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SE Commentary

HD **FACTS SELDOM MATCH FORECASTS**

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Treasury's rosy outlook tends to obscure the real bottom line

The new Treasury secretary, John Fraser, who takes over next year, will have many issues before him, but producing a budget in May with some realistic scenarios for how the government's finances might evolve should be top of the list.

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This week's budget update didn't get close, continuing the Panglossian view that Treasury has clung to since May 2009 that we're just going through a bit of a soft patch from which we'll soon emerge, most probably in two years.

Reading the text, which is probably more the Abbott government's doing than Treasury's, you'd hardly know there was a problem.

"The Australian economy continues to grow solidly," says the first paragraph of the budget document.

Sure, growth would slow a bit this year — indeed, growth in nominal gross domestic product, which is the value of all the goods and services produced and which dictates tax revenue — would be the slowest since the credit squeeze 55 years ago. That almost saw the Menzies government turfed at the next election.

But it will bounce back next year, the budget papers assure readers, and by 2016-17 we'll be back to the long-term trend. With growth recovering, tax revenue would be rocketing along.

On each of the 10 occasions Treasury has revisited its budget forecasts since late 2010, it has had to downgrade them as reality punctures the bubble of such an imaginary future.

It is not the result of spendthrift governments introducing new entitlements — just the economy failing to perform as well as Treasury expected. It updates forecasts twice every year and three times in election years.

Treasury first tried estimating the 2014-15 budget bottom line in December 2011; between budgets, updates and pre-election estimates, it has now had nine goes at getting the number right.

Every time it looked, the outlook was worse. The total downgrades due to the state of the economy now tally to $58 **billion** for that year alone.

Part of the problem is the assumptions Treasury routinely makes when it prepares a four-year outlook for the budget. It does detailed forecasts for two years but then, because economic forecasting is such an unreliable art, it simply assumes things return to their long-run average.

Every year, one of these "long-term average" years comes into focus for a detailed forecast and gets marked down as the sluggish growth that has followed the global financial crisis continues.

However, it also reflects repeated errors in forecasting both the economy and the link between economic growth and tax revenue. Treasury was not alone in underestimating the height of the commodity price boom through the latter half of the 2000s.

But the belief it started to express in late 2006 that commodity prices would remain in the stratosphere for decades to come set the budget up for massive downgrades once prices started to tumble in the third quarter of 2011.

As late as October 2012, Treasury was still forecasting in the mid-year update that the budget would return to surplus in the 2012-13 financial year; the complete failure of the **mining** tax to generate any revenue and the collapse in **company** tax that was reported by the tax office to Treasury the same day showed it was an impossible dream.

Responding to its forecasting failures, Treasury commissioned an internal review in 2012, which concluded its own performance was "comparable with, or better than, those of official agencies overseas" and was also as good as that of the private-sector Deloitte Access Economics.

Treasury acknowledged it had underestimated growth during the boom and overestimated it during the downturn, but said this was hard to avoid.

Deloitte partner Chris Richardson says budget forecasting used to be a lot easier when the key variable was the slow-moving unemployment rate than it is now, when the budget bottom line swings with the volatile price of **iron ore**.

Since its forecasting review, Treasury has been publishing margins of error in its estimates, and they are wide.

It can only be 70 per cent confident that receipts in 2015-16 will be somewhere between 19 per cent and 22 per cent of GDP — a range equivalent to about $50bn.

However, Treasury has not acted on the recommendation from the review that it start using scenarios to show what would happen if its estimates were wrong — or, if it has, they have not been published.

Treasury fails its minister and the nation by allowing the political debate to proceed on the basis that the budget is on track for a return to surplus in 2019-20 when it knows full well the uncertainty around this is extreme.

Every commodity boom in history has been followed by a bust, and it takes no more than a downturn in **China**'s growth to produce one now.

The fact this is a realistic danger is shown by the policy moves being made by the **Chinese** government in an effort to avert it.

Treasury should be including in its budget papers a scenario showing what happens if it is wrong about commodity prices remaining forever high.This would focus the minds of everyone — including Labor and the querulous crossbenchers — on just how much is at **stake** in repairing the budget while we still have some growth.

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