6 May 2015

Australian Federal budget 2015: a preview

2015/16: a $41bn deficit

$10bn a year slippage, as national income squeezed

- **Westpac expects the underlying budget deficit for 2015/16 to be announced by the Federal Government as $41bn on Budget night on May 12.**
- **That is a $10bn deterioration from the Government's December forecast, published in the Mid-Year Economic and Fiscal (MYEFO), and a $24bn blow-out from the Government's May 2014 forecast.**
- **Across the four years to 2017/18, the deterioration since MYEFO is $34bn.**
- **Pressures on the Federal Budget evident in recent years have continued. Most notably, the terms of trade falling at a double digit pace in 2014 is squeezing national income. In particular, the outlook for the key iron ore price is around $20 lower than the $60/t assumed in MYEFO.**
- **The larger than expected negative income shock will see the Federal Government downgrading their growth forecasts in the May Budget, with flow-on effects to the budget bottom line.**
- **On output growth, we expect the Government to trim forecast real GDP growth by 0.25% for each of the three years 2014/15 to 2016/17. That yields a profile of: 2.25%, 2.75%, and 3.25%. The forecast for nominal GDP growth in 2015/16 is set to be cut sharply, down 1ppt to a soft 3.5%, albeit up from 1.5% in 2014/15.**
- **The budget impact from lower commodity prices and a weaker general economic environment is expected to be almost $9bn in 2015/16 and $10bn in 2016/17.**
- **Adding to the budget woes is the Senate impasse. Delays to the passage of savings measures introduced in the 2014 Budget will cost the budget a further $1bn to $2bn a year. The Government remains committed to a number of savings measures yet to be passed by the Senate. These will continue to be included in the forward estimates, but there must be a risk of a further $20bn-$25bn slippage in the Government figures across the four years.**
- **The 2015 Budget is to focus on jobs, families and small business. The centre piece will be reform of child care funding and a family package, as well as a tax cut for small business. There will be no net impact on the budget. These measures will be fully funded, in part by shelving the paid parental leave scheme.**
- **On tax, the Treasurer has hinted at a number of measures aimed at repairing the tax net. We've allowed for a $1bn to $2bn a year boost.**
- **The return to budget surplus will be further delayed, potentially to 2020/21 or 2021/22, a year or two later than projected in MYEFO.**
- **Net debt climbs to around $350bn, 19.0% of GDP, in 2017/18. This will represent the peak, as a share of GDP - on Budget 2015 forecasts. That is a $34bn deterioration from the MYEFO forecast for 2017/18 of $316bn, 17.0% of GDP.**

Table 1

Underlying cash balance, $bn	'14/15	'15/16	'16/17	'17/18
MYEFO	**–40.4**	**–31.2**	**–20.8**	**–11.5**
% GDP	–2.5	–1.9	–1.2	–0.6
Iron ore price, lower	–1.0	–5.0	–5.0	–5.0
Softer economy	–0.6	–3.8	–5.2	–5.0
Senate impasse	-1.0	-2.0	-1.0	-1.0
Debt servicing	0.0	0.0	-1.0	-1.5
Revenue measures	0.0	1.0	1.0	2.0
Net deterioration	*-2.6*	*–9.8*	*–11.2*	*–10.5*
Budget position *	**–43.0**	**–41.0**	**–32.0**	**–22.0**
% GDP	–2.7	–2.5	–1.8	–1.2
Net debt				
MYEFO	**245**	**280**	**304**	**316**
% GDP	15.2	16.7	17.2	17.0
Budget position *	**247**	**292**	**328**	**350**
% GDP	15.4	17.6	18.8	19.0

* Westpac's expectation of Government forecasts to appear in 2015 Budget

Table 2

Key forecasts		'14/15	'15/16	'16/17	'17/18
Real GDP	MYEFO	2.50	3.00	3.50	3.50
(% chg)	Budget *	2.25	2.75	3.25	3.50
Nominal GDP	MYEFO	1.50	4.50	5.25	5.25
(% chg)	Budget *	1.50	3.50	5.00	5.25
Terms of trade	MYEFO	-13.5	-3.75	–	–
(% chg)	Budget *	-11.0	-6.00	–	–
Unemployment	MYEFO	6.50	6.50	6.00	5.75
	Budget *	6.50	6.50	6.00	5.75

* Westpac's expectation of Government forecasts to appear in 2015 Budget

Sources: Budget papers, ABS, Westpac Economics

Economic growth: downgrade
The Australian economy lost momentum in calendar 2014, against the backdrop of plunging commodity prices. The terms of trade fell by a little in excess of 10% in 2014, intensifying the downward pressure on incomes across the economy, both profits and wages.

Forecasters, including ourselves and the RBA, have lowered their growth numbers as a result of the larger than expected negative income shock. The Federal Government will do likewise.

On the iron ore price, the MYEFO forecast of US$60/t free on board will be lowered sharply. Reports in April suggested a potential Budget forecast of US$35/t, at the time the spot price was around $47. More recently, spot has recovered to $58. We are assuming a forecast of around $40 (fob). The $20 cut to the iron ore price will cost the budget in the order of $5bn a year.

That forecast looks conservative but “safe”. The Government will not want to be confronted with another downgrade of the fiscal position as a result of a further “miss” on the iron ore forecast, especially in an election year. On the other hand, given the cost curves of the major producers, a $40 forecast looks like a reasonable “floor”.

On output, we expect the Government to trim their real GDP growth forecast by 0.25% for each of the three years 2014/15 to 2016/17, bringing the Government more into line with our forecasts. That would produce a revised GDP profile of: 2.5% actual for 2013/14; slowing to 2.25% in 2014/15; improving but remaining below trend at 2.75% in 2015/16; and then strengthening to 3.25% in 2016/17. For 2017/18, we expect the forecast to remain unchanged at 3.50%.

On the size of the economy, nominal GDP, the Government's very downbeat forecast for 2014/15 of only 1.5% is on track. For the year ahead, the 2015/16 number will need to be reduced aggressively given the weaker commodity price environment, lowered by 1ppt to a very soft 3.50% in our view. The 2016/17 forecast will be trimmed by 0.25% to 5.0%, reflecting weaker output. For 2017/18, we expect the forecast, of 5.25%, to be unchanged.

Revenue hit from weaker economy
In the 2015 Budget, revenue numbers will be scaled back from earlier expectations to reflect the weaker economic backdrop. Nominal GDP growth is 1% lower in 2015/16 and 0.25% lower in 2016/17 than in MYEFO, on our expectations. Notably, the key iron ore price could be cut by around $20, to US$40/t.

The downgrade to the budget position could be in the order of $8.8bn for 2015/16, increasing to a $10.2bn write down in 2016/17. Personal income tax collections will be impacted by slower wages growth and company tax will be dented by weaker profits. Another effect of weak wages growth will be the impact on Family Tax Benefits as more families than expected remain below the eligibility thresholds.

As for the 2014/15 year, the deterioration in the budget position relative to MYEFO could be relatively modest, potentially less than $2bn. The monthly financial statements, available for the initial 9 months of the financial year, report that the budget is currently tracking a little ahead of forecast. However, we anticipate slippage in the final quarter.

Senate impasse
Many of the policy measures introduced in the 2014 Budget have been frustrated by the Senate. Some measures have been shelved, some amended and others are up for negotiation.

Note, those saving measures yet to be passed but which are still government policy will remain in the forward estimates. Although, the impact from any timing delays will need to be booked as a cost to the budget.

Given this patchwork the precise dollar impact of the Senate impasse is unclear. Some reports put the cost at around $1bn for the 2014/15 year, rising to $2bn in 2015/16, and then at $1bn for the following two years.

The 2014 Budget included saving measures, particularly around health, education, and pensions which grow in impact beyond 2017/18. The Government remains committed to these medium-term structural savings. This is critically important, given the need to fund a number of existing policies, such as the National Disability Scheme, whose costs escalate over the medium-term.

Budget 2015: key themes
The Government has indicated that the 2015 Budget is to focus on jobs, families and small business. The centre piece will be reform of child care funding and a family package, with a view to lifting female participation in the workforce, as well as a tax cut for small business.

There will be no net impact on the budget, these measures will be fully funded. The paid parental leave scheme will not proceed, saving a net $1.3bn in 2015/16. Other policy initiatives, in dollar terms, are likely to be modest and offset by saving measures.

Tax reform: integrity measures
The Government has opened a discussion on tax reform. A Tax Discussion Paper was released by the Treasury in March and the Government will release a White Paper in 2016, leading into the next Federal Election.

In the 2015 Budget, ahead of a broader tax reform package, the focus will be on beginning to repair the tax net. The Treasurer has hinted at a number of measures aimed at enhancing the integrity of the tax system, including: a "Google tax", directed at addressing profit shifting; GST broadening, to tax such new services as Netflix; potentially modifying dividend imputation arrangements, at the margin, to address costly tax refunds; the introduction of a bank levy, as proposed by the former government; and application fees on foreign investment in the property sector. The potential dollar impact from such integrity measures will be difficult for the Treasury and ATO to predict. We've allowed for the benefit to rise to $2bn in 2017/18.

Timing of the surplus
We estimate that the budget position for 2017/18 will be reported to have deteriorated from an $11.5bn deficit as forecast in MYEFO to a $22.0bn deficit, a shortfall of $10.5bn.

On the figuring in MYEFO, the budget was estimated to reach surplus by 2019/20 (which was itself a one year delay on the 2014 Budget profile).

We estimate that the $10.5bn annual “shortfall” will delay the likely “surplus” date by one to two years, with surplus now not likely until 2020/2021 or 2021/2022. If correct, that would see the Federal budget in deficit for twelve to thirteen consecutive years, with a cumulative deficit in excess of 25% of GDP.

Net debt

Net debt will, on our numbers, climb to around $350bn, 19.0% of GDP, in 2017/18. That is a $34bn deterioration from the MYEFO forecast for 2017/18 of $316bn, 17.0% of GDP. The $34bn is the cumulative slippage in the budget position across the four years 2014/15 to 2017/18.

The 2017/18 year is likely to represent the peak in net debt, as a share of GDP, as forecast in the 2015 Budget. Such an outcome, if achieved, would be relatively low by historical and international standards. That said, it is notable that net debt levels have increased, rising from 6.0% at June 2011, to almost 14% at June 2014, and then to a forecast 19% at June 2018.

The “Elephant in the Room” on all our numbers and the ones that will be released on Budget night is that the forecasts assume that the bulk of the $36bn in savings over 4 years that were announced in the 2014 Budget eventually become law. The reality is that the bulk of these savings, in the order of $20-$25bn cumulative impact over the four year forecast period, are held up in the Senate. Our numbers, which are conservative relative to other estimates we have seen reported, estimate a slippage relative to MYEFO of around $34bn over the 4 years from 2014/15. Failure to deliver on the outstanding “savings” from last year’s Budget would further delay the return to surplus, potentially by another couple of years.

Secondly, our estimate of the timing of reaching surplus will be affected not only by the successful passage of these outstanding near term savings but also the longer term savings, including the scaling back of payments to the states of $80bn and the restructuring of pension arrangements. The $80bn in reduced payments to the states is the cumulative impact from 2017/18 to 2024/25, including a $20bn impact in the 2024/25 year alone.

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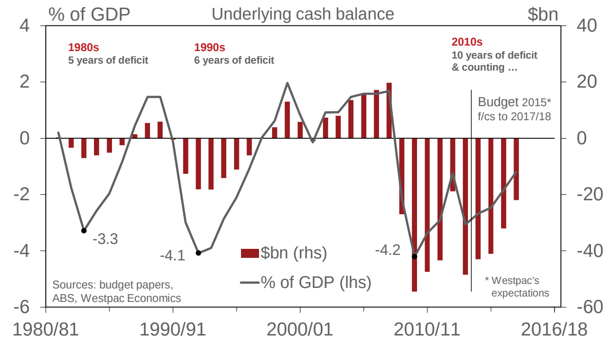
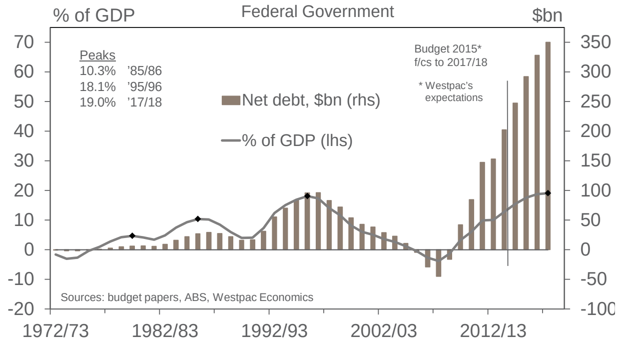
Federal budget: the long road to surplus



Australia: public net debt



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