8 May 2014

Australian Federal budget 2014: a preview
2014/15: a $26bn deficit
The journey back to surplus begins

- **Westpac expects the underlying budget deficit for 2014/15 to be announced by the government as $26.0bn on Budget night on May 13. That is about $8bn lower than the estimate from the government's Mid Year review of $33.9bn.**
- **The improvement will come from a modest increase in the government's nominal GDP growth forecasts, 3.5% to 4.25% for 2013/14 and 3.5% to 4.0% for 2014/15. That will improve the 2014/15 starting point by $4bn. There will also be a number of policy initiatives on both the revenue and spending sides (a further $5bn). Partly offsetting the reduced spending initiatives will be a $1bn increase in infrastructure investment.**
- **On the revenue side it looks likely the government will announce a temporary deficit levy raising $1bn a year and a lift in the fuel excise, also raising $1bn a year.**
- **On the expenditure side there are likely to be net spending cuts of $3bn including a tightening of eligibility conditions for family tax benefits.**
- **The government will be able to announce this near term budget outcome as a considerable success by reducing the underlying deficit from 3.0% of GDP in 2013/14 to 1.6% of GDP in 2014/15.**
- **Given the strong rhetoric from the government in the lead up to the Budget these "savings" appear to be quite modest. However, they will be in line with the principles set out in the Committee of Audit which focuses on the medium term and returning the budget to a respectable surplus (1% of GDP) by 2023/24. Note that the near term spending savings envisaged by the Committee are modest: $2bn in 2014/15; $3bn in 2015/16; and $5bn in 2016/17.**
- **To identify the magnitude of that challenge we can look to the Committee's sources of long term savings to reduce outlays by $60-$70bn per annum by 2023/24. The key sources of those savings are: pensions, $10bn; health, $20bn; family assistance, $7bn; foreign aid, $5bn; and $20bn from other programs including defence; schools; universities; industry assistance and government departments.**
- **The government will not adopt all of the initiatives suggested by the Committee, so the likely projected surplus is likely to be reached a little later than the Committee's target of 2019/20. However, we expect the broad mix of savings to be quite similar.**
- **Westpac is in broad agreement with the government's near term growth forecasts. Further, we do not believe that the new policies , including the levy, will make a meaningful impact on consumer spending.**
- **We also point out that the expected near term stance of the Budget will be significantly less contractionary than the first Howard/Costello budget in 1996. That budget included net savings over the 3 years of 3.1% of GDP compared with our estimate for this budget of 1% of GDP.**

Table 1

Underlying cash balance, $bn	'13/14	'14/15	'15/16	'16/17
MYEFO	**–47.0**	**–33.9**	**–24.1**	**–17.7**
%GDP	–3.0	–2.1	–1.4	–1.0
Growth f/cs, upgrade	0.0	+3.9	+4.1	+4.2
Levy & fuel excise	0.0	2.0	2.0	2.0
Net savings	0.0	3.0	3.0	4.5
Measures	*0.0*	*5.0*	*5.0*	*6.5*
%GDP	0.0	–0.3	–0.3	–0.4
Infrastructure	0.0	–1.0	–1.0	–1.0
Net improvement	*0.0*	*+7.9*	*+8.1*	*+9.7*
Budget night *	**–47.0**	**–26.0**	**–16.0**	**–8.0**
%GDP	–3.0	–1.6	–0.9	–0.4

* Westpac's expectation of Government forecasts to appear in 2014 Budget

Table 2

Key forecasts		'13/14	'14/15	'15/16	'16/17
Real GDP	MYEFO	2.50	2.50	3.00	3.00
(% chg)	Budget *	2.75	2.75	3.00	3.00
Nominal GDP	MYEFO	3.50	3.50	4.75	4.75
(% chg)	Budget *	4.25	4.00	4.75	4.75
Terms of trade	MYEFO	–5.00	–5.00	–	–
(% chg)	Budget *	–3.00	–5.00	–3.00	–3.00

* Westpac's expectation of Government forecasts to appear in 2014 Budget

Sources: Budget papers, ABS, Westpac Economics

Budget starting position: a small improvement

To gauge the starting position for the budget relative to that in MYEFO we consider two factors: (1) actual monthly revenue and expenditure outcomes so far in the current financial year; and (2) likely revisions to key economic growth forecasts. On this occasion, we assess that the first of these factors points to no material change, while the second, the economic growth numbers, suggests a small improvement from 2014/15.

The Department of Finance reports that for the initial 8 months of the 2013/14 financial year, the underlying cash balance is $2.8bn ahead of expectations, while the fiscal balance is $3.2bn ahead of forecast. Critically, the bulk of this divergence from MYEFO is an undershoot of expenses, with lower than expected expenses for grants, wages and salaries and the supply of goods and services. We are mindful that expenditure undershoots part way through a year can evaporate by years' end, indicating that the apparent improvement was due to timing issues around payments. Accordingly, we are inclined to expect little to no change in the budget position in 2013/14.

Economic prospects are a little better than anticipated. Likely upgrades to the growth number, as discussed below, indicate that the economy in 2014/15 will be some $20bn larger than assumed in MYEFO. This would translate into stronger revenues and an improved budget position in the order of $4bn a year.

Economic growth: upgrade

The Government is likely to nudge up their forecasts of economic growth for this financial year and next, with the recent data indicating that conditions have been a little better than anticipated.

On output, we expect the Government to forecast real GDP growth of 2.75% for 2013/14 and 2014/15, upgraded by 0.25ppts in both years from 2.50% in MYEFO, published on December 17.

On the size of the economy, nominal GDP, the MYEFO forecasts had growth at 3.50% in 2013/14 and 2014/15, a well below trend pace. We expect nominal GDP growth for 2013/14 to be upgraded by 0.75% to 4.25% reflecting slightly more favourable movements in output, the terms of trade and domestic prices. For 2014/15, we expect an upgrade of 0.50% to 4.00%, centred on output and domestic prices. The implication of these changes is that the economy in 2014/15 will be $20bn larger than assumed in MYEFO.

As for 2015/16 and 2016/17, in MYEFO real GDP growth was forecast to be 3.0% in each year and nominal GDP 4.75% in both years. We do not envisage changes to these numbers. In addition, we expect the forecasts for the 2017/18 year, which rolls into the published figures, to also be 3.0% and 4.75%.

Policy measures: spending, savings, tax reform

The Government is set to tighten and reprioritise expenditures. In addition, the government will introduce a new tax (a deficit levy), a likely lift in fuel excise and new charges for health services (co-payments).

The National Commission of Audit (NCA) provides some insights. The suggestion is that spending cuts will be small in the period to 2016/17. The large savings do not start until 2017/18, that is after the next Federal election, scheduled to be in 2016 if the government runs the full 3 year term.

The NCA envisages savings of around $2bn in 2014/15 and $3bn 2015/16. In 2017/18, savings leap to $20bn, rising to around $30bn in 2019/20 and $65bn in 2023/24.

The key concern is that in 2017/18 expenditure on current policies is set to jump, by around 7.4%, and it keeps rising at an annual rate of 6% a year thereafter. This reflects the impact of the National Disability Insurance Scheme, defence spending, a deal with the state governments on hospitals, education funding and foreign aid commitments.

The NCA suggests reforms to family payments as well as to welfare benefits, the introduction of co-payments for health services, winding back industry assistance, rationalisation of government bodies and agencies, and privatisations.

Infrastructure spending

With the government committed to boosting infrastructure spending, the budget will include a $10bn infrastructure package, according to recent reports.

On funding, we've assumed only part of this is met from the budget, in the order of $1bn a year. Much of the money is to be provided from a new fund, to be established from the proceeds of asset sales. Medibank private is to be sold in the coming year, with expected proceeds of $4bn.

Stance of fiscal policy

The budget deficit narrowed from 2.9% of GDP in 2011/12 to 1.2% in 2012/13 and then widened to an estimated 3.0% of GDP in 2013/14.

On our figuring, the deficit narrows by 1.4% of GDP in 2014/15, from 3.0% to 1.6%. We assess that the tightening of fiscal policy is in the order of 0.5ppts of GDP. The remaining 0.9ppts is accounted for by a one-off payment to the RBA, which inflates the 2013/14 deficit, and by automatic stabilisers (namely, a lift in revenue growth associated with improved economic conditions). Note, we have factored in discretionary policy measures of $5bn for 2014/15 (0.3ppts of GDP) to be unveiled in the upcoming budget.

The budget strategy, if consistent with the approach recommended by the NCA, is one of incremental adjustments in the short-term and more substantial reprioritising of expenditures from 2017/18, when spending is set to accelerate sharply on current policy.

This contrasts with the approach in the 1996/97 budget, the initial budget of the Howard Government. In that budget, net savings achieved over three years equated to 3.1% of GDP. In today's dollars, that would be worth $54bn over three years. We've factored in savings in the upcoming budget of almost $17bn over three years, representing 1.0% of GDP.

Budget measures are expected to have a fairly minor impact on consumer spending. A temporary deficit levy raising an extra $1bn a year for example equates to about 0.1% of total annual consumption, or 0.4% of total retail sales. With the levy only applied to high income earners – a group whose spending is less sensitive to income changes than those facing tighter budget constraints – the actual impact on spending will be even smaller. There is little prospect of the changes impacting heavily in one month either – income tax changes tend to have a more gradual impact over the course of a full year compared to lump sum fiscal payments. The same is likely to be broadly true for other policy measures such as increases in fuel excise, and Budget savings on pensions, health and family assistance. Many of these policy measures are likely to have their impact in outer years rather than near term as well.

The real wildcard for the Budget impact on consumer demand is around confidence. Here the risks run both ways. Sentiment has clearly been negatively-affected in the lead-in to the Budget with plenty of warnings about the need for difficult policy decisions. However, sentiment could clearly stage a 'relief rally' if the Budget is not as 'bad' as feared.

A return to surplus in 2020/21

The May Budget will include medium-term fiscal projections. These are likely to indicate a possible timing for a return to budget surplus.

The NCA's reform scenario had the budget in balance in 2018/19 and then in surplus in 2019/20, with the surplus rising to 1.0% of GDP in 2023/24, consistent with the government's high level fiscal strategy.

The budget could well show a slightly later timing on a return to balance and then to surplus, say in 2019/20 and 2020/21 respectively, given that the government is unlikely to adopt all of the Committee's recommendations.

To place that in context, this would have the budget in deficit for 11 consecutive years, from 2008/09 to 2018/19. A return to surplus would not occur in the term of this government, nor in the term of the next government (assuming that is from 2016 to 2019).

A key objective is to have fiscal policy flexibility to deal with the next crisis/next economic downturn. Such flexibility served Australia well in the most recent global crisis. With this in mind, a credible path back to surplus needs to be set in place.

Net debt

The Federal budget has been in deficit since the 2008/09 financial year, when the global downturn hit. The underlying cash deficit totals $191bn over the five years to 2012/13. Over this five year period net public debt increased by $198bn to be $153bn (10.0% of GDP) as at June 2013.

In MYEFO, net debt rises to $281bn (15.7% of GDP) as at June 2017, an increase of $128bn over the four year forecast period.

On our figuring, net debt rises to $255bn (14.1% of GDP) as at June 2017, an increase of $102bn. That is some $26bn less than in MYEFO, reflecting one-for-one the cumulative improvement in the budget position over the four years.

By way of reference, in the National Commission of Audit (NCA), net debt under a "business as usual" scenario "would rise above 15% of GDP and remain elevated through to 2023/24 and beyond". This NCA scenario is premised on the assumption that the tax to GDP ratio is capped at 24%. In MYEFO, the medium-term scenario included a tax boost from "bracket creep".

Tax reform: white paper

The government is committed to a comprehensive Taxation White Paper. All aspects of the tax system are to be 'on the table'. The expectation is that the government's response to the white paper would form part of their platform for a possible second term.

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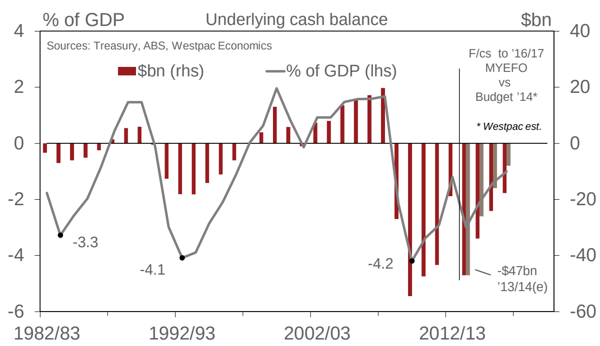
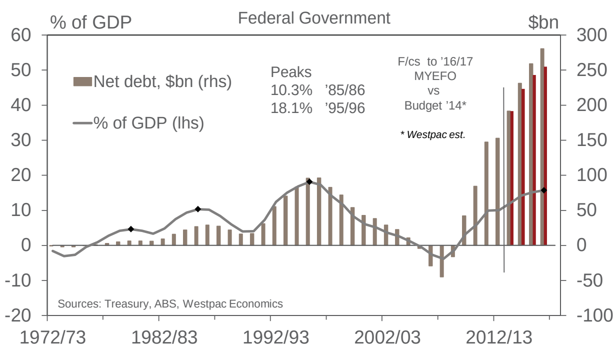
Australian Federal budget balance



Australia: public net debt



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