



PARLIAMENTARY BUDGET OFFICE

Analysis and Advice on the Details of the "Report on Variance between Mid Year (December 2010) and March 2011 Update" prepared for the NSW Premier and Treasurer by the acting Secretary to the NSW Treasury, Michael Lambert,

and

Analysis and Advice on Claims in the Associated Media Release of 27 April 2011, "Black Hole Blows Out Further" by the NSW Premier, The Hon Barry O'Farrell.

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Introduction

In an undated document, "Report on Variance between Mid Year (December 2010) and March 2011 Update", the acting Secretary to the NSW Treasury, Michael Lambert, provided advice to the NSW Premier, the Hon Barry O'Farrell, and Treasurer, Mr Michael Baird, on a "significant variation between mid year review budget and forward estimates position and [the position] advised to the incoming Government based on March information".

The report identified the sources of the variations in the estimates and it offered judgements as to whether the budget estimates and forward estimates published in the 2010-11 Half-Yearly Review and in the briefing provided in March to the incoming government were accurate and based on latest information.

On 27 April, 2011, the Premier issued a media release, "Black Hole Blows Out Further", which related to that report. The release included a number of claims made by the Premier and the NSW Treasurer on the former government's budgeting practices.

This briefing has been prepared at a request made on 28 April 2011 by a Member of the NSW Parliament, as provided for by Section 13 of the *Parliamentary Budget Officer Act 2010*. It provides advice and analysis of a technical nature on financial, fiscal and economic matters raised by the above-mentioned report and by the associated media release.

The Report

Variance in Budget Advice

The report shows that the budget outcome for 2010-11 and for the three subsequent years included in the 2010-11 Half-Yearly Review amounted to a surplus of \$904 million. The equivalent figure reported for the March briefing to the incoming government was a deficit of \$1,029 million. The variance between these two sets of estimates for the four years thus totals \$1,933 million, the figure reported by Mr Lambert. The total value of receipts and expenses for these four years (as recorded in the above-mentioned Half-Yearly Review) amounted to \$484,786 million. The variance is less than 40 basis points of that total (under 0.4 of a per cent).

This might under-estimate the variance because the figure of \$1,933 million appears not to reflect fully the influence of the "Rail Smoothing" which was introduced by the former government to shift spending on rail grants from future years, when surpluses were thought to be too low, to nearer financial years, when it was thought surpluses could better accommodate this spending. In the March briefing provided to the incoming government, Treasury eliminated these smoothing movements, in order, as Mr Lambert says, to provide the incoming government with "a more accurate picture of budget trends".

This modification seemingly made the budget results for the four years worse. It appears - the report is not totally clear - that the underlying budget outcomes for 2010-11 and the three subsequent years from the time of the 2010-11 Half-Yearly Review to the March briefing deteriorated from an underlying surplus of \$1,389 million to an underlying deficit of \$1,029 million. Still, this variance is \$2,418 million or under 50 basis points of total receipts and expenses.

The total budget and forward estimate figures for receipts and expenses reported in the Half-Yearly Review and the equivalent figures used to brief the incoming government in March were thus likely to have been within 99.5 per cent of each other.

The reported variance between the estimates for the budget outcome contained in the 2010-11 Budget and in the 2010-11 Half-Yearly Review was \$2,245 million. This was around the same size as the further variance between the Half-Yearly Review and the March briefing to the incoming government. Such changes are no surprise to budget practitioners who routinely see large swings in budget figures arising from updated economic statistics. They understand that a deficit or surplus is the small difference between two large figures, and that this difference can be (and often is) substantively changed by relatively minor movements in those figures, especially when movements are re-enforcing (for example, when reducing receipts occur simultaneously with increasing expenses).

Appropriateness of Smoothing Budget Outcomes

One issue raised in this process is whether it was proper or otherwise appropriate for the former government to direct that grants for state railway projects be used to smooth expected budget outcomes.

There is nothing in law which prevents governments from shifting the timing of payments to meet perceived budget capacities. The practice of 'smoothing' is also unexceptional, and one commonly used by the Commonwealth and doubtless other jurisdictions in Australia.

Smoothing can involve additional costs. For example, where the recipient of a grant is a non-government entity, the state forgoes the benefit of cash provided to the recipient earlier than required. Where the grant is intended for capital works, any delay in providing grants can disrupt the orderly conduct of capital works and thus increase project costs. On the other hand, where capital spending is accelerated for the purposes of smoothing, benefits from such capital investments can be obtained earlier than originally planned.

In the case in question, it seems no additional costs need be involved. RailCorp would have acquired the benefits inherent in receiving grants earlier than needed, but Treasury could take this into account when determining RailCorp's operational subsidy needs. And because the grants were paid in advance, there need not have been adverse impacts on capital works.

It is true that delaying or advancing receipts or expenses often provides more of an apparent advantage than an actual economic benefit. In part, smoothing is encouraged by the need to segment continuing economic activity into annual budgets and by uninformed media responses to budgetary issues.

It is highly desirable that governments account for these timing changes by publicly advising that they have occurred or will occur. As Mr Lambert observed, the 2010-11 Half-Yearly Review specifically adverted to this matter (see pages 9 and 10 of that Review).

Explanation of Variances

Mr Lambert's report proceeded to identify the causes of the \$1,933 million variance noted above. Reduced receipts estimates totalled more than the variance. There is nothing in Mr Lambert's explanation which requires additional comment, except for the Commonwealth's transfer of GST grants to NSW.

Mr Lambert advised that the fall in GST revenues, mainly arising from unexpected reductions in the growth of household spending, "produced a deterioration in revenue of \$863 million for the four year period". Mr Lambert reported that this issue was first seen in January and was confirmed in February. None of this could have been incorporated in the 2010-11 Half-Yearly Review which was published in December.

It is also noteworthy that on 1 March 2011, the then Secretary to the NSW Treasury, Michael Schur, advised Mr Richard Torbay, as one of many parliamentary leaders defined by the *Parliamentary Budget Officer Act 2010*, of a newly advised fall in GST payments to NSW. Presumably Mr Schur also informed all other parliamentary leaders, including the then premier, Ms Kristina Kenneally, and the then leader of the opposition, Mr O'Farrell.

Mr Schur's letter followed the publication on 25 February 2011 of advice provided by the Commonwealth Grants Commission on 15 February to the Commonwealth Treasurer concerning the division of net GST receipts among the states and territories. Mr Schur advised that new information led to "an expected worsening of the 2011-12 Budget result by \$130 million". There was a clear inference of further revenue falls in the following years. (This information was reflected in the footnote to the report issued by the Parliamentary Budget Office on 21 March 2011 about the budget impact of election policies proposed by the NSW Branch of the Australian Labor Party.)

Mr Schur's advice to parliamentary leaders of declining GST receipts followed his published update to the Statement of Uncommitted Funds. The *Parliamentary Budget Officer Act 2010* requires Treasury to prepare such a statement before state general elections. The statement was published on 15 December and Mr Schur provided an update on 27 January 2011.

What is clear from Mr Lambert's comments on variances and from public steps taken by Mr Schur is that Treasury took no steps to hide or manipulate budget figures. Budget estimates were prepared on the basis of all available contemporary information. Moreover, Mr Schur actively advised relevant parties of developments in the budget.

However, the new government's response to the March briefing suggests that NSW Parliament might consider legislation which allows Treasury to publish an updated version of the state's fiscal and economic outlook shortly before state general elections. A more recent version of a budget update - along the lines required in the Commonwealth and Tasmania and being considered in Queensland and South Australia - would have better met the needs of the electorate and the incoming government than did the 2010-11 Half-Yearly Review published in December.

Addition of 2014-15 Estimates

Another source of apparent concern is the impact on the total budget outlook of the additional deficit of \$2,339 million arising in 2014-15.

It is well known that each NSW Budget includes forecasts for the budget year and projections for the next three years, the so-called forward estimate period. For the last budget, the figures thus canvassed 2010-11 and the three following years to 2013-14. The 2010-11 Half-Yearly Review covered the same period.

When a government begins its consideration of the impending budget - in this case, 2011-12 - it is customary to add the projected budget figures for the next out-year, in this case, 2014-15. It is thus unsurprising that the NSW Treasury's briefing to the incoming government would canvass, for the first time, the outlook for 2014-15.

It might have been disconcerting for the incoming government to have been presented with a presumably unwanted and previously unknown additional deficit. But it would have been unprofessional had Treasury not provided the new government with those figures.

The incoming government presented the resulting total deficit outlook as a "black hole". Two things can be advised about this. Firstly, a study undertaken by the Parliamentary Budget Office of the accuracy of past forward estimates included with NSW budgets suggests that those estimates be treated cautiously. They provide a context for decisions for the current budget, but they are too uncertain to allow governments to be prescriptive about out-years.

Secondly, the hole was only unknown (one version of the import of "black") for the same reason we do not know the projections for 2015-16. Whether or not projections for 2015-16 add to or reduce the projected accumulated deficit will not be known until work begins in a year's time on the 2012-13 Budget. The government could ask Treasury to provide now an estimate of the 2015-16 Budget outcome, but it is unlikely that such an exercise would be commissioned or would be useful.

Solar Bonus Scheme

On 1 February, 2011, the former premier announced changes to the funding of the solar bonus scheme (a scheme which provides subsidies for eligible small scale solar electricity generation). Relevant estimates in the 2010-11 Budget and the 2010-11 Half-Yearly Review were based on the prior funding policy which provided for electricity distributors to recover the costs of the scheme from customers.

Ms Kenneally, announced that from 1 July 2011 the NSW government would "off-set the full impact of the NSW Solar Bonus Scheme on household electricity bills by redirecting uncommitted funds from the NSW Climate Change Fund, as well as drawing \$55 million in efficiencies from the electricity network business". "Electricity customers will not pay any extra charges to cover the costs of the Solar Bonus Scheme", the then Premier stated. (News Release, Premier of New South Wales, 1 February 2011). This statement is inconsistent with the reported Treasury view of government policy.

Mr Lambert' report says "the then Government announced that the cost of the Scheme would be met from unallocated funds within the Climate Change Fund and through an increase in the Climate Change Fund levy". The levy increase is "effectively passed on to consumers in the form of higher electricity charges". Because the Climate Change Fund, even with the increased levy, would not have sufficient monies to finance the scheme, the budget estimates provided to the incoming

government in March "assumed that any year-by-year residual cost ... would flow directly through to electricity prices and therefore would not represent a Budget impact".

The report also includes, in Table 3, estimates of the budget impact of an alternative policy under which "the Budget rather than electricity consumers pick up the shortfall in funding". This adds \$651 million to the accumulated deficits for 2010-11 to 2014-15. Again this figure could not have been included in the December Half-Yearly Review.

The Lambert report also comments on the Solar Bonus Scheme's impact on expenses following the 2010-11 Half-Yearly Review. It notes that "Additional expenses of \$711 m [are] associated with the then government's decision to continue and increase the Climate Change Fund levy and allocate those funds to meet the costs of the Solar Bonus Scheme". (Because of the assumed increased levy, not all of these additional expenses would have affected the budget outcome.)

The above comments shows that an inconsistency existed between the then government's 1 February announcement and the funding approach adopted by Treasury in preparing its March estimates for the incoming government. Mr Lambert's conclusion, that the Treasury approach "reflected what was understood as then government policy", conveys a little of the inherent confusion or conflict.

Summary

The report prepared by Mr Lambert concluded that the estimates prepared at the various stages of the budget for 2010-11, including the March briefing, were accurate and used up-to-date information. Apart from conflicts between public statements and the associated budget estimates for the Solar Bonus Scheme, the Parliamentary Budget Office agrees with that judgement.

Mr Schur's actions to update budget information for the purposes of the *Parliamentary Budget Officer Act 2010* support the view that Treasury acted professionally and transparently.

The Parliamentary Budget Office draws attention to the benefits of legislative changes which would allow Treasury to publish a fiscal and economic update shortly before state general elections.

The Media Release

A number of judgements or claims were made in the media release issued by the Premier on 27 April 2011, "Black Hole Blows Out further". This part of the briefing addresses the request to provide analysis and advice on those claims.

Black Hole

The first claim, the existence of a '\$4.5 billion "black hole"' has, in part, been considered earlier. The idea that the existence of a substantial increase in the projected accumulated deficit was 'unknown' has been explained by the difficulties inherent in forecasting and by the nature of budgeting practice adopted by all jurisdictions in Australia.

The provision of forward estimates provides a useful context for the impending budget, but their inherent weaknesses suggest that they cannot be seen as accurate forecasts. It would thus

overstate their usefulness to suggest that forward estimates offer a reliable indicator of future budget outcomes.

Moreover, the size of the accumulated budget deficit from 2010-11 to 2014-15, \$4,384 million, even if it were to eventuate, would not itself imperil the state's finances or its AAA credit rating. That accumulated deficit estimate is less than 75 basis points of the revenues and expenses for the five years. And the government should be aware that, even if it took no remedial action, further parameter changes which will inevitably arise in the coming months and years will as likely improve the budget outlook as weaken it. Moreover, the general government's current net debt and unfunded superannuation level is about \$8 billion below the level which might lead to a review of the AAA credit rating and there are few sub-sovereign entities outside of Australia which enjoy a AAA credit rating.

This does not mean that the incoming government should ignore the growth in the deficit since the 2010-11 Half-Yearly Review or the impact of the additional deficit projected for 2014-15. The government will need to use these data in developing its first budget.

Solar Bonus Scheme

The claim that the "audit also found that an additional \$759 million was needed to cover unfunded costs of the Solar Bonus Scheme" has merit (though as noted earlier the Lambert Report uses a figure of \$651 million).

A claim is also made that the "failure to take the additional budget impact of the Solar Bonus Scheme into account could only have occurred if Treasury advice on the scheme's impact was not sought or simply ignored". This is a speculative conclusion and the alternatives offered are not the only feasible options. There was confusion between what Treasury believed the former government decided and what the former premier announced. Mr Lambert's cryptic comment on this matter, referred to earlier, offers support for this view. The reason that led Treasury to its view of the budgetary consequences of the announced change in policy is not known.

During the preparation of this briefing, the Energy Minister, the Hon Chris Hartcher, announced that the Solar Bonus Scheme had been placed on hold pending legislation to close the Scheme to new applicants.

Other Claims

The media release offers other claims of "gross economic incompetence". Insofar as fiscal policy is concerned, the state's AAA status does not support this claim. A fear that the budget deficit "could grow even further" is merely an assertion made without evidence. A claim that "Labor had 'cooked the books' to distort the true state of NSW's finances" is not supported either by the report issued by Mr Lambert or by this Office's examination of available data.

A further claim that moving the timing of payment of rail grants is a "dodgy deal [used] to deceive the people of NSW into thinking the State's finances were sound" was likely made without understanding how prevalent is the use of this technique throughout Australia. A redistribution of grants to redistribute accumulated the timing of surpluses need not - and in this case probably did

not - affect underlying accumulated results. That the 2010-11 Half-Yearly Review specifically disclosed this matter shows that deception was neither intended nor achieved.

Summary Advice on Media Claims

The above analysis suggests that most of the claims made in the relevant media release of 27 April 2011 are unsupported by evidence or conflict with available information on the state's fiscal position and budgetary processes.

Parliamentary Budget Office
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