

# COMMONWEALTH GRANTS COMMISSION (CGC) 2010 REVIEW

## COMMISSION POSITION PAPER CGC 2008/30

### THE ADJUSTED BUDGET

#### NEW SOUTH WALES TREASURY COMMENTS

APRIL 2009

NSW Treasury has made numerous submissions opposing the direct method of assessing capital expenses. We therefore do not support the inclusion of the non-replacement capital expenditure and net lending categories in the Commission's proposed adjusted budget.

NSW Treasury supports the inclusion of Commonwealth Specific Purpose Payments (SPPs) and Commonwealth own purpose expenses (COPEs) in the adjusted budget where they have an impact on State fiscal capacities, including an indirect impact through a reduced call on State budgets. NSW Treasury has provided further comment on SPP and COPE issues in its comments on the Commission discussion paper on the treatment of Commonwealth payments to the States.

NSW Treasury agrees with the Commission's view that the Northern Territory would need to demonstrate that its payments to local government for rationalisation are average State policy to have the spending included in the adjusted budget. NSW Government payments to local government generally are made for specific purposes. The payments are generally classified as current grant expenses or capital grant expenses.

NSW Treasury considers that the inclusion of ACT municipal transactions in the expense categories constitutes an inconsistency in the treatment of jurisdictions. However, provided it has no material effect on the relativities, NSW Treasury agrees that for simplicity it may be appropriate to include these transactions.

NSW Treasury does not understand why the Commission would seek to exclude from the adjusted budget operating expenses on subsidy payments to GBEs simply because they may be described as "capital injections". NSW Treasury considers that if the payments are analogous to grants and impact on general government net worth, they are quite distinct from "equity injections" which do not impact on net worth.

NSW Treasury therefore considers the Commission's decision not to include capital injections of an operating expenses nature in the adjusted budget does appear inconsistent with its decision to include cross subsidies between Government Business Enterprises (GBE) in the adjusted budget.

We are not aware of any cross-subsidy arrangements between GBEs or "reduced dividend" arrangements in New South Wales.

The adjusted budget is the representation of State budgets that the Commission uses to calculate the Australian average per capita revenues and expenses. It is the collection of all the expense and revenue categories that the Commission examines. Though the data required for its construction comes mainly from the ABS Government Financial Statistics (GFS) as well as State budgets and other sources, it does not reproduce the figures contained in the GFS since adjustments are made to suit the Commission's purposes. For example, some revenues and expenses are excluded by the terms of reference provided to the Commission, and some adjustments are made to enhance comparability between the States.

Commission Position Paper CGC 2008/30 provides the Commission's views on the adjusted budget required for the 2010 Review. NSW Treasury has no comment on the Commission's proposals in relation to the inclusion in the adjusted budget of currently excluded GFS transactions and a reconciliation item to GFS net lending and the continued inclusion of recurrent and capital SPPs.

### **Capital assessment and capital transactions**

In the 2004 Review the equalisation framework included only transactions that contributed to the net operating balance. State capital needs were assessed through net debt charges and depreciation. The Commission has indicated a preference for the direct method of assessing State capital needs. Implementation of that assessment would involve extending the equalisation framework to transactions that contribute to net lending and consequent changes to the adjusted budget.

To facilitate the direct assessment of State capital needs, the Commission intends to include two assessment categories in the adjusted budget:

- non-replacement capital expenditure, excluding expenditure on the acquisition of land. It would be calculated as gross fixed capital formation (expenditure on non-financial assets (net) for produced assets, assets acquired below fair value, assets donated and assets acquired under finance leases) less depreciation plus change in inventories and
- net lending. This is the outcome of State operations and is defined as net operating balance less non-replacement capital expenditure and other transactions in non-financial assets.

NSW Treasury has made numerous submissions opposing the direct method of assessing capital expenses. We do not intend to repeat those arguments here, suffice it to say that we do not support the inclusion of the non-replacement capital expenditure and net lending categories in the Commission's proposed adjusted budget.

### **Commonwealth Own Purpose Expenses (COPEs)**

NSW Treasury supports the inclusion of COPEs where they have an impact on State fiscal capacities, including an indirect impact through a reduced call on State budgets.

We note that the Commission intends to continue including COPEs paid to States, or COPEs where the average policy is to pay them to the States, in the adjusted budget. We note the Commission's intention to leave COPEs paid to mainly non-government organisations out of scope and assess a disability factor if there is an indirect impact.

NSW Treasury will provide further comment on SPP and COPE issues in its comments on the Commission discussion paper on the treatment of Commonwealth payments to the States.

### **Local government expenses**

NSW Treasury notes the Commission's intention to continue to include in relevant categories and assess financial assistance provided by State governments to local government. (Australian Government financial assistance paid "through" the States to local government is not included since it does not impact on State financial outcomes.)

NSW Treasury notes the Northern Territory's submission that the Northern Territory's ongoing financial assistance for the restructuring of regional shires should be assessed on an APC basis. The Northern Territory argues the spending is necessary and significant because of the large Indigenous population living in the shires.

NSW Treasury notes that other States have rationalised and amalgamated local government areas, seemingly without significant financial assistance. We agree with the Commission's view that the Northern Territory would need to demonstrate that its payments to local government for rationalisation are average State policy. If the Northern Territory payments to local government are in fact another way of providing support to Indigenous communities they should be assessed in the relevant expense category assessment, provided it represents average State policy.

The Commission sought information on whether State governments provide general revenue assistance to their local governments, and if so for what purposes and where they are classified in GFS. NSW Government payments to local government generally are made for specific purposes such as library services, open space, sporting facilities, country water supply and sewerage and roads. The payments are generally classified as current grant expenses or capital grant expenses.

## **ACT municipal transactions**

In the 2004 Review, some specific adjustments were made to the adjusted budget to reflect the differences in administrative and accounting arrangements between the States. One such difference is the ACT Government's undertaking of functions normally undertaken by local government in other States. ACT municipal transactions were removed for consistency with the scope of included transactions for other States, though this adjustment ceased in the 2007 Update.

The Commission notes that the inclusion of ACT municipal transactions in the expense categories has no material effect on the relativities. For simplicity, reliability and materiality reasons, the Commission intends to continue including the ACT's municipal expenses in the expense categories. The ACT's rate revenues will be included in the budget balancing transactions category.

NSW Treasury considers that the inclusion of ACT municipal transactions in the expense categories constitutes an inconsistency in the treatment of jurisdictions. Provided it has no material effect on the relativities, NSW Treasury agrees that for simplicity it may be appropriate to include these transactions. However, if the transactions ever materially affected the relativities they would compromise the achievement of HFE.

## **Government assistance to Government Business Enterprises (GBEs)**

NSW Treasury does not understand why the Commission would seek to exclude from the adjusted budget operating expenses on subsidy payments to GBEs described as "capital injections" but include in the adjusted budget subsidy payments to GBEs (and associated dividends) provided through cross-subsidies among GBEs.

The Commission appears to establish three principles to apply in these cases.

- "We said earlier that we will include transactions that contribute to the GFS net lending in the adjusted budget."<sup>1</sup>
- "Average State policy will therefore be recognised in the adjusted budget."<sup>2</sup>
- "We do not want accounting structures used by States to determine what is and what is not included in the adjusted budget."<sup>3</sup>

Judged against these principles, NSW Treasury considers the proposed exclusion of currently included general government assistance to GBEs by way of "capital injections" is

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<sup>1</sup> CGC Position Paper CGC 2008/30, *The Adjusted Budget*, October 2008, para. 54.

<sup>2</sup> CGC 2008/30, para. 54.

<sup>3</sup> CGC 2008/30, para. 57.

inconsistent with the proposed inclusion in the adjusted budget of currently excluded assistance to GBEs by way of cross-subsidies between GBEs. NSW Treasury wonders whether there may be some confusion created by the terms “capital injections” and “equity injections.”

### Capital injections

Currently, the Commission includes general subsidies, community service obligations (CSO) payments and capital and recurrent grants paid by the State general governments to their GBEs in the adjusted budget. New South Wales and the ACT describe some of their operating expenses on subsidy payments to GBEs as “capital injections”. Because they are recorded as operating expenses, these transactions were included in the 2004 Review adjusted budget.

The Commission now says it does not intend to include the previously included “capital injections”. The Commission notes it has said it will include in the adjusted budget transactions that contribute to GFS net lending. The Commission argues the non-inclusion of capital injections “will mean that to the extent that States on average provide assistance to their GBEs through operating transactions, the amounts will be included in the adjusted budget. To the extent they provide this support through equity injections, that will not be included in the adjusted budget. Average State policy will therefore be recognised in the adjusted budget.”<sup>4</sup>

NSW Treasury considers that “capital injections” provided to GBEs should be included in the adjusted budget if they are in the nature of operating expenses analogous to capital grants, e.g., are provided to GBEs to undertake capital expenditure, are recorded as operating expenses and impact on the net operating balance/net lending.

If the “capital injections” are not operating expenses, for example, because they are reflected in the general government sector balance sheet stock of equity held in other public sector entities, there would be a case for excluding them from the adjusted budget. In that case, the transactions would not affect net worth because they swap one form of financial asset for another, or if financed by general government sector borrowing produce a liability to offset the increase in assets. “Equity injections” provided to GBEs for balance sheet purposes and which are recorded in the cash flow statement should not be included in the adjusted budget.

### GBE cross-subsidies

Currently, the Commission does not include in the adjusted budget cross subsidies between GBEs which substitute for general government assistance to GBEs by way of, for example, community service obligation (CSO) payments. It now proposes to include them where the subsidy is transparent and it is known that the subsidy is not included in the GFS.

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<sup>4</sup> CGC Position Paper CGC 2008/30, *The Adjusted Budget*, October 2008, para. 54.

Western Australia has a cross subsidy arrangement between its electricity GBEs to subsidise electricity prices in remote communities. Lower electricity prices in remote communities (supplied by Horizon Power) are subsidised through higher electricity prices in less remote communities (supplied by Western Power) through a Tariff Equalisation Fund into which Western Power pays funds into and from which Horizon Power draws funds. Because the transactions are not recorded in the State general government operating statement, they are not included in the adjusted budget. If the subsidy were paid by the State government to Horizon Power through a community service obligation (CSO) and the CSO funded by higher dividends from Western Power, the subsidies and matching dividends would be included in the adjusted budget.

Western Australia has submitted that the Commission should include the cross subsidies between its electricity GBEs in the adjusted budget since they are analogous to subsidies paid in other States through CSO arrangements and adjusted dividend payments.

The Commission has decided that if reliable data on this and other subsidies (and their matching dividends) are available, it will include them in the adjusted budget to reduce the impact of different accounting treatments on adjusted budget figures. The Commission accepts in principle that cross-subsidies within GBEs should be included in the adjusted budget to improve data comparability across States.

NSW Treasury has some sympathy with this view. There is an argument that assistance to GBEs arranged as cross-subsidies between GBEs should be included in the adjusted budget since if arranged differently the transactions would be included in the adjusted budget. Nonetheless, there is also an argument that, as currently arranged, the transactions do not contribute to GFS net lending, and may not reflect average State policy.

NSW Treasury considers there should be consistency of treatment of capital injections and GBE cross-subsidies. We consider the Commission has not clearly established the difference between the two cases that warrants such apparent inconsistency of treatment.

### Impact on net lending

The Commission argues that equity injections are excluded because they are “cash flow statement transactions which do not affect a State’s net lending outcome, or reduce a State’s net financial assets or net worth.” Capital grants are operating expenses which do influence these outcomes. “On the other hand, cross-subsidies are operating items and if brought in on the revenue and expense sides of the adjusted budget will have no impact on net lending.”<sup>5</sup>

The capital injections the Commission seeks to exclude are described as “operating expenses on subsidy payments to GBEs . . . recorded as operating expenses”<sup>6</sup> and, if not offset

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<sup>5</sup> CGC 2008/30, para. 58.

<sup>6</sup> CGC 2008/30, para. 53.

elsewhere in the operating statement, should impact on the net operating result/net lending. The cross-subsidies the Commission seeks to include, being confined to the GBE sector, are not recorded in the general government operating statement and will not affect the general government net operating result/net lending (though NSW Treasury recognises that if arranged differently the transactions would be included in the general government operating statement).

#### Average State policy

As noted above, the Commission argues that the non-inclusion of capital injections in the adjusted budget will mean that to the extent that States on average provide assistance to their GBEs through operating transactions, the amounts will be included in the adjusted budget. To the extent they provide this support through equity injections, that will not be included in the adjusted budget. Average State policy will therefore be recognised in the adjusted budget.

Equally it could be suggested that the non-inclusion of assistance to GBEs via cross-subsidies between GBEs in the adjusted budget will mean that to the extent that States on average provide assistance to their GBEs through operating transactions, the amounts will be included in the adjusted budget. To the extent they provide this support through cross-subsidies between GBEs, that will not be included in the adjusted budget. Average State policy will therefore be recognised in the adjusted budget.

#### Impact of accounting treatment

The Commission argues that bringing cross-subsidies and associated dividends in, though it will have no impact on net lending, will allow average expenses and revenues within the operating statement to reflect what States are doing (save for different accounting treatment).

Equally it could be argued that including operating cost-like capital injections in the adjusted budget will allow average expenses and revenues within the operating statement to reflect what States are doing (save for different accounting treatment) and reflect the impact on the net operating balance/net lending of “capital injections” included in the operating statement.

While arguing that it does not want accounting structures used by States to determine what is and what is not included in the adjusted budget, the outcome of the Commission’s proposed treatments appears to produce exactly that result. In one case – the provision of assistance to GBEs through operating cost-like cross subsidies between GBEs rather than CSOs – the form of the arrangement will not matter since both will be included. In the other case – the provision of capital assistance to GBEs through operating cost-like capital injections rather than capital grants – the form of the arrangement will matter, since the former will be excluded and the latter will be included.

## Conclusion

As noted above, NSW Treasury has some sympathy with the proposal to include GBE cross-subsidies (and their matching dividends) in the adjusted budget on the grounds that the arrangement is analogous to a general government CSO payment/dividend arrangement to a GBE (with an offsetting dividend receipt). However, we cannot understand why the Commission would not, on the same basis, include “capital injections” if they are analogous to capital grants.

The Commission sought information from States on whether States have cross-subsidies between GBEs or “reduced dividend” requirements for GBEs. We are not aware of any cross-subsidy arrangements between GBEs in New South Wales. The NSW commercial policy framework recognises that social programs funded through cross subsidies distort the production and investment decisions of GBEs and the consumption decisions of the public. Social programs should therefore be funded transparently through the Budget via social policy program payments. Dividends are determined individually for each business, taking account of operational requirements and investment programs.