

Standing Committee on Finance and Public Administration

ANSWER TO QUESTION ON NOTICE

Finance and Deregulation Portfolio

Department of Finance and Deregulation

Supplementary Estimates Hearing – October 2010

Outcome 1, Program NA

Topic: Review of conservative bias allowance

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Senator Cormann asked:

Has that review which you conducted in the lead up to the 2009-10 budget ever been publicly released?

Mr Tune—I do not think so. I will take it on notice.

Senator CORMANN—Could I ask you to consider tabling that document and, if you decide not to table it, to give us a statement of reasons as to why it is not in the public interest

Mr Tune—I will take the question on notice.

Senator CORMANN—Thank you. I am just anticipating that, if you were of a mind not to release it, I would be asking formally for a statement of reasons as to why it would not be in the public interest.

Answer:

The review of the conservative bias allowance (CBA) prior to the 2009-10 Budget was undertaken in September 2008. A copy of the review is attached.

REVIEW OF THE CONSERVATIVE BIAS ALLOWANCE

1. BACKGROUND

The conservative bias allowance (CBA) is an allowance included in the contingency reserve to provide for the tendency for the estimates of expenses for existing Government policy to be revised upwards in the forward years. The level of this allowance is based on past experience and is intended improve the overall accuracy of the forward estimates. The CBA is included in the estimates at the time of the creation of the Third Forward Year estimates (FE3) and is progressively reduced as the estimate for FE3 gradually move over time toward becoming the Budget year estimates.

Table 1 shows the current CBA levels as a percentage of total expenses and the planned draw-downs for each year as agreed at the time of the 2007-08 MYEFO.

Table 1: Current CBA setting and draw-down schedule

	<i>Current CBA rates at each major estimates Update (per cent)</i>				<i>Corresponding draws-downs (per cent)</i>			
	2008-09	2009-10	2010-11	2011-12	2008-09	2009-10	2010-11	2011-12
2007-08 Budget	1.00	2.00	3.00	--	--	--	--	--
2007-08 MYEFO	0.50	1.25	2.00	--	0.50	0.75	1.00	--
2008-09 Budget	0.00	1.00	1.50	2.50	0.50	0.25	0.50	--
2008-09 MYEFO	--	0.50	1.25	2.00	--	0.50	0.25	0.50
2009-10 Budget	--	0.00	1.00	1.50	--	0.50	0.25	0.50
2009-10 MYEFO	--	--	0.50	1.25	--	--	0.50	0.25
2010-11 Budget	--	--	0.00	1.00	--	--	0.50	0.25
2010-11 MYEFO	--	--	--	0.50	--	--	--	0.50
2011-12 Budget	--	--	--	0.00	--	--	--	0.50

Note: The rates in the table represent percentages to be applied to the estimated total general government sector expenses excluding GST payments for the calculation of the conservative bias allowance.

The CBA is calculated as a percentage of estimated total expenses, a system that was established in 1987-88. Table 2 shows that the CBA was initially set at a relatively modest 0.75 per cent of outlays in the FE3 year and was gradually increased to 3 per cent by the 1998-99 Budget. The level of the CBA was relatively stable after that time until a number of adjustments from 2005-06.

Table 2: History of the level of CBA

	<i>Per cent of estimated aggregate expenditure</i>		
	FE 1	FE 2	FE 3
1987-88 Budget	0.25	0.50	0.75
1988-89 Budget	0.50	0.75	1.00
1991-92 Budget	0.50	1.00	1.50
1992-93 Budget	0.75	1.25	1.75
1997-98 MYEFO	1.00	1.50	2.00
1998-99 Budget	1.00	2.00	3.00
2005-06 Budget	1.00	2.00	4.00
2007-08 Budget	1.00	2.00	3.00
2007-08 MYEFO	1.00	1.50	2.50

2. ANALYSIS

The CBA was introduced to compensate for the tendency of estimates of existing programs to be understated in the forward years. This tendency, which was based on past trends, was for the growth in program estimates to be understated due to factors that were specific to individual programs, particularly changes in the demand. The CBA was intended to compensate for likely upward revisions in program estimates for these program specific reasons but not for variations due to changes in economic parameters, as the published forward estimates are explicitly based on existing economic parameters.

Changes in program estimates due to program specific factors are recorded in CBMS as “program specific parameter” variations. Traditionally, the appropriateness of the size of the CBA has been assessed by analysing these program specific parameter variations between the publication of estimates as the third forward estimates year (FE3) and when those estimates become the budget estimates three years later. The CBA mechanism is working as intended if the upward revision to the estimates over that three year period largely tracks the progressive drawdown of the CBA.

The total program specific estimates variations for each estimates year are shown as a percentage of total expenses in Table 3. This table allows a direct comparison with the percentages used to calculate the CBA as it shows the program specific estimates variations between, for example, the publication of the estimates for FE3 and the publication of the subsequent budget estimates. It indicates that for 2002-03 and 2003-04 the CBA drawdowns were broadly offset by upwards variations due to program specific parameter movements. From 2004-05, this pattern appears to begin to break down and from 2005-06 aggregate program specific estimates variations were downward rather than upward as assumed in the CBA. If this trend becomes permanent, then the existence of the CBA would not fulfil its objective of improving the accuracy of the forward estimates.

Table 3: Program specific parameter variations as a percentage of total expenses

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
FE3 to Budget	3.9%	3.3%	1.2%	-0.6%	-1.7%	-2.4%	-2.7%	-2.0%	-0.6%
FE2 to Budget	2.7%	1.2%	-0.3%	-0.8%	-1.3%	-2.0%	-1.8%	-0.8%	
FE1 to Budget	1.0%	0.0%	-0.5%	-0.3%	-0.9%	-1.0%	-0.6%		

A key limitation in using this traditional analysis as the basis for determining the settings for the CBA is that it relies on the accuracy of the aggregate data for program specific estimates variations, and an analysis of the data indicates that there are some deficiencies in this area. In particular, the Australian Taxation Office and the Department of Veterans’ Affairs have not been using the program specific reason code in making changes to their administered programs in the past few years. Other key agencies do not use the program specific parameter reason code consistently and occasionally make large adjustments using the “other variations” reason code.

In the light of these classification issues, there is a case for including some of these “other estimates variations” in the analysis of the CBA. This analysis requires manual examination of the data as it is necessary to exclude those material “other estimates variations” that are made for reasons that are correctly classified as “other”, such as contingency reserve entries that may be subsequently offset by government decisions.

Table 4 totals variations classified as “program specific parameter” as well as those variations classified as “other” that, on review, should more be appropriately classified as “program specific parameter”.

Table 4: Program specific parameter variations and selected other variations as a percentage of total expenses

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
FE3 to Budget	5.3%	4.5%	4.4%	2.1%	0.7%	-0.5%	-2.4%	-2.1%	-0.9%
FE2 to Budget	4.1%	3.0%	1.1%	1.4%	1.1%	-1.5%	-2.0%	-0.9%	
FE1 to Budget	2.6%	0.2%	0.4%	1.5%	0.0%	-1.0%	-0.7%		

Unlike the earlier and traditional analysis of the CBA, this shows that the change in the behaviour of program specific parameters occur later (2007-08 as opposed to 2005-06) and is not as large as might be suggested by considering program specific parameter changes alone.

In attempting to explain the change in behaviour of the direction of the program specific parameter changes, it is important to take account of a number of one-off issues that have affected the estimates in recent years. In the main, these are changes resulting from Welfare-to-Work. This was a large and complex package announced in the 2005-06 Budget with estimates that, combined with the strong economic environment, overstated its income support related costs. From 2007-08 onwards there have been several large reductions in estimates (captured through program specific parameter adjustments) as a result of a review of the costs of the Welfare to Work package.

These changes are likely to be one-off and should therefore be excluded to give a more accurate picture of likely future trends in program specific parameter changes. These changes have been excluded from the analysis in Table 5 below.

Table 5: Program specific parameter variations, excluding changes related to Welfare to Work adjustments and selected other variations as a percentage of total expenses

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
FE3 to Budget	5.3%	4.5%	4.4%	2.1%	0.7%	-0.1%	-1.2%	-0.8%	-0.1%
FE2 to Budget	4.1%	3.0%	1.1%	1.4%	1.1%	-1.2%	-0.9%	-0.1%	
FE1 to Budget	2.6%	0.2%	0.4%	1.5%	0.0%	-0.6%	-0.2%		

Removing the effects of the Welfare to Work estimates changes show that the change in the behaviour of program specific parameter adjustments still occurs in 2007-08 and 2008-09, but it is smaller than previously thought and the size of the reductions is falling in the forward estimates.

While the reasons for the change in the behaviour of program specific adjustments cannot be stated with certainty, the last few years have been characterised by a period of strong economic growth (experienced through strong growth in wages, employment and asset prices). A large part of the effects of economic growth on outlays is captured in the forward estimates through general parameter changes (such as changes in the forecast level of unemployment). However, some of the effects are also captured in program specific parameters. These range from growth in wages that may lead to a reduction in the number of people eligible for Family Tax Benefit to the effects of asset growth reducing eligibility for income support. These factors will tend to lead to lower increases in program specific parameter changes in a time of very strong and sustained economic growth. Conversely, however, they will tend to increase the size of upwards variations in program specific parameters should the economy turn down. Given the current uncertainties surrounding the economic environment, such changes cannot be ruled out in the immediate future.

Finance also made a concerted effort since mid 2006 to have agencies thoroughly revise their expense estimates, and this has resulted in a number of other downward revisions being made to programme estimates. Now having “squeezed down” the estimates, there is a possibility that a more typical long term pattern of upwards programme specific parameter variations may return.

3. CONCLUSIONS

The experience of the past two years suggests that the CBA may be set too high. Since 2006-07, there have been consistent program specific parameter related downward revisions to the estimates of multiple financial years over the budget cycle, whereas the CBA allows for an increase in program specific parameter variations in the forward estimates.

However, it would also be inadvisable to place too much emphasis on recent experience because there have been a number of specific factors that have led to a reduction in estimates and such reductions are likely to be one-off.

There may also be signs that the recent downward adjustments to PSPs are coming to an end and the increasing uncertainty of the economic outlook may suggest that future changes in program specific parameters may act to increase the forward estimates.

It would therefore be prudent to take a cautious approach to reducing the CBA as the past tendency to underestimate future growth in program specific parameters may be returning.

There appears, nevertheless, to be strong grounds to reduce the CBA by ½ of a percentage point in FE3, FE2, and FE1. With this proposed CBA setting, it is estimated that the total expenses estimates would be reduced by around \$1.3 billion in the first forward estimate year and \$1.4 billion in the second and third forward estimate years.

4. RECOMMENDATION

That the conservative bias allowance be reduced to 0.5 per cent of expenses in forward estimate year one (2010-11 in the upcoming Budget), 1.0 per cent of expenses in forward estimate year two (2011-12) and 2.0 per cent of expenses in forward estimates year three (2012-13).

- In implementing this reduction, the conservative bias allowance would be drawn down to 0.5 per cent in 2009-10 (unchanged from the current scheduled drawdown), 1.0 per cent in 2010-11 (compared to the current 1.25 per cent), and 1.75 per cent in 2011-12 (compared to the current 2.0 per cent).

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