CHAPTER 1 OVERVIEW OF STRATEGIC DIRECTION AND ENVIRONMENT

1.1 GOVERNMENT FINANCIAL MANAGEMENT FOCUS

The Government is committed to delivering the services required by the community while strengthening the state's financial position. In keeping with this commitment, the Government's overall strategy is aimed at ensuring:

- Economic development and jobs;
- Social justice;
- Environmental protection; and
- Improved financial performance.

The 1999-2000 NSW Budget provides for a substantial operating surplus while delivering improved services to the community and reducing the State's overall tax burden.

The Government will improve the quality of services it provides to the community by:

- Continuing to improve coordination between agencies
- Reshaping and improving government structures
- Supporting rural and regional community initiatives
- Effective use of information technology

The Financial Result

The General Government Sector is expected to record an operating surplus of $2,097 million for 1999-2000, compared with an expected surplus of $2,259 million for 1998-99.

General Government net worth (ie total assets less total liabilities) is expected to increase from $33,714 million at 30 June 1999 to $35,877 million at 30 June 2000.

The Budget includes a number of capital investment initiatives that will continue to enhance the quality of the State's infrastructure.

The Budget assumes a modest growth in current outlays from $22,162 million projected in 1998-99 to $22,447 million in 1999-2000[2]. This reflects the Government's commitment to get good value for money from expenditure on services.

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[2] *Adjusted for impact of the Superannuation conversion offer*

1.2 FISCAL STRATEGY STATEMENT

Introduction

In previous years, the Government has included a *Budget Strategy* or *Budget Policy Statement* in Budget Paper No. 2. As from the 1999-2000 Budget this will be replaced with a *Fiscal Strategy Statement*, recognising the broader context in which the Budget has been developed. This statement elaborates on the contribution that the Government's financial management policies are making to the development of the New South Wales economy, and job creation in particular.

The Government's fiscal strategy has at its foundations the *General Government Debt Elimination Act*, 1995.

Box 1.1: Fiscal Principles and Targets in the Debt Elimination Act

1 Adherence to fiscal targets:

- short-term fiscal target – achievement of sustainable surplus budget by 1998-99;
- medium-term fiscal target – reduce General Government Sector net debt to a sustainable level by 30 June 2005; and
- long-term fiscal target – eliminate General Government Sector net debt by 30 June 2020.

2 Maintaining or increasing General Government Sector net worth.

3 Funding employer superannuation contributions.

4 Asset maintenance.

5 Constrained growth in net cost of services and outlays.

6 Prudent risk management.

7 Tax restraint.

Medium-Term Fiscal Strategy

The *Debt Elimination Act* targets zero net debt by 2020. At this stage, a medium-term fiscal strategy is being pursued that is consistent with that long-term goal and the other targets and principles of the Act (see Box 1.1).

A Medium-Term Fiscal Rule

The medium-term fiscal rule now being applied in New South Wales is that the Budget should be at least balanced (on a GFS cash basis) over the course of a full business cycle. Adherence to this rule ensures that budget transactions do not add to net debt over the medium-term.

This rule recognises the need to take into account the business cycle as well as underlying trends. The impact of the business cycle on both revenue and outlays means that in any year the budget outcome is influenced by the position in the cycle. In New South Wales, the Budget is also strongly affected by the cycle in property-related revenues. Therefore, in targeting budget outcomes consistent with the medium-term fiscal strategy, it is necessary to allow for cyclical influences. While budget surpluses are expected when the economy is strong, when the economic cycle turns down, small budget deficits would still be consistent with the medium-term rule.

The Medium-Term Targets

The Act specifies June 2005 as the medium-term target date. If the Budget were balanced on average in the six years to 2004-05, General Government net debt would be $10 billion or 3½ percent of Gross State Product (GSP) at the end of the period (leaving aside the effects of extraordinary transactions such as the proposed superannuation conversion offer[3]).

However, in the favourable economic climate projected to 2002-03, the medium-term fiscal rule calls for significant budget surpluses. For the budget and forward estimates years, surpluses averaging almost $600 million, or around 0.25 percent of GSP, are projected. General Government net debt is projected to shrink to $7.8 billion or 2.9 percent of

[3] *See Chapter 5 for details.*

GSP by June 2003. If the favourable economic climate and the surpluses were to continue beyond that point, net debt would decline further to around 2¼ percent of GSP by June 2005, the medium-term target date specified in the Act.

The maintenance of surpluses in the medium-term is reinforced by the following considerations:

- In looking beyond the medium-term there will be significant pressures on the Budget, including those associated with changing social and demographic factors, and technological change. Recent work undertaken by the OECD[4] demonstrates the scope for demographic factors to put pressure on government budgets. Technological advances are increasing the scope for economic transactions to be moved between jurisdictions. This could place some pressure on government revenue bases;

- Improvements in the net financial assets position of the General Government Sector amount to an improvement in public sector saving. The longer term need to increase national saving and restrain current consumption has received much attention in recent years. The benefits of higher public sector saving can also be much more immediate, as recently demonstrated by the resilience of the Australian economy to external shocks. While the New South Wales Budget alone does not have a substantial influence on national saving, it comprises a substantial part of the overall public sector contribution; and

- Medium-term targets need to be framed with reference to the *long-term fiscal target* of eliminating net debt in the General Government Sector by 2020. This suggests that some reasonable progress needs to be made in reducing levels of net debt over the medium term.

The main benefits of adhering to the medium-term fiscal targets will be:

- The reduction in interest costs at a given interest rate. The interest bill on General Government Sector debt was substantially reduced in

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[4] *OECD Economic Surveys, 1998-99, Australia*

1998-99 with the use of the $1.1 billion TAB sale proceeds to pay off debt. This lowered the annual interest bill to around $1.3 billion (net of the temporary additional debt costs associated with the superannuation conversion offer). But this is still around five percent of Budget receipts. Further reducing debt will free up additional resources for service provision and/or provide scope to reduce the tax burden, and at the same time decrease the exposure of the Budget to economic downturns;

- Stronger budgetary resilience in the face of shocks. At the projected levels of net debt, the Budget will be more resilient to a cyclical economic downturn, such as that of the early 1990s;

- Greater flexibility to respond to the budgetary implications of demographic and other structural shifts. Even though such influences are likely to impact over a longer timeframe than that covered by the current forward estimates, if they are not recognised in setting medium-term targets, future policy options will become much more constrained; and

- Ensure New South Wales strengthens its AAA rating, which will help attract business investment to the State and minimise interest expense.

Tax and Expenditure Restraint

The medium-term strategy requires that surpluses be achieved through expenditure restraint rather than overall tax increases. Indeed, the strategy allows for net tax reductions with the objective of enhancing the climate for business investment and employment growth in New South Wales. The Commonwealth Grants Commission's measures of tax effort show that the tax burden in New South Wales has been above the average of other States since the late 1970s, the whole of the period for which a measure has been published. The Government's objective is to close the gap over the medium-term. The first step in this direction is being made in this Budget and further tax reductions have been foreshadowed and allowed for in the forward estimates.

The targets for debt and tax reduction require a reduced rate of growth in expenditure in future years. In the ten years to 1998-99, outlays grew at an average rate of 2.5 percent in real terms. Over the next four years, aggregate outlays are projected to grow at an average annual rate of just under two percent in nominal terms. It is particularly important to restrain growth in recurrent outlays, as increases in one year have similar sized impacts on the budget outcome in future years. Recurrent outlays constitute 85 percent of total outlays and have dominated the growth of total outlays in recent years.

The single most significant recurrent expense relates to employee costs. The public sector wage agreements that have been in place over the past two or three years have led to significant real wage increases, mostly in the 10 to 14 percent range. This has put NSW public sector wages at, and in most cases above, the other States. Now, with NSW public sector pay at competitive levels, the Government expects only moderate wage growth in the coming years.

The planned expenditure restraint will achieve financial objectives without compromising the quality of government services. Standards, as measured by the Commonwealth Grants Commission's index of service provision, have risen in New South Wales relative to the other States during the 1990s. The medium-term strategy emphasises productivity growth and other financial management improvement techniques to maintain service provision at a high level without strong growth in expenditure.

A Broader View of the Balance Sheet [5]

While the emphasis above is on General Government Sector net debt, the medium-term fiscal strategy has a broader focus that encompasses other General Government Sector balance sheet items and, more broadly, Total State finances.

The biggest non debt liabilities on the General Government Sector balance sheet are employee entitlements (dominated by the unfunded superannuation liability) and insurance liabilities.

The very favourable reaction of the financial markets to the superannuation conversion offer demonstrates that the State’s unfunded superannuation

[5] *Balance sheets are labelled* Statement of Financial Position *in these Budget Papers.*

liability is seen as imposing the same sorts of policy constraints as State debt. Indeed, in dollar terms the unfunded superannuation liability has been slightly larger than net debt in the past few years.

Insurance liabilities are also of a significant magnitude (exceeding $3 billion), and with recent deteriorating trends in some areas, will require careful management. The Insurance Ministerial Corporation has net liabilities of around $400 million largely associated with unfunded closed schemes (the Transport Accidents Compensation Fund and the Governmental Workers Fund). In addition, the increasing costs of workers compensation under the coverage of WorkCover flow on to the liabilities associated with workers compensation claims in the government sector which are self-insured. This is increasing liabilities even though the self-insurance scheme has out performed the WorkCover scheme.

The assets side of the General Government Sector balance sheet is dominated by non-current assets, principally land and buildings and infrastructure systems. An important part of the Government's overall fiscal strategy is the proper management and maintenance of these physical assets.

Where such non-current assets do not produce a cash-flow and cannot be rapidly liquidated, they are defined as *non-financial assets*[6]. The remaining *financial assets* on the balance sheet are exceeded by the gross (financial) liabilities, with the difference being defined as the *net financial liabilities* position, as derived in Table 5.2 in Chapter 5. This is a useful aggregate to focus on, because from a creditor's perspective, non-financial assets will typically not be regarded as a valuable source of collateral.

The main objective in seeking to reduce net debt and unfunded employee entitlements is to lower the *net financial liabilities* of the General Government Sector.

As at June 1998, net financial liabilities of the General Government Sector were $28.8 billion or 14 percent of GSP and are projected to decline to $24.8 billion or 9.2 percent of GSP as at 30 June 2003. Chart 1.1 illustrates the past and projected paths with the projected budget surpluses extrapolated to 2004-05.

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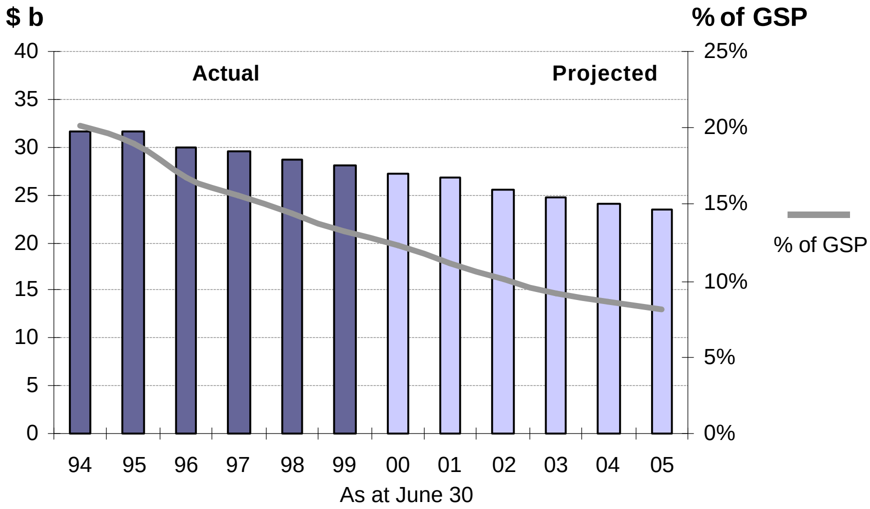
[6] *This term is used on Financial Assets and Liabilities (FALS) balance sheets.*

Chart 1.1: General Government Net Financial Liabilities



Broadening the focus to the Total State requires consideration of the Public Trading Enterprise (PTE) Sector and the Public Financial Enterprise (PFE) Sector.

In contrast with the approach taken in relation to the General Government Sector, the primary emphasis for the PTE Sector is not on managing down aggregate liabilities. This is because, in principle, there is an optimal quantum of debt consistent with a PTE's optimal capital structure. While the contribution that the PTE sector makes to the Total State balance sheet is of great importance, the focus is on strengthening individual PTE's balance sheets rather than reducing liabilities. This requires careful management of physical and other assets as well as liabilities.

A number of PTEs have had their balance sheets restructured in recent years to give them more appropriate capital structures. But because debt and other liabilities can be transferred between sectors, credit rating agencies and other external analysts will regard changes in the Total State's net debt, and broader measures of the Total State's financial liabilities, as important financial indicators. As shown in the following table, both net financial liabilities and net debt for the Total State have been falling and are projected to fall further over the forward estimates period.

Table 1.1: Trends in Liabilities, Total State

	Net Debt $m	*Net Financial Liabilities $m*
Actual:		
1995	19,592	43,846
1996	18,971	44,641
1997	18,758	41,479
1998	18,646	40,897
Estimated:		
1999	21,857 [a]	40,621
2000	20,844 [a]	39,809
2001	19,474 [a]	39,284
2002	17,442	38,198
2003	16,716	37,318

[a] *Total State net debt is temporarily increased in these years to fund the superannuation conversion offer.*

When non-financial assets such as land and buildings are sold to the private sector, this further reduces the net financial liabilities of the Total State, and typically also of the General Government Sector.

The PFE Sector in New South Wales is very small relative to the other sectors, and dominated by the NSW Treasury Corporation (TCorp). TCorp operates as a commercial entity, and best practice corporate finance principles are applied to the management of its balance sheet.

Recent Performance

This section provides the *Budget Policy Statement* for the 1999-2000 Budget as required under the *General Government Debt Elimination Act*.

Section 21 of the Act requires a statement providing details on the following matters:

- an assessment of progress achieved against the fiscal targets and seven fiscal principles set out in the Act;
- projection of the ability to achieve fiscal targets in the future and to ensure the achievement of fiscal principles; and

- three-year projections of all relevant economic and financial variables.

The latter are given in Tables 1.8 and 1.9 in this Budget Paper.

Progress Against Fiscal Targets and Principles

1. Adherence to Fiscal Targets

The short, medium and long-term fiscal targets specified in the Act are given in Box 1.1.[7]

For 1998-99 and later years, the projections in the following table indicate that the *short-term fiscal target* is being met.

Table 1.2: Budget Results, 1996-97 to 2002-03 (GFS cash basis)

1996-97 $m	*1997-98 $m*	*1998-99[(a)] $m*	*1999-2000[(a)] $m*	*2000-01[(a)] $m*	*2001-02[(a)] $m*	*2002-03 $m*
151	(29)	382	214	363	976	766

(a) After adjusting for the superannuation conversion offer.

In particular, the projections show a strong growth in General Government Sector surpluses in later years. This growth in surpluses reflects restraint in current outlays growth and the passing of Olympic Games costs, which peak from 1996-97 to 1999-2000. The substantial increases in the surpluses after 1999-2000 reflect, in part, the completion of major venue construction. Some of the improvement in the surplus from 2000-01 to 2001-02 reflects the inclusion in 2000-01 of substantial Government service costs for the Olympics.

As noted in the discussion of the medium-term fiscal strategy, the above projections for the GFS cash outcomes are consistent with the *medium-term target*.

[7] *The Act specifies targets on a GFS cash basis.*

The medium-term target, in turn, represents progress towards the *long-term target.* Projections for General Government Sector net debt based on the Budget forward estimates, shown in Table 1.3, demonstrate this progress.

Table 1.3: General Government Sector Net Debt

Year	*$m*
Actual:	
1994	12,327
1995	11,904
1996	10,342
1997	10,605
1998	10,120
Estimated:	
1999	12,896 [(a)]
2000	11,883 [(a)]
2001	10,513 [(a)]
2002	8,481
2003	7,755

[(a)] Net debt is temporarily increased in these years to fund the superannuation conversion offer, offset by corresponding falls in the unfunded superannuation liability.

2. General Government Sector Net Worth

Net worth is defined as *total assets* less *total liabilities.* The relevant fiscal principle in the Act is to ensure the net worth of the General Government Sector is at least maintained in real terms. Trends in the net worth of the general government sector are set out in Table 1.4.

Table 1.4: Trends in Net Worth

30 June	*Assets $m*	*Liabilities $m*	*Net Worth $m*
Actual:			
1996	60,709	39,876	20,833
1997	63,847	39,025	24,822
1998	70,236	38,948	31,288
Estimated:			
1999	70,939	37,222	33,717
2000	72,389	36,500	35,889
2001	73,686	36,014	37,672
2002	76,050	35,894	40,156
2003	78,415	35,913	42,502

The increases in net worth in recent years and those projected will be more than sufficient to maintain net worth in real terms over the next four years. This is a reflection of the policies adopted by the Government to strategically manage its assets and to actively manage its net financial liabilities.

3. Funding Employer Superannuation Contributions

Since 1992, measures have been implemented to gradually phase-in full funding of superannuation liabilities. These included the closing to new entrants of the State Authorities Superannuation Scheme (SASS), a defined benefits scheme, and the development of long-term funding plans to extinguish unfunded liabilities.

Movements in the level of unfunded liabilities are set out in the following table and are discussed further in chapter 5.

Table 1.5: Unfunded Superannuation Liabilities, General Government Sector

As at 30 June	*Unfunded Superannuation Liability $m*
Actual:	
1994[a]	12,250
1995[a]	12,687
1996	12,331
1997	10,949
1998	11,188
Estimated:	
1999	8,056
2000	8,301
2001	9,101
2002	9,904
2003	9,705

[a] *Data for these years relates to the Budget Sector.*

Unfunded superannuation liabilities account for the majority of non-debt liabilities for the General Government Sector (and likewise the Total State sector). The principle of employer funding of superannuation contributions under the Act requires that:

- accruing current service superannuation liabilities should be fully funded for non Budget-dependent agencies (ie. those receiving direct Budget appropriations) and be fully funded for Budget-dependent agencies by 2020; and

- there should be a phased-in funding to eliminate existing past service unfunded liabilities.

The government's long term funding plan will extinguish unfunded liabilities for the general government sector by 2045, and for the PTE and PFE sectors by 2022.

In support of this plan, the Government proposes to offer members of some closed defined benefits schemes, the State Superannuation Scheme and the Police Superannuation Scheme, the opportunity to convert their accrued benefits to lump sums to be transferred to the First State Superannuation accumulation scheme. Further details of this superannuation conversion offer are given in chapter 5. The projections for the unfunded liability in the above table assume a twenty percent take up rate of this offer.

This, and other funding initiatives will result in the smoothing out of superannuation payments. Otherwise, employer payments would consume a disproportionately high level of Budget outlays in future decades.

Based on latest actuarial projections and trends, the accruing General Government Sector liability is being funded to a substantial extent and is expected to be fully funded on an ongoing basis well before the 2020 target date. Non-Budget dependent agencies are fully funding each year's superannuation expense as required.

4. Asset Maintenance

The introduction of accrual accounting in the General Government Sector has largely provided the information required to develop a formal asset maintenance policy. This has helped remove the bias towards the acquisition of further assets at the expense of proper asset maintenance.

Under the asset management policy, agencies are required to develop asset maintenance plans which identify all assets, set out a maintenance program for each asset or grouping of assets, identify any deferred maintenance requirements and establish a funding plan.

Asset maintenance plans for most budget-dependent General Government agencies have now been developed and are in operation or are being finalised.

The result of this process will be the endorsement of an asset maintenance program and the broad commitment by government of providing sufficient funding for this. This will replace funding that might otherwise have gone towards new capital projects. However, the purpose of asset maintenance plans is to minimise the whole-of-life cost of assets, by ensuring that they live out their designed life. This avoids the cost of replacing assets at an earlier date.

5. Constrained Growth in Net Cost of Services and Outlays

The *Debt Elimination Act* defines this principle as keeping the rate of growth in the net cost of services and outlays below the rate of growth in inflation and population (i.e. zero real growth in per capita terms). In respect of capital outlays, the principle is to be applied over a three-to-five-year period to allow for the impact of large projects.

In the four years to 1998-99, both current and capital outlays grew by a little over five percent per annum. This implies average real per capita growth of around two percent per annum, above the zero growth target.

Commonwealth Grants Commission data from the early 1990s show important areas where service provision expenditures in New South Wales were below other States, including public health, nursing homes, corrective services, emergency services and roads. The departure from the zero real per capita growth rate in the more recent period was partly due to policies to raise standards of service provision in New South Wales. Public sector wage rates in New South Wales had also fallen relative to those elsewhere. Significant wage increases in the past two or three years have restored relativities, while also contributing to the rate of growth of outlays.

The 1999-2000 Budget and forward estimates have been framed to meet the principle of constrained growth in outlays. The Budget provides for growth in the net cost of services of 3.5 percent in nominal terms in 1999-2000, roughly constant in real per capita terms, and averaging 2.2 percent per year over the forward estimates period.

As a result of reductions in Olympics related capital expenditure, and the 1998-99 figure being inflated by almost $400 million associated with a transfer of assets from the Department of Housing to the Aboriginal Housing Office and Department of Urban Affairs and Planning, capital outlays are projected to fall by 7.7 percent in 1999-2000 in nominal terms. The discretionary component of General Government Sector capital outlays is projected to grow marginally in real terms over the forward estimates period. For the Total State capital outlays will increase from over $17 billion in the four years to 1998-99 to over $20 billion in the coming four years.

6. Prudent Risk Management

Risk management refers to the strategies that can be adopted by the Government or an agency to minimise the risk of the Government or agency not meeting its objectives in delivering services to the community. Certain risks can be centrally managed while others are the direct responsibility of individual agencies.

To assist agencies to manage their risks, Treasury released a *Risk Management and Internal Control Toolkit* in 1997. The Toolkit is a self-assessment tool to assist agencies to implement best practice risk management strategies.

The Toolkit provides detailed guidance to enable agencies to identify areas within their operations where risks are not being adequately managed. Once any risk gaps have been identified, generic strategies in the Toolkit can be tailored to the specific needs of the agency and employed to assist in mitigating these risks. The Toolkit complements Treasury's Statement of Best Practice for Internal Control and Audit.

Treasury officers have assisted three agencies (Advance Energy, the Department of Sport and Recreation, and the Mid-North Coast Area Health Service) in implementing the Toolkit. Many other agencies are applying the self-assessment Toolkit using the implementation guidance contained in the Toolkit.

Risk management covers all aspects of the core business of an agency, including service delivery, asset management, environmental issues, ethics, fraud, organisational culture, all forms of legal liability, and the processes involved in identifying, assessing and managing those risks. Risk management involves everyone in an organisation.

At the level of the General Government, risk management includes management of sector-wide liabilities, including debt and unfunded superannuation liabilities. The insurance risks of all Budget Dependent General Government agencies are covered by the Government's own self-insurance scheme, the Treasury Managed Fund. Financial risks for the Sector are largely centralised, as the Treasury Corporation manages the Government's debt portfolio.

7. Tax Restraint

This fiscal principle requires that "the level of taxes should be restrained to the maximum possible extent...". Given the policy priorities of government and the constraints on alternative revenue sources such as Commonwealth grants, net tax policy changes added to the tax burden each year until 1997-98. This is illustrated in Table 1.6.

Table 1.6: Trends in Tax Levels

Year	Policy Induced Tax Increases[a] $m
1989-90	200
1990-91	310
1991-92	80
1992-93	240
1993-94	100
1994-95	(40)
1995-96	10
1996-97	180 [b]
1997-98	280 [b][c]
1998-99	(110) [b]
1999-2000	(290)
2000-01	(100) [d]
2001-02	(270) [d]
2002-03	(180) [d]

[a] *Net effect on the year shown of all tax changes, whether announced in that year or in previous years.*

[b] *Includes impact of tax increases introduced to fund the Fiscal Contribution Payments to the Commonwealth.*

[c] *Excludes the one-off loss from abolishing business franchise fees and replacement by Commonwealth safety net taxes.*

[d] *Includes impact of measures foreshadowed in this Budget only. The reductions in 2000-01 are the residual impacts of changes in prior years.*

Competition continues to place downward pressure on the contributions to the budget from PTEs, and New South Wales continues to be handicapped by horizontal fiscal equalisation, subsidising other States to the tune of $1.3 billion a year (see Chapter 9 for further details). Nevertheless, there has been some easing of the constraints enabling New South Wales to start to lower its tax burden:

- the Fiscal Contribution Payments imposed by the Commonwealth Government (totalling $530 million) have terminated; and

- New South Wales will receive an increased share of Financial Assistance Grants from the Commonwealth from 1999-2000.

As a consequence, there are several reductions in taxes that will come into effect from 1 July 1999 relating to payroll tax and land tax. These are discussed at greater length in Section 3.3. Further tax reductions in the out-years are planned including additional reductions in the rate of payroll tax to 6.2 percent from 1 July 2001, and to 6.0 percent from 1 July 2002. This foreshadowing of these tax reductions is consistent with there being "a reasonable degree of predictability about the level and stability of tax rates for future years" as required under the Act. In addition, if the GST and the related Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations come into effect, the central Sydney accommodation levy will be removed from July 2000 and Financial Institutions and Share Transfer duties one year later.

Overall tax receipts are estimated to increase by an average of only 2.1 percent per year to the end of the forward estimates period, the low rate of growth reflecting the 1999-2000 reductions in tax rates and the future reductions. The projected rate of increase is well under the trend nominal growth rate of the economy of around 5 ½ percent.

1.3 THE ECONOMY

Introduction

Both revenues and outlays are affected by conditions in the economy. Economic factors are most critical in respect of performance for taxes, interest costs and departmental payments[8].

This section reviews the performance of the economy compared with expectations in 1998-99 and discusses the economic forecasts that underlie the 1999-2000 Budget.

Despite an unfavourable international environment, the New South Wales economy performed better than expected in 1998-99, with output and employment growth both above Budget forecasts, unemployment and inflation coming in below predictions, and interest rates broadly below expectations.

Economic conditions are likely to be a little less favourable for Budget performance in 1999-2000, with marginally lower growth in output and employment, and slightly higher inflation and long-term interest rates. However, the balance of risks leans towards the upside for most variables.

Sources of uncertainty in the outlook include the world economic outlook and potential changes in national tax policy. The economic parameters are predicated on unchanged policy, and exclude the possible impacts of the Commonwealth's proposed tax reforms. Should new tax legislation proceed, the likely impact on 1999-2000 outcomes (with the possible exception of a few sectors such as motor vehicle sales and dwelling construction) would be modest.

[8] *The sensitivity of the Budget to economic variables is analysed in Section 2.5.*

Recent Performance

Overall, economic outcomes in Australia and New South Wales in 1998-99 are likely to be more favourable than expected in the 1998-99 Budget despite weaker than expected conditions abroad (with the exception of North America). The underlying resilience of the economy to the Asian crisis had its foundations in the financial and structural reform programs of the previous two decades, raising the flexibility and productivity of the economy and confidence in financial markets.

Table 1.7: Revisions to 1998-99 Estimates[a]

	98-99 Budget Time	*Half Yearly Review*	*Current Estimate*
Gross State Product	3	3½	4½
Employment	1½	2	2¼
Unemployment rate[b]	7½	7¼	7
CPI (Sydney)	2¼	1¾	1½
Wages[c]	3¾	3½	4¾

Notes: (a) Year average percent change, unless otherwise indicated.

(b) Year average, percent.

(c) Average weekly ordinary time earnings of full-time adults in New South Wales.

Treasury's economic estimates for 1998-99 were upgraded progressively during the year in line with improving economic indicators and rising business and consumer expectations. One set of revisions was published in the Half-Yearly Review in February 1999, and estimates in this Budget reflect further revisions to the outlook.

The increase in the *GSP growth* estimate is largely due to higher than expected *private consumption*, reflecting large gains in real disposable income, low interest rates, and falling prices for major consumer durables (particularly motor vehicles) as well as wealth effects from property and sharemarket appreciation and the AMP demutualisation - all of which boosted consumer confidence. Insurance payments against the Sydney hail damage in April 1999 may provide some further boost to household income in the final quarter of 1998-99 as well as in early 1999-2000.

Higher than expected household disposable income and private consumption have had a positive impact on a range of revenue collections.

After a sharp deterioration in the first half of 1998-99, business confidence rebounded very strongly in the final six months. While *machinery and equipment investment* seems likely to underperform against initial predictions, *non-residential construction* will be stronger than forecast in the 1998-99 Budget. New *residential construction* also will be stronger than expected, and house prices and turnover have remained firm. This strength in both the residential and non-residential sectors has helped increase contracts and conveyances stamp duty during 1998-99.

Public sector expenditure growth is expected to be more moderate than private sector expenditure growth during 1998-99.

Employment in the first eleven months of 1998 averaged 2.4 percent higher than a year earlier, well above 1998-99 Budget estimates, with substantial contributions from both part-time (up 3.8 percent) and full-time (up 2.0 percent) employment. Strong labour demand and stable participation rates reduced average *unemployment* to 7.0 percent in the first eleven months of 1998-99.

Price outcomes were better than had been anticipated, due primarily to the strength of competitive pressures resulting from the Asian economic slowdown which more than offset upward pressures from the depreciation in the Australian dollar exchange rate. This was particularly noticeable for motor vehicles prices which were subject to steep discounting and producer rebates. These factors tended to maintain motor vehicle turnover at high levels, contributing to upward revisions to Budget estimates for motor vehicle registration stamp duty during the course of the year.

The Sydney *consumer price index* averaged 1.7 percent higher than a year earlier during the first three quarters of 1998-99, and trends in national wages and material inputs suggest low inflation is likely to continue through to the end of the year. This has helped keep costs down on the outlay side of the Budget.

Average weekly earnings increased at an annual rate of 4.6 percent in the first three quarters of 1998-99, although much of this resulted from shifts in workforce composition from lower to higher skilled jobs. The *Wage Cost Index*, which eliminates composition shift effects, shows New South Wales wages growing at a more moderate rate of 3.5 percent during the first three quarters of 1998-99. Wage cost growth was more rapid in the public sector than in the private sector during that period, and was a major factor in the growth of Budget outlays.

The combined strength of wages and of employment boosted *total compensation of employees* by 6.3 percent per annum in the first three quarters of 1998-99. After taking into account timing, threshold and other adjustment factors, the performance of payroll tax receipts to April was consistent with these trends in employment and earnings.

Concerns about the flow-on of world financial market disarray after the Russian default in August led most central banks including the RBA to ease monetary policy during the second half of 1998. Weak world economic growth and a flight-to-quality also helped restrain *interest rates* during 1998-99, with the ten-year bond rate averaging 70 basis points below a year earlier (in contrast to Budget projections of a 30 basis point increase) - and this led to valuable savings in interest on public debt.

Domestic capital markets recorded strong gains in 1998-99 as investors factored in Australia's financial and economic resilience to the Asian crisis, the stability of low interest rate settings, and the associated pick-up in consumer and business confidence. This further boosted receipts from contracts and conveyancing duty as well as share transfer duty.

In summary, economic conditions in 1998-99 have proved generally more supportive of a strong Budget performance than had been anticipated at the beginning of the financial year. The strength of national economic growth sustained through the March quarter 1999 suggests that the balance of risks to the 1998-99 estimates remains on the upside.

Outlook for 1999-2000

Although the world economic outlook is brighter than in the first half of 1998-99, growth is still expected to remain subdued in 1999-2000. Despite its surprising strength in recent months, the US economy is still expected to slow, and the sustainability of Japan's recovery remains uncertain. The main improvement has been in the outlook for the battered East Asian and Latin American economies.

Table 1.8: Economic Performance and Outlook[(a)]

	Outcomes	*Estimates*	*Forecasts*	
	1997-98	*1998-99*	*1999-2000*	*2000-01*
New South Wales				
Gross State Product	4.1	4½	3¼	3¾
State Final Demand	4.7	4½	3½	3
Employment	0.7	2¼	1¾	2
Unemployment rate[(b)]	7.6	7	6¾	6¾
CPI (Sydney)	0.1	1½	2	3¼
Wages[(c)]	3.1	4¾	3¾	4¼
Australia				
Non-farm GDP deflator	1.4	1	1¾	3
Ten year bond rate[(b)]	6.0	5¼	5¾	6¼

Source: Australian Bureau of Statistics; NSW Treasury.

Notes: (a) Year average percent change, unless otherwise indicated.

(b) Year average, percent.

(c) Average weekly ordinary time earnings of full time adults in New South Wales.

Activity in Australia is likely to be more moderate in 1999-2000 due to the flow-through of weak world economic growth as well as a cyclical slow-down in business investment.

The New South Wales economy is expected to perform in line with the national economy, as it did in 1998-99. *Output* is forecast to increase by 3¼ percent in 1999-2000 (around the estimated long-run potential growth rate for New South Wales and Australia as a whole), down from 4½ percent in 1998-99. This will be a fairly remarkable outcome against the backdrop of economic collapse in Asia and under-performance in Europe.

Private consumption in New South Wales is expected to slow from 4½ percent in 1998-99 to 3¾ percent in 1999-2000 reflecting some moderation in the growth of wage and salary income, dissipation of wealth effects from the AMP demutualisation, and financial constraints on further expansion of household debt.

In the past, the *dwelling construction* sector often followed a pronounced four-to-five-year cycle associated with swings in interest rates and unemployment. Recent steady monetary policy and fairly stable employment markets are expected to dampen this cycle in 1999-2000, during which this sector is forecast to expand by 4 percent.

Business investment in New South Wales is expected to remain subdued in 1999-2000, although the *machinery and equipment* component may record some growth. The December 1998 ABS survey reported expectations of a substantial cut in New South Wales private capital expenditure from the corresponding forecast a year earlier, although this was much more moderate than the reduction expected in some other states. Weak resource sector profitability, maturation of the upswing in Sydney commercial building and completion of some Olympics related activity will reduce *non-residential construction* somewhat in 1999-2000 from its 1998-99 highs.

Growth in *public final demand* should remain moderate in 1999-2000.

The slowdown in output growth is likely to be accompanied by a reduction in New South Wales *employment growth* to around 1: percent in 1999-2000 from 2¼ percent in the previous year. This slowdown appeared already underway in the second half of 1998-99, although a parallel acceleration in leading indicators such as the ANZ Job Advertisements series underscored the degree of uncertainty in such forecasts.

There is expected to be a cyclical weakening in *labour productivity growth* in 1999-2000 as output slows more rapidly than employment. *Labour force participation* was very subdued in 1998-99 despite faster employment growth. Should this pattern continue, even the more moderate employment growth expected ahead should be sufficient to yield a marginal further reduction in the *unemployment rate*.

Wages growth is expected to decline marginally to 3¾ percent in 1999-2000. Growth will remain slightly higher in New South Wales than nationally, due as much to compositional shifts as to pay-rate effects. Award wage increases available under the 1999 Safety Net Decision are modest, and the trend in federal enterprise bargaining agreements shows no tendency to accelerate.

Sydney *consumer price inflation* is expected to rise from 1½ percent in 1998-99 to 2 percent in 1999-2000. World oil prices have recovered substantially from the 20-year lows reached in December 1998. Worldwide competitive discounting for manufactured goods also will provide less of a restraint than it did at the peak of the Asian crisis. Since importers did not pass on the full cost of Australia's currency depreciation in 1998 they are unlikely to pass on the full savings from currency appreciation, should that be sustained, in the year ahead.

With the inflation outlook remaining at the lower end of the 2-3 percent target range for monetary policy, it is assumed that the RBA will not raise *interest rates* before June 2000. Long-term capital markets are driven primarily by overseas developments. Signs of overheating in the United States, the massive expansion in Japanese bond issuance to finance its fiscal expansion, and early indicators of recovery in Asia had already moved bond yields higher by late 1998-99, and they are assumed to remain around those levels in 1999-2000.

Risks to the forecasts in 1999-2000 include uncertainty regarding developments in the world economy, problems related to information technology (the "Y2K Bug"), and business and consumer precautionary responses to proposed tax reform measures. However, the risk to the world outlook appears to be weighted to the upside, noting the nearly continuous upgrades in the second half of 1998-99 to surveyed private sector forecasts for growth in the United States and Asia in the year ahead.

Economic Outlook for the Forward Years

New South Wales economic growth is expected to be slightly higher in 2000-01, with support from stronger world economic activity and a moderate boost from the Sydney Olympics. These factors are likely to lift *GSP growth* to a forecast 3¾ percent with most or all of the gain from the previous year contributed by net exports. *Employment growth* should also improve. Faster growth in wages and demand in 2000-01 are more likely to generate pressures on *consumer prices* than in the previous year. Economic prospects for 2000-01 are subject to an unusual degree of uncertainty, including (in addition to world growth prospects and the Olympic Games factors) the impact of any new federal taxation arrangements that may be implemented.

It is possible that the pace of output and employment growth may moderate somewhat in the first year after the Olympics, but they should return to trend quickly thereafter. Prospects for the economy throughout the period beyond 1999-2000 will remain dominated by factors unrelated to the Olympics – particularly the strength of the global economy, the business cycle and domestic policy settings.

The medium-term framework adopts parameters close to actual average performance achieved over the nine-year period 1991-92 to 1998-99, which is the longest for which consistent data are currently available[9]. During that period economic growth averaged 3.3 percent, population growth averaged 1.0 percent and employment growth averaged 1.2 percent in New South Wales.

The medium-term framework also incorporates assumptions for prices, wages and interest rates as indicated in Table 1.9.

A guide to the consequences of changes in the economic parameters is provided in Section 2.5, which assesses the sensitivity of the Budget cash outcome to alternative economic scenarios.

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[9] *Including Budget estimates for 1998-99.*

Table 1.9: Economic Parameters[(a)]

	Medium Term
Gross State Product	3¼
Population	1
Employment	1¼
CPI (Sydney)	2½
Wages[(b)]	4
Ten year bond rate[(c)]	6

Notes: (a) Year average percent change, unless otherwise indicated..

(b) Average weekly ordinary time earnings of full-time adults in New South Wales.

(c) Year average, percent.

Major Risk Factors

Clearly, the New South Wales economy, together with the rest of Australia, is influenced by events in the world's major economies, in particular the United States, Europe, Japan and the other East Asian economies. Key risks to the forecasts include:

- fear that overheating in the United States economy may lead to strong monetary policy intervention and a steep correction in financial markets; and

- Japan may fail to sustain the tentative resumption of growth it recorded in the March quarter, further delaying the recovery of world growth beyond 2000.

The Budget has been prepared excluding the possible impacts of the Commonwealth's tax reform package. Although new tax policies will not be implemented before 2000-01, some anticipatory changes in economic behaviour might be expected. Areas most likely to be affected include motor vehicle sales, given the proposed reduction in tax on vehicles; and dwelling construction and alterations, which would become more costly following the introduction of the proposed tax reforms. However, businesses, consumers and financial institutions can all be expected to alter their behaviour, to some extent in anticipation of the tax policy changes.