Federal Budget 2018-19: 'This Time It's Personal'

May 2018

Executive Summary

— The Federal Government and the nation's fiscal position have become the beneficiaries of an unexpected windfall – primarily in the form of higher tax revenue due to the improved performance of the domestic and global economies (and the adoption of some conservative economic forecasts a year ago).

— In the Budget, the Government has largely 'banked' this windfall in the early years – allowing for a 2018-19 deficit of $14.5b (or 0.8% of GDP) followed by a small $2.2b (or 0.1% of GDP) surplus in 2019-20. The return to surplus, therefore, comes one year earlier than previously projected. However, it's in the year 2020-21 and beyond that the policy decisions taken in this Budget incur the greatest net cost, thereby crimping future surpluses.

— As referenced in our title, the centrepiece of the Budget is personal tax relief via the seven-year Personal Income Tax Plan. That relief is initially modest and targeted to lower and middle income earners yet becomes more substantial via the 'promise' of more significant threshold and bracket changes from 2022-23. These measures, along with the scrapping of the Medicare Levy increase scheduled for next year, clearly shift the Government's policy focus from company to personal tax cuts (although the Government has retained the commitment to last year's ten-year Enterprise Tax Plan). There is an obvious political motivation here.

— In terms of new initiatives, the big ticket items are $24.5bn (or 1.3% of GDP) of new transport infrastructure spending as part of the exiting 10 year program (although this is accounted for as an off-budget item) as well as initiatives in relation to aged care, the environment and health care.

— For the economy, the Budget provides a little extra stimulus to underpin what we believe is an already improving trajectory. Accordingly, it adds to the conviction that the economy will reach (if not exceed) 3% real GDP growth during 2018-19. The ratings agencies should also be encouraged by the earlier return to surplus - further diminishing the (low) prospect of a ratings downgrade.

— Overall, the Budget has benefited from a cyclical economic improvement. Hence, its sustainability is not assured. However, there is also a clear case for easing household financial pressures (after an extended period of weak wage growth) and improving the nation's infrastructure. The Budget balances these competing demands, prioritising a return to surplus while back-ending (and taking off-budget) the cost of new initiatives.

Budget Projections

Despite the Australian economy generally operating below par over the past 12 months, several important developments have benefited the nation's finances. Stronger company taxes have followed from high commodity prices. Capital gains tax revenue has lifted along with property and share prices. Employment growth in excess of 3% has flowed through to PAYG revenues and even GST income has been stronger than forecast.

As a result, a cyclical windfall has lowered the starting point for the 2018-19 Budget by more than $8bn – with the vast majority of this being 'saved' by the Government aiming for a 2018-19 deficit of $14.5bn (or 0.8% of GDP), down from the $21.4bn (1.1% of GDP) of last year's Budget.

For 2019-20, a small surplus of $2.2bn (or 0.1% of GDP) is anticipated – a year earlier than previously projected. We see this as a credible forecast, backed by conservative economic forecasts. Chart 1 on the following page shows the improvement in the budget trajectory from last year's Budget to this year's.

Turning to the nation's net public sector debt, the projected peak level of debt has been reduced and brought forward. Compared to last year's forecast of a peak of 19.8% of GDP in 2018-19, the Budget now sees an 18.6% peak in the current financial year. This retains Australia 's favourable position in an international context (as shown in Chart 2).

CHART 1: Projected Budget Balance Trajectory

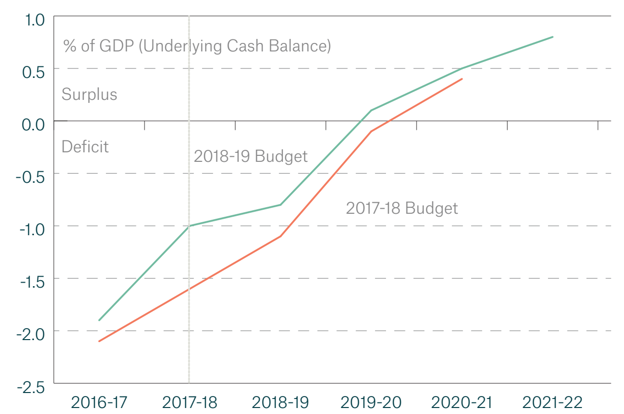
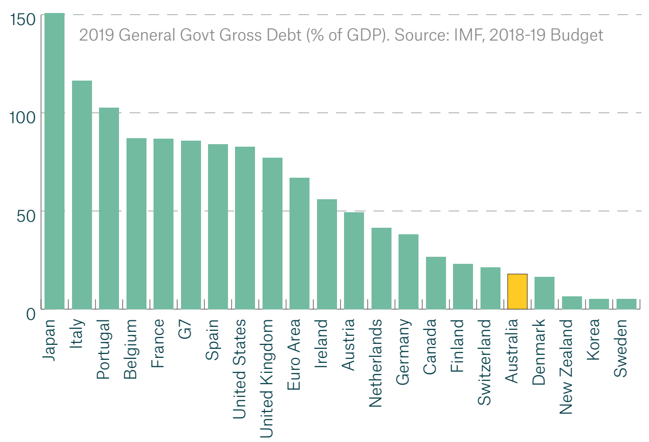


CHART 2: International Foreign Debt Levels



Major Budget Initiatives

There are a number of initiatives contained in the 2018-19 Budget, although many had already been known ahead of the release. As has been flagged, personal income tax relief was a key theme, with the government focused on supporting the upturn in the economy.

In terms of the revenue measures, the key Government announcements included the following.

— Plans to make personal income tax "lower, fairer and simpler" over a seven-year period. From 1 July, low and middle-income earners (earning up to $90,000) will receive the full offset of $530 per year. The upper threshold of the 32.5% tax bracket will also be increased to $90,000 from 1 July 2018. From 2022-23, the top threshold for the 19% tax bracket will rise to $41,000, with the top threshold for the 32.5% bracket lifting to $120,000. From 1 July 2024, the 37% tax bracket will be abolished, with the top (45%) tax bracket only applying for incomes above $200,000. These changes are tabled below.

— There will be no increase in the Medicare Levy, from the current 2%, in July 2019.

— Cracking down on the "black economy". In addition to combating illicit tobacco, an economy-wide cash payment limit of $10,000, as well as new and enhanced ATO enforcement measures, will be introduced.

On the spending side, the key announcements included the following.

— Further investment in infrastructure. The Government announced $24.5b in funding for new major transport projects and initiatives, as part of its $75b 2018-19 to 2027-28 program. A Roads of Strategic Importance initiative will also be established, with $3.5b of funding to upgrade key routes.

— Expanding the aged care system to fund around 14,000 additional high-level home care packages.

— Investment in health care, via increased funding for public hospitals, as well as new and amended listings in the Pharmaceutical Benefits Scheme.

— Support for regional Australia. This comes via improvements to water infrastructure for farmers, as well as investment to secure the future of the Great Barrier Reef. There is also funding to boost services and remote Indigenous housing in the Northern Territory.

New Personal Tax Rates and Thresholds, 2018-19, 2022-23 and 2024-25

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

Household and Business Impacts

For households, tax cuts targeted to lower and middle income earners will provide some offset to weak wage growth. For those on average weekly earnings, the tax saving in 2018-19 is $530 (or an additional 0.9% of disposable income).

Although small in size now, the outlook (with the caveat attached to all long term policy and economic 'promises') for greater tax relief in coming years may boost consumer confidence and the willingness to spend.

Businesses, meanwhile, may be encouraged by the ongoing infrastructure initiatives, the extension of the $20,000 instant asset write-off and the continued commitment to lower the company tax rate to 25% for all companies by 2026-27.

In the lead up to the Budget, survey data has shown that business confidence is high and investment intentions are being revised higher. We see the Budget as reinforcing these positive trends.

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Economic Outlook and Forecasts

The trends in the global and domestic economies have been favourable over the past year. The upswing in the global economy has been broader-based and the outlook for the next few years has repeatedly been revised higher by various international agencies, such as the IMF (as shown in Chart 3). The faster global momentum has consequently supported commodity prices, which in turn, have acted as a source of support for Australia's terms of trade, nominal GDP and government revenues over the past year. This dynamic has been compounded by the stronger than anticipated Australian labour market over the past year (illustrated in Chart 4) which has flowed through to tax receipts.

The challenge is for this momentum to continue. We believe that it will, which is also the message from the economic assumptions underpinning the 2018-19 Budget. If anything, some of the key assumptions, such as the view that iron ore prices will track at US$55/tonne over the next two years and the moderation in nominal GDP growth over the next few years, are arguably keeping with the Treasury's more conservative recent bias.

In terms of the some of the other numbers (tabled on the following page), the Treasury sees Australian real GDP growth accelerating to 3% and holding there over the next few years - broadly in-line with the RBA's view - while the unemployment rate is seen drifting a little lower (down to 5% by 2021-22). As excess capacity in the labour market is absorbed, wage growth is predicted to accelerate from 2.1% per annum currently towards 3.5% by 2020-21.

We broadly agree with this macroeconomic outlook. In our opinion, the mix of faster global activity, stronger resource export volumes (as LNG production continues to come on stream), ongoing improvement in non-mining business investment, and the impulse from domestic infrastructure spending (and associated spill-overs) should see growth accelerate sharply over 2018-19. Added to these factors is the tailwind (albeit marginal) afforded to household consumption via the announced tax relief for low-to-middle income earners and, in later years from the shift, towards the flatter income tax structure.

CHART 3: Global Growth Forecasts

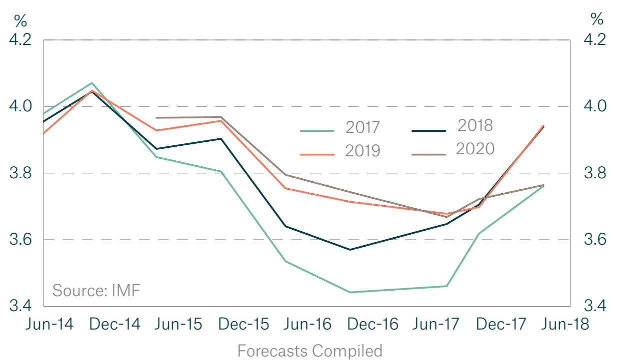
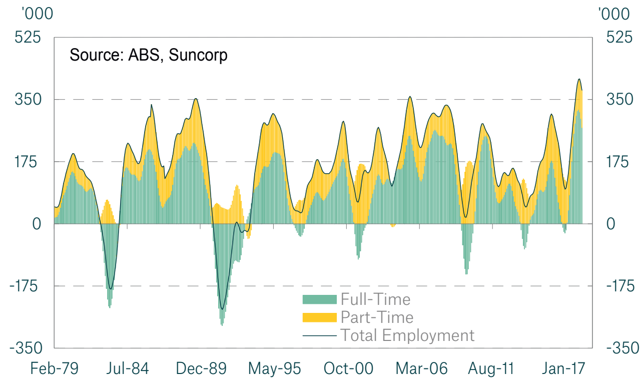


CHART 4: Australia Employment Growth (rolling 12-month sum)



KEY BUDGET METRICS	Outcomes 2016-17	Estimates 2017-18	Forecasts 2018-19	Forecasts 2019-20	Forecasts 2020-21	Forecasts 2021-22
Real GDP (annual % change)	2.1	2.75	3.00	3.00	3.00	3.00
Nominal GDP (annual % change)	5.9	4.25	3.75	4.75	4.50	4.50
CPI Inflation (annual % change)	1.9	2.00	2.25	2.50	2.50	2.50
Wage Price Index (annual % change)	1.9	2.25	2.75	3.25	3.50	3.50
Unemployment Rate (%)	5.6	5.5	5.25	5.25	5.25	5.00
Budget Underlying Cash Balance ($b) % of GDP	-33.2 -1.9	-18.2 -1.0	-14.5 -0.8	2.2 0.1	11.0 0.5	16.6 0.8
Net Debt ($b) % of GDP	325.1 18.5	341.0 18.6	349.9 18.4	344.0 17.3	334.3 16.1	319.3 14.7

Financial Market and RBA Implications

When it comes to the RBA, we believe that the Budget and some of the initiatives, particularly related to infrastructure spending and tax relief for low and middle-income earners, should at the margin, help to reinforce its positive outlook. Some easing in the headwinds facing households, although modest, will be welcomed.

More broadly, with leading indicators pointing to an acceleration in growth to an above trend pace over 2018-19, excess capacity should continue to be absorbed. In time, these trends should feed through to a pick-up in wage growth and inflation pressures. We remain of the view that the RBA is set to commence a modest tightening cycle towards the end of 2018, in contrast to market pricing which currently has the first interest rate rise pencilled in for mid-2019.

Looking at other markets, Australian equities may be encouraged by the Government's continued commitment to phasing in company tax cuts, as well as the changes to personal taxes. That said, global developments, such as the building inflation pressures in the US, the outlook for ongoing policy normalisation by the US Fed, and geopolitical tensions in the Middle-East are offsetting factors in the near-term.

There was little immediate reaction to the Budget in financial markets, including the AUD, SPI futures or bond and money market yields.

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