THE 2020-21 AUSTRALIAN GOVERNMENT BUDGET: AN (IMMEDIATE) ASSESSMENT

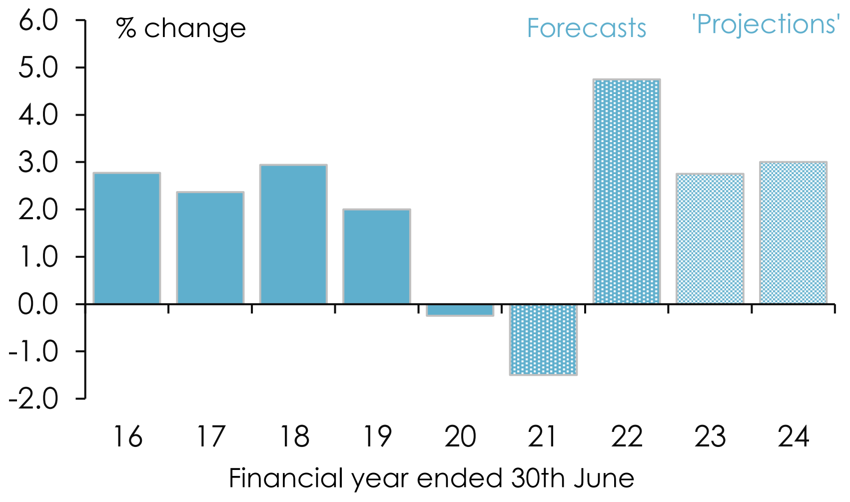
6TH OCTOBER 2020

SAUL ESLAKE
CORINNA ECONOMIC ADVISORY PTY LTD

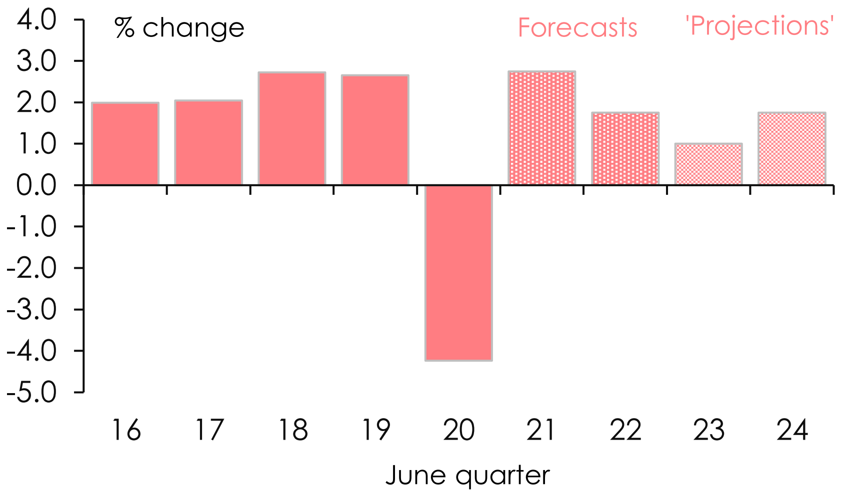
The view on the economy

Treasury predicts a reasonably strong turnaround in economic activity with 4¼% real GDP growth in calendar 2021 after -3¾% in 2020

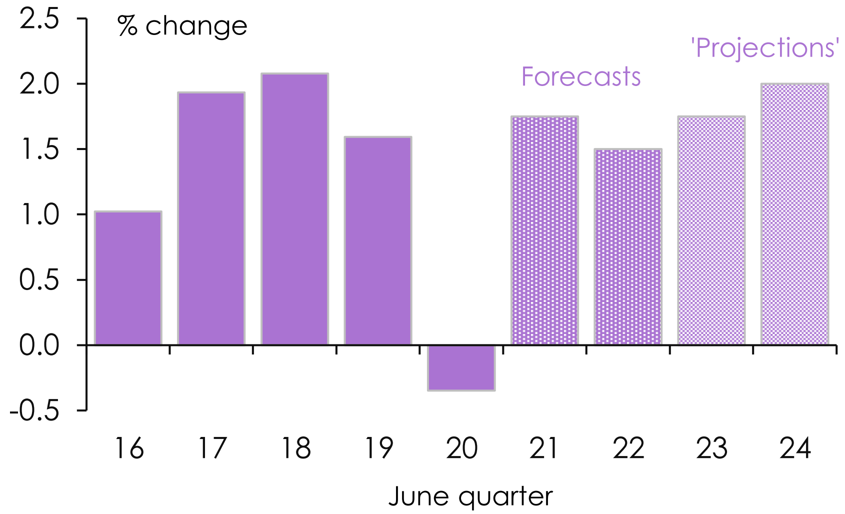
Real GDP



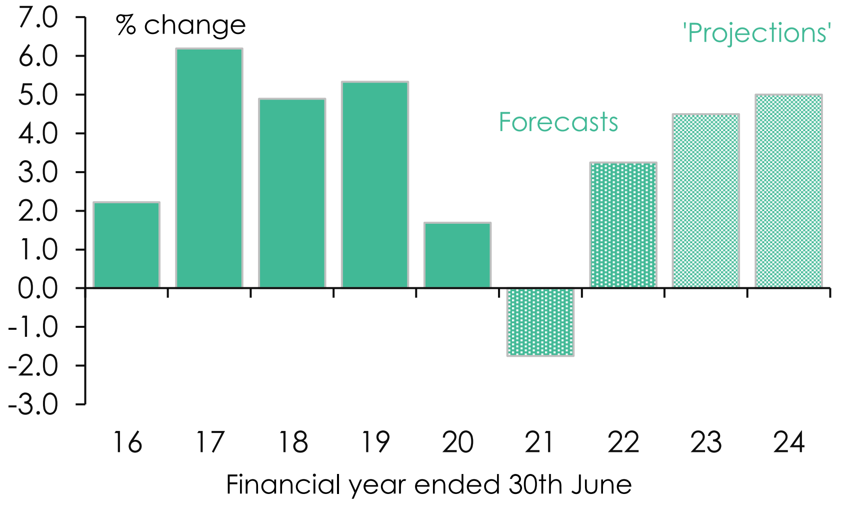
Employment



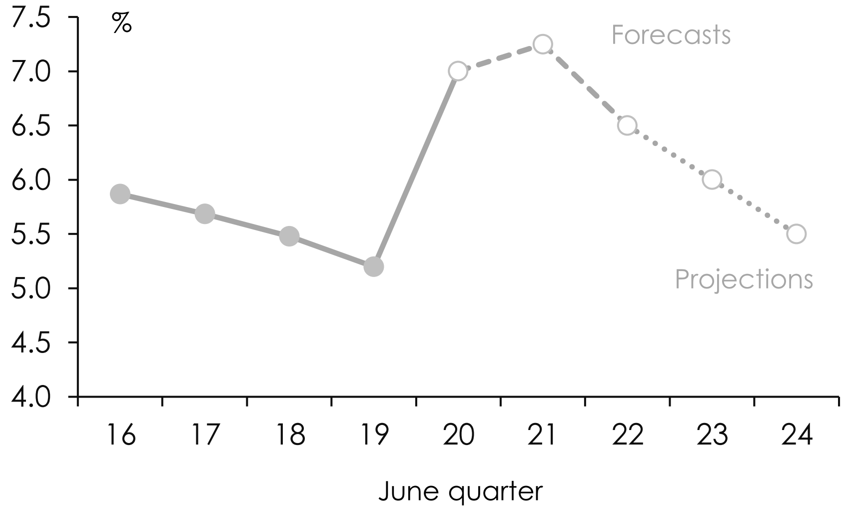
Consumer price index



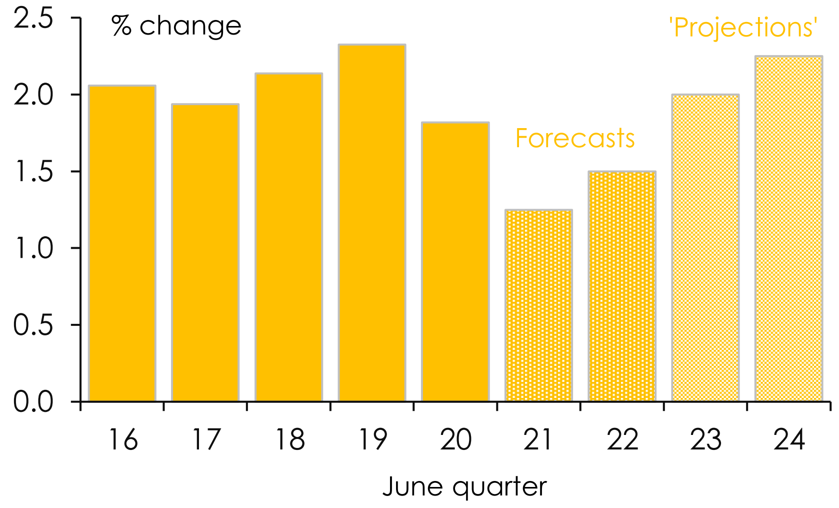
Nominal GDP



Unemployment rate



Wage price index



Note: 'Forecasts' are Treasury's 'best endeavours' estimates for the current and following financial years. 'Projections' for the following two financial years are *not* forecasts, but rather are based on a 'medium-term methodology and supply side assumptions' based on a premise that 'any spare capacity in the economy is absorbed over five years following the end of the forecast period' (ie from 2022-23 through 2027-28 inclusive). Sources: ABS; 2020-21 Budget Paper No. 1, Statement No. 2.

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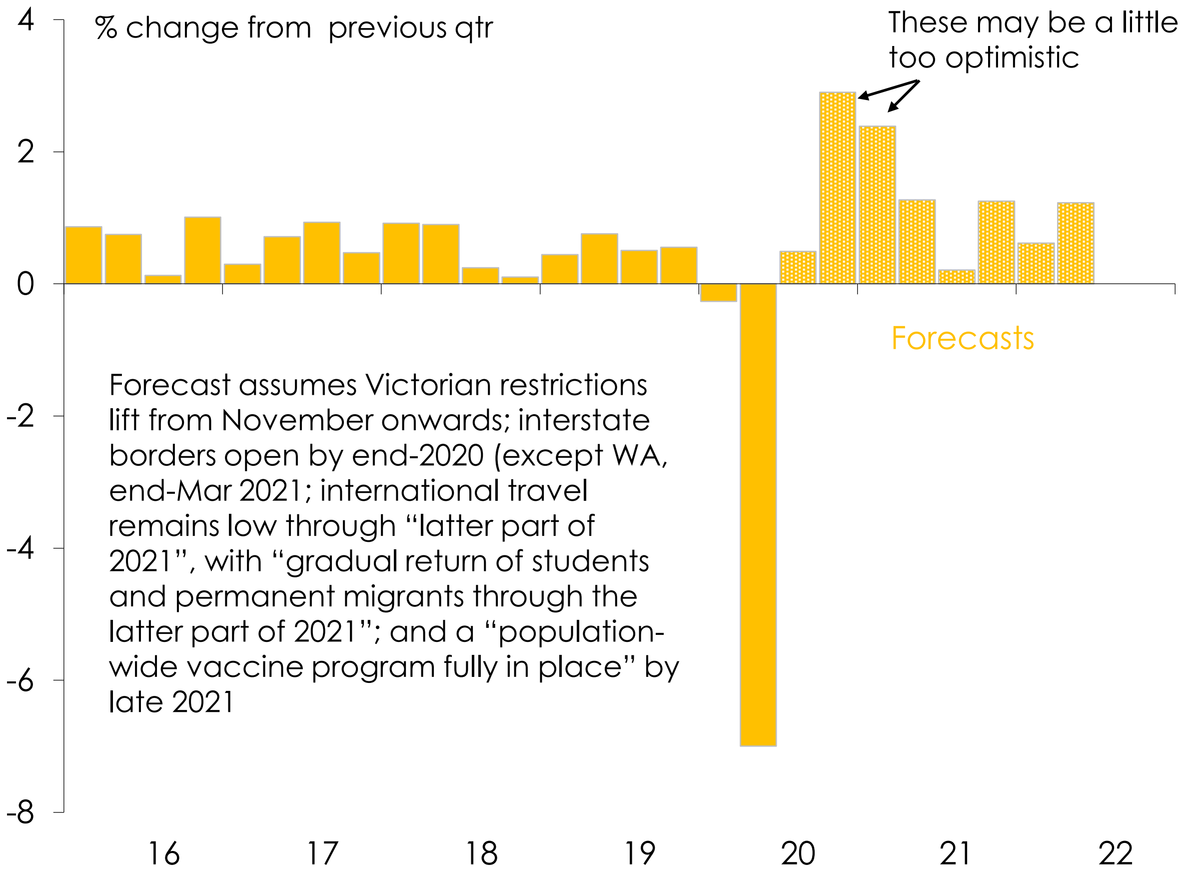
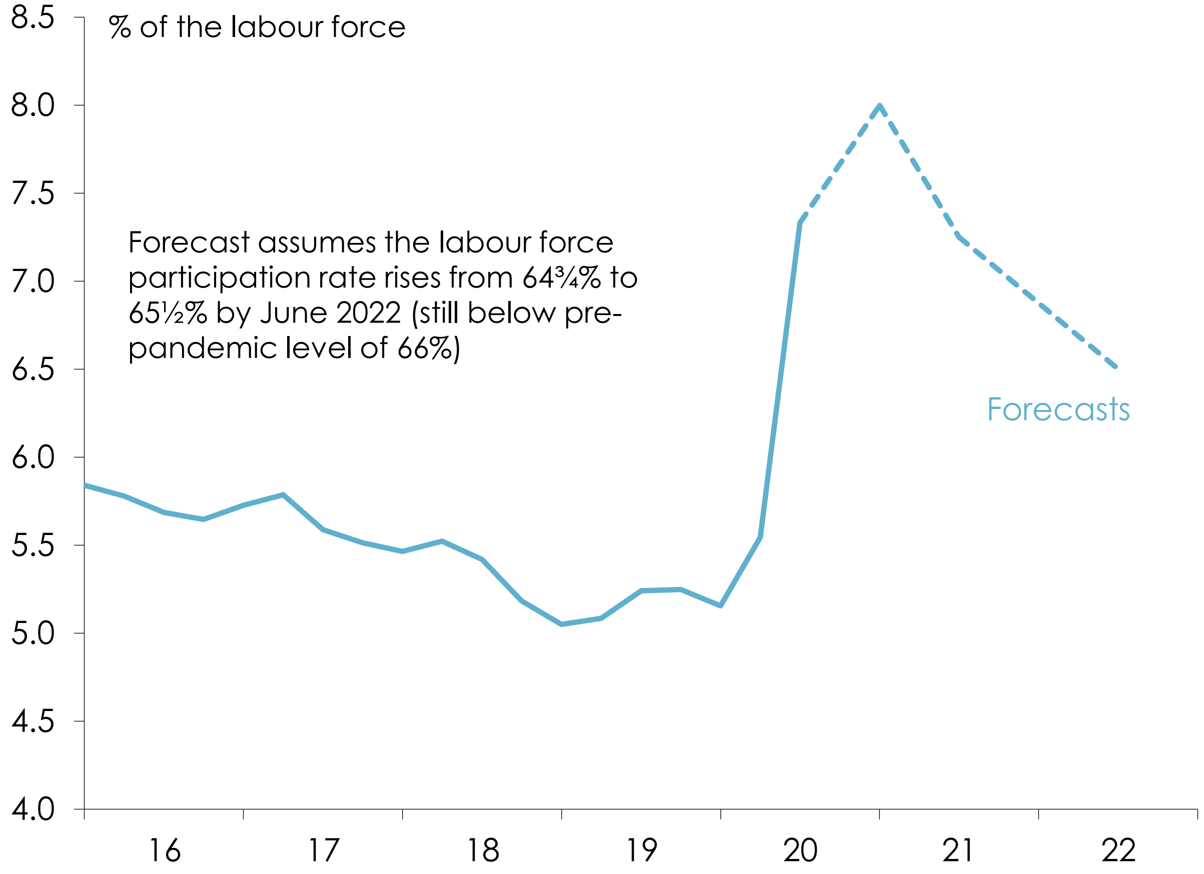
More detailed forecasts show the Government expects a ‘growth surge’ over summer followed by more modest growth in 2021-22

Real GDP growth



- Treasury expects that economic growth resumed in the September quarter, will reach almost 3% in the December quarter, 2½% in the March quarter 2021 and then average ¾% per quarter for the next 5 quarters

Unemployment



- Treasury expects the unemployment rate to peak at 8% in the December quarter, and then fall to 6½% by the June quarter 2022

Sources: ABS; Australian Government, 2020-21 Budget Paper No. 1, Statement No. 2.

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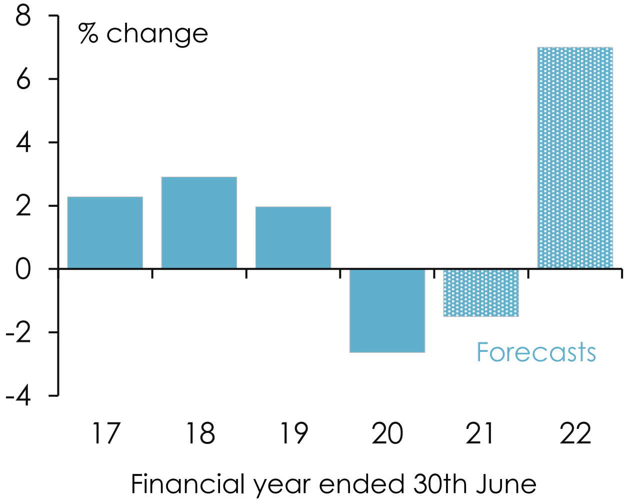
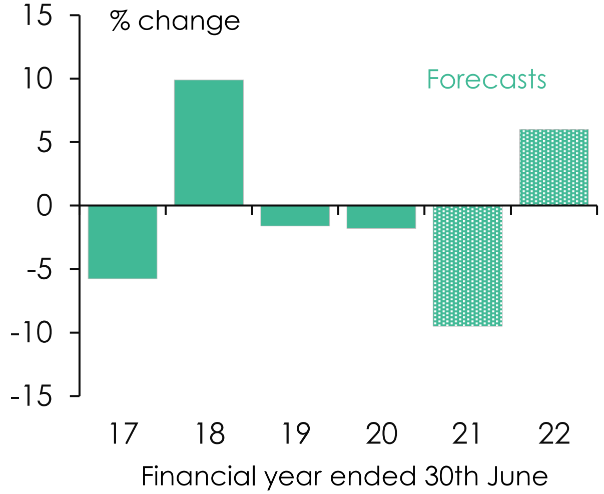
Household consumption and housing investment are expected to drive the recovery, while the current account balance is set to back into deficit

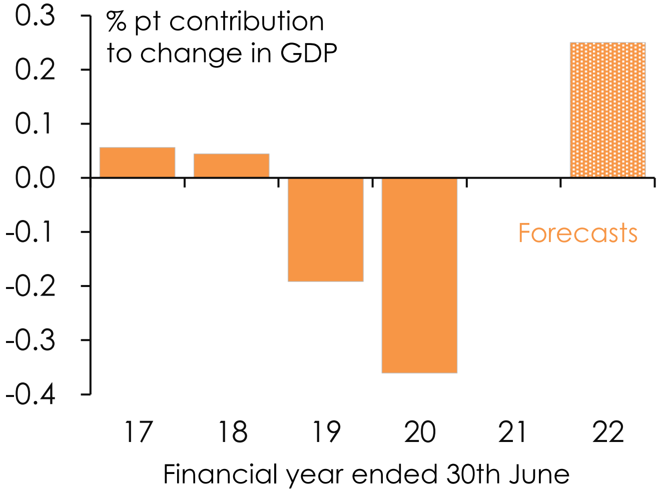
Household consumption



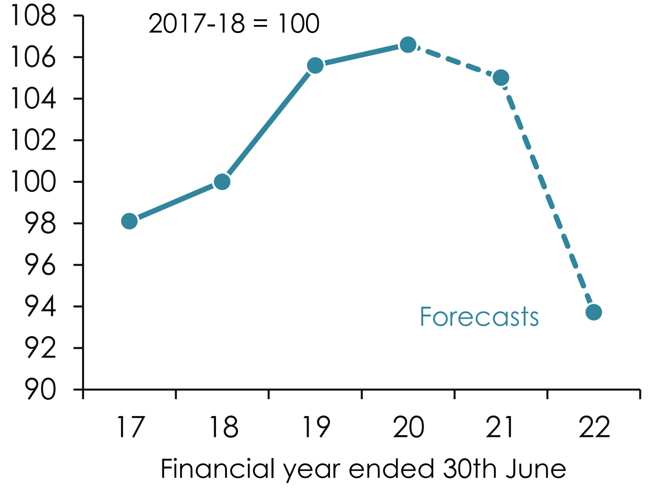
Business investment



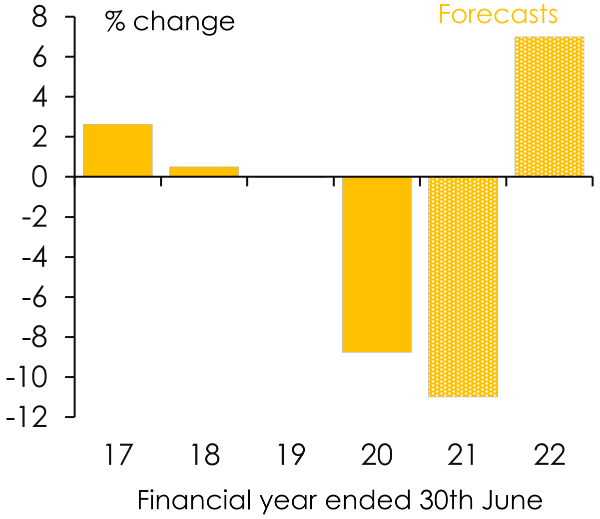
Change in inventories



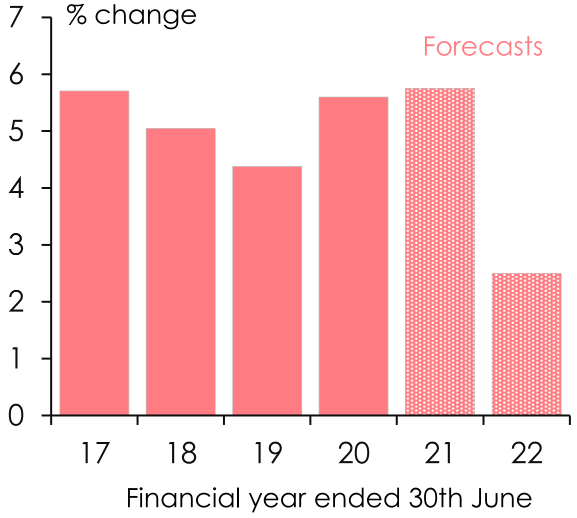
Terms of trade



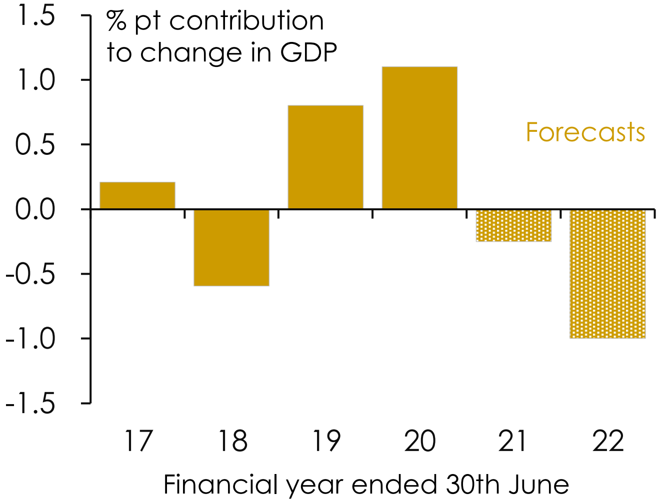
Dwelling investment



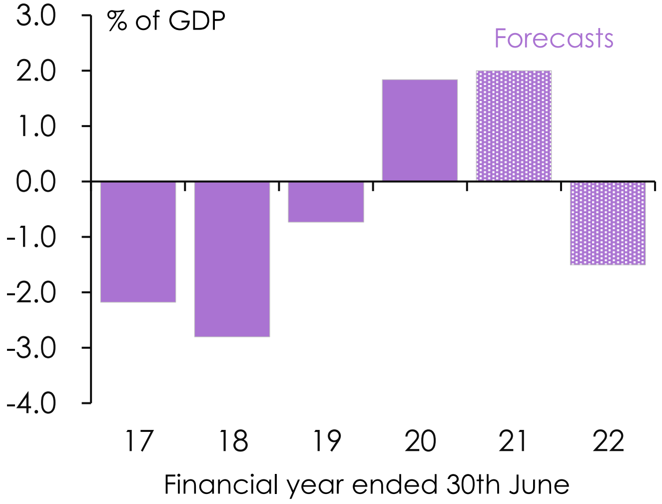
Public spending



Net exports



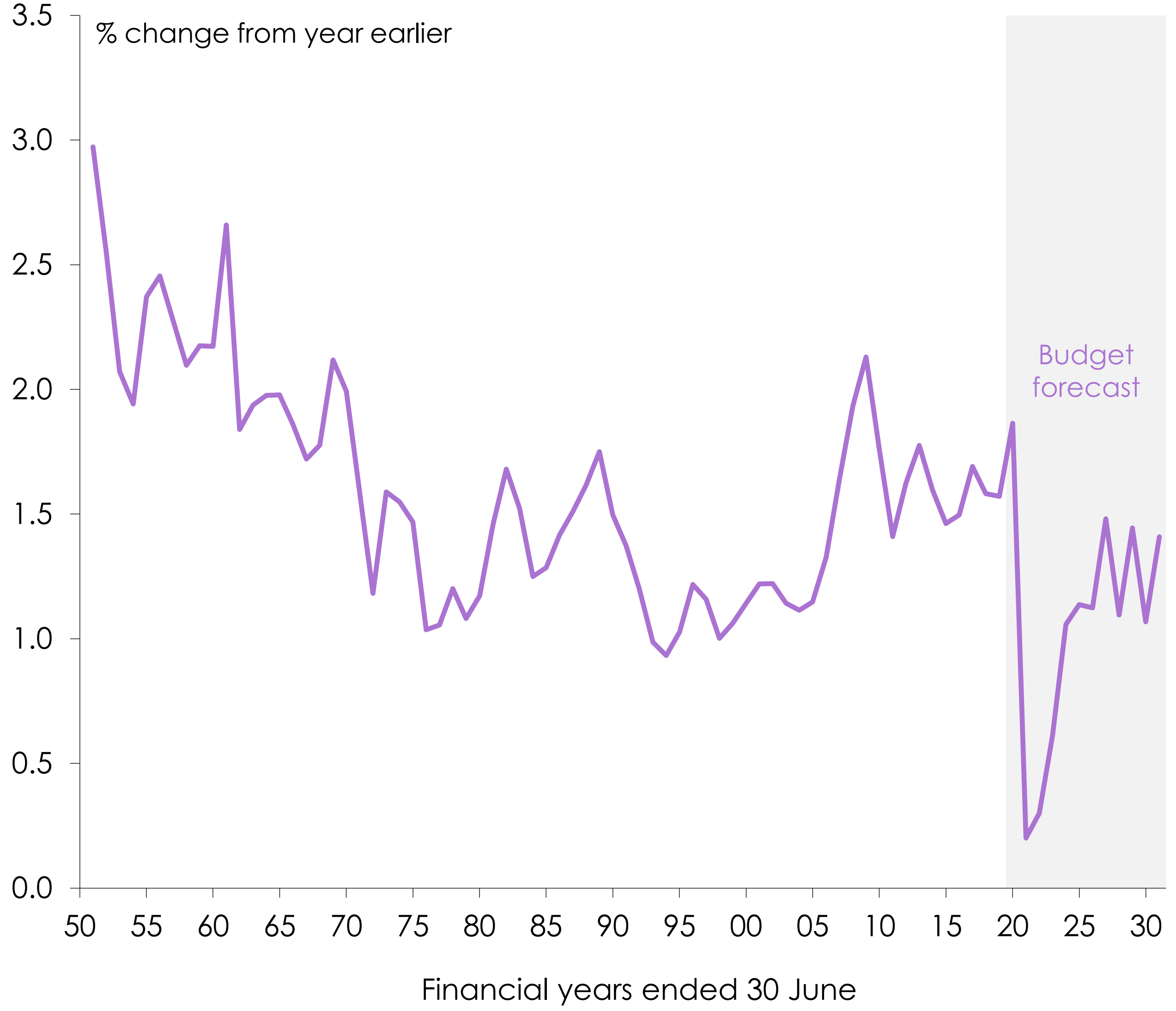
Current account balance



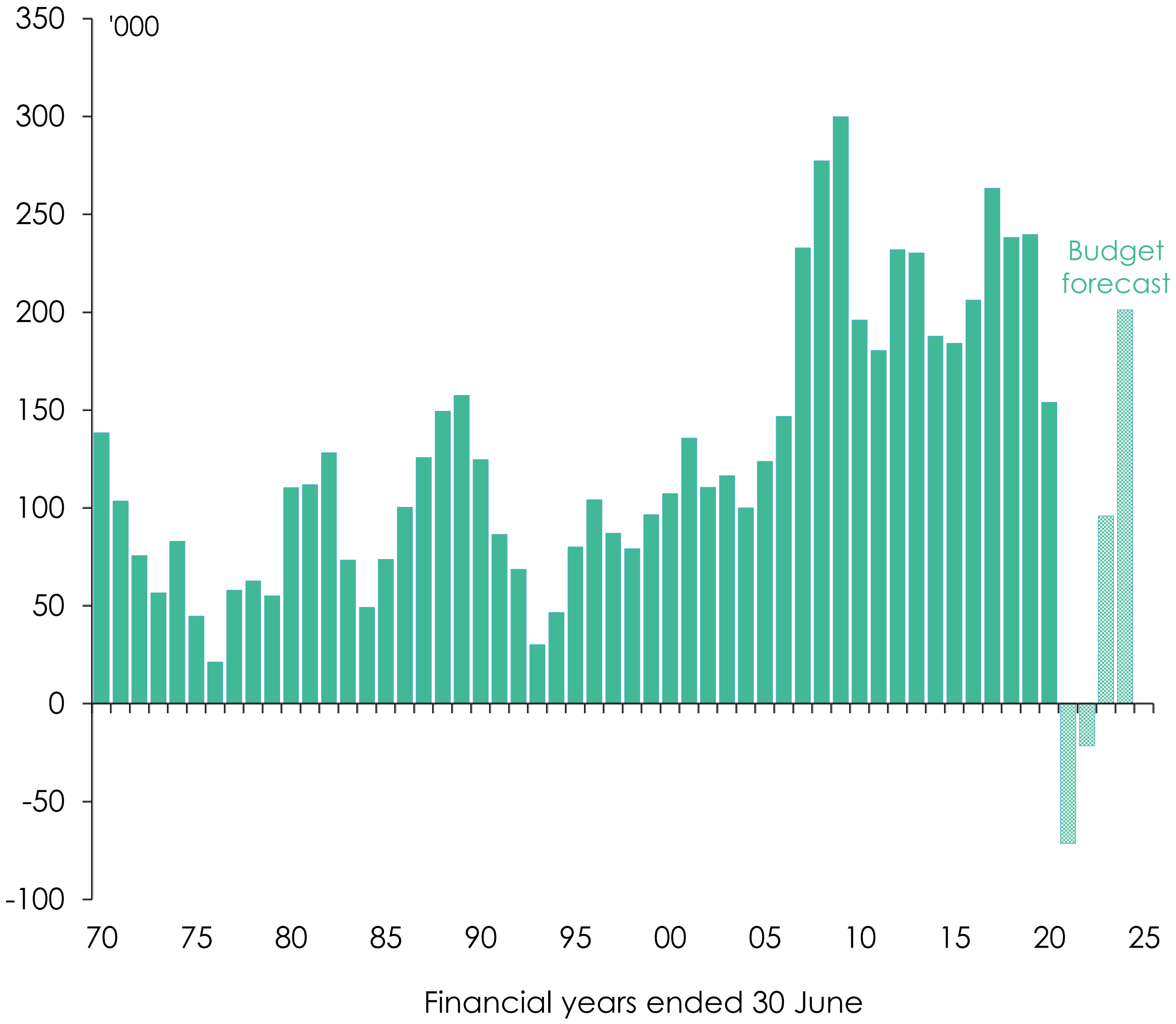
Note: Business investment and public spending exclude transactions in second-hand assets. Employment growth is June quarter on June quarter; unemployment rate is June quarter; all other figures are for financial years. Net overseas migration assumed to fall from 223K in 2018-19 to 154K in 2019-20, -72K in 2020-21 and -22K in 2021-22; international travel bans lifted gradually through 2021; iron ore price falling to US$55/t FoB by June 2021; metallurgical and thermal coal prices remaining at US$108/t and $51/t respectively; oil prices at US$46/bbl; and the A$ remaining at around US72¢. *Sources:* ABS; Australian Government, 2020-21 Budget Paper No. 1, Statement No. 2.

Australia's population growth in 2020-21 is expected to be the lowest in over one hundred years, due largely to the stop in immigration

Population growth



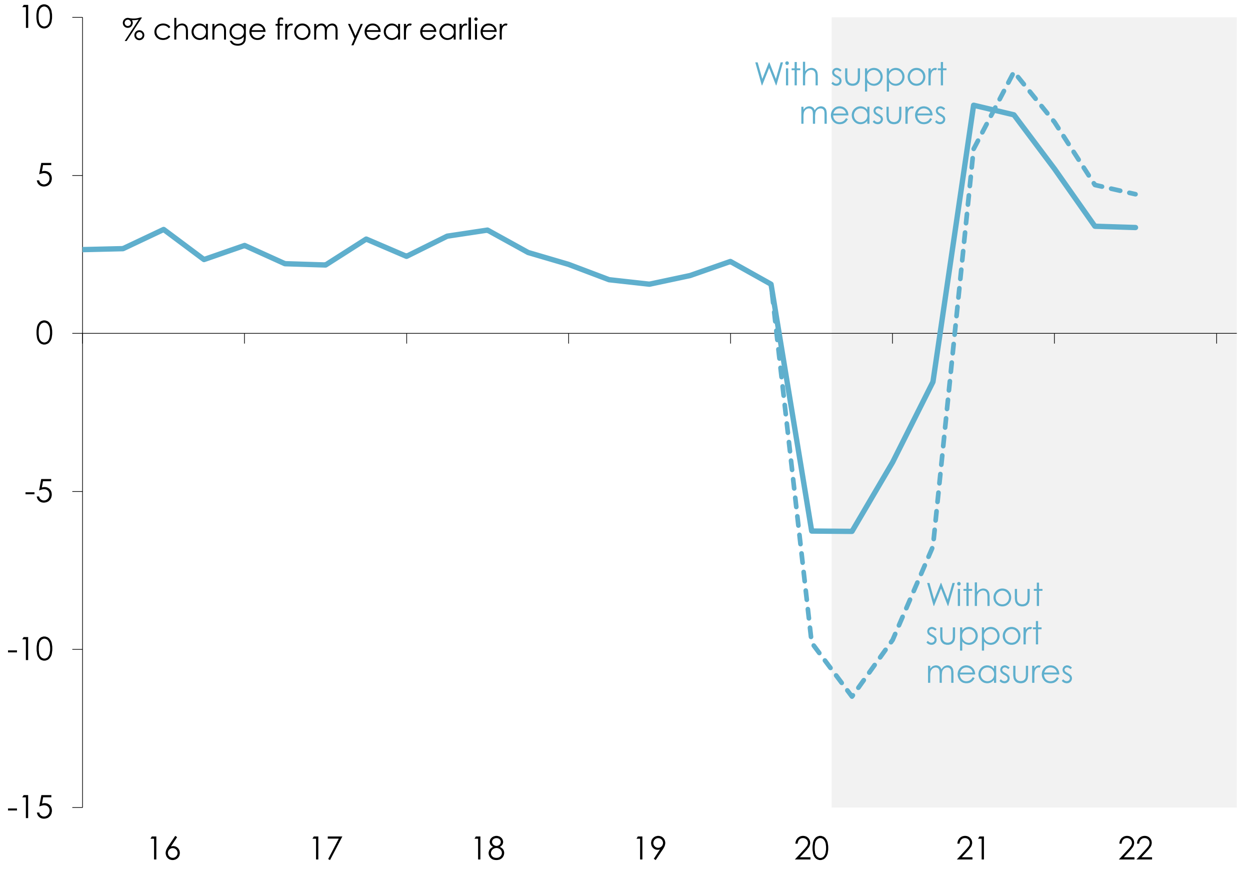
Net overseas migration



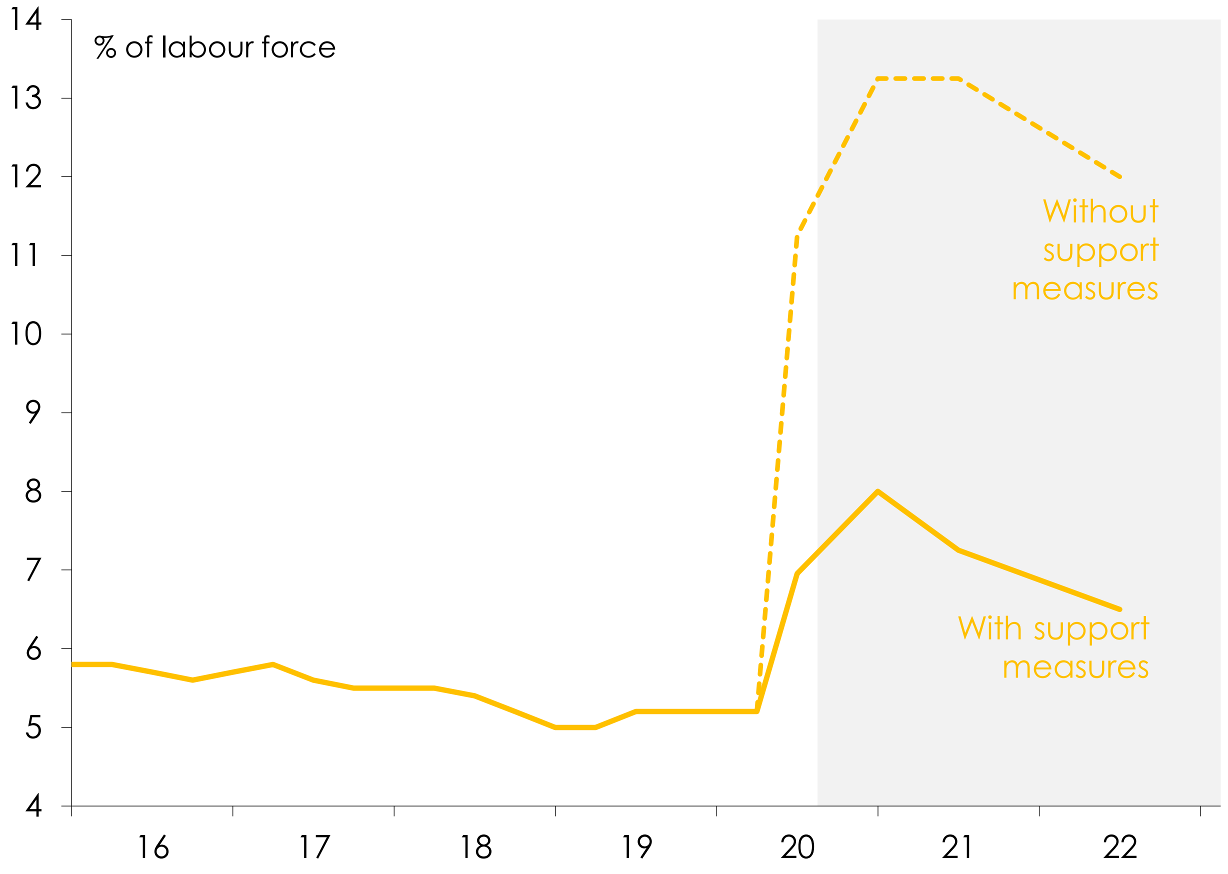
Sources: ABS, National, state and territory population; Australian Government, 2020-21 *Budget Paper No. 1, Statement No. 2* and *Budget Paper No. 3, Appendix A*.

Without the fiscal support measures economic activity would have been much weaker and unemployment would have been much higher

Real GDP growth



Unemployment



- **Without fiscal support measures, real GDP may have fallen by 12% (rather than 7%), and by Q2 2022 may still have been 1½% below its Q4 2019 level, rather than 2¾% above that level as per the Budget forecast**
- **Without fiscal support measures, the unemployment rate may have peaked at 13¼% in Q4 2020 – and stayed there until Q2 2021 – rather than peaking at 8% in Q4 2020 and falling to 6½% by Q2 2022**

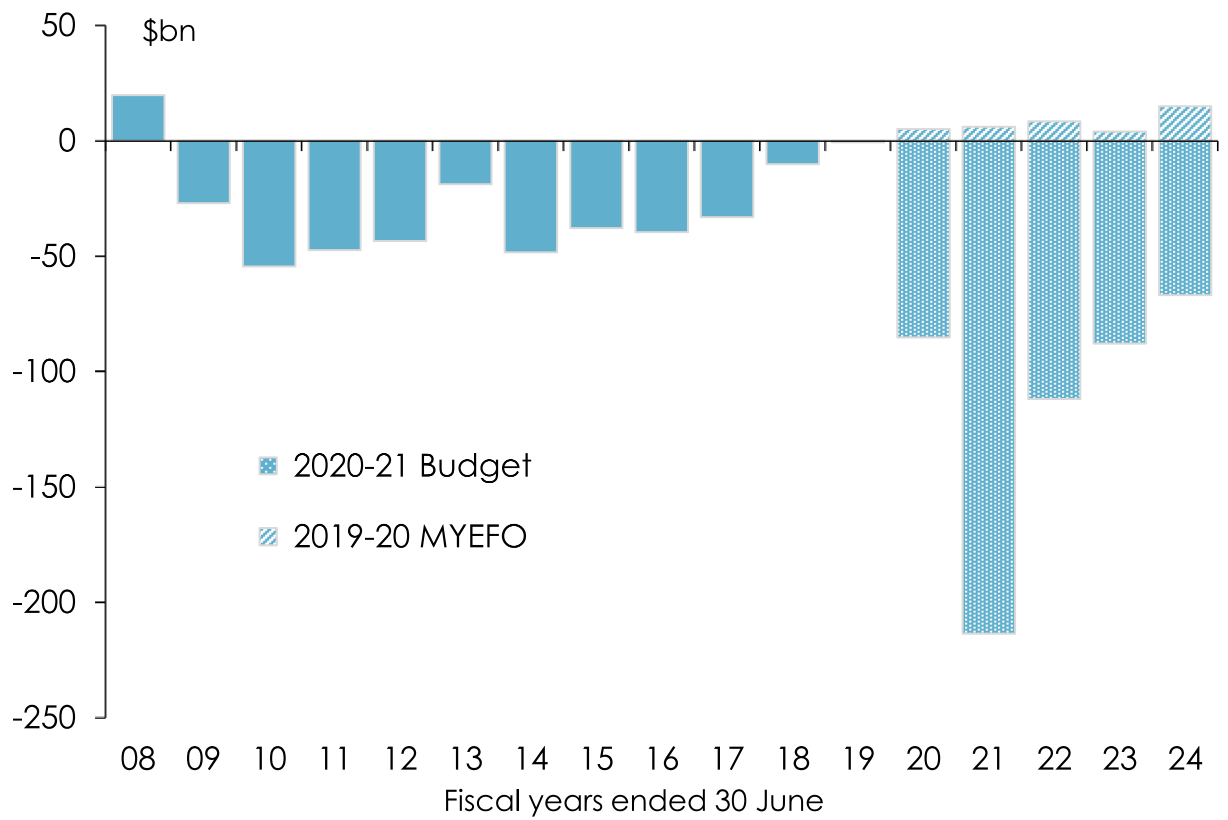
Note: Shaded areas denote forecasts. *Sources:* ABS; Treasury estimates as published in Australian Government, 2020-21 *Budget Paper No. 1, Budget Statement No. 4*.

The shape of the Budget

The Government's budget position has changed dramatically since the onset of Covid-19

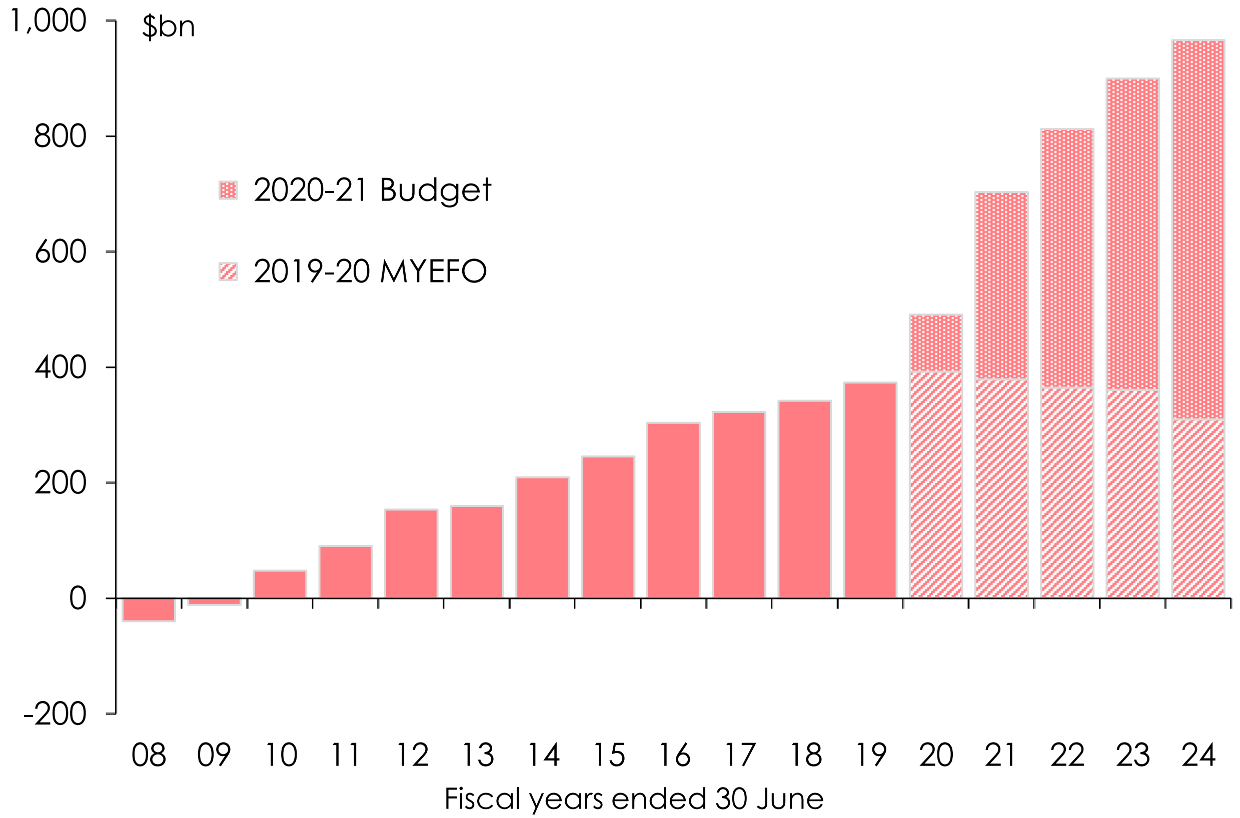
'2019-20 Mid-Year Economic & Fiscal Outlook (MYEFO) and 2020-21 Budget forward estimates compared

'Underlying' cash balance



- **Last December, the Government was confidently predicting a return to budget surpluses – now, it is forecasting deficits totalling $566bn over the five years to 2023-24**

Net debt



- **Last December, net debt was expected to have peaked at $392bn in June 2020, and fall to $310bn by June 2024 – instead it rose to $490bn at June 2020, and is now expected to reach $966bn by June 2024**

Sources: Australian Government, 2019-20 *Mid-Year Economic and Fiscal Outlook*; 2020-21 *Budget Paper No. 1, Budget Statement No. 4*.

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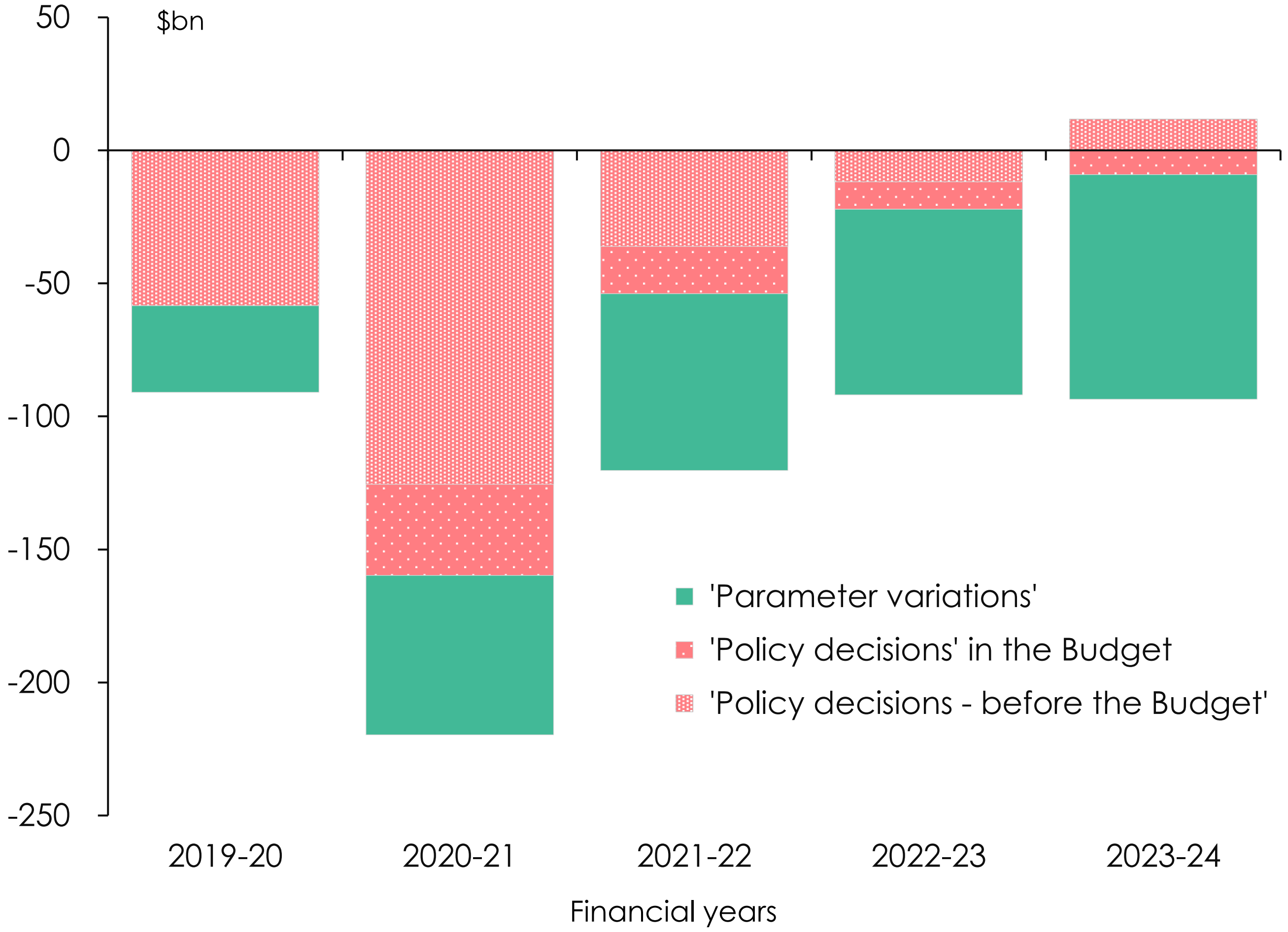
The Government has (quite rightly) 'recalibrated' its fiscal strategy in response to the dramatically changed circumstances

- Since coming to office in 2013, the Coalition Government, under Prime Ministers Abbott, Turnbull and now Morrison, and Treasurers Hockey, Morrison and now Frydenberg, has pursued a fiscal strategy of "returning the budget to balance by maintaining strong fiscal discipline, strengthening the Government's balance sheet and redirecting government spending to boost productivity and workforce participation" (2017 Budget Paper No 1) or more simply "to achieve budget surpluses, on average, over the course of the economic cycle … and reducing debt" (2019 Budget Paper 1)
- This year's Budget Papers (correctly) recognize that "the Covid-19 pandemic has fundamentally reshaped the economic and fiscal outlook" - and that, as the Treasurer said last month, maintaining the previous fiscal strategy would "now be damaging to the economy and unrealistic"
  - If the Treasurer had been willing to quote Maynard Keynes he could have defended the change of strategy with "when the facts change, I change my mind – what do you do?"
- This year's Budget thus introduces a new fiscal strategy which will consist of two phases
- The first phase, which will "remain in place until the unemployment rate is comfortably back under 6%", will have three elements -
  - allowing 'automatic stabilizers' (tax receipts and cyclically-sensitive spending) to "work freely to support the economy"
  - continue providing "temporary, proportionate and targeted fiscal support" to "private sector jobs and investment", and
  - "structural reforms" which "position the economy for the jobs of the future and which improve the ease of doing business"
- The second phase will also comprise three elements -
  - "structural reforms" that "increase our economy's potential", while maintaining a "central focus on jobs and growth"
  - a shift from providing "targeted and temporary support" to "stabilizing gross and net debt" (expressed as pc of GDP) and
  - starting "the hard work of rebuilding our fiscal buffers"

The deterioration in the budget 'bottom line' is roughly equally attributable to 'policy decisions' and changes in the economic outlook

Sources of the changes in forward estimates of the budget's 'underlying cash balance' between the 2019-20 MYEFO and the 2020-21 Budget



Source: Australian Government, *2020-21 Budget Paper No. 1, Statement No. 3* and *Budget Paper No. 2, Budget Measures*; Corinna.

- In December last year the Government was anticipating budget surpluses totalling $38.4bn over the five years to 2023-24: now it is forecasting deficits totalling $566bn – a 'turnaround' of $605bn
- Of that $605bn 'turnaround',
  - $292bn (just under half) is attributable to 'policy decisions', that is, conscious decisions to spend money or reduce taxes
  - and $313bn (just under half) is attributable to what the Budget Papers call 'parameter variations', that is, changes in economic forecasts or other assumptions on which forward estimates of receipts and payments depend
- $232bn (or 80%) of the 'policy decisions' were taken before the 2020-21 Budget (most of them in the first three months of the pandemic
- 'Policy decisions in the 2020-21 Budget amount to 'only' $62bn
- $160bn (55%) of the total 'policy decisions' affect the 2020-21 financial year

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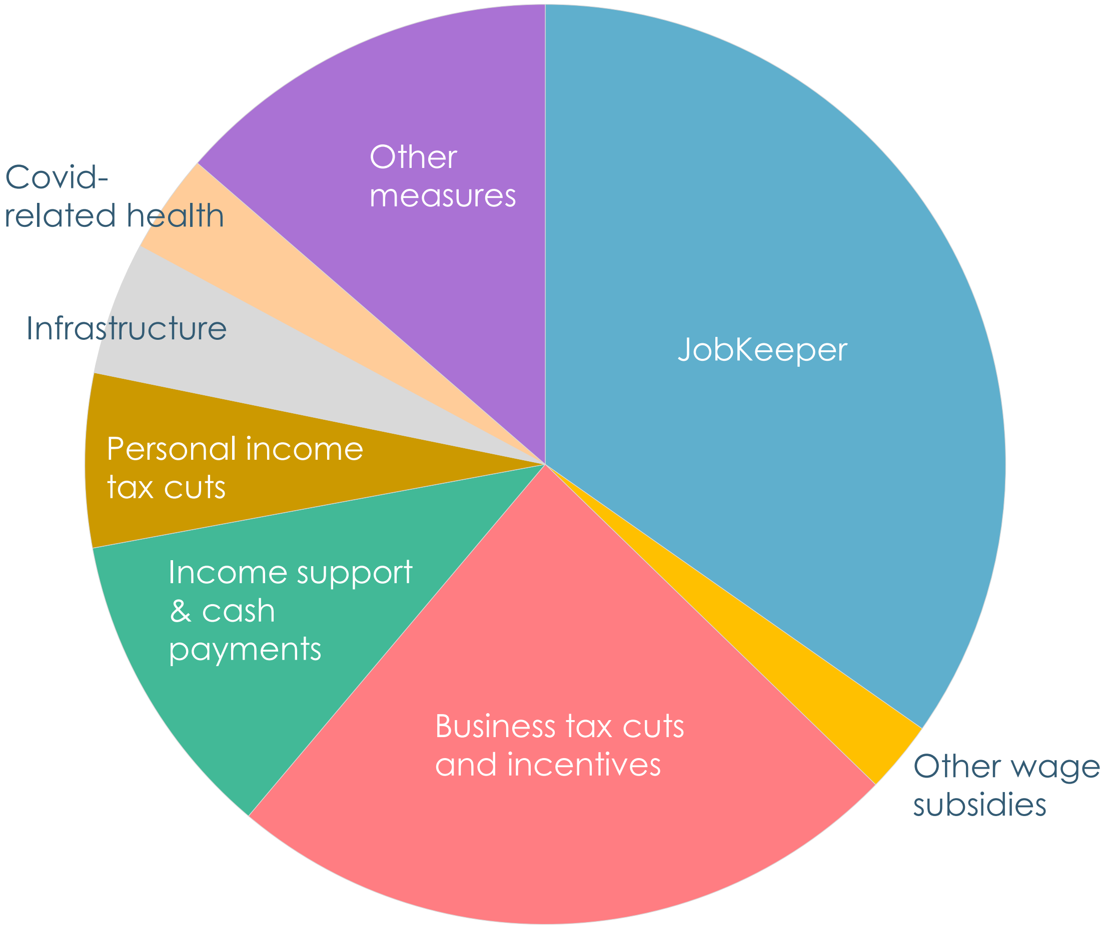
JobKeeper has accounted for 35% of the total cost of policy decisions, and business tax cuts and incentives a further 24%

Budget impact of major 'policy decisions' since December 2019

$ million

	2019-20	*2020-21*	*2021-22*	*2022-23*	*2023-24*	*Total*
JobKeeper	-20,576	-80,726				-101,302
Cash flow for employers	-14,900	-17,000				-31,900
Instant asset write-off		-3,900	-12,200	-16,700	5,100	-27,700
Income support	-6,383	-15,758	-262	-117	-78	-22,598
Tax cuts bring forward		-6,940	-16,870	5,730	250	-17,830
Infrastructure stimulus		-4,324	-4,487	-2,900	-1,920	-13,631
Covid-19 health measures	-4,147	-5,461	-835	70	178	-10,195
Cash payments	-5,576	-3,714				-9,289
Tax loss carry back		-2	-3,121	-2,271	540	-4,854
Jobmaker Hiring credit		-850	-2,900	-250		-4,000
Apprentices & trainees wage subsidies	-369	-3,331	-878	6	14	-3,342
Accelerated depreciation		-1,500	-5,200	200	3,300	-3,200
R& D tax threshold		-310	-450	-590	-650	-2,000
Aviation support	-520	-1,262				-1,782
Modern Manufacturing strategy		-79	-454	-587	-389	-1,509
Other	-5,930	-14,625	-6,203	-4,783	-3,696	-36,452
Total	-58,399	-159,782	-53,860	-22,191	2,648	-291,584

Share of total 'bottom line' impact over five years to 2023-24 of major policy measures



Source: Australian Government, *2020-21 Budget Paper No. 1, Statement No. 3* and *Budget Paper No. 2, Budget Measures*; Corinna.

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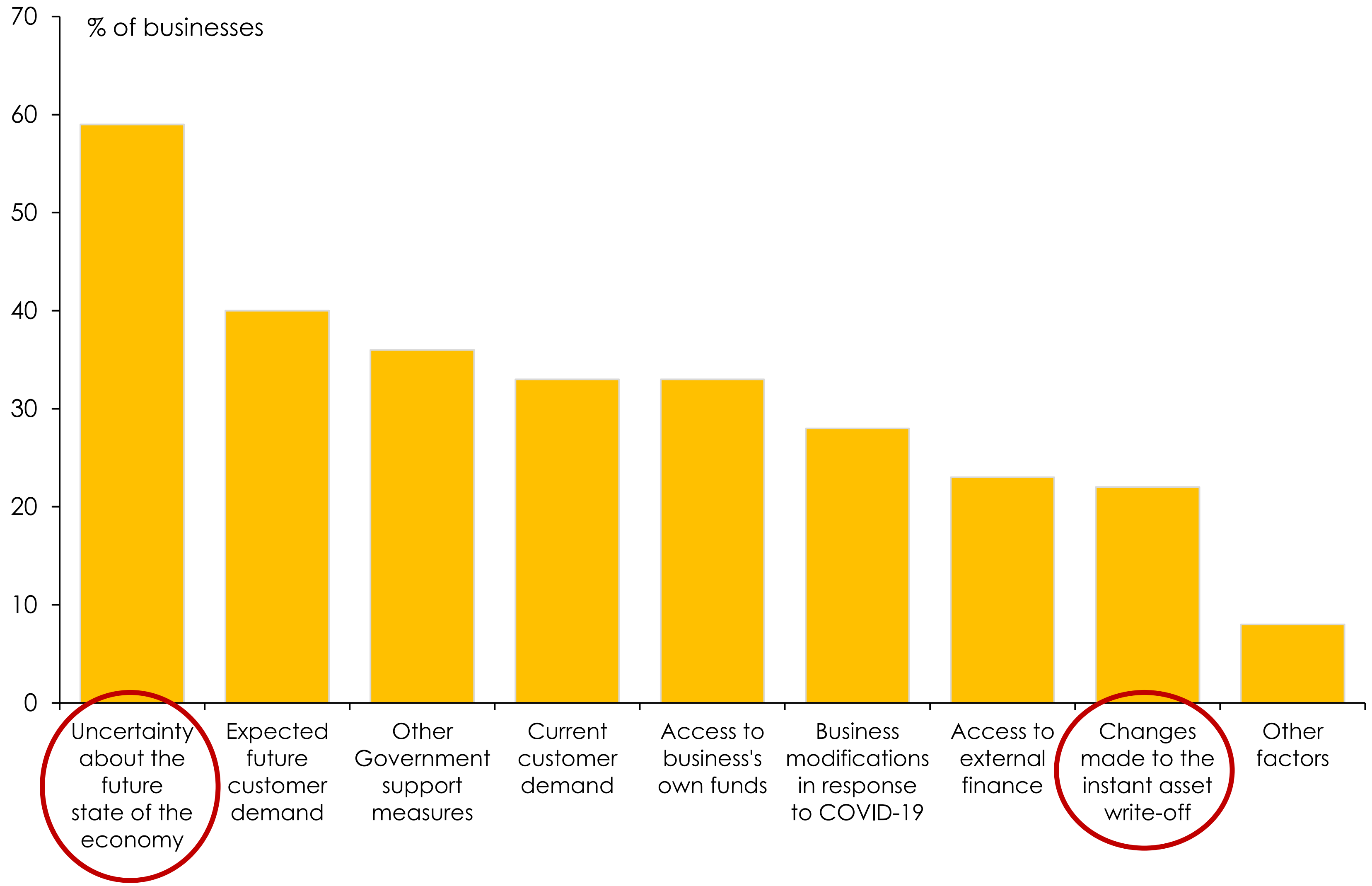
Budget announcements were mainly about incentives for business and earlier personal income tax cuts for households

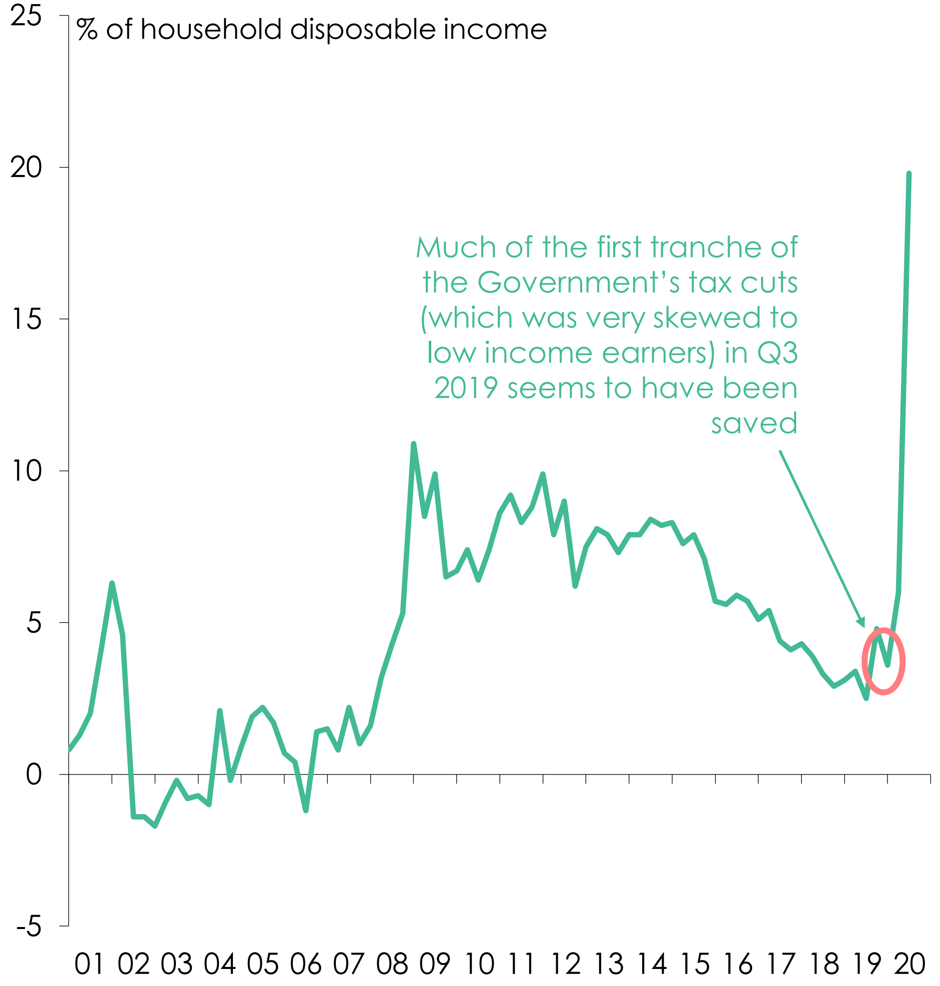
- The biggest single measure in the Budget was the 'temporary full expensing' of purchases of depreciable assets by businesses with turnover of less than $5bn, available until 30th June 2022 (at a cost to revenue of $26.7bn over four years)
  - this is in effect an extension of the 'instant asset write off' for small businesses (introduced five years ago and extended in March this year) to almost 99% of all businesses
- Companies with turnover of up to $5bn will also be able to claim refunds of tax paid in or after 2018-19 if they incur tax losses during the 2019-20, 2020-21 or 2021-22 years (at a cost to revenue of $4.9bn over four years)
- There are also two big wage subsidy programs for business to encourage hiring
  - the JobMaker Hiring Credit provides $4bn over four years for incentives (wage subsidies of up to $200 per week for 12 months) to hire people aged 16-35 who have previously been JobSeeker or Youth Allowance (Other) recipients for at least one of the three previous months – with what appear to be adequate safeguards against employers sacking older workers to replace them with subsidized younger ones
  - $1.2bn for a 50% wages subsidy up to $7000 per quarter for new apprentices and trainees until September next year
- For individuals the largest measure was the (previously flagged) bring-forward by two years of the personal income tax cuts previously legislated to take effect from 1st July 2022 (at a cost to revenue of $17.8bn)
  - the Government is obviously sensitive to suggestions that these tax cuts are skewed towards middle- and higher-income earners, because it has left the third tranche of cuts (which come into effect on 1st July 2024) unchanged, and extended the 'Lamington' (the Low & Middle Income Tax Offset') for another year
  - while this measure obviously will put a lot of "money into people's pockets", there's no guarantee they will take it out and spend it, especially given uncertainties over the end of JobKeeper, mortgage repayment holidays etc
- Most of the spending measures (including $8¾bn of additional funding to states for infrastructure, $2bn for aged care, $1½bn for the 'modern manufacturing' strategy) had been detailed or deliberately leaked before the budget

It's by no means certain that businesses and households will respond to the budget incentives in the way that the budget assumes

Factors affecting business investment decisions, August 2020



Household saving rate



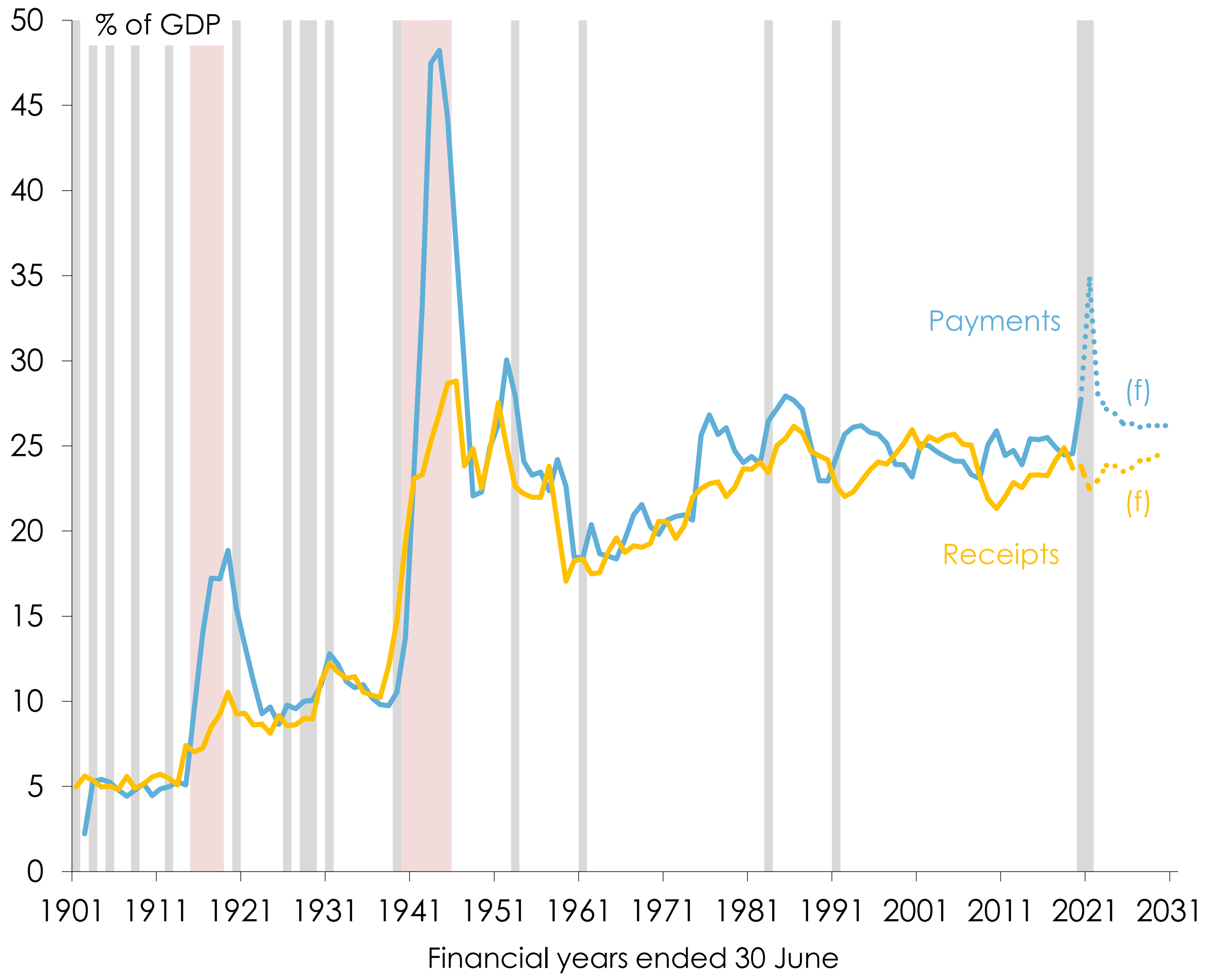
Sources: ABS, Business Impacts of Covid-19, August 2020 (based on survey conducted between 12th and 19th August; Australian National Accounts: National Income, Expenditure and Product, June quarter 2020.

What wasn't in the Budget?

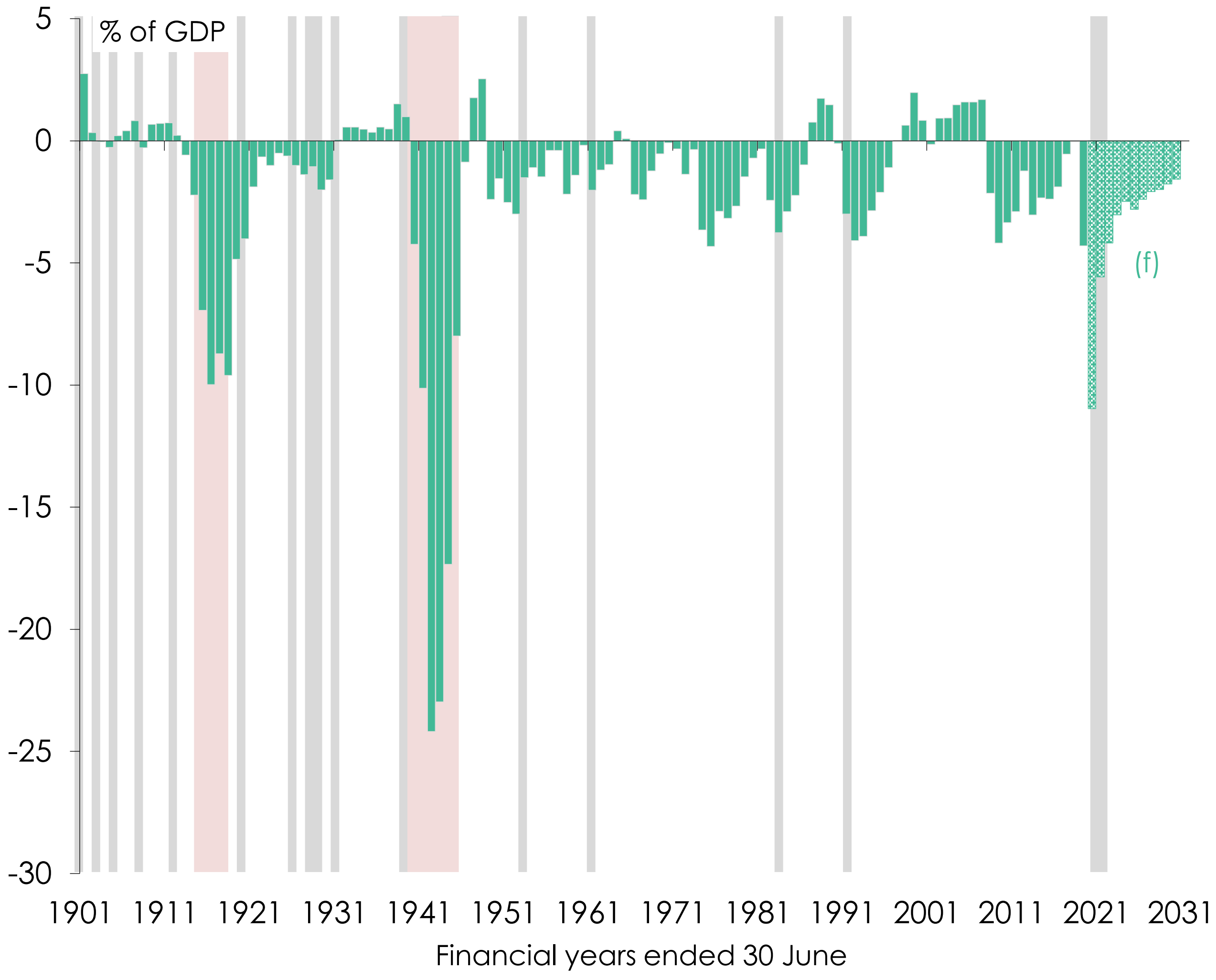
- No suggestion of any extension to JobKeeper beyond the currently scheduled expiry date of 31st March 2021
  - however that doesn't preclude the possibility of the Government extending the scheme again in the event of (for example) another Victorian-style outbreak, or if unemployment were to be much higher in the early part of next year than the budget assumes
- There was no mention of any adjustments to the rate of JobSeeker payment
  - as things stand, this payment will revert to the old Newstart level of $40 per day on 31st December
  - the Government has previously said that "ongoing arrangements in relation to JobSeeker payments will be announced later this year", after it has "had the opportunity to further assess … how many people and to what extent people are able to get back into work"
- There was nothing new in the budget for child care
  - beyond funding for the previously-announced extension of the now-terminated national subsidy scheme for Victoria until 31st January next year
- There was no additional funding in the budget for social housing
  - beyond the previously-announced decision to allow the National Housing Finance and Investment Corporation (NHFIC) to issue an additional $1bn of bonds to attract institutional investment into new affordable housing supply (which has no impact on the budget)
  - despite almost unanimous opinion from economists and others that additional spending on affordable housing would be a highly effective form of fiscal stimulus (as well as an appropriate response to a pressing need)
- Other than the (previously announced) proposed changes to insolvency and credit laws, there was very little by way of policy or funding for productivity-enhancing structural reforms
  - the Treasurer's Budget Speech made much of proposed changes to superannuation, but these seem to be directed more at assuaging the Government's backbench critics of industry super funds than making major changes

The deficit is forecast to widen to $214bn (11% of GDP), the biggest since 1944-45, and still to be around $50bn pa in the second half of the 2020s

Australian Government receipts and payments



Australian Government budget deficit or surplus



Note: Payments and the budget surplus or deficit are 'underlying' (that is, exclude 'net investments in financial assets for policy purposes') after 1989-90, when state governments became responsible for issuing their own debt, and 'headline' before that. Areas shaded in grey are fiscal years in which real GDP contracted; areas shaded in pink are World Wars I and II. (f) denotes forecasts or projections.

Sources: Global Financial Data; Australian Government, 2020-21 Budget Paper No. 1, Statement No. 3.

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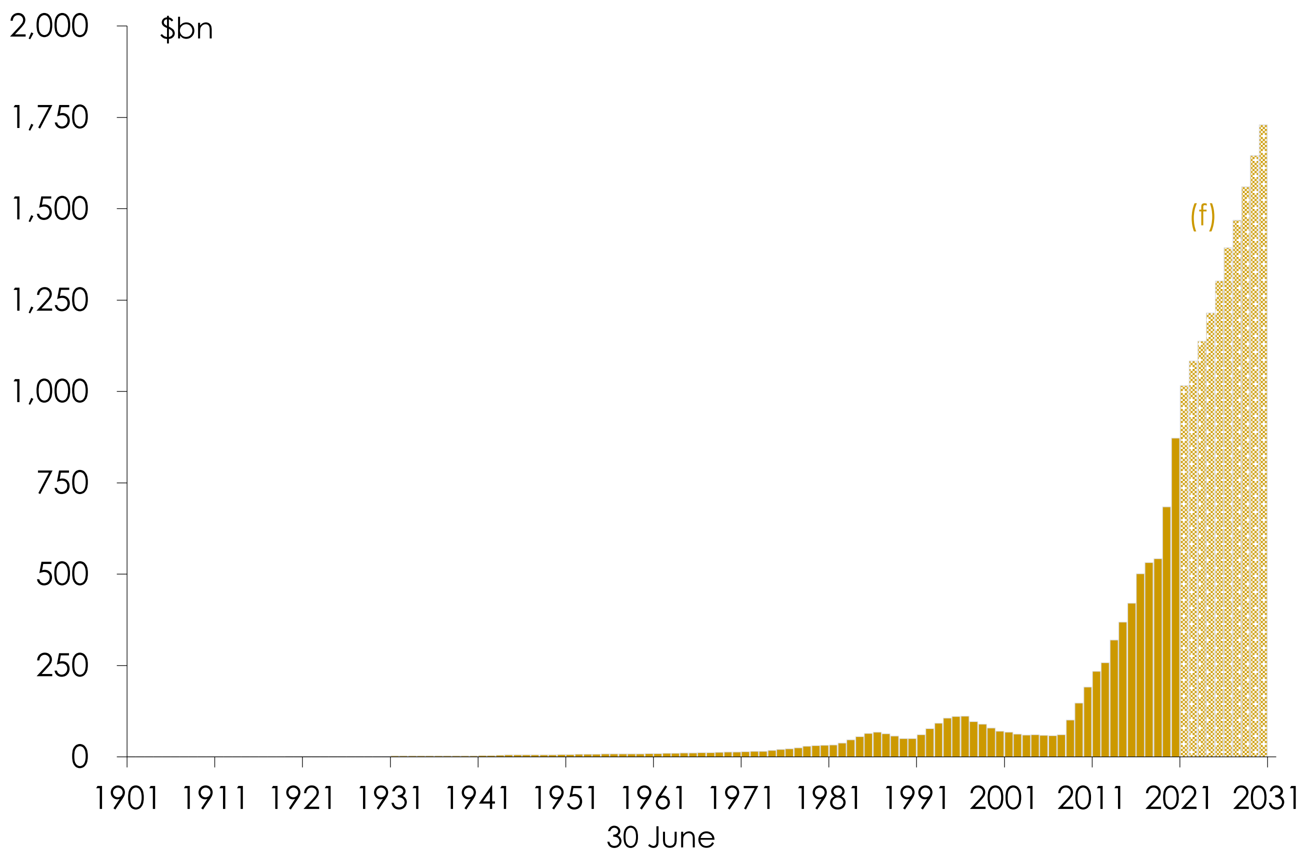
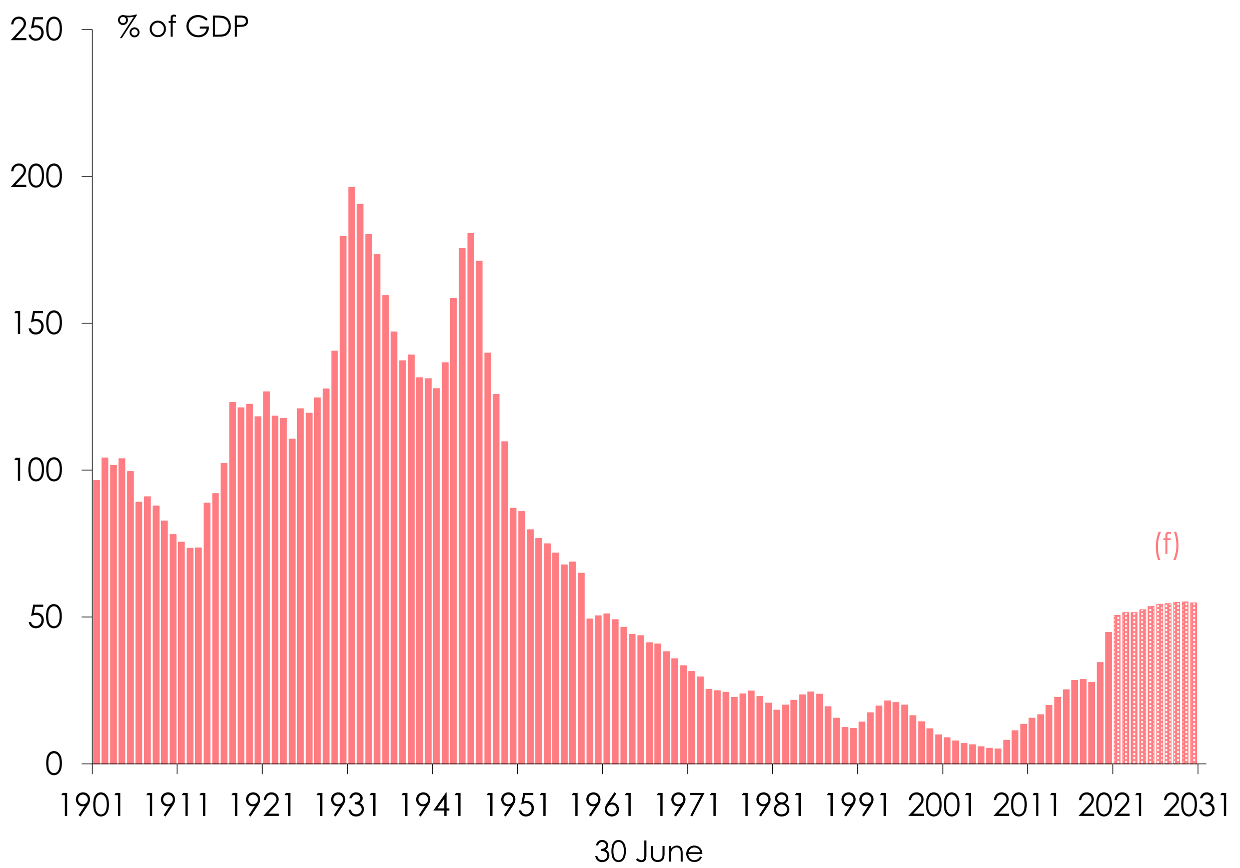
However there's no need for undue alarm at the level of debt which will be incurred by the Australian Government

Australian Government gross public debt in $



Australian Government gross debt as a pc of GDP



- **The Government's gross debt will top $1 trillion during the 2021-22 financial year, and reach almost $1¾ trillion by the end of the decade**
- **However as a percentage of GDP, the Government's gross debt will still be less than it was in any of the first sixty years of Australia's existence as an independent nation**

Note: (f) denotes forecasts. *Sources:* Global Financial Data; Australian Government, 2020-21 *Budget Paper No. 1, Statement No. 3*.

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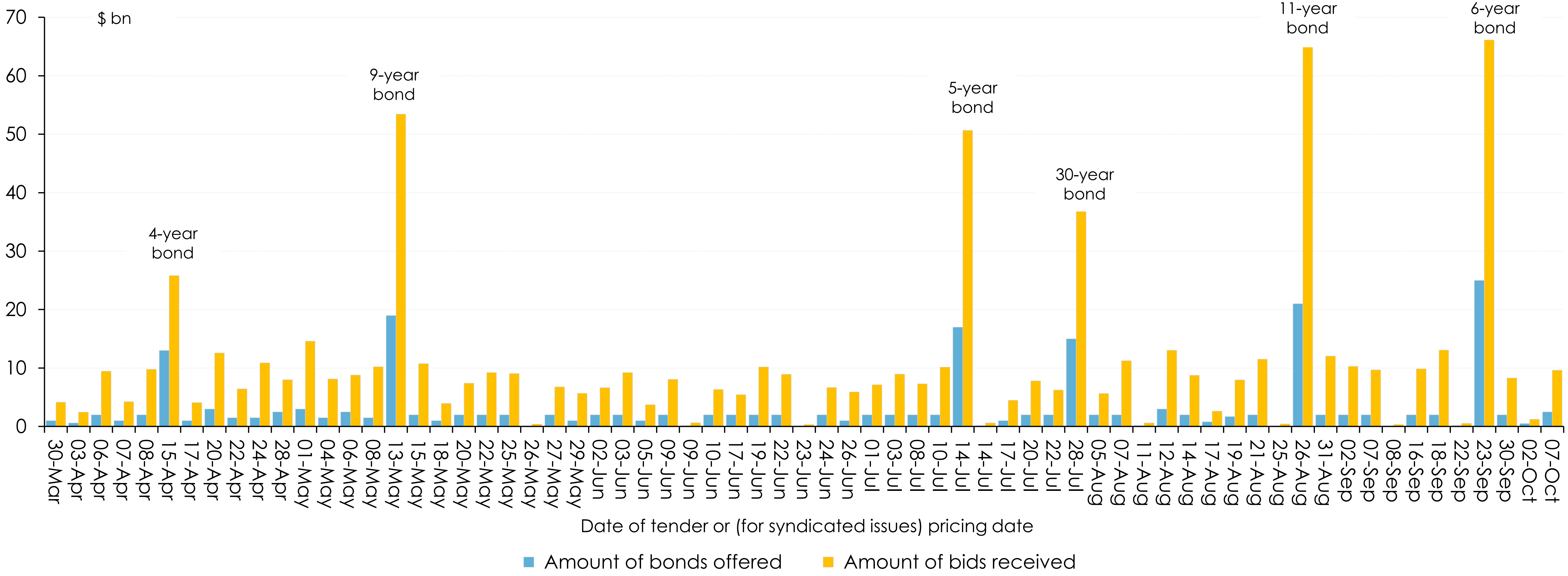
The Australian Government continues to have absolutely no difficulty financing its significantly higher deficits

Australian government bond issuance since March 2020



- Since 30th March, the Australian Office of Financial Management (which conducts the Government's borrowing programs) has issued $207.1bn of Treasury bonds - based on the volume of bids received it could have borrowed $728bn with yields at most 4 basis points (0.04 of a pc point) above the highest yields actually accepted

Source: Australian Office of Financial Management data hub; Corinna.

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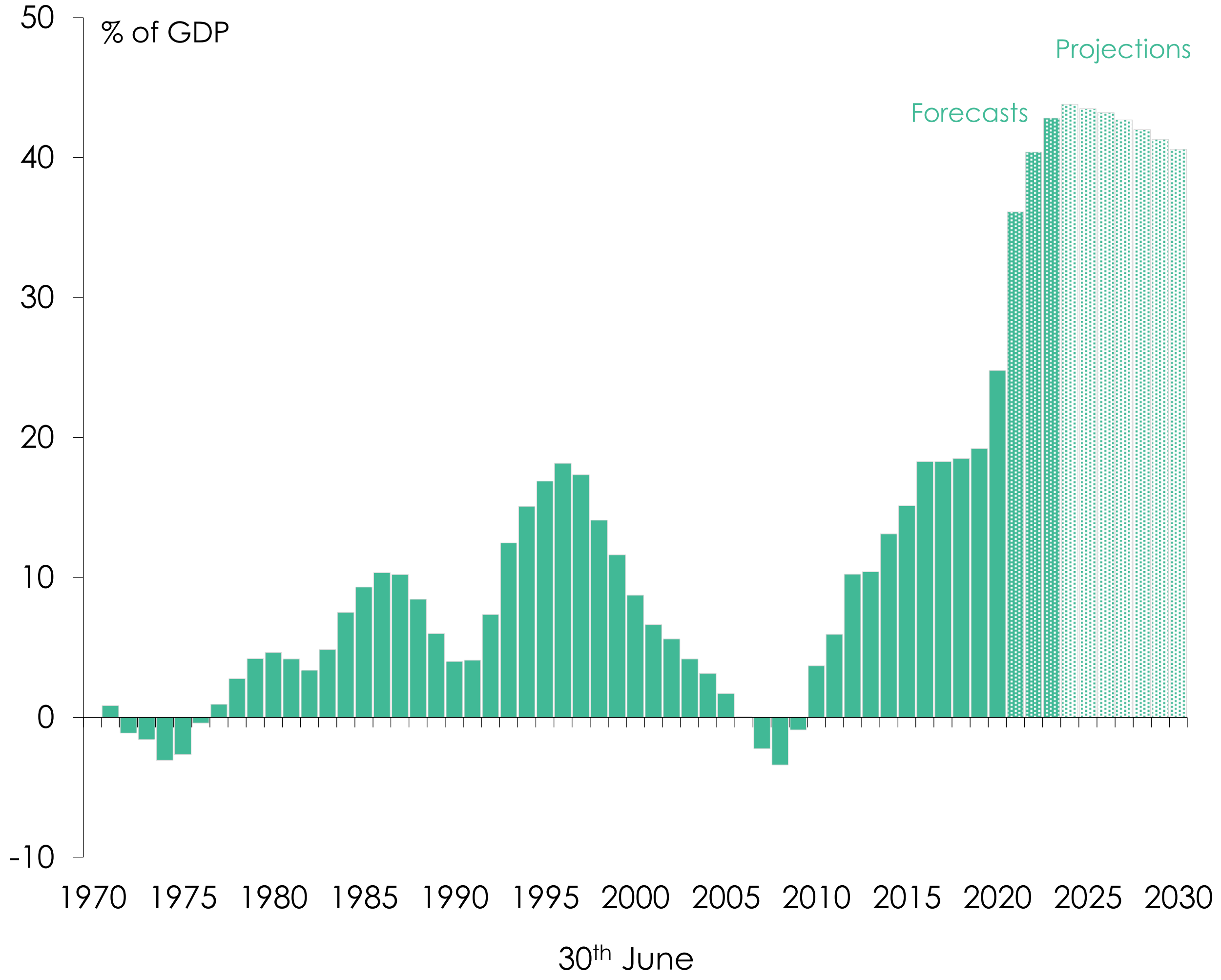
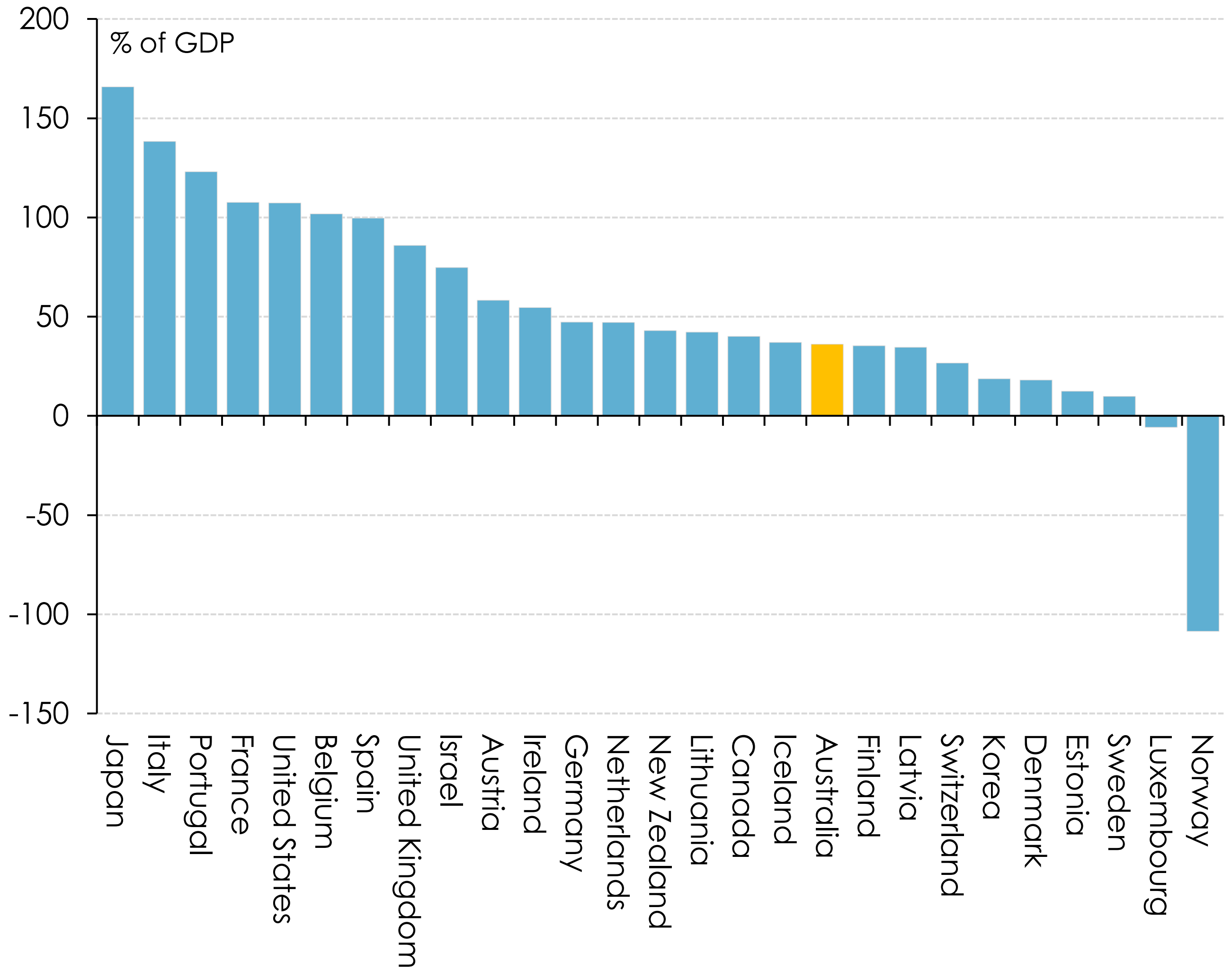
Although Australia's government net debt will reach new record highs, it will still be relatively low by comparison with most 'advanced' economies

Australian Government net debt as a percentage of GDP



Net debt of Australian and other 'advanced' economy governments as a pc of GDP, 2021



Sources: Australian Government, 2020-21 *Budget Paper No. 1, Statement No. 11*; New Zealand Treasury, *Pre-Election Economic and Fiscal Update*, 16th September 2020; IMF, *Fiscal Monitor*, April 2020.

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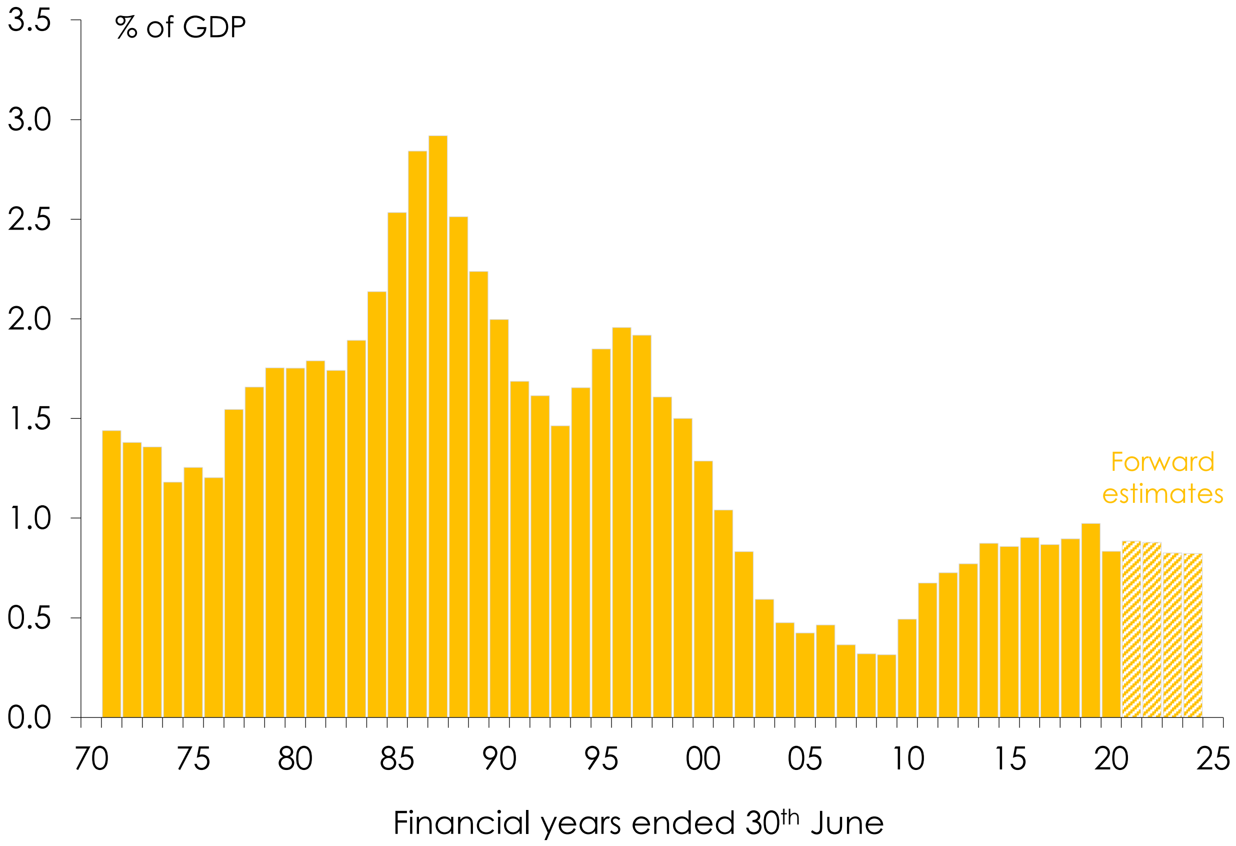
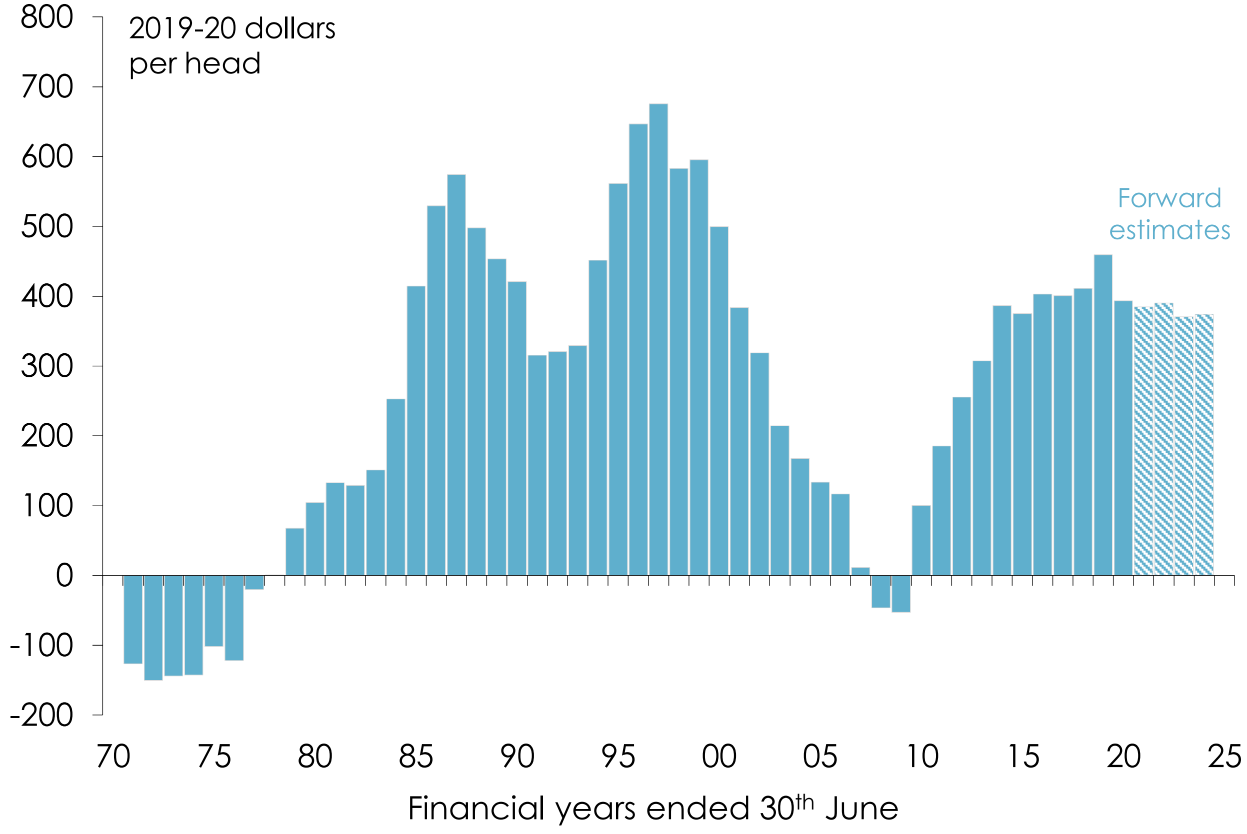
Because interest rates are so low, the cost of servicing the debt which the Government is racking up will be low by historical standards

Australian Government interest payments as a percentage of GDP



- **As a percentage of GDP, the Government's gross interest payments will be less than they were in the 1970s, 1980s and 1990s, and less than they were in 2017-18 or 2018-19**

Australian Government net interest payments per head of population in 2019-20 dollars



- **Net interest payments per head of population will be less than they were in the second half of the 1980s, between 1993-94 and 1999-2000, or between 2015-16 and 2019-20**

Note: (f) denotes forecasts. *Sources:* Global Financial Data; Australian Government, 2020-21 *Budget Paper No. 1, Statement No. 11*; Corinna.

An overall assessment

An ‘appropriate’ budget for the circumstances – although it is heavily reliant on individuals and businesses responding positively

- **It’s highly appropriate that the Government has chosen to run a post-war budget deficit (in the worst recession since the Great Depression) and, as a result, accumulate the highest level of debt (as a percentage of national income) in more than 60 years**
  - not to have done so would almost certainly have resulted in a deeper and longer recession, and a slower and more vulnerable recovery
  - the government is having no difficulty funding its record deficit (it doesn’t need the RBA to buy bonds directly from it), and it will have no difficulty servicing the resulting debt
- **The Government’s economic recovery strategy is heavily reliant on households spending their tax cuts, and businesses responding positively to incentives to invest and hire**
  - both theory and (recent) evidence suggests that a significant proportion of the tax cuts may be saved – providing the same amount of money to households in the form of time-limited, tradeable vouchers would have been much more effective
  - the investment incentives will probably work if businesses become confident that there will be sufficient demand for their products to make the investment worthwhile – although note that almost all capital goods are imported nowadays
  - the hiring subsidies for apprentices and young adults are appropriate, well-targeted and appear to have adequate safeguards against ‘substituting’ for older employees
- **By contrast the Government has largely eschewed additional direct spending**
  - the additional infrastructure spending in the budget is quite small
  - the Government has rejected advice from almost all quarters to increase spending on social housing as a form of stimulus
- **The economic forecasts and assumptions may be a little optimistic in places but aren’t unreasonable**
  - although as the budget papers note, if there are more outbreaks of the virus which *can’t* be contained, or if a population-wide vaccine program isn’t “fully in place” by late 2021, economic growth would be materially weaker
  - growth will be weaker if households and businesses *don’t* respond as expected to the budget measures

What could go wrong?

- Another 'wave' of infections (à la Victoria) would seriously undermine the forecast economic recovery, and require additional fiscal responses
- Similarly, if a vaccine *isn't* widely available by late next year, or if it isn't effective, or if a large proportion of the population refuse to take it, then the economic recovery would be delayed, set back or both
- The budget strategy is heavily dependent on households and businesses responding positively to the incentives in the budget
  - there's obviously a non-trivial possibility (supported by recent experience) that households will save (or pay down debt with) the money they get from the bring-forward of income tax cuts, rather than spend it
  - and although recent history is kinder to the assumption that business will respond positively to the investment incentives, the 'incentive effect' will be up against deeper and more pervasive uncertainty about the economic outlook than has been the case when these measures have been successfully applied before
- There may still be some risks associated with the termination of JobKeeper and the scheduled drop in JobSeeker payments
  - it will be important to monitor the impact of the 'step-down' in JobKeeper payments which took effect at the end of last month (which will show up in the ABS' weekly payroll jobs series released in early November) to gauge whether there might be a larger risk when JobKeeper ends on 31st March 2021 as currently scheduled
- There may also be some medium-term risk of the Government reverting to its former 'deficit and debt reduction' strategy prematurely
  - the Treasurer has said that 'Phase 2' of its new strategy (budget repair) won't begin until the unemployment rate is 'comfortably under 6%', which on the Government's *projections* won't be until 2023-24
  - the Treasurer hasn't defined what he means by 'comfortably' under 6% - but one could still ask, why 6% - when the 'NAIRU' (non-accelerating inflation rate of unemployment) has traditionally been put at 5%, the RBA had revised its estimate down to 4½%, and the US Fed seems to think that it may be even lower there (for reasons which could also apply in Australia)

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