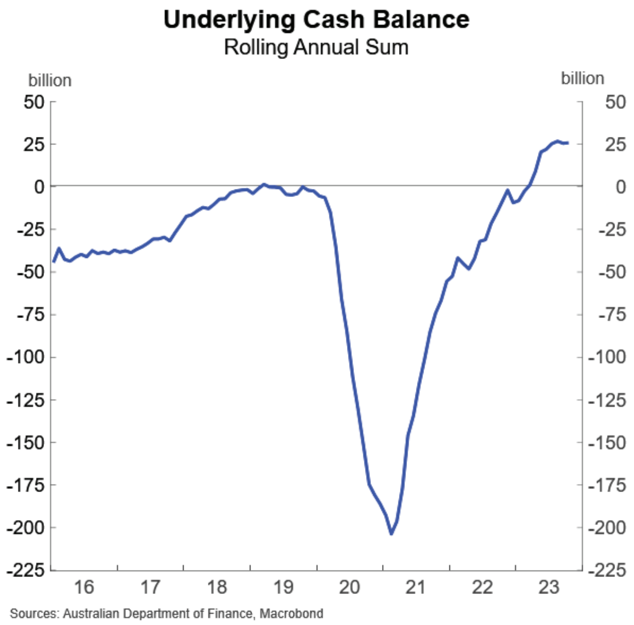
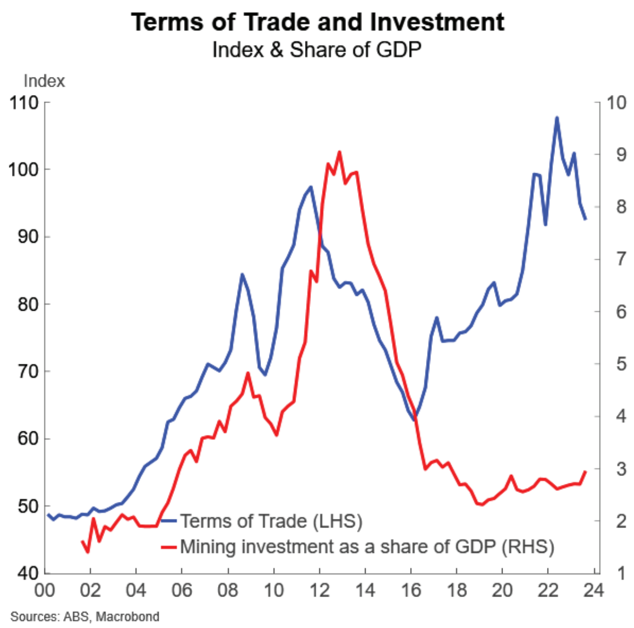
BULLETIN

12 December 2023

Fiscal Insights
Budget sweet spot – but for how long?

- Ahead of tomorrow's Mid-Year Economic and Fiscal Outlook (MYEFO), we maintain our call for the Government to record a second consecutive surplus in 2023-24. However, tomorrow's update is likely to remain conservative, showing improvement but unlikely to print a surplus.
- Data since the May Budget points to upside risks – commodity prices are tracking well above what was assumed, population growth has exceeded all expectations, the labour market remains resilient, and the 2022-23 final bottom line was five times better than expected. On the downside, the cost of capital is higher, but that's likely to bite in future years.
- Why has the underlying strength in the Government's finances exceeded everyone's expectations? We've reached a budget sweet spot. We have seen the current elevated levels of commodity prices before, the difference this time is that miners are not investing. This means there's a closer link between elevated prices and profits, and thereby, taxable income.
- Record population growth and higher nominal income has helped boost income tax to a record share of income. However, given this has been driven by migration, we haven't seen a corresponding rise in public service delivery costs – this will take time as arrivals gradually become eligible to access public services such as healthcare. Demand for infrastructure has also increased but it will take time for the government to meet this and for expenses to rise.
- But we cannot remain in this sweet spot forever. The Government's migration strategy will see population growth slow. This will mean growth in taxes will ease while costs of delivering public services will catch up. The mining sector has signalled it intends to invest in the net-zero transition. This is likely to see capital deductions grow, while commodity prices may also cool.
- If the windfalls are temporary, should most of it be saved? We think so. This will help ensure monetary and fiscal policy are working in tandem and will put us in a stronger financial position to weather future challenges.





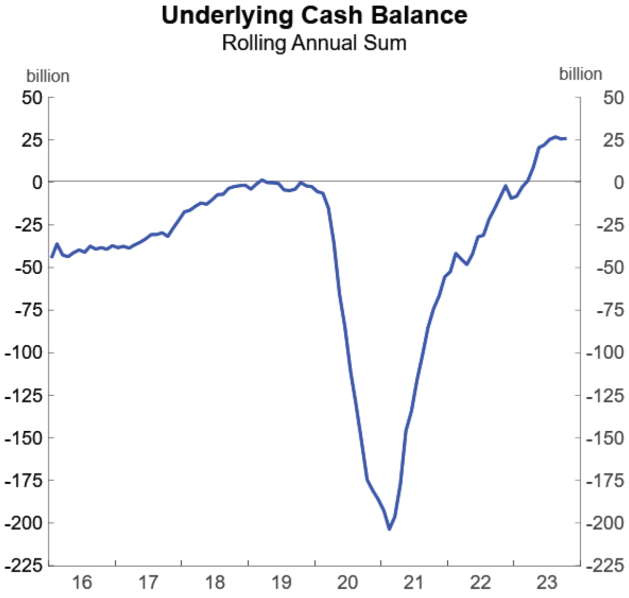
How are the finances tracking?

As its starting point, the 2023-24 Mid-Year Economic and Fiscal Outlook (MYEFO) will use the 2022-23 Final Budget Outcome (FBO) which showed the Government recorded a budget surplus of $22.1 billion - more than five times higher the $4.2 billion surplus predicted in May.

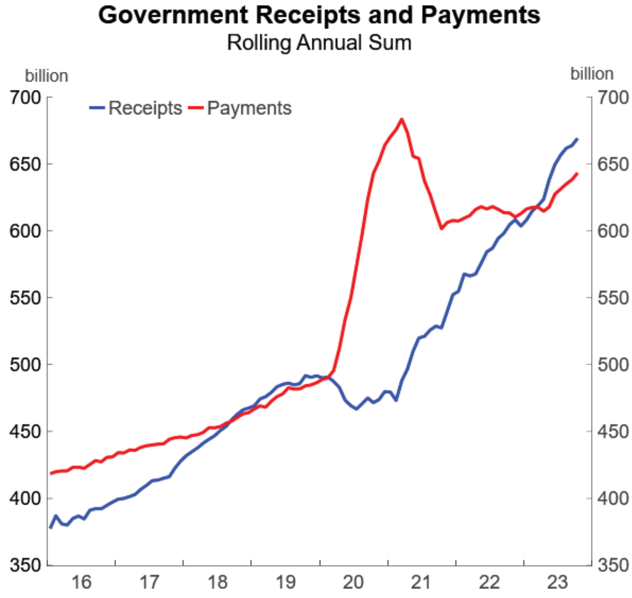
Since the end of the 2022-23 financial year, the Government's finances have continued to surprise on the upside. Over the first four months of the 2023-24 financial year, total revenue is tracking $8.4 billion ahead of where it was expected to be, while payments are tracking $0.8 billion lower.

This means over the year to the end of October the Government is running a surplus of around $25 billion. This number will fall through the remainder of the year as payments jump due to prescheduled increases from indexation and grants to state and local governments.

However, we're not expecting the bottom line to erode fully. Instead, we're expecting the Government will record a surplus of at least $11 billion when it unveils the 2023-24 FBO next September.



Sources: Australian Department of Finance, Macrobond



Sources: Australian Department of Finance, Macrobond

Higher commodity prices alone could wipe out the 2023-24 deficit.

One of the drivers underpinning the exceptional near-term budget outlook are the higher-than-expected commodity prices. Back in May the Government assumed the price of iron ore would fall from US$117 to US$60 tonne by the end of the March quarter 2024. We are almost at the end of the December quarter and the price of iron ore has increased to be around US$130 a tonne.

It doesn't just stop at iron ore. The metallurgical coal spot price was assumed to decline from US$342 to US$140 a tonne – it is currently trading around US$330 a tonne. And, the thermal coal spot price was assumed to decline from US$260 to US$70 a tonne – it is currently trading at around US$150 a tonne.

Taken together, this is likely to boost revenue by around $20 billion in 2023-24 and $10 billion in 2024-25. The fact that higher prices today impact tax revenue next year reflects the lags in the tax system – instalments paid by companies adjust with a lag. On assessment payments also rise with a lag as profits and taxable income surprise on the upside.

This increase alone could wipe out the budget deficit of $13.9 billion in 2023-24 expected in the May Budget.

But the record surge in overseas arrivals is likely to help.

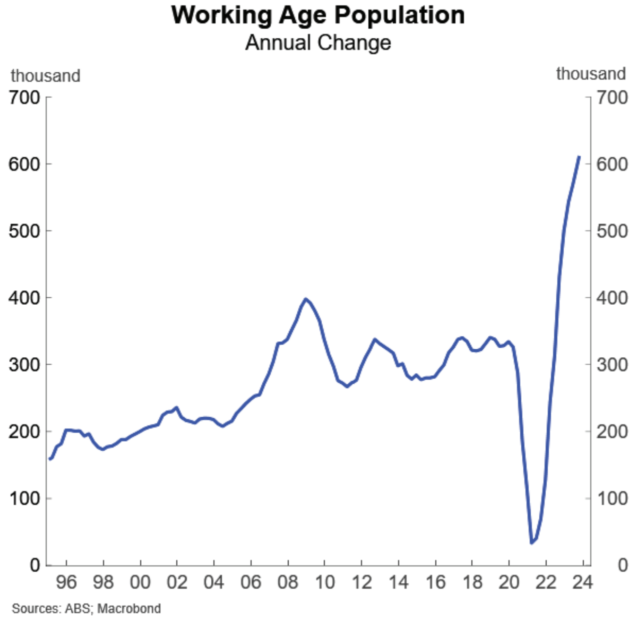
There has been substantial commentary to date focused on the budget windfalls from higher-than-expected commodity prices. However, the record surge in net overseas arrivals will also provide a significant fiscal dividend.

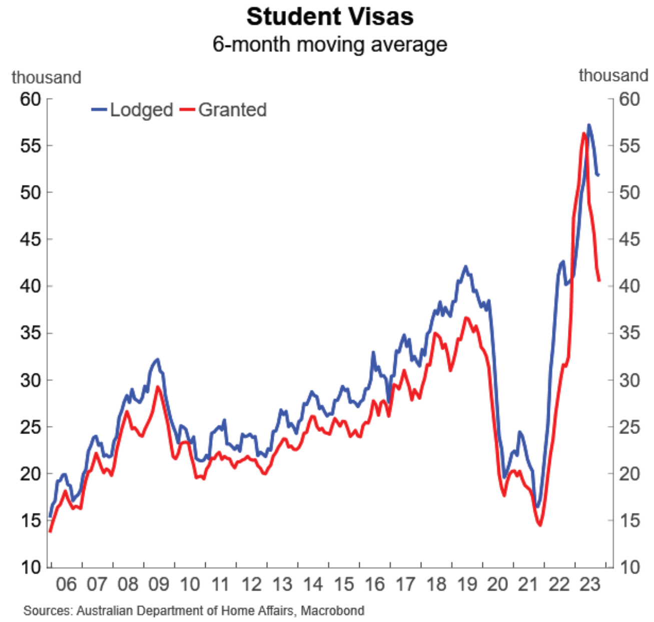
Foreigners that relocate to Australia pay income tax on their salaries and indirect taxes on the goods and services they consume. They also have limited access to subsidised public services and income support payments – this means that the net positive impact on the budget will be front loaded.

We are unlikely to remain in this sweet spot forever.

The Government has announced the revamped migration strategy which aims to better target the program toward areas where there are acute skill shortages and to reduce the size of the program over the next few years to more sustainable levels. Indeed, the Government is predicting that net overseas migration will fall from 510k in 2023-24 to 250k in 2024-25.

Integrity measures around student visas will be ramped up to ensure only genuine students come to Australia. We have recently seen the number of student visas lodged and granted decline sharply. Tightening up integrity around the program will help ensure that this continues. At the same time new skilled visas will help target important areas where specialist skills are needed.



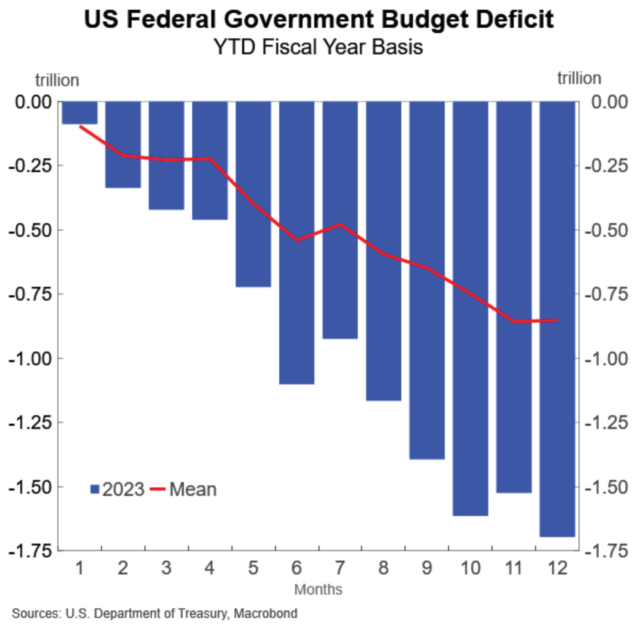


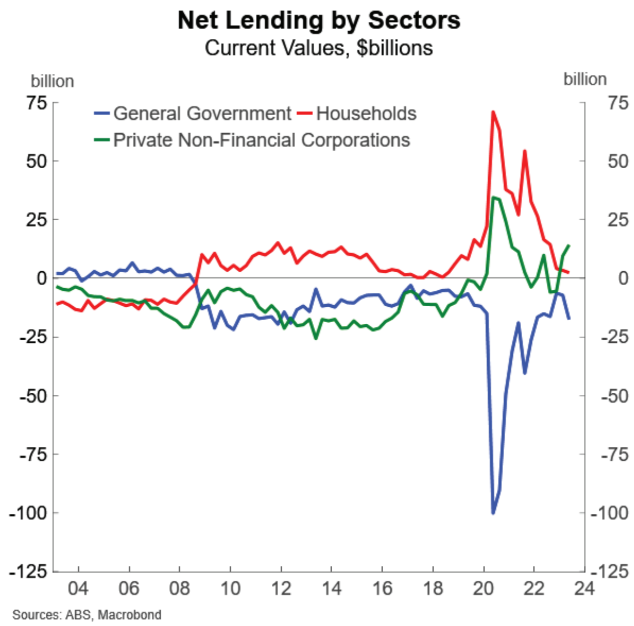
Saving windfalls makes sense in an uncertain world.

If the windfalls are temporary, should most of it be saved? We think so.

This will help ensure monetary and fiscal policy are working in tandem and will put us in a stronger financial position to weather future challenges. This is in contrast to the US where the general government deficit is running above average levels and debt levels are rising. This could see the US government have less fiscal flexibility to respond to the next shock.

In Australia, the ability to roll out significant fiscal packages in response to the COVID-19 pandemic and global financial crisis allowed us to weather these shocks more effectively than in other comparable countries.





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