Martin Place, Sydney
Destination NSW

06.

Our fiscal challenge

The fiscal gap is expected to reach 2.6 per cent of GSP in 2061, smaller than expectations in the 2016 NSW Intergenerational Report of 3.4 per cent in 2056.

NSW Government spending on the services and infrastructure that the people of New South Wales need is expected to grow faster than the revenue sources that we rely upon to fund public spending. If not addressed, this gap in our finances each year will result in growing public debt. Over time, this will also limit the extra fiscal capacity that the NSW Government has to deal with significant or unexpected events that require a public response.

The fiscal gap of 2.6 per cent is smaller than estimated in the 2016 NSW Intergenerational Report (which projected a 3.4 per cent gap in 2055-56). A number of factors account for this – in particular, changes to modelling methods to better estimate both health expenses as we age, and account for growth in health funding from the Commonwealth (which is now projected to be more in line with hospital expenses). Updated economic and demographic assumptions since the previous Report – including lower productivity growth and fertility rates which reduce both expense and revenue growth – have also impacted the fiscal gap.

The fiscal gap is defined in the *Fiscal Responsibility Act 2012* as the projected change in revenues less expenditures as a percentage of Gross State Product (GSP), including net capital expenditure but excluding interest. The change is measured between the base year, 2018-19, and the end of the projection period in 2060-61.

Fiscal gap projections allow us to estimate how fiscal pressures could build over the long term if current policies do not change.

When the fiscal gap is measured, the cost of servicing debt that has previously built up is not included in the calculation. So, alongside the fiscal gap, we also need to consider how much debt the State is accumulating, as interest payments on growing debt will make operating deficits worse over time.

Chart 6.1 shows how fiscal pressures are projected to build over the longer term relative to the size of the economy, with the fiscal gap projected to reach 2.6 per cent of GSP by 2060-61 (excluding earnings from the NSW Generations Fund (NGF)).

By 2061:

Growth in government spending will exceed growth in revenues (excl. NGF) by

0.5 PERCENTAGE POINTS

on average each year

Fiscal gap if no action is taken

2.6 PER CENT

of GSP (excl. NGF)

Net debt of

$125,000

per person (in today's dollars)

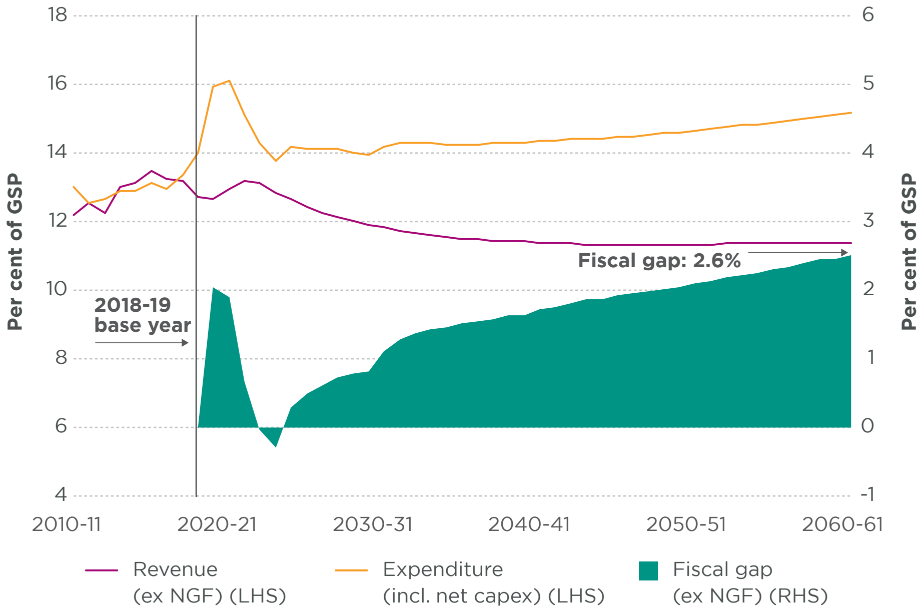
NSW Generations Fund to reach

$430 billion

(in today's dollars)

6.1 Managing our State finances for future generations

CHART 6.1: FISCAL GAP



Source: NSW Treasury.

The fiscal gap of 2.6 per cent of GSP in 2060-61 is the result of government spending on services and infrastructure growing faster each year than revenue is growing. This reflects a range of structural factors including economic and demographic changes, led by an ageing population and falling workforce participation, leading to declining growth in State revenue sources such as payroll taxes and stamp duties, and faster growth in health-related spending. Slower growth in other revenue sources, including sales of goods and service and coal royalties, also contributes to the growing fiscal gap. The nature of our federal system of government and growing reliance on Commonwealth funding is another contributor, with a fall in Goods and Services Tax (GST) revenues relative to the size of the economy over the projection period as a higher proportion of discretionary spending goes towards health and education and the NSW share of the Australian population declines.

The fiscal gap of 2.6 per cent excludes earnings from the NSW Generations Fund. The Fund earns investment returns each year, which are reinvested back into the Fund. These earnings are State revenues, and if we were to include these in our fiscal gap calculations, this gap would shrink to 0.6 per cent of GSP in 2060-61. NSW legislation, however, provides that these funds are to be used for retiring the State's debt, and they are therefore excluded from the fiscal gap projection of 2.6 per cent of GSP. Instead, the reinvested earnings over the projection period are assumed to add to the balance available for future debt retirement.

Fiscal pressures will accumulate over the next 40 years, causing net debt to grow

In the absence of measures to address this structural imbalance between revenue and government spending, New South Wales would face continuing deficits year on year. Without policy interventions, this would increase debt levels in an unsustainable way. Assuming no policy changes to manage expenditure, NSW Government spending is projected to grow faster than revenues by around 0.5 percentage points on average each year (excluding revenues earned by the NSW Generations Fund). Over 40 years, this modest annual deficit would accumulate into a growing gap between government spending and revenues, forcing government to rely more heavily on borrowings to fund services and infrastructure.

This would significantly impact the State's borrowings, with gross debt projected to reach $1.9 trillion in today's dollars (or 133 per cent of GSP) by 2060-61[77] (Chart 6.2). Our net debt position would reach 100 per cent of GSP by 2060-61 after taking into account the substantial assets held in the NSW Generations Fund.

This would represent, in this scenario, net debt of around $125,000 per person in New South Wales (in today's dollars), leaving future generations significantly exposed to risk – from known trends and future shocks – challenging the ongoing delivery of quality government services. This accumulation of debt also exposes the State to the risk of future rises in our borrowing costs in financial markets, which could lead to a greater share of government revenues being used to pay interest costs rather than to deliver services and infrastructure.

Net debt

Projection for 2060-61

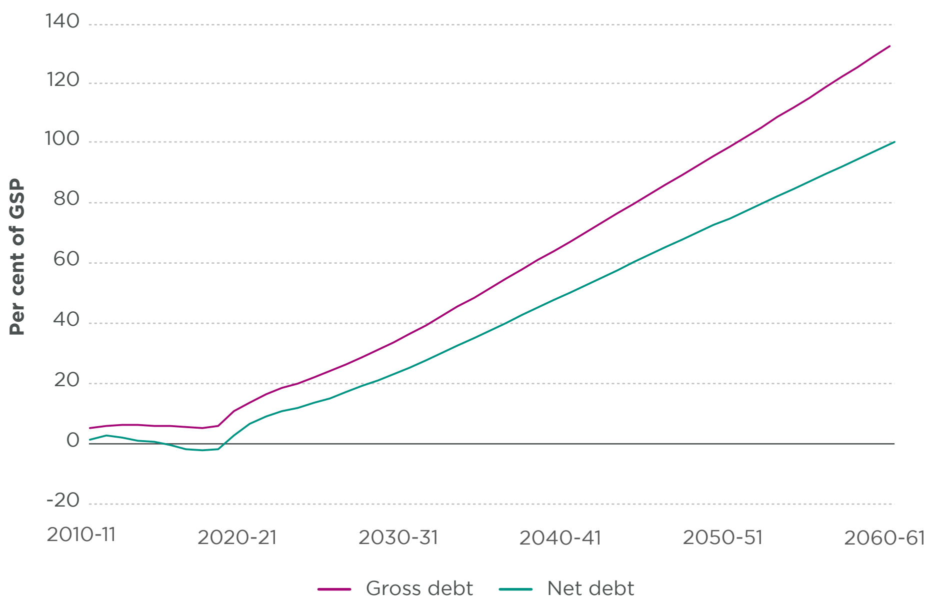
100 PER CENT
of GSP

$125,000
per person in NSW (in today's dollars)

It is important to remember that the projections in this Report assume government takes no action to address the imbalance between revenue and expenditure. In reality, the *Fiscal Responsibility Act 2012* requires corrective measures be introduced to ensure that these projected outcomes do not occur.

The NSW Generations Fund also provides a substantial pool of assets that future generations can use to help manage any build up in debt. We assume for modelling purposes in this Report, however, that while funds are available for debt retirement at any time, the Fund is not used to retire State debt prior to 2060-61.

CHART 6.2: GROSS AND NET DEBT TO 2060-61 (INCLUDING THE NSW GENERATIONS FUND)



Source: NSW Treasury.

[77] The diversion of revenues into the NSW Generations Fund (SOC dividends and coal royalties) also contributes to the accumulation of gross debt. Without these borrowings, gross debt is projected to reach 122 per cent of GSP by 2060-61.

6.2 The NSW Generations Fund will help future generations manage debt

The NSW Government established the State's first sovereign wealth fund in 2018, in line with similar decisions taken by several other advanced and resource-rich economies over time. The NSW Generations Fund is a debt retirement fund whose purpose is to reduce the debt of the State, as set out in the *NSW Generations Funds Act 2018*.

The Fund was seeded in 2018 with an initial investment of $10 billion, comprising $7 billion following the sale of a 51 per cent stake in WestConnex, and $3 billion from balance sheet reserves.

The NSW Generations Fund will support the State's credit rating over the long term by helping to keep debt levels manageable and promoting intergenerational equity.

Both major global credit ratings agencies have recognised the Fund as a direct offset to the State's debt levels, with Moody's considering growth in the Fund as key to supporting New South Wales' triple-A credit rating following the increase in debt associated with the COVID-19 pandemic. This is important because it helps to reduce the State's cost of borrowing in normal market conditions and ensure future generations can benefit from the Government's fiscal strength today.

The NSW Generations Fund will grow over time through ongoing contributions from distributions from the State's minority interests in WestConnex, Ausgrid and Endeavour; dividends, income tax equivalents and government guarantee fees received from state-owned corporations; and from the State's mining royalties. Funds in the NSW Generations Fund are "locked away" by legislation for the purpose of future debt retirement. All earnings are reinvested, adding to the Fund's balance over time.

The Fund's expected long-term rate of return is CPI + 4.5 per cent, which is broadly comparable to other sovereign wealth funds. For example, the Commonwealth Government's Future Fund's investment return objective is CPI + 4 per cent to 5 per cent. Since inception, the NSW Generations Fund has returned 8.05 per cent per annum on average,[78] or around $2.0 billion in total.

The balance of the Fund is projected to reach $14.6 billion by June 2021[79] and $430 billion (in today's dollars) by 2060-61 (Chart 6.3). This is equivalent to 31 per cent of GSP in 2060-61.

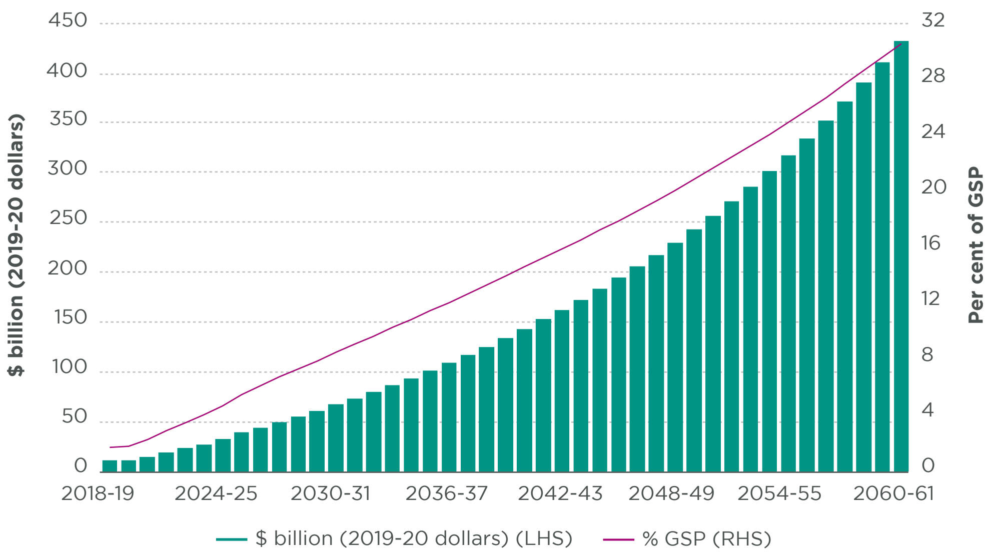
We assume for this Report that the Fund is not used to retire State debt prior to 2060-61. The NSW Treasurer, however, can use the NSW Generations Fund to pay down State debt at any time.[80] In determining whether, and at what point, to pay down debt, a variety of factors would be considered including the Fund's size, the State's debt levels, interest costs, investment margins and all other associated risks.

[78] To 31 March 2021.

[79] Projection as at the 2020-21 Half-Yearly Review.

[80] *NSW Generations Funds Act 2018* (s10).

CHART 6.3: PROJECTED BALANCE OF THE NSW GENERATIONS FUND



Source: NSW Treasury.

6.3 Securing a resilient New South Wales to 2061

The size of the fiscal challenge remains large

Despite the NSW Generations Fund, the underlying structural imbalance between the State's revenue and expense growth and the subsequent debt implications will remain a serious challenge over the coming decades.

State finances also remain vulnerable to uncertainty and volatility — meaning that the gap between revenue and spending growth will vary from these projections. In particular, New South Wales is becoming more vulnerable to funding decisions made by the Commonwealth Government, and volatility in spending to address natural disasters.

A fiscal gap of 2.6 per cent of GSP by 2060-61 is a substantial imbalance; equivalent to around two-thirds of the current health budget or almost all of the current education budget.

However, this assumes we do nothing to address the challenges on the horizon. There are a number of paths available to government to bring greater balance to our long-term fiscal position, such as improving key contributors to sustained economic growth — including participation and productivity — revenue reform, and improving the effectiveness of public spending.

Planning for a prosperous and resilient future

A range of factors largely outside the NSW Government's direct control can influence the size of the fiscal gap. This includes decisions of other levels of government; general economic conditions in the rest of Australia and internationally; international demand for our coal exports as our trading partners transition to greener sources of energy; and the extent of global warming. Government decisions, however, can have a material impact on our long-term economic outcomes and fiscal sustainability. This Report outlines a range of reform opportunities that can either be directly implemented by the NSW Government, or that New South Wales can work with the Commonwealth to introduce, which could drive stronger economic growth and reduce the fiscal gap.

To build a prosperous and resilient future, New South Wales can build on its strong economic foundations and boost its ability to adapt in the face of future challenges and opportunities.

Fundamental policy responses within the direct control of the NSW Government include state measures to boost productivity and workforce participation, lift education and training standards, modernise the State's revenue base, and shift to more efficient user charges. Those that are largely NSW-driven but cannot realise full benefits without co-operation with the Commonwealth Government include skilling the workforce, boosting women's economic participation, and continuing to focus health services on early intervention and prevention. In full cooperation with the Commonwealth Government, New South Wales can achieve a more sustainable State revenue base through tax reform, effective migration policies to grow our population, improved service funding agreements, and fairer and more reliable flow of GST revenues to the states.

These opportunities are explored more fully below. Chart 6.4 compares the potential impact on the fiscal gap of realising some of these opportunities, relative to the projected base case of a fiscal gap of 2.6 per cent of GSP in 2060-61.

Boosting productivity growth and workforce participation would have the most significant impacts on the fiscal gap.

As shown in Chart 6.4, materially lifting productivity growth and achieving parity in women's workforce participation would have the most significant impacts on the fiscal gap. This shows the importance of identifying and implementing reforms that will drive improvements above the current trends in productivity growth and in women's participation in the paid workforce. These are the types of step changes that will enable us to raise living standards over the long-term and to ensure a sustainable future footing for public spending.

Supporting the right environment for investment and innovation to drive productivity

An enabling business environment in New South Wales is more important than ever in today's context of global competition and as countries seek to attract business in the wake of the COVID-19 pandemic. The NSW Government is responding to these challenges by attracting innovative businesses and making public investments through its 2040 Economic Blueprint, R&D Action Plan and the Global NSW Strategy. The NSW Government is also making it simpler to open new businesses and encouraging businesses to launch new products and services through regulatory reforms, precincts and the 24-Hour Economy Strategy.

This Report assumes productivity will grow at 1.2 per cent each year, based on the average pace of growth over the past 30 years. This is lower than the 2016 NSW Intergenerational Report assumption of 1.5 per cent reflecting declines in productivity growth since the last report. Chapter 2 highlights the importance of productivity growth to improve living standards over time. All levels of government can stimulate productivity growth through tax and regulation reform, and with effective investment in education, health and productivity-boosting infrastructure.

Boosting productivity growth has a material impact on the fiscal gap. For example, a 0.1 percentage point increase in annual productivity growth to 1.3 per cent could reduce the fiscal gap to around 2.3 per cent of GSP. An increase in productivity growth to 1.4 per cent could decrease the fiscal gap even further, to 1.9 per cent of GSP.

Productivity growth

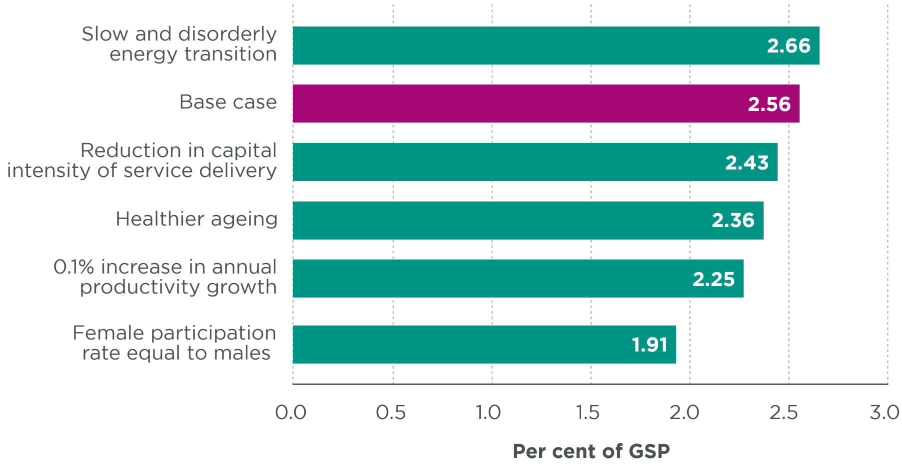
0.1 percentage point increase in annual productivity growth could narrow the fiscal gap to

2.3 PER CENT OF GSP

0.2 percentage points increase in annual productivity growth could narrow the fiscal gap to

1.9 PER CENT OF GSP

CHART 6.4: IMPACTS OF POLICY AND STRUCTURAL CHANGES ON THE FISCAL GAP (MUTUALLY EXCLUSIVE)



Source: NSW Treasury.

A highly skilled and adaptable workforce

Increasing automation, Artificial Intelligence, advancing technologies, growing consumption of services and the shift towards a low carbon economy will continue to change the skills that people need to work. Workers with cognitive, social and collaborative skills will be in greater demand particularly in high-growth industries like health care and social services — such as disability support and aged care — and in hi-tech industries where there will be a shift toward managerial roles.

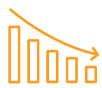
Lifelong learning will be increasingly important. We can expect workers will need to update their skillsets more frequently in the future. The government can support greater access to lifelong learning through the TAFE system, which will continue to adapt course content, teaching practices and methods (such as using digital platforms) in response to shifts in demand for specific skills, with greater integration between work and education. Skilled migration will also be important in meeting skills gaps and offsetting the impacts on participation rates of an ageing population.

Such improvements will allow more people to participate in the economy. For example, as discussed in Chapter 2, higher workforce participation rates amongst women require addressing the key reasons that women leave the workforce or reduce their participation in paid work, including access to and the cost of childcare. There would also be considerable economic benefits from addressing the gender segregation in occupations and industries, and supporting greater workplace flexibility, contributing to faster growth in incomes and a larger economy.

To indicate the potential size of this opportunity: if we were to close the participation rate gap between women and men over the next 20 years, by 2060-61 the total participation rate would be 66.3 per cent (around 5 percentage points higher than baseline projections) and the fiscal gap lower by around 0.7 percentage points at 1.9 per cent of GSP.

Participation rate gap

Closing the participation rate gap between women and men over the next 20 years could narrow the fiscal gap to



1.9 PER CENT OF GSP

Improving health outcomes

Keeping people healthy is essential for quality of life, enabling people to participate productively at school, work and in their communities. Health spending is projected to remain the largest component of total government spending — contributing almost 40 per cent of overall growth in recurrent spending to 2060-61 – to manage the needs of an ageing population and the burden of chronic health conditions, and to integrate technological advances in health care. In response to these challenges, governments can focus more on prevention of chronic illness and early intervention before people's health needs become acute and require hospitalisation. We can also use technology to streamline service delivery, personalise health service experiences and supplement in-person care with virtual health care services, to make health services more effective and more efficient. Commonwealth-State reforms that support preventative health measures and services that can be accessed virtually will help people lead healthier lives – wherever they live.

The ageing population places substantial pressure on health spending as demand for urgent, complex and costly health services increases, accounting for around 1.2 percentage points of the 2.6 per cent of GSP fiscal gap. As we live longer, we are spending more years in good health but also more years in ill-health. Chapter 4 outlines a range of actions the government could take to improve the health of the population. If we stem the increase in years spent in ill-health, through healthier lives and better targeted health care, the fiscal gap could be reduced to around 2.4 per cent of GSP.[81]

Benefits of digitisation and reduced reliance on physical infrastructure to deliver government services

As Chapter 4 discusses, better use of existing assets and delivery outside of traditional physical infrastructure, such as online virtual service delivery, not only offers direct benefits to the people of New South Wales now, but also benefits future generations by alleviating the need to build new, often costly physical infrastructure such as hospitals, courts, prisons and roads. Innovations that reduce demand and reliance on physical infrastructure can promote better outcomes for citizens and fiscal sustainability for the future. For example, a 10 per cent reduction in the reliance on physical infrastructure for delivery of services across health, education, transport and the justice systems would reduce growth in capital expenditure and improve the fiscal gap to around 2.4 per cent of GSP.[82]

[81] The healthy ageing scenario refers to the compression of morbidity scenario where years spent in healthy life relative to life expectancy increases by 10 per cent for individuals over the age of 65.

[82] Modelling assumes that a total 10 per cent reduction is achieved by the end of the projection period, with the capital intensity of service delivery reducing over time.

Cooperation on migration and GST with the Commonwealth Government

Natural population growth will continue to slow and, in 2020-21 and 2021-22, more overseas migrants are expected to leave than arrive in New South Wales for the first time since World War II.

Overseas migration has been a critical part of the State's strong economic growth. Cooperation with the Commonwealth Government on future migration intakes will be needed as skilled migrants moving into the State help to bridge skills gaps, reduce labour shortages and balance our ageing population.

New South Wales will also become more reliant on Commonwealth Government funding sources as our population ages, consumer preferences evolve and the world changes – such as the transition to greener technology. Increasing reliance on Commonwealth Government funding agreements and specific grants renders the State vulnerable to funding uncertainty and can make it more challenging for government to make the best investments to deliver the outcomes for the people of New South Wales.

New South Wales will continue to advocate for GST reform to address the decline in GST revenues, and reform to the Commonwealth's distribution of GST revenues to states to make it more equitable.

Energy transition plan and electric vehicles

The global community, including New South Wales, is moving towards greener generation and use of energy. An orderly shift in our energy mix will support future productivity growth. Further, New South Wales has an opportunity to be a leader in renewable energy and storage. The NSW Electricity Infrastructure Roadmap lays out the framework for government to ensure an orderly transition from fossil fuel generation to renewables, and by 2040, most energy generated in the State is expected to be from renewable sources.

Consumers and businesses are already choosing to move towards a greener future in transport. The CSIRO projects that almost all vehicles on Australian roads could be electric by 2050.[83] The NSW Net Zero Plan supports this trend by committing to co-funding the roll out of fast-charging infrastructure for electric vehicles, and increasing targets for the government's electric and hybrid fleet vehicles. The tax system will also need to adapt to ensure that all road users contribute to road infrastructure maintenance, while preserving incentives for people to opt for green transport.

The transition to renewable energy generation under the NSW Electricity Infrastructure Roadmap is aimed at ensuring new generation is in place in time for the retirement of New South Wales' existing coal generators over the coming decades. Under a "slow and disorderly" transition scenario, a hypothetical scenario in which the Roadmap is not implemented and replacement generation is not put in place, electricity prices could be higher and more volatile, impacting other sectors in the economy. Over the next 40 years, this would leave our economy smaller by 0.9 per cent, or $13 billion.[84] This is because as coal-fired generators are retired energy prices may spike, potentially disrupting businesses that rely on electricity to serve their customers. This would lead to a deterioration in the fiscal gap to around 2.7 per cent.

[83] Graham, P.W. and Havas, L., *Projections for small-scale embedded technologies, CSIRO*, Australia, 2020.

[84] NSW Treasury, *The sensitivity of the NSW economic and fiscal outlook to global coal demand and the broader energy transition for the 2021 NSW Intergenerational Report,* Treasury Technical Research Paper Series, TTRP 21-07, 2021.

Property tax reform

Property tax reform is a significant economic reform opportunity that can boost productivity and workforce participation. As discussed in Chapter 3, a reform option put forward for consultation is to replace stamp duty – an inefficient tax on property transactions that discourages people from moving homes and acts as a barrier to home ownership – with a new property tax that encourages optimal use of property and land.

Housing plays an important role in peoples' quality of life and the State's economic growth. Stamp duty on property purchases impedes the State's economic growth and the benefits of homeownership for individuals. Removing stamp duty would increase mobility for people by making it easier to move homes, whether it be to move closer to job opportunities or move into a home that is more suitable for their stage in life. This increased mobility would reduce geographical barriers to employment, resulting in improved workforce participation and productivity, and reduced unemployment. By supporting economic growth and employment, property tax reform would contribute to a stronger revenue base.

Property tax reform would also support higher homeownership rates, which is a foundation of a secure and independent retirement. For individuals, this would help secure higher material living standards during retirement. For government, it can help manage expenses by reducing the risk of people being dependent on government-funded services such as social housing.