Government Response to the Pegasus Economics report

Review of the ACT Budget 2020-21

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Treasurer
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Introduction

In its *Inquiries into Annual and Financial Reports 2019-2020 and ACT Budget 2020-2021*, the Standing Committee on Public Accounts commissioned Pegasus Economics to review the 2020-21 ACT Budget. Pegasus subsequently produced the *Review of the ACT Budget 2020-21* for the Committee's consideration.

The Pegasus Report provides a range of assessments regarding the 2020-21 Budget. A copy of the report can be found on the Legislative Assembly website (under the *'Specialist Budget Adviser Report'* tab).

The Treasurer ordinarily delivers the ACT's annual budget in June. However, consistent with the position of all State and Territory Governments and the Commonwealth, the Legislative Assembly resolved to delay the publication of the 2020-21 Budget until after the 2020 ACT Election, as a result of the uncertainty associated with the COVID-19 pandemic.

Following the outbreak of COVID-19 in Australia in early 2020, Australian states and territories implemented COVID-19 response strategies, with all jurisdictions launching programs to bolster the delivery of health services, protect jobs and businesses, and provide practical support for households.

The Treasurer released an Economic and Fiscal Update in August 2020 (August 2020 EFU[1]), with the ACT becoming the first Government in Australia to present budget forecasts that covered the full four-year forward estimates, highlighting the long-term impacts of COVID-19 on the Territory economy.

In terms of our COVID-19 response, our rolling program of targeted and measured support has included significant investment in local jobs, our community, and our people – with these actions assisting us in avoiding more significant losses in economic output.

This response is presented in two sections. As noted on page vii of the Pegasus Report, a number of questions were provided to ACT Treasury as part of the community briefing session prior to the release of the 2020-21 Budget. These questions are addressed on pages 4 and 5, while matters raised by the Pegasus Report itself are considered from page 6 onwards. As there is overlap between the two, in some instances, the community briefing session questions are addressed in the response to the Pegasus Report.

Pegasus' review of the 2020-21 Budget provides a number of important observations regarding the Government's activities, and Pegasus' assessment that "…the Budget represents a measured and responsible approach to management of the impacts of the COVID-19 pandemic on the ACT economy"[2] are welcomed and acknowledged. In turn, the Government wishes to present this response to the matters raised.

[1] ACT Government: August 2020 Economic and Fiscal Update

[2] Pegasus Economics: Review of the ACT Budget 2020-21, page vi

Pegasus Economics' 2020-21 Budget Briefing questions

1. Why doesn't the ACT present its budget in the uniform budget presentation used by other States and Territories?

The Territory's budget presentation is consistent with the Uniform Presentation Framework, with the only departure being the inclusion of the Superannuation Return Adjustment to produce the Headline Net Operating Balance (HNOB). This inclusion ensures that the defined benefit superannuation expenses and revenue are reported on a consistent basis.

The full amount of superannuation interest and service costs are recognised in transaction expenses, while part of the revenue (the capital gains component on investments) is recognised as other economic flows. The superannuation return adjustment, when combined with income earnings recognised in transaction revenue, equates to 6.75 per cent return on the investment assets.

The Government considers that the HNOB provides the most relevant and meaningful information for making long-term budget allocation decisions, and the inclusion of the full amount of the long-term investment earnings is necessary to provide an accurate assessment of the longer-term sustainability of the budget position.

2. To what extent is the growth in expenditure due to a) demand driven parameters, b) economic parameters such as indexation and c) discretionary policy decisions?

Tables 3.1.2 of the 2020-21 Budget Outlook presents a breakdown between policy decisions and technical adjustments. Chapter 3.2 of the Budget Outlook presents detailed explanations of all new policy initiatives.

Table 3.1.3 provides a further breakdown of major technical adjustments, incorporating movements for items such as GST revenue.

Additional details regarding expenditure drivers is on page 17 of this document.

3. Where in the budget papers can we find the actual payments and forecasts for grants to individual community, arts and sporting organisations?

This information is presented in agency Annual Reports rather than the budget papers.

4. Where can we find a reconciliation of the savings actually achieved against savings forecast in previous budgets?

Funding previously identified as savings have been removed from the relevant agency's base funding and returned to the budget to be spent on other Government priorities. The Government will continue to periodically review the functions/programs that it currently undertakes to determine whether more efficient structures and arrangements can be introduced.

5. Does the ACT government have a dividend policy for GTE/GBEs?

A response regarding dividend policy is on page 16 of this document.

6. Where in the budget papers can we find the actual dividend payments and forecasts for GTE/GBEs ?

A response regarding dividend payments and forecasts is on page 16 of this document.

7. What other returns to the government have been made by GBE/GTEs and where can we find those transactions?

A response regarding returns to government/transactions made by GBEs is on page 16 of this document.

8. Are monies owed to the Territory (Debtors/Receivables) subject to a recoverability/collectability test say monthly?

Monies owed to the Territory are assessed on an annual basis at a minimum.

The Chief Minister, Treasury and Economic Development Directorate maintains the *ACT Government Debtor Management Policy* (the Policy) which outlines principles associated with the management of debts owed to ACT Government entities by non-ACT Government entities. The Policy was most recently updated in December 2020.

The Policy applies to all ACT Government entities excluding Territory-owned Corporations. It requires each ACT Government entity to:

- act in accordance with its Director-General Instructions on accounts receivable and debt management or equivalent, alongside existing internally managed debt management procedures and guidelines;
- review existing internally managed debt management procedures and guidelines and take necessary action to comply with the principles outlined in the Policy;
- consider engaging specialist personnel (ACT Government Shared Services) in implementing the centralised end-to-end debt management model discussed in the Policy (Section 6), where appropriate; and
- ensure that the appropriate delegations are established, and considerations taken into account in the engagement of the Whole of Government mercantile agent.

The Policy recognises that recovery arrangements for a given debtor should be considered on a case by case basis taking into account a range of factors including legislative requirements, social sensitivities, technical capabilities and financial considerations.

<u>Pegasus Economics' *Review of the ACT Budget 2020-21* – Queries and responses</u>

Economic forecasts
(Chapter 2, pages 3 to 12)

Pegasus considers that most of the ACT Budget economic forecasts for 2020-21 and 2021-22 "appear reasonable", with the exception of growth in the consumer price index in both 2020-21 and 2021-22, which "appears to be a little on the low side" (2021, page 3).

In addition to the CPI commentary, the following sections address a number of matters raised by Pegasus' analysis.

Long-term projection methodology (Section 2.2, page 8)

Pegasus comments that "the ACT Government (2021, page 17) has now decided to incorporate the impact of historically low population growth rather than adopting the assumption of a return to long-term growth. As such, Pegasus is much more comfortable with the long-term projections for growth in ACT final demand presented in the ACT Budget. These projections have a much more solid foundation than reversion to a historical trend that may not be realised."

Response:

The key assumptions underpinning the 2020-21 Budget are detailed on page 17 of the 2020-21 Budget Outlook.

The methodology adopted for the 2020-21 Budget (of not using long-term historical averages in the final year of the budget projection period) is a temporary departure due to the effects of COVID-19. We will return to the approach of using long-term historical averages in the final year of the budget projection period once the COVID-19 international border restrictions are no longer having an effect on population growth.

Given the level of the uncertainty surrounding forecasts beyond the budget year and one year ahead, a return to trend assumption is the most robust methodology. This methodology is also used by the Commonwealth and other states and territories in presenting economic forecasts and projections.

The ACT population forecasts in the 2020-21 Budget have adopted the migration assumptions published by the Centre for Population, which reflects the Commonwealth Government's migration policy and the impact of COVID-19 international border restrictions. This has lowered population growth over the forward estimates.

This reduction in population growth will also constrain employment and economic growth over that period and, as a result, it was not appropriate to use long-term historical average growth rates. Employment and economic growth forecasts were recalibrated to reflect lower population growth.

Economic uplift associated with the ACT Government's COVID-19 response (Section 2.2, page 10)

Pegasus comments that it is difficult to discern evidence of any major stimulus provided to the ACT economy by the ACT Government: "While there isn't anything necessarily wrong with the approach taken by the ACT Government, by the same token perhaps it shouldn't be trying to take some credit for an economic stimulus that it didn't really contribute all that much towards".

Response:

The ACT's fiscal response to the COVID-19 pandemic amounted to approximately $913 million in 2020, or 2.23 per cent of the ACT's GSP in June 2020.

The ACT's fiscal response as a portion of GSP is broadly similar to other jurisdictions, noting other factors such as the fact that the public health impact of COVID-19 in the ACT was less severe than in some other jurisdictions, including Victoria.

As a result of the successful management of the public health emergency and broader resilience of the ACT economy, the economic and fiscal impacts of COVID-19 have not been as significant in the ACT as in some other jurisdictions. Nonetheless, the ACT's economic support measures, such as fast-tracking existing projects, revenue deferrals and the provision of low or no-cost loans, have provided valuable support to businesses.

The ACT Government response is necessarily different to the Commonwealth's as we do not have the same policy levers to provide cash directly to households and businesses but provide stimulus through a number of recovery packages including waivers, freezing indexation on a range of a number of fees and charges and delivering shovel-ready infrastructure projects.

The Reserve Bank Governor recognised that the significant fiscal policy response of both the Commonwealth and State Governments led to better economic outcomes than initially expected.

He noted "The second factor is the very significant fiscal policy support in Australia, which as measured by the change in the aggregate budget position is almost 15 per cent of GDP. Most of this support has been delivered by the Australian Government, but the states and territories have also played a role too"[3].

A comparison of state and territory COVID-19 responses relative to Gross State Product is presented for each jurisdiction in Table 1 below:

[3] Address to the National Press Club of Australia, 3 February 2021

Table 1: State and territory COVID-19 responses relative to GSP, 2020

Jurisdiction	GSP, June 2020 $ m	Size of Total Support $ m	Total Support, Percent GSP
ACT	40,902	913	2.23
NT	26,153	797	3.05
TAS	32,102	1,343	4.18
SA	108,334	2,871	2.65
WA	292,284	6,698	2.29
QLD	363,524	11,087	3.05
VIC	458,895	14,245	3.10
NSW	624,923	17,952	2.87
Total	**1,947,117**	**55,906**	**2.87**

Sources: ABS 5220.0, Commonwealth circular of state and territory COVID-19 response announcements and CMTEDD calculations.

Consumer Price Index (CPI) (Section 2.5, page 12)

Pegasus notes that "… if anything, the 3 per cent forecast for 2020-21 may actually be on low side as it requires some modest reduction in the Consumer Price Index (CPI) in the March and June quarters 2021 to actually be achieved."

Response:

Page 34 of the 2020-21 Budget Outlook discusses the drivers of CPI growth.

In the December quarter 2020, Canberra's CPI grew strongly by 0.8 per cent, following an increase of 2.3 per cent in the September quarter 2020. Similar to the whole of Australia, the December quarter outcome in Canberra was mainly driven by the price increases in domestic holiday travel and accommodation, childcare and tobacco, with each category contributing 0.3 of a percentage point.

The December quarter outcome was released by the ABS on 27 January 2021, too late to be included in the forecasts in the 2020-21 Budget, which was published on 9 February. However, it was recognised in the discussion in the Budget Outlook.

As noted in the 2020-21 Budget Outlook, these strong outcomes largely reflect one-off effects following some policy changes, for example, the reintroduction of childcare fees and a significant increase (12.5 per cent) in excise duty rates for tobacco on 1 September 2020 (page 36).

The 2020-21 Budget Outlook also noted the strong growth in inflation was partly attributable to the changing consumer behaviour caused by the COVID-19 pandemic, which could pose an upside risk to the headline CPI forecast of 3 per cent in 2020-21. A key example is the price increase in domestic holiday travel and accommodation as the international borders remain closed (page 36).

Further, an upside scenario on CPI has been provided in the 2020-21 Budget. While the underlying CPI (1.5 per cent) has been used as the baseline forecast, rather than the headline CPI, the upside scenario is an indication of possible stronger CPI growth (page 152).

Government policies (Section 2.5, page 12)

Pegasus notes that while the CPI forecast of 1¼ per cent growth for the ACT in 2021-22 does not appear unreasonable, Pegasus suspects that it may actually be ½ per cent on the low side. This is on the basis that forecasts for the ACT should probably be around ¼ per cent higher than national forecasts for the CPI that are currently for growth of around 1½ per cent in 2021-22 (Commonwealth of Australia, 2020, page 19).

Pegasus has previously suggested that ACT Government policies and practices may have locked in slightly higher inflation for the ACT than experienced in the other capital cities through tax reform and inefficient service delivery (Davey & Fisher, 2017, page 11).

Response:

Under the tax reform program, increases in general rates above the Wage Price Index are used to offset reductions in revenue from the abolition of insurance and conveyance duties, noting insurance duty was abolished in the ACT on 1 July 2016. As the CPI measures the price change in both general rates and stamp duty (which is included in other financial services, together with real estate agent services, legal and conveyancing services, stockbroking services), tax reform should not necessarily result in higher inflation. Pegasus has provided no evidence of inefficient service delivery.

We also note the average over the year inflation between the ACT and Australia from June 2019 to December 2020 is identical at 1.2 per cent.

Moreover, since the reform was introduced in the 2013-14 Budget, the ACT's CPI has grown on average by 1.2 per cent per year (i.e. compound annual average growth terms). This compares to both NSW and Australia as a whole at 1.3 per cent per year.

Population (Section 2.6, page 12)

Pegasus comments that "…with the exception of 2020-21, the population forecasts and projections contained in the ACT Budget are consistent with those produced by the Commonwealth Government Centre for Population (2020)[4]. However, the Centre for Population (CFP) (2020) is forecasting negative population growth of 0.3 per cent in 2020-21, that would be consistent with a population growth forecast of −¼ per cent in 2020-21, whereas the ACT Government has forecast population growth of ¼ per cent for 2020-21."

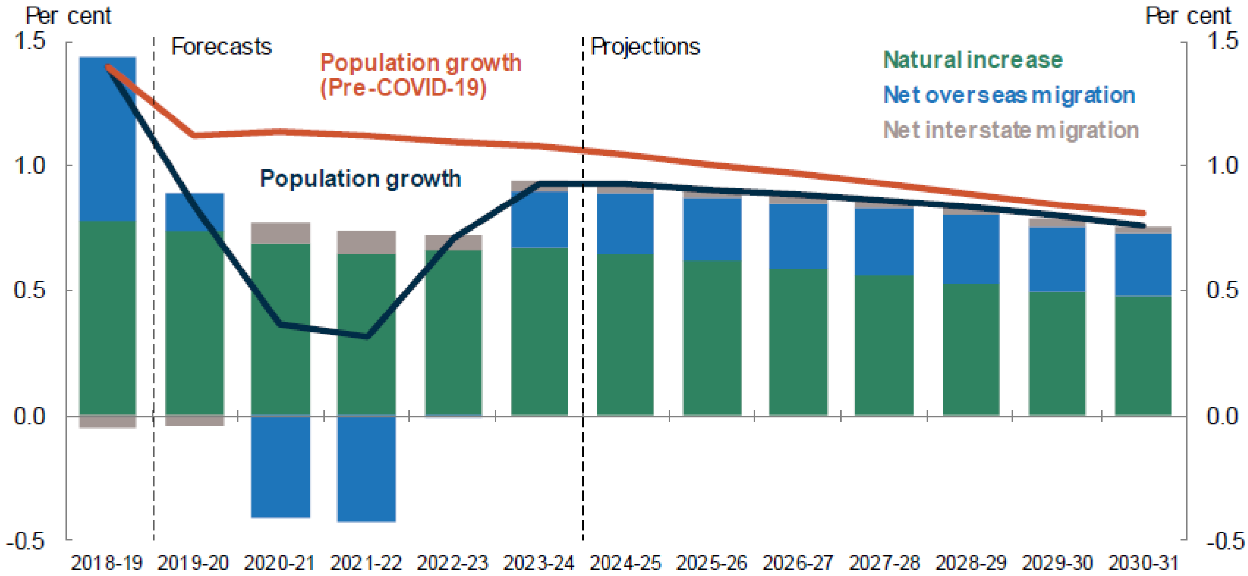
Response:

The ACT's population forecasts and population related assumptions are consistent with CFP's for every year – we have, however, applied the latest base available from the ABS Estimated Resident Population data (reflecting population as at June 2020 released on 17 December 2020).

[4] https://population.gov.au/publications/publications-population-statement.html

In addition, the CFP has not forecast a negative population growth of 0.3 per cent for the ACT in 2020-21 in the central/baseline case. While the CFP has forecast a negative Net Overseas Migration for the ACT in 2020-21, consistent with Australia's, it has forecast positive population growth of 0.36 per cent (rounded to 0.25 per cent in the ACT Budget) for the ACT in 2020-21 (as reflected in Chart 53 on page 70 of the Population Statement reproduced as Figure 1 below).

Figure 1: Future population growth and components, Australian Capital Territory, 2018-19 to 2030-31



Source: (Australian Bureau of Statistics, National, state and territory population, March 2020, 2020), Centre for Population projections

Fiscal position
(Chapter 3, pages 13 to 19)

Pegasus considers that "… there is some improvement against the forecasts shown in the August 2020 Economic and Fiscal Update at around the worst period of the COVID-19 pandemic in Australia but the Budget is now expected to be in deep deficit for the foreseeable future … the deterioration in the fiscal position has been driven by changes in the economy" *(page 13)*.

Pegasus considers that the the ACT Government's position of "… restoring public finances … after the impact of COVID has passed" is a "… sensible strategy" *(page 15)*.

However, Pegasus notes that "… a return to surplus for the ACT Government will require favourable economic circumstances and considerable fiscal discipline over a long period of time" (page 16) and that "… there is little doubt that the Government will be able to meet its immediate financial obligations. However, the current trajectory cannot be sustained indefinitely. The ACT Government will need at some point to develop strategies to restore its fiscal position and reduce its levels of debt" *(page 19)*.

In relation to matters of Budget Paper transparency:

- Pegasus considers that additional details in relation to the presentation of technical adjustments to revenue and expenses should be provided *(page 14)*.

- Pegasus also suggests that returning to a practice of publishing the previous year's budget estimate alongside the estimated outcome and budget estimates would improve transparency *(page 17)*.

- Pegasus considers that "… it would be useful if in future budgets the ACT Government could supplement the information already provided by presenting information on movements in further measures of the ACT's financial position over time. In particular, Pegasus suggests it would be useful if future budget papers were to provide information to allow for a reliable identification of short-term assets and short-term liabilities" *(page 18)*.

Response:

As has been stated in previous budget papers and responses to prior Pegasus analyses, the Government maintains a commitment to balance the Territory's budget over the economic cycle. The Government recognises the importance of managing the Territory's finances in a sustainable way; however, as experienced by virtually every Government around the world, the onset of pandemic conditions has necessitated significant outlays designed to reduce transmission rates, bolster health systems, and protect as many jobs as possible.

From the ACT's perspective, it was necessary to update to the Government's fiscal and budget strategy in the August 2020 EFU in light of the significant changes in the ACT's economic and fiscal circumstances as a result of the pandemic.

The 2020-21 Budget also clearly indicates that as the health and economic impacts of the COVID-19 pass, the Government will work to restore the Territory's budget. We intend to do this gradually and consistent with the pace of the economic recovery, to ensure that high quality essential services can continue to be provided to the people of the ACT.

As described in the Fiscal and Budget Strategy section of the 2020-21 Budget Outlook, the Government remains committed to:

- supporting the ACT economy to survive and recover from the COVID-19 pandemic;

- restoring public finances, after the impact of COVID-19 has passed, by systematically reducing debt over the long term; and

- strategically investing in infrastructure that improves wellbeing and supports economic growth in the longer term.

For comparison purposes, Figure 2 below presents the Headline Net Operating Balance position for the 2019-20 Budget Review (pre-COVID-19), the August 2020 EFU, and the 2020-21 Budget (current estimates/forecasts). The Territory's current finances have improved relative to the August 2020 EFU, largely reflecting a more positive economic outlook in the ACT and nationally, driven by, for example, strong land sales forecasts and an upward revision to our GST pool. However, they still remain below the estimates in the 2019-20 Budget Review.

The 2020-21 Budget Outlook further indicates that the economic growth for the ACT is expected to maintain its positive trajectory, with an increasing contribution from the private sector as household consumption and business investment recover on the back of diminishing uncertainties and support from the Territory and Commonwealth Government.

Figure 2 – Historical Headline Net Operating Balance comparison

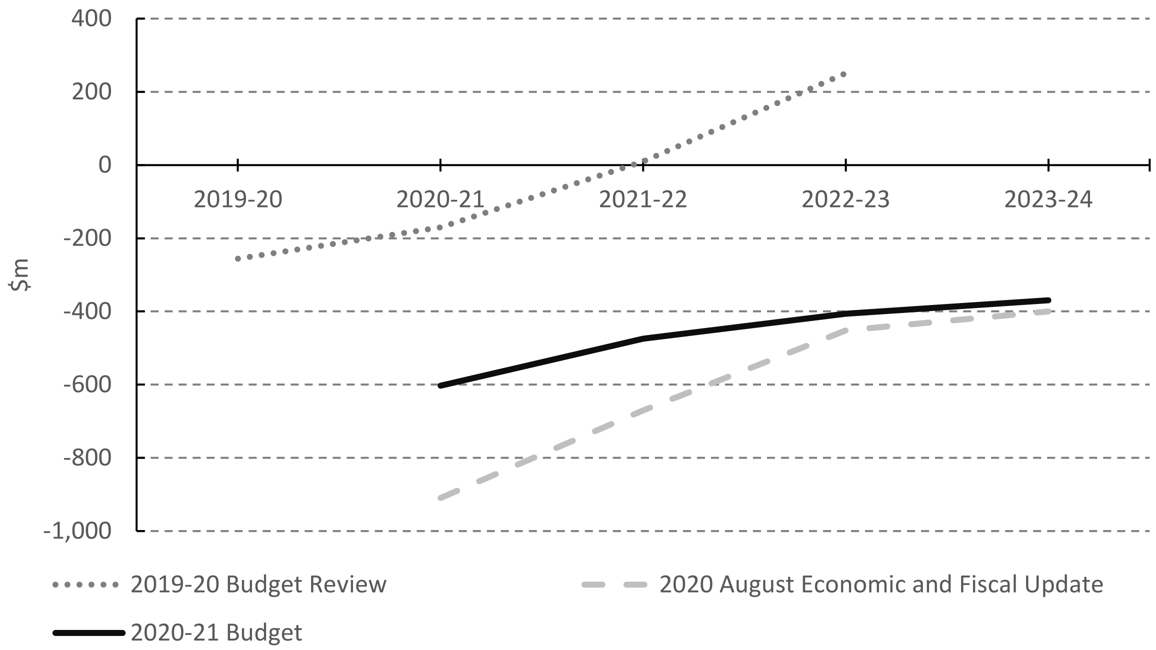
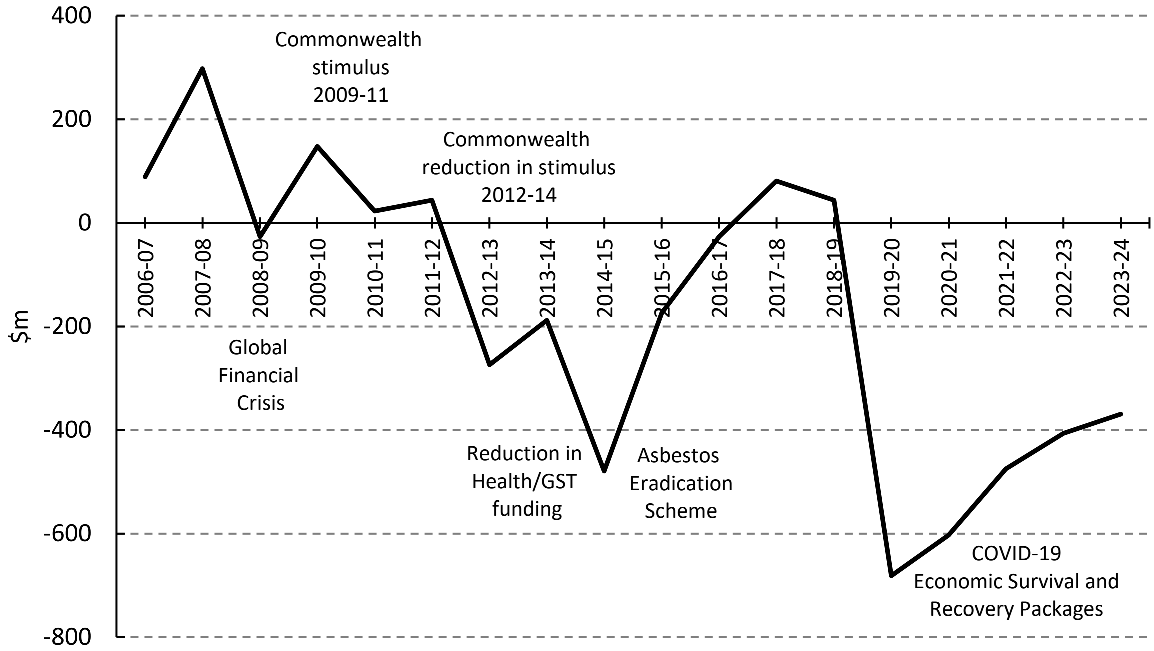


Figure 3 below reflects the historical performance of the Territory's budget in responding to prior economic and fiscal shocks. From each significant shock we have faced – from the Global Financial Crisis, Commonwealth reductions to GST and health funding, the Asbestos Eradication Scheme, and now COVID-19 – the Territory's budget has returned to broad balance following the implementation of recovery-style or stabilising initiatives, designed to buffer our local economy and protect jobs. As indicated in the 2020-21 Budget Outlook, our return to balance will take some time, and will be a function of evolving pandemic conditions and the strength of our economic recovery; however, we expect our current positive trajectory to continue.

The Government will also use opportunities presented by historically low interest rates to expand our infrastructure program, supporting growth and productivity, and maintaining our high standards of liveability.

Figure 3 – Headline Net Operating Balance time series



Notes:

HNOB details as per Appendix F to 2020-21 Budget Outlook – Key Aggregates History.
2006-07 to 2019-20: actual outcomes, 2020-21 to 2023-24: current 2020-21 Budget estimates.

Technical adjustments: Technical adjustments are adjustments which are typically outside the Government's control and are not triggered by an explicit decision by Cabinet and can result in appropriation variations. These adjustments are caused by changes in CPI, remuneration tribunal decisions, as well as the reprofiling of funding across years for the completion of projects. Details of the many adjustments that are technical in nature are not generally provided.

Budget estimates presentation**:** Changes to the structure of the financial tables were as a result of delay in the 2020-21 Budget and the need to provide additional information including the actual 2019-20 outcome.

Short-term assets/liabilities: Short-term assets and short-term liabilities are specified in the budget statements of each agency as current and non-current.

Other fiscal indicators (Section 3.4, page 18)

Pegasus notes that in financial audits, the ACT Auditor-General has employed measures such as:

- assets to liabilities coverage;
- short term assets to short term liabilities coverage; and
- financial assets to liabilities coverage (ACT Auditor-General, 2015, pp. 12-13).

Pegasus suggests that the benefit of these measures is that they provide an indication of the Territory's capacity to meet its obligations over the short and medium-term. As part of this review, Pegasus undertook analysis of the capacity of the General Government sector to meets its financial obligations using similar ratios. The coverage of assets to liabilities falls over the budget and forward years from about 1.8 times in 2020-21 to about 1.6 times in 2023-24.

Response:

These ratios can all be readily calculated from information contained in the 2020-21 Budget. They are not specifically included in the 2020-21 Budget due to the well-known limitations of considering financial ratios in isolation and the fact that they are generally more relevant to the private sector than governments.

From our desktop review, no other Australian jurisdiction includes these ratios in their budgets.

Ratios included in budgets by other Australian jurisdictions generally focus on comparisons of metrics against GSP (GDP Commonwealth) and/or revenue. For example, the 2020-21 NSW Budget includes:

- Taxation revenue/GSP
- Total revenue/GSP
- Total expenses/GSP
- Net Operating Balance/GSP
- Capital expenditure/GSP
- Net lending or borrowing/GSP
- Borrowings/GSP
- Net debt/GSP
- Net Financial Liabilities/GSP
- Interest expense/GSP

The ACT 2020-21 Budget also focuses on comparisons against GSP and includes:

- Net debt/GSP
- Net Financial Liabilities/GSP
- Net worth/GSP

Taxation reform
(Section 4.3, pages 24 to 26)

Pegasus states that "…one curious feature of the ACT Government's tax reform is that with an expected buoyant ACT residential property market, residential conveyances are forecast to become an increasing tax base for the ACT Government over the years ahead. It appears incongruous for the ACT Government to be collecting more revenue from both residential conveyances and general rates when it is supposedly more than midway through its transition from transaction-based taxes to land-based taxes".

Pegasus considers that the ACT Government's approach to its tax reform may risk undermining the main efficiency benefits associated with the policy measure, namely encouraging people to change their housing to better suit their requirements. Pegasus suggests that an alternative approach worth further consideration is that of charging annual property tax for those who elect not to pay residential stamp duty.

Response:

Through the tax reform program, the Government is shifting to general rates as a more reliable revenue source to fund our essential services such as hospitals, schools, transport and city maintenance. Moving to a more economically efficient and stable revenue base is delivering considerable economic benefits and ensures that the government can continue to deliver high quality services into the future.

Conveyance duty rates are decreasing every year, and the proportion of own source revenue from this inefficient tax is decreasing, while the proportion of own source revenue from general rates is increasing. We have now replaced around half of the revenue from conveyance and insurance duty with general rates. Detailed analysis of the impacts and outcomes of the tax reform program to date, published in August last year alongside the August 2020 EFU, showed that the tax reform has been broadly revenue neutral over its first seven years, collecting slightly less revenue than in the absence of tax reform.

The underlying combined revenue pool of stamp duty and general rates continues to grow in line with economic conditions. Revenue from residential stamp duty is expected to increase in 2020-21 as a result of the strong property market, driven in part by Commonwealth and ACT Government COVID-19 stimulus measures. It is important to note that the increase in stamp duty is much smaller than it would have been without tax reform.

There is no evidence that the tax reform program is discouraging people from moving to accommodation that better suits their needs, and growth in property transfers does not support this claim.

Economic and tax experts have noted that the opt-in nature of NSW's proposed property tax reform, similar to the concept proposed by Pegasus for further consideration, will stretch out the transition to the proposed new property tax.

Dividends and income tax equivalents (Section 4.4, pages 26 to 28)

Pegasus considers that the budget treatment of revenue from dividends is not fully transparent and requires some explanation.

Response:

The ACT Government's dividend policy is set out in each entity's annual report:

- Icon Water maintains a dividend policy of 100 per cent distribution of net profit after tax less gifted asset revenue. An interim, fully authorised dividend is declared and paid in June with a provision made for the payment of a final dividend in October (see page 129 of the 2019-20 annual report).
- The City Renewal Authority pays the Territory a dividend of 100 per cent of net profits after tax excluding net gifted assets (see page 124 of the 2019-20 annual report).
- The Suburban Land Agency operates under a policy of declaring a dividend of 100 per cent of its net operating surplus payable to the ACT Government (see page 95 of the 2019-20 annual report).

The key reason for the volatility referred to in the Pegasus report is the difficulty associated with predicting the impact of the COVID-19 pandemic on the housing market and the broader ACT economy in general.

The budget statements for each entity show the estimates for dividends approved and cashflows for payment of dividends.

It is not possible to estimate the components of each of these figures with sufficient reliability to provide any further meaningful explanation of the flows expected from dividends.

The financial statements sections of the budget statements of Icon Water, the City Renewal Authority and the Suburban Land Authority contain information on forecast dividends approved and paid.

Expenditure (Chapter 5, pages 29 to 31)

Pegasus considers that growth in expenses is relatively modest in comparison to historical rates.

Pegasus considers that the amount of lock-in of expenses limits the scope for the ACT Government to influence the level of public expenditure and the broader fiscal position in the short to medium term.

Response:

As would be expected, one of the main driving factors for expenditure growth in the 2020-21 Budget has been the COVID-19 pandemic. The ACT Government response to the pandemic has involved growth in expenditure across health, hospital and medical services, as well as rental relief for ACT Government properties.

While these expenses may be difficult to reduce in the short to medium term, they are necessary in the circumstances and are an appropriate use of fiscal policy. The time-limited and/or one-off nature of the pandemic response expenditure also affects calculated expenditure growth across the forward estimates period.

The effect of time-limited expenditure on growth rates over four-year budget periods has previously been observed, for example, as a result of the expenditure on the Loose-fill Asbestos Insulation Eradication Scheme. In this case, the time-limited expenditure in 2014-15 and 2015-16 resulted in an average annual increase in expenses between 2014-15 and 2017-18 of 1.61 per cent.

Expenses by function (Section 5.2, page 30)

Pegasus notes that the major areas of growth in expenses over the budget and forward estimates relative to the 2019-20 outcome are also in general public services, education and health. Pegasus suggests that this is consistent with traditional patterns of spending in the ACT, and perhaps surprisingly, the Government proposes to reduce spending in dollar terms over the forward estimates on environmental protection and on recreation, culture and religion relative to the 2019-20 outcome.

Response:

The variations in environmental protection expenditure are mainly due to the surrender of large-scale generation certificates, which are mostly allocated to the environmental protection function codes. This includes both fewer certificates forecast for surrender over the forward estimates period and lower estimated market forward prices per certificate for future surrenders. This is because the ACT Government reached 100 per cent renewable electricity generation in 2020, which included a full surrender of existing certificates. From 2021-22 onwards, the ACT Government will surrender only those certificates which it generates within that year in order to maintain 100 per cent renewable energy generation.

The decreased expense levels in the Recreation, culture and religion forward estimates compared to the 2020-21 Budget is mainly due to the one-year funding for the COVID-19 response in 2020-21, followed by a return to normal growth rates. COVID-19 response measures contributing to this temporary increase primarily include:

- supporting public pool operators;
- operational funding for Canberra Olympic Pool; and
- the Choose CBR program.

Capital works and infrastructure (Chapter 6, pages 32 to 35)

Pegasus notes that in 2019, a new capital works reserve of $140 million was established under the *Financial Management Act 1996 (FMA)*. The reserve permits agencies to advance their capital works program during the financial year and draw on the reserve should existing appropriation be exhausted. While noting that quarterly update reports will be provided to the Assembly, Pegasus has suggested further details be provided in relation to:

- criteria established to assess claims on the reserve;
- authority to approve such claims; and
- assurance over the usage of the appropriation.

Response:

Details of the operation of the Capital Works Reserve were provided to the Legislative Assembly in the *Financial Management Amendment Bill 2019* and associated Explanatory Statement.

The key criteria for agencies to access the Reserve are that:

- agencies with a multi-year budget allocations for capital works can draw on their future funding if their capital expenditure in a budget year exceeds their allocation for that year; and
- a payment from the Reserve for a project cannot result in the total funding for the project exceeding the total amount budgeted for the project.

The accountability and transparency over the use of funds from the Reserve are governed under the *FMA*:

- the power to authorise payments from the Reserve is vested in the Treasurer under section 18E;
- the Treasurer must notify the Assembly of details on payments from the Reserve in the quarterly financial statements under sections 18G and 26; and
- the Territory's financial operations in a year are reported in the annual financial statement prepared by the Under Treasurer and audited by the Auditor-General. Both the annual financial statement and the Auditor-General's opinion on the statement are presented by the Treasurer to the Assembly (sections 22 to 25 of the *FMA*).

The operation of the Capital Works Reserve is subject to the same level of accountability and reporting to the Assembly as other Territory financial transactions.

Capital Works Program Planning and Delivery (Section 6.2, page 34)

Pegasus notes that "… one consistent pattern in the forward estimates for capital works program forecasts is the eventual decrease in spending across the forward years that is never actually realised. The Committee might wish to inquire of officials how far into the future the planning timeframe for the capital works program extends".

Response:

The ACT annual budget is a four-year rolling program with new initiatives introduced by the Government each year. The forward estimates in a particular budget reflect decisions made in that budget year. These estimates are revised at budget review and in the annual budgets to reflect new budget decisions.

The capital works program is guided by the *ACT Infrastructure Plan*, which includes potential projects over the short (current works-in-progress/new works from the 2019-20 Budget), medium (considered within five years), and long term (beyond five years, out to the 2030s). The introduction of a particular initiative in a budget is decided primarily on the basis of community needs, economic circumstances, budget priorities and industry capacity.

Net Debt
(Section 7.2, pages 36 to 38)

Pegasus considers that it is possible that changes to the budget treatment of Public Private Partnerships from 2021 foreshadowed in the 2020-21 Budget will add to pressures on the ACT Government's reported debt position.

Pegasus states that the ACT will need to raise additional borrowings to fund its expanded levels of debt. Pegasus notes that an expansionary fiscal response to the COVID-19 pandemic has been pursued across all Australian jurisdictions and that a short-term increase in net debt can be a sensible response to adverse economic shocks. Pegasus considers that high levels of continuing debt are undesirable as they impose debt servicing costs and can reduce future budget flexibility. Pegasus also states that Australian interest rates are at historical lows and the ACT's net debt is manageable. However, the report suggests that if interest rates were to rise in future years the ACT would be faced with higher public debt interest bills and the Budget would come under significant stress.

Pegasus also considers that the Budget Papers do not indicate any long-term strategy for paying down the stock of accumulated debt and that this is of concern.

Response:

The ACT Government will adopt AASB1059: *Service Concession Arrangements: Grantors* in the 2021-22 Budget process, consistent with the Government's approach to implementing new accounting standards in the next appropriate budget update, once the standard's impacts have been fully evaluated.

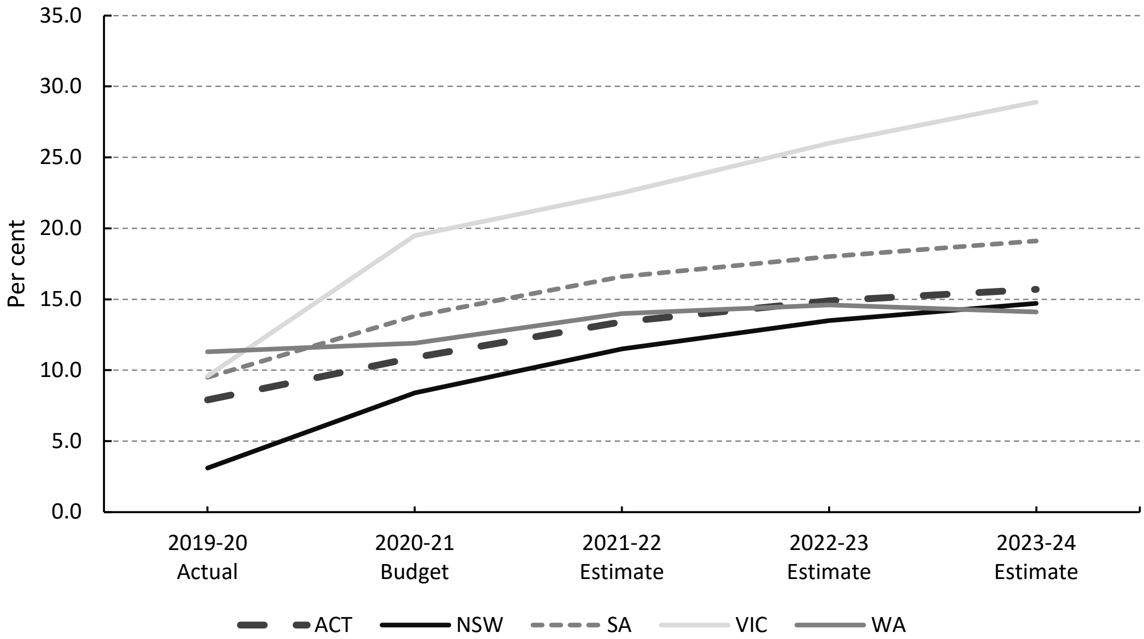
The implementation of AASB 1059 in the 2020-21 Budget would not have affected the reported debt position. Existing Public Private Partnership (PPP) arrangements that are in scope of AASB 1059 would be affected by a presentational change from finance leases to service concession arrangement liabilities, both of which are classified as debt.

Impacts on the reported debt position as a result of AASB 1059 in the 2020-21 Budget would only be relevant for any new arrangements as AASB 1059 changes the timing of recognition of service concession arrangement liabilities from on completion (existing PPP finance lease arrangements) to during construction. There are no new arrangements of this nature forecast as part of the 2020-21 Budget estimates.

In relation to the long-term strategy for paying off debt, the Territory's traditional method of doing so is operating cash surpluses and asset sales. The net debt position of every government in the world has worsened during the pandemic. The ACT's position relative to the other Australian states and territories is very strong. That is reflected in the fact that we are now the only Australian state or territory still holding an S&P AAA credit rating, which was reaffirmed in March 2021 following the release of the 2020-21 Budget, and one of only of a small number of subnational governments in the world with such a credit rating. While our net debt position has deteriorated, the ACT is well placed to service that debt and to pay it down over time.

Further, as outlined in the *Jurisdictional Comparison* section (Chapter 3.9) of the 2020-21 Budget Outlook, the ACT has one of the lowest Net Debt to GSP ratios of all Australian jurisdictions (Figure 4 refers).

Figure 4 – Net Debt to Gross State Product comparison



Source: Jurisdictions' 2020-21 Budget Papers. Not all jurisdictions have elected to present the net debt to GSP metric in their budget papers.

Net financial liabilities (Section 7.3 pages 38 to 39)

Pegasus considers that continued growth in the ratio of net financial liabilities to GSP is not desirable in terms of the sustainability of the ACT Government's debt and that the Territory's financial liabilities are now growing slightly faster than the Territory's capacity to support them. Pegasus suggests that this can be maintained while interest rates are low and there is some confidence of future growth in the economy but that the ACT Government will need to develop strategies to achieve its previously articulated principle that the ratio of net financial liabilities to GSP should be broadly stable over time.

Response:

The growth in net financial liabilities includes the estimated growth in net debt discussed above and the defined benefit superannuation liability.

The reaffirmation of our AAA credit rating confirms the Government has a high degree of creditworthiness and is in a strong position to meet the current and future estimated debt obligations.

The Government maintains a funding plan to extinguish the unfunded superannuation liability obligation over time, in conjunction with meeting the current annual retirement benefit payment obligations.

Superannuation (Section 7.5, pages 40 to 43)

Pegasus suggests that there is some question as to whether the target investment return assumption can be met in the short to medium term given the risks to the Australian and global economy. Pegasus considers that without a significant increase in investment returns or additional contributions, the ACT Government seems unlikely to achieve its goal of full funding of the superannuation liability by 2030. Pegasus notes, however, that there is no indication that the ACT Government will have any difficulties in meeting its unfunded superannuation obligations.

Response:

As acknowledged in the 2020-21 Budget Outlook Appendix I *Statement of Risk* under Financial investment assets and liabilities, the outlook for investment returns continues to be challenging. Any negative impacts to both future investment earnings and the liability valuation will increase the likelihood that the timeframe to extinguish the Territory's unfunded superannuation liability may need to be extended.

The target investment return objective, the superannuation liability valuation estimates, and the funding plan objective are re-assessed annually.

Economic risks
(Section 8.2, pages 44 to 45)

Pegasus considers that a risk to the economic outlook that is not remarked upon in the statement of risks is the risk of a downturn in the housing market (including residential construction), although some of the triggers for a downturn are acknowledged in the Budget papers.

Response:

The most likely downside risk to the ACT economy relates to the pandemic, so this is the focus of the downside scenario discussed on page 38 of the 2020-21 Budget Outlook. The downside scenario incorporates a downside scenario for the housing market, through weaker dwelling investment, which drives lower GSP in the forecast scenario Figure 2.2.15 on page 38 of the 2020-21 Budget Outlook.

The implications of the downside scenario for residential conveyance duty, and other key own source revenue lines is outlined on pages 151 and 152 of the 2020-21 Budget Outlook. However, the recent performance of the housing market has been stronger than expected.

Budget accounting, classification and valuation issues – Disclosure of key accounting practices
(Section 9.2, pages 46 to 47)

Pegasus raises concerns in relation to the accounting treatment in the Budget for Public Private Partnerships. These include:

- Was AASB 1049 adopted as the basis of accounting and presentation in preparing the budget financial statements?
- Why, unlike other Australian jurisdictions, are the bases of accounting, key accounting policies and a disaggregation of key assets and liabilities not disclosed in notes accompanying the financial statement?

Response:

AASB 1049: Whole of Government and General Government Sector reporting (AASB 1049) was adopted as the basis of accounting and presentation in the consolidated budget financial statements. The only deviation from AASB 1049 was the inclusion of the superannuation return adjustment to the Uniform Presentation Framework Net Operating Balance to obtain the Headline Net Operating Balance (HNOB).

The inclusion of the superannuation return adjustment ensures that the defined benefit superannuation expenses and revenue are reported on a consistent basis. The full amounts of superannuation interest and service cost are recognised in transaction expenses, while part of the revenue (the capital gains component on investments) is recognised as other economic flows. The superannuation return adjustment, when combined with income earnings recognised in transaction revenue, equates to 6.75 per cent return on the investment assets.

The HNOB has been a long standing measure used by the ACT to provide the most relevant and meaningful information for making long-term budget allocation decisions, and the inclusion of the full amount of the long-term investment earnings is necessary to provide an accurate assessment of the longer-term sustainability of the budget position.

The Government remains committed to improving disclosures around the of use of accounting standards in the Territory's budget papers. Following the 2019-20 estimates hearing, the Government agreed that disclosures would be considered as an area for improvement.

Given additional work associated with the impact of COVID-19 (for example, *Financial Management Act 1996* reforms, development of stimulus responses, etc), a more substantial review of disclosures was not possible in the 2020-21 Budget context.

There is no specific Australian accounting standard or authoritative view for the preparation and presentation of prospective financial statements. On this basis, the Territory's budget papers have been prepared having regard to applicable Australian Accounting Standards.

A desktop review indicates the ACT's disclosures are broadly consistent with other Australian jurisdictions.

Opportunities remain to improve the levels of disclosure. These opportunities will be considered for future budget papers.

Budget accounting, classification and valuation issues – Superannuation return adjustment (Section 9.3, pages 47 to 48)

Pegasus raises concerns in relation to the CPI assumption used for the purpose of calculating the nominal investment return. Pegasus suggests that it would be helpful to explain the rationale for the adoption of the assumption.

Pegasus also suggests that a more conservative approach to the return objective for the Superannuation Provision Account portfolio would appear to be warranted given economic uncertainties.

Pegasus also raises concerns about the superannuation return assumption as it results in a 2021 forecast that is $80 million more than the pre-COVID 2019-20 Budget forecast, while acknowledging that higher than average returns might be expected following the downturn associated with COVID.

Response:

The modelling assumptions underlying the target return objectives, including for CPI, incorporate current market pricing and are the base case expectations for major asset class returns, risk (volatility) and correlations of returns over a ten-year outlook.

Capital Market Assumptions are prepared by an Asset Consultant and subsequently reviewed (Treasury officials in consultation with the Investment Advisory Board) to determine preferred strategic asset class exposures to support the particular target investment return. The Asset Consultant undertakes an annual review of their capital market assumptions, setting out expectations for asset class returns, risks (volatility) and correlations for all major asset classes.

The development of the Capital Market Assumptions include consideration of fundamental drivers of investment markets and analysis of historical data. The asset class return assumptions are based on expectations for the real risk-free rate, inflation and risk premiums for each asset class.

The economic assumptions adopted for the 2020-21 Budget include forecasts and projections over 2020-21 and forward years. Due to the current low interest rate environment, the investment strategies incorporate Capital Market Assumption expectations over a ten year period.

The Superannuation Provision Account's target return objective of CPI plus 4.75 per cent has reduced from a nominal return estimate of 7.25 per cent per annum in the 2019-20 Budget to 6.75 per cent per annum for the 2020-21 Budget, due to the reduction in the CPI assumption.

The return assumption for the 2020-21 financial year is based on a projection from the end December 2020 investment position and incorporates an estimated investment return of approximately 12 per cent. The investment return for the Superannuation Provision Account portfolio for the 2020-21 financial year to end December 2020 was 8.9 per cent.

Budget accounting, classification and valuation issues – Public Private Partnerships (Section 9.5, pages 49 to 51)

Pegasus raises concerns about the accounting treatment of Public Private Partnerships, in particular:

- Why has AASB 1059 Service Concession Arrangements: Grantors not been adopted for the Light Rail Stage 1 and the Law Courts PPP projects, particularly given it was adopted by NSW in its budget forward years and fully by Victoria?
- Why has AASB 1059 not been adopted in respect to the budget forward years?
- What would be the impact on the Budget balances had AASB 1059 been adopted?
- Why has IPSASB 32 not been adopted?

Response:

AASB 1059 was not adopted for the 2020-21 Budget, as Treasury was assessing the full impact of the standard, including determining which arrangements were in scope. However, consistent with the Government's approach to implementing new accounting standards in the next appropriate budget update, once the standard's impacts have been fully evaluated, it will be implemented for the 2021-22 Budget.

The implementation of AASB 1059 in the 2020-21 Budget would result only in a presentational change from finance leases to service concession arrangement liabilities, both of which are classified as debt. There would be no impact on any headline debt metric.

Impacts on key fiscal measures in the 2020-21 Budget as a result of adopting AASB 1059 would only be relevant for any new arrangements as AASB 1059 changes the timing of recognition of service concession arrangement liabilities from on completion (existing PPP finance lease arrangements) to during construction. There are no new arrangements of this nature forecast as part of the 2020-21 Budget estimates.

For the same reasons cited above, IPSAS 32 has also not yet been adopted.

Application of AASB 1059 (Section 9.5, page 50)

Pegasus considers that "… AASB 1059 has not been applied to the budget and forward years, despite being applicable. The Committee should note that other jurisdictions with major PPP arrangements, particularly NSW and Victoria, adopted AASB 1059 in the preparation of their respective 2020-21 Budgets. NSW, whilst not adopting AASB 1059 in the 2020-21 budget year, did adopt the standard in each of the forward years. Victoria became the first state to fully adopt AASB 1059 from 1 July 2019 and has now applied it on a full retrospective basis as outlined by the Victorian Auditor-General (2020, p. 25).

The statement in Appendix G that the ACT Government's approach is consistent with other jurisdictions is, therefore, not correct".

Response:

The statement in Appendix G that the ACT Government's approach is consistent with other jurisdictions did not refer to the adoption of AASB 1059. It referred to the approach other jurisdictions had prescribed to accounting for PPP leasing arrangements in the absence of any accounting standards prior to the introduction of AASB 16 and AASB 1059.