Global Markets Research

Economics: Preview

3 May 2017

Budget 2017: what to expect?

- The 2017 Commonwealth Budget is scheduled for 9 May.
- We put the Budget deficit for 2017/18 at $28bn.
- Budgets typically aim to deliver good news on growth, jobs and incomes. The first two are on track but income risks remain.
- The debt and deficit debate is shifting in a way that favours spending on much needed infrastructure.

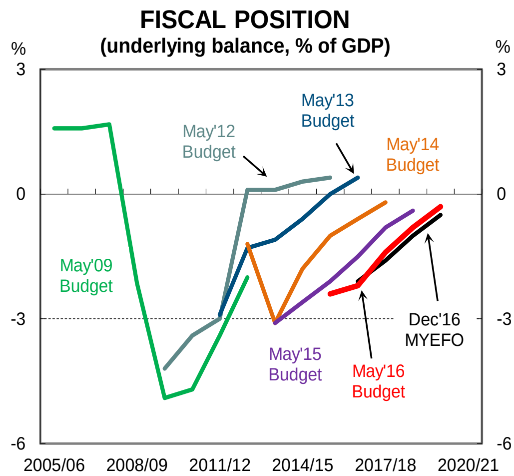
Budget thematics

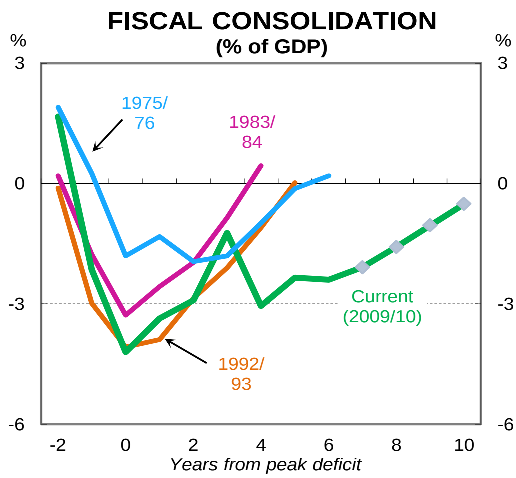
The big set piece for fiscal policy is coming up with the Commonwealth Budget on 9 May. What also looks "set" is the broad budget themes. The fiscal landscape will not be dramatically reshaped.

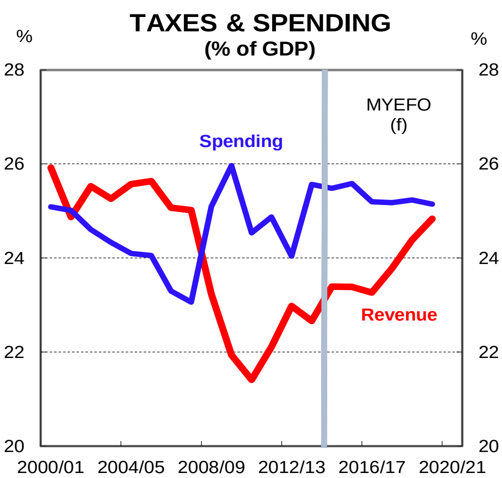
We see the broad parameters of the 2017 Budget as:

- *ongoing* underlying budget deficits over the four-year projection period;
- *declining* deficits in dollar terms and relative to the size of the economy;
- the elusive *surplus* still on target for 2020/21 (which will finally fall within the budget projection period);
- an earlier return to balance/surplus on the new (old) net operating balance measure – perhaps by 2019/20;
- an emphasis on spending restraint to drive bottom line improvements (at least in the budget "marketing", although revenue ie bracket creep will probably do most of the work);
- tax "reform" limited to the remaining components of the Enterprise Tax Plan;
- a characterisation of economic and fiscal assumptions as conservative;
- a desire to maintain the AAA rating;
- a proposition that infrastructure is the answer to the nation's ills – driving jobs & growth, helping fix housing affordability, solving energy security, boosting productivity and incomes;
- reforming education funding; and
- a push to place defence spending as an economic multiplier.

The fiscal landscape may not shift too much. But many of these outcomes are desirable. Balancing the budget is necessary over the medium term. But there are reasonable arguments for not moving too quickly given







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lingering concerns over the economic backdrop. Conservative assumptions mean any upside "surprise" can be devoted to budget repair. Spending restraint is an important part of fiscal discipline. Disentangling recurrent and capital spending can only improve the fiscal debate. More infrastructure spending helps lift short-term demand. And infrastructure spending is one of the keys to boosting income and productivity over the longer-term.

But there are also some areas that are a little disappointing or questionable. A budget has two sides. So attempting to limit fiscal repair to just the expenditure side can distort the process. Revenues should rise as the impact of the commodity bust wanes. But budget figuring suggests "bracket creep" will do a fair proportion of the heavy lifting. Deloitte Access Economics, for example, estimates that bracket creep will be worth an additional $8.8bn in revenue by 2019/20.

Positive benefits should flow from company tax cuts. Benefits would be greater, however, if these cuts were part of an integrated package including personal income tax and the GST.

The government is also a little late to the infrastructure party. The need to lift infrastructure spending has been evident for a while. Borrowing costs have been exceptionally low for some time. There is slack in the labour market. And we have not made use of Australia's fiscal space. The OECD estimates that Australia has significant "fiscal space" (the gap between actual debt and market tolerance for more debt). Fiscal space has increased by 23% of GDP between 2014 and 2016 as the impact of lower interest rates more than offsets the impact of a slower potential GDP growth rate. The AAA story plays in here. Such a rating may provide some benefits in times of stress. But the size of the potential benefit is probably much reduced.

A better starting point?

We put the starting point for this year's Budget deliberations in *better* position than expected at the time of the mid-year review (MYEFO) in December:

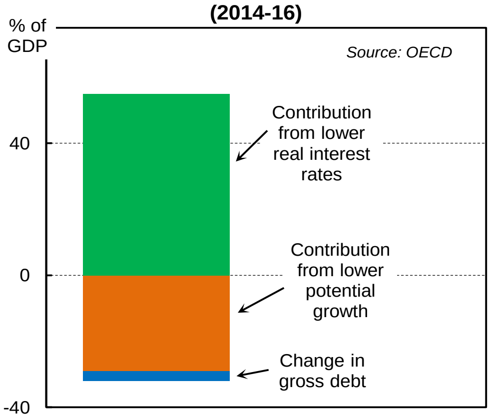
- Budget deficits so far in the current financial year are better than expected. Monthly financial statements for the first eight months of 2016/17 shows the run rate for the period about $3½bn better than projected.
- The income recession is over. Nominal GDP growth (the tax base) has picked up sharply after an extended period of weakness. Our forecasts have nominal GDP growing by 5½% in 2016/17, the fastest pace of growth in five years.

Our simple budget forecasting model captures the impact of some economic parameter changes since MYEFO. The model results point to a net improvement in the budget bottom line of $12bn over the next three years.

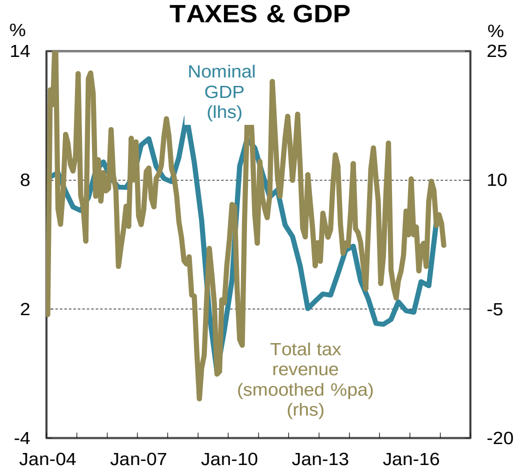
This improvement needs to be put in context. Every bit helps. But the $12bn looks like a rounding error relative to projections showing total spending of $1.4trn over the next three years. And the income recovery is skewed towards corporates rather than households at this stage. The revenue impact may be smaller as a result.

New policy initiatives since the mid-year Review have been negligible. It appears that the starting point for 2017/18 budget deliberations is a deficit of around $28bn. Assuming the government funds any further new spending via savings elsewhere, or keeps it off balance sheet, then the underlying deficit announced on Budget night should be close to this figure.

CHANGE IN FISCAL SPACE
(2014-16)



TAXES & GDP



BUDGET BALANCE PROJECTIONS
(% of GDP)

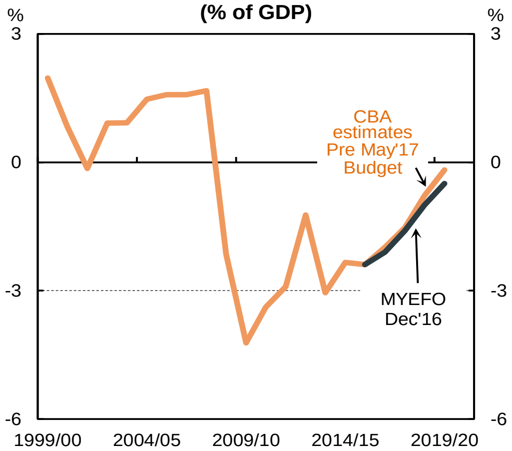


Table 1: Some Budget Figuring ($bn)

	2016/17	2017/18	2018/19	2019/20
Budget balance as at Mid-Year Review (Dec'15)	-36.5	-28.7	-19.7	-10.0
Changed economic parameters (CBA estimates)	1.8	1.0	4.9	6.5
Policy changes since MYEFO	-0.5	-0.5	~	~
May'17 Budget starting point	-35.2	-28.2	-14.8	-3.6

Budget figuring will include the so-called zombie measures that have been stuck in unlegislated limbo for some time now. These measures were worth $8½bn as of February 2017. The government has had some success in clearing the decks since then and does seem inclined to push on with the task. Outcomes here are a wildcard in budget figuring.

A different presentation

The government has livened up the fiscal debate by introducing the idea of "good" and "bad" debt. Beyond the theatrics, this distinction should prove useful in shifting the debt-is-evil mindset and allowing a sensible debate on how to fund the day-to-day running costs and longer-term infrastructure needs. We have argued this proposition for a few years now.

In practical terms, this shift means the net operating balance will receive equal billing with the underlying budget deficit. We recommend using:

- the *net operating balance* when assessing the sustainability of government operations;
- the *underlying budget balance* when thinking about the impact of the budget on the economy; and
- the *headline budget balance* from a financing and financial market perspective.

Our back-of-the envelope calculations are shown on the facing chart. As noted earlier, these calculations suggest an earlier return to balance/surplus on the net operating balance measure – perhaps by 2019/20.

Presumably, the good debt is that generated by the capex task (purple bars) and the bad is that resulting from the excess of recurrent spending over revenue (green bars).

But the Treasurer has indicated that the 2017 Budget will "be assigning the level of government debt across portfolios". We have had a go at producing some numbers.

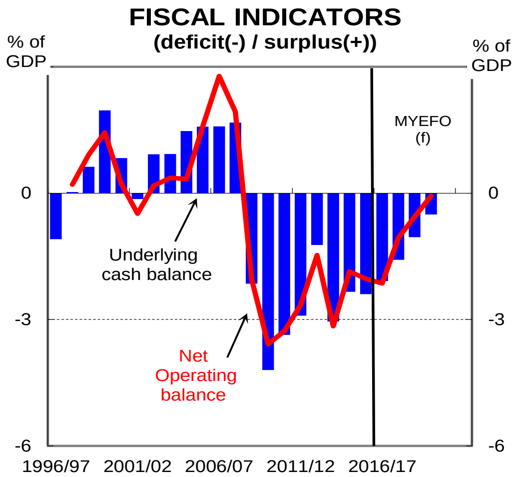
The facing chart shows government debt, proxied by CGS on issue, allocated according to shares in general government expenses by purpose. The (very) arbitrary delineation between good and bad is education and economic services versus the rest. There are a lot of methodological issues to resolve here. How do you treat defence spending for example? Is building a patrol boat recurrent spending or investment in a long life asset?

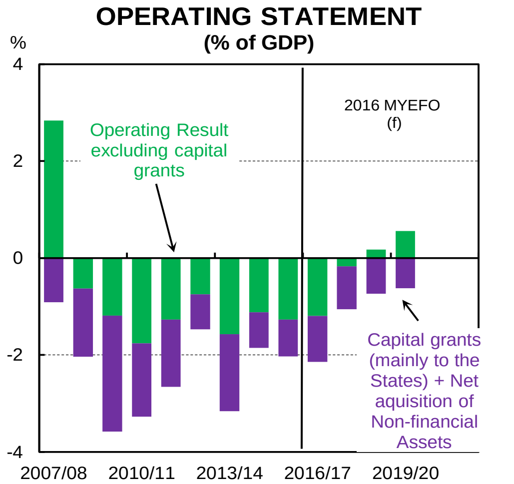
Budget initiatives

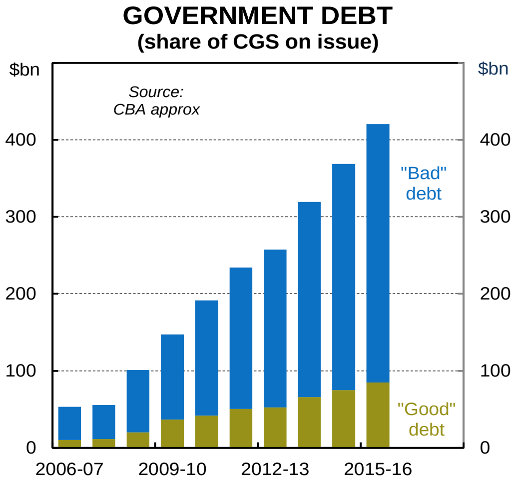
Some budget initiatives have already been announced. And the shape of other likely initiatives are becoming clearer.

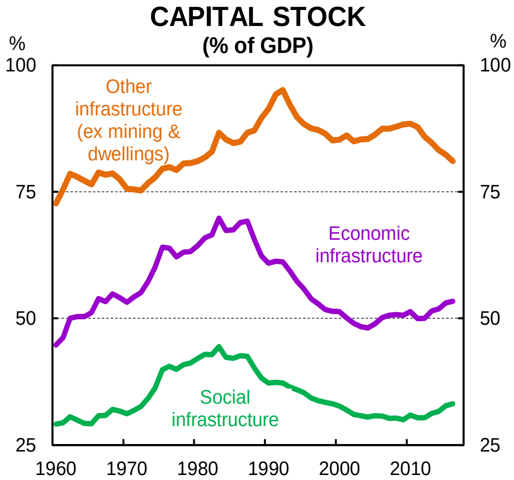
The good-debt-bad-debt approach clears the decks for increased spending on **infrastructure**. The Government has announced that it will build the new airport at Badgerys Creek. Spending on an inland rail line from Melbourne to Brisbane also seems likely. Spending on energy infrastructure would not be surprising given recent problems. Snowy Mountains 2.0 is under discussion!

The initially highlighted budget focus on **housing affordability** seems to have receded. Nevertheless, some initiatives seem likely. The debate about housing and superannuation has waxed and waned. But help for first-home buyers and some encouragement for older homeowners to downsize built around superannuation are possible. Housing tax arrangements are unlikely to change. There is some discussion of a vacant property tax to help lift rental supply. But the Treasurer seems more enamoured with the









bond aggregator concept to help fund affordable housing.

Infrastructure spending is another tool to help deal with affordability. But much progress on this front seems unlikely in this year's budget.

Reform of **education** is a theme that has already been announced. Changes in university funding and student debt arrangements appear to be recycled into more school funding. Gonski 2.0 is coming!

Another potential source of savings are measures to reduce the cost of medicines under the Pharmaceutical Benefits Scheme (PBS). Any savings, however, look set to be used to add new drugs to the PBS.

Tax reform will make little progress in the 2017 budget. The ongoing plan to extend **company tax cuts** to the big end of town will remain in budget figuring. The leftover parts of the Enterprise Tax Plan will be sold as a necessary economic reform and essential to maintaining international tax competitiveness. Expect to hear as well about the lifting of the middle tax threshold and the removal of the Temporary Budget Repair Levy. But these were announced in earlier budgets. Expect also to see various ongoing reviews in areas such as sharing GST revenue and the petroleum resource rent tax dressed up as tax reform.

Economic reform more broadly will probably be limited to highlighting the benefits of the childcare package and Youth Jobs PaTH program.

The perennial crackdown on welfare cheats, multinationals and extracting a public service **efficiency dividend** will no doubt be on display again. Indeed the higher education reform package expects to achieve an efficiency dividend of $2.8bn over two years.

To this mix will be added a likely push on the **black economy**. The government has established a Black Economy Taskforce. The ABS puts the cash economy at about 1½% of GDP (or $21bn). Of that, the Taskforce estimates some $10bn is untaxed.

The macroeconomic backdrop

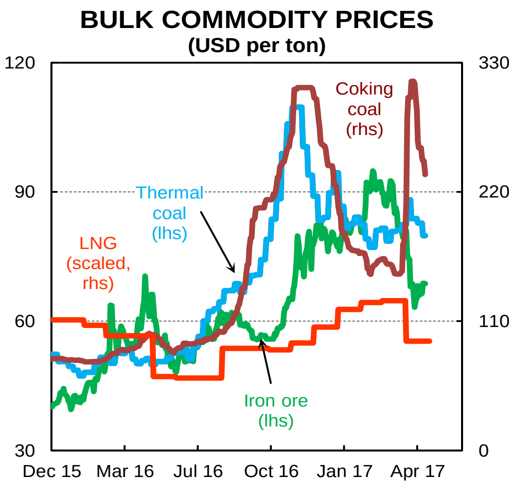
The government appears more confident about the global economic backdrop than it has been for some time. And this is spilling over into views on the domestic economy as well. Treasurer Morrison recently noted that "things are beginning to look up, and we can be more confident that there are better days ahead". But he also made it clear that budget figuring would be based on what he called conservative assumptions.

From that perspective we are likely to see only small changes to the broad economic parameters used in the mid-year budget review in December. That said, a better global backdrop and more public spending may see some upgrades to real GDP forecasts.

There is also some potential for an upgrade to parts of the *nominal* story. The commodity price assumptions that are critical to budget figuring were given a conservative bent in the mid-year budget review. But bulk commodity prices have proved relatively resilient and in some cases, such as oil and thermal coal, could be revised higher.

Table 2: Budget Assumptions & Forecasts

Variable	MYEFO forecasts for 2017/18	Likely direction of shift in May Budget
Trading partner growth	4%pa in 2017 and 2018	↑
Iron ore	USD55 per tonne from Q3 2017	→
Metallurgical coal	USD120 per tonne from Q1 2018	→
Thermal coal	USD62 per tonne from Q1 2018	↑
Terms of trade	-3¾%	↑
Nominal GDP	3¾%	↑
Cash rate	In line with market pricing (which had the cash rate at 1½% in 2017)	→
TWI	65	→
AUD	USD0.75	→
Tapis oil	USD49	↑
Public demand	2¼%	↑
Wages	2½%	→
Unemployment	5½% by Jun'18	→
Real GDP	2¾%	↑
CPI	2%pa by Jun'18	→



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