Opening statement to the Economics Legislation Committee
Dr Steven Kennedy PSM
Secretary to the Treasury
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Thank you for the opportunity to make an opening statement.

International outlook

Having peaked in mid-to-late 2022, global inflation continues to ease.

Goods and energy price pressures have generally fallen, which is flowing through to headline inflation rates in many countries. However, the speed at which global inflation is moderating has slowed.

This is not unexpected. The echoes of the supply side price shocks are becoming smaller, and economies are transitioning back towards services leading inflation. The cycle in the price of services tends to lag that in goods and be more persistent, rising more slowly and falling more slowly. We can see this in a number of countries with core services inflation now being the largest contributor to headline inflation.

The moderation in inflation across advanced economies has led financial markets to bring forward their expectations of policy interest rate cuts.

In the United States, prospects for a soft landing have improved and current market pricing indicates that the Federal Reserve will begin reducing the federal funds rate in the June quarter, with around 1 percentage point of cuts fully priced in by the end of 2024.

Central banks, including the Fed, have shifted to more neutral policy guidance but have emphasised that more evidence is needed to be confident that inflation is headed back to target sustainably before easing monetary policy. The median projection among Fed officials as of December 2023 implied cumulative interest rate cuts by the end of 2024 of around 75 basis points.

The lagged effects of sharp monetary tightening seen over the past two years coupled with ongoing weakness in China's economy are expected to weigh on global growth in 2024. We expect global growth over 2023, 2024 and 2025 to be the weakest three years in three decades outside the global financial crisis and pandemic.

While the extreme volatility of the early 2020s has abated, recent events have highlighted that conditions are ever-changing. The disruption to shipping in the Red Sea has impacted global trade flows, increasing the costs and shipping times for seaborne freight between Europe and Asia. This could temporarily impact some domestic supply chains, including for passenger motor vehicles. And while global oil prices have fallen over recent months, they remain volatile.

Domestic outlook

This summer has reminded us that natural disasters are an ever-present risk in Australia, with cyclones, severe storms, floods, and bushfires impacting communities over December and January. These events have had particularly acute impacts on communities in Queensland, New South Wales and Victoria at a time when regions reliant on tourism and agriculture are in their peak seasons.

Many Australians will experience these natural disasters as an increase in the price of fresh produce. For those directly affected, the experience is much worse. But we expect the increases in fresh food prices to be less severe than those following floods across eastern Australia in 2021. We are also seeing effects from the increased severity and frequency of disasters in higher insurance premiums for those in exposed regions.

The Australian economy expanded by 0.2 per cent in the September quarter of last year, with continued strength in investment and services exports supporting demand.

Household consumption was flat in the quarter, with cost of living pressures continuing to weigh on real incomes and spending. While households are still saving in aggregate, the rate of saving is at its lowest point since the December quarter of 2007, and some are drawing on their accumulated savings to support consumption and service mortgage costs. This is the weakest period in per capita consumption since the GFC, although, fortunately it has not been accompanied by a significant deterioration in employment, which is often the case when consumption weakens.

Weakness in the household sector is being partly offset by stronger-than-expected investment and continued growth in services exports. We expect investment to remain elevated in the near-term, supported by a solid pipeline of public infrastructure projects, commercial buildings, private sector electricity infrastructure, and some large LNG projects.

The residential construction sector continues to face constraints, but is steadily working through a substantial pipeline, which will support activity in the near term. And there are early signs that conditions have stabilised and we expect a recovery in dwelling construction in 2024–25 and beyond, supported by growing demand and improving returns for investors.

The labour market remains strong but as expected there are signs of cooling.

The unemployment rate rose gradually in 2023, in response to the slowing economy. Labour demand has softened, with job ads easing from recent peaks and employment growth beginning to slow. The adjustment in the labour market has also occurred through reduced hours worked. We have seen average hours worked fall 4.6 per cent since its peak in April 2023. There are also early signs that the participation rate may have reached a cyclical peak, and we expect participation to moderate further as the labour market cools.

The unemployment rate is forecast to rise to 4½ per cent by the June quarter of 2025, and the participation rate and average hours are both expected to fall back further.

The strong employment growth over the past two years has had the welcome benefit of bringing more people into employment, particularly younger people and the long-term unemployed. It has also helped to improve the near-term budget position.

Inflation

There are encouraging signs on the inflation outlook with inflation continuing to moderate.

Annual inflation eased to 4.1 per cent in the December quarter 2023, well below its peak of 7.8 per cent in the December quarter 2022.

An easing in global supply chain disruption and normalisation in demand for goods has led to a moderation in goods inflation.

While volatility in global oil prices fed through to volatility at the bowser in late 2023, the overall moderation in oil prices over recent months has reduced the inflationary pressure from automotive fuels compared to the Mid-Year Economic and Fiscal Outlook (MYEFO) forecasts.

As in other economies, the initial impact of the pandemic and 2022 supply shocks have faded. But they are continuing to ripple through the economy and have been a driver of some services components – for example, businesses continue to face higher electricity costs.

More broadly, the drivers of inflation are normalising, with services inflation now leading. We expect that services inflation has likely peaked and will moderate over the next two years, as the second-round effects of earlier shocks fall away and the economy cools.

Rental price growth has added to inflationary pressures. Near-record low vacancy rates reflect strong rental demand amid constrained housing supply. Rental demand has been driven by strong growth in population following the reopening of international borders after the pandemic. The increase in Commonwealth Rent Assistance has helped to reduce the impact of rental price rises for the most vulnerable households.

Over the six months to December, Commonwealth rental assistance reduced the increase in rental prices by 1.6 percentage points and the energy bill relief rebates reduced electricity prices by 11.9 percentage points, both reducing the pressure on inflation more broadly.

Inflation has largely unfolded as expected since the forecasts released in the October 2022 Budget, when we were better able to capture and understand the likely impact of the significant supply shocks underway.

There is some downside risk to the near-term inflation forecasts published most recently at MYEFO reflecting the recent flow of information, although we still expect to see volatility in monthly inflation. We have not changed our view on inflation's steady return to the target band.

Further, and as we outlined some time ago, there has been no evidence of a wage price spiral emerging and no evidence of a change in inflation expectations. This provides further confidence that the unemployment rate can be maintained at levels previously thought unsustainable.

Not surprisingly there has been considerable focus on inflation and ongoing concerns about lifting productivity in the medium term and both remain crucial to future prosperity.

There has been perhaps less focus on the ongoing strong labour market outcomes and associated opportunities.

With the right policy choices, there remains a rare opportunity to sustain the economy closer to full employment than has been the case for many decades. Such an outcome would be life changing for many disadvantaged Australians.

Advice on amending tax cuts

Many households are continuing to be affected by cost of living pressures.

The Government recently announced a redesign of the 'Stage 3' tax cuts.

Treasury and the Department of Finance have been engaged in ongoing consideration of cost of living options since 2022, as reflected in both Budgets to date.

In December, the Prime Minister asked the Treasury and the Department of Finance to identify further options to provide cost of living relief to Australian households without putting upward pressure on inflation.

Treasury analysis, released by the Government at the time of their announcement, highlighted that price rises reflected in the CPI have been broad-based and, affected all Australian households. However, unanticipated cost of living increases associated with the rapid rise in inflation and rising interest rates have disproportionately impacted low-and middle-income households, who have less capacity to absorb rising prices.

Our advice recommended that redesigning the Stage 3 tax cuts was the most appropriate way of providing relief to households affected by cost of living pressures, while not impacting the inflation outlook.

We recommended proceeding with a tax cut of a similar size to counter the effect of increasing average income tax rates and because the immediate pressure on the Budget has been abating.

The Stage 3 tax cuts were designed under dramatically different circumstances than what we face today. While the initial impact of the COVID-19 pandemic and 2022 supply shocks have faded, their effect continues to ripple through the economy.

Our recommended redesign delivers an overall tax cut around the size of the original Stage 3 tax cuts, providing a save to the budget in 2024–25 of around $1.3 billion, and a total cost over the forward estimates of around $1.3 billion.

The redesign distributes the future impact of bracket creep more evenly. Taxpayers in the first seven taxable income deciles are expected to face a smaller increase in average tax rates over the coming years compared to no change and the original Stage 3.

Under the new arrangements, all taxpayers will now experience similar increases in average tax rates over time.

The redesign is also expected to result in a larger increase in participation. This is driven primarily by increases in hours worked and participation of women with taxable incomes between $20,000 and $75,000 – overall. We expect the change to persist given the change in growth of average tax cuts.

The redesign of the Stage 3 tax cuts will not add to inflationary pressures.

It is worth noting the economic environment in which these changes are taking place. The proposed tax changes come into effect from 1 July and will be delivered over the course of the financial year - as I highlighted earlier, over this period we expect inflation to continue to moderate - returning to the target band - while labour market conditions are expected to continue to ease and the unemployment rate to rise.

Competition reform

Treasury recently commenced a review of competition policy. The review is examining competition policy settings with a particular focus on merger policy and non-compete agreements in employment contracts, as well options to revitalise the national competition agenda.

An immediate priority for the Taskforce is looking at ways to ensure Australia's merger control system can properly target and stop harmful mergers that reduce competition, stifle innovation or lift prices.

The Government is working with the states and territories through the Council on Federal Financial Relations to revitalise our thirty-year-old National Competition Policy. Promoting efficient markets and competition is fundamental to lifting productivity and living standards.

This is particularly important for the new and growing areas of the economy such as the care and support sector and supporting the transition to net zero.

The Government has announced two complementary reviews to ensure regulatory settings appropriately support a competitive and sustainable food and grocery industry:

- a review of the Food and Grocery Code of Conduct, led by the Hon Dr Craig Emerson, which will report to Government by 30 June 2024; and
- an Australian Competition and Consumer Commission (ACCC) price inquiry into the supermarket sector, to ensure Australians are paying a fair price for their everyday groceries.

Near-term fiscal outlook

The 2023–24 Mid-Year Economic and Fiscal Outlook released in December continued to show welcome improvements in the near-term fiscal outlook.

A small deficit of $1.1 billion is now forecast for 2023–24, an improvement of $12.8 billion compared to Budget. In total over the forward estimates, the underlying cash balance has improved by $39.5 billion.

Tax receipts have been revised up by $64.4 billion across the forward estimates, with most of the upgrade coming from personal income tax and company tax. Personal income tax upgrades are driven by strong employment growth.

Higher company tax receipts reflect near-term strength in commodity export prices and higher non-mining corporate profits. Given iron ore and metallurgical coal prices have remained above their assumed MYEFO glide path, there are further upside risks to tax receipts.

Total payments have increased by $27.8 billion over the forward estimates. This largely reflects upwards revisions to existing payments, including interest on Government debt, the National Disability Insurance Scheme and Child Care Subsidy. Real payments growth is expected to remain low by historic standards and is forecast to average 0.8 per cent over five years to 2026-27.

Increases in interest payments reflect a higher cost of borrowing. The assumed weighted average cost of borrowing rose from 3.4 per cent at the time of Budget to 4.7 per cent at MYEFO. This reflects the increase in the 10-year yield on Australian Government bonds to the highest level since 2011 and mirrored trends in bond markets globally, in part due to expectations that central bank policy rates may remain higher for longer.

As a result of higher bond yields, MYEFO projected Australian Government interest payments will be the fastest growing major payment over the medium term. Bond yields have fallen since MYEFO, with the 10-year yield currently around 4.2 per cent. If these declines are sustained, this will unwind some of the upwards revisions to interest payments in MYEFO.

New policy decisions since Budget had a small impact on the budget balance, reducing the underlying cash balance by $5.2 billion over the forward estimates, and $650 million in 2023-24. Returning 92 per cent of tax upgrades in MYEFO to the budget continues to help ensure that fiscal policy works with monetary policy and does not add to inflationary pressures, and lowers debt.

As a result of the improved fiscal outlook, gross debt is now expected to fall to 34.0 per cent of GDP by 30 June 2023, 5.1 percentage points lower than at the height of the pandemic on 30 June 2021. Gross debt is expected to remain lower than projected at Budget across the medium term.

While these improvements are encouraging, budget deficits are still projected across the medium-term, and the debt-to-GDP ratio remains high by historic standards.

In finishing I would like to acknowledge that this will be the last Senate Estimates hearing for Mr Chris Jordan AO. Mr Jordan has served as the ATO Commissioner since 1 January 2013 and leaves a proud legacy for the ATO and the tax system.

The new ATO Commissioner, Mr Rob Heferen, who previously worked at the ATO and served as Deputy Secretary of Revenue Group at Treasury, will commence on 1 March 2024. We warmly congratulate Rob on his appointment.

Thank you for the opportunity to provide you with an update.