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Economic Strategy

For Extraordinary Times

- Extraordinarily, the RBA cut interest rates on the same day as the Treasurer provided a budget for increasing private sector employment.
- This is a rare example of monetary and fiscal policy directed towards the same objective at the same time.

Rate Cut

We have been saying over recent months that we expected a rate cut when the RBA met in May. We thought that the lowest growth rate of average weekly earnings this century would lead to downward pressure on core CPI. The result for the March quarter was to produce the lowest core inflation rate this century. The trimmed measure of inflation came in at 1.7% for year to March. The quarterly increase was only 0.2%.

The RBA reacted to this low inflation by cutting the cash rate by 25 basis points to 1.75%. We think this merely adjusts the cash rate to the decline in the year-on-year inflation. The problem that remains is the very low quarterly rate. Should this very low quarterly rate be repeated in following quarters, then the year-on-year growth rate of core inflation will continue to fall. Further cuts in the cash rate may be necessary to stop Australia falling into a disinflationary cycle.

Chart 1: General Government Sector Receipts and Payments

SOURCES: Budget Paper No 1, Statement 10 Table 1

A Budget for Turnbull's Tradies

I have now covered more Australian budgets than I care to remember. Many Budget Speeches are not memorable, however this one is different. What makes it unusual is that the Treasurer actually seems to understand how the economy works. In real life, profits generate investment. Investment then leads to jobs growth.

When governments tax profits, they reduce the amount of money that can be invested. Reducing the amount of money that can be invested then reduces the amount of jobs that can be created. Simply put, a tax on profits is a tax on job creation. This is particularly true for small business. Most Treasurers never seem to work that out.

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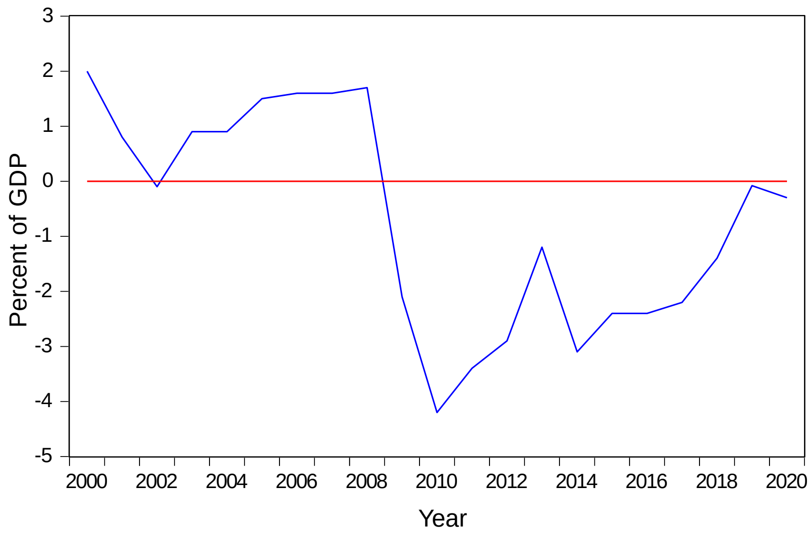
Chart 2: Underlying Cash Balance



SOURCES: Budget Paper No 1, Statement 10 Table 1

This Treasurer has worked it out. We can see this from Page 3 of Scott Morrison's Budget Speech. This is where he talks about his ten year enterprise plan to support jobs and growth. He correctly notes that small and medium businesses support most job creation. He remarks that these businesses are overwhelmingly Australian owned and are more likely to invest their earnings in future growth. He says that "a tax on their businesses is a tax on their enterprise and the jobs they provide."

He then announces a program to leave the small to medium size businesses with more money to invest. This means they will have more investment to create more jobs. He reduces the company tax rate to 27.5% for companies with turnover up to $10 million. Businesses with up to $10 million of turnover will be able to access other tax incentives including small business depreciation pooling provisions. As he says this means that 870,000 businesses employing 3.4 million Australians will have their tax rates reduced. We might call this money for "Turnbull's Tradies".

Also, from 1 July 2016, businesses with a turnover of less than $10 million will be able to access instant writeoff for equipment purchases up to $20,000. This program will expire on 30 June 2017.

The Treasurer tells us that the turnover threshold for access to the lower company tax rate of 27.5% will be extended form $10 million to $25 million in 2017/18, to $50 million in 2018/19 and $100 million in 2019/20. This means that by 2020, more than half of all employees of companies in Australia will be in companies paying a lower tax rate of 27.5%. He says that means there will be 4.9 million employees whose jobs will be supported by a lower tax rate in four years' time.

What is smart about this program is that it provides extra investment at exactly the location in the economy at small to medium sized business where most jobs are created.

Fiscal Outlook

In Chart 1 on page 1 we see receipts and payment for the Australian general government sector over the period from 1999/2000 up to and including 2019/2020. The chart shows us the extraordinary expansion spending in 2009/2010 and the slump in revenue at the time of the global financial crisis.

Spending reached its peak at 26% of GDP in 2009/10. At that time, receipts had slumped to 22% of GDP. The low in receipts was actually reached the following year in 2010/11 when receipts declined to 21.4%. Since that time, it has been a struggle to increase revenue. By 2013/14 revenue had improved to only 22.7% of GDP. At the same time payments stood at 25.6% of GDP.

Table 1: Estimates of Australian General Government Expenses by Function

Function	2016-2017 AUD $m	% of Total Expenses
Social Security and Welfare	158,612	35.2%
Other Purposes	89,129	19.8%
Health	71,413	15.9%
Education	33,669	7.5%
Defence	27,155	6.0%
General Public Services	22,659	5.0%
Transport and Communication	11,131	2.5%
Other Economic Affairs	9,832	2.2%
Fuel and Energy	6,687	1.5%
Housing and Community Amenities	5,282	1.2%
Public Order and Safety	4,915	1.1%
Mining, Manufacturing and Construction	3,545	0.8%
Recreation and Culture	3,401	0.8%
Agriculture, Forestry and Fishing	3,122	0.7%
Total Expenses	**450,553**	**100%**

SOURCES: Budget Paper No.1: Budget Strategy and Outlook 2016-17; Morgans

This meant that even by 2013/14, payments had hardly declined at all from their peak proportion of GDP reached during the global financial crisis. That is still true even in 2016/17. Payments in 2016/17 are 25.8% of GDP. This is only 0.2% of GDP lower that the peak reached during the global financial crisis. The real problem with the Australian budget is that spending went up and never ever came down.

Even the future scenario for this budget sees us as spending 25.2% of GDP in 2019/20. It is only the steady rise of receipts to 25.1% of GDP in 2019/20 that allows the budget to get close to balance. Again, this is a problem of spending that went up and never came down. The austerity fairy never reached Australia.

In Chart 2, we see the underlying cash balance that results from the slow rise of revenue in the face of implacably high spending. We see how the underlying cash balance has to struggle slowly year by year to rise towards a level almost approximating a balanced budget.

Where the Money is Going

In Table 1 above, we can see where the money is going. In 2016/17 the government proposes to spend $450.6 billion Australian dollars. The largest single sector of expenditure is Social Security and Welfare. This sector absorbs $158.6 billion. This is 35.2% of the total budget.

The next biggest sector is health. There the government proposes to spend $71.4 billion. This is 15.9% of the budget. Then follows Education. Here the government proposes to spend $33.7 billion. This is 7.5% of the total budget.

The next is Defence. Here the government proposes to spend $27.2 billion. This is 6% of the total budget. These items together amount to 64.6% of the total budget. The other sectors can be seen in Table 1.

Table 2: Estimates of Increases in Australian General Government Expenses by Function

Function	2015-16 AUD $m	2016-17 AUD $m	Dollar Increase $m
Social Security and Welfare	154,000	158,612	4,612
Other Purposes	85,701	89,129	3,428
Transport and Communication	8,575	11,131	2,556
Health	69,381	71,413	2,032
Education	31,854	33,669	1,815
Defence	26,348	27,155	807
General Public Services	22,162	22,659	497
Mining, Manufacturing and Construction	3,142	3,545	403
Agriculture, Forestry and Fishing	3,063	3,122	59
Other Economic Affairs	9,792	9,832	40
Public Order and Safety	4,885	4,915	30
Fuel and Energy	6,706	6,687	-19
Housing and Community Amenities	5,329	5,282	-47
Recreation and Culture	3,530	3,401	-129
Total Expenses	**434,469**	**450,553**	**16,084**

SOURCES: Budget Paper No.1: Budget Strategy and Outlook 2015-16 & 2016-17; Morgans

In Table 2, we can see the increases in the budget sectors. We have calculated these increases “Budget to Budget”. They are the increases between those included in last year’s budget compared to the same items in this year’s budget.

The largest increase is in Social Security and Welfare. Here we see an increase of $4.6 billion. Transport and Communication interestingly has the next largest increase. This sees outlays rise by $2.6 billion. This reveals the governments shift to increase spending on transport infrastructure.

The next largest sector of increase is Health which sees an increased spending of $2 billion. Education then sees an increase of $1.8 billion. Defence sees an increase in spending of $0.8 billion.

The Economic Outlook

Budget Paper No 1, Table 1 2-6 suggests that we should prepare for a steady recovery of the Australian economy. Real GDP is expected to rise by 2.5% in 2015/16. This growth rate continues into 2016/17. Only in 2017/18 does growth increase to 3.0%.

What appears to be happening is that household consumption is growing at a steady rate of 3% per year throughout. At the same time, a steady decline in mining investment is being counter balanced by modest growth in dwelling investment.

Exports of goods and services grow faster than imports. Exports are expected to rise by 6% in 2015/16. Imports are expected to be flat. Exports are expected to grow by 5% in 2016/17. Imports are expected to grow by only 2.5%. In 2017/18 exports are expected to grow again by 5.5%. Imports are expected to grow by only 3%. Clearly most of the GDP growth is expected to result from Australia’s improved trade performance.

The result is a steady decline in unemployment down to a level of 5.5%. The budget forecasts have unemployment stabilizing at 5.5%. This is the only area where we think the forecasts are wrong. We see employment steadily falling down to 5% and below. We think unemployment will be extremely low in historic terms by the end period of the budget outlook.

Conclusion

This budget has the government continuing to spend near current levels. Government receipts rise only slowly to achieve a near balance by 2018/19. What makes this budget different is that the Treasurer actually seems to understand how the economy works.

A steady reduction in taxation on small and medium businesses leaves them more money to invest. With more money to invest, they can create more jobs. Rarely has the problem of creating jobs in a modern economy been more correctly and precisely addressed.

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