The 2015-16 Australian Budget – repair, fair or despair?

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Key points

> The 2015-16 Budget has seen a shift in focus from budget repair towards supporting growth and fairness.

> Thanks to another blow to revenue the budget deficit for 2015-16 is now projected to be $35bn (compared to just $17bn in last year's budget); return to budget balance or surplus has been pushed out a year to 2019-20.

> New spending, eg on child care and a small business tax cut, has been more than offset by various savings.

> This year's Budget should be far more positive for confidence than last year's, but a return to surplus is looking more distant.

> The impact on the share market is likely to be minimal.

Introduction

After the political and economic failure of last year's budget, this year's Budget represents a significant change in focus for the Government. Not only was it relatively 'boring' with no major surprises, but the focus on dealing with a 'budget emergency' has been replaced with a new focus on 'boosting jobs, growth and opportunity' and 'progressing budget repair in a responsible, measured and fair way' (as if the Government now recognises that it wasn't last year!). As a result, we are unlikely to see the big blow to confidence that last year's fairness debate and Senate debacle caused. The danger is that the return to surplus is looking more distant than ever.

Key budget measures

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

- More generous child care payments;
- Lower taxes and increased deductions for small business;
- Increased infrastructure spending in northern Australia.

New spending has been offset by various savings, including:

- A lowering in the asset test for the pension and an increase in withdrawal rates;
- Measures to cut tax avoidance by multinational companies;
- Extension of the GST to digital downloads from offshore;
- Dropping the proposed Paid Parental Leave scheme – announced pre-budget; and
- The Government is also tying the child care expansion to the Senate passing some of last year's family welfare cuts.

The budget bottom line

While the Government has seemingly ditched the 'budget emergency' the budget is actually in worse state than a year ago as revenue has had a $52bn hit over four years due lower commodity prices and wages growth. As a result, the budget deficit projections have blown out by an average $13bn per annum compared to last year's budget. The return to balance or surplus has therefore been delayed by another year to 2019-20 and even then its wafer thin at just 0.1% of GDP. After a 2014-15 budget deficit of $41bn (2.6% of GDP) the deficit for 2015-16 is forecast to be around $35bn (2.1% of GDP).

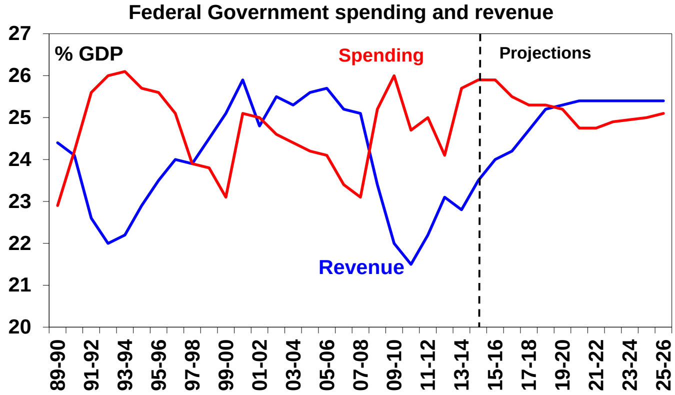
Underlying cash budget balance projections

	2014-15	2015-16	2016-17	2017-18	2018-19
2014-15 Budget, $bn	-29.8	-17.1	-10.6	-2.8	
MYEFO,$bn	-40.4	-31.2	-20.8	-11.5	-10.0*
%GDP	-2.5	-1.9	-1.2	-0.6	-0.5
Policy changes, $bn	-0.6	-4.5	-2.5	+0.5	+0.5
Saving from PPL, $bn	+0.2	+2.4	+2.8	+2.5	+2.6
Net policy impact, $bn	-0.4	-2.1	+0.3	+0.8	+3.1
%GDP	0.0	-0.1	0.0	0.0	+0.2
Budget, $bn	**-41.1**	**-35.1**	**-25.8**	**-14.4**	**-6.9**
%GDP	**-2.6**	**-2.1**	**-1.5**	**-0.8**	**-0.4**

* implied. Source: Australian Treasury, AMP Capital

With the Government offsetting all new spending with savings, the actual policy impact on the economy this year and next is trivial. See the red figures in the table above. However, the projected decline in the budget deficit in the years ahead (as revenue flows improve with the economy and some of last year's measures put a lid on spending growth) means that fiscal policy will still be acting as drag on growth.

Federal Government spending and revenue



Implied from Budget papers from 2019-20. Source: Aust Treasury, AMP Capital

Economic assumptions

The major economic assumptions underpinning the Budget are shown in the next table. Like the Reserve Bank of Australia (RBA) the Government has downgraded its near-term growth and inflation forecasts. The iron ore price is now expected to average $US48/tonne over the next four years, compared to $US96/tonne assumed in the last budget. While the recent rebound provides confidence on this front, it's not at all clear it will be sustained given surging supply.

Budget economic assumptions

		2014-15	2015-16	2016-17	2017-18
Real GDP	MYEFO	2.5	3.0	3.5	3.5
% year	**Budget**	**2.5**	**2.75**	**3.25**	**3.5**
	AMP	2.5	2.75	3.2	3.0
Inflation	MYEFO	2.5	2.5	2.5	2.5
% to June	**Budget**	**1.75**	**2.5**	**2.5**	**2.5**
	AMP	1.5	2.0	2.5	2.5
Nominal GDP	MYEFO	1.5	4.5	5.25	5.25
% year	**Budget**	**1.5**	**3.25**	**5.5**	**5.25**
Unemp Rate	MYEFO	6.5	6.5	6.0	5.75
% June	**Budget**	**6.25**	**6.5**	**6.25**	**6.0**
	AMP	6.5	6.5	6.25	6.0

Source: Australian Treasury, AMP Capital

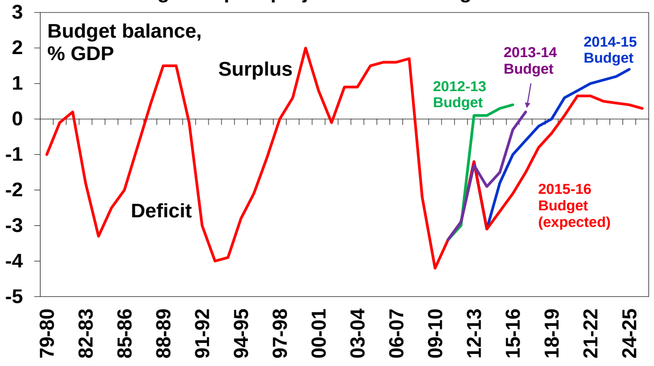
Assessment and risks

The debate in Australia over the budget is no doubt leading some to despair. A year ago the Government tried to oversell the 'budget emergency' story. However, with the net public debt to Gross Domestic Product (GDP) ratio running around a quarter of the OECD average, this message was always over the top. With 95 quarters without a recession Australians and hence the populist Senate did not buy the emergency story, particularly after the Budget came to be perceived as unfair. What's more, the Government did a terrible job of selling last year's budget – with the cigar and wink episodes as standouts.

However, Australia does have a budget problem. Government spending surged 25% between 2006-07 and 2008-09 to combat the Global Financial Crisis. This has never been unwound and we are still spending the proceeds of the boom even though it's gone away. While our public debt ratio is low compared to the US, Europe and Japan, comparing ourselves to a bad bunch may not be wise. In 2008, Ireland's net public debt was close to where Australia's is now. Yet it skyrocketed when its boom turned to bust and we know how that ended.

The 2015-16 Budget is projecting an 11 year run of deficits which swamps the seven years seen in the 1990s and the five years in the 1980s. What's worse is that this time around it's come despite the longest boom in our history – and we haven't even had a recession. The continuing delay in returning to balance or surplus from a projection of 2012-13 in the 2012-13 Budget, to 2016-17 in the 2013-14 Budget, to 2018-19 in the 2014-15 Budget and now to around 2019-20 is cause for concern and begs the question whether we will ever get there. There are real reasons for concern here because demographic pressures on the budget will start to build early next decade and we now don't have a lot of flexibility to provide stimulus should our luck turn against us and the economy really turn down.

Budget surplus projections - blowing in the wind



Implied from Budget Papers from 1919-20. Source: Aust Treasury, AMP Capital

The good news is by adopting what might be seen as a fairer approach to repairing the budget, this year's Budget should have a more positive impact on confidence. The proposed measures should benefit the economy and stand a greater chance of getting through the Senate. This is positive for growth generally and should help undo some of the damage done through last year.

What's more, the ongoing focus on boosting infrastructure spending, the help for small business and the boost to childcare spending are also positive for growth. The enhanced child care assistance is a far better use of public funds than the Government's costly and now dumped Parental Leave Scheme.

However, there are three main risks. First, the Government's projected 7% plus revenue growth from 2017-18 is at risk of being too optimistic particularly as it's based on economic growth returning to 3.5%. Similarly, the commodity price assumptions could yet prove to be too optimistic. Consequently, we may still see more deficit blow outs in the years ahead.

Second, while our base case is that Australia's AAA sovereign credit rating is secure, the ongoing uncertainty around the deficit outlook and return to surplus could prompt credit ratings agencies to look at it more closely at some point.

Finally, there remains a risk that some of the measures may not pass the Senate, particularly given the Government has tied some of this year's goodies to the passage of some of last year's welfare cuts.

Implications for the RBA

While this Budget could provide a boost to confidence, ongoing fiscal tightening will act as a mild drain on growth in the years ahead. As such, it's hard to see major implications for the RBA. Our view remains that we have probably seen the low for the cash rate but that the risks are skewed to more cuts and a rate hike is a long way off.

Implications for Australian assets

Cash and term deposits – with interest rates expected to remain low for an extended period, returns from cash and bank term deposits are expected to remain very low at around 2%.

Bonds – a major impact on the bond market from the Budget is unlikely. With five year bond yields at 2.4%, it's hard to see great returns from Australian sovereign bonds over the next few years.

Shares – the potential boost to confidence from this Budget could be a small positive for the Australian share market. However, it's offset by the ongoing drag coming from fiscal policy. Overall, the Budget's impact is unlikely to be huge. Stocks that benefit from infrastructure and child care spending may be beneficiaries.

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

The Australian dollar – the announcements in the Budget alone are not radical enough to have much impact on the $A. With the commodity price boom fading, the interest rate differential in favour of Australia having fallen and the $A still too high, the trend in the $A is likely to remain down.

Concluding comments

The 2015-16 Budget with its more measured & fairer approach goes some way to undoing the hit to confidence from last year's budget debacle. However, risks remain around the revenue assumptions, when we will get back to surplus and the Senate.

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