

Deloitte Access Economics

Input to the BCA's 2015-16 Budget submission

23 February 2015

Contents

Executive Summary.....	i
1 Background.....	1
2 The cost of doing nothing.....	2
2.1 Separating the 'structural' from the 'cyclical'.....	3
2.2 Structural and cyclical Budget balances.....	4
2.3 Why does the structural position improve?.....	5
2.4 Fiscal positives.....	5
2.5 And there's bad news.....	6
2.6 The importance of 'bracket creep'.....	7
2.7 Intergenerational cost pressures.....	10
2.8 How big a gap?.....	13
3 The risks are larger than generally recognised.....	14
3.1 What drives the terms of trade?.....	14
3.2 The official view has been changing.....	15
3.3 Risks have increasingly been recognised.....	17
3.4 But those risks could be greater still.....	18
4 The shifting balance of policy costs.....	23
4.1 The benefits of the boom.....	23
4.2 The policy costs that accompanied the boom.....	24
4.3 A gradual shift to savings.....	25
4.4 What cost more: spending increases or tax cuts?.....	27
Appendix A : Structural Budget analysis.....	30
Limitation of our work.....	36

Charts

Chart 2.1 : The structural underlying cash balance – various estimates.....	4
Chart 2.2 : Estimated single-year effects of bracket creep due to both price inflation and real wage growth.....	8
Chart 2.3 : Estimated cumulative effects of bracket creep due to both price inflation and real wage growth.....	9
Chart 2.4 : Marginal tax rate paid by those earning AWOTE, half AWOTE and twice AWOTE ..	10
Chart 2.5 : Projections of Federal primary balances – 2003 IGR.....	11
Chart 3.1 : The terms of trade – Federal Treasury projections.....	16
Chart 3.2 : Treasury terms of trade forecasts at the time of the 2014-15 Budget.....	16

Liability limited by a scheme approved under Professional Standards Legislation.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity.

Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

© 2015 Deloitte Access Economics Pty Ltd

Chart 3.3 : Budget impacts from a fall in the terms of trade (\$bn)	18
Chart 3.4 : Annual standard deviation in key economic drivers of the budget	19
Chart 3.5 : Budget impacts from real and nominal economy shocks	20
Chart 3.6 : Net debt impacts from real and nominal economy shocks.....	21
Chart 3.7 : Revenue losses and spending increases in a 'commodity slowdown' (\$bn), 2013-1422	
Chart 4.1 : The effect of the economy on the Budget	24
Chart 4.2 : Impact of (1) policy decisions and (2) the economy on the Budget	25
Chart 4.3 : Cumulative effect of policy changes by financial year	26
Chart 4.4 : Spending policy costs as a share of total policy costs over the past decade	28
Chart 4.5 : Government revenue and expenditure as a share of GDP over time	29
Chart A.1 : The actual and structural unemployment rates	34
Chart A.2 : The actual and structural level of the terms of trade	34

Executive Summary

The resources boom of the past decade had a temporary impact on Australia's fiscal finances, meaning that the nation has been left with the structural burden of the policy promises adopted by both sides of politics now that the impact of the boom on the Budget has dropped away.

We partied hard, and the resultant hangover is a big one.

Even today, few people realise that the Budget was far and away the biggest beneficiary of the resources boom – far more than the likes of the mining sector or of Western Australia. Indeed, as the analysis in Chapter 4 of this report notes, the past decade effectively saw a 'Budget bubble' as the resources boom impacts on Canberra's cash came and went.

The last handful of months have underscored just how rapidly the Budget bubble of the past decade is now unwinding. 2013 saw coal prices collapse, 2014 saw iron ore prices collapse, and the closing months of 2014 also saw oil prices (and hence gas prices) join the casualty list. All of these come at considerable budgetary cost, as does the more recent phase of wage moderation.

Is there a problem?

One of the underlying difficulties in the national debate over the trajectory of our fiscal finances is that ordinary Australians see an economy which has challenges but is broadly performing well. They therefore find it hard to understand when governments and bureaucrats speak of large problems facing the Federal Budget.

Chapter 2 of this report therefore looks at the views of experts – the IMF, OECD, the Parliamentary Budget Office, Treasury itself and Deloitte Access Economics' own analysis – as to whether the problems of the moment are cyclical (temporary) or structural (lingering).

The analysis of those experts reveals a Budget position which, in structural terms, has been worse than that seen in the reported deficit figures, as the resources boom of the past decade helped to mask Australia's weakening Budget fundamentals.

For example, the IMF estimates that the Federal Budget was in structural deficit of more than 3% of national income in each and every year from 2009 through 2014, with its 3.0% estimate in the latter year equivalent to \$48.5 billion.

Will that problem go away?

There is reason to expect that underlying Budget position will improve over the next few years, with a number of factors at play:

- **Some gains occur via fiscal drag or 'bracket creep'** the Budget gets slowly better when you take your hands off the wheel because wage gains push people into higher tax brackets. But at around \$3 billion a year, that's a helping hand rather than a silver bullet. Closing a fifth of the structural Budget deficit after five years isn't exactly Speedy Gonzales. Moreover, bracket creep isn't merely a smaller driver of Budget repair than generally

recognised. It also involves additional pressure on taxpayers and the Australian economy over time.

- **A lift in capital gains** is also expected to be a positive for the structural Budget balance, aided by the increase in housing and share prices in recent years.
- **Yet the biggest potential improvement lies in the policy plans laid out in the May 2014 Budget – which these expert analyses all assume are passed in full.** The cost savings in the 2014-15 Budget would – if enacted – build a lot over time, with shifts to more sensible indexation arrangements for a bunch of benefits (including the age pension itself), as well as making it harder to get access to some benefits (including family tax benefit B), and health care cards for seniors.

However, the better news by 2017-18 is a temporary respite, with the structural deficit set to worsen again thereafter. Although the Budget's savings broadened beyond 2017-18 – such as new indexation arrangements for payments to the States for hospitals and schools – there are three problems:

- **First, over the next decade a swag of existing Federal Government programs will become more expensive** – Treasury analysis quoted in the Commission of Audit pointed to rapid growth in disability insurance, child care and paid parental leave, hospital and school funding, carer support, aged care, Medicare, disability pensions, age pensions and Defence. That means much of the Budget is already promised to grow fast, with the bulk of that pain falling just beyond the current forward estimates.
- The most quoted benchmark for restoring the Budget to health has been to hold inflation-adjusted spending growth to 2% a year, yet – even were it to get through the Senate – the 2014-15 Budget only reduced spending growth over the coming decade from 3.7% a year (as it was projected to be before the Budget) to 2.7%.
- **Second, an ageing population and relatively rapid health cost growth threaten the longer term health of the Budget.** More than a decade on from the first *Intergenerational Report*, little has been done in net terms to address these costs. That is a worry – especially as the first wave of baby boomer retirements is already hitting the Budget bottom line.
- **Third, the Senate may well reject much of the planned savings May's Budget laid out.**

In other words, although expert analysis shows the Budget deficit improving in the four years of 'the forward estimates', that is mostly because of (1) the assumption that Australian political processes will see big policy cost savings occur, and because (2) those analyses finish before known problems hit the Budget bottom line after 2017-18.

So how big a gap does Australia face? Given the above caveats on the future path of the structural shortfall, it may make sense to use the IMF's estimate of the structural Budget deficit (for 2014) of \$48.5 billion as a benchmark for the underlying – and ongoing – fiscal gap that Australia faces.

Using that benchmark, then **it would take something like fifteen years of bracket creep to return the Budget to structural balance, or two decades of bracket creep to return to a structural surplus of around 1% of national income.**

Were such a course to be adopted over the next two decades, then the top marginal tax rate would cut in at just 1.1 times average weekly ordinary time earnings (AWOTE).

Alternatively, **were the structural shortfall in Australia's social compact with itself to be closed solely by an increase in the average rate of personal income tax – currently 17.6% of wages and salaries – then the latter would need to lift by more than a quarter to 22.3%.**

Could the problem be even worse than yet recognised?

Yet those aren't the only problems threatening Australia's fiscal finances.

Just as the global upswing in commodity prices boosted the Budget for much of the past decade, the current global meltdown in commodity prices has been ripping into revenues.

The 2014-15 Budget and subsequent MYEFO were more conservative than the consensus on what might happen to commodity prices, but both appear to have understated the size of the downswing now underway. A key question considered in this report is therefore a fairly simple one: what if the terms of trade were to go back whence they came?

In brief, Australia is on the downswing of a rollercoaster ride, and that ride may end up in a much worse place than official projections are currently assuming. Indeed, even a return of the terms of trade to where they were is not necessarily the worst that could happen. History is very clear that commodities typically overshoot on the downswing just as they do on the upswing. Every other commodity price boom in Australian history has petered out (and usually seen a bust before 'normality' returns).

This report doesn't model such a bust. But what we have modelled – a return to the terms of trade levels of 2002-03 – could itself prove to be too optimistic. Even so, such a scenario (and associated impacts on the real economy) would see an additional \$114 billion added to the deficit over the next four years, with the Budget deficit being 1.8% of GDP larger than it would otherwise have been in 2017-18.

In other words, history suggests that the Budget pain of the moment could be just a foretaste, as the commodity price gains of the past decade continue to unwind.

Does the problem lie more in spending or in revenue?

Among those who do recognise that a problem exists, many think the biggest difficulties facing the Budget lie on the revenue side. They point to the phase in which Australia racked up eight personal income tax cuts in a row, and therefore assume that the bulk of the cost of the policy promises of the past decade are attributable to tax cuts rather than spending increases.

Chapter 4 debunks that myth. It uses Treasury's own figuring on the cost of policy promises over the past decade to allocate those across spending increases and net cuts to taxes.

And whereas it is indeed true that the opening years of the Budget bonanza introduced by the resources boom saw policy costs split roughly equally between revenue and spending (a point reached with the large – and ultimately bipartisan – tax cuts announced ahead of the 2007 Federal election), it has in fact been decisions to add to spending which have ended up being the dominant component of the decisions of Australia's Parliament over the past decade.

In part that is because the earlier phase of discretionary personal income tax cuts stopped some years ago. And in part it is because recent years have seen a variety of taxes go up – a list that includes an increase in the Medicare levy to help pay for disability insurance, ongoing

increases in cigarette excise, a return to price indexation for petrol excise, and the likes of the temporary Budget repair levy. In contrast, the butcher's bill from spending increases has continued to mount. These began with family benefits and baby bonuses, but more recent years have seen costs such as disability care, extra funding for schools, additional funding for national security and more generous arrangements for paid parental leave.

The upshot is that, currently, the ongoing policy costs adopted over the past decade are running about 80/20 in terms of spending increases/net tax cuts. Although that doesn't, of itself, say that closing the Budget gap Australia faces should necessarily be split the same way – 80% through spending cuts and 20% through tax increases – it does suggest that the big policy costs of the last decade were in spending.

Deloitte Access Economics

30 January 2015

1 Background

The Business Council of Australia (BCA) has requested that Deloitte Access Economics (DAE) assist it with better informing the public debate in Australia around the size, nature and importance of the fiscal repair task.

Specifically, this report:

1. **Demonstrates that doing nothing will leave the Budget in deficit.** Chapter 2 shows that the Federal Budget is in structural deficit. It does so by drawing on our own analysis, as well as estimates from the OECD, IMF and the Parliamentary Budget Office. It further shows that, even allowing for bracket creep (fiscal drag), the Budget will remain in deficit. We estimate the rise in the average income tax rate that would be needed to get back to structural surplus in 2017-18.
2. **Demonstrates that the risks are larger than generally recognised.** Chapter 3 shows, were the terms of trade drop to 2003 levels – an outcome which would be relatively favourable compared with past commodity cycles – then the ongoing impact on the Budget would be rather larger than the public realises.
3. **Demonstrates that the extra policy burden on the Budget has been in spending.** Chapter 4 analyses Treasury data to show that, over the past decade, policy decisions have added rather more to spending than they have detracted from revenue.

2 The cost of doing nothing

If Australia is to have an honest and open debate about the Budget, it needs to first understand the need for Budget repair.

At any given time the Budget of the day is a function of two things – the state of the economy, and the promises of politicians. For much of the past decade it was the former factor – the largest boom ever seen by Australia – that masked the growing cost of the latter.

Even today, few people realise that the Budget was far and away the biggest beneficiary of the resources boom, far more than the likes of the mining sector or of Western Australia.

As unprecedented revenue windfalls rolled in from the early 2000s onwards it was easy for both sides of politics and the broader Australian community to lose touch with the choices needed to maintain a sustainable Budget position.

The ‘rivers of gold’ flowing in from the mining boom obscured the true state of the Australian Budget. As fast as the temporary income flows filled the Government’s coffers, successive Governments handed them back through permanent promises of lower taxes and increased expenditure on benefits, pensions, health and education.

No previous boom in economic history has been permanent. Yet for all too long – even well after the GFC – official forecasts of the Budget, politicians and the public assumed that the mining boom would be. But the impact of the resources boom was always going to be a temporary one, meaning the permanent promises the nation made to itself are now increasingly showing up as a problem for the Budget bottom line.

That combination of a temporary boom with permanent promises is one that will leave a lasting legacy of structural deficits unless action is taken to address the task of Budget repair.

The last handful of months have underscored just how rapidly the Budget bubble of the past decade is now unwinding. 2013 saw coal prices collapse, 2014 saw iron ore prices collapse, and the closing months of 2014 also saw oil prices (and hence gas prices) join the casualty list.

All of these come at considerable budgetary cost, as does the more recent phase of wage moderation.

So while Australia’s economy has so far navigated the transition away from a commodity price and investment boom in reasonable shape, the same can’t be said of the nation’s Budget.

In this chapter we look at the views of experts – the IMF, OECD, the Parliamentary Budget Office, Treasury itself and Deloitte Access Economics’ own analysis – to untangle the impact of the resources boom (and the business cycle more generally) from the policy costs incurred in recent years.

The former proved to be temporary, and the latter permanent.

Doing that ‘untangling’ is needed so as to identify the whether the problems of the moment are cyclical (temporary) or structural (lingering).

With this ‘true’ starting point for the Budget we then go on to examine the implications of avoiding the tough choices and relying on business as usual to address the task of fiscal repair.

In short, the view of the experts is that Australia’s Budget position is firmly in a state of structural deficit. Worse still, it is not going to fix itself.

Hard choices will need to be made. The thing about hard choices is that the longer you wait, the worse they get.

2.1 Separating the ‘structural’ from the ‘cyclical’

Determining where the Budget will settle is important, because it helps us assess just how far from sustainable current budgetary settings are.

Estimates of the ‘structural Budget balance’ indicate where the Budget balance would be if the economy were running at trend levels of activity (trend levels – not trend growth rates).

Yet although the concept is straightforward enough – asking “*what is the underlying position?*” – tracking the health of national Budgets is tough. A range of factors are at play. Sometimes deficits are a flash in the pan, sometimes they’re a symptom of a Budget in real trouble.

Knowing the difference is a matter of sorting the economic cycle from the underlying balance of revenues and spending. Up until 2003, that assessment meant looking at measures such as unemployment as clues to the impact of the economy on the Budget. If, for example, if we were running a deficit even when unemployment was low, that pointed to underlying structural weakness in the Budget. Or if we were running a surplus even when unemployment was higher than usual, that pointed to structural strength in this nation’s social contract with itself.

Accordingly, modellers could use the unemployment rate or a range of related statistics such as ‘output gaps’ to usefully identify the structural health of Australia’s economy.

The logic behind using these measures is that (1) some of the automatic stabilisers within the Budget are a function of unemployment rates, and that (2) Budget revenues are closely tied to economic output, for which unemployment can be a handy yardstick.

Yet unemployment benefits are a small and shrinking share of overall public spending. More important still is that the most volatile parts of the bottom line – profit based taxes – are not as closely tied to measures of unemployment and output as they used to be.

Indeed, since 2003 the revenue side of Australia’s Federal Budget has shown little linkage to shifts in the unemployment rate. Rather, it is commodity prices which now drive the Budget.

The big shift in China-driven coal and iron ore prices over the past decade – the dominant driver of the terms of trade – led to a fundamental improvement in revenues well beyond what was showing up in traditional output and unemployment measures.

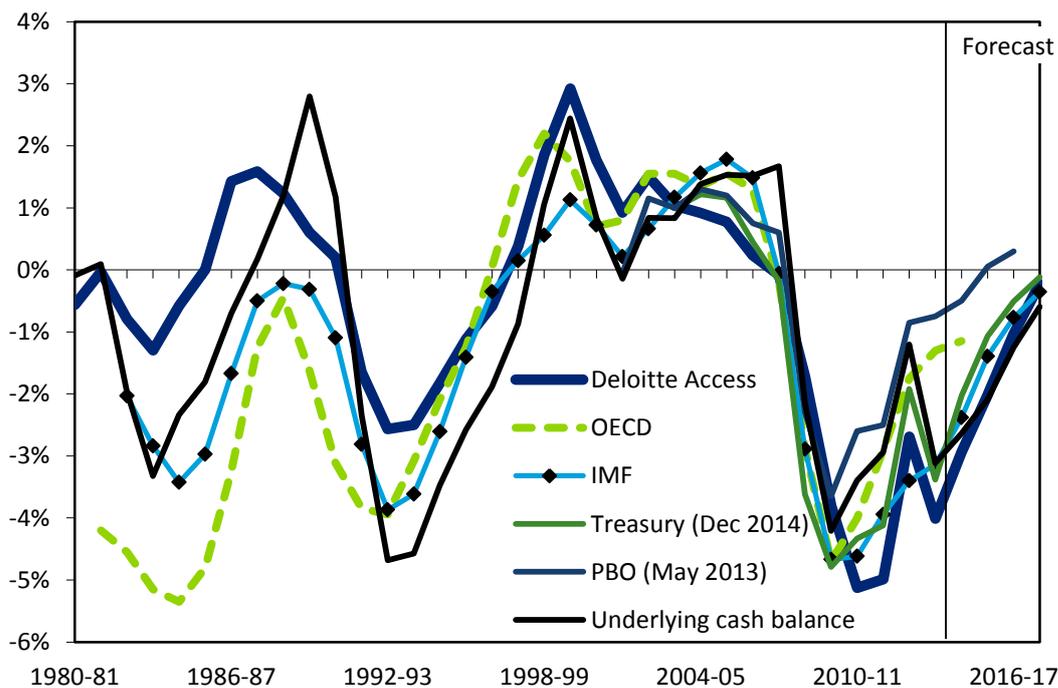
Higher coal and iron ore prices boosted everything from jobs and retail sales, as well as sharemarkets and housing prices. With the health of the Budget more closely tied to those areas of the economy more sensitive to movements in commodity prices, the latter has become the best proxy for the underlying health of the Budget.

2.2 Structural and cyclical Budget balances

So what do the experts say? Structural balance estimates are made by Deloitte Access Economics, the IMF, the OECD, Federal Treasury and the Parliamentary Budget Office. Those estimates are shown in Chart 2.1 below. That chart tells a fascinating story:

- All these experts have a similar – and very depressing – view of the underlying health of the Australian Federal Budget.
- And all of them look for it to improve notably, with announced policy measures and the steady impact of fiscal drag helping to close the structural deficit. By 2017-18, all the estimates have the structural underlying cash balance at, or near zero.

Chart 2.1: The structural underlying cash balance – various estimates



It is important to remember that estimates from the different organisations use Treasury's numbers as a starting point. Given that the Budget outlook was downgraded at MYEFO in late 2014, the next update from each of the Parliamentary Budget Office (PBO), OECD, IMF and Deloitte Access Economics will show a worse trajectory than mapped out in the chart above.

For now, however, the likes of the IMF have estimated that the Federal Budget was in structural deficit of more than 3% of national income in each and every year from 2009 through 2014, with its 3.0% estimate in the latter year equivalent to \$48.5 billion.

2.3 Why does the structural position improve?

All of the organisations in Chart 2.1 show the structural deficit improving rapidly over coming years. Indeed, improvements in the structural balance predicted over the forward estimates period are similar to the efforts of the past, such as the structural strengthening in the 1990s thanks to the tough Budgets of 1993 and (especially) 1996, or that achieved in the second half of the 1980s.

That seems pretty comforting.

But should it? Will existing policy settings see the Budget “whirr back into surplus”, or are there hard yards ahead?

2.4 Fiscal positives

There are some fiscal positives which will tend to move the Budget back toward structural balance over this period.

Personal tax rises as wage gains push people into higher tax brackets

Some structural gains will occur via fiscal drag as wage gains push people into higher tax brackets – the Budget gets slowly better when you take your hands off the wheel.

That pace is pretty rapid, the net result of factors that reduce the pace of drag (today’s low wage growth and the big tax cuts of the past) and those that increase it. On the latter front there are 1.3 million taxpayers with incomes in the \$30,000 to \$37,000 range (and whose marginal tax rate may therefore soon jump 14 percentage points), and a further 0.8 million taxpayers with incomes in the \$70,000 to \$80,000 range (and whose marginal tax rate may therefore soon jump 4 percentage points).

Even so, at around \$3 billion a year, that’s a help rather than a solo solution.

We discuss bracket creep in more detail later in this chapter.

Capital gains have already been notable, especially in housing

Some similarly-sized good news comes from a lift in capital gains (which shows up here as an improved structural Budget balance), aided by a lift in housing and share prices in recent years.

That is because the Deloitte Access Economics’ methodology doesn’t capture some GFC-related effects which continue to drag on revenue collections, particularly capital gains taxes. That sees delayed improvements in the tax take showing up as structural improvements under this methodology as these effects take time to work their way through the tax system.

In other words, a portion of the structural improvements seen in the Deloitte Access Economics figuring are essentially cyclical effects in disguise, as is true of matching periods of weakness in these tax collections in recent times, which tend to exaggerate structural deficits.

Structural gains over the next three years in particular benefit from a substantial lift in revenues as some key revenues tied to profit levels and asset market returns recover from ongoing GFC related weakness.

The 2014-15 Budget spelt out major policy savings

Yet the biggest improvement lies in the policy plans laid out in May's Budget. If fully enacted, these would build a lot over time, with changes to indexation arrangements for a bunch of benefits (including the age pension itself), as well as making it harder to get some benefits (including family benefit B), and the tightening in the eligibility for health care cards for seniors.

This latter factor is crucial, and yet all-too-little understood. The forecasts of the experts do indeed show an improvement in Australia's fiscal finances, but the short term improvement painted in Chart 2.1 has more to do with the assumption that Australia's political processes will deliver Budget repair, rather than the actuality of that repair.

2.5 And there's bad news

Yet there is another problem here. The detailed figuring in the Budget itself only goes out for four years ('the forward estimates') at any given time, and the forecasts of the experts shown in Chart 2.1 at best do the same.

Sadly, a few shoals lie just beyond that timeframe.

The better news by 2017-18 is a temporary respite, with the structural deficit set to worsen again thereafter. Although the Budget's savings broadened beyond 2017-18 – such as new indexation arrangements for payments to the States for hospitals and schools – there are three problems.

Many key existing policies will see their costs accelerate

First, over the next decade a swag of existing Federal Government programs will become more expensive – Treasury analysis quoted in the Commission of Audit pointed to rapid growth in disability insurance, child care and paid parental leave, hospital and school funding, carer support, aged care, Medicare, disability pensions, age pensions and Defence.

That means much of the Budget is already promised to grow fast, with the bulk of that pain falling just beyond the current forward estimates.

The most quoted benchmark for restoring the Budget to health has been to hold inflation-adjusted spending growth to 2% a year yet, even were it to get through the Senate, the 2014-15 Budget only reduced spending growth over the coming decade from 3.7% a year (as it was projected to be before the Budget) to 2.7%.

Intergenerational costs are creeping ever closer

Second, an ageing population and relatively rapid health cost growth threaten the longer term health of the Budget. More than a decade on from the first *Intergenerational Report*,

little has been done in net terms to address these costs. That is a worry – especially as the first wave of baby boomer retirements is already hitting the Budget bottom line.

We discuss intergenerational cost pressures in more detail later in this chapter.

Australia's political processes aren't helping

Third, the Senate has rejected (or intimated that it would reject) much of the planned savings May's Budget laid out. These include changes to higher education sector funding and HECS-HELP debt indexation and thresholds; as well as changes to the rates of payment, eligibility and indexation of social security benefits.

In other words, although expert analysis shows the Budget deficit improving in the four years of 'the forward estimates', that is mostly because of (1) the assumption that Australian political processes will see big policy cost savings occur, and because (2) those analyses finish before known problems hit the Budget bottom line after 2017-18.

2.6 The importance of 'bracket creep'

We touched on the point above that many see fiscal repair as nothing more than sitting back and waiting for bracket creep to restore the Budget to health.

That's not going to happen.

Australia's progressive personal income tax system is based on marginal rate thresholds that are fixed over time.

As a result, government revenues benefit from fiscal drag or 'bracket creep' as higher prices and wages drive individual taxpayers into higher marginal tax brackets over time.

In other words, when governments do nothing, average rates of personal income tax go up, helping to lift revenues.

Unlike other forms of fiscal repair, bracket creep doesn't require any action at all on the part of governments, which also makes it a more politically attractive choice to close the gaps evident in the Budget at present.

Overall revenue gains from bracket creep can be divided into two components:

- **A nominal component** which occurs as prices rise, increasing average tax rates even if real wages are going nowhere.
- **A real component**, which occurs because wage gains tend to outpace price increases over time, shifting taxpayers even further into higher tax brackets. This type of bracket creep is a natural feature of a progressive income tax system, and occurs even in those countries which index tax thresholds to price levels.

From the point of view of individual taxpayers, the first form of bracket creep can represent a cut in real disposable income over time. That is why estimates of fiscal drag typically exclude the real component and focus on the impact of price inflation on income tax revenue over time.

From the point of view of the kind of structural Budget analysis presented in this chapter, however, both forms of bracket creep are relevant. Because the decomposition of wage levels into structural and cyclical involves ratios, rather than dollar amounts, it does not account for any increase in marginal tax rates due to either prices or real wage gains. As a result, revenue gains from both nominal and real bracket creep show up as an improvement in the structural Budget balance.

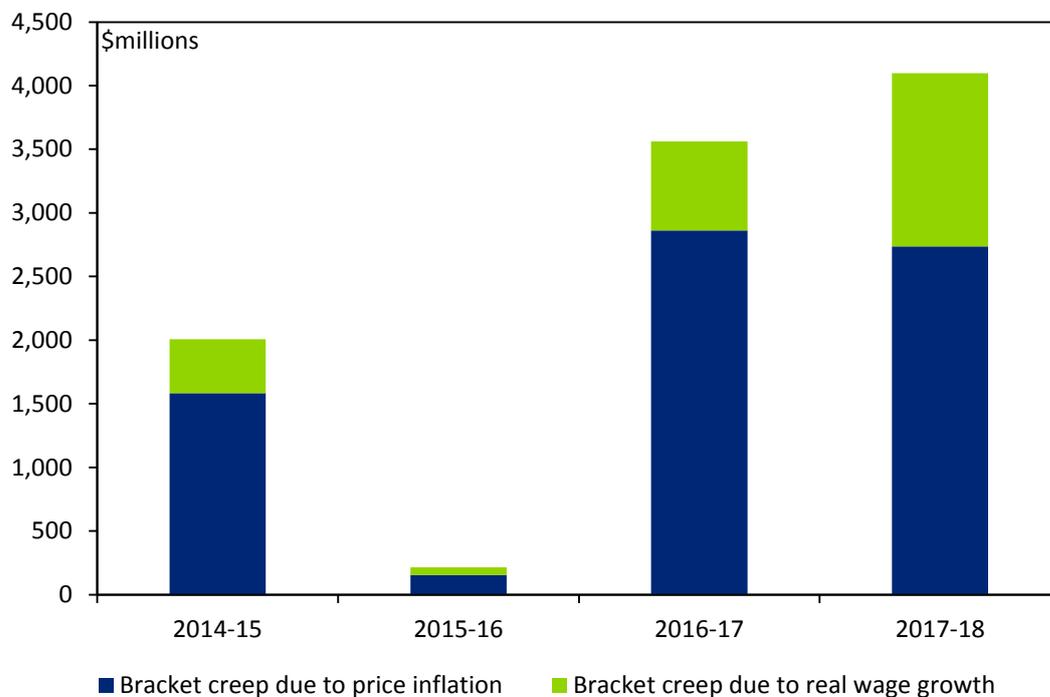
So how important is bracket creep likely to be in fixing the Budget?

Deloitte Access Economics calculates fiscal drag by comparing forecast receipts for total taxes on individuals (PAYG *plus* 'other individuals' *less* refunds) on three different bases:

- First our baseline forecasts, which include announced rates and thresholds over the forward estimates.
- Then using the 2013-14 rates and thresholds factored up for forecast increases in the CPI, starting in 2014-15. The difference between these forecasts and those in the baseline represent the nominal component of bracket creep.
- Finally using the 2013-14 rates and thresholds factored up for forecast increases in Average Weekly Earnings (AWE), again starting in 2014-15. The difference between these forecasts and those based on CPI indexation alone form the real component of bracket creep.

Chart 2.2 shows estimates of each of the two components of bracket creep over the forward estimates period.

Chart 2.2: Estimated single-year effects of bracket creep due to both price inflation and real wage growth

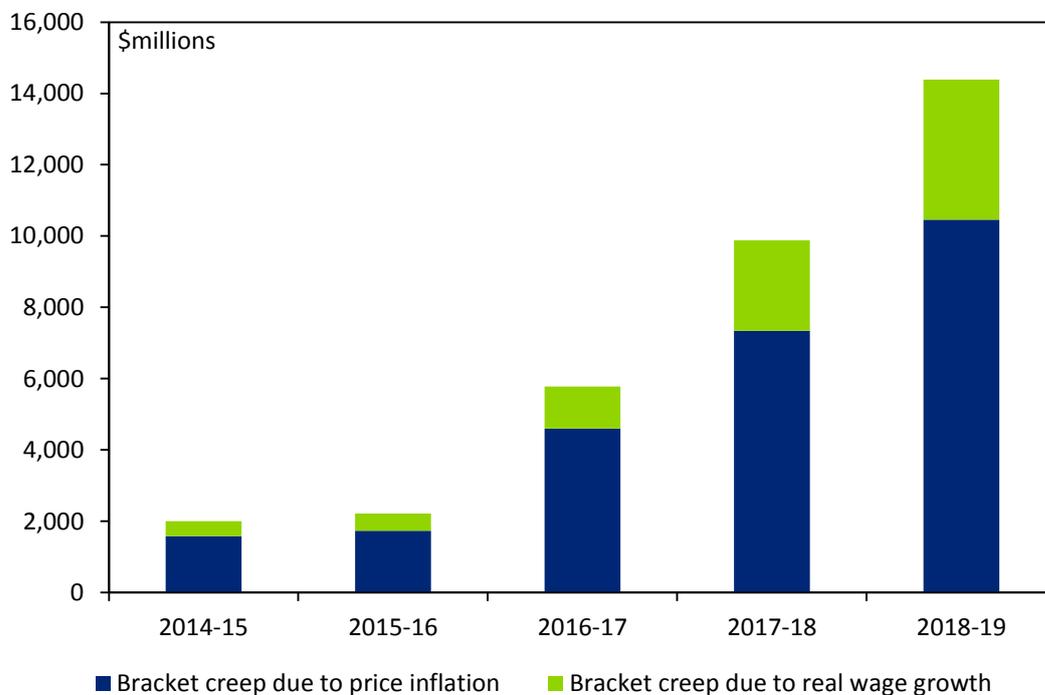


It shows that bracket creep does play an important role in the improved structural Budget balance predicted over the next four years.

Initially the benefits of bracket creep are small at around \$2 billion in 2014-15, and an even smaller addition to that total in 2015-16. (A final round of income tax cuts built into the forward estimates are felt in 2015-16 as the tax free threshold is increased from \$18,200 to \$19,400 – with that increase effectively handing much of bracket creep back to taxpayers in that year.)

From there additional revenues rise solidly in 2016-17 and 2017-18 as wage gains recover from a period of weakness in the near term, and with no further tax cuts in the pipeline. It lifts to more than \$4 billion extra in the latter year.

Chart 2.3: Estimated cumulative effects of bracket creep due to both price inflation and real wage growth



Overall, the cumulative bracket creep across the five years to 2018-19 of just over \$15 billion could account for as much as one-fifth of the structural gap identified for 2014-15 in Chart 2.3.

That makes it an important component of the structural improvement seen over the forward estimates period.

But closing a fifth of the structural Budget deficit after five years isn't exactly Speedy Gonzales. And it isn't nearly as big a factor in Budget repair as some public commentary might suggest.

Note that two factors are important here – wage growth is low, and past tax cuts have reduced the impact of bracket creep. Moreover, bracket creep isn't merely a smaller driver of Budget repair than generally recognised. It also involves additional pressure on taxpayers and the Australian economy over time.

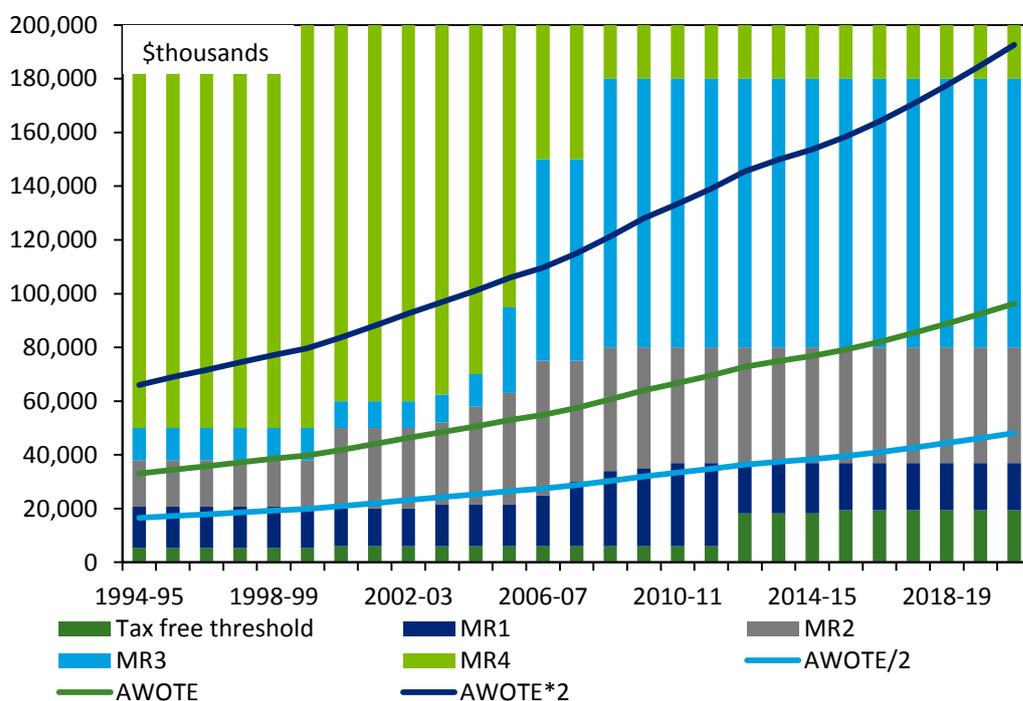
It is important to remember that relying on bracket creep to improve the bottom line is a choice, and it is not without its costs.

The estimates seen in Chart 2.2 earlier are the result of 1.7 million Australians, or some 18% of all taxpayers, entering higher tax brackets over the four year forward estimates period.

And effectively all taxpayers would pay a higher average rate of tax. (An increase in your wage will mean that a bigger share of your income will be taxed at a higher rate than it was before, regardless of whether you tripped over the next increase in marginal thresholds.)

That would involve some substantial shifts in the marginal tax rates faced by typical taxpayers.

Chart 2.4: Marginal tax rate paid by those earning AWOTE, half AWOTE and twice AWOTE



As greater shares of the workforce are subject to higher marginal rates of tax, incentives to work and to earn are eroded. That is particularly true among lower income earners, for whom interactions between the tax and transfer systems can produce substantial effective marginal tax rates.

Indeed, bracket creep does little to repair Australia’s social compact – to the extent that it makes current promises more affordable, it does so by eroding the progressivity in our system of personal income tax.

2.7 Intergenerational cost pressures

The previous section explained why fiscal drag was too slow and too small to fill Australia’s budgetary hole, and that it can have its most notable impacts on lower income earners.

The current section focusses on the long view – intergenerational costs.

The political and policy debate in Australia has been rapidly changing as the commodity price rug is pulled from under Budget revenues. Yet that debate remains focused on short term outcomes, meaning some important big picture trends are all too easy to forget.

That is why recent policy changes have spent so much time shifting the timing of various spending and tax measures around, and why the promises of recent times have always been careful to focus on new spending outside the four years of the forward estimates.

Those promises, together with the impact of rapid growth in spending across a range of programs both old and new means that **the structural deficit is set to worsen over the longer term as an ageing population and relatively rapid health cost growth threaten the longer term health of the Budget.**

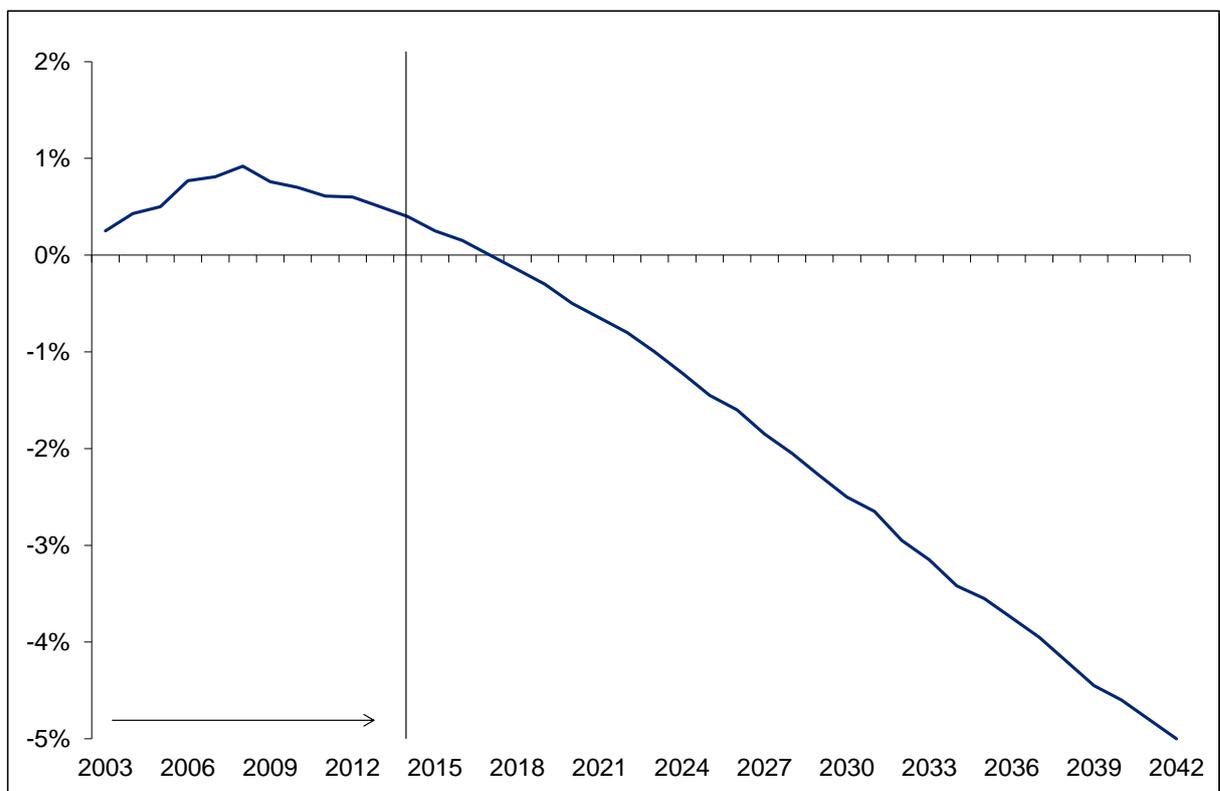
That sees even more areas of spending adding to the task of Budget repair, including carer support, aged care, Medicare, the Pharmaceutical Benefits Scheme, disability pensions, disability insurance, and age pensions.

You couldn't say that we weren't warned. The first *Intergenerational Report (IGR)*, released in 2003, highlighted twin challenges to the Budget over coming decades:

- **a quantity challenge**, as an ageing population will mean more retirees and fewer workers to support them; and,
- **a price challenge**, as the increasing cost and usage of health and aged care put further pressure on government spending.

Those challenges are intertwined, and they will be a big problem for the Budget going forward.

Chart 2.5: Projections of Federal primary balances – 2003 IGR



The initial IGR informed our policymakers of Australia's demographic destiny, and that business as usual would see the Budget in some serious trouble. Chart 2.5 shows the 2003 IGR projections of Federal primary balances (that is, the bottom line excluding interest payments).

It shows the projection made in the 2003 IGR that the Budget position would improve in the short term, with surpluses peaking in 2007-08 – a prediction which, thanks to the timing of the GFC, was more or less on the money.

By 2013-14, those initial IGR projections then saw Budget surpluses shrinking fast, before turning into deficits by 2016-17 and rapidly going downhill from there.

A decade later, the Budget is starting from a worse position and little has been done to make the Budget position more sustainable.

If anything, policy decisions since 2003 have made it worse, because the mining boom – and the Budget bubble that it created – lulled governments and Treasury into thinking that things were better than they really were.

We've wasted a decade.

So what?

Long term Budget pressures are noteworthy at least in part because they have implications for where policy should be headed today.

When looking at the true state of the Budget it is important to factor in the challenges of the future. A rough road ahead, other things equal, means that current policies will see the Budget position getting worse over time rather than better.

While it is true that the ups and downs of commodity prices have been the dominant driver of recent Budget trends, some longer term perspective is useful here.

At the time of the first IGR, the predicted Budget pain was a decade away. But that decade has since come and gone, and many of the problems identified in the IGR are now very much upon us.

With Australia's fourth IGR just around the corner, these same demographic factors still loom large. The new IGR will show a Budget that starts from a position of weakness, rather than one of strength, and it will show that the pressures of an ageing population are more immediate today than they were in previous years.

Some will dismiss the IGR as an effort to manufacture a Budget crisis for political ends.

Yet the opposite is more likely. The IGRs assume a stable revenue base and thus haven't taken into account shrinking of the GST base relative to total consumer spending and impacts of some other concessions, including superannuation tax concessions which will continue to grow in importance as the population ages.

They are silent about the pressures on the States, which recent history has shown are often pushed onto the Commonwealth through Federal Government grants and increased Commonwealth activity in policy areas which have historically been under State responsibility.

Indeed, recent moves have seen greater pressure placed on State Budgets over time, with new arrangements for hospital and school funding set to exacerbate existing State Budget woes.

2.8 How big a gap?

The previous sections have noted a large structural deficit, and questioned the projections showing that deficit closing fast in the next few years (as that improvement is heavily reliant on the Senate passing measures that it appears unlikely to actually pass).

The previous sections have also noted that longer term (intergenerational costs) are looming.

So how big a gap does Australia face? Given the above caveats on the future path of the structural shortfall, it may make sense to use the IMF's estimate of the structural Budget deficit (for 2014) of \$48.5 billion as a benchmark for the underlying – and ongoing – fiscal gap that Australia faces.

Using that benchmark, then **it would take something like fifteen years of bracket creep to return the Budget to structural balance, or two decades of bracket creep to return to a structural surplus of around 1% of national income.**

Were such a course to be adopted over the next two decades, then the top marginal tax rate would cut in at just 1.1 times average weekly ordinary time earnings (AWOTE).

Alternatively, **were the structural shortfall in Australia's social compact with itself to be closed solely by an increase in the average rate of personal income tax – currently 17.6% of wages and salaries – then the latter would need to lift by more than a quarter to 22.3%.**

3 The risks are larger than generally recognised

As the discussion in Chapter 2 notes, commodity prices have become the key economic driver of Australia's Budget over the past decade. Developments in commodity prices are therefore crucial to the Budget outlook.

Official Budget figures are based on Treasury forecasts for Australia's terms of trade – the ratio of the prices the nation receives for our exports and those we pay on imports.

Yet those forecasts are far from certain. Over the past year rapid price falls on world markets have highlighted the important and ongoing risks to the Budget outlook.

In this chapter we explore the efforts of official forecasters to account for those risks, and present Deloitte Access Economics' alternative estimates of the potential for commodity price movements to present downside risks to the Federal Budget.

3.1 What drives the terms of trade?

A vital question for the fiscal outlook is how much of the commodity price boom of recent years will become an ongoing feature of the global economic landscape.

Will Australia's terms of trade sit permanently higher than they did through the second half of the 20th century? Or will shifting market forces take prices back to more or less where they were before China's demand for resources took off?

On the face of it there seems to be a case for higher commodity prices becoming an ongoing feature of the economic landscape. After all:

- Not only is the world's population growing, but so too is its prosperity, and both factors add to industrial commodity demand.
- At the same time there is a relatively fixed supply of minerals which the world steadily eating our way through, and that mix of rising demand and falling supply should lead to a longer term uptrend in relative industrial commodity prices.

So there are certainly good reasons to think that the world's demand for resources is markedly different from that of decades past.

Despite slowing economic growth in China, demand for raw materials remains strong, with other major developing economies such as India also contributing to the potential for strong global demand over the longer term.

Other things equal, that suggests prices will remain above their past levels too.

To be clear, few advocates of higher commodity prices argue that prices will shift permanently. Rather, they see an extended period in which the pace of demand growth will be so strong

that supply will struggle to catch up – with that period lasting through the next two decades as China and then India and others industrialise. **Yet increases in demand are only one part of the commodity price picture, and there are a number of reasons to expect that the price gains seen over the past decade or more are more temporary than demand alone might suggest.**

A key feature of the resource boom on a global scale has been investment, improvement and innovation in the techniques used by the world’s miners and drillers to extract resources that were previously considered off limits due to higher extraction and processing costs.

Those efforts together with the impact of technological change in one of the world’s most capital intensive industries have resulted in productivity growth outpacing that elsewhere – a classic recipe for downward pressure on prices over time.

That is because commodity prices are set by both supply and demand, and current increases in supply, like the increases in demand that preceded them, are unprecedented.

As Deloitte Access Economics often stresses, you can only ever have a boom in two out of three of demand, supply and price. The longer term implications of a continuing industrial revolution in centred on China and India in coming decades will be a continuation of the boom in commodity demand.

That leaves the outlook for commodity supply as the key to prices. And, as recent evidence has shown, the capacity of the world’s miners to match and exceed higher demand growth can put substantial pressure on prices.

Looking forward, that pressure may see prices return much closer to their long run averages.

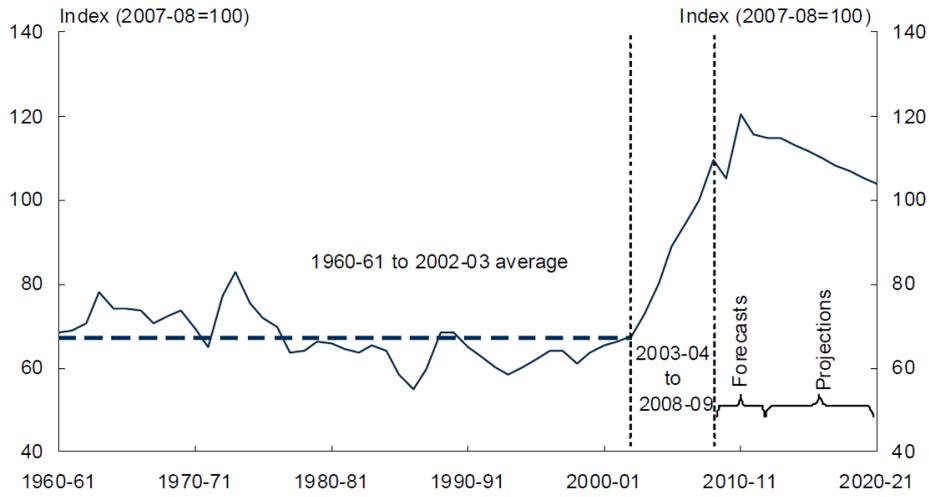
3.2 The official view has been changing

Developments in commodity prices have been evolving at a rapid pace. Price increases as the boom took hold were unprecedented, and price falls as the nature of the boom has shifted have been similarly rapid.

Those developments have seen forecasters revising expectations of the future for the terms of trade – and indeed for the Budget bottom line – at a rapid pace.

Chart 3.1 is drawn from the 2010-11 Commonwealth Budget. It shows Federal Treasury’s then projections for the terms of trade through to 2020-21.

Chart 3.1: The terms of trade – Federal Treasury projections

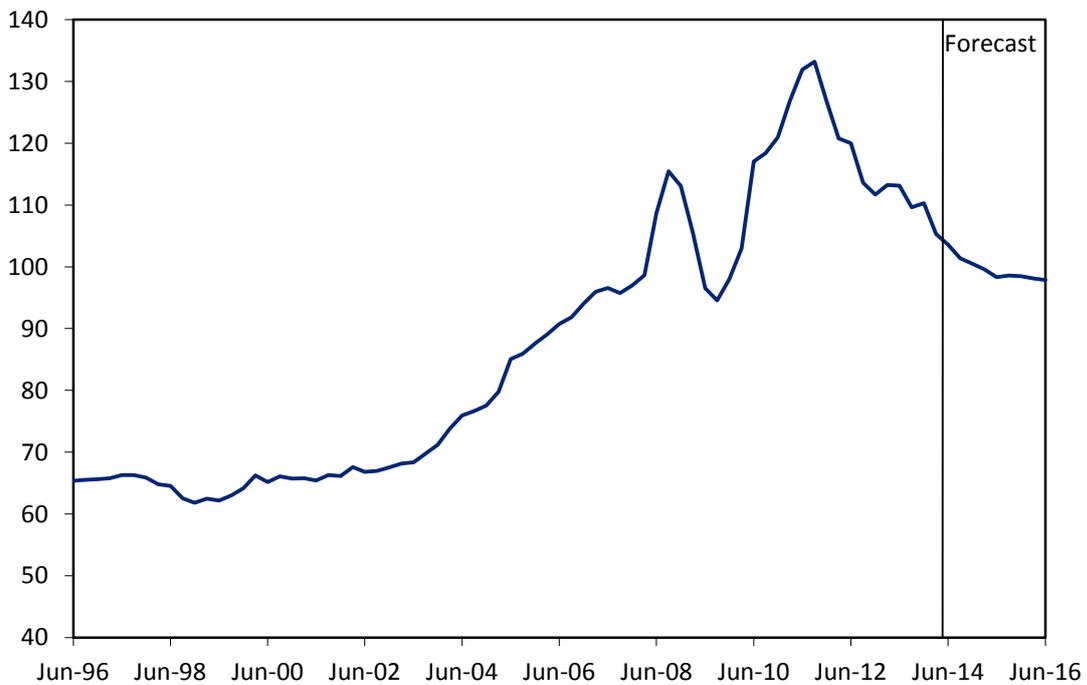


Source: Federal Treasury, Budget Paper No 1, 2010-11, page 4-5.

Those projections were prepared prior to the commodity price peaks seen in mid-2011. They saw the terms of trade peaking in the short term before softening thereafter, but remaining well above longer term averages for a decade or more due to strong commodity demand in China and India.

Chart 3.2 below shows Treasury's updated forecasts for the terms of trade from the 2014-15 MYEFO, rebased to the same index numbers as shown in Chart 3.1. Compared to the forecasts in the above chart, the terms of trade peak that was actually reached was considerably higher.

Chart 3.2: Treasury terms of trade forecasts at the time of the 2014-15 Budget



Source: Federal Treasury, Budget Paper No 1, 2014-15, page 2-15.

However, the drop since that peak has also been sharper than forecast.

The upshot is that the terms of trade is already below where Treasury's earlier projections had it. In effect, the terms of trade has dropped to where Chart 3.1 saw it reaching in 2020-21.

The latest official forecasts continue to see declines in the terms of trade going forward, representing a substantially lower medium term outlook than that of previous years.

That more cautious view is a sensible one, and it has had important implications for the Budget bottom line over the intervening period.

It is also a reminder not only that downside risks to the Budget from falling commodity prices exist, but that they are already playing out.

3.3 Risks have increasingly been recognised

Yet there is a chance that what occurs is rather nastier than the official projections are allowing for.

Assessing where commodity prices stand today versus where they will be in the longer term isn't easy.

That has seen sensitivity analysis – the approach of developing alternative estimates assuming different outcomes from those expected as a 'central case' – becoming an important feature of Budget analysis in recent times.

That is a development that Deloitte Access Economics welcomes, and one that policymakers and the broader public should also be pleased to see.

Over the past year both the Treasury and the PBO have looked at what might happen to the Commonwealth Budget position as the result of a larger reduction in the terms of trade than is currently expected.

- Treasury considers a scenario consistent with a reduction in the terms of trade of around 4%¹ in the most recent MYEFO, presenting estimates of the resulting change in the Budget balance for 2014-15 and 2015-16.
- The PBO looks a 10% reduction in the terms of trade, publishing estimates from 2014-15 to 2024-25 of the resulting impact on the Budget balance in its publication entitled *The sensitivity of budget projections to changes in economic parameters*. This is a rather larger reduction than that considered by Treasury in the Budget papers.

Chart 3.3 compares the results of the two scenarios published by Treasury and the PBO with Deloitte Access Economics estimates based on a 4% fall in the terms of trade by 2017-18:

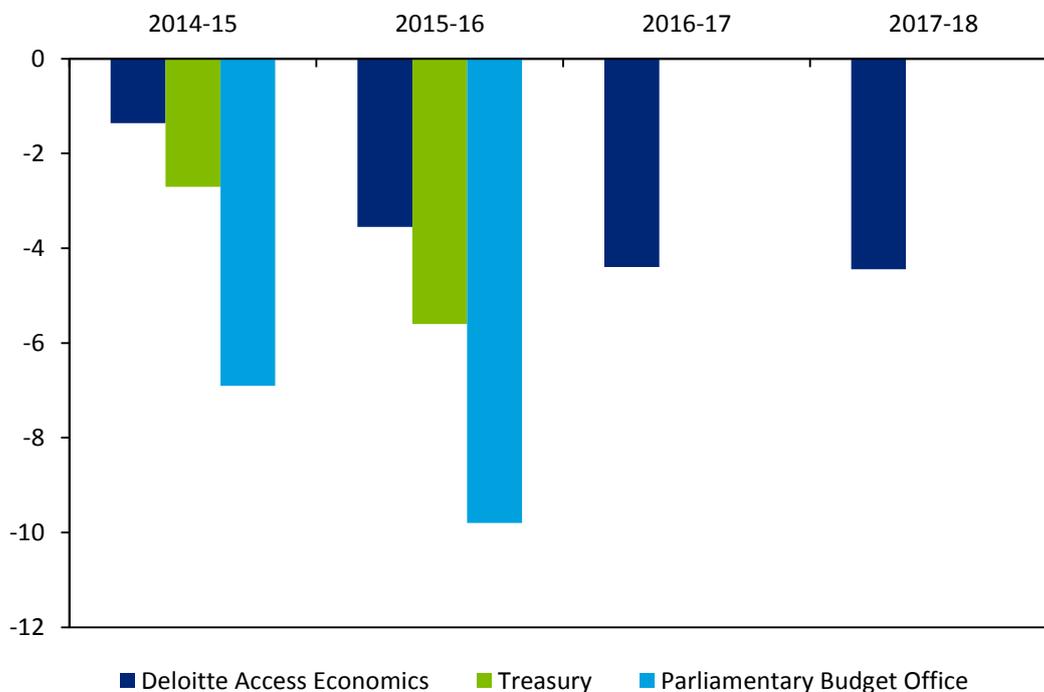
- Treasury's fall of 1% in the nominal size of the Australian economy is made up of a reduction of ¼% in the real economy, with the remaining ¾% of the fall in nominal GDP in response to lower prices (particularly in commodity prices).

¹ Specifically, the figures presented are for a 1% decrease in the nominal economy due to a fall in the terms of trade.

- In contrast, Deloitte Access Economics' initial scenario consists of price negatives (with no knock on impacts to the real economy).

As mentioned earlier, the PBO estimates a larger shock to the term of trade (at 10%) than either the Treasury or Deloitte Access Economics initially examined in the chart below (at 4%).

Chart 3.3: Budget impacts from a fall in the terms of trade (\$bn)



Source: Federal Treasury (MYEFO, Table 3.18 at page 60), the PBO (“The sensitivity of budget projections to changes in economic parameters”, Table 5-2 at page 38) and Deloitte Access Economics

Even the more conservative estimates from Deloitte Access Economics' own modelling show a notable increase in Budget deficits as a result of a small unexpected fall in the terms of trade.

That should come as a warning on the risks to the Budget, as it is important to note here that the reduction in the terms of trade we are talking about here is not that large. A 4% reduction is about two thirds of its average year-to-year variation (6.6%²).

Even the PBO's scenario, though a rather larger fall in the terms of trade than had been considered in published official sources to date, represents a relatively small movement when compared to actual shifts in the terms of trade of late.

3.4 But those risks could be greater still

Though official estimates do acknowledge the risks to the Budget from falling commodity prices, those risks may be notably larger than the figures contained in published official estimates.

² Specifically, this is the standard deviation of year-to-year percentage changes in the terms of trade over the period 1981-82 to 2013-14.

There are few certainties here, and indeed the commodity price falls of recent times may mean that much of the expected price adjustment has already occurred – meaning the optimism which continues to underpin Treasury forecasts may turn out to be right.

However, the range of possible outcomes is wide, and it now makes sense to include in Budget sensitivity analysis the possibility that the commodity price boom could unwind entirely – and do so sooner, rather than later.

The 2014-15 Budget and subsequent MYEFO were more conservative than the consensus on what might happen to commodity prices, but both appear to have understated the size of the downswing now underway.

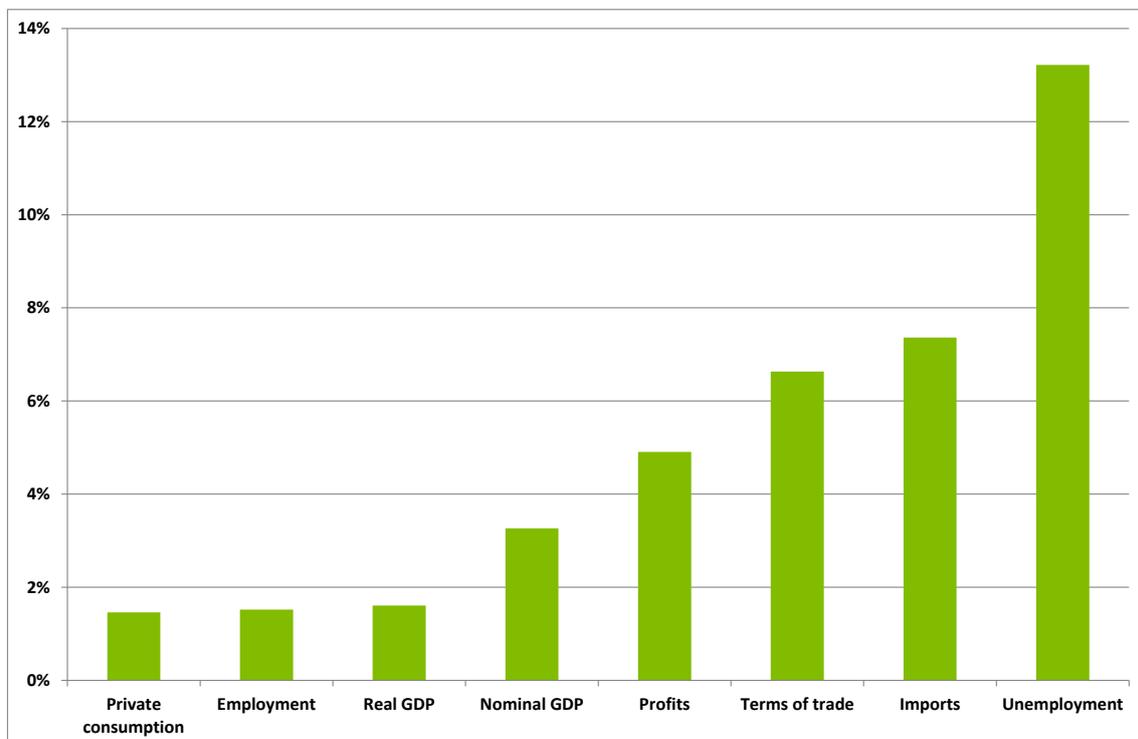
A key question considered in this report is therefore a fairly simple one: what if the terms of trade were to go back whence they came? In particular, it is worth considering a scenario in which Australia’s terms of trade return to the levels seen in 2002-03 – just before the commodity boom roared to life.

The latter levels are close to the longer run average evident through the previous four decades and are substantially closer to current levels than they were just 12 months ago.

To assess the potential of such a scenario to hurt the Budget outlook Deloitte Access Economics has constructed estimates of the impact on the Budget of four separate scenarios.

As noted below, these scenarios are calibrated using past volatility – specifically, the annual standard deviation calculated on annual growth rates between 1980-81 and 2013-14, as shown in Chart 3.4.

Chart 3.4: Annual standard deviation in key economic drivers of the budget



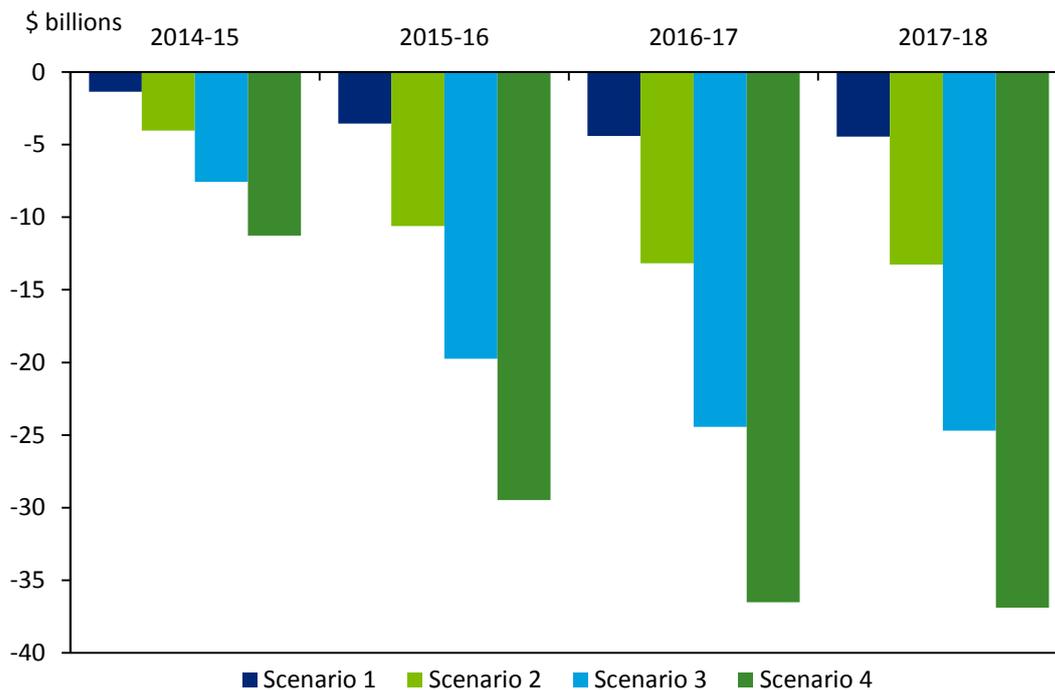
Source: Deloitte Access Economics, Australian Bureau of Statistics

Specifically:

- **Scenario 1 looks at fall in terms of trade by 4%** – essentially matching Treasury’s existing scenario analysis presented in the 2014-15 MYEFO.
- **Scenario 2 represents the effect a ‘typical’ real economy slowdown** in which each of the economic aggregates identified in in Chart 3.4 above (that is, including the likes of employment, profits, private consumer spending and import volumes) are one annual standard deviation lower than they are in the baseline.
- **Scenario 3 examines a fall in the terms of trade back to level seen in 2002-03**, with that fall playing out gradually over the four year forward estimates period. This represents a fall of some 21% relative to our baseline projections and 31% relative to the latest official data from the ABS.
- **Scenario 4 combines scenarios 2 and 3** to look at a fall in the terms of trade back to 2002-03 levels combined with a real economy slowdown.

Chart 3.5 below shows the effect on the Budget over the forward estimates of the four scenarios mentioned above. We estimate that if **the terms of trade were to return to its 2003 level that the Budget deficit would be higher by a cumulative \$76 billion over the four years** (scenario 3 – the light blue bars).

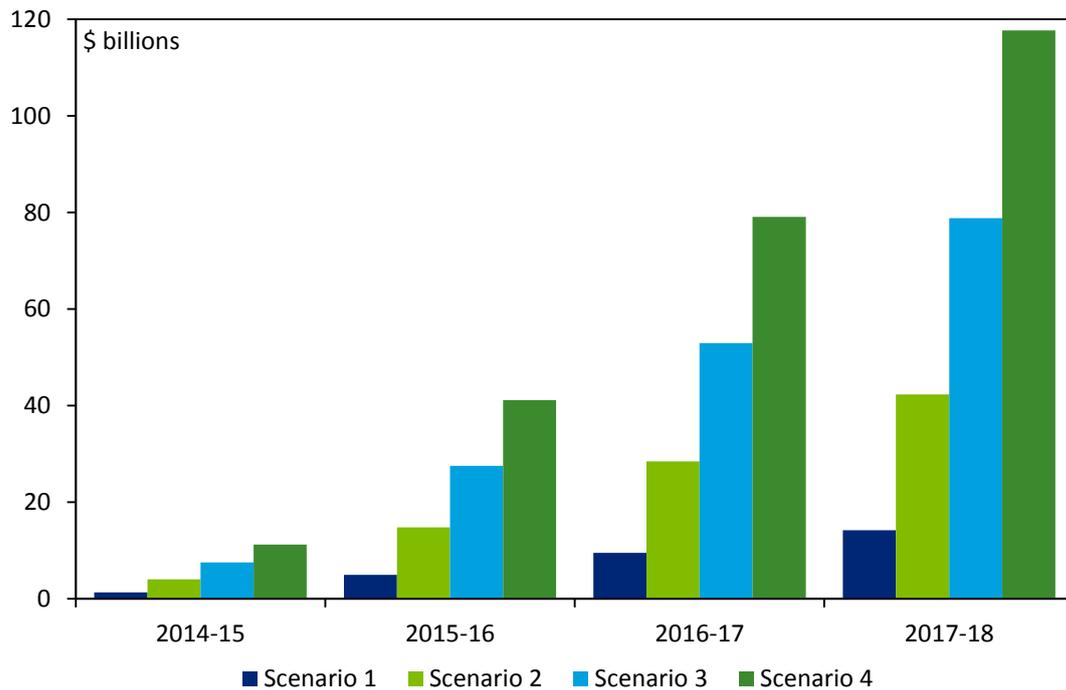
Chart 3.5: Budget impacts from real and nominal economy shocks



Source: Deloitte Access Economics

This would result in the deficit being about 1.2% of GDP larger than it would otherwise be. That impact is substantial – close to twice the estimates for a typical downturn in the real economy. This would also result in net debt being around \$78 billion, or 4.8% of GDP higher in 2017-18 (Chart 3.6).

Chart 3.6: Net debt impacts from real and nominal economy shocks



Source: Deloitte Access Economics

Scenario 4 combines the commodity price fall with a slowdown in the real economy. It highlights the risks that a rapid fall in the terms of trade results in flow on effects to the broader Australian economy, hurting growth in jobs, wages and the economy as a whole.

In practice the flow on effects of the terms of trade to other parts of the real economy would be cushioned by falls in the \$A, while the modelling presented here assumes that the \$A remains unaffected. Still, it is unlikely that the Australian economy would survive the substantial export price falls seen in this scenario completely unscathed.

In this case, an additional \$114 billion is added to the deficit over the next four years, with the Budget deficit being 1.8% of GDP larger than it would otherwise have been in 2017-18.

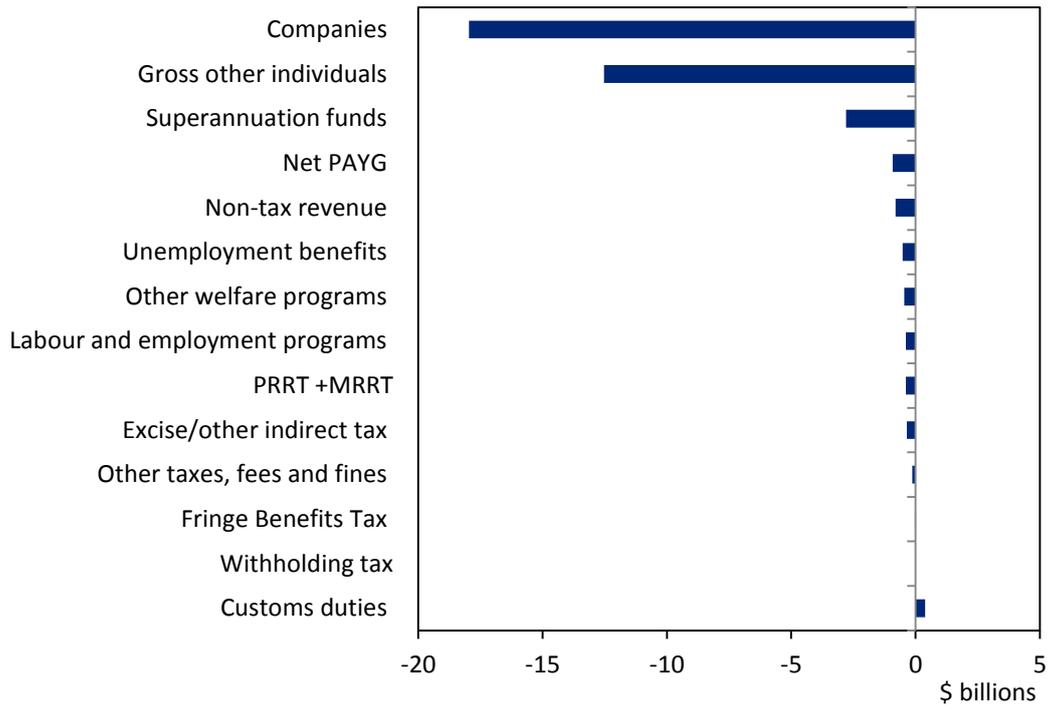
Additionally, net debt also increases to be \$118 billion or 7.1% of GDP higher in 2017-18.

The effect on the Budget mostly comes from a reduction in revenue collected, with a rather smaller contribution from increased expenditure on welfare programs and the like (Chart 3.7).

Profit-related taxes take the biggest hit. Among the most volatile of Federal taxes these are heavily reliant on commodity prices and vary considerably with the business cycle. Company tax collections fall by \$18 billion in 2017-18, while those for 'gross other individuals' fall by a further \$12.5 billion in the same year. Revenue from superannuation funds, the PRRT and net PAYG taxes all also fall.

In total, revenue received (including the GST) falls by a marked \$36.3 billion in 2017-18, while expenditure increases \$1.4 billion.

Chart 3.7: Revenue losses and spending increases in a ‘commodity slowdown’ (\$bn), 2013-14



Source: Deloitte Access Economics

The level at which commodity prices will eventually settle is highly uncertain – and the figures considered in the third scenario are becoming increasingly plausible.

Although Deloitte Access Economics doesn’t forecast a fall in commodity prices sufficient to return the terms of trade to 2002-03 levels, history certainly suggests such a fall – or worse – could be on the cards. And so does the current momentum in markets, as a combination of an economic slowdown in China and surging global commodity supply has shown over the past two years, the long expected shift in the balance between global demand and global supply can occur surprisingly fast.

With that experience in mind, now is time that the risk of more substantial falls in commodity prices entered into the thinking of policymakers.

4 The shifting balance of policy costs

Australia's fiscal fortunes have seen some dramatic shifts over the past decade, with a massive tax revenue boom emerging from surging commodity prices, before retreating just as quickly following the peaks of 2011. That pattern of a rapid rise followed by a rapid fall has seen similar effects on the willingness of policymakers to deliver spending increases and tax cuts.

In this chapter we explore the marked differences between the decisions made as key parts of the economy surged, as well as those policy decisions made as the effect of the resources boom on revenues has cooled.

It is important to understand what we've done as the nation considers what it should do next. And that is all the more true when 'what we've done' is not what people think it is – despite popular perception, the net policy costs of the last decade have been overwhelmingly due to spending increases rather than due to net tax cuts.

4.1 The benefits of the boom

While the resources boom of the last decade was good for the economy, it was stunningly good for the Budget. That's because the boom:

- Pushed up commodity prices such as coal and iron ore, in turn sending profits (the most heavily taxed part of incomes) soaring. And it pushed up sharemarkets and underpinned earlier gains in housing prices, with those capital gains also turbocharging the tax take.
- Finally, higher wealth thanks to healthy share and housing prices encouraged families to spend, boosting spending taxes. And although there was eventually a surge in construction spending by miners – which, unlike extra spending by families, adds to tax deductions rather than the tax take – that spending came later in proceedings.

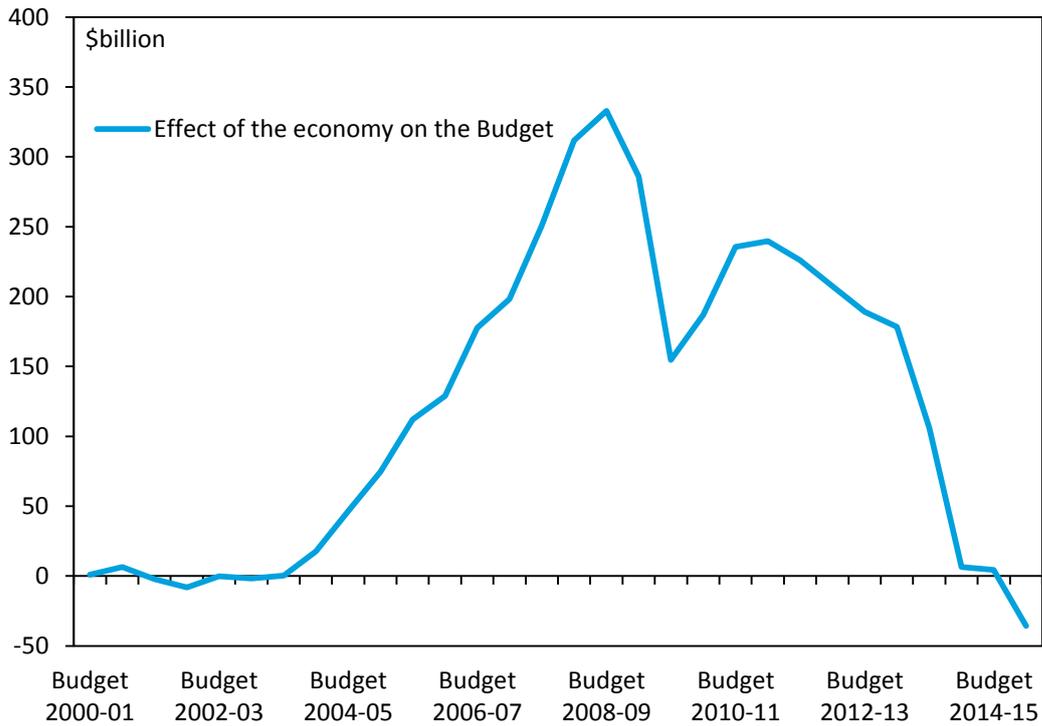
The simple summary is that the resources boom helped to create a 'Budget bubble' here in Australia. There are only ever two major impacts on the Budget: the health of the economy, and the decisions of politicians. Chart 4.1 below uses Treasury's own numbers to show the impact of these on the Budget's trajectory as at each update.

Starting with the 2000-01 Budget it tracks the cumulative effect of shifts in the economy on the Budget projections.

Canberra's numbers are always given over four years, but even when you divide the 2008 peak by four, that's a gift to the Budget which briefly peaked at over \$80 billion a year.

The global financial crisis then rapidly halved that Budget bonanza, but China's own stimulus in response to the GFC sent commodity prices soaring to even higher peaks. That renewed rush of gold into Canberra's coffers – and Treasury's optimism about how long it would last – was what encouraged then Treasurer Wayne Swan to promise a return to surplus "three years early".

Chart 4.1: The effect of the economy on the Budget



Source: Deloitte Access Economics, Federal Treasury

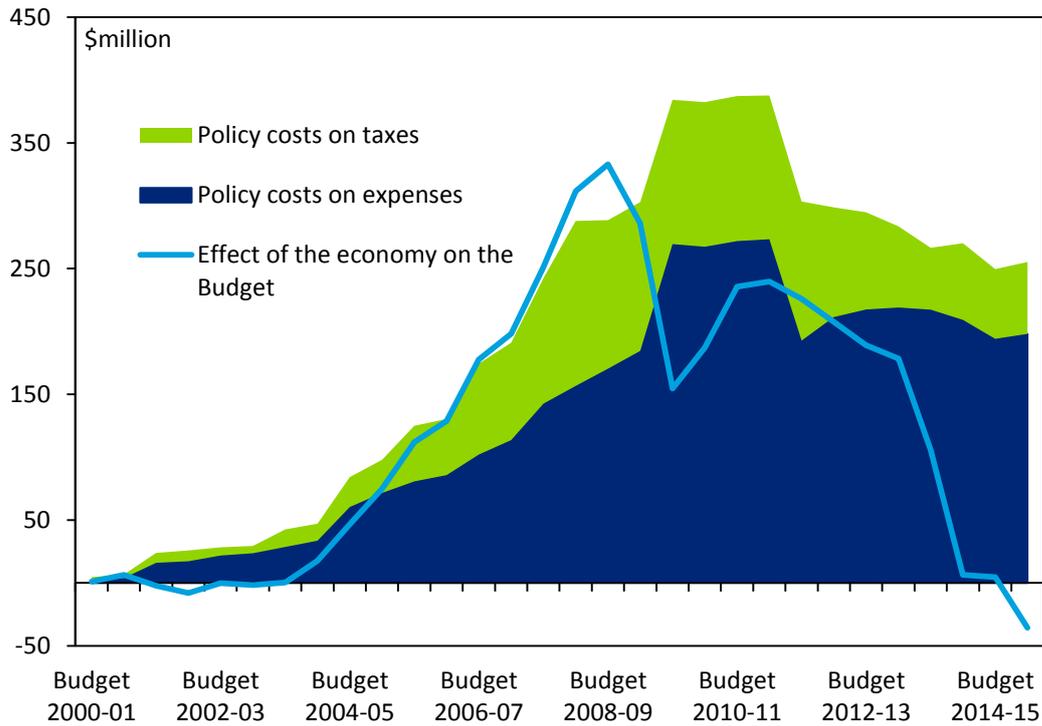
4.2 The policy costs that accompanied the boom

So what did the nation’s leaders do with the dollars delivered to them by the biggest boom Australia has ever experienced? The Chart 4.2 adds the cumulative effect of policy decisions over the four year forward estimates, on revenue and spending at each Budget update.

From the start of last decade, successive governments of both political persuasions gave back this remarkable tax windfall via a combination of lower taxes and increased expenditure.

Under the Coalition, that increased spending came via the likes of higher family payments and the baby bonus while under, Labor, expenditure initially increased due to the stimulus measures introduced in response to the GFC, then in a more lasting fashion thereafter via new funding for health and education, as well as compensation for the mining and carbon taxes.

Chart 4.2: Impact of (1) policy decisions and (2) the economy on the Budget



Source: Deloitte Access Economics, Federal Treasury

4.3 A gradual shift to savings

Yet coal and iron ore prices peaked back in 2011, and the subsequent Budget story has been very different.

Lower commodity prices and lacklustre receipts from the likes of capital gains taxes saw Treasury revising down its estimates of how much money the economy would deliver for the Budget. These revisions came relatively slowly at first, but then came in a rush after the pre-Christmas 2012 admission that there'd be no surplus in 2012-13.

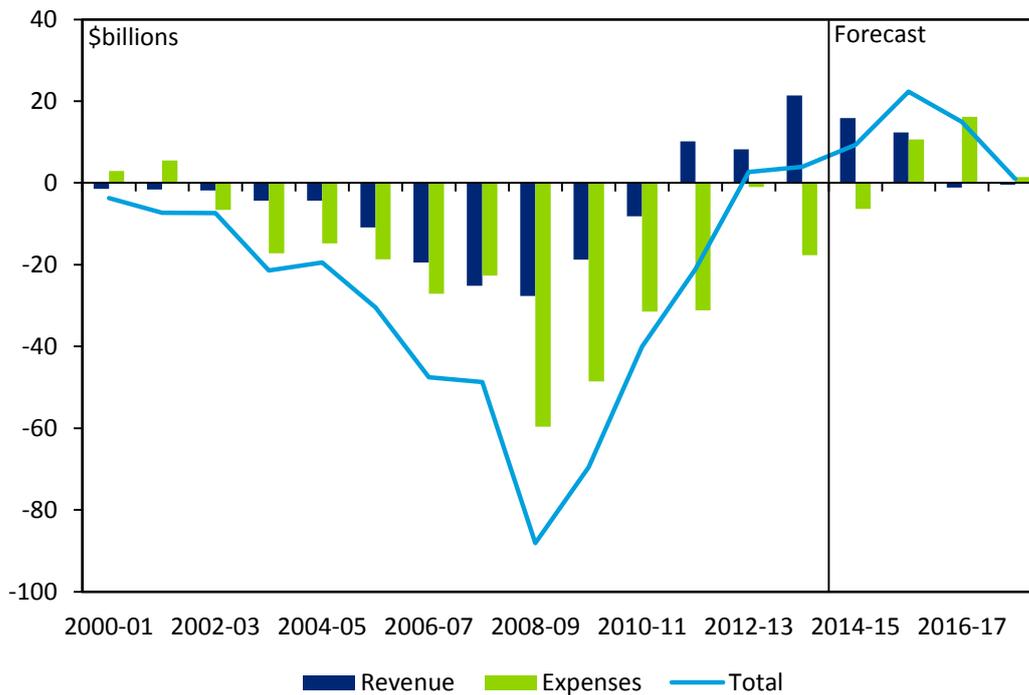
And now we're back where we began. The bonanza delivered by the economy to the Budget has now gone. Like every other boom in Australia's history, it turned out to be temporary.

That phase of retreating expectations of the Budget due to the economy has seen successive governments turn their attention away from new policy promises and towards measures aimed at reducing Budget deficits over time.

Chart 4.3 below shows an alternative way of showing the policy effects of changes in revenue and expenditure on the Budget. This chart shows the cumulative effect on the Budget bottom line in each financial year of policy changes made from Budget 2000-01 through to MYEFO 2014-15, with improvements to the bottom line showing up as positive values on the chart.

That is, while Chart 4.2 earlier keeps track of four year totals over time, the measures in Chart 4.3 are the sum of a number of changes aimed at specific years, with each value independent of the last.

Chart 4.3: Cumulative effect of policy changes by financial year



Source: Deloitte Access Economics

As the chart shows, from 2002-03 through to the onset of the GFC, the Government of the day (initially the Coalition, and then Labor) gave back the windfall gains as both increased expenditure and tax cuts. In total, government expenditure increased by \$107 billion over the six years from 2002-03 as a result of policy decisions, while revenue returned via policy decisions was \$66 billion.

In effect, policy decisions were pumping up an already strong economy.

But the effect of policy decisions peaked in the 2008-09 financial year, due to a combination of income tax cuts promised during the 2007 election campaign, along with the initial impact of increased government expenditure from the economic stimulus.

Expenditure from policy decisions then increased in each subsequent year to 2013-14. That phase first came as a result of compensation and other spending related to the mining and carbon taxes. Later, spending increased due to policy decisions such as the introduction of the National Disability Insurance Scheme (NDIS) and additional schools funding.

Yet the turn in the policy tide began a while ago. Moves to address spending were already underway before the 2014-15 Budget, including under the previous Labor Government. Early moves to rein in spending started in late 2012, including changes to the private health insurance rebate and reductions in the baby bonus after the first child.

Then Labor’s last Budget in May 2013 took aim at family payments and made a host of tweaks to the carbon tax package aimed at containing costs. Further cuts were announced in the Mini-Budget released just ahead of the election campaign, this time squeezing government

departments via an increasing the efficiency dividend, further dismantling spending associated with the carbon tax and cutting foreign aid.

During this period the former Government also began to raise revenue through policy changes. The introduction of the carbon and mining taxes, as well as the increase in the Medicare levy are the stand out policies. Additionally, a range of other changes were made to duties, excises and deductions.

This continued with the election of the Coalition, with revenue impacts via the re-indexation of fuel excise and the introduction of the Budget repair levy, and a range of spending savings. The latter included changes to more sensible indexation arrangements for a bunch of benefits (including the age pension itself), as well as making it harder to get access to some benefits (including family tax benefit B), and health care cards for seniors

While the policy tide has turned, **Chart 4.3 highlights that the efforts of successive governments to improve the Budget balance via new policy savings have been notably smaller than the matching policy promises of prior years.**

Furthermore, by only including the years of the forward estimates, the data presented in the chart understates the effect of past policy decisions on the Budget. In effect, policy decisions made during the boom years will continue to have implications for the national Budget for many years to come, whether they be the personal income tax cuts of prior years, or the introduction of new expenditure policies such as the NDIS.

Finally, the figuring here assumes that current Government policy passes through the Senate, including the expenditure savings noted in Chart 4.3.

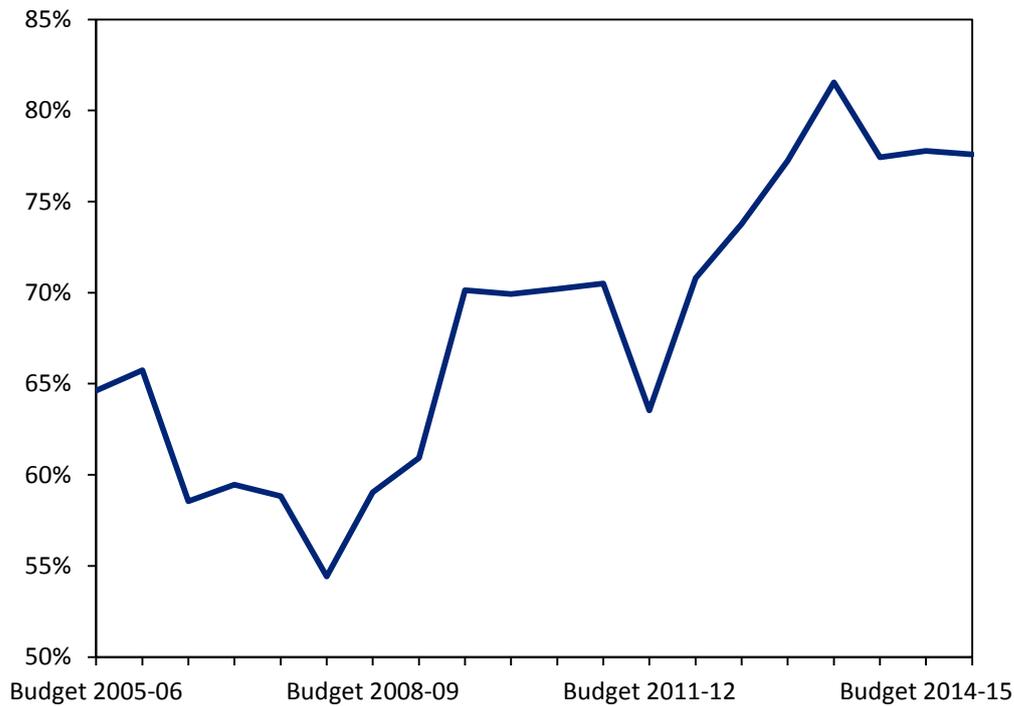
4.4 What cost more: spending increases or tax cuts?

This figuring – drawn from Treasury’s own analysis – shows that much of the policy repair effort to date has been focused on increasing revenues, rather than reducing spending.

That is, while spending was the bigger contributor to policy costs during the good times, policy moves aimed at repairing the Budget since the peak of the boom have been aimed almost exclusively at increasing revenues.

Chart 4.4 shows the bulk of the burden of Budget of policy decisions since the 2000-01 Budget has been falling on spending, rather than revenue.

Chart 4.4: Spending policy costs as a share of total policy costs over the past decade



Source: Deloitte Access Economics

It shows that spending and revenue decisions were close to evenly split just prior to the onset of the GFC, with the revenue share of total policy costs peaking with the announcement of very large personal income tax cuts ahead of the 2007 Federal election. Virtually all of those tax cuts announced by the then Coalition Government were enacted by the incoming Labor Government.

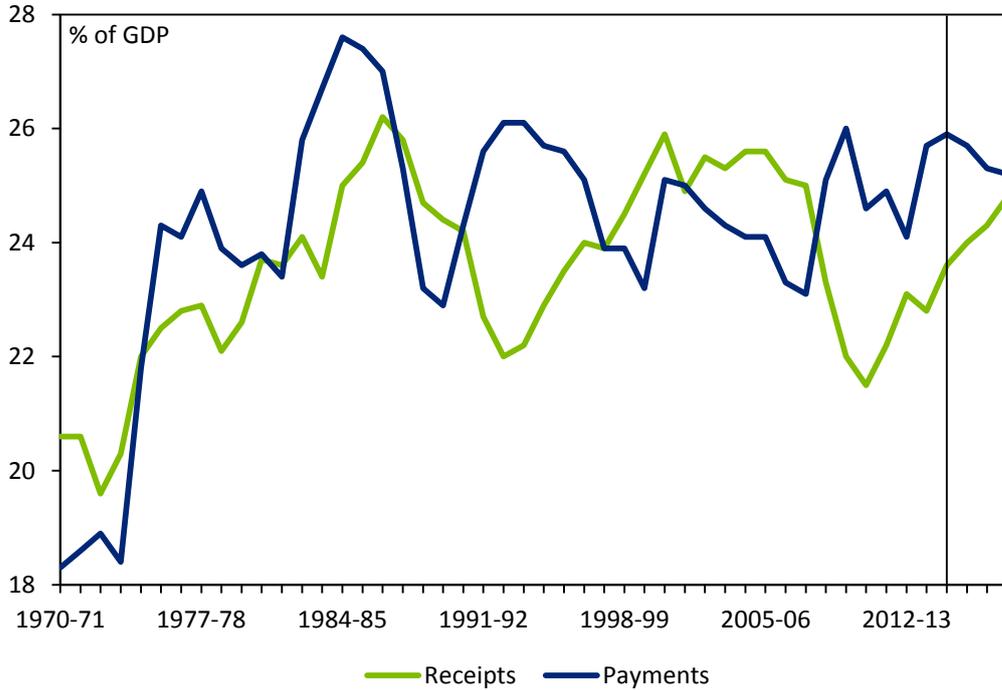
In the years since then policy decisions to increase spending and to cut revenue have seen spending accounting for as much as four out of every five dollars of the substantial Budget costs associated with policy decisions over the past decade.

The focus in recent years on achieving Budget repair via raising revenue rather than measures aimed at curbing spending is stronger still when you consider the fact that one important policy choice is excluded from the figures above. Because leaving personal income tax thresholds where they are doesn't involve a policy change in the figures included here, the effects of bracket creep come atop the revenue increases seen in Chart 4.3.

With the latter set to play a role in current plans to repair the structural Budget position, **that suggests the policy balance between revenue and spending measures in recent times is even more skewed in favour of higher revenues than suggested by the figures above.**

Chart 4.5 below takes a longer term view of the spending and revenue of the Federal Government.

Chart 4.5: Government revenue and expenditure as a share of GDP over time



Source: Federal Treasury, MYEFO, 2014-15, Table D5 page 272.

With the notable exception of the peak in 2009-10 amid GFC-related stimulus spending, spending as a share of GDP remains higher than it has been since the mid-1990s, while revenue as a share of GDP is projected to continue its recent rapid recovery from its GFC lows.

While, along with Chart 4.3, the official forecasts here do show policy savings on the spending side of the Budget increasing across the forward estimates, those savings remain relatively modest, and many of them are still subject to Senate approval.

With increased spending accounting for the lion's share of the policy decisions which have added to the structural deficits evident in the current Budget position, it makes sense for spending policy to be closely scrutinised on the path to Budget repair.

Doing so will require a strong commitment from both Government and the broader community to containing growth in spending over the years ahead.

Appendix A: Structural Budget analysis

In this Appendix we describe the methodology applied by Deloitte Access Economics in constructing estimates of the structural Budget balance.

The Budget balance at any given time is a function of two factors:

- **The changing fortunes of the economic cycle.** These give rise to movements in the cyclical Budget balance. They include, for example, the impact of stronger than trend job levels on personal income tax receipts, or of higher than trend profit levels on tax receipts such as company taxes.
- **All other influences.** These mainly reflect discretionary moves taken by governments, such as spending on programs, or cutting tax rates. Other influences are more subtle. For example, if inflation is running fast, then so too is fiscal drag ('bracket creep'). The year-to-year gain from this is taken to represent an improvement in the Budget's structural balance (a net increase in revenue). But any discretionary tax 'cut' (as the Government hands back the effect of inflation) is a net structural worsening. A similarly subtle influence would be if the Tax Office became more or less firm in applying the law.

A healthy dose of caution is required when making conclusions from structural Budget models. In general, year-to-year changes in the structural balance are more useful and accurate than the actual level at any particular time.

Yet without separating the structural and cyclical components of the Budget position it can be difficult to assess the 'true' state of Australia's Budget fortunes.

Drivers of the budget cycle have changed

Tracking the health of national Budgets is tough. There are a range of factors at play, many of which interact with each other, making it difficult to estimate the individual effects. It can also be difficult to separate out the structural and cyclical components of different economic variables, making it hard to estimate the 'true' state of the Budget. Differences in estimation of the cyclical and structural components can be the difference between thinking the Budget position is in a temporary reversible hole, compared to a permanent state of red ink.

Up until 2003, that meant looking at traditional measures like unemployment as clues to the impact of the economy on the Budget. If, for example, we were running a deficit even when unemployment was low, that pointed to underlying structural weakness in the Budget. Or if we were running a surplus even when unemployment was higher than usual, that pointed to structural strength in this nation's social contract with itself.

Accordingly, modellers could use the unemployment rate or a range of related statistics such as 'output gaps' – which show the difference between actual economic output and its estimated long-run trend – to usefully identify the structural health of Australia's economy.

These types of relationships are still an important part of published analysis of the structural health of Australia's Federal Budget.

The logic behind using these measures is that 1) some of the automatic stabilisers within the Budget are a function of unemployment rates, and that 2) Budget revenues are closely tied to economic output, for which unemployment can be a handy yardstick.

Yet since 2003 the revenue side of Australia's Federal Budget has shown little linkage to shifts in the unemployment rate. Unemployment benefits are a small and shrinking share of overall public spending. More important still is that the most volatile parts of the bottom line – profit based taxes – are not as closely tied to measures of unemployment and output as they used to be.

As Deloitte Access Economics has argued many times and in many places, that shift in China-driven coal and iron ore prices – the dominant driver of the terms of trade – led to a fundamental improvement in revenues well beyond what was showing up in traditional output and unemployment measures.

That's because some key revenue bases were lifted alongside the terms of trade. Higher coal and iron ore prices boosted everything from employment and retail sales, as well as sharemarkets and housing prices. With the health of the Budget more closely tied to those areas of the economy more sensitive to movements in commodity prices, the latter has become the best proxy for the underlying health of the Budget.

That does present some difficulty for the kind of structural Budget measures seen here. Unlike the unemployment rate coal and iron ore prices are tricky to get a handle on, and have flow on effects to Australia's economy and asset markets that have only recently become apparent. That makes the range of reasonable estimates for the structural Budget balance rather wider than it has been in the past.

The key implication here is that a very technological and very contestable assumption is now absolutely make or break for Australia's Federal Budget.

All in all, the Federal Budget is still built on rather shakier foundations than most policymakers realise. One implication of the increased volatility – greater risk – that implies is the case for taking out more insurance.

Deloitte Access Economics has long argued that the extent to which successive governments on both sides of the political divide handed out tax cuts and spending increases over the past decade left the Budget vulnerable to the sorts of shifts we have seen.

Headline and underlying Budget cash balances

The analysis here concentrates on the **underlying structural cash balance** of the Budget. If this is in balance, then the Federal Government is (in trend terms) neither increasing nor decreasing its net indebtedness, and the actual underlying Federal Budget balance reflects merely the impact of the economic cycle.

When looking at the cyclical properties of the overall budget balance, it is usual to split it into just **two components**:

- **The cyclical balance** Changes in the cyclical balance give an estimate of the budgetary impact of aggregate fluctuations through the induced (or automatic) changes in tax bases and social welfare spending. By construction, the cyclical balance is zero when the economy is 'at trend', and its variations are thought to be outside the immediate control of the fiscal authorities.
- **The cyclically-adjusted ('structural') balance.** The cyclically-adjusted balance (CAB) is the hypothetical overall balance that would be observed if output was at trend levels. The CAB is simply calculated by subtracting the estimated effect on the fiscal accounts of the business cycle.

Cyclical adjustment offers an intuitive way of dealing with the fact that tax revenue and government spending move automatically with the business cycle. The idea is that, once they are cyclically adjusted, changes in fiscal variables reflect policymakers' actual decisions to change tax rates and spending levels.

Changes in the CAB are generally interpreted as resulting mostly from discretionary actions by policymakers.

To complicate matters, however, the CAB suffers from two important problems.

First, some variables affecting fiscal balances are not perfectly correlated with output fluctuations. For example, exceptional declines in asset prices may reduce revenues by more than could be explained by looking at output gap changes.

Several effects are worth considering.

- **Share prices:** Recent swings in sharemarkets were more pronounced than in past business cycles, and would, thus, not be fully included in the above estimates. The fall in revenues could come through several channels, including declines in capital gains taxation, a fall in wealth, consumption, and consumption tax revenue, and the impact on company tax revenue associated with a dip in financial sector profits.
- **Housing prices:** Similar comments apply to the swings in housing prices.
- **Exchange rates:** The appreciation of the \$A has squeezed the profits of exporters and those who compete with imports, with consequences for company tax revenue.

Overall, these other non-discretionary effects were sizeable in the GFC and its aftermath, and tend to be harder to include in the usual cyclical adjustment analysis.

Second, where counter-cyclical (stimulus) policies have been adopted, a shrinking negative CAB could reflect the fiscal benefits of improving cyclical conditions rather than true fiscal consolidation measures initiated by the Government.

While the traditional approach copes well with the impact of so called 'automatic stabilisers' – changes in the Budget which occur naturally when circumstances change – that is less true of deliberate countercyclical policies.

The present cyclical adjustment framework largely presupposes that all stimulus measures are permanent in nature, and need to be deliberately reversed or terminated by policy decision.

In practice however, discretionary adjustment/consolidation (or savings) measures are only needed to address the fiscal cost of:

- stimulus measures that are not temporary or reversible, and
- any asset price or commodity price falls that may not return to 'normal' in a reasonable period of time.

Of course, if the impact of any temporary stimulus measures on net debt is to be reversed, matching policy interventions are needed to put the budget into structural surplus during the above-trend part of the business cycle.

The actual and structural economies

In simple terms, short term Budget forecasts are generally a function of demand, while long term forecasts are a function of supply.

The idea of a structural Budget is to bridge this gap as much as possible – by removing the distortions to revenues caused by excess demand (or alternatively, by a lack of demand).

Data on the Australian economy over the past quarter of a century are used to construct an underlying trend ('structural') set of economic variables, which are used to create a set of structural Budget balances. Components of national output, employment and wage data are smoothed using a trend rate of growth between 1980-81 and 1995-96; years chosen as 'mid-points' in economic cycles (rather than years at which the economy was operating at near potential levels, as the Federal bureaucracy has on occasion done for similar estimates). This trend growth is extrapolated, giving forecasts for the structural economy.

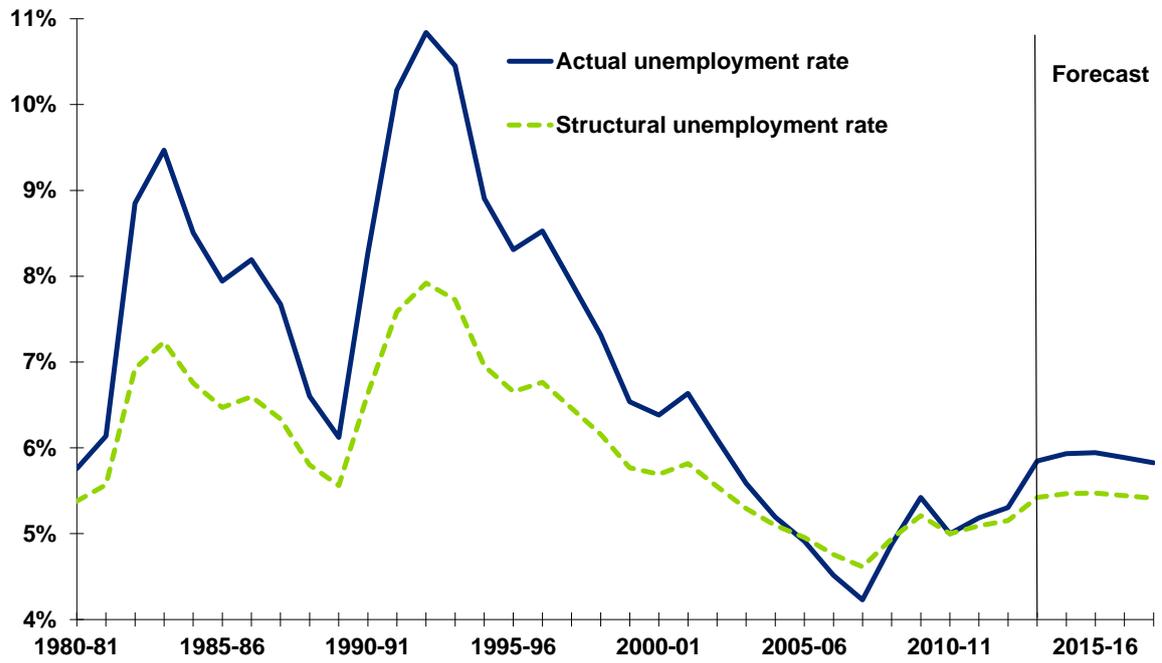
Using mid-points rather than peaks shifts more of any Budget balance to the structural, rather than cyclical, side. The usual approach is to use peaks. However, if one's intention is to ensure that, over the course of the cycle, cyclical Budget balances average out to zero (or thereabouts), the mid-point approach is better.

Deloitte Access Economics' structural economic variables are then compared with their actual values in the past and their forecast values from our *Business Outlook* publication. A set of ratios for each variable in each year is calculated as the value in the structural economy divided by its actual (or forecast) value.

There are two exceptions to this general approach worth noting. The first is that the structural unemployment rate moves with the economic cycle, as shown in Chart A.1 below.

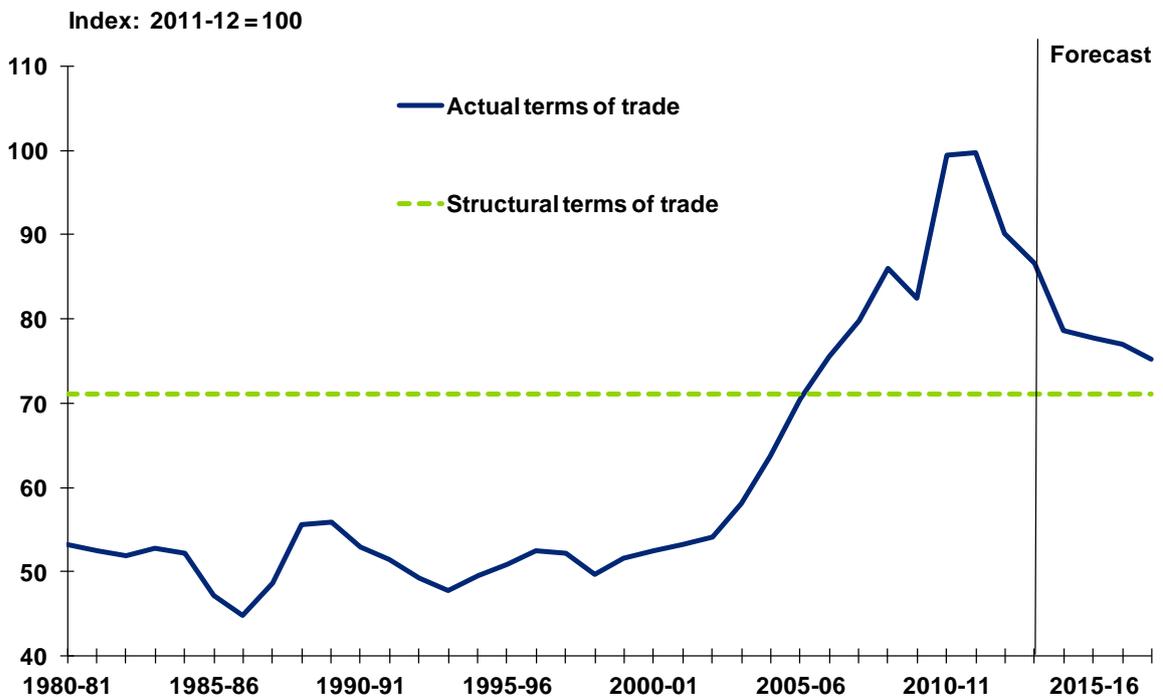
The second factor is that we think that some of the increases in commodity prices through to 2011 were cyclical rather than structural. Our methodology takes the difference in nominal national output directly attributable to shifts in the terms of trade away from their longer term average, allowing 20% of that gap to affect company tax revenues, and 5% of it to affect the revenue from 'other individuals'. These are conservative adjustments given taxes account for almost a quarter of nominal output.

Chart A.1: The actual and structural unemployment rates



Both the PBO and Treasury give ranges for the structural levels of the terms of trade, and we use the mid-points of those ranges for the 'structural' terms of trade.

Chart A.2: The actual and structural level of the terms of trade



Importantly, that assumption still sees Australia's terms of trade remain notably higher than it was through much of the nation's history – effectively assuming a permanent shift in favour of our major commodity exports.

As the discussion in Chapter 3 below highlights, where the terms of trade ultimately land will have major implications for the sort of analysis seen here, with a lower structural terms of trade shifting a greater share of today's deficits onto the structural side.

The ratios calculated between the actual and structural economies are then used to create a set of structural Budget payments and receipts. A number of components of the actual Federal Budget are transformed into structural equivalents by applying estimated ratios of appropriate economic variables to the actual and forecast receipts and payments in the Budget. This process removes the cyclical element from the Budget figures so as to obtain the structural Budget balance, which is assumed to move with the structural economy.

Once a structural Budget has been calculated, the underlying structural balance is calculated as total receipts minus total expenses. The cyclical balance is then defined as the difference between the actual and structural Budget balances.

Limitation of our work

General use restriction

This report is prepared solely for the use of the Business Council of Australia in accordance with the terms of our engagement letter dated 9 December 2014. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity, including members of the Business Council of Australia. The report has been prepared for the purpose of providing input to the BCA's 2015-16 Federal Budget submission.

This report must not, in whole or in part, be included in any document which will be made publicly available or in a public forum without our express written consent.

Contact us

Deloitte Access Economics
ACN: 49 633 116

Level 1
9 Sydney Avenue
Barton ACT 2600
PO Box 6334
Kingston ACT 2604 Australia

Tel: +61 2 6175 2000
Fax: +61 2 6175 2001

www.deloitte.com/au/economics

Deloitte Access Economics is Australia's pre-eminent economics advisory practice and a member of Deloitte's global economics group. The Directors and staff of Access Economics joined Deloitte in 2011.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

About Deloitte

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 170,000 professionals are committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 5,400 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© 2015 Deloitte Access Economics Pty Ltd