Deloitte Access Economics

Media Release

FOR IMMEDIATE RELEASE

Budget Monitor: The Budget balancing act

The bottom line

- Yes, the Federal Budget needs repair.
- No, that doesn't need to happen in a rush.
- Yes, most of the repair should come from spending cuts.
- No, that doesn't mean ignoring the potential for higher taxes.
- Yes, a temporary deficit levy is a tax.
- No, that doesn't mean it is a bad idea.

The economy and the Budget

Mr and Mrs Australia don't understand why the news on the economy is reasonable, but the news on the Budget is sackcloth and ashes. That lack of understanding by the electorate is a big problem, and it's why selling the ideas in the Commission of Audit is a tough gig.

What went wrong. It's a tragedy.

The simple summary is that the resources boom of the last decade was good for the economy, but stunningly good for the Budget. The boost to the Budget from the economy briefly peaked at over $80 billion a year just ahead of the global financial crisis.

The GFC then rapidly halved that Budget bonanza, but China's own stimulus in response to the GFC sent commodity prices soaring to even higher peaks. That renewed rush of gold into Canberra's coffers – and Treasury's optimism about how long it would last – was what encouraged Wayne Swan to promise a return to surplus "three years early".

But it didn't last. Coal and iron ore prices peaked back in 2011, and capital gains remain elusive. So Treasury kept revising down its estimates of how much money would be in the Budget. These revisions came relatively slowly at first, but then they came in a rush after the Christmas 2012 admission that there'd be no surplus in 2012-13.

And now we're back where we began. The bonanza delivered by the economy to the Budget has now gone. **Like every other boom in our history, it turned out to be temporary**.

Policy decisions and the Budget

So what did the nation's leaders do with the dollars delivered to them by the biggest boom Australia has ever experienced? Policy trucked that enormous windfall back out again via family benefits, baby bonuses and a trail of tax cuts. Then spending jumped further still with the stimulus, though it subsequently dropped back. Yet, despite its rhetoric, the last Government never really made a policy dent on spending until the death, in part as its new mining and carbon taxes came with a lot of compensation spending attached to them.

So the nation's politicians – both sides – took the temporary boom of the past decade and spent it all on an orgy of permanent promises such as family benefits and tax cuts.

Frustratingly, 2013 was no different. In fact it got even worse. **Just when Treasury was accelerating the pace of its revenue writedowns, the politicians were accelerating the pace of bipartisan promises. The latter were dominated by disability insurance and school funding**.

It was group denial at its most astounding. That's why we dubbed the 2013 election as "the Seinfeld election" – a Federal election about nothing, in which both sides made promises that the tax system simply cannot pay for.

Australian electorate, we have a problem.

The outlook for the tax take

The good news is that the huge revenue writedowns look like being close to an end:

- Record low wage growth hasn't stopped the tax take from individuals edging $0.6 billion ahead of the conservative official forecasts for 2013-14, while a pick up in the job market from its recent stall speed and the imposition of the new 'deficit levy' may see the latter margin jump to $4.2 billion in 2014-15.
- At the same time an extended period of low interest rates is finally having its wicked way with retail and with housing construction. And as spending lifts, so too does the take from spending taxes such as the GST, while the lower $A has pushed up import prices and hence customs duty collections. That has left the overall indirect tax take ahead of the latest official estimates by $2.0 billion in 2013-14 and $1.7 billion in 2014-15.
- But the good news on the tax take from individuals and spending taxes is eaten up by, you guessed it, yet another shortfall on company tax. The latter will be flat in 2013-14, while superannuation taxes will fall, both disappointing Treasury hopes. Ditto resource rent taxes, including the mining tax, which will fall well shy of official expectations, leaving these 'profit taxes' suffering a shortfall of $3.0 billion versus the forecasts in MYEFO.

Or, in other words, those who thought Treasury was being too conservative on the tax take in MYEFO were wrong, at least as far as 2013-14 is concerned. Although the mix is different, the sombre Treasury story is essentially correct, with our forecasts for the overall tax take a whisker ($260 million) behind their official equivalents.

On the other side of the ledger there have been few new policy costs and not much economic news affecting outlays. But some of the better news on revenue is GST, which gets handed back to the States, leaving **the 2013-14 cash deficit at $48.4 billion, some $1.4 billion worse than the MYEFO forecast of $47.0 billion.**

2014-15 looks better

Yet although it won't be true of 2013-14, it looks as if the Mid-Year Review released in late 2013 was a tad too negative on 2014-15. Since MYEFO the news has been better in terms of sharemarket gains, while recent data also revised up job numbers. Most notably of all, profits have started to get some momentum, partly thanks to low interest rates, and more importantly still thanks to a lower $A. So although 2014-15 won't be a great year for company tax collections, it will at least see an end to the bleeding.

That combination sees us estimating "better-than-official-forecasts" for heavy hitters such as company tax, superannuation taxes, Pay As You Go taxes on individuals, and the GST.

Then add in a bit more than $2 billion from the new 'deficit levy', and the overall revenue take jumps to $7.3 billion ahead of MYEFO. Yet that good news doesn't matchingly flow through to the bottom line. For example, the better news on the GST just gets handed to the States (and shows up as increased spending). However, as is true of 2013-14, the news on the outlays side of the Budget is otherwise rats and mice – there have been relatively few decisions since MYEFO, and nor does the economic news imply much for outlays.

Hence, and ignoring policy savings expected to be announced on Budget night (aside from the deficit levy), **Deloitte Access Economics therefore estimates the "no policy change" cash deficit at $27.4 billion in 2014-15. That is some $6.5 billion better than MYEFO projected.**

No 'whirring back into surplus' in 2015-16 and 2016-17

Our forecasts don't improve further relative to official equivalents in 2015-16 and 2016-17.

The good news on personal income taxes fades as boomer retirement continues to weigh on job gains. And although wage growth will lift from today's record lows, it will do so slowly.

Equally, the long agony on company tax hasn't ended yet, with world commodity prices on an ebb tide – meaning the good news we see in 2014-15 doesn't get much better in later years.

Finally, although the news remains good on the GST, that money then goes to the States.

Hence after revenue outperformance of $7.3 billion versus official forecasts in 2014-15, we see the gap broadly steady at $5.1 billion in 2015-16 and $7.3 billion in 2016-17. Both these latter years benefit by over $2 billion from the new deficit levy (though, as usual, we haven't allowed for the other policy measures expected to be announced on Budget night). **With little action on outlays – at least until Budget night – we see the "no policy change" deficit at $19.0**

billion in 2015-16, $5.1 billion better than MYEFO projected, followed by a deficit of $11.2 billion in 2016-17, $6.5 billion better than MYEFO projected.

And now for the tricky bit

Although *Budget Monitor* forecasts through to 2016-17, the Budget will go a year further, to 2017-18. That is important, as it serves to illustrate the Everest that the Budget must climb.

No, MYEFO didn't exaggerate the problems here – or, at least, not markedly so.

We recognise that there'll be some cynics. After all, that tried and trusted model – the gasp and hand over the mouth on discovery of the Budget black hole – is once again the story of the moment. Yet that doesn't mean it is wrong. Rather, what the MYEFO did do was to spell out a much more realistic picture of where the Budget was headed in the medium term:

- Most importantly, and as we've long since noted to clients, election years tend to see big policies announced, the cost of which arrive with a delay and are then phased in so as to allow politicians to claim credit for the new policy without actually having to pay for its cost.
- 2013 was no exception, with both sides making big and expensive new promises around disability insurance and school funding, while the years immediately beyond the four years covered by the Federal forward estimates also see a sharp lift in overseas aid and the leading edge of some expensive costs around Defence Department procurement.

So there's trouble just around the corner. The Budget will start to show that, as it will show big additional dollar costs in 2017-18 for the likes of disability insurance and overseas aid.

Accordingly, unless Budget night reveals some much needed fiscal medicine, the deficit will worsen notably in 2017-18 compared with 2016-17.

More importantly still, these troubles will linger, and the official family no longer has to pretend otherwise: Treasury's ten year forecasts now use the longer term average for spending growth as an indicator of underlying pressures on the Budget. Ahead of the election, Australians had to suffer the crude fiction of a return to surplus built on the promise by the then Government to keep spending growth to no more than 2% a year after inflation.

That promise holds about as much worth as when the authors of *Budget Monitor* vow to drop 10 kilos. To simply say that you'll do so by losing a kilo a month is not to have a plan – that's just a hope. You actually need to spell out how you'll eat less (cut spending) and exercise more (raise taxes). We see the earlier promise to maintain spending growth to less than 2% extra a year after inflation in much the same way. It merely promises to do something about a problem, and then pretends that the promise was of itself a solution to the problem.

Err, no … Although the amount is arguable, Australia's Budget was never on a path back to sustainable surplus. Rather, Australia has a big Budget problem. As Chapter 1 notes, that's something that Deloitte Access Economics has been saying ad nauseam for some time, so it's kinda nice to have the official family finally on our side.

Then again, it's not rocket science: when both parties go to the election promising to (a) massively increase spending and (b) rapidly return the Federal Budget to surplus, then you can confidently expect that (c) it doesn't add up. The nation has made promises to itself that it simply cannot afford. Canberra increasingly – finally – recognises that. Sadly for our nation, however, Mr and Mrs Suburbs haven't yet been told the truth.

What to do, what to do …

Then again, truth will out. It is finally there to see in the Treasury numbers in MYEFO, while the Parliamentary Budget Office has also been doing great work. Most importantly of all, the Commission of Audit doesn't merely identify the problem, it is chockfull of solutions. It will probably be the light on the hill for spending in much the same way the Henry Review is for tax. They will stand as key yardsticks for the national debate.

Yet we can't say we're convinced there'll be much action in the short term. The imminent Budget may yet be one in which the Government talks big but acts rather smaller than its own rhetoric, cutting back less than it should, and justifying such a 'softly, softly' approach on the grounds the economy is too fragile to withstand the impact of larger cuts.

We certainly hope we are wrong. That approach would merely repeat the experience Australia had under the previous Government, who also liked to talk big but act small. To be clear, we wouldn't argue for big cuts tomorrow: that would indeed unnecessarily hurt the economy. But the Government needs to use the platform of the Commission of

Audit to start making its case to the electorate for cuts and tax increases, to announce as many of those measures as it can in the Budget, and to have them take effect over a number of years.

Spending cuts need to be the focus

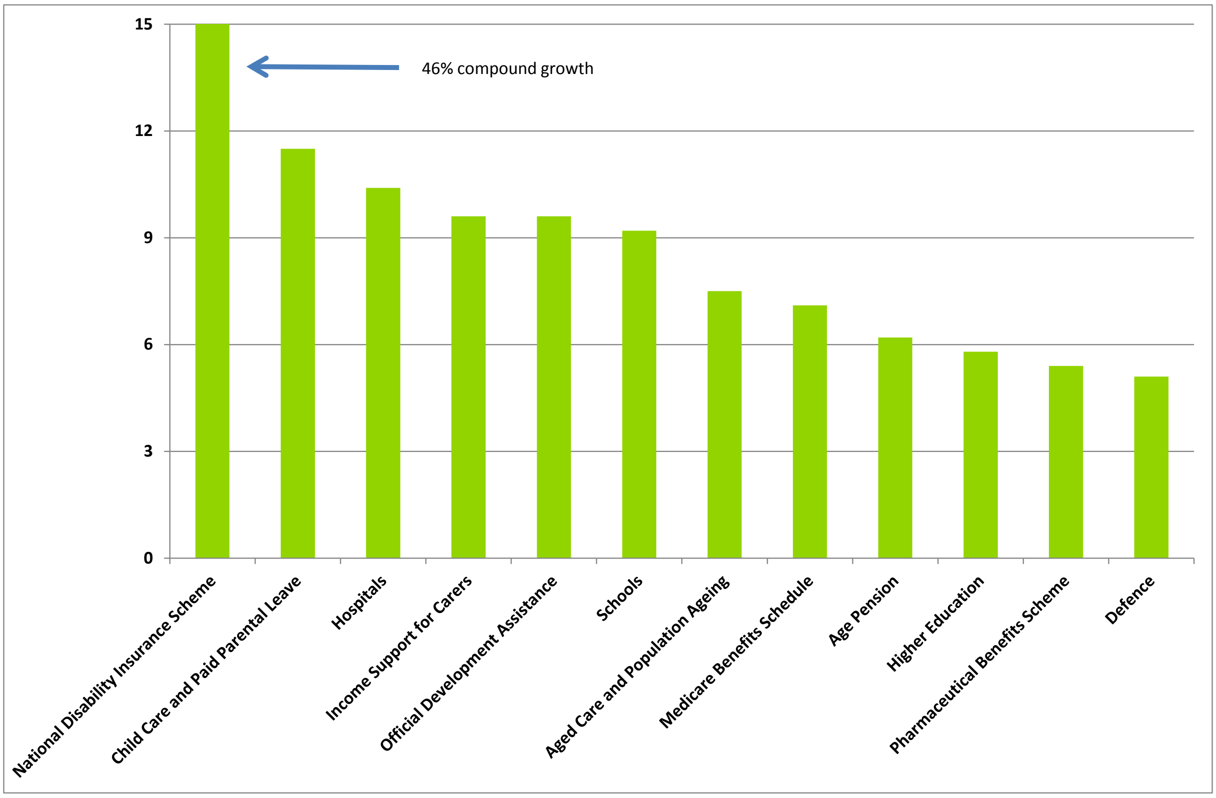
We have no problem with much of the Budget repair task falling to spending cuts rather than tax increases. Since the last Commission of Audit reported in 1996, a series of (frankly bad) decisions have pumped up our spending, especially over the past decade.

Note that isn't an argument for "last in, first out". For example, although you can certainly argue the specifics, a rich nation such as Australia should have a disability insurance scheme. And there are some areas of spending which need to go up rather than down – the national shame of our inadequate unemployment benefits leaps to mind, as do the series of cuts made to foreign aid. Both these are examples of a nation that could do better.

Yet the bottom line is that we waste all too much of what we spend: a range of middle class welfare, industry welfare and top end tax breaks neither add to national prosperity or to fairness. (And if government programs don't contribute to prosperity and/or fairness, then why the hell is the nation spending taxpayers' money on them?)

Chart i below draws on Commission of Audit data to show the fastest growing large spending programs – those growing more rapidly than national income. That list is depressingly long.

Chart i: Average annual nominal growth in outlays to 2023-24



That said, the Commission of Audit has mapped out the conversation Australia needs to have – even if it doesn't want to have it. Look at it this way: the deficit won't go away, so neither will the Commission's ideas. **Although we don't agree with everything that the Commission of Audit said** (in the same way that we didn't with the Henry Review), **there are some of its recommendations that are not just good policy, but also good sense**:

- Linking the age pension age and the super preservation age to changing longevity,
- Broadening means tests on pensions to include the family home values above $750,000,
- Reforming family payments and tightening eligibility tests,
- Introducing new co-payments for Medicare services,
- Introducing greater spending controls in the National Disability Insurance Scheme, and
- Eliminating subsidies to businesses.

There are also some areas where our views differ a bit from the Commission's prescriptions. For example, we wouldn't change the wage benchmark for age pensions, but we would raise pensions at a rate closer to prices than wages. (Our approach would see pensions higher than the Commission's approach for some years, but then grow more slowly over time.) And we have some reservations about increasing withdrawal rates for key payments to 75 cents in the dollar. While tighter targeting of welfare is a good thing, economists note the importance of effective marginal tax rates in reducing the incentive to move from welfare to work. On its own, a 75 cent withdrawal rate may be appropriate, but there are other taxes, charges and means tests to take into account – including those in health and aged care.

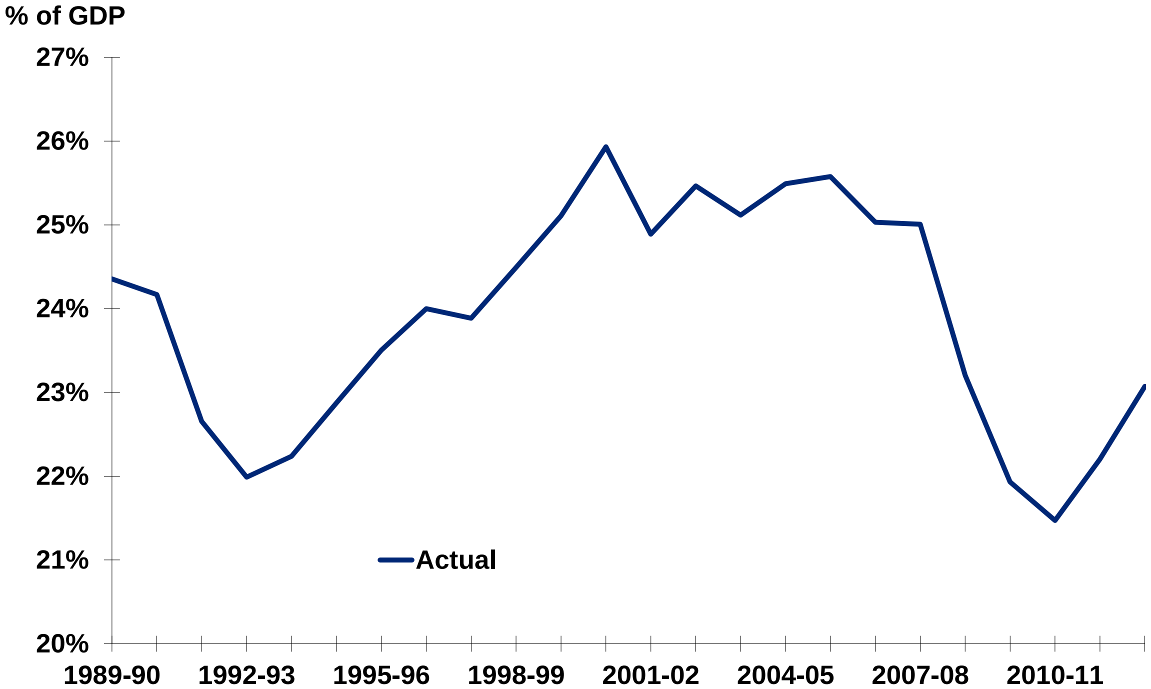
And the Commission of Audit didn't look at tax, meaning it didn't have much to say on eliminating top end tax breaks. We've long seen superannuation as a good example of one area where relatively bigger benefits go to the better off. That's an idea which is starting to catch on, but will have to wait for the tax white paper later in the year.

Yet these don't change the big picture: count us as supporters of the Commission's agenda.

But let's not ignore tax

Yet although the bulk of the heavy lifting should fall to spending cuts, we shouldn't blind ourselves to tax. **We take it as a good sign the Government is looking to have a 'deficit levy'. Yes, that is a tax**. And we've long said the bulk of Budget repair should come from cutting spending rather than raising taxes.

Chart ii: Total tax to GDP (%)



Yet equally we've always said taxes shouldn't be ignored. The Government will have hated having a deficit levy, which says to us they are serious about Budget repair. It is true there are things we'd do on the tax front well ahead of any deficit levy (broadening the base and raising the GST rate, plus appropriate compensation; doing Henry Review-style reforms to super; reviving the last Government's attempt to close the FBT loophole around cars; shifting to taxing alcohol by alcoholic content; re-starting the indexation of petrol excise etc).

However, **politics rules out many of the more sensible revenue measures in the Budget**. Besides, personal income taxes were a big beneficiary in the boom years. Thanks to the many tax cuts of the past decade, personal income taxes averaged 11.2% of national income in the past quarter of a century, but were 10.6% in 2012-13.

The big fall in taxes as a share of national income occurred at least in part because eight tax cuts in a row cut personal income taxes to a multi-decade low in 2009-10. And as Chart ii shows, the overall tax take is also a smaller share of the national income pie than it used to be. Similarly, arguments about the potential for workers to be discouraged out of job markets by high marginal tax rates are easy to overstate: much of the rich world has both higher personal income taxes and higher participation by both women and older workers.

So although personal income taxes aren't the first tax that we'd raise – that honour probably falls to a properly compensated widening in the GST net – this chart serves as a reminder that there's no sense in focussing on just one side of the Budget. Both spending cuts and tax increases will need to be considered to achieve more sustainable fiscal futures. **For a Government that wants to be seen as serious about Budget repair, its deficit levy – targeted to the top end – therefore makes sense.**

Or other risks to the Budget

And don't get us started on the latest round of wobbles in iron ore prices. It's not our central forecast, but any genuine Budget analyst in Australia should tremble in their booties at the risk of a more significant China slowdown that cuts commodity prices down to size. That would make the outlook for Budget deficits rather worse than they already are. And it would make the repair task – which already has sectional interests screaming – much bigger.

Summary table: Overall Budget projections ($ million)

	Actual	Forecast			
	2012-13	**2013-14**	**2014-15**	**2015-16**	**2016-17**
ACCRUAL TAX REVENUE	337,522	351,112	373,591	399,731	428,517
Real growth *	6.7%	2.3%	4.4%	4.9%	4.7%
% of GDP	22.2%	22.1%	22.4%	22.9%	23.2%
ACCRUAL NON-TAX REVENUE **	22,837	22,543	21,589	22,787	23,815
TOTAL ACCRUAL REVENUE	360,359	373,655	395,179	422,517	452,332
Real growth *	6.8%	1.9%	3.8%	4.8%	4.5%
ACCRUAL EXPENSES	382,644	413,184	418,516	435,981	457,926
Real growth *	1.5%	6.1%	-0.6%	2.1%	2.5%
% of GDP	25.1%	26.0%	25.1%	25.0%	24.8%
OPERATING BALANCE (+ is surplus)	**-22,285**	**-39,530**	**-23,337**	**-13,463**	**-5,594**
NET CAPITAL INVESTMENT	**987**	**3,706**	**1,628**	**180**	**2,378**
FISCAL BALANCE (+ is surplus)	**-23,272**	**-43,236**	**-24,965**	**-13,643**	**-7,972**
% of GDP	-1.5%	-2.7%	-1.5%	-0.8%	-0.4%
Official forecast of fiscal balance		***-41,843***	***-31,504***	***-18,776***	***-14,456***
DIFFERENCE in fiscal (ie, accrual) balance		**-1,393**	**6,539**	**5,133**	**6,484**
CASH REVENUE	351,251	364,663	390,040	414,177	440,116
CASH OUTLAYS	366,891	410,173	414,454	429,991	447,927
FUTURE FUND EARNINGS	2,682	2,871	2,953	3,138	3,373
CASH UNDERLYING BAL (+ is surplus)	**-18,322**	**-48,382**	**-27,367**	**-18,951**	**-11,184**
% of GDP	-1.2%	-3.0%	-1.6%	-1.1%	-0.6%
Official forecast of cash balance		***-46,989***	***-33,907***	***-24,083***	***-17,668***
DIFFERENCE in underlying cash balance		**-1,393**	**6,540**	**5,132**	**6,484**
HEADLINE CASH BALANCE	**-20,442**	**-53,033**	**-35,897**	**-26,554**	**-19,292**
STRUCTURAL CASH UNDERLYING	**-39,839**	**-61,496**	**-34,284**	**-22,530**	**-13,483**
% of GDP	-2.6%	-3.9%	-2.1%	-1.3%	-0.7%

* Real growth rates are calculated using the GDP deflator.

** Excludes revenue from the sale of goods and services.

Summary Table: Main economic forecasts

	Outcomes and estimates (a)	Forecasts			
	2012-13 Year Average	2013-14 Year Average	2014-15 Year Average	2015-16 Year Average	2016-17 Year Average
Panel A – Demand and Output (b)					
Private consumption	2.0%	2.5%	2.7%	2.8%	2.9%
Private investment					
Dwellings	-0.1%	3.6%	11.0%	8.5%	6.9%
Business investment	6.2%	-5.4%	-3.8%	-4.6%	-0.5%
Non-dwelling construction	14.0%	-3.8%	-5.9%	-7.2%	-2.8%
Equipment	-4.7%	-12.3%	-2.2%	-0.9%	4.4%
Private final demand	2.8%	1.0%	1.9%	1.7%	2.6%
Public final demand	-1.4%	2.3%	2.5%	2.2%	2.6%
Total final demand	1.9%	1.4%	1.8%	1.8%	2.6%
Increase in stocks (c)					
Private non-farm	-0.2%	-0.2%	0.1%	0.0%	0.0%
Farm and public authority	0.0%	0.0%	0.0%	0.0%	0.0%
Gross national expenditure	1.6%	1.1%	1.9%	1.8%	2.7%
Exports of goods and services	6.0%	5.4%	4.2%	4.3%	6.2%
Imports of goods and services	0.5%	-2.7%	1.2%	-0.2%	4.5%
Net exports (c)	1.2%	1.7%	0.7%	1.0%	0.6%
Real gross domestic product	2.6%	2.7%	2.7%	2.8%	3.1%
Non-farm product	2.8%	2.7%	2.8%	2.8%	3.2%
Farm product	-3.8%	5.4%	1.3%	0.8%	2.0%
Nominal gross domestic product	2.5%	4.5%	4.7%	4.8%	5.6%
Panel B – Expenditure Excl. Asset Sales					
Underlying business investment	6.2%	-4.7%	-4.9%	-4.5%	-0.5%
Underlying non-dwelling construction	13.9%	-2.8%	-7.2%	-7.1%	-2.8%
Underlying equipment	-4.3%	-11.4%	-3.7%	-0.9%	4.2%
Underlying private final demand	2.8%	1.1%	1.6%	1.7%	2.6%
Underlying public final demand	-1.4%	2.3%	2.5%	2.2%	2.6%
Panel C – Other Economic Measures (d)					
Prices and wages					
Consumer price index	2.3%	2.8%	2.2%	2.7%	2.9%
'Underlying' measure	2.5%	2.8%	2.3%	2.8%	2.9%
Gross product deflator	-0.2%	1.7%	1.9%	2.0%	2.4%
Average earnings (e)	1.7%	2.5%	2.8%	3.1%	4.1%
Average weekly earnings (f)	4.4%	3.0%	2.8%	3.2%	4.0%
Labour market					
Employment (labour force survey basis)	1.2%	0.8%	1.2%	1.6%	1.9%
Unemployment rate (per cent)	5.3%	6.0%	6.2%	6.1%	6.0%
Participation rate (per cent)	65.0%	64.8%	64.6%	64.5%	64.5%
External accounts					
Terms of trade	-9.8%	-4.2%	-5.8%	-2.3%	-1.2%
Current account balance					
$ billion	55.7	48.7	64.5	66.7	69.4
Percentage of GDP	3.7%	3.1%	3.9%	3.8%	3.8%
Panel D – International Assumptions					
Major trading partners					
Real GDP	2.6%	2.8%	3.3%	3.6%	3.7%
Inflation	1.8%	2.6%	2.3%	2.2%	2.2%
Crude oil (Tapis $US/barrel)	$113	$117	$115	$114	$116
TWI index (Index points)	77.4	70.1	65.7	63.3	61.2

(a) Calculated using seasonally adjusted data.
(b) Chain-weighted volume measures. Unless otherwise indicated, figures are percentage change on previous year.
(c) Percentage point contribution to change in GDP.
(d) Percentage change on preceding year unless otherwise noted.
(e) National accounts basis.
(f) Survey basis.

See Deloitte media releases and research at www.deloitte.com.au

Follow us – @DeloitteNewsAU

For further information (media):
Chris Richardson
Deloitte Access Economics
T: 02 6175 2000
M: 0414 466 156

For further information on Budget Monitor subscriptions and other subscription publications issued by Deloitte Access Economics:

Kellie Chalker-Hall
Manager, Marketing & Subscriptions
Deloitte Access Economics
T: 02 6175 2000
daesubscriptions@deloitte.com.au