Federal Budget 2023-24

Budget Preview

7 May 2023

Surplus is a happy budget beginning; beware the ending

On Tuesday evening, bracket creep, more migrants and the deliberate under-forecasting of commodity prices will have worked their fiscal magic and likely turned the Government's refreshed underlying cash balance estimate for 2022-23 into a surplus.

If the Government resisted pressure to give this away by allocating it to new purposes, the underlying cash balances for the coming four years would also look better than they did at the October Budget. Net debt and interest costs will also take a step down, despite higher interest rates.

But because the improvement comes from an unexpectedly strong labour market, higher wages, more migration than anticipated and Treasury's continued practice of under-estimating commodity price forecasts, it doesn't fix the structural deficit.

This is a problem that stems from government spending being set as close as possible to total revenue, while Government tolerates unexpected demand driving upward spending too.

Continually managing toward the upper-bound of total revenue is missing the opportunity to move the budget into structural balance. Restoring balance is crucial to ensure the Government can cushion the economy from future shocks, flexibly manage our way towards net zero emissions and other worthy policy goals – while not leaving the next generation to pay off their parent's debt.

To move the budget into structural balance, the Government must do three things:

1. Not add to spending, without at least offsetting it elsewhere
2. Change existing policy to lower spending and find new revenue that will persist over time
3. Put in place policies to assist the private sector to maximise its productivity.

The Treasurer has promised to bank 'most of the revenue windfall'. But in reality, he needs to bank all of it and make tough decisions about existing policy to put Australia's Federal Budget back on track.

Under promise, over deliver

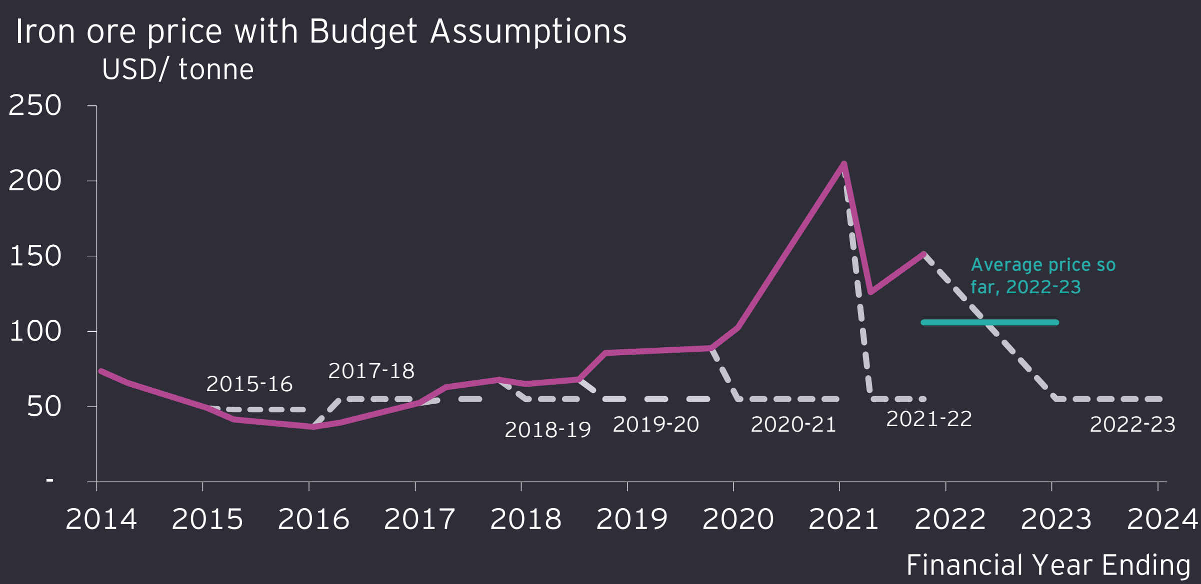
The underlying cash balance for 2022-23 will likely be close to balance, and maybe even a surplus, compared to an estimated $36.9 billion deficit at the time of the October 2022 Budget, according to indications from the monthly government finance figures.

This substantial improvement follows from higher wages and employment (including the employment of new migrants) and strong corporate profits, resulting in higher company and personal income tax receipts. Upward revisions had also been made in the last Budget, similarly, reflecting a faster than expected recovery from COVID-19 lockdowns. That means that the underlying cash balance projection made in March 2022 of -$78.0 billion for the current financial year, now looks incredibly pessimistic.

In October, the unemployment rate was assumed to be 3.75 per cent by the June quarter but was lower than this at 3.5 per cent in March. Population growth is likely to be closer to 2 per cent than the 1.4 per cent assumed in October.

As has been the case for some years, the Government's commodity price forecasts have been conservative, resulting in a boost to tax receipts when prices don't fall as Treasury predict. We expect this boost on iron ore taxes alone to result in an additional $2 billion in revenue in 2022-23.

It has been reported that the Government will accept the Treasury's recommendation and, in the future, make the forecasting path slightly less conservative, by assuming it takes longer to get to the projected lower price.



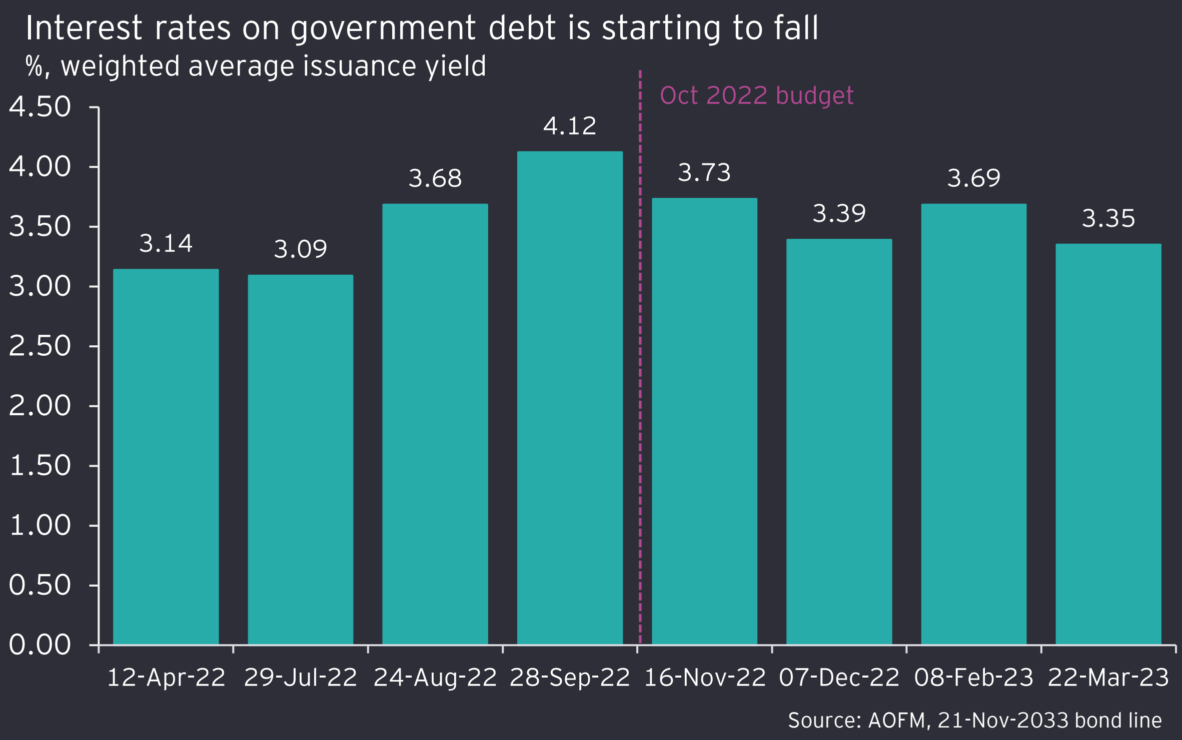
Source: EY, Hamburg Institute of International Economics & Commonwealth Treasury forecast free on board (FOB) instead of cost, insurance & freight (CIF) prices

The improved position for 2022-23 helps strengthen the starting point for the 2023-24 Budget, but the positive cyclical forces will fade as the economy slows. That means that while the underlying cash deficits will be lower than the -$44 billion, -$51.3 billion and -$49.6 billion predicted for the 2023-24, 2024-25 and 2025-26 years, they will be worse than the improved result for 2022-23.

This is a welcome development, although it is based on a 'no policy change' basis.

Net debt will be lower than expected in October's Budget. For this reason, and because the Government has been able to issue new debt at a slightly lower rate since October, the interest bill will be lower too.

Budget leaks have suggested that the annual interest paid on debt will be $17.7bn in 2022-23, down from an estimate $18.9 billion estimate in October last year. The peak will be $27.1bn in 2025-26, down from an estimated $32.6 billion in October.



The list of new policy spends so far is long

The Government's policy decisions have so far been heavily weighted to further spending. A quick tally of pre-Budget media coverage includes the following policy announcements:

- Over $11 billion for increased wages for aged care workers (although this is partly paid for by already allocated contingency reserve funds)
- Credits for power bills for welfare recipients
- Defence spending lifted to 2.2 per cent of GDP by 2030, but no addition expenditure over the short term
- $2.2 billion 'Restoring Medicare' package focussed on primary care
- $720 million to lift NDIA's capability, capacity and systems to support participants while reducing the target growth rate from 14 per cent to 8 per cent
- $535 million for National Collecting Institutions
- $314 million for an additional tax deduction for small businesses to electrify their operations
- $262 million for Commonwealth national parks
- $240 million for a Hobart sports stadium
- $150 million to improve the quality of water flowing into the Great Barrier Reef
- $50 million for Long COVID research
- $39 million for 117 new EV charging stations on the nation's highways
- $25 million to support former cashless debit card communities
- $19 million for the Community Child Care Fund for disadvantaged communities
- Expand the First Home Guarantee Scheme, the Regional Home Buyers Scheme and the Family Home Guarantee Scheme to friends, siblings and other family members
- Rent support measures (depreciation, withholding tax).

There has also been media speculation that the JobSeeker payment will be increased and the single parenting payment will be maintained for parents without a job until their youngest child is an early teenager (from the current age of eight).

The reasons for lifting JobSeeker are clear and well-articulated. But without offsetting this multibillion dollar spend elsewhere in the Budget, the cost will potentially be higher interest rates, which households and businesses cannot afford.

Non-discretionary spending that adds to the Government's commitments must also be added to expenditure, including national disaster payments.

Offsetting a very small fraction of this, there will be few revenue changes. So far, we know of:

- New taxes on tobacco products
- More onerous Petroleum Resources Rent Tax
- Reduced concession tax rates on future earnings on super balances above $3 million from 2025–26

Many of the new spending promises for low-income earners are needed, given the cost of living is increasing and the real purchasing power of the most vulnerable is deteriorating. But spending will push up income in the economy at a time when it is already high.

Spending more and saving less will simply drive more inflation, higher interest rates and crowd out the private sector which is furiously bidding for the same resources as government.

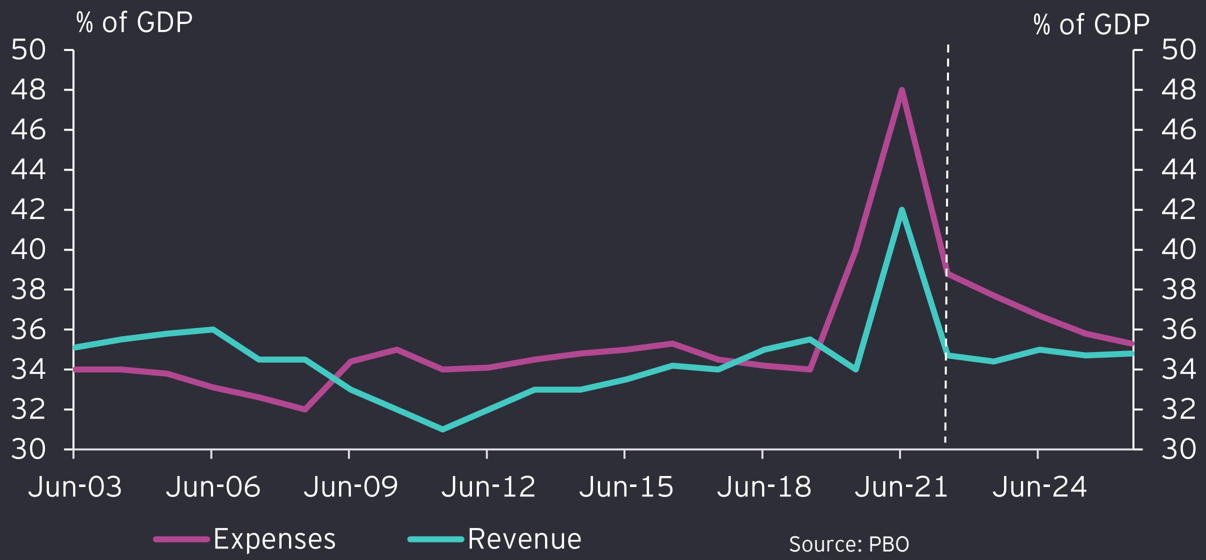
There are only a few revenue reforms that can match the rising spend, and the Treasurer doesn't seem likely to raise the GST, reform franking credits or dramatically reshape our company or personal tax system.

When Commonwealth policies are added to state government policies – even before considering this year's Budget commitments – total spending across all layers of government is higher as a share of GDP over the coming four years than in the pre-COVID-19 period.

Taking the punch bowl away from the COVID-19 fiscal party is proving to be an impossible task.

Given inflation is high and persistent, the Reserve Bank's job of getting inflation back to target will become harder at the margin.

Government revenue and expenses*

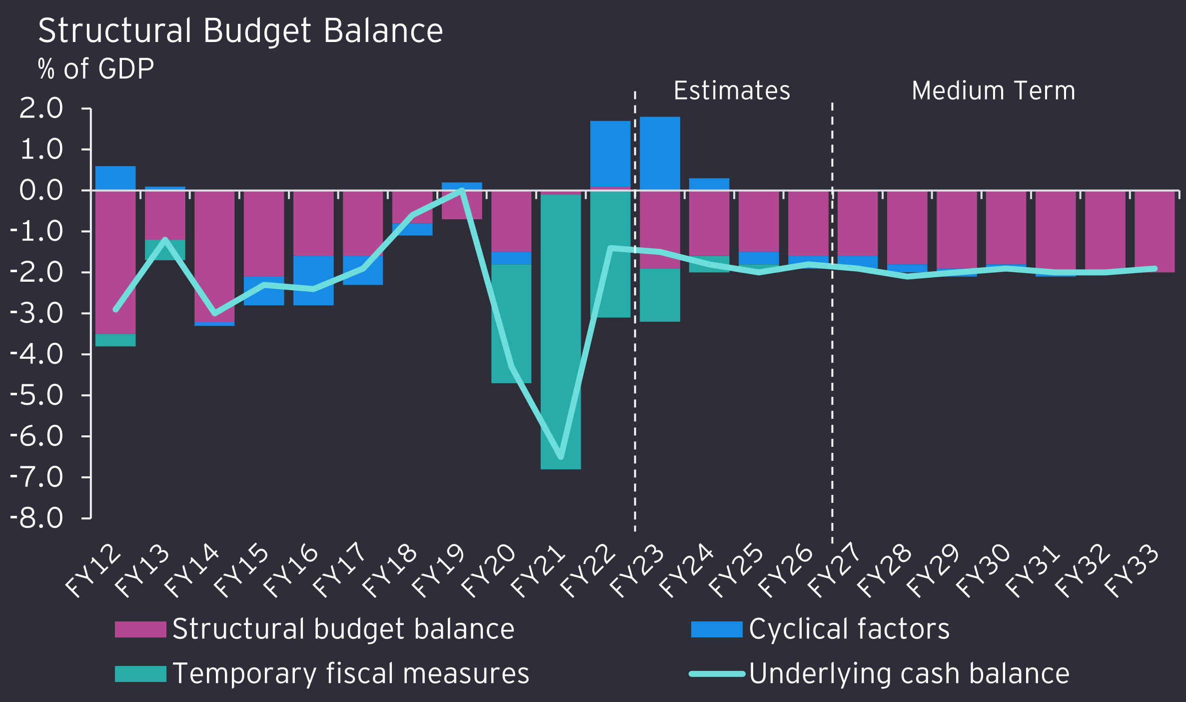


Source: PBO
*State & Commonwealth governments

The structural budget will remain in deficit

In the Federal Budget, the gap between spending and revenue – when cyclical and temporary factors are excluded- suggests there will be a structural budget shortfall of around 2 per cent of GDP for the next 10 years.

The ongoing structural deficit is the crux of the fiscal problem and the reason we forecast an unhappy ending to the Treasurer's fiscal story.



Source: Commonwealth Budget

But there are solutions and the Government is moving towards them.

First, the Government can squeeze more value for money out of its current spend. But we need action from our reviews – not just more of them. Speeding up the process and implementation of the NDIS, Medicare and migration reviews will help make more out of existing spend in all these areas.

If the Government successfully implements the recommendations from the reviews, they will also increase labour availability in an economy that needs more skills. They may also lift workforce participation and productivity in government administration.

Revisiting $120 billion worth of planned infrastructure is also a positive step forward. This will extract better value from government spending as it questions the projects currently in the National Infrastructure Investment Pipeline.

These are still works in progress, but they are solid commitments. The triple benefit of increased labour availability, increased labour productivity and a lift in government productivity would be warmly welcomed by business.

Second, the Government can cut spending or reform the tax system to make it more efficient. The uproar about the reduction in the tax concession planned for superannuation balances of more than $3 million, and lack of tax reform over several decades, is clear evidence this is much easier said than done.

Third, the Government can put in place measures to help the private sector increase productivity.

The 2021 Intergenerational Report illustrated that if the productivity growth rate rose to the long-term average of 1.5 per cent (which it averaged over the 30 years to 2018-19) – rather than its recent average of 1.2 per cent – the structural budget deficit could eventually be closed. Over 40 years, real and nominal GDP would be 9.5 per cent higher, and the underling cash balance as a share of GDP would be 2.2 percentage points lower.

This is particularly difficult when the fiscal position must be kept tight and there are dozens of priorities in the welfare system that have become urgent because of the erosion of unindexed benefits by high inflation.

Some policies like spending on AUKUS, expanding the NBN and Digital ID to make government services more accessible, are in part motivated by productivity goals. But these are politically hard to implement when high inflation is hurting low-income earners.

But productivity enhancing policy isn't all about government prop-ups or spending.

The Government must focus on doing what it does best – training the workforce, providing supportive infrastructure and a level playing field, with clear rules of engagement.

Ongoing labour shortages are already forcing the private sector to invest in a range of productivity enhancing programs and an upskilled workforce. Think driverless trains in the Pilbara, investment in new software and automated warehouses in Western Sydney.

So much more can be done without significant government investment.

Embarking on a Universities Accord and reducing compliance costs in trade are good examples of positive intent from the Government.

Professor Rod Sims provides other reform ideas. He has argued that productivity could be lifted by Government prioritisation of pro-competition policies. He suggested stronger merger laws to help the ACCC prevent anti-competitive mergers and a law against unfair practices akin to those in the UK, US and most of Europe.

Much has been made this budget cycle about the needs of those who are less well off. But it is their needs that will be the subject of drastic cuts in the future if we fail to embrace disciplined fiscal policy which works co-operatively with monetary policy and promotes productivity reform.

These are needed to ensure we can grow our economy's capacity, stabilise our debt and create a more positive future for generations of Australians.

Ill-disciplined fiscal policy will continue to crowd out private sector investment and provide Australia with no room for critical, even legislated, goals like achieving net zero emissions by 2050.

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7 May 2023

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