SUBMISSION TO SENATE SELECT COMMITTEE ON STATE GOVERNMENT FINANCIAL MANAGEMENT

REFERENCE: COMMONWEALTH AND STATE AND TERRITORY FISCAL RELATIONS AND STATE AND TERRITORY GOVERNMENT FINANCIAL MANAGEMENT

INTRODUCTION

The submission is based upon a discussion paper prepared by the NSW Shadow Treasurer and argues that there is an urgent need for greater accountability and transparency to assess the efficiency of revenue and spending by the NSW Government. The submission does not directly address the levels of Commonwealth funding to the State.

The sudden revelation that New South Wales requires extra baseload electricity capacity by 2013-14, and that the NSW Government cannot fund the investment without putting the State's AAA credit rating at risk, demonstrates the folly in relying on the current NSW Government's Budget, plans and reports to understand the true state of the NSW Budget sector. A new level of scrutiny and transparency of the NSW Budget sector is needed to assure the community that the NSW Government can meet future risks and challenges to the NSW Budget and economy.

The State Government's inability to manage and contain expenses growth, itself a contributor to inflationary pressures, has been noted by the ratings agencies and the Government's own audit.

The State's Budget Results, and the State's Rating, have consistently been sustained by unforseen windfall tax revenues – highlighting twin negatives of high taxes holding back economic growth and the susceptibility of the Budget to volatile tax revenues in times of economic downturn and by payments from the public trading enterprises.

The decision by the current NSW Government to greatly increase debt to fund the infrastructure backlog has exacerbated the threat to the State's operating position. By reversing a long policy of debt reduction, aimed at creating a fiscal "cushion" to respond to an economic downturn, the NSW Government has put additional pressure on the State's public trading enterprises at a time of uncertainty and shifted the burden of debt to utility consumers who face increased fees and charges to pay for the debt.

In addition to abandoning that debt policy, the current NSW Government has cast aside any pretence of Budget transparency, instead obstructing scrutiny, refusing to provide consistent financial information and engaging in budget adhockery in the context of wildly fluctuating forecasts and poor reporting.

Many risks and challenges face NSW such as drought, climate change, inflation and increased pressures on services owing to demographic change. Other unforeseen challenges are inevitable. What is not known is the current NSW Government's strategy to address these challenges.

The people of New South Wales are entitled to accountability, transparency and clear strategies from the Government of the day not only in relation to security of our supply of electricity but in respect of known and unknown risks and challenges facing our State. We are all entitled to know whether or not the Government of the day is managing the State in our best interests.

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1. BACKGROUND

The revelation that NSW will need new baseload generating capacity by 2013-14 is hardly surprising given the looming electricity supply crunch has been apparent for more than a decade. Yet the State's latest economic plan and the 2007-08 Budget[1] offer hardly a hint of the problem and neither the NSW Government's State Infrastructure Strategy[2] nor its State Plan offer a strategy for dealing with the problem.

Even more troubling is the fact that the NSW Budget sector cannot fund the investment, without putting the State's AAA credit rating at risk. Treasury modelling provided to the Owen Inquiry confirms this *"… with public sector provision of generation investment, total State net debt would exceed the levels that were reached in 1991"* [3] (when Moody's placed NSW on Credit Watch).

Standard & Poor's has also noted the risk to NSW's rating and pointed out the current State Government's fundamental weakness in economic management – its chronic inability to control expenses, itself a contributor to inflationary pressures:

> *"In the event that the government enters into substantially larger debt or fails to maintain its operating position in surplus, there may be downward pressure on the rating."* [4]

> *"NSW has regularly had difficulty with cost control with expenditure pressures largely in the areas of health and transport service provision and wages growth."* [5]

NSW Treasury's Mid Year Review[6] published in December 2007 confirmed the current State Government has slipped back into the pattern of out of control expenses growth. Expenses growth for 2007/08 is now projected to be 6.8% against the Budget forecast of 3.6%, consistent with the pattern of expenses growth since the late 1990's.

The Budget result has consistently been rescued by payments from Public Trading Enterprises (PTEs) and unforecast tax windfalls.

That the Government is continuing to rely on unforecast tax revenues to rescue the Budget Result was further confirmed in the Mid Year Review (State tax revenues up $993 million since the Budget forecasts).

The electricity issues bring into sharp focus NSW's exposures to large risky trading enterprises. The current State Government approach to management of the PTEs has been to plunder dividends and other payments, forcing PTEs to borrow instead of funding infrastructure. Reporting and accountability practices potentially distort the Total State position. A proper understanding of the PTEs depends on vigilance in spotting PTE Annual Reports, often at a significant time lapse from the Budget and other results.

[1] BP2, Section 5.3, BP4, 4-11.
[2] State Infrastructure Strategy, p. 41.
[3] Owen Report, p. 6 –23
[4] S&P's, NSW Credit Report, September 2007, p. 2.
[5] S&P's, NSW Credit Report, September 2007, p. 6.
[6] General Government Financial Statement for the six months ended 31 December 2007.

Table 1: General Government Total Expenses

	2003-04 Actual	2004-05 Actual	2005-06 Actual	2006-07 Revised	2007-08 Budget	2007-08 Mid-Year Review
In $ billions						
Employee-related	18.4	19.5	20.7	21.5	22.4	22.8
Maintenance & other operating	8.3	8.6	8.3	9.0	9.4	9.7
Grants and subsidies	7.1	7.3	8.3	10.0	9.1	9.6
Finance, Depreciation, Other	2.7	3.1	3.3	3.5	3.8	3.7
TOTAL EXPENSES	36.5	38.5	40.7	44.0	44.6	45.8
Growth rate (%)	6.5	5.5	5.7	8.2	1.3	
Growth rate (%) excluding $960 million Rail Grant in 2006-07	6.5	5.5	5.7	5.9	3.6	6.8 *

SOURCE: Budget Paper 2 2007-08, Budget Overview iii, 2007-08 Mid-Year Review except
** Expenses Budget 2006/07, $42.892 billion, Mid-Year Review 2007/08, $45,796 billion*

The NSW Government's response to the infrastructure rundown and services failure has been a massive increase in projected debt particularly in the PTEs, in breach of the Government's own legislated fiscal strategies. The result is that the NSW Budget no longer has a "cushion" in the event of a serious economic downturn, cannot fund the electricity investment without putting the AAA Rating at risk, and consumers are faced with significant increases in utility fees and charges to fund the extra debt.

Indeed, following warnings from commentators, the Mid Year Review indicates that the Government appears to have pared the growth of debt back somewhat, although it is unclear how much this is due to Government action or simply the extra tax revenues and delays in the infrastructure roll out.

The NSW economy and Government are facing very significant challenges and risks in the coming decades. There are risks from the very size of the NSW budget (the General Government Sector is projected to reach $51 billion revenues in 2010/11 plus $17.5 Billion in the PTEs), the risky industries NSW Government enterprises operate in (particularly the electricity companies), climate change and drought, the aging population and long-term demographic changes. And that says nothing about the potential impacts of any international crisis, possibly arising in the short-term as a result of the US economy weakening and the sub-prime loan crisis, the impacts on borrowing costs and investment returns on unfunded superannuation liabilities or inflationary pressures in Australia.

After nearly 13 years control of the Treasury benches, Labor in New South Wales takes the Budget process for granted and increasingly treats Parliament as a rubber stamp. This trend has accelerated under the current State Government which refuses to answer questions and has engaged in a new level of Budget adhockery. There have been huge transactions and variances in the current NSW Treasurer's budgets and the later State accounts with little or no explanation or commentary on the policy behind the decisions or their impacts on the Budget and economy. His first Budget forecast a deficit and was wildly wrong on revenues and expenditure. His second Budget is critically reliant on control of expenditure growth, particularly wages, however, as noted in Table 1 above, this appears to have already failed.

Taxpayers and the community in general are entitled to expect that the Government has a coherent and transparent economic policy and credible strategies for known risks and challenges. They are entitled to accountability and scrutiny.

This submission demonstrates that reliance upon the current NSW Government's published (even legislated) fiscal targets, forecasting and reports is a dubious proposition.

2. BUDGET AND FISCAL STRATEGY IN NSW SINCE 1995

Under Premier Carr and Treasurer Egan, the NSW Government set out its fiscal strategy, principles and targets in the *General Government Debt Elimination Act 1995* (*Debt Elimination Act)* soon after coming to power in 1995. The underlying strategy was to reduce debt in the General Government Sector ("GGS") (and ultimately eliminate GGS debt) while improving service delivery; with the objective of providing a safety cushion to be able to borrow in the event of a downturn rather than increasing taxes or reducing services.

By legislating, following a model used in New Zealand, various US States and Canadian Provinces and European nations, Premier Carr and Treasurer Egan were making a statement as to their priority on economic management and commitment to debt reduction in the GGS.

The political justification was that the legislation was a response to the debt left by the Greiner/Fahey Coalition Governments and NSW having been placed on Credit Watch. However the late 1980's and early 1990's had seen the State Government scandals of WA Inc., SA Inc. and in Victoria, together with the Keating "recession we had to have", which had all created conditions in the late 1980's and mid 1990's for debt reduction and a new focus on financial management.

Although this justification was used for more than a decade, few would seriously dispute in retrospect that the 1991 Credit Watch was the result of general economic conditions. Even the current NSW Government actually admits this, for example in the 2005-06 Budget Papers:

> *"…indeed in 1991 a **downturn in the economy** saw NSW placed on credit watch for a possible ratings downgrade. The State's high debt levels placed in jeopardy the government's ability to maintain steady growth in its service delivery in the face of cyclical fluctuations in revenue growth."* [7]

Indeed the Greiner/Fahey experience was the source of the underlying strategy adopted by the succeeding Government: that is, ensure a strong Budget position to allow for economic shocks.

However the Debt Elimination Act failed to impose another core discipline for Government – keeping expenses growth in check, particularly in relation to revenues. Instead expenses growth was linked to GSP growth – a recipe for difficulties which was finally recognised in the 2005-06 Budget:

> *"The need to constrain the growth in net cost of services and expenses is emphasised, with Fiscal Principle No. 2 in the Fiscal Responsibility Bill previously specified as Fiscal Principle No. 5 in the Debt Elimination Act, it has been amended to constrain expenditure growth at or below the long-run average growth in revenue rather than the growth in Gross State Product.*

[7] NSW 2005-06 BP2, 1-6.

This change emphasises the point that in the long-run a government's capacity to spend on a sustainable basis is limited by the revenues it recovers. Growth in Gross State Product does not always provide a good measure of the growth in revenue capacity". [8]

With the benefit of continuously improving economic circumstances and rising revenues, the Carr/Egan governments delivered cash surpluses to 2003-04 and reduced General Government Net Debt from $12.2 billion in 1995 (7.4% of Gross State Product "GSP") to $2.6 billion in 2003-04 (0.9% of GSP) in line with the target in the Debt Elimination Act.

However the GGS debt reduction was achieved principally on consistent unforecast tax windfalls as shown in Table 2. General Government Sector debt reduction was also achieved at the expense of investment in new infrastructure and maintenance of old infrastructure, by shifting debt to the PTEs and by raiding the PTEs for dividends and other payments. It was also accompanied by a growth in the bureaucracy, waste and mismanagement which, in turn, contributed to a core weakness in Labor's financial management: expenses were growing even faster than the tax revenues.

Table 2: Unforecast Tax Windfalls

Budget Year	Budgeted Revenue ($M)	Actual Revenue ($M)	Difference ($M)	% as overspend
1995-96	$10,745	$11,230	$485	4.51%
1996-97	$11,284	$12,286	$1,002	8.88%
1997-98	$12,912	$12,920	$8	0.06%
1998-99	$14,000	$14,137	$137	0.98%
1999-00	$13,945	$15,185	$1,240	8.89%
2000-01	$12,412	$13,343	$931	7.50%
2001-02	$12,084	$13,216	$1,132	9.37%
2002-03	$12,865	$14,154	$1,289	10.02%
2003-04	$14,198	$15,026	$828	5.83%
2004-05	$15,520	$15,332	-$188	-1.21%
2005-06	$16,269	$15,910	-$359	-2.21%
2006-07	$16,719	$17,775	$1,056	6.32%
Total	**$162,953**	**$170,514**	**$7,561**	**4.64%**

SOURCE: Each year's Budget Paper 2

[8] BP2, 1-22.

Stokes and Vertigan found in their audit:

> *"In each of the past nine years, actual expenses have exceeded budgeted expenses by at least $1 billion".*[9]

The following chart illustrates the point.

Table 3: Expenditure blowouts

Year	Budgeted Spending	Actual Spending	Overspent	% as overspend	budgeted % increase	actual % increase
1994/95	$20,252	$20,250	-$2	-0.01%		
1995/96	$21,686	$21,339	-$347	-1.60%	7.08%	5.38%
1996/97	$22,281	$23,386	$1,105	4.96%	2.74%	9.59%
1997/98	$23,816	$24,159	$343	1.44%	6.89%	3.31%
1998/99	$24,957	$28,255	$3,298	13.21%	4.79%	16.95%
1999/00	$27,495	$26,145	-$1,350	-4.91%	10.17%	-7.47%
2000/01	$29,205	$30,534	$1,329	4.55%	6.22%	16.79%
2001/02	$30,696	$32,262	$1,566	5.10%	5.11%	5.66%
2002/03	$32,335	$34,277	$1,942	6.01%	5.34%	6.25%
2003/04	$34,912	$36,517	$1,605	4.60%	7.97%	6.53%
2004/05	$37,438	$38,506	$1,068	2.85%	7.24%	5.45%
2005/06	$40,557	$40,687	$130	0.32%	8.33%	5.66%
2006/07	$42,892	$43,946	$1,054	2.46%	5.76%	8.01%
Total	**$368,270**	**$380,013**	**$11,743**	**3.69%**	**6.41%**	**6.98%**

** includes $960 million grant to TIDC.*

The core strategy – debt reduction to provide a cushion in a downturn – was tested in 2003-04 when Treasurer Egan budgeted for just a $43 million surplus, *"… mainly from the expected slowdown in revenue growth."* [10]

Despite buoyant tax revenues, expenses were becoming a serious problem. By April 2004 Treasurer Egan was forced to a mini-budget introducing the disastrous vendor duty and abolishing the land tax thresholds to pay for public sector pay rises. Instead of following the core strategy and borrowing from the "cushion" created by their debt reduction policy, when the crunch occurred, Carr and Egan's first action was to increase taxes.

Treasurer Egan retired and, his successor, Treasurer Refshauge produced his 2005-06 Budget. However before retiring Treasurer Egan pronounced the success of the debt reduction strategy (in the face of mounting criticism that infrastructure was crumbling and arguments that an injection of debt would be necessary to fund a catch up). Treasurer Egan also announced the replacement of the Debt Elimination Act and a change in reporting the Budget result from net lending result to operating result (which immediately changed deficits into surpluses).

[9] Stokes & Vertigan, February 2006, p. 20.
[10] 2003-04 BP2ii, pp. 1, 7.

Premier Iemma's first act as Premier and Treasurer was to initiate the audit of State finances. Messrs Stokes and Vertigan found that:

> *"The financial challenge is defined primarily by the prevailing growth rates in budget revenue and expenses. The underlying growth rates, reflecting trends that have emerged in recent years, are 5% per annum growth in budget revenues and 6% per annum growth in expenses."* [11]

The mounting electoral pressures brought about by the decline in services and lack of infrastructure investment together with the spiral of the Budget into deficit in 2005-06 saw Premier Iemma and Treasurer Costa respond by embarking on massive infrastructure spending significantly financed by borrowing, particularly in the PTEs. This change of Government leadership heralded a switch to short term political decisions in fiscal policy. The vendor tax was abolished and land tax thresholds returned.

3. NSW GOVERNMENT DEBT POLICIES vs LEGISLATED TARGETS

For 11 years, the NSW Government's debt strategy had been clear – it was enshrined in legislation, first the *Debt Elimination Act*, then from 2005, the *Fiscal Responsibility Act* (FRA). The FRA is still law, but under Premier Iemma and Treasurer Costa it is ignored in favour of the current NSW Government's decision taken prior to the 2007 election to greatly increase debt to fund the State's infrastructure backlog.

The NSW Government's Legislated debt strategy and targets were said to be set in the context of a broader strategy:

> *"to strengthen the State's balance sheet by reducing general government sector net debt and other financial liabilities to sustainable levels. Once this is achieved, in the event of a recession or major cyclical downturn in revenue, the government could meet the revenue shortfall by borrowing, thereby allowing the balance sheet to temporarily absorb the impact rather than having to reduce service delivery."* [12]

Treasurer Costa's 2007-08 Budget repeats the broad strategy in these terms:

> *"The objective of the government medium-term fiscal strategy is to maintain service delivery notwithstanding economic and fiscal shocks."* [13]

However, the Carr/Egan certainties about debt dissolved when the new leadership had to face up to the electoral consequences of the run-down in infrastructure and services and the Budget expense crisis in 2005-06.

With the budget in May 2005, Treasurer Refshauge introduced the promised *Fiscal Responsibility Act* replacing the *Debt Elimination Act* and removing the *Debt Elimination Act's* goal *"to eliminate net debt for the general government sector by 30 June 2020"*, as it was now generally accepted as sound that governments should have some level of borrowing.

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[11] Stokes & Vertigan, February 2006, p. 2.
[12] NSW 2005-06 BP2, 1-6.
[13] NSW 2007-08 BP2, 1-2.

The *Debt Elimination Act* principle *"to reduce general government net debt to a sustainable level by 30 June, 2005"* was declared satisfied, with general government net debt as a proportion of GSP at 0.8%. This was said to be a sustainable level.

Just to highlight and reaffirm the point, the 2005 Budget Papers in their discussion of State Sector Net Debt state:

> *"in recent years the strategy has been to reduce net debt in this sector to a sustainable level. This was achieved in 2004-05. Future Budgets are being planned to maintain net debt at or below the same level as a proportion of GSP."* [14]

> *"Future Budgets are forecast to maintain this low gearing ratio in the general government sector."* [15]

The FRA included as key elements of the State's Fiscal Strategy:

- General government net financial liabilities at or below 7.5% of GSP by June 2010 and 6% by June 2015;
- General government sector net debt as a share of GSP at or below the June 2005 level (0.8%); and
- 4 year average annual growth in net cost of services and expenses at or below the long-term average revenue growth.

As a result of the current NSW Government's infrastructure/debt package contained in the State Infrastructure Strategy and their 2007 election strategy plus continuing expenses growth the legislated targets have been breached. None of the key targets was projected to be achieved in the 2007-08 Budget, although the net financial liabilities goal was projected to be achieved by 2011 (one year late).

Standard & Poor's commented in its September 2007 Credit Report:

> *"although maintaining the Budget in surplus, the government has failed to achieve 3 key elements of its Fiscal Strategy. This represents a weakening commitment to the Fiscal Strategy and reduces the extent to which this Strategy supports the State's credit quality."* [16]

> *"It is a weakness that the State forecast an accrual operating deficit in its previous Budget and is not fully meeting its fiscal targets."* [17]

Treasurer Costa's first Budget in 2006-07 anticipated breaching the FRA targets, however, in the spirit of the legislation the Budget papers did make an argument that the breach would be temporary and that there would be a return to the targets. Treasurer Costa's 2007-08 Budget drops any pretence that the breach of the targets is temporary. Following Opposition questioning, the Mid Year Review in December 2007 sought to address the breaches, although hardly convincingly:

[14] NSW 2005-06 BP2, 4-12.
[15] NSW 2005-06 BP2, 4-14.
[16] S&P's, NSW Credit Report, September 2007, p. 5.
[17] S&P's, NSW Credit Report, September 2007, p. 2.

"Although net debt will be higher than the 0.8% target, it is being reduced and is expected to stabilise at 1.5% of GSP. Stabilisation of net debt at this level is consistent with the intent of the fiscal strategy as long as the more important target of reducing net financial liabilities remains on track … That is from 8.1% of GSP in June 2008, net financial liabilities will decline to 7.6%. Net financial liabilities will therefore be marginally higher than the 2010 fiscal target of 7.5%." [18]

Although the FRA does not carry any sanctions or penalties for failure to comply with the Government's debt targets, as Standard & Poor's have noted, the breach is a risk for the State's AAA Rating, and the breaches cannot be justified as temporary or for the purposes of evening out Budget results when there are pressures on revenues. The other important question arising from the breaches goes to the credibility of a Government, Premier and Treasurer who cannot comply with their own legislated fiscal targets.

The FRA does not tell the whole story. It only applies to the GGS not to the PTE sector. This is discussed further in the next section.

It should be noted that a difficulty with the FRA is that its targets are expressed in terms of GSP. There is a problem in setting targets against GSP, as the GSP figure for the Budget estimates period relies upon NSW Treasury's own forecasts and neither the GSP figure nor the method for its calculation is published. In effect, the target setter also sets the measure.

As Treasury's forecast numbers for GSP are not made public, the reliability of any claimed compliance or the extent of any breach of the FRA cannot be adequately tested.

The failure of the current NSW Government to meet its own legislated fiscal strategy and targets is a weakness in its economic management credentials.

4. THE PTE SECTOR AND DEBT

The NSW Government has used the PTE Sector to save the Budget result and to shift debt from the GGS.

Over almost 13 years, the NSW Government has randomly extracted dividends, tax equivalents, capital repayments and loan guarantee fees from the PTEs without any explicit strategy or explanation. Table 4 shows total payments by PTEs to 2006/07 of over $18 billion.

The absence of any explicit PTE debt strategy has meant that the Government was able to shift debt to the PTE sector, thus improving the general government ratios but also potentially exposing the State to greater risk and effectively adding to the tax burdens of consumers who pay the interest on PTE debt.

[18] General Government Financial Statement for the six months ended 31 December 2007 (Mid Year Review), p. 8.

Table 4: Dividends etc to the NSW Government from PTEs since 1995

	$M DIVIDENDS	$M TAXES	$M OTHER	$M TOTAL	$M INTEREST
1995-96 Revised	918.7	360.3	42.0	1,321.0	
1996-97 Revised	873.5	582.0	179.0	1,634.5	
1997-98 Actual	1,023.0	599.0	183.0	1,805.0	865.0
1998-99 Actual	941.0	427.0	75.0	1,443.0	790.0
1999-00 Actual	907.0	298.0	94.0	1,299.0	692.0
2000-01 Actual	717.0	506.0	9.0	1,232.0	825.0
2001-02 Actual	626.0	602.0	0.0	1,228.0	813.0
2002-03 Actual	768.0	499.0		1,267.0	823
2003-04 Actual	1,028.0	586.0		1,614.0	787
2004-05 Actual	1,024.0	576.0		1,600.0	904
2005-06 Actual	1,225.0	611.0		1,836.0	832
2006-07 Revised	1,142.0	626.0		1,768.0	962
2007-08 Budget	1,145.0	619.0		1,764.0	1203
2008-09 FE	1,173.0	660.0		1,833.0	1457
2009-10 FE	1,315.0	656.0		1,971.0	1770
2010-11 FE	1,409.0	672.0		2,081.0	2071

SOURCE: Budget Papers 1995-2008

Indeed, the Government has been quite explicit in its policy to use debt in the PTE sector to cut GGS debt. For example, the 2005-06 Budget Papers record:

> *"The proceeds of those (Carr/Egan) budget surpluses, and the* ***regearing*** *of the public trading enterprise sector* ***(to commercial levels),*** *were used to reduce general government sector underlying net debt from $12.2 billion in 1995 (7.4% of GSP) to $2.6 billion in 2003-04 (0.9% of GSP)."* [19]

This begs the question, if the PTEs were regeared to commercial levels in 2005, how is the additional borrowing since to be categorised?

Based on figures in the 2007-08 Budget, PTE sector debt was projected to grow from 96.4% to 172.9% as a proportion of operating revenue from 2005 to 2011 or from around 4% of GSP to 7.8% as outlined in Table 5 below.

Whilst this submission does not argue against debt in the PTE sector the absence of any coherent overall strategy for the State is a weakness in transparency and accountability.

[19] NSW 2005-06 BP2, 1-7.

Table 5: NSW Government PTE Sector Debt

	ACTUAL		REVISED	FORECAST			
Year ended June 30	2005	2006	2007	2008	2009	2010	2011
Operating revenue ($M)	13,535	14,434	15,894	15,220	16,282	17,538	19,095
Net Debt ($M)	13,051	13,802	15,706	20,785	25,388	29417	33,010
Net Debt/Operating Revenue	96.4	95.6	98.8	136.6	155.9	167.7	172.9

Source: 2007-08 Budget Paper 2, pp. 9-12, 9-13, 9-18, 9-19.

Standard & Poor's have commented in their 2007 Report:

> *"NSW's operating performance is largely comparable to Victoria but given the large PTE spending the State's performance after capital spending tends to be weaker than Victoria when considering both the Public Trading Enterprises and the core government."* [20]

> *"While increased debt costs in the PTE sector are expected to be met by growing revenues, we believe the funds generated by the State's PTEs are subject to greater risk than funds generated by the general government sector. Given this, the credit quality of the consolidated group is weakened."*[21]

Treasury Secretary, John Pierce, at a recent Estimates hearing noted that the PTE debt is ultimately the State's risk anyway:

> *"**The Hon. Greg Pearce:** So basically the State is guaranteeing the PTE and therefore the State is taking the risk.*
> ***Mr John Pierce (Treasury Secretary):** Yes. If you got the situation where a public trading enterprise defaulted then the liability will rest with the State."* [22]

The strategy of shifting debt into the PTEs deserves renewed scrutiny.

5. BUDGET ANOMALIES & PRACTICES

The NSW Government's almost 13 years of expenses blowouts, high anti-competitive taxes, debt policy switches and infrastructure and services decline have been accompanied by a deterioration in Budget transparency and accountability and the reduction of Parliament's role to a virtual rubber stamp.

Whilst the Budget papers and State Accounts contain considerable material, transparency and accountability have been weakened by the State Government's Budget processes and financial management in several respects, including:

- reporting of Budget information is inconsistent and routinely changed to suit political exigencies;

[20] S&P's, NSW Credit Report, September 2007, p. 3.
[21] S&P's, NSW Credit Report, September 2007, p. 6.
[22] Estimates 26.10.2007, p. 46.

- billion dollar transactions are routine without adequate explanation;
- millions of dollars are switched between programs or paid without prior appropriations or explanation as to the variances;
- debate on the Budget and its management and results is perfunctory, the Budget Estimates process has been emasculated with late night hearings, failure to provide answers to questions, and the Public Accounts Committee, controlled by the Government, has virtually ceased to function as to serious scrutiny; and
- the treatment of the PTEs.

These are serious weaknesses in transparency and accountability, especially when considering the significant fluctuations and variations in forecasts and results, which have reached a new level under the current Government, as shown in Table 6.

Table 6: Projections versus Actuals

	Projected in Budget June 2006-07	**Projected in Half-yearly Budget Review 2006-07**	**Actual 2006-07**	**Projected in Budget time June 2007-08**	**Projected in Half-yearly Budget Review 2007-08**
Budget result	-696m	-497m	584	376	506
Revenue	42,196m	42,801m	44,530m	44,994m	46,302m
Total expenses	42,892m	43,298m	43,946m	44,618m	45,796m
Net financial liabilities -% of GSP	29,044m 8.6% of GSP	29,008m 8.7% of GSP	26,157m	28,439m 8.0% of GSP	28,890m 8.1% of GSP
Net debt -% of GSP	6,190m 1.8% of GSP	3,981m 1.2% of GSP	3,234m	5,354m 1.5% of GSP	4.837m 1.4% of GSP
Capital expenditure	4,387m	4,575m	4,286m	4,937m	4,849m
State final demand	2.5%	1.5%	2.2%	3.5%	4%
Gross state product	2.5%	1.5%	1.8%	2.5%	2.75%
Employment	1.25%	1.25%	1.8%	1.5%	2%
Unemployment	5.25%	5.25%	5%	5%	4.25%
Sydney CPI	2.75%	3%	2.7%	2.5%	2.25%

SOURCE: Budget Papers 2006-2008

Two continuing trends in the mis-forecasts are the windfall tax revenues and the continuing blowouts in expenses above budget targets. The 2006/07 expenses increase target of 5.7% blew out to 5.9% and the 2007/08 target of 3.6% has already blown out to 6.8%.

Indeed, when tested on provision of core public services (such as provision of health, education, police services etc) utilising core Government revenues from the tax base, the current NSW Government has consistently operated a cash deficit and has relied on funds derived from its PTEs to rescue its financial position.

In the category of Budget information, perhaps the most audacious example of inconsistency was former Treasurer Egan switching the measure of the Budget result from the net lending result, to operating result, instantly reporting a surplus instead of deficit, in 2003-04. Under Treasurer Costa new depths have been plumbed in the quality and consistency of Budget reporting. A number of examples from the 2007 Budget are indicative:

- Program Statements were not included (BP3) when the 2007-08 budget was announced in June. The explanation that this information was not included because of the 2007 State Election and portfolio restructuring does not hold. By contrast, there was no such difficulty including the Program Statements after the 2003 Election in the Budget for 2003-04.

- Information which ought to be disclosed in Budget Paper 4 in relation to capital expenditure has been routinely excluded, based on a contention that excluded matters are commercially confidential, including:

    (i) the competitive Government Sector (which includes the electricity assets) where the total expenditure of $2.944 billion was left without any explanation whatsoever, even as to the identification of projects.[23] The lack of information extends even to projects which have been let subsequent to public tender processes and

    (ii) somewhat bizarrely, the Roads & Traffic Authority has ceased to include start date for projects.[24]

Billion dollar transactions and variations are routine with little explanation.

For example the 2007-08 Budget disclosed a "grant " of $960 million to the Transport Infrastructure Development Corporation (TIDC) in the 2006-07 year. This grant was not foreshadowed in either the 2006-07 Budget or the Mid-Year Review. Indeed the 2006-07 Budget forecast *"growth in Budget grants for capital for rail, almost doubling from $331 million in 2000-01 to $605 million in 2005-06"* [25] but *"a decline in grants for the Epping to Chatswood Rail Line (from $152 million in 2006-07 to $18.9 million in 2007-08)."* [26]

This grant virtually matched the unforecast transfer duty receipts for 2006-07 reported in the 2007-08 Budget.

Another example of multi- billion dollar shifts was the forecast in the 2006-07 Budget Papers of borrowings of approximately $2.2 billion, much of which was to be paid to reduce superannuation liabilities. Instead, some $7.175 billion detailed in the cash flow statement for the Liability Management Ministerial Corporation was transferred to the superannuation trustees, apparently late in the year.

Why did the Government accumulate $7.175 billion in the General Government Liability Management Fund (GGLMF)? The Budget Papers say that the accumulation of funds in the GGLMF was to allow flexibility in the timing of superannuation contributions to the public sector defined

[23] BP4, 5-92.
[24] See BP4, 5-56.
[25] 2006-07 BP 2, 2-12.
[26] 2006-07 BP 2, 2-19.

benefits schemes and to optimise the manner in which the Government achieves the fiscal targets of eliminating net debt by 2020 and fully funding superannuation liabilities by 2030.[27]

The question is particularly relevant as the funds in GGLMF were invested in fixed interest securities for a number of years, at times when the superannuation trustees were earning 15-20% return on funds.

Under Treasurer Egan, the *Public Finance and Audit Act 1983* was amended to allow agencies to swap funds between programs during a year. Whilst each agency is required to produce a Results and Services Plan, the financial measures and results are often not made public and there is no explanation or scrutiny of agency spending shifts.

Shifting of funds has extended to another surprising example, the Crown Finance Entity, which was established to deal with general government sector expenditures which are not the subject of a specific departmental or agency appropriation.

The Auditor General has highlighted transfers from the Crown Finance Entity, to fund a range of expenditures including a grandstand at Energy Australia Stadium, Newcastle and extra inmate costs, which ought to have been funded by agencies.[28]

In the category of by-passing the Parliament, the Treasurer's Advance is regularly used to fund items which ought to have been funded from agency budgets. For example, more than 70 items of expenditure, totalling nearly $400 million were included in the Appropriation Act 2007 related to expenditure in 2005-06. They included expenditures such as the $2.5 million for advertising by the Premier's Department, $1.083 million for the appointment of a private sector partner to manage the Police Property Portfolio and $3.8 million for additional construction at the Western Sydney Dragway. These items were appropriated 12 months after the close of the relevant Financial Year, well after the audited Statement of Budget Result was released.

The blatantly political use of these procedures is demonstrated in relation to the $25 million payment in compensation for the Government's election motivated revision of the timetable for transitional arrangements following the opening of the Lane Cove Tunnel which was only accounted for by the Government as a Treasurer's Advance in June 2007.

These payments are supposed to be justified under of the *Public Finance & Audit Act 1983* as to "exigencies of government" which could not be reasonably anticipated in the Budget. However, the question arises as to whether the payments for 2005-06 authorised in the 2007 Act and payments which appear to be regular agency outlays in fact are justified or whether they reflect sloppy or other mismanagement.

All of these practices mitigate against transparent and accountable use of public funds whether provided by the Commonwealth or from State taxes and revenues.

6. RISKS TO THE NSW ECONOMY/BUDGET

The NSW economy and Budget face a number of known and unknown risks and challenges. Foremost amongst known risks and challenges are those associated with ageing and demographic

[27] See 2004-05 BP 3, 22-18, 2005-06 BP 3, 22-21 and 2006-07 BP 3, 22-14.
[28] Auditor General Report Vol 3, 2007 pp. 22-23.

change and their impact on services and expenses - where the NSW Government's record since 1995 is poor.

The Stokes Vertigan Audit summarised the issues as follows:

> *"New South Wales is currently entering the largest demographic change in the State's history. This change will have repercussions for the State's finances. Past declines in the fertility rate, increases in life expectancy and the baby-boomers reaching retirement age will mean that for the first time in the State, growth in the working age population will slow to below population growth. This will mean slower State GSP growth and perhaps slower State revenue growth. However, the main fiscal impact of this so called "aging of the population" is likely to be felt on the expenses side, especially in health services. In 2004, 55,000 people in NSW turned 65. The Australian Bureau of Statistics estimates that in 2012, 80,000 will turn 65. In the next twenty years, the number of people in NSW aged 65 or over will increase from 900,000 to 1,600,000."*[29]

The "Fiscal Gap" as a result of these trends was noted in the 2006-07 Budget as around 3.4% of the GSP over the 40year horizon to 2043/44 or around $23 billion in 2006.07 dollars.[30] The 2007.08 Budget measures make the situation worse, projecting an addition of 0.1% to the fiscal gap – 3.5% of GSP.[31] Noting the issue is not enough - where is the current State Government's strategy to address the issues? These matters impact on future investment capacity.

NSW is particularly vulnerable to slowdowns in the economy because of the Government's heavy reliance on transaction related taxes (exacerbated by its policies which have stalled the new home market) and the susceptibility of NSW export base to currency fluctuations. Commonwealth sourced revenue may not be so susceptible to fluctuation.

The current credit crisis flowing from the sub-prime debacle poses risks as NSW embarks upon its $20 billion debt program as well as risks to investment revenues and unfunded superannuation. Inflation driven by a wages blow-out (where the NSW Government is leading the way) poses further risks.

Further long-term financial pressures are likely to impact on the NSW Budget due to climate change and the measures required to meet the proposed Australian carbon trading scheme (a significant issue in the current electricity debate).

The long-term financial liabilities associated with NSW PTEs and infrastructure are also unclear or unknown.

In summary, the NSW Budget already faces stress including from the structural problems associated with its revenue sources and commitment to high expenses.

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[29] Stokes & Vertigan, February 2006, p. 2.
[30] 2006/07 BP6, vi.
[31] 2007/08 BP2, 1-16.

7. OPTIONS FOR REFORM

It is clear that the NSW Government's legislated fiscal targets as set out in the FRA no longer determine Government policy and that the shifting of debt to the PTEs is a threat to infrastructure renewal and service delivery. Budget practices raise questions as to performance in managing agency allocations and implementing savings and reform strategies.

The current approach to reporting and accountability raises serious questions as to the Government's capacity to deal with known risks and challenges, such as its PTE investment in electricity, and unknown risks, including the international economic situation.

Options for an improved level of scrutiny and transparency might include:

1 The Government should publish its strategy or plans to address the Fiscal Gap and the associated challenges arising from the ageing population and demographic change and report progress in each Budget and Mid Year Review.

2 The Treasurer should be required to make a statement to Parliament within 60 days explaining Budget variations of a certain level and the redirection of surplus funds from one purpose or program to another where the sum exceeds, say, $10 million.

3 The Government should revise and publish its debt strategy for the short, medium and long-term including a full explanation of the PTE debt strategy and the implications for the Total State Sector Budget and NSW economy and report progress and any variation in subsequent Budgets and Mid Year Reviews.

4 The NSW Government or the Parliament (in the event the Government is unwilling to do so) should formally request that the annual ratings reviews performed by the Ratings Agencies be expanded to encompass commentary on the position of NSW's PTEs as well as the general government sector. The Ratings Agencies should be encouraged to break-down the figures on the PTE sector and show how State Government policies impact in the sector from year to year.

8. CONCLUSION

The community is entitled to an assurance that the Government is prudently and competently managing the Budget sector and that the Budget and the Government's fiscal strategy provide the margin to deal with unexpected shocks and the expected and known longer term fiscal problems. However, the level of transparency and accountability currently prevailing cannot provide this assurance.

The NSW Governments' principal sources of revenue are from the Commonwealth, NSW's own tax base and the NSW PTE's. The effectiveness and efficiency of the NSW Government in managing its financial resources is impacted by its Budget and reporting practices and the use of PTE revenues and debt.

This paper has exposed a number of those shortcomings and practices. Taxpayers and the community are entitled to transparent and accountable financial management and to be confident that the government of the day has a full grasp of upcoming financial risks and challenges. Part of that assurance should be proper and adequate disclosure by the Government of its assessment of the risks and problems and also its plan to address those risks and challenges.

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