<u>Report on Variance between Mid Year (December 2010) and March 2011 Update</u>

Issue

Advice to the Treasurer and the Premier concerning the significant variation between the mid year review budget and forward estimates position and that advised to the incoming Government based on March information.

Background

The advice provided by Treasury to the Incoming Government on the latest financial position differed from that reported in the mid year review and raised the issue of whether the financial position reported in the mid year review was accurate. The budget time, mid year review and March budget and forward estimates of the Budget result are as follows:

Table 1: 2010-11 and Forward Estimates Projections

	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m	2014-15 $m
Budget time	773	885	863	628	NA
Mid year review	167	176	432	129	NA
March 2011	365	204	(405)	(1,193)	(2,339)

The variance between the mid year review and the budget was a deterioration of $2,245m over the four year period and between the mid year review and March 2011 was a further deterioration of $1,933m.

Assessment

The advice in the March update reported the financial position for 2010-11 and the three forward estimate years, 2011-12 to 2013-14. In addition a fourth forward estimate year was added, that of 2014-15. This year has a projected deficit of $2,339m which reflects the ramping up of the rail capital grants ($947m in 2010-11, rising to $2,132m in 2013-14 and $3,224m in 2014-15). Adding this total projected deficit to the variances from the mid year review produced a total of $4.3b. However, the budget and forward estimates variance was in fact $1,933m given that there had been no published forward estimate for 2014-15 against which to measure variance.

There are two key questions to address:

1. Did the presentation of the mid year review financial position provide an accurate picture of the financial position as at that time, based on the latest available information or was there misreporting of the financial position?
2. Does the March 2011 update reflect the latest available information and are the variances relative to the mid term review based on information that only became available post the mid term review?

The mid year updated the position with respect to 2010-11 and the forward estimates and was based on the latest available information at the time of the review. It reflected over the four year period a decline of approximately $1 billion in revenue and an increase in expenditure of about $1.2 billion. While the update was at December 2010, certain information only reflected data for October which became available in late November. One example of this was the information on GST revenue. There is no evidence of any misreporting or non utilisation of available information.

However, rail capital grants were pre paid both in the 2010-11 budget and in the mid year review with a view to reducing the surplus in the early years and reduce the projected deficit for 2013-14. This was undertaken at the direction of the then government. It should be noted that the prepayment of rail grants is not inconsistent with accounting standards which require recording of grant payments on a cash basis and that the mid year review did explicitly reference the prepayment of capital grants. In order to present a more accurate picture of Budget trends, the pre payment of the rail grants were reversed in the brief provided to the incoming government. The impact of the smoothing process is set out in the table below.

Table 2: Rail Grant Prepayment Budget Impact

	2010-11 $m	**2011-12 $m**	**2012-13 $m**	**2013-14 $m**	**2014-15 $m**
2010-11 Budget Result	773	885	863	628	NA
Rail Smoothing	-	585	300	(400)	(485)
Underlying Result	773	1,470	1,163	228	NA
Half-Yearly Review	167	176	432	129	NA
Rail Smoothing	-	885	300	(700)	(485)
Underlying Result	167	1,061	732	(571)	NA
March Estimates	365	204	(405)	(1,193)	(2,339)

The second point to note is that the Budget and mid year review did not incorporate any allowance for the cost of the Solar Bonus Scheme as, under the prevailing policy at the time, the Scheme was to be funded directly from higher electricity charges. Subsequent to the mid year review, 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[1]. However even with the increased levy, the Climate Change Fund has insufficient resources to meet the cost of the Solar Bonus Scheme on a year by year basis. The March estimates assumed that any year-by-year residual cost associated with the Solar Bonus Scheme beyond the level able to be funded by the Climate Change Fund would flow directly through to electricity prices and therefore not represent a Budget impact.

[1] The Climate Change Fund levy is nevertheless effectively passed on to consumers in the form of higher electricity prices.

Table 3 below presents the March estimates based on an alternative assumption whereby the Budget rather than electricity consumers pick up the shortfall in funding under the Solar Bonus Scheme.

Table 3: March Estimates Adjusted for Solar Bonus Scheme Funded Cost

	2010-11 $m	**2011-12 $m**	**2012-13 $m**	**2013-14 $m**	**2014-15 $m**
March Estimates	365	204	(405)	(1,193)	(2,339)
Residual Solar Bonus Scheme Costs	(a)	283	145	123	100
Adjusted March Estimates	365	(79)	(550)	(1,316)	(2,439)

(a) For 2010-11 the shortfall in funding available from the Climate Change Fund is already included in the March estimates as passing on of the cost of the Scheme through electricity prices in that year is not possible.

This approach results in a $2.48 billion deterioration in the Budget position on the published mid year review and a $4.7 billion deterioration on the published 2010-11 Budget projections.

Turning to the second question, the total variance in the financial position for the budget year and the three forward estimate years presented in March relative to the mid year review was a deterioration of $1,933m. Of this total variance, deterioration in revenue accounted for $1,983m and there was a net improvement in total expenses of $50m. While a variance of $1,933m may seem large it needs to be noted that it relates to four years and hence is an average of approximately $500m per annum. Further, given that the budget result is the interaction of total expenses and total revenue which are in the order of $55b, the total variance is less than 1%.

The key revenue variations between the mid term review and the March update were as follows:

- **Transfer duty:** Estimates are up in 2010-11, artificially boosted by the duty accruing from the electricity transaction (this accounted for $180m of the additional $240m revenue in that year). However, beyond 2010-11 there is a projected net decline of around $500m which reflects the impact of both changes in projected interest rates and declining volumes of transactions. At the time of the mid year review it was expected there would be further rate rises in 2010-11. However, by March the view was taken that these would be pushed out into 2011-12 with an adjustment to the timing of the interest rate impact, combined with a mark down for lower than expected volumes.
- **Payroll tax**: Post the mid year review the number of full time employees has levelled out contrary to expectations while total employment has continued to increase. Aggregate hours worked have also levelled out. This information on aggregate hours worked was released in February 2011, after the mid year review. Associated with this has been a plateauing of full time employment and an increase in part time employment. This has contributed $311m to the deterioration in revenue over the projection period.

- **Government guarantees fees** : Along with the inclusion of updated data, mid year review adopted a new methodology for assessing GGF resulting in a net decrease in fees of $455m. In the March review further adjustments were made to reflect the application of the changed approach to existing debt, and the impact of the electricity transaction resulting in a further downward revision in revenue estimates of $195m.
- **Speeding fines**: Revenues from this source were revised down at the time of the mid year review by over $200m in 2010-11 and 2011-12, reflecting the delay in the roll out of speed/red light cameras and lower revenues per camera following the decision to increase the visibility of cameras. The mid year review assumed the roll out of cameras would be significantly accelerated to June 2011 rather than 2013 and the speed tolerance provided for camera fines would be removed. Subsequent to the mid year review, there have been further delays in the roll out of cameras resulting in reductions in revenue of $291 million for the 4 years to 2013-14 as shown in the March estimates.
- **GST**: There has been downward revisions since the GFC, reflecting the shift in consumer behaviour towards savings. At the time of the mid year review it was felt that this trend had stabilised. The latest available data at the time of the mid year review was for October (the data is available with a delay of about three weeks from month end) which was in line with Australian Government forecasts. However the data available in January for December showed a significant national drop from previous projections and the data for January and February does not show any reversal of this loss. In addition to the increase in the savings ratio, there has been a trend of a declining ratio of GST taxed consumption to total consumption expenditure as relatively higher growth has occurred in non taxed items such as health and education. This has produced a deterioration in revenue of $863m for the four year period.
- **Financial distributions**: Reflecting the impact of the electricity asset sales and the reversal of a mid year review assumption that the new methodology used for Government Guarantee Fees would be budget neutral, there has been a decline in dividends and tax equivalent payments of $882m over the forward period in the March estimates.

There have been some partial offsets to these, namely additional revenue for the Climate Change Fund levy and interest income but the net position is a $1,983m deterioration in revenue since the time of the mid year review for the period 2010-11 to 2013-14.

The key expense variations between the mid term review and the March update were as follows:

- **Climate Change Fund:** Additional expenses of $711m associated with the then government's decision to continue and increase the Climate Change Fund levy and allocate these funds to meet the cost of the Solar Bonus Scheme.
- **Rail Capital Grants:** Unwinding of the rail smoothing grants reduced expenses over the period to 2013-14 by $485m.
- **Interest:** The impact of the electricity transaction reduced interest costs. This was partly offset by the deterioration of the Budget position resulting in a net saving of $474m over the period to 2013-14.

Conclusion

In summary, both the mid year review and the March 2011 update provided to the incoming government accurately reflected available information at the time and were consistent with a robust approach to Budgeting adopted by the NSW Treasury.

Apart from the government directed budget smoothing associated with the pre payment of rail capital grants, Budget aggregates presented in the 2010-11 Budget and mid year review provided an accurate representation of State finances.

The approach adopted in the March estimates of assuming residual costs associated with the Solar Bonus Scheme were funded directly by higher electricity prices reflected what was understood as then government policy.

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Acting Secretary

1. Treasurer
2. Premier