

## The 2021-22 Federal Budget: Fiscal Policy in the COVID-19 era

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The 2021-22 Federal Budget can be seen as the final main instalment in the Federal Government's fiscal policy response to the COVID-19 pandemic<sup>1</sup>. This makes it timely to assess fiscal policy in the COVID-19 era and draw any lessons for the future. This note is a preview of a forthcoming working paper that will provide the full and updated analysis.

The pre-COVID starting point for fiscal policy was set out in the 2019-20 MYEFO. The subsequent stream of COVID policy responses are conveniently summarized in the 2020-21 and 2021-22 budget documents.

Compared to other advanced economies, the pandemic and associated economic restrictions were less severe in Australia. Thus, from 2019 to 2020, GDP fell by only 2.5 per cent in Australia, compared to [4.7 per cent in all advanced economies](#). Despite our smaller economic shock, the strength of our fiscal response has been similar.

### JobKeeper

This fiscal response was led by JobKeeper, which ended after 12 months in March 2021. At a budget cost of \$89 billion, or the equivalent of 4.5 per cent of annual GDP, JobKeeper provided flat rate payments per employee for businesses experiencing substantially lower turnover under COVID restrictions. In effect, JobKeeper provided the employer with a wage subsidy for employees who remained active, while it provided employees who became inactive with a superior alternative to the JobSeeker benefit.

[Treasury](#) found that JobKeeper largely achieved its three main aims: (i) to keep workers in an unbroken relationship with their existing employer; (ii) to help businesses remain viable; and (iii) to compensate workers and business owners for income losses from restrictions.

In three cases, JobKeeper over-achieved in pursuing its third aim of compensation. These cases of over-compensation led to excessive budgetary costs and blunted economic incentives.

The first case of over-compensation was when the original JobKeeper payment of \$1,500 per fortnight exceeded the usual wage received by a part-time employee. If COVID restrictions made such an employee inactive, they were better off financially to remain inactive with their existing employer and receive JobKeeper, than to obtain active part-time employment with an alternative employer at their usual part-time wage. This suppression of active employment was addressed after the program had run for six months, when a different and lower rate of JobKeeper payment was introduced for part-time employees.

The second case of over-compensation payment occurred because a business was able to receive JobKeeper payments for the six months from April to September 2020 on the basis of meeting the loss of turnover test only in the first month, April 2020. In practice, in May and June COVID restrictions were substantially eased in states other than Victoria, leading to some recovery in business turnover. Thus, Ownership Matters reports that of the 66 ASX300 entities who received JobKeeper in the second half of 2020, 34 of the entities reported an increase in underlying earnings from pre-pandemic levels<sup>2</sup>. Seemingly, these 34 entities were over-compensated by JobKeeper. Again, this over-compensation was addressed after the program had run for six months, when updated loss of turnover tests were applied for the remaining six months of the program through to March 2021.

The third case of over-compensation occurred because businesses who only narrowly qualified for JobKeeper under the loss of turnover test nevertheless received the same rate of JobKeeper payment as businesses who experienced more severe losses of turnover. Table 1 shows how the profits made by an “average” business varied under JobKeeper depending on their loss of turnover.

**Table 1**  
**Profit at alternative operating rates (\$'000 per year)**

Operating rate	0%	50%	70%	100%
Revenue	0	683	956	1,366
JobKeeper	212	212	212	0
Inactive labour	-212	-106	-64	0
Active labour	0	-210	-282	-403
Other variable costs	0	-362	-506	-723
Profit	0	226	317	240

The “average” business was constructed using ABS data from the input-output tables, the labour force survey and the counts of Australian businesses. This representative business usually makes an annual profit of \$240,000 on turnover of \$1,366,000. It has 5.4 employees of whom 1.7 are part-time.

If completely shut down by COVID restrictions, a business makes a profit of zero so there is no return to capital<sup>3</sup>. The JobKeeper payment of \$212,000 is passed on to employees, who are all inactive (Table 1, column for %0 operating rate).

In contrast, a business that is able to operate at the JobKeeper eligibility cap of 70 per cent of normal turnover<sup>4</sup> is over-compensated by JobKeeper. It loses 30 per cent of its usual profit i.e. 30% of \$240,000 = \$72,000. However, this is more than offset by the JobKeeper wage subsidy it receives for active employees of \$148,000, calculated at the total JobKeeper payment of \$212,000 less the amount forwarded to inactive employees of \$64,000. This leaves a net gain in profit of \$76,000, raising profit from its pre-COVID level of \$240,000 to \$316,000 (or actually to \$317,000, after eliminating rounding errors, as reported in Table 1).

Hence, after most economic restrictions were lifted, many businesses had a profit incentive to restrain turnover to 70 per cent of normal to retain eligibility for JobKeeper, instead of returning to full operations and losing JobKeeper. Like the first case of over-compensation, this third case is undesirable because it suppresses active employment. It also appears inequitable in that those employees who are kept inactive if a business profiteers from JobKeeper, only receive the JobKeeper payment rather than their usual wage.

Unlike the first two cases of over-compensation, this third case of over-compensation was not fully addressed by the changes made to JobKeeper in midstream<sup>5</sup>. This made ending JobKeeper and the associated suppression of active employment a pre-requisite for achieving a full economic recovery. For that reason, the Federal Government’s decision to end JobKeeper in March 2021 was appropriate, given that most economic restrictions had been already lifted.

Some narrower economic restrictions remain, especially on international travel, and future major outbreaks cannot be ruled out, so there may be a case for further compensation programs. Any new program should avoid a repeat of the situation where businesses not affected by COVID restrictions can profiteer by suppressing their turnover sufficiently to

narrowly qualify for government payments. To avoid such profiteering, payments should be better targeted at businesses who are affected by COVID restrictions (for example, by varying payment rates by industry, as in the Singapore program), and lower payments should be made to businesses who only narrowly qualify under a loss of turnover test.

### Assessing the fiscal stimulus

Table 2 shows the Budget cost of JobKeeper and other policy measures that have made up the COVID-era fiscal stimulus. Like the \$89 billion JobKeeper program, some of these measures were temporary, being intended to dampen the economic impact of the COVID-19 pandemic and associated economic restrictions.

**Table 2**  
**Budget Cost of COVID-era Fiscal Policy Measures (\$ billion)**

Policy Measure	19-20	20-21	21-22	22-23	23-24	24-25	total
JobKeeper	35	54	0	0	0	0	89
accelerated depreciation until 2022-23	0	5	17	17	3	6	49
boosting cash flow for employers	15	20	0	0	0	0	35
JobSeeker supplements	6	15	2	2	2	2	29
bring forward of stage 2 income tax cuts	0	7	17	2	0	0	26
other policy measures	3	34	39	28	29	12	145
Total	58	137	75	49	34	20	373

Sources: 2020-21 and 2021-22 Federal Budget documents; ABS quarterly national accounts

Accelerated depreciation of business investment has been made available under a series of three programs at a total cost of \$49 billion. The most recent and generous of these, the temporary full expensing program, allows for full immediate expensing of certain investments undertaken up until 2022-23.

The boosting cash flow for employers program made two lump sum transfers to businesses in 2020, to help them remain financially viable. The budget cost was \$35 billion.

Compared to pre-COVID plans, personal income taxes were cut for two consecutive years, from 2020-21 to 2021-22. This was achieved by introducing the stage 2 tax cuts earlier, in 2020-21 instead of 2022-23, while maintaining the original timetable for abolishing the LMITO tax offset in 2022-23. The budget cost was \$26 billion.

The fortnightly rate of JobSeeker benefit was supplemented by decreasing amounts of \$550, \$550, \$250 and \$150 in the four quarters ending in the March quarter 2021. Following these temporary supplements, a permanent supplement of \$50 was introduced, at an annual budget cost of around \$2 billion (Table 2). The total budget cost of the supplements through to 2024-25 is \$29 billion.

The remaining policy measures are shown in Table 2 as a single line item, and some of these measures have significant permanent budget costs. For example, the response to the Aged Care Royal Commission entails a permanent, annual cost of about \$5 billion.

To assess whether this COVID-era fiscal policy provided the appropriate amount of fiscal stimulus, three alternative scenarios were simulated using a prominent [macro-econometric model of the Australian economy](#). Following further development work in 2020, this model incorporates fiscal policy and its behavioural effects at a finer level of detail than other

Australian macro-econometric models, such as those maintained by the Reserve Bank and Treasury, making it more suitable for this type of analysis.

The *Baseline Scenario* incorporates all of the COVID-era policy measures set out in Table 2, a total of \$373 billion in discretionary fiscal stimulus. This is more than “the Government’s total economic support response to the crisis” of \$291 billion referred to in [the 2021-22 Budget](#). This is because Table 2 includes all fiscal policy decisions over the period, not just those explicitly linked to the COVID economic downturn by the Government.

Table 2 only includes Federal Government fiscal measures, as reported in Federal Budget documents. If state government measures were also taken into account, the total fiscal stimulus would be a bit larger.

In the second scenario, known as the *Automatic Stabilisers Scenario*, all of the \$373 billion in COVID-era fiscal policy measures included in the *Baseline Scenario* are removed. This scenario begins in the June quarter 2020, when the first measures are introduced in the *Baseline Scenario*.

Just as in the *Baseline Scenario*, the usual automatic stabilisers are allowed to operate in the *Automatic Stabilisers Scenario*. That is, the weaker economy under COVID-19 reduces the budget balance by increasing the number of welfare recipients and shrinking tax bases.

To assess the merit of the fiscal stimulus package at a macro level, economic outcomes under the *Baseline Scenario* were compared with economic outcomes under the *Automatic Stabilisers Scenario*. Paths are compared for public net borrowing (Chart 1), the unemployment rate (Chart 2) and real GDP (Chart 3).

Chart 1 shows that the automatic stabilisers lead to a significant increase in public net borrowing over the period from 2019-20 to 2022-23. However, this is dwarfed by the massive increase in borrowing from the discretionary fiscal stimulus present in the *Baseline Scenario*. The *Baseline Scenario* for public net borrowing differs somewhat from the Budget projection for the underlying cash balance mainly due to differences in definitions<sup>6</sup>.

Chart 2 shows that the fiscal stimulus in the *Baseline Scenario* was successful in moderating the impact of the COVID restrictions on unemployment. The unemployment rate is an average of 3.0 percentage points lower from 2021 to 2023 in the *Baseline Scenario* compared to the *Automatic Stabilisers Scenario*.

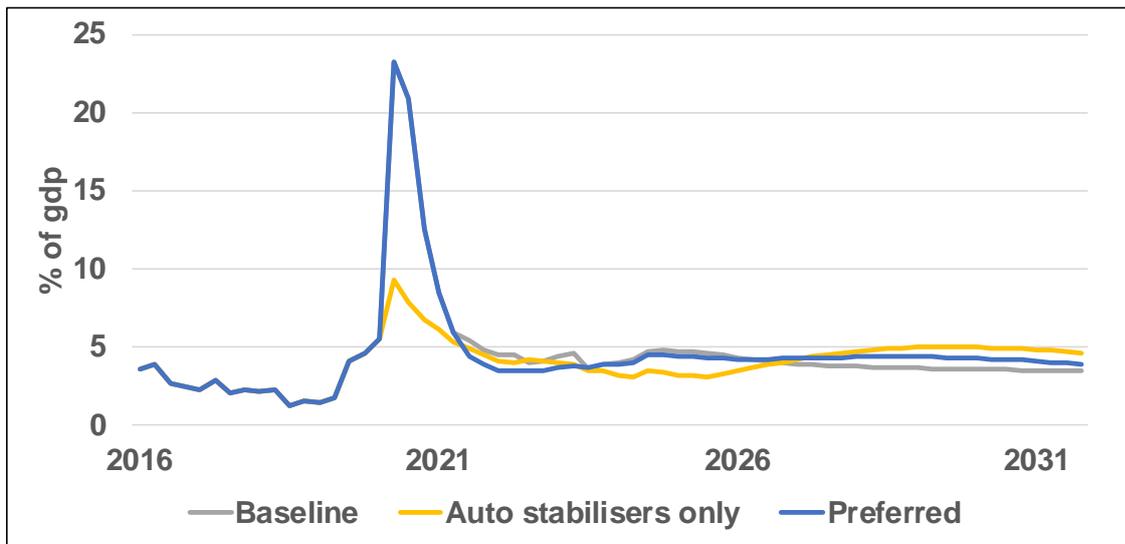
Similarly, Chart 3 shows that the fiscal stimulus was successful in limiting COVID-related weakness in GDP. Without the fiscal stimulus, real GDP is an average of 5.4 per cent lower from 2020-21 to 2022-23.

While the simulation results show that the fiscal stimulus measures greatly improved macroeconomic outcomes, they also suggest that there is room for improvement in two respects.

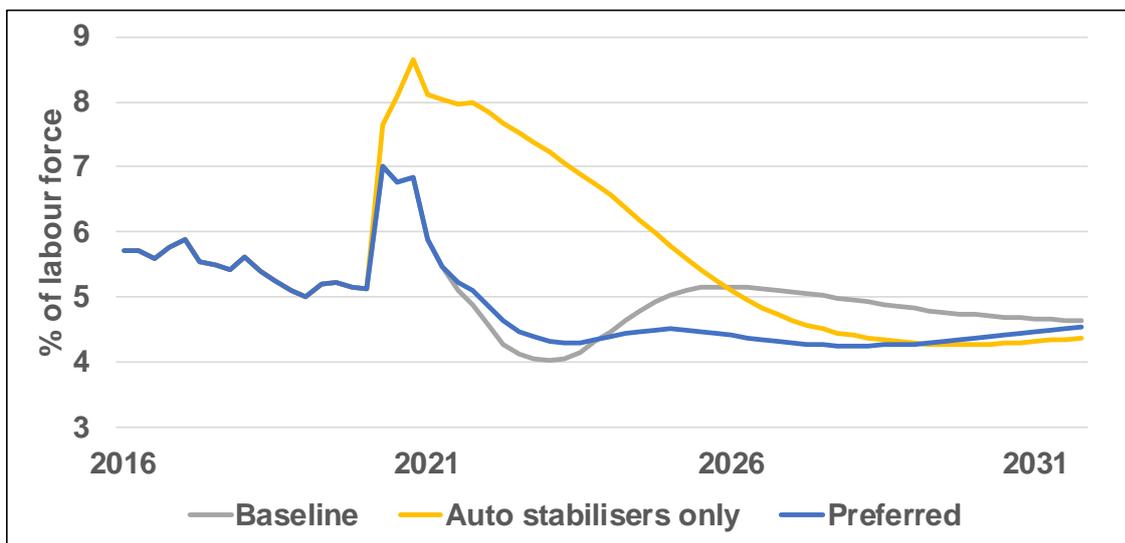
First, the effects of the fiscal stimulus extend beyond the period of major restrictions. In the *Baseline Scenario*, this pushes the unemployment rate all the way down to 4 per cent, below the estimated sustainable rate of 4.5 per cent (Chart 2). This leads to an outbreak of inflation that is met with tighter monetary policy. This pauses economic growth and pushes unemployment back over 5 per cent, before the macroeconomy finally stabilizes on a sustainable path with an unemployment rate of 4.5 per cent.

Second, the fiscal measures provide gains that are temporary, not permanent. From the middle of 2024, the path of real GDP is very similar in both scenarios (Chart 3).

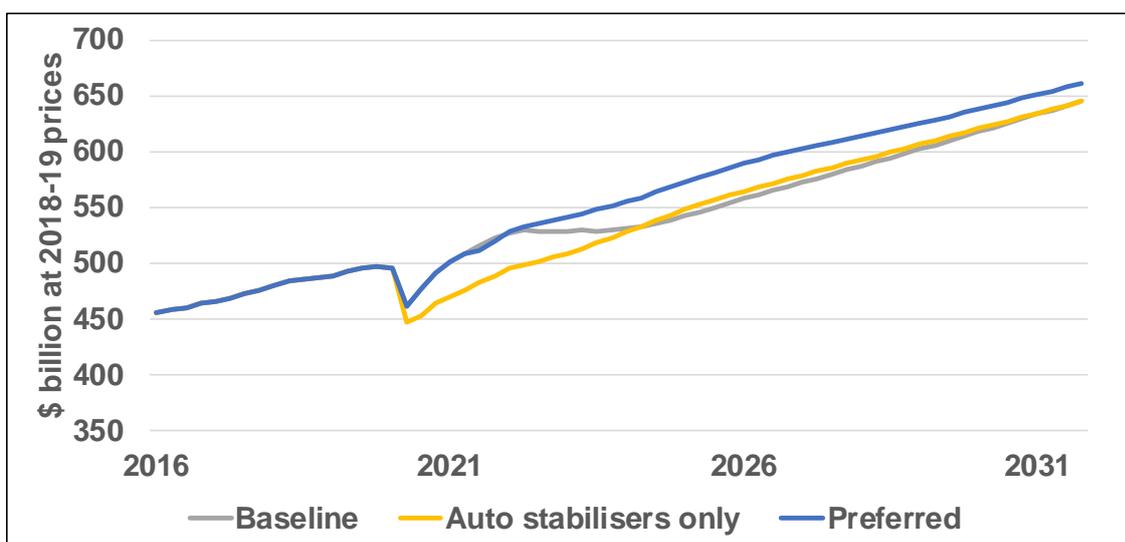
**Chart 1: public net borrowing**



**Chart 2: unemployment rate**



**Chart 3: real GDP**



## Preferred Scenario

The *Preferred Scenario* aims to address these two issues, the over-extended effects of the fiscal stimulus and the lack of long-term benefits, through modest policy changes from the September quarter 2021.

To shorten the fiscal stimulus, the *Preferred Scenario* ends the 'other policy measures' in Table 2 from 2021-22. This provides a budget saving of \$108 billion. It is accepted that, in practice, some of these other policy measures are worthwhile, such as the increased funding of aged care. In this scenario such worthwhile new programs would be maintained, but fully funded by cuts to lower priority programs.

In a further saving, the *Preferred Scenario* reduces the size of the cut in personal income tax for 2021-22. It does this by reversing the decision in the 2021-22 Budget to extend the LMITO for an extra year until 2021-22. This provides an additional budget saving of \$8 billion.

The *Preferred Scenario* delivers ongoing benefits through two modest tax reforms.

First, the temporary full expensing program for eligible business investment, which is scheduled to expire in 2022-23, is broadened and made permanent. The eligibility cap of \$5 billion in annual turnover is removed, so that full expensing is available to all companies.

Full expensing aims to remove the disincentive effect on eligible investment from the delays in expensing under usual tax depreciation arrangements. Following the US example (known as bonus depreciation), the Australian full expensing program covers investment in machinery and equipment, but not the long-lived investments in building and structures, perhaps because of the more extended budget costs of allowing full expensing in the latter case<sup>7</sup>.

Second, from 2021-22, the *Preferred Scenario* abolishes stamp duty on conveyancing and replaces it with a land tax, similar to local government rates. Stamp duty on conveyancing discourages owner-occupier households from moving to optimize the location and nature of their housing to their employment opportunities and the stages of their life cycle. The resulting misallocation between households of the available stock of residential land and dwellings is costly, with that stock accounting for \$7.4 trillion of total household net worth of \$12.0 trillion.

This housing tax reform was proposed by the Henry Tax Review and, more recently, by the NSW Government. However, if only some states make the change, the resulting hybrid nature of the housing taxation system will distort the housing market, especially near state borders. So the Australian Government has an important role to play in providing leadership and support to make this a nationwide tax reform.

Chart 1 shows that public net borrowing in the immediate outyears is lower in the *Preferred Scenario* than in the *Baseline Scenario*. In particular, as a share of GDP, public net borrowing is 1.0 and 0.7 lower in 2021/22 and 2022/23 respectively.

Chart 2 shows that this attenuation of the fiscal stimulus largely eliminates the cycle in the unemployment rate seen in the *Baseline Scenario*. Instead, unemployment stabilizes at close to the sustainable rate of 4.5 per cent from mid-2022. In brief, the macroeconomy is more stable.

Chart 3 shows the permanent gains in economic activity from the modest tax reforms. Real GDP is about 6 per cent above its baseline path in 2024-25 and 2025-26, and 3.4 per cent

above in the long term. The additional business investment induced by permanent full expensing raises productivity, leading to permanent gains in economic activity of 3.4 per cent in agriculture, 2.3 per cent in mining, 3.4 per cent in manufacturing and 2.3 per cent in private, non-housing services. The abolition of stamp duty increases household mobility, leading to a permanent gain of 10.8 per cent in housing services, which is concentrated in the real estate sector.

### **Goal for Net Debt**

A final remarkable aspect of the Budget is the shift that has occurred in the goal for Federal Government net debt. In the 2019-20 Budget, net debt was projected to decline from 19.2 per cent of GDP in 2018-19 to 0 per cent of GDP by the end of the medium term in 2029-30.

This medium-term debt projection was raised drastically in the 2020-21 Budget, following the massive COVID fiscal stimulus, and it remains drastically higher in the 2021-22 Budget. Net debt is now expected to reach a peak of 40.9 per cent of GDP in 2024-25, before falling to 37.0 per cent of GDP by the end of the medium term in 2031-32. So the medium-term projection for net debt has lifted from 0 to 37 per cent of GDP as part of the fiscal policy response to COVID.

In effect, on current planning, the government debt that was issued to fund the COVID fiscal stimulus remains outstanding into the medium-term. This plan has been influenced by the current low level of interest rates.

Over the Forward Estimates, the assumed weighted average cost of borrowing via Treasury Bonds is only 1.6 per cent. Applying this to the projected net debt of 37 per cent of GDP gives a net interest cost of only 0.6 per cent of GDP.

Over the same Forward Estimates period, nominal GDP is projected to grow at an average annual rate of 3.8 per cent. If it assumed that it is safe to borrow as long as net debt rises no faster than GDP, then applying this GDP growth rate to the projected net debt gives a borrowing capacity of 1.4 per cent of GDP.

Hence this holding of net debt adds more to borrowing capacity – 1.4 per cent of GDP – than it does to net interest costs – 0.6 per cent of GDP. This leaves a net gain to the budget of 0.8 per cent of GDP that can be used to fund higher spending or lower taxes. Similar reasoning appears in the 2020-21 Budget and helps explain the government's apparently sanguine attitude about holding substantially more debt into the medium term. However, the reasoning has two shortcomings.

First, the reasoning relies on interest rates remaining very low by historical standards. While that is the central scenario priced into bond markets, it is a scenario surrounded by a wide margin of error. It is conceivable that interest rates could move up so that government debt switches from being a fiscal advantage to a fiscal disadvantage, a possibility that should be taken into account when managing risk.

Second, the reasoning abstracts from any connection between the level of government debt and the interest rate at which international capital markets are prepared to fund that debt. If the risk premium attached to Australian Government debt becomes sufficiently sensitive to the level of that debt, the budget advantage from the debt can reverse. A number of countries in the EU have had that experience over the past decade.

The low level of interest rates does provide a more benign environment for government debt, especially to the extent that it is used to finance worthwhile investments. However, on balance, these is a case that the Federal Government should plan on making more progress

in winding back its debt. It is very likely to have the opportunity to do this when the Budget's very pessimistic assumption of iron prices reverting to normal in 12 months is revised upwards, substantially boosting projected revenue. That boost should be banked in a lower debt projection.

## Lessons

From this note, five lessons for the future can be drawn from fiscal policy in the COVID-19 era.

1. To limit profiteering from programs such as JobKeeper, payments should be better targeted at businesses who are affected by restrictions (for example, by varying payment rates by industry) and lower payments should be made to businesses who only narrowly qualify for support under a loss of turnover test.
2. The massive fiscal stimulus of the COVID era greatly improved outcomes for unemployment and GDP compared to merely relying on the automatic stabilisers to counter the economic downturn.
3. At the same time, the fiscal stimulus should not extend beyond the end of the restrictions, because this is likely to lead to an over-correction in the economy in 2022 to 2024, with inflation, higher interest rates and a rebound in unemployment.
4. There is an opportunity to generate a lasting, significant gain in living standards by making permanent the temporary program of full expensing of certain business investment and extending it to all companies, and also by encouraging a nationwide switch from taxing housing transactions to taxing housing land.
5. The government should plan on making more progress in reducing its debt to GDP ratio over the next decade. It can do this by "banking" the gain in projected revenues when its very pessimistic assumption for iron ores prices is very likely revised up.

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<sup>1</sup> This is barring a mishap in which there is a severe outbreak before most of the population has been fully vaccinated. In that case, there would likely be further major restrictions and fiscal stimulus.

<sup>2</sup> Kariyawasam N. and Samson J. (2021), "Update on JobKeeper & other government subsidies in ASX300", Ownership Matters, 17 March.

<sup>3</sup> This poses a risk of insolvency to the extent that capital is partly funded by debt, or that some costs such as lease payments are contractually fixed. Government COVID policies encouraged moratoriums on loan and lease payments for businesses in financial distress from COVID to reduce this insolvency risk.

<sup>4</sup> Smaller businesses were eligible for JobKeeper if they experienced a turnover loss of 30 per cent or more. Larger businesses, with normal annual turnover of over \$1 billion, were eligible if they experienced a larger turnover loss of 50 per cent or more.

<sup>5</sup> JobKeeper payments were made progressively less generous, reducing the extent of over-compensation of businesses who narrowly qualified. Under the payment arrangements in place from April to September 2020, the average business was over-compensated if its turnover was at least 53 per cent of normal. This rose to 62 per cent under the arrangements from October to December 2020 and 66 per cent under the arrangements from January to March 2021. But throughout, smaller businesses could claim JobKeeper if their turnover was up to 70 per cent of normal, so there was always the opportunity to profiteer from JobKeeper for smaller businesses not constrained by economic restrictions.

<sup>6</sup> While the Budget definition only covers net borrowing associated with the Federal Budget, the model definition also includes net borrowing by state and local governments and government business enterprises, leading to larger borrowing estimates on a model basis. Furthermore, the budget cost of the company and personal income tax measures is captured on an accrual basis in the model, compared to a cash basis in the Budget, which defers some costs. Thus, the costs of the measures show up in the Budget over a more extended time frame than in the model.

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<sup>7</sup> In the ideal form of the Brown Tax proposed in 1948, full expensing is accompanied by the abolition of the deduction for net interest costs. This because full expensing means that investment costs are already fully deductible, irrespective of whether the investment happens to be financed by debt or equity. However, when the USA introduced full expensing in 2017, it capped the deduction for net interest expenses at 30 per cent of EBITDA, instead of eliminating it. Perhaps this less drastic change aims to recognize that full expensing is not permitted for investment in building and structures. A similar cap on interest deductions could be applied in Australia to help offset the budget cost of making full expensing permanent.