THE 2021-22 AUSTRALIAN GOVERNMENT BUDGET: AN (IMMEDIATE) ASSESSMENT

12TH MAY 2021

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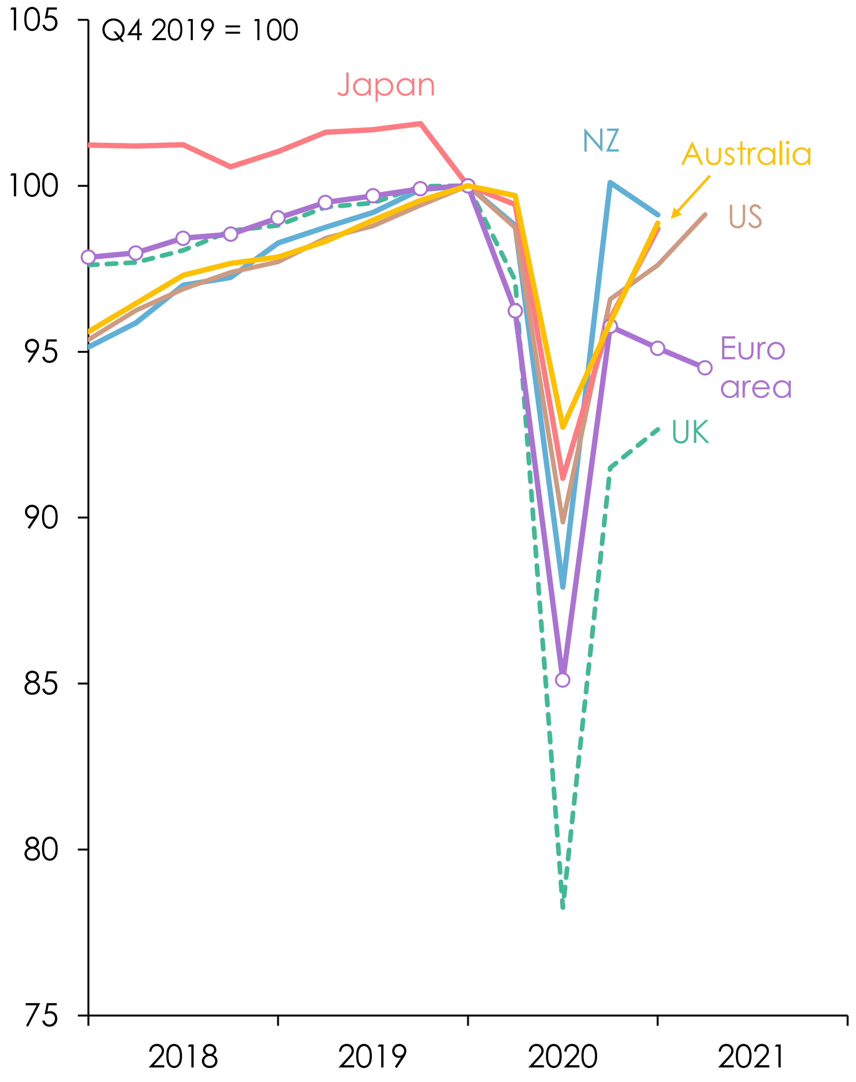
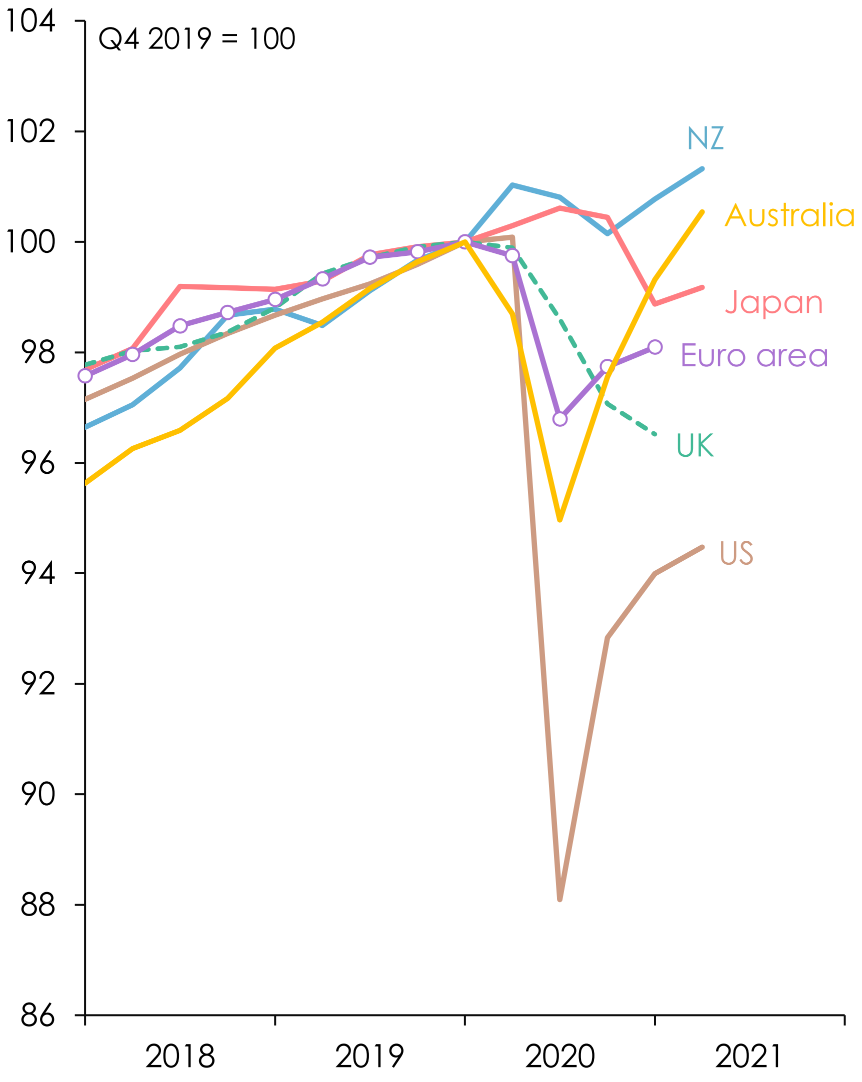
CORINNA ECONOMIC ADVISORY PTY LTD

Australia's recession hasn't been as severe as those experienced in most other comparable countries …

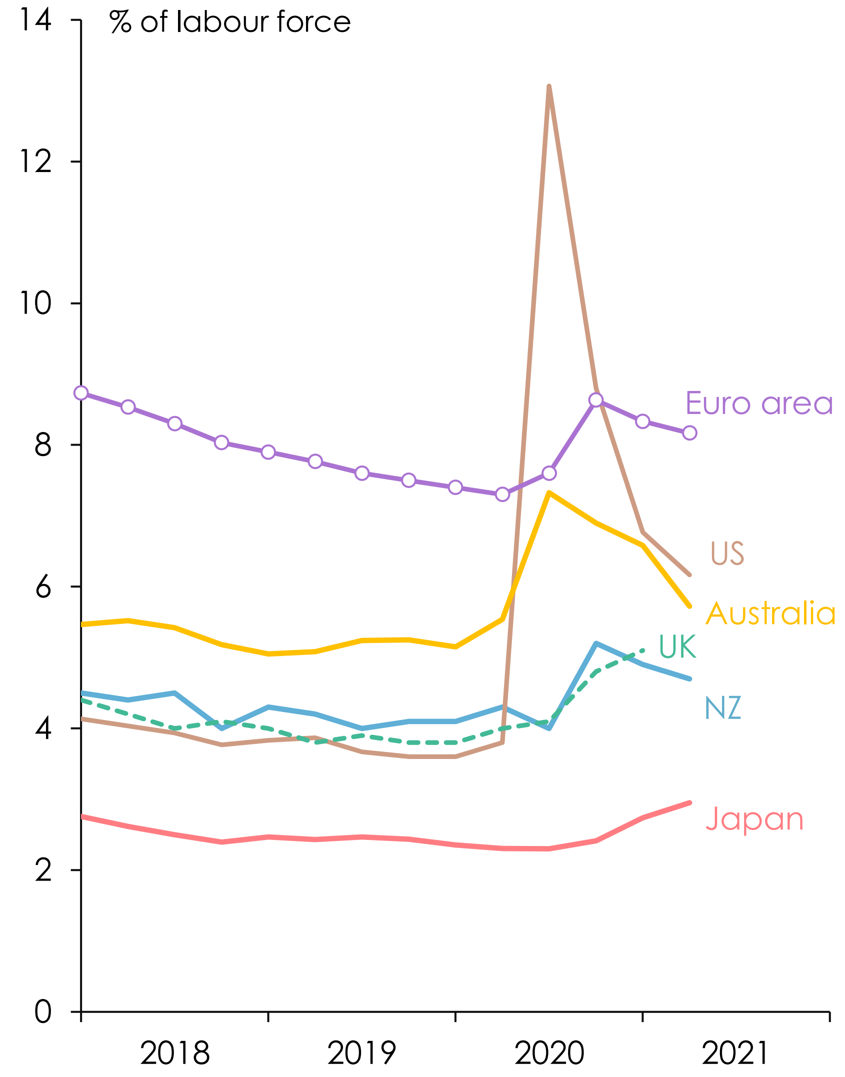
Level of real GDP



Employment



Unemployment



Sources: ABS; Statistics NZ; US Bureau of Economic Analysis; US Bureau of Labor Statistics; Japan Economic & Social Research Institute; Statistics Bureau of Japan; Eurostat; UK Office for National Statistics; Corinna.

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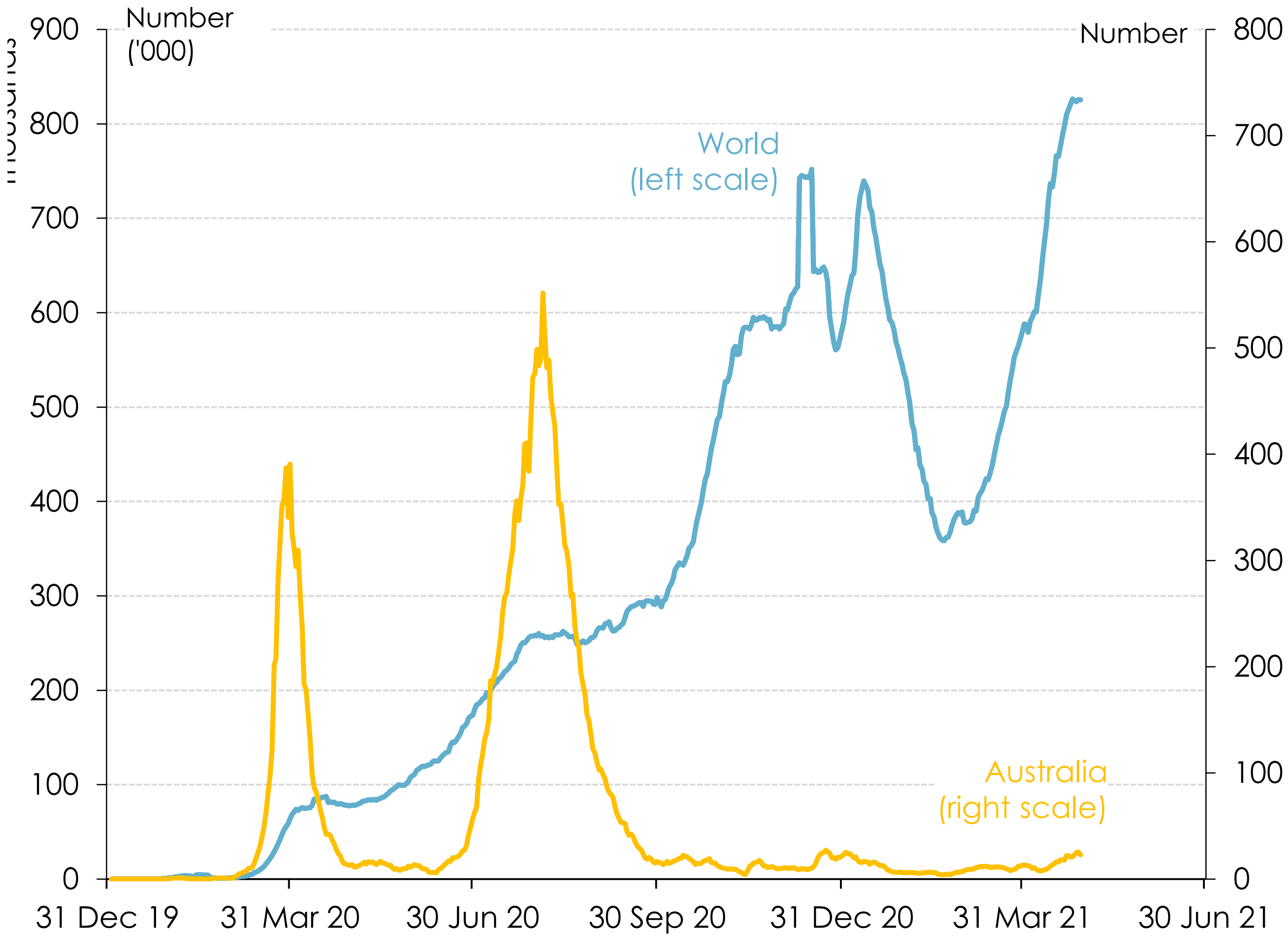
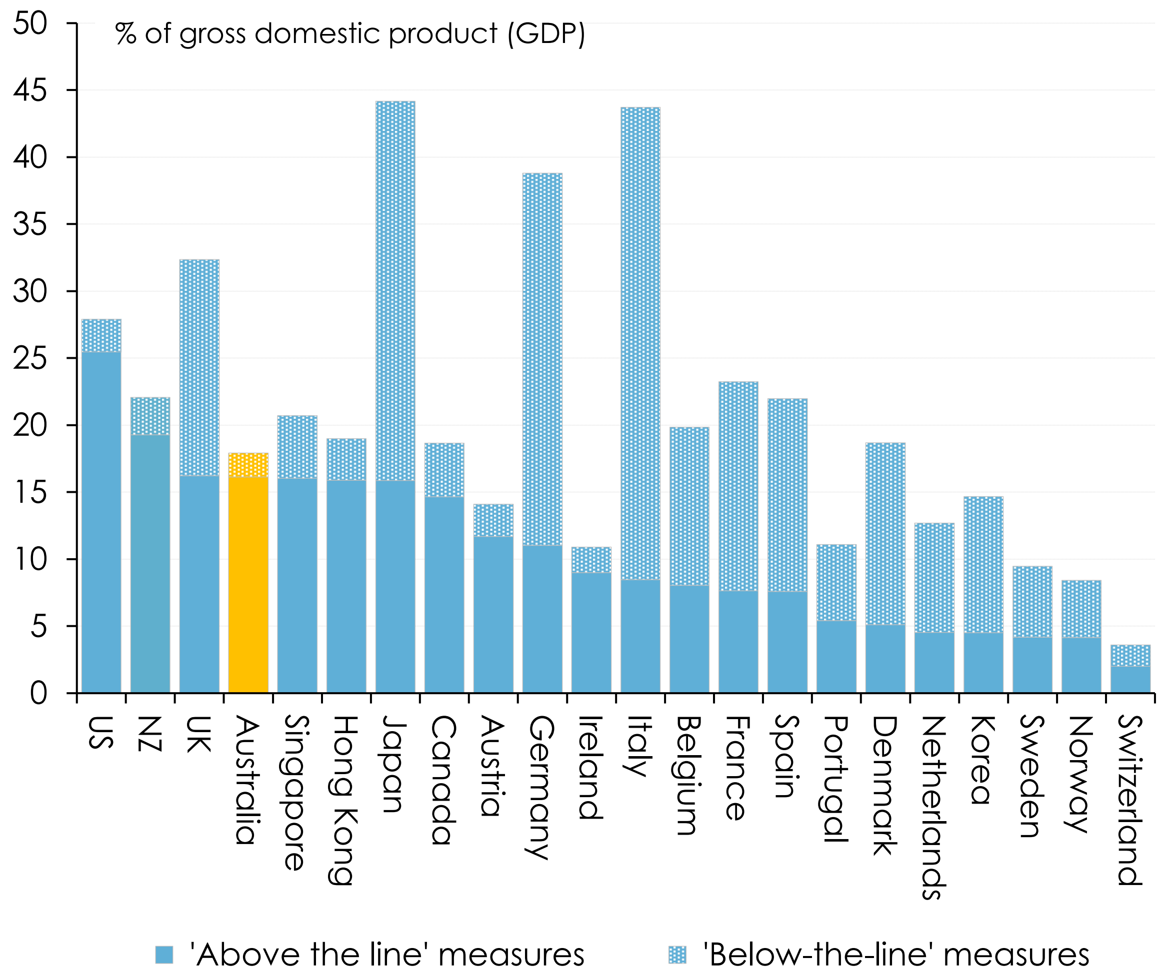
… that's because we've done a better job than most others of managing the virus – and because governments have provided more fiscal support

New covid-19 infections, Australia compared with the world



Fiscal policy responses to Covid-19 – selected 'advanced economies



Note: 'Above the line' measures comprise additional or accelerated spending and deferred or foregone revenue. 'Below the line' measures comprise equity injections, loans, asset purchases and debt assumptions, but do not include loan guarantees or other contingent liabilities. 'DMs' means 'developed markets' (or 'advanced economies'). Data includes measures announced up until 17th March 2021. *Sources:* University of Oxford, *Our World in Data*; IMF, *Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic*, April 2021.

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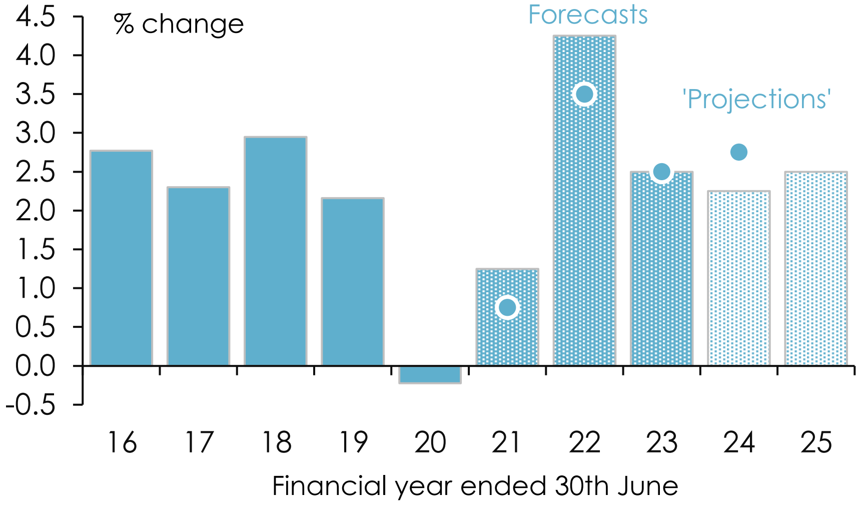
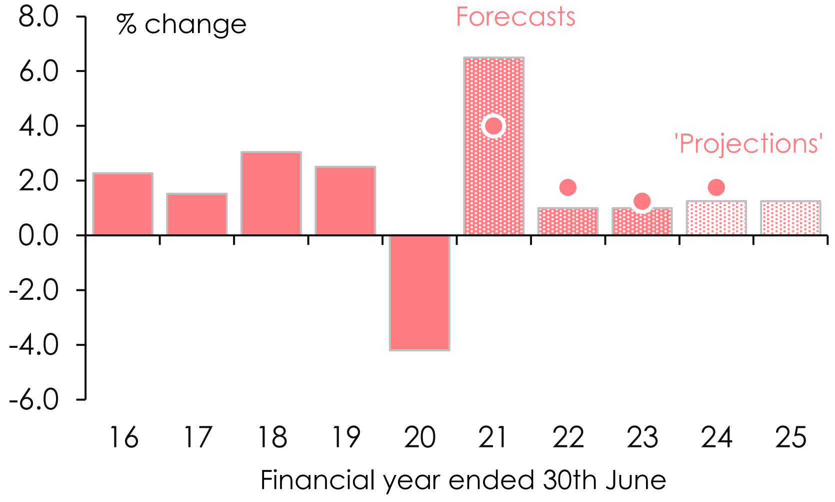
The economy looks much stronger in 2020-21 and 2021-22 than it did in December, but forecasts for wage & price inflation are only slightly higher

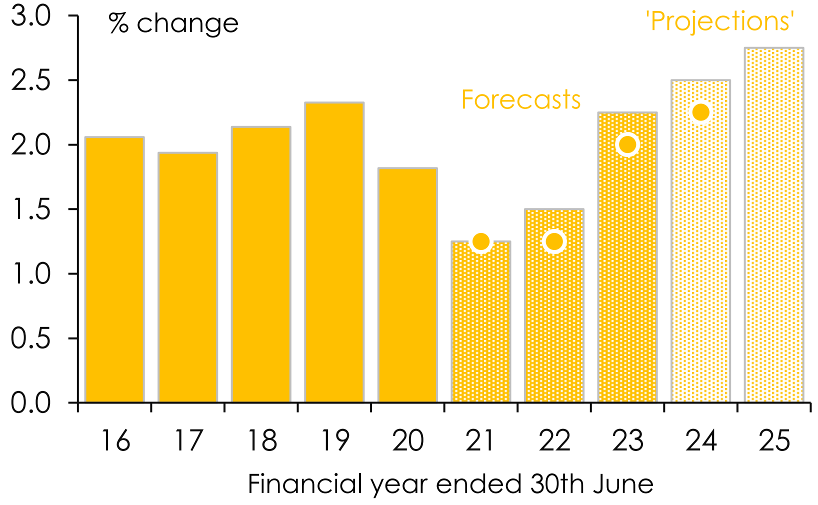
Real GDP



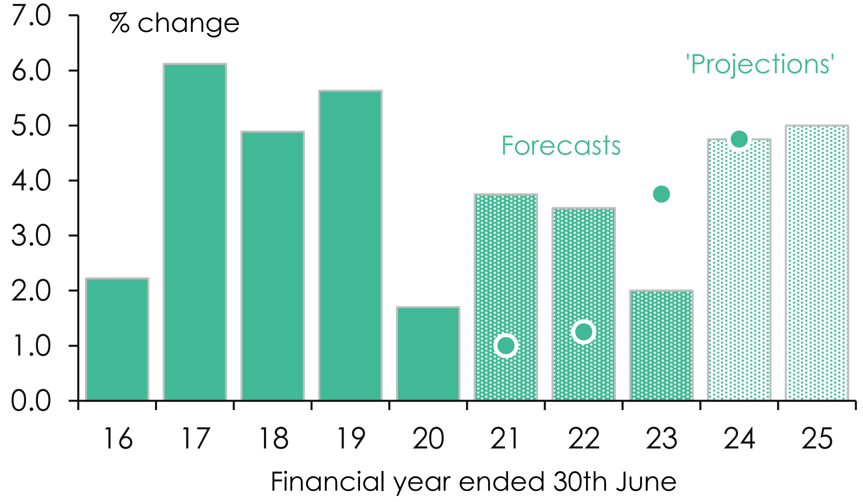
Employment



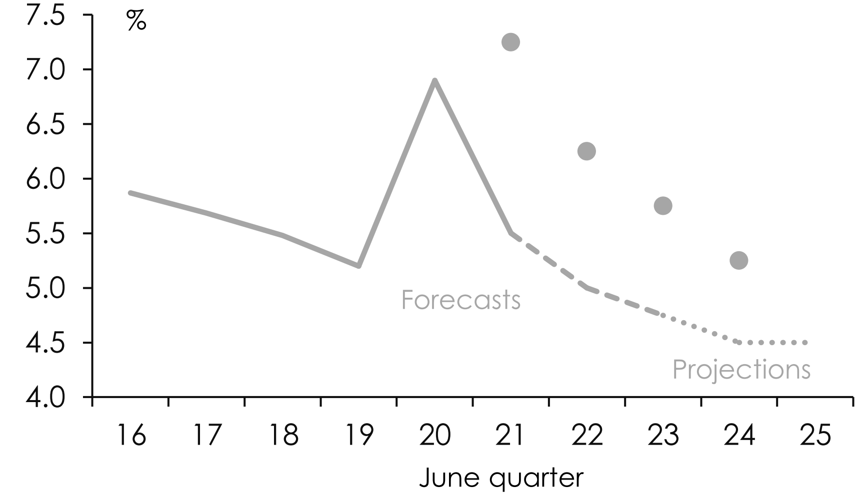
Wage price index



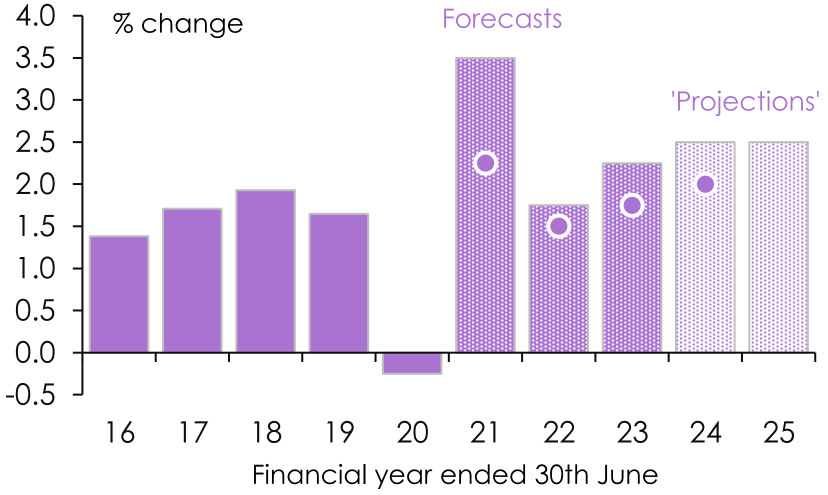
Nominal GDP



Unemployment rate



Consumer price index



Note: Dots represent the forecasts and projections from the 2020-21 Mid-Year Economic & Fiscal Outlook (MYEFO) published in December last year. 'Forecasts' are Treasury's 'best endeavours' estimates for the current and following two financial years. 'Projections' for 2023-24 and 2024-25 are *not* forecasts, but rather are based on assumptions about the path by which output converges on its 'potential' level. Sources: ABS; 2020-21 MYEFO and 2021-22 *Budget Paper No. 1, Statement No. 2*.

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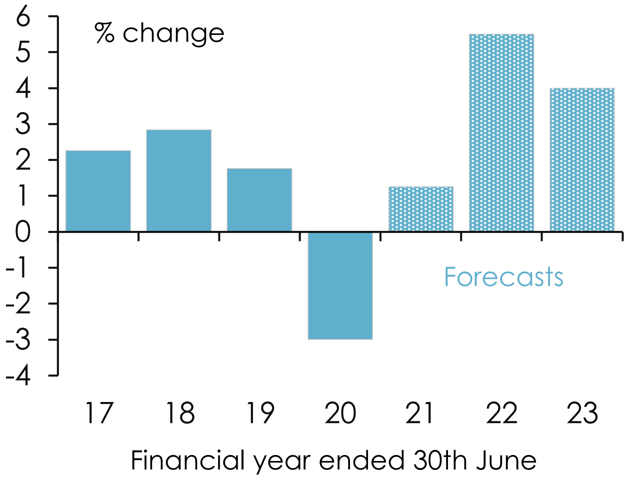
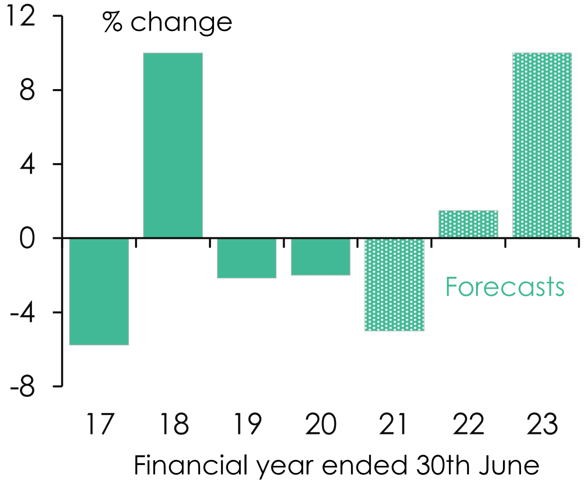
Economic recovery expected to be driven by household spending with business investment picking up in 2022-23 as public spending slows

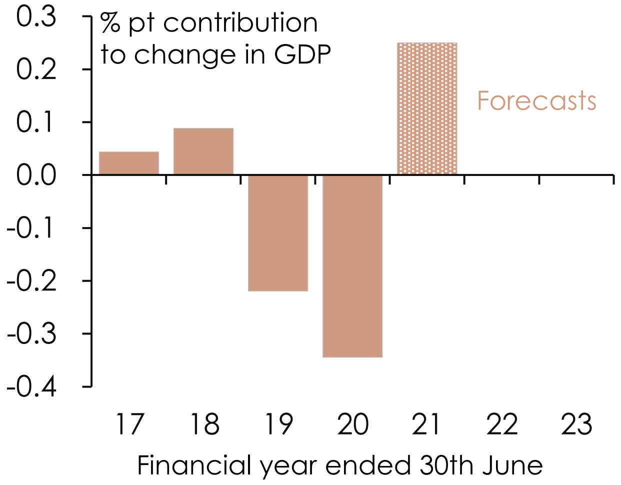
Household consumption



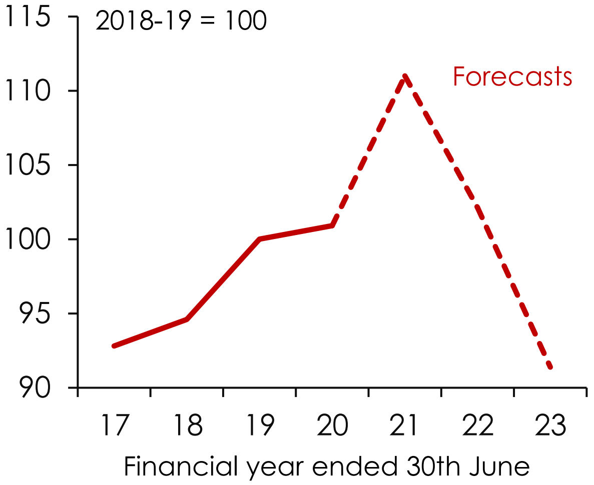
Business investment



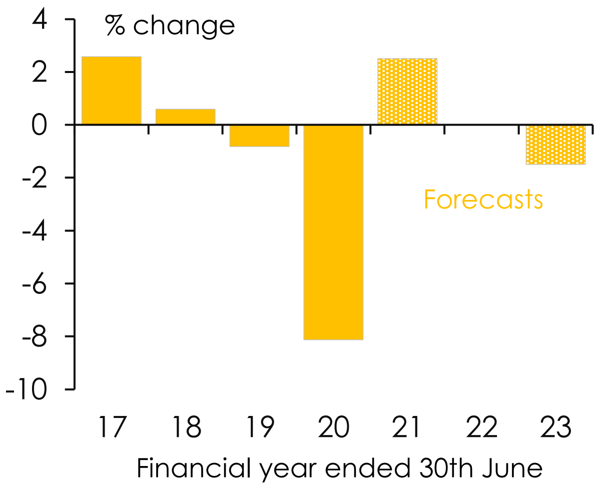
Change in inventories



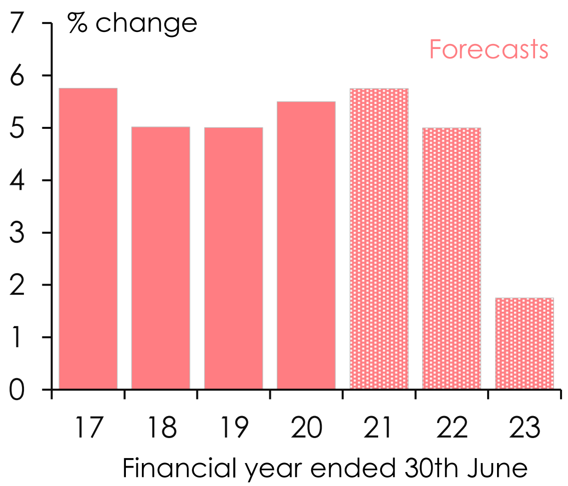
Terms of trade



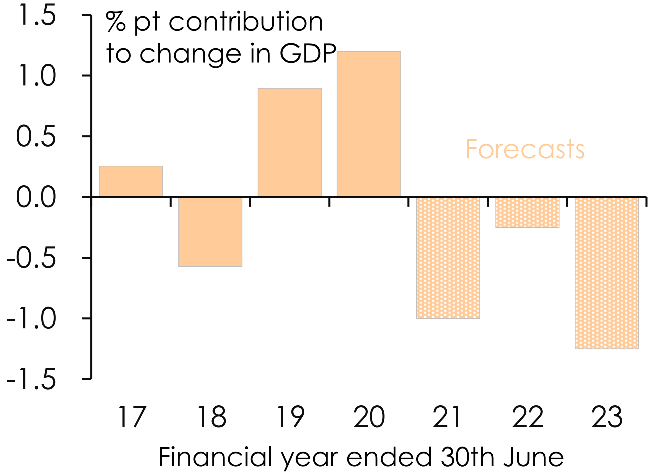
Dwelling investment



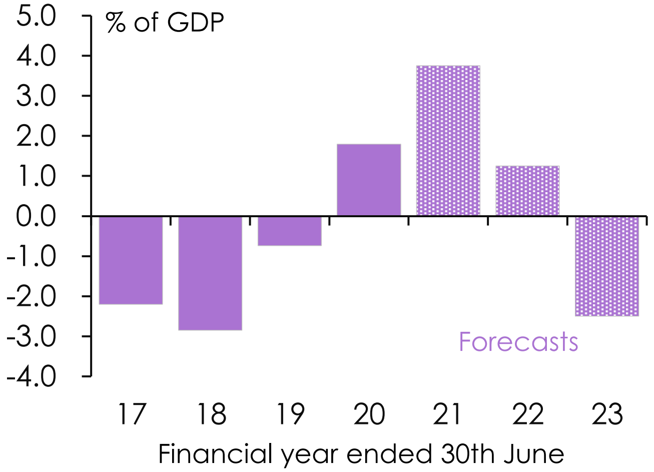
Public spending



Net exports



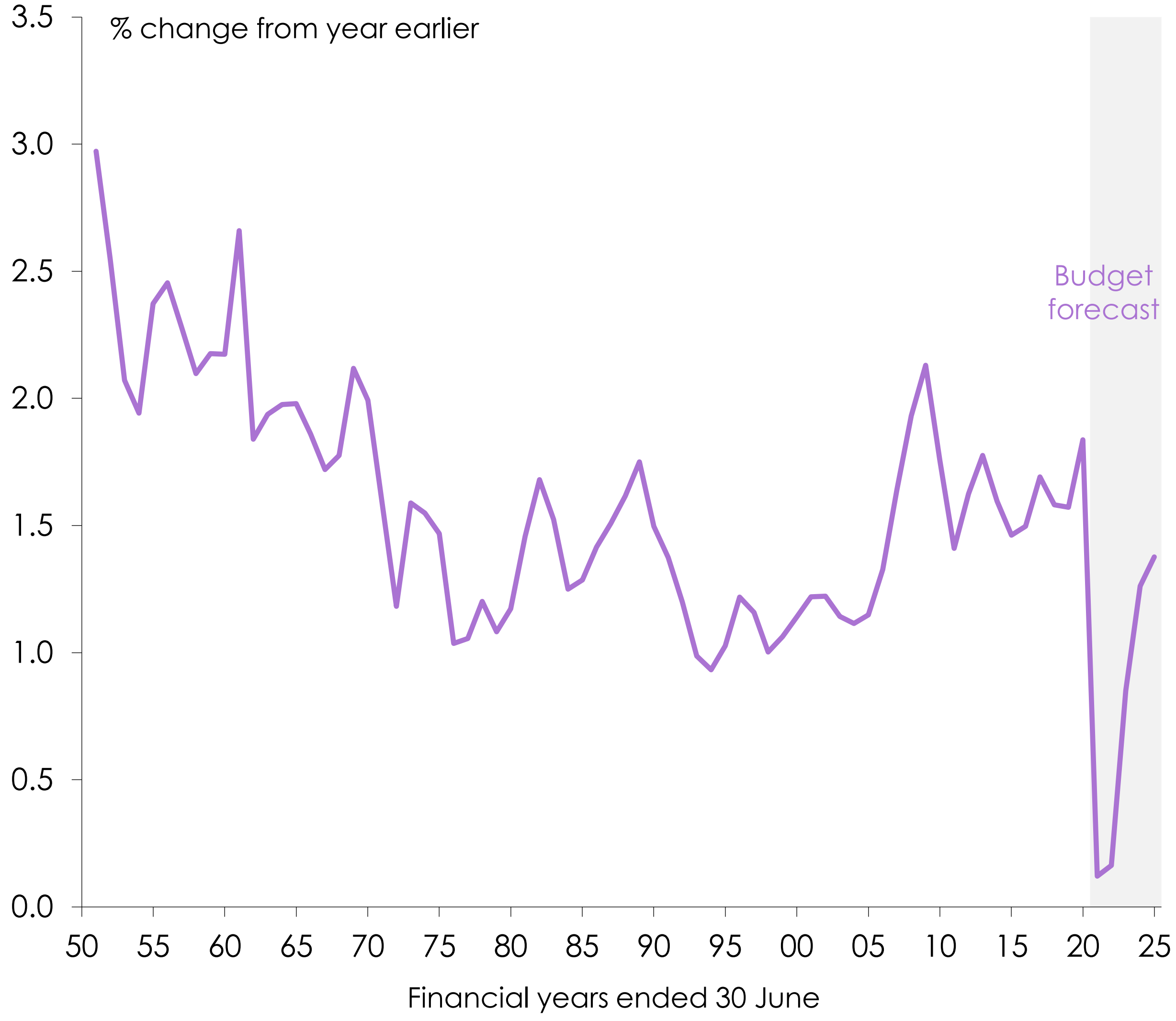
Current account balance



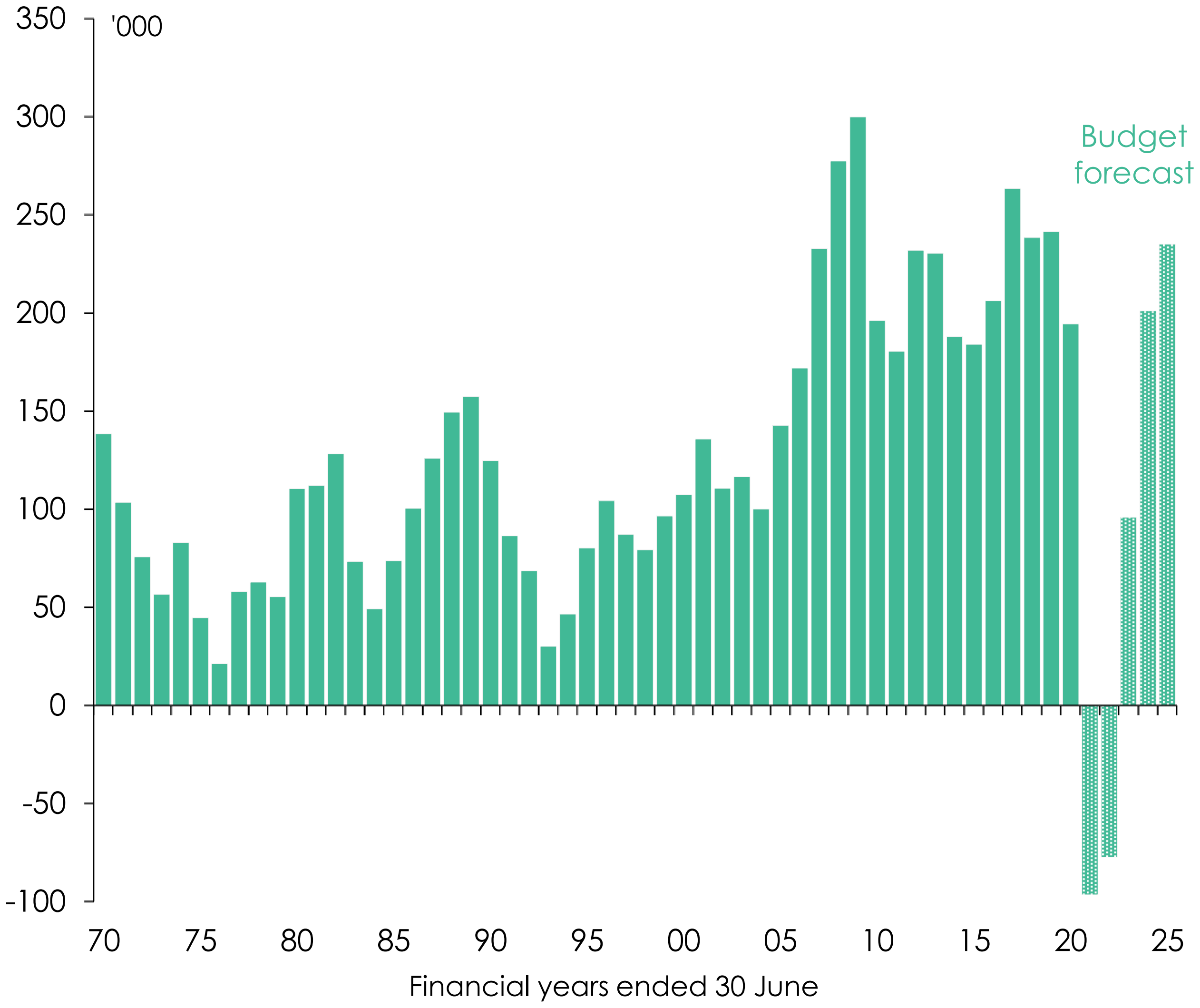
Note: Business investment and public spending exclude transactions in second-hand assets. Employment growth is June quarter on June quarter; unemployment rate is June quarter; all other figures are for financial years. Net overseas migration assumed to be -97K in 2020-21 and -77K in 2021-22 before turning positive in 2022-23 and rising to 235K by 2024-25; iron ore price falling to US$55/t FoB by Q1 2022; metallurgical and thermal coal prices remaining at US$1112/t and $93/t respectively; oil prices at US$65/bbl; and the A$ remaining at around US77¢. *Sources*: ABS; Australian Government, 2021-22 Budget Paper No. 1, Statement No. 2.

An important assumption underlying the Budget forecasts is that net immigration resumes in 2022-23 and returns to previous levels by 2024-25

Population growth



Net overseas migration



Sources: ABS, *National, state and territory population*; Australian Government, 2021-22 *Budget Paper No. 1, Statement No. 2* and *Budget Paper No. 3, Appendix A*.

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The economy could do better than the Government has forecast – at least with regard to economic growth, if not on inflation

- **Treasury's forecasts for real GDP growth of 4¼% for 2021-22 and 2½% for 2022-23 are appreciably below the Reserve Bank's (published last Friday) of 5% and 3¼%, respectively**
- **Likewise, Treasury has been more cautious with regard to the unemployment rate, which it has falling to 5% by June 2022, 4¾% by June 2023 and 4½% by June 2024, whereas the RBA's forecast has the unemployment rate at 5% by December this year, at 4¾% by June next year (a year earlier than Treasury), and 4½% by December 2022 (18 months earlier than Treasury)**
- **Despite those difference, however, the Government is slightly more bullish on inflation than the Reserve Bank, expecting the annual 'headline' inflation rate to be at 2¼% by the June quarter of 2023, cf. the RBA's forecast of 2%**
  - Treasury appears to have wages growth starting to pick up slightly earlier than the RBA, even though it is forecasting unemployment to decline more slowly
- **Treasury's forecast of strong growth in consumer spending over the next two years seems soundly-based given the elevated level of household saving, the assumption that outbound travel will remain prohibited until mid-2022 (in effect diverting the $55bn or so that Australians would otherwise spend on overseas travel each year towards domestic spending), and the tax cut for low- and middle-income earners included in this Budget**
  - although there may be some downside risk to the forecast of 12½% growth in non-mining business investment in 2022-23, notwithstanding the currently elevated level of business confidence and the extension of tax incentives for investment in this Budget
- **Treasury has again made very conservative forecasts of iron ore prices**
  - the iron ore price is assumed to fall from the current level of over US$200/t to $55/t by the March quarter of next year
  - if the iron ore price remained 'elevated' (whatever that means) until March next year before falling immediately to $55, the Government would collect an additional $5½bn in tax revenues in 2021-22 and $7bn in 2022-23

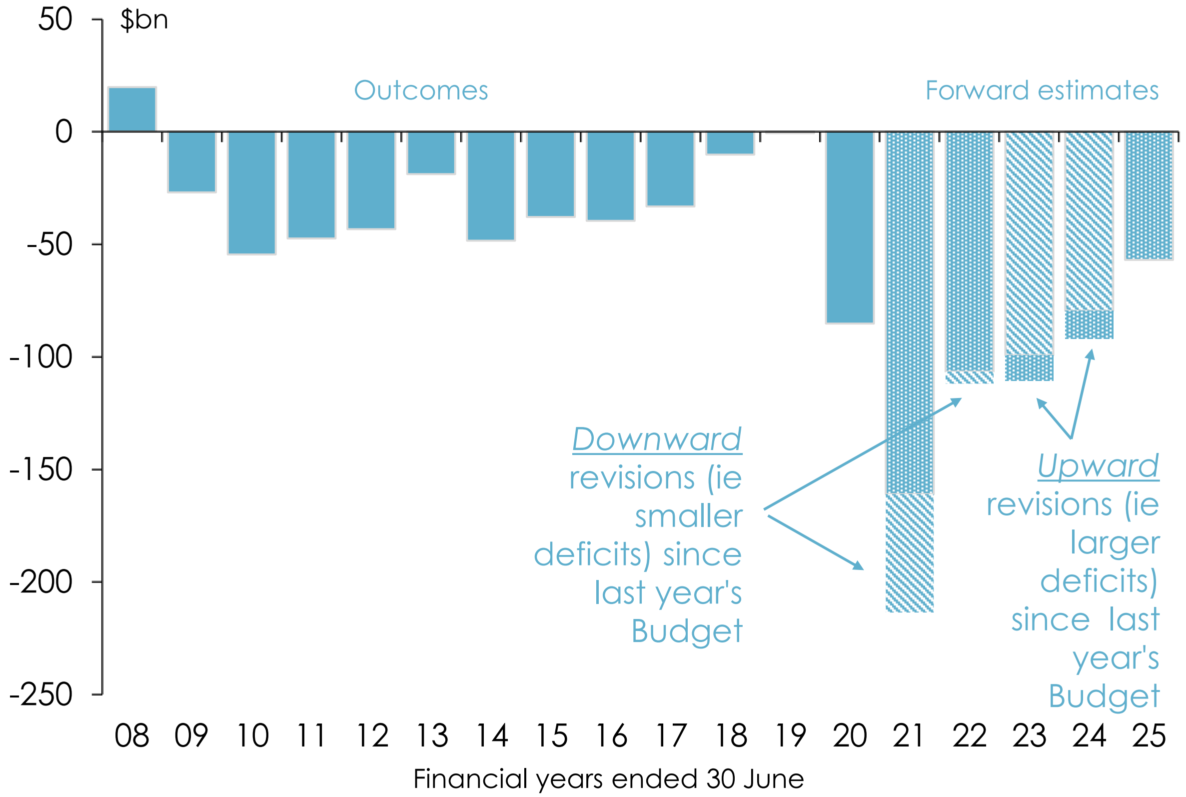
The 2021-22 Budget is unashamedly about 'securing economic recovery' and getting unemployment down – 'budget repair' can wait

- 12 days out from last year's (delayed) 2020-21 Budget, Treasurer Frydenberg formally ditched the Government's emphasis on achieving budget surpluses and eliminating net debt – pivoting to providing "temporary, targeted and proportionate" support to "private sector jobs and investment" and allowing the budget's 'automatic stabilizers' (revenues and cyclically-sensitive spending) to "work freely to support the economy"
  - and stipulated that the Government would not embark upon the task of 'budget repair' until the unemployment rate was "comfortably below 6%" (which the ensuing Budget envisaged would not be until mid-2024)
- 12 days out from the this year's Budget the Treasurer again 're-calibrated' the Government's fiscal strategy (although not as dramatically as last year)
  - the Government's priority for the time being is to "drive the unemployment rate down to where it was prior to the pandemic [just above 5%] and then even lower … and … to see that sustained"
  - although not saying so explicitly, the Treasurer appeared to suggest that the Government wouldn't begin discretionary 'fiscal consolidation' until the economy had attained the 'non-inflation accelerating rate of unemployment' (NAIRU) which a Treasury now puts at 4½-5% (down from "around 5% previously"
  - the Treasurer explicitly ruled out "any sharp pivots towards 'austerity'"
- Although it is undoubtedly politically convenient (allowing the Government to avoiding cutting spending or raising taxes before the election which has to be held before late May next year), it is nonetheless the 'Right and Proper Thing To Do' from the standpoint of Good Economic Policy
- For the next year or so anyway, fiscal & monetary policy will be working in harmony rather than at 'cross purposes'
  - in contrast to much of the past two decades, in particular 2002-2008 when the RBA was gradually tightening monetary policy but the Howard and Rudd governments gave repeated rounds of income tax cuts and 'cash bonuses',
  - and 2014-19 when the RBA was intermittently loosening monetary policy but the Abbott, Turnbull & Morrison Governments were tightening fiscal policy in pursuit of budget surpluses

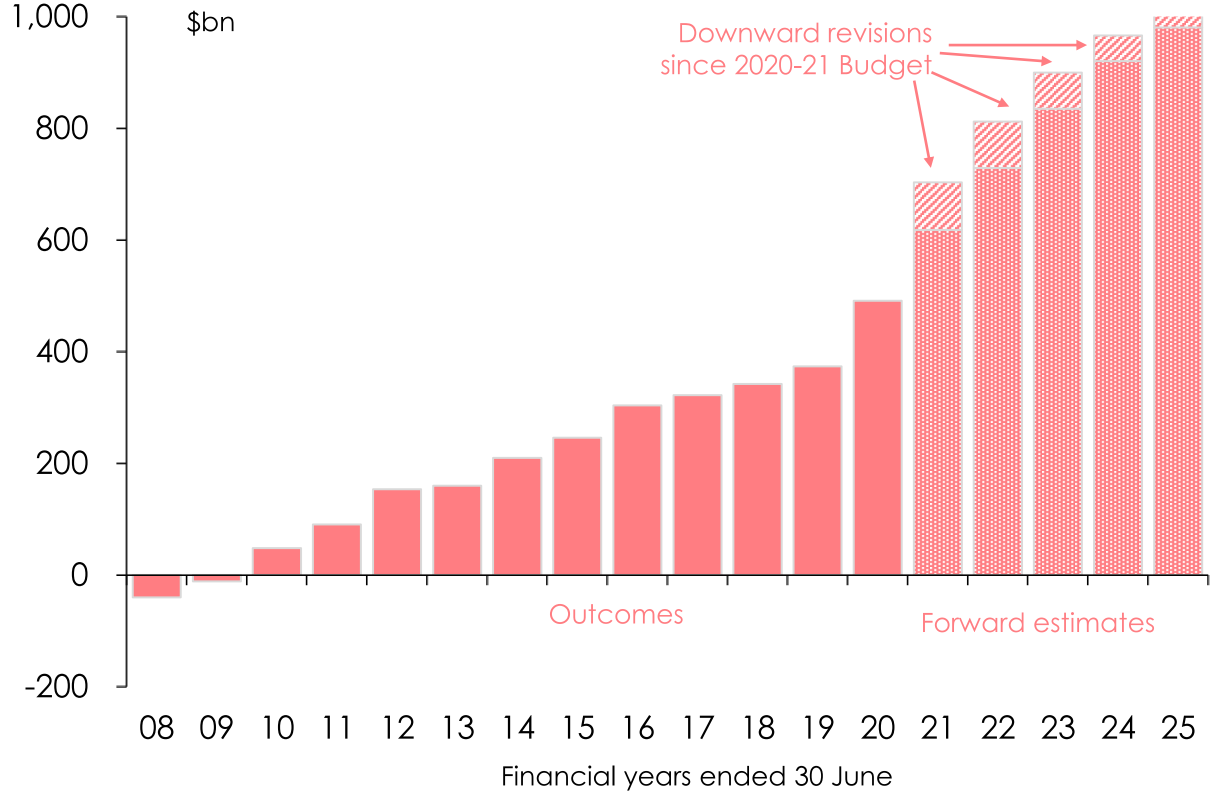
The deficit for 2020-21 will be a lot (and that for 2021-22 a bit) smaller than previously forecast, the deficits for 2022-23 and 2023-24 will be *larger*

2021-22 Budget forward estimates compared with those from last year's (2020-21) Budget

'Underlying' cash balance



Net debt



- **The deficits for 2020-21 and 2021-22 have been revised <u>down</u> by \$53bn and \$5bn respectively since last year's Budget – but the deficits for 2022-23 and 2023-24 have been revised <u>up</u> by \$11bn and \$13bn respectively**

- **In last year's Budget, net debt was forecast to \$966bn by 30th June 2024 – that forecast has been revised down by \$46bn**

Source: Australian Government, 2021-22 *Budget Paper No. 1, Statement 3: Fiscal Strategy and Outlook*.

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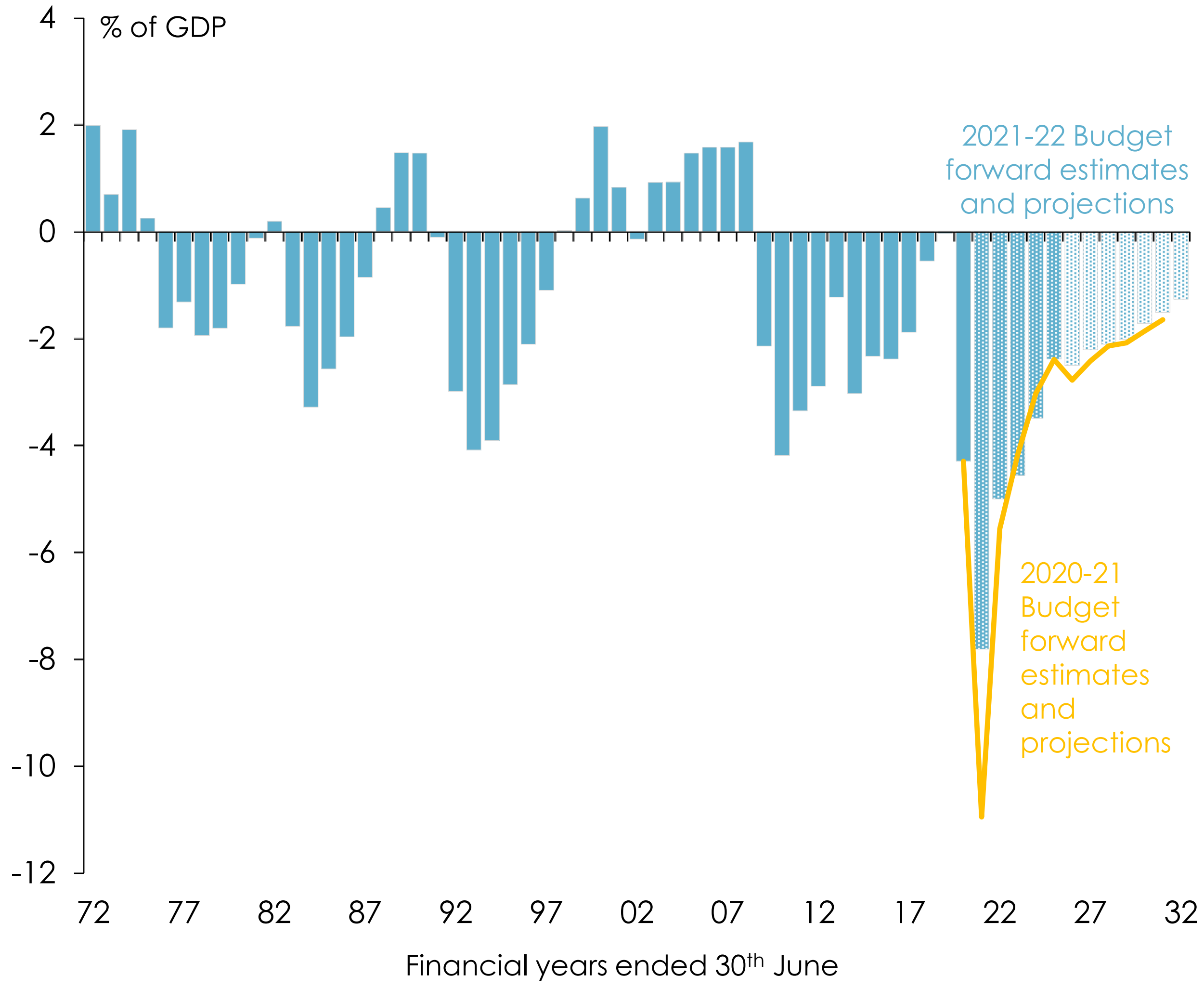
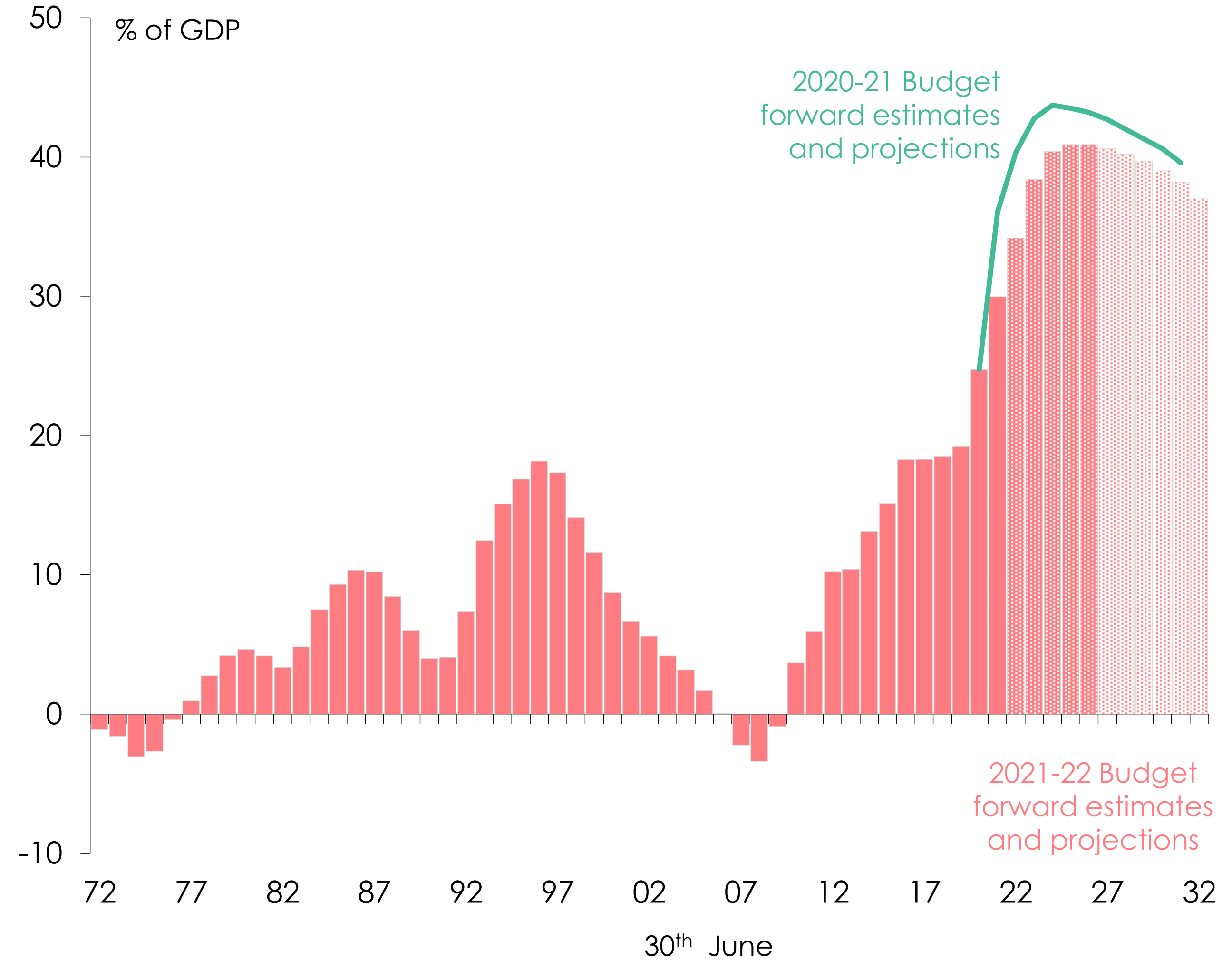
The Budget quite consciously kicks the 'budget repair' can down the road (presumably until after the next election …

'Medium-term' projections of the 'underlying cash balance' and net debt

'Underlying' cash balance



Net debt



Source: Australian Government, 2021-22 *Budget Paper No. 1, Statement 3: Fiscal Strategy and Outlook* and *Statement 11: Historical Australian Government data*.

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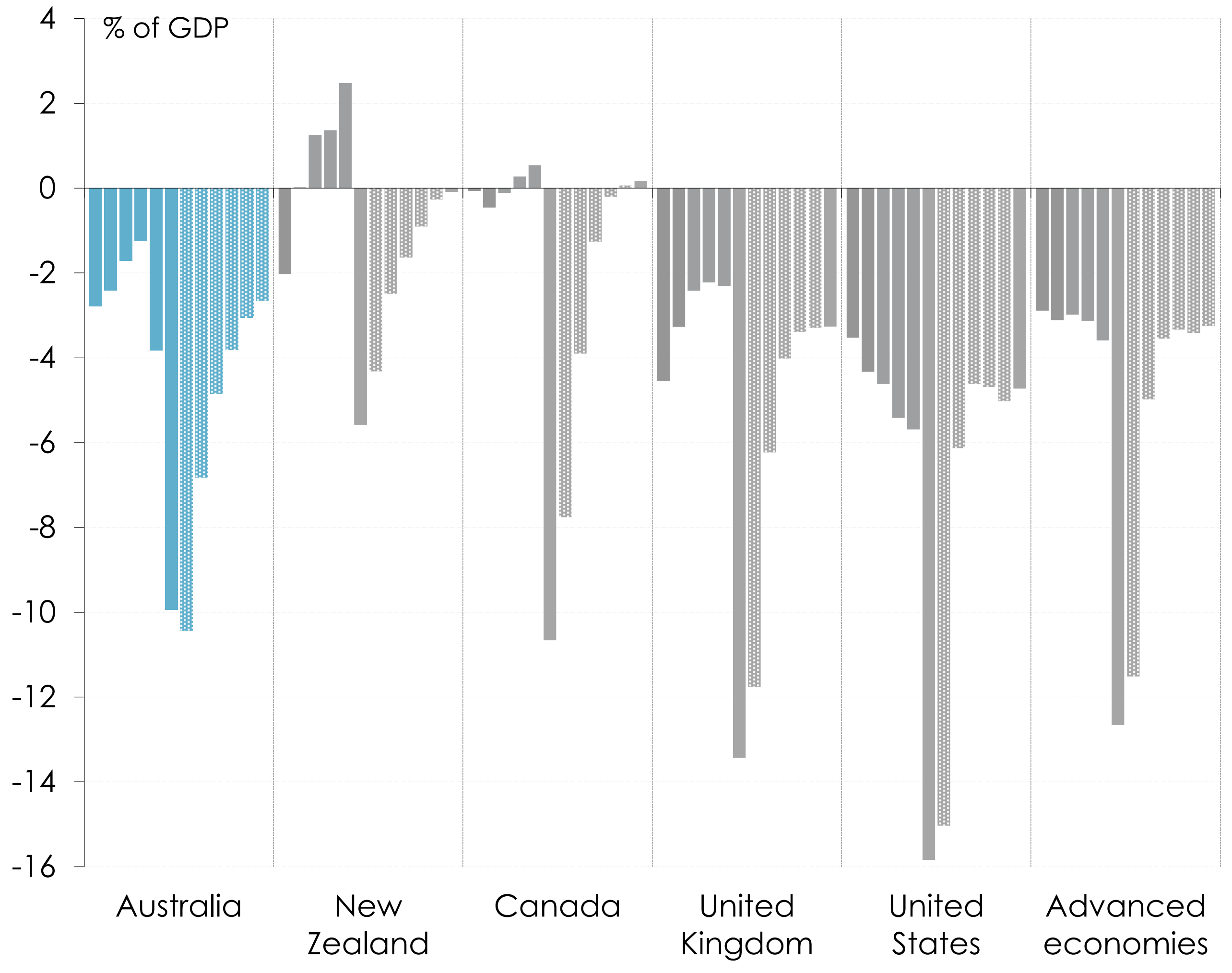
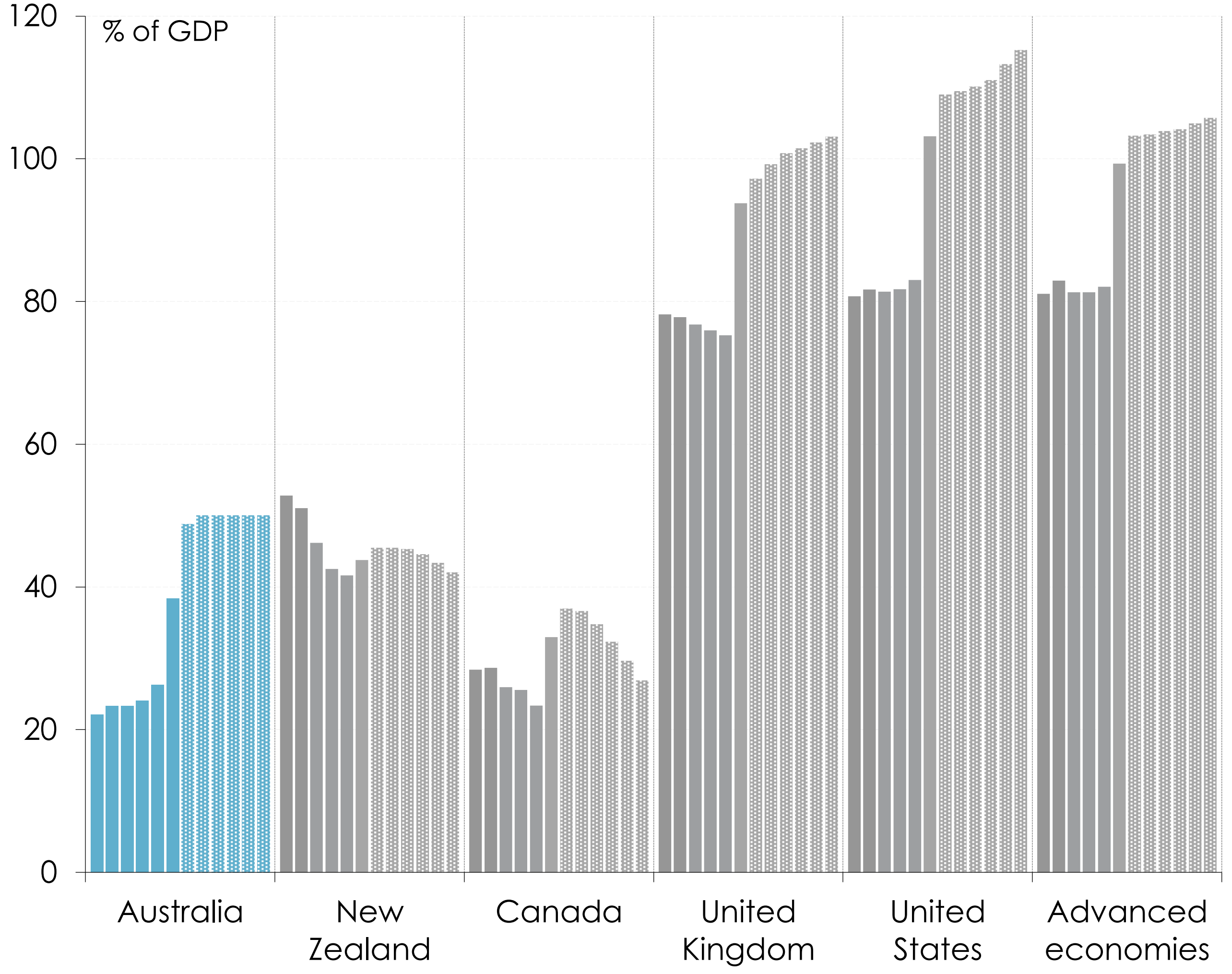
… which it can afford to do given that Australia's public finances are in much better shape than those of most other comparable countries …

Australia's budget balances and government net debt vs other comparable 'advanced' economies

Budget balances, 2015-26



Net debt, 2015-26



Note: The data depicted in this chart include state (or provincial) and local governments (as well as national governments), and do not reflect changes to estimates and forecasts for Australia made in the 2021-22 Federal Budget (though they will not have materially altered the general trends shown above).
Source: International Monetary Fund, *Fiscal Monitor*, April 2021.

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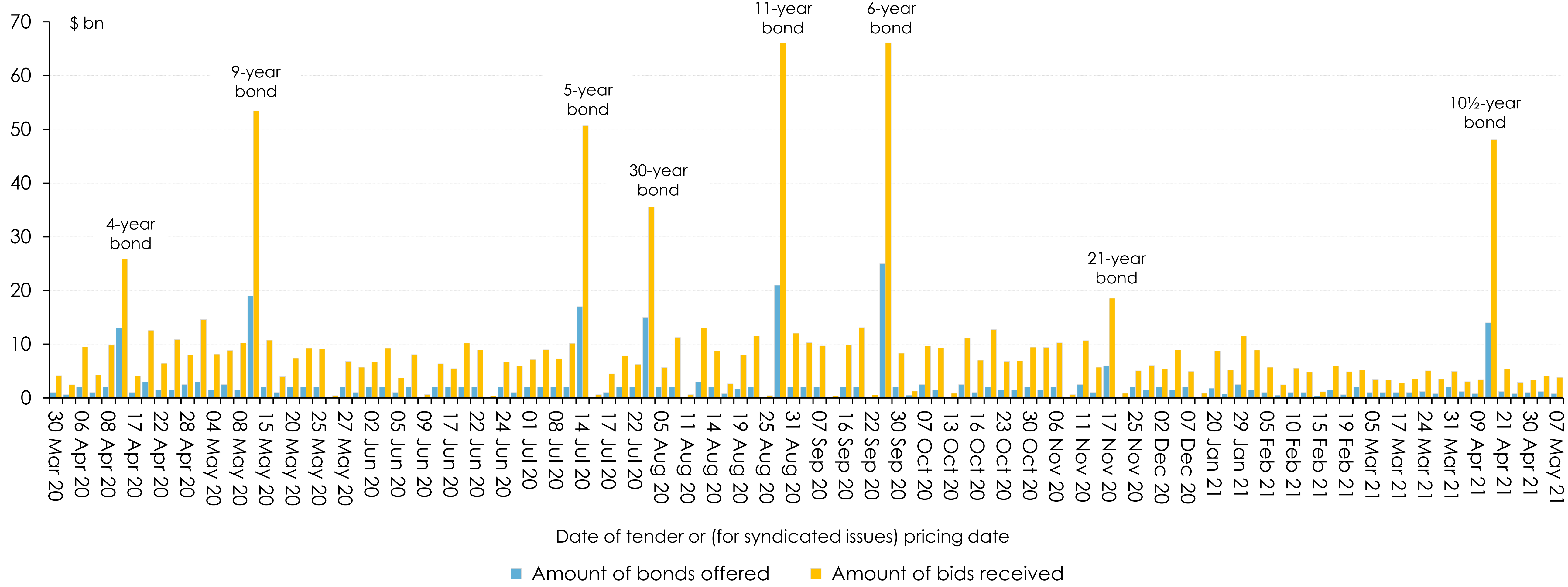
… and the Australian Government continues to have absolutely no difficulty borrowing to finance its deficits

Australian government bond issuance since March 2020



- **Since 30th March 2020, the Australian Office of Financial Management has issued $309bn of Treasury bonds – based on the volume of bids received it could have borrowed over $1.13 trn 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.

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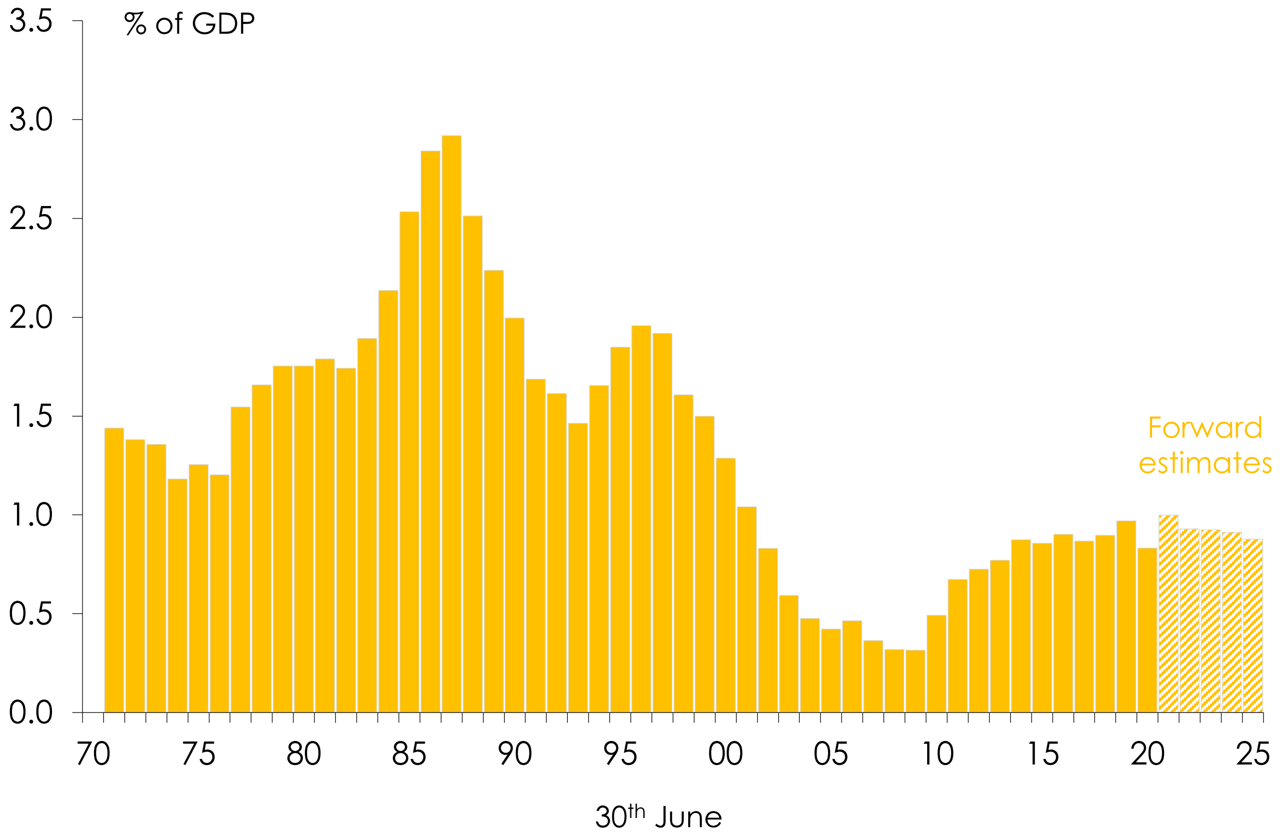
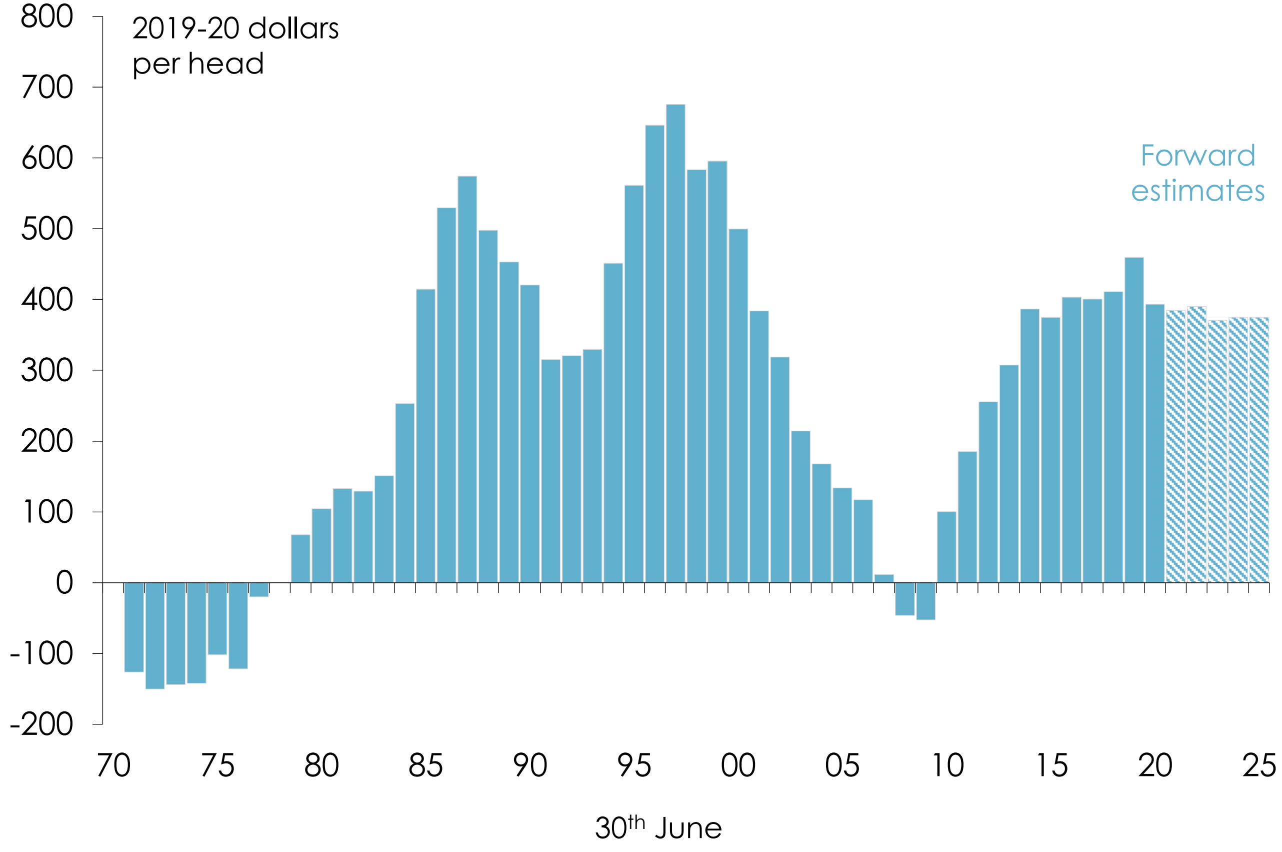
Because interest rates are so low, the cost of servicing the debt which the Government is racking up will be low by historical standards

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

Source: Australian Government, 2021-22 Budget Paper No. 1, Statement 7: Debt Statement and Statement 11: Historical Australian Government data.

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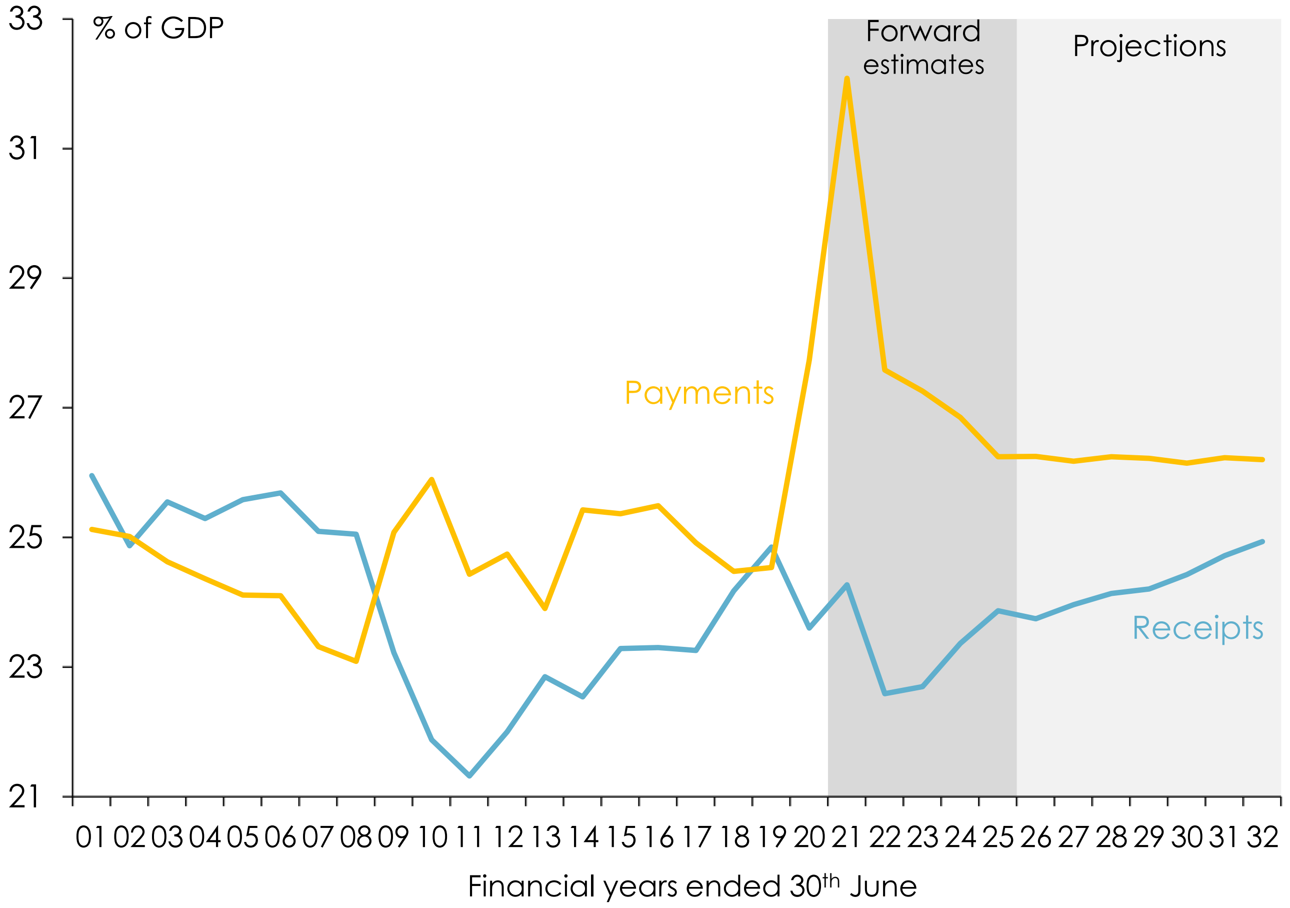
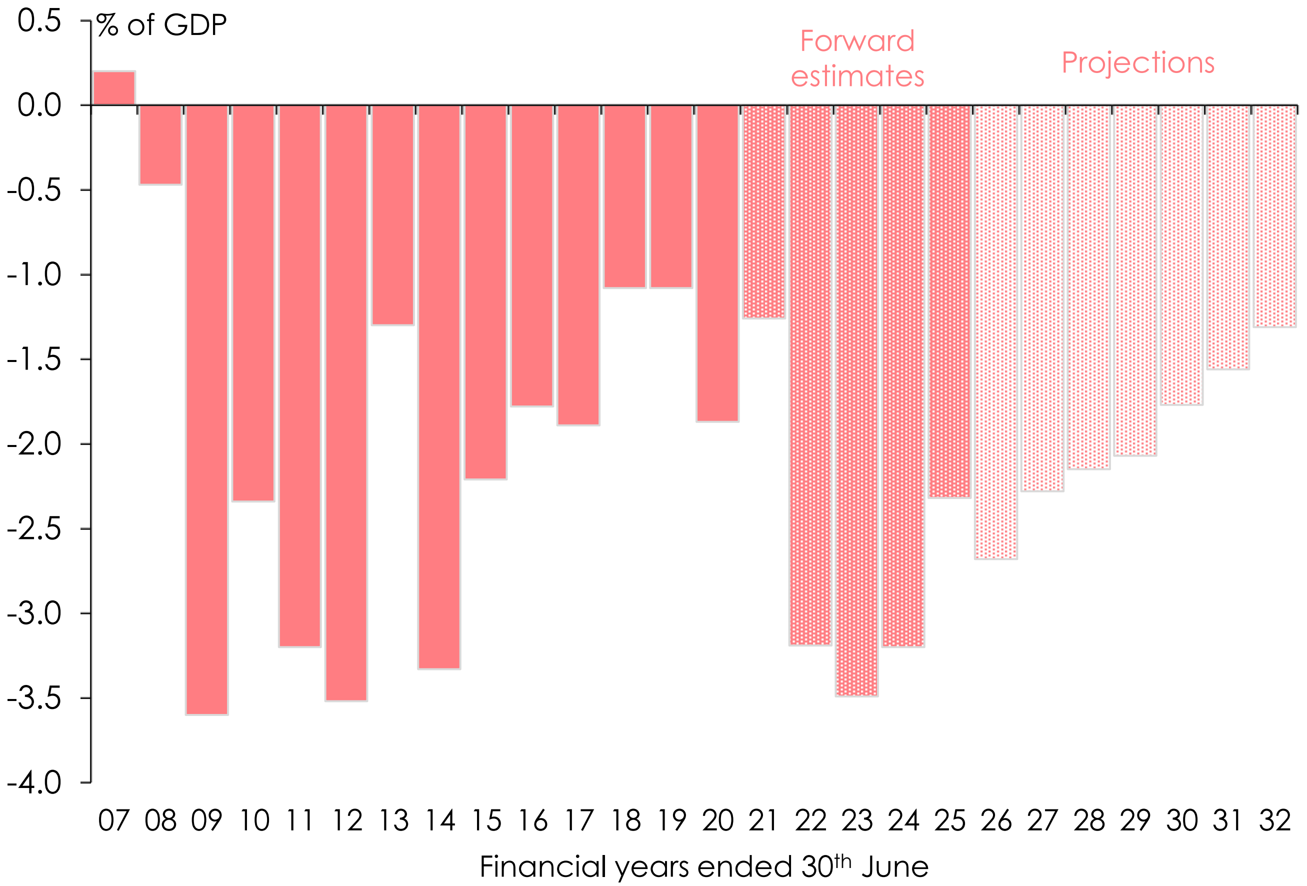
This budget actually *increases* the 'structural' deficit in the next two fiscal years – and it will still be over 1% of GDP in ten years

Receipt and payments as a pc of GDP



- **In 10 years' time, payments will still be 1¾ pc pts of GDP higher than the average for the 20 years prior to the pandemic while receipts will be ¼ pc pt of GDP lower**

The 'structural' budget balance

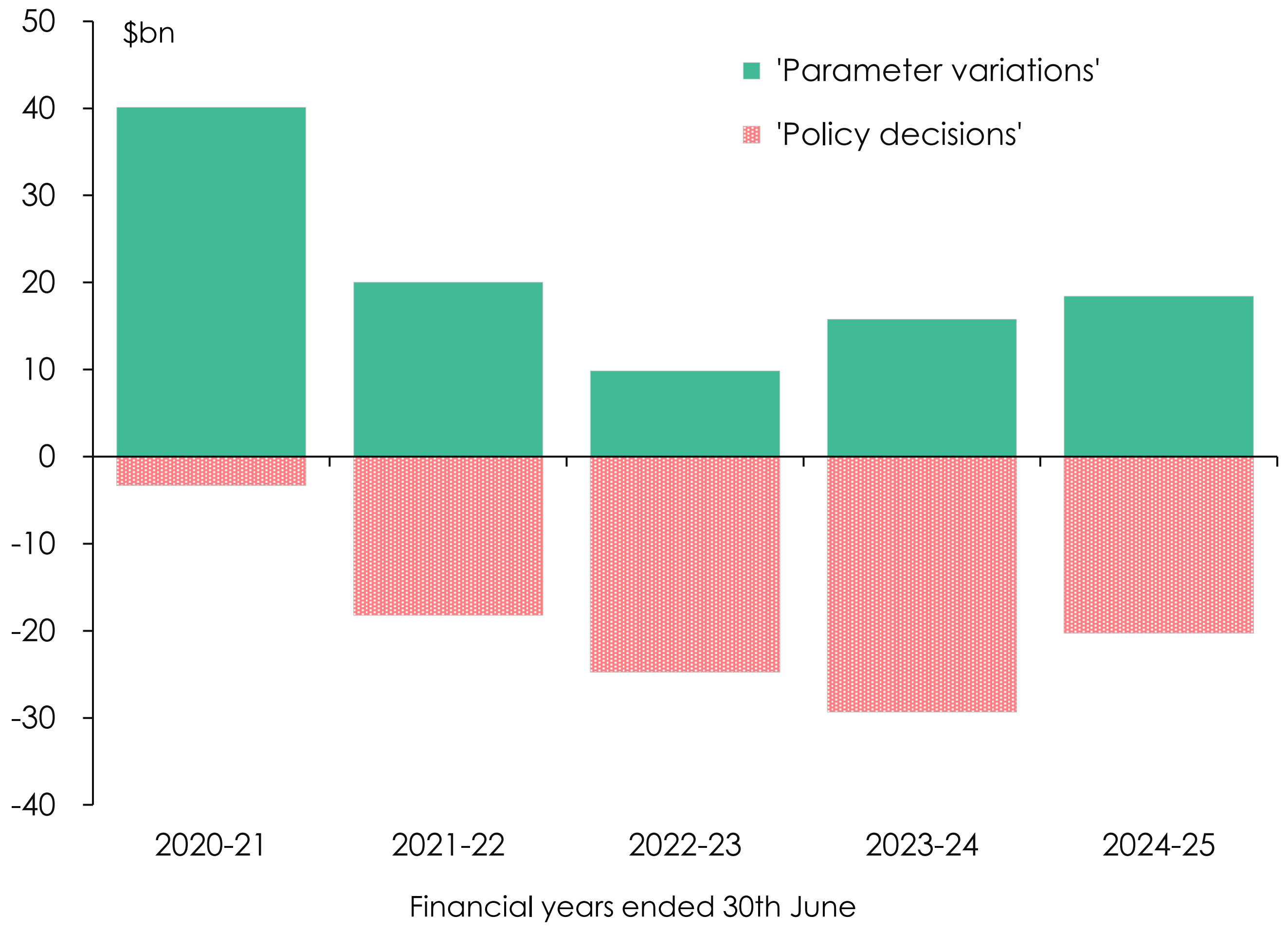


- **There will still be a 'structural' budget deficit of 1¼% of GDP in 10 years' time (and note that the structural deficit widens in 2021-22 and 2022-23)**

Note: The 'structural' budget balance *excludes* both cyclical influences on the budget balance (the impact of fluctuations in economic activity, and in asset and commodity prices on receipts and payments) and temporary fiscal stimulus payments. *Source:* Australian Government, 2021-22 *Budget Paper No. 1, Statement 3: Fiscal Strategy and Outlook* and *Statement 11: Historical Australian Government data*.

The increase in the deficits forecast for 2022-23 and 2023-24 is the result of conscious policy decisions to increase spending and cut taxes

Sources of the changes in forward estimates of the 'underlying cash balance' between the 2020-21 MYEFO and the 2021-22 Budget



- The budget affects the economy (through the 'policy decisions' which the Government makes as it puts the Budget together) – but the economy also affects the Budget (via what the Budget Papers call 'parameter variations' in receipts and payments)
- 'Parameter variations' between last December's Mid-Year Economic & Fiscal Outlook (MYEFO) and this year's Budget improved the 'bottom line' over the five years to 2024-25 by a total of $104bn
  - all of which was attributable to upward revisions to forecasts of tax receipts, particularly personal income tax and GST, but also company and super fund tax
- However $96bn (92%) of those 'windfall gains' have been absorbed by 'policy decisions'
  - which have added $68bn to payments and subtracted $28bn from receipts over the five years to 2024-25
- 'Policy decisions' added $15bn more to the forecast deficit in 2022-23, and $14bn more to the deficit for 2023-24, than 'parameter variations' reduced it

Source: Australian Government, 2021-22 *Budget Paper No. 1, Statement 3: Fiscal Strategy and Outlook*.

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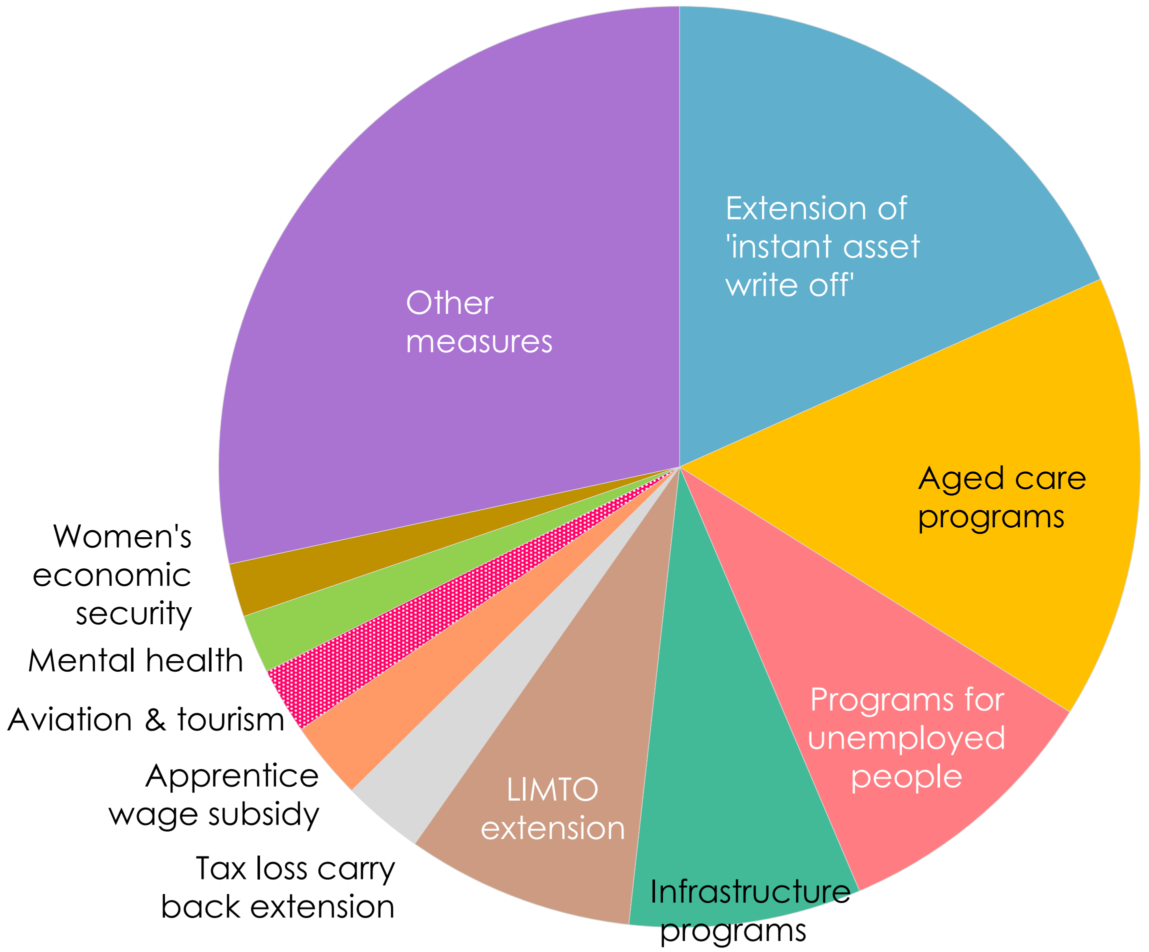
Extending the 'instant asset write off', increased spending on aged care, programs for jobless people, infrastructure and tax cuts are the big items

Budget impact of major 'policy decisions' since December 2020

$ million

	2020-21	*2021-22*	*2022-23*	*2023-24*	*2024-25*	*Total*
Extension of 'instant asset write-off'			-600	-10,900	-6,400	-17,900
Aged Care programs	-263	-1,598	-3,596	-4,817	-4,977	-15,251
Increased support for unemployed people	-697	-2,622	-2,093	-2,027	-2,025	-9,464
Infrastructure programs		-688	-2,945	-2,160	-2,164	-7,957
Retention of LMITO for 2021-22			-7,400	-400		-7,800
Extension of temporary loss carry back				-3,200	410	-2,790
Apprenticeship wage subsidy expansion	-140	-1,507	-1,033	-1	2	-2,679
Aviation and tourism industry support	-965	-1,318				-2,283
Mental health initiatives		-413	-547	-485	-566	-2,011
Additional Covid vaccine purchases	-537	-1,318	-11	-7	-7	-1,880
Women's Economic Security measures	21	-19	-532	-645	-654	-1,829
Universal access to pre-school	16	-156	-472	-487	-524	-1,623
'Building Australia's resilience'		-295	-351	-330	-262	-1,238
Changes to employee share schemes				-345	-205	-550
Extra funding for ASIO		-69	-107	-116	-122	-414
'Decisions taken but not yet announced'	-1,191	-3,631	-1,040	-896	-744	-7,502
Other	422	-4,576	-4,031	-2,515	-2,003	-12,703
Total	-3,334	-18,210	-24,758	-29,331	-20,241	-95,874

Share of total 'bottom line' impact over five years to 2024-25 of major policy measures



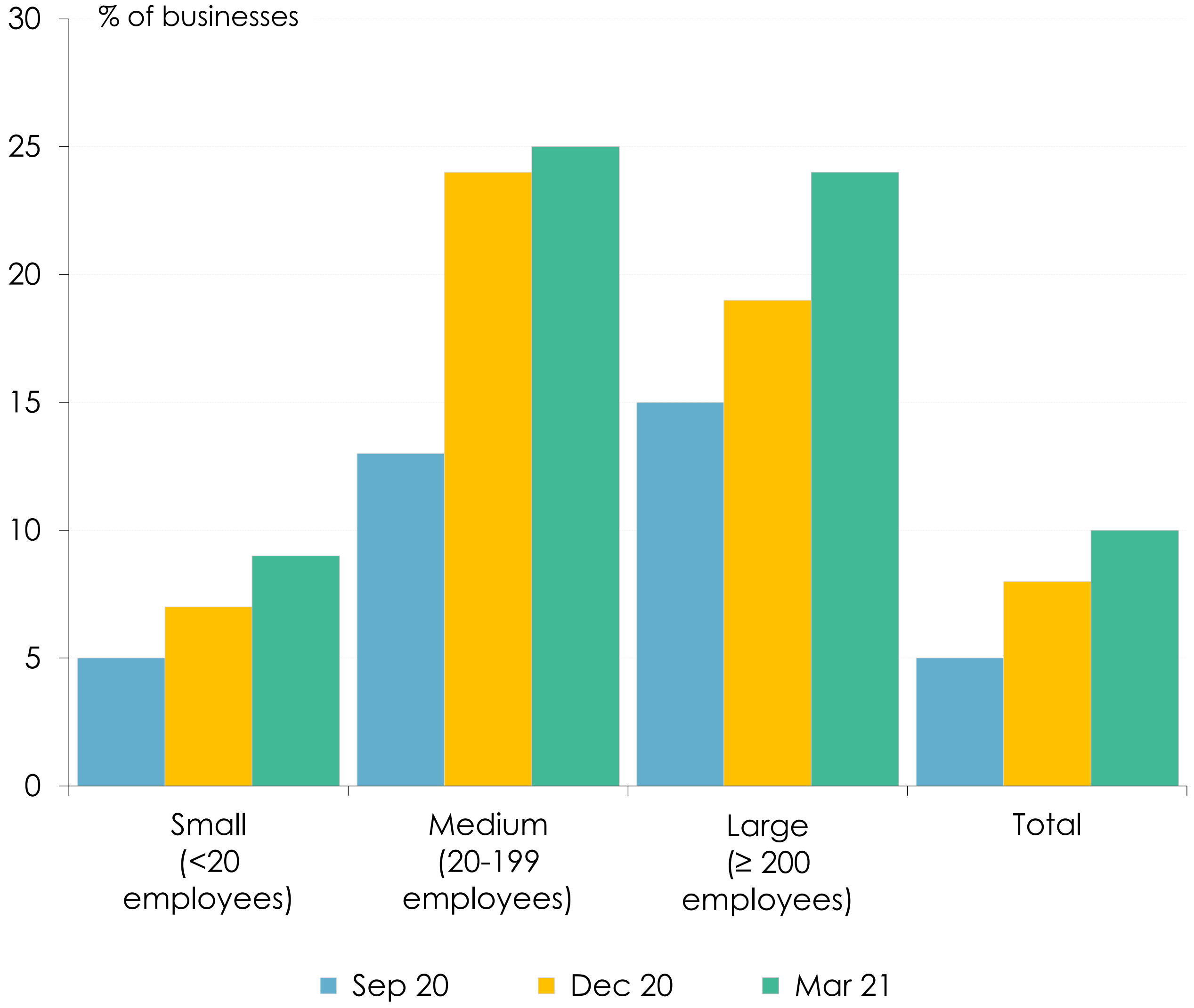
Source: Australian Government, 2021-22 Budget Paper No. 1, Statement 3: Fiscal Strategy and Outlook; Budget Paper No. 2: Budget Measures; and Securing Australia's Recovery: Overview .

Tax measures in the budget mostly short-term 'fixes' – although there is one small 'gem'

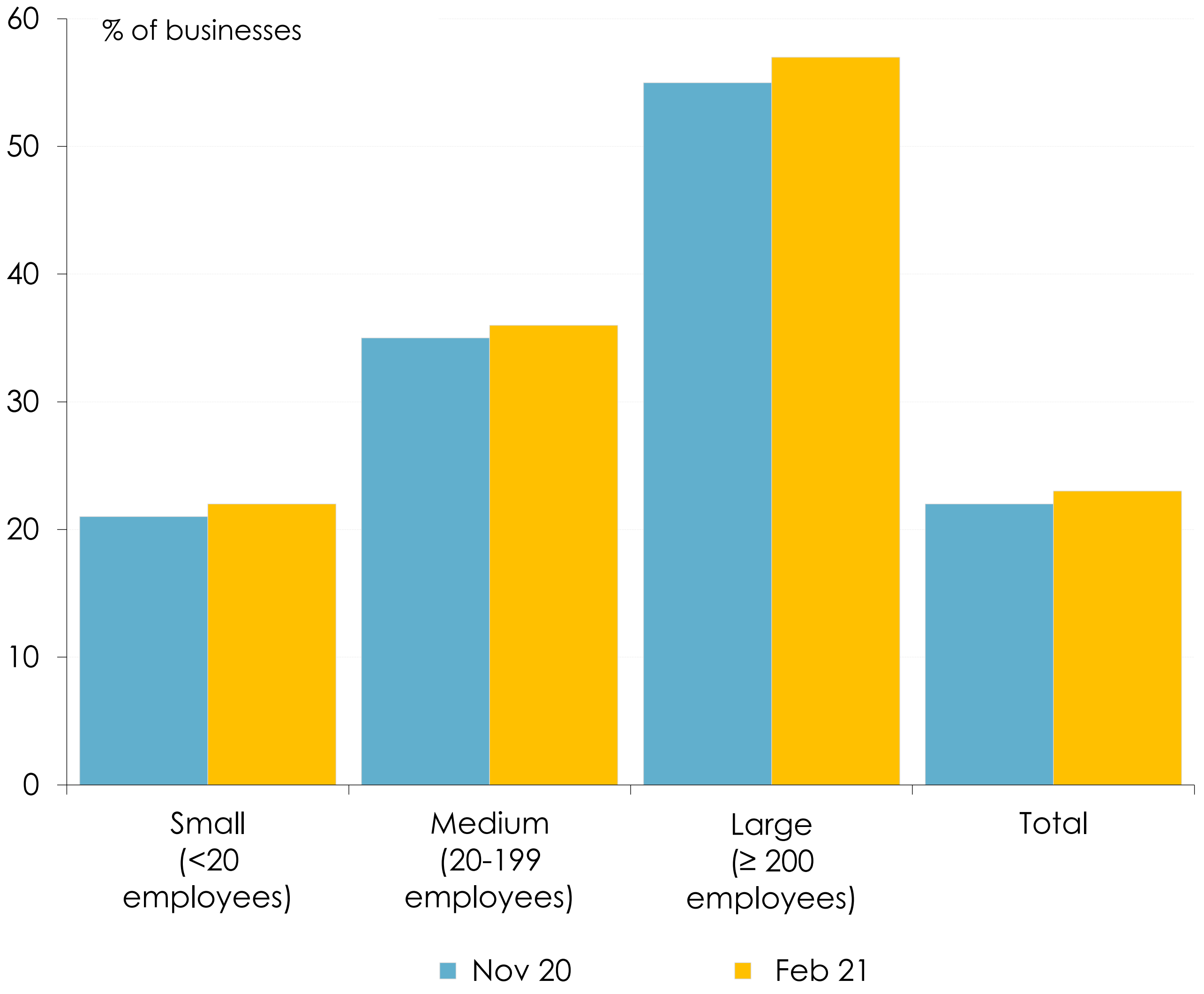
- The biggest single measure in this Budget (as it was in last year's) is the extension for another year of the 'instant asset write off' (or 'temporary full expensing' as the Budget Papers call it) of investment in 'depreciable assets' by small businesses (those with annual turnover of less than $5mn) by another 12 months (until June 2023)
  - this reduces revenue by $18bn over the four years to 2024-25, although $14½bn of this is 'clawed back' over the following six years through reduced deductions for depreciation
- A further measure for small business is the extension of the 'temporary loss carry-back' provision (which allows eligible businesses to use current period losses to offset previously taxed profits back to 2018-19) for another 12 months (until June 2023)
  - this reduces revenue by $2¾bn over the four years to 2024-25, although as with the extension of the 'instant asset write off' some of this is recouped over the medium term
- The other large measure is the extension of the Low & Middle Income Tax Offset (LIMTO or 'Lamington') – which provides a tax rebate for people with incomes up to $126,000, with a maximum rebate of $1,080 for people with incomes of between $48,000 and $90,000 – for another year (ie to 2021-22) at a revenue cost of $7½bn in 2022-23
  - this was originally meant to be a one-off measure as part of the first tranche of the Morrison Government's three-stage tax cut program, in 2019-20, but was extended by another year in last year's Budget – if it hadn't been extended again, a large group of taxpayers (voters) would have faced a $20/week tax increase in the lead-up to the next election
- Changes to the tax treatment of employee share schemes so that beneficiaries don't have to pay tax on them when they cease employment with the company that granted them will forego $550mn in 2023-24 & 2024-25
- The one small 'gem' is the 'patent tax box system' where corporate income from medical or bio-tech (and possibly clean energy) patents will be taxed at a concessional rate of17% (at a revenue cost of only $100mn a year)
  - ideally the Government should adopt this approach to *all* new business and pay for it by scrapping unjustified tax preferences for small businesses (simply because they are small)

It's medium-sized and large businesses who will be the 'engine rooms' of job creation and investment, not small ones

Proportion of businesses planning to increase employment, by size of business



Proportion of businesses planning to increase capital expenditures, by business size



Source: ABS, *Business Conditions and Sentiments*, March 2021.

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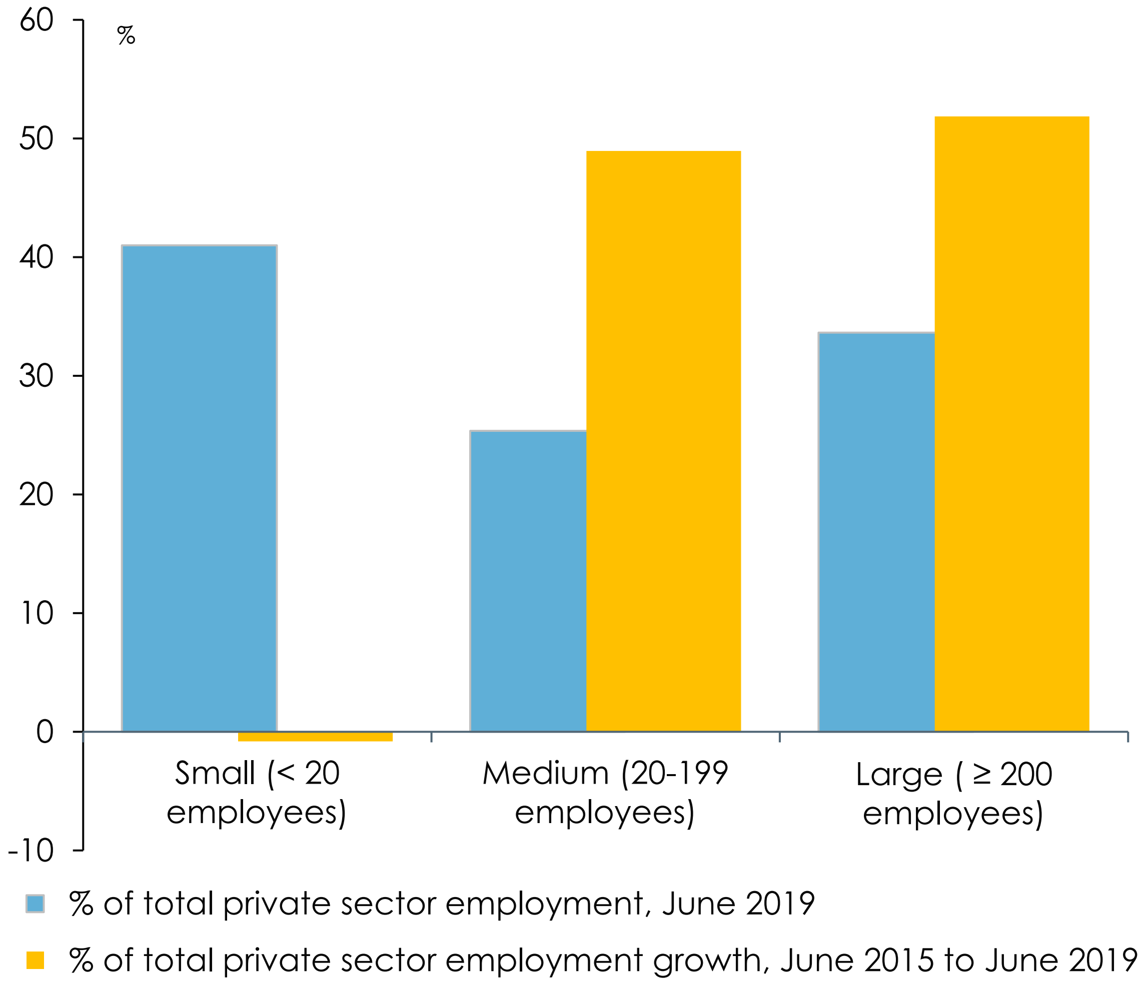
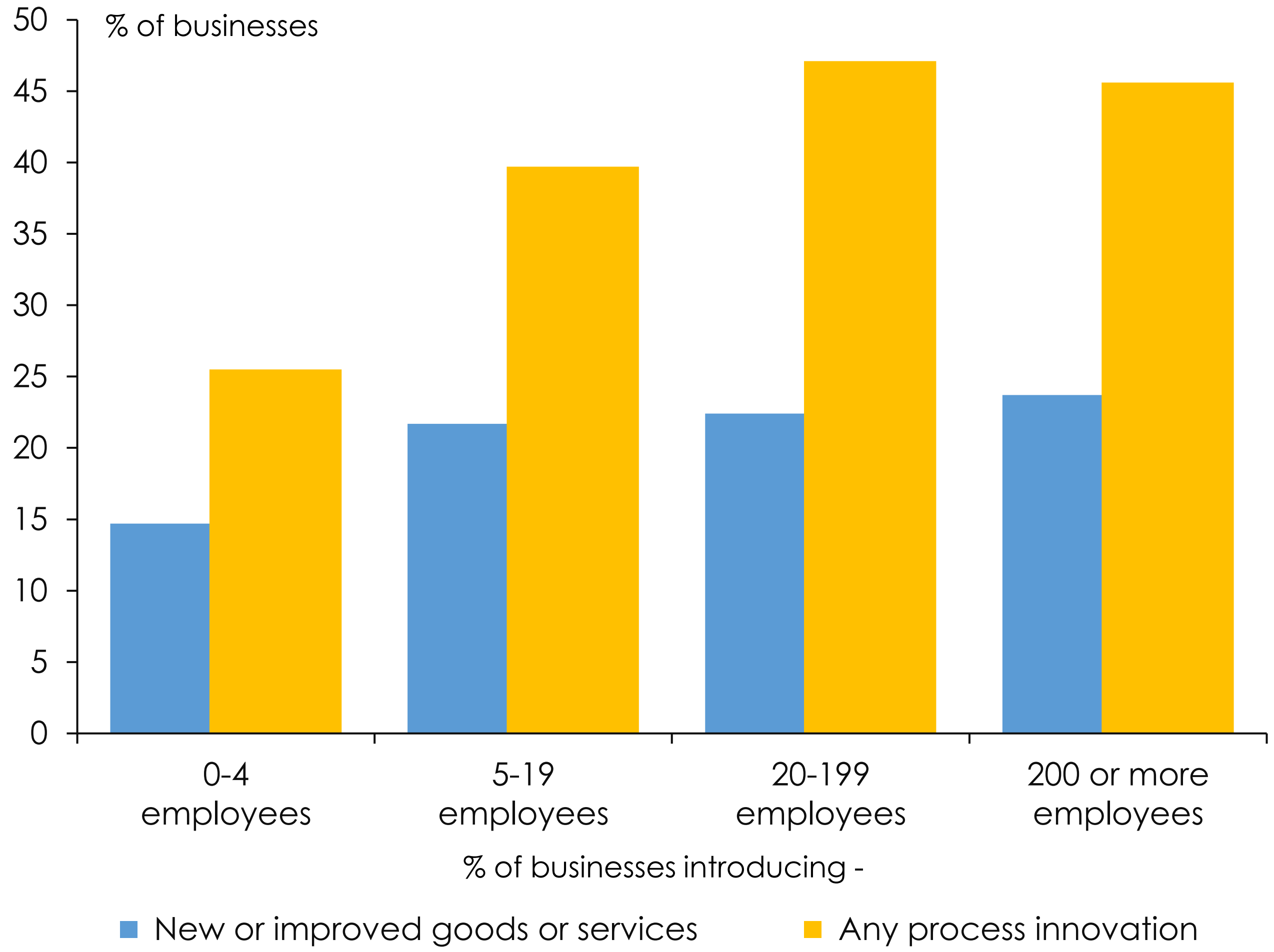
Small business isn't really the 'engine room of the economy' – in either job creation or innovation

Shares of private sector employment, and employment growth, by business size



Innovative activity by business size, 2018-19



Sources: ABS, *Australian Industry* and *Characteristics of Australian business*, 2018-19.

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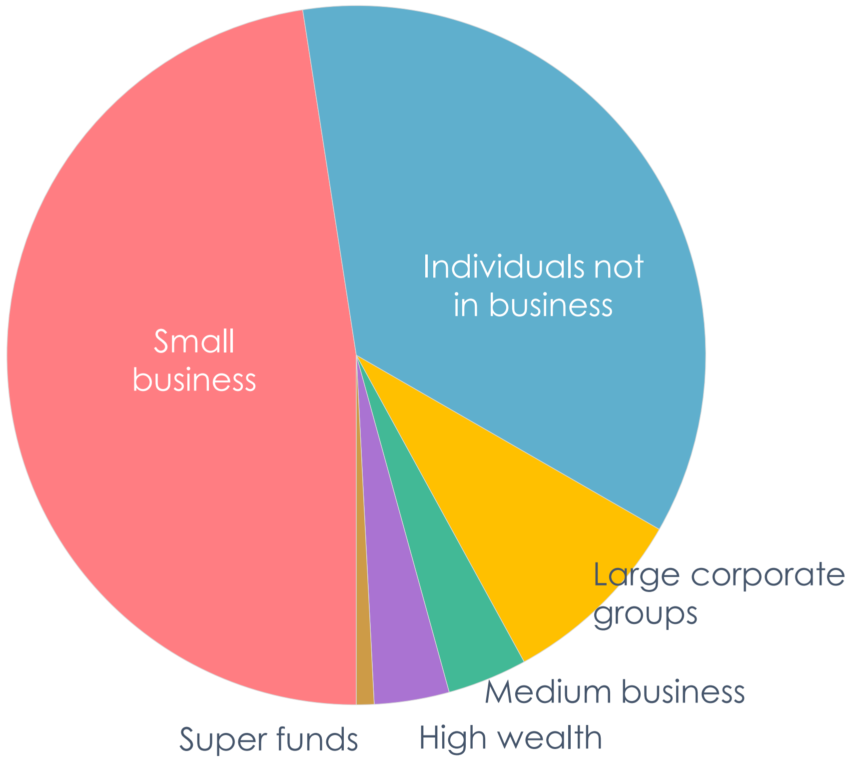
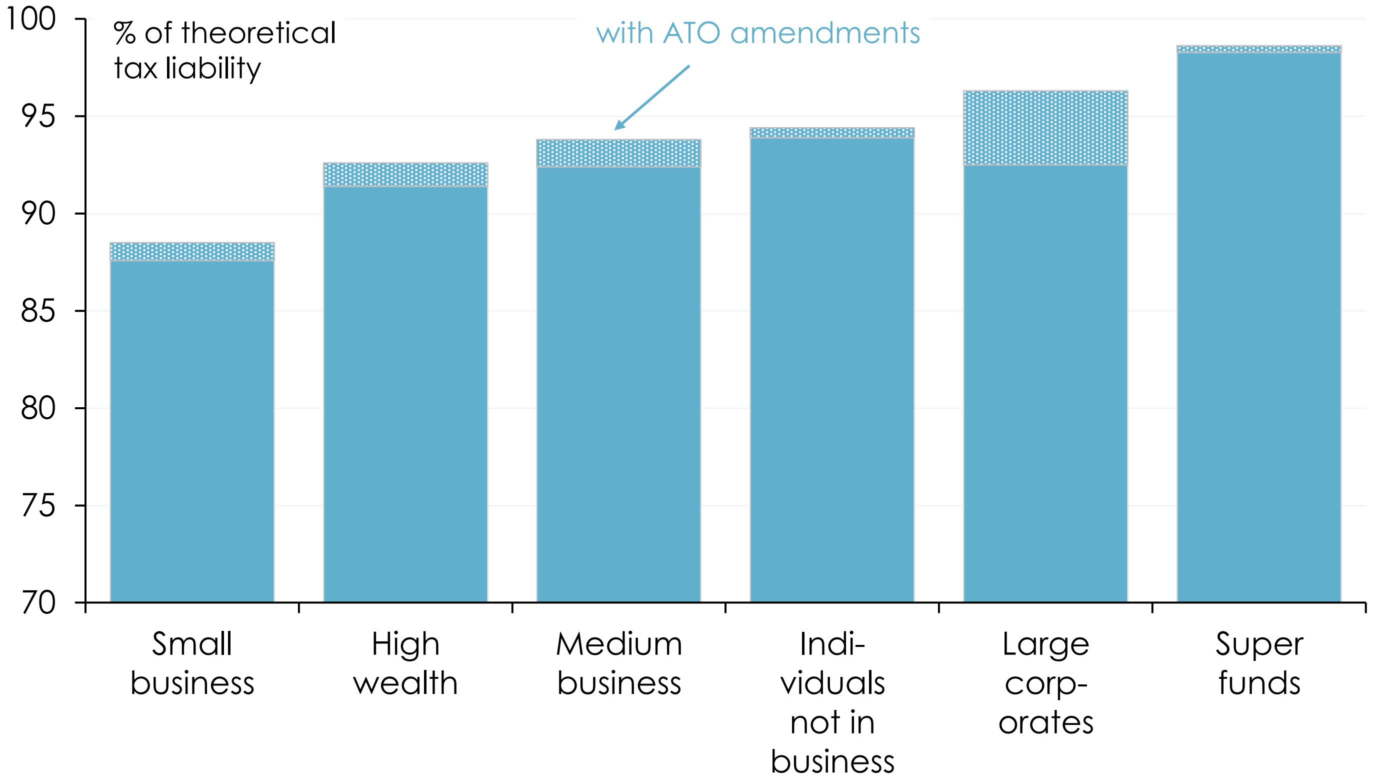
What small business *is* good at is not paying tax – and their reward for that is a lower tax rate, and now 'extra protection' from the ATO

Income-based 'tax gaps' by class of taxpayer, 2017-18



Share of theoretical tax liability paid voluntarily and after ATO amendments, 2017-18



- **Small businesses account for 44% of the total 'gap' between what the ATO collected in 2017-18 from various income-based taxes and what it estimates it would have collected given 100% compliance with the tax law – cf. large corporates 15% and high wealth individuals 3½%**
- **Small businesses pay a smaller proportion of the tax which the ATO estimates they 'should' than either large corporates or high net worth individuals – contrary to the popular perception that the latter two are the groups least likely to be paying their 'fair share' of tax**

Note: 'small' businesses are those with income of up to $10mn; medium businesses are those with income of up to $250mn; and large corporates those with income of over $250mn. 'High wealth' individuals are those who (with associates) control wealth of more than $50mn. *Source:* Australian Taxation Office. *Disclosure:* Saul Eslake is a member of the ATO's Tax Gap Independent Expert Panel which provides advice on the suitability of the ATO's gap estimates and methodologies.

The new housing measures in the Budget are small, but mis-guided

- The Budget provides $775mn to extend the construction commencement requirement under the HomeBuilder grant program from 6 months to 18 months
  - which is understandable given the lengthy backlogs now being encountered in the housing industry
- The Budget contains three additional measures which are purportedly intended to boost home ownership
  - the 'maximum releasable amount' of voluntary concessional and non-concessional superannuation contributions which can be withdrawn to form a deposit under the First Home Super Saver Scheme will be increased from $30K to $50K
  - the First Home Loan Deposit Scheme (under which eligible first home buyers can borrow to purchase a newly-constructed home, or contract to build a new one, with a deposit of 5%, with a Government guarantee of up to 15% of the price) will be extended to allow another 10,000 applicants in 2021-22
  - a new Family Home Guarantee will allow up to 10,000 single parents to purchase a home with a deposit of as little as 2% (with the Government guaranteeing up to 18% of the mortgage)
- These measures *will* benefit the (relatively small number of) people who can get to the front of the queue for them
  - but you'd like to think that governments would by now have realized (given almost six decades of unequivocal evidence) that schemes which allow intending home-buyers to pay more for housing than they otherwise would (which is what these and other schemes do) result in *more expensive housing*, not in higher home ownership rates
  - you'd also like to think that governments would have learned from the US experience in the years before the GFC that getting people into home ownership on very high initial LVR mortgages is *not* a good idea, either for the people involved or for financial system
- Unfortunately politicians know all to well that the number of voters who benefit from continually escalating house prices is vastly greater than the number of voters (and others) who are disadvantaged by them
- There's really nothing else in this budget to increase the supply of housing – especially of affordable rental housing

The cost of assuaging Western Australia's grievances over GST revenue-sharing continues to escalate

- In 2018, the Morrison Government – in response to sustained pressure from Western Australia – imposed changes in the way the revenue from the GST is distributed among the states and territories
  - instead of being distributed to as to enable all states and territories to be able (if they choose) to provide the same range and standard of services to their citizens as the richest state (which for most of the past decade or so has been WA), GST revenues will be distributed in order to raise the 'fiscal capacity' of states and territories to the stronger of NSW or Victoria
  - additionally, from 2022-23 no state will get less than 70% (from 2024-25, 75%) of what it would receive under a notional 'equal per capita' distribution of GST revenues (the only state which had been receiving less than these proportions had been WA)
- These changes mean, in effect, that when iron ore prices are above around US$70-75/tonne, WA gets a larger share of GST revenue than it would have done under the arrangements which applied up until 2020-21 – in effect, it gets to 'keep' a larger share of its mineral royalty revenue windfalls
  - note that if the iron ore deposits had been at (for example) Broken Hill, rather than in the Pilbara, NSW would not have received the same favourable treatment (because it would still be the 'benchmark' state)
- Because the GST-sharing arrangements are, ordinarily, a 'zero-sum game', WA's gains are at the expense of the other states and territories
  - however the Morrison Government agreed, as a 'transitional measure', to 'top up' the GST pool so that no other state or territory would be worse off than they would have been had the changes not been made – until 2026-27
  - because (contrary to the assumptions made when this 'deal' was imposed on the states and territories in 2018) the iron ore price has sky-rocketed, the cost of this 'transitional guarantee' for the years 2021-22 through 2023-24 has escalated by $1¾bn (or 33%) since last year's Budget
- In effect, the Federal Government will be adding $7½ bn to its own deficit over the four years to 2024-25, so that WA (the only government in Australia, and probably one of very few anywhere in the world, which is running budget surpluses) can get $7½bn more of GST revenues than it would have done otherwise

In summary

- The Australian economy has done better than expected – and better than most other ‘advanced’ economies – since the onset of Covid-19
  - because we’ve done better than most at keeping the virus at bay, and because governments have done more to support households and businesses through the recession (and afterwards) than in most other countries
- The Government’s decision to defer the task of ‘discretionary budget repair’ for at least another year is politically expedient, but that it doesn’t make it wrong – on the contrary it is The Right And Proper Thing To Do
  - fiscal and monetary policy will be working in harmony towards a common goal (an unemployment rate of “4 point something” or lower) rather than at ‘cross purposes’ as they have done more often than not in the past two decades
  - which makes it much more likely that the common goal will be achieved
  - many of the Treasury’s economic forecasts are conservative – and the outcomes could be better than those forecasts
  - although ultimately whoever is in government by the middle of this decade will need to make some politically ‘challenging’ decisions about spending and/or revenues
- The budgetary position has benefited significantly from the earlier- and stronger-than-expected recovery in economic activity and employment to date – but this Budget directs nearly all of those benefits to increased spending or tax cuts
  - the Budget consciously increases the ‘structural’ deficit in 2022-23 and 2023-24
  - the Budget’s tax cuts are mostly short-term ‘fixes’ rather than either genuine reforms, or lasting cuts
- The housing-related measures in the Budget won’t do anything to increase home ownership, but will instead add further to upward pressure on prices (albeit only at the margin)
- The Government’s confidence in small business as the ‘engine room of the economy’ is totally misplaced
- The Budget’s generosity to Western Australia – increasing its own deficit in order to boost WA’s surpluses) is really quite scandalous

This document has been prepared by Saul Eslake on behalf of Corinna Economic Advisory Pty Ltd, ABN 165 668 058 69, whose registered office is located at Level 11, 114 William Street, Melbourne, Victoria 3000 Australia.

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