<u>March Quarter, 2019</u>

<u>The Supervised Fund: Macroeconomic Outlook</u>

Budget and Election edition

Overview

The Australian Government Budget of 2019-20, presented to the House of Representatives by Treasurer Josh Frydenberg on 2nd April 2019, showed a surplus would be recorded in the national accounts for the first time since 2007-08. For the 2019-20 fiscal year, an estimated surplus of $7.1bn is underpinned by a strong labour market (unemployment at 5%, compared to 5.5% a year ago) and rising profits from mining companies. The price of iron ore, Australia's largest commodity export (price chart shown in Image 1 below) has contributed strongly towards an 11% increase in company tax collections compared with last year.

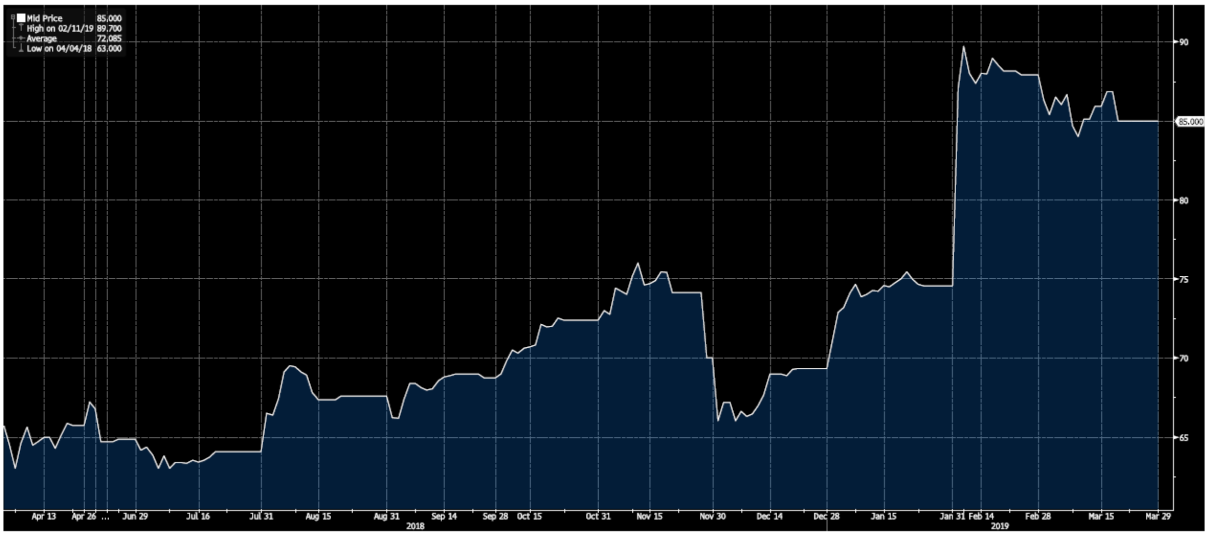

Image 1: Iron ore (62% CFR China) price, April 2018 – March 2019 (source: Bloomberg)

Other contributions to a larger-than-expected government surplus this year include the Coalition abandoning its attempt to lower company tax rates for big businesses, a $2.1bn saving resulting from automating Centrelink's income assessment process, and $1.6bn underspending on the NDIS due to a slower roll-out than expected.

As a result of expected future continuing surpluses, the Coalition anticipates Australian government net debt will be eliminated by 2029-30 (see Image 2 below):

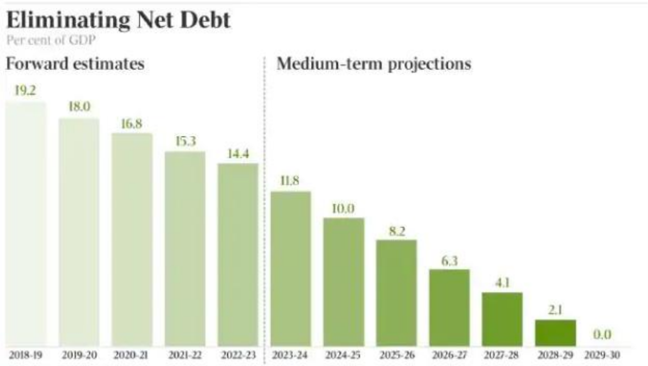

Image 2: Australian government net debt projections in the 2019-20 budget (source: The Australian)

However, assumptions underpinning the government's medium-term projections appear optimistic. They include 2.75% real GDP growth until 2021-22 and 3% beyond that, 3.5% growth in wages from June 2022, and unemployment remaining flat at 5%.

Over the same 10-year period, the budget papers predict US and Chinese economic growth to slow, and the IMF is predicting 2.1% GDP growth for Australia this calendar year. Across the last three years, wage growth in Australia has remained closer to 2%, even whilst the economy has been growing. There is no allowance for an economic downturn built into the figures, and the impact of falling house prices may serve to meaningfully dampen household spending. All this implies that if the government seriously wishes to eliminate net debt, it may need to embark on more significant reforms than those outlined in this year's budget.

The following section outlines some of the main measures announced in the 2019-20 budget. It is worth noting the budget has not yet been introduced to Parliament, as it is awaiting the outcome of the May 18 federal election. Thus, this paper also examines the Australian Labor Party's (ALP) alternative policies, and analyses each party's proposed budget from the perspective of an investor.

Budget measures

a) Personal income tax

The centrepiece of the 2019-20 Australian federal budget is a reduction in personal income tax rates and thresholds. Starting July 2024, a new 30% tax bracket for people earning between $45,001 and $200,000 will be introduced, which is expected to comprise 70% of all taxpayers. The 37% tax rate will be abolished and the highest tax rate will be 45% for those earning over $200,000.

Rates in 2017-18	Thresholds in 2017-18	New Rates in 2024-25	New Thresholds in 2024-25
Nil	Up to $18,200	Nil	Up to $18,200
19 per cent	$18,201 - $37,000	19 per cent	$18,201 - $45,000
32.5 per cent	$37,001 - $87,000	30 per cent	$45,001 - $200,000
37 per cent	$87,001 - $180,000	-	-
45 per cent	Above $180,000	45 per cent	Above $200,000

Image 3: 2019-20 Federal budget tax thresholds (source: budget.gov.au)

The following table outlines the tax payable by an individual before and after the introduction of the new personal tax rates and thresholds (excluding Medicare levy and tax offsets):

Income	Tax payable before changes	Tax payable after changes
$50,000	$7,797	$6,592
$100,000	$24,632	$21,592
$200,000	$63,232	$51,592
$300,000	$108,232	$96,592

Additionally, the Coalition will legislate to increase the Low and Middle Income Tax Offset (LMITO), a measure directly reducing the amount of tax to be paid. Notably, those on incomes between $48,001 and $90,000 will receive an offset of $1,080 instead of the existing $530, which gradually reduces to $0 for those earning between $90,000 and $126,000. The Coalition's version of this policy is intended to be temporary, ending in 2022-23.

The ALP, by contrast, intends to introduce a permanent version of stage one of the Coalition's tax plan, being an increase in the LMITO, while discarding those elements of its plan that involve tax cuts. Like the Coalition, it will offer a $1,080 tax offset for those on incomes between $48,001 and $90,000, but increase the offset for those earning under $48,001 to $350 from the $255 proposed by the Coalition.

A reduction in personal tax rates and thresholds above the $90,000 income level will not occur under the ALP. Instead, it plans to reintroduce the temporary budget repair levy, so that people with a taxable income of more than $180,000 will need to pay an extra 2% tax (which would remain until the budget surplus equalled 1% of GDP, expected to be in 2023 under the ALP). This would result in a top tax bracket of 49% for incomes over $180,000 when the Medicare levy is included, compared with 47% for incomes over $200,000 under Coalition policy. The ALP proposes to keep the 37% tax rate and will not lower the 32.5% tax rate. The below table shows the tax payable from July 2024 under Coalition and ALP governments (excluding Medicare levy and tax offsets):

Income	Tax payable (Coalition)	Tax payable (ALP)[1]
$50,000	$6,592	$7,797
$100,000	$21,592	$24,496
$200,000	$51,592	$63,496
$300,000	$96,592	$110,496

The ALP intends to use the money it saves from its higher taxation to pay for the LMITO and a variety of social welfare policies (such as cancer funding and other policies to be clarified during the election campaign), as well as to improve the budget surplus.

Some economists, such as Robert Carling, a Senior Fellow at the Centre for Independent Studies, have commented on the inefficiency of an LMITO policy compared to tax cuts. While the LMITO directly reimburses low and middle income earners, it does not improve their incentive to work. By comparison, a tax cut at the lowest income level will benefit all income earners, even as they move into higher tax brackets. The 2010 Henry Tax Review, commissioned by the Rudd government, paid heed to this sort of thinking by suggesting a 35% tax rate (including the Medicare levy) that covered 97% of Australians, and removing inefficient payments and smaller taxes. The idea being that a flatter tax rate would expand the tax base by reducing disincentives to work and improving incentives to save. The 2019-20 budget proposed by the Coalition appears to be at least partially modelled on this notion of a simpler taxation policy.

Over the last decade Australia's taxation system has done little to combat 'bracket creep', the phenomenon whereby income earners pay more tax in real terms as they are pushed into higher tax brackets. For example, an individual earning $175,000 and receiving annual pay rises of 3% will very quickly be pushed into the top tax bracket, which starts at $180,000. Some economists suggest this could be prevented by raising tax bracket thresholds in line with inflation, however when the government decides not to do this it benefits by receiving increased tax revenues. Under the Coalition's tax plan, by the time the top tax threshold is increased in July 2024 it will have been 15 years between such increases. Although these proposals will address bracket creep for top income earners, the bottom 80% will be paying more tax in real terms. Meanwhile, the ALP's policy of not adjusting most tax thresholds and rates deliberately takes advantage of bracket creep, allowing it to raise more revenue over time without making legislative changes to the tax system.

b) Company tax

The 2019-20 budget revealed fast-tracked company tax cuts for small businesses, so that a 25% tax rate will apply to companies with revenue under $50m five years earlier than previously planned. Currently, companies with turnover under $50m pay 27.5% tax on profits, which will be reduced to 25% by July 2021. The tax rate for companies above this $50m revenue threshold will remain at 30%. The ALP is adopting the same company tax plan as the Coalition for the 2019 election. This tax plan is summarised in the below table:

[1] Assumes the following tax rates: 19% payable for incomes $18,201 - $37,000, 32.5% payable for incomes $37,001 - $90,000, 37% payable for incomes $90,001 - $180,000 and 47% for incomes $180,001 and above (includes deficit levy).

Income year	Aggregated turnover threshold	Tax rate for base rate entities under the threshold	Tax rate for all other companies
2017–18	$25m	27.5%	30.0%
2018–19 to 2019–20	$50m	27.5%	30.0%
2020–21	$50m	26.0%	30.0%
2021–22	$50m	25.0%	30.0%

Image 4: Progressive changes to the company tax rate (source: ato.gov.au)

There are problems with adopting separate 25% and 30% tax rates for Australian-based companies. A two-tiered taxation system risks distorting incentives for companies operating near the $50m revenue threshold. They may try to artificially restructure their affairs or limit their growth to avoid crossing the threshold. Companies should be encouraged to grow, rather than punished for growing. Further, a 30% tax rate is uncompetitive when compared to other major economies. The US company tax rate is 21%, the UK's is 19% and Singapore's is 17%. On this basis, Australia is a relatively unattractive destination for big companies to domicile, and there is a risk that those already domiciled may decide to leave.

The Coalition also announced in the budget that it would expand its instant asset write-off policy by allowing businesses with turnover up to $50m to access it (from $10m currently), and increase the amount that can be written off from $25,000 to $30,000. This policy allows small businesses to immediately claim tax deductions on such asset purchases as tools, cars and equipment. The ALP's comparable policy allows businesses to deduct 20% of investment in eligible depreciable assets over $20,000 (with the balance depreciated in line with normal depreciation schedules).

The extension of the Coalition's version of this scheme to 30 June 2020 is expected to apply to a further 22,000 businesses (on top of the 350,000 businesses that have already taken advantage of it). When the policy was first introduced, retailers such as JB Hi-Fi and Officeworks saw a sales bump, as small and medium enterprises increased their spend on assets eligible for a tax deduction under the programme. Car dealerships (e.g. ASX-listed AP Eagers) and other office suppliers are also expected to gain.

c) Other measures

Other notable budget measures include a huge boost to infrastructure spending, a significant increase in funding to financial oversight agencies ASIC and APRA, extra aged and health care funding, a package to reform the Vocational Education and Training (VET) system and increased defence commitments. Spending cuts will affect universities and the CSIRO, as well as the R&D tax incentive scheme.

In relation to infrastructure, an extra $25bn expenditure on such projects was announced in the 2019-20 budget, on top of $75bn already earmarked to occur over the coming decade. Much of this is for major road and rail projects, while some is for related initiatives such as the Melbourne-Geelong fast rail, and a $3bn increase to the Urban Congestion Fund. Infrastructure-focused companies, such as Adelaide Brighton (which sells construction materials), Boral and many smaller specialised engineering-related companies will benefit from this boost in funding.

Meanwhile, the banking and financial services industry, which accounts for 32% of the ASX200, is expected to remain under regulatory pressure following the Royal Commission. ASIC's annual funding will be increased by $400m and APRA's by $150m. Bankers may decide to exercise caution as they wait to see the impact of these funding increases, and as the recommendations of the Royal Commission are implemented.

Policies of the Australian Labor Party

The ALP intends to approach the 2019 federal election with three policies of particular relevance to readers of this report: abolishing negative gearing on purchases of existing homes, halving the capital gains tax discount from 50% to 25% across all relevant asset classes, and removing the ability of individuals to receive franking credit refunds that exceed their tax payable. Certain classes of assets would be disadvantaged if these policies were enacted.

Prices of existing homes would fall as investors would no longer be able to deduct a net loss associated with their investment against their income. However, the policy would not apply to the construction of new homes, so residential building companies would not be directly disadvantaged (although new housing commencements are, incidentally, falling at 16%). A PwC study[2] found that this measure would increase government income in the short-term, but not necessarily the medium term, as individuals might be expected to instead offset investment costs against future capital gains. Instead of immediately claiming costs associated with an investment against personal income tax, these costs might be claimed after the asset is sold in order to reduce capital gains tax. On the other hand, the policy might lead to a more sustainable housing market, as investors / speculators are discouraged from taking out excessive debt with the expectation of capital price growth.

The ALP also proposes to halve the capital gains discount, so that people who hold assets for over 12 months would be liable to pay 75% of their marginal tax rate on any capital gain (equivalent to a 25% discount), as compared with 50% currently. Investments made by superannuation funds would be excluded, and the start date has not yet been announced (the policy would only apply to purchases made after the relevant start date).

The ALP's proposed change to franking credits will, and already has been, impacting investors' attitude towards their shareholdings. Its policy would stop individuals from receiving cash refunds of franking credits (in excess of what they already pay in tax). This includes SMSFs in retirement phase that have no tax payable, which would thereby not be eligible to receive imputation credit refunds. In anticipation of these changes being enacted, companies have been paying out dividends to use up their franking credits balance.

Impact of ALP's policies on investment

The ALP's policies would unquestionably reduce investor demand for residential housing, thus pushing down house prices (which is what the ALP appears to intend, to the benefit of first home buyers). General economic knock-on effects would ensue, as the value of home-owners' net assets decrease and consumption spending is subsequently cut. This has already been witnessed in the market for new cars, where vehicle sales have been hardest hit in those cities that have experienced the largest house price falls (car sales are down over 10% in Sydney and Melbourne).

[2] Source: https://www.pwc.com.au/tax/assets/tax-reform/tax-reform-negative-gearing-15feb16.pdf

Shares would also be affected, given a reduction in the CGT discount would decrease the after-tax gain available to investors. A strong dividend-paying, residential housing investment company listed on the ASX might be one to avoid if the ALP is elected. Conversely, it might become a good candidate for investment if the ALP is not elected. Australia's economy is strong, underpinned by employment and wage growth, and interest rates are expected to remain low for some time. Negative sentiment around the housing sector might begin to dissipate if some of the policies discussed above are not implemented, especially given the banking Royal Commission was not as damaging as some anticipated. Companies such as Queensland homebuilder Tamawood explicitly stated its customers had experienced delays getting loans approved as a consequence of the Royal Commission. This situation should be stabilising by now.

Conclusion

The 2019-20 budget handed down by the Coalition will benefit investors in numerous ways. Income taxes will be gradually reduced, which in addition to directly benefiting individuals, particularly those on higher incomes, should help spur consumer demand. Company taxes for small businesses will be reduced (by the ALP as well), and massive amounts of extra infrastructure will be developed. However it is worth remembering, particularly in relation to the Coalition's income tax cuts, that two elections are expected to occur before they can be fully implemented. This, and the possibility of economic exigencies, could well mean that only those tax policies that benefit the lowest income earners are implemented in the coming years.

The Supervised Fund should benefit from a number of the measures announced in the budget. Some of its invested companies with turnover under $50m will experience lower tax rates. The infrastructure boom will result in more work for some of the fund's companies. Others that will benefit are on the radar. One holding may become an important supplier to the Snowy Hydro 2.0 project, into which the government is injecting $1.4bn.

If the ALP wins government at the May 18 election, tax cuts and threshold reductions will not occur for most individuals. Property and shares would be adversely affected due to negative gearing, capital gains tax and franking credit reforms. However, some specific sectors, such as health and education, may benefit. The 2019 federal election will have some considerable ramifications for investors, and The Supervised Fund will be monitoring carefully to ensure its portfolio is appropriately positioned.

Lachlan Kirwan and Joseph Constable

The Supervised Fund

12th April 2019