05.

Sustainable revenue

Sustainable government revenues are essential for New South Wales to deliver public services and infrastructure for current and future generations.

As the needs and demands of our population evolve, and our economy changes, the way that government raises revenue will have to adapt.

The social and economic changes projected in this report will slow revenue growth into the future. If we continue to rely on current revenue sources without reform or change, our revenues will grow more slowly than the economy and more slowly than the growth in our spending. If we do not address this, our ability to invest in public services and infrastructure will become increasingly reliant on borrowing and impose a growing burden of debt on future generations.

Over time, the decline in state revenue sources will also lead to New South Wales becoming more reliant on payments received from the Commonwealth Government.

Under Australia's federal system of government, states are responsible for critical services and delivery of around half of the operational services and infrastructure that Australians rely on. However, states do not have the capability to raise sufficient revenue to fund these. The Commonwealth raises around 80 per cent of Australian tax revenue.[65] To bridge this gap, New South Wales receives Goods and Services Tax (GST) revenue and funding under a range of national and state specific funding arrangements with the Commonwealth Government.

Goods and Services Tax is an important source of funding that is "untied", enabling New South Wales to make spending decisions to meet the needs of citizens across different types of services and infrastructure, in a flexible way. However, based on its current design, GST will not grow in line with the economy and New South Wales will become more reliant on 'tied' funding negotiated with the Commonwealth for specific purposes.

Our taxes and other sources of revenue should aim to be efficient, fair and robust, and grow in line with the State's needs. How we design our sources of revenue will need to be responsive to social, economic and technological change in order to continue to meet these principles.

There are a range of opportunities to secure a sustainable foundation for providing government services and infrastructure into the future.

Measures that lift productivity and participation rates will grow our economy and flow through to state government revenues, without increasing the tax burden. In relation to tax reform, one of the most significant opportunities that we have as a state is to move away from stamp duty towards an annual property tax, as discussed in Chapter 3. There are other opportunities to modernise our taxes, such as how we design road user charges as we transition from fossil fuels to electric vehicles.

Working together, Australian jurisdictions can modernise the GST to make it more robust, and improve funding arrangements to support a stronger, fairer federation. Goods and Services Tax reform will ensure states have access to a stable source of revenue that grows in line with the economy and are rewarded for pursuing reforms that grow their economies.

[65] ABS, *Government Finance Statistics for 2018-19,* cat no. 5512.0, 2020, Canberra.

Over the period to 2060-61

Revenue will grow by an average of

4.0 PER CENT

a year to 2060-61

Revenue as a share of GSP will decline from 12.9 per cent to

11.5 PER CENT

by 2060-61

Revenues from the Commonwealth will increase from 38.7 per cent to

46.6 PER CENT

of our revenue base by 2060-61

NSW's share of the national GST pool will decline from 27 per cent to

24 PER CENT

by 2060-61

5.1 Where our revenue comes from and how it is changing

New South Wales collects revenue from a range of sources. Our major state taxes are payroll tax and property-related taxes. The sale of goods and services, such as transport fares, constitutes a major share of non-tax revenues.

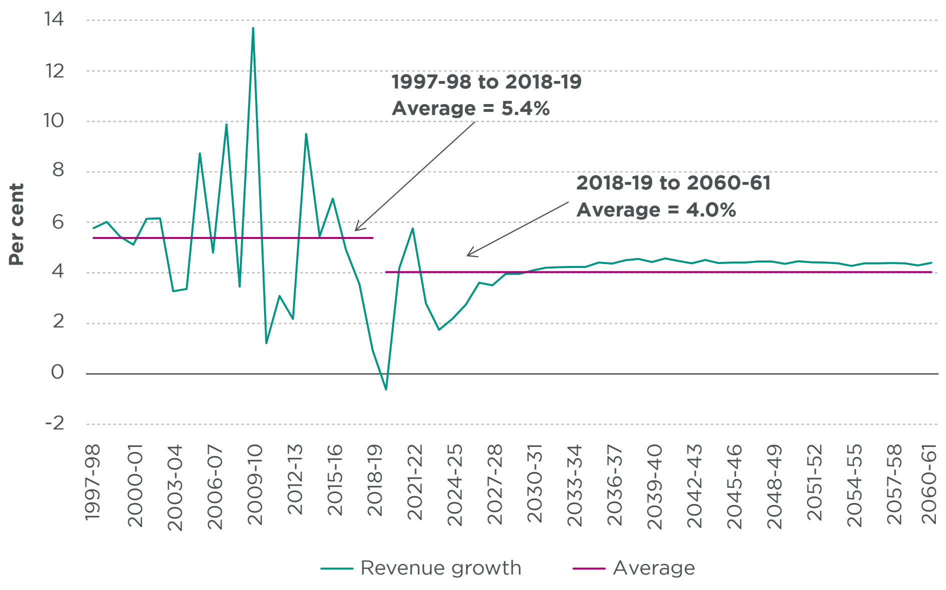
Our federal system of government limits the types of activities that states can tax. Major sources of revenue, such as company tax, excises and personal income tax are only available to the Commonwealth Government.[66] The GST is collected by the Commonwealth, under powers not available to the states and territories, and passed on in the form of grant payments.

Revenue will grow more slowly than previously

Based on the long-run population, productivity and economic growth projections set out in earlier chapters, revenue growth is projected to slow to 4.0 per cent a year on average to 2060-61.[67]

This means that, in the absence of changes to tax settings, or reform which generates higher levels of productivity in the state or nationally, revenues will grow more slowly than the average annual revenue growth seen over the past 20 years, which has been 5.4 per cent (Chart 5.1). Importantly, revenue growth will be lower than projected spending growth (4.5 per cent).

CHART 5.1: NSW ANNUAL REVENUE GROWTH



Source: NSW Treasury.

Note: Revenue projections in this chapter exclude the dividends generated by the NSW Generations Fund unless otherwise stated. The sustainability of state revenues is determined by those revenues that are available to support current spending on government services and investment. For this reason, it is helpful to exclude dividend payments from the Fund. While the Fund will play an important role in supporting the long-run sustainability of government debt (see Chapter 6), earnings from the fund are to be reinvested rather than made available to support public spending.

[66] Under Commonwealth legislation, grants from the Commonwealth to the states are conditional on states not imposing income tax, which in addition to the high costs and burden of a dual system, effectively rules out states levying income taxes.

[67] Note the numbers in this chapter exclude investment returns from the NSW Generations Fund (NGF) unless otherwise stated. The NGF is addressed separately in Chapter 6.

Revenues will decline as a share of the economy

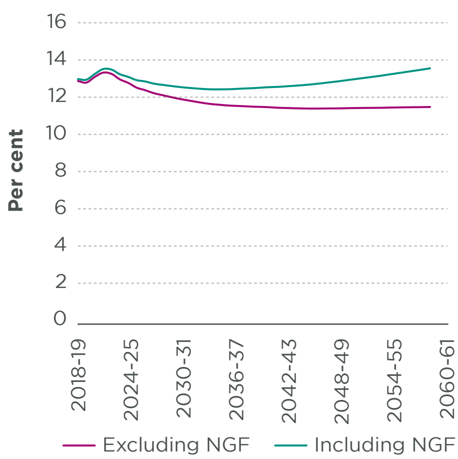
Revenue as a share of the economy (measured as GSP) is projected to decline from 12.9 per cent in 2018-19 to 11.5 per cent by 2060-61 (Chart 5.2). This means the government will have less revenue for delivering services and infrastructure relative to the growing size of the NSW population and economy.

In the next few years, the property cycle is expected to drive growth in property-related taxes before the market moves past its peak and housing activity slows. After this point, economic growth is projected to outpace growth in state taxes and key non-tax revenues, such as mining royalties and sales of goods and services. As population ageing drives increased health-related spending, on the assumption that current national health funding arrangements continue, Commonwealth National Partnership payments will grow and begin to offset further declines in state-based revenues.

If investment returns from the NSW Generations Fund were taken into account, revenue as a share of GSP would increase over the long-run to around 13.5 per cent by 2060-61. Other revenues which are currently diverted into the fund include distributions from the state's Ausgrid and Endeavour investments, other dividends, income tax equivalents and government guarantee fees from State Owned Corporations, as well as mining royalties.

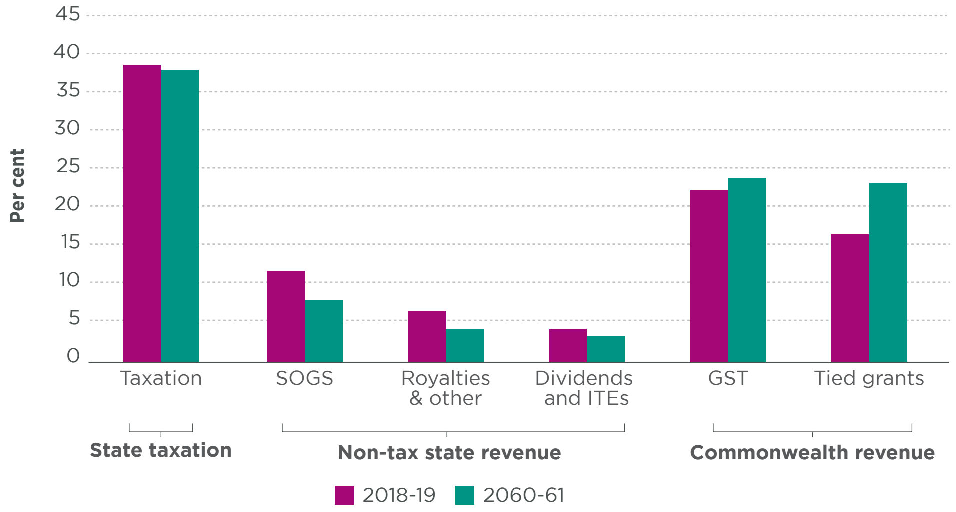
The earnings from the NSW Generations Fund are not a useable source of revenue for general expenditure. Returns from the Fund are reinvested and help to grow the fund over time, with returns set aside for the purpose of debt retirement. This is critical for keeping public debt at sustainable levels, so that future generations are not burdened with unfairly high levels of debt.

CHART 5.2: REVENUE AS A SHARE OF GSP



Source: NSW Treasury.

CHART 5.3: REVENUE SHARES AND CONTRIBUTION TO TOTAL REVENUE BASE



Source: NSW Treasury.

Revenue is becoming increasingly reliant on Commonwealth transfers

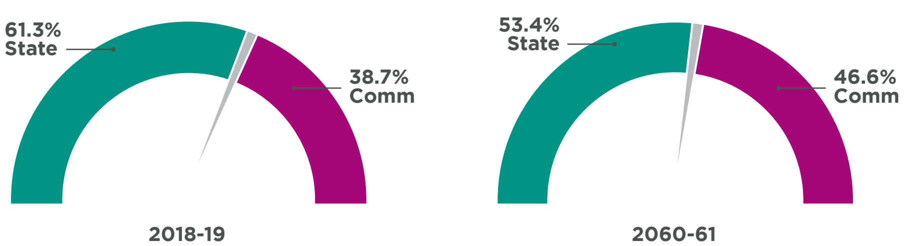
Where our revenue comes from will change over time. Chart 5.3 shows how the composition of our revenue base will change to 2060-61.

State taxation revenues are projected to fall modestly as a share of total NSW revenues, primarily because of slower population growth and faster population ageing. Our other state revenue streams, including the Sale of Goods and Services (SOGS), revenue from royalties and investment dividends (excluding the NSW Generations Fund) are also projected to fall as a share of our revenue base.

As a result of lower growth in state-based revenues, revenues from the Commonwealth will increase as a share of our funding base (Chart 5.4). In particular, Commonwealth tied payments become a greater share of the funds available to the NSW Government.

This assumes that current tied funding arrangements with the Commonwealth continue on the terms set out in existing agreements, in particular Commonwealth payments towards hospital expenses under the National Health Reform Agreement (NHRA).

CHART 5.4: CHANGE IN COMMONWEALTH SHARE OF TOTAL REVENUE



Source: NSW Treasury.

5.2 Growth in NSW state revenue sources will slow

State tax and non-tax revenue sources will fall as a share of our revenue out to 2060-61. This means that a shrinking share of the revenues available to pay for government services will be received from sources over which the NSW Government has direct control (funding received by the state from the Commonwealth Government is addressed separately in section 5.3).

In 2018-19, NSW state revenues totalled $49.6 billion, of which taxation revenues accounted for $31.0 billion and other non-tax sources (excluding the NSW Generations Fund) accounted for $18.6 billion. In 2060-61, NSW state revenues are projected to be $86.8 billion, representing an average growth rate of 3.7 per cent between 2018-19 and 2060-61. This is slower than broader economic growth and growth in spending (Chart 5.5). It is also slower than projected revenue growth in the 2016 NSW Intergenerational Report.

Revenue from state taxation

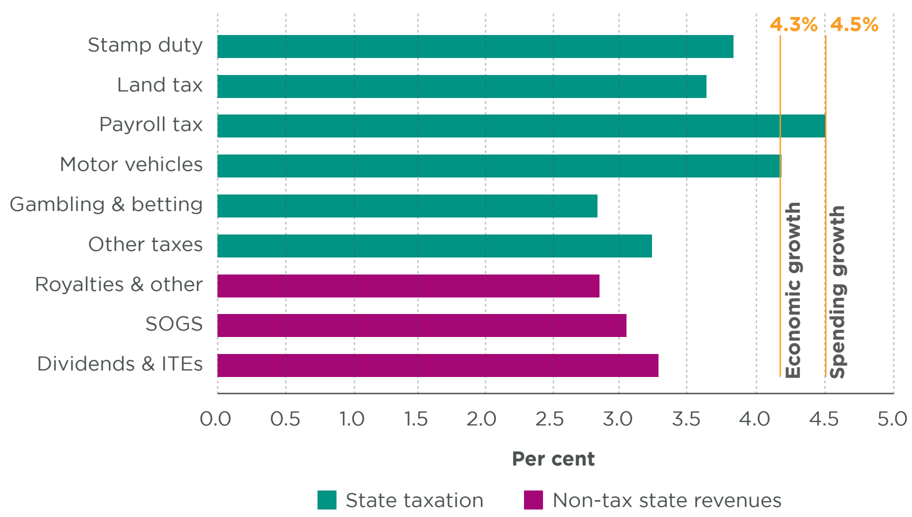
Slower population growth and population ageing will lead to slower growth in state tax revenues

State taxes are a critical component of our revenue base. They are primarily comprised of property and income-related taxes.

Property-related taxes include stamp duty on property transfers and land tax.

To 2060-61, stamp duty revenue is projected to grow by an average of 3.9 per cent a year, slower than projected in the 2016 NSW Intergenerational Report. This reduced growth rate reflects the fact that population growth is projected to be slower than previously anticipated, which will reduce pressure on house prices as housing stock increases relative to population size. Since older citizens move home less often, the shift towards an ageing population will also reduce the growth in number of property transactions.

CHART 5.5: AVERAGE ANNUAL GROWTH IN STATE REVENUES 2018-19 TO 2060-61



Source: NSW Treasury.
Note: All growth rates, including revenue, spending and economic growth are in nominal terms.

Historically, revenue from stamp duty on property transfers has been highly volatile, reflecting volatility in the housing market in terms of both prices and transaction volumes. As set out in Chapter 3, stamp duty is one of the most inefficient state taxes because it increases the cost for people to move to find a job, to be closer to schools or to match housing size to their family or life situation.

Land tax is far more stable than stamp duty because it is not directly affected by changes in transaction activity, only property stock and price levels. On current tax settings, land tax revenue is projected to increase by an average of 3.7 per cent from 2018-19 to 2060-61. This reflects progressive increases in the housing stock — albeit rising at a slower rate than in recent years, due to slowing population growth — and rising house prices.

Income-related taxes are taxes for which income levels are a primary driver, and include payroll, motor vehicle and gambling taxes. Revenues from these taxes are expected to grow on average by 4.2 per cent per year to 2060-61. The ageing of the population will lower the growth of income-related revenues over this period, in line with a fall in working age population as a share of total population.

Payroll tax is the largest income-related tax, and the largest component of state tax revenue in New South Wales. It is one of the more efficient taxes available to the State,[68] with a low economic cost relative to other state taxes. The amount of payroll tax received is determined by the total wages paid to workers in the broader economy. Growth in total payrolls is expected to slow over time as the share of working-age population declines. Other disruptions not currently accounted for in these projections, such as the rise of the gig economy and a shift towards sole traders, could see the wages of a growing percentage of workers fall below the payroll tax threshold, and lead to lower growth in payroll tax receipts.

Motor vehicle and vehicle weight taxes are expected to grow at an annual average rate of 4.3 per cent to 2060-61. While this is broadly in line with growth in overall economic activity, this estimate could drop lower in the future if ridesharing becomes more mainstream for a new generation of potential car owners.

Gambling and betting revenue is expected to grow at an annual average rate of 2.9 per cent to 2060-61, reflecting long-term expectations for wage growth. Recent innovations in gambling and betting have included internet gaming, strong growth in online betting, and the ability to place bets with online operators not subject to New South Wales betting taxes. In 2019, this trend drove the introduction of a point-of-consumption tax, which taxes online gambling according to where the bet is placed.

Revenue from non-tax state sources

Mining royalties from coal will decline as global demand weakens

Revenues from royalties, fines, regulatory fees and other grants are expected to grow by an average of 2.7 per cent a year to 2060-61, falling as a share of total state revenues. This is primarily driven by a decline in royalties revenues associated with falling global demand for coal.

Most coal produced in New South Wales is exported, and the future of the industry is largely dependent on global demand. In 2020, New South Wales' three top thermal coal export markets — Japan, South Korea and China — all announced their intention to achieve net zero emissions by the middle of the century. Consequently, global demand is projected to be weaker than the long-term estimates presented in the 2016 NSW Intergenerational Report.

Under current projections, coal sales (and production) remain at current levels until 2031 then decline to 44 per cent of current levels by 2061. Since global coal demand depends on factors outside the control of the NSW Government, it is subject to considerable uncertainty (see Box 5.1).

So that future generations benefit from today's non-renewable resources, royalties revenues from coal are invested into the NSW Generations Fund. They will contribute an expected $42 billion in real terms into the fund over the period to 2060-61.

[68] NSW Treasury, *NSW Review of Federal Financial Relations,* Sydney, 2020.

Other non-tax revenues to grow more slowly than broader revenue

Sales of Goods and Services (SOGS), which includes items such as rents, tolls, transport fares and hospital patient fees are projected to grow by an average of 3.1 per cent over the period to 2060-61. Over the projection period SOGS revenues are escalated by CPI and population growth. In some cases, a more appropriate volume or price escalator has been used. For example, patient fees are escalated by private health insurance coverage and health inflation. Overall, these factors are growing more slowly than broader revenues. As a result, SOGS will decline as a share of total revenue, from 11.9 per cent in 2018-19 to 8.2 per cent by 2060-61.

Additionally, state revenues from dividends and income tax equivalent (ITE) payments are expected to grow by an average of 3.4 per cent a year to 2060-61.[69] This is slower than broader growth in revenues and will fall as a share of our revenue base from 4.4 per cent in 2018-19 to 3.3 per cent by 2060-61.

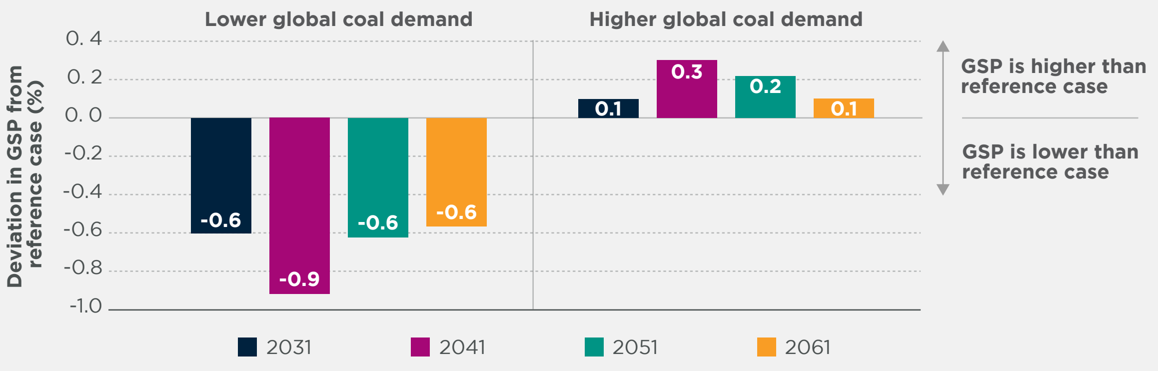
Box 5.1: What will happen to global coal demand?

If the global transition away from coal occurs at a slower or faster pace than projected, there will be impacts on our revenue base and the broader economy.

Under a scenario of higher global coal demand, New South Wales could export up to an additional 1,600 Mt of coal between now and 2061. The cumulative impact of additional revenue and investment returns would result in the NGF balance being $43 billion larger by 2061. This would also see a boost to the wider economy of 0.1 per cent by 2061 (see Chart 5.6).

In contrast, if the global shift to renewable energy is faster than anticipated, coal production in New South Wales could cease by 2042. The cumulative impact of lower revenue and foregone investment returns would reduce the NGF balance by $65 billion by 2061. In this scenario, the economy would be 0.6 per cent smaller by 2061.[70]

CHART 5.6: SENSITIVITY OF NSW GROSS STATE PRODUCT TO GLOBAL COAL DEMAND



Source: NSW Treasury.

[69] Excluding NSW Generations Fund dividends which are set out in Chapter 6.

[70] Refer to the following paper for more information on NSW coal projections: NSW Treasury, *The sensitivity of the NSW economic and fiscal outlook to global coal demand and the broader energy transition*, 2021 Intergenerational Report Treasury Technical Research Paper Series, TTRP 21-07, 2021.

5.3 Revenue from the Commonwealth

In 2060-61, revenues from the Commonwealth are expected to total $75.7 billion, representing an average growth rate of 4.5 per cent a year to 2060-61. Commonwealth payments will grow from 38.7 per cent of the State's total revenue base in 2018-19 to 46.6 per cent in 2060-61.

Commonwealth revenue payments to the states are necessary because there is a mismatch between the Commonwealth's capacity to raise revenue and the responsibility of states and territories to deliver services and infrastructure.

The mismatch in revenue collection and spending responsibilities between the states and the Commonwealth means that the financial capacity of Australian governments is 'vertically imbalanced',[71] with states relying on the Commonwealth to fund essential services. The resulting funding gap between states' revenues and their spending responsibilities totaled $112 billion for all states in 2018-19.

By international standards, Australia has a high level of imbalance: states are significantly more reliant on transfers from the national government than in Canada, Germany and the United States.

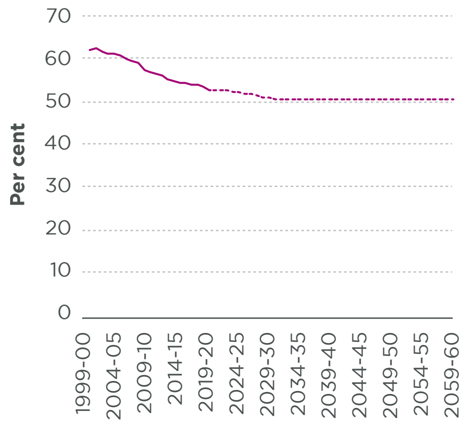
The GST base is declining as the taxable share of household spending falls

The GST is the largest single source of revenue for the NSW Government, providing just over one fifth of total revenue in 2018-19, roughly equal to stamp duty and payroll tax combined. To 2060-61 GST as a share of total revenues will increase marginally, to 24 per cent.

As a consumption-based tax, GST is also one of Australia's most efficient taxes, although in practice the efficiency of GST is diluted by concessions which mean only about half of all consumption is taxed. GST funding to the states is 'untied' — it is revenue that New South Wales can use to deliver services for citizens in a way that is tailored to our circumstances. When introduced in 2000, the GST replaced a range of inefficient taxes with a single, simple, and transparent source of funding.

By putting in place a funding stream that was predictable and would grow with the economy, the GST was designed to improve the way states receive revenues to fund services and infrastructure.

CHART 5.7: SHARE OF TAXABLE CONSUMPTION



Source: ABS Household Expenditure Survey.

Note: Estimates of the share of taxable consumption are constructed using the ABS Household Expenditure Survey to determine the portion of each category in the Household Final Consumption Expenditure (series. 5206008, Table 8) that incurs GST. Changes in the share of spending in each category then determine the aggregate share of household consumption.

[71] Known as vertical fiscal imbalance.

However, over the past 20 years, GST has not grown in line with the economy as was intended and has fallen as a proportion of Gross Domestic Product (GDP). This is largely because consumer spending on goods and services that do not incur GST — health care and education — has outpaced taxable spending.

While demographic factors have played a part, especially in relation to health spending, households in all age groups have contributed to this trend.

The share of consumption that is subject to GST will continue to decline over the next decade, from 54 per cent at 2018-19 to around 51 per cent by 2029-30, before steadying out to 2060-61 (Chart 5.7). This would see GST as a share of NSW GSP fall from 2.8 per cent in 2018-19 to 2.7 per cent by 2060-61.

Into the future, New South Wales' share of the national GST pool is also expected to decline, from 27 per cent in 2018-19 to 24 per cent in 2060-61 (See Box 5.2).

Box 5.2: How the GST is distributed

In November 2018, the Commonwealth made changes to Australia's horizontal fiscal equalisation (HFE) arrangements. This included introducing a GST revenue sharing 'relativity floor', that is, a minimum share of GST that a state receives irrespective of fiscal capacity, and changes to certain standards. These changes reduce New South Wales's share of national GST revenue.

The Commonwealth Government distributes GST with the aim of allowing all state and territory governments to deliver a similar standard of services to residents for a similar tax burden. This is referred to as horizontal fiscal equalisation.

Horizontal fiscal equalisation is a method that shares the GST across states by measuring their relative fiscal capacity (otherwise known as a 'relativity'). It involves looking at various factors that affect the cost of delivering government services and infrastructure, and capacity to raise revenue across states and territories. Some of these factors are geographic and demographic, and include natural resource endowments.

This means GST is not shared between states and territories based solely on their share of Australia's population. Rather, the goal is to assess the relative needs and capacities of each state and territory government to provide comparable services to their residents. As New South Wales has a relatively strong fiscal capacity compared to other states and territories, it receives a lower GST share than if GST were distributed purely based on population share. For example, in 2018-19, New South Wales accounted for 32 per cent of the Australian population but received 27 per cent of national GST revenues.

The 2018 changes made by the Commonwealth improve Western Australia's GST share at the expense of the other states and territories. In recognition of these impacts, temporary support was provided through a legislated 'no worse off' guarantee until the end of 2026-27. Without this guarantee in place, New South Wales stood to lose significant funding: $4 billion from 2021-22 to 2026-27.

The overall impact of the HFE changes and how GST is distributed will leave New South Wales worse off in the long run, with lower GST revenue over the period to 2060-61 than would otherwise be the case. These increasingly complex and unfair HFE arrangements present significant longer term downside risks to the State. Reforms to simplify and improve fairness should be pursued. Permanent adoption of the no worse off guarantee beyond 2026-27 funded by the Commonwealth, or alternatively, unwinding the Commonwealth's changes are two immediate options. However, more broadly, the NSW Government continues to support HFE reform that sees distribution moving towards an equal per capita share, topping up weaker states through other means.

Box 5.3: NSW Review of Federal Financial Relations

Australia is a federation — a system of government that brings power closer to the people and ensures diversity and choice across the country. It allows governments to tailor policy and services to the local needs of communities, while securing national consistency where needed. Done well, federalism can be one of the most effective forms of government, and federal countries have long performed better than unitary countries in delivering economic growth.[72]

New South Wales has taken a leading role in driving a stronger, more effective federation that is fit for the long-term. In 2019, the NSW Government announced an independent review into federal financial relations, appointing a panel of pre-eminent experts to examine the funding arrangements that New South Wales relies upon, and develop options for the state to meet its funding needs sustainably over the long term. The panel, chaired by Mr David Thodey, drew together leading experts in public policy reform, microeconomics and tax, constitutional law and federal financial relations.

The panel found that Australia's model of federation is not best practice, with the large and growing imbalance between the Commonwealth and the State having a centralising effect on the operations of government, with the Commonwealth entering into policy areas not given to it by the Constitution through its influence on funding agreements and grants.

As a result, Australia is not making the most of its federation. The panel concluded that continuing a 'business as usual' approach will create 'a legacy of undesirable choices for the generations of tomorrow'.

The review made a broad-ranging set of recommendations to state and Commonwealth governments to set up our federation for the future, including:

For New South Wales:

- Phase out some of the State's most inefficient taxes, including transfer duties and insurance taxes.
- Transition to the use of broad-based land taxes, to promote a more equitable and efficient tax system.
- Work with other states to address the hollowing out of payroll tax, support harmonisation of the tax base and reduce complexity.
- Work with other states to modernise the way that roads are used and funded.

For states with the Commonwealth:

- Develop projections of national GST revenues to account for the declining tax base (which we do in this report, see GST section over).
- Develop reforms to the GST to offset this decline while also taking measures to maintain equity.
- Develop a personal income tax sharing model, which is revenue neutral for the taxpayer, with revenue distributed to the state in which it is generated.
- Review and reform all Commonwealth-state funding agreements to reduce administrative burdens, clarity roles and responsibilities and ensure programs that need long-term stable funding are funded from an ongoing source rather than short term grants.

[72] NSW Treasury, *NSW Review of Federal Financial Relations,* Sydney, 2020.

Commonwealth tied payments will grow as a share of the state revenue base[73]

Outside of GST, New South Wales receives funding from the Commonwealth under National Agreements and National Partnerships. Funding under these agreements is tied to specific services, such as funding hospitals and schools, and specifics projects or programs, such as the COVID-19 response and distributing essential vaccines.

Between 2018-19 and 2060-61, tied Commonwealth payments are expected to increase as a share of our total revenue base, from 16 per cent in 2018-19 to 22 per cent in 2060-61, and as a share of total Commonwealth revenue to New South Wales. This reflects an average 4.8 per cent a year growth to 2061.

Tied funding for health services, including public hospitals, currently represents over half of tied revenues and is expected to grow to more than 70 per cent of total tied revenues by 2061 (See Chart 5.8).

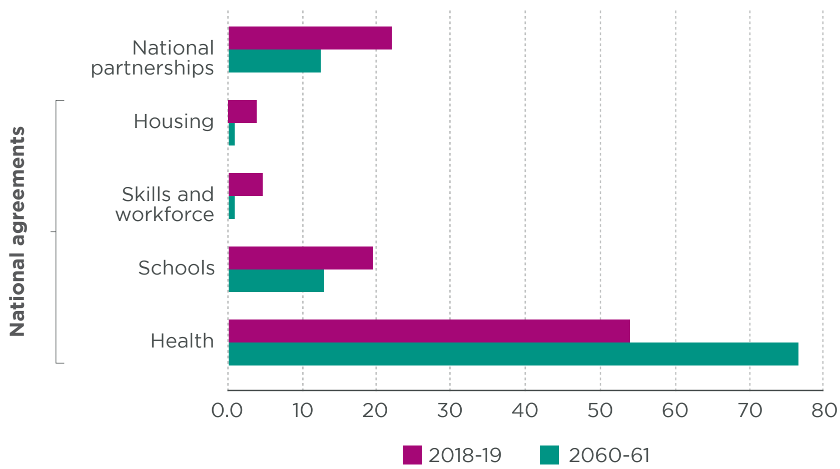
Without reform to either boost state revenues, boost GST revenue or provide another form of untied funding to the states, this greater reliance on tied payments will make it harder for state governments to innovate and provide services that produce the best outcomes for their citizens.

In their current design, tied funding agreements do not give states sufficient funding certainty in areas of long-term need (for example, public dental care). Their sometimes prescriptive requirements limit opportunities for states to be flexible, innovate and adapt. Negotiating and reporting tied funding agreements takes time and resources, and a shared vision of the outcomes sought, or a joint solution to Australia's underlying problems is often lacking.[74] This makes it harder for states and territories to plan for the future and invest money in a way that creates the greatest value for their citizens.

It will also be harder for states to manage the demand for services in situations where cost of service delivery grows more strongly than associated payments from the Commonwealth. For example, should pressures on hospitals continue to build and there is insufficient investment in primary care, there is a risk that state government spending on health will outstrip payments from the Commonwealth, even as Commonwealth payments are growing.

It is important to note that these projections are based on current funding arrangements. Actual future tied Commonwealth revenues will depend heavily on future Commonwealth decisions, and negotiations with the states. Through the National Federation Reform Council, Council of Federal Financial Relations and other intergovernmental forums, New South Wales will continue to advocate for Commonwealth funding on terms that produces the best outcomes for people.

CHART 5.8: SECTOR SHARE OF TIED COMMONWEALTH REVENUES



Source: NSW Treasury.

[73] Payments linked to National Agreements for achieving national objectives in four key areas of state-service delivery: public hospitals, schooling, housing and homelessness and skills and workforce development, and National Partnership and Project Agreements for the delivery of specific projects or policy initiatives.

[74] NSW Treasury, *NSW Review of Federal Financial Relations,* Sydney, 2020, Table 1 pp.24-25.

Box 5.4: National funding agreements on health and education

Health National Agreement — Funding under the Health National Agreement is the most significant driver of growth in tied payments. This reflects the high the pace of growth in projected NSW health expenses. Despite this, projected growth in Commonwealth payments will not keep pace with projected growth in health expenses.

Under the 2020-25 Addendum to the National Health Reform Agreement, the Commonwealth funds 45 per cent of increases in efficient hospital activity, subject to a 6.5 per cent annual growth cap – beyond which all growth in costs will be funded by the state. The agreement brings the projected annual rate of growth in these revenues to 5.7 per cent. These revenues represent around 30 per cent of total NSW health expenses.

To keep health care costs sustainable Commonwealth-state cooperation is needed to support people to manage their health, and ensure they receive the right care in the right place and at the right time. This should include access to timely and appropriate aged care services. Effective investment in early intervention and care outside of hospitals is essential to support better health outcomes and reduce the need for 'acute' care in hospitals.

A significant portion of that investment is a Commonwealth responsibility, as it requires effective primary and preventative care. Yet, under current funding arrangements, the states bear the majority of costs and financial risk from growing demand for public hospitals, while the Commonwealth's exposure to this risk is capped.

School National Agreement – Schools represent just under a quarter of total tied Commonwealth revenues to New South Wales. Commonwealth funding for government schooling is indexed by the projected rate of growth of the student population, plus a Commonwealth legislated school resourcing growth factor. Our ageing population is expected to put downward pressure on growth in Commonwealth funding for schools out to 2060-61. These revenues are projected to grow at an average of 3.8 per cent in the long run, compared to 4.2 per cent in education expenses.

5.4 Opportunities to build a strong and sustainable revenue base

On current policy settings, growth in total revenue will fall short of economic growth in New South Wales and of growth in NSW Government spending. This implies that, over time, governments face a choice between reducing the cost of providing public services and infrastructure, increasing revenues through broader revenue collection or higher rates, or accepting an unsustainable trajectory for public borrowing.

By modernising how we raise revenues we can provide a more sustainable funding base for the delivery of government services and infrastructure for our children and grandchildren.

Reforms to boost productivity increase revenues without imposing additional taxes, by generating higher economic activity and incomes. Increased productivity can also reduce spending on certain government services and reduce government spending relative to the size of the economy. Raising annual productivity growth by 0.1 percentage point out to 2061 — an increase from 1.2 per cent to 1.3 per cent on average over the period – would increase annual revenue growth from 4.0 per cent to 4.1 per cent, resulting in an extra $8.3 billion in revenue each year by 2061.

Opportunities for productivity reform are available within the state tax system and include moving away from economically costly taxes, towards more efficient revenue sources. Chapter 3 discusses a significant opportunity for reform to the way property is taxed in New South Wales. Another example of how our revenue system might change is in response to energy transition and the move towards more environmentally friendly vehicles (Box 5.5). Other options include reducing the state's reliance on transaction-based charges, such as taxes on insurance and motor vehicles.

Further significant reform opportunities would require cooperation between the Commonwealth and states to implement. Broadening the GST base would ensure states have access to a stable source of revenue that grows in line with the economy over time. Reforms to the way that GST is distributed could result in a more equitable and efficient system that incentivises states to pursue reforms that grow their economies. Together these reforms would support productivity growth and ensure the state can continue to fund and deliver high quality services and infrastructure in a sustainable way.

Box 5.5: Electric vehicles and adapting to technological change

Electric vehicles (EVs) are expected to become a significant share of vehicles in Australia within the next 40 years. The CSIRO projects that up to the entire motor vehicle fleet could be electric by 2050.[75]

Treasury modelling indicates the potential for significant economic benefits from the uptake of electric vehicles. Projections indicate that the NSW economy could be $5.3 billion larger by 2061 (0.4 per cent of GSP) if our move to electric vehicles follows the Australian Energy Market Operator's (AEMO's) 'step change' projection instead of the 'slow change' projection.[76] This because electricity is cheaper than petrol, and would be produced in New South Wales rather than imported from overseas or Western Australia.

The pace of transition to electric vehicles depends on factors including price, global supply, ease of charging and battery capacity. There are some levers that governments can use to influence this, for example by supporting the availability of charging infrastructure and targets for government fleets.

The NSW Government is supporting the transition to electric and other low emission vehicles through the NSW Net Zero Plan. As part of this plan, the NSW Government will co-fund the deployment of fast-electric vehicle infrastructure and increase targets for electric and hybrid fleet vehicles.

Associated with the move away from fossil fuel-based cars is the loss of fuel excise revenue collected by the Commonwealth. This revenue was already in structural decline over time as vehicles have become more efficient, but is still substantial: the Commonwealth raised $17.6 billion in excise on diesel and petrol in 2019-20.

While this revenue is not specifically set aside for road-related expenditure, in practice, the Commonwealth contributes to road construction and maintenance in New South Wales, with Commonwealth grants accounting for 31 per cent of the state's road-related revenues.

Electric vehicles do not currently pay an equivalent to fuel excise or a road user charge. As the uptake of electric vehicles increases, a growing cost burden of supporting road infrastructure and maintenance will fall on the general tax payer. This impact could be amplified by broader changes to transport habits and technology, such as increased car and ride sharing, and the introduction of autonomous vehicles.

As more NSW citizens make the shift towards this new technology, the taxation system will need to adapt and modernise to ensure a fair road user charging scheme into the future, while continuing to support environmentally friendly transport options.

The NSW Review of Federal Financial Relations (2020) concluded that the take up of electric vehicles provides an opportunity to pilot a distance-based road user charge, as a step towards a more efficient road funding system that better reflects the social cost of road use.

75 Graham, P and Havas, L, *Projections for Small-scale Embedded Technologies,* CSIRO, Australia, 2020.

76 Refer to the following paper for more information on these projections: *NSW Treasury, The sensitivity of the NSW economic and fiscal outlook to global coal demand and the broader energy transition,* 2021 Intergenerational Report Treasury Technical Research Paper Series, TTRP 21-07, 2021.