

2007-08 Federal Budget: Lots of redistribution spiced with some reform

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Overview

- The underlying cash balance is expected to be in surplus to the tune of \$13.6bn (1.3% of GDP) in 2006-07, and \$10.6bn (1.0% of GDP) in 2007-08. Thereafter, surpluses are projected to remain around, or a little above, the 1% of GDP mark.
- Revenue surprises have again enabled the Government to fund large tax cuts and expenditures on electorally-appealing measures whilst still maintaining significant surpluses and therefore an air of fiscal prudence.
- Total receipts in 2006-07 are expected to be \$3.8bn higher than at the time of the 2006-07 Budget last May. For the three years spanning 2007-08 to 2009-10, revenues are now forecast to be a whopping \$23.6bn more than at the last Budget.
- As in previous years, the Government has spent almost every cent of this revenue surprise – this year on tax cuts and increased child care assistance for families, and spending on a range of infrastructure measures to expand the supply side of the economy.
- On balance, this Budget imparts some stimulus to the economy, but should be within the tolerance band of the Reserve Bank, particularly given the low inflation outcomes over the past two quarters.
- In the short run, there is little justification for the Reserve Bank to lift interest rates and we believe rates are now on hold until after the election. However, in the medium term, with an economy which is already capacity constrained, and with growth expected to accelerate, the Reserve Bank will remain alert to an acceleration in price pressures.
- Treasury has a positive outlook for the economy over the next year. The global environment will remain supportive, and with an assumed rebound in rural production, Australian growth will accelerate to 3¼% in 2007-08 from 2½% in 2006-07. Treasury's view of inflation is similar to that of the Reserve Bank, with inflation expected to be in the upper half of the target band by June 2008.
- The 2007-08 Budget does appear to have paid some heed to Treasury Secretary Ken Henry's advice that in a 'full employment' economy, 'policy interventions' should be directed towards 'expanding the nation's supply capacity'. But it hasn't avoided actions whose principal economic impact will be to boost demand. In an election year, it probably would have been naïve and unrealistic to have expected otherwise.

Key Budget aggregates

	06-07(e)	07-08(f)	08-09(p)	09-10(p)	10-11(p)
Underlying cash balance					
\$bn	13.6	10.6	12.7	13.8	12.4
% of GDP	1.3	1.0	1.1	1.2	1.0
Fiscal balance					
\$bn	11.9	10.0	11.9	14.1	13.7
% of GDP	1.2	0.9	1.0	1.2	1.1

Source: Budget Papers

Saul Eslake
Chief Economist

The Budget embodies a trade-off between good economics and good politics

The government has received yet another windfall revenue gain...

...and has spent all of it

The Budget is mildly stimulatory...

Lots of redistribution spiced with some reform

Budgets always embody a trade-off between good economics and good politics, and never are the tensions inherent in that trade-off greater than in an election year when the Government is behind in the polls. We've been here before, of course, in 2001 and in 2004; on each of those occasions a generous Budget made a major contribution to securing the Government's re-election some six months later.

This trade-off is somewhat easier in an economy which is operating at close to full employment and also benefiting from a resources boom that has been both stronger and more enduring than anyone had predicted. It allows the Government to appear both generous (by handing out lots of well-targeted cash) *and* responsible (by running what it can characterise as 'strong' surpluses).

Since the Mid-Year Economic and Fiscal Outlook was released last December, what the Budget Papers term 'parameter variations' – that is, upward revisions to estimates of revenue and downward revisions to estimates of expenses as a result of changes in economic assumptions, observed changes in the level of tax collections, etc. – have put roughly an additional \$70bn at the Government's disposal for the five years 2006-07 through 2010-11, (around \$20bn of it from additional company tax collections). By our calculations, which incorporate very conservative assumptions regarding years beyond the four year forward estimates period for which estimates are published in each Budget, that brings the total 'windfall' gains over the nine years covered by this and the past four Budgets to \$398bn. (For perspective, these numbers are equivalent to about 4% of GDP over the nine-year period).

Of the \$70bn extra which the Government has had put at its disposal over the current and next four financial years, it has in the lead-up to this Budget spent or given away in tax cuts \$71bn. That brings the cumulative total of 'policy decisions' since the 2003-04 Budget to \$388bn (again making very conservative assumptions about the impact of 'policy decisions' beyond the fourth year after the Budget in which they were made).

This still leaves 'underlying' cash surpluses in the range of 1-1¼% of GDP in each of the current and next four financial years, which the Government views as contributions to national saving and as a source of downward pressure on interest rates.

However we believe that the impact of a Budget on the economy cannot be judged solely by whether the Budget is in surplus or not, nor necessarily by the change in the surplus as a percentage of GDP from year to year (the short-hand method used by many economists). It is also important to consider the impact of the Government's revenue and expenditure policies on the saving and spending patterns of different sectors of the economy.

The Government has been collecting its 30% share of the additional revenue initially accruing to mining companies as a result of the commodity boom – as it is perfectly entitled to do – but, rather than saving a significant proportion of it in the form of larger Budget surpluses than originally envisaged, has been handing over more than half of it to households in the form of tax cuts or increased benefit payments. This Budget continues that pattern – personal income tax cuts and increases in benefit payments (including \$3.2bn in one-off cash payments to various categories of individuals before the end of the current financial year) account for \$36bn of the \$71bn cost of 'policy decisions'.

Had mining companies not had to hand over 30% of their increased profits to the Government, they would likely have recorded higher retained earnings (saving), increased dividends (more than half of which would in turn have leaked overseas to foreign shareholders or have been re-invested by institutional shareholders), or increased levels of capital expenditure which would have in turn enhanced the economy's supply potential. But the households who are the beneficiaries of the Government's generosity are likely to spend all of it (and a bit more, since the aggregate household saving rate is negative). So even though the Budget surplus is little changed from year to year, there is a stimulatory impact on domestic demand.

...but there are also some constructive reforms to expand the supply side of the economy

This helps explain why household demand has strengthened during the current financial year notwithstanding the three increases in interest rates between May and November 2006. Fiscal largesse has more than offset monetary stringency, and will likely continue to do so in 2007-08.

Fortunately, from the Government's perspective, the lower-than-expected inflation outcomes of the past two quarters have removed the threat of any increase in interest rates between now and the next election. The give-aways in this Budget do not alter that conclusion. But they do re-inforce the likelihood that, eventually (though now not until after the election), interest rates will rise again.

That is not to say that the Government has been 'irresponsible', or that the Budget does not contain important and constructive reforms.

The income tax cuts have been structured in a way that should improve incentives to work among low-income earners and second-income earners considering returning to employment after a period of caring for children. The restructuring of the Child Care Benefit should also have a positive impact, at the margin, on labour force participation. The additional funding for higher and technical education (including the creation of an Endowment Fund for universities), and the focussed initiatives on school education, are welcome investments in Australia's human capital. The \$3bn for the National Plan for Water Security, the \$4.7bn extension of the Auslink roads program and the \$750mn program for Indigenous Australians are all directed to obvious needs.

Nonetheless we find it impossible not to wonder whether future generations of Australians might not look back upon the nearly \$400bn of windfall gains that have been redistributed through this and the preceding four Budgets and wonder whether we could not have had rather more far-reaching reform, for that enormous sum. As but one example, it ought to have been possible to have achieved much more comprehensive reform of the personal income tax system – in the same spirit as that which informed the Howard Government's reform of the indirect and company income tax systems seven years ago, that is, broadening the base and lowering rates – than what has emerged from the past two Budgets and this one, which has been for the most part a matter of moving thresholds (admittedly by large amounts in some cases) and tinkering with the top two rates.

We have no serious dispute with Treasury's economic forecasts for the 2007-08 year, even though inevitably there are differences over the growth rates of individual components of GDP. On the assumption (and at this stage that's all it is) that the drought breaks, growth of 3¾% should be attainable (especially given the stimulus to household demand coming from the Budget).

We hope that this time the Treasury is right in forecasting a pick-up in export volumes, having 'over-estimated' growth in this aggregate by an average of 5 pc points per annum over the past five years (not that our forecasts have been any better on that score). The forecast assumes that non-rural commodity prices will fall in 2007-08 (while noting, not unreasonably in the light of recent experience, that they might not). It's a little surprising that the unemployment rate is forecast to increase back to 5%, although Treasury says that's partly due to increases in the labour force participation rate induced by some of the Government's other reforms.

It is disappointing – but not unrealistic – that, after rebounding from a mere ½% in 2006-07 to a forecast 2% in 2007-08, labour productivity growth is implicitly assumed to revert to its pre-1990s average of 1¾% per annum in 2008-09 and beyond.

The 2007-08 Budget does appear to have paid some heed to Treasury Secretary Ken Henry's advice that in a 'full employment' economy, 'policy interventions' should be directed towards 'expanding the nation's supply capacity'. But it hasn't avoided actions whose principal economic impact will be to boost demand. In an election year, it probably would have been naive and unrealistic to have expected otherwise.

Mark Rodrigues
Senior Economist, Australia

Budget details

It must be an election year...

Peter Costello's 12th Budget is a good election year budget, with a little (and in some cases a lot) in it for everyone. As was well telegraphed, major new expenditures were largely directed toward three broad categories: families (child care and of course, tax cuts); infrastructure (education, roads and water); and defence.

Of course, it's easy to be generous when you're swimming in cash. Once again, revenues have surprised on the upside, with total receipts in 2006-07 expected to be \$3bn higher than forecast in the 2006-07 Mid-Year Economic and Fiscal Outlook (MYEFO) in December and over \$3.8bn higher than at the time of the 2006-07 Budget last May. For the three years spanning 2007-08 to 2009-10, revenues are now forecast to be almost \$15bn higher than expected at MYEFO and a whopping \$23.6bn more than at the last Budget (even after a \$22.4bn fall in revenue over this period as a result of personal income tax cuts announced in this Budget).

The majority of the 'surprise' comes from corporate taxes courtesy of China and the commodity price boom, with company and petroleum resource rent tax receipts estimated to be \$480mn higher in 2006-07 relative to the 2006-07 Budget forecast, and \$19bn higher for the three-year period commencing 2007-08. Stronger labour market outcomes (higher employment and wages) also boosted revenues from individuals. Relative to last year's Budget, individuals taxation is expected to be \$1.7bn higher in 2006-07, and \$14.9bn higher for the three years commencing 2007-08 (excluding the effect of the latest round of tax cuts).

Windfall revenues have been almost entirely spent

As in previous years, the Government has spent almost every cent of this revenue surprise. Policy decisions taken since the 2006-07 Budget amount to \$6.25bn in 2006-07 and \$61.4bn over the period 2007-08 to 2009-10 (see page 11 for a detailed list of new Budget measures). This compares with 'parameter and other variations' that have added \$9.1bn in 2006-07 and \$64.7bn between 2007-08 and 2009-10 to the Budget bottom line.

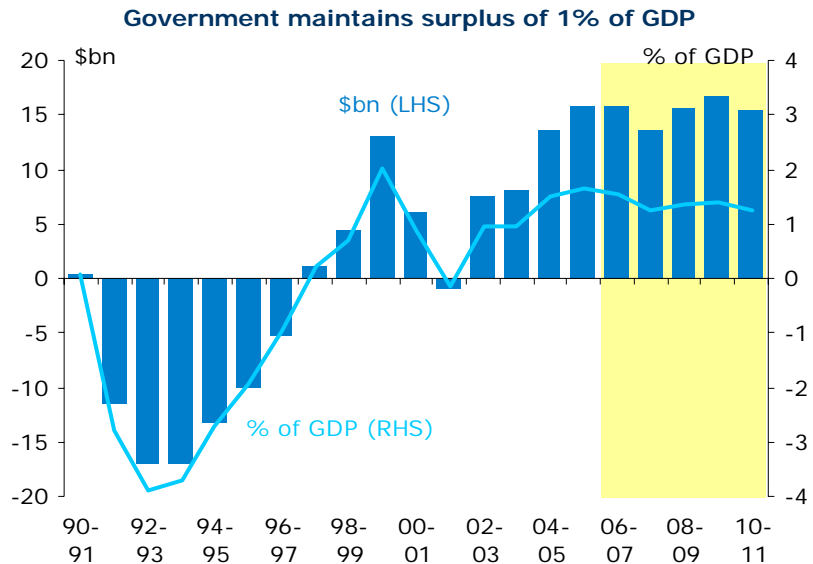
Reconciliation of general government underlying cash balance estimates

	06-07	07-08	08-09	09-10
	\$bn	\$bn	\$bn	\$bn
2006-07 Budget	10,828	10,628	11,225	12,019
Policy decisions	-2,317	-5,455	-4,712	-5,010
Parameter and other variations	3,316	4,489	5,331	6,987
Total changes	999	-966	618	1,977
2006-07 MYEFO	11,827	9,662	11,844	13,997
Policy decisions	-3937	-11,885	-15,880	-18,467
Parameter and other variations	5,741	12,861	16,747	18,282
Total changes	1,804	975	867	-185
2007-08 Budget	13,631	10,637	12,712	13,812

Source: Budget Papers

In other words, the revenue surprises have enabled the Government to fund massive expenditures on electorally appealing measures whilst still maintaining significant surpluses and therefore an air of fiscal prudence. The underlying cash balance is expected to be in surplus to the tune of \$13.6bn (1.3% of GDP) in 2006-07, and \$10.6bn (1.0% of GDP) in 2007-08. Thereafter, surpluses are projected to remain around, or a little above, the 1% of GDP mark.

Revenue surprises stem from higher company and personal income tax receipts



Note: For the purposes of consistent comparison with earlier years, Future Fund earnings are included in the underlying cash balance from 2005-06.

Source: Budget Papers

Whether this Budget is fiscally prudent will be hotly debated

The question of whether this Budget is fiscally prudent in an economy operating at full capacity is one that will be hotly debated over coming days and weeks. The Government will of course point to the fact that the Budget is in surplus and is forecast to remain in surplus at between 1 and 1½% of GDP, as evidence of fiscal responsibility. A less kind analysis would note that the Government is pumping almost \$70bn into the economy between 2006-07 and 2009-10, and, but for the policy decisions since the 2006-07 Budget, this Budget would be in surplus to the tune of \$19.9bn (1.9% of GDP) in 2006-07 and between \$28bn (2.5% of GDP) and \$37.3bn (3.1% of GDP) over the next three years.

However, not all new initiatives will stimulate the economy and therefore generate inflationary pressures to the same extent. Many of the policies are medium-term measures aimed at expanding the overall supply capacity of the economy, and to that extent, would have a moderating effect on inflation in the longer term. The \$3.5bn *Realising Our Potential* education package, the \$22.3bn road and rail infrastructure package between 2009-10 and 2013-14, and the \$10bn National Plan for Water Security would fall into this category.

In the end, the assessment of how stimulatory this Budget is will hinge on the extent to which it directly boosts household disposable incomes in the near term.

More tax cuts

The 2007-08 introduces another wave of personal income tax cuts, spread out over the next two years. From 1 July 2007 the 30% threshold will be raised to \$30,000 (from \$25,000) and the Low Income Tax Offset will be increased to \$750 per annum (up from \$600) and phased out from \$30,000 (up from \$25,000). From 1 July 2008, the 40% threshold will be raised to \$80,001 (from \$75,001) and the 45% threshold will be raised to \$180,001 (from \$150,001). This will boost household disposable incomes by \$5.3bn in 2007-08 and by a total of \$31.5bn over the next four years.

Measures in the Budget targeted at families and older Australians will also directly boost household incomes. From 1 July, the Child Care Benefit will increase by 10% while the Child Care Tax Rebate will be made available as a direct payment shortly after the year in which the child care costs are incurred. Together, these changes will boost household incomes by \$451.6mn in 2006-07 and \$657.6mn in 2007-08. Meanwhile, bonus payments to seniors and carers will boost household incomes by over \$1.7bn before the end of this financial year.

Overall these measures will boost household disposable incomes by around \$2bn this year and \$6bn in 2007-08. All other things being equal, we would expect at

Tony Pearson
Head of Australian Economics

A strong economy will get even stronger

least a one-for-one flow through to household consumption (assuming a zero savings rate), boosting consumption growth by 1ppt in 2007-08. However, the transmission of tax cuts to household spending has been somewhat less than expected over the past four years, and next year's stimulus, while not insignificant, will be less than in previous years. On balance, given recent low inflation outcomes and notwithstanding already strong household demand, we expect that this level of stimulus would remain within the RBA's tolerance zone.

Economic forecasts

The Government sees a strong economy that will get even stronger. The global environment will remain supportive and most components of Australian domestic demand will remain solid. Real GDP is expected to increase by 3¾% in 2007-08, a significant acceleration on the 2½% expected for 2006-07. This mainly reflects improved conditions in the rural sector, and is based on an assumption of a return to more normal seasonal rainfall and a partial recovery from the drought, which will add ½ppt to growth. It also reflects the beginning of a recovery in dwelling investment, accelerating export growth, and continued solid growth in employment, household consumption and business investment. We broadly agree with this view.

The global environment is expected to remain very supportive with world growth anticipated to be a buoyant 5% in 2007 and 2008, only a little below the 5.4% recorded in 2006, which was the fastest pace recorded in over 30 years. This will be driven by strong growth in China, India, Japan and the Euro area. Growth in the United States will slow in 2007 before reaccelerating in 2008. There are nevertheless downside risks to this positive world view. These include a sharper than expected slowing in the United States, increased inflationary pressures, a return to higher oil prices, an increase in financial market volatility, and a disorderly unwinding of global imbalances (such as the Yen carry trade and the United States current account deficit).

International GDP growth forecasts^(a)

	2007		2008	
	Budget	ANZ	Budget	ANZ
United States	2¼	2.3	3	3.0
Euro area	2½	2.1	2¼	2.0
Japan	2	2.3	2	2.0
China	10½	10.2	10¼	9.6
India	8¼	8.7	7¾	8.5
Other East Asia	5	5.3	5	5.4
World	5	4.6	5	4.6

Source: Budget Papers and Economics@ANZ.

(a) Growth rates for World and the euro area are calculated using GDP weights based on purchasing power parity, while growth rates for Other East Asia are calculated using export trade weights.

Turning to the domestic economy, conditions in the household sector are expected to remain buoyant. Employment growth is expected to remain strong, although the annual rate of growth will ease to 1½% in 2007-08 from 2½% in 2006-07. Wage growth will remain at around its current cyclic high of 4¼%pa. These underlying drivers of household disposable income will be supported by the tax cuts and benefit changes announced in the Budget, as well as continued strong wealth gains. These positives will maintain household consumption at around the current 3½%pa pace.

Investment in dwellings is expected to lift slightly this year and next after two years of decline. The recovery will be led initially by alterations and additions, and then by owner-occupiers building houses, with an increase in rental yields expected to encourage more investor activity during 2008.

Growth in business investment will slow from the very strong pace of the past four years but will remain at a high level. Mining and construction will continue to underpin business investment, although capacity constraints and delays in obtaining labour and materials could moderate expansion in this sector.

Public final demand – that is, investment and consumption by governments and their enterprises – will continue to grow strongly. This will include a sharp lift in investment by state and local governments, with a focus on infrastructure.

Australian economic forecasts^(a)

	2006-07		2007-08	
	Budget	ANZ	Budget	ANZ
Demand and output				
Consumption	3½	3.7	3½	3.8
Dwellings	2½	2.5	2½	3.2
Business investment ^(b)	4	2.3	7½	3.1
<i>Non-dwelling</i>	12	9.7	7	9.8
<i>Plant and equipment</i>	-1½	-3.2	6½	-2.8
Priv. demand	3½	3.2	4¼	3.6
Public demand	4	5.1	3¾	3.5
Changes in inventories	0	-0.1	¼	0.2
GNE	3½	3.5	4¼	3.8
Net exports ^(c)	-1¼	-1.4	-½	-0.4
<i>Exports</i>	3	3.6	5	6.4
<i>Imports</i>	8½	9.4	6½	6.9
GDP	2½	2.5	3¾	3.5
Other indicators				
CPI	2¾	2.8	2½	2.3
Employment	2½	2.6	1½	1.9
Unemployment rate (%)	4¾	4.6	5	4.6
Wage price index	4¼	4.1	4¼	4.1
Terms of trade	6	8.1	-1½	0.5
Current account (\$mn)	-58¼	-57.6	-65¾	-60.4
% of GDP	-5¾	5.5	-6	5.4

Source: Budget Papers and Economics@ANZ

(a) Per cent change on previous year unless otherwise stated.

(b) Excluding transfers of second-hand asset sales from the public sector to the private sector.

(c) % point contribution to growth in GDP.

One of the frustrations is that net exports will continue to subtract from growth in 2007-08. It is not that exports won't grow; they will, with an acceleration in growth to 5% in 2007-08, up from 3% in 2006-07. This will continue to be led by growth in non-rural commodity exports. The problem for the external sector is that imports will also continue to grow strongly, albeit at a slightly slower pace than in 2006-07. The overall effect is that net exports will subtract ½ppt from growth in 2007-08 – but at least that is an improvement on the expected 1¼% deduction from growth in 2006-07.

We believe interest rates are now on hold until after the election

Wain Yuen
Economist, Industry

The key source of Australia's stellar economic performance over the past half decade has been the fabulous rise in the terms of trade, which reached the highest level in over 50 years in the December quarter 2006. Each year the Government assumes the terms of trade has peaked, and will decline over the forward estimates as increased supply comes on stream. It is no different this year - except this time we believe they have got it broadly right. One implication of this is that the successive windfall gains to the Budget of the past half decade might now be coming to an end; we may have seen the last of the really big spending Budgets.

Inflation is expected to ease to 2½% in 2007-08 from 2¾% in 2006-07. However, the through-the-year picture is not so benign, with inflation accelerating to 2¾% over the four quarters to June 2008. This view is consistent with that of the Reserve Bank published in the recent May Statement on Monetary Policy. In the short run there is little justification for the Reserve Bank to lift interest rates and we believe rates are now on hold until after the election. However, in the medium term, with an economy which is already capacity constrained, and with growth expected to accelerate, the Reserve Bank will remain alert to an acceleration in price pressures.

Impact on business

After the Government's announcement of its \$1.4bn industry policy last week, business might have been optimistic about what the 2007-08 Budget might deliver. But there was little directly aimed at business. Instead the Budget delivered a few measures to reduce small business compliance costs, further details about the Government's industry policy and an easing in the carry-forward of tax losses for large businesses.

Small business measures

The Budget Overview claims that "the Government will cut tax on small business by \$540mn over four years ...". However, further analysis shows that the \$540mn tax cut is largely illusory. Around half of this tax cut appears attributable to the Government not proceeding with changes to the way it currently taxes finance leases.

What the budget offers is a handful of measures designed to reduce small business compliance costs:

- From 1 July 2007, businesses with turnover below \$75,000 need not register for the GST.
- From 1 July 2008, businesses that register for GST and choose to report and pay GST annually may also pay their pay-as-you-go instalments annually.
- Businesses will no longer require a tax invoice to claim GST credits for purchases of \$75 or less.

In addition, the budget allocates \$49mn over four years for an integrated online registration system for both the Australian Business Number (ABN) and business names.

The Budget also provides \$14.3mn to extend the Government's *Building Entrepreneurship in Small Business* program for another two years. This program funds third party service providers to deliver skills development, mentoring, succession planning and advisory services to small businesses.

\$1.4bn industry policy

Further details about the Government's ten year \$1.4bn industry policy were included in the Budget. The main elements of the policy are:

- At a cost of \$200mn over four years, the 175% R&D tax concession was extended to subsidiaries of multinational enterprises.
- \$171mn over five years was allocated to establish Australian Industry Productivity Centres which will provide advisory and diagnostic services to small and medium enterprises.

- \$122mn over five years was provided to support Australian businesses participating in global supply chains.

Large business measures

Turning to large businesses, the Government will make it easier for companies with an income in excess of \$100mn to carry forward losses, at an estimated cost of \$175mn over four years.

Measures benefiting businesses indirectly

All businesses will benefit to the extent that the personal income tax cuts flow through to increased consumer spending. Businesses will also benefit from the Government's attempts to ease labour supply constraints. In particular, an increase in the net migration intake will help in the near term, while education and training programs (see page 11 for further details) will help in the longer term.

Financial market implications

The Government's underlying cash surplus for 2007-08 was a little below, but within the range of market forecasts, limiting the financial market impact. Markets were priced for fiscal stimulus in 2007-08 and they got it. The bank-bill futures strip was unchanged, while the three-year futures contract had rallied 1.5bps one hour after the Budget was released. The ten-year futures contract had rallied 2.5bps, helping the curve to flatten 1bp. We suspect the market was already short heading into the Budget. The A\$ which had jumped half a US cent earlier in the day, following the stronger than expected retail sales figures, slipped from US\$0.83, but found support at US\$82.80.

Medium term, the 2007-08 Budget reinforces our strategic outlook that yields will ultimately move higher at the front-end of the Australian yield curve. We think the Government's fiscal policy has only emphasised the risks to monetary policy and front-end yields. We think the new medium term trading range for three-years is likely to be 94.00 to 93.25. The risks to monetary policy from fiscal stimulus supports our view that the A\$ will remain within a US\$0.80 to US\$0.84 range, with short-term risks skewed to the upside.

The Australian Office of Financial Management's (AOFM) bond issuance program for 2007-08 will remain in line with the Government's aim to maintain liquid and efficient Treasury bond and bond futures markets. This involves issuing a five-year and 13-year bond in alternate years. Gross issuance in the 2007-08 fiscal year will amount to \$5.1bn. This issuance will be directed towards a further \$2.1bn of the April 2012 bond, and a \$3.0bn of a new May 2021 bond.

Announced Bond Issuance Program

	Amount (A\$bn)	Timing
Bonds on issue, 30-June-07	47.2	
Maturities		
10.0% Oct-07	2.9	H2 2007
Top Up		
5.75% Apr-12	2.1	H2 2007*
New Issuance		
May-2021	0.8	H2 2007*
May-2021	2.2	H1 2008*
Net Issuance	2.2	
Bonds on issue, 30-Jun-08	49.4	

Source: ANZ Investment Bank and Commonwealth Treasury

*ANZ expectations

We think this is consistent with the 2021 bond entering the ten-year bond futures basket in mid 2008, after the expiry of the June 2008 futures contract.

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There has been little financial market impact

But the Budget emphasises the risks to monetary policy and short-term yields

The May 2021 bond will replace the April 2015 bond in the ten-year basket in the September 2008 bond futures contract. By mid 2008, the \$3.0bn on issue should be enough to ensure sufficient liquidity in a bond that is part of the ten-year bond futures contract basket.

Taking into account maturities and Australian Government holdings, net issuance in 2007-08 will be around \$2.2bn. This will take the amount of Australian commonwealth Government Bonds (ACGBs) on issue to \$49.4bn by 30 June 2008.

Future Fund in good shape and Education Fund established

The Future Fund, which was established last financial year to offset the Government's own unfunded superannuation liabilities, will have \$52bn of assets by the end of June. The current balance of \$49bn will be topped up with just under \$3bn in earnings by the end of the financial year. The Government also expects to make a further contribution to the Fund from the second instalment of Telstra sale proceeds.

The Government did not commit to adding the 2006-07 surplus or any future surpluses to the Fund, which may be because the current asset base could grow to its target of \$140bn by 2020 without any more injections. We estimate that the Fund could reach this target without any more surpluses as long as the Fund achieves nominal growth of around 8%.

There was no further information in the Budget about the Future Fund's investment strategy given that it is now in the hands of the Future Fund Board of Guardians. But we do know from the Budget that the Future Fund assets are all currently held as cash and fixed interest securities and this will progressively be invested in a mix of cash, fixed interest and equities over the coming years.

Given the Future Fund is in such good shape the Government has had to find another use for its embarrassing riches and this time it has chosen education. The Government has allocated \$5bn from the 2006-07 surplus to establish a Higher Education Endowment Fund. The income from the Fund, which will also be managed and invested by the Future Fund's Board of Governors, will be distributed to individual institutions for capital works and research facilities by the Minister for Education, Science and Training.

Given the Government has no debt and revenues continue to surprise on the upside, the Treasurer has to keep finding new ways to invest the surplus cash without adding to interest rate pressure. This education capital fund, like the Future Fund and to some extent the Communications Fund and Water Fund, give the Government capacity to target politically sensitive areas without directly stimulating the economy. We would argue that the Government would be better not to be consistently surprised by the strength of its tax revenues in the first place, but the choice of a higher education fund is better for the short-term economic outlook than further tax cuts.

Key policy measures at a glance

Families

- Tax cuts worth \$31.5bn over four years. From 1 July 2007, the low income tax offset will increase to \$750 per year and the 30% threshold will rise from \$25,000 to \$30,000. From 1 July 2008, the 40% threshold will increase to \$80,000 and the 45% threshold will increase to \$180,000.
- Improvements to child care. From 1 July 2007, rates of Child Care Benefit will increase by 10% on top of indexation and the Child Care Rebate will be available as a direct payment shortly after the end of the year.

Superannuation and Older Australians

- One-off doubling of superannuation co-contribution for eligible contributions made in 2005-06 to improve superannuation savings for low income earners by \$1.1bn.
- One-off payments of between \$500 and \$1,000 to older Australians and carers to be paid by 30 June 2007.

Health

- \$772mn for improved detection and treatment of chronic and complex conditions, \$486mn for medical research infrastructure in 2006-07, \$1.6bn for aged care initiatives.

Defence and Security

- \$6.1bn over ten years to enhance recruitment and retention of military personnel and logistics.
- \$702mn for the fight against terrorism and improved e-security.

Business

- Reduced tax compliance costs for small business. From 1 July 2007 business with turnover below \$75,000 need not register for the GST. Those who voluntarily register will have the option of reporting and paying GST annually, and those who do so may also elect to pay pay-as-you-go instalments annually. Business will no longer require a tax invoice for purchases of \$75 or less.
- Expansion of access to the 175% R&D tax concession to cost \$200mn over 4 years.
- \$171mn over five years to establish Australian Industry Productivity Centres.
- Allowing previous years tax losses to offset profits for companies with turnover of \$100mn or over, to cost \$175mn over four years.

Transport

- \$22.3bn over the five years from 2009-10 for road and rail infrastructure, including \$416.8bn for the national network.

Education

- \$5bn in a new Higher Education Endowment Fund with the earnings to provide a perpetual source of funding for capital works and research facilities.
- \$768mn for universities to simplify and boost funding and enrolment flexibility.
- \$222mn for extra income support for tertiary students and an extra 3,500 Commonwealth scholarships.
- \$549mn for 1st and 2nd year apprentices in skill-shortage trades for a \$300 education voucher to offset fees. If under 30 years of age, a \$1,000 tax-free wage top-up will apply.
- \$843mn to improve the quality of teachers. \$700 tutorial vouchers to help students meet literacy and numeracy standards.

Agriculture and the environment

- An additional \$314mn in Exceptional Circumstances assistance.
- \$342mn for improved rural services.
- \$205mn to extend the Agriculture – Advancing Australia initiative.
- \$741mn for 'practical' climate change initiatives, including the doubling to \$8,000 for the installation of solar panels by households.
- \$10bn over ten years to conserve and sustain Australia's water supply.
- \$2bn to extend the National Heritage Trust.

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