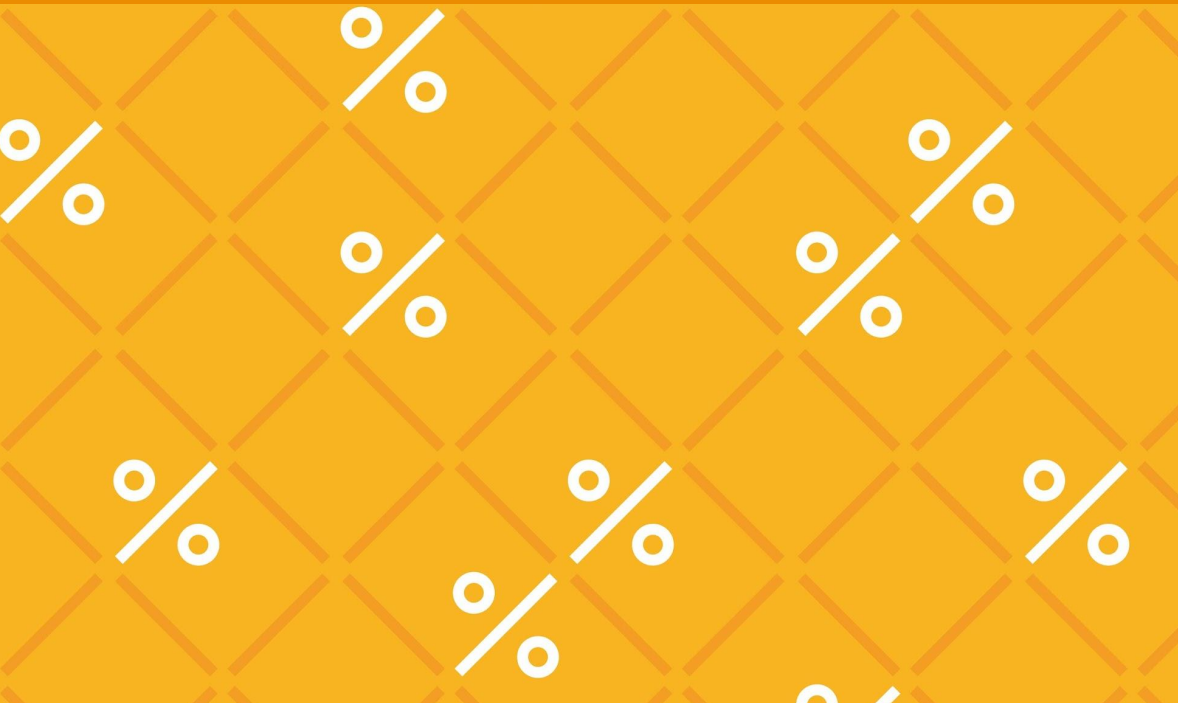


Delivering a Surplus in a Slowing Economy

The 2019-20 Mid-Year Economic and
Fiscal Outlook (MYEFO)

December 2019



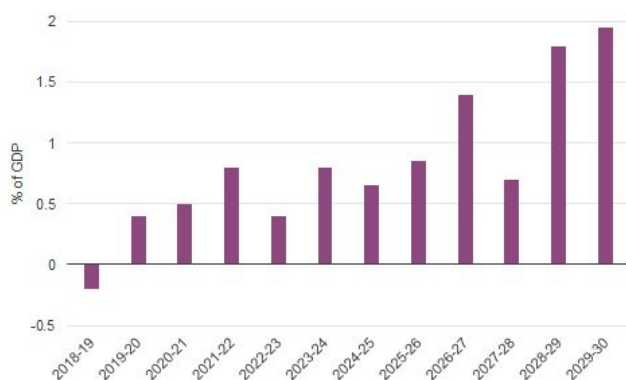
Delivering a Surplus in a Slowing Economy

The Mid-Year Economic and Fiscal Outlook (MYEFO) is the Australian Government's update to the Budget. It provides a snapshot of what has happened in the Australian economy and the Government's fiscal position since the April pre-election Budget, as well as revised forecasts for the coming years.

This year's MYEFO is framed by three particular features.

First, **the Government is politically locked in to protecting the surplus**. In the April Budget the Government laid out a roadmap of surpluses for the next decade (see figure below). Despite a slowing economy, and a \$2b downward revision, we are on track for a surplus of \$5b in the next Budget.

Underlying cash balance

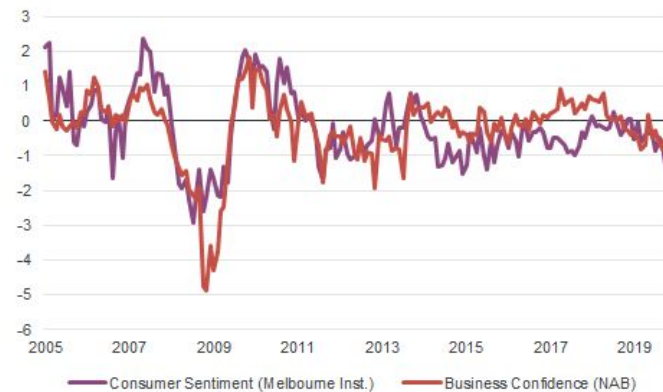


Having campaigned during the election as being the superior economic manager, the Government is politically committed to delivering a surplus. This is set to be achieved, with the Government standing firm against the calls, including from the Governor of the Reserve Bank of Australia (RBA), to increase fiscal stimulus (i.e. spending on infrastructure).

Second, despite concerns about weakness in global trade, **Australia has, for the first time, both a sustained export surplus and a current account surplus**. Commodity prices have generally been higher than expected in recent years, resulting in the peculiar environment where a slowing world is nevertheless willing to pay us more for our exports. We see this as a major driver of strong corporate tax receipts over the forward estimates.

Third, the domestic economy is framed by **weak consumer and business confidence** (see next figure). This reflects a combination of factors such as continued low wages growth, uncertainty caused by falling house prices, and increased underemployment. We expect this to cascade into lower retail sales and reduced business investment.

Business and consumer confidence



These three factors combine to provide an unusual outcome that we see presented in this MYEFO - a strengthened Budget outcome, albeit lower than forecast in April, in a weakening economy.

Specifically, this MYEFO brings continued good news on the fiscal side, with:

- continued strong corporate tax receipts underpinned by a lower \$A and understated commodity price assumptions
- relatively constrained spending underpinned by employment growth.

However, the MYEFO results also suggest that the best conditions are behind us for the next few years:

- economic growth is forecast to continue to underperform against long term trends
- corporate taxes will slow on the back of commodity prices which have started on a downward trajectory and bank profits are significantly down
- poor wage growth continues, meaning that PAYG tax receipts will continue to underperform
- depressed consumer confidence is translating into continued weakness in retail sales and so undermining GST receipts.

With continued sluggish below-trend economic growth, there is nothing in MYEFO that points to a circuit-breaker to trigger an uplift in the domestic economy.

The \$33b downgrade of future tax revenues, and the downward revision of surpluses by \$22b over the next four years, means the Government has little room for error to deliver on the promise of future surpluses while also rebooting the economy.

In the following pages we highlight some of the key features of the 2019 MYEFO report.

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The Economic Environment

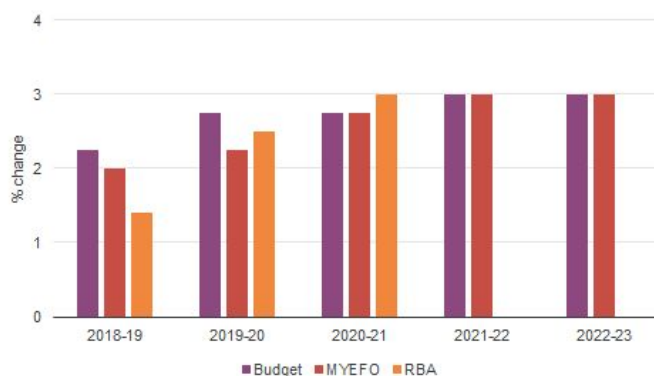
Australia's economy has been slowing for some time on the back of local factors (e.g. falling house prices, the drought, etc).

However, economic activity has slowed even since the April Budget.

In MYEFO the Government has downgraded growth forecasts down from 2.75% to that more in line with the RBA's forecast of 2.6%, although this may itself be too optimistic.

This growth is being propped up by government expenditure and exports.

Real GDP growth forecasts



Australia is not alone in having slowing economic growth. As shown in the table, since April a number of Australia's major trading partners have seen their economic growth forecasts revised downwards.

Despite these softer forecasts:

- Global growth is expected to be 3% in 2019, picking up to 3.5% in 2021.
- Australia's major trading partners are forecast to grow by 3.5% in 2019, 3.75% in 2020 and 4% in 2021.

Australia has weathered the recent global trade uncertainty, and maybe over benefitted. Whether this is sustainable will be a critical success factor for future Budgets and our economy.

Change in GDP growth forecasts (percentage points) since the April Budget

	2018	2019	2020	2021
China	0	0	-0.25	0
India	0.1	-2.5	-1.75	-1
Japan	-0.5	0	-0.25	0
United States	-0.1	1	-0.25	0
Euro Area	0.1	0	-0.25	0
Other East Asia	0	-0.75	-0.5	-0.25
Major Trading Partners	-0.1	-0.5	-0.25	0
World	-0.1	-0.5	-0.25	0

The Government has consistently pointed to strong labour market performance (i.e. jobs growth) as one of the hallmarks of its claim for superior economic management.

The headline participation rate has increased to record highs over the past year with continued increases in participation by women and older Australians.

Leading employment indicators suggest that employment growth is likely to moderate over the forward estimates as shown in the figure to the right.

The labour force participation rate is forecast to remain near historically high levels, while the unemployment rate is expected to be 5¼ % across the forecast period.

Employment growth



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The Economic Environment (Cont'd)

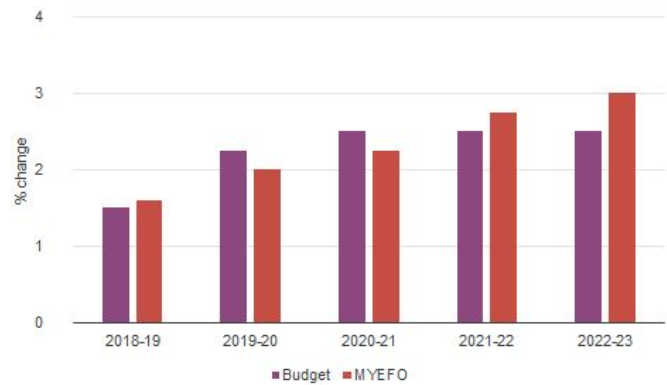
Consumer price inflation, at 1.7% through the year to the September quarter 2019, remains below the RBA's target of 2% to 3%. Indeed, measures of underlying inflation have fallen to historic lows, with trimmed mean inflation at 1.6% through the year to the September quarter 2019.

This under-target outcome reflects that:

- the economy has slowed
- economic growth shows up more in jobs (and less in inflation) than it used to.

Subdued inflationary pressure overall and lower forecasts for wage growth have resulted in downgrades to forecasts for consumer price inflation over the forecast period since the Budget.

Consumer price index

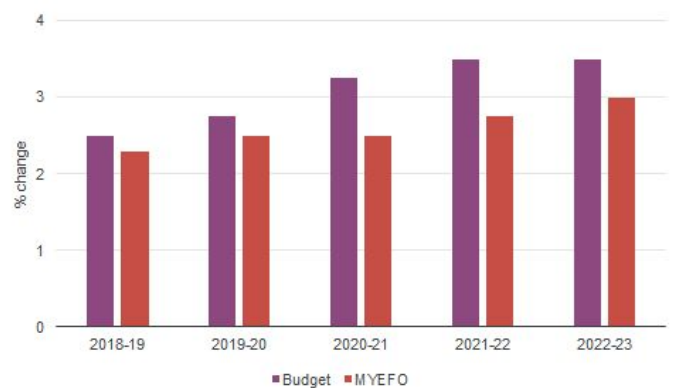


PwC was critical of the overly optimistic wage growth forecasts at the time of the Budget. This has been borne out, with lower than projected growth through to MYEFO and revisions down for future wages growth.

The low wages growth is explained by a range of factors, including: lower inflation expectations; low productivity growth; and employment growth that has drawn people into the labour market who were not previously looking for work, suggesting there may be more spare capacity than previously thought.

The Government has stressed that wage growth outcomes to date have continued to outstrip inflation.

Wage price index

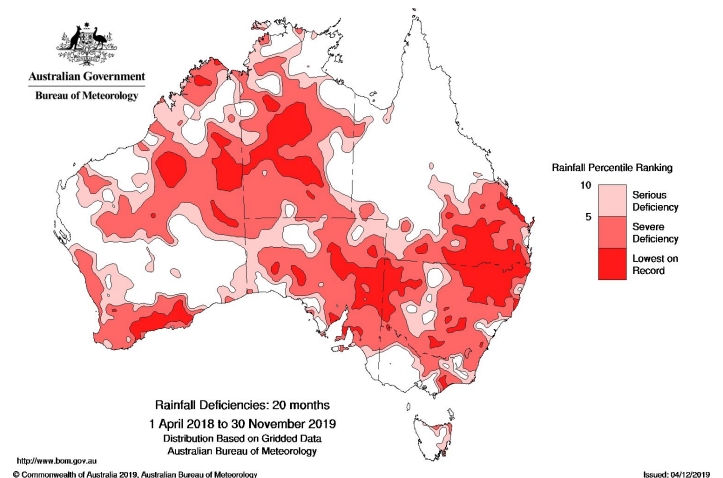


At the time of the Budget, the drought was expected to result in a ¼ of a percent decline in real GDP growth in 2018-19.

Ongoing drought conditions have resulted in a downgrade to farm GDP forecasts in 2019-20. Farm GDP and rural exports are forecast to decline in 2019-20 by 3 and 8.5% respectively. The fall in farm GDP is expected to detract around 0.1 percentage points from real GDP growth in 2019-20, following a detraction of 0.2 percentage points in 2018-19.

Primary producers will be hopeful that the MYEFO projection holds true that there will be a return to average seasonal conditions in 2020-21.

Recent drought conditions by region



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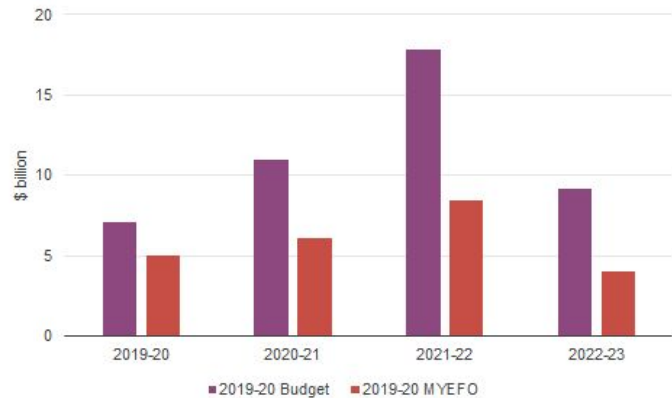
The Commonwealth's Fiscal Position

Protecting the projected surplus has been a stated priority of the Government. MYEFO forecasts that the underlying cash balance is expected to be a surplus of \$5 billion (0.3% of GDP) in 2019-20, with surpluses in subsequent years.

This reflects a downward revision of \$2b for 2019-20 and \$22b over the forward estimates.

Such surpluses are wafer-thin and provide little wiggle-room for a Government that is under pressure from the RBA and others to provide additional fiscal stimulation to reboot the economy.

Underlying cash balance



Growth in government spending (i.e. payments) is projected to be 1.3% across the forward estimates.

Since the 2019 Budget, expected total receipts have been revised down by about \$3b in 2019-20 and \$32.6b over the four years to 2022-23. The downward revision in 2019-20 is mainly driven by downgrades to superannuation fund taxes and GST, as well as non-tax receipts. The downward revision from 2020-21 to 2022-23 is mainly driven by downgrades to the forecasts for individuals taxes, company tax and GST. Tax receipts are projected to remain below the Government's tax-to-GDP cap of 23.9% over the medium term

Total payments and total receipts



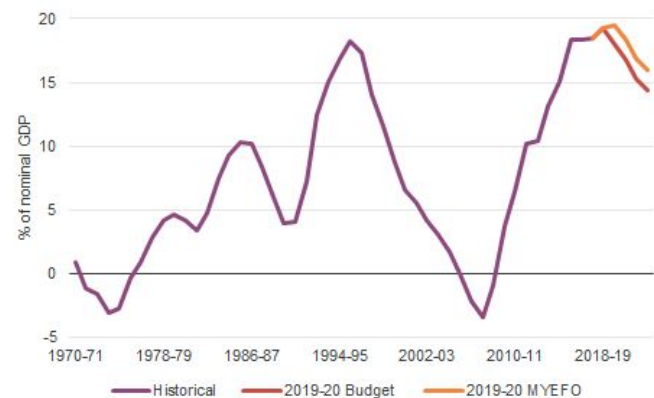
Net debt is projected to be \$392.3 billion in 2019-20 (19.5% of GDP) and is forecast to improve across the forward estimates and medium term.

Gross debt as a share of GDP is also expected to decline over the forward estimates and medium term.

Net debt and gross debt are expected to decline as a share of the economy in each year of the forward estimates and the medium term.

In the Budget the Government projected that there would be zero net debt by 2029-30. The smaller projected surpluses means wrigg that this aspiration will likely be delayed.

General government sector net debt



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The Commonwealth's Fiscal Position

Policy decisions since the 2019 Pre-election Economic and Fiscal Outlook (PEFO), released jointly by the Treasury and the Department of Finance on 17 April 2019, have increased total receipts by:

- \$291m in 2019-20
- \$295m over the four years to 2022-23.

Key measures over the forward estimates are shown to the right.

Increasing receipts:

- Combating illegal phoenixing to reduce its impact on businesses, employees and government, which is estimated to increase receipts by \$165 million.
- Expanding the Working Holiday Maker program which is estimated to increase receipts by \$101m.

Decreasing receipts:

- Increasing cost recovery and not proceeding with the original biosecurity imports levy which is estimated to decrease receipts by \$344m. The Government will work with industry on the design of an alternative biosecurity levy.
- Refinements to the research and development tax incentive, which is estimated to decrease receipts by \$235m.

The net impact of payment-related policy decisions since the 2019 PEFO has increased total cash payments by:

- \$2.4b in 2019-20
- \$8.3b over the four years to 2022-23.

Significant measures are shown to the right.

Increasing payments:

- Funding for a package of measures for the Infrastructure Investment Program to accelerate critical infrastructure projects across Australia, which is expected to increase payments by \$750m in 2019-20 (\$4.2b over four years to 2022-23).
- Funding for a package of measures to support farmers and communities in drought, which is expected to increase payments by \$325m in 2019-20 (\$766m over four years to 2022-23). These measures build on existing programs and drought support announced by the Government since the Budget, which will exceed \$8b over the medium term.
- Funding for a package of Aged Care measures to primarily respond to the priorities identified in the interim report of the Aged Care Royal Commission. This will increase the number of home care packages, reduce the use of medication as a chemical restraint and providing a stronger evidence base to support new targets to reduce the number of younger people in residential aged care. This is expected to increase payments by \$173m in 2019-20, and by \$625m over four years to 2022-23.

Decreasing payments:

- Maintaining the Efficiency Dividend at the 2018-19 level of 2% for a further two years before stepping down to 1.5% in 2021-22 and returning to the base rate of 1.0% from 1 July 2022, which is expected to decrease payments by \$1.5b over four years to 2022-23.

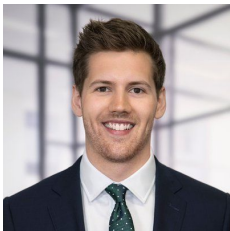
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