Tuesday, 9 May 2017

Federal Budget 2017-18

Tax and Build!

Tonight's budget forecasts a deficit in 2017-18 of $29.4 billion (1.6% of GDP). It is the tenth consecutive federal deficit and is an improvement from the expected deficit of $37.6 billion in 2016-17 and $39.6 billion deficit in 2015-16. The deficits to 2020-21 are projected to continue to shrink. A projected return to surplus by 2020-21 remains intact.

It is encouraging that the budget deficits are projected to decrease over the out years, but progress has been slow and achieving a budget surplus by 2020-21 might still prove elusive.

In last year's budget, the government expected a deficit in 2017-18 of $26.1 billion. That was revised in December's Mid-Year Economic & Fiscal Outlook (MYEFO) to $28.7 billion and, now, five months later has been revised again to $29.4 billion. It highlights the slow progress in addressing budget repair.

Indeed, the deficit projections have deteriorated for 2016-17, 2017-18 and 2018-19 from the MYEFO and budget projections of last year. This deterioration has occurred against a backdrop of higher commodity prices, which has boosted company profits and the government's tax intake.

Across the four years to 2020-21, the improvement in the deficit is $4.0 billion from MYEFO. Projections for the underlying cash balance have only improved for 2019-20, but this is three years away. This projection for 2019-20 is likely to be subject to revisions, especially given the overly optimistic economic forecasts that underlie it.

Budget themes

By far the biggest emphasis is on infrastructure spending. The increase in the medicare levy, a new levy on banks and more fees for higher education are aimed to help repair the budget.

Implicit in the budget is the notion that infrastructure is the holy grail - the government's answers to jobs, growth, productivity and housing. The government's reframing of the budget in terms of good debt and bad debt is a part of this story and is designed to pave the way for increased spending on infrastructure.

When does the budget get back in the black?

The government remains committed to returning the budget to balance by 2020-21. A surplus of $7.4 billion is projected for 2020-21 (or 0.4% of GDP). Achieving this timing will depend on the economic assumptions underlying the budget projections to be accurate.

The largest single tax is that on wage and salary earners. And the wages assumptions stand out as the most optimistic economic assumption underlying the budget projections. Wages growth is weak and grew at a record low pace of 1.9% in the most recent data released for the December quarter. The government is projecting a lift in wages growth in every out year, so that it is at 3.75% in 2020-21. It is difficult to foresee such a spike in wages and the government itself is only forecasting a modest fall in the unemployment rate in its own projections. With wages accounting for a big chunk of tax revenues, there is a possibility the budget will not get back to the black by

2020-21.

There are good reasons not to move too quickly in balancing the budget because there are risks to the economic outlook. The Australian economy still has some fragilities has it transitions away from mining investment towards more diversified growth.

“Good” versus “bad” debt?

There will be a change to the way government reports debt and links it to spending by distinguishing between “good debt” and “bad debt”. In past budgets all debt has been lumped together, whether it is for capital or recurrent purposes.

In this budget, the government separates debt for capital spending, labelled as good debt, and debt for recurrent spending, labelled as bad debt.

Capital spending is that which lifts “productive capacity and produces future income” (such as infrastructure). Recurrent spending is considered spending for day-to-day expenses, such as welfare and education.

How do these changes impact the budget bottom line?

There is some merit in separating good debt from bad debt. Spending restraint is a critical element of fiscal discipline. Separating recurrent and capital spending can help improve the fiscal debate about how to fund everyday running costs of government and longer-run infrastructure needs.

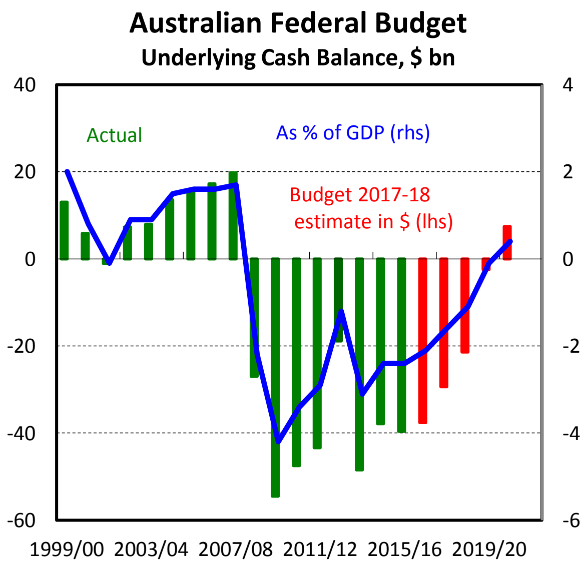
But both debts still have to be repaid. No debt is costless. Moreover, the ratings agencies will continue to focus on total debt.

The government separates good and bad debt by reporting the net operating balance alongside the underlying cash balance. The net operating balance is useful when assessing the sustainability of government operations. It is the balance between revenue and recurrent expenses and excludes expenditure on the acquisition of capital assets.

The underlying cash balance is the most useful measure when thinking about the impact of the budget on the economy. The underlying cash balance remains the key measure and basis for fiscal strategy.

It is arguable whether borrowing for infrastructure projects is always good. Accounting classifications do not turn particular infrastructure projects into productivity-enhancing investment that yield a proper return. Therefore, infrastructure-project selection is critical.

It is also debateable whether recurrent spending is all bad. Spending on areas like education and healthcare are examples of recurrent spending; but, they can improve productivity and are investments in human capital.



Budget aggregates and major economic parameters[b]

	Actual	Estimates			Projections	
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Underlying cash balance ($b)[a]	**-39.6**	**-37.6**	**-29.4**	**-21.4**	**-2.5**	**7.4**
Per cent of GDP	-2.4	-2.1	-1.6	-1.1	-0.1	0.4
Net operating balance ($b)	**-33.6**	**-38.7**	**-19.8**	**-10.8**	**7.6**	**17.5**
Per cent of GDP	-2.0	-2.2	-1.1	-0.6	0.4	0.8

(a) Excludes expected net Future Fund earnings before 2020-21.

	Outcomes	Forecasts			Projections	
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Real GDP	2.6	1 3/4	2 3/4	3	3	3
Employment	1.9	1	1 1/2	1 1/2	1 1/2	1 1/2
Unemployment rate	5.7	5 3/4	5 3/4	5 1/2	5 1/2	5 1/4
Consumer price index	1.0	2	2	2 1/4	2 1/2	2 1/2
Wage price index	2.1	2	2 1/2	3	3 1/2	3 3/4
Nominal GDP	2.3	6	4	4	4 1/2	4 3/4

(b) Year average growth unless otherwise stated. From 2015-16 to 2018-19, employment and the wage price index are through the year growth to the June quarter. The unemployment rate is the rate for the June quarter. The consumer price index is through the year growth to the June quarter.

What about the economic forecasts underpinning the Budget?

Budget estimates are underpinned by assumptions for economic growth and incomes. The budget assumptions are relying on an improvement in growth and incomes to reduce the budget deficit.

The government is more confident about the world economic outlook and this has also helped improve their views on the domestic economic outlook. Treasurer Morrison in his last pre-budget speech said that he is more confident of “better days ahead”. But Morrison also stressed that budget figuring would be based on conservative assumptions, especially in relation to commodity prices that are highly volatile.

The budget assumes an iron ore price of US$55 per tonne and metallurgical coal at US$120 per tonne. These assumptions look reasonable against current spot prices but are hopeful over the medium term.

The budget projections for wages growth stand out as overly optimistic. It leaves the government vulnerable to not achieving a budget surplus by 2020-21.

The budget revised downwards GDP growth to 1.75% for 2016-17 due to the impact of Cyclone Debbie on economic activity. A rebound to 2.75% growth is expected for 2017-18 and firmer growth of 3.0% is expected again in 2018-19. These forecasts seem reasonable. Our forecasts for economic growth are firmer in 2016-17, similar in 2017-18 and slightly firmer at 3.2% for 2018-19.

The period of very weak income growth is over. The recovery in commodity prices last year has helped incomes recover, although it has been partially offset by weak wage inflation. Nominal GDP growth (the tax base) has picked up sharply after an extended period of weakness. Nominal GDP is expected to rise sharply to 6.0% in 2017-18, after only 2.3% growth in 2016-17. Nominal GDP growth of 4.0% is then expected for 2018-19 and in 2019-20. Our forecasts for nominal GDP are lower in 2017-18 at 5.0% and at 3.5% in 2018-19.

Is our AAA credit rating at risk?

Australia's government debt position is better than many other advanced economies and government debt repayments are not onerous.

Australia is in an elite club of nations with a sovereign credit rating of AAA. This rating has been in danger ever since S&P attached a negative outlook to Australia in July last year, suggesting a downgrade remains a possibility. Ratings agencies require confidence in the government's ability to materially reduce budget deficits and return to a balanced budget by 2020-21

In the wake of the budget delivery, both Moody's and Fitch have provided positive commentary. Moody's remarked that the budget path was "very similar to prior updates" and that there is "nothing particularly worrying" about the budget. S&P have yet to comment.

We expect that the risk of a downgrade will remain, but a downgrade is not imminent or certain.

Will tonight's Budget build consumer confidence?

Housing affordability has been a big issue for Australians. Therefore, some measures to address housing affordability in the budget are a positive for the consumer. However, these measures only tinker at the edges.

For consumers, there were also no 'sugar-hits' from the budget; there were no large scale tax cuts or handouts which would have had an obvious positive (but likely temporary) boost for consumer sentiment.

Consumer confidence has been close to neutral in recent months, according to the MI-Westpac index. The increase to the Medicare levy could be a slight dampener for consumer confidence.

How about business confidence?

The big spending on infrastructure projects will be beneficial for businesses. Other major positives for business in the budget included the proposal to push forward with the company tax cut and the extension to the instant depreciation write-off for small businesses. These measures should help business confidence hold up. However, the company tax cut was previously announced in last year's budget. The last reading on business confidence taken ahead of the budget showed business confidence hit a seven-year high.

What is has been done about housing affordability and will it work?

There were some positive measures that should assist in tackling housing affordability, although only at the margin (see below for more details). Some government measures in the past, such as first home owner grants, only boosted demand, pushed prices higher, and actually may have worsened affordability over the long-term. Thankfully, the government has refrained from implementing many demand-boosting policies.

Housing affordability is a complex issue that cannot be solved easily. A lack of supply over the past decade, strong population growth and low interest rates have all helped to prop up house prices to their current lofty levels.

What does the budget mean for economic growth in 2017-18?

In this Budget, the Government didn't tighten its belt sharply, nor did it go on a massive spending spree. However, the infrastructure spending plans announced in the Budget will support Australia's economic growth and productivity in coming years, as the boost from dwelling investment wanes.

The budget and interest rates

The budget forecasts solid economic growth in 2017-18. Inflation, however, is forecast to remain low, suggesting a rate hike is not likely in the near term. However, concerns around heated housing market activity and the high level of household indebtedness suggest an interest rate cut is also unlikely this year. In contrast, the US Federal Reserve is likely to follow up its March rate hike with two further rate hikes this year. The Fed is also expected to begin tapering its balance sheet later this year. US bond yields are likely to continue to experience upward pressure as a result of the winding back of monetary easing in the US. Australian bonds have been tracking closely with US bond yields. We expect this to continue with Australian bond and swap yields dragged higher by US bond yields, although not by as much.

Nothing in tonight's budget changes the near-term outlook for the Reserve Bank.

The budget and the Australian dollar

The Australian dollar fell to a four-month low following the release of weak retailing data earlier in the day. The release of the budget failed to revive the currency, which softened further, hitting a fresh low of 73.29 US cents. The Aussie dollar has declined since mid March, tracking weakness in the iron ore price. The direction of the AUD over the next six months will depend upon interest rate differentials and movements in commodity prices. We expect the AUD/USD to sit near US 75 cents at the end of 2017, given our expectation commodity prices will not revisit their 2016 lows and that rate hikes from the US Federal Reserve are mostly priced in by financial markets.

Key budget initiatives

For businesses:

- Small businesses with turnover less than $10 million will get an extension of the immediate tax deduction for assets costing up to $20k, which was due to end 30 June 2017.
- Commitment to lowering the company tax rate to 25% for all businesses by 2026-27 which was announced in the previous budget. A cut to the company tax rate is expected to provide a lift to the economy, boosting jobs, investment and wages, although the impact may take some time. Treasury estimates that it will grow the economy by 1% after a decade.
- The corporate tax rate cut is a start, but needs to be complemented by a broader structural reform of taxation that makes our tax base more stable and does not penalise growth, investment or incentives.
- The Government will provide up to $300 million over two years to establish a National Partnership on Regulatory Reform (NPRR) to reduce regulatory restrictions on small businesses.

Housing:

- From 1 July, savers can salary sacrifice extra contributions into their super account up to a maximum of $30,000 in total and $15,000 in a single year. They can withdraw that cash from 1 July 2018 and onwards.
- A “ghost house tax” to be imposed on foreign owners, who leave their properties vacant for at least six months of the year.
- Changes to capital gains tax (CGT) for foreign residents.
- Introducing a 50% cap on foreign ownership in new developments.
- A “bond aggregator model” which allow easily accessible loans at lower interest rates and for longer-terms for community housing associations. The model allows community housing associations access to bond markets as an alternative and more stable form of funding.
- Allowing a non-concessional contribution to superannuation of up to $300k for persons aged 65 or over for from the proceeds of selling their home. Exemptions for retirees who downsize and sell their homes on new superannuation caps of $100k in after-tax contributions and $1.6 million in retirement accounts.
- No abolition of negative gearing, but a tightening of rules for what is tax deductible. The deduction of travel expenses will no longer be allowed and there are now limitations on depreciation on plant and equipment deductions.

Infrastructure:

- The government is delivering $75 billion infrastructure funding and financing from 2017-18 to 2026-27. This budget expands the use of equity and debt financing to fund infrastructure projects. Infrastructure investment should improve productivity, boost jobs and expand economic growth.
- The key projects are:
  - Western Sydney airport. The government plans to make an equity investment of up to $5.3 billion in WSA Co, a new Commonwealth-owned company, to fund the first stage of development of Western Sydney airport at Badgerys Creek. Works will commence by 2018 and operations begin by 2026.
  - Melbourne to Brisbane inland rail project.
  - $1 billion in additional infrastructure funding for Victoria, including $500 million to upgrade regional rail and $30 million to support planning for a rail link from the Melbourne CBD to Tullamarine Airport.
  - In Queensland, the government is providing $844 million from 2017-18 for new Bruce Highway priority projects.
  - In Western Australia, the government is giving $1.6 billion for new projects.
  - Expansion of Snowy Hydro power plant.
- The Government is establishing the Infrastructure and Project Financing Agency on 1 July 2017 to assist in the identification, development and assessment of equity and debt financing options for investment in major infrastructure projects.

Education:

- In “Gonski 2.0” the Government will deliver an $18.6 billion education package for schools over the next decade, from 2018. The funding will be allocated based on needs-based school funding. This is, however, a smaller increase in funding than was scheduled previously by Labor. Funding to some private and Catholic schools will be cut or frozen.
- The higher education sector will have its funding cut by $2.8 billion over four years. Students fees will increase by a total of 7.5%, phased in over four years starting in 2018, but all of the additional cost can be deferred on the Higher Education Loan Program (HELP) scheme. The repayment threshold for these loans will be lowered from income of $51,957 (for 2018-19) to income of $42,000 in mid-2018, so students will begin repaying their loans earlier. Universities will face funding cuts. Universities will have to meet a 2.5% efficiency dividend on the Commonwealth Grant Scheme in 2018 and 2019 and elements of university funding will be contingent on performance.

Welfare:

- Full funding of the National Disability Insurance Scheme by 2020, to support people with a significant and permanent disability.
- Strengthening participation requirements to ensure welfare recipients are looking for work, with penalties for deliberate non-compliance.
- Expansion of trial restricting welfare recipients from buying alcohol, gambling or withdrawing cash.
- Extension of homelessness service funding worth $375 million over three years from 2018-19.

Health:

- The four-year freeze on Medicare rebates will lift this July for some GP visits, extending to specialists and medical procedures over the next three years. A standard GP consultation, which has remained at $37.05 since 2013, will rise to $40.

Banking:

- A new bank levy of 6 basis points will be introduced on large banks with liabilities above $100 billion (excluding customer deposits of less than $250,000 and additional capital requirements).
- The Government will establish the Australian Financial Complaints Authority, as a one-stop shop for consumers and small businesses to resolve disputes. ASIC will have expanded powers to oversee this authority.
- A new banking executive accountability regime will be introduced.
- Open banking regime from 2018 to give customers power over their own data.

Contact Listing

Chief Economist	Senior Economist	Senior Economist
Besa Deda dedab@bankofmelbourne.com.au (02) 8254 3251	Josephine Horton hortonj@bankofmelbourne.com.au (02) 8253 6696	Janu Chan chanj@bankofmelbourne.com.au (02) 8253 0898