

Federal Budget 2017-18 *A Business Focus*



Bank of Melbourne Economics
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Outline and Key Themes

- The Federal Government released its Budget for 2017-18 on May 9.
- Budget deficit estimates for 2017-18 and in the out years deteriorated from the estimates provided five months earlier in the Mid Year Economic & Fiscal Outlook (MYEFO) and from the estimates given at the time of last year's budget.
- A return to surplus is still expected for 2020-21.
- While there were some measures aimed at Budget repair, the path to surplus continues to rely upon an improvement in economic growth & stronger wages growth.
- There were four 'broad' themes in this year's Budget. They were infrastructure, housing, education and levies.

Key Policies in This Year's Budget

Small Businesses

- The accelerated depreciation write off for assets less than \$20,000 available to businesses with turnover less than \$10 million will be extended by another year to 30 June 2018.

All Businesses

- A reaffirmation of the commitment to cut the company tax rate to 25% by 2026-27 for all companies.

Major Banks

- A levy on Authorised Deposit-taking Institutions (ADIs) with licensed entity liabilities of at least \$100 billion of an annualised 6 basis points of liabilities.

Personal Income Tax

- Increase to the Medicare levy from 2.0% to 2.5% of taxable income from 1 July 2019. Current exemptions to stay in place.
- The low-income threshold is to be increased.

Education

- \$18.6 billion education package on needs-based funding.
- Higher education funding cut by \$2.8 billion.

Infrastructure

- Establishment of a 10-year allocation for funding in road and rail investment worth \$75 billion.

Housing

- A variety of measures aimed at improving housing affordability.

Key Measures for Businesses

- The government re-committed to reducing the company tax rate to 25% for all companies by 2026-27. This measure was announced in last year's Budget.
- The immediate tax deduction for assets costing less than \$20,000, which was due to expire 30 June 2017, has been extended another year. It will continue to apply to businesses with turnover < \$10 million.
- Abolition of 457 visa and replaced with a new Temporary Skill Shortage (TSS) visa, which will have stricter eligibility requirements. From March 2018, businesses with employees on a Temporary Skill Shortage (TSS) visa need to pay an annual levy and business with employees sponsored on subclass 186 visas or subclass 187 visas need to pay a one-off payment.

Other Measures Affecting SMEs

- The government will provide \$300 million over two years to establish a National Partnership on Regulatory Reform (NPRR) with States and Territories to remove regulatory restrictions on small businesses and competition. However, the measure is reportedly facing resistance in some States.
- Capital gains tax (CGT) concessions will be amended so that concessions can only be accessed in relation to assets used in a small business or ownership interests in a small business.
- \$15 million towards a small business information campaign to educate small business on programs and assistance available to them.
- The taxable payments reporting system (TPRS) has been extended to contractors in the courier and cleaning industries. TPRS requires businesses to report payments made to contractors to the ATO and is currently in place in the building and construction industry.

Property – First-Home Buyers

- Allow voluntary contributions to superannuation from 1 July 2017 to be withdrawn for a first-home deposit. Up to \$15,000 per annum and \$30,000 in total can be contributed and withdrawn from 1 July 2018.
- Concessional contributions and associated deemed earnings will be taxed at 15%. Non-concessional contributions will not be taxed nor will withdrawals of non-concessional amounts.
- Withdrawals of concessional contributions and earnings will be taxed at the individual's marginal rate less a 30% offset.

Property – Foreigners

- Introduction of a “ghost tax” on foreign owners of residential property which are unoccupied or unavailable for rent for at least 6 months. The charge is levied annually and worth the foreign investment application fee.
- Expanding capital gains tax (CGT) measures on foreigners. This includes denying access to the CGT main residence exemption (from 9 May 2017), increasing the CGT withholding rate (from 10% to 12.5%), and reducing the CGT withholding threshold for foreign tax residents (from \$2 million to \$750,000).
- A cap of 50% on foreign ownership in new housing developments, effective 9 May 2017.

Property - Investors

- From 1 July 2017, the Government will limit plant and equipment depreciation deductions to outlays actually incurred by investors in residential real estate properties. This means that owners of a property will not be able to claim deductions for plant and equipment purchased by a previous owner of the property. This measure applies to residential properties purchased after 9 May 2017.
- Deductions for travel expenses related to inspecting, maintaining or collecting rent for a residential property will no longer be allowed from 1 July 2017.
- From 1 January 2018, the capital gains tax (CGT) discount will increase from 50% to 60% for investment in qualified affordable housing.

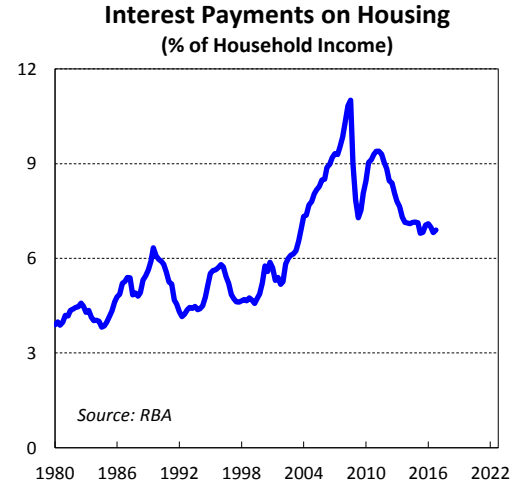
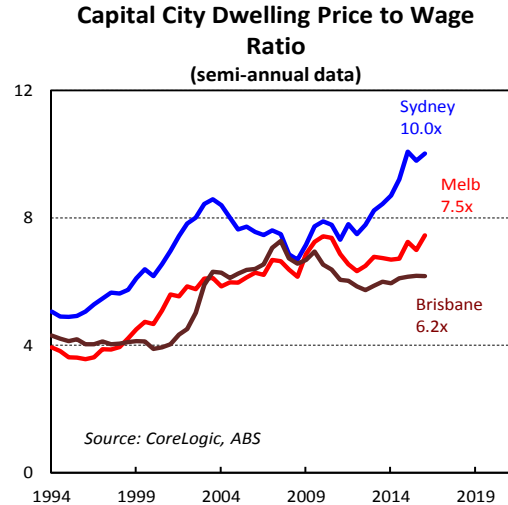
Property - Retirees

- Allowing people aged over 65 years old to make a non-concessional contribution of up to \$300,000 from the proceeds of selling their home from 1 July 2018.

Affordable Housing Assistance

- There were a raft of measures designed to support affordable housing associations. These include:
- Enabling Managed Investment Trusts (MITs) to invest in affordable housing. This will give tax concessions for investors through MITs.
- Establishing a National Housing Finance and Investment Corporation (NHFIC). The NHFIC will act as a bond aggregator to provide cheaper and longer-term financing through the wholesale market for community housing providers.

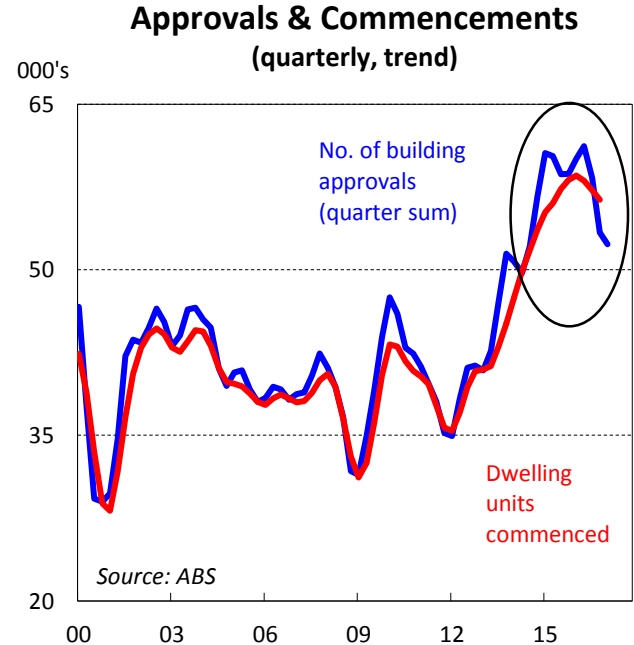
Housing Affordability & the Budget



- The announced measures only tinker around the edges in addressing housing affordability. Residential property prices are elevated, particularly in Sydney and Melbourne, because interest rates are low. In Sydney, there is also a shortage of dwellings.

Resi Building - Downturn Looms?

- Demand for new residential developments will likely be negatively impacted - reflecting the new measures to restrict plant and depreciation deductions for investors and restricting foreign purchases to 50% of new developments.
- These restrictions on new developments could exacerbate a downturn in residential construction at a time when the cycle is already beginning to turn.
- The measure introduced to encourage housing demand from first-home buyers is only modest.



Infrastructure - NSW

- Forms the centrepiece of the Federal Budget. Provides stimulus to the economy by boosting construction, jobs and economic activity.
- Increasing total funding and financing commitments to transport infrastructure projects to over \$70 billion from 2013-14 to 2020-21.
- The main projects by States and territories are:

New South Wales:

- The Government is making an equity investment of up to \$5.3 billion in WSA Co, a new Commonwealth-owned company, to fund the first stage of development of Western Sydney Airport. Works will commence by late 2018 and airport operations will begin by 2026. The terminal will have capacity for 10 million passengers each year — about the size of Adelaide Airport. \$13.8 million for the Far North Collector Road. Forecast to generate 20,000 jobs by the early 2030s.
- \$13.8 million for the Far North Collector Road.

Infrastructure – QLD and VIC

Queensland:

- \$843.8 million for new Bruce Highway priority projects, including for the Pine River to Caloundra upgrade and Deception Bay interchange upgrade.

Victoria:

- \$1 billion in additional infrastructure funding for Victoria. Including \$500 million to upgrade regional rail and \$30 million to support planning for a rail link from the Melbourne CBD to Tullamarine Airport.
- The funding to upgrade regional rail will include \$100 million for the Geelong Rail Line duplication and \$100 million for the North East Rail Line upgrade.
- Provision of a further \$20.2 million for Murray Basin Rail.
- \$30 million over two years from 2017-18 for business-case development for the Tullamarine Rail Link.

Infrastructure – Joint NSW / QLD / VIC

Regional NSW, Queensland and Victoria:

- The Government will deliver the Melbourne to Brisbane Inland Rail project.
- Will do this through a \$8.4 billion equity investment in the Australian Rail Track Corporation and a public private partnership for the most complex elements of the project.
- Work on this 1,700 km nation building rail investment will commence in 2017-18 and is projected in the Budget to support 16,000 jobs at the peak of construction.

Infrastructure – SA and WA

South Australia:

- \$40 million in local roads funding

Western Australia:

- \$1.6 billion for new projects, including for better road access to the Fiona Stanley Hospital precinct and \$700 million towards the METRONET rail project.

Manufacturing

- A \$101.5 million Advanced Manufacturing Fund to promote research and capital development for high-technology manufacturing businesses.
- \$30 million for the Portland Aluminium Smelter joint venture.
- High-value added and specialised manufacturing are the more viable areas of manufacturing in Australia.
- The fall in the Australian dollar since its 2013 peak has eased pressure off the sector.
- More recently, improving demand from Asian economies are helping lift the prospects for manufacturing industries.

Health - I

- The health sector was a 'winner' in this budget. The government plans to spend \$1 billion more on health next financial year.
- An increase in the Medicare levy from 1 July 2019 from 2% to 2.5% will ensure the National Disability Insurance Scheme is fully funded by 2020. This will support people with a significant and permanent disability. News reports suggest the Labor party is opposed to the Medicare Levy increase for those people earning under \$87,000 a year.
- Indexation of certain items on the Medicare Benefits Schedule will be phased back in at a cost of \$1 billion over four years from 2017-18. This includes the lifting of the four-year freeze on Medicare rebates for some GP visits from July 2017, extending to specialists and specialist procedures over the following two years.

Health - II

- A standard GP consultation which has remained at \$37.05 since 2013 will rise to \$40.
- Funding to continue and expand the My Health Record system at a cost of \$374.2 million over two years from 2017-18.
- Increased funding for mental health, including mental health support, treatment and research.
- Funding to modernise the information, communication & technology (ICT) and payments systems for health services, including Medicare, the Pharmaceutical Benefits Scheme, aged care and related payments.

Hospitality and Leisure - I

- The increase in the Medicare levy from 2% to 2.5% from 1 July 2019 will weigh on consumer spending, particularly discretionary forms of spending, negatively impacting the leisure/hospitality industry.
- The spending power of higher-income earners, however, will benefit from the ending of the budget repair levy.
- The increased spending on infrastructure will likely have a positive impact on the tourism industry. Projects include the Western Sydney Airport.
- Funding to promote tourism in the region impacted by Cyclone Debbie in 2016-17 is a positive for the industry. However, the budget included reduced funding to Tourism Australia over the next four years.

Hospitality and Leisure - II

- The hospitality and leisure industry employs many people on Temporary Work 457 visas, especially in roles such as chefs, cooks and restaurant managers. These visas are being removed. They will be replaced with Temporary Skills Shortage visas, which are more restrictive and costly (with a levy for employers on these and certain other visas).
- The levy payments by employers for employees on the Temporary Skills Shortage visas, along with funding from the Government, will be used to fund the Skilling Australians Fund. This will increase apprenticeships and traineeships, which will provide a boost to hospitality and leisure staffing in time.

Professional Services - I

- Small businesses will continue to be able to immediately deduct eligible assets costing less than \$20,000 for another 12 months (to 30 June 2018). This will help with cash flow for small businesses (with annual turnover up to \$10 million).
- The budget committed to lowering the company tax rate to 25% for all businesses by 2026-27 (as announced in the previous Budget).
- The budget provided up to \$300 million over two years to establish a National Partnership on Regulatory Reform (NPRR) to allow the State and Territory governments to reduce regulatory restrictions on small businesses (i.e. red tape). News reports suggest some States have refused to participate, so the impact of this measure is now uncertain.
- Following the Interim report of the Black Economy Taskforce, the Government will prohibit sales suppression technology and software which allows businesses to understate income.

Professional Services - II

- Access to CGT concessions for small business will be tightened from 1 July 2017.
- Extension of current tax relief for the merging superannuation funds until 1 July 2020.
- The use of limited recourse borrowing arrangements in a superannuation fund will be included in a member's total superannuation balance and pension transfer balance cap (of \$1.6 million) from 1 July 2017.
- The integrity of related-party transactions within superannuation funds will be tightened from 1 July 2018.

Education - Schools

- Schools, on balance, were winners in this budget.
- In “Gonski 2.0”, the Government will deliver an \$18.6 billion education package for schools over the next decade, from 2018.
- The funding will be allocated on a needs-based school funding model.
- Funding to some private and Catholic schools will be cut or frozen.
- News reports indicate Labor will vote against the changes, on the basis that it is a smaller increase in school funding than was scheduled previously by Labor.

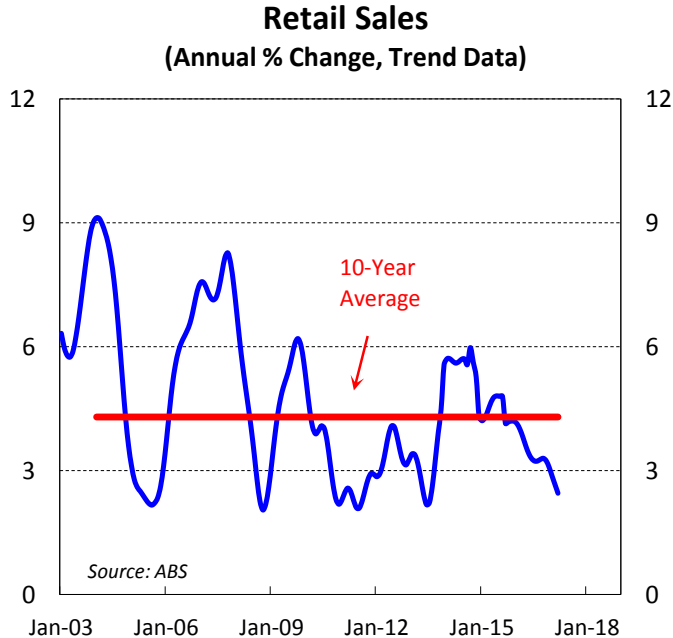
Education – Higher Education

- The higher education sector fared poorly in this budget. It will have its funding cut by \$2.8 billion over four years.
- Universities will have to meet a 2.5% efficiency dividend on the Commonwealth Grant Scheme in 2018 and 2019 and elements of university funding will be contingent on performance.
- Student fees will rise by 7.5%, phased in over 4 years starting in 2018.
- All of the additional cost of the fees can be deferred on the Higher Education Loan Program (HELP) scheme. The Budget included changes to the HELP scheme, including a reduction in the repayment threshold from \$51,957 (for 2018-19) to \$42,000 in mid-2018. This means students will begin repaying their loans earlier. There will also be a change in the repayment rate, so that debt is repaid faster.
- News reports suggest these measures for higher education may not pass through Senate; the bill is opposed by Labor, the Greens and independent Jacqui Lambie.

Seniors and Aged Care

- From 1 July 2018, individuals aged 65 and older will be able to make a non-concessional contribution of up to \$300,000 using proceeds from the sale of a principal residence held for at least 10 years into their superannuation. These downsizing contributions will not be subject to the existing contribution caps. The contribution will be exempt from the age test, the work test and the \$1.6 million total superannuation balance test, but will not be exempt from the \$1.6 million transfer balance cap. The Government is also allowing “both members of a couple” to take advantage of the concession for the same home.
- The Zero Real Interest Loans program provided loans to assist aged-care providers to build or extend residential aged-care services in areas of high need. Loans provided under the program attract an interest rate equivalent to the consumer price index. Four funding rounds were completed, with the final round of offers finalised in 2013. No further loans will be allocated.
- Tougher residency requirements for access to the Age Pension.

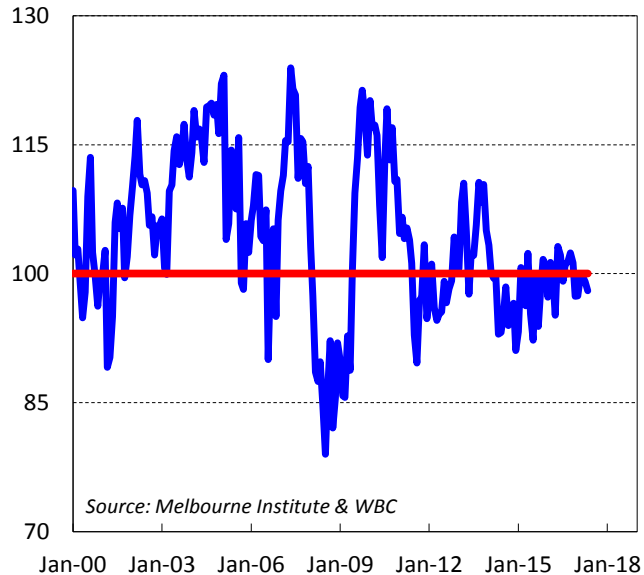
Consumers – Better or Worse Off?



- The increase in the Medicare levy surcharge from 2% to 2.5% will mean those households subject to the levy and earning up to \$180,000 will be worse off from 1 July 2019.
- However, a 2% temporary deficit reduction levy for incomes over \$180,000 will end 1 July 2017. Higher income earners will therefore be better off.
- Weak income growth however, will likely continue to keep a lid on consumer spending.

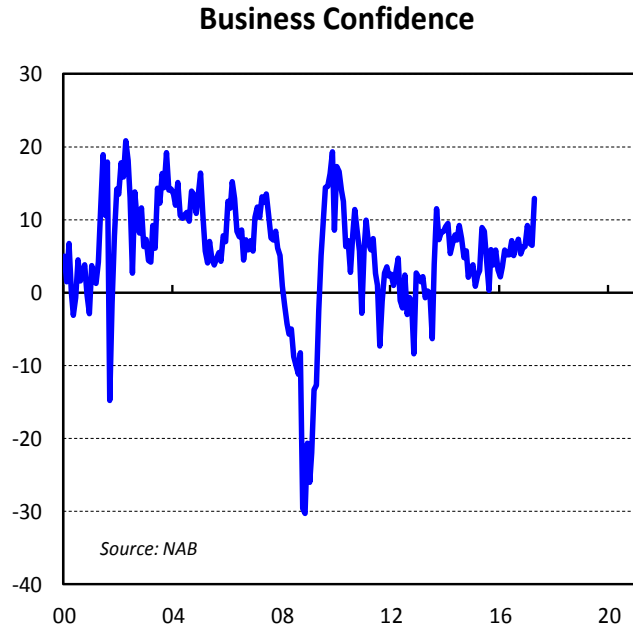
Consumer Confidence

Consumer Sentiment Index



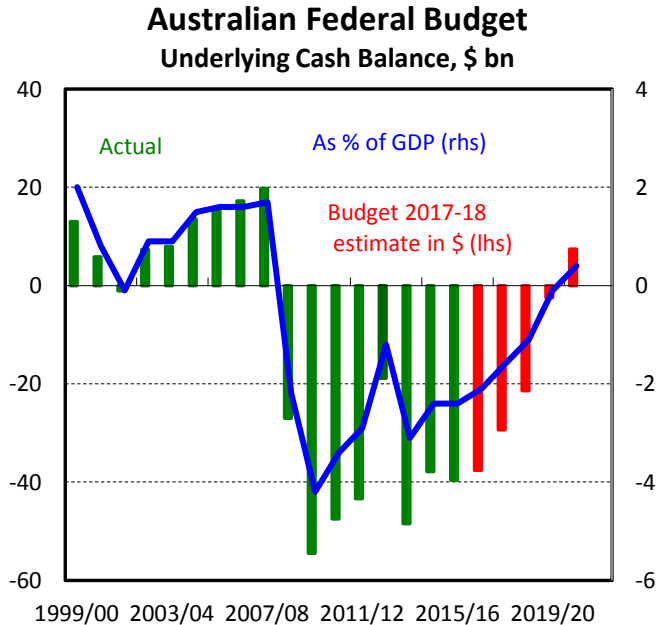
- The Westpac-MI gauge of consumer confidence fell by 1.1% in May to 98.0, indicating pessimists slightly outweigh optimists in the economy.
- 33% of households expect the Federal Budget to have a negative impact on family finances versus 7% expecting an improvement.
- While the response from households is negative towards the Federal Budget, the impact on confidence appears to be marginal.

Business Confidence



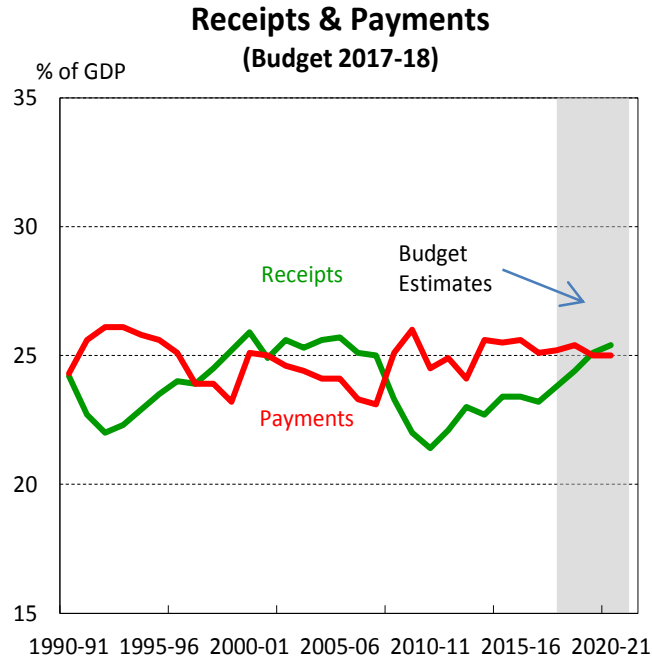
- The data on business confidence that will give us the first read on the impact of the Budget on business sentiment is due for release on June 13. In April, business confidence rose to 12.9 index points, which was the highest in seven years.
- Infrastructure spending, the proposal to push forward with the company tax cuts and the extension to the instant depreciation write-off for small businesses are positives for businesses.
- However, some of these measures had been previously announced.

The Budget Bottom Line



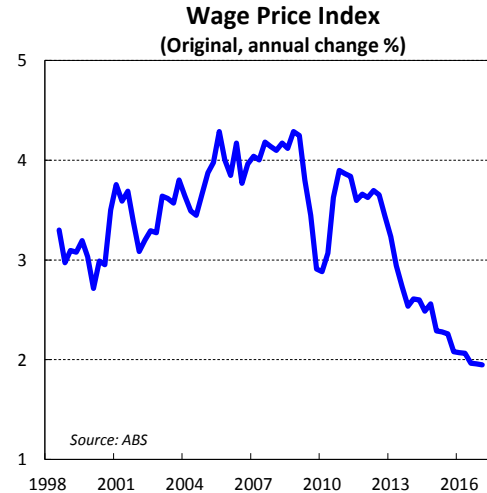
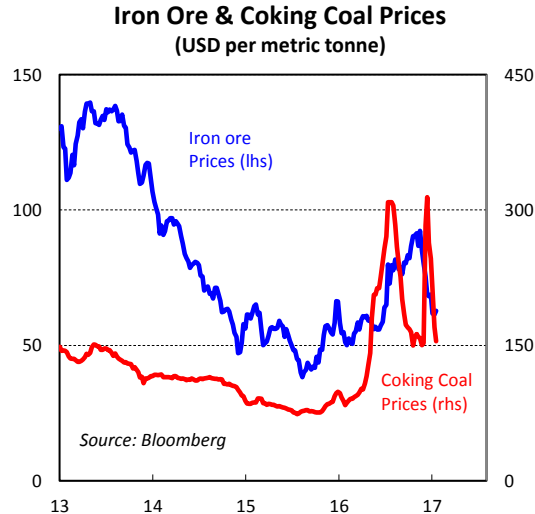
- The Government is expecting an underlying cash deficit of \$29.4 billion in 2017-18 after an expected deficit of \$37.6 billion in 2016-17.
- A surplus is projected for 2020-21.
- The path to a surplus depends on economic parameters being met.

Will the Budget be Back in the Black?



- The path to a surplus depends highly on higher revenues.
- Higher revenues is in turn highly dependent on a lift in the rate of economic growth and incomes.

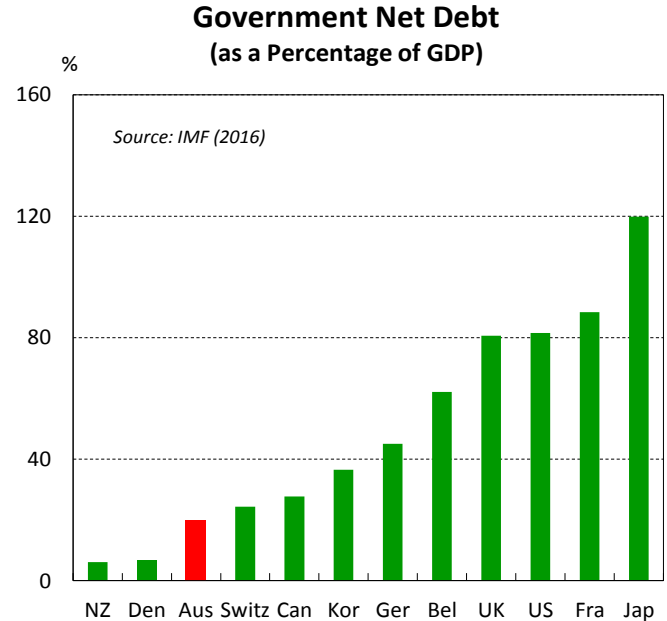
Revenue Growth – Where From?



- A stabilisation of commodity prices will help the Budget bottom line. But wages growth remains subdued, running at sub 2% per annum. The Budget's forecasts for wages appear overly optimistic. Projections are for wages to grow by 2.5% in 2017-18, lifting to 3.75% in 2020-21.

No Need for Urgent Action

- There is no need to sharply raise taxes or cut spending to reach a budget surplus in a hurry.
- Net debt is expected to now peak at 19.8% of GDP in 2018-19, which is low by international standards.



But Long-Run Issues Remain

- Ideally, the budget should be in balance over the long-run. The budget is forecasting a return to surplus in 2020, but depends on economic parameters turning out as projected.
- Measures aimed at budget repair continue to be piecemeal, and further complicate Australia's complicated tax and transfer system.
- The 2017-18 budget again failed to tackle tough structural issues. The talk of broad and wide-ranging tax reform was raised in early 2015 appears to have been forgotten. Reform which aims at simplifying and reducing economic costs of tax policies would have long-term benefits.
- The sustainability of public finances with an ageing population is a key long-term issue.
- Following the Budget, Moody's and Standard & Poor's (S&P) credit rating agencies reaffirmed Australia's top AAA credit rating. However, S&P continues to hold a negative outlook which suggests a risk of a downgrade remains.

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