



**China Boom Mark II =
Last Call for Fiscal Discipline
Commonwealth & State
Government 2011-12
Budget Bulletin**

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What follows is a detailed examination of the Australian Government and States budget forecasts before Budget, providing a full update of likely parameter changes and our best guess at policy changes since the mid-year update. Along the way each jurisdiction's overall fiscal and budgetary performance is assessed, along with risks to the outlook. To our knowledge this publication is the only one-stop budget and economic bulletin on Australian governments available today. Enjoy!

The full version of the Commonwealth & State Government 2011-12 Budget Bulletin can be downloaded at our website on a subscription basis. Please contact our office manager during business hours on (02) 6161 3542 or by emailing office.manager@macroeconomics.com.au.

*The forecasts and projections contained in this Budget Bulletin are subject to unavoidable statistical variation. While all care has been taken to ensure that the statistical variation is kept to a minimum, care should be exercised whenever using this information. Our forecasts and projections only take into account information that was available to **Macroeconomics** up to the date of this report and so its findings may be affected by new information. Should you require clarification of any material, please contact us.*



Table of Contents

EXECUTIVE SUMMARY	7
Budget Bottom Line for the States	12
Budget Bottom Line for Consolidated General Government	14
The Economic Outlook for 2011-12 and Beyond	15
INTRODUCTION: WINDFALLS FOREVER & EVER	17
Budget Outlook	17
Structural Budget Outlook	20
The State and Territory Budget Outlook.....	24
Summing Up the Budget Outlook for All Governments.....	29
So What do we do Now?	30
Next Steps for Economic Reform.....	32
Time to Rebuild National Savings	33
1. COMMONWEALTH GOVERNMENT.....	36
1.1 Introduction	36
1.2 Economic Outlook	36
1.3 Budget Outlook.....	39
1.4 Structural Budget Position	42
1.5 Fiscal Stimulus	44
1.6 Savings Record	44
1.7 Infrastructure Investment Plans	44
2. NEW SOUTH WALES GOVERNMENT.....	46
2.1 Introduction	46



2.2	Economic Outlook	47
2.3	Budget Outlook.....	47
2.4	Fiscal Stimulus	48
2.5	Savings Record	49
2.6	Infrastructure Investment Plans	49
3. VICTORIAN GOVERNMENT		50
3.1	Introduction	50
3.2	Economic Outlook	50
3.3	Budget Outlook.....	51
3.4	Fiscal Stimulus	52
3.5	Savings Record	52
3.6	Infrastructure Investment Plans	53
4. QUEENSLAND GOVERNMENT		54
4.1	Introduction	54
4.2	Economic Outlook	55
4.3	Budget Outlook.....	55
4.4	Fiscal Stimulus	56
4.5	Savings Record	57
4.6	Infrastructure Investment Plans	57
5. WESTERN AUSTRALIAN GOVERNMENT.....		58
5.1	Introduction	58
5.2	Economic Outlook	58
5.3	Budget Outlook.....	59
5.4	Fiscal Stimulus	61



5.5	Savings Record	61
5.6	Infrastructure Investment Plans	61
6. SOUTH AUSTRALIAN GOVERNMENT		63
6.1	Introduction	63
6.2	Economic Outlook	65
6.3	Budget Outlook.....	65
6.4	Fiscal Stimulus	66
6.5	Savings Record	66
6.6	Infrastructure Investment Plans	67
7. TASMANIAN GOVERNMENT		68
7.1	Introduction	68
7.2	Economic Outlook	69
7.3	Budget Outlook.....	69
7.4	Fiscal Stimulus	70
7.5	Savings Record	70
7.6	Infrastructure Investment Plans	71
8. AUSTRALIAN CAPITAL TERRITORY GOVERNMENT		72
8.1	Introduction	72
8.2	Economic Outlook	73
8.3	Budget Outlook.....	73
8.4	Fiscal Stimulus	74
8.5	Savings Record	75
8.6	Infrastructure Investment Plans	75



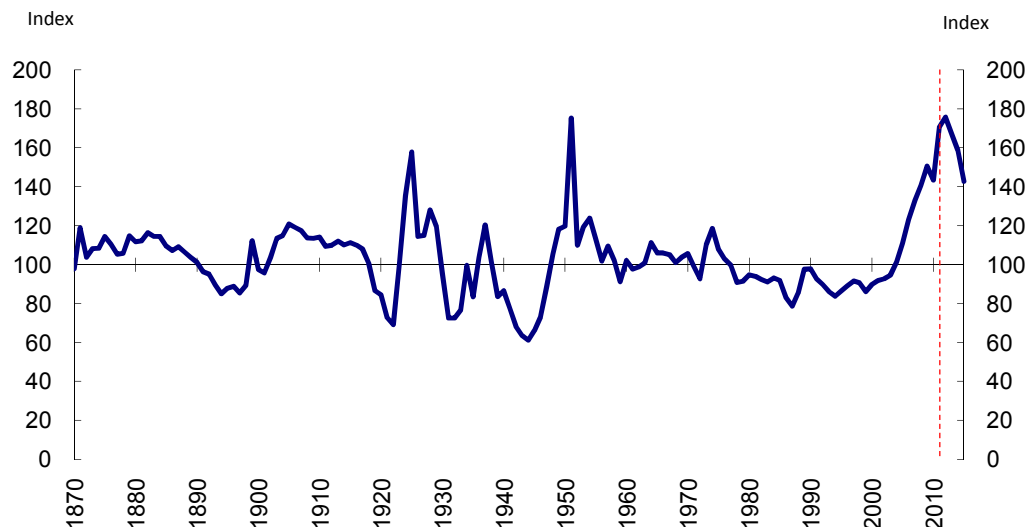
9. NORTHERN TERRITORY GOVERNMENT	77
9.1 Introduction	77
9.2 Economic Outlook	78
9.3 Budget Outlook.....	78
9.4 Fiscal Stimulus	79
9.5 Savings Record	79
9.6 Infrastructure Investment Plans	80



Executive Summary

Unless Australian governments act now to address their budget deficits and prepare for leaner and more volatile times, they are failing in their duty of care. The Australian economy and Australian government budgets circa 2011 are tied to an asset price boom of international origin which will inevitably collapse and expose Australian governments to significant budget challenges just as the economy is softening.¹ Further evidence of our thesis is the fact that many commodity prices have risen by more than 50 per cent on global markets in the last six months whilst the Reserve Bank tells us Australia's terms of trade is approaching the highest level in 140 years.² Our record terms of trade underpins both the Gillard Government's hopes of returning to surplus over the next year and the budget aspirations of most State governments across the nation.

Chart 1: Terms of Trade



Source: RBA special request and **Macroeconomics** estimates.

Note: Index 1900/01 to 1999/2000 = 100

We say that the clear implication of the terms of trade shock is that Australian governments should take precautionary measures now to prepare for a financial storm. Remember that without the China Boom from 2004 Australia's fiscal position would be more akin to that of the United States and the United Kingdom who are currently running budget deficits in the order of **10 per cent of GDP**. While Treasury tells us that 'China Boom' prices may last for

¹ Since 2008 expansionary United States Monetary Policy has underpinned commodity and asset prices throughout the Asian region as capital flows associated with 'quantitative easing' have migrated from US banks and hedge funds searching for the highest rates of return. Since late 2009 these capital flows have fuelled the rapid expansion in asset prices in the region, including residential and commercial property. If Milton Friedman were still alive he would remind us that monetary expansion always leads to price inflation, just not necessarily consumer price inflation.

² The terms of trade are at the highest level in 140 years if you look at five-year rolling average data.



a decade or more, we suspect that commodity prices will return to something close to the cost of production before 2015 as significant new supply avenues comes on line. **That's just common sense.**

The 2011-12 Budget is the fourth for Treasurer Swan, who has never managed to run a budget surplus or achieve a net reduction in discretionary spending in any of his Budgets. This is really his last chance to demonstrate his fiscal credentials and prepare the way for a structural tightening in fiscal policy. We hope he will rise to the challenge in 2011 and announce significant savings on Budget night. If he does not he runs the risk of being remembered as a great 'industry' minister but mediocre treasurer who failed the microeconomic reform test (remembering the last major reform was the GST in 2001).

As for the role of Treasury in fiscal strategy, our advice is that the Minister needs to be convinced of the wisdom of a more aggressive tightening. OK, so Treasury previously opposed a sovereign wealth fund to lock away the China Boom surplus, but now there is a new Secretary in town - Dr Martin Parkinson. Surely it is time to reconsider this option. Remember Dr Parkinson, the words of the old German proverb, *den bock zum Gärtner machen* or **don't put the goat in charge of the vegetable garden.**

We expect the 2011-12 Budget will be a traditional post-election **hard decisions** exercise achieving significant spending cuts in one hit to minimise the short-term political damage before the next election in 2013 and maximise the medium-term positive economic impact. Of course the political realities of minority government may complicate this story and make it harder for the Gillard Government to achieve significant reductions.

Our budget tracking model now has the Commonwealth Budget in cash deficit by **\$14.1 billion** dollars (around 0.9 per cent of GDP) in 2011-12 (**Table 1**). This is worse than the **\$12.3 billion** deficit forecast last MYEFO and is mainly due to lower than expected business tax receipts and higher discretionary spending associated with the Queensland and Victorian floods and Cyclone Yasi. Unfortunately, the Treasurer's job is being made more difficult by unexpectedly low capital gains receipts due to losses carried forward from GFC Mark I, the fact that company tax receipts are being impacted by larger than anticipated write-offs of capital expenditure in the mining industry and the higher \$A. Regrettably, it is not conceivable that the Treasurer will announce a **surplus** for 2011-12 on Budget night because he and Finance Minister Penny Wong cannot muster up enough savings from line agencies to get the job done. To achieve large savings in one hit the Government must address middle class welfare. It appears the Government does not have the courage to attempt this.

**Table 1: Commonwealth General Government Budget & Net Debt**

	Actual	Estimates		Projections		
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
	\$b	\$b	\$b	\$b	\$b	\$b
Budget Balance	-52.8	-47.1	-14.1	0.2	5.3	8.3
<i>Percentage of GDP</i>	-4.1	-3.4	-0.9	0.0	0.3	0.5
Net Debt	42.3	89.4	103.5	103.4	98.1	89.7
<i>Percentage of GDP</i>	3.3	6.4	6.9	6.6	6.0	5.3

Source: Budget Papers and Macroeconomics estimates. Subject to rounding

We still expect the budget will return to a small surplus of around **\$160 million** by 2012-13 but this is far smaller than was predicted by Treasurer Wayne Swan on Budget Night 2010. Commonwealth net debt is expected to peak at around **\$104 billion** (6.9 per cent of GDP) in 2011-12 and fall to around **\$90 billion** (5.4 per cent of GDP) by 2014-15 (see **Table 1**).

Unfortunately the budget bottom-line is tied to the record terms of trade from China Boom Mark II. Without these record terms of trade the budget will not return to surplus. Even with the terms of trade close to a **140 year peak**, the Gillard Government is struggling to return the budget to surplus on a sustainable basis. After 10 years of commodity-related revenue windfalls the most we have to show for it is high employment levels.

Table 2: Commonwealth Headline and Structural Budget

	Actual	Estimates		Projections		
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
	\$b	\$b	\$b	\$b	\$b	\$b
Budget Balance	-52.8	-47.1	-14.1	0.2	5.3	8.3
<i>Impact of the Economic Cycle</i>	37.8	13.4	-17.0	-6.9	9.3	14.9
<i>Impact of the Commodity Cycle</i>	-18.8	-35.1	-42.0	-42.7	-43.6	-39.0
<i>Impact of One-Off Measures</i>	0.0	3.0	-4.0	-4.5	-4.0	-4.5
Structural Balance (Net Policy)	-33.8	-65.8	-77.1	-53.9	-33.0	-20.2
<i>Percentage of GDP</i>	-2.6	-4.7	-5.1	-3.4	-2.0	-1.2

Source: Budget Papers and Macroeconomics estimates. Subject to rounding

The structural budget position is in quite a big mess. In April 2008 we told you that the Commonwealth had been running a structural deficit since 2007-08 of around **\$25 billion**, and that corrective measures were needed to close the fiscal gap. Since then, more pressing concerns (GFC1 and the 2010 election) diverted the Government's attention and so postponed the necessary structural repair of the budget, which even Treasury acknowledges is in need of urgent remedial action.