

PART 1: OVERVIEW

INTRODUCTION

The Government is returning the budget to surplus in 2012-13, notwithstanding a weaker global economy that has weighed heavily on tax receipts. Returning to surplus is appropriate given current economic conditions, with the economy forecast to grow around trend, the unemployment rate forecast to remain low and commodity prices remaining high by historical standards. Returning to surplus provides ongoing scope for monetary policy to respond to economic developments and underpins confidence in Australia's public finances at a time of global economic uncertainty.

Global growth is expected to be lower than forecast at Budget, as the recession in the euro area and the subdued recovery in the United States bear on the growth of key trading partners in the emerging market economies of Asia. While still robust, China's economic growth has moderated more than expected at the 2012-13 Budget and by most official forecasters, reflecting weaker external demand and a deliberate policy-induced slowing in domestic activity. The euro area debt crisis and the impending legislated fiscal contraction in the United States (the 'fiscal cliff') are adding to global economic uncertainty and this is likely to continue into 2013.

Despite a weaker global outlook, the fundamentals of the Australian economy remain strong and the outlook remains positive. The Australian economy continues to outperform every major advanced economy. While some sectors face challenging conditions, the economy is expected to grow around trend, underpinned by a surge in resources investment, strong growth in export volumes and solid growth in household consumption.

While the outlook for the Australian economy is positive, external factors are weighing heavily on parts of the economy and tax receipts. The moderation in world Gross Domestic Product (GDP) growth has contributed to a greater-than-expected easing in global prices of Australia's non-rural bulk commodities. This has been the primary driver of a substantial write-down in total tax receipts of over \$20 billion over the forward estimates.

To return the budget to surplus in 2012-13 and beyond, the Government has made substantial targeted savings, ensuring that Australia's public finances remain strong. These decisions return the budget to surplus ahead of any major advanced economy, contribute to growing surpluses and improve the long-term sustainability of the budget.

The Government has continued its commitment over the past few years to find the savings to fund new priorities and maintain Australia's strong fiscal position. This has been achieved in the face of a substantial write-down in tax receipts of almost \$160 billion over the five years since the beginning of the Global Financial Crisis (GFC).

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Since mid-2009 the Government has more than offset all new spending. Savings in this Mid-Year Economic and Fiscal Outlook (MYEFO) total \$16.4 billion, and have funded initiatives such as dental reform, and will help make room for the delivery of new priorities in future years.

Maintaining Australia's strong public finances means getting the long-term settings right, so that the Australian community can take advantage of the significant opportunities of the Asian century from a position of strength. The Government has made clear it will pursue significant new priorities, including school funding reform and a National Disability Insurance Scheme (NDIS). The Government continues to make enduring savings that will help make room for these national priorities in the medium term. The Government will identify further savings to help fund these priorities.

The underlying cash surplus is expected to be \$1.1 billion (0.1 per cent of GDP) in 2012-13, growing to \$2.2 billion (0.1 per cent of GDP) in 2013-14. Table 1.1 presents the fiscal and underlying cash balances for 2012-13 to 2015-16.

Returning to surplus in 2012-13 is appropriate given current economic conditions, reflecting a targeted approach to savings that minimises the impacts of the fiscal consolidation on the economy, and on vulnerable people. The Government will continue to balance these considerations, and will continue to ensure its approach to savings is appropriate for the economic conditions and is fair on the community.

Table 1.1: Budget aggregates

	Estimates			
	2012-13		2013-14	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance(\$b)(a)	1.5	1.1	2.0	2.2
Per cent of GDP	0.1	0.1	0.1	0.1
Fiscal balance(\$b)	2.5	1.2	2.6	4.3
Per cent of GDP	0.2	0.1	0.2	0.3
	Projections			
	2014-15		2015-16	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance(\$b)(a)	5.3	3.3	7.5	6.4
Per cent of GDP	0.3	0.2	0.4	0.4
Fiscal balance(\$b)	7.0	6.9	9.5	9.8
Per cent of GDP	0.4	0.4	0.5	0.5

(a) MYEFO figures report net Future Fund earnings, whereas Budget figures report gross Future Fund earnings. This is further explained in Appendix B.

ECONOMIC OUTLOOK

Against a weaker international backdrop and the structural change taking place domestically, the Australian economy has continued to grow strongly and outperform every major advanced economy. The unemployment rate has remained low and

underlying inflation is at the bottom of the Reserve Bank's target band. However, global economic conditions have weakened since Budget, weighing on confidence and causing a larger-than-anticipated decline in the prices of Australia's key non-rural commodity exports.

Economic growth has slowed in the major advanced economies. The euro area is in recession and new policy interventions have been necessary to prevent the sovereign debt crisis from escalating. The recovery in the United States has remained moderate, despite substantial monetary policy easing, reflecting persistent underlying weakness in the housing and labour markets.

This weakness in the major advanced economies is now having a larger bearing on growth in the emerging market economies of Asia. China's economic growth, while still robust, has eased, reflecting both weaker external demand and a policy-induced slowdown in the property sector. This has been reflected in slower growth in industrial production and investment, reducing demand for resources and driving larger-than-anticipated falls in non-rural commodity prices.

Global growth forecasts have been downgraded from 3½ per cent to 3¼ per cent in 2012 and from 4 per cent to 3¾ per cent in 2013. Growth expectations have been revised down in the euro area for 2013 and across the forecast horizon in the large emerging market economies. However, growth in the emerging market economies of Asia is still expected to be relatively robust, including in China, where the authorities retain significant capacity to support growth. The emerging market economies in aggregate are expected to contribute over three-quarters of total global growth in 2012 and 2013.

Risks to the international growth outlook remain firmly on the downside. The threat of financial contagion from the crisis in the euro area remains significant, while the potential fiscal cliff in the United States threatens an already fragile recovery. In both cases, policy makers face difficult political challenges, but the risks to global economic and financial conditions of not acting decisively are substantial.

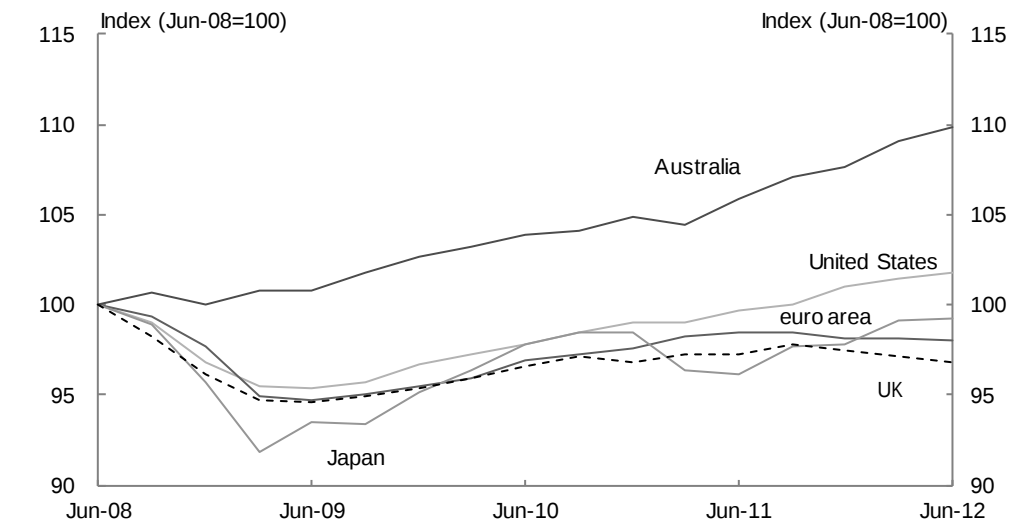
These uncertainties are complicating macroeconomic management elsewhere, including in China, where there is a risk that the combination of weaker-than-anticipated external demand and the authorities' efforts to place their economy on a more sustainable growth path could result in a larger slowdown in economic activity than desired. As seen in recent months, a larger-than-anticipated slowdown in China can have significant implications for global commodities markets and Australia's export revenues.

With few signs of an immediate resolution to the euro area debt crisis or the United States fiscal cliff, the risks and uncertainties surrounding the international outlook are likely to persist into 2013.

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In the face of substantial global headwinds, the Australian economy has grown strongly. Australia's level of economic activity is significantly above its pre-GFC level, in stark contrast to the major advanced economies (Chart 1.1). The outlook for the Australian economy also remains positive. Australia's real GDP is expected to grow at around trend over the forecast period, faster than every major advanced economy.

Chart 1.1: GDP levels for advanced economies



Source: ABS cat. no. 5206.0, national statistical agencies, Thomson Reuters and Treasury.

Australia's real GDP is forecast to grow 3 per cent in both 2012-13 and 2013-14. While this is a downgrade of $\frac{1}{4}$ of a percentage point in 2012-13 compared with Budget, this follows stronger-than-anticipated growth in 2011-12. The downward revision to forecast nominal GDP growth since Budget is more significant, primarily because of larger-than-anticipated falls in global prices for some of Australia's key non-rural commodity exports that have already occurred.

Global energy and steel demand growth has eased as world GDP growth has moderated, reducing demand for raw materials such as coal and iron ore. The decline in iron ore and coal prices to mid-September, while consistent with lower demand, appeared to exceed market fundamentals. Iron ore prices have since increased and it is anticipated they will regain further ground over the coming months.

Still, consistent with a weaker international growth outlook, global prices for these commodities are expected to remain below the levels forecast at Budget. Consequently, while Australia's terms of trade are expected to remain high by historical standards, the decline over the forecast period is expected to be greater than anticipated at Budget, driving a downward revision to forecast nominal GDP growth to 4 per cent in 2012-13 from 5 per cent at Budget.

Australia's unemployment rate is forecast to remain low, albeit rising slightly from $5\frac{1}{4}$ per cent in the September quarter 2012 to $5\frac{1}{2}$ per cent by the end of 2012-13,

consistent with moderate employment growth over the forecast period. Australia's low unemployment rate stands in stark contrast with the high unemployment rates in the major advanced economies and is an important measure of Australia's relative economic strength.

Headline and underlying inflation are forecast to remain in the bottom half of the Reserve Bank's target band, abstracting from the one-off impact of introducing the carbon price. This is consistent with the forecast slight rise in Australia's unemployment rate and continued pass-through of the high exchange rate to consumer prices.

Table 1.2 presents the major economic parameters used in preparing the 2012-13 MYEFO.

Table 1.2: Major economic parameters^(a)

	Forecasts		Projections	
	2012-13	2013-14	2014-15	2015-16
Real GDP	3	3	3	3
Employment	1	1 1/4	1 1/2	1 1/2
Unemployment rate	5 1/2	5 1/2	5	5
Consumer Price Index	3	2 1/4	2 1/2	2 1/2
Nominal GDP	4	5 1/2	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 for the June quarter.

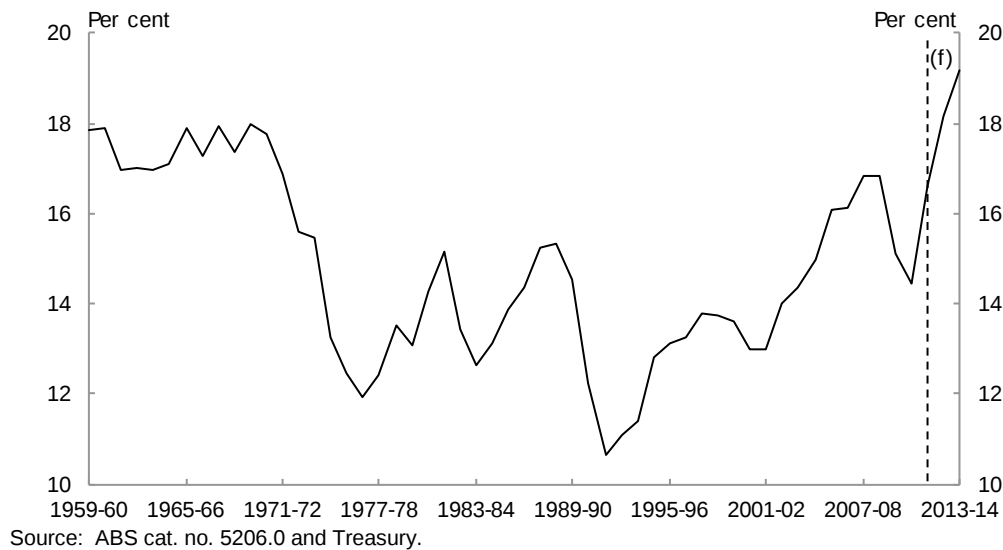
Source: Treasury.

The outlook for Australia's real GDP growth continues to be underpinned by a surge of investment in the resources sector, strong growth in the volume of commodity exports and solid household demand.

New business investment is expected to reach 50-year highs as a share of GDP over the forecast period (Chart 1.2), driven by the resources sector. Over \$260 billion of resources investments have received final investment approval and the majority of these projects are already under construction. Resources investment as a share of GDP is expected to peak during the forecast period and remain at historically high levels through to at least the middle of this decade, converting the largest terms of trade boom in Australia's history to an enduring increase in our economic capacity. Following 75 per cent growth in 2011-12, the latest capital expenditure survey suggests a further 45 per cent increase in mining investment in 2012-13.

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Chart 1.2: New business investment (share of GDP)



Recent falls in global commodity prices have led to some scaling back of investment plans, largely in the coal sector where the pace of expansions has been slowed and the closure of a few high-cost mines has been brought forward. However, the resources investment pipeline is dominated by large LNG projects where investment decisions are taken over long time horizons, underpinned by projections of the energy needs of the Asian region over a period of decades.

The resources investment peak will coincide with the start of the production and exports phase of many projects, with the resources sector expected to make a significant contribution to real GDP growth over the forecast period. Australia's non-rural commodity exports are expected to grow 15 per cent over the next two years, notwithstanding a modest downgrade to forecast growth in coal exports since Budget, partly reflecting announced production cuts.

Conditions across the economy remain uneven, with some sectors experiencing challenging conditions. Investment intentions outside the resources sector for 2012-13 remain relatively subdued, with the uncertain global environment, household deleveraging, shifting household expenditure patterns and the high exchange rate weighing heavily on some sectors.

Notwithstanding these pressures, household consumption remains solid in aggregate and there are tentative signs that residential building activity may be starting to improve. As resources investment passes its peak, the forecasts are for low interest rates and rising incomes to support modest growth in dwelling construction and non-mining business investment in 2013-14. These forecasts incorporate the 150 basis point reduction in the official cash rate since November 2011 and broadly reflect the market's expectations for future movements in official interest rates.

The key risks to Australia's economic outlook are external. The crisis in the euro area is at risk of further escalation, the imminent fiscal tightening in the United States threatens an already weak recovery and the new Chinese leadership face the challenging task of placing their economy on a more sustainable growth path in the context of a weak and uncertain outlook for external demand. These uncertainties are driving considerable volatility in global commodities markets, with attendant risks to Australia's terms of trade and nominal GDP growth.

Still, with a low unemployment rate, solid GDP growth, a strong financial sector, room to manoeuvre on monetary policy and strong public finances, Australia is well-placed to manage the effects of any further deterioration in the global economy.

RETURNING THE BUDGET TO SURPLUS

The Government is returning the budget to surplus in 2012-13 even though the recent fall in global commodity prices and the weaker global economic outlook have made the task more challenging.

While iron ore prices have recently regained some ground, global non-rural commodity prices are expected to remain below the levels forecast at Budget. Largely because of lower commodity prices, nominal GDP growth in 2012-13 is forecast to be lower than at Budget and this is expected to result in slower growth in tax receipts. In particular, company tax and resource rent taxes have been revised down since the Budget. This results in tax receipts being over \$20 billion lower over the forward estimates.

Notwithstanding the substantial write-down in total tax receipts, the Government will return the budget to surplus in 2012-13, with small but growing surpluses over the forward estimates. Returning to surplus in 2012-13 remains appropriate given current conditions, reflecting a targeted approach to savings that minimises the overall impact of the Government's fiscal consolidation on the economy. The economy is forecast to grow around trend, the unemployment rate is forecast to remain low and commodity prices remain high by historical standards.

In normal circumstances, with fiscal policy focussed on the medium term, monetary policy should play the primary role in managing demand to keep the economy growing at close to capacity consistent with achieving the medium-term inflation target. The Government's fiscal consolidation continues to provide scope for monetary policy to respond to economic developments, as needed.

With global uncertainty likely to persist well into 2013, the Government's ongoing commitment to fiscal discipline will ensure that Australia's public finances remain strong, underpinning confidence in the strength of the Australian economy. The strength of Australia's public finances is a key reason behind Australia being one of only seven countries to have a AAA credit rating with a stable outlook from all three major ratings agencies. This, along with Australia's positive economic outlook, has

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made Commonwealth Government Securities relatively attractive for investors, which has contributed to interest rates on these securities recently falling to historic lows. Keeping Australia's public finances strong will also support the Government's capacity to respond to unanticipated events in uncertain global economic times.

Targeted and responsible savings

The Government has announced that it will pursue significant long-term reforms to schools and disabilities. The Government will fundamentally reform the model for school funding, with a new system to be phased in over six years from calendar year 2014. Launch sites for the NDIS will commence from July 2013, the first step towards a better deal for Australians with a disability.

In each of these areas additional resources will be required from the Commonwealth Government and State and Territory Governments. Detailed negotiations are still being progressed in both of these areas.

Funding these new important priorities will require tough budget choices. The Government will continue to build on its record of delivering enduring savings that improve the budget position over the long term in some areas in order to free up the resources necessary to deliver key reforms like reforming the model for school funding and improving support for those with disabilities.

The Government has designed a package of savings worth \$16.4 billion in 2012-13 and over the forward estimates. These measures have been carefully selected to minimise the impact on the economy and on vulnerable people, while still maintaining strong public finances. These savings spread the work of returning to surplus in a fair way, taking into account the ability to pay, and targeting spending to the areas of highest need. These savings are necessary to maintain the budget position, and continue the progress in strengthening the medium-term fiscal position.

Delivering on key priorities while maintaining strong public finances

From 1 January 2014, under the Dental Health Reform Package more than 3 million children and teenagers will be eligible for government-subsidised dental care, as well as more than one million low-income adults and Australians in rural and remote areas. These new programs will replace the Medicare Teen Dental Plan and the poorly targeted Chronic Disease Dental Scheme.

The cost of this important dental health reform will be offset by savings including from changes to private health insurance. The Private Health Insurance rebate will be adjusted to ensure that it grows at a sustainable rate. The Government's contribution to private health insurance will be calculated using commercial premiums as at 1 April 2013 and then indexed annually by the lesser of CPI or the actual increase in commercial premiums. This will be used to determine an individual's private health insurance rebate. These changes will reduce the growth of the rebate, which has been

projected to be one of the fastest growing components of Commonwealth health expenditure over the medium term.

In conjunction with this measure, the Government will streamline arrangements for the 2013 premium setting round for private health insurance. The Government will also undertake discussions with industry and consumer groups on options for further simplification of premium setting which will drive competition and continue to deliver strong consumer protection from 2014.

When fully implemented, the Government's response to the Expert Panel on Asylum Seekers will deter people from making dangerous boat voyages to Australia, including by expanding asylum seekers' options for regular migration to Australia. The response will have initial costs, but will save lives. Arrival numbers to date since the 2012-13 Budget have been higher than estimated, and the additional costs of these arrivals have been provisioned in this MYEFO. Arrival numbers are expected to decline as the new policy is fully implemented, reducing the pressure on the budget from irregular maritime arrivals.

The Government is making changes to the Australian Apprenticeships Incentives Program (AAIP) that will better target spending towards areas of high skill need. Changes to the standard incentive payments will ensure that the focus of the AAIP is on encouraging employers to take on apprentices in high skill need areas and train them through to completion. These changes will ensure the \$3.3 billion funding over the forward estimates provided through the AAIP is best directed to help address skill shortages and does not duplicate other Government funded initiatives including, for example, the National Workforce Development Funding and the National Partnership Agreement on Skills Reform.

From 1 July 2013, the Government will reduce the Baby Bonus payment for second and subsequent children to \$3,000. This will help ensure the sustainability of the family payment system and better reflect the actual up-front costs of a child. Families will continue to benefit from the Government's wide ranging reforms for families, including Paid Parental Leave, the increase in the Child Care Rebate from 30 per cent to 50 per cent of out-of-pocket child care expenses, the SchoolKids bonus, and Family Tax Benefit Part A and B.

The Government's higher education reforms in response to the Bradley Review are now fully implemented and universities are embracing the new demand driven funding system, driving substantially higher costs in higher education and student income support. An additional \$5.3 billion in funding from 2010 to 2015 for universities will be provided to support the growth in student enrolments resulting from the Government's reforms. This funding is supporting the additional 150,000 university students that are enrolled in university in 2012 compared to 2007 (a 27.8 per cent increase). The increase in enrolments will see efficiencies being realised in the delivery of courses, particularly from economies of scale. Longer-term growth in some research funding to universities will be temporarily slowed to ensure that

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research funding to universities remains sustainable. Additionally, changes to tertiary education funding and student assistance are being made to ensure that the system operates effectively. The Government will continue to consider how to ensure that the growth in university expenditure will remain sustainable in the future.

Company tax collection arrangements will be reformed to introduce monthly Pay As You Go for large companies. This will ensure that instalments are more closely aligned to fluctuations in these businesses' income. It will better align company tax payments with goods and services tax payments for affected businesses, and will ensure better accounting for company tax collected in a financial year. Many other countries already have monthly instalments, including Canada, Sweden, Finland and the Netherlands. The Government will consult with the business community on the best way to implement this change, ahead of its phased commencement from 1 January 2014.

The ongoing process of improvements to ensure the integrity and fairness of the tax system will be enhanced. In-house fringe benefits provided through salary sacrifice arrangements will no longer be given concessional tax treatment, improving fairness for employees of firms who do not offer these arrangements. The Australian Taxation Office (ATO) will also receive additional funding for compliance activities, including specific targeting of under-reporting of cash transactions and tax avoidance and evasion schemes.

The Government will make changes to the operation of lost superannuation and unclaimed bank account and life insurance provisions. The changes will increase the number of lost superannuation accounts transferred to the ATO, who will be given additional funding to implement this measure and to use their data matching resources to match lost accounts with active accounts. For the first time, the Government will pay interest at the rate of CPI inflation on all unclaimed superannuation monies reclaimed from the ATO and unclaimed monies reclaimed from the Australian Securities and Investments Commission from 1 July 2013, which will preserve their value over time.

FISCAL OUTLOOK

The expected underlying cash surplus for 2012-13 is \$1.1 billion (0.1 per cent of GDP), increasing to \$2.2 billion (0.1 per cent of GDP) in 2013-14.

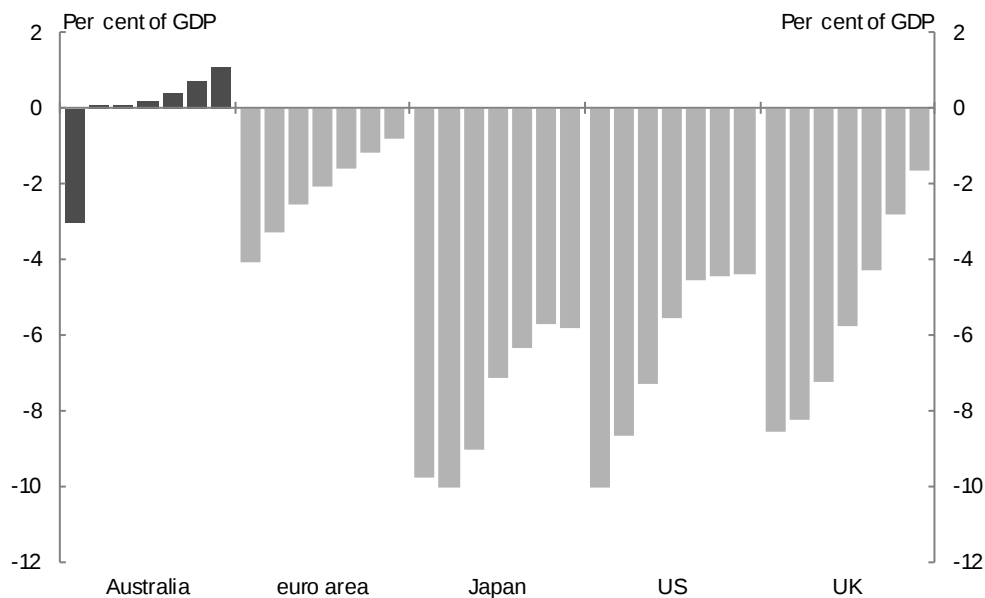
The expected surplus in 2012-13 is smaller than expected at Budget, driven in large part by the weaker global outlook and the consequent substantial write-down in tax receipts. Over the five years since the onset of the GFC there has been a substantial write-down in tax receipts totalling almost \$160 billion.

Total tax receipts have been revised down by around \$4 billion in 2012-13 in large part because of weaker non-rural commodity prices. This was offset in part by non-tax receipts and payments variations of around \$2 billion.

The Government has made a number of savings decisions in response to the write-down in tax receipts across the forward estimates. In total, savings of \$16.4 billion have been made in 2012-13 and across the forward estimates, with the net budget impact of all policy decisions improving the budget bottom line by \$10.5 billion. The savings decisions made by the 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 1.3). The average net debt position of the major advanced economies is projected to peak at 95 per cent of GDP in 2016, almost 10 times higher than the expected peak in Australia's net debt of 10.0 per cent of GDP in 2011-12 (Chart 1.4).

Chart 1.3: International comparison of budget balances, 2011-2017

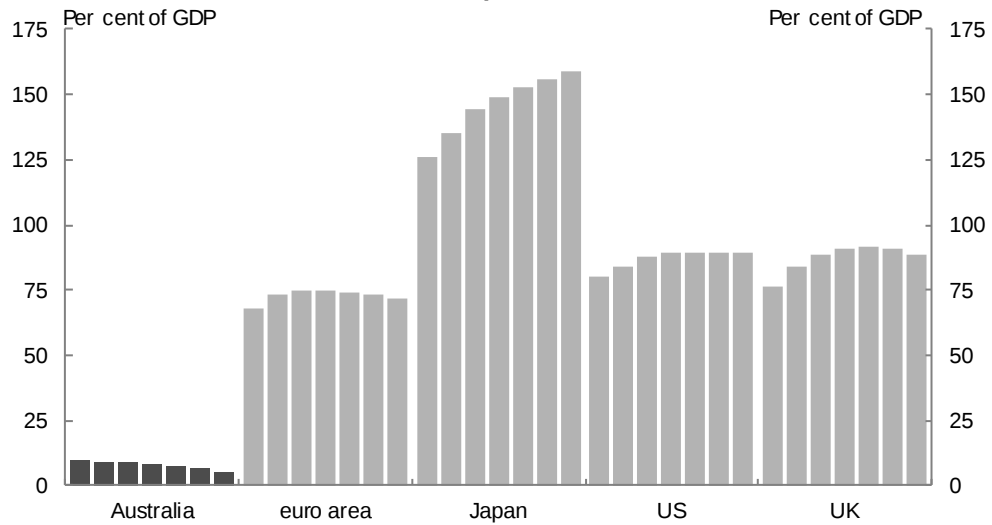


Note: Australian data are for the Australian Government general government sector underlying cash balance and refer to financial years beginning 2011-12. Data for all other economies are total government and refer to calendar years beginning 2011.

Source: IMF *Fiscal Monitor* October 2012 and Treasury.

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Chart 1.4: International comparison of net debt, 2011-2017



Note: Australian data are for the Australian Government general government sector and refer to financial years beginning 2011-12. Data for all other economies are total government and refer to calendar years beginning 2011.

Source: IMF *Fiscal Monitor* October 2012 and Treasury.