Confidential

Review of ACT Budget 2011-12

Prepared for the ACT Legislative Assembly's Select Committee on Estimates 2011-12

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ACIL Tasman

Economics Policy Strategy

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Executive summary

This report has been prepared for the ACT Legislative Assembly's Select Committee on Estimates 2011-12. The intention of this review is to assist the Committee in its deliberations in relation to the 2011-12 ACT Budget.

Economic Outlook for the ACT

The main drag on ACT growth over 2011-12 is likely to remain the efforts by the Commonwealth Government to return its budget to surplus with flow-on effects to household budgets combined with likely tighter monetary policy. The Commonwealth Government's fiscal consolidation will potentially have outsized impacts in the ACT.

Enduring impact of the GFC

The GFC caused major economic dislocation on a global scale which inevitably impacted on Australia and the ACT. Concerns regarding the enduring effects of the GFC are well founded as issues continue to be raised about a number of European countries ability to service their debt.

In Australia and around the world the GFC caused a re-assessment of risk. Households actively curtailed their borrowing flowing into weaker consumer spending. Many small businesses (including building developers) found credit expensive and difficult to obtain which slowed business investment outside the resources sector. These constraints are moderating but are still limiting activity levels in the ACT and nationally.

Budgetary assumptions key findings

Reflecting the above pressures, the forecast of 2.25 per cent GSP growth in 2011-12 appears reasonable.

The most recent quarterly results for the CPI suggest that the Budget's CPI assumptions may be too conservative. A higher inflation outcome, particularly in future years, could put pressure on the budget returning to surplus in 2013-14.

Overall the Budget's employment forecasts appear reasonable.

The Budget's wage price index forecasts (3.75 per cent for 2010-11, which then falls to 3.5 per cent in 2011-12) may be on the low side.

Overall the Budget's long term projections/forecasts are conservative and appear reasonable.

However, there are a number of risks to the Budget forecasts and projections. Most of these risks are outside of the control of the ACT. However, one risk -

the unknown level of restraint expected in the 2011-12 Commonwealth Budget – could be eliminated or at least reduced if the ACT Budget was brought down after the Commonwealth Budget.

Revenue

The main drivers underlying revenue growth include strong gains in dividend and tax equivalents (mainly the projected ramp-up in LDA[1] dividends) and gains from contributed assets.

Key findings

Lease Variation Change charge

The Budget includes no new taxes. However, changes have been made to the change of use charge by the codification of the Lease Variation Change (LVC) charge. The LVC charge increases the ACT Budget's dependence on revenue from the property sector. The transitional arrangements associated with the LVC charge could, amongst other things, create an incentive for builders and redevelopers to bring forward applications for lease variations in order to avoid paying the maximum tax in future years.

GST

There is a material uncertainty regarding the ACT's GST revenue. The logic for the downward adjustment in GST revenue, relative to the latest update from the Commonwealth Grants Commission, appears to be sound given the evidence for the erosion of the GST pool. However, the methodology used to adjust the estimate is not transparent.

Payroll tax

The payroll tax forecasts outstrip the combination of employment growth and wage price inflation, but appear reasonable overall. That said, the precise assumptions underlying the estimates are not fully clear to the consultants.

Dividend and national tax equivalent revenue

The rise in expected dividend and national tax equivalent payments is considerable. There is little clarity in the assumptions which underpin how the LDA dividend and national tax equivalent payments have been calculated. Continuation of the wet weather in 2011-12 could reduce ACTEW revenues and dividend payments. Further investigation of these estimates should be considered.

Expenditure

According to the ACT 2011-12 Budget papers, expenditure is expected to increase by 6.1 per cent in 2011-12 to $4.1 billion. The expected increase largely reflects wage inflation, growth in the health funding envelope from

[1] Land Development Agency

previous budgets and the net impact of policy initiatives (with spending partly offset by expected savings).

Key findings

A number of expenditure functions are expected to grow at above average levels into 2011-12 and in some cases across the budget horizon. These functions include:

- Health – expenditures are projected to go above $1 billion for the first time in 2011-12 (up 8.5 per cent). This trend of strong, above average expenditure growth is expected to continue across the forecast period averaging 6.3 per cent per annum to 2014-15
  - It is not within the scope of this Budget review to assess the revenue and cost pressures associated with the health Directorate's forward pressure on the Budget's expenditures. However, it would appear that this issue needs urgent policy investigation and potentially renegotiation of cross-border arrangements with the NSW Government
- Social security – spending is forecast to increase sharply in 2011-12 (up 9.9 per cent) and to remain at that elevated level into 2012-13.
  - Clarification of the reasons for the estimated increase in social security spending in 2011-12 seems warranted
- Other purposes – expenditure is forecast to increase by 13.8 per cent in 2011-12 and to average 7.7 per cent growth across the budget horizon
  - Other purposes expenditure is becoming a major category of overall budget expenditure and probably needs to now be disaggregated to identify the major drivers and to ensure that it is not used to disguise newly emerging expenditures that avoid adequate scrutiny.

Savings

Efficiency dividend

The efficiency dividend is expected to achieve savings of $66.6 million across the budget horizon. In principle efficiency dividends are not intended to impact on the volume and quality of services provided. However, it is not that simple in actuality.

It should also be noted that in general, global efficiency dividends take no account of the relative efficiency of different agencies ***prior to*** the commencement of the dividend approach.

The concern with achieving the expected efficiency dividend savings, particularly over the longer term is highlighted by the Budget itself, which notes the problems encountered by the Education and Training Directorate and the Community Services Directorate both of which were unable to meet their dividend expectations given downside risks to front line services.

Other Public sector savings

In addition to the efficiency dividend, the Budget incorporates further savings of $150.7 million in public sector agency expenditures over the budget horizon.

Key findings

Efficiency dividends are a rather crude and blunt approach that is significantly sub-optimal compared to pro-active, considered and internally coordinated deliberations involving re-prioritisation of expenditure, as appears to be the case with the proposed savings initiatives. However, the interaction of the efficiency dividend with the savings initiatives is not clear and should be questioned by the Committee. At a minimum the interaction should monitored closely over the budget years to ensure that expenditure reductions are not double-counted as both an efficiency dividend and a savings initiative.

Without a detailed knowledge of the exact functions of the proposed public sector staff to be cut, the target staffing levels seems to be achievable without the need for a large number of expensive redundancy payments.

Infrastructure

Capital works

The 2011-12 Budget continues the ACT's recent budgetary trends to invest heavily in new infrastructure. The expenditure for the 2011-12 financial year for new work and work-in-progress is estimated to be $824 million, which exceeds the previous year's record expenditure by an order of $156 million (or 15.1 per cent).

In light of the ACT's strong economic climate the need to continue and expand the largest capital expenditure program in the Territory's history of self government should be considered. For example, the budget does not analyse whether the proposed very high capital works expenditures would place excessive pressure on wage rates and the demand for Territory's labour supply. Pressures of this nature could crowd out private sector activity in the Territory.

Further, the budget does not appear to consider whether the costs estimated for the capital works will need to be escalated because of national demands for construction arising from the recent national disasters in other Australian states.

Government debt and AAA rating

A substantial part of the new capital works expenditure in 2011-12 and 2012-13 will be funded by additional borrowings.

Based on the 2011-12 Budget estimates the Territory's general government debt will be at historical highs in 2011-12 and 2012-13. By 30 June 2012 the general government sector (which excludes Public Trading Enterprises, such as

ACTEW) will have $631.4 million in debt, rising to around $930 million in 2013. Consistent with normal budgetary arrangements, the public debt figures included in the ACT budget papers exclude operating leases.

The ACT targets maintenance of its credit rating as an independent indicator of sustainable levels of debt. Standard & Poors have recently (16 March 2011) re-affirmed the ACT credit rating as stable at AAA for long-term and A1+ for short-term. However, the longer term fiscal sustainability of the ACT could come under some pressure if the ACT Government continues to run a capital works program at the level seen in 2010-11 and in this current Budget, particularly if the economy was exposed to an external shock similar to the GFC. Ratings agencies and debt providers would have already factored the extent of operating leases into their respective analyses around credit ratings and interest rates. Therefore there is no further downside risk to ratings or upside risk to interest rates from the extent of operating leases.

Triple bottom line accountability

Most of the performance and accountability measures in the Budget relate to economic impacts and outcomes.

Social well-being

The Budget Papers list a number of initiatives to address affordable housing. However, from our reading of the Budget Papers, there were no performance indicators which demonstrate that the Affordable Housing Action Plan is *actually achieving* more affordable housing for Territorians.

Some of the strategic/accountability indicators contained in Budget Paper No.4 provide material that relates to measuring to social well-being continue to be very dispersed. It would be useful to have at least some key performance and accountability indicators that relate to social well-being summarised and consolidated in one place within the Budget Paper.

The environment

A number of materially significant environmental policies and measures have been identified in the Budget Papers. These include:

- The GreenPower policy
- The ACT Electricity Feed-in Tariff Scheme
- The Sustainability in Public Housing, Sustainability in the Built Environment, Sustainable ICT and the Sustainable Schools Initiatives
- A range of transport initiatives

- A Renewable Energy Target (15 per cent of ACT energy from renewable sources by 2012 and 25 per cent by 2020).

It is not clear whether the current ACT Government policies in relation to sustainable energy satisfy COAG's complementary measures principles.

The impact of many of these policies and measures on the Budget are difficult to quantify either because:

- the ACT Government does not directly bear most of the cost (such as the Feed-in Tariff Scheme or the Sustainability in the Built Environment policies)
- they integrate policies other than GHG abatement (such as water savings, biodiversity and landscape protection, assisting low income people, etc)
- are likely to be undertaken in the absence of any GHG benefits (such as using energy efficient ICT, improving the longevity of building shells etc).

An indicative cost of GreenPower

The Budget does not provide any quantification of these policies or their cost-effectiveness. For example, the total cost associated with purchasing 37.5 per cent of the ACT Government's electricity from GreenPower does not appear to be discussed in the Budget Paper. Our very preliminary and indicative analysis of the GreenPower policy indicates that the total cost of the policy could be around $4.5 million in 2011-12 (and around $21.9 million over the four years to 2014-15).

Impact of a national carbon price policy on the ACT Budget

Without a detailed study it is difficult to quantify the fiscal impact that the introduction of a national carbon price policy will have on the ACT Budget.

Recent estimates in a variety of studies have indicated the NEM price of electricity could rise by $20-$30/MWh over the period to 2020 while the cost of petrol would increase by 5-7 cents per litre. Without knowing the ACT Government's electricity and petrol usage it is difficult to ascertain the implications for the Budget. An order of magnitude estimate is that total fuel expenses may increase by the low millions (e.g. $2-5 million) each year if the Australian Government proceeds with a carbon price policy.

There will no doubt be implications on the revenue side, but estimation of these is complex. As explained in the main report, this analysis should be treated as indicative only and a more detailed analysis would be required to provide more specific guidance.

1 Introduction

This report has been prepared for the ACT Legislative Assembly's Select Committee on Estimates 2011-12 to assist the Committee in its deliberations in relation to the 2011-12 ACT Budget. The range of matters covered in this report covers the issues raised in the request for quote and includes particular issues raised by Committee members at a meeting with ACIL Tasman consultants on 2 May 2011.

1.1 The 2011-12 Budget – a snapshot

The 2011-12 Budget estimates that the previously predicted deficit in 2010-11 has been turned around to a surplus of $19.7 million. This result has been largely achieved via a large one-off tax assessment relating to prior years.

The ACT Budget is estimated to return to a deficit of $36.9 million, in 2011-12 but is projected to return to a small surplus of $1.6 million in 2013-14, with a more 'sustainable' surplus of $56.6 million expected by 2014-15.

Headline revenue is forecast to grow at 2.8% in 2011-12. However, this understates the pace of underlying revenue growth. Underlying revenue would exclude the revenue associated with shares and marketable securities and payments from the Federal government linked to its *Nation Building Economic Stimulus Plan*. These are not ongoing sources of revenue and thus need to be excluded to gauge the underlying pace of revenue growth across the Budget horizon. After exclusion of these temporary revenues, underlying revenue is forecast to grow by 7.2 per cent in 2011-12 before moderating to 3.8 per cent in 2012-13.

The 2011-12 Budget included a number of new policy initiatives entailing $266 million in expenditures over four years. These expenditures are largely offset by public sector efficiency savings and expected revenue increases announced in the Budget.

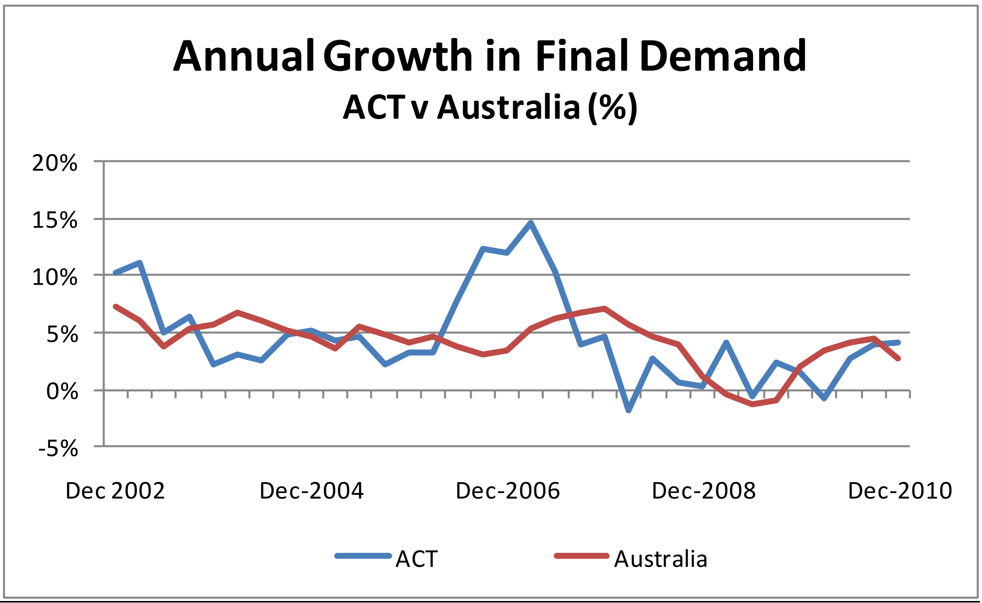
The Budget also provides for a major investment in infrastructure. New investment is estimated to be some $885 million over the four years. The Budget also announced new government borrowings totalling $650 million in 2011-12 and 2012-13.

2 Economic Outlook for the ACT

2.1.1 Growth outlook

Estimates of gross state product (GSP) are only compiled by the ABS on an annual basis with 2009-10 the latest available. Consequently it is difficult to ascertain whether the forecasts for ACT GSP for 2010-11 are on track. However, the latest ABS data on state final demand for the ACT shows annual growth stable at around 4 per cent across the September and December quarters of 2010, unlike nationally where there has been a pronounced slowdown with national final demand growing at 2.7 per cent at the December quarter 2010 compared with 4.4 per cent at the September quarter. The national slowdown likely partly reflects the impact in the December quarter of the floods in Queensland and elsewhere, which are estimated by the RBA to have reduced national GDP growth in that quarter by 0.5 per cent. The exposure of the ACT to these droughts and to other more recent natural disasters appears to be less than for other states more directly impacted. This suggests that the ACT had stronger growth momentum going into calendar 2011 and reinforces the Budget forecast that state final demand growth will average 4.0 per cent across 2010-11.

Figure 1 **Growth momentum - ACT v Australia**



Data source: ABS 5206.0

However, the main drag on ACT growth over 2011-12 is likely to remain the efforts by the Commonwealth Government to return its budget to surplus with this fiscal consolidation potentially having outsized impacts in the ACT. The likely flow-on effects to household budgets combined with likely tighter monetary policy will constrain household spending and business investment resulting in further growth moderation at the GSP level in 2011-12.

Key Finding

Reflecting these pressures, the forecast of 2.25 per cent GSP growth in 2011-12 appears reasonable.

2.1.2 Outlook for inflation

Inflation spiked in the March quarter 2011 at both the national level (up 1.6 per cent in the quarter and the annual rate is now 3.3 per cent) and within the ACT (up 1.5 per cent in the quarter and the annual rate is now 3.0 per cent). This arguably reflects a range of structural (rather than cyclical factors) including:

- the impacts of natural disasters like the floods and cyclone Yasi (which boosted the prices of fruits by 14.5 per cent and of vegetables by 16.0 per cent)
- rising unrest in the Middle East and North Africa and consequent concerns around the security of medium term global oil supply (Australian petrol prices rose by 8.8 per cent in the March quarter)
- large increases in the costs of health, education and some utilities
- strong population growth
- rising commodity prices reflecting continuing strong demand.

The outsized inflation outcome occurred despite the strength of the $A and reported widespread retail discounting. Going forward these upside risks to inflation are likely to continue especially in the face of a robust labour market, ongoing skills shortages and improving consumer demand.

The Budget's CPI forecasts appear to have been leveraged off the December quarter CPI outcome with the March quarter 2011 outcome only released by the ABS on 28 April 2011. The March quarter CPI outcome was higher than most economic forecasters expected. It appears unlikely that the 2010-11 CPI forecast of 2.5 per cent on average for the year can be achieved. To do so would now require an increase in the June quarter 2011 of only 0.4 per cent. There is also some risk that CPI outcomes beyond 2010-11 will be higher than forecast in the Budget. Private sector forecasters have generally revised upwards their CPI forecasts since the release of the March quarter outcome and general expectations that the RBA will tighten monetary policy have been brought forward.

The Budget Papers analyse the sensitivity of revenue and expenses to a 1 percentage point increase in the CPI (Budget Paper No 3, Appendix B, page 296). A higher than forecast CPI outcome increases taxation revenue; revenue from sales of goods, Commonwealth Government Grants and other revenue; and increases expenditures.

The impacts vary across the Budget horizon. In the Budget year (2011-12) it is claimed that agencies would adjust expenditure plans to absorb any cost increases caused by a higher CPI outcome and consequently there is assumed to be no impact on expenditures from a higher than forecast inflation outcome. If this is correct, budgeted savings in other areas of expenditure will need to be even higher to maintain the Budget expenditure forecasts. This increases the degree of difficulty around achieving the efficiency dividend and savings initiatives. The Budget sensitivities also do not reflect any risk of changes to sales of goods, Commonwealth Government Grants and Other revenue in 2011-12 based on higher inflation outcomes.

Beyond 2011-12 higher inflation would also result in adjustments to Budget revenues and expenditures. Using 2012-13 as an example and based on the Budget sensitivities, a CPI outcome 1 percentage point higher than forecast would boost taxation revenue by $0.9 million (rising to $2.1 million in 2014-15); sales of goods and services, Commonwealth Government Grants and Other Revenue by $7.3 million (rising to $23.4 million in 2014-15); and expenses by $17.5 million (rising to $57.3 million in 2014-15). Given that expenditures are more sensitive to the CPI than revenue, sustained higher inflation would expose the Budget result to significant downward pressure and potentially defer the return to surplus.

Key Finding

In summary the most recent quarterly results for the CPI suggest that the Budget's CPI assumptions may be too conservative. A higher inflation outcome, particularly in future years, could put pressure on the Budget returning to surplus in 2013-14.

2.1.3 Outlook for employment

The Budget forecasts a significant easing in employment growth across 2011-12. This is a lagged response to softer growth in demand and GSP and reflects some moderation in ACT population growth from the strong rates seen in recent years. Employment growth across Australia (including the ACT) has surprised on the upside across recent post-GFC years. This reflects increased labour market flexibility and the increased skills base of workers both of which moderated the reduction in total employment. For example, as the economy slowed post-GFC workers shifted to part-time employment instead of becoming unemployed. There is some potential for employment to again outperform expectations although this is offset by the potential for fiscal consolidation at the national level to drive a slowdown.

Key Finding

Overall the employment forecasts appear reasonable.

2.1.4 Outlook for wages

Wage inflation based on the wage price index (WPI) is forecast to rise only moderately in 2010-11 to around 3.75 per cent. This would essentially require the remaining quarterly outcomes for 2010-11 to be 0.7 per cent, slightly below long-term historical quarterly outcomes (0.9 per cent).[2] Given the continuing tight labour market and emerging skills shortages this assumption may be too low even despite downward pressures on public service wage inflation. This reflects the fact that the ACT labour market, whilst highly public service oriented, is not quarantined from other influences likely to be pushing wages higher.

Higher wage inflation would tend to boost revenue in future years given that general rates and various fees are directly indexed to the WPI. Table B.2 in the Budget illustrates the sensitivity of taxation and other revenues to a 1 percentage point increase in the WPI. There would also likely be some upwards pressures on ACT public sector wage levels which is not considered in the disclosed sensitivities.

Key Finding

In summary the wage price index forecast of 3.75 per cent for 2010-11 before falling to 3.5 per cent in 2011-12 may be on the low side.

2.1.5 Enduring effects of the GFC

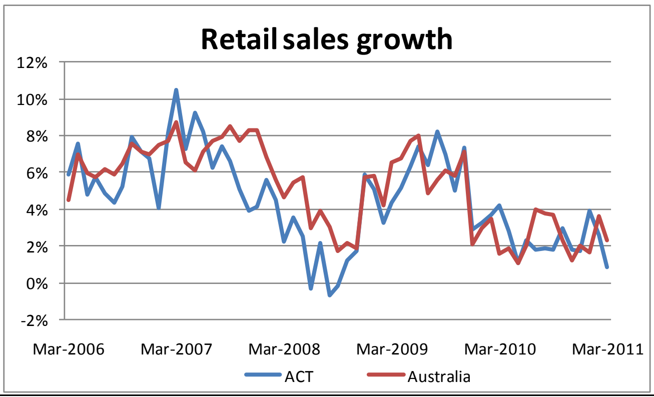
The GFC caused major economic dislocation on a global scale which inevitably impacted on Australia. Aggressive fiscal policy easing and proximity to rapidly modernising and urbanising China resulted in Australia outperforming other developed economies. The ACT was affected by these forces as well but arguably is less exposed to the offsetting influence of China.

The GFC caused significant reductions in household balance sheets mainly due to sharp falls in equity prices. Although share indices and household balance sheets have largely recovered, consumers remain cautious. Typically consumers

[2] Note the latest available data from the ABS is for the December quarter 2010.

will take longer to recover from slowdowns due to financial shocks than slowdowns caused by other factors. This is evident in continuing weak consumer spending where the growth trends for the ACT has matched those for Australia even though the latest reading shows ACT retail sales growth (0.8 per cent) weaker than the national rate (2.3 per cent). Retail sales growth since the GFC is noticeably lower than it was prior to the GFC and arguably less cyclical in both the ACT and nationally. Heightened caution amongst consumers has resulted in a large increase in household savings as well as constraining consumer spending.

Figure 2 **Retail sales growth**



Data source: ABS 8501.0

Key Finding

The GFC caused a re-assessment of risk. Households actively curtailed their borrowing flowing into weaker consumer spending. Many small businesses (including building developers) found credit expensive and difficult to obtain which slowed business investment outside the resources sector. These constraints are moderating but are still limiting activity levels in the ACT and nationally.

2.1.6 Long-term projections

The Budget has maintained the long-held convention of undertaking specific *forecasts* for the budget year and applying *projections* to subsequent years. The *projections* are based on long-run historical averages and are provided for indicative planning purposes only and are not intended as specific *forecasts*.

It is noted that the projections for GSP and state final demand (SFD) year average growth have both been revised lower relative to the projections in previous budgets. Projected GSP growth is now 3.0 per cent per annum (down from 3.25 per cent in the 2010-11 Budget) and projected SFD growth is now 4.75 per cent (down from 5.25 per cent). The more pronounced reduction of SFD growth (down 0.5 per cent) relative to that in GSP growth (down 0.25 per cent) implies better long-term performance of the net export sector than previously expected. Nevertheless, ACIL Tasman considers that the applied projections are reasonable given that the long-term average (1989-90 to 2009-10) for ACT GSP is around 2.9 per cent and for SFD is now around 4.75 per cent.

The other projections applied appear reasonable and close to their long-term historical averages.

Key Finding

In summary long term projections/forecasts are conservative and appear reasonable.

2.1.7 Risks to Economic Outlook

The Budget Papers itemise a number of key risks to the economic outlook (Appendix C, Budget Paper No 3) reflecting the challenges facing major developed economies and rising uncertainty regarding the global growth profile. These identified risks centre around:

- greater than currently anticipated expenditure restraint by the Commonwealth Government
- an extended period of household caution especially linked to tighter monetary policy and recent spate of natural disasters
- the sustainability of public finance and growth in European economies
- uncertain impacts of policy tightening in China
- stresses in global commodity markets
- the recent natural disaster in Japan which will likely crimp global growth.

Other potential emerging risks not specifically covered in the Budget include:

- the risk of higher wage inflation especially in a tight labour market with continuing skills shortages. While the driving factors may not be ACT-specific, they nevertheless flow into ACT wage settings particularly, in the private sector. (The impact of any national wages pressure on the ACT public sector's wages bill, at least in the short term, is likely to be minimal given that most agencies have finalised wage negotiations.)
- the risk that Australian house prices are over-valued and some correction emerges which would have a negative wealth effect on household spending.[3] This would not only constrain economic growth but also

[3] Besides the increasing number newspaper articles having a cautious or pessimistic attitude to the Australian housing market, more detailed studies by organisations such as the IMF

negatively impact the GST pool with flow-on impacts for the distribution of GST revenue back to the ACT.

Key Finding

There are a number of risks to the Budget forecasts and projections. Most are outside of the control of the ACT. However, one risk - the unknown level of restraint expected in the 2011-12 Commonwealth Budget - could be eliminated or at least reduced if the ACT Budget was brought down after the Commonwealth Budget.

(weblink) and the Economist (weblink) have consistently indicated that Australian house prices are above fair value (although the extent may be disputed).

3 Budget Revenue Projections

The budget process involves multiple trade-offs including between policy objectives and prudent long-term fiscal management, the latter often constrained by revenue potential. Hence revenue forecasts are a central focus of the budget process.

3.1 Overview of Revenue

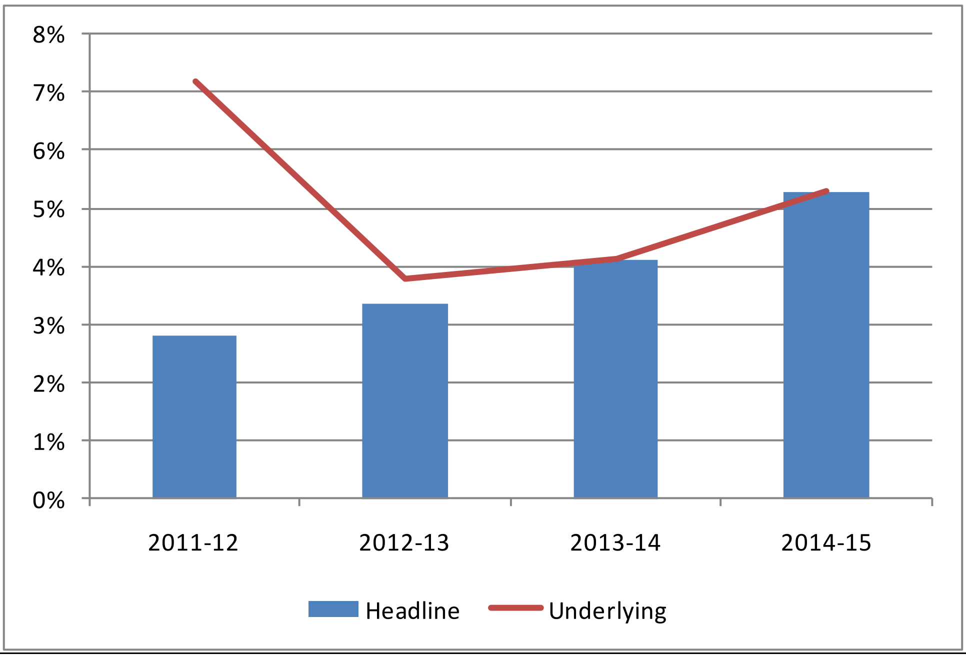
As Figure 3 illustrates, revenue growth is expected to accelerate steadily over the ACT 2011-12 Budget horizon from 2.8 per cent in 2011-12 to 5.3 per cent in 2014-15. This growth profile broadly matches the economic growth profile (with appropriate revenue/tax impact lags); the proposed changes to tax rates (especially the change to the change of use charge); and the projected increases in total Commonwealth funding including GST-linked revenues.

Growth calculations based on headline revenue estimates tend to lower forward growth rates because the 2010-11 revenue base is heightened by two significant and essentially one-off receipts. First, an increase in the revenue associated with shares and marketable securities, which relates to a one off tax assessment relating to prior years of $77.6 million and second, by payments from the Federal government linked to its *Nation Building Economic Stimulus Plan*. These are not ongoing sources of revenue and thus need to be excluded to gauge the underlying pace of revenue growth across the Budget horizon. After exclusion of these temporary revenues, underlying revenue is forecast to grow by 7.2 per cent in 2011-12 before moderating to 3.8 per cent in 2012-13.

The main drivers of underlying revenue growth include strong gains in dividend and tax equivalents (mainly the projected ramp-up in LDA[4] dividends) and gains from contributed assets. From 2012-13 and beyond the underlying rate of revenue growth converges with the headline as the components that are specifically excluded to derive underlying revenue do not continue significantly beyond 2010-11.

[4] Land Development Agency

Figure 3 **Headline and underlying revenue growth**



Data source: ACT Budget Paper No 3 table 3.1.1 and ACIL Tasman calculations

3.2 Specific Revenue Issues

Growth in projected revenue is focused on very strong growth in dividends and tax equivalents, especially from the LDA and ACTEW. Potential issues with specific revenue metrics that may require clarification are discussed below.

3.2.1 Change of use charges

After significant review the ACT government has decided to commence codification of the Lease Variation Change charge (LVC; previously known as a change of use charge) to commence on 1 July 2011 by establishing a public register of fixed charges for different land uses in all suburbs across the ACT. The discontinuance of the long-standing approach of applying fixed valuations for units, townhouses and dual occupancy developments will result in considerable increases in charges to developers. Consequently, the Government is providing a four-year transition period to assist industry adjust to the current market values. The transition involves a remission of effective rates which the Budget estimates will save industry around $8.5 million over four years (based on the 75 per cent LVC rate). The forecast revenue from the LVC increases sharply in 2011-12 as a result of introducing fixed charges and thereafter increases more steadily as the remission rate diminishes across the Budget horizon.

Whilst the LVC has a strong basis in economic theory and is consistent with the thrust of the recent Henry Tax Review, it is nevertheless likely to have some material impacts in the short and longer term. These impacts include:

- An incentive for builders and redevelopers to bring forward applications for lease variations in order to avoid the tax. This could result in higher prices being achieved for sales in the short term
- in the longer term a potential for the devaluation of some existing house prices, particularly those in the inner city suburbs, given the reduced potential for (or higher cost of) redevelopment. (We note that the Property Council have estimated that the reduction could be as much as $100,000.) To the extent that housing-related wealth effects impact on household spending propensities there may be some consequent downside risk to aggregate consumer spending
- the increased cost of re-development will necessarily increase the total construction costs of units built on land subject to the Lease Variation Change charge. At least a portion, of these higher costs will be passed on in the form of both higher purchase costs and higher rental cost.

The LVC also increases the ACT Budget's dependence on revenue from the property sector.

3.2.2 GST revenue grants to the ACT

The Budget Papers outline a range of difficulties in forecasting GST revenue grants to the ACT across the Budget horizon. The accumulated variation in expected GST revenues between the 2010-11 and 2011-12 budgets is detailed in Budget Paper No. 3, Table 7.2.1 and is around $60 million per annum on average across the Budget horizon. This is a material uncertainty relative to total ACT budget revenues.

Table 1 **Adjustments made to GST revenue grant estimates since the 2010-11 Budget**

GST Revenue Grants to the ACT		2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m	2014-15 $m
2011-12 ACT Budget	May 11	845.6	879.9	932.0	987.1	1,045.2
Accumulated variation from 2010-11 Budget to 2011-12 Budget		-33.7	-55.8	-61.9	-64.6	8.6
% change		-3.8	-6.0	-6.2	-6.1	0.8

Data source: ACT Budget Paper No 3, *Table 7.2.1, p.253*

The predominant uncertainty is around the size of the GST pool for the relevant year (i.e. the amount of GST collected across the national economy). The last update to the GST pool size appears to have been the Commonwealth Treasury's Mid Year Economic and Fiscal Outlook released in November

2010. Given the uncertainties surrounding economic growth momentum (especially softening consumer demand) it is difficult to predict the pool size although it appears unlikely to grow at the rate previously expected as the Budget has reduced its forecast for national GDP growth. As a result it appears that the GST pool will be lower than applied by the Commonwealth Grants Commission (CGC) in its recently released review. As indicated in the Budget Papers (Budget Paper No. 3, page 252), reflecting this uncertainty, Australian states and the ACT are now constructing their own estimates of the GST pool and incorporating those into forward estimates of GST-related revenue. Budget Paper No.3 Table 7.2.1 indicates that the revision applied to the nation-wide GST pool, based on ACT Treasury modelling, expected to be collected for 2010-11 (which educates GST payments to the state and territories for 2011-12) reduced the expected GST revenue for the ACT by $14.2 million, relative to the CGC estimate for the ACT of $894.1 million (see parameter variation number 6 below table 7.2.1).

The logic for this adjustment is quite sound given the evidence of pool erosion although the estimate is not transparent. It appears that the ACT has reduced the estimate of the GST pool relevant for 2011-12 by around $800 million based on the ACT share of the national GST pool (around 1.8 per cent) and a national pool size of $50 billion. The revised pool after the ACT Treasury adjustments is around $49.2 billion instead of $50 billion applied by the CGC.

Key Finding

In summary, there is a material uncertainty regarding the ACT's GST revenue. The logic for the downward adjustment in GST revenue appears to be sound given the evidence of pool erosion. However, the methodology used to adjust the estimate is not transparent.

3.2.3 Payroll tax

Payroll tax remains an integral component of the ACT tax base and is rising as a share of ACT taxation revenue, from 24.9 per cent in 2011-12 to 26.2 per cent by 2014-15 despite the stable payroll tax rate (6.85 per cent across the Budget horizon). The forecast increase in payroll tax revenue (7.5 per cent in 2011-12 and 6.4 per cent in subsequent years) appears to reflect the forecast improvement in employment growth across the Budget horizon combined with ACT wages growth. It should also be noted that any upside for employment in 2011-12 could translate into higher payroll tax revenue.

Key Finding

The payroll tax forecasts out strip the combination of employment growth and wage price inflation, but appear reasonable overall. That

said, the precise assumptions underlying the estimates are not fully clear to the consultants.

3.2.4 General rates

General rates are levied on property owners to provide funding for a range of municipal and other services for the ACT community. This revenue stream reflects the dual state and local focus of the ACT government. General rate revenue is forecast to grow above 6 per cent per annum in all years of the forecast horizon. The forecast increases in revenue from general rates reflects the forecast increase in wages (generally around 3.5 per cent to 4.0 per cent); revisions to the fixed charges and ratings factors applied to the average unimproved values and increases in the number of rateable properties. On balance, these forecasts appear reasonable. Although there is some potential for wage inflation to be somewhat higher than forecast for 2011-12 (3.75 per cent) and in the subsequent years which were projected at 3.5 per cent per annum. Prudent budgeting would support use of lower wage inflation forecasts. Given the link between wages and general rates there could be some potential upside around rates revenue.

Key Finding

In summary the general rates revenue forecasts seem reasonable.

3.2.5 Land tax

Revenue from land tax is forecast to increase by 5.2 per cent in 2011-12 and to grow at around 4.5 per cent per annum across the Budget horizon. The drivers of this forecast growth include inflation in the average unimproved values of land and growth in the number of taxable properties.

3.2.6 Conveyances

Duty is levied on the agreement for sale or transfer of land, a Crown lease or a land use entitlement located in the ACT. Conveyance revenue spiked higher in 2010-11 (up 4.4 per cent) reflecting the strength in housing prices and the volume of activity in the residential property and small commercial property markets. Not surprisingly revenue growth is expected to moderate across the Budget horizon.

3.2.7 Dividends and tax equivalents

Aggregate revenue from dividends and tax equivalents is forecast to increase sharply in 2011-12 (up 35.8 per cent). This primarily reflects sharp forecast increases in dividends from ACTEW and dividends and income tax equivalents from the Land Development Agency (LDA).

Table 2 **Budget estimates of dividend and tax equivalent income**

2010-11 Budget $'000		2010-11 Est. Outcome $'000	2011-12 Budget $'000	Var %	2012-13 Estimate $'000	2013-14 Estimate $'000	2014-15 Estimate $'000
	Dividends						
60,383	Dividends - ACTEW	61,224	88,761	45	94,440	105,775	110,465
3,339	Dividends - ACTTAB	2,309	2,338	1	2,581	2,833	3,097
900	Dividends - CIT Solutions	900	1,300	44	800	800	800
24,414	Dividends - Land Development Agency	32,919	115,265	250	115,997	110,325	132,706
44,322	Dividends from Financial Investments	105,446	66,999	-36	68,114	72,486	76,825
133,358	Total Dividends	202,798	274,663	35	281,932	292,219	323,893
	Tax Equivalents						
53,130	Income Tax Equivalent	77,569	105,940	37	94,960	97,038	109,447
53,130	Total Tax Equivalents	77,569	105,940	37	94,960	97,038	109,447
186,488	Total Dividend and Tax Equivalents	280,367	380,603	36	376,892	389,257	433,340

Data source: Budget Paper No.3. Table 3.1.10, p.64,

3.2.8 ACTEW

The increase in expected dividends from ACTEW reflects the expected increase in volumes given the relaxation of water restrictions as well as increased water and wastewater charges endorsed by the ICRC (in 2008). The interplay of increased charges and removal of restrictions combined with some expectation of a return to normal rainfall suggest some risk of over-forecasting the volume uplift going forward. Delays in capital works have appeared to boost ACTEW profits in 2010-11 (lower interest and depreciation) but this may reverse going forward as capital works move back on to schedule.

If the recent very wet conditions continue into the new year ACTEW's profitability and hence dividend payments could be over estimated.

3.2.9 Land Development Agency

The profits from development and marketing activities of the LDA are recognised as dividend revenues in the ACT budget. Dividends from the LDA are forecast to almost quadruple in 2011-12 (up 250.1 per cent). The Budget Papers indicate that this quadrupling of dividends reflects expected higher profits driven by increased land sales given the Governments accelerated Land Release Program. It is not clear if the likely downturn in land prices, due to the large increase in supply of land in the ACT, has been factored into these estimates.

However, it is also of interest to note that dividend payments remain high across the four year estimates, with dividends paid by the LDA in 2014-15 forecast to be around $17.4 million higher than estimated to be paid in 2011-12 (see Table 2). This situation arises even though residential land releases are scheduled to decline from 5,500 sites in 2011-12 to 4,000 sites in 2014-15 and commercial and industrial land releases are to remain relatively constant (see Table 3).

Table 3 **Indicative residential land release program**

Location	2011-12	2012-13	2013-14	2014-15
Gungahlin	1,261	1,450	1,400	1,050
Belconnen	560	750	200	200
Central Canberra	943	600	700	800
Molonglo	2,100	1,300	800	800
Woden and Weston	486	500	500	800
Tuggeranong	0	200	250	200
Other	150	200	150	150
Total	5,500	5,000	4,000	4,000

Data source: Budget Paper No.3, Table 5.3.1, p.134

Simultaneously, the LDA is part of the National Tax Equivalent regime (which requires ACT public trading enterprises to make income tax equivalent payments to the ACT). Increases in income tax equivalent payments by the LDA are the main source of the budgeted increase in overall revenue from income tax equivalents in 2011-12 reflecting the reasons discussed above. The budget details the derivation of the component of LDA profits that are treated as dividend revenue (excludes asset sales which are treated as capital) but does not detail whether the income tax equivalent approach applies to the total profit of the LDA (including asset sales) or just to the component considered as income.

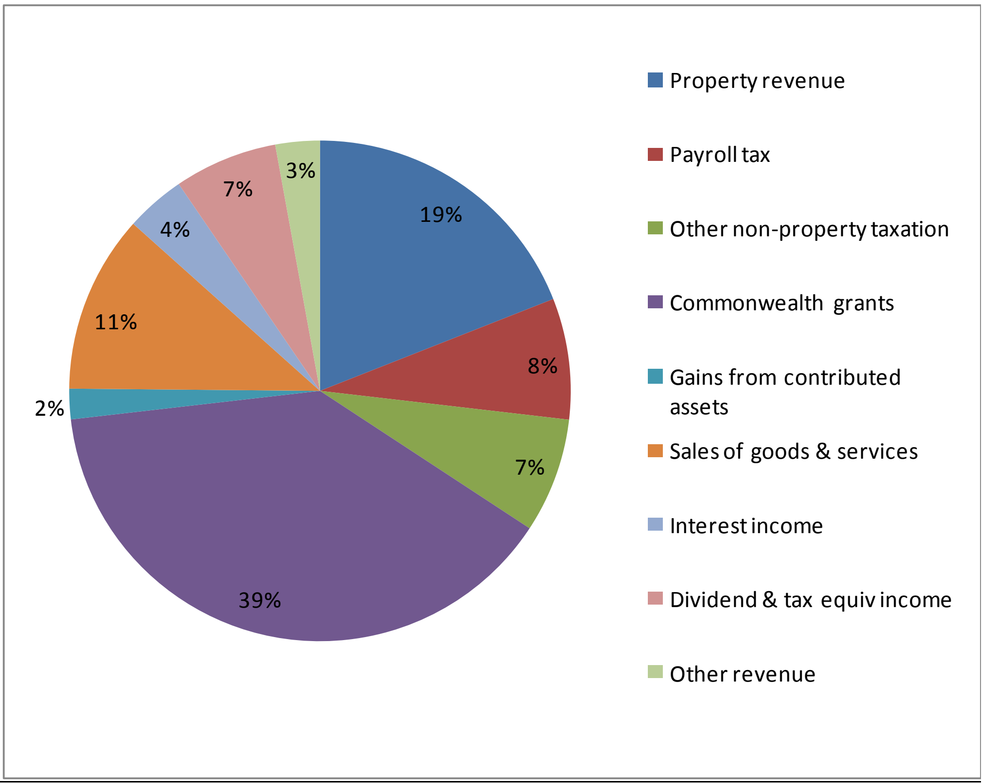
Key Finding

The rise in expected dividend and national tax equivalent payments is considerable. There is little clarity in the assumptions which underpin how the LDA dividend and national tax equivalent payments have been calculated. Continuation of the wet weather in 2011-12 could reduce ACTEW revenues and dividend payments. Further investigation of these estimates should be considered.

3.3 Revenue mix

The figure below depicts a high level distribution of ACT budget revenue across the major ***total*** revenue components as forecast for 2011-12. The dominant source of revenue is grants from the Commonwealth Government, which is expected to comprise around 39 per cent of ACT total revenue in 2011-12. Own-source taxation accounted for around one-third of total revenue - almost equally split between property and non-property taxes.

Figure 4 **Major components of ACT budget total revenue 2011-12**

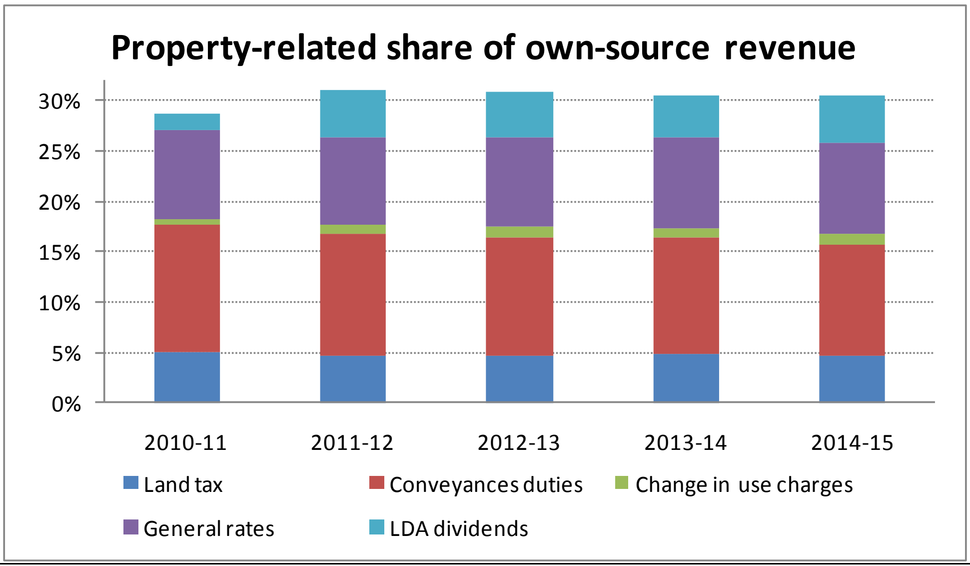


Data source: ACT Budget Paper No. 3, table 3.1.1

3.3.1 Reliance on property-related revenues

The ACT Budget is reliant on property-related revenue sources (including Land Tax, Duties on Conveyances, Change of Use charge and dividends from the LDA) over the Budget horizon. Relative to ACT **own-source** revenues (i.e. essentially excluding Commonwealth Grants) the share derived from these property-related sources is projected to rise from 19.7 per cent in 2011-11 to 21.5 per cent in 2014-15. Including general rates (although relating to services provided rate revenue is dependent on property market valuations) the share of own source revenue dependent on the property sector rises from 28.7 per cent in 2010-11 to 30.6 per cent in 2014-15.

Figure 5 **Reliance on property-related revenues**



Data source: Budget Paper No. 3, tables 3.1.1 and 3.1.2

A significant portion of ACT revenue is reliant on the property sector and is therefore exposed to downside risks. As noted previously, there is some concern that house prices in particular are over-valued (relative to rental yields) with consequent risk of downward correction. The dividend projections associated with the LDA appear optimistic (250 per cent increase forecast for 2011-12 and remaining broadly at that level across the Budget horizon). There appears material risk that these dividend projections will not be achieved especially given the projected reductions in expected land release.

3.3.2 Own-source revenues

According to the Commonwealth Grants Commission (CGC) the ACT has the fourth lowest (across the states and territories) fiscal capacity partly stemming from a below average capacity to raise revenue but offset by a below average cost of service provision (CGC page 22). This reflects the fact that there is no material mining activity in the ACT and below average payments from the Commonwealth.

This essentially forces the ACT to provide an above average share of total revenue from its own sources. Based on ABS data (see figure below), ACT raises about 56.4 per cent of total revenue via own-source revenues compared with an average across all states and territories of 50.4 per cent. In turn, the majority of the ACT's own source taxation revenue comes from two areas - payroll tax and taxes on property-related transactions including general rates (largely related to its dual municipal role).

Figure 6 **Comparison of state own-source revenue shares**

Data source: ABS

3.3.3 Alternative revenue sources

The ACT faces a number of constraints in terms of its revenue raising capability.

For example, a large share of the ACT's employment base is exempt from payroll tax since it is Commonwealth based. The ACT private sector employment base - which can attract payroll tax - is relatively smaller than in other states and thus aggregate ACT payroll tax revenue is relatively lower than in other states when measured per total employed person. A similar constraint applies to Commonwealth property in the ACT against which the ACT cannot raise general rates. It is not clear whether the Budget has specifically accounted for the *Payroll Tax Bill 2011* although the Explanatory memorandum to the bill states that there is no change to policy as a result of the bill, which is more focused on national tax harmonisation and decreasing the compliance burden for businesses that operate across state and territory borders.

The pre-dominance of the public sector in the ACT necessarily means that other sectors are relatively smaller than in other states. For example, the mining sector, which has been a critical driver of GSP, employment, and other tax relevant parameters in other states and territories, is relatively minor in the ACT. Similarly manufacturing is under-represented in the ACT relative to other states.

The more narrow industry base in the ACT limits the capacity and flexibility of the ACT to raise new and alternate taxes. The ACT tax capability is also significantly constrained by the rates of similar taxes applicable in surrounding NSW since uncompetitive ACT tax rates would risk leakage of people, employment and economic activity out of the ACT and into NSW. ACT has a significantly smaller population than NSW and thus limited scope to exploit scale economies in taxation arrangements (and service delivery). These factors are part of the CGC deliberations on distributing the GST revenue but are offset to varying extents by a range of other positives including around government expenditures. Nevertheless, the ACT tax base is narrower and less diverse than those of other states with mining sectors, diversified industry bases and larger populations.

3.3.4 Synchronisation with Federal Budget

The current convention, whereby each year the ACT budget (and that of most other states) pre-dates release of the Commonwealth budget, introduces significant uncertainty and ultimately inefficiencies into the budget process, particularly for the ACT.

The ACT budget includes an educated estimate on the quantum of GST and various grants from the Commonwealth Government to derive projections of revenue around which expenditure and other decisions are based. However, the release of the Commonwealth budget inevitably results in changes to the quanta of these grants. This results in the following inefficiencies:

- considerable pre-budget forecasting (and potentially re-work) is required by agencies involved in the preparation of budget parameters (mainly Treasury)
- important decisions requiring trade-offs around the appropriate level of expenditure, deficit and borrowing may be potentially sub-optimal, given the likelihood of divergence between ACT expectations of various parameters included in their budget and guiding their policy trade-offs and the ultimate outcome released in the Commonwealth budget

As noted above, the ACT economy is particularly exposed to the Commonwealth budget's cyclicality. This means that the Commonwealth budget not only impacts ***directly*** on various revenue and expenditure components of the ACT budget, but also impacts directly on the ACT economy and thus ***indirectly*** on ACT budget parameters sensitive to the ACT economic cycle. This reinforces the need for the ACT budget to post-date the Federal budget as the latter will affect economic growth expectations nationally as well as in the ACT.

4 Outlook for Government Expenditure

According to the ACT 2011-12 Budget Papers, expenditure is expected to increase by 6.1 per cent in 2011-12 to $4.1 billion. Of this expenditure:

- 47 per cent relates to employees wages and superannuation; and
- from a portfolio perspective around 53 per cent relates to health and education.

The expected increase largely reflects wage inflation, growth in the health funding envelope from previous budgets and the net impact of policy initiatives (with spending offset by expected savings).

4.1 A new public service, single agency model

The 2011-12 Budget makes provision for a new single agency model for delivering public sector outcomes. The new model which formally commences on 1 July 2011, has nine directorates with each reporting to the Head of the Public Service (who will also take the responsibility for the Chief Minister's Directorate). The single agency public service model is a key recommendation of the Review of the ACT public service by Dr Allan Hawke.[5]

Under the single agency model all Directorates will utilise a common administrative services/corporate division. Whilst the Hawke review did not focus on savings (or estimate their quantum) the report does expect some efficiencies, including improved flexibility and reduced duplication of effort, to arise from the new structure.

4.2 Expenditure accountability

The Hawke review considered that there is a need to review the Budgetary process. The review noted, amongst other things, that Budget discipline can be undermined by a belief that the fiscal situation will always be better in the final result than forecast. While recognising that fluctuations around the final budget result and the earlier Budget estimate are inevitable and occur in every jurisdiction, the need for accuracy of estimates for matters within the ACT Government's control was considered to be strong. In this regard, the Hawke review considered the option of requiring directorates (departments) with cost overruns to find cost savings elsewhere.

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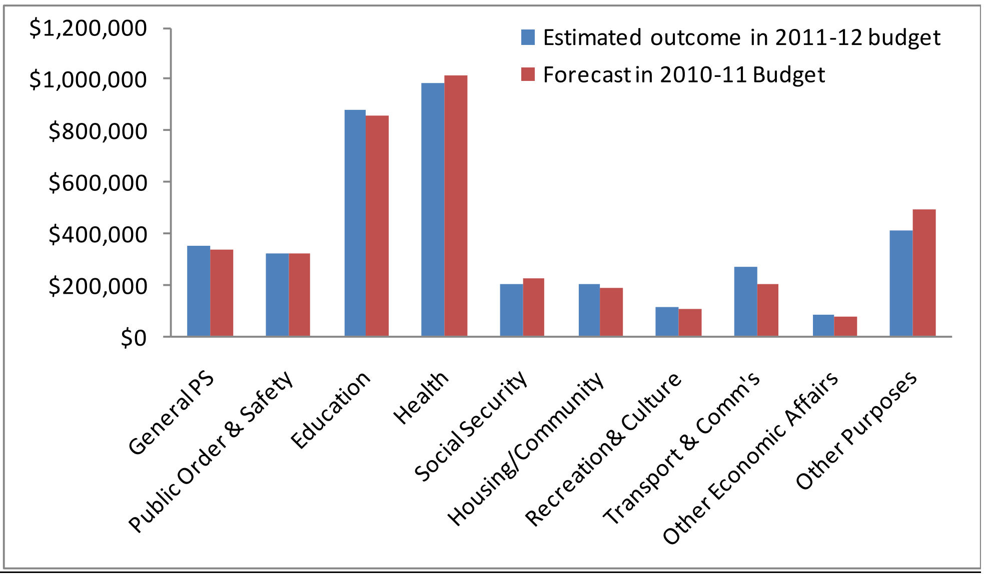
5 ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Service*, Dr Allan Hawke, February 2011.

> Spending proposals would be managed better by a rule that if expenditure exceeds what is estimated, offsetting savings must be found from within the same Directorate.[6]

One indicator of emerging cost pressures and risks around sustainability is a comparison of the now likely outcome for 2010-11 as disclosed in the current Budget Papers with the estimates for 2010-11 (in the budget document from last year). This can be undertaken at a functional level. Although deviations in likely outcomes from (last years) budget forecasts can reflect a number of factors, it can be informative to identify the reasons behind such divergence from the perspective of improving future forecasts and to identify any material shifts that could indicate emerging pressures that if remedied promptly can bring expenditure growth closer to revenue growth and support fiscal sustainability.

Figure 7 **Government Expenses by function 2010-11 ($'000)**



Data source: ACT 2011-12 Budget Paper No. 3 page 355, ACT 2010-11 Budget Paper No. 3 page 345

Education expenditures are now expected to total around $881.9 million in 2010-11 compared with the forecast last year of $858.4 million. The increase relative to forecast (around $23.6 million) is mainly comprised of an increase of around $13 million in secondary education and lesser increases in tertiary education (around $2 million) and pre-school education (around $4 million).

Expenditure related to housing and community amenity for 2010-11 is now expected to be $205.9 million - significantly higher than last year's budget

[6] ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Service*, Dr Allan Hawke, February 2011, p.234.

forecast of $188.9 million. Most of this increase seems to be linked to the "other sanitation and protection of the environment" category.

Social security expenditure in 2010-11 is now expected to be significantly lower in 2010-11 ($201.5 million) than expected in last year's budget (estimated at $223.6 million). Welfare expenditures for "family and children" and for the aged are both likely to be significantly lower partially offset by higher than forecast expenditures for disability related welfare and welfare services not elsewhere classified.

The overall outcome for health expenditure in 2010-11 is now expected to be around $26 million lower than envisaged in the 2010-11 budget. This largely reflects lower expenditure in "acute care institutions" and in "community health services". These are quite surprising reductions especially given expectations around strongly rising health costs a sentiment echoed recently by the ACT Treasurer and Minister for Health. Given continuing demand pressures in these areas it would be useful to understand how these cost reductions (relative to forecast) were achieved.

Key Finding

Identification and analysis of the reason behind these expenditure variations can be informative. In some cases early remedial action can provide significant long-term fiscal benefits. There could also be merit in considering imposing a rule along the lines identified in the Hawke review, i.e. that if expenditure exceeds what is estimated, requiring the same Directorate to find offsetting savings.

The committee may wish to seek additional information on the reasons behind the differences between forecast and expected actual expenditures in areas such as health.

4.3 Forward pressures

A number of expenditure functions are expected to grow at above average levels into 2011-12 and in some cases across the Budget horizon. These expenditure functions need to be examined to ensure efficiency and appropriate controls. The following are issues related to forward pressures identified by the consultants' relatively brief review of the ACT 2011-12 Budget Papers.

4.3.1 Health

Health expenditures are projected to go above $1 billion for the first time in 2011-12 (up 8.5 per cent) reflecting a range of well understood drivers of health costs (including health-related inflation, rising population and ageing). This trend of strong, above average expenditure growth is expected to continue across the forecast period averaging 6.3 per cent per annum to 2014-15.

The Budget argues that the acute problem around cross-border patients (e.g. patients from NSW that seek care in the ACT as a regional health hub) is putting stress on the ACT health budget and service delivery to its citizens. The Hawke report cited the following dimensions to this problem.

> In health, for example, cross border patients account for 25% of inpatient hospital activity in the ACT and 30% of the ACT elective surgery waiting list. NSW patients comprise 12% of ACT emergency department activity. NSW patients are also typically older and sicker than ACT patients with a 30% higher average acuity. 7

Key Finding

It is not within the scope of this Budget review to assess the revenue and cost pressures associated with this forward pressure on the Budget's expenditures. However, it would appear that this issue needs urgent policy investigation and potentially renegotiation of arrangements in the area with the NSW Government.

4.3.2 Social security

Social security spending is forecast to increase quite sharply in 2011-12 (up 9.9 per cent) and to remain at that elevated level into 2012-13 (up only 0.3 per cent). In subsequent years expenditure growth appears to be at more normal levels.

Key Finding

Clarification of the reasons for the estimated increase in social security spending in 2011-12 seems warranted by the Committee.

4.3.3 Education

Education expenditures are forecast to remain essentially flat in 2011-12 rising by less than $1 million on a base level of around $882 million. Education costs in the ACT appear to be impacted by offsetting forces as students continue to

[7] ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Service*, Dr Allan Hawke, February 2011, p.47.

drift from government schools to private schools (albeit at a slower pace according to the Hawke report)[8].

This education drift moderates the pace of uplift in ACT Government education costs but is offset to some extent by the greater teaching costs associated with some of those remaining in public education[9]. According to the Hawke review[10], the ACT also incurs considerable net costs in educating regional students (i.e. from NSW but without any funding from NSW) and only receives partial compensation via the Commonwealth Government Grants equalisation processes. Dr Hawke recommends that approaches to cross-border recovery in education (as well as other areas) need to be examined.

Key Finding

The potential for recovery of net cross-border costs associated with education should be a focus area.

4.3.4 General public service

Expenditures on general public service are the fastest growing functional category in both the budget year (up 18.8 per cent) and across the entire budget horizon (up 12.5 per cent per annum).

4.3.5 Other purposes

Expenditure on 'Other purposes' is forecast to increase by 13.8 per cent in 2011-12 and to average growth across the Budget horizon of 7.7 per cent. It is not fully clear, from our reading of the Budget, what is covered by the Other purposes expenditure and what drives its increase.

Key Finding

Other purposes expenditure is becoming a major category of overall budget expenditure and probably needs to now be disaggregated to identify the major drivers and to ensure that it is not used to disguise newly emerging expenditures that avoid adequate scrutiny.

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8 ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Service* Dr Allan Hawke, February 2011, p.162.

9 ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Service* Dr Allan Hawke, February 2011, p.162.

10 ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Service,* Dr Allan Hawke, February 2011, p.48.

4.3.6 Agriculture

Agriculture related expenditures are forecast to fall sharply in 2011-12 (down 16.0 per cent) and across the Budget horizon (down 4.7 per cent per annum). It is likely that this change is driven by the drought being in large part being alleviated in the ACT as a result of the improved weather.

4.4 Efficiency dividends

The efficiency dividend introduced in the 2010-11 Budget comes into effect on 1 July 2011. The Budget Papers report that the efficiency dividend is expected to achieve savings of $66.6 million across the Budget horizon. The efficiency dividend required by ACT Government agencies depends on size and is increased across time as below.

- for agencies with Government Payment for Outputs (GPO) appropriations of less than $20 million - the dividend is to be applied at 0.5 per cent for in 2011-12; 0.75 per cent for 2012-13; and 1.0 per cent for 2013-14
- for agencies with GPO appropriations above $20 million - the dividend is to be applied at 1.0 per cent for in 2011-12; 1.5 per cent for 2012-13; and 2.0 per cent for 2013-14.

Efficiency dividends can fall heavily on agencies that have only limited discretionary funding options. This issue was investigated in detail in 2008 by the Commonwealth Parliament's Joint Committee of Public Accounts and Audit. The Committee report found that the nature of the agency and related to this their opportunity to reduce costs is often related to the agency's size. Smaller agencies are often less able to continually, year after year achieve efficiency dividends.

However, the nature of the service provided can also be important. For example, The Hawke review[11] provides insight into how relatively minor percentage efficiency dividends can translate into significant reductions in impacted areas after certain critical areas are effectively quarantined from contributing to the dividend, after recognising that it is impractical to reduce depreciation and after recognising that other non-discretionary expenditures cannot be reduced. This results in an outsized effective reduction in the area(s) ultimately contributing to the dividend. Dr Hawke provides an example where a 1 per cent efficiency dividend translates to an effective 7 per cent reduction in the impacted area within the (then) Department of Education and Training.

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[11] ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Service* , Dr Allan Hawke, February 2011, p.165.

The Budget Papers argue that in principle these efficiency dividends will not impact the volume and quality of services provided, as they are designed to reduce the inputs involved for the same service volumes and quality (reflecting real efficiency gains). In fact agencies are supposed to focus on identifying reductions in operating costs that do not impact outputs. However, it is not that simple in actuality. The concern with achieving the expected efficiency dividend savings, particularly over the longer term is highlighted by the Budget itself, which notes the problems encountered by the Education and Training Directorate and the Community Services Directorate both of which were unable to meet their dividend expectations given downside risks to front line services[12].

The Hawke Review also notes the Community and Public Sector Union have been longstanding opponents of the 2009-10 and 2010-11 Budget decisions to impose the efficiency dividend. Their concerns reflect the real risks over time to the volume and quality of services delivered against a background of cumulative expenditure reductions

> The efficiency dividend is having a significant impact on the capacity of the ACTPS to effectively deliver government policy and objectives. The CPSU believes that the ongoing negative impact of the efficiency dividend on the ACTPS is an example that demonstrates why the efficiency dividend needs to end.
>
> Some larger ACTPS agencies may initially be able to absorb some of the government cuts by diverting project funds, using own source income or economies of scale to maintain staffing levels and functions following the introduction of the efficiency dividend. However, this is not sustainable in the long term.[13]

It should also be noted that in general, global efficiency dividends take no account of the relative efficiency of different agencies ***prior to*** the commencement of the dividend approach. Efficient and inefficient agencies are typically required to make the same relative dividend contribution. Given this, efficiency dividends are a rather crude and blunt approach that is significantly sub-optimal compared to pro-active, considered and internally coordinated deliberations involving re-prioritisation of expenditure.

4.5 Savings initiatives

In addition to the efficiency dividend, the Budget incorporates further savings of $150.7 million in public sector agency expenditures over the Budget horizon. The Budget Papers claim these savings will be achieved by reducing administrative inputs, streamlining business processes, improving back office

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12 Budget Paper No. 3, page 26

13 ACTPS Review Final Report, *Governing the city state, One ACT Government – One ACT Public Servic*e, Dr Allan Hawke, February 2011, p.166.

efficiency, improving efficiency in land development, and by limiting growth in staffing numbers.

Savings in **administrative costs** are to be achieved by reducing input costs such as travel, accommodation, printing, stationery, recruitment, electricity usage and fleet. These savings will be administratively problematic to implement and monitor across the public sector. Although not the main focus it is claimed that reductions in these inputs will have attendant environmental benefits. The Expenditure Review and Evaluation Committee [14]has scoped potential **business process streamlining** and identified improvements around shared services (human resources, finance), transaction processing, removal of duplicate processes and systems, better technology utilisation and changes to staffing structure. These types of expenditure reduction measures are difficult to implement, target and monitor – particularly when the Budget has also introduced an efficiency dividend.

One initiative related to theses public sector savings is that the Government intends to put the **Land Development Agency** on a similar footing to private sector land developers by requiring interest charges relating to its access to englobo land. This appears to be a positive step. However, it does not appear to fully address the concerns raised in the Hawke Review[15] (pages 180-181) since even after requiring interest payments from the LDA it:

- still leaves the LDA with a significant commercial advantage including via access to cabinet material
- still exposes the government to new risks in joint ventures and direct land development
- still may create perverse incentives to resist the sale of land
- still may add to house construction costs

The LDA remains not fully commercial and yet not fully integrated into the ACTPS. The Hawke Review recommended a structure better suited an environment where it was solely focused on commercial outcomes. This would reduce current risks and uncertainties around its operation by government with sometimes competing objectives (e.g. high land prices to maximise returns to ACT versus maintaining affordable housing across the ACT).

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14 ACT Budget Paper No. 3, pages 29-32.

15 ACTPS Review Final Report, Governing *the city state, One ACT Government – One ACT Public Service,* Dr Allan Hawke, February 2011, p.180-181.

Key Finding

Efficiency dividends are a rather crude and blunt approach that is significantly sub-optimal compared to pro-active, considered and internally coordinated deliberations involving re-prioritisation of expenditure, as appears to be the case with the proposed savings initiatives. However, the interaction of the efficiency dividend with the savings initiatives is not clear. At a minimum the interaction should monitored closely over the budget years to ensure that expenditure reductions are not double-counted as both an efficiency dividend and a savings initiative.

The Committee may wish to question what work has been done to examine the interaction of the efficiency dividend with the savings initiatives.

4.6 Public section job reductions

Section 1.5 of Budget Paper No.3 says that Full Time Equivalent (FTE) will only grow by around 110. This is misleading as it is allowing a growth of 110 FTE jobs relative to what was budgeted for in 2010-11. In fact, according to Appendix E of Budget Paper No.4, whole of Government staffing numbers are being **allowed to increase by 180 FTE jobs** compared to the 2010-11 estimated outcome (from 17,489 to 17,669 FTE jobs). This would indicate that the reductions are not as draconian as may be feared by the general rhetoric.

Based on the 110 increase in staff numbers relative to the 2010-11 budgeted number, the Budget Papers say that this is based on new policy initiatives adding 320 FTE jobs offset by reductions totalling around 210 FTE jobs from improving the efficiency of back office functions. The reductions are to be achieved through natural attrition and where necessary through targeted voluntary redundancies without recourse to involuntary redundancy.

One outcome of the blunt efficiency dividend may be that labour costs are viewed as the more variable component of certain programs such that jobs may be shed in an effort to maintain operative programs. This may boost the likelihood that the job reductions are achieved but it may ultimately be at the expense of service delivery.

Primarily, 232 additional positions are to be created in the Directorates of Justice and Community Safety, Education and Training and Community Services. A total of 768 FTE staff are to be lost from discontinued agencies (543), the Chief Minister's Directorate (85) and the Territory and Municipal Services Directorate (140). Most of the people currently filling these positions are likely to simply be transferred to fill the 636 new positions in the new

Economic Development (179) and Sustainable Development (457) Directorates. Besides the estimated loss of a further 30 positions from the Canberra Institute of Technology, there are a range of other relatively minor changes in job numbers across many of the other Directorates. It is unknown how many of the projected downward changes are due to the savings in back office functions.

Key Finding

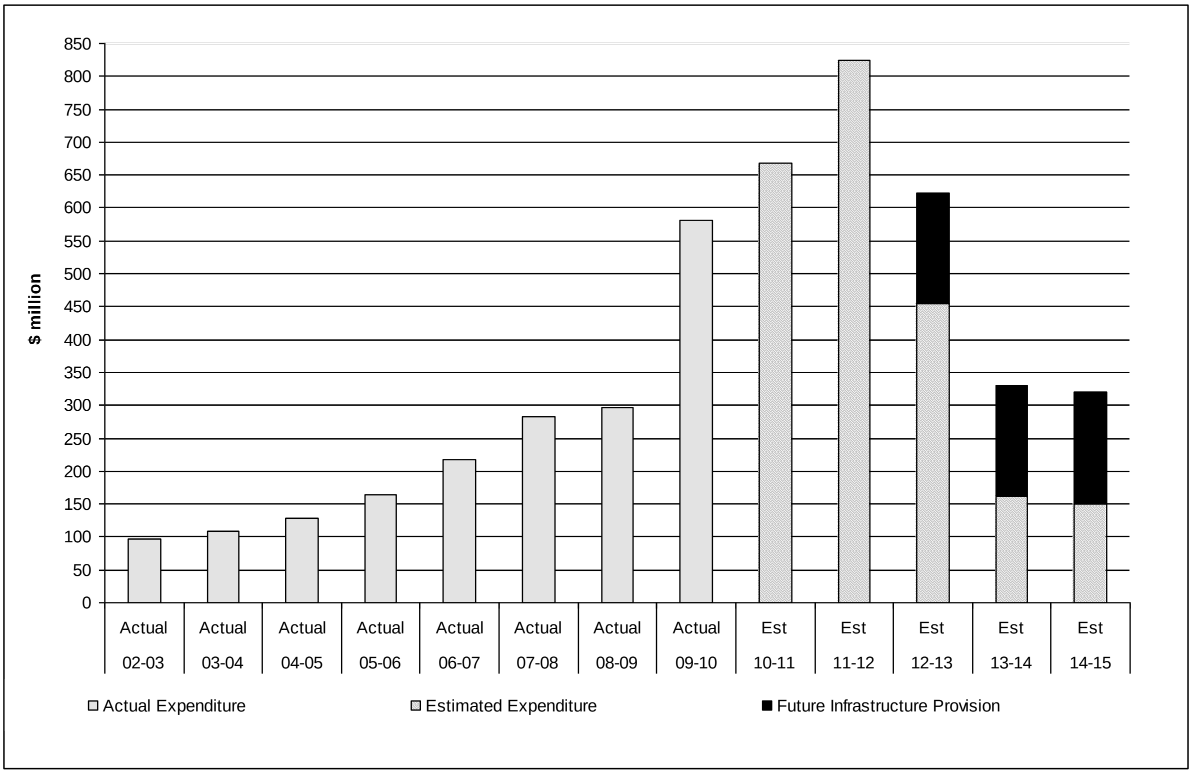
Without a detailed knowledge of the exact functions of the proposed public sector staff to be cut, the target seems to be achievable without the need for a large number of expensive redundancy payments.

5 Infrastructure

5.1 Capital works program

The 2011-12 Budget continues the ACT's recent budgetary trends to invest heavily in new infrastructure. As shown in Figure 8 the expenditure for the 2011-12 financial year for new work and work-in-progress is estimated to be $824 million, which exceeds the previous year's record expenditure by around $156 million or 15.1 per cent.

Figure 8 **Capital works expenditure program**



Data source: ACT Budget 2011-12, Budget Paper No 3: Budget Overview, Figure 5.4.4, p.137.

Only a small proportion of the estimated capital works expenditures included for expenditure in the 2011-12 financial year represent a roll-over of capital works programmed in the 2010-11 Budget for expenditure in 2010-11.

Table 4 **Works-in-progress including rollovers and re-profiling**

	2011-12 Allocation	2012-13 Allocation	2013-14 Allocation	2014-15 Allocation	Four Year Investment	Total Value
	$'000	$'000	$'000	$'000	$'000	$'000
Works in Progress						
2010-11 and Prior Year Programs	422,531	136,434	16,418	850	**576,233**	**576,233**
2010-11 Rollovers/Re-profiling	84,194	45,300	0	0	**129,494**	**129,494**
Sub-Total (Works in Progress)	506,725	181,734	16,418	850	705,727	705,727

Data source: ACT Budget 2011-12, Budget Paper No 3: Budget Overview, Table 5.1.1, p. 123.

The majority (506.7 million) of the capital works program expenditures estimated for outlay in the 2011-12 financial year relates to work-in-progress (on previously committed programs). However, the 2011-12 Budget has announced a **new** program of investments in infrastructure that is estimated to cost $317.5 million (Table 5.1.1).

In light of the ACT's strong economic climate the need to continue and expand the largest capital expenditure program in the Territory's history of self government should be considered. For example, the Budget does not analyse whether the proposed very high capital works expenditures would place excessive pressure on wage rates and the demand for Territory's labour supply. Pressures of this nature could crowd out private sector activity in the Territory.

Further, the Budget does not consider whether the costs estimated for these capital works will need to be escalated because of national demands for construction arising from the recent national disasters in other Australian states.

5.1.1 Government borrowing

The Treasurer announced that general government borrowing will increase by $650 million, which is $200 million more than forecast in the 2010-11 Budget. Of this, $350 million will need to be borrowed in 2011-12 with the remaining $300 million to be borrowed in the following year. These new borrowings are to be funded through a fixed rate nominal bond issue involving semi-annual interest payments with the principal to be repaid in full at maturity.

A substantial part of the new capital works expenditure in 2011-12 and 2012-13 will be funded by these additional borrowings. The Budget Papers report that assets to be funded, in part, by the new capital borrowings include:

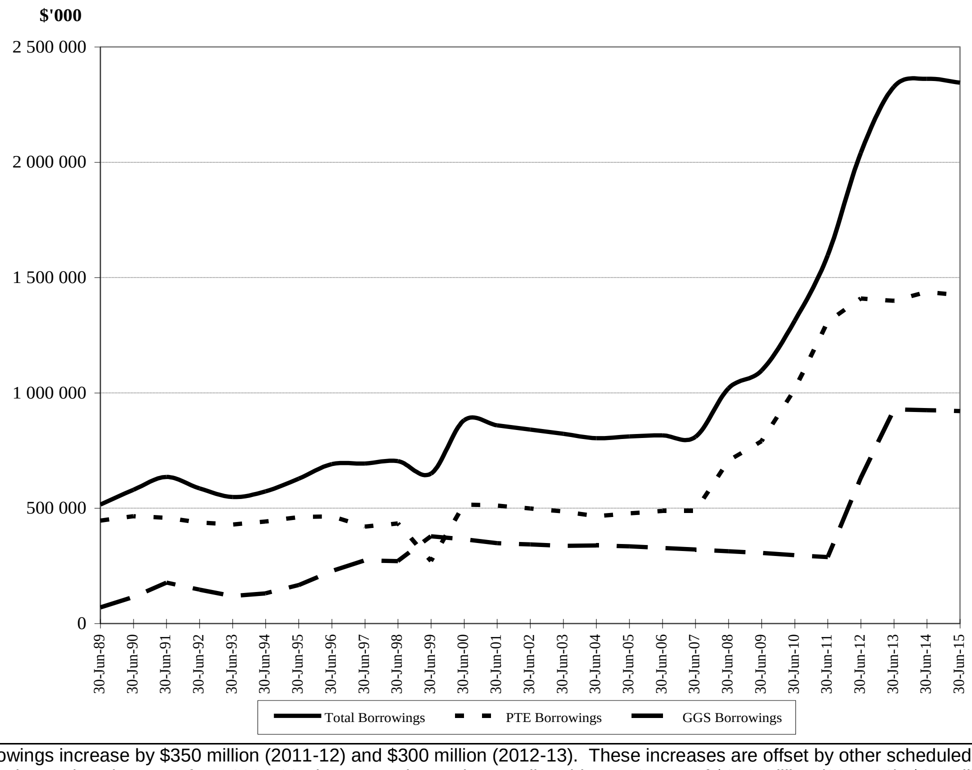
- Continuation of the implementation of the capital asset development plan to build a sustainable and modern health system

- The Majura Parkway.

The 2011-12 Budget estimates that the Territory's general government debt will be at historical highs in 2011-12 and 2012-13. By 30 June 2012 the general government sector (which excludes Public Trading Enterprises, such as ACTEW) will have $631.4 million in debt, rising to around $930 million in 2013 (see Figure 9).

The Budget Papers report that approximately 63 per cent of total Territory borrowings are held on a floating interest rate basis. An increase in market interest rates would have a direct impact on the interest costs of these borrowings, which would impose additional pressure on the Budget's bottom line outcome.

Figure 9 **ACT external debt, broken down by general government sector and private trading enterprise debt: 1989-90 to 2011-12 and the Forward estimates**



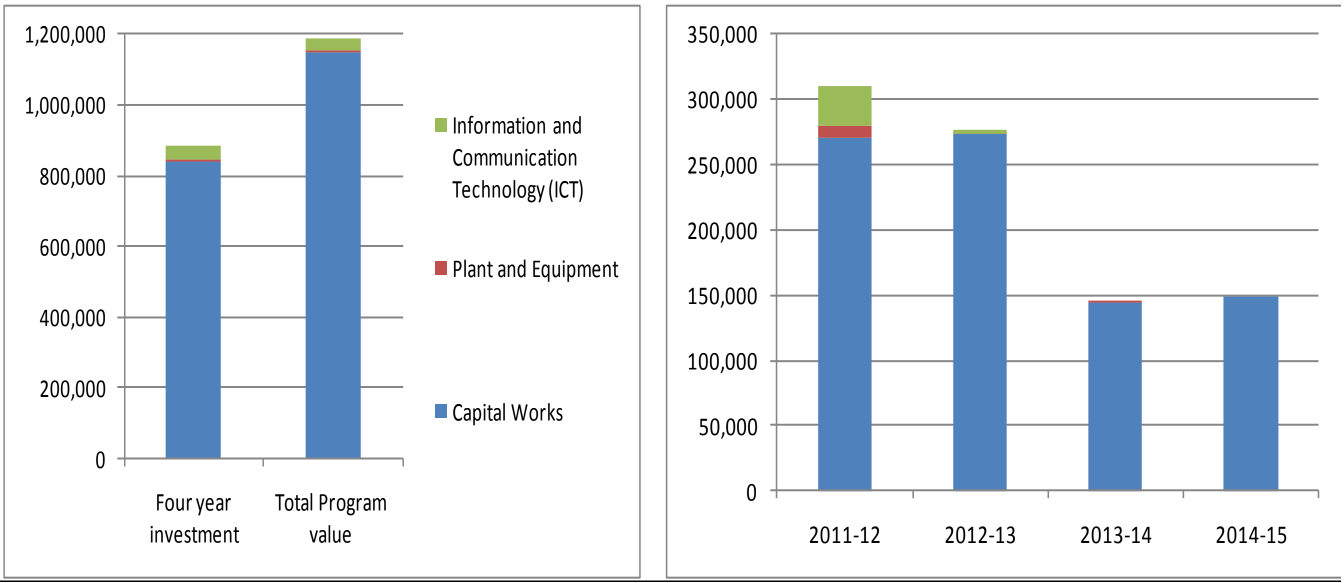
Note: GGS borrowings increase by $350 million (2011-12) and $300 million (2012-13). These increases are offset by other scheduled GGS borrowing principal repayments. PTE borrowings increase from 2007-08, due to new borrowings attributable to ACTEW of $300 million (2007-08), $97 million (2008-09), $243 million (2009-10), $300 million (2010-11), $180 million (2011-12) and $50 million (2013-14). These increases are offset by other PTE borrowing scheduled principal repayments

Data source: ACT Budget 2011-12, Budget Paper No 3: Budget Overview Figure 6.2.1, p. 224.

5.2 2011-12 Budget capital investment initiatives

The 2011-12 Budget announced new infrastructure expenditures totalling $882.2 million over four years. The total value for this program of investment increases to $1,189.5 million by 2016-17. This is because additional expenditures of $183. 8 million (in 2015-16) and $123.5 million (in 2016-17) is required to complete the Government Office Building project. Figure 10 show that by far the majority of these new expenditures ($838.6 million) relate to Capital works.

Figure 10 **2011-12 Budget total new infrastructure investment program, $'000**



Data source ACT Budget 2011-12, Budget Paper No 3: Budget Overview, Table 5.5.1, p.139

The following table provides a breakdown of the new capital works expenditure by agency. The estimates for the 2011-12 financial year indicate that the Health Directorate, followed by the Economic Development Directorate will have the highest expenditure outlays on new capital works. However, it can also be seen from Table 5 that over the four years of estimates the Economic Development Directorate and the Territory and Municipal Services Directorate will have the largest outlays for new capital works.

Table 5 **2011-12 Budget, summary of capital works associated with the new Infrastructure investment program, by agency, $'000**

Agency	2011-12	2012-13	2013-14	2014-15	Four year investment
Chief Minister's Directorate	3,080	2,200	0	0	5,280
Territory and Municipal Services Directorate	56,668	62,089	63,506	36,741	219,004

Agency	2011-12	2012-13	2013-14	2014-15	Four year investment
Economic Development Directorate	60,544	63,325	41,719	110,620	276,208
Health Directorate	62,581	59,755	3,666	0	126,002
Justice and Community Safety Directorate	5,919	-	-	-	5,919
Sustainable Development Directorate	54,720	73,750	34,000	0	162,470
Community Services Directorate	12,555	10,000	5	25	22,585
Housing ACT	11,446	2,000	2,000	2,000	17,446
ACT Public Cemeteries Authority	727	0	0	0	727
Canberra Institute of Technology	1695	0	0	0	1,695
Exhibition Park Corporation	1265	0	0	0	1,265
Total new capital works	271,200	273,119	144,896	149,386	838,601

Data source: ACT Budget 2011-12, Budget Paper No 3: Budget Overview Table 5.5.2, p.140 – 143.

5.2.1 Health Directorate

In 2011-12 the Health Directorate is estimated to outlay $62.6 million in new capital works infrastructure expenditures. The following three projects are estimated to account for $50.3 million of expenditure in 2011-12:

- Clinical Services Redevelopment, Phase 3 – $15.7 million in 2011-12 with an additional $10 million estimated for expenditure in 2012-13
- Enhancing Canberra Hospital Facilities (Design) – $20 million in 2011-12 with an additional $20 million estimated for expenditure in 2012-13
- Staging, Decanting and Continuity of Services – $14.6 million in 2011-12 with an additional $4.83 million estimated for expenditure in 2012-13

5.2.2 Economic Development Directorate

In 2011-12 the Economic Development Directorate is estimated to outlay $60.5 million in new capital works infrastructure initiatives. The majority of these expenditures are for relatively small projects. For example:

- $150,000 has been allocated for a Gungahlin Office Accommodation Feasibility study
- $750,000 has been allocated for the design of the proposed Manuka Oval Redevelopment.

It should be noted that funds have not been provided in the Budget's forward estimates for any additional capital work to be undertaken on either of these projects.

The four largest outlays estimated for new capital works expenditure by the Economic Development Directorate in 2011-12 are as follows:

- Horse Park Drive Extension to Moncrieff Group Centre – $15 million in 2011-12 with an additional $9 million estimated for expenditure in 2012-13
- John Gorton Drive Extension to Molonglo 2 and Group Centre – $10 million in 2011-12 with an additional $24 million estimated for expenditure in 2012-13
- Narrabundah Long Stay Park – Symonston – $5 million in 2011-12
- National Arboretum Canberra – $4.3 million in 2011-12 and 2012-13 with an additional $5 million estimated for expenditure in 2013-14 and 2014-15. However, it should be noted that this expenditure has been reported as a Commonwealth contribution. (In addition Budget Paper No 3 expenditure initiatives (p.91) indicates that another $1.4 million in Commonwealth funds has been allocated over the 2011-12 and 2012-13 financial years to create a new entity to manage the arboretum.)

The most ambitious capital works project under the Economic Development Directorate is the proposed six green stars Government Office Building, which 'will enable better integration of services to the community'. It is understood that the new building will house all Directorates, excluding some or all front line services under one roof.

The Budget Papers report that the majority of the capital works expenditures for this project will to be outlaid in the years 2014-15 to 2016-17.

Table 6 **Government office building estimated capital works expenditures, $'000**

	2011-12	2012-13	2013-14	2014-15	Four year estimated investment	2015-16	2016-17	Total estimated investment
Government office building	500	1,000	21,539	101,825	124,864	183,822	123,510	432,196

Data source: ACT Budget 2011-12, Budget Paper No 3: Budget Overview Table 5.5.2, p.141 and Note to Table 5.5.1 p.139.

The estimates indicate that the Government has made a decision to own rather than lease the proposed new Government office building. Currently the ACT public service is housed in a mix of Government owned and leased buildings. It is of interest to note that one of the Government's largest Public Trading Enterprises, ACTEW, has recently sold its head office accommodation in Civic and moved to new leased accommodation in Civic.

There are a number of pros and cons associated with any decision to purchase or lease office space. Some of the positive considerations for purchasing include:

- The building can be constructed to meet the Governments precise needs (though some leased new buildings can be purpose built)

- The building will become a Territory asset
- Operating costs could be lower
  - as no rent must be paid to a landlord for the buildings leased life
  - economies of scale and scope may be achieved.
    - … In this context the review of the ACT Public Service by Dr Allan Hawke noted 'A single ACTPS agency under a single Chief Executive and Head of the ACTPS would ..... be entirely consistent with, and enhanced by, construction of the proposed ACT Government Office Building in Civic'.[16]

Negative considerations for purchasing include that funds will need to be raised upfront to fund the purchase by increasing Government borrowing or by redirecting funds away from other community investments, such as roads, schools, hospitals and the like.

ACIL Tasman understands that the Government has investigated the Business case for the new office building. There could be merit in the Assembly reviewing this Business case to fully clarify whether the benefits of alternative options have been considered. Options covered by the Business case should ideally include analysis of the benefits and costs of:

- retrofitting existing office buildings to meet the Governments future needs
- the Government owning the proposed new Government office building
- the Government leasing the new purpose built office building.

5.2.3 Territory and Municipal Services Directorate

The Territory and Municipal Services Directorate has 33 new capital works initiatives with expenditures allocated for the 2011-12 financial year at a cost of $56.7 million. These projects range from a single year outlay of $100,000 for Park signs to additional budgetary funding of the North Weston Pond and Bridge of $15 million (with another $5 million allocated for expenditure in 2012-13).

However, over the period 2011-12 to 2014-15 more than half of the new capital works expenditures under the TAMS directorate that has been announced in the Budget has been allocated to the Majura Parkway project.[17]

As announced by the Chief Minister, additional Federal funding will be required for this project to go ahead.

[16] ACTPS Review Final Report, Governing the city state, One ACT Government – One ACT Public Service Allan Hawke, February 2011, p.82.

[17] The Majura Parkway is planned to replace Majura Road linking the Monaro Highway and the Federal Highway.

> The Government will continue working with the Commonwealth to progress this initiative, in particular seeking matching investment, recognising that the Majura Parkway is a nationally significant project that aligns with a number of Infrastructure Australia's strategic priorities.[18]

If the project does go ahead the estimates indicate that the Majura Parkway development would require ACT Government funding of $144 million. It can be seen from Table 7 that the Budget estimates provide only very limited funds for other new TAMS capital work initiatives in the later years of the forward estimates. In the final year of the estimates only $2.74 million has been allocated to other TAMS capital works projects.

Table 7 **Territory and Municipal Services Directorate new capital works expenditures, $'000**

	2011-12	2012-13	2013-14	2014-15	Four year estimated investment
Transport for Canberra – Majura Parkway	0	50,000	60,000	34,000	144,000
Other new TAMS capital works initiatives	56,668	12,089	3,506	2,741	75,004
Total estimate	56,668	62,089	63,506	36,741	219,004

Data source: ACT Budget 2011-12, Budget Paper No 3: Budget Overview Table 5.5.2, p.140.

[18] Jon Stanhope, MLA, ACT Budget delivers $256 million for transport infrastructure, Media Release 3 May 2011, http://www.chiefminister.act.gov.au/media.php?v=10685

6 Budget Capacity in Delivering Key Policy Objectives

Although the ACT budget (and typically all budgets) have a natural bias towards focussing on short-term outcomes this should be balanced with a longer term perspective. In the short-term fiscal sustainability is referenced against the Budget outcome (surplus or deficit) which indicates whether over the budget year the government can fund all of its expenditure program (including wage payments to public service employees); deliver its income transfer programs and meet its debt servicing requirements as they fall due. Over the longer term sustainability requires the government to be able to meet all of its service delivery and financial obligations into the future without over-reliance on debt (which may in any case compromise its long-term ability to deliver services and finance debt).

The ACT Government remains committed to responsible fiscal management over the long-term. The Government outlines a number of key objectives and measures that guide budget deliberations. These include:

- to achieve a General Government Sector Net Operating Surplus;
- to maintain operating cash surpluses
- to maintain a AAA credit rating;
- to manage debt prudently and maintain net financial liabilities within the range of all AAA rated jurisdictions;
- to fully fund the Territory's unfunded superannuation liability by 2030;
- to maintain quality services and infrastructure;
- to make targeted investments to achieve strategic objectives of economic growth, reducing future costs and addressing chronic disadvantage; and
- to maintain taxation revenues at sustainable levels.

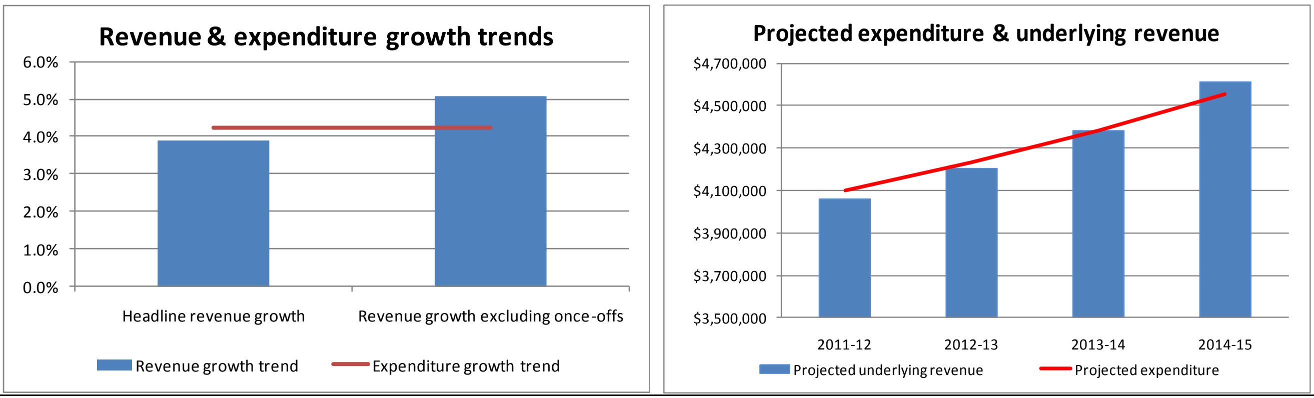
6.1 Sustainability of the operating balance

The ACT 2011-12 Budget has clear objectives around achieving a general government sector operating surplus and to maintain cash operating surpluses. This does not require that every year achieves an operating surplus but that temporary deficits are offset by surpluses at other times so that on average, across the budget cycle, the operating balance is in surplus. The 2009-10 budget adopted a plan to return the operating balance to surplus by 2015-16. However, stronger economic growth, increased revenues (including higher PTE dividends), expected savings (via savings measures including the efficiency dividend) coupled with new policy initiatives resulted in the 2010-11 budget bringing this date forward to 2013-14. This expectation has been maintained in the 2011-12 Budget, which expects that the operating balance will be in small surplus ($1.6 million) by 2013-14, with a more significant surplus ($56.6 million) projected for 2014-15.

We note that the operating surplus targeted in the ACT budget is after including gains from superannuation investments consistent with the approach in other state jurisdictions. This is valid since the return on super reduces the annual super expense. It is worth noting though that these gains from superannuation progressively approach $100 million per annum in the forward years and thus are critical in achieving surplus (non-inclusion of these would result in operating deficits across all years in the Budget horizon).

Figure 11a (Revenue and expenditure growth trends) illustrates the Budget's high level revenue and expenditure trends over the period 2010-11 to 2014-15. Growth in two revenue metrics is plotted. Firstly headline revenue growth which is curtailed by the inclusion of .the once-off Commonwealth stimulus payments (the *Nation Building and Jobs Plan*) and the once-off uplift to revenue from marketable securities (via a one-off tax assessment relating to prior years) in 2010-11 that will not be repeated. These once-off revenues are not part of underlying revenue from the context of long-term fiscal sustainability. Their exclusion from underlying revenue lifts the average growth rate for revenue over the Budget horizon.

Figure 11 **Projected revenue growth versus expenditure growth**



Data source: ACT Budget Paper 3, tables 1.2.1, 3.1.1, and 3.1.2,

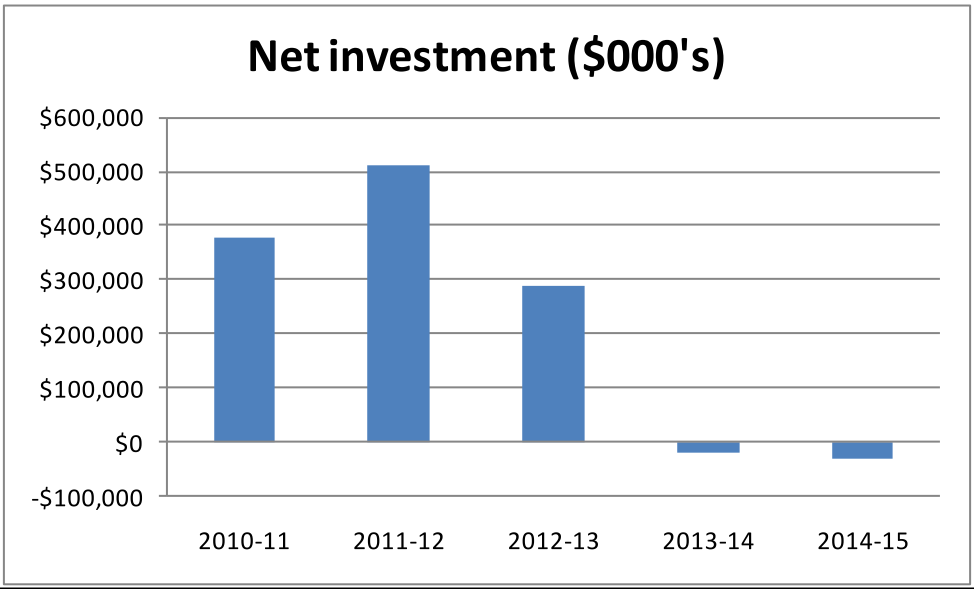
Figure 11 illustrates that, at least over the Budget horizon, underlying revenue growth (under the Budget's assumptions) appears likely to outpace expenditure growth. This implies that the underlying settings of the ACT budget will continue to improve underlining ongoing sustainability.

However, this finding is subject to the Budget's assumed revenue growth and savings being achieved. As noted elsewhere in this report, there is uncertainty in regards to the Budget's ability to achieve certain revenue and saving estimates.

6.2 Sustainability of infrastructure and investment

The service capacity of government infrastructure needs to be at least maintained through time to ensure that the asset base can deliver the range of public services demanded by citizens. This requires active management of infrastructure and sufficient annual investment to ensure a sustainable level both in the short and medium term. One test for the sustainability of service delivery from infrastructure is whether planned investment is larger than depreciation which reduces infrastructure stock and/or service capability. If investment is below annual depreciation there is some risk that service capacity will not be maintained. This net investment indicator (annual capital investment less annual depreciation) is best viewed over the long term.

Figure 12 **Net Investment (annual capital investment less annual depreciation)**



[a] Data source: ACT Budget Paper No. 3, tables 4.1.1 and 5.4.4

The ramp-up in capital investment over 2011-12 ($824.2 million) and 2012-13 ($622.6 million) is well above projected depreciation in those years (around $320 million in each year) implying significant net capital investment and that the capital stock and its service capability is being augmented or expanded. In subsequent years (2013-14 and 2014-15) projected capital investment returns to longer term investment trends, with net investment levels close to but below the level of depreciation in each year.

6.3 Sustainability of net debt and maintaining credit AAA rating

As noted above the Budget intends to borrow $350 million in 2011-12 and an extra $300 million in 2012-13 (see section 5.1.1). This represents a significant and sustained increase relative to historical levels but appears relatively prudent given the health of the ACT balance sheet and the need to maintain the service capability of infrastructure assets.

The assets funded by debt need to increase the productive capacity of the economy and provide long-term benefits to the community. Amongst other assets, the debt raised will fund the Majura Parkway (subject to Commonwealth matched funding) and enhanced health system assets. Both of these appear to be essential assets that will enhance productive capacity across the ACT and hence debt funding is supportable.

The ACT targets maintenance of its credit rating as an independent indicator of sustainable levels of debt. Standard & Poors have recently (16 March 2011) re-affirmed the ACT credit rating as stable at AAA for long-term and A1+ for short-term. However, the longer term fiscal sustainability of the ACT could come under some pressure if the ACT Government continued to run a capital works program at the level seen in 2010-11 and continued in this current Budget, particularly if the economy was exposed to an external shock similar to the GFC.

6.4 Exposure to external shock

As noted above, there are significant risks to the growth outlook which could negatively impact ACT's fiscal position. The relatively small projected surpluses imply that the ACT's fiscal health remains vulnerable to major external shock. The GFC significantly impacted ACT fiscal settings and although in reasonable shape, the ACT is not well-placed to withstand another similar financial shock, without resorting to increasing borrowings.

The relatively strong balance sheet, even allowing for the projected debt increase over the next few years, combined with strong credit rating suggest that the ACT has scope to further increase borrowings to maintain funding and public services if an external shock eventuated.

7 Social and Environmental Impacts

7.1 Triple bottom-line

Chapter 8 of Budget Paper No.3 entitled *A Sustainable Territory*, is the main instrument in the Budget which attempts to inject a triple bottom line approach into the ACT Budget Papers. The 2010-11 Budget acknowledged that the introduction of triple bottom line approach was then very much a work-in-progress:

> The ACT Government continues to work on improving its overarching sustainability framework. In 2010-11, the Government will finalise development on a new triple bottom line assessment tool, and implement its use across Government. (ACT Government, 2010, p. 265)

There is little evidence in the 2011-12 Budget Papers that much progress has been made, though the latest Chapter 8 in Budget Paper No. 3 also entitled *A Sustainable Territory* states:

> The ACT Government uses a triple bottom line approach to sustainability, recognising the interdependence of social, economic and environmental well-being. The Government has acknowledged that decision-making will often involve different emphases amongst the three principles.

As was the case in the 2010-11 Chapter, the discussion in Budget Paper No. 3 Chapter 8 has a strong emphasis on the environment. The Chapter has only a passing discussion of social well-being, which is generally in the context of a social program's relationship to environmental outcomes. For example, the discussion of public housing in the sustainably chapter only focuses on improving the energy efficiency of the public housing stock.

The Chapter does not provide any indicators of progress towards achieving environmental or social sustainability objectives.

7.2 Social well-being

There are numerous initiatives in the Budget which together could improve the social well-being of Territorians. However these initiatives, including those directed to public housing, community services infrastructure, education and health, are often discussed in terms of economics. Budget Paper No. 2 points out that the:

> Achievement of the goals of Affordable Housing Action Plan is a key element of Government's social and economic strategy.[19]

[19] ACT Budget 2011-12, Budget Paper No.2, p.2.

The Budget Papers list a number of initiatives to address affordable housing including: releasing land in Ngunnawal for aged care; loan and grant monies being provided to the University of Canberra for student accommodation; and the enhancement of the design and delivery of the indicative land release program.[20]

However, the consultant could not identify from the reading of the Budget Papers, any performance indicators which demonstrate that the Affordable Housing Action Plan is *actually achieving* more affordable housing for Territorians.

While some of the strategic/accountability indicators contained in Budget Paper No.4 provide material that relates to measuring social well-being, it continues to be dispersed. It would be useful to have at least some key performance and accountability indicators that relate to social well-being summarised and consolidated in one place within the Budget Papers.

7.3 Greenhouse gas emissions

In October 2010 the *Climate Change Greenhouse Gas Reduction Act 2010* (the Act) was passed by the Legislative Assembly. The key measures of the Act include:

- GHG emission reduction target
  - The Act will set a target to cut greenhouse gas emissions by 40% by 2020 and by 80% by 2050, based on 1990 levels. The principal target under the Act is 'zero net emissions' by 2060, making it one of the most ambitious targets in the country. Total emissions will be reduced through avoidance and mitigation activities, and may be offset outside of the ACT.
- Renewable energy target
  - The ACT Bill also allows for renewable energy targets for the ACT to be prescribed in regulation. Although targets were released on the 5th May 2011, it seems the regulations are yet to be prepared.
- Sector agreements
  - The ACT Bill allows the government to voluntarily enter into sector agreements with a particular person, entity, and industry or business group. The purpose of these agreements is to encourage private entities to take action and adopt strategies to reduce greenhouse gas emissions or to adapt to climate change.

The consultant has been requested to discuss the 'achievability' of the ACT GHG abatement target, the potential impact for the Budget along with the

[20] See ACT Budget 2011-12, Budget Paper No.2, p.19.

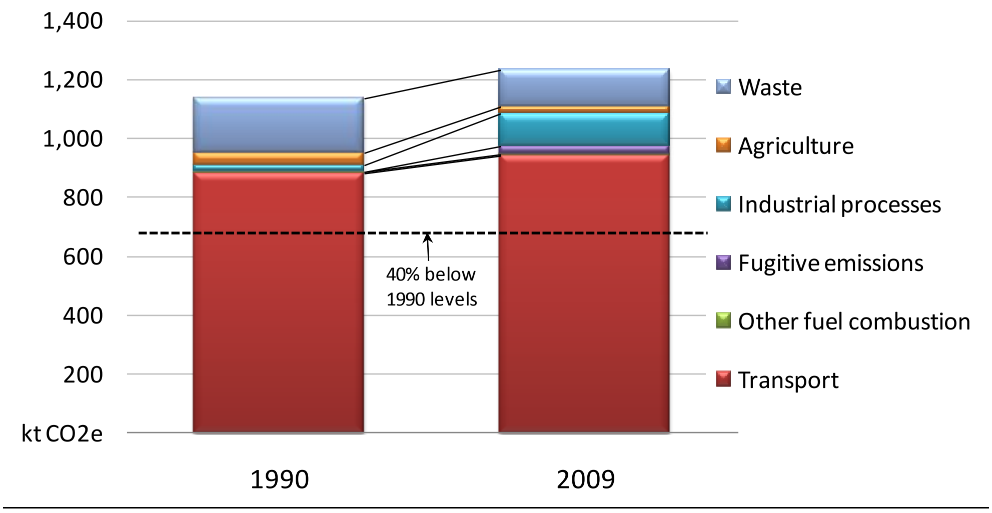
potential impact of the renewed push for a national carbon price. This is a complex request to address in the timeframe provided to prepare this report but a brief discussion and analysis has been provided in the following sections.

7.3.1 Achievability

The key issue with achieving the emission target is the definition of the scope of ACTs emissions. Emissions directly emitted within the ACT (referred to as Scope 1 emissions by the DCCEE) are presented in Figure 13. This is the standard emissions accounting framework used by all national governments reporting to the UNFCCC. Total emissions (including land use, land use change and forestry emissions) rose by 6.4 per cent between 1990 and 2009, with fuel combustion by transport accounting for just under 80 per cent of total emissions.

In the absence of funding abatement outside of the ACT[21], achieving a 40 per cent reduction in Scope 1 emissions by 2020 is only possible with significant technological change throughout the ACT vehicle fleet (or significant behavioural change). In the absence of imposing significant punitive measures on ACT residents and businesses, the ACT Government has a limited number of levers to bring about such an outcome[22].

Figure 13 **DCCEE estimated ACT greenhouse gas emissions by sector, 1990 and 2009 (excluding LULUCF)**



Data source: DCCEE (2011), *State and Territory Greenhouse Gas Inventories 2009*, Commonwealth of Australia, April.

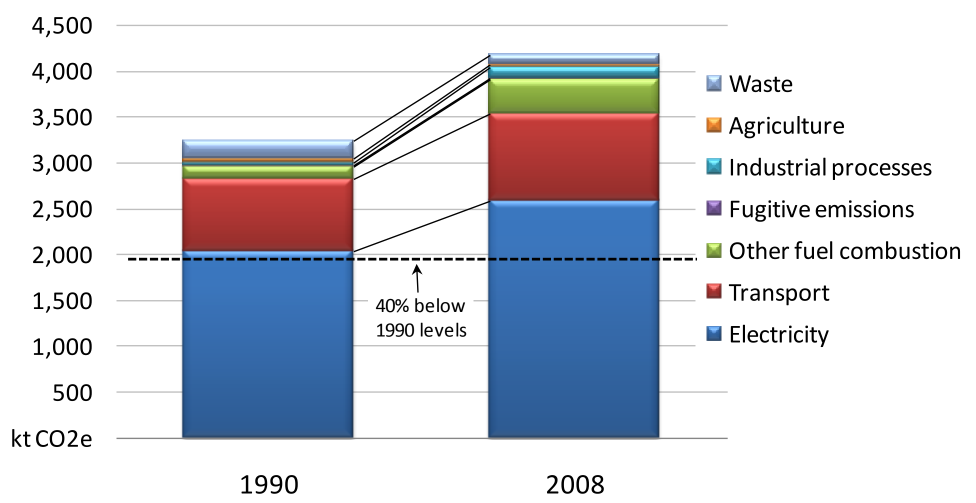
[21] Including carbon offsets.

[22] This is not to say that the target cannot be met. However, for that to happen either cost effective technologies will have to emerge (and be adopted) and/or behaviour changes will have to occur. The challenge is considerable, particularly given the relatively short time frame, and the ACT Government's ability to facilitate or encourage the transition is limited.

As a consequence of the nature of the ACT's Scope 1 emissions, the emissions targets include Scope 2 emissions. In the case of the ACT, the key difference between the emissions accounting for Scope 1 and Scope 2 is that Scope 2 includes the emissions associated with all electricity generated outside of the ACT itself (which is the majority).

In 2010, the ACT Government released its own Greenhouse Gas Inventory (called the ACT GGI). According to the ACT GGI estimates, including the Scope 2 emissions associated with electricity consumption, the estimated emissions increase to around 2,600 kt CO_2e – just over 60 per cent of which are related to electricity (see Figure 14).

Figure 14 **ACT GGI estimated ACT greenhouse gas emissions by sector, 1990 and 2008 (excluding LULUCF)**



Data source: DECCEW (2010), *ACT Greenhouse Gas Emissions: ACT Greenhouse Gas Inventory 2010*, Australian Capital Territory.

A potential issue with the ACT achieving the GHG abatement targets is the fact that they are based on an accounting methodology that is different to that used by the Australian Government. Further, the current ACT GGI states (emphasis added):

> The ACT GGI is **not intended as a strict carbon accounting report**, but rather is a source of information for the ACT Government...[23]

The level of uncertainty associated with the ACT GGI methodology is not clear.

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[23] Page 1 of DECCEW (2010), *ACT Greenhouse Gas Emissions: ACT Greenhouse Gas Inventory 2010*.)

Since the ACT population is likely to grow by at least 10 per cent over the period to 2020, the challenge is actually to reduce current emissions per capita by at least 35 per cent over the next nine years.

Given the importance of electricity in the ACT GGI accounting, most Government policies are aimed at reducing Scope 2 emissions. It should be noted, however, that except for purchasing GreenPower or increasing self generation, the ACT has no influence on the emissions intensity of electricity supplied to the Territory from the national electricity market (NEM).

Even in the absence of any new policies (including a carbon price) affecting the emissions intensity of delivered electricity, the combined effects of existing policies and likely changes in the generation sector are likely to reduce the emissions intensity of electricity generated in the NEM by at least 7 per cent between 2010-11 and 2019-20. In terms of meeting its target, the ACT will benefit from this reduction.

7.3.2 Complementarity of ACT abatement measures

In accordance with the agreed COAG Complementarity Principles, there should be robust justification for mitigation measures to co-exist alongside the primary mitigation instrument, the carbon price. Mitigation measures should *cost-effectively* reduce the costs of meeting the national emissions reduction target by either:

- meeting a gap in the coverage of the carbon price, or
- addressing a market failure that prevents the carbon price from reducing emissions at least cost.

In addition, measures to address the equity impacts of the carbon price may also be justified. The principles for assessing complementary measures are outlined in Box 1.[24]

Box 1 COAG's Principles for Assessment of Measures to Complement a Price on Carbon

Complementary measures should be assessed against the following principles.

1. The measures are targeted at a market failure that is not expected to be adequately addressed by a price on carbon or that impinges on its effectiveness in driving emissions reductions.

[24] While these principles were developed in association with the proposed introduction of (the now shelved) Carbon Pollution Reduction Scheme (CPRS), we expect that they would continue to apply under the proposed measures to put a price on carbon currently being considered.

- For example, research and development failures, common use infrastructure issues, information failures and excess market power.

Complementary measures should adhere to the principles of efficiency, effectiveness, equity and administrative simplicity and be kept under review. They may include:

a) measures targeted at a market failure in a sector that is not covered by the carbon price.

b) measures for where the price signals provided by the price on carbon are insufficient to overcome other market failures that prevent the take-up of otherwise cost-effective abatement measures.

c) measures targeted at sectors of the economy where price signals may not be as significant a driver of decision making (e.g. land use and planning).

d) some measures in (a) or (b) may only need to be transitional depending on expected changes in coverage or movements in the carbon price.

2. Complementary measures should be tightly targeted to the market failure identified in the above criteria that are amenable to government intervention. Where the measures are regulatory they should meet best-practice regulatory principles, including that the benefits of any government intervention should outweigh the costs.
3. Complementary measures may also be targeted to manage the impacts of the carbon price on particular sectors of the economy (for example to address equity or regional development concerns). Where this is the case, in line with regulatory best-practice, the non-abatement objective should be clearly identified and it should be established that the measure is the best method of attaining the objective.
4. Where measures meet the above criteria, they should generally be implemented by the level of government that is best able to deliver the measure. In determining this, consideration should be given to which level of government has responsibility as defined by the Constitution or convention/practice, the regulatory and compliance costs that will be imposed on the community, and how the delivery of the measure is best coordinated or managed across jurisdictions.

Source: ACIL Tasman based on COAG Meeting Outcomes 29 November 2008

A number of materially significant policies and measures have been identified in the Budget Papers. These include:

- The GreenPower policy, whereby the ACT Government will purchase 37.5 per cent of its electricity needs from renewable energy
- The ACT Electricity Feed-in Tariff Scheme
- The Sustainability in Public Housing, Sustainability in the Built Environment, Sustainable ICT and the Sustainable Schools Initiatives
- A range of transport initiatives aimed at increasing the overall use of so-called 'sustainable transport modes' and promoting higher vehicle occupancy rates

- A Renewable Energy Target (15 per cent of ACT energy from renewable sources by 2012 and 25 per cent by 2020).

With the introduction of a carbon price, it will be efficient to adopt renewable energy up to the point where its marginal cost equates to that of other energy sources, inclusive of a carbon price. Hence, if energy markets are functioning efficiently, there should be no need to mandate renewable energy as a greenhouse gas abatement measure. The objectives of increased use of renewable energy, namely reduced greenhouse gas emissions from government operations, support for the renewable energy industry, and encouraging renewable energy projects can in theory be achieved most efficiently by the introduction of an appropriate carbon price.

Key finding

It would be useful to understand whether current ACT Government policies in relation to sustainable energy satisfy the COAG complementary measures principles.

Possible question

Has the ACT Government assessed its sustainable energy policies against COAG's principles for complementary measures?

7.3.3 Impact of climate change mitigation policies on the Budget

The impact of many of the policies and measures on the Budget are difficult to quantify either because the ACT Government does not directly bear most of the cost (such as the Feed-in Tariff Scheme or the Sustainability in the Built Environment policies), they integrate policies other than GHG abatement (such as water savings, biodiversity and landscape protection, assisting low income people, etc) or are likely to be undertaken in the absence of any GHG benefits (such as using energy efficient ICT, improving the longevity of building shells etc).

We have briefly attempted to quantify the Budget impacts of the current GreenPower policy as well as the potential implications of a national carbon price. This analysis should be treated as indicative only and a more detailed analysis would be required to provide more specific guidance.

GreenPower policy

One of the key recurrent expenditure policies that seems to be raised throughout the Budget and the media releases is the move to increase the share of the ACT Government's electricity purchased from renewable sources (through 'GreenPower') from 32.5 to 37.5 per cent[25]. This increase is on top of the increase from 30 to 32.5 per cent in the previous (2010-11) Budget.

According to Table 4.2.2 in Budget Paper No. 3 (p.78), the proposed 5 percentage point increase in the purchases of GreenPower will add $610,000 to the cost of the ACT Government's electricity usage in 2011-12, increasing to $856,000 in 2014-15. This increased cost of electricity is on top of the $302,000 estimated increase associated with the 2010-11 Budget new initiative of a 2.5 percentage point increase.

The total cost of the policy associated with purchasing 37.5 per cent of the ACT Government's electricity from GreenPower does not appear to be discussed in the Budget Paper. ACIL Tasman has only found references to the incremental cost associated with the increases in the proportion of renewable electricity purchased.

Based on the 2011-12 incremental increase, it is estimated that the total cost of the 37.5 per cent GreenPower policy will be approximately $4,575,000 in 2011-12 (and around $21.9 million over the four years to 2014-15). To put this in context, based on Table 4.3.7 in Budget Paper No. 3 (p.115), the total cost of electricity (including GreenPower) is estimated to be $22.9 million in 2011-12 (and $95.1 million over the forward estimates)[26]. Based on these numbers, the GreenPower policy would appear to increase the cost of the electricity consumed by the ACT Government by about 25 per cent.

Based on the Budget estimates, the level of expenditure is equivalent to just over 55 jobs or just over 85 per cent of the cost of building the Gungahlin leisure centre.

Impact of a national carbon price policy

Without a detailed study it is difficult to quantify the fiscal impact that the introduction of a national carbon price policy will have on the ACT Budget.

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[25] This figure is taken from page 88 of Budget Paper 3 which also details the annual cost implication of the initiative. We note that page 274 of Chapter 8 of Budget Paper 3 states the increase is to 35 per cent.

[26] We note that Table F.18 in Budget Paper 3 (p.357) has a 2011-12 budgeted expenditure of only $7.67 million for electricity for the General Government Sector. It is unknown what causes the discrepancy.

Recent estimates in a variety of studies have indicated the NEM price of electricity could rise by $20-$30/MWh over the period to 2020 while the cost of petrol would increase by 5-7 cents per litre. Without knowing the ACT Government's electricity and petrol usage it is difficult to ascertain the implications for the Budget. An order of magnitude estimate is that total fuel expenses may increase by the low millions (e.g. $2-5 million) each year if the Australian Government proceeds with a carbon price policy.

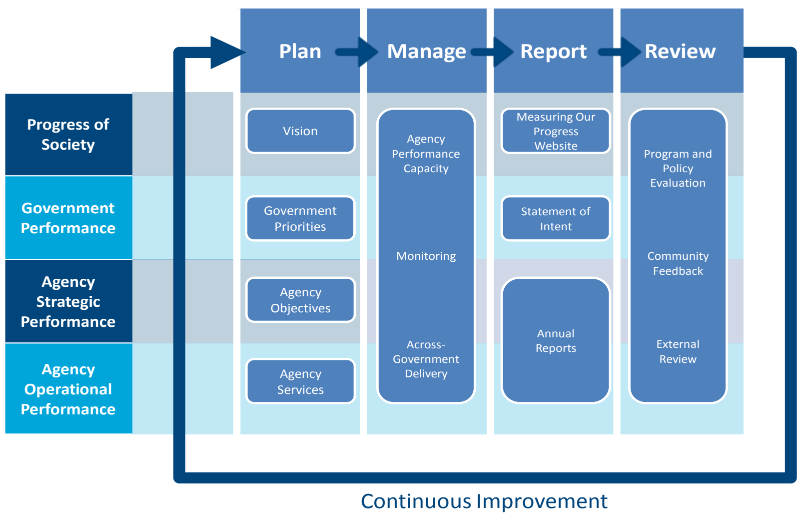
There will no doubt be implications on the revenue side, but estimation of these is complex. Nonetheless, the ACT is likely to be less negatively affected compared to other regions that have emission intensive activities.

8 Accountability value of performance indicators and targets

It is often difficult to measure outputs and outcomes in a public sector context because the targets or objectives often do not easily lend themselves to quantification.

The recent Review of the ACT public service by Dr Allan Hawke recommended that performance assessment be seen as a continuous flow, which can be represented by Figure 15. The vertical plane in the figure shows the different levels at which government performance and accountability are assessed, while the cyclical process demonstrates the need to be continually working to improve performance but also accountability.

Figure 15 **The ACT's Performance and Accountability Framework**



Data source: ACTPS Review Final Report, Governing the city state, One ACT Government – One ACT Public Service *Allan Hawke*, February 2011, Figure 15, p.228

In considering the wide range of performance indicators used in the public service the review (p.219), amongst other things, made the following recommendation:

> The Review recommends that the ACT Government continue work underway to recalibrate the ACT's strategic planning framework along the lines of the Scottish *National Performance Framework*. There are too many indicators, and those there are might be expressed in clearer and more measurable language. This should be supported by effort across the ACTPS to align mechanisms for collecting and collating performance information more efficiently. In this process, the indicators

> required under national frameworks should be taken as a given and ACT specific measures (if indeed it is appropriate for them to exist at all) developed making use of existing data sets, or able to be collected at the same time as national indicators, wherever possible.
>
> The ACTPS is not big enough to manage sustainably a reporting burden of the sort it currently bears, nor would it necessarily be an efficient or effective use of resources even if the capacity existed. There is an enormous reputational and service delivery risk in attempting to do a large number of things, in comparison to a tighter and more defined list of goals and delivering against them at the highest standards.

Budget Paper No 4 provides a wide range of performance and accountability indicators on Directorate agency performance. For example, the Treasury Directorate reports the following four strategic objectives (and related indicators):

1. Achieve a Budget operating surplus
2. Maintaining a AAA credit rating
3. Maintain Net Financial liabilities within the range of AAA jurisdictions
4. To be among the top four jurisdictions in taxation revenue forecasting accuracy.

At least the first three of these strategic objectives are heavily dependent on Government policy. In other words, the Treasury can give advice and counsel to Government in order to achieve these objectives, but ultimately it is the Government's decision on whether the advice is taken. The fourth strategic objective is more reflective of Treasury performance. The indicator for this fourth strategic objective is shown below. In this current budget, as in the previous budget, a time series is provided. This time series is helpful for identifying any performance trends.

Table 8 **Strategic indicator 4 – mean percentage error in taxation revenue forecasts across jurisdictions**

MPE	ACT Ranking	NSW per cent	VIC per cent	QLD per cent	SA per cent	WA per cent	TAS per cent	ACT per cent	NT per cent
2002-03 to 2006-07	4th	3.3	5.6	11.5	7.9	16.5	11.7	9.1	*
2003-04 to 2007-08	4th	2.4	6.3	9.3	7.6	17.8	10.3	8.3	12.8
2004-05 to 2008-09	4th	0.5	3.8	3.3	4.4	11.5	4.6	4.2	12.3
2005-06 to 2009-10	6th	2.0	4.2	1.5	4.0	10.4	3.4	7.0	10.0

Note: Forecasts for General Government Sector taxation revenue are based on Australian Bureau of Statistics publications.

* Forecast variance information for the Northern Territory is not available.

Data source: ACT Budget 2011-12, Budget Paper No. 4, p.147

It is often difficult to measure outputs and outcomes in a public sector context because the targets or objectives often do not easily lend themselves to quantification. For instance, the Chief Minister's Directorate reports on four

Strategic Objectives. However, the Budget Paper discusses only two Strategic indicators, namely:

- Retention of employees in the ACT public service – the permanent separation rate for 2009-10 was 6.4 per cent
- Community members feel able to have a say within the community on important issues. Unfortunately the cross state data reported was from the 2006 Australian Bureau of Statistics General Social Survey.[27]

In some respects it is easier for Public Trading Enterprises and other government organisations delivering services to the public to report on tangible performance indicators. For example, ACTION reports on Total yearly passenger boardings as a strategic indictor and reports results for past five years (Figure 16) and provides a target for 2010-11. ACTION also lists the following accountability indicators:

	2010-11 Targets	2010-11 Est. Outcome	2011-12 Targets
a-Timeliness of ACTION services[1]	83 per cent	83 per cent	n/a
b Customer satisfaction with ACTION services as assessed by passenger surveys	85 per cent	85 per cent	85 per cent
c Increase in modal share (adult work trip increase in accordance with the Sustainable Transport Plan)[2,3]	2.9 per cent	1.5 per cent	n/a
d Increase in total patronage[2,4]	1,330,000	265,000	n/a
e Percentage of fleet fully compliant with standards under the DDA[5]	48.9 per cent	44.6 per cent	n/a
f Percentage of in service fleet fully compliant with standards under the DDA[5]	n/a	n/a	51 per cent
g Percentage of fleet Euro 3 Emission or better Standard compliant[6]	31.8 per cent	34.4 per cent	n/a
h Percentage of in service fleet Euro 3 or better Emission Standard compliant[6]	n/a	n/a	40 per cent
i Total cost per vehicle kilometre	$4.27	$4.33	$4.52
j Total cost per passenger boarding[2]	$6.18	$6.49	$6.00
k Farebox recovery as a percentage of total cost[7]	21.8 per cent	17.6 per cent	22 per cent
l Percentage of services operating on scheduled time[8]	n/a	n/a	85 per cent

Notes:

1. Measure discontinued due to introduction of Accountability Indicator (l).
2. The result has been impacted by the inability to collect and record accurate patronage data due to the failing ticketing system. A new ticketing system was implemented in early April 2011.
3. Measure discontinued due to transfer of associated function to Sustainable Development Directorate following the Administrative Arrangement changes that take effect from 1 July 2011.
4. This measure is discontinued as patronage is measured as part of the ACTION Strategic Indicator 1 - Total Yearly Passenger Boardings.
5. The existing measure (e) is discontinued and replaced with (f) for clarity.
6. The existing measure (g) is discontinued and replaced with (h) for clarity.
7. Estimated Outcome is impacted by below budget fares revenue and a recorded reduction in patronage as a result of the lack of reliable data from the failing ticketing system combined with increased operational costs.
8. This is a new indicator. The measure is calculated using GPS data from the MyWay Ticketing system.

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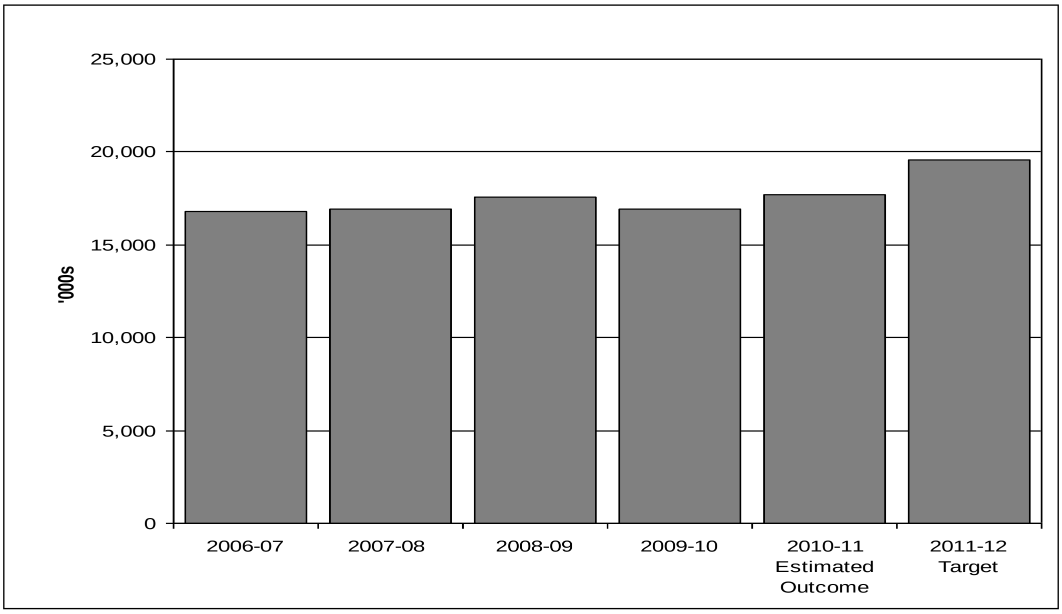
27 ACT Budget *2011-12, Budget* paper No. 4, p.31-32

Some of these accountability indicators have changed slightly in their description since the last Budget. There could be considerable value if all of this information, not just Total yearly passenger boardings, was collected into a longer time series then it would provide information on trends in service delivery which could in turn be used for accountability purposes.

Figure 16 **ACTION Strategic Indictor – total yearly passenger boardings**



Data source: ACT Budget 2011-12, Budget Paper No. 4, p.112

A range of performance indicators have also been provided for other agencies in Budget Paper No.4. One of the most comprehensive and informative set of strategic indicators (26 in number) are provided for the Health Directorate. It is likely that all or at least the majority of these strategic indicators are collected for the Productivity Commission reporting process. Similarly the Education and Training Directorate has numerous accountability indicators, many of which are likely to reflect the need for reporting under the National Assessment program.

In all instances there is likely to be considerable value in requiring all Directorates and public trading enterprises to report a time series for at least a number of key strategic and accountability indicators.