The 2018/19 Budget – initial views

- The underlying Budget deficit for 2018/19 is put at $14.5bn (0.8% of GDP), and the elusive Budget surplus is now pencilled in for 2019/20.
- The net operating balance also returns to surplus in 2019/20.
- Surpluses build steadily in the outyears.
- The well-telegraphed themes to do with personal income tax cuts, health & aged care, and the environment were delivered.
- The main “surprise” was the amount of revenue available to fund tax cuts and other initiatives.
- The main disappointment was that most of the improvement in the Budget bottom line from here is still driven by the revenue side (even with tax cuts).
- Net government debt now peaks at $349.9bn in 2018/19. Gross debt peaks at $579bn in 20019/20.
- Financial market reaction was, as usual, limited.

The big picture

The 2018 Budget was clearly framed against a very different backdrop than the post GFC Budgets of the past decade. Better income outcomes have allowed revenues to surprise on the upside. And a better economic backdrop, especially in the labour market, means spending restraint has been easier to achieve.

But you take what luck comes your way. And the Government has been able to deliver a fiscal package that contains tax cuts and increased spending in key areas such as infrastructure, health & aged care and the environment. They are also set to deliver the elusive Budget surplus a year earlier than previously expected (albeit a wafer thin surplus).

Most Budget initiatives were well telegraphed over the previous couple of weeks. The main “surprise” was the amount of revenue available to fund tax cuts and other initiatives. The main disappointment was most of the improvement in the Budget bottom line from here is still driven by the revenue side (even with tax cuts). There are also some elements of what could be seen as a watering down of the medium-term fiscal strategy.

The Budget Papers run for thousands of pages. But too often the focus comes down to the one number – the Budget balance in its various guises. From that narrow perspective:

- An *underlying cash surplus* is in sight and the pace of deficit reduction continues around the average of recent years (0.4-0.5% of GDP pa). What is changing is that the stance of fiscal policy looks more appropriate. We always had some reservations about the pace of fiscal consolidation in an economy that was running below trend with high levels of underemployment. But above-trend growth is expected from here and further fiscal consolidation should not be a threat to the growth outlook.
- The *net operating balance* is in surplus from 2018/19. So the Government is now covering the cost of its day-to-day operations.
- The headline deficit is on a narrowing track but a surplus is unlikely before 2020/21. So the potential pressures on financial markets are receding at a slower pace, courtesy of the infrastructure boom. The cumulative headline balance over the next four years falls short of the underlying balance by $22bn. It is a proxy for the funding task required by the infrastructure push.

The details behind these trends, however, remind us that fiscal policy is more than just the bottom line outcomes. Most of the initiatives proposed are desirable or needed to deal with the challenges faced by the Australian economy.

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Budgets are typically judged on equity, efficiency and effectiveness. And the key Budget measures can be given a conditional tick. But the IMF suggests that fiscal policy has a greater role to play in fostering sustainable and inclusive growth. Fiscal policy should be countercyclical, growth friendly and inclusive. From this broad perspective the 2018 Budget ticks the boxes:

- the deficit is expected to decline and surpluses emerge as economic growth lifts so fiscal policy can be seen as moving in the right direction;
- the focus on infrastructure and personal income tax cuts is growth friendly; and
- spending on health and aged care will help inclusion.

Scoring the Budget

The Budget, in Paul Keating's famous line, is "whirring back into surplus". In fact the pace of improvement in the budget position is one of the fastest in at least twenty years. As a result, the Government has been able to credibly forecast a return to surplus in 2019/20, a year earlier than previously expected.

To give this result some perspective, though, Budget forecasts have projected a return to surplus since the May 2010 Budget. There is an old economist's line about "never changing a good forecast because it will be right eventually". But even by this metric the time taken for Budget repair is unusually elongated. The Government has battled against an extended period of income weakness that has crimped revenues. And the Government has struggled to rein in spending to the extent hoped. Outlays have expanded on the back of of structural trends such as the aging population, political roadblocks in the Senate, and the lack of appetite in the community for spending cuts in areas like welfare.

Nevertheless, the money is there. The revenue windfall accruing to government finances is real. But that windfall is being asked to pay for a lot – tax cuts, new spending and a surplus!

While the Government has characterised its economic assumptions as conservative, these assumptions should be scrutinised closely. Especially the key income assumptions relating to wages, the terms-of-trade and nominal GDP that ultimately drive revenue projections:

- wages growth slowly picks up and is expected to be running at a near normal rate of 3¼% in 2019/20.
- the terms-of-trade falls as commodity prices unwind some of the earlier gains; and
- nominal GDP (or the tax base) is expected to grow at a modest pace over the forecast period.

Frankly it is hard to quibble with these underlying Budget assumptions. They look reasonable and not too dissimilar to our own. We might argue that wages growth will not lift as quickly given the slow progress expected in winding down the unemployment rate. And we might argue that the longer-run prices for iron ore and coal should be lower than assumed. But the difference would only be at the margin.

Wages are the key to many parts of the economic and policy story at the moment. A sustainable improvement in the Budget bottom line is difficult to achieve without the revenue flow from higher wages. It is difficult to see a turn in the inflation and interest rate story without a lift in wages growth. And a wages boost would alleviate some of the strains on household budgets and reduce the risks from high levels of household debt. Small wonder that RBA Governor Lowe has returned repeatedly to the need for wages to lift. And suggested that we should all be knocking on the boss's door! The Governor has also recently added social cohesion to the long list of risks emanating from the subdued wages backdrop.

From that perspective, putting personal income tax cuts on the table should be applauded. Even if it comes at some cost to fiscal consolidation. For the same reason, the emerging debate about adjusting the Newstart allowance deserves serious consideration (although missing from the Budget). And it highlights one of the missing links in the policy debate. Economists talk endlessly about monetary policy and fiscal policy. But wages policy should be on the agenda as well.

That's easy to suggest. But concrete ideas are required. At one level we should emphasise the critical importance of getting the broader economic and policy parameters right. Do that and businesses will expand, invest and hire. Wages would follow eventually. Not surprisingly, most economists would argue that the proposed company tax cuts are also desirable. But these cuts are proving difficult to achieve. And if weak wages growth is a significant economic risk, then the question is can we afford to wait? One possibility worth debating is the idea being discussed in Japan of skewing tax cuts to those companies that agree to lift wages and capex.

There is also the question of whether personal income tax cuts will help the economy. The cuts have been skewed towards the lower end of the income range. This is smart economics – lower income households are more budget constrained and likely to spend the proceeds. It's also smart fiscal policy – it reduces the near-term pressures on the Budget balance and while the cuts expand and build over time, they can be fine-tuned to changing economic circumstances. It's also smart politics – an election is due sometime over the next year and the debate about equity typically sharpens through that period.

There is now a danger, however, of the politics getting in the way of a reasoned tax debate. A progressive tax system is desirable. But:

- the top 21% of income earners pay 70% of all income taxes;
- the top marginal rate has increased over the past couple of years and the top rate cuts in at a low income multiple; and
- Australia's top rate is high and the threshold is low on a global comparison.

This combination is a risk to productivity and labour-force participation. But these observations struggle for oxygen in any debate about tax reform. Indeed, the tax cut proposals leave any adjustments to the top end of the tax range to 2024 when the top threshold lifts from $180k to $200k and the top marginal rate remains at 45%. The Government makes something of a virtue of this by noting the top 20% of taxpayers will still pay around 60% of all personal income tax.

Similarly, the needed discussion about the interaction of the tax and benefits' system is not sexy and gets little attention in the policy debate. The combination of a progressive tax system, high withdrawal rates for social benefits and repayments for HECS/HELP debts impose high effective marginal tax rates on second income earners. OECD estimates show Australia has one of the highest implicit taxes on returning to work on a global comparison.

Past tax cuts have generally had a positive impact on consumer spending momentum. But the impact depends on background economic conditions at the time. Tax cuts have generally proved less stimulatory when associated with recessions or "shocks" like the GFC. The positive economic backdrop this time makes a positive outcome more likely.

Household expectation's about their financial position is also correlated with their reaction to Budget measures. A Newspoll survey reports that households rate spending on health and infrastructure and cutting debt and deficits as more important than tax cuts. Nevertheless, measures in the 2018 Budget are generally consumer/household friendly and should lift sentiment. A positive reaction makes it more likely that tax cuts will be spent.

Business confidence is very resilient at present. And we would expect budget initiatives to have little impact on business sentiment. SME's should be happy with the tax cut already delivered and the extension of the $20k instant asset write-off for another year. At the big end of town, surveys show company directors favour tax reform, energy policy, productivity and infrastructure spending as priorities. Business should be happy with the infrastructure story. But company tax cuts and energy security remains work in progress. The tightening up of R&D funding may be a disincentive at the margin. Overall, there was probably not enough to stimulate the "animal spirits" needed to assure a lift in non-mining capex.

Lifting infrastructure spending, again, comes at a cost to the Budget bottom line (an extra $24.5bn in this Budget). But, again, we would argue that this lift is desirable. The Federal Government was late to the infrastructure party but is now making up for lost time. We have long argued the case for an infrastructure push. Such spending boosts demand in the short term and lifts incomes and productivity over the longer haul. Both are desirable outcomes. Treasury analysis suggests that the public investment (or infrastructure multiplier) is about 4. That is every $1 invested generates GDP increases of $4 over the life of the asset. This is a very attractive rate of return.

There is scope for a virtuous circle here. Many of the delivery organisations for infrastructure projects are set up as commercial operations eg Western Sydney Airport Co, suggesting some new assets will be for sale. The demand for long-life assets is there. A 2017 survey of potential investors by Infrastructure Partnerships Australia, for example, showed 70% were "highly likely" to invest in Australian infrastructure. Some 25% indicated they were willing to invest $2bn or more. Sale proceeds could then be recycled back into new infrastructure spending.

The same survey shows an increase in perceived sovereign and political risk. And the company tax debate means Australia's attractiveness relative to the rest of the world has declined a little. These outcomes emphasise the importance of getting the overall policy backdrop right.

One small concern here is whether we are trying to do too much. We are boosting infrastructure construction at a time when residential construction is running at record highs and non-residential construction is lifting. The risk is that construction costs rise.

Nor should we ignore human capital. Education spending helps improve labour market flexibility and job and income prospects. The majority of new job creation, for example, is in services that require higher levels of educational attainment. And incomes tend to rise with educational attainment. There wasn't much in the 2018 Budget, other than an indication of support for the recommendations of Gonski 2.0.

Nevertheless, for worthwhile reasons, the Budget balance will be smaller than otherwise. By definition these smaller surpluses mean progress in winding back government debt will be slow (although debt:GDP ratios will show a more noticeable decline). But we should not fear some debt-financed infrastructure. These are long-life assets and it makes sense to share the costs across the users over time. Borrowing and paying interest is an effective way of achieving this aim.

What we should be concerned about is the constraints on future policy. By failing to reload the fiscal cannon, we are limiting our ability to deploy fiscal policy against any future "shock" that might come along.

We should also be concerned about the all too ready tendency of governments of all persuasions to parley a maybe temporary boost to revenue into longer-term tax and spending commitments.

That said, there are some spending and savings initiatives that will improve the Budget balance over time. These measures are worth near $2bn in terms of lower spending and near $11bn of extra revenue over the next four years. Most of the extra revenue is to be squeezed out of the Black Economy. That may prove to be a difficult quest.

On a related issue, the changes to the medium-term fiscal strategy come with some risks. The focus is now on keeping the tax share of GDP to no more than 23.9%. This tax "speed limit" is justified as a spending discipline and a "warning light" of when tax relief is required.

The 23.9% of GDP limit is actually at the top end of the historical range so looks reasonably light as a spending "discipline". It is around the levels run during the Howard-Costello Government.

The limit is a reasonable indication of the need to control against bracket creep and the distortions that can emerge as taxpayers cross into higher thresholds. But it does essentially require a fair share of future surpluses get handed back as tax cuts. The strategy to push surpluses towards 1% of GDP and pay off debt looks a little redundant from that perspective.

The Budget arithmetic

The forecasts in the December 2017 Mid-Year Economic & Fiscal Outlook (MYEFO) projected underlying deficits totalling $4.9bn over the 2018/19-2021/22 period. Parameter and other variations since then have improved the budget bottom line by $35bn. The policy proposals formalised in tonight's Budget have handed back nearly $15bn through tax cuts and the like. We are now looking at accumulated <u>surpluses</u> worth $15bn over the period to 2021/22.

The policy impact is driven by a mainly by revenue measures costing $15bn and a limited contribution from spending changes worth only $0.4bn over the period.

The economy & the Budget

The Budget economic parameters are similar to those laid out by the RBA in its recent *Statement on Monetary Policy*. That is, Australia is on track for a period of above-trend growth that (slowly) winds excess capacity out of the labour market. As a result, wages growth and inflations rates (slowly) move higher.

Above trend growth is a reasonable assumption. The economy has a fair degree of momentum at present. It is getting easier for the economy to grow as the headwinds from falling commodity prices and mining capex are over or nearly over. A fair amount of the growth story looks "locked in" (think LNG exports, infrastructure and the tourism and education booms). Some of the downside risks have retreated a little. Residential construction, for example, looks set to run at an elevated rate. The turn in non-mining capex appears to have finally arrived.

The main domestic risk relates to the interaction of high household debt levels and weak income growth. The Budget assumes consumer spending growth lifts from around 2½%pa to 3%pa through the forecast period. Ongoing weak income growth means to get there, however, the savings rate needs to fall further. These assumptions seem a tad optimistic, even with some stimulus from tax cuts.

Most risks seem centred offshore. They relate to the potential for a global trade war, other geopolitical strains and high levels of corporate debt in China. Nevertheless, Budget economic figuring is based on a solid global outlook.

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