

## 8. NSW: BETTER LIVES, BETTER FUTURES

### 8.1 Four pillars to improve the lives of citizens, now and into the future

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The Government's fiscal and economic policies, combined with record infrastructure investment, have transformed New South Wales into the economic engine room of Australia. In the four years to June 2018 the New South Wales economy experienced the fastest per capita growth of any state in Australia.

The Government's investment decisions have dramatically improved the quality and level of service that citizens receive from government, leading the way with the Service NSW network. While improving services for today, the Government has maintained a clear focus on the future, initiating and leading the largest infrastructure program in the State's history.

The Government's ambitious agenda – including the election commitment package funded through this Budget – is being sustainably delivered due to disciplined financial management. The Government is keeping debt at sustainable levels, and retaining a triple-A credit rating.

The State has managed through recent global and local challenges, growing the economy and maintaining budget surpluses, without raising taxes. However, the Government is not taking its past success for granted and is planning for the future. The Government is implementing four policy pillars to support continued prosperity for New South Wales.

The first pillar is an Economic Blueprint for the future of New South Wales (the Blueprint). It will present long-term strategies to deliver the next phase of economic growth. The Government established the NSW Productivity Commission in 2018 to identify reform priorities for the economy, to support business investment and innovation, and improve lives. The Blueprint will complement this.

The second pillar is managing a balance sheet that lowers the financial burden for future generations. In the 2018-19 Budget, New South Wales became the first state or territory in Australia to establish a sovereign wealth fund, the NSW Generations Fund (NGF). Seeded with an initial investment of \$10.0 billion in late 2018, the NGF is projected to grow to more than \$28.0 billion over the next decade. This initiative will help the Government maintain sustainable debt levels consistent with a triple-A credit rating, helping support current and future generations.

The third pillar is re-examining federal financial relations from a state perspective. As the NSW economy continues to grow and evolve, the Government will need to maintain a stable and reliable revenue base to fund essential services and infrastructure. The Government is therefore undertaking a review of the State's revenue system as it relates to federal funding and its interactions with the state tax system. The Government wants the people of New South Wales to join in the conversation on how the revenue system can work better for all, including better integration between state and federal taxes.

The fourth and final pillar is ensuring government is focused on delivering better outcomes, not bigger government. The Government is continuing its move to outcomes budgeting. At the same time, it is announcing the Digital Restart Fund and is consolidating public sector agencies, so the State's public administration is streamlined, effective and citizen focused.

## **8.2 The Government wants New South Wales to be a great place to live, work, run a business and raise a family**

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The Government is looking at how it can best support future growth and prosperity. Key strategies include:

- ensuring the State budget is sustainable, with inter-generational measures like the NGF
- having the fiscal capacity to tap into innovation opportunities (such as the Digital Restart Fund) and to quickly respond to economic challenges (such as drought assistance)
- ensuring government is agile and nimble in the face of disruption and technological change
- readying the State's workforce and education system for the jobs of the future
- supporting the State's most vulnerable citizens.

### **New South Wales' fiscal and economic strengths**

Since coming into office in 2011, the Government has built up the State's fiscal and economic capacity.

Under the Government's stewardship the New South Wales economy has been able to adapt from the end of the mining boom to service-driven growth, lifting skills and jobs growth across all regions. A positive indicator of the economy's transition is the State's trend unemployment rate, which is near a 40 year low. In an encouraging sign for the future, the State's workforce participation rate is the highest on record, with female participation a particular standout.

Fiscal discipline has been a core tenet of this Government's leadership. It has built a reputation for being a world leader in asset recycling – ensuring the State's balance sheet is optimised and capital is being employed in the most productive way possible. On the operating side, expense management has been pivotal in getting the State's finances on a sustainable footing. Through these measures, the Government has funded a record infrastructure program while minimising reliance on borrowings. It has delivered a meaningful and lasting legacy – the next generation will benefit from the infrastructure being built now, without the need to repay excessive debt.

### **More is needed to overcome the challenges of tomorrow**

While New South Wales has enjoyed an historically long period of economic growth without recession, and the NSW Government has successfully managed recent headwinds, the State will face new challenges into the future. Both short and long-term risks could affect the Government's capacity to deliver the infrastructure and services that citizens need.

Short-term risks centre around the global economy, the local housing market, persistent drought conditions and subdued household income growth. Although the outlook for the global economy remains generally favourable, global institutions have recently pared back growth expectations. Any disruption to global trade could impact New South Wales, particularly through commodity and service exports and their multiplier effects on the local economy.

Beyond the immediate horizon, New South Wales is expected to face economic and fiscal challenges. The ageing of the population will place ongoing pressure on state-delivered services (such as health care). Lifting customer service expectations and emerging technologies could disrupt traditional government service delivery models. While these longer trends unfold, growth in revenues is unlikely to keep pace.

### **8.3 Setting up New South Wales for future success**

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#### **Pillar one: The Economic Blueprint**

##### **New South Wales' economic transition**

The New South Wales economy has powered national economic performance in recent years. In the four years to 2017-18, New South Wales:

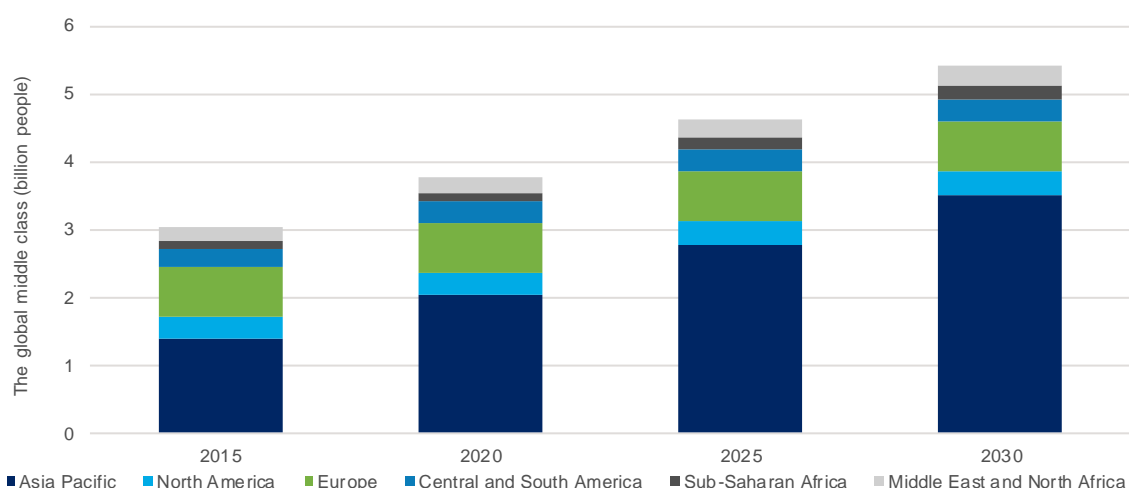
- delivered nearly 40 per cent of growth in national output and new jobs, well above the State's population share of 32 per cent
- had 64 per cent of national public investment growth
- recorded more than half the nation's dwelling commencements.

In the last year alone, New South Wales attracted 37 per cent of Australia's overseas tourists and 38 per cent of international students coming to Australia. Both these sectors account for a significant share of New South Wales' service exports.

New South Wales has abundant natural resources, a pristine environment, enviable living standards and a well-educated and highly-skilled workforce. It boasts popular tourist destinations, stable and reliable government and institutions, highly sought-after education facilities, a world-leading service sector, and highly competitive industries, particularly in advanced manufacturing.

New South Wales is already expanding trade into Asian markets. The State's top four merchandise export destinations are Japan, China, South Korea and Taiwan. The extraordinary growth in the number of middle-class citizens in Asia has the potential to drive economic growth in New South Wales for decades to come. As household incomes and living standards improve in many regional economies (see Chart 8.1), there will be significant and untapped trade opportunities for New South Wales industries.

Chart 8.1: China and India have significant potential as export destinations



Source: Brookings Institute and NSW Treasury

The Government is developing a new trade and investment strategy for New South Wales to respond to these trends. The strategy will focus efforts to attract international investment, facilitate exports, create jobs and grow the economy.

Changes to the economy are on the horizon. The disruption of advancing automation and robotics is already occurring, changing the nature of workplaces, lifestyles and jobs. While this technology has enormous potential to improve living standards and create new jobs, there are also transitional challenges that will weigh on parts of the economy.

The future economy must also continue to support individual freedom and aspiration – providing all people with a fair opportunity to work, make a living and support their families. The Government is well advanced into preparing a blueprint to take account of these challenges and opportunities, and lay out a long-term vision for New South Wales.

## An Economic Blueprint for tomorrow

The Blueprint will build on the significant achievements of the Government since it was elected in 2011. The Government has established place-based strategic precincts and technology hubs that build on competitive advantages and nurture innovation and ideas. Previously neglected non-urban connectivity and infrastructure are renewed areas of focus, to help revitalise regions. To spark productivity growth in New South Wales, the Government established the NSW Productivity Commission in 2018 which has re-energised the productivity and reform agenda. A Productivity White Paper will be published later this year.

The Blueprint will draw on extensive future-focused work to date, both inside and outside government. It will gather fresh insights from an extensive consultation process that is already underway. The Blueprint will knit together this knowledge and provide an over-arching strategic framework from which other forward-looking plans (for example for regional growth, productivity, transport, innovation and small business) can build.

The Blueprint will target emerging growth industries of the future, and how these may affect the State's economic composition. There could be long-lasting implications for the way in which we educate and prepare the workforce of tomorrow. Indeed, the skills these people will need to prosper may be very different to those of today.

New South Wales has several current advantages – for example financial and professional services, advanced manufacturing and food production. There will be other areas of advantage in the future and while the Government may not be able to identify them all today, it can forge an environment that encourages investment and growth.

The Blueprint will identify likely major trading partners in the decades to come. In doing all of this, it will lay out long-term strategies that will help deliver the next phase of the State's economic growth. The Blueprint will be comprehensive, and it will be forward-looking. It will lay the foundations for a stronger economic and financial future.

## **Pillar two: Managing a balance sheet that lowers the burden for future generations**

### **The NSW Generations Fund (NGF)**

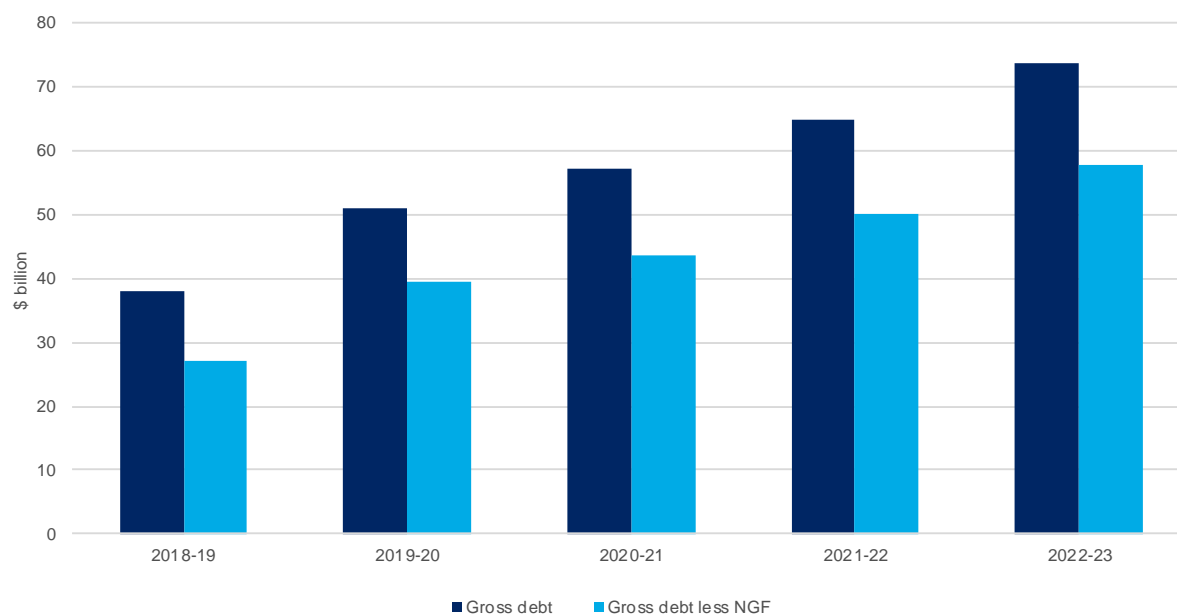
To avoid constraining future generations with substantial debt, the Government has established a dedicated debt retirement fund – the NGF. This sustainable approach to debt reduction is made possible by the Government's strong financial management and innovative reform, helping unlock the potential of the State's balance sheet. The NGF was seeded with an initial investment of \$10 billion in late 2018. Over the next decade, the NGF is projected to grow to more than \$28 billion.

By ring-fencing the NGF through the *NSW Generations Funds Act 2018*, it safeguards the NGF's assets for debt retirement and prevents the NGF from being misused by future governments. Enshrining the NGF in legislation has supported both major credit ratings agencies recognising the NGF as an offset to State debt (Chart 8.2). This innovative approach allows the NGF to support the triple-A credit rating in a way that other States' investment funds cannot.

The State's minority interest in WestConnex is also included in the NGF. This approach helps ensure that the WestConnex minority interest does not become a 'lazy asset' on the State's balance sheet and continues to help benefit the people of New South Wales now and into the future.

This active approach to balance sheet management will support the Government's infrastructure program without burdening future generations with unmanageable debt.

Chart 8.2: General government gross debt – with and without the NGF debt offset



## Pillar three: Re-examining federal financial relations from a state perspective

### Current state of federal financial relations

Under Australia's federal system, states have primary responsibility for delivering frontline government services and infrastructure. Yet, states also have some constraints on access to efficient, stable revenue sources to fully fund this expenditure and investment.

This means the states rely heavily on Commonwealth funding to deliver essential services. In 2019-20, the Commonwealth will provide New South Wales with around \$32.4 billion (38.4 per cent of the State's revenue). This includes \$18.7 billion of GST payments and \$13.3 billion in tied payments flowing from National Agreements, National Partnerships and Project Agreements.

Over time the Commonwealth funding system has evolved into one that is complex, uncertain and discourages state reform. The distribution of GST revenue and Commonwealth funding agreements weigh on the future stability of the State's revenue base and affect budget flexibility.

Federal financial arrangements require reform if states are to address long-term revenue and expenditure challenges and provide citizens with value for money in return for their taxes. A federal system that recognises the sovereign role of states and provides appropriate incentives for economic reform is fundamental.

In light of these challenges, it is time to review our federal financial relations system – from a state perspective – to ensure it delivers fair and stable revenue to New South Wales and positions the State to meet future challenges.

## Why the federal financial relations system requires examining

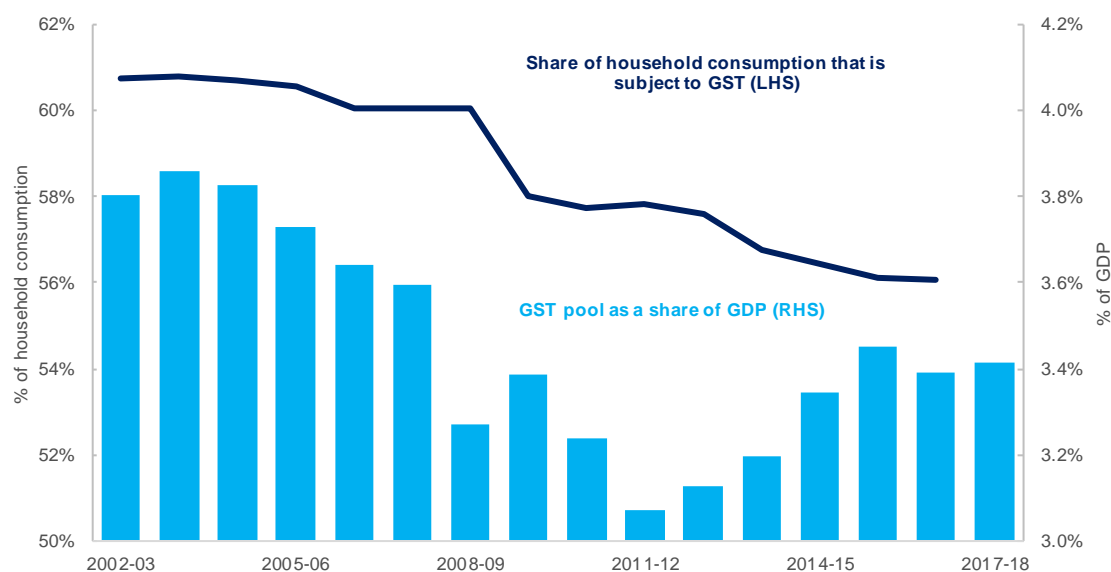
Although the current model for federal financial relations was established on a principle of collaboration, over time these arrangements have become complex and highly restrictive.

The current system of GST revenue allocation – known as Horizontal Fiscal Equalisation – is complex, discourages productivity-enhancing reform, and penalises states with responsible fiscal policies and strong economies.

At the same time, limited visibility on expected trends and growth in GST receipts means that states are exposed to sudden write-downs in revenue. In its 2019-20 Budget, the Commonwealth downgraded its forecast for the GST pool by \$8.3 billion over four years from its mid-year budget update. This is consistent with historic volatility, in which the GST pool has annually grown by up to 9 per cent and fallen by up to 2.7 per cent.

Over the long-term, GST payments could also become suppressed by a shift in household spending towards goods and services that are not subject to GST (including health care, education, financial services and residential rent) and weak inflation for retail goods (Chart 8.3).

Chart 8.3: An eroding GST base raises further risks to NSW revenue

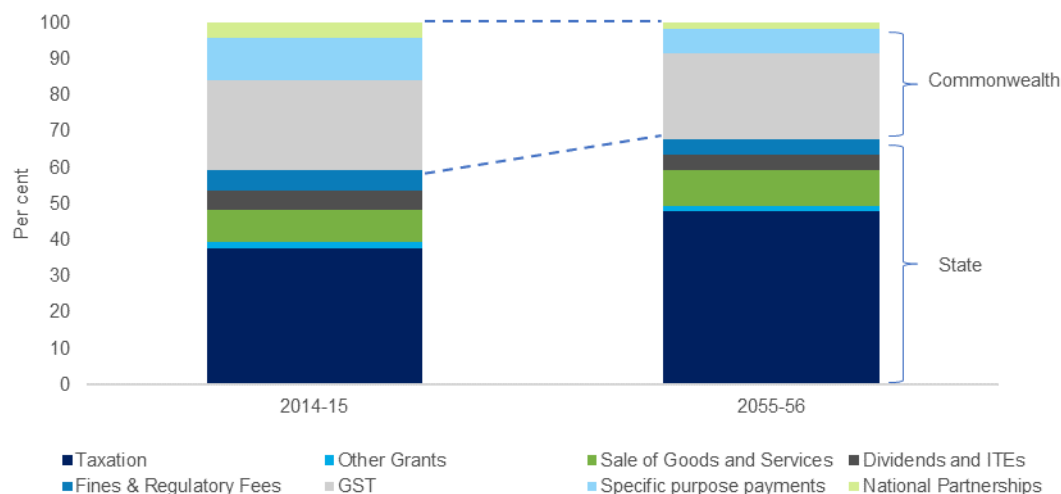


Source: ABS 5206.0 and Commonwealth Parliamentary Budget Office

In addition to GST payments, New South Wales also relies on four National Agreements and more than 40 National Partnerships and Project Agreements with the Commonwealth. The complexity and excessive conditions in these agreements hinder the ability to fund and deliver services efficiently and in line with community needs. These agreements erode state sovereignty by restricting state flexibility to allocate funding to the most critical areas. Commonwealth funding is also unlikely to match future growth in demand for services, requiring states to lift their share of the funding. Yet the states' ability to do this is also constrained by current federal financial arrangements.

Over the long term, the Commonwealth's own fiscal pressures may weigh on grant funding. The New South Wales 2016 Intergenerational Report projects that Commonwealth funding could fall to around 32 per cent of State revenue by 2055-56, shifting the State's financing burden back towards its own sources of revenue (Chart 8.4).

Chart 8.4: Commonwealth funding is falling as a share of total revenue



Source: NSW Intergenerational Report 2016

### Interactions with the New South Wales' tax system

New South Wales relies on a range of state taxes that can be volatile and costly to the State economy. Yet, incentives to undertake tax reform can be affected by potential implications for the State's share of Commonwealth funding.

Lower taxes are important because all taxation creates economic costs over and above the direct financial costs on taxpayers. Taxes can deter productive activities by reducing the rewards for effort and work. They can also discourage individuals from making economic decisions that would benefit themselves, their families and the wider community. Major Commonwealth taxes, including the GST and personal income tax, impose relatively lower economic costs. Some state taxes, on the other hand, have relatively high economic costs.

The volatility of some taxes also makes it difficult for governments to plan ahead and manage their finances. Property transfer duty and minerals royalties, for example, are volatile revenue streams. New South Wales has become more reliant on transfer duties in recent years, which rose from \$3.8 billion in 2011-12 to \$9.7 billion at its peak in 2016-17. Since the 2017-18 Budget a softening of the housing market has resulted in a write down of more than \$10 billion in forecast transfer duty.



## **New South Wales' review of federal financial relations**

The NSW Government is committed to managing fiscal pressures through strong fiscal management, controlling expenditure and cutting government waste. However, part of the challenge is to ensure New South Wales revenue is steady and predictable.

The NSW Government will ask a diverse and independent panel of experts to review how we can improve the federal financial relations system. The Panel will also consider how the Commonwealth funding system interacts with state taxes. The Panel will consult with the community and recommend options to improve the revenue system and encourage a more reliable system of Commonwealth funding.

The Government also recognises these revenue challenges are not unique to New South Wales. While this review is an opportunity for New South Wales to demonstrate initiative, the cooperative involvement of all states and territories through the Board of Treasurers will be critical to achieving meaningful and enduring reform.

## **Pillar four: Ensuring governments are focused on delivering outcomes**

Delivering outcomes is what matters most and this will continue to be the first priority for the Government. New South Wales is leading the way in shifting government thinking around outcome budgeting and performance accountability.

Under outcome budgeting, funding discussions move away from traditional outputs (for example a new school) and towards the outcome that citizens care about (giving our children the best chance of success). Outcome budgeting embeds richer policy discussions, leading to better decisions, before funding is then allocated through the Budget process.

Outcome budgeting is not just about improving new policy decisions. It drives a discussion on what is being achieved with the total \$83.3 billion annual recurrent spend. When sustained over years to come, outcome budgeting will change how the Government plans, funds and delivers results for the people of New South Wales.

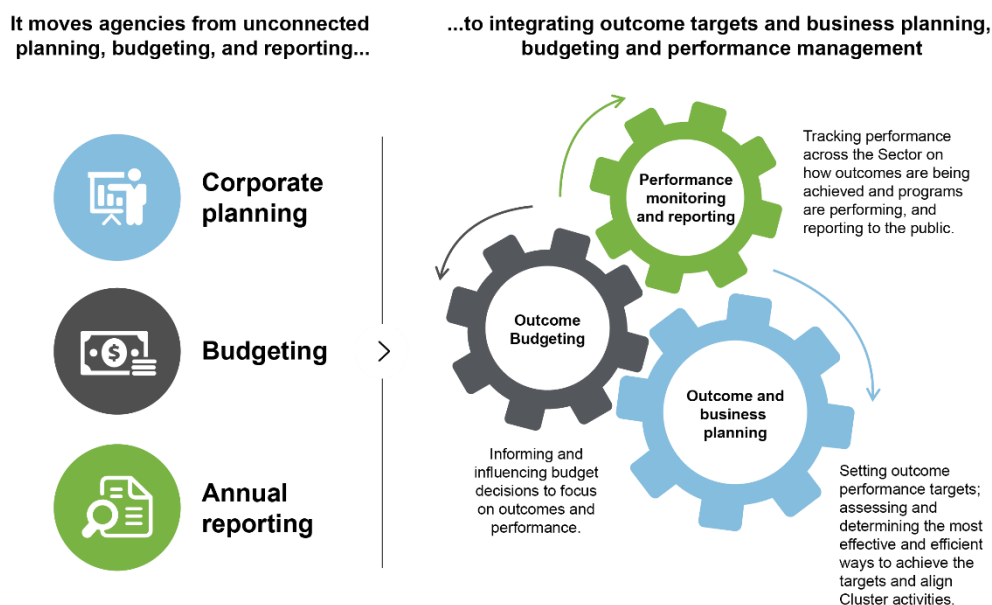
## **Designing a system that delivers better outcomes**

The Government has established 38 State Outcomes (see Budget Paper No 3. *Budget Estimates*) to assist with investment decision making.

The Government has recently reorganised the public sector into eight clusters (down from 10) to streamline how it operates and to improve collaboration. This reorganisation has coincided with the establishment of the State Outcomes, which are fit for purpose to the new model.

The Government takes performance seriously and this means setting targets for each State Outcome to deliver. Now that a suite of 38 State Outcomes has been established for the new machinery of government structure, attention is turning to setting measures that will drive a performance-based culture across the public sector (Diagram 8.1). This is important to get right and will be a feature of future releases of Budget Paper No.3 *Budget Estimates*, just as it was a feature in the 2018-19 Budget under the previous machinery of government structure.

Figure 8.1: Outcome budgeting encompasses and integrates the three aspects of performance accountability



## Supporting the State’s education system to deliver outcomes

Since 2011 the Government has made record investments in schools, including through substantial extra funding to public schools through the Gonski 2.0 agreement. This includes more than \$6.4 billion additional funding to 2027 for public schools across New South Wales from next year.

This spend is not the end in itself. Driving better outcomes for children is what matters. The NSW Department of Education is the first department to make a significant shift to outcome budgeting. It is established a plan to ensure the Government’s record investment provides young people with the best educational outcomes in Australia.

Every cluster in the NSW Government will be following the Department of Education with outcome-focussed plans that provide a clear roadmap to delivering results.

## Remaining Australia’s economic driving force well into the future

Together, these four pillars build on the State’s strong foundations to ensure the economy remains strong, resilient to shocks and responsive to new opportunities. These strategies will position New South Wales to remain Australia’s driving force well into the future. More importantly, meeting the needs of citizens will be at the centre of every government decision, so that New South Wales continues to be a great place to live work, run a business and raise a family.