Economics update

Fiscal consolidation paves way to 2012-13 surplus

As governments around the world move to slash their budget deficits, the Australian Government has reinforced its commitment to fiscal consolidation by tightening fiscal policy in 2011-12 with the eventual aim of returning the budget to surplus by 2012-13. The Gillard Government's first budget forecasts a fiscal deficit equal to -1.4 per cent of GDP in 2011-12, down from -3.3 per cent in 2010-11. The fiscal policy stance is contractionary, with the Government undertaking the fastest fiscal consolidation in over four decades. The 2011-12 Federal Budget also announces supply-side reforms, with the aim of preparing the Australian economy for the future challenges of 'mining boom mark II'. Towards this end, the centrepiece of the Budget is a labour market program designed to improve labour force skills and lift workforce participation. Despite a short term deterioration in the forecast fiscal position due to weaker than expected economic growth and the impact of natural disasters, Australia's medium term fiscal position appears strong. This issue of the *Economics Update* analyses the impact of the 2011-12 Federal Budget on the Australian economy.

> *"Recent natural disasters have had a significant impact on the Australian economy and the Government's fiscal position, but medium-term prospects are for strong economic growth, low and falling unemployment and rising incomes. While the high Australian dollar and legacy effects from the global financial crisis are weighing particularly heavily on some sectors, the overall economy is expected to grow at an above-trend rate over the next two years…With the unemployment rate already low, the unprecedented mining investment boom will stretch the economy's capacity over the coming years. It is important that the Government does not compound these pressures, which is why it will return the budget to surplus in 2012-13 and beyond… The return to surplus will be achieved before any major advanced economy through the implementation of the fastest fiscal consolidation in at least forty years...This Budget delivers on the Government's fiscal strategy while also continuing to invest in the economy's productive capacity."*
>
> 2011-12 Commonwealth Budget Paper 1, Statement 1

The Policy Mix

Fiscal policy has played a major role in the economic policy mix in recent years. The slowdown in domestic economic growth in 2009 due to the global financial crisis was partly offset by countercyclical fiscal policy. The use of expansionary fiscal policy in 2008-09 and 2009-10 provided significant macroeconomic stimulus to the Australian economy. The combination of discretionary stimulus spending and a cyclical drop-off in taxation revenue saw large fiscal deficits, equal to -\$29.7 billion (-2.4 per cent of GDP) in 2008-09 and -\$52.9 billion (-4.1 per cent of GDP) in 2009-10. At the same time, monetary policy moved towards an expansionary stance. The renewed focus on fiscal policy came after over a decade in which fiscal policy had played a support role to monetary policy, which was the primary macroeconomic management tool.

As the domestic economy recovered, Australia entered a new period of fiscal consolidation in 2010, with the Government expressing an aim to return the budget to surplus by 2012-13. In the 2011-12 Budget the Government has reinforced its medium-term fiscal strategy of achieving budget surpluses, on average, over the economic cycle. To do so, the Government has relied on automatic stabilisers to improve the cyclical component of the budget together with limits on the growth in discretionary spending.
The Government

Main features

- Fiscal deficit to decrease from -\$45.7 billion (-3.3 per cent of GDP) in 2010-11 to -\$20.3 billion (-1.4 per cent of GDP) in 2011-12.
- Fiscal stance is contractionary, due to both discretionary and cyclical factors.
- Budget forecast to return to surplus in 2012-13.
- Lingering impacts of the GFC and natural disasters have increased the estimated fiscal deficits for 2010-11 and 2011-12.
- Emphasis on boosting productive capacity through lifting workforce participation, addressing skills shortages and investing in infrastructure.

ISSN 1327-2683

has committed to a cap on growth in real government spending equal to 2 per cent per year, until the budget returns to a surplus of 1 per cent of GDP. The Budget contains $22.2 billion in savings over the next four years, which has helped cut the fiscal deficit to -$20.3 billion in 2011-12.

However, a less favourable cyclical environment over the last six months has led to an increase in the estimated fiscal deficits for 2010-11 and 2011-12. Recent natural disasters in Australia, together with lower than expected taxation receipts due to the lingering impacts of the global financial crisis have resulted in an estimated increase in the fiscal deficit in 2010-11 by $3.8 billion and in 2011-12 by $9.4 billion (compared with the Mid-Year Economic and Fiscal Outlook 2010-11 – 'MYEFO' – an update on Australia's fiscal position released in November 2010). Larger deficits in the short term means that net government debt is now expected to peak at 7.2 per cent of GDP in 2011-12, which is still well below levels in other advanced economies.

The 2011-12 Budget also demonstrates the longer-term role of governments in implementing structural reforms. The Budget targets the supply side of the economy by announcing several new microeconomic reform measures. Many of the Government's longer-term reforms follow recommendations made by the Henry Tax Review, which was released in the lead up to last year's budget. The centrepiece of the 2011-12 Budget is a labour market program which aims to improve labour force skills and boost workforce participation. The Government has also prioritised reforms to education, infrastructure and social welfare. The Government argues that these measures are necessary to boost the economy's productive capacity in order to take full advantage of the continuing strength of the global commodities boom. They are also important in spreading the gains from rising national income across Australia's 'patchwork economy'.

	Actual	Estimates			Projections	
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Underlying cash balance ($bn)	**-54.8**	**-49.4**	**-22.6**	**3.5**	**3.7**	**5.8**
Per cent of GDP	-4.3	-3.6	-1.5	0.2	0.2	0.3
Fiscal balance ($bn)	**-52.9**	**-45.7**	**-20.3**	**4.0**	**3.2**	**8.5**
Per cent of GDP	-4.1	-3.3	-1.4	0.3	0.2	0.5

Source: 2011-12 Commonwealth Budget Paper 1, Statement 1

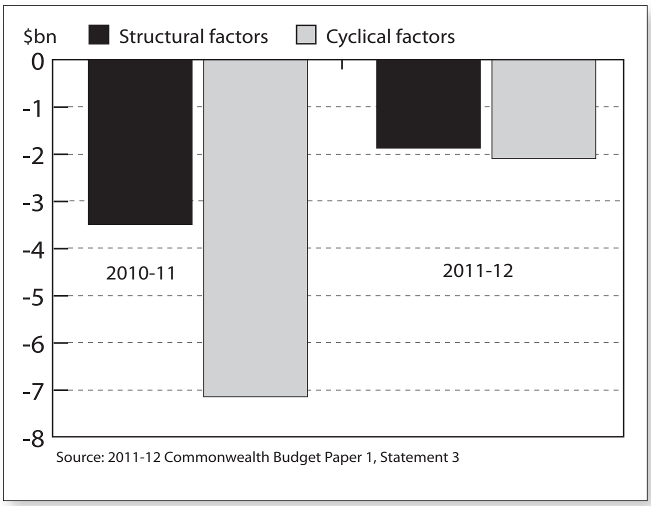
Goals of Fiscal Policy in 2011-12

1. Fiscal tightening and return to surplus

The first goal of the 2011-12 Budget is to maintain the Government's policy of fiscal consolidation. Fiscal consolidation is the policy of maintaining balanced or surplus budgets over the course of the economic cycle. As the economy has recovered from an economic downturn, this requires a return to budget surpluses in the medium term. Fiscal tightening in the 2011-12 Budget means that the Australian economy is on track towards the eventual aim of returning to a small budget surplus in 2012-13. This will be achieved through limiting the growth in discretionary spending and allowing automatic stabilisers to improve the budget balance. As such, the fiscal stance is contractionary, with the fiscal deficit forecast to decrease from -3.3 per cent of GDP in 2010-11 to -1.4 per cent of GDP in 2011-12.

In order to return the Budget to surplus, the Government has made $22.2 billion in savings (in the form of reductions in discretionary spending), over the next four years. All new spending in the 2011-12 Budget is offset by savings elsewhere in the Budget. The Government has also capped the growth in real government spending to 2 per cent per year, until the budget returns to a surplus of 1 per cent of GDP. Although this still allows for growth in discretionary spending, it is capped at a low level of 2 per cent, which means that over coming years the growth in taxation revenue due to the automatic stabilisers will eventually push the budget back into surplus. Improvements in the cyclical component of the budget will be driven by a forecasted recovery in the economy's growth rate to trend levels of 4.0 per cent in 2011-12 and 3.75 per cent in 2012-13. With demand pressures expected to pick up and unemployment forecast to fall to 4.5 per cent in 2012-13, it is important that the government does not add to inflationary pressures. Tighter fiscal policy exerts a contractionary effect on the economy, reducing the extent to which the Reserve Bank of Australia (RBA) may have to reduce demand pressures by lifting the cash rate.

However, short term challenges have hit Australia's fiscal position over the past six months, leading to upwards revisions in the forecast budget deficits for 2010-11 and 2011-12. Recent natural disasters in Australia – the December floods in Queensland and Cyclone Yasi – are expected to require reconstruction expenditure of $6.6 billion over six years. Despite this, the worsening in Australia's forecast fiscal



Effect on fiscal outcome (since 2010-11 MYEFO)

position is largely the result of cyclical factors, caused by lower-than-expected economic growth and reduced taxation receipts. The natural disasters in Australia are expected to reduce economic output by $9 billion in 2010-11, subtracting ½ a percentage point from real GDP growth. Natural disasters in Japan and New Zealand are expected to subtract a further ¼ of a percentage point from Australia's GDP growth in 2010-11. Continued weaknesses in consumer spending are also detracting from economic growth. As such, Treasury has revised down its estimates for growth in real GDP in 2010-11 to 2.25 per cent from 3.25 per cent in the MYEFO. This has seen taxation receipts fall by $16.3 billion over 2010-11 and 2011-12 relative to the MYEFO estimates.

2. Lift workforce skills and participation

The Budget contains significant measures to boost Australia's productive capacity by increasing workforce participation and investing in skills. The centrepiece of the 2011-12 Budget is the *Building Australia's Future Workforce* package, a labour market program designed to address emerging skills shortages as the economy approaches full employment. With unemployment forecast to fall to 4.75 per cent in 2011-12, Australia will once again be operating close to or at its 'natural rate' of unemployment. Labour market programs are aimed at decreasing the natural rate of unemployment and increasing the labour supply. The policy consists of $3 billion over six years in programs aimed at increasing the skills level of the labour force. It establishes a new $558 million *National Workforce Development Fund* which is expected to deliver 130,000 training places over four years. This is essentially a labour market retraining policy which aims to update the skills of the structurally unemployed to enable them to find employment. The Government will also increase funding for the vocational education and training system as well as the Apprenticeships system. The 2011-12 Budget also allocates 16,000 skilled migration places to regional areas in order to address skills shortages in regional communities.

The *Building Australia's Future Workforce* package contains measures to boost workforce participation by creating incentives to work and tightening access to social welfare. Increasing workforce participation for those previously on income support will increase the economy's productive capacity, while reducing the future strain on social welfare spending. Some of these policies include:

- Bringing forward the Low Income Tax Offset, allowing low-income workers to receive a larger tax refund in their regular pay.
- Phasing out the Dependent Spouse Tax Offset, which previously allowed dependent spouses who were not working to claim a tax offset.
- Extending the 'Earn or Learn' requirement to those up to age 21, forcing young people to either work or participate in education or training.
- Providing 35,000 targeted wage subsidies to employers who hire those who have been unemployed for more than two years.
- Tightening the eligibility criteria and increasing participation requirements for Disability Support Pension recipients, especially those under 35 years with a partial work capacity.

3. Boost infrastructure capacity

The 2011-12 Budget has made further investments in the economy's productive capacity by increasing infrastructure spending to help reduce capacity constraints. Prior to the global financial crisis, supply constraints – such as infrastructure bottlenecks, as well as skills shortages – restrained the growth in Australia's export volumes, preventing Australia from achieving its economic growth potential during a global resources boom. As the economy recovers, many of these pressures are re-emerging. The 2011-12 Budget continues the implementation of the Government's $36.2 billion *Nation Building Program*, announced in the 2008-09 Budget. The program provides significant investment in road, rail and port infrastructure over six years aimed at easing ezxport bottlenecks. The 2011-12 Budget also contains funding for a number of regional infrastructure projects, aimed primarily at Australia's mining regions. Additionally, the Government has announced plans to give Infrastructure Australia (Australia's infrastructure advisory body), a broader role in targeting infrastructure policy towards export bottlenecks. There are also measures to remove barriers to private investment in 'nationally significant' infrastructure projects through tax incentives. In addition, the Government has signalled its intention to continue with the rollout of the *National Broadband Network*, one of the largest areas of infrastructure spending in recent years.

4. Increased spending on priority areas

The Government has focused discretionary spending on a range of priority areas. The 2011-12 Budget announced a much anticipated $2.2 billion mental health reform package. The Government also guaranteed $16.4 billion in additional growth funding for public hospitals over six years, after indicating in February that the Commonwealth Government will increase its share of public hospital funding. An estimated $6.6 billion will also be provided over six years for rebuilding infrastructure in communities affected by natural disasters. In addition, there are significant funding increases for projects in regional communities. Meanwhile, the Government has indicated that it plans to introduce a carbon tax to commence on 1 July 2012.

The Fiscal Outcome

The 2011-12 financial year will see the fiscal deficit decrease to -$20.3 billion, or -1.4 per cent of GDP. The deficit is significantly smaller than the previous financial year (-$45.7 billion). The size of the budget deficit is a reflection of two factors: a turnaround in cyclical factors as the economy has recovered, and limits on the growth in discretionary spending.

Cyclical Factors

As economic growth has returned following the slowdown during the global financial crisis, the cyclical components of the budget – the automatic stabilisers – have worked to gradually increase government revenue and moderate government expenditure.

Stronger economic growth leads to rising incomes and company profits (particularly in the mining sector), which in turn increases personal income tax revenue and company tax revenue. Stronger economic growth also leads to falling cyclical unemployment, reducing government expenditure on social welfare in the form of unemployment benefits.

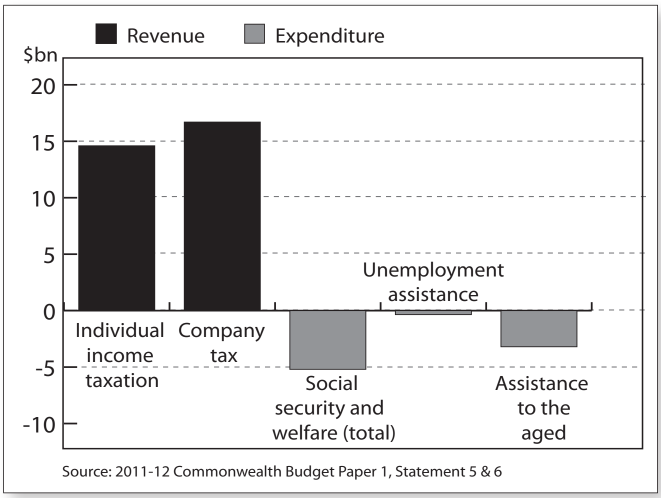
	Actual	Estimates			Projections	
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Revenue ($bn)	**292.8**	**310.8**	**350.0**	**383.1**	**405.2**	**425.8**
Per cent of GDP	22.8	22.4	23.7	24.6	24.7	24.6
Expenditure ($bn)	**339.2**	**350.8**	**365.8**	**380.5**	**399.0**	**414.1**
Per cent of GDP	26.4	25.3	24.8	24.4	24.3	23.9

Source: 2011-12 Commonwealth Budget Paper 1, Statement 3

On the revenue side, income taxation is expected to rebound over 2011-12. Individual income taxation receipts are forecast to grow by 10.7 per cent from $136.3 billion in 2010-11 to $150.9 billion in 2011-12. In addition, company tax receipts are expected to grow by an enormous 28.8 per cent from $57.9 billion in 2010-11 to $74.6 billion in 2011-12. This is largely due to the expected increases in company profits in the mining sector as a result of the global resources boom.

However, the cyclical factors affecting revenue have not all worked in the same direction. In late 2010 and early 2011, the effects of Cyclone Yasi and severe flooding in Queensland, an appreciating exchange rate, and subdued household consumption levels have restrained the potential growth in taxation revenue and necessitated increased government spending. In addition, revenue from capital gains tax has been slow to recover from the global financial crisis, while higher than expected depreciation expenses have partly held back the growth in company tax revenue. Changes in automatic stabilisers are expected to result in the fiscal deficit being $6.9 billion higher in 2011-12 than it otherwise would have been. However overall, taxation revenue is expected to increase due to cyclical factors, contributing to the reduction in the overall budget deficit in 2011-12.

On the expenditure side, the 2011-12 Budget anticipates only moderate growth in social security and welfare spending. This reflects stronger economic growth since the global financial crisis and falling unemployment. Social security and welfare spending is forecast to grow by just 4.5 per cent from $116.7 billion in 2010-11 to $121.9 billion in 2011-12. In particular, unemployment assistance is expected to grow by $202 million, or just 2.9 per cent, over 2011-12. The principal driver of growth in welfare payments is income support for the aged. This is because the age pension is linked to a fixed proportion of male total average weekly earnings. As incomes continue to rise, assistance to the aged is expected to increase by $3.2 billion over 2011-12.



Impact of changes in cyclical factors on 2011-12 fiscal outcome

Discretionary Changes

The Government has also announced a range of discretionary policy changes to support the contractionary impact of the automatic stabilisers in tightening fiscal policy. The major discretionary change to revenue is the introduction of a temporary flood levy in 2011-12 to contribute to the costs of rebuilding infrastructure following the recent floods. The levy will apply at 0.5 per cent of taxable income in excess of $50,000, and 1 per cent of taxable income in excess of $100,000.

Government spending is forecast to increase by $15.0 billion in 2011-12, representing real growth of 1.2 per cent on the previous financial year. The Government's aim is that average real growth in government payments between 2011-12 and 2014-15 is expected to equal 1.5 per cent. This is consistent with the Government's fiscal strategy of keeping real annual spending growth within 2 per cent. Total expenditure is expected to decrease as a percentage of GDP from 25.3 per cent in 2010-11 to 23.9 per cent in 2014-15. Some of the major items of government expenditure over the next four years include:

- $6.6 billion for natural disaster reconstruction, much of which will be paid for by the temporary flood levy.
- Increasing the proportion of the Low Income Tax Offset that is delivered through workers' weekly pay packets ($1.25 billion).
- $558 million *National Workforce Development Fund* (co-funded by business) to address skills shortages.
- $3 billion skills package over six years, building on the 2010-11 Budget's *Skills for Sustainable Growth* strategy.
- $1 billion extra funding for road transport infrastructure, building on the $36.2 billion *Nation Building Program*.
- Increasing family payments and extending the Education Tax Refund ($772 million).
- Instant tax write-off of the first $5,000 of any motor vehicle purchased for small businesses ($350 million).

However, most new spending is to be offset by savings elsewhere in the Budget. The Government expects to make $22.2 billion in savings over the next four years. Two-thirds of these savings are spending reductions. Some of the major savings items include:

- Reducing family payments by pausing indexation ($2.0 billion)
- Introduction of the temporary flood and cyclone reconstruction levy ($1.7 billion)
- Reducing Defence spending through reprioritisation ($2.4 billion)
- Increase in the 'efficiency dividend' (that is, budget cuts) for the public sector ($1.1 billion)

- Reforms to the fringe benefits tax for cars ($954 million)
- Phasing out the Dependent Spouse Tax Offset ($755 million)
- Cutting the Green Car Innovation Fund program ($434 million)
- Reduction in funding for the Carbon Capture and Storage Flagships program ($250 million)
- Overall government revenue will increase from $310.8 billion in 2010-11 to $350.0 billion in 2011-12, whilst government expenditure will rise from $350.8 billion in 2010-11 to $365.8 billion in 2011-12.

Australia's government finances remain amongst the strongest in the Organisation for Economic Cooperation and Development (OECD), with the budget projected to return to surplus in 2012-13. Net government debt is expected to peak at 7.2 per cent of GDP in 2011-12, or $106.6 billion. In the major advanced economies, net government debt is expected to reach an average peak of around 90 per cent of GDP in 2016, over twelve times higher than the expected peak in the Australian Government's net debt.

Impacts of Fiscal Policy

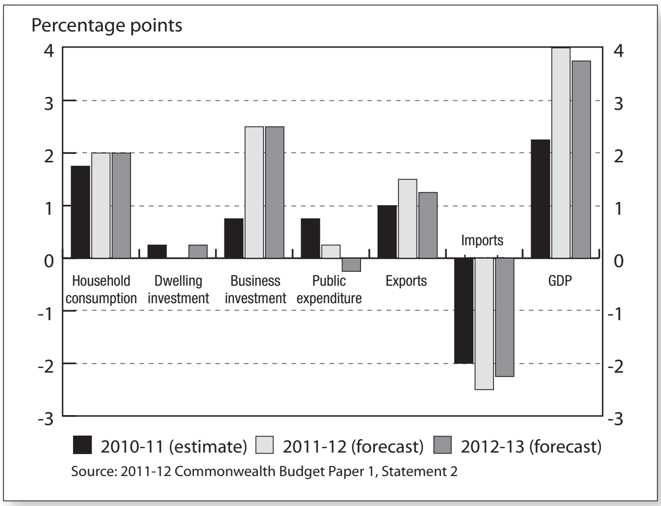
Impact on economic growth

SHORT TO MEDIUM TERM

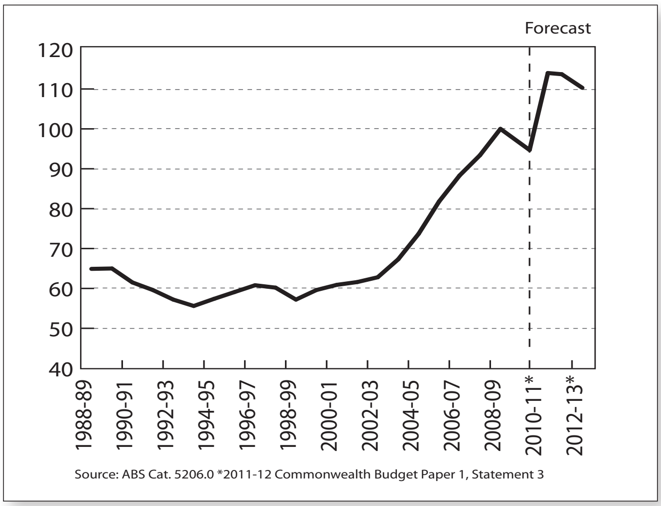
The impact of the 2011-12 Budget on economic growth is likely to be contractionary in the short term. In 2010-11 the economy is forecast to grow by 2.25 per cent, on par with growth of 2.3 per cent in 2009-10. From 2011, growth in public expenditure is expected to decline sharply, with the removal of fiscal stimulus expected to reduce GDP growth by around 1 percentage point in 2010-11 and by ½ a percentage point in 2011-12. This is a necessary effect of the automatic stabilisers and the move towards contractionary fiscal policy as economic growth improves – it is commonly referred to as 'fiscal drag'. However, the pace of the economic recovery from a mild domestic downturn in late 2008 is slightly slower than expected. The recent natural disasters in Australia, Japan and New Zealand are expected to subtract ¾ of a percentage point from economic growth in 2010-11. Subdued growth in consumer spending has also detracted from growth. Nevertheless, real GDP growth is forecast to rebound to 4.0 per cent in 2011-12 and 3.75 per cent in 2012-13. The positive medium-term growth outlook is underpinned by significant growth in resources investment and strong growth in non-rural commodity exports.

Household consumption growth, while weak at present, is expected to increase steadily over the next two years, adding two percentage points to GDP growth in 2011-12 and 2012-13. Continual improvements in household income and lower unemployment are expected to underpin household consumption growth of 3 per cent in 2010-11, rising to 3.5 per cent in 2011-12 and 2012-13. Also, for the first time in nine years the Federal Budget has not provided income tax cuts. In previous budgets, governments have reduced income tax rates and increased income tax thresholds in order to increase household disposable income and boost consumption expenditure. In the 2011-12 Budget, the temporary flood levy has actually provided a slight tax increase. Though small, the levy will have the effect of slightly reducing household disposable income.

Business investment is recovering strongly, and is expected to grow by 16 per cent in 2011-12 and 14.5 per cent in 2012-13, contributing 2.5 percentage points to GDP growth in both years. The Budget notes that Australia is in the early phases of potentially the biggest investment boom in history. Mining investment is forecast to reach a record $76 billion in 2011-12, with Treasury estimating the total value of the current pipeline of resources investment at over $380 billion. The rapid industrialisation of emerging Asia – particularly China – is expected to sustain strong growth in resources demand together with high prices for Australia's key export commodities. In 2010-11 the terms of trade are forecast to reach their highest sustained levels in 140 years, driven by price rises for coal and iron ore. However, in comparison with the mining boom prior to the global financial crisis ('mining boom mark I'), the economy is operating closer to full capacity and consumers are behaving more cautiously. This has seen the emergence of a 'patchwork economy', with a significant divergence between the performance of the mining and non-mining sectors of the Australian economy.



Contributions to GDP growth



Terms of Trade Index (2008-09=100)

Though the Government aims to minimise the length of time in which the Budget remains in deficit, Australia's fiscal deficits in 2010-11 and 2011-12 may have a negative impact on Australia's economic recovery through the 'crowding out' effect. When the government budget is in deficit, the government finances the deficit by borrowing from the private sector. In essence, the government soaks up private savings that might have otherwise been used to fund private investment. This is likely to put upward pressure on domestic interest rates, 'crowding out' private investors. However, given the current strength of business investment, this effect is likely to be minimal. Perhaps more likely, domestic investors may instead turn to overseas sources of finance that offer a lower interest rate. This increases foreign borrowing, generating servicing costs which increase the net primary income deficit, worsening the current account deficit (the 'twin deficits hypothesis' – that a budget deficit will lead to a current account deficit). However, the risks of budget deficits crowding out private investors are reduced in the long term by the Government's fiscal consolidation strategy.

The main risks to the economic growth outlook are related to the strength of the global recovery. Global output is forecast to grow by 4.25 per cent and 4.5 per cent in 2011 and 2012 respectively, down from 5.0 per cent in 2010. Downside risks to the global recovery include ongoing sovereign debt problems in Europe, persistently high unemployment in the United States and Europe, fiscal sustainability issues amongst the major advanced economies, inflationary pressures in emerging economies and rising oil prices. These factors mean that the global economy is vulnerable to a second economic downturn which would destroy the forecasts upon which the budget is based. Treasury has estimated that a 4 per cent fall in the forecast terms of trade would wipe out the planned 2012-13 surplus. This demonstrates that, ultimately, Australia's fiscal strategy is dependent upon the continued strength of the global economic recovery.

LONG TERM

The 2011-12 Budget contains a number of measures to boost the economy's productive capacity in the long run. These include measures to improve productivity levels through investment in skills and education, increasing infrastructure capacity and boosting workforce participation. Increases in productive capacity lead to a higher sustainable economic growth rate.

The centrepiece of the Budget's supply-side measures is the *Building Australia's Future Workforce* package. It aims to address the increasing demand for skilled labour as the economy approaches full employment, as well as the persistence of low rates of participation amongst certain groups in the community. The Budget allocates $3 billion over six years to meet emerging skills shortages, including $1.75 billion in funding for the vocational education and training system. A $558 million *National Workforce Development Fund* is also expected to provide 130,000 training places targeted at industries facing critical skills shortages. These measures seek to address the skills shortages that pushed up labour-costs during 'mining boom mark I'.

The 2011-12 Budget also provides significant investment in infrastructure. Through the *Nation Building Program*, the Government plans to invest $36.2 billion in roads, rail and ports over the six years from the 2008-09 Budget. The 2011-12 Budget provides $916 million for eight regional infrastructure projects to be funded from the *Regional Infrastructure Fund*, which will provide a total of $6.0 billion over the eleven years to 2020-21 for investment in infrastructure in regional Australia. These projects are primarily designed to improve infrastructure in mining regions and boost Australia's export capacity. Higher spending on key road, rail and port networks, especially in the resource-rich states, will relieve the infrastructure bottlenecks that have constrained the growth in Australia's export volumes in the past. Additionally, the planned rollout of the *National Broadband Network* is likely to boost Australia's productivity, given the central role that the internet plays in the operations of most businesses, particularly in the services sector.

Impact on unemployment and workforce participation

Relatively strong domestic growth since the global downturn has led to significant improvements in the labour market over the past year. Treasury forecasts employment to grow by 2.75 per cent in 2010-11 – well above trend – before easing slightly to 1.75 per cent in 2011-12 and 2012-13. The unemployment rate is expected to fall from 5.0 per cent in 2010-11 to 4.75 per cent in 2011-12 and further to 4.5 per cent in 2012-13, around the level of full employment. Treasury estimates that Australia's non-accelerating inflation rate of unemployment (NAIRU) lies between 4.5 and 5 per cent. Therefore, the expected decrease in unemployment would be likely to create wage and price pressures in the future.

An economy operating at or close to the NAIRU runs the risk of excessive inflationary pressures if it continues to expand. In addition, the NAIRU, or 'natural rate' of unemployment consists of structural, frictional and hard-core unemployment, none of which is able to satisfy the labour demands of firms in the labour market. The labour market programs announced in the 2011-12 Budget are aimed at reducing the natural rate of unemployment. This is evident in three policies. First, the policy of providing training places for the unemployed aims to address the cause of structural unemployment by giving the unemployed the opportunity to retrain and gain the skills demanded by firms in the labour market. Secondly, there is the policy of providing wage subsidies to employers who hire persons who have been unemployed for more than two years. This is a policy which aims to reduce the level of long-term unemployment by encouraging employers through financial incentives to hire the long-term unemployed. Thirdly, increased funding of vocational education and training aims to increase the skills of young people entering the labour force, who are the most vulnerable to becoming unemployed. This aims to prevent the further growth of structural unemployment among the youth.

Australia's labour force participation rate has increased slightly over the past year, reflecting the return of job seekers previously discouraged during the downturn (a reduction in hidden unemployment), as well as the continued rise in female and older-worker participation. The participation rate is forecast to remain at record highs of around 66 per cent over the next two years, before declining gradually with the ageing of the population.

The 2011-12 Budget provides measures to boost workforce participation over the long term. The *Building Australia's Future Workforce* package provides incentives to workforce participation, especially amongst groups with low participation levels. Measures to tighten payment eligibility and participation requirements, as well as improving incentives in the tax system, are likely to boost workforce participation. These measures include allowing working single parents to keep a greater amount of government payments through a more generous income test, bringing forward the Low Income Tax Offset and introducing participation requirements for Disability Support Pension recipients under 35 years with a partial work capacity.

Impact on external stability

Surplus budgets throughout the 2000s had a favourable impact upon external stability. The policy of fiscal consolidation (running balanced or surplus budgets) enabled the government to avoid the crowding out effect and eliminate net government debt in 2006, as well as directly increasing national savings through the establishment of the Future Fund and various other funds in which to save budget surpluses.

However, continuing budget deficits until 2012-13 are likely to have a negative impact on external stability. The 'twin deficits hypothesis' suggests that the sale of government bonds to finance the deficit may crowd out private domestic investment and worsen the net primary income account producing a 'twin deficit' on the current account. Commonwealth Government Securities on issue are expected to increase from $192 billion in 2010-11 to $225 billion in 2011-12. Further, because Australia has open capital markets, government bonds can be purchased by overseas investors, which can lead to an increase in the government's foreign debt. In fact, the RBA estimates that over 80 per cent of Commonwealth Government Securities on issue are in overseas ownership. Therefore, the financing of Australia's budget deficits until 2012-13 is likely to lead to an increase in foreign liabilities as foreign investors purchase Commonwealth government bonds. This will increase the net primary income deficit, as those liabilities must be serviced with interest repayments. In this way, successive budget deficits are likely to result in a higher level of foreign liabilities, contributing to the structural component of the current account deficit (CAD) through the net primary income account.

The CAD is expected to narrow to just 2.0 per cent of GDP in 2010-11, the smallest deficit as a proportion of GDP since 1979-80. Australia's balance on goods and services (BOGS) is forecast to record a surplus of 2.5 per cent of GDP in 2010-11, reflecting price rises in mining exports, rising export revenue and higher global demand. However, the reprieve in the current account is expected to be short-lived, with the CAD forecast to widen to -4 per cent of GDP in 2011-12 and -5.25 per cent of GDP in 2012-13. With the BOGS expected to remain in surplus, the widening in the CAD will be driven by a deterioration in the net primary income balance from -4.25 per cent of GDP in 2011-12 to an enormous -5.75 per cent in 2012-13. This largely reflects expected increases in mining profits which will be distributed to shareholders in the form of higher dividends. As approximately 40 per cent of the Australian share market is foreign owned, any increase in company profits will inevitably increase payments of dividends to overseas shareholders, which are recorded on the net primary income account, increasing the CAD.

In previous budgets, the Government has announced measures to increase national savings in order to reduce the private sector's call on foreign capital. This has included plans to increase the compulsory superannuation guarantee from 9 per cent to 12 per cent by 2019, as well as tax discounts on interest income. However, this Budget includes no major policies designed to increase national savings. Presumably, this is because the household savings ratio is at a 25 year high, averaging 9.6 per cent over 2009 and 2010.

Several measures in the Budget are also likely to have a positive effect on the balance on goods and services. Increased spending on infrastructure is likely to result in an increase in the productive capacity of Australia's export sector, which should lead to an increase in export volumes and faster economic growth. This will help Australia address the problems arising from the return of capacity constraints with 'mining boom mark II'. In addition, increased spending on training and education should help improve the international competitiveness of Australia's labour force, improving the quality of Australia's exports (particularly of services).

The Government is less active in addressing external stability than in its approach to other economic objectives such as economic growth and unemployment. More than anything, the Government aims to limit the risk of external financing crises by maintaining a policy of fiscal consolidation and a strong focus on microeconomic reform.

Impact on the distribution of income

Fiscal policy is the only government economic policy which directly targets the distribution of income and wealth. Overall, the 2011-12 Budget is expected to improve the distribution of income in Australia. Beyond discretionary policy changes, the government also has an ongoing role in reducing income inequality through progressive income taxation and transfer payments, as well as the provision of government services such as health and education, and policies to reduce unemployment in the long term.

The 2011-12 Budget contains some measures that will improve the distribution of income. Bringing forward the Low Income Tax Offset, increasing Family Tax Benefit A for older teenagers and extending the Education Tax Refund will improve income equality by more closely targeting welfare payments to lower income earners. The flood levy is also likely to have a positive impact on the distribution of income, since it is a progressive tax that aims to redistribute income towards those whose wealth has been destroyed by reason of the floods. However, the Government's move to tighten access to the Disability Support Pension (DSP) may disadvantage some of the most vulnerable people in society. DSP recipients under 35 years of age with an assessed work capacity of more than eight hours per week will face a higher participation requirement.

Conclusion

The 2011-12 Budget supports the Government's medium term fiscal strategy by charting the path back to surplus through fiscal tightening. By allowing cyclical factors to flow through to the budget balance and by offsetting new spending, the Government aims to return the budget to surplus in 2012-13. In the short term, risks around the budget outcome are related to the continued strength of Australia's terms of trade, the sovereign debt crisis in Europe and inflation remaining within the 2 to 3 per cent target band. The lingering threat of a double-dip recession has not yet lifted its shadow from the global economy. The 2011-12 Budget also makes a substantial investment in Australia's future productive capacity by improving workforce skills, boosting workforce participation and investing in infrastructure. However, there is a very real question whether these supply-side reforms go far enough in addressing emerging supply-side constraints in the Australian economy. In the longer term, fiscal policy in Australia faces the formidable challenges of managing a patchwork economy, responding to climate change, and preparing for the fiscal burden of population ageing.

Multiple Choice Questions

1 What is the fiscal stance for 2011-12?

(A) Surplus
(B) Deficit
(C) Contractionary
(D) Expansionary

2 What is the fiscal outcome for 2011-12?

(A) Surplus
(B) Deficit
(C) Contractionary
(D) Expansionary

3 Which of the following is the main goal of the Government's medium term fiscal strategy?

(A) Increasing the level of taxation revenue
(B) Decreasing the level of government expenditure
(C) Achieving budget surpluses on average over the medium term
(D) Reducing government debt in the short term

4 Which of the following is most likely to improve the budget balance?

(A) An improvement in cyclical factors
(B) A strong Australian dollar
(C) Lower global growth
(D) Increased government expenditure

5 During an economic recovery, which of the following would be the effect of automatic stabilisers on the budget?

(A) Lower unemployment benefits, higher taxation revenue
(B) Lower unemployment benefits, lower taxation revenue
(C) Higher unemployment benefits, higher taxation revenue
(D) Higher unemployment benefits, lower taxation revenue

6 Which of the following is likely to increase the participation rate?

(A) Increasing the rate of the age pension

(B) Increasing the effective tax rate for middle income earners

(C) Providing job search assistance for disengaged workers

(D) Decreasing the Low Income Tax Offset

7 Which of the following is likely to increase the size of a budget deficit?

(A) Higher economic growth

(B) Lower consumer spending

(C) Rising terms of trade

(D) Lower unemployment

8 Which of the following is likely to increase Australia's productive capacity in the long term?

(A) Lower spending on education and training

(B) Increasing the marginal income tax rates

(C) Lower interest rates

(D) Infrastructure spending in regional areas

9 Which of the following would lead to an increase in foreign liabilities and net primary income outflows?

(A) A budget surplus

(B) A budget deficit

(C) Increased taxation receipts

(D) A strategy of fiscal consolidation

10 Which of the following is forecast to contribute the most to GDP growth in 2011-12?

(A) Consumption

(B) Investment

(C) Government expenditure

(D) Net exports

Short Answer Questions

11 Describe the major goals of the 2011-12 Budget.

12 Describe the economic outlook for the Australian economy over the medium term.

13 Discuss the impact of the 2011-12 Budget on economic growth.

14 Explain how cyclical and structural factors affected the budget outcome in the 2011-12 Budget.

15 Analyse the role of fiscal policy in the government's economic policy mix in 2011.

Statistics

Budget Figures

	2010-11	% of GDP	2011-12	% of GDP
Fiscal balance	-45.7	-3.3	-20.3	-1.4
Underlying cash balance	-49.4	-3.6	-22.6	-1.5
Revenue	310.8	22.4	350.0	23.7
Expenditure	350.8	25.3	365.8	24.8

Because Treasury uses complex accounting methods, revenue and expenditure do not add up precisely to the fiscal balance or underlying cash balance

Treasury Forecasts

	2010-11	2011-12	2012-13
Economic growth	2.25%	4.0%	3.75%
Household consumption	3.0%	3.5%	3.5%
Business investment	4.5%	16%	14.5%
Inflation (CPI)	3.25%	2.75%	3.0%
Wage price index	4.0%	4.0%	4.25%
Unemployment rate	5.0%	4.75%	4.5%
Participation rate	66.0%	66.0%	66.0%
Employment growth	2.75%	1.75%	1.75%
Current account (% GDP)	-2.0%	-4.0%	-5.25%
Terms of trade (% change)	19.25%	-0.25%	-3.0%
Exports	4.0%	6.5%	5.5%
Imports	9.0%	10.5%	8.5%

Source: 2011-12 Commonwealth Budget Paper No. 1, Statement 2

Quotes & Questions

Quotes

Reactions to the 2011-12 Budget

"The Budget has many elements within it that should be commended and are...entirely appropriate measures and policies for the current economic environment. However, the Government has failed to undertake any truly significant economic reform...we see this as a missed opportunity. The Australian Government budget will remain highly vulnerable to a downturn in the global economy and commodity prices, and meaningful progress on tax and welfare reform will have to wait..."

ANZ Australian Federal Budget Report 2011-12, 11 May 2011

" There is no doubt that the budget will impose a contractionary influence on the economy. This influence is almost entirely due to the government allowing the cyclical improvement in the economy to work through to the bottom line without seeking new spending initiatives to soak up the cyclical windfall. With the improvement expected to be rapid (particularly due to the surge in the terms of trade) the fiscal position will improve by 3.8 per cent of GDP over only two years – this is by far the sharpest two-year drag on the economy in the fiscal position since 1970..."

Westpac chief economist Bill Evans, interview in the Business Spectator, 14 May 2011

"This budget makes a determined effort to embrace the need for structural change, both by enhancing people's ability to adapt to structural change and cushioning some of the adverse consequences that structural change will bring...There are worthwhile investments in skills formation and economic infrastructure, measures designed to increase participation in the labour force among groups who have been disengaged from the world of work for prolonged periods, and increased spending on mental health...There are "quality" savings measures as well, including tighter targeting of assistance to families, changes to the fringe benefits tax rules for employer-provided cars...phasing out the dependent spouse tax offset and removing the low-income tax offset for property income received by children...But precisely because the government has spent virtually all that it has saved, it is simply not credible to describe this budget as a "tough" one from a macro-economic perspective."

Saul Eslake, The Age, 11 May 2011

Leading Edge Education delivers quality educational assistance to teachers and students through a range of textbooks, workbooks, study resources, tuition programs and holiday workshops.

Economics Update is published by Leading Edge Education.

Leading Edge Education
PO Box Q3, Queen Victoria Building
Sydney NSW 2000 Australia
Tel: 02 8263 3800 | Fax: 02 8263 3838
Email: mail@leadingedge.com.au | Website: www.leadingedge.com.au

ABN 50 129 068 257