Submission
No 3

INQUIRY INTO DEBT RETIREMENT FUND

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Submission - Debt Retirement Fund inquiry

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Introduction

This submission draws extensively on a report I prepared in 2021 for Coolabah Capital Investments, *An Assessment of Public Policy Implications of Decisions in relation to the NSW Generations Fund and NSW Government Debt*. That report is available online at https://coolabahcapital.com/wp-content/uploads/2021/08/Report-Dr-Stephen-Bartos-NGF-2021.pdf.

This submission includes material from that report, reproduced with the kind permission of Coolabah Investments, to address the terms of reference of the inquiry into the NSW Debt Retirement Fund (DRF). I would reiterate the disclaimer made in that report that it did not constitute legal advice and does not purport to address legal issues.

ToR 1

The first of the inquiry terms of reference asks what the longer-term purpose of the DRF is, considering the State's fiscal outlook, including:

> (i) factors that should be considered when determining the DRF's optimal size
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> (ii) the appropriate thresholds for further contributions to the DRF, and
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> (iii) the appropriate thresholds for retiring debt using funds from the DRF

At present, according to the NSW Generations Funds 2021-22 Fact Sheet, the purpose of the Debt Retirement Fund (DRF) "is to provide funding for reducing the debt of the State in accordance with the principles of sound financial management set out in section 7 of the *Fiscal Responsibility Act* (2012)".

In a situation where the NSW government raises additional debt to invest in the Debt Retirement Fund (DRF) there appears to be an obvious conflict between the stated purpose and actual practice. As noted in my 2021 report:

> "Past contributions to the DRF have primarily come from NSW reserves and the proceeds of the sale of 51% of WestConnex. Raising more debt than is required to meet the NSW budget deficit financing requirement appears to be in conflict with the intended purpose of the DRF to reduce the State's debt."
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> "When the NSW Treasurer established the Debt Retirement Fund (DRF) he said it would "offset debt and insure against the $17 billion fiscal gap forecast by 2056. Securing our State's finances today—and into the future." (Legislative Assembly Hansard – 19 June 2018).
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> The 2018-19 Budget papers also provide information on the purpose of the Fund:

[1] I was the PBO for NSW between September 2022 and June 2023. This submission however is provided in a personal capacity and does not represent an official PBO position. It is based on publicly available information and does not draw on any information or advice provided confidentially to the NSW PBO.

> With the State's balance sheet in a position of unprecedented strength, the Government will seed the NGF with $3 billion sourced from balance sheet reserves and ensure these funds can only be used for debt retirement. Over time, growth in the NGF – from investment earnings and future contributions – will help the Government to maintain sustainable debt levels consistent with a triple-A credit rating. (2018-19 NSW Budget, p 1-2)

Reducing budgetary risk was not referred to in the second reading speech or the 2018-19 Budget papers, but can be inferred from fund's enabling legislation, the *NSW Generations Fund Act 2018*. Under that Act (s.8) the purpose of the Debt Retirement Fund is "to provide funding for reducing the debt of the State in accordance with the principles of sound financial management set out in section 7 of the Fiscal Responsibility Act 2012." Section 7 of the Fiscal Responsibility Act 2012 sets out three principles for sound financial management:

• responsible and sustainable spending, taxation and infrastructure investment,

• effective financial and asset management, and

• achieving intergenerational equity.

Of particular note is a requirement for risk management practices (s.7(3)(d)) and that policy decisions are made having regard to their financial effects on future generations (s.7(4)(a)).

Taking on debt to invest in equities is inherently high risk for any entity, including a government agency. There is no guarantee that the return on investment from equities will always be higher than the cost of debt. Because both interest rates and share prices are subject to high volatility the risks involved in this kind of strategy can compound - for example, if interest rates were to rise at the same time as share values fell, compelling an entity to refinance its debt at higher cost (assuming it could find willing lenders) and/or divest itself of shares at a disadvantageous time. …

It should be noted that as a general rule sovereign wealth funds globally do invest in equities, among other assets, as does the NGF. The difference is that typically sovereign wealth funds are established when governments have low debt or surplus cash, including gains from asset sales or budget surpluses. This indeed was the case when the NGF was established with an initial investment of $10bn comprising $7bn from the sale of 51% in WestConnex and $3bn from reserves. At the time of its establishment NSW was running a surplus budget and had prospects of additional unexpected revenue (so much so that the NFG legislation explicitly provides (s.9(2)) for the Treasurer to direct "windfall tax revenue" to the Debt Retirement Fund).

… a cautious approach to fiscal risk management would be to take on as little additional debt as possible and use the income from the NGF for its intended and legislated purpose of debt reduction.

In almost all instances observed internationally, sovereign wealth funds are established to manage a country's or state's excess revenues when the jurisdiction is running strong surpluses or has large gains from selling assets or natural resources. The sovereign wealth fund is in effect a "future proofing" strategy, storing funds to be applied to repayment of future debts if the jurisdiction finds itself in deficit. This is a more prudent long-term strategy than spending a surplus on immediate handouts. This was explicitly behind the establishment of the Commonwealth's Future Fund - then Treasurer Peter Costello did not

> want to see his budget surpluses frittered away on current spending and created the Future Fund as a mechanism to provide for meeting long term liabilities (Peter Costello, Budget Lockup Press Conference, 10 May 2005)."

Further guidance on the purposes of a sovereign wealth fund (SWF) such as the DRF can be obtained from a variety of well-respected international sources such as the International Monetary Fund. Of particular note is an IMF Working Paper of August 2009 titled *Setting up a Sovereign Wealth Fund: Some Policy and Operational Considerations* Prepared by Udaibir S. Das, Yinqiu Lu, Christian Mulder, and Amadou Sy (at https://www.imf.org/external/pubs/ft/wp/2009/wp09179.pdf accessed 15 July 2023). The working paper notes that

> The IMF broadly distinguishes five types of SWFs: (i) reserve investment corporations that aim to enhance returns on reserves (ii) pension-reserve funds; (iii) fiscal stabilization funds; (iv) fiscal savings funds; and (v) development funds that use returns to invest for development purposes.

As indicated by that IMF working paper, the purposes of a SWF are different in different country settings. In NSW the purpose of the DRF could be best characterised as a fiscal savings fund. In this context, using it to invest windfall budget gains (for example from unexpected royalty revenues or higher than expected returns from asset sales) would be an appropriate operational objective. Raising debt to invest in equities would not be a suitable purpose. By contrast, where in a developing country the primary purpose of a SWF is to address thin domestic equity markets and finance emerging private corporations, debt funding of the SWF might be consistent with its purpose (albeit involving considerable political and fiscal risk).

This is discussed further in my 2021 report:

> "While investment in equities is becoming increasingly common through sovereign wealth funds (SWFs) around the world, there are concerns about the potential negative impact of funds being financed by debt. It is not a practice seen in most developed country SWFs.
>
> A commonly advanced rationale for SWFs themselves to issue debt is to encourage development of a bond market in underdeveloped countries - see Lugo S, and Bertoni F, 'The Use of Debt by Sovereign Wealth Funds', *Oxford Handbook of Sovereign Wealth Funds*, at oxfordhandbooks.com viewed 30 June 2021.
>
> That situation does not apply in NSW, which benefits from a liquid domestic government bond market worth over $A1 trillion. The same authors also observe "use of debt is less common among SWFs from democratic countries, where it can entail higher political risk". "

It is also worth noting that since that earlier report the COVID-19 pandemic has had a considerable impact on the operations of SWFs.

> The roles that SWFs take on are diverse. Besides investing abroad to earn commercial returns, some SWFs are created as macro-stabilization "rainy day funds". In response to the financial crisis caused by the COVID-19 pandemic, several such funds were required to act as first-responders by their governments. López (2022) notes that a total of $211.3 billion had been withdrawn from 33 funds across 27 countries during the first 2 years of the pandemic. Five out of the 33 funds had over 50% of their funds withdrawn and three funds were exhausted completely – Mexico's FEIP, Colombia's FAEP, and Peru's FEF. SWFs also

> contributed $57 billion to bailouts of domestic industries, of which $19 billion was injected into airlines alone.[2]

ToR 2

The second term of reference asks what risks and opportunities, to the Budget or otherwise, the Government should consider with respect to the DRF.

One of the risks associated with the management of the DRF is how it affects the State's credit rating. My 2021 report noted that market participants at the time perceived

> "…that in effect NSW is raising more debt than it requires to meet its immediate deficit financing requirements, and applying the additional funds raised to the NGF. On the face of it, taking on more debt than needed, and then applying those monies to a debt reduction fund, appears contradictory…
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> What appears to be driving this approach is firstly the fact that the funds held by the NGF are classified as an offset to gross NSW government debt, and secondly, that buying equities (assuming this is the intention of further investments in the NGF) while the cost of debt is near record lows is apparently seen as a good trade for taxpayers. In the year to April 2021 the NGF achieved a return of 15.5% (Budget, Table 6.2, p6- 4), although it lost money in the 2020 financial year as equities performed poorly. While it might on the surface appear attractive for a government to borrow at low interest rates and gamble some, or all, of the proceeds on the stock market to earn higher returns, this approach entails high risk. It is quite common for equity markets to fall by 50% or more (as seen in 1987, 2001, and 2008-09); volatility is one of the defining characteristics of equities markets.
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> If the value of the NGF falls sharply, this will materially increase NSW's net debt given that the NGF is currently treated as an offset to NSW government gross debt in the NSW Budget and by the credit rating agencies. It will further raise questions about the ability to use the NGF to repay NSW debt, which could then increase the cost of NSW government debt. This could in turn threaten NSW's AA+ credit rating from ratings agency Standard and Poors, which was downgraded from AAA in December 2020 because of the large increase in gross government debt.
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> The *NSW Generations Fund Act 2018* stipulates that the DRF is to "provide funding for reducing the debt of the State in accordance with the principles of sound financial management set out in Section 7 of the Fiscal Responsibility Act 2012". The principles include references to risk management practices and require policy decisions to be made having regard to their financial effects on future generations…
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> A significant risk to governments is their overall level of indebtedness, or gross debt. The NSW 2021-22 Budget provides figures only on net debt - that is, gross debt less financial assets4 . Net debt is improving compared with previous forecasts. The Budget papers note: …net debt in June 2021 is projected to be $40.6 billion, an improvement of $4.8 billion since the 2020-21 Half-Yearly Review. This is being driven by an improved revenue outlook

[2] William L. Megginson, Asif I. Malik, and Xin Yue Zhou 2023 'Sovereign wealth funds in the post-pandemic era' *Journal of International Business Policy* (open source article at https://www.ncbi.nlm.nih.gov/pmc/articles/PMC10092925/#:~:text=In%20response%20to%20the%20financial,2%20years%20of%20the%20pandemic viewed 15 July 2023)

(reducing the State's borrowing requirements) and higher-than-expected performance of the State's investment funds, particularly the NGF. (Budget p.6-3)

Gross debt is however an important metric. Higher gross debt exposes a government to increased risk from movements in interest rates. Over the long term it is desirable to reduce both gross and net debt. The Commonwealth government's recently released 2021 Intergenerational Report (IGR) makes the observation "Gross debt is an important indicator of fiscal sustainability." (IGR, 28 June 2021, p.78).

In line with this observation, the Commonwealth IGR says: "A key focus of the Government's medium-term fiscal strategy is to grow the economy in order to stabilise and then reduce debt [ie gross debt] as a share of the economy." (IGR, p.79). A key word in that sentence is stabilise. Higher than needed levels of gross debt lead to greater instability in the face of interest rate movements, and therefore to a higher fiscal risk for the State. Levels of debt are already at a record high, not only in NSW but in every Australian jurisdiction, due to the economic impact of the COVID-19 pandemic. A strategy to reduce fiscal risk would involve lower rather than higher than levels of gross debt. Clearly while the State is in budget deficit it requires borrowing - but a prudent fiscal risk management strategy would be to avoid discretionary increases in new debt. This is particularly so if the increase in debt is applied to investments in equities, a strategy that could amplify fiscal risk in any major downturn.

…The risks associated with borrowing to purchase equities, discussed previously, affect not only the current fiscal position but also future generations. While it is impossible to predict peaks and troughs in share markets, severe downturns involving losses of 50% or more happen periodically (for example, in 1987, 2001, 2008-09) as do smaller yet still very significant falls. They are inevitable even if their timing cannot be predicted[3].

When a downturn happens, future generations will be more exposed to fiscal risk than they would have been had the NSW government not taken on additional borrowings to invest in the NGF.

…When S&P downgraded NSW from AAA to AA+ in December 2020 it commented: "The economic shock caused by the COVID-19 pandemic will see NSW lose billions of dollars in forecast revenue, while cushioning the economy through fiscal stimulus and a large infrastructure program. The state will post historically large operating and after-capital-account deficits this fiscal year. As a result, debt will rise sharply, even if prospective asset sales eventuate. We are consequently lowering our long-term issuer credit rating on NSW to 'AA+' from 'AAA'." Standard & Poor's, December 2020.

…A study by the Natural Resource Governance Institute[4] of a selection of international SWFs that reported publicly (at least half do not) found, not surprisingly, that higher returns correlated with higher volatility or risk of loss. Some funds with high returns also reported years where returns were zero or negative. This reinforces the dangers of debt financing for a SWF. Indeed, in 2020, the NGF itself lost money for NSW taxpayers, highlighting that the NGF can become a risk amplifier for the NSW budget."

[3] Stibel, J. (2009) 'Why We Can't Predict Financial Markets' *Harvard Business Review*, Harvard, Mass.
[4] Bauer, A (2018) 'How Good are Sovereign Wealth Funds at Investing money Made from Natural Resources', Natural Resource Governance Institute, at resourcegovernance.org viewed 29 June 2021

In summary, this discussion suggests that while NSW has a high level of net debt an effective risk management strategy, consistent with the principles of sound financial management set out in Section 7 of the *Fiscal Responsibility Act*, would be to reduce debt where possible rather than increase debt to enable further investments by the DRF. While historical experience indicates that higher returns can be achieved over the long term from equities, these come with risks that will have an unpredictable impact on future generations.

Finally, there are considerable political and public policy risks associated with public sector investments in equities. These have the potential to distort markets and provide an incentive for corrupt conduct. These are important for the committee to bear in mind.

Attachment A

Please see below a link to my 2021 report prepared for and published by Coolabah Capital Investments. If the committee is agreeable, I would request this report be included in full as an attachment to this submission.

https://coolabahcapital.com/wp-content/uploads/2021/08/Report-Dr-Stephen-Bartos-NGF-2021.pdf.