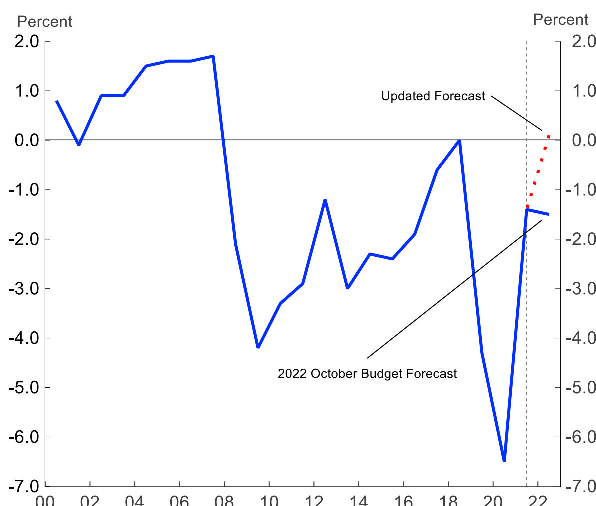
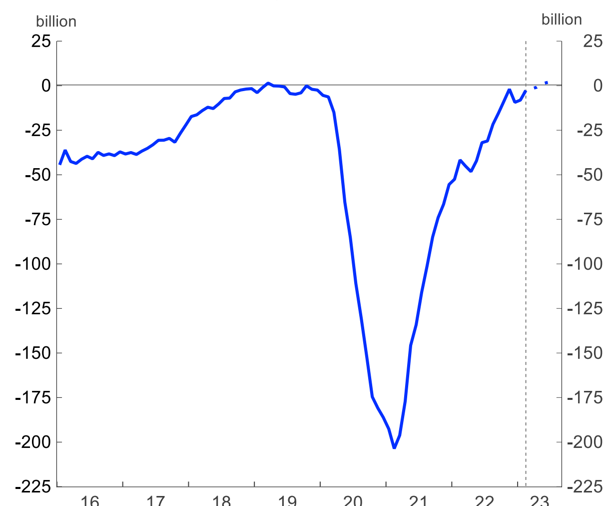
Thursday, 27 April 2023

Fiscal Insights

Can Jim 'Charm' the Budget?

- **In two weeks, the Treasurer will deliver one of the most difficult budgets to frame in recent memory. There are mounting pressures pulling the public purse in opposite directions.**
- **Household incomes have gone backwards at a record pace due to high inflation, increasing interest rates and accelerating rents. While it may be appropriate to provide vulnerable Australians with cost-of-living support, untargeted spending risks adding to inflationary pressures, which can only mean one thing - higher interest rates.**
- **There are likely to be new calls on the budget. The Government has flagged initiatives to strengthen the resilience of the economy through spending on the care sector and investing in clean energy. There are unavoidable decisions on expiring tax measures and providing the housing and infrastructure required for the record surge in overseas arrivals. Without offsetting savings or an increase in the tax take, larger deficits risk downgrades to Australia's credit rating.**
- **The 2022-23 bottom line is likely to be much better than expected, making it challenging to convince the electorate on the need for restraint. Indeed, on the back of higher-than-expected commodity prices, the record surge in overseas arrivals and elevated inflation, which push up income and indirect tax receipts, we expect the 2022-23 bottom line to improve from a forecast deficit of 1.5 per cent of GDP (2022 October Budget estimate) to a small surplus of 0.1 per cent of GDP. This would be the first time since 2007-08 that the budget is in surplus.**
- **We plan to publish a series of insights in the lead up to the 9 May Budget. This first note looks at the improving budget bottom line over the next two years. Given the backdrop of an improving fiscal position, we argue that focussing on alternative published measures of the bottom line may better reflect the broad sweep of funding pressures.**





Following recent travels to the International Monetary Fund (IMF) and World Bank Spring Meetings, the Federal Treasurer warned the global economy is in a “precarious position.” Russia’s invasion of the Ukraine, improving but ongoing supply-chain disruptions, banking turmoil in the US and Europe, and pressure on incomes from elevated inflation and higher interest rates are all contributing to a more volatile global economy and a more uncertain outlook.

We would add that the Treasury coffers have indirectly benefited from the outcomes of this volatility. High commodity prices, elevated inflation, and the record surge in the overseas arrivals have, to some extent, resulted from the shocks to the global economy and are boosting revenue.

Take net overseas arrivals for example. While overseas arrivals have made an impressive recovery following the resumption of international travel, the recovery in Aussie’s departing our shores has lagged, contributing to the record net arrival number. Without the volatility in the global economy departures could be significantly higher, which would have resulted in lower net arrivals.

What’s the fiscal impact of the record surge in overseas arrivals?

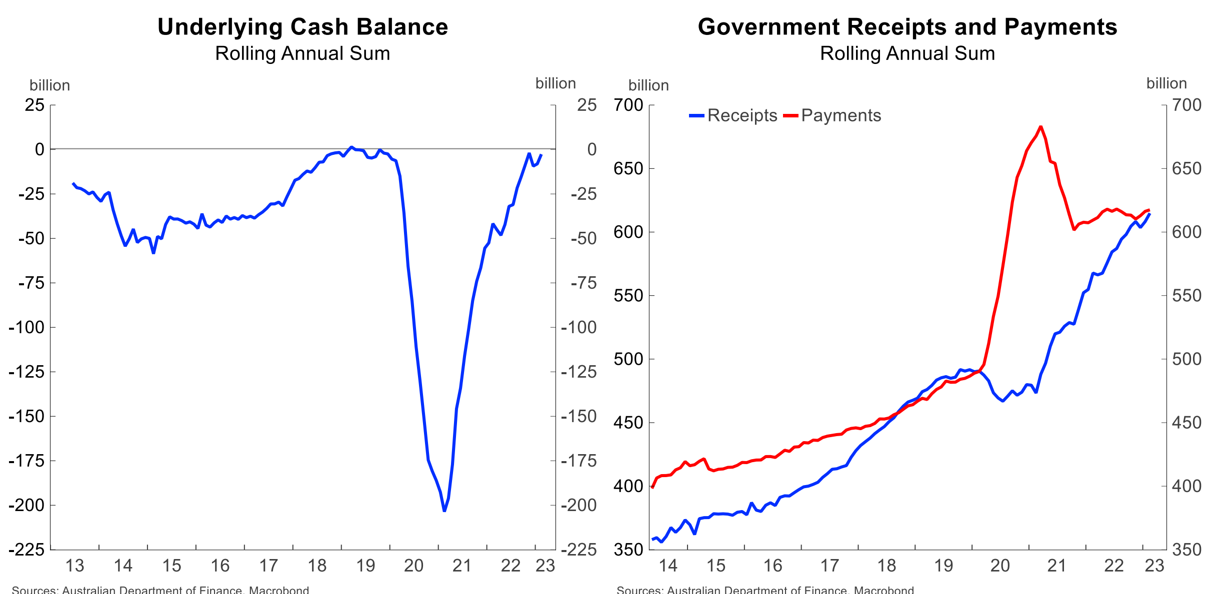
There has been substantial commentary to date focused on the budget windfalls from higher-than-expected commodity prices and elevated inflation. However, the record surge in net overseas arrivals will also provide a significant fiscal dividend.

Foreigners that relocate to Australia pay income tax on their salaries and indirect taxes on the goods and services they consume. They also have limited access to subsidised public services and income support payments – this means that the net positive impact on the budget will be front loaded.

Net overseas arrivals in the temporary visa categories that add to labour supply were around 390,000 over the first nine months of 2022-23 – a record high. Consistent with these numbers, the Treasurer has publicly stated that net overseas migration will be upgraded to around 650,000 over 2022-23 and 2023-24 in the May Budget – much higher than the 470,000 expected in the October 2022 Budget. Based on these figures, we estimate that the record surge in arrivals will add around $2.5 billion to government revenue in 2022-23 alone (this includes personal income tax, visa application charges and other indirect taxes such as GST), $5.5 billion over 2022-23 and 2023-24, and around $11 billion over the four years to 2025-26.

Has Treasury already banked some of these revenue windfalls?

The short answer is, absolutely! Over the past year, the Budget position has improved by an impressive $39 billion.



Monthly finance statistics show that the deficit over the year to the end of February 2023 was $2.7 billion compared with a deficit of $41.7 billion over the year to the end of February 2022.

These statistics show that the improvement has largely been driven by higher tax receipts, most notably company and personal income tax receipts. Growth in government payments has also moderated, contributing to the impressive budget turnaround.

This improvement was not expected five months ago when the 2022 October Budget was published - the deficit was forecast to deteriorate from $32 billion in 2021-22 to $37 billion in 2022-23.

We expect this improvement to persist over the remainder of 2022-23 and deliver the first small surplus since 2007-08.

- The labour market remains incredibly resilient, and arrivals continue to surprise on the upside, adding to the number of people employed. This will continue to boost personal income tax, indirect taxes and lead to lower than expected social assistance benefits, including unemployment benefits.
- Commodity prices are likely to remain elevated and higher than the assumed long run price factored into the budget over the remainder of the year. More importantly, given the lags in the tax system, the budget will receive a boost when businesses, particularly miners, make tax balancing payments this financial year. We estimate that the higher-than-expected commodity prices will add around $9 billion to tax collections in 2022-23, $12 billion in 2023-24 and around $22 billion over the four years to 2025-26. This assumes no change to the current commodity price forecasting framework, which will provide a further boost to revenue.
- Inflation while falling remains elevated. This will increase indirect tax collections such as GST and fuel and alcohol excise.
- Payments are likely to partly offset some of this strength – indexation of government support payments in late March and the payments of grants to states/local government are likely to increase as we approach the end of the financial year.

Putting all this together, the fiscal automatic stabilisers are expected to deliver a small budget surplus of 0.1 per cent of GDP in 2022-23.

Of course, the other side of the equation is spending due to policy changes. The government has flagged some of cost-of-living support such as “electricity subsidies” which may tip the outcome into a small deficit.

Does this mean there is going to be a surplus in 2023-24?

Unlikely! The lags in the tax system will deliver around $25 billion in windfalls from the current strength in commodity prices and the larger labour market in 2023-24. However, under the weight of higher interest rates and accelerating rents, we expect the economy to slow and the unemployment rate to increase in 2023-24. This will be a drag on the budget.

There will also be additional spending pressures hitting 2023-24 and the outer forecast years, such as the aged care wage decision and the greater than expected take up of government programs such as the NDIS.

The government will also have to make unavoidable decisions around expiring COVID-related measures, including the immediate expensing and the loss carry back schemes, which may mean more spending. We will discuss the unwinding of some of these measures and the implications for the economy in a forthcoming note.

Is a 2022-23 balanced budget or surplus at odds with the Government's call for restraint?

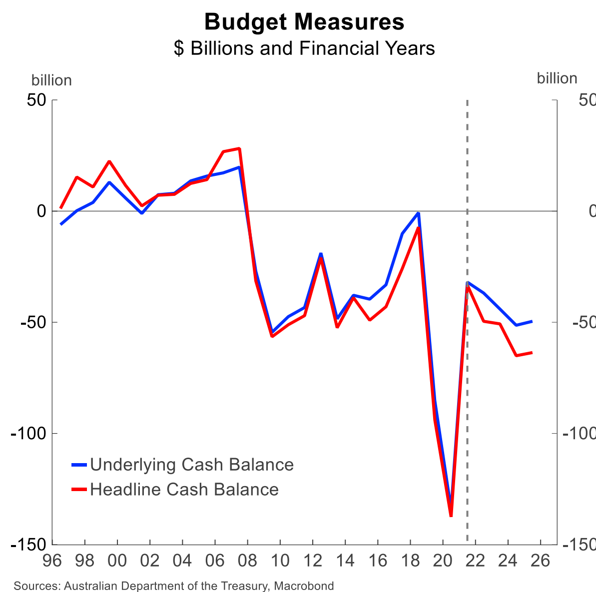
It may be hard to convince Australians that there is urgent need for fiscal restraint or tax increases if the budget is back in balance or records a small surplus.

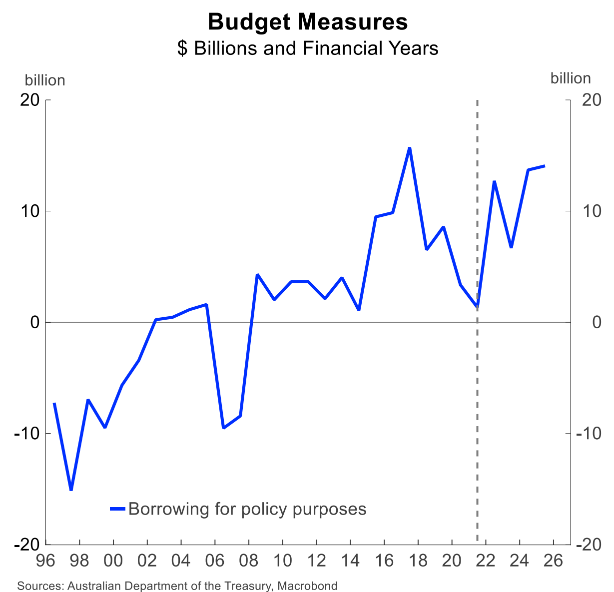
One approach is to focus on the medium-term pressures, such as NDIS and aged care.

Another is for commentators and analyst to place more emphasis on the headline budget balance (HCB), rather than the underlying measure (UCB), to better reflect the broad sweep of policy funding initiatives.

The HCB includes the use of public balance sheet or borrowing to finance policy initiatives. The UCB does not capture these balance sheet transactions.

Borrowing to fund policy priorities adds to gross debt, which needs to be serviced and eventually paid off. The October 2022 Budget showed that the Government expects to borrow around $15 billion by the end of the forward estimates period in 2025-26 to fund policy.





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