth in debt and associated debt servicing costs from these elevated levels beyond 2014-15.

Holding debt-to-revenue ratio constant beyond 2014-15 would keep debt at prudent and sustainable levels. Another way to express debt growing in line with revenue is that the net lending position should be limited to the growth rate of revenues times the previous year's net debt level. Thus, net lending becomes the instrument to achieve the desired balance sheet outcome.

Given the economic and revenue cycle, the net lending target should be trend revenue growth (5.2 per cent), rather than current-year revenue growth.

- This would set the net lending target at 5.2 per cent of the previous year's debt level.
- Once a sustainable debt level is achieved, this also implies that the net lending requirement growth would be limited to 5.2 per cent per annum.
- This target implies that the sum of expenses and net capital spending would also be limited to growth of 5.2 per cent (or alternatively expenses excluding depreciation and gross capital spending could only grow by 5.2 per cent).

The net lending target could be met by a combination of revenue, expense or capital spending levels. A strong feature of a net lending target is the explicit trade-offs between these three major decision variables.

Departures from targets

The fiscal policy needs a well-defined and robust process to identify and correct trends that are inconsistent with targets. With respect to the core targets (the net lending result, and the ceilings on net debt and net financial liabilities):

- the Budget may provide for temporary departures from those targets, but
- it must contain measures for credibly ensuring a return to the targets by the end of the forward estimates.

Medium and Long Term Policy Framework

In large part, fiscal outcomes reflect the accumulation of decisions over a number of years. Fiscal policy must therefore be set in a medium and longer term framework cognisant of forthcoming fiscal pressures, particularly the ageing of the population.

For this reason:

- the Government should continue to publish (each five years) a Long-Term Fiscal Pressures Report which takes into account demographic changes and its expected impact on the State's finances (the 'fiscal gap')
- each Budget should quantify the impact of budget measures on the long-term fiscal gap.

12.4 Improved budget compliance

There has been a history in NSW of expenditure exceeding the Budget and forward estimates, despite substantial provisions built into the Budget at a central level. This has led to further increases in provisions as a risk management approach. Reducing deviation between budgeted and actual expenditure will reduce the risk profile of the Budget and allow for reduced provisioning.

Background

There has been a progressive deterioration in state finances in recent years. Since 2007-08, the general government net financial liabilities and net debt targets in the Fiscal Responsibility Act have not been met. Accelerated expenses growth combined with a large increase in the State's infrastructure program has caused the credit rating metrics to approach the threshold at which NSW's AAA credit rating would be reviewed.

Almost all large agencies have failed to manage within their budget allocations and have reported actual expenses higher than budget, a situation which has persisted for an extended period. There have also been frequent ad hoc funding decisions made outside the formal budget process, which have added to the pressure on expenditure. Given a long-term declining trend in revenues as a share of the economy, regaining control over the growth in expenditure assumes even greater significance and urgency.

Analysis

Poor budget compliance in the general government sector in the recent past can be attributed to the following root causes:

- a culture that budgets do not matter
- a lack of accountability coupled with ineffective incentives and sanctions for failure to comply with budgets
- limited capacity of CEOs to manage their input costs, in particular employee-related expenses
- poor financial management skills and focus.

These are discussed briefly below.

Culture

Budget compliance has not been seen as a core responsibility of portfolio ministers and CEOs. Strong revenue growth in the past (until 2005-06) created an incorrect impression of fiscal wellbeing.

Budgets were not viewed as hard targets. The Treasurer's Advance (TA), which should be used for unforeseeable contingencies, has been used to fund budget overruns on a regular basis as well as new programs outside the budget process. The TA has been routinely exceeded and the Treasurer has annually submitted a supplementary appropriation bill to Parliament towards the end of the financial year.

The view that budgets are soft targets has been reinforced by the current system of tolerance limits on the main budget control, the net cost of services (agency expenses less user charges). This was meant to reduce the administrative burden of requiring the Treasurer to approve minor budget variances. In practice, however, the upper tolerance limit has been treated as the real budget, with consequential adverse impacts on the budget result.

Supplementation requests have become institutionalised. Significant financial commitments have been proposed by ministers and agreed weeks after the Budget was delivered. The Budget Committee effectively operated a continuous year-round budget process. Such an approach undermined the budget process and Treasury has had to maintain substantial provisions at a central level not only for unexpected events but also to manage budget overruns. As a result, this reinforced the perception that Treasury was responsible for state-wide budget compliance and cost control, and could find funds when required to offset budget overruns by agencies. This in turn led to further increases in provisions as a risk management approach.

A lack of accountability and budget compliance measures

There has been a general lack of accountability for budget compliance, and policy and service delivery failures. Budget compliance has been poor and infrastructure projects have often been delivered late and over-budget.

There have been virtually no real incentives or sanctions to ensure budget compliance or a formal process to hold ministers accountable for budget compliance. It has not been mandatory for CEOs to have budget compliance in their performance agreements.

Expenditure Review Committee (ERC) oversight of recurrent expenditure against budget allocation has not been an effective incentive for budget compliance. Agencies have failed to appear at ERC meetings as scheduled or have not taken appropriate action in response to ERC decisions.

The Public Accounts and Estimates committees have also been ineffective in holding ministers and agencies to account.

Limited capacity for CEOs to manage their input costs

CEOs have been restricted in their ability to manage their costs, particularly employee-related expenses through wage agreements or the ability to adjust workforce numbers. Similarly the wages policy, where wage increases are funded at 2.5 per cent despite actual agreements being higher, has resulted in a gap some agencies can’t bridge.

Agency amalgamations were implemented in July 2009, resulting in the merger of smaller departments into larger principal departments, and the assignment of principal departments and statutory bodies into portfolio-based clusters.

Agency amalgamations should have supported better cost management through better coordination, reduced duplication and expenditure reprioritisation. This was not able to be achieved in NSW because some principal departments had multiple ministerial budget holders and the degree of principal department CEO control over statutory bodies within the cluster was unclear. Synergies are therefore yet to be realised.[3]

Previously, CEOs have not had the ability to retain any savings during a financial year as agencies must return unspent appropriations to Treasury at year-end. This has

[3] The Public Sector Employment and Management (Departments) Order 2011 (as amended by the Public Sector and Employment Management (Departments and Ministers) Amendment Order 2011) applied from 4 April 2011 and resulted in further substantial changes to the structure of the NSW public service. Individual government entities were allocated to one of nine clusters, each headed by a principal department. (refer to Agency amalgamations and Ministerial accountability later in this section.).

reduced the ability of CEOs to manage costs flexibly across financial years and has encouraged year-end spend-ups.

Poor financial management skills and focus

Government and community expectations for more accountable, transparent and efficient delivery of services require a financially literate public sector workforce. Increasingly complex financial management and reporting requirements (i.e. the move from cash-based to accrual-based accounting and performance-based reporting) makes it necessary for staff to have specific relevant qualifications.

The Department of Premier and Cabinet (DPC) circular C1999-69 *Qualification for Senior Financial Management and Accounting Positions* applied to CFOs (or similar titled positions). The policy required that people recruited or promoted to such financial management positions should have relevant tertiary qualifications and maintain membership of a professional accounting body. However, the policy was prospective in its application and exempted officers who already held such positions.

The Accountancy Skill Shortage – Strategy Group Report published by DPC in 2008 noted that across the sector, finance work is undertaken by employees that do not have nor are required to have tertiary qualifications in accounting. The sector has also experienced difficulty in attracting and retaining qualified staff.

The Public Accounts Committee (PAC) in its *Report on Quality and Timeliness of Financial Reporting (2010)* similarly discussed the need to improve the accounting skills of staff within government agencies.

Many CFOs in the general government sector have not been members of the executive team, and have focused on financial reporting and day-to-day accounting functions rather than on providing strategic advice to the CEO. Similarly, finance functions have focused on routine transaction processing tasks, rather than analysing costs and performance.

Setting the tone at the top

The effectiveness of any proposed reforms will be determined by the willingness of the Cabinet, Budget Committee and individual ministers to collectively enforce, and be governed by, the reforms and processes recommended below.

Ministers and CEOs should set the right 'tone at the top' if a culture where budget compliance is given priority is to be established. Lower level controls and incentives will be ineffective if higher level activities are conducted in an ad hoc and ill-disciplined manner.

Ministers (as well as CEOs) should take responsibility for managing priorities to avoid cost increases. Ministers need to support CEOs in achieving their budget. CEOs' commitment to staying within budget must similarly be visible throughout their departments.

Improving budget compliance

There are existing control, funding, monitoring and review mechanisms for budget compliance. The reforms proposed below are intended to make them more effective (through the introduction of appropriate incentives and sanctions) and assist in creating the right culture to support the Government's commitment to strong, disciplined financial management based on:

- ensuring expense growth is less than, or equal to, trend in revenue growth
- ensuring Cabinet ministers are accountable for fiscal direction and infrastructure delivery.

In addition to delivering a sustainable fiscal policy position, implementation of these reforms will:

- reduce deviation between budgeted and actual expenditure, reduce the risk profile of the Budget and allow for reduced central provisioning
- increase the capacity to fund new policy initiatives or deliver lower taxes by reducing waste and improving efficiency
- facilitate superior policy and service delivery outcomes because projects and programs are delivered on time and within budget
- engender a more structured decision-making process, resulting in better policy and service delivery outcomes.

Formal funding agreements

There should be a formal funding agreement with each minister and CEO, based on a Statement of Service Outputs (refer to Section 12.5). This should be signed at the conclusion of the annual budget process.

CEOs will be held accountable for managing within their allocated budget by the Premier, rather than the portfolio minister, through performance agreements administered by the Public Service Commissioner (PSC).

Performance agreements should be consistent with the hierarchy of panning documents, that is the NSW State Plan, Budget Policy Statement, Statement of Service Outputs and agency corporate and business plans.

The Premier should review the performance of agencies against targets set out in the NSW State Plan, the published Statement of Priorities, the Statement of Service Outputs and actual performance against budget on an annual and bi-annual basis respectively with coordinating ministers. The department CEO should attend the review meeting. The review outcome should also inform the annual performance review of the CEO.

Budget compliance as a mandatory element of CEO performance agreements

The current CEO Performance Agreement requires CEOs to nominate organisational performance accountabilities. However, it has not been mandatory to include budget compliance in this agreement. Given that budget compliance has been poor, this should be introduced as a mandatory key element. Greater weighting should also be attached to performance on this aspect and CEOs and ministers should be advised accordingly. Further, in addition to CEOs, coordinating ministers should also have formal performance agreements with the Premier.

As is current practice, Treasury should continue to provide input on this aspect of the performance agreement and performance review.

Loss of reputation may be a powerful incentive for budget compliance. In addition, the Premier, based on advice from the Public Service Commission, might consider further performance sanctions for budget overruns. These might include CEO remuneration and/or contract renewal.

Budget supplementation should require Parliamentary approval

Agencies should be expected to manage within expenditure limits and requests for supplementation should not normally be submitted or supported.

If budget supplementation is sought, either due to an inability of the agency to manage within the approved budget or to fund new programs outside of the budget process, ministers should put forward a request for additional resources, supported by a business case, for approval by the Budget Committee. The materiality limits for supplementation requests should be rigorously applied.

In all cases, Budget Committee approval must be obtained prior to incurring the additional expenditure. If supported by the Budget Committee, supplementary expenditure should be authorised by Parliament. Ministers, rather than the Treasurer, should be required to introduce their own supplementary appropriation bills into Parliament[4].

Ministers should not be required to seek approval from Parliament for variances in non-cash items (such as depreciation) as appropriations will continue to be cash-based.

Reinforce budget and Expenditure Review Committee processes

Budget Committee processes should be highly disciplined. Funding decisions should only be made on the basis of the following requirements:

§ as part of the formal Budget process to allow the relative ranking of proposals to be considered

§ with a proper evidence base (e.g. Financial Impact Statements) to ensure sufficient information is available for informed decision to be taken, and

§ after normal submission lodgement practice to allow adequate time for the matter to be considered.

All Cabinet Minutes should be submitted with a Treasury-endorsed FIS before being considered by the Government. A Treasury-endorsed FIS attests to the accuracy and correctness of a proposal costing; it does not imply any assessment of the merits of the proposal.

The Budget Committee should meet less frequently – say, monthly (other than during the budget preparation process) – and focus on strategic issues as well as track actual

[4] Other Australian jurisdictions require parliamentary approval for budget supplementation. In New Zealand, the minister is required to seek Cabinet and Parliamentary approval for budget supplementation.

as against budget position. Submission processes, timelines and materiality guidelines should be rigorously followed so that the Budget Committee can make informed decisions on those strategic issues.

Exception-based reporting by Treasury to the ERC should identify agencies where budget overruns occur or where there are significant risks to the Budget. Responsible ministers and CEOs should be required to appear before the ERC to ensure issues are resolved.

Where budget compliance continues to be an issue, consideration should be given to: referring agency programs to the Independent Evaluation Office; requiring more frequent reporting of performance; and/or the appointment of an ERC representative to the agency executive till performance improves.

The ERC could also function as a forum to discuss policy options contributing to agencies staying on budget.

Tighten Treasury administrative controls

The Treasurer's Advance (TA) should not be used to routinely fund regular budget overruns and new programs outside the budget process. The TA should be curtailed and should not be available for purposes other than genuinely unforeseen and unavoidable circumstances.

Treasury should continue to regularly monitor and review agency expenditure against budget and provide advice to the ERC where material budget risks become apparent.

Devolution of responsibility and accountability

In conjunction with greater accountability and tighter controls over budgets, greater flexibility should be afforded to principal department ministers and CEOs who are best positioned to manage resources effectively and efficiently.

The cluster minister and principal department CEO should be responsible for working with other ministers and CEOs in the cluster to achieve strategic alignment. All Cabinet Minutes submitted in respect to responsibilities for the cluster must be submitted by the cluster minister and, where relevant, the specific portfolio minister.

CEOs should be given greater authority to make changes to the cost of service delivery or level of agency activity during the year, to avoid overspending.

In particular, CEOs should be provided with greater control over their employee-related expenses through a range of workforce reforms. These reforms should include improving performance management arrangements, management of excess employees including revisions to redundancy and redeployment policies, greater workforce flexibility, and reforming award conditions (refer to recommendations in Chapter 17).

CEOs will require ongoing ministerial support for specifically identified reform strategies – for example, reducing staff numbers, exiting or varying service levels in selected service areas, or implementing the recommendations flowing from the Better Value and Services program and its successor.

Rollover of unspent appropriations

Other Australian jurisdictions allow the carrying forward of some savings to future years. Rollover of funds across years should be allowed to provide ministers and CEOs with greater year-end flexibility and reduce the incentives for wasteful and inefficient year-end spend-ups[5]. Such carry-forwards should be limited in any given year to a nominated percentage of the annual appropriation and should be approved by Parliament via a Special Appropriation Bill.

Financial Management Framework for non-budget-dependent agencies

Financial controls for non-budget-dependent general government agencies have been based on the general principle that, because they are self-funded from regulatory and user charges, they are subject to lighter touch monitoring and reporting compared to budget-dependent agencies.

The key financial controls that apply to general government budget-dependent agencies are the net cost of services (NCOS) for recurrent expenditure and the Asset Authorisation Limit (AAL) for capital expenditure.

While NCOS controls apply to both budget and non-budget-dependent general government agencies, there are differences in the allowable tolerances and in how these tolerances are applied.

Tolerances for non-budget-dependent agencies are typically higher – for example, a large non-budget-dependent agency with total expenses of over $100 million is allowed a tolerance of $5 million, whereas a budget-dependent agency with a NCOS of $100–200 million is only allowed a tolerance of $0.75–1.5 million.

NCOS limits are determined based on total expenses for non-budget-dependent agencies and on NCOS for budget-dependent agencies. Non-budget-dependent agencies are permitted to increase their NCOS up to the tolerance limit as part of the budget process.

Unlike budget-dependent agencies, Capital Authorisation Limits do not apply to non-budget-dependent agencies.

This model is becoming increasingly inappropriate as an increasing number of core government services are being delivered through grant-funded entities. The Roads and Traffic Authority and various cultural institutions are already funded via grants and many other general government agencies will become grant funded under new appropriation arrangements, and the distinction between budget and non-budget dependent agencies is becoming blurred.

A new financial management framework for non-budget-dependent agencies should be introduced, bringing about consistency with budget-dependent agencies in the application of NCOS tolerances, capital authorisation limits and performance agreements (which should be either a Statement of Service Outputs or a Statement of Business Intent, depending on the agency's objectives).

---

5 It is not recommended to permit borrowing from future year's appropriations.

12.5 Output budgeting

Background

The existing budget process has made use of Results and Services Plans (RSP), which have helped identify the Government's desired results and the specific services that contribute to achieving these results. Budget Paper 3 (Agency Budget Estimates) was revamped to a Results and Services basis in 2008-09.

The next stage of development should lead to a greater understanding and management of service (output) costs and linking these costs to budget allocations. Unlike the private sector, where the costs of goods and services are continuously analysed and managed, costs in the public sector have tended to be managed around internal administrative functions and structures. A move to a more rigorous output-based budgeting system, where there is explicit funding of groups of services, will:

- increase the transparency, accountability and contestability of agency expenditure
- enable outputs to be more robustly linked to resource allocations
- provide a mechanism for agency heads to understand the real and opportunity cost of delivering certain outputs to the community and make better decisions in the public interest
- enable a consistent set of measures to be used for planning, budgeting, monitoring and reporting.

This section examines the strengths and weaknesses of the RSP and how output budgeting could be best adopted in NSW to build on these strengths and address the weaknesses, acknowledging that implementing an output budgeting system will require a significant investment in skills and systems and sustained effort over a period of time.

Results and Services Plans – an assessment

The current RSP was introduced in 2007 Treasury Policy Paper TPP 07-03 as a service delivery and funding plan to be prepared by all general government budget and selected non-budget agencies to support decision making by the Budget Committee of Cabinet.

The RSP explicitly linked results (outcomes) and services (outputs) through a results logic methodology.

RSPs have helped identify the Government's desired results and the specific services that contribute to achieving these results. However, RSPs have not significantly influenced the budget allocation process and have not been successful as an accountability or budgeting tool, or in influencing funding decisions. This is because although the policy required services to be costed, in actual practice, service group expenditure in RSPs was not determined based on the costs of services to be delivered. Instead, service group expenditure was derived as a top-down distribution of the agency's budget to service groups. Further, while the RSP was required to describe an agency's business in its entirety, annual budget processes focused on incremental expenditure and continue to do so. As a result, there was no strong linkage between the RSP as an agency service delivery and funding plan and budget expenditure.

In 2008, following a review, most agencies were required to produce RSPs only once in four years. This further weakened the links between RSPs and the budget process, and between RSPs and annual funding decisions.

RSPs do not provide a real mechanism for making agencies accountable for their expenditure. There was no monitoring system to ensure that actual performance met planned performance in terms of outputs delivered for the actual expenditure incurred, and no related incentives or consequences.

In the absence of any link with actual funding, lack of consequences for failure to meet agreed targets and because of some duplication with agencies' corporate and business planning, many agencies considered RSPs to be a compliance exercise.

The RSP process can be greatly enhanced by explicitly identifying services to be delivered by agencies and costing these services and building agency budgets on this basis rather than historical cost.

Outputs vs outcomes

In order to link resource allocation with service delivery, sound performance measures must first be developed. Service delivery performance can be measured by outcomes and/or outputs.

Where outcomes can be accurately measured, they have great utility in the formulation of public policy decisions. Outcome performance indicators are essential for better decision making regarding resource allocation, planning and management practices and assessment of the real impact of deliverables on communities. However, relying on outcomes as the basis of performance assessment can be greatly problematic as:

§ they are often difficult to measure

§ they are derived through a multivariable relationship with outputs which can make it difficult to assess which strategies were responsible for certain effects; for example, an outcome of reduced youth crime may have been affected by several factors, including better crime prevention programs, increased police presence, better educational access, stronger family support, targeted alcohol and drug programs as well as a general increase in general community activities that generate social capital within the community

§ they are not immediate, may take many years to mature and so are difficult to map annually against certain inputs and outputs (this is particularly evident in complex fields such as health and education).

Output measures quantify the service delivered and the resources allocated to produce the output, e.g. the number of staff. Output measures are easier to quantify and are more straightforward to cost than outcomes. Outputs can also be measured immediately, whereas the impact of the output on a social outcome might take some time. However, outputs themselves do not reflect the public value impact of programs. There can also be a temptation to over-emphasise particular indicators simply because they are able to be quantified easily.

The outputs to be used as the basis of a performance measurement and costing system should therefore be carefully selected and strongly linked to intended outcomes. There also needs to be a periodic review, say every three to five years, to assess whether the services are contributing as expected to the intended results.

Output budgeting

Output budgeting is a form of program budgeting that places greater emphasis on outputs and ensuring accountability through the use of robust performance indicators. Performance measures (typically *cost, quantity, timeliness* and *quality*) help ensure services are delivered to an agreed standard.

Where outputs are measured in this way, they can assist in assessing:

- whether the benefit of a service delivered to the community exceeds the cost of providing that service
- whether the government agency is the most efficient, effective and appropriate vehicle to deliver that service
- the opportunity cost of delivering a service by providing a consistent benchmark to facilitate comparison, prioritisation and final selection between outputs.

Output budgeting models

Output budgeting models range in sophistication from the presentation of output information as background information to budgetary decisions through to fully-integrated frameworks that operate according to market-type mechanisms. Output budgeting models can be broadly classified into four categories:

Level 1: Presentation (budget presentation of output costs)

Service measures are present in budget papers but are usually used as background information only and do not affect budget allocations. Such a model is simple to administer. While it is a useful starting point, it has little impact on decision making. This is currently the NSW approach.

Level 2: Informed/indirect linkage (budget funding informed by output costs)

Budget allocations are linked to measurable results in the form of output costs. Performance information is important, but does not wholly determine the final amount of resources allocated. Services are not funded on unit costs. Budget decisions are made after discussions around considerations such as ‘is the spending on this particular activity justified?’

This approach allows for a superior understanding of base allocations and for stronger controls at the service-group level, rather than the agency level. Implementation requires enhanced capabilities (processes, systems and skills) in both agencies and Treasury.

Level 3 *Direct linkage (budget funding based on unit costs)*

Allocation of resources is directly linked to units of performance. Services funding is based on budgeted volume and unit costs, with specific performance indicators. The outputs-based appropriation serves as the upper expenditure limit of the agency.

This model has the advantage of allowing significantly improved analysis, for example, through examination of cost, volume and efficiency variances. However, it is complex and more expensive to administer. Output cost management must be cascaded down through the organisation and become fully integrated with agency planning to realise the full benefits.

Level 4 *Direct linkage – Purchaser/provider (budget funding based on prices)*

Some jurisdictions, such as Victoria, treat the budget mechanism as an internal market whereby the government purchases certain services from departments and agencies for an agreed price in a market-type transaction. This is ultimately expected to encourage efficiency as agencies incorporate profit results into their delivery expectations while delivering agreed outputs that meet strict quality criteria.

The main advantage of this approach is that it creates stronger incentives by replacing budget pressure with price pressures. Implementation of a purchaser/provider model could also potentially provide a basis for contestability of services. However, it is complex and costly to administer and as discussed below, establishing prices can be very difficult in practice.

Output budgeting – challenges

The costs and benefits increase with increasing sophistication of the output budgeting model adopted, going from Level 1 to 4 as above. Reliable output systems are complicated to administer, require sophisticated information management systems and are extremely expensive to implement. Investment in such systems positively correlates with the quality of the information and its effectiveness.

During the 1990s, most Australian jurisdictions (NSW being an exception) and New Zealand adopted purchaser/provider models, that is the Level 4 approach. With the exception of New Zealand and Victoria, other jurisdictions have since pulled back from this to varying extents.

Some of the major challenges those jurisdictions encountered include the following:

§ **Pricing is very difficult.** In the many instances where a comparable market price cannot be determined or does not exist, prices have to be based on benchmarking. This is not always possible, and even where it is feasible, it remains a costly and demanding process. Treasuries only have the capability to undertake pricing exercises for a limited number of activities. ‘Pricing reviews’ have generally not worked.

§ **Lack of range.** The output system does not measure and cost all kinds of service delivery well. Particularly problematic are:

  - those outputs where production is contingent on another set of circumstances such as emergency services
  - services where outputs cannot be broken into homogenous units that can be consistently priced (e.g. police investigations).
- **Inadequate targets.** In its simplest form, output measurement and costing presumes a constant relationship between any unit of output and an outcome. This may result in insufficient performance targets being set. More sophisticated approaches can be adopted, but these add complexity and cost.
- **Lack of alternative supplier.** A true market-based mechanism requires that the cost of production remain less than the price charged or the agency should eventually be forced to exit the market. If market exit is not a credible threat (particularly for critical services where there are no alternative suppliers), agencies may not regard the consequences of financial failure as significant and may instead choose to absorb the consequences of non-compliance.

However, as long as the limitations identified in other jurisdictions are considered and inform the design of the system, it is considered that there is merit in pursuing a form of output budgeting in NSW, because:

- linking funding to the costs of services being delivered will allow explicit funding decisions that cover 100 per cent of the Budget, rather than the typically 3 per cent represented by new expenditure proposals
- output costing is comprehensively applied in the private sector where the trend has been towards more sophistication and precision, e.g. activity-based costing
- there are no obvious alternatives in the public sector (features such as forward estimates, fiscal strategies and accrual accounting make Australian jurisdictions well advanced compared to many overseas jurisdictions)
- jurisdictions that have demonstrated better practice have still retained substantial elements of the output budgeting model, for example NZ and Victoria.

However, rather than attempt to move the whole sector to a purchaser/provider model, as some other jurisdictions have attempted, it is recommended that NSW pragmatically and selectively applies output budgeting models that are most appropriate to particular agencies and services.

Output budgeting – design principles for NSW

Outcomes (results) and outputs (services) should remain the foundations of the Financial Management System.

Outcomes should be linked to outputs using the existing results logic methodology that is central to the current RSP framework. Agencies have considerable experience in applying this methodology, which is well established in NSW.

Output costs (and associated performance measures) should be the basic building blocks of budgets and should be consistently used for planning, budgeting, monitoring and reporting.

Proposed model for NSW

It is recommended that NSW implement an output budgeting framework that links allocations to costs of services. The approach should be flexible to take into account:

- the nature of agency outputs and the practicality of setting budgets by volume and unit cost/prices, and
- the cost/benefit of establishing the necessary systems to support a progression beyond the Level 2 model above (budget funding informed by output costs).

The implementation strategy should focus on moving all NSW agencies and their outputs, from Level 1 to the appropriate level, as a minimum, to Level 2, as summarised in Table 12.5.1 below.

Table 12.5.1 Hierarchy of output budget approaches

Level	Model	Possible applications
1	Budget presentation of output costs	All agencies are currently at this level. However, intent should be to move all at least to the next level.
2	Budget funding informed by output costs	Small agencies, policy activities, heterogeneous service providers (e.g. NSW Treasury)
3	Direct budget funding based on unit costs	Large relatively homogenous services where prices *cannot* easily be determined (e.g. Corrective Services, Education)
4	Direct budget funding based on prices	Large homogenous services where prices *can* be determined (e.g. Health, Education)

In some cases, agencies (or selected services within an agency) may move progressively through the levels. In many cases, however, it may be cost effective for agencies to remain at Level 2 because:

- the nature of their services means that it is not sensible to set budgets by volume and unit cost/prices, and
- it is not cost effective to set up the necessary systems to support a move beyond Level 2.

For example, the services of an agency that primarily provides policy advice are broadly analogous to the services provided by a consulting firm. Outputs are not homogenous. Such firms typically charge an hourly rate, not a unit price. For such services, performance measures are more sensibly based around quality rather than quantity.

Establishing meaningful prices for the outputs would also be problematic. It would not be cost effective for such agencies to set up time recording and billing systems required to implement a full purchaser/provider model. It would, therefore, be more cost effective to manage around administrative units and conduct costing exercises from time to time to provide justification for the budget allocation.

Conversely, it is possible to establish unit costs in departments which deliver a large volume of relatively homogenous services, for example Education or Corrective Services. In a more limited number of instances, it may be possible to establish an efficient price (e.g. selected programs in Health).

It is not necessary for the whole of the agency or department to adopt output budgeting at the same level of sophistication. It may be more appropriate and cost effective for different outputs in the same agency to adopt output budgeting to different levels of sophistication, depending on the nature of the output. An example of this approach from the Health portfolio that involved the implementation of activity-based funding, as agreed by the Council of Australian Governments, is illustrated in Table 12.5.2 below.

Table 12.5.2 Output budgeting application in Health

Program	Output Budgeting Model
Acute	Level 4: Direct budget funding based on prices
Emergency departments	
Outpatients	
Rehabilitation and extended care	
Mental health	
Primary and community care	Level 2: Budget funding informed by output costs
Ambulance	
Teaching and research	
Population health	
Aboriginal health	

Statement of Service Outputs

The RSP should be replaced by a Statement of Service Outputs, which should consist of:

- a high-level results logic diagram that links services to results and associated results measures
- a detailed identification of the specific services to be delivered, service standards (e.g. measures of quantity, quality and timeliness) to be met or achieved, and the costs of providing these services.

The results logic methodology adopted in the RSP should be retained so there is a clear 'line of sight' between results (outcomes) and services (outputs) that the agency will deliver.

A limited, manageable number of services should be agreed by Treasury with agencies based on materiality. The appropriate level for output budgeting for each such service should also be agreed.

These services and their associated costs should be clearly identified in the Statement of Service Outputs. Unlike the RSP, service group expenditure should be constructed using a bottom-up approach, based on the cost and quantum of explicitly identified services the agency is to deliver. Agency budgets should be the aggregate of service group expenditures.

The Statement of Service Outputs should initially build on the service group structures currently in budget papers, which should be reviewed by Treasury with agencies to ensure suitability for output-based budgeting. Outputs, performance measures and program structures should be further developed and gradually refined over a period of time with full agency involvement.

The Statement of Service Outputs should form the basis of a formal funding agreement between the minister and the Treasurer and between the CEO and the Secretary of Treasury.

The Statement of Service Outputs should also align closely with outcomes and key performance indicators in the agency's corporate plan. This alignment, combined with the useful nature of the information generated by the focus on costing services, should also help to mitigate the previous issue of agencies treating the RSP process as one of compliance.

The Statement of Service Outputs should be revised in alignment with the budget cycle and reported in Budget Paper 3. Negotiation of services (outputs), service costs and service measures at the commencement of every budget cycle should become integral to the budget process.

Costs and service measures specified in the Statement of Service Outputs should be monitored by agencies and Treasury during the course of the year, with formal reporting on accomplishment to the Budget Committee of Cabinet, at least annually and preferably every six months. Monitoring by Treasury of agency performance against targets will be paramount to ensuring accountability.

The measures in the Statement of Service Outputs should be reported in departments' annual reports. These measures should also be included in CEO performance agreements.

Elements in the existing RSP template which are duplicated with agencies' corporate and business plans or elsewhere, such as discussions of organisational capability, risks and risk management strategies, should not be included in the Statement of Service Outputs. The Statement of Service Outputs should specifically be a funding agreement based on results logic and the quantification and costing of services that are directly linked to the agency's desired outcomes through the results logic methodology.

Statement of Service Outputs versus Results and Services Plan - a comparison

Table 12.5.3 below demonstrates how the Statement of Service Outputs will build on the RSP's strengths while addressing some weaknesses with the previous process.

Table 12.5.3 Comparison of the Statement of Service Output process with the RSP

	RSP	Statement of Service Outputs
Agreement entered into by	Agency CEO and minister	Formal funding agreement to be signed by minister and the Treasurer and between the CEO and the Secretary of Treasury.
Frequency	Once every four years	Annual.
Link to outcomes (results)	Results linked to services through a results logic methodology	Results linked to services through a results logic methodology.
Service costing	Top-down, high-level allocation of total expenses to service groups	Service group expenditure constructed bottom-up, based on the cost and quantum of explicitly identified service (outputs) the agency is to deliver.
Link to agency budget	Provides background information and context	Direct link. Agency budget expected to be justified based on the cost and quantum of service (outputs) to be delivered. Negotiations as part of budget process.
Evaluation of new policy proposals	Provides background information and context	New policy proposals evaluated based on the impact on service measures.
Results and service measures	Reported in budget papers	Reported in budget papers, annual reports. Specifically includes cost, quantity, quality and timeliness for services.
Monitoring and reporting	Annually in budget papers	Regular monitoring by Treasury. Formal reporting to Budget Committee every six months. Annual reporting in budget papers and annual reports.
Links with agency corporate and business planning	Some overlap in content but essentially independent processes	The Statement of Service Outputs and the results logic should be key drivers in planning as agencies develop strategies to manage the costs of services.
Agency focus	At service-group level, managed by line item	Agencies will need to focus on managing the cost of services (outputs).
Link to performance agreements	No direct link	Performance on Statement of Service Output measures reviewed as part of CEO performance review.
Benchmarking	RSP framework did not support benchmarking	Costing of services (outputs) on a consistent basis will permit benchmarking and assessments such as whether the benefit of a service (output) delivered to the community exceeds the cost of providing that service output and whether the government agency is the most efficient, effective and appropriate vehicle to deliver that service.

Implementation considerations

The Statement of Service Outputs is a tool to support a new way of budgeting and must be supported by the right processes and commitment.

The introduction of service cost-based budgeting will only be successful if implemented within a holistic package of reforms. Success will rely on strong foundations such as budget incentives/penalties, greater CEO accountability and flexibility and performance management, and robust information collection and management.

The mechanisms that will incentivise Treasury and agencies to approach budgeting differently lie in the benefits of this approach. These include the competitive incentives through improved benchmarking, price signals and market reviews as well as public performance reporting in budget papers and annual reports. These benefits are likely to accrue to some areas more than others (that is direct service delivery rather than in policy and regulatory activities). Direct service delivery, however, represents the majority of general government operating and capital expenditure.

Capabilities and systems in both Treasury and agencies will need to be enhanced to support the introduction of the new system.

Migration from the top-down RSP approach to budgeting to the bottom-up Statement of Service Outputs approach is a major undertaking, given the need to design a methodology, build capabilities in both Treasury and agencies and introduce costing systems. Full implementation should be phased over several years, allowing for agency involvement in the development of service indicators and standards.

Implementation will require the identification of indicators and service standards, development of a robust methodology and consistent output costing model for services (counting rules), development and introduction of costing systems and establishing linkages with the budget process, agency corporate and business planning and the CEO and SES performance and accountability framework.

It is recommended that implementation should proceed in three phases as shown in Table 12.5.4 below. Implementation should commence with pilot testing, followed by gradual extension across the sector. A ‘big bang’ approach is not recommended.

Table 12.5.4 Phased Implementation of Output Budgeting

Phase	Deliverable
Phase 1	Planning and development of methodology, including identification of processes and required capabilities at each Level (2, 3 or 4) Pilot testing in selected agency(ies)
Phase 2	All agencies migrated to Level 2
Phase 3	Selected agencies – or selected services within agencies – migrated to the appropriate higher level

Full implementation could take three to four years. It will require significant commitment and resources to build related capabilities, as well as a significant investment in information systems to support implementation.

Benefits

The implementation of an output budgeting system will lead to:

- better understanding of costs and benefits of government services
- budgets based on proper business planning, not 'last year plus'
- better understanding of variances (cost, volume, efficiency)
- in conjunction with other reforms, stronger controls (at output rather than at agency levels)
- a means to test the market.

Output budgeting should be cascaded through the agency so that it becomes a management tool rather than a Treasury-imposed reporting requirement. As CEOs find the information generated increasingly useful in the assessment of the cost/benefits of their programs, output budgeting will provide greater value to agency planning, decision making and management.

12.6 Financial and risk management in agencies

This section identifies areas in which improvements can be made in the approach to both financial management and risk management within general government agencies in the NSW public sector.

Financial management

The *Public Finance and Audit Act 1983* (PFAA) requires the Head of an Authority to ensure an effective system of internal control over the financial and related operations of the Authority.

An effective financial management framework within agencies is integral to good corporate governance. While financial management frameworks are generally in place, there are some weaknesses, to varying degrees across the sector, that should be addressed.

Legislation

The current NSW *Public Finance and Audit Act 1983* sets out prescriptive public finance administration and audit obligations. While this legislation has been progressively amended, (e.g. to reflect emerging initiatives, such as accrual accounting), it does not constitute a coherent management framework. For example, agency financial reporting and annual reporting obligations are in separate Acts. In general, the current legislation focuses on compliance and not performance management. A number of reforms to the legislation were identified in the fundamental review conducted in 1998, but the review did not receive government endorsement.

The PFAA 1983 should be reviewed and modernised to, among other things:

- define roles and responsibilities of key players (e.g. the CFO)
- define performance in terms of outcomes, outputs and financial compliance
- mandate key elements of the management cycle such as strategic planning, risk management and attestation of compliance.

Policy and procedures

In addition to legislation, financial management and accountability is governed by Treasurer's Directions and Circulars, Premier's Memorandum and Circulars and Templates and other supporting material. However, the absence of a sound legislative basis limits the effectiveness of these policies.

Other jurisdictions have established formal financial management compliance frameworks to assist agencies to establish and maintain effective and consistent financial management practices across the public sector. Such frameworks are designed to supplement strong financial management legislation and typically provide specific guidance on governance processes, the internal control environment, risk management, systems, procedures and financial and management reporting. As part of this, agencies are often required to annually certify compliance with all applicable legislation and Directions.

NSW Treasury currently requires agencies to attest to compliance with the Internal Audit and Risk Management Policy. CFOs are also required to separately certify that their agency has an effective system of internal controls to ensure financial information provided to Treasury is accurate. However, there is no formal attestation covering other elements of the financial management framework.

A comprehensive financial management framework will assist NSW public sector agencies establish and maintain effective financial management to support the achievement of their key objectives and goals. Such a framework will assist Treasury to monitor the standard of financial management and compliance with relevant legislation and other elements of the financial management framework. Further, this framework will give agencies the ability to benchmark their financial management practices.

The experience of other jurisdictions indicates that the development of such a framework requires significant and sustained multi-agency effort.

Roles and responsibilities

The Public Accounts Committee (PAC) recommended that the Premier ensure that accountability for accurate and timely financial reporting be included in all CEOs' performance agreements. The Government has supported this recommendation as part of a broader reform of CEO accountability.

Agency CFOs should be the main proponent of financial discipline and the financial management framework. However, CFOs and other key finance officers have not always received appropriate managerial prominence within agencies.

In the private sector, the CFO is normally expected to be the CEO's key adviser in corporate strategy development. This is because financial issues are a key element of corporate strategy and the finance function is often responsible for the management and analysis of non-financial performance information.

In the NSW general government sector, many CFOs do not have this role. They are not always a key member of the executive team and focus more narrowly on financial reporting and day-to-day accounting functions. Similarly, finance functions focus on routine transaction processing tasks, rather than analysing costs and performance.

The Government has also supported the principle that CFOs should be made more explicitly accountable for the quality of financial information produced by their agencies.

Commencing in March 2011, Treasury has required all CFOs to express an annual formal opinion as to the effectiveness of internal controls over the financial information prepared by their agencies. This requirement is not currently legislated as recommended by the PAC. Instead, it was decided to assess the effectiveness of this new certification process before determining whether it needs to be supported by amendments to the PFAA.

Additionally, CFOs, CEOs and ministers should sign off periodically on financial reports provided to Treasury, including financial projections for the balance of the year. Such certifications should be provided every six months (that is, accompanying half-year and end-of-financial-year returns) as well as at the time of providing financial data for inclusion in the budget papers.

Annual reports

The PAC recommended that, by 2013 at the latest, the Treasurer develop and implement a program to bring forward the deadline for the tabling of annual reports in Parliament to three months after the end of the financial year.

The Government has supported this recommendation. Amendments will be required to the statutory reporting deadlines set out in the PFAA, the *Annual Reports (Statutory Bodies) Act 1984* and the *Annual Reports (Departments) Act 1985*.

The early close procedures currently being adopted should facilitate earlier tabling of annual reports. As the change to annual report deadlines is significant, it is expected to be fully implemented by 2013.

Risk management

Agencies should have rigorous risk management and internal control processes in place to ensure services and projects are delivered as planned.

Treasury issued Treasury Policy Paper (TPP) 09-05, Internal Audit and Risk Management Policy in 2009 as a direction to department heads and statutory bodies (refer Section 7.2). Unlike previous guidelines, the policy is mandatory.

While the Heads of Authorities are primarily responsible for developing and implementing a risk management framework at department and agency level, risk is also the responsibility of all individuals in the organisation.

Management and staff at all levels in the sector – and in particular, key roles such as the Chief Executive, Chief Audit Executive and Risk Management Officers – should have the risk-related competencies to fulfil their accountabilities and responsibilities.

12.7 The Auditor-General

The Auditor-General (AG), along with key Parliamentary Committees, plays a critical role in good governance and accountability under a Westminster system of government. The framework for the operation of the AG is set down in the *Public Finance and Audit Act 1983* (PFAA).

Some of the AG's powers and responsibilities need to be refined to improve the position's role and effectiveness and to reflect better practice in other jurisdictions, including:

- enhanced powers such as access to Cabinet documents, if approved by the Premier, and explicit powers to undertake compliance audits
- enhanced accountabilities, such as mandatory compliance with Australian Auditing Standards (AAS) and direct accountability to the PAC.

The adoption of these recommendations will ensure that the AG is held to the highest standards of accountability, which is required given the position's importance within a whole-of-government accountability framework.

Enhancing the role and effectiveness of the Auditor-General

New powers

Increase powers of the AG to access Cabinet documents

Although the NSW Government has occasionally given the AG access to Cabinet documents, NSW legislation does not currently give the AG a statutory right to access those documents. As a result, the NSW AG cannot identify all transactions and risks relevant to an audit. Accordingly, the PFAA should be amended to:

- permit the AG to request and, if approved by the Premier, gain access to Cabinet documents relevant to the audit of agency activities and
- prevent the AG from reporting information in Cabinet documents whenever the Premier or a delegate formally advises the AG that disclosure of that information is not in the public interest.

Provide the AG with explicit power to undertake compliance audits

Compliance reviews seek to confirm that specific legislation, directions and regulations have been adhered to by government agencies. Under the PFAA, the AG has no explicit power to undertake a compliance audit or related service and must be requested to undertake those audits.

The PFAA should be amended to provide the AG with an explicit power to undertake compliance audits. The AG should be required to conduct these audits within an expanded performance and compliance audit budget.

Expand the AG's role in the audit of entities that are not directly controlled by a department, statutory body or minister

Currently, the PFAA *automatically* empowers the AG to audit entities directly controlled by a single statutory body, department or minister. However, the PFAA does not *automatically* empower the AG to audit an entity based on more than 50 per cent of its ownership or voting rights being held by more than one department, statutory body or minister.

The AG should be granted automatic authority to audit an entity if any combination of departments, statutory bodies or ministers have in total:

- an ownership interest of more than 50 per cent in that entity or
- more than 50 per cent of the voting rights in that entity.

This will increase the perceived independence of the AG (as the Treasurer will no longer need to provide the AG with authority for such audits). It will also eliminate the unnecessary administrative time currently required to arrange Executive Council approval to prescribe those audits and request that the AG perform those audits.

Empower the AG to audit the legislature

Although the AG is automatically empowered to audit government departments, statutory bodies and controlled entities, the AG is not automatically empowered to audit the legislature. Instead, the AG must obtain permission each year to conduct an audit of the legislature from the legislature's Presiding Officers. Other jurisdictions have defined the legislature as a government department, enabling it to be audited. The PFAA should be amended to automatically empower the AG to audit the legislature.

Permit the AG to choose not to audit dormant agencies

In contrast to other jurisdictions, the NSW AG must audit dormant agencies. This incurs unnecessary administrative costs. The AG should be permitted to nominate dormant agencies which will not be subject to an audit. Legislative amendments should require that the AG obtain the Treasurer or a delegate's approval not to audit such agencies to ensure that the AG cannot unilaterally decide which agencies will not be audited.

Clear accountability for the Auditor-General

Require the AG to comply with AAS

In contrast to other jurisdictions, the PFAA only requires that the AG 'have regard to professional standards and practices'. Although the NSW AG already audits in accordance with Australian Auditing Standards (AAS), this compliance is not formalised in the PFAA. The Victorian and Tasmanian Auditors-General are required to comply with AAS. To align with best practice in other jurisdictions, the PFAA should be amended to require that the AG comply with AAS.

Improving the accountability of the AG to Parliament

Despite being an Officer of Parliament, there is no formal accountability relationship to Parliament as in other jurisdictions. The PFAA should be amended to formalise the AG's relationship to the PAC. In particular the following is proposed:

- empower the PAC to undertake activities (hearings, submissions, etc.) and report on the performance of the AG
- require the AG to confer with and have regard to the audit priorities of the PAC and
- require the AG to submit an annual work plan to the PAC and consider PAC comments.

The PAC should effectively operate as the agent of Parliament to strengthen its links with the AG.

Require the AG to include agency comments in any Report to Parliament

Currently the AG is only required to give agencies the opportunity to include their comments in performance audit reports. The AG is not required to include agency comments in audit reports on financial statements. Requiring the AG to include agency comments on any Report to Parliament would increase the usefulness of those reports by providing a balanced view, particularly where an agency disagrees with the AG. The AG should give an agency five business days to comment on financial statement audit reports and 10 business days to comment on performance and compliance audit reports.

Require the review of the Audit Office to be provided directly to the PAC rather than to the AG to pass on to the PAC

An independent review of the NSW Audit Office's performance is conducted every three years. However, in contrast to other jurisdictions, NSW is the only jurisdiction where the Audit Office's reviewer reports to the AG instead of directly to the PAC. This requirement is currently in the PFAA. The PFAA should be amended so that the Audit Office's reviewer reports directly to the PAC.

Other

Reduce the number of days during which an agency can respond to a performance audit report

The PFAA gives an agency 28 days to respond to a performance audit report. This is longer than the time allowed by each Australian jurisdiction apart from the Commonwealth. Queensland gives its agencies 21 days, Western Australia 14 days, Victoria 10 business days and Tasmania three business days.

Consideration should be given to reducing the 28-day comment period in the PFAA to 10 business days in line with the practice in other jurisdictions.

Extend the PFAA requirement for review of the Audit Office from once every three years to once every four years

The PFAA requires that the PAC engage a person to review the practices and standards of the Audit Office at least once every three years. The PAC has previously asked to amend the PFAA so that it would only be required to engage a reviewer once every four years. The PFAA should be amended to require the PAC engage a person to review the Audit Office once every four years.

Clarifying the application of Section 38 of the PFAA 1983

PFAA Section 38(1) requires that the Auditor-General preserve secrecy except in circumstances listed in Section 38(2). These circumstances include ‘a report or communication authorised or required to be made by or under this Act or the prescribed requirements’ (Section 38(2)(d)).

Treasury’s Internal Audit and Risk Management Policy, TPP 09-05 mandates the establishment of Audit and Risk Committees (ARCs) in agencies. ARCs must have an independent chair and a majority of independent members, drawn from a panel of prequalified individuals.

The Audit Office is concerned whether PFAA Section 38(1) may prevent Audit Office staff from disclosing information about a particular audit to the independent members in an ARC.

TPP 09-05 also makes reference to multi-agency or cluster ARCs where one ARC may oversight more than one agency. There are some legal issues to be resolved to permit such multi-agency ARCs. However, the Audit Office is also concerned as to whether Section 38(1) will prevent Audit Office staff from disclosing information to an ARC established pursuant to TPP 09-05 that is the ARC for more than one agency.

This matter should be resolved by Treasury in consultation with the Audit Office and the Crown Solicitor, and if necessary, legislation be changed to permit the Audit Office to disclose information to members of ARCs constituted in accordance with TPP 09-05.

12.8 Public Accounts Committee

The NSW Public Accounts Committee (PAC) has responsibilities under the *Public Finance and Audit Act 1983* (PFAA) to inquire into, and report on, activities of government that are reported in the Total State Sector Accounts and the accounts of the State's Authorities. The Committee scrutinises the actions of the Government on behalf of the Legislative Assembly and along with key Parliamentary Committees, plays a critical role in good governance and accountability under a Westminster system of government.

The PAC should be a proactive, bipartisan champion of better financial management practice. However, it has had a much lower profile in NSW than equivalent committees in other jurisdictions. Certain roles and responsibilities of the PAC need to be refined to improve its effectiveness and to bring it in line with better practice in other jurisdictions, including:

- reviewing the PAC structure and membership
- making the Auditor-General (AG) more accountable to the Parliament through the PAC
- strengthening the procedures for government responses to the PAC's recommendations
- enhancing the PAC's capabilities
- improving the PAC performance reporting process.

The adoption of these recommendations would give the PAC a greater ability to discharge its responsibility as a Parliamentary oversight body to hold the Government accountable for its actions.

Enhancing the role and effectiveness of the PAC

Review the PAC structure and membership

As the PAC is only a Committee of the Legislative Assembly, the current structure does not represent the views of the whole Parliament. Other jurisdictions have made their equivalent Public Accounts Committees joint committees of both Houses of Parliament. Furthermore, the NSW Parliament has already established the Committees overseeing the Independent Commission Against Corruption (ICAC) and Ombudsman as Joint Committees of both Houses of Parliament. Similarly, the PFAA should be amended to make the PAC a joint committee of both Houses of Parliament.

The PAC Chair and Deputy Chair have been members of the Government. However, it is convention in other jurisdictions to ensure a balance of political representation in these positions. If the PAC Chair remains a member of the Government, the Deputy Chair should be from the Opposition. This will achieve a more balanced political representation and ensure that the PAC structure is in line with other jurisdictions.

When a new PAC Chair is appointed, they must have the qualities and experience to ensure that the PAC works efficiently and effectively.

In contrast to other jurisdictions, no current or former shadow ministers have been PAC members. If new members are appointed to the PAC, senior opposition members should be considered for positions, so that they can provide continuity of knowledge and give guidance and mentoring to less experienced members.

Strengthen the relationship between the AG and PAC

As outlined in Section 12.8, the relationship between the AG and the PAC needs to be strengthened by amending the PFAA to:

- empower the PAC to undertake (hearings, submissions, etc.) and report on the performance of the AG
- require the AG to confer with and have regard to the audit priorities of the PAC
- require the AG to submit an annual work plan to the PAC and consider PAC comments
- require a review of the AG every four years (rather than every three years) and for the review to report directly to the PAC.

Strengthen procedures for Government response to the PAC's recommendations

The PAC currently reports to and is accountable to the Parliament. However, the Government is responsible for responding to the PAC's recommendations. A Public Accounts Committee is only effective if its recommendations are promptly and transparently considered by government.

Other Australian parliaments have introduced legislation requiring their governments to respond to PAC recommendations. However, the NSW Parliament has not enacted such legislation. Instead, NSW Government ministers are required by Legislative Assembly Standing Order to respond to PAC recommendations. This requirement could be strengthened by enacting legislation, as per other jurisdictions.

Enhance the PAC's capabilities

PAC member remuneration and resources should be reviewed to ensure that the PAC has the capability to discharge its mandate. The PAC should be appropriately staffed to enable it to:

- make more informed decisions with better quality information
- perform more self-initiated inquiries and consider AG's reports that are priority items for the PAC
- develop better performance reporting processes
- engage in meaningful secondment arrangements with other agencies to foster the exchange of knowledge.

Improve the PAC performance reporting process

The PAC should consider improving its performance reporting process so that it can clearly demonstrate to stakeholders it is fulfilling its roles and responsibilities. The current suite of the PAC key performance indicators (KPIs) that are reported on in the Annual Review do not comprehensively reflect the PAC's performance.

The PAC should consider adopting a more extensive suite of KPIs and actual performance on each KPI should be assessed against realistic targets set by the PAC and reported in the Committee's Annual Review. This could enhance the transparency of the PAC's activities, demonstrate a stronger link between PAC performance and results, and reflect the PAC's commitment to accountability. Improving the PAC performance reporting process would bring the PAC in line with other jurisdictions such as Victoria, which is considered to be a leader in PAC performance reporting.

Examples of KPIs that could be adopted include:

- timeliness of reporting, for example elapsed time between the final PAC hearing for an enquiry and the release of the PAC's report on that enquiry, time taken for consideration of and comment on AG's annual work plan
- percentage of PAC recommendations accepted by the Government.

The PAC should also consider enhancing its reporting structure in its Annual Review to communicate its performance more clearly by:

- reporting on the percentage of PAC recommendations accepted/rejected/under review by government
- reporting on the number of government responses to PAC recommendations by principal department.

12.9 Recommendations

The Financial Audit recommends:	
Budget decision making	
12.1	A Cabinet-approved Budget Policy Statement be made at the beginning of each budget process that is consistent with fiscal sustainability targets and sets key financial targets over the forward estimates period.
12.2	An annual Statement of Priorities that identifies priority areas for funding be approved by Cabinet at the commencement of each Budget process, consistent with the Budget Policy Statement and aligned to the NSW State Plan, with the priorities guiding resource allocation decisions through the annual budget process.
12.3	Making the Net Lending Result, rather than the Budget Result, the principal focus in setting the fiscal strategy and for ongoing budget management purposes, with the Net Operating Balance retained as the measure of the Budget Result to ensure comparability with other states and territories.
12.4	Establishment of a non-commercial PTE sector comprising those PTEs that are funded through operating subsidies and/or capital grants from the Budget, as well as internal revenue sources. The sector should have a specific financial management framework, including the requirement that no debt is allocated to it.
12.5	All new (recurrent and capital) expenditure proposals be supported by robust business cases based upon improved corporate and medium-term planning, with business cases associated with major infrastructure projects reviewed by Infrastructure NSW.
12.6	Savings targets be risk assessed jointly by Treasury and the relevant agency, and the risk-weighted savings be reflected in the agencies' budgets and forward estimates.
12.7	Maintenance of effort proposals be restricted to genuinely unforeseeable and extraordinary issues or those that arise from approved formula-driven arrangements.
12.8	All key budget framework documents be published, along with the annual budget strategy, business cases for approved programs or projects, the outcomes of program reviews and details of key processes, such as the Budget process.
12.9	The State invest in developing the skills necessary to support the new financial management framework with the Public Service Commissioner (PSC) playing a key role in facilitating the development of sector-wide skills.
Improved budget compliance	
12.10	Ministers and CEOs have formal performance agreements with – and be held accountable by – the Premier, with a formal funding agreement with Ministers and CEOs signed at the end of the Budget process.
12.11	Budget compliance is made a key and mandatory element of CEO performance agreements, with performance sanctions for budget overruns, with portfolio ministers not permitted to direct agency CEOs to exceed budget without renegotiation of their funding agreement or, in urgent cases, confirmation from the Premier and Treasurer.
12.12	The portfolio minister, not the Treasurer, be required (with Budget Committee approval) to seek an additional appropriation from Parliament, if Budget supplementation is required outside the 'exigencies of government' due to either an inability of the agency to manage within the approved budget or to fund new programs outside of the Budget process.
12.13	All Cabinet Minutes be considered by the Government only if submitted with a Treasury-endorsed Financial Impact Statement.
12.14	Treasury Administrative Controls be tightened by curtailing the Treasurer's Advance and limiting its use to genuine contingencies.

The Financial Audit recommends:	
12.15	Allowing the rollover of funds across years if approved by Parliament via a Special Appropriation Bill.
12.16	The cluster Minister be the Budget holder for the cluster, with the only exceptions being: § where there is a second departmental cluster that is not strategically aligned with the principal department § independent bodies such as ICAC. with the cluster Minister and the principal department CEO being responsible for achieving strategic alignment within the cluster and responsible for all cluster proposals made to Cabinet.
Output-based budgeting	
12.17	Implement an output-based budgeting model, building on the service group information currently in the Budget Papers and customised to individual agencies with a formal 'Statement of Service Outputs' signed by the Minister and the CEO based on services specified in terms of quantity, quality, cost and timeliness.
Financial and risk management in agencies	
12.18	Development of a comprehensive whole-of-government compliance framework to support the NSW financial management framework, providing specific guidance to agencies on governance processes, the internal control environment, systems, procedures and management, and financial reporting.
12.19	The Financial Management Framework include a new financial management framework for general government non-budget-dependent agencies, to bring about consistency with budget-dependent agencies in the application of net cost of services tolerances, capital authorisation limits and introducing consistent disciplines to permit greater scrutiny and control such as a requirement to produce Statements of Business Intent.
12.20	The *Public Finance and Audit Act 1983* be amended to reflect the revised approach to financial management, including: defining the roles and responsibilities of key parties (e.g. the CFO); mandating key elements of the management cycle such as strategic planning, risk management and attestation of compliance; defining performance in terms of outcomes, outputs and financial compliance; and requiring annual reports to be tabled in Parliament within three months of the end of financial year (by 2013).
12.21	Requiring CFOs, CEOs and Ministers to sign off on financial reports provided to Treasury, including financial projections for the balance of the year, with such certifications provided every six months, that is accompanying half year and end of financial year returns.
12.22	Reporting financial measures and departmental key performance indicators in agency corporate and business plans, performance reports and annual reports.
12.23	Responsibility for compliance with the Budget be cascaded to the CFO and all staff in agencies with budget control responsibilities through performance agreements.
12.24	A comprehensive reporting framework be agreed between Treasury and agencies that includes both financial and non-financial metrics for programs (including service (output) metrics and FTE numbers).
12.25	The Public Service Commission, with the assistance of the Department of Premier and Cabinet and Treasury, take the lead in developing and implementing a strategy to build risk management capability across the sector.

The Financial Audit recommends:	
The Auditor-General	
12.26	The Auditor-General’s powers be enhanced by: § increasing powers of the AG to access Cabinet documents § providing the AG with explicit power to undertake compliance audits § expanding the AG’s role in the audit of entities not directly controlled by a statutory body, department or minister § empowering the AG to audit the Legislature § permitting the AG to choose not to audit dormant agencies.
12.27	The Auditor-General’s accountability be enhanced by: § requiring the AG to comply with Australian Accounting Standards § making the AG directly accountable to the Public Accounts Committee (PAC) § requiring the AG to include agency comments in any report to Parliament § requiring the review of the Audit Office to be provided directly to the PAC rather than to the AG for on-passing to the PAC § reducing the number of days an agency has to respond to a performance audit report.
The Public Accounts Committee	
12.28	The PAC’s role and effectiveness be enhanced by: § reviewing the PAC structure and membership § making the AG directly accountable to the PAC (refer to recommendation 12.27) § strengthening procedures for government responses to the PAC’s recommendations § enhancing the PAC’s capabilities § improving the PAC performance reporting process.
The Fiscal Responsibility Act	
12.29	Amending the *Fiscal Responsibility Act* to make the fiscal sustainability target that net financial liabilities for both the total state sector not exceed total revenue, with the target phased in over the period to 2019-20 and thereafter maintained.

13 REVENUE REFORM

Key points

- Numerous reviews have concluded that the majority of state taxes are generally inefficient in that they distort economic activity, hinder economic growth and lead to a significant welfare loss. Most recently, the Australia's Future Tax System review (the Henry Review) found that:

  Many of the current State taxes are inherently of poor quality while other State taxes need to be reformed. Increasing the rates of tax on existing State taxes would not be a sustainable way of funding services in the future[1].

- NSW's current tax system does not provide a sustainable and efficient basis for funding increasing levels of service delivery. Fundamental tax reform, such as replacing inefficient taxes with more efficient taxes, is necessary to remove economic distortions, promote economic growth, underpin productivity improvements, reduce complexity and enhance the sustainability of increased levels of service delivery.

- Taxes provide roughly one third of NSW revenue. Taxes are the only significant part of NSW revenue that the Government has significant freedom to adjust. However, it would be economically inefficient to fund new spending initiatives using the current system of state taxes.

- Fundamental tax reform could reduce the economic cost of taxation, remove distortions from decision making and raise productivity. This would make it economically sustainable for the State to use its own revenue sources to fund new initiatives.

- Reform of the taxation system should be based on seeking to address the relative inefficiency of the current tax system. Reforms should be supported that improve efficiency while maintaining enough revenue to satisfy growing demands for state government services.

13.1 Fundamental tax reform

Reforms to improve the efficiency of state taxes offer the potential for large gains to the economy. By switching from inefficient taxes to efficient taxes, while continuing to raise the current level of revenue, tax reform could provide benefits to NSW households worth more than $4 billion per year and increase gross state product (GSP) by more than 1.8 per cent.

[1] Australia's Future Tax System review (AFTS), Part 2, p.680.

Measures of the excess burden (efficiency cost, over and above the tax revenue raised) for selected state and Commonwealth taxes are provided in Table 13.1.1. Excess burden measures the added value to consumers that could be achieved if a tax were repealed (see Box 1). For example, repeal of transfer duty would improve state-wide consumer welfare by the equivalent of an extra $2.6 billion of income per year (around $370 per person). For NSW, total excess burden is estimated to be around $5.4 billion per year, or 26 per cent of tax revenue.

Table 13.1.1 The excess burden of selected taxes

Revenue source	Revenue 2011-12[(a)] ($m)	Total excess burden ($m)	Marginal excess burden (cents per dollar of revenue)	Average excess burden (cents per dollar of revenue)
Transfer duty	4,126	2,558	80	62
Emergency services levy	633	373	68	59
Vehicle stamp duty	608	188	33	31
Insurance duty and health insurance levy	893	259	31	29
Vehicle registration	1,895	474	31	25
Payroll tax rate	6,855	1,371	35	20
Payroll tax threshold	-	-	-8	-
Land tax rate	2,483	149	9	6
Land tax threshold	-	-	-8	-
Royalties	1,809	72	13	4
Gambling taxes	1,878	0	0	0
Total for state taxes	**21,180**	**5,445**	**-**	**26**
Personal income tax	-	-	24	16
Corporate income tax	-	-	40	23
GST	-	-	8	6
NSW council rates	3,284[(b)]	66	3	2

Sources:
(a) State revenue estimates are from the 2010-11 Half-Yearly Review.
(b) Council rates revenue is for 2008-09, and is drawn from ABS 5212. Excess burden estimates for state and council taxes are from Econtech, 2011. Excess burden estimates for Commonwealth taxes are from Econtech 2010.

One of the most important objectives of tax reform is to minimise the tax system's deadweight loss associated with the Government's chosen level of spending. For a given revenue target, the deadweight loss can be reduced by cutting inefficient taxes and simultaneously increasing efficient taxes. The most efficient sources of NSW revenue are land tax, royalties (although this depends on the terms of trade), and the goods and services tax (GST). The municipal rate base is also a highly efficient source of revenue.

Pursuing the idea of improving the efficiency of the NSW tax base, this section sets out ideas for a major overhaul of NSW taxes, including revenue-neutral reform intended to improve the efficiency of existing taxes, potential new sources of revenue, and reforms which NSW could conduct jointly with other Australian governments.

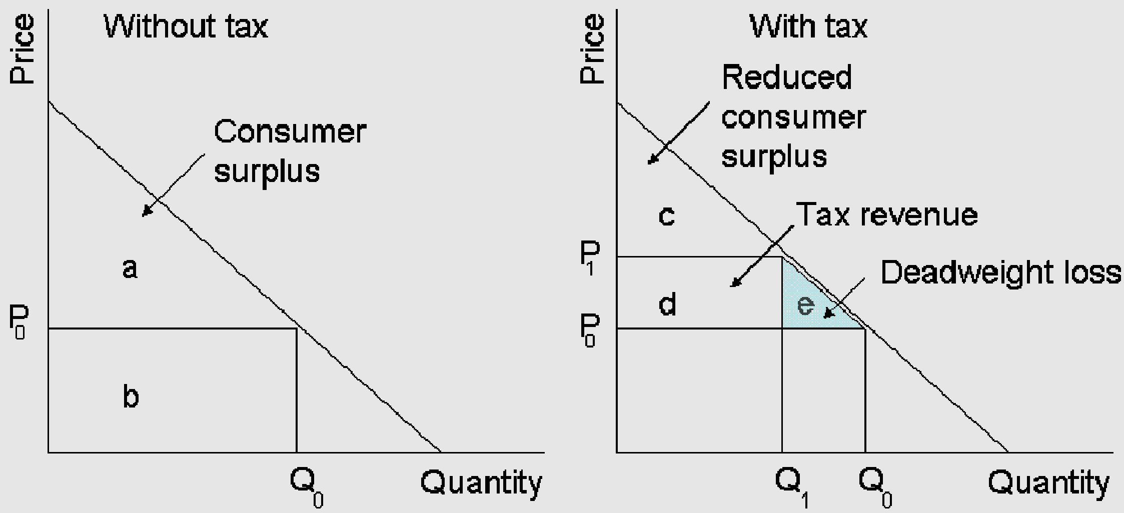
Box 1 – The excess burden of taxation

Figure 13.1.1 illustrates the concept of the 'excess burden' of a tax, a measure of its efficiency. Excess burden is also known as the deadweight loss of a tax[2].

The left panel shows a demand curve, which measures the value that people place on additional units of a good. As the price rises, a smaller quantity is demanded. At price P_0, the quantity Q_0 is purchased. In a competitive market, the market value of goods is equal to the cost of production, and is given by the price x the quantity, or area *b*. Consumers value goods at more than the purchase price, or they wouldn't buy them. This consumer surplus is given by area *a*.

In the right panel, when a tax is imposed the price rises to P_1, and the quantity purchased falls to Q_1. The consumer surplus is reduced to area *c*. Some of the lost consumer surplus is transferred as tax revenue to the Government, measured by area *d*. This tax revenue is not lost to society, as it can be spent on government services. But some of the consumer surplus is destroyed by the tax: area *e*. The destroyed consumer surplus, *e*, is known as the deadweight loss of the tax and is the economic cost of taxation. A tax with a larger deadweight loss is less efficient.

Figure 13.1.1 Measuring the deadweight loss of a tax



Reform options for each major tax are set out below.

[2] Technically, these are different concepts, with the excess burden measured using a Hicksian demand curve, and deadweight loss measured using a Marshallian demand curve. The excess burden is the appropriate concept for tax reform purposes.

Transfer duty

The Financial Audit proposes a transition from transfer duty to an annual Stamp Duty Replacement Tax (SDRT), levied on the value of all land, regardless of how it is used or who owns it.

Once fully implemented, the annual welfare gain of this reform is $2.3 billion and GSP increases by 1.2 per cent.

Transfer duty is the most inefficient of NSW state taxes (average excess burden is 62 per cent). By comparison, a well-designed tax on land values is highly efficient (zero excess burden).

The proposed rates of the annual SDRT are 0.75 per cent of the assessed land value of properties with land value less than $775 per square metre and a marginal rate of 1.0 per cent on land values above this threshold.

These rates have been calculated to ensure that, as close as possible, the present value of annual SDRT payments will be equal to the amount of transfer duty that would otherwise have been paid on a property.

The SDRT would not replace the existing land tax on business land and investor-held residential land. For these property owners, the SDRT would apply in addition to the existing land tax. Once the SDRT applies to a majority of residential properties, it may be possible to merge the two systems.

Under the recommended transitional paths, there would be a revenue shortfall in the initial years. This would be funded by debt, supported by a new revenue stream.

Transition for residential and farming properties

Various paths are possible to manage the transition from transfer duty to SDRT. Different transition paths are recommended for residential and business land.

For residential properties, it is recommended that SDRT should apply only after a property is transferred for the first time. People whose circumstances do not change would not be liable for the new tax. Once the new regime is introduced, the first sale of a property would trigger application of the SDRT to that property. Under this approach, about 50 per cent of residential properties would be subject to the SDRT after nine years, 70 per cent after 15 years, and 80 per cent after 20 years.

For homebuyers, instead of paying transfer duty averaging about $19,000 based on the market value of the property, the purchase would trigger application of the SDRT averaging about $2,260 per year based on the land value of the property. That is, the up-front tax payments involved in buying a home would be significantly reduced. In most cases, the present value of SDRT payments will be about the same as the transfer duty that would otherwise have been paid.

The SDRT would apply to all properties, including principal places of residence. Applying land tax to people’s homes has typically been controversial. In this case, however, the SDRT would replace stamp duty, which already applies to people’s homes.

It is recommended that farming land should be subject to the same transition. Transfers of farming land within families are typically exempt from transfer duty, and it is proposed that such transfers should not trigger application of the SDRT.

Transition for business properties

It is recommended the SDRT should apply immediately to all business land, except farming land. Businesses that have recently paid stamp duty could claim that they are subject to double taxation. This concern could be addressed by providing a rebate that recognises stamp duty paid in recent years. One possible scheme might be:

- a tax credit is given for stamp duty paid in any of the past five years (the value of the credit is 100 per cent of the stamp duty paid in the past year, reducing in a straight line to 20 per cent for stamp duty paid five years ago)
- the tax credit grows at the inflation rate each year
- the value of the tax credit is reduced each year by the value of any land tax owed by the taxpayer, until the tax credit is extinguished.

The starting value of these concessions would be around $2.1 billion and the cost to revenue would be spread over about twelve years. The cost of the concessions would be around $380 million in the first year (i.e. around 100,000 businesses have paid stamp duty in the past five years, and average annual SDRT payments per business would be $3,800), with the cost of concessions falling steadily to zero by Year 12[3].

The businesses that would be most adversely affected by the changes are those that hold large quantities of land and those that rarely engage in land sales (e.g. owners of large commercial shopping centres). An alternative transition path could be to use the same mechanism as is proposed for residential transfer duty. The SDRT would only be applied after a transfer of land title. This would imply an additional state debt burden during the transition period.

Managing the transitional revenue shortfall

Under the recommended transitional paths for residential and business land, the Government would have a revenue shortfall in the initial years.

For residential land, this shortfall arises because, for example, in the first year, instead of receiving an average of around $19,000 per transaction, the Government would receive around $2,260. For business land, the revenue shortfall arises from tax credits given in recognition of recently paid transfer duty.

These revenue shortfalls could be reduced by increasing the SDRT rates. But this would undermine the message that the new tax has the same present value as the stamp duty it replaces.

Alternatively the revenue shortfall could be managed by increasing government debt. In order to maintain the State's AAA credit rating, debt repayments would need to be supported by a new revenue stream of around $900 million per year. With this revenue

[3] To maintain budget neutrality in Year 1, while providing credit for stamp duty paid in the past five years, the tax rates would need to roughly double from an average of 0.8 per cent of land value to 1.9 per cent of land value.

stream, the transitional debt would peak at $15.4 billion in Year 10, and would be paid off in Year 23. It is recommended that the revenue stream be generated by lowering the existing land tax threshold to $120,000.

Possible alternative reforms

An alternative transition mechanism away from transfer duty could be to introduce SDRT on all properties simultaneously, at a low rate, and gradually increase the rate over time. At the same time, rates of transfer duty could be reduced over time, to ensure overall revenue neutrality.

The main advantage of this transition path is that budget neutrality can be maintained in all years. There would be no need to increase government debt to fund the transition.

The disadvantage of this transition path would lie in its application to residential property. Even at a low introductory rate, the new tax would apply to home owners whose situation has not changed. That is, under this transition path, home owners who have not sold their houses would become subject to a new land tax, albeit with a low rate. This is likely to give rise to calls for exemptions, particularly for low income earners or the principal place of residence, which would undermine the efficiency of the SDRT.

If no transition away from transfer duty occurs, consideration could be given to indexing the thresholds at which marginal transfer duty rates apply. In the absence of indexation, rising property prices mean that effective rates of transfer duty increase over time. Deadweight loss measures indicate that this is a highly inefficient way for the Government to raise additional revenue.

Insurance taxes

The Financial Audit recommends:

- replacing the emergency services levy with a levy averaging $213 per rateable property, collected through local council rate collection
- eliminating insurance stamp duty and the Health Insurance Levy, replacing the revenue by lowering the payroll tax threshold to $300,000.

The combined annual NSW welfare gain of these reforms is around $600 million, and the boost to NSW GSP is 0.1 per cent.

Insurance taxes are among the State's most inefficient taxes. Combined revenue from insurance taxes is expected to be $1,526 million in 2010-11, with an average deadweight loss of 32 cents per dollar of revenue. Every extra dollar raised through an equal proportionate rate increase to all insurance taxes carries a marginal excess burden of 41 cents.

These taxes include emergency services levies, stamp duty on insurance contracts and the Health Insurance Levy, and create a disincentive for people to be either insured or insured to a proper level. The proposed arrangement ensures that all property owners share in paying for emergency services, rather than placing the burden on those who happen to buy insurance.

Emergency services levies

Emergency services levies are expected to raise $633 million in 2011-12. The excess burden is 59 per cent, or $373 million per year. Emergency service levies are paid by insurance companies and are used to fund fire and other emergency services. The economic effect of these taxes is passed on to consumers, resulting in an increase in insurance premiums and a reduction in demand for insurance.

The current effect of emergency services levies on insurance premiums is indicated by the standard mark-ups that insurance companies make. The Insurance Council of Australia (ICA) recommends that its members cover the costs of the emergency services levy by increasing premiums by the percentages set out in Table 13.1.2.

Table 13.1.2 Increase in insurance premiums recommended by ICA to cover emergency services levies

Commercial loss from fire and specific industrial risks	Contractors, excluding public liability	Home	Motor vehicle
39%	39%	21%	1%

Repealing the emergency services levy would reduce insurance prices by a corresponding amount. There are 130 general insurance businesses nationally, and competition is likely to ensure that cost reductions are passed on. A government agency, such as the NSW Department of Fair Trading, could be charged with verifying that cost reductions are passed on to consumers.

Responding to the 2009 Victorian Bushfires Royal Commission, the Victorian Government has announced it will repeal its emergency services levies and replace the revenue with a property-based tax. This will leave NSW as the only remaining state that taxes general insurance to fund emergency services. (In Tasmania, some commercial insurance policies are taxed to make a partial contribution to the funding of fire services.)

A property-based tax to fund emergency services would provide a strong link between the tax and the service provided[4]. The cost of emergency services is largely (93 per cent) related to fire services, which directly benefit property owners and their neighbours[5].

Among property-based charges, options include (a) using the existing council rates base, or (b) using the existing land tax base. Based on measures of excess burden, the council rates base is more efficient than the existing land tax. Just as important, with

4 It is sometimes argued that insurance companies should pay because they benefit from the provision of emergency services through reduced claims. While true in the short run, in the longer run insurance companies are in the business of managing risk and do not benefit from services which reduce household risks. In the limit, if there were no household risks, there would be no household market for insurance.

5 Approximately 15 per cent of fire service call-outs are related to road accidents. In principle, a fixed annual fee could be applied to each vehicle to cover these costs. But the excess burden of vehicle taxes is already high and it would be inefficient to increase them. In contrast, property levies are an efficient source of revenue, with low excess burden.

around 2.9 million rateable properties and around 150,000 current land-tax payers, the average annual payment would be $213 per rateable property versus $4,113 per land-tax payer[6]. The council rate base seems preferable.

In imposing an additional levy on properties subject to council rates, options include:

- passing the burden on to councils, leaving the councils free to distribute the burden among rate-payers in the same way as the existing council contribution to emergency services
- imposing an equal fee per rateable property or a tax at a flat rate of land value
- imposing different fees per rateable property, reflecting an assessment of the value of the property and their exposure to fire and other risks
- imposing different fees per rateable property reflecting the cost of providing emergency services.

On grounds of administrative simplicity, a flat fee or tax rate per rateable property would be preferred. On efficiency grounds, a levy that takes account of property values, costs of service and risks would be preferred, since it better matches the payment made with the benefits received, but this option would require a significant study to develop an assessment mechanism.

Insurance duty and health insurance levy

Stamp duty on insurance contracts is expected to raise $741 million in 2011-12. The Health Insurance Levy is expected to raise $152 million in 2011-12. The excess burden of these taxes is estimated to be 29 per cent, or $259 million per year.

There is no obvious alternative source of revenue for these taxes. Removing them will require some combination of either spending cuts or tax increases. Among existing taxes, two potential sources for significant revenue increases are the GST and payroll tax.

Lowering the payroll tax threshold could provide the needed additional revenue with a low deadweight loss. Payroll tax currently applies to firms with an annual wage bill exceeding $658,000. Lowering this threshold to $600,000 would bring in an additional 1,035 payroll tax payers, and would generate enough revenue ($741 million) to remove the Health Insurance Levy. Lowering the threshold to $350,000 would bring in an extra 13,000 businesses, and would generate enough revenue to remove insurance duty. Lowering the threshold to $300,000 would bring in an extra 16,350 businesses, and would generate enough revenue to replace both taxes.

Amending the GST would require agreement between all Australian governments. NSW expects to receive $15,761 million in GST revenue in 2011-12. To increase this revenue by $893 million would imply a GST rate increase from 10 per cent to

6 Alternatively, the emergency services levy could be replaced by lowering the land tax threshold and applying the existing rate of 1.6 per cent. A land tax threshold of $250,000 would bring in about 150,000 new land-tax payers, who would pay land tax averaging about $4,000 each.

10.6 per cent[7]. Lowering the payroll tax threshold has a marginal excess burden of -8 per cent, while an increase in the GST has a marginal excess burden of +8 per cent. Overall, it is preferable to replace insurance duty by lowering the payroll tax threshold, rather than increasing the GST rate.

Payroll tax

The Financial Audit recommends:

- lowering the payroll tax threshold
- abolishing indexation of the threshold.

The annual welfare gain from lowering the threshold to $330,000 (and using the extra revenue to cut less efficient taxes) is $236 million.

Payroll tax is expected to raise $6,855 million in 2011-12. It is the largest single source of NSW tax revenue. Payroll tax is paid by businesses at a rate of 5.45 per cent of their payroll (i.e. wages bill), above a threshold of $658,000 (equivalent to around 10 staff on average wages). The payroll tax threshold is indexed annually in line with the movement in the Sydney consumer price index (CPI).

Increasing the payroll tax rate would be inefficient, but lowering the tax threshold would improve efficiency. The average excess burden of the tax is 20 per cent, giving a total excess burden of $1,371 million. Increasing the tax rate marginally would increase the excess burden by 35 per cent of any extra revenue generated. But lowering the tax threshold marginally would reduce the excess burden by 8 per cent of any extra revenue generated. If the threshold were eliminated entirely, the average excess burden of the additional revenue would be 5 per cent of the additional revenue – one of the lowest-cost sources of additional revenue available.

There are four main options for improving the efficiency of the payroll tax:

- reduce the threshold
- replace the tax with increased GST revenue
- replace the tax with a state income tax supplement
- replace the tax with a new business cashflow tax.

In the short term, the best option for improving the efficiency of the payroll tax is to lower the threshold. Indexation of the payroll tax threshold should be abolished. In the longer term, a business cashflow tax warrants further investigation.

Reducing the payroll tax threshold

Cutting the threshold to $330,000 (half its current level) would raise an additional $818 million in 2011-12, and would reduce the excess burden of payroll tax by around $23 million per annum. The additional revenue could be used to reduce less efficient

[7] Alternatively, removing GST exemptions would generate significant revenue, of which NSW would receive around 30 per cent. The food exemption is estimated to cost $6.1 billion nationally in 2011-12, implying forgone NSW revenue of $1.83 billion.

taxes. Assuming these other taxes have an average excess burden of 26 per cent, the total welfare gain would be $236 million.

Abolishing indexation of the payroll tax threshold could provide a gradual transition to a lower real value of the threshold, as inflation increases firms' wage bills beyond the fixed threshold. Abandoning indexation in 2011-12 (i.e. preserving the 2010-11 threshold of $658,000) would, assuming forecast inflation rates, generate an extra $32 million in 2011-12, $58 million in 2012-13 and $83 million in 2013-14, compared with current forecasts. The cost of a gradual transition is a delay in potential economic gains.

Replacing payroll tax with increased GST revenue

Abolition of payroll tax could be funded in NSW if the GST rate was increased to 15 per cent[8]. This reform would reduce the excess burden of NSW revenue by $811 million in 2011-12.

Alternatively, it would be possible to remove existing exemptions from the GST, such as those for food, health and education purchases. Based on current rules for distribution of the GST revenues, this would provide an additional $4.8 billion for NSW.

To fund the abolition of payroll tax, the GST rate would need to be raised to 11.3 per cent, in addition to the removal of exemptions. Removing GST exemptions would have the added benefit of lowering the excess burden of the GST, so the total efficiency gain would be greater than $811 million.

However, the cooperation of all Australian governments is needed to reform the GST. Further, increased reliance on the GST would reduce NSW's ability to determine its own revenue level and to respond to changing priorities.

Replacing payroll tax with a state income tax supplement

The Henry Review proposed a possible option for states to share the personal income tax base, with the freedom to set a flat rate of tax on income above the tax-free threshold.

If a state income tax supplement were to increase the total rate of personal income tax, the revenue switch from payroll tax would actually be less efficient than the status quo. The marginal excess burden of personal income tax is 24 per cent, while the average excess burden of the payroll tax is 20 per cent.

The Henry Review contemplated the possibility of lowering the Commonwealth's personal income tax rates, to accommodate a state surcharge. But the Henry Review linked this to an equivalent reduction in state grants, which would not help states planning to cut existing revenue sources. If instead the Commonwealth replaced its lost revenue with any other of its own taxes, the overall effect of the changes would depend on whether the marginal excess burden of the replacement revenue source was greater or less than 20 per cent, which is the average excess burden of payroll tax.

---

8 Estimated NSW revenue from the GST is $14,140 million in 2011-12, and payroll tax is $6,329 million; so the GST rate would need to increase to 14.5 per cent to fund repeal of payroll tax. This ignores any revenue that needs to be diverted to increased transfer payments to compensate for transitional effects.

More efficient Commonwealth options could include increases in the GST, petrol excise, or the Minerals Resource Rent Tax (MRRT).

Overall, a state income tax is not a suitable replacement for payroll tax revenue, except as part of a larger reform of Commonwealth-State financial relations.

Replacing payroll tax with a new business cashflow tax

The Henry Review proposed that payroll tax be replaced by a business cashflow tax. A business cashflow tax is likely to have an excess burden that is roughly the same as the GST, or perhaps a little lower. So a revenue swap from payroll tax to a business cashflow tax would lower the excess burden of NSW taxes by over $800 million.

A business cashflow tax has potentially low compliance costs. A firm's cost of complying with payroll tax is estimated to average $3,000 per year, with the ratio between costs and payroll size greater for smaller firms[9]. Lower compliance costs could encourage support from existing payroll tax paying businesses. In addition, high compliance costs for small firms dictate a relatively high tax-free threshold for payroll tax. This threshold could be lower for a cashflow tax.

It is unclear whether a business cashflow tax could be implemented by a state acting unilaterally. Constitutionally, there should be few difficulties: a business cashflow tax could be drafted in the form of an income tax. In practice, a nationally consistent approach may be necessary to give credit for interstate purchases by firms, and to deal with firms which operate across state borders. It would be possible to implement a national scheme without the involvement of the Commonwealth, through an intergovernmental agreement involving all the states and territories.

Overall, the business cashflow tax is an appealing concept, which warrants further investigation.

Land tax

The Financial Audit recommends gradually changing the State's existing land tax so that it applies at a single flat rate to all land, other than the principal place of residence, with no tax-free threshold.

The revised land tax would apply in addition to the proposed Stamp Duty Replacement Tax.

This reform would yield an annual welfare gain of $149 million, once fully implemented.

By broadening the tax base, land tax would become a more useful tool in managing the State's economy, since small changes in land tax rates could have larger effects on tax revenue.

[9] QCCI (1996), 'Regulatory Compliance Costs and Other Burdens, A Survey Report', Queensland Chamber of Commerce and Industry, estimated that Queensland firms spent an average of 43 hours annually complying with payroll tax requirements. Average annual compliance costs increased with firm size, but the time spent declined for firms employing more than 100 employees. The hourly wage rate of $72.50 is drawn from Allen Consulting Group (2009), 'A harmonised payroll tax system for NSW and Victoria, Estimated change in the administrative burden', a report prepared for the Victorian Competition and Efficiency Commission.

Land tax is expected to raise $2.5 billion in 2011-12. It has an estimated excess burden of 6 per cent of the revenue raised, or $149 million per year. It applies to a small tax base, with only around 150,000 land taxpayers in the State. Key elements of the current tax are as follows:

- it does not apply to land used as a principal place of residence, or to farmland
- investment and business holdings of residential land are exempt unless the taxpayer has an aggregate landholding of more than $387,000
- aggregate landholdings above the tax-free threshold are taxed at 1.6 per cent of the site value of the land, which includes the value of services such as sewerage, but does not include buildings on the land
- a second threshold applies at $2,366,000, above which aggregate landholdings are taxed at a rate of 2.0 per cent of site value
- the land tax thresholds are indexed annually to movements in state-wide average land values.

The main defect of the current land tax is its narrow base, which precludes its use as a source of significant additional revenue even though it is a relatively efficient revenue source. To raise an additional $150 million of total revenue from the existing tax base of 150,000 taxpayers, the average land-tax payer would need to pay an additional $1,000 per year, on top of the current average annual land tax bill of around $16,000 per year.

Lowering the tax-free threshold would improve welfare. The marginal excess burden associated with the extra revenue from a slightly lower threshold is -8 per cent (a negative number indicates a welfare improvement). Entirely removing the tax-free threshold would generate $1.69 billion of extra revenue, for zero change in excess burden compared with the current tax.

A well-designed land tax could provide tax revenue with zero excess burden. The current excess burden of 6 per cent arises for two main reasons:

- The tax can be avoided by changing the use of a particular property to a principal place of residence. It thus discourages the provision of rental accommodation.
- The application of land tax to aggregate holdings of taxpayers, rather than individual properties, discourages institutional investors (e.g. superannuation funds) who might otherwise invest in rental accommodation. Small investors can avoid the tax by owning single low-value rental properties that are beneath the threshold. If an institution owned multiple properties of the same value, its aggregate holdings would be subject to the land tax. Encouraging institutional investment in rental properties could be one element of a strategy aimed at increasing housing supply.

The proposed direction for reform is to move towards a single flat tax on all investment and business properties. The issue of taxing the principal place of residence could be addressed through the proposed Stamp Duty Replacement Tax and need not be addressed through reform of the current land tax. The narrowness of the base could be addressed by applying land tax to all other properties (i.e. removing the tax-free threshold). And if all properties are subject to a single flat rate of tax, it becomes irrelevant whether the tax base is aggregate holdings or individual properties.

Revenue-neutral land tax reform, applying a single flat rate to all investment and business land, would involve a revised land tax rate of 1.1 per cent. It would increase the number of land taxpayers by around 386,000.

While the desired direction is clear, there is no easy transition path. Expanding the tax base means that some people who currently do not pay land tax would pay land tax for the first time[10]. If immediate reform is judged not to be feasible, two options for gradual reform are:

- Bottom-up reform. A first step could be a tax rate of 0.2 per cent applied to aggregate land-holdings less than $387,000 (i.e. new land-tax payers would pay a maximum of $774 per year). This would generate additional revenue of $140 million, which would permit the top marginal rate of land tax to be reduced to 1.72 per cent. Subsequent incremental reforms could be adopted to achieve a uniform tax rate for all investment and business land.
- Top-down reform. Removing indexation of the land tax thresholds would result in a gradual expansion of the tax net to include properties that are currently exempt. Additional revenue generated by this 'bracket creep' could be used to reduce the 2 per cent tax rate that applies to properties above the upper threshold. Compared with current forecasts, removing indexation in 2011 is estimated to generate additional revenue of $24 million in the 2012 land tax year, $60 million in 2013 and $91 million in 2014. This could be used to reduce the top rate to 1.96 per cent, 1.89 per cent and 1.84 per cent in successive years. With average inflation of 2.5 per cent, the top tax rate could be eliminated by 2019.

Motor vehicle taxes

The Financial Audit recommends introducing a state-wide system of road pricing, which will be used to remove weight tax and stamp duty on vehicle transfers.

The annual welfare gain from abolishing vehicle taxes would be $662 million. Raising revenue through efficient road pricing would reduce the welfare costs of congestion and road damage by up to $5 billion per year.

Removing existing vehicle taxes would require around $2.5 billion of revenue, which could be achieved with a state-wide road network pricing scheme. A combination of a state-wide base road user charge, applying per kilometre, and a Sydney congestion charge which varies by time of day and location, could be used to ensure roughly equivalent impacts on rural and urban households.

[10] In 2005, NSW removed the tax-free threshold and lowered the tax rate for existing land-tax payers. A rate of 0.4 per cent was applied to properties valued at less than $400,000. A rate of 0.6 per cent applied above $400,000, and a rate of 1.4 per cent applied above $500,000. The number of land-tax payers increased from 147,364 in 2004 to 533,850 in 2005. The tax-free threshold in 2004 was $317,000, so the maximum tax payable by a property owner who had previously paid no tax was $1,268 per year. The reform was reversed in 2006.

A possible first step in this direction is consistent tolling across all the Sydney Orbital Network, including pricing that varies by time of day. Applying current average tolls to the untolled portion of the network and removing the M5 Cashback Scheme, might generate around $780 million annually.

Replacing existing heavy vehicle registration charges with a nationally equivalent road usage price per kilometre could generate an additional $100 million for the State, from interstate trucks that use NSW roads. The NSW Transport Department estimates that prices covering the full marginal cost imposed by heavy vehicles could raise around $1 billion for NSW. NSW should consider means of accelerating Council of Australian Governments (COAG) planning for heavy vehicle road pricing, including unilateral implementation.

Administrative costs of road pricing schemes will be a key determinant of their success, and should be investigated closely. If administration costs are high, it would be efficient to use congestion pricing to increase the overall revenue from vehicles.

Motor vehicle taxes include annual weight tax and vehicle registration charges and stamp duty payable when ownership is transferred on new or second-hand cars. They are expected to deliver $2,503 million of revenue in 2011-12. The average excess burden of these taxes is estimated at 26 per cent of the revenue, or $662 million.

The Henry Review recommended that road pricing should be used to replace vehicle taxes.

Administrative costs

Administrative costs could be in the range of 10 to 25 per cent of plausible revenue from road pricing schemes. The level of these costs, relative to revenue generated, will affect the overall efficiency of any road pricing scheme, and have a significant financial impact on road users.

The presence of significant administrative costs means that a scheme that is revenue-neutral (i.e. raises around $2 billion of revenue from light vehicles) would impose greater direct financial costs on light vehicle users. In effect, the hidden efficiency costs of vehicle taxes (average excess burden of around 25 per cent of revenue raised), would be replaced by direct administrative costs. Provided the administrative costs are less than the excess burden of vehicle taxes, such a scheme would improve efficiency. Further, a congestion charge should help to reduce congestion. However the direct financial implications for a majority of households may impede public acceptance.

The implications of high administrative costs include that:

- the administrative costs of a network pricing scheme are likely to be a key determinant of its public acceptance, and will therefore require extensive study
- it may be desirable to increase revenue from road pricing beyond current vehicle taxation, in order to reduce administrative costs as a proportion of the revenue; the additional revenue could be returned to households in the form of alternative tax cuts or as particular expenditure, such as improved roads or public transport.

Network pricing

A combination of a base price per kilometre, applying state-wide, and a variable time-of-day congestion price, applying only in Sydney, would help to share the benefits of abolishing existing vehicle taxes between rural and urban NSW.

Current light vehicle taxes could be replaced with a state-wide road price of around 4 cents per kilometre. Urban households would be favoured relative to rural households, since rural households drive further on average.

Efficient congestion pricing that covers the full costs of congestion and varies by time of day and location could raise up to $5 billion in gross revenue. Netting out existing vehicle taxes and administration costs, this would increase state revenue by $2 billion. Relying solely on congestion pricing to replace current vehicle taxes would favour rural NSW.

Table 13.1.3 sets out hypothetical Sydney congestion prices that could operate in conjunction with a state-wide light vehicle base price of 2.5 cents per kilometre. Assuming administrative costs of 10 per cent of gross revenue, this scheme would raise around $2 billion of light vehicle net revenue. Table 13.1.4 sets out estimates of regional household income effects if current vehicle taxes are replaced by the hypothetical scheme.

Table 13.1.3 Hypothetical Sydney congestion prices (cents/km)

	Weekday	Weekend
AM peak	3.83	0
Inter peak	2.65	1.15
PM peak	3.46	1.15
Night-time	0	0

Table 13.1.4 Average annual household costs under hypothetical road pricing scheme

	Current taxes ($)	Base charge per km ($)	Congestion charge ($)	Net increase ($)
Inner Sydney	408	334	172	97
Eastern Suburbs	554	388	305	138
St George-Sutherland	726	496	407	177
Canterbury-Bankstown	617	359	287	30
Fairfield-Liverpool	753	597	515	360
Outer South West Sydney	807	770	699	662
Inner West Sydney	623	369	285	31
Central Western Sydney	834	793	706	665
Outer Western Sydney	834	793	706	665

	Current taxes ($)	Base charge per km ($)	Congestion charge ($)	Net increase ($)
Blacktown	684	614	517	447
Lower Northern Sydney	623	413	305	95
Central Northern Sydney	839	584	544	289
Northern Beaches	716	447	375	106
Gosford-Wyong	737	773	-	36
Newcastle	759	635	-	-124
Wollongong	734	672	-	-62
Nowra-Bomaderry	718	461	-	-257
Illawarra balance	846	1,090	-	244

Note: The hypothetical road pricing scheme consists of a state-wide road price of 2.5 cents per kilometre and Sydney congestion prices as set out in Table 13.1.3. Net increase in household costs reflects the replacement of vehicle taxes by the road pricing scheme.

Cordon pricing

Cordon pricing is one of the best known examples of pricing to address congestion, following London's example. A $10 charge to drive into 13 major Sydney centres could generate around $1,600 million per year, including $309 million from the airport area, $277 million from Sydney CBD and $175 million from St Leonards/Crows Nest. However Sydney's congestion is highly decentralised and cordon pricing may exacerbate congestion in areas just outside the cordons. Overall, cordon pricing is unlikely to be the optimal response to congestion in Sydney.

Corridor pricing

Consistent tolling, with pricing that varies by time of day, along the Sydney Orbital network could be a useful place to begin in gaining public acceptance of efficient road pricing.

Sydney's congestion tends to be concentrated along corridors, rather than in particular commercial centres. Variable tolling of the Sydney Orbital network, on a consistent basis by time of day, has a potentially valuable contribution to be made in terms of spreading road use across time. However it would fall short as a means of replacing existing vehicle tax revenue. Extending the average toll rates on the Sydney orbital network to the currently untolled sections could generate around $700 million annually. Removing the M5 Cashback Scheme could provide a further $76 million in savings in 2011-12. These revenues and savings could be used to reduce vehicle taxes and/or increase spending on transport or other services.

To move beyond the pricing of motorways, corridor pricing would need to take on the attributes of network pricing. For example, setting a price to deal with congestion on Parramatta Road would be likely to increase congestion on neighbouring roads.

Heavy vehicle road pricing

The State could benefit financially from a transition to road pricing for heavy vehicles, because of the large proportion of trucks that are registered out of state but use NSW roads.

All states and territories currently implement nationally agreed uniform registration charges for heavy vehicles. NSW revenue from heavy vehicle charges is approximately $166 million. Keeping the same national level of revenue and moving to a system of heavy vehicle road pricing, under which the revenue flows to the states where vehicles are used rather than where they are registered, NSW revenue would increase to $263 million. The increase in NSW revenue would arise from trucks registered in other states that drive on NSW roads.

The NSW Department of Transport considers that heavy vehicle charges do not cover the full marginal cost of road damage caused by heavy vehicles. The department estimates that replacing the existing fuel excise and registration charges with efficient heavy vehicle road pricing could raise over $1 billion per year for NSW.

Royalties

The Financial Audit recommends that new mining projects be given a choice between being charged under a NSW resource rent tax or under the existing royalty system.

An efficient rent tax that applied to a third of NSW mining output, and that doubled tax revenue as a proportion of profit, could generate $600 million extra revenue and yield a welfare gain in the order of $176 million per year. This extra revenue is as compared with the existing royalty system.

A tax that is applied only to new mines could apply to around a third of the value of NSW mining output within ten years, and half the value of output within 20 years, reflecting historic rates of mine closures and openings.

NSW royalties are expected to be $1,809 million in 2011-12. The excess burden of royalties depends on the prevailing price for mineral products. The economic impact of royalties is greatest when prices are low. Royalties can provide an incentive for mines to be shut down early. This effect will remain under the Commonwealth's proposed Minerals Resource Rent Tax, so there remains potential benefit in reforming NSW royalties.

A well-designed resource rent tax that is applied only to new projects would increase rates of return for those projects, relative to those obtained under royalties, while at the same time generating more money for the Government. It would also increase mining output and employment.

Mining companies could be given the choice between royalties or an increased resource rent tax for any new project, including coal projects. Economic analysis suggests that with good design, most companies developing new mines will choose the resource rent tax. As new projects progress, this approach would provide a growing contribution to NSW revenue. It would provide a gradual transition to a more efficient tax system, in a way that need not cause confrontation with the mining industry.

Key to understanding this proposal, in the context of recent opposition to the Commonwealth's proposal for a Resource Super Profits Tax (RSPT), and its successor the Minerals Resource Rent Tax, is that these taxes apply to both new and existing projects. While the RSPT would have increased rates of return on new projects, it would also have reduced rates of return on existing projects. The reduced profits that firms expected on existing projects outweighed the present value of increased profits on new projects, resulting in mining company opposition.

By limiting the NSW proposal to new projects, and by providing mining companies with a choice of tax regime, there is an opportunity for both the Government and the mining companies to win.

Goods and services tax

The Financial Audit recommends removing GST exemptions for food, education and health products to generate up to $4.8 billion per annum for NSW. In turn, the potential welfare gain in NSW would be around $1.3 billion per annum.

The Audit also recommends launching a process for constitutional reform to remove the prohibition on states levying excise taxes.

While the GST cannot be directly controlled by the State Government, no treatment of fundamental tax reform should ignore it. It is one of the most efficient taxes in Australia, with an average excess burden of 6 per cent, which is associated with national revenue of $46.2 billion in 2010-11. The revenue from the GST is distributed to states and territories without restrictions on its use.

Additional revenue could be generated with low efficiency cost, either by raising the GST rate above 10 per cent, or by removing exemptions from the GST. In choosing between these two options, it would be more efficient to remove exemptions from the GST. Removing food, health and education exemptions would generate approximately $13 billion of extra revenue nationally[11], which, based on the current distribution of GST revenue, would imply an extra $4.8 billion per annum for NSW.

Removal of GST exemptions, particularly the food exemption, presents a possible conflict between efficiency and equity objectives. Removal of exemptions would reduce the national deadweight loss of the GST by around $2.7 billion per annum. It would reduce the compliance costs for small businesses which must distinguish between goods that are subject to the GST and goods that are not. At the same time, it would raise the relative price of goods, including food, which represent a greater proportion of the income of the poorest in the community. This equity objection could be addressed through an increase in transfer payments to people on low incomes, although this would reduce the revenue available for distribution to states and territories.

---

[11] Commonwealth 2009 Tax Expenditures statement, forecast for 2011-12, estimates the cost to revenue of GST exemptions as: food: $6,100 million; education: $2,950 million; and health: $4,060 million (including health services, private health insurance, drugs, medical aids and residential care).

The GST has been implemented as a Commonwealth tax, with the money transferred to states, in order to avoid a constitutional prohibition on states levying excise taxes. The High Court broadened its interpretation of excise in 1997, resulting in the abolition of state taxes on tobacco, alcohol and fuel. It is not impossible that the High Court could broaden its interpretation again, to include additional state taxes. While tax reform is on the national agenda, COAG could consider constitutional reform (requiring a referendum), to provide states with the constitutional power to levy excises.

State income tax

The Financial Audit recommends increasing states' taxing autonomy by permitting them to set their own personal income tax supplement, as a flat rate of up to 5 percentage points.

The Commonwealth could reduce its rates of personal income tax by 3 percentage points, and offset its own revenue loss by reducing state grants by a corresponding amount. To ensure total income tax rates remain unchanged, the starting rate of state personal income tax supplements should be 3 percentage points.

For NSW the combined effect of these reforms would be revenue neutral, with a reduction in Commonwealth grants totalling $6 billion, and a new revenue stream of $6 billion from the state personal income tax[12].

The Henry Review proposed that a state personal income tax supplement could be used to reduce vertical fiscal imbalance. States would have the freedom to vary the income tax rate, within a narrow band. The Commonwealth would reduce its income tax rates[13] and offset its revenue loss by reducing grants to states. The revenue switch would not change the excess burden of the Australian tax system, but it would improve state revenue autonomy[14].

The details of the scheme would need to be worked out in concert with the Commonwealth and other Australian governments. The Commonwealth could reduce its personal income tax rates by, for example, 3 percentage points for all income levels, and the states would be given the freedom to set a state income tax surcharge of up to, for example, 5 percentage points. The state surcharge should be a flat rate, leaving the Commonwealth in control of the progressivity of the total tax and transfer system.

A possible concern with a state income tax surcharge is inter-jurisdictional competition, which could create pressures for states to set a zero income tax surcharge. The Commonwealth provided legislatively for the states to set an income tax surcharge in

[12] Personal income tax revenue is expected to be around $150 billion in 2011-12. The average personal income tax rate, for those above the tax-free threshold, may be around 25 per cent. Accordingly, a rate of 5 percentage points could correspond to 20 per cent of personal income tax revenue, or $30 billion. Assuming NSW generates a third of this revenue, a 5 percentage point tax supplement could generate $10 billion for NSW; a 3 percentage point tax could generate $6 billion.

[13] It would not improve the efficiency of the tax system to apply a state income tax supplement on top of the existing Commonwealth personal income tax rates. The marginal excess burden of the existing personal income tax is 24 per cent, which is close to the average excess burden of state taxes.

[14] There is no constitutional prohibition on a state income tax, and the states levied income taxes until 1942. The Commonwealth has the constitutional power to levy income tax (under the taxation power), and introduced an income tax in 1915. The two levels of income tax co-existed for several decades, and joint Commonwealth and state income tax returns were introduced in 1936. During World War II, the Commonwealth increased its income tax rates significantly, and made it a condition for the receipt of Commonwealth grants that states should not levy income tax. Accordingly, the states abandoned their income taxes in 1942.

1976, but no state took advantage of it and the legislation was repealed in 1989. The Henry Review notes that when introduced in 1976, the Commonwealth did not lower its income tax rates to accommodate a state surcharge.

13.2 Prioritising tax reform

The first priority of any tax reform is that the resulting tax revenue meets the Government's revenue needs. While nobody likes paying taxes, government services need to be funded.

Other economic criteria include improving the efficiency of the tax system, ensuring revenue sources that will grow with the State's economy, maintaining State Government control of revenue and the reform process, reducing the volatility of revenue sources and equity considerations.

Suggested criteria for assessing and prioritising tax reform are set out below.

Efficiency

Taxation imposes a deadweight loss (see Box 1) on the economy, over and above the tax revenue which is taken from taxpayers and which is returned to taxpayers through government spending. Reducing this deadweight loss is one of the most important objectives of tax reform.

Deadweight loss measures provide a blueprint for desirable tax reform (see Table 13.1.1). Fundamental tax reform, involving the abolition of taxes or major increases in revenue, can be prioritised having regard to measures of average deadweight loss. Changes to tax rates to achieve relatively minor changes in total revenue can be prioritised having regard to marginal deadweight loss measures.

The marginal deadweight loss is the economic cost associated with raising an additional dollar of revenue. If the additional revenue is used for new spending, the marginal deadweight loss sets a threshold rate of return that the new spending should desirably achieve. For example, if additional spending is funded by an increase in the payroll tax rate, that spending should generate a social rate of return of 35 per cent.

Revenue-neutral tax reform could reduce the deadweight loss of taxation – at the same time as maintaining current spending – by lowering inefficient taxes and increasing efficient taxes. Tax increases should be focused on the taxes with low deadweight loss. Tax cuts should be focused on the least efficient taxes.

See additional discussion of efficiency below as well.

Adequate and growing revenue

NSW has growing demand for services. Any reforms that abolish or reduce revenue sources must be accompanied by new measures that provide at least as much replacement revenue. Revenue sources should desirably grow with the economy. Thus, for example, an increasing concern with Commonwealth taxation is that fuel taxes may decline as a revenue source as measures are implemented to reduce carbon emissions.

State control

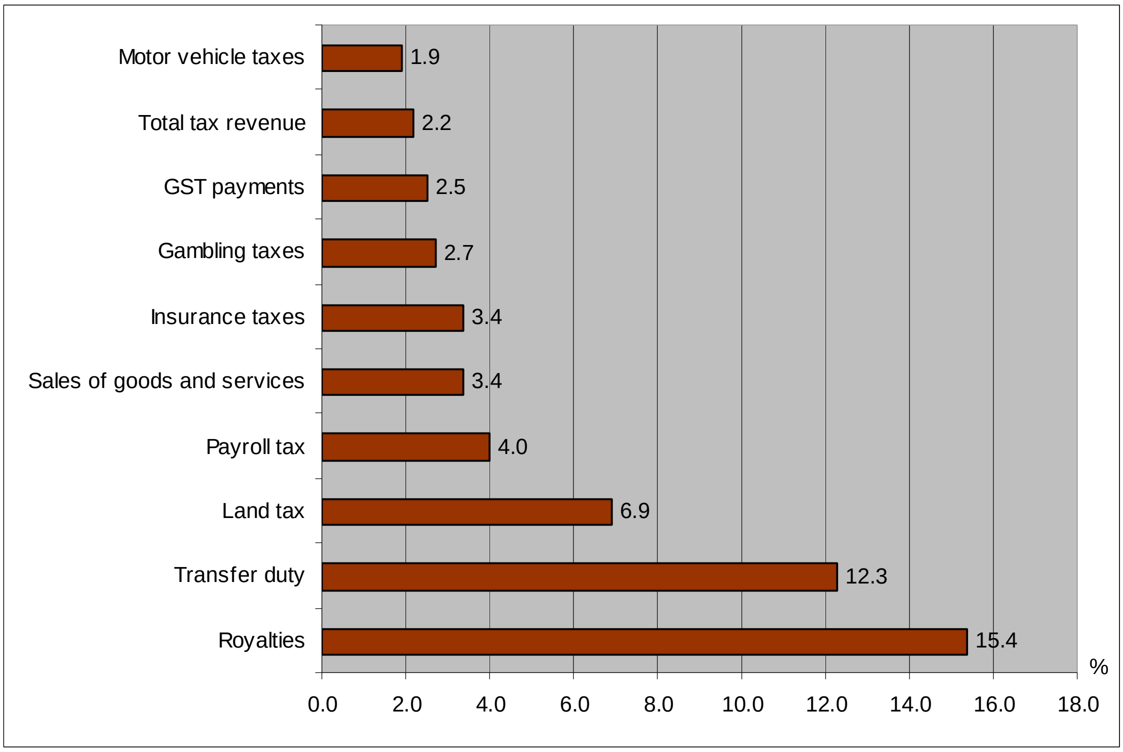
NSW needs control over several major taxes to maintain flexibility to adapt to changing priorities. On this criterion, state taxes are preferable to Commonwealth grants. The Commonwealth's decision (since reversed) in 2010 to reserve around 30 per cent of GST revenue, and to take control of elements of health spending, underscores the inherent risks of relying on Commonwealth grants. The need for revenue flexibility also underpins the reforms over recent years to harmonise payroll tax definitions and processes across states, while permitting different payroll tax rates.

An additional reform criterion is whether NSW can take sole control of the reform process. Reforms involving the GST fail this test, since they would require amendment of the existing Inter-Governmental Agreement.

Volatility

Revenue volatility makes it difficult to plan state budgets. NSW would benefit from reforms that reduce revenue volatility. As seen in Figure 13.2.1, transfer duty and royalties are the most significant sources of volatility in NSW revenues. Total tax revenue is less volatile than the average volatility of individual taxes, since at times individual taxes vary in opposite directions.

Figure 13.2.1 Revenue deviation from trend, 2000-01 to 2010-11



Source: Treasury calculations of the mean absolute deviation from revenue logarithmic trends, as a proportion of the revenue.

Note: Some variation is due to policy changes. Adjusting revenue for major policy changes, the deviation from trend is 13.9 per cent for royalties, 11.0 per cent for transfer duty and 2.3 per cent for payroll tax.

Equity and distribution of income

NSW revenue measures should aim at horizontal equity – the concept that taxpayers with similar characteristics should be treated equally.

Vertical equity – the difference between rich and poor – should not be a significant reform criterion for state taxes. Vertical equity considerations should be the concern of the Commonwealth Government. The Commonwealth can take account of the interaction of all taxes, and can achieve progressive outcomes through the personal income tax and the social security and transfer system. As *The Economist* has noted, 'It is the system as a whole that needs to be progressive, not every single tax'[15].

NSW property taxes have a progressive scale. Higher value property transactions are subject to higher rates of stamp duty, and larger landholdings held by investors are subject to higher rates of land tax.

It cannot be assumed that people who buy expensive property invariably have high incomes, or that people who buy less expensive property have lower incomes. It follows that property taxes perform poorly as an instrument for redistributing income. Nevertheless, given the existing progressive rate structure of NSW property taxes, any reforms to these taxes would need to take account of their distributional effects.

Compensation

Effective tax reform should yield a net social benefit. Part of this social benefit could be used to provide compensation for those adversely affected by tax changes.

Where possible, classes of taxpayer who are adversely affected by proposed reforms could be compensated, either through reductions in other taxes or through additional government services.

Focusing on efficiency

Arguably the most important priority in tax reform is the efficiency of the resulting tax system.

Table 13.2.1 summarises the annual welfare gains from a set of possible tax reforms and, where available, provides additional information about effects on GDP and employment, within NSW and nationally. Estimates of Australian benefits assume all states implement the same reforms as NSW. The largest welfare gain is from a national tax reform package.

Table 13.2.1 Effect of possible tax reforms

	Australian employment (% increase)	Australian GDP (% increase)	Australian welfare gain ($m)	NSW employment (% increase)	NSW GSP (% increase)	**NSW welfare gain ($m)**
1. National package	0.1	1.8	12,000	0.1	1.8	**4,000**
2. Unilateral NSW package				0.3	1.4	**2,900**
3. Replace transfer duty with efficient land tax	0.2	1.3	8,000	0.2	1.2	**2,300**

15 The Economist, 11 November 2010.

	Australian employment (% increase)	Australian GDP (% increase)	Australian welfare gain ($m)	NSW employment (% increase)	NSW GSP (% increase)	**NSW welfare gain ($m)**
4. Replace insurance duties by lowering payroll tax threshold	0.0	0.0	1,000	0.0	0.0	**400**
5. Replace emergency services levy with levy on council rates	0.0	0.0	400	0.1	0.1	**200**
6. Replace current land tax with an efficient land tax	0.0	0.0	200	0.0	0.0	**100**
7. Halve payroll tax threshold[16]	-0.2	-0.2	700	-0.2	-0.3	**240**
8. Replace vehicle taxes with Sydney congestion price[17]						**720**
9. Introduce an efficient resource rent tax for new NSW mines[18]						**180**

Source: Econtech 2011 and Treasury calculations for reforms 8 and 9.

There are two broad approaches that can be taken in respect to tax reform. The first is a national, multilateral approach which seeks the support and cooperation of the Commonwealth and other states and territories. The second is a unilateral approach in which NSW undertakes tax reform alone.

The benefits of a national approach are two-fold:

- enabling the consideration of a broader range of tax reform options than can be considered in a unilateral approach
- providing some level of political protection by being joined with other governments in a common reform initiative.

The disadvantage is the difficulty of achieving a consensus and acting on it.

Managing the tax reform process

Reform is potentially easier to implement if those who lose directly from a tax reform can be compensated with alternative tax cuts or spending measures. Gradual transitions may also be more readily accepted, although they run the risk that reform may peter out prior to completion. The process by which reform is implemented may also affect its prospects of public acceptance.

Examples of recent tax reform suggest two elements for success. First, the substance of the proposed package typically involves a level of compensation for those who are

16 Lowering the NSW payroll tax threshold to $330,000 would generate $818 million in extra revenue for NSW and reduce the excess burden of the payroll tax by $23 million. The extra revenue can be used to reduce other NSW taxes, with average excess burden of 26 per cent (i.e. $213 million welfare gain).

17 Welfare gain measures the excess burden of vehicle taxes, which would be repealed. An efficient congestion price would provide additional social benefits, through reduced congestion.

18 Welfare gain assumes a resource rent tax applying only to new mines that raises $600 million per year in extra revenue compared to the potential revenue from current royalties. The resource rent tax avoids the 5 per cent excess burden of coal royalties, and the additional $600 million revenue can be used to reduce inefficient state taxes, which feature an average excess burden of 26 per cent.

adversely affected. Second, a structured process is used to build public acceptance of the changes, and to refine proposals in light of key points of opposition before the proposal is adopted by the Government.

Some recent examples of tax reform, which has achieved varying degrees of success or failure, include the following:

- **CGT and FBT.** The introduction of capital gains tax and fringe benefits tax at the Commonwealth level, combined with income tax rate cuts. This followed a period of managed public debate and the 1985 Tax Summit. The Cabinet had not decided to support Option C, a goods and services tax, until relatively close to the summit. This left little time to muster public support and address public concerns, and the option was dropped during the summit.
- **The GST.** The introduction of the GST package in 2000, which included income tax rate cuts and abolition of various state taxes. The process of detailed design of the final package included an election fought over the principle of the GST, a year of detailed design work by Commonwealth Treasury and negotiations over those details in the Senate, resulting in exemptions for food.
- **Land tax in NSW.** In the April 2004 Mini-Budget, the NSW Government removed the land tax threshold and lowered the rate. These changes were unwound in the July 2005 Budget following opposition from small investors. The base broadening improved economic efficiency, but it brought about 300,000 new taxpayers into the tax net without offering any direct compensation. There was no consultation process to prepare ground for the changes.
- **Resource rent tax.** In May 2010, the Commonwealth announced it would impose a 40 per cent resource rent tax on all mining profits, including profits generated from past investments. In July 2010, following opposition from mining companies, the proposed tax was wound back to apply only to iron ore and coal, at a rate of 22.5 per cent, and with additional concessions which undermined the efficiency of the tax. The initial announcement took large amounts of profit from existing operations with little by way of compensation and was made without prior consultation on the specific proposal.

If a major set of tax reforms is considered to have merit, it is suggested that the Government follows a traditional reform process. A Green Paper could be used to canvass options, without setting out the Government's position. Following public discussion and consultation, a White Paper could be used to set out the Government's proposed position, but leaving technical details for further discussion. Finally, draft legislation could be introduced which permits consultation on the specific proposals before introduction into Parliament. This period of consultation can help avoid embarrassment in re-drafting legislation within the Parliament (or worse, enacting poorly drafted legislation). The quality of policy announcements and legislation can be improved when an opportunity is given for public comment.

The recommendations in the chapter set out two main reform packages, which could be pursued either with the Commonwealth or unilaterally.

Getting rid of inefficient taxes would require alternative revenue streams or spending cuts. Where the recommendations propose replacement revenue, alternative options could be considered from the list of possible and efficient sources in Table 13.2.2.

Table 13.2.2 Potential efficient sources of significant additional NSW revenue

	$ million
Remove exemptions from the GST	4,800
Increase the GST rate to 12.5%	3,900
Remove the land tax tax-free threshold	1,690
Lower the threshold at which the payroll tax applies to $330,000.	818
Impose consistent tolling on Sydney Orbital Network	760
Remove tax concessions for clubs	665
Impose a property levy on top of council rates, averaging $210 per rateable property (business and residential)	580

13.3 User charges

General government sales of goods and services are expected to generate $4.7 billion of revenue in 2011-12, including regulatory fees, non-regulatory charges and charging for competitively neutral services. Per capita, NSW raises less from user charges than other jurisdictions. On the face of it, this suggests there is scope for increasing revenue from user charges.

Public transport fares do not appear in the Government's accounts as revenue from sales of goods and services. They are subsidised in recognition of the public benefits they provide. Accordingly, increases in public transport fares would reduce expenditures on subsidies, rather than appearing in the Budget as additional government revenue. The net effect on the fiscal balance is the same, and consideration of user charges should embrace the role of public transport fares in managing demand, and sending price signals for improved transport supply.

For revenue-generating user charges, decisions about which goods or services to charge and the appropriate costing and pricing approach to apply, are often made within general government departments under administrative authority. This has resulted in great variability across agencies in their setting of user charges, with no system of regular review or systematic indexing to movements in the CPI.

Some guidance to general government departments for pricing are outlined in NSW Treasury guidance such as 'Guidelines for Pricing for User Charges (TPP01-2 June 2001)' and 'Service Costing in General Government Sector Agencies (TPP07-3 June 2007)'. NSW has recently developed an economic framework which is being applied across government agencies to identify business activities for which service delivery models and funding arrangements including user charges are considered. This economic framework delineates activity for government policy, regulatory activity and the provision of government services.

Where government businesses are in actual or potential competition with the private sector, the Commonwealth and NSW Government have committed to ensuring that the prices charged by government are adjusted to reflect the advantages and disadvantages of public ownership.

There are a very large number of different user charges, which individually generate relatively small amounts of revenue. Given the variety of approaches to user charges across departments, a coordinated approach is required to comprehensively review the existing system of user charges. Accordingly, prior to any decision on individual charges, a comprehensive review of the existing system of user charges should be undertaken, possibly by IPART. The review should:

- identify principles for setting user charges, including efficiency considerations such as the management of demand and capacity
- identify equity considerations which may suggest alternative levels for user charges
- identify instances where user charges should include a premium to reflect any external costs imposed on others, such as pollution under the ‘polluter-pays’ principle
- benchmark all user charges against these principles
- suggest a mechanism for the regular centralised review and revision of user charges.

In addition to this general review of revenue-generating user charges, a separate review should be conducted in respect of public transport subsidies to identify the scope for better managing demand and the supply of public transport through revised fare structures and levels.

Revenue-generating user charges

There are over 900 charges and levies administered by NSW general government agencies classified as sales of goods and services. This revenue does not include sales of goods and services by state owned corporations, which are reflected in government revenue figures through their impact on dividends.

Forecast sales of goods and services in 2011-12 are set out in Table 13.3.1. There is no consolidated register of all user charges in NSW and about $1.4 billion of revenue is reported as ‘other’, which includes a host of relatively small sums for each government agency. There has been no recent comprehensive review of these charges.

Table 13.3.1 Forecast sales of goods and services for 2011-12

Category	$m
Fees for service	654
Patient fees	540
Veterans Affairs	314

Category	$m
Court fees	232
Rents and leases	218
Land title fees	161
Road tolls	147
Department of Health – other sales	837
Department of Education and Training – other sales	162
All remaining sales of goods and services	1,405

Implementing competitive neutrality principles as part of national competition policy, Treasury Policy Paper (TPP01-02) provides pricing guidelines for all agencies undertaking significant business activities in competitive or contestable markets. This leaves unaddressed government pricing which is not part of a significant business (i.e. small amounts of money), or where there is no contestable market (e.g. court fees).

General government user charges are not indexed or reviewed consistently across government. In many cases, information is not collected centrally and overall monitoring and review is patchy. For example, NSW Liquor Licence Fees have not been reviewed or increased since 1983, and many fees charged for regulatory licensing activities by Fair Trading have not been increased for a number of years.

Recent policy changes

In 2010, NSW introduced ad valorem fees for the registration of land title transfers, in addition to stamp duty. This was expected to generate roughly $100 million of additional revenue in 2010-11. The Government has abolished this tax.

Some of the fluctuations over time in the level of user charges in NSW arise from accounting treatment changes. For example, revenue from rents and leases in 2009-10 was around $200 million higher than expected in that year's budget, because of unexpected progress in transferring properties from government agencies to the State Property Authority. The additional rental revenue was offset by greater rental expenses of government agencies that occupy these properties.

Interstate comparison

There is no completely accurate way of comparing user charges across states, but it is clear that NSW raises less per capita than the national average. This is shown in Table 13.3.2 below.

Comparison of budget figures for sales of goods and services can present a misleading impression, because of differences in budgetary classification across jurisdictions. For example, ad valorem fees for registration of land title transfers could be treated as user charges in some states, but are grouped with stamp duty revenue in NSW.

The Australian Bureau of Statistics and the Commonwealth Grants Commission (CGC) have provided figures which group common charges together, although they do not use the same groupings. Unfortunately, neither of these data sources has provided a recent update.

Table 13.3.2 Per capita comparison of user charges across jurisdictions

	ABS 2008-09 ($)	CGC 2007-08 ($)	Budgets 2010-11 ($)
New South Wales	627	563	636
Victoria	917	727	723
Queensland	817	657	727
Western Australia	637	624	1,060
South Australia	1,052	836	894
Tasmania	729	658	1,138
Australian Capital Territory	1,081	1,025	1,421
Northern Territory	754	500	1,208
Average (excluding NSW)	**855**	**718**	**1,024**

Sources: ABS 3222.0 and 5512.0; CGC Relative Fiscal Capacities of the States, 2008; State and Territory Budgets for 2010-11.

Table 13.3.3 provides a breakdown which identifies some of the sources of variations between states in per capita levels, using the CGC's classifications in 2007-08. The two largest variations are for 'property titles' and 'other user charges'.

In the case of property titles, the introduction of ad valorem fees for title registration in 2010 increased NSW per capita user charges by around $14. In the area of 'other user charges' a specialist review would be required to identify the major sources of discrepancy between NSW and other states.

Table 13.3.3 Breakdown of per capita user charges across jurisdictions

	NSW ($)	VIC ($)	QLD ($)	WA ($)	SA ($)	TAS ($)	ACT ($)	NT ($)	Average ($)
Hospital patient fees	56.02	33.05	40.60	77.18	54.40	37.35	37.57	31.89	48.28
Law and order fees and fines	74.08	86.07	78.05	61.93	17.36	75.46	53.37	37.23	71.68
Property titles	18.12	44.67	58.13	30.98	83.11	28.00	20.84	11.36	39.07
Public safety	74.03	86.23	70.32	75.11	69.85	92.76	35.44	3.45	75.20
National parks and wildlife services	6.08	4.19	3.33	18.83	0.00	18.15	0.00	10.08	6.11
General public services	91.57	86.32	111.45	22.31	197.35	87.77	222.63	65.03	96.98
Other user charges	244.00	385.97	295.48	338.10	413.89	318.88	655.43	341.02	321.08
Total	**563.41**	**726.50**	**657.46**	**624.44**	**835.96**	**658.37**	**1,025.29**	**500.05**	**658.41**

Reform issues

Ideally, user charges would be set at levels which reflect the cost of service provision, including the cost of capital, adjustments where appropriate to ensure neutrality with competing private firms, and an additional margin that acts as an implicit tax. These charges should be regularly reviewed to reflect changes in the cost of providing services, specifically. There is also scope for increasing consistency in the setting of user chargers within NSW government departments.

While interstate comparison suggests there is scope to increase user charges, it is hard to determine whether the $4.7 billion of revenue from user charges is too much, too little or about right.

The case of ad valorem fees for land title registration suggests caution should be used in comparing NSW charges with other states. Before the introduction of these fees in 2010, NSW had significantly lower per capita user charges for property compared to other states – suggesting scope for an increase. However, the fees have a high excess burden and the Government has introduced legislation to abolish them. This shows that charging less than other states is not necessarily a reason to alter NSW user charges.

The 2008 IPART Review of State Taxation recommended that in the short term, NSW user fees and charges practices should be benchmarked with those in other states; guidelines and principles for these fees and charges should be developed; and all NSW user fees and charges not currently subject to a periodic review or indexation arrangement should be indexed annually to movements in the CPI.

Co-payments in health

User charges in health are increasingly being used to encourage patients to make better use of health services while containing costs. Under Medicare principles, public patients in public hospitals are treated free of change, but NSW and other states have a range of co-payments for non-hospital services. Other states have applied co-payments on a wider base and with fewer exemptions than in NSW.

The introduction of co-payments on a similar basis to other states for services such as dental health, community health services and ambulance services would provide price signals to patients and encourage more cost-effective consumption of non-hospital healthcare services. For example, the 2008 Performance Review of the Ambulance Service of NSW found a high level of inappropriate use of ambulance services by the community and that this was a growing problem. Pricing has the potential to manage demand for non-hospital services such as ambulances and, with appropriate concessions for low-income earners, equity concerns can also be addressed.

Co-payments have been implemented in other states for oral health and community health services. Moreover, in many other states, ambulance fees are higher and have fewer exemptions. Revenues derived from the co-payments could be used to provide a greater range of health services to the NSW community.

Public transport fares

As shown in Table 13.3.4, public transport fares meet a fraction of the cost of providing public transport. A level of subsidisation is economically justifiable, since the social benefits of public transport are not entirely received by passengers. For example, vehicle congestion is reduced and property owners can charge higher rents for properties served by public transport.

Table 13.3.4 Public transport cost-recovery ratios

	2004-05	2009-10
RailCorp	24.3%	21.8%
STA	48.5%	49.2%
Sydney Ferries	49.1%	36.5%

However, an empirical consequence is overall lower funding for public transport because of the constraints on budget funding. In turn, this limits capacity during peak periods, which leads to growing congestion and undermines reliability.

As an example, this section focuses on the subsidy provided to CityRail, including the level of the subsidy and the structure of the fares.

Cost recovery of CityRail fares

Urban rail services are the most important public transport mode in NSW, representing 67 per cent of all public transport commuter journeys in Metropolitan Sydney and 86 per cent of public transport subsidy.

As shown in Figure 13.3.5, the cost-recovery ratio of CityRail services from 2005-06 to 2009-10 has declined marginally from 22.0 per cent to 21.8 per cent. In 2009-10, CityRail received $2.06 billion in public subsidy, an increase of 30.5 per cent from 2006-07. This funding was equivalent to a subsidy of $787 a year from each household in 2009-10, a rise from $584 since 2005-06[19].

Table 13.3.5 CityRail cost-recovery ratios 2005-06 to 2009-10

FIS data	2005-06	2006-07	2007-08	2008-09	2009-10	2006-10
	$ '000	$ '000	$ '000	$ '000	$ '000	% Change
(1) NSW Government contribution	1,581,332	1,833,395	1,857,927	2,172,993	2,064,407	30.5%
(2) CityRail passenger revenue	526,501	568,257	622,979	660,814	693,278	31.7%
(3) Total operating expenses	2,398,166	2,392,351	2,638,937	3,061,990	3,182,091	32.7%
Cost-recovery ratio (2) / (3)	22.0%	23.8%	23.6%	21.6%	21.8%	-0.76%

The level of cost recovery by CityRail is much lower than in several comparable cities, as seen in Table 13.3.6.

Table 13.3.6 Cost recovery ratios in a sample of global cities

City (Operator)	Cost recovery (%)	Year of data
Sydney (RailCorp)	22.5%	2009-10
London (London Underground)	75.2%	2009-10
Montreal (Metro)	57.1%	2006-07
New York (Metropolitan Transit Authority)	55.5%	2009-10

Sources: RailCorp (2010), 2009-10 Annual Report; Transport for London (2010), Annual Report and Accounts, p.122; Societe de Transport de Montreal, Annual Report; Metropolitan Transit Authority, 2009-10 Annual Report.

The Independent Pricing and Regulatory Tribunal (IPART) is responsible for determining the maximum fare levels to be paid by CityRail users. IPART's methodology is to calculate the efficient cost of providing CityRail services, with funding apportioned between government contributions (i.e. the benefit to society) and fares (i.e. benefit to passengers).

In its 2009-2012 fares determination, IPART estimated that the efficient cost to RailCorp of providing CityRail services was $2.35 billion in 2008-09. It estimated that the benefit to society provided by CityRail services was $1.73 billion in that year

[19] Table 1 NSW Government contribution in 2009-10 and 2005-06 divided by total NSW households of 2,707,445 and 2,548,057 as per ABS (2010) Household and Family Projections (Cat. 3236.0, Table 1.2).

(mostly avoided road congestion costs), which should be funded by government. The remaining $600 million was to be funded from passenger fares and RailCorp's other revenue sources.

There are divergent views on the estimates of social benefits of CityRail services. RailCorp estimated the social benefits of CityRail services at $1.0 billion in 2006-07 in its submission to IPART. CRA International, which was commissioned by IPART to evaluate this issue, estimated the social benefits from CityRail services at $1.06 billion in 2006-07[20]. This is $640 million lower than the $1.8 billion estimate ultimately used by IPART in setting the maximum fare for 2008-09[21].

In December 2010, the previous Government decided not to increase CityRail fares in 2011 in line with IPART's determination. As a result, cost recovery at CityRail is only 22.5 per cent in 2010-11, compared with the 29.5 per cent cost recovery rate implied by IPART's determination.

Stagnant farebox revenue results in lower funding for public transport, leading to a cycle of reduced serviced quality, decline in demand and further pressures to reduce service costs. In contrast, raising fares could generate revenue for service improvements along the network.

The Financial Audit recommends that IPART conducts a study of international and interstate methodologies for the determination of levels of public transport subsidies, with a view to determining the appropriateness of current NSW subsidies.

MyZone cross subsidisation

The introduction of the MyZone fare structure has imposed a price cap on long-distance routes that is well below the actual cost of providing these services, inducing further excess demand and potentially distorting capital investment and land-use decisions.

Before the MyZone fare structure was introduced, pricing was based on a flag fall charge and a variable per kilometre charge. There were 20 price classes to reflect the higher cost of providing rail services at greater distances. The MyZone ticketing system has increased the flag fall component and reduced the variable charge. Only five price classes now exist, with an effective price cap on travel distances over 65 kilometres.

The MyZone ticketing system benefits users living further away from the CBD. While MyZone may have been introduced in support of social equity objectives, the pricing structure is economically inefficient, providing the greatest subsidy to those who travel the furthest.

The economic cost of the MyZone price cap is likely to increase over the long term. Because of artificially cheap travel, people may choose to live further from their work. The resultant land use patterns will affect the types and costs of required public infrastructure. Generally, it is more expensive to service areas of low population density

[20] CRA International (2008), Value of CityRail externalities and optimal Government subsidy, p.9.

[21] IPART's estimate of social benefits exceeded that of CRA International for reasons including higher traffic forecasts and wage and CPI increases, and an estimate of the time cost of congestion based on CityRail passengers' wages rather than average NSW wages.

than those with higher densities. For example, a 2010 study on alternative growth paths for Sydney by the Centre for International Economics indicates that direct infrastructure costs (including transport, physical and social infrastructure) are around $4.2 billion higher for a greenfield focussed growth path (50 per cent greenfield) than an urban renewal growth path (10 per cent greenfield) over 25 years. The economic cost increases further if congestion and environmental impacts are included[22].

The Commission recommends that the zonal fare structure be reviewed to develop an appropriate balance between efficiency (i.e. matching fares with the cost of services), simplicity of ticketing, the Government's social equity objectives and CityRail's revenue needs. Consideration should be given to achieving social equity objectives by providing assistance to targeted socio-economic groups, rather than fare-related benefits to all residents of particular geographic areas.

13.4 Tax expenditures and concessions

Tax expenditures are revenue forgone as a result of reduced taxes for particular groups. They are equivalent to taxing everyone at the general rate, and then spending money directly to the favoured group. Concessions involve the provision of government goods and services at lower prices than paid by the general community. Tax expenditures and concessions have the same fiscal impact as normal budget expenditure.

Tax expenditures should be distinguished from core design features of taxes. For example, land tax is not applied to a home owner's principal place of residence. This is considered a core feature of the tax design, rather than a tax expenditure. The measurement of a tax expenditure is thus determined by the benchmark, which is based on a judgement of the core features of the tax.

Major tax expenditures are estimated to be $4,722 million in 2010-11 which is equivalent to 23.4 per cent of tax collected.

Table 13.4.1 Major tax expenditures (2010-11)

	Tax expenditure ($m)	Tax expenditure as % of tax revenue collected
Purchaser transfer duty	954	23.6
General and life insurance duty	750	107.1
Mortgage duty	138	104.5
Marketable securities duty	107	227.7
Payroll tax	1,053	16.7
Land tax	599	25.7
Taxes on motor vehicles	407	17.1
Parking space levy	49	46.7

[22] The Centre for International Economics (2011), 'The benefits and costs of alternative growth paths for Sydney', p.19.

	Tax expenditure ($m)	Tax expenditure as % of tax revenue collected
Gambling and betting taxes	665	36.9
Total	4,722	23.4

Current tax expenditures

Transfer duty

Transfer duty is expected to raise $4,049 million (or 20 per cent of tax revenue) in 2010-11 and a further $954 million (23.5 per cent of transfer duty revenue) is forgone as tax exemptions.

The major transfer duty tax expenditure item is First Home Plus, which provides exemptions or concessions on transfer duty for people who are buying their first home in NSW. This tax expenditure is estimated to forgo $504 million of revenue annually.

Insurance duty

General and life insurance duty is estimated to raise $700 million in 2010-11, while a further $750 million is foregone in exemptions.

The benchmark general insurance tax rate is 9 per cent of premium paid. The benchmark life insurance duty rate is 10 cents per $200 where the sum assured is less than $2,000 and $1 plus 20 cents per $200 or part thereof where the sum assured is greater than $2,000.

Major insurance duty tax expenditures are:

Motor vehicle, aviation, disability income and occupational indemnity insurance concessional rate of 5 per cent and crop and livestock insurance at 2.5 per cent	$229 million
Green slips (third-party motor vehicle personal injury) exemption	$140 million
Marine and cargo insurance duty exemption	$14 million
WorkCover insurance premiums exemption	$245 million
Superannuation exemption	$103 million
Annuities exemption	$19 million

Mortgage duty

Mortgage duty on owner-occupied residences was abolished on 1 September 2007 and mortgage duty on non-owner-occupied residences was abolished on 1 July 2008. Mortgage duty revenue is expected to be $132 million in 2010-11 with tax expenditures and concessions exceeding 100 per cent. The benchmark tax rate is $5 up to $16,000, plus $4 per $1,000 or part thereof on the excess. The tax is scheduled to be abolished on 1 July 2012.

The main mortgage duty tax expenditure is a concessional duty rate for refinancing mortgages of up to $1 million. The concessional rate is estimated to forgo $138 million of potential revenue.

Marketable securities duty

Marketable securities duty revenue is expected to be $47 million in 2010-11 with measurable exemptions relating to corporate reconstructions of $107 million plus a number of minor exemptions. The benchmark tax rate is 60 cents per $100 or part thereof, with the purchaser paying the duty. This tax is scheduled to be abolished on 1 July 2012.

Motor vehicle registration duty

Motor vehicle registration duty revenue is expected to be $606 million in 2010-11. Exemptions and concessions are estimated to be $80 million. In the absence of motor vehicle registration duty reform there is limited scope for tax expenditure savings.

Payroll tax

2010-11 payroll tax is revenue is estimated to be $6,324 million, with exemptions estimated at $1,053 million – representing 16.7 per cent of payroll tax revenue.

From 1 July 2010 to 30 June 2011, the payroll tax benchmark is defined as aggregate annual gross remuneration paid by a single or group taxpayer in excess of a threshold of $658,000. The benchmark tax rate, effective from 1 July 2010, is 5.5 per cent and will decrease to 5.45 per cent from 1 January 2011.

Major payroll tax exemptions and concessions are:

Public hospitals and area health services	$519 million
Schools and colleges	$164 million
Religious institutions	$12 million
Charitable institutions	$40 million
Local councils	$191 million
Private hospitals and nursing homes	$13 million
Home care services	$10 million
Apprentices	$52 million
Trainees	$35 million
Redundancy	$6 million
Maternity leave	$11 million

Tax forgone from firms below the threshold is not measured as a tax expenditure.

Land tax

Land tax is expected to raise $2,328 million in the 2010-11 Budget, with a further $599 million in exemptions – representing 25.7 per cent of land tax collected.

The 2010 benchmark tax rate is 1.6 per cent above $376,000 and 2 per cent above $2.299 million.

Major land tax exemptions and concessions are:

Land used for primary production exemption	$403 million
Retirement village exemption	$102 million
Boarding houses for low income persons	$7 million
Racing clubs	$8 million
Employer and employee organisations	$3 million
Co-operatives	$9 million
Public cemeteries and crematoria	$14 million
Public and private hospitals and area health services	$18 million
Early payment discount	$18 million
Religious societies	$13 million
NB: Principal place of residence is not estimated as a tax expenditure	

Vehicle weight tax

Vehicle weight tax is expected to raise $1,421 million in 2010-11, representing 7 per cent of taxation revenue. Tax expenditures are a further $228 million or 16 per cent of weight tax.

The benchmark is all vehicles intended for on-road use, with the exception of Commonwealth Government vehicles which, for constitutional reasons, do not form part of the tax base. The benchmark tax rate is as defined in the *Motor Vehicles Taxation Act 1988 (NSW)* for private and business vehicles.

Major vehicle weight tax expenditures are:

Selected social security recipients	$177 million
Primary producers	$23 million
General purpose plant	$20 million
Roadwork equipment – including local government	$6 million
Commonwealth Government departments	$1 million

Driver licences

The benchmark is the licensing of all persons to drive a vehicle in NSW on public roads. The benchmark tax rates in 2009-10 were $47 for a one-year licence, $113 for a three-year licence and $151 for a five-year licence.

Major driver licence tax expenditures and concessions are $59 million for selected social security recipients.

Vehicle transfer fees

Vehicle transfer fees apply to all transfers of previously registered vehicles. From 1 July 2009, the benchmark rate is $27 for individuals and motor dealers. There are few exemptions and little scope for reducing concessions.

Motor vehicle registration fees

Registration fees apply to all vehicles intended for on-road use. The benchmark tax rate in 2009-10 is $55 for most motor vehicles, $240 for trucks with a mass of 5 tonnes or more and $358 for articulated trucks. There are few exemptions and little scope for reducing concessions.

Gambling and betting taxes

NSW taxation revenue from gambling in 2010-11 is expected to be $1,804 million, which represents 8.93 per cent of total taxation revenue. The cost of tax expenditures and concessions is estimated to be $665 million in 2010-11 or 36.9 per cent of gambling revenue.

The benchmark for gaming machines in hotels and registered clubs is defined to be the rates of taxation applying to hotels, which vary from 5 per cent to 50 per cent, depending on the level of annual profits from gaming machines.

Poker machines installed in registered clubs are taxed at lower rates than poker machines in hotels. Clubs in NSW enjoy tax concessions in relation to electronic gaming machines estimated in 2010-11 at $665 million. Clubs in NSW enjoy other tax benefits including that, as mutual organisations, they pay no income tax.

Parking space levy

The parking space levy applies to off-street parking spaces in the City of Sydney, North Sydney, Milsons Point, Chatswood, Parramatta, St Leonards and Bondi Junction business areas. The policy objectives are to discourage car use in major commercial centres, encourage the use of public transport and to improve air quality.

For 2009-10, the benchmark parking space levy was $2,000 per space in Category 1 areas and $710 per space in Category 2 areas.

Revenue is estimated in 2010-11 at $105 million with various exemptions estimated at $49 million, representing 46.7 per cent of revenue collected. There are a number of practical exemptions, with limited scope to reduce tax expenditure.

Current concessions

Concessions on fees and charges for government goods and services are valued at $1,725 million in 2010-11, as summarised in Table 13.4.2.

Table 13.4.2 Major concessions in 2010-11

Policy area	$m
Education (e.g. school bus fares)	615
Health (e.g. ambulance service for pensioners)	190
Social security and welfare (e.g. public transport concessions for seniors and students)	498
Housing and community amenities (e.g. council rates concessions for pensioners)	407
Recreation and culture (e.g. national parks entry for pensioners)	10
Agriculture, forestry, fishing and hunting (e.g. pensioners' fishing licences)	4
Total	1,725

Concessions to holders of Pensioner Concession and Health Care Cards account for approximately $1 billion. Most of this is effectively means tested except for public transport concessions for seniors which are available to residents over 60 years of age and not in full-time work. Public transport concessions are estimated to have cost $444 million in 2010-11.

Reform of tax expenditures and concessions

The removal of tax expenditures would boost revenue and may improve total social wellbeing. Social security policy objectives could be addressed through direct budget outlays and be subject to appropriate scrutiny through the Budget Committee of Cabinet, rather than through largely unmonitored tax expenditures.

The following sections suggest possible approaches to the elimination of $4.1 billion of tax expenditures and concessions.

Pensioners and aged citizens ($1,286 million)

Tax expenditures and concessions for social security recipients and elderly citizens include reduced vehicle weight tax and driver licence fees, council rates and energy rebates, concessional public transport for people aged over 60, transfer duty concessions for people aged over 65, water rebates in the Hunter Valley, ambulance services for pensioners, and retirement village exemption from land tax. The sum of these benefits is estimated to be $1.3 billion annually.

Across Australian states, different schemes of support for social security recipients may result in different outcomes. Transfer and income support payments are the primary responsibility of the Commonwealth. A better approach would be to ensure that the Commonwealth Government is responsible for all support to social security recipients.

The Commonwealth could increase pensions in return for states dropping all concessional treatment of social security recipients. This would ensure a national approach to the provision of benefits. The Commonwealth is the appropriate government to manage the provision of social security, as it has information about incomes and determines pensions. Transfer of responsibility for all income support to pensioners and older citizens could form part of a cooperative scheme of national reform of transfer payments.

A lesser scheme for reducing tax expenditures could confine concessions for the elderly to those with Commonwealth pensions. This reform would in effect introduce means testing for the provision of these concessions. The most important change would be for people aged over 60 who receive public transport benefits, even though they may have a reasonable income and asset base. This change could reduce the cost of public transport concessions by around $180 million per year.

Insurance duty concessions ($750 million)

General and life insurance duties are estimated to raise around $700 million in 2010-11. Many forms of insurance receive exemptions from stamp duty, or concessional rates of duty. Exemptions include third-party motor vehicle insurance, marine and cargo insurance, and WorkCover premiums. If the 9 per cent general insurance duty rate were applied broadly to other forms of insurance, an additional $750 million of tax revenue could be generated.

Insurance taxes are highly inefficient, have a high economic cost and should be abolished. If they are not abolished, it would be preferable to lower the rates applied to general and life insurance, and extend the same rates to all forms of insurance as follows:

- an insurance duty rate of 5 per cent, applying to all insurance except health insurance, would be approximately revenue-neutral (raising $777 million in 2011-12, as a replacement for the current system of general insurance duty (expected to raise $741 million)
- an insurance duty rate of 4.5 per cent could be achieved by bringing health insurance into the general scheme[23]; in 2011-12, this would generate $926 million, compared with $893 million expected from existing insurance duty plus the health insurance levy.

Clubs ($665 million)

Poker machines installed in clubs are taxed at substantially lower rates than poker machines in hotels. The cost of this tax expenditure is estimated at $665 million in 2010-11. In addition to the lower basic rates, clubs benefit from further rate reductions if they contribute to certain eligible community projects. Some of these can be in-kind contributions. Finally, registered clubs operate as not-for-profit mutual entities, meaning that member contributions and receipts from member dealings are not treated as taxable income[24].

[23] The Health Insurance Levy is currently hypothecated to fund ambulance services, is imposed at a flat rate per policy and is imposed under separate legislation.

[24] Some clubs are also classified as exempt institutions under the Income Tax Assessment Act 1997 as their main purpose is to encourage sport music, literature, a game (e.g. chess and bridge) or art.

The Productivity Commission, in its recent report on gambling, found that ‘the large tax concessions on gaming revenue enjoyed by clubs in some jurisdictions (notably NSW) cannot be justified on the basis of realised community benefits. There are strong grounds for these concessions to be significantly reduced.’

It is sometimes suggested that the benefits are appropriate because of the contributions that clubs make to local communities. The Productivity Commission found that ‘the social contributions by clubs … tend to be narrowly focused on sports activities and on subsidised benefits for club members. The value of contributions to the broader community is a small share of the value of the tax concessions.’ A possible alternative scheme for the provision of benefits to community and sporting associations would be to remove the tax concessions for clubs, channelling some of the resulting tax revenues through local councils for spending on local associations.

There is no strong equity or efficiency argument for the preservation of tax subsidies for clubs. Club gaming revenue should be treated in the same way as hotel gaming revenue. This tax expenditure is one of the highest priorities for removal.

Hospitals ($542 million)

Hospitals are exempt from payroll tax. In 2010-11, the cost of this exemption is estimated to be $519 million for public hospitals and area health services and $23 million for private hospitals, nursing homes and home care services.

To the extent that the State Government must meet the costs of public hospitals, removing their exemption from payroll tax is simply an accounting exercise: the extra tax revenue would need to be allocated to extra spending on public hospitals. However there is a competitive neutrality argument that all industries should be subject to the same tax rules, so that employment and other factors of production are channelled to their most productive uses[25]. The imposition of payroll tax on hospitals should be further considered when national reforms of health funding are finalised.

First home owner transfer duty concessions ($504 million)

First home buyers receive exemption from transfer duty on properties costing up to $500,000 and concessional transfer duty rates on properties costing up to $600,000. These concessions are worth up to $17,990. In addition, the State Government pays a first home owner grant of $7,000, for properties costing less than $835,000.

First home buyer assistance contributes to demand for home ownership, tending to increase home prices, particularly for typical first home buyer properties. The $7,000 first home owner’s grant was introduced as part of the GST package to compensate new entrants into the housing market for the effects of the GST on house costs. Arguably, the original purpose of this grant has now passed, but state governments have increased the benefits by providing additional reductions in transfer duty. There is no evidence that these concessions help in purchasing property. In some cases,

[25] This argument applies to all industry-specific exemptions from payroll tax, which together cost $949 million in forgone revenue. For example, councils are exempt from payroll tax ($191 million revenue forgone). Imposing payroll tax on councils could, however, result in councils imposing rates on State Government property and may also require changes in rate-capping.

concessions may have the perverse effect of encouraging buyers to pay more than they can afford.

If fundamental reform of transfer duty (i.e. its replacement with a stamp duty replacement tax levied on land values) does not occur, the transfer duty concessions for first home buyers should be abolished or reduced. The additional revenue could be used to reduce transfer duty rates for everyone.

Alternatively, the class of people who can claim first home concessions could be restricted, for example through means testing or by restricting the concessions to newly built homes as a means of encouraging new housing supply. The continuing need and benefit of the $7,000 grant should also be considered.

Primary producers ($426 million)

Farmers are exempt from land tax (valued at $403 million in 2010-11) and pay reduced vehicle weight tax (valued at $23 million). Transfers of land within the family are also exempt from transfer duty (not costed).

Broadening the base of the land tax to include farmers would improve the efficiency of state taxation. Introducing land tax would reduce the land value for existing owners: any prospective purchasers of the land would pay less because it would be subject to land tax.

Transitional mechanisms for imposing land tax on farming land could include: (a) gradual ramping up of land tax rates over time for farming land; or (b) transition to land tax based on transfers of legal title, as proposed for reform of transfer duty on residential land.

13.5 Commonwealth payments

The Intergovernmental Agreement on Federal Financial Relations (IGA), signed by all the states and the Commonwealth in December 2008, sets out the key features of Australia's Commonwealth state financial relations.

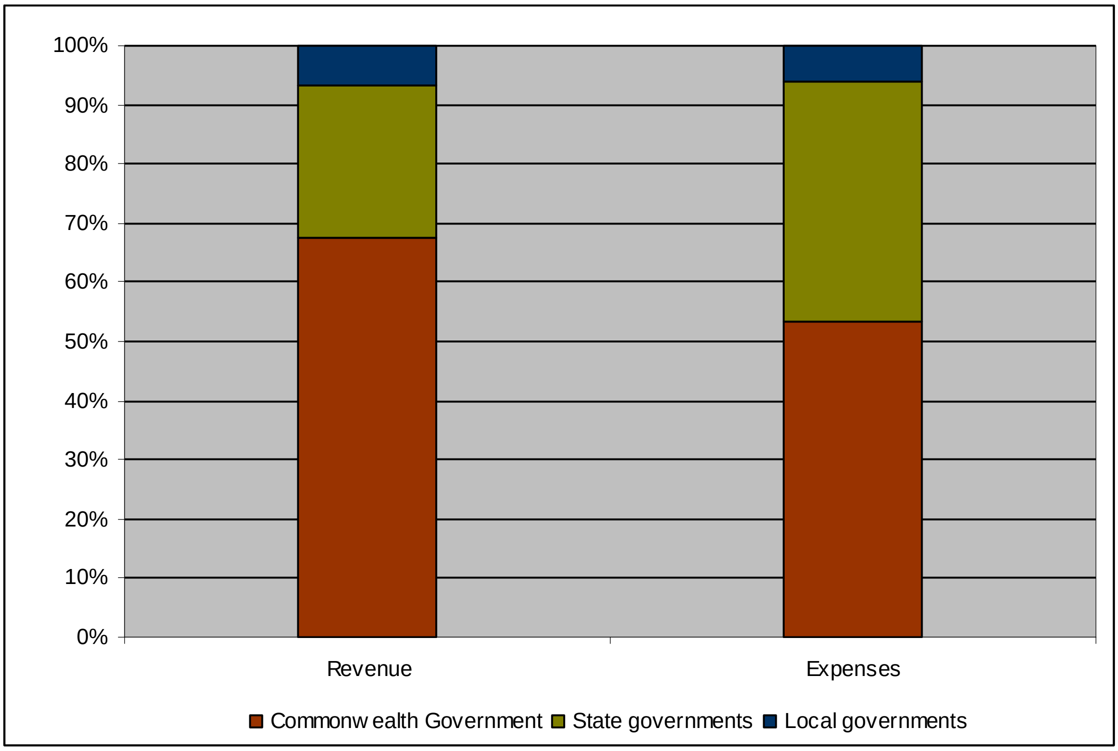
Almost half of NSW budget revenue consists of Commonwealth payments, making this the single largest source of state revenue. It is also a source of revenue over which NSW has only minor direct influence. This relatively high level of dependence, combined with the Commonwealth's superior revenue raising powers, has also seen the Commonwealth increasingly attempt to encroach on traditional state areas of responsibility.

In 2009-10, the Commonwealth Government accounted for around 68 per cent of own-source revenue raised by all levels of government, but was responsible for only 53 per cent of government own-purpose spending. State governments accounted for around 26 per cent of own-source revenue and around 41 per cent of own-purpose spending.

The extent of vertical fiscal imbalance – the mismatch between the funds that levels of government need to fulfil spending responsibilities and their revenue raising capacities

– between Commonwealth and state governments in Australia in 2009-10 is shown in Figure 13.5.1.

Figure 13.5.1 Vertical fiscal imbalance 2009-10



The mismatch of spending responsibilities and revenue-raising capacities between the national and state governments produces a need for large financial transfers between levels of government.

In 2009-10, the Commonwealth Government's payments to the other levels of government totalled $97 billion, of which around $82 billion went to state governments for own-purpose spending (with the remainder going to local government or non-government schools, either directly or 'through' the states). In other words, over a quarter (around 28 per cent) of total national government revenue of $293 billion in 2009-10 was transferred to state governments.

On the other side of the coin, in 2009-10 state governments as a whole in Australia received nearly half (around 46 per cent) of total revenue (excluding federal payments 'through' the states and direct to local government) from the national government. For individual states, the share of total revenue received from the national government ranged from 39 per cent for the Australian Capital Territory to 73 per cent for the Northern Territory.

There is a strong argument to be made that responsible government is enhanced when taxing powers and spending responsibilities are more closely aligned. The closest possible alignment of taxing powers and spending responsibilities enhances transparency and accountability, reducing the potential for popular confusion over the respective funding and service delivery roles of national and state governments. It also enhances the environment for the cost-effective delivery of government services that reflect community preferences and local conditions.

Where a clear assignment of tax powers between levels of government cannot be aligned with spending responsibilities, intergovernmental fiscal transfers are required. The transfer mechanism/allocation formula should be easily understood and administered, should not reduce the incentive for states to provide services efficiently, and should reinforce the accountability of states for the provision of services for which they are responsible.

Transfers to the states comprise both untied (or general revenue) payments, primarily goods and services tax (GST) revenue, and tied payments distributed via National Agreement and National Partnership payments.

GST Revenue

In 2009-10, GST payments from the Commonwealth were $13.5 billion, providing 24 per cent of total NSW revenue. In 2010-11, GST payments are expected to provide 25 per cent of total NSW revenue.

The amount of GST payments a state receives depends on the state's population; the state's GST relativity, which adjusts the population share; and the overall amount of GST revenue (the GST 'pool').

The Commonwealth Grants Commission and horizontal fiscal equalisation

The Commonwealth Grants Commission (CGC) is an independent statutory body that makes recommendations to the Commonwealth Treasurer on the distribution of GST revenue among the states. Commonwealth Treasurers tend to accept the CGC's recommendations.

The Commission consists of up to five part-time members, generally with Commonwealth or state public service or academic backgrounds, and a secretariat of 40 to 50 Commonwealth public service staff.

GST revenue grants are distributed among the states according to horizontal fiscal equalisation (HFE) principles. HFE has been interpreted by the Commission to mean that states should receive funding from the GST pool such that if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide the same standard of services and the same per capita level of physical and financial assets.

The assessments of revenue capacity and spending need made by the CGC are intended to adjust for differences in economic, geographic or demographic circumstances which are outside the control of states:

- differences in economy include things like relative wage costs (which affect spending) or relative land values (which affect land tax revenue)

- differences in geography include things like land area (which affects costs of providing services) and relative resource endowments (which affects relative ability to raise revenue from mining royalties)
- differences in demography include things like the relative proportion of states' populations of aged people (which affects the need to spend on health) and young people (which affects the need to spend on education). Population settlement patterns – concentrated or dispersed – also affect the costs of providing services.

Differences in policy, which states can control, are not intended to be included in measures of relative fiscal capacities.

These differences in state circumstances (or 'disabilities') are combined into one measure: the relativity for each state. The average for Australia is one. A relativity below one means a state (overall) gets less than its population share of GST revenue. A relativity above one means a state gets more than its population share of GST revenue.

The data used by the Commission to calculate the relativities are obtained largely from the Australian Bureau of Statistics (ABS) and the states and territories.

In the annual update of relativities, changes in state GST revenue shares result mainly from the substitution of a more recent year's data for an earlier year's data, or revisions in the data for the years used, with the approach involving a rolling three years of data. Changes in state GST revenue amounts result mainly from the growth in the GST pool from year to year.

The most important number for a state Treasurer in any CGC Update Report is the difference between the amount the CGC recommends a state should receive in GST revenue for the following financial year and the amount built into the state's forward estimates of revenue. The key impact for the following budget is the difference between what NSW will get and what we thought NSW would get.

Periodic CGC methodology reviews

Every five or six years, the CGC reviews the underlying methodology it uses to assess states' relative capacities to raise revenue and relative costs of providing services. The last review, which reported in 2010, established the methodology the CGC will use to assess state GST revenue shares from 2010-11 until the next review.

In the review years, changes in state GST revenue shares also can result from changes in the methods the CGC uses to assess state revenue raising capacities and spending needs.

Although the CGC's 2010 Review increased NSW share of GST revenues, it did not reduce NSW concerns with the principle and implementation of HFE by the CGC. Rather, the outcomes reinforce the need for an independent review of how HFE is defined and implemented to ensure that it is not detrimental to overall economic efficiency and flexibility in Australia.

The main outcomes of the 2010 Review included:

- A change in the methods used to assess revenue raising capacity and spending needs. The most significant change was in the assessment of capital expenses, which the Commission assessed based on up-front investment in new capital assets, with an emphasis on population growth as a driver of state investment decisions.

  Previous assessment methods for investment in infrastructure used a debt charges assessment to recognise the financial implications of state requirements to borrow to provide *new* infrastructure and a depreciation assessment to recognise the financial consequences of using up *existing* infrastructure.

  Because some states were funding new infrastructure from current year or accumulated budget surpluses, the CGC considered the debt charges assessment no longer adequately addressed state needs for new infrastructure resulting from changing state circumstances and population growth.

  The CGC also argued that state revenue capacities – from interest earnings on cash and other assets and dividends from holding in public trading enterprises – were influenced by state holdings of net financial worth. Since states build net financial worth through the accumulation of net lending, the CGC thought it necessary also to include a more direct assessment of state net lending.

  In effect, the CGC's method involves an equalisation of per capita stocks of non-financial and financial net assets, which took HFE into areas it had never been before.

- Shortening the assessment period – the number of years' data used to calculate the relativities – from five years to three years.

NSW' increased GST revenue share – 30.7 per cent of the GST pool in 2010-11 compared with 30.2 per cent in 2009-10 – resulted from three influences:

- gains from shortening the assessment period from five years to three years – which favoured NSW, since our annual relativity has been increasing in recent years
- gains from changed state circumstances, with the resource-rich states growing at above Australian average pace
- losses from the changed methods used to assess revenue capacity and spending needs.

Overall, in a longer term structural sense, the changes disadvantage NSW.

The gains from changes in state circumstances reflect largely cyclical influences related to the enhanced capacities of other states to raise their own revenues. In Queensland and Western Australia in particular, the resources boom has increased revenue from mining royalties and indirectly boosted other tax bases (also see GST cross-subsidies below).

However, the changes to assessment methods will permanently reduce NSW GST revenue. The $701 million that NSW is estimated to have lost in 2010-11 will not be unwound in future assessments. In addition, the new methods for the capital assessment will continue to benefit those states with annual population growth above the Australian average.

GST cross-subsidies

NSW has always been a ‘donor’ state in the distribution of GST:

- Its share of national GST payments has always been below its share of national population. NSW GST share is currently the highest it has been since the GST was introduced (and, before that, the distribution of Financial Assistance Grants/Tax Sharing Grants).
- NSW’s share of GST payments has increased in recent years, mainly due to the increase in the capacity of states like Western Australia and Queensland to raise their own revenues associated with the resources boom. The resources boom has increased those states’ capacities to raise revenue from mining royalties, and also from other taxes like payroll tax, property transfer stamp duty and land tax, reflecting the increases in employment, wages, property market activity and land prices associated with the mining boom.
- Earlier in the last decade, NSW’s share of GST payments declined, largely reflecting the state’s increased capacity to raise its own revenue from property transfer duty and land tax, reflecting the property market boom.

NSW share of GST revenue and its population share since 2000-01 are shown in Figure 13.5.2.

Figure 13.5.2 NSW population and GST shares 2001-02 to 2010-11

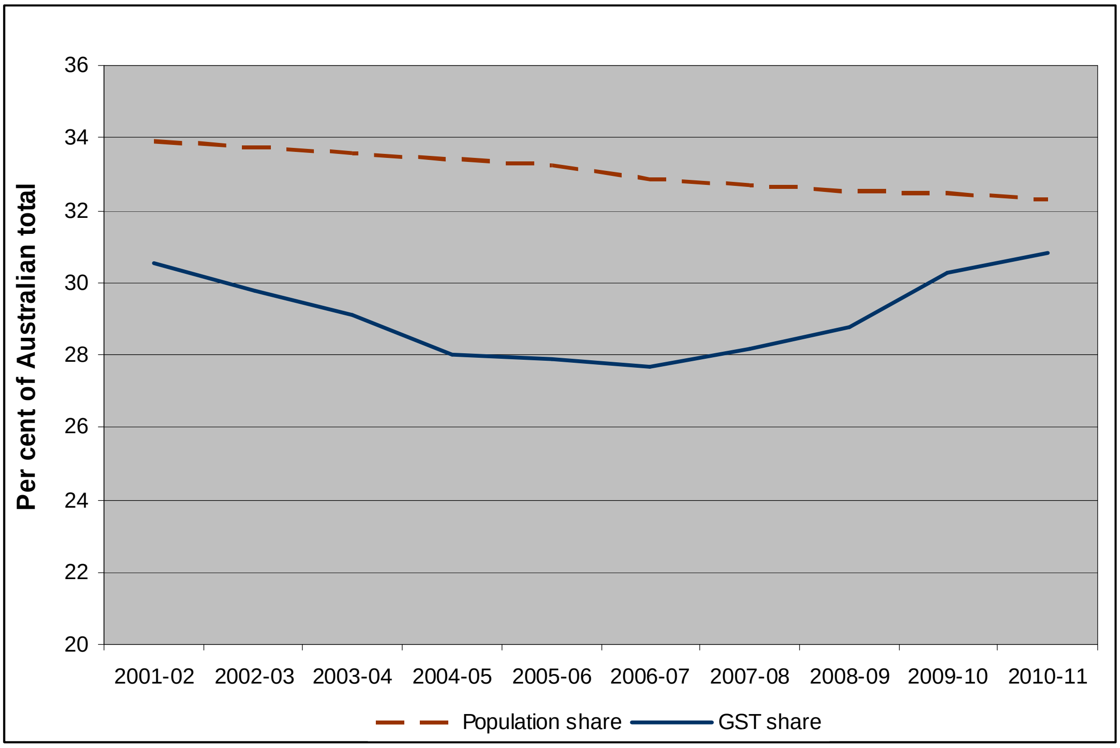


Table 13.5.1 shows state GST cross-subsidies compared to an equal population share of GST, i.e. the amount the GST payment from each year's GST pool varied from the amount the state would have received if the distribution was based on population. The key points to note are:

- the increasing cross-subsidy paid by NSW from 2002-03 to 2006-07 mirrors the decline in NSW's GST share shown in Figure 13.14, with the falling cross-subsidy since then mirroring NSW's increasing GST share.
- South Australia, Tasmania, ACT and Northern Territory have always been beneficiaries of the GST cross-subsidy.
- Western Australia started the decade as a donor state, was a beneficiary for the three years from 2004-05 to 2006-07, and then moved back to donor status.
- Queensland became a donor in 2008-09.

Table 13.5.1 GST cross-subsidies based on population ($m)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2000-01	-959	-963	113	-23	383	394	78	978
2001-02	-894	-1,002	32	-89	413	417	106	1,018
2002-03	-1,198	-1,188	110	-79	511	516	119	1,210
2003-04	-1,485	-1,255	177	-112	604	598	122	1,351
2004-05	-1,921	-1,389	484	134	608	590	114	1,380
2005-06	-2,008	-1,354	414	115	630	611	129	1,462
2006-07	-2,066	-1,211	254	20	616	635	140	1,612
2007-08	-1,929	-1,237	98	-275	732	674	165	1,772
2008-09	-1,557	-896	-306	-601	718	643	173	1,826

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
2009-10	-955	-876	-745	-973	807	624	193	1,926
2010-11	-709	-686	-815	-1,532	986	661	116	1,978
2011-12	-664	-1,172	-718	-1,464	990	674	94	2,261
Total	-16,345	-13,228	-904	-4,878	7,998	7,036	1,549	18,773

Table 13.5.2 shows the major sources of change from an equal per capita distribution of GST for 2011-12, based on the CGC's 2011 Update, with the key points to note being:

- In the revenue assessments, the biggest redistribution is in the mining revenue assessment. The redistribution in this category has grown enormously in recent years because mining revenues in some states have grown enormously.
- Even with the pause in the resources boom with the global financial crisis in 2009-10, for both Queensland and Western Australia mining revenue more than trebled between 2003-04 and 2009-10, and mining revenue per capita nearly trebled between those years.
- In the expense assessments, population dispersion and the proportion of Indigenous Australians have always been large redistributors of GST revenue.

Table 13.5.2 Major sources of change from equal per capita distribution 2011-12

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total [(a)]
Effects on revenue raising capacity									
Mining production	1,325	1,845	-1,213	-2,520	379	127	125	-69	3,802
Payrolls paid	-440	-99	447	-340	272	127	-2	36	881
Effects on expense requirements									
Indigenous population	-551	-1,695	527	521	-231	16	-87	1,501	2,565
Population dispersion	-549	-805	379	653	160	-89	-199	450	1,642
Interstate wage levels	500	-500	-462	509	-128	-97	89	89	1,187
Effects on Commonwealth payments									
Commonwealth payments	208	615	-345	6	-229	-103	78	-230	908
Total	-664	-1,172	-718	-1,464	990	674	94	2,261	4,019

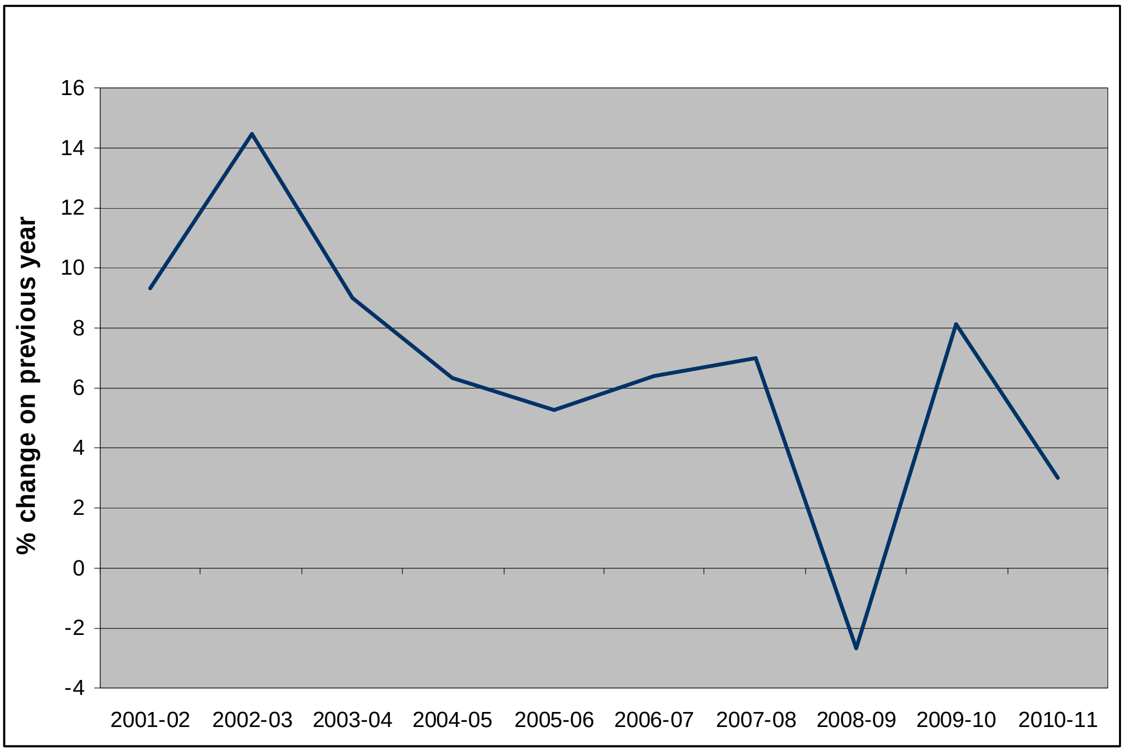
The GST pool

Table 13.5.3 shows the GST pool underlying annual GST payments to the states for the years 2001-02 to 2010-11. Average annual growth for the period was 6.2 per cent, though year-on-year growth is quite variable within a range of -2.7 per cent in 2008-09 and 14.4 per cent in 2002-03 (see Figure 13.5.3).

Table 13.5.3 GST pool 2001-02 to 2010-11 ($m)

2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
26,632	30,479	33,219	35,323	37,182	39,552	42,330	41,189	44,529	45,863

Figure 13.5.3 GST pool growth 2002-03 to 2010-11



HFE reform

The distribution of the GST is a financial zero sum game; an increase in grants for one state requires a decrease in grants for other states. NSW's ability to influence the outcome is limited because all the other states and territories are also attempting to maximise their share, and the CGC appears to give equal weight to all states. The CGC itself is also a participant in the system, developing its own reform options and directions.

The donor states tend to form a group arguing for reform of the system (although usually with differing major directions for reform), while the recipient states tend to try to prevent any attempted reform out of fear of losing revenue. This tends to leave the CGC in a position where it directs much of the methodological review agenda.

Under the current system, NSW cannot influence the outcome on its own. However, the State has long had major concerns with the way the principles of HFE are applied:

§ it emphasises equality at the expense of efficiency or incentives for recipient states to promote economic growth or improvements in services to reduce the disabilities that gain them a higher share of GST revenue

- there are no incentives for states to undertake economic reform, since the benefits of reform can be equalised away and tax reform (not being 'average' policy) is not recognised or compensated under HFE
- it lacks transparency and fosters ever-increasing complexity, despite previous efforts to simplify the process
- assessed relativities, and therefore GST revenue to the states, vary unpredictably, predominantly because of changes in methods and other decisions made by the CGC but also due to data revisions
- the burden of equalisation is spread inequitably: NSW and Victoria bore excessive burdens in the early 2000s; Western Australia is arguably bearing an excessive burden now
- it ties up resources in the CGC to assess states' spending needs and revenue raising capacities, and in the states to demonstrate their spending needs and revenue raising capacities.

NSW has advanced these concerns in the course of methodology reviews with limited success.

On 30 March 2011, the Commonwealth Government announced a review of the distribution of GST revenue to the states and territories. The review will be conducted by ex-Premiers Nick Greiner (NSW), John Brumby (Victoria) and South Australian businessman Bruce Carter.

Terms of Reference for the review accept as a key principle that the states should have the ability to provide broadly equivalent services in areas such as education, health and public transport.

However, the terms of reference note also the need to take into account principles of allocative efficiency, simplicity and transparency, and predictability and stability in the outcomes in distributing GST revenue.

The review will be advised by a Heads of Treasuries Advisory Committee comprising representatives from all states and territories. It will be supported by a secretariat within the Commonwealth Treasury, with representation from the states and territories as well as the CGC as appropriate. It will consult the public and state governments and seek written submissions.

The review will not affect the distribution of the GST revenue in 2011-12 or 2012-13. It will provide an interim report to the Commonwealth Treasurer by February 2012 and a final report by September 2012. The Treasurer then will bring the final report to the Council of Australian Governments (COAG) for consideration before a final decision is made on new arrangements by the end of 2013.

The CGC will continue to serve as the independent umpire and make recommendations on the distribution of GST revenue. The Commonwealth Government will request the CGC to update its methodology to reflect any agreed recommendations from the review.

The review is probably NSW’s best chance to attempt to advance a reform agenda that takes account of structural change in the economy, endemic underperformance by some states and the entrenched disadvantage faced by the Indigenous population.

National Agreements and National Partnerships

National Agreements (NA) and National Partnerships (NP) represent the tied part of Commonwealth grants to the states. Whereas the GST grants are untied and can be used for any purpose, NAs and NPs must be used in a specified area of expenditure and for a specified purpose. This restricts the states’ policy flexibility and assigns greater weight to the Commonwealth’s policy agenda.

Under the previous Specific Purpose Payment (SPP) regime, states had to meet a series of input controls, including matching funding, in order to receive the SPPs.

In recent years there has been substantial reform to both Commonwealth-State financial arrangements and national policy objectives, reflected in the *Intergovernmental Agreement on Federal Financial Relations 2009* (IGA).

In 2008, a reform agenda was established to focus on boosting productivity, workforce participation and the geographic mobility of labour, as well as supporting the wider objectives of better services for the community, social inclusion, closing the gap on Indigenous disadvantage and environmental sustainability.

The IGA provides for two types of Commonwealth-State agreements.

National Agreements (NAs) are first tier, long-term agreements to guide the Commonwealth and states and territories in the delivery of services across a particular sector. They define the objectives, outcomes, outputs and performance indicators that apply to a service delivery sector, and clarify the respective roles and responsibilities of different levels of government.

There were originally six NAs covering the key areas of health, education, skills and training, housing, disabilities and Indigenous reform. In 2010, an extra health agreement was signed and in 2011 an early childhood agreement is being developed. These agreements are not time limited, but are generally aligned to five-year SPP Agreements, which specify the financial support the Commonwealth will give states in their delivery of services. The exception to this is Indigenous reform, where there is no specific SPP funding linked to the policy objectives of the NA, and healthcare, where two NAs are funded under one SPP.

This new NA/SPP framework replaces more than 90 SPPs that existed before the introduction of the IGA.

It is intended that the NAs do not include input controls and change the focus to meeting outcomes.

National Partnerships (NPs) are short or medium-term agreements to tackle specific national reform priorities. This includes delivering specific projects, facilitating reforms to service delivery or rewarding those jurisdictions that deliver on national reforms or achieve specific, ambitious service delivery improvements. Under the IGA, NPs are meant to be time-limited agreements and should support or complement the policy intentions of their respective National Agreement.

NPs define the objectives, outputs and performance benchmarks and roles and responsibilities of respective levels of government for the agreed tasks at hand.

Although the IGA does not specify any limit on the number of NPs that can be negotiated, this mechanism has become overused. Since the first tranche of policy reform NPs in late 2008 and early 2009, the number of NPs has grown to over 100. This partly reflects growth in the use of this funding mechanism for purposes not intended by the IGA. For example, numerous small projects, states-specific projects and rolling over of existing ('deemed') funding agreements that have no reform purpose have been categorised as NPs. Abstracting from these types of agreements, there is a core of 48 largely reform-based NPs (see Table 13.5.4).

The 2010 Heads of Treasuries Review of NAs and NPs recommended that a new type of agreement be developed that can cater for small projects and/or small amounts of funding without the negotiation process required for an NP, and without the associated obligations of an NP (such as reporting requirements) being placed on states. This recommendation was accepted, leading to the introduction of Implementation Plans (IPs), which are also listed in Table 13.5.4.

Table 13.5.4 National Partnerships and Implementation Plans by portfolio (number)

	National Partnerships		Implementation Plans[b]
	All	Excluding deemed	
Health	37	9	25
Infrastructure	21	5	8
Education, Skills and Training	14	12	24
Environment	12	5	1
Indigenous[a]	6	5	15
Housing	5	5	32
Competition and Regulation	3	3	
Other:			1
Community Services	5	2	-
Communications	2	2	-
TOTAL	105	48	106

(a) Excludes three NPs that are included under education, health and housing respectively.
(b) There is a tranche of about another 30 IPs, mostly in health, that are still under negotiation.

Unlike NA funding, which is a steady stream of annual funding over a number of years, NP funding can be lumpy. In particular, up-front facilitation funding may be provided by the Commonwealth to kick start a reform process or increase service delivery in a jurisdiction. In some instances, there may be no further funding for the life of the NP agreement, although performance benchmarks and reporting requirements still apply. For those agreements involving reward funding, states have to achieve benchmark targets to be eligible for reward monies. In some instances, states also have to make a co-contribution to the Commonwealth funding of a particular policy commitment.

Implementation of the IGA by the Commonwealth with regard to NPs has been patchy.

The IGA represented a significant change to intergovernmental financial relations and received strong support from state jurisdictions in 2008. States were to gain from an end to inefficient transfers and administrative overheads, the removal of Commonwealth prescriptions and guaranteed greater fiscal autonomy through untied block funding. While this was true of NAs and their associated SPPs, implementation of NP agreements has been more uneven.

In many NPs, the Commonwealth continues to negotiate input controls and require excessive reporting regimes which divert resources from reforms to administration. In some agreements (e.g. Building the Education Revolution NP and the Productivity Places NP) the Commonwealth has unilaterally changed elements of the agreements, resulting in budget impacts and planning difficulties as NSW attempts to roll out the reforms.

Heads of Treasuries reviewed the implementation of the IGA and found that there were a number of strategic and implementation issues that needed to be addressed. These issues included:

- cultural change in agencies
- improved performance monitoring and reporting – there were some significant data problems
- reduced reporting burden associated with agreements.

A Senior Officials Steering Committee (with a NSW Treasury representative) will be responsible for implementation of the recommendations.

The question of whether funding for NPs will be continued is a significant issue in the current IGA framework. To date, states have had little experience as to whether the Commonwealth will continue NP funding beyond the expiry date of an NP. The uncertainty around future funding presents a budget risk for states. States need to know as early as possible whether funding is to be continued beyond the life of the initial NP, as reform programs often involve increasing the level of service delivery. When current NPs expire, there will be a significant drop in the funding level from the Commonwealth, with over $1 billion to NSW due to expire before 31 December 2012.

States are currently developing a protocol to engage with the Commonwealth prior to the expiry of the NPs. The Commonwealth has said that any decisions over the treatment of an expiring NP will depend on the Commonwealth's budget position. This leaves a significant budget risk with the states.

The Ministerial Council agreed that state and territory Treasurers will formally advise the Commonwealth Treasurer of their views regarding NPs, in terms of whether funding should continue and if so, in what form, for consideration in the Commonwealth budget process by September each year.

Implementation Plans are third tier agreements that are sometimes negotiated in conjunction with an NP. A key purpose of IPs is to agree on state-specific service delivery characteristics or starting points to the national reform process that are not outlined in the NP itself. However, both bilateral and multilateral IPs are being overused (more than 100 now exist across all jurisdictions).

National Agreement and National Partnership funding to NSW

Over the five years to 2013-14, COAG funding to NSW will total $55.9 billion, comprising $36.3 billion in National Agreement/SPP funding and $19.6 billion in National Partnership funding.

In 2010-11, NSW will receive a total of $11.3 billion, comprising $6.9 billion in National Agreement/SPP funding and almost $4.5 billion in National Partnership funding.

In the five years to 2013-14, 58 per cent of NA funding relates to healthcare, 23 per cent to education and skills and training, and 5 per cent to housing, disabilities and home and community care respectively (see Table 13.5.5).

Table 13.5.5 National Agreement Funding to NSW ($m)

By Agreement	2009-10	2010-11	2011-12	2012-13	2013-14	Total
Healthcare	3,711	3,951	4,204	4,477	4,757	21,099
Education	1,106	1,170	1,238	1,308	1,379	6,200
Skills and Training	439	443	448	452	456	2,237
Affordable Housing	300	350	401	418	438	1,907
Disability	384	388	396	404	411	1,983
Indigenous[(a)]	354	379	406	406	406	1,951
Home and Community Care[(b)]	262	181	162	167	176	948
Other[(c)]	6,555	6,861	7,255	7,631	8,022	36,325
Total	3,711	3,951	4,204	4,477	4,757	21,099

(a) There is no funding attached to this NA.
(b) HACC funding may occur in a different form from 2011-12, but NSW will still be paid for delivering services on behalf of the CW.
(c) Other includes payments still outside the IGA framework.

NP funding to NSW is shown in Table 13.5.6.

On an aggregate basis, NP funding is influenced by the large amount NSW receives under the fiscal stimulus package delivered through the Nation Building and Jobs Plan NP ($5.4 billion from 2008-09 to 2011-12).

Table 13.5.6 National Partnership (NP) funding to NSW 2009-10 to 2013-14 ($m)

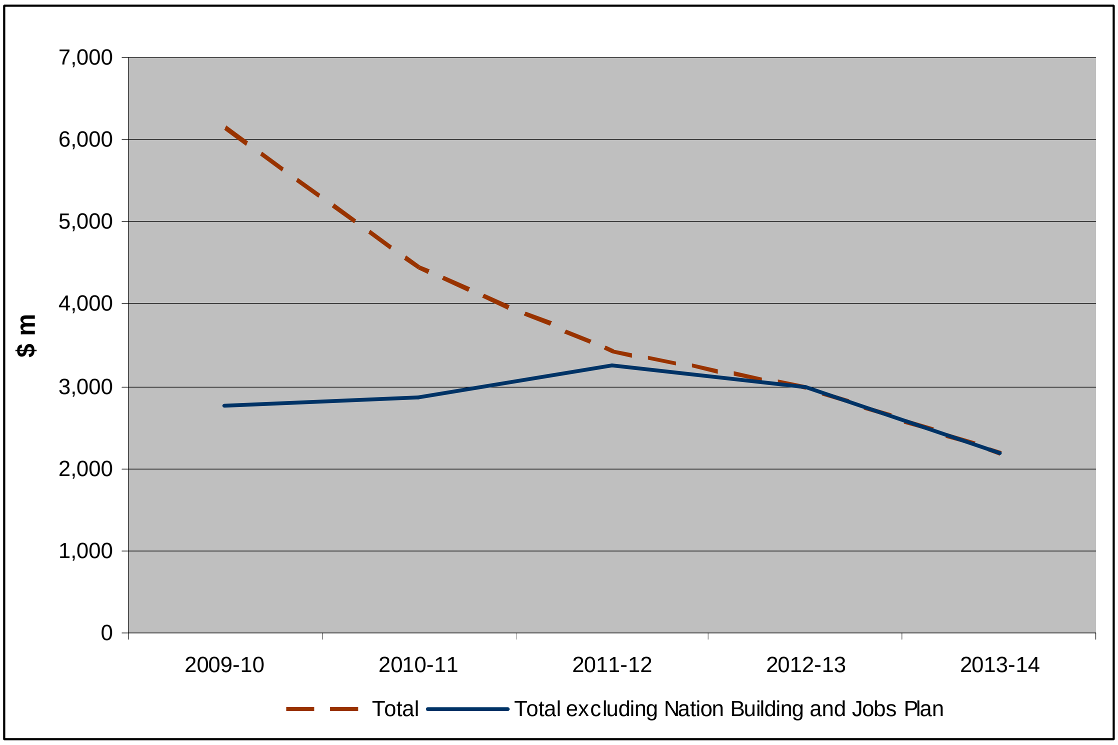
Portfolio NP Funding	2009-10	2010-11	2011-12	2012-13	2013-14	Total
Health	208	240	197	223	225	1,093
Health & Hospitals Network[(a)]	42	315	361	290	317	1,327
Stimulus Plan	3,364	1,685	171	-	-	5,221
Infrastructure - NBF	64	502	882	493	22	1,963
Education & Training	437	430	626	619	336	2,447
Transport	1,277	727	1,056	923	976	4,959

Portfolio NP Funding	2009-10	2010-11	2011-12	2012-13	2013-14	Total
Housing	235	58	61	68	47	468
Environment	65	64	66	43	3	241
Other	654	457	314	197	248	1,870
Total	6,345	4,479	3,734	2,857	2,174	19,588

(a) This NP agreement was revised at COAG on 13 February 2011, bringing forward $260 million of funding for NSW compared with what is shown above, but leaving the total five-year funding unchanged.

Figure 13.5.6 highlights this difference, with total annual NP funding falling significantly from its peak in 2009-10, but annual funding, excluding the National Building and Jobs Plan NP, remaining fairly steady until 2012-13, when the winding back of the Nation Building for the Future (road and rail infrastructure) NP and transport NPs begin.

Figure 13.5.4 National Partnership funding to NSW 2009-10 to 2013-14



At its February 2011 meeting, COAG committed to a streamlined agenda built around five themes:

- a long-term strategy for economic and social participation
- a national economy driven by our competitive advantages
- a more sustainable and liveable Australia
- better health services and a more sustainable health system for all Australians
- closing the gap on Indigenous disadvantage.

13.6 Recommendations

The Financial Audit recommends:	
13.1	The NSW Government seek the support of all Australian governments in the reform of state and territory taxation on a revenue neutral basis aimed at improving its economic efficiency, and growth characteristics and reducing revenue volatility.
As part of a multilateral or unilateral reform process, consideration be given to the following reforms:	
13.2	Abolition of the emergency services levy on insurance companies and imposition of a property levy on rateable property with a public consultation process used to identify the most effective way of allocating this property levy across properties.
13.3	Abolition of insurance duty and the health insurance levy and fund by lowering the payroll tax threshold.
13.4	If recommendation 13.3 is not implemented, removal of general insurance tax concessions and applying a single flat rate of 4.5 per cent to all insurance other than life insurance. The new rate would apply to general insurance, third party motor vehicle insurance, marine and cargo insurance, WorkCover premiums and health insurance.
13.5	Abolition of transfer duty and imposition of a 'Stamp Duty Replacement Tax' (SDRT) on land value.
13.6	Abolition of indexation of the land tax threshold, using the additional revenue generated by bracket creep each year to gradually reduce the 2 per cent top tax rate towards the base 1.6 per cent rate. The objective is to have a single flat rate of tax applying to all investment and business land[26] and in the long run, consider merging the land tax and the SDRT (if implemented).
13.7	Preparation of a discussion paper on a business cash flow tax, examining its potential for lower transaction and efficiency costs than payroll tax and also examining the compliance and enforcement implications that might arise if different states set different rates for a business cash flow tax.
13.8	Abolition of the indexation of the payroll tax threshold as a first priority, followed by reducing the threshold to a suitable economic level, with a corresponding reduction in the tax rate.
13.9	Increase reliance on road pricing as a source of revenue, using any additional revenue to reduce vehicle taxes. § In the short-term, introducing consistent tolling across all currently untolled sections of the Sydney Orbital Network with tolling reflecting the distance travelled, and incorporate a congestion price that varies by location and time of day. § In the medium-term, renegotiating existing toll concessions, to ensure consistent tolling across all of the Sydney Orbital Network with tolling reflecting the distance travelled, and incorporate a congestion price that varies by location and time of day. In the longer term, introduce a state-wide system of road pricing, with a base fee per kilometre for road use and a congestion supplement in congested areas that varies by time of day and location. Studies to implement such a system should begin immediately.
13.10	Consider means of accelerating reforms of heavy vehicle road pricing, including unilateral implementation of state-wide road usage prices for heavy vehicles operating in NSW.
13.11	Launch a feasibility study for the introduction of a state-wide system of road pricing, including a base element per kilometre, and a congestion charge element which varies by location and time of day. In the long run, use road pricing to eliminate all vehicle taxes and to fund improvements in roads and public transport.

[26] Starting from the current land tax threshold of $387,000, with annual inflation of 2.5 per cent the additional revenue generated from bracket creep (relative to current revenue forecasts), would be sufficient to abolish the 2 per cent top rate by 2018-19.

The Financial Audit recommends:	
13.12	Investigate mining industry interest in a potential revision of royalties, to provide companies that develop new mines with a choice between the existing royalties regime or an efficient resource rent tax.
13.13	Review the level of royalties for minerals subject to fixed dollar fees per tonne and provide for regular indexation of those tax rates.
13.14	Investigate Council of Australian Governments (COAG) interest in a process of constitutional reform to remove the constitutional prohibition on state excise taxes.
Tax reform process	
13.15	If major tax reforms are pursued, a consultative process be used to refine the reform details. This process would include issuing a Green Paper to set out the main options for public consultation, followed by a White Paper that sets out the Government's favoured options and invite comment on technical details. Draft legislation should be issued for comment before introduction into Parliament.
User charges	
13.16	Commission IPART to conduct a review of all NSW user charges that appear in the Budget as general government revenue, as well as mineral royalties that are not *ad valorem*. The review should: § identify principles for setting user charges, including efficiency considerations such as the management of demand and capacity § identify equity considerations which may suggest alternative levels for user charges § identify instances where user charges should include a premium to reflect any external costs imposed on others, such as pollution under the 'polluter-pays' principle § benchmark all user charges against these principles § suggest a mechanism for the regular centralised review and revision of user charges.
13.17	Phase in an adjustment of RailCorp fares to those allowed under the IPART determination in order to provide an appropriate level of user contribution as distinct from tax payer funding.
13.18	Review of the zonal structure of public transport fares, including the number and size of zones and the extent to which fares reflect distance travelled and set out and maintain a target level of user contributions to efficient operating costs.
13.19	Implementation of co-payments for a range of non-hospital services such as dental, community health and ambulance services, with appropriate concessions for low income earners.
Tax expenditures and concessions	
13.20	Removal of tax concessions for clubs, applying the same tax rates as for hotels.
13.21	Imposition of land tax on primary producers, with provisions for a gradual transition.
13.22	Investigate imposing payroll tax on hospitals, when national reforms of health funding are finalised, in order to ensure competitive neutrality.
National Partnerships	
13.23	Supporting the implementation of the recommendations of the Heads of Treasuries review of National Partnerships.

14 AN ECONOMIC DEVELOPMENT STRATEGY

Key points

- States do not have the role or ability to undertake macroeconomic management and hence are limited to influencing the state economy through the supply side. Microeconomic and structural reforms not only improve the performance of the state economy over the longer term, but also improve revenue performance and reduce the demand for social services expenditure.
- Committing to an explicit Economic Development Strategy (EDS) will help focus and discipline efforts to strengthen the NSW economy and help deliver on the Government's commitments to rebuild the state economy. A consistent, predictable and appropriate approach to government economic policies can also build confidence among household and private sector investors.
- Economic growth depends on population, participation and productivity (the three Ps). The ultimate goal of the EDS should be to improve the welfare of NSW residents through measures that enhance the productivity of the NSW economy and increase labour force participation.
- Given the limited policy levers of state governments, this can best be achieved by supporting competition-enhancing reforms and reducing the regulatory burden on the economy, thereby encouraging growth and mobility of private investment and human capital. At the same time, the EDS should provide a framework for assessing direct government assistance (expenditure or subsidies) to selected sectors and providing such assistance only where this is justified on the basis of comprehensive cost-benefit analysis. This would help minimise risks and opportunity costs associated with poorly designed government interventions.
- Private investment has not performed as well in NSW as in other states in recent years. Under-supply of new housing is the most prominent indicator of NSW private investment lagging behind the rest of Australia. The current NSW planning system is not sufficiently responsive to the economics that drive development and investment decisions. The EDS should recognise that the vast majority of decisions that determine the location of employment and housing are made by individuals and businesses, not government.
- The EDS should aim to provide a framework and underlying principles, and adequate review processes for government decisions and policies across a broad range of programs including industry development, agriculture, environment and vocational education and training. To help drive reforms through the budget process and support the achievement of State Plan targets, NSW should use a program of regulatory reform, public-private dialogue and program or project specific initiatives, developed with the application of these underlying principles and review processes.

14.1 Why we need an Economic Development Strategy

An Economic Development Strategy (EDS) is needed because:

- ***It will provide the policy framework to guide policies directed at the goal of improving the welfare of NSW residents through measures that enhance the productivity and job-creating potential of the NSW economy.***

  Economic growth depends on population, participation and productivity. There are two ways that the Government can contribute to improved productivity. First, it can introduce productivity-enhancing measures within the public sector. Second, it can apply regulation, taxation, expenditure and other government interventions in ways that encourage private households and businesses to improve their own productivity. This chapter discusses measures to address the second approach; the first is the focus of other chapters.

- ***Assists the financial strategy, as a stronger NSW economy ultimately contributes to a stronger financial position for the State Government and improves its capacity to deliver public services.***

  A stronger economy leads to stronger state finances through improved state revenues and reduced demand for publicly funded social services (because more people are better off and earning income from gainful employment) and improves government capacity to fund public services. A strong overall fiscal position also improves the Government's capacity to withstand future fiscal shocks arising from factors outside its control (e.g. downturns in commodity, financial or export markets).

- ***Seeks to identify and address the reasons that NSW has underperformed economically relative to other states.***

  Real per capita growth of NSW gross state product broadly kept pace with other states until the start of the resources boom in 2003-04, but has not grown as quickly as other states in recent years. This is understandable in regard to the key resource states of Queensland and Western Australia, but is of concern when it also applies relative to Victoria which has less exposure to the resources sector than NSW. Real per capita growth in business investment has fallen behind the rest of Australia, particularly Victoria, since 2001.

  Sound and efficient investment is a key to productivity, employment and future economic growth because, on the supply side, it increases productive capacity and reduces bottlenecks while on the demand side it stimulates an increase in economic activity, which in turn starts a beneficial chain reaction that can generate activity greater than the original increase. Efficient investment is essential for the NSW economy to keep generating income well into the future (referred to as the 'investment multiplier' effect).

  The largest underperformance in NSW has been in housing investment over the past decade; today new housing supply in NSW is at record lows (see Chapter 6 for further details). There is an expectation the Government will address this issue. While states have no control over macroeconomic policy, they have some influence on supply-side levers which affect business investment, particularly state regulation of the use of land or economic activities within state borders (e.g. development approval processes that affect residential construction).

- ***Provides clarity on the economic policy levers at a state level.***

  The State Government is not responsible for macroeconomic management and has limited policy levers other than maintaining a sustainable fiscal position. Therefore economic policy goals should be realistic and achievable, with a clear focus on microeconomic reform. Many factors that impact on the economy (e.g. private business expectations and developments in global markets) are outside the Government's control, so expectations have to be managed. Simplistic 'solutions' that do not work (e.g. providing stamp duty concessions to stimulate housing simply increases housing prices and ignores the fundamental problem of housing supply) must be avoided because there is an opportunity cost associated with public funds.

- ***Provides a framework for assessing the full range of policies.***

  The EDS should aim to provide a framework and underlying principles, and adequate review processes for government decisions and policies which can be applied across a broad range of programs including industry development, agriculture, environment and vocational education and training.

  Many policies serve multiple objectives, though the primary objective relates to service delivery. As such, economic impacts are often secondary considerations and there is a risk of policies having unintended consequences for the economy. A poorly considered strategy, particularly one which does not take into account the actual policy levers available to the State Government, is not costless. Such a strategy could displace government funds from more efficient or higher-priority uses and result in wasted capital investment. Avoiding 'bad' policy and poor implementation is at least as important as identifying 'good' policy. Good process is essential in order to develop good policy, implement well and manage risks.

An EDS that provides a framework and governing principles for public sector economic policies and programs will provide a consistent basis for:

- enhancing competition and improving productivity and employment
- reducing the costs of doing business in NSW
- helping make the best and most efficient use of NSW's limited revenue
- supporting business and investor confidence
- achieving improved revenue growth to fund state services.

A well-developed EDS that pulls all of these considerations together will be welcomed by the business sector. It could be a component of a new State Plan, along with a services/social strategy, an environment strategy and a fiscal strategy.

14.2 What should feature in an Economic Development Strategy?

An EDS should include high-level statements setting out the Government's goals and aspirations for the NSW economy and regional development as well as provide clarity on the areas of Government responsibility that influence economic outcomes, positively and negatively. Above all, it should be a practical guide to shape the development of realistic and effective policies.

A state government can set some of the conditions for the economy, but its overall role in economic development is limited and economic growth is mainly driven by decisions of the private sector (both individuals and businesses). The EDS should include specific policies to be implemented over the Government's term in office, but should set realistic expectations about the contribution of those policies. It should also communicate that policy settings are designed to enhance NSW's capacity to evolve, adjust and to cope with change.

The strategy statement should recognise the importance of the Government's own actions in such areas as:

§ human services and social policy in supporting productivity and participation in employment

§ public investment in supporting economic growth, particularly in transport

§ more efficient government businesses to support reliable and cost efficient utility services.

The EDS should also outline changes that will improve the business environment in NSW, including:

§ an effective planning system that explicitly supports business and housing investment, while providing good due process to fully recognise local community interests

§ an efficient, pro-growth tax mix

§ the policies and actions that facilitate the growth of regional NSW

§ more competitive domestic markets assisted by more market-compatible regulations and standards

§ an effective industry and trade policy that helps support a dynamic and adaptable economy

§ positioning NSW to adjust to a lower carbon world and adapt to climate change

§ a workforce with the right skills and the flexibility to adjust in a globalised economy

§ efficient, effective, evidence-based regulatory policies including land-use planning

§ the decision processes that will facilitate all of the above.

Reforming the planning system and housing supply

Problems with the existing planning system

The Government's review of the *Environmental Planning and Assessment Act 1979* and associated regulations should focus on reducing uncertainty, incorporating economic principles, promoting flexible land use zones and amending anti-competitive planning regulations. This should help to address the issues of restrictive planning policies, poor approval processes and anti-competitive regulations that do not take account of market preferences. These issues can create high business rents, increase development costs, reduce the commercial feasibility of developments and result in higher prices faced by households.

The private sector has recently described NSW as 'the most difficult state in Australia' in which to do business[1]. The planning process can be highly complex and uncertain[2], while at the same time being highly prescriptive. In NSW, most land is zoned under a local environmental planning (LEP) instrument. Rules set out permissible uses, height controls, floor space ratio controls and flooding constraints. There is a tendency towards micro-regulation. For example, in 'enterprise corridors' there is a 200m^2 floor space limit on new business operations. The business sector considers that these regulations are convoluted and arbitrary, deter innovation, prevent relocation to meet changing market demands and undermine competition.

At the same time, the system is in many respects discretionary. Compliance with prescriptive rules and applicable development controls does not provide entitlement to approval. Decision makers can draw on a wide array of policies and regulations that may justify refusal of a development application. This lack of certainty can increase finance costs or make finance unavailable, or can encourage developers to take their business to other jurisdictions.

Businesses also cite delays in development approvals as costly, representing an additional disincentive for development. Despite some improvements since 2008-09, council determination of projects took an average of 67 days in 2009-10[3], compared with the legal benchmark of between 40 and 60 days. Delays of up to 365 days are common and some development approvals can take up to two years. For 'integrated' development requiring consideration by state agencies, decision making can be fragmented, inconsistent and slow.

There is potential for better regulations or increased competition to contribute to improved economic performance. For example:

- **Commercial development.** Commercial development in the Sydney central business district (CBD) could be even stronger if relatively restrictive controls on zoning, building heights, floor space ratios and micro regulations were relaxed. These factors are contributing to commercial rents costing $700 per square metre per year for prime grade space in the Sydney CBD[4], compared to $400 in Melbourne[5]. According to Knight Frank

---

1 P Abelson, *Economic Review of Urban Planning (Progress Report*), January 2011, p.9.
2 Urban Taskforce Australia, *Fixing Town Planning Laws*, September 2010, states that the *Environmental Planning and Assessment Act 1979* (EPA Act) has been amended on 122 occasions, and that there are 326 environmental planning instruments in force and hundreds of development control plans.
3 Department of Planning, *Local Development Performance Monitoring: 2009–10*, January 2011.
4 'Prime net commercial rents 2010', BIS Shrapnel, *Sydney Commercial Property 2010–2020 Update*, October 2010, p.24.
5 Net effective rents in Docklands, Property Council of Australia - Office Market Report Breakfast, 3 February 2011.

property, commercial rents in Sydney were the 11th most expensive in the world in 2009, exceeding those in London and New York[6].

- **Retail.** In the retail sector, the Australian Competition and Consumer Commission (ACCC) has found that town planning laws are limiting competition in grocery retailing[7]. In 2008, ACCC Chairman Allan Fels and co-authors found that restrictions on retail business development (e.g. hours of operation), lack of available sites due to rezoning and restrictions on store formats, were 'upholding anti-competitive processes that elsewhere would potentially be considered to be contravening the *Trade Practices Act*'[8,9].

  Such restrictions increase the prices of groceries and household goods[10], dampen productivity and result in losses of income**.** Fels et al. estimated that the adverse impact of planning regulation on retail productivity growth is in the order of 1-1.5 per cent per annum and that over 50 years the cost of these restrictions on retail competition is $52 billion to $78 billion in NSW gross state product (net present value terms)[11].

- **Housing.** In the housing sector, supply and affordability are important and challenging issues for governments to resolve. The private sector has pointed out that regulatory restrictions on higher density development, micro–regulations, slow and lengthy development approval processes and a lack of confidence in the predictability of planning regulations, have increased uncertainty and added risk premiums on development activity.

While there is no single dominant cause of the lack of housing production in NSW, these factors have contributed to a substantial decline in production in NSW compared to increases in other parts of Australia (Chapter 6 provides further discussion on housing supply trends in NSW and the rest of Australia). IPART notes that NSW housing supply has failed to keep up with housing demand and recommends that housing affordability be addressed not by demand-side measures (e.g. first home buyer tax concessions or subsidies) but by removing restrictions on the supply side. This is because demand subsidies exacerbate supply issues by attracting investors who may not otherwise have entered the market, ultimately forcing prices even higher and further depressing housing affordability[12].

The Metropolitan Plan

The current planning system is not aligned with market realities. While useful in setting parameters or general strategic directions, the existing Metropolitan Plan is not a sufficiently robust source on which to base critical infrastructure investment decisions. The Plan presents a desired scenario which future planning instruments and government investment may help promote, but not necessarily deliver.

---

6 Knight Frank, *2010 Global Real Estate Markets: Annual Review and Outlook*.

7 Australian Competition and Consumer Commission, *Inquiry into the Competitiveness of Retail Prices for Standard Groceries (August 2008)*.

8 A Fels, S Beare and S Szakiel, 2008, *Choice Free Zone*, Report prepared for Urban Taskforce Australia, p. 12.

9 For example, Aldi Stores argues that planning restrictions – including caps on retail sizes in certain zoning classifications – are significantly constraining their ability to expand and compete in NSW.

10 A Fels, S Beare and S Szakiel (2008), p.64, cites evidence that prices for food staples were on average 22 per cent higher, and household and personal care products were between 33 and 39 per cent higher in mid-priced stores than in large supermarkets that are often restricted by the planning system.

11 A Fels, S Beare and S Szakiel (2008), p. 13.

12 Independent Pricing and Regulatory Tribunal (2011), *Reform Priorities: Report to the NSW Government*, April 2011, pp.97-103.

For example, the Metropolitan Plan projected that 30 per cent of new housing would be in greenfield areas. However, current market evidence does not support this target. Over the last five years greenfield housing has averaged only 15 per cent of total production after a gradual decline over the last two decades. This decline has been influenced by land available for release, shifting home buyer preferences, the location of employment growth and the absolute distance of new release areas from the Sydney CBD (see Chapter 16 for further discussion on the need for a robust evidence base for infrastructure and metropolitan planning decisions).

The Metropolitan Plan also forecast that 50 per cent of jobs growth would be in Western Sydney, including 20 per cent in South Western Sydney (a 106 per cent increase to 2036), and that 20 per cent of new housing would be infill housing in current outer ring areas. By contrast, a Treasury analysis based on a commissioned report by BIS Shrapnel estimates employment growth will be strongest in the 'Global Economic Corridor' between Macquarie Park and the CBD, at around 50 per cent of total employment growth in Sydney to 2021.

The Metropolitan Plan appears to be a planner's view of what 'ought' to be rather than reflecting what households and businesses are likely to require. Property development and business location decisions are driven by private financial considerations rather than broad government aspirations of what NSW cities and towns should hypothetically look like. Future infrastructure investment decisions must therefore be based on the best economic evidence available. For this reason, the existing Metropolitan Plan should be reviewed to provide a proper foundation for state planning, including transport planning. This review should give proper weight to the role that market forces play in influencing the location of investment in housing and business.

Priorities for government action

The Government's establishment of the Planning Review Panel to review the NSW planning system will be one of the most critical early actions. The Government has also made policy commitments related to land release in Sydney and development contributions. Major transport projects, such as the north-west and south-west rail links, are key components of the Sydney Metropolitan Plan.

A good planning system should reflect and balance the concerns of local communities and the State as a whole by considering economic and non-economic factors. The Government has recognised the need for a reserve power to deal with some major projects because there will be situations where there is a clash between local and broader interests.

The previous Part 3A process, which sought to provide state-based accelerated consideration of major projects, played an economically significant role, approving over $19 billion worth of projects in 2009-10 alone. This is equivalent to around 20 per cent of total capital expenditure undertaken in NSW in that year. However, the use of Part 3A has been problematic because the absence of clear criteria for referrals led to an appearance of arbitrariness and lack of transparency. Having agreed to repeal Part 3A, the Government should avoid creating a hiatus around the processing of projects that would have been determined under Part 3A and should put in place as soon as possible a new system based on economic principles that define what should be seen as a state-significant development and appropriate evaluation processes and criteria.

Planning settings must be practical and transparent and must provide predictable and timely assessments. The vast majority of decisions that determine the location of employment and housing are made by individuals and businesses, not by government. The strengths of existing concentrations of economic activity should be built upon and not treated as imbalances, in particular Sydney's CBD and global economic corridor or 'global arc'[13].

Notwithstanding the importance of the regions, the future of the NSW economy is tied to the future of Sydney. Sydney is Australia's only truly global city. The City of Sydney Council[14] estimates that economic activity generated in the Sydney local government area in 2007-08 (including those parts of the global arc located within the Sydney City LGA) was about 8 per cent of the total Australian economy. BIS Shrapnel research into property investment industry intentions indicates that between 2010 and 2021 over 54 per cent of new office space will be created in Sydney's central region and over two-thirds will be in central Sydney and the north/north-east combined[15]. Speculative development outside this corridor is seen as too risky, and this is the market reality that planning settings and transport planning must recognise.

Early priorities should be to:

- Introduce a soundly based alternative to Part 3A which has clear, economically sound principles for identifying state-significant projects, as well as transparency and independence in respect to the assessment process. Part 3A is being repealed subject to transitional arrangements for certain projects already in the major projects assessment system under Part 3A. An alternative mechanism for new projects that require a broader assessment should be implemented well in advance of the broader review of the Environmental Planning and Assessment Act.
- Introduce, ahead of the review of the Environmental Planning and Assessment Act, a coordinated assessment and approval process that applies to all projects above a certain size that require multi-agency approvals, referrals or concurrences. In this regard, consideration should be given to approaches adopted in other jurisdictions, for example the Growth Management Initiative in Southeast Queensland and efforts to improve coordination between planning and referral bodies in Western Australia[16].
- Review the existing Metropolitan Plan to provide the basis for a new Transport Plan, giving proper weight to the role that market forces play in influencing location decisions.

Reducing the tax burden

The Government recognises the desirability of reducing the tax burden and is terminating the Torrens Assurance Levy and using payroll tax incentives to encourage new jobs.

The Henry Tax Review found that the current system of state taxes is economically inefficient and does not provide a sustainable basis for increasing levels of service delivery. Fundamental

---

13 The Sydney global arc refers to the corridor of concentrated jobs, transport infrastructure (e.g. the airport, the motorway focused on the Eastern Distributor) and economic activity from Macquarie Park through Chatswood, St Leonards, North Sydney and the Sydney CBD to Sydney Airport and Port Botany. Businesses in sectors such as finance, legal services, information technology, engineering and marketing are located within the arc.

14 http://www.cityofsydney.nsw.gov.au/AboutSydney/CityResearch/AtAGlance.asp

15 BIS Shrapnel, *Forecasting the Distribution of Dedicated Office Employment within Sydney*, February 2011, p.3.

16 Productivity Commission, *Performance Benchmarking of Australian Business Regulation: Planning, Zoning and Development Assessment*, April 2011.

tax reform, through replacing inefficient taxes that create economic and welfare losses with efficient taxes, would remove distortions that encourage unproductive activity and assist in promoting economic growth, underpin productivity improvements, reduce complexity and enhance the sustainability of increased levels of service delivery.

It is important that in any tax reforms, NSW maintains sufficient control over tax bases so it can adjust revenue to meet changes in economic circumstances and fund service delivery needs.

National-based reform could include expansion of broader-based national taxes to fund the repeal of inefficient state taxes.

A more efficient tax regime should contribute to increased productivity. However, any tax reform process should also be based on extensive stakeholder consultation. The Government should have a clear position before the Commonwealth Government's tax summit in October 2011. Chapter 13 provides further discussion on revenue reform.

More competition, better regulation

The EDS should clearly articulate the Government's commitment to competition as the key driver of productivity and economic growth. In order to sustain a strong economy, NSW needs to strive to produce an open-opportunity economic environment. While competition is not an end in itself, it is an efficient way of realising greater innovation and productivity and of encouraging initiative.

Many NSW regulations complicate business operations and stifle competition. The Government's proposed 'one on, two off' approach can help redress the balance, though it is only considering the flow and not the stock of regulation. There should also be a proactive program to address regulations and restrictions that impose unnecessary costs and sometimes hamper competition and growth potential. Many of these were introduced with insufficient regard to economic consequences (see examples in the discussion on 'Reforming the planning system and housing supply' above) and for other policy purposes. Areas for potential regulatory reform include the taxi industry, ferry services, pharmacies and environmental regulation.

For example, in relation to transport services:

- **Taxis.** While recent reforms allow the Department of Transport to set the number of new annual taxi licences, this is unlikely to drive performance change because entry is still effectively regulated through prohibitively high licence prices, which lead to unnecessarily high fares. The Government could consider an integrated reform package which over time leads to the removal of actual or de facto quantitative restrictions on the number of licences and a better governance model that removes conflicts of interest by allowing an independent regulator (rather than the taxi networks) to implement and monitor government regulations.
- **Ferries.** The Department of Transport has launched transitional arrangements leading towards private sector franchising of ferry services in Sydney Harbour, with the franchising process to be completed by the end of 2012. Deregulation measures (e.g.

addressing restrictions on wharf access at Circular Quay) are needed to complement this process.

Progress on national approaches to deregulation and cutting red tape has been slow. The latest wave of economic reform through COAG is far less ambitious than previous rounds. If a Commonwealth-directed approach continues to prove inadequate, state and territory proposals could be pursued through the Council for the Australian Federation.

While there will continue to be benefits in pursuing multilateral agreements that harmonise regulation and promote competition reforms, a state government can unilaterally promote appropriate competition within its boundaries. NSW's regulatory reform and gatekeeping arrangements will be critical to efforts to reduce the regulatory burden in NSW. Premier's Memorandum 2009-20 covers the Government's current regulatory policy, as embodied in the *Guide to Better Regulation*. The Guide requires all NSW Government agencies to comply with the better regulation requirements and quality standards for all new and amending regulatory proposals and demonstrate the application of the better regulation principles[17].

Application of the principles entails the preparation of a Better Regulation Statement (BRS) for significant new and amending proposals, which must be submitted with a Cabinet Minute or Executive Council Minute. A Regulatory Impact Statement (RIS) prepared under the *Subordinate Legislation Act 1989* may be completed in lieu of a BRS. The BRS or RIS provides information to enable portfolio ministers, the Premier and Cabinet to make an informed decision about a regulatory proposal and also provides information to business and the community. This ensures transparency and accountability in the regulatory development process. The BRS or RIS and supporting documents must be published on an agency's website after a Bill is introduced into Parliament or a Regulation is published on the NSW Government legislation website and should remain on the agency website while the regulation is in force[18].

The formal regulatory impact assessment process in NSW is not sufficiently robust or comprehensive. This is illustrated by Figure 14.1.1. In particular:

- While a BRS is required to consider multiple options in terms of their costs and benefits, the *Guide to Better Regulation* is not sufficiently rigorous in regard to the requirement to assess costs and benefits of a regulatory initiative. For example, the Guide presents the highly subjective methodology of multi-criteria analysis or 'balanced scorecard' approach as an alternative (rather than an adjunct) to comprehensive cost-benefit analysis.

- Regulation can arise through non-legislative processes (e.g. administrative changes) which are not explicitly the subject of existing gate-keeping arrangements (area D in Figure 14.1.1). Regulatory gate-keeping arrangements should therefore allow for the

[17] These principles are: (1) the need for government action should be established; (2) the objective of government action should be clear; (3) the impact of government action should be properly understood by considering the costs and benefits of a range of options, including non-regulatory options; (4) government action should be effective and proportional; (5) consultation with business and the community should inform regulatory development; (6) the simplification, repeal, reform or consolidation of existing regulation should be considered; and (7) regulation should be periodically reviewed and if necessary reformed to ensure its continued efficiency and effectiveness.

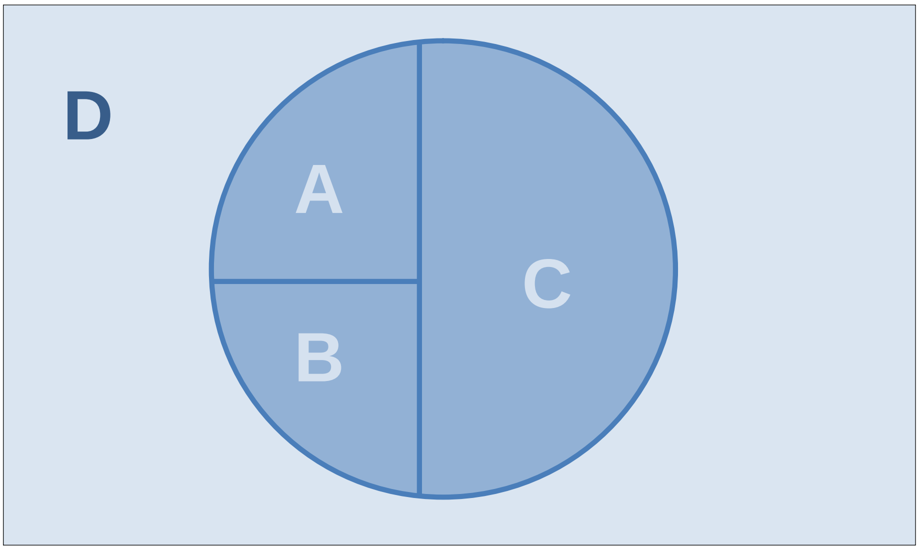
[18] The BRO's *Annual Update on Regulatory Reform 2009-10* reports that in 2009–10, the BRO assessed 160 Cabinet Minutes and 335 Executive Council proposals, of which 31 were considered as significant proposals that required either a BRS or an RIS. The BRO website provides links to 84 publicly available BRS and RIS documents dating back to 2008 (http://www.betterregulation.nsw.gov.au/better_regulation_requirements/published_better_regulation_statements).

provision of direct advice to Cabinet on any potential regulatory impacts associated with all Cabinet submissions, including those not necessarily arising from legislation.

§ Publications of the Better Regulation Office (BRO) suggest that, while the BRO reports on a broad range of regulatory matters, not all of its reviews necessarily take an explicit competition policy perspective.

§ Regulation Impact Statement requirements under the Subordinate Legislation Act (area C in Figure 14.1.1) require periodic (typically every five years or so) assessment of new statutory regulations and existing regulations. However, there is no equivalent legislative requirement for primary legislation, resulting in some primary legislation (area B in Figure 14.1.1) not being subject to periodic review. It would be desirable for the regulatory reform agenda to address this gap.

Figure 14.1.1: Areas covered by NSW regulation



Notes:

A+B = Regulation covered by **Primary** Legislation, where:

A = Primary legislation that contains provisions for periodic statutory reviews. A Better Regulation Statement (BRS) is required to be prepared for significant new and amending proposals.

B = Primary legislation that does not contain provisions for periodic statutory reviews.

C = Regulation covered by (existing or new) **Subordinate** Legislation, which is covered by the *Subordinate Legislation Act 1989*. This Act requires the preparation of a Regulatory Impact Statement before a statutory rule can be issued, and (except for specific statutory rules named in the Act) provides for repeal of a statutory rule five years after its publication. Schedule 1 of the Act sets out guidelines for assessing costs and benefits of the statutory rule and Schedule 2 sets out requirements for the preparation of an RIS.

A+B+C = All legislation.

D = Regulation that arises through **non-legislative** processes (e.g. administrative changes).

Areas A to D can all potentially affect competition.

Since the original 1995 National Competition Policy Agreement expired, there has been no initiative to systematically review legislation that has the specific effect of restricting competition. NSW should undertake such competition policy reviews on its own initiative (irrespective of any intergovernmental commitments), and periodic statutory reviews of NSW legislation provide the opportunity to do so.

A Regulatory Reform ministerial portfolio was created in April 2007. At the time, this provided a focal point for regulatory reform initiatives. While the BRO website states that the NSW Premier is now responsible for regulatory reform and for driving the NSW Government's regulatory reform agenda, this does not appear to be explicitly as Minister for Regulatory Reform.

Given the Premier's other substantial responsibilities, a case could be made for re-instituting an explicit ministerial position, or alternatively, allocating this responsibility to the Treasurer who is the Cabinet's key economic adviser. The success of the arrangement will be contingent on the willingness of the responsible minister to take a strong line at the Cabinet table. Ideally, the minister should be able to veto a proposal proceeding until regulatory impacts, including benefits realisation, have been satisfactorily addressed.

Targeted reviews into specific regulatory areas or industries with the potential for red tape reduction have been completed across a wide range of sectors in recent years. However, there is scope to improve the process for selecting areas for future targeted reviews and to make the process more transparent. This includes systematic procedures for consultation across Government and with business and consumer groups in identifying these areas.

The newly created Small Business Commissioner should have a mandate to identify regulatory imposts that create potentially significant costs for business. The Commissioner could make references to the BRO or IPART to undertake a regulatory impact assessment, which would investigate the scope for revising or removing the impost. More generally, competition policy reforms should be further promoted through references to IPART under section 12A of the IPART Act, which gives the Tribunal the power to investigate and report on any matter with respect to pricing, industry or competition that is referred to it by the Premier.

What is required to support the Economic Development Strategy (EDS) is a well-structured, prioritised regulatory reform program and a good process to ensure that regulatory reform commitments are implemented. Treasury, the Department of Premier (including the BRO) and the Department of Finance and Services will need to contribute to the development of a prioritised work program and provide institutional support for regulatory reform and assessment processes.

The Government has committed to Treasury undertaking a whole-of-government microeconomic reform advisory role and to it assisting the Government to meet its commitments to Council of Australian Governments (COAG) related competition policy reforms. To this end, a Microeconomic Reform Unit (MRU) is to be established in Treasury, with a work program that includes activities to address the issues identified above. One option for resourcing the MRU would be to transfer part or all of the BRO to Treasury. This would allow both the flow and the stock of regulations to be comprehensively reviewed.

Oversight and direction of the MRU could be undertaken by a Microeconomic Reform Advisory Board or similar economic body (possibly comprising independent members from academia and the private sector as well as government representatives) which would be responsible for formulating a microeconomic reform and competition policy agenda and reporting against that agenda on a periodic basis to the appropriate Cabinet committee.

Facilitating regional opportunities

The Government has a strong focus on regional NSW. The State and regional economies are in a continuous state of change. For regional development to be successful, it must complement market realities in a globalised world rather than seek to work against such market trends. The challenge is to create a virtuous circle of self-sustaining growth based on regional comparative advantages. The Government should also support communities adapting to unavoidable external changes such as climate change and shifts in global economic forces.

Appropriate economic and social infrastructure and services are important because they are part of the foundations of a region's economic base. However, like other policy areas, regional policy has to confront the challenge of limited resources. Not all activities are sustainable in all communities and it is difficult to decide what infrastructure is required and its best location.

The Government has committed to commencing, within its first 100 days, a council-by-council audit of the local infrastructure backlog. This audit, which has commenced and is being led by the Division of Local Government (within the Department of Premier and Cabinet) in consultation with the Department of Planning and Infrastructure, will need to develop a good process for determining priorities and avoiding raising unrealistic expectations.

The Government has indicated its intention to establish a Local Infrastructure Renewal Scheme providing interest subsidies to councils. It plans to allocate funding of $70 million over four years for this purpose. Such an interest subsidy is only one of a number of funding sources specifically to address an infrastructure backlog, and other options should be explored.

By itself, an interest subsidy may not suffice for the following reasons. First, there has not been an assessment undertaken as yet of the scale of the backlog and hence there is no basis for knowing whether the interest subsidy fund is sufficient. Second, many councils either follow a practice of not borrowing or do not have a rate base sufficient to generate an income stream to service debt; hence the interest subsidy will not assist these councils. Third, even with a subsidised interest rate, the current rate pegging system makes it difficult for councils to fund additional debt. It is proposed that in addition to access to the interest subsidy fund, councils be given greater flexibility under the rate pegging process operated by IPART to address infrastructure backlog funding.

Good process will support better decision making. Regional policy assessment processes should be evidence-based, sound and consistent. This will help the Government and affected communities to identify difficulties in advance and manage and mitigate risk through better designed policies. These processes should be outlined in the Economic Development Strategy.

More effective industry and trade policy

Industry assistance programs can lack a robust basis for evaluating and selecting projects, as well as the *ex post* assessment of results achieved. Often programs have multiple or unclear objectives that complicate assessment. This highlights the need for:

- a coherent and consistent process for assessing on an *ex ante* basis and prioritising government initiatives aimed at economic development. Among other things, this will entail stricter compliance with existing guidance on the preparation of business cases, the application of sufficiently rigorous cost-benefit analysis, adequate vetting/due diligence processes, rigorous value for money and public interest tests, benchmarking and adequate review processes to ensure accountability for funding

- systematic independent *ex post* evaluation of existing programs to determine whether they are still meeting their objectives and whether they should be redesigned, terminated or replaced by more appropriate and economically efficient interventions. For example, a program could be highly efficient, but if it is ineffective in achieving its objectives, or effective but no longer aligned with government priorities, funding should be re-allocated to other programs. The ongoing, systematic review of existing programs could also contribute to performance or process benchmarking to aid the design of future programs.

Chapter 15 of this report documents lessons from specific industry assistance programs recommended for review or redesign. It also makes recommendations regarding mechanisms for regular program effectiveness reviews, including the establishment of an Independent Evaluation Office.

The Government has indicated an intention to develop Industry Action Plans. The previous Government's industry plans were contained in the NSW Business Sector Growth Plan (BSGP) released in September 2010, which was developed by the NSW Innovation Council. The BSGP provides a reasonable starting point for developing future policy.

The Government's initial priorities include appointing a Parliamentary Secretary for Asia Pacific Trade and establishing Destination NSW. Given that State Government funding carries an opportunity cost[19], trade assistance should be based on programs whose net economic benefits have been demonstrated through rigorous cost-benefit analysis (*ex ante*) or post-evaluation (*ex post*), particularly as external trade promotion and incentives are largely a Commonwealth responsibility.

The Government should recommit to the Interstate Investment Co-operation Agreement which expires in September 2011 because this agreement institutes a useful process that helps to limit the extent of counterproductive bidding wars between the states. The Government is also

[19] For example, the Productivity Commission (2011) in *Trade and Assistance Review 2009-10*, p.1, noted that 'Although assistance generally benefits the firms or industries that receive it, it typically imposes costs on other sectors of the economy. For example, direct business subsidies increase returns to recipient firms and industries, but to fund the subsidies governments must increase taxes and charges, cut back on other spending, or borrow additional funds. Similarly, while tariffs provide some price relief to domestic producers, they result in higher input costs for other local businesses and higher prices for consumers, who then have less money to spend on other goods and services.'

commencing the development of a new convention and exhibition centre, and it is desirable that the centre is established and operated on a sound commercial basis.

Many industry policies in the past have attempted to meet multiple objectives without careful *a priori* assessment of costs and benefits. A policy approach with a single, well-defined, measurable objective is much more likely to be successful. The best guiding principles for industry policy are based on strong evidence that without government intervention, investment will be insufficient and that government can successfully and efficiently support that investment. There may be weaknesses in innovation, environmental and procurement markets, but sound assessment is essential to help ensure proposed actions advance the State's economic prospects.

Policy should be neutral with respect to industry structure implications. There should be independent evaluation of outcomes from major programs that provide industry assistance in any form, commencing with those programs recommended for review in Chapter 15.

Policy decisions should also reflect the current economic environment. The NSW economy is close to full employment. Government industry assistance is unlikely to reduce unemployment queues, but runs a real risk of favouring one (potentially viable) business or industry at the expense or inconvenience of other (established) businesses and industries. At a minimum, displacing employees from existing activities could be expected to inflate operating costs.

The EDS should outline a better framework for assessing industry assistance proposals. This should identify how assistance would help broaden development and be supported by thorough assessment processes. To enforce this discipline, the Government should budget for a fixed cap on funding for industry assistance and special events.

Positioning the NSW economy for climate change

Climate change mitigation and adaptation can potentially lead to significant economic restructuring[20]. Typically, climate change mitigation is best addressed at the national level, while climate change adaptation (being more location-specific) is best addressed at the state or local level.

Climate change policy should be part of an EDS. Many climate change programs are in substance industry subsidies and much of the climate change policy debate is focused on the need to create new jobs in 'clean' industries, including renewable energy.

Mitigation

The Government's appointment of a Parliamentary Secretary for Renewable Energy provides the opportunity to develop good policy approaches. Lessons can be drawn from the recent very significant program implementation failures that have occurred at both Commonwealth and state level. While the Government has stated that it does not support a carbon tax, the costs of abatement are likely to be lower from consistent Commonwealth Government abatement

---

[20] Climate change mitigation measures aim to tackle the causes of climate change (for example, reducing emissions of carbon dioxide and other greenhouse gases through, say, a national carbon price or emissions trading scheme), while climate change adaptation measures seek to promote adjustment to the effects of climate change (for example, building future coastal infrastructure to higher standards in order to deal with possible future increase in sea levels).

programs than from a continuation of the current hotchpotch of state and Commonwealth programs.

The high costs of the current approach have become much more visible in recent power price regulatory determinations. A recent assessment of climate change programs by the Grattan Institute highlighted that many programs that provide grants and rebates have not only been costly, but have failed to contribute additional abatement[21]. Programs that achieve meaningful emission reductions will necessarily increase the costs faced by industry and households. However, costly programs and programs that fail to produce significant additional abatement must be avoided.

State mitigation programs should only be pursued where they complement Commonwealth programs. The policy development and assessment process developed by IPART in its 2009 review of NSW's complementary programs should be utilised to help achieve this.

The Government previously indicated its intention to propose to the Tax Summit that the Commonwealth offset the impact of a carbon tax on household power bills. The Premier has called on the Commonwealth to meet the costs its renewable energy programs are imposing on electricity consumers. Notwithstanding these calls, the Government is committed to providing $250 rebates on power bills to low-income households. The Government should continue to try and maintain pressure on the Commonwealth, both to clearly assume primary responsibility for climate change mitigation and discharge consequential income support policies.

With the introduction of a national carbon tax, it is desirable that the NSW Greenhouse Gas Abatement Scheme (GGAS) be terminated. The NSW Government will need to negotiate compensation arrangements with the Commonwealth for GGAS participants who will be adversely impacted by the scheme's closure. NSW's trade-exposed, emissions-intensive industries (e.g. coal, aluminium and electricity generation) and regions with emissions-intensive economic structures (e.g. Hunter and Far West) will also require particular attention.

Adaptation

Adaptation to climate change is an important state government policy concern. However, because of the significant uncertainty associated with long term projections of climate change at a smaller than continental scale, it is considered inappropriate for state governments to carry all of the risks associated with climate change adaptation. For example, there is a risk that long-term responses, such as building public infrastructure to a much higher standard to withstand possible adverse effects of global warming, may result in those standards being set higher than necessary.

As this could prove costly to taxpayers, the Government needs to institute appropriate risk management and planning regimes to help avoid, manage and minimise the costs of adaptation. In particular, premature spending commitments related to 'strengthening' public infrastructure, or private parties strengthening their private infrastructure with implicit or explicit public subsidies, must be avoided. Governments, private individuals, households and firms will each have their respective roles to play in managing climate related risks. As a general

[21] J Daley and T Edis, *Learning the Hard Way: Australia's Policies to Reduce Emissions*, Grattan Institute, April 2011.

principle, those who bear the risk and benefit from reducing that risk (i.e. reduced damages) will be in the best position to manage a particular risk.

Linking training and development to the needs of the economy

Human resource development is an essential part of any economic development strategy. There is a direct link between productivity, on the one hand, and the quantity and quality of labour skills and a functional and responsive labour market, on the other.

The Commonwealth and the states do not have equal influence in all policy areas that affect labour productivity growth. The Commonwealth is responsible for welfare and benefit payments, employment policies and income taxation – all of which affect incentives for labour force participation. NSW is responsible for the regulation of labour practices within its borders (e.g. occupational licensing) and shares responsibility with the Commonwealth for the delivery of services to improve the quality of labour supply (e.g. vocational education and training).

Australian census data shows that for all age groups, labour force participation rates and labour force status increase as the level of educational attainment increases. Worldwide, research by the Organisation for Economic Co-operation and Development (OECD) shows there is a clear link between education and training and a country's labour market performance[22]. This is the basis for National Agreements and National Partnership Agreements agreed by COAG, which are aimed at boosting productivity and skills through vocational education and training programs.

Future education and training initiatives will need to be responsive to shifting demographics, notably the ageing of the labour force and future increases in age-dependency ratios. The ageing of the teacher labour force is an issue and challenge that affects the school education, vocational education and university sectors equally. For example, in NSW about 45 per cent of school teachers are aged 50 years or over, many of whom are expected to retire over the next seven years. The Government is implementing comprehensive workforce planning and initiatives (e.g. competitive teacher salaries, and comprehensive training and mentoring programs for new teachers) to retain experienced teachers and attract new teachers[23].

In regard to Vocational Education and Training (VET), while various reforms have been introduced in the past decade, the OECD in 2008 cited the persistence of various problems in the Australian VET sector. These included a serious problem with the ageing of the teacher labour force; a lack of clarity about Commonwealth and state responsibilities; funding principles not consistent with human capital policies and principles; difficulties with skills forecasting; data gaps or weaknesses; rigidity in apprenticeship training arrangements; and inefficient training package development and implementation processes[24]. The Commonwealth and states have made efforts in recent years to address these issues and improve the responsiveness of the VET system to the demands of a changing economy.

---

[22] Australian Census and OECD data cited in IPART, 2006, *Up-skilling NSW – How vocational education and training can help overcome skill shortages, improve labour market outcomes and raise economic growth,* pp.14-17.

[23] *NSW Auditor-General's Report to Parliament 2010, Volume 10 – focusing on Education and Communities,* section on Department of Education and Training, pp.112-114, provides further details on teacher age profile and turnover, initiatives for retention of teachers, and regional profile of highly accomplished teachers in NSW.

[24] K Hoeckel, S Field, D Justesen and M Kim, *Learning for Jobs: OECD Reviews of Vocational Education and Training - Australia*, November 2008, pp.12-13.

In January 2011[25], recommendations of an Expert Panel appointed by the Commonwealth Government included the redirection of current Commonwealth Government employer incentives to provide structured support services to eligible apprentices and trainees, and the promotion of a competency-based progression culture for apprentices (this recommendation was subsequently adopted in the 2011-12 Commonwealth Budget).

In May 2011, Skills Australia[26] recommended a reform of Australia's VET system to raise productivity and to address the skills challenges that threaten the nation's economic growth. Skills Australia recommended:

- a restructure of the incentives framework and a move to a more competitive system
- a nationally agreed entitlement to full, publicly funded places for individuals undertaking vocational courses up to and including Certificate III and all foundation skills courses
- the redirection of existing funding streams into an 'Enterprise Skills Investment Fund' where funds will be paid directly to enterprises, rather than being allocated to states and territories
- a reduction in the number of VET practitioners working under supervision and without a Certificate IV in Training and Assessment from 2011 (a similar recommendation was made in the recently released Productivity Commission Report on VET[27])
- progressively changing the public funding of registered training organisations from being input-based to output-outcome-based, to improve completion rates
- giving access to Commonwealth-supported places to VET providers offering specialist degrees with a vocational emphasis
- introducing individual and enterprise demand-based funding as a core feature of the next intergovernmental resourcing agreement for the sector, entitling individuals to public subsidies.

Measures in the 2011-12 Commonwealth Budget aim to encourage participation in work and training to meet the labour demands of the Australian economy. In order to improve economic growth and meet labour shortages, the Commonwealth Budget includes funding for:

- initiatives to support apprentices – including industry development strategies that enable apprentices to gain their qualifications sooner through competency-based training; and the mentoring of 40,000 apprentices to increase the apprenticeship completion rate
- the New Enterprise Incentive Scheme, which offers accredited small business training, business advice, mentoring and income support
- a National Workforce Development Fund to support enterprise-based training in skills shortage areas which includes supporting 130,000 new training places
- enhancing the skills levels and opportunities of older Australians.

To complement the Commonwealth's initiatives, priority should be given to TAFE Better Services reforms, including: productivity improvements to make TAFE more competitive with

---

[25] Expert Panel, *A shared responsibility – Apprenticeships for the 21st Century, Final report of the Expert Panel,* 31 January 2011.
[26] Skills Australia, *Skills for Prosperity: a roadmap for Vocational Education and Training*, May 2011.
[27] Productivity Commission *Research Report: Vocational Education and Training Workforce,* April 2011.

private providers; organisational reforms to streamline TAFE Institutes and enable them to control assets and explore rationalisation opportunities; and the restructure of some TAFE course offerings and the setting of more cost-reflective TAFE fees. These measures should help increase the responsiveness of VET services in shifting market demands for skilled labour.

In regard to school education, enhancing workforce participation and labour productivity will also require increasing the proportion of young people meeting basic literacy and numeracy standards and improving overall levels of achievement in school. An increasing number of students are staying on at school or are in training, in part reflecting legislation to increase the school leaving age. In 2010, the overall retention rate of all full-time students in NSW from Year 7 to Year 12 was 73 per cent – an improvement from 71 per cent in 2006.

NSW is currently performing well above the OECD average on international tests on literacy and numeracy, and is close to the Australian average. However, reports on the Program for International Student Assessment (PISA) for various years show that between 2000 and 2009, the decline in average PISA scores for reading and mathematics in NSW was greater than the declines for Australia and the OECD average[28]. The focus needs to be on improvements in teacher quality, improving achievement levels at the top and bottom end of the performance scale, and on improving the attainment levels of disadvantaged students to enable greater economic participation.

In regard to skills in the workplace, some anecdotal evidence in recent years suggests that skill shortages in some sectors (e.g. mining and construction) are having an adverse impact on output in the Australian economy. Low levels of language, literacy and numeracy levels have also been perceived to have a negative impact on Australia's workforce productivity. To help address this, the 2011-12 Commonwealth Budget aims to provide funding to assist people in attaining the basic skills of reading, writing and numeracy. TAFE Better Services reforms should also help address these needs.

In 2008, the Business Council of Australia pointed to a shortage of young people with the knowledge and skills required for many areas of demand in the Australian workforce[29]. The 2010 NSW Skill Shortage List of the Commonwealth Department of Education, Employment and Workplace Relations shows that NSW-wide skills shortages are particularly evident within technical and trades industries. For instance, shortages were identified in 29 of the 72 trades occupations examined.

NSW should continue to develop its education and training policies and programs to support improvement in school retention rates and should also fill the need for skills that are in short supply, where these programs are shown to provide positive net economic benefits.

[28] Data were sourced from the Australian Council for Education Research (ACER) Report on the 2009 PISA results and from the website of the NSW Department of Education and Training (https://www.det.nsw.edu.au/home/).

[29] Business Council of Australia media release in response to the Australian Government's discussion paper on reform directions for vocational education and training, 2 April 2008. See BCA website (http://www.bca.com.au/Content/101392.aspx).

14.3 Recommendations

The Financial Audit recommends:	
Economic Development Strategy	
14.1	The preparation and promulgation of an Economic Development Strategy through a Green Paper process to be led by the Treasurer.
Specific economic reform initiatives.	
14.2	The review of the *Environmental Planning and Assessment Act 1979* and associated regulations, focusing on incorporating economic principles, reducing uncertainty, promoting flexible land use zones and amending anti-competitive planning regulations that do not take into account market preferences.
14.3	A review and update be undertaken of the Metropolitan Plan as a matter of urgency to provide the necessary basis for a new Transport Plan as well as for broader Sydney region planning. This review should give proper weight to the role that market forces play in influencing the location of investment in housing and business.
14.4	A timely replacement for Part 3A of the *Environmental Planning and Assessment Act 1979* be implemented as a matter of priority with clear, economically sound principles for identifying state-significant projects and a transparent and independent decision making process.
14.5	A coordinated approval process be introduced for all projects above a certain scale – and involving multiple agency approvals – that draws upon approaches adopted in other jurisdictions, including the South-East Queensland Growth Management Initiative.
14.6	Noting the risk of continuing the rate pegging system, the State explores with IPART options to provide councils with greater financial flexibility.
14.7	High priority be given to regulatory reform and broadening of its scope to address gaps identified, including (but not limited to): § systematic review of significant new or existing primary legislation that currently have no statutory provision for periodic reviews (of the type mandated by the *Subordinate Legislation Act*) § systematic review of significant new or existing regulation in non-legislative forms § incorporating in the *Guide to Better Regulation* clearer guidance on the conduct of cost-benefit analysis of regulations § examining the scope to improve and make more transparent the process for selecting areas for future targeted reviews and improving dialogue with business and consumer groups. Further, that these tasks be undertaken by the newly established Microeconomic Reform Unit within Treasury under the supervision of an advisory board which will be responsible for formulating a microeconomic reform and competition policy agenda (encompassing the above tasks) and reporting periodically against that agenda to an appropriate Cabinet committee.
14.8	The application to industry assistance programs of a more consistent economically based process to assess and prioritise Government's initiatives for industry assistance on an *ex ante* basis (including stricter compliance with existing guidance on the preparation of business cases, the application of comprehensive cost-benefit analysis, rigorous value for money and public interest tests) and undertake systematic independent *ex post* evaluation of existing programs.
14.9	The State seek to ensure the Commonwealth takes primary responsibility for climate change mitigation and associated income support policies, with any state mitigation programs being complementary to Commonwealth programs. In turn, the NSW Greenhouse Gas Abatement Scheme (GGAS) be terminated with the introduction of a national carbon tax and/or emission trading scheme with Commonwealth compensation arrangements sought for GGAS participants.
14.10	NSW recommit to the existing Interstate Investment Cooperation Agreement which expires in September 2011.

The Financial Audit recommends:	
14.11	In support of human capital development, priority be given to Vocational Education and Training (VET) reforms including increasing contestability and productivity improvements to make TAFE more competitive with private providers.

15 REFORMING SERVICE DELIVERY

Key points

- The key principles proposed to underpin the reform of service provision are: proactive and innovative service provision; devolution of service delivery responsibility; good governance; efficient provision and pricing of services; regular effectiveness reviews; and transparency of performance and costs.
- Some existing high-level benchmarking suggests that service outcomes in NSW are in many areas equal to or better than other comparable jurisdictions, e.g. waiting time performance in healthcare. This is a counterpoint to other benchmarks where NSW underperforms or is more costly, such as road condition.
- Benchmarking should be more extensively employed to measure and assess performance in both the general government and public trading enterprise (PTE) sectors, including identifying appropriate agency performance benchmarks and establishing an ongoing process for trend analysis of benchmarks and more transparent reporting. However, benchmarking is only the first step. Identifying a variance in performance then requires analysis to identify the reason for the variance and how to address it.
- There has been considerable focus in recent years on achieving improvements in efficiency, which includes putting in place efficiency dividends, efficiency savings to offset wage increases above 2.5 per cent and whole-of-government initiatives to streamline corporate services.
- Collectively, the required savings across agencies relating to efficiency dividends, wage increase offsets and the whole-of-government information and communication technology (ICT) review builds to around $2.4 billion by the end of the forward estimates period (2014-15).
- A series of whole-of-government, government business and agency-specific expenditure reviews, conducted over the last 18 months by NSW Treasury under the Better Services and Value (BS&V) initiative, have identified various efficiency improvement opportunities across government and agencies.
- As well as the BS&V review opportunities, options to reduce the rate of expenditure growth are available through workforce and wages reforms; reprioritisation of program expenditure; previously planned efficiency measures and wage offsets; corporate and shared services reform savings; and various specific initiatives, including the Government’s election savings commitments such as the procurement reforms.

- The efficiency opportunities carry varying degrees of risk depending on the implementation complexity, stakeholder issues and level of confidence in the savings estimate. The Audit identifies specific reforms and opportunities across key policy areas that warrant further consideration or action by agencies and the Government.
- Recognising that there are key challenges in delivering extensive, complex and sensitive reform programs, a series of governance and accountability reforms will also be required across government to drive effective monitoring of agency budgets and the delivery of agency-specific and whole-of-government reforms and initiatives.
- Programs in the general government sector have often commenced without rigorous cost-benefit analysis and well-defined objectives, or continued without regular evaluations. Many programs have commenced as pilots without clear sunset arrangements for termination. In particular, concessions and community service obligations (CSOs) lack a process of regular reviews. A cohesive whole-of-government approach to determining concessions policy is also lacking.
- A review is needed of all CSOs and grants to ensure they are properly costed and effectively targeted by the relevant minister. The cost of concessions is expected to grow due to greater eligibility for concessions from the ageing and expanding population.
- An Independent Evaluation Office (IEO) should be established, overseen by a governance board drawn from academic institutions, the private sector, the Department of Premier and Cabinet and Treasury. The IEO should develop a program evaluation framework and establish rolling evaluations.
- Strict cost-benefit analysis requirements and guidelines should be introduced for new recurrent programs to enable the Government to make informed decisions. Program proposals for Cabinet consideration should be submitted, with business cases, in sufficient time to allow adequate review.

15.1 Overview: principles for effective service delivery

This chapter focuses on how to ensure that service programs are providing the right services in the right way at value for money to government. The first question to address is whether there is a case for public service provision which needs to be assessed by reference to the following considerations:

- whether there is evidence of market failure such that market provision does not achieve a socially desirable outcome, so justifying government funding.
- whether there are actual or potential service providers that could be contracted, so allowing the government to outsource the delivery of the service.

In the event that it is concluded that it is appropriate for government to provide and fund a service it is suggested that appropriate principles need to be established. The suggested principles are as follows:

1. **Proactive and innovative service provision:** there is strong evidence that a proactive approach in a wide range of areas, such as early intervention in dysfunctional families and early childhood programs, preventive health initiatives, mitigating the impacts of emerging mental illnesses and addressing recidivism, is far more effective and of lower cost over time than a reactive approach that addresses the problems at a later stage. The same considerations apply in other sectors, such as the environment.
2. **Devolution of service delivery:** locating the service delivery decision making as close as possible to the level of interface with clients will provide more responsive and effective service provision.
3. **Good governance:** good governance can produce better outcomes. An important example is the separation of purchaser from provider, with the purchaser having a focus on the needs of the client, uncompromised by the interests of the service provider and allowing for contestability in service provision.
4. **Efficient provision and pricing:** there is a need to regularly review services to ensure they are being provided in an efficient manner and that they are appropriately priced. Over time, technology changes and there are spatial changes in population and other factors that necessitate changes in the way services are provided. Similarly it is necessary to assess, from time to time, public versus private benefits generated by services and whether the pricing approach reflects this appropriately.
5. **Regular reviews of the effectiveness and appropriateness of programs:** programs need to be regularly assessed to determine if the objectives are still valid and the programs are achieving desired outcomes. There has been a lack of program evaluation in NSW in recent years.
6. **Transparency:** transparency is essential to inform clients, providers and the public about service delivery programs and their operation, and to provide an information base to assess efficiency and effectiveness.

The first three principles are concerned with how best to structure service provision, while the rest are concerned with ensuring high-level performance and value for money. Performance can be assessed at a number of levels and it is important to assess programs in terms of efficiency, effectiveness and appropriateness.

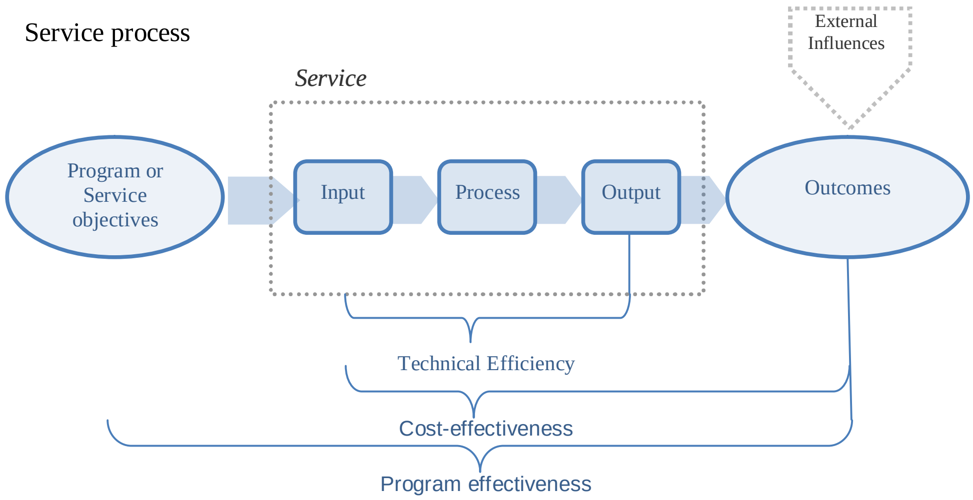
Efficiency is the relationship between inputs and outputs, seeking to achieve the maximum output for a given set of inputs – or to minimise inputs to achieve a given level of output. For example, the number of health procedures performed by a hospital relative to a given quantum of staff and resources.

Effectiveness is the relationship between the outputs produced and the outcomes achieved. Taking the example of the hospital, clearly the ultimate objective is not to undertake clinical procedures but to achieve a good health outcome measured by recovery and the attainment of quality living. A service could be very efficient but it may be quite ineffective in terms of achieving desired outcomes. There are two types of effectiveness: program effectiveness and cost effectiveness. Program effectiveness is the relationship between the program and the outcomes while cost effectiveness is the relationship between the cost of the inputs and the outcomes achieved.

Appropriateness is whether the program meets the priority needs of the community and is in accord with the Government's key priorities. A program could be both very efficient and effective but may not address key priorities of the community and government.

The following flow chart diagrammatically depicts the relationship between efficiency and effectiveness.

Figure 15.1.1 Service process flow chart



Source: Report on Government Services 2011, Steering Committee for the Review of Government Service Provision, volume 1.

15.2 Benchmarking service delivery

Benchmarking can be a powerful tool for identifying better practices and areas of relative under-performance in government services. Benchmarking can be snapshot analysis to identify immediate differences in comparative benchmarks, or review trends over a period of time, as in a longitudinal study.

Benchmarking data can be service inputs, outputs or outcomes, and be quantitative or qualitative, depending on the service being considered. However, access to suitable data can be an issue. To address this, government might form bilateral or multilateral agreements with other jurisdictions or the private sector.

Examples of benchmarking which have been used within agency expenditure reviews include:

§ Report on Government Services (ROGS), produced annually by the Productivity Commission, which predominantly focuses on social, justice, health and education outcomes

§ Council of Australian Governments Reform Council (CRC), which reports to COAG on state and territory performance against benchmarks specified in the six National Agreements

- Australian Bureau of Statistics (ABS) and other statistical reporting bodies like the Australian Institute of Health and Welfare (AIHW)
- Commonwealth Grants Commission (CGC), which compares per capita expenditure by policy areas on a standardised basis for the States and Territories to determine the allocation of federal GST revenue
- industry-specific benchmarking associations, e.g. Comet Nova for rail and Australian Council of Healthcare Standards (ACHS) for Health
- internal benchmarking within organisations, which can also be useful in identifying best practices or areas of relative under-performance, particularly when industry-specific benchmarking is not widely available, e.g. State of the Parks reporting in NSW.

Benchmarking can also be used to assess a function such as business regulation in the Productivity Commission's report *Performance Benchmarking of Australian Business Regulation: Planning, Zoning and Development Assessments*. However, it is important to note that benchmarking often has significant limitations, including:

- lack of comparability of services and institutional structures between jurisdictions, producing data that is not directly comparable. For example, in the education sector, comparison of staffing resources at a school level is difficult across jurisdictions due to differing staffing classifications, particularly in relation to non-teaching support staff
- timeliness concerns where data cleansing or comparability adjustments are made, resulting in the data often being released months or years later. For example, the 2011 ROGS report relates to health outcomes for the 2008-09 financial year
- difficulty of measuring outcomes, especially in the general government sector. Outcomes are inherently difficult to measure, not easily attributable to any particular intervention or take many years to emerge
- while benchmarking is useful in identifying differential performance and cost, it does not by itself identify the causes or solutions; this typically requires more rigorous analysis.

For these reasons, benchmarking is often best used to identify potential areas for further investigation, rather than to draw conclusions. With these caveats, the following benchmarking information provides examples of how NSW compares to other states in a number of key areas of service delivery.

Health

- NSW had the highest proportion of patients seen within national benchmarks for Emergency Department waiting times in 2009-10 at 73 per cent.
- NSW had the highest proportion of patients seen within recommended waiting times for elective surgery, with 91 per cent of patients treated within recommended times in 2008-09.
- In NSW, the average cost per separation – a measure of efficiency of services provided to patients who are admitted to hospital – was $4,557 in 2009-10

compared to a national average of $4,706, and for the first time was less than Victoria's average cost per separation of $4,591.

Education

- NSW national literacy and numeracy mean scores are higher than the national average in all tests and at all year levels except in Year 7 and Year 9 writing.
- The proportion of the 20- to 24-year-old population with a Year 12 education or equivalent is above the national average.
- The NSW Program for International Student Assessment (PISA) mean score of 516 points in 2009 for reading literacy was significantly higher than the OECD average of 493 points.
- The per-student cost at primary and secondary government schools is $700 higher in NSW than Victoria.
- TAFE teacher costs are significantly higher than other states and face-to-face hours are lower.

Rail

- Customer satisfaction levels in Sydney were 74 per cent, higher than both Brisbane and Melbourne.
- Peak On-time Running (OTR) in Sydney was 96 per cent, higher than Perth, Melbourne and Brisbane (though noting that there are inherent problems with comparability given differing definitions of OTR).

Police

- NSW Police receive fewer complaints per 100,000 people at a rate of 91.6 versus a national average of 92.3 per 100,000, compared to Victoria and Queensland at 130.1 and 104.2, respectively.
- Real recurrent expenditure on police services per head of population in NSW was $347, compared to a national average of $355. Victoria operates at $317 per head of population.

Courts and Corrective Services

- While NSW's cost per offender per day for custodial sentences is less than the national average at $270, this also reflects NSW's unusually high proportion of offenders housed in minimum-security facilities. Actions to encourage community-based sentencing for petty offenders or to reduce the number of remandees would be expected to raise this average cost.
- Court case clearance rates are greater in both the Supreme Court and District Courts that the overall national average.
- Cost per criminal case finalised for Local and Magistrates Courts are higher in NSW than the national average, at $550 versus $400.
- Cost per criminal case finalised for the Supreme Court is $29,000 versus a national average of $16,000 and $28,000 in Victoria.

- The NSW adult incarceration rate is now 181.5 per 100,000 people in custodial management. The 2009-10 national average was 169.1 per 100,000, but this encompasses a wide variance between low-incarceration states such as Victoria (105.2) and the ACT (68.3) and high-incarceration states such as WA (274.1) and the Northern Territory (655.8)[1].
- NSW's private prisons operate at about $107 per inmate per day, compared to the national average of $275 as listed in the Productivity Commission's Report on Government Services.

In a number of policy sectors, NSW has policy settings that drive up costs without apparently improving overall outcomes for the state. For example, the rate of incarceration of young people in juvenile justice centres in NSW is 49.3 per 100,000 people, compared with 33.8 nationally. This is driven by the State's policies for addressing crime and offending behaviour, and the sentencing policies of NSW Courts.

Policy settings in NSW, which emphasise investigation rather than supporting families, also result in more children being removed from their families, at 9.9 per 1,000 in NSW compared with 5.7 for the rest of Australia. Such settings have led to NSW spending substantially more per capita on Child Protection Services than all other states or territories except the Northern Territory and Queensland.

More detailed work is required to:

- identify appropriate benchmarks for NSW agency effectiveness and efficiency performance
- identify and examine areas of relative under-performance
- address real performance issues where found
- establish ongoing processes for more transparent reporting.

15.3 Proactive and innovative service provision

Proactive service provision can be categorised as policy or interventions that are anticipatory and intended to avoid or mitigate negative outcomes rather than react to negative events. This concept incorporates early intervention and prevention measures. Early intervention seeks to mitigate the extent of an emerging problem by treating it early (for example, early intervention in dysfunctional families to avoid removal of children from families), while prevention seeks to manage risk factors to prevent a negative outcome (for example, education as to the dangers of exposure to the sun and cigarette smoking to improve health outcomes).

Early intervention and prevention can require significant up-front resources, which may be required in advance of scaling back of acute services. There is a need for an appropriate balance to be met between proactive intervention to reduce future demands and providing services to address current demands. Not all early interventions will be cost effective and careful analysis is required to identify the optimal interventions.

Proactive interventions also imply a high level of investigation of risks and resultant preparedness. Proactive social policy interventions deal with an emerging or underlying

[1] Drawn from 5/6/11 Offender Population Report & Report on Government Services.

social problem in a timely and effective manner, rather than reacting at a later stage when the problem becomes fully established.

An important consideration in maximising the personal and societal outcomes from proactive social programs is the extent to which they enhance human and social capital. Human capital is broadly the stock of capabilities that enable an individual to be productive in the workplace and in society. These capabilities include educational (cognitive) skills and health status. Social capital is a related concept which may be thought of as an ability to interact with other members of society and is associated with better functioning communities and higher individual satisfaction with life.

Enhanced human and social capital improves individual wellbeing and can translate to broader social and economic benefits. For instance, many studies have focused on the impact of health on employment participation. Chronic illnesses in Australia account for a loss of some 600,000 full-time equivalent workers a year, which is similar to the number of unemployed workers.

Another key area for building human capital is education. For example, investment in teacher quality, discussed later in this section, can have a marked effect on human capital and long-term economic outcomes. It is estimated that a student with a teacher in the top 10 per cent of teachers in the country could achieve in half a year what a student with a teacher in the bottom 10 per cent of effectiveness achieves in a full year[2].

Enhancing human and social capital should therefore be a particular focus for proactive social programs, given the potential for individuals to derive greater benefits from being more employable and the wider economic benefits that flow from this.

Empirical studies indicate that higher levels of education attainment are strongly associated with significant future returns to the economy through increased productivity and participation. Various studies estimate the impact of a one standard deviation increase in test scores on GDP growth to be of the order of 1 per cent[3].

Areas of social policy that lend themselves to proactive NSW Government responses include:

- early intervention in dysfunctional families and early childhood programs
- effective health risk assessment and triage
- preventative health initiatives
- improving outcomes for Aboriginal people
- mitigating the impacts of emerging mental illness
- preventing re-offending
- preventing homelessness

---

[2] Leigh, A., *Disconnected*, University of New South Wales Press, Sydney (2010), as quoted by Applied Economics – An Economic Assessment of Human and Social Capital Interventions, prepared for NSW Treasury, January 2011.

[3] Applied Economics – An Economic Assessment of Human and Social Capital Interventions, prepared for NSW Treasury, January 2011. (This notes that macroeconomic studies have estimated that an increase in cognitive skills of one standard deviation would increase GDP growth by an amount in the order of 1% per annum (see, most recently, Hanushek and Woessman (2010) whose point estimate is 1.864%; see also the survey in Jensen (2010) of eight studies giving results generally between 0.6% and 2%)).

- delaying entry to residential care for people with a disability cared for at home
- improving the quality of teaching and support for children with low literacy or numeracy skills
- reducing truancy and encouraging school retention.

Proactive policy and services are likely to be characterised by all or some of the following features:

- a results- and outcomes-focused outlook, with clear policy and program goals, including development of human and social capital
- an analytical, integrated approach
  - use of environmental scanning and scenario modelling to identify emerging risks and their seriousness, using a broad range of professional disciplines (such as economics, science, sociology, medicine and psychology) to design interventions
  - cooperation between policy makers and service delivery organisations to identify options for program and policy improvements, supported by professional program management
- extensive use of evidence
  - a commitment to evidence-based policy and practice with clear calculation of program costs and benefits
  - rigorous program evaluation and adjustment of failing programs, with benchmarking of outcomes with similar programs elsewhere
- a focus on incentives
  - assessment of incentives within programs and identification of unintended consequences from policy and programs, with incentives for positive program performance
  - price signals and positive psychology to promote required change with clear sanctions where appropriate.

Proactive social policy would also be supported by a number of tools and approaches such as those discussed in the next section.

Recommended proactive social policy interventions

Early intervention

Early intervention programs may include home visits by professionals, parent education and training, quality child care and preschool, family support, school-based programs and community-wide interventions[4].

There is a substantial body of research which supports the basic premises underlying early childhood interventions, such as a 2004 meta-analysis of early intervention programs, which found a cost-benefit return of 2.36 to 1[5].

At the earliest stage, there is evidence that fetal drug and alcohol spectrum disorders (FDASDs) are potentially very important contributors to utilisation of the State's social provision safety nets and reduced productivity. A study in the United States found that even 'expensive' fetal alcohol syndrome prevention may be cost effective. After implementing a state-wide register of FDASD infants, the most useful pro-active behavioural intervention identified was an education program about alcohol and drug use as risk factors.

Interventions to support nurturing family environments are critical for children's life outcomes and to reduce the risk of entry to out-of-home care. This is particularly important in NSW given that the rate per 1,000 of children aged 0 to 17 years in out-of-home care is above the national average and is more than twice the rate in Victoria[6].

For less serious cases of childhood neglect, access to quality early childhood education may be the main intervention that is required along with parental education. Quality pre-school is likely to improve children's social and cognitive skills and help make up for gaps in the quality of care at home. Ensuring affordable and accessible access to quality pre-school for children in this situation therefore remains a priority.

Across early intervention for children there is a need for rigorous assessment of program effectiveness, as well as sound tools to assess need and match clients to the right programs.

Improving mental health

Mental illness is common in Australia, with one in five Australians experiencing a mental illness at some stage in their lives. Prevalence (including substance use disorder) is greatest among 18 to 24 year olds (27 per cent) while prevalence among people 65 years and over is 6.1 per cent.

Mental disorders are the third leading cause of disability burden in Australia, accounting for an estimated 27 per cent of the total years lost due to disability[5]. Major depression accounts for more days lost to illness than almost any other physical or mental disorder. Mitigating the impacts of mental illness therefore has great potential to enhance people's human and social capital, including their ability to participate in employment.

Mental illness also results in pressure on emergency departments, which could be reduced by better management of mental illness at the community level. The 'NSW and

---

4 Queensland Council of Social Services 2007, 'Cost effectiveness of early intervention programs for Queensland'.
5 Aos, S. et al. 2004, 'Benefits and costs of prevention and early intervention programs for youth', Washington State Institute for Public Policy, Olympia, WA.
6 Productivity Report on Government Services 2011, Table 15A.5, 2009-10 data.

Community Mental Health Strategy 2007–2012: From Prevention and Early Intervention to Recovery' describes the model for community mental health services to be developed and delivered by 2012.

The link between mental illness and incarceration is also important. Better management of mental illness may have a positive impact on incarceration rates. In NSW, 54 per cent of women in prison and 39 per cent of men in prison have at some point in their lives been diagnosed by a medical doctor as having a 'psychiatric problem'[7] and many have attempted suicide.

The Stateside Mental Health Directorate in Justice Health provides comprehensive mental health care to offenders, young people and formal forensic patients in a range of settings. Referral to specialised mental health services is arranged through Justice Health centres.

A further issue is that in some cases, when mentally ill people appear before the courts, the magistrate or judge has limited referral options. In 2006, the Australian Parliament Senate Select Committee on Mental Health recommended that there should be a 'significant expansion of mental health courts and diversion programs, focused on keeping people with mental illness out of prison and supporting them with health, housing and employment services that will reduce offending behaviour and assist with recovery'.

The NSW State-Wide Court Liaison Service provides mentally ill offenders with court-based diversion options from the criminal justice system towards treatment in mental health facilities. One example is Biryani Cottage at Malabar, opened in March 1994. This provides an alternative to custody for female offenders with mental health disorders or mild intellectual disabilities who also have problems with abuse of alcohol or other drugs. The main focus of the Biryani program is to stabilise mental health and alcohol or drug issues and to help these women access long-term community rehabilitation programs and resources. The need for additional programs in this area, as well as their positive social outcomes and savings, should be investigated.

Treating mental illness and related issues in the younger population is important given its early intervention potential (including preventing crime and homelessness) and the prevalence of mental issues in the 18- to 24-year-old age group. One example is the headspace initiative[8], which is funded by the Commonwealth and private partners and offers health advice, support and information for young people aged 12 to 25. Scope for further reform of services for young people should be investigated in the context of the additional Commonwealth funding.

On June 2, the Minister for Mental Health Kevin Humphries launched the NSW Mental Health Taskforce. The taskforce will advise on how best to establish the new NSW Mental Health Commission. The Commission is to ensure that there is quarantined and accountable funding for mental health expenditure, and that resources are focused where they are needed most and through the most appropriate models of care.

---

7 Butler & Milner, NSW Inmate Health Survey, NSW Department of Corrective Services, 2003.

8 Details at http://www.headspace.org.au.

Improving teacher quality

Improving teacher effectiveness has a major impact on educational outcomes, economic growth and societal outcomes.

An increase in teacher effectiveness of 10 per cent would lift Australia's education systems into the highest performing group of countries in the world. In the longer term, this would improve the productivity of Australian workers and increase long-run economic growth. This is in addition to other benefits of better education to individual's wellbeing and society as a whole[9].

These estimates echo international research about the gaps in outcomes between students who have less-effective teachers and students who have highly effective teachers. For example, researchers found that an average eight-year-old student assigned three top-performing teachers in a row would outperform another average eight-year-old student by 53 percentile points by the time they reached the age of 11[10].

The Grattan Institute Report 'Investing in Our Teachers, Investing in Our Economy' summarises five main mechanisms to improve teacher effectiveness[11]:

1. improve the quality of applicants to the teaching profession
2. improve the quality of teachers' initial education and training
3. evaluate and provide feedback to develop teachers once they enter the profession and are working in our schools
4. recognise and reward effective teachers
5. move on ineffective teachers who have been unable to increase their effectiveness through development programs.

Research in the US and Australia indicates that there is a case for pay reforms, noting:

- the teaching profession does not reward individuals with ability and technical qualifications adequately compared to the non-teacher labour market
- the salary gap between teachers and non-teachers widens as the career progresses and the salary for teachers plateaus after 10 years
- teaching is becoming an increasingly financially attractive occupation for lower-aptitude individuals
- the basis of compensation for teachers does not provide meaningful incentives for teachers with a good track record to work in disadvantaged schools.

Various initiatives to improve teacher quality are being trialled under the Smarter Schools National Partnership. Key initiatives include a differential pay structure for excellent teachers (highly accomplished teachers), incentive payments for principals and para-professionals to support teachers, establishing Centres of Excellence (school sites to demonstrate and develop high-quality teaching practices) and providing teacher mentors to support new teachers.

---

9 Jensen, B., *Investing in Our Teachers, Investing in Our Economy* (Grattan Institute), 2010.
10 *Cumulative and Residual Effects of Teachers on Future Student Academic Achievement*, William L. Sanders and June C. Rivers, November 1996, University of Tennessee.
11 Jensen ibid, p.13.

The current pay for NSW teachers is based on seniority. There is a 13-step scale and in 2010, teacher salaries ranged between $42,000 and $82,000 per annum. Under the Smarter Schools National Partnerships, 100 new 'Highly Accomplished Teacher' (HAT) positions are being created with higher pay rates ($101,846 per annum) to teach in disadvantaged schools.

The Commonwealth has announced a bonus for teachers of about $8,100 for those with the most experience and around $5,400 for those in the first few years of their career. About 8,700 – or one in 10 – NSW teachers will be eligible for the bonus.

The strong evidence on teacher quality warrants investigation of further models that are focused on attracting and retaining good teachers in NSW.

Early intervention for homelessness

There is no single cause of homelessness. However, people 'at risk' of homelessness typically face multiple difficulties that may include domestic violence, mental health problems, poverty or drug and alcohol issues. Homelessness should not be viewed just as a 'housing' problem[12].

The four main pathways into homelessness are[13]:

- housing stress, often driven by poverty and accumulated debt
- family breakdown, often driven by domestic violence
- poor life transitions, including transitions from out-of-home care, prison or statutory care
- untreated metal health and substance abuse.

Prevention and early intervention initiatives that focus on key transition points and life events have been shown to be the most cost-effective in reducing homelessness. For example, analysis by the Australian Housing and Urban Research Institute (AHURI)[14] indicates that the cost of intervention is fully offset by whole-of-government savings gained through lower utilisation of health and justice services.

The NSW Government is committed under the National Partnership on Homelessness to achieving the following benchmark targets by 2013 (based on the ABS Census 2011):

- 7 per cent reduction in the overall level of homelessness to less than 97,350 people
- 25 per cent reduction in the number of people sleeping rough to less than 12,300 people or equivalent measure of six homeless people sleeping rough per 10,000 population
- by 2013, a decrease of a third to 6,300 Indigenous Australians who are homeless.

---

[12] Pleace, N, *Single homelessness as social exclusion: The unique and the extreme*. Social Policy & Administration, p.32, pp.46-59, 2008.
[13] Johnson, G., Gronda, H., & Coutts, S. *On the outside: pathways in and out of homelessness*. Melbourne: Australian Scholarly Publishing, 2008.
[14] *The Cost-effectiveness of homelessness: a first assessment*, AHURI Final Report No.119, June 2008.

Diversion of offenders

Programs to divert drug users and drug-related offenders from prisons developed from the late 1990s. This was driven by multiple factors, including an over-burdened criminal justice system and increased research showing that diversion could be a useful tool to address drug use and drug-related crime[15].

The NSW Drug Court was established in 1998. Eligible defendants are referred from other courts. Acceptance into the program results in a custodial remand for detoxification and assessment and each participant leaves with an individual treatment plan. Successful completion of the three-phase treatment program can take up to 12 months. If the program is not completed successfully the participant returns to court and may be re-sentenced.

NSW Magistrates can place defendants, whose offending may not be as significant as those entering the Drug Court and are likely to be granted bail, into the Magistrates Early Referral into Treatment (MERIT) program. MERIT involves completing compulsory treatment for drug or alcohol addiction as a condition of bail.

The NSW Court Referral of Eligible Defendants Into Treatment (CREDIT) program commenced as a trial program in Tamworth and Burwood Local Courts in August 2009. CREDIT aims to provide Local Court defendants with access to a wide range of treatment options and services to assist them to reduce their chance of re-offending. These may include assistance in areas such as accommodation, financial counselling, mental health assessment or drug and alcohol treatment. Defendants are referred to the program prior to entering a plea.

The Bureau of Crime Statistics and Research (BOCSAR) released a paper on the drug portion of MERIT in mid-2009. The report found that the re-offending rate for defendants who completed the program was 12 per cent lower than for those with drug problems who did not participate. BOCSAR is currently working on an analysis of CREDIT. BOCSAR is also seeking to analyse the alcohol portion of MERIT later this year.

These evaluations should be used to drive program improvements, including ensuring that all people likely to benefit from the programs can access them. Ensuring access is likely to improve human and social capital and reduce custodial costs over the long term. Evaluation of programs should also provide an input to debate within the community to both inform policy and assist the community to be better informed of important policy considerations.

Linking prison operation to reducing recidivism

Over $1 billion is invested in the system annually by the State. There is evidence that more effective prison management can have a positive impact on recidivism, thus providing both better individual and social outcomes, as well as reducing the cost of the prison system.

There is scope for contractual arrangements to incentivise better outcomes for prisoners. Under a program being piloted in Britain, a private-sector prison operator is

[15] *Best practice in the diversion of alcohol and other drug offenders: Proceedings of the ADCA diversion forum*. Canberra: Alcohol and other Drugs Council of Australia, 1996.

paid more for managing the Doncaster prison if it can cut the reoffending rate of released inmates. A similar approach is being trialled In New Zealand, with Serco about to take over Auckland's Mt Eden jail under a contract that also links its payment to reduction in the re-conviction rate for released prisoners.

Improved outcomes in recidivism should be included in contracting of prisons and in performance agreements for senior executives of government-operated prisons. Social impact bonds, discussed below, may be a relevant model here.

Social impact bond trials and program performance reform

A social impact bond is a financial instrument that makes a reward payment for social programs that achieve agreed social outcomes. It is suited to programs where the potential savings to government, due to achievement of the outcomes, exceed the cost of the reward payment. This delivers a net saving to government and ensures government only pays for services that have demonstrated positive outcomes.

Private investors contribute funding at the beginning of the bond and the reward payment is based on the achievement of agreed outcomes. Successful over-performance can trigger returns that are attractive to investors, though the major attraction to investors is to be associated with an innovative program with good social outcomes.

Moreover, non-government organisations (NGOs) can be innovative in how they achieve the designated outcome and benefit from a direct relationship with investors. Bonds also encourage greater use of evidence and evaluation of social programs and can act as a catalyst for new performance contracting mechanisms (as seen in the United Kingdom).

As social impact bonds do not prescribe how an outcome is achieved, they allow flexibility to change the service delivery in response to interim results. This encourages further innovation in service delivery and a continuous evaluation and improvement process. Areas where social impact bonds may be feasible include:

- preventing offending among juveniles and adults
- preventing entry to out-of-home care
- supporting people with a disability to be cared for at home for a longer time
- assisting people with a disability to transition to work
- supporting young people dealing with drug abuse or mental illness.

Social impact bonds

There is increasing international interest in the potential of social impact bonds. Social impact bonds involve an investor funding a social program, with the Government paying a reward for achievement of pre-agreed outcomes. Potential benefits include:

- government only pays for services that have a demonstrated positive outcome
- investors are able to make a social impact while receiving a financial return
- Non Government Organisations (NGOs) can be innovative in how they achieve the designated outcome and benefit from a direct relationship with investors
- encourages greater use of evidence and evaluation of social programs
- catalyst for new performance contracting mechanisms (as used in the UK).

A Centre for Social Impact (CSI) report released in February 2011 concluded that the social impact bonds concept is feasible in the NSW context and that NSW has the necessary market conditions to trial this new approach. The next step would involve seeking expressions of interest (EOIs) from NGOs that satisfy the key criteria for the development of a social impact bond.

The NSW Government should consider the merits of social impact bonds.

Given social impact bonds may employ innovative approaches and models, the NSW Government would need to be fully appraised of program risks before entering a social impact bond contract. Further, the social impact bond is a specific model but some of the principles might be applied more generally to service contracts.

For instance, if there is a formal audit function for the achievement of social impact bond targets, this might be extended to allow audit of outcomes from new service contracts with NGOs that include performance payments or other rewards in recognition of achieving agreed outcomes. Other rewards might include automatic contract extension or expansion of services.

Social impact bonds and enhanced program outcome measurement might also offer a way of ensuring that people are able to exit social programs (such as training to support workforce participation for people with a disability) once they have met the program goals. This is important to keep programs outcome-focused and to reduce welfare dependency.

NSW should also consider adopting other innovative social policy approaches such as Mindspace UK (based on behavioural economics) and experimental economics (experimental economics is a relatively new tool which examines actions and behaviour of individuals under different set ups and conditions, in the attempt to analyse the implications of such actions and behaviour for economic development and growth).

These approaches could be part of a greater emphasis on delivering services that are designed to respond to complex human needs and motivations, along with quantitative evaluation of effectiveness. This also ties into greater use of rigorous evaluation such as randomised control trials. Some issues that may lend themselves to a greater focus from behavioural economics and quantitative evaluation of effectiveness include:

- public alcohol abuse and related violence

- obesity
- juvenile crime
- truancy and improving school retention, e.g. breakfast clubs
- tenant-supported maintenance programs (building social and economic capital)
- prevention and management of chronic disease
- the functioning of Aboriginal communities.

Some of these approaches may also lend themselves to implementation under the social impact bond model. There may also be scope for behavioural economics based models to build human and social capital.

15.4 Devolution

There are strong grounds for believing that devolution of responsibility and accountability to the local level, where there is direct interaction with clients, creates a much more effective approach to service provision. The alternative model involves keeping the full range of responsibilities at a head office corporate level, adopting in effect a whole-of-state or perhaps a broad regional model. This has, for example, been the traditional approach in both school education and health, though in the case of health there has been a move over the years to a regional model based around the concept of a network of hospitals and other health facilities.

There will always be various functions that should be located at a central level in order to achieve a consistency of approach and to exploit economies of scale. An example in education is curriculum development, while health examples include policy and public health. Common to both areas is centralised purchasing.

However, at the service provision level there is a strong case for devolving further responsibility and accountability, including control of resources. Key benefits of such an approach include:

- allowing decisions on the most effective way to deliver services to be decided at the local level, having regard to local conditions and circumstances
- allowing head office corporate cost savings to be achieved that benefit both the Budget and local service provision
- enabling the delivery of services that are more responsive to client needs.

Case Study – Better Schools

The Better Schools Pilot, which began operating in 2010-11 at 47 schools, is designed to provide increased flexibility and authority for principals, staff and their school communities. It is also designed to provide the opportunity to enhance capacity to manage resources locally for the benefit of students. The initiative is part of the Commonwealth National Partnership on Teacher Quality Reward Reform 4: ‘Increased local decision making about recruitment, staffing and budget’, and is consistent with OECD research indicating a correlation between increased local management capacity and improved learning outcomes for students.

In August 2009, the former NSW Department of Education and Training invited all NSW schools to submit an expression of interest (EOI) in participating in a pilot program aimed at increasing local decision making about recruitment, staffing and budgeting. Before submitting an EOI, principals were asked to consult with their staff, parents and citizens, and/or School Councils to get their support. Following advice from Regional Directors and Senior Officers, 47 schools representing all school types from across NSW were chosen.

Principals joined the pilot as it provided an opportunity for flexibility, preparing for the future of schooling and greater control of finance and staffing within their schools.

The pilot consists of five distinct but interdependent streams:

- capacity building
- improvements to existing business systems
- more operational flexibility
- policies and procedures
- evaluation.

Effective management, quality service delivery, ensuring ever better student outcomes and implementing change are all important day-to-day tasks for all those who work in schools. The pilot is an attempt to provide schools with the opportunity to more closely match their resource capacity to their students' needs. Anticipated benefits include:

- setting up a new approach to schools' budgeting that includes funding for staff costs and other resources
- driving a culture change towards more financial and human resource responsibility in operating schools

Devolution of responsibility and accountability to the local level is also occurring within Health through the creation of local health districts, discussed later in this chapter. Scope for devolving operations across other areas of government should also be explored.

It is also possible to devolve at the client level by moving away from a centralised approach in the delivery of human services towards an emphasis on autonomy and choice of individual clients. These approaches include the potential use of vouchers, providing information on service providers and their effectiveness, individualised packages of care in the disability and health sectors, and giving consumers a choice when matching services to their needs. This greater role for clients requires a significant organisational and cultural change to facilitate informed decision making at the client level and among service providers.

There is evidence to show that empowering clients with individualised funding packages can provide better client outcomes and reduce long-term costs for some health and disability services (discussed later in this chapter under Section 15.9).

Rationalisation of regional locations

There are three levels of rationalisation of regional locations to consider: the co-location of government agencies in regional areas, combined with devolution or rebalancing of authorities between regional and central offices to arrive at optimal resourcing; and improved focusing the delivery of expensive specialist services.

Historically, the expansion of government service delivery across most of NSW has been more focused on providing services than gaining benefits from integrated planning across various government departments. This has resulted in numerous instances where regional areas are serviced by multiple government departments, each operating from individual offices that often have idle accommodation capacity. Co-location of government departments provides an approach for government to achieve savings without changing service specifics.

Co-location approaches are already in place within NSW metropolitan areas as accommodation utilisation can more easily be managed by the State Property Authority within both leased and government-owned buildings. Other jurisdictions have also successfully undertaken co-location programs, such as South Australia where government regions were harmonised across departments, with multiple locations across departments.

The second rationalisation opportunity with respect to regional location is for specialist facilities that are in multiple locations and are experiencing changes in demand or facing supply-side factors that make the current configuration less than optimal. For example:

- agriculture research centres in a large number of regional locations dilutes economies of scale and face large numbers of staff retirements with difficulties to fund suitable staff replacement. The key objective of effective agricultural research is compromised by the secondary objective of maintaining a regional presence
- schools of a relatively small scale in close proximity to larger schools. The closure of these schools would provide students with a greater range of curriculum choice as well as achieving financial savings
- police station manning that no longer reflects the current crime situation. There is at present a degree of rigidity in transferring police resources from areas of lower need to areas of higher need
- hospitals with less than optimum scale in certain procedures, which creates a safety issue as well as costing more than a more efficient hospital located within reasonable proximity.

15.5 Good governance

Governance frameworks influence how the objectives of government service delivery are set and achieved, so that risks are managed and performance is optimised. Implementing the most appropriate governance framework in areas such as purchaser-provider arrangements, funding and decision making is necessary to ensure effective service provision and productivity.

Governance frameworks are necessarily multi-layered:

- Commonwealth-State relations for relevant services and projects
- central agency and line agency interactions

- line agencies which may also include decentralised or regional delivery requirements, along with provision of services through purchaser-provider arrangements.

Service delivery across NSW has some historical examples of policy backflips, cost blowouts and delayed delivery exacerbated by poor governance arrangements. The issue is generally not that government lacks robust processes for the appraisal, selection and oversight of services and projects, but that these processes are not always fully adhered to, particularly where public pressure for action sometimes encouraged decisions to be made with inadequate evidence and assessment.

As outlined in the preceding section, devolution is one key mechanism for shifting responsibility for service delivery to a local level where the provider is closer to the needs of the population. However, under a devolved model there is still a need to eliminate unnecessary duplication for successful service delivery administration arrangements. Moreover, devolution of service delivery requires sound governance arrangements and a refocus of the role of departments in setting performance requirements, monitoring, and managing performance and purchasing services to meet goals most cost effectively.

Good, effective governance can also be supported through strengthened financial management across agencies. In particular, application of strategic financial management, combined with clear accountability for budget control, can enhance resource allocation decisions and budget management within all agencies. For example, agency reviews have recommended that the role and profile of agency Chief Financial Officers be elevated, moving them away from the traditional financial accountant function to that of corporate financial strategist.

Agency finance areas should be optimised through: an appropriate mix of staff trained in financial (including strategic) management, internal finance reporting and accountability disciplines; more robust financial management systems, processes and decision making tools; and improved data to support decision making at all levels.

As highlighted in the preceding section, it is also possible to encourage greater budget ownership and responsibility through the decentralisation of authority and accountability.

Leveraging synergies across cultural institutions

Within NSW there are specific governance challenges due to the diverse range of organisations and structures providing services in arts, sports and recreation for the community. The differing structure of these agencies has historically raised a range of governance concerns. The recent restructure of this sector has separated the arts functions from the sport, recreation and community functions but has not fully addressed the governance concerns.

Case study – Arts, culture, sports, recreation and communities

State sporting, recreation and arts organisations are governed by separate trust boards which constrained the capacity of the former Communities NSW (and will continue to constrain the respective new principal departments) to reprioritise spending across the portfolio. The separation of trust boards has also enabled these boards to directly report and lobby the Minister and/or Premier regarding agency funding proposals. While this allows for outcomes that may be in the individual trusts' interests, it precludes a coordinated approach across the portfolio, which may have achieved a better and more effective outcome.

Across various cultural institutions there is a lack of cross entity co-operation to achieve synergies, in particular for shared services, procurement and back office functions. Activities such as facilities maintenance, cleaning, security, insurance, procurement of goods and services, collections management, digitisation, cataloguing and conducting exhibitions across various entities are not well coordinated, with this disaggregation leading to inefficiencies and higher costs.

A range of grant programs (e.g. sporting and cultural) estimated at around $150 million in 2010-11 has been managed without common systems, processes and resources to administer major grants. Additionally, the programs quite often have not operated within budget, therefore requiring budget supplementations during the year.[

There are eleven sporting centres and accommodation facilities, 10 of which operate at a loss. However, the Government does not need to deliver sports and recreation programs or operate and manage sport and recreation centres that can easily be serviced by alternative providers.

Historically, there has also been significant uncoordinated government spending on stadia made in the absence of a robust framework. A Major Stadia Strategy needs to be developed to manage the State's stadia needs cost effectively.

Greater use of contracting and purchaser-provider relationships within the communities sector would improve the focus on core functions.

Funding arrangements are another key area for governance reform. Funds could be tied to specified service outcomes, instead of being provided as untied funds. This would enhance transparency, financial control and accountability in the achievement of specific outcomes. Untied funding does not provide a clear distinction between efficient service delivery and the actual cost of services, resulting in more funding for inefficient services.

Streamlining FaCS

The recent formation of the Department of Family and Community Services (FaCS) has provided an opportunity for governance reform within family and community services by integrating and streamlining the delivery of services to vulnerable households.

Examples of possible improvements are combining all head office functions, eliminating duplication and decentralising service delivery administration. Such changes would assist FaCS in integrating regional planning and regional boundaries by:

- reducing the duplication across a wide range of activities, including policy development, finance, IT, HR, asset management and asset/recurrent procurement
- decentralising all service administration functions which can be delivered in a regional framework.

FaCS could also adopt organisational design principles based on creating a client-centric, flexible and responsive organisation, with a minimum number of layers from the Director-General to the client and with devolved decision making. Currently, management levels and spans of control vary significantly across the Ageing, Disability and Home Care, Community Services and Housing divisions of FaCS.

Purchaser-provider separation

The traditional public service delivery model involves a government agency setting policy, developing and funding programs, delivering services and assessing results. An alternative model – purchaser-provider – separates out the role of purchaser and funder from that of the service provider. This approach has a number of advantages:

- requires the purchasing entity to focus on the needs of the population it wishes to service, unconstrained and uninfluenced by considerations of the service producer – this enables the services to be designed having regard to the needs of the clients rather than the interests of the producer
- creates the need for a well-defined service contract, including how to assess performance
- enables an objective assessment of performance to be undertaken
- facilitates the creation of a contestable market in service provision, with the ability to tap into a range of service providers, including those in the private sector and NGOs, and allowing for benchmarking.

Government purchasing authorities can contract for a mix of services that best meets the interests of their populations and uses their buying power. Released from the role of providing services, purchasing authorities are able to design service provision which spans across traditional service boundaries and maintains independence between the interests of users and providers. This ensures services are designed with the interest of users first – rather than the interests of providers – and places a focus on managing contracts with the most cost-effective forms of service delivery.

Defining outcomes and creating competition between service providers is central to the perceived benefits of purchaser-provider models of service delivery. In particular, the ability to clarify roles and responsibilities helps improve responsiveness to clients.

NSW Health

Case Study – NSW Health

The private health sector is well developed in NSW. Private hospitals provide approximately 65 per cent of elective surgery and there is extensive private provision of diagnostic and laboratory services. There are also private suppliers of support services (e.g. linen, clinical waste, cleaning, food). Contracting with the private health sector also provides an alternative and complementary means of expanding health services to meet community needs and can help to resolve access issues.

The move to greater use of purchaser-provider models within NSW Health is also an inevitable consequence of national health reforms, with the Commonwealth moving to fund 50 per cent of efficient growth in hospital services using Activity Based Funding. NSW will be responsible for health system management through service agreements negotiated with autonomous board-controlled Local Health Districts (LHDs) which will manage hospital and other health services and promote the health needs of its residents. A key objective for establishing LHDs is to give local communities and clinicians a greater say in the delivery of their local health services. Transparent governance and reporting frameworks will need to be established to ensure accountability for service provision by LHDs. This will need to be coupled with a strong central purchasing function within NSW Health in order to deliver efficiencies and improved value for money.

This clearer distinction between NSW Health as the purchaser and LHDs as providers will open the door to greater use of economic levers such as activity-based funding, pay-for-performance incentives, contracts with private sector and other performance-oriented funding arrangements. These economic levers, in conjunction with quality improvement programs, will help to deliver better health outcomes and value for money.

NSW Health has developed a Performance and Management Framework that provides a basis on which to build its purchasing and stewardship role and inform the negotiation of service level agreements with LHDs. The framework identifies performance targets, a monitoring cycle and an escalation/de-escalation process for poor performing LHDs. Importantly, financial performance is given equivalent weight to non-financial performance.

NSW Health has also developed and is implementing an activity-based funding model called Episode Funding that covers acute in-patients, emergency departments, intensive care and designated sub-acute and non-acute services. Under the national health reforms, the use of activity-based funding will expand to include outpatients, community-based sub-acute and non-acute care and mental health. This will mean that around 80 per cent of NSW Health expenditure will eventually be met through activity-based funding models.

Activity-based funding will provide better information on the services delivered and enable benchmarking costs across a range of providers. This can be used by NSW Health when negotiating activity-based funding with LHDs, and by LHDs when setting internal activity-based budgets for local hospitals. Purchasers will also be able to use activity-based funding to purchase services from non-government organisations (NGOs) and private providers of health services, where this can help to address access issues and to promote more efficient service delivery.

Activity-based funding can be used by purchasers to address significant cost variations within the State’s health system. These variations are reported in the NSW Health Services Comparison Data Book 2008-09 from NSW Health, which includes the average cost for acute activity measured using diagnostic related groups (DRGs). For example, the difference between the highest and lowest cost for the State’s teaching hospitals was $1,400, with Royal North Shore reporting an average cost of $3,300 per cost-weighted separation and Westmead $4,720.

Out-of-Home Care Program

The Department of Family and Community Services (FaCS) already contracts with NGOs for delivery of some out-of-home care (OOHC) places, but is still responsible for the provision of the majority of OOHC services. Both the Wood Inquiry in 2008 and the Usher Review in 1992 recommended that service provision should be undertaken by the NGO sector and cited the inherent conflict in being both a funder and provider of services:

> *…the appropriate, long-term role for the Department of Community Services should be to assess and review service needs, negotiate contracts with service providers, and to monitor standards, and to ensure programme and financial accountability on the part of service providers. The Department should not continue to operate as a major substitute care provider. Such activity by the State Government seriously compromises its proper assessment, contracting, review and monitoring roles in relation to the provision of services…*[16]*.*

The Government has committed to continuing the transition of OOHC services to the NGO sector. Currently less than 20 per cent of OOHC places are provided by NGOs.

The crisis nature of OOHC has required that government, through FaCS, remain as a the current provider of last resort. The direct provision of this service from FaCS will reduce during the transition period as greater use of purchaser-provider arrangements with NGOs are put into place. To minimise potential conflict during this transition period there must be clear separation of the service provision role from the responsibility for the purchasing of services within the organisation.

However, before there can be an expansion in contracting with NGOs, it is necessary to address a number of major deficiencies in the current approach to contracting with the NGOs. One reason why NGO places have been relatively expensive is the high level of underutilisation of paid places. Better contract purchasing, matching of placements with need, and performance management would improve utilisation.

Variability in unit costs has also been a concern. For example, the unit cost of some NGO General Foster Care places can be double the cost of a place provided by Community Services for a child with the same assessed level of needs. It is unclear the degree to which the child's outcomes are improved by receiving the higher cost place and whether this represents value for money for the taxpayer. It is also questionable on equity grounds whether such variability is acceptable.

Within the context of significant increases in both numbers of children and variability of OOHC unit costs, a review of the system was undertaken in 2009, which led to reforms in early 2010 focusing on:

- reducing entry to OOHC by providing more family support services
- increasing exits from OOHC by providing more family restoration and adoption services and reviewing non-statutory cases to ensure only those children and young people at genuine risk of harm remain in OOHC

[16] NSW Ministerial Committee, 'A Report to the Minister for Health and Community Services from the Committee established to review Substitute Care Services in NSW' *(Usher Review)*, 1992, p4 and the 'Special Commission of Inquiry into Child Protection Services in NSW' *(Wood Inquiry),* 2008, p656.

- reducing unit costs through NGO contract reform, with additional potential savings from reducing contingencies and allowances to be considered.

These have not been fully or effectively implemented. Failure to achieve the anticipated outcomes could result in additional costs of up to $500 million over the forward estimates period.

Further skills and capacity building within FaCS is required for it to effectively undertake the contract function and to be an effective purchaser. FACS should identify and establish this required expertise as a priority, along with more aggressive reform of the broader NGO engagement model across FaCS. A task force has been set up to review all aspects of the engagement model, including contracting, monitoring and reporting, capacity building and skills and capabilities, as well as separation of purchaser/provider roles.

Public transport costs

Within the transport sector, the combination of high expenditure growth and poor productivity in government-provided transport services reflects at least in part poor governance arrangements.

There is significant evidence that productivity levels are below achievable benchmarks. For example:

- RailCorp employee expenses have increased by 9.3 per cent per annum since 2006-07. Wages growth has been 4 per cent per annum, while headcount within RailCorp has grown by 20 per cent since 2007 (mainly train drivers, specialist engineering trades and apprentices), which has driven growth in overall employee expenses.
- The IPART 2009 review of rail benchmarked RailCorp's costs as being $600 million per annum higher than comparative railway operators. A number of reforms were identified by LEK Consulting and have been subsequently implemented by RailCorp, though there is much more that needs to be done. Some of the efficiency opportunities identified within the report will require policy changes (e.g. driver-only trains).
- Station costs per passenger are 75 per cent higher than Melbourne, double that of Queensland (City train) and 2.5 times higher than the CometNova international benchmark average for similarly sized rail systems.
- The RTA has over 7,000 employees, compared to 3,000 in the comparable organisation in Victoria. This cannot be explained by either population (30 per cent higher) or asset base (which is roughly equal with 21,000 kilometres of roads in NSW, and 22,300 kilometres in Victoria).
- The smoothness of NSW roads or overall ride quality was 89 per cent, which was below Queensland (93 per cent) and Western Australia (98 per cent). However, these are not offset by lower costs, with the NSW Roads and Traffic Authority (RTA) spending $6,340 per lane km on road roughness maintenance against the larger states' average of $4,000.
- Sydney Ferries staff members enjoy premium wages and operating conditions – including generous annual leave (10 weeks) and pay levels upwards of 30 per

cent higher than for similar semi-skilled work. Sydney Ferries' average income per employee was $99,000 in 2007-08, compared to $62,500 for the State Transit Authority (STA).

Remedying these deficiencies would require reforming operational practices and public-sector governance frameworks in the shorter term. In the longer term, evidence from other jurisdictions suggests that contracting out aspects of the transport system has generally proven more successful than attempts to reform public agencies within existing structural frameworks.

Inefficiency in the transport sector reflects a number of factors, including:

§ limited labour capacity and an inflexible labour force, resulting in over-reliance on the use of long-term contractors for day-to-day operations, ultimately leading to higher operational costs

§ limited productivity improvements achieved through complex and inflexible industrial relations processes

§ dated work practices across the whole sector

§ a tendency to apply a 'no losers' condition when introducing change, such as in the implementation of new fare structures, changed bus routes or ceasing uneconomic services

§ a general resistance to structural change despite significant potential for financial savings and/or efficiency gains – for example, contracting out the operation of ferry services or rail maintenance

§ growth in demand, which has tended to be met by investment in the system and hence higher operating costs, rather than using more effective demand management practices.

Reflecting this range of deficiencies, transport monopolies are under pressure to shift to greater use of purchaser-provider arrangements. The transport sector is hampered by a deficit building cycle of low labour productivity, misallocation of capital and low fares. The lack of economic efficiency and ineffective use of scare resources in turn contributes to ongoing service delivery challenges and risks to state finances.

Recent modelling by Treasury, based on historical expenditure trends and RailCorp's own projections, suggests a growing gap of $190 million per annum by 2014-15 between operating expenses and existing approved Budget support. For the RTA, modelling suggests a growing funding gap of $260 million per annum by 2014-15.

Case study – Transport expenditure growth

Public transport services within NSW have seen substantial growth in public funding, which has exceeded budget revenue growth in recent years. For instance, RailCorp funding has increased from $1.64 billion to $2.3 billion (5.9 per cent per annum) between 2004-05 and 2009-10, while grants to Sydney Ferries have nearly doubled from $44 million to $84 million (11.25 per cent per annum) over the same period.

Significant capital expenditure in recent years and inefficient asset management has also led to calls for increased maintenance expenditure. The RTA has requested an additional $300 million in recurrent allocations and $125 million in capital allocations per annum for maintenance operations ($4.25 billion total over 10 years). RailCorp has also requested an additional $1.12 billion over the forward estimates period, predominantly for maintenance activity.

This situation has been exacerbated by static fare box revenue in recent years, driven by weak demand during the global financial crisis and deferred fare rises. RailCorp's cost recovery has fallen from 23.2 per cent to 21.5 per cent since 2008, while Sydney Ferries' cost recovery has fallen from 37.3 per cent to 33.6 per cent over the same period.

Recent restructuring of the transport sector opens up the opportunity for market-based approaches. The introduction of bus contracting in 2005 was an example of this.

Case study – Department of Transport bus contracts

The Department of Transport (DoT) currently has 15 contracts with private bus operators in the Sydney Metropolitan Area and 10 contracts with regional bus operators. As the purchaser of public bus transport services, the DoT stipulates the service outcomes required from the private bus operators. These include bus routes, fare schedules and timetables, safety standards and accreditation, information management systems and the requirement for a complaints register.

Payments from the DoT are tied to specific service outcomes (such as on-time running and transport in special events), resulting in transparency and operating performance incentives for private bus operators. If private bus operators fail to meet the set service outcomes, the contract could be terminated and given to another private bus operator. Contestability is also increased by allowing leases of buses and bus depots to be transferred to successor operators. This reduces barriers to market entry and increases competition for the market, though any future competitive contracting should adjust for benefits enjoyed by any incumbent operator to ensure a level playing field during the contracting process.

Private bus operators are commercial entities which are required to efficiently deliver the agreed services outcomes or face bankruptcy. This element is noticeably absent from traditional government-owned transport providers, where there is moral hazard in that inefficiency can be rewarded with greater public subsidies. The separation of government ownership and service provision also reduces potential interference in operational service delivery, which could reduce accountability and create inefficiencies.

The recently created Integrated Transport Authority within the Department of Transport Cluster is a first step in expanding the purchaser-provider model. By centralising transport sector policy and procurement functions, it allows front-line transport agencies to focus on service delivery outcomes under the direction of a central body.

Historically, the DoT has established service contracts with public sector transport agencies. However, these contracts have been incomplete and contain limited incentives to improve service delivery. The lack of these elements may potentially compromise accountability and transparency, and hinder the efficient delivery of transport services.

As part of establishing the Integrated Transport Authority, the DoT should reform the governance framework through:

- Corporatising key transport delivery agencies. This would formalise their relationship with the DoT and the Government generally, and ensure a separation between government as 'owner' of these agencies as opposed to the Government as a 'client' of these businesses. This allows the corporatised agencies to be treated on the same footing as any other transport providers that are privately owned.

- Developing arm's-length service delivery contracts between the DoT and delivery agencies, with funding following a defined set of service outcomes at efficient cost. This will help make it transparent which funding is provided for service provision, as opposed to funding that is provided to subsidise inefficiency or in support of social policy objectives.

Within the transport sector, a purchaser-provider model would clarify accountability and improve incentives for the efficient management of individual transport operators. Once implemented, it would be easier for the Government to purchase services from private transport operators in the future, where it judged this would lead to better outcomes.

Improved approach to contracting of services

Experience elsewhere has shown that the most powerful driver of cost efficiency and improved service delivery has been the introduction of competition into the provision of public services.

To support agencies in their contracting of services, NSW Treasury has developed an economic framework which assesses agency service delivery and funding arrangements against economic principles. This economic framework has been applied during the expenditure review of a number of government agencies, which now guides future market testing of specific business functions in those agencies.

The primary consideration of the framework is that government should only be undertaking activities which are required of it, and that decisions about whether activities are funded from the Budget or through user charges should be guided by consideration of public versus private benefits.

This helps ensure that public funds are only directed to necessary areas of government delivery. The economic framework has been developed using principles of market failure and contestability models which consider the role of government in the performance of policy, regulatory activity and the provision of service.

Other important considerations are:

- the nature of market failures that drive government intervention and regulation
- whether contestable markets exist for comparable services
- whether the provision of an existing service by government would deliver greater public value if it was delivered by others outside of government.

At the same time, it is necessary to carefully design a contracting approach. The example of the NGO contracts in the OOHC area is an example of poor contract design.

Determining areas within general government to market test

During the expenditure review of the former Department of Services, Technology and Administration (which has since been amalgamated into the Department of Finance and Services), an assessment of their business activities against the Treasury economic framework determined that a number of areas should undergo market testing. Further detail on pricing analysis is included within the discussion of user charges in Chapter 13. Areas which have been identified for market testing within DSTA include:

- parts of NSW Public Works, including the Government Architect Office, along with Water Solutions
- the fleet management services of State Fleet
- State Records.

Similarly, during the review of the Land and Property Management Authority (LPMA), the expenditure review determined that a number of areas should be market tested including:

- Land and Property Information (LPI) information registers, spatial data and map products
- Crown Lands Division (CLD) management of services and land management tenures, along with their management of excess land disposal.

The objectives of these delivery and market reforms are to:

- increase the cost effectiveness (i.e. the productive efficiency) of service provision by increasing competitive pressures in markets that have historically been largely provided by public-sector monopolies
- improve the allocative efficiency of service provision by allowing service providers greater flexibility to respond to customer demand.

An important consideration in applying the economic framework was the setting of user charges and the need to ensure consistency with competitive neutrality principles.

Case study - Improving contestability of transport services

Sydney Ferries

A private contractor should be able to more effectively (and efficiently) deliver ferry services and reduce the growing $88 million subsidy requirement and defer upwards of $175 million of fleet replacement (to the extent a private operator is able to deploy existing spare capacity into scheduled ferry services). The operating costs of private ferries on Sydney Harbour are considerably less (for instance, it costs Sydney Ferries less to charter a fully crewed private vessel than to operate their own vessel). Private operators see significant potential to exploit Sydney Ferries' tourist traffic (50 per cent of patronage) and could also take on the risk of vessel provision and maintenance.

Franchising Sydney Ferries would require requesting tenders from potential operators to provide an agreed set of services, similar to how the DoT organises private bus providers in Sydney. DoT is currently progressing franchising of Sydney Ferries.

RailCorp

Structural reform of the rail sector would be complex and carry significant transactional costs and long lead times to implementation. In the first instance, a comprehensive outsourcing program for key functions at RailCorp would need to be implemented. In-house maintenance is being progressively replaced by private-sector provision at RailCorp, although an extensive internal capability is expected to remain.

The simplest franchise model for RailCorp would be to outsource the entire business as a single integrated operation. This is the model that has been followed in Melbourne. This has the advantage of maximising synergies and integration benefits but potentially reduces the competitive benefits.

Alternatively, vertical (functional) and horizontal (line of business) disaggregation might be considered.

Under vertical disaggregation, Government could retain revenue risk and outsource the operations on a fee for service basis. The rationale is that the Government is best able to manage revenue and patronage risk given Government controls many of the levers which influence revenue (for example - fares, competition options, subsidies etc).

The most appropriate horizontal separation would be to separate and franchise separately the CountryLink business from the CityRail business.

Detailed analysis would be required to determine which franchising approach was most suitable to RailCorp, dependent on the nature of its services and functions and its existing capabilities.

15.6 Efficient provision and pricing

Efficiency savings are achieved by either increasing the output for a given level of inputs or achieving the same output for a reduced level of inputs. As such, they do not impact on service provision.

Requirements for efficiencies have been imposed on all general government sector agencies. These are in two parts: an across-the-board productivity dividend of between 1 per cent per annum and 1.5 per cent per annum of controllable operating costs; and a requirement that any increase in wages above the level funded in the Budget (2.5 per cent per annum) must be funded by offsetting labour productivity improvements.

To help agencies achieve these savings in the most effective manner possible, the Better Services and Value initiative was established. This initiative involved central agencies working collaboratively with individual agencies to identify and then implement efficiency savings.

In addition to cost efficiency it is necessary to keep under review the appropriate pricing policy and specifically the balance between tax payer and user funding.

Explicit efficiency savings assumptions built into the forward estimates

The current forward estimates assume a slowdown over the period to 2014-15 of expenditure from the historic growth rate of 6.2 per cent per annum. This slowdown is largely underpinned by savings assumptions related to efficiency dividends and current wages policy:

- efficiency dividends were first introduced in the 2005-06 Budget and have been incorporated into subsequent budgets at 1 per cent in 2010-11, 1.5 per cent in 2011-12 and 2012-13, and 1 per cent in 2013-14
- since September 2007, agencies have been funded for wage increases of 2.5 per cent, with any increases above this to be met by agencies from employee-related savings
- a review of whole-of-government information and communications technology (ICT) expenditure allocated further savings across agencies.

Table 15.6.1 sets out the estimated aggregate savings targets for efficiency dividends and wages offsets from existing enterprise agreements as well as ICT savings incorporated into agencies' current forward estimates.

Table 15.6.1 Estimated savings incorporated into agency Forward Estimates

Increment v 2009-10 actual ($m)	2011-12	2012-13	2013-14	2014-15
Efficiency dividend	820	1,340	1,700	1,840
Wage offsets (current EBA only)	550	600	600	600
ICT review savings deducted from agency budgets*	85	85	85	TBD
	1,455	**2,025**	**2,385**	**2,440**

* The ICT review will deliver savings of $98 million in 2010-11, rising to $221 million in 2011-12, $228 million in 2012-13 and then $230 million per annum from 2013-14 onwards. The amounts reflected in this table are the proportion of savings deducted from agency budgets and placed in a central pool for reinvestment in strategic ICT initiatives that improve efficiency. Funding of the central pool has been applied up to 2013-14, with funding beyond this period yet to be determined. The remainder of the savings are retained by agencies.

Allocation of efficiency savings targets

In a well-functioning system, efficiency dividends can be an effective way of ensuring that government agency managers drive continuous productivity improvements in the same way managers do in the private sector. Key features of efficiency dividends are:

- agencies are responsible for finding and delivering the targets based on knowledge of their own business, thereby increasing the likelihood of success
- expenditure that is fully non-controllable by agencies is generally excluded from savings targets
- the dividend provides an ongoing incentive for agencies to operate efficiently and make further productivity gains, irrespective of their size
- the dividend captures both productive and allocative efficiency gains as savings arising from productivity gains are re-allocated to key government priorities.

Over the past 18 months, NSW Treasury has undertaken three broad streams of reviews under the general heading of the Better Services and Value initiative in collaboration with agencies and external consultants. These are:

- agency-specific expenditure reviews covering the full range of agency operations
- whole-of-government reviews of common functions such as ICT

- reviews of State owned corporations (SOCs) and government businesses.

In addition to these reviews, the Department of Premier and Cabinet (DPC) has led a whole-of-government corporate and shared services reform program. This function has now been transferred to the Department of Finance and Services (DFS).

The reviews have adopted the following overarching principles:

- the savings initiatives should result in no deterioration in service outcomes to the community; in many cases the savings initiatives actually have the potential to improve service outcomes
- the savings initiatives should be evidence-based
- reviews should be conducted collaboratively between the agencies/government businesses, Treasury and the consultants, with the agency/government business represented on all working groups and steering committees.

Many of the opportunities identified through the reviews reflect a few key themes that are common to several agencies:

- workforce flexibility and efficiency
- responsibility, transparency and evidence-based decision making
- decentralisation of authority and accountability
- modernisation of service delivery, especially in regional areas
- partnership, outsourcing and divestment, so the Government can focus on core tasks.

It is sometimes argued that efficiency dividends are tougher on smaller agencies, but there is no clear evidence of this. While smaller agencies may have less flexibility in some respects, they may also face less high-profile pressures. Analysis indicates that the budget performance and expenditure growth of small agencies is on average similar to that of larger agencies.

Monitoring and delivery of efficiency dividends and savings targets must be supported by a range of other tools. These include a robust process to interrogate agencies' base expenditure, periodic rebasing of agencies' budgets to reflect changing government policy priorities, a strong financial management framework that sets incentives to achieve efficiencies, and managerial capacity to implement efficiency measures, including changes to workforce management practices. These conditions have not been fully present in recent years. Reforms to provide these tools are discussed in other parts of this Audit.

Efficiency dividends are administratively simpler than variable savings targets. However, in general, the 'across the board' approach does not consider: the specific situation of every agency (other than Health which, unique among general government agencies, is able to retain all productivity savings to fund growth); their financial circumstances; or distinguish between agencies that are already lean and those that have further scope to increase efficiency.

While it is possible to allocate variable savings targets for agencies, a key challenge with this approach has been the information asymmetry between central and line agencies. This makes it difficult to gauge the fairness, achievability and acceptability of variable targets. Various expenditure reviews undertaken by Treasury over the past 18 months have partly assisted in addressing this asymmetry; the reviews have provided greater transparency on agency operations, financials and potential areas for efficiency improvement.

Proposed reforms and initiatives to strengthen the financial management framework, and create the infrastructure to track the implementation of efficiency savings (namely a network of agency-based Project Management Offices and a NSW Treasury-based Central Program Management Office) will introduce disciplines and processes to enhance transparency and reduce the information asymmetry between agencies and Treasury.

These reforms provide a basis to transition from general government sector-wide efficiency dividends to a more targeted approach to agency savings, with Treasury undertaking a program of rolling agency efficiency reviews which establish the specific savings targets. The focus of the reviews should be on the general government and non-commercial public trading enterprise sector. The recommendations in the report on reforms to the SOC governance and performance framework should be sufficient to deliver improved performance without the need for efficiency reviews.

Whole-of-government opportunities

Strategic whole-of-government expenditure reviews focus on discrete areas of expenditure with well-documented evidence to support reforms that achieve efficiencies and improve service delivery.

The reviews undertaken capture all general government agencies (i.e. budget and non-budget dependent) and public trading enterprises (PTEs), excluding State owned corporations (SOCs).

In 2009-10, Treasury conducted strategic reviews covering legal services and ICT.

Legal services

The legal services review examined drivers of legal expenditure by government agencies, including how legal services are purchased and monitored. Recommendations focused on improving procurement practices, development of the 'informed purchaser' model, training and information sharing for government lawyers, and centralised coordination of legal services.

It is expected that these initiatives will support annual savings of around $11.6 million.

ICT review

The ICT review is projected to deliver savings of $98 million in 2010-11, rising to $221 million in 2011-12, $228 million in 2012-13 and $230 million per annum from 2013-14 onwards. Around half of these savings will be retained by agencies to help them meet their efficiency dividend (all savings in the case of NSW Health) and the remainder placed in a central pool for reinvestment in strategic, efficiency-improving ICT projects that are allocated through a competitive bidding process.

Savings measures identified through the ICT review are: renegotiation of vendor contracts; reductions in internal ICT staff costs; use of contractors; consolidation of data centres, servers or virtualisation; improved efficiencies in voice and wide area networking; refinement of service levels; outsourcing opportunities; and amalgamation of services with other agencies.

In addition to the reviews of legal services and ICT, sector-wide reviews of telecommunications expenditure, use of purchasing cards and fleet services are also currently underway. These are detailed next.

Purchasing cards

This current review is seeking to identify efficiency improvements in procurement and payment processes for low-value, high-volume transactions through increased use of purchasing cards (Pcards) and other electronic payment processes. For example, the separate expenditure review of the Roads and Traffic Authority (RTA) identified significant savings by replacing the use of cheques for payments to vendors with electronic funds transfer (EFT) systems, and by introducing the use of Pcards for high-volume, low-risk, low-value purchases.

As part of this review, 26 agencies have been selected to be reviewed in detail and to form the foundation for extrapolation to the whole of government.

Fleet efficiency review

This current review is seeking to identify both immediate and long-term saving opportunities for whole-of-government vehicle fleet expenditure. The review will also identify policy and governance mechanisms to guide greater fleet efficiencies.

Telecommunications review

This review aims to ensure that NSW government agencies are being billed correctly, that redundant or unused services are removed, that telecommunication services are optimised and that costs are further reduced across government.

The review will also allow agencies and government to better understand what is available in the way of telecommunications services and improve value for money. The review is expected to be completed by July 2011 with a plan to implement the review recommendations by November 2011'.

Procurement reforms

As part of the Government's election priorities, a whole-of-government review will be undertaken on current government procurement, with a target to achieve savings of $1 billion over four years, starting in 2011-12.

The reform is to be driven through a policy of requiring departments to use whole-of-government contracts, unless local suppliers can offer better prices. The savings identified will be spent on new programs reflecting the Government's policy priorities.

The procurement reform will build on the current work of the State Contracts Control Board, Department of Finance and Services (DFS) and Treasury. The review will cover all general government agencies and non-commercial public trading enterprises.

Corporate and Shared Services reform

Corporate and Shared Services (CSS) (for example, HR, OH&S, ICT, legal services and procurement) are currently provided in a fragmented way across the public sector, with some provided internally and some through other government entities and departments. An overarching Blueprint on Corporate and Shared Services reform was released in March 2010.

The Blueprint aims to reduce back-office costs through consolidation to six core CSS providers across government within a three-year timeframe, down from the current 20 providers. The Blueprint will drive common standards and architecture across the CSS providers, underpinned by comprehensive benchmarking and centralised program monitoring.

Table 15.6.2 The six proposed CSS providers under the blueprint

Shared services provider	Agencies supported	Number of FTEs supported
ServiceFirst	Premier and Cabinet Finance and Services Treasury Trade and Investment Regional Infrastructure and Services Office of Communities	24,000
Businesslink	Department of Family and Community Services	22,623
Transport	Department of Transport RailCorp Roads and Traffic Authority Sydney Ferries State Transit Authority NSW Maritime Other related transport entities	27,964
Attorney General and Justice	Department of Attorney General and Justice (including Corrective Services and Juvenile Justice) Ministry for Police and Emergency Services (including NSW Police; Fire and Rescue NSW; Rural Fire Services; State Emergency Services and NSW Crime Commission)	37,865
Health Shared Services	Health	96,364
Education and Communities	Learning Management and Business Reform Shared Services (excluding Office of Communities)	99,599

Having six CSS providers may not be the optimal configuration. There is evidence that a smaller number would be more efficient, but it has been decided to start with six and closely assess performance with a view to possible further amalgamations.

In order to ensure a consistent, highly commercial and market-informed approach, it is proposed that a single commercial board be established to oversee the operations of all six CSS businesses. The board members should be independent and possess appropriate skills and experience.

Delivering the reforms

There are key challenges in delivering extensive, complex and sensitive reform programs, including stakeholder management, reform sequencing, strong oversight and ensuring the workforce has the resources, skills and tools required. Reforms to workforce management policies and the financial management framework will be a precondition for successful delivery of most of these reforms.

Setting clear agency savings targets as part of the 2011-12 Budget process and ensuring ministerial and CEO accountability for meeting those targets will be key to implementing and achieving the reforms. Agencies will need to develop savings plans, drawing on appropriate opportunities identified through BSV reviews and elsewhere, noting that for the more significant reforms, further verification and implementation planning will be required.

Inter-jurisdictional experience shows that sequencing of reforms can be critical to the success of major change programs. Agency plans should consider not only technical issues such as dependencies between projects and availability of resources, but also broader issues such as how early reforms shape the stakeholder environment for further improvements. On key issues such as workforce reforms, central government will need to ensure inter-agency coordination.

The successful delivery of reform also depends on the effectiveness of program and project management, and the availability of targeted reporting to best support governance.

Ongoing support will also be needed, including clear project governance, transparent progress reporting and support from central agencies. Agencies are likely to require new skills and system investments to deliver some reforms. It is proposed that Program Management Offices (PMOs) be established in agencies to facilitate, monitor and report on realising the planning, implementation and benefits of the reforms, and help drive discipline, provide support and ensure consistent use of best practices in project management. This has already commenced for larger agencies.

Complementing the establishment of PMOs in agencies, it is proposed that Treasury establish a Central Project Management Office (CPMO) focused on overseeing reform initiatives and savings plans across all agencies. The CPMO should provide aggregated, whole-of-government reporting, the content of which is derived from agency PMO reporting. To drive consistency, the CPMO should set minimum standards, tools and methods for program management. It should also ensure quality control, support devolved accountability and, from a whole-of-government perspective, provide all levels of management with ‘early warning’ reports to minimise risk to benefits realisation.

Efficient pricing of services

Beyond the consideration of technical efficiency is the issue of allocative efficiency and in particular the matter of appropriate pricing of services. For pure public goods such as law and order there is no basis for imposing a user charge . However most services provided by the State are not in this category and pricing of services is a valid option. What needs to be assessed is the extent to which the efficient cost of the service is recovered from users relative to being funded by the taxpayer. Whenever a decision is made not to charge users for services, the default is that the tax payer pays.

The key consideration in coming to a view of user versus tax payer funding is the degree to which the service provides private versus public benefits. For example, education provides a benefit to the individual but it also provides a general benefit to society. It is also a service that is available to all citizens in that education is compulsory to a certain age. This is why public education is free at the primary and secondary level but why there is a degree of user charging at the tertiary level.

Another example is public transport which clearly confers a private benefit, through reducing congestion and the environmental impact of private transport, but also provides a social benefit. The issue then is what is the appropriate division between taxpayer and user contribution. There is also an equity consideration here in that public transport is largely available in the major metropolitan areas rather than in regional areas and the country so there is the equity issue of why those without access to public transport should pay for it. In the case of Sydney metropolitan rail, user charges only recover about 22% of operating costs. There would appear to be a strong case for greater level of cost recovery than this through the fare box even accepting that full cost recovery is not appropriate.

Section 13.3 discusses user charges in greater detail.

15.7 Regular effectiveness reviews

While achieving efficiency of expenditure is an important requirement of sound public finance, it is not sufficient for expenditure management good practice. What is also required is an assessment on a regular basis of whether programs are effective in achieving their objectives: whether there are more effective ways to address the same objective and whether the objective and program is still relevant and a priority. A program could be highly efficient but if it is ineffective in achieving its objectives or effective but no longer aligned with government policy and priorities, the resources involved should be reallocated to other programs. Unfortunately, there has been little in the way of program evaluation at the central or agency level in recent years.

This section examines a number of programs which are assessed as ineffective. It is not meant to be an exhaustive list but to identify particular examples of programs that need reform in a timely manner.

Beyond addressing specific programs, there is a need to establish an ongoing, independent program review process.

Case study – Solar Bonus Scheme

When it commenced on 1 January 2010, the Solar Bonus Scheme (SBS) provided a gross payment of 60 cents per kilowatt hour for all electricity generated from small solar photovoltaic systems connected to the grid. The Scheme runs until 31 December 2016.

The SBS was established without sufficient analysis, under inadequate timeframes and with last-minute policy and regulatory changes, compounded by poor responsiveness to the higher than expected uptake. This poor policy process has meant that the scheme has proven very expensive, for only minimal, highly inefficient outcomes.

- A decision was taken to establish a scheme before advice was sought. The decision to introduce the feed-in tariff (FiT) scheme was made by the Government of the day without seeking advice from departments as to whether such a scheme was efficient or cost-effective. While a task force was established to advise on scheme design, there was no opportunity for it to consider the base case of 'no action'. The Government did not seek an economic appraisal to assess the case for the scheme and no consideration was given to its complementarity to or interactions with other state and national programs.
- There was insufficient time for proper analysis. The task force was provided with only eight weeks to advise the Government – over the December to January 2010-11 period – when there were high staff absences and limited access to stakeholders and expert consultants. This time frame was insufficient to provide considered or comprehensive analysis and did not permit any modelling of the likely uptake and costs of the scheme. This was problematic as hypothetical scenarios were treated by the Government as 'likely', so major cost risks were ignored.
- The scheme was announced despite FiTs being considered and rejected by COAG. In 2008, COAG examined and recommended against a national FiT scheme and agreed that if state schemes did proceed they should seek harmonisation across jurisdictions. The NSW scheme was inconsistent with the agreed national principles.
- A last-minute policy change increased costs and raised regulatory credibility concerns. The scheme was dramatically redesigned less than two months before it was to commence, by moving from a net to a gross feed in tariff. As well as increasing costs and regulatory risk for market participants, the new scheme had a lower cost-benefit ratio and a significantly increased risk of cost blow-out.
- An inadequate response to greater than expected uptake. With a much higher than expected uptake, scheme costs quickly blew out to more than four times the highest estimates. There were insufficient checks and balances in place to respond to the scheme's popularity, and while a review were built in, it was slow to commence once triggered.

In October 2010, in response to a dramatically higher than expected uptake rate, the tariff payable for new participants in the scheme was reduced to 20c and total scheme participation capped at 300MW. In an effort to reduce the total cost of the scheme, the O'Farrell Government proposed reducing the tariff for those eligible for the higher rate from 60c to 40c. However the Government withdrew the proposal on the basis that it did not believe it would be passed by the Upper House.

The final cost of the scheme will depend on the capacity of connections deemed eligible to participate, as well as natural variations in weather and system performance. While a 300MW cap had been in place, the Government has since indicated it will allow all those who applied to participate before 28 April 2011 to receive payments. If the cap were enforced, the scheme is currently estimated to cost $1.44 billion over its life. However with the cap not enforced, based on current available data on uptake rates, the cost could rise to $1.62 billion. These are estimated costs based on the best available data at the present time, but these estimates will continue to fluctuate over the coming years.

Feed-in tariffs, like those provided under the Solar Bonus Scheme, subsidise technologies which are very expensive, in terms of both cost of carbon abatement and the value of renewable energy produced. The Solar Bonus Scheme paid $600/MWh for every unit of energy renewable energy produced. This compares to an average cost of renewable energy produced by a commercial wind farm of around $120/MWh.

The primary motivation for pursuing renewable energy policies such as feed-in tariffs is generally assumed to be to mitigate carbon emissions in response to climate change concerns. However, in the context of existing renewable energy policies, including the Commonwealth's Renewable Energy Target (RET), the NSW feed-in tariff is unlikely to have achieved any additional carbon mitigation and at best, has seen high-cost abatement substitute lower cost options. There are wide-ranging methodologies for estimating the cost per tonne of carbon dioxide abated through the NSW Solar Bonus Scheme, but all acknowledge it is very high. Abatement costs up to and beyond $600 per tonne have been estimated. This compares to estimates of a possible starting price for the national carbon tax of around $20 to $30 per tonne CO_2e.

In acknowledgement that the Solar Bonus Scheme could not be considered an efficient way to mitigate carbon, the scheme was focused on delivering industry development benefits rather than environmental gains.

Case study – V8 Supercars

The former Government agreed to provide a financial contribution of up to $35 million (capped) over five years (from 2008-09) to facilitate the V8 Supercar event being held at Sydney's Olympic Park.

In June 2010, the Auditor-General's evaluation of the Government's investment in the V8 Supercar races at Sydney Olympic Park found that direct negotiation with the private proponent was not supported by a comprehensive business case, probity plan or expert advice, leading to the Government making a poorly informed decision. The review recommended major changes in the decision-making process for government support of major events[17]. These recommendations are yet to be implemented.

- The decision to allocate funding for this event was not supported by a robust business case. Staging the event at Sydney Olympic Park was a high-cost option and the business case did not sufficiently analyse the costs and benefits of using alternative venues. Economic analysis conducted after the event showed that the assumptions in the business case were not robust. The benefits to the NSW economy from the event were significantly below those forecast in the business case. Moreover, costs were underestimated due to the failure to include value of in-kind support that agencies have and will need to provide for the event.
- Giving in-principle support undermined the negotiation strategy. The Auditor-General's evaluation did not find a coherent negotiation strategy was used in dealing with the proponent. Available assessment and negotiation processes already established within Events NSW were not used. The Government approved the funding for the event while negotiations and detailed planning were continuing, which constrained its ability to maximise value for money.
- Failure to engage advisory committee and experts. An investment of this scale impacts a wide range of stakeholders, often with conflicting interests. These potential financial and operational risks need to be properly mitigated. Government negotiations with the proponent should have been informed by a group of technical experts retained throughout the process. The use of experts was limited to certain specified tasks only. Expertise in Events NSW was not used.

Such issues resulted in the Government making a quick decision based on rushed and limited analysis and incomplete costings in response to pressure from the proponent.

Program evaluation process

While a framework for implementing and assessing the efficiency of initiatives has been established in recent years, there is no such framework in place to evaluate the effectiveness of programs. In particular:

- there are no consistent and strict requirements for business cases for new recurrent proposals

[17] These recommendations include the adoption of guidelines for economic evaluation agreed by Treasury; agreeing on a consistent method for determining impacts of these events; and that assessment, negotiation and management of events follow best practice for the preparation of business cases, analysis of costs and economic impacts, use of expert assistance, negotiation strategies, supervision and post-event evaluation. See *Auditor-General's Report: Performance Audit of Government Investment in V8 Supercar Races at Sydney Olympic Park*, June 2010, p.2.

- there is no clear framework for rigorous program evaluation (how and when it is undertaken, including proper use of control groups or baselines) and for assessing value for money from government spending
- evaluations, to the degree this occurs, are typically controlled by the agency running the program, creating potential conflicts of interest
- the results of program evaluations can be undermined by vested and sectional interests that inevitably develop in support of programs
- insufficient resources are devoted to program evaluation despite its capacity to improve frontline service delivery
- government often sees program evaluation as a threat rather than an opportunity to refocus programs to achieve value for money.

Ensuring that government programs deliver results requires a multi-faceted effort. Key elements of an improved approach to program evaluation include:

1. <u>Tighter up-front scrutiny of new proposals</u>

   Strict requirements for robust business cases should accompany proposals for new programs or initiatives, with preparation guidelines where the cost of a project is above a specified threshold. These business cases should clearly specify appropriate baselines to be used for comparison with the proposed reform.

2. <u>Program evaluation should be built into all program approvals, with dedicated funds being set aside to fund evaluations</u>

   Any approval for a new or enhanced program should include an agreed and suitable evaluation methodology, clear assessment criteria and an agreed time frame to undertake the evaluation. The approval should set aside the required funding for undertaking the evaluation which should be overseen by an Independent Evaluation Office (IEO, see below).

3. <u>Enhancing program evaluation capacity within government by improving access to expert guidance on evaluation quality</u>

   The public sector's skills in undertaking program evaluation needs to be enhanced. An important element of this is increasing involvement of suitable external parties in designing and reviewing programs.

   Individual agencies should have the capacity to undertake smaller scale program evaluations. Larger scale and strategically important program evaluations should be conducted by an IEO. Agencies responsible for conducting smaller scale evaluations should follow a government evaluation framework, provide evaluation results to an independent evaluation office and have an ongoing monitoring regime.

4. <u>Ensuring the independence of program evaluation through third-party reviews</u>

   New governments, particularly reforming governments, actively evaluate programs. However, over time, a political imperative arises to avoid negative assessments that could be construed as criticisms of the Government's performance. If program evaluation oversight is located within a central agency, pressures can emerge in terms of how findings are presented for publication, with a view to avoiding potential embarrassment for the Government. For these reasons, the program review function needs to be independent of government and transparent, as envisaged in the structure of the proposed IEO outlined below.

5. Entrenching program evaluation disclosure within legislation

   Public disclosure of program evaluations is critical to the success of the proposed frameworks. Public disclosure will:

   - ensure the quality of programs evaluations remain high
   - help neutralise vested interests that support ineffective programs
   - increase informed public debate by providing accurate and reliable information.

   An Independent Evaluation Office is proposed to oversee and support evaluations of both new and existing programs, including reviews of cost-effectiveness to ensure all programs are subject to an appropriate level of assessment on a rolling basis. This evaluation program should include community service obligations and concessions.

   The IEO should be overseen by a governance board drawn from academic institutions, the private sector, the Department of Premier and Cabinet and Treasury. The proposed IEO board should have a majority of independent members and report directly to the Premier. This will help to deal with the issues raised above and would also ensure its independence from the interests of agencies that run programs[18].

   Program evaluation should be undertaken at both the IEO level and at the level of individual agencies. The key purpose of the IEO is to establish a suitable framework and approach for program evaluation in the general government and non-commercial PTE sectors, and to ensure there is a high-quality program evaluation process in place. In this regard, its role is analogous to Infrastructure NSW (INSW) in the infrastructure area. As with INSW, it is not possible to undertake all the work at a central level. However, it would be appropriate for the IEO to be fully involved in major program evaluations and evaluations that involve multiple agencies or which have broader whole-of-government implications. Relevant agencies would also be closely involved in these situations. In most cases, individual agencies would be responsible for undertaking evaluations.

   To ensure effective program evaluation can be undertaken, the IEO should be granted powers via legislation to require agencies to cooperate with the provision of program information. This legislation could reflect, at a high level, the evaluation principles in the evaluation policy framework mentioned above.

   The IEO would:

   - undertake (or contract out) significant program evaluations (including cross-agency reviews) and oversee program evaluations conducted by other government agencies
   - support the development of agency evaluation capacity through partnerships on evaluations; dissemination of best-practice guidance;

[18] The IEO should report to the Premier but not be subject to direction or, if subject to direction, the direction must be gazetted.

networking and formal education activities; and assistance with capacity-building projects such as data standardisation

- develop or endorse methodologies for agencies that need to undertake a cycle of evaluations of their programs, which may be linked to wider expenditure review or audit programs
- publish all program evaluations that it undertakes, oversees or supports, including, where possible, underlying source data (the IEO could publish a critique of these evaluations where there were quality concerns or other issues)
- publish summaries of the outcomes of program evaluations to help build an evidence base to make decisions on new programs, reform of programs or termination of programs
- monitor and report on department and agency evaluation activities.

15.8 Transparency of performance

Transparency provides a powerful mechanism to drive improved performance and centres on three elements.

The first element involves establishing and publishing input, output and outcome information by program. The input, output and outcome information is available in Budget Paper No. 3 in regard to Service Groups, though it will need to be refined and improved over time, especially in respect to outcome information.

It should be noted that Service Groups information is at a much more aggregated level than programs and hence does not provide the level of granularity required for program evaluation.

Agencies maintain program information but it is not clear how well the information is maintained or how well the programs are structured.

It is recommended Treasury undertake a full review of program information at the agency level with a view to ensuring that program structure is appropriate and program information is maintained. It is further recommended that Treasury establish a direct link to program information held by agencies as well as financial information in general. Access to program information should also be available to the other central agencies and to the IEO.

Second, it is highly desirable that benchmarking information is developed for each of the agencies and the major programs. It is noted that the Expenditure and Management Audit has this as one of its terms of reference. However, the time scale to undertake such an exercise, particularly for the general government sector, and the level of cooperation required across jurisdictions would indicate this is not feasible in the time frame allocated to the Commission of Audit.

The Heads of Treasuries (HOTS) have as one of their reform projects, a review of government services. This will involve all Australian jurisdictions and could be a suitable vehicle for undertaking benchmarking across policy sector as well as reviewing key issues such as contestability and separation of purchaser and provider roles.

Third, it is proposed that the IEO prepare an annual report setting out the work it has undertaken over the year and providing a commentary on the state of development of program evaluation.

15.9 Agency-specific opportunities

Across the agencies and major functional areas of government, there are specific efficiency and effectiveness opportunities that warrant further consideration by the Expenditure Review Committee (ERC) of Cabinet and Cabinet itself.

Health

The 2009-10 Budget for NSW Health introduced a growth funding model of 5.4 per cent per annum for Net Cost of Services. NSW Health is able to keep all the revenues and efficiency savings it achieves, with Commonwealth National Partnership payments and enhancements on top of growth funding.

As part of Health's growth funding arrangements, a Health Efficiency Improvement Taskforce (HEIT) was established to provide an inter-agency forum to identify strategies to increase efficiency and productivity, improve resource utilisation within the public health system and to provide inter-agency advice and support in progressing those strategies.

Strategies to improve efficiency and maintain revenue growth are being developed under four broad categories:

- funding and regulation: examples include episode funding based on funding hospitals using benchmark costs and local revenue generation efforts
- clinical services: implementation of the severe chronic disease management strategy to prevent avoidable hospitalisation and initiatives to reduce hospital infection and medication errors
- workforce effectiveness: reducing use of locums and overtime
- shared services: procurement reforms.

A major area of reform is reducing unwarranted variations in clinical practice and associated costs:

Case study – Clinical variations

Clinical variation is the extent to which clinical practice and treatment costs vary across health services. The causes of variations are likely due to clinicians' preference for alternative treatment options, the inefficient allocation of resources between functional areas, the inability to shift resources between regions to address variations in supply and the inability to integrate care services for individuals across programs.

NSW Health's Health Care Atlas has identified a number of clinical variations across NSW by Local Government Area (LGA):

- preference-sensitive surgery rates varied by up to 280 per cent
- admissions for chronic conditions varied up to 175 per cent
- readmission rates for preference-sensitive surgery varied by up to 1,400 per cent

- average number of hospital days at the end of life varied by up to 216 per cent.

The extent of clinical variation was also revealed by IPART's Hospital costs and outcomes study for NSW Health.

Reform options

1. Improve systematic collection and publication of data on clinical variations
2. Involve patients more in decision making to establish the right level of variation based on patients' own assessments of needs and risk
3. Promote the use of evidence-based clinical guidelines and assessments of the cost-effectiveness of new technology and procedures
4. Introduce incentives and penalties to adhere to clinical guidelines and cost-effective care
5. Increase investment in evidence-based prevention and early intervention strategies that help to avoid hospitalisation (around 200,000 separations a year in NSW hospitals are potentially avoidable)
6. Improve palliative care options in some locations, especially those out of hospital.

The Better Services and Value program funded a pilot project with the NSW Health Bureau of Health Information and Agency for Clinical Information to identify and assess unwarranted variations in hospital admissions, focused on chronic obstructive pulmonary disease or congestive heart failure. An evaluation of the impact of clinical guidelines on readmissions is also planned.

Other health efficiency reforms warranting further consideration include:

- **Hospital efficiency**: Cost per weighted separation for acute in-patient care varies dramatically from hospital to hospital in NSW. Data from the NSW Health Comparison Data Book 2008-09 shows that the standard deviation for all hospitals for cost per weighted separation was $650[19]. For example, the difference between the highest and lowest cost for the state's teaching hospitals was $1,400, with Royal North Shore reporting an average cost of $3,301 and Westmead $4,720. This significant variation in cost per separation suggests scope for cost and efficiency improvements in some hospitals. Strategies to drive efficiency improvements should focus on identifying hospitals that are best practice and those that need to improve efficiency; improving the efficiency at the hospital level through information exchange; and implementation of the recommendations of IPART's Hospital costs and outcomes study for NSW Health.
- **purchasing of clinical and non-clinical services:** Greater contracting with the private sector and market testing relative to public sector provision has the potential to introduce an element of competition that can promote improved value for money. Increasing purchasing of elective surgery and other clinical services from the private sector can also help to resolve access issues.
- **Workforce reform:** More flexible use of skill mix, including broadening the role of current professions, can contribute to a more efficient use of the health

[19] http://www.health.nsw.gov.au/pubs/2010/pdf/yellowbook_09.pdf

workforce as well as addressing shortages. Regulations preventing the wider use of nurse practitioners should also be reviewed.

- **Personalised budgets in health**: Individualised health funding packages involve a portable package of funds allocated to a patient, giving them control over how they purchase their healthcare. Personalised funding packages aim to increase health system choices. Patient choice acts as a mechanism to improve quality of healthcare and reduce ineffective interventions and inefficiencies in the health system. Other jurisdictions such as the United Kingdom are piloting personal health budgets as part of a personalisation agenda.
- **Service and hospital re-configuration:** The Special Commission of Inquiry into Public Hospitals led by Commissioner Peter Garling highlighted potential risks to patient safety and quality of care arising from the present hospital configuration around the State. The current configuration of services has developed from decades of historical decisions rather than a contemporary assessment of the best configuration of a comprehensive and safe health system for NSW. This configuration creates variability in the volume of services that would be regarded as an appropriate critical mass for sustainable service delivery across each of the public hospitals. The Inquiry highlighted potential risks to patient safety and quality of care under aspects of the present hospital configuration around the State. The inquiry recommended that NSW Health undertake a service re-configuration review looking at the use of hospital facilities. There is scope to implement service realignments that will improve cost-effectiveness, safety and sustainability of services by consolidating and networking services. This could be supported by establishing an Independent Reconfiguration Board, as in the UK, to advise the Minister for Health on contested proposals for health service changes proposed for Local Health Districts.

Education

Schools

Current policy around student-to-teacher ratios warrants further investigation. In 2003, the former Government implemented a class size reduction policy that reduced kindergarten, 1st class and 2nd class sizes to 20, 21 and 22 respectively.

However, as noted in Section 15.3, research suggests that teacher quality is a far greater determinant of educational outcomes than class sizes. There is little definitive evidence supporting a relationship between class size and student achievement. Yet the current class size policy has significant implications for the Department of Education and Communities' cost structure and workforce arrangements.

Government has the option to revisit the 2003 policy. However, this needs to be considered in the context of any changes to the distribution of authority to increase the proportion of local decisions made in local schools.

Noting the importance of teacher quality, an independent agency review of the former Department of Education and Training identified scope to improve teacher quality in NSW through implementation of more effective performance management systems to deal with poor performing teachers and through refinements to the Teacher Career

Progression model. Improvements in dealing with poorer teacher quality levels could be one of the more significant reforms for the education sector.

There is also the opportunity to rationalise the number and location of schools, improving educational outcomes while reducing costs.

Case study – Optimising school infrastructure

There is an opportunity for school rationalisation that will improve educational opportunities for students while reducing overall system resources. Similarly, sharing common services frees up resources for educational outcomes rather than support costs.

Emerging research links improved educational outcomes to larger student cohorts. This can be delivered through appropriate asset investment decisions, such as developing larger sized schools.

A distributed authority model provides a framework where regional and local asset optimisation is much more likely to occur, as the opportunity cost of inefficient assets is more clearly understood at the local level.

In the 13 years since 1996, only 49 schools have been closed; this is an average of less than four schools per year. This compares to a long-term average of 28 schools a year.

While there has been negligible school rationalisation, the Department of Education and Communities has pursued related reform areas which require further study and piloting. These include establishing communities or clusters of schools to create larger 'virtual' schools or multi-campus schools; facilitating better equity across schools; and investing in technology that improves remote and virtual access to school education, to facilitate interactive and interconnected teaching and learning.

Vocational education and training (VET)

Pricing arrangements for TAFE NSW courses require review. There is little relationship between student contributions, the cost of course provision or demand for government-subsidised training places.

There may also be hidden cross-subsidies between TAFE commercial operations (including international education) and course fees for government-subsidised places. Further, there is a mix of delivery channels used within TAFE including face-to-face, correspondence and online education, each with a unique pricing approach. Consideration of how these changes are used and their pricing should take into account the impact the different delivery channels have on student completion rates.

There is scope to improve TAFE teacher productivity. NSW TAFE teachers have lower face-to-face teaching hours per teacher than most other states (including Queensland and Victoria) and higher salary rates compared to all states (for example, 18 per cent higher salary rates per teacher than Queensland and 14 per cent higher salary rates per teacher than Victoria for top-level teachers).

Productivity improvements could be achieved through changes to the annual teaching load per teacher, which specifies weekly face-to-face teaching load per teacher and the number of teaching weeks. Higher productivity levels of TAFE teachers would support improved learning outcomes and increase TAFE's ability to compete with private providers in the contestable vocational education and training (VET) sector market.

Further opportunities to increase TAFE efficiency may exist through:

- considering the optimal number of institutes, including the financial viability of individual institutes
- a review of course offerings
- determining the most effective governance model to increase autonomy and accountability, and enable institutes to apply directly for Commonwealth funding.

Family and Community Services (FaCS)

There is an opportunity to leverage innovative and efficient NGOs to take a greater role in the delivery of human services across out-of-home care (OOHC), disability and social housing. However, as outlined in section 15.5, maximising the benefits of services delivered through the NGO sector will require careful contract design and support.

Case study – Out-of-home care

Between 2004-05 and 2010-11, expenditure on OOHC services for children separated from their parents has increased from $304 million to an anticipated $694 million, an increase of almost 15 per cent per annum. This growth in expenditure is financially unsustainable.

The increase in the OOHC budget has been driven by significant increases in the number of children in OOHC, length of stay and the average unit cost of providing an OOHC place.

In 2004-05, approximately 10,000 children were in OOHC in NSW; in 2010-11 there will be over 18,000. As at June 2010, NSW had the highest rate of children in OOHC in Australia – 9.9 per thousand compared with about 5.7 per thousand excluding NSW (or almost 75 per cent higher in NSW than the rest of Australia).

There has been a general increase in OOHC across Australian jurisdictions over the past decade. However, it is not clear why there has been such high growth in NSW. This may be a result of more resources being deployed to investigate abuse. For example, in 2009-10, NSW spent $219 per child on child protection services compared to $175 per child on average in Australia; only the Northern Territory spent more per child on child protection services. Another factor is the lack of sufficient family support services, which aim to address the causes of abuse and neglect so that children can remain safely within the family unit.

Transport

There is scope to optimise project planning and selection to ensure projects are selected based on economic merit and according to the needs of the whole network. Too often capital expenditure is seen as the only option. In the transport area there are valid demand management options that are likely to be far more effective than pursuing capital expenditure options alone.

Sydney experiences significant traffic congestion on its roads and overcrowding on the CityRail network during peak periods. The underlying problem is that the long-run marginal costs of service provision and externalities (congestion and overcrowding costs) are not reflected in the pricing of transport services faced by travellers.

There are a number of demand management measures that could help relieve capacity constraints by shifting discretionary peak travel to off-peak periods where there is significant surplus capacity. This can be achieved through using price to signal the economic and social costs of travelling and regulatory measures where price signalling may not be feasible. This allows scarce peak capacity to be used for more valuable travelling purposes.

Potential demand management measures to help signal the economic and social costs of travelling include:

- More distinct peak pricing of transport fares, which would involve higher public transport fares in peak periods and lower fares in off-peak periods to reflect the different economic and social costs of travelling at different times of the day. Peak pricing of fares is commonly practised on European transport networks; for example, peak prices in the UK are 40 per cent higher than off-peak prices.
- Requiring concessions and free travel to be used in off-peak periods could reduce demand for peak network services.
- Removing on-street parking on key arterial and CBD roads and prioritising bus travel. Removing key capacity pinch points could improve traffic and bus flow in a short timeframe.
- Road pricing on motorways and arterial roads to reflect congestion levels. Studies of road pricing in Singapore and London suggest that an 18 to 20 per cent reduction in traffic volumes can reduce excess delays by 33 per cent and decreased travel times by 24 per cent.

Reviews have also identified that there is potential to introduce greater outsourcing and contestability for asset maintenance across the transport sector. In addition, the M5 Cashback Scheme and the School Student Transport Scheme are specific ineffective programs within Transport that warrant further investigation:

Case study – M5 Cashback Scheme

The M5 Cashback Scheme was introduced on 1 January 1997 and allows private motorists to claim back tolls paid for travelling on the M5 motorway in Sydney.

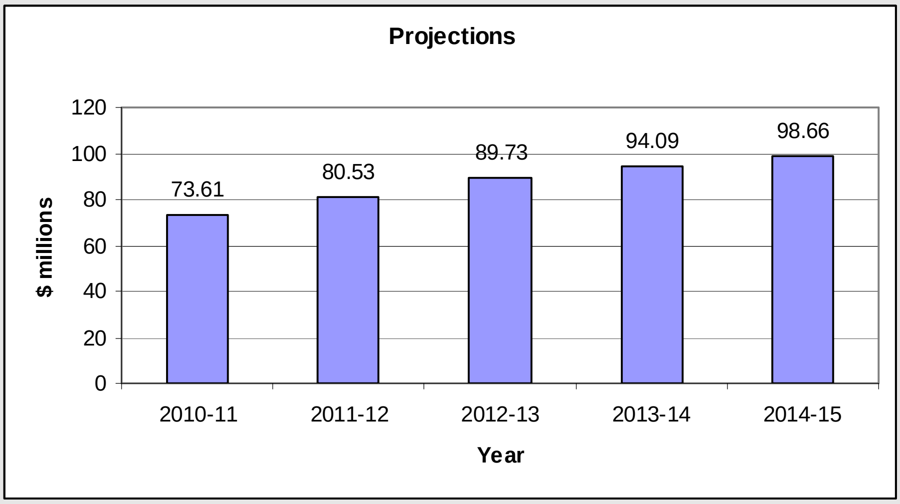
<u>Case for change</u>

The M5 Cashback Scheme is an inefficient subsidy that imposes a significant financial and economic burden on the State.

The projected total cost for the M5 Cashback Scheme for 2010-11 is $73.61 million. This cost is equivalent to 4.3 per cent of the RTA's recurrent budget allocation. The Cashback Scheme demand is projected to grow by 5 per cent per annum, with a 12.5 per cent increase in toll prices every four years. Administration costs are projected to increase by 2.5 per cent per annum. By 2014-15, total costs will increase to $98.66 million, or 5.2 per cent of the RTA's recurrent budget allocation.

The M5 Cashback Scheme subsidised 17.6 million private motor trips in 2010-11. This is projected to increase to 20.8 million by 2014-15.

Figure 15.9.1 M5 Cashback Scheme projections



The M5 Cashback Scheme induces additional traffic on the M5 by lowering the cost of travel. M5 morning traffic speeds have decreased from 44km/hour in 2006 to 35km/hour in 2010[20]. Current M5 traffic volumes are in excess of 100 per cent of capacity throughout the motorway during peak periods[21]. By 2021, M5 traffic volumes are projected to increase to 120 per cent throughout the whole motorway during peak periods[22]. Congestion occurs where traffic volumes exceed 60 per cent of road capacity, with congestion increasing exponentially as traffic volumes rise higher.

Traffic congestion is estimated to have cost NSW $4.9 billion in 2010. This is expected to increase to $7.8 billion by 2020[23]. These economic costs primarily stem from increased travel times, increased travel time variability, higher vehicle operating costs and, to a lesser extent, higher air pollution, reduced health outcomes and increased traffic accidents.

Removing or reducing the level of subsidy offered by the M5 Cashback Scheme should dampen, at the margin, private motoring demand, reducing congestion and its consequential social and economic impacts.

<u>Reform options</u>

1. End the M5 Cashback Scheme. This option will yield recurrent savings of $363 million over the next four years from 2011-12 to 2014-15. This option is administratively simple to implement.

2. Tighten the eligibility criteria of the M5 Cashback Scheme. This option could involve tightening the criteria to target a specific policy objective, e.g. subsidising private motorists residing only in South-West Sydney who use the motorway for local travel. This option is would have higher administrative costs than ending the scheme.

[20] Roads and Traffic Authority (2011), Travel Speeds in Sydney Metropolitan Area.
[21] Bureau of Transport Statistics (2011), Customised data request on road volume and capacity in Sydney.
[22] Bureau of Transport Statistics (2011), Customised data request on road volume and capacity in Sydney.
[23] Bureau of Transport and Regional Economics (2005), Estimating urban traffic and congestion cost trends for Australia cities, Working Paper no.71, p.108.

Risks of reform

The primary risk relates to public resistance against withdrawing this subsidy, particularly from residents of South-West Sydney.

There may also be issues with the private operator of the M5 (Interlink Roads Pty Ltd) as the M5 Cashback Scheme generates additional traffic and revenues for the operator.

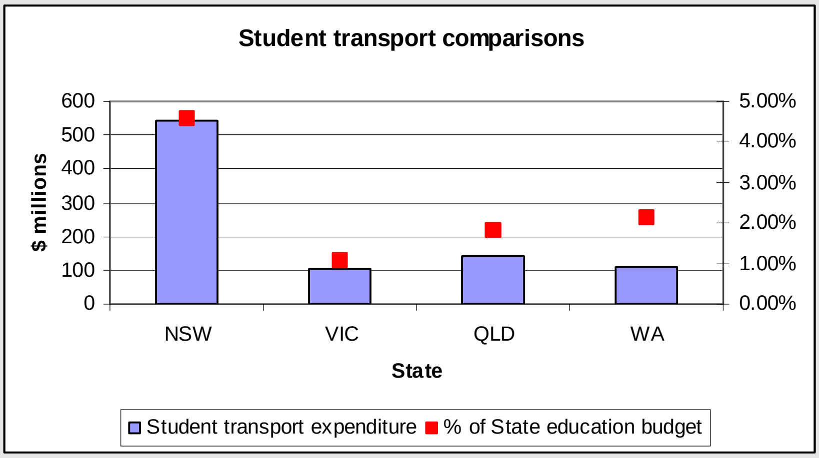
Case study – School Student Transport Scheme (SSTS)

The program supports school attendance and choice by funding student travel to any school (including Catholic and private) in NSW for which they are eligible, not just the nearest State school. Free travel is provided on trains, buses and ferries.

Case for change

NSW's STSS offers the most generous travel subsidy and eligibility criteria compared with other major states. This generosity comes at considerable cost to NSW taxpayers.

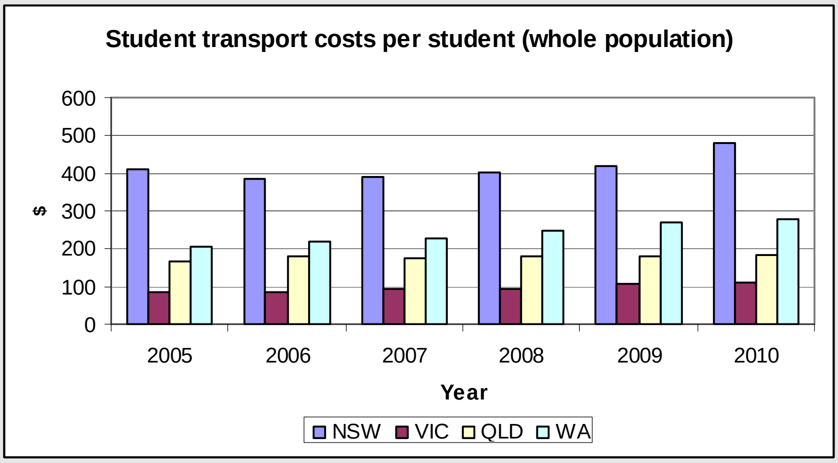
Figure 15.9.2 Comparison of student transport expenditure



Sources: NSW and interstate Budget Papers 2010-11.

The estimated cost of the SSTS was $541 million in 2010-11, more than five times the equivalent scheme in Victoria ($102 million). The SSTS is equivalent to 4.6 per cent of the NSW education budget, compared with only 1.1 per cent in Victoria.

Figure 15.9.3 Interstate student transport costs per student (2010, whole student population)



Sources: State Budget Papers 2010-11, ABS (2011), Schools (Cat. 4221.0), Table 40a Full-time students

Figure 15.9.3 above illustrates that on a total state student population basis (i.e. all students – not just eligible students), the SSTS costs the equivalent of $480 per annum per student. In comparison, in Victoria the cost is equivalent to $110 per annum per student.

The high cost of NSW's SSTS scheme is due to its generous eligibility requirements compared to other states, as outlined in Table 15.9.1 below.

Table 15.9.1 Interstate student transport eligibility requirements

State	Student Restriction	School Restriction	Distance Restriction	Mode Restrictions
NSW	All students (metropolitan and regional).	All government and non-government schools (no maximum distance restriction).	Primary: >2.3km Secondary: >2.9km	Free travel across all public transport modes.
VIC	Outer-metropolitan and regional students only.	Restricted to the nearest government and non-government school.	>4.8km for both primary and secondary students	Concession rate only on rail network.
QLD	All students (metropolitan and regional).	Restricted to the nearest government and non-government school.	Primary: >3.2km Secondary: >4.8km	Generally no free travel on train network except under specific circumstances.
WA	Regional students only.	Restricted to the nearest government and non-government school.	>4.5km for both primary and secondary students	No free travel on train network, concession rate only.

Sources: NSW Department of Transport < http://www.transport.nsw.gov.au/ssts/ssts.html>, Victoria Department of Education and Early Childhood Development <http://www.eduweb.vic.gov.au/edulibrary/public/schadmin/schops/Resources/Procedural_Guidelines_School_Contract_Buses_(Rural_and_Regional)_Aug10_v2.pdf>, Queensland Department of Transport and Main Roads < http://education.qld.gov.au/students/transport/docs/stas_brochure_lowres.pdf> and Western Australia Public Transport Authority <http://www.schoolbuses.wa.gov.au/Parents/Informationforparents/Childattendingmainstreamfacility/Studenteligibility/tabid/225/Default.aspx>.

The SSTS has undergone numerous changes since its inception in 1904 as a subsidy to country students for travel to the nearest appropriate school. These changes have extended the eligibility of the scheme, removed travel and school restrictions and moved the scheme from offering concessionary travel to offering free travel. While ensuring student access to schooling is important to ensuring social equity, the direct and indirect costs of the scheme as currently structured are very likely to substantially exceed the societal benefits it provides. It is appropriate to consider whether the scheme could be restructured to retain its core social benefits at lower cost.

Reform options

The SSTS should be reformed with the principal objective of ensuring every child has access to a primary and secondary education regardless of their social and economic circumstances.

The potential reform options for SSTS are summarised below which depending on the policy objective could combine options:

Table 15.9.2 Reform options for the SSTS

Options (Components)	Advantages	Disadvantages
Means testing the eligibility for SSTS	Efficiency, financial and equity improvements.	Administratively intensive and would need to leverage the Commonwealth welfare agencies or the ATO.
Require payment per school term	Induce discipline in travel patterns and educational decisions.	Administratively intensive and will create equity issues.
Increase minimum distance threshold and/or cap travel distances	Efficiency, financial and equity improvements with minimal administrative changes, also applied in other states.	No effective change – redraw boundary maps for each school – may have equity implications.
Limit free travel to the nearest appropriate school	Accords with the intent of the SSTS in ensuring access to education, also applied in other states.	No effective change – redraw boundary maps for each school – may have equity implications.
Await electronic ticketing (base case)	Allows better identification of travel patterns and allows SSTS to reflect actual use.	Will not remedy the generous SSTS eligibility criteria, implementing electronic ticketing is in its infant stages and would not be available in near future.

It should be noted that limiting the SSTS will not jeopardise the viability of private bus operators as recent reforms to bus contracts have resulted in private bus operators being paid primarily on a gross operating expenditure basis.

Risks of reform

There are risks associated with reforming the SSTS:

- Depending on the approach taken, administration could be costly and could mitigate the benefits generated. This is especially the case with means testing.

- § Transport for educational purposes is highly inelastic. Limiting the eligibility of the SSTS may see substitution from public transport to car use, thereby exacerbating traffic congestion and its associated economic costs.
- § To ensure fairness, existing students may have to be 'grandfathered' under the old SSTS. Only new students commencing primary or high school would then be subjected to new provisions in the SSTS. This limits the financial benefits realised in the short term but would generate savings over time.

Finance and Services

Efficiency opportunities may exist through market testing of contestable services currently provided by NSW Public Works, ServiceFirst, Internal Audit Bureau, StateFleet and State Records Authority.

The review of the Office of State Revenue (OSR) also noted significant revenue improvement opportunities for government through outsourcing of overdue debt collection and potential improvements to Payroll and Land Tax compliance. In addition, migrating to automated and more cost-effective revenue collection channels and contact centre optimisation provides scope for OSR operational improvements.

Planning and Infrastructure

The Department of Planning and Infrastructure (DP&I) receives around a third of its funding from external sources. These include:

- § Planning Reform Fees charged on development, which accounts for around $17 million each year
- § development assessment fees, estimated at $12 million per annum for state-significant projects (previously assessed under Part 3A)
- § development contribution revenues associated with state infrastructure levies and voluntary planning agreements through provisions in the Environmental Planning and Assessment Act 1979.

The 2010 funding review of the Department of Planning recommended a review of development assessment fees and established a basis for reforming funding arrangements within the Department. Consistent with that review, it is recommended that revenues derived through Planning Reform Fees and Development Assessment Fees are banked as Crown Receipts to improve accountability and transparency (subject to administrative requirements). Consolidated funding for the Department of Planning and Infrastructure would be adjusted to meet efficient underlying costs of those core planning functions.

It is also recommended that a comprehensive review of planning fees is undertaken as part of the upcoming review of the Environmental Planning and Assessment Act 1979, having regard to:

- § future state-significant development and infrastructure projects have fees that fully recover efficient underlying assessment costs

- there is full recovery of costs associated with the Planning Assessment Commission, Joint Regional Planning Panels and other assessment arrangements (including LEP spot rezoning)
- revised fee structures are not open to negotiation with DP&I.

Trade and Investment, Regional Infrastructure and Services

Various reviews across the cluster have highlighted the need for improvements in the rigour of business cases, performance monitoring and reporting, post-evaluation assessment, benchmarking and accountability. The agency review of the former Department of Industry and Investment (DII) noted that the current approach to economic development has a number of deficiencies:

- guidance regarding prioritisation of Industry and Investment activities between the 13 regions and between industry sectors is not well articulated; there is no clear alignment of Industry and Investment interventions and the desired outcomes of the whole-of-government plans
- performance and impact measures for interventions are generally at a high, aggregate level, making assessment of individual programs difficult
- certain Industry and Investment activities do not appear to have formal post-intervention evaluations to guide future decision making; the investment guidelines indicate that a survey of the firm receiving assistance is the primary evaluation instrument
- within the Primary Industries portfolio, resource allocation decisions appear to follow an iterative process which lacks transparency; the link back to whole-of-government strategic direction is also unclear.

The following drought assistance case study illustrates some of these challenges.

Case study – Drought assistance

The Department of Trade and Investment, Regional Infrastructure and Services is the lead agency for a number of financial assistance programs which are in place for farmers suffering hardship during the drought in NSW.

Two major programs administered in NSW are Transport Subsidies, which is a state scheme and Exceptional Circumstances (EC), which is a Commonwealth scheme. Transport Subsidies are rebates on transportation costs for moving water for domestic use, water for fodder and stock, stock to and from agistment, and stock to sale. Transport Subsidies are funded by the NSW Government. EC provides interest rate subsidies for farmers in financial hardship. The NSW Government contributes 10 per cent of the funding towards EC, with the remaining 90 per cent funded by the Commonwealth Government.

The NSW Government also funds other drought assistance measures such as the Drought Support Workers, Farm Family Gatherings, Drought Workshops, the Business Drought Assistance Payroll Tax Scheme, Wild Dog Destruction Board rate waiver, Western Land Lease rate waiver and the Drought Household Assistance Scheme.

Case for change

These programs are not well targeted; almost all assistance going to open-range livestock farmers and there is little provided for other farmers or other businesses and families affected by drought. Certain programs are also inconsistent with one of the primary objectives of the National Drought Policy, which is to protect the agricultural resource base and encourage primary producers and other sections of rural Australia to adopt self-reliant approaches to managing for climatic variability.

As an example, the Productivity Commission report on Government Drought Support (2009) states that transport subsidies do not encourage producers to be more self-reliant. The program encourages producers to be less reactive to changes in climate conditions and more exposed to climate risks. Also by encouraging producers to hold onto stock, there is an increased potential for environmental degradation through effects such as increased soil erosion.

Similarly, EC provides the most assistance to those with the largest debt, which can be inefficient and marginal businesses. There is an incentive for farmers to build debt and/or not reduce debt when faced with drought risk, as governments have a history of subsidising its cost.

There are better options to help farmers, such as supporting a market in weather derivatives which enable farmers to hedge against climate impacts and schemes that provide assistance linked to maintenance of vegetation cover.

NSW farmers received the largest amount of EC payments from 2002-03 to 2007-08, compared to farmers in other states.

Table 15.9.3 State comparison of EC payments

	NSW	QLD	VIC	WA	SA	TAS
Year	**$m**	**$m**	**$m**	**$m**	**$m**	**$m**
2001-02	…	4	…	6	…	…
2002-03	22	16	13	5	1	…
2003-04	52	32	12	6	1	…
2004-05	68	37	13	5	1	…
2005-06	155	62	29	4	2	…
2006-07	303	113	124	3	10	…
2007-08	329	95	116	9	50	4
TOTAL	**929**	**359**	**307**	**38**	**65**	**4**

Source: Productivity Commission Inquiry Report: Government Drought Support, 27 Feb. 2009.

The NSW Government has provided the largest amount of transport subsidies, compared to other states.

Table 15.9.4 State comparison of transport subsidies

Year	NSW $'000	QLD $'000	NT $'000
2002-03	26,012	7,676	…
2003-04	20,803	12,395	…
2004-05	18,773	5,594	…
2005-06	14,794	6,176	…
2006-07	30,615	13,484	172
2007-08	19,336	10,476	64
Total	**130,333**	**55,801**	**236**

Source: Productivity Commission Inquiry Report: Government Drought Support, 27 February 2009.

Cost of program

Since 2002, more than $550 million has been committed for all programs, of which $165 million was for the Drought Transport Subsidy Scheme. Around $60 million was committed for drought assistance measures in 2009-10.

Reform options

It is proposed that there is a review of NSW drought measures, including an evaluation of how drought measures have been targeted in practice, given the cessation of the drought, the national review of drought policy and the report by the Productivity Commission. Any savings will be in the form of avoided future costs.

To provide an indication of potential savings, the Western Australian Government experienced a 28 per cent reduction in drought support expenditure under a 12-month pilot funded by the Commonwealth. The pilot commenced in July 2010 with the aim of better supporting farmers and rural communities in preparing for future challenges, rather than waiting until they are in crisis to offer assistance. As such, the pilot measures are mostly consistent with the Productivity Commission's recommendations.

Risks of reform

There is likely to be high stakeholder resistance to any reduction in financial assistance to farmers. One key to managing this will be a comprehensive assessment of how drought assistance has been targeted, to allow informed discussion of criteria for targeting future drought assistance. Consideration should also be given to possible alignment between a refocused drought assistance policy and other forms of government intervention in regional NSW, such as regional development support, including support for the development of markets in environmental services.

The Productivity Commission in 2009 recommended in view of the current scale and breadth of support to businesses, and the likely interaction of competing measures, consideration should be given to another broad review of industry assistance. Other factors to consider would be the eligibility criteria, funding and contractual arrangements, outcomes and impacts of all industry assistance. Application of an economic framework, as recommended by the review of the former DII, would also provide a consistent and transparent framework to aid the prioritisation and evaluation of service delivery and investments.

Other reform opportunities within the cluster include:

- **Cost recovery for services with private benefits:** There is significant scope for the Department of Primary Industries (DPI) to increase recovery of efficient overhead costs associated with research funded from external sources. The definition of what constitutes efficient cost and the degree of recovery requires further consideration. Further, the DPI should seek out external funding sources that share the strategic research goals.
- **Reforms to extension and education services:** There are opportunities for the DPI to change the way it delivers education and extension services by making wider use of web-based channels. It could also discontinue courses that have low attendance or are already being provided by TAFE or private providers, and partner with those same providers in a coordinating or syllabus development capacity.
- **Consolidation of programs:** Avoid duplication by consolidating the various industry assistance programs into two programs based on regional or industry assistance.
- **Co-locate or consolidate underutilised facilities**: Underutilised research stations and office accommodation was identified as an inefficiency in the review, with scope for the cluster to consolidate a number of facilities across the State and develop sustainable centres of excellence. It is noted that this will have regional employment impacts but will significantly improve research and hence industry performance, which is the prime objective.

Environment

The Commonwealth influences policy and program development for water and climate, which in turn impacts the NSW environment sector.

The proposed Murray Darling Basin Plan poses significant economic and budget risks. The NSW Office of Water (NOW) will principally manage these risks and the implementation of the plan in NSW. The establishment of a CEO Committee of relevant line and central agencies, reporting to Cabinet, to oversee the Government's Murray Darling Basin Plan response is recommended.

The Commonwealth also drives climate change policy at a national level and should be responsible for funding associated climate change mitigation or adaptation programs. It is recommended that a full assessment of all NSW renewable energy programs is conducted in relation to cost-benefits and their continuing relevance in the context of contemporary Commonwealth policy direction.

Various environmental programs funded through the Waste and Environment Levy and the Climate Change Fund require further evaluation for efficiency and outcomes. More specifically, an evaluation of the policy of hypothecating taxation revenue for unspecified environmental programs is warranted. This should also consider the current administrative arrangements which allow the minister discretion on how to allocate this funding.

At state level, IPART has been critical of NOW's lack of capacity to participate effectively in water pricing determinations. NOW must develop its financial and budget management capacities and monitoring frameworks to ensure future pricing determinations are transparent to consumers.

In terms of environmental land management, there should be further exploration of opportunities to develop and promote market-based conservation measures on private land. Opportunities could include integration with other incentives such as rate exemptions and tax deductibility of donations.

There is also scope for greater efficiency within the environmental portfolios through:

- workforce planning that focuses on reducing vacancies and expanding spans of control
- consolidation of regional structures and increased online service delivery
- prioritisation of maintenance works and decommissioning of underutilised assets
- an agency-wide cost recovery framework to improve revenue.

Justice

The number of offenders in custody in NSW has grown over the past decade (rising from an average of 9,101 in 2005-06 to 10,352 in 2009-10 before falling slightly to 10,083 at 5 June 2011). These increased imprisonment rates are recognised to have been due to policy and legislative changes that have led to presumptions of remand rather than bail and terms of imprisonment for minor offences that may result in community-based sentencing in other jurisdictions. In 2009-10, NSW maintained 34.8 per cent of its inmates in minimum-security facilities compared to the rest of Australia at 12.5 per cent.

Reforms to criminal justice legislation have been initiated, aimed at reducing the number of prisoners incarcerated and on remand for minor offences, rather than under alternative forms of correctional management. At the same time, there has been a small reduction in the number of prisoners in custody (as detailed above), but the effects of these reforms have not yet been fully assessed.

Operational efficiencies have been sought through implementation of Corrective Services NSW's The Way Forward reforms, which have included the restructuring of prisoners' routines, a centralised rostering system to minimise rorting of overtime, increased use of casuals rather than overtime for operational staff, and new sick leave and overtime policies. However, these efficiencies have resulted in only minor savings, which Corrective Services NSW advises is due partly to the inability to shed unnecessary staff by means of mandatory redundancy and the inability to close inefficient and unneeded facilities.

The use of private sector expertise in correctional facilities management could realise annual savings of around 25 per cent. Private sector management would be suitable for 11 out of 36 corrective facilities (only two are under private sector management currently), with potential savings of around $36 million to $60 million per annum.

There is also scope to modernise court registries to improve efficiency and service delivery through technological enhancements and improved case management.

Police

The major opportunities for improved efficiency in the police area relate to reforms to improve workforce flexibility and to address the spiralling cost and workforce distortion of the Death and Disability Scheme.

The previous Government determined the number of sworn officers to be employed by the NSW Police Force by publishing a target officer number known as 'police authorised strength'. The total authorised strength has in turn been allocated to individual local area commands. The NSW Police Force reports 'authorised' and 'actual' police numbers for each local area command every month on its website.

As a benchmark, the 'authorised strength' number does not provide a meaningful measure of policing performance. At a fundamental level, it is an input measure that has no regard to either outputs or outcomes achieved. It includes officers on long-term sick leave providing no productive output and includes sworn officers working in administrative positions. It provides no indication of the proportion of officers employed part time and it fails to include civilian personnel who make a direct contribution to front-line policing (such as scene of crime officers). It takes no account of the proportion of officer time spent on front-line policing and provides no scope for productivity improvements to offset demand growth. It also restricts the ability of the Police Force to relocate officers to respond to emerging crime patterns.

The 1997 Royal Commission into the NSW Police Service made a recommendation to abolish the concept of an authorised strength number altogether. The Commission recommended:

> *"There be no return to the concept of authorised strength or any similar notion and the Police Commissioner be given the authority and flexibility to determine matters of staffing structure and deployment to meet current needs and resources*[24]."

This Audit supports the findings of the 1997 Royal Commission and recommends cessation of the police authorised strength concept. Further, other workforce input controls (which prescribe minimum staffing levels) being applied across agencies, either through policy or agreed locally, should be examined to better understand their implications on workforce efficiency and flexibility.

The current rostering arrangements of NSW Police are not consistent with best practice, being rigid and impacting on overall workforce efficiency and flexibility to match resources to demand. General duties officers, for example, work predominantly 12 hour shifts, with 4 days on and 4 days off. This rigidity has been identified as:

- increasing the risk of not being able to attend calls quickly
- delaying follow up action
- not being in the interest of officers in terms of health and safety
- negatively impacting victim support.

Moving to a flexible system allows for the matching of staff numbers to workloads by recognising that the daily activities across Local Area Commands can vary and shifts

[24] *Royal Commission into the NSW Police Service Final Report*, May 1997, Volume 2, p.242.

should reflect this. Having more officers on hand in periods of high activity allows police to be better able to respond. For example, general duties officers can be on duty daily, working shifts of between six to 12 hours per day and starting and finishing at different times. Flexible rostering is also likely to improve levels of service provision, officer health and safety and overall productivity, as staffing will better reflect incident activity.

Additional efficiencies are also possible through better training of responses using existing options, including the Police Assistance Line; broader use of single-unit responses for low-risk and non-urgent matters; rotations of general duties officers to dedicated criminal investigation units; and using freed-up officer time for more proactive and community policing.

Case study – Police Death and Disability Scheme

Three schemes have been established under separate industrial awards for police, fire-fighters and ambulance officers. These schemes provide benefits in the event of on- or off-duty injuries resulting in death or disabilities. The police scheme was established in 2005 and has the largest number of members.

Case for change

The cost of the Police Death and Disability (D&D) scheme is far exceeding its budget. Government has contributed over $300 million more than its 3.6 per cent contribution ceiling over the past six years. The flow-on impact on workers' compensation has also led to substantial increases in the Police Force's premium. The other schemes (above) are also beginning to show similar patterns with sharp increases in claims and financial liabilities.

The Auditor General's Report (Managing Injured Police 2008) noted that the Death and Disability Award 2005 is structured in a way to provide an incentive for early separation. Officers can access large lump sum payments after taking extended sick leave at full pay. The overall combined benefits provide little incentive for officers to return to work. The adverse impact on police productivity, performance and culture is significant.

In comparison to other jurisdictions, the NSW Police scheme is the most generous in terms of benefits and government contributions. The schemes in other jurisdictions, apart from the Northern Territory, require officers to fully meet the cost of their benefits and all schemes cost less than 1 per cent of wages compared to 11 per cent in NSW.

Only 1 per cent of officers left NSW Police through retirement in 2009-10, with 55 per cent exiting for medical reasons. This compares with 14 per cent retiring and 9 per cent medical exits in Queensland.

The average tenure of officers under the current scheme leaving for medical reasons is 11 years, compared to 25 years for officers covered under the former (pre-1988) scheme. The percentage of officers leaving for medical reasons under the current scheme has increased from 9 per cent in 2005-06 to 52 per cent in 2009-10.

Cost of program

The cost of the police scheme has increased from $51 million in 2005-06 to $184 million in 2009-10 and continues to rise rapidly. The D&D schemes are also driving up workers compensation costs. The cost of NSW Police's workers compensation has increased from $55 million in 2005-06 to $87 million in 2009-10, and is projected to be over $150 million in 2010-11. The scheme's cost was intended to be 5.4 per cent (with 3.6 per cent employer contribution) of eligible salaries but is currently running at over 11 per cent.

The other schemes are also beginning to show a similar pattern in claims, particularly fire-fighters, with an outstanding liability of $36 million at June 2010, up $10 million from the previous year.

Reform approach

Develop an integrated plan for death and disability and workers compensation reforms to address the unintended outcomes arising from the current scheme design.

Risks of reform

While NSW Police recognises the negative impacts of the scheme on workforce management, there is likely to be significant stakeholder resistance to any change in the current scheme.

Central agencies

The reviews of the Department of Premier and Cabinet (DPC) and NSW Treasury have each highlighted the need for detailed analysis and redesign of key processes and activities across both central agencies.

A number of DPC and Treasury processes have broader resource implications across government. For example, the preparation of the Budget and monthly monitoring consumes significant resources in many agencies. A redesign of key processes across the central agencies provides scope for more significant savings within line agencies.

Benefits arising out of process redesign could be realised in a number of ways, including: workforce efficiencies and reduced contractor usage and consulting expenditure; greater leverage of technology; and enhanced data quality and reduced information asymmetry between line and central agencies.

There is also scope to improve cost recovery and user charging arrangements relating to major events. The Auditor-General has recommended a number of significant changes in the decision-making process for government support of major events[25]. This includes the need for more consistent, complete and accurate costing of events by all agencies involved.

An inter-agency working group has reviewed the Government's current user charges policy for major events[26], agreeing on a number of major changes in August 2010. The proposed changes have not yet been formally considered. The proposed changes

[25] *Auditor-General's Report: Performance Audit of Government Investment in V8 Supercar Races at Sydney Olympic Park*, June 2010.

[26] See Department of Premier and Cabinet, *Whole-of-Government Policy for the Application of User Charges for Major and Special Events*, December 2003, for details of existing government policy.

should be brought forward for the Government's consideration and approval at the earliest opportunity.

Reviewing concessions and community service obligations across government

There is scope for central agencies to develop a more cohesive approach to concessions and community service obligations (CSOs) across government.

An important principle that needs to underlie any approach to concessions and CSOs is that the Commonwealth has both the constitutional responsibility for income support and the financial means to deliver it, unlike the states.

It is proposed that IPART be commissioned to review all concessions and CSOs and provide an economic framework for designing concession programs. Major concession programs across government include pensioner concessions for transport, water and energy, and the School Student Transport Scheme discussed above. Non-specific CSOs and grants (such as subsidies to housing and transport agencies) should be identified and reviewed as part of reforms in those portfolios.

In 2010-11, approximately $1.7 billion was spent on concession programs in NSW, with a further $3.8 billion provided as grants to government businesses for non-commercial activities. The cost of concessions is expected to escalate due to the ageing and expanding population and the concurrent growth in eligibility for concessions. This will place increasing pressure on the State's finances.

A recent review of the Roads and Traffic Authority (RTA) identified concessions as an area requiring further examination. Specific examples include the escalating cost of the RTA's concession arrangements for motor vehicle registration and weight tax, whereby NSW residents holding a pensioner concession card are not required to pay an annual vehicle registration fee or weight tax. The estimated cost of these concessions is around $161 million per annum in forgone revenue and will continue to increase by around $11 million per annum across the forward estimates. In most other jurisdictions, pensioner concession card holders typically pay round $90 to $130 per annum towards the cost of registrations and/or weight tax.

IPART's 2011 report to the new NSW Government on Reform Priorities found that water rebates are around four times greater than energy rebates. Also, water rebates differ significantly between water utilities – rebates for a Sydney Water customer could be three times higher than a customer of Hunter Water, Gosford City Council or Wyong Shire Council. Further, the existing concessions may not provide well-targeted assistance to households in need. Around 22 per cent of low-income households do not hold concession cards and are therefore not eligible for card-based utility concessions. IPART's utilities impact assessment model, based on household survey results, could be useful in calculating the impact of increases in utility prices on different households, the cost to government of changes in concession programs and the flow-on impacts on households.

A recent Treasury review of CSO policy and case studies suggested that the processes for identification, ministerial direction and costing of CSOs were not being rigorously followed. There was also a lack of understanding between parties of their individual roles and responsibilities, and insufficient emphasis on monitoring and reviewing – not only of value for money but of delivered social policy outcomes.

15.10 Recommendations

The Financial Audit recommends:	
Principles for effective service delivery	
15.1	The following principles be adopted across government for guiding service delivery policy, planning and operations: § proactive and innovative rather than reactive service, delivery with a focus on prevention and early intervention § devolution of service delivery decision making to as close as possible to the level of interface with clients § good governance, including separation of the purchasing from the provider functions to provide a focus on the needs of the client uncompromised by the interests of the service provider and to allow for contestability in service provision § a focus on continuous improvement in efficiency § regular evaluations being undertaken on the effectiveness and appropriateness of programs § transparency with respect to performance.
15.2	The Government undertakes a pilot study on implementing an appropriate charge on capital for budget-dependent agencies. The outcomes of this pilot study would be evaluated by Government to determine the appropriateness of implementing a capital charging framework across relevant government departments
Benchmarking	
15.3	Performance benchmarks be established for general government and non-commercial public trading enterprise sector agencies to provide the information base to facilitate an assessment of efficiency and effectiveness in service provision.
Proactive and innovative service delivery	
15.4	Central agencies promote full assessment of proactive and innovative approaches in the human services, health and justice areas. Where there is compelling evidence for the effectiveness and efficiency of proposed proactive and innovative programs, they should be brought to the attention of Cabinet and the Expenditure Review Committee of Cabinet.
15.5	The NSW Government assess the feasibility of a trial of social impact bonds in a number of areas including preventing juvenile reoffending and reducing entry to out of home care.
15.6	Treasury and relevant agencies identify a small number of areas in which application of behavioural economics could result in more effective programs and work with relevant parties to examine the potential for pilot program reforms.
Devolution	
15.7	Noting the Better Schools devolution trial in the schools area, all government agencies be required to investigate and report back to the Expenditure Review Committee of Cabinet on opportunities for further devolution of service delivery.
15.8	A full review of the spatial delivery of services both within metropolitan areas and regional locations be undertaken by a Taskforce led by the central agencies with a view to: § achieving multi agency co-location of services § rationalisation of the spatial location of specialist facilities such as police stations, schools, hospitals, research stations to achieve the most efficient and effective provision of services, with greater use of alternative technology to provide assistance and information to the community.
Good governance	
15.9	The Central Agencies work with government departments to investigate opportunities to utilise purchaser-provider arrangements for delivery of government services at better value to the State.

The Financial Audit recommends:	
15.10	The Central Agencies establish a Task Force to review opportunities to improve the contracting and governance frameworks for service delivery purchased from the private or NGO sectors, including but not limited to: § implementation of performance-based contracting § increasing accountability, transparency and performance monitoring § streamlining contract management and administration arrangements, including minimising 'red tape' and establishing 'centres of excellence' in grants administration and contracts management across government.
15.11	RailCorp, the State Transit Authority (STA) and the Roads and Traffic Authority (RTA) be corporatised with high quality, commercial boards established under a commercial charter, with arms length service delivery agreements with the Department of Transport, based on phasing out inefficiency costs in the provision of services.
Efficiency	
15.12	All government departments continue investigating opportunities for market testing and contracting with the private sector and NGOs for services.
15.13	General government sector-wide efficiency dividends be replaced with a more targeted approach to agency savings, with the Expenditure Review Directorate of Treasury having responsibility for working with agencies on a rolling program of agency efficiency evaluation, reporting to the Expenditure Review Committee of Cabinet.
15.14	Appropriate line-agency Project Management Offices and a NSW Treasury Central Program Management Office be established to drive effective monitoring and delivery of agency-specific and whole-of-government reforms and initiatives.
15.15	The establishment of central corporate and shared services businesses within clusters, noting the plan to establish six such businesses, with a consistent approach to systems and an appropriate governance structure featuring a single commercial board of suitably experienced independents oversighting all six businesses. The board would be responsible for driving efficiency improvements and benchmarking against best practice, including possible further consolidation of the businesses.
Effectiveness	
15.16	The establishment of a new policy framework to drive NSW Government program evaluation which includes an Independent Evaluation Office with the following features: § a Board of Governance reporting directly to the Premier that is comprised of a majority of independent members to support independence of the Office § responsibility to undertake, contract and support rigorous evaluation of Government programs § responsibility to assist with and analyse development of enhanced rigorous evaluation capacity within agencies, including the ability to effectively contract independent program evaluation § powers under legislation to require agencies to provide necessary program information § establishment legislation that mandates that the Independent Evaluation Office provides guidance to promote transparency and public evidence on the performance of government programs.
15.17	Introduction of cost-benefit analysis requirements and guidelines for all new recurrent projects and programs, including the delineation of an evaluation process that is undertaken within a defined period of establishment.
Transparency	
15.18	Treasury to review current program information of general government agencies and work with general government agencies to develop comprehensive program information.

The Financial Audit recommends:	
15.19	Treasury to establish a direct link to program information held by agencies as well as financial information in general and access to agency program information be made available to the other central agencies and to the Independent Evaluation Office.
15.20	The development of a suite of benchmark performance information for general government, non-commercial public trading enterprise sector agencies and major programs.
15.21	The IEO set out in its annual report the work undertaken in program evaluation and provide a commentary on the state of development of program evaluation.
Agency-specific	
15.22	NSW Health to accelerate benchmarking to reduce cost variation, targeting best practice cost, and expansion of activity-based funding as a tool to improve the efficiency of health service through purchaser-provider arrangements.
15.23	NSW Health to work with Local Health Districts (LHDs) to undertake a service review with the aim of implementing service realignments and re-configurations that will improve cost effectiveness, safety and sustainability of services by consolidating and networking services where clinically appropriate.
15.24	An Independent Re-configuration Board be established to advise the Minister for Health on contested proposals for health service changes proposed for LHDs to improve services.
15.25	NSW Health to support LHDs in developing integrated plans to meet health needs of local communities. These should include purchaser-provider arrangements with local private hospitals, primary health care services and Medicare Locals.
15.26	NSW Health to market test non-clinical services such as food, linen, security, facility management and maintenance to ascertain where contracting out of these services can improve cost effectiveness and efficiency within the health system.
15.27	NSW Health to ensure that plans to increase the autonomy of LHDs are accompanied by: § strong accountabilities to ensure performance incentives drive value for money and budget discipline § strong information and research systems to support benchmarking, evaluation and dissemination of best practice § strategies to build clinical leadership at a local level and purchasing and strategic capacity at a head office level § limited use of ministerial and departmental direction on service delivery and development matters, with more decisions made by LHDs § networking efforts across LHDs to achieve economies of scale.
15.28	The Department of Family and Community Services (FaCS) to reform the Out of Home Care (OOHC) purchaser-provider model to significantly expand purchasing from the NGO sector of OOHC (outplacement of children at risk) placements and deliver a lower average cost than currently achieved in NSW. This requires improved contracting practices and capabilities within FaCS and could be achieved by the already established taskforce to drive reforms and engage with NGOs and other involved parties.
15.29	FaCS to review the policy settings and child protection data in other jurisdictions to assess why the number of children in OOHC in NSW is higher than in other jurisdictions. This review should also assess the appropriateness of the balance of resources between family support services and child protection services and effectiveness of family support services.
15.30	The roll-out of individualised funding in FaCS for disability services be accelerated following a review of implementation in other jurisdictions. The scope for a broader roll-out of individualised funding across other human services areas, including Health, should also be investigated.
15.31	Full contestability be implemented for RTA and RailCorp maintenance operations and other suitable inputs to private providers to achieve better value for money.

The Financial Audit recommends:	
15.32	Noting the proposed franchising of ferry operations, together with increased contestability, consideration be given to implementation of contestability of whole transport operations through franchising, once current major inefficiencies have been removed.
15.33	Planning Reform Fees and Development Assessment Fees charged by the Department of Planning and Investment (DPI) be banked as Crown receipts, with DPI being fully funded from the Budget to improve accountability and transparency.
15.34	A comprehensive review of planning fees be undertaken as part of the upcoming review of the *Environmental Planning and Assessment Act 1979*.
15.35	A CEO Committee, reporting to Cabinet, be established to oversee the Government's Murray Darling Basin Plan.
15.36	A full assessment of all energy renewable programs be conducted in relation to cost-benefits and their relevance in the context of contemporary Commonwealth policy direction such as the proposed introduction of a carbon tax.
15.37	Cessation of the police authorised strength concept, allowing the Police Commissioner greater authority and flexibility to determine matters of staffing structure and deployment to meet current needs and resources.
15.38	NSW Police implement reforms to increase flexibility in police rostering, allowing better capacity to better match resources with demand across the Local Area Commands.
15.39	The Police Death and Disability Scheme and associated other equivalent schemes be the subject of major reform to make it affordable, equitable and provide the appropriate incentives to return police to work in as timely a manner as possible, modelled on the successful programs in other jurisdictions.
15.40	Review existing governance arrangements across art, sport and recreation entities with a view to rationalising the number of individual agencies and governing trust boards to maximise shared service arrangements and improve resource allocation.
15.41	Develop and implement purchaser-provider arrangements between Arts NSW and cultural institutions, with an in-built system of integrated planning and budgeting.
15.42	Implement the proposed changes to the Government's User Charges for Special Events, developed through an inter-agency working group in 2010.
15.43	IPART undertake a full review of all concessions and community service obligations (CSOs) and develop an economic framework for the assessment of concession programs.

16 IMPROVING ASSET MANAGEMENT AND PRIORITISATION AND EFFECTIVENESS OF CAPITAL EXPENDITURE

Key points

- Infrastructure planning in NSW is inadequate despite a government-mandated planning, project appraisal and budget approval process. This has resulted in flawed project prioritisation and selection, feasibility/integration problems and cost blow-outs, ultimately leading to policy reversals and a perceived 'failure to deliver'.
- Issues with infrastructure planning have included:
  - projects have been promoted for their own sake, with inadequate evidence of expected service benefits and system-wide prioritisation, or of wider economic or social benefits
  - a failure to rigorously assess projects, with an inconsistent adherence to state procurement and project appraisal processes, which require objective analysis of economic and social benefits and costs
  - excessive focus on new infrastructure provision over ensuring the appropriate maintenance and full utilisation of existing infrastructure
  - inadequate emphasis on developing and prioritising medium-term infrastructure plans within realistic funding limits (consistent with Total Asset Management policy for developing the State Infrastructure Strategy)
  - lack of attention to alternatives or complements to capital expenditure such as effective demand management.
- The establishment of Infrastructure NSW to coordinate and 'quality assure' infrastructure planning and oversee the delivery of major infrastructure projects can assist in addressing these infrastructure planning issues.
- Infrastructure planning issues are acute in the transport sector. Traditional supply-side measures are unlikely to be sufficient to address the challenges of peak road congestion and overcrowding of public transport services.
- Introducing more effective demand management approaches, in tandem with the provision of new transport infrastructure, is required to significantly improve outcomes. Pricing measures are likely to be the most effective demand management interventions and represent substantially better value for money for the community than new infrastructure alone.
- There are significant opportunities to improve the efficiency of service delivery by selectively rationalising state infrastructure assets.

16.1 Overview

The Government owns fixed assets valued in excess of $115 billion at book value. Their replacement cost is likely to be many times higher. These assets comprise much of the essential infrastructure of NSW. They enable the delivery of essential government services to the community, like health and education, ensure the provision of electricity and water to consumers and, through the transport system, physically link businesses to markets and individuals to their communities.

Over the forward estimates period, the Government is projected to invest over $62 billion in the State's infrastructure. The ultimate goal of this investment may vary across different sectors (beyond merely satisfying the perceived demand). Investment in the transport, water and electricity sectors, for example, may primarily be to sustain economic growth, whereas investment in hospitals, schools and police stations may be to deliver the Government's social objectives.

The Government's role in delivering infrastructure varies across sectors. Budget-controlled general government agencies play a large role in the planning, project selection and funding and delivery of social and transport infrastructure. In contrast, the delivery of core economic infrastructure in the water and electricity sectors is effectively delegated to commercial agencies supervised by a price regulator.

However, all government agencies need to take a strategic approach to both managing their existing asset base and investing in new infrastructure.

Capital assets should not be seen as an 'end' in themselves, but as a facilitator of desired societal objectives. This means both capital management and investment plans should be based on an identification of:

§ the underlying economic and social goals government is trying to achieve

§ the service improvements required to support these goals

§ the available options that will achieve the desired service improvements.

These options should include not only capital investment programs, but also options that improve the utilisation of the existing asset stock and other non-asset-based options, where possible. For example, improving travel time to work may be achieved more effectively, at significantly lower community cost, by measures such as pricing incentives and staggered working hours rather than by a massive investment to increase peak-hour capacity.

To identify the best solution, each option needs to be appraised and prioritised based on its strategic fit, benefits and costs, delivery risks and affordability. In the commercial public trading enterprise (PTE) sector, financial appraisal will identify the most effective projects. In the general government and non-commercial PTE sectors, where most infrastructure is funded by the State, economic appraisal methods, which consider wider economic and social benefits and costs, should be used.

Once a set of investment priorities has been established, government needs to determine the most appropriate methods of funding and financing these investments. Ultimately, all funding is provided either by users or by taxation (whether from state or Commonwealth grants to delivery providers). Financing refers to cash (provided by the public or private sectors) to cover the timing mismatch between funding and the up-front expenditure inherent to most capital investment. For example, under the privately financed project (PFP) model, a hospital building is built using finance raised by the private sector but ultimately funded by taxation and user charges.

The use of a PFP should be a delivery option considered after the economic and financial feasibility of a project is established, based on improving value for money and achieving an appropriate risk allocation. Conversely, the fact a project may have a revenue stream does not of itself make a PFP economically justifiable. For example, the necessary user charge may have attributes of a tax and in fact be independent of the incremental value added by the new infrastructure. Section 8.2 discusses the need for rigorous assessment with regard to contractor capability and criteria that should be considered prior to entering into a PFP.

Economic infrastructure developed by the commercial PTE sector mostly operates in well-governed, established market and regulatory frameworks. The Total Asset Management (TAM) planning process has encouraged budget-dependent agencies to take a holistic approach to service and asset planning and is used by Treasury to estimate future capital expenditure requirements in the State Infrastructure Strategy (SIS). The State's procurement policy is founded on objective evaluation and independent review of project proposals and is consistent with best practice both in Australia and overseas. NSW has also been at the forefront of developing PFP policies and processes.

However, although NSW has a robust asset management and capital investment framework, there is variable consistency and quality in its practical application. Rigorous planning is sometimes absent and tends to follow, rather than lead, the commitment to an infrastructure investment. There is therefore a need to reinforce the commitment to proper capital planning, to enable desired societal outcomes to be met, while ensuring investment remains affordable to the State.

Most of the changes suggested in this chapter do not require NSW to significantly alter its existing policies and processes. More important is to ensure that these processes are consistently adhered to. It is expected Infrastructure NSW (INSW) will play a significant role in this regard. INSW has been established by the Government to improve the identification, prioritisation and delivery of critical infrastructure across the State.

16.2 Current issues with infrastructure planning and management

Infrastructure planning in NSW has not consistently followed the Government's policies and processes, resulting in flaws in the planning and management of major programs, particularly those that are funded by the Budget. Particular concerns include the following:

- Some specific infrastructure projects have been pursued for their own sake. The underlying societal objectives of an investment are either not identified, or projects are not properly analysed to determine what outcomes they actually deliver.
- Projected service demand is often treated as a 'given' that must be met by infrastructure almost regardless of the cost or value offered. There is also limited recognition of 'excess', meaning low-value demand that is often induced by the free (or highly subsidised) provision of infrastructure.
- Projects are not always subject to rigorous evaluation before they are announced publicly. This includes both financial and economic cost-benefit analyses which are sometimes treated as a 'compliance' exercise, rather than being genuinely used by agencies to identify and evaluate optimal service solutions. Announced cost estimates are often much lower than final outturn costs.
- The supporting evidence base for projects is sometimes inadequate and anecdotal in nature.
- The Metropolitan Strategy, which forms the underpinning of much metropolitan infrastructure planning including the $50.2 billion Transport Plan, is based on an aspirational spatial distribution rather than actual market evidence.
- Limited consideration has been given to the coordination and prioritisation of new infrastructure within and across sectors (including, for example, between different transport modes).
- An emphasis has been placed on providing new fixed infrastructure over maintaining existing assets or improving the utilisation of existing assets.
- The annual budget process (and a four-yearly electoral cycle) has reduced planning horizons and commitments and can lead to a cycle of new project announcements disconnected from a holistic planning strategy.
- A failure to strategically prioritise needs within realistic future funding limits set by reference to the fiscal capacity of the State.
- Public project commitments have been made before detailed studies have been completed. There have sometimes been significant feasibility, integration or network-wide issues that have not been resolved, or major differences between an announced project cost and the actual delivery cost. The latter is in part because of failure to include escalation, recognise recurrent impacts and include all works within the project scope and proper contingency allowances.

These issues are discussed in more detail below.

As a consequence of the above failings, plans have frequently changed. For example, NSW set out seven (sometimes conflicting) transport plans from 1998 to 2010, and many prematurely announced projects have not been delivered. The perceived ‘failure to deliver’ stems from inadequate planning, which in turn results in flawed project selection, cost blow-outs and, eventually, policy reversals. Some recent illustrative case studies are set out below.

Infrastructure planning has been more effective in the commercial PTE sector, where the stronger market and regulatory frameworks encourage rational capital allocation decisions. Nevertheless, the commercial PTE sector capital program has a significant impact on total state capital expenditure levels and debt financing, which can potentially constrain general government expenditure. Moreover, given recent public debate on the impact of these businesses’ investments on community cost of living and the broader economy, there is merit in considering ways to further strengthen these frameworks and improve the link between these and related government processes for determining service standards and budget prioritisation and formulation.

The general government capital program is dominated by the $50.2 billion Metropolitan Transport Plan which requires a complete reassessment. At present the Transport Plan is simply a collection of projects without any intermodal integration or demand side solutions. The Financial Audit welcomes the decision that Infrastructure NSW will undertake a full review of the plan. However, the review will need to go beyond the projects to an underlying needs analysis based on a fully revised, market informed Metropolitan Strategy. It will need to assess underlying population and economic factors, alternatives to infrastructure and the role of demand management. This will inevitably lead to reassessment of the projects currently in the plan and of projects and strategies not at present addressed in the plan. Some of the projects have been endorsed by the Government, the most prominent being the North West Rail Link. This project is estimated to cost $10 billion and is estimated to provide 28 million rail passenger journeys per year but of this only 9 million are new rail journeys (the other 19 million involve diversion from other rail lines). The cost per incremental trip is estimated at $80. It should also be noted that the project has exhibited a marked increase in capital cost. In the February 2010 Transport Plan it was estimated at $6.7 billion, but was revised to $7.5 billion in April for the submission to Infrastructure Australia and was further revised to $9.4 billion in May 2010. While accepting the Government’s commitment to the project, there is a clear need to reassess the scale, cost, timing and linkage of this project to the overall rail strategy. It is also suggested that rather than draw on detailed design by the public sector, the discipline and competitiveness of the private sector should be used to design, construct, maintain and possibly operate the line.

Case study – Cancellation of the Sydney Metro

Announced in 2008, the Sydney Metro was a proposed metro rail line running from Rozelle and Pyrmont, connecting at Wynyard, Town Hall and Central. It was derived from a North West metro system conceived as an alternative to a North West Rail Link.

The Sydney Metro Authority was formed and tasked with its development and planning. Despite heavy criticism from within the transport sector and NSW business forums, the Authority continued planning until February 2010 when the previous Government released its Metropolitan Transport Plan and announced its intention to no longer proceed[1].

The 2010 Auditor-General's Report confirmed that as at 30 June 2010, $412 million had been spent on Metro projects, including $176 million in project expenditure which was written off, $94.9 million in cost reimbursement claims and $103 million in property acquisition claims. The high public visibility of the project and its failure has produced considerable public concern as to the integrity and effectiveness of infrastructure planning.

Arguably, while the project had transport benefits, for example, reducing bus traffic into the CBD and improving travel times for Victoria Road commuters, it could not address the core transport challenge of congestion on the Western rail lines and at city stations. This would depend upon a much larger metro network being built. When this proved unaffordable, the principal rationale for the project was lost.

Case study – Economic assessment of the Parramatta-Epping Rail Link

The Parramatta-Epping Rail Link (PERL) has long been included in a raft of RailCorp capital project plans for future network upgrades. PERL's relative importance was reflected in the Metropolitan Transport Plan (MTP), released in February 2010, which did not rate the link a priority for the first 10 years of the plan[2]. There has not been a detailed economic evaluation prepared for PERL. In fact, the Infrastructure Australia submission for the project sought funding for a further investigation, including developing a business case.

In August 2010, the Commonwealth offered financial assistance of $2.1 billion specifically for the PERL, to commence in 2014-15, with no advice on the likely yearly cashflow to NSW. There were a number of risks associated with the project, including pressure on the State's capacity to stay within the MTP total funding envelope, high-risk construction conditions that had not been fully examined and an actual project scope which had not been settled.

[1] Audit Office of NSW (2010), *Auditor-General's Report to Parliament 2010: Volume Nine*, p.197.
[2] NSW Government (2010), *Metropolitan Transport Plan*, p.43.

Case study – Transport plans in NSW

There have been multiple transport plans and major announced innovations in public transport over the last 12 years:

- 1998 – Action for Transport 2010 – an integrated transport plan for Sydney
- 2002 – Long Term Strategic Plan for Rail (Christie Report)
- 2005 – Metropolitan Rail Expansion Program
- 2006 – Urban Transport Statement
- 2008 – Sydney Link – NW Metro project first component
- 2008 – Sydney Metro – CBD metro only
- 2010 – Metropolitan Transport Plan – a 10-year, $50 billion funded program

The latest Metropolitan Transport Plan was the largest single planned investment in NSW. However, many of the constituent infrastructure projects have not yet been the subject of detailed economic or financial evaluations.

It included light rail, significant additional buses, ferry fleet replacement, the Western Express Line and additional rolling stock (rail). The plan excluded operational strategies to address future demand and was solely focused on infrastructure solutions.

The plan was an infrastructure-only plan, in common with those of the past and did not offer a comprehensive strategy that addressed all elements of operations, including reforming user charges.

Inadequate specification of infrastructure investment objectives

Infrastructure investment in NSW has sometimes been poorly targeted to deliver on the Government's underlying social and economic goals.

A driving reason for investment is often to satisfy an unmet demand, which presents as congestion or queuing. However, the fact there is an unmet demand is not of itself proof that there are social or economic benefits from providing infrastructure in general or at a particular location. It also does not follow that increasing capacity will lead to improved service outcomes.

For example, addressing traffic congestion by increasing road or public transport capacity on outer city arterial routes may perversely encourage the further dispersal of businesses and residences and induce an increase in vehicle travel and congestion. Further, demand for many government services is unconstrained by no, or highly subsidised, user charges, with congestion and waiting lists the only factors that control what is otherwise an effectively unlimited demand.

Another example is the transport sector investment driven partly by the previous Government's State Plan target to increase the modal share of public transport (by, for example, the rapid expansion of bus fleets). This target (as opposed to individual projects) of itself is not directly correlated to economic growth or improved social equity.

Even if the investment can be linked to a desired social or economic benefit, the questions remain: ‘Is it value for money compared to other alternatives?’ ‘What is the improvement in the overall productivity of the State?’ and/or ‘What is the subsidy cost for each beneficiary and is this either appropriate or intended?’

The proper way to analyse a prospective project is to undertake a full cost-benefit study which measures both the economic value of the project (including social and environmental impacts) and identifies the full range of beneficiaries and those that may be worse off (including taxpayers).

These studies not only describe the overall productivity impact of a project but also identify the winners and losers (generally taxpayers), and the nature of the benefit conferred. It is then legitimate to ask whether the benefits conferred are appropriate and in fact deliver on the intended social/economic or equity objective.

An example is the current program to acquire over 600 new train carriages to replace older rolling stock. From an operational perspective, older carriages are more expensive to maintain and are less reliable, but the substantial capital costs of a new asset make keeping older rolling stock running (‘sweating the asset’) a far superior business proposition. This is the approach taken by many commuter railways across the world. But the benefit of new rolling stock is air-conditioning for travellers. This is highly valued during Sydney’s hot summer days and helps the cost-benefit study to ‘stack up’. The question is whether this benefit should be subsidised by taxpayers or funded solely by higher fares, given it is clearly a benefit to users rather than the wider society.

Similarly, the value of infrastructure is not necessarily captured by targeted users but may be appropriated, for example, by owners of properties serviced by the infrastructure. Those owners may, in turn, be able to charge higher rents to the businesses and users who can take advantage of the new facilities.

Weak evidence base in planning for NSW

Infrastructure investment decisions are very heavily influenced by demographic and planning assumptions. Two important sources of information are the outcomes of the Strategic Travel Model (STM) maintained by the Bureau of Transport Statistics (BTS) and the Metropolitan Plan developed by the Department of Planning and Infrastructure. However, both have shortcomings.

The STM operates within a framework of fixed assumptions on land use, modal share, population growth, employment distribution and pricing scenarios. It doesn’t have a dynamic component that allows for the fixed assumptions to be updated. For example, it does not capture changes in private investments (in housing and businesses) and travel patterns that are induced by changes in a transport network. The STM also has relatively limited statistical validity given it is calibrated using data from only 5,000 households surveyed each year[3].

The Metropolitan Plan presented a desired scenario which future planning instruments and government investment may promote, but not necessarily deliver. Critical outputs included the location of new housing and of new jobs.

The Plan assumed 30 per cent of new housing would be in greenfield areas and 50 per cent of jobs growth in Western Sydney, including 20 per cent in South Western Sydney (a 106 per cent increase to 2036). In addition, 20 per cent of new housing was planned as infill housing in current outer-ring areas.

The Metropolitan Plan reflected planner desires and not market reality. In relation to greenfield development, the current market evidence does not support this target. Over the past five years, greenfield housing has averaged around 15 per cent of total production following a gradual decline over the past two decades. This was not just influenced by land available for release, but by the shifting preferences of home buyers, the relative location of employment growth and the absolute distance of new release areas from the Sydney CBD. These factors translated into lower values for housing, particularly in the South West, which in turn reduced the feasibility of land development. Similarly, based on land value, increasing housing density has not been feasible in many middle-ring and all outer-ring suburbs.

Future infrastructure investment decisions must be based on the best economic evidence that is available. The Metropolitan Plan is not a sufficiently robust source to anchor decisions which may involve investing tens of billions of dollars. Similarly, while the STM can certainly contribute to decision making, its shortcomings mean that it should not be determinative for every major investment.

This is underlined by findings of a report by the Centre for International Economics, commissioned by the Department of Planning and Infrastructure, which found that transport and physical infrastructure costs can be substantially higher for greenfield development than for development in existing areas[4]. This reflects the need to connect greenfield areas into existing transport, water and energy networks, and to provide necessary social infrastructure. Accordingly, if housing and employment targets do not accurately reflect changing consumer preferences for infill development, there is risk new assets will be under-utilised and unnecessary costs incurred.

---

[3] Bureau of Transport Statistics (2010), *NSW Transport Household Travel Survey*, pp.45-46.

[4] Centre for International Economics (2010), *The Benefits and Costs of Alternative Growth Paths for Sydney: Economic Social and Environmental Impacts*, Prepared for NSW Department of Planning.

Poor infrastructure coordination

Integration and coordination of infrastructure planning has also been inadequate. It has proven challenging to coordinate infrastructure investment in growth areas by all relevant state agencies to enable intended residential and commercial development to proceed in a coordinated manner. These infrastructure services span both the general government – transport, health, education and emergency services – and PTE sectors, including water and electricity distribution.

In the transport sector, projects in one mode have often been developed in isolation by a line agency without sufficient consideration of portfolio impacts. As a result, intermodal services are insufficiently coordinated in many areas. A particular example in Sydney was the almost simultaneous delivery of the Airport Rail Link and the Eastern Distributor – the latter enabling a 15-minute taxi ride from the CBD to the airport, which all but eliminated the benefit of the railway for business travellers.

Issues with coordination may have arisen in part from inadequacies in the State's infrastructure planning framework. The development of the State Infrastructure Strategy has historically been primarily a coordination exercise based upon a compilation of agencies' individual Total Asset Management plans. Central agencies have not used the process to ensure compliance with specific state economic and social goals, or to make sure project plans are coordinated across different agencies.

Case study – Infrastructure coordination of stadia across NSW

There has been a lumpy, uncoordinated and ad hoc approach by government to spending on stadia across NSW. Over the past five years (2006-07 to 2010-11), funding of around $175 million was allocated towards the upgrade of NSW stadia without reference to an overarching strategy based on a comprehensive assessment of the State's needs. For example, a $45 million contribution (over two years) was committed towards the redevelopment of Sydney Showgrounds, Olympic Park, right next to an existing stadium (Olympic Stadium) which could have been utilised.

Inadequate focus on maintenance and recurrent costs

Ensuring existing infrastructure is maintained to a level appropriate to meet the demands placed on it by users is, in some ways, the most important aspect of effective infrastructure planning. In the general government and non-commercial PTE sectors, however, priority has often been given to new investment over ensuring the existing asset stock is adequately maintained.

For example, the RTA has shifted its spending significantly towards development and away from maintenance. The Audit Office's 2006 report on state roads noted that since 1995-96 spending on maintenance had grown by 20 per cent in real terms but spending on developing the road network had grown by more than 50 per cent[5]. The Commonwealth's contribution to development more than doubled, but its contribution to maintenance fell by a fifth. This leaves the RTA having to fund the increased maintenance expenditure required to prevent its asset stock deteriorating from state sources, which can result in funding being diverted from other areas. These areas include expansion of congested urban roads that largely fall outside Commonwealth programs and which the RTA and the State Government see as a priority.

Similarly, NSW Health has a capital program of $1 billion in major capital and $100 million in minor capital works for 2010-11. This includes significant upgrades for the Liverpool, Nepean, Orange and Royal North Shore hospitals. Health is not subject to efficiency savings targets; it is meant to meet its costs within a growth funding model that recognises an appropriate level of growth adjusted for an efficiency factor. Capital projects submitted by Health are in principle understood to have any associated costs met from within its overall funding envelope. However, Health has recently indicated that it is unable to meet the anticipated recurrent costs from its current program of capital investments from its agreed 5.4 per cent annual growth funding allocation. Health is indicating that the recurrent impacts of new assets are now adding to its funding risk.

To try and ensure maintenance issues are taken account of, current Total Asset Maintenance (TAM) policy requires agencies to explain how asset expansion is prioritised relative to maintenance needs. Budget submissions require Financial Impact Statements for each project that identify recurrent costs associated with capital projects. However, adherence has been partial, which creates a risk in respect to the forward estimates.

Poor maintenance arises partly because agencies in the general government and non-commercial PTE sectors, which are primarily funded by government grants, lack the commercial signals that encourage SOCs and privately owned corporations to maintain their asset stock. It may also arise because maintenance activity is inherently less visible than new investment and therefore may not be prioritised by governments to the degree required.

Under utilisation of existing infrastructure

On average, the State has sufficient infrastructure to meet the total demands placed upon it. The challenge is that demand varies considerably from the average and fluctuates over time. There is also shifting demand between regions influenced by changing demography.

This phenomenon is perhaps most readily apparent in the transport sector. At peak hours, metropolitan Sydney and some regional towns experience significant road congestion and public transport overcrowding. Outside of these times, capacity is generally available. These demand patterns exist because transport users do not face

5 Audit Office of NSW (2006), 'Performance Audit: Condition of State Roads, Roads and Traffic Authority of NSW', p.32.

the true economic and social costs of their travel decisions – the congestion and overcrowding they cause.

This results in investing to achieve peak-period capacity such as with road and rail capacity and with energy generation and distribution capacity. While it is clearly necessary to plan peak demand, it is also necessary to consider to what extent peak demand can be influenced and shifted.

In the area of roads, time-of-day tolling and congestion pricing can have a significant impact on road use. In the energy sector, load interrupt-ability provisions for certain forms of load and measures that encourage energy conservation can reduce the need for massive peak period investment.

In social infrastructure, asset utilisation can be improved also. For example, hospitals in NSW have been able to increase the numbers of operations they perform without increasing investment in expensive theatre capacity by adopting twenty-four hour running.

Case study – Asset utilisation of courts

The number and location of courts operating in NSW does not reflect the current operating environment but rather historic factors. Analysis of operational data (2007-08 caseload) and financial information (2008-09) indicates that:

- the 50 courts with the smallest caseload comprise less than 2 per cent of the total workload across all NSW local courts, but constitute around 4 per cent of total expenditure
- the bottom 100 courts comprise around 12 per cent of the total workload and represent around 19 per cent of total expenditure
- in aggregate, almost $100 million is expended across NSW local courts per annum, including substantial outgoings and maintenance related to underutilised court infrastructure.

Given extremely low caseloads at some local courts and a disproportionate level of expenditure, it appears it may be reasonable to examine the feasibility of reducing the number of smaller courts and making better use of the balance.

Implementation of a hub and spoke model, for example, could enable closure of less utilised courts, consolidation of services at regional hubs and limited service provision at other courts within the system.

Case study – Asset utilisation of school facilities

For school infrastructure, demographic changes can create mismatches between local student numbers and the capacity and distribution of existing school facilities. In practice, strategies to improve poorly utilised schools are complex and must consider the economic and demographic impacts of closing schools and investing in other schools, issues for parents and the school community and the future flexibility of facilities.

Current levels of underutilised school facilities impact the effectiveness of the overall resources available for schools. About 8 per cent of total school buildings are excess to the requirements of students attending those schools (after allowing a 30 per cent threshold above standards).

This causes unnecessary spending on maintenance, cleaning, capital spending and administration. There is also emerging research that links improved educational outcomes with larger student cohorts, typically in larger sized schools.

Inadequate project prioritisation

The Government does not have a system for ranking budget-funded projects across sectors, and while individual agencies may have a system, potentially driven by addressing pressure points resulting from actual or forecast excess demand, the criteria is not transparent or coordinated across government.

For example, while economic and financial evaluations are routinely used to assess individual projects, these are not used to rank projects. Even within portfolios there are examples of projects with significantly different benefit-to-cost ratios. For example, the un-tolled M5 East duplication has a benefit-cost ratio of 2.42[6], compared to the North West Railway of 1.39[7] and the Berry road bypass project with 0.3.

Project selection is also not always weighted by the number or extent of beneficiaries. For example, while Sydney accounts for 63 per cent of the State's population and for 55 per cent of total vehicle kilometres travelled in 2010-11, it only accounts for 20 per cent of the RTA's total major capital program.

There is also no basis for allocating scarce budget capital between sectors, with current investment influenced by the historic rates of investment rather than an assessment of objective needs.

Poor project cost estimation

Government has a very poor history of completing major projects on time and/or within (initially announced) budgets. Particular examples include the Epping-Chatswood Rail Link (see case study), the Millennium Train sets and the Liverpool and Royal North Shore hospital redevelopments. Poor cost estimation obviously prejudices infrastructure planning and can lead to poor project selection.

Case study – Costing the Epping-Chatswood Rail Link

The original announced cost in 1998 (Action for Transport for 2010) of the Parramatta-Chatswood Rail Link was $1.4 billion.

[6] Department of Transport (2010), *Updated Transport Submission by NSW Government to Infrastructure Australia; M5 East Expansion*, p.74.

[7] Department of Transport (2010), *Updated Transport Submission by NSW Government to Infrastructure Australia; North West Rail – Hills District Line,* p.12.

The announced cost of the Epping to Chatswood Rail Link component alone, when commissioned in 2001-02 (Budget Paper No. 4) was $1.6 billion. The final completion cost for the Epping to Chatswood section was $2.3 billion.

The approximately $700 million difference was driven by project escalation (inflation) of 3 per cent per annum ($270 million), a project contingency ($200 million), additional noise mitigation in tunnels ($83 million) and other unbudgeted costs, including scope changes, interface works and commissioning costs ($124 million).

While defensible, the changes in cost could – and should – have been anticipated and incorporated in the initial estimate used for decision making. The cost estimates, including an appropriate project contingency, should be set at a 'P90' level, meaning there is only 1 in 10 chance the estimate will be exceeded.

16.3 Proposals to improve infrastructure planning and management

Infrastructure NSW – applying a strong integrated planning framework

The creation of Infrastructure NSW (INSW) provides an opportunity to strengthen existing infrastructure planning processes and to particularly address:

- the co-ordination of infrastructure planning and delivery
- the prioritisation of projects within sectors and across government
- the compliance by agencies with the Government's procurement policies (as a condition precedent to recognising projects within the requisite plan) and in particular the application of rigorous project planning and assessment tools including economic evaluations.

Infrastructure NSW should drive:

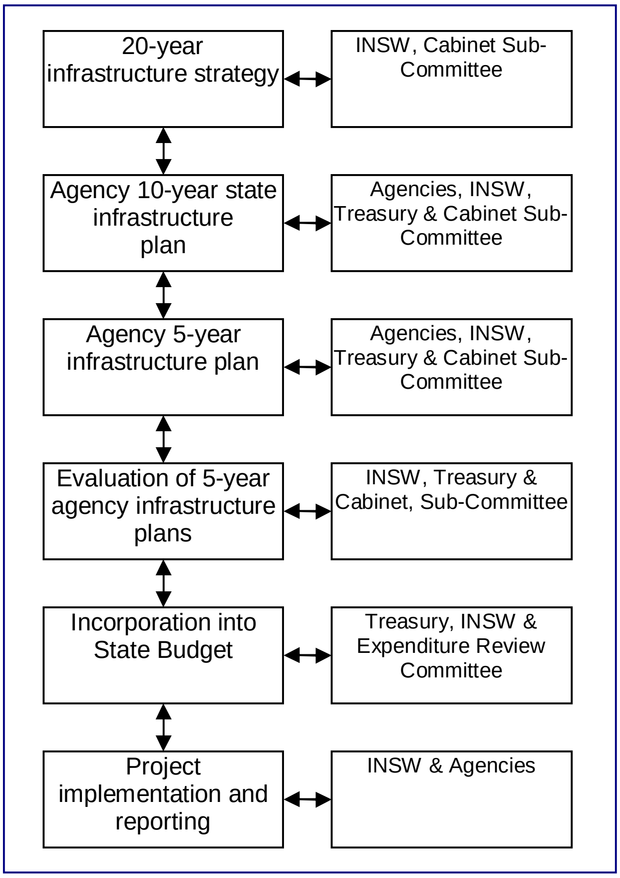
- The revision of the State Infrastructure Strategy (SIS). This should become a 20-year, high-level strategy setting out long-term infrastructure priorities based on sound evidence and aimed at achieving defined social and economic goals set out in the State and Metropolitan Plans. The SIS should be reviewed every five years, in line with the reviews of these plans. As per Infrastructure Australia's approach, INSW should take a thematic approach, focussing on service needs and infrastructure or capacity gaps (the problems), rather than specific investment projects (potential solutions), which cannot be specified with confidence over this timeframe.
- The development/update of a 10-year infrastructure plan. This will set out specific measures designed to meet the priorities of the 20-year SIS. This plan will provide total capital expenditure estimates by sector, based on agency Total Asset Management (TAM) Plans and PTE Statements of Corporate/Business Intent, and be aligned with the State's overall fiscal strategy and resourcing constraints. The plan would include major investment projects, provisions for future (unspecified) requirements and would also be supported by other options for meeting community needs, such as service changes and demand

management strategies. The 10-year plan would be flexible to changing circumstances (not a committed list of projects) and be revised every two years.

§ The introduction of detailed five-year agency infrastructure plans for the general government and non-commercial PTE sectors. These plans would identify immediate priority infrastructure projects, their rationale for selection, timing, estimated cost and recommended funding and delivery model. These plans should also detail each agency's asset management strategy to ensure recurrent impacts – particularly maintenance expenditure – are accounted for. The first four years of these plans would be incorporated into the State Budget. They would be reviewed annually.

This recommended approach remains consistent with existing TAM Policy for developing the SIS (refer Chapter 8). The links between plans over the various timeframes are set out in Figure 16.3.1.

Figure 16.3.1 Proposed infrastructure development approach



INSW's role should be to lead the development of these plans, working with principal departments and line agencies, who will retain detailed planning responsibilities, reflecting their expertise in their sector, resourcing and the importance of maintaining effective accountability.

It is expected INSW will submit these infrastructure plans to a dedicated Infrastructure Sub-Committee of Cabinet for their endorsement. Funding approval for specific projects to be included in the detailed five-year agency infrastructure plans should remain with a separate Budget Sub-Committee of Cabinet and form part of the wider budget process. This is essential to ensure that plans are consistent with the fiscal strategy.

As a first step to develop the initial SIS, it is recommended INSW:

- undertake a comprehensive audit of the existing asset stock of NSW
- review forecasts of future demands on NSW's asset stock, including population growth, employment trends, expected land-use patterns, environmental concerns and technological change, based upon Department of Planning and agency advice, and other available evidence
- review agencies' TAM plans and their current methods and capabilities for prioritising infrastructure needs and evaluating project merit and make recommendations for improvements.

The infrastructure audit will provide infrastructure planners in NSW with an understanding of key asset 'gaps' in existing infrastructure and quantify the maintenance activity required to restore existing infrastructure to a sustainable level.

Infrastructure planning will be supported by the Government's decision to consolidate NSW agencies within nine clusters. For example, in the transport sector, the Government is in the process of establishing an integrated approach to transport planning and delivery under the Department of Transport. This will promote the optimisation of sector's capital programs across all modes, including the consideration of the trade-offs (and synergies) between delivering public transport and enhancing the road network.

Improve identification of alternatives to infrastructure solutions

New infrastructure is attractive to both users and agencies. Its construction often provides tangible physical evidence to the community of an agency's and a government's commitment. However, infrastructure, beyond its sometimes high up front capital cost and operating cost, has inherent shortcomings. For example, it is often fixed and can't be moved or converted to meet a change in future demand.

As part of the initial infrastructure project appraisal, a full range of options should be considered. These include:

- alternative forms of infrastructure that may deliver the same outcome (e.g. a bus network versus a fixed railway)
- alternative programs that might displace the need for infrastructure (e.g. visiting community nurses as opposed to an expanded care facility)
- making better use of existing assets (public or private) that have capacity or can be adapted to use (e.g. wheelchair taxis rather than ambulances, private charter vessels that are available during the commuter peak rather than new ferries, extending operating hours at busy facilities, contracting with private hospitals)

- managing excess demand and congestion by the use of economic pricing (e.g. the deferral of the need to build additional dams through variable rather than fixed water pricing) or clearer eligibility criteria focussed on the actual objectives of a program
- changing the specification or regulatory conditions to meet actual conditions (e.g. scheduling bus replacement based on actual fleet condition rather than an arbitrary average fleet age)
- continuing to maintain or refurbishing existing assets, with an emphasis on the utility of a public asset and its safety and fitness for purpose; it does not necessarily need to conform to a standard of amenity or presentation that users might expect of a good they were purchasing for themselves.

These alternatives should be formally canvassed as part of a business case, which is reviewed through the Gateway Review process.

Reform option 1 – Road pricing of the Sydney Motorway Network to reduce congestion

Peak period traffic congestion in Sydney is costly, chronic and systemic. In 2010, the avoidable social cost of traffic congestion in Sydney was estimated to be $4.9 billion. This figure is expected to rise to nearly $7.8 billion by 2020[8].

Overseas evidence suggests road pricing can have a significant and immediate impact on reducing traffic congestion by signalling to road users the marginal cost to society of using the road network.

The Henry Tax Review also recommended that governments analyse the potential network-wide benefits and costs of introducing variable congestion pricing on existing tolled roads and consider its expansion to heavily congested parts of the network (Recommendation 61)[9].

Currently, only the Sydney motorway network has some semblance of road pricing through the imposition of tolls. However, this is determined in an inefficient manner as not all sections of all motorways are tolled and the tolls are set to recover the costs of asset construction rather than reflect the marginal cost to society of using the road network at that time.

Reform Options

Reform option 1 – Increasing and broadening road tolling

The Financial Audit recommends that the Government investigates the introduction of consistent tolling across all the Sydney Orbital Network as a first step.

This would include pricing that varies by time of day and distance travelled. Analysis undertaken by NSW Treasury suggests that applying a 50 cents per kilometre charge for the untolled portion of the network (including restoring tolls on the M4), and reforming the M5 Cashback scheme, might generate up to $780 million annually.

---

8 Bureau of Transport and Regional Economics (2007), *Estimating urban traffic and congestion cost trends for Australian Cities*, Working Paper 71, p.108.

9 The Treasury (2009), *Australia's future tax system, Report to the Treasurer*, p.377.

Tolling the Sydney Orbital Network, also known as a corridor pricing approach, is suited to Sydney's travel patterns. Congestion tends to be concentrated along corridors, rather than in particular commercial centres.

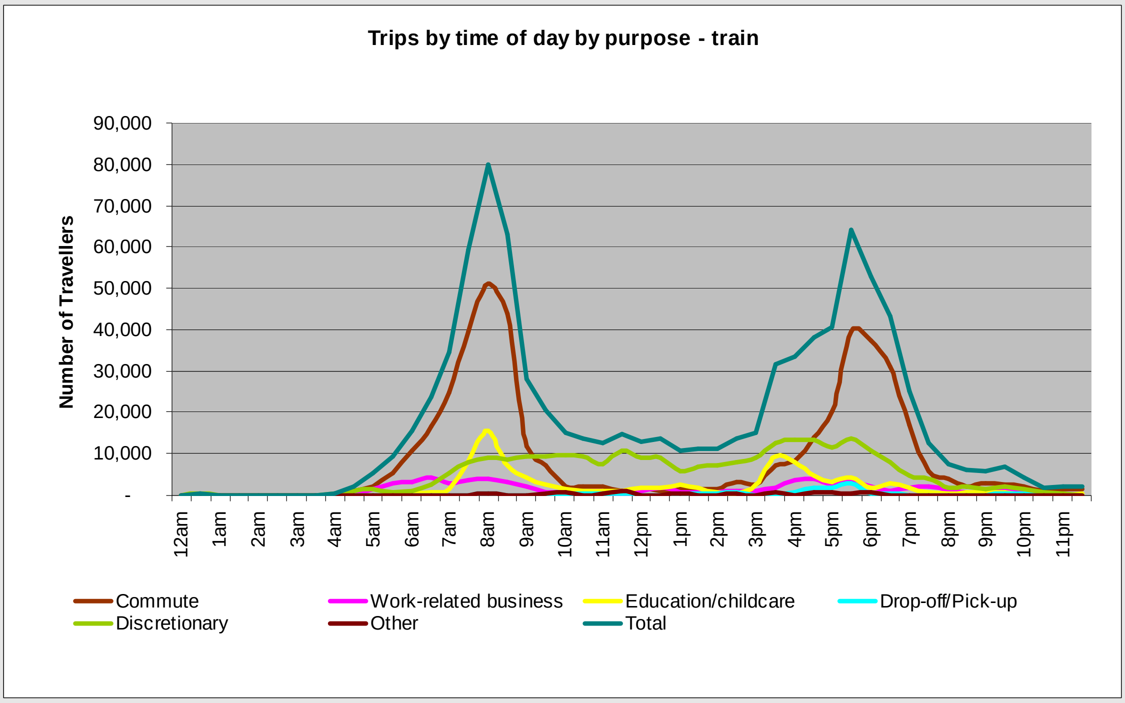
Over the longer term, extending tolling beyond major motorways would require a wider network pricing scheme. This would require tolling to be applied to all roads across NSW to prevent traffic moving from tolled to un-tolled corridors.

Further information on road pricing reforms are set out in chapter 13.

Reform option 2 – Improving public transport asset utilisation through fares policy

The current structure of CityRail fares amplifies the rail system's capacity constraints. This has led to demand for CityRail services being highly concentrated during the morning peak period from 8am to 9am.

Figure 16.3.2 Train trips by time of day

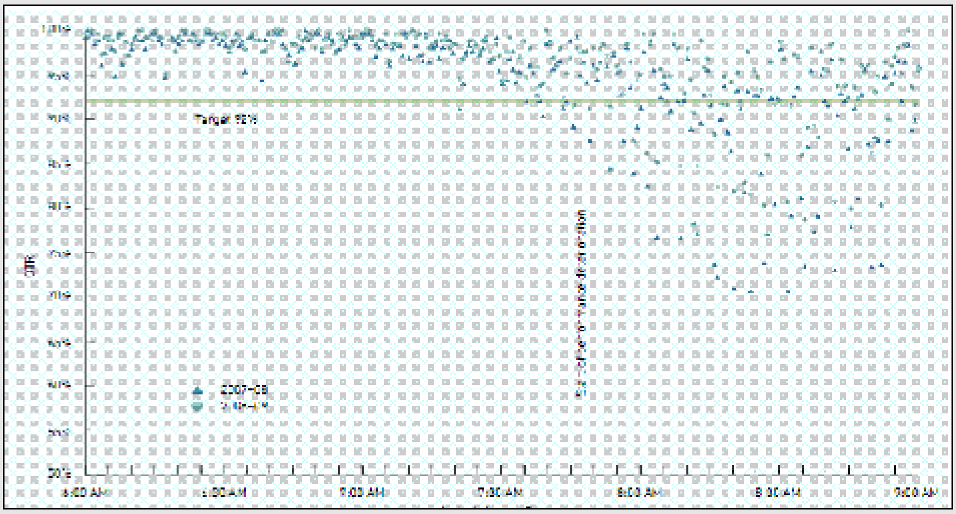


Source: Bureau of Transport Statistics (2010), *Customised Data Request*.

This concentration of demand for rail services creates significant overcrowding on the Illawarra, Northern and West train lines where AM peak crowding is at 130 per cent, 140 per cent and 120 per cent, respectively, of seating capacity.

This service overcrowding has led to the deterioration of on-time running for AM peak services arriving at Central. Figure 16.3.3 below illustrates the CityRail on-time running during the AM peak. It shows that performance deteriorates sharply during peak periods. This is in part driven by extended dwell times at key stations slowing train movements.

Figure 16.3.3 2008-09 AM peak CityRail on-time running



Source: Independent Transport Safety and Reliability Regulator (2009), *Transport Reliability Report 08-09*.

Without intervention, it is expected that overcrowding will continue to worsen. Figures 16.3.4 and 16.3.5 illustrate the forecast increase in overcrowding at peak hours between now and 2036, assuming no new infrastructure is provided or pricing reform undertaken.

Figure 16.3.4 CityRail network 2011

Figure 16.3.5 CityRail network 2036

Source: Bureau of Transport Statistics (2011), *Customised Data Request.*

While new infrastructure can alleviate overcrowding and its resultant economic impacts to a degree, providing sufficient capacity to meet peak demand, particularly in the short-to-medium term will be extremely challenging, given affordability and delivery constraints. Increasing peak fares can assist in addressing the underlying capacity constraints through filtering and shifting peak discretionary travel (representing 16.4 per cent of AM peak travel) to off-peak times.

At present, peak return fares are only 30 per cent higher than off-peak return fares, despite the marginal cost to society of peak fares being many times greater. Other jurisdictions have experimented with much greater differentiation in pricing levels; in London, for example, the difference between peak and off-peak fares can be over 70 per cent.

Reforming concession entitlements could also assist. Uniquely in Australia, the Pensioner Excursion Ticket provides low-cost travel to senior NSW residents during peak hours. Shifting the concession to off-peak only could significantly reduce congestion.

The Financial Audit recommends that fare structures be revised to provide a greater difference between peak and off-peak fares (but for travel to congested destinations only), and that concessional travel for senior residents be restricted to off-peak periods.

Improve project evaluation

Despite compliance being mandatory, in 2009-10 only 80 per cent of projects went through the Gateway Review process. This problem was most acute on some major and contentious projects, where public pressure for action encouraged decisions to be made before projects had been fully developed or evaluated. As a result, infrastructure plans have included projects of negligible benefit.

The simple discipline should be applied that it is a condition precedent for a project to be recognised in a plan (and qualify for budget funding) that it has been evaluated in accordance with the procurement policy.

The Government's procurement policy mandates the use of economic evaluations to assess the proposed project and its alternatives. This approach is preferred to other forms of subjective evaluation (for example, so called multi-criteria analysis) which can be used to support otherwise financially and economically unsustainable projects.

There are guidance available to assist general government and non-commercial PTE agencies in undertaking project evaluations.

Infrastructure NSW (INSW) can help by ensuring compliance with this appraisal framework and 'quality assuring' individual project evaluations undertaken by agencies. Issues that INSW could consider in this role would include:

- that proposed infrastructure projects are based on a solid evidence base and will effectively meet the objectives in the 20-year State Infrastructure Strategy
- where appropriate, there has been cross-agency coordination of the proposed infrastructure project

- that all realistic options (including demand management options) have been evaluated and the most efficient and effective option has been chosen – this includes undertaking a comparisons of costs, benefits and potential risks of various options
- that the disciplines of the Government's procurement policy have been applied without exception
- that the project business case contains a realistic implementation plan and risk-management framework.

INSW could also look to further standardise the approach taken by agencies to project evaluation, to enable projects from different sectors to be compared more readily. The Financial Audit recommends that, where possible, cost-benefit analysis is used and that the Government sets a benefit-cost ratio hurdle that all applicable projects should meet. Cost-benefit analysis is well-established and less subject to bias than many other methods. The Financial Audit recommends a benefit-cost ratio hurdle of 1.5 be established in line with the informal benchmark utilised by Infrastructure Australia.

Infrastructure Standards

Various bodies have been established to set standards for infrastructure. Examples include the Office of Resources and Energy, RTA and the Dam Safety Committee. Often the standards are set without any form of cost-benefit assessment. The Financial Audit recommends that future standards be required to be reviewed by IPART, applying a comprehensive cost-benefit assessment and the standard setting body must have full regard to this assessment in setting the standard.

Case study – Infrastructure standards

In both social and economic infrastructure, government has a major role in setting infrastructure reliability and safety standards. Inadequate evaluation of the impacts from these regulations can lead to government imposing costs on society that outweigh the benefits provided by the infrastructure.

The Office of Resources and Energy, for example, sets licence conditions for NSW energy in terms of expected system performance that can have significant implications for the types and costs of infrastructure constructed.

The RTA constructs roads according to detailed standards it develops internally through its Engineering and Technical Services division. These are based on higher level design standards developed by Ausroads for the whole country. Over time, these standards have changed to accommodate technological change and to target improved safety performance.

While many of these standards are sensible and reflect changing stakeholder expectations, it is important that individual standards do not impose excess costs on users and society as a whole. The Financial Audit recommends that Infrastructure NSW undertakes a detailed audit of existing infrastructure standards to identify opportunities to improve value for money.

Rationalising assets

Government services and the supporting asset base often reflect the service demands of prior decades. Examples include the location and size of schools, the number and specification of hospitals and the country rail network. The fixed nature of some assets mean they cannot be readily changed to respond to changes, for example, in population spread, client base or the electronic interface expectations of today's public.

Reviews across the general government sector have concluded that significant rationalisation of specialised facilities and depots would reduce waste and improve service efficiency and quality.

There is an opportunity to consolidate regional office accommodation and depots to improve productivity and governance within small operational workgroups. Rationalising administrative assets would also support the Government's desire to move towards delivering services through single shopfronts or points of contact.

Case study – Rationalising assets in Primary Industries and Minerals and Energy

Primary Industries and Minerals and Energy Divisions occupy over 100 locations with more than 1,700 full-time equivalent employees across these locations, mostly situated across regional NSW. There is a mixture of leased (mainly office accommodation) and owned facilities (research stations). Analysis shows that a number of the office accommodation sites are staffed with less than three employees or, in the case of research stations, are significantly underutilised in terms of projects undertaken.

These offices and stations provide a small contribution to local employment (in most cases less than 1 per cent). Consolidation could increase the productivity and management of small work teams and improve the utilisation of research stations. It was noted that the ageing profile of the divisions provides the opportunity to consider alternative service delivery models.

16.4 Recommendations

The Financial Audit recommends:	
Improved effectiveness and prioritisation of capital expenditure	
16.1	The following priorities be established for Infrastructure NSW: § undertake an audit of the existing infrastructure asset stock, including future demands and the identification of key gaps § revise the State Infrastructure Strategy to provide a 10- to 20-year context of key emerging service deficiencies and community priorities § develop/update a 10-year Infrastructure Plan, including total capital expenditure estimates by sector, through the review and prioritisation of agencies' Total Asset Management plans § review agencies' project evaluations to facilitate prioritisation of funding and the development of five-year agency infrastructure plans (aligned to budget estimates) § co-ordinate planning between sectors to facilitate efficient and timely project delivery § ensure compliance for all significant capital projects with the Gateway process set out in the State's Procurement Policy.
16.2	The option of the use of a privately funded projects (PFP) approach for infrastructure projects can be considered once a project has been fully evaluated and endorsed, with the choice of PFP approach based on achieving value for money and appropriate risk allocation.
16.3	A rigorous contractor capability assessment be undertaken for all significant capital projects, including PFPs, to ensure its selected contractor has the full capability to undertake the role.
16.4	Noting the circumstances under which a PFP should be considered (refer to section 8.2) and that PFPs can be effective approach for managing major project risk and cost, consideration be given to refining the availability model to substitute to an appropriate extent public sector for private sector debt at the end of the construction stage.
16.5	Require that any draft asset or reliability standards that will have a material impact on state capital expenditure be the subject of a full cost-benefit analysis by Infrastructure NSW, with the agency responsible for setting the standard required to have full regard to the cost-benefit analysis.
16.6	Infrastructure NSW to work with the Department of Transport on the development of the state's Transport Master Plan, having full regard to the revised Metropolitan Strategy. This should include a full review of the North West Sector rail project to ensure it is assessed in a holistic manner having full regard to the total system wide implications of the project.
16.7	Full consideration should be given to using the private sector to design, construct, maintain and possibly operate the North West Rail line.
16.8	Re-affirm that agencies' Total Asset Management Strategies include plans to appropriately rationalise their asset bases.
16.9	Direct the Department of Transport, in consultation with Infrastructure NSW and IPART, to develop strategies and supporting analysis for the application of appropriate pricing signals across the Transport network, with an objective of reducing peak congestion and increase utilisation in off-peak periods.
16.10	Require as a precondition of funding that all material capital projects have undertaken the Gateway assessment.

17 WORKFORCE MANAGEMENT AND WAGES POLICY

Key points

- Workforce management practices and policies must be reformed to ensure that fiscal targets are achieved.
- Employee expenses are around half of all government expenditure and have been growing at 6.3 per cent per annum since the wages policy of capping wage growth at 2.5 per cent per annum commenced in 2008-09[1]. This includes average wage increases of 4 per cent[2].
- The Government has recently announced changes to wages policy that will provide greater discipline to the wages determination process.
- If CEOs are to be accountable for financial performance, they also need to have more control over their workforces:
  - changing appointment and redundancy processes to improve agencies' flexibility to direct resources to emerging service needs
  - linking salaries more closely to levels of employee performance
  - reforming and modernising employment conditions
  - simplifying and making more effective employee performance systems to encourage and support employee performance
  - improving workforce planning to better respond to movements in workforce composition and effectively manage attrition associated with retiring baby boomers.

17.1 Wages policy

Budget context

In 2010-11, approximately 49 per cent of government expenses will be employee-related payments. Managing this expenditure is a major challenge given that front-line services, such as education, health care and policing are labour intensive.

Employee expenses in 2010-11 are projected to be[3]:

- $24.6 billion (excluding superannuation)
- $27.7 billion (including superannuation).

Every 1 per cent increase in employee-related expenses costs $277 million a year.

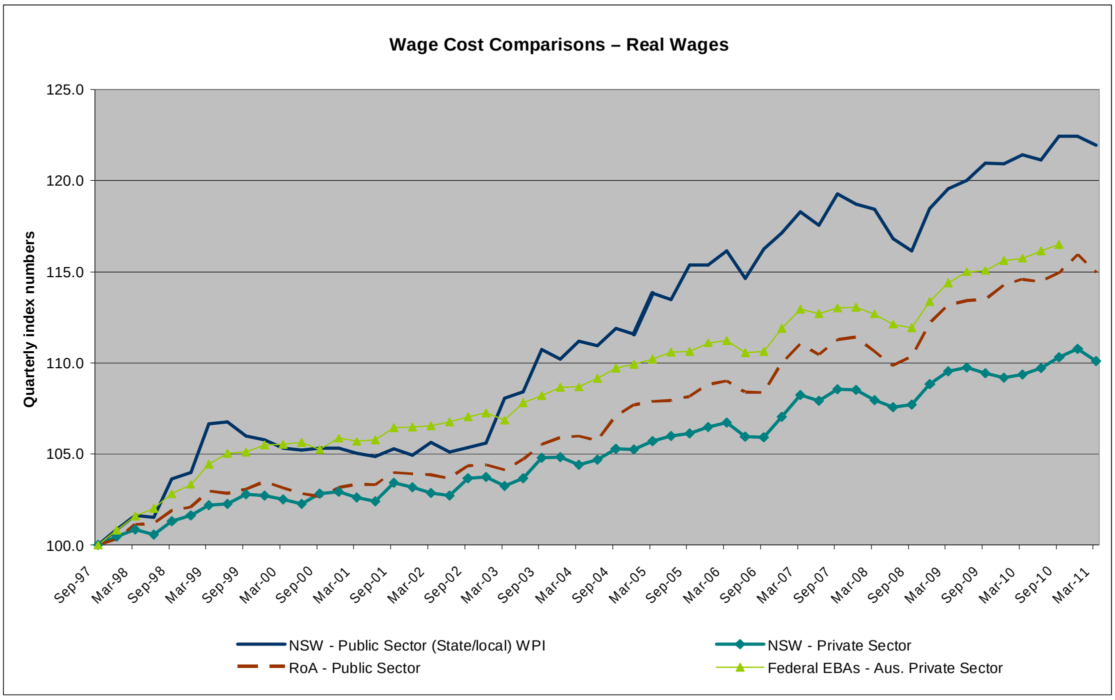
---

1 Includes actuarial valuation changes and administrative agency restructures of 1.1 per cent per annum for the four years to 2009-10. Wages Policy commenced in September 2007 and took effect with the expiration of each award over time.
2 Weighted average wage increase for general government sector 2008-09 to 2010-11.
3 NSW Treasury, 2010-11 Half-Yearly Review.

NSW public sector wages

Public sector employees in NSW have received wage increases well above other employee groups for an extended period.

Figure 17.1.1 Comparison of real wage increases in public and private sectors



Since 1997, public sector wages have increased by 21.9 per cent in real terms. NSW public sector wage growth has exceeded the NSW private sector by 10.7 per cent and the public sector in the rest of Australia by 6.1 per cent[4]. If private sector increases had applied in the past 13 years, employee expenses this year would have been $3 billion lower.

Research by the University of Sydney has found that teachers, police and nurses in NSW are paid around 4 per cent more than in other states and territories, and around 6 per cent more than in Victoria[5]. These data reflect base rates of pay for staff of equivalent grade or rank. The research does not fully reflect different staffing costs as no consideration is given to workforce composition or different benefits and conditions. By way of example, the University of Sydney research identified that senior police constables are paid around 4.3 per cent more in NSW than the rest of Australia. Data from the 2011 Report on Government Services show that average police staff costs in NSW are $119,129 per officer compared to $104,782 in other states – a difference of 13.7 per cent[6].

Wage restraint is necessary to restore parity and provide scope for the Government to improve services and deliver infrastructure.

4 ABS Wage Price Index to March 2011.
5 http://sydney.edu.au/business/__data/assets/pdf_file/0003/99426/NSW_Public_Sector_Pay_Note_1.pdf
6 http://www.pc.gov.au/gsp/reports/rogs/2011 (Police data tables).

Wages funding policy

Wages policy provides funding for wage increases and associated costs at 2.5 per cent per year. This is the mid-point of the Reserve Bank of Australia's (RBA) 2-3 per cent target inflation range. Over the period since the RBA inflation target was given operational independence in 1996, actual inflation, as measured by the CPI, has in fact been 2.5 per cent per annum after excluding the impact of the introduction of the GST. Wage outcomes greater than 2.5 per cent must be funded by employee-related cost savings such as improved management of sick leave, reduced overtime and enhanced rostering arrangements.

Budget allocations in the forward estimates require agencies to:

- limit the net cost of wage increases to 2.5 per cent
- achieve efficiency dividends of 1.5 per cent per annum for 2011-12 and 2012-13 and 1 per cent in 2013-14
- manage changes to workforce composition (grade structures and employee numbers) within approved funding limits.

Importance of wages policy to the overall budget strategy

In order to provide an indication of the challenges and importance of an effective wages policy, wage increases of, for example, 4 per cent[7] for new awards, would require offsets of $3.89 billion over the forward estimates period.

A number of major employee groups (police, teachers and nurses) have received wage increases (or other negotiated increases in employee-related expenses)[8] above 2.5 per cent without offsets being identified.

To date, general government agencies are reporting sufficient wage offsets to fund increases of up to 3.25 per cent[9]. The cost of wage increases above 2.5 per cent per annum is shown below in Table 17.1.1.

Table 17.1.1 Cost of increases above 2.5 per cent (future agreements only) $million

	2011-12	2012-13	2013-14	2014-15	Total
Wage increase					
2.75%	54	116	195	276	641
3%	108	231	391	553	1,285
3.25%	162	348	588	833	1,932
3.50%	217	464	786	1,114	2,581
3.75%	271	581	985	1,398	3,234
4%	325	698	1,185	1,683	3,890
Estimated risk of 4% increase[10]	163	350	597	850	1,958

Operation of 2007 public sector wages policy

The 2007 wages policy was partly successful in restraining wages growth and linking wage increases to employee related savings. However:

7 Average weighted increase for general government employees between 2008-09 and 2009-10.
8 Including a commitment for an additional 1,400 nurses.
9 This is 2.5 per cent plus offsets of 0.75 per cent.
10 Assumes wage increases of 4 per cent with offsets sufficient to fund an increase of 3.25 per cent.

- the NSW Industrial Relations Commission (IRC) was not required to give effect to the wages policy
- general government agencies did not identify sufficient savings to fully offset wage increases above 2.5 per cent
- increases above 2.5 per cent were paid in advance for planned savings, creating a significant risk that increases above 2.5 per cent were not fully offset
- the ability to offer offsets was limited by inflexible workforce management policies (e.g. managing excess employees policy, appointment processes and staffing ratios)
- general government agencies are reporting wage offsets of around $1.09 billion since 2008-09, however the total cost of wage increases above 2.5 per cent for these employees was $2 billion, a shortfall of $910 million[11].

NSW public sector wages policy 2011

On 16 June 2011 the *Industrial Relations Amendment (Public Sector Conditions of Employment) Bill 2011* was passed by NSW Parliament[12]. The bill amended the *Industrial Relation Act 1996* (NSW) to require the Industrial Relations Commission to give effect to government policies on public sector conditions of employment that are declared by regulations.

The *Industrial Relations (Public Sector Conditions of Employment) Regulation 2011* was made on 20 June 2011. The regulation:

- allows increases in remuneration and conditions of employment in excess of 2.5 per cent, but only if sufficient employee-related cost savings have been achieved to fully offset the increased employee-related costs
- requires that employee-related cost savings be in addition to existing savings measures, efficiency dividends and whole-of-government reform measures
- limits the back payment of wage increases, other than in exceptional circumstances
- requires awards and agreements to contain clear and comprehensive no extra claims clauses
- prevents policies regarding the management of excess public sector employees from being incorporated into industrial instruments.

The 2011 public sector wages policy retains the key requirement of the 2007 policy that wage increases above 2.5 per cent must be offset by employee-related cost savings. However, previous wage increases were paid in advance and there was no certainty that offsetting savings to fund increases above 2.5 per cent would occur. Revised arrangements require that increases above 2.5 per cent are only paid when required savings have been achieved.

---

11 Monitoring data as reported to Treasury at March 2011, covers the period from 2008-09 to 2010-11, major agencies only.

12 Parliament of NSW, *Industrial Relations Amendment (Public Sector Conditions of Employment) Bill 2011* (available at http://www.parliament.nsw.gov.au/prod/parlment/nswbills.nsf/0/C78B213F28ABF8DBCA25789A002446D3?Open&shownotes).

New arrangements for State owned corporations

The previous wages policy applied to Public Service Departments, the Government Service, any other public sector service within the meaning of the *Public Sector Employment and Management Act 2002,* and State owned corporations (SOCs).

The Government has exempted SOCs from the wages policy as:

- SOCs are covered by Fair Work Australia, and legislative changes impacting the NSW Industrial Relations Commission will not affect SOCs
- SOCs may operate in national markets and bid competitively for talent
- SOCs are subject to dividend targets and operate within the Government's Commercial Policy Framework
- SOC boards are responsible for setting strategic aims and ensuring obligations to the Government and other relevant stakeholders are met.

SOCs will continue to be required to take account of the Government's wages policy when negotiating wage increases (as required under the *Fiscal Responsibility Act*).

Decentralising the Crown Employees (Public Sector Salaries) Award

The *Crown Employees (Public Sector Salaries) Award* (Crown Salaries Award) covers public servants in a wide range of occupations including WorkCover inspectors, prison officers, school administrative workers, park rangers, legal officers and administrative and clerical officers. The Award covers around 79,000 employees, or around a quarter of the total NSW public sector workforce.

Maintaining the Crown Salaries Award centrally would mean that wage offsets achieved (or not achieved) for one employee group would impact the wage outcomes for all other employee groups covered by the Award. This will reduce the direct link between wage increases and the delivery of reform. This is likely to reduce the willingness of employees to cooperate with reform measures.

Decentralising bargaining for the Crown Salaries Award would help to reinforce CEO accountability and would enable more scope for bargaining to be linked to reform within agencies, rather than sector-wide initiatives. However, a decision to decentralise bargaining would also need to consider the possible impact of wage disparity on workforce mobility.

The recent Moran report *Ahead of the Game: Blueprint for the Reform of Australian Government Administration* found 'anecdotal evidence' that decentralised bargaining in the Commonwealth Government may have discouraged workforce mobility due to the emergence of significant variations in wages and conditions across agencies[13].

Bargaining in the Commonwealth was devolved in 1997 to around 100 different agencies. This has resulted in significant differences in pay scales across the sector. In its response to the Moran report, the Australian Public Service Commission (APSC) noted that mobility rates had remained at 3 per cent for the last 10-15 years but that the proportion of employees with experience in only one agency had risen over the past few years.

---

[13] http://www.dpmc.gov.au/publications/aga_reform/aga_reform_blueprint/part4.6.cfm

A key learning from the experience in the Commonwealth Public Sector is that effective public sector management is an evolving process. In its response to the Moran report, the APSC noted:

> *Over the last twenty years, the move to a more devolved public service with decision-making and control shifting from central agencies to individual agency heads has brought substantial efficiencies, flexibility and agility.*[14]

As evidenced from the Commonwealth experience, a period of devolution is necessary to drive efficiency within agencies. A subsequent period of increased centralisation may be required to improve consistency and standardise better practice across the sector. Public sector management in NSW is at a different phase of this cycle to the Commonwealth, with increased accountability only now being devolved to principal departments.

Devolved bargaining in the Commonwealth was an important part of the process to improve agency accountability and efficiency. Relatively small impacts on mobility took some time to emerge, even with bargaining devolved to around 100 agencies.

The impact on workforce mobility is likely to be less substantial in NSW than it was for the Commonwealth because:

- the Crown Salaries Award includes a range of distinct occupational groups where existing cross-agency mobility is already limited
- bargaining for administrative and clerical personnel could be devolved to nine principal departments rather than a multitude of small agencies, limiting the scope for significant pay differences.

Decentralising the Crown Salaries Award could initially occur with distinct occupational groups. Bargaining for administrative and clerical personnel could subsequently be devolved to principal departments, pending further analysis of possible impacts on workforce mobility.

It is recommended that the Public Service Commission consider options to decentralise bargaining for the Crown Salaries Award taking into account possible impacts on workforce mobility.

Inclusion of management and other policies in industrial instruments

The inclusion of staff ratios, workforce management policies and death and disability benefits in industrial instruments has restricted the scope for workplace reform.

The *Industrial Relations (Public Sector Conditions of Employment) Regulation 2011* explicitly prevents excess employee policies from being included in industrial instruments. Excluding management policies from industrial instruments will help to ensure that government has sufficient flexibility to change its policies in response to emerging priorities, changes in economic conditions or changes in service delivery design.

It is recommended that the Department of Premier and Cabinet amend the NSW Public Sector Wages Policy 2011 to include a provision that additional staff ratios, workforce

---

[14] http://www.dpmc.gov.au/consultation/aga_reform/pdfs/0114%20Australian%20Public%20Service%20Commission.pdf

management policies and death and disability benefits should not be included in industrial instruments.

17.2 Workforce management

Employee-related expenditure is driven by increases to rates of pay and benefits, increases in workforce size and changes to the grading composition of the workforce. Each of these components should be addressed to moderate the growth in expenditure to sustainable levels.

The *Industrial Relations Amendment (Public Sector Conditions of Employment) Bill 2011* and associated regulations will help to maintain public sector wage restraint by enhancing the status of the wages policy in proceedings before the IRC.

Other potential reforms to public sector employment arrangements include improving arrangements to manage excess employees, extending application of performance management systems, increasing workforce flexibility, progressing strategic workforce planning frameworks and reforming conditions of employment.

Improved management of excess employees

Key features of the previous Government's Managing Excess Employees policy included:

- a 12-month redeployment period during which officers retained their full salaries
- an extension to the redeployment period for any time that an officer occupied a temporary position
- eligibility for 12 months' salary maintenance if officers were redeployed to a lower position
- forced redundancy could not occur without the 'provision of reasonable redeployment opportunities to suitable positions'.

Outcomes of the previous policy included the following:

- at 31 March 2011 there were 510 officers on the excess officers list. The retention period had expired for 54 of these officers. This excludes employees in temporary roles and some employee groups such as teachers
- the Department of Premier and Cabinet has advised that not a single officer was retrenched under the previous policy
- officers were not retrenched at the end of 12 months for a number of reasons including:
    - temporary roles could continue indefinitely (some officers on the excess officers list were declared excess as far back as 1995)
    - the policy required agencies to provide reasonable redeployment opportunities to suitable positions. This provided grounds for dispute regarding the definition of reasonable and suitable
    - the policy required retrenchment to be a last and unavoidable resort, with one interpretation being that public sector retrenchment is always avoidable

    - there may have been a lack of will to follow through with retrenchment.
- the indefinite redeployment period offered no financial incentive to actively seek a new job
- the likelihood of redeployment deteriorated over time. Thirty-six per cent of officers were redeployed within three months and only 15 per cent were redeployed within three to six months.

Changes to the Managing Excess Employees Policy

A revised *Managing Excess Employees Policy* was announced on 22 June 2011. The policy retains existing voluntary redundancy entitlements for officers accepting an offer within two weeks of being declared excess. Key changes in the new policy include:

- the retention period is reduced from 12 to three months
- salary maintenance is reduced from 12 to three months
- severance payments are reduced for officers not accepting a voluntary redundancy
- the retention period is not suspended for temporary appointments
- employees will be retrenched at the end of the process.

Officers declared excess before the announcement of the new policy have been offered an additional $10,000 incentive to accept a voluntary redundancy before 1 August 2011.

NSW's previous and revised excess employee provisions compared to Victoria and the statutory minimum are set out in Table 17.2.1.

Table 17.2.1 Comparison of redeployment and redundancy in NSW and Victoria with the statutory minimum

	Statutory minimum	Victoria	NSW (previous)	NSW (revised)
Redeployment period	Nil	3 months (with extension of up to 3 months for temporary appointments)	12 months (not enforced)	3 months
Salary maintenance (if redeployed at lower grade)	Nil	6 months	12 months	3 months
Voluntary redundancy	NA	4 weeks pay in lieu 2 weeks pay per year of service up to 15 years $10,000 incentive	4 weeks pay in lieu (+1 if over 45 and 5 years service) 3 weeks pay per year of service up to 13 years Additional incentive for early acceptance (8 weeks after 3 years service)	4 weeks pay in lieu (+1 if over 45 and 5 years service) 3 weeks pay per year of service up to 13 years Additional incentive for early acceptance (8 weeks after 3 years service)
Retrenchment package forced redundancy	Up to 20 weeks pay depending on length of service	4 weeks pay in lieu (+1 if over 45 and 2 years service) 2 weeks pay per year of service up to 10 years	4 weeks pay in lieu (+1 if over 45 and 5 years service) 3 weeks pay per year of service up to 13 years	Statutory minimum plus 4 or 5 weeks pay depending on age

The revised policy retains the current voluntary redundancy payment rates, and brings NSW's redeployment and redundancy provisions more into line with community standards.

It is recommended that the Public Service Commission review the *Public Sector Employment and Management Act 2002* and other relevant employment legislation to support the application of the new policy across the sector.

Performance management system

The NSW public sector employs around 386,000 people[15]. The workforce includes many highly motivated, capable and talented employees.

A high-performance culture is essential to ensure that the skills and capabilities of the workforce are harnessed to deliver the best possible service to the people of NSW. A performance culture is dependent on a number of factors including:

- § the quality of leadership and the extent that a high standard of performance is established as a core value throughout the public sector
- § the effectiveness of the CEO accountability framework and the extent that this flows down to management practices across the sector
- § the quality of tools and the commitment to measuring and reporting performance at both an agency and individual level

---

[15] Headcount at 2010 census date, see http://www.dpc.nsw.gov.au/__data/assets/pdf_file/0020/120737/2010_SnapshotReport_P2011_004.pdf

- the ability to recognise and reward high performance
- the effectiveness of processes to ensure that employees' skills and capabilities are well matched to their roles
- the ability to manage underperformance.

A modern public sector performance management system would help agencies control expenditure and improve service outcomes. Current performance management arrangements are inadequate because:

- salary progression arrangements often make no distinction between 'exceptional' and 'satisfactory' performance and do not always reward high performers
- selection and appointment processes can be inflexible and do not always ensure a good job match
- sanctions for underperformance are complicated and rarely applied
- there is no consistent performance management framework across the sector.

Some examples of this in practice include:

- a Grade 3 Senior Officer is entitled to transition from a salary of $161,000 to $177,000 after a year of satisfactory performance
- teachers can progress from a salary of $42,000 to $82,000 over 13 years without any real link to performance
- the Public Sector Management Handbook prescribes a six-step process for managing poor performance. Escalation to dismissal requires five letters to the employee. Dismissal decisions may still be subject to dispute resolution procedures before the IRC even if these processes are followed.

Improved performance management arrangements could include:

- linking salary more closely to the level of employee performance, including:
  - accelerating career progression for exceptional performers
  - including an 'at-risk' component at the higher end of each salary band.
- improving processes to ensure that jobs are matched with employee capabilities, including:
  - robust selection and appointment processes
  - greater flexibility to move staff to different roles
  - access to training and development to support ongoing skills development.
- improving processes to recognise and reward good performance
- simplifying processes for managing poor employee performance
- standardising performance review processes across agencies for executive and non-executive employees

- reinforcing the distinction between redundancy and redeployment, and performance management.

Better workforce flexibility

More flexible employment arrangements would enable agencies to allocate personnel to emerging areas of service need. The current appointment system can create a number of inflexibilities, such as:

- signalling to employees that they are employed to deliver a specific function and have a right to decline work outside their job description
- restricting the capacity of managers to redeploy staff to different duties.

An alternative approach is to appoint employees to a substantive remuneration level. Under this arrangement, employees would:

- no longer 'own' a position
- be assigned duties appropriate for their remuneration level and skill set
- be assigned to different duties over time to reflect the needs of the organisation
- not be able to refuse a reasonable direction to take on new or varied duties.

Giving managers the control of a total budget rather than a fixed staffing establishment could also support efforts to improve flexibility and performance.

Workforce flexibility is also constrained by input controls for a number of employee groups. The nurses' award prescribes minimum staffing levels (nursing hours per patient bed day). Other input controls (e.g. police authorised strength and teacher-pupil ratios) are set by policy or agreed locally. Input controls are blunt instruments that do not guarantee service quality and constrain management from directing resources to areas of need.

Extension of contracts to employees other than SES

The extension of contracts to employees other than Senior Executive Service (SES) employees would help improve flexibility and reinforce performance management frameworks.

Individual contracts could be put in place at higher salary points (e.g. above $100,000 or for all senior officers) or more broadly across the sector.

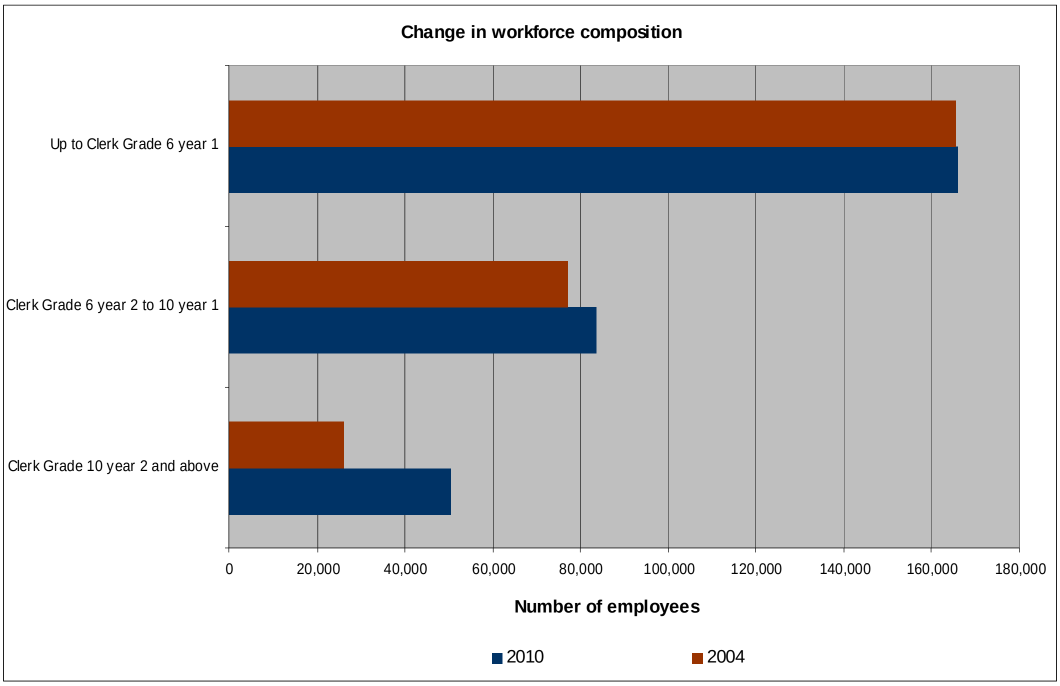
Implementation would need to occur progressively for new and promoted employees with existing staff conditions being 'grandfathered'. In New Zealand, the *Employment Contract Act 1991* places every employee's conditions of employment in an employment contract with their employer, on either an individual or collective basis. Collective contracts continue to be used where there are large groups of employees in similar work arrangements.

It is recommended introducing contracts for senior officers. This would address a present anomaly where it is possible for non-contract senior officers to be paid more than contracted SES officers. Senior officer salaries (under the *Crown Employees (Public Sector – Salaries 2008) Award*) can be up to $177,000. Senior Executive Service salaries currently start at $155,000.

Better workforce planning and strategy

A significant part of the increase in employee-related expenses can be attributed to changes in workforce composition. Between 2004 and 2010, the number of employees at Grade 10 year 2 equivalent and above (i.e. with salaries above $95,319) increased by 94 per cent (see Figure 17.2.1). The number of staff at lower levels was largely unchanged over this period.

Figure 17.2.1 Change in workforce composition 2004 to 2010



Changes in the workforce profile may partly reflect a concerted strategy by the public sector to retain highly skilled functions while outsourcing lower skilled work. However, movements in workforce composition are more likely to reflect poor job evaluation when positions are created, and a desire to retain individuals through promotion when there is no change in skills or job requirements.

There is a lack of transparency and accountability across the sector and movements in workforce composition are not necessarily supported by appropriate cost-benefit analysis.

The next few years offer an opportunity to manage major workforce changes as about 20 per cent of the sector workforce will reach retirement age. The expected departure of a large cohort of staff will assist to reconfigure the workforce, but this will only deliver real savings if the transitions are well planned and managed. Effective workforce planning will also be critical to ensure there is no loss of service continuity during this period of change.

A whole-of-sector strategic workforce planning framework could be mandated to ensure efficient and effective staff allocation across the various sectors of government.

The Department of Premier and Cabinet intends to expand the range of workforce information available as part of its Workforce Information Project. Improved access to reliable workforce profile data will be an important requirement for effective workforce planning.

Reforming award conditions

Reforms to award conditions have delivered significant savings to date and should continue to be included in employee bargaining parameters.

Organisational reform measures (e.g. restructuring) are the most common savings measure put forward by agencies to offset wage increases above 2.5 per cent. Reforms to award conditions have been less common, but have delivered significant savings.

In 2009-10, agencies reported 55 separate organisational reform measures delivering total savings of $70 million. By comparison the Department of Education and Training reported that changes to workers' compensation top-up arrangements delivered savings of $100 million.

It is recommended that the Public Service Commission conduct a detailed review of employment conditions to identify future reform opportunities.

Staff freezes or reductions in labour hire

A sector-wide policy to freeze the number of staff or reduce the use of labour hire is not supported. A staff freeze has a number of limitations including:

- it may not deliver savings; a staff freeze has been in place since 2009[16] and has not reduced employee-related expenditure
- it limits the flexibility of managers to deliver services and budget outcomes and is contrary to the renewed emphasis on empowerment and accountability.

Reductions in labour hire have been included as part of many agencies' efficiency dividends or wage offsets. The use of labour hire can be efficient in the short term and further savings in this area may be limited.

These measures could be put in place by a CEO as appropriate without being mandated across the sector.

[16] http://www.dpc.nsw.gov.au/publications/memos_and_circulars/circulars/2010/c2010-18_staffing_freeze

17.3 Recommendations

The Financial Audit recommends:	
17.1	Noting that the recent wages policy reform is consistent with the policy that applied previously but addresses the deficiencies that made it not fully effective and so should assist in maintaining suitable public sector wages restraint.
17.2	The Public Service Commission consider options to decentralise bargaining for the Crown Salaries Award, taking into account possible adverse impacts on workforce mobility.
17.3	The Department of Premier and Cabinet amends the *NSW Public Sector Wages Policy 2011* to include a provision that additional staff ratios, workforce management policies and death and disability benefits should not be included in industrial instruments.
17.4	The Public Service Commission review the *Public Sector Employment and Management Act 2002* and other relevant employment legislation to support the application of the new *Managing Excess Employees Policy* across the entire public sector and not just the core public service.
17.5	The Public Service Commission introduce new performance management arrangements to: § link salary more closely to the level of employee performance § improve processes to ensure that jobs are matched with employee capabilities § improve processes to recognise and reward good performance § simplify processes for managing poor performance § standardise performance review processes across agencies for executive and non-executive employees § reinforce the distinction between redundancy and redeployment and performance management.
17.6	The Public Service Commission introduce new workforce management arrangements to: § appoint employees to a substantive remuneration level rather than a specific position § extend employment contracts to senior officers below the Senior Executive Service § require all agencies to prepare detailed workforce management plans and better monitor movements in workforce composition § ensure managers have flexibility to direct resources to areas of service need.
17.7	The Department of Premier and Cabinet review the integrity of workforce profile data and improve governance arrangements to: § make the data more accessible across the sector § improve processes to rectify data quality issues.
17.8	The Public Service Commission conduct a detailed review of employment conditions to identify and quantify reform opportunities across the sector. This should include: § a cross-jurisdictional review of award entitlements and salaries for individual employee groups § a cross-jurisdictional review of employment conditions included in state-based legislation, including a comparison with National Employment Standards covered in the *Fair Work Act 2009*.

18 BALANCE SHEET MANAGEMENT

Key points

- There are opportunities for restructuring and divesting of business assets in the electricity and water sectors, as well as in the ports and forestry industries after a reform phase. This will maintain service delivery and ensure that prices are as low as possible, consistent with meeting operating costs, capital investment and a return on capital. An opportunity also exists to establish an Infrastructure Fund as a way to realise value on existing income generating infrastructure assets in order to fund superannuation liabilities and new income generating infrastructure assets.

- Government property is one of the major resources and cost centres for agencies providing services to the community. Property represents one of the major recurrent costs to the Government after staff and information and communications technology (ICT) costs.

- Substantial reforms have been undertaken in managing government property over the past 15 years, to improve the functionality of property (that is, better support service delivery outcomes) while minimising associated costs. Over this period there has also been a substantial rationalisation of government property assets through surplus property divestment.

- The key areas that impact on the efficiency of the government property portfolio are space usage (e.g. square metres per person); property management; facility management and maintenance; strategic planning; and property divestment.

- Further review is required of the proposal to use a major infrastructure asset to offset part or whole of the State’s net unfunded superannuation liability.

- There are opportunities to further rationalise the funds management function, including further centralisation of the superannuation schemes and the investment function with respect to Compensation Authorities Division.

- There is a need for direct interaction with the Australian and International Accounting Boards to seek to ensure that the accounting standard for reporting superannuation liabilities properly reflects the underlying financial position.

18.1 Divestment of non-core assets

Over time, governments tend to build up and retain ownership of assets and businesses that once addressed market failures, but are no longer core to the role of government. It is necessary to review on an ongoing basis the rationale for ownership and, where appropriate, divest non-core businesses.

Role of government

Governments pursue a variety of objectives and the ability to deliver on those objectives is ultimately constrained by, among other things, available resources. There is therefore a strong public interest in those resources being used efficiently. This means it is important for the Government to be clear about desired outcomes and the best means of achieving them.

At the state level, the core role of government is policy, appropriate and efficient regulation and the delivery of services that are pure public goods or are assessed as merit goods. While the Government provides funding to support the provision of such services, it does not have to provide them directly, because it can contract with the private sector and non-government organisations for delivery of services.

The case for public provision, as distinct from public funding, is strongest for pure public goods, which are mainly in the areas of public health and law and order. For these services, public funding is needed to ensure delivery of an economically efficient level of service, recognising positive spill-over impacts on the rest of the community.

In the case of merit goods such as health and education, which have social benefits exceeding the private benefits to those consuming them, there are alternative providers, so the core government functions are policy, regulation and funding. If market failures are identified, there is again a case for government provision and a need to ensure that provision is efficient and effective. Similarly, public transport has certain externalities (such as reduced road congestion and environmental benefits) that mean full cost recovery from users is seldom an optimal outcome. Efficiencies can be realised through contracted services and franchised business models, but within an overall framework of government ownership.

Many services provided by government businesses begin as a core function of government, to address market failure. For utility businesses such as energy and water utilities, there was a belief that the technologies required for these activities exhibited such significant economies of scale that they were natural monopolies. To eliminate the potential for abuse of this monopoly power, they were retained in public ownership. Other policy objectives were pursued at the time – in particular under-recovering costs for the so-called ‘essential services’, and setting utility tariffs to provide cross subsidies – and were facilitated by public ownership. Prices were generally set too low (insofar as they did not adequately recover the cost of capital), which did not promote efficient investment decisions. Utility services were effectively subsidised by taxpayers, though without any transparency.

In addition, nascent capital markets were often unable to support the level of investment required to develop and maintain major infrastructure such as dams, energy generators, water and electricity reticulation networks and ports. In the absence of a clear regime for commercial cost recovery for such facilities, there was little prospect that private sector businesses would be able to raise sufficient capital to invest in such infrastructure with any assurance of recovery of the cost of particularly long-lived assets.

As government businesses move along the spectrum towards cost recovery through user charges or market-based revenues, the case for private sector provision becomes clearer. Private ownership imposes capital market disciplines that cannot be replicated under public ownership, most obviously through the equity and debt markets and because management is exposed to the threat of takeover. In many jurisdictions these services are provided by the private sector or by a mix of public and private businesses. Social outcomes can be achieved by businesses receiving payments through the Budget, for example, in the form of concessions.

Private sector involvement

Increasingly sophisticated capital markets and access to significant institutional funds, both domestically and internationally, has not only made private sector involvement in infrastructure a possibility, it has also led to significant private sector demand for investment in assets with long-lived and secure returns.

Structural reform, directed at separating competitive from monopolistic functions and the development of new approaches to economic regulation, have opened up the opportunity for private sector participation in monopolistic utilities and the divestment of competitive businesses.

A substantial program of privatisation, both internationally and in Australia, has demonstrated that a range of traditional government functions can be successfully privatised. Examples include the privatisation of UK airports, energy and water utilities; Australian federal airports; Victorian energy providers and franchised transport services; and a range of ports that have either been privately developed or privatised.

Potential benefits of private sector involvement

Full or partial privatisation offers a range of potential benefits including:

- releasing public sector capital to undertake the core functions of government
- potentially realising value in excess of value in public ownership, which can be applied to government priorities
- avoids the tieing up of scarce capital funds on investments readily funded by the private sector.

- removing businesses from the influence of bureaucratic intervention and government policy goals
- reducing the State's risk exposure and hence potentially improving its credit position
- improved service delivery and reduced costs by applying private sector expertise and discipline – although operating expenses in a regulated business are passed through to consumers, there is an ongoing incentive for privately operated businesses to outperform regulatory allowances within a price period, leading to a 'ratcheting down' effect
- removing market distortions that may have arisen despite competitive neutrality measures
- more efficient capital investment – private owners of regulated utilities have no additional incentive (arguably, they receive less incentive) to over-invest in regulated assets (compared to over-investment during public ownership) because scarce capital can be deployed elsewhere to earn more than regulated returns
- improved decision making from direct shareholding (or part shareholding) by private sector capital.

The financial implications of privatisation need to be considered in the context of achieving a sustainable fiscal position. The direct financial benefits of privatisation include the possibility of risk transfer and of achieving a sale price higher than retention value. With risk transfer, the credit rating agencies will take a view on how a transaction affects the financial sustainability of the State. For example, if high-risk, high-return assets are sold, the total state balance sheet would be seen as less risky, so a higher tolerance range for state debt issuance (for a given credit rating) may be a benefit. Any assessment of sale options will include impacts on the ratings agency metrics and the broader concept of a sustainable financial position, as well as direct financial benefits.

The New Zealand Government is exploring the option of partial privatisation of a number of state-owned enterprises with it being a majority investor and minority shares to be held by the private sector. Private shareholders would be represented by directors on the board of the corporation. The aim of this arrangement is to introduce private sector investment – and corresponding risks to investors – that will encourage a level of involvement in decision making that cannot be replicated through a commercial framework alone. However, the complications inherent in minority equity ownership should not be understated. In particular, the rationale for government ownership under such a model would be undermined by the difficulty of setting government policy goals for the entity, which affect the financial return for the minority stakeholder. Further, in a federation, there is the additional issue of the loss of tax equivalent payments from the businesses and the reduced financial benefits would need to be factored in when reviewing this model of partial privatisation.

Financial implications of privatisation

There are a number of financial considerations that need to be taken into account when assessing the option of privatisation.

First, it is necessary to assess retention value, that is the value to the State as owner of retaining the business in public ownership. This should be assessed on a discounted cash flow basis, discounting pre-tax cash flow by a suitable risk adjusted discount rate, typically by the weighted average cost of capital.

Second, the sale of a business has no direct impact on the budget result which is an operating financial statement and hence excludes capital transactions. There is an indirect impact through the loss of any dividends and tax equivalent payments and the offset of a reduced debt cost, if the sale proceeds are used to retire debt or additional investment income if the sale proceeds are invested in financial assets.

Third, the sale of the business does reduce the net borrowing requirement for the relevant period as the sale proceeds are treated as an offset to capital expenditure. This does not translate into a reduction in net debt unless the sale proceeds are used to retire debt or are held in financial assets.

Finally, in order to achieve a sustainable financial outcome from the sale or lease it is necessary that sale proceeds are invested in a financial asset or used to retire debt to a level sufficient to generate the level of cash flow produced under retention.

A clear distinction needs to be made between the balance sheet impact of privatisation and privatisation as a funding source. This is often a source of confusion which has led to proposals to place the proceeds of privatisation into funds to fund various projects. There is no objection with placing the proceeds of privatisation into funds but what needs to be clear is that in the main the funds cannot be used as a funding source for projects.

Privatisation of an income generating business asset can be used to free up the State balance sheet if the proceeds are used to retire debt, fund superannuation liabilities or be invested in financial assets. The income stream generated by the business asset needs to be replaced by either lower debt cost or investment income. Such an approach conforms with the requirements for financial sustainability. Using the proceeds of privatisation to invest in a non income generating project does not conform with the principle of financial sustainability. In the case of placing the proceeds of privatisation in a fund, only the capital sum in excess of retention value and the income generated by the fund should be used as a funding source.

Business structure and ownership options

As noted above, private sector involvement in ownership or operation of government businesses has the potential to further improve efficiency while reducing the need for public sector infrastructure investment. Specific areas in NSW in which it is worthwhile to explore the rationale for government ownership include the following:

- A number of State owned corporations (SOCs) and commercial public trading enterprises (PTEs), such as Forests NSW and Landcom, operate in contestable markets, so decisions on ongoing government ownership need to consider the role these businesses play in achieving broader public outcomes. It should be noted that broader public outcomes can be achieved by mechanisms other than public ownership.
- Regulated monopoly businesses, such as energy infrastructure and water utilities, have precedents for successful privatisation in other jurisdictions, where their monopoly status has been managed through effective regulation.
- Businesses in the ports sector display monopoly characteristics, however their market power is balanced by established commercial relationships with a relatively small number of sophisticated customers. These circumstances are well suited to lighter handed forms of economic regulation under private sector ownership.

Electricity sector

Generation

The previous Government sold the electricity retailers combined with what is termed 'GenTrader contracts' relating to the Eraring and Delta West electricity generators. GenTrader contracts are in effect the right to control and own the energy output from the associated power stations, with the actual generators remaining under public ownership.

The sale results achieved for the retailers were satisfactory, but the results achieved for the GenTraders were less so – although viewing the sale as a package, the overall result achieved sale proceeds in excess of retention value.

As a result, the State now owns three companies that operate the following four power-generating businesses:

- Eraring, with an associated GenTrader agreement with Origin
- Delta West, with an associated GenTrader agreement with TRUenergy
- Delta Coast
- Macquarie Generation.

The major generating assets associated with these businesses are as follows:

Eraring Energy (Central Coast)

- Eraring Power Station – a 2,640MW nameplate capacity coal-fired station
- A portfolio of wind farm and hydropower stations

Delta West (west of the Blue Mountains, near Lithgow)

- Mt. Piper Power Station – a 1,320MW nameplate capacity coal-fired station
- Wallerawang Power Station – a 1,000MW nameplate capacity coal-fired station

Delta Coast (Central Coast)

- Vales Point Power Station – a 1,320MW nameplate capacity coal-fired station
- Munmorah Power Station – a 600MW nameplate capacity coal-fired station
- Colongra Power Station – a 667MW open-cycle, gas-turbine station

Macquarie Generation (Hunter Valley)

- Bayswater Power Station – a 2,640MW nameplate capacity coal-fired station
- Liddell Power Station – a 2,000MW nameplate capacity coal-fired station.

The NSW Government also owns a 58 per cent stake in Snowy Hydro Limited.

The previous Government set itself a series of objectives regarding the privatisation of the electricity businesses, which are summarised in the table below, along with an assessment of the results achieved.

Table 18.1.1 NSW Government electricity transaction: objectives and outcomes

Objective	Assessed outcome
Achieve competitive retail and wholesale markets	Achieved to a reasonable extent, with diversity of ownership and Origin and TRUenergy given sufficient scale to compete in retail with AGL and two substantial private sector GenTraders. The Government's objective of a new entrant was not achieved.
Ensure private investments in electricity	The core objective was private sector investment in base-load generation. It is not clear whether this will be achieved, with continuing strong public sector involvement in generation and the private sector's reluctance to invest in base-load generation as distinct from peak generation.
Ensure reliable supply	To the degree that this links to peak period capacity, there are incentives in place to achieve this, but as noted above, this is less clear for base-load generators.
Optimise sale proceeds	Achieved with retail but not with generation, although the simultaneous offer of retail and generation may have helped achieve good prices for retail.
Reduce risk	Only partially achieved. There is some residual risk with non-novated retail contracts and risk exposure with the GenTraders, through the Availability Liquidated Damages (ALDs), though significantly less than under retention (outages and industrial relations); cost overruns; and coal supply at a set price from Cobbora. More generally, the sale of all retail businesses while retaining two major generators, has exposed the State to greater risk given that previously the State was on both sides of the national market – both supply and demand –but is now only on the supply side. However, downside risk is limited, as generators tend to contract only some of their capacity and reserve adequate capacity to cover plant outages.

The transaction objectives were not fully achieved. In particular the sale did not achieve:

- a substantial new entrant to the NSW market to enhance competition
- certainty about private sector commitment to invest in base-load power supply in a timely manner, noting that in August 2010, the Australian Energy Market Operator (AEMO) concluded that under a medium economic growth scenario, new generation capacity would be needed by 2016-2017
- an optimum level of sale proceeds, given that the complex nature of the GenTrader model both discouraged participation by energy companies and would have produced a discount for those that did participate
- reduction in risk – with the exposure to electricity market risks and volatility increasing because, whereas previously there was a reasonably balanced position regarding exposure to wholesale market, with retailers and generators covering both sides of the market, the State is now only exposed on one side:

sale into the market through its ownership of Delta Coast and Macquarie Generation.

The GenTrader model is not an optimal model with its main virtue being that it was a means of transferring ownership of the trading function without the need for legislation. The GenTrader model is not an appropriate model going forward as it does not fully realise value and creates sub optimal relationship between the GenTrader entity and the generator. In particular:

- The generators do not operate at maximum effective capacity
- There is a non optimum allocation of risk between the generator and the GenTrader
- The complexity of the relationship between the GenTrader and the generator creates lost value and discourages private sector participation

There are very strong grounds for selling the remaining generators, including the generators that have contracts with the GenTraders. It is strongly recommended that a sale of the remaining market operating generator businesses (Macquarie Generation and Delta Coast) should be as whole businesses rather than through GenTrader contracts.

There is likely to be significant residual value in the two businesses with GenTrader agreements in place, Eraring and Delta West, and that, in addition to TRUenergy and Origin, there could be other parties interested in bidding in a competitive sale. Conversely, there is the opportunity to negotiate with TRUenergy and Origin on the basis of achieving fair and full value.

Finally, there is no rationale for continuing government ownership of Snowy Hydro Limited and discussions should be entered into with the other shareholders – the Commonwealth and Victoria – regarding its sale.

Cobbora

Cobbora is a risk mitigation measure that was initiated by the NSW generators prior to the December 2010 energy transaction as a way of addressing coal supply security issues for NSW power stations. This reflected the boom in the export coal market, with accelerating coal prices and the diversion of coal supplies into the more lucrative export market. Eraring, Delta and Macquarie were facing the situation where more than 50 per cent of their forecast needs in 2016-17 were uncontracted and securing supplies at competitive prices was proving to be highly problematic.

The opportunity for the private sector to bid on the role of developing and operating the Cobbora coal resource was taken to the market, with bidders able to bid on the basis of the price at which they would be able to supply the generators, with the ability to export excess coal reserves.

While a preferred party was identified, agreement could not be reached on financial terms. The Government decided to enter into agreements with the GenTraders to supply coal at a certain price from Cobbora, with a decision to be taken after the energy transaction on the longer term ownership of Cobbora.

Clearly, the Government is not a specialist in coal mine development. While it would be possible to bring in suitable expertise through contracted services, developing the mine would require substantial state funding, which would displace priority social and economic infrastructure. Accordingly, the Government should prepare a broad development plan for Cobbora that allows appropriate commercial flexibility, while defining the core requirements of the generators as the core customers. Proposals should then be sought regarding development and operation of the mine.

Electricity network businesses

Following the sale of the three retail businesses, the State owns three distributors – Ausgrid (formerly Energy Australia), Endeavour Energy (formerly Integral Energy) and Essential Energy (formerly Country Energy) – and a transmission business, TransGrid. Each is a local monopoly within its area of operation and each is regulated by the Australian Energy Regulator (AER), which is a part of the Australian Competition and Consumer Commission (ACCC). The AER-determined regulatory asset base of the four entities totalled $26.5 billion as at June 2011.

The benefits of entering into long-term leases for the network businesses are as follows:

- It will probably deliver value in excess of the value of the businesses to the State. Comparable transactions in Australia and overseas have achieved more than 20 per cent to 30 per cent above the regulatory asset base.
- The businesses will be fully regulated, so consumers are protected from price exploitation regardless of whoever owns the businesses.
- It overcomes the inherent conflict in the Government being the owner of the businesses and also a regulator.
- There is evidence that private sector owners will manage the businesses more effectively, achieving lower costs that would flow through to lower prices.
- Avoids tieing up scare capital funds in investments that the private sector is prepared to fund.
- Would enable a massive reduction in State’s net debt or unfunded superannuation liabilities.

The State is currently investigating the feasibility of merging two of the three distributors. It should be noted that a merger would be unnecessary and potentially counterproductive if the decision was made to proceed with a sale or long-term lease.

Water sector

The Government, as part of its election promises, has proposed the long-term lease of Sydney Water Corporation's fully owned subsidiary, Sydney Desalination Plant Pty Ltd (SDP). The proceeds of this lease would be used to partly fund additional infrastructure spending through Restart NSW. However, unless the plant can be removed from the State's balance sheet, the transaction will not provide any additional funding capacity.

The sale or lease transaction could be completed over six to nine months, taking into account work already undertaken by Sydney Water to establish the plant as a standalone entity.

There are a number of issues that will need to be managed including ensuring that the plant can be expanded if necessary, optimising the sale price by managing regulatory risks and, where possible, reducing uncertainty. A key step will be an Independent Pricing and Regulatory Tribunal (IPART) determination on the price paid for water purchases from the desalination plant. Changes to the regulatory framework need to go beyond establishing a suitable price path; they must involve a full review of the regulatory instruments for Sydney's bulk water market. IPART should be given this broader remit, and the regulatory changes should be made before any sale or lease of the desalination plant.

Ports sector

Ports are key infrastructure elements and a fundamental part of the transport logistics chain. They facilitate the import and export of goods with the rest of the world via ocean shipping and are central to delivering economic growth. Some ports also cater for passengers while others are used for security and defence purposes.

Commercial ports in Australia generally fall into one of the following three categories reflecting the type of goods handled:

1. Container ports
2. Bulk commodity ports
3. Mixed cargo ports.

Most ports in Australia are owned by state and territory governments, with the exception of the following privately owned major ports:

- Flinders Ports, South Australia (which owns the Port of Adelaide and various regional South Australian ports)
- Port of Brisbane, Queensland
- Port Walcott, Western Australia
- Port of Portland, Victoria.

In NSW, prior to 1995, the Maritime Services Board of NSW was responsible for managing the NSW ports. With the commencement of the *Ports and Maritime Administration Act 1995*, the Maritime Services Board was abolished and Sydney Ports Corporation, Newcastle Port Corporation and Port Kembla Port Corporation were created as statutory State owned corporations (SOCs) to manage the State's commercial ports.

NSW Maritime was created in 2004 under the *Ports and Maritime Administration Act 1995*, replacing the Waterways Authority and the Maritime Ministerial Holding Corporation. NSW Maritime is responsible for managing marine safety, regulating commercial and recreational boating and overseeing port operations. The authority is also responsible for property management of submerged lands in Sydney Harbour, Newcastle Harbour, Botany Bay and Port Kembla and for providing the NSW Government with strategic advice on ports and maritime matters. NSW Maritime also manages the small regional ports of Port of Yamba and Port of Eden.

There is no compelling case for continued government ownership of ports, as demonstrated by the recent Port of Brisbane long-term lease. Efficient port operations will benefit NSW's economic development, but sound economic pricing must be implemented before an appropriate value can be realised from a sale or lease of the three major port businesses.

Currently, the Minister for Ports sets port prices, but this system is not transparent and has not delivered adequate commercial returns. Reforming port pricing will enhance transparency across the sector and improve commercial returns for the port corporations.

A light-handed regulatory regime should be established for NSW Ports, including greater pricing autonomy, consultation with users on proposed pricing changes and provisions for regulator intervention if there is evidence of the port businesses misusing market power. The objective is to achieve transparent pricing for monopoly services supplied by the port corporations, based on agreed pricing principles. This approach, which could be implemented by the end of 2011, would be based on similar regimes in place at Victorian, Queensland and South Australian ports and in Australian airports.

Pricing reforms should include user-pays charges for cruise passengers using Sydney Harbour's cruise terminals and should increase legislative flexibility regarding the structure of charges. In addition, the existing port cargo access charge should be incorporated in wharfage charges.

Once pricing has been reformed, consideration should be given to the long-term lease of each port. The ports undertake a landlord role, which could be undertaken just as effectively (or even more effectively) by the private sector. Before proceeding with a long-term lease, it will be necessary to clearly define the roles and strategic direction of each port as part of a state-wide ports strategy.

The structural separation of the port businesses from NSW Maritime included separating ownership of the ports from the underlying seabed and navigational channel assets. While the port corporations pay NSW Maritime for the use of the channels through a percentage of navigational charges, this is not related to the value of the underlying asset base or the cost to NSW Maritime of providing the service.

Furthermore, as the port corporations are responsible for dredging and maintaining the channels, this separation of ownership compromises the port corporations' ability to account for the value of the asset enhancement and recover its value from port users.

It is recommended that the seabed and channels be vested in the port corporations, or provided for under long-term leases and the establishment of a long-term basis for efficient port charges that transparently reflect assets used in providing port services.

Forestry sector

Forests NSW is an entity that sits within the Department of Primary Industries and comprises two separate operating units: native forests and plantation forests. The plantation business is fully commercial and operates in a competitive market, supplying the building materials industry and the pulp and paper industry. While there was a case for public ownership when the plantation business was first established, this justification is no longer present.

It is recommended that the plantation business be separated from Forests NSW and corporatised and as part of the process of corporatisation, the native title, policy and research functions are separated out and retained while the plantation business is established on an efficient basis. Once corporatised it is proposed it is prepared for privatisation by means of a long term lease in line with the approach followed in Victoria and Queensland and which South Australia is proceeding with.

18.2 Infrastructure Fund

An issue considered by the Financial Audit is whether there are alternative and possibly better approaches to realising value from non-core income generating infrastructure assets than the traditional asset sale process which has significant transaction costs. The approach which has been explored is that of creating an Infrastructure Fund which would be an entity that would realise value over time from the asset but would provide the means, if the State wished, to retain some level of residual interest in the asset.

The key objective of such an approach would be to recycle capital on the State's balance sheet by selling down interest in established brownfield assets in order to fund greenfield infrastructure that may not be able to be funded by the private sector in a cost effective way. In effect the State would invest in greenfield infrastructure not able to be effectively developed by the private sector and once established seek to realise value from the private sector.

Another objective that could be pursued is to address the net liabilities of the closed defined benefit schemes. This could be achieved by assigning an interest in the assets to the beneficial ownership of the superannuation scheme. However, this would need to occur in a way that did not unduly distort the strategic asset allocation of the scheme. This would require that any interest assigned to the scheme was consistent with the strategic asset allocation.

It is appropriate that the Infrastructure Fund draw upon the expertise and experience of Treasury Corporation which is a substantial financial investor. It would also be appropriate for an investment committee to be established to oversight the operations and performance of the Infrastructure Fund.

Consideration will need to be given as to the structure of the Fund and of the form that external investor interest would take. One option is a unit trust model which allows for investors to invest in a number of assets. An alternative model is to allow investors to invest directly in individual assets. It is possible that there could be a number of mechanisms used, that is a unit trust fund for investors who would prefer the diversification benefits of such a model and direct investment in individual assets for other investors.

The infrastructure assets, which could be SOC businesses, could be vested into the Fund on an enterprise basis (that is with existing debt) or could be vested in on an equity basis. If the latter, the fund could then issue debt to achieve a suitable capital structure and use the proceeds generated to invest in new income generating assets or else to create a more diversified portfolio. One option would be to create a suitably diversified portfolio of assets for the superannuation scheme to address the funding shortfall in a way consistent with its strategic asset allocation.

Once the Infrastructure Fund was established there would be flexibility to seek the involvement of private sector investors with the proceeds of any sale of interests reallocated to other suitable new NSW infrastructure or else used to fund superannuation liabilities.

The key benefits of this model are as follows:

- enables the value of existing infrastructure assets to be realised and the monies so released available to be used to fund superannuation liabilities or to fund new infrastructure assets
- provides the opportunity for long term private sector investors to invest in established infrastructure and to tap into their expertise on strategy and performance
- creates a more commercial environment for the operation of the infrastructure assets
- creates a potentially significant income stream for the State in the form of investment management fees.

There are many issues that would need to be addressed including the structure of the fund, the nature of the interest available to private sector investors, how rating agencies would assess the arrangement and the tax treatment of the infrastructure businesses in the fund. It is recommended that Treasury, Treasury Corporation and suitable private sector advisers with a full understanding of the requirements of private sector investors undertake a detailed scoping study of the proposal.

18.3 Property management

History of property reforms to 2011

Over the past few years, a number of reforms have been introduced to improve the performance of the Government's office accommodation portfolio, culminating in the formation of the State Property Authority (SPA) in late 2006.

Initial reforms focused on reducing space requirements (from an average high of 24 square metres per person) and improving property planning. A benchmark of 15 square metres per person was implemented for all new accommodation, with the aim of achieving a government-wide average of 18 square metres per person (to account for smaller, less efficient offices in regional locations, and the large number of government heritage buildings). These reforms also introduced the need to develop facility plans to promote more efficient use of space and office accommodation design principles were developed.

In 2005, the average space target was reduced to 17 square metres per person and new Sydney CBD accommodation had to achieve 14 square metres per person. Overall, average space use is now 17.05 square metres per person.

Lease negotiations were also targeted as an area for improvement. In 2008, all office accommodation leasing was centralised to ensure lease negotiations were professionally managed and coordinated and the Government achieved the best possible deals. Centralising lease negotiations has resulted in a more professional approach to negotiations and allows the Government to leverage its considerable presence in the market to improve essential lease terms (e.g. rent review mechanisms) across multiple office markets.

Agencies are required to occupy vacant government space in the first instance to minimise surplus space or double rent. Government office space vacancies are currently less than 1 per cent, compared to market averages of 7 to 10 per cent.

The SPA was established in September 2006, with the aim of further improving property management and property disposal outcomes.

Treasury, in consultation with the SPA, undertook a review of property policy, resulting in the adoption of a number of Government Property Principles from 2008 onwards. The key principles require:

- immediate vesting (from 1 July 2008) to the SPA of all government-owned office accommodation
- implementation of a commercial rental charge for all office accommodation vested in the SPA
- transfer to the SPA of management responsibility for all government-leased office accommodation
- extension of the Government Leasing Service within the SPA, to include all lease renewals and new and existing lease negotiations for generic property in the greater Sydney Metropolitan area
- regular and ongoing SPA reviews of agency property portfolios, to identify efficiencies that could improve service delivery (implementation of these reviews must be monitored by the Government Asset Management Committee (GAMC) and reported to the Government)
- review and endorsement of all proposed property acquisitions and disposals by the GAMC
- making the SPA the Government's preferred acquisition and disposal agency
- making the SPA the lead agency for all multi-faceted property proposals that are interlinked by timing, location or use.

The main reform was to vest all government-owned office accommodation from agencies (excluding SOCs) to the SPA and to apply a rental charge as a form of applying a capital charge. The office vesting program is substantially complete.

Agencies were only funded for the net component of the rental charge (excluding operating costs such as cleaning and property maintenance) on the presumption that agencies should have already been budgeting for the operating costs and maintenance. After operating costs, SPA returns the net rent to the Consolidated Fund as a dividend.

As expected, a significant number of the properties vested in the SPA had been poorly maintained.

Opportunities for improvement

The establishment of the SPA and the new property policies has been successful in improving management and maintenance of the Government's office accommodation portfolio. With the consolidation of the office accommodation portfolio, the SPA will be able to increase its focus on property rationalisation, including the disposal of surplus properties.

Further initiatives to improve property management and derive additional value from the Government's property portfolio are outlined below.

Improving space utilisation

While substantial improvements in space utilisation have been achieved over the past few years, there are still opportunities to achieve further savings. Office design is continuously evolving and a number of more efficient office fit-out options have emerged. Improved space utilisation should only be pursued to the extent that office functionality, safety and disability access are not compromised – a proviso supported by the ongoing requirement to prepare facility plans. To achieve better utilisation, an effective monitoring process is necessary. This process should be applied on an exception basis: if an agency identifies a need for space utilisation greater than 14 square metres per person for premises larger than 1,000 square metres, approval must be obtained from the GAMC.

It should also be noted that the Government has a high proportion of tenancies in heritage buildings and small offices (especially in rural areas), neither of which are conducive to lower space densities.

Space utilisation of less than 14 square metres per person can be achieved for certain office functions (e.g. in process-orientated jobs and at call centres) but these roles are less prevalent in government agencies. A high proportion of government office use is devoted to knowledge-based and policy work, which require a number of different settings depending on the work being undertaken and are less likely to achieve densities lower than 14 metres per person. Lower densities are often achieved in some private sector roles such as banking (e.g. processing roles) or consulting firms, where a high proportion of staff members work out of clients' offices and only require a small home office area. The Internal Audit Bureau is an example where this model has worked within the Government.

In the past, the predecessor to the SPA published an annual table of agencies' space utilisation performance. This information, comparing agency-to-agency performance, encouraged agencies to improve utilisation in line with benchmarks.

Further improving space utilisation is a long-term objective as it takes up to 10 years to amortise the cost of a fit-out and refitting needs to be assessed on a cost-benefit basis. New space targets should be applied to all new fit-outs, or where a major refit is required (i.e. where a fit-out would have to be undertaken regardless of the desire to improve space utilisation).

Vesting operational property

Over the past two years, the SPA has undertaken a program to vest most government owned and leased office accommodation. The SPA now has 1,242,000 square metres under management, housing a total of 73,000 staff, with a total rental cost of $310,837,000.

The objective of vesting the properties in the SPA was to establish property management on a professional level, improve maintenance outcomes, provide economies of scale for facility management contracts (e.g. cleaning and security) and better facilitate the rationalisation of properties.

Initially it was determined that the SPA would only vest office accommodation to give it sufficient time to build capacity to manage the additional properties. The *State Property Authority Act 2006* (SPA Act) allows for further vesting of non-office accommodation (operational property) but not certain classes of Crown Land.

At this stage, the SPA does not have the capacity or capability to manage non-office properties on a large scale. Consideration should now be given to whether the Government wants to further consolidate property management within one agency. The lead time to implement such a strategy will be significant, given that the SPA will have to build extra capacity and capability to manage specialised facilities.

Further vesting could be undertaken in a staged process, starting with car parks, depots, warehouses and motor registries, for example, and could be limited to budget sector agencies and non-commercial public trading enterprises (PTEs). Vesting other properties such as hospitals or schools will be substantially more difficult.

Vesting operational property could simplify the imposition of a capital or land use charge over operational property, which would better recognise the direct costs of service provision and encourage agencies to identify rationalisation opportunities. A similar approach to that used to assess the cost of office accommodation could be adopted for operational accommodation. A capital charge approach is discussed in more detail later in this chapter.

Another option is to vest the underlying land in SPA and apply a rental charge based on land value, yet allow the agencies to retain ownership and management of the improvements to the land (e.g. school buildings). This approach may facilitate the rationalisation of underutilised land.

An issue with regard to vesting other properties in SPA is the substantial transfer of maintenance liabilities. It is generally accepted that agencies have not maintained government-owned properties to a reasonable standard for a long time. Maintenance costs are one of the few recurrent expenses that agencies can easily cut without any immediate impact. This became evident with the vesting of office accommodation to the

SPA, when a significant number of properties were handed over in a poor state of repair. Consequently, additional funding had to be provided to the SPA to bring the properties up to a minimum standard of repair.

If more properties are transferred to the SPA, there will be greater transparency about the maintenance requirements for properties making it necessary to substantially boost the SPA's recurrent and capital budget.

One particular obstacle to vesting operational properties is that the SPA Act does not allow certain Crown Lands to be vested. As a substantial number of operational properties are on Crown Land, the SPA Act may need to be amended. This should be considered as part of the SPA Act review, which is due for completion by June 2012.

Improving property management

One of the objectives of centralising government property is improving property management in terms of quality and cost.

The SPA (and its predecessors) has outsourced the day-to-day management of its property portfolio since the early 1990s while retaining strategic planning, portfolio management, infrastructure works and certain finance functions in-house.

Generally, this outsourcing has been successful and is considered the norm in all jurisdictions.

The SPA recently established a team to manage a number of properties (67 office properties and 27 non-office properties) in-house from mid-2011, in a defined geographical region (Lidcombe to Lithgow). In doing so, the SPA hopes to benchmark performance of the outsourced contracts against the in-house services, with a view to substantially expanding the in-house team. The rationale of having an in-house team to manage a relatively small number of properties is questionable and consideration should be given as to whether a better outcome would be achieved by bundling these properties into a new outsourcing tender. Any proposed expansion of the SPA's in-house management services would need to be carefully considered in terms of optimum use of resources.

All NSW Police properties and infrastructure works have been outsourced in the past five years and it was recently decided to extend this contract for two years. While NSW Police still retains ownership of these properties, the SPA is the contract manager. Given that the management of the police portfolio is already outsourced and the SPA is involved in contract management, this may be a good test-case portfolio to vest in its entirety as it contains both generic (i.e. office) and operational (i.e. police stations) properties. There may be opportunities to benefit from economies of scale if the SPA took control of this portfolio, allowing NSW Police to reduce or redeploy existing staff involved in managing the portfolio. The SPA may also be able to achieve greater efficiencies with a larger portfolio under management. The SPA and NSW Police should prepare a business case to identify the benefits and costs of vesting the police portfolio, including the implications for maintenance expenditure.

Improving property disposals

The SPA is the Government's preferred disposal agency; however, agencies are not mandated (under Premier's Memorandum 2008-06) to utilise the SPA's property disposal project management services. This memorandum requires all agencies except SOCs to submit proposed property disposals for assessment by the Property Disposal Assessment Panel (a sub-committee of the GAMC), to determine if the disposal strategy is appropriate, identify any strategic issues or other government uses and nominate the preferred disposal agency.

Agencies have been reluctant to use the SPA due to perceived high disposal costs, including the SPA's fee for service. Disposal costs are often high as agencies mostly seek SPA assistance regarding complex properties. The Government has previously not supported mandating the use of the SPA, as property disposal is seen as a contestable process.

Another significant factor affecting disposal performance is that the 'best' surplus properties have been divested over the past fifteen years and those remaining have significant problems including contamination, heritage issues or community opposition. In addition, surplus property asset sales have increasingly been tied to specific infrastructure programs, so agencies plan forward disposals to match cash flow needs associated with specific infrastructure works. This can be problematic as the sale of surplus government property is poorly perceived by the community and local factors can significantly affect the outcome of property sales, resulting in a less than optimum return to the divesting agency.

Disposal performance, particularly of more difficult properties, could be improved by vesting any surplus properties in the SPA. This would separate the agency from the property and the SPA could fund the disposal process and recover reasonable expenses from the disposal proceeds.

The SPA also has a significant portfolio in its own right and over the past three years has been focused on the vesting program and acquiring strategically necessary property.

Disposal activity was affected by the global financial crisis in the form of restrictions on funding for new projects. Given limited investment activity, developers have shown a preference for greenfield sites rather than the brownfield sites that make up much of the Government's surplus stock.

The SPA currently owns 158 properties with an estimated total value of $951 million. Past asset disposal proceeds, including disposals on behalf of other agencies are: $99 million in 2007-08; $24 million in 2008-09; $105 million in 2009-10 (including a $75 million sale of land at Newcastle to the Newcastle Ports Authority under Ministerial direction); and $5.6 million in the first half of 2010-11. When the SPA was established it was expected to achieve asset sales of more than $200 million per annum, although this expectation was based on flawed data and assumptions.

The SPA should be instructed to undertake a detailed review of selected high-value properties to ascertain whether, considering the improving market, now is an appropriate time to pursue divestment. Buildings that should be given priority review include Bligh House (valued at more than $30 million) and Commonwealth Street (valued at more than $10 million) in Sydney, together with the Maritime Building (valued at more than $140 million), which is currently owned by the Maritime Authority and is embargoed from sale until 2014 when the current complex transaction structure will be simplified. The SPA also holds property at Macquarie Park that has previously been set aside for a Defence Industry Precinct. Initial reviews of the proposal suggest that the outcomes linked to the site may be questionable, and the overall approach should be reconsidered. This vacant site is valued at more than $40 million.

Capital charging

A capital charge is the imposition of a fee to reflect the economic value of using capital, which could be applied to general government agencies.

The cost of using general office spaces is currently reflected in market rents paid to the SPA, so no capital charge would apply to these assets.

A capital charge could cover more specific purpose-built infrastructure such as schools, hospitals and police stations.

Such a charge would have two broad aims, namely:

1. creating greater transparency in the cost of using capital to provide government services
2. establishing an economic incentive for promoting better asset management practices and greater value for money.

If applied, agencies, initially, would account for the capital charge expense and the revenue to fund it – as notional transactions with no underlying cash flows. At this stage the notional capital charge would be a costing exercise only. While it would improve the quality of cost information in the general government sector, it would not subject managers to a cost discipline.

The longer term goal of promoting better asset management in agencies could be achieved by replacing the notional charge with a cash charge. The difference between a cash payment to the Government and funding received from the Government for the charge would then be based on the agency achieving asset management efficiencies.

Previously, there has not been strong support for a general government sector-wide funded capital charge for the following reasons:

§ while the incentive may encourage rationalisation of surplus assets, it will not guarantee improved asset management

- it is difficult to determine the extent to which changes to the asset base are the result of more efficient asset management or other factors, such as accounting adjustments
- it is often difficult in practice to determine an efficient funding level independent of an agency's actual capital base
- financially penalising agencies for poor asset management may penalise the recipients of the agency's services, rather than its management.

Adoption of charges on capital – both notional and cash-based incentives – has had mixed results in NSW and other jurisdictions.

An internal capital charging policy was introduced in NSW Health in 2001 and put into limited operation in 2008-09. The policy's impact on asset management was limited to increasing transparency in service delivery costs, encouraging asset rationalisation and indirectly supporting asset maintenance.

The 2006 New Zealand Expenditure Review Report on Asset Management found that agencies viewed the charge as having no real fiscal impact and did not see it as a significant factor in asset management decisions. Additionally, any incentive gained from asset rationalisation was seen to be diluted as much of it went back to the consolidated revenues.

Relocating functions and jobs to suburban and regional locations

The Government has a policy of minimising the occupation of high-cost Sydney CBD office accommodation unless it is required for service delivery. Presently, agencies wishing to remain in, or relocate to, the Sydney CBD must present a business case to GAMC justifying that need. While this is a relatively new process and has not resulted in any immediate relocations out of the Sydney CBD, it has identified a number of future medium-term (three- to five-year) opportunities for major relocations. Key agencies identified as having potential to relocate to suburban locations include the head offices of the Department of Environment and Climate Change; the Department of Ageing, Disability and Homecare; and Fire and Rescue NSW (all currently in the Sydney CBD); and NSW Health (currently in North Sydney).

Previous governments have successfully implemented suburban or regional relocation programs aimed at reducing accommodation costs, kick-starting or revitalising regional property markets and providing new regional employment opportunities. Relocating offices to suburban and regional locations can also provide transport benefits by promoting reverse commutes away from the Sydney CBD.

Relocating head offices to metropolitan suburbs has been fairly successful in the past; however, relocating head offices to country locations is less so, as the cost of relocating staff (particularly specialists) can outweigh the benefits of cheaper rent. The availability of suitable accommodation can be limited in regional locations, making it necessary to develop a suitable building at a higher rental cost to the Government. On the other hand, relocating call centres to country areas has been more successful, because they require less specialised staff and have a more mobile workforce.

The Government now has the opportunity to capitalise on work to date, to develop a program of relocating functions and jobs from high-cost accommodation to suburban locations (for head offices) or to country locations (for call centres).

A task force should be established to identify potential relocation opportunities and develop business cases for consideration by the Government. The task force should include members from the Department of Premier and Cabinet, NSW Treasury, the Department of Finance and Services, and the Department of Planning.

Clear criteria need to be established to ensure any proposed relocations are cost-effective and will not adversely affect service delivery outcomes. These criteria should include:

§ service delivery impacts

§ full relocation costs (including staff costs)

§ suburban or regional benefits

§ ownership (building) versus leasing benefits

§ preferred locations (based on the Department of Planning's Metropolitan and Regional Strategies)

§ timing

§ funding requirements.

18.4 Funds Management

Rationalising fund management functions

Most jurisdictions in Australia have already centralised investment management functions within the general government sector: examples are the Queensland Investment Corporation (QIC) and the Victorian Fund Management Corporation (VFMC) which also mange in those states Public Trading Enterprises and superannuation asset portfolios.

NSW can be characterised as having a decentralised approach to the funds management function in contrast to the centralised approach with VFMC in Victoria and QIC in Queensland. This has the advantage of diversifying management risk. The disadvantage is that of overlap of functions and hence some cost inefficiencies. Also it is more difficult for the state to have a consolidated view of the investment position.

It is noted that in the case of QIC, its charter has been broadened to allow it to compete in the private sector for funds management roles. Such an approach is not recommended for NSW.

There are two issues to consider.

First, a large number of general government agencies undertake their own investment function, including setting investment strategy. These agencies do not have as a core expertise investment management. It is proposed that a Treasurer's Direction be issued under section 9 of the Public Finance and Audit Act requiring all general government agencies to undertake their investments through Treasury Corporation.

The second issue is the case for consolidating the investment function in respect to the more specialised investment bodies outside the general government sector. There are a number of entities in NSW that undertake investment functions or are superannuation entities or both, these being Treasury Corporation, State Super, WorkCover, the Energy Industries Superannuation Scheme, the Judges Pension Scheme, the Parliamentary Contributory Superannuation Scheme, the Dust Diseases Compensation Fund, The Long Service Leave Building Corporation, Life Time Care and Support Corporation and NSW Self Insurance Corporation.

Treasury Corporation is the State's central borrower on behalf of both the crown and all public trading enterprises, including SOCs. It also invests on behalf of the crown and provides investment facilities to public trading enterprises. It is the logical vehicle for any centralisation of the investment function.

WorkCover operates the workers compensation scheme for all state based employees and is part of the Compensation Authorities Staff Division (CASD) which also includes Workers Compensation Dust Diseases Board, Lifetime Care and Support Authority, Long Service Leave Payments Corporation and Motor Accidents Authority. WorkCover administers work based health and safety, injury management, return to work and workers compensation laws and manages the workers compensation scheme. In that role it also manages the investment funds that were $ 10.5 billion as at June 2010.

Workers Compensation Dust Diseases Board manages a no fault compensation and services scheme directed at workers and their dependents who have contacted a dust disease. Total funds under management as at June 2010 were $631million.

Life Time Care and Support Authority provides treatment, rehabilitation and attendant care services to people severally injured in motor vehicle accidents on a no fault basis. Investment as at June 2010 was $1084million, all placed through Treasury Corporation.

Long Service Leave Payments Corporation manages the portable long service payments scheme for workers in the building and construction industry.

Workcover, while a State administered scheme, is operated on behalf of industry. Hence the State does not underwrite the scheme but has an interest in ensuring optimal performance as any sub performance acts in the same way as a tax on the industry.

In addition to the various industry schemes there are a number of superannuation schemes.

State Super manages the closed defined benefit superannuation schemes and undertakes investments of approximately $30billion.

Energy Industries Superannuation Scheme operates the superannuation scheme for state owned energy companies and undertakes investments of about $2 billion.

The Parliamentary Contributions Superannuation fund has $207million under management as at June 2010, managed by Russell Investment Group.

NSW Self Insurance Corporation manages the Treasury Managed Fund which covers a number of self insurance schemes covering governmental workers compensation, motor vehicle and miscellaneous risks, public liability as well as the Builders Warranty Catastrophe reinsurance scheme. Investments of about $5.4billion are held against potential liabilities, with NSW Treasury Corporation managing the investment.

In the case of the investment function undertaken within the CASD, there is a process underway of seeking to streamline the investment function across the various agencies and this involves the use of NSW Treasury Corporation. With respect to the main investment area, WorkCover, there is sufficient scale to support an investment function and there is a need to avoid the State appearing to take on any form of underwriting role for the scheme. However, there is merit in seeking to utilise further the specialised investment expertise and infrastructure of Treasury Corporation. Accordingly, it is proposed that Treasury, with Treasury Corporation and CASD assess the current investment arrangements and the opportunities to improve investment governance and rationalise the investment function.

In the case of the Energy Superannuation Scheme (ESS), there are three considerations that support the investment function being centralised:

- Scale is at the small end of the distribution curve and means that it can only support a limited investment function.
- The privatisation of electricity retail and GenTraders and the prospective privatisation of the other energy corporations calls into question the rationale of having a separate energy sector superannuation scheme.
- The governance of the investment function is inadequate with very limited investment expertise present in the Investment Committee.

Approximately 50% of the ESS funds are in deferred benefit schemes and 50% in accumulation benefit schemes. It is recommended that the defined benefit portion is transferred to State Super and the accumulation portion is transferred to First State Super, subject to consideration of the option set out below for separating the benefit administration from the investment function for State Super.

The Parliamentary Contributory Superannuation Scheme is too small to be effective either in respect to benefit administration or investment management. It is proposed that the scheme is transferred to State Super.

Similarly the Judges scheme is too small to be efficient and it is proposed to also be transferred to be administered by State Super.

A quite different issue arises with respect to State Super which, with an investment fund of approximately $30billionn, is one of the country's largest investment funds and supports a professional investment approach, with a small in-house investment advisory team and fully contracted out funds management and asset consultancy. The issue here is that, in the main, the investment risk is to the account of the State but the State does not have direct influence over the risk return trade-off decisions. State Super administers closed defined benefit schemes of the State with the State underwriting the benefit provided and hence being exposed to the investment return generated. At the same time it is noted that a number of the schemes have a small accumulation component that is invested on behalf of members.

Under the current arrangement the superannuation trustees oversight not only the administration of the schemes but also the investment function, though the main principal for the investment function is in fact the State as the scheme underwriter and funder.

If the State wishes to have greater direction over the investment strategy of State Super and in particular over decisions with respect to the risk-return trade off, one option is to separate the investment function from the superannuation scheme administration function, as occurs with QIC and Q Super in Queensland. The option would be to transfer the investment function to Treasury Corporation. If this were to occur the State would need to have full regard to the interests of members whose funds are included in the funds under management. This would require the separation of the funds of members from those of the State. It would also require the establishment of a high level, expert investment committee to oversight the investment strategy and performance.

Superannuation liabilities

Reported superannuation provisions measure the value of unfunded defined-benefit superannuation liabilities (i.e. the difference between the gross value of superannuation liabilities and the value of superannuation fund assets). The gross value of liabilities is based on the present value of accrued defined-benefit obligations at the end of the reporting period.

Until 2005, the discount rate used to estimate the present value of gross liabilities was based on the forecast earning rate for assets held in the fund (currently 8.6 per cent after tax). This rate was used – and the liability estimated – in accordance with the long-standing Australian accounting standard AAS 25 – Financial Reporting by Superannuation Plans, also known as the actuarial funding standard.

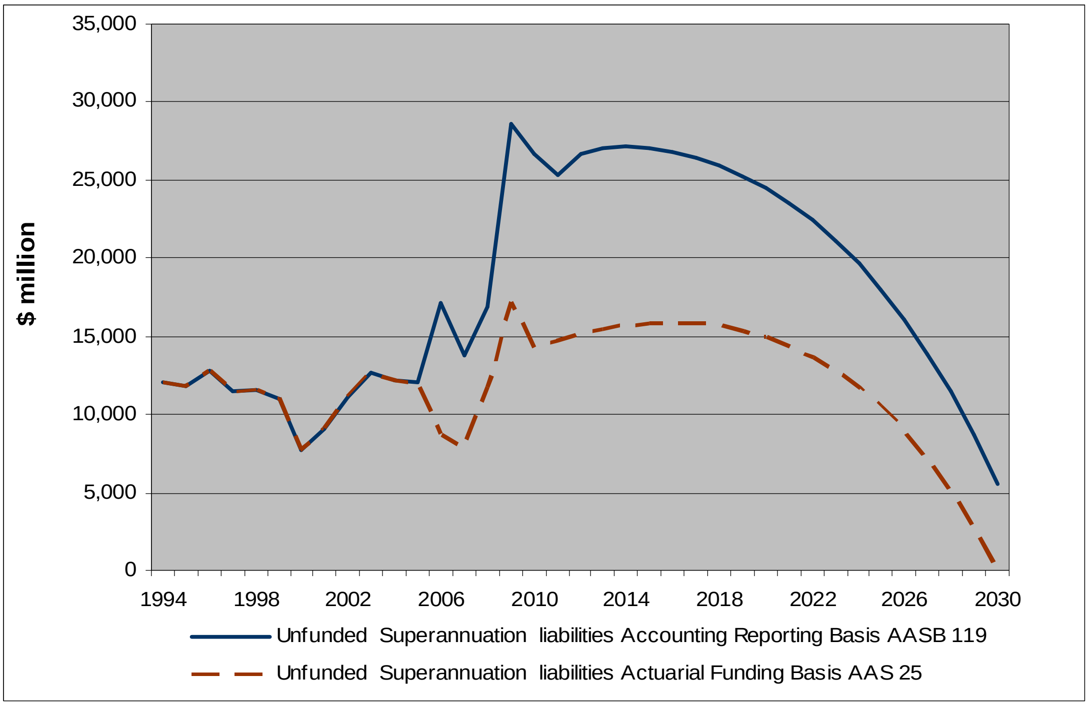
Treasury also used this standard to estimate future funding requirements and meet the Government's 2030 full funding target under the Fiscal Responsibility Act 2005.

AAS 25 was superseded in 2005 with the adoption of the international accounting standard AASB 119 – Employee Benefits, also known as the reporting standard or reporting basis. This standard requires the use of long-term government bond rates as the discount rate for estimating the present value of gross liabilities.

AASB 119 is now the standard used by the Commonwealth and State governments for reporting superannuation liabilities in budgets and financial statements. AASB 119 is also the standard used by the Australian Bureau of Statistics (ABS) for Government Finance Statistic (GFS) reporting purposes.

The following figure shows the impact of AASB 119 (i.e. the difference between it and AAS 25). The government bond rate is lower than the forecast earning rate, so liabilities reported under AASB 119 are higher than liabilities measured under AAS 25 (the forecast bond rate is 5.85 per cent, and the forecast earnings rate is 8.6 per cent after tax). As bond rates vary from year to year, the value of the liability under AASB 119 has also varied.

Figure 18.4.1 Unfunded superannuation liabilities under AASB 119 and AAS 25



Superannuation funding arrangements

Although NSW now uses AASB 119 for reporting purposes, AAS 25 is still used to estimate ongoing funding requirements and meet funding targets.

AASB 119 is too problematic to use for funding purposes. Using a bond rate inherently overestimates the unfunded liability and misrepresents the level of funding required to meet the liability over time. AASB 119 may be suitable for schemes without funding or with a bond-based asset portfolio, but it does not recognise the impact growth-based asset portfolios can have on earnings and future funding requirements, due to the existence of the equity risk premium.

AASB 119 is also not suited for targeting purposes. If it was used to target full funding by 2030, funding levels would be increased over time, diverting funds from other uses and creating a risk of over-funding. As Figure 18.3.2 shows, AASB 119 would still be reporting a liability of around $5 billion for 2030 even though the scheme is fully funded.

Table 18.3.1 shows the current general government sector State Super funding plan. The actuarial model incorporates forecast earning rates, employee contributions, benefit payments and other cash flows, plus employer contributions to target asset values over time.

As earning rates fluctuate and other cash flows are relatively fixed, employer contributions are used to target asset levels to equal the level of gross liabilities in 2030. The current small deficit for 2030 is primarily due to the lower than expected investment returns since the plan was last revised.

Table 18.4.1 State Super general government – forecast scheme cash flows and funding targets February 2011 ($000)

Year end 30 Jun	% invest return (all assets)	Assets start balance	Total employer contribution	Employee contribution	Benefit payment	Other	Earnings	Assets closing balance	Liability, year end	Unfunded liability, year end
2011	14.10	23,979	1,394	370	-3,165	-55	3,286	25,809	40,652	14,843
2012	8.60	25,809	1,456	344	-3,372	-162	2,146	26,222	41,466	15,244
2013	8.60	26,222	1,522	313	-3,562	-179	2,174	26,489	42,065	15,576
2014	8.60	26,489	1,591	278	-3,699	-197	2,192	26,654	42,484	15,830
2015	8.60	26,654	1,664	245	-3,840	-216	2,201	26,707	42,708	16,001
2016	8.60	26,707	1,740	214	-3,971	-236	2,201	26,655	42,733	16,078
2017	8.60	26,655	1,821	187	-4,094	-256	2,192	26,504	42,558	16,054
2018	8.60	26,504	1,906	161	-4,194	-276	2,177	26,276	42,194	15,916
2019	8.60	26,278	1,995	136	-4,266	-297	2,156	26,002	41,661	15,659
2020	8.60	26,002	2,090	115	-4,314	-317	2,133	25,708	40,982	15,274
2021	8.60	25,708	2,190	97	-4,363	-338	2,108	25,401	40,151	14,749
2022	8.60	25,401	2,295	81	-4,373	-359	2,084	25,129	39,198	14,069
2023	8.60	25,129	2,406	68	-4,381	-380	2,063	24,905	38,123	13,218
2024	8.60	24,905	2,523	56	-4,325	-400	2,050	24,809	36,988	12,178
2025	8.60	24,809	2,646	47	-4,301	-422	2,047	24,826	35,758	10,932
2026	8.60	24,826	2,776	40	-4,239	-443	2,055	25,014	34,470	9,456
2027	8.60	25,014	2,912	33	-4,188	-465	2,078	25,385	33,110	7,726
2028	8.60	25,385	3,055	27	-4,120	-488	2,118	25,977	31,691	5,714
2029	8.60	25,977	3,206	22	-4,043	-511	2,177	26,829	30,221	3,392
2030	8.60	26,829	3,365	18	-3,883	-534	2,263	28,057	28,782	725

This table covers State Super funding arrangements in the general government sector and does not include the Energy Industries Superannuation Scheme, the Parliamentary Contributory Superannuation Fund or the Judges Pension Scheme. Funding arrangements for PTEs and SOCs are set on a case-by-case basis and are generally intended to fully fund accruing liabilities and to fund any shortfall in past liabilities over an agreed period.

Funding levels have been significantly increased in the aftermath of the global financial crisis. In 2009-10, $510 million from the sale of NSW Lotteries was contributed to State Super. The Crown provides most of the employer funds in the general government sector for 2011 general government sector funding was increased from $1.2 million to $1.4 billion, indexed by 5 per cent per annum in subsequent years to 2030.

The International Accounting Standard Board has adopted a revised AASB 119 accounting standard which changes the methodology for calculating net superannuation expense. Previously interest expense was calculated as gross liability times the bond rate and the expected return in assets was calculated as gross assets times its foreseeable investment return. Under the revised approach interest expense is calculated as a net measure, net of return on investment assets and calculated on the basis of a bond rate. This has a negative financial impact of about $800 million per annum.

Other matters

Chapter 4 addressed a range of other balance sheet issues in relation to WorkCover, Reliance Rail, university superannuation funding, the proposed carbon tax and public housing assets, which are taken up in the recommendations.

18.5 Recommendations

The Financial Audit recommends:	
Sale or lease or restructure of businesses	
18.1	All proceeds from the sale or lease of income generating businesses be used in a financially sustainable manner either by retirement of debt, funding net superannuation liability or investing in financial assets, with only any excess above retention value and income generated used as a funding source.
18.2	Having regard to the findings of the Judicial Review into the Electricity Transactions, proceed with the long-term lease or sale of the generator businesses, including those subject to GenTrader agreements and the sale or long term lease of the network businesses rather than the merger of the distributors.
18.3	The State prepare a broad development plan for the Cobbora coal mine, allowing appropriate commercial flexibility while defining the requirements of the GenTraders as core customers, then seek proposals from the private sector for the divestment of the mine site and its development and operation.
18.4	Enter into discussions with the two other shareholding governments, the Commonwealth and Victoria, with a view to obtaining agreement to the sale of Snowy Hydro.
18.5	IPART establish a suitable price path and undertake a review of the regulatory instruments for Sydney's bulk water supply market and, following that, undertake a long term lease or sale of Sydney Desalination Plant Pty Ltd.
18.6	Investigate transferring Sydney Catchment Authority, a bulk water supplier to Sydney Water Corporation, into Sydney Water Corporation, subject to retaining full transparency in respect to the costs of each component of the business.
18.7	Separate the Forests NSW plantation business from the Department of Primary Industries, then corporatise and execute a long term lease of the business.
18.8	Establish a light-handed regulatory regime for NSW Ports, including greater pricing autonomy, consultation with users on proposed pricing changes and provision for regulator intervention if there is evidence of port businesses misusing market power.
18.9	The role and strategic direction of each port be established within an overall state ports strategy.
18.10	Seabed and channels be vested in the port corporations or provided for under a long-term lease and the current channel charge payable to NSW Maritime be removed.
18.11	Subject to achieving recommendations 18.7, 18.8 and 18.9, long-term leases be established for each of the ports, with the private sector assuming the lessee role.
Property management	
18.12	All new office accommodation over 1,000m^2 achieve a maximum space utilisation of 14m^2/person unless the agency can demonstrate a clear service delivery requirement for higher space utilisation, to be approved by the Government Asset Management Committee.
18.13	State Property Authority publish an annual table of agency space utilisation performance.
18.14	Where an agency determines that it must exceed the 14m^2/person target for operational reasons, a business case be submitted to the Government Asset Management Committee for approval.
18.15	All car parks, depots, warehouses and motor registries be assessed to determine the benefits of vesting these assets to the State Property Authority (SPA).

The Financial Audit recommends:	
18.16	The State Property Authority, in consultation with the NSW Police Force, develop a business case to determine the costs, benefits and any other implications (particularly maintenance costs) for the vesting of the entire Police property portfolio (including operational property) and make recommendations to the Expenditure Review Committee.
18.17	The current review of the *State Property Authority Act 2006* includes review of any parts of the Act that may impede vesting of operational property to SPA (particularly in relation to Crown Land).
18.18	An assessment be undertaken of the rationale of the in house property management function within SPA relative to the full property management function being outsourced to the private sector.
18.19	SPA review selected major SPA owned assets to identify opportunities for the disposal of more property.
18.20	Establishment of a task force to identify potential relocation opportunities and develop business cases for consideration by Government. The task force should include membership from the Department of Premier and Cabinet, NSW Treasury, Department of Finance and Services and the Department of Planning.
Infrastructure Fund	
18.21	A full review be undertaken of the option of establishing the NSW Infrastructure Fund, under the management of Treasury Corporation, with the transfer of suitable infrastructure assets to the fund as a means of funding net superannuation liabilities and new income generating infrastructure assets.
Funds management	
18.22	A Treasurer's direction be issued under Section 9 of the *Public Finance and Audit Act 1987* requiring all general government agencies to undertake new investments through Treasury Corporation.
18.23	The Judges Pension Scheme, the Parliamentary Contributory Superannuation Scheme and the defined benefit component of the Energy Industries Superannuation Scheme (EISS) be consolidated into the State Superannuation Scheme, with the accumulation component of EISS transferred to First State Super.
18.24	Undertake a review involving the Compensation Authorities, Treasury and NSW Treasury Corporation to seek to establish a central, professional investment function.
18.25	In the event that there is a desire to have greater strategic input to the risk-return trade-off decision in respect to State Super investments, consider the option of transferring the investment function of the State Superannuation Trustee Corporation to NSW Treasury Corporation, with an external, independent Investment Committee established to oversee the investment function. This function would be subject to a statement of risk-return objectives established by the Treasurer.
Liability Management	
18.26	Confirm the Government's commitment to achieve full funding of superannuation liabilities by 2030.
18.27	Representation be made at the highest level to the Australian and International Accounting Standards Boards to have accounting standard AASB119 reflect the underlying financial position with respect to unfunded superannuation liabilities.
18.28	Noting that the liability for the Work Cover scheme is correctly recognised in the Total State Sector Financial Statement.

The Financial Audit recommends:	
18.29	Noting that the liability for superannuation in the Total State Sector Financial Statements reflects the unfunded liability in respect to employment service to the present time but does not reflect future service liability.
18.30	Noting that the Total State Sector Financial Statements will need to record a contingent liability arising from the electricity sale transaction in regard to Availability Liquidated Damages which is estimated at $360 million in present value terms.
18.31	Noting that the State is under no obligation to guarantee or support the financial position of Reliance Rail, the counter party in the Waratah Rail contract, but prudence would support developing contingency plans that have regard to the risk of insolvency of the credit wrappers or the failure of Reliance Rail to draw down the next tranche of debt, which is due in February 2012.
18.32	Noting that there is an unfunded liability in respect to NSW-based universities' superannuation liabilities, which is substantially a Commonwealth liability but has not been formally recognised as such by the Commonwealth. The State, as a matter of urgency, should seek to have the Commonwealth agree to an independent actuarial review of the university superannuation liability as a matter of urgency in order to resolve the distribution of liabilities between the Commonwealth and NSW.
Other balance sheet matters	
18.33	Noting the substantial negative impact of the proposed carbon tax on the value of the state owned generators and seek agreement with the Commonwealth on suitable compensation.
18.34	A full strategic and financial evaluation be undertaken of the proposal to transfer the major part of public housing assets to community housing trusts

19 IMPROVED STATE OWNED CORPORATION GOVERNANCE AND PERFORMANCE

Key points

- Improvements to governance arrangements for SOCs, such as a reformed board appointment process that has full regard to the necessary mix of relevant skills and experience, and updating corporate governance provisions in legislation, will also improve the ability of boards to meet the Government's expectations of business performance.
- Boards have indicated a wish for greater strategic engagement with their shareholders. This will be implemented and include the introduction of an annual general meeting with shareholders, attended by the chair and chief executive.
- There is a need for clearer, commercially based performance measures for each of the SOCs, including an equity hurdle rate.

The State owned corporation (SOC) policy and governance framework has been put in place progressively since the 1988 Commission of Audit report. The framework is fundamentally sound in concept and has led to significantly improved transparency and performance. However, there has been some deterioration in certain aspects of the legislative framework. The principal area of concern is in the use of enabling or portfolio legislation to take over and change various aspects of the governance framework set out in the *State Owned Corporations Act 1989* (the SOC Act) so that the governance provisions now differ between the water, energy, ports and other sectors and are inconsistent with best practice. Set out below are various areas where improvements are proposed in both the governance framework and the way it is applied.

Financial performance, while improving over time, is still not fully in line with best practice benchmarks and there are proposals to establish clear financial performance requirements.

19.1 Strengthened shareholder engagement

In recent years, there has been little shareholder engagement with SOCs and their boards. This has resulted in a lack of strategic direction from shareholders to SOC boards and an impression that the shareholder does not see its role as a priority. This has in turn created a vacuum which, to varying degrees, has been filled by the portfolio ministers taking on a broader role, usually at the cost of poorer financial performance.

Regardless of the quality of the legislation and the policy framework, if shareholding ministers are not actively involved, the SOC model will not deliver to its potential.

The proposed improvements for shareholder involvement are as follows:

- the Treasurer to continue to undertake the role of the shareholder minister for all SOCs, with the Minister for Finance and Services to be the second shareholder minister; if there is a conflict between portfolio and shareholder responsibilities for either minister, another shareholder minister to be appointed
- an annual meeting between the shareholders and the chair and CEO of each SOC to be held to review the past year's performance, agree on major initiatives and strategic directions and approve the annual Statement of Corporate Intent
- Treasury to continue to hold tri-annual meetings with the chair and CEO of each SOC to review business performance and address any relevant commercial issue requiring shareholder input
- Treasury to provide commercial policy and business analysis to both shareholders, including quarterly reports on business performance
- Treasury to attend SOC board meetings annually to provide an overview of the Budget and update boards on commercial policy developments, as well as to receive an update on business strategy.

19.2 Board appointments

The 2010 Review of SOC Boards identified opportunities to improve board performance. Based on interviews with each SOC chair, an emerging theme was that most chairs would like to amend board composition and address gaps in specific skills and experience.

These comments were supported by the review findings, which while assessing overall good performance and governance by the Boards, identified that some boards were compromised by conflicts of interest, inexperience, a poor understanding of the director and Board role, insufficient time or a poor match of experience to positions.

Improved governance provisions will require a common approach for SOC boards to engage in the important management decisions of selecting board members and the CEO.

It is noted that different provisions apply to different groups of SOCs as the enabling legislation has taken on various governance functions, overriding the SOC Act which was intended as the overarching governance legislation. This issue is addressed below.

Consistent with best practice, the Government has adopted a revised approach to be followed on board appointments. The fundamental principles are:

- applying a merit principle by selecting the person who best meets the requirements of the position both at present and in terms of the strategic direction of the SOC and who can most effectively work with the board
- meeting the skills and experience requirements of each board
- involving the relevant chair in decision-making on board selection.

This approach applies in jurisdictions such as New Zealand, the UK and Tasmania and is consistent with private sector practice.

Treasury, as the shareholder support unit and adviser, has already started working more closely with SOC chairs to identify skills requirements and potential director candidates, and this has been supported by chairs as a substantial improvement. The new approach is as follows:

- All SOC boards are required to establish a nominations committee to regularly assess required board skills and experience, having regard to their medium-term strategic direction, to assess these against current skills and experience and to identify any gaps. In addition, the committee will identify potential director candidates with the necessary skills and experience.
- Treasury will upgrade its database of all existing directors with information on their skills and experience and establish a database of suitable candidate directors. The shareholding ministers can submit information on persons for inclusion in the database.
- All SOC boards are required to undertake, no less frequently than every two years, a full performance review of the board and each director.
- As a general guideline, directors and chairs should serve no more than two to three terms on a SOC to ensure boards and board members remain independent on a board, but can be considered for an extension in exceptional circumstances and can be considered for appointment to another SOC.
- Where a director or chair reaches the end of a term, that director or chair is to be reappointed for a suitable term, provided the person has been assessed as performing to a suitable standard, possesses the necessary skills and experience, has not served an excessive term and is willing and available to serve for the additional term.
- Directors who have performed well may be considered for appointment to other SOC boards where they have the appropriate skills, experience and availability.
- In the case of a board vacancy, a selection panel is to be convened, chaired by Department of Premier and Cabinet with Treasury as the representative of the shareholding ministers, the chair of the board and an independent person selected on the basis of board experience. The panel will draw upon the names provided by the nominations committee, the Treasury database and any names provided by the shareholding ministers. The panel will interview shortlisted candidates and make a recommendation to the shareholding ministers. In the event that the shareholding ministers do not support the recommendation, they can request that the panel provides a further nominee or nominees.
- If the vacancy involves the chair of a SOC board, the independent member must be a person with private sector or SOC chair experience and the Chair is not a member of the panel.

- In the event that Unions NSW and staff directors continue to be provided with a position on SOC boards, the Unions NSW or staff director candidates will be required to meet the skills and experience needs identified by the board.

In the case of staff elected directors, there is a dual role as an employee accountable to the CEO and as a board member where the person monitors and assesses the performance of the CEO and the organisation. There is also a perceived and at times real conflict between the duties of the staff elected director to the corporation and the expectation of staff that the staff director will represent the interests of staff. These are inherent and unresolvable conflicts.

In the case of Unions NSW nominated directors, the above direct conflict is not present. However, the director is nominated by Unions NSW and inevitably the SOC will be in a situation of negotiation with an affiliated union at some point in time. Further the Board oversights Industrial Relations policy and workplace management issues that can result in a direct conflict with Unions NSW policy and approach.

19.3 Legislative framework

Application of the Corporations Act to SOCs

The SOC Act needs to be updated to maintain its relevance and effectiveness for SOCs. In addition to improving clarity of objectives and removing overlaps with enabling legislation (see below), it is desirable that the *Corporations Act 2001* (Cth) applies to SOCs on a comparable basis to their private sector counterparts, with modifications relevant to their ownership by government.

One option is to reform the SOC Act to reflect updated provisions of the Corporations Act. While the SOC Act is based in some respects on corporations legislation, it should reflect amendments to the law, including in the areas of public disclosure, directors' accountabilities to the corporation and shareholders and directors' and officers' duties, including trading while insolvent. This continues the current NSW model of Statutory SOCs which the previous Government introduced in place of company SOCs in 1995. This option requires ongoing amendments to the SOC Act as changes to the Corporations Act are made and would be cumbersome to administer.

Another option to achieve consistency with the Corporations Act is for that Act to apply directly to SOCs by reason of those SOCs becoming companies regulated under the Corporations Act. This is most easily done by using the Company SOC provisions of the SOC Act. This applies in Queensland and is underway in Tasmania.

In Queensland, a review of the governance arrangements under the *Government Owned Companies Act 1993* (the GOC Act) was undertaken in 2006. The review identified that the most effective way to overcome the problem of different and out-of-date regulatory standards being applied to statutory GOCs was to abolish the concept of statutory GOCs and convert over time all existing statutory GOCs to company GOCs, incorporated under the Corporations Act. This allowed for the regulatory regimes of both entities to be aligned as originally intended. By applying the Australian Securities and Investments Commission as regulator, this removed a possible conflict of interest of the voting shareholders who would also have to take action against directors if they breached directors' duties. The GOC Act was amended to this effect in 2007 and from 2007, Queensland's GOCs were progressively incorporated as Company GOCs.

Queensland's GOC Act is similar to the company SOC provisions in NSW. It has a reserve power of direction by shareholders and shareholders may alter the constitution of the company. The Queensland approach deals with a potential conflict that was identified in NSW under the company SOC model. In NSW, the concern was that a direction with non-commercial implications may require directors not to act in the best interest of the corporation, which would be a breach of their duties. In Queensland, the tension between directors' duties under the Corporations Act and the need for the board to abide by shareholder directions is dealt with by a commercially transparent process for shareholding ministers to issue directions. These include:

§ A requirement for shareholding ministers to consult with a GOC board before giving a direction and for boards to advise whether the direction would not be in the commercial interest of the GOC.

§ Provisions allowing a board to notify the shareholders and the Auditor-General that a direction is likely to cause insolvency, with shareholders to respond by advising that they do not consider the board's opinion valid (and the direction remains in force) or they do consider it valid (and the direction is suspended). The direction is suspended from the time of initial notice by the board while the issue is being considered.

§ Other shareholder directions that are not considered to cause insolvency, but are non-commercial and not in accord with competitive neutrality are treated as community service obligations (CSOs). Provision exists for compensation to the GOC from the State Budget and the costs of meeting these obligations are to be disclosed in the Statement of Corporate Intent, whether reimbursed or not. This again ameliorates the possible conflict for directors who are asked to implement non-commercial policies.

In practice, there have been very few directions to GOCs. The Queensland approach should be adopted in NSW, with the addition that SOCs should disclose in their annual reports the cost of non-commercial directions for which they do not receive compensation.

There should also be a more commercially transparent process by which the Government requests SOCs to take into account policies that apply to the general government sector, for example regarding remuneration or local purchasing, while allowing SOCs to operate commercially based on conditions in their industry. To apply the principles of general government sector policies to SOCs, the Government could request the SOC board to observe the policy and to consult with the shareholders if it sees a commercial need to depart from that. This allows the Government to address the community's expectations regarding these general policies, while having regard to the different market circumstances in which SOCs operate compared with the general government sector.

Along with this greater focus on commercial performance and board and CEO accountability, the approach to remuneration should be reviewed. CEO remuneration should be more closely linked to performance and there should be a review of appropriate quantum of board remuneration based on businesses of comparable risk and complexity.

SOC Act amendments – clarifying and removing conflicting objectives

The 2010 Review of SOC Boards identified inconsistencies and conflicting objectives between enabling legislation and the SOC Act. This creates complexity and potentially has adverse implications for businesses and board performance.

The *New Zealand State Owned Enterprises Act 1986* sets SOCs a primary overarching objective with sub-objectives that are to be achieved at standards similar to comparable entities. Based on the New Zealand model, the SOC Act should be amended to make its primary objective shareholder returns and performance to generally applicable corporate standards.

Under the SOC Act, the default position is that the portfolio minister administers the foundation charter (which is the SOC's enabling legislation). The Premier can also nominate a different minister to be the portfolio minister for the purposes of the SOC Act. Where the enabling legislation has additional principal objectives, these are of equal importance to SOC Act objectives.

SOC boards and management must balance these competing objectives in common with other organisations. However, a more coherent set of principal objectives would encourage each board to set SOC-specific objectives, an aspect of good corporate governance noted by the SOC board review.

Under either a company or statutory SOC model, the SOC Act should be amended to give SOCs a concise and general statement of objectives. This would confirm the Government's expectations and priorities for SOCs. The SOC Act currently provides for the following equally important but conflicting objectives:

- to be a successful business and, to this end:
  - to operate at least as efficiently as any comparable businesses
  - to maximise the net worth of the State's investment in the SOC
- to exhibit a sense of social responsibility
- to conduct its operations in compliance with the principles of ecologically sustainable development
- to exhibit a sense of responsibility towards regional development and decentralisation.

The Review of SOC Boards noted that the SOC Act statutory objective to 'exhibit a sense of responsibility towards regional development and decentralisation' is very specific and goes beyond normal good practice for corporate citizenship. This objective should be removed from the SOC Act and enabling legislation so that the objectives more closely match those of private sector organisations.

Based on the New Zealand model, the SOC Act should be amended to make its primary objective shareholder returns and performance to generally applicable corporate standards and in conformance with licensing conditions, if applicable. The primary objective of SOCs should be to be 'a successful business', defined as:

- being as profitable as a comparable business not owned by the Crown
- being a good employer to generally accepted standards
- having a sense of social responsibility and endeavouring to accommodate the interests of the community in which it operates.

Provisions in enabling legislation that allow for SOCs to be given non-commercial objectives should be removed, in particular those relating to the ports corporations and Landcom. These objectives can be agreed under the provisions for directions by shareholder ministers, which allow for government policies to be included in SOC objectives on a commercially transparent basis.

Consistent and appropriate governance legislation applying to SOCs

Under the proposal to apply the Corporations Act to SOCs, the SOC Act should be the sole vehicle for governance and shareholder provisions specific to SOCs as NSW Government-owned companies. Other legislation should be amended to centralise governance provisions in the SOC Act and remove conflicting provisions in enabling legislation. Matters to be addressed include:

- Different requirements in the SOC Act and enabling legislation of SOCs for board size, director and CEO appointment processes.

  The key requirements should be that the shareholding ministers select the boards through an appropriate merit-based process which provides for board input and that the board selects the CEO and in that process consults with the shareholding ministers but not the portfolio minister.

- Requirements for union/staff director roles in the SOC Act and in the enabling legislation of relevant SOCs.

  The appointment of union-nominated directors or staff-elected directors creates a major conflict of interest situation for those persons. In the case of staff elected directors, there is a dual role as an employee accountable to the CEO and as a board member the person monitors and assesses the performance of the CEO and the organisation. These are inherent and unresolvable conflicts. In the case of Unions NSW nominated directors, the above direct conflict is not present. However, the director is nominated by Unions NSW and inevitably the SOC will be in a situation of negotiation with an affiliated union at some point in time. Further the Board oversights Industrial Relations policy and workplace management issues that can result in a direct conflict with Unions NSW policy and approach.

- Consistent provisions for removal of directors.
- Changes in the enabling legislation to remove any matters concerning the shareholder role. For example, powers of direction under section 10A of the *Ports and Maritime Administration Act 1995* may not be consistent with a commercial approach to pricing by the ports.

Implementing a consistent process for directions to SOCs

The process for issuing directions to SOCs to undertake non-commercial activities is an important safeguard against incursion into the businesses' commercial objectives. It requires the measures to be explicitly considered and costed and allows for transparency of this cost in the context of the State Budget.

Where unfunded policy activities are imposed on SOCs, they are currently not considered explicitly in the budget process and implicitly reduce funding for other budget-funded activities through lower dividends and tax payments. They also distort the reported commercial performance of individual businesses and divert management attention. These departures from the model of autonomous management within a shareholder framework have reduced the performance of SOCs and hence their economic and fiscal contributions.

Currently there are different legislated processes for portfolio ministers to issue directions to SOCs. For example, Sections 10 and 11 of the *Landcom Corporations Act* provides for the portfolio minister to set priorities for the SOC board before consulting with the shareholders. Similar arrangements also apply in the ports sector. A consistent and transparent approach to the issuing of directions is needed in the SOC Act, including the full involvement of shareholders and a publicly available Register of Directions. The process should reflect the Queensland approach for SOCs to transparently consider if a direction is non-commercial.

SOCs compliance with COAG requirements

In February 2006, the Council of Australian Governments (COAG) agreed to a *Competition and Infrastructure Reform Agreement (CIRA)*. The CIRA included, amongst other things, a commitment to "enhance the application of competitive neutrality principles to government business enterprises engaged in significant business activities in competition with the private sector."

In April 2007, COAG also recommitted to an amended *Competition Principles Agreement,* which was originally agreed to by COAG in 1995 under the auspices of National Competition Policy.

Heads of Treasuries developed an annual reporting mechanism for COAG regarding the enhanced application of competitive neutrality principles to government business enterprises. In 2010, the COAG Reform Council[1] (CRC) reviewed each jurisdictions' self-assessment of compliance against the principles. All New South Wales SOCs are largely compliant with the principles. The Productivity Commission will be undertaking a review of the *Competition and Infrastructure Reform Agreement* in 2012.

[1] ***National Partnership Agreement to Deliver a Seamless National Economy: Performance Report for 2009-10*, Report to the Council of Australian Governments, 23 December 2010, COAG Reform Council**

Competition neutrality principles

The *Competition and Infrastructure Reform Agreement* commits all Australian governments to the following competition neutrality principles:

Objectives

a. That the enterprise has clear commercial objectives.

b. That any non commercial objectives or obligations established for the enterprise are clearly specified and publicly reported.

c. That enterprises do not exercise regulatory or planning approval functions in circumstances in which they compete with private sector enterprises.

Governance

d. That the responsibilities of the governing board of the enterprise and the performance measures against which the board will be held accountable are published.

e. That the governing board is appointed on the basis of particular skills needed by the board.

f. That having received strategic guidance from the government about the achievement of its objectives, the enterprise has operational autonomy in the day to day management of its affairs.

g. That the dividend policy applicable to the enterprise should be clearly and publicly specified.

h. That any payments to the government as shareholder or for the purposes of competitive neutrality, such as taxes, tax equivalent payments, special dividends, capital repayments, are identified in a transparent manner.

Reporting

i. That at least annually the enterprise will report publicly on its commercial performance and on its performance of any non commercial activities.

j. That any directions given to the enterprise by the government are published.

k. That where the legislation establishing an enterprise derogates from competitive neutrality the derogation has been published.

Source: COAG National Reform Agenda, Competition and Infrastructure Reform Agreement, page 26, April 2007.

19.4 Financial performance

Chapter 9 provided information on the financial performance of SOCs, which indicated that there was room for improvement. There needs to be a more robust and commercial conversation between the shareholder and the SOCs; a conversation that is founded on the same approach that applies in the private sector.

The critical requirement is to establish an explicit price for equity. At present, SOCs regard equity as free and seek to maximise it relative to debt. What is needed is an equity hurdle rate that applies to each SOC reflecting its risk characteristics. In addition, a financial model should be established for each SOC, which enables a valuation to be undertaken of the SOC on a regular basis and to track movements in value over time.

Finally, it is proposed that an annual report is prepared by Treasury, as the shareholder adviser, which assesses the performance of each SOC on key performance metrics. This report should be published.

19.5 Recommendations

The Financial Audit recommends:	
Governance	
19.1	An annual meeting between the shareholders and the chair and CEO of each SOC be held to review past year performance, discuss and agree on major initiatives and strategic directions for businesses and approve the Statement of Corporate Intent.
19.2	Establishment of a revised board appointment process which is merit-based, transparent, addresses the specific skills and experience requirements of each board and allows for board input through the chair.
19.3	All SOCs be subject to the *Corporations Act* through the operation of the Company SOC provisions of the *SOC Act*.
19.4	Centralisation of governance provisions for SOCs in the *SOC Act* and removal from enabling legislation (including objectives of SOCs, provisions for issuing directions, the size and composition of boards and roles and responsibilities of shareholder and portfolio ministers), updating the *SOC Act* to reflect best practice.
19.5	Establish a transparent process for requiring SOCs to take into account state policies. This approach should reflect the Queensland approach that seeks the advice of the SOC on the commercial implications of requirements before the approval of the shareholding minister is sought to its imposition.
19.6	A Register of Directions be maintained by Treasury in addition to publication in the Government Gazette as provided in Section 20P(5) of the *SOC Act*.
19.7	Businesses be compensated for non-commercial activities that they are directed to undertake, subject to funding approval through the annual budget process.
19.8	The costs to SOCs of meeting all non-commercial directions be disclosed in annual reports and Treasury's financial performance evaluation is adjusted in line with the costs of these activities.
19.9	The approach to CEO and board remuneration be reviewed with CEO remuneration more closely linked to performance and the appropriate quantum of board remuneration based on businesses of comparable risk, complexity, scale and profitability.
SOC performance	
19.10	An equity hurdle rate be established and maintained for each SOC, reflecting its risk characteristics.
19.11	Treasury implement a consistent approach to analysing SOC performance and shareholder returns, with a standardised template applied to all SOCs/PTEs.
19.12	Return on invested capital be used as the primary performance evaluation measure for commercial PTEs including SOCs.
19.13	For regulated SOCs, capital expenditure and operating expenditure forecasts be explicitly compared with those allowed by the regulator.
19.14	SOCs/PTEs be required to provide scenario analysis as part of their Corporate Plan and Statement of Corporate Intent/Statement of Business Intent forecasts.
19.15	Annual indicative valuations of the equity in each SOC/PTE be prepared based on 10-year forecasts and provided in Statement of Corporate Intent (SCI) documentation. These forecasts should initially be prepared by Treasury then later by SOCs/PTEs.
19.16	Performance information be published in an Annual Portfolio Report of SOCs, prepared by Treasury, so as to strengthen accountability and incentives. This could include key performance metrics relevant to other stakeholders to indicate factors influencing pricing, service standards and financial returns to government.

The Financial Audit recommends:	
Compliance with COAG Requirements	
19.17	The NSW Government should undertake a review to ensure all SOCs fully comply with the *Competition and Infrastructure Reform Agreement* and *Competition Principles Agreement.*

ABBREVIATIONS

AAA	Advancing Australian Agriculture
AAS	Australian Auditing Standards
AASB	Australian Accounting Standards Board
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACHS	Australian Council on Healthcare Standards
ADHC	Ageing, Disability and Home Care
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AG	Attorney-General
AHURI	Australian Housing and Urban Research Institute
AIHW	Australian Institute of Health and Welfare
ALDs	availability liquidated damages
AMF	Auburn Maintenance Facility
APSC	Australian Public Service Commission
ARC	Audit and Risk Committee
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
BBA	budget balancing assistance
BCC	Budget Committee of Cabinet
BI	Business Intelligence
BOCSAR	Bureau of Crime Statistics and Research
BRO	Better Regulation Office
BRS	Better Regulation Statement

BS&V	Better Services and Value
BSGP	Business Sector Growth Plan
BSVP	Better Services and Value Plan
BSVT	Better Services and Value Taskforce
CAEs	Colleges of Advanced Education
CAGR	compound average growth rate
CBD	central business district
CGC	Commonwealth Grants Commission
CHP	Community Housing Provider
CLD	Crown Lands Division
COAG	Council of Australian Governments
CPI	consumer price index
CPL	capital planning limit
CPMO	central program management office
CPRS	Carbon Pollution Reduction Scheme
CREDIT	Court Referral of Eligible Defendants into Treatment
CSI	Centre for Social Impact
CSO	community service obligation
CSS	Corporate and Shared Services
D&D	Death and Disability
DEEWR	Department of Education, Employment and Workplace Relations
DET	Department of Education and Training
DFS	Department of Finance and Services
DHS	Department of Human Services
DII	Department of Industry and Investment

DoT	Department of Transport
DP&I	Department of Planning and Infrastructure
DPC	Department of Premier and Cabinet
DRGs	diagnosis-related groups
DSTA	Department of Services, Technology and Administration
EBA	enterprise bargaining agreement
EBITDA	earnings before interest, tax, depreciation and amortisation
EC	exceptional circumstances
EDS	Economic Development Strategy
EFT	electronic funds transfer
EOIs	expressions of interest
ERC	Expenditure Review Committee
ERM	enterprise risk management
ERP	enterprise resource planning
FaCS	Family and Community Services
FDASD	fetal drug and alcohol spectrum disorder
FEA	Forest Enterprises Australia
FHOG	First Home Owner Grant
FIS	financial information systems
FIS	Financial Impact Statement
FiT	feed-in tariff
Fitch	Fitch Ratings Ltd.
FRA	*Fiscal Responsibility Act 2005*
FTE	full-time equivalent
GAMC	Government Asset Management Committee

GDP	gross domestic product
GFC	global financial crisis
GFS	Government Finance Statistics
GGAS	Greenhouse Gas Abatement Scheme
GGDEA	*General Government Debt Elimination Act 1995*
GGLMF	General Government Liability Management Fund
GGS	general government sector
GMA	guaranteed minimum amount
GMR	Greater Metropolitan Region (of Sydney)
GOC	government owned corporation
GPG	General Purpose Grant
GSP	gross state product
GST	goods and services tax
GTA	GenTrader agreements
GTE	Government Trading Enterprise
HAT	highly accomplished teacher
HEIT	Health Efficiency Improvement Taskforce
HFE	horizontal fiscal equalisation
HOTS	Heads of Treasuries
ICA	Insurance Council of Australia
ICAC	Independent Commission Against Corruption
ICT	information and communication technology
ICU	intensive care unit
IEO	Independent Evaluation Office
IGA	intergovernmental agreement

IHPA	Independent Hospital Pricing Authority
INSW	Infrastructure NSW
IP	implementation plan
IPART	Independent Pricing and Regulatory Tribunal
IRC	Industrial Relations Commission
ITTA	*Income Tax Assessment Act 1997*
KPI	key performance indicator
LEP	local environmental planning
LGA	Local Government Area
LHD	Local Health District
LHN	Local Health Network
LPI	land and property information
LPMA	Land and Property Management Authority
LSL	long service leave
LTFPM	Long Term Fiscal Pressures Model
MCFFR	Ministerial Council for Federal Financial Relations
MCPRS	Major Capital Projects Reporting System
MEE	Managing Excess Employees
MERIT	Magistrates Early Referral into Treatment
MoE	maintenance of effort
Moody's	Moody's Investors Service
MRRT	Minerals Resource Rent Tax
MRU	Microeconomic Reform Unit
MTFM	Medium Term Fiscal Model
MTP	Metropolitan Transport Plan

NA	National Agreement
NBF	Nation Building Fund
NCP	National Competition Policy
NFL	net financial liabilities
NFPS	Non-Financial Public Sector
NGO	non-government organisation
NHS	National Health Service
NOW	NSW Office of Water
NP	National Partnership
NPP	National Partnership payment
NSWIC	NSW Infrastructure Corporation
NTER	National Tax Equivalent Regime
OECD	Organisation for Economic Co-operation and Development
OH&S	occupational health and safety
OOHC	out-of-home care
OSR	Office of State Revenue
OTR	on-time running
P&C	Parents and Citizens' Association
PAC	Public Accounts Committee
Pcards	purchasing cards
PFAA	*Public Finance and Audit Act 1983*
PFC	public financial corporation
PFE	public financial enterprise
PFNC	public non-financial corporation
PFPs	privately financed projects or privately funded partnership

PISA	Program for International Student Assessment
PMO	program management office
PPP	public private partnership
PSA	Public Service Association
PSC	Public Service Commissioner
PTE	public trading enterprise
RAD	Resource Allocation Directorate
RBA	Reserve Bank of Australia
RET	renewable energy target
RIS	Regulatory Impact Statement
RoA	rest of Australia
ROA	return on assets
ROE	return on equity
ROGS	Report on Government Services
ROIC	return on invested capital
RSP	Results and Services Plan
RSPT	Resource Super Profits Tax
RTA	Roads and Traffic Authority
S&P	Standard and Poor’s
SAUs	set availability unit allowances
SBI	Statement of Business Intent
SBS	Solar Bonus Scheme
SCA	Sydney Catchment Authority
SCI	Statement of Corporate Intent
SDRT	Stamp Duty Replacement Tax

SES	Senior Executive Service
SIBs	social impact bonds
SIS	State Infrastructure Strategy
SOC	State owned corporation
SPA	State Property Authority
SPP	Specific Purpose Payment
SSTS	School Student Transport Schemes
ST2	Stronger Together 2
STA	State Transit Authority
TA	Treasurer's Advance
TAFE	Technical and Further Education
TAM	Total Asset Management
TER	tax equivalent regime
TMF	Treasury Managed Fund
TPP	Treasury policy paper
VET	Vocational Education and Training
VFMC	Victorian Funds Management Corporation
WAN	wide area network
WCA	WorkCover Authority
WPI	wage price index

GLOSSARY

Allocative efficiency

An optimal allocation of scarce resources in the economy, such that those resources are directed to end uses that generate the maximum benefit to society. Allocative efficiency pertains to the total economy, where the allocation of resources across the economy results in the production of a combination of goods and services that best accords with the pattern of consumer demands. Should not be confused with 'productive efficiency', where a discrete production unit(s) produces a given level of output of a given good or service at least cost – eg, an 'efficiency dividend' of a government agency typically refers to a 'productive efficiency' context. See also 'market failure' and 'efficiency dividend'.

Appropriation

The funds appropriated by Parliament from the consolidated fund to Ministers for the purposes of funding agency activities (either recurrent or capital).

Budget-dependent agencies

These are general government agencies that receive an appropriation from the Consolidated Fund. This is their predominant funding source (rather than user charges or other revenues).

Budget result

The Budget result represents the difference between expenses and revenues from transactions for the general government sector. This measure is equivalent to the net operating balance adopted in accounting standard AASB 1049 *Whole-of-Government and General Government Sector Financial Reporting*.

Capital expenditure

This is expenditure relating to the acquisition or enhancement of property, plant and equipment (including land and buildings, plant and equipment and infrastructure systems) and intangibles (including computer software and easements).

Cash surplus/(deficit)

Net cash flows from operating activities plus net cash flows from acquisition and disposal of non-financial assets (less distributions paid for the public non-financial corporation [PNFC] and public financial corporation [PFC] sectors).

Commercial Policy Framework

The policy suite that applies a shareholder framework to government businesses and seeks to impose private sector disciplines. Principles include independent boards and management with authority and autonomy, clear commercial objectives, effective performance monitoring and rewards and sanctions to create an incentive to maximise the value of the businesses, and competitive neutrality measures.

Community service obligations

Non-commercial activities that government businesses are directed to undertake by the Government that they would not undertake commercially. These should be costed by the business and reviewed in the State Budget, to rank them against other priorities and for transparency. Funding may be provided from the Budget, and for those that are not reimbursed, Treasury's performance monitoring should be adjusted.

Competitive neutrality

Policies applied to government businesses so that they are not advantaged or disadvantaged relative to their private sector counterparts, due to their ownership by government. Policies include the government guarantee fee and the tax equivalent regime.

Consolidated Fund

The fund is established under s39 of the *Constitution Act 1902*. Public monies collected on behalf of the State form this fund. This includes:

- taxes, fines, fees collected
- Australian Government grants and
- dividends and tax equivalent payments from public trading and public financial enterprises.

Corporate governance

The framework of rules and relationships by which authority is exercised by and controlled in government businesses. For SOCs, the board is charged with governance within the framework set by the State Owned Corporations Act 1989, and for all businesses the Commercial Policy Framework applies.

Cost-benefit analysis

Also referred to as 'benefit-cost analysis' (BCA), pertains to a technique for systematically analysing all the costs and benefits of various options to achieve a given objective. BCA assists in the selection of projects or programs that maximise benefits to the community relative to costs, and helps ensure that decision makers are aware of all likely direct and indirect costs and benefits as well as externalities (to the extent it is possible to quantify these) associated with different options. See also 'Externality'.

Efficiency dividend

The efficiency dividend represents a return to the Budget of gains expected to arise from increased operating efficiency in general government sector agencies.

Externality

The impact of an activity that confers costs (a 'negative externality') or benefits (a 'positive externality') on a third party that are not fully reflected in prices. Externalities can arise during the production or consumption phases of the activity and may be of an environmental, social or financial nature. See also 'Market failure', 'Allocative efficiency', 'Information asymmetry' and 'Cost benefit analysis'.

Financial Impact Statement (FIS)

The Financial Impact Statement accompanies Cabinet Minutes and is intended to demonstrate to Cabinet or a Cabinet Committee the financial impact of the proposal being referred for a decision. The Financial Impact Statement includes on-costs to other agencies, offsetting savings and the manner in which it is proposed to fund the initiative.

Financial Management Framework

The NSW Financial Management Framework comprises of a suite of legislation, policies and procedures aimed at maintaining aggregate fiscal discipline, allocating resources in line with the Government's strategic priorities and using Budget resources efficiently.

Fiscal gap

The fiscal gap is the difference between the base period primary balance as a share of gross state product (GSP) and the primary balance as a share of GSP at the end of the projection period, on a no policy change basis. The primary balance is the gap between spending and revenue excluding interest transactions but including net capital expenditure. A positive gap implies that fiscal pressures will be building over the projection period.

Fiscal Responsibility Act 2005 (NSW)

The Act sets out both medium-term and long-term fiscal targets and principles providing a framework for budgeting in New South Wales.

Forward estimates

The forward estimates are the projected annual position for all revenues and expenditures for each year of a four year planning horizon (ie budget year, plus three out years). Forward estimates are prepared on a no policy change basis, that is, they reflect existing policy.

Full-time equivalent (FTE)

This is the standard measure of staffing in terms of a full-time equivalent number of positions.

Gateway review system

Gateway Reviews are reviews of major procurement projects by independent people at defined decision points (gates) in projects. Gateway is not an audit, a detailed technical review or an inquiry, but a review by experienced 'peers' to provide a 'fresh' view of the project. The NSW Government developed the system to help agencies improve their procurement discipline and to achieve better service results from their procurement activity.

General government sector

This is an ABS classification of agencies that provide public services (such as health, education and police), or perform a regulatory function. General government agencies are funded in the main by taxation (directly or indirectly). Within this sector there are budget dependent and non-budget dependent agencies.

Government Finance Statistics (GFS)

A system of financial reporting developed by the International Monetary Fund and used by the Australian Bureau of Statistics to classify the financial transactions of governments and measure their impact on the rest of the economy.

Gross state product (GSP)

The total market value of final goods and services produced within a state.

Horizontal fiscal equalisation (HFE)

A distribution of GST revenue to State and territory governments such that, after allowing for material factors affecting revenues and expenditures, each jurisdiction should have the fiscal capacity to supply services and associated infrastructure at the same standard, provided each jurisdiction made the same effort to raise revenue from its own sources, operated at the same level of efficiency and maintained the same per capita net financial worth.

Information asymmetry

A situation where one party to a transaction has more or better information than the other(s), creating an imbalance of power that favours the more knowledgeable party in the transaction and resulting in sub-optimal resource allocation. Examples include adverse selection (eg, a more costly or inferior option is selected because the buyer may be unaware of the true cost) or moral hazard (eg, a party to the transaction who is protected from risk behaves differently than if they were exposed to that risk). See also 'Market failure' and 'Allocative efficiency'.

Long term fiscal model

Demographic based model which NSW Treasury has developed to examine the long-run (40 year) impact of ageing of the population on the NSW economy and fiscal position.

Maintenance of effort (MoE)

Maintenance of Effort proposals are proposals to maintain existing Government services in terms of service nature, availability, quantity and quality. It includes proposals to rollover or re-profile existing programs and address extraordinary, unforeseen and uncontrollable circumstances.

Market failure

A situation where allocative efficiency is not attained due to sub-optimal market structures (eg, monopolies) and/or the failure of costs and benefits to be internalised in market prices, thereby sending erroneous signals on which producers and consumers base their decisions. Market failures tend to be associated with information asymmetries, non-competitive markets, externalities or public goods. The claimed existence of a market failure is often used to justify government intervention in that particular market. See also 'Allocative efficiency', 'Externality' and 'Information asymmetry'.

Medium Term Fiscal Model (MTFM)

A NSW Treasury developed model which examines the fiscal position of the state over the next decade. Uses SCI and SBI operating balance and balance sheet information for the PTE sector and for the general government sector uses SIS capital expenditure and assumptions for budget expense and revenue growth.

National Agreement (NA) payments

An Australian Government grant to States and Territories which must be spent in the key service delivery sector (healthcare, schools, skills and workforce development, disability services and affordable housing, and Indigenous reforms) for which it is provided. States are free to allocate the funds within that sector to achieve the mutually agreed objectives specified in the associated National Agreement.

National Partnership payment (NPP)

An Australian Government grant to States and Territories to support the delivery of specified outputs or projects, to facilitate reforms or to reward the delivery of nationally significant reforms. Each NPP is supported by a National Partnership Agreement which defines mutually agreed objectives, outputs and performance benchmarks.

Net cost of services

In agency operating statements this measures the net cost of providing government services. It equals operating expenses less operating revenues, and excludes government contributions.

Net debt

Net debt equals the sum of deposits held, advances received, loans and other borrowings less the sum of cash and deposits, advances paid and investments, loans and placements.

Net financial liabilities (NFL)

This is the total liabilities less financial assets, other than equity in PNFCs and PFCs. It is a more accurate indicator than net debt of a jurisdiction's fiscal position. This is because it is a broader measure than net debt in that it includes significant liabilities other than borrowings (for example, accrued employee liabilities such as superannuation and long service leave entitlements). For the PNFC and PFC sectors, it is equal to negative net financial worth. For the general government sector NFL, excluding the net worth of other sectors results in a purer measure than net financial worth as, in general, the net worth of other sectors of government is backed up by physical assets.

Net lending/(borrowing)

The financing requirement of government, calculated as the net operating balance less the net acquisition of non-financial assets. It also equals transactions in financial assets less transactions in liabilities. A positive result reflects a net lending position and a negative result reflects a net borrowing position.

Net operating balance

This is calculated as revenue from transactions less expenses from transactions.

Net worth

An economic measure of wealth and is equal to total assets less liabilities.

Non-budget dependent general government agencies

These are general government agencies that do not rely on the Consolidated Fund for direct financial support. They predominantly source funds from regulatory and user charges (but may receive budget funding in the form of grants from other general government agencies for certain activities or services).

Non-financial public sector

This is a sub-sector formed by the consolidation of the general government sector and public non-financial corporations (PNFC) sector.

Productivity

A measure of output per unit of input from a production process. In relation to the aggregate economy, measures of productivity may be based on a single input (eg, labour productivity is the ratio of the real value of output to the value of labour input) or all inputs (eg, multifactor productivity or total factor productivity is the ratio of the real value of output to the combined value of labour and capital inputs). Similar measures can also be developed for a discrete production unit, eg, a company or department.

Public financial enterprise (PFE)

An ABS classification of agencies that have one, or more, of the following functions:

- that of a central bank
- the acceptance of demand, time or savings deposits or
- the authority to incur liabilities and acquire financial assets in the market on their own account.

For GFS purposes these are referred to as public financial corporations (PFC).

Privately Financed Projects (PFP)

This involves the creation of an infrastructure asset through private sector financing and private ownership for a concession period (usually long term). The Government may contribute to the project by providing land or capital works, through risk sharing, revenue diversion or purchase of the agreed services.

Public trading enterprise (PTE)

An ABS classification of agencies where user charges represent a significant proportion of revenue and the agency operates with a broadly commercial orientation. For GFS purposes, the ABS refers to these as Public Non-Financial Corporations (PNFC).

Results and Services Plan (RSP)

A service delivery and funding plan prepared by an agency to support decision making by the Cabinet Standing Committee on the Budget. The RSP provides a clear 'line of sight' for performance management by setting out the linkages between State Plan priorities, the results that an agency is working towards, the services it delivers to contribute to those results, and the costs of delivering those services as reflected in the agency's budget.

Royalties

A mineral royalty is the price charged by the Government for the transfer of the right to extract a mineral resource. The prices (royalty rates) for different minerals are prescribed in mining legislation and associated regulations.

Services

These are the 'end products' or direct services that are delivered to clients or recipients, the broader community or another government agency. They are expected to contribute to Government priorities.

Service groups

Services that are grouped together on the basis of the results they contribute to, the client group that they serve, common cost drivers or other service measures. There should be a clear 'line of sight' between the service groups and the services and activities that are costed and managed as part of internal business planning.

Social capital

Social capital focuses on social relations that have productive benefits. It may be thought of as an ability to interact with other members of society and is associated with better functioning communities and higher individual satisfaction with life.

Social rate of return

The social rate of return of a project is the increase in welfare that results from the project, expressed as a proportion of the cost of the project. For a project with wider social benefits, the social rate of return will typically exceed the private rate of return, or financial rate of return, which is the amount of money returned to the project developer expressed as a proportion of project costs.

Stamp Duty Replacement Tax (SDRT)

This is a tax proposed in Chapter 13 to replace stamp duty on transfers of real estate (ie transfer duty). The proposed tax would be based on land values rather than market values of property, and would be payable annually instead of being paid when properties are bought.

Statement of Business Intent (SBI)

For commercial government businesses that are not State Owned Corporations, an agreement with the Government on the objectives and obligations by which they will operate, encompassing 10 years with a focus on the next 12 months

Statement of Corporate Intent (SCI)

For State Owned Corporations, an agreement with the Government on the objectives and obligations by which they will operate, encompassing 10 years with a focus on the next 12 months

State owned corporation (SOC)

Government businesses which have been established with a governance structure mirroring as far as possible that of a publicly listed company. State owned corporations are scheduled under the *State Owned Corporations Act 1989* (Schedule 5).

Structural deficit

A budget deficit that persists even when revenues are at trend levels. It indicates that government spending is too high for the current revenue base.

Surplus/(deficit)

In Budget Paper No.3 *Budget Estimates* this is the agency accounting result which corresponds to profit or loss in private sector reports. It equals the net cost of services adjusted for government contributions. This is not the same as the budget result or the GFS cash surplus/(deficit).

Total Asset Management (TAM)

An agency's TAM plan sets out its asset expenditure priorities and funding projections over a rolling ten year period, to ensure physical asset management plans are aligned with service priorities and performance targets, and are financially sustainable. TAM covers the acquisition, maintenance, operation and disposal of all physical assets, including land, buildings, infrastructure, plant and equipment, and information technology.

Total expenses

The total amount of expenses incurred in the provision of goods and services, regardless of whether a cash payment is made to meet the expense in the same year. It does not include expenditure on the purchase of assets. It also excludes losses, which are classified as other economic flows.

Total revenues

This is the total amount of revenue due by way of taxation, Australian Government grants and from other sources (excluding asset sales) regardless of whether a cash payment is received. It excludes gains, which are classified as other economic flows.

Total state sector

Represents all agencies and corporations owned and controlled by the NSW Government. It comprises the general government, public trading (also referred to as the public non-financial corporations) and public financial enterprises.

Transfer duty

This is one of the various forms of stamp duty. It is a tax that is levied on purchases of real estate, based on the market value of the property transferred.

Treasurer's Advance (TA)

The Advance to the Treasurer is an amount included each year within the recurrent and capital appropriations to the Treasurer to meet ordinary expenses that generally could not have been foreseen at Budget time, e.g. a new policy initiative by the Government post-budget.

Vertical fiscal imbalance

The significant mismatch between the States' and territories' large spending responsibilities but limited revenue raising options and the Australian Government's capacity to raise much more revenue than is required for its own spending needs. VFI produces a need for large financial transfers from the Australian to State and territory governments.

Wage offsets

Wages policy provides funding for wage increases and associated costs at 2.5 per cent per year. Increases in wages and conditions greater than 2.5 per cent must be funded by employee-related cost savings. Employee related cost savings that fund increases in wages or conditions above 2.5 per cent per annum are referred to as wage offsets.

Welfare

Economic welfare refers to the overall well-being of society. Measures of economic welfare take account of the amounts that people pay for goods and services, the additional well-being that they receive over and above the price paid (consumer surplus), and any costs (eg pollution, congestion) or benefits they impose on others.

CHART AND TABLE LIST

BIBLIOGRAPHY

Abelson, Peter. *Economic Review of Urban Planning (Progress Report).* January 2011

Alcohol and other Drugs Council of Australia. *Best Practice in the Diversion of Alcohol and Other Drug Offenders: Proceedings of the ADCA Diversion Forum*. Canberra: 1996.

Applied Economics*. An Economic Assessment of Human and Social Capital Interventions, prepared for NSW Treasury*. Sydney: 2011.

Australian Bureau of Statistics. *Australian Demographic Statistics - 3101.0*. Canberra.

Australian Bureau of Statistics. *Australian National Accounts: State Accounts - 5220.0*. Canberra.

Australian Bureau of Statistics. *Australian System of Government Finance Statistics: Concepts, Sources and Methods, Cat No 5514.0*. Canberra: 2005.

Australian Bureau of Statistics. *CGC Relative Fiscal Capacities of the States - 3222.0*, Canberra: 2008.

Australian Bureau of Statistics. *Consumer Price Index - 6401.0.* Canberra: March 2011.

Australian Bureau of Statistics. *Council Rates Revenue 2008-09 - 5212*. Canberra: 2009.

Australian Bureau of Statistics. *Household and Family Projections (Cat. 3236.0, Table 1.2)*. Canberra: 2010.

Australian Bureau of Statistics. *NSW State and Regional Indicators - 1338.1*. Canberra: December 2010.

Australian Bureau of Statistics. *State and Territory Budgets for 2010-11: 5512.0.* Canberra: 2011.

Australian Bureau of Statistics. *Schools Australia 2009 - 4221.* Canberra: 2009.

Australian Bureau of Statistics. *Wage Price Index*. Canberra: March 2011.

Australian Housing and Urban Research Institute. *The Cost-Effectiveness of Homelessness: A First Assessment, Final Report No.119.* June 2008

Aos, Steve et al. *Benefits and Costs Of Prevention And Early Intervention Programs For Youth.* Olympia, Washington: Washington State Institute for Public Policy, 2004.

Audit Office of NSW. *Auditor-General's Report to Parliament 2010: Volume Nine.* Sydney: 2010.

Audit Office of NSW. *Performance Audit Condition of State Roads, Roads and Traffic Authority of NSW.* Sydney: 2006.

Audit Office of NSW. *Performance Audit of Government Investment in V8 Supercar Races at Sydney Olympic Park.* Sydney: 2010.

Audit Office of NSW. *Report to Parliament 2010, Volume 10 – Focusing on Education and Communities: Department of Education and Training*. Sydney: 2010.

Australian Competition and Consumer Commission. *Inquiry into the Competitiveness of Retail Prices for Standard Groceries.* 2008.

Better Regulation Office. *Annual Update on Regulatory Reform 2009-10*. 2010.

BIS Shrapnel. *Forecasting the Distribution of Dedicated Office Employment within Sydney*. Sydney: February 2011.

BIS Shrapnel. *Sydney Commercial Property 2010–2020 Update, Prime Net Commercial Rents 2010.* Sydney: October 2010.

Bureau of Transport and Regional Economics. *Estimating Urban Traffic and Congestion Cost Trends for Australian Cities - Working Paper 71*. 2007.

Bureau of Transport Statistics. 2010.

Bureau of Transport Statistics. *Customised Data Request on Road Volume and Capacity in Sydney*. Sydney: 2011.

Bureau of Transport Statistics. *NSW Transport Household Travel Survey*. Sydney: 2010.

Butler, Tony and Lucas Milner. *NSW Inmate Health Survey.* Sydney: NSW Department of Corrective Services, 2003.

Centre for International Economics. *The Benefits and Costs of Alternative Growth Paths for Sydney: Economic Social and Environmental Impacts.* Sydney: 2010.

COAG National Reform Agenda. *Competition and Infrastructure Reform Agreement.* Canberra: 2007.

Daley, John and Tristan Edis. *Learning the Hard Way: Australia's Policies to Reduce Emissions*. Melbourne: Grattan Institute, April 2011.

Department of Planning*. Local Development Performance Monitoring: 2009–10*. Sydney: January 2011.

Department of Premier and Cabinet. *NSW Public Sector Workforce: Profile 2000-10 Snapshot tables*. Sydney: 2010.

Department of Premier and Cabinet*. Wages Policy and Workforce Management, Section 5.4.6 - Key Reform Issues for Wages Policy in Brief 5.4*.

Department of Premier and Cabinet. *Whole-of-Government Policy for the Application of User Charges for Major and Special Events*. Sydney: December 2003.

Department of Treasury and Finance, Victoria. *In Pursuit of Additional Value – a Benchmarking Study into Alliancing in the Australian Public Sector*. Melbourne: 2009.

Department of Transport. *Updated Transport Submission by NSW Government to Infrastructure Australia: North West Rail – Hills District Line.* Sydney: 2010.

Econtech. Excess *Burden Estimates for Commonwealth taxes*. 2010.

Econtech. *Excess Burden Estimates for State and Council Taxes.* 2011.

Econtech. *Treasury Calculations for Reforms 8 and 9*. 2011.

Ernst & Young. *Government Business Performance Assessment and Capital Management Project for NSW Treasury*. Sydney: January 2011.

Fels, Allan, Stephen Beare and Stephanie Szakiel. *Choice Free Zone*. Canberra: Urban Taskforce Australia, 2008.

Queensland Chamber of Commerce and Industry. *Regulatory Compliance Costs and Other Burdens - A Survey Report.* Brisbane: 1996.

Hoeckel, Kathrin et al. *Learning for Jobs: OECD Reviews of Vocational Education and Training – Australia.* November 2008.

Independent Pricing and Regulatory Tribunal. *Reform Priorities: Report to the NSW Government.* Sydney: April 2011.

Independent Pricing and Regulatory Tribunal. *Review of the Productivity of State-Owned Corporations.* Sydney: 2010.

Independent Transport Safety and Reliability Regulator. *Transport Reliability Report 08-09.* Sydney: 2009.

Independent Pricing and Regulatory Tribunal. *Up-Skilling NSW – How Vocational Education and Training Can Help Overcome Skill Shortages, Improve Labour Market Outcomes and Raise Economic Growth, Australian Census and OECD Data*. Sydney: 2006.

Jensen, Ben. *Investing in Our Teachers, Investing in Our Economy*. Melbourne: Grattan Institute, 2010.

Johnson, Guy, Hellene Gronda, and Sally Coutts. *On the Outside: Pathways in and out of Homelessness.* Melbourne: Australian Scholarly Publishing, 2008.

Leigh, Andrew. *Disconnected*. Sydney: University of New South Wales Press, 2010.

Knight Frank. *Global Real Estate Markets: Annual Review and Outlook 2009-10.* 2010.

KPMG. *DJAG Initial Scan of Expenditure Final Report.* Sydney: 2010.

McDowell, Jim et al. *A Shared Responsibility – Apprenticeships for the 21st Century*, *Final Report by Expert Panel.* Canberra: January 2011.

Metropolitan Transport Authority. *Annual Report 2009-10*. 2010.

Moody's Investors Service. *How Far Can Aaa Governments Stretch Their Balance Sheets.* February 2009.

Moody's Investor Service. *Rating Action: Queensland (State of) Australia, Moody's Lowers Queensland's Rating to Aa1.* May 2009.

NSW Treasury. *Half-Yearly Review of the Budget 2010-11: State Revenue Estimates*. Sydney: 2011.

NSW Treasury. *Half-Yearly-Review Expenditure Forecasts 2011-12 to 2013-14*. Sydney: 2011.

NSW Treasury. *Mid-Year Review 2010-11*. Sydney: 2011.

NSW Treasury. *Budget Papers 2010-11, BP3.* Sydney: 2011.

NSW Treasury. *Budget Papers 2008-09, BP2.* Sydney: 2009.

NSW Treasury. *Budget Papers 2003-04*, BP2. Sydney: 2004.

NSW Treasury. *Treasury Policy Paper TPP08-02.* Sydney: 2008.

NSW Treasury. *Workforce Profile 2010 Table 1*. Sydney: 2010.

NSW Police. *Management accounts*.

RailCorp, *Annual Report 2009-10*. Sydney: 2010.

Parents and Citizens' Association of NSW, 2008.

Property Council of Australia. *Office Market Report: Net effective Rents in Docklands.* February 2011.

Productivity Commission. *Financial Performance of Government Trading Enterprises, 2004-05 to 2006-07, Productivity Commission Research Paper*. Canberra, July 2008.

Productivity Commission. *Performance Benchmarking of Australian Business Regulation: Planning, Zoning and Development Assessment.* Canberra: April 2011.

Productivity Commission. *Productivity Commission Inquiry Report, Government Drought Support.* Canberra: February 2009.

Productivity Commission. *Productivity Report on Government Services 2011: Table 15A.5, 2009-10 data*. Canberra: 2011.

Productivity Commission. *Vocational Education and Training Workforce, Productivity Commission Research Report*. Canberra: April 2011.

Productivity Commission Research Report. *Impacts of Advances in Medical Technology in Australia.* Melbourne: 2005.

Productivity Commission. *Trade and Assistance Review 2009-10.* Canberra: 2011.

Pleace, Nicholas. *Single Homelessness as Social Exclusion: The Unique and the Extreme, Social Policy & Administration.* 1998.

Parliament of NSW. *Industrial Relations Amendment (Public Sector Conditions of Employment) Bill 2011.*

Roads and Traffic Authority. *Travel Speeds in Sydney Metropolitan Area*. Sydney: 2011.

Royal Commission into the NSW Police Service Final Report. Sydney: May 1997.

Sanders, William and June Rivers. *Cumulative and Residual Effects of Teachers on Future Student Academic Achievement.* University of Tennessee, November 1996.

School Student Transport Scheme NSW. November 2008.

Skills Australia. *Skills for Prosperity: A Roadmap for Vocational Education and Training.* Canberra: May 2011.

Smart, Mike. *Value of CityRail Externalities and Optimal Government Subsidy.* Sydney: CRA International: 2008.

Standard & Poor's. *Ratings Direct on the Direct Credit Portal – South Australia (State of).* August 2009.

The Allen Consulting Group. *A Harmonised Payroll Tax System for NSW and Victoria, Estimated Change in the Administrative Burden*. Sydney: 2009.

The Allen Consulting Group. *Report to Infrastructure Partnerships Australia: Performance of PPPs and Traditional Procurement in Australia.* November 2007.

The Audit Office of NSW. *NSW Auditor-General's Report to Parliament 2010: Focusing on Education and Communities, Department of Education and Training, volume 10*. Canberra: 2010.

The Centre for International Economics. *The Benefits and Costs of Alternative Growth Paths for Sydney.* 2011.

The Public Sector Employment and Management (Departments) Order 2011*, Public Sector Employment and Management Act 2002.*

The Treasury. *Australia's Future Tax System - Report to the Treasurer*. Canberra: 2009.

The Treasury. *Commonwealth 2009 Tax Expenditures Statement - Forecast for 2011-12*. Canberra: 2010.

The Economist, 11 November 2010.

Transport for London. *Annual Report and Accounts*. London: 2010.

Turner and Townsend. *Gateway Review Process Refresh Program*. July 2008.

Societe de Transport de Montreal. *Annual Report 2010.* Montreal: 2010.

Urban Taskforce Australia. *Fixing Town Planning Laws, September 2010 - Updated Transport Submission by NSW Government to Infrastructure Australia; M5 East Expansion*. Sydney: 2010.

Usher Review. *A Report to the Minister for Health and Community Services from the Committee established to review Substitute Care Services in NSW*. Sydney: NSW Ministerial Committee, 1992.

Valentine, Kylie and Ilan Katz. *Cost Effectiveness of Early Intervention Programs for Queensland*. Brisbane: Queensland Council of Social Services, 2007.

Wood Inquiry. *Special Commission of Inquiry into Child Protection Services in NSW.* Sydney: 2008.

www.headspace.org.au

www.cityofsydney.nsw.gov.au/AboutSydney/CityResearch/AtAGlance.asp

www.dpc.nsw.gov.au/publications/memos_and_circulars/circulars/2010/c2010-18_staffing_freeze

www.dpmc.gov.au/publications/aga_reform/aga_reform_blueprint/part4.6.cfm

www.dpmc.gov.au/consultation/aga_reform/pdfs/0114%20Australian%20Public%20Service%20Commission.pdf

www.dpc.nsw.gov.au/__data/assets/pdf_file/0020/120737/2010_SnapshotReport_P2011_004.pdf

www.health.nsw.gov.au/pubs/2010/pdf/yellowbook_09.pdf

www.parliament.nsw.gov.au/prod/parlment/nswbills.nsf/0/C78B213F28ABF8DBCA25789A002446D3?Open&shownotes)

www.pc.gov.au/gsp/reports/rogs/2011 (Police data tables)

www.sydney.edu.au/business/__data/assets/pdf_file/0003/99426/NSW_Public_Sector_Pay_Note_1.pdf