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Budget Monitor

Short term gain, long term pain

4 May 2023

Deloitte Access Economics

Budget Monitor is a source of independent projections of the Federal Budget, including detailed estimates of future spending and revenues.

Contents

Executive summary

Short term gain, long term pain

Budget aggregates

Based on policy announcements to 21 April 2023 and updated economic parameters, the underlying cash deficit is estimated to be $8.7 billion in 2022-23 before increasing to $35.6 billion in 2025-26. Net debt is expected to be 23.6% of GDP in 2025-26 compared to 28.5% estimated in the 2022-23 October Budget.

Budget forecasts

$ billion	2022-23	2023-24	2024-25	2025-26
Underlying cash balance % of GDP	-0.3%	-0.7%	-1.3%	-1.3%
Fiscal balance % of GDP	-0.4%	-0.8%	-1.7%	-1.3%
Revenue % of GDP	25.9%	25.5%	24.8%	25.1%
Expenses % of GDP	25.8%	25.8%	26.1%	26.1%
Net debt % of GDP	21.3%	21.8%	22.7%	23.6%

Source: Deloitte Access Economics

Economic drivers

Nominal economic growth will be faster in 2022-23 than the official forecasts assumed, providing an uplift in revenue. However, the economic outlook is weakening as a result of rising interest rates and fragile global conditions.

Revenue

The 2023-24 Budget is expected to reveal more than $80 billion in additional revenue over the next four years as a result of higher commodity prices and higher inflation than was assumed in the official forecasts.

Expenses

Policy announcements to 21 April 2023 include only a modest net increase in spending over the next four years, with lower unemployment and lower interest costs helping to offset an increase in spending from new policy.

Budget backdrop

The last edition of *Budget Monitor*, released ahead of the 2022-23 October Budget, talked of the 'cyclical serendipity' of high commodity prices and elevated inflation that was providing an enormous boost to tax revenue.

That hasn't changed.

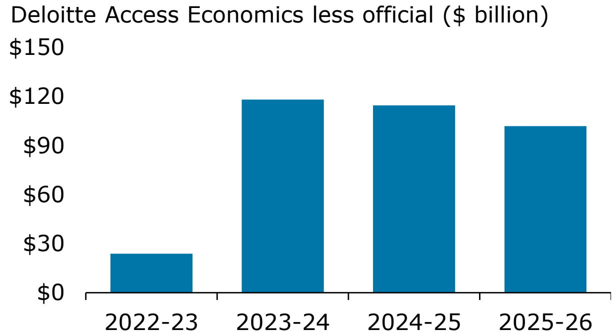
Although the economic headlines have hardly been positive of late, Deloitte Access Economics is expecting the economy to boost the bottom line by billions in the 2023-24 Budget. How can that be? Well, even though Australia's economic outlook has darkened, it's still brighter than what Treasury had assumed in the 2022-23 October Budget.

The temporary surge in tax receipts is delivering an astonishing turnaround in the government's fiscal position – so much so that the budget position crept back into the black over the 12 months to March 2023. Can that surplus be maintained for 2022-23 overall? It's a close call, though Deloitte Access Economics' best estimate is that the financial year will end in a small underlying cash deficit of some $8.7 billion.

As a direct result of that extra revenue, government spending will also be lower than otherwise thought.

The 2023-24 Budget is expected to show that spending on interest costs will be billions of dollars lower over the next four years, thanks to both more revenue (and hence smaller deficits) and lower interest rates. That will provide a further improvement to the budget bottom line in the years ahead, and means the profile for net debt will again be revised down.

Chart i Difference in nominal GDP forecasts



Source: Deloitte Access Economics, based on Commonwealth of Australia data

Despite the near term improvement in the budget bottom line, however, anyone expecting the May 9 Budget to include a cash splash aimed at Australians doing it tough is likely to be disappointed.

Something will be included to cushion the cost of living blow, with a likely focus on offsetting yet another round of rocketing electricity prices. Do too much, though, and the government risks putting additional upward pressure on inflation and encouraging the Reserve Bank of Australia (RBA) to hike interest rates further. Do too little and low income households, and the economy more generally, will be left teetering. It's little wonder, then, that the government has been describing this upcoming Federal Budget as 'a balancing act'.

But while this budget will detail a substantial improvement in the forecast deficits over the next four years compared to the official forecasts from October, it is expected to show a worsening of the longer term structural deficit.

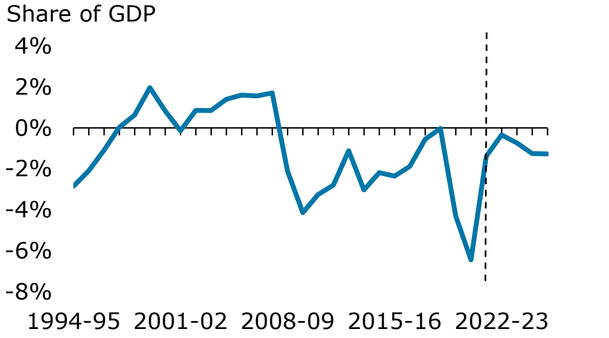
It seems very likely that the size of government – measured in terms of government spending as a share of the economy – will need to be higher in the future than it has been in the past. Both the latest official forecasts and the figures that Deloitte Access Economics is presenting in this edition of *Budget Monitor* show underlying cash payments reaching almost 28% of GDP a decade from now. For context, that compares to a multi-decade, pre-pandemic average of around 25% of GDP.

Not everyone will be happy about that. But given the seven large and critical areas of government spending that are growing most rapidly – health, education, welfare payments, aged care, the NDIS, defence and interest costs – it's hard to reach a different conclusion credibly and comprehensively.

Higher spending appears unavoidable but, importantly, that isn't a blank cheque. Government spending should be efficient, taxes should be as low as possible, and they should be levied in a way which does minimum damage to economic activity. These days, many of the ideas billed as 'tax reform' are actually ideas on 'budget repair'. Both are important, but they are two different topics.

The design of the tax system matters – perhaps now more than ever. Given the near term fiscal position is likely better than expected, and the longer term fiscal position likely worse, there is an imperative to act now.

Chart ii Underlying cash balance to GDP



Source: Deloitte Access Economics, based on Commonwealth of Australia data

Budget forecasts

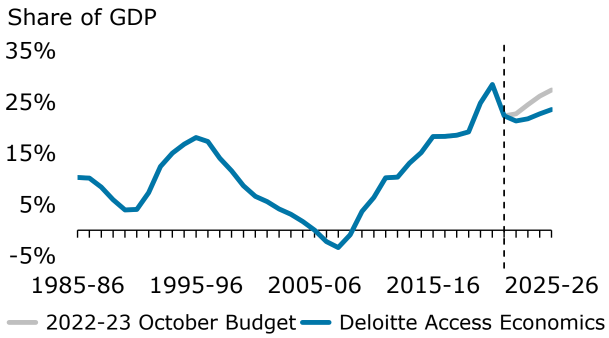
Deloitte Access Economics' forecasts for key budget aggregates are shown in Table i.

The strength in commodity prices and company tax receipts means that the 2023-24 Budget is expected to unveil more than $80 billion in additional revenue over the next four years, compared to what was included in the 2022-23 October Budget.

Spending is also expected to be higher as a result of policy announcements to 21 April 2023, which have been included in this report. That increase in spending from policy decisions is partially offset by a saving in interest costs (as a result of both lower deficits and a lower government borrowing rate). Cumulative underlying cash deficits are now expected to be $84.9 billion lower over the four years to 2025-26.

As a result, net debt – shown in Chart iii below – is expected to average less than 23% of GDP over the next four years, compared to the official forecast of more than 26% of GDP anticipated at the time of the 2022-23 October Budget.

Chart iii Net debt to GDP



Source: Deloitte Access Economics, based on Commonwealth of Australia data

Table i Budget projections

	Outcome 2021-22	Forecast 2022-23	2023-24	2024-25	2025-26
Budget aggregates, $ billion					
Revenue (accrual)	**596.4**	**652.8**	**659.0**	**666.0**	**703.9**
% of GDP	25.8%	25.9%	25.5%	24.8%	25.1%
Taxation revenue	**550.4**	**605.3**	**613.0**	**619.5**	**656.5**
% of GDP	23.8%	24.0%	23.7%	23.1%	23.4%
Non-taxation revenue	**46.0**	**47.4**	**46.0**	**46.5**	**47.4**
% of GDP	2.0%	1.9%	1.8%	1.7%	1.7%
Expenses (accrual)	**623.0**	**650.6**	**667.0**	**701.4**	**729.8**
% of GDP	27.0%	25.8%	25.8%	26.1%	26.1%
Fiscal balance	**-35.1**	**-10.6**	**-19.9**	**-44.4**	**-35.9**
% of GDP	-1.5%	-0.4%	-0.8%	-1.7%	-1.3%
Official forecast of fiscal balance	-35.1	-38.7	-44.9	-62.1	-49.9
Difference in fiscal balance	0.0	28.1	25.0	17.7	14.0
Underlying cash balance	**-32.0**	**-8.7**	**-19.0**	**-33.6**	**-35.6**
% of GDP	-1.4%	-0.3%	-0.7%	-1.3%	-1.3%
Official forecast of underlying cash balance	-32.0	-36.9	-44.0	-51.3	-49.6
Difference in underlying cash balance	0.0	28.1	25.0	17.7	14.0
Net cash flows from investments in financial assets[1]	**-1.3**	**-12.7**	**-6.7**	**-13.7**	**-14.1**
Headline cash balance	**-33.3**	**-21.4**	**-25.7**	**-47.3**	**-49.6**
% of GDP	-1.4%	-0.9%	-1.0%	-1.8%	-1.8%
Official forecast of headline cash balance	-33.3	-49.6	-50.7	-65.0	-63.6
Difference in headline cash balance	0.0	28.1	25.0	17.7	14.0
Net debt	**515.7**	**537.1**	**562.8**	**610.1**	**659.7**
% of GDP	22.3%	21.3%	21.8%	22.7%	23.6%
Official forecast of net debt (% of GDP)	22.5%	23.0%	25.8%	27.4%	28.5%
Economic forecasts, % growth					
Real GDP	3.7%	3.1%	0.9%	1.6%	2.0%
Employment^	3.6%	2.1%	0.8%	1.3%	1.6%
Unemployment rate*	3.8%	3.7%	4.3%	4.6%	4.6%
Consumer price index^	6.1%	6.6%	3.2%	2.4%	2.5%
Wage price index^	2.6%	3.8%	3.7%	3.1%	3.0%
Nominal GDP	11.0%	9.0%	2.7%	3.8%	4.4%

Rates of growth in all tables (unless otherwise indicated) are 'year average percentage changes' – the percentage change between the year indicated and the prior year. ^Employment, consumer price index and wage price index are through the year growth to the June quarter. *Unemployment rate is the rate for the June quarter. 'Official forecasts' refer to projections in the 2022-23 October Budget.
[1] Net cash flows from investments in financial assets for policy purposes. Prior to 1999-00 these flows were known as 'net advances'.
Source: Deloitte Access Economics, Commonwealth of Australia.

Budget backdrop

A short term boost to revenue hides longer term cracks and the reform imperative.

This edition of *Budget Monitor*

Budget Monitor provides an independent view on the Federal Budget.

Unless otherwise indicated, the official forecasts shown in this issue of *Budget Monitor* are drawn from the 2022-23 October Budget.

To produce the budget forecasts presented in this report, Deloitte Access Economics has updated the latest budget figures by incorporating:

- Latest actual Commonwealth Monthly Financial Statements data for 2022-23 published by the Department of Finance and available up to March 2023
- The effect of policy decisions announced by the Federal Government up to and including 21 April 2023
- The effect of changes in economic parameters based on Deloitte Access Economics' latest forecasts and therefore capturing any difference between those forecasts and Treasury's view of the economic outlook included in the last Budget.

Deloitte Access Economics' latest economic forecasts were published in the March 2023 edition of *Business Outlook* and released publicly on 18 April 2023.

This edition of *Budget Monitor* includes analysis showing the budget implications of a number of alternative tax policy settings. This analysis should be considered with reference to the assumptions and caveats included throughout this report. Importantly, the modelled policies do not represent an exhaustive set of reform options. Rather, they are a few examples of balanced, meaningful and achievable reforms that would place the budget on a firmer structural footing, while contributing to a more equitable and efficient tax system.

Tax reform is not an end in itself. Rather, it serves a number of important economic and social functions. To this end, good tax reform should be consistent with the interrelated objectives of efficiency, equity, investment which drives productivity, and economic development.

As economies undergo structural change, tax reform must be seen as both a driver of, and responder to, this structural change. A fit for purpose tax system reinforces trust in government and drives economic prosperity.

The remainder of this backdrop describes a complex economic and policy context for the preparation of the 2023-24 Budget.

A balancing act

For too many years, politics has dominated economics and reform has fallen by the wayside. That result is not costless. Deloitte Access Economics' latest *Business Outlook* forecasts no growth in economic output per person – a measure of our standard of living – over the next three years. Why? One key reason is that policymakers have not been tending to the capacity of the economy, have kicked the can of reform down the road, and have made permanent budget commitments based on temporary revenue gains.

There are two circumstances which provide the opportunity for reform – when a crisis hits or when there are rivers of gold flowing into the Treasury coffers. At the intersection of the end of the pandemic and a surge in revenue, the time is ripe for reform.

Balancing the nation's books has never been an easy job. However being the Treasurer of Australia has scarcely seemed more difficult than it does right now. That's not a comment on the current occupant of the role but of the situation that he is facing – revenue is up strongly, but using that money to provide cost of living relief risks further fanning inflation.

With a meaningful number of households around the country feeling the pinch from cost of living pressures – from higher prices at the supermarket and soaring rents to the rapid rise in interest rates – the desire to use the budget to help would be difficult to resist.

It would be made even more tempting knowing that tax revenue is flooding into the government coffers at a rate that would make even the most optimistic Treasurer blush.

As the following pages of this edition of *Budget Monitor* make clear, the government is in the midst of banking yet another 'unanticipated' revenue boost thanks to Treasury's very conservative assumptions for commodity prices in the 2022-23 October Budget.

Despite the need and the near term capacity, anyone expecting the Budget to include a cash splash aimed at Australians doing it tough is likely to be disappointed.

Among those will be the authors of the first *Economic Inclusion Advisory Committee* report, released a few weeks before the Budget. The centrepiece recommendation of that report was a suggested increase in the JobSeeker payment from the current level of just below $50 per day up to a level equivalent to 90% of the age pension (or around $68 per day). It's a policy change that is hard to argue with. A payment of $68 per day is not generous, and with the unemployment rate so low, those recipients currently receiving JobSeeker are people with a genuine need.

That makes this a very worthy and necessary policy change. However, at a cost of some $6 billion per year, it would also be expensive, and the Government has been quick to hose down expectations.

Something will be included in the Budget to cushion the cost of living blow, with a likely focus on offsetting yet another round of rocketing electricity prices. Do too much, though, and the government risks putting additional upward pressure on inflation and encouraging the RBA to hike interest rates further. Do too little and low income households (and the economy more generally) will be left teetering.

JobSeeker should absolutely be increased, but inflation pressures haven't gone away. A middle ground would be to phase in a lift to JobSeeker, and to change the indexation so that it keeps pace with other payments over time, such as the age pension.

Added to that mix are some important structural considerations regarding the future health of the budget position. Indeed, balancing the budget is a concern for the longer term, while balancing the economy is about finding the right settings to match the economic conditions of the moment.

It's little wonder, then, that the government has been describing this upcoming Federal Budget as 'a balancing act'. Will that balance be achieved? Competing budget priorities need to be considered with reference to an overarching framework. They involve, among other things, questions of values and ethics, fairness and efficiency, affordability and sustainability. That's why Deloitte Access Economics has long described the Federal Budget as the nation's social compact.

Decisions on the size and composition of taxation and spending need to be made holistically. Spending needs to align with the level and quality of government services that Australians want, expect and – importantly – are willing to pay for. That should dictate the amount of tax revenue needed, and that revenue should be raised as efficiently and equitably as possible. That overarching narrative has been missing from Australian political discussion for a long time. Policy is mostly decided in a piecemeal fashion and talk of real tax reform has too often been seen as an election risk. This has skewed the political and economic discourse much more to the short term than is desirable.

The day after the 2022-23 October Budget was handed down, Deloitte Access Economics described the document as one of 'no surprises'. That's a polite way of saying 'no significant decisions'. Being the Treasurer is a difficult job. But it's time for some difficult decisions.

Tax policy: The case for reform

Tax reform is becoming more boring.

Not more boring in the sense that a general discussion on the merits of tax reform now causes the average Australian's eyes to glaze over the way few other topics can – that has always been true. But more boring in the sense that the conversation has barely advanced in the last two decades.

While reform has stalled, the discussion over this period has largely focused on changes designed to make taxes less damaging to the economy, benefiting the 'winners' from reform and enabling a degree of compensation for the 'losers'. That type of tax reform is good for the economy because it boosts productivity and allows necessary government revenue to be raised in the most efficient way.

The Henry Tax Review – published exactly 13 years ago – was an important contribution, though the list of tax policy proposals produced in Australia in recent decades would fill more than a couple of libraries.

By definition, economic reform – including tax reform – involves trade-offs. It is virtually impossible to implement sensible, productivity-boosting reforms that also leave every single individual in a better position. And yet politicians have become increasingly allergic to policy changes which make anybody worse off.

As many commentators have opined, it is difficult to imagine yesterday's economic reform successes – from Hawke and Keating on tariffs, superannuation and financial deregulation to Howard on the goods and services tax (GST) – being matched by today's politics. But this is a tad harsh, as there are reformists on both sides of the political divide, but reform is difficult to navigate when short-termism dominates.

Many of the reforms of past decades represented some of the low hanging fruit – the slightly more obvious, though not more straightforward proposals – but it is also true that, in days gone by, politicians were better able to focus on the 'bigger picture' without a 24 hour news cycle which amplifies the voices of the 'losers' of reform and drowns out the voices of those who stand to gain alongside the long term economic benefits.

Unfortunately, the task of implementing tax changes that will boost productivity and make Australia a more prosperous country has also now become even harder for another reason: the Federal Budget has a deep structural deficit problem.

Indeed, while the Federal Budget released on 9 May will detail a substantial improvement in the forecast deficits over the next four years compared to the official forecasts from October – so much so that a surplus is within touching distance – it is expected to show a worsening of the longer term structural deficit.

The significance of that structural deficit means that, these days, many of the ideas billed as 'tax reform' are actually ideas on 'budget repair'. Both are important, but they are two different topics. Those two general themes – the fact that Australia's national conversation in relation to tax reform is increasingly dominated by the 'losers of reform', and the fact that the Federal Budget is in a more dire longer term position – are a dangerous combination.

The Federal Budget needs more revenue. But how that revenue is raised matters for the future of Australia.

The design of the tax system matters – perhaps now more than ever. Rather than snatching extra tax revenue from the easiest source, government should be looking to move Australia's tax system toward better taxes that give us better outcomes as a country. Given the near term fiscal position is likely better than expected, and the longer term fiscal position likely worse, there is an imperative to act now.

Some guiding principles

If anyone was starting with a blank sheet of paper, Australia's existing tax and transfer system is not what would be sketched. While that's not a realistic benchmark, it's a sign the current design can and should be improved. As noted above, the existing research and work dedicated to designing a better tax system is vast.

This edition of *Budget Monitor* is not seeking to restate the case comprehensively, but rather to add to the discussion with some costed examples of policy changes that would be a step in the right direction. In order to propose policy changes, however, some general principles should be applied. The size of government – measured in terms of expenditure as a share of the economy – will likely need to be higher in the future than it has been in the past. But that's not a blank cheque. Without the guidance of good fiscal rules, budget policy can lack credibility and become unsustainable over time.

The following two guiding principles are not exhaustive, but they would be a good start:

1. The level of spending should enable the provision of quality government services, support economic reforms. Tax revenue – on average, over the economic cycle – should be sufficient to provide these services and allow debt to be reduced gradually and consistently as a share of the economy.
2. Taxes used for general revenue raising should be levied as efficiently and equitably as possible. Tax bases should be as broad as possible and tax rates should be as low as possible. Equity should be considered across various dimensions, including intergenerational equity.

Neither of these principles are revolutionary or radical. Nor are they new ideas. But they are sensible fiscal rules which can not only lead Australia back to a balanced budget – they can also set the platform for a better tax system and a fairer and more productive Australia.

Transparency of long run objectives and open conversations of reform – with an inclusive approach to dialogue – is the only way to drive consensus on reform beyond the forward estimates and beyond the electoral cycle.

The budget suffers from some known structural challenges dominated by spending pressures in a number of large and rapidly growing programs. That spending is funded by a mix of taxes and related fiscal settings which are less efficient than they could be and less equitable than they should be.

At the same time, the Australian economy is also suffering from structural challenges.

It is well known that Australia's population is ageing. However, it is sometimes forgotten that the proportion of Australians born after a particular year continues to increase over time. In 2020, for example, the proportion of Australians who were born after 1970 (and were therefore aged 50 or younger at the beginning of this decade) surpassed two-thirds.

This cohort spent at least their formative years – and, for many, their entire lives – experiencing the exhilaration brought by the forces of globalisation, technological change and financialisation.

These Australians have known homes to be not just a roof over their head but also a source of wealth and income; witnessed the demolition of Australia's 'tyranny of distance' through vast improvements in electronic communication and commercial air travel; enjoyed the productivity gains brought by the internet, wifi and smartphones; and made the most of the possibilities that more open access to capital markets can enable.

How can it be, therefore, that this cohort includes the first generation of Australians expected to be worse off financially compared to their parents? The answer to this complex question of income and intergenerational inequality is not straightforward. But the budget can help.

Economic reform that pays attention to building the productive capacity of the economy through incentivising investment is key to lifting productivity and our standards of living. With an ageing population and with the looming challenge of climate change, this is more important than ever. Australia's tax system can better support both growth and fairness, driving wealth creation and economic inclusion.

The anticipated near-term improvement in the country's fiscal position provides the perfect opportunity to put in place some measures that can help to push back against these issues, before they become even more entrenched, and even more difficult to unwind.

Implications for budget policy

Deloitte Access Economics has modelled some examples of policy changes that are consistent with good fiscal rules. These changes, together with others, can both improve Australia's tax mix and shift the budget back towards a more sustainable footing over time.

Rather than being the whole solution, this should be seen as a starting point for policy debate beyond just tax reform. Most of the policies could help to repair the budget and, in various combinations, would shift the tax system in the right direction for a stronger and fairer economy. Complemented by reforms to competition in markets, regulatory efficiencies, innovation and education reforms, and an improvement in the efficiency of public services, tax reform can drive economic growth with a better, more equitable, distribution of the economic pie.

An explanation of three policy changes, along with a costing of the budget implications, is outlined in the final chapter of this report, with a summary provided below.

Stage 3.1: <u>Even less</u> personal income tax

The budget needs more revenue and that means tax revenue needs to increase overall. But that doesn't mean that *every* tax should increase.

Australia's personal income tax rates have been the subject of much discussion in recent years, with particular reference to the legislated Stage 3 tax cuts which will apply from 1 July 2024.

Most of that discussion has focused on the large cost of the tax cuts and the fact that they mainly benefit high income earners. Both of those features of the Stage 3 tax cuts are true. However, even with the Stage 3 tax cuts in place, the official forecasts from the 2022-23 October Budget show personal income tax collections increasing by 1.5% of GDP over the next decade. That will see taxes on the income of individuals account for more than 53.5% of all tax revenue in the budget, and the average rate of personal income tax climb to a record high of 26.4%.

In Deloitte Access Economics' view, changes need to be made at bottom end of the personal income tax structure to reduce complexity, ease administrative burden and contain the contribution that personal income tax makes to the revenue base (with more efficient taxes filling the void).

The current tax free threshold of $18,200 has remained unchanged for more than a decade and should be increased, while flatter personal income tax thresholds would help to deal with bracket creep.

A broad(er)-based GST with a higher rate

One of the most efficient taxes levied by the Commonwealth is the GST. At its introduction in 2000, the rate of the GST was set at 10% and the tax base excluded several segments of household expenditure. Very little has changed since then – the rate is still 10% and the tax base has undergone only very minor tinkering. But as a relatively efficient tax, the GST should raise a greater proportion of Australia's tax revenue.

The GST is not a progressive tax because Australians with higher incomes spend a smaller proportion of that income relative to Australians with lower incomes.

Deloitte Access Economics' modelling of an increase in the rate of the GST to 15% and a broadening of the base includes appropriate compensation for low income households.

An important note: This proposal would see the Commonwealth retain the additional revenue raised, rather than the states and territories.

A less generous capital gains tax discount

The capital gains tax (CGT) discount of 50% for assets held for longer than 12 months is intended to provide an allowance for inflation and encourage savings. That is, the discount is applied in recognition that inflation accounts for some of the gain in the value of an asset over time, and that only the real, inflation-adjusted gain should be taxed. That principle makes good sense, and it could be achieved – as used to be the case – via indexation. But that can be complicated, while discounting the taxable gain is straightforward. Even with the burst of inflation seen over the past year, the 50% discount over-compensates. Deloitte Access Economics has modelled a reduction in the discount from 50% to 33.33%.

The long list

Good budget reform is more than just revenue and spending, but goes to the purpose of reform – to build productive capacity, to incentivise human agency, to distribute economic gains fairly, to shape the structure of our economy and the nature of our society.

To this end, tax reforms should be analysed and debated. The pros and cons should be subject to scrutiny, the trade-offs the subject of debate, the distributional impacts analysed.

The reality is that perfect tax reform will never be implemented, so a menu is needed to assess various combinations. Various individuals or organisations have provided a list of ideas over many years, including within the Ralph Review, the Henry Review, and the publications of the Grattan Institute, Business Council of Australia and the Australian Council of Social Service, to name a few.

In this edition of *Budget Monitor* we delve into some of the detail on three reform ideas, A broader list for debate is included below:

- Specific and targeted reviews of the largest and fastest-growing Commonwealth spending programs, including reform of the NDIS and eliminating waste and fraud in the Medicare system

- Reducing the corporate tax rate for large businesses to 25%, while more efficiently taxing those segments of the economy which earn economic rents – a generally accepted principle in good fiscal management
- Comprehensively dealing with inefficiencies in the way labour income is taxed relative to income from saving and investing
- Introducing a carbon tax to ensure that the cost of polluting is ultimately borne by the polluter and helping to incentivise the clean energy transition
- Introducing road user charging
- Reforming superannuation where tax concessions distort the incentives to save
- Supporting the states and territories to abolish inefficient taxes such as stamp duty and reform other taxes such as payroll tax.

As an aside, readers may be looking for one item that is not on this list: negative gearing. A fundamental tenet of the tax system is that costs incurred in the course of earning taxable income are deductible. That includes interest costs on debt borrowed to fund the purchase of an income-producing asset.

All Australians should be on notice: taxes will likely need to be higher in the future. Deloitte Access Economics' long list includes a lot of good policy and, in net terms, would raise a lot of revenue. Not all of these policies would be popular, but good, bad or indifferent, these reform ideas, and others, should be on the table for a respectful discussion.

A better debate on tax cannot wait.

Economic outlook

The economy hands over revenue on a platter.

The Australian economic outlook

Nominal GDP and the terms of trade

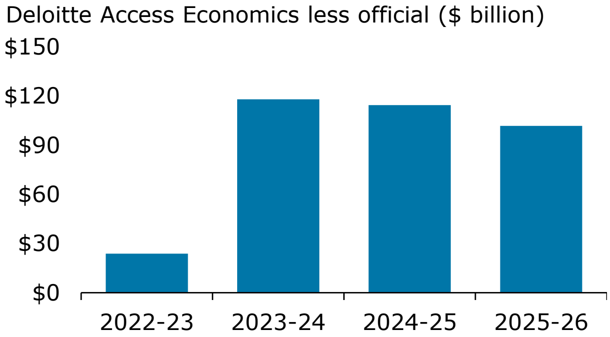
Commentary and headlines related to the Australian economy have hardly been complementary of late. While the labour market remains robust, cracks are appearing and rapidly widening throughout other parts of the economy, sparking fears of a significant slowdown.

Readers may therefore be a touch surprised to note that Deloitte Access Economics is expecting the economy to boost the bottom line by billions in the 2023-24 Budget. How can that be? Well, even though Australia's economic outlook has darkened, it's still rosier than what Treasury assumed in the 2022-23 October Budget.

That is particularly true in relation to nominal GDP growth. Treasury's assumed nominal GDP growth for 2023-24 included in the previous Budget was -1.0%, compared to Deloitte Access Economics' current forecast of 2.7% (which itself may turn out to be on the low side).

Treasury's assumption that nominal GDP would contract in 2023-24 was consistent with deliberately conservative commodity price (and therefore terms of trade) assumptions.

Chart 1 Difference in nominal GDP forecasts



Source: Deloitte Access Economics, based on Commonwealth of Australia data

The 2022-23 October Budget assumed steep falls in commodity prices such as iron ore and thermal coal. That wasn't a surprise – such conservatism has been a feature of budgets since 2017, following almost a decade of over-estimating commodity prices and company tax revenue after the 2008 financial crisis. (As an aside, the Treasurer has confirmed that the 2023-24 Budget will include an alternative approach to arriving at commodity price assumptions, but one that remains 'conservative and cautious'.)

Suffice to say, the steep falls in commodity prices assumed in the previous Budget have not come to fruition. Rather than fall, the iron ore spot price is today higher than it was in October 2022. And while the thermal coal price has declined, it hasn't come close to dropping by more than 86%, as the 2022-23 October Budget assumed.

Higher commodity prices mean a larger nominal economy, and a larger nominal economy means more tax revenue. As Chart 1 shows, Deloitte Access Economics expects nominal GDP to be some $360 billion larger over the next four years compared to the assumptions included in the 2022-23 October Budget. That will provide a huge boost to revenue in the near term.

The other economic parameter which will have an outsized influence on the bottom line in the 2023-24 Budget is interest rates. The combination of less borrowing (due to the lift in revenue) and slightly lower borrowing costs will save billions in interest repayments over the next four years.

The real economy

There is less good news in the outlook for the real economy, with households and the housing sector weighing on the near term picture.

Deloitte Access Economics is expecting real economic growth of less than 1.0% in 2023-24, compared to nominal growth of almost 3.0%. If realised, that would be the slowest pace of real growth since the early 1990s excluding the pandemic period.

A slowing in the rate of economic growth shouldn't be a surprise. The RBA has raised interest rates at a record pace, inflation is materially outpacing wage growth and has pushed up the cost of living, and the housing sector is dealing with the hangover of higher materials prices and labour shortages. At the same time, businesses are increasingly cautious and unwilling to invest in growth for the future, and the international environment is full of risks.

That combination makes for a sobering outlook. There are, however, some important positives to note. Deloitte Access Economics expects that interest rates have now peaked in Australia, particularly after the RBA hiked the cash rate again at the Board meeting in May.

Another positive for the economy is the recent surge in the number of permanent and temporary migrants streaming into Australia.

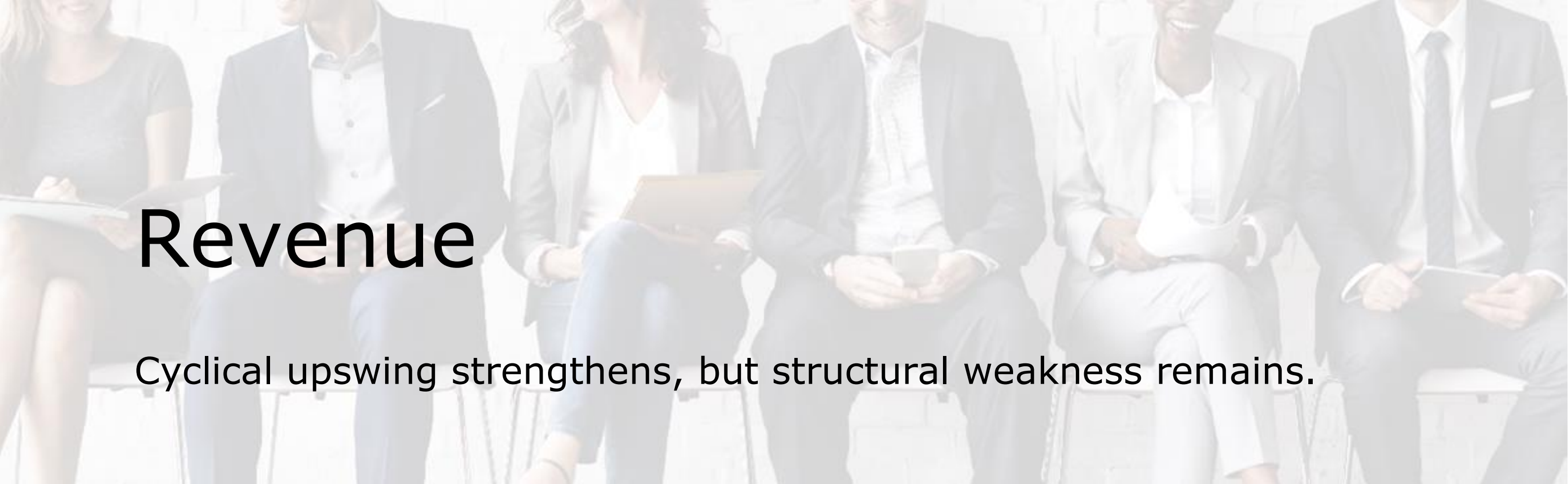
Though that's not unambiguously good news. Australia's housing market is exceptionally tight and the prospect of a further large step change in the number of people looking for somewhere to live is daunting. But a larger population will add to demand in the economy and is expected to help stave off recession.

The subdued pace of economic growth in Australia over the next 12-18 months is expected to see the unemployment rate drift gradually higher, though not drastically so. It's the nominal economy that matters most for the Federal Budget, and so while a slowdown in real terms is hardly helpful, the economy is still boosting federal coffers more than was anticipated when the last official forecasts were prepared in October.

Table 1 Australian economic forecasts (% growth)

	History 2021-22	Forecasts 2022-23	2023-24	2024-25	2025-26
Gross domestic product					
Household consumption	3.7%	5.3%	0.0%	1.4%	2.3%
Dwelling investment	2.9%	-3.8%	-1.2%	4.3%	5.8%
Business investment	7.0%	3.5%	-0.2%	0.8%	2.5%
Public final demand	6.4%	2.0%	3.7%	3.1%	2.8%
Gross national expenditure	5.1%	3.0%	0.7%	2.0%	2.6%
Real GDP	3.7%	3.1%	0.9%	1.6%	2.0%
Nominal GDP	11.0%	9.0%	2.7%	3.8%	4.4%
Prices and wages					
Consumer price index^	6.1%	6.6%	3.2%	2.4%	2.5%
Wage price index^	2.6%	3.8%	3.7%	3.1%	3.0%
GDP deflator	7.1%	5.8%	1.7%	2.1%	2.3%
Terms of trade	11.8%	-2.5%	-5.6%	0.5%	0.7%
Labour market and population					
Participation rate*	66.7%	66.5%	66.4%	66.4%	66.4%
Employment^	3.6%	2.1%	0.8%	1.3%	1.6%
Unemployment rate*	3.8%	3.7%	4.3%	4.6%	4.6%
Population	0.7%	1.7%	1.5%	1.4%	1.4%

Note: Base year for real data is 2019-20. Rates of growth in all tables (unless otherwise indicated) are 'year average percentage changes' – the percentage change between the year indicated and the prior year. ^Employment, consumer price index and wage price index are through the year growth to the June quarter. *Unemployment rate and participation rate is the rate for the June quarter.
Source: Deloitte Access Economics, Australian Bureau of Statistics



Revenue

Cyclical upswing strengthens, but structural weakness remains.

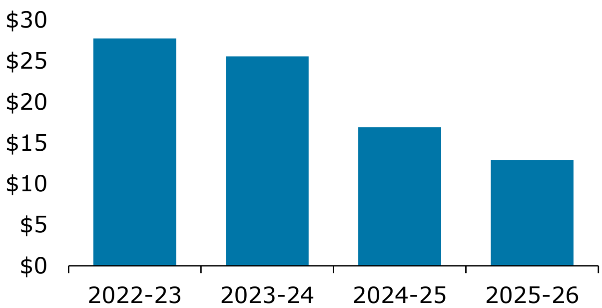
The last edition of *Budget Monitor*, released ahead of the 2022-23 October Budget, talked of the 'cyclical serendipity' of high commodity prices and elevated inflation that was providing an enormous boost to tax revenue.

That hasn't changed. The temporary surge in tax receipts continues to deliver an astonishing turnaround to the government's fiscal position – so much so that the budget position crept back into the black over the 12 months to March 2023. Can that surplus be maintained for 2022-23 overall? It's a close call, though Deloitte Access Economics' best estimate is that the financial year will end in a small deficit.

Can that surplus be maintained further into the future? In short, no. While clearly less 'temporary' than previously expected, the cyclical upswing delivering record revenues will eventually peter out.

That doesn't necessarily mean that revenue will undershoot official forecasts (Treasury's conservative assumptions on commodity prices – expected to be slightly less conservative in the 2023-24 Budget – will help to make sure of that).

Chart 2 Total revenue forecasts compared to 2022-23 October Budget



Source: Deloitte Access Economics, based on Commonwealth of Australia data

Table 2 Accrual revenue estimates ($ billion)

	2022-23		2023-24		2024-25		2025-26	
	Official estimate	*Budget Monitor*	Official estimate	*Budget Monitor*	Official estimate	Budget Monitor	Official estimate	Budget Monitor
Individuals[1]	286.6	296.8	311.5	318.9	305.5	313.7	327.3	334.9
Company tax	129.9	149.5	101.7	119.3	117.7	124.8	128.0	132.2
Superannuation fund taxes	12.7	10.3	20.5	22.0	22.0	23.5	24.4	25.5
Other income tax[2]	6.2	6.8	5.9	5.9	5.5	5.6	5.3	5.5
Total income tax	**435.4**	**463.4**	**439.6**	**466.1**	**450.8**	**467.5**	**485.1**	**498.2**
GST	86.8	85.8	88.6	87.0	90.8	90.4	95.5	95.0
Excise and customs duty	42.9	43.2	46.3	46.4	47.8	48.0	49.3	49.3
Other indirect tax[3]	12.8	13.0	13.2	13.5	13.3	13.5	13.7	14.0
Total indirect tax	**142.5**	**142.0**	**148.1**	**146.9**	**151.9**	**152.0**	**158.5**	**158.3**
Total taxation revenue	**577.9**	**605.3**	**587.7**	**613.0**	**602.7**	**619.5**	**643.6**	**656.5**
Non-taxation revenue[4]	**47.1**	**47.4**	**45.8**	**46.0**	**46.4**	**46.5**	**47.5**	**47.4**
Total revenue	**625.0**	**652.8**	**633.4**	**659.0**	**649.1**	**666.0**	**691.0**	**703.9**

Note: Official estimate refers to 2022-23 October Budget. 1 Individuals includes gross income tax withholding, gross other individuals less refunds. 2 Other income tax includes fringe benefits tax and petroleum resource rent tax. 3 Other indirect tax includes wine equalisation tax, luxury car tax, Major Bank Levy, Agricultural levies, and other taxes. 4 Non-taxation revenue includes sales of goods and services, interest, dividends and distributions, other non-taxation revenue.
Source: Deloitte Access Economics, The Commonwealth of Australia

But it does mean that, at some point, the upside surprises that are proving so lucrative will be a thing of the past.

Deloitte Access Economics expects that some $27.8 billion in additional revenue will be collected in 2022-23 compared to what was expected in the last official forecasts in October 2022. If realised, that would see revenue in 2022-23 increase by more than $56 billion on the prior year, compared to a $39 billion lift in expenditure.

Deloitte Access Economics' revenue forecasts compared to the latest official estimates are shown in Chart 2 and Table 2 on the previous page.

Individuals and other withholding tax

Gross income tax withholding

The single largest component of tax revenue is income tax withholding, which has been boosted by recent strength in the Australian labour market. That strength has held up even as the national economic outlook has deteriorated, and the unemployment rate remains around the lowest rate in 50 years.

A stronger labour market means more Australians earning a salary and paying income tax. This is expected to pay off over the forward estimates, with Deloitte Access Economics forecasting more revenue from gross income tax withholding in each year from 2022-23 to 2025-26 compared to the forecasts in the 2022-23 October Budget.

This is a result of a more positive outlook for employment compared to the latest official forecasts. Deloitte Access Economics is expecting employment growth of 2.1% over the year to June 2023, while the 2022-23 October Budget anticipated 1.8%. Cumulatively over the forward estimates, Deloitte Access Economics' forecasts for employment are 1.0% higher than the official forecasts.

While wage growth is expected to be slightly softer over the next four years, the stronger forecast for employment growth means that Deloitte Access Economics' expectations for the overall wage bill are higher than Treasury's latest numbers over the next four years.

Chart 3 Wage Price Index

Source: Australian Bureau of Statistics, Deloitte Access Economics

The largest policy affecting gross income tax withholding is the Stage 3 tax cuts. By reducing the marginal tax rate that applies to income over $45,000 to 30 cents, the Stage 3 cuts provide relief to most taxpayers. But by extending that 30 cent rate up to $200,000 – and abolishing the 37 cent rung of the income tax system in the process – the policy primarily advantages high income earners (with the earlier Stages 1 and 2 favouring low and middle income earners).

Even with the Stage 3 cuts in place, however, the share of Commonwealth taxation revenue accounted for by tax on individuals' earnings (including the Medicare levy) continues to increase over time. The average income tax rate paid by Australians is expected to climb to a record high over the next decade.

Overall, Deloitte Access Economics anticipates income tax withholding to be some $27.1 billion higher in total than the October 2022-23 Budget forecasts over the next four years.

Gross 'other individuals' tax

'Other individuals' includes taxes on non-wage incomes such as from unincorporated (often small) businesses, as well as on farm incomes, interest, rent and dividends, plus taxes on some wages and salaries not in withholding tax.

There are several factors that placed upward pressure on 'other individuals' tax collections in the current financial year, most of which will remain relevant in 2023-24:

- The incomes of farmers were increased by elevated export prices and near-record volumes
- Dwelling rents are in the process of moving higher given the very tight housing market and surge in migration
- Higher interest rates mean that interest income for savers is higher than it has been for some time.

CommSec has estimated that some $35 billion in aggregate dividends will be paid by Australian companies from February to June 2023. That result is down some 17% from the previous reporting period six months earlier, but similar (down 3%) to the same period in 2022.

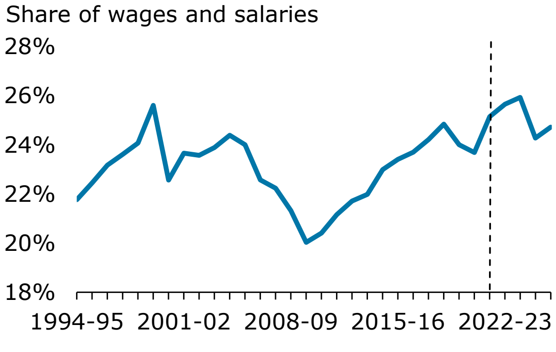
Income tax refunds for individuals

The stronger outlook for the labour market and income tax withholding results in Deloitte Access Economics forecasting marginally larger income tax refunds relative to the latest official estimates throughout the forecast period (a net negative for revenue). The size of refunds also depends on any relevant policy decisions. This includes the extension of the low and middle income tax offset (LMITO) into 2021-22, which has added to refunds in 2022-23. While Deloitte Access Economics' forecast refunds are slightly higher than the official figures over the forward estimates period, they are below the artificially high peak seen in 2022-23 caused by the LMITO extension.

Total revenue from taxes on individuals

Total revenue from taxes on individuals is forecast to be higher than official forecasts throughout the forecast period, though the outperformance is strongest in 2022-23 as a result of the firmer expectations for employment growth.

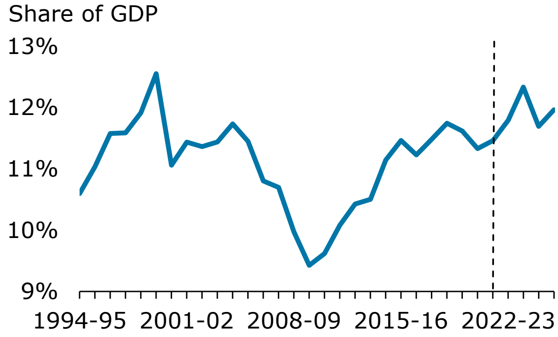
Chart 4 Average rate of personal income tax



Source: Deloitte Access Economics, Australian Bureau of Statistics

The average rate of personal income tax is expected to be more than 25.7% in 2022-23 – the highest rate since the late 1980s – while taxes on individuals as a share of the economy is similarly approaching close to a record high, as seen in Chart 5 below.

Chart 5 Taxes on individuals as a share of GDP



Source: Australian Bureau of Statistics, Deloitte Access Economics

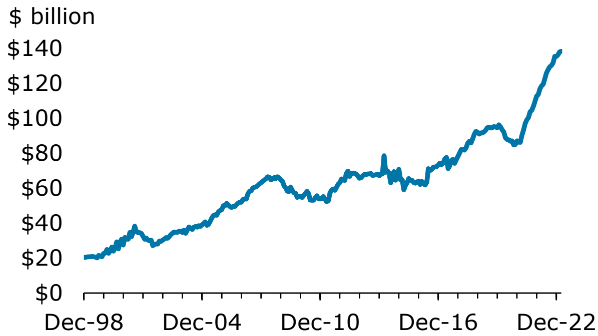
Company and other (non-personal) income tax

Company income tax

Company income tax is the key driver of the forecast improvement in the budget bottom line. In 2022-23, company tax collections are expected to go close to breaching $150 billion for the first time. That result would be almost a $20 billion improvement on the official forecast revealed in October 2022 and represents growth of 18.7% compared to company tax collected in 2021-22 (itself the previous record high).

Deloitte Access Economics expects company income tax revenue to be higher than official estimates throughout the next four years, though most of that outperformance is anticipated in 2022-23 and 2023-24 as a result of elevated commodity prices. Iron ore and thermal coal prices are well above the levels assumed in the 2022-23 October Budget, while metallurgical coal prices are also slightly higher. The resultant windfall is only temporary, however, as commodity prices are expected to begin to moderate. This presents a degree of risk for the company tax take once commodity prices and mining profits return to more normal levels, given relative softness in non-mining profits.

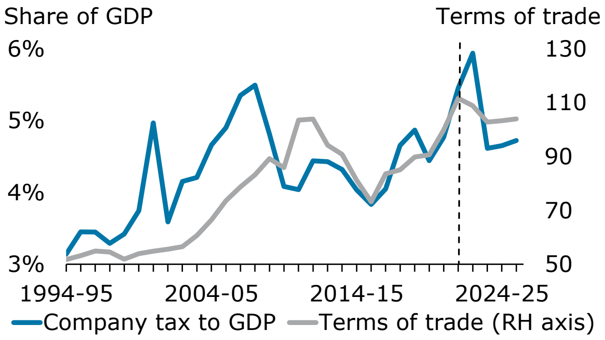
Chart 6 Company tax, rolling 12 month total



Source: Deloitte Access Economics

The company revenue tax take is expected to be some 20% lower in 2023-24, compared to 2022-23, though this is a fall from a forecast record high. Company tax revenue is then expected to see growth of 4.6% and 6.0% in 2024-25 and 2025-26 respectively. On average, company tax is expected to be around 60% higher over the forward estimates period compared to the average level seen over the past decade.

Chart 7 Company tax and terms of trade



Source: Australian Bureau of Statistics, Deloitte Access Economics

Fringe benefits tax

The stronger anticipated growth in employment (and the wage bill more generally) is expected to result in a modestly higher fringe benefits tax (FBT) collections compared to the forecast in the 2022-23 October Budget. Deloitte Access Economics forecasts FBT collections to be above official forecasts from 2022-23 to 2025-26, adding a relatively meagre $470 million to revenue in total over that period.

Petroleum resource rent tax

Petroleum Resource Rent Tax (PRRT) collections are expected to be higher in 2022-23 compared to the latest official forecast.

Natural gas prices have declined since mid-2022 as weaker economic conditions outweighed supply-side constraints due to the embargo on Russian energy commodities.

Despite those falls, gas prices remain historically high and are currently well above the $630 per tonne assumption included in the 2022-23 October Budget. An expected further retreat in prices beyond 2022-23 means Deloitte Access Economics is anticipating revenue recede.

The outlook for global gas prices is highly dependent on the development of global conditions, however, including the length of the conflict in Ukraine.

This presents a degree of upside risk in PRRT collections from 2023-24, given that the prices of both oil and gas may again shift higher, while Treasury has now completed a review of reforms to the PRRT and has delivered recommendations to Government. Any resulting policy changes are expected to see the tax take increased in the future.

Superannuation fund taxes

Superannuation taxes are levied on contributions to super and earnings from super. The stronger than expected growth in employment noted earlier is a positive for the overall wage bill and taxes on superannuation contributions. The superannuation guarantee rate is also legislated to increase from its current rate of 10.5% to 12% by 2025-26, which will add further to contributions (and, therefore contributions taxes).

However, the upward pressure on contributions taxes is expected to be more than offset by a fall in earnings taxes. The Australian and global share markets play a large role in super fund earnings, and these funds have weakened amid a slowdown in the global economy.

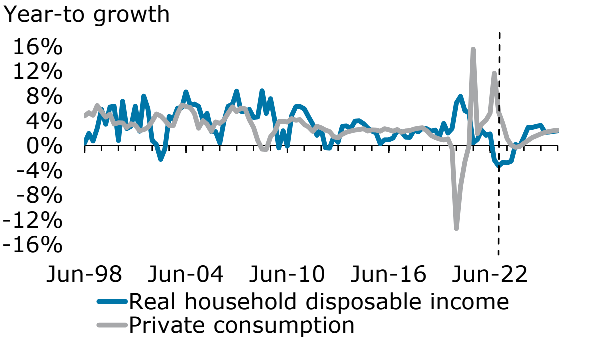
After doubling in 2021-22 to $26.6 billion, superannuation taxes are forecast to fall back to around $10.3 billion in 2022-23. This reflects weaker tax receipts on earnings following the strong returns in 2021-22. Super taxes are expected to grow solidly from 2023-24 due to taxes on steadily rising contributions and an assumption of more average returns.

Goods and services tax

Consumer spending is a key driver of GST revenue and an important indicator of the health of overall economic activity.

However, the near term prognosis for spending is far from rosy, as household budgets are squeezed by cost of living pressures amid a rise in interest rates and a high inflationary environment. While household spending is expected to grow by 5.3% for the 2022-23 financial year, economic conditions will see the pace of spending stagnate through 2023-24.

Chart 8 Consumer spending and real household disposable income



Source: Australian Bureau of Statistics, Deloitte Access Economics

Dwelling construction activity – another key source of GST revenue – is also expected to weaken as economic conditions deteriorate. Residential property construction activity is expected to fall by almost 20% in 2022-23 relative to 2021-22. That said, strong underlying demand should see a recovery in 2024-25 and 2025-26.

Due to the current economic conditions, Deloitte Access Economics expects GST collections to underperform the 2022-23 October Budget forecasts over the forward estimates period. Most of that underperformance is anticipated in 2022-23 and 2023-24, with the gap to the official forecasts narrowing thereafter. The total difference in GST receipts is forecast to be $3.5 billion over the next four years.

Excise and custom duties

Excise duties

Excise duties apply to a range of products, most notably petroleum products, beer, spirits and tobacco.

The excise is paid on the volume of products manufactured in Australia and rates are typically indexed twice per year in line with the Consumer Price Index.

Total excise duty is forecast to surge at double-digit rates in 2022-23 and 2023-24 as petroleum collections recover from the temporary cut in the excise rate in 2022, and higher inflation flows through to index rates across all products. But the pace of growth is forecast to slow from 2024-25. Deloitte Access Economics forecasts a similar amount of excise revenue over the next four years compared to the forecasts in the 2022-23 October Budget.

There are several longer-run trends influencing this part of the budget including the increased uptake of electric vehicles (with recently announced fuel emission standards pressing fast-forward on this transition) and the fact that Australians are drinking smaller quantities of more expensive alcohol (which hurts excise collections that are based on volume rather than value).

Customs duties

Customs duties are levied on the nominal value of imports which, thanks in particular to higher prices, continues to run hot. That is driving some small upward revisions to customs duties across the forecast period. Demand is strong for the sorts of products that attract customs duty.

A long history of trade liberalisation means that customs duties are levied on a relatively small base. Around one third of revenue comes from passenger vehicles and textiles, clothing and footwear. New passenger vehicle sales are continuing to grow following an extended period of supply chain disruptions, while the amount spent on clothing rose sharply over the past year.

Deloitte Access Economics forecasts slightly higher customs duty revenue across the forecast period from 2022-23 to 2025-26 compared to the official forecasts. But the bulk of the better news is in 2022-23 as overall collections are forecast to fall from 2023-24 as pressures on household budgets weighs on import values.

Other indirect tax

Other indirect taxes include the Major Bank Levy, the Wine Equalisation Tax, agricultural levies and broadcasting fees, as well as all other tax revenues collected by Commonwealth agencies.

Deloitte Access Economics expects other indirect taxes to broadly track in line with official forecasts in each year to 2025-26, with only a relatively modest $1.1 billion of additional indirect tax revenue (or around 2%) anticipated over the next four years compared to the forecasts in the 2022-23 October Budget.

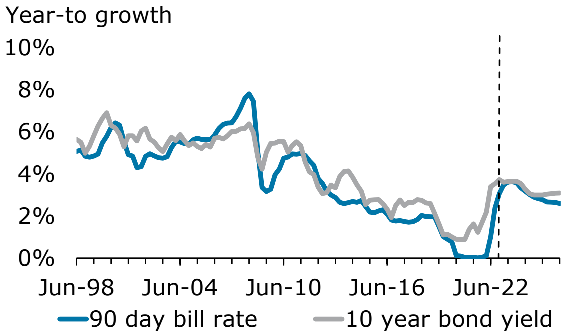
Non-taxation revenue

Interest receipts

The Australian Government owes a lot of money, but there are a few debts – and interest payments on those debts – that go the other way.

These interest receipts come from the states, cash balances held with the RBA, other financial assets and on money earned from the Commonwealth guarantee on some of the borrowings of the commercial banks.

Chart 9 Interest rates



Source: Deloitte Access Economics

Dividend receipts

The main dividends typically received by the government are those from the RBA. These dividends are drawn from underlying earnings and realised gains and losses on assets the RBA sells in the market.

However, the combination of the central bank's response to the pandemic period and higher bond yields has left its financial position in pieces. Deloitte Access Economics is not anticipating that a dividend will be distributed to the government for many years to come.

Dividends from other entities – in particular, Australia Post – will help, though a lack of a divided from the RBA is likely to mean 2022-23 records the lowest level of dividend receipts since 2017-18.

Other non-taxation revenue

Other non-tax revenue includes the sales of goods and services (revenues from the direct provision of goods and services and amounts paid by the states to the Commonwealth for the provision of GST collections), as well as earnings from the Future Fund.

Deloitte Access Economics expects other non-tax revenue to rise modestly in 2022-23, before falling slightly in 2023-24. This is driven by weaker markets weighing on Future Fund earnings.

Expenses and budget aggregates

Kicking the can…

Expenses

Overview

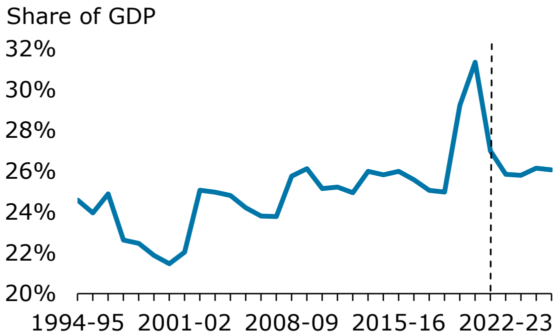
Economists can't help but find the bad news in almost any situation.

The revenue picture painted in the previous section of this report is quite something, and the fact that the budget was in surplus over the 12 months to March 2023, just a few years after the onset of the COVID-19 pandemic, is extraordinary. The additional boost to revenue now expected over the next four years will make that picture even brighter.

As a direct result of that extra revenue, government spending will also be lower than otherwise thought. The 2023-24 Budget is expected to show that spending on interest costs will be billions of dollars lower over the next four years, thanks to both more revenue (and hence smaller deficits) and lower interest rates.

Where, then, is the bad news? Deloitte Access Economics' concern is that the short term boost to revenue will further delay the decisions needed to get the budget position on a stronger footing over the longer term.

Chart 10 Accrual spending as a share of GDP

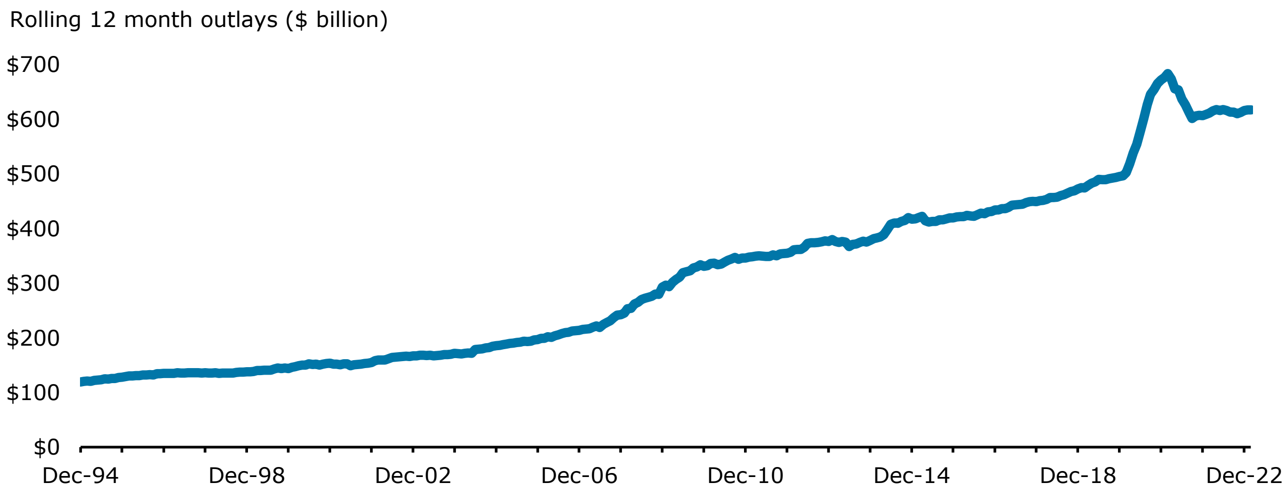


Source: Deloitte Access Economics, based on Commonwealth of Australia data

It seems very likely that the size of government – measured in terms of government spending as a share of the economy – will need to be higher in the future than it has been in the past. That doesn't necessarily mean larger budget deficits and more debt – it could mean higher taxes instead.

Not everyone will be happy about that. But given the seven large and critical areas of government spending that are growing most rapidly – health, education, welfare payments, aged care, the NDIS, defence and interest costs – it's hard to reach a different conclusion credibly and comprehensively.

Chart 11 Federal spending, rolling 12 month total



Source: Based on Commonwealth of Australia data

Both the latest official forecasts and the figures that Deloitte Access Economics is presenting in this edition of *Budget Monitor* show underlying cash payments reaching almost 28% of GDP a decade from now. For context, that compares to a multi-decade, pre-pandemic average of around 25% of GDP.

Higher spending appears unavoidable but, importantly, that isn't a blank cheque. Government spending should be efficient, taxes should be as low as possible, and they should be levied in a way which does minimum damage to economic activity.

But Australians rightly seem to want their government to fund and effectively deliver services such as the NDIS, and aged care and defence. Those programs can be tweaked – and spending caps such as the 8% annual growth cap for the NDIS can be implemented – but the costs are still enormous.

What about other spending? Couldn't that be pared back in order to make room? Absolutely. But that's already occurring, with the 2022-23 October Budget assuming that total spending outside of those seven areas will decline by almost 1.5% of GDP over the next decade.

Note, spending on this 'other' category will still rise in absolute terms, but the slower growth will see its share of overall government spending fall from more than 38% today to less than 32% ten years from now.

So, government spending will be higher in the future as a share of the economy. That isn't a particularly controversial statement given that government spending has been gradually trending upward as a share of the economy for decades. But without a matching increase in revenue, it is a recipe for an ever worsening budget deficit.

That's the hard part for politicians and policymakers. When somebody needs to make a difficult decision, it is usually best not to delay lest the situation worsens. Yet it increasingly seems as though the government is biding its time until after the next election, now potentially less than two years away, to make the tough calls.

The budget implications of the recent Defence Strategic Review are a potential case in point. That the additional $19 billion required over the next four years to fund the Review's recommendations will come from within the existing Defence budget is welcome.

That the full cost of the recommendations is currently unknown and has been pushed out beyond the current budget period – and the current election cycle – is far less encouraging.

The Treasurer has been candid in his statements on the budget challenge and the role of government in the economy more generally. Here's hoping that translates into actions.

The net effect of parameter variations and those policy decisions that have been announced are outlined below.

Effect of parameter variations

Differences between Deloitte Access Economics' latest economic forecasts and those in the 2022-23 October Budget provide the basis for some of the adjustments from the official forecasts.

The expenses reconciliation in Table 3 shows that slightly faster inflation in the current year compared to Treasury's previous expectations will add to spending, given that a range of spending is indexed to consumer prices.

However the most significant parameter in this upcoming Federal Budget is interest rates. The cost of borrowing may be rising rapidly for households, but the interest rate that applies to most of the Commonwealth's new borrowing – the government bond rate – is lower today than it was expected to be at the time the 2022-23 October Budget was finalised.

That means that interest repayments on new borrowing will be lower than previously thought, while lower deficits mean there will need to be less borrowing overall.

In terms of specific drivers:

- **Activity:** Deloitte Access Economics typically uses the unemployment rate as a proxy for the impact of economic activity on government spending. The labour market remains in good shape, though the unemployment rate is likely to drift higher through 2023 and 2024.
- **Exchange rates:** Differences in exchange rates affect the budgeted cost of interest payments, defence purchases, foreign aid, and embassy spending.
- **Prices:** Inflation remains elevated and is expected to reach 6.6% over the year to June 2023 compared to an assumption in the 2022-23 October Budget of 5.75%.

- **Wages:** Variations in wages affect outlays both directly (via higher wages for the public service) and indirectly (via programs that are effectively partly indexed to wage costs). Wage growth has returned to pre-pandemic norms though will strengthen only moderately from here.
- **Interest rates and the budget balance:** The cost of Public Debt Interest (PDI) can vary due to changes in the size of the debt, and changes in the interest rate charged on the debt.

Overall, economic parameters are expected to subtract from spending compared to the 2022-23 October Budget, most notably in the back half of the forward estimates period and predominately due to the impact of interest costs.

Table 3 Expenses reconciliation ($ billion)

	Forecast 2022-23	**2023-24**	**2024-25**	**2025-26**
Official accrual spending	650.9	666.5	702.3	731.0
Budget Monitor accrual spending	650.6	667.0	701.4	729.8
Difference on accrual outlays	-0.4	0.6	-0.8	-1.1
Effect of parameter variations (net, including public debt interest)	*-0.3*	*-1.9*	*-2.7*	*-2.9*
Effect of policy decisions (net)	*1.0*	*4.0*	*2.2*	*2.3*
GST adjustment	*-1.1*	*-1.6*	*-0.4*	*-0.5*
Effect of parameter variations				
Unemployment	0.0	-0.4	0.3	0.8
Exchange rates	0.0	0.0	0.0	0.0
Consumer price index	0.9	0.6	0.6	0.6
Wages	0.0	0.0	-0.1	-0.4
Public debt interest variation	-1.2	-2.0	-3.4	-4.0
Total effect of parameter variations (net)	**-0.3**	**-1.9**	**-2.7**	**-2.9**
Effect of policy decisions taken since 2022-23 October Budget				
Agriculture, Environment and Water	0.0	0.0	0.0	0.0
AG, Defence, Home Affairs, Emergency Management and VA	0.0	0.3	0.0	0.0
Child Care, Education, Skills, Training and Youth	0.0	0.0	0.0	0.0
Climate Change and Energy	0.1	1.5	0.0	0.0
Communications and the Arts	0.1	0.1	0.1	0.1
Families, Social Services, NDIS and Government Services	0.0	0.1	0.0	0.0
First Nations	0.0	0.0	0.0	0.0
Foreign Affairs and Trade	0.0	0.0	0.0	0.0
Health and Aged Care	0.1	1.9	2.0	2.0
Infrastructure	0.0	0.0	0.0	0.0
Secure Jobs and Industry	0.0	0.0	0.0	0.0
Treasury, Finance, Housing and the Public Service	0.7	0.1	0.1	0.1
Other	0.0	0.0	0.0	0.0
Total effect of policy decisions (net)	**1.0**	**4.0**	**2.2**	**2.3**

Note: Effect of policy decisions taken since election have been identified by Deloitte Access Economics from public sources and include decisions announced to 21 April 2023. While the intention is to include all announcements, the list may not be exhaustive.

Effect of policy decisions

The government has been working through the vast amount of funding allocated to policies as a part of election commitments. However, as usual a smattering of new spending policies have been announced ahead of the Budget. Some of these commitments were to address crises across Australia, including:

- Supporting households through cost of living pressures through the Energy Bill Relief Fund (totaling $1.5 billion)
- Dedicating funds to Central Australia and Alice Springs to improve community safety ($250 million for Central Australia and an additional $48 million for Alice Springs community safety programs)
- Increased homelessness funding (including an extra $67.5 million to states and territories for the National Housing and Homelessness Agreement and $91.7 million for the youth homelessness Reconnect program over the next three years)
- More funding for family, domestic and sexual violence support ($16.4 million over four years for the National Perpetrator Intervention and Referral Services program and to train frontline workers)

Some of the new commitments relate to longer term policies and spending including:

- New spending associated with the AUKUS submarine deal
- Ongoing funding to Australia's cultural institutions (through a $535.3 million investment in the National Collecting Institutions over four years)
- Funding for the Government's new National Cultural Policy, Revive ($286 million over four years)

While Deloitte Access Economics doesn't make a game of trying to predict further spending that will be announced in the Budget, there are a few further commitments that are expected, including in relation to cost of living (which has been a key theme in the lead up to the Budget).

In all, costs associated with the new policy measures shown in *Budget Monitor* are only those that have been announced between the 2022-23 October Budget and 21 April 2023. As a result, these figures are likely quite a bit lower compared to the cost of new policy evident in the Budget. Policy decisions already announced are expected to add an estimated $9.5 billion to net spending over the forward estimates.

Total accrual spending

The overall impact on accrual spending is shown in Table 3 above. Taken together, the net effect of parameter variations and policy decisions (plus an adjustment for the expected change in the distribution of the GST to the states and territories), is that spending over the four years to 2025-26 is expected to be broadly in line with what was expected at the time of the 2022-23 October Budget. Keep in mind that is in net terms – that is, the increase in spending after allowing for the spare cash that lower interest repayments will offer.

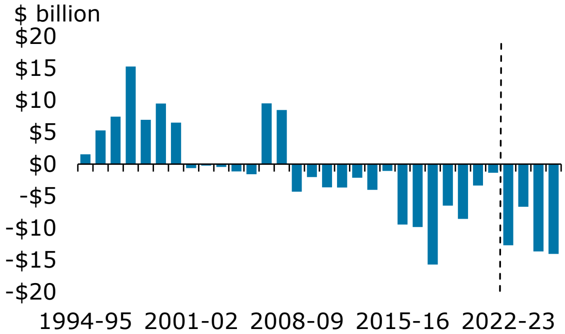
As a result, and combined with the increase in revenue expected over the same four years, the position laid out in the 2023-24 Budget will look healthier over the forward estimates than the corresponding figures from October 2022. That's a great result, and will no doubt dominate all the headlines on the day after the Budget is handed down. But it's beyond the next four years that has Deloitte Access Economics concerned.

Net advances and other matters

Net advances are the final element needed to estimate the headline cash balance. Headline deficits have been worse than underlying deficits over the past decade. As seen in Chart 12, that trend will worsen still as a result of governments' increasing penchant for parking funds to pay for large spending promises in 'off budget' entities.

That term is a misnomer, of course. 'Off budget' doesn't mean that you can't find the policy in the budget papers. It is better described as 'indirect', 'alternative' or 'balance sheet' financing – the money still appears on the balance sheet and in the headline cash balance, but not in the (typically referenced) underlying cash balance.

Chart 12 Difference between the headline and underlying cash balance



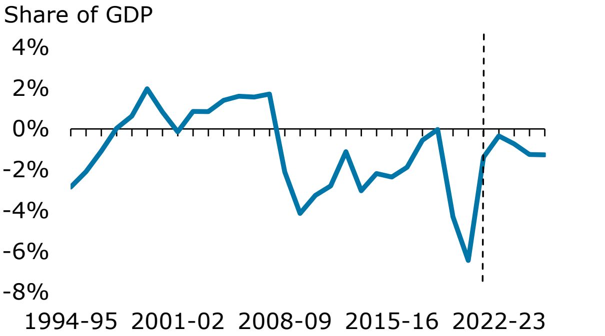
Source: Deloitte Access Economics, based on Commonwealth of Australia data

The budget balance

Deloitte Access Economics' overall budget aggregate projections are shown in Table 4 below. Relative to the 2022-23 October Budget, the table shows an improvement in the underlying budget balance of $28.1 billion this year and some $84.9 billion over the four years to 2025-26.

That's a very healthy improvement in just six short months, and sees the underlying balance sitting at an average of less than 1.0% of GDP over the period to 2025-26 (see Chart 13).

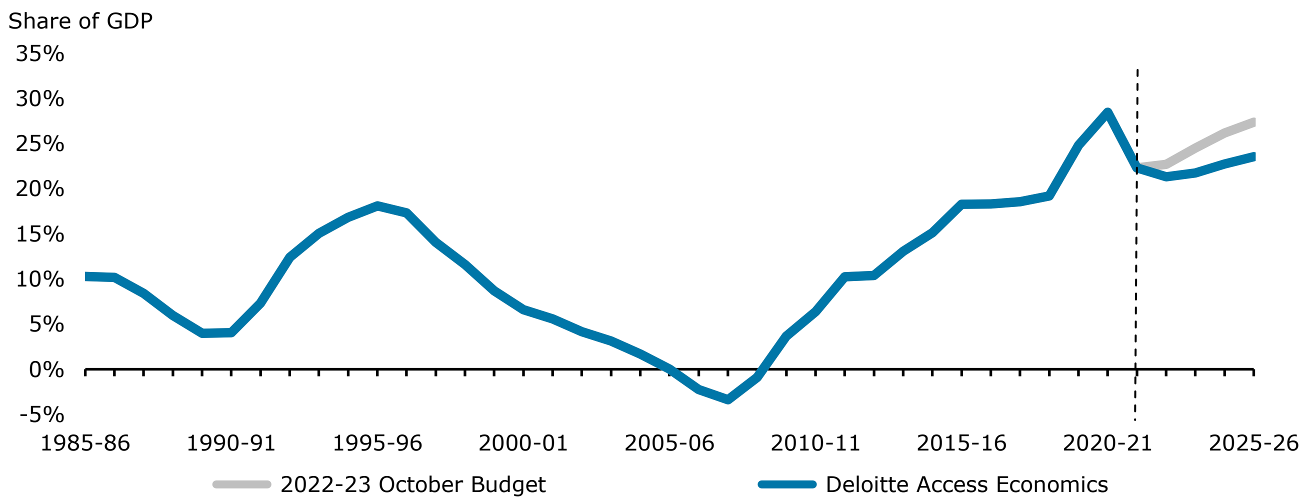
Chart 13 Underlying cash balance share of GDP



Source: Deloitte Access Economics, based on Commonwealth of Australia data

With a similar recovery anticipated in the headline balance, net debt is also likely to be in a far better position than was previously expected. The 2022-23 October Budget assumed net debt would climb to 28.5% as a share of the Australian economy by 2025-26 (with a steady upward march to almost 32% of GDP forecast for the subsequent years to 2032-33).

Chart 14 Net debt as a share of GDP



Source: Deloitte Access Economics, based on Commonwealth of Australia data

Deloitte Access Economics' forecasts incorporate a much flatter profile for net debt as a share of the economy over the next four years, shown in Chart 14 below.

As noted elsewhere in this report, net debt as a share of the economy has benefited from a range of good news and healthier assumptions. First, the boost to revenue means that deficits are lower (and hence the government is not required to take on as much debt), while a larger economy lifts the denominator in the ratio, reducing debt measured as a share of GDP. Note, however, that the government borrowing rate is slightly lower now than at the time of the 2022-23 March Budget, including relative to the rate earned on financial assets. While that helps in terms of interest costs and borrowing requirements, it does also lift the value of net debt, given it is measured in terms of its market value (meaning the value or 'price' of debt already borrowed increases as yields fall).

That sounds like a good outcome – and it is. But it isn't good enough and these forecasts are no solution to the deep, structural deficit that is evident beyond the next four years.

As was the case in October 2022, the Treasurer will need to announce on budget night both an enormous upgrade to revenue in the short term, while warning of significant and rapidly growing costs lurking just barely below the surface.

Table 4 Overall budget projections

	Outcome 2021-22	Forecast 2022-23	2023-24	2024-25	2025-26
Budget aggregates, $ billion					
Revenue (accrual)	**596.4**	**652.8**	**659.0**	**666.0**	**703.9**
% of GDP	25.8%	25.9%	25.5%	24.8%	25.1%
Expenses (accrual)	**623.1**	**650.6**	**667.0**	**701.4**	**729.8**
% of GDP	27.0%	25.8%	25.8%	26.1%	26.1%
Operating balance	**-26.6**	**2.2**	**-8.0**	**-35.4**	**-26.0**
% of GDP	-1.2%	0.1%	-0.3%	-1.3%	-0.9%
Fiscal balance	**-35.1**	**-10.6**	**-19.9**	**-44.4**	**-35.9**
% of GDP	-1.5%	-0.4%	-0.8%	-1.7%	-1.3%
Official forecast of fiscal balance	-35.1	-38.7	-44.9	-62.1	-49.9
Difference in fiscal balance	0.0	28.1	25.0	17.7	14.0
Underlying cash balance	**-32.0**	**-8.7**	**-19.0**	**-33.6**	**-35.6**
% of GDP	-1.4%	-0.3%	-0.7%	-1.3%	-1.3%
Official forecast of underlying cash balance	-32.0	-36.9	-44.0	-51.3	-49.6
Difference in underlying cash balance	0.0	28.1	25.0	17.7	14.0
Net cash flows from investments in financial assets[1]	**-1.3**	**-12.7**	**-6.7**	**-13.7**	**-14.1**
Headline cash balance	**-33.3**	**-21.4**	**-25.7**	**-47.3**	**-49.6**
% of GDP	-1.4%	-0.9%	-1.0%	-1.8%	-1.8%
Official forecast of headline cash balance	-33.3	-49.6	-50.7	-65.0	-63.6
Difference in headline cash balance	0.0	28.1	25.0	17.7	14.0
Net debt	**515.7**	**537.1**	**562.8**	**610.1**	**659.7**
% of GDP	22.3%	21.3%	21.8%	22.7%	23.6%
Official forecast of net debt (% of GDP)	22.5%	23.0%	25.8%	27.4%	28.5%

Source: Deloitte Access Economics, The Commonwealth of Australia

1 Net cash flows from investments in financial assets for policy purposes. Prior to 1999-00 these flows were known as 'net advances'.

Alternative policy settings

What could better policy look like for the budget?

In addition to providing an independent view of the expected budget position, this edition of *Budget Monitor* analyses the fiscal implications of some alternative tax policy settings.

These policy costings have been included to demonstrate the effect that some balanced, meaningful and sensible tax reforms would have on the budget. They are examples of reform options rather than a comprehensive suite of changes – more can and should be done to give the budget a firmer footing over the longer term.

Three alternative policy proposals are explored over the next several pages:

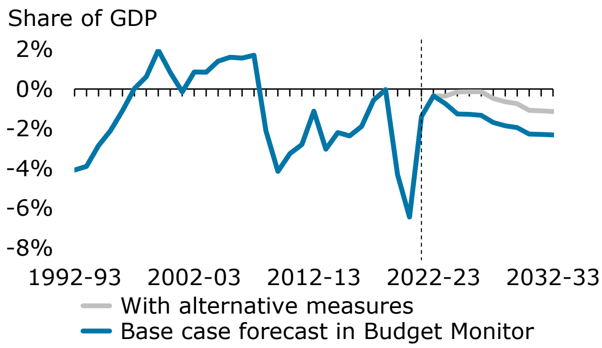
- An alternative personal income tax structure, with a higher tax-free threshold and simplification of marginal rates
- An increase in the rate of the GST to 15% and an expansion of the tax base, with compensation where appropriate
- A reduction in the CGT discount to 33.33%.

As shown in Chart 15 and Table 5, the combined impact of these policies would raise an additional $354 billion in revenue over the next 10 years and shift the budget close to surplus over the forward estimates period.

But these policies are not the complete solution to structural reform of the budget. That will require a closer look at the 'long list' set out earlier in this report.

The proposed policies have been primarily designed to improve efficiency and equity, and underpin an improvement in living standards. But the policies are 'high level' in that there is enough detail to analyse the policies from a budget standpoint, but significantly more detail and analysis would be required to fully understand the economic impact and distributional consequences of each proposal.

Chart 15 Underlying cash balance share of GDP



Source: Deloitte Access Economics, The Commonwealth of Australia

Table 5 Revenue impact from alternative policy proposals

	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33
Net revenue impact of policy, $ billion (accrual)										
Income tax	**-31.6**	**-12.8**	**-13.6**	**-14.2**	**-15.0**	**-15.7**	**-16.6**	**-17.5**	**-18.5**	**-19.6**
% of GDP	-1.2%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%
GST	**40.2**	**41.5**	**43.4**	**46.1**	**48.5**	**51.0**	**53.2**	**55.2**	**57.7**	**60.4**
% of GDP	1.6%	1.5%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%
CGT	**1.3**	**1.1**	**1.9**	**2.9**	**3.8**	**3.7**	**4.1**	**4.3**	**4.5**	**4.7**
% of GDP	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.12%
Total	**9.9**	**29.8**	**31.7**	**34.8**	**37.3**	**39.0**	**40.7**	**42.0**	**43.7**	**45.5**
% of GDP	0.4%	1.1%	1.1%	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%

Source: Deloitte Access Economics

Alternative personal income tax structure

Policy description

This policy change is a simplification of the Stage 3 personal income tax structure to just two thresholds and two marginal rates. The modelled policy is defined as follows:

- A tax-free threshold of $30,000 (up from the current $18,200)
- A 30% marginal tax rate on income earned from $30,000 to $200,000
- A 45% tax rate on income earned over $200,000.

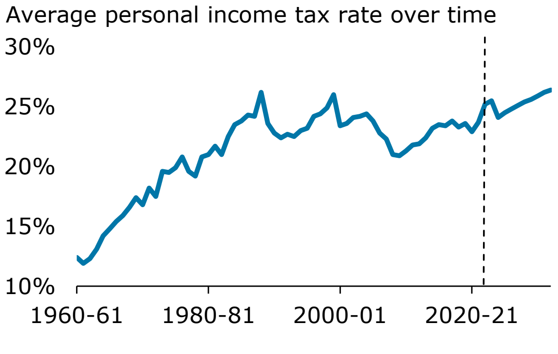
Costing approach and assumptions

The cost of this policy has been estimated using a detailed distribution of taxpayers' wage and salary income. Income tax has been calculated under the legislated rates – the current rates for 2023-24 and the post-Stage 3 tax cut rates from 2024-25 onwards – and the proposed rates. Adjustments have been made to account for refunds and other non-wage and non-salary income to estimate total income tax under the proposed rate structure.

The legislated Stage 3 personal income tax cuts have been the subject of significant debate. Much of the discussion has focused on the large cost of the tax cuts and the fact that they mainly benefit high income earners.

Both of those statements are true. However, even with the Stage 3 tax cuts in place, the share of Commonwealth tax revenue raised from personal income tax will track higher into the future. Deloitte Access Economics estimates that personal income tax will account for 52% of all tax revenue by 2031-32, not far off the 53% share of tax revenue that was raised by personal income tax in the five years prior to the introduction of the GST in 2000.

Chart 16 Average personal income tax rate



Source: The Commonwealth of Australia

Chart 16 shows that the average personal income tax rate has risen from 21% in 2009-10 to 25% in 2022-23. The Stage 3 tax cuts are expected to reduce this to 24% in 2024-25. But the long run trajectory will still see the average tax rate reach a record high of more than 26% within a decade.

The spending pressures on the budget mean that more revenue is needed. But that doesn't mean that *all* taxes should increase, and it doesn't mean that the Stage 3 cuts should be cancelled. In fact, given that bracket creep will see the average rate of personal income tax continue to rise to a record high even after those tax cuts are applied, personal income tax could be cut further.

A flatter and lower income tax structure would reduce the tax burden on Australia's wage earners and sole traders. The tax-free threshold of $18,200 has been the same for more than a decade, and Deloitte Access Economics' view is that changes are needed at the bottom end of the income tax structure to reduce complexity, ease administrative burden, and boost workforce participation.

While all individuals would pay less income tax under the proposed policy, low-income workers would be the main winners – workers earning $30,000 would save around $2,200 per year.

The higher tax-free threshold would also reduce complications in the tax and transfer system. The current combination of personal income tax and income tests on transfer payments leads to prohibitively high effective marginal tax rates (EMTR) for low-income workers in the welfare system, which is a large disincentive to taking on more work. Lifting the tax-free threshold to $30,000 would remove this complication for a significant cohort of low-income workers and should encourage increased hours and output from this segment of Australia's labour force.

The proposed income tax structure wouldn't completely solve the problem of EMTRs, which would remain punitive for many workers in the welfare system. But this could be addressed via the transfer system rather than the tax system. Overall, a higher tax-free threshold and lower average tax rate would lead to more equitable outcomes for people who balance part-time work with other responsibilities like caring for children or managing a medical condition.

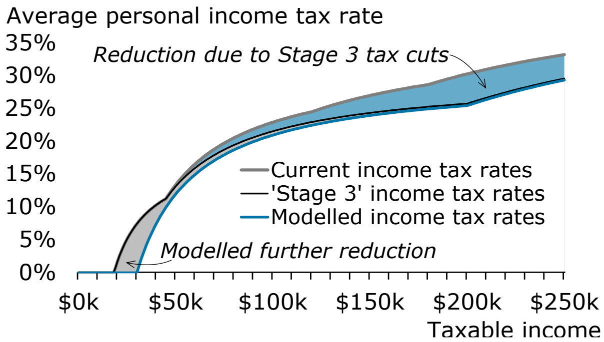
The higher tax-free threshold would benefit higher earners too. Anyone earning over $45,000 per year would save around $600 per year on top of the savings from the Stage 3 tax cuts. But this proposal is rightly focused on the lower end of the income tax distribution, both for reasons of fairness and because that is the big opportunity when it comes to maximising labour force participation – something which is less of a problem now, but will become more of a problem as Australia's population ages.

Nearly half of the income tax savings from the proposed reform would go to the bottom third of income earners, while more than 80% would go to those earning less than $100,000.

The distribution of the annual tax saving from this policy change is shown in Chart 17 (in terms of the difference in the average personal income tax rate) and Chart 18 (which shows the annual tax saving as a share of taxable income). As the charts show, every taxpayer would benefit from this policy change, though those on a relatively lower income would benefit the most.

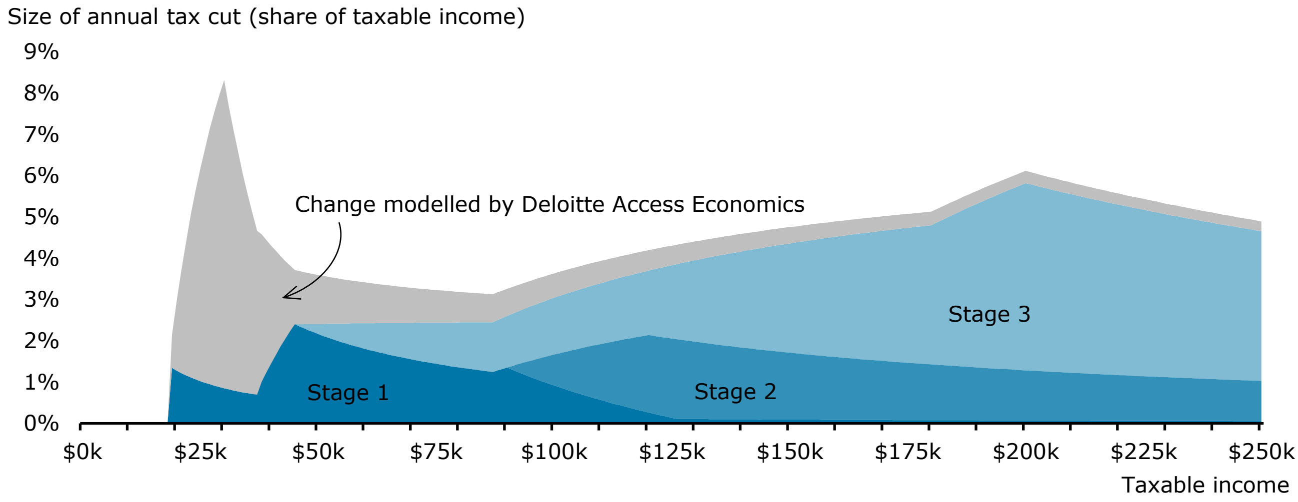
The estimated cost of the proposed income tax structure is an average of $15.9 billion per year on top of the Stage 3 tax cuts. It is assumed that this policy would be introduced from 1 July 2023, which means the $31.6 billion cost in 2023-24 effectively includes both the cost of Deloitte Access Economics' proposed rates, and the cost of bringing forward the Stage 3 tax cuts.

Chart 17 Average tax rates, current and proposed



Source: Deloitte Access Economics

Chart 18 Size of annual tax saving as a share of income



Source: Deloitte Access Economics

Table 6 Estimated revenue impact of alternative personal income tax policy

	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33
Net revenue impact of policy, $ billion (accrual)										
Revenue	-31.6	-12.8	-13.6	-14.2	-15.0	-15.7	-16.6	-17.5	-18.5	-19.6
% of GDP	-1.2%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%

Source: Deloitte Access Economics

A broader (and higher) GST rate

Policy description

This policy change includes two amendments to the GST: broadening the tax base to include food and education, and increasing the GST rate to 15%. A compensation package for lower income households would include the tax changes set out in the previous policy costing (with a focus on an increase in the tax-free threshold), along with a 9.5% increase in government welfare payments. This increase in welfare would come into effect in 2023-24 after which normal indexation of welfare payments would resume.

Importantly, the assumption under this policy is that the additional revenue earned would be retained by the Commonwealth Government rather than be distributed to the states and territories.

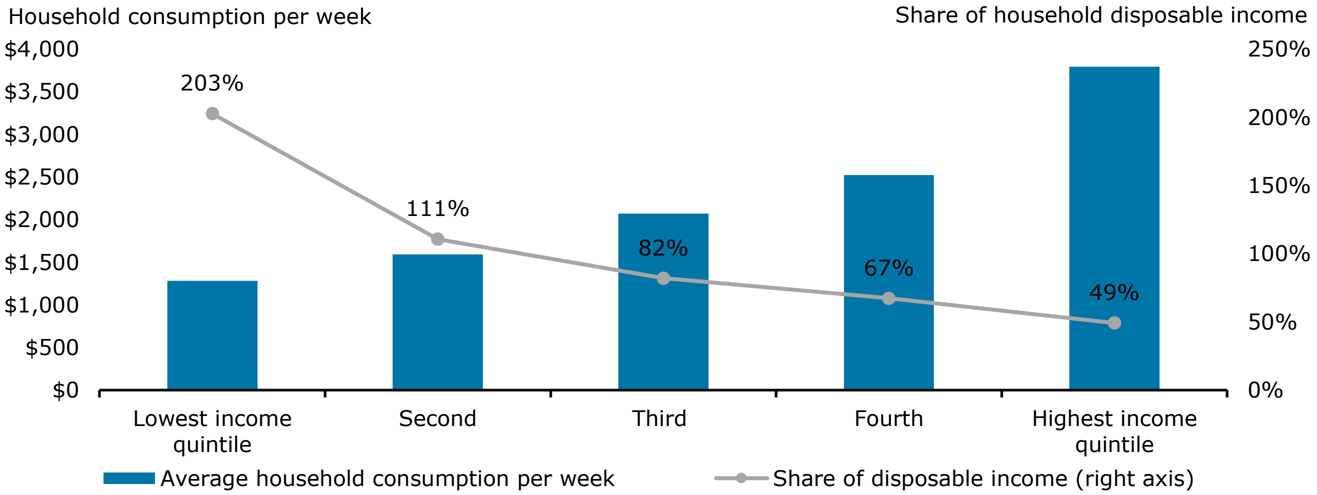
Costing approach and assumptions

The cost of the higher GST rate has been modelled by applying an assumed price elasticity of 0.5 to the existing tax base. The broader base has been modelled using Commonwealth Treasury estimates for the cost of GST exemptions (as per the 2022-23 *Tax Expenditure Statement*) to approximate the amount of untaxed consumption of food and education. Price elasticities of around 0.1 and 0.2 have been assumed for food and education consumption respectively. The longer-term forecasts are underpinned by Deloitte Access Economics' projections of nominal non-housing consumption. The compensation package is based on the non-admin cost of social security and welfare from the 2022-23 Commonwealth Budget.

The GST is one of the most efficient taxes levied by the Commonwealth, which makes it a prime candidate for funding both budget repair and the removal of more damaging taxes. That was the key argument when the GST was introduced in 2000 and it's an equally valid argument today. Yet the GST rate has been set at 10% since it was introduced and the tax base continues to exclude several major segments of household consumption including food, education, health care, medicine, child care, water and sewerage. That's too long a list of exclusions for a tax that is as efficient as the GST. This tax should make up a greater share of Australia's tax revenue in order to fund a less damaging tax mix overall.

Most of the exclusions from the GST were made on the basis that a consumption tax is highly regressive and would be even more so if levied on necessities, both of which are true. Chart 19 shows higher income households spend a smaller *proportion* of income on consumption than lower income households. That translates to a smaller *proportion* of income on GST. But while it's important to have a progressive tax system as a whole, that doesn't mean that every individual tax needs to be progressive. The policy modelled here would increase the revenue raised from the GST and compensate lower income households through the transfer system, as well as via the tax cuts outlined in the previous section.

Chart 19 Household consumption as a share of disposable income by household income quintile

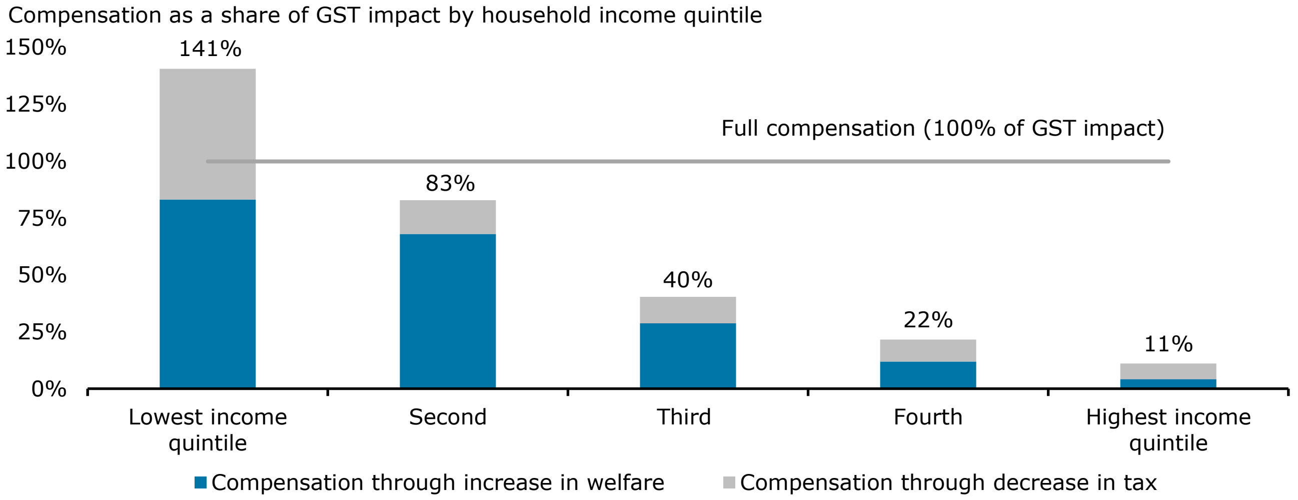


Source: Australian Bureau of Statistics

The proposed compensation package is a 9.5% increase in all transfer payments. That would be enough to ensure households who depend solely on welfare are no worse off under the proposed policy. In conjunction with the personal income tax cuts, Deloitte Access Economics estimates that many low-income households would in fact be 'over-compensated' by this package. That is, the increase in welfare payments and decrease in personal income tax would outweigh the additional GST paid by the household.

This is demonstrated in Chart 20. Under this proposal, the average household in the lowest income quintile would pay some $3,300 additional GST in 2023-24, receive an additional $2,800 in welfare and pay $1,900 less personal income tax. That compensation adds up to about 141% of the GST impact. For higher income households, the lower income tax and higher welfare payments do not offset the GST. This shows that it is possible to raise more GST revenue while maintaining progressivity.

Chart 20 Compensation as a share of additional GST by household income quintile



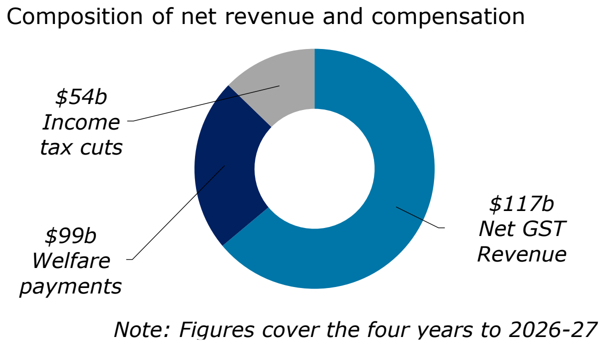
Source: Australian Bureau of Statistics

Increasing the rate of GST to 15% would raise an average of $52 billion per year between 2023-24 and 2031-32. Broadening the tax base to include food and education would raise a further $27 billion per year, making the combined increase in revenue some $79 billion per year over the first ten years. Even after accounting for $30 billion per year in additional welfare payments, the budget would see an average increase in revenue of almost $50 billion per year on average.

Chart 21 shows the aggregate revenue and compensation over the four years to 2026-27. The net effect of the income tax cuts proposed earlier (excluding Stage 3), combined with the higher welfare payments and increased GST, is an estimated $117 billion over four years.

Importantly, all the revenue raised by this policy is assumed to be retained by the Commonwealth rather than being distributed to the states and territories.

Chart 21 Distribution of revenue from policy



Source: Deloitte Access Economics

Table 7 Estimated revenue impact of alternative broader and higher GST (net of compensation)

	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33
Net revenue impact of policy, $ billion (accrual)										
Net revenue	40.2	41.5	43.4	46.1	48.5	51.0	53.2	55.2	57.7	60.4
% of GDP	1.6%	1.5%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%

Source: Deloitte Access Economics. Note: Figures in this table are net of welfare payments but do not include any of the cost of income tax cuts (the entire cost of which is reported in Table 6).

A less generous CGT discount

Policy description

This policy change reduces the CGT discount for individuals from 50% to 33.33%. This discount applies to assets that were owned for at least 12 months and are disposed of by an Australian tax resident. The reduced discount would be phased in (in equal instalments) over five years. There would be no change to the existing 33.33% discount for superannuation funds.

Costing approach and assumptions

The cost of this policy has been estimated using Commonwealth Treasury estimates of the cost of the CGT discount (as per the 2022-23 *Tax Expenditure Statement*) to estimate the total quantum of net capital gains currently eligible for the discount. The tax base has been grown using 2022-23 Budget projections, Australian Taxation Office data on net capital gains by asset type, and Deloitte Access Economics' in-house projections of dwelling prices, GDP, and other drivers of underlying asset values.

The decline in the discount rate is phased in to reach 33.33% by 2027-28 and applied to aggregate net capital gains in each year. An estimated marginal tax rate of 36.1% is applied to the discounted capital gains to calculate net revenue.

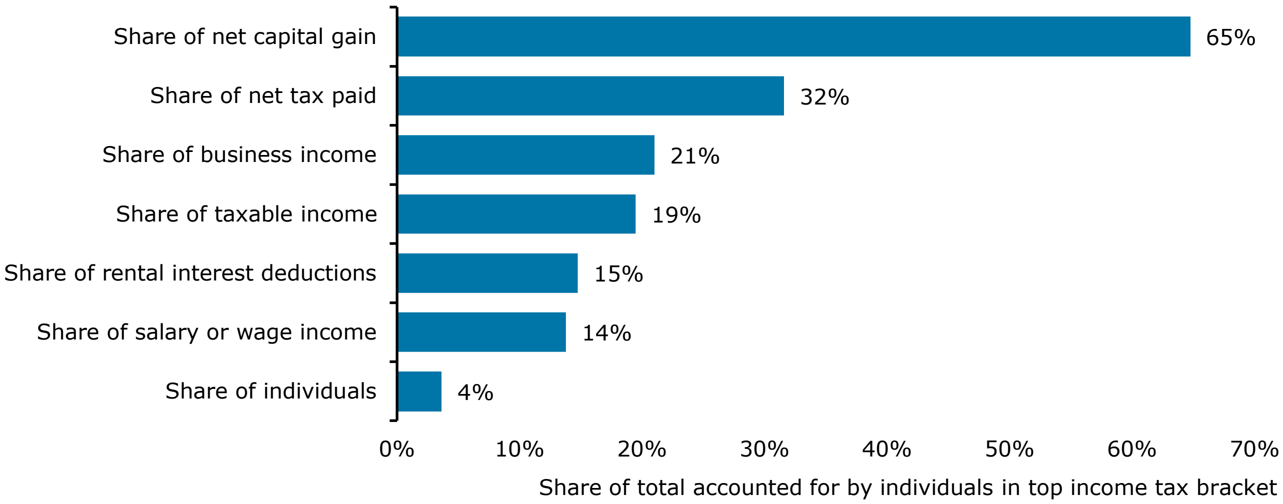
A behavioural response is adopted (in line with Parliamentary Budget Office assumptions in policy costing *PER660*) in which 5% of asset disposals are brought forward from 2024-25 to 2023-24, 2.5% of asset disposals are brought forward from 2025-26 to 2024-25, and 1.25% of asset disposals are brought forward each year until the new discount rate is fully phased in.

The current CGT discount of 50% is notionally applied in recognition that inflation accounts for some of the capital appreciation of an asset over time, and that only the real, inflation-adjusted gain should be taxed. While that is a sensible principle, in practice the 50% discount does a poor job of approximating the proportion of capital gain that is due to inflation.

Taxing real capital gains could be achieved by indexing the acquisition price of an asset. This used to be the method used in Australia, but it is relatively complicated. The alternative, current approach of discounting the taxable gain by 50% is quite straightforward, but the 50% discount provides too much relief. Even with last year's resurgence of inflation, the 50% discount is an overly generous level of compensation.

As Chart 22 shows, nearly two thirds of net capital gains go to people in the top tax bracket. That's partly because the realisation of a capital gain pushes people into a higher tax bracket than usual. But it's partly because wealthy Australians own more assets than poorer Australians, and more assets mean more capital gains.

Chart 22 Various shares accounted for by individuals in the top income tax bracket, 2019-20



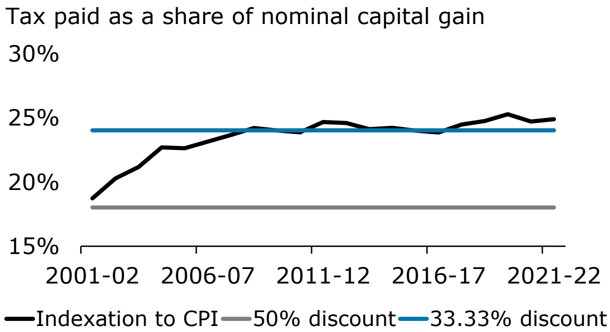
Source: Deloitte Access Economics, Australian Taxation Office

Providing the wealthiest Australians with an overly generous allowance for inflation isn't a good outcome from an equity standpoint. And this overly generous discount has also led to inefficiencies in the way Australians use their savings. That is one of the factors that has contributed to Australia's obsession with residential property investment.

Investors are incentivised to hold investments on a low or negative yield on the basis that strong capital growth will be taxed at a discount. That has led to inefficient allocation of capital into the housing market and contributed to intergenerational inequity in home ownership rates.

Deloitte Access Economics proposes a reduction in the discount from 50% to 33.33%. Chart 23 shows the effect of a 33.33% and 50% discount on the average rate of tax paid on a nominal capital gain, assuming that an asset was bought in 2000-01, that the value grew in line with nominal GDP, and that the taxpayer faced an average marginal tax rate of 36.1% on the discounted capital gain.

Chart 23 Tax paid as a share of capital gain



Source: Deloitte Access Economics

Overall, the average rate of tax paid under a 33.33% discount tracks much closer to the tax that would be paid on the real capital gain (as calculated by indexing the purchase price to CPI). The 50% discount is closer to the indexation method for a short holding period, but the compounding effect of inflation-adjusted returns mean that 50% is much too generous for assets that have been held for longer time periods.

Applying a 33.33% discount gives a better approximation of the real capital gain of an asset over longer holding periods. When assets are held for short time periods, the 33.33% discount is likely to undercompensate investors for inflation. But this strengthens the incentive for longer term saving – an incentive that weakened significantly over the past decade of persistently low inflation prior to last year's break out.

The 33.33% discount would also help to tackle the difference between the effective tax rate faced on capital gains income relative to other sources of income earned on savings. For example, income earned on bank deposits is taxed at an individual's full marginal rate, while income earned from capital gains is currently taxed at half that marginal rate. Closing this gap will help remove distortions in how savers choose to invest.

The total revenue raised from this policy would build up over the first five years as the 33.33% rate is gradually phased in. The policy would be expected to raise an average of $1.8 billion per year over the budget estimates, growing to an average of $4.1 billion per year over the first five years after the change to the discount rate is fully implemented.

Table 8 Estimated revenue impact of lower CGT discount

	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33
Net revenue impact of policy, $ billion (accrual)										
Revenue	1.3	1.1	1.9	2.9	3.8	3.7	4.1	4.3	4.5	4.7
% of GDP	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.12%

Source: Deloitte Access Economics

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