MACROECONOMICS.COM.AU

Hey Big Spender...

Where's the Micro Reform?

Commonwealth & State Government 2010-11 Budget Bulletin

Date: Monday, 3 May 2010

This is an abridged version of the 2010-11 Budget Bulletin, which is available to our subscribers. The publication is usually released two weeks before each Commonwealth Budget and around the release of the Mid-year update. The Bulletin is not to be used for any reason without our express permission. To be included on the distribution list for future Macroeconomics' releases please email: office.manager@macroeconomics.com.au.

For any enquiries about this document, please contact:

Stephen Anthony
T: 02 6161 3542
E: stephen.anthony@macroeconomics.com.au

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 analysis of their performance. Included also is some broader commentary on the economic and fiscal outlook. To our knowledge this publication is the only one stop budget and economic bulletin on Australian governments available today. Enjoy!

*The full version (74 pages) of the Commonwealth & State Government 2010-11 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**.*

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table of Contents

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au

ACN 128 878 535 ABN 901 2887 8535

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au

ACN 128 878 535 ABN 901 2887 8535

In this Bulletin

Budget season is upon us again in a Federal election year to boot. So what is the likelihood of the Rudd Government taking the necessary prudent fiscal path in 2010 by eliminating Howard Government superannuation rorts and tightening the screws on middle and upper class welfare recipients? **Somewhere between Buckley's and none**. And the Henry Review has confirmed this. Having recommended measures to make our tax system simpler, fairer and efficient, the Rudd Government has chosen to cherry pick a handful of recommendations, put others on the backburner and ignore the rest. It is unfortunate that those recommendations in this latter grouping relate to aspects of our tax system that cause the most inefficiencies and disincentives.

We applaud Ken Henry for what is a visionary report that no doubt will be a blueprint for reform over coming decades. Looking at some of the recommendations of the Review dealing with broadening the tax base, widening means-tests to include the family home, charging of capital gains tax on the family home and negative gearing on property, these are fundamental microeconomic reforms which if ever implemented would have significant longer term benefits for the economy. The fact that the Government has rejected so many of the Review's key recommendations outright, or gone its own way on others (e.g. superannuation), suggests that they were never serious about 'root and branch' reform of the tax system. This could be painted as political pragmatism, but it seems to be simply business as usual for the risk-averse first Rudd Government. Either way the Government's response is short sighted and cynical.

Unfortunately, the grab bag of measures the Government has pulled from the Review owes more to the next election than to fundamental economic reform (Table 1). Meanwhile the Government has undermined the structural foundations of the budget by making the revenue base more heavily reliant on the temporary China boom, whilst providing permanent superannuation concessions and company tax reductions.

Perhaps the Rudd Government's response to the Henry review – which is revenue positive as opposed to revenue neutral – says more about their proclivity to spend than their ability to reform. Their fiscal stimulus certainly broke all the records – but it did achieve what no other developed economy did. We again congratulate the Rudd Government for acting pre-emptively to spend big and fast in the face of GFC1 to forestall the domestic impacts of the cataclysmic seizure of credit markets at the height of the Great Panic in October 2008.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Rudd's decisiveness, coupled with RBA interest rate cuts and the amazing resilience of coal and iron ore exports to Chinese, **truly saved our bacon** in 2009 and kept the unemployment rate below **6 per cent**, a truly Herculean feat.

Table 1: Henry Tax Review Measures

	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b	Total $b
Receipts					
Company tax cut	0.0	0.0	-0.3	-2.0	-2.3
Small business instant write-off and simplified depreciation	0.0	0.0	0.0	-1.0	-1.0
Head start on lower company tax rate for small business	0.0	-0.1	-0.3	-0.2	-0.6
Resources super profits tax	0.0	0.0	3.0	9.0	12.0
Resources exploration rebate	0.0	0.0	-0.5	-0.6	-1.1
Superannuation concessional contribution caps	0.0	0.0	-0.5	-0.8	-1.3
Superannuation low income earners government contribution	0.0	0.0	0.0	-0.8	-0.8
Raising the superannuation guarantee age limit from 70 to 75	0.0	0.0	0.0	0.0	0.0
Increasing the superannuation guarantee rate to 12 per cent	0.0	0.0	0.0	-0.2	-0.2
Payments					
State infrastructure fund	0.0	0.0	-0.7	-0.7	-1.4
Total	**0.0**	**-0.1**	**0.6**	**2.6**	**3.2**

Source: Government response to the Henry Tax Review recommendations.

But... as we warned this time last year, there have been numerous policy mistakes as well. Poorly designed fiscal stimulus measures associated with the 'cash splash', roof insulation, and primary school shelter sheds etc. etc. will cost up to **$70 billion** and failed to purchase any real microeconomic reform. By our reckoning **$45 billion** will be spent on low grade measures. To waste so much money in such a short amount of time is also a truly Herculean feat.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Now the Rudd Government is spending a further **$5 billion** over the outlook to modify the funding arrangements for public hospitals. **Please!** This doesn't sound like 'root and branch' reform of the health care system. This after the 'great surrender' on Climate Change and the CPRS. The silver lining is that the Government won't be going ahead with the ridiculous plan of paying the largest carbon polluters **$4.5 billion** over the forward estimates and **$37 billion** by the end of the decade.

Sadly you can only fire the fiscal cannon once, and we missed. Now we have even less capacity to deliver the much needed microeconomic reform that every *parrot in the pet shop is squawking about* and a world of hard savings decisions to make. And who will make the hard decisions? The same people who by all reports are addicted to spending and have missed numerous opportunities to spring clean our public finances and who are now caught between a sea of **red ink** and growing public debt, albeit from a low base.

Budget Outlook

The Commonwealth general government will run a budget **cash** deficit of around **$37 billion in 2010-11** (2.7 per cent of GDP), depending on the mix of new measures and savings announced on Budget night, with deficits falling over the outlook but still in excess of **$7 billion**. These estimates incorporate our understanding of updated parameter estimates since the November MYEFO and factor in significant discretionary spending associated with the Government's health and hospital COAG reform and policy changes associated with the Henry Tax Review (the reason why the release of the Bulletin is a few days late this year). Government net debt is now expected to rise to over **$91 billion** by 2013-14 (5.7 per cent of GDP).

Unless the Rudd Government finally undertakes that spring clean of federal finances **or** is blessed with very favourable economic parameter variations, in terms of the growth in real economy or commodity prices, it will not run a budget surplus until at least 2014-15. **And it may never deliver another budget surplus if it can't curb its rate of real policy spending** which is averaging over **2.7 per cent** over the forward estimates removing the impact of GFC1 stimulus (see Table 2).

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 2: Real Spending Growth by the Rudd Government

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
Payments spending base	331.5	340.4	347.5	363.0	377.0
Real growth in spending (%)	**2.1**	**0.6**	**-0.6**	**1.8**	**1.4**
GFC1 Stimulus Spending	25.4	16.2	5.6	-2.2	0.0
Payments spending base (excluding stimulus)	306.0	324.2	342.0	365.2	377.0
Real growth in spending (excluding stimulus) (%)	1.9	3.8	2.8	4.2	0.7
Macroeconomics GFS budget deficit	**-45.7**	**-36.8**	**-14.4**	**-7.3**	**-7.1**

Source: Budget Papers & **Macroeconomics** estimates.

To achieve budget surpluses before the end of 2013-14 the Rudd Government must tackle the pesky structural budget deficit (currently around **$26 billion)** by cutting the discretionary spending base and capping new policy decisions.

State and Territory budgets are also in bad structural shape, so stronger activity on the horizon won't help them much. They have combined GFS cash deficits of around **$14 billion** in 2010-11, largely due to their commitment to spending over **$116 billion** in public infrastructure over the forward estimates period to 2013-14. The downside to all this new capital formation is the run up in total general government sector indebtedness to around **$64 billion** (4 per cent of GDP) by 2013-14, with State non financial public corporations carrying at least **$123 billion** in additional debt by the end of the outlook. All's well that ends well provided these infrastructure projects were selected using rigorous cost-benefit criteria. Does that ever happen in Australia? Meanwhile, most jurisdictions also have unfunded superannuation liabilities which combined sum to something like **$117 billion** (see Table 3).

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 3: State & Territory Liabilities by 2013-14

	Net Debt $b	Unfunded Superannuation $b	Non-financial Public Corporations $b
NSW	7.7	29.1	39.7
VIC	26.6	37.4	15.3
QLD	18.3	27.0	44.4
WA	7.5	9.1	15.3
SA	3.9	8.3	3.5
TAS	-0.4	3.1	3.0
ACT	-0.6	2.8	0.9
NT	1.3	0.0	1.2
Total	**64.3**	**116.8**	**123.3**

Source: Macroeconomics estimates.

In terms of the fiscal performance of various jurisdictions, New South Wales is on the mend albeit from a very low base, Queensland has lost it way and its AAA credit rating and needs drastic reform to maintain its once pre-eminent position, while the highly regarded Victoria is on a debt funded infrastructure spending binge which we suspect will end badly. Only the Australian Capital Territory can be regarded as really prudent, having undertaken an extensive savings round at the height of the boom to position itself to manage the downturn which came last year, with an honourable mention for South Australia. Most jurisdictions 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 & Queensland). Now collectively they are paying too many public servants too high wages (Table 4). Most jurisdictions are also playing catch-up with public infrastructure spending (e.g., Victoria, Queensland and Western Australia) forcing them to run **large GFS cash deficits** over the next four years to 2013-14.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 4: General Government Public Sector Employment & Earnings Growth from 1999-2000

	Commonwealth Government				State Governments			
	Employment '000	Growth %	Earnings $b	Growth %	Employment '000	Growth %	Earnings $b	Growth %
1999-00	148.9	3.3	7.0	1.5	976.3	1.0	39.4	5.7
2000-01	152.7	2.6	7.4	5.7	980.8	0.5	41.1	4.3
2001-02	175.5	14.9	7.9	6.8	1,000.0	2.0	43.6	6.0
2002-03	158.3	-9.8	8.2	3.8	1,018.6	1.9	46.2	6.1
2003-04	162.1	2.4	9.3	13.4	1,057.2	3.8	50.0	8.2
2004-05	161.6	-0.3	9.6	3.2	1,093.9	3.5	54.4	8.8
2005-06	167.5	3.7	10.2	6.3	1,109.4	1.4	57.4	5.4
2006-07	186.9	11.6	11.5	12.8	1,143.2	3.1	61.4	7.0
2007-08	185.5	-0.8	12.4	7.8	1,228.1	7.4	68.5	11.7
2008-09	188.9	1.8	13.3	7.3	1,266.5	3.1	73.7	7.5
Average		**2.9**		**6.9**		**2.8**		**7.1**

Source: ABS Survey of Employment and Earnings. Subject to rounding.

We estimate the combined budget deficit of *all* Australian governments will be **$50 billion** (around 3.7 per cent of GDP) in 2010-11 with general government net debt rising to **$156 million** (9.7 per cent of GDP) over the outlook. This excludes local government, and around **$129 billion** in total public sector corporate borrowings expected to accumulate by 2013-14, along with up to **$117 billion** in unfunded state superannuation liabilities.

Whilst it is professionally unrewarding to worry about public debt levels in Australia (see Senator Joyce) we note that total public sector financial liabilities are set to exceed **$400 billion** by 2013-14 (**26 per cent** of GDP), with the IGR burden looming, significant Defence equipment spends necessary, and with superannuation tax concessions not

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

modelled in the IGR now worth **$32 billion** and set to be worth around **$170 billion** by the middle of next decade.

The bad news is that Australia already has net external liabilities of around **$768 billion** or **60 per cent of GDP** so any future sovereign 'debt' crisis such as that presented by Greece in 2010 may hit us very hard. Whilst Australia has a healthy banking system, strong trade links with the fastest growing region in the world, and still relatively small (but rising) public indebtedness – our private sector is more heavily reliant on net capital inflows to fund future growth.

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.

Next Steps for Economic Reform

A fundamental point for all levels of Australian government is that the dividend associated with the China boom has often been wasted by successive Governments who refuse to rein in spending, or use spending to invest in growth enhancing reform.

There are many things that Australian governments could and should have done in recent time to support activity while building the future economy. Governments should have focused on sensible discretionary measures to raise productivity in the economy, whilst focusing on eliminating public sector waste and undue regulation on business. They could have also focused on controlling the cost of employing labour by insisting on **wage restraint** wherever possible, on the part of public servants. They could have invested in major physical infrastructure projects of national importance. It seems that very little of this type of activity was undertaken, even after all the hyberbole about "evidence based policy".

So what should be next for the Rudd Government? Well the 2010-11 Budget will include the Health and Hospitals Reform package and the savings required to fund much of it. It will also incorporate the Government's decisions regarding the Henry Tax Review. Building on both of these the Government should also consider the following.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

(i) Developing a consistent ‘means testing’ framework for all income transfers.

(ii) Introducing cost sharing incentive contracts into public procurement processes to help lower the annual public procurement bill of Australia governments, currently worth around **$175 billion** in 2010-11.

(iii) Introducing program reporting to all levels of government by requiring all officials to account for each dollar spent, and sign-off that their program 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 (in line with the Henry Review findings).

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

Economic Outlook

By our reckoning the Australian economy will achieve solid growth of around **3.0 per cent** in 2010-11 followed by **3.5 per cent** in 2011-12 then trailing off over the outlook period. We believe that talk of growth rates in excess of 3.5 per cent over the next few years are fanciful. Unfortunately most economic forecasters are treating China as a **perpetual motion machine** and ignoring the dependence of China on stronger growth in the United States and Europe which are both still precariously balancing fundamental structural imbalances.

Indeed it may be that even trend growth levels in Australia prove too difficult to achieve given the lack of genuine growth drivers over the next 18 months and the ongoing high risk environment that has resulted from GFC1. Then there is the looming prospect of GFC2 sparked by sovereign indebtedness which would hit Australia harder because of our heavy private indebtedness and need to access foreign savings to fund a significant portion of domestic investment. (Remember - you can only fire the fiscal cannon once). A key point is that a modest downturn is not followed by a spectacular recovery – but more a return to trend activity.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 5: State & Territory Economic Drivers

State	Economic Driver
New South Wales	Commercial and residential property development
Victoria	Public infrastructure projects
Queensland	Mining coal, LNG projects and population growth
Western Australia	Mining iron ore and Gorgon LNG project
South Australia	Public infrastructure projects and defence AWD shipbuilding
Tasmania	Environmentally friendly pulp/paper Mill (if it ever takes off)?
Australian Capital Territory	Commercial and residential property development
Northern Territory	Mining, LNG projects

Each state or territory will benefit from the upturn in activity that will be magnified in various regional centres due to specific regional drivers related to mining and large public and private infrastructure projects underway or just commencing (especially in Western Australia, Queensland, South Australia and Victoria) and a resurgence in commercial and residential property development in New South Wales and the continuing boom in this sector in the Australian Capital Territory (Table 5).

This Bulletin tells the story of life after GFC1 and specifically just how much of the dividend of the China Boom has been wasted on poor policy decision making. 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.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Introduction: Big Spending Government

Our budget tracking model now has the Commonwealth Budget in cash deficit by around **$37 billion** dollars in 2010-11 with net debt rising to **$91 billion** by 2013-14.

Budget Bottom Line for the Commonwealth

Following the significant discretionary easing in 2008 & 2009, combined with the loosening of the budget's automatic stabilisers and the sudden collapse of much of the windfall revenue windfalls associated with the commodity boom, we expect Australian Government to post a large deficit of around **$37 billion** (2.7 per cent of GDP) in 2010-11 based on our understanding of parameter changes and new policy and savings measures since the last update (Table 6). This represents a **$9.8 billion** turnaround from the Government's deficit forecast at MYEFO, mainly due to higher than anticipated employment outcomes and their flow through to the tax and spending base.

Table 6: Commonwealth General Government Budget Forecasts

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
Macroeconomics GFS Budget Balance	**-45.7**	**-36.8**	**-14.4**	**-7.3**	**-7.1**
Percentage of GDP	-3.5	-2.7	-1.0	-0.5	-0.4
Macroeconomics Net Debt	**28.7**	**65.0**	**78.4**	**85.6**	**91.3**
Percentage of GDP	2.2	4.7	5.4	5.6	5.7

Source: ABS, Budget Papers & Macroeconomics estimates. Subject to rounding.

Recap on the Structural Deficit

This time last year we told you that the Commonwealth had been running a structural deficit since 2006-07 of around **$25 billion**, and that corrective measures were needed to close the fiscal gap.[1] We have no reason to think the structural budget position has improved in

[1] The structural balance adjusts the headline cash balance for movements in real output and the terms of trade away from the longer term trend. We welcome the fact that the Australian Treasury from Budget 2009-10 has now followed our approach and adjusted its new structural balance model to reflect movements in the terms of trade.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

the last twelve months (see Table 7), although we forecast an improvement over the outlook period provided the Rudd Government is true to its real spending cap of 2 per cent.

The large structural deficit is based on our assessment of long term trend revenue streams, and is driven by nominal GDP shares and commodity prices movements. Commodity prices are still contributing to windfall budget revenues which are increasing again over the outlook. Meanwhile the underlying real economy is still detracting from budget revenues over the estimates period through higher expenses largely associated with unemployment benefit payments.

Table 7: Headline and Structural Budget From 2009-10 Actual & Estimates

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
Macroeconomics GFS Budget Balance	**-45.7**	**-36.8**	**-14.4**	**-7.3**	**-7.1**
Impact of the Economic Cycle	4.2	7.1	8.6	12.3	20.0
Impact of the Commodity Cycle	-9.3	-12.8	-21.2	-23.2	-28.1
Impact of One-Off Measures	25.4	16.2	5.6	2	0
Structural Balance	**-25.3**	**-26.4**	**-21.4**	**-16.2**	**-15.2**
(Per cent of GDP)	-1.9	-1.9	-1.5	-1.1	-0.9

Source: Macroeconomics estimates.

By our reckoning in two budget rounds since coming to office, the Rudd Government has generated new **net** discretionary spending (including fixed assets purchases) totalling **$108 billion**, including undertaken temporary GFC1 stimulus spending worth around **$70 billion**. This total does not include policy spending associated with the 2010-11 Budget. Whilst the Finance Minister says the Rudd Government's first two budgets contained **$55 billion** of savings initiatives over five years, and that the bulk of these were spending cuts, this does not square with the expenditure reconciliation tables in Budget Paper No.1.[2] These tables suggest a **net** increase in policy spending of around **$38 billion** over five years and that there has been no **net** slowing in discretionary spending over the forward estimates and hence no structural improvement in the budget.

[2] Finance Minister Lindsay Tanner has said total savings in the 2008 Budget were $33 billion and that total savings in the 2008 Budget were $22 billion. AFR, 22 April 2010, p.3.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

This increase in discretionary spending is reflected in a rise in the structural budget deficit to $26.4 billion in 2010-11 (1.9 per cent of GDP). While much of the $38 billion increase in the permanent discretionary spending base has been devoted to low benefit activity that will not contribute to reducing the debt burden associated with greater public borrowing (for example, the increase in the age pension). Further, we reckon that around $45 billion of the $70 billion in temporary GFC1 stimulus spending was also wasted on uneconomic projects (see Attachment 1 for detail).

After the recession we never had, the Commonwealth still has a structural deficit of around **$26 billion** in 2010-11 and faces the prospect of running budget deficits until favourable parameter variations associated with the China Boom do the heavy lifting to repair the budget bottom-line.

Budget Bottom Line for the States

The State and Territory governments also have structural budget issues. Each jurisdiction is playing catch-up with public infrastructure spending forcing some of them to run **large GFS cash deficits.** Collectively State governments are sitting on a GFS cash deficit of around **$14 billion** in 2010-11 with total general government net debt rising to **$67 billion** by 2013-14. However, unlike the Commonwealth there is a good chance that many of the State and Territory governments will be running small GFS cash surpluses over the next four years. 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.

Table 8: General Government State Structural Budget Outcome

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
GFS Net Lending(+)/Borrowing(-)	**-19.1**	**-13.5**	**-6.2**	**-5.5**	**-7.5**
Less Windfall Revenue Heads (stamp duties, land taxes, royalties etc.)	-1.4	-1.9	-3.1	-3.1	-3.1
Structural Budget Balance	**-20.5**	**-15.4**	**-9.3**	**-8.6**	**-10.6**

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 the Commonwealth.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 8 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 'on aggregate' are collectively running large deficits.

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 'less full' and the nation's 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 **$2 to $3 billion** based on our estimates. Meanwhile, State and Territory general governments have committed to significant infrastructure spending totalling **$89.3 billion** over the next four years while their public corporations have plans to spend even more again. Leading the pack is New South Wales, Victoria and Queensland.

Budget Bottom Line for Consolidated General Government

So now we begin the new budget year 2010-11 with the combined (net lending) cash deficit of Australian governments at around **$50 billion** (or **3.7 per cent** of GDP) and heading for total Australian public sector external liabilities north of **$400 billion** in 2013-14 and still rising. No surpluses, just a sea of **red ink** and a mountain of debt. **Fantastic!**

The parlous position of the budget highlights the need for structural repair. This is especially true if the original 'rigorous' 2002-03 IGR Report prediction of a **5 per cent** of GDP fiscal gap related to population ageing and health technology cost pressures begins emerging in 2015-16. We favour the conclusion of the original IGR to the two more recent versions because it was based on a more realistic profile for nominal GDP stripping out the commodity price benefit associated with the **China Boom** effect.

Given that **both** the Commonwealth and State governments are running large GFS cash deficits, the capacity of Australian governments to undertake further fiscal stimulus if required over the next few years has been reduced. Essentially there is now a long queue of sovereigns looking to borrow more cash and very few lenders. Whilst it is true to say that Australia has significantly less public debt in GDP terms than most developed countries, we also have significantly more private debt than just about every nation in GDP terms, so the

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

combination of modest rising public debt and **significant** private dis-saving could be disastrous for Australia. Fiscal strategy should be 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.

Still Waiting For the Great Leap Forward

The political honeymoon afforded to a new government for bold reform is now over. It was born, nurtured and quickly orphaned. Despite promising to take a "meat-axe" to public spending before the last federal election, the first two budgets of the Rudd Government contained no net savings over the forward estimates, whilst cutting spending on nationally important institutions such as the CSIRO.

The Rudd Government even wasted GFC1 which presented a second chance for bold reform. The old saying is "never waste a crisis". It would have been a great time for government to get on the front foot and advocate some significant structural changes to generate growth throughout the next decade.[3] **Another missed opportunity!**

Table 9: Achievements & Failures of the Rudd Government

Achievements	Failures
• Macroeconomic management • MySchools website • Raising the retirement age for age pension • Uniform national industrial relations regime • Uniform occupational health and safety regime • Operation Sunlight (Budget accountability)	• Microeconomic reform agenda • Carbon tax • Public health system • Quality of the GFC1 stimulus measures • Structural separation of Telstra (?)

We supported the Rudd Government's decisive and proactive approach to GFC1 from October 2008. We are glad that this approach spared the nation from unnecessary economic hardship associated with unemployment. It would have been the height of

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

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

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 so much waste to achieve a noble goal! The textbooks say that a fiscal expansion for a small open economy is likely to fail because it tends to be crowded out by imports, especially when it targets low quality measures.[4] But the Rudd GFC1 stimulus was successful and it was loaded with **junk** measures. Unfortunately, future Australian governments may be emboldened to do something similar and that would be shameful.

It appears to an outsider that the Rudd Government lurches from one day to the next without a policy framework, confusing activity with accomplishment, 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. Senior bureaucrats seem to provide tacit endorsement to low grade policy choices rather than articulating a bold reform agenda. In the words of Sir Humphrey, they are “a pleasure to work with”. The same senior bureaucrats who presided over the irresponsible spending in the Howard years, provided no blue print for significant reform to the incoming.

Why can’t we conduct a ruthless war on waste during an election year? As yet there has been no ‘real’ savings round conducted by the Rudd Government. Perhaps certain spending cuts were delayed because of GFC1, but this would be a good time in the business cycle to cut the fat out of the discretionary spending base. **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, many of which relate to broken promises. We anticipate the Government has agreed to discretionary cuts to spending programs worth around **$6.4 billion** over four years. Of course if we have overstated the extent of savings achieved just add these back onto our budget deficit forecasts. Headlining this effort are the following high priority savings items:

4 Tony Makin, ‘Beware the Spending Spree’ AFR, 15 December 2008.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

- **$1.6 billion** saved from the abolition of the CPRS;
- **$756 million** saved from scrapping the election commitment to build 260 Childcare Centres; and
- **$700 million** saved from cancelling the ceiling insulation scheme component of the Energy Efficient Homes program.

But these are piecemeal reforms without any logical policy foundation. Now it is time to develop a consistent set of means-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.

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 with the economy strengthening, governments have a better than average reason to undertake a savings round. We also argue that cutting waste 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** discretionary tightening up to 1 per cent of GDP in 2010 (up to **$13 billion**) is appropriate, as is targeting low grade spending measures which would help to restore the structural integrity of the budget and improving incentives for work and entrepreneurial effort. The savings list is quite obvious and widely known (see Table 10). The key focus is on middle and upper class welfare recipients. However, the size of the likely reductions is typically a function of the type of tightening of eligibility criteria that is chosen in each case and can be more or less strict. We say spread the pain of adjustment as thinly as possible and impose the largest burden on those likely to benefit from an upswing in the business cycle.

Most of the adjustment burden in our saving list 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**, and with an ageing population. Then there is the

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

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, 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.

Table 10: Spreading the Burden of Spending Cuts

	2010-11 $b	**Reform**	**Saving** $b	**Cumulative** $b
Program				
Age Pension	32.7	Tightening eligibility	5.0	5.0
Superannuation Tax Concessions	32.0	Tax all payouts before and after 65 at normal MTRs	4.4	9.4
Family Tax Benefit	17.2	Tightening eligibility	3.8	13.2
Defence Capital	9.3	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
Carer Allowance	1.3	Means testing eligibility	0.4	22.2
First Homeowners Grant	1.5	Introduce means test and apply only to new homes	0.3	22.5
Child-care tax rebate	1.0	Means testing eligibility	0.4	22.9
GFS Expenses & Concessions	**120.2**			**22.9**

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

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

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

compensating low income individuals who are impacted. 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.

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 was 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 provided a strategic review and reform action plan aimed at improving 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.*[5]

---

[5] 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

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 11: Top 20 Programs by Expense in 2009-10

Program	Agency	2009-10 $m	2010-11 $m	2011-12 $	2012-13 $m	Growth %
Revenue assistance to the States & Territories	Treasury	41,824	44,356	47,180	50,132	6.2
Income support for seniors	FaHCSIA	29,335	31,698	33,790	36,149	7.1
Family tax benefit	FaCHSIA	17,424	17,249	17,335	17,559	0.3
Medicare services	Health	15,003	15,649	16,498	17,311	4.9
Disability support pension	FaHCSIA	11,558	12,234	12,680	13,185	4.5
National healthcare specific purpose payment	Treasury	11,224	11,978	12,820	13,747	7.0
Job seeker income support	DEEWR	8,876	10,411	10,122	9,090	1.4
Government schools – Payments to/through States	Treasury	8,592	6,953	4,256	4,283	-19.1
Pharmaceuticals and pharmaceutical services	Health	8,403	8,961	9,503	10,003	6.0
Higher education support	DEEWR	6,615	6,538	6,765	6,944	1.7
Non-government schools – National support	DEEWR	6,457	6,936	7,479	8,045	7.6
Housing – Payments to/through States	Treasury	6,318	3,145	1,696	1,427	-37.4
Commonwealth debt management	AOFM	6,264	8,340	10,659	12,493	26.1
Residential aged care	Health	6,170	6,551	6,914	7,183	5.2
Public sector superannuation	Finance	5,793	5,878	5,963	6,063	1.5
Parents' income support	DEEWR	5,295	5,295	5,319	5,453	1.0
Fuel tax credits scheme	ATO	5,073	5,134	5,281	5,694	4.0
Army capabilities	Defence	4,804	4,776	4,855	4,916	0.8
Air force capabilities	Defence	4,308	4,310	4,378	4,460	1.2
Income support for carers	FaHCSIA	4,120	4,985	5,454	5,936	13.1
Total		**213,455**	**221,380**	**228,946**	**240,075**	**12.5**

Source: 2009-10 Budget Papers, BP.1, p.6-10.

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.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

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. The Government's commitment to instituting the Operation Sunshine findings also saw the publication of program estimates for the Top 20 Programs in the 2009-10 Budget (Table 11). We applaud this trend and hope that Government will now report estimates and outcomes **for all** its 500 or so spending programs.

But it is noteworthy especially in the context stimulus announcements made during late 2008 and early 2009, that the Government 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.**[6]

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

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Attachment 1: The GFC1 Stimulus Measure by Measure

What follows is our best effort to quantify the totality of the Rudd Government's GFC1 policy spending in response to the two months of global financial turmoil which followed the Lehman Brothers collapse on 15 September 2008 and to assess the economic impact.

The measures were rolled out as part of three large packages with some filler measures in between (see Table 12).

- 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.
- 18 November 2008 - **$300 million** for local councils to build local community infrastructure, all to be spent in 2008-09.
- 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 with **$100 million** spent in 2008-09, and **$345 million** 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; funding for building and repairing school halls and community facilities; funding for 20,000 public housing (see Table 10 for financial details).

A simple economic analysis of the impact of the stimulus is as follows. In total the stimulus was worth around **$70 billion dollars**. Around **$23 billion** or **2 per cent** of GDP in stimulus was spent in 2008-09 and 2009-10**.** This stimulus combined with the RBA's 425 bps monetary easing provided a **total macroeconomic policy stimulus** in both years of around **4.5 per cent** of GDP in 2009 and 2010. Around **$45 billion** of the total stimulus has been dedicated to low grade transfer payment measures, including around **$23 billion** for social infrastructure spending projects. If more of the stimulus spending had been dedicated to public infrastructure assets in transport and water, then projects would have been more likely to generate longer term benefits, especially compared to spending on school shelter sheds and welfare payments to households.[7]

7 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.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 12: GFC1 Stimulus Spending from 2008-09

	2008-09 $b	2009-10 $b	2010-11 $b	2011-12 $b	Total $b	Quality Measure
	Economic Stimulus Package					
Payments to families	3.9				3.9	Low
Payments to pensioners	4.8				4.8	Low
Payments to first homeowners	1.2	0.4			1.5	Low
Training places	0.2				0.2	High
	National Building Package					
Local government capital works	0.3				0.3	Low
Renewable energy fund – bring forward net impact	0.1	0.3			0.4	Low
Investment allowance	0.0	0.8	0.8		1.6	High
Small business tax relief	0.4	-0.4			0	High
Building Australia roads project	0.3	0.4			0.7	High
Black spot program	0.1				0.1	High
	Nation Building and Jobs Plan					
Building the education revolution	1.0	8.6	5.1		14.7	Low
20,000 social and Defence homes	0.3	4.3	1.8	0.3	6.6	Low
Energy efficient homes	0.0	1.5	1.5	0.7	3.9	Low
Small and general business tax break	0.0	0.8	1.4	0.5	2.7	High
Tax bonus for working Australians	7.0	1.2			8.2	Low
Single-income family bonus	1.3	0.1			1.4	Low
Farmers' hardship bonus	0.02				0.02	Low
Back to school bonus	2.3	0.3			2.6	Low
Training and learning bonus	0.4	0.1			0.5	Low
Pension increase		0.5	0.5	0.6	1.6	Low
Building Australia (Fiscal Stimulus Mk III)		7.0	5.6	4.0	16.6	Low
Total	**23.5**	**26.0**	**16.7**	**6.1**	**72.3**	

Source: MYEFO, Budget Papers & **Macroeconomics** estimates. Subject to rounding.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

1. Commonwealth Government

The following chapter examines in more detail the economic and fiscal prospects for the Commonwealth Government.

1.1 Introduction

After keeping the economy and budget in reasonable shape during the most significant global financial crisis in 50 years the Rudd Government now needs to undertake a thorough spring clean of federal finances **or** it will not run a budget surplus until at least 2014-15, unless it is blessed with very favourable economic parameter variations, in terms of the real economy or commodity prices. **And it may never deliver another budget surplus if it can't curb its rate of spending** which is averaging over **3.2 per cent** in real terms since 2008-09, removing the impact of the GFC1 stimulus. To achieve budget surpluses before the end of 2013-14 the Rudd Government must tackle the pesky structural budget deficit and control the growth of the spending base. **This may prove the greatest challenge of a populist government, with no real economic or reform charter and an apparent addiction to spending**.

1.2 Economic Outlook

Our budget forecasts for the Commonwealth are underpinned by our reckoning that the Australian economy will achieve solid growth around trend of **3.0 per cent** in 2010-11, and **3.5 per cent** in 2011-12 then trailing off over the outlook period. There are five good reasons why:

1. The significant growth acceleration that followed downturns in the early 1980s and 1990s was in part due to the depth of the downturn which preceded it.
2. Those that expect further continued windfalls from commodity prices forget that likely increases next year take our terms of trade back to the 50 year high reached pre GFC1. How much further can the index rise and how sustainable is an economy/budget built on a 50 year price peak?
3. The huge fiscal and monetary stimulus equivalent to around **4.5 percentage points** of GDP in **2008-09 & 2009-10** employed to forestall the downturn must now contribute to the slowing of activity as policy makers now target medium term macro policy goals.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

4. There is no significant productivity dividend from a previous microeconomic reform to drive growth after the GFC1 downturn in Australia. Apparently governments have forgotten about *real* reform.
5. The repricing of risk after the GFC1 will tend to reduce asset prices and force a drawn out process of business and household balance sheet repair that will also have a dampening impact on budget revenues.

Table 13: Domestic Economy Forecasts

	2008-09 Year Average	2009-10 Year Average	2010-11 Year Average	2011-12 Year Average	2012-13 Year Average	2013-14 Year Average
Demand and Output	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
Household Consumption	1.9	3	¾	4¼	2	1
Private Investment						
Dwellings	-1.5	-3½	-3	0	6½	1
Total Business Investment	6.5	-3	8	1¼	3	1¼
Non-dwelling Construction	7.1	-4½	15¾	-1½	2¼	2¼
Machinery & Equipment	5.7	3½	9½	3½	3¼	1
Private Final Demand	2.3	1¼	2	3¼	2½	1
Public Final Demand	4.4	3¾	¼	2½	1¾	½
Total Final Demand	2.7	1¾	1¾	3¼	2¼	1
Exports of Goods and Services	0.5	1½	7½	3½	2	¾
Imports of Goods and Services	-2.7	1¾	3½	1¾	-1½	-½
Gross National Product	1.3	2¼	3	3½	3	1¼
Non-Farm Product	1.0	2	3	3¼	3	1½
Farm Product	17.6	22½	11¼	8¾	5½	1¼
Other Economic measures	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
External Accounts						
Terms of Trade (pps)	9.6	-13	13	0	0	0
Current Account Balance						
$billion	-17.5	-18½	-10¼	-5¾	-3½	-7
Percentage of GDP	-4.6	-4½	-4	-3½	-2¾	-2½
Labour Market						
Employment (labour force survey basis)	-0.6	3	2¼	1¾	2	1¾
Unemployment rate (per cent)	6.1	5¼	5	5½	5½	6
Participation rate (per cent)	65	65	63¾	63½	63¼	63¼
Prices and Wages						
Consumer Price Index	3.2	2½	2¾	2¾	2½	2½
Gross Non-Farm Product Deflator	5.5	1¼	2¼	2¾	2¾	2¾
Wage Price Index	4.0	3¼	3¾	4	4¼	4¼

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

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

We are not sure that the Great Panic or GFC1 has run its course and it may be followed by future financial shockwaves focussed on the sovereign indebtedness of many developed economies. We expect the impact on the real economy will last for the next several years, as the resultant rising cost of capital and repricing of risk. For Australia in 2010, the adjustment process will tend to act as a brake on real activity at least for the next few years, tending to keep activity below trend for most of the outlook period with the output gap tending to widen by the end of the period. Table 13 includes forecasts for the key macroeconomic and financial variables for the domestic economy which underpin this edition of the Budget Bulletin.

While activity may be somewhat subdued in the domestic economy, the 'income' effects associated with a recovery of our terms of trade by around **13.5 per cent** during the next financial year which will add around **$35 billion** to real national income progressively from 2011-12 and 2012-13 will tend to underpin growth in asset prices and leave many Australian's feeling more wealthy and with a greater propensity to spend. The **China boom** continues. Unfortunately activity in most of the developed economies is still a long way below trend which may help to constrain growth in Australia.

While GFC1 was beyond the control of Australian policy makers, the resultant downturn and recovery is looking like a drawn out process as global markets wait for US/European banks to repair their balance sheets and restore confidence. While official forecasters such as the IMF are becoming increasingly upbeat about prospects for global growth, recent sovereign debt concerns specifically relating to **Greece** underscore the fragility of the emerging global recovery. Systemic financial and economic reforms are needed to clear the stockpile of bad debt accumulated by financial institutions and the mounting stockpile of public debt that nations accumulated as they sort to counteract the GFC1 downturn in their economies. But will GFC1 be soon followed by GFC2? The global economy may still provide another financial crisis over the coming years, given the heightened uncertainty after the first shock and because of the fundamental imbalances in global trade and finances. However, while there is certainly scope for further rounds of destabilising financial shocks undermining the global real economy), it appears that a global recovery has begun and is gathering momentum. That said the global cost of capital has risen to reflect a repricing of risk.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

1.3 Budget Outlook

The 2009-10 Budget told the story of the significant discretionary easing of 2008 & 2009, combined with the loosening of the budget's automatic stabilisers and the sudden collapse of much of the windfall revenue windfalls associated with the commodity boom.

The 2010-11 Budget tells the story of the first steps in recovery of the budget bottom-line. We expect Australian Government to announce an underlying cash deficit on Budget night of around **$36.8 billion** dollars in 2010-11 based on our understanding of parameter changes and new stimulus policy and savings measures since the last update (Table 14). These estimates incorporate the significant discretionary spending associated with the Governments health and hospital COAG reform and policy changes associated with the Henry Tax Review Government net debt is now expected to rise to over **$97 billion** by 2013-14 (6.4 per cent of GDP).

Table 14: Commonwealth General Government Budget Balance

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
Macroeconomics GFS Budget Balance	**-45.7**	**-36.8**	**-14.4**	**-7.3**	**-7.1**
Percentage of GDP	-3.5	-2.7	-1.0	-0.5	-0.4

Source: Macroeconomics estimates.

The underlying cash deficit of **$36.8 billion in 2010-11** represents a **$9.8 billion** improvement in the bottom-line largely from the MYEFO forecast driven by improved income tax receipts as hours worked rose in Australian workplaces and from lower benefit payments and a lower unemployment rate that was expected at MYEFO. Offsetting these favourable parameter changes is a significant increase in discretionary spending in 2010-11, largely explained by certain underspends in 2009-10 associated with the Governments Building the Education Revolution stimulus package and the moving of this funding into 2010-11 (Table 15).

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 15: Commonwealth General Government Budget Forecasts

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b
MYEFO Budget Balance	-57.7	-46.6	-31.2	-15.9
Impact of Receipt Parameter Variations	5.4	9.5	11.6	2.9
Impact of Payment Parameter Variations	3.2	6.0	5.5	4.8
Impact of New Measures	3.4	-5.7	-0.3	0.3
Impact of Henry Tax Review	0.0	0.0	-0.1	0.6
Macroeconomics Budget Balance	**-45.7**	**-36.8**	**-14.4**	**-7.3**
Percentage of GDP	-3.5	-2.7	-1.0	-0.5

Source: Macroeconomics estimates.

The budget outlook in 2011-12 and over the period of the forward estimates is consistently stronger than was expected at MYEFO due mainly to stronger than anticipated individual income tax receipts associated with stronger than anticipated activity and a significant strengthening in company tax receipts as outlined in Table 16.

Table 16: Commonwealth General Government Receipts – Variations from MYEFO 2009-10

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b
Gross Income Tax Withholding	3.1	5.3	2.9	1.9
Gross Other Individual	3.9	4.9	4.2	3.7
Company Tax	-0.5	-0.2	3.7	0.1
Other	-1.2	-0.6	0.7	-2.8
Total	**5.4**	**9.5**	**11.6**	**2.9**

Source: Macroeconomics estimates.

Our forecasts of receipts by revenue head for the 2010-11 Budget is outlined in Table 17.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 17: Commonwealth General Government Sector Receipts

	2009-10 $m	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
Gross Income Tax Withholding	121,140	129,678	138,477	149,017	153,644
Percentage of GDP	9.3	9.4	9.5	9.7	9.6
Gross Other Individual	30,918	32,343	33,614	35,820	37,703
Percentage of GDP	2.4	2.4	2.3	2.3	2.4
Less Refunds	24,747	25,985	26,284	26,648	28,081
Total Individuals and Withholding Taxation	**127,311**	**136,036**	**145,807**	**158,189**	**163,266**
Fringe Benefits Tax	3,059	2,753	2,836	2,921	3,008
Percentage of GDP	0.2	0.2	0.2	0.2	0.2
Superannuation Funds	6,650	8,140	9,730	10,285	9,990
Percentage of GDP	0.5	0.6	0.7	0.7	0.6
Company Tax	52,132	56,323	70,758	75,672	81,293
Percentage of GDP	4.0	4.1	4.9	4.9	5.1
Petroleum Resource Rent	2,216	2,248	2,280	2,313	2,346
Percentage of GDP	0.2	0.2	0.2	0.2	0.1
Income Taxation Receipts	**191,368**	**205,500**	**231,411**	**249,380**	**259,903**
Percentage of GDP	14.7	15.0	15.9	16.2	16.2
Total Sales Tax	43,987	46,031	48,214	52,095	54,674
Percentage of GDP	3.4	3.4	3.3	3.4	3.4
Total Excise Duty Receipts	25,297	25,505	25,689	25,864	25,983
Percentage of GDP	1.9	1.9	1.8	1.7	1.6
Total Customs Duty Receipts	5,995	6,305	6,595	6,881	7,118
Percentage of GDP	0.5	0.5	0.5	0.4	0.4
Indirect Taxation Receipts	77,644	80,047	82,806	87,245	90,252
Percentage of GDP	6.0	5.8	5.7	5.7	5.6
Other Indirect Taxation	2,365	2,206	2,308	2,405	2,477
Percentage of GDP	0.2	0.2	0.2	0.2	0.2
Macroeconomics General Government Sector Receipts	**396,323**	**421,583**	**460,024**	**494,814**	**513,421**
Percentage of GDP	**30.4**	**30.7**	**31.5**	**32.1**	**32.1**

Source: Macroeconomics estimates. Subject to rounding.
Note: Company tax includes resources super profits tax.

In terms of payments, the improvement in the budget bottom-line over the outlook period is also due to lower than anticipated outlays due to favourable parameter variations related to

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

employment benefits, higher education student assistance and public debt interest (Table 18).

Table 18: General Government Sector Payments Forecasts – MYEFO 2009-10 Variations

	2009-10 $m	2010-11 $m	2011-12 $m	2012-13 $m
Indexation	-9	-90	90	180
Job Seeker Income Support	1,328	3,030	2,422	1,919
Higher Education Student Assistance	840	2038	1525	1225
Measures (net)	3,430	-5,686	-313	350
GST Adjustment	261	-343	-851	-1051
Public Debt Interest	772	1326	2306	2484
Total	**6,621**	**276**	**5,179**	**5,106**

Source: Macroeconomics estimates.

Offsetting the improved budget bottom-line is the impact of policy decisions taken over the outlook period, which has a significant factor especially in the budget year. Key decisions detracting from the bottom-line is the rephasing associated with the Building the Education Revolution program, new spending associated with the continuation of the Afghanistan Deployment and measures associated with the Public Health and Hospitals Reform package as outlined in Table 19 below. Blocked Senate savings proposals also contribute to the budget deficit. New policy is offset to varying degrees by administered and department savings in each year of the outlook period.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 19: Total Measures since MYEFO 2009-10

	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b	Total $b
Receipts					
Licence fees for free to air television	-125.0	-125.0	0.0	0.0	-250.0
Payments					
Rural tertiary hardship fund	-5.0	-5.0	-5.0	-5.0	-20.0
Elective surgery	-75.0	-75.0	-75.0	-75.0	-300.0
Aviation security	-50.0	-50.0	-50.0	-50.0	-200.0
29 high priority projects in indigenous communities	-11.5	-11.5	-11.5	-11.5	-46.0
Biometric checking	-17.3	-17.3	-17.3	-17.3	-69.0
Community development in 500 indigenous communities	-43.0	-43.0	-43.0	-43.0	-172.0
GP training places	-84.8	-84.8	-84.8	-84.8	-339.0
Specialist doctor training	-36.3	-36.3	-36.3	-36.3	-145.0
Funding for long-term illness including diabetes	-109.0	-109.0	-109.0	-109.0	-436.0
Paying the states to improve hospital emergency wards	-125.0	-125.0	-125.0	-125.0	-500.0
Taking over full responsibility for aged-care funding	-112.5	-112.5	-112.5	-112.5	-450.0
New hospitals	-643.3	-643.3	-643.3	-643.3	-2,573.0
Mental Health	-28.8	-28.8	-28.8	-28.8	-115.0
Training health professionals	-40.0	-40.0	-40.0	-40.0	-160.0
New aged care	-72.3	-72.3	-72.3	-72.3	-289.0
Continued Afghanistan troop deployment	-1,223.0	N/D	N/D	N/D	-1,223.0
Reopening Curtin detention facility	-457.0	-250.0	-75.0	-50.0	-832.0
Rephasing education revolution	-3,200.0				-3,200.0

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b	Total $b
Savings					
Administrative savings (unspecified)	0.0	400.0	1,200.0	400.0	1,600.0
260 childcare centres	223.0	256.0	245.0		724.0
Energy efficient homes (ceiling insulation)	350.0	350.0			700.0
Program reductions (unspecified)		350.0	700.0	700.0	1,750.0
Abolition CPRS	424.4	387.8	365.8	468.7	1,646.7
Blocked Savings (Senate)					
Private health insurance	-675.0	-675.0	-675.0	-675.0	-2700.0
Dental treatment	-172.5	-172.5	-172.5	-172.5	-690.0
Alcopops tax (incl. GST)	-750.0	-750.0	-750.0	-750.0	-3000.0
Total	**-5,685.6**	**-313.2**	**349.8**	**-171.3**	**-5,820.3**

Source: Budget Papers & **Macroeconomics** estimates.

In addition to the normal 'measures' we have also included a summary of the total financial impact over the forward estimates of the Henry Taxation Review (Table 20).

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 20: Henry Tax Review Measures

	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b	Total $b
Receipts					
Company tax cut	0.0	0.0	-0.3	-2.0	-2.3
Small business instant write-off and simplified depreciation	0.0	0.0	0.0	-1.0	-1.0
Head start on lower company tax rate for small business	0.0	-0.1	-0.3	-0.2	-0.6
Resources super profits tax	0.0	0.0	3.0	9.0	12.0
Resources exploration rebate	0.0	0.0	-0.5	-0.6	-1.1
Superannuation concessional contribution caps	0.0	0.0	-0.5	-0.8	-1.3
Superannuation low income earners government contribution	0.0	0.0	0.0	-0.8	-0.8
Raising the superannuation guarantee age limit from 70 to 75	0.0	0.0	0.0	0.0	0.0
Increasing the superannuation guarantee rate to 12 per cent	0.0	0.0	0.0	-0.2	-0.2
Payments					
State infrastructure fund	0	0	-0.7	-0.7	-1.4
Total	**0**	**-0.1**	**0.6**	**2.6**	**3.2**

Source: Government response to the Henry Review recommendations.

1.4 Structural Budget Position

This time last year we told you that the Commonwealth had been running a structural deficit since 2006-07 of around **$25 billion**, and that corrective measures needed to be taken to close the fiscal gap. We have no reason to think the structural budget position has improved in the last twelve months (Table 21). However, it is anticipated that the structural deficit will fall over the outlook period to well under **$20 billion** if the Rudd Government manages to restrain spending growth to below 2 per cent in line with its fiscal strategy.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 21: Commonwealth Government Structural Budget Forecasts

	2008-09 $b	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
Macroeconomics Budget Balance	**-27.1**	**-45.7**	**-36.8**	**-14.4**	**-7.3**	**-7.1**
Impact of the Economic Cycle	2.5	4.2	7.1	8.6	12.3	20.0
(Output gap share of GDP)	-1.0	-2.4	-2.9	-3.0	-3.6	-6.0
Impact of the Commodity Cycle	-21.2	-9.3	-12.8	-21.2	-23.2	-28.1
Impact of One-Off GFC1 Measures	23.5	25.4	16.2	5.6	2	0
Structural Balance	**-22.2**	**-25.3**	**-26.4**	**-21.4**	**-16.2**	**-15.2**
Per cent of GDP	-1.8	-1.9	-1.9	-1.5	-1.1	-0.9

Source: ABS, Budget Papers & Macroeconomics estimates. Subject to rounding.

Indeed the key to reducing the structural deficit through time will be to constrain real spending growth to below the growth in real GDP (assuming a return to long run average terms of trade). Table 22 details our forecasts of the Rudd Governments likely spending performance over the outlook period which suggest that they will manage to contain real spending growth to below 2 per cent in each year of the outlook period, but that spending growth will outstrip 2 per cent target, removing the impact of the GFC1 stimulus.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 22: Growth in Spending as Percentage of GDP

	2008-09 %	2009-10 %	2010-11 %	2011-12 %	2012-13 %	2013-14 %
Growth in Nominal Payments	16.3	4.9	2.7	2.1	4.4	3.9
CPI	3.2	2.8	2.1	2.7	2.6	2.5
Growth in Real Payments	13.1	2.1	0.6	-0.6	1.8	1.4
Growth in Real Payments excluding GFC1 spending	**0.0**	**1.9**	**3.8**	**2.8**	**4.2**	**0.7**

Source: MYEFO & **Macroeconomics** estimates.

1.5 Fiscal Stimulus

Commonwealth fiscal policy will contribute to a contraction in the national economy of around **1 to 2 percentage points** of GDP in 2010-11 and 2011-12, with a broadly neutral stimulatory impact over the out years (Table 23).

Table 23: Commonwealth General Government Fiscal Stimulus

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
Macroeconomics Underlying Cash Balance	-45.7	-36.8	-14.4	-7.3	-7.1
Fiscal Stimulus in Dollars	23.5	25.4	16.2	5.6	-2.2
Fiscal Stimulus in GDP	**1.8**	**1.9**	**1.1**	**0.4**	**-0.1**

Source: Macroeconomics estimates.

1.6 Saving Record

The Commonwealth has contributed around **$72 billion** to national savings in the form of accumulated budget surpluses for the 10 year period ending 2008-09. It is expected to draw on national savings by around **$118.3 billion** over the period of the forward estimates. Net debt is expected to rise to **$91 billion** over the forward estimates period (Table 24).

.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535

Table 24: Commonwealth General Government Net Debt

	2009-10 $b	2010-11 $b	2011-12 $b	2012-13 $b	2013-14 $b
Macroeconomics Net Debt	**28.7**	**65.0**	**78.4**	**85.6**	**91.3**
Percentage of GDP	2.3	4.8	5.5	5.7	5.9

Source: Macroeconomics estimates.

1.7 Infrastructure Investment Plans

The Commonwealth will invest around **$62 billion** in capital equipment and direct public infrastructure purchases over the next four years of which defence materiel will comprise just over one-third on average (Table 25).

Table 25: Commonwealth General Government Spending Plans on Infrastructure

	2009-10 $m	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m
Net capital investment (net purchases less depreciation)	**-16,278**	**-15,904**	**-15,628**	**-14,762**	**-15,662**
Defence net capital investment	-4,128	-5,868	-5,868	-5,189	-5,889
Defence net capital investment as a percentage of total net capital investment	25.4	36.9	37.5	35.2	37.6

Source: Macroeconomics estimates.

Canberra (Head Office) Phone 02 6161 3542 Fax 02 6169 3042 **Melbourne** Phone 0406 378 242
Postal Address GPO Box 2483, Canberra ACT 2601 **Email** office.manager@macroeconomics.com.au **Web** www.macroeconomics.com.au
ACN 128 878 535 ABN 901 2887 8535