Federal Budget 2024-25

Budget Preview

12 May 2024

Business wants fiscal discipline, then help to lift productivity

A year on from the 2023-24 Budget, with the economy facing the prospect of interest rates and inflation remaining higher for longer, we find ourselves reinforcing the calls we made this time last year.

We maintain our view that business, and the Australian people more broadly, need the Government to prioritise fiscal discipline to ensure inflation isn't higher than it needs to be; bring the structural budget closer to balance; and accelerate the pace of policy reform to help boost our flailing productivity.

This year, like last year and the year before, we call on the Government:

1. Not add to spending, unless offsetting it elsewhere
2. Change existing policy to lower spending and find new revenue that will persist over time
3. Put in place policies to assist the private sector to maximise productivity growth.

Headline inflation has come down from a peak of 7.8 per cent to 3.6 per cent in the year to the March quarter and consumers have tightened their belts. Unemployment remains low. But with inflation outside the Reserve Bank's target band, the Government cannot afford to let fiscal discipline slip. This is especially so given $23 billion of tax cuts are already locked and loaded, additional spending has been announced for housing, and state governments are providing billions of dollars in household handouts too. Offsetting new spending with cuts elsewhere, at least over the next 12 months, is essential to keeping the fiscal envelope tight.

Progress in narrowing the structural deficit has been encouraging but needs to go much further too. The list of policy announcements that are likely to increase expenses on an ongoing basis also need to be offset with cuts that are even larger to bring long term spending and revenue back into balance.

Building a better working world

With numerous, well-known external challenges, the reform reviews that have been commissioned and researched over the last two years should urgently progress, including trade reform, the Universities Accord, and the migration redesign.

The Future Made in Australia policy seems likely to divert labour and capital resources to meet non-economic policy ambitions, and so additional work will be required to boost productivity growth through ongoing structural reform.

There will be an election within 12 months, so the Government should use this Budget to convince voters why a more ambitious agenda, including root and branch reform of the tax system, is needed in its second term. If done optimally, tax reform will reduce waste, boost productivity and go a long way to fixing the structural budget deficit.

Fiscal discipline is essential in a precarious inflation environment

It's widely expected the Government will provide further cost-of-living assistance to households and small business.

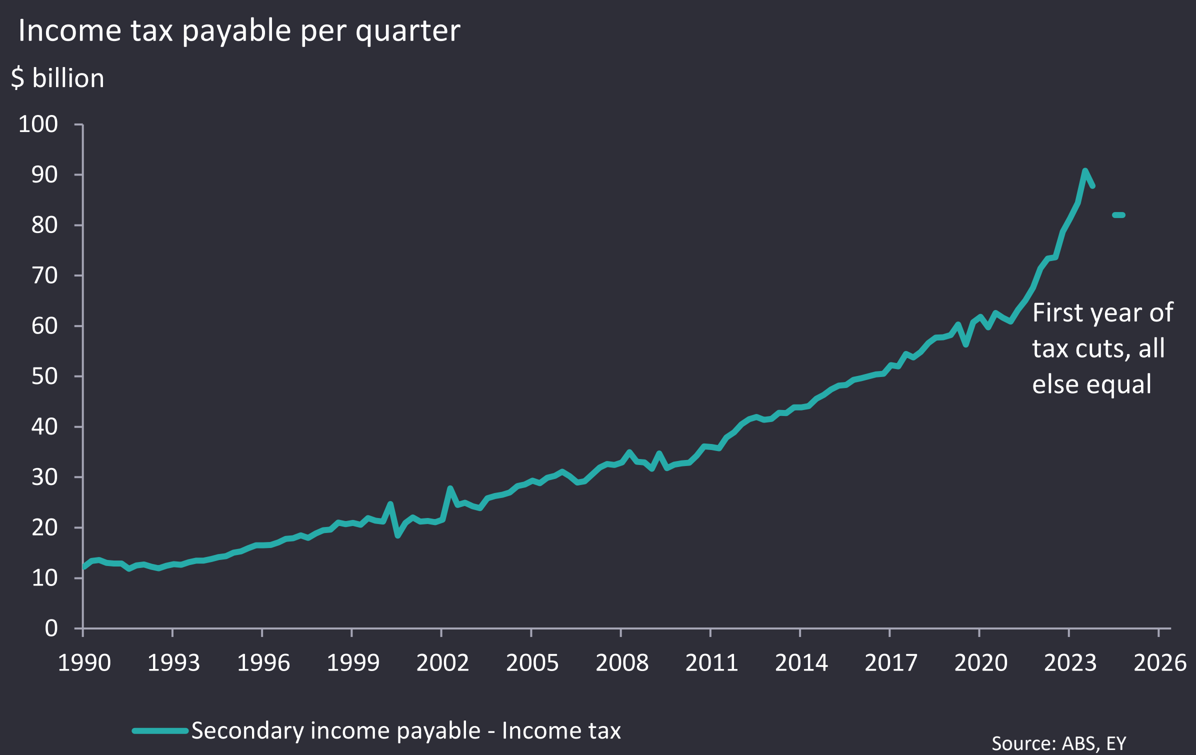
Importantly, this will build on the housing commitments and cost-of-living relief already announced this month, including by the Victorian and Western Australian governments in their budgets, and the recently announced electricity rebate for Queensland households. We estimate these state measures will, collectively, add $3.5 billion to the economy over the coming four years, with most of that expenditure concentrated in the near term.

The redesigned 'Stage 3' personal income tax cuts, starting 1 July, are being packaged as part of the cost-of-living relief measures, but they are not new policy in this Budget.

The redesign – which will lower the tax cuts for those earning over $150,000 pa, and increase the cuts to those earning less – will decrease revenue by roughly the same amount as the original design, according to Treasury estimates.

In the first year, they are estimated to lower government revenue by around $23 billion, and more thereafter. The $23 billion of tax cuts only offsets some of the higher tax take that households have been paying over recent years, including because of bracket creep. Income tax payable increased by a record $47 billion in 2023 compared to 2022, with the share of income tax relative to household income rising by 2-3 percentage points to about 23 per cent in 2023.

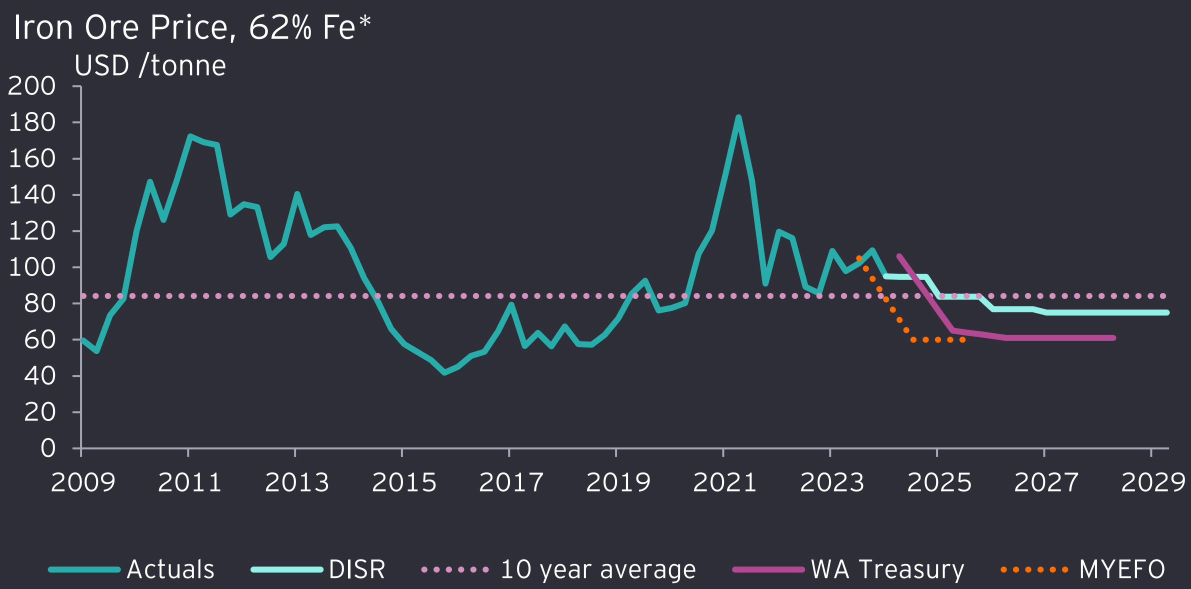
The tax cuts will not change the inflation outlook held by the Reserve Bank, as the broad tax cut impact has been known and factored into their existing forecasts for some time.



Source: ABS, EY

Short-term revenue upside means less borrowings than expected

The labour market, migration, inflation and higher than forecast commodity prices will have collectively boosted government revenue. As has been the case in recent budgets, Treasury's deliberately conservative method of forecasting commodity prices, such as iron ore, will mean a substantial upside revenue surprise, as resource producers pay more company tax than forecast.



* DISR and Commonwealth Treasury forecast free on board (FOB), WA Treasury forecasts have been adjusted for cost and freight.

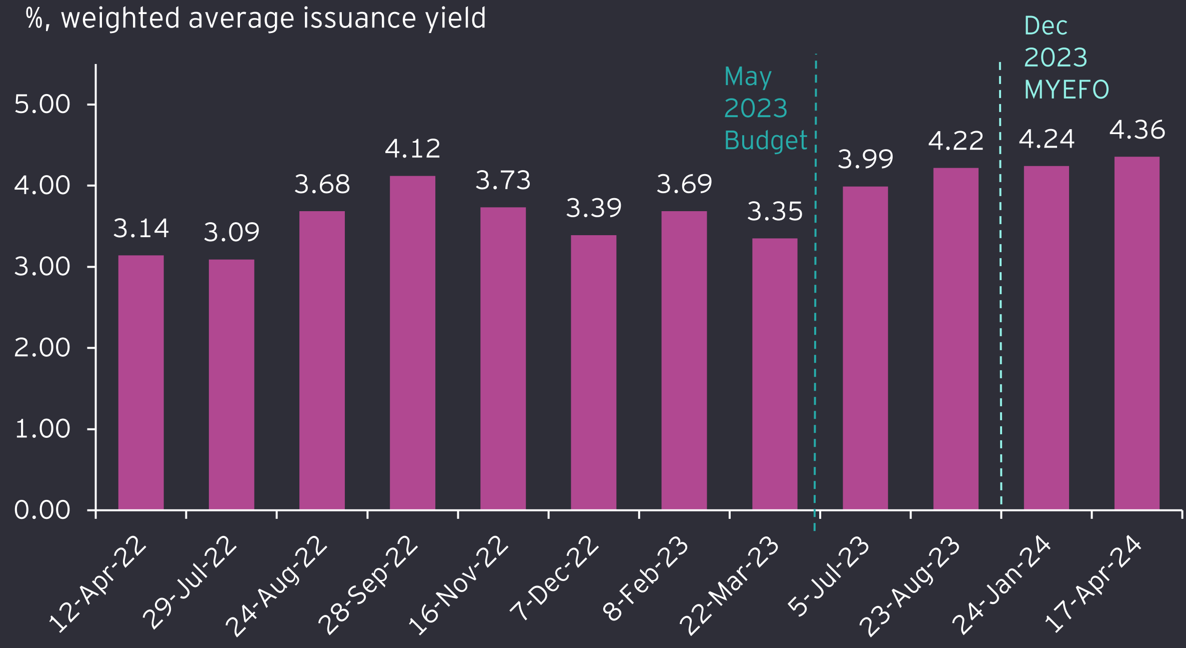
Source: DISR (March 2024), Commonwealth (MYEFO 2023-24, Budget 2024-25) and WA (2024-25)

For context, the $65.8 billion improvement in the 2023-24 underlying cash balance between the 2020-21 Budget estimate (-$66.9 billion) and the last the Mid-Year Economic and Fiscal Outlook (MYEFO) in December last year (-$1.1 billion) is clearly substantial. This highlights how strong the Australian economy has been in the pandemic recovery – exceeding Treasury's expectations. At the same time, the terms of trade have worked strongly in Australia's favour over the last three and a half years.

MYEFO projections had a 2024-25 underlying cash balance of -$18.8 billion, of -$35.1 billion in 2025-25 and -$19.5 billion in 2026-27. Over the next four years, the Treasurer has foreshadowed that some of the deficits in the budget "will be a little bigger than they were at MYEFO, some of them will be a little better."

The improvement in the underlying cash balance will also lower net debt and interest repayments in 2023-24. Offsetting this somewhat is higher interest rates, which have been rising since the 2023-24 Budget last May.

Interest rates on government debt



Source: AOFM, EY, 21-Nov-2033 bond line

The improvement in recent revenues and lower expenditure is a good starting point and puts the fiscal trajectory on a better footing than was assumed in MYEFO. But the real test will be in the policy decisions in this Budget which (mostly) impact revenue and expenditure not only in the four years ahead, but over the long-term.

The list of new policy spends so far

The Government's pre-announced policy decisions have been heavily weighted to spending rather than saving, thwarting the task of tightening the structural budget deficit. Considerable heavy lifting will be required to balance this new spending with savings in the budget.

Cost-of-living relief, the Future Made in Australia policies and housing form the core of these.

Major policy announcements include:

- $11.3 billion in funding for housing ($9.3 billion of which is to extend the National Agreement on Social Housing and Homelessness)
- $11.1 billion over 10 years for a navy fleet

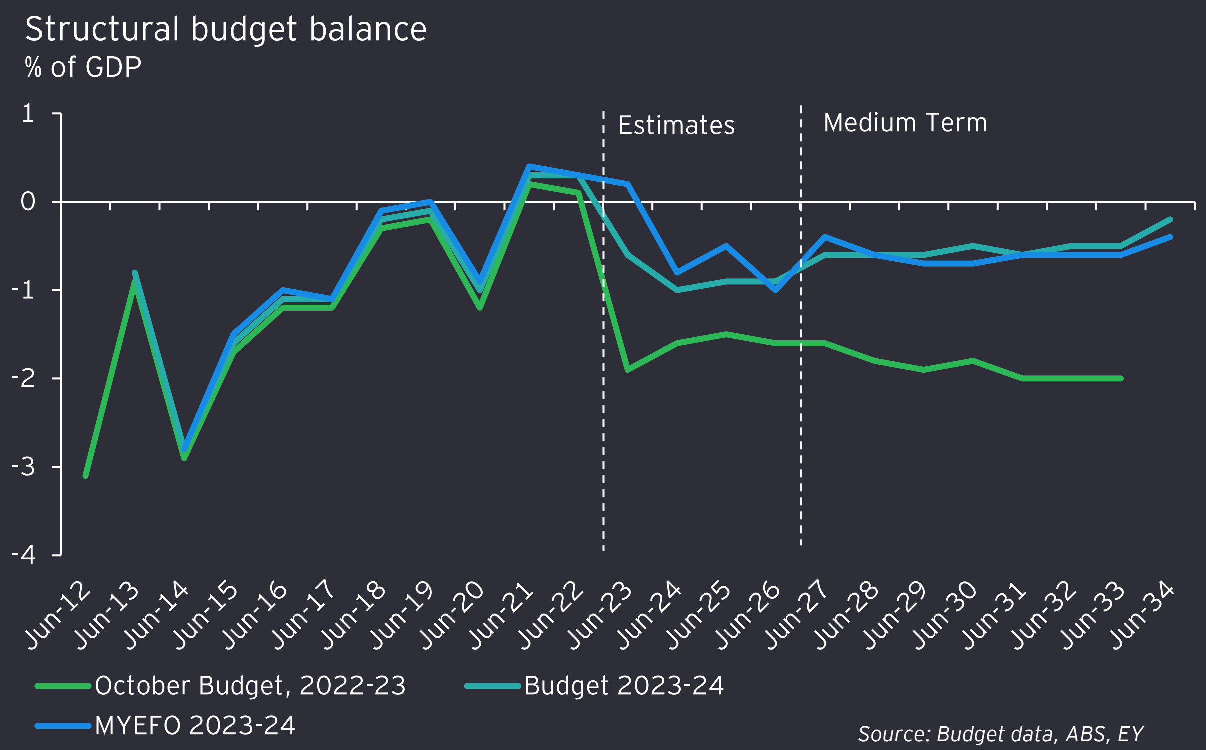
- $925 million over 5 years for a leaving violence program
- Multipronged Future Made in Australia package, including:
  - PsiQuantum - 400 new technology jobs in Brisbane
  - $1 billion Solar Sunshot program
  - $1.9 billion for Health Research
- More flexible work arrangements for carers
- $519 million boost to the Future Drought Fund
- $166 million to implement reforms to the anti-money laundering and counter-terrorism financing regime
- $161 million over four years for a National Firearms Register
- $100 million to a new national Active Transport Fund
- $90.6 million to boost the number of skilled workers in the construction and housing sector through Free TAFE place and pre-TAFE placements
- Changed approach to indexing student debt
- Commonwealth Prac Payment for students undertaking mandatory workplace placements required for university and vocational education and training qualifications
- Superannuation to be paid on government funded paid parental leave

The main savings measures are targeted from reducing consultants and contractors and $441 million is expected to be saved by improving compliance and accuracy of the Child Care Subsidy program. More substantial savings measures are required to offset additional spending.

The structural budget has been improving, but there is more to do

When temporary cyclical factors like high commodity prices or lower than normal unemployment is subtracted from revenue and expense projections, what is left is the structural budget position. It's a good estimate of how government policy dictates revenues and expenses. A sustainable budget position would have revenue and expenses aligning, to bring the structural budget closer to balance. This is key to capping debt and preparing the budget for future shocks.

The Government has identified aged care, medical benefits, defence, hospitals, the NDIS and interest payments as areas where spending is growing quickly, and part of the reason the current projected structural budget position is in deficit out to 2033-34.



Source: Budget data, ABS, EY

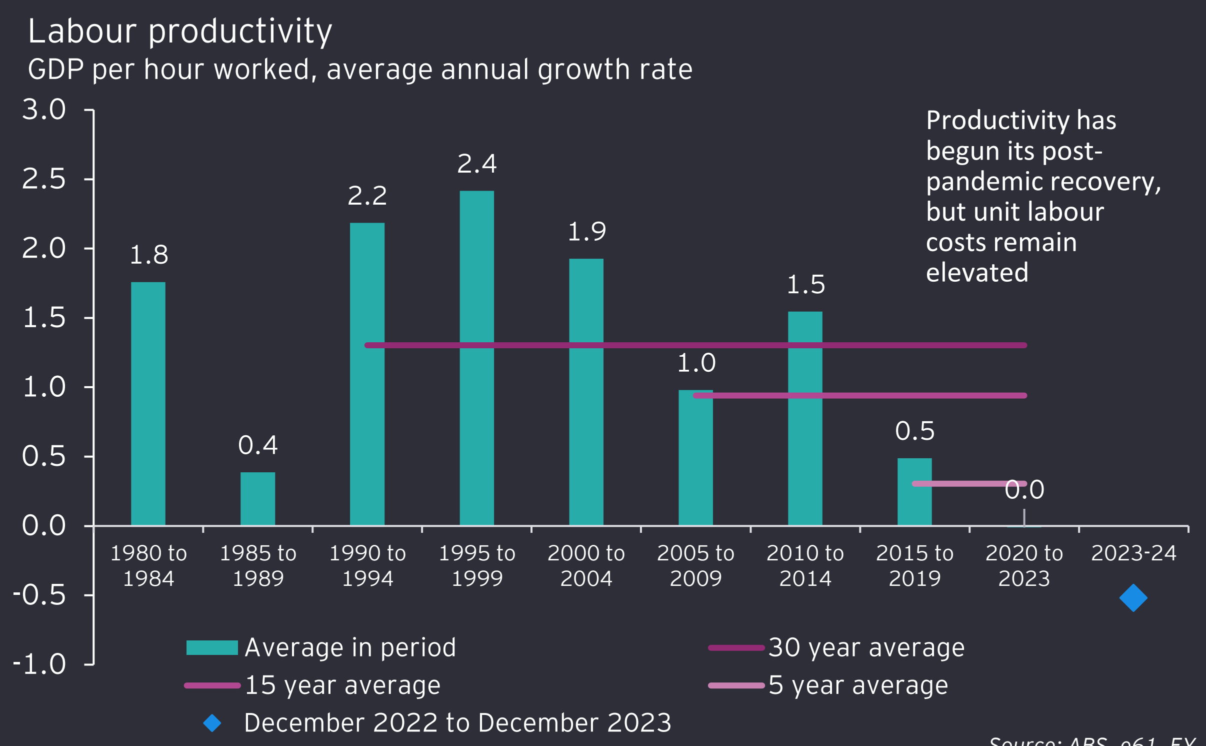
For structural improvement in the budget, policy changes are needed to lift revenue or lower expenditure to meet many of these necessary budget obligations. Positive cyclical outcomes or upside 'surprises' to commodity prices will not alone deliver these outcomes.

The 2021 Intergenerational Report highlighted that if the productivity growth rate rose to the long-term average of 1.5 per cent (30 years to 2018-19) – rather than not improving at all (as has been the case in the 2020-23 period) – the structural budget deficit could eventually be closed. Over 40 years, real and nominal GDP would be 9.5 per cent higher, and the underling cash balance as a share of GDP would be 2.2 percentage points lower.

Reform journey must accelerate

The Future Made in Australia policies so far appear to target multiple policy objectives. These include driving advanced manufacturing activity, providing economic security and facilitating the transition to net-zero emissions. While these objectives are all admirable, the opportunity cost may be diverted capital and labour resources from economic activity that would be more productive. A better focus would be allowing the economy's labour and capital resources to be allocated to their absolute best use.

The Government currently predicts productivity growth of 1.2 per cent per annum over the long-term. That follows decades of productivity growth slowing. A real budget success story would see that number revised higher in the forecasts, because policy changes result in better ways of doing things and better utilisation of people.



Source: ABS, e61, EY

Positive changes have been set in motion. These include the reforms recommended in the Universities Accord. Government and universities have been moving forward with plans to improve the accessibility of university education through broader learning delivery, including digital learning, while providing support services to people who previously did not think they belonged in a university setting.

As well as setting up Australia's population with the labour it needs for a more complex economy, these developments are also opening Australian universities to more students globally, boosting potential export income.

The 'once-in a-generation' migration reform by the Commonwealth Government is progressing, and a pre-Budget policy announcement to streamline the process of recognising the qualifications of tradies who are already in Australia is very welcome.

But there are also too many rigidities in the migration policy implementation. The experience of submitting a skills assessment under the Temporary Skills Shortage visa system is onerous.

And one and a half years on from the Jobs and Skills Summit, the Government is still consulting on how to distinguish 'specialist skills' from 'core skills' and 'essential skills' to make their visa reform framework a reality.

In the trade arena, the Simplified Trade System modernisation agenda has identified several opportunities for upgrading our plethora of border systems and complex regulations, reducing the time business must spend on government administrative obligations. Treasury's recent removal of small nuisance tariffs was a welcome change. Despite being the most significant unilateral tariff reform in decades, the Government lost barely any revenue and business administration was simplified.

But there remain far too many layers of out-dated legislation across too many departments. Multiple regulators at the border still rely on numerous clunky, paper-based systems which don't speak to one another.

With the election within 12 months, the Government should use its Budget narrative as a starting point to convince voters why a more ambitious reform agenda is needed in its second term.

Reforming our tax system would be a substantial step in the right direction. If redesigned against the principles of fairness, efficiency, simplicity, sustainability and coherence, the $800 billion of taxes collected annually by the Commonwealth and state governments could help better allocate labour and capital.

Former Treasury Secretary Dr Ken Henry, author of the 2010 tax reform report has provided the framework. His review said revenue should be raised mainly from four sources: private consumption, personal income, business income and economic rents from natural resources and land (on comprehensive bases).

Other taxes should be maintained only if they efficiently address social or economic costs. Taxes that prevent resources being optimally allocated, such as property transfer duties – discouraging people from moving house and freeing up housing stock or taking suitable jobs – should be removed.

Proper implementation is also important. Tax changes should only be introduced prospectively. Retrospective taxation undermines investor confidence and government efforts to attract investment into Australia. Also, choosing parts of a plan supposed to be delivered as a whole – such as the resources super profits tax from the Henry review – is sub-optimal.

An uncertain economic outlook needs strong fiscal buffers

Changes to Treasury's economic forecasts in the 2024-25 Budget will likely be small relative to the last fiscal update MYEFO published in December.

Global economic outcomes have been slightly stronger than expected, but the list of uncertainties related to geopolitical tension, new trade barriers, an unusually high number of elections and higher for longer interest rates, mean the case for rebuilding fiscal buffers remains strong.

Slight downward revisions to Australia's real GDP growth in 2023-24 and 2024-25, which Treasury last forecast at 1¾ per cent and 2¼ per cent, are expected as rate hikes continue to flow through the Australian economy. The nominal GDP forecast, which is the more important indicator of revenue growth will likely be broadly unchanged at 4¼ per cent in 2023-24 and pushed a little higher in 2024-25.

Inflation forecasts are likely to be unchanged for 2023-24, given the last forecast for the year to the June 2024 was 3¾ per cent in MYEFO and the latest (March quarter 2024) equivalent was 3.6 per cent. Inflation is still likely to be forecast to reach the central bank's 2-3 per cent target band in 2024-25.

Disciplined fiscal policy, which works co-operatively with monetary policy and promotes productivity reform, will ensure we can grow our economy's capacity, stabilise our debt and create a more positive future for generations of Australians.

Cherelle Murphy | EY Regional Chief Economist, Oceania
12 May 2024

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