Economy contracts in March quarter

Confirmation that the level of activity in the Australian economy contracted in the March quarter was contained in the National Accounts data. The level of real Gross Domestic Product (GDP) fell by 0.3% over the 3-months to March, to bring the annual rate of economic growth down to positive 1.4%. This represents a fall from the 2.2% recorded during the year ended last December and is the lowest annual rate of GDP growth since 2009. The average rate of annual GDP growth over the past three decades has been well above the current rate at 3.0%. However, as indicated on the chart below, growth has been hovering between 2% and 3% for most of the past decade.

March’s contraction in output is the first negative quarterly growth outcome recorded since March 2011. With the Coronavirus related shutdowns only coming into force towards the end of the March 2020 quarter, further and sharper declines in output are expected to have occurred in the June quarter.

As the largest component of domestic demand, household consumption typically accounts for a significant proportion of any change in aggregate demand in the Australian economy. Household consumption dropped by 1.1% during the March quarter, resulting in the annual growth being negative 0.2% (in real terms after adjusting for inflation). There were large variations in spending levels across categories last quarter. Spending by households on goods was 1.0% higher, whereas spending on services declined 2.4%. Households spent more on goods such as food, pharmaceutical & medical supplies, audio-visual equipment and computers. However, spending on service items such as cafes & restaurants, travel, accommodation and elective medical procedures declined sharply.

In contrast to the overall decline in household consumption expenditure, government consumption spending rose by 1.8% over the March quarter, to be 6.2% higher for the year.

Despite the rise in unemployment towards the end of the March quarter, household disposable income increased during the 3-month period. This reflected an increase in government social assistance benefits due to the introduction of new support packages in response to the Coronavirus shutdowns. Payments related to summer bushfires, both from the government and insurance schemes, also boosted household income. With household disposable income rising and consumption expenditure falling, the household savings ratio increased sharply. The household savings ratio (i.e. the percentage of household disposable income that is saved rather than spent on consumption) jumped from 3.5% to 5.5%. As shown on the chart above, the savings ratio is now at its highest level since September 2016. The savings ratio will typically...
rise in periods of heightened economic uncertainty as household become more cautious about their future financial prospects.

Offsetting some of the decline in from household consumption was a solid contribution from net exports. Over the March quarter, export volumes declined 3.5%; whereas imports declined by 6.2%. The lower level of imports was consistent with the slowdown in spending domestically, both in terms of consumption and investment. The fall in exports was mainly attributable to lower service exports (e.g. education and travel) with the exports of goods dropping by only 0.7%.

Business investment fell marginally over the March quarter, with a decline of 0.8%. This continues a prolonged period of low or minimal growth in business investment expenditure. There was, however, a rise of 3.6% in mining sector business investment over the quarter, which is now 10.3% higher for the year.

With the housing cycle in a period decline, there was a 1.7% fall in spending on the construction of residential dwellings. This was the 7th consecutive negative quarter, with spending now 9.7% below the level recorded last year.

Despite the fall in overall consumption in the quarter, the level of inventories declined. Inventories, also known as stocks, represent production that has taken place, but is yet to be sold. A spike in consumer spending on specific goods in response to the Coronavirus crisis would have contributed to some of the fall in inventories over the quarter. The fall may also reflect anticipation by producers that demand in the future is going to fall below current levels, with production decreased in preparation of this. Falling inventory levels detract from economic growth aggregates in the period they are recorded as they imply production levels were below the level of aggregate demand.

Q1: Identify the areas of expenditure that made a negative contribution to aggregate demand in the Australian economy over the March quarter.

Q2: Outline a possible explanation for the fall in inventories recorded over the March quarter.

Q3: Explain why the household savings ratio may have increased over the latest period.

Medium term fiscal projections released

With the Commonwealth Government’s Budget Statement for the 2020/21 financial year delayed from May to October, and the economic environment changed significantly by the Coronavirus control measures, there is currently considerable uncertainty around the detail of the Government’s financial projections. The Treasurer was due to provide an economic and fiscal update in June, however this update has been delayed until July 23rd. At this time, the results of a review of the “Job Keeper” program will be known.

In the interim, the Parliamentary Budget Office (PBO) has released “medium term fiscal scenarios” to demonstrate the impact on Commonwealth Government finances of 3 alternative economic scenarios defined by the Reserve Bank and described as “baseline”, “upside” and “downside”. Under all scenarios used for projections by the PBO, the economy is clearly weaker than when the last government budget estimates were made in December as part of the Mid-Year Economic and Fiscal Outlook Statement. In addition, a range of government spending programs aimed to help combat the impact of the economic downturn have had a materially negative impact on the budget.

Government stimulus measures are estimated to add approximately $50 billion to net expenditure in 2019/20 and $130 billion in 2020/21. In subsequent years, expenditure is expected to remain higher due to increased interest payments on government debt and higher ongoing levels of unemployment. In addition to the higher expenditure, revenue is expected to decline due to weaker economic growth and employment. This has the effect of reducing personal income and company tax revenue. In 2020/21 this impact on revenue is expected to be between $40 billion and $90 billion, with revenue remaining lower in subsequent years than previously forecast.
The net impact of the changes in fiscal outlook on the 2019/20 financial year position is a deterioration of approximately $70 billion (3.4% of GDP). In 2020/21, the deterioration is estimated to be between $170 and $215 billion. This would result in the Government’s net debt position being higher by between 14% and 19% of GDP by the end of 2020/21. With the budget forecast to remain in deficit until at least 2029/30, debt is projected to remain at these elevated levels.

Q4: Explain why the Commonwealth Government’s revenue is expected to decline due to the changes in the state of the economy resulting from the Coronavirus related control measures.

GST receipts allocated to States

In addition to the impact on the Commonwealth Government’s finances, the Coronavirus crisis is also expected to materially impact State Governments. A major source of State Government revenue is the allocation of grants from the Commonwealth Government. A significant proportion of these grants to State Governments are derived from the collection of the Goods and Services Tax (GST). Under current arrangements, the Commonwealth Government collects the GST and this revenue is then passed directly through to the States.

Each year around March, the Government Grants Commission makes its recommendations on the distribution of GST amongst the States. Fundamental to the methodology used by the Grants Commission to distribute payments to the States is the concept of “Horizontal Fiscal Equalisation”. Horizontal Fiscal Equalisation aims to ensure that differences in revenue raising capacity and costs of service delivery are offset by the grants provided. Under this principle, each State Government should be able to “provide similar standards of public services at a similar tax burden.” Since 2019, a benchmark has also been adopted that will ensure the fiscal capacity of all States and Territories is at least the equal of NSW or Victoria (whichever is higher).

Population size heavily influences allocations, as do other factors, such as the State’s ability to earn revenue from other sources. That is, those States with a greater revenue raising capacity will tend to receive lower allocations per person. Costs to provide services are also considered. Those States with higher costs will be compensated by higher GST allocations. The table below shows the planned distribution of GST in 2020/21 and the funding variance per person.

<table>
<thead>
<tr>
<th>State</th>
<th>Funding from GST Pool $bn</th>
<th>Population (m)</th>
<th>Funding per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW</td>
<td>$19.8</td>
<td>8.1</td>
<td>$2,440</td>
</tr>
<tr>
<td>VIC</td>
<td>$17.1</td>
<td>6.7</td>
<td>$2,566</td>
</tr>
<tr>
<td>QLD</td>
<td>$14.3</td>
<td>5.1</td>
<td>$2,785</td>
</tr>
<tr>
<td>WA</td>
<td>$3.1</td>
<td>2.6</td>
<td>$1,177</td>
</tr>
<tr>
<td>SA</td>
<td>$6.3</td>
<td>1.8</td>
<td>$3,558</td>
</tr>
<tr>
<td>TAS</td>
<td>$2.7</td>
<td>0.5</td>
<td>$5,006</td>
</tr>
<tr>
<td>ACT</td>
<td>$1.3</td>
<td>0.4</td>
<td>$3,089</td>
</tr>
<tr>
<td>NT</td>
<td>$3.1</td>
<td>0.2</td>
<td>$12,461</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$67.6</td>
<td>25.5</td>
<td>$2,650</td>
</tr>
</tbody>
</table>

Source: Grants Commission, ABS 3101

As has typically been the case, WA has the lowest proposed allocation of GST revenue per person due to its strong ability to raise revenue from other sources, especially via mining royalties. As such, this method of distribution of GST revenue is one mechanism by which the benefit of the mining industry is shared across the wider economy. However, the Commonwealth Government will be making supplementary payments to Western Australia to meet the principle that each State receives no less than 70% of the actual GST revenue raised in that State.

In late May, the Prime Minister, Mr. Morrison, announced a change in the framework governing Commonwealth – State relations. Previously, the Council of Australian Governments (COAG) was the key forum for managing intergovernmental issues, including financial relationships. COAG consisted of the Prime Minister, State and Territory leaders and the President of the Australian Local Government Association. COAG...
is being replaced by the National Federation Reform Council. The Prime Minister outlined that “at the centre of the National Federation Reform Council will be National Cabinet”. The National Cabinet was formed in March to provide a coordinated response to the COVID-19 crisis and consists of the Prime Minister, Premiers and Territory leaders. The Council on Federal Financial Relations (CFFR), consisting of State and Commonwealth Treasurers, will report to National Cabinet and take responsibility for all inter government funding agreements

Q5: Describe the process by which GST revenue is currently allocated to the State Governments.

**Minimum wage increase granted**

The Fair Work Commission handed down its 2020 Annual Wage Review in June. It was decided by the Commission’s Expert Panel for annual wage reviews that a $13.00 per week increase would be granted to workers on minimum award wages. This lifts the National Minimum Wage to $753.80 per week ($19.84 per hour) and represents a 1.75% increase. Some 2.2 million workers will be impacted by the change. The higher wage will be effective for some workers on July 1st this year. However, other workers in industries that are more heavily impacted by the COVID-19 crisis will have the increase delayed until 1st November or 1st February.

This 1.75% rise follows a 3.0% increase in minimum wages last year and is below the latest rate of increase in the overall Australian Wage Price Index of 2.1% (i.e. the average applying across the wider economy in the year to March).

In assessing the minimum wage increase, the Fair Work Commission (FWC) is required to take into account factors such as:

- The state of the economy
- The relative living standards of the low paid
- Promotion of social inclusion through increased workforce participation
- The principle of equal remuneration for work of equal or comparable value

As indicated on the chart below, the gap in the rate of increase between the minimum wage and the broader rate of wages growth across the economy had been widened over recent years but has narrowed this year with a lower rate of increase granted in the minimum wage. The state of the economy and the potential negative impact on employment of higher wages was a key consideration of the Commission in granting the lower wage increase this year. The Commission also took into account “tax-transfer system and other changes which have taken effect in the current Review period which have benefitted low-paid households.”

Notwithstanding the smaller wage rise granted this year, the Commission did highlight a desire to avoid a rate of increase below the rate of inflation. The Commission noted that “*any increase we award which is less than increases in prices and living costs would mean that many award-reliant employees would be less able to meet their needs. For some households such an outcome would lead to further disadvantage and may place them at greater risk of moving into poverty.*

Q6: Explain the rationale for the FWC’s decision to grant a smaller increase in the minimum wage this year than in previous years.

Q7: Evaluate the impact of the increase in the minimum wage on the equality of income distribution across the broader economy.