

PART 1: OVERVIEW

INTRODUCTION

International growth prospects have weakened markedly since Budget and the risks to global stability from the European sovereign debt crisis have intensified. While these significant global headwinds are weighing heavily on Australia's economic and fiscal outlook, the Government remains on track to deliver a budget surplus in 2012-13.

The deterioration in global conditions has contributed to a weaker near-term outlook for the Australian economy than at Budget, with forecast gross domestic product (GDP) and employment growth both revised lower.

Conditions are also expected to remain uneven, with the weaker global economy, the high Australian dollar and cautious household spending behaviour creating significant challenges for some sectors.

Notwithstanding the deterioration in global conditions since Budget, the Australian economy continues to outperform the developed world with solid growth prospects, low unemployment, a record pipeline of resources investment, and strong public finances.

The downward revision to the economic outlook from Budget has reduced tax receipts by over \$20 billion over the forward estimates. Lower employment growth since Budget is impacting on taxes on wages and salaries, and volatile financial markets are affecting equity prices and hence capital gains receipts.

The underlying cash deficit is expected to be \$37.1 billion (2.5 per cent of GDP) in 2011-12, returning to a small surplus of \$1.5 billion (0.1 per cent of GDP) in 2012-13. Table 1.1 presents the fiscal and underlying cash balances for 2011-12 to 2014-15.

While the revised outlook for revenue has made the return to surplus more difficult than at Budget, the European sovereign debt crisis has underscored the importance of maintaining fiscal credibility.

This is why the Government is taking steps to build savings steadily over the forward estimates, to ensure Australia's public finances and economy remain strong and to underpin confidence at a time of heightened global instability.

Table 1.1: Budget aggregates

	Estimates			
	2011-12		2012-13	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance(\$b)(a)	-22.6	-37.1	3.5	1.5
Per cent of GDP	-1.5	-2.5	0.2	0.1
Fiscal balance(\$b)	-20.3	-32.4	4.0	4.7
Per cent of GDP	-1.4	-2.2	0.3	0.3
	Projections			
	2013-14		2014-15	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance(\$b)(a)	3.7	1.9	5.8	3.1
Per cent of GDP	0.2	0.1	0.3	0.2
Fiscal balance(\$b)	3.2	4.2	8.5	6.4
Per cent of GDP	0.2	0.3	0.5	0.4

(a) Excludes expected Future Fund earnings.

ECONOMIC OUTLOOK

Global economic and financial conditions have deteriorated markedly in recent months, exacerbating some of the existing stresses on parts of the Australian economy. These developments have been transmitted through a number of channels, with considerable volatility in the exchange rate, falls in Australian equity prices, significant falls in prices of some of Australia's key export commodities – particularly iron ore and coal – and weaker business and consumer confidence. This has contributed to a reduction in momentum in some parts of the economy and a slowdown in employment growth.

The European sovereign debt crisis has escalated, contributing to significant volatility in financial markets and undermining global confidence. With Greece requiring a substantial write-down of its sovereign debt and growing pressure on Spanish and Italian Government bond yields, concerns about the credit-worthiness of financial institutions with significant exposure to European sovereign debt have increased. There are also growing signs of spillovers to the real economy in Europe, with implications for its major trading partners. European leaders have agreed, in principle, to measures to help stabilise the situation. However, a number of important details are yet to be resolved, the implementation task is substantial and the risks to global financial stability remain elevated. The euro area is expected to return to recession in 2012, which will represent a significant headwind for global growth and reduce final demand for Asian produced goods.

The deterioration in Europe has coincided with weak growth in the United States (US), further weighing on global growth prospects at a time when monetary and fiscal policy are significantly constrained in the major advanced economies. The substantial near-term fiscal tightening currently legislated in the US, lingering uncertainties around the US Government debt ceiling and doubts as to whether a credible

medium-term fiscal consolidation plan can be agreed upon have added to the unease in global financial markets.

These adverse developments in the major advanced economies are being transmitted globally through financial market, confidence and trade channels. Still, emerging market economies overall are expected to continue growing at relatively solid rates. While weakness in Europe and the US is expected to have negative flow-on effects to our region, growth in emerging Asia is forecast to remain strong, underpinned by domestic demand. However, this could change if events in Europe were to trigger significant deleveraging in global financial markets or a more severe economic growth slow down in the major advanced economies than currently factored into the forecasts.

Global growth forecasts have been downgraded to 4 per cent in 2011 and 3½ per cent in 2012, largely reflecting lower expected growth in the major advanced economies, before rising to 4 per cent in 2013. The emerging market economies are expected to contribute over three-quarters of total global growth over the next two years.

The forecasts assume a continuation of the uncertainty surrounding the debt problems in Greece and other highly indebted European countries, but that a disorderly resolution of problems is avoided. However, the potential for the European sovereign debt crisis to cause major dislocation in global financial markets, generating further substantial growth deterioration in the major advanced economies and transmission of weakness to emerging markets, is a significant risk to the economic outlook.

Against this weaker international backdrop, forecast growth in Australia's real GDP and employment has been revised down since Budget. While the Australian economy is expected to grow at around its trend rate over the forecast horizon, conditions are expected to remain uneven across the economy. Real GDP is forecast to grow by 3¼ per cent in both 2011-12 and 2012-13, downgrades of ¾ of a percentage point in 2011-12 and ½ of a percentage point in 2012-13 compared with Budget. The labour market outlook has also softened. The unemployment rate is expected to remain low, but increase slightly to 5½ per cent by the June quarter 2012, in line with the downward revision to forecast employment growth (Table 1.2).

Table 1.2 presents the major economic parameters used in preparing the Mid-Year Economic and Fiscal Outlook (MYEFO) 2011-12.

Table 1.2: Major economic parameters ^{(a) (b)}

	Forecasts		Projections	
	2011-12	2012-13	2013-14	2014-15
Real GDP	3 1/4	3 1/4	3	3
Employment	1	1 1/2	1 1/2	1 1/2
Unemployment rate	5 1/2	5 1/2	5	5
Consumer Price Index	2 1/4	3 1/4	2 1/2	2 1/2
Nominal GDP	6 1/4	5	5 1/4	5 1/4

(a) Real and nominal GDP are year-average growth. Employment and CPI are through-the-year growth to the June quarter. The unemployment rate is the rate in the June quarter.

(b) The forecasts incorporate the introduction of a carbon price on 1 July 2012.

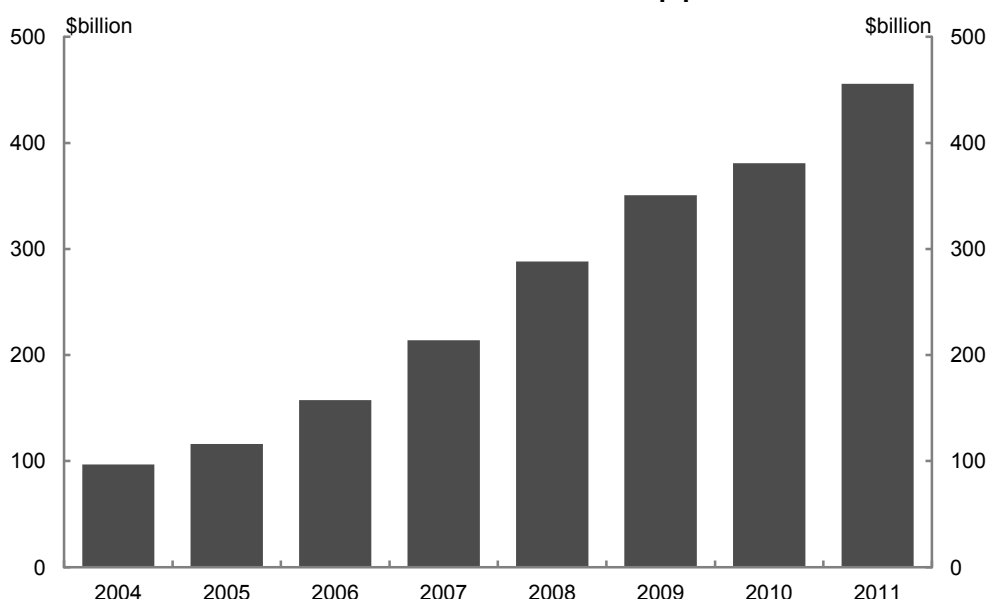
Source: Treasury.

Australia's economic growth prospects are driven by record investment intentions in the resources sector and strong forecast growth in commodity exports.

Commodity prices have fallen in recent months, but the outlook for prices and investment remains favourable, notwithstanding the unsettled global environment. In value terms around two-thirds of the large mining projects included in the economic forecasts have received final investment approval, with the majority of these already under construction. Prices of Australia's bulk commodity exports remained strong through to the September quarter, driving Australia's terms of trade to new record highs. Since then, however, iron ore and coal spot prices have fallen significantly, as have prices in other commodity markets. While recent declines in global steel production point to some moderation in demand, by the end of October prices seemed to have moved by more than could be explained by changes in the prospects for supply and demand in these markets. Iron ore spot prices have since increased and appear likely to regain further lost ground over the coming months.

Looking beyond these near-term movements, the medium-term outlook is for Australia's terms of trade to decline as the global supply of iron ore and coal increases. Still, the rapid pace of economic development in emerging Asia, and the prospect that strong resources-intensive investment in China and India will continue for many years to come, underpin expectations that the decline in the terms of trade will be gradual. Australia's terms of trade are forecast to rise 1¾ per cent in 2011-12, before declining 5¼ per cent in 2012-13. The medium-term projections assume that Australia's terms of trade will decline by a further 20 per cent over the subsequent 15 year period.

Investment decisions in the resources sector are taken over long time horizons, driven by medium-term projections of the growing resource needs of the large emerging market economies. These projections remain intact, notwithstanding the recent deterioration in global conditions, with the pipeline of resources investment in Australia continuing to grow since Budget to over \$450 billion (Chart 1.1). Following growth of 34 per cent in resources investment in 2010-11, resources companies expect to increase their capital expenditure by a further 74 per cent in 2011-12, supporting a strong outlook for commodity exports and activity in the related construction and services sectors.

Chart 1.1: Resources investment pipeline

Source: ABARES and BREE.

Elsewhere, the outlook is uneven with the uncertain global environment adding to existing strains on some parts of the economy. Local share prices have fallen in line with global markets, reducing the financial wealth of households and weighing on consumer spending decisions. Investment intentions have also declined outside of the resources sector, with less favourable external conditions adding to existing pressures from the high exchange rate and cautious household spending behaviour. Reduced momentum in the non-mining economy is evident in the recent slowdown in employment growth and is reflected in the softer labour market outlook.

While conditions have become more challenging for those sectors that are not benefiting – either directly or indirectly – from the resources boom, the Australian economy is expected to grow at around its trend rate in aggregate over the forecast period. The unemployment rate is expected to remain low, but increase slightly to around 5½ per cent over the forecast period, with employment growth forecast to be weaker than expected at Budget, at 1 per cent through the year to the June quarter 2012 and 1½ per cent through the year to the June quarter 2013. Headline inflation is expected to remain contained, rising from 2¼ per cent through the year to the June quarter 2012 to 3¼ per cent through the year to the June quarter 2013, including a one-off ¾ of a percentage point addition due to the introduction of a carbon price on 1 July 2012.

RETURNING THE BUDGET TO SURPLUS

The Government remains on track to deliver a budget surplus in 2012-13, despite the ongoing challenges to the near-term outlook that have made the return to surplus more difficult.

The weaker and more fragile global economic and financial conditions have contributed to a reduction in momentum in some parts of the Australian economy. Asset prices are softer and employment growth is expected to be weaker than at Budget, with businesses more reluctant to expand their workforce in the current uncertain global environment.

The weaker labour market has led to downward revisions to personal income tax. Meanwhile, softer asset prices are flowing through to lower capital gains taxes paid by companies, superannuation funds, and individuals. In total, the revised economic outlook has reduced tax receipts by more than \$20 billion over the forward estimates.

In the context of more challenging global conditions and uncertainty around the outlook, it is appropriate to maintain a disciplined approach to spending and return the budget to surplus.

The European sovereign debt crisis highlights the importance of maintaining strong public finances. Maintaining fiscal discipline and strong public finances will help sustain confidence, which is particularly important at a time of heightened global instability.

Given the substantial downgrades to budget revenues, the Government has identified \$6.8 billion in net savings over the forward estimates. This has been necessary given the reduction in tax receipts and the need to fund the significant policy reforms announced since the 2011-12 Budget.

The current global instability and uneven conditions domestically mean that it would not be prudent, at this point in time, for an even tighter fiscal outcome in the short term.

Since the Budget the Government has announced details of its comprehensive plan to secure a clean energy future. The reforms introduce a price on carbon pollution, that reduce expected carbon pollution by at least 160 million tonnes per annum by 2020. The reforms also include significant assistance to households through higher family payments and pensions, and tax cuts to all taxpayers earning up to \$80,000. The reforms will also free up to one million people from having to lodge a tax return by trebling the tax free threshold. While the package involves upfront costs in 2011-12, it is broadly budget neutral in the three years to 2014-15.

Savings have also been achieved through a combination of expenditure cuts, deferring some initiatives and measures to improve the integrity and fairness of the taxation

system. These savings steadily build over the forward estimates with many of the decisions providing ongoing improvements to the budget position. This mix of savings over the forward estimates is appropriate given the near-term uncertainty but more solid medium-term prospects.

The Government has taken further steps to make the family payment system sustainable for the long term. Resetting the Baby Bonus to \$5,000 and pausing indexation will continue to deliver substantial financial support to new parents while ensuring the ongoing viability of the payment. In addition, as part of changes to strengthen immunisation arrangements for young children, families will need to meet immunisation requirements to receive the Family Tax Benefit Part A end of year supplement for children aged one, two and five. These stronger incentives will replace the maternity immunisation allowance and help improve immunisation rates over time.

The Government is undertaking a number of reforms that improve the fairness and efficiency of the tax system. The Government is acting to stop the misuse of the living-away-from-home benefit concessions by requiring individuals to substantiate their expenses and limiting access to the concession for temporary residents to those who maintain a home for their own use in Australia that they are living away from for work. These changes will, amongst other things, ensure that a level playing field exists between temporary residents and permanent residents. Widespread exploitation of this tax concession was one of the issues raised at the Tax Forum held earlier this year. The Government is also supporting workforce participation by extending the phase out of the Dependent Spouse Tax Offset to those aged 60 years and under at 1 July 2012.

The Government will also reform aspects of the retirement income system. Given that from 1 July 2012, the Government will provide a new superannuation contribution to low income earners that will refund the contributions tax payable on superannuation contributions, the existing co-contribution scheme will be reduced. The new low income superannuation contribution is better targeted and more widely available, benefiting more than three times as many low-income earners. Other savings have been achieved in the taxation system through pausing the indexation of the superannuation concessional contribution caps and deferring the commencement of some new measures announced in the 2010-11 Budget.

Changes are being made to school education rewards programs to reflect the need for ongoing stakeholder consultation and the phase-in of reward payments. The Reward Payments for School Improvement program will be rephased to allow for greater stakeholder consultation, with funding provided to develop and implement the National Schools Improvement Framework, including testing pilot projects. The Reward Payments for Great Teachers program will be fully phased in over 18 months, with eligible teachers receiving a reward in the first year and second year under the new Professional Standards for Teachers. The Government will continue to work with

States and Territories to facilitate redesign of their performance management policies over this time.

Changes are also being made to reward funding for universities, in recognition of the increased funding available to universities through the introduction of the demand-driven system on 1 January 2012, higher indexation rates and increased research and capital grants. The Government will continue with reward funding for universities to prioritise enrolment by students from low socio-economic backgrounds while not proceeding with other elements. In addition, the Government is reinstating the Band 2 contribution rate for mathematics, statistics and science for students commencing study from 2013, with transitional arrangements for existing students. The lower National Priority rates have not had the intended positive impacts on student demand.

Broader savings have also been achieved through improved pricing arrangements for visas, bringing them closer in line with the real costs of assessment and international practice. To reduce the cost of government administration, the Government has also decided to apply an additional one-off efficiency dividend of 2.5 per cent in 2012-13 to the majority of Commonwealth agencies and will ask entities to report annually to the Government on their reduced spending.

FISCAL OUTLOOK

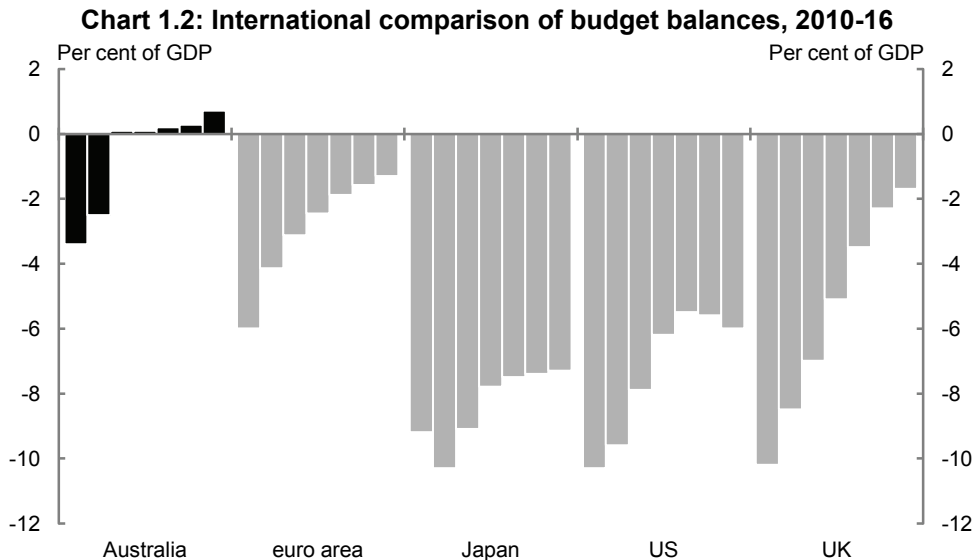
The forecast underlying cash deficit for 2011-12 is \$37.1 billion (2.5 per cent of GDP), returning to a small surplus of \$1.5 billion (0.1 per cent of GDP) in 2012-13.

The forecast deficit in 2011-12 is larger than expected at Budget, with around two-thirds of the increase reflecting variations to receipts and payments as distinct from policy decisions.

Tax receipts have been revised down by \$4.8 billion in 2011-12 in large part because of the weaker near-term outlook for the economy. In addition, payments have increased by \$2.3 billion under the Natural Disaster Relief and Recovery Arrangements, including an additional advance payment to Queensland to ensure necessary reconstruction and repair work can happen as soon as possible. Decisions to provide significant assistance to households and business as part of the policy reform to reduce carbon pollution and to accelerate funding for key infrastructure projects have also contributed to the change in budget position in 2011-12.

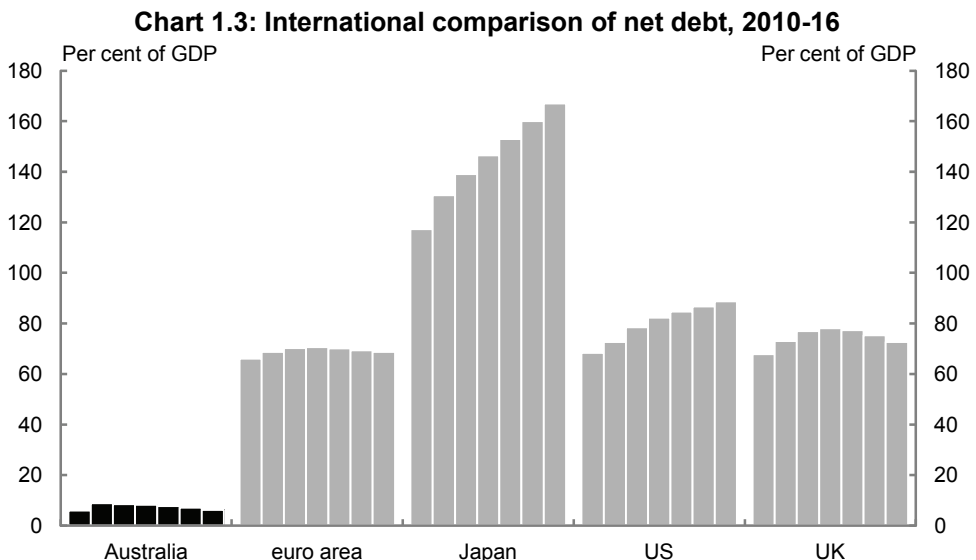
The Government has made a number of savings decisions in response to the shortfall in tax receipts across the forward estimates. In total, \$11.5 billion in savings decisions outside of the Clean Energy Future package have been made, with the combined effect of all policy decisions improving the budget bottom-line by \$6.8 billion. The savings decisions made by Government will help to leave Australia in a substantially stronger fiscal position than any of the major advanced economies.

Australia will return the budget to surplus ahead of the major advanced economies (Chart 1.2). The average net debt position of the major advanced economies (G7) is projected to reach 92.9 per cent of GDP in 2016, more than 10 times higher than the expected peak in Australia's net debt of 8.9 per cent of GDP (Chart 1.3).



Note: Australian data are for the Australian Government general government sector and refer to financial years beginning 2010-11. Data for all other economies are total government and refer to calendar years beginning 2010.

Source: IMF Fiscal Monitor September 2011, IMF World Economic Outlook September 2011 and Treasury.



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