BULLETIN

21 October 2022

Budget to highlight Fiscal challenge

The Australian Treasurer will release the Federal Budget next week on October 25.

We forecast that the deficit will increase to $45 billion in 2022/23, from $31.9bn for 2021/22, but will still be $32.9 billion less than in the April Pre-Election and Fiscal Outlook (PEFO).

This will be an update on the PEFO which was prepared by the Secretary to the Treasury and the Secretary to the Department of Finance ahead of the May Federal election.

Coming so quickly after the March 29 Budget of the previous government it is essentially a restatement of the March Budget.

In the October Budget, the newly elected government is set to deliver on their election promises, with a focus on child care; education and training; aged care; health care; and climate change. These policies were largely fully funded – as costed by the Parliamentary Budget Office. We expect little to no impact on the underlying budget deficit from new policy.

Earlier this week we released a very detailed analysis of the numbers we expect to be included in the October Budget (See Evans and Hanlan, 18 October).

In that analysis we used the economic forecasts that we expect the government to adopt in the Budget. This is largely taken from the Treasurer's Ministerial Statement to Parliament on July 28. We anticipate that the July forecasts will be revised for the 2023/24 year, with growth marked down even further and inflation and the unemployment rate marked higher.

We anticipate that the government will downgrade GDP growth in 2023/24 from 2.0% to 1.5%; lift inflation by 0.75% to 3.5%; and raise the unemployment rate from 4.0% to 4.25%.

In our Budget Preview we have drawn out an important message which we expect will be the key theme of the Treasurer's commentary on Budget Night.

That theme will be that the profile for the budget deficit differs greatly from that in PEFO.

PEFO anticipated that the deficit would decline each year, with a path back towards balance and that gross debt to GDP would gradually stabilise around 45% of GDP.

By contrast, the October Budget, which will incorporate a much smaller deficit outcome for 2021/22, by some $47.9bn, will likely project that the deficit which increase each year.

The deficit will become elevated, potentially at around 2.7% of GDP in 2025/26, and the gross debt to GDP ratio will exhibit an upward trend – albeit still at around that 45% mark by the end of the forecast period.

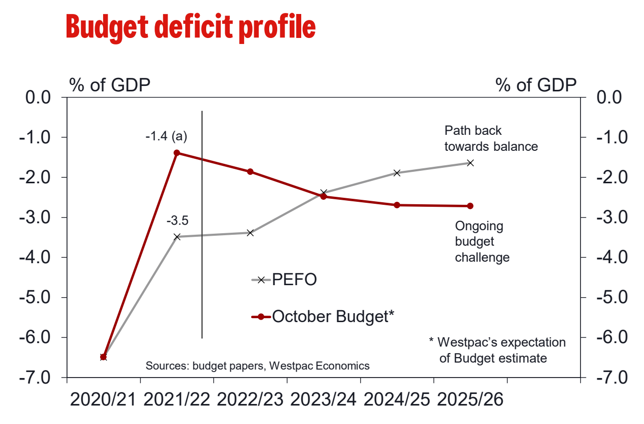
An ongoing structural budget deficit and rising public debt highlights the need for fiscal reform.

We do not believe the Treasurer will introduce new policies in the October Budget to deal with that but expect he will open the debate on the need for reform as an urgent economic priority.

Table 1: key budget numbers

	'21/22	'22/23	'23/24	'24/25	'25/26
$bn					
Budget deficit, PEFO	**-79.8**	**-77.9**	**-56.5**	**-47.1**	**-42.9**
% of GDP	-3.5	-3.4	-2.4	-1.9	-1.6
Revenue surprise	27.6	59.5	14.5	1.1	3.0
Payment surprise	-20.3	26.4	18.0	22.0	32.2
Net improvement	47.9	32.9	-3.5	-20.9	-29.1
Budget deficit, October	**-31.9**	**-45.0**	**-60.0**	**-68.0**	**-72.0**
% of GDP	-1.4	-1.9	-2.5	-2.7	-2.7
Gross debt, PEFO	906	977	1,056	1,117	1,169
% of GDP	39.5	42.5	44.6	44.9	44.7
Gross debt, October	895	902	994	1,086	1,176
% of GDP	39.0	37.3	41.1	43.0	44.3

* Westpac's expectations of Government forecasts to appear in the October Budget.
** **Budget deficit refers to the underlying cash deficit.**
Sources: budget papers, ABS, Westpac Economics



In our analysis we estimate that the Treasurer's forecasts for the underlying deficits will be as in Table 1.

Note that PEFO forecast that the underlying deficit would fall from 3.5% of GDP in 2021/22 to 1.6% of GDP in 2025/26.

By sharp contrast, we anticipate that the October Budget will forecast that the underlying deficit will rise from the lower than expected 1.4% of GDP outcome for 2021/22 to 2.7% for 2024/25 and 2025/26.

As noted above, the deficit for 2021/22 came in $47.9 billion lower than expected in PEFO.

We expect the deficit to widen to $45bn in 2022/23, but that is still $32.7 billion lower than in PEFO.

So, over the first two years, the budget deficit will be $81bn lower than expected.

From 2023/24 the story changes. The budget deficit is expected to deteriorate by $54bn over the final three years of the forward estimates – reducing the net improvement over the five years to a modest $27bn.

There are two key dynamics driving this turnaround.

First, currently the economy is performing stronger than expected but from here, the economic outlook deteriorates dure to high inflation and rising interest rates.

Whereas the size of the economy in 2022/23 is now forecast to be 5% larger than anticipated in PEFO, by 2025/26 that narrows to only 1.3%. Moreover, while the revenue share of the economy surprised to the high side in 2021/22 and will likely do so in 2022/23, by 2025/26 that share is likely to underperform relative to PEFO, in part reflecting a higher unemployment rate.

Revenue across the five years is expected to be $106bn higher than in PEFO – but this is front loaded, with an $87bn upside in the initial two years and only a $4bn upside in the final two years.

Second, is the profile for expenses.

For 2021/22, expenses came in $20bn lower than expected and while that is likely to be reversed in 2022/23, on our figuring expenses over the initial two years are only $6bn higher than expected in PEFO.

However, there is considerable upward pressure on expenses, which will become more apparent over the final years of the forward estimates. In PEFO, the reverse was expected, with expenses as a share of the economy projected to fall over the final two years of the forward estimates.

Wage and price pressures, along with higher interest costs, are adding to expenditures.

The other and most notable source of change is the costing of existing programs, with NDIS; aged care; health care and defence key sources of pressure.

We have incorporated these effects by lifting the expenses profile across the five years by $78bn relative to PEFO.

With this budget deficit rising and becoming elevated as a share of GDP the Treasurer is very likely to initiate a debate on the best way to approach structural budget repair.

Stage Three Tax Cuts in the Firing Line

Having made a convincing case that Budget repair is urgent the Treasurer is likely to open the debate around repair initiatives for the May Budget when the government will need to provide a much more comforting outlook for the fiscal position.

This debate will be around very significant savings rather than marginal initiatives.

In that regard the Stage 3 Tax Cuts are likely to be scrutinised closely.

The Parliamentary Budget Office recently costed the cuts at $17.7 bn in 2024/25, lifting to $20.4 bn in 2025/26 – around 0.8% of GDP. The dollar cost rises by around a couple of billion a year, to be at an estimated $36.9bn in 2032/33 - with the cumulative cost over the nine year period at $243.5bn.

Based on our numbers, cancelling the cuts would reduce the deficit in 2025/26 from 2.7% of GDP to 1.9% of GDP – allowing significant stability in the projected debt to GDP ratios going forward.

While that may make eminent sense from a fiscal perspective dropping those cuts is not good economics:

- We expect the economy to be operating well below capacity in 2023/24 with the RBA moving to cut rates during 2024 so a fiscal tightening would be inconsistent with the goals of monetary policy.
- Around 70% of the benefits go to the “higher income” earners but they already pay 65% of total tax; and the Stages 1 and 2 were specifically targeted at low income earners.
- One aspect of the Stage 3 is to increase the threshold at which the maximum tax rate begins from $180,000 to $200, 000. If indexed since the last time that ceiling was lifted (2008) the threshold would now be $250,000 – comparable with UK and Canada and well short of US.
- Lowering the marginal rate from 37% to 30% for income earners above $120,000 would provide real incentive for middle income earners – potentially boosting participation and productivity.
- The reduction in the marginal tax rate for income earners between $45,000 and $120,000 from 32.5% to 30% is an expensive aspect of the Stage 3 cuts that may also come under scrutiny separately from the benefits outlined above. Such a move does represent a significant 7.7% reduction in the marginal tax rate for lower/middle income earners and is consistent with the major objectives of lifting incentives and lowering the overall share of direct tax and should also be retained.
- Australia needs to change its tax mix to lessen reliance on direct taxes – cancelling direct tax cuts only exacerbates that problem.

Conclusion

Next week’s Budget is unlikely to include any major new fiscal initiatives.

But the changes in the underlying forecasts and reassessments of the costs of existing social programs will show that Australia’s debt to GDP ratio is unlikely to stabilise over the forecast period.

That highlights the risk that overall debt to GDP ratio does not stabilise in the long term.

Such results will be interpreted by the Treasurer as highlighting a major fiscal challenge.

While we agree with the analysis we do not believe that the solution is to cancel the Stage 3 tax cuts.

Bill Evans, Chief Economist

DISCLAIMER

Things you should know.

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary only and is not intended to constitute or be relied upon as personal financial advice. To the extent that this material contains any general advice, it has been prepared without taking into account your objectives, financial situation or needs, and because of this, you should, before acting on it, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs, and, the disclosure documents (including any product disclosure statement) of any financial product you may consider. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a client of Westpac.

For XYLO Foreign Exchange clients: This information is provided to you solely for your own use and is not to be distributed to any third parties. XYLO Foreign Exchange is a division of Westpac Banking Corporation ABN 33 007 457 141 and Australian credit licence 233714. Information is current as at date shown on the publication. This information has been prepared without taking account of your objectives, financial situation or needs. Because of this you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs. XYLO Foreign Exchange's combined Financial Services Guide and Product Disclosure Statement can be obtained by calling XYLO Foreign Exchange on 1300 995 639, or by emailing customercare@XYLO.com.au.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking and Insurance Regulatory Commission (CBIRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Disclaimer continued overleaf

Disclaimer continued

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

I. Chinese Wall/Cell arrangements;

II. physical separation of various Business/Support Units;

III. Strict and well defined wall/cell crossing procedures;

IV. a “need to know” policy;

V. documented and well defined procedures for dealing with conflicts of interest;

VI. reasonable steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.