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Economic Research Note

Aussie 2014-15 Budget outcome: Hockey's stick

- **Coalition's first budget includes material spending savings and some tax rises, but few surprises**
- **Deficits promised over the forward estimates period; return to surplus delayed until 2018-19**
- **Welfare portfolio suffers most, but Treasurer promised significant new spending on roads**
- **Tax rises for high income earners and indexation returns for petrol taxes**

Australian Treasurer Joe Hockey tonight delivered the first budget of the Coalition government that was elected last September. The government had been jawboning for weeks about the need to deliver a dose of fiscal tough love, so it is no surprise that Hockey tonight raised taxes and took a stick to government spending, slicing into bloated welfare payments, in particular. The austerity delivered tonight is relatively modest, though, as it fails to deliver a budget surplus over the forward estimates period. It fits, however, with the government's narrative in framing this budget that the so-called "age of entitlement" was over, that burden sharing was required, and that some bold action was needed to repair a budget imbalance of close to 3% of GDP.

Mr. Hockey announced major expenditure savings across government, merging departments and announcing redundancies, but also committed the government to new spending, particularly on roads. To help pay for the new infrastructure, the Treasurer raised taxes on high income earners, reinstated six-monthly indexation on petrol tax, and added a new charge for visits to the doctor. There were, though, few surprises tonight, most of the measures having been strategically leaked beforehand, to soften the blow.

What Budget emergency?

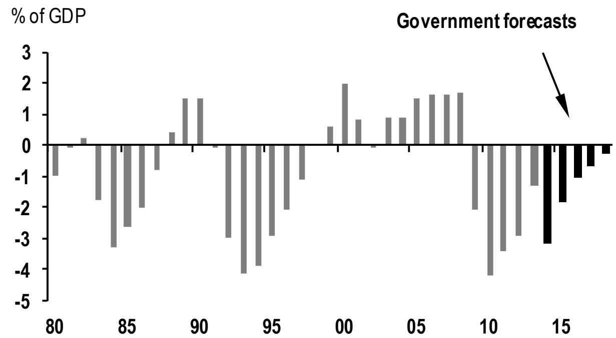
Still, the budget shows that Mr. Hockey will preside over deficits for some time yet, albeit progressively diminishing in size, so the level of public debt will continue to climb. The deficit for the next fiscal year (2014-15) likely will be $29.8 billion (1.8% of GDP), and public debt will be 24% of GDP. Australia's public accounts, then, will remain in great shape relative to the imbalances elsewhere. Indeed, Australia's coveted AAA sovereign credit rating is not under immediate threat, even with deficits projected over the entire forward estimates period.

Commonwealth budget position and forecasts

	13-14(e)	14-15(f)	15-16(f)	16-17(f)	17-18(f)
Budget balance					
A$ bn	-49.9	-29.8	-17.1	-10.6	-2.8
% of GDP	-3.1	-1.8	-1.0	-0.6	-0.2
GDP growth (%oya)					
Budget forecasts	2.75	2.5	3.0	3.5	3.5
J.P. Morgan forecasts	2.7	3.0	3.0	3.0	3.25

Source: J.P. Morgan estimates

Commonwealth budget balance



Source: Budget papers.

The most politically-sensitive measures that could have made the public accounts look even better, including an increase in the rate of the GST and a broadening of its base, which would ease pressure on Commonwealth grants to the states, and addressing generous tax distortions in favour of housing, have been postponed. Mr. Hockey has avoided action to tackle the generous negative gearing provisions, in particular, which costs the budget many billions of dollars each year. There were no major changes to the superannuation (private pension) system, except the timing of the planned lift to the maximum 12% contribution rate was delayed. Some of these measures, however, may be addressed as part of the Tax White Paper promised by the Treasurer.

Echoes of Costello's '96 budget

It is expected that newly-elected governments will accuse their predecessors of not disclosing the true nature of the budget, and blaming them for leaving behind a fiscal mess. The new occupants of the Treasury benches then have a plausible excuse to undertake the necessary surgery. Indeed, this budget has echoes of the equivalent offering of 1996, when then Treasurer Costello delivered a tough budget soon after the Coalition government was elected. The subsequent Labor government, elected in 2007, promised to be fiscal conservatives, but this noble aim was jettisoned when the "great recession" took hold. Labor never got around to being

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conservative, and failed to deliver a surplus in any of its six years in charge.

This time, the government will hope that voters will accept the need for smaller government, now that the commodity price boom, which inflated revenue collections for the previous Coalition government, is over and the peak in mining investment, which drained corporate tax revenue from Labor, has passed. The problem for the government is that deep welfare cuts, the rise in the pension age and higher petrol prices will resonate with lower income earners, especially as the government promised before the election not to raise any taxes nor touch the aged pension. The opposition parties have focused on the government's broken promises for weeks, and now have evidence to support their case.

In this context, the government may struggle to get some of its announced measures through the upper house Senate. The Greens party, which has nine votes of the 76, has indicated it will oppose the proposed income tax levy, mainly because it is not permanent, and Labor and the Greens probably will oppose at least some of the planned welfare cuts, as well as corporate tax breaks. Abolition of the mining and carbon taxes, too, a long held goal of the new government, remains problematic. The somewhat unpredictable Palmer United Party, whose members control a batch of upper house votes, could be crucial. The government may be forced to split the proposed measures into separate legislative bills, as Labor did, to avoid tonight's budget being blocked in its entirety, which would trigger fresh elections in both houses.

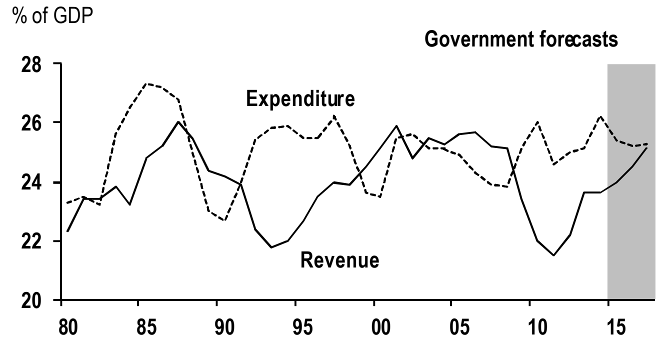
Hockey can blame Labor … for now

The government trails in most published opinion polls, partly because of speculation over the bad news being delivered tonight. Indeed, the politics surrounding this budget are difficult, given the Opposition's accusations of confected fiscal emergencies and broken promises. Nervous government MPs are being told to expect the government's standing in polls to deteriorate before it improves.

Mr. Hockey, though, still could blame Labor for leaving the public finances in poor shape and get away with it; after tonight, the state of the budget will be his problem. Also, he could unleash reparative measures with the next election still more than two years away; delaying the pain would risk more voters remembering who inflicted it. Finally, the Treasurer could have a credibility problem if he had baulked on tough measures, having consistently warned there was a fiscal crisis and declaring a budget emergency.

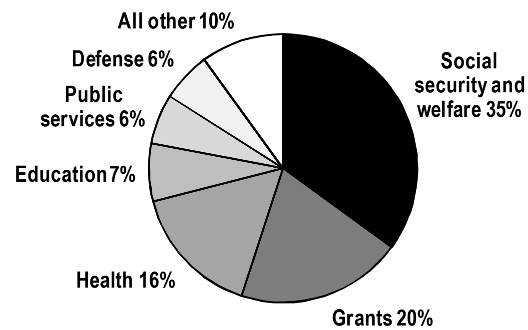
According to Mr. Hockey, the aim of the budget is to set the public accounts onto a sustainable path back towards surplus. He is imposing some pain in what he calls "the national

Commonwealth Government revenue and expenditure



Source: Budget papers.

Commonwealth government spending - 2014-15



Source: Budget papers.

interest". Fiscal profligacy by the previous Coalition and Labor governments had pushed the budget into a position of structural deficit of close to 1% of GDP. The previous Coalition government had handed back much of the proceeds of the mining boom in income tax breaks, and greatly expanded so-called middle class welfare. The subsequent Labor government blew out stimulus spending during the dark days of 2008-09, and never found the courage to rein it in as revenue collections slumped.

Mr. Hockey, however, must undertake his budget repair job carefully; cutting spending too deeply could have undermined confidence and derailed the economy's stop-start return back to trend growth. Failing to cut deeply enough, though, could see deficits continue beyond the next decade, potentially threatening Australia's coveted AAA sovereign credit rating. Mr. Hockey described this as a "growth budget", and there is material, job-creating new spending on infrastructure to support the claim.

"Leaks" left little room for surprises

Most of the major policy initiatives announced tonight had been strategically leaked or speculated about in the media for weeks, so there was little room for surprises. The only material unexpected announcement tonight was a payment to employers that encourages employment of older people. With everything essentially leaked and in the price, financial markets were unmoved; AUD traded at 93.41 just after the Treasurer delivered his budget speech, unchanged from the level trading before Mr. Hockey spoke.

The economic impact of the budget near term probably will be a felt mainly via a drag on confidence, given the income tax rises, welfare cuts and resumption of petrol tax indexation. Consumer confidence already is low and fragile, and the material cuts announced tonight will make that worse. Over the medium term, the Commonwealth government's drag is larger than we had estimated from earlier government deficit projections, at 2.5% of GDP over four years (2% previously). Fiscal policy, then, will remain a material headwind for the economy for some time yet.

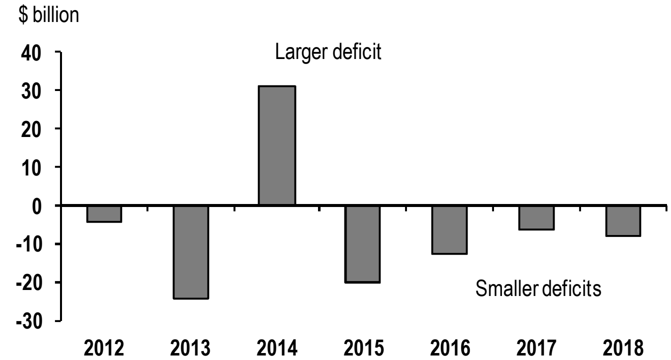
The bottom line: deficits until 2018-19

There were no major surprises in the projected fiscal imbalances over the forward estimates; they were only slightly lower than we had expected. The budget predicts that the underlying cash deficit in the next fiscal year will be $29.8 billion (1.8% of GDP). The deficit for the current fiscal year will be $49.9 billion (3.1% of GDP), slightly worse than was estimate in the MYEFO document late last year. The Treasurer predicts that the deficits will shrink gradually over the forward estimates period, dwindling to a mere 0.2% of GDP ($2.8 billion) by 2017-18. If realized, these will leave Australia in very good shape in global comparisons.

Wisely, the Treasurer has avoided the previous Labor government's approach of predicting a return to surplus in the near term; Labor did so repeatedly, and suffered political embarrassment when it failed to deliver. Instead, the budget assumes that a surplus will not be delivered until 2018-19, and predicts it will grow to 1% of the economy by 2022-23. The budget predicts that revenue as a share of GDP will recover to 25.5% by 2017-18 (up from the current 23.6%), and that spending will fall to 25.3% of GDP by 2017-18, from an expected peak of 26.2% in 2013-14.

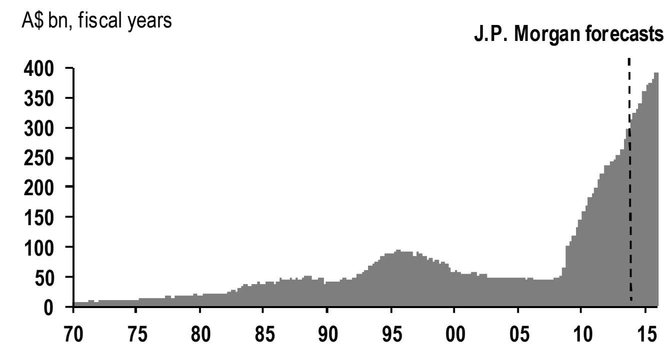
The budget projects that Government debt over the forward estimates period will peak at $450 billion in 2017-18, or just under 24% of GDP. CGS issuance in the year ended June 2015 will be $73.7 billion, sliding to $65 billion by 2016-17. Total CGS on issue by 2016-17 will be $430 billion. CGS on issue of $667 billion by 2023-24 was projected in MYEFO, but this now will be somewhat lower. There was no need to increase the debt limit in this budget; the limit was abolished last year by the current government in an agreement with the Greens party, in exchange for better disclosure of public finances.

Projected change in budget deficit - government forecasts



Source: Budget papers, J.P. Morgan.

Gross Commonwealth Government bond issuance



Source: Budget papers, J.P. Morgan.

The economy: confidence drag near term

The budget forecasts growth in the economy in the year ended June 2015 of 2.5%, below the J.P. Morgan estimate of 3.0%. The Treasury expects growth of 3% to 3.5% in subsequent years, meaning the economy will continue to grow at a sub—trend pace in the near term. The implication is that the jobless rate will continue to rise; the budget forecasts a peak unemployment rate of 6.25%, the same as predicted in MYEFO back in December, with the jobless rate then stable until 2016-17.

There are a few potentially productivity enhancing measures in the Budget, which could help to enhance growth in the economy over time. The proposed corporate tax cut would help (although it seems to be tied to the proposed paid parental leave scheme), and smaller government means there could be less crowding out of the private sector. The planned working for the dole scheme also may generate more hours of work, but the ultimate dividend from this probably is small.

Near term, though, the biggest impact likely will be a drag on consumer confidence, which will make the rotation in the sources of growth in the economy away from mining investment more problematic. It also leaves open the possibility that the RBA will be forced to provide modest stimulus later this year, particularly with AUD still misbehaving above 90 US cents. The RBA has assumed for some time that the public sector will be a drag on growth in the economy over the medium term, and tonight's revelations probably do not change this assessment much. Like us, RBA officials likely had been assuming the fiscal drag would be larger than before, but not materially so.

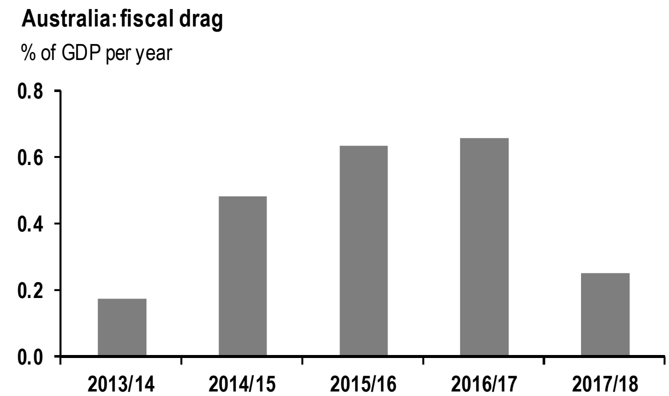
Larger fiscal drag of 2.5% over four years

On the basis of items explicitly accounted for in individual budget line items (i.e. excluding the announced, but not explicitly-costed changes to the company tax rate and PPL levy), we have upped our estimates of fiscal drag by 1 to 2/10ths of GDP on average, per year, relative to the baseline fiscal scenario set last year. Fiscal policy is now estimated to take 0.5%-pts from growth in 2014/15, from 0.2%-pts this year, escalating to 0.6%-pt in 2015/16, and 0.7%-pt in 2016/17, before diminishing to 0.3%-pts in 2017/18.

The majority of the drag in our estimates was delivered by adjustments announced in prior budget updates, through the increase to the Medicare Levy, cutting of the carbon and mining taxation compensation, and cuts to family tax benefits and education funding on the expenditure side. The most significant contribution to the incremental drag announced in the 2014/15 budget comes from cuts to transfers and government payments (representing over 80% of 'saves' among bigger line items), mostly from adjustments to the Family Tax Benefit programs and changes to health-related expenditure and rebates.

We assign an average multiplier of 0.5 to such changes, having excluded from the expenditure cuts the large, but zero domestic multiplier item of reduced foreign aid disbursements. For the tax measures, we exclude the increase in the fuel excise, which is earmarked for roads spending. This reduces the macro impact of tax changes mostly to the Budget Repair Levy. The multiplier we have assigned for the upper income tax levy is smaller (-0.6) than we usually assume for tax measures, since the burden will fall on households with a lower than average propensity to consume.

On the positive side, the government have pledged an additional A$11.6 billion of infrastructure investment. There is significant uncertainty surrounding the treatment of these items, and the much larger headline figures cited for the overall infrastructure program, given the lack of detail around funding arrangements. We are inclined to take the element of these programs that has not been explicitly accounted for (i.e. the off budget capital items) as mostly a wash, particularly given the similarly opaque cuts to other infrastructure programs (NBN and CEFC) announced previously. The same goes for the government's new A$20 billion medical R&D



Source: Budget papers, J.P. Morgan.

fund, since equity contributions have an associated multiplier of zero, until projects are realized, and subsidies drawn down. Of the A$11.6 billion in new infrastructure projects, roughly 60% appears to represent genuine new deficit spending, to which we apply a high multiplier of 0.9.

We apply a lower multiplier (0.5) to the remaining element of the projects, both because it relies on an asset sale program that assumes state participation (hardly certain), and because this effectively means the private sector is being asked to indirectly fund new public investment, in contrast to a bond-funded deficit spending program. The latter need not crowd out private investment since bonds and private investment projects are not competing assets (and particularly since foreign participation in the bond market very high).

Spending: welfare the main target

The budget projects that expenditure as a share of GDP will stay broadly flat at just over 25% of GDP over the forward estimates period. The main expenditure measures announced tonight included the following measures:

- Cuts to the welfare portfolio, including:
    - Tighter eligibility criteria for family tax benefits and disability support pensions. The threshold for Family Tax Benefit (FTB B) will be lowered to $100,000 (from $150,000) from 1 July 2014, reducing cash payments by $2.6 billion over the next four years. Further, eligibility for the FTB Part B will be limited to families whose youngest child is younger than six years of age, reducing cash payments by $1.6 billion to FY2018. Family benefit payments will be frozen for two years.

  - Changing access to income support arrangements for people under 30 years of age, to encourage young people with full work capacity to be earning, learning or participating in *Work for the Dole*. This is expected to reduce cash payments by $1.2 billion over the next four years.

  - A rise in the entitlement age for the aged-pension from 67 to 70 by 1 July 2035. This will affect people born after 1965.

- On health, there were two important changes:

  - the Medicare Benefits Schedule rebates will be lowered by $5 for general practitioner consultations and out-of-hospital pathology and diagnostic imaging services; and

  - the providers of medical services now can collect a $7 patient contribution, expected to raise $3.4 billion over the forward estimates. These funds will be invested in the Medical Research Future Fund, which will be established on 1 January 2015.

- Closure and amalgamation of dozens of government departments, resulting in 16,000 redundancies, mainly by attrition.

- A freeze in growth in foreign aid. The total savings are worth more than $8 billion over the forward estimates period.

These savings will be partly offset by new spending announcements, including:

- Additional road funding. The government promised before the budget to boost infrastructure, and this measure forms a key element of this pledge. The budget commits an additional $6.3 billion to roads funding over the next four years, an amount to be complimented by spending by the various state governments.

- Strengthening incentives for mature age job seekers to re-enter the workforce with the creation of a new wage subsidy — *Restart* — expected to increase cash payments by $18 million in 2014-15 ($304 million over the four years to 2017-18). Incentives include payments of $10,000 to employers who hire mature age job seekers aged 50 or over.

- A $20 billion medical research fund will be established, funded by the Medicare co-payment, which will return dividends to the government. The funds will be kept out of general revenue, and will be used to fund medical research.

- The establishment of the Asset Recycling Initiative, which will provide State and Territory governments with incentive payments to unlock capital from state-owned assets and reinvest the proceeds in new productivity-enhancing economic infrastructure will cost $5.0 billion to FY2018.

- A new Infrastructure Investment Program to support economic growth is expected to increase cash payments by $3.7 billion over to 2017-18. Funding will be provided to States and Territories to expedite existing large infrastructure projects and new high productivity infrastructure projects and road safety programs.

- Delivering a Western Sydney Infrastructure Plan by funding major road projects for the development of a second Sydney airport at Badgerys Creek and providing the transport infrastructure necessary to support a growing population in Western Sydney. This Plan is expected to increase cash payments by $103 million in 2014-15 (or $2.9 billion over the ten years to 2023-24).

Revenue: income and petrol tax rises

The budget expects revenue as a share of GDP to rise from the current 23.6% to 25.5% over four years. The main revenue raising measures included:

- The imposition of a temporary (i.e. four years) 2% levy on the top personal tax rate, raising $3.1 billion over four years. The levy kicks in from 1 July 2014 for taxpayers earning $180,000 a year. The government hopes that branding the new temporary impost a levy will convince voters that this does not break the government's promise not to impose new taxes.

- From 1 August 2014, the 38.4 cent per litre petrol excise will be re-indexed, the previous six-monthly indexation regime having been suspended by the Howard government in 2001. This will lift the tax component of petrol prices in line with inflation and raise up to $1.5 billion per year.

- Abolishing of the Mature Age Workers Tax Offset and the Dependent Spouse Tax Offset will save $1.1 billion over the forward estimates period.

These revenue raising measures will be partly offset by tax reductions, including:

- The company tax rate is being trimmed from the current 30% to 28.5%, but this is not a new promise; the government's aspiration always has been to lower taxes on companies. It seems the planned tax cut is contingent on the Paid Parental Leave (PPL) scheme passing through the Parliament (see below).

- The government is pushing ahead with its plans to abolish the mining and carbon taxes imposed by Labor. The mining tax raised unexpectedly low levels of revenue, but the carbon tax reaps close to $6 billion per year.

Other measures: asset sales and PPL

Outside revenue and spending, Treasurer Hockey announced the following measures:

- The Treasurer announced that, in addition to Medibank Private, the sale of which already has been approved, the government will sell off all or part of the Australian Mint, Defence housing, and the registry functions of ASIC.

- Establishing the Emissions Reduction Fund from 1 July 2014, expected to increase cash payments by $75 million in 2014-15 (and by $2.6 billion over the ten years to 2023-24).

- Deregulating higher education to allow universities to more actively manage fee structures.

- The long-promised paid parental leave scheme will be introduced, albeit in slightly cut down form, partly funded by a 1.5% levy on top of the corporate tax rate for the top 3,000 companies. The scheme is capped to those earning $100,000, rather than the $150,000 the Coalition took to the election.