Chapter 2:

THE ECONOMY

2.1 INTRODUCTION

Both the revenue and the outlay sides of the Budget are affected by the state of the NSW economy and more broadly the Australian economy. This chapter discusses the main features of the NSW economy, reviews the recent performance of the NSW and Australian economies, and provides the forecasts for the main economic parameters that underlie the Budget projections. Consideration is also given to some of the important assumptions that underlie the forecasts. Alternative budget scenarios show the potential impact of changes in these assumptions on the outcomes for 1996-97.

The broad outlook for 1996-97 as summarised in Figure 2.1, is for a pick-up in both national and State output. Little improvement from the weakening employment growth that is evident in the latter part of 1995-96 is expected in 1996-97.

In the following two years, economic growth is expected to remain steady at a little over 3 per cent and there should be some consequent pick up in the labour market. Annual inflation is expected to have increased to over 4 per cent by the end of 1995-96 and then is projected to fall back to close to 3 per cent in the two years beyond, pushing against the upper limit of the Reserve Bank's inflation target.

STRUCTURE OF THE NEW SOUTH WALES ECONOMY

New South Wales is Australia's largest and most diverse State economy accounting for over one third of national output. Therefore developments in the national economy are generally reflected in the State economy.

All nineteen broad industry sectors are represented in New South Wales as indicated in Figure 2.2. However, the relative contributions of the NSW agriculture and mining sectors are smaller than those sectors nationally, reducing the relative exposure of the State economy to commodity market cycles. On the other hand, with mining accounting for only 1.7 per cent of State output (but 4.3 per cent of national output), New South Wales will benefit much less than States such as Queensland and Western Australia from strong growth in this resource based sector that may be evident in the coming year or so.

Similarly to the Australian economy, the most significant industry sectors in the State by output are (in order of importance and excluding ownership of dwellings) manufacturing, property and business services, retail trade, and wholesale trade, jointly accounting for 40 per cent of total NSW output and 44 per cent of total NSW employment.

The contribution of the State to the national finance, property and business services industries (almost 40 per cent) and wholesale trade (39 per cent) is particularly significant. The finance, property and business services industry includes banking, insurance, superannuation, property development, computer services, accounting services, legal services and marketing services. Over the last decade or so New South Wales has been a major beneficiary from strong growth in these areas and other service industries such as those associated with hospitality, recreation and tourism.

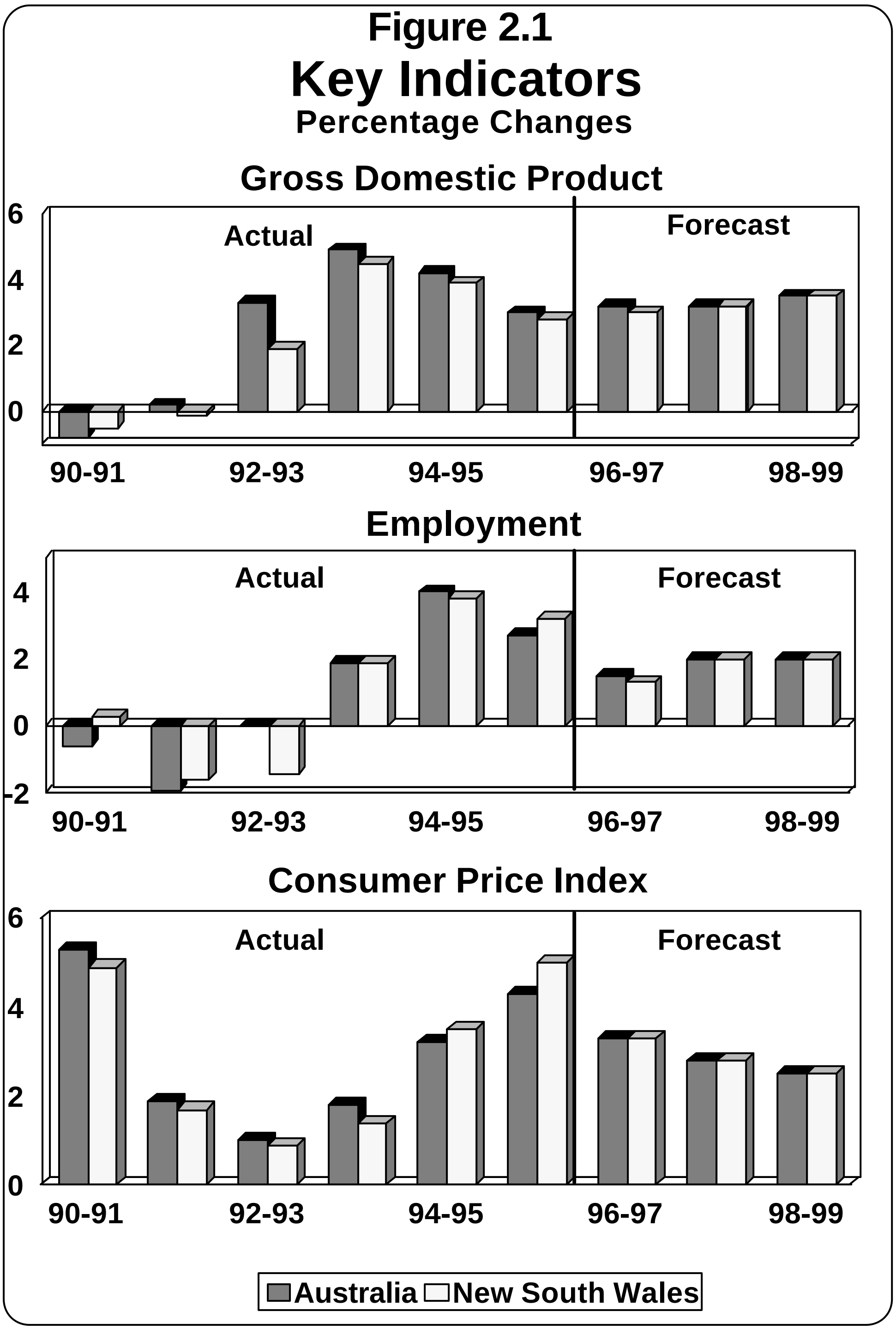
Figure 2.1
Key Indicators
Percentage Changes
Gross Domestic Product
Actual
Forecast
6
4
2
0
90-91
92-93
94-95
96-97
98-99
Employment
Actual
Forecast
4
2
0
-2
90-91
92-93
94-95
96-97
98-99
Consumer Price Index
Actual
Forecast
6
4
2
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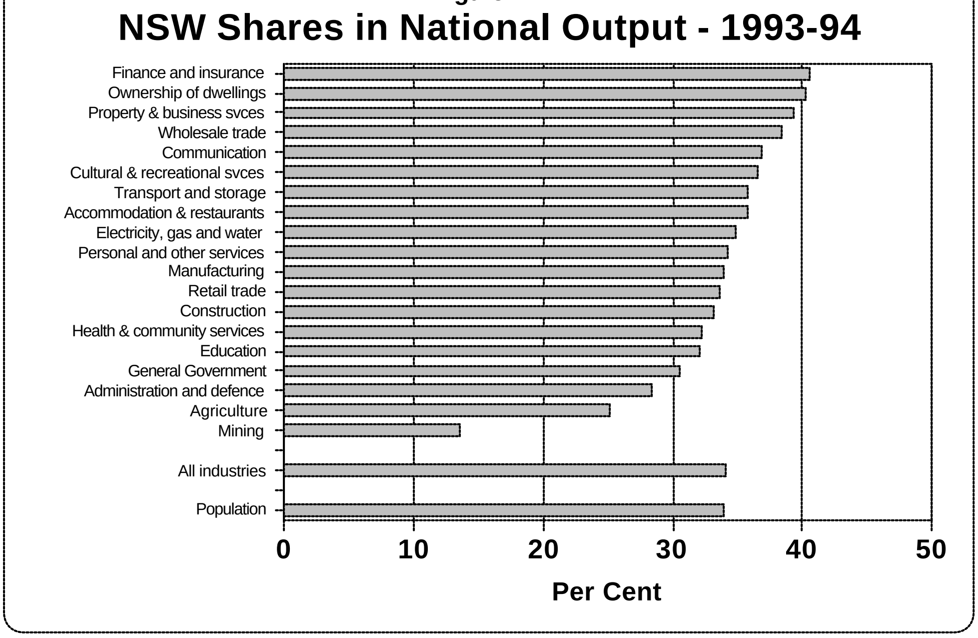
90-91
92-93
94-95
96-97
98-99
Australia
New South Wales

Figure 2.2



The composition of the economy within the broad industry sectors is also very important. Manufacturing, for example, is less dominated in New South Wales than in some other States by those components most adversely affected by industry reform and restructuring, such as motor vehicles and textiles.

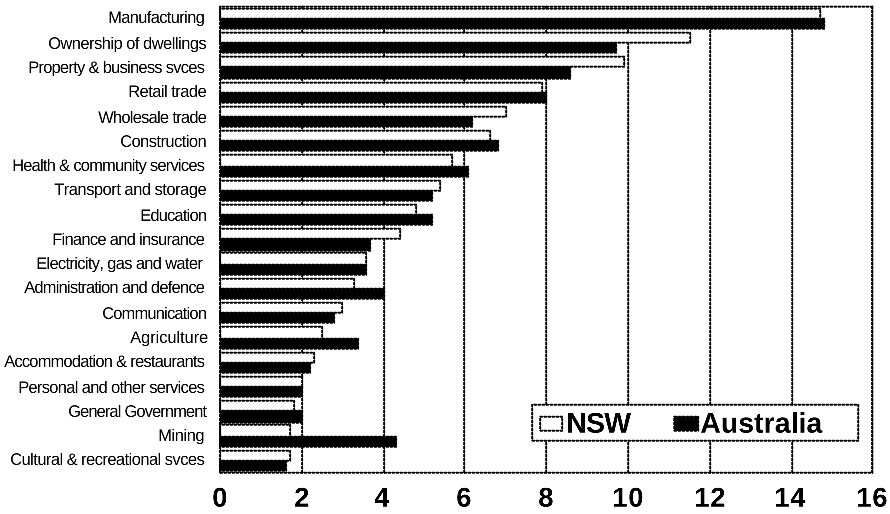
One of the most significant developments for the national economy over recent years has been the increase in international trade. Merchandise exports grew by 7.3 per cent per year in real terms between 1984-85 and 1994-95, and are now equal to 17 per cent of national output compared with 11 per cent 10 years ago. Exports of services are equal to 4.5 per cent of output.

Correspondingly, the NSW economy has also become increasingly open with international exports of goods and services growing at a similar rate to the national average, although overseas trade is relatively less important to the State than the national average. However, because the States trade with each other as well as other countries, the State economies are more open than the international trade data alone suggests. The ABS estimates that in 1994-95 NSW interstate exports (including foreign imports destined for other States that enter Australia via New South Wales) were equal to 20.4 per cent of NSW output, and NSW overseas exports were equal to 14.8 per cent of NSW output.

An important consequence of this trend is that the NSW economy is increasingly affected by the strength of other economies, both overseas and interstate, and therefore by factors well beyond local influence.

Figure 2.3

Industry Shares in Total Output - 1993-94



Sources of Uncertainty

Any set of economic forecasts is subject to uncertainty, and therefore subject to a number of caveats. The following qualifications should be borne in mind when interpreting the forecasts contained in the following sections -

- Aligning the Budget with the start of the financial year and the Budgets of other Australian governments has many clear benefits. However, the earlier timing does make the forecasts for the economy subject to greater uncertainty than previous Budgets. The available data is necessarily more limited. For example, State and National Accounts data is only available for the first two quarters of 1995-96.

- Much of the data that is available and influences the forecasts will be subject to revision. Such revisions have on past occasions been sufficiently large to have required a re-interpretation of the path taken by the economy in the recent past.

- The quality of much of the State Accounts data is significantly poorer than National Accounts data, because of larger sampling errors, data availability, and for conceptual reasons. The ABS categorises its real GSP estimates as *experimental* to reflect their imprecision. Therefore the significance of GSP trends, whether actual or forecast, should not be overstated.

- The forecasts require assumptions regarding events which are themselves very uncertain, such as the outlook for the world economy, future wages outcomes and the industrial relations climate, and the Commonwealth Government's fiscal strategy.

- The relationship between the economy and Budget outcomes is imprecise, and therefore the implications of changes in the forecasts for the economy on the Budget cannot be precisely determined.

Nevertheless, there is some scope for assessing the possible magnitude of the impact on the Budget of changes in some of the economic parameters, as discussed in section 2.4.

2.2 ECONOMIC TRENDS

Due to the timing of this Budget, the information utilised in this section is limited for the most part to data covering the period to the end of the December 1995 quarter.

NATIONAL AND STATE OUTPUT

Real GDP(I) growth fell from 4.9 per cent in 1993-94 to 4.2 per cent in 1994-95. Annual growth in the first half of 1995-96 declined to 2.6 per cent. Partial indicators since the turn of the year suggest that growth probably slowed further during the March 1996 quarter. Business expectations surveys, however, suggest that the economy may turn out to be a bit stronger in the June quarter.

Relative to Australia, NSW GSP growth in 1994-95 of 3.9 per cent appears to have been adversely affected by the drought. Annual growth in GSP in the first half of 1995-96 was reduced to 2.4 per cent, with reasonably solid State Final Demand offset by a weaker international merchandise trade performance. For 1995-96 as a whole, GSP is estimated to increase by 2.8 per cent, marginally below the expected GDP growth of 3 per cent. However the expected growth in NSW State Final Demand of 2.6 per cent is more than half a percentage point above the expected growth in Gross National Expenditure.

Labour market

Growth in demand for labour reached a peak in the first half of 1995 with an increase of 1.3 per cent in the June quarter. However, by the first quarter of 1996 employment growth had flattened to 0.1 per cent. The national unemployment rate fell to 8.4 per cent in the June quarter 1995, down 1.6 points from its level a year earlier, but then remained flat through the March quarter 1996. Leading indicators suggested a rebound in the labour market was unlikely before the end of 1995-96.

Employment growth was stronger in the State than the national average during the second half of 1995, averaging 1 per cent per quarter compared to 0.4 per cent nationally. In the first quarter of 1996, however, NSW employment growth flattened, as it did around the nation. Employment growth in New South Wales in 1995-96 is expected to end up around 3 per cent, exceeding the national average by about half a percentage point.

Wages

Adult ordinary time pay (AWOTE) growth accelerated during 1994-95 and 1995-96, peaking at an annual rate of 5.1 per cent in seasonally adjusted terms in the September 1995 quarter before slowing to 4.2 per cent in the March 1996 quarter. However the adult ordinary time measure may have been biased upward by the restructuring of pay packages within enterprise bargaining agreements and may not reflect compositional changes in the work force. Average total weekly earnings of all employees increased by only 2.8 per cent in the year to March 1996.

Wage growth in the State moved above the national average during 1994-95, and remained about 1.5 percentage points higher than Australia in the December 1995 quarter. Strong growth in employment and output in some sectors of the NSW economy was one factor explaining this. Wages are expected to grow more moderately both nationally and in New South Wales during the second half of 1995-96, reflecting a weaker labour market.

Prices

Headline inflation (CPI) accelerated from 1.8 per cent in 1993-94 to 3.2 per cent in 1994-95 and was 3.7 per cent in the year to March 1996. Headline inflation is expected to average 4.3 per cent for 1995-96 as a whole. The "underlying" inflation measure (which excludes mortgage interest charges amongst other things) rose by about 1 percentage point less than the headline rate in 1994-95 and is expected to increase by about 3.3 per cent in 1995-96.

Inflation in New South Wales was lower than in Australia in 1993-94 and was close to the national average in 1994-95. However headline CPI growth was higher in the State in each of the four quarters to March 1996 and is expected to be 5 per cent for the 1995-96 year, about 0.7 of a point above Australia.

Balance of Payments

Australia's current account deficit peaked in 1994-95 at $27.6 billion. Imports were driven up by the surge in business investment while export growth was constrained by the drought.

In the first eight months of 1995-96 the current account deficit averaged 19.2 per cent lower than in the previous year, helped by the slowdown in investment, the recovery from the drought, and by improving terms of trade. Commodity prices in February 1996 were 5 per cent higher than at the beginning of the financial year in foreign currency terms. For 1995-96 as a whole, the current account deficit is expected to total around $22 billion or 4.6 per cent of GDP.

Interest rates

After a 2.75 point tightening in monetary policy in the first half of 1994-95, the RBA cash rate was held steady over the next 12 months, and is expected to stay unchanged for the remainder of 1995-96, given that inflation remains near the upper limit of the RBA target range (of 2 to 3 percentage points over a run of years).

Australia's long term interest rates are set in world capital markets, and reflect expectations for world inflation and demand for capital, plus a premium for Australia's own inflation performance and risk. From a peak of 10.5 per cent in 1994 10-year bond rates fell steadily to 8 per cent by the end of January 1996, reflecting weakening economic growth abroad plus firm domestic monetary policy. This trend came to an abrupt end in early 1996 when markets became convinced that world output growth and inflation were about to accelerate. Bond rates in Australia quickly went back up to around 8.5 - 9.0 per cent, about the same level at which they started the financial year.

Exchange rates

Following a steep decline in 1994-95, Australia's trade weighted exchange rate index (TWI) recovered quickly early in 1995-96. The exchange rate was also helped by the growing short-term interest rate differential in favour of Australia as the RBA chose not to follow several other OECD countries in easing monetary policy. The TWI went through a second strong upsurge in the first half of 1996 following an upward revision in market expectations for world economic growth and demand for Australian commodity exports.

Revisions to 1995-96 Forecasts

Table 2.1: Comparison of Forecasts for 1995-96

(Annual Average Percentage Change)

	1995-96 Budget	1996-97 Budget	Actual First Half Year
	%	%	%
National GDP(I)	3.2	3.0	2.6 (1)
NSW GSP	3.7	2.8	2.4 (1)
NSW Employment	3.0	3.0	3.7 (2)
Sydney CPI	4.3	5.0	5.4 (2)

(1) First two quarters of 1995-96 compared to same period of 1994-95.
(2) First three quarters of 1995-96 compared to same period of 1994-95.

As Table 2.1 shows, the outcomes for 1995-96 that are expected at present are somewhat different from the forecasts in the 1995-96 Budget.

- The 0.2 per cent downward revision to GDP reflects recent trends across a range of indicators including GDP in the first half of the year, the labour market, leading indicators of dwelling construction, and business confidence surveys.
- The downward revision in NSW GSP reflects a downward revision in growth estimates for the 1994-95 base year, results in the first half of 1995-96, and a smaller than expected boost from the drought recovery.
- ABARE estimates that NSW crop production will be almost 150 per cent higher in 1995-96 crop year (against 64 per cent for the rest of Australia), and the ABS reports that dwelling construction fell only 5.1 per cent in the State through the first half of 1995-96 (compared to 19 per cent in the rest of Australia). Nonetheless as GSP growth has been less than GDP growth in the first half of the financial year, these factors appear to have been offset by other factors.
- The upward revision in the Sydney CPI reflects the performance in the first three quarters of the 1995-96 financial year.

Estimates for the 1995-96 Budget outcomes are based on these expected outcomes for the economy.

2.3 ECONOMIC OUTLOOK FOR 1996-97 ONWARDS

The estimates and forecasts for the main economic aggregates that underlie the 1996-97 Budget and forward estimates are shown in Table 2.2.

Outlook for 1996-97

The outlook for economic growth in 1996-97 is a little more optimistic than forecast at the time of the 1995-96 Budget. Growth in output is anticipated to continue to pick up somewhat as the year continues, though employment growth is expected to be lower than in 1995-96. However, the outlook for inflation is more favourable than for 1995-96, and the economy should end the year well positioned for sustainable higher growth in the remainder of the decade.

- Nationally, economic growth is expected to increase slightly to 3.2 per cent in 1996-97 from 3.0 per cent in 1995-96;
- There is likely to be a shift in the composition of growth, from public to private final demand, reflecting strong business investment and the priorities of the new Federal Government;
- Growth in employment in 1996-97 is expected to be weak, at around half the 1995-96 rate;
- Inflation in 1996-97 should decline as measured by the headline Consumer Price Index, but will remain steady in underlying terms;
- NSW output growth is likely to be slightly less than the national average in 1996-97;
- NSW employment growth is expected to be slightly below the national rate in 1996-97 following a year of relatively strong growth compared to Australia in 1995-96.

The critical assumptions which present risks to the achievement of the forecast outcomes include the prospects for the world economy, the outlook for wages and industrial relations and the impact of the new Federal Government’s budget measures on economic growth. These factors are discussed at the end of this section, and an analysis of the possible implications of changes to some critical assumptions is contained in section 2.4.

Table 2.2: Economic Performance and Outlook(1)

	1994-95	1995-96(e)	1996-97(f)	1997-98(f)	1998-99(f)
1. ECONOMIC OUTPUT(2)					
Income Based GDP	4.2	3.0	3.2	3.2	3.5
Private Consumption	5.0	3.6	2.7	2.5	2.6
Private Dwelling Construction	4.0	(-) 12.5	(-) 3.0	10.0	8.0
Business Sector Investment	17.5	6.9	8.2	7.9	9.2
Public Final Demand	5.5	1.3	0.8	1.1	3.2
Gross National Expenditure	6.6	2.0	2.7	3.0	4.0
Exports	3.2	8.3	9.0	8.4	8.2
Imports	17.7	3.8	7.0	7.8	10.3
2. CURRENT ACCOUNT ($b)(3)	(-) 27.6	(-) 22.0	(-) 20.6	(-) 24.3	(-) 27.0
Per cent of GDP	(-) 6.1	(-) 4.6	(-) 4.1	(-) 4.5	(-) 4.7
Net Foreign Debt ($b)(4)	180.6	186.8	202.3	217.8	222.0
3. Prices					
National CPI Index	3.2	4.3	3.3	2.8	2.5
C'wealth Treasury "Underlying" CPI	2.1	3.3	3.3	2.9	2.7
Non-Farm GDP Deflator	1.4	2.8	2.0	3.1	2.4
Terms of Trade	4.5	3.1	1.3	0.2	(-) 0.1
4. Wages:(5)					
Survey AWE (full time adult)	4.5	4.5	4.3	3.2	3.5
National Accounts AWE	1.8	4.5	4.5	3.1	3.3
5. National Employment	4.0	2.6	1.5	2.0	2.0
Unemployment Rate(6)	8.9	8.5	8.5	8.1	7.9
6. Financial Variables(4)					
Interest Rates: 90-day bills	7.7	7.5	7.5	7.5	7.5
10-Year Bonds	9.3	8.7	8.6	8.3	8.2
Mortgages(7)	10.5	10.5	10.5	10.4	10.4
Exchange Rates: $US/$A Rate	71.7	79.3	77.9	78.5	78.2
TWI Index	49.2	58.7	56.4	56.9	56.5
7. New South Wales					
Output (Gross State Product)(2)	3.9	2.8	3.0	3.2	3.5
Private Consumption(2)	4.5	4.1	2.5	2.5	2.6
Private Dwelling Construction	8.1	(-)10.0	(-)0.5	10.0	8.0
Business Sector Investment(2)	24.6	6.9	8.2	7.9	13.3
State Final Demand(2)	6.8	2.6	2.7	3.3	4.4
Employment	3.8	3.0	1.3	2.0	2.0
Unemployment Rate(6)	8.6	7.9	7.9	7.8	7.6
Inflation (Sydney CPI)	3.5	5.0	3.3	2.8	2.5
Wages AWE (full time adult)(5)	5.7	6.1	4.3	3.2	3.5

(1) All figures are annual average rates of change unless otherwise indicated.
(2) Growth in real (constant price) terms.
(3) Current $.
(4) Levels in June quarter, current $.
(5) Growth in nominal (current price) terms.
(6) Average for financial year.
(7) Predominant bank variable rate.
(e) Estimate.

(f) Forecast.

Prospects for New South Wales

In 1996-97 NSW growth is forecast to be slightly below the national average. This is largely because -

- New South Wales does not benefit from a favourable commodity outlook to the same extent as some other States; and
- over the long term, NSW annual output growth has averaged about a quarter of a percentage point or so below national growth, in part because annual population growth in New South Wales averages about a quarter of a percentage point below Australia; and this relationship is expected to continue.

Components of Growth

Private Consumption

Following on from a slowdown in growth in 1995-96, private consumption growth is expected to slow further in 1996-97 due to more subdued growth in jobs, relatively low real wage growth, and weaker consumer confidence.

Dwelling Construction

Private dwelling investment is expected to reach a trough during 1996, but growth in the financial year 1996-97 is still likely to be negative in year average terms. The growth trend in private sector housing approvals appeared to remain negative in early 1996, and indications of a turnaround in housing finance commitments remained tentative. The increased upside risks for mortgage interest rates may also dampen demand.

There are a wide range of views on the 1996-97 outlook for dwelling construction. However a useful benchmark is the view of the Indicative Planning Council for the Housing Industry, which expects housing starts in 1996-97 to be only fractionally higher than the depressed outcome for 1995-96, which suggests that the National Accounts result could again be negative.

Business Investment

Business investment growth is forecast to be around 8 per cent in 1996-97 for both Australia and New South Wales, boosted by stronger world growth and the positive outlook for commodities. The composition is likely to shift from non-dwelling construction (new investment growth is expected to slow from 24 per cent in 1995-96 to 10 per cent in 1996-97) to plant and equipment investment (which is expected to accelerate from 1 per cent to 8 per cent). This pattern is consistent with the evidence from the ABS survey of capital expenditure expectations.

As a large proportion of plant and equipment is imported, any increase in this component of business investment is substantially offset by import growth, leaving a relatively small net addition to domestic growth in the short term.

Business investment is one of the most volatile components of GDP growth (fluctuating between a low of -14 per cent and a high of +17.5 per cent over the last six years), and hence one of the most uncertain. A change in business and consumer confidence could lead to business investment growth outcomes different to those forecast. One factor that is likely to have a significant impact on business confidence will be the rate of world growth flowing through to commodity prices, as this will influence expectations of the profitability or otherwise of investment projects in the Australian resources sector.

Wage pressures have tended to erode profit shares in GDP recently, and the upswing in interest rates has increased investment costs. In addition, to the extent that the rising exchange rate experienced in early 1996 is expected to be maintained, this will tend to lower the competitiveness of investments in Australia. These considerations present down side risks to the forecasts.

Public Final Demand

The contribution to growth from public final demand is expected to be negligible in 1996-97, in part as a consequence of the Commonwealth government's announced intentions of cutting $4 billion off the Commonwealth budget result in each of the next two years. There is uncertainty about the size and impact of the cuts that will be achieved. In any case most of the States and Territories are expected to maintain tight budget strategies over the next few years.

Foreign Trade

Australia's export growth is expected to strengthen slightly in 1996-97, but with imports expected to grow at almost twice their growth rate in 1995-96 the improvement in the trade balance is expected to be less than that in 1995-96. The net contribution of foreign trade to GDP growth is therefore expected to decline from 1 point in 1995-96 to 0.5 points in 1996-97.

Some of the appreciation in the $A that has occurred in the first quarter of 1996 is expected to be maintained through 1996-97, given an expectation of higher global commodity prices. The prospects are favourable for grains, coal, iron and some metals. The short term outlook for wool, sugar and beef on the other hand is less promising.

Higher commodity prices will be beneficial for export earnings. On the other hand, a higher dollar will offset some of those gains to commodity exporters, and will unambiguously reduce the competitiveness of non-commodity exporters as well as domestic producers competing with imports. The higher terms of trade, however, will augment the real income of Australian consumers, thereby raising final demand, other things being equal.

Inventory Investment

Slower growth in final demand has led to a downward adjustment in private sector inventory targets, detracting an estimated 0.2 points from GDP in 1995-96. With the recovery in demand in 1996-97, however, inventory accumulation is likely to recover and is expected to make a 0.1 point positive contribution to growth nationally.

The Labour Market

The labour market was flat in the first quarter of 1996 and leading indicators of employment offered little prospect of any significant pick up over the remainder of the calendar year. Even if employment growth were to accelerate from the start of 1997, the year average outcomes for 1996-97 are likely to be well down from the previous year.

Wages and Prices

The forecasts for the national economy provide for surveyed average weekly earnings growth to slow marginally to 4.3 per cent in 1996-97 from 4.5 per cent in 1995-96. There is expected to be a larger fall in wages growth in New South Wales from over 6 per cent to under 4.5 per cent.

With the expected moderation of wage pressures on prices, and the forecast rate of demand growth being well below the sustainable rate of growth, it is likely that the increase in the headline CPI in 1996-97 will be lower than 1995-96 both nationally and in New South Wales. Consistent with this, the underlying CPI will be steady. However, there are some significant risks to both the wage and price forecasts from the industrial relations climate, discussed below.

Major Risk Factors

Economic Outlook for the World's Major Economies

The outlook for the Australian and NSW economies is strongly influenced by the outlook for the world's major economies, in particular the United States, Japan, South-East Asia, and Europe. This is mainly because the Australian economy is relatively open, and relatively small, and quite dependent on the strength of various global commodity markets.

Underlying the forecasts for the Australian and NSW economies and consistent with the most recent forecasts of the IMF, is the expectation that world economic growth in 1996 will be a little stronger than 1995, followed by a stronger acceleration in 1997. For both the United States and the European Union, growth in 1996 is expected to be very moderate and lower than in 1995, but will accelerate again to around 2.5 per cent in 1997. However, Japan is expected to enjoy a reasonable recovery in 1996 with growth a little over 2.5 per cent, which will be sustained into 1997. While there is expected to be some slow down in the rates of growth of the South East Asian economies and China, rates of growth through to the end of 1997 will remain very strong compared to Western Europe, the US and Japan. If the inflationary fears which drove up bond rates in early 1996 linger, there may be little moderation in interest rates during 1996-97.

Substantial uncertainty surrounds the outlook for the world's major economies, and hence this assessment. Given that the assessment above is quite positive, the greater risks appear to be on the downside although that view could easily change quite quickly.

- **Industrial Relations**

The election of a Coalition Government has brought about the demise of the Wages and Prices Accord, and the new Government has indicated its intention to change the federal industrial relations system. This raises the prospect of conflict between the labour movement and the Commonwealth. These factors significantly raise the risk to the forecasts for 1996-97 and beyond while the parties test the limits of their bargaining power in a more deregulated environment.

A significant wages break-out would lead to higher inflation than forecast, and provoke a tightening of monetary policy which would reduce the rate of growth. Furthermore, the interruptions to production caused by industrial unrest would imply lower growth. Therefore there is some risk that industrial unrest could lead to a significantly lower rate of growth than that forecast.

- **Fiscal Policy**

The new Commonwealth Government has announced expenditure reductions of $4 billion (which is equal to 0.9 per cent of GDP) in each of 1996-97 and 1997-98.

Cuts of this order of magnitude will be difficult to achieve. In any case, possible Commonwealth cuts in transfer payments aimed at reducing the budget deficit will not directly reduce public final demand. However, such cuts would be expected to reduce household disposable income, and private consumption will be reduced to the extent that the cuts are not absorbed through lower rates of private saving. Furthermore, because of the possibility of there being one off redundancy payments associated with reductions in Commonwealth public sector employment in both 1996-97 and 1997-98, cuts in the underlying budget position may exceed the net cuts on a cash basis in both years.

After allowing for possible slippage from targets, in 1996-97 these cuts could perhaps reduce public final demand by around 0.3 percentage points in GDP below the level that would have been expected in the absence of fiscal consolidation. The impact of the cuts is expected to be somewhat greater in the following year.

The impact of Commonwealth fiscal consolidation on growth has been assumed to be small, with the negative impact of a lower fiscal stimulus offset to some extent by the positive impact on business and consumer expectations.

Medium Term Outlook

Table 2.2 contains forecasts out to 1998-99. The medium term outlook is predicated on the following assumptions -

- economic growth is expected to remain fairly steady in 1997-98 with the gradual growth in world demand, and low rates of inflation helping to keep interest rates down;
- Australia's non-inflationary growth potential over the coming decade will be lifted by microeconomic and competition policy reforms; and
- in the medium term, given the size and diversity of its economy, New South Wales' economic performance is likely to average fairly close to that of Australia as a whole.

2.4 ALTERNATIVE BUDGET SCENARIOS

The revenue and expenditure sides of the Budget are influenced by uncertainty to different degrees. On the revenue side, items which can be quite sensitive to variations in key economic indicators include payroll tax and stamp duties, both very important sources of State revenue. Payroll tax is affected by both employment levels and wage rates. Stamp duty income from contracts and conveyances and share transfers, as well as land tax, are all significantly affected by changes in asset prices and trading volumes, and such changes are difficult to forecast accurately. Other sources of tax revenue such as the amount spent on cars, petrol, alcohol, tobacco and gambling are affected by general economic conditions.

In the short term, the expenditure side of the Budget is relatively insensitive to changes in economic conditions. This is because many expenditure quantities are locked in at the time of the Budget and until such time as budget levels are reviewed for the following year. Nevertheless, changes in wage rates could have some impact on outlays as wages account for a large proportion of recurrent outlays, and an earlier Budget increases the scope for such changes to occur during the Budget year. Changes in interest rates can also have some impact on the cost of servicing the budget sector debt.

There are always a range of different views on the outlook for the economy. For example, the current range of published forecasts for GDP growth in 1996-97 spans a percentage point either side of Treasury’s forecast of 3.2 per cent. However, the range of plausible outcomes extends well beyond the 2-4 per cent band.

Section 2.1 notes the major sources of uncertainty that may ultimately impact on the Budget. Section 2.3 discussed some of the major risk factors associated with the assumptions underlying the economic forecasts: the outlook for the world economy; the outlook for domestic wages, prices growth and industrial relations; and the impact of tighter Commonwealth government fiscal policy. In order to illustrate the potential impact of some of the sources of uncertainty on the Budget outcome, three alternative scenarios are explored: a *high demand*, scenario; a *wage blow-out* scenario; and a *low demand* scenario.

The *high demand* scenario is based on the presumption that either higher world growth increases domestic growth, or that the response of domestic growth to a given rate of world growth is stronger than the base forecast. With GDP growth approaching 5 per cent, supply side and balance of payments constraints will put pressure on prices and interest rates. In the *wage blow-out* scenario, increases in average weekly earnings of almost 7 per cent in parallel with significant industrial unrest, lead to a strong tightening in monetary policy and a significant reduction in demand and output. In the *low demand* scenario, sluggish growth in the US, Europe and Japan coupled with tight fiscal policy lead to very low domestic growth, some softening of wages and prices, flat employment growth, and some loosening of monetary policy.

The alternative scenarios are defined in terms of some key economic parameters that influence the State Budget, with the deviations from the base forecast given in Table 2.3. The values in Table 2.3 represent the average deviations over a twelve month period. The alternative budget outcomes given in Table 2.4 are given on the basis of *no* explicit revenue or expenditure response on the part of the State government compared to policy under the base forecast.

While the expected underlying budget outcome is for a surplus of $5 million, under the *high demand* scenario the outcome could easily be a surplus of $220 million, or under the *wage blow-out* scenario the budget outcome could be a deficit as high as $320 million. These are not confidence limits or alternative forecasts, but are intended to indicate some of the possible sources of deviation from the base case and potential magnitudes.

Table 2.3: Economic Scenarios

	Budget Estimates	Growth Rates - Change on Budget Estimate		
		High Demand	Wage Blow-out	Low Demand
	%	% points	% points	% points
Aggregate Demand (GSP)	3.0	+ 1.6	(-) 1.5	(-) 1.5
NSW Employment	1.3	+ 1.0	(-) 1.5	(-) 0.5
Wages (AWE)	4.3	+ 1.0	+ 2.5	(-) 1.5
Budget Sector Wages	3.0	0	+ 1.5	(-) 0.5
Consumer Prices (Sydney)	3.3	+ 0.5	+ 2.0	(-) 0.5
90-Day Bill Rate	7.5	+ 1.0	+ 2.0	(-) 1.0
10-Year Bond Rate	8.6	+ 1.0	+ 1.0	(-) 1.5

The *wage blow-out* scenario is particularly bad for the Budget because the expenditure side of the Budget is increased without any compensating offsets on the revenue side (note that the positive impact of higher wages on payroll tax receipts is offset by the negative impact of lower employment). However, the *low demand* scenario is not so bad because even though there is a big fall in revenues, it is offset to some extent by lower expenditures. The *high demand* scenario is very favourable for the Budget because revenues are increased without a significant growth in outlays.

Table 2.4: Alternative Budget Outcomes

	Budget Estimates	Change on Budget Estimate[2] High Demand	Wage Blow-out	Low Demand
	$m	$m	$m	$m
Current Financial Result	2,243	+ 235	(-) 267	(-) 146
Outlays	19,246	+ 47	+ 265	(-) 131
Receipts	21,490	+ 282	(-) 2	(-) 277
Tax	11,284	+ 201	(-) 47	(-) 199
Non-tax	10,206	+ 81	+ 45	(-) 78
Capital Financial Result[1]	(2,238)	(-) 20	(-) 60	+ 23
Outlays[1]	3,175	+ 25	+ 80	(-) 31
Receipts	937	+ 5	+ 20	(-) 8
Total Result[1]	5	+ 215	(-) 327	(-) 123

(1) Results shown are net of equity restructure payments from Non Budget sector agencies.
(2) Values should be added to budget estimate to give a revised budget estimate.

These scenarios demonstrate the point that the budget outcome is the difference between two very large values (total outlays and total receipts both exceed $20 billion), and a given outcome can be achieved in many different ways. Moreover, the composition of the revenue side in particular could be somewhat different from that in the base forecasts.