PART 2
FISCAL AND ECONOMIC OUTLOOK

This part presents the main budget aggregates for the 2005-06 Budget and reconciles these with estimates from the 2004-05 MYEFO. It includes the budget financial statements and outlines the sensitivity of the budget estimates to the uncertainty of the economic parameters.

More detail on budget revenue and expenses is included in Statements 5 and 6.

This part discusses the outlook for the domestic and international economies.

This part also discusses the Australian economy's recent strong performance and the scope to sustain our prosperity. Policies and choices that support rapid productivity growth and widespread participation in the economy and society can further the wellbeing of all Australians.

STATEMENT 2: FISCAL OUTLOOK

This statement summarises the main budget aggregates for the Australian Government general government sector.

The fiscal outlook for Australia remains strong, with the Government forecasting an underlying cash surplus of $8.9 billion in 2005-06. Across the forward estimates, the Government has maintained the budget in a strong surplus position after providing for personal income tax cuts of $21.7 billion and a $3.6 billion welfare reform package.

The Government's sound fiscal management will see further reductions to net debt across the forward years. The continued strengthening of net worth through strong surpluses and initiatives such as the Future Fund leaves government finances well placed to deal with the medium-term fiscal pressures projected in the Productivity Commission's recent report on the *Economic Implications of an Ageing Australia*.

This Budget provides for around $16 billion to be allocated to the Future Fund in 2005-06.

STATEMENT 2: FISCAL OUTLOOK

The fiscal outlook for Australia remains strong, with the Government forecasting its eighth budget surplus. Across the forward estimates period, the Government has maintained the budget in surplus after providing $21.7 billion of personal income tax cuts, $3.6 billion on a *Welfare to Work* package to improve work incentives and labour force participation and $2.5 billion to abolish the superannuation surcharge.

BUDGET AGGREGATES

An underlying cash surplus of $8.9 billion is expected in 2005-06 compared with an estimated surplus of $4.5 billion at the *Mid-Year Economic and Fiscal Outlook 2004-05* (MYEFO). Underlying cash surpluses are projected to continue across the forward estimates.

In accrual terms, a fiscal surplus in 2005-06 of $7.4 billion is forecast compared to $3.5 billion at MYEFO. Fiscal surpluses are expected to continue across the forward estimates.

Table 1: Australian Government general government sector budget aggregates[(a)]

	Actual	Estimates		Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Revenue ($b)	**187.6**	**202.7**	**214.5**	**222.9**	**233.4**	**245.3**
Per cent of GDP	23.1	23.5	23.1	23.0	23.2	23.1
Expenses ($b)	**182.0**	**195.0**	**206.1**	**214.8**	**225.4**	**236.6**
Per cent of GDP	22.4	22.6	22.2	22.2	22.4	22.3
Net operating balance ($b)	5.6	7.7	8.4	8.1	8.0	8.8
Net capital investment ($b)	0.7	0.7	1.0	0.6	0.0	-0.3
Fiscal balance ($b)	**4.8**	**7.0**	**7.4**	**7.5**	**8.0**	**9.0**
Per cent of GDP	0.6	0.8	0.8	0.8	0.8	0.9
Underlying cash balance ($b)(b)	**8.0**	**9.2**	**8.9**	**7.9**	**8.5**	**9.3**
Per cent of GDP	1.0	1.1	1.0	0.8	0.8	0.9
Memorandum item:						
Headline cash balance ($b)	7.6	7.9	7.9	18.2	18.6	19.4

(a) All estimates are based on Government Finance Statistics (GFS) standards, but with goods and services tax (GST) revenue collected on behalf of the states and territories netted off revenue and expenses.
(b) Excludes expected Future Fund earnings from 2005-06 onwards. For further explanation refer to Statement 2 Box 1 and Statement 8.

VARIATIONS TO THE FISCAL BALANCE ESTIMATES

The upward revision of $3.9 billion in the 2005-06 fiscal surplus since MYEFO largely reflects higher than anticipated revenue from companies, small unincorporated

businesses and personal investors. This is partly offset by the impact of personal income tax cuts and the Government's *Welfare to Work* package.

Table 2 provides a reconciliation of the fiscal balance estimates between the 2004-05 Budget, the 2004-05 MYEFO and the 2005-06 Budget.

Table 2: Reconciliation of 2004-05 Budget, 2004-05 MYEFO and 2005-06 Budget fiscal balance estimates

	Estimates		Projections	
	2004-05	2005-06	2006-07	2007-08
	$m	$m	$m	$m
2004-05 Budget fiscal balance	**698**	**712**	**2,291**	**2,619**
Per cent of GDP	0.1	0.1	0.2	0.3
Changes between 2004-05 Budget and MYEFO				
Effect of policy decisions(a)				
Revenue	-11	-401	-1,115	-1,025
Expenses	1,646	2,943	3,250	3,367
Net capital investment	227	116	104	172
Total policy decisions impact on fiscal balance(b)	-1,885	-3,460	-4,469	-4,564
Effect of parameter and other variations				
Revenue	6,303	6,514	6,486	7,237
Expenses	-142	16	-919	-1,418
Net capital investment	330	254	244	133
Total parameter and other variations impact on fiscal balance(b)	6,115	6,245	7,161	8,522
2004-05 MYEFO fiscal balance	**4,929**	**3,497**	**4,984**	**6,577**
Per cent of GDP	0.6	0.4	0.5	0.6
Changes between MYEFO and 2005-06 Budget				
Effect of policy decisions(a)				
Revenue	-35	-3,472	-6,675	-7,662
Expenses	932	2,040	3,041	3,201
Net capital investment	12	251	166	83
Total policy decisions impact on fiscal balance(b)	-978	-5,763	-9,882	-10,946
Effect of parameter and other variations				
Revenue	3,258	10,486	11,986	11,725
Expenses	272	456	-598	-690
Net capital investment	-66	354	228	44
Total parameter and other variations impact on fiscal balance(b)	3,053	9,676	12,356	12,372
2005-06 Budget fiscal balance	**7,003**	**7,410**	**7,458**	**8,003**
Per cent of GDP	0.8	0.8	0.8	0.8

(a) Excludes the public debt net interest effect of policy measures.
(b) A positive number for revenue indicates an increase in the fiscal balance, while a positive number for expenses and net capital investment indicates a decrease in the fiscal balance.

Variations in revenue estimates

Total revenue for 2005-06 has been revised up by $7.0 billion since MYEFO, reflecting higher estimated revenue from companies, personal investors and small

unincorporated businesses. These upward revisions have been partly offset by the impact of the Government's decision to provide further personal income tax cuts.

Policy decisions since the 2004-05 MYEFO are expected to reduce taxation revenue by around $3.5 billion in 2005-06 and around $26.1 billion over the forward years. The major policy decisions affecting revenue over the four year period 2005-06 to 2008-09 are outlined below.

- The personal income tax cuts taking effect from 1 July 2005 and 1 July 2006 will reduce revenue by $3.1 billion in 2005-06, and $21.7 billion over the forward estimates period.

- The abolition of the superannuation contributions and termination payments surcharge for contributions made from 1 July 2005 will reduce revenue by $650 million in 2006-07 and $2.5 billion over the forward estimates.

- The removal of the 3 per cent tariff applying to business inputs imported under a tariff concession order, effective from 11 May 2005, will reduce revenue by $36 million in 2004-05, $290 million in 2005-06 and $1.3 billion over the forward estimates.

- The extension of the eligibility criteria for the mature age worker tax offset will reduce revenue by $70 million in 2005-06 and $295 million over the forward estimates period.

- A four-year income tax exemption for temporary residents for most foreign source income, including capital gains, commencing from July 2006, will reduce revenue by $50 million in 2007-08 and $105 million over the forward estimates.

- Changes to the capital gains tax treatment of non-resident investors in Australia will reduce revenue by $50 million in 2005-06 and $230 million over the forward estimates.

- Recognition for tax purposes of certain currently unrecognised business capital expenditures ('blackhole expenditures') from 2006-07 will reduce revenue by $35 million in 2006-07, increasing in later years, to a cost of $205 million over the forward estimates.

- Changes to the capital allowance treatment of film copyright to ensure the application of the effective life depreciation regime, with effect to expenditures after 1 July 2004, will reduce revenue by $15 million in 2005-06 and $175 million over the forward estimates.

- Abolition of the foreign loss and foreign tax credit quarantining, with effect from the first income year after Royal Assent, will reduce revenue by $25 million in 2007-08 and in 2008-09.

Parameter and other variations are expected to increase revenue in 2005-06 by $10.5 billion, relative to the MYEFO forecasts. These upward revisions reflect the flow on effect of a stronger expected revenue base in 2004-05 and a significant upward revision to nominal GDP growth in 2005-06.

- Relative to MYEFO, nominal GDP growth for 2005-06 has been revised up by 1¾ percentage points to 7½ per cent — despite a slight downward revision to real GDP growth — reflecting significant increases in estimated growth in the GDP deflator as a result of recent increases in commodity export prices (see Box 3, Statement 3).

- These increases are expected to lift corporate profits significantly in 2005-06, which — due to the timing of company tax collections — will boost revenue in both 2005-06 and 2006-07. Reflecting this, estimated company income tax revenue for 2005-06 has been revised up by $4.7 billion since MYEFO, and by a further $3.8 billion in 2006-07.

The Budget estimates also incorporate adjustments to forecasting methodology to align the estimates more closely with recent experience (see Box 1, Statement 5). These adjustments affect the gross other individuals, refunds for individuals and company income tax revenue heads and generally increase estimated revenue from MYEFO for 2005-06 and the projection years.

Relative to MYEFO, estimated total revenue for 2004-05 has been revised up by $3.2 billion, largely owing to higher expected revenue from wage and salary earners, personal investors and small unincorporated businesses.

More detail on how the revised outlook for the economy has affected individual revenue heads over the forward estimates period is provided in Statement 5. A full description of all policy measures since MYEFO is provided in Budget Paper No. 2, *Budget Measures 2005-06*.

Variations in expense estimates

Since MYEFO, estimated expenses for 2005-06 have increased by $2.5 billion reflecting the impact of new policy decisions of $2.0 billion and parameter and other variations of $0.5 billion.

Major policy decisions since MYEFO that have increased expenses include:

- $430 million in 2005-06 ($2 billion over the five years from 2004-05) to increase the maximum rate of Family Tax Benefit Part B, as announced in the *Extra Assistance for Families* election commitment;

- $207 million in 2005-06 ($797 million over four years) to continue assisting the Solomon Islands Government in the restoration of law and order and broad-ranging economic, governance and public sector reforms;

- $177 million in 2005-06 ($211 million over four years from 2004-05) for the deployment of additional troops to provide security and training in Southern Iraq;

- $174 million in 2005-06 ($211 million over three years from 2004-05) to continue the Australian Defence Force contribution to stabilisation and reconstruction activities in Iraq (Operation Catalyst);

- $170 million in 2005-06 ($3.5 billion over four years) for the *Welfare to Work* package to increase workforce participation and reduce welfare dependency while retaining a strong safety net for those in need;

- $115 million in 2005-06 ($500 million over five years from 2004-05) for the grants component of the Australian-Indonesia Partnership for Reconstruction and Development Package to help Indonesia restore health, education and local government services in the worst tsunami affected areas, and improve economic governance and public administration. This is in addition to the $500 million in concessional loans over five years to be directed to reconstruction and rehabilitation of major infrastructure across Indonesia; and

- $112 million in 2005-06 ($579 million over four years) to continue funding for quarantine border protection programmes delivered by the Australian Quarantine and Inspection Service, the Australian Customs Service and Biosecurity Australia.

Major policy decisions reducing expenses include:

- a $139 million reduction in 2005-06 ($1 billion over five years from 2004-05) due to changes to listing arrangements for pharmaceuticals which will see a price reduction of at least 12.5 per cent when the first new brand of an already listed medicine is added to the Pharmaceutical Benefits Scheme; and

- an $84 million decrease in 2005-06 ($335 million over four years) resulting from the withdrawal of the funding offer to state and territory governments to extend concessions to Commonwealth Seniors Health Card holders.

In 2005-06, parameter and other variations have increased forecast expenses by $0.5 billion since MYEFO largely reflecting:

- a $588 million increase in estimated civilian superannuation expenses, largely due to higher nominal interest expense reflecting changes in the estimate of the Consumer Price Index;

- a $398 million increase in Defence expenses reflecting an increase in the estimated non-farm GDP deflator, which is used to index Defence operating expenses;

- a rephasing of $300 million by the Department of Defence of its major capital equipment acquisition programme from beyond the forward estimates period into 2005-06 to meet current funding requirements, including from expected improvements in performance in the delivery of the Defence Capability Plan;

- a $232 million increase in expenses administered by the Australian Taxation Office resulting from a change in accounting policy which recognises certain payments in the year of accrual rather than the year of payment;

- a $220 million increase in expenses due to a reclassification of Defence Housing Authority expenses following the adoption of the Inventory Accounting Standard which has resulted in expenses being recognised for the purpose of Government Finance Statistics;

- a $200 million increase in Energy Grants Credit Scheme expenses, flowing on from higher than forecast claims activity in 2004-05 due to expected increases in the mining and road transport sectors; and

- a $70 million increase in Private Health Insurance Rebate expenses, primarily resulting from higher than expected premium increases and levels of insurance coverage.

The above increase in expenses is partially offset by:

- a $439 million reduction in anticipated Newstart Allowance and Youth Allowance expenses, largely due to the stronger labour market reducing the expected number of unemployment benefit recipients;

- a $120 million reduction for Superannuation Guarantee Programme expenses, primarily due to delays in processing claims;

- a $69 million reduction in expenses for the Cleaner Fuels Grant Scheme due to a lower than forecast take-up of bio-diesel production grants;

- the removal of the provision for the implementation of election commitments now reported as policy measures; and

- the regular draw-down of the conservative bias allowance[1] reducing estimated expenses by around $1 billion each year from 2005-06.

In 2004-05, estimated expenses have increased by $1.2 billion since MYEFO. This largely reflects new spending of $932 million including $314 million for a one-off lump-sum payment to eligible carers and $212 million towards the Family Tax Benefit Part B package. Parameter and other variations have increased expenses by $272 million and include a $1 billion increase in expenses administered by the Australian Taxation Office resulting from a change in accounting policy, partially offset by other variations including a $140 million underspend associated with the delayed deployment of Australian Federal Police staff to Papua New Guinea.

More detailed information on expenses can be found in Statement 6. A full description of all policy measures since MYEFO can be found in Budget Paper No. 2, *Budget Measures 2005-06*.

Variations in net capital investment estimates

In 2005-06, forecast net capital investment has increased by $605 million since the 2004-05 MYEFO. This represents the combined effect of:

- new policy measures of $251 million, including $56 million largely to ensure the *Welfare to Work* reforms are supported by high quality information technology, $42 million of additional investment in improved security for Australian diplomatic missions, $16 million to continue assisting the Solomon Islands Government in the restoration of law and order and broad ranging economic, governance and public sector reforms, and $11 million for the deployment of additional troops to provide security and training in Southern Iraq; and

- parameter and other variations of $354 million, largely due to a $195 million revision in estimated Defence Housing Authority sales, $101 million in capital investment by the Overseas Property Office and a further $34 million investment for the construction of the Christmas Island Immigration Reception and Processing Centre. These increases are partially offset by sales in the Defence Property Sales programme estimated at $89 million.

In 2004-05, estimated net capital investment has decreased by $54 million since MYEFO, largely reflecting parameter and other variations.

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1 The forward estimates include an allowance for the established tendency of existing government policy (particularly demand driven programmes) to be higher than estimated in the forward years. To offset this the contingency reserve includes an allowance based on past experience to preserve the overall integrity of forward estimates. This allowance, known as the conservative bias allowance, is progressively reduced so that the budget year conservative bias allowance is zero by budget night.

More detailed information on net capital investment can be found in Statement 6. A full description of all policy measures since the MYEFO can be found in Budget Paper No. 2, *Budget Measures 2005-06*.

CASH FLOWS

In 2005-06, an underlying cash surplus of $8.9 billion is expected, compared with the MYEFO estimate of $4.5 billion. The improvement in the underlying cash surplus is largely due to the same variations that affect the fiscal balance. From 2005-06 onwards, the exclusion of Future Fund earnings lowers the underlying cash balance relative to the fiscal balance.

Box 1: Budget treatment of expected Future Fund earnings

The Government has announced that it will establish a Future Fund to offset superannuation liabilities that would otherwise be a burden to future generations.

The Government is reporting the underlying cash balance excluding Future Fund earnings from 2005-06 onwards because the earnings will be reinvested to meet future superannuation payments and are therefore not available for current spending. However, Future Fund earnings are included in the fiscal balance because superannuation expenses relating to future cash payments are recorded in the fiscal balance estimates.

The rate of return on the Future Fund investments will depend on the actual asset allocation across different asset classes. Once the enabling legislation has passed, the Future Fund Management Board will be responsible for investments in accordance with a broad investment mandate. In the absence of an investment mandate, the budget and forward estimates assume the initial investment of seed capital will earn a return equal to yields on other term deposits held by the Government.

Expected Future Fund earnings are separately identified in the Australian Government cash flow statement in Statement 2, Appendix B and the historic tables in Statement 13.

Table 3 provides a summary of Australian Government general government sector cash flows.

Table 3: Summary of Australian Government general government sector cash flows[(a)]

	Estimates		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
	$b	$b	$b	$b	$b
Cash receipts					
Operating cash receipts	202.2	214.2	221.7	232.3	244.1
Capital cash receipts(b)	0.4	0.3	0.2	0.3	0.2
Total cash receipts	202.7	214.5	221.9	232.5	244.2
Cash payments					
Operating cash payments	190.9	202.0	210.4	220.7	231.9
Capital cash payments(c)	2.6	3.1	2.5	2.3	2.0
Total cash payments	193.4	205.1	213.0	223.0	233.9
Finance leases and similar arrangements(d)	0.0	0.0	0.0	0.0	0.0
GFS cash surplus(+)/deficit(-)	9.2	9.4	8.9	9.5	10.3
Per cent of GDP	1.1	1.0	0.9	0.9	1.0
less Future Fund earnings	0.0	0.5	0.9	1.0	1.1
Underlying cash balance(e)	**9.2**	**8.9**	**7.9**	**8.5**	**9.3**
Per cent of GDP	1.1	1.0	0.8	0.8	0.9
Memorandum items:					
Net cash flows from investments in financial assets for policy purposes(f)	-1.3	-1.5	9.3	9.1	9.0
plus Future Fund earnings	0.0	0.5	0.9	1.0	1.1
Headline cash balance	**7.9**	**7.9**	**18.2**	**18.6**	**19.4**

(a) Cash flows are derived from the accrual GFS framework excluding GST.
(b) Equivalent to cash receipts from the sale of non-financial assets in the GFS cash flow statement.
(c) Equivalent to cash payments for purchases of new and second-hand non-financial assets in the GFS cash flow statement.
(d) The acquisition of assets under finance leases decreases the underlying cash balance. The disposal of assets previously held under finance leases increases the underlying cash balance.
(e) Excludes expected Future Fund earnings from 2005-06 onwards. For further explanation refer to Statement 2 Box 1 and Statement 8.
(f) Under the cash budgeting framework, these cash flows were referred to as net advances.

Table 4 provides a reconciliation of the variations in the underlying cash balance estimates.

Table 4: Reconciliation of Australian Government general government sector underlying cash balance estimates

	Estimates		Projections	
	2004-05	2005-06	2006-07	2007-08
	$m	$m	$m	$m
2004-05 Budget underlying cash balance	**2,391**	**1,587**	**3,438**	**4,501**
Changes from 2004-05 Budget to MYEFO				
Effect of policy decisions(a)	-1,728	-3,355	-4,423	-4,541
Effect of parameter and other variations	5,543	6,227	6,682	7,625
Total variations	**3,816**	**2,872**	**2,259**	**3,084**
2004-05 MYEFO underlying cash balance	**6,206**	**4,459**	**5,697**	**7,584**
Changes from MYEFO to 2005-06 Budget				
Effect of policy decisions(a)	-744	-5,755	-9,377	-10,687
Effect of parameter and other variations	3,759	10,678	12,556	12,600
Total variations	**3,015**	**4,923**	**3,179**	**1,912**
less Future Fund earnings	0	462	943	997
2005-06 Budget underlying cash balance(b)	**9,221**	**8,921**	**7,933**	**8,500**

(a) Excludes the public debt net interest effect of policy measures.
(b) Excludes expected Future Fund earnings from 2005-06 onwards. For further explanation refer to Statement 2 Box 1 and Statement 8.

While the 2005-06 fiscal balance has increased by $3.9 billion since MYEFO, the underlying cash balance has increased by $4.5 billion. This difference between the change in the underlying cash balance and the fiscal balance largely reflects increased superannuation expenses and Australian Taxation Office administered expenses resulting from a change in accounting treatment which affect the fiscal balance but not the cash balance. These differences are partly offset by Future Fund earnings, which are included in the fiscal balance but excluded from the underlying cash balance.

Headline cash balance

A headline cash surplus of $7.9 billion is now forecast for 2005-06 compared with a surplus of $3.0 billion at MYEFO. The increase in the headline cash surplus estimate since MYEFO largely reflects the increase in the underlying cash balance plus the inclusion of expected Future Fund earnings.

NET DEBT AND NET WORTH

With the budget remaining in cash surplus in 2005-06 and the forward years, further falls in net debt are expected. From its peak of 19.1 per cent of GDP in 1995-96, net debt is estimated to fall to $6.1 billion (0.7 per cent of GDP) by the end of 2005-06. Net interest payments are also expected to fall over the forward estimates.

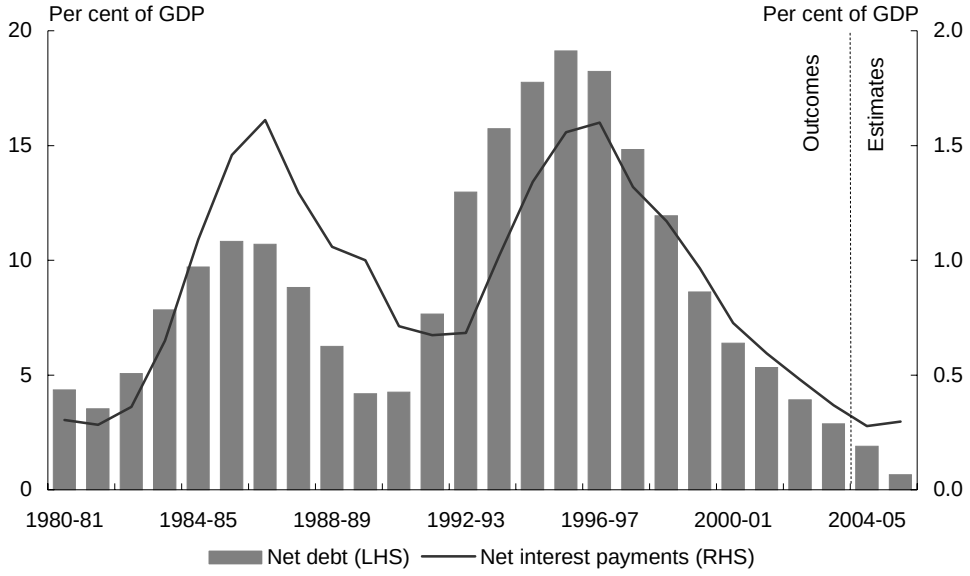
Table 5 and Chart 1 provide a summary of Australian Government general government sector net worth, net debt and net interest payments.

Table 5: Australian Government general government sector net worth, net debt and net interest payments

	Estimates		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
	$b	$b	$b	$b	$b
Financial assets	119.4	127.9	138.5	151.5	163.4
Non-financial assets	41.3	42.4	43.1	43.0	42.8
Total assets	**160.6**	**170.3**	**181.6**	**194.5**	**206.2**
Total liabilities	**194.7**	**198.1**	**202.0**	**208.2**	**212.1**
Net worth	**-34.1**	**-27.8**	**-20.4**	**-13.7**	**-5.9**
Net debt(a)(b)	**16.3**	**6.1**	**-14.0**	**-34.6**	**-56.4**
Per cent of GDP	1.9	0.7	-1.5	-3.4	-5.3
Net interest payments(c)	**2.4**	**2.8**	**1.2**	**-0.2**	**-1.3**
Per cent of GDP	0.3	0.3	0.1	0.0	-0.1

(a) Net debt equals the sum of deposits held, advances received, government securities, loans and other borrowing, minus the sum of cash and deposits, advances paid and investments, loans and placements.
(b) Includes the impact of the further sale of the Australian Government's shareholding in Telstra, but may change as a result of the establishment of the Future Fund.
(c) Australian Government cash interest payments less cash interest receipts. The 2005-06 estimates include the recognition in cash terms of the capital growth on inflation indexed bonds maturing in that year.

Chart 1: Australian Government general government sector net debt and net interest payments



Source: Data are from ABS Cat. No. 5513.0, Australian Government Final Budget Outcomes and Treasury estimates.

Australia's net debt is at low levels and is projected to fall over the forward estimates period. The net debt projections have improved considerably since MYEFO, reflecting larger than anticipated cash surpluses.

Australia's net debt position compares favourably to other industrialised countries. The ratio of Australia's total general government sector net debt to GDP is among the lowest in the OECD and is considerably lower than in Europe, Japan and the United States (see Statement 1).

Having peaked at $8.4 billion in 1996-97, net interest payments are expected to decline to $2.8 billion in 2005-06, representing annual interest savings of around $5.7 billion.

Net worth is expected to improve from -$34.1 billion in 2004-05 to -$5.9 billion in 2008-09, mainly reflecting cumulative surpluses in the forward estimates. The prospects for net worth mean the Government's finances are well placed to deal with emerging fiscal pressures.

MEDIUM-TERM FISCAL OUTLOOK

Importance of fiscal sustainability

Delivering sustainable fiscal policy is a key requirement of good government. By not living beyond its means, the Government prevents costly burdens being placed on future generations. Further, when governments are fiscally responsible, they provide a secure investment environment that encourages growth.

By reducing debt to manageable levels, the Government has put its finances in a sound position and generated substantial savings that can be directed to other purposes. However, sustainable fiscal policy is more than just prudent reduction of past debts. It involves managing all elements of the balance sheet — such as the unfunded superannuation liability — and a forward-looking strategy to address the looming fiscal pressures yet to affect Government finances.

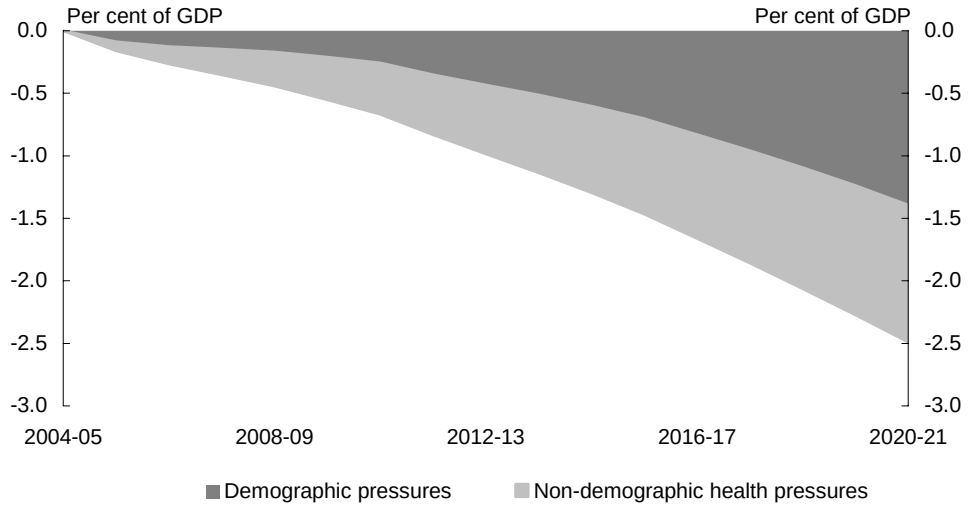
The Government recognised the importance of fiscal sustainability by committing to the regular release of the Intergenerational Report, with the first report in 2002 foreshadowing a significant fiscal gap opening over the long term. The Government is committed to managing these fiscal pressures by implementing pro-growth policies that raise productivity and encourage greater participation in the economy. The Government complements this by taking a long-term view when managing the fiscal outlook. Without making moderate reforms today, more drastic policy solutions will become inevitable in the future.

Medium-term budget pressures

While the current budget position is strong, significant fiscal pressures will emerge beyond the forward estimates period. Demographic change is expected to lead to both lower taxation receipts — due to falls in workforce participation — and higher payments, mainly for pensions and health care. In this budget, the GDP projection in 2008-09 has been lowered by ¼ per cent, reflecting the initial step of recognising slowing economic growth from the ageing of the population. Medium-term pressures are generated from rising health care costs, relating to increasing demand for health services, technological advances and demographic change.

While these fiscal pressures are most evident over the long term, they will have significant effects within the next ten years. The Productivity Commission's report on the *Economic Implications of an Ageing Australia* suggests that a fiscal gap of around 1.5 per cent of GDP will emerge by 2015-16; equivalent to $13 billion in today's terms. A breakdown of the impact of these fiscal pressures is reflected in Chart 1 below.

Chart 1: Medium-term fiscal pressures



Source: Productivity Commission, 2005, *Economic Implications of an Ageing Australia.*

Improving fiscal sustainability

The Government already has a strong record on fiscal sustainability by reducing net debt by an estimated $90 billion, from 19 per cent of GDP in 1995-96 to 0.7 per cent of GDP in 2005-06. This has freed up interest savings of around $5.7 billion annually that can be applied to other fiscal pressures. In addition, the Government has released a series of packages designed to lower fiscal pressures over the medium to long term.

The Government's currently unfunded superannuation liability to employees is the largest liability on the balance sheet at around $91 billion in 2004-05. By establishing the Future Fund, the Government has pre-committed resources to meet future

superannuation payments. As Future Fund earnings are not available for other spending, they are excluded from the underlying cash balance. Funding superannuation now will reduce future pressures on the budget at a time when the Government will need to face the spending challenges of an ageing population.

In addition to establishing the Future Fund, the Government has closed entry to the Public Sector Superannuation Scheme to limit future growth in the liability. Overall, these reforms ensure that superannuation costs are not passed onto future generations at a time when other demographic pressures emerge.

Also in this budget the Government has announced a comprehensive reform package that will improve the outlook for workforce participation and place the welfare system on a more sustainable basis. New obligations to seek part-time work will ensure that those who are able to work do so. The combination of improved payment and income test arrangements, a new compliance regime that encourages people to meet their obligations and funding for a range of new and expanded services will increase participation by moving people out of welfare and into work.

Also, the introduction of the Child Care Tax Rebate and the provision of additional child care places assist parents returning to the workforce after having children. Together, these packages will lead to greater workforce participation that strengthens both the overall economy and the Government's finances over the medium term.

Healthcare costs currently represent 18 per cent of the Government expenses and will continue to grow strongly in the future. In particular, expenses for the Pharmaceutical Benefits Scheme increased by 11 per cent in 2003-04, reflecting higher general demand for health services — an effect that will be compounded through demographic change. The increase in PBS patient co-payments, the mandatory 12.5 per cent price reduction for generic drugs as well as the raising of the Medicare Safety Net thresholds are directed to returning healthcare to a sustainable footing so that future generations can also enjoy high quality health services.

APPENDIX A: REPORTING STANDARDS

The *Charter of Budget Honesty Act 1998* requires that the budget be based on external reporting standards, and that departures from applicable external reporting standards be identified.

The major external standards used for budget reporting purposes are:

- the Australian Bureau of Statistics' (ABS) accrual Government Finance Statistics (GFS) publication *Australian System of Government Finance Statistics: Concepts, Sources and Methods* Cat. No. 5514.0, which in turn is based on the International Monetary Fund (IMF) accrual GFS framework; and

- Australian Accounting Standards (AAS), including AAS 31 *Financial Reporting by Governments*.

The operating statement and balance sheet include an adjustment to take account of the estimated impact of the Australian Equivalents to International Financial Reporting Standards (AEIFRS) on Australian Government general government sector reporting. There is no immediate direct impact on the underlying cash balance and the GFS surplus/deficit in this statement and in Statement 9. There is an impact on both the fiscal balance and net worth in this statement and in the general government sector of Statement 9. The AEIFRS reporting requirements and impact on the AAS Statement of Financial Performance and Statement of Financial Position are outlined in Note 2 of Statement 10.

The Budget tables, with the exception of tables in Statement 9, do not include goods and services tax (GST) collections and equivalent payments to the states. However, under the *Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations*, all GST receipts are appropriated to the states and territories and thus are not available for expenditure by the Australian Government. Because the Australian Taxation Office collects GST as an agent for the states and territories, GST receipts are not shown as Australian Government revenue. Estimates of GST receipts are provided in Table 2 of Statement 8.

ABS GFS requires that provisions for bad and doubtful debts be excluded from the balance sheet. This treatment has not been adopted because excluding such provisions would overstate the value of Australian Government assets in the balance sheet (and would, therefore, be inconsistent with the market valuation principle).

The AAS financial statements currently record IMF Special Drawing Rights (SDRs) as a liability. This is consistent with AAS. The GFS statements also record SDRs as a liability. However, in accordance with the IMF"s GFS manual, IMF SDRs are not treated as a liability in ABS GFS although they are treated this way in other IMF documentation. In view of these differences, the current approach will remain in place

pending further consultation with the IMF, and developments in train to harmonise GFS and AAS.

Similarly, the GFS financial statements currently adopt the AAS treatment for circulating coins. Under this treatment revenue is recognised upon the issue of coins and no liability is recorded, as there is no legal obligation requiring coins on issue to be repurchased by the Australian Government. However, in ABS GFS, coins on issue are treated as a liability and no revenue is recognised. The current accounting treatment will remain in place pending further consultation with the IMF, and developments in train to harmonise GFS and AAS.

The ABS GFS also requires defence weapons be treated as expenses. Defence weapons inventories are recorded as capital investment rather than expenses until such inventories can be reliably identified and measured. This treatment does not affect the underlying cash or fiscal balances.

In order to ensure the reporting of reliable AAS and GFS budget estimates and outcomes, taxation revenue is recognised the earlier of when an assessment of a tax liability is made or cash payment is received by the Australian Taxation Office or the Australian Customs Service. This method is permitted under both GFS and AAS when there is an inability to reliably measure taxation revenue at the time the underlying transactions or events occur. Accordingly, for most categories of taxation revenue, there is a short lag between the time at which the underlying economic activity giving rise to the tax liability occurs and when the revenue is recognised. Longer lags of up to a year occur for some elements of company and superannuation funds taxation.

Additional information on the reporting standards and budget concepts is provided in Statement 8.

APPENDIX B: BUDGET FINANCIAL STATEMENTS

The budget financial statements consist of an operating statement, balance sheet, cash flow statement and statement of other economic flows (reconciliation of net worth) for the Australian Government general government sector. The budget financial statements are based on GFS standards with the exception of the divergences discussed in Appendix A.

Table B1: Australian Government general government sector operating statement

	Estimates		Projections		
	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m
Revenue					
Taxation revenue	190,201	201,267	208,999	218,798	230,120
Current grants and subsidies	0	0	0	0	0
Sales of goods and services	4,828	4,965	5,194	5,330	5,363
Interest income	1,562	2,000	2,853	3,997	5,025
Dividend income	3,146	3,312	2,952	2,357	1,852
Other	2,929	2,967	2,884	2,924	2,966
Total revenue	**202,666**	**214,511**	**222,882**	**233,405**	**245,326**
Expenses					
Gross operating expenses					
Depreciation	1,892	2,140	2,252	2,341	2,361
Superannuation	2,487	2,363	2,409	2,434	2,479
Salaries and wages	11,922	12,617	12,828	13,164	13,668
Payment for supply of goods and services	45,246	48,395	50,538	52,858	54,020
Other operating expenses	2,814	2,584	2,618	2,770	2,917
Total gross operating expenses	*64,362*	*68,100*	*70,645*	*73,567*	*75,444*
Nominal superannuation interest expense	4,882	5,713	5,594	5,821	5,947
Other interest expenses	4,131	3,851	3,774	3,761	3,574
Other property expenses	0	0	0	0	0
Current transfers					
Grant expenses	37,203	40,559	40,742	42,293	42,892
Subsidy expenses	6,470	6,560	6,697	6,936	7,466
Personal benefit payments in cash	74,478	77,545	83,258	88,742	97,033
Other current transfers	0	0	0	0	0
Total current transfers	*118,151*	*124,664*	*130,697*	*137,972*	*147,390*
Capital transfers	3,486	3,754	4,097	4,279	4,213
Total expenses	**195,012**	**206,081**	**214,806**	**225,400**	**236,568**
Net operating balance	**7,655**	**8,430**	**8,076**	**8,005**	**8,758**
Net acquisition of non-financial assets					
Purchases of non-financial assets	2,487	2,920	2,392	2,429	2,104
less Sales of non-financial assets	364	285	174	250	188
less Depreciation	1,892	2,140	2,252	2,341	2,361
plus Change in inventories	374	340	473	273	270
plus Other movements in non-financial assets	47	185	178	-111	-89
Total net acquisition of non-financial assets	**652**	**1,020**	**617**	**1**	**-264**
Net lending/fiscal balance(a)	**7,003**	**7,410**	**7,458**	**8,003**	**9,022**

(a) The term fiscal balance is not used by the ABS.

Table B2: Australian Government general government sector balance sheet

	Estimates		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
	$m	$m	$m	$m	$m
Assets					
Financial assets					
Cash and deposits	927	288	459	210	143
Advances paid	19,314	20,536	22,001	23,921	26,059
Investments, loans and placements(a)	31,066	38,096	56,389	77,150	96,186
Other non-equity assets	17,147	17,856	19,477	21,336	23,410
Equity(b)	50,895	51,137	40,166	28,854	17,570
Total financial assets	*119,351*	*127,913*	*138,493*	*151,472*	*163,368*
Non-financial assets					
Land	4,863	5,161	5,119	5,027	4,973
Buildings	13,894	14,008	14,263	14,428	14,536
Plant, equipment and infrastructure	8,411	8,578	8,716	8,546	8,256
Inventories	5,299	5,570	5,989	6,228	6,463
Heritage and cultural assets	6,698	6,739	6,766	6,787	6,808
Other non-financial assets	2,085	2,341	2,207	2,006	1,762
Total non-financial assets	*41,250*	*42,397*	*43,060*	*43,022*	*42,798*
Total assets	**160,601**	**170,310**	**181,553**	**194,494**	**206,166**
Liabilities					
Deposits held	365	365	365	365	365
Advances received	0	0	0	0	0
Government securities(a)	61,452	59,284	59,106	60,932	60,633
Loans	5,595	5,164	5,190	5,212	4,912
Other borrowing	224	189	158	124	90
Superannuation liability	91,071	95,578	98,801	101,997	105,168
Other employee entitlements and provisions	7,605	7,812	7,918	8,080	8,266
Other non-equity liabilities	28,416	29,699	30,436	31,493	32,655
Total liabilities	**194,727**	**198,089**	**201,974**	**208,201**	**212,088**
Net worth(c)	**-34,126**	**-27,779**	**-20,421**	**-13,708**	**-5,922**
Net debt(d)	16,328	6,080	-14,031	-34,649	-56,389

(a) For 2005-06 and the forward years, the netting of assets — investments, loans and placements — and liabilities — government securities — has been removed so that both lines are now reported on a gross basis.

(b) Equity includes the valuation of the Telstra shareholding, which is valued at the average of the daily share price over a 90-day period, except in the sale years where the valuation is based on the expected sale price.

(c) Net worth is calculated as total assets minus total liabilities.

(d) Net debt equals the sum of deposits held, advances received, government securities, loans and other borrowing, minus the sum of cash and deposits, advances paid and investments, loans and placements.

Table B3: Australian Government general government sector cash flow statement[(a)]

	Estimates		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
	$m	$m	$m	$m	$m
Cash receipts from operating activities					
Taxes received	186,205	197,829	204,975	214,781	225,895
Receipts from sales of goods and services	5,015	5,165	5,385	5,526	5,565
Grants and subsidies received	0	0	0	0	0
Interest receipts	1,460	1,828	2,649	3,783	4,789
Dividends	3,808	3,632	2,952	2,357	1,852
GST input credits received by general government	2,908	2,844	2,882	2,976	3,018
Other receipts	2,849	2,926	2,875	2,851	2,938
Total operating receipts	**202,246**	**214,224**	**221,717**	**232,275**	**244,057**
Cash payments for operating activities					
Payments for goods and services	-48,518	-51,455	-53,809	-56,082	-57,310
Grants and subsidies paid	-45,200	-49,195	-50,285	-52,167	-52,753
Interest paid	-3,856	-4,587	-3,808	-3,534	-3,450
Personal benefit payments	-73,664	-76,487	-82,415	-88,071	-96,604
Salaries, wages and other entitlements	-16,508	-17,102	-17,371	-18,002	-18,693
GST payments by general government to taxation authority	-120	-120	-122	-123	-124
Other payments for operating activities	-2,988	-3,079	-2,635	-2,730	-2,958
Total operating payments	**-190,855**	**-202,026**	**-210,443**	**-220,710**	**-231,892**
Net cash flows from operating activities	**11,391**	**12,198**	**11,273**	**11,565**	**12,165**
Cash flows from investments in non-financial assets					
Sales of non-financial assets	416	291	175	250	188
Purchases of non-financial assets	-2,579	-3,102	-2,549	-2,313	-2,011
Net cash flows from investments in non-financial assets	**-2,163**	**-2,812**	**-2,374**	**-2,063**	**-1,823**
Net cash flows from investments in financial assets for policy purposes	**-1,317**	**-1,518**	**9,286**	**9,054**	**9,022**
Cash flows from investments in financial assets for liquidity purposes					
Increase in investments	-7,456	-7,217	-18,306	-20,751	-19,023
Net cash flows from investments in financial assets for liquidity purposes	**-7,456**	**-7,217**	**-18,306**	**-20,751**	**-19,023**
Cash flows from financing activities					
Advances received (net)	0	0	0	0	0
Borrowing (net)	188	-1,579	-30	1,928	-481
Deposits received (net)	0	0	0	0	0
Other financing (net)	-1,306	288	322	18	72
Net cash flows from financing activities	**-1,118**	**-1,291**	**291**	**1,946**	**-408**
Net increase/decrease in cash held	**-663**	**-639**	**171**	**-249**	**-67**
Net cash from operating activities and investments in non-financial assets	**9,227**	**9,387**	**8,899**	**9,502**	**10,342**
Finance leases and similar arrangements(b)	-7	-4	-23	-5	-4
GFS cash surplus(+)/deficit(-)	9,221	9,383	8,876	9,497	10,338
less Future Fund earnings	0	462	943	997	1,054
Equals underlying cash balance	**9,221**	**8,921**	**7,933**	**8,500**	**9,284**
plus net cash flows from investments in financial assets for policy purposes	-1,317	-1,518	9,286	9,054	9,022
plus Future Fund earnings	0	462	943	997	1,054
Equals headline cash balance	**7,904**	**7,865**	**18,163**	**18,550**	**19,360**

(a) A positive number denotes a cash inflow; a negative sign denotes a cash outflow.
(b) The acquisition of assets under finance leases decreases the underlying cash balance. The disposal of assets previously held under finance leases increases the underlying cash balance.

Table B4: Australian Government general government sector statement of other economic flows (reconciliation of net worth)

	Estimates		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
	$m	$m	$m	$m	$m
Opening net worth	**-37,803**	**-34,126**	**-27,779**	**-20,421**	**-13,708**
Opening net worth adjustments(a)	-1,741	0	0	0	0
Adjusted opening net worth	**-39,544**	**-34,126**	**-27,779**	**-20,421**	**-13,708**
Change in net worth from operating transactions	**7,655**	**8,430**	**8,076**	**8,005**	**8,758**
Change in net worth from other economic flows					
Revaluation of equity(b)	1,301	261	322	-19	4
Net writedowns of assets (including bad and doubtful debts)	-2,226	-1,447	-1,650	-1,693	-1,306
Assets recognised for the first time	23	94	80	58	58
Liabilities recognised for the first time	0	0	0	0	0
Actuarial revaluations	-937	0	0	0	0
Net foreign exchange gains	-384	0	0	0	0
Net swap interest received	180	102	96	77	70
Market valuation of debt	-195	371	303	257	148
Other economic revaluations(c)	2	-1,463	131	29	53
Total other economic flows	**-2,236**	**-2,083**	**-717**	**-1,291**	**-973**
Closing net worth	**-34,126**	**-27,779**	**-20,421**	**-13,708**	**-5,922**

(a) Decrease in net worth arising from a change in recognition of family tax benefits and other expenses from a cash to an accrual basis.

(b) Revaluations of equity reflect changes in the market valuation of commercial entities, including a change in the value of the Telstra shareholding which is valued at the average daily share price over a 90-day period, except in the sale years where the valuation is based on the expected sale price. This line also reflects any equity revaluations at the point of disposal or sale.

(c) Largely reflects revaluation of assets and liabilities and Australian Equivalents to International Financial Reporting Standards adjustments.

APPENDIX C: SENSITIVITY OF EXPENSES AND REVENUE TO ECONOMIC DEVELOPMENTS

A guide to the sensitivity of the forward estimates of expenses and revenue due to variations in economic parameters in 2005-06 is provided in Table C1. It is important to note that the sensitivity analysis gives only a 'rule of thumb' indication of the impact on the budget of changes in prices, wages and other parameters. In each case, the analysis presents the estimated effects of a change in one economic variable only and does not attempt to capture the linkages between economic variables that characterise changes in the economy more broadly.

Table C1: Sensitivity of expenses and revenue to changes in economic parameters

	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m
Expenses				
Prices	1,310	860	900	920
Wages	120	410	450	470
Unemployment benefit recipients	250	250	260	270
Safety Net Adjustment	40	150	240	340
Revenue				
Prices	50	110	110	110
Wages	1,570	1,690	1,800	1,930
Employment	1,080	1,150	1,240	1,320
Private final demand	280	290	300	300
Profit	340	560	610	650

EXPENSES

On the expenses side, the sensitivity analysis of the estimates provides for the following assumptions about changes to four broad groups of parameters. An increase in any of the parameters considered will lead to an increase in expenses and a decrease in any of the parameters will lead to a reduction in expenses.

Prices

All price growth rates are assumed to change by one percentage point in the September quarter 2005 and to remain unchanged subsequently, with wage and salary growth rates left unchanged through the Budget and forward years.

- The effect of a change in prices is due to the indexation of Australian Government expenses and a large one-off impact on superannuation liabilities in 2005-06, which in turn impacts on the superannuation interest expense.

Wages

All wage and salary growth rates are assumed to change by one percentage point in the September quarter 2005 and to remain unchanged subsequently, with all price growth rates left unchanged through the Budget and forward years.

- The effect of a change in wage and salary growth rates is largely due to the Government's commitment to maintain selected pensions at a minimum of 25 per cent of Male Total Average Weekly Earnings. The wages effect in Table C1 above does not include changes to wage and salary payments in Australian Government departmental expenses.

Unemployment Benefit recipients (includes Newstart Allowance and Unemployed Youth Allowance recipients)

The total number of recipients is assumed to change by 5 per cent in the Budget year and the following years.

Safety Net Adjustment

The Safety Net Adjustment determined by the Australian Industrial Relations Commission is assumed to change by $2 per week in 2005-06 and the following years.

- About $50 billion of expenses in 2005-06, comprising agency departmental expenses, other Australian Government Own Purpose Expenses and Specific Purpose Payments to the states of a departmental expense nature, are indexed to weighted averages of movements in the Consumer Price Index and the Safety Net Adjustment.

REVENUE

On the revenue side, the sensitivity analysis of the estimates provides for the following assumptions about changes to five broad groups of parameters. An increase in any of the parameters considered will lead to an increase in revenue and a decrease in any of the parameters will lead to a reduction in revenue.

Prices

All price deflators are assumed to change by one percentage point at the start of the September quarter 2005, with wage deflators left unchanged.

- A change in prices affects revenue primarily through changes in other excise.

Wages

All wage and salary growth rates are assumed to change by one percentage point from the beginning of the September quarter 2005, with price deflators left unchanged.

- A change in wage and salary growth rates affects revenue through changes in gross income tax withholding and fringe benefits tax.

Employment

The level of employment is assumed to change by one percentage point from the beginning of the September quarter 2005, with no change in the composition of employment.

- A change in employment affects revenue through increases in gross income tax withholding.

Private final demand

The level of private final demand (consumption plus investment) is assumed to change by one percentage point from the beginning of the September quarter 2005, with no change in the composition of demand.

- A change in private final demand affects revenue primarily through changes in excise and customs duty collections.

Profits

The level of company profits is assumed to change by one percentage point from the beginning of the September quarter 2005.

- A change in the level of company profits affects revenue through changes in company tax collections.

STATEMENT 3: ECONOMIC OUTLOOK

This statement presents the economic forecasts that underlie the budget estimates.

STATEMENT 3: ECONOMIC OUTLOOK

The Australian economy is expected to record solid growth in real GDP in 2005-06 after passing through a soft patch in 2004-05. Strong world demand for commodities will benefit Australia through increasing export volumes and higher terms of trade, both of which will support strong growth in national income. Gross national expenditure is forecast to grow at more moderate rates in 2004-05 and 2005-06 after a period of exceptionally strong growth in recent years. Employment growth is forecast to ease towards trend in 2005-06, while inflation is expected to remain moderate.

OVERVIEW

The rebalancing of **economic growth** in Australia from domestic to external sources that was foreshadowed in the 2004-05 Budget is occurring slowly. Real GDP growth is forecast to be 2 per cent in 2004-05, lower than the forecast presented in the *Mid-Year Economic and Fiscal Outlook 2004-05* (MYEFO). Dwelling investment and consumption growth slowed in the second half of 2004, after having experienced rapid growth in recent years. Export growth has also been slower than expected given the strength of world economic conditions. This largely reflects a continued high exchange rate, and the long lead times required to increase production in the mining sector and to expand export capacity. Despite slow growth in export volumes, high commodity prices provided a substantial boost to domestic income in 2004-05.

In 2005-06, the rebalancing of growth from domestic to external sources is expected to continue, with economic growth forecast to strengthen to 3 per cent. Gross national expenditure is expected to grow solidly, albeit slower than the very high average rate seen since 2001-02. Growth in household consumption and dwelling investment is expected to moderate, while business investment and public demand are forecast to grow at around trend rates.

Exports are expected to be an important contributor to growth in 2005-06. The mining sector invested around A$20 billion over 2003 and 2004 to boost capacity, which should be reflected in significant growth in non-rural commodity exports over the coming year. Rural exports are forecast to grow modestly in 2005-06, with growth restrained by a smaller grain harvest. Solid growth is expected in other categories of exports, supported by a strong world economy, but still affected by the high exchange rate.

The current account deficit (CAD) is forecast to narrow in 2005-06. The combination of increased export volumes and prices should lead to a markedly smaller trade deficit. The reduction in the CAD will be somewhat smaller than the reduction in the trade deficit because part of the additional income from higher commodity prices will accrue to foreigners. Payment of additional income abroad will increase Australia's net income deficit.

Employment growth is forecast to ease towards trend in 2005-06, following the period of slower GDP growth in 2004. Unemployment is expected to remain around its current rate through 2005-06. Wage growth is forecast to remain moderate although, with the unemployment rate at a 28-year low, some localised wage pressures have begun to appear in particular industries and geographic areas. Inflation is expected to remain moderate in 2005-06.

The **world economy** is forecast to remain strong over the next two years. World economic growth is forecast to be 4¼ per cent in 2005 and 4 per cent in 2006. This is a little below the very brisk growth rate of 5.1 per cent in 2004. High oil prices and the effects of tighter macroeconomic policies, particularly in the United States and China, are contributing to the modest slowing. World inflationary pressures are expected to remain contained. There is little evidence yet that higher commodity prices are leading to significant second-round price increases in the major industrialised countries.

In the domestic economy, **household consumption** growth is expected to moderate to 3¼ per cent in 2005-06, supporting a modest rebuilding of household saving. A substantial slowdown in the accumulation of housing wealth, following several years of very strong growth, and the recent increase in official interest rates will restrain consumption. High petrol prices are also expected to continue to retard consumption growth. Partly offsetting these factors, consumption will be supported by the effects of past increases in non-housing wealth, particularly share prices, and continued solid growth in household incomes. Household incomes will benefit from continued employment growth and income tax cuts, although some portion of the tax cuts is likely to be saved.

Dwelling investment fell in the second half of 2004 after growing by almost 50 per cent in the three years to 2003-04. Dwelling investment is expected to fall by 2 per cent in 2005-06 as the recent increase in official interest rates and falls in house prices combine to dampen activity, particularly in the investor sector. However, the current housing downturn is expected to be muted compared with past cycles, with dwelling investment supported by a strong labour market and solid underlying demand for new dwellings.

Business investment is expected to again grow solidly in 2005-06. The growth in business investment in recent years has been broadly based, with the mining sector a particularly important contributor. The investment environment remains favourable, with high capacity utilisation, a relatively low cost of capital and very strong corporate balance sheets.

Public final demand should grow at a solid rate of 3¾ per cent in 2005-06, with strong growth in public investment and slowing growth in public consumption.

Australia's **net export** position is expected to strengthen in 2005-06, reflecting a rebalancing of growth from domestic to external sources. Exports are forecast to grow by 7 per cent in 2005-06, after a period of sluggish growth since 2001-02. Modest

growth in exports through this period has reflected the various economic shocks buffeting the Australian economy, a slow investment response to rising terms of trade and the high exchange rate since late 2003. Growth in **imports** is expected to ease to 8 per cent in 2005-06, in line with moderating growth in gross national expenditure.

The increase in world demand for raw materials, and limited world supply response, has resulted in markedly higher commodity prices (see Box 1). As a result, Australia's **terms of trade** are forecast to increase by 12¼ per cent in 2005-06, building on the 9¾ per cent increase expected for 2004-05. With an increase in the terms of trade and stronger export growth, the **current account deficit** is expected to narrow to 5¼ per cent of GDP in 2005-06.

Higher export prices are likely to result in very strong **nominal GDP** growth. Nominal GDP is forecast to grow by 7½ per cent in 2005-06. Corporate profits are likely to increase significantly in 2005-06 as mining companies benefit from higher export prices.

Employment growth is expected to moderate to 1¾ per cent in 2005-06, in line with recent slower GDP growth. The unemployment rate fell to 5.1 per cent in December 2004, the lowest rate in close to three decades. The unemployment rate is forecast to remain around 5 per cent, on average, over 2005-06. Rates of workforce participation are expected to remain broadly unchanged, albeit at high levels.

Inflation is expected to remain within the target band, with the Consumer Price Index forecast to increase by 2¾ per cent in 2005-06 as petrol prices remain high in the near term. This pressure is expected to moderate through 2005-06, with inflation forecast to be 2½ per cent through the year to the June quarter 2006. The cyclical slowing in labour productivity in 2004-05 is expected to have only a modest flow-through to consumer prices. There is no evidence that higher oil and other commodity prices are leading to significant second-round increases in consumer prices, although this remains a risk.

Wage growth is expected to increase modestly in 2005-06, with the Wage Price Index forecast to grow by 4 per cent. With the unemployment rate at a 28-year low, some localised wage pressures have appeared in particular regions and occupations. However, relative wage adjustment is an important signalling mechanism in a high employment economy and there is little evidence of generalised wage pressures or skill shortages. This is likely to remain the case as the economy passes through a period of more moderate employment growth.

A key **risk** to the economic outlook is the effect of the significant rise in Australia's export prices, which is forecast to take the terms of trade to their highest level since the early 1950s. The way in which mining companies respond to this additional income — by investing it, saving it or returning it to shareholders — will be important for the outlook.

Higher export prices are expected to have only a limited effect on household finances, primarily through equity holdings in mining companies. It is unlikely that higher export prices will result in significant growth in wages outside the mining sector itself, or have a major impact on aggregate employment growth across the economy. However, if these effects are greater than anticipated, then it is possible that resulting higher household incomes would lead to higher household consumption than currently forecast.

Higher export prices are not expected to result in a significant increase in investment by mining companies in 2005-06 over that which has already been announced. While it is possible that companies might invest more quickly than anticipated in response to high commodity prices, this upside risk is offset somewhat by the likelihood that commodity prices will fall beyond the present forecast period. As a substantial increase in supply is forthcoming from more recent investment in many countries, it is likely that commodity prices will retrace significantly in the medium term. This raises some issues for the projections of nominal GDP in 2006-07 and beyond. These issues are discussed in more detail in Box 7.

High commodity prices, particularly high oil prices, also present a downside risk for economic growth. Oil prices directly affect petrol prices and indirectly affect the prices of many other goods and services. High prices for iron ore affect steel prices and the cost of engineering and building construction. If oil prices increase further, this would present a downside risk to the forecasts for GDP growth in the near term. In the medium term, Australia would benefit from higher commodity prices as a net energy and mineral exporter and this would most likely boost economic growth.

Previous budget discussions of the economic outlook have identified a risk to consumption growth from the increasing level of household debt. In aggregate, there is no evidence that households are having difficulties servicing their current debt and, with consumption and dwelling investment both expected to slow, it is likely that households will take on debt at a slower rate through 2005-06. Nevertheless, there remains a possibility that households will seek to rebuild their saving to a greater extent than anticipated, leading to lower consumption growth than forecast.

While the risks around developments in the housing sector appear to have abated somewhat since the 2004-05 Budget, there remain concerns in particular market segments. Overall, it appears that house prices fell modestly over 2004. The likely outcome is that house prices will remain broadly flat in 2005-06 as the housing market continues to adjust to lower rates of turnover. While this adjustment is expected to be orderly, if house prices were to fall further then this would put downward pressure on consumption growth.

With the unemployment rate at its lowest level in a generation, there is a risk that the tight labour market could lead to wage increases across the economy that are greater than is justified by productivity growth. This would put upward pressure on unit

labour costs and inflation. Measures to increase workforce participation outlined in this Budget should help to reduce this risk over the medium term.

As is normal practice, the forecasts for the rural sector are predicated on an assumption that average seasonal conditions will prevail in 2005-06. The actual timing and distribution of rainfall through 2005 will have an important influence on rural production and exports in 2005-06, as will the lingering effects of dry weather in recent years.

The near-term risks for the world economic outlook appear to be balanced. But some medium-term downside risks remain, largely centred on different growth profiles across major economies, and associated fiscal and current account imbalances. While these imbalances may persist for some time without significant adverse consequences, they increase the vulnerability of the world economy to destabilising changes in financing flows.

Table 1: Domestic economy forecasts[(a)]

	Outcomes(b)	Estimates	Forecasts	
	2003-04 year average	2004-05 year average	2005-06 year average	Four quarters to June 2006
Panel A - Demand and output(c)				
Household consumption	5.6	4	3 1/4	3 1/2
Private investment				
Dwellings	7.3	-2	-2	1
Total business investment(d)	9.4	8	6	6
Non-dwelling construction(d)	12.5	2	2	2
Machinery and equipment(d)	7.8	11	7	7
Private final demand(d)	6.2	3 3/4	3 1/2	3 3/4
Public final demand(d)	3.8	6	3 3/4	1 1/4
Total final demand	5.7	4 1/4	3 1/2	3 1/4
Change in inventories(e)				
Private non-farm	0.0	- 1/4	1/4	1/4
Farm and public authorities(f)	0.6	- 1/4	0	0
Gross national expenditure	6.2	3 1/2	3 3/4	3 1/2
Exports of goods and services	1.6	2	7	7
Imports of goods and services	12.4	10	8	8
Net exports(e)	-2.4	-2	-1	- 3/4
Gross domestic product	4.1	2	3	3 1/4
Non-farm product	3.3	2 1/4	3	2 3/4
Farm product	35.8	-8	5	17
Panel B - Other selected economic measures				
External accounts				
Terms of trade	7.0	9 3/4	12 1/4	6
Current account balance				
$billion	-47.4	-56 1/4	-48	
Percentage of GDP	-5.8	-6 1/2	-5 1/4	
Labour market				
Employment (labour force survey basis)	1.8	2 3/4	1 3/4	1 1/2
Unemployment rate (per cent)(g)	5.8	5 1/4	5	5
Participation rate (per cent)(g)	63.5	63 3/4	63 3/4	63 3/4
Prices and wages				
Consumer Price Index	2.4	2 1/2	2 3/4	2 1/2
Gross non-farm product deflator	3.6	4	4 1/2	3 1/2
Wage Price Index	3.6	3 3/4	4	4

(a) Percentage change on previous year unless otherwise indicated.
(b) Calculated using original data.
(c) Chain volume measures.
(d) Excluding transfers of second-hand assets from the public sector to the private sector.
(e) Percentage point contribution to growth in GDP.
(f) For presentational purposes, inventories held by privatised marketing authorities are included with the inventories of the farm sector and public marketing authorities.
(g) The estimate in the final column is the forecast rate in the June quarter 2006.
Source: Australian Bureau of Statistics (ABS) Cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

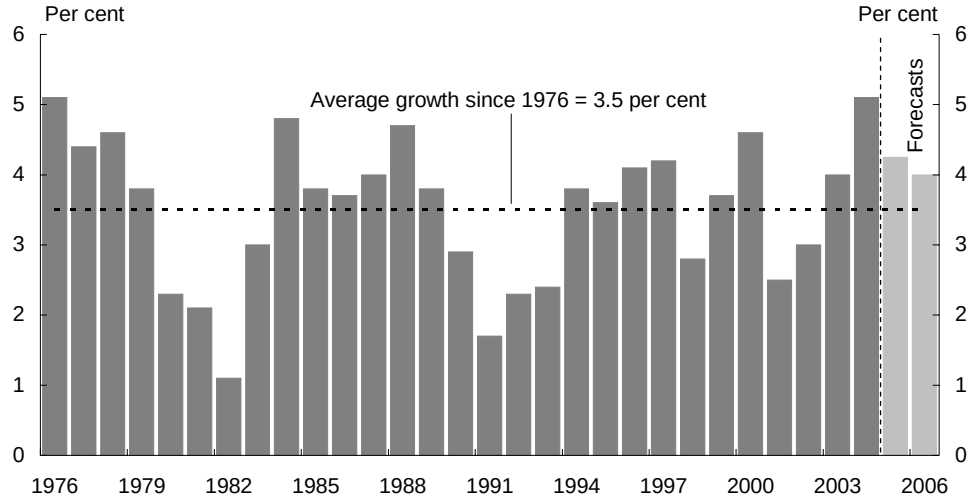
THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The world economy grew by 5.1 per cent in 2004, its fastest rate in close to 30 years and around ½ of a percentage point higher than expected at MYEFO. Strong growth was recorded across most regions, with emerging markets, in particular, benefiting from low world interest rates combined with strong demand and high prices for their commodity exports.

After peaking in the early part of 2004, world growth eased over the remainder of the year and into 2005 as the effects of high oil prices and tighter policy, particularly in the United States and China, took hold. However, with conditions in the world economy expected to remain favourable, growth is expected to stabilise at the still-solid rates recorded in the latter part of 2004, although the pattern of growth across countries is likely to be more unbalanced than previously anticipated.

World GDP growth is forecast to ease to 4¼ per cent in 2005 and 4 per cent in 2006 (see Chart 1). Growth in Australia's major trading partners is expected to ease from 4.9 per cent in 2004 to around trend rates of 3¾ per cent in 2005 and 2006.

Chart 1: World GDP growth[(a)]



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity.
Source: International Monetary Fund and Treasury.

World inflationary pressures are expected to remain muted. To date there has been little evidence of significant second-round effects from higher oil and other commodity prices in the major industrialised economies. In part, this reflects competitive product and labour markets and the success of macroeconomic policy in establishing well-anchored inflation expectations.

Risks to the outlook appear broadly balanced in the near term, although the persistence of global imbalances — reflected in current account positions — has increased the underlying vulnerability of the world economy over the medium term.

A downside risk to world growth stems from the increasingly unbalanced nature of the current expansion. The easing of world growth in the second half of 2004 was particularly evident in Japan and the euro area, while other major regions continued to grow strongly. This heightens the world economy's exposure to developments in a few key economies, particularly the United States and China.

Unbalanced growth, if sustained, is likely to exacerbate already large current account imbalances around the world, increasing the risk of a disorderly adjustment in financial markets. The US current account deficit was a record US$666 billion in 2004, equivalent to two-thirds of the aggregate current account surpluses in the rest of the world. These imbalances are attributable to a number of factors, including insufficient saving in the United States (particularly by the public sector), disappointing growth in Japan and the euro area (reducing their attractiveness relative to the United States as a destination for global capital), and a degree of under-investment in some East Asian countries (resulting in large and continuing current account surpluses in that region).

A gradual and orderly unwinding of these imbalances remains the most likely path of adjustment in the medium term. This would require a combination of fiscal consolidation in the United States, further US dollar depreciation and an improvement in the growth performance of Japan and the euro area. The depreciation of the dollar to date has been relatively steady and the normalisation of interest rates in the United States should also provide impetus for increased private saving, particularly if house price growth slows.

While the policy prescriptions required to rebalance the world economy are understood, little progress has been made in implementing them, suggesting that imbalances will continue to deepen in the near term. The longer policy action is deferred, the more exposed the United States and the world economy will be to a sudden change in sentiment regarding the relative risk and reward from holding US dollar assets. Such a change in investor sentiment could result in an abrupt and disruptive adjustment to exchange rates and interest rates.

Of more immediate concern are continued high and volatile oil prices. While the benchmark West Texas Intermediate price has moderated from the record nominal high of over US$57 per barrel in early April, it remains high by historical standards. To date, high oil prices have had a limited impact on world economic growth and core inflation. However, with oil prices expected to remain high in the medium to longer term, there remains the possibility that they will feed into inflation expectations more than currently expected. This risk is greater given that excess capacity in some major economies, including the United States, has been largely unwound over 2004. A sharp increase in inflation expectations could be particularly damaging for world growth

given the unusually low level of US long-term interest rates and historically low risk premia on corporate and emerging market debt.

On the upside, world growth over the past few years has consistently been stronger than anticipated. The factors that have underpinned this — accommodative monetary policy, healthy corporate balance sheets and benign financial market conditions — remain in place. As a result, the current economic expansion could prove more resilient than currently envisaged.

Table 2: International GDP growth forecasts[(a)]

	2003	2004	2005	2006
	Actual	Estimate	Forecast	Forecast
United States	3.0	4.4	3 1/2	3 1/2
Euro area[(b)]	0.5	1.8	1 1/2	2
Japan	1.4	2.6	1 1/4	2
China	9.3	9.5	8 1/2	8
Other East Asia[(c)]	3.6	6.1	4 3/4	5
Major trading partners	3.4	4.9	3 3/4	3 3/4
OECD	2.2	3.4	2 3/4	2 3/4
World	4.0	5.1	4 1/4	4

(a) World, OECD and euro area growth rates are calculated using GDP weights based on purchasing power parity. Calculations for major trading partners and other East Asia use export trade weights.
(b) 2004 estimate adjusted for the number of working days.
(c) Other East Asia consists of Korea, Singapore, Taiwan, Hong Kong, Indonesia, Malaysia, Thailand, and the Philippines.
Source: Various national statistical authorities, International Monetary Fund and Treasury.

Economic growth in the **United States** evolved largely as expected through 2004. Growth remained solid, but moderated as excess capacity in the economy narrowed and policy settings moved toward more neutral levels. Concerns about the labour market, which had been slow to recover from the 2001 recession, abated somewhat, with solid, albeit intermittent, gains in employment.

Domestic demand in the United States is expected to rebalance progressively away from household consumption toward business investment in 2005. The business sector, which has rebuilt its financial position in recent years, is expected to continue to invest strongly in 2005 and 2006. Conversely, households, which have spent well ahead of growth in income, driving the household saving rate to record lows, are expected to consolidate their finances. While household income will be supported by the ongoing recovery in the labour market, the high level of household debt makes consumption sensitive to increases in interest rates and fluctuations in income. A risk remains that US households may move abruptly to consolidate their financial position, particularly if financial market conditions tighten sharply.

Inflationary pressures in the United States are expected to remain in check over the forecast period, with inflation expectations well-anchored and the monetary tightening cycle now well underway. However, with the labour market expected to tighten

further, productivity growth slowing from cyclical peaks, and higher oil and other commodity prices, growth in unit labour costs could be stronger than expected.

After growing strongly toward the end of 2003 and in the early part of 2004, **Japan's** economy contracted in the middle of 2004 and posted only moderate growth in the December quarter. However, there are concerns about the quality of national accounts data, which have been subject to frequent and large revisions. Partial data indicate a more moderate easing in growth over the course of 2004.

Fundamentals in the Japanese economy have improved significantly in recent years, suggesting a continuation of growth in the period ahead. Structural reforms have improved business sentiment and corporate profits and the unemployment rate has fallen to near six-year lows. Deflation, which has weighed on consumer and business confidence in recent years, eased in 2004 and is expected by the Bank of Japan to end in early 2006.

China's economy grew at its fastest rate in almost a decade in 2004, contributing strongly to world growth and demand for commodities (see Box 1). However, concerns remain about the sustainability of the expansion, and the efficiency of the investment underpinning it. Authorities continued to use a combination of market instruments and administrative controls to tighten monetary conditions over the course of 2004 and there are signs that these measures are having an effect. While investment remains unsustainably high as a share of GDP, it has moderated somewhat. Growth in other key indicators, including industrial production, money supply and credit, eased in 2004. These data suggest that economic growth will slow to a more sustainable rate of around 8 per cent, although there remains considerable uncertainty about the timing and extent of the slowing.

The strength of the Chinese economy has led to external calls for greater flexibility in its exchange rate, particularly from the United States. However, a more flexible Chinese exchange rate is likely to have only a limited impact on global imbalances. Broader liberalisation of the capital account should be approached cautiously and coincide with a further strengthening in the Chinese financial system. These reforms, if complemented by ongoing structural reforms elsewhere in the economy, would provide a sound footing for balanced growth in the long term.

The **rest of East Asia** also grew strongly in 2004, underpinned by strong external and domestic demand. However, growth appears to have peaked, with regional economies (except Indonesia) expected to grow at a slower pace in 2005 and 2006. This reflects easing export growth due to more moderate world demand and a slowing in the global information and communication technology cycle. That said, the outlook for domestic demand remains positive, and should support still-solid growth in the region. The notable exception is Korea, where domestic demand remains weak following the bursting of the household credit bubble in 2003, although more recently, there have been signs of a pick-up in consumer and business confidence.

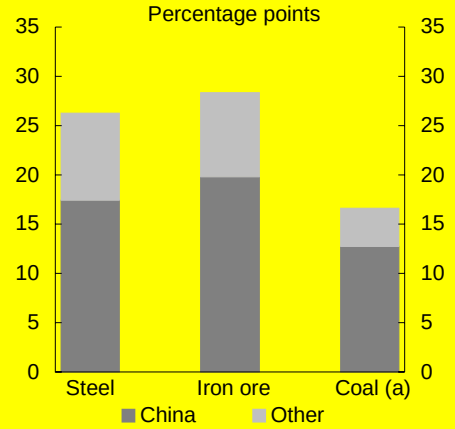
Box 1: World demand and commodity prices

The world economy grew rapidly in 2004. The composition of growth was weighted heavily towards the United States and China. Together these two countries contributed 2.2 percentage points to world growth of 5.1 per cent in 2004.

The United States and China are major commodity users. Their strong output growth saw a significant increase in demand for commodities such as oil, iron ore and coal.

In particular, China's emergence as a major commodity importer has had a significant impact. For example, over the period 2001 to 2004, China was responsible for 70 per cent of the world increase in iron ore consumption (Chart A).

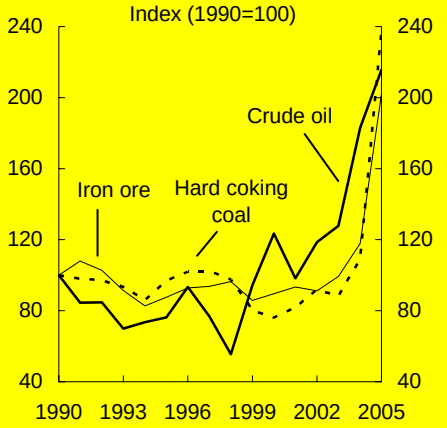
Chart A: Growth in world commodity consumption, 2001 to 2004



(a) Coal consumption growth from 2001 to 2003.
Source: AME Mineral Economics and BP Statistical Review of World Energy.

The rapid rise in commodity prices (Chart B) has generated significant benefits for commodity exporters like Australia, Canada, the Middle East, Russia and South Africa.

Chart B: Commodity prices (US$)[(a)]



(a) Year from April to March.
Source: ABARE, Thomson Financial and Treasury.

Investment in exploration and production has increased in response to the sustained commodity price rise. As a consequence, despite continued strong demand, commodity prices are likely to ease somewhat as additional world production comes on stream. However, if world demand were to falter, there is a risk that commodity prices could fall further than anticipated.

Growth in the **euro area** slowed sharply in the second half of 2004, with the combination of euro appreciation and high oil prices undermining the modest recovery that had taken place since the middle of 2003. Looking forward, growth is forecast to pick-up from recent levels, albeit at a more moderate pace than previously expected. The favourable world economic outlook will continue to underpin exports, despite the appreciation of the euro. Solid corporate profitability should see an improvement in the labour market, supporting a rebound in consumer spending.

The risks to this outlook, however, are skewed to the downside and reflect long-standing structural weaknesses. While some progress has been made on pension, health care and labour market reform in Germany and France, and on pension reform in Italy, more needs to be done. Reforms to lift labour force participation and productivity are particularly important in the face of rapidly ageing populations.

The **United Kingdom** economy grew strongly over the course of 2004, although recent data suggest that monetary policy tightening during that year is beginning to have an effect. The outlook is for growth to remain steady at recent, more moderate, rates.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

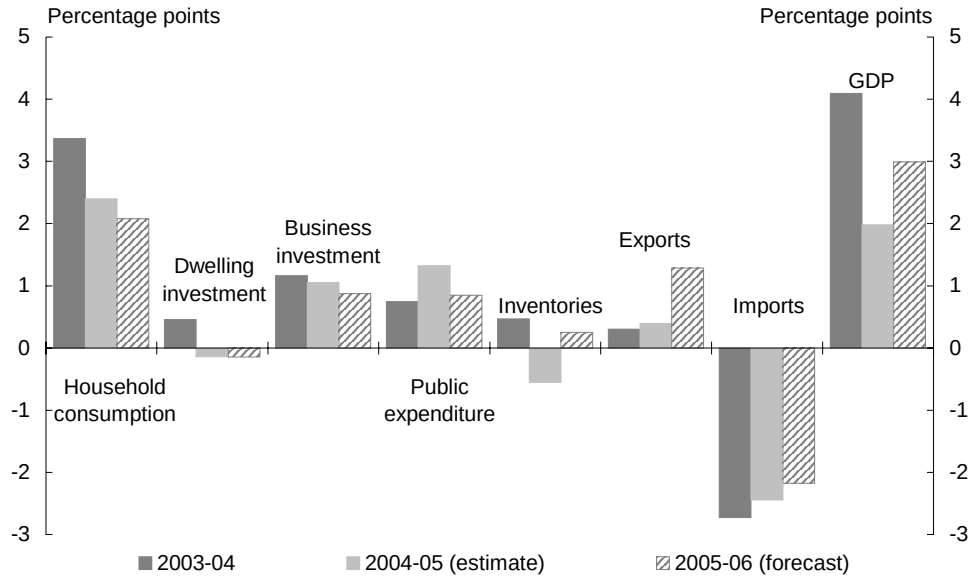
Key assumptions

The forecasts for the domestic economy are underpinned by several key technical assumptions. The exchange rate is assumed to remain around the average level of recent months (a trade weighted index of around 64). Interest rates are assumed to remain at current levels. World oil prices (West Texas Intermediate) are assumed to remain broadly unchanged through 2005-06, consistent with market expectations. The farm sector forecasts are based on an assumption of average seasonal conditions in 2005-06.

Demand and output

The rebalancing of growth from domestic to external sources that was foreshadowed in the 2004-05 Budget is occurring slowly and remains the most likely path for the economy in the period ahead. In the second half of 2004, gross national expenditure growth slowed, but export growth failed to pick up significantly, leading to a slowing in GDP growth from the very strong rates of recent years. GDP growth is expected to be 2 per cent in 2004-05 (see Chart 2). In contrast with moderate GDP growth, national income is expected to grow strongly, reflecting increased export prices.

Chart 2: Contributions to GDP growth[(a)(b)]



(a) Excluding transfers of second-hand assets from the public sector to the private sector.
(b) All charts in the domestic economy outlook section use seasonally adjusted data unless otherwise specified.
Source: ABS Cat. No. 5206.0 and Treasury.

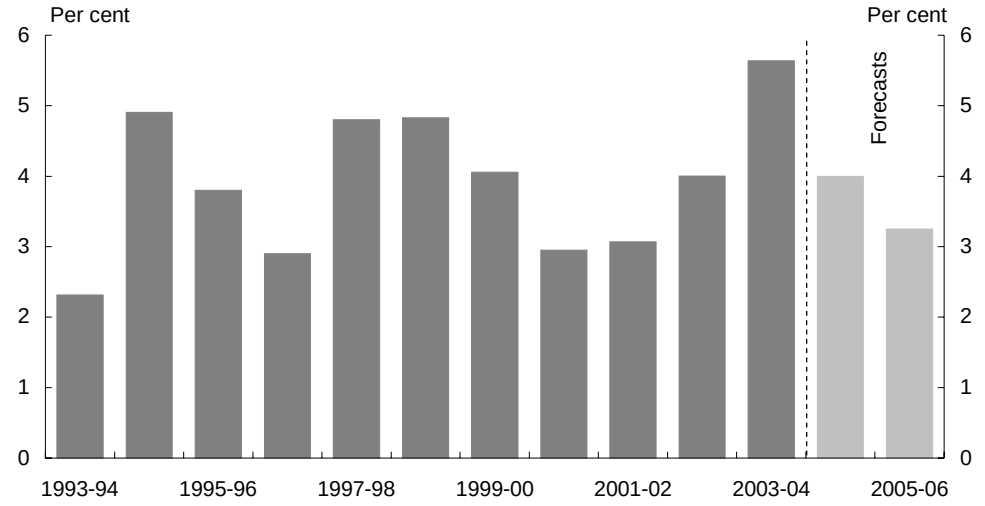
GDP growth is forecast to strengthen to 3 per cent in 2005-06. Household consumption is expected to make a smaller contribution to growth, while dwelling investment is again expected to detract from growth after the high level of construction activity in recent years. The contribution to growth from business investment is expected to remain solid. Public expenditure will contribute solidly across the forecast period. Imports are expected to detract less from growth, broadly in line with the developments in the domestic economy. Exports are forecast to make a larger contribution to growth in 2005-06, particularly as additional capacity comes on stream in the resources sector.

Non-farm GDP is forecast to grow by 2¼ per cent in 2004-05, strengthening to 3 per cent in 2005-06. Farm GDP is expected to fall by 8 per cent in 2004-05, largely reflecting generally dry conditions and the late arrival of spring rains in some areas, before increasing by 5 per cent in 2005-06 on the assumption of average seasonal conditions.

Household consumption

Household consumption is forecast to grow by 3¼ per cent in 2005-06, down from the 4 per cent growth expected for 2004-05 and below the rapid rates of growth recorded in recent years (see Chart 3).

Chart 3: Growth in consumption



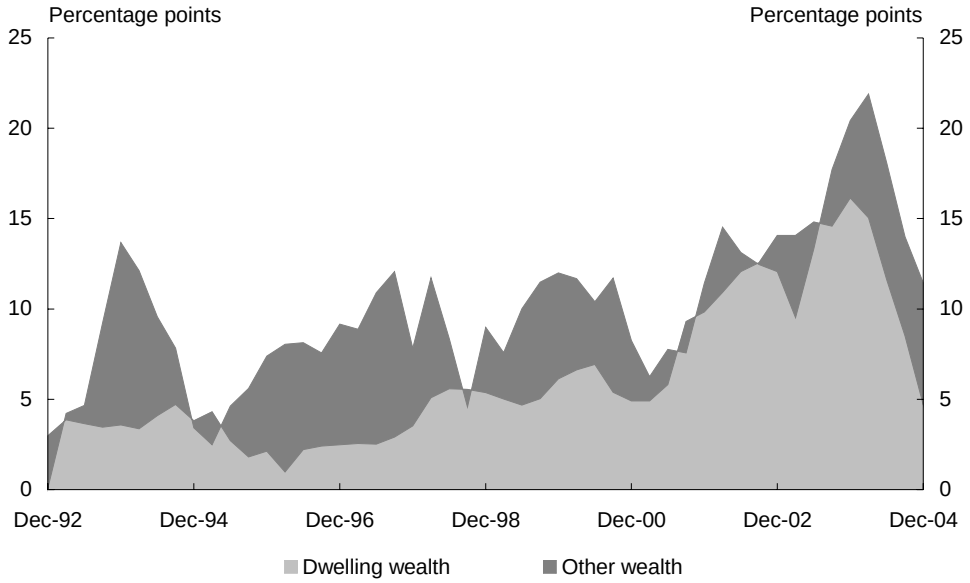
Source: ABS Cat. No. 5206.0 and Treasury.

Household income has grown steadily over the past decade, supported by increases in employment and real wages. However, the growth in income over the past decade has been insufficient to explain all of the increase in consumption. The other major contributing factor has been an increase in household wealth. Through the 1990s, higher wealth generally took the form of higher equity prices, although higher house

prices have been the more important factor in recent years (see Chart 4). These increases in wealth have seen consumption grow by more than income on average and, as a result, the household saving ratio has fallen. Australia's changing demographic profile, and the lower demand for precautionary savings in a stable and prosperous economic environment, may also have affected saving behaviour in the past decade (see Box 4).

Households are expected to increase their consumption by less than the increase in their income over 2004-05 and 2005-06. Accordingly, the rate of household saving is expected to increase, albeit by a modest amount. Recent data provide evidence that a rebuilding of household saving may have already commenced. Household nominal net disposable income increased by 6.9 per cent through the year to the December quarter 2004, while nominal consumption expenditure increased by a more moderate 5.4 per cent. It appears that some households saved the additional income from the 2004-05 Budget measures that reduced income taxes and increased the financial assistance to families with children. This trend is likely to continue with further income tax cuts and measures to support saving in the 2005-06 Budget.

Chart 4: Contributions to growth in nominal household wealth[(a)]



(a) Percentage point contribution to through-the-year growth.
Source: Treasury.

The expected easing in household consumption, and the consequent increase in saving, is partly the result of the substantial slowdown in house price growth over the past year. Although there can be large differences between the various measures of house prices, this slowdown was evident across all of the major data sources. For example, the Australian Bureau of Statistics' measure of established house prices grew by 18.9 per cent over 2003, but only by 2.7 per cent over 2004. If households seek to

rebuild their saving more quickly in response to these developments, then household consumption growth would be lower.

One factor that has offset the lower growth in housing wealth is the large growth in non-dwelling wealth over the past few years. The ASX200 share price index increased by more than 30 per cent in the two years to April 2005. This increase partly reflects the improved prospects of resource companies following substantial increases in world commodity prices — the resources component of the ASX200 increased by more than 80 per cent over the same two-year period.

Aside from lower growth in housing wealth, other factors that are likely to slow household consumption over the forecast period are the increase in official interest rates in March 2005 and high petrol prices. The forecasts assume that oil prices remain broadly unchanged over 2005-06 and, therefore, that petrol prices stabilise. But there is a risk that oil prices increase and put further pressure on consumption spending.

Dwelling investment

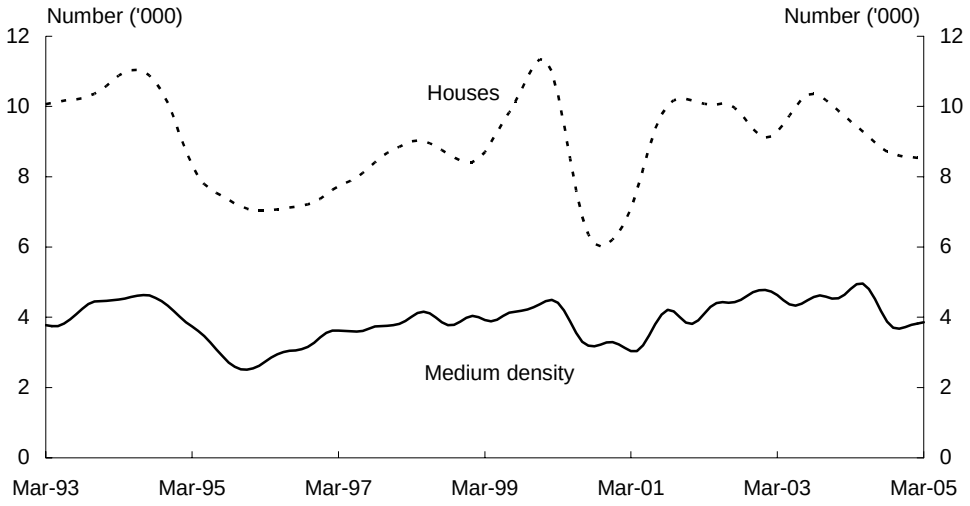
Dwelling investment is forecast to fall by 2 per cent in both 2004-05 and 2005-06, after very strong growth over the previous three years. Dwelling investment fell in the second half of 2004 and forward indicators of activity in the housing sector, such as dwelling approvals, suggest that this modest downward trend will continue in coming months (see Chart 5).

Other partial housing sector indicators point to lower activity. In late 2004 and early 2005, the number of monthly finance commitments for the construction or purchase of new dwellings by owner-occupiers was running around 15 per cent below its most recent peak in October 2003. Much of the speculative activity in the investor market also appears to have passed, with the value of investor finance falling significantly over the same period.

Thus far, the current housing cycle is unwinding in an orderly manner, with a gradual fall in housing activity levels across much of the country and house prices stabilising or falling a little. The risk of a sharp fall in house prices appears to have abated since the 2004-05 Budget. However, the rental yields on investment properties are still very low, suggesting that house prices may fall further in real terms. It seems likely that this adjustment will continue to occur gradually, without causing significant disruption to household finances. However, there remains a risk that a prolonged period of falling or flat house prices may lead households to rein in consumption expenditure more than expected.

There is no evidence of a widespread oversupply of new housing. Consistent with favourable economic conditions, the current downturn in housing activity is expected to be relatively shallow, although it is likely that medium density construction activity in the larger cities will continue to fall through 2005-06.

Chart 5: Private dwelling approvals



Source: ABS Cat. No. 8731.0 (trend data).

Business investment

Businesses are in a good position to undertake additional investment expenditure. Business profits have been strong across most sectors (especially in mining), capacity utilisation is at high levels and the Australian dollar prices of many investment goods have been falling over recent years.

New business investment is forecast to grow by 6 per cent in 2005-06, and remain at a very high level in real terms, having increased by almost 40 per cent in the three years to 2003-04 (see Chart 6). However, falling prices for business investment, particularly for imported machinery and equipment, have meant that nominal business investment has remained broadly constant as a share of nominal GDP.

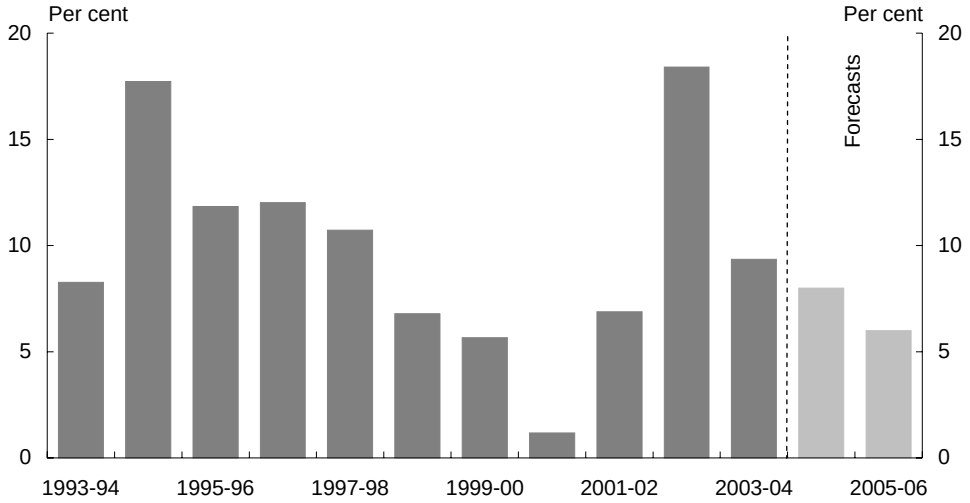
The mining sector has been an important contributor to business investment over recent years. Data from the Australian Bureau of Statistics' *Survey of New Capital Expenditure and Expected Expenditure* (CAPEX) shows that mining sector investment has been running above A$2 billion a quarter for more than two years, compared with a little above A$1 billion a quarter at the beginning of the decade. Mining sector investment should remain high for some time yet, given strong world demand for commodities.

Investment in non-dwelling construction is expected to grow by around 2 per cent in both 2004-05 and 2005-06. These forecast growth rates represent a moderation from the very strong growth in this category in recent years. Increasing commercial office vacancy rates, a slower rate of commencement of new infrastructure projects and increasing prices for steel and cement will restrain growth in non-dwelling construction. Nevertheless, continuing work on a number of large projects, and

supportive conditions for business investment more generally, will help to hold non-dwelling construction at its current high levels.

New machinery and equipment investment is also forecast to remain at high levels in 2005-06 with forecast growth of 7 per cent. The first estimate of investment intentions for equipment, plant and machinery in 2005-06 from the CAPEX survey was 5.2 per cent higher (in nominal terms) than the equivalent estimate for 2004-05. Initial estimates of investment intentions can provide only a broad indication of likely outcomes. Nevertheless, the CAPEX expectations provide early support for continued strong growth in 2005-06.

Chart 6: Growth in new business investment



Source: ABS Cat. No. 5206.0 and Treasury.

Inventories

Changes in inventories are forecast to contribute ¼ of a percentage point to GDP growth in 2005-06, primarily through growth in private non-farm inventories. Despite a positive contribution to growth from inventories, the inventories to sales ratio is expected to fall further in 2005-06 as strengthening export growth boosts overall sales.

Farm and public authority inventories (including the inventories of privatised marketing authorities) are expected to fall in 2004-05, following lower grain production in 2004, and then remain broadly unchanged at this level in 2005-06.

Public final demand

Public final demand is forecast to increase by 3¾ per cent in 2005-06, after expected strong growth of 6 per cent in 2004-05. Public investment expenditure has grown strongly over 2004. In 2005-06, growth in public investment expenditure is expected to slow, as is growth in public consumption.

Net exports and the current account

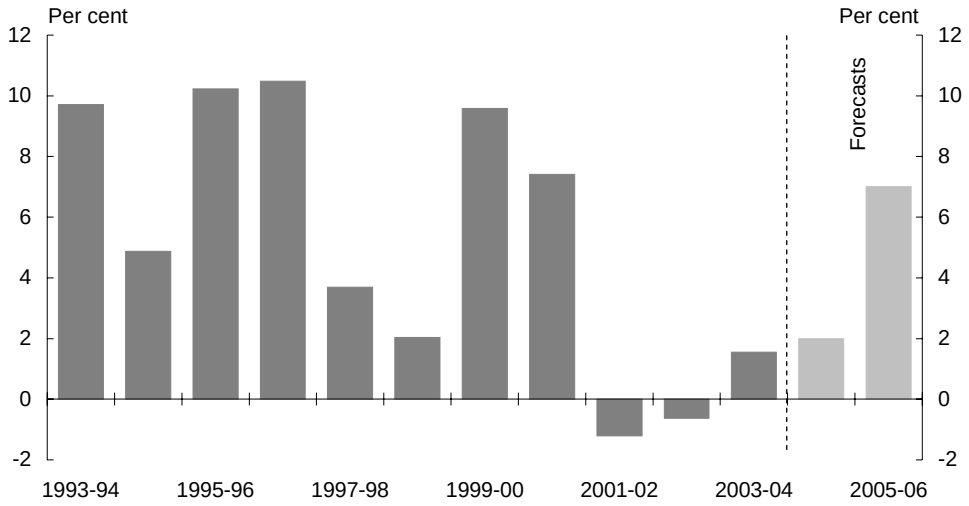
Net exports

Net exports have made a significant detraction from GDP growth over the past three years. Strong growth in gross national expenditure and a high exchange rate have supported import growth in recent years, while export growth has been subdued (see Chart 7). Net exports are expected to detract a further 1 percentage point from GDP growth in 2005-06, an improvement from previous years.

A number of shocks to the economy in the first half of this decade have acted to constrain export growth. The 2002-03 drought and subsequent dry weather conditions affected rural exports, the slowdown in the world economy in 2001 and 2002 weighed on manufactured and service exports, and various health and security concerns have affected international travel and business. The increase in the exchange rate since 2002 has also reduced the price competitiveness of Australian exports.

In volume terms, export growth still remains below what could be expected for this stage of the world economic cycle. An important part of the explanation for this relatively weak growth in export volumes is the long lead times on investment in the mining sector (see Box 2). Around A$20 billion has been invested in new production and transportation capacity in the mining sector over the past two years alone, but non-rural commodity export volumes have remained broadly flat.

Chart 7: Growth in exports

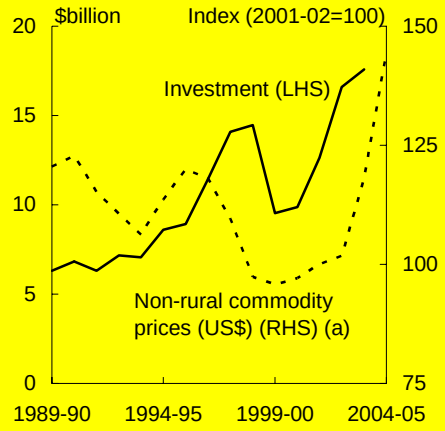


Source: ABS Cat. No. 5206.0 and Treasury.

Box 2: Mining capacity constraints

Global demand for commodities has increased more than expected over recent years, while resource production has increased only modestly. As a result, commodity prices have increased dramatically.

Chart A: Commodity prices and Australian mining investment

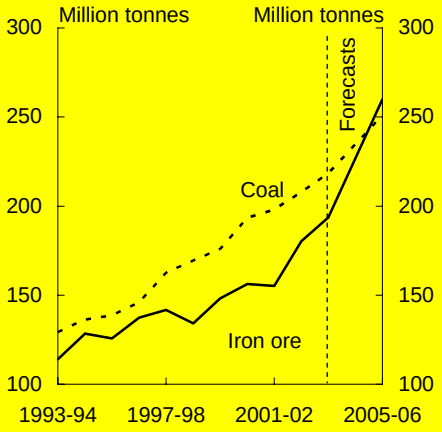


(a) Data for 2004-05 are year-average to April.
Source: ABS Cat. No. 5204.0 and RBA (original data).

The limited initial supply response reflects the large fixed costs inherent in mining projects. These costs mean that mining operations and supply chains are most profitable when operating close to capacity. Hence, there is often little spare capacity to meet an unexpected increase in demand.

Australian mining investment has surged following the increase in commodity prices since 2000 (Chart A). The resulting increase in output has already begun to lift export volumes (Chart B). There is still further productive capacity to come on stream, with resource exports expected to increase by a further 15 per cent by June 2006.

Chart B: Iron ore and coal export volumes



Source: Unpublished ABS data and Treasury (original data).

Some infrastructure constraints emerged as mining output increased. In vertically-integrated production and transport chains, such as in the iron ore and liquefied natural gas industries, these constraints are being addressed in tandem with increases in output. In cases where ownership of the production and transport chain is more fragmented, such as in the coal industry, infrastructure investment has tended to lag increases in production, leading to some bottlenecks.

Strong global demand and sustained high prices will encourage an increased supply of resources from Australia and the rest of the world. The interplay between rising global demand and supply makes predicting the future course of commodity prices particularly difficult. However, the mining sector is likely to be a significant contributor to national income in coming years.

The additional production flowing from new investment in parts of the mining sector has so far been outweighed by falling production for other commodities. Production in some of Australia's mature oil fields off Western Australia and in Bass Strait, for example, has fallen sharply over the past two years. This situation is expected to be redressed to some degree in 2005-06 as a significant expansion of capacity in areas such as liquefied natural gas and iron ore is brought into production.

After growing strongly in the late 1990s, export volumes for rural goods have not grown over the first half of this decade. The 2002-03 drought had a major impact on rural production. Grain production recovered strongly in 2003, but fell slightly in 2004. The production of livestock and some water-intensive crops has still not fully recovered from the drought. On the assumption of average seasonal conditions, rural exports are forecast to grow modestly in 2005-06.

Manufactured exports have grown more strongly, on average, than commodity exports in recent years. However, manufactured export growth has still been considerably below the average rate recorded through the 1990s. The maturing of some of Australia's manufactured export industries and the upward movement in the exchange rate since late 2001 explain some of this slowdown. The increasing quality and diversity of the goods produced by some newly industrialising countries, such as China, is also leading to increased competition and significant movements in the prices of some internationally-traded manufactured goods. It is difficult to predict precisely how Australia's exporters of manufactured goods will respond to these challenges, but a modest strengthening in manufactured export growth is expected in 2005-06.

Service exports have been broadly flat in recent years, partly reflecting the impact of a rising exchange rate and health and security concerns for international travel. Growth in service exports is expected to strengthen in 2005-06 in response to favourable world economic conditions.

Growth in imports is forecast to be 8 per cent in 2005-06, marginally slower than in 2004-05. Falling import prices and strong growth in all of the components of gross national expenditure have supported import growth in recent years. Slower growth in gross national expenditure over the forecast period will contribute to slower import growth.

The terms of trade

The terms of trade are expected to increase substantially in 2005-06, largely reflecting the convergence of strong world demand for commodities and relatively low growth in commodity supply. The exchange rate is broadly unchanged from the start of 2004, so the recent prices received for commodities in Australian dollars have generally tracked the price movements on world markets (usually expressed in US dollars). Continuing falls in import prices are also expected to support growth in the terms of trade.

In 2005-06, the terms of trade are forecast to increase by 12¼ per cent, after growth of 7.0 per cent in 2003-04 and expected growth of 9¾ per cent in 2004-05. This exceptional period of growth will take Australia's terms of trade to their highest level in 50 years.

In the late 1990s, the world supply of commodities grew strongly. Uncertainty around world economic developments, particularly following the Asian financial crisis in 1997, saw commodity prices fall to their lowest level in more than two decades in US dollar terms. This led commodity producers to reduce their investment in new capacity, notwithstanding the structural increase in global demand associated with the rapid growth in China and elsewhere. The sentiment of the time was reflected in the very strong interest in 'new economy' industries at the expense of 'old economy' industries such as mining.

Demand for commodities was relatively subdued in the following years, with most of the world's economies entering a period of subdued growth in 2001 and 2002. But some economies, most notably that of China, continued to grow strongly and increase their demand for commodities throughout these years. As the United States and, to a lesser extent, the rest of the world entered a period of stronger economic growth in 2003 and 2004, the demand for commodities quickly outstripped supply. As a result, commodity prices began to increase sharply.

Australia has benefited from these strong increases in world commodity prices and this is evident in the higher terms of trade. The prices for coal and iron ore, in particular, have increased substantially in recent rounds of contract negotiations with Japanese and Chinese buyers (see Box 3).

It seems unlikely that world commodity prices will be sustained at these levels indefinitely because the present high prices substantially exceed the cost of new production. Consequently, a large amount of investment in mining projects is already underway around the world, including in Australia. Continuing high commodity prices will encourage more investment. While the planning and construction lead times on mining projects are typically very long, meaning that supply responses typically lag demand changes, it is likely that the world supply of commodities will increase in 2005-06 and future years. For example, over the next three years, world production of iron ore is expected to increase by around 20 per cent.

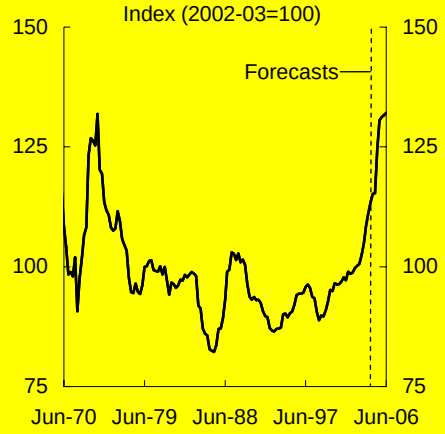
An increasing world supply of commodities should place downward pressure on commodity prices over time. The timing and extent of any such price adjustment is very difficult to predict. Since contract prices are typically struck before the beginning of the Japanese financial year on 1 April, any substantial adjustment is unlikely to occur before the June quarter 2006. However, there is a risk that Australia's terms of trade will fall over the medium term from their historical highs in 2005-06. This, in turn, carries significant implications for the budget projections for 2006-07 and beyond, particularly with respect to company tax collections from the mining sector. See Box 7 for a discussion of commodity prices and the budget projections.

Box 3: Booming commodity prices

Recent contract negotiations have locked in strong US dollar price increases in 2005 for some of Australia's key bulk commodity exports. In particular, hard coking coal prices are up by 120 per cent, iron ore prices are up by 70 per cent and steaming coal prices are up by 20 per cent.

Largely because of these export price increases, the terms of trade are expected to increase by 12¼ per cent in 2005-06, to be at their highest level in 50 years (Chart A).

Chart A: Terms of trade



Source: ABS Cat. No. 5302.0 and Treasury.

Assuming no change in the exchange rate, these commodity price increases will add approximately 2 per cent to nominal GDP in 2005-06. This additional income will benefit a number of sectors in the economy.

Mining companies will receive higher revenue, boosting their profits. Mining company shareholders (including superannuation funds) will also benefit, either from higher dividend payments or, if companies retain their earnings, stronger capital gains.

Higher prices, if sustained, will also support higher capacity utilisation and stronger investment in the mining industry with the effect of boosting production and exports. As a result, suppliers of goods and services to the mining industry will also benefit from stronger earnings. Although the mining sector is not labour intensive, employment may also increase modestly.

Governments will also benefit from higher royalties and company taxation.

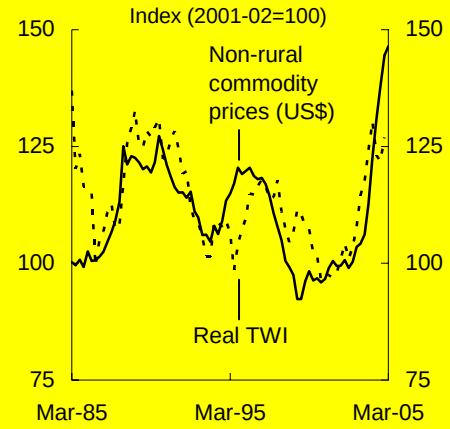
Higher commodity prices are expected to reduce the trade deficit by around 2 per cent of GDP. However, foreign investors in the Australian mining sector will receive some of the income generated by the higher commodity prices. Higher dividend payments and repatriated earnings of foreign investors are expected to widen the net income deficit component of the current account by around 1 per cent of GDP.

Thus, the increase in the net income deficit will partially offset the reduction in the trade deficit, with the overall current account deficit reduced by around 1 per cent of GDP.

Box 3: Booming commodity prices (continued)

This analysis is based on the technical assumption of an unchanged exchange rate. However, since the float of the Australian dollar in 1983, an appreciation of the exchange rate has generally accompanied an increase in world commodity prices (Chart B).

Chart B: Commodity prices and the real exchange rate



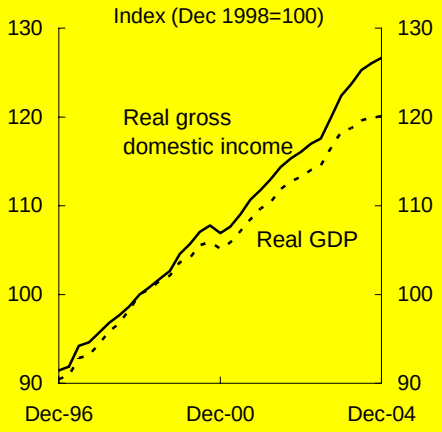
Source: RBA (original data).

If the exchange rate was to appreciate further in response to higher commodity prices, the benefits of stronger world demand for Australian exports would pass through the economy in a different way. The terms of trade and real incomes would still be higher. But, for resource exporters, the higher exchange rate would dampen the effect of the price increase on revenue. And for exporters of manufactures and services, and import-competing industries, a higher exchange rate would make it more difficult to compete.

Consumers and domestic producers would still benefit directly from improved purchasing power as import prices fall.

The increase in purchasing power is captured in the real gross domestic income (GDI) measure (Chart C). Real GDI is estimated as the volume of GDP plus the terms of trade effect.

Chart C: Terms of trade effect on purchasing power



Source: ABS Cat. No. 5206.0.

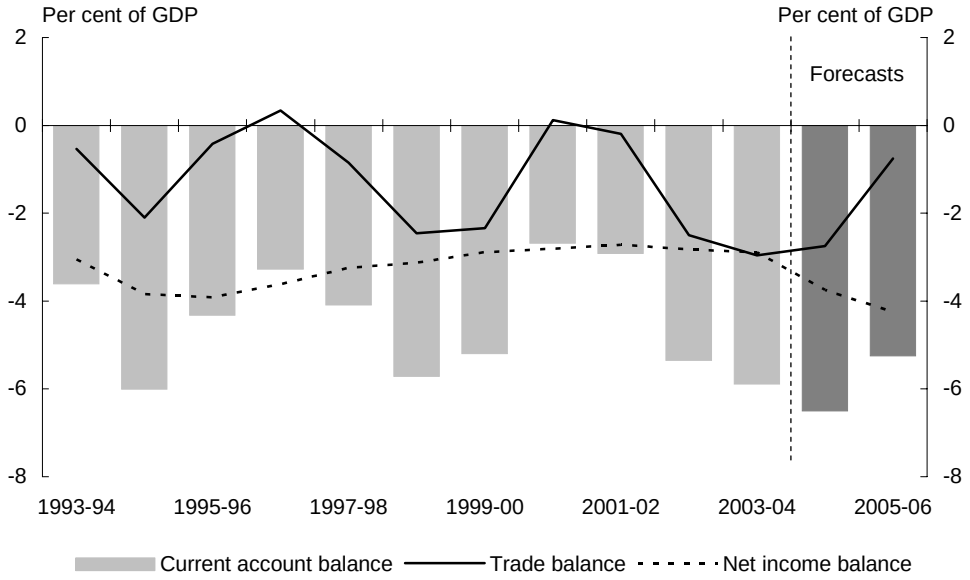
Regardless of how the benefits flow through the economy, the current high demand for Australia's commodity exports is generating considerable real income gains.

The current account

The current account deficit (CAD) has remained relatively high as a proportion of GDP in recent years, largely reflecting an increase in the trade deficit since 2001-02 (see Chart 8). As discussed in the net export section, export growth has been subdued in recent years, while import growth has remained robust, in line with strong growth in gross national expenditure. Australia's CAD is financed by an offsetting capital account surplus, the components of which are examined in Box 4.

An important influence on movements in the CAD over the forecast period will be the boom in commodity export prices. The net income deficit will increase as higher export prices result in higher profits being paid to foreign investors in the Australian mining sector, but this will be offset by the positive impact of higher prices on the trade deficit.

Chart 8: Current account balance



Source: ABS Cat. No. 5302.0, 5206.0 and Treasury.

The CAD is forecast to narrow to 5¼ per cent of GDP in 2005-06 from an expected 6½ per cent of GDP in 2004-05. Higher commodity prices will contribute to this improvement in the CAD (see Box 3).

Box 4: The balance of payments and net lending

The balance of payments consists of the current account (goods, services and income transactions between Australia and the rest of the world) and the capital account (flows of funds between Australia and the rest of the world that are required to finance current account transactions).

A country that invests more than it saves records a current account deficit (CAD). This is financed by an inflow of funds from the rest of the world, which is recorded as a capital account surplus.

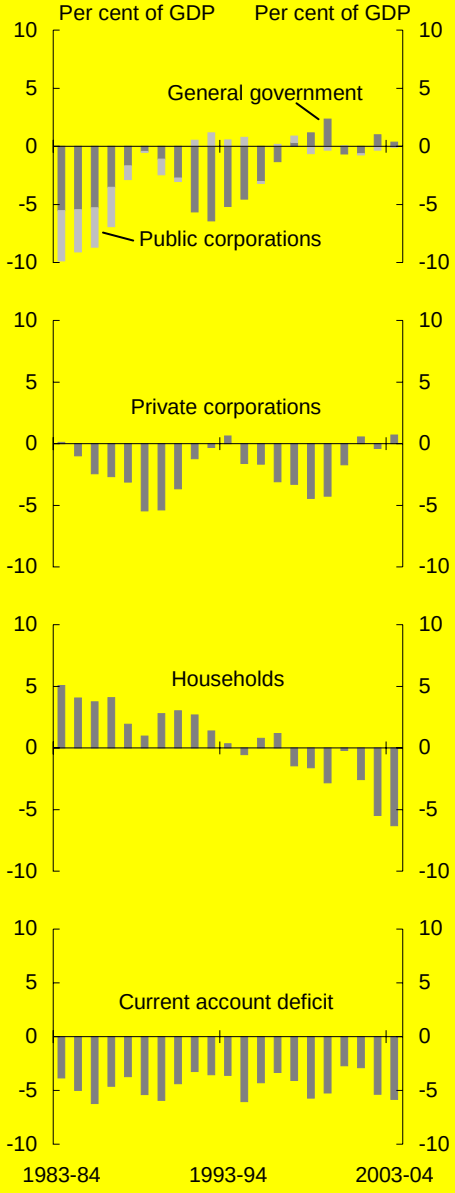
The net lending framework decomposes the economy's financing requirements between the household, corporate and public sectors. The net lending framework for Australia is presented in Chart A. Negative figures indicate a requirement to borrow from other sectors or from the rest of the world.

Since 1996-97, the government sector has become a small net lender on average, making a positive direct contribution to the current account balance.

Private corporations have also become small net lenders in recent years, as companies have funded investment from profits rather than borrowings.

Almost all of the recent increase in the CAD is attributable to the household sector. In other words, households have been borrowing from other sectors and, ultimately, from the rest of the world, via the banking system.

Chart A: Net Lending



Source: ABS Cat. No. 5204.0, 5302.0 and Treasury (original data).

Box 4: The balance of payments and net lending (continued)

The increase in households' net borrowing is partly a result of higher household wealth (from higher house prices), leading households to invest more and save less.

Higher investment and lower saving is also a response to a more stable and resilient economy with sustained employment growth and low inflation. In a stable economy, households may choose to hold a lower level of precautionary savings than in a volatile economy.

In addition, deregulation of financial markets, combined with low inflation, has lowered borrowing costs. This has allowed households greater flexibility to spread their consumption and investment decisions over time.

The outlook for 2005-06 is for GDP growth to rebalance away from domestic to external sources. Accordingly, while the corporate and government sectors are expected to remain net lenders, the household sector's net borrowing is expected to decrease in line with easing dwelling investment and consumption.

Labour market, wages and prices

Labour market

Employment has continued to grow rapidly through 2004-05, with the unemployment rate falling to a 28-year low of 5.1 per cent in December 2004. Construction employment has increased strongly over the past year, reflecting the high levels of economic activity in that sector.

Forward indicators of employment, such as measures of job vacancies, point to further solid employment growth in coming months. For example, the Australian Bureau of Statistics' job vacancy series increased by around 40 per cent through the year to February 2005.

Employment growth is expected to moderate to 1¾ per cent in 2005-06 as the effects of recent slower GDP growth feed through to the labour market. In particular, employment growth in the construction sector is expected to slow, reflecting the flattening of growth in residential and commercial construction.

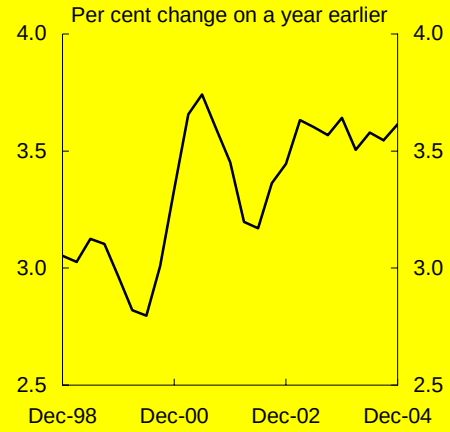
The unemployment rate is forecast to remain near 5 per cent through 2005-06 after averaging around 5¼ per cent in 2004-05. Workforce participation is forecast to remain high by historical standards at 63¾ per cent on average in 2005-06. This is a little below its level of recent months. This Budget contains measures to increase workforce participation over the medium term. In the short term these measures will place upwards pressure on measured unemployment as new entrants to the labour market take time to find jobs.

Box 5: Labour market flexibility

The labour market has performed very strongly over the past 12 months, with the unemployment rate falling to a 28-year low.

Given this historically low outcome, it is not surprising that some business surveys are indicating that suitable labour is becoming more difficult to find. However, there is currently no evidence of widespread labour shortages or generalised wage pressure (Chart A).

Chart A: Wage price index



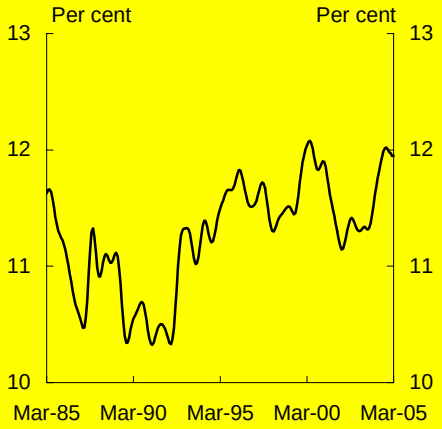
Source: ABS Cat. No. 6345.0.

This combination of low unemployment and moderate wage growth reflects past labour market reforms which have created more flexible working arrangements. This has led to a more efficient allocation of labour, higher productivity and increased real wages without triggering inflationary pressure.

These reforms have also encouraged more people to participate in the labour force, with greater flexibility in the degree to which they participate. For example, part-time employment now accounts for around 28 per cent of total employment.

Given the right circumstances, around a quarter of these workers have indicated they would like to work more hours, increasing the available pool of labour. Employers have been drawing on this pool, with the flows of workers from part-time to full-time employment around record highs (Chart B).

Chart B: Proportion of part-time workers gaining full-time employment



Source: ABS Cat. No. 6203.0, 6291.0.55.001 (trend data).

The ability to utilise existing workers more effectively should lessen the impact of tighter labour market conditions on economic activity and inflation.

While the unemployment rate is at a 28-year low, there is further scope to increase labour inputs to production through the better use of under-utilised labour and by encouraging greater workforce participation (see Box 5).

Wages

Moderate wage growth in recent years has provided a good foundation for sustained economic growth. The Wage Price Index has averaged growth of around 3½ per cent for the past two years. These moderate outcomes are welcome in the light of a steadily falling unemployment rate.

Reforms in recent years to boost the economy's productive potential, particularly those in the area of workplace relations, have supported this healthy combination of strong employment and moderate nominal wage growth (see Box 5). Statement 4 in the 2004-05 Budget discussed labour market flexibility issues in more detail.

Wage growth is expected to increase over 2005-06, with the Wage Price Index forecast to grow by 4 per cent. Some localised wage pressure has appeared in specific industries and occupations, particularly in those areas affected by conditions in the mining sector. With the unemployment rate at a 28-year low, it is likely that some localised wage pressures will remain. Such relative wage adjustment is an important signalling mechanism in a high employment economy, helping to direct workers to the areas of their highest productive value.

At this stage, there is no evidence of more generalised wage pressure, and the expected more modest employment growth in the period ahead should help to contain overall wage pressure. However, it will remain important that wage growth is backed by increases in productivity on average — particularly with the current very low levels of unemployment — to support further sustainable economic growth.

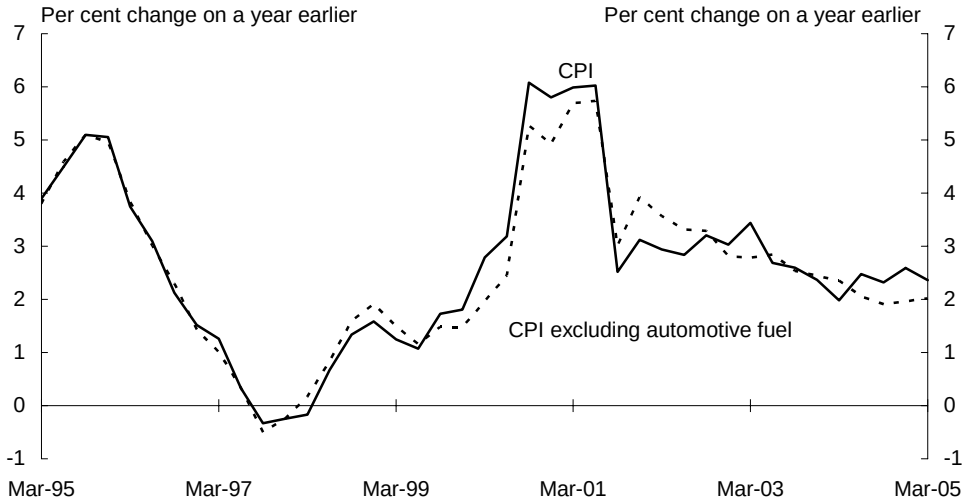
Prices

Inflation has been contained in recent years (see Chart 9), reflecting moderate growth in unit labour costs, the effects of a higher exchange rate and vigorous competition in the retail sector. The Consumer Price Index (CPI) increased by 2.4 per cent through the year to the March quarter 2005. Although petrol prices are expected to place some further upward pressure on consumer prices in the near term, inflation is expected to remain moderate, with the CPI forecast to grow by 2½ per cent through the year to the June quarter 2006.

Unit labour costs are forecast to increase in 2004-05, reflecting a cyclical slowing in productivity growth and a slight increase in wage growth. While this will put some upward pressure on inflation, businesses are expected to look through some of the cyclical slowing in productivity growth in order to ameliorate volatility in retail prices.

Oil prices have continued to exert some upward pressure on the CPI in recent quarters. The direct impact of oil prices has been through higher petrol prices, although the prices of some other goods and services — air fares for example — have also been affected. Oil prices are assumed to remain broadly unchanged over 2005-06 and, therefore, petrol prices are expected to stabilise.

Chart 9: Inflation



Source: ABS Cat. No. 6401.0 (original data).

Box 6: Real GDP projections

The economic outlook includes projections for real GDP growth beyond the immediate two forecast years. From the 2005-06 Budget, this assumption is amended from 3½ per cent to 3¼ per cent per annum for 2008-09 and beyond.

The Intergenerational Report (IGR) notes that falling labour market participation due to an ageing population is expected to lower potential GDP growth in the coming decades.

Projections of GDP growth for 2008-09 will begin to reflect the IGR projections of declining participation rates and hence employment growth. Specifically, projections for employment growth have been adjusted down to 1¼ per cent in 2008-09, bringing projected GDP growth down to 3¼ per cent (Table A).

Table A: Economic projections[(a)]

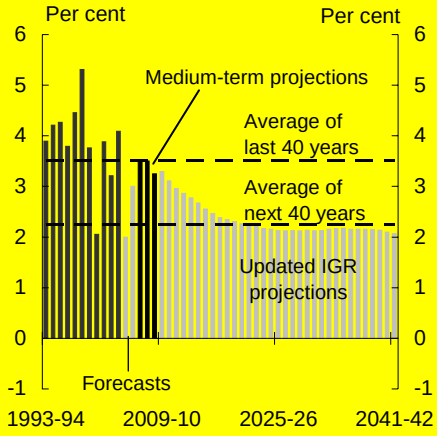
	2006-07	2007-08	2008-09
Employment(b)	1 1/2	1 1/2	1 1/4
Productivity	2	2	2
Real GDP	3 1/2	3 1/2	3 1/4
Wages(c)	3 3/4	3 3/4	4
CPI	2 1/2	2 1/2	2 1/2

(a) Percentage change on previous year.
(b) Labour Force Survey.
(c) Wage Price Index.
Source: Treasury.

The projections for 2006-07 and 2007-08 assume that the wage share of GDP continues to fall. From 2008-09, compensation of employees and corporate profits are assumed to grow at the same rate as nominal GDP, keeping the wage share constant. As a result, wages are projected to grow by 4 per cent in 2008-09.

The long run implications for GDP growth of adopting the IGR projections for declining aggregate participation and hence employment growth are shown in Chart A.

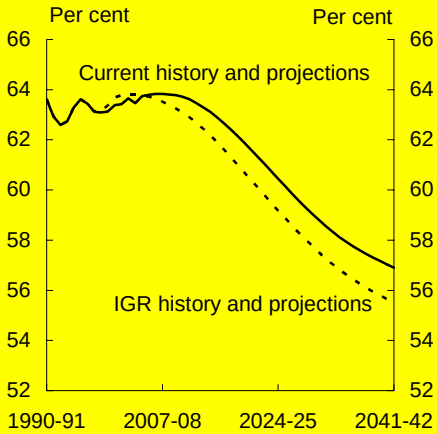
Chart A: Real GDP growth



Source: ABS Cat. No. 5206.0 and Treasury.

These projections are based on new population and participation data available since the 2002-03 IGR. With these new data, the peak in participation is now projected to occur in 2006-07 (Chart B).

Chart B: Participation rate



Source: ABS Cat. No. 6202.0 and Treasury (original data).

Box 7: Nominal GDP projections

Nominal GDP is forecast to grow by 7½ per cent in 2005-06, largely reflecting increases in Australia's commodity export prices.

Nominal GDP has grown very strongly for a number of years. In 2003-04, nominal GDP grew by 7.3 per cent, largely reflecting the impact of housing demand on both real GDP and domestic prices. Strong growth in the terms of trade and the effects of higher oil prices are expected to result in nominal GDP growth of 6 per cent in 2004-05.

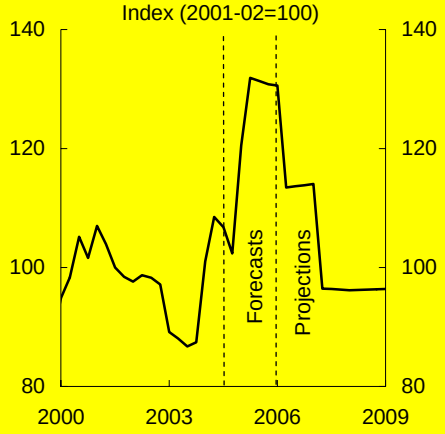
Nominal GDP projections, for the period 2006-07 to 2008-09, are typically based on underlying trends for real GDP and the GDP deflator – they are not forecasts. However, if the GDP deflator is projected at its historically-based trend growth rate, it would imply that commodity prices would remain at historically high levels over the entire projection period.

Beyond the forecast period, world supply for commodities that Australia exports is expected to increase in response to the recent surge in demand. This is likely to place downward pressure on Australia's export prices. As a result, not all of the recent boost to Australia's nominal income will be permanent.

How much of recent nominal income gains will be unwound in the projection period is a matter for judgement.

The approach, adopted in this Budget's fiscal projections, is to assume that commodity prices return to their long-run average level over the first two years of the projection period (Chart A). As a result, nominal GDP growth in 2006-07 and 2007-08 is not projected to grow as strongly. Projected real GDP growth is unaffected by the technical assumption for commodity prices.

Chart A: Commodity prices



Source: ABS Cat. No. 5302.0 and Treasury.

The interplay between rising global demand and supply makes predicting the future course of resource prices particularly difficult. Therefore, there is considerable uncertainty around the technical assumption for commodity prices.

STATEMENT 4: PROSPERITY AND SUSTAINABILITY

Australia's successful economic performance over the last decade provides a sound basis for future national prosperity if the right decisions are made for the future. Importantly, that performance also provides valuable experience to help us determine what policy measures need to be implemented to expand opportunities for all Australians.

Over the next 40 years the number of people over the age of 65 is projected to double. However the number of people of traditional working age will hardly increase. This presents a challenge to the sustainability of economic growth. The demand for greater availability and higher quality aged care, and the rising cost of health care — only partly due to population ageing — will put pressure also on fiscal sustainability. Those concerns and others, such as maintaining the environment, will become more pressing over time. Solutions will require longer planning horizons than have been employed in the past.

Policy choices will have little effect on the numbers of people of traditional working age. Solutions will therefore need to focus on facilitating further productivity improvements and increasing labour force participation for those of working age. This will involve some difficult tradeoffs.

The task will be made easier if there is widespread understanding of policy drivers and an environment where firms and individuals are able to respond positively to the opportunities that sound policy can create.

CONTENTS

STATEMENT 4: PROSPERITY AND SUSTAINABILITY

This statement examines the evolution in policies and institutions most likely to contribute to further increases in Australia's prosperity and the wellbeing of all Australians over the medium to long term. Those same policies and institutions are also those most likely to enhance Australia's ability to deal with future economic shocks. While further policy evolution will not be easy, the cost of failing to do so would be significant.

Australia's very successful recent economic performance provides valuable insights into the types of decisions needed to enhance opportunity for all Australians, while providing a solid foundation for continued national prosperity.

Our continued prosperity relies on making better use of our natural, man-made and human resources. This is not a simple task and necessarily involves some difficult tradeoffs. Subjecting policies to the following tests will inform decision-making.

- Do they improve prospects of sustaining and improving the quality of our natural, man-made and human resources?
- Do they improve the prospects of public and private resources being used more productively?
- Do they promote participation in the paid and voluntary workforce?
- Do they make the economy more resilient and adaptable to possible shocks and challenges?
- Are they cost effective and sustainable in the long term, irrespective of whether their objective is achieved through taxation, expenditure or regulation?

MAINTAINING A STRONG ECONOMY

Over the past decade Australia has performed very well against the measures of income, wealth, human development and employment. This strong performance is based on a set of sound policies, institutions and investments that have enabled Australia to make better use of its resources.

The strength of the economic performance, and the Australian Government's sound fiscal position, present a unique opportunity to implement a cohesive policy agenda that will underpin strong economic growth now and over the decades to come.

Just as the decisions of the past have created our prospects today, so too, the decisions made today and into the future will influence our long term prosperity and opportunity.

Those decisions will be taken against the background of population ageing, rising health and aged care costs, and threats to the quality of the natural environment that will challenge the sustainability of our recent impressive performance. Policy improvements implemented now can help to soften the downside risks of the future.

Realistic changes to rates of fertility and immigration would have little discernible impact on the rate at which the population is projected to age over the next half century. Therefore maintaining the per capita growth rates to which Australia has become accustomed will require ongoing improvements in productivity growth and labour force participation.

Strong, sustainable economic growth is needed to generate the public and private wealth to meet growing demands, not only to support the growing proportion of elderly people in the community, but also to fund increased expenditure on health care which will be driven not just by ageing but by technological improvements as well. Without strong, sustainable economic growth Australia would eventually be forced to adopt new or higher taxes to meet recurrent demands. High taxes and debt repayments would, in turn, act as a drag on economic growth.

The discussion in **Building on a strong foundation** focuses on the public and private decisions, and other domestic and international factors, that have produced the strong economic performance of the past decade or so. Policy has focused on improving the efficiency of the private sector and establishing a stable medium-term macroeconomic framework through a series of coordinated and complementary reforms. In combination, those policies have helped Australians benefit from favourable domestic and international influences and overcome adverse economic shocks such as global slowdowns.

The subsequent sections examine those policy reforms that, in light of the ageing population, are most likely to contribute to increased future prosperity. Such reforms could underpin productivity growth and increase levels of participation in both the paid and voluntary workforce.

As **Being more productive** discusses, that will require:

- further and ongoing improvement to infrastructure investment decisions;
- increasing competition through continued reform of domestic labour and product markets and enhanced international engagement;
- improving the cost-effectiveness of government;

- avoiding unnecessary regulatory complexity; and
- taking better account of costs and benefits in decision-making, particularly in making sound decisions on the use and maintenance of the natural environment.

With the ageing of the population it will be important that more Australians be given the opportunity of **Improving participation and sharing Australia's prosperity** through policies that support participation in the labour force and society more generally. They include strengthening the capacity to participate through improved education and health, improving the balance of incentives to shift from welfare-to-work to avoid cycles of dependency, and enhancing the flexibility of working arrangements. Decisions to participate in paid or unpaid employment, and tradeoffs between work and leisure, are inherently personal ones. However, government policies can and do influence those choices.

Australia does not face the public debt problems of many countries. However, we will face stark choices in the future if we do not act pre-emptively to address emerging fiscal pressures from an ageing population. This requires **Maintaining a disciplined approach to fiscal policy**, including new strategies that take a broader view of the Australian Government's balance sheet and address future pressures on the tax base.

BUILDING ON A STRONG FOUNDATION

Australia's recent economic performance is impressive, both compared with other developed countries and by historical standards. In the four decades from 1950, growth in GDP per person — one indicator of improvements in living standards — usually fell below the OECD average rate of growth. However, in the past decade or so Australia's performance has improved dramatically (Chart 1). GDP per person has grown much faster, on average, than in both the United States and the OECD, raising Australia from 18th highest GDP per person among OECD countries to 8th today.

This section highlights the main drivers of Australia's new prosperity and discusses the ways in which Australians have benefited.

Chart 1: Australia's economic revival

The difference between Australian and OECD average GDP per person[(a)]

(a) OECD data are for the 24 longest standing OECD member countries.
Source: Groningen Growth and Development Centre and The Conference Board (2005).

The reasons for Australia's prosperity

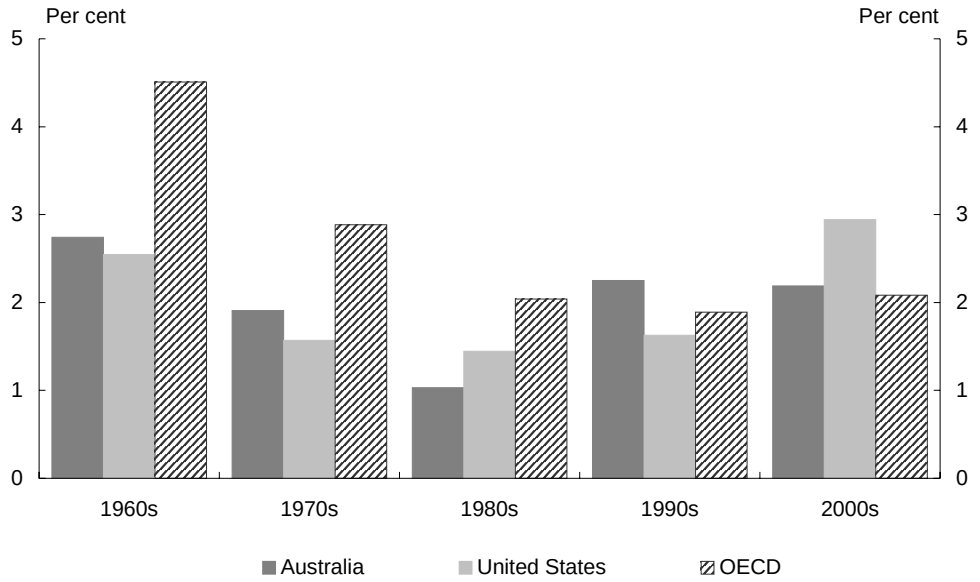
One approach to understanding the drivers of economic growth is to consider trends in population growth, labour force participation and productivity (see the detailed discussion in Budget Paper No. 1, *Budget Strategy and Outlook 2003-04*, Statement 4). Improvement in living standards, as measured by GDP per person, is the result of growth over time in the proportion of the population that is of working age, the number of hours worked by each person of working age, and the volume and quality of goods and services produced during those hours of work.

From the early 1990s, higher rates of labour productivity growth, rather than more favourable changes in the population age structure, or labour force participation rates, have driven Australia's strong economic performance. Labour force participation, as measured by the combination of average hours worked and the rate of employment among those aged 15 years and older, contributed little to growth in output and average incomes over the last four decades. While the increase in the participation of women in the workforce has more than offset the gradual decline in the participation of men, increased aggregate participation has been largely offset by the decline in average hours worked, largely reflecting the increase in part-time work (ABS 2005f; Reserve Bank of Australia 1997).

Beginning at the start of the 1990s, Australia's rate of labour productivity growth revived following decades of lagging other major developed countries. Productivity grew more rapidly during the latter half of the 1990s than during any comparable period in the past forty years. Australian labour productivity even grew faster than the 'new economy' of the United States (Chart 2). The revival since the 1990s is especially

remarkable in that it did not accompany a worldwide productivity boom. Indeed the average rate of labour productivity growth was slower across the OECD during the 1990s than in the previous decade. This suggests that additional circumstances unique to the Australian economy were responsible.

Chart 2: Labour productivity growth[(a)]



(a) OECD data are for the 24 longest standing OECD member countries. Data are average annual growth rates.

Source: Groningen Growth and Development Centre and The Conference Board (2005).

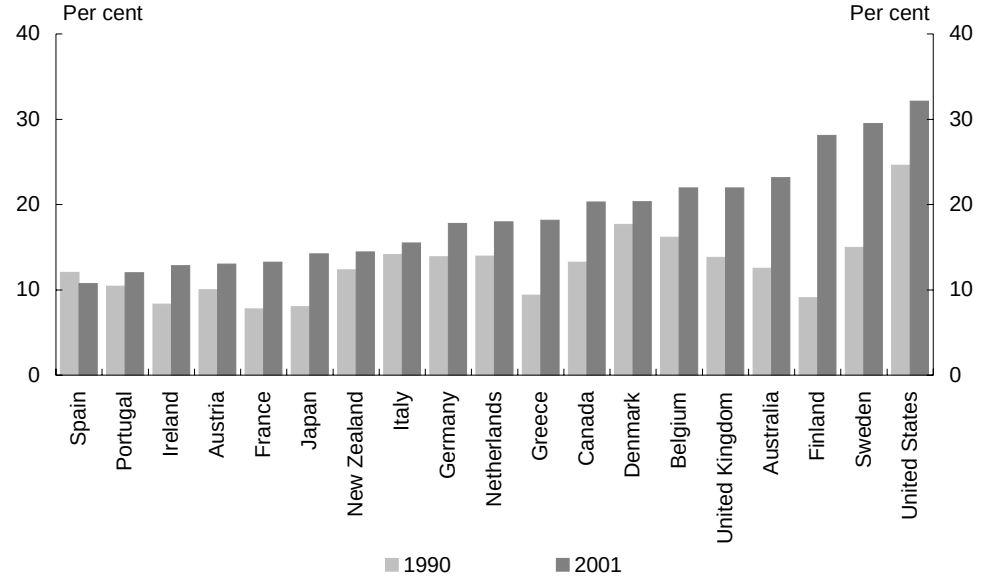
Labour productivity growth over time reflects:

- increases in capital per worker (that is, capital deepening);
- improvements in labour quality through education and experience; and
- improvements in the efficiency with which labour and capital are used, through innovative work practices, the achievement of economies of scale and technological developments.

In the 1990s, the rate of capital deepening accelerated from the slow pace of the 1980s (ABS 2004a). The rapid investment in, and use of, information and communication technology was particularly important. Australia has been among the world's leading users of information and communication technology (Chart 3).

Chart 3: Investment in information and communication technology

Share of non-residential fixed capital formation



Source: OECD (2005b).

However, improved efficiency (often referred to as multi-factor productivity) was the predominant driver of Australia's productivity revival (ABS 2004a). Australia's multi-factor productivity growth during the 1990s was stronger than for all other OECD countries for which data are available, except Finland and Ireland (OECD 2005b).

Central among the drivers of this improved efficiency was the broad and deep programme of mutually reinforcing reforms implemented during recent decades (IMF 2004; OECD 2005a; Parham 2004). Key reforms included: liberalising trade, foreign investment, financial markets and workplace relations regimes; tax reform (including reforms of the indirect tax system and targeted incentives to work and save); corporate law reform; and implementing a broad-ranging National Competition Policy agenda.

The resulting increase in domestic and international competition encouraged both a more efficient allocation of resources and a more vigorous pursuit of productivity improvement. More flexible labour markets permitted the reorganisation of work practices to take advantage of improvements in technology and skills. More flexible financial markets improved access for new, developing industries to the capital they required.

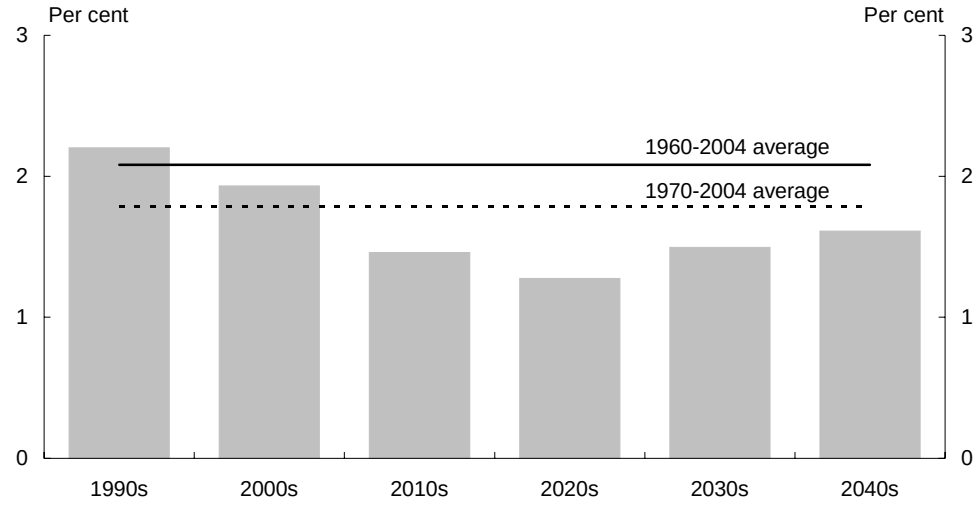
Microeconomic reforms and changes in behaviour have worked to raise the level of output the economy is capable of producing. They have been complemented by the Australian Government's macroeconomic reforms in the mid-1990s which placed both

fiscal and monetary policies within sustainable medium-term frameworks. Sound and sustainable macroeconomic policies have delivered a smoother pace of economic growth. They have helped avoid inflationary pressures while accommodating a steady decline in the unemployment rate. The resulting stable, low interest rate environment has provided security for firms to innovate and invest.

In recent years, Australian incomes have been bolstered by favourable changes in the relative prices of our imports and exports. Rapid economic development in China and India raised global demand and prices for the resources that Australia exports, while reducing the world price for manufactured imports. This has continued previous trends that resulted from rapidly declining prices for information technology and communications equipment. Shifts in the terms of trade will influence the direction in which Australia's manufacturing, mining and service sectors develop and contribute to ongoing prosperity.

The challenge will be to continue to improve living standards as the baby-boomer generation moves into retirement and causes a decline in the proportion of the population of traditional working age (15 to 64 years, that is, between compulsory school and age pension age). This will tend to reduce the proportion of Australians participating in the labour force and slow economic growth (Chart 4).

Chart 4: Projections of average annual growth in GDP per person



Source: ABS (2004a); and Productivity Commission (2005a).

The benefits of increased prosperity

The benefits of Australia's greater prosperity have been widely shared.

More Australians are now able to find work, with more than 1.5 million jobs created since 1996 (ABS 2005g). This has permitted a record high proportion of people of traditional working age to be engaged actively in the workforce. The unemployment

rate has fallen from a peak of almost 11 per cent in 1992 to around 5 per cent, the lowest rate since the mid-1970s.

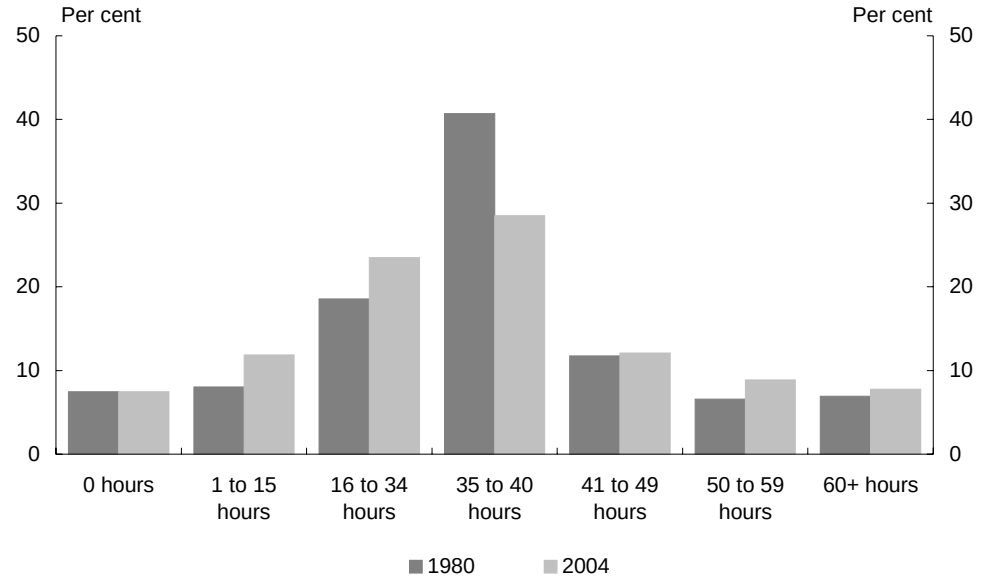
The disposable incomes of Australian households have increased. Strong productivity growth has allowed real wage rates to increase. On average, adults working in full-time jobs earned around $200 more per week in 2004 than they did in 1990 in 2004 dollars (ABS 2005b, 2005c). The benefits of real wage growth have been shared with Australians on a wide range of pensions, including the Age Pension, as those pensions increase in line with male total average weekly earnings.

Australian households now also have greater flexibility to manage their work, study, personal and leisure time. This is illustrated by the broader distribution of working hours (Chart 5). Part-time and casual work enables people to tailor their work to the demands of personal commitments and enables employers to meet better the demands of their customers. Almost half of the jobs created in the past decade have been part-time (ABS 2005a). While the majority of part-time workers are satisfied with the number of hours they work, a minority would prefer to work more hours.

This flexibility has allowed more Australians to study beyond the compulsory school age while managing work commitments. Almost two-thirds of those enrolled in post-secondary education or training are participating in the labour force, with a majority working part-time (ABS 2004b).

Chart 5: Employment by hours worked per week

Per cent of employed persons



Source: ABS (2005f).

Australians also have more flexibility to choose the time at which they retire. Although Australians are living longer than a generation ago, many are retiring earlier from full-time work. Some have moved into more flexible work arrangements, while others are involved in caring and other voluntary roles, or simply enjoying more leisure. Others have chosen to continue to work beyond age pension age.

Economic growth also has strengthened Australian household balance sheets. Household wealth has doubled over the past decade (ABS 2004a). This has been assisted by increased coverage and rates of saving into superannuation over the past two decades. Reliable employment also has provided households with greater capacity to save, borrow and invest for their futures.

Economic prosperity has allowed the Australian Government to expand the provision of public services while lowering tax rates. In addition, sound fiscal management has contributed to a reduction in Australian Government debt levels to among the lowest in the OECD (OECD 2004b).

Australia's economic development has also allowed the achievement of broader social objectives. The United Nations measures such achievements using a Human Development Index (United Nations 2004). It considers improvements in human capabilities and opportunities by incorporating indicators of health and education together with output per person. By this measure, the wellbeing of Australians ranked the third highest of 177 countries in 2002. This is 11 places higher than in 1990 and nine places higher than rankings based on output per person alone.

The challenge is to maintain and further improve the policy and institutional environment for future prosperity.

BEING MORE PRODUCTIVE

Productivity growth is central to determining future living standards. Productivity growth is about getting more out of the finite resources available — working smarter, not harder. Increased productivity will provide more and higher quality goods and services and greater choice for Australians.

Australia's productivity growth will depend both on the development of technology throughout the world that expands the productivity potential for all countries and continued improvement in domestic performance that will see Australia move closer to the productivity potential inherent in world best practice.

There is good reason to be optimistic about future productivity growth. International productivity potential may continue to expand rapidly through ongoing improvements in technology, including information and communication technologies. Strong competition and increasing openness to international trade and investment will encourage Australian businesses to make best use of such developments. Such growth

can be supported through appropriate infrastructure provision, sound governance arrangements in both the private and public sectors and efficient management of our natural resources.

Despite recent strong productivity growth, Australia remains well below international productivity potential. In aggregate, Australian workers produce only around 80 to 85 per cent as much per hour as their peers in the United States (Groningen Growth and Development Centre and The Conference Board 2005). While the aggregate data mask significant sectoral differences, it is clear that a range of policy reforms could help Australia close this gap further.

However, it needs to be recognised that a number of factors peculiar to Australia are likely to hinder the ability to close the gap entirely. Geography affects economic success. Australia's small and dispersed population limits our exploitation of economies of scale, reduces the intensity of competition and increases transport costs compared with larger and more concentrated markets (Box 1). Distance and population will inevitably constrain Australia in achieving world-leading productivity performance in at least some industries and, hence, in aggregate GDP per person. Nonetheless, significant improvements can still be made with the right policies and economic environment.

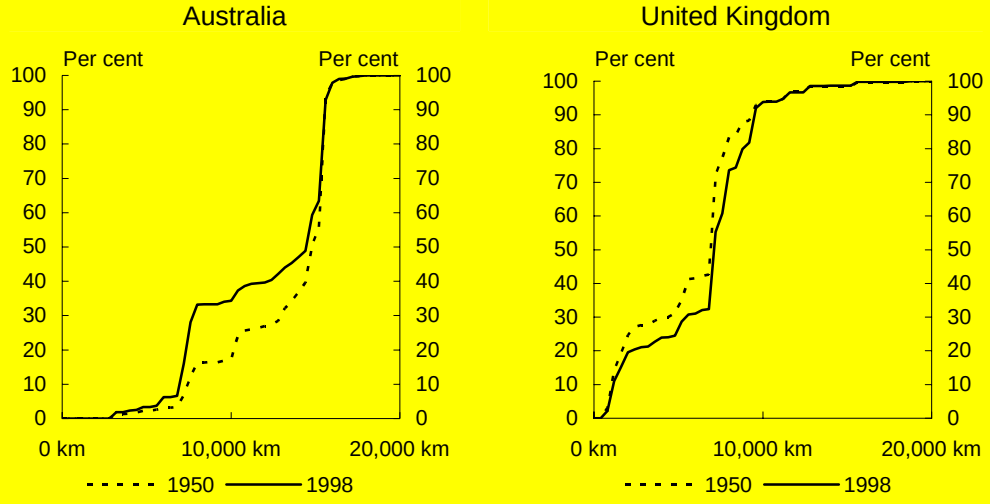
Box 1: Australia's economic remoteness

Australia has a small and dispersed population and is remote from the majority of the world's economic activity.

Australia has only 20 million people spread around the world's sixth largest land area. No two cities of more than one million are closer than 600 kilometres apart. In comparison, California has around 34 million people in a land area one-twentieth of Australia's (McLean and Taylor 2001).

Australia is second only to New Zealand in the OECD as the most remote economy from world economic activity. This is despite the recent rapid economic development in Asia. From the 1950s to the 1990s, the proportion of world GDP within 10,000 kilometres of Sydney increased from 17 per cent to 34 per cent (Chart 6). In comparison, 94 per cent of world GDP was within 10,000 kilometres of London in both the 1950s and the 1990s.

Chart 6: Distance to world GDP from Australia and the United Kingdom[(a)]



(a) Charts show the percentage of world GDP within certain distances of Sydney and London.
Source: Ewing and Battersby (2005).

Enhanced international integration and engagement

Higher productivity can be achieved by specialising in the industries to which Australia is best suited and by achieving economies of scale and scope. A small population and the costs of trading both within Australia and with major international markets constitute key economic hurdles to Australia achieving world-best levels of productivity (Box 1). Effective international integration can help reduce the limiting effects of Australia's geography and relatively small population.

Australia has taken significant steps to liberalise cross-border movement in goods and services, capital and people. This has resulted in:

- access to cheaper and better inputs and final goods and services;
- more efficient allocation of natural, man-made and human resources, with greater specialisation in areas of comparative advantage;
- access to international financial markets to fund investment, smooth consumption and expenditure over time, and share risks;
- transfer of skills and technology; and
- increased competition, promoting innovation and dynamic efficiency.

While increased global integration opens new opportunities for exchange, it also raises the need to manage new risks, including international economic and financial shocks, international crime, terrorism and contagious diseases.

As a small, open economy, Australia has a strong interest in the development of rules-based multilateral systems governing such areas as trade, investment, taxation, financial regulation, terrorist financing and money laundering. However, bilateral and regional integration is becoming increasingly important within East Asia. This region accounts for around half of Australia's trade (ABS 2005e) and its importance to the world economy has increased considerably over recent decades. The trend will continue as China and other emerging Asian economies continue to develop rapidly.

For Australia, the shift toward regionalism and bilateralism within Asia, most notably in trade policy, raises difficult questions about the appropriate balance between multilateral, regional and bilateral engagement. Nevertheless, a well-considered approach to regional and bilateral engagement can complement multilateral arrangements. When entering bilateral and regional agreements, it is important to focus on maximising potential gains and not adding unduly to the complexity of international trade and investment rules. The benefits of international trade and investment are best achieved when accompanied by reductions in behind-the-border barriers to new entrants, whether foreign or domestic.

Maintaining and investing in Australia's infrastructure

Infrastructure plays a key role in facilitating economic activities and contributing to Australia's general wellbeing. Both labour and capital rely upon access to efficient infrastructure to underpin their productivity. Over the past 20 years, Australian governments have implemented wide-ranging reforms to boost productivity in infrastructure sectors and contribute to economic growth. The recent Review of National Competition Policy Reforms (Productivity Commission 2005b) found that productivity gains in the six major infrastructure sectors that underwent most reform

since 1990 permanently added 2.5 per cent to GDP. For example, output per worker in electricity, gas, urban water, telecommunications and rail freight more than doubled over the 1990s. Productivity gains have lowered prices and raised average incomes.

In the process of reform, governments have had to grapple with complex issues of ownership, regulation and contract arrangements, and to develop sound decision-making frameworks to encourage appropriate investment decisions. Despite significant progress, challenges remain in many areas.

Given its nature, infrastructure often requires some form of government involvement — this may be in the form of direct provision, planning and coordination of networks, or regulation of monopoly assets. Where government provision is necessary, effective investment decision-making should involve sound cost-benefit analysis.

Many governments here and abroad have privatised some infrastructure businesses, such as in the energy, transport and communications sectors, that generated sufficient revenue to be financially viable. In those cases, the focus for governments has shifted from that of ownership to facilitating vigorous competition or, where that is not possible, regulating prices charged by monopoly networks.

Some governments have retained ownership of assets in key sectors together with regulatory responsibility and political accountability. The conflict between those roles can put at risk effective pricing and investment decisions. Government intervention is still preventing prices from reflecting the true economic cost of production in some infrastructure service markets.

For example, some state governments in Australia are discouraging potential new private-sector investors by continuing to own electricity assets, cross-subsidising their generators and retailers, and capping retail prices (Productivity Commission 2005b). Few infrastructure facilities utilise time of day or congestion pricing for infrastructure services. Further, most rural and urban water prices currently do not take account of the value of water in alternative uses and water trading regimes are in their infancy.

Regulated price setting at the appropriate level is always a difficult process. Depending on how prices are set, suppliers may invest too much or too little in infrastructure. Either case can lead to inefficient use of scarce resources — reducing the resilience and reliability of networks and lowering overall productivity and economic growth. Moreover, infrastructure choices can be distorted between competing industries. Promoting competitive infrastructure markets is desirable, where feasible, as it promotes efficient use of, and investment in, infrastructure and reduces the need for regulated pricing. New entrants and effective competition between existing players also can play a critical role in lifting productivity and stimulating the introduction of innovative new technologies, services and practices in the provision of infrastructure.

As noted in Statement 3, global demand for resources has increased significantly over recent years. Supply responses typically have lags because of the large fixed costs inherent in mining projects and significant volatility in commodity prices. There has consequently been little spare capacity to meet increased demand and prices have increased significantly. In response to rising prices, Australian mining investment has surged and the resulting increase in output has begun to lift export volumes.

As a result, the resource boom has put pressure on the capacity of some key east coast rail lines and ports. However, concerns have also been expressed about systemic, long-term capacity constraints emerging in electricity, rural and urban water and interstate freight and urban passenger road and rail networks (Business Council of Australia 2005; Productivity Commission 2005b).

Despite the many productivity and cost gains delivered during the past two decades, a further set of initiatives could build on these gains. Such initiatives could encourage competition, improve incentives for investors to install appropriate new infrastructure facilities and encourage their more efficient use. Successful reforms could boost national productivity significantly. In 2005 the Council of Australian Governments will review ongoing arrangements for National Competition Policy. The Australian Government initiated the Productivity Commission review to inform this process.

The role of government

Governments alone cannot resolve every problem and achieve every political, economic and cultural objective of society. In most cases private markets, individuals and communities will be better placed to meet the objectives they are seeking. In some instances governments are best placed to act, while other cases will require public and private cooperation.

As such, governments face a continuing challenge in defining the scope of their roles and in performing efficiently and effectively. Yet Australia's prosperity depends on the sound use of scarce resources in both the public and private sectors.

Governments can support productivity growth in the broader economy through efficiently managing public sector agencies to deliver services to the public in an effective manner. They also have a role in improving the efficiency of private markets by setting regulations that provide a framework for, and secure confidence in, market operations. Competitive forces will continue to drive ongoing productivity improvements. In Australia's federal system of government the rate of productivity growth in both the public and private sectors also depends on the effectiveness with which the three levels of government work together.

By establishing sound frameworks for decision-making and resource allocation, well-governed institutions and markets reduce the risk of economic instability and the vulnerability of the economy. They help contain the shocks to which an economy is exposed, making it easier for firms and households to adjust. Despite being exposed to

the large negative external shocks of the East Asian financial crisis, for example, Singapore and Australia fared relatively well. This was due partly to sound governance arrangements within public institutions and domestic economies (Johnson et al 2000; de Brouwer 2003).

Governance

Governance is one key area where governments can act to improve productivity. Governance covers the set of arrangements by which those managing an organisation are accountable to those with a legitimate interest in the organisation.

Improving governance standards for companies is the focus of the Corporate Law Economic Reform Program (CLERP). The objective is to boost investor confidence that boards and management will make sound decisions and increase the return on shareholder funds for the ongoing benefit of shareholders, employees and the wider community.

In the public sector, governance is about how parliaments, governments, boards and public service managers relate to each other and are answerable for the cost-effective performance of public functions and the delivery of public services. Reforms have strengthened financial and accountability arrangements and sharpened the focus on effective public service delivery. The reforms have included introducing the Charter of Budget Honesty, new financial management legislation, whole-of-government budgeting, reporting on an accrual basis, and strengthened performance reporting and benchmarking requirements.

That said, the best policies in the world will not deliver the intended outcomes if government agencies do not implement them in the manner governments intended. While some steps have been taken to improve arrangements between the Australian Government and its agencies, the Review of the Corporate Governance of Statutory Authorities and Office Holders (Department of Finance and Administration 2003), also known as the Uhrig Review, found governance could be enhanced by providing greater clarity in the relationships between Ministers, their departments, the Parliament, the public, statutory authorities and office holders.

The Uhrig Review developed templates of best practice governance principles. The application of those principles is intended to provide statutory authorities and office holders with clear purpose and guidance about government expectations and objectives. The governance arrangements of Australian Government statutory authorities and office holders are to be assessed against the templates by March 2006. Assessments are continuing, with implementation of the recommendations to occur on a rolling basis by March 2007.

Australian Government and state relations

The effective and productive delivery of government services also is affected significantly by the relationship between the three levels of government, and

particularly between the Australian Government and the states. This is because they are jointly involved in almost every functional area of government, with the exception of defence.

The Australian Government has sound reasons for involvement in many functional areas. They include promoting national standards, ensuring coordination and achieving national objectives such as enhanced productivity and participation. Similarly, state governments have sound reasons for involvement. However, joint government involvement in the same functional areas raises significant challenges including complexity for the public, cost and blame shifting, and possible duplication or gaps in service delivery.

In the medium term, all tiers of government will face significant pressure from the ongoing effect of cost drivers including demographic change. The Productivity Commission (2005a) projects that the aggregate fiscal pressure for all governments associated with the ageing population could be over 6 per cent of GDP by 2044-45 with the bulk of this expected to be borne by the Australian Government, but state governments face pressures as well. Growing spending pressures in key areas of service delivery accentuate the need to ensure that service provision is as effective and efficient as possible.

Some recent progress has been made in improving the allocation of the roles and responsibilities of governments. In addition, the introduction of the GST provided the states with a growing source of revenue. This enabled states to abolish a range of inefficient taxes and provided them with more funding certainty to meet their responsibilities.

Going forward, it will be important for the Australian Government and the states to clarify roles and responsibilities in order to improve productivity in the provision of services to the public while sustaining government finances. Clarification of roles will require consideration of national strategic priorities and judgements as to the tier of government that is likely to discharge those priorities most effectively.

Complexity and uncertainty

Complexity and uncertainty increase as markets expand beyond state and national borders. This can add to the cost of transactions and thereby limit the potential opportunities for increased investment and consumption.

Government intervention through the rule of law provides a framework to reduce uncertainty by providing greater confidence that private transactions will be completed satisfactorily. Through regulation, revenue raising activities and spending decisions, governments may add to or reduce the complexity faced by market participants. For example, governments might reduce complexity by requiring providers of similar products to promote or advertise them in a consistent, easily comparable manner.

On the other hand, contradictory regulations across sub-national levels of government can add to the difficulty of doing business. Addressing such issues was behind the Australian Government's drive to set consistent regulation of corporations and the securities and financial systems. It is also an important driver of the Australian Government's intention to develop a uniform approach to workplace relations.

In many cases, market participants can assist in managing complexity, thereby helping individuals to deal with complex information, procedures or regulation.

Governments may add unnecessarily to complexity by over-regulation, by setting ineffective or inappropriate regulation or policies, or by too frequently changing them. Over-regulation might arise, for example, when government decision-making is heavily influenced by the demands of the most risk averse, or where the concern being addressed is not fully understood by regulators. The Australian Government has sought to reduce the likelihood of such outcomes through the establishment of a number of consultative arrangements, including the Board of Taxation and the Financial Sector Advisory Council, and by consulting with business and consumer groups when developing legislation.

The design of policies and the way that laws and regulations are crafted also can add unnecessarily to complexity. For instance, attempts to cover in detail all current possible treatments in the law may require constant updates and additions as society and markets continue to evolve. In such circumstances principle-based drafting of laws and regulations may be more appropriate. Policy measures also can be incremental, adding one layer of complexity to another. On occasions more comprehensive policy redesign may overcome decades of built up complexity.

Australia's tri-level system of government and our need to integrate with the global community influence the levels of complexity Australians face and the impact of this complexity on market efficiency. For example, recent reports by both the Productivity Commission (2005b) and the Business Council of Australia (2005) have concluded that differing greenhouse policies between jurisdictions are imposing costs, creating uncertainty and impeding investment in Australia's infrastructure. As another example, businesses that operate across states and self-insure for workers' compensation face added costs from complying with different related financial and prudential requirements in each jurisdiction.

Maintaining our natural environment

Continued economic growth and prosperity require sound management of the natural environment. Clean water, clean air, arable land and sustainable timber stocks for example are essential to the productive capacity of almost all sectors within the Australian economy. The natural environment also provides important recreational and other benefits that, despite being less tangible in a financial sense, still make a valuable contribution to the wellbeing of Australians.

Until recent decades, there has been a lack of understanding of the role that Australia's unique environment plays in supporting the economy. The seeming limitless nature of Australia's natural environment meant it had sometimes been undervalued. Pressures on the environment are manifest in problems such as salinity, concerns over water quality and quantity, and issues surrounding greenhouse emissions.

Over time Australians have increasingly come to value the environment more highly and to seek solutions to environmental challenges. In response Australian Government expenditure on the environment has increased substantially in recent years and is budgeted to reach $3.2 billion in 2005-06. This budget builds on flagship environmental programmes such as the Natural Heritage Trust and the National Plan for Salinity and Water Quality. It establishes the $2 billion Australian Water Fund, commits an additional $181 million to protecting Australia's fisheries in the Southern Ocean from over-fishing and provides an additional $100 million for environmental research.

Unlike most other scarce commodities, there are no effective markets for many environmental goods and services. This reflects factors such as a lack of clear property rights, the existence of externalities and the public good characteristics of the environment. As a result, users of the goods and services provided by the natural environment often have faced little incentive to recognise the costs that they have imposed, given the alternative uses to which natural resources could have been put. Where this has occurred, it is likely that environmental resources have been used in ways that have not been economically efficient and which have failed to recognise their potential contribution to community amenity. In many instances, inefficient use of environmental resources has contributed to environmental degradation.

The inefficient use of environmental resources can constrain economic productivity and prevent future generations from enjoying the same high levels of environmental benefits that Australians enjoy today. A commonly cited example where this could occur is if water catchments were allowed to become degraded. The 'free' water filtration provided by the environment then would need to be replaced with expensive water filtration plants, thereby diverting workers and capital from alternative productive activities.

With demographic factors placing increased pressure on government budgets, sustainable resource use will need to be governed mainly by market incentives and regulatory approaches rather than by direct government spending. A key benefit of market-based approaches is that they seek to correct the underlying market failures that lead to environmental degradation. Market-based approaches provide a clear incentive to use environmental resources efficiently and to seek out more innovative production techniques.

By using markets to solve environmental problems, economic growth and higher living standards need not be at odds with improved environmental outcomes. Internationally, markets are increasingly likely to be used to manage the

environmental impacts of nitrous oxide, sulphur and greenhouse gas emissions and to support conservation. Reflecting Australia's particular circumstances, opportunities for the innovative use of environmental markets are being examined on a case-by-case basis in areas such as fisheries, native vegetation and salinity.

A significant example of a market solution is the National Water Initiative (NWI), which was agreed in June 2004 by the Australian Government and most states. A key objective of the NWI is to establish a clearly defined property rights framework for water and the creation of effective water markets. The price signals created by such markets will provide incentives for water to be transferred to its highest value use. This will encourage investment in water-efficient technology and infrastructure that will be needed to sustain Australia's future economic growth. At the same time, the property rights and water planning frameworks included in the NWI will be based on best available scientific knowledge so that water use is more consistent with environmental sustainability.

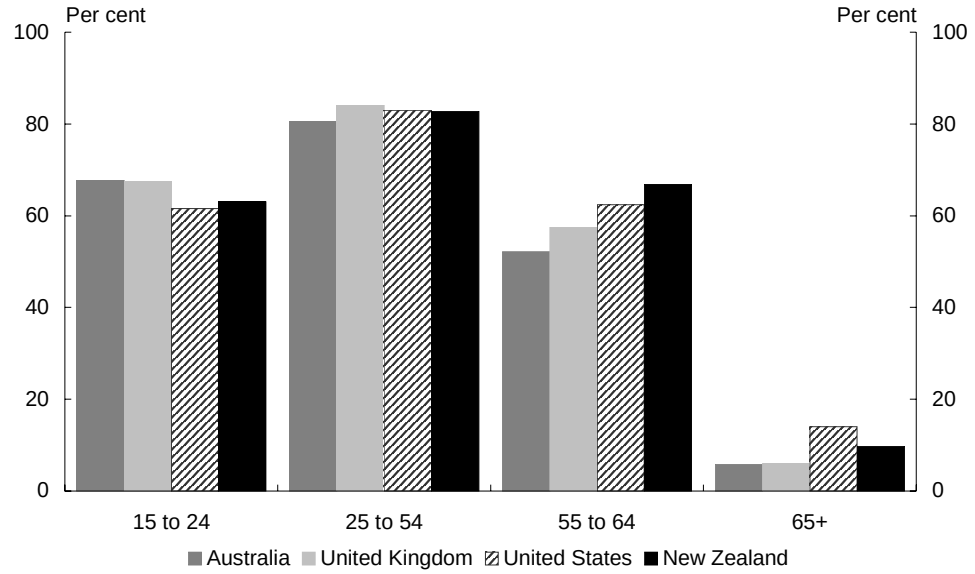
IMPROVING PARTICIPATION AND SHARING AUSTRALIA'S PROSPERITY

Households contribute to and share in the benefits of an increasingly prosperous Australia.

The entire community benefits from the output produced through work. This is true whether work is for an income or not. Many people gain a sense of worth from their work and enjoy greater opportunities for social engagement, which enhance both mental and physical wellbeing. Though not normally recorded in economic statistics, unpaid work within the home and by unpaid carers and volunteers contributes significantly to the community. Voluntary work is also an important path to paid employment for many people. Almost one-third of Australian adults undertake some form of voluntary work, contributing an average of more than 3 hours per week (ABS 2001). It is through paid work, however, that most people support their pre-retirement lifestyles and save for retirement, while contributing to measured economic growth.

The ageing of the population will slow the growth in living standards in coming decades unless productivity growth and labour force participation rates increase. Australia's overall labour force participation rate, the 12th highest in the OECD, remains modest by international standards (OECD 2004a). Labour force participation in Australia decreases markedly in older age groups. Some people retire or leave the workforce in their forties and fifties. While declining participation is consistent with the trend in other OECD nations, total participation in Australia for those aged 55 years and older is lower than the OECD average and well below that in the United States, United Kingdom and New Zealand (Chart 7).

Chart 7: Labour force participation rate by age, 2003



Source: OECD (2004a).

While the nature and extent of workforce participation is largely a matter of individual choice, such choices may be distorted by disincentives or obstacles to participation that impose unnecessary costs on individuals and society. Since 1996, the Australian Government has implemented a range of policies to support an individual's choice to engage in the labour force and remove disincentives to such participation. Among those policies are workplace relations reform, increasing assistance with child care, reforms to the income support and family assistance systems, income tax reductions and changed superannuation arrangements. Those reforms have helped improve participation rates.

Going forward, the ageing population will require even higher rates of participation. The Australian Government has identified three broad categories of policy reform that should promote higher participation rates:

- strengthening an individual's capacity to work through better health and education;

- improving incentives and removing barriers to undertake work, through welfare reform and creating more flexible and adaptable retirement income arrangements; and

- increasing the flexibility of the labour market, to facilitate greater employment options and encourage job creation.

While the full benefit of many of those reforms may not be measured for some time to come, they underpin and set the tone for ongoing efforts required to sustain current growth rates in Australia's standard of living.

Strengthening capacity

Education and training systems provide the skills and flexibility the workforce needs to meet the requirements of an increasingly dynamic and complex economy. Illness and injury, on the other hand, reduce workforce participation and limit lifestyle choices and overall wellbeing.

A skilled workforce

Education plays a critical role in allowing people to participate more fully in society. Education also has costs in terms of both the financial cost of acquiring the education and the time that students otherwise could have spent working or enjoying leisure. As with any investment, more is not always better. Education will be most effective when individuals and societies invest in the right people, the right skills and at the right time.

Australians have been investing steadily more time and effort into education (Box 2). Surveys suggest that higher levels of education and training are likely to increase labour force participation over time. In 2001 the labour force participation rate for people aged 25 to 64 with post-school qualifications was 85 per cent, but only 63 per cent for people who had no post-school qualifications (ABS 2003). Unemployment rates are also far lower for people with post-school qualifications.

Box 2: Australia's qualifications profile

Australians have become more highly qualified over the past few decades (Table 1). While older Australians are less likely to have been educated beyond lower secondary school than their peers within the rest of the OECD, the qualifications profile for younger Australians is very similar to their OECD counterparts.

Australia's overall qualifications profile is hollow in the middle. Fewer Australians complete upper secondary education than in the rest of the OECD, while more Australians hold either tertiary or only lower secondary qualifications. However, the qualifications profile for 25 to 34 year olds suggests this may be changing. Current upper secondary retention rates suggest that younger cohorts will be at least as well-qualified as 25 to 34 year olds are today.

Table 1: Highest qualification obtained, per cent by age group, 2002

	Age group				
	25-34	35-44	45-54	55-64	Total
Australia					
Tertiary	35.8	31.2	30.5	22.5	30.8
Upper secondary(a)	36.7	30.7	27.3	23.2	30.2
Lower secondary	27.5	38.1	42.2	54.3	39.1
Rest of OECD(b)					
Tertiary	30.7	26.9	25.1	19.0	26.0
Upper secondary(a)	43.8	44.1	42.7	38.3	42.6
Lower secondary	25.5	29.0	32.2	42.7	31.4
Difference(c)					
Tertiary	5.1	4.3	5.4	3.5	4.8
Upper secondary(a)	-7.1	-13.4	-15.4	-15.1	-12.4
Lower secondary	2.0	9.1	10.0	11.6	7.7

(a) Includes post-school non-tertiary qualifications.
(b) Excludes Luxembourg.
(c) Percentage points.
Source: Australian Government Treasury calculations based on OECD (2004a).

Education and training also support high levels of productivity. More highly trained employees are likely to be more innovative, developing and using new ideas and technology that can lead to new and better products or more efficient ways of working.

The Australian Government has implemented initiatives in recent years aimed at improving educational and skill attainment across all age groups. Ongoing reforms have enhanced greatly the scope, consistency and labour market responsiveness of the vocational education and training system. Participation in vocational education and training has grown strongly.

The Australian Government is building on earlier initiatives by establishing 24 Australian technical colleges, expanding school-based new apprenticeships,

increasing pre-vocational training places and increasing income support for new apprentices.

The Australian and state governments are negotiating new vocational education and training agreements to increase the flexibility of the training system. Planned reforms include removing impediments to user choice so that employers and employees have greater freedom to choose the training organisation that best suits their needs. Reforms also are designed to improve the responsiveness of the training system to emerging skill shortages by creating 20,000 new targeted training places.

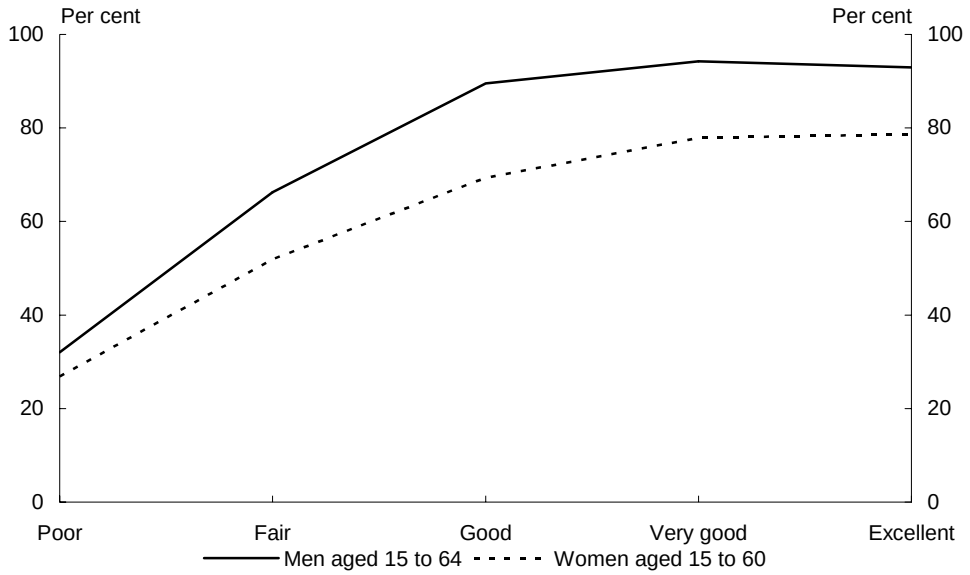
Even so, sometimes shortfalls in the supply of skilled workers may emerge for which the optimal solution may be targeted immigration. At such times, skilled migration is a useful complement to education and training initiatives. Skilled migration provides a rapid boost to the national skills pool, whereas education and training initiatives take longer to deliver skilled workers to the labour market. Accordingly, the Government will increase skilled migration in 2005-06 by 20,000, delivering a total skilled migration intake of 97,500.

A healthy workforce

In general, healthier people are likely to be more productive and have higher labour force participation rates, leading to potentially higher disposable incomes, wealth and general wellbeing (Chart 8). Healthier people are also more likely to respond positively to incentives to remain in the labour force beyond traditional retirement ages, participate in voluntary positions within the community upon retirement and require less assistance later in life. Deteriorating health is often associated with early retirement.

Employers also benefit from healthier workforces, not only through increased labour force participation and productivity, but from the reduced costs of lower rates of absenteeism due to ill health or disability. The community benefits from the fewer resources needed for health care and more widespread community engagement.

Chart 8: Labour force participation rate by health status



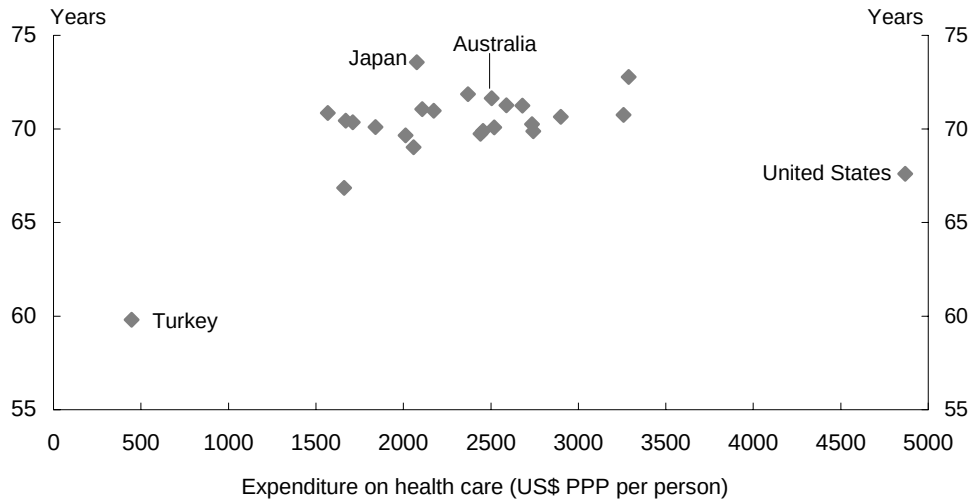
Source: Cai and Kalb (2004).

Chronic diseases, such as heart disease, cancer and diabetes directly reduce the wellbeing of sufferers and their carers, and have an adverse effect on the prosperity of the community through reduced participation and productivity. Those diseases are among the leading causes of death in Australia, yet many of them have preventable risk factors related to lifestyle, including tobacco use, excess consumption of alcohol, unhealthy diet and physical inactivity.

Australians are living longer, but have more health concerns. While life expectancy at birth increased from around 73 years in the latter half of the 1970s to 80 years in 2001, the proportion of Australians reporting long-term health conditions rose from 45 per cent to 78 per cent over this period (ABS 2002, 2004c; Australian Institute of Health and Welfare 2000). The trend is partly due to the increasing prevalence of lifestyle-related diseases and partly due to the development of treatments that alleviate previously fatal conditions.

Similar developments have increased health care expenditure in most OECD countries in recent decades. However, perhaps surprisingly, the level of health expenditure across OECD countries is not strongly correlated with the health of their populations (Chart 9). Australians enjoy longer, healthier lives than the populations of many countries, such as the United States, that spend more on health care. This suggests that better health outcomes are not necessarily the result of more expenditure and that factors such as the structure of the health system and active and healthy lifestyles can be more important.

Chart 9: Healthy life expectancy and health care in 24 OECD countries, 2001



Source: OECD (2004c); and WHO (2002).

Ultimately, individuals, families and communities make the lifestyle choices that can lead to the development of chronic disease. Governments cannot proscribe choices, but they can provide incentives and sanctions to encourage healthier lifestyle choices. For example, governments have imposed high excises on tobacco and restricted where people are permitted to smoke. In other areas there may be limited scope for incentives or sanctions, but governments have a role to provide relevant health promotion information. Governments also can aim to have a broad range of policies and programmes — including public transportation, parks, school curricula, town planning, as well as the health care system — that support healthy lifestyle choices.

The most cost-effective approach to many chronic illnesses is likely to be a population strategy that raises awareness, changes social attitudes and improves lifestyles, thereby removing or reducing the underlying causes that make the disease common (WHO 2002, 2004). With changing community attitudes, the maintenance of healthier lifestyles becomes easier for any particular individual as the healthier behaviour becomes more common place (Rose 1985, 1994).

The 2004 Building a Healthy, Active Australia package aims to promote better population health by encouraging children to adopt healthy habits for life. Analyses by Rose and the WHO suggest such programmes are likely to be even more effective in changing social attitudes were they extended to involve families and the entire community.

Improving incentives and removing barriers

While decisions to participate in the paid or unpaid workforce are necessarily personal they have impacts on the wellbeing of the nation through the relationship between

participation, economic growth and prosperity. These decisions are influenced by provision of income support, tax arrangements, retirement incomes policies and other incentives and barriers to participation.

Income support systems provide a social safety net. They also should aim to recognise an individual's desire to work by encouraging, promoting and assisting them to seek out and participate in paid work to the extent they are able. The challenge for government is to balance the set of incentives, assistance and requirements in such a way as to avoid creating cycles of dependency, while maximising the voluntary participation of people with diverse capacities and availabilities for work.

While labour force participation is currently at historic high levels, there is room for further improvement. Of the 14 million people aged 15 to 64 years, only about 10 million are currently in the labour force. Around 2.7 million receive income support, including sole parents, the unemployed and recipients of the Disability Support Pension (DSP).

Welfare system reforms and income tax reductions have improved the incentives to participate for most income support recipients. The 2004-05 More help for families package improved incentives for people to participate in the workforce. The 2001-02 Australians Working Together package included reforms to assist out-of-work people back into the workforce. They included introducing working and training credits, mutual obligation requirements for some job seekers and initiatives targeting parents, the mature aged, indigenous Australians and people with disabilities. Many of these groups of people have lower than average participation rates.

Despite the progress to date, more could be done to match incentives with individuals' capacities to contribute. Currently, only around one in six income support recipients are required to look actively for work. While a proportion of the remainder are involved in other important activities, such as education and family-related commitments, more income support recipients could participate in the labour market. This would improve the longer-term economic and social wellbeing of the individuals concerned and add to the prosperity of the community.

The OECD (2005a) has noted that the DSP, in part due to its generosity, may be used by some as an early retirement vehicle. It is paid at the same rate as the Age Pension and is significantly higher than unemployment benefits. More than 40 per cent of all DSP recipients in June 2004 were aged 55 or older, with just over 20 per cent of all recipients aged 60 or older.

In this budget, the Australian Government introduces additional reforms to the income support system to encourage further labour force participation. The further reform of the welfare system in this budget focuses on assisting those who have the capacity to work to do so, while maintaining an appropriate level of assistance to provide a minimum standard of living. The reforms achieve this through a balance of financial

incentives, obligations to look for work and a broad-ranging package of services to assist those who have been out of the workforce for an extended period.

An individual's decision to participate in the labour force is affected by both the additional income tax paid and the withdrawal of income support payments through income testing arrangements. Taken together, the interactions are described as effective marginal tax rates (EMTRs), although of course they are not actual tax rates.

EMTRs have fallen in recent years largely through reduced income tax rates and reduced family assistance taper rates. The changes particularly assist women wishing to re-enter the workforce after having children. In addition, the increase in thresholds for the top marginal tax rates has improved incentives for some workers to take on additional work, seek promotion and invest in further skills.

In this budget the Government has taken further steps to reduce EMTRs through relaxation of the income test for Newstart Allowance. This will reduce the current 70 per cent withdrawal rate to 60 per cent and increase the range of income over which the 50 per cent withdrawal rate applies.

With an ageing population, any improvement in the labour force participation of mature age workers will help sustain growth and prosperity. Governments can encourage and support individual choices to stay in the workforce beyond traditional retirement age.

It is very difficult to reverse retirement decisions, once taken (OECD 2003). Policy may more effectively encourage people still in the workforce to delay retirement. Consistent with this, the Australian Government has introduced a number of initiatives to encourage older workers to remain in the workforce, including tailored services to assist mature age job-seekers to find new employment and flexible assistance to help parents, carers or mature age people to find work. It also has removed the restriction on access to superannuation by those still in employment, enabling older workers to move gradually into retirement by supplementing reduced employment earnings with their superannuation entitlements. For workers older than 55 years the Australian Government has introduced the Mature Age Worker Tax Offset that provides an annual tax rebate of up to $500 on earned income.

Together those reforms are likely to have contributed to the recent increase in the labour force participation rates of those aged 55 years and older.

Enhancing flexibility

Through reform, what was a highly centralised and regulated workplace relations system in Australia has moved to one more focused on agreement making at the workplace or enterprise level. Today, only around 20 per cent of workers have their pay and conditions set directly by awards (ABS 2005d). This significant change has

increased enterprise flexibility and competitiveness and has contributed to the Australian economy's strong employment and economic growth over recent years.

Employees also can more easily negotiate working arrangements that suit their other commitments or lifestyle choices. The number of people choosing to work part-time has increased rapidly and this trend is likely to continue as the population ages.

The reforms provide a firm foundation, but there remains significant scope to do more. Greater flexibility in employment arrangements and conditions would promote workplace productivity and allow employers and employees to tailor wages and conditions to their specific skills and needs. This creates greater opportunities for people to find jobs, increase their incomes and respond positively to changing industry demands for labour.

The Australian Government has proposed further changes to workplace relations that reduce the degree of regulation around the termination of employment, address pattern bargaining, streamline agreement-making processes and simplify awards to promote workplace agreements.

MAINTAINING A DISCIPLINED APPROACH TO FISCAL POLICY

The challenges Australia faces in sustaining its economic performance will shape the direction of fiscal policy in the years ahead. The challenges will translate into additional pressures on public finances and will influence future decisions about the content of government expenditure programmes and the structure of the tax system.

As with households, governments must manage budgets so they can meet their financial commitments, including regular expenses and debt repayments, from current and expected future income. In many other developed countries, this will mean cutting spending or raising taxes to reduce government debt to levels that can be serviced through future tax and other government revenues.

Fortunately Australia does not face such stark choices. Responsible management of revenue and expenditure has resulted in a succession of budget surpluses. Those surpluses have been used to repay debt. Government debt is now at levels that are among the lowest in the OECD (OECD 2004b).

The task going forward is to ensure that policies safeguard the sound fiscal position and that budgetary decisions are consistent with promoting productivity and participation. This means maintaining a responsible approach to government expenditures and securing a tax base that can fund those expenditures in an efficient and equitable manner. It also means managing pressures and risks to revenue or expenditure so future governments can continue to provide essential goods and services in a manner that promotes fairness in distributing public resources between generations of Australians. Maintaining a responsible fiscal position is important to

maintaining low inflation and low interest rates today, thereby providing a more stable environment for households and firms to make investment decisions.

The ageing population, technological advancement in health care and rising community expectations about access to the latest medical treatments are likely to place significant pressure on government finances. In addition, pressure on public finances is likely to come from increasing community expectations around maintenance of our natural and man-made environment.

Maintaining a sound fiscal position will require governments to design programmes with a view to promoting productivity and participation, thus securing the viability of their revenue base. It will also require improved allocation of functions and coordination of programme delivery across the three levels of government so that publicly provided goods and services are delivered as efficiently and effectively as possible. A particular challenge in this regard will be to coordinate an approach to the delivery of infrastructure that pays regard to the appropriate balance between public and private provision, and develops the regulatory environment needed to support the latter.

Governments at all levels also will need to take a broader view of their balance sheets, taking greater account of the need to meet contingent liabilities and future pressures on the tax base and expenditures. As discussed in more detail in Statement 2, the Australian Government is taking steps to help offset the liability associated with unfunded public sector superannuation by establishing the Future Fund, comprising financial assets built up using current and future budget surpluses.

A key outcome of funding the superannuation liability will be to improve the Australian Government's net worth and financial sustainability. It will also change the measurement of financial performance — giving more attention to the evolution of the Australian Government's assets and liabilities over time, rather than simply current receipts and payments.

An approach to fiscal policy that focuses more clearly on improvements in the balance sheet recognises that many of the fiscal pressures governments face will arise decades into the future. The production of the 2002 Intergenerational Report, which assessed expenditure pressures, was an important first step in this direction. Ensuring fiscal sustainability will require longer term planning horizons than have been employed in the past. This requires a view of the likely path of the budget aggregates and a more detailed understanding of how individual programmes may contribute to fiscal pressures over the medium to longer term.

The sustainability of fiscal policy depends not only on decisions made in the budget, but on the range of economic and social policies needed to provide higher income levels into the future. Critically, Australia needs to take advantage of opportunities to secure higher national income through trade, including with growing economies such

as China and India. Australia's current fiscal position in part reflects the dividends of a positive international engagement strategy.

This budget has responsibly banked some of the additional revenue generated by higher export prices to help meet the fiscal challenges ahead.

CONCLUSION

The sustained strong performance of the Australian economy over the last decade has meant that Australians are enjoying increased prosperity and wellbeing. The strong performance has been underpinned by a sustained reform effort aimed at improving productivity and labour force participation.

The strong economy, combined with a sound fiscal outlook, presents a unique opportunity to develop and implement a cohesive policy agenda for making even better use of our natural, man-made and human resources, thereby locking in future growth and prosperity. The opportunity should not be wasted because strong growth and sound policies will be the best weapons against the impact of an ageing population and other future known and unknown challenges.

Some of those policies will build on and refine past reforms. Some challenges will take policy into new areas or new directions. In all areas, the challenge is to identify barriers to sustained economic growth and to engage individuals, businesses and governments in implementing appropriate solutions.

The success with which governments implement such policies, and how well individuals and businesses respond to them, will determine the extent to which Australia achieves strong economic growth and prosperity now and over the decades to come.

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