

CHAPTER 5: THE ECONOMY AND OTHER FACTORS AFFECTING BUDGET OUTCOMES

Economic Situation and Outlook

NSW output growth of 3½ percent in 2003-04 will be a little firmer than expectations in the 2003-04 Budget. Growth in state final demand is likely to be stronger than anticipated while net exports are likely to be weaker than expected.

- ◆ Despite little contribution from dwelling construction, domestic demand grew by around 4½ percent, boosted by a lift in consumer and business spending.
- ◆ Net exports were constrained by strong import growth and only partial recovery from the drought.

The forecasts for 2004-05 assume that with continuing robust world output growth, exports will contribute strongly to growth, but not enough to offset a decline in dwelling construction and slower growth in other components of domestic demand.

- ◆ NSW state final demand is forecast to increase by 3 percent, and gross state product is estimated to increase by 3¼ percent.
- ◆ NSW employment growth is projected to be 1¼ percent, while the unemployment rate should be steady at 5½ percent, below the national average.

Factors Affecting Budget Outcomes

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

- ◆ Stresses affecting the global outlook, particularly the US “twin deficits”, the sustainability of China’s rapid growth, and world oil prices;
- ◆ Domestic economic uncertainties, including the housing cycle, drought, the exchange rate and interest rates.

In addition to economic parameters, Budget estimates are framed on the basis of no change in government policy and other parameters. Key factors which have recently affected Budget outcomes include:

- ◆ Arbitrated public sector wage increases above those planned for; and
- ◆ Commonwealth policy on intergovernmental financial relations.

5.1 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 2004-05 budget estimates are presented in Section 5.2.

The sensitivity of budget outcomes to change in underlying factors is considered in Section 5.3. These factors include changing economic circumstances, unanticipated policy and regulatory decisions, changed demand for services, and the realisation of contingent liabilities.

5.2 THE ECONOMIC SITUATION AND OUTLOOK

At this time last year there were considerable concerns about the global economic outlook. Consensus forecasts for world output growth had been continuously revised lower, financial markets had deteriorated and there were concerns about global deflation. Meanwhile the drought had taken a large toll on an otherwise robust domestic economy. The Reserve Bank of Australia had indicated that if global conditions continued to deteriorate it would consider lowering interest rates.

Nevertheless, a modest global recovery was forecast to take place over 2003-04 in light of the significant global fiscal and monetary stimulus in place. That recovery did take hold as the year progressed, although concerns about the sustainability of the US and global recovery have only very recently receded. At present a continuation of firm global growth through 2004-05 is in prospect with the risks to such an outlook more balanced than has been the case for several years.

Stronger global demand for resources (particularly from China) lifted Australia's terms of trade, while expansionary fiscal and monetary policy settings in the United States contributed to a depreciation of the US\$ against major currencies. These factors drove a sharp upward adjustment in the Australian exchange rate during the first half of 2003-04. Despite strong growth in domestic demand and private sector credit, the Reserve Bank kept interest rates on hold until late in 2003. This reflected concern about the negative impact of rapid currency appreciation and hesitant global recovery on the national economy.

The activity of financial investors in the housing sector surged during the last few years, fuelled by low interest rates, capital gains tax changes favourable to property investment, and until 2003-04, comparatively weak returns in equity markets. This contributed to an unusual extension of the current housing cycle – accompanied by a rapid expansion in housing credit, a rising ratio of investors to owner-occupiers in total housing finance and a ramp-up of house prices. The weaker trend in housing finance and residential building approvals in the first half of 2004 suggests that the housing cycle might finally be entering a downswing.

A still buoyant housing and construction sector helped to maintain strong growth in employment and wages, providing a boost to consumer spending and overall domestic demand during 2003-04.

Inflation eased in 2003-04 under the weight of falling import prices. The combination of strong domestic demand and a high exchange rate drove a wedge between trends for prices of traded goods (stable or falling) and non-traded goods (strongly increasing). Without some easing in domestically sourced inflation, there is a risk that general price inflation will accelerate once the exchange rate stops rising, especially against the US dollar.

The forecasts for 2004-05 are for output growth to ease marginally. Slower domestic demand growth, principally due to a decline in housing investment, will largely be offset by gains in net exports. These forecasts assume continued firm global expansion, further improvements in agricultural output, moderately softer dwelling construction activity, and only marginally higher interest rates.

Uncertainties include the timing of the US monetary policy response to a narrowing output gap in that country and the reaction of global financial markets as rates rise. Security concerns could detract from global economic performance as could ongoing high oil prices. Domestically, while the slowing of dwelling activity thus far has been moderate, historically the cyclical movements in this industry often have proved larger and more disruptive than initially anticipated. Drought conditions currently affect nearly 80 percent of New South Wales. The Australian Bureau of Agricultural and Resource Economics (ABARE) and the Bureau of Meteorology expect average seasonal conditions in agriculture in 2004-05, with low risk of an El Nino event emerging¹. The possibility of continued drought, however, cannot be precluded.

RECENT PERFORMANCE²

NSW economic output growth in 2003-04 was slightly above 2003-04 Budget expectations. Growth relied somewhat more on domestic demand and less on net exports than anticipated in the Budget.

¹ Australian Bureau of Agricultural and Resource Economics (ABARE), Crop Report, 8 June 2004

² 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 early June 2004, which included: results to June 2003 for gross state product; to March 2004 for state final demand, consumer prices and wage costs; and to May 2004 for employment.

Moderate outcomes for net exports reflected a very strong lift in the exchange rate, still moderate growth in overseas markets, a less than full recovery in rural production and strong growth in import volumes. The strength of imports reflected robust investment and consumer demand. While crop production was up considerably on drought-affected 2002-03, conditions remained mixed and output did not recover to previous peaks. Despite a boost from the 2003 Rugby World Cup, inbound tourist numbers declined for a second year in 2003-04, reflecting continued economic and security uncertainties abroad. While strong North Asian demand boosted minerals and energy exports, this initially provided less benefit to New South Wales than to other more resource-intensive States.

Domestic demand expanded very strongly in the first half of 2003-04, supported by robust private consumption, resilient dwelling investment and a pick-up in non-residential construction. This strength reflected continued low interest rates, strong gains in asset prices, falling unemployment, strong growth in real wages, and the boost to real incomes from Australia's rising terms of trade. It also reflected a lift in Privately Financed Projects (PFP) infrastructure construction spending in New South Wales. In line with the strong growth in domestic demand, employment growth in New South Wales also exceeded expectations.

Table 5.1: Revised 2003-04 Estimates

(Year average percent change, unless otherwise indicated)

	2003-04 Budget	Half Yearly Review	Current Estimate
Gross State Product	3 ¼	3 ½	3 ½
State Final Demand	3 ¼	3 ¾	4 ½
Employment	1 ¼	1 ½	1 ½
Unemployment rate (year average, percent)	5 ¾	5 ½	5 ½
CPI (Sydney)	2 ¼	2 ¼	2 ¼
Wages (wage cost index, ordinary time)	3 ½	3¾	3 ¾

The global economic recovery was more synchronised in 2003-04, with marked accelerations in growth in the United States and Japan adding to continued robust performance in non-Japan Asia, particularly China. The upswing in those regions offset still sluggish trends in continental Europe. Initial concerns over deflation and a 'jobless' recovery in the United States were dissipated by sharp lifts in both employment and prices in early 2004. Health-related issues (SARS and Asian bird flu) receded, although both geopolitical uncertainties and financial stresses related to US budget and current account deficits remained of concern. Nonetheless consensus forecasts³ for 2004 world output growth improved steadily from 2.9 percent in July 2003 to 3.8 percent in May 2004.

³ Consensus Economics Inc., *Asia Pacific Consensus Forecasts, various issues.*

The major central banks kept monetary policy on hold during the first eleven months of 2003-04, with no change in the United States, Japan or the European Monetary Union. Policy initially eased before tightening again in the United Kingdom and New Zealand; while Canada reduced its intervention rate over the course of the year.

In *the domestic economy* strong growth in consumption spending and business investment was partially offset by the output impacts of the drought-affected rural sector and weaker than expected non-farm exports. While NSW state final demand is estimated to have increased by 4½ percent, weak net exports limited gross state product growth to 3½ percent.

ABARE reported that Australian winter crop production reached record levels in 2003-04, and solid if less spectacular gains are likely for the summer cropping season. In New South Wales, winter crop production is estimated to have increased by 141 percent to 8 million tonnes, but still well short of the 10 to 11 million tonnes during the three years preceding the 2002-03 drought.⁴ The ABS has estimated that the increase in gross value of national agricultural production should add 0.6 percentage points to GDP between 2002-03 and 2003-04.⁵ In New South Wales, given the sector's less complete recovery and its smaller share in the total economy, the contribution to 2003-04 output growth will be more modest.

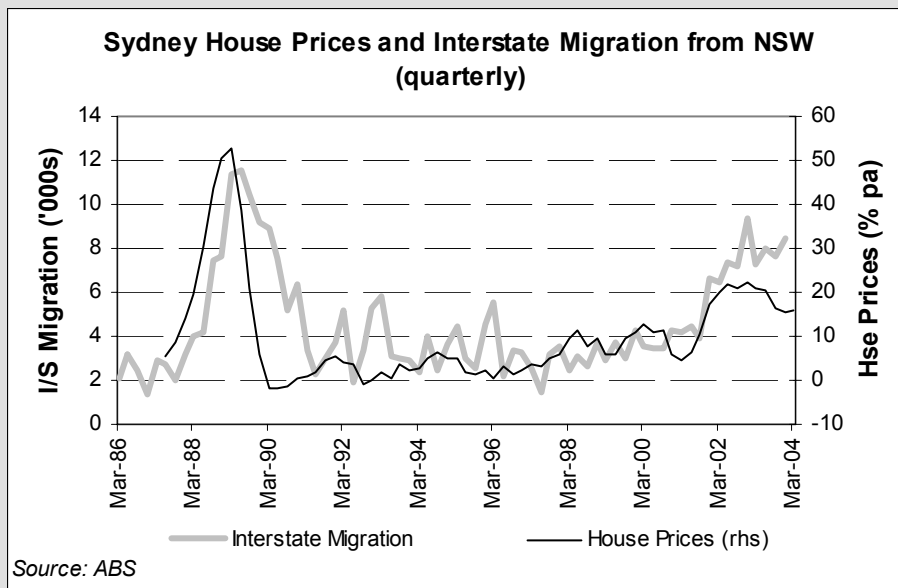
The pace of *consumer spending* lifted further in the first half of 2003-04, reflecting solid growth in employment and wages, higher property and equity valuations and purchasing power gains from Australia's rising exchange rate and terms of trade. However, trends in retail turnover and motor vehicle sales suggested growth was starting to moderate in the second half of the year, reflecting tighter monetary policy, some easing in residential construction and higher petroleum prices.

Dwelling construction continued to expand in the first half of 2003-04 but appeared to be easing back gradually in the second half. The cyclical upswing was prolonged by speculative investor activity encouraged by low interest rates and favourable federal tax arrangements. This ramped up established house prices and reduced affordability for first home owners – whose share in the housing finance approvals declined to historical lows.

⁴ ABARE, *Australian Crop Report, June 2004*.

⁵ ABS, *Australian National Accounts, March Quarter 2004*.

Box 5.1: Housing and Demographic Cycles



State economic performance is influenced by population growth, which has slowed from 1.3 percent in 2001 to 0.8 percent in 2003. One factor is a decline in New South Wales' share of net overseas migration to Australia during the past two years. In addition, net interstate migration from New South Wales has been larger than usual. Historically, interstate migration is correlated with the housing cycle, as shown in the chart above. Now that house price inflation has begun to slow, the historical relationship suggests interstate migration could also taper off, with a positive impact on NSW population growth.

Business investment remained firm, responding to improved profit ratios, high levels of capacity utilisation, improving world economic prospects, low financing costs and flat or declining prices for imported equipment (although cost pressures in building and construction increased). NSW business investment was also supported by Privately Financed Projects (PFP) infrastructure outlays which are estimated to have quadrupled to nearly \$1 billion in 2003-04.

The *labour market* made solid gains, with NSW employment rising by an estimated 1½ percent and the unemployment rate declining from 6 to 5½ percent. Through the year to the March quarter 2004, employment growth was strongest in the transport and storage, accommodation and restaurants, property and business services, retail trade and education sectors. Employment was weakest in the wholesale trade, manufacturing, communications, and general government sectors.

Inflationary pressures receded in 2003-04. Strong global competition from China in manufactured goods and a sharply higher exchange rate maintained downward pressure on inflation. The A\$ rose by 23.2 percent against the US\$ and by 15.9 percent against the Trade Weighted Index (TWI) in the first eleven months of 2003-04 compared to a year earlier. Price falls for tradeables (down 0.5 percent through the year to March, despite increased petroleum prices) offset faster growth in prices for non-tradeable items such as construction and service industry outputs.

Skilled labour shortages put upward pressure on wages in the construction industry and a bunching of wage adjustments in the public sector added pressure to total wage cost growth, which peaked at an annual rate of 4.1 percent in the December quarter 2003. Outside those two sectors, however, wage pressures remained moderate. Total wage cost growth slowed to 3.7 percent in the March quarter.

At the start of 2003-04, the RBA indicated that further weakness in the global outlook could prompt interest rate easings. The global outlook, however, improved rapidly in the first half of the year. The RBA then had to balance the case for tighter policy to contain high levels of capacity utilisation in the domestic economy and rapid private credit growth, against the case for policy moderation to offset the drag on net exports from the rapidly rising exchange rate.

Monetary policy was held steady until November and then tightened in two steps by a total of ½ percentage point. The RBA then paused to assess the effect, leaving policy unchanged through the remainder of 2003-04. While long bond rates were volatile, they drifted generally higher in response to evidence of improving United States employment and output, rising US inflation and the gradual hardening of Federal Reserve Board commentary on the monetary policy outlook.

OUTLOOK FOR 2004-05

In 2004-05 the world economy (except continental Europe) appears to be shifting into a synchronised upswing, as reflected in strong IMF predictions for global GDP and trade growth. Imbalances in the domestic economy are expected to decline, with stronger exports partially offsetting the easing of dwelling sector activity to more sustainable levels. Net exports may benefit from a more stable exchange rate, as well as more broad-based demand from world markets.

Within Australia, private consumption growth is expected to be slightly slower and the pace of business investment to slow but remain firm, while dwelling construction activity will ease back after three years of expansion. The first positive contribution to growth from net exports since 2000-01 should offset most of the slowdown in domestic demand, with aggregate output growth expected to be only slightly less than in 2003-04. As a result, employment growth will ease marginally and wages growth should stabilise.

Table 5.2: Economic Performance and Outlook

(Percent change, year average, unless otherwise indicated)

	Outcomes 2002-03	Estimates 2003-04	Forecasts 2004-05
New South Wales			
Gross state product	2.2	3 ½	3 ¼
State final demand	5.3	4 ½	3
Employment	2.0	1 ½	1 ¼
Unemployment rate (year average, percent)	6.0	5 ½	5 ½
Sydney CPI	2.8	2 ¼	2 ½
Wage cost index	3.5	3 ¾	3 ¾
Australia			
Non-farm GDP deflator	2.6	2 ½	2 ½
Ten year bond rate (year average, percent)	5.3	5 ¾	6 ¼

With a steadier exchange rate and terms of trade, however, the relief valve of low or falling tradeable sector inflation will tighten. This will see overall inflation rise, especially if current price pressures in the non-tradeables sector do not ease. In these circumstances it is likely that the current stance of monetary policy will be adjusted, though any adjustment should be small.

The global economic recovery is expected to continue and broaden further in 2004-05, as reflected in the recent IMF Outlook. The IMF forecasts global output growth at about 4½ percent and world trade growth at about 6½ percent in both 2004 and 2005, with the balance of uncertainties weighted to the up side. While the pace of expansion may ease somewhat in the United States and Japan, it should accelerate in Europe while remaining very robust in non-Japan East Asia. Key issues identified for IMF member states are how to achieve an orderly resolution to global imbalances (notably the large US current account deficit and the global petroleum market), resist protectionist pressures and manage the transition to higher interest rates.

*State final demand*⁶ growth in 2004-05 is likely to slow to around 3 percent from 4½ percent in the previous year.

- ◆ After very buoyant growth in 2003-04, *household consumption* growth is expected to slow in 2004-05. Higher interest rates, less buoyant asset prices, weaker housing construction activity and slower employment growth will restrain consumer spending, although reduced income taxes and higher social benefit payments will add to consumer demand.
- ◆ *Fixed investment* growth is expected to be slightly more moderate in 2004-05.
 - *Dwelling investment* growth eased from a peak annual rate of 49 percent in December 2002 to 4 percent in December 2003, and turned negative in March 2004. The sector is expected to continue gradually declining throughout 2004-05. The downturn is expected to be modest, given still firm underlying demand and, in the main, few signs of significant excess supply.
 - *Business investment* will continue to expand at a robust pace in 2004-05, though a little slower than seen in 2003-04. Private capital expenditure intentions in New South Wales point to nominal declines of about 12 percent in building expenditure and 1 percent in plant and equipment expenditure in 2004-05. While real building investment may be slightly weaker (construction output prices are rising at an annual rate of around 8 percent), real plant and equipment business investment should be considerably stronger (output prices of capital imports have been declining at an annual rate of around 15 percent). Private business investment growth also will be boosted by increased cash outlays by PFP transport and social infrastructure projects⁷.
- ◆ Growth in *public demand* is expected to strengthen with increased federal spending as announced in the Commonwealth Budget and priority NSW Government initiatives, particularly in health and transport, as outlined in the April mini-Budget and detailed in this Budget.

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

⁷ *Privately Financed Projects (PFP) work done* (nine new schools, Lane Cove Tunnel, Western Sydney Orbital, Cross City Tunnel, alternative waste treatment plant and Royal Prince Alfred Car Park projects) is projected to increase from \$978 million in 2003-04 to \$1,307 million in 2004-05. PFP activity during the four years from 2004-05 will be further supported by the \$1.5 billion railway rolling stock renewal project.

- ◆ *Net exports* should make a positive contribution to growth, reflecting further gains in rural production (provided there is a break in the drought currently affecting nearly 80 percent of New South Wales), further strengthening in world demand for NSW minerals, manufactures and tourist services and slower growth in import volumes.
 - In line with ABARE forecasts,⁸ it is assumed that NSW winter crop production will increase by around 17 percent in 2004-05, contrasting with a 13 percent decline for the rest of Australia. Therefore growth in NSW real farm production should be stronger than the national average, which ABARE forecasts will increase by 1.9 percent. Falls in rural commodity prices, however, may sharply reduce the net value of farm production in 2004-05, following large gains in 2003-04. NSW mineral producers, particularly coal miners, should enjoy stronger returns reflecting large price increases in forward contracts negotiated during 2003-04.

NSW *employment growth* is expected to slow from 1½ percent in 2003-04 to 1¼ percent (near the long-term average) in 2004-05, reflecting the cyclical shift from employment intensive sectors such as dwelling construction to more capital intensive sectors such as mining. With growth in working age population continuing to ease, however, the forecast pace of job creation should be sufficient to keep the NSW *unemployment rate* steady at 5½ percent.

Wage cost growth in the private sector is expected to remain moderate in light of the stabilisation in the unemployment rate and as construction activity slows (a sector which has experienced above average wage pressure in the last few years). The AIRC national minimum wage decision in May 2004, providing a \$19 per week or 4.2 percent increase to lower-paid workers, will exert some upward pressure. It is assumed that growth in public sector wages will moderate in 2004-05. Recent increases awarded by the Industrial Relations Commission (IRC) to teachers and nurses, however, demonstrate that less moderate outcomes cannot be precluded.

The *Sydney CPI* is expected to grow in line with recent RBA projections, with underlying inflation declining to around 1¾ percent during 2004 before rising to around 2½ percent in 2005⁹. Key drivers include the exchange rate, petroleum prices (these are assumed to be steady in year average terms, implying a decline through the year to June 2005). Wage pressures are expected to remain steady.

⁸ ABARE, Australian Commodities, *March quarter 2004*; and Australian Crop Report, *June 2004*.

⁹ RBA, Statement on Monetary Policy, *May 2004*.

Competitive pressures in the domestic economy are expected to improve with more moderate growth in domestic demand, and this will slow the pace of inflation. Declining world prices of manufactures (in part reflecting China's emergence as "the world's workshop") also should help contain domestic inflationary pressures.

With global expansion now more firmly based and with the risk of a destabilising rise in the exchange rate now abating, the RBA is expected to follow other major central banks in gradually removing some of the stimulus of historically low current monetary policy settings. In Australia, however, the policy adjustment task is nearly complete, while in the United States and some other countries it has yet to begin.

MEDIUM TERM OUTLOOK

Prospects for the economy beyond 2004-05 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 2004-05 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 5.3: Economic Parameters Beyond 2004-05

(Percent change, year average, unless otherwise indicated)

	Medium Term
Gross state product	3¼
Population	1
Employment	1¼
Sydney CPI	2½
Wage cost index	3½
Ten year bond rate (year average, percent)	6½

5.3 FACTORS AFFECTING 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.

ECONOMIC UNCERTAINTY

Factors of uncertainty in the economic outlook for 2004-05 include:

- ◆ While the forecasts assume a moderate downturn in dwelling construction, some previous downturns (often associated with sharp tightenings in monetary policy) have been much more severe. Because the dwelling sector has strong direct and indirect influence on demand for labour and goods, it is an important determinant of aggregate economic output and employment. In addition, the large rise in housing-related debt by households (as occupiers and as investors) in recent years has increased their exposure to swings in the cycle and other shocks leading to higher interest rates or increased unemployment. With households devoting an unprecedented share of their disposable income to debt servicing, any adverse economic shock could oblige them to cut back on consumption – risking a broader economic downturn.
- ◆ A large portion of New South Wales remains affected by drought. A continuation of drought would further degrade the difficult conditions now affecting much of rural New South Wales, undermine exports and slow State economic growth.
- ◆ Oil prices have risen sharply in months leading up to the Budget. If recent levels are sustained or exceeded, whether due to production limits by oil exporting countries, unanticipated growth in demand in oil importing countries or geopolitical factors impeding supply, this could weaken real incomes and global economic growth and increase inflation. The International Energy Agency estimates that a \$10 per barrel increase in the oil price retards world growth by half a percentage point, with a far larger impact on oil importing developing countries such as India, Thailand and China¹¹.

¹⁰ Key source publications and their release dates are reported in the footnote on page 5-3.

¹¹ International Energy Agency, Analysis of the Impact of High Oil Prices on the Global Economy, May 2004.

- ◆ Further widening of the United States “twin deficits” (on budget and on balance of payments) would increase the possibility of a destabilising sell-off in bonds, or a prolonged decline in the US exchange rate. The United States trade deficit also increases global protectionist pressures. Uncertainty over US fiscal policy may increase with the approach of elections in November 2004.

Box 5.2: Uncertainties in the Outlook for Inflation

While inflation is expected to average 2.5 percent in 2004-05, it is possible that the outcome could be higher or lower.

Why might inflation be lower than forecast? Much of the recent pressure on non-tradeables in the CPI (which increased by 4.1 percent through the year to March) is attributable to the dwelling market boom (which drove up housing costs) and the drought (which lifted food prices). With the housing cycle turning down and provided that there is a break in the drought currently affecting most of New South Wales, these pressures may now reverse.

Why might inflation be higher than forecast? Factors of concern are: (a) the reversal of the exchange rate which, after appreciating from US49c in March 2001 to US80c in February 2004, was back below US70c in early June; (b) the recent lift in world oil prices – with potentially far-ranging secondary effects on prices across the rest of the economy; (c) high capacity utilisation and tight labour markets in the domestic economy, (d) fiscal stimulus from increased spending and reduced taxation measures announced in the Commonwealth budget, and (e) the possibility that Chinese currency revaluation may lift world prices for manufactured goods, which up to now have contributed to CPI stability.

- ◆ China’s current growth rate may be unsustainable, and authorities have begun to impose credit restrictions and other measures to rein in demand. But China’s financial system and poorly performing banks may not be robust enough to absorb adjustment without major disruption. Hence a mild tightening might end with a severe slowdown, drop in imports, and shock to trading partner economies.

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

Box 5.3: Housing – Soft or Hard Landing?

The evolution of the housing market over the next year or two is a major uncertainty. The housing sector is very important to the NSW budget. Related revenues (transfer duty, mortgage duty and land tax) account for 15 percent of total general government sector revenue in 2004-05. The housing market also is very volatile.

The forecasts utilised in the Budget and the revenue projections could be characterised as a 'soft landing' scenario. A robust global economy, strong domestic corporate profits, firm employment growth, a historically low unemployment rate and neutral, rather than tight, monetary policy are all expected to support such a scenario. This is consistent with the Commonwealth Budget assessment that "the rate of increase in nominal house prices is expected to flatten in 2004-05".¹ It is also consistent with the OECD's assessment that "the projected downturn of the housing investment cycle is in line with declining lending to owner-occupiers and investors and a softening general sentiment about the property market."²

At this stage available data (which lags activity considerably) and anecdotes do suggest that some of the heat seen in the market has dissipated and that a peak has been reached. The Reserve Bank commented recently "... a turning point appears to have been reached in the housing market after the overheated levels of late last year"³.

While general economic conditions should support the soft landing scenario (and may even provide some upside risk), there are two concerns on the downside.

The first is that pockets of excess supply in inner city investor housing could see a sharp downturn in these prices as investors attempt to exit the market. This could then lead to some spill-over into other housing markets, dampening sentiment and prices more broadly.

The other is that there may have been a bubble in housing prices, which might burst at some stage. Price increases in housing seen in recent years certainly fulfil the requirements of an asset price 'boom' as defined by the IMF⁴. The IMF also suggested that some 40 percent of booms end in busts. So the risk of a broader housing price decline, with severe negative impacts on the economy more generally, cannot be precluded. That said, the IMF also noted that housing busts were normally associated with high interest rates. Provided that inflation remains contained, as anticipated in the Budget, that risk should be small.

Footnotes:

1. Commonwealth Treasury (2004), Budget Strategy and Outlook 2004-05, Budget Paper No. 1, Canberra, May;
2. Organisation of Economic Cooperation and Development (2004), OECD Economic Outlook, pages 114-116, Paris, 11 May;
3. Reserve Bank of Australia (RBA) (2004), Statement on Monetary Policy, Sydney, 8 May; and
4. International Monetary Fund (IMF) (2003a), 'When Bubbles Burst', Chapter 2, World Economic Outlook, Washington DC, April.

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 5.4. 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. 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 Commonwealth grant bases (such as household consumption).

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 **general purpose and specific purpose payments** to the States are described in Chapter 7. From 2004-05, general purpose payments to New South Wales will depend on the amount of GST collected. Since the GST is levied on private consumption, NSW receipts in excess of the Guaranteed Minimum Amount will vary in line with fluctuations in household expenditure.

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.

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 5.4 provides estimates only for the dwellings component.*

Table 5.4: Sensitivity of Fiscal Aggregates to Changes in Selected Economic Parameters, 2004-05 (effect of a one percent increase, unless otherwise indicated)

Parameter	Effect on the 2004-05 Budget Result (\$m) ¹
A. Factors affecting tax revenue	
Dwelling sales (price or volume)	40
Motor vehicle sales	15
Employment	52
Private sector wages	57
Household disposable income	9
B. Factors affecting grant revenue	
Household consumption ²	97
C. Factors affecting expenses	
Public sector wages and salaries	-180
Prices of goods and services	-101
Interest rates ³	-17
Effect on 2004-05 Net Financial Liabilities (\$m)⁵	
D. Factors affecting Superannuation Liabilities⁴	
Public sector wages and salaries	174
Sydney CPI	182
Investment return ³	-130

¹ 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.

² Projected GST receipts are \$9,744 million. GMA provisions limit NSW exposure to GST shortfalls during the next few years.

³ Effect of a one percentage point increase in the indicated factor (interest rate, or rate of return).

⁴ Factors affecting superannuation liabilities also indirectly affect expenses in the operating statement. For brevity, however, these indirect effects are not detailed in the table.

⁵ 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).

Superannuation factors will affect the operating result as well as the Net Financial Liabilities. For example, an increase in 2004-05 investment earnings on NSW public sector pooled superannuation funds from 7.3 percent to 8.3 percent will decrease projected unfunded superannuation liabilities by about \$130 million. In turn, total superannuation expense for 2004-05 will decrease by about \$8 million. This is because, for net lending GFS reporting purposes, an increase in unfunded liabilities is regarded as a borrowing with a notional borrowing cost as determined by the Fund's actuary.

OTHER FACTORS AFFECTING 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 can affect the revenue streams of government-owned transport, electricity and water businesses.
- ◆ Unforeseen events such as natural disasters where the government intervenes in the public interest.

Factors Affecting Expenditure

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 educational 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 2004-05, the Treasurer's Advance is \$240 million for recurrent services, and \$110 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 49.7 percent at the beginning of February to 79.5 percent at the start of June 2004.

The Government's drought relief initiatives include transport subsidies, various interest, rent and fee deferrals or waivers, water cartage, and other measures. Actual expenditure on drought relief assistance in 2004-05 will depend on the timing of the breaking of drought and subsequent agricultural recovery, with funding to be drawn from the Treasurer's Advance.

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 outcome is 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 \$180 million. In addition, a 1 percent pay rise adds an estimated \$50 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. These are in the range of 13 to 25 percent, or an average of 19 percent. The wages policy implies nominal pay rises of about 3 percent per year through negotiated settlements.

Recent increases granted by the NSW Industrial Relations Commission (IRC), a State judicial body with arbitration powers, have been well in excess of the Government's policy.

In December 2003 the IRC awarded a pay increase for public hospital nurses of 3.5 percent from 1 January 2004. This pay increase was additional to an interim 6 percent rise awarded by the IRC from 1 January 2003. These increases cumulate to 9.7 percent over two years.

On 9 June 2004, the IRC announced their final decision regarding the teachers' pay claim. The decision provides for salary increases of 3 percent from 1 July 2004 and 3.5 percent from 1 January 2005. This followed an interim arbitrated 5.5 percent increase from 1 January 2004. These increases cumulate to 12.5 percent over two years.

In contrast, settlements being reached in other States have generally been in the 3 to 4 percent per year range. For example, recently concluded Victorian agreements for teachers, nurses and public servants have provided for annual salary increases of 3.5 percent. Recently concluded Queensland agreements for teachers and for firefighters have provided for annual salary increases averaging 3.5 to 3.6 percent.

The short-term outlook is for continuing uncertainty from further arbitrated cases as current wage agreements with other public sector unions expire.

The Government's wages policy reflects what the public sector can afford at a time when revenues are increasing only modestly and there are large increases in spending on health, education, community services and other government services.

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 2002-03 Report, Note 19 identifies total quantifiable contingent liabilities of \$490 million as at 30 June 2003. The main quantifiable items are NSW Treasury Corporation's bonds on loan (less securities held) of \$124 million, and known claims including legal proceedings against NSW Police of \$110 million. The general government sector component of total quantifiable contingent liabilities is \$227 million.

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

FACTORS AFFECTING NON-TAX REVENUES

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 New South Wales' 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 2009. However, the Commission's annual updates prior to 2009 could also lead to significant changes in States' funding.

New South Wales also receives Budget Balancing Assistance from the Commonwealth to compensate for any shortfall between GST revenue and the Guaranteed Minimum Amount (GMA). Although the GMA is subject to an agreed methodology, it too is subject to uncertainties. The GMA for New South Wales has tended to decline over recent years. For example, the GMA for 2004-05 was \$10,030 million as at June 2002, but had fallen to \$9,631 million by May 2004.

Commonwealth Specific Purpose Payments

Specific Purpose Payments that are due for re-negotiation in 2004, or which were due for re-negotiation earlier but have been delayed, are as follows:

- ◆ Australian National Training Authority Agreement;
- ◆ Government Schools Grants; and
- ◆ The Indigenous Education Strategic Initiatives Program.

The outcome of these reviews will also affect the Budget.

Public Trading Enterprise (PTE) Financial Performance

The State's PTEs operate in commercial markets for which future revenues and costs can be characterised by a high degree of uncertainty. Unanticipated variations in PTE profits affect the budget via dividend and tax equivalent payments (financial distributions), and through capital and operating subsidies.

For example, a 1 percent positive (negative) variation in EnergyAustralia's forecast 2004-05 pre-tax profit results in a \$1.54 million increase (\$1.54 million decrease) in its financial distributions to Government.

OTHER FACTORS

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 (IPART) and the Australian Competition and Consumer Commission (ACCC).

IPART is currently undertaking a fare review for government bus and ferry services delivered by the State Transit Authority and Sydney Ferries Corporation, to take effect from 31 October 2004. At time of writing, the 2004-05 IPART fare review process for CityRail had been deferred until further notice. These price determinations have an important influence on the level of budget subsidies required for public transport services.

The ACCC is currently reviewing maximum allowable electricity transmission revenues for EnergyAustralia and TransGrid for the period from 1 July 2004 to 30 June 2009. At time of writing, the ACCC's final decision is due for public release in early August 2004.

On 10 June 2004, IPART completed determinations on electricity distribution network prices, and regulated retail prices for the four state-owned electricity distributors – EnergyAustralia, Integral Energy, Country Energy, and Australian Inland Energy and Water. The determination on electricity distribution covers the five year period from 2004-05 to 2008-09. The determination on electricity retail prices applies to customers who use less than 160MW of electricity per year and have not accepted a competitive offer from another electricity supplier; this determination covers the three year period from 2004-05 to 2006-07.

Price paths for water, sewerage and stormwater services for customers supplied by Sydney Water Corporation, Hunter Water Corporation, and Gosford and Wyong councils for the period 1 July 2003 to 30 June 2005 were set in May 2003. In the same month, the Tribunal concluded a mid-term review of Sydney Catchment Authority's water supply services price path for the period 1 October 2000 to 30 June 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.

