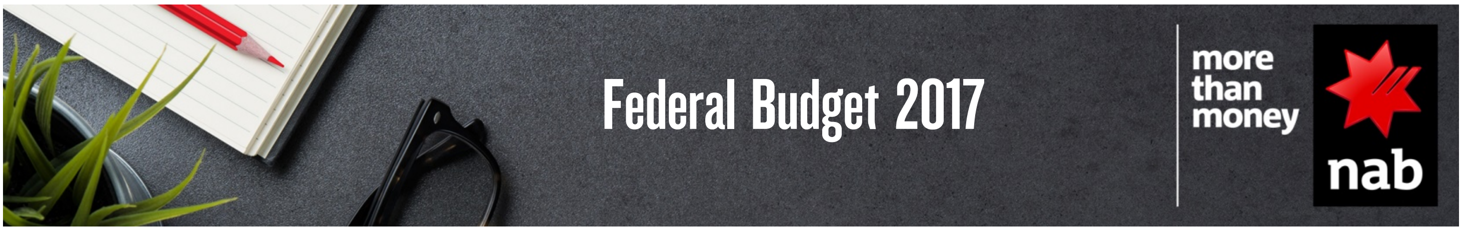


INITIAL RESPONSE - *Behind the smoke and mirrors*

Attempting to look through the “good” and the “bad”, at first blush this year’s federal budget appears to contain little shift in the government’s overall fiscal stance as measured by key budget aggregates over the next couple of years, although it includes a more rapid improvement in the fiscal balance towards the end of the projection period. Fiscal policy remains moderately contractionary over the four-year estimates period, although greater expenditure on infrastructure and education relative to the Mid-year Economic Outlook (see key measures below) should have some positive impact on Australia’s long-term growth prospects.

	Estimates						Projections		
	2016-17(e)		2017-18(e)		2018-19(e)		2019-20(p)		2020-21(p)
	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	MYEFO	Budget	Budget
Underlying cash balance, $bn	-36.5	-37.6	-28.7	-29.4	-19.7	-21.4	-10.0	-2.5	7.4
% of GDP	-2.1	-2.1	-1.6	-1.6	-1.0	-1.1	-0.5	-0.1	0.4
Net operating balance	-37.5	-38.7	-19.2	-19.8	-10.6	-10.8	-1.3	7.6	17.5
% of GDP	-2.1	-2.2	-1.1	-1.1	-0.6	-0.6	-0.1	0.4	0.8
Net capital investment	-4.0	-2.0	-3.1	-0.5	-4.7	-4.8	-5.2	-4.9	-6.0
% of GDP	-0.2	-0.1	-0.2	0.0	-0.3	-0.3	-0.3	-0.2	-0.3
Fiscal balance, $bn	-41.5	-40.7	-22.3	-20.3	-15.3	15.5	-6.4	2.7	11.4
% of GDP	-2.4	-2.3	-1.2	-1.1	-0.8	-0.8	-0.3	0.1	0.6
Net debt, $bn	317.2	325.1	343.0	354.9	359.0	375.1	363.8	374.7	366.2
% of GDP	18.1	18.6	18.9	19.5	19.0	19.8	18.4	18.9	17.6

Source: Commonwealth Treasury

- The government has retained its forecasts for the **underlying cash balance** to return to surplus in 2020-21 (see chart below). This is despite slightly higher deficits in the next two years even with the boost from temporarily higher coal and iron ore prices. Compared with the Mid-Year Economic and Fiscal Outlook released in December 2016, the underlying cash deficit is marginally higher up to 2018-19, but then improves more rapidly in 2019-20 and 2020-21, in part as the haul from new revenue measures really starts to kick in.

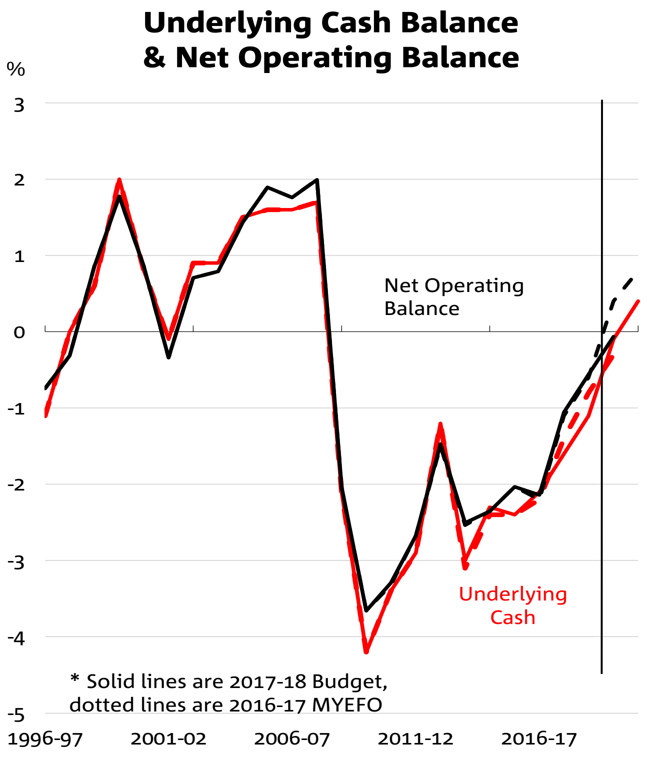
- In a departure from tradition, the Government is now also emphasising the **operating balance**, which aims to measure recurrent revenue less expenses and removes net capital expenditure (see chart below). It is calculated on an accrual rather than cash basis. The operating balance returns to surplus slightly earlier in 2019-20, compared with a deficit of $1.3 bn at the time of MYEFO. **Net capital expenditure**, meanwhile is weaker than at MYEFO, but this reflects ‘parameter’ variations with actual policy decisions slightly positive. This measure does not capture all infrastructure spending (see key measures below).

- While we take no issue with the government’s **economic growth** estimates for 2016-17 and 2017-18, we see downside risks to the projected 3% p.a. growth between 2018-19 and 2020-21. This rate of growth is higher than Treasury’s own estimate of potential growth for Australia of ~2¾% p.a. (although the government may argue that investment in infrastructure and education in this budget will be shifting that dial). NAB’s forecasts see real GDP growth of 2.9% in 2017-18 (similar to the Government’s 2.75% estimate) but only 2.4% in 2018-19, before growth reverts to our (lower) long-run growth estimate of ~2½% p.a. The government has sensibly taken a prudent approach to their forecasts for key commodity prices such as iron ore and coal, and hence the terms of trade. The government’s unemployment rate forecasts of 5¾% in 2016-17 and 2017-18 appear reasonable, although the government’s wage growth forecasts in the out-years of 3% to 3¾% continue to look overly strong.

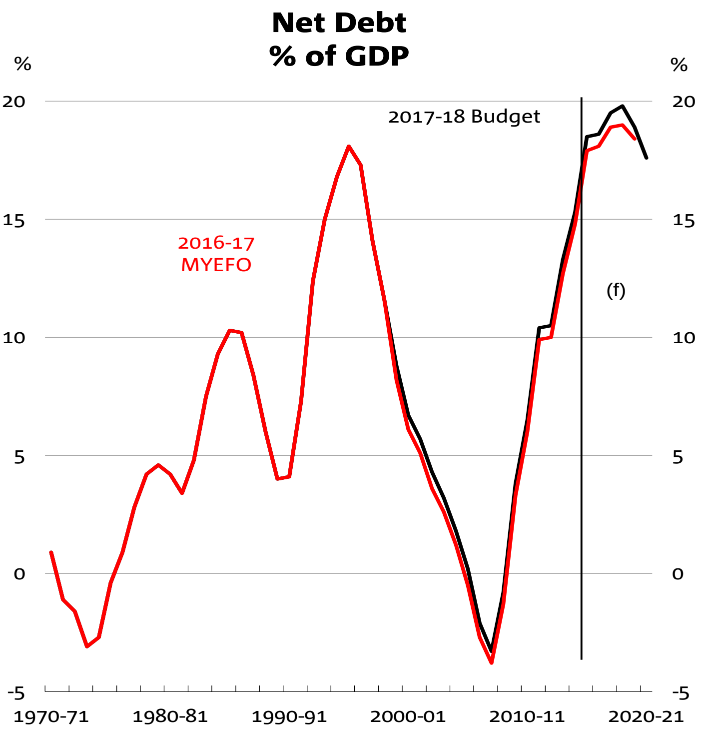
- Looking at the “**parameter variations” versus “policy changes**”, windfall gains from higher commodity prices in 2016-17 and particularly 2017-18 have largely been used to fund higher expenditure. Parameter variations account for much of the (very large) improvement in the budget balance in 2019-20.

- The government is spending somewhat more freely in this Budget, projecting growth in **payments** to average 4.2% over the four years to 2020-21; while similar to estimated growth in 2016-17, this is higher than in the two prior years. As a percentage of GDP, **payments** are forecast to rise to 25.4% of GDP by 2018-19 before moving lower to 25% in 2019-20 (not significantly different, on average, to the 25.2% between 2016-17 and 2019-20 as at MYEFO). By way of context, expenses peaked at around 26% during the post-GFC stimulus in 2009-10 up from around 23% of GDP in the two years prior to the GFC. **Receipts** still do the vast majority of the repair job on the budget balance, rising from 23.4% of GDP in 2015-16 to 25.4% in 2020-21 (compared with the goal of reaching 24.8% in 2019-20 as at MYEFO). Within revenue, the budget remains very reliant on rising income tax as a percentage of GDP (via bracket creep and the increased Medicare levy), which exposes the budget to downside risk should wages growth or employment growth continue to disappoint, or average hours worked continues to decline. Corporate tax is also expected to increase strongly as a percentage of GDP through the four-year estimate period, despite corporate tax rate cuts, with some impetus in the near-term because of temporarily higher commodity prices.

- **Net government debt** is expected to peak in 2018-19 at 19.8% of GDP, compared to the MYEFO estimate of 19% of GDP, and edges lower thereafter (see chart below). Part, but not all, of the increase in net debt since MYEFO is due to changes in accounting standards. Net implied CGS issuance is expected to be $38 bn in 2017-18, compared with $43 at MYEFO and $81 bn in 2016-17, with an outstanding face value at $537bn. Despite, all the talk of **"good" and "bad" debt**, pre budget, the emphasis remained on total net debt, but with added focus on the net operating balance. While we agree with the shift in emphasis away from demonising all forms of debt, and agree that the government should take advantage of historically low funding costs, scrutiny over project selection remains paramount and funds must be channelled into productivity-enhancing investments. Ultimately, all debt must be repaid, and ratings agencies will continue to focus on aggregate debt measures. While net debt is a bit higher than projected at MYEFO, partly due to accounting changes, with little change in the path back to surplus beyond 2017-18 and net debt projected to gradually decrease beyond 2018-19, our initial impression is that these figures will not alter Australia's credit rating. Moody's has noted that the Budget is consistent with the current AAA credit rating, and we expect S&P to retain the AAA rating with negative outlook.



Source: Commonwealth Treasury



Source: Commonwealth Treasury

Key measures

<u>Infrastructure</u>

The Budget includes a headline $70 bn figure for transport infrastructure investment from 2013-14 to 2020-21 (up from $50 bn last budget). Major new infrastructure measures in the budget include:

- An equity investment of up to $5.3b in a new Commonwealth-owned company, WSA Co, to build the first stage of the Western Sydney Airport.

- An equity investment of $8.4b in the Australian Rail Track Corporation to build the Inland Rail project. The project will include a PPP component for the complex Toowoomba-Brisbane section.
- 10 year allocation for road and rail funding, expected to deliver $75 bn in funding from 2017-18 to 2026-27. A $10 bn National Rail Program will provide funding to urban and regional rail projects over a 10 year period.
- Additional $1 bn infrastructure spending for Victoria, including $500m for regional rail (including $100m for the Geelong line and $100m for the north eastern line), $30m for airport rail link planning and a further $20.2 million for Murray Basin rail. Includes asset recycling funding.
- $844m for Queensland Bruce Highway upgrades.
- $700m for WA's Metronet rail project
- $2.9b for the Western Sydney Infrastructure Plan, $1.5b funding and a $2b concessional loan for WestConnex, $500m for the M80 Ring Road, $1.14b for Toowoomba second range crossing, $914m for Gateway Upgrade North, $1.6b for North-South Corridor projects in Adelaide, $400m for Midland Highway (Tas), NT - Regional Roads Productivity Package and $77 million for the Northern Territory Roads Package. $600 million for the Northern Australia Roads Programme and $100 million for the Northern Australia Beef Roads Programme.
- $2.3b asset recycling money
- Establishing the Infrastructure and Project Financing Agency

<u>Housing affordability</u>

- Direct assistance to first home buyers.
- Giving access to voluntary super contributions ($15k per year -- $30k in total – will receive concessional tax treatment.
- Allowing people aged 65 and over to contribute downsizing funds into superannuation (up to $300,000 and only for principal residence owned for >10 years).
- Social housing measures.
- Replace the existing National Affordable Housing Agreement with a new National Housing and Homelessness Agreement, with additional funding of $375m over 3 years (from 2018-19).
- Tax incentives for private investment in affordable housing.
- Establish the National Housing Finance and Investment Corporation to provide cheaper finance for community housing.
- Additional supply-side measures.
- Working with states regarding supply targets and zoning reform.
- Establish a $1 bn National Housing Infrastructure Facility to help remove infrastructure bottlenecks to housing supply.
- Releasing Commonwealth government land (namely defence land in Maribyrnong (suburb of Melbourne)).
- Introducing a 50% cap on foreign investment approvals for new developments.
- Levy imposed of foreign owner of unoccupied property ($5,000 per year).
- Changes to investor deductions – disallowing travel deductions and more stringent requirements for deduction on plant and equipment attached to the property.

<u>Other measures</u>

- The Government will extend for a further 12 months – to 30 June 2018 – the ability for small businesses with an annual turnover of $10 million or less to immediately deduct purchases of eligible assets each costing less than $20,000.
- Corporate tax cut for large businesses maintained.
- Gonski 2.0. $18.6 bn in extra funding for schools, using needs-based funding model.
- The Government will offer the states and territories a $300m incentive over two years to reduce red tape. Aimed at reducing regulatory burdens and removing unnecessary restrictions on competition.
- Freeze lifted on indexation of Medicare and Pharmaceutical Benefits Scheme. Set up Medical Guarantee Fund. Reverse removal of bulk-billing incentive for diagnostic imaging and pathology. New money for health research. Adding more affordable drugs and medicines to the PBS.
- The National Disability Insurance scheme to be fully funded by a 0.5 percentage point increase in the Medicare levy in two years' time.
- Not proceeding with previous unlegislated budget repair measures which is expected to increase payments by $2.3 bn in 2017-18 ($15.5 bn over four years to 2020-21, with an associated increase in receipts of $962 million over the same period).
- Childcare package of $373 bn to easing cost of living pressures on families. $428 million to extend access to early childhood education.
- Defence spending to be increased to 2 per cent of GDP three years early. $300 million to the Australian Federal Police for counter-terrorism.
- $90 million set aside to ensure domestic gas supply. Funding for Snowy Hydro extension and $37 million to South Australia for new infrastructure.

- Levy on firms hiring foreign workers to raise $1.2 bn for a Skilling Australian Fund to train workers, on top of already announced changes to skilled visa categories.
- New tax on big banks' liabilities starting July 1 to raise $6.2 bn over forward estimates. New customer complaints authority. Permanent team in the ACCC to investigate competition in the banking and financial sector.
- Toughening multinational anti-avoidance laws.
- Efficiency dividend of 2.5 per cent on universities for next two years. Students to pay additional 7.5 per cent for tuition, to be phased in over four years, with income repayment thresholds for HELP scheme lowered.
- Tax crackdown extended to structures involving foreign partnerships and trusts plus hybrid structures.
- Extra funding to the Tax Office to fight financial and organised crime, and to chase tax criminals.
- Penalties for welfare recipients who fail to turn up to appointments or take on suitable work. New drug testing for welfare recipients. A crackdown on recipients of multiple payments. Stricter residency rules for new migrants to access Australian pensions.
- Changed targeting of skilled visas and Skilling Australians Fund

Further details will be provided in our larger Budget Briefing to be released overnight.

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