Budget '22 – Learning to love the deficit

- A stronger economy has again delivered an improving fiscal backdrop.
- It's a pre-election Budget but some of the improvement is allowed to flow through to the bottom line.
- Fiscal success is now couched in terms of *sustainability* - the benchmark is a lower debt:GDP ratio.
- The focus is on the cost of living – measures are worth $11bn or 1% of consumer spending.
- There are measures to support economic momentum – fiscal headwinds to growth are modest.
- Budget projections imply some very respectable economic outcomes (if achieved).

The ability of the Australian economy to produce rivers of gold for the government remains unparalleled.

Once again, the Treasurer has delivered a fiscal document that reveals a dramatic improvement in government finances. Once again, the old fiscal equation that "more revenue = more spending" has been applied. And once again, we've been presented with a set of economic forecasts that look better than seemed possible only a few months ago.

What is different this time is that some of the benefit from improved economic parameters is flowing through to budget bottom lines. The trajectory for debt and deficits is improved relative to the May 2021 Budget and the December 2021 Mid-Year Review.

The fiscal authorities continue the process of tiptoeing away from the "surplus or bust" mentality that has prevailed for much of the past couple of decades. The goal is now full employment. Measuring fiscal success is now couched in terms of *sustainability*. And the benchmark for success is a declining debt:GDP ratio.

In a *forecast* sense, at least, this Budget delivers (Charts 1 & 2). The unemployment rate is put at 3¾% later in 2022. Most economists would see full employment around these levels. The net debt:GDP ratio is projected to level out at 33.1% in 2025 and then decline by 6ppts over the next decade. The peak is lower and the decline faster than earlier expected.

But Budgets need to be judged on more than the forecasts. There is a good reason that the words

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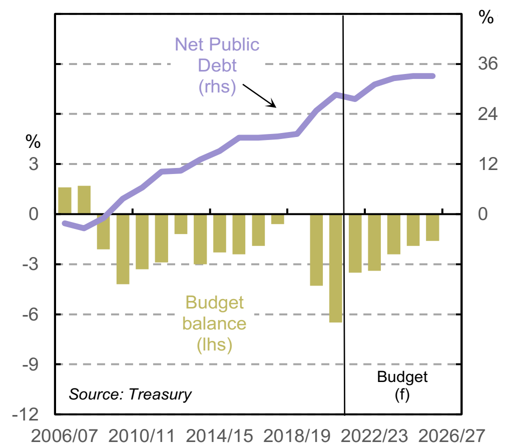

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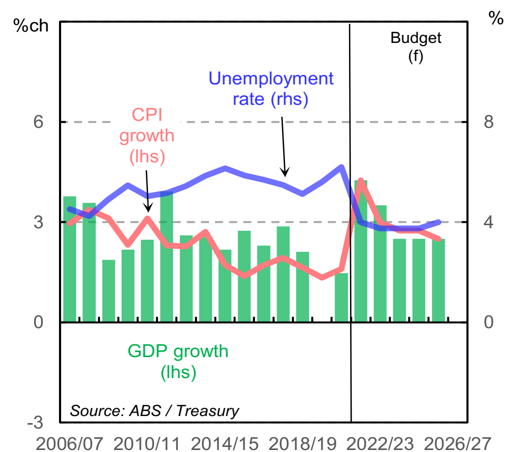

"budget forecast" and "rubbery" often appear in the same sentence. Reality can disappoint!

Economists typically judge Budgets through three different lenses. The focus is on the Budget as an accounting exercise, as an economic policy plan and as a political document.

Most weight this time should be on the Budget as a political document. It is, after all, a pre-Election Budget. Most of the policy measures are directed towards areas of perceived government weakness. The cost of living is a particular focus. Indeed, part of the strategy seems to be to tie as many measures as possible back to living costs. Cuts to the fuel excise and cash handouts are the centrepiece. But expansion of the Home Guarantee Scheme, the regular indexation of pension payments, PBS changes and spending on things like Snowy 2.0 are also portrayed as easing cost pressures. The Government is also at pains to remind the voters of earlier measures that help with the cost of living, such as childcare support.

Despite the many column inches that will be devoted to Budget analysis, this one might have a short shelf life. A Federal Election is approaching rapidly. The opinion polls favour a change of the guard. We may all be back later in the year applying the same three lenses to a Labor Budget!

What is likely to survive any change in Government is the focus on full employment. The goal is within our grasp. Spending may be reoriented. But the fiscal breaks will not be applied any more harshly.

The RBA is fully on board. The pursuit of full employment is a key reason RBA Governor Lowe is fighting a valiant rear-guard action against the pressures to lift interest rates. Interestingly, he also sees *sustainability* as a key consideration. So inflation must be sustainably within the RBA's target range of 2-3% before a rate rise is on the table. And that requires a lift in wages growth. Full-employment is one path to that end. The calls for a rapid-fire rate response to current inflation metrics look a little ambitious given that backdrop.

Much of the Budget was well telegraphed (as usual). From that perspective, the main "surprise" was the absence of an extension to the low and middle income tax offset. Effectively it means a tax rise (via a smaller refund) in 2023/24.

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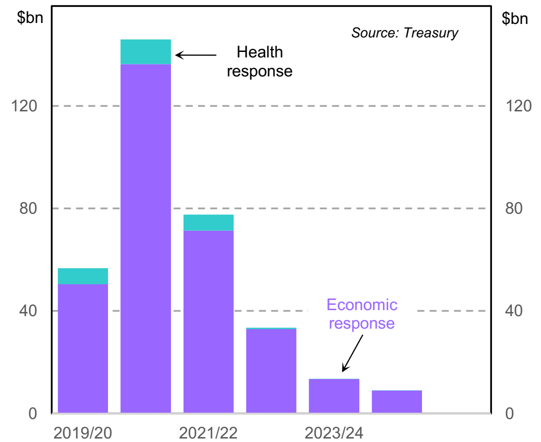

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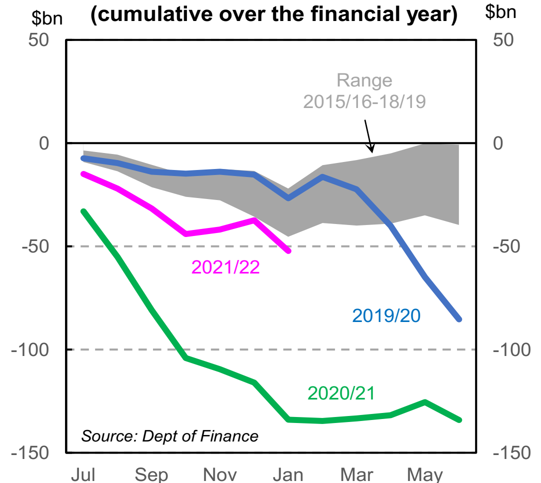

Table 1: Key Budget Aggregates ($bn)

	22/23	23/24	24/25	25/26
Revenue	547.6	585.2	615.2	643.9
Spending	625.6	641.7	662.3	687.0
Balance	**-78.0**	**-56.5**	**-47.1**	**-43.1**
(% of GDP)	*(-3.4)*	*(-2.4)*	*(-1.9)*	*(-1.6)*
Net Debt	**714.9**	**772.1**	**823.3**	**864.7**
(% of GDP)	*(31.1)*	*(32.6)*	*(33.1)*	*(33.1)*

The main "disappointment" was the scatter-gun approach taken with the cost of living measures. Limiting the frequency or duration of the measures is appropriate – such as the 6-month cut to petrol excise. A better targeting to lower-income households, however, would have helped contain budget costs. Petrol accounts for a much larger share of spending by low income earners who typically live further out, with less access to public transport and with more cars (Chart 5).

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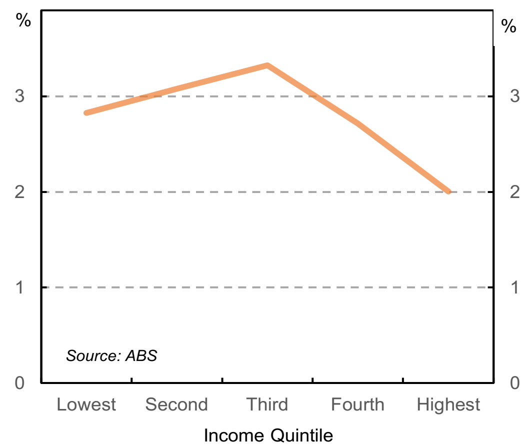

The numbers

The casual observer would probably conclude that budget forecasts are scarcely worth the paper they are written on. (And it's a considerable amount of Paper – Statement No. 1 of this Budget alone runs to 365 pages).

The Budget deficit for 2020/21, for example, was initially put at $214bn. About six months later that had been revised down to $161bn. And a few months after that the actual budget outcome printed at $134bn.

These forecasting gyrations reflect the difficulties in forecasting against the backdrop of an unexpected pandemic-driven recession. So we should cut the Treasury boffins some slack. But it should also be acknowledged that the extraordinary policy response actually worked. A pre-Budget tally of government support and recovery measures stands at $337bn (16% of GDP) over 2019/20-2024/25 (Chart 3).

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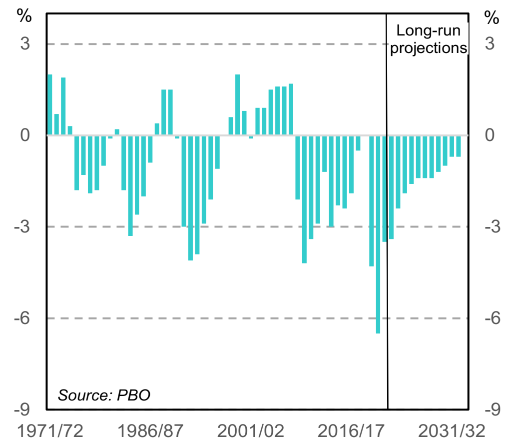

The 2022/23 Budget has also been framed against an uncertain backdrop. With that caveat in mind, the projections show prospective deficits back into the "normal" pre-pandemic range by 2024/25 (Chart 4).

Nevertheless, Budget deficits continue through the current Budget projection period. The deficit declines from 3.4% of GDP in 2022/23 to 1.6% of GDP by 2025/26 (Table 1). And deficits persist thereafter. Longer-run projections stretch out to 2032/33 with not a surplus in sight (Chart 6).

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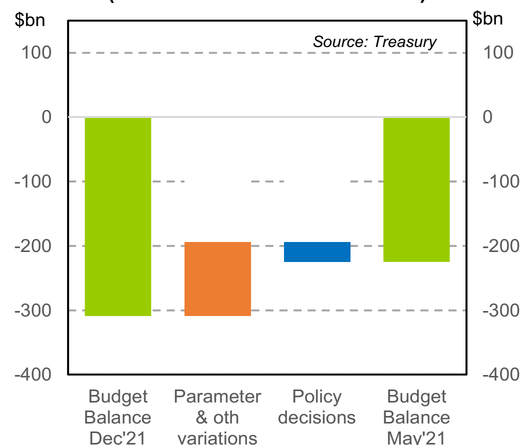

The expectation at the end of 2021 was that Budget deficits would cumulate up to $309bn over the four years to 2025/26. The Budget mathematics (Chart 7) now show that parameter & other variations – or "the economy" – will improve the budget bottom line by $115bn over the period. Some $30bn of this improvement is paid back through policy initiatives.

The cumulative budget *deficits* over the next 4 years now stands at $225bn.

Ongoing budget deficits means government debt outstanding will still rise, although the peak debt is now lower. Nevertheless, *gross* debt will punch through $1 trillion (44.6% of GDP) in 2023/24. Debt declines as a share of GDP thereafter, subsiding to 40.3% of GDP by 2032/33.

The peak may be lower and the trend may be down. But these sorts of debt ratios remain the highest since World War 2 (Chart 8).

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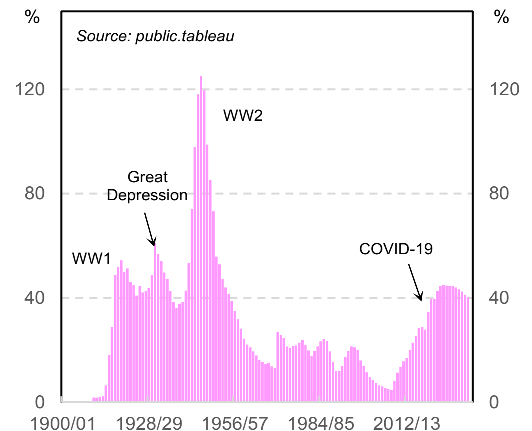

The politics

Politicians learn early on that the voters are an ungrateful lot. Budget goodies are soon forgotten. But perceived failings linger on. And certainly surveys show the dominant perception at the moment is that the government is moving in the wrong direction (Chart 9).

Economists are more generous. Most would acknowledge the exceptional performance of the Australian economy. And the role played by policy makers in delivering that performance.

That performance includes a strong economic recovery that means Australia is one of the few economies where GDP is *above* pre-pandemic levels (Chart 10). And a labour market performance that involved little lasting damage compared with previous recessions (Chart 11).

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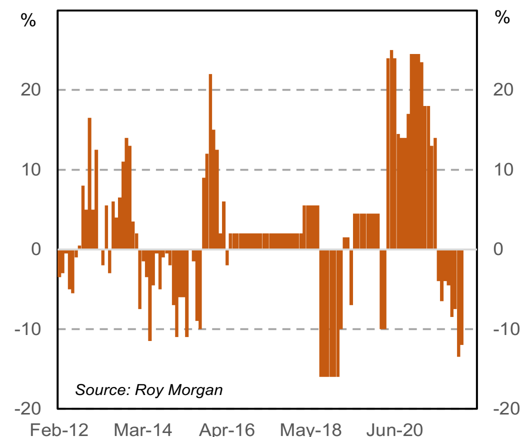

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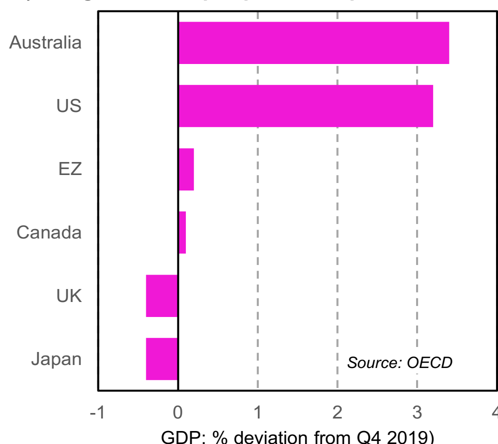

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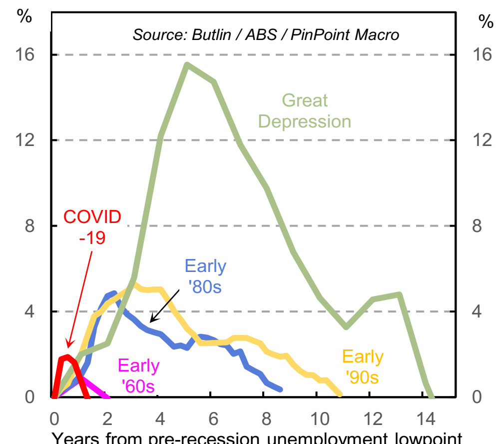

Table 2: Key Issues for Business

	Budget outcome
Climate change	√
Skills shortages	√
Energy policy	x
Tax reform	x
Productivity growth	√
Housing affordability	√

Source: AICD

Table 3: Key Issues for Households

	Budget outcome
Cost of living	√
Healthcare & aging	√
Economy & finances	√
Climate change	√
Employment & wages	√
Housing & interest rates	√

Source: JWS Research

But households and businesses have moved on. Their wish lists for the government to deliver are summarised in Tables 2 & 3. There are some crossovers. Both groups are looking for action on climate change and housing affordability. But some sharp divergences as well.

The government has chosen to go hard on cost-of-living issues, the dominant household concern. And other household concerns have also been addressed to varying degrees. The business wish list received less attention this time.

A word cloud based on the Treasurer's speech underscores the point (Chart 12). Word clouds highlight key words and the frequency of their use. The larger the word, the more it has been used. The cloud shows:

- the cost of living is featured;
- the usual patriotic appeal to "Australians";
- the emphasis on power through the frequent use of "will", "billion", "stronger", "record";
- policy strength through the focus on the "plan", "jobs" and "economy"; and
- some words of reassurance like "support", "plan", "services", "security" and "health".

Pressures on the cost-of-living are widespread. But clearly petrol is a key focus. Voter's trending Google searches for "cheap petrol" are running at record highs (Chart 13). So the decision to cut the petrol excise is smart politics.

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AUSTRALIA: CHEAP PETROL
(trending Google searches)

The ability to deliver a fair amount of pre-Election largesse and deliver an improving fiscal backdrop is, once again, testament to the strength of the economic recovery.

It is also a reflection of the usual political manoeuvring behind the scenes. The Government's war chest was reloaded in earlier fiscal statements. The Mid-Year Economic & Fiscal Outlook (MYEFO) released at the end of 2021 had an allowance of $16bn for policy decisions made but not yet announced over the next four years (Chart 14). This item is a standard feature of budget accounting. But clearly the amount available far exceeds the levels of previous years.

And it seems that there is room for more to be trickled out during the election campaign. This Budget has an allowance of $2.4bn under the "not yet announced" category for the next two years.

The Budget employs what has been the standard assumption in recent years that the iron ore price will eventually subside to US$55 per tonne. By Q3 2022 in this Budget. Economists learn to never change a good forecast – because it will be right eventually. But the iron ore forecast has proved too pessimistic for a very long time (Chart 15). Similar comments apply to other commodity price assumptions.

It is a conservative assumption that does impose some discipline on spending plans. There is, for example, a close correlation between commodity prices, the terms-of-trade and nominal GDP growth. Nominal GDP is total income, or the tax base. The side benefit of a conservative nominal GDP profile is it limits the revenue available for the other side of politics to fund their election promises.

Budget sensitivity analysis shows that a delay in commodity prices dropping to longer run averages by six months would boost nominal GDP by $135bn and tax receipts by $30bn (over the next 4 years).

The correlation between commodities, the terms-of-trade and incomes also highlights one of the structural problems all governments face at present. The benefits of higher commodity prices and a rising terms-of-trade were typically shared across business (profits), households (wages) and government (revenue). But the correlation with wages growth weakened sharply over the 2016-19 period (Chart 16). It explains why faster wages growth is a policy

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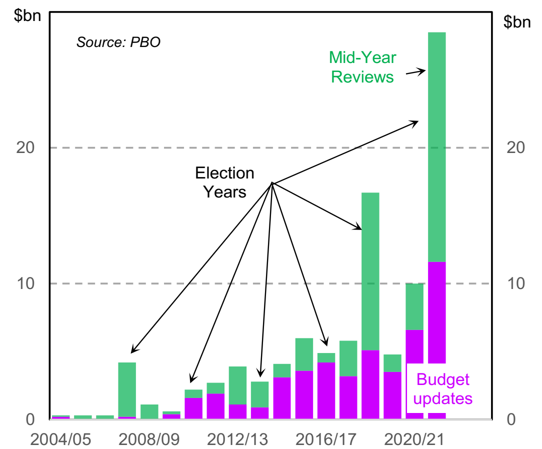

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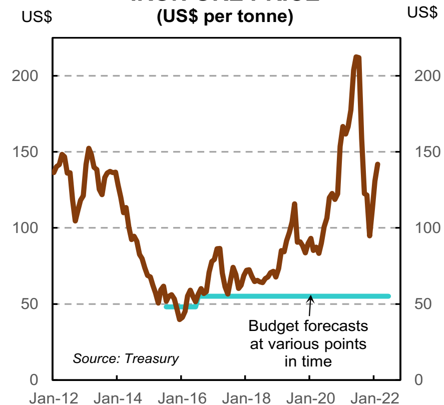

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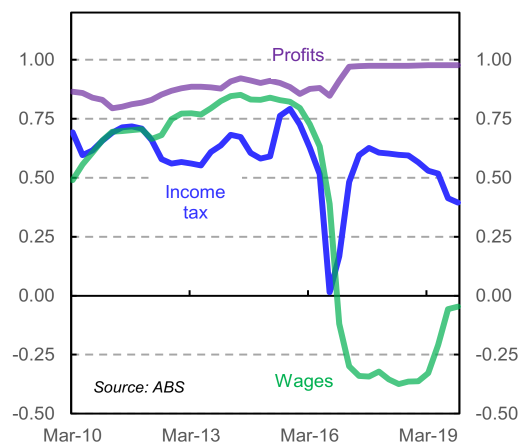

priority. The most effective fiscal tool to this end is getting the tax system right. Australia's over reliance on taxing households is a long running feature of the economic debate (Chart 17).

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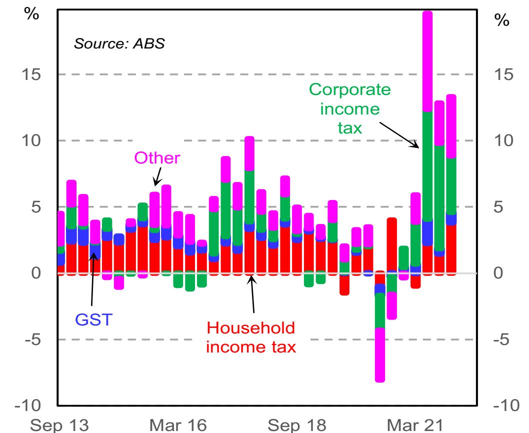

The plan

Beyond the base political considerations, there is still a need for fiscal settings that calibrate to the needs of the economy. These needs have both short and long-term dimensions.

In the short-term its all about sustaining economic momentum. In the longer-run its about setting up the economy and the Budget to deal with issues like climate change and the aging population.

The short-term momentum is needed to deal with the ongoing impact of the pandemic and new challenges such as the Russia-Ukraine conflict. And momentum is needed to allow the RBA to start normalising policy settings and reduce the risks associated with the extended period of low interest rates.

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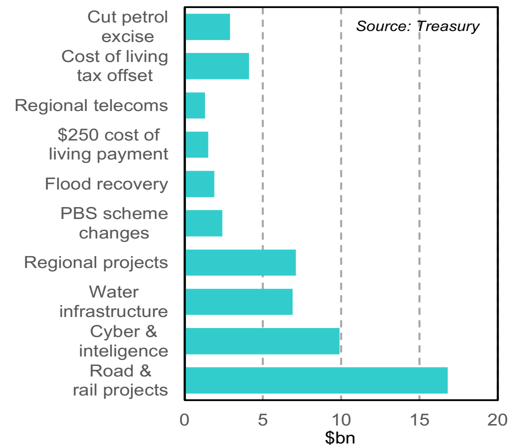

Stripping out the politics behind some Budget decisions, some budget measures should assist in maintaining momentum (Chart 18). These include:

- the support to household spending power from the various cost of living measures – some back-of-the envelope calculations put these measures at $11bn or 1% of consumer spending;
- additional infrastructure spending;
- flood recovery payments;
- defence spending with a significant focus on construction; and
- various regional initiatives.

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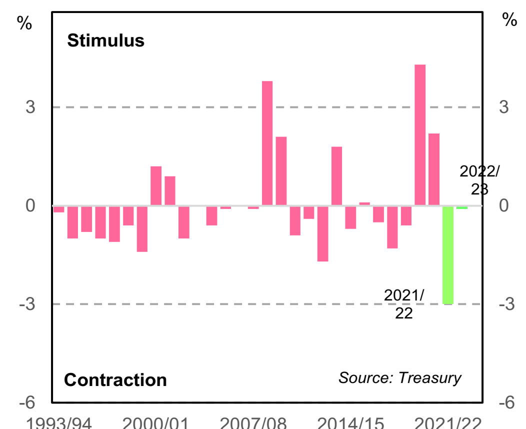

Policy makers have taken the lessons from the fiscal mistakes made after the Global Financial Crisis (GFC) in 2007-09. Too rapid a fiscal withdrawal in some countries, especially in Europe, crimped recoveries post GFC. And made the process of fiscal repair harder to achieve.

The 2022 Budget does shift the fiscal dial further in a contractionary direction - just (Chart 19). The fiscal contraction in last year's Budget was quite large. But this was a mathematical inevitability rather than a policy choice given the size of the stimulus injected

in the previous two years. The additional contraction in this year's Budget is very modest. It shouldn't provide much of a headwind to the recovery.

The shift in fiscal thinking comes as policy makers sense one of the more elusive policy goals is within their grasp. As discussed earlier, this goal is full employment.

Full employment is something of a movable feast. A number in the 3-4% range seems to be the current consensus. The Budget forecasts have the unemployment rate at 3¾% later in 2022. And, somewhat surprisingly, tracking sideways from there.

A sub 4% unemployment rate was last achieved back in 1974. As I observed in last month's *inFocus*, Gough Whitlam was Prime Minister, Richard Nixon had just quit as US President, Cyclone Tracy hit Darwin and some band called ABBA had just won the Eurovision song contest!

A new goal brings with it the need for a new benchmark to measure fiscal progress. The Treasurer has been road testing some ideas in the past few months. The focus has settled on the debt:GDP ratio. And the benchmark for success is a declining ratio over time.

The debt:GDP ratio typically rises as a result of recession and war. We have managed to wind the ratio back after the various spikes recorded over the past century (Chart 20). And the Budget projections indicate we are on track to achieve that goal.

That said, progress in winding back the ratio is quite slow relative to previous debt reduction cycles. (Chart 20 again).

The Treasurer has also been heavily marketing the fiscal sustainability "equation". Fiscal sustainability requires the interest rate on government debt to remain below the growth rate in nominal GDP. In that case debt:GDP ratios will decline over time.

Budget figuring assumes a weighted average bond yield of only 2¼%. And have nominal GDP growth running at a healthy average of 4¾%pa. It looks like "mission accomplished" (Chart 21).

As anyone with a mortgage knows, it's not so much how much you owe as whether you can *service* the debt. And the Budget figuring is a little less attractive on debt servicing. Projections for net interest

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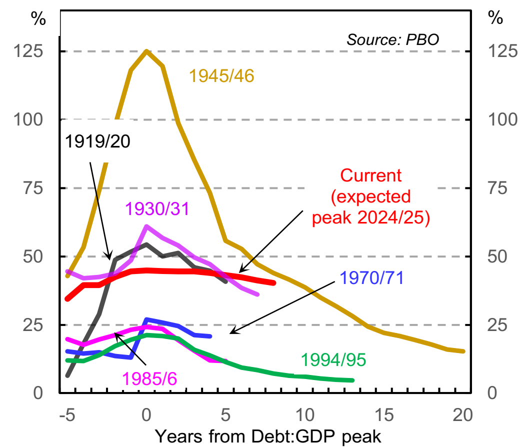

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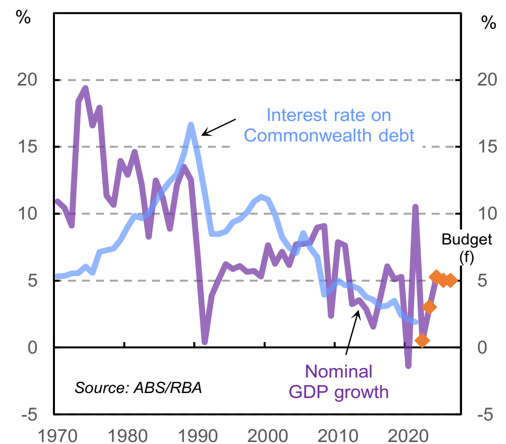

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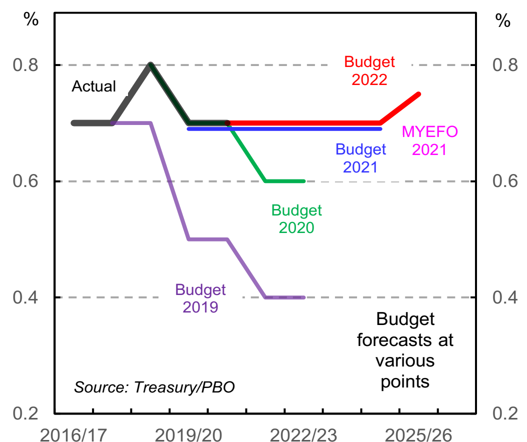

payments have steadily increased since the 2019 Budget. And a smallish further rise is pencilled into this Budget (Chart 22).

That said, debt servicing costs remain quite low overall. And well below levels recorded last time the debt:GDP ratio rose during the 1990s (Chart 23).

Sustainability is helped by some smart moves by the Australian Office of Financial Management (AOFM). They manage the national debt for the Government. The AOFM has taken advantage of the period of low interest rates to issue more long-term debt. The average duration of Commonwealth government bonds on issue now stands at over 7 years (Chart 24). They have essentially "locked in" low interest rates for an extended period.

The Government wants to shift the focus to the debt:GDP ratio for judging the Budget. And that's a useful addition to the debate. But we shouldn't ignore the more traditional Budget benchmarks.

Economists, for example, generally have little concern about debt used to invest in assets that generate a return and help the economy over the medium term – like infrastructure. They are less comfortable with debt that is used to finance *recurrent* spending.

The COVID policy response did push up recurrent spending sharply (proxied by the net operating balance on Chart 25). But this balance is now declining back to more "normal" levels. The Government's needs will increasingly reflect borrowing for capital spending.

As a sporting nation we often want to benchmark Australia against our global competitors.

Data from the IMF shows that on a globally comparable basis Australian government debt stands well below most G-7 economies and at the middle of the range of advanced economies overall.

The Budget economic parameters, if achieved, would mean some very respectable outcomes for the Australian economy.

Budget forecasts are summarised in Table 4. The recovery is projected to accelerate in 2022/23. Growth is strong enough to drive solid job gains and reach full employment. The only fly in the ointment is an uncomfortably high inflation rate that will add to

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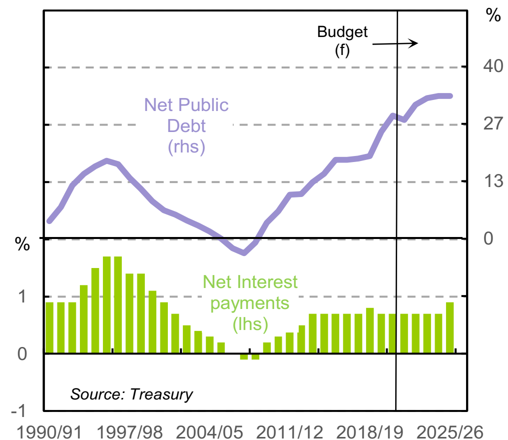

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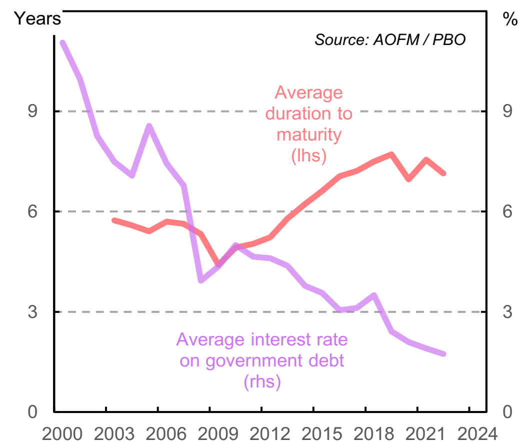

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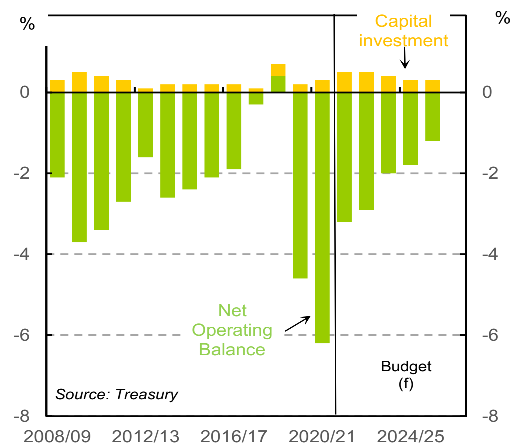

pressure on the RBA to lift interest rates. The only disappointment is the lack of wage inflation despite achieving full employment. Wages growth is assumed to pick up. But it remains below the 3½%pa rate previously regarded as "normal". The forecasts also imply a further fall in real wages in the near term.

A lot needs to go right to turn these forecasts into reality. In particular, we need to see full participation by the Australian consumer and Australian business.

Consumer spending does most of the heavy lifting, rising by very robust 5¾% in 2022/23. If achieved, this would be the fastest growth in consumer spending since 1981/82. Higher mortgage rates would be a headwind. But Budget handouts and a very high level of excess savings are available to fund an increase in spending. Falling unemployment should help give consumers confidence to spend.

Business investment is a long-running source of disappointment in the Australian economic story. Capex as a share of GDP is at multi-decade lows. Leading indicators are encouraging. But business capex remains a major downside *domestic* risk.

Budget forecasts have business investment rising by a chunky 9% in 2022/23. Some of the temporary business capex incentives in the Budget, such as the small business Technology Investment Boost, will help. Additional funding for the Modern Manufacturing Strategy will also help.

The current account balance is projected to collapse back into deficit. The extraordinary turnaround of nearly 10% of GDP is the mechanical outcome of an equally impressive collapse in Australia's terms-of-trade. The forecasts look way too pessimistic.

The current account forecasts are usually ignored in the Budget analysis. The current view is that there is a structural or permanent improvement in our external position. For the accountants, a surplus means we no longer need to borrow from the rest of the world. Our exposure to global risks is lower as a result. The current account surplus is one reason why the agencies are happy to leave Australia with a AAA credit rating despite large budget deficits (Chart 26). This rating could be at risk if the current account forecasts prove correct.

Table 4: Key Forecasts (%pa)

	21/22	22/23	23/24
Real GDP	**4¼**	**3½**	**2½**
Employment	2¾	1½	1½
Unemployment (%)	**4**	**3¾**	**3¾**
CPI (yr to June)	4¼	3	2¾
Wages (yr to June)	2¾	3¼	3¼
Terms-of-trade	11	-21¼	-8¾
Nominal GDP	**10¾**	**½**	**3**
Current account (% of GDP)	3¾	-3¼	-6

Source: Treasury

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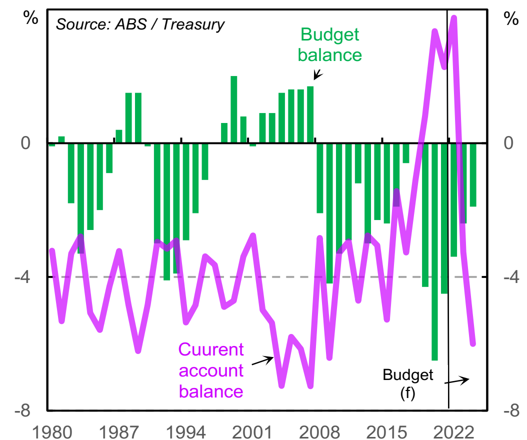
AUSTRALIA: KEY BALANCES
(% of GDP)



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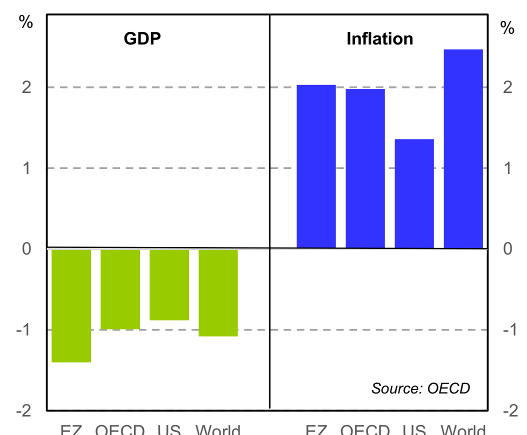
RUSSIA-UKRAINE CONFLICT
(impact on GDP & inflation | % dev from baseline)



The global backdrop is also uncertain. Along side some of the longer-running risks such as the pandemic, supply chain disruptions, imbalances in the Chinese property and financial markets, there is now a new uncertainty related to the Russia-Ukraine war.

Some preliminary analysis by the OECD suggests the war could reduce global GDP growth and lift global inflation rates (Chart 27). The projections show the war could reduce global GDP growth by 1% and add more than 2% to the global inflation rate.

All wars involve winners and losers. And Australia will have a foot in both those camps. The tragedy in the Ukraine has contributed to higher commodity prices. As a commodity exporter, Australia benefits. The terms of trade rises, driving national income higher. Government revenue and company profits are where the gains appear. The other outcome that seems certain is higher inflation. Real wages weaken further in that environment and the pressure on the RBA to increase interest rates intensifies.

The Budget is always under pressure. It reflects the classic economist's dilemma: balancing out unlimited wants with limited resources.

The inability to get that balance right has contributed to a decline in trust in government (Chart 28). One idea that has developed on the back of this is the budget is really a contract between the population and government. And this contract is urgent need of repair.

The social experts who have researched this issue suggest that getting the fiscal policy settings right for the longer-term is key. Short-term fixes with other objectives in mind, such as winning votes, should be avoided.

An example is Australia's aging population. It's an area where costs will rise over time with no clear plan on how to fund those rising costs.

A dissection of government spending based on age throws up some clear warning signs for older age groups. Older age groups receive a larger share of government largesse than any other on a per capita basis (Chart 29). This skew reflects spending associated with health, the age pension and aged cared.

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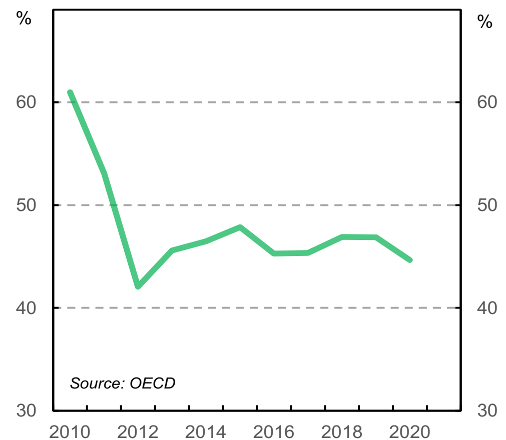

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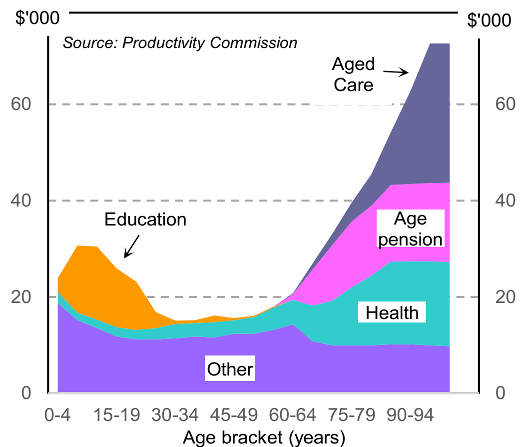

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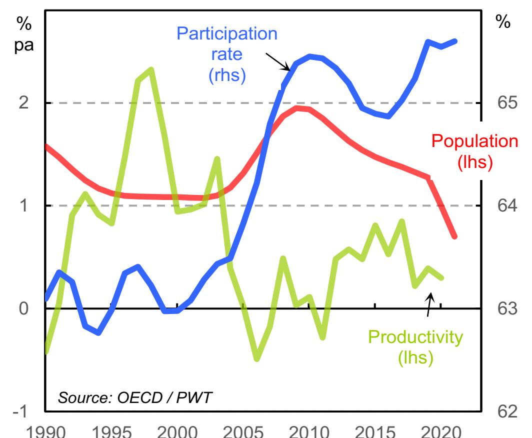


The implication is that governments of all persuasions will need to keep a tight rein on *spending*. The pressure on older age groups to fund their own retirement will only continue. From that perspective, the 2022 Budget will add to those pressures as spending on age care is lifted further. The Royal Commission into Aged Care suggests more spending will be required.

Economists will always agree that Budgets need to be judged by their longer-term implications as much as anything else. And economists will also always then reach into their kitbags and pull out the 3 P's.

The 3-P's are Population, Participation and Productivity. Trends in the 3 P's ultimately drive economic activity, jobs and incomes (Chart 30). They create the wealth needed to fund Australia's longer-run objectives and deal with the longer-run challenges.

While not strictly a Budget measure, the decision to reopen the Australian border will see *population* growth pick up. The Budget parameters have net overseas migration returning to more normal levels of 213,000 by 2024.

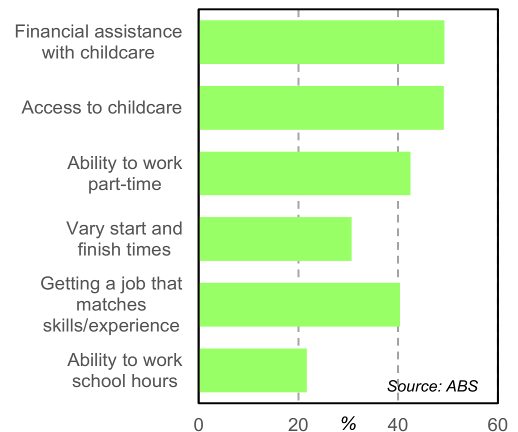
Some Budget measures will help lift *participation.* Spending on Childcare is typically seen as the key to raising participation (Chart 31). But measures in the 2022 Budget such as the enhanced Paid Parental Leave Scheme and changes to income thresholds will help.

And some measures will help with *productivity*. The additional spending on infrastructure is particularly notable – on transport, water, supply chains and telecommunications.

Economists love infrastructure because it generates activity and jobs. But it also lifts productivity. Economists will also like the additional spending announced on apprenticeships and skills. Upskilling is not only good for productivity but is also associated with increased earnings (Chart 32).

Meanwhile, I'm off to book a seat on the Sydney-Newcastle bullet train!

31



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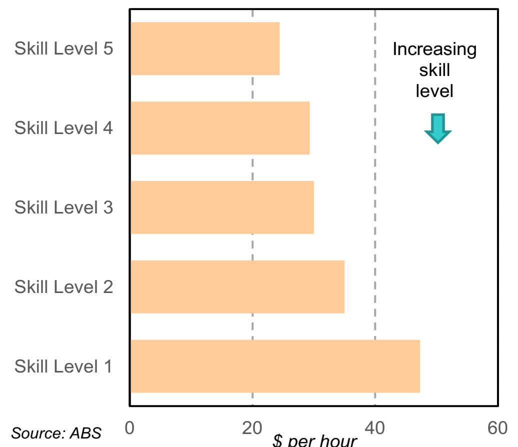

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