AMP CAPITAL

The 2016-17 Australian Budget – putting popularity ahead of austerity

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Key points

> While the iron ore price has improved, the budget deficit is now projected to be $39.9bn in 2016-17 (up from $35bn in last year's budget). Return to surplus is still not expected until 2020-21.

> Modest personal and corporate income tax cuts are largely offset by superannuation reforms & higher tobacco excise. There is insignificant fiscal stimulus.

> The Budget may provide a small boost to confidence.

> Expect minimal impact on the share market, but maybe a small boost to discretionary retail shares.

Introduction

This year's Budget faced two challenges.[1] First to serve as the Government's main economic statement with sufficient sweeteners ahead of a likely July 2 election. Second, to provide more confidence that the budget is on track to a surplus to keep ratings agencies on side after they have recently started to lose patience. It's arguably achieved a bit of the former via modest individual and small business tax cuts funded in part by a wind back in superannuation concessions for higher income earners but it's not clear we are any closer to a budget surplus. Superannuation reform is in fact a key aspect of this Budget.

Key budget measures

As usual, most of the key measures have already been pre-announced or leaked. The goodies include:

- A tax cut for middle income earners via an increase in the $80,000 threshold at which the 37% marginal tax rate kicks in to $87,000. Or more correctly the return of fiscal drag.
- The 2% deficit levy on those earning more than $180,000 to end as scheduled from July next year.
- The corporate tax rate for companies with turnover up to $10m cut to 27.5% and expanded access to the $20,000 instant asset write off increased from $2m to $10m.
- The large company tax rate to fall to 25% by 2026-27.
- More funding for education, but only from 2018.

This has been offset by various savings, including:

- Significant superannuation reform around enshrining its objective as providing income in retirement, including lowering the 30% contribution tax rate from $300,000 to $250,000, a lowering in the concessionary contributions cap to $25,000 pa, a $1.6m cap on the amount that can be transferred to tax free retirement accounts and a $0.5m life-time non-concessional cap only partly offset by measure to improve the flexibility of super.
- Another cut back in public service spending.
- Increases in tobacco excise.
- More measures to crack down on multinational tax avoiders (including a Diverted Profits Tax) and welfare cheats.

Holding the line on the deficit outlook

Yet again the budget is in worse state than a year ago, albeit not much so relative to December's mid year review (MYEFO). The budget deficit projections have blown out by an average $8bn per annum compared to last year's budget. As already reported in MYEFO the return to surplus is not now expected until 2020-21 and even then it's expected to again be wafer thin at just 0.2% of GDP. After a 2015-16 budget deficit of $39.9bn (2.4% of GDP) the deficit for 2016-17 is forecast to be around $37bn (2.2% of GDP).

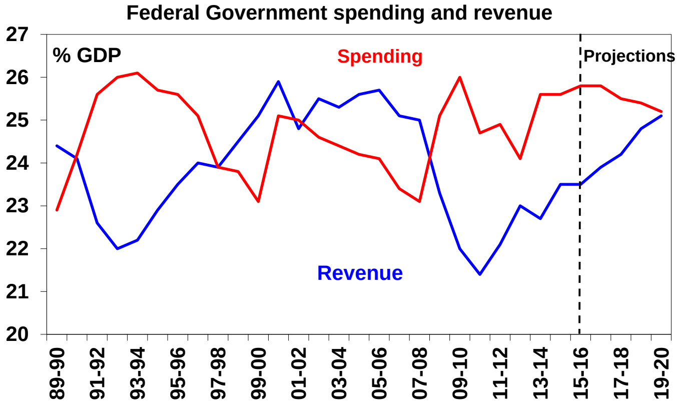
Underlying cash budget balance projections

	2015-16	2016-17	2017-18	2018-19	2019-20
2015-16 Budget, $bn	-35.1	-25.8	-14.4	-6.9	1.3
MYEFO,$bn	-37.4	-33.7	-23.0	-14.2	-7.3
%GDP	-2.3	-2.0	-1.3	-0.7	-0.3
Policy changes, $bn	-0.2	-3.1	+0.4	-1.5	+5.9
%GDP	-0.0	-0.2	0.0	-0.1	+0.3
Parameter chgs, $bn	-2.4	-0.3	-3.5	+0.3	-4.5
Budget, $bn	**-39.9**	**-37.1**	**-26.1**	**-15.4**	**-6.0**
%GDP	**-2.4**	**-2.2**	**-1.4**	**-0.8**	**-0.3**

Source: Australian Treasury, AMP Capital

With new policy initiatives largely offset by saving, the actual policy impact on the economy next year is just $3.1bn or 0.2% of GDP. See the red figures in the table above. However, the projected decline in the budget deficit in the years ahead (as revenue flows improve with the economy and some of previous years' measures constrain spending) means that fiscal policy will still be acting as drag on growth.

Federal Government spending and revenue



Source: Australian Treasury, AMP Capital

[1] This note prepared with the help of Diana Mousina, Economist, AMP Capital.

Economic assumptions

The major economic assumptions underpinning the Budget are shown in the next table. The growth numbers look reasonable but the unemployment and inflation assumptions look a bit too high for the next year or so. The iron ore price is now expected to average $US55/tonne over the next four years, compared to $US39/tonne assumed in December's MYEFO. While it's now running above $US60/tonne this appears to owe more to commodity price speculation in China rather than fundamentals.

Budget economic assumptions

		2015-16	2016-17	2017-18	2018-19
Real GDP	MYEFO	2.5	2.75	3.0	3.0
% year	**Budget**	**2.5**	**2.5**	**3.0**	**3.0**
	AMP	2.75	2.6	3.0	3.0
Inflation	MYEFO	2.0	2.25	2.5	2.5
% to June	**Budget**	**1.25**	**2.0**	**2.25**	**2.5**
	AMP	1.4	2.0	2.25	2.5
Nominal GDP	MYEFO	2.75	4.5	5.00	5.25
% year	**Budget**	**2.5**	**4.25**	**5.0**	**5.0**
Unemp Rate	MYEFO	6.0	6.0	5.75	5.5
% June	**Budget**	**5.75**	**5.5**	**5.5**	**5.5**
	AMP	6.0	6.0	6.0	6.0

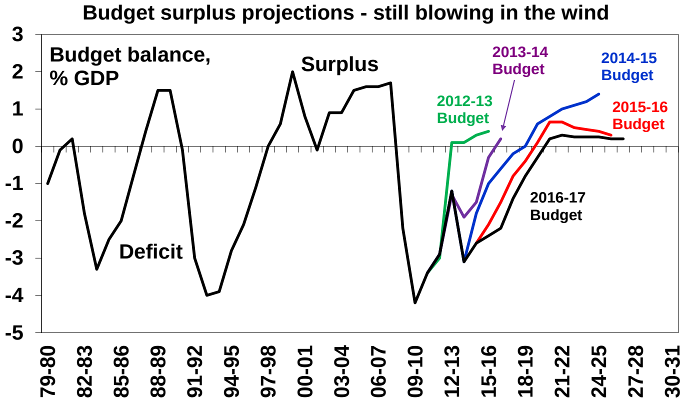
Source: Australian Treasury, AMP Capital

Assessment and risks

Australia still has a budget deficit problem. Government spending surged 25% between 2006-07 and 2008-09 to combat the GFC and this has never been unwound. We are still spending the proceeds of the boom even though it's long gone. While our public debt to GDP ratio is low compared to the US, Europe and Japan, comparing ourselves to a bad bunch may not be wise. And in any case we are a bit different to Europe and Japan which run current account surpluses and so are not dependent on the rest of the world for capital inflow and the US which has the benefit of the US dollar being a reserve currency. Australia's sizeable current account deficit of 4% of GDP means we have the classic twin deficit problem that leaves us vulnerable should foreign investor sentiment turn against us.

The 2015-16 Budget is projecting a 12 year run of deficits totalling 27% of GDP which swamps the seven years totalling 17% of GDP seen in the 1990s and the five years totalling 12% of GDP in the 1980s. And unlike back then that we haven't even had a recession. The continuing delay in returning to surplus from a projection of 2012-13 in the 2012-13 Budget, to 2016-17 in the 2013-14 Budget, to 2018-19 in the 2014-15 Budget, to 2019-20 in last year's Budget and now to around 2020-21 is cause for concern and begs the question whether we will ever get there. Demographic pressures on the budget will start to build early next decade and we now don't have a lot of flexibility to provide stimulus should our luck turn against us and the economy really turn down.

Budget surplus projections - still blowing in the wind



Implied from Budget Papers from 1920-21. Source: Aust Treasury, AMP Capital

The good news is that the modest personal income tax cuts (albeit only amounting to $4.30/week for someone earning $85,000) and the small business tax breaks should help provide some boost to confidence. While there is some debate as to whether they will past the Senate in time to commence on July 1, the political pressure to pass them combined with the proposed changes to super suggest that they probably will.

Not too much should be made of the Government's claim to be spending on $50bn on infrastructure out to 2019-20 as much of this is just a repackaging of existing infrastructure spending.

However, there are three main risks. First, the Government's projected 6% plus revenue growth from 2016-17 is at risk of being too optimistic given the ongoing disappointments regarding nominal growth. Similarly, the rebound in the iron ore price could prove to be premature, given the ongoing global steel glut. So, we may still see more deficit blow outs.

Second, while our base case is that Australia's AAA sovereign credit rating will be maintained, the ongoing uncertainty around the return to surplus could prompt credit ratings agencies to look at putting us on credit watch at some point.

Finally, the coming election could put the current budget strategy again at risk, continuing the ongoing political instability of the last few years with five PMs in less than five years. Maybe a double dissolution will lead to a more rational Senate resulting in more rational budgetary policy, but that's far from assured.

Implications for the RBA

While this Budget could provide a boost to confidence like we saw last year, ongoing fiscal tightening will act as a mild drain on growth in the years ahead. As such, it's hard to see major implications for the RBA. After the latest rate cut we see another move later this year to ensure aimed at preventing a further fall in inflation.

Implications for Australian assets

Cash and term deposits – with interest rates expected to remain low or fall further, returns from cash and bank term deposits are expected to remain very low at around 2%.

Bonds – a major impact on the bond market from the Budget is unlikely. With five year bond yields at 2%, it's hard to see great returns from sovereign bonds over the next few years.

Shares – the potential boost to confidence from this Budget could be a small positive for the Australian share market. However, it's offset by the ongoing drag coming from fiscal policy. Discretionary retail stocks could benefit from the tax cuts.

Property – the Budget is unlikely to have much impact on property markets where the dominant impact remains very low interest rates. Expect further modest gains in most cities although momentum may slow further over the year ahead in Sydney.

The Australian dollar – the announcements in the Budget alone are not radical enough to have much impact on the $A. With the commodity prices remaining weak, the interest rate differential in favour of Australia likely to fall further and the $A still too high, the trend in the $A is likely to remain down.

Concluding comments

The 2016-17 Budget provides some pre-election goodies but holds the line on spending growth. But it doesn't get us any closer to getting the deficit under control with risks remaining around the revenue assumptions. The budget strategy's durability also faces uncertainty given a likely July 2 election.

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