

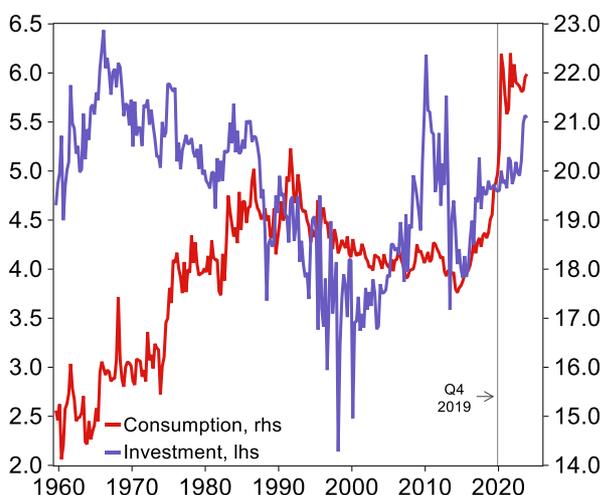
Friday, 26 April 2024

National fiscal outlook

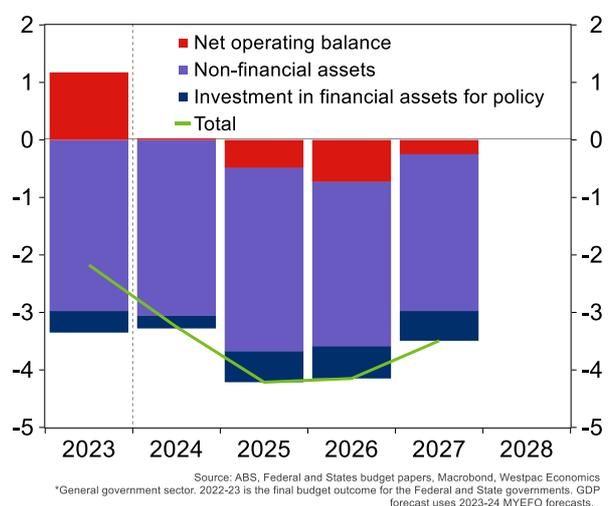
No room for sweeteners in existing fiscal pulse

- Government spending remains elevated as a share of the economy after it spiked during the pandemic. These spending pressures have been masked by the temporary boost to revenues.
- As the temporary boost to revenue fades and spending pressures mount the national fiscal impulse is forecast to increase by around one percentage point of GDP in 2024-25, following a similar sized boost in 2023-24.
- This growing fiscal impulse, that is the net boost to aggregate demand, is likely to help offset the squeeze on household incomes but adds to inflation risks. International Monetary Fund (IMF) research suggests that a one percentage point of GDP increase in government expenditure could boost inflation by at least half a percentage point.
- In our view, this is unlikely given the slowdown in the economy, but a further loosening in fiscal settings runs this risk. Governments (Federal and states and territory governments) need to consider budget proposals against the backdrop of this easing in fiscal settings as we head into budget season.
- Longer term fiscal settings should also be considered as we deal with mounting spending pressures. Had the national net operating balance been running at levels recorded during the mining investment boom, where the macroeconomic backdrop was similar to what we are experiencing (elevated commodity prices, solid population growth, a pickup in wages leading to bracket creep, and low unemployment), the national fiscal impulse would be broadly balanced.
- Instead, in 2024-25 we are expecting a small national operating deficit (0.5% of GDP) with the forecast increase in capital outlays funded entirely through borrowing and adding in net terms to aggregate demand in the economy.

Public investment and consumption
% of real GDP



Total fiscal impulse
% of nominal GDP



In Australia, demands on Federal and state and territory governments (or “governments”) have been steadily increasing. This has been driven by demographics such as the ageing of the population, but equally as important, changes in societal preferences. There’s been a shift away from user pays and means testing towards universal subsidised access to public services such as health care, disability support and more recently universal access to subsidised childcare, early education, and vocational training. This trend accelerated during the pandemic where support provided by governments spiked and has remained elevated at close to record high levels, notwithstanding the strength of the macroeconomy and labour market.

There are new challenges on the horizon. The economy continues to adjust from the aftermath of the pandemic while transitioning to net-zero emissions and a world characterised by more uncertainty and geopolitical instability. As the structure of the economy changes there will inevitably be a period of “creative destruction” – some industries will blossom, others will perish. This is not necessarily a bad thing, it’s the way capitalist economies evolve, change, and generate productivity booms. However, there are costs, particularly for those associated with industries in structural decline.

It’s become clear that governments around the world and here in Australia are, and will continue to play, an active role in this adjustment – by providing support to help households and businesses cushion the impacts of these adjustments. Governments are even looking to manage the “creative destruction” process by picking and investing in new emerging industries.

This research piece looks at the fiscal outlook across both Federal and state and territory governments. The analysis largely uses forecasts published in mid-year budget updates released in late 2023 and early 2024. While the focus tends to be on the Federal budget, state and territories governments also significantly contribute to the national fiscal impulse: they account for around 70% of total government investment and around 35% of total government expenses.

Their inclusion gives rise to interesting interactions. For example, the Federal net operating surplus in 2023-24 is expected to be fully offset by a deficit across the states. This is not a coincidence. We have previously said ([link](#)) that the Federal budget is in a sweet spot – boosted by elevated commodity prices and the increase in international students and migrants that add to tax revenue and have limited impacts on costs. On the other hand, state budgets mainly benefit indirectly, through higher GST. Only a few states benefit directly through commodity royalties. Notwithstanding this, states are responsible for delivering infrastructure, public health services and public schooling where demands has increased due to the growing population. This suggest that looking at only one level of government provides a partial gauge of the fiscal impulse.

The starting position: current level of spending remains elevated.

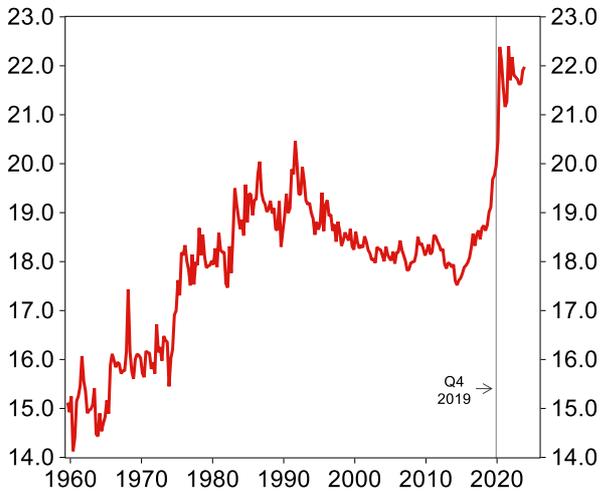
We have seen total government spending remain around record highs after it spiked during the pandemic. Government consumption (spending to provide subsidised public goods and services) as a share of the real economy increased from the pre pandemic decade average of 18.5% of the economy, to a peak of 22.4% in the September quarter of 2021. At the end of 2023, it remained elevated at 22.0% of GDP – around 3.5 percentage points above the pre pandemic decade average.

Looking ahead, total national government expenditure (services provided by the government domestically and also other support such as social assistance benefits, overseas aid assistance etc) as a share of the nominal economy is forecast to be around 40% over the next four years. This is much higher than the average of 37.0% of nominal GDP recorded during the mining investment boom when the macroeconomic backdrop was like what we have recently experienced: high commodity prices, solid population growth, a pickup in wages growth leading to bracket creep, and low unemployment. The Federal government is forecasting expenses as a share of GDP to

increase from 24.9% in 2022-23 to 25.8% in 2023-24 (an increase of around 1 percentage point of GDP), before reaching a peak of 26.3% of GDP in 2025-26.

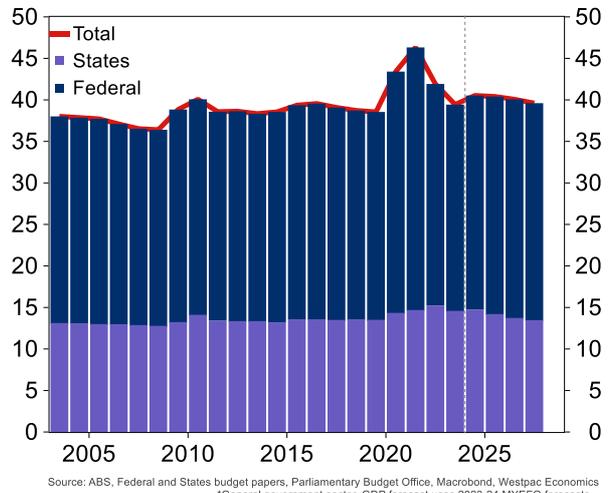
Total public consumption

% of real GDP



Government expenditure*

% of nominal GDP



How are governments financing this increased expenditure?

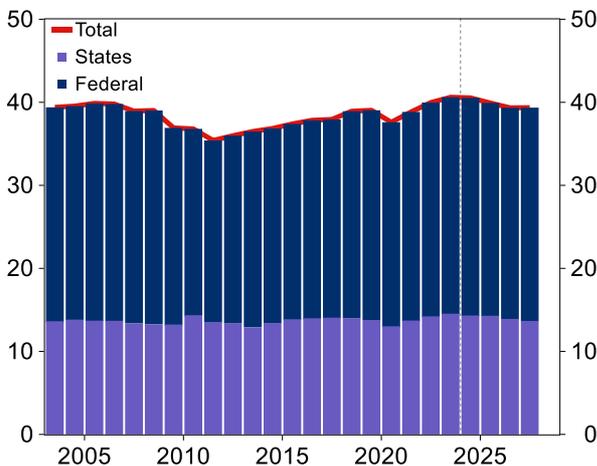
Government revenues have been boosted by temporary factors, which include high commodity prices, the extraordinary increase in overseas arrivals (which supports income tax receipts), low unemployment and ongoing bracket creep. Bracket creep is squeezing household incomes, with income tax as a share of disposable income sitting close to record high levels. Some relief is in the way with the rejigged stage 3 tax cuts commencing 1 July 2024.

As a result of the Federal government banking revenue windfalls, the net operating balance across governments was a surplus of 1.2% of the economy in 2022-23 – the largest surplus since 2007-08. This came on the back of a net operating deficit of 1.9% of GDP in the 2021-22 financial year which was still impacted by COVID related policies. The fiscal consolidation assisted the monetary authorities in slowing demand. The surplus was used to finance public investment, reducing the need for public borrowing.

Looking beyond 2022-23, government forecasts suggest a substantial loosening in fiscal settings over the next few years.

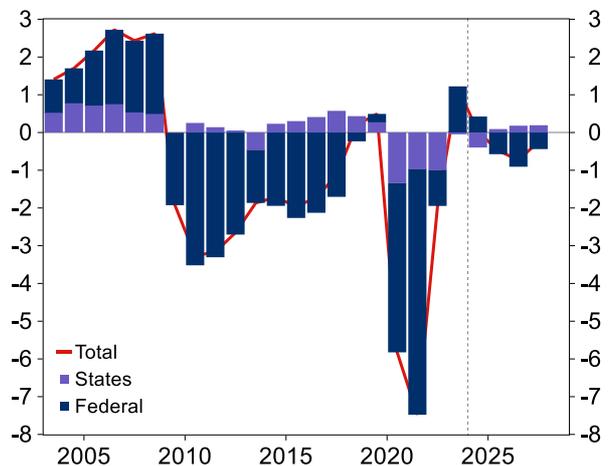
Government revenue*

% of nominal GDP



Net operating balance*

% of nominal GDP



The national net operating budget is expected to deteriorate as the temporary windfall fades and spending pressures mount. In the 2023-24 financial year, expenses are expected to be fully offset by revenues, with the operating budget balanced. The operating budget is then expected to slip into a deficit of 0.5% of the nominal economy in 2024-25.

Are capital outlays increasing?

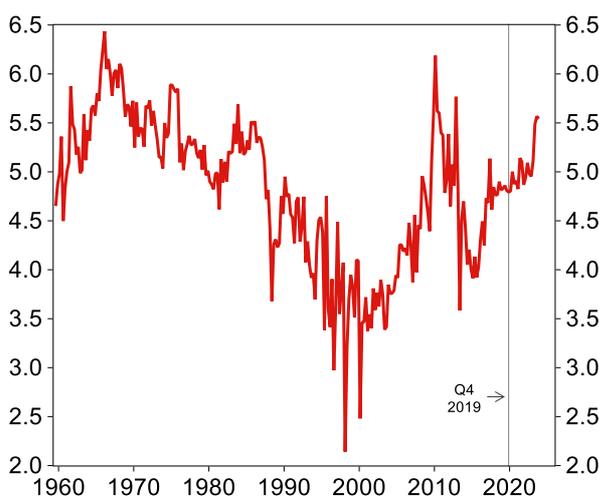
Part of the temporary windfalls have also been used to invest in infrastructure and other capital goods like buildings, IT systems and equipment. We have seen total public investment (including public non-financial corporations such as Water NSW) as a share of the real economy increase to around 5.6% of the real economy - well above the pre pandemic decade average of 4.7% of GDP and rivalling the levels seen in the aftermath of the GFC when governments invested heavily to cater for the larger population and in response to the negative demand shock caused by the GFC.

Importantly, this investment sits outside the operating budget. As such it represents a net increase in aggregate demand when a net operating surplus is insufficient to fully fund the capital outlays. Here again, total government spending on investment remains elevated and is forecast to increase over the next four years – from 4.2% of the nominal economy in 2023-24 to 4.7% in 2024-25. In 2024-25, governments are expecting to increase investment by around 14%, with this largely being driven by the Federal government providing the Clean Energy Finance Corporation and Housing Australia additional capital to help with essentials like the transition to net zero emissions and to deliver more affordable housing.

Public investment forecasts include investment in non-financial assets (such as infrastructure) and investment in financial assets for policy purposes. Investment in financial assets for policy purposes usually take the form of a loan or equity injections where the spending is undertaken by a third party, usually a public corporation. As such, in budget documents it is treated as a balance sheet transaction rather than “spending” which hits the bottom line. However, for our purposes, this transaction adds to spending and, therefore, is included in our measure of investment. It makes no difference to aggregate demand whether governments invest directly or indirectly through loans/equity injections to third parties. It all impacts aggregate demand.

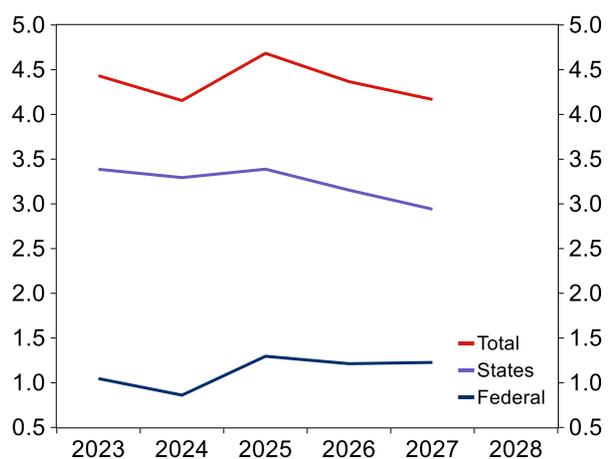
Public investment

% of real GDP



Public investment*

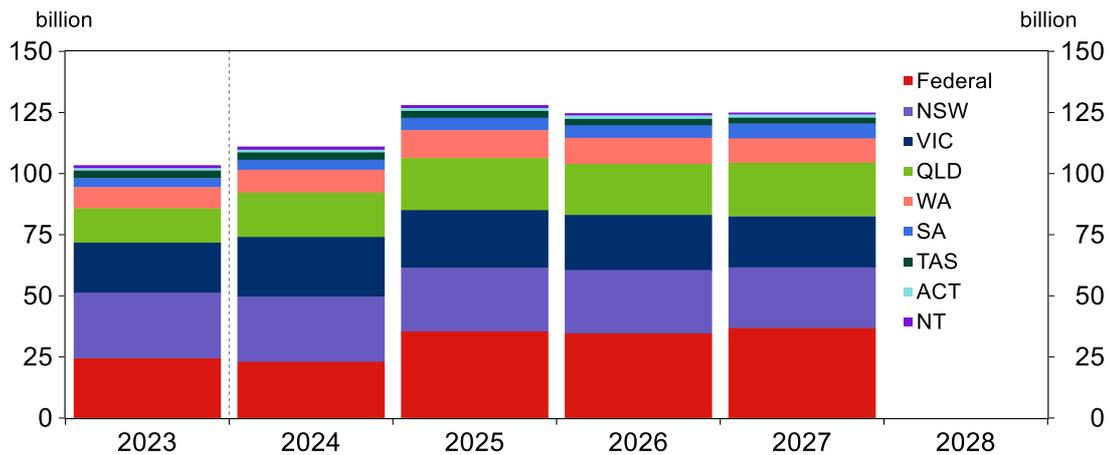
% of nominal GDP



Most of this investment is expected to be driven by states and territories, accounting for around 70% of total expected public investment.

Expected public investment*

By states

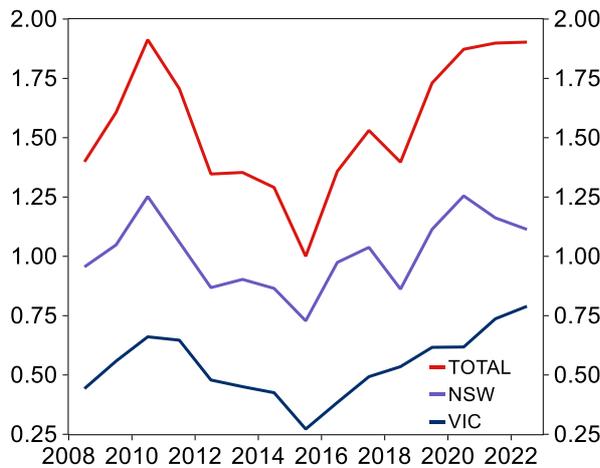


Source: ABS, Federal and States budget papers, Macrobond, Westpac Economics
 *Total non-financial government sector. 2022-23 is the final budget outcome for the Federal and State governments. GDP forecast uses 2023-24 MYEFO forecasts.

The largest two states (NSW and Victoria) account for around 60% of total investment across all state and territory governments. These two states have also seen public investment pick up over the last decade – from around 1.3% of nominal GDP in 2011-12 to around 1.9% of nominal GDP in 2021-22.

Public investment by state*

% of nominal GDP



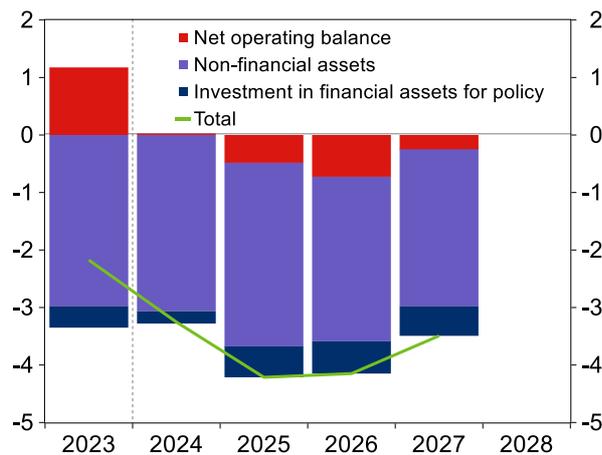
Chat Source: ABS, States budget papers and final budget outcomes, Macrobond, Westpac Economics
 *Public non-financial sector.

What does this mean for the fiscal impulse?

Putting this together, the operating budget and investment plans across governments, shows that the general government fiscal impulse is expected to increase – from around 2.2% of GDP in 2022-23 to 3.3% of GDP in 2023-24. This suggests that the fiscal impulse will increase by around 1.1 percentage points of GDP in 2023-24, rivalling the increase in the fiscal impulse recorded in 2009-10, following the Global Financial Crisis (GFC), when the national net operating deficit deteriorated from 1.9% of GDP to 3.3% of GDP. In 2024-25, the fiscal impulse is forecast to rise to 4.2% of GDP, another increase of around 1.0 percentage point of GDP.

Total fiscal impulse

% of nominal GDP

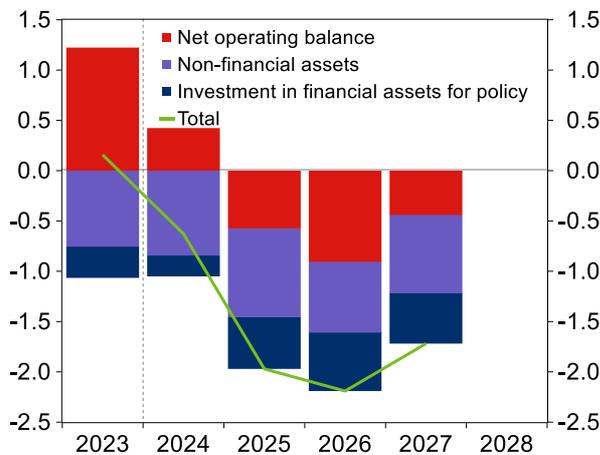


Source: ABS, Federal and States budget papers, Macrobond, Westpac Economics
 *General government sector. 2022-23 is the final budget outcome for the Federal and State governments. GDP forecast uses 2023-24 MYEFO forecasts.

The composition of the fiscal impulse is changing, with a larger share driven by the Federal government. The Federal operating budget is expected to deteriorate, while investment is set to tick up as a share of the economy with investment growing in the net zero transition, housing, and defence. On the other hand, the operating balance across states is expected to improve with the investment pipeline expected to remain at an elevated level of GDP over the next four years.

Federal fiscal impulse

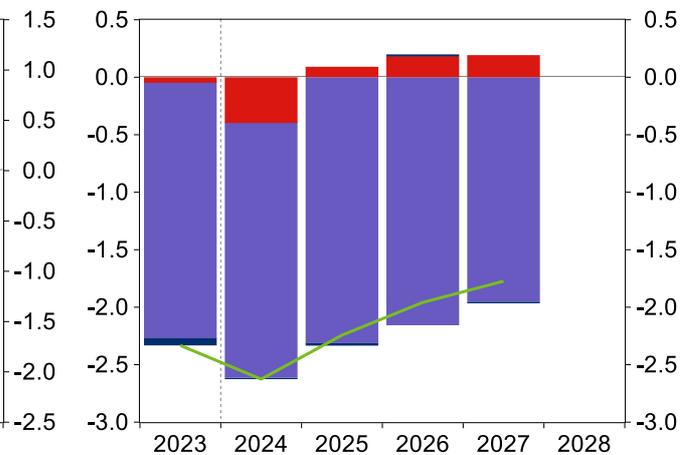
% of nominal GDP



Source: ABS, Federal and States budget papers, Macrobond, Westpac Economics
 *General government sector. 2022-23 is the final budget outcome for the Federal and State governments. GDP forecast uses 2023-24 MYEFO forecasts.

States fiscal impulse

% of nominal GDP



Source: ABS, Federal and States budget papers, Macrobond, Westpac Economics
 *General government sector. 2022-23 is the final budget outcome for the Federal and State governments. GDP forecast uses 2023-24 MYEFO forecasts.

The fiscal impulse represents the net boost to aggregate demand from governments. When governments are balancing their books and net outflows (consumption and investment) equals inflows (mainly tax revenue) the impulse will be flat or neutral. The change in the impulse is important when looking at the change in demand, activity, and inflationary pressures.

Is the fiscal impulse appropriate?

It's clear that government spending is helping to offset the drag from bracket creep on household incomes. In fact, household consumption of goods and services is currently being subsidised by governments, in the form of larger rental subsidies, electricity rebates and extra payments for childcare, aged care and pharmaceutical products.

Notwithstanding the forecast deterioration in the net operating balance, compared to the decade following the GFC, the national operating deficit is not large (average over the period 2020-11 to

2018-19 was a deficit of 1.5% of GDP). However, the economy is much stronger than in the aftermath of the GFC. The unemployment rate is at 3.8% and remains close to a 50-year low, the rebound in international students and migrants was larger than anticipated by policymakers and economists, wages growth is higher leading to bracket creep, and commodity prices remain elevated.

Arguably the economic backdrop is like the pre GFC period where the national net operating surplus was closer to 2.5% of nominal GDP. If we were running surpluses this size today, the aggregate fiscal impulse would be close to flat – instead this fiscal year governments are expecting to run a balanced budget with investment adding around 3.3% of GDP to demand. In 2024-25, governments expect to run a net operating deficit of 0.5% of GDP, with investment adding around 3.7% of GDP to demand in the economy.

Will this impulse add to inflation?

Recently published International Monetary Fund (IMF) research suggests that for advanced economies like Australia, a one percentage point of GDP increase in government spending adds around 0.5 percentage points to inflation in the first year. The IMF has also found similar impacts when looking at the budget in holistic way - a deterioration of one standard deviation in the budget to GDP ratio adds 0.56 percentage points to inflation in the first year, and a cumulative 0.71 percentage points over the medium term.

These estimates are based on the average responses over numerous cycles. However, we are not in an average period – the economy has slowed, the supply side of the economy is expanding as supply-chain disruptions dissipate and household incomes are being squeezed. This starting point is likely to dampen the inflation response.

However, a further loosening in fiscal settings runs this risk. Governments need to consider budget proposals against the backdrop of this easing in fiscal settings as we head into budget season.

Are there risks to these published outlooks?

This analysis largely uses forecasts published in mid-year budget updates released late 2023 and early 2024. There is considerable upside risk for the Federal budget given the conservative commodity price assumptions (we will release our formal estimates in the lead up to the Federal budget). However, states, on the other hand, have been downgrading their fiscal outlooks and could continue to do so as expenses grow more quickly than revenue. Therefore, risks to the national fiscal outlook are broadly balanced.

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