

Current Issues Brief
No. 6 2004–05

The 2004 Budget: some issues arising

Every Budget raises a host of issues and generates a good deal of discussion. This paper examines just a few of the issues arising out of the 2004 Budget.

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9 August 2004

ISSN 1449-8472

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Acknowledgements

Thanks to the participants of a workshop held on 15 July 2004.

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Published by the Information and Research Services, Parliamentary Library,
Department of Parliamentary Services, 2004.

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Glossary

Accrual accounting. The system which brings to account both monetary (for example, salary payments) and other activities (for example, depreciation of assets and increases in long service leave liabilities) in the period when they are incurred. Accrual accounting differs from cash accounting, which recognises only monetary transactions and only when such a transaction takes place. Accrual accounting includes the value of future obligations that are being created as a result of present activities. It includes information about revenues, expenses, assets and liabilities that cannot be obtained by cash accounting.

Accrual Budget. A comprehensive Budget incorporating assets, liabilities, expenses and revenues, not just monetary receipts and payments. Accrual Budgeting extends cash Budgeting by incorporating all resource implications such as depreciation and increases in liabilities.

Budget aggregates. Refers to totals of revenue, expenses and the Budget balance (surplus/deficit).

Budget balance. The term used to refer to a Budget outcome, whether a surplus or deficit. The 'fiscal balance' in accrual Budgets is the counterpart of 'underlying cash balance' in cash Budgets. The Budget Papers contain both the fiscal balance and the underlying cash balance. The fiscal balance shows the financial impact of the government's activities while the cash balance gives a better indication of the macroeconomic impact of the budget.

Cash balance. Cash balance (which can be a cash surplus or cash deficit) is the budget outcome in cash terms, the sum of all cash receipts minus all cash expenses. This is to be distinguished from the fiscal balance, an accrual concept.

Commonwealth Government Securities (CGS). CGS are Treasury notes and bonds issued by the Commonwealth Government. Treasury Notes are short-term debt securities and are mainly issued to fund the Commonwealth's within-year financing needs. Treasury Bonds are a medium to long-term debt security that carry an annual rate of interest fixed over the life of the security, payable in six monthly instalments. Notes and bonds are actioned by the government as required.

Contractionary policies. Contractionary policies refer to monetary and fiscal policies designed to slow down the level of economic activity. That might be necessary if, for example, the economy is regarded as growing too rapidly with the consequent risk of inflation.

Economic parameters. The values of economic variables—such as movements in prices, wages, employment, and interest and exchange rates—on which the Budget and forward year's estimates are based. Parameters are based on the forecasts of the Joint Economic Forecasting Group.

Effective marginal tax rate (EMTR). The marginal tax rate refers to the additional tax on the additional dollar of income. Just above the \$6000 income threshold the marginal tax rate is 17 per cent or 17 cents in the dollar. The *EMTR* refers to the combined effect of the marginal tax rate itself as well as the withdrawal of social security benefits as the beneficiary's income increases. The combined effect of benefit withdrawal and the tax system can imply a very heavy penalty for the additional dollar of private income.

Estimates. Expected expenses and revenue of the Commonwealth. Expense estimates are prepared for each item in the Budget in consultations between the Department of Finance and Administration and the agency responsible for program delivery. Treasury prepares tax revenue estimates.

Expense. Total value of all of the resources consumed in producing goods and services. Expenses include cash items such as salary payments as well as expenses that have been incurred—such as accruing employee entitlements—which will be paid in the future.

Fiscal balance. In accrual Budgets, the difference between the operating surplus and net investment in fixed assets. It is equivalent to government revenue less expenses less net investment in fixed assets. The fiscal balance measures the government's net relationship with other sectors of the economy. A surplus, for example, indicates that the Commonwealth is reducing its net debt to other sectors. The fiscal balance is thus an indicator of the financial impact of the Commonwealth's operations on the rest of the economy.

Fiscal policy. The use of government spending and taxation to influence the level of economic activity. 'Discretionary' fiscal policy seeks to counter cycles in the economy.

Fiscal stimulus or impact. The set of spending and taxation arrangements in the budget will have an effect on the private sector of the economy that may be stimulatory or contractionary. A measure of the fiscal stimulus or impact is an attempt to quantify the stimulatory impact of the budget.

Forward estimates. Estimates of the revenues and costs of on-going Government policy after allowing for estimated movements in parameters. The forward estimates do not include provision for new programs or expansion of existing programs that the Government has not yet agreed to. Nor do they include programs that are due to cease. Forward estimates are a system of rolling three-year financial estimates. After the Budget is passed, the first year of the forward estimates becomes the base for next year's Budget bid, and another out-year is added to the forward estimates.

Growth dividend. Higher economic growth tends to be associated with improved budget balances due to the higher tax receipts as well as reductions in the need to assist job seekers when the economy is buoyant. Improved surpluses can be regarded as a 'dividend' that might be used to increase expenses or cut taxes.

Joint Economic Forecasting Group (JEFG). A group of officials from Treasury, Department of the Prime Minister and Cabinet, Department of Finance and Administration, Reserve Bank of Australia and Australian Bureau of Statistics. The group meets three or four times a year after the quarterly national accounts are released to review official economic forecasts. JEFG examines economic forecasts in light of the economic outlook for the remainder of the Budget year and the following year.

Keynesian. After the English economist, John Maynard Keynes, who is associated with macroeconomic policies designed to stabilise the economy, especially the use of stimulatory fiscal policies to counter unemployment.

Liquidity. Generally refers the amount of cash in the economy and the ease of converting other assets into cash. The more liquid is the financial system, the easier it is for people to raise the funds they need to undertake their spending plans.

Micro reform. Microeconomics is the study of the smaller economic units such as the firm, industry, market, consumer and worker. Micro reform refers to economic policies designed to address concerns at the level of those units, generally using market forces or pro-competition policies and addressing regulations that influence decisions made by those units.

Mid-Year Economic and Fiscal Outlook (MYEFO). Essentially an update of the Budget estimates. The MYEFO takes account of actual trends in spending and revenue in the year to date and revenue or expense decisions taken since the Budget. The MYEFO is published around November.

Monetarist. Monetarist refers to the policies that emphasise controlling the money supply or people advocating those policies.

Net debt. Net debt is the difference between all outstanding debt and the value of financial assets held. Net debt is a narrower concept than the Commonwealth's net worth which also include equity, such as the Telstra holding, as well as non-financial assets such as land, buildings, plant and equipment etc. Major negative items such as superannuation liability and other employee entitlements and provisions are also excluded in net debt but are included as negative items in net worth.

Projections. In the Budget Papers 'projections' refers to future revenues, expenses and other magnitudes that are based on simple extrapolations of past trends in GDP, employment, prices and other relevant magnitudes. By contrast estimates are based on specific forecasts of the economy. For example, estimates of revenue in 2004–05 in the 2004 Budget are based on forecasts of how the economy is expected to behave in that year. However, for years beyond, projections are made on the assumption that economic growth and other parameters are likely to behave as they have on average in the past.

Revenue. Revenue in this paper refers to the taxation collected by the government and other current receipts of the government. Receipts on capital account, such as the proceeds of asset sales, are not included.

Tax expenditures. The financial benefits that individuals and businesses derive from tax concessions in the forms of exemptions, deductions, rebates or reduced rates. Concessions reduce or delay the collection of tax revenue. Governments can use concessions to allocate resources to different activities in much the same way that they can use direct spending programs.

Underlying (cash) balance. The cash budget counterpart of the fiscal balance in accrual Budgets. The underlying cash balance is a broad indicator of the Commonwealth's cash flow requirements. For example, an underlying cash surplus reflects the extent to which cash is available to the Commonwealth either to increase its financial assets or decrease its liabilities (assuming no revaluations and other changes occur). The underlying balance differs from the 'headline' balance—the actual cash outcome—by, for example, excluding proceeds from the sale of assets on the grounds that these are one-off or abnormal items.

Executive summary

The 2004 Budget was the ninth under the present Treasurer, Peter Costello. Each Budget raises a multitude of issues and this paper aims to outline the main features as well as raise four issues arising from the 2004 Budget. Those issues are:

1. The macroeconomic impact of the Budget.
2. The consequences of issuing more debt than necessary to support the market in government bonds.
3. The question of unemployment and economic policy.

For 2004–05 the Budget is expected to produce a modest surplus of \$2.4 billion. Further surpluses are forecast through to 2007–08. Economic growth and other favourable conditions have delivered surpluses and allowed new spending and tax initiatives worth \$37 billion over a four-year period. The main items include personal tax cuts, increases in the family tax benefit, security and defence initiatives as well as additional spending on education, health, age care and transport. The delivery of some benefits as relatively large one-off payments is a new development.

The impact of this Budget on the economy and employment will reflect the fiscal impact itself as well as any ‘incentive effects’ due to changing tax and benefit arrangements. There have been claims that the incentive effects in the 2004 Budget will encourage labour market participation. On the other hand, independent research by the Melbourne Institute of Applied Economic and Social Research claims the incentive effects may well be negative. It is suggested that the higher return on additional work is offset by the need to work less to attain a target income.

Commentators have been concerned about the size of the fiscal stimulus in the 2004 Budget. Those concerns are likely to be overstated. This Budget was framed in the context of better than expected budget balances. However, higher budget surpluses meant that the previous Budget was in fact much less stimulatory than previously thought. At least some of the new initiatives would have offset a relatively contractionary 2003 Budget. Apart from that, the Budget was heading for unsustainable surpluses that had to be trimmed.

The Government’s net debt is now around \$26 billion. However, the Government has borrowed \$66 billion and has various forms of debt on issue. With the difference the government has accumulated financial assets worth \$40 billion. On that \$40 billion it has earned \$1014 million while its borrowing costs were \$2362 million giving a loss of \$1348 million. That loss could be prevented by liquidating its financial assets and repaying debt, or alternatively, improving the earnings performance of its portfolio.

This year the Budget Papers included a Statement on the question of unemployment. Australia currently is experiencing unemployment below 6 per cent. The Statement

suggests that better outcomes from now on can be expected as a result of the micro reform agenda that has produced a more flexible labour market. That thesis does not explain the 2 per cent average unemployment rate in the first half of the postwar period compared with the average of 7.5 per cent in the second half.

Whatever the impact of the micro reform agenda, there was also a fundamental shift in economic policy half way through the postwar period. Immediately after the war there was a consensus that governments could and should intervene in the economy to try to reach full employment. That period came to an end with the 'monetarist' doctrine—the belief that governments should not intervene in the economy other than by trying to keep the money supply constant. Peaks in unemployment have been associated with contractionary monetary and fiscal policies. Between the last major unemployment peak and the present, monetary policy has been more accommodating and fiscal policy has occasionally assisted.

There has been a debate about whether or not the GST is a Commonwealth tax. The Government argues that the GST is a State tax and all tax collected is simply passed on to the States and Territories. However, the Auditor-General and others argue that the GST is a Commonwealth tax. If it is then it should be included as such in the Budget Papers. If the GST is included in Commonwealth revenue then the effect is to add around 4 per cent of GDP to the size of Commonwealth Government revenues.

Main features

On 12 May 2004 the Treasurer, Peter Costello, brought down his ninth Budget. The Budget estimates a cash surplus of \$2.4 billion or 0.3 per cent of GDP. This is the seventh cash surplus under Costello. The fiscal balance is also in surplus at \$0.7 billion or 0.1 per cent of GDP as a result of revenues estimated to be \$193.2 billion, compared with expenses of \$192.3 billion. As a share of GDP, revenue is estimated at 22.5 per cent and expenses virtually the same at 22.4 per cent. Revenues have increased by 3.8 per cent and expenses by 5.0 per cent above the 2003–04 estimates. Note that since the Budget is brought down in May, figures for 2003–04 are estimates and subject to revision in the *Final Budget Outcome*, which in 2003 was published in September.

The projections also anticipate further positive fiscal balances and surplus cash balances in the years 2005–06 to 2007–08. The actual projections are provided in Table 1.

Table 1. Budget features—\$billion

	Estimates		Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08
revenue	186.2	193.2	201.4	212.2	223.1
expenses	183.1	192.3	200.6	210.0	220.9
capital investment	0	0.1	0	-0.1	-0.4
fiscal balance	3.0	0.7	0.7	2.3	2.6
underlying cash balance	4.6	2.4	1.6	3.4	4.5
Budget features — % GDP					
	Estimates		Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08
revenue	23.0	22.5	22.2	22.2	22.1
expenses	22.6	22.4	22.1	22.0	21.9
capital investment	0	0	0	0	0
fiscal balance	0.4	0.1	0.1	0.2	0.3
underlying cash balance	0.6	0.3	0.2	0.4	0.4

Source: *Budget Strategy and Outlook 2004-05, Budget Paper No 1.*

The Australian economy has experienced a continuous period of strong economic growth since the early 1990s, interrupted only by the brief hiccup due to the introduction of the GST in 2000-01 and associated changes in other taxes. That strong economic growth has been favourable to revenue and has kept expenditure down, especially in social security and welfare.

The 2004-05 Budget included substantial initiatives that gave rise to *The Australian Financial Review* headline ‘Costello’s \$37 bn vote grab’.¹ That figure, \$37 billion, is equal to the impact of the revenue and expenses initiatives, or policy decisions, in 2003-04, the Budget year 2004-05, as well as the forward estimates for 2005-06 and 2006-07. The new initiatives in those years have the cumulative effect of reducing the budget balance by \$37 billion. However, that is largely paid for by much higher than expected surpluses due to economic growth and other factors that might be referred to as the ‘growth dividend’. In effect there was a huge error in the Government’s favour. Economic growth and other factors caused the surplus to be much higher than estimated by increasing tax revenues and reducing spending in areas sensitive to the state of the economy.

Any error in the estimates is put down to ‘parameter and other variations’. In principle that phrase refers to things like a growth or inflation rate that differs from the forecast and so interferes with estimates of tax collections and various spending items. There may also be errors in forecasting average tax rates, take up rates for spending programs, and a host of other factors. As result of ‘parameter and other variations’ the Budget balance from 2003-04 to 2006-7 was due to be \$29 billion higher than forecast in December 2003 when the 2003-04 Mid-Year Economic and Fiscal Outlook (MYEFO) was published. That \$29 billion comes on top of the \$17 billion improvement in the budget balance due to parameter and other variations between the May 2003 Budget and the December MYEFO.

All in all, before the policy decisions, there was an improved budget balance of \$46 billion over the span of years from 2003–04 to 2006–07.

Two main observations follow from the above. First, there seems to be an unusually large error in the earlier forecasts. The error is well over one per cent of GDP. Some of that is due to the underestimate of the performance of the economy, but GDP growth in the 2003 Budget was forecast to be 3.25 per cent in 2003–04 compared with the 3.75 per cent now expected. That does not seem to be a sufficiently large difference to explain a forecast budget improvement since May 2003 of \$9.5 billion just for 2003–04. The implication seems to be that the bulk of the error in estimating the surplus could not be explained by economic parameters. Even if the economic variables had come in exactly as forecast there would still have been a significant error in the revenue and expenses estimates. This does not appear to be an isolated event. The last four Budgets have underestimated eventual revenue outcomes by \$5.5 billion on average.²

The second important implication is that if no policy changes were made, it would have meant that the budget surpluses would have reached almost \$16 billion per annum by 2006–07.³ Without returning that revenue, there would have been a massive withdrawal of liquidity from the private sector. A withdrawal of liquidity at that rate would not have been sustainable. The implication is that the main problem facing the Government was always going to be how to return a massive improvement in the budget balance. The surplus can be returned through tax reductions, increases in expenses or some combination of the two.

This Budget returns the growth dividend with personal tax cuts and other revenue measures worth \$15.6 billion. That figure and the others in the rest of this paragraph refer to the span of years 2004–05 to 2007–8. Almost all the reduction in revenue is due to the reductions in personal taxation worth \$14.73 billion and incentives to save for retirement at \$0.61 billion. The Budget also increases outlays by \$29.8 billion. Of that, \$17.2 billion goes towards increases in the family tax benefit (FTB), payments on the birth of a child and the superannuation co-contribution for low-income earners.⁴ In addition, security issues receive additional resources in this Budget with additional expenses of \$1.4 billion in Attorney-Generals and \$1.6 billion in Defence. Additional spending in Education, Science and Training is \$1.5 billion; in Health and Ageing, \$2.6 billion; while Transport and Regional Services receives an additional \$2.1 billion, mainly as a result of the AusLink initiatives.⁵

With the impact of the tax cuts and FTB measures, the Treasurer has summarised this Budget as one designed to ‘meet the challenges for families, for our ageing population, for retirement incomes and to improve incentives...’⁶ The Secretary of the Treasury, Ken Henry, also stressed the importance of incentives in a recent speech.⁷ Those themes are taken up below.

A controversial feature of the present Budget is the use of lump-sum payments to assist families with children. An example is the one-off \$600 cash handout to FTB recipients to

be paid before the end of the financial year and, in subsequent years after the lodgement of tax returns (to verify family income). This is a rare method of providing additional assistance to those considered in need of extra financial assistance. Normally extra assistance for low-income families is provided by way of a payment rate increase or changes to the income test arrangements. Perhaps the only precedent for a one-off cash handout is the \$1000 one-off payment provided to those on age pension before the November 2001 election.⁸ Another precedent, but overseas, is the child tax credit (which US President George Bush increased from \$600 to \$1000 in 2003). This tax credit is payable to low to middle income earners with children as a refund at the end of the financial year. This was introduced in the Jobs and Growth Tax Relief Reconciliation Act of 2003.⁹

Macroeconomic impacts

The macroeconomic impact of the Budget will reflect both the fiscal stimulus itself and any behavioural changes likely to follow the change in incentives provided for in the Budget. The fiscal stimulus works in two ways. First, taxpayers will have more money in their pockets that they are likely to spend on additional goods and services thereby boosting income elsewhere and so generating second round spending effects. In this way the initial increase in income generates subsequent increases in spending and income in a continuing process. The second round and subsequent rounds of income and spending are part of the 'multiplier' effect brought about by the initial stimulus through the tax cuts. Press reports suggest that the family payments were being paid into bank accounts and run down, presumably to be spent over the following week.¹⁰

The direct spending in the Budget will also provide a stimulus. In that case the increase in spending is experienced first by suppliers of goods and services to government, as well as new employees.

In addition to the fiscal stimulus there are also incentive effects that can change macroeconomic outcomes. Henry recently emphasised that lower 'effective marginal tax rates' (EMTRs) will encourage people to move into the workforce, and, if already in it, to work longer hours.¹¹ That is the 'incentive effect' contained in the Budget. On the incentive issue, Henry said:

The centre-piece of this year's budget is a package of enhanced family payments and tax cuts. Significantly for the pro-growth strategy, the package reduces effective marginal tax rates (EMTRs) in important areas: cutting the marginal tax rate from 42 per cent to 30 per cent for those with taxable incomes between \$52,000 and \$63,000; cutting the marginal rate from 47 per cent to 42 per cent for those with taxable incomes between \$63,000 and \$80,000; and cutting the withdrawal rate on family tax benefits from 30 per cent to 20 per cent, building on the earlier cut from 50 per cent.

Continued reductions, over time, in EMTRs will be important to enhancing incentive – to boosting workforce participation, especially of older workers, the internationally mobile and females.¹²

Accordingly Henry sees the Budget as strongly pro-growth since it gives a central role to policies that enhance productivity and growth. It is, of course, impossible to put a precise number on the size of that effect. The effect may even be negative in theory. That is because there are two competing forces. On the one hand lower marginal taxes make additional work more attractive. On the other hand, lower taxes mean that less work is required to reach a target income. Economists refer to these as the ‘substitution effect’ and the ‘income effect’ respectively. These terms are further explained in the box below. A belief that lower marginal taxes encourage greater participation in the workforce suggests a belief that the substitution effect is stronger than the income effect.

The Melbourne Institute of Applied Economic and Social Research has examined the actual incentives in the tax cuts and family package and concluded that the incentives were actually likely to reduce labour force participation. There was indeed an increase in incentives to work which had the effect of increasing labour force participation. However, offsetting that was the negative effect of the ‘income effect’ of the FTB. The FTB increases incomes of low income families with children and so, within limits, it reduces the amount of labour force participation required to reach a target after-tax income.¹³ That can offset the ‘substitution effect’ due to the reduced effective marginal tax rates.

‘Substitution Effect’ and ‘Income Effect’ explained

The ‘substitution effect’ refers to the possibility that a change in relative prices is likely to cause a shift in purchases from the relatively more expensive to the relatively less expensive item. In the present context, there is an increase in the after-tax income to be derived from any additional hours spent at work. That on its own would imply a switch towards additional hours of work.

The ‘income effect’ abstracts from the ‘substitution effect’ and refers to changes in behaviour due to a change in purchasing power or income that may be associated with, for example, a change in relative prices. For example, a reduction in food prices may mean people feel better off and so spend more on coffee. In the present case the income effect refers to possible changes in people’s work effort when the tax and other changes make them feel better off. An individual may take a higher income or additional leisure or a bit of both.

Of course it has to be pointed out that all of the above assumes that the individual is free to choose whether or not to work and, if the decision is work, then the individual is free to decide their hours of work. It is very rare that people face such a wide array of work options. In addition, by putting all of the analysis in terms of the choices facing individuals there is the risk that work tests and other factors are ignored.

The fiscal stimulus is a more difficult concept to measure. The fiscal stimulus in the budget has to be measured in such a way that abstracts from changes in the budget balance due to changes in the economic environment. For example, a lower level of economic activity and high unemployment is associated with a higher deficit/lower surplus not because the budget settings have changed but because the lower level of activity is associated with lower tax collections and higher social security payments. The stimulus is

difficult to measure in an absolute sense but it is easier to compare one budget with another by looking at the discretionary changes from year to year. Table 2 compares the stimulus in the 2004 Budget with the stimulus in the 2003 Budget.¹⁴ This table also relies on forecasts of GDP over the years to 2006–07. To obtain those the latest available GDP figures are used and then updated using the forecasts and projections given in *Budget Paper No 1*.

Table 2. Estimated fiscal stimulus, 2004 Budget compared with 2003 Budget

		\$b	% GDP
estimate	2003–04	7.202	0.88
estimate	2004–05	9.617	1.11
projections	2005–06	11.883	1.30
projections	2006–07	13.515	1.39

Source: 2004–05 Budget Paper No. 1; ABS, *National Income, Expenditure and Product, December quarter 2003*, Cat no 5206.0.

According to table 2 the present Budget is quite stimulatory compared with the 2003 Budget settings. However, that begs the question of just how much stimulus there was in the 2003 Budget. It is likely that the 2003 Budget turned out to be much more contractionary/less stimulatory than thought at May 2003. That would account for the significant underestimation of the size of the surplus. Economic growth was also higher than expected by 0.5 per cent of GDP. However, that would not account for large errors of, for example, \$11.5 billion in 2004–05, around 1.3 per cent of GDP. The additional surplus from the higher growth in GDP is likely to be of the order of 0.25 per cent of GDP. So it appears that the stimulus in the 2004 Budget (compared with the 2003 Budget) does little more than compensate for the error in estimating the surplus arising out of the 2003 Budget. That error in effect produces an unintended contractionary impact.

In the present Budget Papers there is no explicit justification for any stimulus provided. However, in the 2002–03 Budget there is a justification for a stimulatory budget. It says:

Expansionary fiscal policy settings in 2000-01 and 2001-02 helped Australia maintain solid economic growth relative to other developed countries during a period of weakness in the international economy. It is estimated that there was a stimulus of around 1 per cent of GDP in those years. In 2000-01, this principally arose from income tax cuts introduced under *The New Tax System*.

A large part of the stimulus in 2001-02 was unavoidable given the impact of high priority defence and domestic security expenditure. This outcome is appropriate given Australia's recent economic circumstances and international developments. It is consistent with the Government's medium-term fiscal strategy, which allows the budget to respond flexibly to short-term developments.¹⁵

In considering the present stimulus in the Budget, it is also worth noting that it was designed in the context of a slowing down in economic growth from 3.75 per cent

estimated for 2003–04 to 3.25 per cent in the year to June 2005. Had the relative contractionary stance been allowed to continue then, the slowdown could have been somewhat worse. Incidentally, there have been critics of the stimulus in the present Budget.¹⁶ But it needs to be pointed out that the alternative of high surpluses into the future is probably not sustainable. Without the policy changes since May 2003, the surplus would have been around \$16 billion by 2006–07. As noted above, that would imply a very significant annual withdrawal of liquidity from the Australian economy.

The Government as a financial institution

This section of the paper attempts to raise an issue that does not appear to have been discussed elsewhere. As at 30 June 2004 it was estimated that net debt on the part of the Commonwealth was \$26 billion. This figure is arrived at by taking government securities on issue plus other similar loans and deducting certain Commonwealth assets: cash and deposits, advances paid, and financial investments, loans and placements. All up, government bonds and other loan-like instruments are worth \$66 billion and from that are deducted financial assets worth \$40 billion to get the net debt figure of \$26 billion.¹⁷

Already the Australian Government has become a large financial institution. By definition a financial institution is an organisation that borrows in order to lend. The Commonwealth Government has borrowed \$66 billion and lent \$40 billion on the above figures. Of course, most financial institutions make a good part of their profit by paying a lower interest on their debt than they earn on their assets. If we examine the Commonwealth Government to see how successful it is as a financial institution the results are interesting. On its debt of \$66 billion at the end of 2003–04 it expects to pay interest of \$3888 million in 2004–05, or 5.86 per cent. However, on its assets the Commonwealth is earning \$1014 million or 2.52 per cent.¹⁸ What that seems to indicate is that the Commonwealth is not very successful at financial intermediation.

Putting that differently, on the net debt of \$26 billion the Commonwealth expects to pay net interest of \$2873 million or 11.04 per cent. However, had the Commonwealth at least broken even and earned the same return on assets as it paid on debt then net interest would have been \$1525 million, a saving to the Budget of \$1348 million. The same savings would be obtained if the \$40 billion in assets were liquidated and used to pay off debt. Unfortunately paying off that debt may not be consistent with the Government's aim of maintaining a market in Commonwealth Government Securities (CGS) even though it is in a position to liquidate most of the CGS. In the Budget Papers the Government announced the results of a review of the CGS market. It said that it 'would maintain sufficient CGS on issue to support the Treasury bond futures market'.¹⁹ The idea is that there are a number of good reasons to maintain the CGS market since government bonds provide a reference point as the one solid and absolutely safe financial instrument denominated in Australian dollars. There is no risk that the Government will not be able to meet its obligations when expressed in A\$. Hence interest rates on government bonds are the pure risk-free interest rate that the market can use as a benchmark against which other interest

rates can be compared. Traditionally it has been accepted that governments assist the financial markets when they operate an orderly government bond market. But the benefits should not be exaggerated; the financial markets would cope with the absence of a CGS market.²⁰ Following the review the Government held consultations with and received submissions from interested parties arguing that there were indeed benefits in keeping the market going (see box).

Benefits of a healthy government bond market

The obvious benefit of a healthy government bond market is the opportunity for investors to purchase securities that give an income yet can be regarded as completely risk free. There is no other asset available to investors that gives absolutely safe and guaranteed returns in Australian dollars. The benefits of having a healthy CGS market include following:

CGS are an attractive long-term investment vehicle, particularly for superannuation funds, life offices and other institutional investors.

CGS assets provide a safe alternative during periods of heightened instability.

CGS are used as the reference point for pricing the other securities, some of which may be expressed as 'bond rate plus x'.

The main rationale addressed in the Budget Papers was that the absence of a CGS market would imply 'slightly higher interest rates, given the current state of development of Australian financial markets. This would result primarily from the higher costs associated with managing interest rate risk without a Treasury bonds futures market'.²¹

What has to be recognised is that there is a very large cost associated with maintaining CGS on issue at the same time as the Government is in a position to liquidate a lot more of it. The present strategy of not paying off debt so as to keep CGS on issue also means that the Government is not able to obtain much of an on-going benefit from its history of budget surpluses. It is reasonable to ask if it is worth \$1.3 billion per annum as the cost of keeping the CGS market alive; perhaps that is too expensive given the rather minor benefits. The alternative is to better manage the government's financial assets to improve the returns above the 2.52 per cent indicated above.

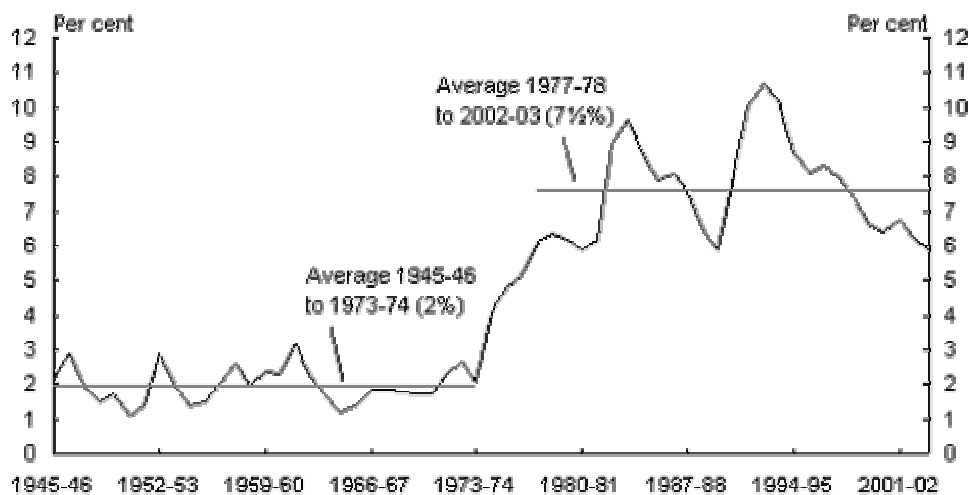
Judging by the interest expected to be paid on debt in future years, there is not likely to be any major reduction in the CGS on issue, even though net debt is expected to decline further and in fact turn negative in 2007–08. What that implies is that the present cost of maintaining CGS on issue is likely to increase in future years. Of course, future net debt figures depend critically on whether or not the Government is able to sell the rest of Telstra. At the moment the Budget Papers assume Telstra will be sold which implies a rapid reduction in net debt in the near future.

Low unemployment and economic policy

Since the 2001 Budget the Budget Papers have been including a Statement on an important aspect of the Australian economy. In earlier years the topics were: 'A more productive Australia', 'Australia's terms of trade', and 'Sustaining growth in Australia's living standards'. This year's Budget Papers contain a Statement on unemployment in Australia.²² The Statement makes the important point that the recent experience of unemployment below 6 per cent is fairly unique. Similar experiences of unemployment below 6 per cent have been rare and brief since the 1970s. Moreover, each time they occurred they were soon followed by subsequent slumps with large increases in unemployment. The Statement expresses an optimism that the present experience will persist, at least in part because the labour market is now more flexible. The more flexible labour market follows two decades or more of micro reform.

A problem with the low unemployment, flexible labour market thesis is apparent from the graph at almost the beginning of the Statement and reproduced as figure 1. Presumably the period before the micro reform agendas was characterised by more rigidity in labour markets. Since World War II unemployment remained very low (by modern standards) for almost three decades. Over that period unemployment averaged 2 per cent. The second half of the postwar period has a much higher unemployment rate averaging 7.5 per cent. Looking at just the second half it is very difficult to discern any overall downward trend in unemployment.

Figure 1. Australia's unemployment rate, 1945-46 to 2003-04



Source: *Statement No 4: Maintaining low unemployment in Australia, 2004-05 Budget Paper No 1.*

There does not appear to be a lot in figure 1 that supports an overall impression of micro reform leading to more labour market flexibility which in turn leads to lower unemployment. The Statement also makes the point that the greater labour market flexibility now is likely to mean that Australia will be able to avoid the imbalances that began to undermine earlier episodes of unusually low unemployment. Hopefully unemployment will remain below 6 per cent for a long time into the future.

Figure 1 invites another observation. The early postwar decades were dominated by the Keynesian consensus—the notion that governments can and should manage the economy so as to produce full employment. The consensus applied in Australia as well as the major overseas economies. Arguably the trends overseas were at least as important for Australia as Australia's own economic policies. The Keynesian consensus was blown apart by the monetarist revival that began to influence policy makers in the mid to late 1970s. The monetarists asserted that any government intervention in the economy was likely to be counter productive and governments should resist the temptation to do things, apart from keeping the money supply under control. Figure 1 also invites the hypothesis that the end of the postwar Keynesian consensus, along with the adoption of monetarism, has been extremely damaging to the economy. Indeed, of the major increases in unemployment on the graph, all were associated with increasing interest rates at the time. Indeed, prior to that Australia's worst experience was the upward blip in 1961 associated with a credit squeeze.

The period from the mid 1970s to the early 1980s saw interest rates increase and contractionary fiscal policies.²³ By contrast, the last decade or so has been associated with generally solid economic growth. However, growth did slow somewhat and produce upward blips in unemployment in 1995–96 and 2000–01. These were both associated with some previous tightening of official interest rates by the Reserve Bank. Those two blips were blemishes in the downward trend since the peak unemployment of 10.9 per cent in December 1992 following the very high interest rates of 1989 and 1990. Despite those blemishes the trend since the early 1990s has been towards both lower interest rates and lower unemployment. Arguably Australia has benefited from a more accommodating monetary policy since the early 1990s, just as the accommodating monetary policy of the US was extremely beneficial through the 1990s. In addition, as noted above, fiscal policy has also been supportive as required in recent times.

The GST

The Auditor-General and a number of commentators in the past have made the point that the GST is a Commonwealth tax even though the Government refuses to recognise it as such.²⁴ For that reason the GST does not appear in tax aggregates published in the Budget papers as Commonwealth taxation. Arguments for putting the GST on the Commonwealth books include the fact that it is provided for in Commonwealth legislation and only the Commonwealth can change it. The present Budget includes a measure to 'simplify the movement from annual to quarterly Pay As You Go (PAYG) instalments'.²⁵ The fact that

the Commonwealth is interested in making policy initiatives that affect the GST would seem to make it even harder to sustain the case against treating it as a Commonwealth tax.

Table 3 has been prepared to show how the Budget revenue appears if the GST receipts are included. The Budget Papers contain the estimates for Commonwealth receipts and GST revenue for 2003–04 and 2004–05 as well as projections for 2005–06 through to 2007–08. It is also useful to show those figures as a share of GDP. The financial year GDP figures are published through to 2002–03. Those are then updated in table 3 by applying the economic parameter estimates and projections given in the Budget Papers. Projections of receipts as a share of GDP differ slightly from the official projections, but are calculated consistently with the figures in the last column that include the GST.

Table 3. Receipts Estimates with and without the GST (cash basis)

		GDP		Receipts		GST		Total Revenue	
			\$b	\$b	% GDP	\$b	\$b	% GDP	
	1996–97		529.89	129.85	24.50	0	129.85	24.50	
	1997–98		561.23	135.78	24.19	0	135.78	24.19	
	1998–99		591.92	146.50	24.75	0	146.50	24.75	
	1999–00		626.04	165.81	26.49	0	165.81	26.49	
	2000–01		671.12	160.83	23.96	24.35	185.18	27.59	
	2001–02		714.37	162.52	22.75	26.63	189.16	26.48	
	2002–03		754.29	176.15	23.35	30.48	206.63	27.39	
estimate	2003–04		813.88	185.21	22.76	33.30	218.51	26.85	
estimate	2004–05		863.42	194.24	22.50	34.46	228.70	26.49	
projections	2005–06		915.99	201.83	22.03	36.61	238.44	26.03	
projections	2006–07		971.75	211.83	21.80	38.72	250.55	25.78	
projections	2007–08		1030.90	222.75	21.61	40.85	263.60	25.57	

Source: Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product, March Quarter 2004*, Cat No 5206.0, 2 June 2004, *2004–05 Budget Paper No 1, Federal Financial Relations 2004–05, Budget Paper No 3* and estimates based on those sources.

The important feature coming out of table 3 is that the inclusion of the GST as a Commonwealth tax would raise the total revenue by almost 4 per cent of GDP in every year since it was introduced. Using the Government's preferred measure Commonwealth receipts peak at 26.49 per cent of GDP in 1999–00 and decline rapidly thereafter to a projected 22.03 per cent of GDP in 2005–06. However, if the GST is included then receipts remain unchanged as a share of GDP between 1999–00 and 2005–06 and only declines slightly in following years.

Conclusion

This paper has ranged over a number of topics but there are some features of the Budget that stand out. This Budget aims for a modest surplus yet includes major tax cuts and spending initiatives worth \$37 billion over a four year period.

The Government has expressed the view that the incentive effects in this Budget will encourage greater labour market participation. However, an assessment by the Melbourne Institute of Applied Economic and Social Research casts doubt on that view and suggests there may be a negative impact on labour market participation.

More attention has gone into the size of the tax cuts and spending measures. That raised the issue of whether there may be too much stimulus in the 2004 Budget. However, without some corrective spending and/or tax measures the Budget was headed towards unsustainable surpluses of around \$16 billion per annum. Those future surpluses had to be addressed. Otherwise they would have imposed a contractionary drag on the economy as well as withdrawing liquidity from the private sector.

Another issue connected to surpluses is the issue of government debt. The combination of past surpluses and asset sales has meant that the government debt is now at very modest levels of around \$26 billion. However, there are \$66 billion in total government bonds and other debt on issue. With the difference the Government has accumulated financial assets worth \$40 billion. The reason for not repaying more debt is that the Government has wanted to maintain a healthy market in government bonds or Commonwealth Government Securities. However, there is a cost in this. The Government has been receiving lower earnings on its assets than the interest it pays on its debt. It could save around \$1.3 billion by using its assets to pay off outstanding debt.

The 2004 Budget Papers include a Statement on unemployment. That Statement suggests that the recent improvement in unemployment to less than 6 per cent reflects improved labour market flexibility which in turn reflects the micro reform agenda over the past couple of decades. However, the discussion begins with a graph showing that until the early 1970s Australia experienced unemployment levels of around 2 per cent. That suggests that the micro reform agenda is unlikely to be the full explanation of what has happened to unemployment. An alternative hypothesis might suggest there have been distinct phases of macroeconomic policy that better explain the various outcomes over the postwar period.

The GST has been a major factor in recent economic policy yet the GST is not treated in the Budget Papers as a Commonwealth tax. The Government argues that the GST is a state tax while other authorities argue it is a Commonwealth tax. Table 3 shows the impact on Commonwealth revenue of including the GST. Not surprisingly, without the GST there is a significant reduction in Commonwealth revenue in the year it was introduced, 2000–01. The effect of including the GST is to add around 4 per cent of GDP to the size of Commonwealth revenue since the introduction of the GST.

1. *The Australian Financial Review*, 12 May 2004, p. 1.

2. Those error estimates are found by examining the 'parameter and other variations' over the last four budgets prepared under the accrual accounting principles. Of course that in no way implicates accrual accounting.
3. That figure is obtained by taking the projected 2006–07 surplus of \$2.3 billion and adding back the effect of policy decisions leading up to and included in the MYEFO, \$1.1 billion, and the effect of policy decisions between the MYEFO and the 2004 Budget, \$12.4 billion. See 2004–04 Budget Paper No. 1, pp. 2–3.
4. Note that the FTB is now classified as an expense, not an offset against revenue as it was formerly treated in the Budget Papers. The Auditor-General has been seeking to reclassify as outlays many items that were formerly treated as offsets against revenue, or tax expenditures. See R. Webb, 'The Commonwealth Budget: Process and Presentation', *Research Paper*, no. 6, Department of the Parliamentary Library 2002–2003, at <http://www.aph.gov.au/library/pubs/rp/2002-03/03RP06.htm>
5. A summary of the initiatives is included in Statement 2: Fiscal Outlook, 2004–05 Budget Paper No. 1, pp. 2–3 to 2–7 while more detail is provided in 2004–05 Budget Paper No. 2, Budget Measures 2004–05. The latter contains full costings over the forward estimates period.
6. The Treasurer, P. Costello, Budget Speech 2004–05, p. 11.
7. K. Henry, 'The fiscal and economic outlook', Address to the Australian Business Economists, Sydney, 18 May 2004 available at <http://www.treasury.gov.au/documents/830/PDF/abe.pdf>
8. See Ian Ireland, 'The Family and Community Services Legislation Amendment (One-off Payment to the Aged) Bill 2001', *Bills Digest* No. 134, Department of the Parliamentary Library, Canberra, 2000–01, at <http://www.aph.gov.au/library/pubs/bd/2000-01/01BD134.htm>
9. This tax was first introduced in 1997. See B. Bischoff, 'What the Bush tax cut means for you', *Tax Matters*, 27 May 2003 at <http://www.smartmoney.com/taxmatters/index.cfm?story=20030527>
10. D. Uren, 'Money in pocket cheers consumers', *The Australian*, 15 July 2004, p. 1.
11. EMTRs are the combined effects of the marginal tax rates themselves as well as the withdrawing of benefits from recipients as their income increases.
12. Henry, *op. cit.*, p. 8.
13. H. Beddelmeyer, P. Dawkins and G. Kalb, 'The Melbourne Institute report on the 2004 Federal Budget', *Mercer – Melbourne Institute Quarterly Bulletin of Economic Trends*, No. 2, 2004, pp.19–23.
14. at page 1–4.
15. Budget Strategy and Outlook 2002–03, 2002–03 Budget Paper No. 1, p. 1–8.
16. Comment on the Budget can be found in the Parliamentary Library site, Budget 2004: Editorials, Opinion, and Media Releases at http://libiis1/Library_Services/budget_library/budgeteditorials2004.htm
17. This can be verified from table 2 page 9–5 of 2004–05 Budget Paper No. 1.

18. Interest income and interest paid are taken from table 3, p. 9–6 of 2004–05 Budget Paper No. 1.
19. 2004–05 Budget Paper No. 1, p. 7–3.
20. That was the initial view of the Government as set out in the discussion paper, Review of the Commonwealth Government Securities Market, Discussion paper, October 2002 at <http://debtreview.treasury.gov.au/content/discussion/downloads/CCSMReview.pdf>
21. 2004–05 Budget Paper No. 1, p. 7–2.
22. ‘Maintaining Low Unemployment in Australia’, Statement No 4, 2004–05 Budget Paper No. 1.
23. B. Hughes, *Exit Full Employment: Economic Policy in the Stone Age*, Sydney: Angus and Robertson, 1980.
24. See R. Webb, *op. cit.*
25. Budget Measures 2004–05, 2004–05 Budget Paper No. 2, p. 34. All budget related papers for 2004–05 are at <http://www.aph.gov.au/budget/2004-05/index.htm>.