**THE ECONOMICS OF THE 2016-17 FEDERAL BUDGET**

Dr. Anthony Stokes Senior Lecturer in Economics, Australian Catholic University

Part 1: How successful have the most recent Federal Budgets been at achieving their planned outcomes?

**Introduction**

The Federal Budget is one of the Australian Government’s macroeconomic policies to manage the economy. The Budget is the main instrument of the Government’s Fiscal Policy strategy. It is an announcement of the planned levels of government expenditure (G) as expenses and government receipts (T) as revenue for the financial year. The Budget Papers set out the Fiscal Policy through the use of changes in the level and direction of government spending (G) and revenue (T) to influence:

- income distribution
- resource allocation
- the level of economic activity.

There are three possible budget outcomes:

- deficit budget, \( G > T \)
- surplus budget, \( T > G \)
- balanced budget, \( G = T \)

Because the Federal Budget is a plan of what the Australian Government expects to achieve, it does not mean that it will be achieved. In the 2014-15 Budget Papers, the Federal Liberal Government, stated that they were aiming to achieve a budget surplus, with a fiscal balance of $1 billion dollars in 2017-18 as shown in Table 1.

<table>
<thead>
<tr>
<th>Table 1. Australian Government Budget Aggregate 2012-13 to 2017-18</th>
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<tr>
<td><strong>Actual</strong></td>
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<td>Receipts</td>
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<td>Payments</td>
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<td>Per cent of GDP</td>
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<td>Net Future Fund earnings</td>
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<td>Underlying cash balance(a)</td>
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<td>Per cent of GDP</td>
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<td>Revenue</td>
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<td>Per cent of GDP</td>
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<td>Expenses</td>
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<td>Net operating balance</td>
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<td>Net capital investment</td>
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<td>Memorandum item:</td>
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<td>Headline cash balance</td>
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(a) Total is equal to the sum of amounts from 2013-14 to 2017-18.
(b) Equivalent to cash payments for operating activities, purchases of non-financial assets and net acquisition of assets under finance leases.
(c) Excludes net Future Fund earnings.


The 2016-17 Budget Papers announced, however, that the Federal Government was projecting that the Budget would now return to a surplus in 2020-21.

**What were the expected outcomes of the 2014-15 and 2015-16 Federal Budgets?**

As shown in Table 2, the 2014-15 and 2015-16 Federal Budgets did not achieve their financial outcomes as planned. In 2014, when the 2014-15 Budget was released, the underlying cash balance was expected to be a deficit of 29.8 billion (-1.8% of GDP). The estimated outcome, at the end of the 2014-15 fiscal year, was that the underlying cash balance had blown out to be a deficit of 37.9 billion (-2.4% of GDP). Likewise, the fiscal balance had risen from a projected deficit in 2014 of $25.9 billion (-1.6% of GDP) to $39.9 billion (-2.5% of GDP). The fiscal balance is the accrual accounting measurement of the cash balance.

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<td>Per cent of GDP</td>
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<tr>
<td>Net operating balance</td>
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<td>Net capital investment</td>
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<td>Fiscal balance</td>
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<td>Per cent of GDP</td>
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The growth in the deficit in 2014-15 came about mainly due to lower revenue than was predicted. Government receipts were expected to be $385.8 billion in the period 2014-15. The estimated receipts outcome at the end of the fiscal year was $378.3 billion, a shortfall of $7.5 billion. The shortfall in revenue in terms of the fiscal balance was $10.6 billion.

In 2015, when the 2015-16 Budget was released, the underlying cash balance was expected to be a deficit of 35.1 billion (-2.1% of GDP). The estimated outcome, at the time of the 2016-17 Budget, was that the underlying cash balance had blown out to be a deficit of 39.9 billion (-2.4% of GDP). Likewise, the fiscal balance had risen from a projected deficit in 2015 of $33.0 billion (-2.0% of GDP) to $39.4 billion (-2.4% of GDP).

The growth in the deficit in 2015-16 came about mainly due to lower revenue than was predicted. Government receipts were expected to be $398.0 billion in the period 2015-16. The estimated receipts outcome at the end of the fiscal year was $388.0 billion, a shortfall of $10 billion. The shortfall in revenue in terms of the fiscal balance was $9 billion. The budget outcome would have been worse except that government expenditure was lower than expected.

So what caused the increase in the size of the budget deficits?

There were a number of causes of the lower levels of revenue and higher levels of expenditure than that planned when the 2014-15 Budget was introduced into the Federal Parliament. Firstly the Parliament itself or, more so, the Senate, blocked a number of sources of revenue and cuts to government expenditure that the Coalition Government and the Treasurer tried to introduce. The Coalition Government did not have the majority of seats in the Senate and as a result called a ‘double dissolution’ of Parliament and a subsequent election in July 2016 in order to get their policies passed.

Falling revenue in 2015-16 was also the result of weaker global growth, a declining terms of trade and falling commodity prices. In addition to this, the Wage Price Index (WPI) only increased 2.2 percent from December 2014 to December 2015. The year-ended pace of wage growth was about 1.4 percentage points below its long-run average and the slowest pace in the 19-year history of this series. This led to lower than expected income tax revenue. A low inflation rate of 1.3% also limited taxation revenue. On the positive side for the Government, the unemployment rate during the period was not as high as predicted in the Budget Papers. This would have helped to reduce the expected outlays on welfare.

As the Government moves into the 2016-17 budget cycle they are left with an increased underlying cash deficit of $39.9 billion and a number of policy measures that are still being blocked by the Senate affecting forward budget estimates.

since the PreElection Economic and Fiscal Outlook 2013, to over $90 billion by 2017-18. The rapid fall in the iron ore price has been the largest single contributor to write-downs to Government tax receipts in 2014-15. Since the announcement of the 2014-15 Budget, iron ore prices have fallen from $96US a tonne to $52US a tonne. Lower wage growth has also led to lower income tax collections. In the 12 months to March 2015, wage growth was only 2.3% compared to an average annual growth rate of around 3.5%.

Many of the issues facing the Federal Government remained during 2015-16. The Liberal Government did not have the majority of seats in the Senate and as a result called a ‘double dissolution’ of Parliament and a subsequent election in July 2016 in order to get their policies passed.

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As the Government moves into the 2016-17 budget cycle they are left with an increased underlying cash deficit of $39.9 billion and a number of policy measures that are still being blocked by the Senate affecting forward budget estimates.
Part 2: What does the Government hope to achieve in the 2016-17 Federal Budget?

Introduction

In recent years the Government has run budget deficits due to the need to stimulate the economy as a result of the Global Financial Crisis and sovereign debt issues in Europe slowing demand. The subsequent loss of government revenue due to low demand and higher payments for welfare have added to the deficit spending, reduced taxation revenue and increased the levels of government borrowing. Figure 1 shows the trends in the budget outcomes over the last 30 years. During periods of recession (1982-83, 1991-92) and slow economic growth (2000-01, 2007-08) budget deficits increased to deal with the problem of insufficient demand and increasing levels of unemployment.

Student activities

1. Why is it desirable for federal governments to be able to influence the following in the Australian economy:
   - income distribution
   - resource allocation
   - the level of economic activity?

2. Using Table 1 explain the differences between:
   - the headline cash balance and the underlying cash balance
   - the underlying cash balance and the fiscal balance
   - net Future Fund Earnings and other receipts.

3. Using Tables 1 and 2 explain why the federal government has found it difficult to achieve a budget surplus or budget balance.

4. List the factors that have caused increased budget deficits in recent years.

5. To what extent is good budgetary policy about balancing the budget?

Figure 1. Australian Government Budget Balance as a Percentage of GDP

In the periods following the economic slowdowns, tightening of Fiscal Policy and increased economic growth rates have led to the budget returning to a surplus. As can be seen from Figure 1, the current plan is also to reduce the budget deficits and to return to a surplus in the next few years.

The impact of budget deficits since 2007-08 has led to an increase in the Australian Government’s Net Debt (Figure 2). By 2006-07 the Australian Government had no debt. The subsequent budget deficits have increased the Australian Government’s Net Debt to 17.3% of GDP in 2015-16, however, this is still much lower than most other industrial nations (Figure 3).

Figure 2. Public Sector Net Debt as a Percentage of GDP

Figure 3. Selected Industrial Nations Public Sector Net Debt as a Percentage of GDP (2014 estimates)

Source: IMF (2015)
Fiscal Strategy

The previous section examined the overall fiscal strategy in recent decades. This section will consider the fiscal strategy associated with the current budget. The fiscal strategy relates to what the Government is actually trying to achieve in the 2016-17 Budget and its subsequent budgets. The Government is aiming to reduce the budget deficits over the next five years by increasing the level of government revenue and reducing the level of government expenditure (Table 3).

Table 3. Australian Government Budget Aggregate 2014-15 to 2019-20

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual</th>
<th>Estimate</th>
<th>Projections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$379.2</td>
<td>$386.0</td>
<td>$411.5</td>
</tr>
<tr>
<td>Per cent of GDP</td>
<td>23.3</td>
<td>23.5</td>
<td>23.9</td>
</tr>
<tr>
<td>Payments</td>
<td>$614.8</td>
<td>$625.0</td>
<td>$644.3</td>
</tr>
<tr>
<td>Per cent of GDP</td>
<td>25.0</td>
<td>25.8</td>
<td>25.9</td>
</tr>
<tr>
<td>Net Future Fund earnings</td>
<td>-4.1</td>
<td>-3.3</td>
<td>-3.6</td>
</tr>
<tr>
<td>Underlying cash balance</td>
<td>-27.9</td>
<td>-26.9</td>
<td>-26.5</td>
</tr>
<tr>
<td>Per cent of GDP</td>
<td>-2.4</td>
<td>-2.2</td>
<td>-2.1</td>
</tr>
<tr>
<td>Revenue</td>
<td>$395.4</td>
<td>$415.9</td>
<td>$445.5</td>
</tr>
<tr>
<td>Per cent of GDP</td>
<td>25.7</td>
<td>24.2</td>
<td>24.9</td>
</tr>
<tr>
<td>Expenses</td>
<td>$471.3</td>
<td>$483.0</td>
<td>$504.3</td>
</tr>
<tr>
<td>Per cent of GDP</td>
<td>25.8</td>
<td>25.0</td>
<td>25.8</td>
</tr>
<tr>
<td>Net operating balance</td>
<td>-37.2</td>
<td>-37.1</td>
<td>-37.1</td>
</tr>
<tr>
<td>Net capital investment</td>
<td>2.7</td>
<td>4.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Balance</td>
<td>-29.9</td>
<td>-35.4</td>
<td>-37.1</td>
</tr>
<tr>
<td>Per cent of GDP</td>
<td>-2.5</td>
<td>-3.4</td>
<td>-3.9</td>
</tr>
</tbody>
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As can be seen in Table 3, the Government is aiming to reduce the underlying cash budget deficit from an estimated $39.9 billion (2.4% of GDP) in 2015-16 to $37.1 billion (2.2% of GDP) in 2016-17. It is proposed that this will be achieved by keeping government payments at 25.8% of GDP in 2016-17. This is to provide some stimulus to the economy in the area of small business. At the same time, government receipts are expected to rise as a result of increased tax revenue from 23.5% of GDP to 23.9% of GDP.

An alternative budget measurement is known as the fiscal balance. This is the accrual accounting measurement of the cash balance. The fiscal strategy is to reduce the overall fiscal balance from a deficit of $39.4 billion in 2015-16 to $37.1 billion in 2016-17. This will be further reduced in coming budgets. While the 2014-15 Budget originally set a target to achieve a surplus of 0.1% of GDP in 2017-18, the 2016-167Budget does not see a surplus occurring in the next four years.

Student activities

6. Why has the federal government needed to stimulate economic growth at times over the last decade and how did it do this?
7. What is the government’s medium-term fiscal strategy and how has it been applied in the periods following economic downturns?
8. What is the major adverse effect of governments not sticking to the medium-term fiscal strategy?
9. Using Figure 2 outline the fluctuations in Australia’s public sector net debt over the past 25 years (our 25 years of uninterrupted economic growth).
10. Discuss the fiscal strategy associated with the 2016-17 Budget.
Budget Measures

As discussed in the first section of this article, the Budget is a plan for the coming fiscal year. The introduction of the Budget does not mean that its outcomes will be achieved. There is still considerable opposition to sections of the Budget which may lead to some of the plans set out in the 2016-17 Budget to be amended or rejected totally. If there is a change of Federal Government in July 2016, it could be expected that the budget deficit could be larger in 2016-17 than currently forecast. This article will discuss what was actually proposed in the 2016-17 Budget Papers and the effect that those proposals would most likely have on resource allocation and income inequality. It should be noted that a number of the policy changes will not take affect till 2018 or later. The Government anticipates that the economy will be on a stronger growth path by then but still proposes some measures now, especially in regards to small business, to stimulate the economy in 2016-17.

Normally the government would aim to reduce the size of the budget deficit by reducing the level of government spending or increasing the level of taxation. The 2016-17 Budget is unusual in that some measures are designed to achieve this goal by reducing the level of government spending and increasing the level of taxation but some measures go against this. One of the reasons this budget is considered controversial is that some policies are actually taking money from the most disadvantaged in the community and giving it to those who are better off.

Plans for Government Revenue 2016-17 Budget

Figure 4 shows the main sources of government revenue in the 2016-17 Budget. The following sections will discuss the main changes that have occurred in regards to taxation revenue in the Budget.

1. Changes to Taxation Policies

a. Small business tax cuts and concessions

The Budget Papers (2016) state that from 1 July 2016, businesses with annual turnover less than $10 million will have a company tax rate of 27.5 per cent. The company tax rate will be progressively lowered to 25 per cent by 2026-27 for all companies. The 2016-17 Budget will also extend a range of concessions already available to small businesses with turnover less than $2 million to all businesses with turnover less than $10 million from 1 July 2016.

In addition, the 2016-17 Budget will provide assistance for all small businesses by increasing the tax discount to 8 per cent for unincorporated businesses with annual turnover less than $5 million, capped at $1,000. This discount will be further increased in phases to reach 16 per cent by 2026-27.

These measures are all designed to encourage businesses to increase investment and employment. While this is a positive incentive for small businesses initially and eventually large businesses, businesses will not expand if there is no demand for their products. So if demand remains low then this will largely just increase the profits of businesses and do little to expand the economy.

Figure 4: Sources of Revenue 2016-17 Budget

b. Minor changes to income tax brackets but increased tax payments due to fiscal drag for low income earners

The Government will prevent average full time wage earners from moving into the second top tax bracket until 2019-20 by increasing the 32.5 per cent tax threshold from $80,000 to $87,000. This change will only benefit those income tax payers earning more than $80,000.

Despite this minor change in the tax bracket most of the increase in tax revenue in the 2016-17 Budget will come from ‘fiscal drag’. As people’s incomes rise they pay a greater proportion of any income gains in tax and their tax payments increase over time.
This is known as ‘bracket creep’ or ‘fiscal drag’. This is why economists argue that income tax rates should be regularly adjusted to reflect rises in money wages to prevent an increased tax burden especially on lower and middle income earners.

Most of the income tax cuts for middle and higher income earners will be funded by increased taxes on cigarettes and tobacco. Smokers, who are mainly low income earners, will face tax increases of 12.5% each year for the next four years, raising $4.7 billion dollars over the four years.

The Federal Government also abolished the 2% deficit levy on those earning more than $180,000 a year. Despite the fact that we still have a budget deficit, this policy would save some high income earners thousands of dollars a year in tax payments.

c. Increased tax and reduced concessions for superannuation schemes

Superannuation is designed to cater for those who have retired. The government’s aim should be to support superannuation so that retirees do not have to draw on an aged pension. This would reduce the welfare burden for the government, especially allowing for the ageing population. The decisions by the government in this budget go against this philosophy.

The 2016-17 Budget introduced a $1.6 million superannuation transfer balance cap on the total amount of superannuation that an individual can transfer into retirement phase accounts. This puts a limit on taxpayer support for tax-free retirement phase accounts.

Families, with combined incomes and superannuation contributions greater than $250,000, would be required to pay 30% tax on their concessional contributions, an increase from the current 15% tax. In addition, the government will lower the superannuation concessional contributions cap to $25,000 per annum from $35,000. Any superannuation contributions over $25,000 would be taxed at a higher rate. This may lead to less money being put into superannuation funds.

d. Reducing tax evasion by large multinational corporations

In the 2015-16 Budget, the Federal Government decided to target 30 multinational corporations, including Google, Apple and Microsoft, who avoid tax by transferring billions of dollars of profits made in Australia to countries overseas with low tax or no tax regimes. Any companies that were caught avoiding tax have to pay back double what they owe plus interest.

In the 2016-17 Budget, the Federal Government introduced a new Diverted Profits Tax and enhanced the Australian Tax Office’s (ATO’s) enforcement capabilities. The Diverted Profits Tax will impose a 40% penalty rate of tax on large multinationals that attempt to shift their Australian profits offshore to avoid paying tax. Together with the 2015-16 Budget changes, the two schemes are expected to raise around $650 million over four years from large multinationals.

**Plans for Government Expenditure 2016-17 Budget**

Figure 5 shows the main areas of government spending in the 2016-17 Budget. The planned level of government spending (payments) in the 2016-17 Budget remains the same percentage of GDP (25.8) as in the 2015-16 Budget. So there is no evidence of a concerted effort to reduce government spending to curtail the budget deficit.

The following sections will discuss the main changes that have occurred in regards to government expenditure in the Budget. Similar to the changes in tax, some areas have had reductions in the levels of spending and some areas have had increases. Again many of these decisions seem more politically driven than driven by economic theories to reduce the budget deficit.

**Figure 5: Areas of Government Expenditure 2016-17 Budget**

Source: Australian Government 2016-17 Budget Papers, Budget Overview
1. Cuts to Government Expenditure

a. Cuts to health care spending

The Federal Government has backed down on its plan to introduce a $7 co-payment for visits to GPs, blood tests and x-rays, which they proposed in the 2014-15 Budget. However, the government has frozen the payments to doctors for their medicare benefits schedule for three years. This is likely to force doctors to charge co-payments, as the government wanted. These changes are most likely to impact on the poor, the elderly and the sick. The 2016-17 Budget estimates that freezing the payments to doctors, who bulk bill patients, will save the government $925 million dollars over four years.

b. Tightening of conditions for welfare for the disabled

Over the next three years, up to 90,000 current Disability Support Pension (DSP) recipients will have their DSP eligibility reviewed to assess their capacity to work. Up to 30,000 of the total reviews will include a Disability Medical Assessment as part of the overall review process for those considered to be a high risk of not being eligible for the payment.

The Budget estimated that changes to the National Disability Insurance Scheme Savings Fund could save the government $2.3 billion dollars over the next four years.

c. Cuts to Family Tax Benefits

The Government is going ahead with its so far unsuccessful plans to cut Family Tax Benefits. This time the Government is attempting a trade off by offering more support for child care if the cuts to Family Tax Benefits are passed in the Senate. If this is approved, families will face cuts in welfare payments under the Federal Government’s changes to Family Tax Benefit rules. The biggest changes will impact Family Tax Benefit Part B (FTB-B), which will be cut for families when their youngest child turns six. Currently about 60 per cent of families with children under the age of 16 receive the payment. The changes will save the Government $1.9 billion over five years.

In addition, all Family Tax Benefit payments will be frozen and remain at current rates for two years, saving the Government $2.6 billion over four years. This will disadvantage families as the cost of living will increase without any compensation from the Government.

d. Increased cost of higher education for students

The Government is still pushing ahead with some of their reforms to deregulate higher education. Even though most of the reforms have been temporarily put on hold, universities will be faced with a 20% funding cut which was part of the government’s planned deregulation of fees. These changes, if they are passed by the Senate, will impact on individuals, income inequality, the development of human capital and productivity. This will create an environment where those students who have the wealth to pursue higher education will do so and those with lower incomes will not. Students will not be going to university based on their academic ability and effort but rather their ability to pay such fees and their willingness to accept such a debt burden.

The 2016-17 Budget estimates that if these changes are adopted that this will reduce government expenditure by $2 billion over the next four years.

2. Increases in Government Expenditure

At a time where the economic theory would suggest that there should not be increases in government spending, especially when the government debt created by the previous government is portrayed as being such a concern, there are, however, some areas of increased spending.

a. Youth Jobs PaTH

The Federal Government has created a new Youth Jobs PaTH (Prepare-Trial-Hire) Programme for young people. The Youth Jobs PaTH responds directly to business feedback that more needs to be done to increase young people’s employability and to provide them with real work experience. The pathway will be open to vulnerable job seekers under 25 years of age who are in employment services. The Youth Jobs PaTH Programme comprises three stages:

• Stage one of the pathway is intensive pre-employment skills training, which will help prepare young job seekers for work by providing them with the basic employability skills they need in a workplace.
• Stage two is an internship placement that links young people with businesses, providing work experience and allowing them to trial the job seeker’s fit in the workplace.
• Stage three, employers who hire an eligible young job seeker in an ongoing job will receive an accelerated wage subsidy of up to $10,000, paid over six months through simpler and more flexible arrangements. (Budget Papers Overview 2016)

b. Increased spending on infrastructure

The Federal Government announced that they will be spending $50 billion on infrastructure between 2013-14 and 2019-20. These plans include:

• A $2 billion National Water Infrastructure Loan Facility that will support major water infrastructure projects, such as dams, building on the $510 million National Water Infrastructure Development Fund.

• $1.5 billion in funding for Victorian transport infrastructure, including upgrades for: the Monash Freeway, the Murray Basin Freight Rail and urban and regional roads.

• The Government has finalised, or is close to finalising, agreements under the Asset Recycling Initiative with four states and territories worth $3.3 billion. These agreements will unlock over $23 billion in State and Territory infrastructure spending, including the Sydney and Melbourne Metro projects.

C. Increased spending on defence

Through the 2016 Defence White Paper, the Government is providing an additional $29.9 billion for Defence over the period to 2025-26. This funding will provide investment in Australia’s defence capability of approximately $195 billion over the next decade. This includes 12 new regionally-superior submarines, 9 future frigates and 12 offshore patrol vessels.

D. Increased spending on hospitals

The Government will provide an estimated additional $2.9 billion between 2017-18 and 2019-20 to support public hospitals, with links to reforms to reduce avoidable hospital admissions, improve patient safety and boost the quality of services.

It should be noted that a number of the expenditure items will not actually be implemented during the life of the 2016-17 Budget.

A summary of the overall changes in the 2016-17 Budget can be seen in Table 4.

Table 4: A Summary of the Overall Impact of the Budget on Various Groups and Sectors of the Australian Economy

<table>
<thead>
<tr>
<th>Winners</th>
<th>Losers</th>
<th>Losers</th>
</tr>
</thead>
<tbody>
<tr>
<td>All business - to receive reduced company tax rates to 27.5% by 2024 and 25% by 2027.</td>
<td>Doctors and the sick - doctors’ medical benefit payments frozen for 3 years. This may lead to copayments.</td>
<td>Smokers - annual 12.5% per annum tax increase up to 2021.</td>
</tr>
<tr>
<td>Small to medium businesses - reduced company tax to 27.5% and a tax discount of 8% for small unincorporated businesses in 2016-17.</td>
<td>Welfare recipients - tightening of welfare safety net and reviewing of 90,000 disability support recipients, including 30,000 requiring further medical assessments.</td>
<td>Aged care - aged care providers will lose more than $1 billion in funding complex health care over a four year period.</td>
</tr>
<tr>
<td>People earning more than $80,000 a year - will receive a tax cut of at least $6 a week. Income earners over $180,000 will no longer have to pay the budget repair levy.</td>
<td>University students - universities will still be hit with a 20% funding cut and fee deregulation may be back on the agenda after the election.</td>
<td>Low and middle income tax payers - those earning under $80,000 a year will face fiscal drag. This will contribute to most of the increased tax revenue.</td>
</tr>
<tr>
<td>Young unemployed - Youth Jobs PaTH offers training and internship programs with incentives to employers worth $750 million.</td>
<td>Families - will have child care subsidies delayed till 2018 but reliant on cuts to family benefits.</td>
<td></td>
</tr>
<tr>
<td>The sick - hospitals to receive $2.9 billion in additional funding in 2017-2020.</td>
<td>Families - cuts to Family Tax Benefit B and all Family Tax Benefit payments will be frozen and remain at current rates for two years.</td>
<td></td>
</tr>
<tr>
<td>Defence- defence projects will receive $195 billion over 10 years.</td>
<td>Multinationals - New Australian Tax Office taskforce to crack down on tax avoidance schemes designed to raise $3.7 billion by 2020.</td>
<td></td>
</tr>
<tr>
<td>Infrastructure- $50 billion on infrastructure spending between 2013-14 and 2019-20</td>
<td>High range superannuation holders and income earners - restrictions on tax concessions for superannuation and higher tax rates for some contributions.</td>
<td></td>
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</table>
Impact on Income Distribution

The study of the 2016-17 Budget by Phillips at ANU confirms that poor families are more severely affected than rich families (Figure 7). The analysis shows that the proposed measures in the 2016-17 Budget would impact low income families with children more significantly than other families for the 2018-19 year. The losses for the middle and top income groups are proportionately much less than low income families.

Phillips reports that the main impacts on income are from reduction in welfare payments, mostly family payments. Income tax reductions, while relatively small for each person benefiting, do apply to a large number of people mostly in the top 40% of the household income distribution. In addition the superannuation changes do assist in providing a more progressive budget impact. The top 20% has a $645 burden while the bottom 20% gains $34 each year on average from the selected changes that were modelled for 2018-19.

Overall, as shown in Figure 7, single parent families in the lowest income group lose the most (-3.6% of disposable income) by the budgetary changes. A couple with children in the lowest income group lose the second most (-2.7% of disposable income). The only category that gains is the second highest income group for a couple with children (0.3% of disposable income).

Figure 7: All Modelled Budget Measures including imputed Superannuation percentage of Disposable Income 2018-19

Phillips’ (2016) results in Table 5 show that the quintile group most affected overall is the bottom 20% who lose 1.5% of their disposable income as a result of the 2016-17 Budget measures by 2018-19. The quintile group that loses most in monetary terms is the second lowest quintile with a loss of $509 in disposable income. The quintile group that loses the least is the second highest quintile with a loss of $100 in disposable income, equalling 0.1% of disposable income.

Phillips (2016) reported that the largest measures in overall dollar impact terms are the welfare changes which have an average annual impact of -$254 in 2018-19. This impact is largest for the second quintile (20 to 40 percentile of the income distribution) at -$460. In terms of percentages of income, the welfare changes impact the bottom income category by -1.2% of income compared to 0% for the top 40%.

The next largest impact is tobacco with an average impact of -$173 and -0.5% of income for the bottom income category and just -0.1% for the top 20%. Income tax is the third largest impact with average gains of $118 which benefit almost entirely the top 40 per cent. The top 20% are, however, worse off by $645 as a result of superannuation changes while the bottom 20% are better off by $34.

Table 5: The Projected Impact of the 2016-17 Budget in Dollars per annum and as a percentage of Disposable Incomes by 2018-19

<table>
<thead>
<tr>
<th>Quintile</th>
<th>Impact in $</th>
<th>% of disposable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quintile 1 (bottom)</td>
<td>-446</td>
<td>-1.5</td>
</tr>
<tr>
<td>Quintile 2</td>
<td>-509</td>
<td>-0.9</td>
</tr>
<tr>
<td>Quintile 3</td>
<td>-223</td>
<td>-0.3</td>
</tr>
<tr>
<td>Quintile 4</td>
<td>-100</td>
<td>-0.1</td>
</tr>
<tr>
<td>Quintile 5 (top)</td>
<td>-424</td>
<td>-0.2</td>
</tr>
</tbody>
</table>

Source: Phillips (2016)

Economic effects and economic outlook

The government’s fiscal stance refers to whether it is trying to increase growth (expansionary policy) or slow the rate of growth in the economy (contractionary policy). Budgets have a number of effects on the economy.
Initially changes in government spending will affect the level of aggregate expenditure and aggregate demand and thus income in the economy. This change in the level of income will be magnified by the multiplier effect. If there is an increase in income this will generate economic growth and lead to higher levels of employment, while reductions in income will do the opposite. A reduction in taxation will have a similar effect to increasing government spending. It will increase income in the economy. An increase in the tax rate will reduce income, leading to a reduction in economic activity and higher unemployment.

The overall economic impact of the 2016-17 Budget relates to a reduction in the deficit by $2.8 billion or 0.2% of GDP. This is a very small amount and considering the blow-out in the 2015-16 Budget estimates, this could actually end up being a larger deficit than both 2014-15 and 2015-16. In addition, the promises of increased spending due to the election will also put pressure on any reduction in the budget deficit in 2016-17. So overall the 2016-17 Budget outcome is likely to have little effect on the economy and economic growth. The only real measure that may create an expansionary economic impact on the economy is the tax concessions for small businesses. This may increase investment spending and have a multiplier effect that will increase aggregate demand and increase GDP. The increased investment and the associated record low interest rates are likely to add stimulus to the economy. So while in theory the 2016-17 Budget is contractionary the actual outcome could be one that expands the economy. Allowing for the fact that most of the employment growth in recent months has been in part-time jobs and with Gross National Expenditure only growing by 1% in the year to March 2016, further stimulus to the economy is desirable. Should this stimulus from Fiscal and Monetary Policy work then this could lead to the situation where tax revenue may be higher than expected and social welfare payments lower leading to a lower budget deficit than planned in the 2016-17 Budget. Still, as was seen with the 2014-15 and 2015-16 Budgets, overseas factors may still have a big impact on the actual budget outcome in 2016-17. Falling commodity prices and a rising Australian dollar would both work to worsen the size of the budget deficit. On the other hand, an improvement in commodity prices and the terms of trade along with a lower dollar would most likely improve the budget outcome.

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**Student activities**

11. List the main plans for government revenue in the 2016-17 budget.

12. List the main plans for government expenditure in the 2016-17 budget.

13. If you were Treasurer would you have approved each of the measures listed in Table 4? Provide reasons in your answer.
Reference List

2. Australian Bureau of Statistics (various), Employee Earnings and Hours, Cat.No. 6306.0. Canberra.
7. Reserve Bank of Australia (various), Reserve Bank Bulletin, Canberra.

Websites

Domestic Economic Conditions

Members began their discussion of the Australian economy by discussing the March quarter consumer price index (CPI). They noted that inflation had been lower than expected. Various measures suggested that underlying inflation had declined to a little less than ¼ per cent, compared with about ½ per cent in the December quarter, to be about 1½ per cent over the year. Headline inflation had been lower still, partly reflecting a decline in fuel prices in the March quarter and over the year. Even so, the CPI data had indicated that weakness in domestic cost pressures had been broadly based. Non-tradables inflation had declined further in March to around its lowest year-ended rate since the late 1990s, reflecting low growth in labour costs and a range of other factors, including heightened retail competition, a moderation in conditions in housing rental and construction markets, and declines in the cost of business inputs such as fuel and utilities. The exchange rate depreciation over the preceding few years had continued to place some upward pressure on the prices of tradable items, although low wage growth and heightened retail competition appeared to have limited the extent to which higher import prices had become evident in retail prices. The prices of tradable items (excluding volatile items and tobacco) were little changed in the March quarter.

Members discussed the extent to which the CPI data provided a signal about ongoing inflation trends. They noted that CPI data were less subject to measurement error than many other key data series. Moreover, the lower-than-expected CPI outcome could not be explained entirely by temporary factors and in fact was significantly driven by low price rises for non-tradable items.

That in turn was consistent with a range of data suggesting quite subdued growth in labour costs (which had also been a bit weaker over 2015 than previously expected).

In their consideration of the outlook, members noted that the staff forecasts for inflation had been lowered. The forecasts embodied the expectation that growth in the wage price index would stabilise around current quarterly growth rates before gradually picking up later in the forecast period. This pick-up was consistent with the outlook for output growth and expected improvements in labour market conditions. In addition, information from the Bank’s business liaison suggested that firms generally had been unwilling to make offers of wage growth below 2 per cent. But if inflation was to be persistently lower than previously forecast, it was possible that, in time, this could be reflected in lower wage growth.

Members noted that wage growth had also been low in many advanced economies, even in cases where labour market conditions had become quite tight. This suggested that some of the factors that might explain these outcomes, such as heightened job insecurity, may be relevant to the current Australian experience.
On the other hand, given the apparent flexibility of the Australian labour market over recent years, members noted the possibility that labour cost growth could pick up sooner or by more than expected as labour market conditions improved.

Employment growth had slowed in the first quarter of 2016, although members noted that it had remained stronger than population growth over the past year. Leading indicators of employment had been somewhat mixed: job vacancies reported by businesses had continued to rise, while job advertisements had been broadly flat over recent months. These indicators, along with the outlook for output growth, suggested that employment would continue to grow, but at a somewhat slower pace than had been evident over the previous year. The unemployment rate had been around 5¾ per cent in recent months and was expected to remain around this level over the next year or so before gradually declining over the forecast period, as output growth increased. The outlook for the unemployment rate was broadly in line with the forecasts presented three months earlier and consistent with spare capacity remaining in the labour market throughout the forecast period.

Members noted that there had been no material change to the forecasts for growth in the Australian economy, although the unexpected strength recorded in the latter part of 2015 had led to an upward revision to year-ended GDP growth in the near term. The effects of low interest rates and the depreciation of the exchange rate since early 2013 were expected to lead to a gradual strengthening of growth to an above-trend rate and help a further rebalancing of activity towards the non-resources sectors of the economy.

Growth in household consumption had increased in the second half of 2015. While the pace of growth in retail sales volumes looked to have been maintained early in 2016, other timely indicators of consumption had eased a little in recent months. Information from the Bank’s liaison with retailers suggested some moderation in trading conditions in 2016, although conditions had remained generally positive. Households’ perceptions of their own finances had declined to around average levels in April, after being above average for most of the past year or so. However, these indicators provided only a rough guide to quarterly growth in consumption, which was forecast to be slightly above average even though real household disposable income had been revised lower, consistent with revisions to wage growth. As a result, the household saving ratio was expected to continue to decline gradually.

The amount of residential construction work still in the pipeline was substantial and had increased further of late. This pointed to further strong growth in dwelling investment, albeit at a gradually declining rate consistent with the decline in building approvals over the previous year. Conditions in established housing markets had stabilised over the past six months or so. Housing prices had grown moderately over 2016, following a small decline at the end of 2015. Housing credit growth had eased a little to around 7 per cent in six-month-ended annualised terms in early 2016. This had followed increases in mortgage rates and the strengthening of banks’ non-price lending terms in response to supervisory actions.

Surveyed conditions in the business sector had remained above average and growth in business credit had increased over the past year or so. Indicators of investment intentions remained weak; for instance, the stock of private non-residential work yet to be done had fallen further in the December quarter, in line with subdued levels of non-residential building approvals. This suggested that non-mining business investment was likely to remain subdued for a time, although it was forecast gradually to pick up later in the forecast period as overall demand strengthened further. Mining investment was expected to continue to fall as projects were progressively completed, although the magnitude of the falls was expected to diminish over the next couple of years, consistent with the forecasts presented in the February Statement on Monetary Policy. Members noted that the recent rally in commodity prices was not expected to boost mining investment over the next couple of years. Project completions were expected to support further growth in resource exports, particularly iron ore and liquefied natural gas (LNG). The contribution of net service exports to growth was expected to continue to be positive given the exchange rate depreciation since 2013.

### International Economic Conditions

Recent data indicated that growth in Australia’s major trading partners had eased around the turn of the year to be somewhat below its decade average in the early part of 2016. The outlook for growth in major trading partners in 2016 and 2017 had been revised a little lower since the February Statement on Monetary Policy to reflect these data as well as some reassessment of the momentum of growth, particularly in Asia. Growth in major trading partners was expected to be supported by accommodative monetary policies, while fiscal policies were expected to be
investment and renewed growth in real estate investment.

The latter was consistent with strength in the Chinese residential property market following earlier government measures designed to stimulate demand. Chinese trade volumes had declined further, which had had flow-on effects to other Asian economies and emerging economies in other regions with strong trade links to China. There had been some indications that slowing employment growth in the high-income economies of east Asia might lead to a slowing in consumption growth in these economies.

The outlook for the Chinese economy had continued to be a key issue. Despite the moderation in growth in the March quarter, the outlook there was similar to that forecast previously, based on the expectation of further support being provided from more stimulatory policy settings. The Chinese authorities appeared, at present, to be giving greater priority to short-term growth objectives over longer-term goals of deleveraging and encouraging growth that was less reliant on investment and heavy industry. However, members noted that the pursuit of near-term growth targets was likely to increase the already elevated levels of debt and could delay addressing the problem of excess capacity in the manufacturing and resources sectors. Therefore, these actions might adversely affect financial stability and the economic outlook in China more broadly in the medium term.

The available data suggested that growth in the United States had eased in the first quarter, partly owing to weakness in private investment in the oil sector. Other components of US domestic demand had been more resilient, supported by very expansionary monetary policy, strong employment growth and increasing household wealth. In contrast, Japanese GDP was likely to have remained little changed in the March quarter. The euro area economy had continued to grow at an above-trend pace, driven by domestic demand.

Although labour markets had shown further improvement across most advanced economies, wage growth had thus far remained subdued. There had been signs of labour cost pressures building and core inflation increasing in the United States and the United Kingdom, where unemployment rates were close to levels typically associated with a pick-up in inflationary pressures. But wage growth had moderated in Japan, despite the unemployment rate being around a 20-year low. Members noted that there was significant uncertainty about the timing and extent of the pick-up in wage growth and inflation that could be expected as labour markets tightened further in the advanced economies. Any changes in expectations about inflationary pressures would have implications for the expected path of monetary policy and consequently exchange rates, which continued to be an important source of uncertainty in the forecasts.

Despite the moderation in major trading partner growth in early 2016, members noted that there had been a further sizeable increase in commodity prices, particularly for iron ore, coking coal and oil. The rise in the prices of bulk commodities had followed the announcement of China's 2016 target for output growth and an expectation that this would be achieved through more stimulatory policy settings. The price of iron ore had increased by 80 per cent from its low point at the end of 2015, but was still only around one-third of its peak level five years earlier. The forecasts assumed that these higher prices of bulk commodities would not be sustained. Demand for steel in China was still expected to decline over the next couple of years and a substantial amount of new, low-cost iron ore supply was likely to enter the market over that period. The price of oil had increased by around 70 per cent since recent lows and this had occurred alongside ongoing speculation about potential caps to OPEC production and signs that oil production in the United States was likely to decline. This had led to an upward revision to LNG prices. The net result of these various movements was that Australia's terms of trade would be slightly higher than previously expected in the near term and were assumed to remain close to recent levels - which were 35 per cent below the recent peak - over the forecast period.

**Financial Markets**

Members commenced their discussion of financial markets by noting that sentiment had continued to improve.

Looking at monetary policy settings of the major central banks, members noted that the Bank of Japan had not changed policy at its meeting in the preceding week, notwithstanding market expectations that policy would be eased further. The yen had appreciated sharply following the announcement and was around 12 per cent higher against the US dollar since the Bank of Japan introduced negative interest rates at the end of January. Participants in Japanese financial markets were continuing to adjust to the new regime of negative interest rates amid occasional signs of market dysfunction.
The US Federal Reserve’s policy settings were left unchanged at the April meeting of the Federal Open Market Committee, as had been expected by market participants. Market pricing implied that there would be, at most, one 25 basis point increase in the federal funds rate during 2016. The European Central Bank had also left its policy settings unchanged in April.

Sovereign bond yields, including in Australia, were little changed in April. In most of the major markets, bond yields had remained close to historic lows.

Members noted that the finances of the Greek Government were likely to come under greater scrutiny in the period ahead. With sizeable debt repayments due around the middle of the year, the Greek Government was negotiating with its official sector creditors about new funding. In contrast, Argentina had issued its first bond since the default in 2001, having reached agreement with its holdout creditors.

In foreign exchange markets, the US dollar had continued to depreciate gradually, with a cumulative depreciation of about 6 per cent since mid January. The Chinese renminbi had also continued to edge lower; the effective exchange rate had depreciated partly because of the appreciation of the yen, which has a significant weight in China’s trade-weighted basket. Members noted there was evidence that capital outflows from China had abated in recent months. The Australian dollar appreciated during the first part of the month following the rise in commodity prices, before depreciating sharply following the release of the March quarter CPI data.

Higher commodity prices – in particular, the increase in oil prices – had boosted global equity markets, with many equity markets recovering their losses from earlier in the year. A notable exception was Japan, where the market was more than 15 per cent lower. In the Australian market, there had been large rises in the share prices of resource companies over the past month.

Bond issuance by the Australian banks thus far in 2016 had been towards the upper end of the range for recent years in both gross and net terms, but wholesale debt costs had not increased significantly overall.

In the domestic market, following the release of the CPI, expectations of a reduction in the cash rate at the present meeting had increased sharply to be around a 50-50 proposition.

Considerations for Monetary Policy

In considering the stance of monetary policy, members noted that the recent data on inflation and labour costs had been lower than expected at the time of the February Statement on Monetary Policy. Although the March quarter outcome for the CPI reflected some temporary factors, the broad-based softness in prices and labour costs signalled less momentum in domestic inflationary pressures than had previously been expected. As a result, there had been a downward revision to the inflation outlook and the profile for wage growth. Underlying inflation was expected to remain around 1–2 per cent over 2016 and to pick up to 1½–2½ per cent by mid 2018.

The recent data suggested that growth in Australia’s major trading partners was likely to be a little softer than previously expected and below its decade average in 2016 and 2017. While growth in the Chinese economy had continued to slow, the growth outlook had remained much as previously forecast based on the expectation of further support being provided by more stimulatory policy settings. The renewed focus of the Chinese authorities on the short-term growth targets had been accompanied by a strong rally in bulk commodity prices over recent months. Higher commodity prices would typically support incomes and activity in Australia. However, the rally in commodity prices was not expected to boost mining investment over the next couple of years.

Sentiment in financial markets had improved following a period of heightened volatility earlier in the year. Despite uncertainty about the global economic outlook and policy settings among the major jurisdictions, funding costs for high-quality borrowers remained very low and, globally, monetary policy was remarkably accommodative.

Domestically, the outlook for economic activity and unemployment had been little changed from that presented three months earlier. The available data suggested that the economy had continued to rebalance following the mining investment boom, supported by very accommodative monetary policy and the depreciation of the exchange rate since early 2013, which had helped the traded sector. GDP growth overall had been a bit stronger than expected over 2015, but appeared to have been sustained at a more moderate pace since then. Growth was forecast to pick up gradually to be above estimates of potential growth later in the forecast period. Accordingly, the unemployment rate was expected to remain around current levels for a time before
declining gradually as GDP growth picked up. The exchange rate depreciation since early 2013 was assisting with growth and the economic adjustment process, although an appreciating exchange rate could complicate this.

In coming to their policy decision, members noted that developments over recent months had not led to a material change in the outlook for economic activity or the unemployment rate, but the outlook for inflation had been revised lower. At the same time, they took careful note of developments in the housing market, which indicated that supervisory measures were strengthening lending standards and that the potential risks of lowering interest rates therefore were less than they had been a year earlier.

Members discussed the merits of adjusting policy at this meeting or awaiting further information before acting. On balance, members were persuaded that prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by easing monetary policy at this meeting.

**The Decision**
The Board decided to lower the cash rate by 25 basis points to 1.75 per cent, effective 4 May.

### Student activities

1. Explain the significance of differences between the following for the Reserve Bank of Australia (RBA) when it is considering changes to the cash rate:
   - headline inflation and underlying inflation
   - non-tradeables inflation and tradeables inflation
   - current inflation data and forecast inflation data
   - employment growth and changes in the unemployment rate
   - an appreciation of the Australian dollar and a depreciation of the Australian dollar
   - higher interest rates and lower interest rates.

2. Examine how changes in the following are likely to affect economic growth in Australia over the next year:
   - household consumption
   - residential construction
   - non-mining business investment
   - mining investment
   - commodity prices
   - growth in Australia’s major trading partners
   - monetary policy settings of the world’s major central banks.

3. Analyse how monetary policy is assisting the rebalancing of the Australian economy.