Federal Budget October 2022-23

Budget Preview

24 October 2022

Budget challenge lies in keeping government size in check

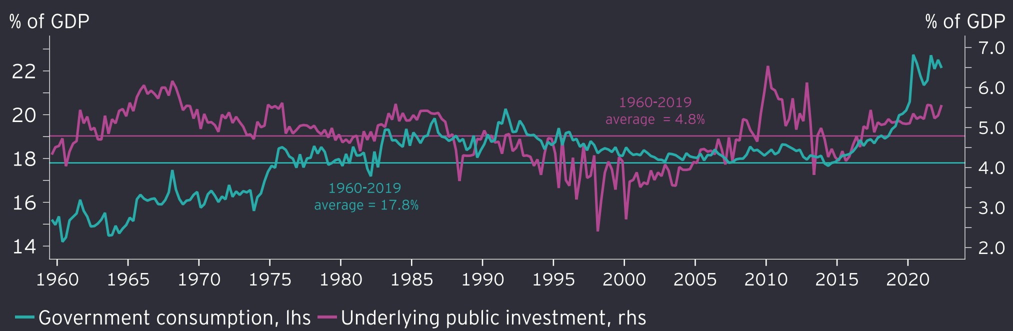
A significant challenge for the Treasurer in this Budget is balancing the books to absorb election commitments, higher debt servicing costs and emergency flood recovery.

But more immediately, the task is keeping the size of government in check at a time when high inflation is becoming more persistent. In a capacity constrained economy, where capital and labour are hard to find, spending that doesn't have a productivity dividend will make the Reserve Bank's job harder. That ultimately could mean higher interest rates than otherwise.

Supportive government measures necessary during the pandemic – such as the purchase of health supplies and vaccines, and additional funding for hospitals – when added to regular commitments and ongoing infrastructure spending, pushed the public sector (federal, state and local) to over 27 per cent of GDP last financial year. That was appropriate in 2020 and 2021, but not this year.

The average size of government in 1960 to 2019 period was just less than 23 per cent.

Public sector size



Source: Macrobond, EY

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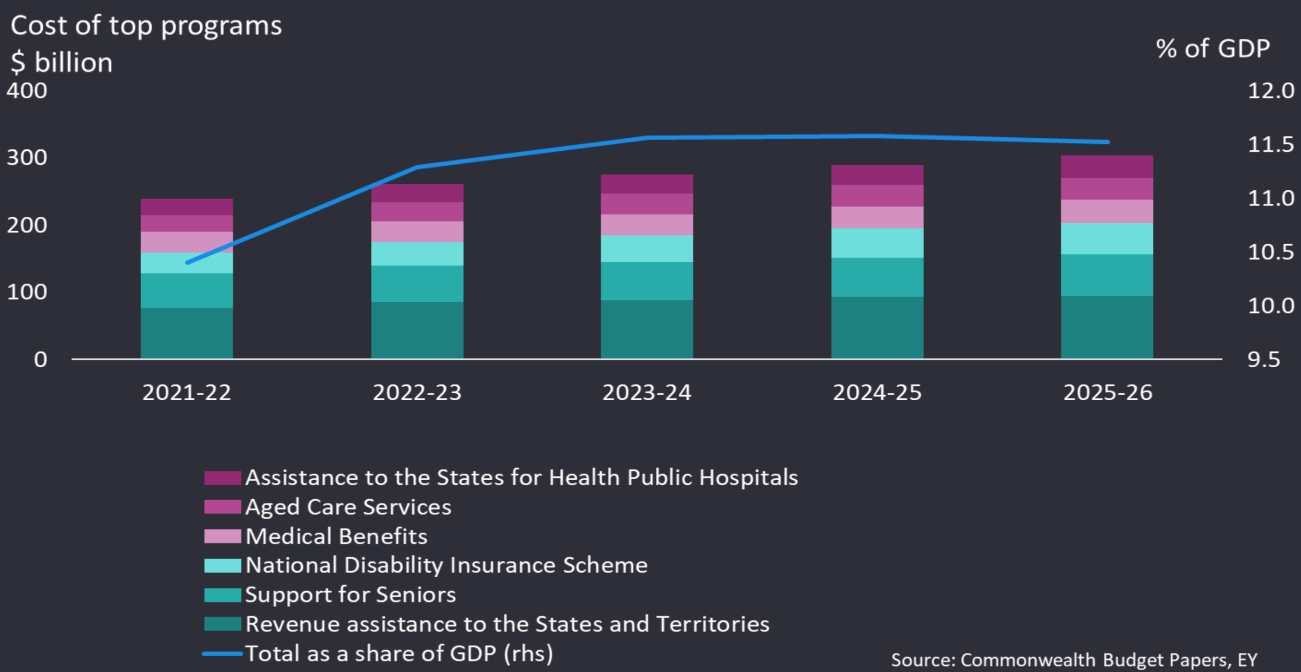
Current high levels of government spending are not suited to an economy with skills shortages and capacity constraints. It is crowding out private sector spending and adding to inflationary pressures.

Commitments made by Labor in the election campaign were costed in March by the Parliamentary Budget Office at a net $6.9 billion over the next four years. Since then, there have been additional policy measures from the Jobs and Skills Summit – including $1 billion for additional fee-free TAFE in 2023 and, from 1 July 2024, an expansion to the government-funded paid parental leave scheme. There are also one-offs like the $2.4 billion allocated over four years for the National Broadband Network (NBN) upgrades.

When considering new spending which also adds to the size of government, non-discretionary spending that adds to the government's commitments must also be considered. These include unanticipated additional COVID-19 health sector assistance and flood recovery, which the Treasurer has recently reserved an additional $3 billion for in the contingency reserve.

An underspend by the Commonwealth Government last financial year – in part due to supply side constraints that meant infrastructure spending could not proceed as planned – means some of 2021- 22 outlays fall in 2022-23, also adding to size of government in the current financial year. The Finance Minister said this could be in the vicinity of $10 billion.

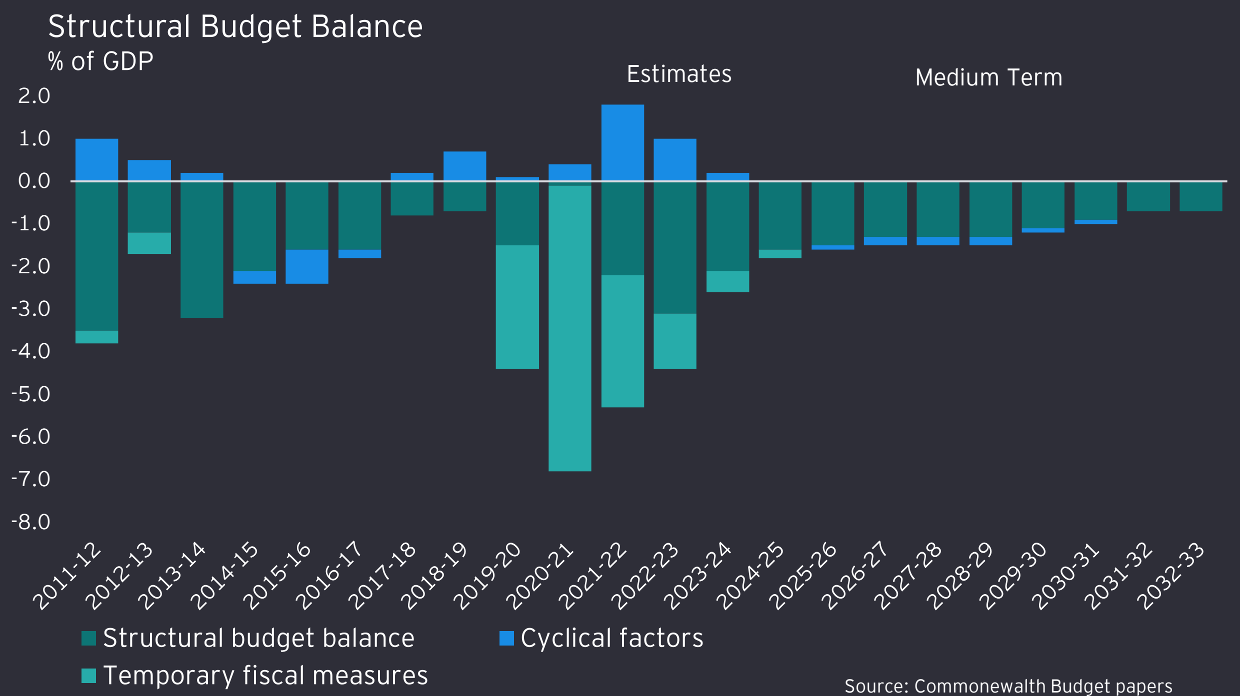


Source: Commonwealth Budget Papers, EY

In the background, the cost of significant policy programs, particularly the National Disability Insurance Scheme (NDIS), aged care, health care and defence, are being revised higher according to the Treasurer. The estimated cost of the six biggest programs, as at the March budget, is shown below. Even at that time, they were growing faster than GDP.

The Treasurer has now estimated the NDIS costs will grow by 12 per cent per annum; hospital spending by 6.1 per cent; aged care costs by 5.5 per cent; and defence spending by 4.4 per cent.

The rising costs of these programs plus additional spending policies, which will not be fully offset by savings or new revenue, means the Budget remains in structural deficit for at least another decade. The estimates of the structural deficit as at the March Budget are shown below.



Source: Commonewalth Budget papers

In the short term, the cyclical positives will be higher than they were in March on account of stronger -than-expected commodity prices and the stronger-than-expected bounce back in the economy post-COVID-19 lockdowns. The weaker-than-expected AUD-USD exchange rate will also help bring in revenue in the short term as it lifts exporters' profits beyond expectations.

But as the Treasurer has been at pains to point out, these won't last long as commodity prices normalise and the economy slows on account of downwardly revised global growth, with many countries recessing, while the Reserve Bank engineers a slowdown with higher interest rates.

So how does the Treasurer balance the books this week?

Reversing the $254 billion of tax cuts planned from 1 July 2024 over 10 years would have been helpful, but that has proved politically impossible – at least for now. The political sacrifice to secure savings that won't land until 2024 doesn't stack up. And in reality, the Government doesn't want to keep collecting more tax as share of income from individuals. Forecasts for the economy suggest mid-2024 might need a primer to help consumers drive activity. Weighing down households with heavy income tax burdens is not helpful when the Government is trying to encourage people to make themselves available to work.

Alternatively, we can grow our way out. But not just by adding public sector dollars to GDP.

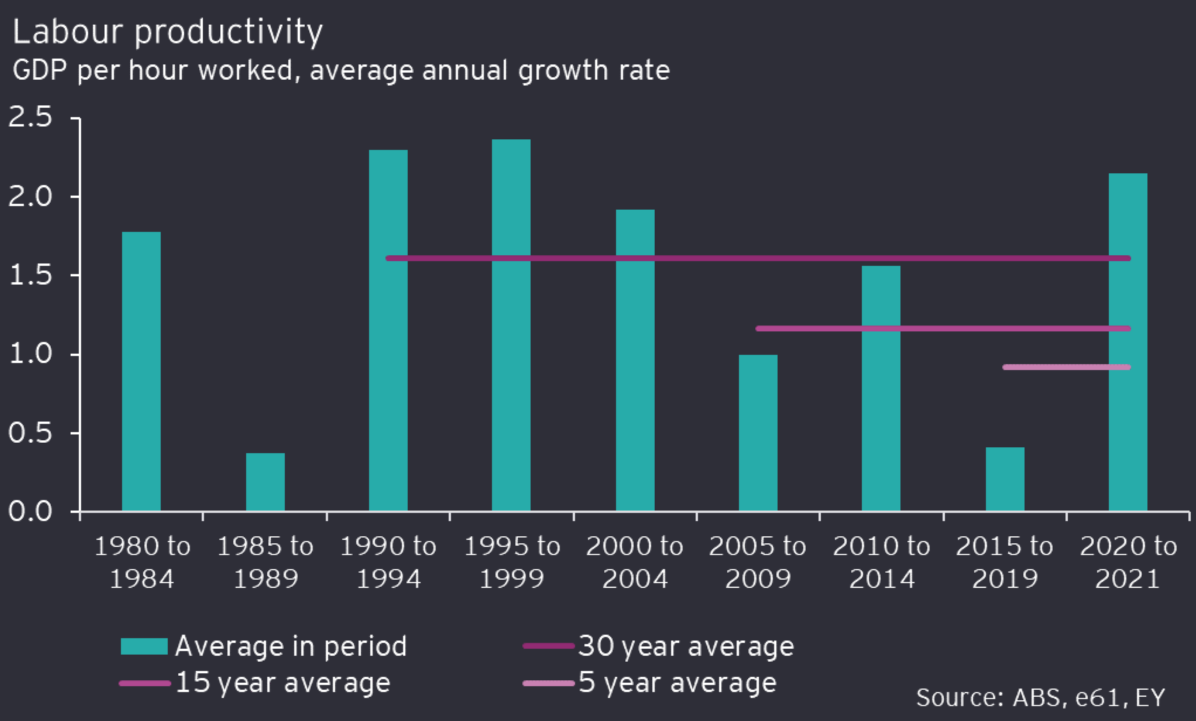
Lifting population, participation and productivity – together – is the only real way to address our structural challenges. They ensure the economy doesn't run out of capacity in future by positively building potential GDP. And that will help ensure Australia can grow without inflation taking off.

Measures to reduce costs for households that lead to some sort of direct economic benefit, like cheaper childcare, will provide a participation dividend. The additional allocated funding for the NBN may also have productivity benefits that are economically welcome.

There were also other noble policy changes coming out of the Jobs and Skills Summit. However, we need more than fee-free TAFE places and virtual work experience programs.

Reserve Bank Governor Lowe recently told a parliamentary committee that he hoped politicians would confront a combination of tax rises, spending cuts or productivity boosting reforms.

The lack of tax reform over several decades will impact on confidence in the private sector to invest, especially as the economy slows. This will have an impact productivity – which has been slowing down and without which we cannot improve our standard of living or get back to a budget balance.



What would make the top of our wish list for this budget?

If the Treasurer is serious about growing our way out of the fiscal impasse and lifting the private sector's share of the economy, spending needs to be cut relative to the current trajectory, and productivity enhancing reforms then put to the top of the list. Tax reform, not just tax cuts, need to be implemented in the current terms of government. Reforms that actually improve the incentive for individuals, particularly those on the periphery of the labour force, to work.

Unfortunately, it is unlikely that any of this will be in this so-called "bread and butter" budget. But we urge the Government to embrace the reforms that the Productivity Commission is currently working up. It must also take very seriously the suggestions that will be made by Treasury in the upcoming White Paper following the recommendations that came out of the Jobs and Skill Summit. The last decade of inaction means that even the Henry Tax Review puts forward concepts and ideas that remain worthy in the tax reform process.

The challenge that Australia faces is that we don't just need a bread and butter budget. We need a bread and butter Treasurer firstly focussed on reigning in spending. Through this bread and butter approach, the Treasurer can let the private sector lead growth which then provides space to invest in productivity measures to grow the capacity of the economy.

As we lift our eyes to the May budget, our hope is that the Treasurer will have done the hard work of cutting spending and inflation will have eased, leaving the Government room to get on with its reform agenda.

Cherelle Murphy | EY Oceania Chief Economist
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