

# THE 2018-19 BUDGET AND THE AUSTRALIAN ECONOMY

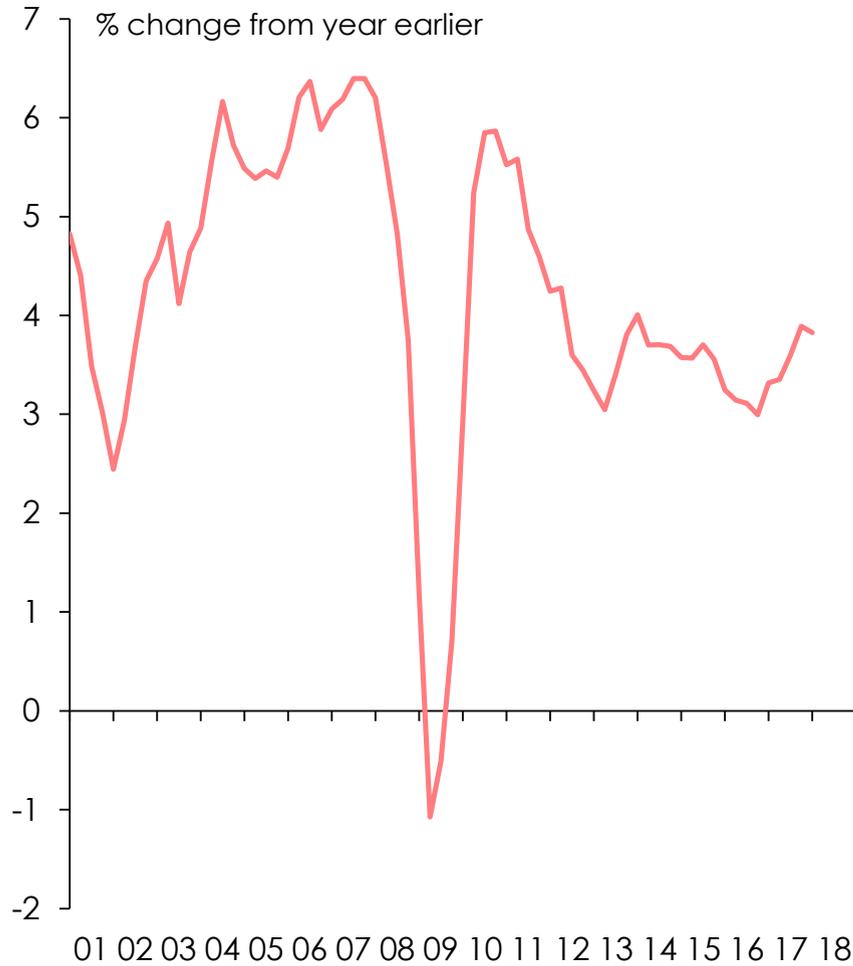
PRESENTATION TO A POST-BUDGET BREAKFAST  
HOSTED BY MOORE STEPHENS

RACV CLUB, MELBOURNE  
10<sup>TH</sup> MAY 2018

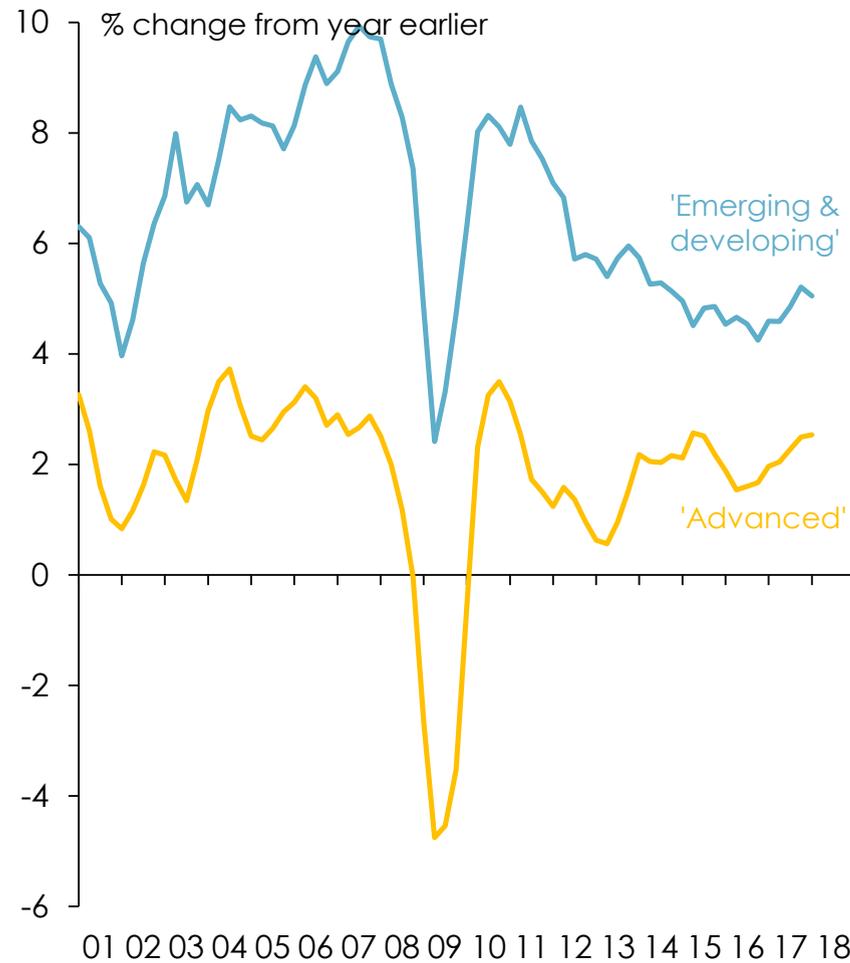
# The international economic context

# The world economy has picked up since the beginning of last year, led by stronger investment in 'advanced' economies

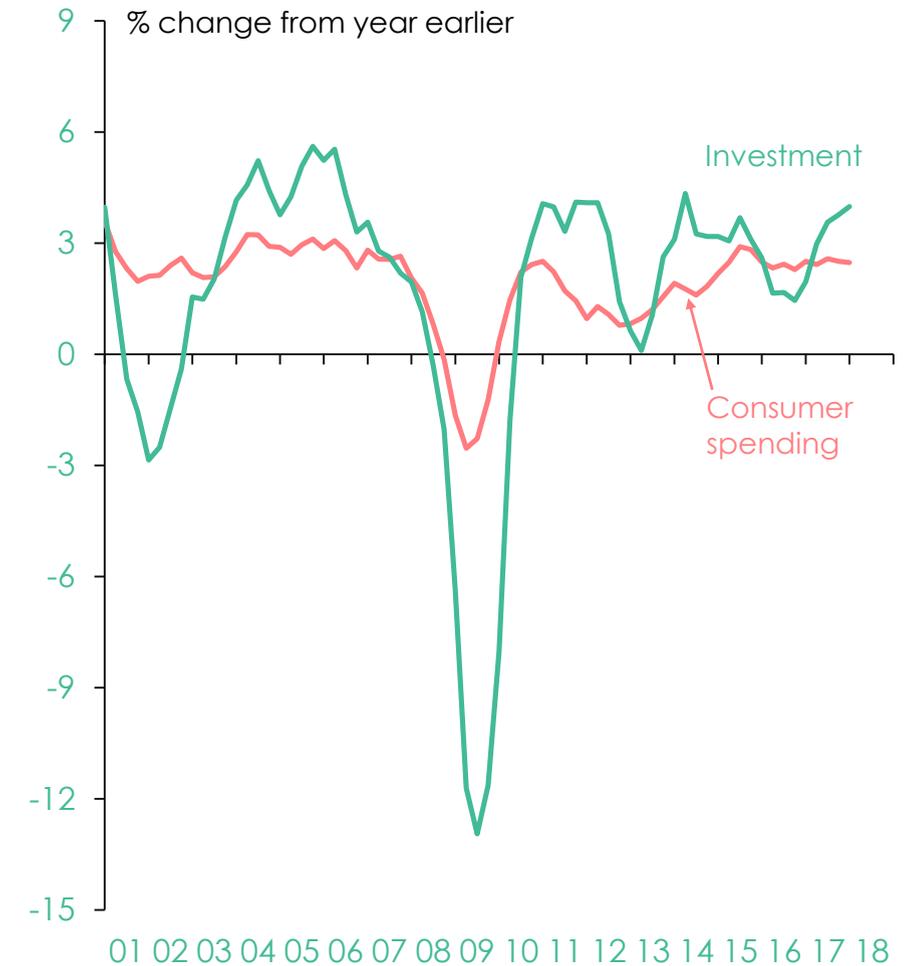
## World economic growth



## 'Advanced' vs 'emerging and developing' economies



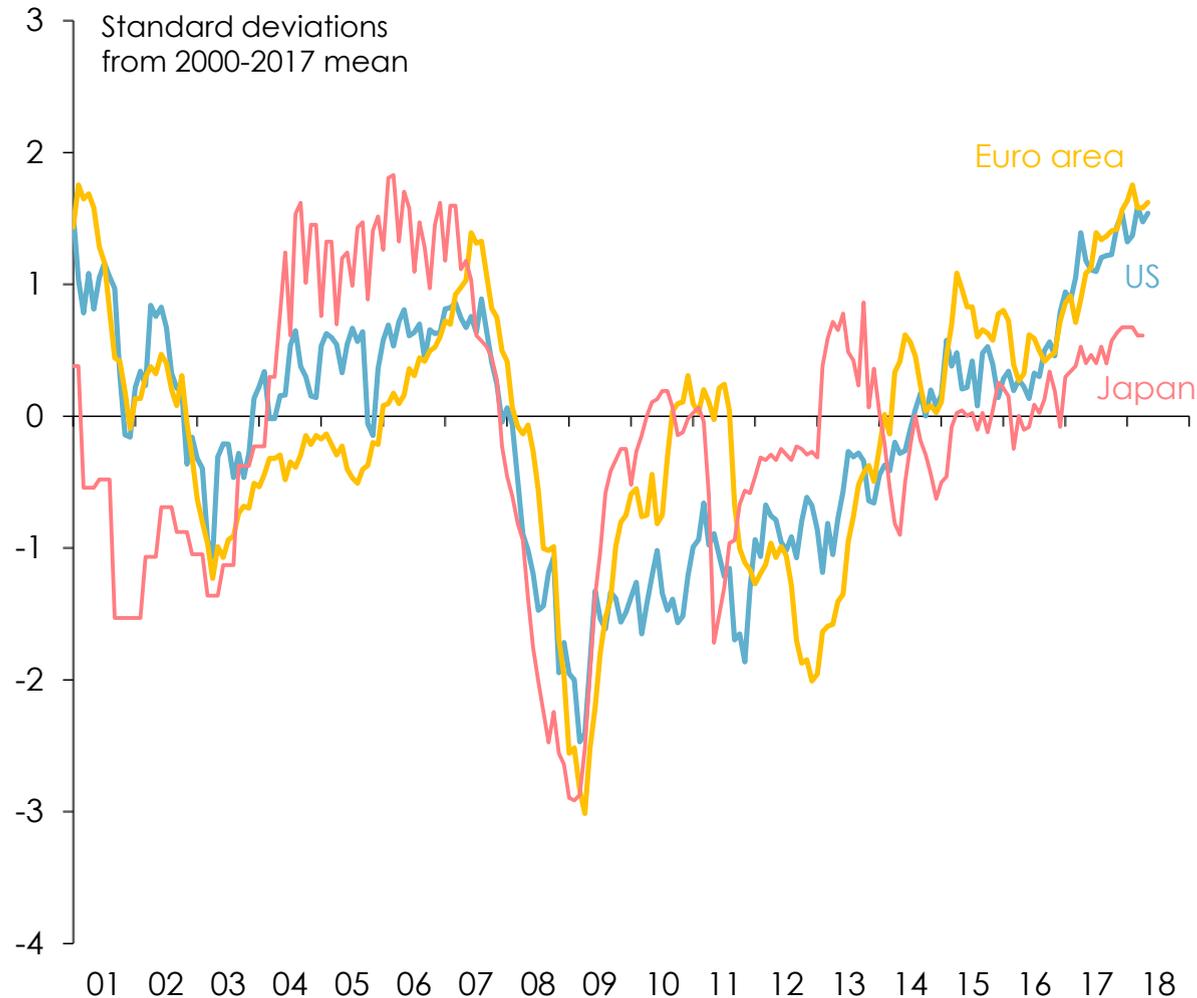
## Major components of developed country growth



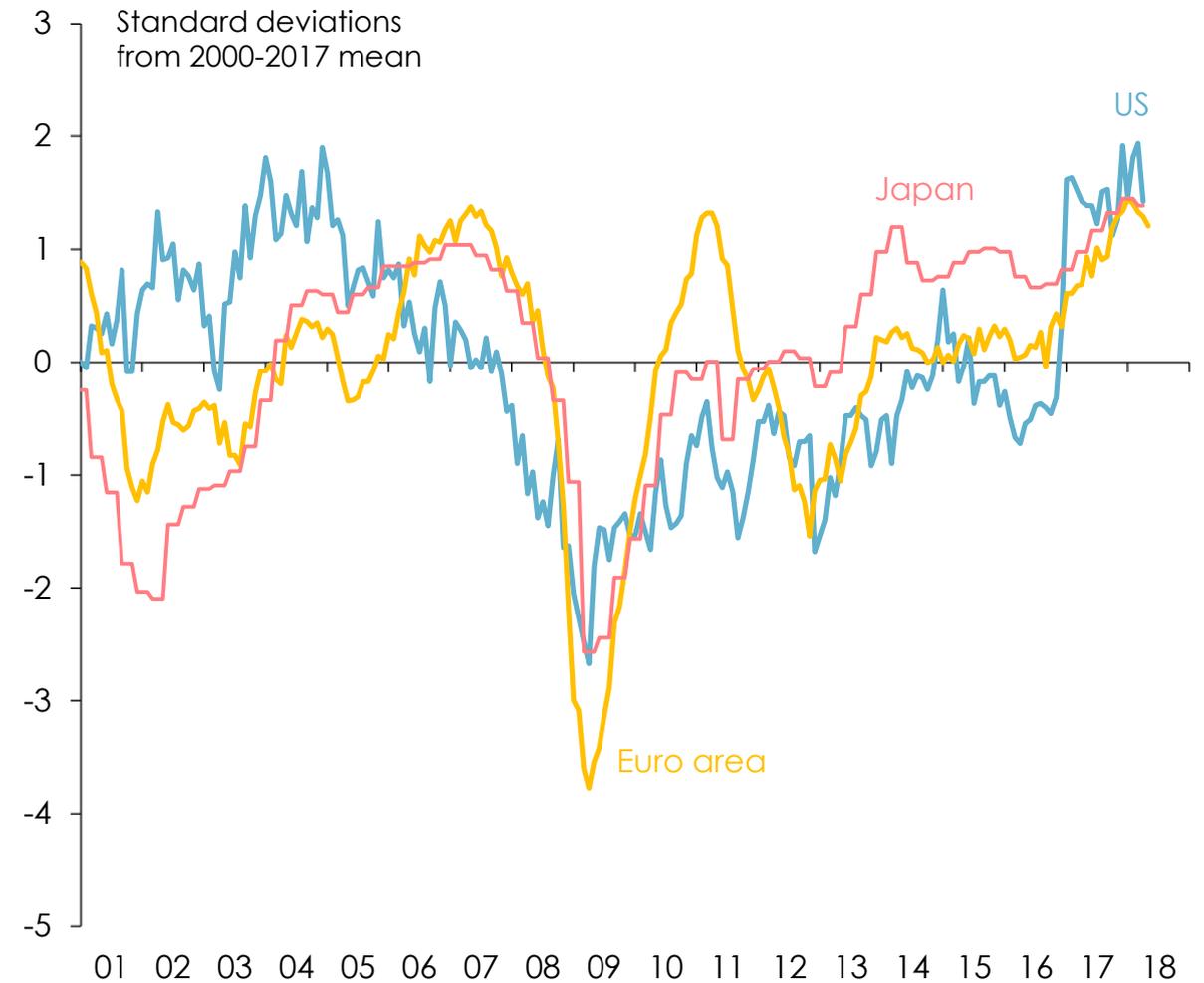
Sources: Thomson Reuters Datastream; IMF; OECD; Eurostat; other national statistical agencies; Corinna Economic Advisory.

# There's been a synchronized improvement in business and consumer confidence in advanced economies

## Consumer confidence



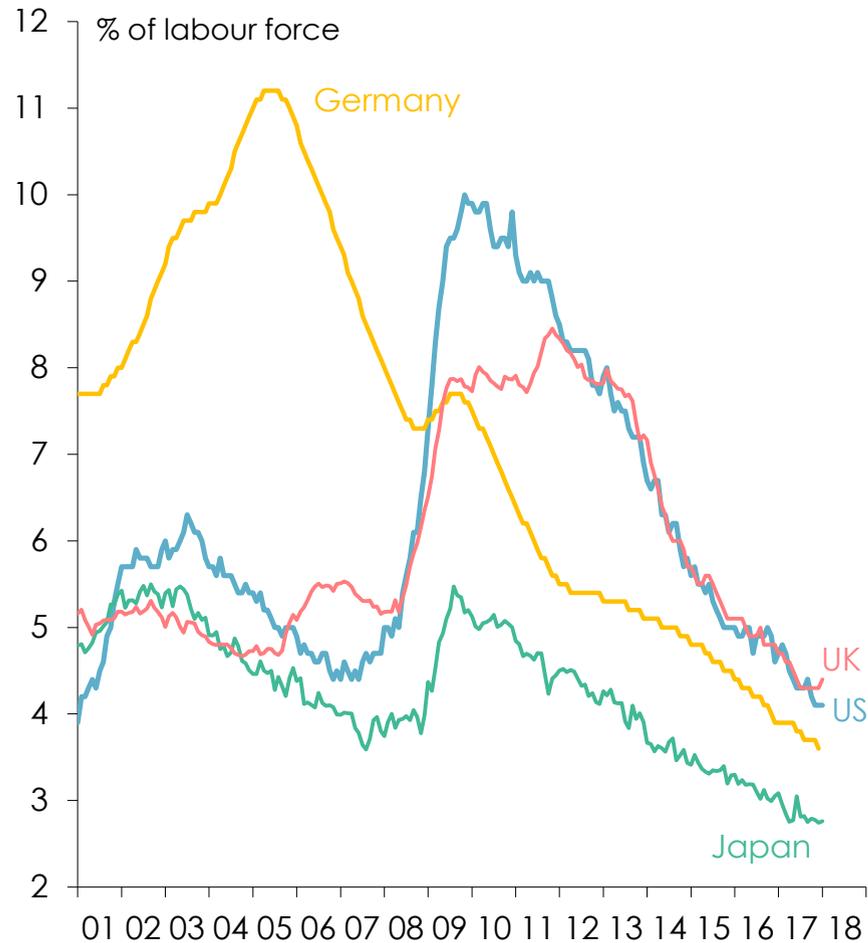
## Business confidence



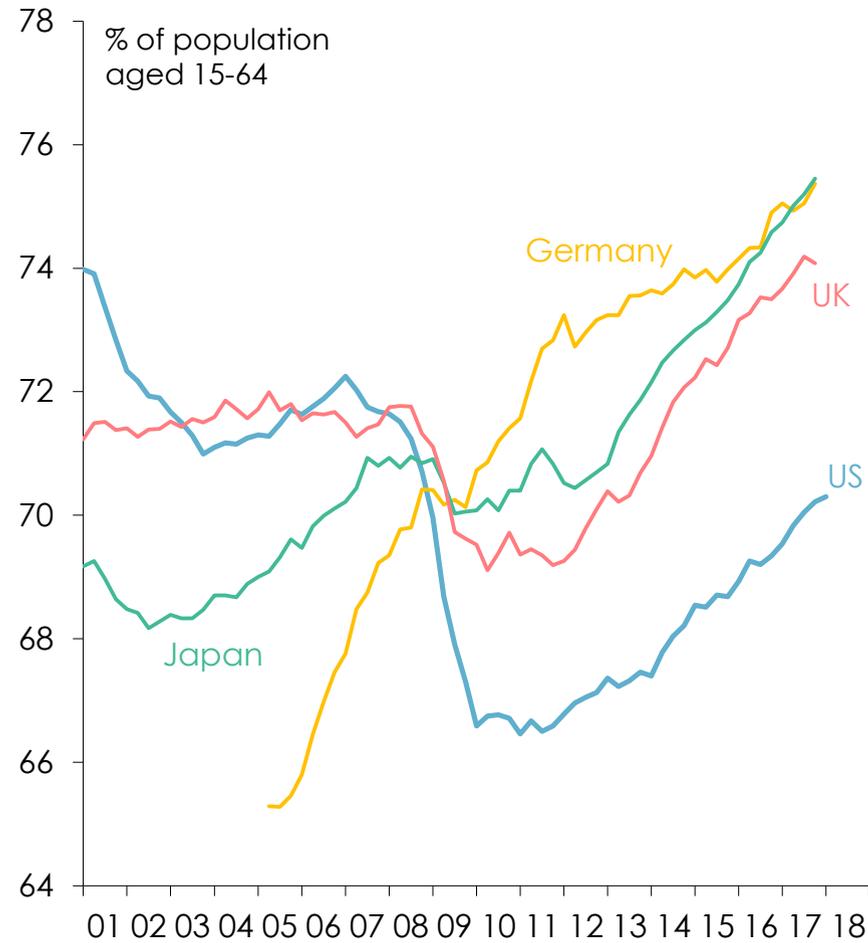
Note: Consumer confidence measures are those compiled by the Conference Board (US), European Commission (euro zone) and Cabinet Office (Japan). Business confidence measures are those compiled by the National Federation of Independent Businesses (US), European Commission (euro zone) and the Bank of Japan (the 'Tankan' survey, averaged over large and small businesses). Sources: above-mentioned agencies and Corinna Economic Advisory.

# Labour markets are getting tighter – especially in the four largest ‘advanced’ economies

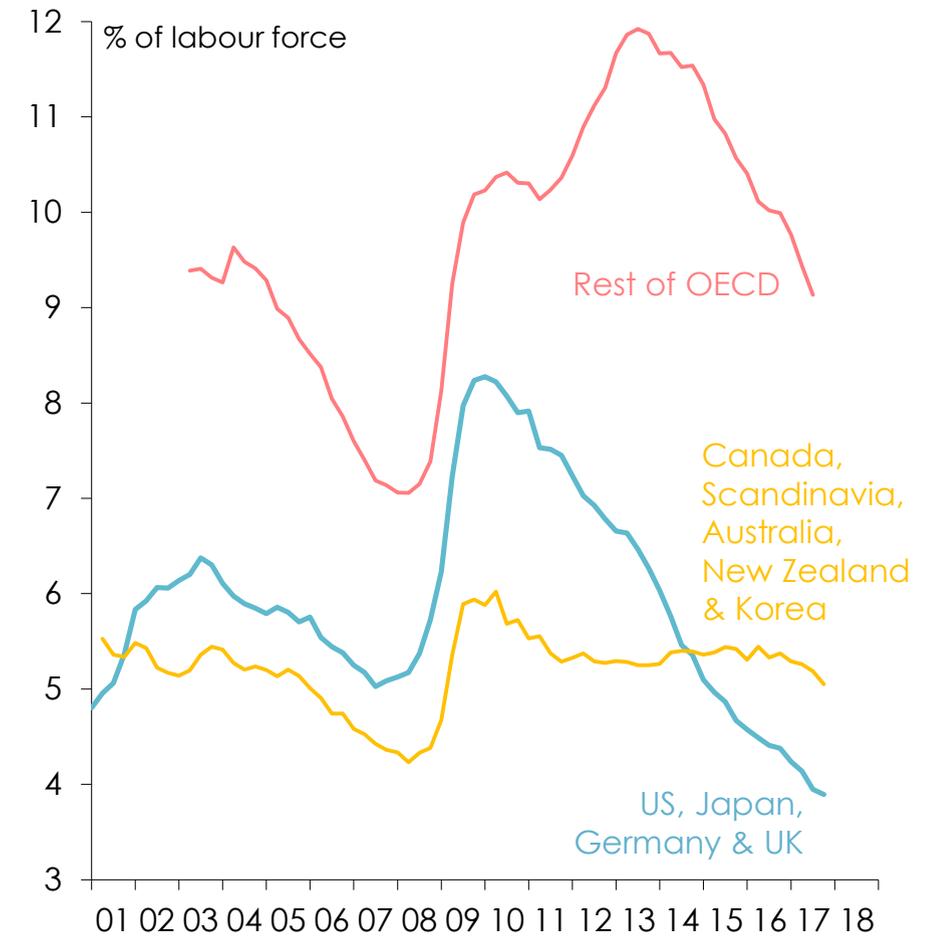
## Unemployment – 4 largest ‘advanced’ economies



## ‘Employment rates’ – 4 largest ‘advanced’ economies



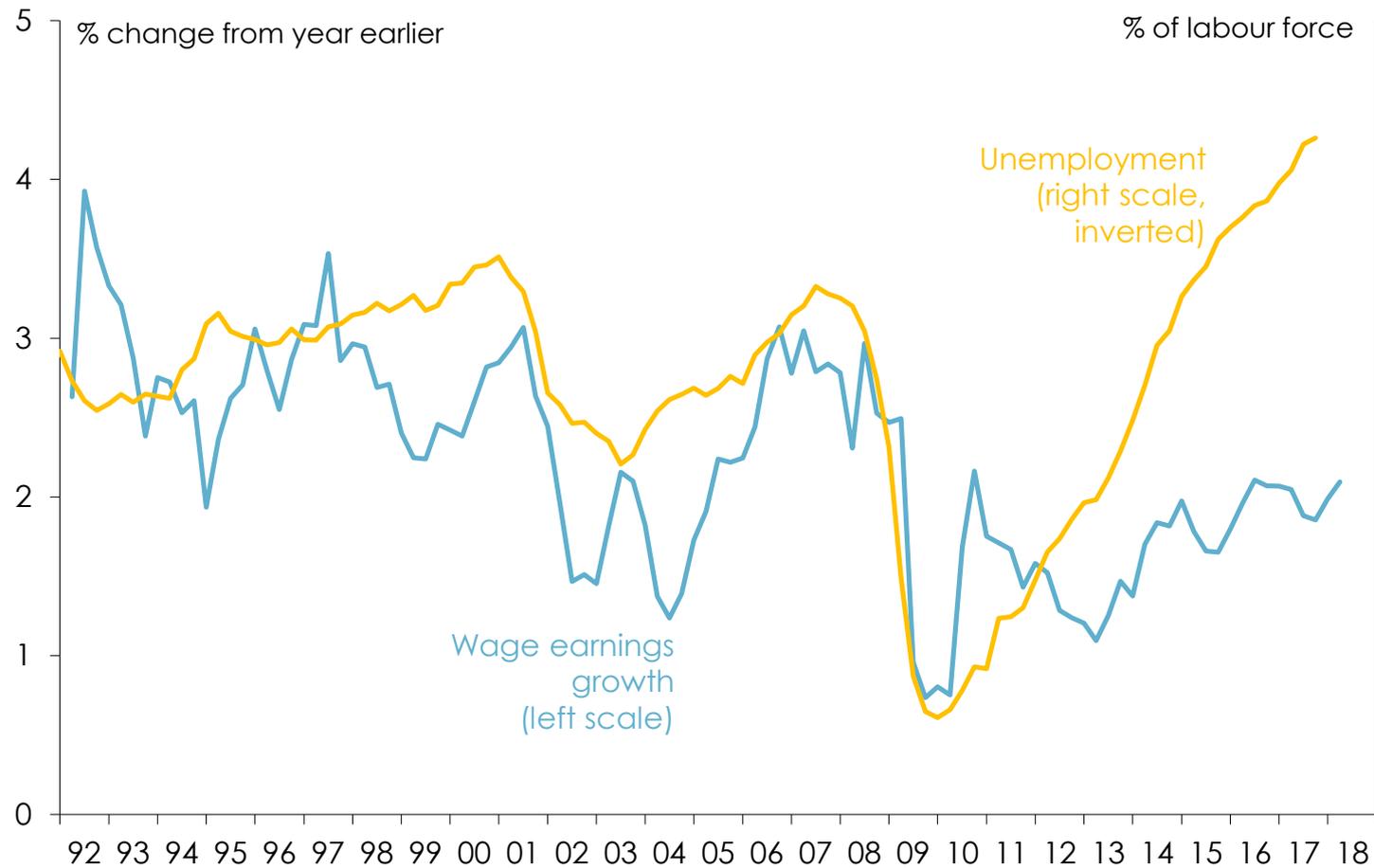
## Unemployment rates – other OECD economies



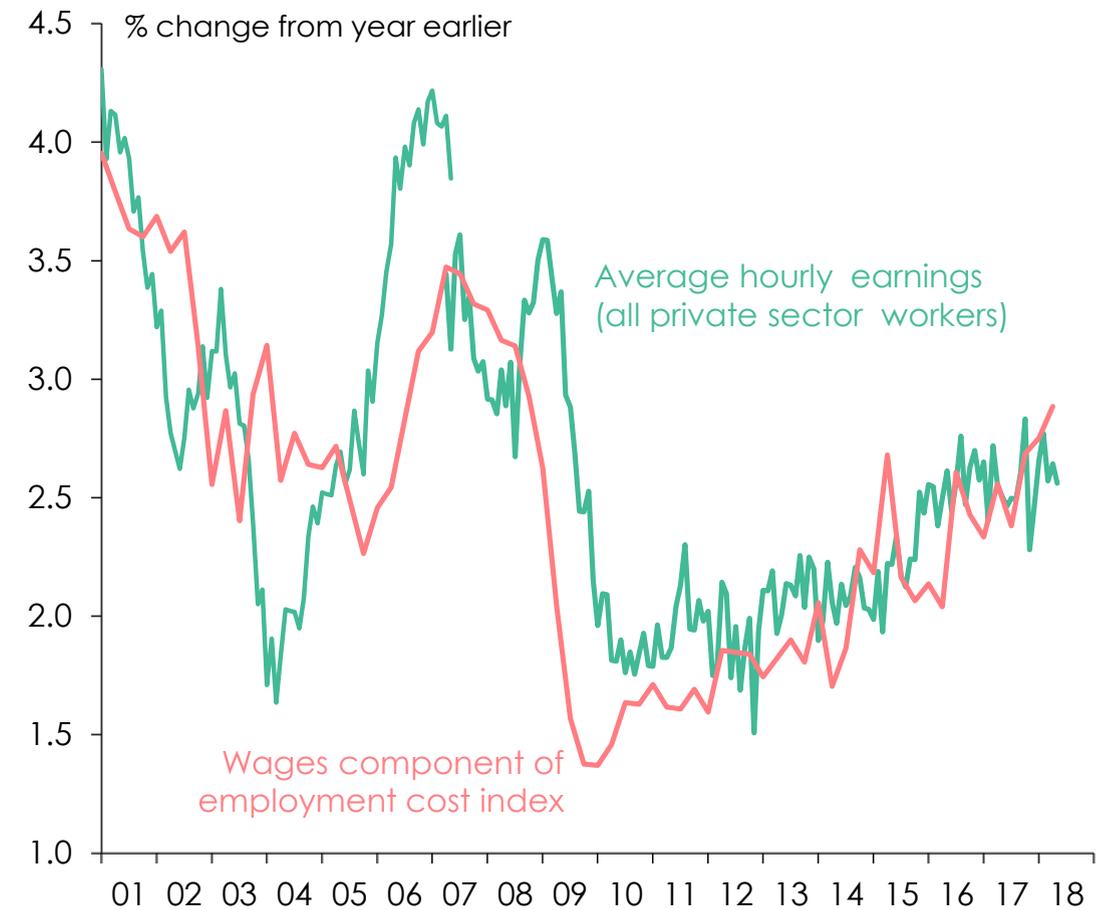
Sources: US Bureau of Labor Statistics; Eurostat; Japan Labour Ministry; Bundesagentur für Arbeit; UK Office of National Statistics; OECD Main Economic Indicators; Corinna Economic Advisory.

# Wages are taking longer to respond to labour market tightening than they did before the crisis – but there are now clear signs of wages rising in the US

## Wages growth and unemployment in the four largest 'advanced' economies



## US measures of wages growth

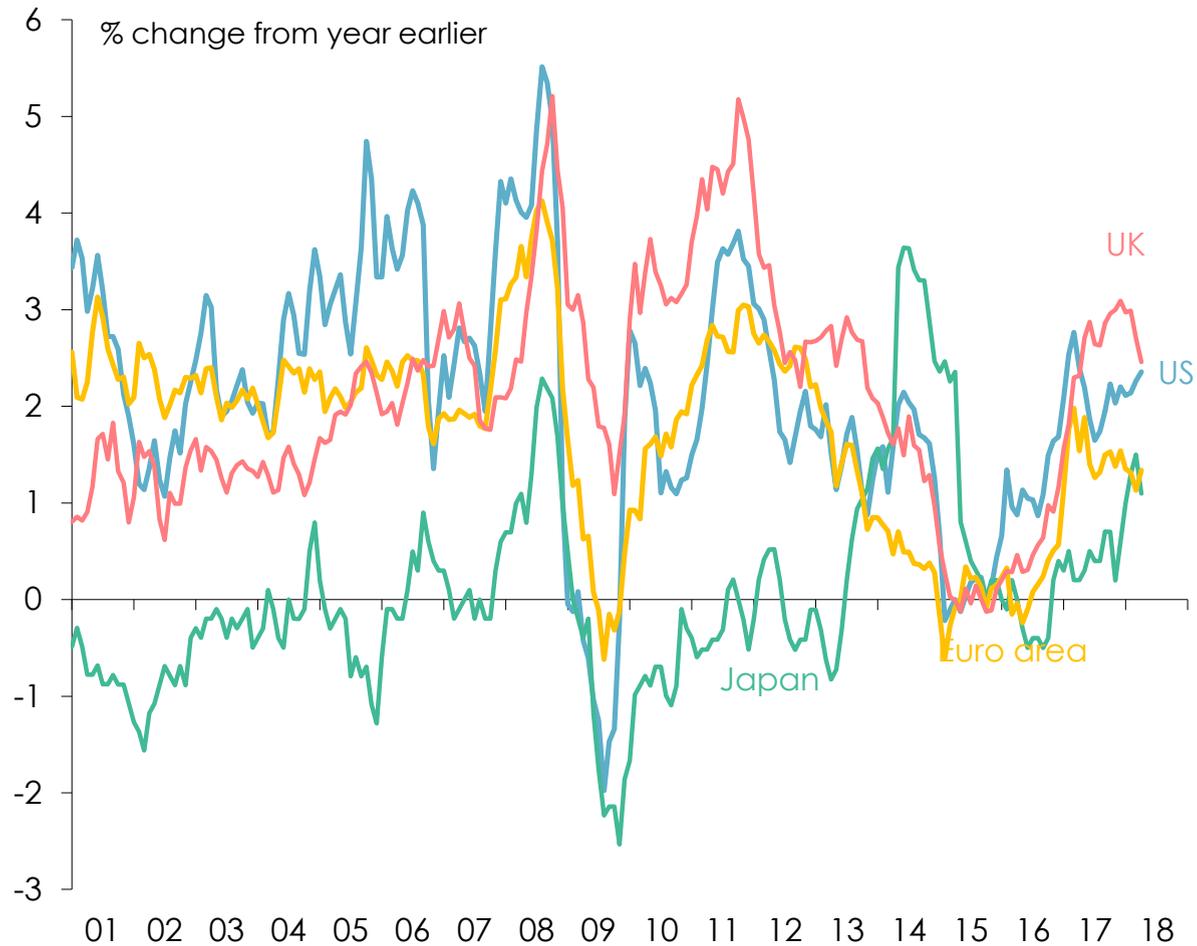


Note: Wages growth and unemployment are averages for the US, Japan, Germany and the UK, weighted by total employment.

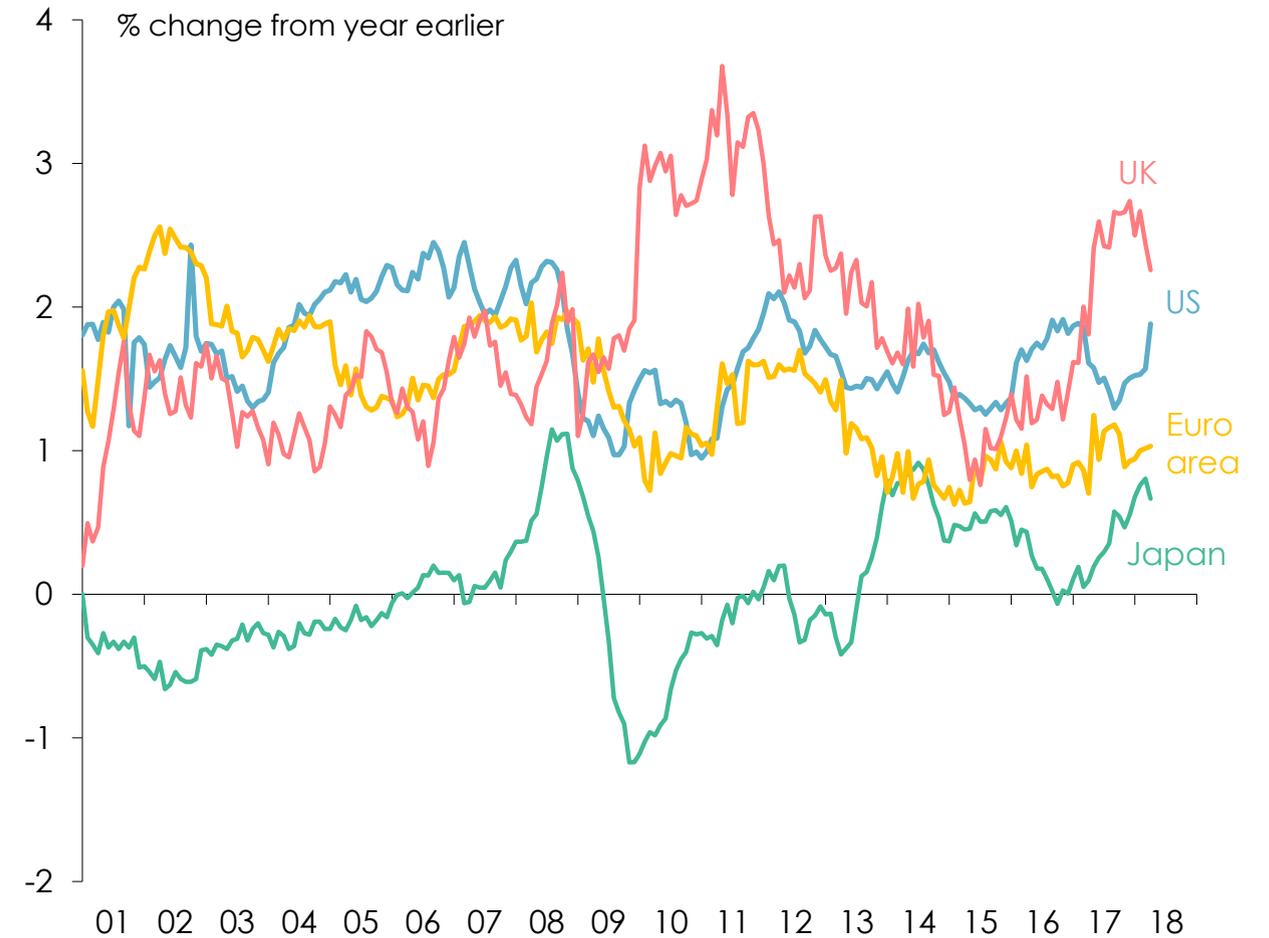
Sources: US Bureau of Labor Statistics; Eurostat; Japan Labour Ministry; Bundesagentur für Arbeit; UK Office of National Statistics; OED; Corinna Economic Advisory.

# Inflation in the major 'advanced' economies is now more clearly heading to where central banks want it to be – although “we’re not there yet”

## 'Headline' consumer price inflation



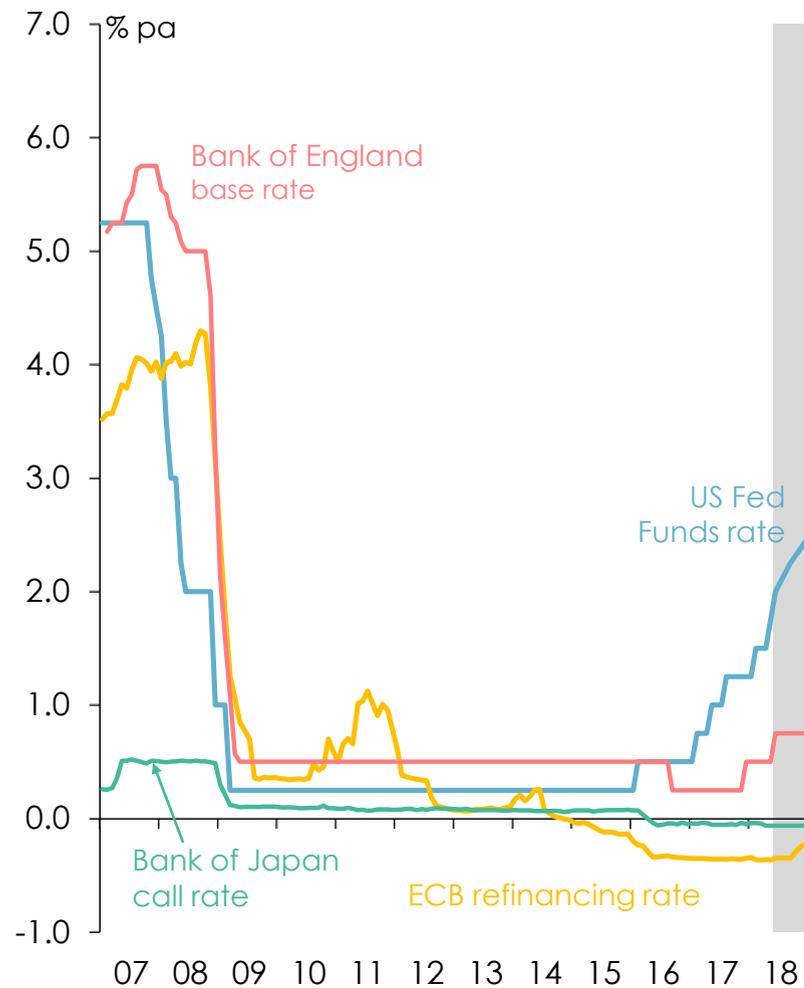
## Central bank preferred measures of 'core inflation'



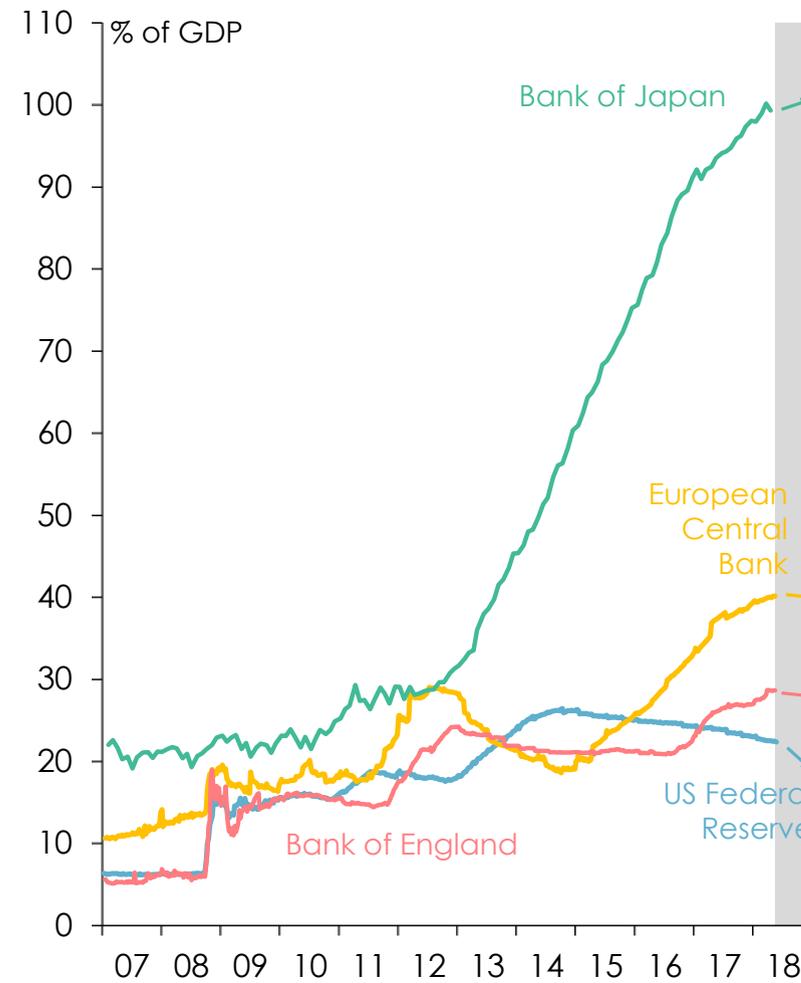
Sources: US Bureau of Labor Statistics and Bureau of Economic Analysis; Eurostat; Japan Statistics Bureau; Bank of Japan; UK Office of National Statistics. Central bank preferred measure of 'core inflation' is private consumption expenditure deflator excluding food and energy in the US; CPI excluding food and energy in the euro area and UK; and 'trimmed mean' in Japan.

# So the era of ultra-cheap money is coming to an end – as bond markets began to sense from the middle of last year

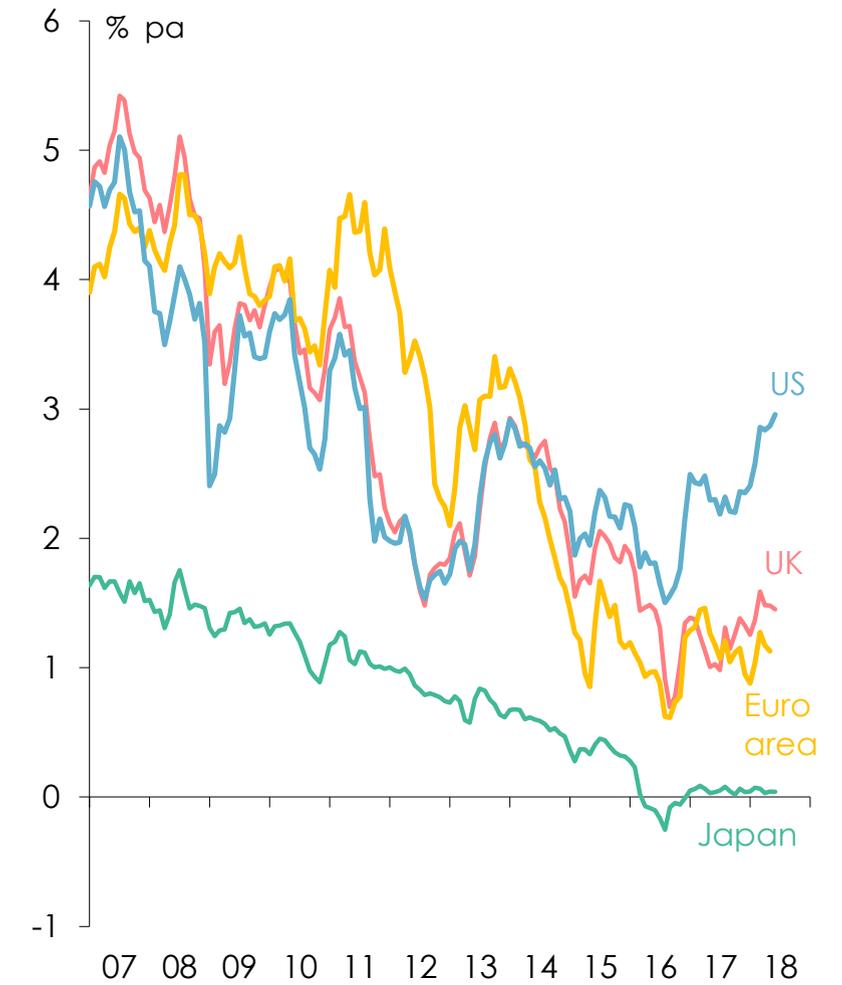
## Major central bank policy interest rates



## Major central bank balance sheets



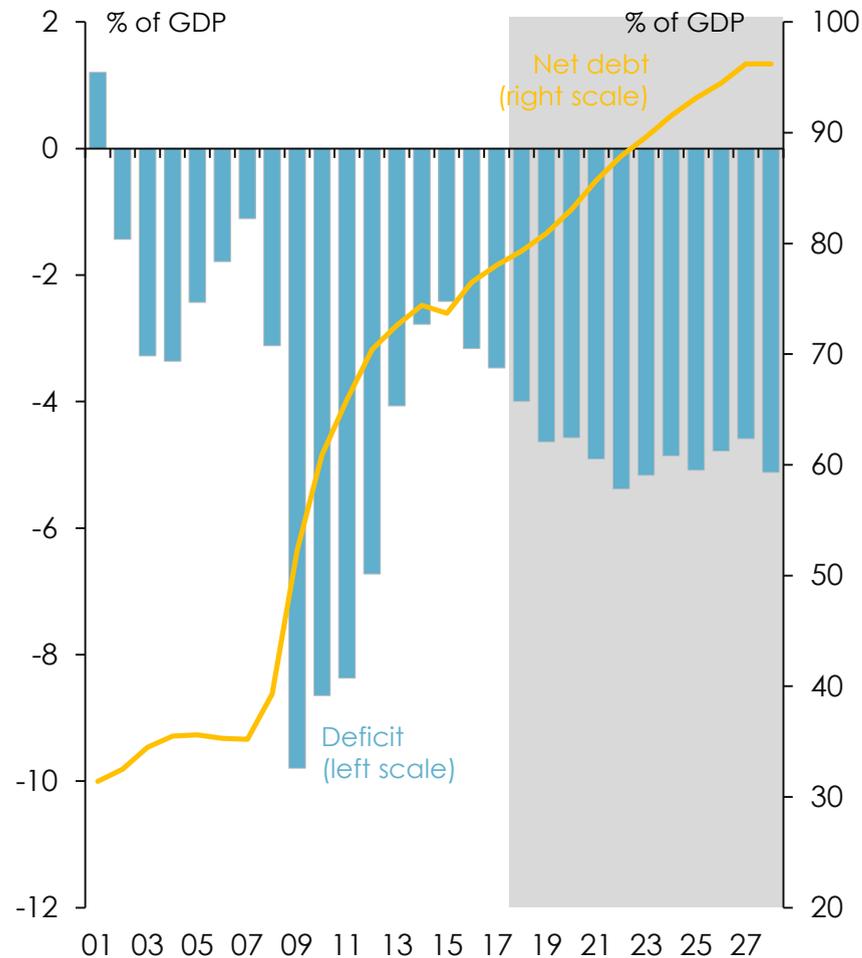
## 10-year bond yields



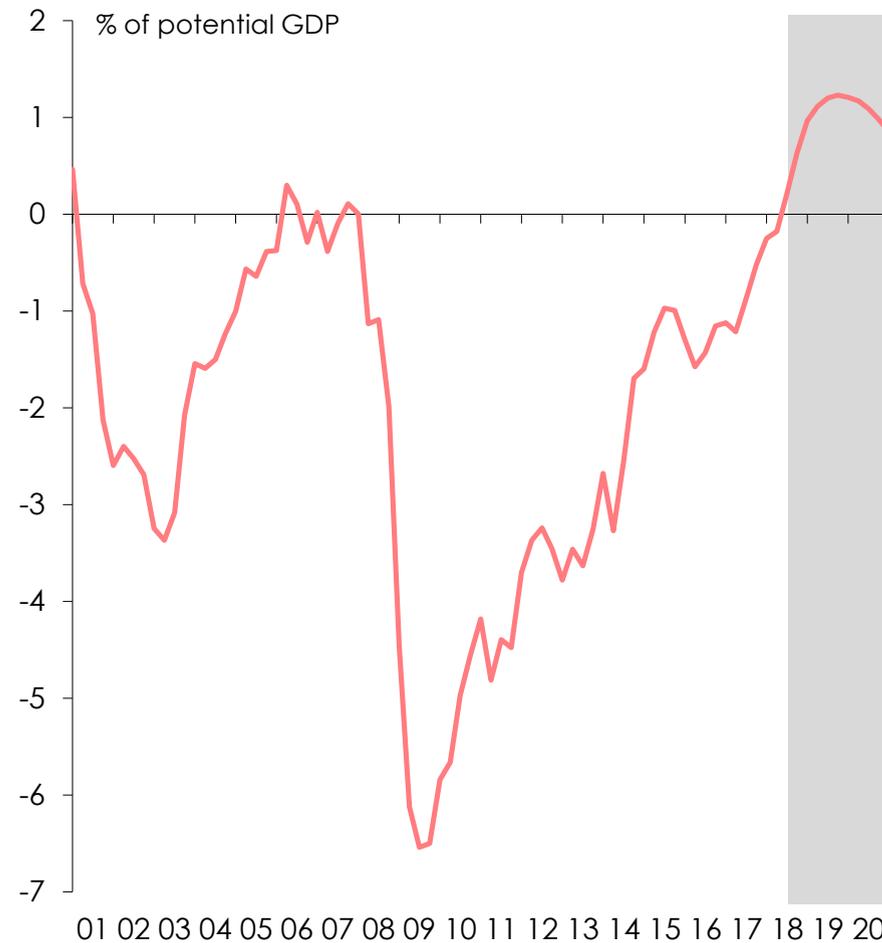
Source: Thomson Reuters Datastream; US Federal Reserve; European Central Bank; Bank of Japan.

# US fiscal stimulus is spectacularly ill-timed from an economic management standpoint and will add to upward pressure on interest rates

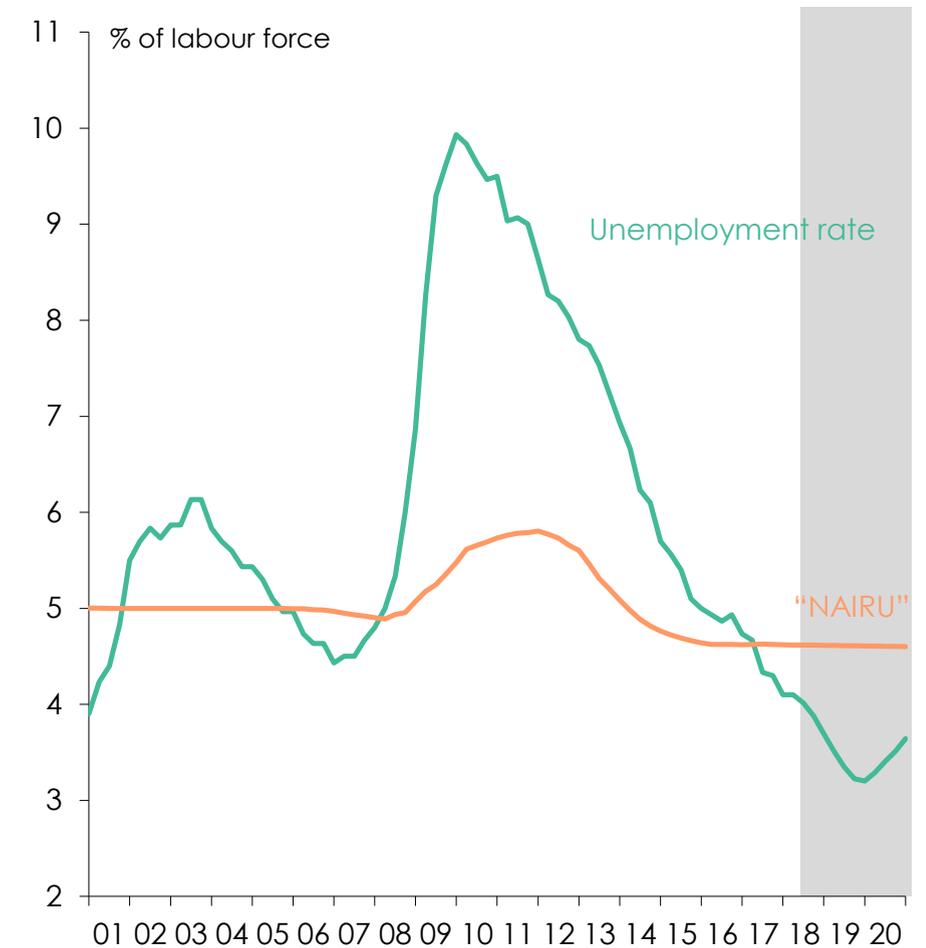
## US Federal Government budget deficit and debt



## US 'output gap'



## US unemployment rate and 'NAIRU'

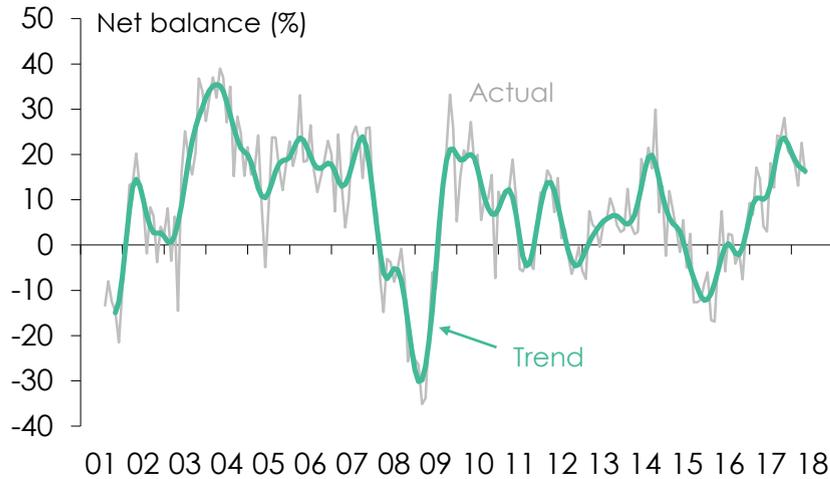


Note: 'Net debt' excludes debt held by the US Federal Reserve. The 'output gap' is the difference between actual and 'potential' GDP. The 'NAIRU' or non-accelerating inflation rate of unemployment' is the lowest level of unemployment consistent with stable inflation.

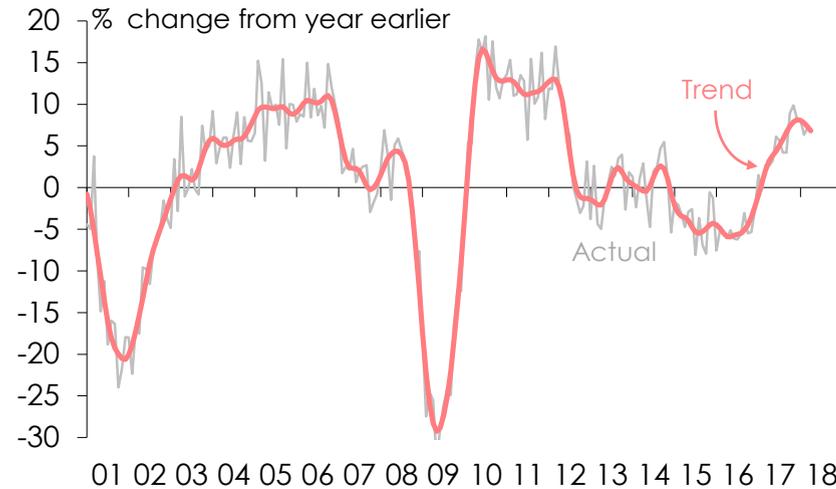
Source: US Congressional Budget Office, *The Budget and Economic Outlook: 2018 to 2028*.

# So the world economy is currently 'as good as it's going to get' – and many 'leading indicators' with good track records are looking 'peaky'

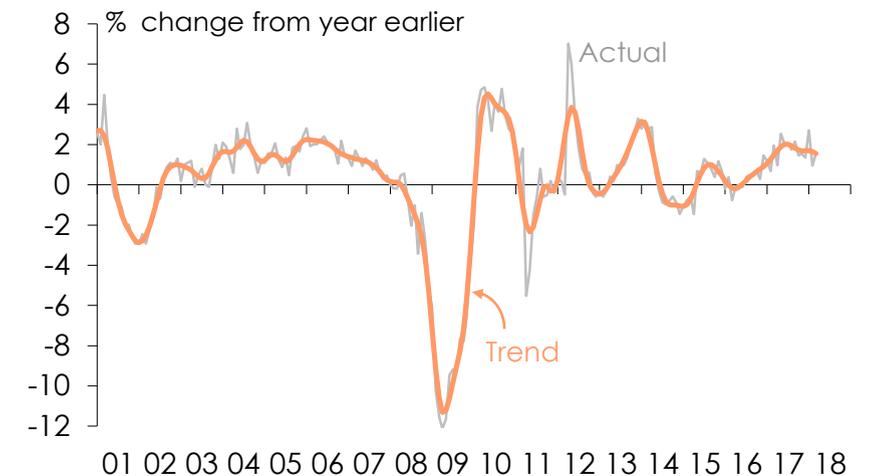
## US – NY Fed 'Empire State' survey



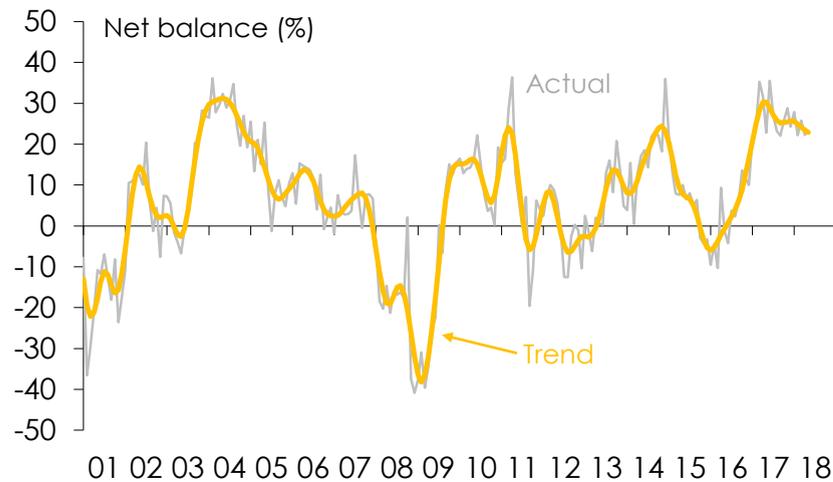
## US – 'core' capital goods orders



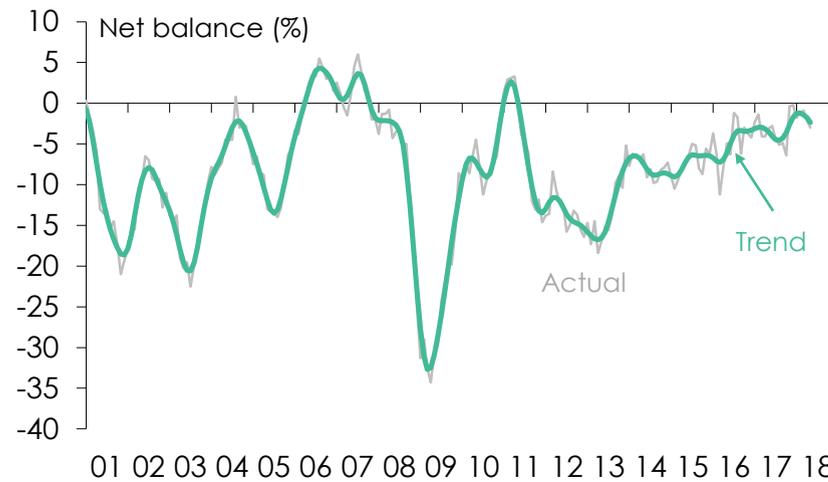
## Japan – METI business activity index



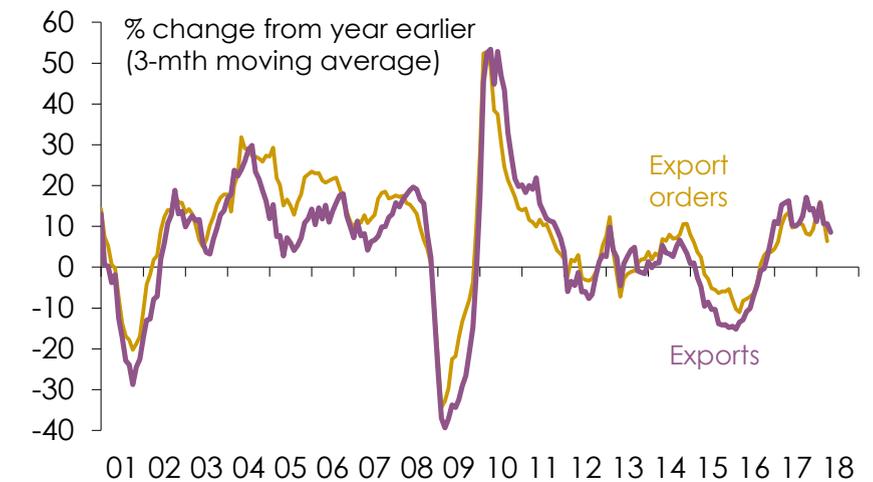
## US – Philly Fed business survey



## Euroland – BNB business survey



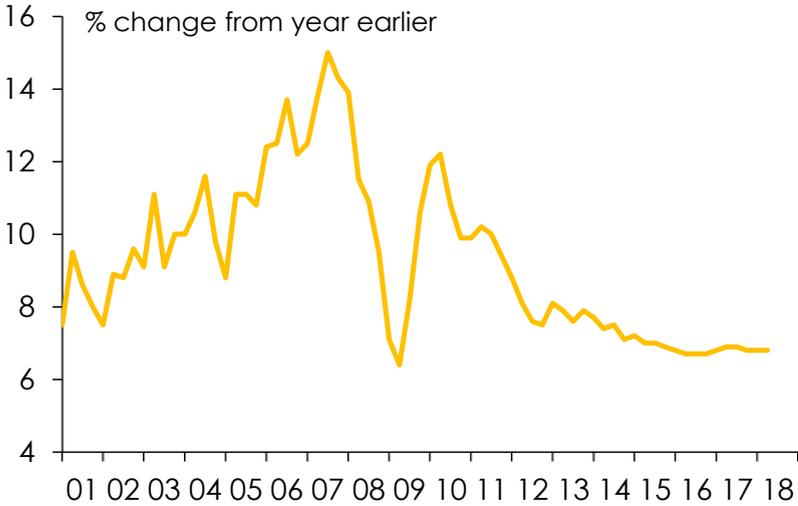
## Taiwan – exports & export orders



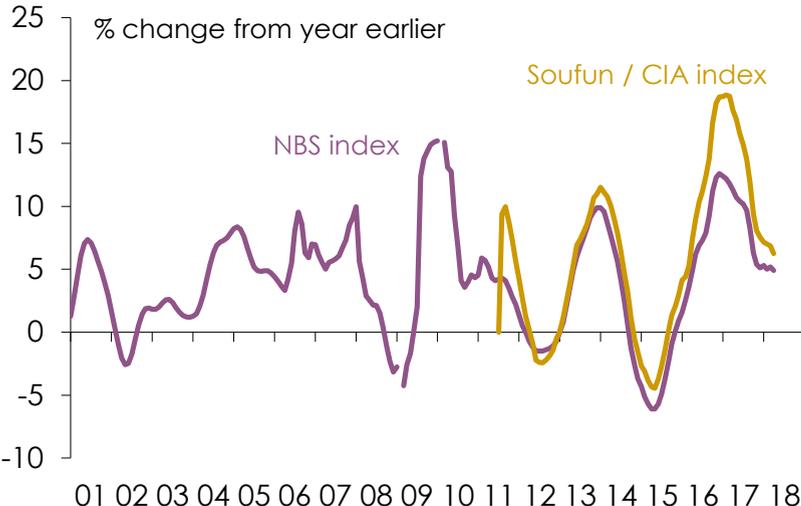
Note: US 'core' capital goods orders excludes defence equipment and aircraft. Sources: Federal Reserve Banks of New York and Philadelphia; US Commerce Department; Belgian National Bank; Japan Ministry of External Trade & Industry; Taiwan Statistical Bureau.

# Amazingly steady Chinese GDP figures masking a slow-down in some of the more cyclical sectors of the economy

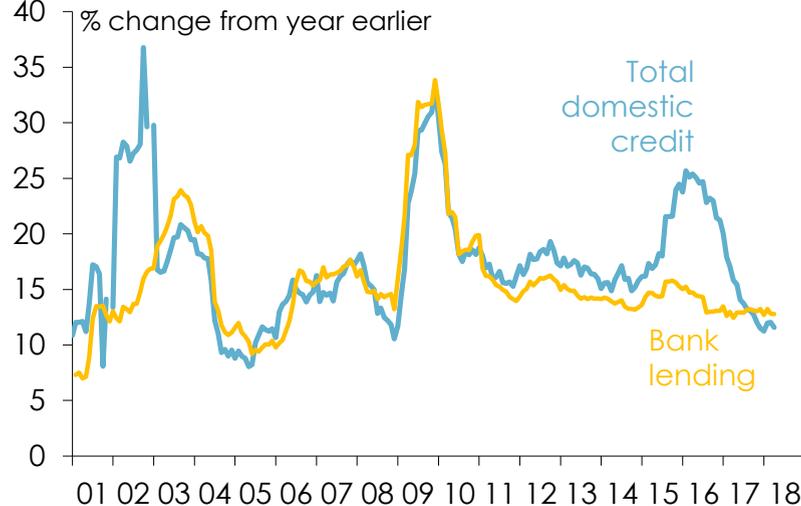
## Real GDP growth



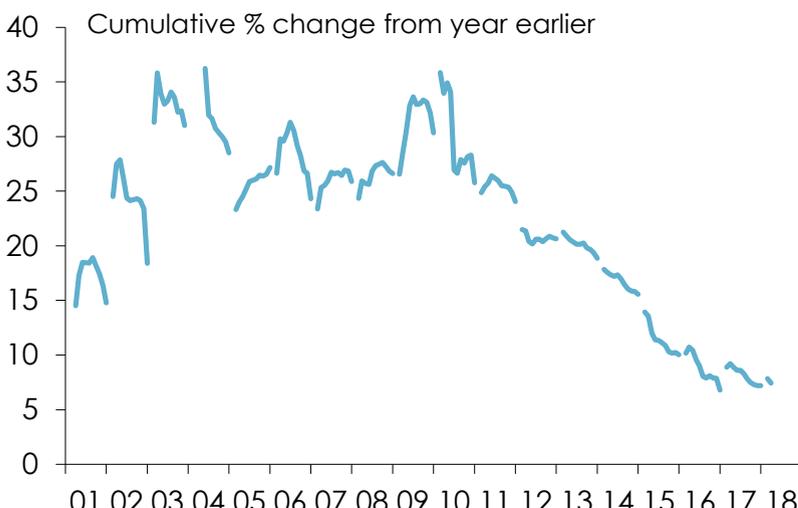
## Residential property prices



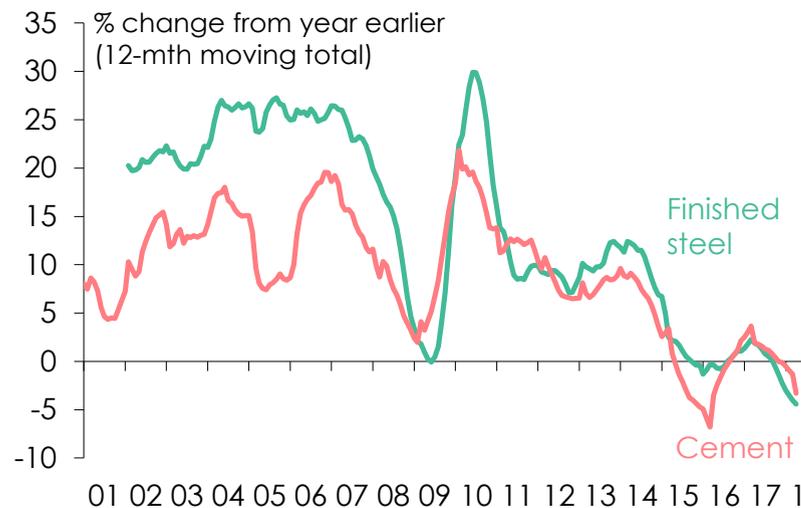
## Credit growth



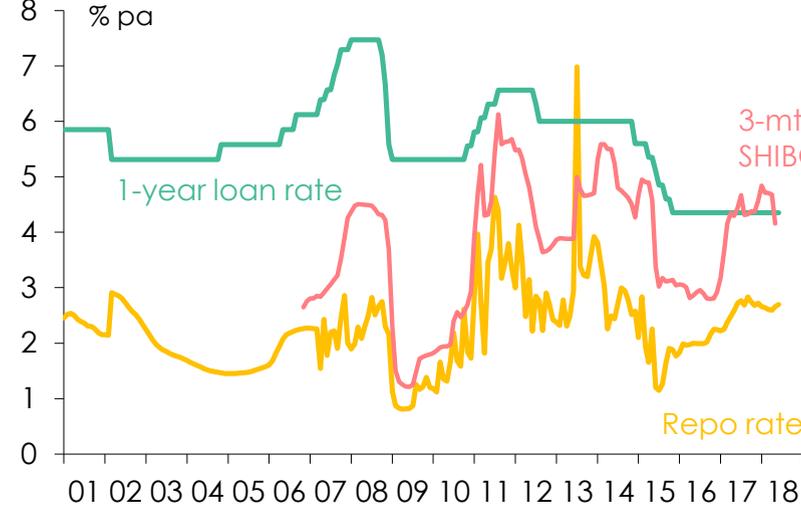
## Fixed asset investment



## Steel and cement production



## Interest rates

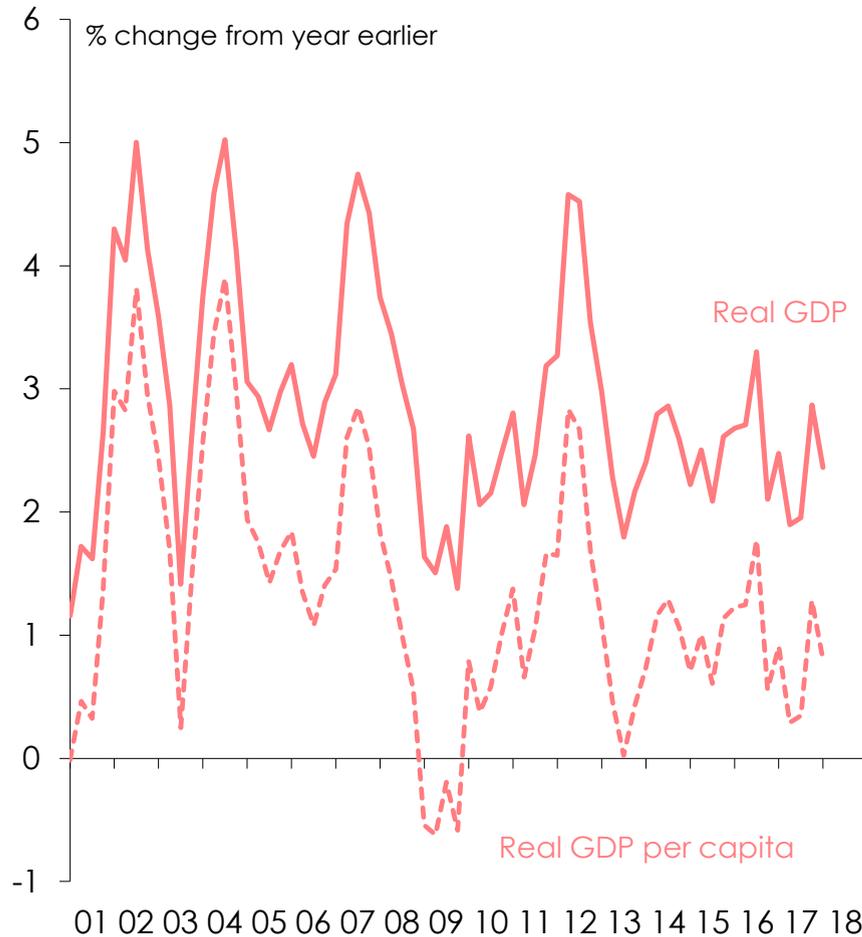


Source: China National Bureau of Statistics; People's Bank of China.

# The Australian economic context

# Australian economic growth is still below trend, there is still a lot of spare capacity in the labour market and inflation is still (just) below-target

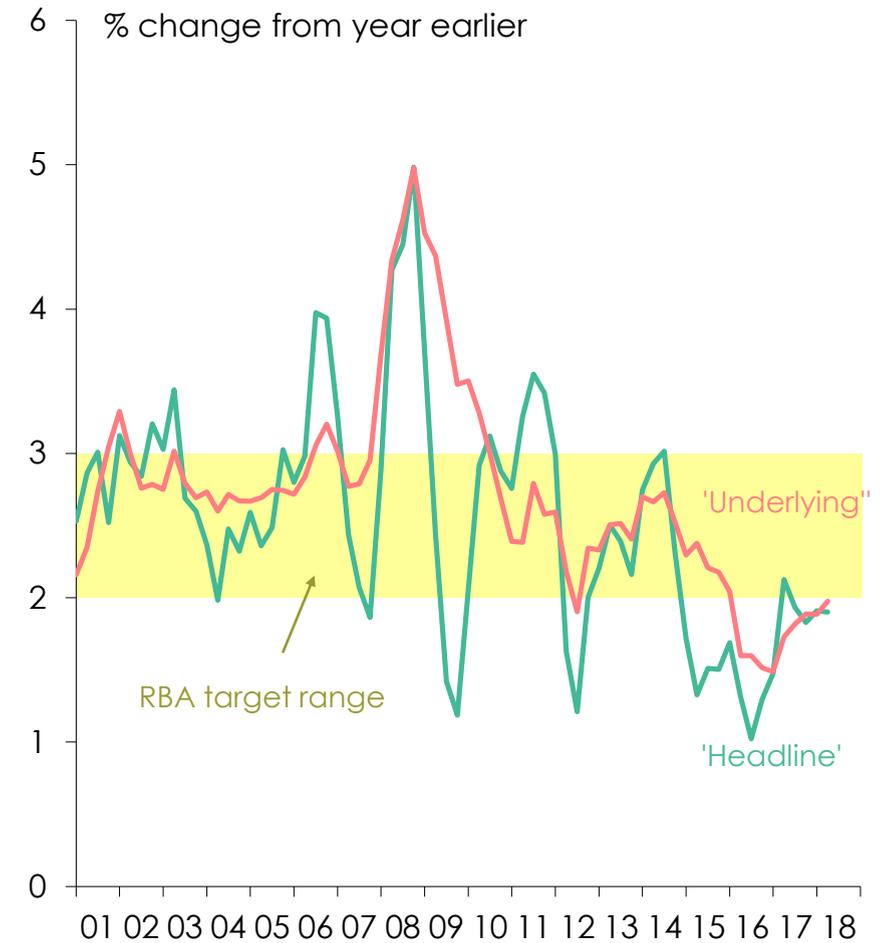
## Economic growth



## Unemployment and under-employment



## Consumer prices

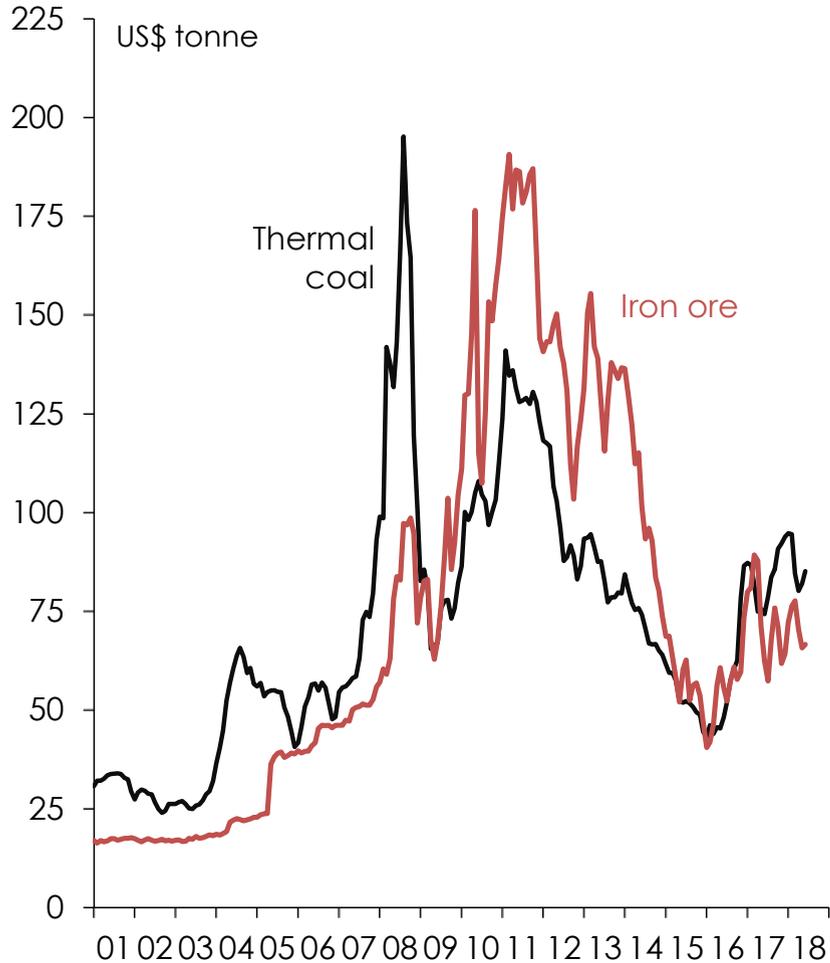


Note: The labour force 'under-utilization' rate includes people employed part-time who are willing and able to work longer hours (and weights them equally with people who are 'unemployed' in the conventional sense). 'Underlying' inflation abstracts from the impact of volatile items (typically items such as petrol, or fruit and vegetables) on the CPI.

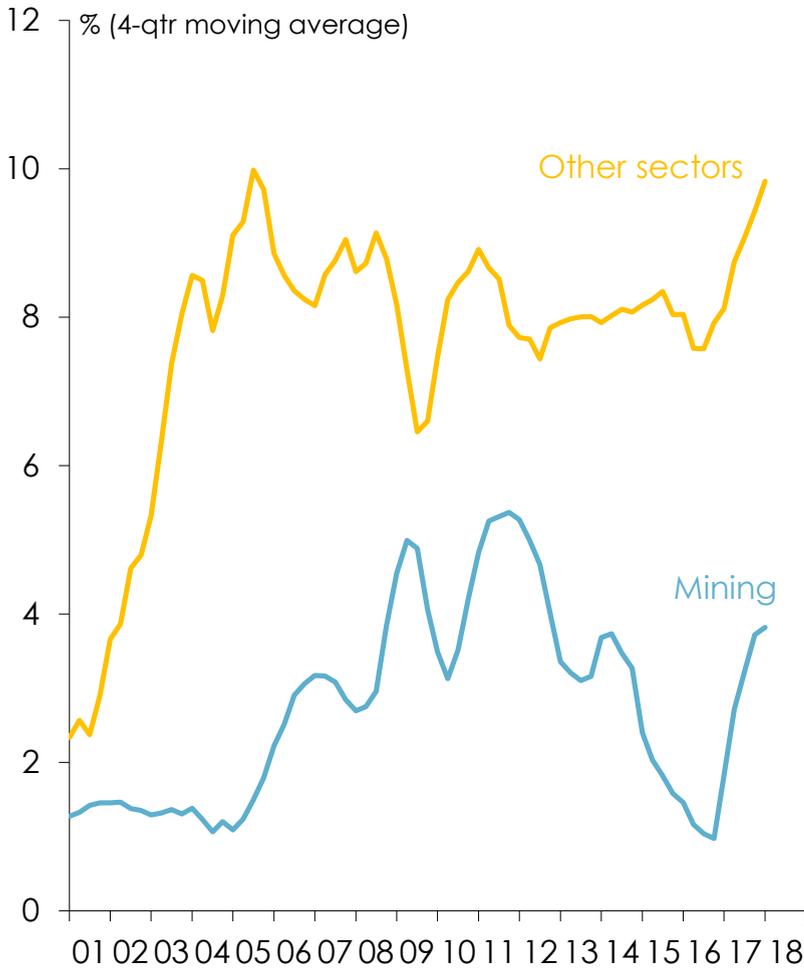
Source: Australian Bureau of Statistics.

# Commodity prices have held up better than expected – prompting a rebound in mining profits, but non-mining profits are also much stronger

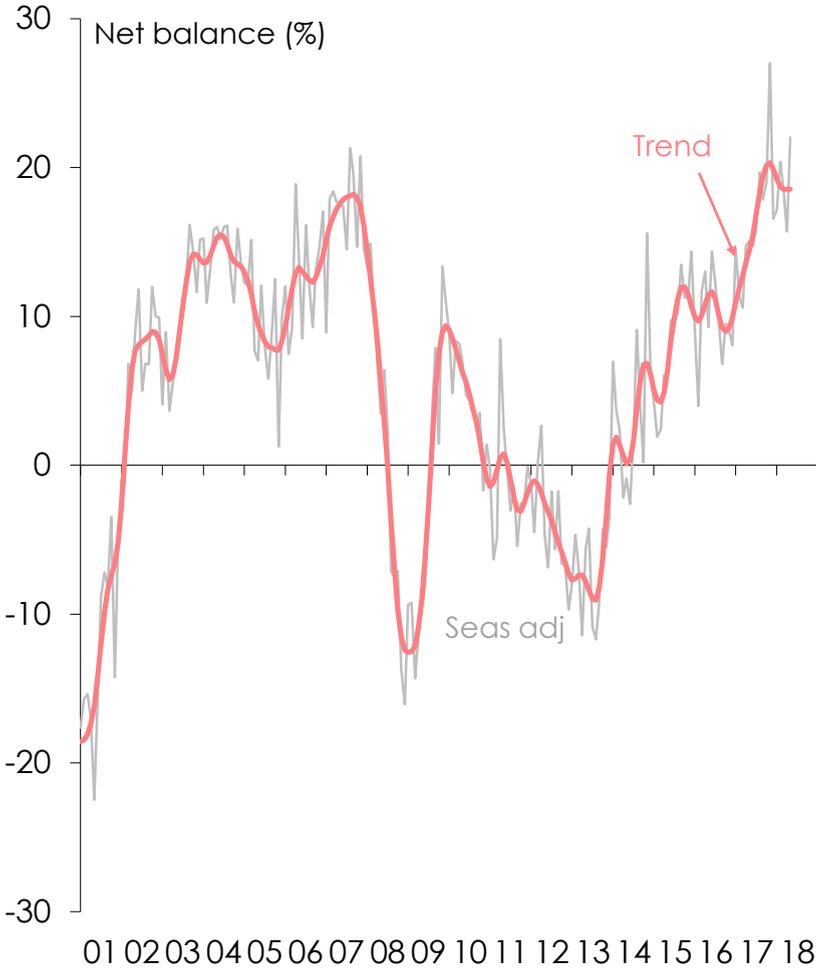
## Iron ore and coal prices



## Pre-tax profits



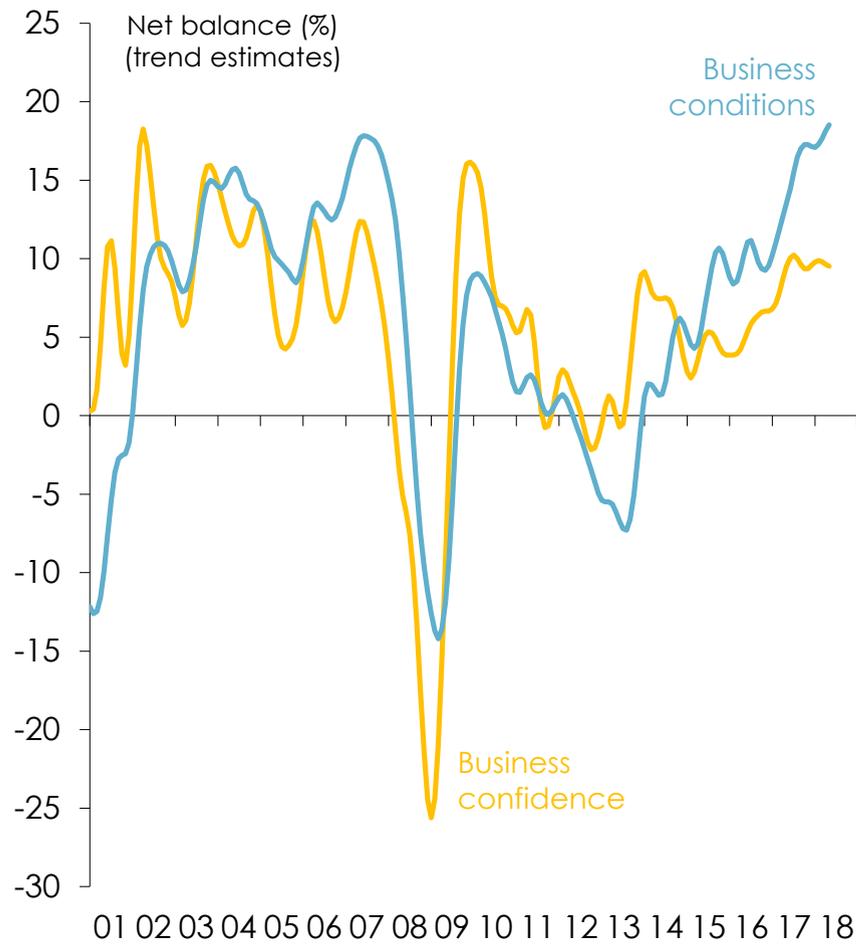
## Business profitability perceptions (NAB survey)



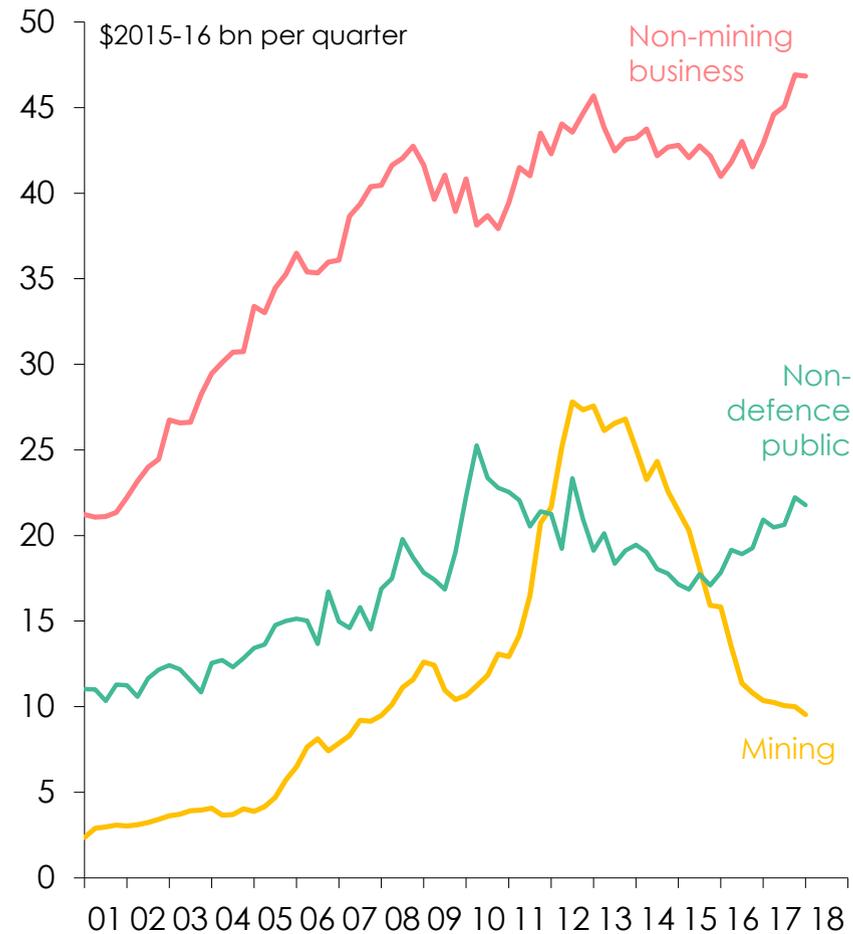
Sources: Thomson Reuters Datastream ; ABS ; NAB.

# Australian business conditions are clearly improving – and that is reflected in a long-awaited pick-up in non-mining investment

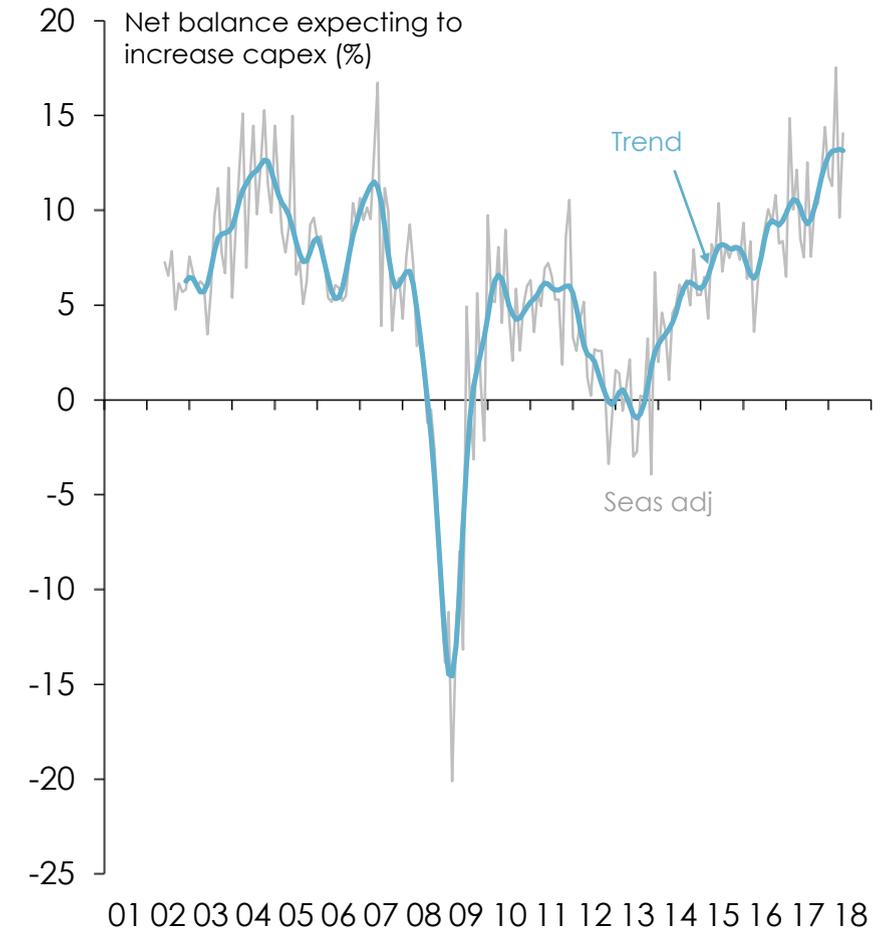
## Business conditions and confidence



## Non-residential investment – mining vs other sectors



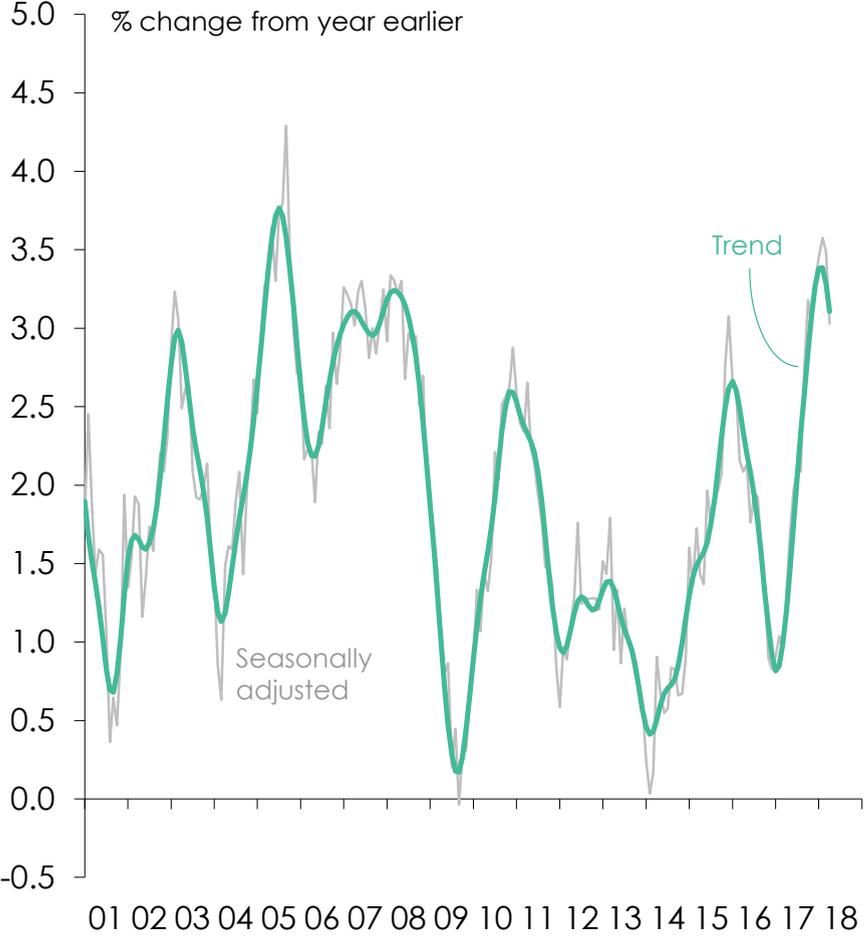
## Business survey capital expenditure expectations



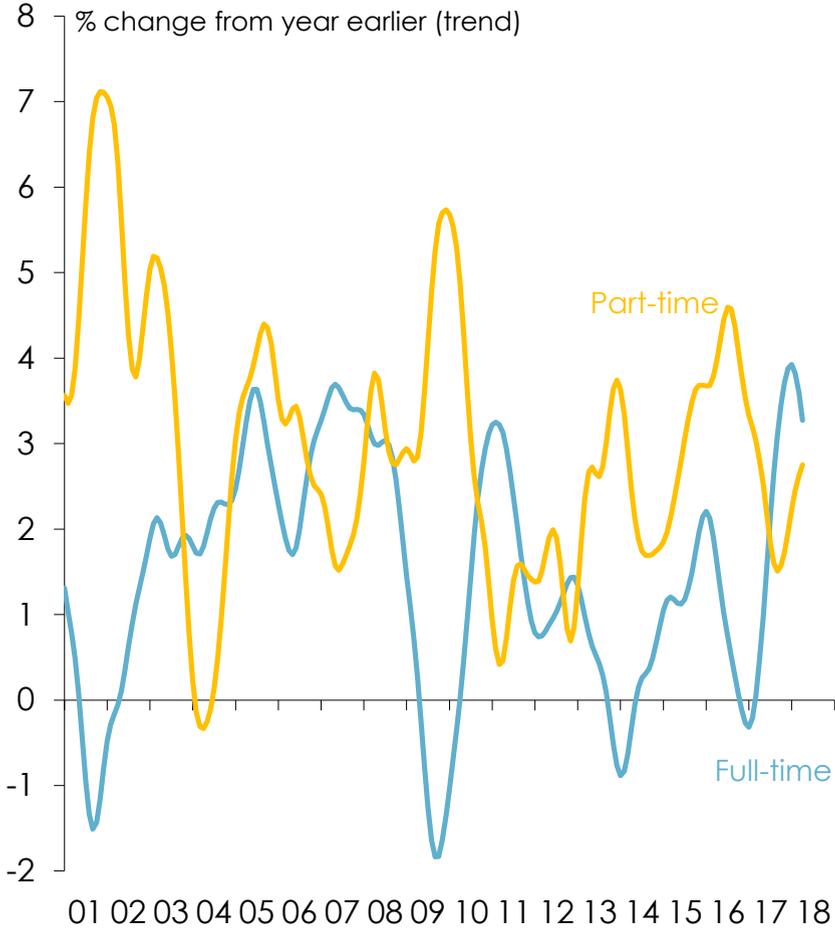
Sources: National Australia Bank; ABS.

# Employment growth has picked up – this time led by full-time employment – and seems likely to be sustained

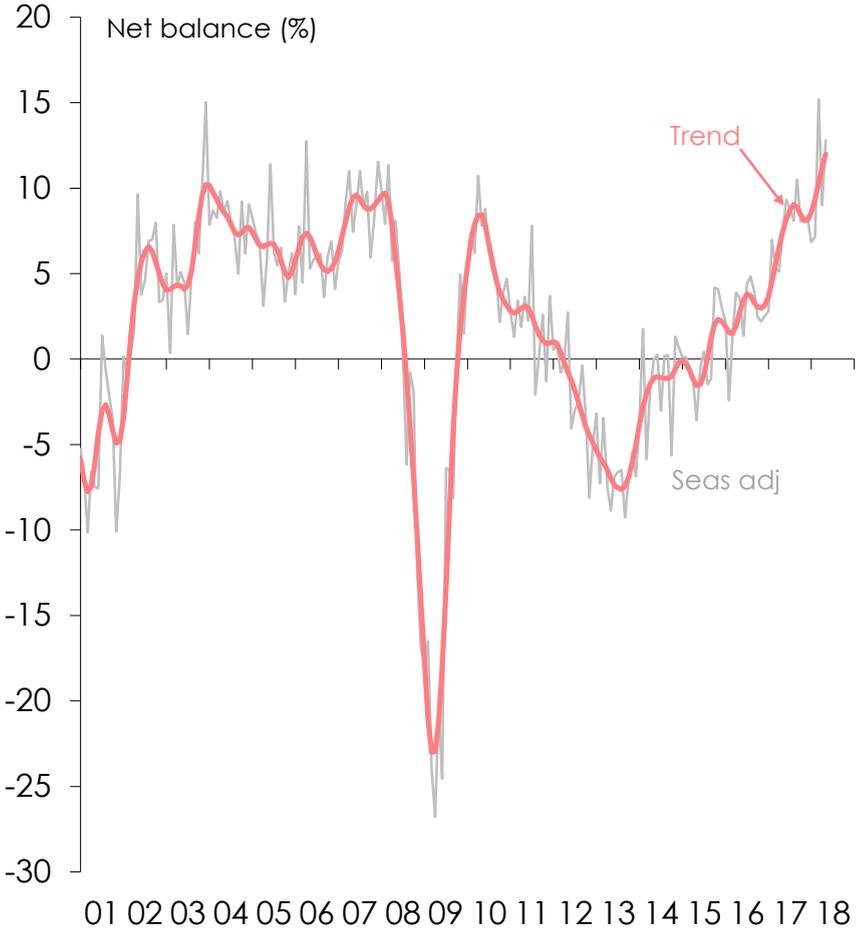
## Employment growth



## Full-time vs part-time employment



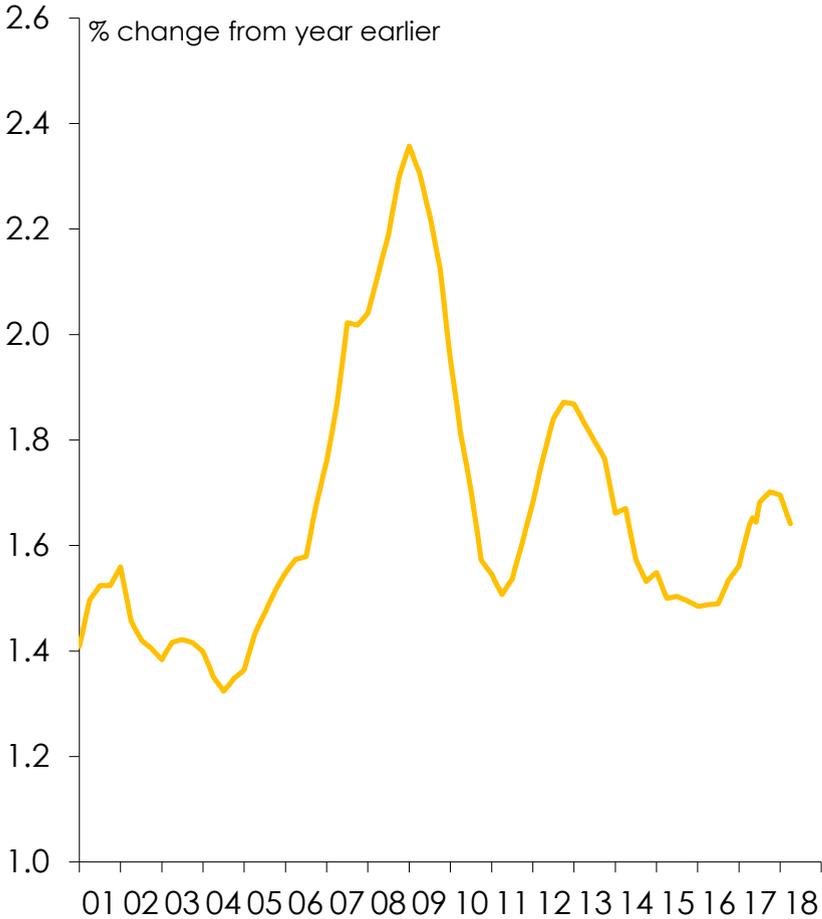
## NAB business survey – employer hiring intentions



Sources: ABS; National Australia Bank.

# But a large share of this employment growth is being absorbed by faster population growth and rising labour force participation

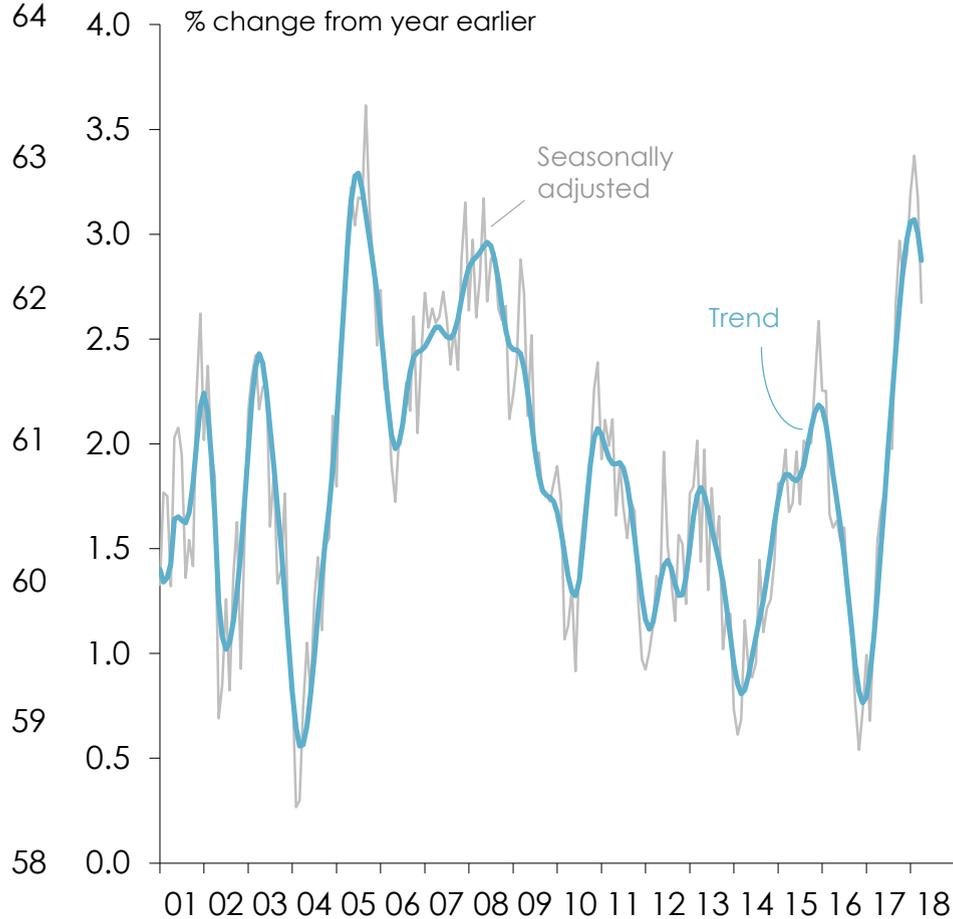
### Civilian working age population growth



### Labour force participation rate



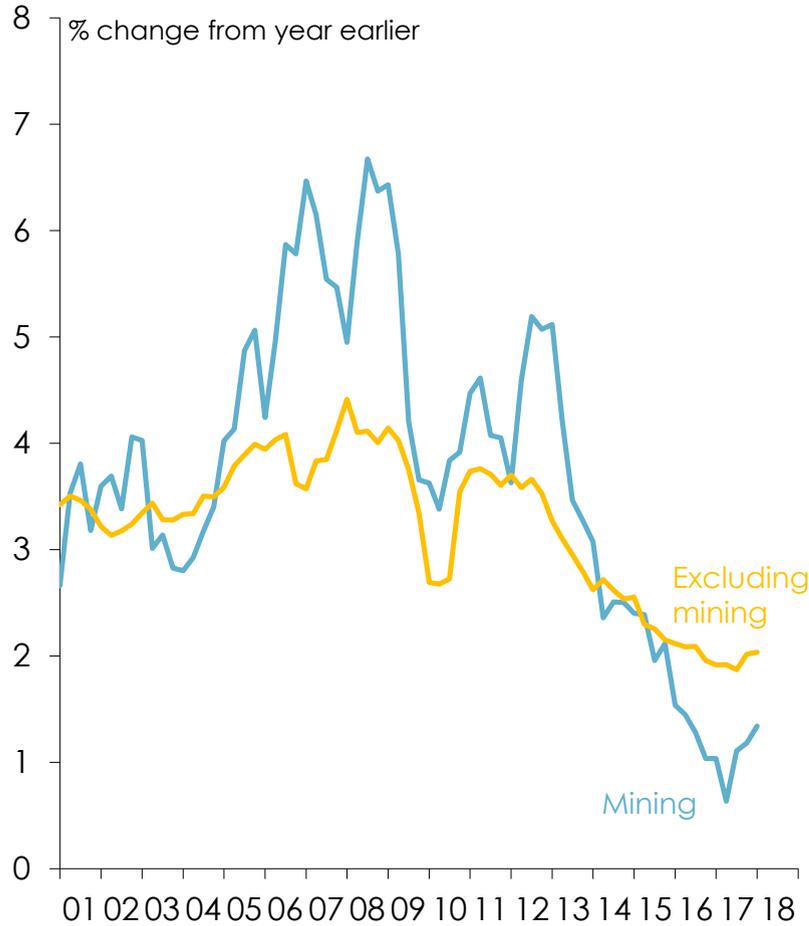
### Labour force growth



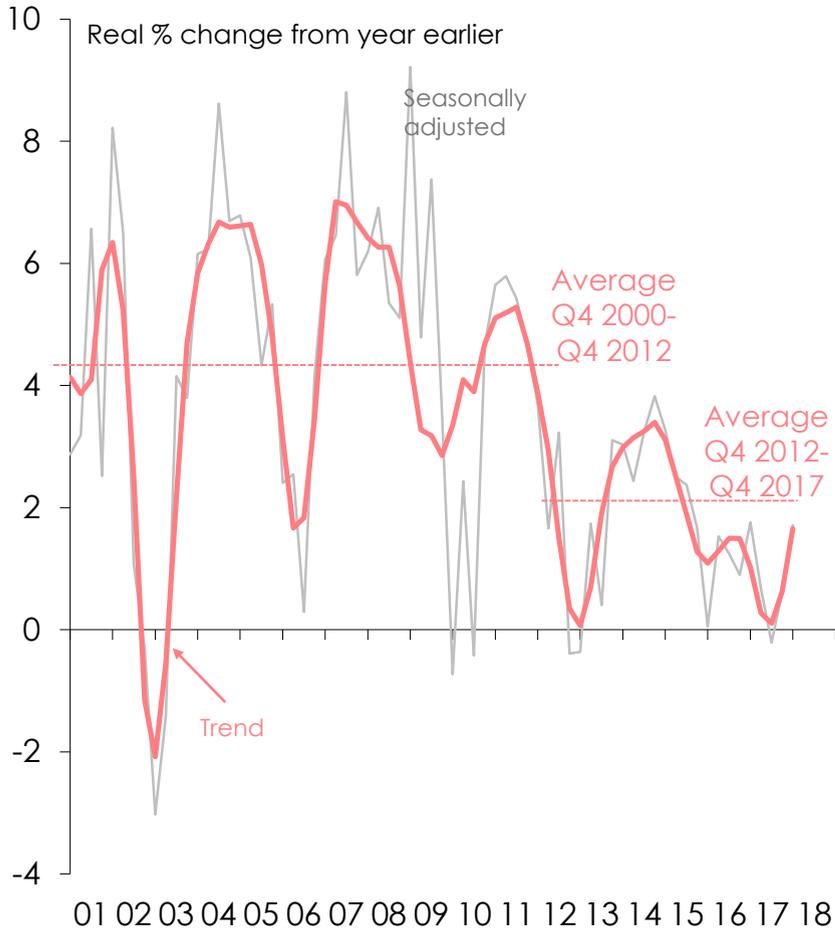
Source: ABS.

# As in other 'advanced' economies however wages growth remains very sluggish, so household income and spending growth continue to be soft

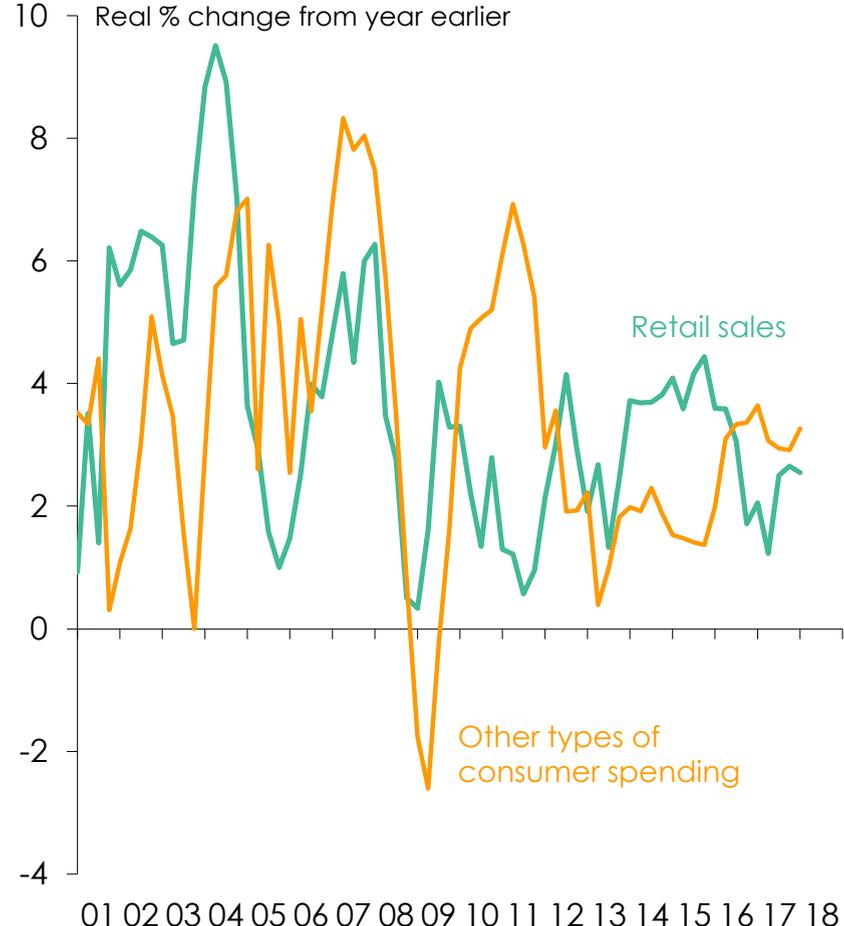
## Wages growth



## Household disposable income



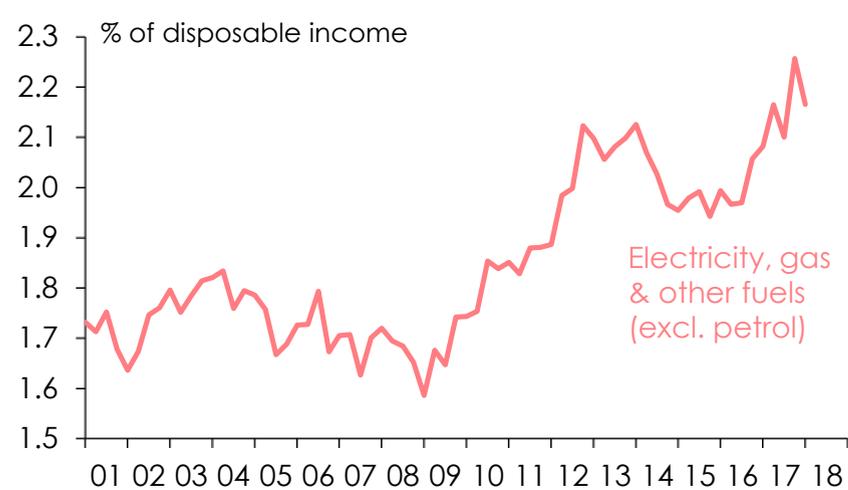
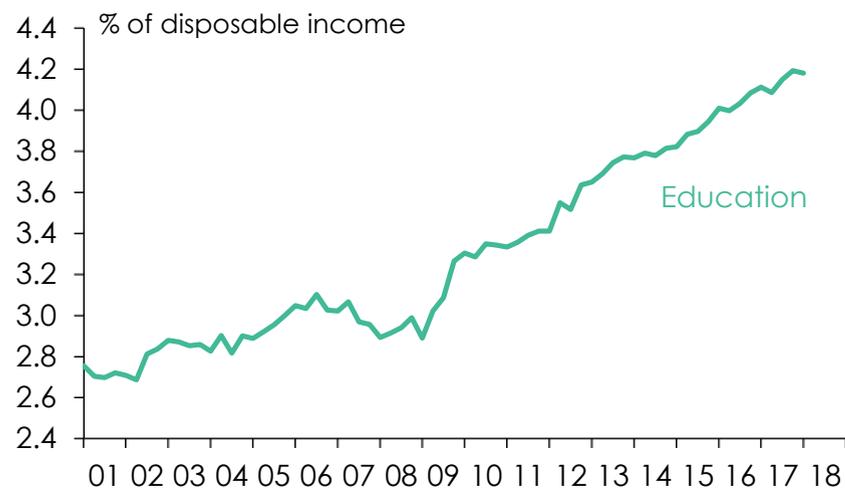
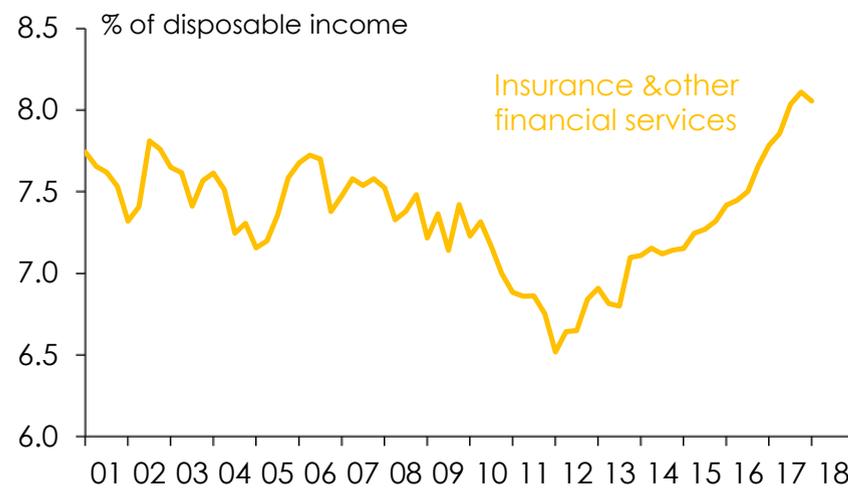
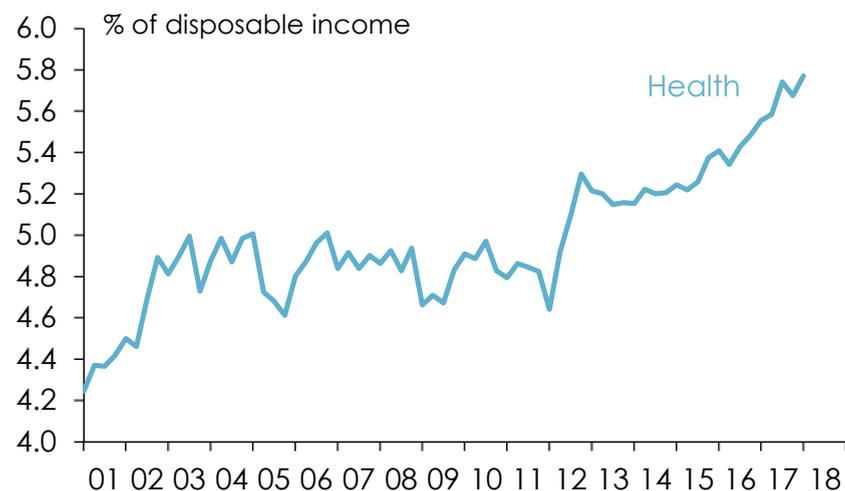
## Household consumption expenditure



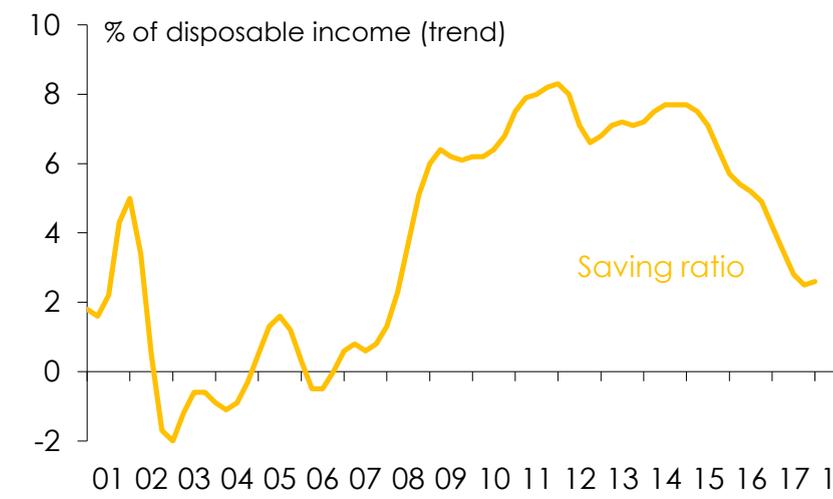
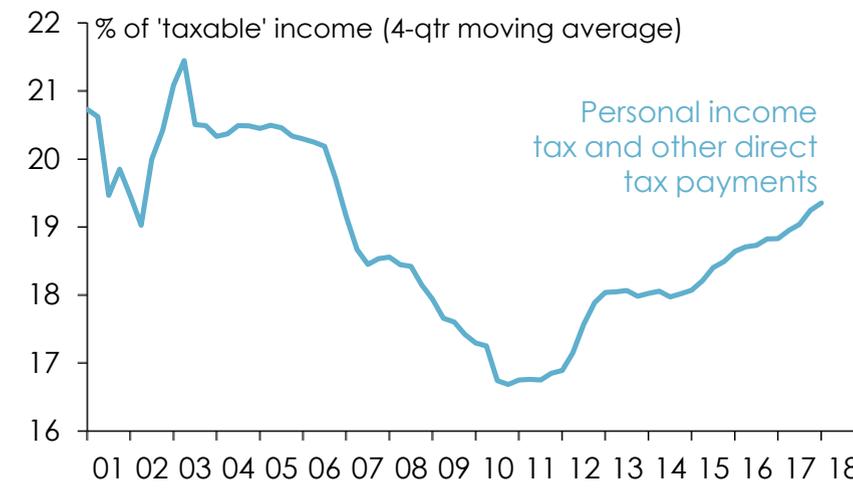
Source: ABS.

# Household budgets are also being squeezed by rising costs of some 'non-discretionary' items, and higher income tax payments

## Selected categories of household consumption expenditure as a pc of disposable income



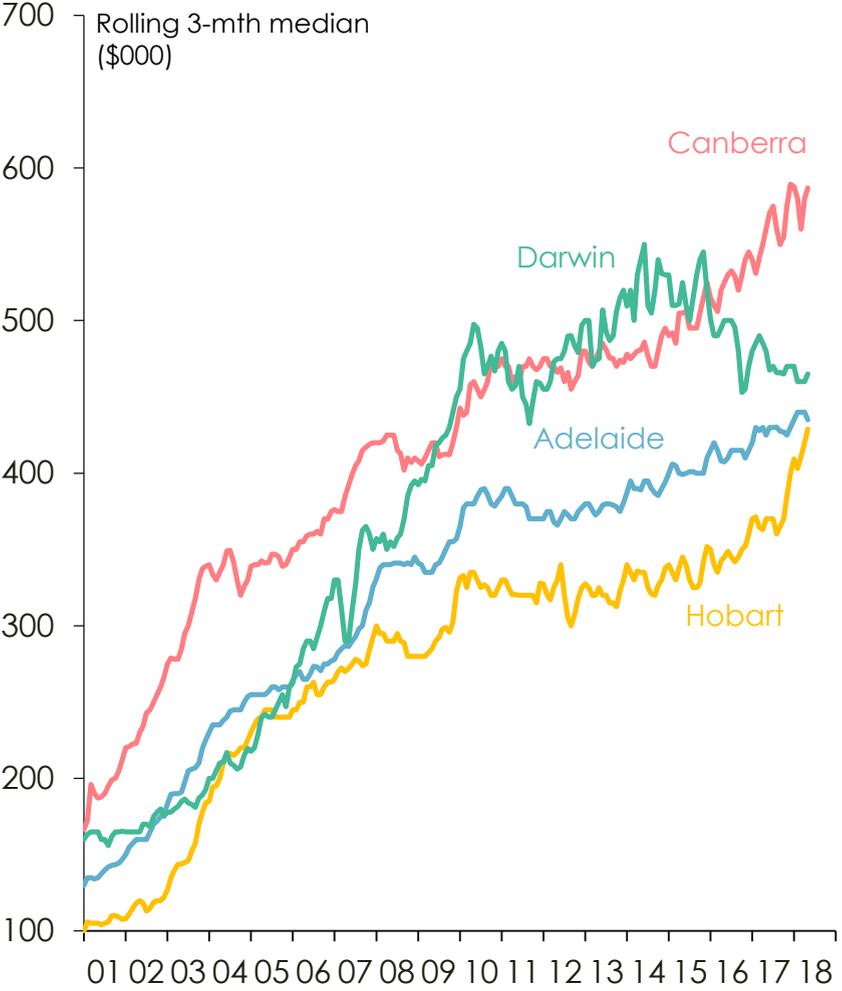
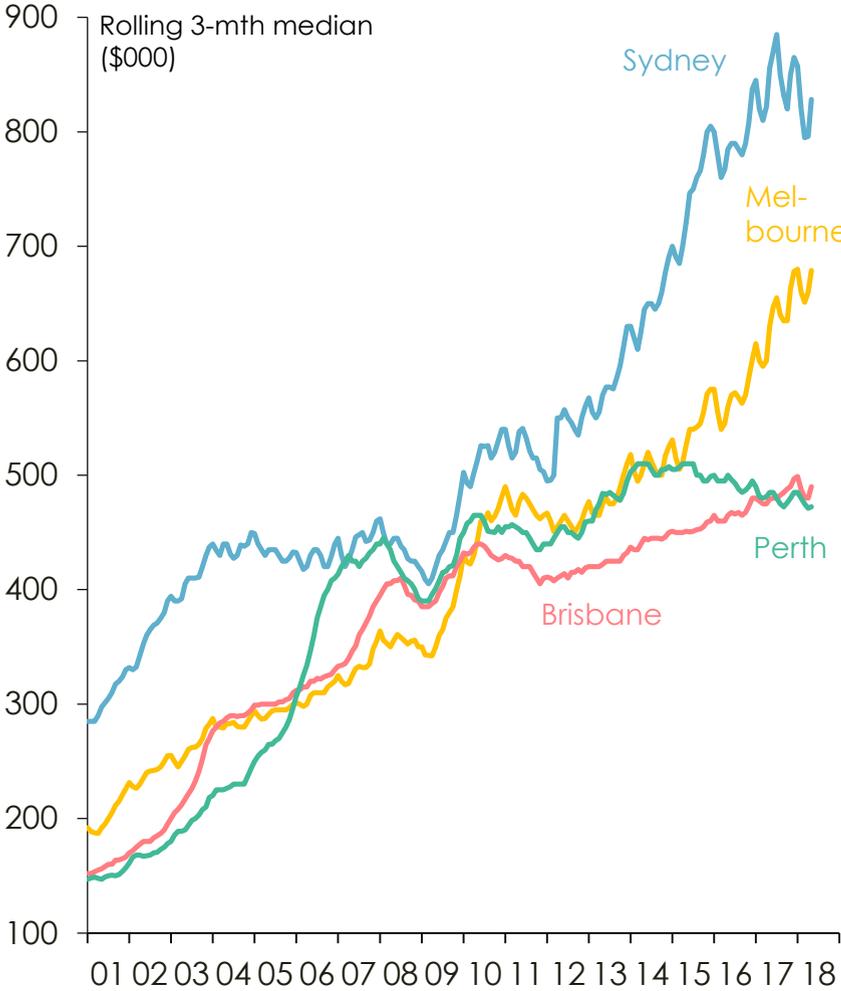
## Household income tax and saving ratios



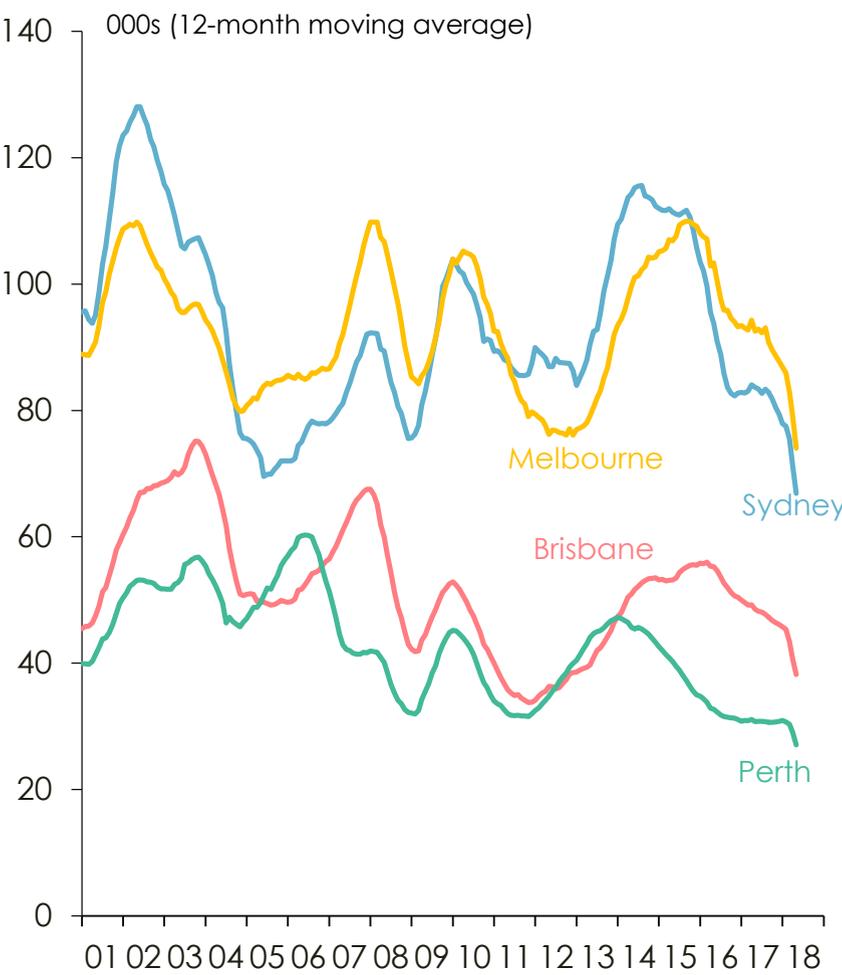
Source: ABS Note: 'taxable' income is gross household income excluding imputed items (dwelling rent, interest on superannuation and pension fund savings and workers' compensation premiums) and interest payments by unincorporated enterprises.

# Capital city residential property markets appear in most cases to have peaked

## Capital city median dwelling sale prices



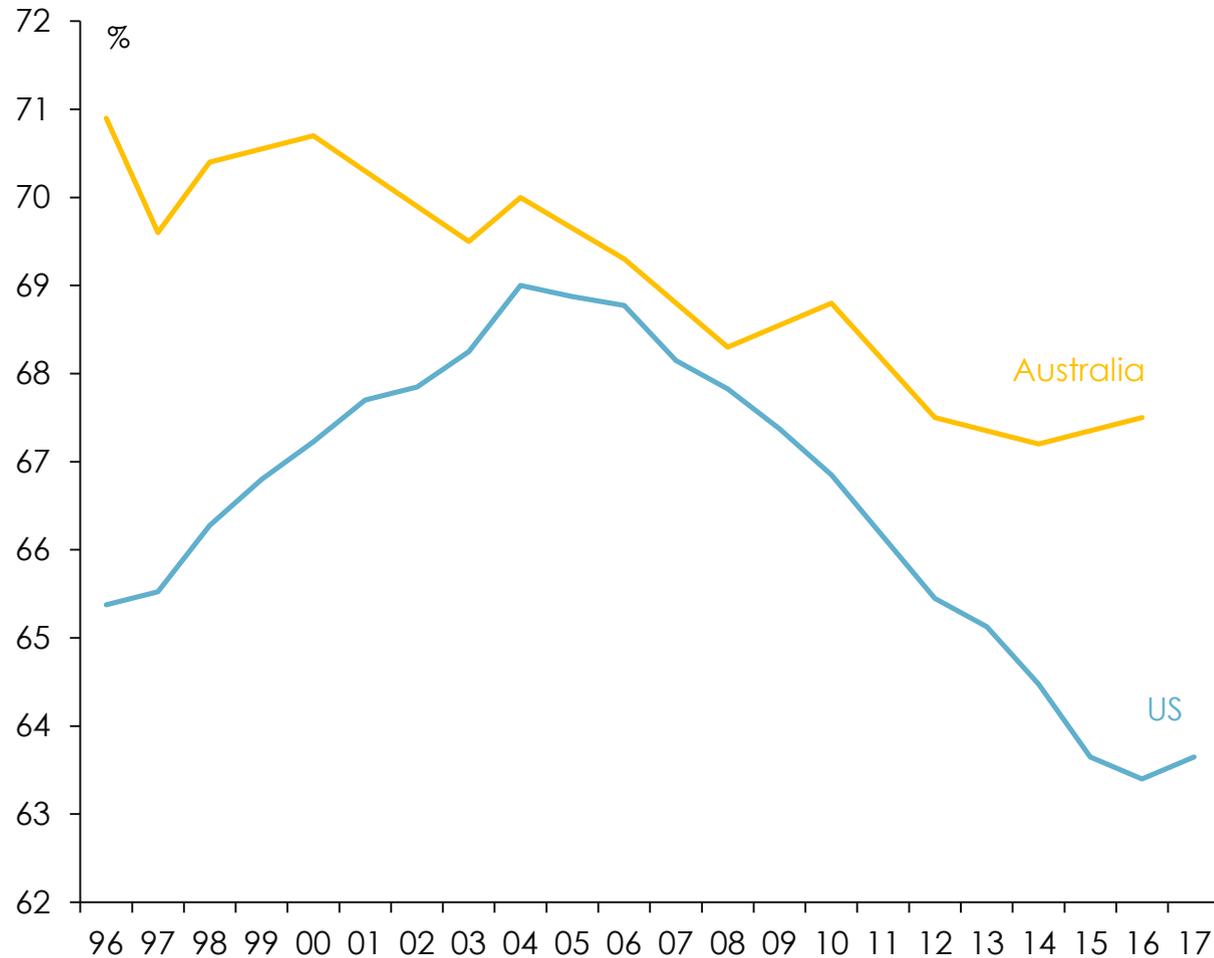
## Sales volumes



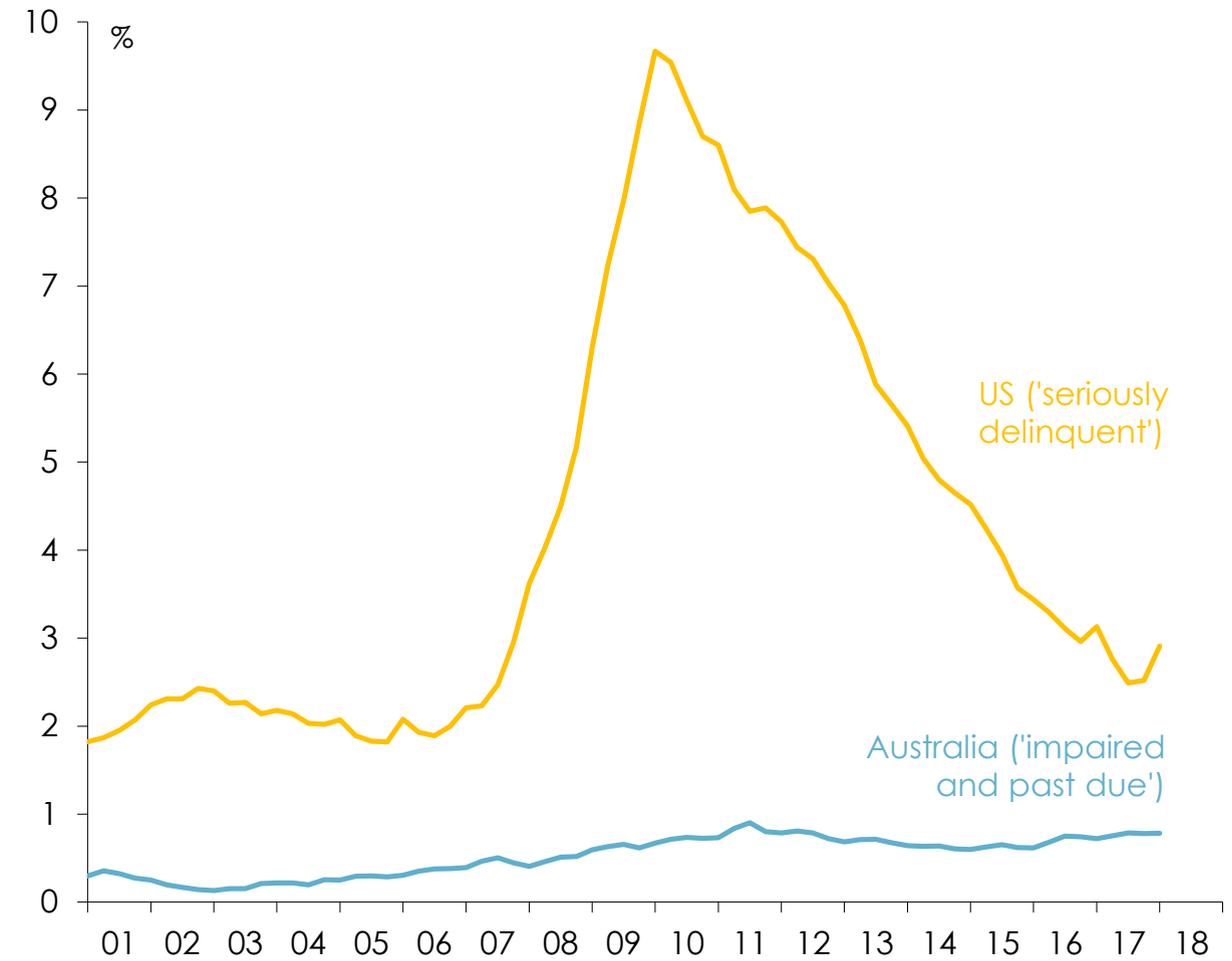
Source: CoreLogic.

# There's unlikely to be a lot of 'forced sellers' in Australia, as there were in the US a decade ago ...

## Home ownership rates, US and Australia



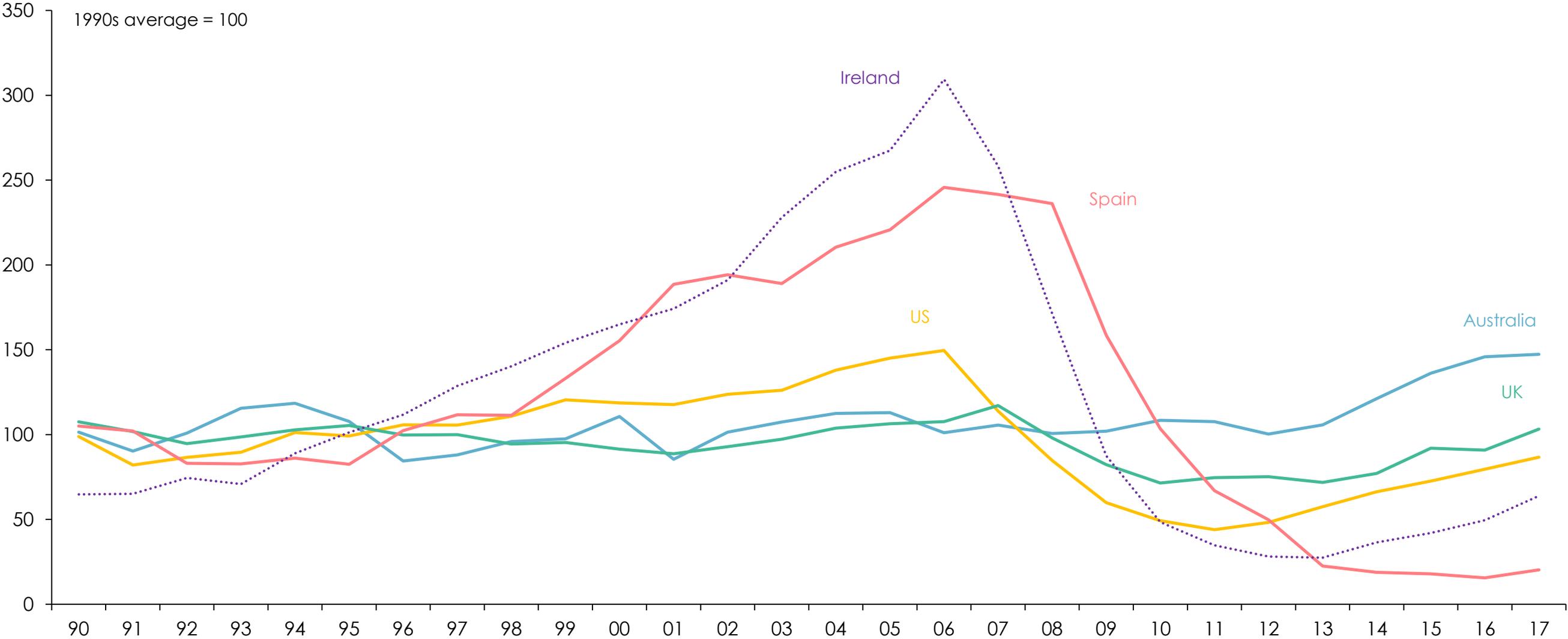
## Mortgage delinquency rates, US and Australia



Sources: ABS, US Department of Commerce; ; Reserve Bank of Australia; Mortgage Bankers' Association of America.

# ... and they're unlikely to be selling into an over-supplied market than in the US, Spain or Ireland a decade ago

## Dwelling completions – Australia and other 'advanced' economies

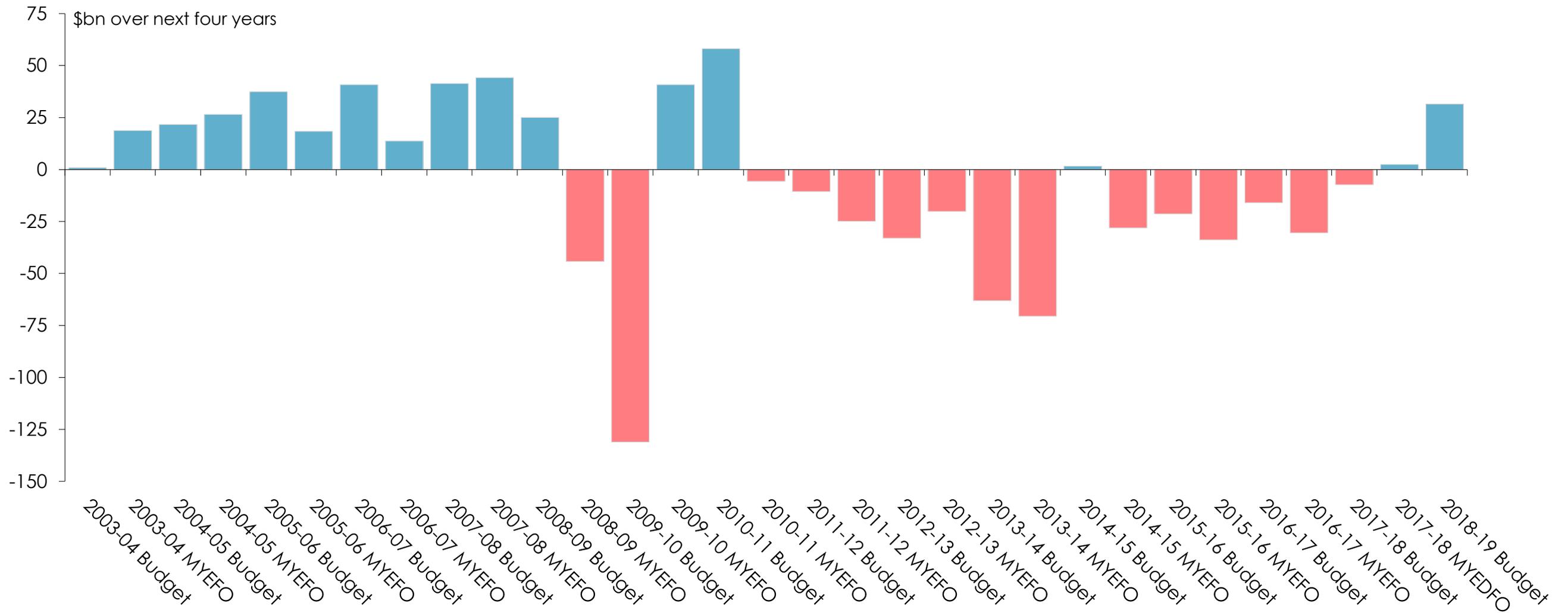


Sources: Australian Bureau of Statistics; US Commerce Department; UK Office of National Statistics; Instituto Nacional de Estadística d'España; Ireland Central Statistics Office.

# The 2018-19 Budget

# For the first time since the recession that didn't happen during the GFC, forward estimates of revenues have been revised upwards

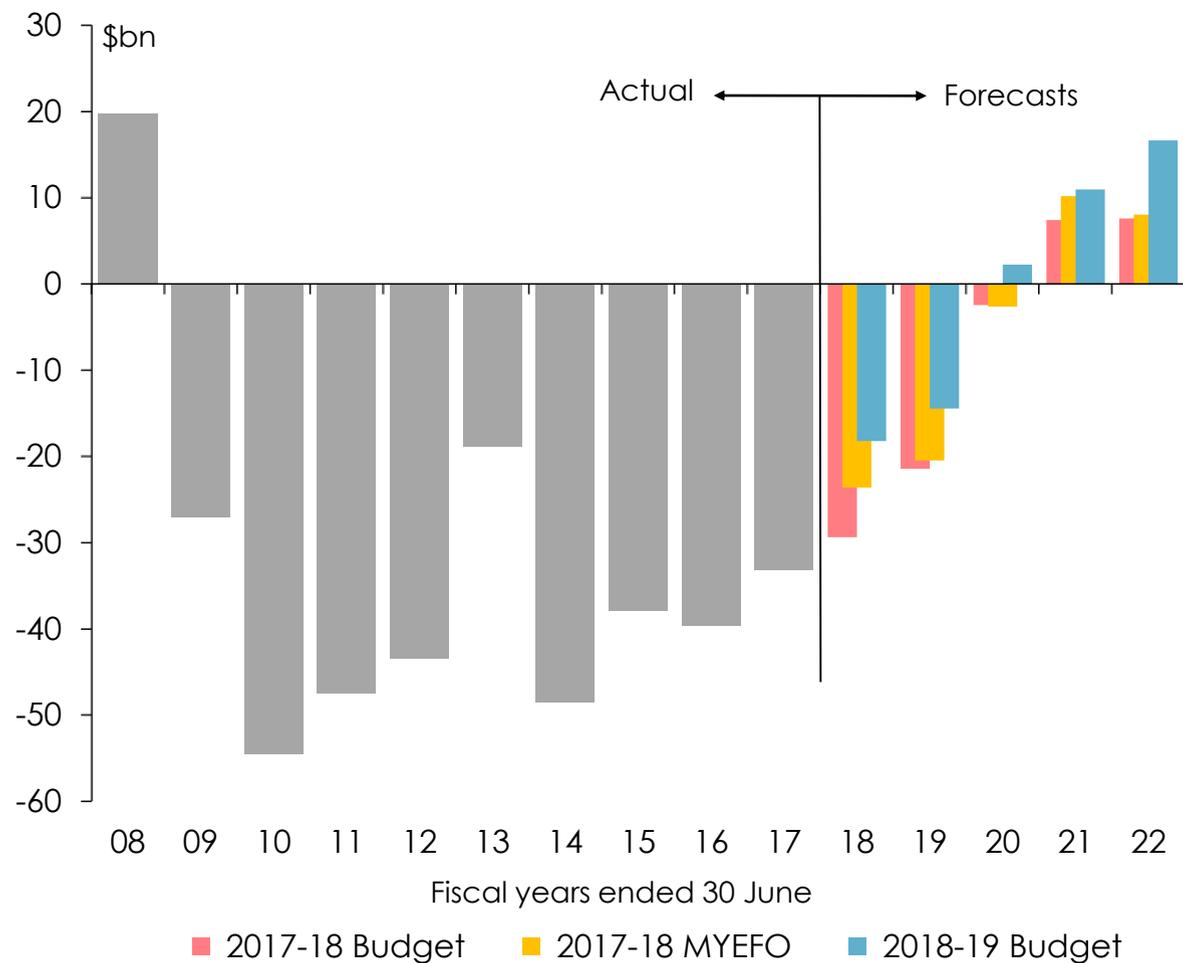
## Revisions to four-year forward estimates of revenues due to 'parameter variations' in successive Budgets and Mid-Year Economic & Fiscal Outlooks (MYEFOs)



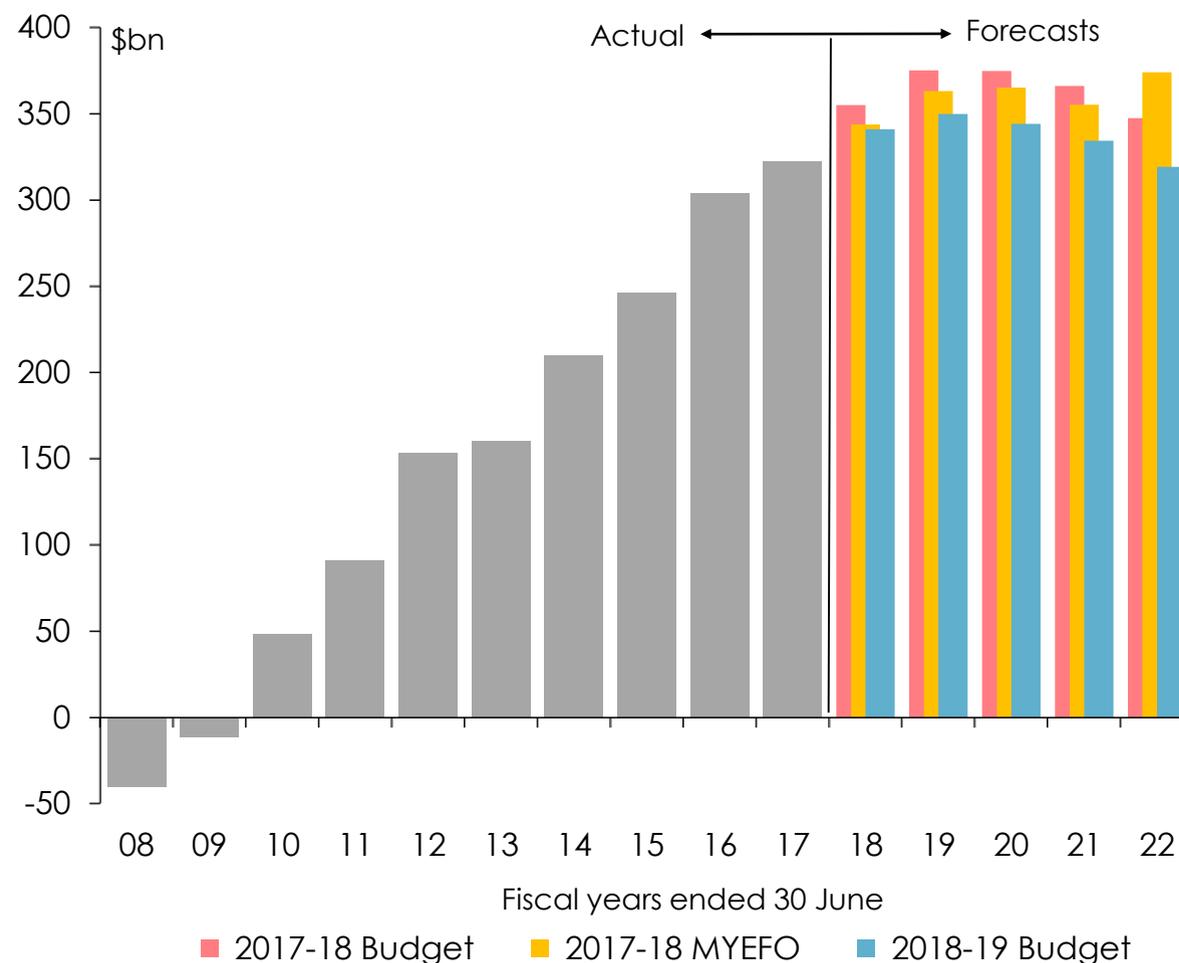
Note: data based on accrual estimates prior to 2013-14, cash estimates thereafter.  
Sources: Parliamentary Budget Office; Budget and MYEFO Papers; Corinna Economic Advisory.

# This revenue windfall has allowed the Government to improve its bottom line, and start paying down debt sooner, and by more ...

## 'Underlying' cash balance



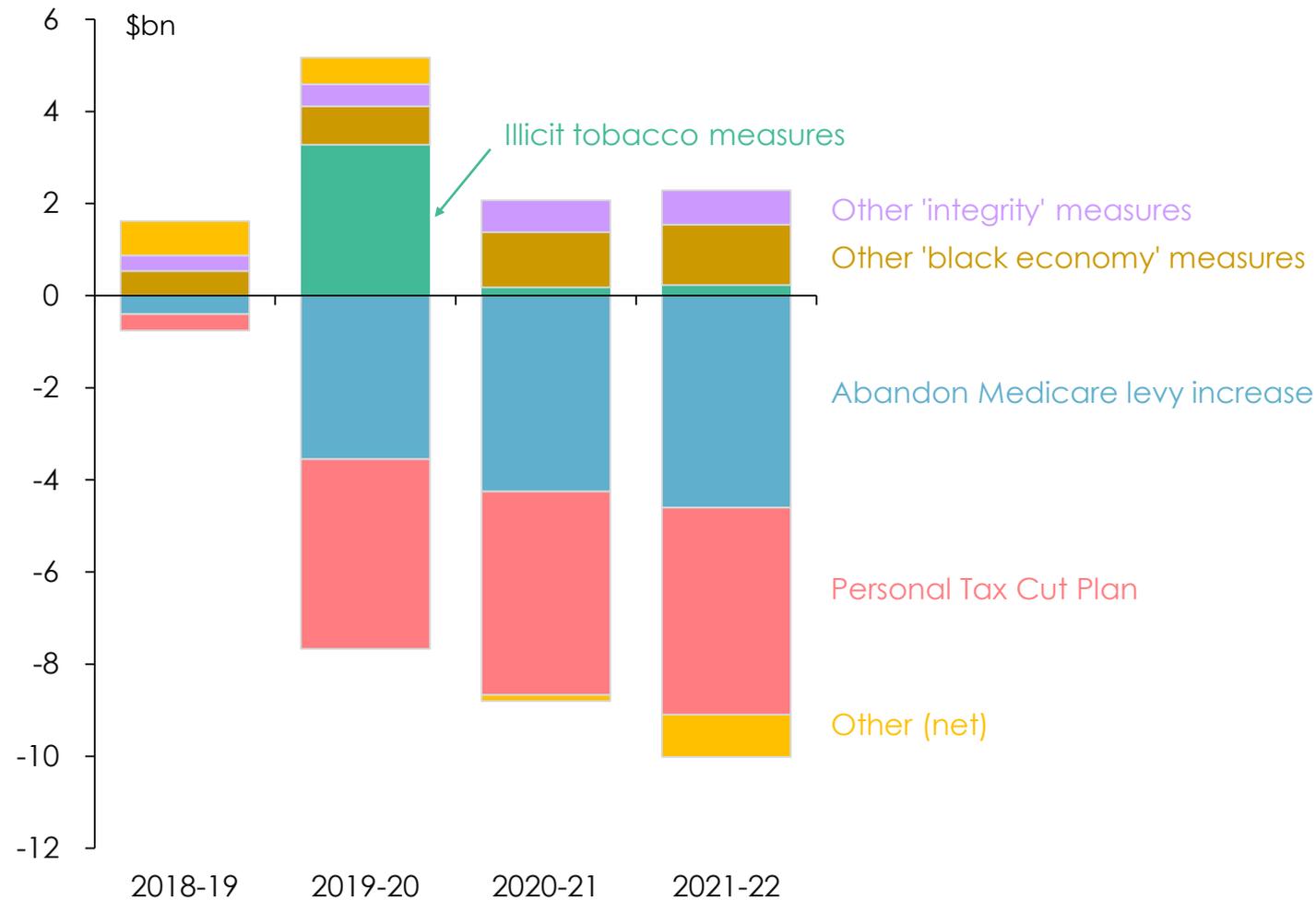
## Net debt



Sources: Budget Paper No. 1, 2017-18 and 2018-19; 2017-18 Mid-Year Economic & Fiscal Outlook (MYEFO).

# ... and to cut taxes by \$26bn over four years, without further significant spending cuts

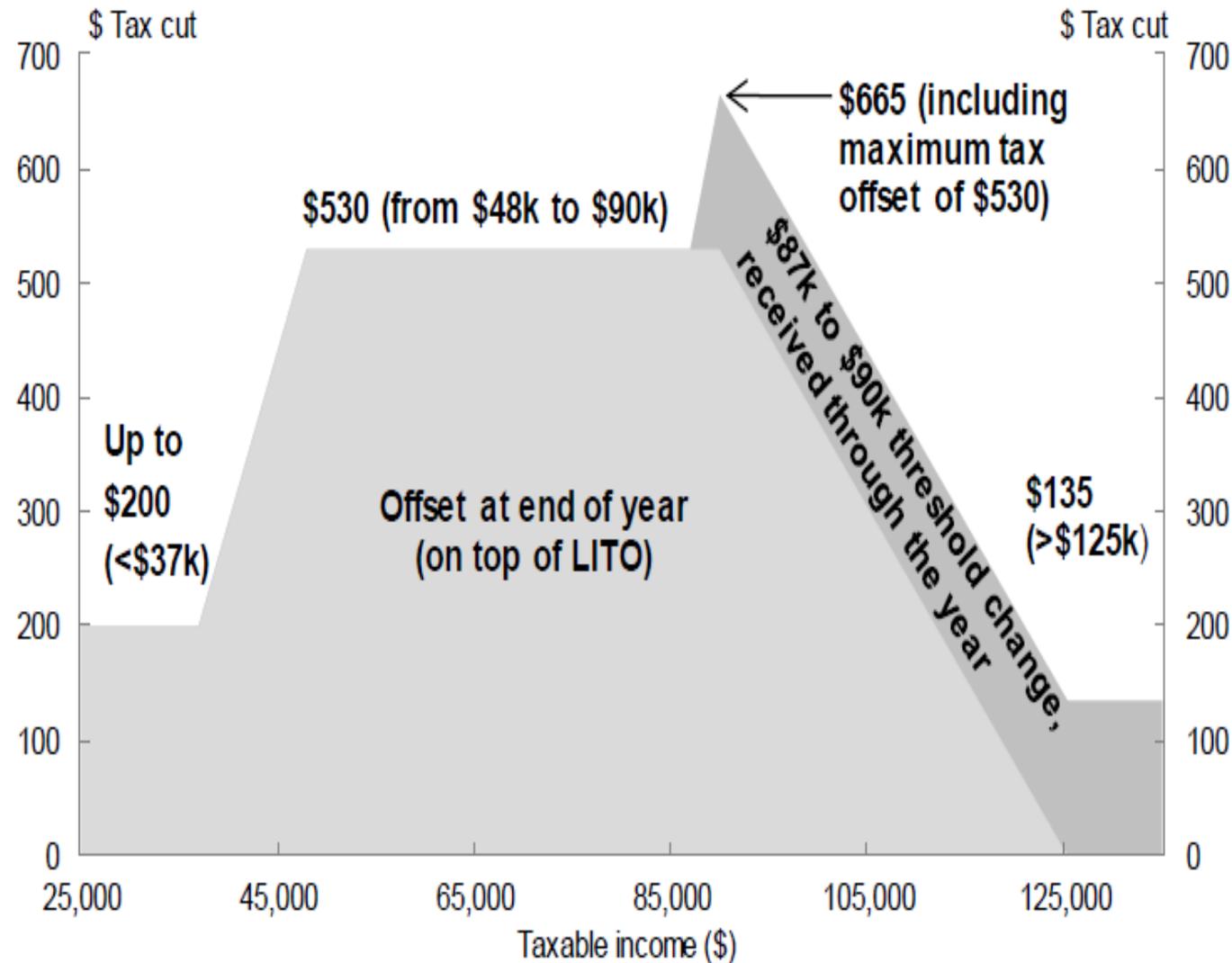
## 'Bottom line' impact of revenue decisions



Sources: Budget Paper No. 2, 2018-19.

- ❑ The two major 'tax cuts' in the 2018-19 Budget will 'cost' \$26.2bn over the four years to 2021-22
  - abandoning the Medicare levy increase proposed in last year's Budget 'costs' \$12.8bn
  - and 'Step 1' of the Government's 'Personal Income Tax Plan' will cost \$13.4bn
- ❑ \$10bn of this 'cost' is offset by measures targeting the 'black economy', and others aimed at strengthening the 'integrity' of the personal and company income tax systems
  - of which the most important is a one-off \$3.3bn gain in 2019-20 from changing the point at which duty on imported tobacco is collected
- ❑ By contrast there is 'only' \$3.6bn of net savings from spending policy decisions in the 2018-19 Budget
- ❑ In total, the Budget 'gives away' about 40% of the revenue windfalls – with the other 60% going to improving the 'bottom line'

# The first part of the Government's 'Personal Income Tax Plan' is cleverly structured to benefit only low- and middle-income taxpayers



Sources: Budget Paper No. 1, 2018-19.

- ❑ 'Step 1' of the Government's 'Personal Income Tax Plan' is delivered via a new 'Low and Middle Income Tax Offset', which will be paid as a lump sum after those eligible have lodged their income tax returns (rather than as a reduction in their PAYE instalment deductions)
- ❑ By comparison with the alternative of cutting the 19% and 32½% rates, or raising the thresholds at which these rates become payable, this structure ensures that taxpayers with taxable incomes above \$125,000 don't get any benefit
  - which reduces the 'bottom line' impact, and makes it easier to 'sell' politically
- ❑ And by structuring the tax cut as a refund, the revenue impact doesn't hit the 'bottom line' until 2019-20
  - the year in which the budget returns to surplus
  - conveniently, the year in which the \$3¼bn one-off impact from changing the timing of tobacco duty payment is felt

# The first part of the Government's 'Personal Income Tax Plan' is cleverly structured to benefit only low- and middle-income taxpayers

## The three stages of the Government's 'Personal Income Tax Plan'

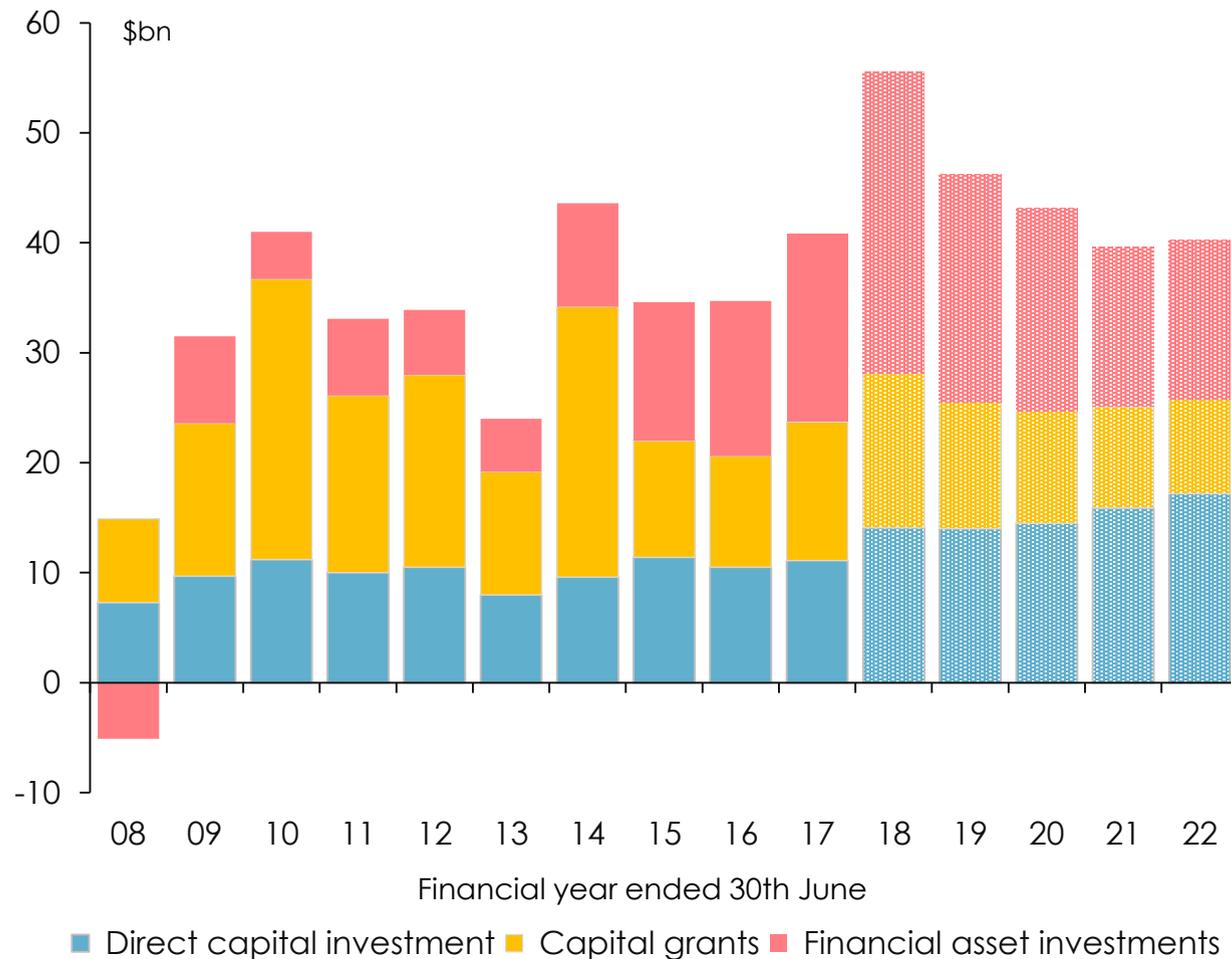
Rate (%)	Current tax thresholds Income range (\$)	New tax thresholds From 1 July 2018 Income range (\$)	New tax thresholds From 1 July 2022 Income range (\$)	New tax thresholds From 1 July 2024 Income range (\$)
Tax free	0 - 18,200	0 - 18,200	0 - 18,200	0 - 18,200
19	18,201 - 37,000	18,201 - 37,000	18,201 - 41,000	18,201 - 41,000
32.5	37,001 - 87,000	37,001 - 90,000	41,001 - 120,000	41,001 - 200,000
37	87,001 - 180,000	90,001 - 180,000	120,001 - 180,000	-
45	>180,000	>180,000	>180,000	>200,000
Low and middle income tax offset	-	Up to 530	-	-
LITO	Up to 445	Up to 445	Up to 645	Up to 645

- ❑ The total cost of the proposed personal income tax cuts is reported to be \$130bn over ten years (although this figure is not in the Budget Papers)
- ❑ The second and especially the third stages will be harder to 'sell' politically, because they imply a lessening in the progressivity of the income tax scales
  - for example post July 2024, a taxpayer on \$80K gets an annual tax reduction of \$540 (equivalent to 0.7% of taxable income), whereas a taxpayer on \$150K gets \$3375 (2.3%), one on \$180K gets \$4725 (2.6%) and one on \$200K or more gets \$7,225 (3.6% of \$200K)

Sources: Budget Paper No. 1, 2018-19; 'Tax Relief Calculator' at [www.budget.gov.au](http://www.budget.gov.au).

# The Budget includes further increases in infrastructure spending – although whether all of this is ‘good’ spending is questionable

## Commonwealth Government capital spending

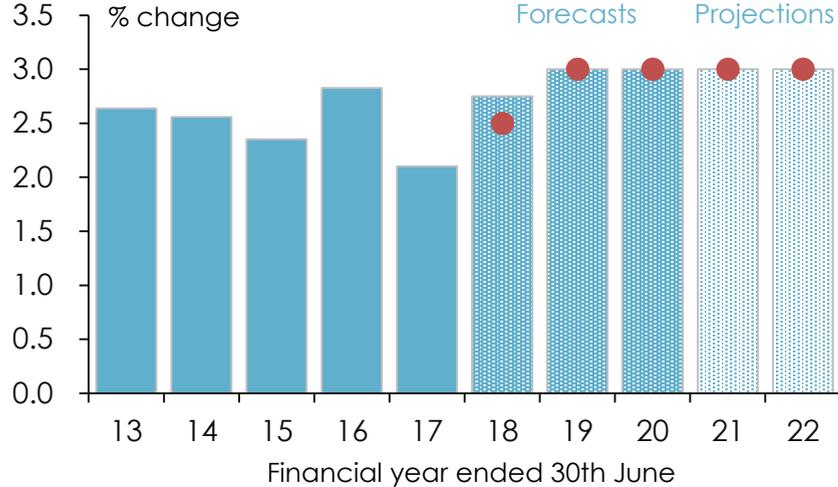


Source: 2018-19 Budget Papers. Statement No. 4.

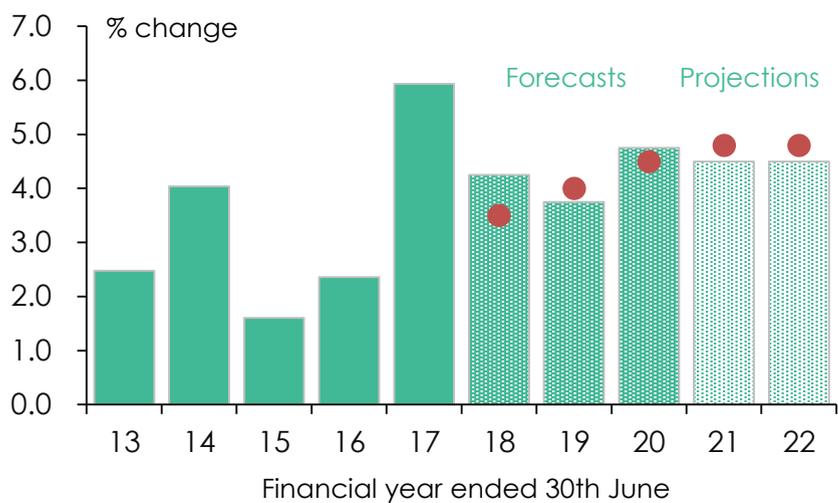
- According to the Budget Papers the Government will spend \$169bn on ‘capital investment’ over the four years to 2021-22
  - however capital investment in each of these years will be less than in 2017-18
- The Budget Papers say that ‘all spending should be assessed for its quality [which] requires a commitment to rigorous project assessment and program evaluation’ and that ‘infrastructure spending should be focussed on improving productivity’
  - it’s not clear that these strictures have been consistently followed – eg the ‘Inland Rail’ project, or ‘porno-scanners’ at domestic airports
- Over 40% of the Government’s capital spending will occur ‘off budget’ via investments in government-controlled companies (eg Inland Rail, Western Sydney Airport and Snowy 2.0)
  - this spending isn’t included in the ‘underlying’ cash balance
  - and typically attracts less scrutiny

# Most of the economic forecasts and projections underpinning the Budget look reasonable – except for the projections for wages growth

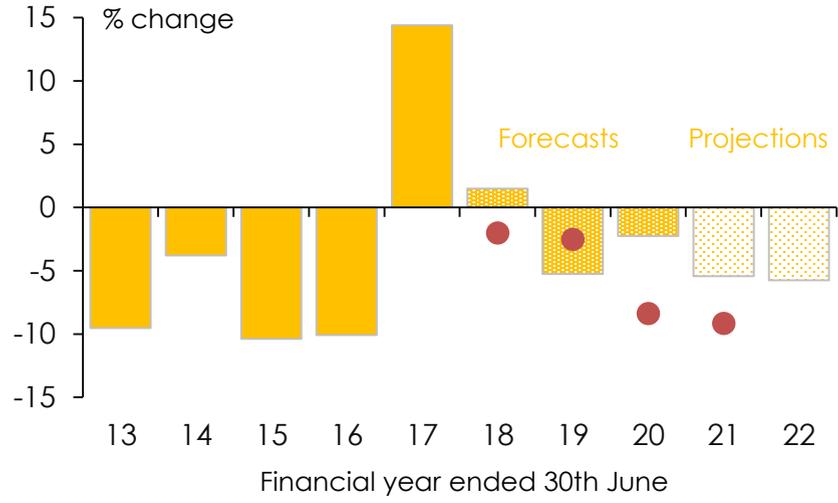
## Real GDP



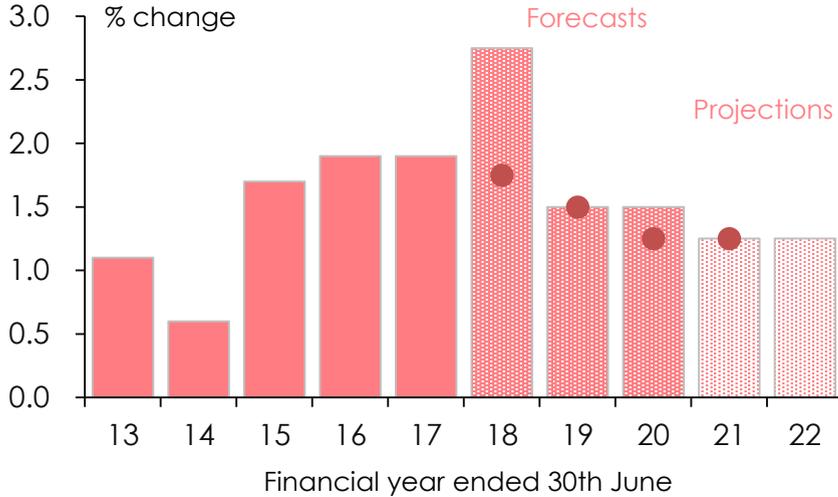
## Nominal GDP



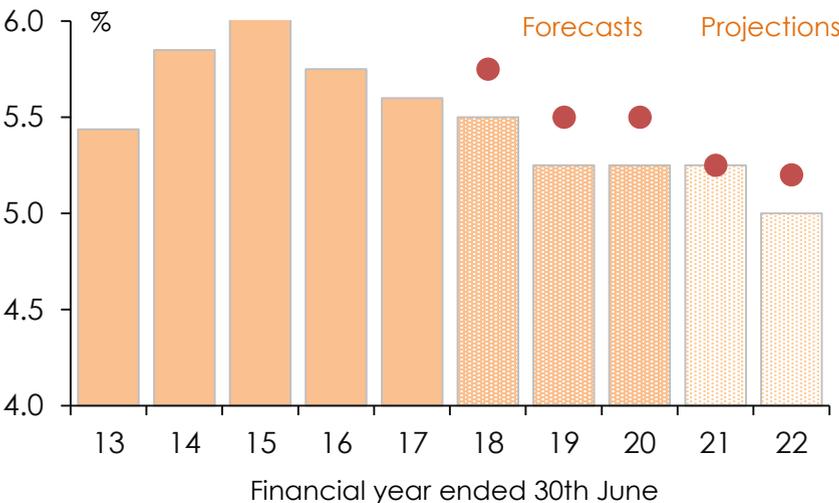
## Terms of trade



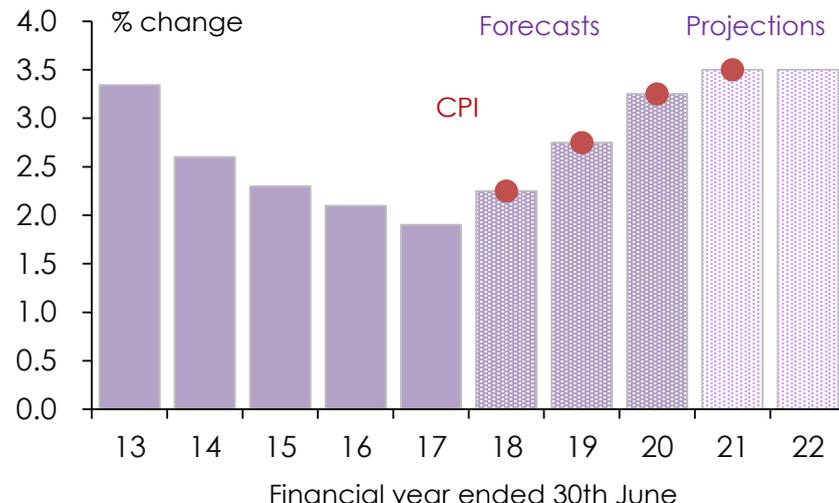
## Employment



## Unemployment



## Wages



Note: Dots in the above charts are the forecasts/projections in the 2017-18 Mid-Year Economic & Fiscal Outlook (MYEFO).  
Sources: ABS; 2018-19 Budget Papers, Statement No. 2, and 2017-18 MYEFO.

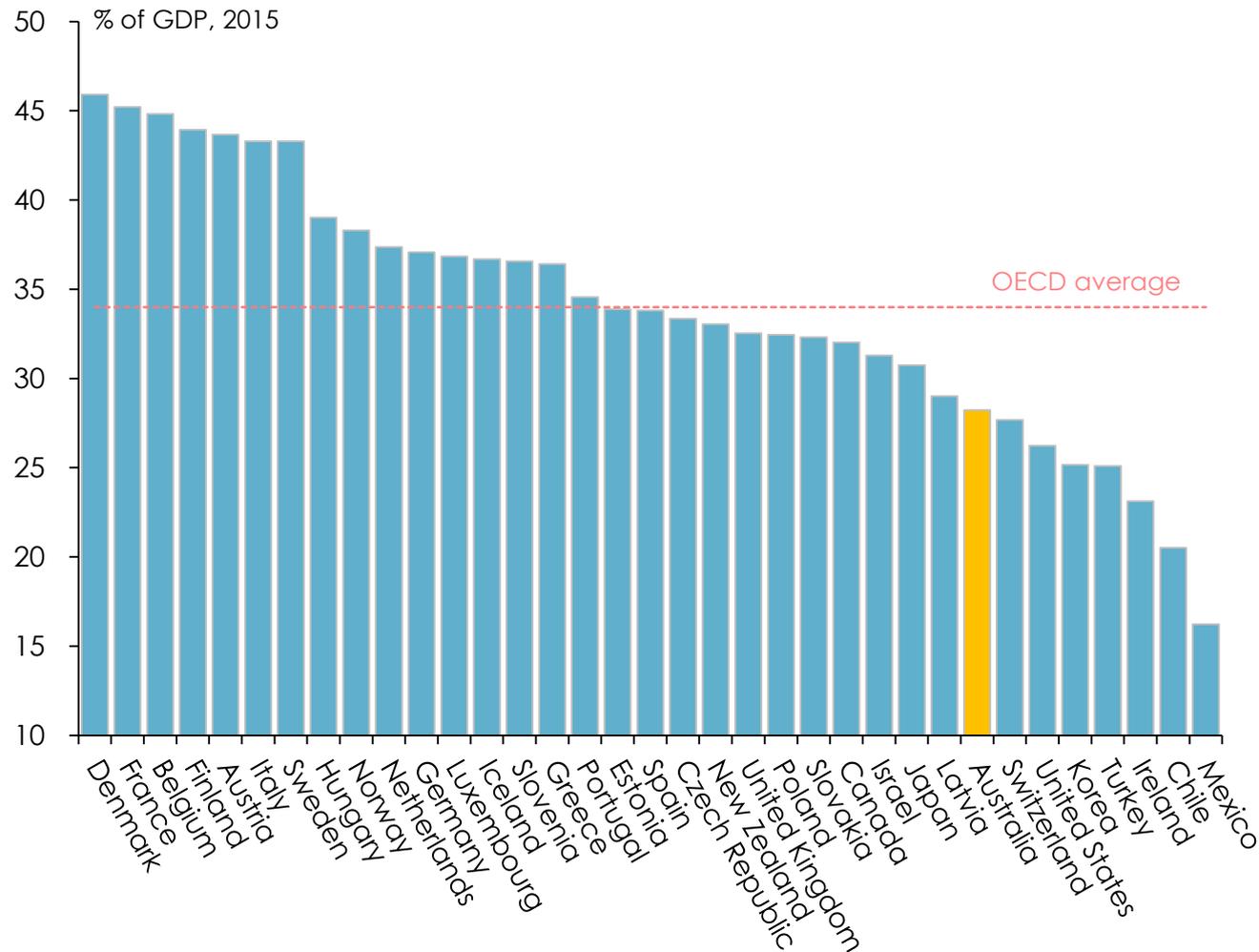
# Some things that perhaps should have been in this year's Budget, but weren't

- ❑ **There was nothing in this year's Budget about housing affordability**
  - Housing was a major focus of last year's Budget
  - Most of the measures foreshadowed in last year's Budget are yet to be implemented, apart from the 'super for housing' scheme (which will likely make the problem worse, at the margin, not better)
  - There is absolutely nothing about housing in this year's Budget
  - The new 'National Housing and Homelessness Agreement' with States and Territories which commences in 2018-19 did not include any increase in funding for affordable rental housing
  - Nor was there any increase in Commonwealth Rent Assistance (to pensioners and others renting privately)
- ❑ **No adjustment to Newstart Allowances**
  - Over the past 20 years the Newstart Allowance has fallen from over 90% of the single age pension to about 66%
  - The Government has again refused to narrow this gap, despite support from across the spectrum of public opinion (from ACOSS and the ACTU to the BCA)
- ❑ **Greater transparency regarding, and more rigorous assessment of, spending on 'security'**
  - The Productivity Commission's latest *Trade and Assistance Review* makes a timely call for 'periodic systemic review by an agency without active involvement in security policy', noting there is 'very little visibility of the costs created by national security measures'
  - It is just ludicrous that the amount of additional spending in the Budget on ASIS cannot be disclosed for 'national security reasons'

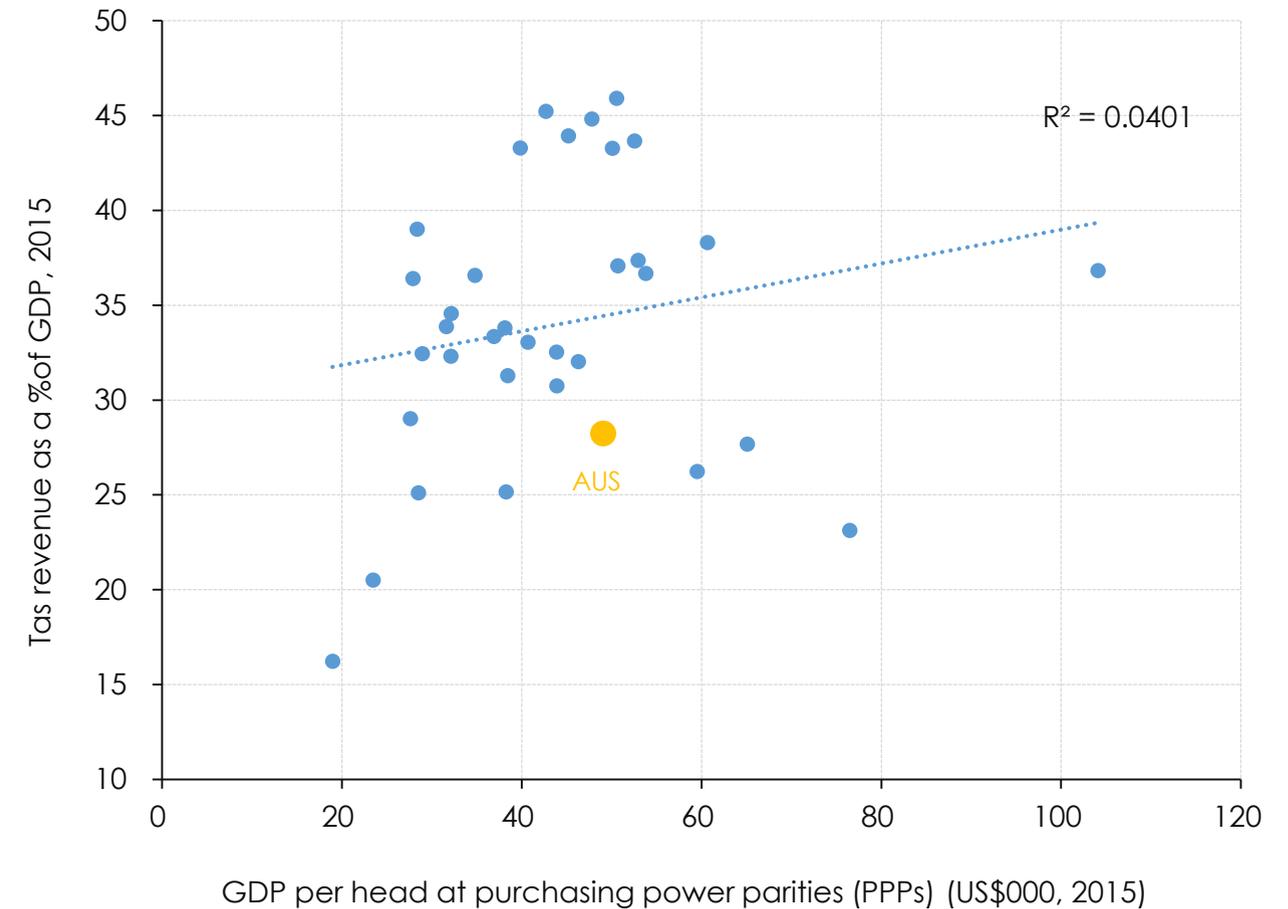
# Some thoughts on tax reform

# Australia isn't a high tax country, by 'advanced' economy standards – and there's no correlation between the tax take and GDP per head

## Total tax revenue as a pc of GDP, OECD countries, 2015



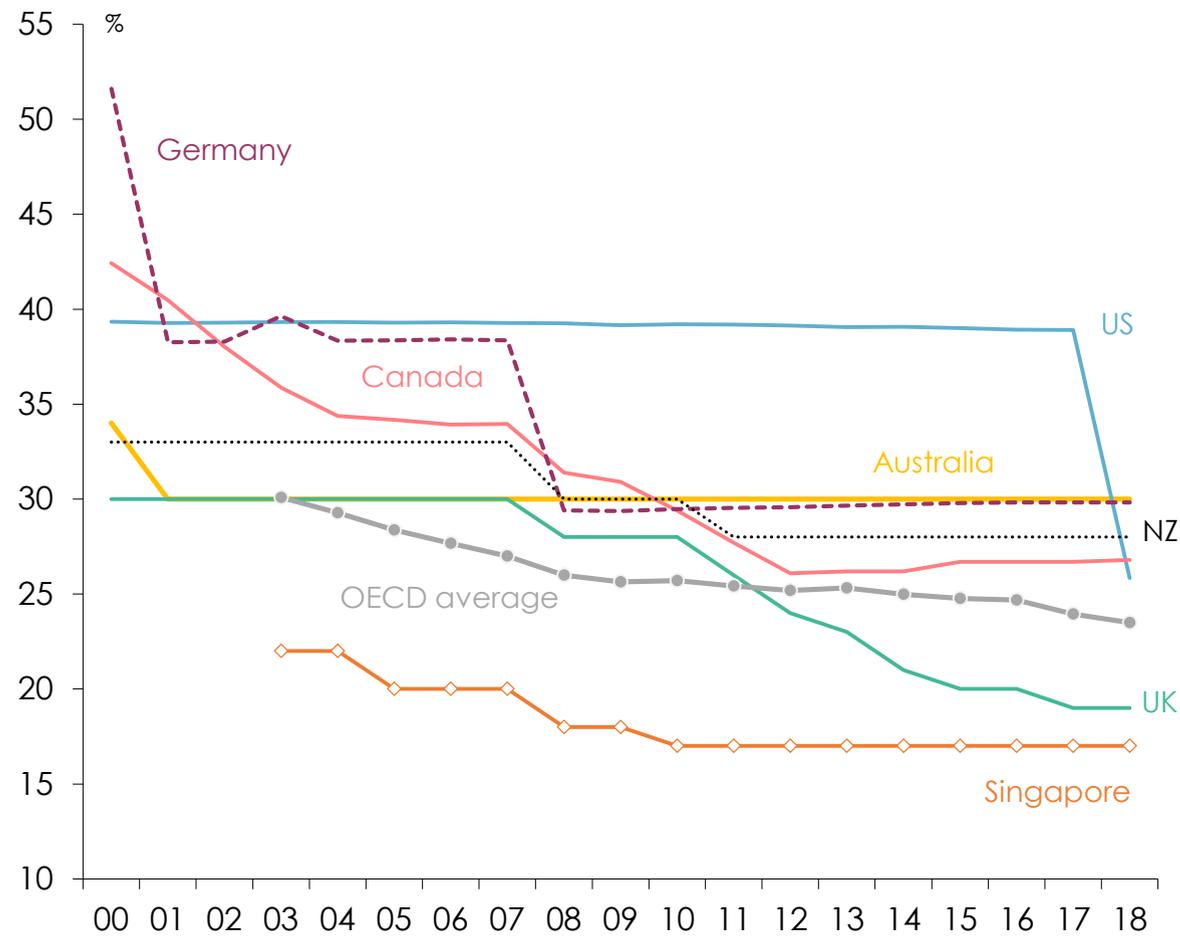
## Tax revenue as a pc of GDP and GDP per capita, OECD countries, 2015



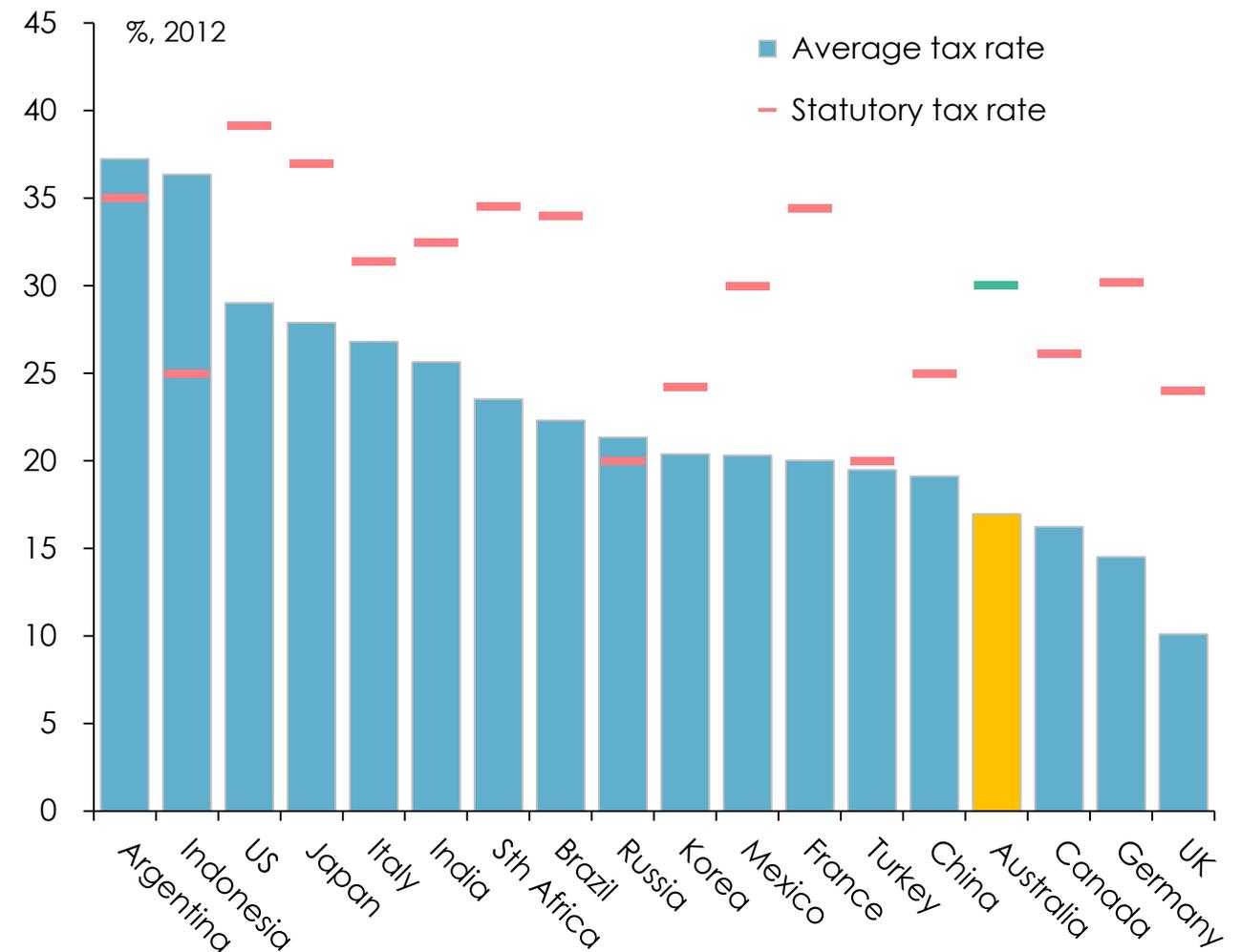
Sources: OECD.Stat, Revenue Statistics – OECD Member Countries and Economic Outlook database.

# Australia's corporate tax rate is one of the highest in the 'developed world' – but companies don't necessarily pay the statutory tax rate

## Corporate tax rates, selected 'advanced' economies, 2000-2018



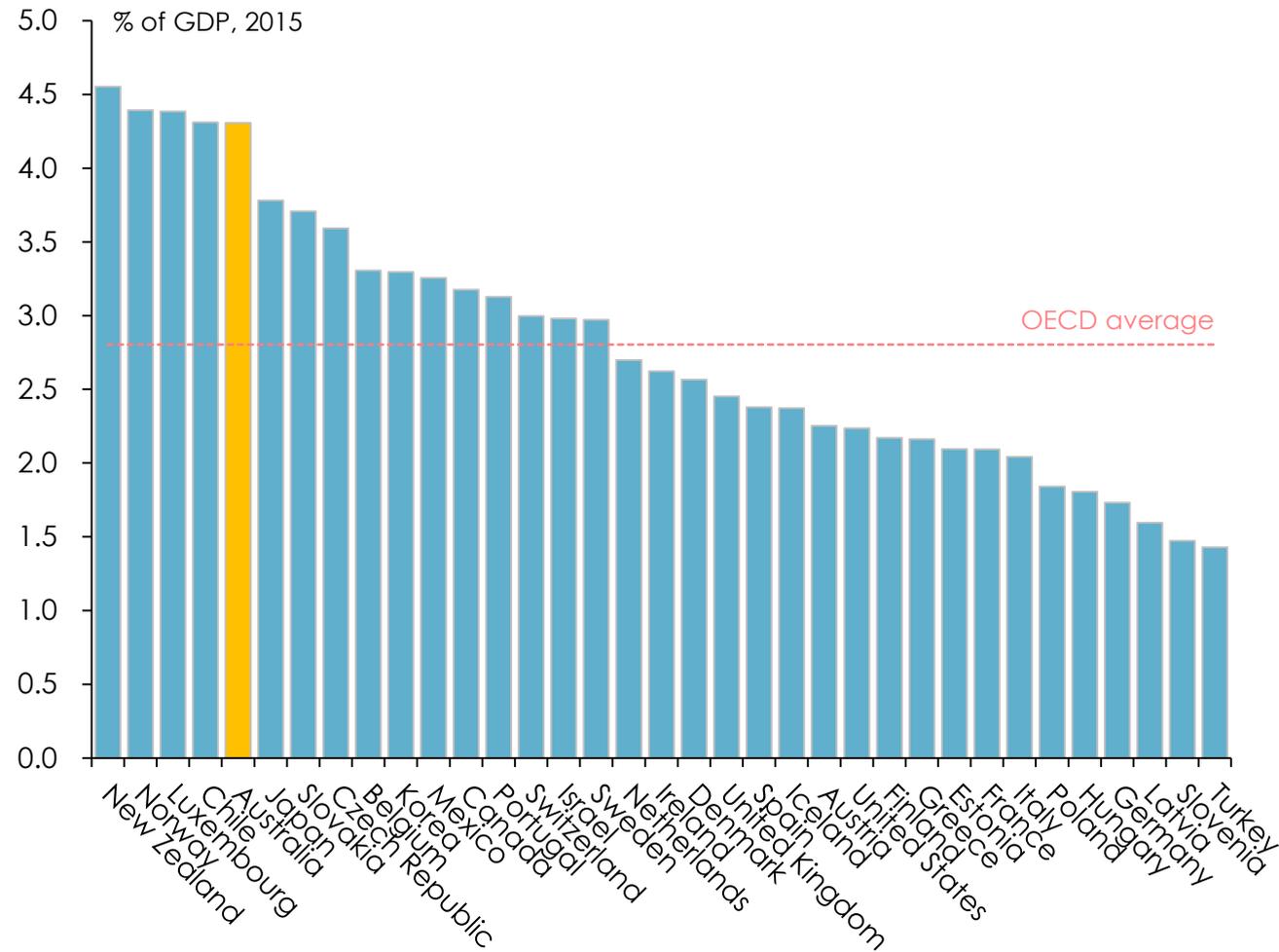
## Statutory vs average corporate tax rates, G20 economies, 2012



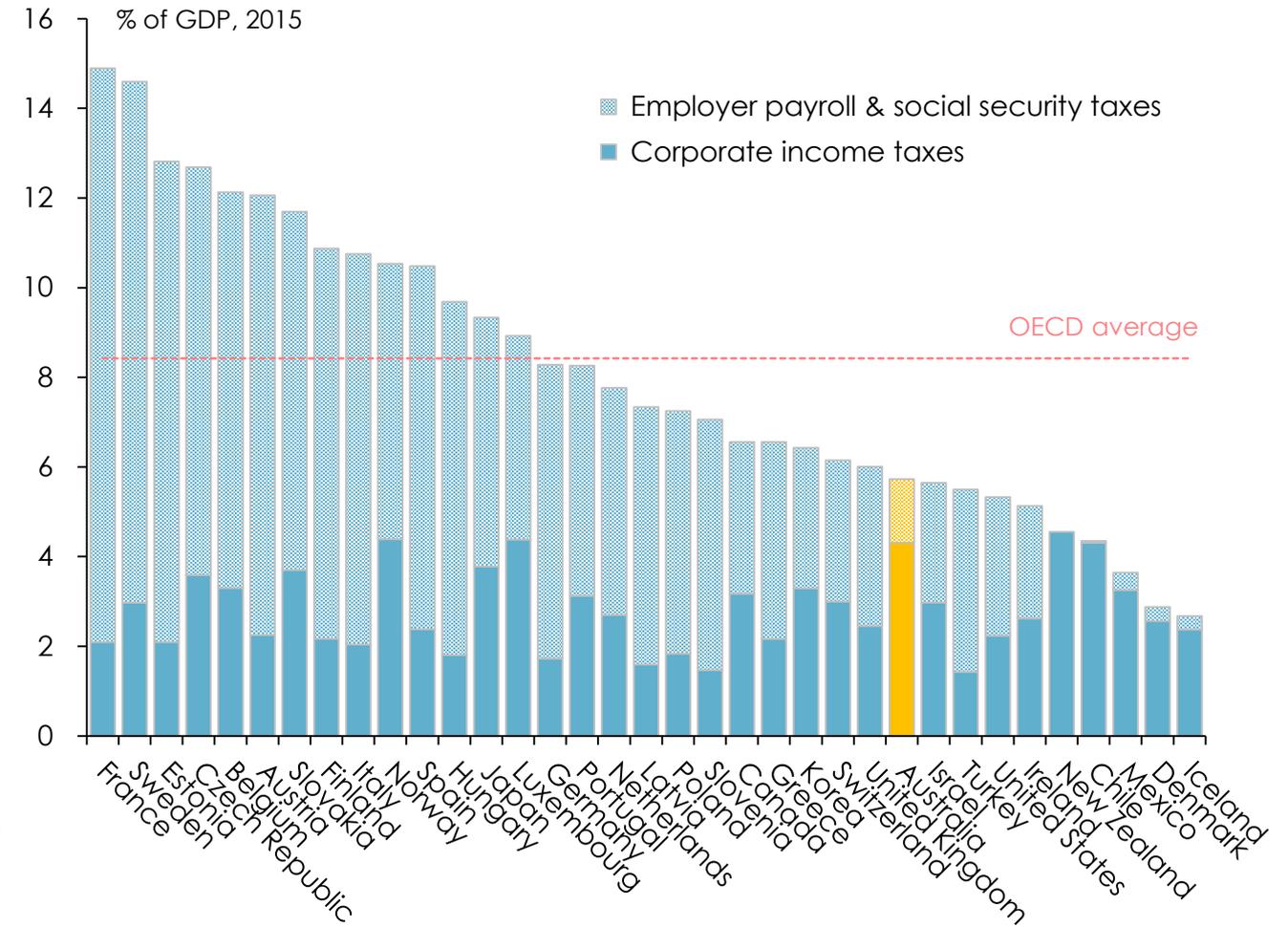
Sources: OECD.Stat, Revenue Statistics – OECD Member Countries; KPMG, Corporate Tax Rates table; US Congressional Budget Office, International Comparisons of Corporate Income Tax Rates, March 2017. Note: Average corporate tax rates are calculated as corporate taxes paid as a percentage of total income, as reported by US-owned companies operating in non-US jurisdictions, and foreign companies operating in the US.

# Australia does collect a lot of revenue from company tax – but the total tax burden on business is not high by ‘advanced’ economy standards

## Company income tax revenue as a pc of GDP, OECD countries, 2015



## Company income and other employer taxes as a pc of GDP, OECD countries, 2015

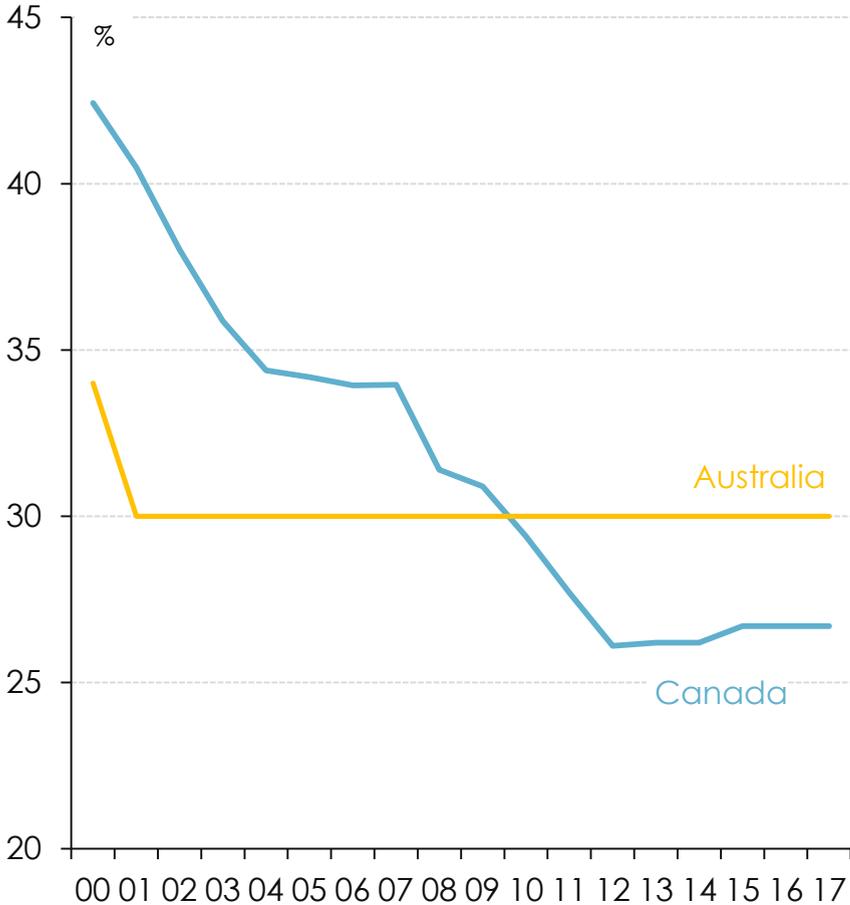


Sources: OECD.Stat, Revenue Statistics – OECD Member Countries.

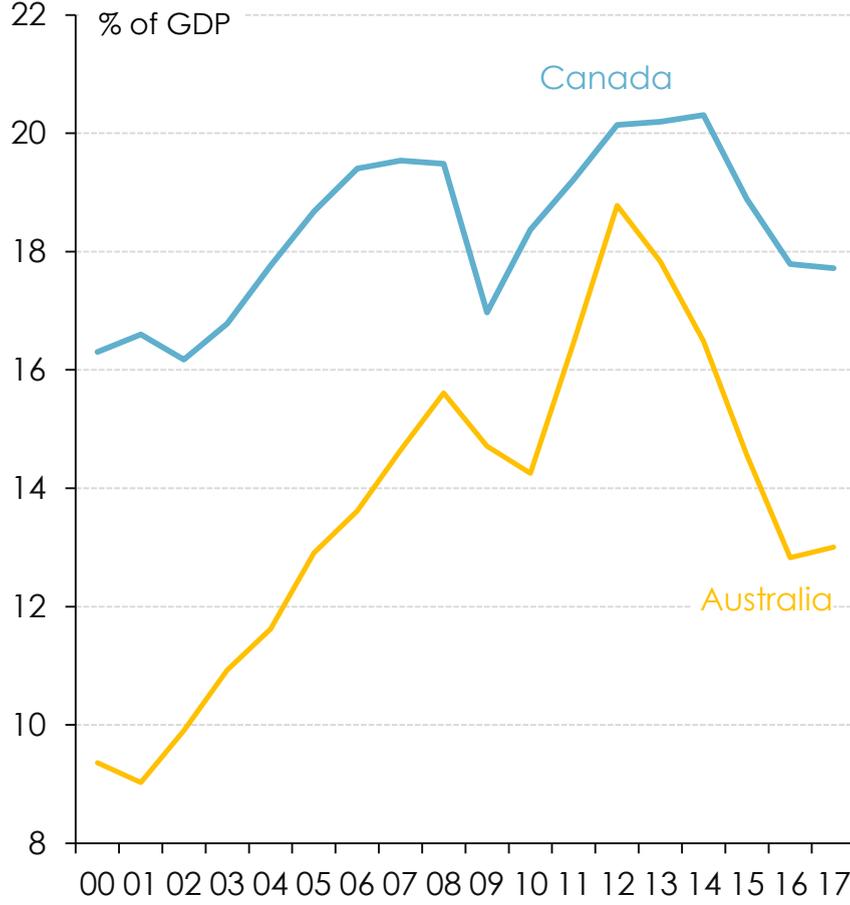
# Canada has cut its corporate tax rate by three times as much as the proposed in Australia – without any obvious lift in investment or wages

## Australia and Canada compared

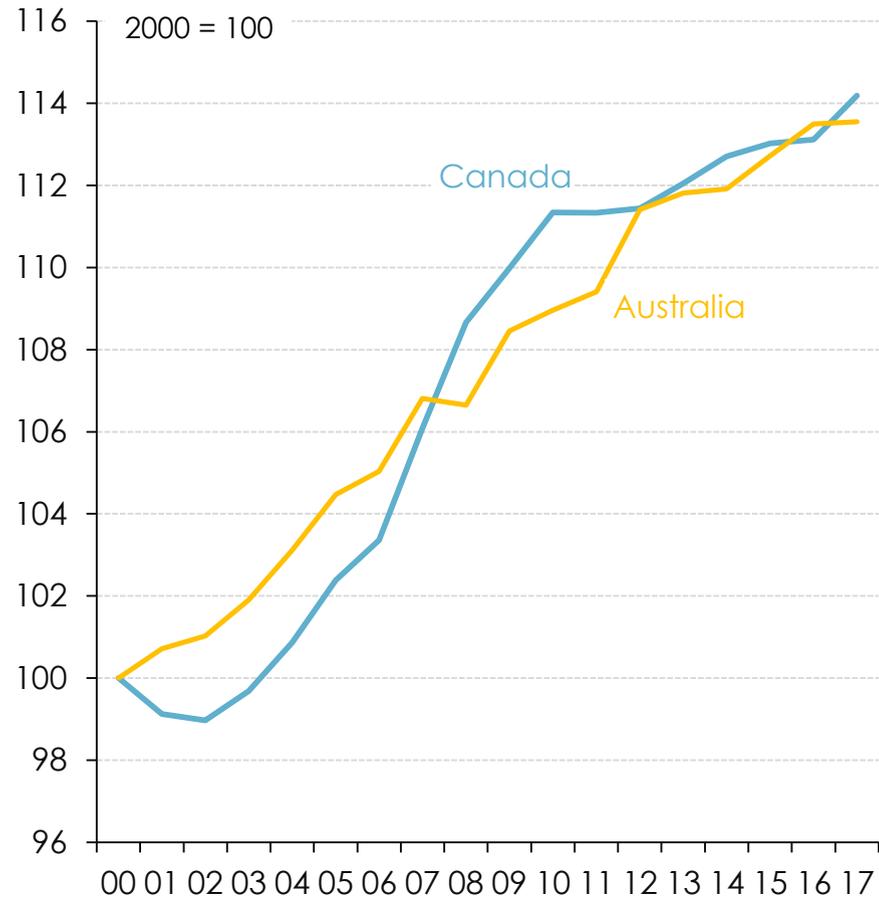
### Company tax rate



### Business investment



### Real wages

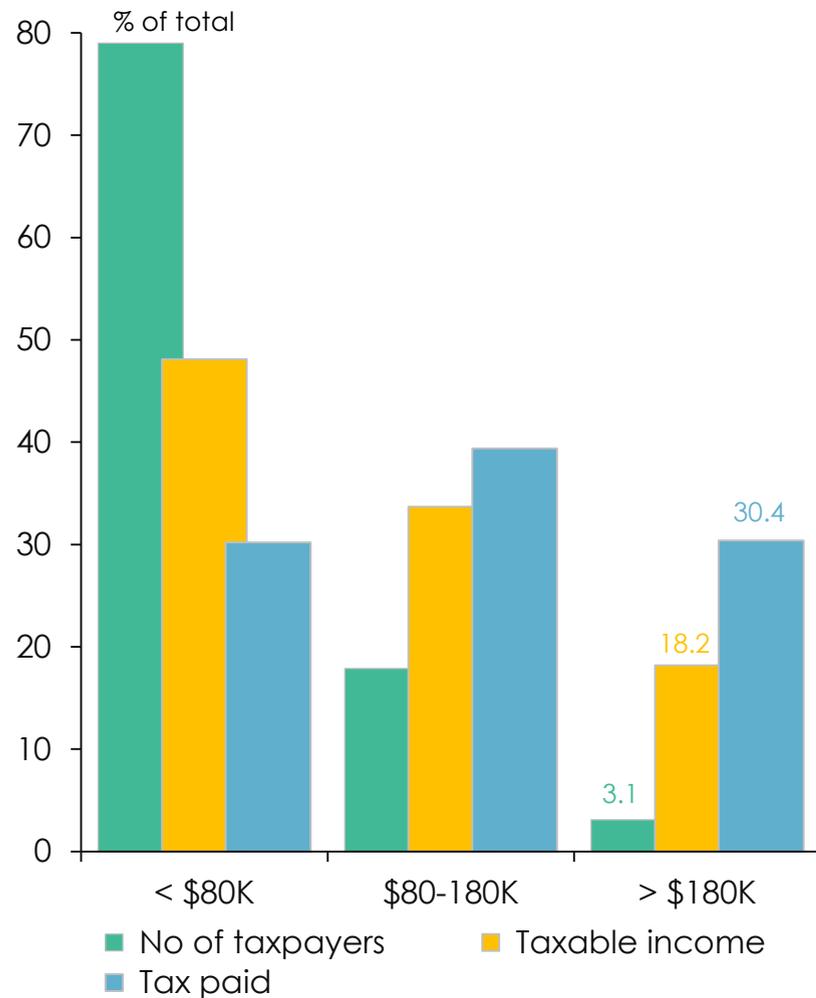


Sources: OECD; ABS; Statistics Canada.

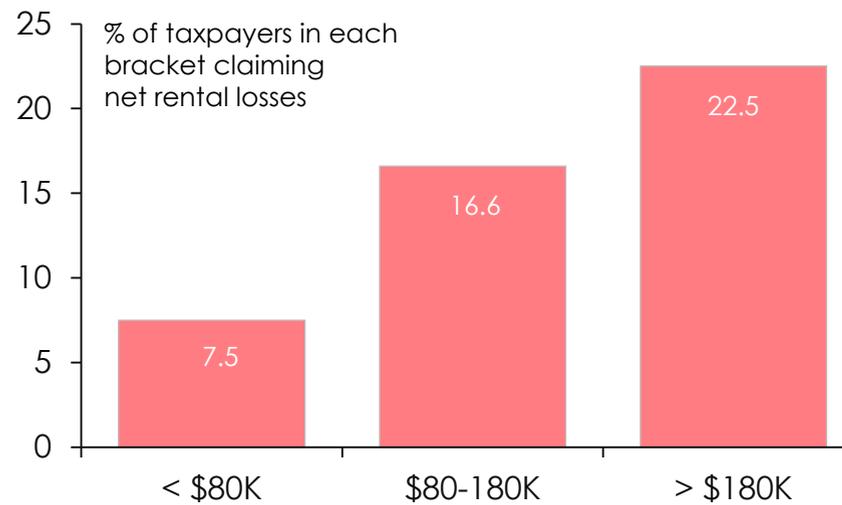
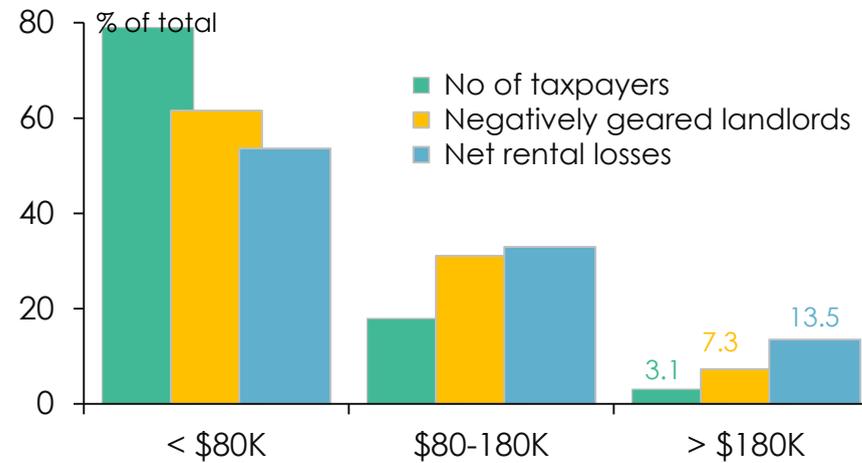


# 3% of taxpayers pay 30% of all personal income tax – but a lot of income earned by high-income earners which isn't taxed at the top rate

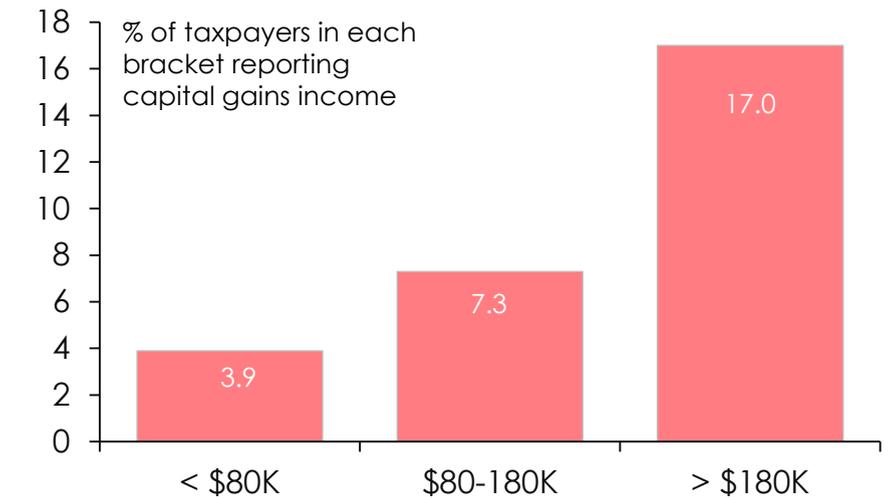
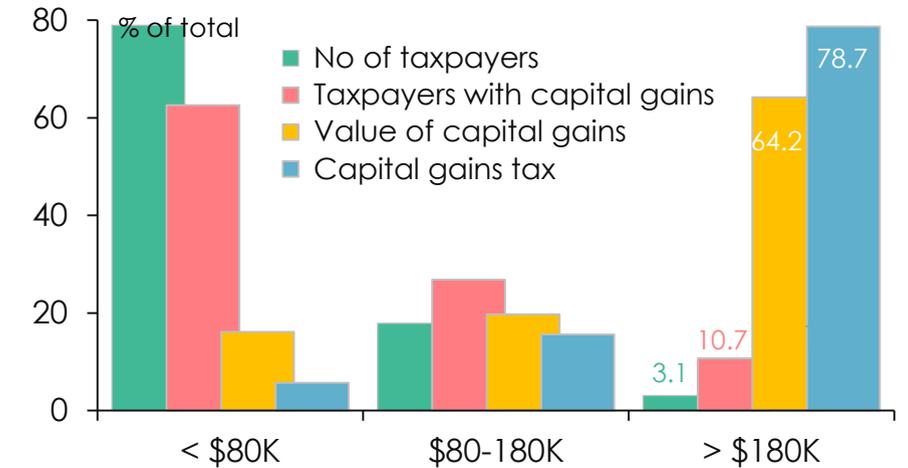
## Taxpayers, income and tax paid by tax bracket, 2015-16



## Negatively geared landlords by tax bracket, 2015-16



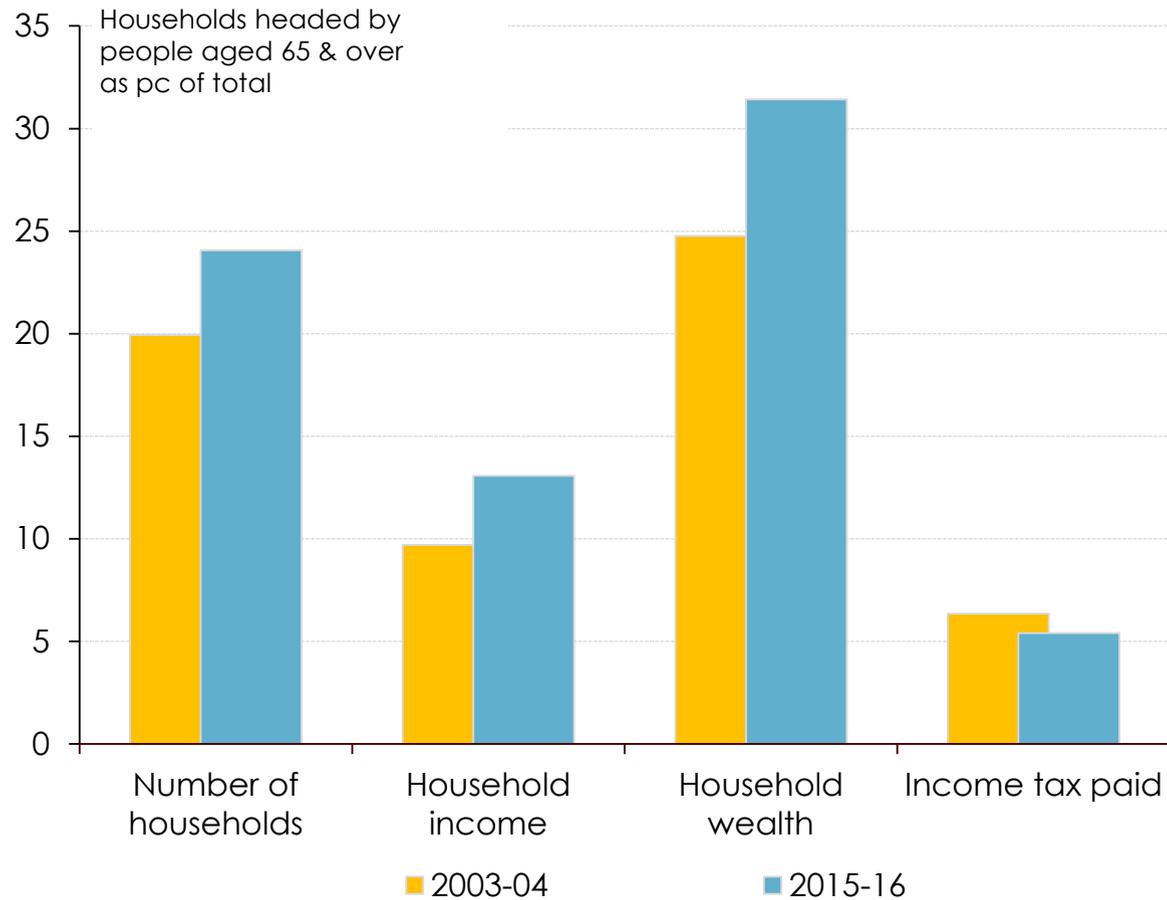
## Capital gains taxpayers, by tax bracket



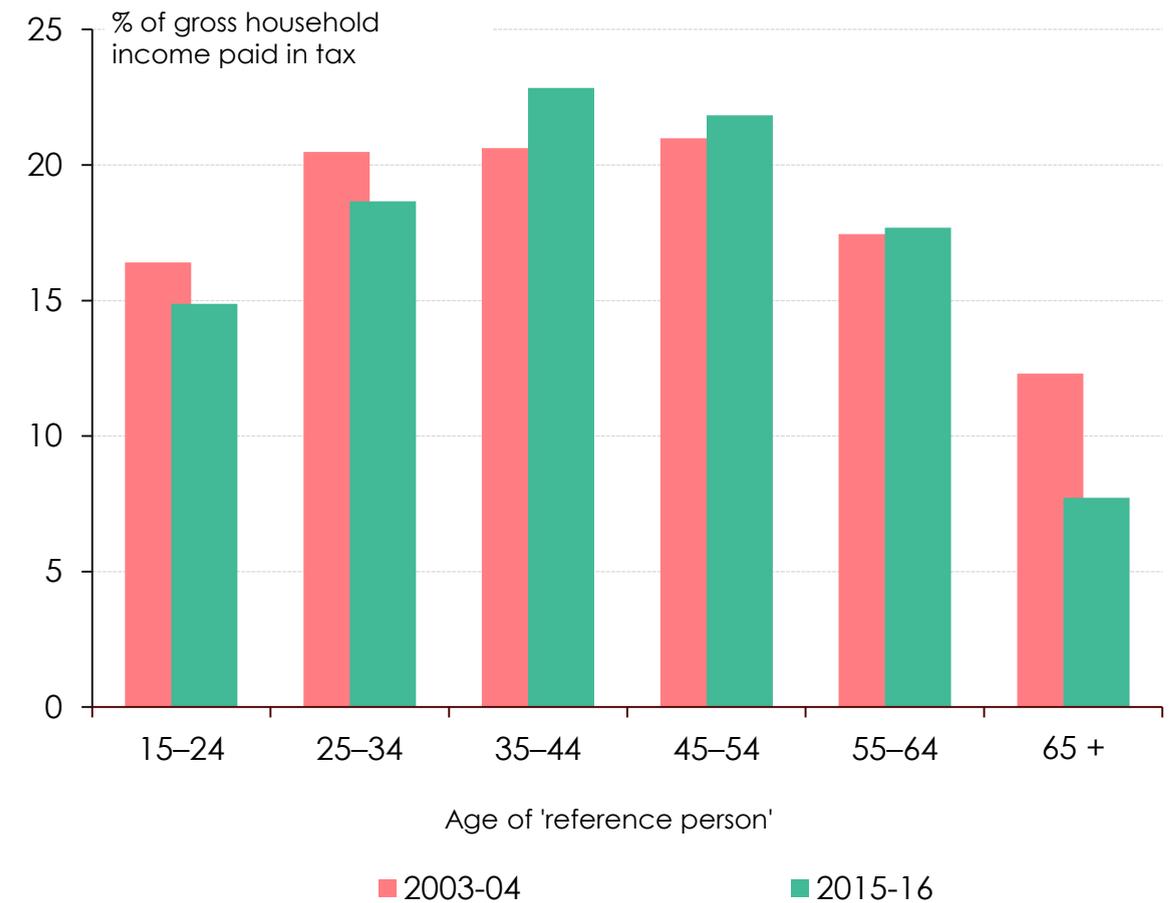
Source: Australian Taxation Office, Taxation Statistics 2015-16.

# Older households have increased their share of household income and wealth over the past 15 years, but are paying a smaller share of tax

## 'Senior' households share of income, wealth and tax



## Income tax paid as a pc of gross income, by age group



Source: ABS, Household Income and Wealth 2003-04 and 2015-16 (6523.0)

# So what should tax reform be about?

- ❑ 'Tax reform' is not simply about cutting taxes
  - “merely cutting or raising taxes in isolation, no matter how beneficial, is not the same as whole of system reform. Nor is it politically palatable”
    - Australian Institute of Company Directors, *Governance of the Nation*, April 2018
- ❑ The starting point for tax reform needs to be the answers to two questions –
  - how much do we want governments to spend on our behalf, on things that we cannot provide for ourselves individually?
  - how can we raise this amount fairly (as between taxpayers in similar *and* different positions), with the least unintended impact on individual or business decision-making, and at the lowest possible compliance cost?
- ❑ The answers to these questions are at least as more a matter of value judgements and political preferences than the result of economic analysis
  - which is why it is appropriate that they are the subject of political debate
- ❑ But most economists would say that tax reform should entail
  - broadening the base of whatever taxes are imposed – that is, reducing or eliminating exemptions, concessions, and preferences which privilege particular groups of taxpayers, types of income or expenditure, forms of business organization or categories of saving over others
  - and imposing the lowest possible rates consistent with raising the required amount of revenue, and with widely-shared notions of fairness and equity