

CHAPTER 6: THE ECONOMY AND RISKS TO BUDGET OUTCOMES

Economic Situation and Outlook

NSW state final demand growth of 3½ percent in 2004-05 will be a little firmer than expectations in the 2004-05 Budget. Net exports are likely to be weaker than expected, and as a result gross state product growth will be below Budget.

- ◆ Business investment increased much more strongly than in 2003-04. This partially offset slower growth in household consumption, and a downturn in housing investment.
- ◆ Imports picked up, reflecting the shift in composition of demand towards business equipment. A higher exchange rate restrained manufactured and service exports, although a rise in wheat production and a strong coal market helped the commodities sector.

The forecasts for 2005-06 assume that the housing cycle will stabilise and begin a modest recovery and business investment will continue expanding at a solid rate. Global growth, although easing a touch, should remain strong, boosting net exports.

- ◆ NSW state final demand is forecast to increase by 3½ percent, and gross state product by 2¾ percent.
- ◆ NSW employment is projected to increase by 1¼ percent, while the unemployment rate will be steady at 5¼ percent.

Risks to Budget Outcomes

The Budget is sensitive to variations between actual and expected outcomes for the economy. Current uncertainties include:

- ◆ interest rates, which might be forced up (at a time of high household debt) by rising global inflation or by excess domestic demand or wages growth;
- ◆ stresses in the world economy, particularly global growth imbalances, high oil prices, and high prices for other non-rural commodities; and
- ◆ domestic economic uncertainties, including capacity constraints, the response of wages to tight labour supply, and the drought.

Budget estimates are framed on the basis of no change in government policy and other parameters. Key factors which could affect Budget outcomes include Commonwealth policy on intergovernmental financial relations.

6.1 INTRODUCTION

Budget estimates rely on assumptions, forecasts and assessments made at the time of their preparation. The recent performance of the economy and economic forecasts underpinning the 2005-06 Budget estimates are presented in Section 6.2.

The sensitivity of budget outcomes to change in underlying factors is considered in Section 6.3. These factors include changing economic circumstances, unanticipated policy and regulatory decisions, changed demand for services, and the realisation of contingent liabilities.

6.2 THE ECONOMIC SITUATION AND OUTLOOK

At this time last year there was considerable uncertainty in the outlook for the housing cycle, the drought, the emergence of global imbalances and oil prices. Despite those risks, developments in 2004-05 unfolded much as anticipated. World growth was underpinned by strong expansion in the United States and China, though growth in Europe disappointed. The buoyant global economy boosted world commodity prices and Australia's terms of trade. Domestic demand slowed much as anticipated but net exports were a larger than expected drag on growth.

In 2005-06, while world growth is expected to moderate, global conditions are expected to remain favourable and strong business investment should ease export capacity constraints. A modest turnaround in the housing sector is likely to assist domestic activity through the year. Employment growth and the unemployment rate should remain steady, while wage and price pressures may be a bit stronger.

RECENT PERFORMANCE ¹

The NSW domestic economy performed broadly in line with Budget expectations during 2004-05. Compared to Budget forecasts, state final demand growth in 2004-05 was slightly stronger while gross state product was weaker (due to high imports). In the labour market, employment growth met expectations, while unemployment came down further than anticipated. On the inflation front, consumer prices rose in line with expectations, but wages growth was more moderate than expected. This was a year of transition, characterised by slower consumer spending and house building with increased business investment setting up the economy for stronger output and employment growth in years ahead.

¹ Unless otherwise indicated, the sources for statistical information in this chapter are ABS (Australian Bureau of Statistics) data releases and NSW Treasury estimates. Economic estimates are based on data available as at mid-May 2005, which included: results to June 2004 for gross state product; to December 2004 for state final demand; to March 2005 for consumer prices and the wage price index; and to April 2005 for employment.

Table 6.1: Revised 2004-05 Estimates

(Year average percent change, unless otherwise indicated)

	2004-05 Budget	Half Yearly Review	Current Estimate
State final demand	3	3	3½
Gross state product	3¼	3	2
Employment	1¼	1¼	1¼
Unemployment rate (year average, percent)	5½	5¼	5¼
CPI (Sydney)	2½	2¾	2½
Wages (wage price index, ordinary time)	3¾	3¾	3½

In the *domestic economy* household consumption was softer than anticipated, dwelling investment was in line with expectations, while business investment was considerably stronger.

Growth in *consumer spending* eased during 2004-05. The downturn in dwelling construction reduced demand for household goods, and falling house valuations did not assist, while high mortgage debt, higher interest rates and rising petrol prices constrained household budgets. Partly offsetting these factors, consumer spending was buoyed by the strong Australian dollar, flat or falling international prices, and lower tariffs on motor vehicles.

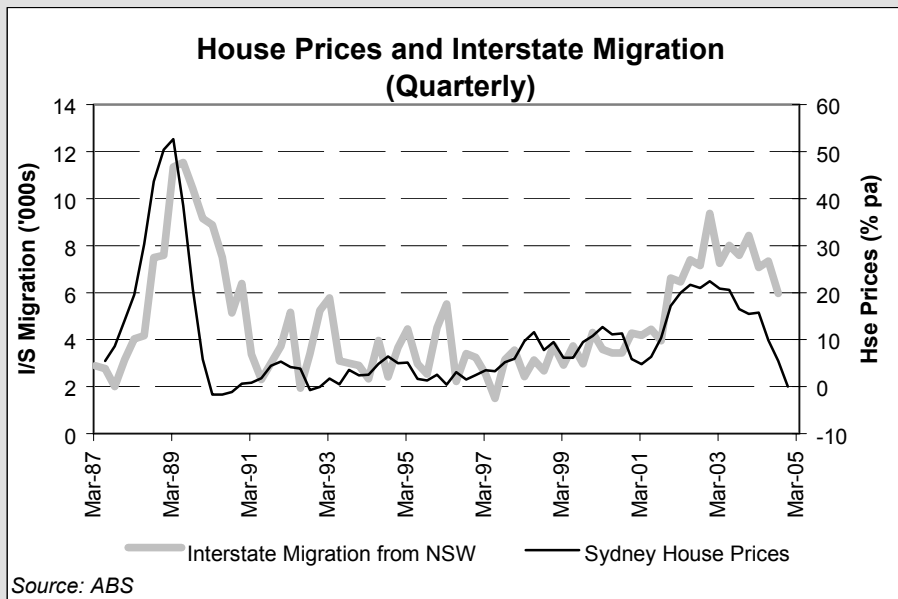
Dwelling construction experienced a moderate downturn in 2004-05. This cyclical decline followed three years of very strong growth and rising house prices during which investor activity (partly speculative) had increasingly supplanted owner-occupiers as the market driver. Despite fears, the housing bubble did not collapse but gradually deflated in 2004-05. The decline in dwelling investment, of around 10 percent, was moderate compared to previous downturns. Sydney house prices (established homes)² eased by about 3½ percent across the three quarters to December 2004.

Business investment strengthened markedly in 2004-05 from an already high base, buoyed by strong profits, high capacity utilisation and robust global economic conditions. NSW business investment continued to be supported by Privately Financed Projects (PFP) infrastructure outlays which are estimated to have increased by over 30 percent in 2004-05.

² The ABS House Price Index (established homes) is based on a stratified sample of prices reported at settlement. Series compiled by other organisations (such as the Real Estate Institute of NSW, Residex, and Australian Property Monitors) use different methodologies, and their results may differ.

Box 6.1: Population growth

During the four years ending 2001-02, NSW population growth averaged 1.2 percent per annum. In the following two years NSW growth slowed to an average 0.8 percent. National population growth remained more or less steady.



The slowdown reflected an increase in net interstate migration from New South Wales to other States, from 12 thousand in 1997-98 to over 30 thousand in both 2002-03 and 2003-04. Factors that may explain this upswing include:

- ◆ a rise in the cost of housing in Sydney (discussed in last year’s Budget) discouraged some would-be interstate immigrants while encouraging some residents to move interstate. Recent data (refer graph) suggests this effect may have begun to reverse, causing net interstate migration from New South Wales to slow; and
- ◆ the sectoral composition of recent economic growth, which favoured resource-intensive States over those more reliant on growth in services and manufactures.

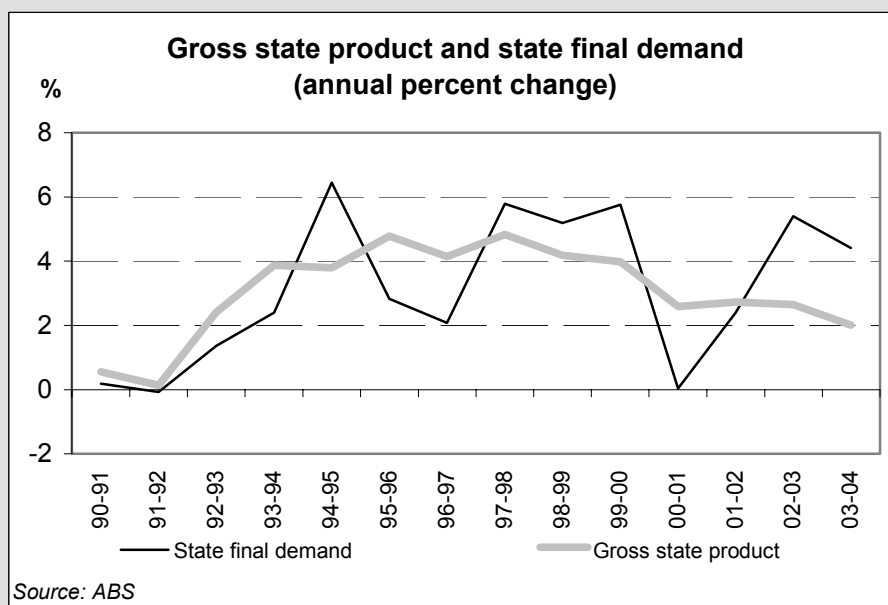
While state final demand increased broadly in line with Budget expectations, gross state product was weighed down by high imports and lacklustre exports. Nevertheless some exports improved strongly:

- ◆ Agricultural exports were helped by further gains in crop production, with a 3 percent increase in winter crop production, and a 28 percent increase in the area planted to summer crops. In calendar year 2004 the value of NSW cereals exports increased by 136 percent or more than \$500 million.

- ◆ Strong world energy demand boosted NSW coal exports, which increased by 42 percent or more than \$1 billion in calendar year 2004.

Box 6.2: Gross state product and state final demand

Gross state product (GSP) is the value of total State output. For consistency with generally accepted practice, the Budget uses nominal GSP as a benchmark for fiscal indicators – e.g. net debt / GSP ratios. But the usefulness of real GSP as a measure of economic performance is limited by its reliance on synthetic data (interstate trade is estimated with a model, rather than measured from collected statistics), problems in attribution (the original supplier of export value-added, and end-user of import value are never known), sensitivity of real GSP measures to estimates for price deflators, susceptibility to revision, and low frequency of release (once only per annum). This is why, after nearly 25 years of publication, the ABS still characterises these estimates as “experimental.” Currently the ABS is developing an alternative “production based” framework with a view to improving the reliability of the GSP estimates.



State final demand (SFD) includes consumption and investment (for private and public sectors). It is a measure of spending (rather than output) in the State. This information is reported quarterly. In estimating SFD components the ABS is able to draw on more robust data collections, although SFD components are occasionally subject to large revisions. Although it measures spending rather than output (and therefore excludes net exports) it does tend to correlate well with aggregate employment and wage movements and responds to economic forces such as monetary policy. It provides a more timely and accurate picture of the health of the NSW economy than GSP.

The *labour market* made further gains, with NSW employment rising by an estimated 1¼ percent and the unemployment rate declining to 5¼ percent³. In year average terms to the March quarter 2005, employment growth was strongest in mining, construction, and personal services. It was weakest in the utilities sector, transport and storage, and agriculture.

Inflationary pressures increased only marginally in 2004-05. Exchange rate appreciation (reflecting stronger export prices) kept downward pressure on prices of most traded items. World commodity prices (petroleum and metals) moved higher. The pace of increase was faster for non-traded items, reflecting tighter capacity as well as higher costs of inputs (such as petroleum).

Skilled labour shortages may have put pressure on wages in some sectors (particularly construction), but this is yet to be reflected in aggregate wage measures. Annual average wage price growth in New South Wales slowed from 3.9 percent in March 2004 to 3.5 percent in March 2004 – reflecting the fading effect of significant public sector wage increases a year earlier. Annual average private sector wage price growth remained steady at 3.3 percent over the same period.

Monetary policy remained on hold during 2004 as the RBA monitored the extent of the slowing in the housing sector. In late 2004 and early 2005, however, RBA statements expressed increasing concern over a widening imbalance between total (domestic and foreign) demand, and Australian productive capacity. At the same time evidence emerged of a stabilisation in the housing slowdown. In a much anticipated move, the RBA raised the cash rate by ¼ of a percentage point to 5.5 percent at its March 2005 meeting “in order to reduce the risk of an unacceptable rise in inflation in the medium term.” While monetary policy was left unchanged in April and May, the RBA maintained a tightening bias, noting that “it would be surprising if interest rates did not have to increase further at some stage of the current expansion”⁴.

OUTLOOK FOR 2005-06

World economic growth is expected to remain strong in 2005-06. Australian exports and terms of trade should record further gains. The prolonged upswing in the global economy is expected to bring higher world interest rates, albeit from low levels.

³ The unemployment rate was 5.1 percent in April 2005.

⁴ Reserve Bank of Australia, *Statement on Monetary Policy*, 6 May 2005.

The NSW economy will accelerate a notch, reflecting further solid business investment and the beginnings of a recovery in the housing sector. State employment growth will maintain a steady pace and the unemployment rate will be stable.

Wages and prices will increase a bit faster. Monetary policy will push interest rates slightly higher.

The main uncertainties for the economy in 2005-06 are associated with unbalanced global growth, oil prices, and monetary policies (both domestic and foreign).

Table 6.2: Economic Performance and Outlook

(Percent change, year average, unless otherwise indicated)

	<i>Outcomes</i> 2003-04	<i>Estimates</i> 2004-05	<i>Forecasts</i> 2005-06
New South Wales			
State final demand	4.7	3½	3½
Gross state product	2	2	2¾
Employment	1.4	1¼	1¼
Unemployment rate (year average, percent)	5.6	5¼	5¼
Sydney CPI	2.1	2½	3
Wage price index	3.8	3½	3¾
Australia			
Non-farm GDP deflator	3.5	4	4½
Ten year bond rate (year average, percent)	5.7	5½	6

Following very strong global expansion in 2004 (output increased by 5 percent and trade expanded by 10 percent), activity is expected to moderate, though remain solid, during the next two years. The International Monetary Fund (IMF) expects global output growth of about 4½ percent and world trade growth of about 7½ percent in both 2005 and 2006⁵. The balance of uncertainties is weighted to the down side, however. The possibility of higher interest rates, falling asset prices, depreciation of the U.S. dollar, higher oil prices and an unbalanced pattern of growth (strong expansion in the United States and China, but underperformance in Europe) all add to the fragility of the current global expansion.

⁵ *International Monetary Fund, World Economic Outlook, April 2005.*

The NSW economy will continue its transition to a more balanced expansion path, with business investment again expected to grow strongly, although the household sector will play more of a role. *State final demand*⁶ will continue to expand at around 3½ percent in 2005-06, with slightly stronger private consumption and a modest rebound in the dwelling sector as the year progresses. While more moderate than the exceptional pace of the previous year, business investment growth will remain robust.

- ◆ After slowing in 2004-05, *household consumption* growth is expected to improve a little in 2005-06. Consumption will be helped by lower income tax rates, stable petrol prices, steady employment gains, and slightly faster wages growth.
- ◆ *Fixed investment* growth is expected to be slightly more moderate in 2005-06.
 - *Dwelling investment* fell sharply in the December quarter 2004 and is expected to ease further into 2005. Trends in dwelling approvals and finance through early 2005 suggest activity was close to a trough, although the RBA interest rate increase in March adds some uncertainty to that assessment. Underlying demand, in terms of wages and employment, remains supportive and population growth may be less of an inhibiting factor than in the recent past. In year average terms, dwelling investment is likely to ease about 10 percent in 2004-05 and to edge up only fractionally in 2005-06.
 - *Business investment* will continue to expand at a robust pace in 2005-06, though a little slower than the previous year. Private capital expenditure intentions in New South Wales point to nominal growth of about 11 percent in building expenditure and 12 percent in plant and equipment expenditure in 2005-06. The boost to private business investment from cash outlays by privately financed public (PFP) transport and social infrastructure projects⁷ will be a touch smaller in 2005-06.
 - Growth in *public demand* is expected to be firm though slightly slower than in 2004-05. Infrastructure spending recorded strong growth in 2004-05 in line with the measures introduced in last year's Budget.

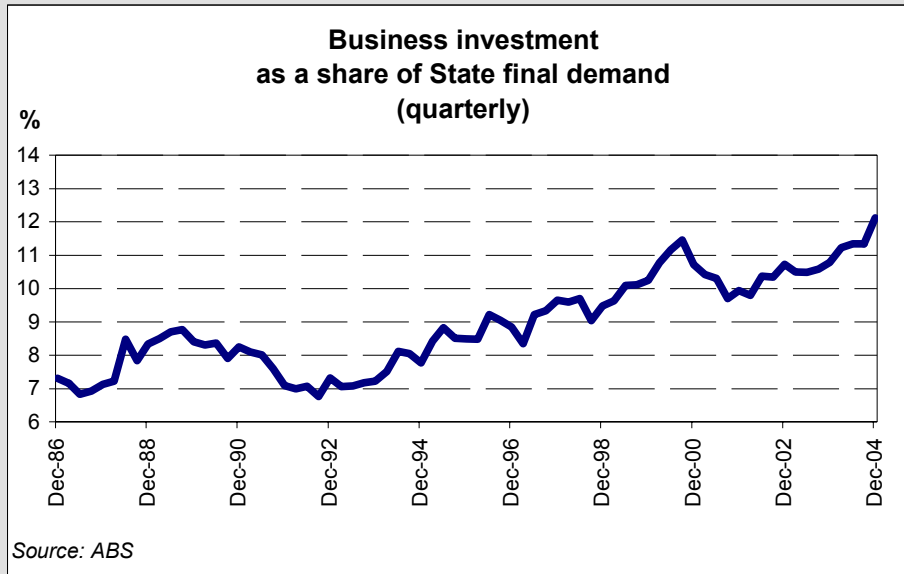
⁶ *State final demand* is the sum of private consumption, dwelling investment, business investment, ownership transfer costs, and public consumption and investment.

⁷ *Work by the private sector on Privately Financed Projects (PFP)* is estimated to peak in 2004-05 with completion of the Cross City Tunnel. Major PFP work during the next four years will include the Lane Cove Tunnel, Western Sydney Orbital, Chatswood Transport Interchange, Newcastle Multi-Purpose Terminal, and Railcorp Rollingstock Renewal Project.

Box 6.3: Outlook for Business Investment

Business investment in New South Wales increased by an average 10 percent per annum in 2002-03 and 2003-04, with strong (8 percent) growth in machinery and equipment and very strong (22 percent) growth in building.

More recent trends point to another substantial acceleration in 2004-05. Business investment climbed to a record 12.1 percent of state final demand in December 2004.



Fundamentals are supportive of further solid growth in investment:

- ◆ profitability is strong;
- ◆ capacity utilisation ratios are high;
- ◆ capital costs remain moderate; and
- ◆ PFPs continue to provide strong support to private sector investment in New South Wales.

The outlook is corroborated by surveyed business investment intentions. Capital expenditure expectations point to solid growth, with increases of 8.1 percent nationally and 11.5 percent in New South Wales between comparable estimates for 2004-05 and 2005-06. Services and infrastructure (the “other sectors” in the Capital Expenditure Survey) rather than mining and manufacturing, have tended to be the key drivers of NSW business investment in recent years.

- ◆ Net *exports* should detract less from growth than the previous year, reflecting further gains in rural production, a further strengthening in world demand for NSW minerals, and less drag on competitiveness from the exchange rate.
 - In line with ABARE forecasts for the national economy,⁸ it is assumed that the volume of farm production will increase by around 2 to 3 percent in 2005-06. Stronger world production will weaken unit export prices, however, reducing the net value of farm production by around 12 percent.
 - On the basis of price increases secured for the 2005-06 Japanese financial year, ABARE forecasts that thermal coal exports will increase by 7 percent in volume and 18.5 percent in value during 2005-06.
 - Manufacturing and service exports will be assisted by continued solid world growth and less pressure on competitiveness from exchange rate appreciation.

NSW *employment growth* is expected to remain steady at around 1¼ percent (near the long-term average) in 2005-06, with better dwelling construction offsetting more moderate growth in other sectors. This growth rate of employment should be sufficient to keep the NSW *unemployment rate* steady at a historically low 5¼ percent.

Wage growth in the private sector is expected to be slightly higher, reflecting continued tight supply of skilled workers. The \$20 per week increase in the minimum wage proposed in the State and Territory Governments submission to the 2005 national wage case⁹ would represent 2.5 percent of the NSW average ordinary time wage rate.

Inflation, as measured by the *Sydney CPI*, is expected to increase in 2005-06 as higher world inflation, a more stable exchange rate, and solid domestic demand continue to flow through to production costs and seller margins.

With inflation likely to be edging towards the top of its 2 to 3 percent target band, the RBA is expected to raise interest rates another notch to prevent inflationary pressures from gaining a firmer foothold. In Australia, however, the policy adjustment task is nearly complete, while in the United States and some other countries it has some distance yet to run.

⁸ Australian Bureau of Agricultural and Resource Economics (ABARE), Australian Commodities, March quarter 2005.

⁹ Australian Industrial Relations Commission, Safety Net Review 2005

Box 6.4: Addressing Skills Shortages

The NSW Government is moving to head off potential skills shortages that would otherwise restrain the NSW economy. A detailed plan released on 20 March 2005 will focus government training resources on skill shortages. It will produce more trained and job ready workers in the areas where the economy needs them most. The **Securing our Skilled Workforce Plan** includes:

- ◆ an extra \$1.6 million to double the accommodation allowance for around 5,000 apprentices who need to travel from regional and rural areas;
- ◆ a \$100 rebate on the cost of car registration for first and second year apprentices in NSW, as an added incentive for young people considering an apprenticeship as part of their career;
- ◆ an extra \$2 million for a new 12-month pilot scheme called **TradeStart** which will allow 450 apprentices to complete the equivalent of a year's TAFE training in just 16 weeks;
- ◆ a job matching service to link TradeStart graduates to employers;
- ◆ investing an extra \$1 million in group training, placing 800 new apprentices with employers who need them most. This will support small business and get workers into regional and rural areas;
- ◆ a new reporting system to ensure that 20 percent of trade work on government construction projects worth more than \$2.5 million is performed by apprentices; and
- ◆ looking at more ways to fast-track adult training.

This plan complements other measures already underway to prepare young people for work, including:

- ◆ a further \$3.5 million in 2005 creating 2,400 pre-apprenticeship places;
- ◆ putting on additional TAFE courses in areas of skill shortage as well as emerging areas such as digital media, aged care and environmental construction; and
- ◆ providing vocational training to 40 percent of year 11 and 12 students.

MEDIUM TERM OUTLOOK

Prospects for the economy beyond 2005-06 will depend on the strength of the global economy, the business cycle, domestic policy settings and productivity trends. Because these factors cannot be predicted with reasonable confidence more than a short period ahead, the Budget estimates beyond 2005-06 are based on economic parameters determined by expectations for their average performance this decade.

The medium term parameters for output, employment and population are consistent with historical performance and with demographic projections by the Australian Bureau of Statistics. Medium term parameters for prices and wages are consistent with public statements by the Reserve Bank of Australia as to their policy objectives.

Table 6.3: Economic Parameters Beyond 2005-06

(Percent change, year average, unless otherwise indicated)

	<i>Medium Term</i>
Gross state product	3¼
Population	1
Employment	1¼
Sydney CPI	2½
Wage cost index	3½
Ten year bond rate (year average, percent)	6

6.3 RISKS TO BUDGET OUTCOMES

Budget estimates rely on assumptions, forecasts and assessments for the economy and other factors made when the Budget was prepared¹⁰.

This section considers the sensitivity of budget outcomes to changing economic circumstances. It also reviews other sources of uncertainty including unanticipated policy and regulatory decisions, changed demand for services, and the realisation of contingent liabilities.

These are among the more salient risks to the outlook at the time of Budget preparation. History suggests that often the critical factors for economic and fiscal outcomes are ones not foreseen or deemed too improbable when the forecasts were assembled.

¹⁰ Key source publications and their release dates are reported in the footnote on page 6-2.

ECONOMIC RISKS

Risks to the economic outlook for 2004-05 include:

Interest rates

While the forecasts assume that interest rates will increase by no more than a quarter of a percentage point beyond the 5½ percent level fixed by the Reserve Bank in March 2005, the outlook faces both global and domestic risks:

- ◆ High oil prices, in conjunction with high global prices for coal, iron ore and base metals, have increased upstream inflation in many economies, including Australia. If upstream inflation feeds through to retail prices and wages – a likely situation if demand increases more strongly than expected – a sharper and more destabilising monetary response might follow.
- ◆ Aggregate measures of wage growth remained well contained during 2004-05, despite anecdotal evidence of tight skilled labour supply across a number of industries. If world growth remains strong and domestic activity rebounds, then labour supply conditions could tighten further. Should this occur, it would increase the risk of a marked acceleration in wage pressures beyond that assumed in the Budget. This would erode business profitability, increase pressure on prices, and risk tighter RBA interest rate settings.

Mortgage interest rates are still near historical lows, despite the cumulative 1¼ point rise in the cash rate since May 2002. Rapid growth in mortgage borrowing, however, has pushed the household debt servicing ratio to the highest levels yet recorded. Therefore any further interest rate increase now would have a far greater impact on household disposable income, consumption and the economy than in the past.

Global imbalances

The more worrying aspect of global growth, according to the IMF, is the continuing divergent pattern of growth. While the United States and China are growing strongly, the euro area is lagging.

Unbalanced growth is contributing to increased current account imbalances. These imbalances are increasing the pressures on the financial system, including exchange rates, and are feeding the forces of protectionism as countries seek to compensate for reduced competitiveness by raising trade barriers.

They also add to the fragility of world growth, which has become increasingly reliant on the performance of just two countries (China and the United States).

World oil prices

The price of West Texas Intermediate (WTI) rose sharply from an average US\$33.70 per barrel in 2003-04 to an average \$50 or more in 2004-05 with spikes close to \$60 in the final quarter of the year.

Factors behind these increases are China's sustained rapid economic growth and the strong US recovery (both economies have high oil intensities), augmented by speculative covering in commodity markets. The risk of a further increase in oil prices is substantial.

According to the IMF, per capita incomes in both China and India are now approaching the stage where demand for motor vehicle transport typically accelerates. Global oil production capacity (particularly outside OPEC) is tightening. Therefore oil prices may trend higher and become more volatile. The world economy has the flexibility to adjust to gradual change. But there is a risk that the abrupt 2004-05 upswing, if sustained, will feed inflation and reduce world growth. There also is the risk of further upward spikes in oil prices that might disrupt activity.

Drought

While the forecasts assume normal climatic conditions will prevail in 2005-06, the area of the State affected by drought has increased sharply in recent months. In early May the Bureau of Meteorology rated the chance of an El Niño event occurring in 2005 year at between 30 and 50 percent, which meant that the risk was around double what might normally be expected at that time of year. Agriculture directly accounted for only two percent of State output in 2003-04. But the sector's extreme volatility in response to drought events, and the flow-on to agricultural supplier and user industries, can significantly affect aggregate State economic performance¹¹.

SENSITIVITY OF THE BUDGET TO ECONOMIC PARAMETERS

A guide to the sensitivity of budget estimates of expenses and revenues to variations in economic parameters is provided in Table 6.4.

The table gives a 'rule of thumb' indication of the direct impact on the Budget of a change in a given parameter. In each case, the analysis presents the estimated effects of a change in one economic variable only, and does not attempt to capture the linkages between economic variables that characterise changes in the economy more broadly.

¹¹ The potential impact on Budget expense is discussed in section "Drought relief assistance" below.

Table 6.4: Sensitivity of Fiscal Aggregates to Changes in Selected Economic Parameters, 2005-06

(Effect of a one percent increase, unless otherwise indicated)

<i>Parameter</i>	<i>Effect on the 2005-06 Budget Result (\$m)^(a)</i>
A. Factors affecting tax revenue	
Dwelling sales (price or volume)	33
Motor vehicle sales	16
Private sector employment	53
Private sector wages	54
Household disposable income	10
B. Factors affecting grant revenue	
Household consumption ^(b)	104
C. Factors affecting expenses	
Public sector wages and salaries	-202
Prices of goods and services	-105
Interest rates ^{(c), (d)}	-18

<i>Parameter</i>	<i>Effect on 2005-06 Net Financial Liabilities (\$m)^(e)</i>
D. Factors affecting Superannuation Liabilities	
Public sector wages and salaries	185
Sydney CPI	170
Investment return ^(c)	-135
Discount rate ^(c)	-3,700

(a) A positive effect (eg, from increased dwelling sales) improves the Budget Result, while a negative effect (eg, from increased public sector wages) weakens the Budget Result.

(b) Projected GST receipts are \$10,374 million.

(c) Effect of a one percentage point increase in the indicated factor (discount rate, interest rate, or rate of return).

(d) Excluding the impact of actuarial adjustments to net financial liabilities.

(e) A positive effect (eg, public sector wages) increases NFL (weakens the financial position), while a negative effect (eg, improved investment returns) reduces NFL (improves the financial position).

The table excludes consideration of possible policy responses. The analysis assumes that changes are uniform across the general government sector and across the Budget year.

Both revenues and expenses may be affected by variations between actual and expected economic outcomes.

Revenues are sensitive to factors affecting revenue bases (such as the value and volume of property and motor vehicle sales, employment and earnings), profits of public enterprises, and household consumption (and its influence on GST revenue).

The main **State taxes** - payroll tax and transfer duty - are sensitive to economic factors. Both employment levels and wage rates affect payroll tax collections. Transfer revenue depends primarily on property market activity, with dwelling transactions accounting for about three-quarters of such revenue¹². Many factors (including monetary policy, Commonwealth tax arrangements, unemployment, and trends in alternative asset markets) contribute to fluctuations in property turnover.

The arrangements for **Commonwealth general purpose and specific purpose payments** to the States are described in Chapter 8.

Expenses are less sensitive than revenues to economic variation within the Budget year. Expenses can be significantly affected by public sector wage decisions, however, and to a lesser extent by changes in the prices of goods and services purchased by Government. Debt retirement since passage of the *General Government Debt Elimination Act 1995* has greatly reduced the Budget's exposure to interest rate fluctuations. The maturity profile of the State's debt portfolio, moreover, limits the immediate impact of interest rate rises.

Net financial liabilities may be affected by accounting adjustments as well as operating results. With the introduction of the new accounting standard AASB1119 from 2005-06, superannuation liabilities must be recalculated each year using a market-determined discount rate. This may lead to significant fluctuations in the General Government Sector's unfunded liability position.

¹² *Non-residential property transactions have far greater variation in size and timing than dwelling transactions. Due to this lumpiness in non-residential transactions, Table 6.4 provides estimates only for the dwellings component.*

OTHER RISKS TO BUDGET OUTCOMES

The Budget is framed on the basis of no change in government policy settings as well as economic and other parameters. Specific expenditure and revenue policies prevailing at budget time (including new policies announced prior to the Budget) are assumed to carry over into the forward estimates period.

In practice, financial outcomes will depend on a diverse range of factors:

- ◆ Costs of policies may vary from those assumed in the Budget estimates, for example because take-up rates differ from expectations.
- ◆ New policy initiatives and fine-tuning of existing policies are inevitable over the forward estimates period.
- ◆ New policies in one area can also have flow-on effects for other related areas. These effects are often hard to predict and may vary significantly from original budget-time estimates.
- ◆ Utility pricing decisions by independent State and Federal economic regulators affect the revenue streams of government-owned transport, electricity and water businesses.
- ◆ Outcomes may be affected by unforeseen events such as natural disasters where the Government intervenes in the public interest.

Expenditure Risks

The main factors that influence the expense side of the Budget include:

Changes in the demand for public sector services

Growth in the demand for public services is largely driven by demographic and social changes and other external factors. These influences can have a substantial impact on the cost of maintaining existing policies, in particular in health, community services, criminal justice and education services.

The forward estimates make allowances for such cost pressures where possible.

Unexpected events

Management of the State's finances requires anticipating the impact of new government policies as well as possible future developments which are external to the State's control. The flexibility to respond to changes in circumstances as they occur is critical to effective budget management and is integral to the NSW fiscal strategy. The impact of possible developments on budget aggregates can be favourable in some circumstances and adverse in others.

Contingency funding is provided in the Budget. The Treasurer's Advance is for contingencies such as those associated with natural disasters and the costs of unanticipated policy responses that may be required in the budget year. A separate Treasurer's Advance is provided for capital works. In 2005-06, the Treasurer's Advance is \$175 million for recurrent services, and \$95 million for capital works and services. To the extent that unanticipated expenditures are funded from the Treasurer's Advance or from other contingency provisions, there will be no effect on budget outcomes.

Drought relief assistance

After some easing of NSW drought conditions during summer, seasonal conditions have again deteriorated. The area of the State affected by drought has expanded from 60.5 percent at the beginning of January 2005 to 87 percent at the start of May 2005.

The Government's drought relief initiatives include transport subsidies, community support measures, interest subsidies and various rent and fee arrangements. Actual expenditure on drought relief assistance in 2005-06 will depend on the duration and severity of the drought.

Technological change

New technologies have the potential to facilitate improvements in the quality of service delivery and/or reduce the cost per unit of service delivery, including in key areas such as education and health. However, new technologies can also lead to demands for new services, especially in the health sector, with the potential to increase expenses.

Public sector wages

The Budget and forward estimates are based on assumptions regarding the rate of growth in public sector wages and employment. General government sector employee costs, which comprise almost 50 percent of total expenses, are the most important factor in determining the budget result. Each 1 percent rise in wages weakens the Budget result by an estimated \$202 million. In addition, a 1 percent pay rise adds an estimated \$57 million to employee entitlement liabilities.

The Government's wages policy seeks to maintain the value of the substantial real wage increases provided to public sector employees since 1996. The wages policy implies nominal pay rises of up to 3 percent per year through negotiated settlements.

Recent settlements with the Public Service Association and the Health Services Union have been negotiated at 4 percent per annum for four years. The reason these settlements have been above the wages policy is that they incorporate an additional 1 percent increase per annum for four years in return for: the Unions withdrawing existing work value cases before the NSW Industrial Relations Commission (IRC); extinguishing all claims for work value up to 1 July 2004; and agreeing to no further salary or conditions claims until 30 June 2008.

These negotiated settlements, while at a significant cost to the Budget, nevertheless take away some of the uncertainties that decisions arbitrated in the NSW IRC have led to in recent years. In coming months settlements will need to be negotiated for other major employee groups, including public hospital nurses (award expired 1 January 2005), police (award expires 1 July 2005) and public school and TAFE teachers (award expires 1 January 2006).

As nurses and teachers have received arbitrated work value increases from the NSW IRC in recent years, negotiations are centred on the wages policy of up to 3 percent per annum. At this stage, there remains considerable risk to budget outcomes unless settlements are consistent with the Government's wages policy.

Wage outcomes affect the long term structure of budget expenses. Public sector pay rises in excess of the Government's wages policy therefore require a structural response such as reduced spending elsewhere and/or higher taxation.

Capital Works

Agencies' expectations of capital works expenditure in a given period can be affected by unavoidable circumstances such as bad weather. While every effort is made to account for these effects, the impact of such factors can differ from that allowed for.

The forward estimates assume that the size of the 'discretionary' component of the capital program (i.e. that component which is not funded through dedicated revenue sources or otherwise locked in) will remain constant in real terms. This means that the forward estimates contain an allowance for new projects yet to be identified or approved.

Contingent Liabilities

Contingent liabilities are obligations that the Government may face if a particular event occurs. Contingent liabilities include:

- ◆ claims for compensation and litigation;
- ◆ State guarantees under statute;
- ◆ other guarantees provided to facilitate the provision of services and the development of infrastructure; and
- ◆ developments where the Government intervenes in the public interest, despite there being no legal obligation for the Government to do so.

The Government's main contingent liabilities, both quantifiable and unquantifiable, are identified in the annual *Report on State Finances*. In the 2003-04 Report, Note 19 identifies total quantifiable contingent liabilities of \$469 million as at 30 June 2004. The main quantifiable items are known claims including legal proceedings against NSW Police of \$111 million, and NSW Treasury Corporation's bonds on loan (less securities held) of \$21 million. The general government sector component of total quantifiable contingent liabilities is \$237 million.

The *Report on State Finances* also identifies contingent liabilities that cannot be quantified, for example from pending litigation.

NON-TAX REVENUE RISKS

Commonwealth General Purpose Payments

The main component of Commonwealth general purpose payments to the States is the distribution of GST revenues. Under the current funding arrangements, the share of funding allocated to each State is recommended by the Commonwealth Grants Commission (CGC). After consultation with the States, the Commonwealth Treasurer has the ultimate responsibility to determine the grants to the States.

New South Wales has no ultimate control over the funding received from the Commonwealth. Given the magnitude of GST revenues to be distributed, even a minor change in NSW' share of the total can have a substantial impact on revenues, and ultimately the Budget outcome. The CGC's 2004 review of relativities resulted in a significant loss of revenue to New South Wales due to changes in the Commission's assessment methodology. The next five-yearly report on the CGC's methodology is due in 2010. However, the Commission's annual updates prior to 2009 could also lead to significant changes in States' funding. That said, the CGC's 2005 annual update had a negligible effect.

At the March 2005 Ministerial Council for Commonwealth-State Financial Relations, the Commonwealth proposed that the States abolish certain business stamp duties that were to be the subject of review this year under the Intergovernmental Agreement. New South Wales rejected the Commonwealth's proposal. There are unquantifiable, but potentially significant, risks to revenue from 2006-07 resulting from this disagreement (see Chapter 8 for details).

Commonwealth Specific Purpose Payments

Specific Purpose Payment agreements are typically re-negotiated every three to five years. As each of these agreements has a limited duration, New South Wales does not have long-term certainty over this significant proportion (about 14 percent) of total budget revenues.

Public Trading Enterprise (PTE) Financial Performance

Many PTEs operate in markets where future costs and revenues are subject to significant uncertainty. Unexpected variations in PTE profits affect the Budget by changing the amount of tax equivalents and dividends they contribute to the Budget. For PTEs not profitable on a stand-alone basis, their performance variations may affect the level of capital and operating subsidies required from the Budget.

OTHER RISKS

Pricing Regulation of Government Monopoly Services

Potential impacts on the Budget, either adverse or favourable, could arise from pricing determinations made by the Independent Pricing and Regulatory Tribunal of New South Wales and the Australian Competition and Consumer Commission (determines prices for electricity transmission). These determinations may affect the Budget by changing the size of tax equivalent and dividend payments received from the businesses, or subsidies paid to the businesses.

The Tribunal is currently conducting a price review for:

- ◆ water, sewerage and stormwater services supplied by Sydney Catchment Authority, Sydney Water Corporation, Hunter Water Corporation and Gosford and Wyong councils – completion is expected in August 2005; and
- ◆ for bulk water supply to farmers, industry and town water suppliers, from water sources managed by State Water Corporation and the Department of Infrastructure, Planning and Natural Resources – completion is expected in June 2005.

The Tribunal's 2004-05 determination for State Transit Authority (STA) bus fares harmonised public and private metropolitan bus fares from 4 January 2005. This increased the price of some STA bus fares whilst reducing the price of many private fares. The impact on financial performance and budget funding requirements will be adjusted through new metropolitan contracts negotiated during 2005.

The Tribunal is expected to make its next fare determinations for metropolitan buses and Sydney Ferries Corporation before the end of 2005.

The Tribunal made no determination on CityRail fares in 2004-05, and has not specified when it will conduct its next review. CityRail's operations are subsidised from the Budget.

The Tribunal's determination on electricity retail prices to certain consumers only lasts until 2006-07. These consumers are those who use less than 160MW of electricity per year and have not accepted a competitive offer from another electricity supplier.

TransGrid's current profit forecasts for 2005-06 to 2008-09 are based on the Commission's April 2004 Draft Determination, on the PTE's maximum allowable electricity transmission revenues for 2004-05 to 2009-10. TransGrid's forecasts do not yet include the Commission's final determination, released in late April 2005.

Other Policy Changes

Changes in Commonwealth Government policies can affect New South Wales. These impacts can be direct such as through unilateral changes in GST arrangements. The impact of these changes cannot be quantified in advance, but can be significant.

Commonwealth Government policy can also have indirect impacts. For example, a change in migration policy, tariff policy, or commitments to international agreements could have flow-on effects to the NSW Budget.

In addition, Commonwealth policy changes can alter demand for State Government services and therefore the costs faced by States; for example, pricing and/or changes to eligibility requirements or waiting list criteria for some social services, and health insurance policy.

Policy changes in other States can flow through to the NSW Budget. For instance, different tax regimes may apply to border regions in order to minimise tax revenue leakages between States or policy changes may affect Commonwealth Grants Commission relativities. Apart from taxation, cross-border charging arrangements by other states for some services can also lead to variations in the demand for or the cost of services provided by New South Wales.