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Commonwealth & State

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Budget Bulletin

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What follows is a detailed examination of Commonwealth and State budget forecasts before Budget night providing a full update of likely spending measures and parameter changes, for the Commonwealth and each State government along with our view of their consolidated performance. Included also is some broader economic and fiscal strategy commentary. To our knowledge this publication is the only one stop budget and economic bulletin on Australian governments available today. Enjoy!

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In this Bulletin

While the Great Panic or GFC now appears to have run its course, the impact on the real economy will last for the next several years, as the resultant rising cost of capital and repricing of risk reduces asset prices and forces a drawn out process of business and household balance sheet repair. For Australia in 2009, the adjustment process will be particularly sharp. The 'income' effect associated with the rapid decline of our terms of trade by around 28 per cent over the next three years will reduce real national income progressively by between **\$40 to \$60 billion** over the period. Falling company profits and higher capital costs impose a stark choice on business – either reduce their wage bill by cutting wages or laying-off staff. Lower income in the form of profits, wages and employment means lower expenditures by businesses and households in the form of capital investment and household consumption, and this feeds itself in a vicious circle. We expect to see unemployment rise above **8 per cent** by July 2010, with the possibility that it will rise much higher thereafter unless activity can be brought back to trend levels.

Unfortunately just as much of the GFC has been beyond the control of Australian policy makers, the resultant downturn and recovery will be drawn out as global markets wait for US/European banks to repair their balance sheets and restore confidence. However, Australian governments can undertake sensible fiscal stimulus to replace lost demand and support measures to alleviate employment costs for business.

Governments can do much to help restore profitability to business. They can adopt sensible discretionary measures to raise productivity in the economy, eliminate waste and undue regulation. They can reduce the cost of employing labour by insisting on **wage restraint** wherever possible, **especially** on the part of public servants. The **good news** is Australia has a healthy banking system, still relatively small public indebtedness and trade links with the fastest growing region in the world.

We congratulate the Rudd Government for acting pre-emptively to spend big and fast in the face of the GFC and avoiding any cataclysmic seizure of credit markets at the height of the Panic in October 2008. Its decisiveness, coupled with a coordinated global macroeconomic stimulus and an orderly disposal of US banking sector assets, should help to **forestall** the worst impacts of the downturn. But there have been policy mistakes as well. Fiscal measures such as the 'cash splash', roof insulation, primary school halls and indexation



windfalls for state governments are inefficient transfers that do nothing to reduce the severity or length of the recession which began in the December quarter 2008. By our reckoning **\$57 billion** has been spent over the last six months on low grade measures, representing around half the total \$100 billion budget windfall associated with the mining boom.

Sadly you can only fire the fiscal cannon once, and we missed. Now we have less capacity to deliver much needed microeconomic reform and a world of hard decisions to make. And who will make the hard decisions? The same people who missed the opportunity for a thorough spring clean of public finances in November 2007 and who are now caught between a sea of **red ink** and a mountain of public debt, not to mention the pile of reviews and white papers.

By our reckoning Commonwealth general government will run a budget **cash** deficit of **\$48 billion in 2009-10** (4.2 per cent of GDP), depending on the mix of new stimulus and savings announced on Budget night, with deficits in excess of **\$50 billion** over the outlook period. These estimates incorporate updated parameter estimates since the February 2009 Budget Update and factor in significant discretionary spending cuts associated with the elimination of the Baby Bonus and significant reductions in retirement and superannuation concessions to high wealth individuals. Even so Government net debt will rise to over **\$174 billion** by 2012-13 (14 per cent of GDP). Beyond that we are looking at Budget deficits as far as the eye can see with no prospect of future surpluses until the Commonwealth eliminates the underlying **\$30 billion dollar** structural deficit by either pruning the discretionary spending base and/or raising taxes. Otherwise **it will never deliver another budget surplus**. We argue that the massive **\$148 billion** reduction in the revenue base since last budget, coupled with **net** new discretionary outlays totalling **\$84 billion** (although many are one-offs), underscores the need for structural reform of the Commonwealth budget. The fiscal ship is taking water and the pirates are not friendly.

Meanwhile we estimate the combined budget deficit of *all* Australian governments will be **\$59 billion** in 2009-10 with general government net debt rising to **\$215 billion** over the outlook. This excludes local government, around **\$120 billion** in total public sector corporate borrowings expected to accumulate by 2012-13, along with up to **\$80 billion** in unfunded state superannuation liabilities. Total public sector financial liabilities are set to exceed **\$400 billion** by 2012-13 (**33 per cent** of GDP), and with the IGR burden looming,



superannuation tax concessions growing alarmingly and now worth **\$22 billion** annually and with a private sector heavily reliant on net capital inflows and foreign liabilities currently exceeding **60 per cent** of GDP.

Big public debt equals future taxation. That hurts the economy in two ways.

- One more dollar of tax raised means one less dollar invested by the productive private sector, with the deadweight efficiency costs and administrative burdens of taxes on top of that.
- When governments borrow, particularly when credit markets are tight, they put upward pressure on interest rates and crowd out pro-growth private activities.

Both of these are really two sides of the same coin.

So what should be next for the Rudd Government? Well the 2009-10 Budget will include the significant infrastructure package, Fiscal Stimulus Mark III as we predicted at MYEFO. It will focus on major roads, interstate rail and port infrastructure projects. Building on this the Government should also consider the following.

- (i) Announcing a significant round of new microeconomic reforms using the current economic crisis to garner support for major reform proposals.
- (ii) Reprioritising base spending to fund a 4th supply-side focussed stimulus. Eliminating waste will also contribute to output and job creation in a net sense.
- (iii) Undertaking high quality spending measures that boost the productive capacity of the nation.

Sensible budget reform targets are not controversial. Some good options would include.

- (i) Developing a consistent 'means testing' framework for all income transfers.
- (ii) Introducing incentive contracts to apply to the annual public procurement bill of Australia governments, currently worth around **\$156 billion** in 2009-10.
- (iii) Bringing program reporting to all levels of government by requiring officials to account for each dollar spent, and sign that their purchases were appropriate, effective and efficient as per the Department of Finance's guidelines of the 1990s.
- (iv) Replacing inefficient price regulation in both the public and private non-traded goods sectors which accounts for around 75 per cent of economic output.
- (v) Introducing tax reforms that restore non-discriminatory treatment of income regardless of source.



- (vi) Reversing the changes to superannuation made in the dying days of the Howard government.

Meanwhile the State governments are collectively in not too bad shape fiscally, given the circumstances. Looking at the combined State general government they are set to run operating cash surpluses of around **\$9 billion** in 2009-10 and have already committed to spending over **\$76 billion** in public infrastructure over the next few years during a period of sustained slowdown in activity in Australia likely to last till 2011-12. State public corporations have also committed to spending an additional **\$100 billion** over the outlook period. Meanwhile Victoria and Queensland have plans for major new additional spending related to transport infrastructure. The catch to all this capital formation is the run up in total general government sector indebtedness to around **\$44 billion** by 2012-13 with significantly more debt held by public corporations. All will be well **if** projects are selected using rigorous cost-benefit criteria.

The **bad news** is that the economic downturn will gather pace in Australia for the rest of 2009 and into the first half of 2010 and that we are looking at a protracted period of below trend activity until business confidence rises and consumer demand stabilises. We can't think of a better time to initiate a new round of growth creating microeconomic reforms. Can you?



Introduction: Big Spending Government

Our budget tracking model now has the Commonwealth Budget in deficit by over **\$48 billion** dollars in 2009-10 (a turnaround of **\$70 billion** dollars within 12 months) based on our understanding of parameter changes and new stimulus policy and savings measures since the last update. This Bulletin tells the story of what happened to the economy and finances of Australian governments since May 2008 to produce this profound turnaround in fiscal fortunes. More positively it addresses the way forward both in terms of repairing the structural integrity of the budget and suggests a new round of microeconomic reforms.

To Recap

This time last year we told you that the Commonwealth had been running a structural deficit since 2006-07 of around **\$20 billion**, and that corrective measures needed to be taken to close the fiscal gap. What we got in the last Commonwealth Budget were skewed priorities such as more funding for so-called 'self funded' retirees while the CSIRO received a funding cut, with no net reduction of spending across the forward estimates.¹

Since Budget and GFC, revenue has collapsed by a total of **\$148 billion** over the outlook period and 1000 flowers have bloomed in terms of new spending measures totalling around **\$102 billion** over the forward estimates, with expectations of significant future spending beyond the forward estimates including.

- The public sector building and owning the National Broadband Network at a total cost of **\$43 billion**.
- The Bradley review into higher education at a total cost of around **\$6.5 billion**.
- Paid maternity leave at an annual cost of around **\$500 million**.
- An election commitment to 'fix' public hospitals.

OK, it is too late to repair the structural foundations of the Commonwealth budget given the stage of the business cycle, but not too late to focus on high quality policy measures and reprioritising budget outlays. We question how much of the stimulus that has been spent so far will generate a financial return that will help service the public debt interest bill associated with the spending. By our reckoning **\$57 billion** has been spent over the last six

¹ Brian Toohey, 'Now's the time to mend the budget holes', AFR, 25 April 2009.



months on low grade measures, representing around half the total **\$100 billion** budget windfall associated with the mining boom.

When the current recession ends the Commonwealth will still have a structural deficit and the prospect of running budget deficits into the future as far as the eye can see. The Government will still be left with a **larger** structural deficit of around 2.1 per cent of GDP or **\$25 billion** dollars, having risen since our last estimate due to the increase in interest payments on public debt with Commonwealth net debt rising to **\$169 billion** by 2012-13 (14 per cent of GDP) and still rising each year. *And yes Virginia, there is an intergenerational crisis coming* as an ageing population increases our social outlays by a further **3 to 5 per cent** of GDP starting from around 2015-16. We see no path back to surplus for the Commonwealth at all unless it:

- (i) undertakes a savings round worth around **2 per cent** of GDP; or
- (ii) raises taxes by a similar margin of **2 per cent** of GDP.

The bad news is that the State and Territory governments are in some ways in worse structural shape than the Commonwealth. They all relied on a narrow tax base and windfall revenues to expand the public payroll during the halcyon days of the property and mining booms (sometimes both at the same time (e.g. Western Australia). Now they are paying too many public servants too high wages. Each jurisdiction is playing catch-up with public infrastructure spending forcing nearly all of them to run **large underlying cash deficits** over the next four years and accumulating more general government net debt in the process - up to \$42 billion in 2012-13. Most also have unfunded superannuation liabilities which combined sum to something like **\$80 billion** and are expecting total public corporations to accumulate total debt of over **\$120 billion** by the end of the outlook period.

Essentially State governments have engaged in structural dis-saving by failing to 'bank' their own stamp duty, land taxes, and mining royalty windfalls since 2002-03, while in recent times undertaking a pro-cyclical spending boom of their own. Collectively State governments are sitting on an underlying cash deficit of around **\$11 billion** in 2009-10. However, unlike the Commonwealth there is a good chance that many of the State and Territory governments will be running small operating cash surpluses over the next four years, in the midst of the downturn (although not in fiscal balance terms once depreciation and provision for superannuation liabilities are included as expenses). This suggests that the consolidated structural budget of State and Territory governments is now in marginally



better shape than the Commonwealth, even if some golden opportunities have been missed.

Now that **both** the Commonwealth and State governments are running large underlying cash deficits, the capacity of Australian governments to undertake further fiscal stimulus in coming months as the downturn takes hold in Australia will be diminished. Essentially there is now a long queue of sovereigns looking to borrow more cash and very few lenders. Of course it is always cheaper to borrow when there are more lenders.

So we begin the new budget year 2009-10 with the combined (net lending) cash deficit of Australian governments at around **\$59 billion** (or **5.1 per cent** of GDP) and heading for total Australian public sector external liabilities in the vicinity of **\$400 billion** in 2012-13 and still rising. No surpluses, just a sea of **red ink** and a mountain of debt. **Fantastic!**

Hitting the Bottle Again

Most of the stimulus measures introduced by Australian governments in response to the GFC have been undertaken by the Commonwealth, which has more capacity to undertake sustained discretionary spending and is responsible for macroeconomic stability. Unfortunately the **drunken sailors** have again left their mark on the Federal budget. Only this time last year did we have the Commonwealth running a cash surplus of around **\$23.5 billion** (or 2 per cent of GDP) in 2009-10 ... then we had two months of global financial turmoil after the Lehman Brothers collapse on 15 September 2008 which saw a frenzy of new spending measures announced all aiming to add stimulus in either the 2009 or 2010 calendar years including the following.

- 14 October 2008 - \$10.4 billion for the *Economic Security Strategy* comprising \$9.7 billion in **2008-09** paid to families (\$3.9 billion), pensioners (\$4.8 billion), first homeowners (\$1.1 billion) and for training places (\$187 million); with a further \$350 million in **2009-10** for first homeowners.
- 10 November 2008 - \$6.2 billion for the *New Car Plan* to assist the 'greening' of the car industry comprising a net fiscal stimulus of around **\$15 million** in 2008-09 and **\$220 million** in 2009-10.
- 18 November 2008 - **\$300 million** for local councils to build local community infrastructure, all to be spent in 2008-09.



- 29 November 2008 - \$15.1 billion in special purpose payments to State and Territory governments including new spending of around **\$3.5 billion** in 2008-09 and a further **\$1.7 billion** in 2009-10 raising indexation to 7.5 per cent over the Budget outlook.
- 12 December 2008 – the \$4.7 billion *Nation Building Package* of capital works in road, rail and schools, comprising net fiscal stimulus of around **\$335 million** in 2008-09 and a further **\$382 million** in 2009-10.
- 14 December 2008 – the bring forward of spending on the Renewable Energy Fund over the next 18 months with an additional **\$100 million** to be spent in 2008-09, and **\$345 million** to be made available in 2009-10.
- 3 February 2009 – the **\$42 billion** *Nation Building and Jobs Plan* which included: cash handouts to families with children and lower income workers (**\$10.5 billion** in 2008-09 and **\$1.6 billion** in 2009-10); funding for building and repairing school halls and community facilities (**\$987 million** in 2008-09 and **\$8.6 billion** in 2010-11); funding for 20,000 public housing and defence homes (**\$260 million** in 2008-09 and **\$4.3 billion** in 2010-11); and funding for home ceiling insulation (**\$39 million** in 2009-10 and **\$1.54 billion** in 2010-11) and training assistance (**\$423 million** in 2009-10 and **\$98 million** in 2010-11).
- 12 May 2009 – we expect the Budget to include: a \$30 per week boost for pensioners (**\$511 million** in 2009-10 and **\$531 million** in 2010-11); major infrastructure stimulus in the form of the *Building Australia Fund* (**\$7 billion** in 2009-10 and \$5.5 billion in 2010-11); Defence White paper new capital funding (**\$1.45 billion** in 2009-10 and 2010-11).

We estimate that by Budget Night the Rudd Government will have committed to total new discretionary spending of **\$102 billion** (excluding “razor gang” savings) over the forward estimates.² This includes the following.

- Around **\$33 billion** or **2.9 per cent** of GDP to be spent in both 2009 and 2010 – each representing a new stimulus in the order of **2 per cent** of GDP assuming a private savings offset of around 30 cents in the dollar.

² These estimates do not account for the financial impact of the uptake of significant unquantifiable liabilities via the downstream fallout from the deposit guarantee on local borrowings which drained liquidity from managed funds and investment funds – since September the Commonwealth has accumulated almost \$1 trillion, or close to 100 per cent of GDP, in contingent liabilities based on deposits, loans and state borrowing guarantees.



- This stimulus combined with the RBA's 425 bps monetary easing will provide a **total macroeconomic policy stimulus** in both years of around **4 per cent** of GDP in 2009 and 2010.
- Around **\$25 billion** is dedicated to infrastructure spending in 2009-10 and a further **\$16 billion** available to be spent in 2010-11.
 - Infrastructure spending is the superior stimulus route because it has twice the bang per buck when compared to payments to households.³
- Around **\$57 billion** has been spent on lower grade forms of stimulus unlikely to generate growth over coming decades but are more or less efficient social transfers (such as cash handouts, school and community halls and ceiling insulation).

Meanwhile, State and Territory general governments have committed to significant infrastructure spending totalling **\$105 billion** over the next four years while their public corporation have plans for to spend even more again. Leading the pack is South Australia, Victoria and Queensland with New South Wales ready to benefit significantly from Commonwealth spending proposals such the *Nation Building* program and the *Building Australia Fund*.

Still Waiting For the Great Leap Forward

The political honeymoon afforded to a new government for bold reform is now over. It was neglected. Despite promising to take a "meat-axe" to public spending before the last federal election, the last Budget contained no net savings over the forward estimates while cutting spending on nationally important institutions such as the CSIRO.

However, the GFC presents a second chance for bold reform. The old saying is "never waste a crisis". This is a good time for government to get on the front foot and advocate some significant structural changes that will generate growth throughout the next decade.⁴

3 The spending multiplier associated with infrastructure spending is in the vicinity of 1.2 to 1.3 per dollar of spending. This is because it is paid to businesses that pay other businesses and so on. Whereas payments to households may be saved so usually have multipliers of between 0.5 & 0.7.

4 The reformist Hawke and Keating Labor Governments actually cut tariffs during the 1990s recession.



We support the Rudd Government's decisive and proactive approach to the GFC from October 2008. We hope that current actions will save the nation from unnecessary economic hardship and unemployment. It would be the height of foolishness for government not to seek to forestall a downturn by spending a few percentage points of GDP on high value measures as an insurance policy against a spending strike by business and households. But fiscal strategy is about building national savings to underpin the productive capacity of the nation over time and to fund for 'no regrets' policy measures in lean years. And don't the textbooks say that a fiscal expansion for a small open economy is more likely than not to fail because it tends to be crowded out by imports, especially where it is targeted at low quality measures.⁵

It appears to the outsider that the Rudd Government lurches from one day to the next without a policy framework, looking for the next political headline to grab, rather than seizing every opportunity to improve public policy outcomes. The sound bite is great, but the substance is lacking. Meanwhile public officials who could help provide the substance seem too fond of their new found influence. As the budget deficit widens (with no respite over coming years), senior bureaucrats (including Treasury officials) seem to provide tacit endorsement to low grade policy choices rather than articulating a bold reform agenda.

*"In a sense, income is being redistributed from more prosperous to less prosperous periods in time"*⁶

In the words of Sir Humphrey, they are "a pleasure to work with". Senior bureaucrats who presided over the irresponsible spending in the Howard years, provided no blue print for significant reform to the incoming government and have none now. The policy cupboard is bare.

⁵ Tony Makin, 'Beware the Spending Spree' AFR, 15 December 2008.

⁶ 'The role of fiscal policy in the current environment', Keynote Address to the Finance Professionals Forum, Nigel Ray, Executive Director Fiscal Group, The Treasury, 31 March 2009 Sydney, p.15.



Why can't we conduct a ruthless war on waste whilst conducting a fiscal expansion? As yet there has been no 'real' savings round conducted by the new Government. This is evidenced by the poor showing at both Budget and MYEFO in 2008-09 which detailed combined discretionary spending cuts of less than **\$2.9 billion** (not counting the discretionary policy easing from October 2008). Now perhaps certain spending cuts have been delayed because of the GFC and certainly many program reviews are still underway. But at least the Howard Government managed to deliver sizeable spending cuts by the end of its first and second year in office in 1997 and 1998 of between ½ to 1 per cent of GDP at the time of the Asian Financial Crisis.

To be fair the Treasurer's speech on Budget Night will unveil significant new savings. We anticipate the Government has agreed to discretionary cuts to spending programs worth up to **\$24 billion** over the forward estimates and headlined by around \$7 billion in savings in 2009-10 including:

- **\$3 billion** per annum in reduction in benefits for high income tax superannuation tax concessions;
- **\$1.5 billion** per annum from tightening the means test for *Family Tax Benefit B* to \$1000 or less per annum; and
- **\$1.3 billion** per annum from eliminating the *Baby Bonus*.

OK this is a good start. Now it is time to develop a consistent set of mean testing arrangements to apply to all government programs and to apply them to Howard-era welfare measures such as the child-care rebates, high-income superannuation concessions, the Medicare safety net and the Private Health Insurance rebate.

Of course if we have overstated the extent of savings achieved just add these back onto our budget deficit forecasts.

Fiscal Stimulus Package Mark III

On Budget night the Rudd Government will use the proceeds of its saving round along with the **\$10 billion** contents of the *Building Australia Fund* to announce **\$25 billion** in new infrastructure projects over the next four years. This represents a net stimulus to the economy in the order of **1.5 per cent** of GDP (**\$17 billion**) as some of the money is already contained in the budget estimates.



Targeted projects are those that were hand picked by Infrastructure Australia after a 'rigorous' cost benefit analysis. As such the economic returns to these projects should be real and long lasting. Also, unlike fiscal stimulus packages Mark I & II, they are fully funded from within the budget or hypothecated sources.

Fiscal Stimulus Package Mark III should be a pre-emptive strike against further destabilisation of domestic activity by international factors and should also assist the economy during a prolonged period of economic weakness. The measures contained in the *Building Australia Fund* program will focus on hard infrastructure - road, rail, ports - and will build on the Government's far sighted commitment to build and own the national broadband network as announced on 7 April 2009. The great difficulty with Fiscal Stimulus Mark III will be rolling out the projects in a timely fashion which was the major difficulty faced by the Keating Government in the early 1990s with the *One Nation* spending package where projects came on stream just as activity was returning to normal levels. However, we expect that this downturn will justify the long lead time associated with these projects.

The Fiscal Stimulus Package Mark III combined with the tax cuts already in the estimates scheduled to begin on 1 July 2009 are likely to help counter the real 'income effect' associated with the anticipated 17 per cent downturn in Australia's terms of trade in 2009-10 lead by declining contract prices for steaming coal (down by 60 per cent) and iron ore (down by 40 per cent). However, this still leaves our terms of trade at around the 2005 level which means that the companies and governments will still be receiving windfalls from stronger commodity prices.

Budget Bottom Line for the Commonwealth

The combination of a significant discretionary easing in 2009 & 2010, combined with the loosening of the budget's automatic stabilisers, and the sudden collapse of the bulk of revenue windfalls associated with the commodity boom, will see the Australian Government post the largest budget deficits in GDP terms since WW2. We estimate that the 2009-10 underlying cash deficit will be **\$48 billion** for the general government sector followed by budget deficits in excess of **\$50 billion** over the forward estimates as is outlined in Table 1.



Table 1 Commonwealth General Government Budget Forecasts

| | 2008-09 \$b | 2009-10 \$b | 2010-11 \$b | 2011-12 \$b |
|--|----------------|----------------|----------------|----------------|
| Updated Economic and Fiscal Outlook | -22.5 | -35.5 | -34.3 | -25.7 |
| <i>Impact of Parmentier Variations</i> | -2.6 | -7.6 | -14.4 | -28.2 |
| <i>Impact of Policy Variations</i> | 0 | -4.9 | -3.3 | -0.3 |
| Macroeconomics Budget Balance | -25.12 | -48.0 | -51.7 | -54.3 |
| Percentage of GDP | -0.021 | -0.041 | -0.045 | -0.045 |

Source: Budget Papers & Macroeconomics estimates.

The sheer magnitude of these deficits over the budget outlook coupled with the speed at which they have emerged (remember that this time last year we forecast budget surpluses in excess of **\$20 billion** in each year) tends to reinforce our argument that the Australian Government budget is in a position of structural deficit in the vicinity of **\$20-25 billion** depending on which year you consider – see Table 2.⁷ The large structural deficit measure is based on our assessment of long term trend revenue streams, and is driven by nominal GDP shares and commodity prices movements. It says that commodity prices are still contributing to windfall budget revenues, but that these are subsiding over the outlook. Meanwhile the underlying real economy is detracting from budget revenues and contributing to higher expenses through social security payments.

⁷ The structural balance adjusts the headline cash balance for movements in real output and the terms of trade away from the longer term trend.



**Table 2: Headline and Structural Budget From 2007-08
Actual & Estimates**

| | 2008-09 \$b | 2009-10 \$b | 2010-11 \$b | 2011-12 \$b | 2012-13 \$b |
|--|----------------|----------------|----------------|----------------|----------------|
| Macroeconomics Budget Balance | -25.1 | -48.0 | -51.7 | -54.3 | -53.6 |
| <i>Impact of the Economic Cycle</i> | 24.5 | 37.1 | 36.8 | 35.4 | 32.8 |
| <i>Impact of the Commodity Cycle</i> | -18.2 | -9.4 | -7.4 | -5.4 | -5.0 |
| Structural Balance | -18.8 | -20.3 | -22.3 | -24.3 | -25.8 |
| (Per cent of GDP) | -0.016 | -0.018 | -0.019 | -0.021 | -0.021 |

Source: Macroeconomics estimates.

Red Ink as Far as the Eye Can See

The parlous position of the budget highlights the need to repair the structural integrity of the budget. Essentially what our numbers suggest is that long after the current downturn is over the budget will still be in significant deficit. Indeed, given the Government's current policy commitments and proclivity to raise spending expectations, the budget will not return to surplus without someone applying a razor to program spending. This is especially true given the original IGR Report prediction in 2002-03 of a **5 per cent** of GDP fiscal gap related to population and budget pressure appearing from 2015-16.⁸

The Budget Bottomline for the States

One of the most disappointing aspects of recent times has been the squandering of the proceeds of the China boom which were frittered away through wasteful spending. Table 3 outlines **Macroeconomics** estimates of State and Territory Governments consolidated budget balances and their structural balance after adjusting various revenue streams to long term trends and making provisions for long term superannuation payments and infrastructure spending. It shows that the State and Territory Governments are also collectively running large deficits mostly attributed to the current 'catch-up' spending on infrastructure represented as a discretionary easing in our model.

⁸ We favour this IGR to the more recent version because it is based on a more realistic profile for nominal GDP based on commodity price assumptions without the China Boom effect.



Table 3: Structural State Budget Outcomes since 1996-97

| | 2008-09 \$b | 2009-10 \$b | 2010-11 \$b | 2011-12 \$b | 2012-13 \$b |
|---|----------------|----------------|----------------|----------------|----------------|
| GFS Net Lending(+)/Borrowing(-) | -5.9 | -11.1 | -8.6 | -8.1 | -8.8 |
| Less Windfall Revenue Heads (stamp duties, land taxes, royalties etc.) | -3.1 | -2.1 | -1.5 | -1.3 | -1.1 |
| Structural Budget Balance | -2.8 | -9 | -7.1 | -6.8 | -7.7 |

Source: ABS 5512.0, Budget Papers & Macroeconomics estimates. This tables reports on a general government sector basis for the State governments to be consistent with our approach to the Commonwealth. However, while the difference between the Commonwealth general government and total budget sector outcomes is very small this is not true for the States.

Essentially State governments have engaged in structural dis-saving by failing to 'bank' their own stamp duty, land taxes, and mining royalty windfalls since 2002-03, to pay for their future infrastructure requirements. Now that the cupboard is bare and the nations stock of public infrastructure is depreciating, they have to borrow to fund new spending. Collectively State governments have a structural imbalance in the order of **\$7 to \$9 billion** based on our estimates.

Time to Reload the Fiscal Cannon

Recent experience tells us that it is easy for governments to spend and indeed sometimes it is necessary. Right now governments have a better than average reason to pump prime. However, it is possible to cut and spend at the same time by eliminating waste and 'buying' microeconomic reform. We also argue that cutting wasted spending can actually increase GDP in the short term because it raises productivity and underpins investor sentiment. If a fiscal expansion by an open economy can be crowded out by imports, a fiscal contraction can stimulate activity by encouraging manufactured exports and tourism via a lower currency. This was true for the Howard Government between 1996 and 1999.

In the current environment aiming for a **net** fiscal stimulus of between 2 to 3 per cent of GDP in 2009 (up to **\$30 billion**) is appropriate provided it is directed at **no-regrets policy** options, and provided that the Rudd Government is correct in assuming that households and business are staging a confidence driven spending strike. However, why not at the



same time identify a pool of up to **\$20 billion** in spending reductions, targeting low grade spending measures which would help to maintain the structural integrity of the budget over a difficult period and improve incentives for work and entrepreneurial effort. The savings list is quite obvious and widely known (see Table 2). However, the size of the likely reductions will usually be a product of the type of tightening of eligibility criteria that is chosen in each case and can be more or less strict. Spread the pain of adjustment as thinly as possible and impose the largest burden on those likely to benefit from an upswing in the cycle.

Most of the adjustment burden is achieved by reversing the worst policy decisions of the Howard Government. For example, restoring the eligibility requirements for the *Age Pension*, the single largest spending program of the Commonwealth, with recent real growth in advance of 5 per cent, with an ageing population. Then there is the need to cap or means test payments such as the *Carers Allowance*, telephone, utility and seniors' concession allowances, and to introduce adequate means testing for programs without means testing, or with low level tests, such as *Family Tax Benefit B*, the *Baby Bonus* and the *Commonwealth Seniors Health Card*. Then there is the need to restructure 'political' programs like the former *Natural Heritage Trust* (now know as *Caring for Country*), and regional and local community grants that still have enough discretion to be exploited during the political cycle.

Large savings can also be achieved by scrapping all current indexation arrangements along with the efficiency dividend and replacing these with CPI indexation and directly compensating individuals with less means. This would also take the pressure of agencies large and small to constantly bid for new resources.

Large savings can also be achieved through the widespread adoption of competitive tendering processes, and incorporating economic efficiency principles into contract design especially for the purchase of large capital items and defence weapons platforms. Large savings can also be achieved through the recentralisation of some departmental expense functions related to office space, accounting, information technology, legal services and human resource management. We note that the Minister for Finance has made great strides in this direction. On 24 November 2008 the Government announced that it had agreed to implement in full the recommendations of Sir Peter Gershon's review of the Government's use of information and communications technology.



Table 4: Spreading the Burden of Spending Cuts

| | 2008-09 \$b | Reform | Saving \$b | Cumulative \$b |
|---------------------------------|----------------|---|---------------|-------------------|
| Program | | | | |
| Age Pension | 26.8 | Tightening eligibility | 5.0 | 5.0 |
| Superannuation Tax Concessions | 9.5 | Tax all payout before 65 at normal MTRs | 4.4 | 9.4 |
| Family Tax Benefit B | 15.2 | Tightening eligibility | 3.8 | 13.2 |
| Defence Capital | 9.8 | Incentive contracting | 1.0 | 14.2 |
| Pharmaceutical Benefits Scheme | 8.9 | Restoring original eligibility criteria for seniors health card | 2.4 | 16.6 |
| Indexation | 7.2 | Adoption of CPI scrapping of the Efficiency Dividend | 0.5 | 17.1 |
| Auslink | 5.0 | Incentive contracting | 0.6 | 17.7 |
| Private Health Insurance Rebate | 4.1 | Abolish and pay directly to hospitals | 4.1 | 21.8 |
| Baby Bonus | 1.4 | Reducing & tightening eligibility | 0.6 | 22.4 |
| Carer Allowance | 1.3 | Means testing eligibility | 0.4 | 22.8 |
| First Homeowners Grant | 1.0 | Introduce means test | 0.3 | 23.1 |
| Child-care tax rebate | 1.0 | Means testing eligibility | 0.4 | 23.5 |
| Total GFS Expenses | 303.6 | | | 23.7 |

Source: Portfolio Budget Statements, Media releases, Macroeconomics estimates.

The Reform Agenda

We also applaud the public release of the Operation Sunlight report by Senator Andrew Murray on 9 December 2008. The release and partial endorsement is the **Rudd Government's major economic achievement of 2008**. You can read the full 'Murray Report' and the Government's response at:

<http://www.finance.gov.au/financial-framework/financial-management-policy-guidance/operation-sunlight/docs/budget-transparency-report.pdf>



The Murray Report provides a strategic review and reform action plan for the accountability of public spending and budget processes of the Commonwealth (with lessons for all Australian governments) with the potential to save billions in public spending. For example, on the issue of the outcomes-outputs framework where public agencies are supposed to nominate tangible performance benchmarks to measure the effectiveness of every policy dollar they spend and then report performance against those benchmarks, he finds:

In the worst cases you have to wonder at the attitude that encourages useless and generalised descriptions, and then ties large appropriations to them, consequently allowing for such wide ministerial and bureaucratic discretion that accountability loses any meaning. Such latitude, especially if rubber stamped by a supine or Executive-dominated Parliament, can result in the legitimacy being confirmed simply because the law does not prohibit such practice.⁹

The Rudd Government is to be commended for adopting most of Senator Murray's recommendations including linking the outcomes-outputs framework to senior public servants salary outcomes. But it is noteworthy in the context of the *Economic Security Strategy* and other stimulus announcements announced in recent weeks, that they chose not to adopt the major recommendation of the 'Good Governance' section of the report, and also missed the opportunity to require ministers and senior bureaucrats to sign-off on that new spending **proposals are an efficient and effective use of public funds in law.**¹⁰

The Economic Outlook Calls for Caution, Not Depression

Right now the United States and United Kingdom are in the middle stages of a severe downturn. The G-20 economies are in now in recession. The Great Recession as it has

⁹ Review of Operation Sunlight: Overhauling Budgetary Transparency Senator Andrew Murray June 2008, p.86. Apparently the Department of Families, Housing, Community Service and Indigenous Affairs (for example) have allocated billions of taxpayer's dollars in recent years to such imprecise performance benchmarks as Outcome 3 'Families and children have choices and opportunities' and Outcome 4 'Strong resilient communities'. If you combine these *flexible* benchmarks with the fact that most of the dollars spent by the agency in question were from 'standing' appropriations and so not reviewed by Parliament (true for about 80 per cent of public spending) then there was no financial pressure on the agency to achieve better outcomes for the disadvantaged beneficiaries of their spending programs, or any financial incentive to achieve value for money for taxpayers. There are many other interesting recommendations provided in the Report and much important discussion.

¹⁰ Using the *Financial Management and Accountability Act (1997)* as suggested by the Australian National Audit Office.



been dubbed by the IMF began as the Great Panic of September 2008 with the collapse of Lehman Brothers and the botched policy response by the United States Treasury. Whilst there is certainly scope for further rounds of destabilising financial shocks undermining the global real economy, we are now seeing the main game of the downturn, the underlying nature of the shocks. And that is essentially a sharp upwards adjustment in the global cost of capital (a repricing of risk) resulting in:

- a sharp increase in the risk premium on business investment;
- a massive capitulation in exports of traded goods (as business's large and small struggle to locate finance); and
- a consolidation of corporate and household balance sheets in response to the repricing of risks and falls in wealth.¹¹

Australia is about to see the real economic impacts associated with the downturn up close. The sharp contraction in world GDP from the Q3 2008 is about to impact on the domestic economy. Up to now we have for the most part been experiencing the impacts of the Reserve Bank's monetary tightening at the end of 2007 coupled with GFC related household and business balance sheet repair. With global output growth likely to be in negative territory for the first time in living memory in 2009 the GFC is about to reach our shores in the form of lower non-farm commodity demand and prices.

A reduction in the terms of trade (what foreigners pay us especially for our resource commodities) means that the value of products that Australians business can produce has been reduced, resulting in a fall in company profits, and a squeeze on company payrolls. We expect terms of trade to fall sharply by around 17 per cent in 2009-10 and decline by around **28 per cent** over the next three years (but remain 20 per cent above the average of the period 1984 to 2003). This represents a progressive **\$40 to \$60 billion** annual reduction in aggregate real income over the next three years. Real national income will decline by more than real GDP because relatively higher import prices reduce real incomes.¹² We expect nominal output will fall in 2009 and be steady in 2010 (the worst outcome for 75 years).

¹¹ Thanks to Saul Eslake and the ANZ Economic Outlook June Quarter 2009 for this succinct presentation of the shocks associated with the GFC.

¹² Ed Shann, 'Step on the gas, that's a runaway train behind us', AFR, 3 March 2009.



Business will be faced with declining profitability just as the global rate of return to capital required by financial market is rising. The only way to restore profitability will be to **either shed labour or reduce wages** costs. Obviously, cooperative arrangements that maintain employment in these circumstances are crucial and these outcomes are achievable under the previous and new federal IR regulations. But the adjustment process that starts with declining company profits and business failures will result in labour shedding, and nominal wage reductions for those lucky enough to stay in work. Vicious feedback loops will depress business investment and household consumption. Government can play a role here by investing heavily in infrastructure to replace lost demand.

Economic output will fall sharply in 2009 (**1.9 per cent**) before recovering to modest growth in 2010 (**1.0 per cent**). For the Budget Year 2009-10 the decline will be somewhat softer with a decline of around **0.3 per cent** in 2009-10 before recovering modestly with output rising by around **0.5 cent** in 2010-11 and staging a modest recovery thereafter. However activity will remain below trend levels. We expect unemployment to reach **8 per cent** by the end of 2009-10 and continue to rise thereafter, albeit at a slower pace until activity in the economy returns to trend levels. Never was wage restraint more necessary to soften the negative consequence of this downturn for Australian households. Fortunately existing IR arrangements should accommodate enterprise solutions to the wage and employment tradeoff.

The severity of these income effects associated with the declining terms of trade will depend on the extent to which their decline is likely to be fully offset by a depreciation in the \$A, which will help to maintain the value of export earnings and soften the impact of declining real incomes associated with higher import prices. Another critical factor will be business investment which has held up so far and will continue to be solid throughout 2009-10. But the experience of the last 1990s downturn was for significant reductions from the boom time investment levels.

There are reasons for cautious optimism for the domestic economy over the next 12-18 months.

- I. The amount of policy stimulus in the pipeline.
 - i. The full impact of the RBAs' 425bps monetary easing is about to come online with the prospect of further interest rate reductions before the end of the loosening cycle in Q4 2009. This is likely to contribute around 2 percentage points to measured activity in 2009.



- ii. Since October 2008 we estimate that the Rudd Government has agreed to \$35 billion in fiscal stimulus at 2009 calendar year or 1½ percentage points to measured activity.
 - iii. Household spending will be supported by the combination of lower petrol prices and lower mortgage interest rates, as well as the Rudd Government's fiscal stimulus¹³.
- II. Falling consumer price inflation should assist to moderate wage demands.¹⁴
 - III. Public infrastructure spending programs throughout the region and at home should help to support domestic activity and place a floor under the prices of some of our major exports.
 - IV. The plan to publicly subsidise the purchase of lower grade banking assets by investors from US banks (ie "the Geithner package") should help to progressively unwind the \$US 4 trillion stockpile of so called 'toxic debt' held by major US financial institutions
 - V. and allow the banking system to expand lending, in the process reversing the deleveraging cycle which is driving down the prices of otherwise worthwhile financial assets, restoring confidence to global credit markets.
 - VI. Restoration of growth in industrial output in China following the significant monetary loosening conducted by authorities since January 2009.
 - VII. The coordinated G-20 monetary and fiscal stimulus undertaken to a greater or lesser degree in various forms by G-20 nations helping to underpin demand and confidence.

Table A1 includes forecasts for the key macroeconomic and financial variables for the domestic economy which underpin this edition of the Budget Bulletin.

¹³ Falling interest rates have reduced loan repayments on an average sized mortgage by over \$7000 a year which was equal to 8 per cent of average household income.

¹⁴ Meanwhile the risk of a deflationary episode in the US & UK impacting other economies is being mitigated by monetary policies dedicated to quantitative easing – essentially a helicopter drop of money into the economy, adding to nominal demand, reducing the large shortfall in demand for goods and services in those economies.



Table A1 Domestic Economy Forecasts

| | 2007-08 | 2008-09 | 2009-10 |
|--|---------------|-----------------|-----------------|
| | Year Average | Year Average | Year Average |
| Demand and Output | Actual | Forecast | Forecast |
| Household Consumption | 3.7 | -1¼ | -2¼ |
| Private Investment | | | |
| <i>Dwellings</i> | 1.4 | -½ | -2½ |
| <i>Total Business Investment</i> | 14.2 | 4¾ | -5 |
| <i>Non-dwelling Construction</i> | 12.8 | 4½ | -2¾ |
| <i>Machinery & Equipment</i> | 17.3 | 4 | -5¼ |
| Private Final Demand | 5.5 | -¾ | -3 |
| Public Final Demand | 4 | 3½ | 4½ |
| <i>Total Final Demand</i> | 5.3 | -¼ | 1½ |
| Change in Inventories (contribution to growth) | | | |
| <i>Private Non-Farm</i> | 0.3 | -1¼ | -¼ |
| <i>Farm and Public Authorities</i> | -0.2 | ¼ | ½ |
| <i>Exports of Goods and Services</i> | 4.3 | 1¼ | 5 |
| <i>Imports of Goods and Services</i> | 12.7 | -2¾ | -4¾ |
| Net Exports (contribution to growth) | -1.9 | 1½ | ¼ |
| Gross National Product | 3.7 | -¼ | -½ |
| <i>Non-Farm Product</i> | 3.6 | 3 ¾ | 3 ½ |
| <i>Farm Product</i> | 8.5 | 15 | 10 |
| Other Economic measures | Actual | Forecast | Forecast |
| External Accounts | | | |
| <i>Terms of Trade (pps)</i> | 5 | 3 | -17 |
| Current Account Balance | | | |
| <i>\$billion</i> | -70¼ | 61¾ | 60¼ |
| <i>Percentage of GDP</i> | -6¼ | -5¼ | -5¼ |
| Labour Market | | | |
| <i>Employment (labour force survey basis)</i> | 2.5 | -½ | ½ |
| <i>Unemployment rate (per cent)</i> | 4.3 | 6 | 8 |
| <i>Participation rate (per cent)</i> | 65.3 | 65 | 65 ¼ |
| Prices and Wages | | | |
| <i>Consumer Price Index</i> | 4.5 | 2 | 1½ |
| <i>Gross Non-Farm Product Deflator</i> | 4.4 | 4 | -1¼ |
| <i>Wage Price Index</i> | 4.1 | 3 | 2½ |

Source: ABS 5204.0 & 5206.0, Budget Papers and Macroeconomics estimates.