

# Treasury and Government Processes

Presentation given by Dr Gül Izmar, Deputy Director General, Research, Funding and Business Analysis, Department of Community Services  
Council of Social Service of NSW (NCOSS) *Window on Economics Seminar Series*, 5 April 2005

## 1. INTRODUCTION

NSW Treasury, The Cabinet Office, and Premier's Department are the central agencies in the NSW public sector, as distinct from the line agencies who are engaged in service provision. While there are overlaps between their functions and activities, the primary roles and responsibilities of the central agencies can be summarised as follows:

### The Cabinet Office

The Cabinet Office's main role is to advise on the Government's policy objectives. This involves the following functions:

- identifying and prioritising key policy issues to be addressed by relevant agencies.
- evaluating the appropriateness of current policies and programs in terms of whether they address real community needs and are consistent with the Government's philosophy.
- coordinating advice to Cabinet and acting as Secretariat to Cabinet and Cabinet Committees.

### Premier's Department

The main role of Premier's Department is ensuring the efficiency and effectiveness of public administration. This involves the following functions:

- providing strategic advice and services to the Premier
- managing issues and projects of significance to NSW
- whole of government coordination of major business, investment, infrastructure and community proposals and initiatives
- improving the management of public sector resources to achieve improved equity, efficiency and effectiveness .

### NSW Treasury

NSW Treasury is responsible for managing the State's finances so as to support the Government's service delivery objectives on a sustainable basis. Treasury consists of the Office of Financial Management (OFM) and Office of State Revenue (OSR). OFM undertakes the financial management functions while OSR is responsible for the revenue collection functions. However tax policy advice is primarily an OFM function.

OFM's functions include

- advising on economic and fiscal policies and strategies
- advising on the efficiency of government businesses and efficiency and effectiveness of government agencies.
- budget management, that is developing and implementing strategies to manage the State's revenues and expenditures
- managing the State's financial assets and liabilities
- managing the State's physical assets

To better understand the context within which OFM undertakes its functions, it is useful to look at the key concepts of the economic theory of the role of government.

## **2. ECONOMIC ROLE OF GOVERNMENT**

Traditionally, the economic theory of the role of government states that where markets can operate freely and prices reflect true community costs and benefits, market forces will produce optimal outcomes ie the amount and quality of goods and services that reflect the preferences of producers and consumers. Hence, the rationale for government involvement revolves around the conditions where the market will not produce these optimal outcomes, ie where there is "market failure".

It is commonly argued that the economic role for government in service provision is limited to the following cases:

- (a) natural monopolies – ie the service provision will be a natural monopoly due to economies of scale or scope;
- (b) public goods – ie some goods and services can only be provided to the entire community.
- (c) externalities – ie there are significant spillover benefits or costs for the community which are not reflected in market prices, such as costs of pollution;
- (d) merit goods – ie the service is considered to have intrinsic value, such as the arts;
- (e) information failure – ie there are considerable uncertainties, lack of information, or asymmetry of information which affects the market's effective operation.
- (f) equity – ie the market outcome would be undesirable on equity grounds (regional equity or income equity).

### **Natural Monopolies**

The existence of a natural monopoly provides a strong economic rationale for government involvement in the provision of services. An unregulated monopoly can lead to excessive concentration of market power, output levels which are lower than optimal, and prices which are higher than optimal.

Avoidance of these possible outcomes is the rationale for government involvement in services which would be natural monopolies. Government involvement can take a variety of forms such as direct service provision or regulation. This argument can also be extended to those situations where there would be only limited competition (ie oligopolies). The government's involvement in electricity and water supply largely rests on these grounds.

A key difficulty with government involvement is to ensure that public monopolies maintain a high level of efficiency. Dividends and tax equivalent payments are some of the mechanisms Treasury uses to promote efficiency and to avoid excessive cost escalation due to inefficiencies. In recent years, the increased focus on efficiency has meant closer scrutiny of the degree to which natural monopolies exist and therefore provide the rationale for government involvement. For example electricity generation need not be a natural monopoly although the electricity distribution network is. The need to separately identify and fund community service obligations has also become important for transparency and efficiency reasons.

### **Public Goods**

Where public goods are involved, the conventional market system does not produce an efficient outcome. With public goods, one person's consumption does not affect the amount available to the next person and once the goods are provided, there is no mechanism from excluding people from using it. In economist's terms, they are non-rival in consumption and non-excludable. This makes it difficult to attribute an appropriate "price" to these goods and services,

In practice pure public goods are rare. Air quality, the justice system and police services are examples. Furthermore, some goods which appear to be public goods can be efficiently provided by the private sector, such as security services. Some components of activities such as police and corrective services are not pure public goods and the outputs can be priced and marketed such as prison management

Those characteristics which make it difficult to market public goods also make it difficult for the public sector to judge the level, type and quality of goods which should be provided.

### **Externalities**

Production and consumption of some goods and services can have spillover effects to people other than the producers and consumers of the good. While these goods can be readily purchased and individuals can choose the extent to which they consume them, there is a difference between the private cost of the good and its social cost.

A wide range of government activities have as their rationale such spillovers; eg environmental protection, education and health programs and, public

transport, to name a few. The form of the government's activities varies widely, reflecting variations in the nature of the externalities. A number of external benefits are obtained by direct government provision on a subsidised or free basis, as in the case of child protection services, education and health. Others, such as provision of childcare services and pollution externalities, may be dealt with through regulation which may force most of the social cost back into the market price.

In most cases, externalities are difficult to quantify. Thus, it is difficult to assess the level of funding or subsidy required to correct for the effects of the externality.

### **Information Failure**

Uncertainty, lack of information, and asymmetry of information between providers and consumers can constrain the efficient functioning of markets and result in less than optimal outcomes. A wide range of government policies are directed at overcoming the poor information base or uncertainties facing commercial businesses. Other government policies are aimed at overcoming the poor information and uncertainty facing consumers. For example, regulation of childcare partly aims to correct information asymmetries in relation to the quality of services, as parents can find it difficult to judge the quality of the services their children are using.

### **Merit Goods**

While in practice they are closely related to externalities, merit goods are those which society considers intrinsically worthwhile for individuals. For example the government's extensive involvement in the arts is based on the concept of merit goods.

In fact there are very few "merit goods". In most instances they represent cases of externalities, however of a less quantifiable nature.

### **Equity**

Achieving equity is an important consideration in government policies in many areas. Equity can be considered at two levels. Firstly a minimum standard of education, health, housing and other community services should be available to all citizens. Secondly, people in different areas of the State and in remote locations should not be overly disadvantaged in their access to community services.

Cross-subsidisation (eg when rail customers paying more than they need to, to keep prices for regional rail customers low) is commonly used to achieve equity. While equity is a very important consideration, hidden or disguised subsidies can reduce the degree of accountability and efficiency of government agencies. To ensure efficiency of operations, it is important that the cost be measured and made transparent in the financial statements of government agencies.

### **3. TREASURY'S MISSION AND OBJECTIVES**

NSW Treasury's mission is stated as "Promoting the allocation of resources to increase the economic welfare of the community" in its 2003-04 Annual Report. To achieve its mission, Treasury has set itself the following objectives:

#### **1. Enhanced Economic Development.**

To enhance the policy and regulatory framework for NSW economic development.

#### **2. Effective Resource Allocation**

To ensure effective resource allocation and management in State sector service delivery.

#### **3. Transparent Financial Management**

To improve the transparency of NSW public sector financial management.

#### **4. Strengthened State Finances**

To strengthen the NSW government financial position.

#### **5. Organisation Building**

To build a values-based organisation that facilitates the achievement of our objectives.

### **4. GOVERNMENT EXPENDITURE AND THE BUDGET PROCESS**

To support the Government's ongoing priority of value for money in service delivery, Treasury has taken a new approach to the 2004-05 Budget and beyond.

As part of the Budget process, all General Government agencies are now required to prepare a Results and Services Plan (RSP). The RSP is a brief, high-level business plan that shows what an agency plans to achieve with its current resources.

The RSP consolidates the 'results focused' approach to service delivery planning which Treasury has been promoting for several years. This emphasises the importance of establishing links between day-to-day activities (services) and medium to long term objectives (results). Clearly defined links help to ensure that limited government resources are being used effectively.

Each RSP outlines key information relating to agency effectiveness and efficiency including:

- the results that an agency plans to achieve for the community.
- the services an agency delivers to achieve those results and the cost of service delivery.
- performance indicators to monitor progress; and
- risk management strategies to address the risks of results not being achieved.

The RSP should therefore be viewed as a strategic planning tool, and not simply a 'budget document'.

The first step in the Budget process consist of the scene setting meetings from late September to early November. Through these the Budget Committee decides which agencies are to be invited to submit "enhancement" proposals, ie proposals for new or expanded services. This is done within the context of the assessment of the overall economic outlook and broad revenue and expenditure projections undertaken by Treasury.

In late October Agencies receive their "allocation letters". These request Agencies to provided their "maintenance" proposals and their RSPs to Treasury by mid November. "Maintenance" proposals cover any additional funding needed to continue providing the existing services. Agencies are expected to fund minor "maintenance" proposals by restructuring their existing operations. The maintenance threshold is 1% of the net cost of services or \$5m, whichever is smaller. Those agencies who have been invited to submit enhancement proposals are required to submit those to Treasury by mid December.

In early February, Ministerial meetings with the Budget Committee take place. These involve further consideration of expenditure priorities. Allocation letters are issued to agencies in March, and agencies submit their final RSPs by April. In March and April finalisation of budget papers and any further adjustments to allocations are done and the Budget is handed down in May.

The analysis of "maintenance" and "enhancement" proposals by Treasury requires difficult trade-offs to be made. Generally there are proposals that are several times over the funding available to be allocated to Agencies. In line with the rationales for government provision of goods and services outlined above, in assessing the allocation of funds to activities proposed by Agencies, the Treasury analysts will seek to ask and answer questions such as:

- why should the goods or services be provided at all? What would happen if the program/activity was abolished?
- why can't the good or service be provided by the private sector?
- what is the relative priority/benefit of allocating funds to this particular program?
- does the proposal represent the most effective and efficient provision of the service?

## **5. GOVERNMENT REVENUES**

General government sector revenue is classified into State revenue and operating revenue. State revenue comprises State tax receipts, Commonwealth Government grants, Government Trading Enterprises (GTE) dividends and tax equivalent payments, and revenue from licences, fees, fines, levies and royalties. Operating revenue is revenue earned by general government sector agencies in the normal course of their operations and mainly consists of user charges levied to recover the cost of providing some goods and services.

Payroll tax is the largest source of taxation revenue, (\$4.4m in 03-04) followed by transfer duties (\$3.9m in 03-04). Other sources include land tax, motor vehicle registration duties, gambling and betting taxes, etc.

The NSW Government depends on Commonwealth grants for around half its revenue. Consequently, financial relations with the Commonwealth significantly influence the financial position of the State. The Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations sets out the current Commonwealth-State financial arrangements.

GST revenue grants constitute the major part of untied grants from the Commonwealth. The GST revenue collected by the Commonwealth is shared among the States on the basis of recommendations made by the Commonwealth Grants Commission according to the principle of horizontal fiscal equalisation. The Commission attempts to equalise the financial capacities of all States based on their revenue raising capacities and their cost of providing the range of State Services. The principle of horizontal fiscal equalisation maintains that the State governments should receive funding such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.

The Grants Commission makes its recommendations on the basis of highly detailed models which require a large number of adjustments. The capacity of the available data to support these adjustments meaningfully is debatable.

The Commonwealth Government also makes National Competition Policy payments to the States for implementing National Competition Policy and related reforms. These payments are subject to the State making satisfactory progress with the implementation of reform commitments.

The Commonwealth Government also makes specific purpose payments (SPPs) which are grants the State must use for specific purposes. The Commonwealth uses SPPs to promote its policies in areas which are the constitutional responsibilities of the States. An agreement between the Commonwealth and the States governs each SPP, and details the specific purposes. These agreements typically last three to five years, and are

renegotiated after that time. Examples are the Housing agreement and the SAAP agreements.

SPPs are generally less efficient than general purpose funding. This is because the Commonwealth controls can often distort the pattern of State expenditure through matching and other requirements and also impose significant administrative costs.

Dividends paid by GTEs represent a return on equity invested by taxpayers in the enterprises. Income tax equivalent payments by GTEs are intended to mirror as closely as possible company tax liabilities that would be incurred if the entities concerned were owned by the private sector.

Dividends and tax equivalents are an important source of revenue, totalling \$1.6m in 03-04. As explained above, they also serve to drive efficient operation of GTEs.

Finally, a strong balance sheet, with low levels of debt and other financial liabilities and a good credit rating associated with sound financial management means less funds required for servicing the debt and allows the government to provide additional funding to government services. Through its prudent debt management NSW Treasury has been able to maintain the State's AAA rating and significantly reduce the interest bill.

## **5. CONCLUSION**

Management of the State's finances and putting the Budget together are complex tasks. They require a sound understanding of the Government's policy directions, a broad range of financial and economic data to be analysed concurrently, an accurate assessment of their implications of the various funding proposals and making of numerous difficult trade-offs between proposals.

Greater interaction between Treasury analysts and other policy analysts in the government and non-government sectors can only lead to a better appreciation of each others perspectives and pressures under which each operate