Economics Report – Some Thoughts on the 2017/18 Budget

9 May 2017

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The last systematic look at the Budget, the Mid-Year Economic and Fiscal Outlook (MYEFO), in December 2016, projected a deficit of $36.5 billion in the current fiscal year, falling to $28.7 billion in 2017/18. Over the period of the forward estimates—the four fiscal years to 2019/20—the deficit was expected to total $94.9 billion, $10.3 billion higher than in the 2016/17 Budget brought down seven months earlier, thus continuing a long pattern of increased forecast deficits. Both receipts and spending were revised down, with slower economic growth, both real and nominal, in the first two years, being the main reason. This has been a depressingly familiar tale in recent years.

The MYEFO projected a return to surplus in 2020/21.

Major Initiatives

As is always the case, the main features of the Budget were "leaked" extensively beforehand. Thus we knew that there would be some kind of tax on the big banks, some further indication of future cuts in company tax, some changes to education funding, Medicare and the PBS, and a tightening up of dole eligibility. We also knew that there would be measures aimed at the "housing affordability crisis", along with some major infrastructure measures.

Good Debt/Bad Debt etc. — a Digression

In anticipation of the latter, the Treasurer opened up a discussion on "good" debt and "bad" debt in the weeks leading up to the Budget. "Good" debt is that which is used to finance the purchase of an asset that will eventually generate an income flow sufficient to service the debt, while "bad" debt is (presumably) everything else.

Perhaps it would be more correct to say that the Treasurer opened a can of worms.

Many economists have argued for years that, if there were profitable projects available, then it made sense to finance them by debt, given how cheap it is these days for the Government to borrow. Businesses separate recurrent spending from capital spending, and so do several national governments, including New Zealand, Canada and the United Kingdom. How hard can it be?

There are several (related) counter-arguments, however. The first is that this is just a new way to attempt to hide ongoing fiscal profligacy ("it's not really a deficit if it's funding infrastructure").

The second is the introduction of the good/bad terminology. This is clearly a consequence of the long-term demonisation of public debt in Australia. Ever since the "debt truck" (a Toyota, from memory) travelled the highways and byways more than 20 years ago, the Australian public has been told that debt, whether "foreign" or "Government" is an unequivocally bad thing, and that we have a lot of it. In fact, Australia's public debt relative to the size of our economy is remarkably small by international standards. But if one starts from this position of demonisation and wishes to change tack, it's not surprising that some debt is still labelled as "bad".

If there is such a thing as "bad" debt, then whatever is generating it will tend to come under close scrutiny. And that means welfare, health spending and education spending, for example.

Which brings us to the third objection; shouldn't health and education be treated as investment spending and hence moved into the "good" debt-generating category?

It is worthwhile pointing out that the accounting necessary to adjust the deficit in order to acknowledge the effect of long-term projects is already done in the Budget, so it's really just a matter of directing the focus to a line item already produced. For what it is worth, last year this showed a return to surplus one year earlier (in 2019/20) than otherwise, and the same applies this year.

Arguments about exactly where the line between current and capital is drawn are, to me, reminiscent of debates about how many angels can fit on the head of a pin. But it is possible to believe the following two things at the same time: **that it makes sense to borrow for long-term projects and that Australia has a long-term Budget imbalance that must eventually be addressed by some combination of spending restraint and higher taxes.** I wrote about this last year, and have taken the liberty of self-plagiarism below.

"In my opinion, the problem hasn't gone just because there is a surplus forecast four years down the track. We never seem to get any closer to that mirage and, even if it is achieved, there is still a **medium-term deficit problem**. If the Budget is simply put in "set and forget" mode, with no changes to revenue other than occasional tax cuts to offset the progressivity of the income-tax tables, and with spending driven by current legislation, a structural deficit will eventually emerge that will tend to rise inexorably over time. We have known about this problem in qualitative terms for a long time, and in quantitative terms since the first Intergenerational Report in 2002. That report analysed what would happen to the deficit in such circumstances in the period to 2042. **Message: any medium-term Budget problem is not a result of the "fiscal profligacy" of the previous Government…**

…The medium-term problem comes about because, left to their own devices, many categories of "age-related" spending will grow faster than nominal GDP, and hence faster than likely revenue growth. This being the case, either this spending must be reined in, or other spending must be curtailed, or taxes must be allowed to rise. The ideal solution would be some combination of all three.

The difficulty is, of course, that the discussion about tax reform tends to be about increasing the efficiency of the tax system; that is, about changing the **tax mix.** What we need also to confront is the necessity to raise more revenue; that is, to increase the tax burden. This is the reason why an eventual increase in the rate of the GST, or a broadening of its coverage, appears inevitable. The other thing that is needed, of course, is not higher rates but fewer ways for people and companies to avoid paying taxes by means of concessions, deductions, exemptions, rebates etc."

Incidentally, there is a huge amount of uninformed commentary on the perils of public debt, in letters to editors and on talkback radio in particular. Here is one way to avoid some of it: **when someone asks "how are we going to pay it back?" or laments that it will be a burden for future generations, pay no further heed.** Government debt does not have to be repaid. It is an asset that investors want to hold. The United Kingdom, for example, has had a public debt to GDP ratio in excess of 40% (more than twice the Australian figure) for more than 400 years.

Back to Major Initiatives

Given the introduction of the good debt/bad debt distinction, it should have surprised no-one when, a few days later, it was announced that the Government would fund the building of Sydney's second airport. **Other major infrastructure projects** in the Budget include the inland rail link between Sydney and Melbourne, and a road and rail package for Western Australia.

The **housing affordability measures** were also flagged in advance. They include a tax on "ghost housing" (dwellings apparently permanently unoccupied), and the ability of potential first-home owners to salary sacrifice in order to save for a deposit. The first of these could spawn a new occupation—people employed to turn the lights on and off periodically in vacant apartments. These measures don't address the "crisis", they only tilt the playing field slightly in the direction of first-home buyers. This is tinkering at the edge of the problem.

Any serious attempt to address the issue needs to work on the balance of supply and demand for housing. It can be argued that higher infrastructure spending is conducive to greater supply of suitable housing. **Any serious attempt to restrain demand would have to look at** negative gearing, or rather **the interaction between negative gearing and the overly generous treatment of capital gains**. The arguments raised in favour of not addressing this issue are disingenuous at best. It is true that negative gearers will now have to pay their own travel expenses for visiting their properties, and will no longer to able to deduct the cost of some plant and equipment, but this is very small beer.

Looking at the measures announced in this Budget in terms of their effect on the bottom line, **spending initiatives** come to $9 billion over the next four years, with health measures (PBS and Medicare) totalling $2.2 billion and school funding (Gonski 2.0) totalling $1.8 billion (hence the labelling of the Budget as Labor Lite?). **Revenue measures** raise $17.4 billion, with a higher Medicare levy to part-finance the NDIS raising $8.2 billion (even though it is only fully effective from 2019/20 on, after the next election) and a levy on the liabilities of the major banks raising $6.2 billion. Reforms to the financing of higher education save $3.8 billion over the next four years.

In addition, several "zombie" measures left over from the 2014 Budget (mainly cuts to spending that have never been passed and never would have been) have been removed from the future Budget figuring. These total an impressive $13.5 billion.

The Figures

The table below looks at the projected path back towards surplus. Relative to the MYEFO, as outlined above, the deficit for the four years to 2019/20 is now estimated to be $4 billion lower (and thus $4.3 billion higher than in last year's Budget), at $90.9 billion. The return to surplus remains at 2020/21, as in the MYEFO.

	Actual	Estimates			Projections		
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	Total(a)
	$b	$b	$b	$b	$b	$b	$b
Receipts	**386.9**	**405.7**	**433.5**	**462.5**	**496.9**	**526.3**	**1,919.2**
Per cent of GDP	23.4	23.2	23.8	24.4	25.1	25.4	
Payments(b)	**423.3**	**440.5**	**459.7**	**480.4**	**495.6**	**518.9**	**1,954.6**
Per cent of GDP	25.6	25.1	25.2	25.4	25.0	25.0	
Net Future Fund earnings(c)	3.2	2.8	3.2	3.5	3.7	na	10.5
Underlying cash balance(d)	**-39.6**	**-37.6**	**-29.4**	**-21.4**	**-2.5**	**7.4**	**-45.9**
Per cent of GDP	-2.4	-2.1	-1.6	-1.1	-0.1	0.4	
Revenue	**395.1**	**412.1**	**444.4**	**476.1**	**510.8**	**540.4**	**1,971.7**
Per cent of GDP	23.9	23.5	24.4	25.2	25.8	26.0	
Expenses	**428.7**	**450.8**	**464.3**	**486.9**	**503.2**	**522.9**	**1,977.2**
Per cent of GDP	25.9	25.7	25.5	25.7	25.4	25.2	
Net operating balance	**-33.6**	**-38.7**	**-19.8**	**-10.8**	**7.6**	**17.5**	**-5.5**
Per cent of GDP	-2.0	-2.2	-1.1	-0.6	0.4	0.8	
Net capital investment	3.8	2.0	0.5	4.8	4.9	6.0	16.2
Fiscal balance	**-37.5**	**-40.7**	**-20.3**	**-15.5**	**2.7**	**11.4**	**-21.7**
Per cent of GDP	-2.3	-2.3	-1.1	-0.8	0.1	0.6	
Memorandum items:							
Net Future Fund earnings(c)	3.2	2.8	3.2	3.5	3.7	4.0	14.5
Headline cash balance	-49.1	-51.1	-48.4	-37.1	-14.8	11.7	-88.7

(a) Total is equal to the sum of amounts from 2017-18 to 2020-21.
(b) Equivalent to cash payments for operating activities, purchases of non-financial assets and net acquisition of assets under finance leases.
(c) Under the *Future Fund Act 2006*, net Future Fund earnings will be available to meet the Government superannuation liability in 2020-21. From this time, the underlying cash balance includes expected net Future Fund earnings.
(d) Excludes expected net Future Fund earnings before 2020-21.

The underlying cash deficit for the current year is expected to be $37.6 billion, falling to $2.5 billion (0.1% of GDP) in 2019/20. A surplus of $7.4 billion is then expected in 2020/21. Receipts rise from 23.2% of GDP this year to 25.4% in 2020/21 while outlays remain close to 25%. For the four years beginning in 2016/17, outlays average 25.2% of GDP, as they did in the 2016/17 MYEFO. The increase in the share of revenues amounts to close to 4.5% real growth per year in the next four years, which seems a touch heroic.

The net operating balance, which adjusts for long-term spending (net capital investment), reaches a surplus of $7.6 billion in 2019/20, one year earlier than the underlying cash deficit.

Net debt rises from 18.6% of one year's GDP in 2016/17 to a peak of 19.8% by 2018/19. This share then retreats to just 8% in 2027/28. In nominal dollars, debt peaks at $375.1 billion in 2018/19. (Australia's government debt remains very low by international standards).

The Economic Background

The economic assumptions behind the Budget are shown in the following table.

	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

(a) 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.
Source: ABS cat. no. 5206.0, 6202.0, 6345.0, 6401.0 and Treasury.

If one were to quibble with the detail of these forecasts, one could argue that they may turn out to be somewhat optimistic. Relative to the MYEFO, real GDP growth has been cut by 0.25% in 2016-17, to 1.75%, before rising to 2.75% in 2017/18 and 3% thereafter. This forecast is, in fact, somewhat less optimistic than those of the RBA and the IMF. That said, it assumes firm growth in consumption fuelled by a steep decline in the saving rate. The unemployment rate is forecast to be 0.25% higher (than in the MYEFO) for the current and next three years. Forecast growth in nominal GDP, which depends heavily on the terms of trade, has been revised down since last year's Budget, by 1% in each of the next two years. The CPI forecast takes three years to get back to the centre of the RBA's target range.

The topic of low wage growth has been front and centre in recent times; a near-doubling to 3.75% just four years from now may be a stretch.

The Budget assumed that the iron ore price falls from US$66 to US$55 by early 2018, about in line with what was assumed in the MYEFO.

What Happens Next?

It is disappointing that we are still looking at 12 years of deficit before a return to surplus, but it's a disappointment that we are used to. The main reason for this chronic streak is that we took the fruits of the (temporary) commodity price boom through to 2011 and used them to finance (permanent) cuts to income taxes (eight in succession), a massive amount of middle-class welfare, the baby bonus, the very generous superannuation tax concessions in 2006, and the lift to the pension a few years ago. In other words, the Budget is paying the price for mistakes made many years ago, and the economy has never been robust enough since then to fix the problem quickly.

While the rhetoric of "debt and deficit" crisis has been dropped (not before time), there remains a medium-term structural issue, as outlined earlier, that must one day be addressed.

Market Reaction

Markets long ago stopped caring much about Budget night. After all, markets react to news, and there is usually little of that.

There are, of course, sectoral issues, but even these may already be factored in. Witness the sell-off in bank stocks in recent days, and particularly in the past 48 hours.

The preoccupation with the possible loss of Australia's AAA rating continues, with the hand-wringers pointing to last year's decision by one agency—S&P—to put Australia on negative watch, an action roughly equivalent to a one-third chance of a downgrade in the next year or two. Despite the continual increases in the near-term deficit forecasts, and hence in the debt, in my opinion such a downgrade is unlikely, although by no means impossible. One of the ratings agencies, Moody's, has already indicated that it will not change its AAA rating.

Even were a downgrade to occur, the effects may well be minor. Borrowing costs for all levels of Government and the banks would probably be placed under pressure, although even this is not certain. When the US lost its AAA rating in 2011, for example, its borrowing costs plummeted in the following months. In my opinion, given the current state of the economy, the costs of imposing greater fiscal rectitude now in order to avoid a downgrade later would have exceeded any benefits. That said, we do know that once the AAA rating is lost it can take a long time to get it back.

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