

New South Wales government services in the global financial crisis

Report by Access Economics Pty Limited for
NSW Public Service Association

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EXECUTIVE SUMMARY

The global financial crisis is now very much a real economic crisis with recession in Australia very hard to avoid in 2009. Access Economics forecasts the national unemployment rate to reach 7.1% by the end of 2009 and peak at 8.4% in early 2011.

New South Wales is at the heart of the impending recession in Australia. The New South Wales unemployment rate is projected to hit 9% by late 2010. Job losses will occur across a variety of sectors, from finance and business services to manufacturing, construction and tourism. Those job losses and the accompanying loss of economic activity will place considerable pressure on revenue collection by the NSW government and, other things equal, see the budget move towards a higher deficit.

But even though challenges are there which are pushing the NSW State budget higher into deficit and it would be prudent to avoid periods of deficits over the long term, government does have considerable discretion over the timing of decisions to raise taxes or cut spending. It isn't in the State's best interest to cut government spending at this point in time. There are two key reasons for that:

- ❑ governments can play a role in mitigating the effects of economic downturns by using their budgets in a counter-cyclical manner (maintaining or increasing government spending at a time when private spending is falling); and
- ❑ there is greater need in the community for government services at the present time (relative to periods when the economy is performing strongly).

The economic case

Automatic stabilisers are the term for built-in elements of the budget that operate without additional interventions to smooth out the peaks and troughs of business cycles – tax receipts fall and many areas of spending naturally rise as the economy deteriorates. Automatic stabilisers will naturally push the budget towards surpluses during periods when the broader economy is performing strongly, and towards deficits when the economy is weak, such as the present time.

The NSW government should not be afraid of short term deficits to try to avoid adding to the effects of the economic downturn. This suggests letting the automatic stabilisers work in the 2009-10 NSW budget rather than notable short term loosening. And it argues against short term tightening. Cutting spending during the downturn simply adds pressures to the broader economy and prolongs the time until the recovery.

The demand for services

Overall there are likely to be few areas of State government spending where there will be reduced demand for services in the period ahead, many services will see unchanged demand (the same level of demand as in the absence of the crisis), but significant areas of the State budget will face an increasing demand for services in the period ahead. This is particularly the case in areas such as public housing and community services, and vocational education and training.

Demand for education and training services is likely to experience an increase as individuals find it increasingly difficult to find employment in the current environment. The global financial crisis is likely to add to demand for services in the community as people lose their

jobs and families come under financial and other pressures. They are more marginal, but there may also be greater demand for services in areas such as law enforcement and related activities (as the weaker economy leads to additional crime or violence), and some areas of health such as mental health and counselling services.

Given the increased demand for State government services that suggests the need to maintain or increase public service employment levels in the short term (in order to deliver those services). This of course is subject to savings which can be made over time by delivering services more efficiently (which can be difficult in many areas such as education and health without affecting quality), or any changes in contracting or outsourcing arrangements. It is also true on average rather than for all agencies – some agencies see increased demand for services over time, or their services assume higher priority, at the same time as other agencies decline.

The case for further temporary measures

Beyond maintaining the delivery of government services, there is a case for governments to further support the economy through the present downturn, as long as additional measures are timely, temporary, and targeted. Timely is important so that additional measures assist during the downturn (rather than beef up a subsequent recovery), temporary so that additional measures do not become a permanent drag on the budget, and targeted so that increased spending results.

Further, any discretionary fiscal stimulus should add to, rather than come at the expense of, investment in the long-term drivers of growth and productivity. In other words, tests for good policy such as whether particular initiatives meet cost/benefit analyses should not be abandoned in times of economic downturn.

Access Economics

May 2009

1. THE GLOBAL FINANCIAL CRISIS: WHAT THIS MEANS FOR NSW

1.1 THE GLOBAL CONTEXT

The world economy is in trouble. Advanced economies are experiencing their biggest declines in the post-war era, reflecting the impact of the global financial crisis on economic activity.

A global recession is occurring as imbalances in markets and economies unwind chaotically.

- ❑ The breakdown in banking and credit markets – which accelerated from September 2008 – is fast hurting all the globe's economies. As almost all nations are slowing, they are all weighing on each other, meaning global recession has unstoppable momentum. The emerging economies generated three quarters of global growth in the past eighteen months, but their slowdowns point to recession here in Australia too.
- ❑ Policymakers are responding rapidly, putting new equity into banks, cutting interest rates, and spending on stimulus packages, but that won't stop a major global recession.

According to the latest IMF forecast, global activity is expected to decline by around ½ to 1% in 2009 on an annual average basis, before recovering gradually in the course of 2010.

Australia came late to this crisis due to the protection afforded by rapid growth in China and other emerging economies around the world in recent years. That growth meant the average industrial commodity saw its price almost quadruple in the last four years, with a crescendo in April 2008 as coking coal prices tripled and iron ore prices rose 85%. **But with China now weaker, recession in Australia will be very hard to avoid in 2009.**

According to a recent speech by the Federal Treasurer, the cost of this global recession in terms of lost global output is likely to be in the order of \$6 trillion in 2009 alone – nearly six times the size of the entire Australian economy.¹

The human cost in terms of jobs lost will be even more devastating. **The International Labor Organisation has said that more than 50 million jobs could be lost worldwide** because of this global financial crisis and associated global recession.

1.2 THE AUSTRALIAN OUTLOOK

Australia is now also being notably affected by the global downturn.

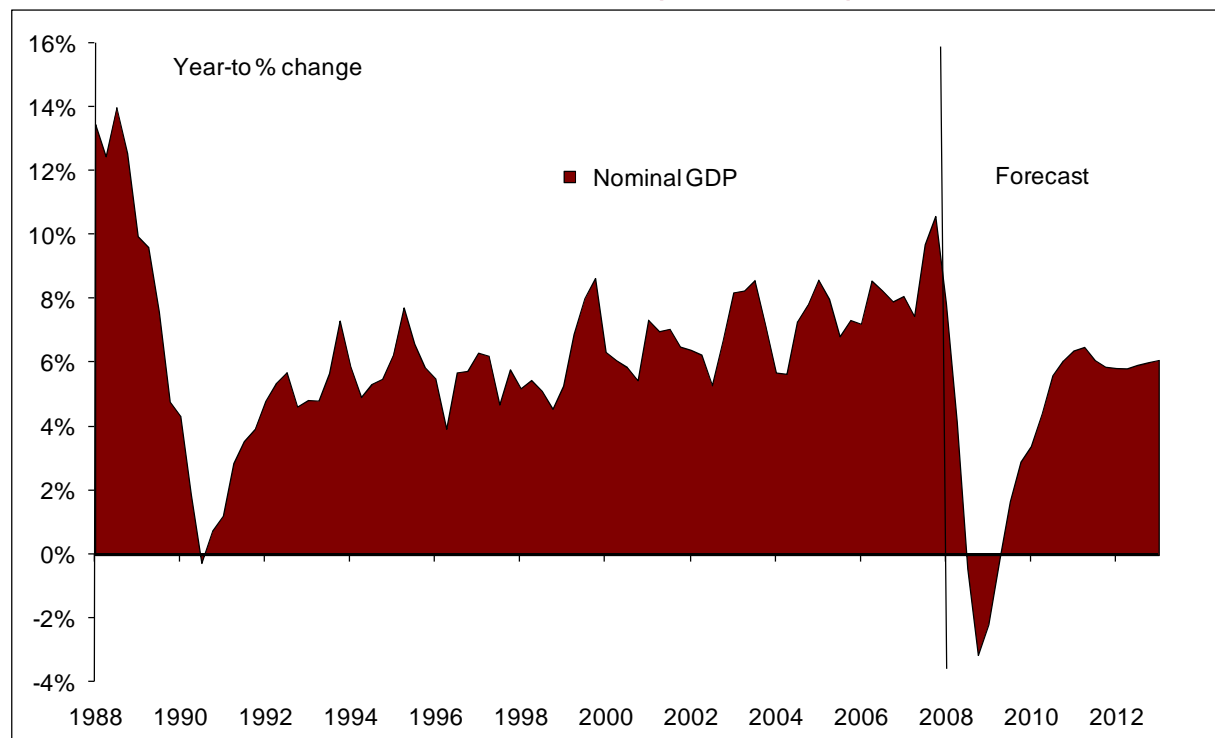
- ❑ National GDP contracted by 0.5% in the December quarter to be only 0.3% higher through the year.
- ❑ Demand for exports is falling, as are global commodity prices. The downturn has already wiped 25% from expected export earnings this year alone, with the possibility of further losses to come.

¹ Federal Treasurer (2009) 'A Future of Promise' - Address to the Sydney Institute, Sydney - 23/03/2009 - <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2009/006.htm&pageID=005&min=wms&Year=&DocType>.

- ❑ And with this global recession now expected to be even more severe than published in the last official forecasts, it will be almost impossible for Australia to avoid a period of negative growth.

Although recession is now expected here, it is the impact on Australian incomes rather than Australian output which holds the biggest risks. That means the key vulnerability for Australia is not the extent to which output falls in two consecutive quarters (the technical definition of recession). Rather, it will be the cut in income that will hurt most. Australian nominal GDP growth was 10.4% over the past year, but it may weaken over the coming year to fare worse than the matching experience in 1991 – see Chart 1.

CHART 1: AUSTRALIAN INCOME (NOMINAL GDP) GROWTH



Source: ABS 5206.0; Access Economics forecasts

While ‘technical’ recession is defined in terms of negative GDP growth, it is in terms of job losses where the most significant impacts of recessions are felt. Higher unemployment also often persists for many years after recessions have ended. The latest Federal Treasury estimates are for Australia’s national unemployment rate to reach 7% by mid 2010. Access Economics forecasts the national unemployment rate to reach 7.1% by the end of 2009 and peak at 8.4% in early 2011.

1.3 WHAT THIS MEANS FOR THE NSW ECONOMY

New South Wales is at the heart of the impending recession in Australia.

The State faces a wide variety of problems, some of which have plagued New South Wales for several years, though some new economic challenges are a direct result of the global financial crisis:

- ❑ Consumers in NSW hit the brakes as interest rates climbed and, their confidence hurt by recent events, they have remained sidelined despite large cuts to interest rates.

NSW is lagging the national average by a considerable margin in retail sales over the past year (see Chart 5).

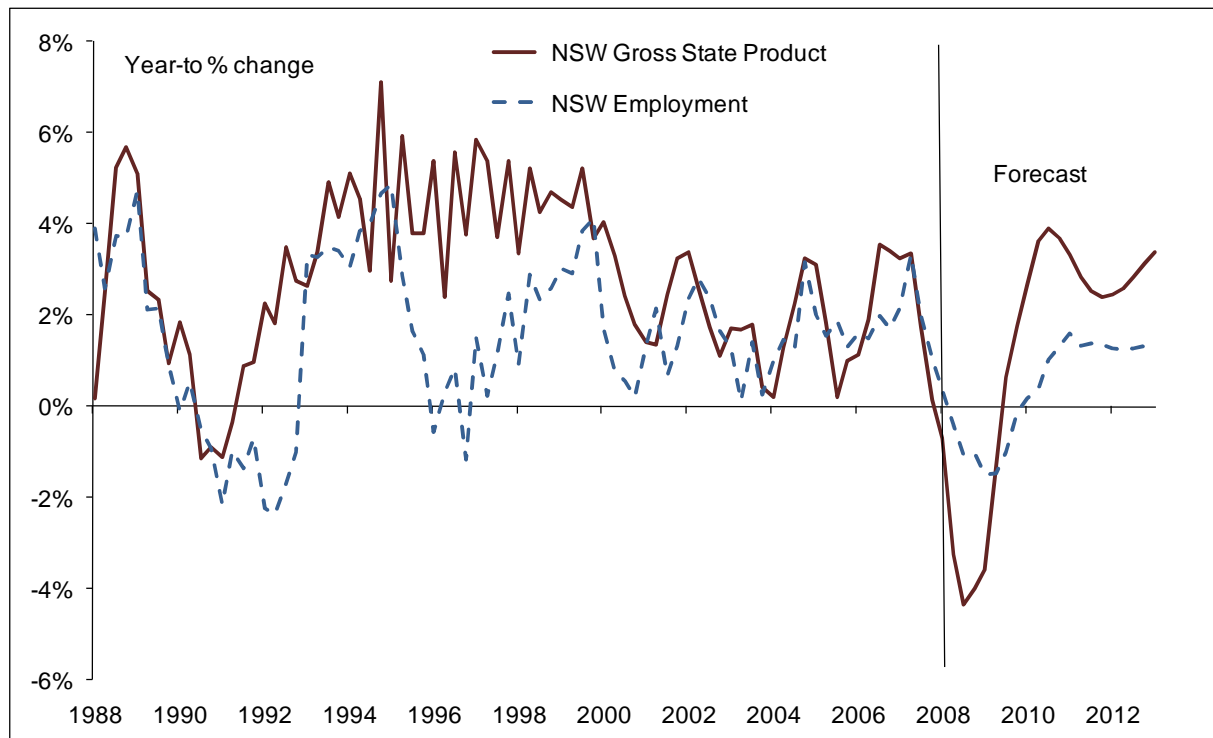
- ❑ The global financial crisis is also affecting employment prospects and falls in the sharemarket have adversely affected house prices. The crisis is being felt more in Sydney than elsewhere in Australia (as Sydney is home to half of Australia's financial institutions).
- ❑ The State Government's mini-Budget further cut demand at a time when demand was already falling fast (see Chart 2).
- ❑ Population growth is poor relative to the rest of Australia, and forward indicators for housing construction are very weak (see Chart 4), while the sharemarket crash has left Sydney's housing prices looking over-extended.
- ❑ This year's rural rebound disappointed amid late rain on the wheat crop.
- ❑ The State's exports are flagging.

Yet while the economic news is grim at present, and economic performance is going to be poor until well into 2010, the NSW economy will eventually recover. Indeed, many of the preconditions for that recovery are already in place:

- ❑ Interest rates have been cut sharply, meaning that NSW's big mortgages are no longer as crippling as they were. It can be argued that Sydney's declining housing prices are moving to more sensible levels, meaning they could attract people from other States.
- ❑ The \$A has also fallen back notably, meaning it is no longer rendering the State's manufacturers uncompetitive internationally or deterring potential tourists to the extent it was until recently.
- ❑ The \$A fell because industrial commodity prices fell. That development is very important. It may be bad news for Australia in general and a specific problem for NSW's coal miners, but it is good for NSW's health relative to that of the rest of Australia. During the boom people and money flowed north and west to the 'sunbelt' States, starving NSW's projects of capital, raising input costs to the State's manufacturers, and making NSW's economic indicators look worse than they really have been. However, these issues will soon be less of a problem.

The present time however is seeing a sharp slowdown in NSW's economic activity. Chart 2 shows that Gross State Product (GSP) or output growth in NSW is expected to be substantially negative through the course of 2009.

With that contraction will come a notable loss of jobs, with **the New South Wales unemployment rate projected to hit 9% by late 2010** (compared with a projected peak of 8.4% nationally). Job losses will occur across a variety of sectors, from finance and business services to manufacturing, construction and tourism. Job losses of course will mean more people in need of government services, as well as a decline in government revenues via lower payroll tax collections.

CHART 2: NSW OUTPUT AND EMPLOYMENT GROWTH

Source: ABS 5206.0; ABS 6202.0; Access Economics forecasts

Other economic indicators which are important to the State government's revenue base include house prices, housing activity, and overall consumer spending.

Chart 3 shows that house prices in Sydney and on average around the country fell over the course of 2008 (by 4.1% in Sydney and 3.3% nationally). Sydney house prices have been subdued for some time following a significant boom in 2002 and 2003.

There is however the potential for a much worse outcome. Housing prices in the United Kingdom have just dropped back to 2004 levels, and the same is true for new homes in the United States. Were that to happen here in Australia, it would mean prices falling more than a quarter from current levels.

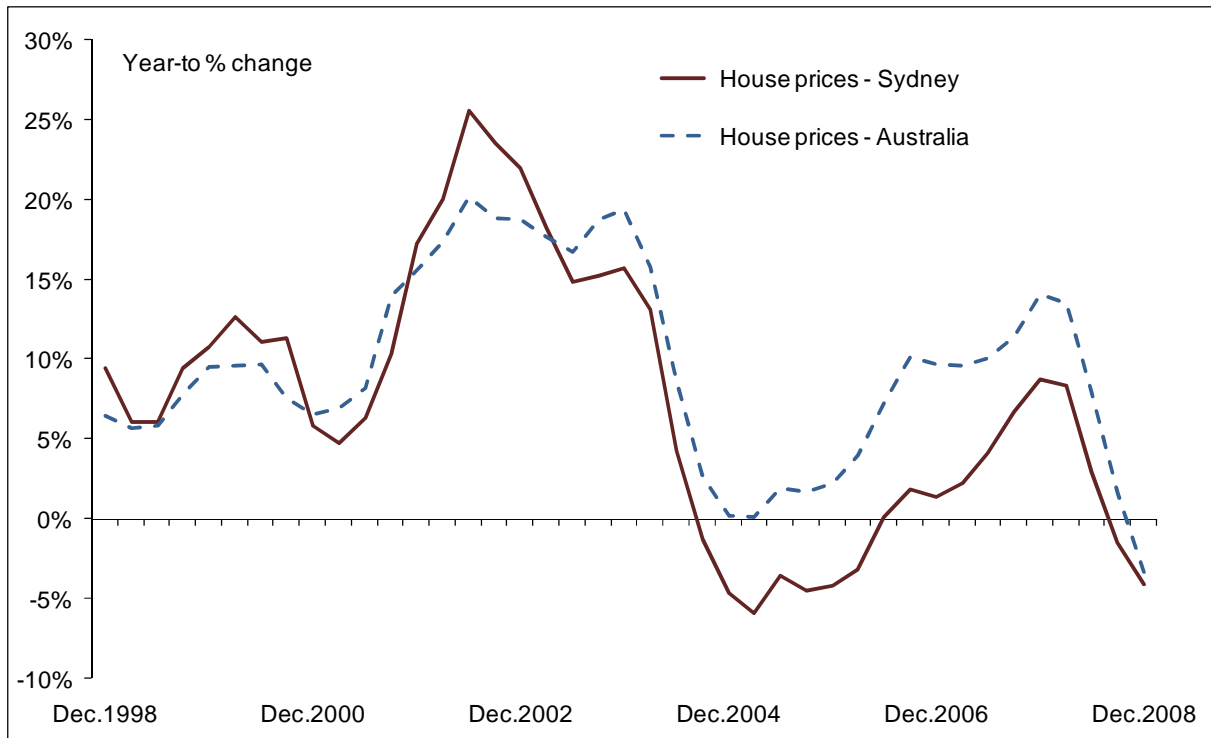
The good news is that there are some Australian-specific reasons which help to explain structural support for higher housing prices here than in some other markets – there are differences in our tax treatment, developer charges, land release patterns and the like. In addition, the lack of housing supply at a time of high population growth here (last year saw Australia's population grow by 359,000 people, a record) provides cyclical underpinning to housing prices (the opposite of what has happened in the US).

Those are all reasons to think that Australia doesn't face the same degree of risk on housing prices than some other nations are experiencing. Yet, with share prices having fallen substantially already, and with Australian national income growth set to also fall, the pressures on Australian housing prices are rising.

Overall, **2009 is expected to be a weak year for house prices.** The negatives of rising uncertainty and a sharp deceleration in the economy with a substantial increase in unemployment will dominate underlying demographic strength, falls in mortgage rates and a shortage in housing stock. However, the substantial interest rate cuts seen to date and

potential for further cuts in the months ahead will help to keep the expected house price falls in check.

CHART 3: HOUSE PRICE GROWTH, SYDNEY AND AUSTRALIA

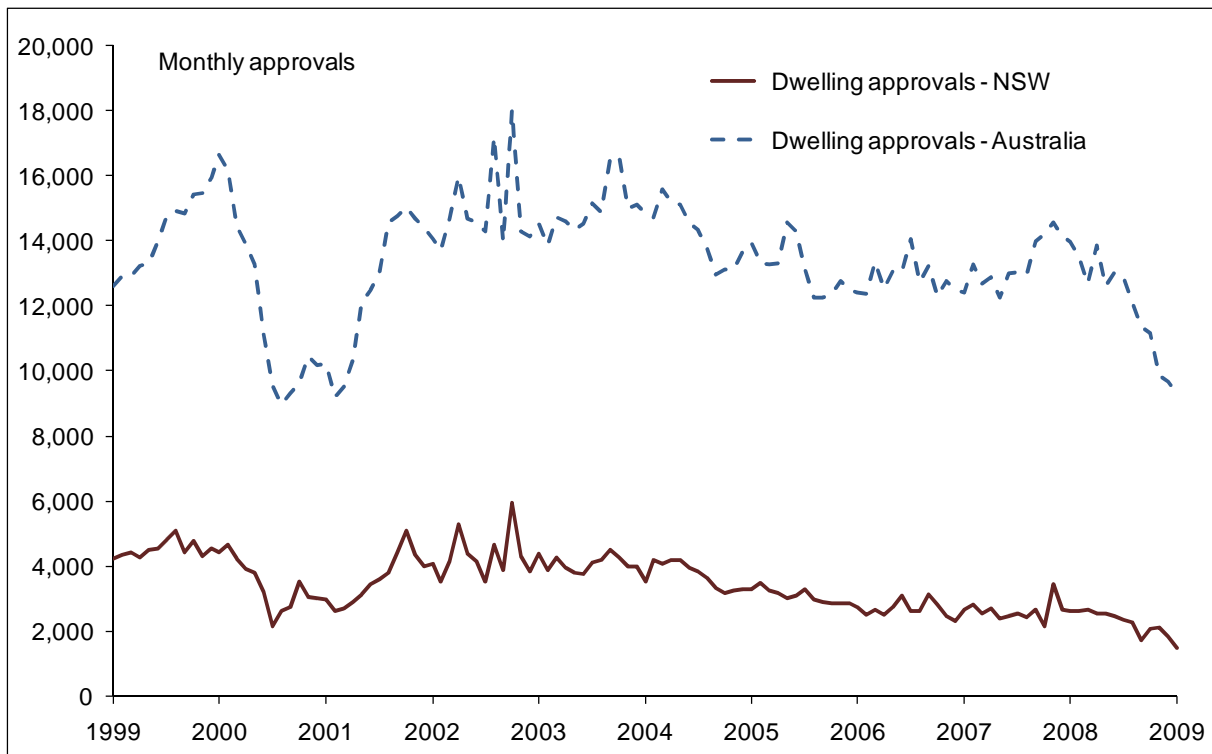


Source: ABS 6416.0

Residential building activity is likely to be one of the areas which leads a broader economic recovery. Unfortunately, on the leading indicators seen so far, that recovery in housing construction is still a little way off.

Indeed, even by the recent poor standards of the NSW housing market, **the latest residential building approvals data are dismal**. There were less than 1,500 dwelling units approved in New South Wales in January 2009 (on seasonally adjusted data), which is less than half the monthly average seen this decade. Without a substantial pick-up in 2009, housing starts may run at half the rate of a decade earlier. But underlying requirements to satisfy the demands of population growth imply that the local home building sector must eventually recover.

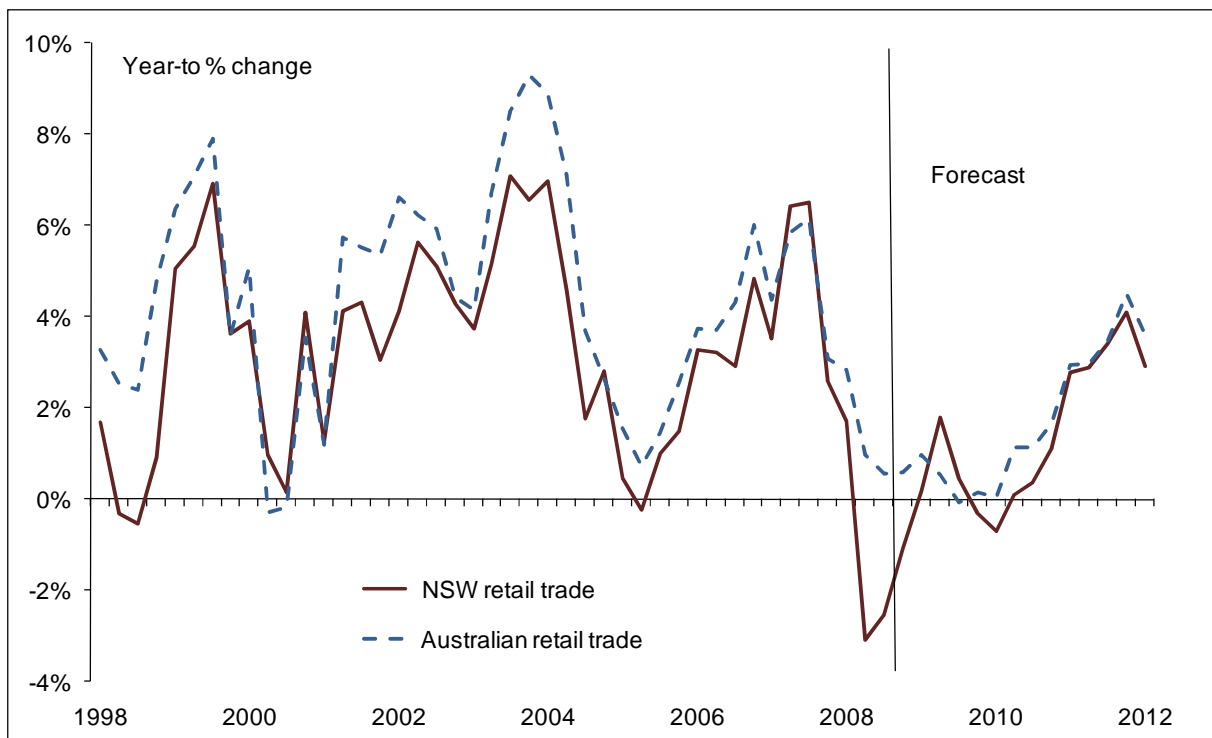
CHART 4: RESIDENTIAL BUILDING APPROVALS, NSW AND AUSTRALIA



Source: ABS 8731.0

Finally, retail spending has been particularly poor in New South Wales over the course of 2008. Over the course of 2008 real (inflation adjusted) retail spending fell by 2.5% in NSW, a much worse outcome than for all other States and Territories.

CHART 5: RETAIL TRADE GROWTH, REAL, NSW AND AUSTRALIA



Source: ABS 8501.0; Access Economics forecasts

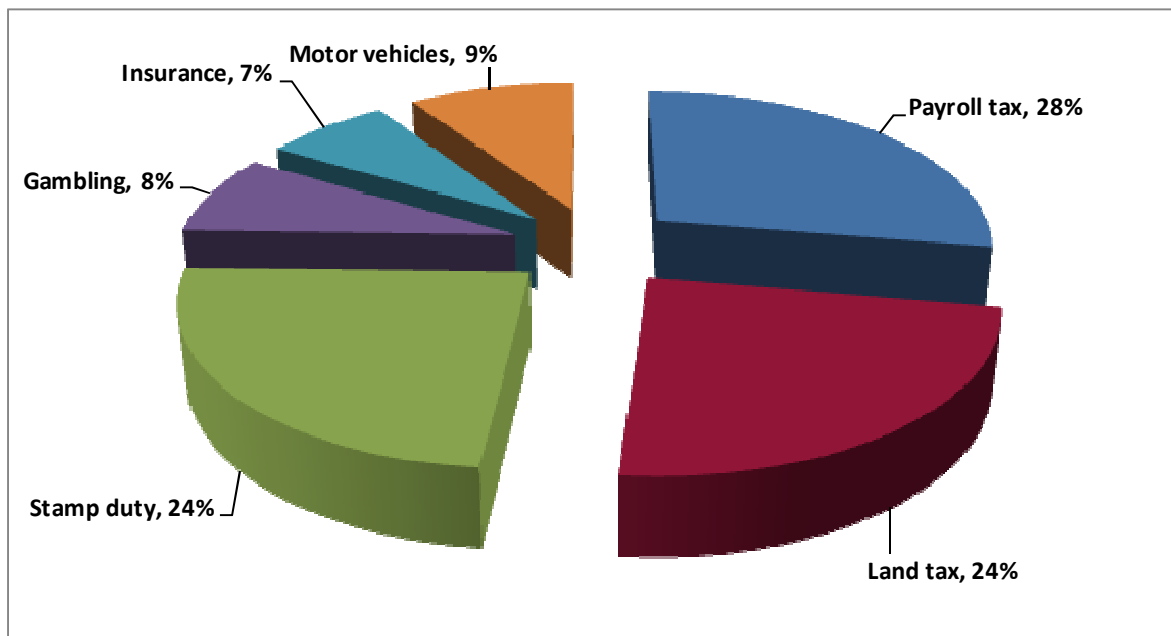
The good news is that there are now some tentative signs of improvement coming via the Federal government's stimulus package and the very large cuts in interest rates since September 2008 (and the latter should be a particular boost to NSW given higher mortgages in Sydney). Retail data for the months of December 2008 and January 2009 were much stronger for NSW, suggesting the State may move back towards the performance of other States. That said, consumer spending Australia-wide is likely to remain very subdued through 2009 as the unemployment rate continues to rise.

1.4 WHAT THIS MEANS FOR NSW PUBLIC FINANCES

1.4.1 REVENUE CHALLENGES

Given current economic conditions, it is on the tax side of the equation where the vulnerability of the NSW Budget lies. Once the GST is taken into account, the States receive a third of the revenue raised nationally. Of the revenue received directly by New South Wales, three-quarters comes from payroll, property and stamp duties on conveyances.

CHART 6: NSW'S SOURCES OF REVENUE AS A SHARE OF TOTAL, 2006-07



Source: ABS 5506.0

Chances are that the next five years will see:

- ❑ Beyond 2009 and 2010, a Federal Government less keen to spend (as beyond the crisis period the Federal government will be looking to rein in what will be a very large budget deficit).
- ❑ A weak outlook for GST collections (weaker than is currently in the Federal budget's forward estimates).
- ❑ An extended bout of housing price weakness – also limiting the pace of turnover – which will affect residential stamp duty collections.
- ❑ An extended bout of weakness in employment growth, which will affect payroll tax collections.

Many of the key revenue drivers for NSW are already under pressure as a result of current conditions. For example, **payroll tax collections have already been affected by weaker job growth** in NSW than nationally, and are under threat in 2009 from further weakness on the job front (with an expected notable lift in unemployment).

So too are revenues raised from cars. In February 2009 there were only 22 409 new cars sold, down 17.6% on a year earlier.

Weak spending by consumers is also eating heavily into national GST collections. The latter are also affected by the pace of housing construction (because the GST is levied on housing construction rather than 'housing consumption'). There were just 1,476 new houses approved in NSW in January 2009, only 15.9% of the national total and less than half the State's population share.

Property taxes are also particularly important for the NSW Budget and these may decline notably with house prices remaining under pressure as discussed in the previous section.

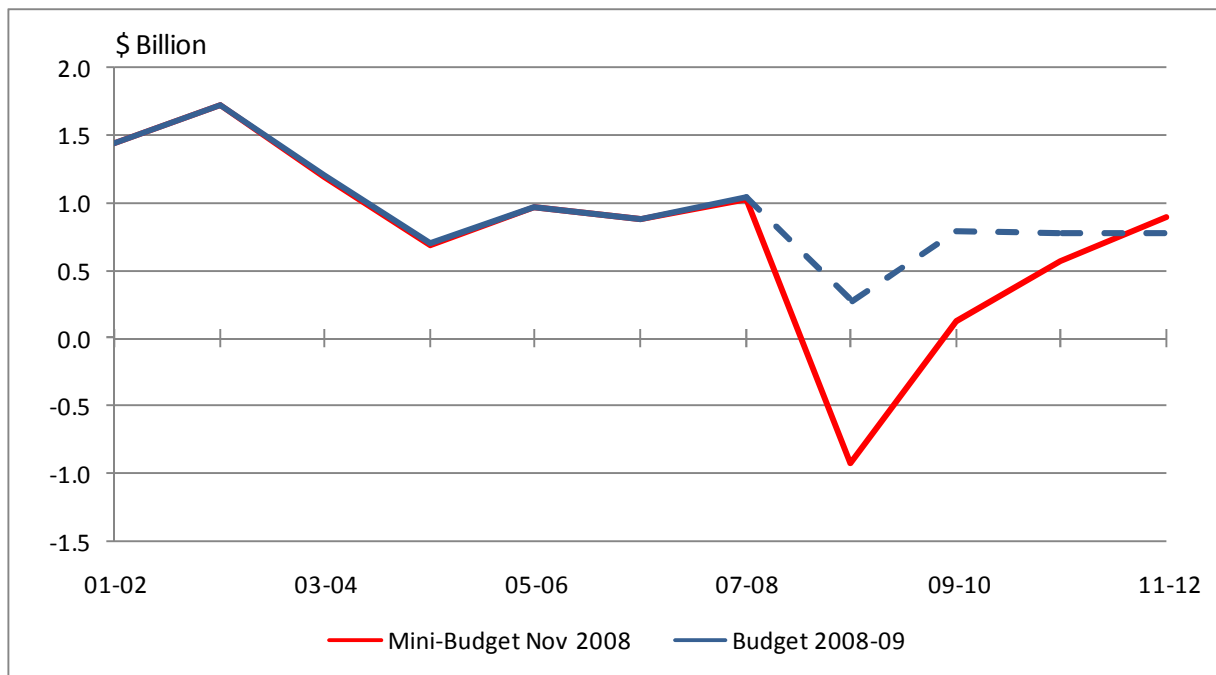
1.4.2 OVERALL BUDGET POSITION

Other things equal, those factors would suggest that **the structural challenges facing the NSW Budget are significant.** In turn, that points to a larger structural adjustment task for the NSW Budget over time. At some point, some expenditures will have to be cut and/or taxes raised. But **government does have considerable discretion over the timing of such decisions. Cutting spending in a period of economic weakness runs the risk of notably worsening the economic environment.**

Federal Treasury and the OECD have strongly argued that government spending should be sustained through an economic downturn, providing some support for the economy. There is also a case for increased public spending to defend against downturn if it satisfies the criteria of being timely, temporary and targeted (discussed in further detail in chapter 2).

The impact of the global financial crisis, combined with an already strained fiscal position, has resulted in a further deterioration of the NSW budget. NSW issued a Mini-Budget update on 11 November 2008 which indicated that the budget was expected to deteriorate from an estimated surplus of \$268 million in 2008-09 at Budget time to a deficit of \$917 million (Chart 7).

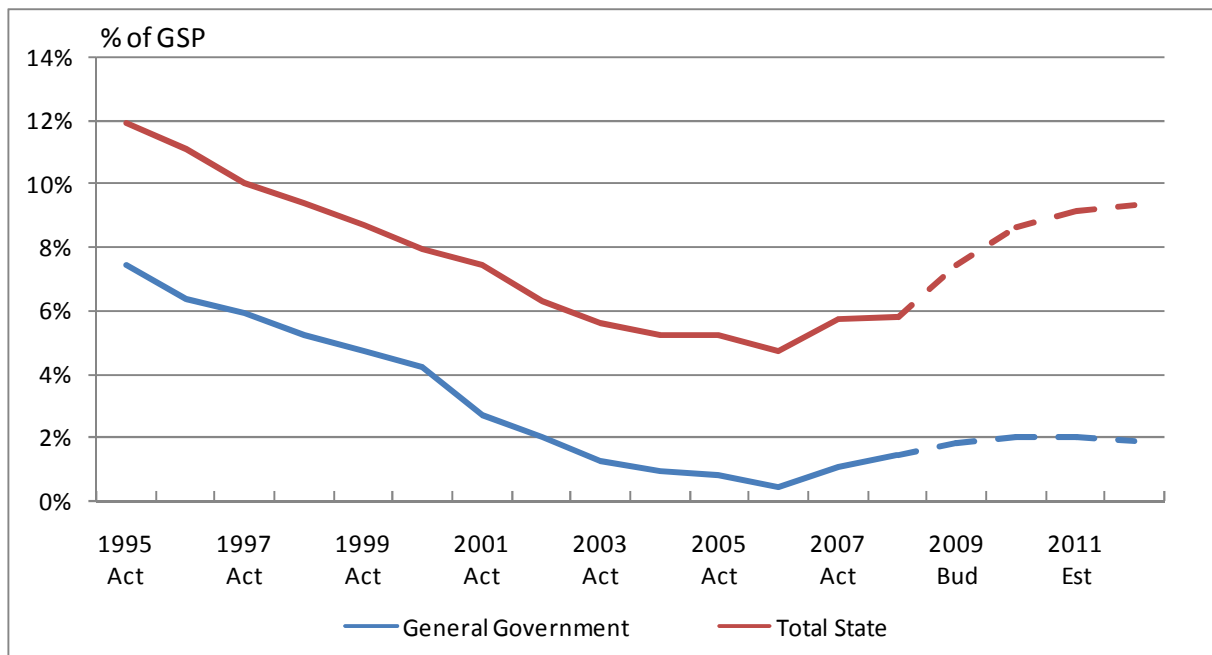
CHART 7: NSW GENERAL GOVERNMENT BUDGET BALANCE



Source: NSW Budget 2008-09, NSW Mini Budget Nov. 2008

This was caused by increased risks to the State's revenues and expenses amid a deteriorating economic outlook. Left unaddressed, the NSW government was of the view that these developments would have placed in jeopardy the Government's ability to continue delivering essential services and put the State's AAA credit rating under increased pressure.

An important fiscal measure is the level of the State government's debt relative to GSP over time. Chart 8 illustrates how net debt in the general government sector is now expected to increase to 2.0% of GSP in 2010, compared to the Budget-time profile of net debt plateauing at 1.7% of GSP. The profile for total State sector net debt (including government enterprises) continues to rise over the forward estimates period, lifting to 9.3% of GSP by 2012.

CHART 8: NET DEBT AS A SHARE OF GROSS STATE PRODUCT

Source: NSW Mini Budget Nov. 2008

Changes introduced in the November 2008 mini Budget were aimed at keeping in check that projected increase in the State's net debt over time. Without these changes the profile for the State's debt would be higher than that shown in Chart 8.

Key elements of the mini Budget included:

- ❑ **A modest increase in operating expenses.** This included a substantial increase in unfunded superannuation liabilities resulting from the global financial market turmoil. Large reductions in asset values have inflated estimates of unfunded superannuation liabilities by around \$5 billion over the forward estimates period. This resulted in an increased superannuation expense of \$140 million in 2008-09 due to significantly lower investment returns arising from the downturn in global equity markets.
- ❑ **Revenues overall remaining largely unchanged over the forward estimates period,** with falling revenues in many areas due to the economic cycle being offset by higher revenue measures, including a notable increase in the parking space levy and notably higher mineral royalties. That is, the Budget position has been supported by higher taxes.
- ❑ **A notable cut back on infrastructure spending by "reprioritising" the government's capital program.** This should reduce the aggregate level of State capital funding to 2011-12 by around \$890 million. Transport has been a major area of reprioritisation, due to the substantial demands and risks in this sector. For example, the decision to indefinitely defer the North West metro project and approve the allocation for a Sydney metro system offers a direct budget saving of almost \$1 billion over the forward estimates.

While the NSW State government was cutting its infrastructure spending, the Federal government's February 2009 Updated Economic and Fiscal Outlook (UEFO) was promoting it in the present climate:

“In particular, where public sector capital works and infrastructure projects can be implemented quickly, they are likely to prove very effective in boosting demand and increasing employment over the next couple of years, while also adding to the productive capacity of the economy in the longer term.” (UEFO, p17)

The overall result was that the revenue measures and cuts to capital spending in the mini Budget were projected to achieve a modest reduction in State net debt relative to Budget time (\$1.1 billion lower in 2012), despite the deteriorating economy.

While the economic environment has deteriorated further since the NSW government handed down its mini Budget in November 2008, the projections for the State's net debt at that point (as shown in Chart 8) were still well within the historic experience over the past 15 years.² That suggests that **in terms of overall debt there is some potential for the NSW government to set its budget in a more neutral or counter-cyclical manner (rather than focusing on cutting spending).**

Instead of being too focused on reducing State debt in the short term, in the current environment a more appropriate focus is for government to act counter-cyclically, supporting the economy through weaker periods such as the present one. Governments should then look to improve budget positions during stronger economic times, when the broader economy can more withstand some restraint, and there is relatively less demand for various government services by those who require them.

A positive development for State governments in general has been the move by the Federal government recently (25 March 2009) to provide the option of a temporary voluntary guarantee for State government borrowing. **This Federal guarantee will make it easier for States to raise funding**, something which was starting to cause difficulties at some State Treasuries. It may then also provide more freedom for States to engage in counter-cyclical budget policy, adding to or supporting demand at a time when private sector activity is rapidly retreating. Of course any additional budget measures need to be worthwhile and justified on cost-benefit grounds, just as existing programs should be periodically reviewed for their effectiveness.

² The projections are however higher than the conservative targets set in the *Fiscal Responsibility Act 2005* including general government net debt to be just 0.8% of GSP. These targets were framed in a period of strong revenues and a strong economy.

2. FISCAL POLICY DURING THE CRISIS

There are a number of issues for policymakers in New South Wales to consider in formulating budget priorities as the State makes its way through the current economic downturn. In considering these issues it is worthwhile to look at the overall structure of fiscal policy.

Fiscal policy is generally made up of two key components, which interact with each other including in times of economic downturn:

- ❑ **Discretionary fiscal expenditures**, where the government has more choice to spend – typically on goods and services such as roads, buildings, trucks, research grants; and
- ❑ **Non discretionary government spending**, which usually takes the form of transfer payments, such as unemployment benefits, pensions, and interest on government debt, or ongoing commitments such as much of the funding for schools and hospitals. Here the government is more committed to such its existing spending commitments.

Automatic stabilisers are the term for built-in elements of the budget that operate without additional interventions to smooth out the peaks and troughs of business cycles. They also form an integral part of non discretionary government spending. The two key automatic stabilisers occur through the tax system and through transfer payments (including social security benefits and services).

- ❑ As the economy slows and incomes fall correspondingly, individuals end up paying a lower proportion of their income in tax. For example, this is the situation for payroll taxes and many transaction taxes collected by the NSW government. This results in lower revenues for government.
- ❑ Government spending on transfer payments and social security services increases automatically in recessions. There is more of a call on government services as individuals experience economic hardship and rely more on the government for assistance. This adds to government spending.

Automatic stabilisers will naturally push the budget towards surpluses during periods when the broader economy is performing strongly, and towards deficits when the economy is weak, such as the present time.

2.1 HOW TO GO ABOUT APPROPRIATE POLICY DESIGN?

The question then arises of how to most appropriately structure fiscal policy in times of economic downturn.

Essentially, governments may choose one or a combination of the following:

- ❑ Maintain a ‘hands off’ approach and let government revenues fall while expenses increase as the automatic stabilisers operate. This can lead to temporary budget deficits but should assist the economy in supporting demand and smoothing out the worst of the downturn;
- ❑ Have a more interventionist approach and employ discretionary fiscal policy to try and boost demand by increasing spending and/or reducing taxes. This is an example of a counter-cyclical fiscal policy which is more feasible if the government already has the resources or ability to borrow without affecting its longer term financial prospects; and

- ❑ Intervene to shore up the budget balance by cutting spending and/or raising taxes. This is an example of a pro-cyclical fiscal policy than can exacerbate the downturn as the government is taking money and demand out of the economy at a time when it is already struggling.

In making this choice, governments generally not only have an eye on the current situation but also on the longer-term picture – which includes not getting into excessive debt. Governments, and State governments in particular, are also in constrained by their available powers and abilities to raise revenue and/or spend.

Keeping the above in mind, governments also need to be aware of their medium-term fiscal strategy which at the Federal level is espoused as running a balanced budget over the economic cycle. In the present environment that means:

- ❑ allowing the variations in revenue and expenditure, which are naturally associated with slower economic growth, to drive a temporary deficit (i.e. letting the automatic stabilisers work);
- ❑ using additional spending to deliver timely, temporary and targeted stimulus; and
- ❑ returning the budget to surplus once the economy recovers by allowing the level of tax receipts to recover naturally as the economy improves and reeling in spending.

Further, any discretionary fiscal stimulus should add to, rather than come at the expense of, investment in the long-term drivers of growth and productivity.

“The global recession and consequent spare capacity means there is scope to combine shorter-term stimulus measures to boost growth in jobs in 2009 with longer-term measures to boost productivity growth...” (UEFO, 2009, page 14)

In other words, tests for good policy such as whether particular initiatives meet cost/benefit analyses should not be abandoned in times of economic downturn.

2.2 TIMELY, TEMPORARY, AND TARGETED

Additional measures (beyond the automatic stabilisers) to support the economy through the present downturn should be timely, temporary, and targeted.

Federal Treasury has – correctly – noted that there are important limits to fiscal policy. In recent years Treasury noted the importance to policymakers of good outcomes among the ‘3Ps’: population, participation and productivity. Those ‘supply side strengths’ remain as important as ever, and need to be the longer term focus of Australian economic policy.

Yet it is not supply that is currently under pressure. It is demand. Federal Treasury therefore used the *2008-09 Mid-Year Economic and Fiscal Outlook* to set out (at page 16, and seen in an extract below) the parameters of good policymaking for budgets in downturns – a set of views it reinforced in the *Updated Economic and Fiscal Outlook* released in February 2009.

In brief, Treasury pointed to the ‘3Ts’ – that Budget policy moves aimed to help the economy need to be timely, temporary and targeted:

- ❑ **Timely**, because unless we act fast, then the government action will merely beef up the recovery rather than help avoid the slowdown.
- ❑ **Temporary**, because in ordinary circumstances demand management lies better with the Reserve Bank and interest rates.

- ❑ **Targeted**, because unless the policy action results in increased spending – a boost to demand at a time when the latter is flagging – then it won't help the economy.

The OECD backs this approach, with its Chief Economist stating recently that:

"It is vital that any discretionary action be timely and temporary and designed to ensure maximum effectiveness." (as part of the editorial released with the OECD Economic Outlook).³

2.2.1 WHY IS 'TIMELY' IMPORTANT?

The policy reaction to downturn needs to be fast so that:

- ❑ It defends against the downturn rather than revs up the recovery – the former is vital, the latter is too late.
- ❑ It helps limit the peak in the unemployment rate (because unemployment, once it rises, lingers for longer – a problem known to economists as 'hysteresis').

That is why Federal Treasury argued in the UEFO released in early February that:

"Measures need to be implemented swiftly so that the boost to demand occurs when it is most needed. In the current situation, this means including measures that take effect in the first half of 2009." (UEFO, 2009, page 13)

However, such handouts are most appropriate for 'smaller' rather than 'larger' downturns. The longer and deeper the current downturn becomes, the more that economists recommend that Government policy action focus on capital works rather than on welfare handouts.

That is because, as Federal Treasury says:

"Where an immediate boost in demand is required, the most effective fiscal policy measures are those that can be implemented quickly and targeted to those who are most likely to spend additional income (that is, liquidity constrained households).

On the other hand, when confronted with a prolonged downturn the most effective fiscal policy measures are those involving direct government investment in the economy that can be implemented quickly (for example, on capital works)." (UEFO, 2009, page 15)

2.2.2 WHY IS 'TEMPORARY' IMPORTANT?

The fiscal policy response to a downturn needs to be 'temporary' for two reasons.

- ❑ First, you can usually leave it to the Reserve Bank to slow the economy down or speed it up. But the Reserve can't do all the heavy lifting in a severe downturn; government Budgets should provide assistance as well.

³ OECD (2008) 'Managing the Global Financial Crisis and Economic Downturn' <http://www.oecd.org/dataoecd/4/50/39739655.pdf>

- ❑ Second, such responses are expensive, and permanent help will often be neither affordable nor appropriate.

As Federal Treasury notes:

“The boost needs to fall away over time so that it no longer operates when it is not needed. Locking in long-term spending poses risks for inflation and interest rates as well as the Government’s budget position. The Government’s strategy for returning the budget to surplus is discussed in Part 4: Fiscal strategy and outlook.” (UEFO, 2009, page 13)

They added that:

“The extraordinary speed and scope of the deterioration in the global economy means that there is a much greater macroeconomic stabilisation role for discretionary fiscal policy than would normally be the case.

At this time, it is critical that the Government leverage its strong balance sheet position to support jobs and growth, and lay the foundations for recovery. Well-designed discretionary fiscal policy should work in conjunction with monetary policy to provide an immediate boost to demand. The most effective fiscal policy measures to achieve this in the current circumstances are those that can be implemented quickly and are targeted to those who are most likely to spend additional income.” (UEFO, 2009, page 13)

2.2.3 WHY IS ‘TARGETED’ IMPORTANT?

Finally, the fiscal policy response needs to be targeted – spent, not saved – otherwise it doesn’t help the economy.

As Federal Treasury noted:

“Spending needs to be targeted carefully so that it maximises the impact on GDP growth.” (UEFO, 2009, page 13)

“Where the economy is confronted with a more severe and prolonged downturn as a result of a significant external shock, well-designed discretionary fiscal policy can add directly to aggregate demand through direct government investment in the economy (for example, on capital works) that are able to be implemented quickly.” (UEFO, 2009, page 13)

2.3 WHAT DOES ALL THIS MEAN FOR NSW?

These broad guidelines for fiscal intervention can equally be applied to NSW fiscal policy in dealing with the current economic environment.

- ❑ **The NSW Government should not be afraid of short term deficits to try to avoid adding to the effects of the economic downturn.**
- ❑ **This suggests letting the automatic stabilisers work in the 2009-10 NSW Budget rather than notable short term loosening.**
- ❑ **And it argues against short term tightening. Cutting spending during the downturn simply adds pressures to the broader economy and prolongs the time until the recovery.**

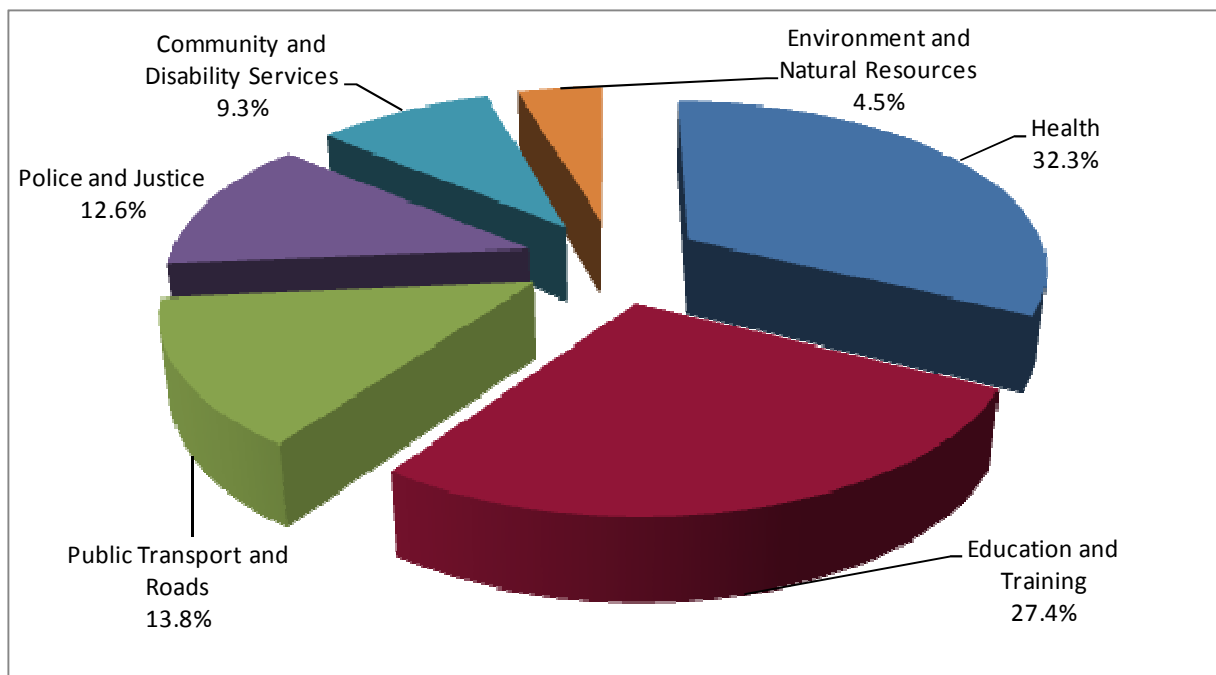
- ❑ **Any discretionary spending above the automatic stabilisers should be timely, temporary and targeted. It should also be subjected to a thorough cost/benefit analysis to ensure it is worthwhile.**
- ❑ **Finally the government should reprioritise existing spending where possible, limit borrowing to sustainable levels, and have a plan to return to a balanced budget once the economy recovers.**

The next chapter examines the main broad components of spending from the New South Wales government, discussing how demand for the services provided by government is likely to fare as the economy deteriorates.

3. HOW WILL DEMAND FOR SERVICES BE AFFECTED?

In assessing how government services will be affected by the global financial crisis and associated economic downturn, it is worthwhile considering what the NSW government spends its money on.

CHART 9: NSW BUDGET EXPENSES BY SERVICE DELIVERY AREAS



Source: NSW Budget 2008-09

Health, and education and training dominate spending priorities, together making up around 60% of government spending. The other main broad areas of spending are roads and transport, law and order, community and environmental services.

The following sections discuss each area of spending and how it may be affected by the economic downturn. Overall there are likely to be few areas of State government spending where there will be reduced demand for services in the period ahead, many services will see unchanged demand (the same level of demand as in the absence of the crisis), but significant areas of the State budget will face an increasing demand for services in the period ahead. This is particularly the case in areas such as public housing and community services, and vocational education and training.

Given the increased demand for State government services that suggests the need to maintain or increase public service employment levels in the short term (in order to deliver those services). This of course is subject to savings which can be made over time by delivering services more efficiently (which can be difficult in many areas such as education and health without affecting quality), or any changes in contracting or outsourcing arrangements. It is also true on average rather than for all agencies – some agencies see increased demand for services over time, or their services assume higher priority, at the same time as other agencies decline.

3.1 HEALTH

According to the NSW budget, health comprises a range of health services such as inpatient hospital care, emergency care, community health and mental health are delivered through eight Area Health Services and State-wide services such as the Ambulance Service key focus areas.

Key focus areas include expanding mental health services, Aboriginal health and acute care capacity.

The bulk of health service spending is driven in large part by demographic factors (the size and age of the population), as well as non-demographic factors such as the high cost of improvements in health technology over time. For the most part that suggests that demand for health services could be largely unaffected by the financial crisis.

However, mental health services and health services provided to disadvantaged members of the community are likely to be an exception. They are likely to see increased demand as affected individuals are affected by the lack of employment and associated problems.

- ❑ The linkages between income and employment status and mental stress/illness are well established in the academic literature. Butterworth et al.⁴, for example, find that relative to those on income support, an unemployed person is 2.22 times more likely to experience mental health problems than someone on no income support.
- ❑ More specifically, it has been suggested that the greatest employment-related impact on mental health is the movement between employment and non-participation in the labour force⁵.

Hence, as increasing numbers of Australians will find themselves unemployed over the coming period, it is likely that demand for and spending on mental health and counselling services may need to rise.

3.2 EDUCATION AND TRAINING

Education and training includes school education services, vocational and workforce training, technical and further education (TAFE) services, and student support services, including school student transport.

Most funding goes to public school education. The other key element supports a vocational training system that improves the skills and qualifications of students and provides life-long learning opportunities for all people in New South Wales.

Demand for education and training services is likely to experience an increase as individuals find it increasingly difficult to find employment in the current environment.

⁴ Butterworth P, Crosier T, Rodges B (2004) 'Mental Health Problems, Disability and Income Support Receipt: A Replication and Extension Using the HILDA Survey', *Australian Journal of Labour Economics*, 7(2); 151-174.

⁵ Dockery, A.M. (2005) 'Mental health and labour force status in Australia', Paper presented to HILDA conference: www.melbourneinstitute.com/hilda/conf/conf2005/confpapers/Session%207C_Mental%20Health/Dockery,%20Mike.pdf.

As the number of people without work increases, service providers are increasingly called on to assist in the search for employment, as well as training and education places.

This could represent itself through a number of channels:

- ❑ there would be an increased use of TAFE and other vocational training services as individuals look to re-skill and/or up-skill;
- ❑ the public education system could also see greater use as students look to stay longer in school and high school retention rates rise – particularly given the relative lack of alternatives in employment; and
- ❑ Universities would also experience a greater demand, though there is little the States can do to facilitate this.

The economic downturn will see a notable shift up in the unemployment rate – one which will likely take many years of subsequent strong economic growth to redress. As the unemployment rate moves up it is likely that the number of long term unemployed will also escalate. The experience from previous downturns is that re-engaging these individuals in the workforce and/or providing adequate social engagement during longer periods of unemployment can be a significant challenge. The current environment is one where additional education and training, as well as social services, can play a very important role in keeping individuals engaged with the workforce, so that they are less likely to slip into long term unemployment when additional job opportunities do emerge again.

An additional demand which may end up being significant in the current environment is a greater number of enrolments within the public school system as some parents are no longer able to afford private school education for their children. Unlike previous economic downturns where job losses were concentrated among lower paid individuals (who are less likely to use private education), this downturn is affecting a broader cross-section of the community. That suggests the additional short term demands on the public school system may well be significant on some areas.

Spending on education has both an *automatic stabiliser element* (it rises as more people are compelled to stay in education or re-skill) and a *discretionary element* as governments seek to boost economic activity and future propensity by additional spending on education and training.

- ❑ The Federal government has already started to increase discretionary spending in education as part of its most recent stimulus package, which includes \$14.7 billion over three years for the *Building the Education Revolution* program.
- ❑ The argument is that investment in education and skills boosts flagging demand in the economy as well as the productivity and prosperity of the country for future generations.
- ❑ The *Building the Education Revolution* program will be structured as an agreement with the States and Territories and the non-government sector to provide extra funding for capital infrastructure for schools, over and above all existing and planned investments.

3.3 PUBLIC TRANSPORT AND ROADS

Public transport and roads services have two components: the management of the road system and road users undertaken by the Roads and Traffic Authority of New South Wales (RTA) and the provision of public transport which is funded through the Ministry of Transport.

It is difficult to say exactly how demand for transport and road services will develop in the current environment.

- ❑ As the economic situation worsens, there is likely to be a greater demand for public transport services as commuters seek out more cost-effective options.
 - However, as an offsetting factor, fuel prices have gone down in recent months – which takes the pressure off private transport.
- ❑ Also, with reduced economic activity there may be less use of transport infrastructure, so potentially some reduced demand for road network services and maintenance at the margin.

Overall, the likely higher demand for public transport does offer some potential for greater capacity utilisation, but is likely to mean some demand for additional services. Those services at present receive an operating subsidy, as well as capital funding. Most of the spending on roads (which could offer some offsetting savings) is on the capital side.

3.4 POLICE AND JUSTICE

Police and justice covers the activities of agencies in the criminal justice system, including services provided by the NSW Police Force, the Attorney General's Department, the Department of Corrective Services, and other emergency services agencies.

With the economic downturn creating additional low-income households as many people lose their jobs, there may be more calls on law and order services.

- ❑ Individuals facing unemployment and financial hardship may turn to criminal activity as a way out of money problems.
- ❑ There may also be a higher prevalence of domestic and other violence as families come under strain.
- ❑ Young people may also be finding it harder to find jobs in the current environment leaving them fewer options and a greater tendency to turn towards anti-social behaviour.

As a result, spending in this area may need to be increased with a greater demand for law enforcement and related activities.

3.5 COMMUNITY AND DISABILITY SERVICES

Community and disability services spending provides community and disability services to support those who are most disadvantaged in our community or who need support during times of crisis.

There is a wide range of responsive services, including accommodation for people with a disability, support and intervention to help families and children at risk, and community-based services to assist frail older people and people with a disability to participate in community life and live at home.

The global financial crisis is likely to add to demand for services in the community as people lose their jobs and families come under financial and other pressures.

Given the level of indebtedness many people were carrying prior to the crisis and the relatively broad incidence of job losses (not just those at the lowest paid end of the spectrum, although they will still be disproportionately affected), there may be a broader range of people requiring community based services over the next two years.

Many community based and social services were already stretched prior to the crisis in which case the additional demand could not be met without further resources. The services most immediately affected by deteriorating economic conditions are in employment, housing, financial and general counselling and emergency relief.

Increased spending in this area is also consistent with the operation of the automatic stabilisers – where the government is called on to provide more transfer payments and community services during economic downturns. Also, spending on such services is a benefit not just to those receiving the services, but also reduces long term social costs and enhances the overall productivity of the economy.

3.6 ENVIRONMENT AND NATURAL RESOURCES

Environment and natural resources covers a range of environmental initiatives and programs targeted at addressing the impact of climate change and reducing greenhouse gas emissions; reducing environmental degradation and pollution; improving waste management; and improving the management of land and water resources and of the coastal environment.

This is a relatively small area of the government's budget and may not see many changes as a result of the downturn.

- ❑ Essential services such as waste and water management will need to continue. As will the management to natural parks and other natural resources.

That said, spending in this policy area is influenced by changing community expectations and values as well as the need to strike a balance between economic growth and environmental and natural resource protection. Such spending may be seen as a lower priority by the community in the short term given more pressing needs. There may also be fewer recreational visits to national parks if there is a prolonged downturn as people may have less capacity to take holidays.

There is likely to be little change to demand for services in this area, and potentially some reduction in the short term.