Bank of Melbourne

Tuesday, 3 May 2016

Federal Budget 2016-17

First Thoughts: Not A Plan. Just Another Budget.

- Tonight's Budget aims for a deficit in 2016-17 of $37.1bn. This compares with an expected deficit of $39.9bn in 2015-16 and $37.9bn in 2014-15. Is this progress? The numbers suggest otherwise.
- In last year's Budget the government expected a deficit in 2015-16 of $35.1bn. That was revised upward at the Mid-year Review to $37.4bn and now, five months later is expected to be $39.9bn.
- So when does the Budget return to surplus? Not in the four years of the forward estimates, but it might get close in 2020 if the projections are to be believed. Given the fragile nature of the transition in the Australian economy away from the mining investment boom and towards more diversified growth, a 'slash and burn' Budget would not have been appropriate. This Budget chips away at the edges and does not rock the boat prior to the election.
- What about the forecasts? Like every Budget, the estimates are underpinned by the assumptions regarding economic growth and incomes. The Budget assumes GDP economic growth of 2.5% in 2016-17 and a pickup to 3.0% in 2017-18. Nominal GDP is expected to pick up to 4.5% in 2016-17 and 5% in 2017-18. The improvement to the Budget bottom line also seems to rely on stabilising commodity prices and a further decline in the unemployment rate to 5.5%. Our forecast is for the economy to grow at a slightly higher 2.7% in 2016-17 and similar growth of 3.0% for 2017-18. Moreover, given the improvement in the labour market of late and the recent rebound in commodity prices, the Budget assumptions appear reasonable. Nonetheless, the Government is relying on a pickup in growth and improving incomes to reduce the Budget deficit.
- How vital is rapid budget repair? Over time, an economy that is growing should be able to reach a budget surplus. Surpluses provide an economy with ammunition for when times get tough. Sooner or later tough times will emerge and fiscal expansion will be required. It would be good to do this from a position of surplus rather than deficit. The 2016-17 Budget plots a course towards a surplus that relies upon economic growth rather than true Budget repair. It did not really tackle the tough structural issues that were promised when talk of tax reform was in the air. Tax reform has been placed in the too hard basket at least until after the 2016 election.
- Is our AAA credit rating at risk? Not from this Budget. Moodys has already reaffirmed the Australia's credit rating following the Budget but did note that the Budget remains vulnerable to adverse shocks. Australia's government debt position is better than many other advanced economies and government debt repayments are not onerous. It is heartening to see that the Federal government is prepared to use its balance sheet and its AAA credit rating to assist the States with their infrastructure financing needs
- Will tonight's Budget build business and consumer confidence? There were measures that should benefit small to medium sized businesses (see below) but there were fewer positive measures for consumers. The Budget should lift the spirits of those beneficiaries of new spending and tax deductions. Equally it will disappoint those whose agendas have not been accepted. Much will depend on how the politics of the Budget are played out in the media. Bitter political headlines do

little to lift confidence.

- What does the Budget mean for economic growth in 2016-17? The Budget was neither hot nor cold. Spending and concessions were funded by savings elsewhere in the Budget. As such it will not massively add to nor detract from growth. The company tax cuts have the potential to lift investment and hiring but will not set the economy on fire. Of more benefit will be the RBA rate cut and the weakness on the Australian dollar that has flowed from it. This is not a bad Budget. It will make a modest contribution to growth in parts of the economy but it is by no means bold and progressive. Perhaps that will wait until after the election.

- The Budget and interest rates. The RBA trumped the Budget by reducing the cash rate from 2.00% to 1.75% just prior to the Budget. The Budget forecasts modest economic growth in 2016-17 which all but rules out any rate hikes in the next twelve months. It also leaves the door open for a rate cut if growth appears to be falling short of the targets for 2016-17. With the latest rate cut coming on the heels of weak inflation numbers, the outlook for inflation over the next 18 months will be crucial. While a low cash rate seems certain for the next twelve months, there is also likely to be little movement on longer yields. The US appears to be backing away from multiple rate hikes and may do, at most, two small hikes in 2016 if not less. As such there should be little upward pressure on bond yields.

- The Budget and the AUD. The AUD tumbled after the RBA's rate cut and resumed its decline after the Budget was announced. The extended decline was more likely European reaction to the RBA rather than a negative response to the Budget. The direction of the AUD over the next six months will depend upon interest rate differentials and commodity prices. We expect the AUD/USD to sit around $US 0.74 by December 2016, driven by the expectation of slightly higher interest rates in the United States and some retracement in commodity prices.

Budget aggregates and major economic parameters

Budget aggregates

	Actual		Estimates		Projections	
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Underlying cash balance ($b)(a)	**-37.9**	**-39.9**	**-37.1**	**-26.1**	**-15.4**	**-6.0**
Per cent of GDP	-2.4	-2.4	-2.2	-1.4	-0.8	-0.3
Fiscal balance ($b)	**-39.9**	**-39.4**	**-37.1**	**-18.7**	**-9.8**	**-2.1**
Per cent of GDP	-2.5	-2.4	-2.2	-1.0	-0.5	-0.1

(a) Excludes net Future Fund earnings.

Major economic parameters(b)

	Outcomes		Forecasts		Projections	
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Real GDP	2.2	2 1/2	2 1/2	3	3	3
Employment	1.6	2	1 3/4	1 3/4	1 1/4	1 1/2
Unemployment rate	6.1	5 3/4	5 1/2	5 1/2	5 1/2	5 1/2
Consumer price index	1.5	1 1/4	2	2 1/4	2 1/2	2 1/2
Wage price index	2.3	2 1/4	2 1/2	2 3/4	3 1/4	3 1/2
Nominal GDP	1.6	2 1/2	4 1/4	5	5	5

(b) Year average growth unless otherwise stated. From 2014-15 to 2017-18, employment and the wage price index are through the year growth to the June quarter. The unemployment rate is the rate for the June quarter. The consumer price index is through the year growth to the June quarter.

Source: ABS cat. no. 5206.0, 6202.0, 6345.0, 6401.0 and Treasury.

Budget Overview

For Businesses:

- A Ten Year Enterprise Tax Plan that will boost new investment, create and support jobs and increase real wages, starting with tax cuts for small and medium-sized enterprises, continued investment in the National Innovation and Science agenda, including support for new start-up businesses.
- From 1 July 2016, businesses with annual turnover less than $10 million will have a company tax rate of 27.5% and progressively lowered to 25% by 2026-27 for all companies.
- Concessions available to small businesses will be extended from businesses with turnover less than $2 million to businesses with turnover less than $10 million from 1 July 2016.
- Combating tax avoidance, especially by multinational corporations. This includes an introduction of a Diverted Profits Tax to impose a 40% penalty rate of tax on multinational corporates that attempt to shift their Australian profits offshore to avoid paying tax.

Defence:

- An additional $29.9 billion for Defence, including the building of submarines, frigates offshore patrol vessels and Pacific patrol boats. Securing an advanced local defence manufacturing industry through the twenty year defence industry plan, driving new high-tech jobs in Australia, including 3,600 direct jobs as part of the Government's naval shipbuilding programme.

Youth Employment:

- Investment of $840 million in a Youth Employment Package, creating a Jobs Programme (PaTH) for training, skills and internship placements.

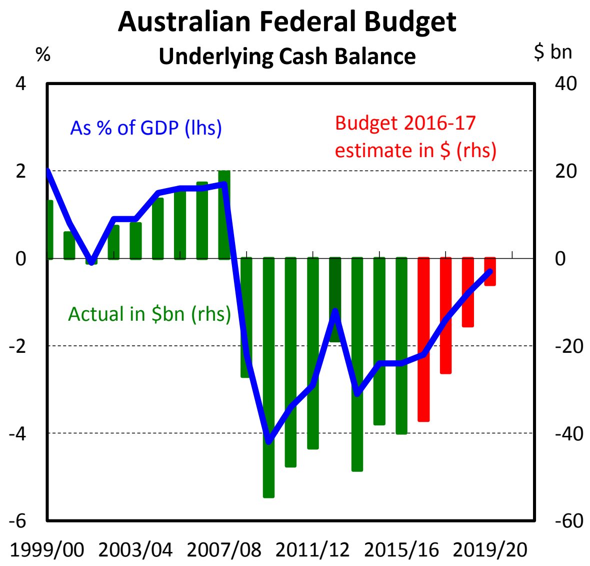
Superannuation Concessions:

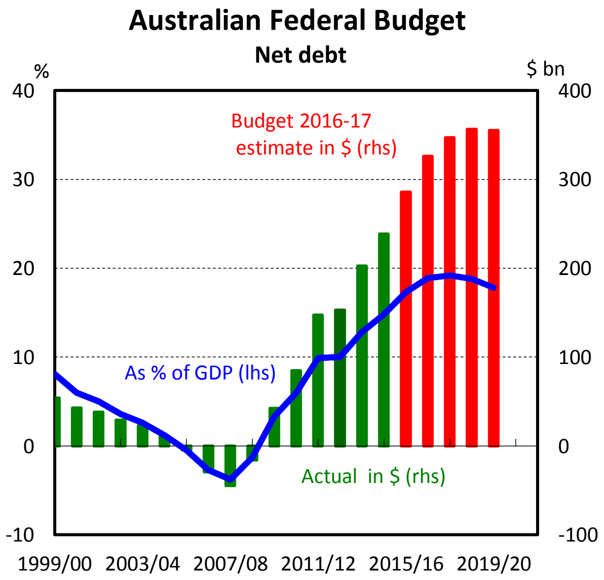
- Closing off generous superannuation tax concessions for Australia's most wealthy and better targeting superannuation tax concessions to support working Australians build independent wealth for their retirement. This includes a introduction of a $1.6 million transfer balance cap on the amount that can be transferred to tax-free retirement phase accounts, 30% tax on concessional contributions for those earning over $250,000, a lower $25,000 annual concessional contribution cap and a $500,000 lifetime non-concessional cap.

Income Tax Changes:

- Raising the 32.5% tax threshold from $80,000 to $87,000. This will reduce taxpayers facing the 37% marginal tax rate.

The Key Macro Budget Charts





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