BULLETIN

6 May 2024

Third consecutive surplus in sight

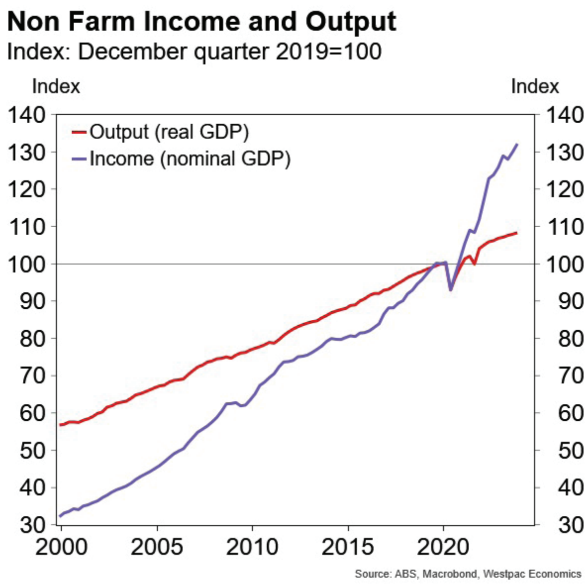
Large revenue upgrades have been a persistent feature of recent budget updates. In fact, since the October 2022 budget, revenues have been upgraded by a massive $341.3 billion over the five years from 2022–23 to 2026–27 – that's close to 15% of annual GDP!

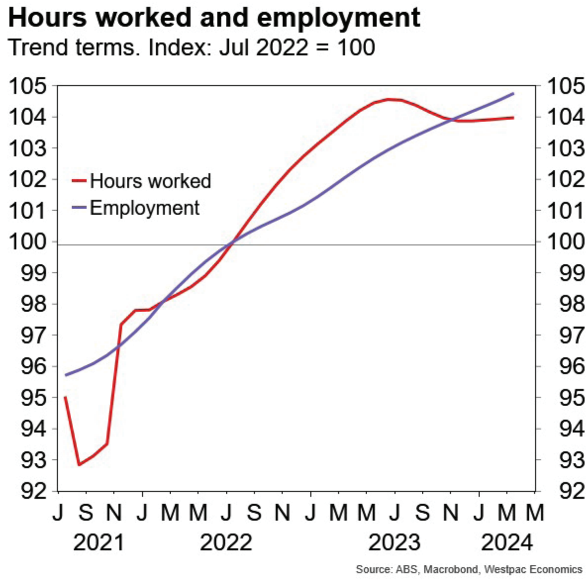
We have previously highlighted the conditions underpinning this remarkable windfall which we have coined the 'budget sweet spot'. High nominal income growth on the back of elevated and increasing commodity prices, accelerating wages growth, high inflation, record population growth and a tight labour market. Indeed, national income has grown by 30% since December 2019, almost four times the pace that output has expanded (8%) over the same period. In the pre pandemic period, national income grew about twice the rate of output.

However, the budget sweet spot can't last forever, the sugar-rush is slowing starting to wear off. The prices of some of our commodity exports are easing, while others remain elevated. Growth in nominal labour income is likely to slow from here: migration and population growth are slowing, and the labour market is loosening with the number of hours worked going sideways for the past nine months. And as inflation continues to decline, multiple tax basis, such as GST collections, will expand more slowly.

The days where we could rely on windfalls to fund policy and deliver strong budget outcomes were always numbered, but now they are running out fast. Instead, desirable fiscal outcomes – those which balance the need to take pressure off inflation while also supporting the more vulnerable – will only come on the back of a disciplined strategy that is calibrated to deal with this changing landscape and mounting structural and social challenges.

To see this shift in fortunes, you need only look at the Government's financial statistics, which track budget outcomes against forecasts on a monthly basis. At this time last year receipts were running around $15 billion above forecast. This year the statistics show that receipts are tracking around $650 million below forecast. While some taxes are tracking ahead of expectations (such as company tax and pay as you go income tax), others are well behind (such as superannuation taxes, possibly due to lower earnings and member contributions).





Company taxes are tracking ahead of forecast, in part driven by commodity prices which have remained elevated, defying their assumed decline. For example, the price of iron ore is sitting at around USD115 per tonne. Back in December, Treasury assumed that it would fall from the average of USD105 per tonne recorded in September to USD60 per tonne by the end of the September quarter 2024.

We estimate that the higher than assumed commodity prices will deliver the budget a revenue windfall of around $8.5 billion in 2023–24 and $22.5 billion over the four years to 2026–27.

However, using Westpac Economics' commodity price forecasts rather than Treasury's systematically conservative ones, we estimate that company tax receipts will be $54.7 billion higher over the four years of the forwards – more than double the upgrade estimated using Treasury's conservative assumptions. This would deliver a third consecutive surplus in 2024-25 and a balanced budget in 2026–27, assuming the impact of policy changes are offset.

On the other side of the ledger, government payments were $8.4 billion lower than forecast around this time last year, while this year they're $4.8 billion lower. This has been driven by lower-than-expected social assistances payment on the back of the labour market that has been more resilient than forecast, and grants made to states and local governments.

While our starting position is softer, there is some upside ahead.

Commodity prices have been higher than assumed by Treasury in the last budget update – the 2023–24 Mid-Year Fiscal and Economic Outlook (MYEFO). This will boost tax collections in the final quarter of the financial year, which will hand the Treasurer a second consecutive surplus. The assumed decline in commodity prices means that Treasury has not factored in large instalments and balancing payments from the mining sector (particularly iron ore miners) over the June quarter. The lags in the tax system will see some of the windfalls from the currently elevated commodity prices (particularly iron ore) flow through in the 2024–25 year. In addition, we're expecting upgrades on pay as you go income tax to be offset by downgrades in superannuation taxes, with indirect taxes remaining broadly unchanged.

In total, we expect receipts to be upgraded by around $23.9 billion over the four years to 2026–27. While significant and in line with pre pandemic outcomes, it's a step down from the upgrades recorded in the post pandemic period. Indeed, it is less than 20% of the $130 billion upgrade recorded last budget!

Change in underlying cash balance*

	2023-24	2024-25	2025-26	2026-27	Total
2023-24 MYEFO	-1,100	-18,800	-35,100	-19,500	-74,500
Receipts variations	8,681	11,005	2,777	1,400	23,863
Payments variations	-2000	-1500	-1500	-1800	-6,800
2024-25 Budget	9,581	-6,295	-30,823	-16,300	-43,837
% of GDP	*0.4*	*-0.2*	*-1.1*	*-0.5*	

*Positive (negative) number means an increase (decrease) in receipts and payments. Updated estimates are on a no "policy change" basis.

On the payments side of the budget, we're also expecting to see positive variations (lower than forecast payments). The labour market has been more resilient than Treasury was expecting back in December. This is part of the reason government payments are lower than forecasts and pay as you go income tax is higher than expected. Compared to the 2023–24 MYEFO print:

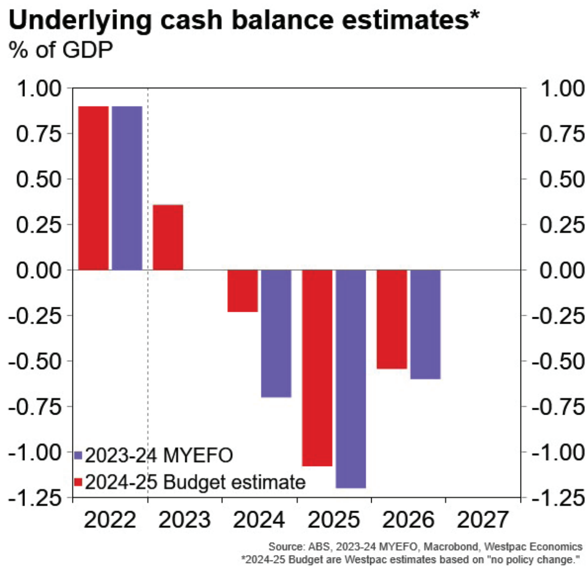
- the unemployment rate is on a slightly lower trajectory (3.8% in March compared to an implied forecast of 4.0% in March)
- inflation is broadly in line with forecasts (3.6% over the year to the March quarter compared to 3.75% in the June quarter)
- the exchange rate is broadly in line with the AUD/USD 0.6500 assumed in the 2023–24 MYEFO

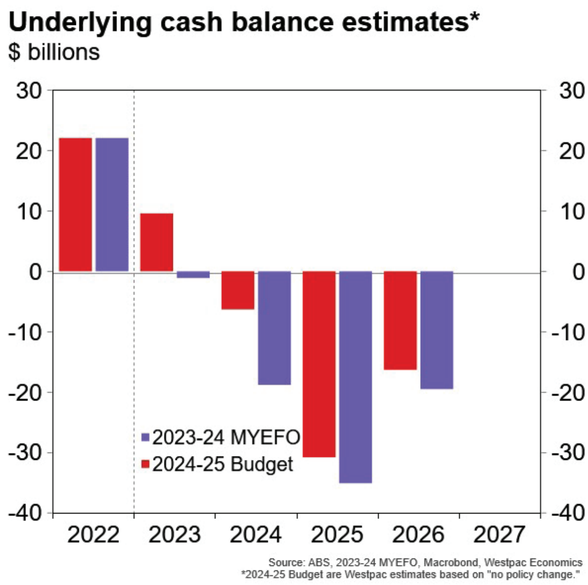
More broadly the economic backdrop is evolving in line with Treasury forecasts. The economy is growing at a below trend rate, as a result inflation is moderating, and the labour market is showing signs that it is also loosening.

There are also savings to be had from lower interest expenses on public debt. The improved bottom line (due to higher revenue) will reduce debt and therefore interest costs. Lower than assumed yields will also reduce interest costs for the government. Back in December, Treasury used an indicative weighted cost of capital over the forward estimates of around 4.7%. Today, we conservatively estimate this is running at around 4.5% (top-end of the recent yield on the 10-year government bond). The lower yield assumption will reduce interest payments, particularly in the outer years of the forwards when the government expects to roll over and issue new debt.

In total, we expect payments to be around $6.8 billion lover over the four years to 2026–27.

Putting this together, we're expecting to see a surplus of around $9.6 billion printed for 2023-24. As the temporary boost to revenue from higher commodity prices dissipates, the bottom-line shifts back to a deficit of $6.7 billion in 2024–25. Government payments are then forecast to outpace receipts, with the deficit growing to $31.2 billion in 2025–26 and $16.4 billion in 2026–27.





Relaxing the "prudent" assumption delivers a third consecutive surplus.

It's well-known that Treasury adopts conservative commodity price assumptions when forecasting. Here we look at what the revenue upgrades could be if we use Westpac's commodity price forecasts, as opposed to the prudent commodity price assumptions used by the Treasury. While our forecasts are also conservative, the currently elevated prices are more persistent reflecting underlying demand and supply conditions.

Commodity price assumptions*

	Sep-23	Sep-24	Sep-25	Sep-26
Iron ore				
2023-24 MYEFO	105	60	60	60
Westpac Economics	105	95	80	80
Metallurgical coal				
2023-24 MYEFO	264	140	140	140
Westpac Economics	264	240	210	200
Thermal coal				
2023-24 MYEFO	144	70	70	70
Westpac Economics	144	115	105	105

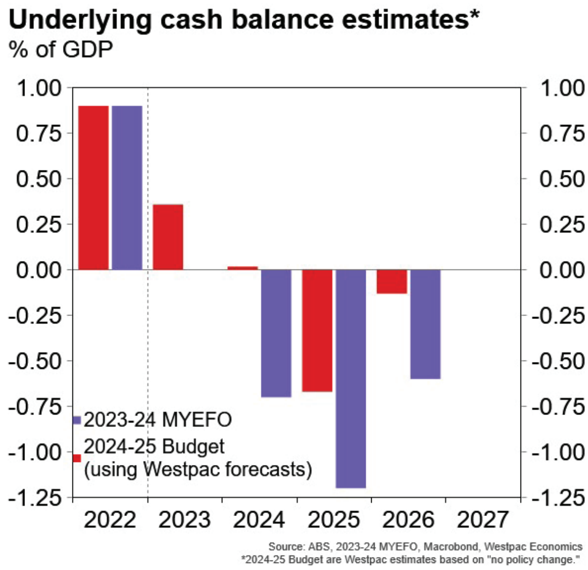
*All prices are in free-on-board (FOB) terms. Treasury assumes prices decline from elevated levels over four quarters – prices beyond the September quarter 2024 are implied.

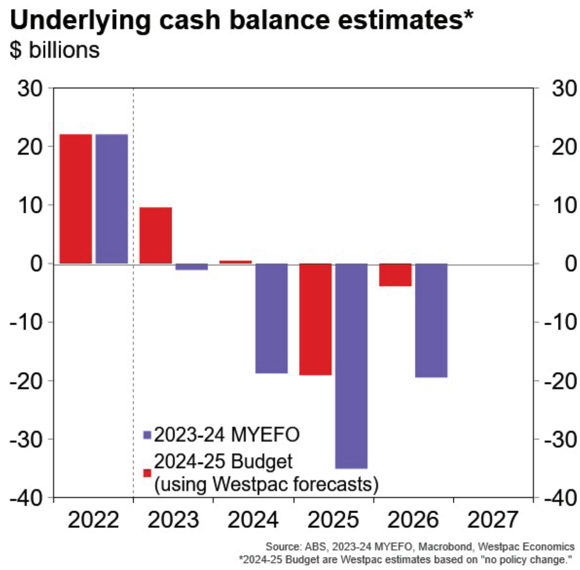
Using these forecasts, we estimate that total upgrades to receipts could be $54.7 billion over the four years of the forwards. More importantly, the Government could record a small surplus of around $500 million in 2024-25 and be in a balanced position in 2026-27 (small deficit of 0.1% of GDP).

This would be the budget outcomes in a "no policy change world" or a world where any new spending is offset by savings elsewhere. The government has announced several measures, which we will factor into our bottom line closer to budget, it remains unclear whether these measures will be offset.

This analysis clearly shows we are in a new fiscal world. Gone are days we could rely on revenue windfalls to drive surpluses. The attention now shifts to prudent fiscal management, which would not only place fiscal policy on a sustainable footing but would also continue to help the Reserve Bank in its fight against inflation.

Pat Bustamante, Senior Economist
Ph: +61 468 571 789





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