

PRE-ELECTION ECONOMIC AND FISCAL OUTLOOK

OVERVIEW

The Australian economy is expected to continue to record solid economic growth and low inflation in 2004-05 and 2005-06, against the backdrop of strong world growth. Near term risks to the economic outlook are balanced, although the medium-term risks to the world outlook described at Budget remain.

The underlying cash and fiscal balances are estimated to be in surplus in 2004-05 and the forward years. Table 1 provides revised estimates and projections of the underlying cash and fiscal balances for the period from 2004-05 to 2007-08.

Table 1: Summary of budget aggregates

| | Estimates | | Projections | |
|--------------------------------------|------------|------------|-------------|------------|
| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| Underlying cash balance (\$b) | 5.3 | 5.1 | 6.9 | 7.9 |
| Per cent of GDP | 0.6 | 0.6 | 0.7 | 0.8 |
| Fiscal balance (\$b) | 3.6 | 4.1 | 6.4 | 6.8 |
| Per cent of GDP | 0.4 | 0.5 | 0.7 | 0.7 |

ECONOMIC OUTLOOK

The Australian economy is expected to record solid economic growth of 3½ per cent in 2004-05, consistent with the Budget forecast. Growth in gross national expenditure is moderating toward trend rates, offset by a gradual improvement in net exports flowing from strong world growth. Inflation is forecast to remain low and unemployment to remain around current levels.

In 2005-06, Gross Domestic Product (GDP) is forecast to grow at 3½ per cent in year average terms, around its long-term average rate. Employment growth is expected to moderate slightly, to 1¾ per cent through the year to the June quarter 2006, in line with an easing in growth in the non-farm economy. Inflation is forecast to remain within the medium-term target band.

Table 2 presents the major economic parameters which underpin the *Pre-Election Economic and Fiscal Outlook 2004* (PEFO) financial estimates. The parameters for 2004-05 and 2005-06 are Treasury forecasts. The parameters for 2006-07 and 2007-08 are projections based on long-term average growth rates, consistent with the usual Budget conventions.

Table 2: Major economic parameters^(a)

| | Forecasts | | Projections | |
|-------------|-----------|---------|-------------|---------|
| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| Real GDP | 3 1/2 | 3 1/2 | 3 1/2 | 3 1/2 |
| Employment | 2 1/4 | 1 3/4 | 1 1/2 | 1 1/2 |
| CPI | 2 1/2 | 2 1/2 | 2 1/2 | 2 1/2 |
| Wages (WCI) | 3 1/2 | 3 3/4 | 3 3/4 | 3 3/4 |

(a) Year-average percentage change.

In 2004-05, household consumption growth is forecast to remain robust, albeit easing from recent strong rates. Forecast consumption reflects sustained employment growth, continuing moderate wage increases, past gains in wealth from housing and equity markets, and decisions contained in the 2004-05 Budget.

Developments in the housing sector will remain an important determinant of consumption growth over the forecast period. Consumption growth has run ahead of income growth for several years now, supported by very strong growth in housing wealth. This has seen households borrow against their increased wealth with a consequent rise in the debt servicing ratio. Rising household debt, particularly a rising proportion of highly geared households, increases the vulnerability of the economy to shocks that affect wealth or incomes.

Growth in the construction sector appears to be moderating, following a number of years of strong increases in activity. Residential construction is expected to continue its recent easing, albeit from very high levels, reflecting slowing in both medium-density and detached housing construction. The drivers of non-residential construction point to a slowdown in that sector; in particular, office vacancy rates are at high levels while rental yields are low.

Growth in business investment is anticipated to ease from current high rates. Investment in externally-oriented sectors, particularly the resources sector, is expected to be very strong in line with the pace of global activity. Offsetting this, investment by domestically focused businesses is moderating from high levels, consistent with the anticipated easing in domestic demand.

Agricultural production is anticipated to remain steady in 2004-05 on the technical assumption of a return to average seasonal conditions. However, the recent deterioration in the Bureau of Meteorology's seasonal outlook for rainfall over the next three months, combined with low sub-soil moisture in many areas and relatively low water levels in major irrigation storages, poses a downside risk to the outlook.

Employment is forecast to grow in line with the pace of non-farm activity. Following strong outcomes in early 2004, employment growth is expected to be 2¼ per cent in year-average terms in 2004-05 compared to the 1¾ per cent anticipated at Budget. The unemployment rate is forecast to average around 5½ per cent during 2004-05 with stronger employment growth partially offset by higher labour force participation.

The headline Consumer Price Index (CPI) is forecast to increase by around 2½ per cent through-the-year to June 2005 compared with 1¾ per cent forecast at Budget. The upward revision reflects higher oil prices, the depreciation of the currency and slightly stronger labour market conditions. While some upside risks to inflation have emerged since Budget, there are currently no signs of systemic inflationary pressure emerging from labour costs. Similarly, there is little evidence of higher oil prices triggering a sustained increase in inflation.

Nonetheless, since Budget, high oil prices have crystallised as a risk to the outlook more generally. Higher oil prices reflect strong global demand as well as tight oil supply conditions and concern over possible supply disruptions. As a technical forecasting assumption, oil prices are assumed to follow the oil futures curve and average around US \$43 per barrel in 2004-05 before declining to around US \$38 per barrel in 2005-06.

The current account deficit is forecast, in year-average terms, to narrow from 6 per cent of GDP in 2003-04 to around 5¾ per cent in 2004-05, due to improvements in the terms of trade and strong world growth. This forecast rests on a technical assumption that the exchange rate will remain around US 71 cents, and the trade weighted index around 61 (in line with recent average levels).

The world economy has strengthened significantly over the past year. Since Budget, the near-term outlook has improved, with stronger conditions in Japan, and to a lesser extent Europe, more than offsetting slightly weaker conditions in the United States. Growth in the world economy is now firmly established with most regions growing strongly, although significant output gaps remain in a number of developed economies. Reflecting these developments, fiscal and monetary policies in major economies are becoming less stimulatory and growth is expected to ease in 2005.

The forecast for world GDP growth in 2004 has been revised up by ¼ of a percentage point since Budget to 4¾ per cent. The forecast for GDP growth in 2004 in Australia's major trading partners has been revised up by ½ of a percentage point to 5¼ per cent. Forecasts for GDP growth in 2005 are unchanged from Budget with world GDP forecast to grow by 4¼ per cent and Australia's major trading partners expected to grow by 4 per cent.

Globally, inflation should remain in check, in part reflecting significant output gaps in a number of major economies and notwithstanding higher energy and other commodity prices.

The risks to the near-term world economic outlook are balanced. There are downside risks around sustained higher oil prices and the impact of terrorism. On the upside, the current cyclical momentum, together with still highly expansive policy settings, could generate a more vigorous and lengthy growth cycle than currently anticipated.

In the medium term, the risks to the global economic outlook remain skewed to the downside. There are concerns about continued large imbalances, both between countries as represented by current accounts and within countries as reflected in fiscal positions. If world growth does not become more balanced, there is a greater risk that these imbalances could lead to sudden destabilising movements in exchange rates and asset prices.

FISCAL OUTLOOK

An underlying cash surplus of \$5.3 billion, or 0.6 per cent of GDP, is estimated for 2004-05, an increase of \$2.9 billion since the 2004-05 Budget. A fiscal surplus of \$3.6 billion, or 0.4 per cent of GDP, is estimated for 2004-05, an increase of \$2.9 billion since the 2004-05 Budget. The fiscal outlook is for continuing underlying cash and fiscal surpluses in the forward years.

Table 3 provides a summary of the major budget aggregates.

Table 3: Australian Government general government budget aggregates^(a)

| | Estimates | | Projections | |
|--------------------------------------|--------------|--------------|--------------|--------------|
| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| Revenue (\$b) | 197.9 | 206.4 | 217.5 | 228.7 |
| Per cent of GDP | 22.9 | 22.6 | 22.6 | 22.5 |
| Expenses (\$b) | 194.0 | 202.2 | 211.3 | 222.4 |
| Per cent of GDP | 22.4 | 22.1 | 21.9 | 21.9 |
| Net operating balance (\$b) | 3.9 | 4.2 | 6.2 | 6.3 |
| Net capital investment (\$b)(b) | 0.3 | 0.1 | -0.2 | -0.5 |
| Fiscal balance (\$b) | 3.6 | 4.1 | 6.4 | 6.8 |
| Per cent of GDP | 0.4 | 0.5 | 0.7 | 0.7 |
| Underlying cash balance (\$b) | 5.3 | 5.1 | 6.9 | 7.9 |
| Per cent of GDP | 0.6 | 0.6 | 0.7 | 0.8 |
| <i>Memorandum item:</i> | | | | |
| Headline cash balance (\$b) | 3.9 | 3.6 | 16.3 | 17.3 |

(a) All estimates are based on Government Finance Statistics (GFS) standards, but with goods and services tax revenue collected on behalf of the states and territories netted off revenue and expenses.

(b) Net capital investment is defined as net acquisition of non-financial assets.

Table 4 provides a reconciliation between the fiscal balance estimates published in the 2004-05 Budget and the 2004 PEFO.

Table 4: Reconciliation of 2004-05 Budget and 2004 Pre-Election Economic and Fiscal Outlook fiscal balance estimates^(a)

| | 2004-05 \$m | 2005-06 \$m | 2006-07 \$m | 2007-08 \$m |
|--|----------------|----------------|----------------|----------------|
| 2004-05 Budget fiscal balance | 698 | 712 | 2,291 | 2,619 |
| Per cent of GDP | 0.1 | 0.1 | 0.2 | 0.3 |
| Effect of policy decisions ^(b) | | | | |
| Revenue | -18 | -392 | -308 | -173 |
| Expenses | 791 | 1,122 | 1,089 | 1,178 |
| Net capital investment | 26 | -2 | -9 | -9 |
| Net effect of policy decisions | -835 | -1,512 | -1,388 | -1,342 |
| Effect of parameter and other variations | | | | |
| Revenue | 4,746 | 5,398 | 5,610 | 5,719 |
| Expenses | 879 | 477 | 162 | 243 |
| Net capital investment | 141 | 10 | -17 | -14 |
| Net effect of parameter and other variations | 3,727 | 4,911 | 5,466 | 5,490 |
| PEFO fiscal balance | 3,589 | 4,112 | 6,369 | 6,766 |
| Per cent of GDP | 0.4 | 0.5 | 0.7 | 0.7 |

(a) A positive number for revenue indicates an increase in the fiscal balance, while a positive number for expenses and net capital investment indicates a decrease in the fiscal balance.

(b) Excludes the public debt interest effect of policy measures.

A range of factors may change the fiscal outlook. Appendix D contains a Statement of Risks which details new or changed risks since the 2004-05 Budget that may have a material effect on the fiscal outlook. Statement 11 of the 2004-05 Budget Paper No. 1 contains a list of all risks as at 2004-05 Budget. A discussion of the estimated sensitivity of the fiscal aggregates to changes to the economic parameters is provided in Attachment C to this Part.

Revenue

Since the 2004-05 Budget, total accrual revenue for 2004-05 has been revised up by \$4.7 billion. The upward revision reflects the flow-on effect of a higher than expected final taxation revenue outcome in 2003-04 as well as the impact of stronger forecast nominal GDP growth in 2004-05.

Taxation revenue in 2004-05 is expected to be underpinned by solid growth in employment and profits. In particular, estimated revenue from income tax withholding has increased by \$840 million while revenue from other individuals and companies has been revised up by \$1.6 billion and by \$860 million respectively.

Estimated non-taxation revenue has increased in 2004-05, mainly due to:

- a \$516 million increase in dividends from Telstra, reflecting Telstra's decision to increase the payout ratio for the ordinary dividend from 75 per cent to 80 per cent of earnings and the recent announcement of a special dividend payment; and

- a \$350 million increase in interest received by the Australian Office of Financial Management on term deposits, resulting from higher headline cash balances.

Revenue measures have only a small impact in 2004-05. The Government's introduction of the Mature-Aged Workers' Participation Tax Offset detracts from growth in personal income taxation revenue from 2005-06. Further details on revenue measures can be found at Appendix A.

Expenses

Since the 2004-05 Budget, estimated expenses for 2004-05 have increased by \$1.7 billion, reflecting the impact of new policy decisions of \$791 million and parameter and other variations of \$879 million.

Major new expense policy decisions affecting 2004-05 include:

- \$252 million in 2004-05 (\$1.8 billion over four years) due to raising the Medicare Rebate to 100 per cent of the Medicare Benefits Schedule fee in relation to all non-referred general practitioner attendances; and
- \$29 million in 2004-05 (\$445 million over four years) due to the increase in the 30 per cent private health insurance rebate for older Australians to 35 per cent for 65 to 69 year olds and to 40 per cent for people over 70 years of age.

Further details on expense measures can be found at Appendix A.

In 2004-05, parameter and other variations¹ have increased expenses by \$879 million, largely reflecting:

- a \$723 million increase due to the impact of higher forecast inflation, mainly increasing the nominal interest expense relating to the Australian Government civilian superannuation liabilities;
- a \$250 million increase in Job Network expenses reflecting the continuation of high levels of activity and outcomes under the current employment services contract;

¹ The contingency reserve includes an allowance for the established tendency of existing government policy (particularly demand driven programmes) to be higher than estimated in the forward years. This allowance, known as the conservative bias allowance, is progressively reduced so that the budget year conservative bias allowance is zero by the Budget. No adjustment has been made to the conservative bias allowance for the PEFO and the standard practice of reducing the conservative bias allowance will occur at the Mid-Year Economic and Fiscal Outlook (MYEFO). Also, a provision in the contingency reserve is included each year at the MYEFO to provide for the established tendency of departments and agencies to underspend their budgets in the current financial year. No provision for underspends in 2004-05 has been included in the PEFO and this will be addressed in the MYEFO.

- a \$197 million increase in education grant payments to the States resulting from the increase in the Average Government Schools Recurrent Cost Index, which is driven by increases in State expenditure on Government schools; and
- a \$142 million increase in expenses relating to the Medicare Safety Net, due mainly to higher estimated rates of family registration and out-of-pocket costs.

These 2004-05 increases are partly offset by:

- a \$598 million reduction in personal benefit expenses administered by the Family and Community Services portfolio, reflecting the stronger than expected decline in the number of social security and family assistance payments, including a \$386 million reduction in Newstart Allowance, consistent with the recent buoyant labour market and economic conditions; and
- a \$330 million movement from 2004-05 to 2005-06 in compensation for states and territories for the revenue impact of allowing small businesses that are voluntarily registered for the goods and services tax (GST) to pay GST annually. The finalisation of the arrangements for compensating the states and territories, since the 2004-05 Budget, means that the impact of this expense in accrual terms occurs in 2005-06 instead of 2004-05 (but the cash payment will still be in 2004-05).

Net capital investment

Forecast net capital investment in 2004-05 has increased by \$167 million since the 2004-05 Budget. This represents the combined effect of:

- new policy decisions of \$26 million, including an additional \$13 million for protective security measures; and
- parameter and other variations of \$141 million, including a \$110 million increase in the Department of Health and Ageing's inventories. The increase in inventories in 2004-05 represents the receipt of vaccines and anti-viral medication that were purchased in 2003-04.

Cash flows

In 2004-05, an underlying cash surplus of \$5.3 billion is expected, compared with \$2.4 billion at the 2004-05 Budget. Major new policy decisions impacting on the underlying cash balance in 2004-05 are largely the same as those impacting on the fiscal balance.

Table 5: Reconciliation of 2004-05 Budget and 2004 Pre-Election Economic and Fiscal Outlook underlying cash balance estimates^(a)

| | 2004-05 \$m | 2005-06 \$m | 2006-07 \$m | 2007-08 \$m |
|---|----------------|----------------|----------------|----------------|
| 2004-05 Budget underlying cash balance | 2,391 | 1,587 | 3,438 | 4,501 |
| Effect of policy decisions(a) | -725 | -1,430 | -1,354 | -1,338 |
| Effect of parameter and other variations | 3,593 | 4,952 | 4,773 | 4,767 |
| Total variations | 2,868 | 3,522 | 3,418 | 3,429 |
| PEFO underlying cash balance | 5,258 | 5,109 | 6,857 | 7,930 |

(a) Excludes the public debt interest effect of policy measures.

Total cash receipts for 2004-05 are estimated to be \$198.6 billion, an increase of \$4.3 billion since Budget – largely driven by the upward revision to cash taxation receipts. The increase in cash taxation receipts is lower than the increase in accrual taxation revenue, reflecting taxation revenue recognised but not expected to be received from individuals and companies in 2004-05.

Total cash payments for 2004-05 are estimated to be \$193.3 billion, an increase of \$1.5 billion since Budget. While parameter and other variations to expenditure generally have similar cash and accrual effects, a significant variation that decreases the fiscal balance relative to the underlying cash balance is an increase in estimated superannuation related expenses, largely due to the impact of a higher forecast for the CPI. This reduces the fiscal balance by \$602 million relative to the underlying cash balance.

Net debt and net worth

Net debt is estimated to be \$19.8 billion by 30 June 2005, a reduction of \$4.9 billion relative to the 2004-05 Budget estimate. This reflects the higher than anticipated final budget outcome for 2003-04 and the upward revision to the projected surplus for 2004-05.

Net worth is estimated to be -\$36.0 billion by 30 June 2005, an improvement of \$6.8 billion relative to the estimate at the 2004-05 Budget. This largely reflects the higher than expected net operating surplus for 2004-05 and the higher than expected opening net worth resulting from a higher than anticipated final budget outcome for 2003-04.