

The 2007-08 Budget: context, construction and consequences

**Presentation to
Economics Society of Australia
(Canberra Branch)**

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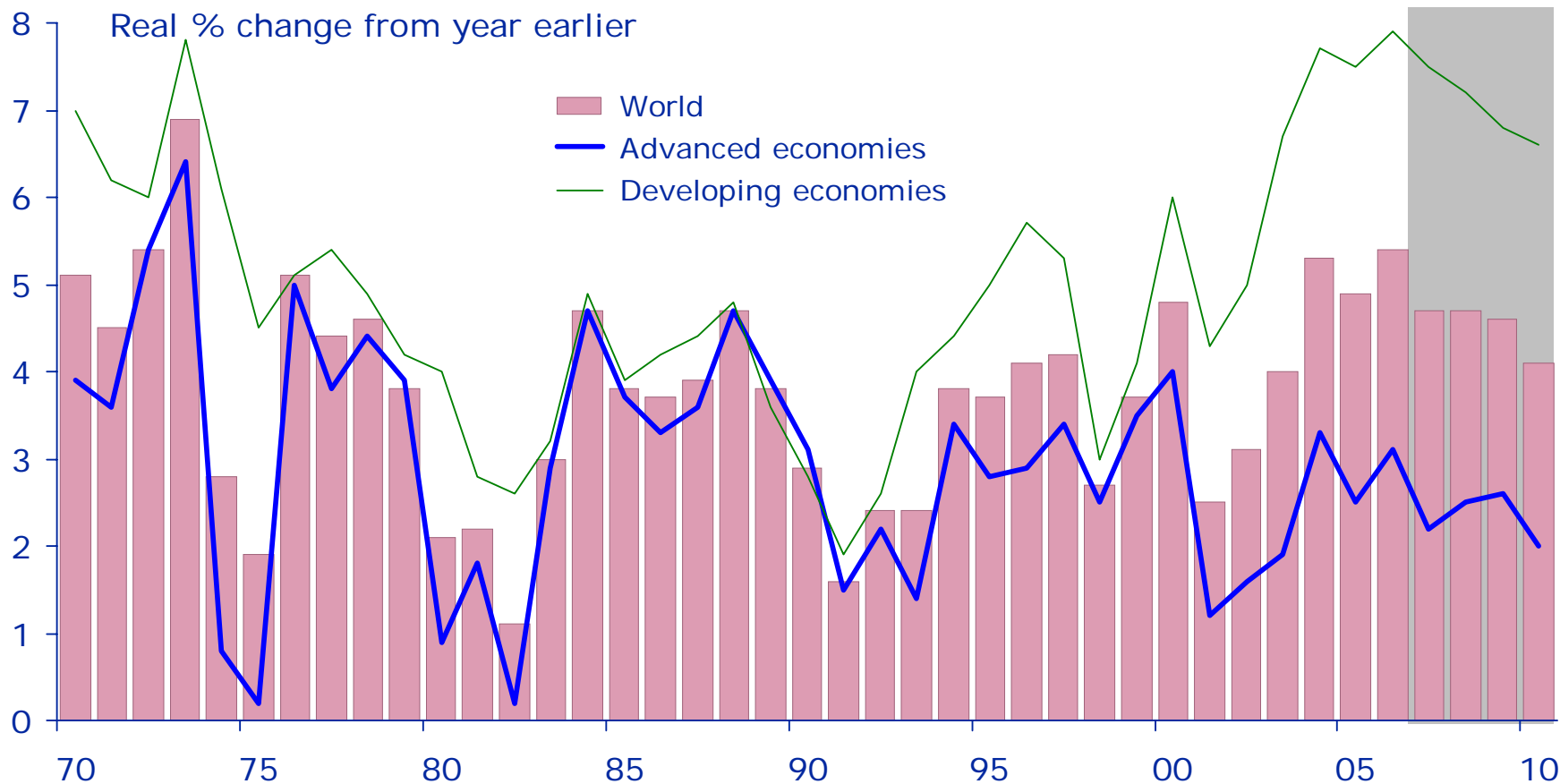
**Canberra Club
14th May 2007**

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World economy in what is likely to be its longest period of above-trend growth in over 30 years

Global economic growth

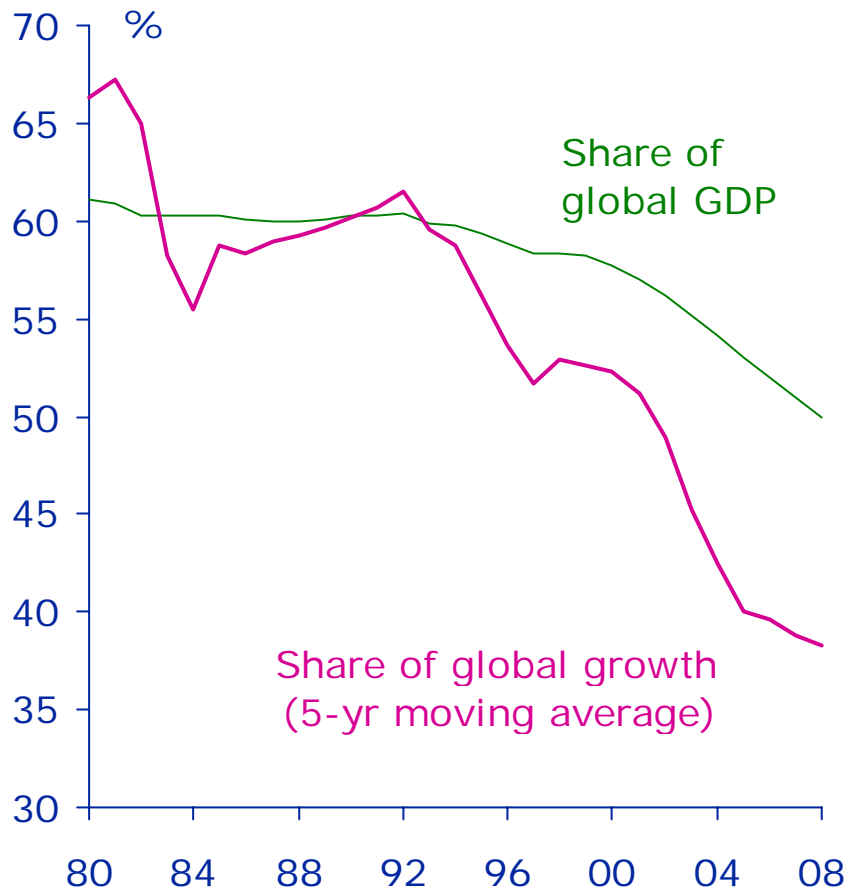


Note: GDP is measured in US\$ at purchasing power parities.

Source: IMF; Economics@ANZ.

Above-trend global growth is largely being driven by developing countries

Advanced economies



Developing economies

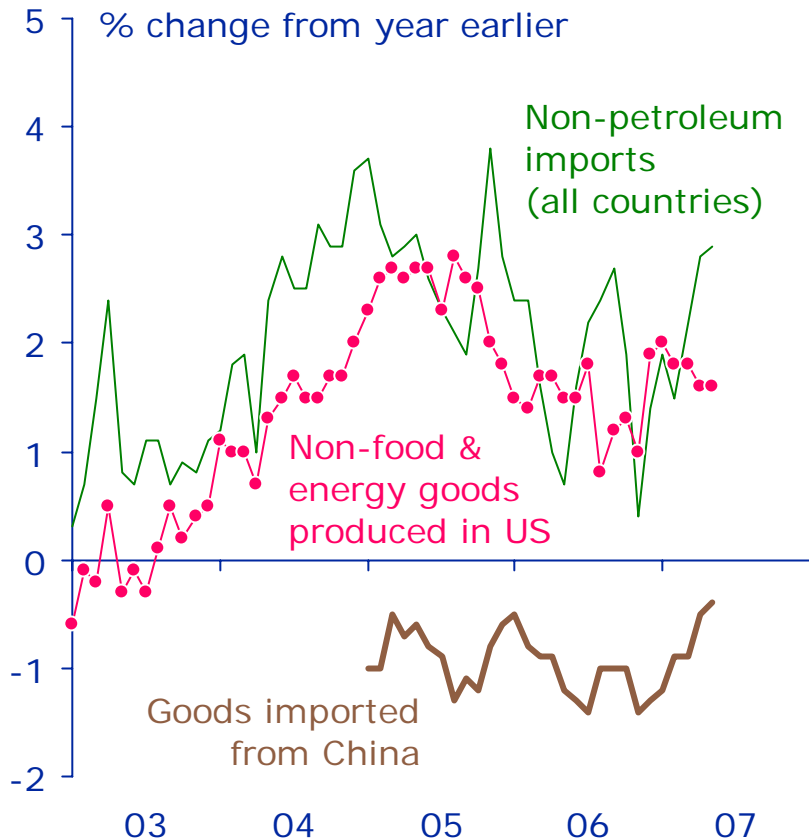


'Advanced' economies comprise the US, Western Europe, Japan, Canada, Australia, New Zealand, Korea, Taiwan, Hong Kong, Singapore and Israel.

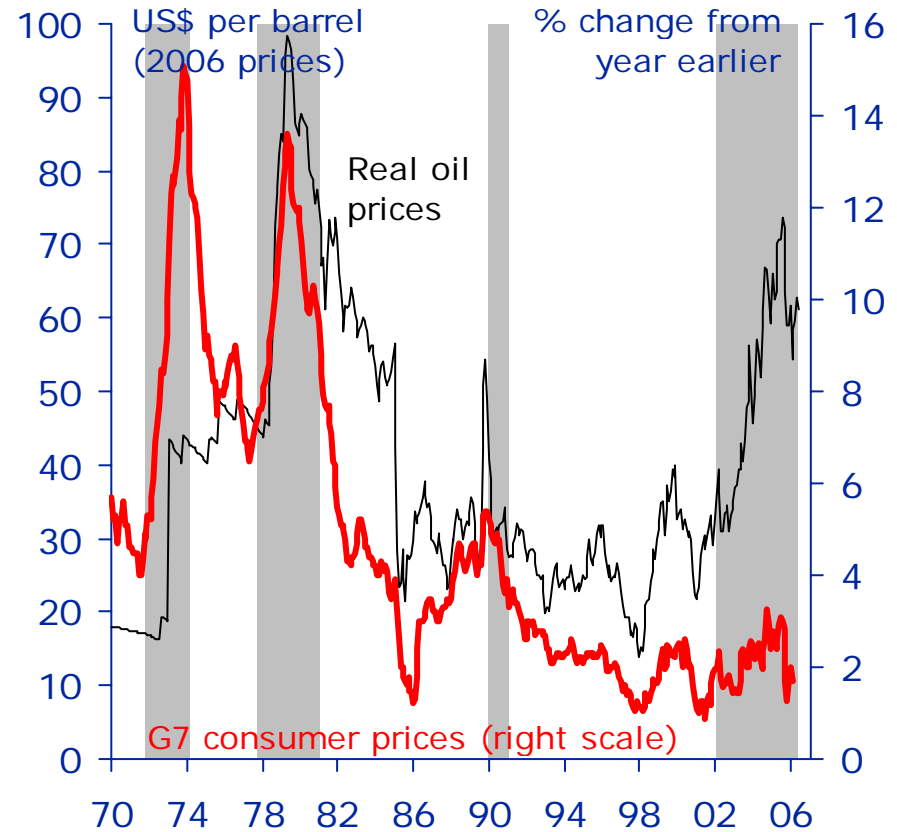
Sources: IMF, *World Economic Outlook*; Economics@ANZ.

Developing economies have provided a source of discipline on advanced economy prices and costs

Wholesale prices of goods in the United States



Oil prices and inflation

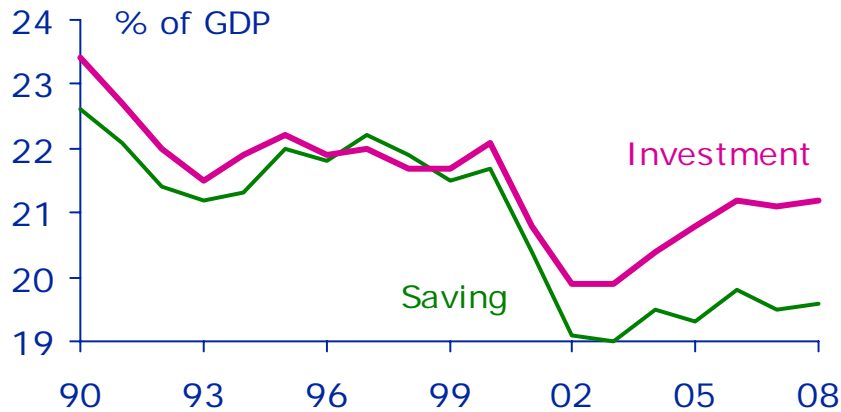


Sources: US Bureau of Economic Analysis; US Bureau of Labor Statistics; OECD; Datastream; Economics@ANZ.

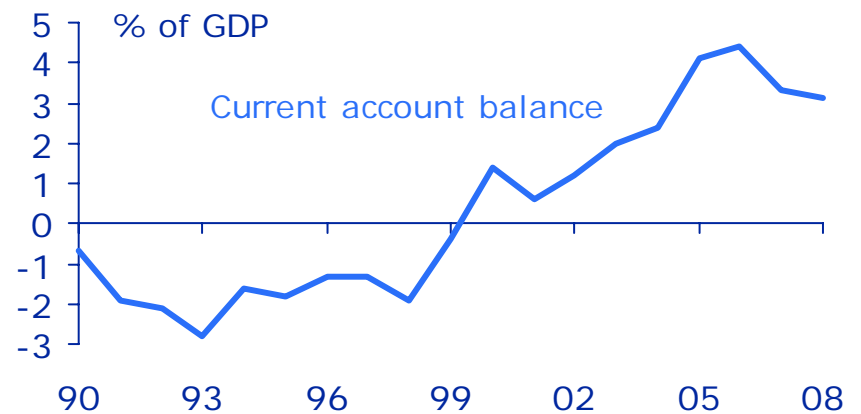
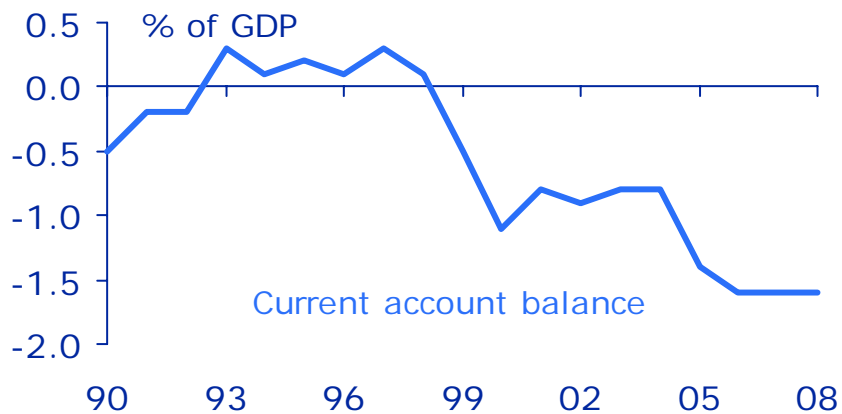
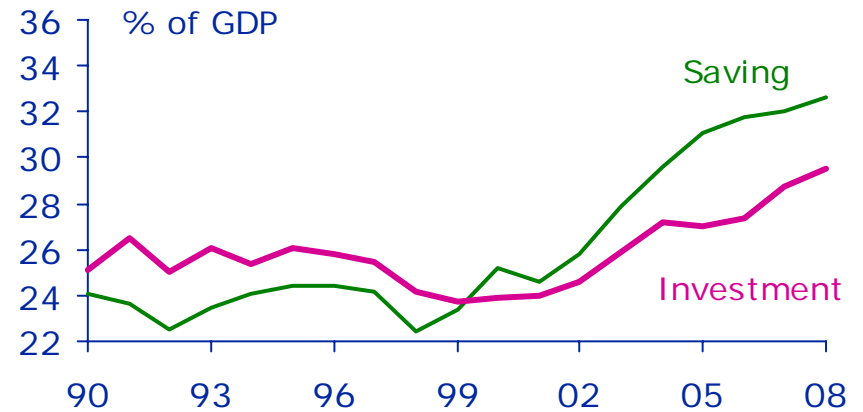
Since the late 1990s, capital has flowed from developing countries to advanced countries

Saving, investment and current account balances

Advanced economies



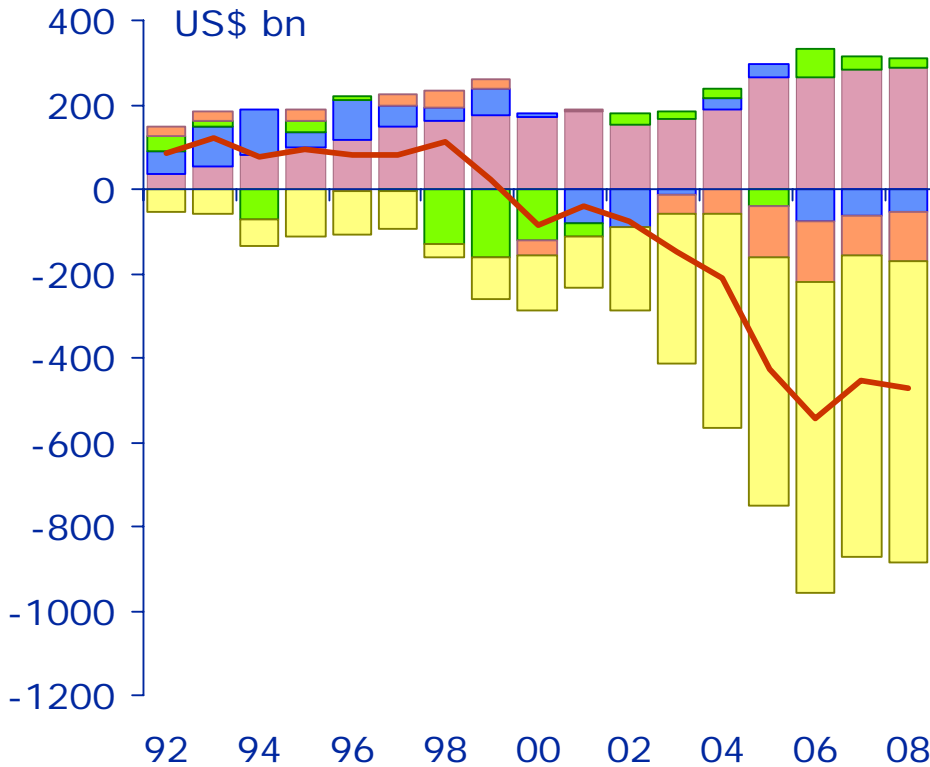
Developing economies



Note: In these charts, Korea, Taiwan, HK, Singapore & Israel are classed as 'advanced economies'. Sources: IMF, World Economic Outlook database (April 2007); Economics@ANZ.

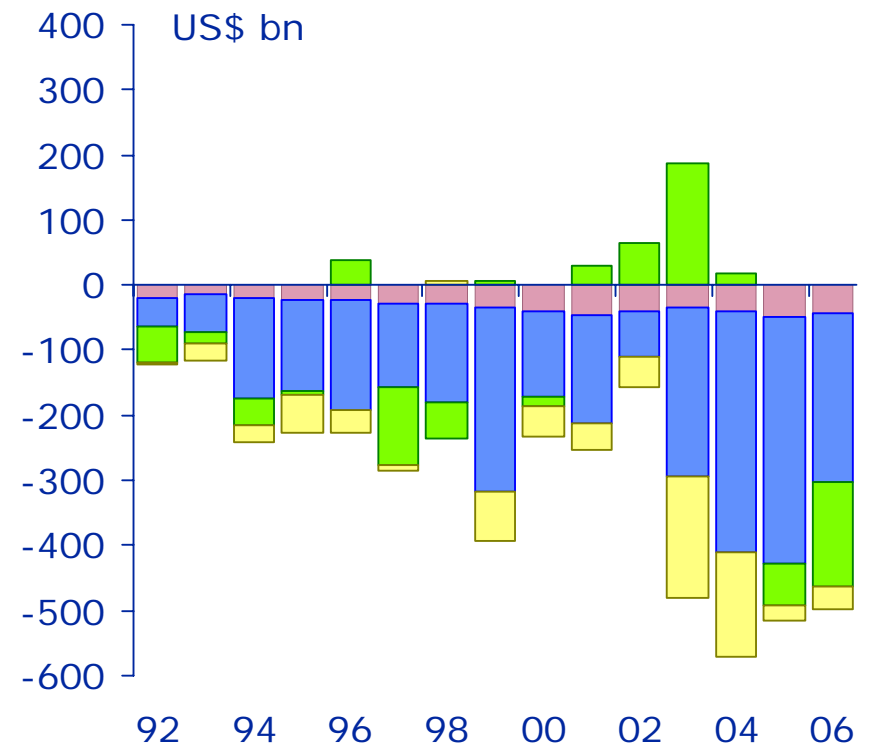
Developing countries have exported massive amounts of capital to the industrialized world

From developing and emerging economies



- Direct investment
- Other private flows (incl bank loans)
- Change in reserves

From Japan

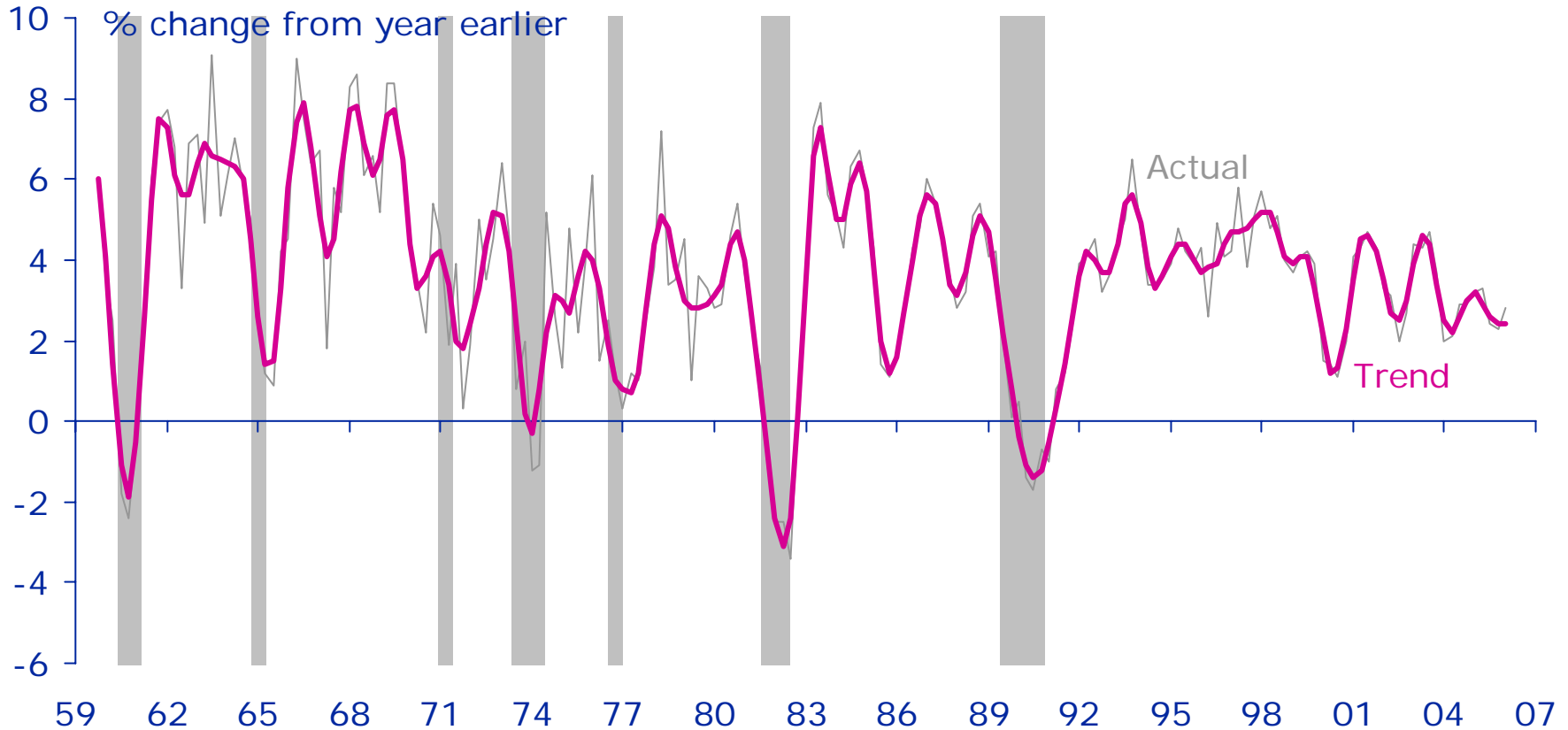


- Private portfolio investment
- Official capital flows (incl govt borrowings)
- Total (incl errors & omissions)

6 Note: 'Developing economies' in this chart includes Korea, Taiwan, Hong Kong, Singapore and Israel.

Australia has now gone more than 15 years without recession, the longest in its history

Real GDP growth



Note: shaded intervals denote periods in which real GDP growth was negative for two or more quarters, or during which real GDP declined from the year-earlier quarter.

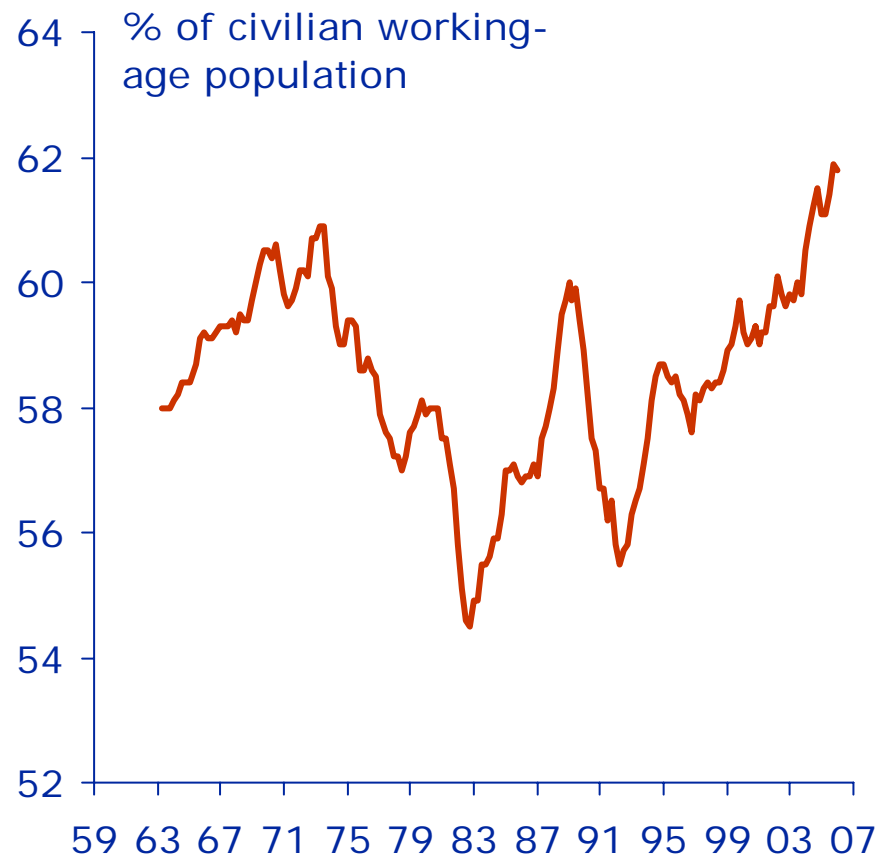
Sources: Australian Bureau of Statistics; Economics@ANZ.

Unemployment is at a 30-year low, while a record proportion of the population is employed

Unemployment



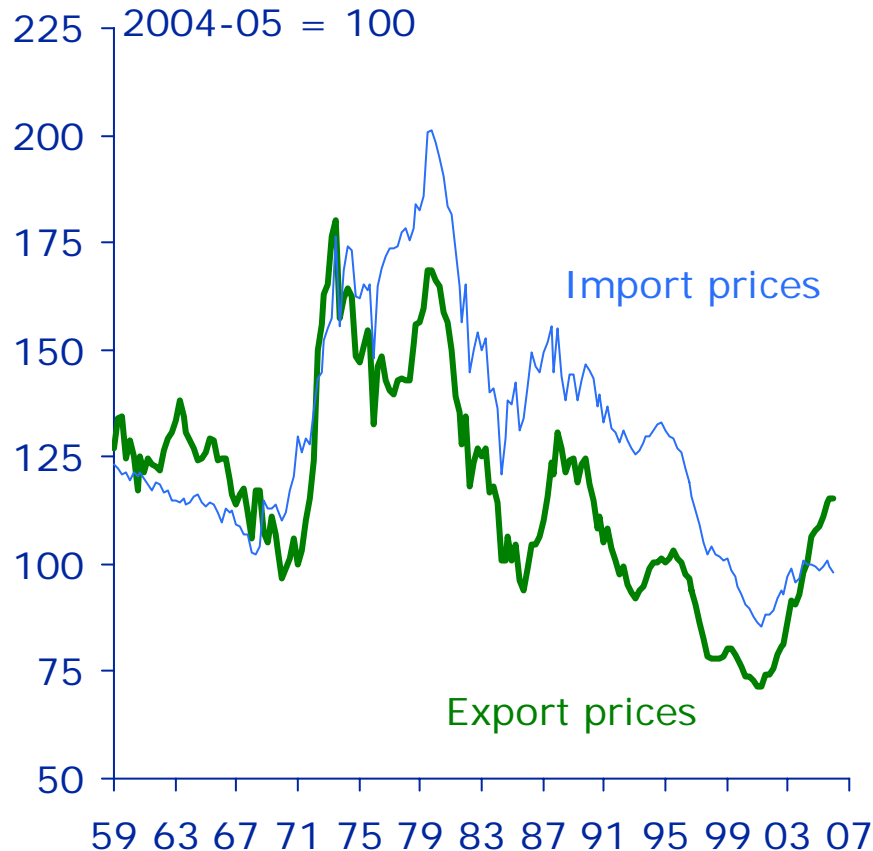
Employment-to-population ratio



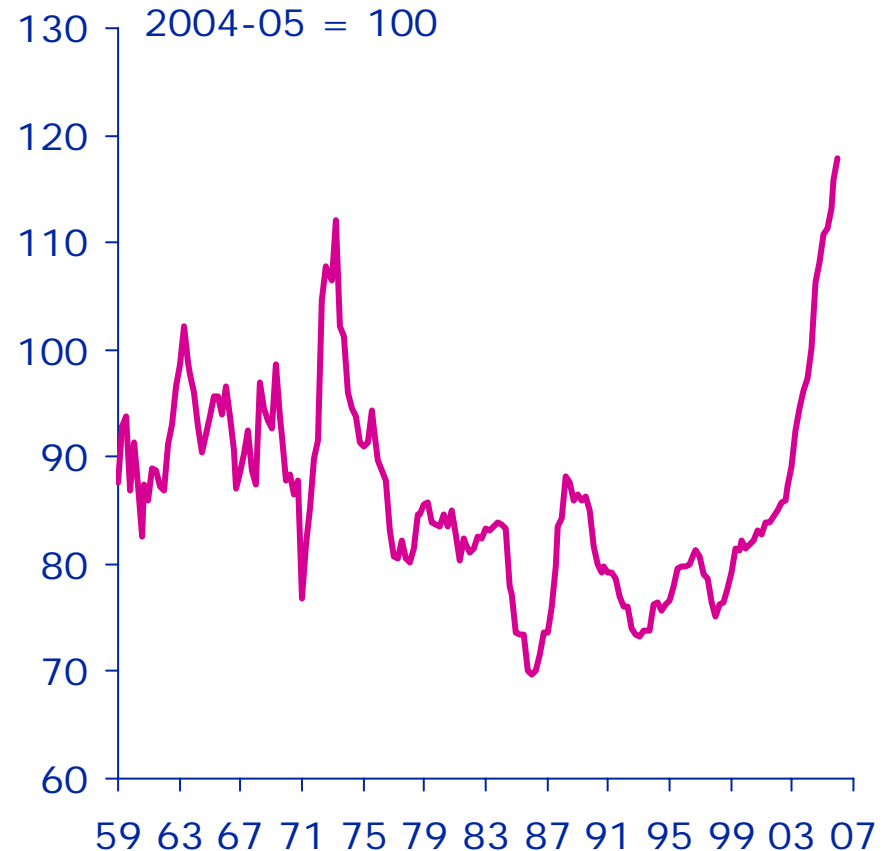
Sources: ABS; Economics@ANZ.

Australia's terms of trade have improved since the early 90s, reversing the decline of the 70s and 80s

Australian export and import prices in real US\$ terms



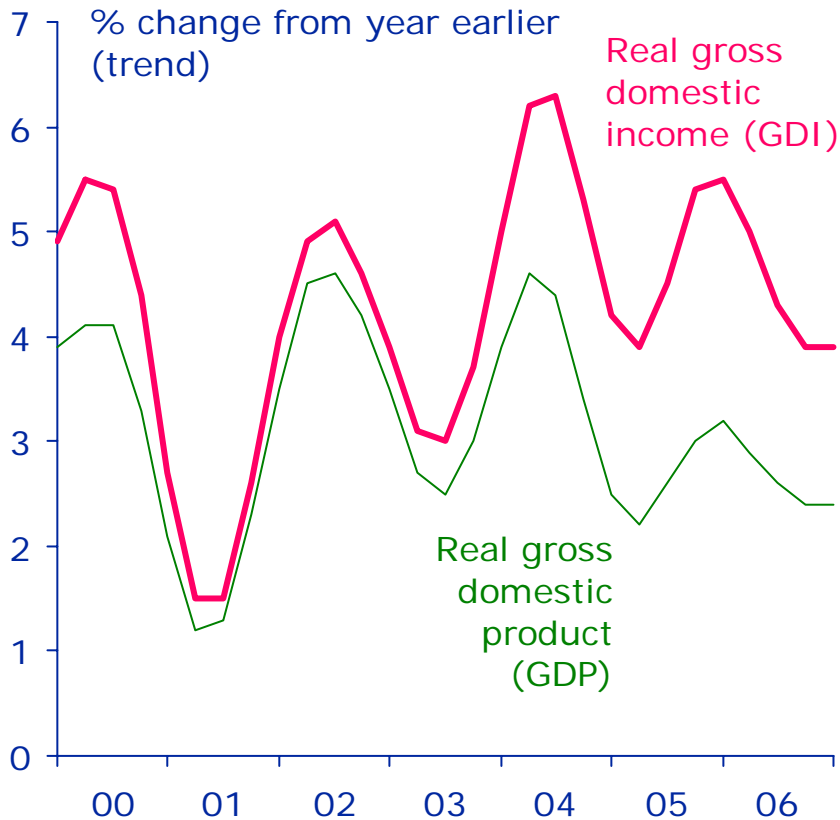
Australia's 'terms of trade'



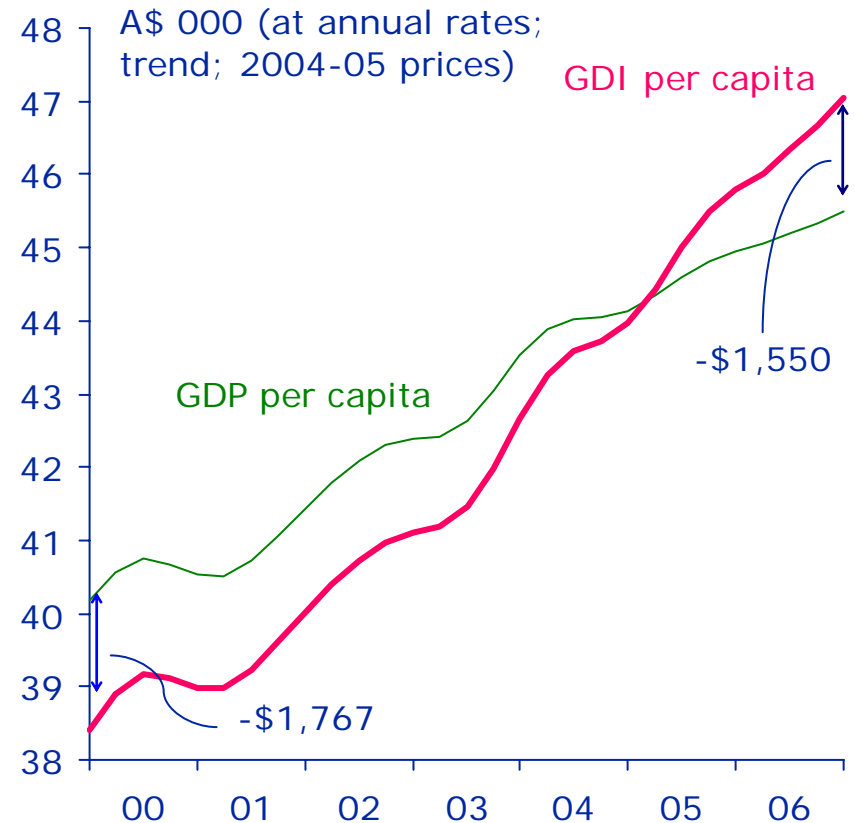
Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Economics@ANZ.

'Terms of trade' gains since 1999 have been worth \$3,316 pa to each Australian, on average

Real gross domestic product and income



Real gross domestic product and income per capita

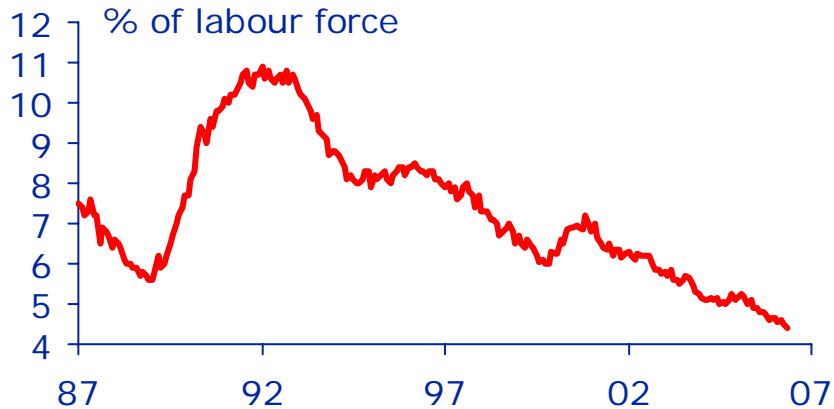


Note: Gross domestic income (GDI) is GDP adjusted for changes in the terms of trade (ratio of export to import prices).

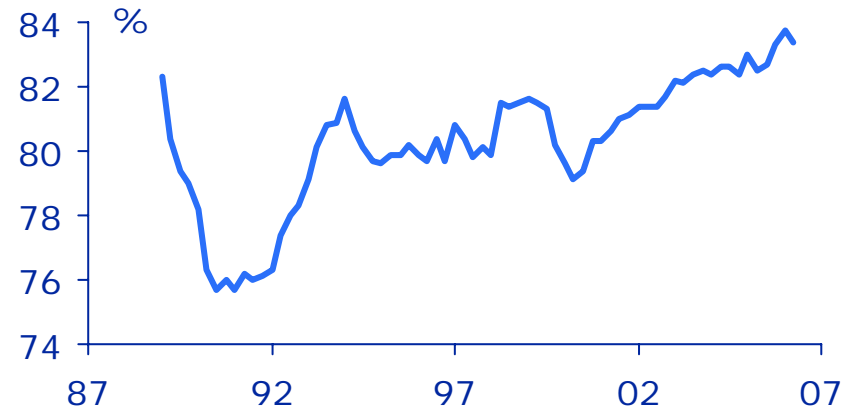
Sources: ABS; Economics@ANZ.

The Australian economy is bumping up against 'capacity constraints'

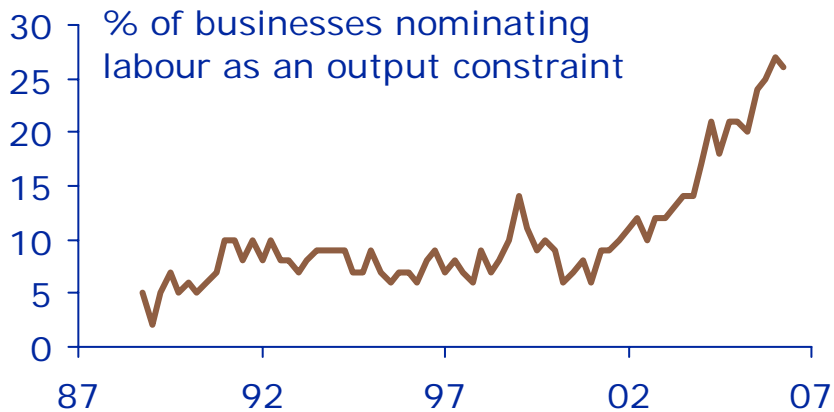
Unemployment rates



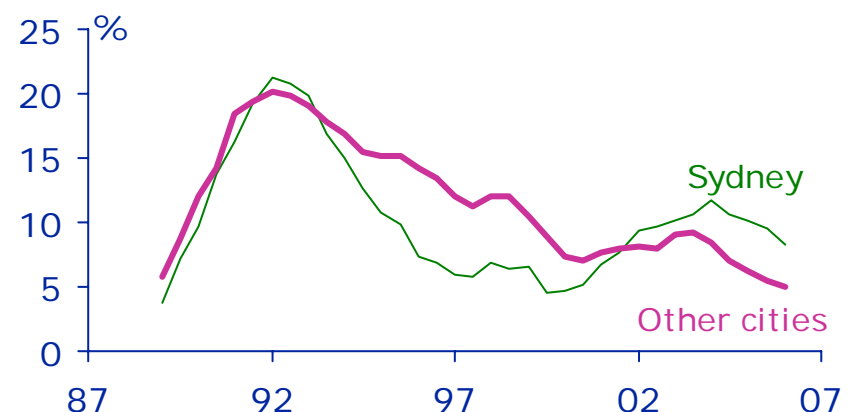
Capacity utilization



Labour shortages



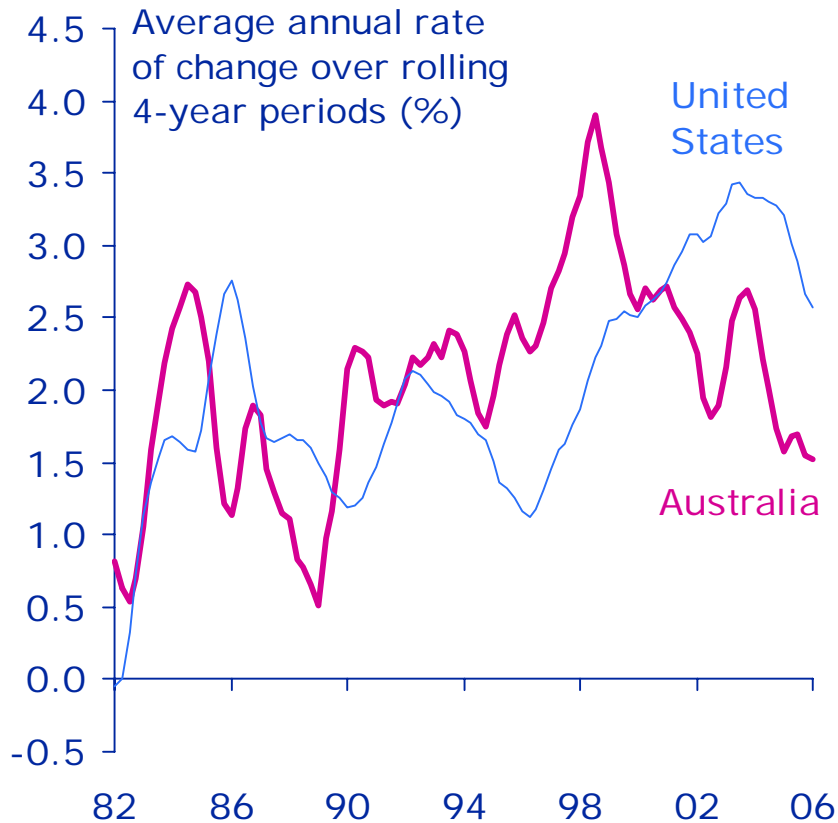
Office vacancy rates



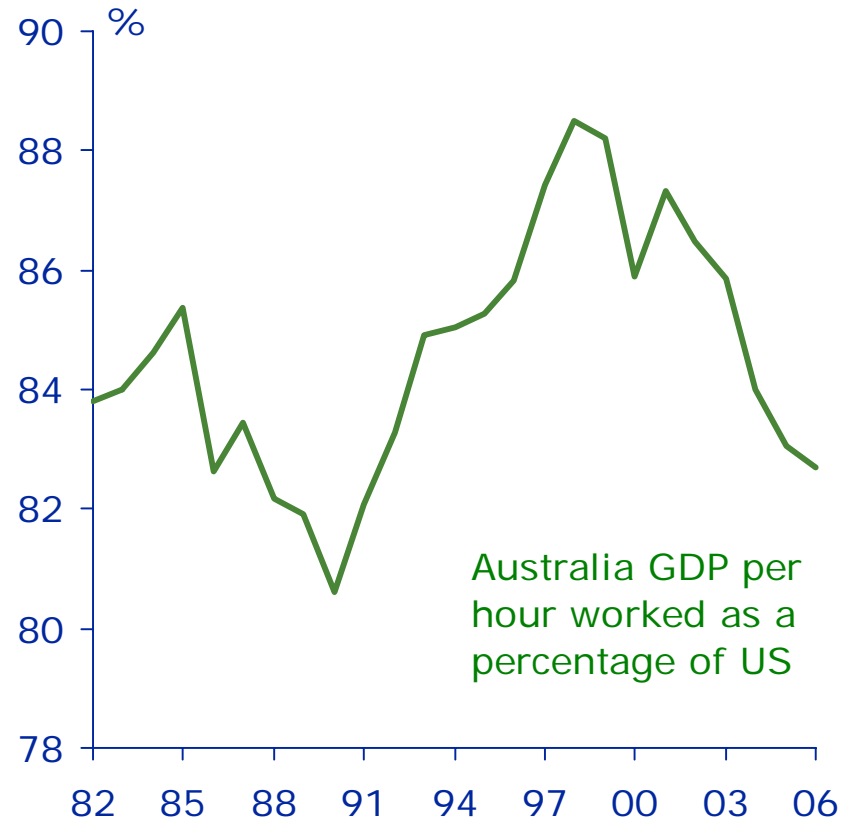
Sources: Australian Bureau of Statistics; National Australia Bank; Property Council of Australia.

Capacity constraints are more binding as a result of the productivity growth slowdown

Labour productivity growth



Labour productivity level

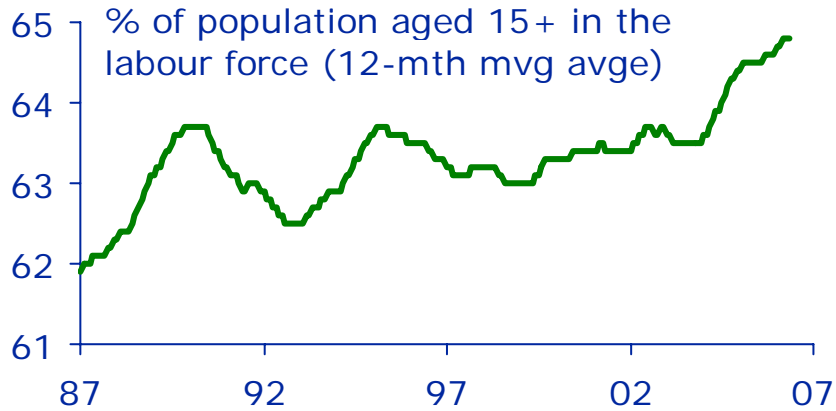


Note: labour productivity is output per hour worked in the non-farm business or 'market' sector.

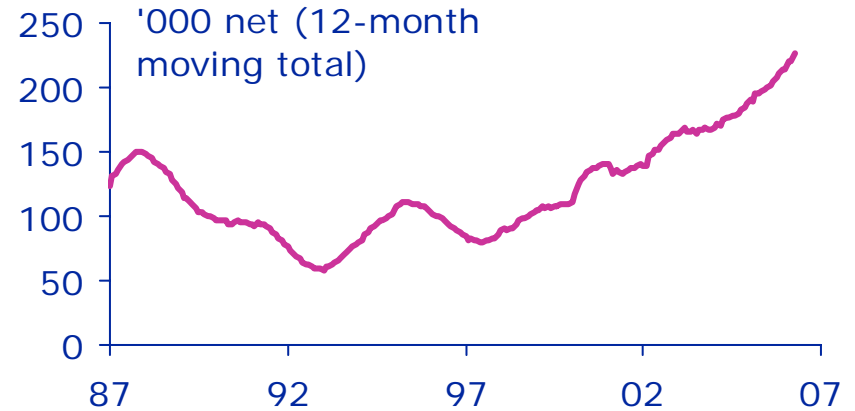
Sources: ABS; US Bureau of Economic Analysis; University of Groningen Growth and Development Centre *Total Economy Database* January 2007.

A number of 'safety valves' have increased the elasticity of labour supply

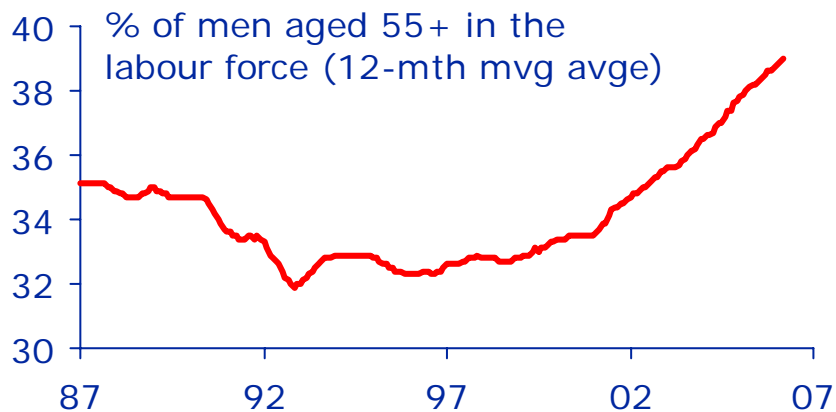
Labour force participation rate



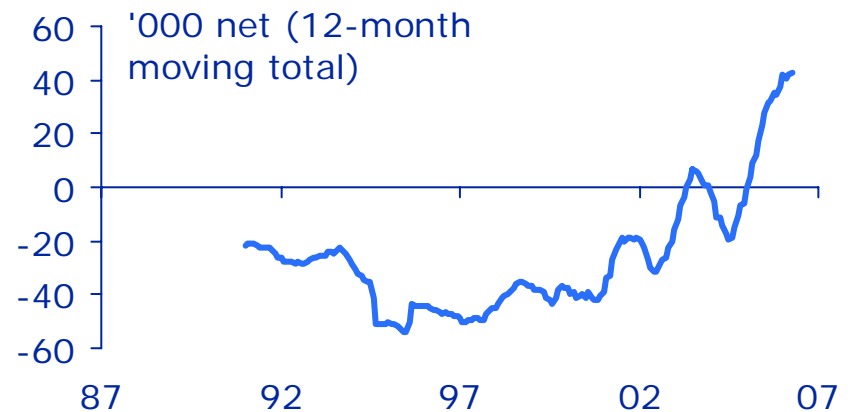
Permanent & long-term migration



Participation rate men over 55



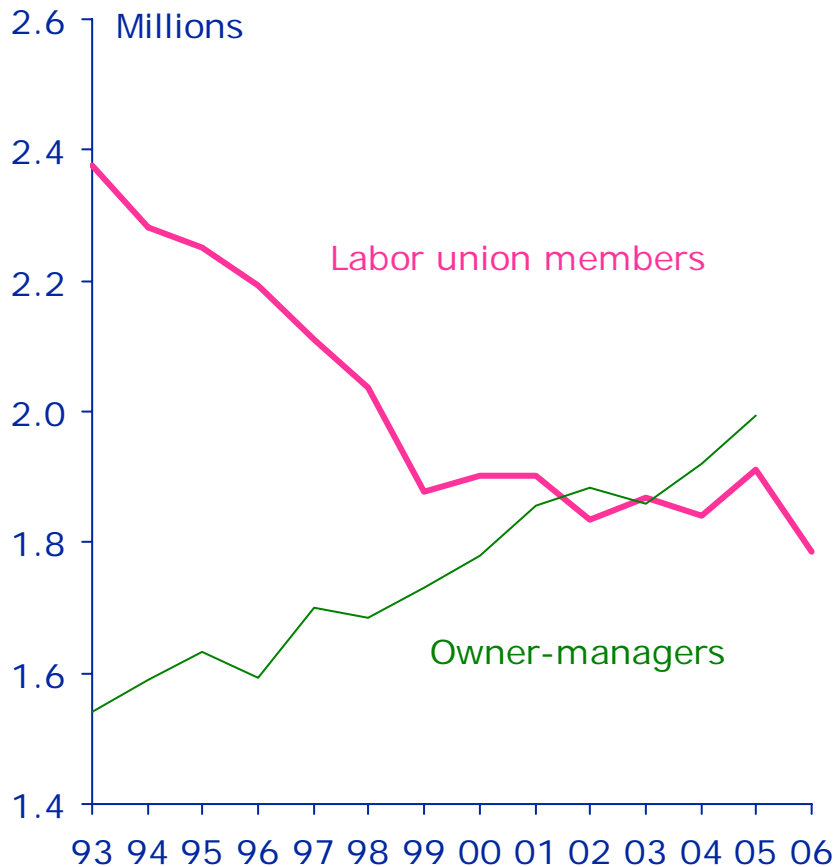
Temporary migration 'for employment'



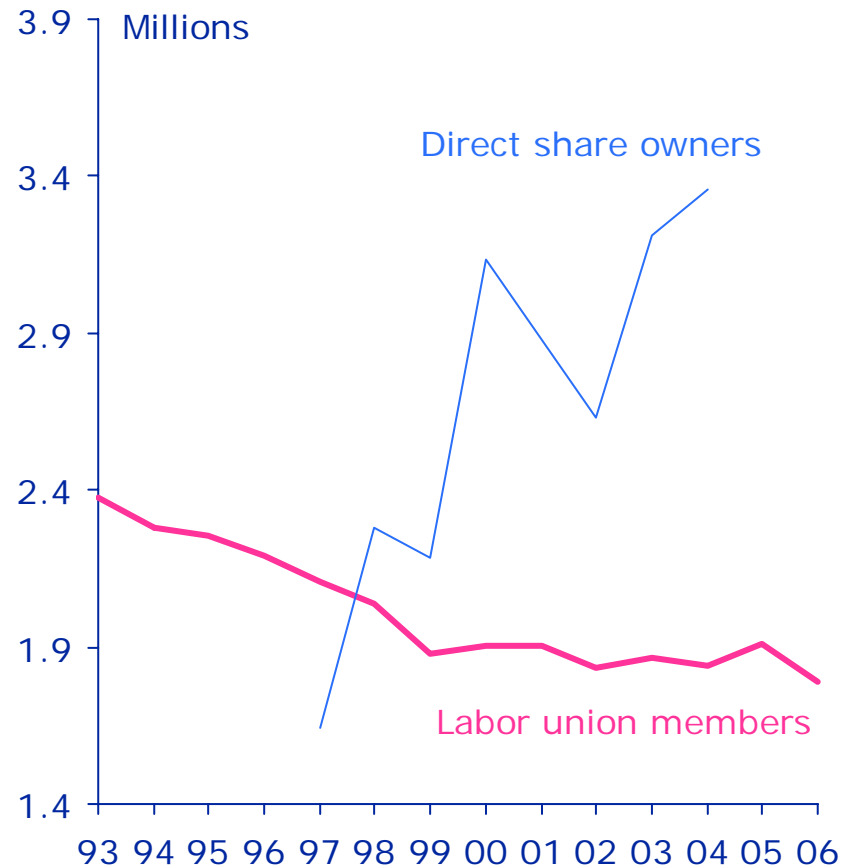
Sources: Australian Bureau of Statistics; Economics@ANZ.

The changing structure of Australia's labour market has also been important

Union members and owner-managers of businesses



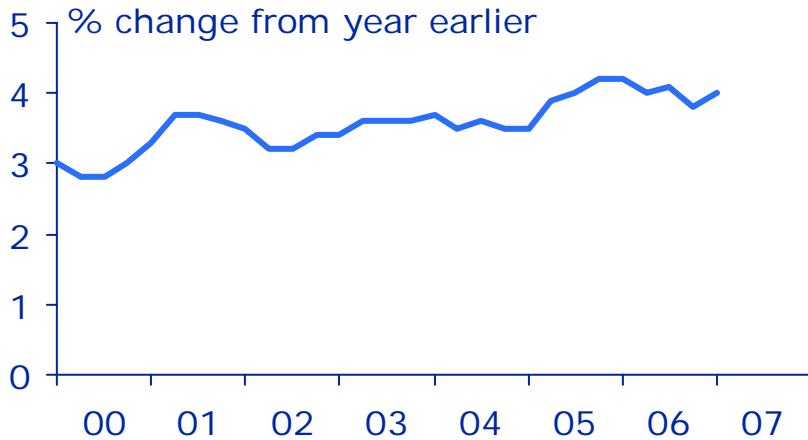
Union members and direct share owners



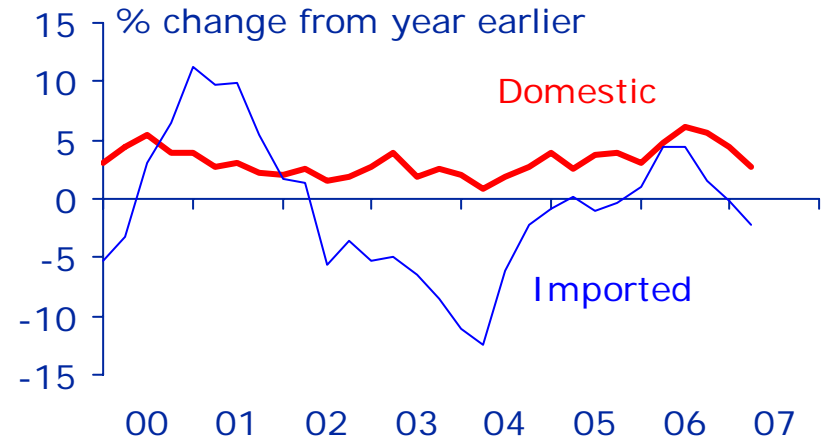
Sources: ABS; Australian Stock Exchange.

There has been remarkably little acceleration in inflation

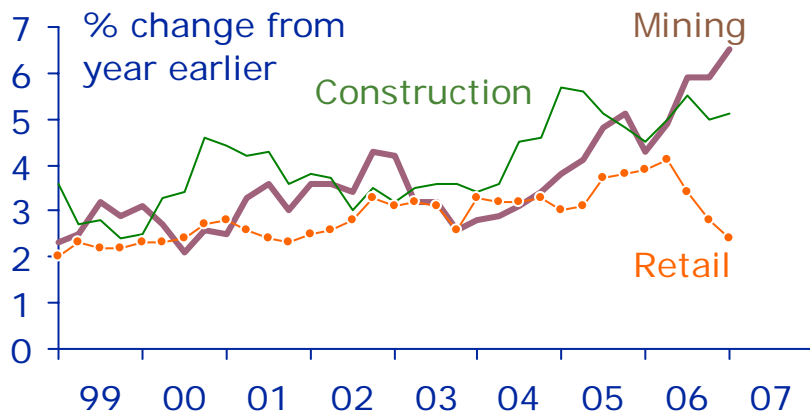
Wage cost index



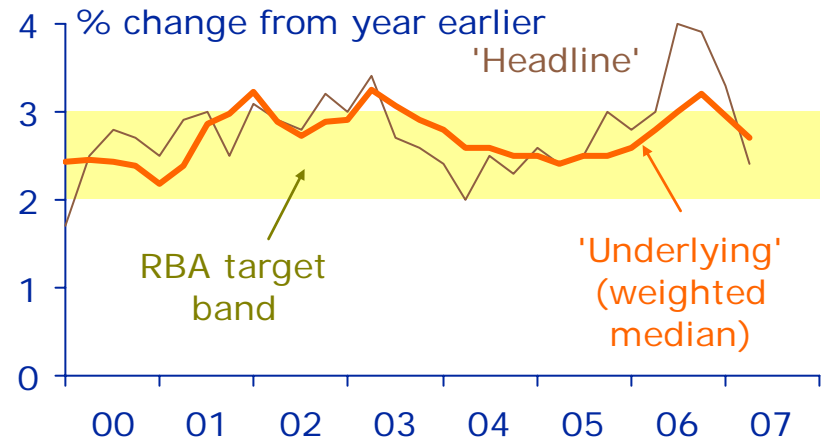
Producer prices*



Wage costs: selected sectors



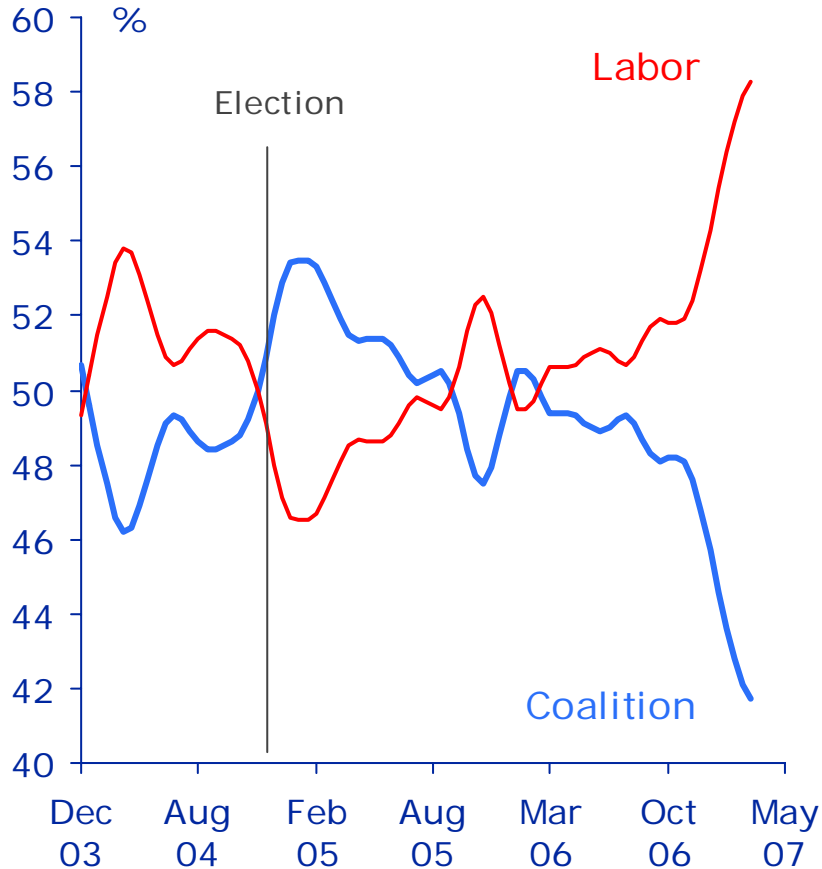
Consumer prices



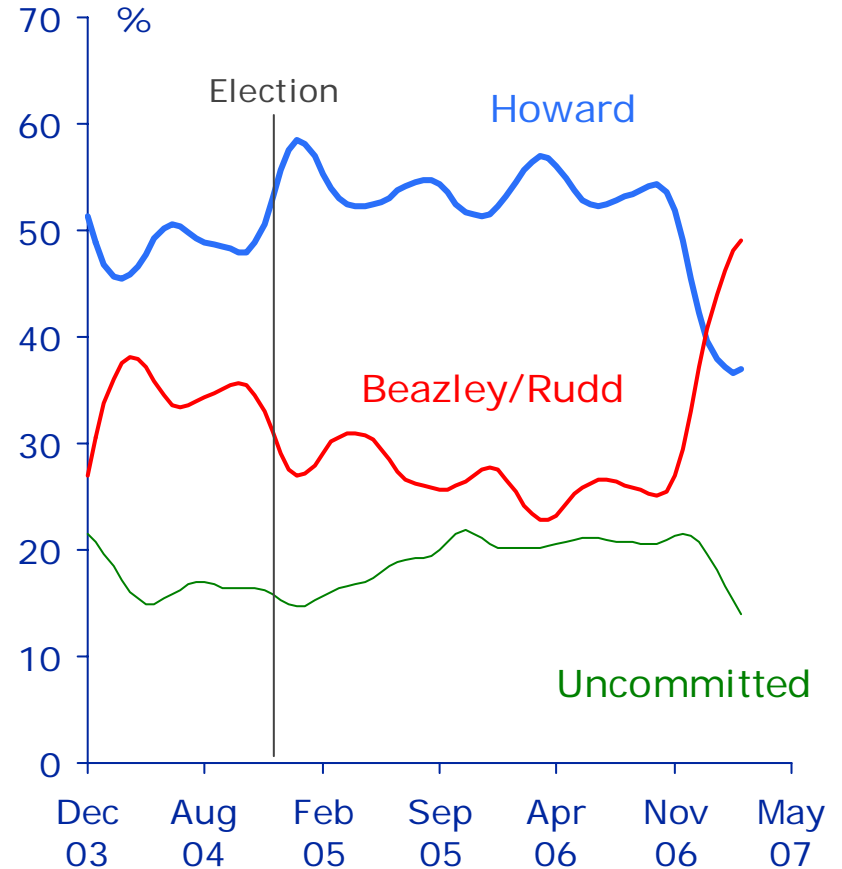
* of consumer goods. Sources: ABS; RBA.

An election is due later this year: and the Government is trailing in the polls

'Two-party preferred' vote (as surveyed by Newspoll)



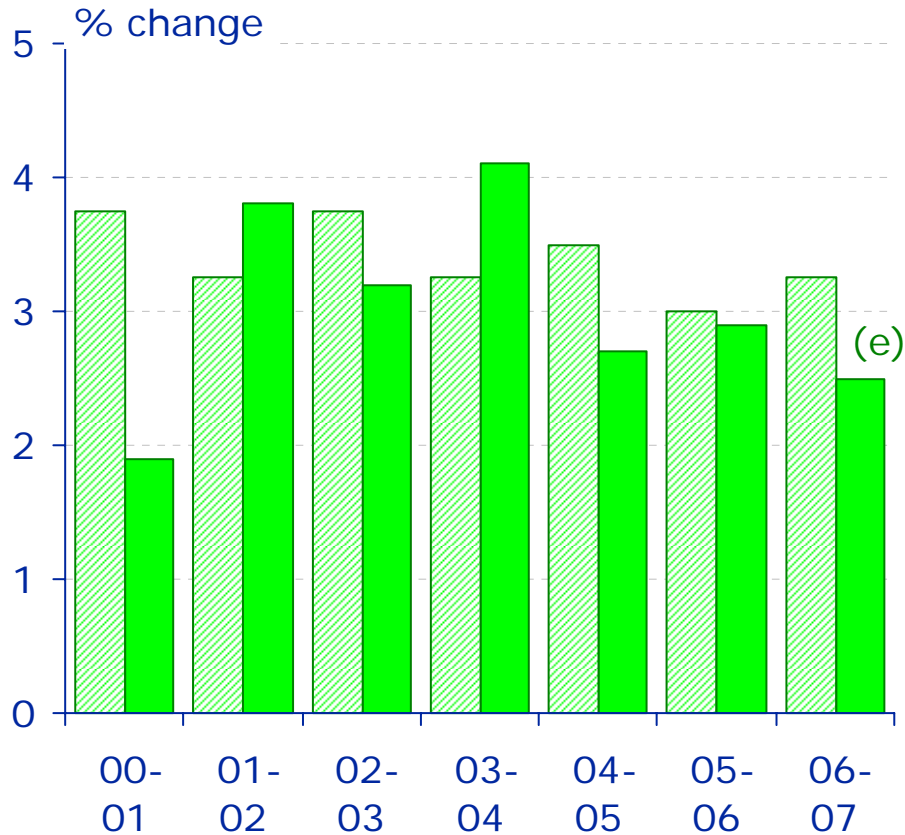
Preferred Prime Minister (as surveyed by Newspoll)



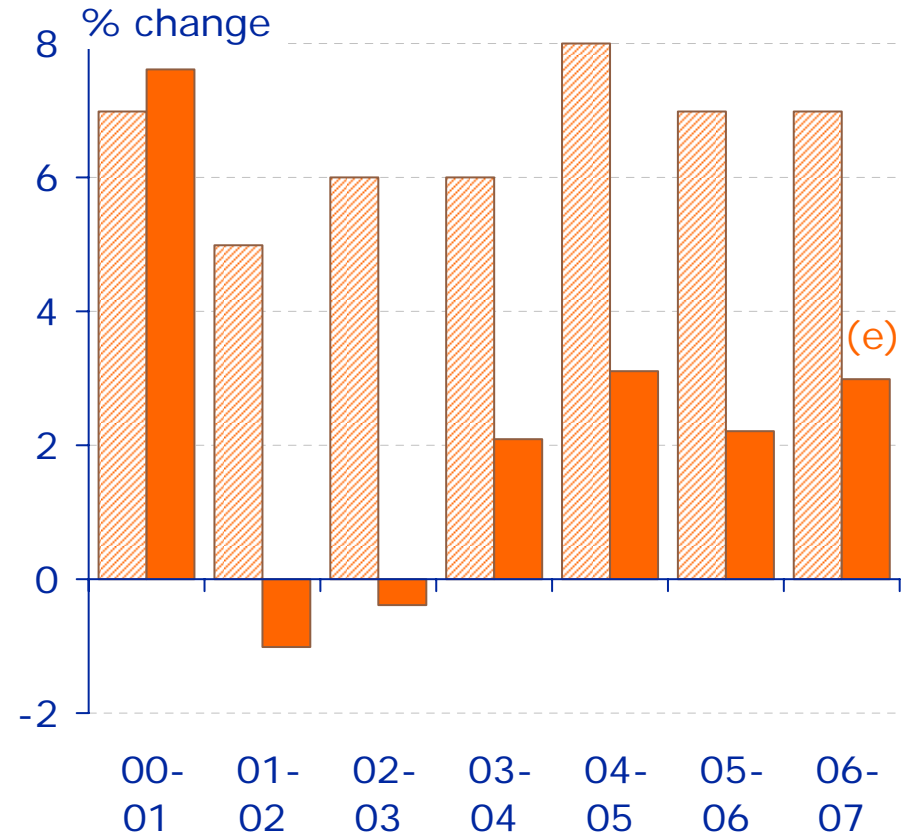
Note: Weekly data are 'smoothed' using a 13-term Henderson moving weighted average as used by the ABS to derive 'trend' data. *Source:* Newspoll.

Although Treasury has usually over-estimated real GDP and especially export volume growth ...

Real GDP



Export volumes



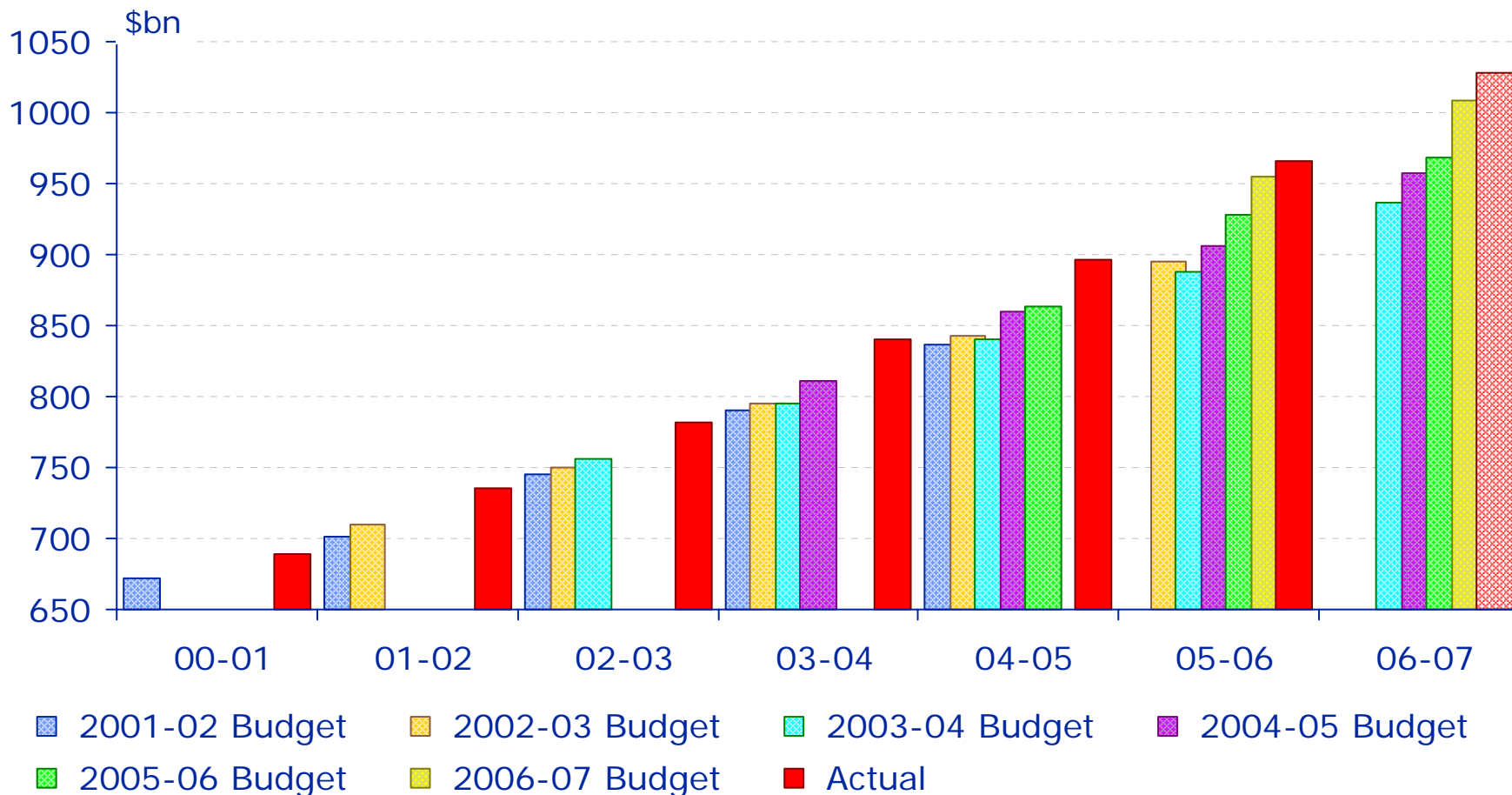
 Budget forecast

 Outcome

Sources: Statement 3, Budget Paper No. 1 (various years); ABS.

... it has consistently under-estimated nominal GDP (which drives tax revenues)

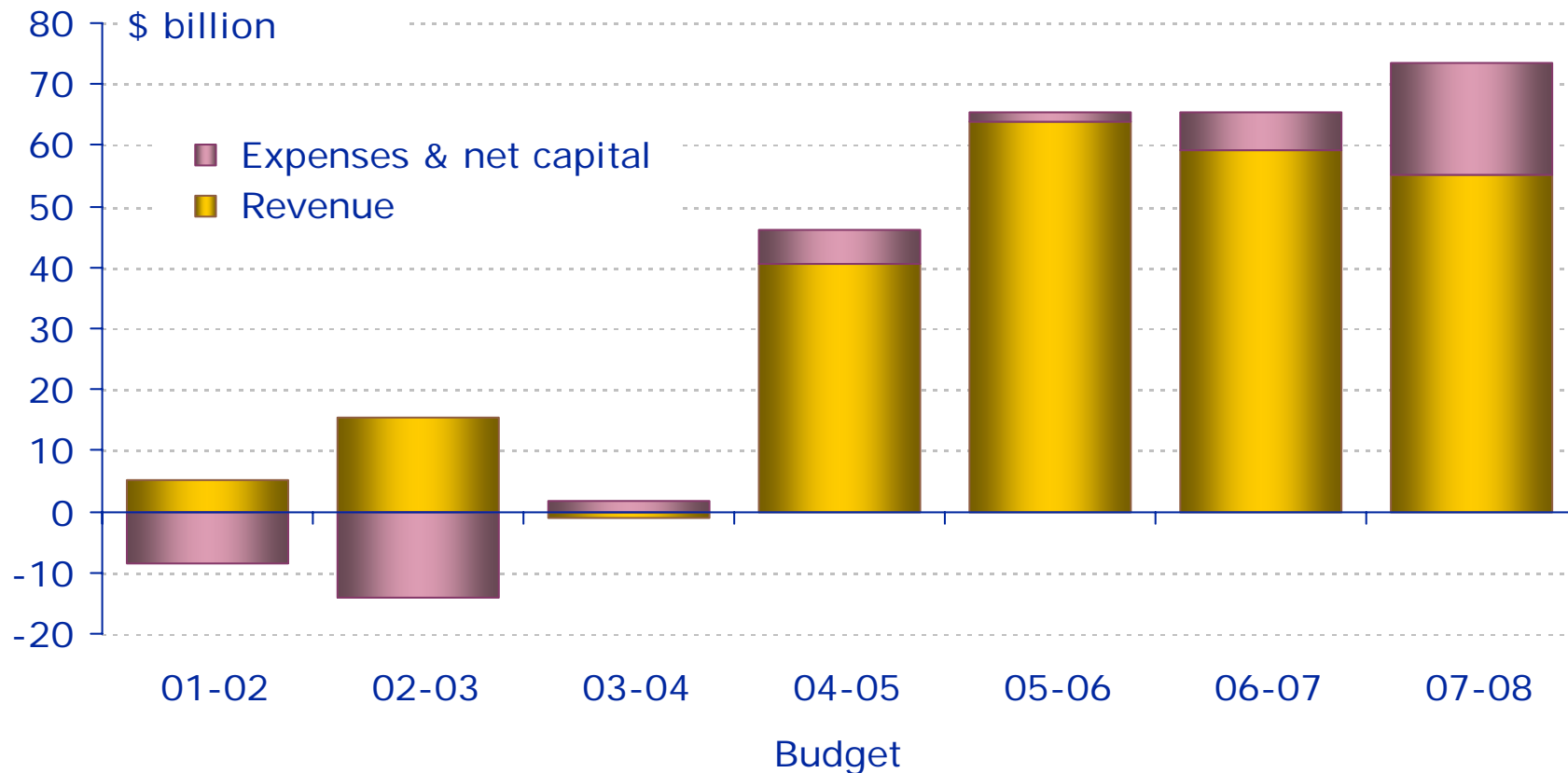
Successive estimates of nominal GDP



Note: Nominal GDP projections inferred from projections of receipts and payments as a pc of GDP in Statement No. 13 of Budget Paper No. 1, various years.

The last four Budgets have been made easier by huge favourable 'parameter variations'

Total impact of 'parameter variations' on four-year accruals Forward Estimates from Budget to Budget

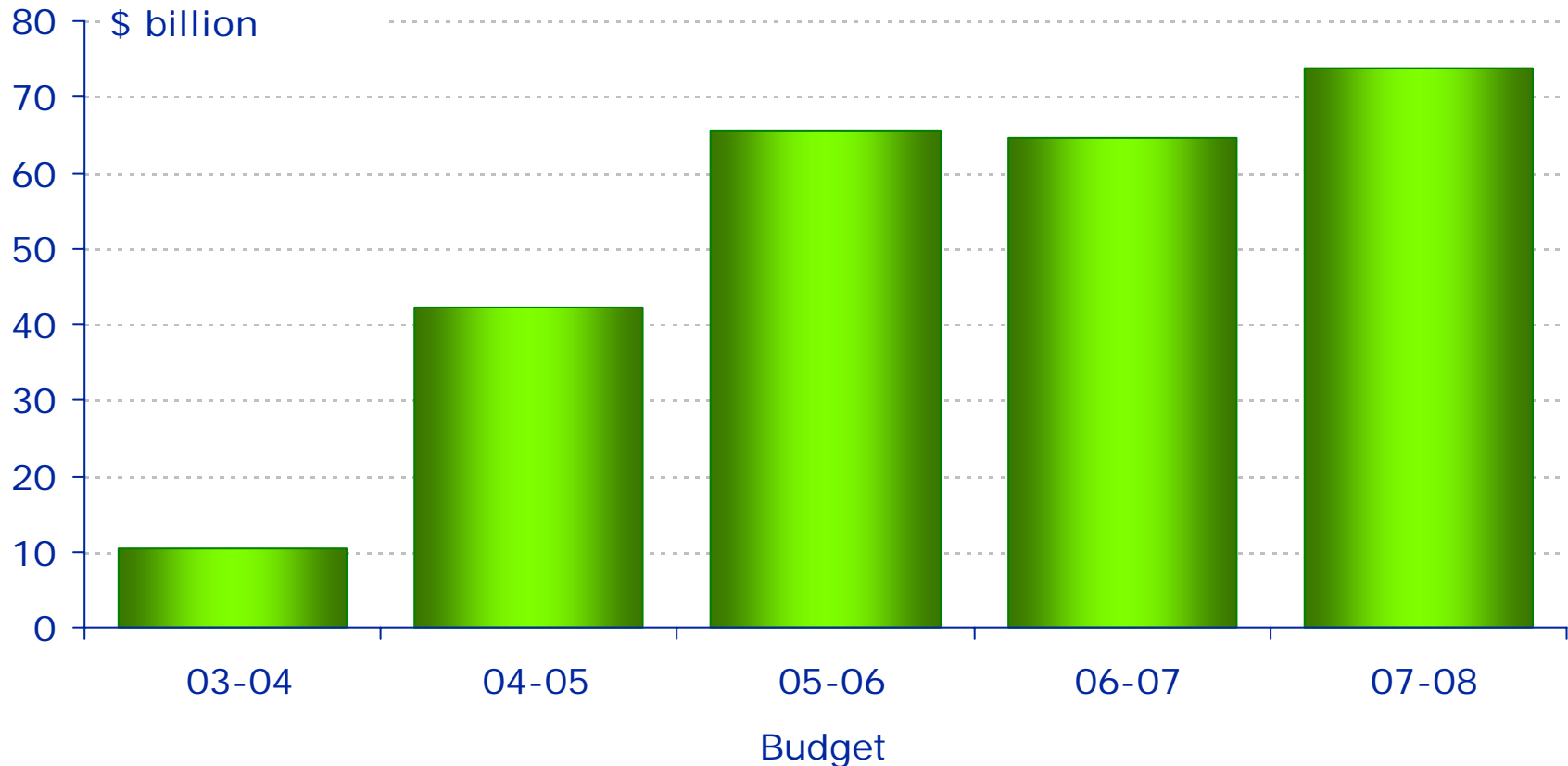


Note: Figures in this chart are based on accrual estimates, and show the impact of 'parameter variations' since the preceding Budget on the forward estimates of revenues and expenses & net capital investment for the four years shown in Table 2 of Statement No. 2 in Budget Paper No. 1 each year.

Sources: Budget Paper No. 1, various years; Economics@ANZ.

The last four Budgets have been made easier by huge favourable 'parameter variations'

Total impact of 'parameter variations' on four-year cash Forward Estimates from Budget to Budget

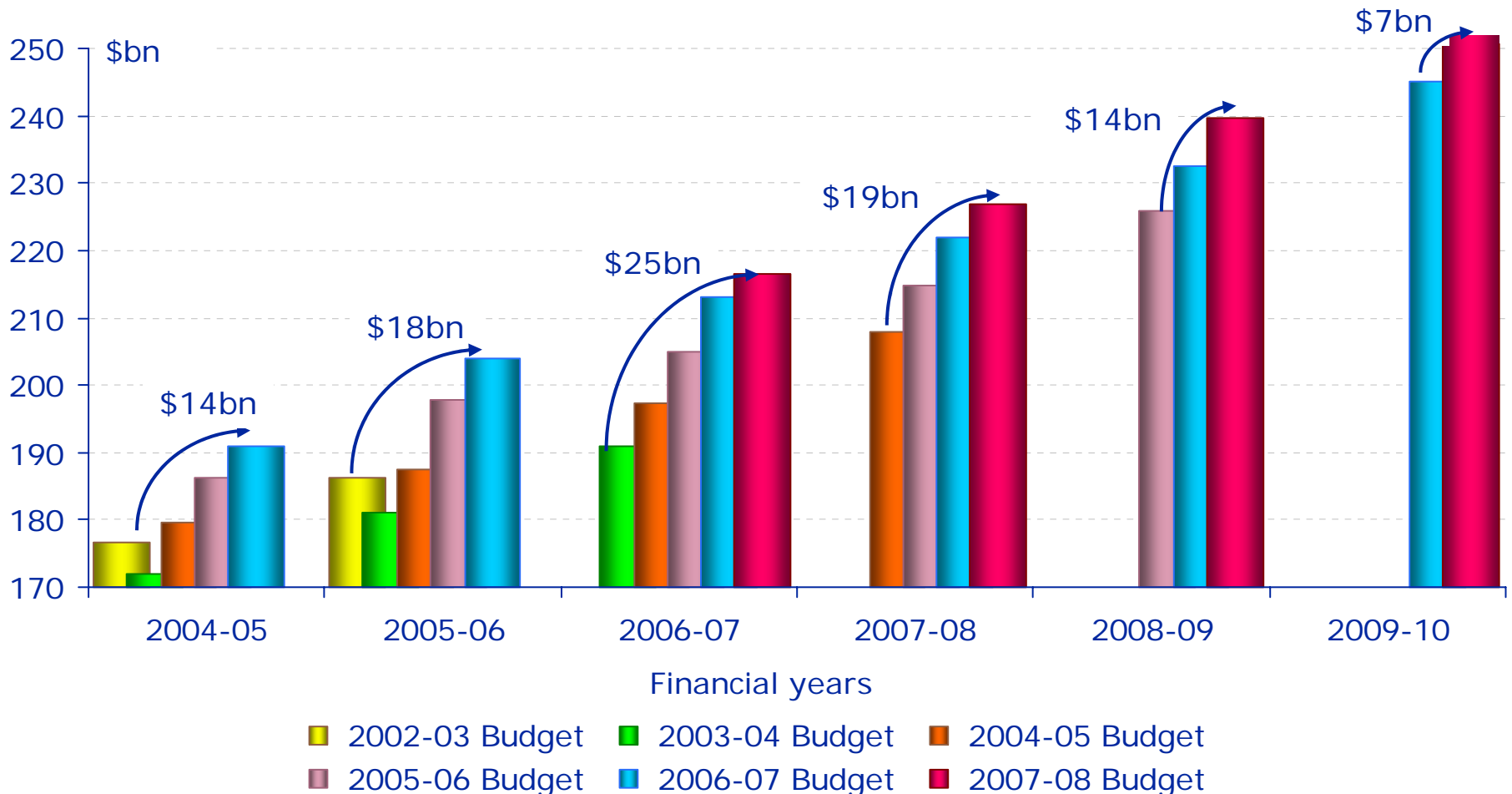


Note: Figures in this chart are based on cash estimates, and show the impact of 'parameter variations' since the preceding Budget on the forward estimates for the four years shown in Table 4 of Statement No. 2 in Budget Paper No. 1 each year. These were not available until the 2002-03 MYEFO and are not broken down into receipts and payments.

²⁰ Sources: Budget Paper No. 1, various years; Economics@ANZ.

Every year, tax revenue projections are revised up – despite successive tax cuts

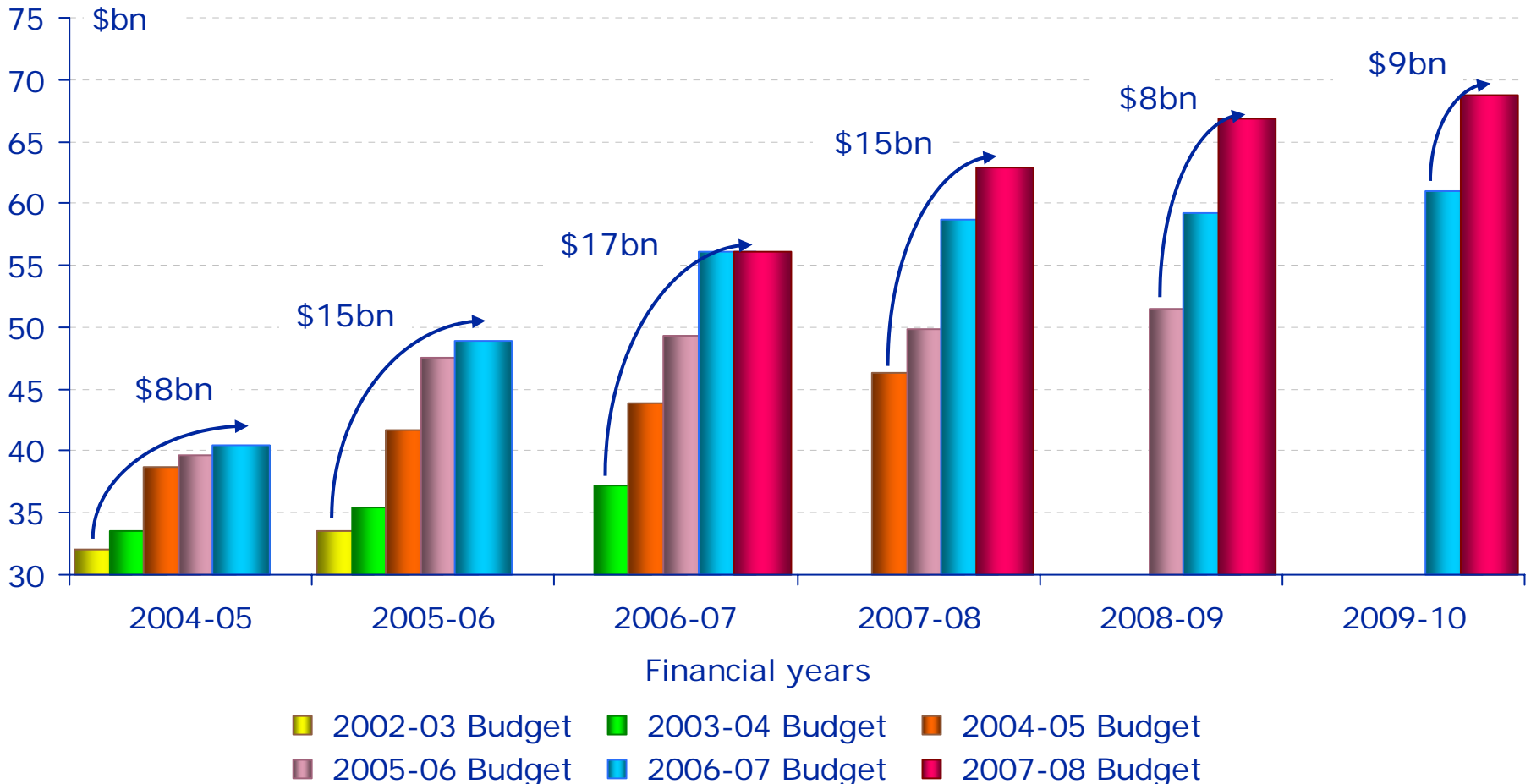
Successive Budget (cash) estimates of total taxation receipts



Source: Table C4: Statement No. 5, Budget Paper No. 1 (various years); Economics@ANZ.

Most of these windfall revenue gains have come from company tax

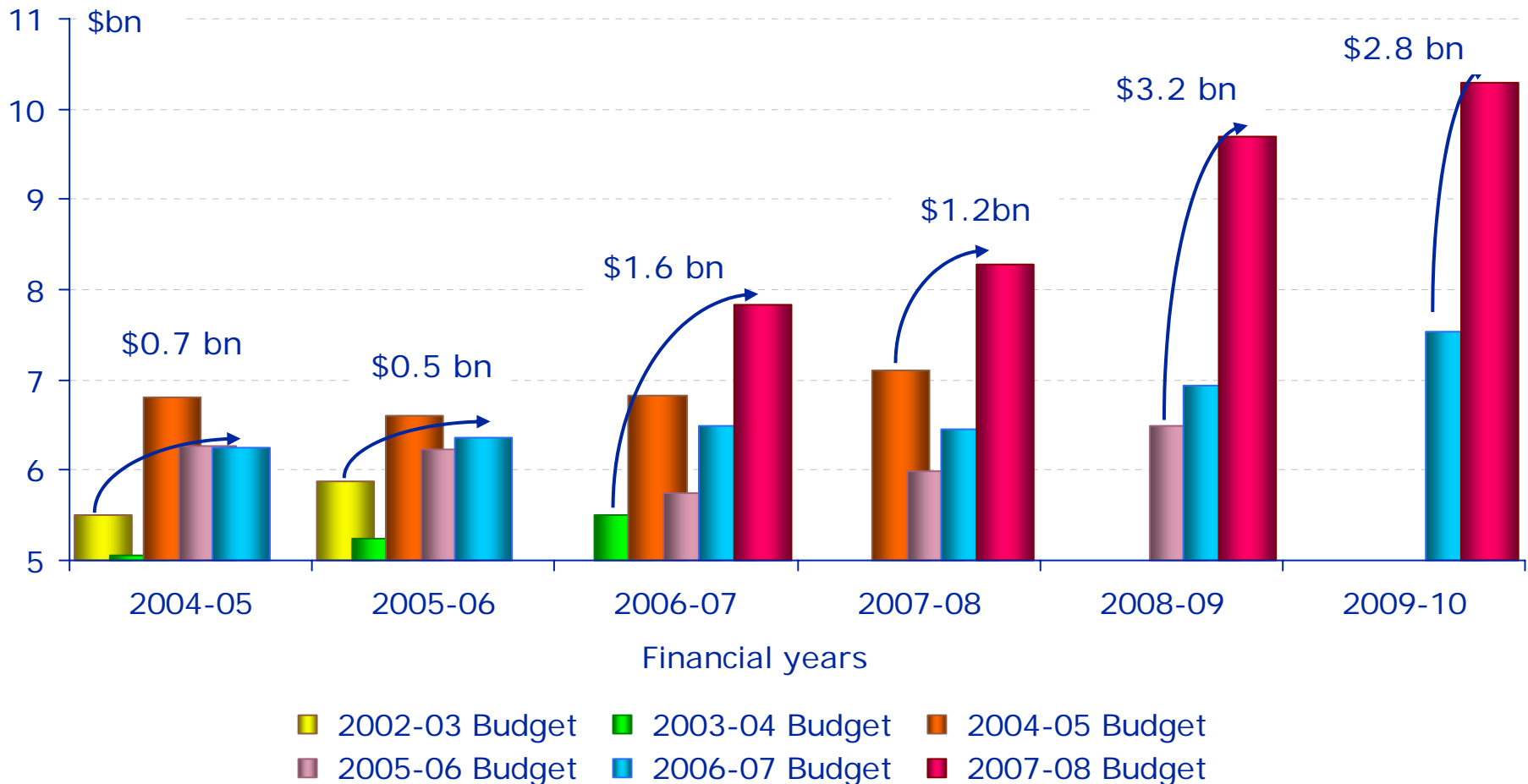
Successive Budget (cash) estimates of company tax receipts



Source: Table C4: Statement No. 5, Budget Paper No. 1 (various years); Economics@ANZ.

Superannuation fund taxes have also begun to emerge as a source of revenue 'bonuses'

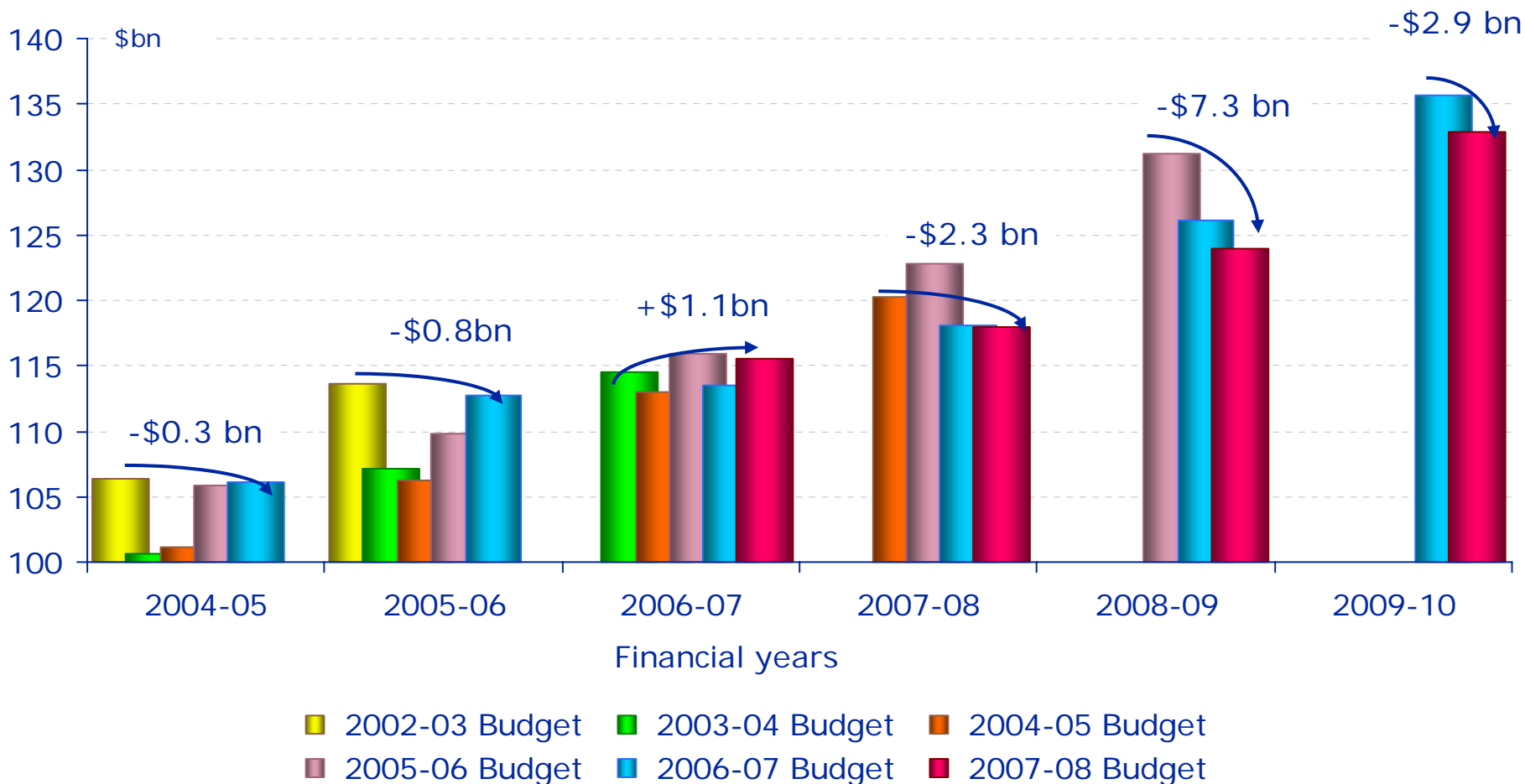
Successive (cash) estimates of super fund tax receipts



Source: Table C4: Statement No. 5, Budget Paper No. 1 (various years); Economics@ANZ.

By contrast, personal income tax revenues have been revised downwards – due to tax cuts

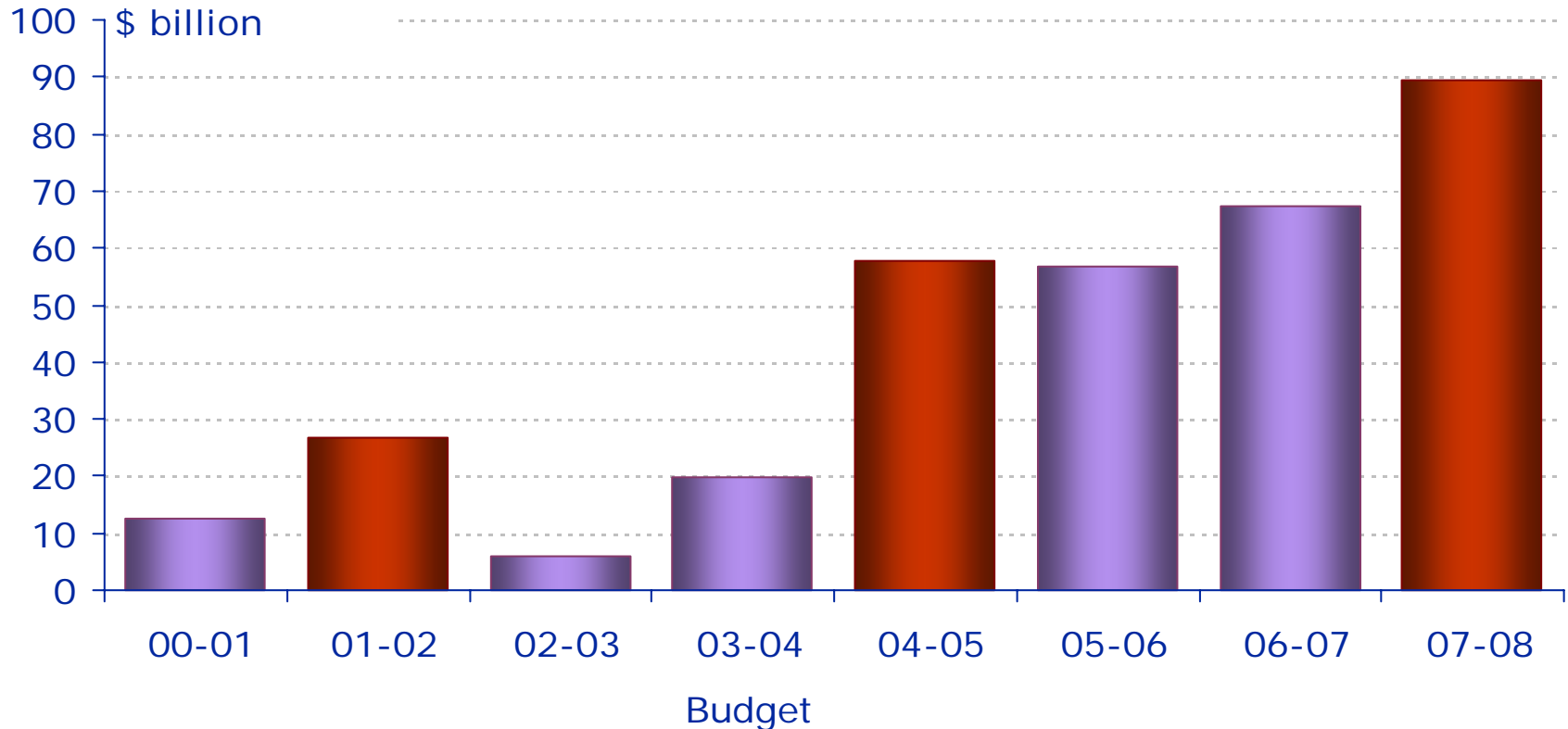
Successive estimates of personal income tax receipts*



Source: Table C4: Statement No. 5, Budget Paper No. 1 (various years); Economics@ANZ.

'Policy decisions' in this Budget (\$89bn over five years) are the biggest ever

Impact of policy decisions over Forward Estimates periods of the last eight Budgets



Note: Figures in this chart based on accrual rather than cash estimates, and represent the total (over the remainder of the preceding year plus the 4 year Forward Estimates period) impact of decisions taken since the previous Budget, compiled from Table 2 in Statement No. 2 of Budget Paper No. 1 together with estimates for the final year of the Forward Estimates period taken from the Tables at the beginning of Parts 1 and 2 of Budget Paper No. 2.

Of 'parameter variations' totalling \$72bn (over 5 years) since MYEFO, only \$3bn has been 'saved'

Reconciliation of successive estimates of the 'underlying' cash balance (\$ bn)

	06-07	07-08	08-09	09-10	10-11	Total
As at May 2006	10.8	10.6	11.2	12.0	10.7 *	53.4
'Parameter variations'	+3.3	+4.9	+5.3	+7.0	+7.0*	27.1
'Policy decisions'	-2.3	-5.5	-4.7	-5.0	-5.0*	-22.5
As at December 2006	11.8	9.7	11.8	14.0	12.6*	60.0
'Parameter variations'	+5.7	+12.9	+16.7	+18.3	+18.3	71.9
'Policy decisions'	-3.9	-11.9	-15.9	-18.5	-18.5*	-68.6
As at May 2007	13.6	10.6	12.7	13.8	12.5	63.3

Note: 'Parameter variations' are changes in spending or revenue projections arising from changes in economic assumptions, changes in the revenue yield from particular taxes, 'slippage' in implementation of policy decisions, etc. For years where estimates of the impact on parameter variations or policy decisions on the cash balance are not available they have been [conservatively] estimated to equal the published estimate for the preceding year. *Source:* Table 4 in Statement No. 2, Budget Paper No. 1 and Economics@ANZ estimates.

There are always instant cash hand-outs in an election year Budget: this was no exception

Budget	Recipients	Amount	Total cost
2001	Pensioners	\$300	\$10 mn
2004	Carers	\$600/ \$1000	\$255 mn
2007	Senior's bonus	\$500	\$1.3bn
	Carers bonus	\$600/ 1000	\$394mn
	Super co-contribution (in respect to eligible 2005-06 contributions)		\$1.1bn
	Ex-prisoners of war in Europe (or widows)	\$25,000	\$57mn over two years
	Child care tax rebate claimants (per child)	Up to \$4,200	\$451mn

Tax cuts and cash hand-outs account for more than half the policy decisions

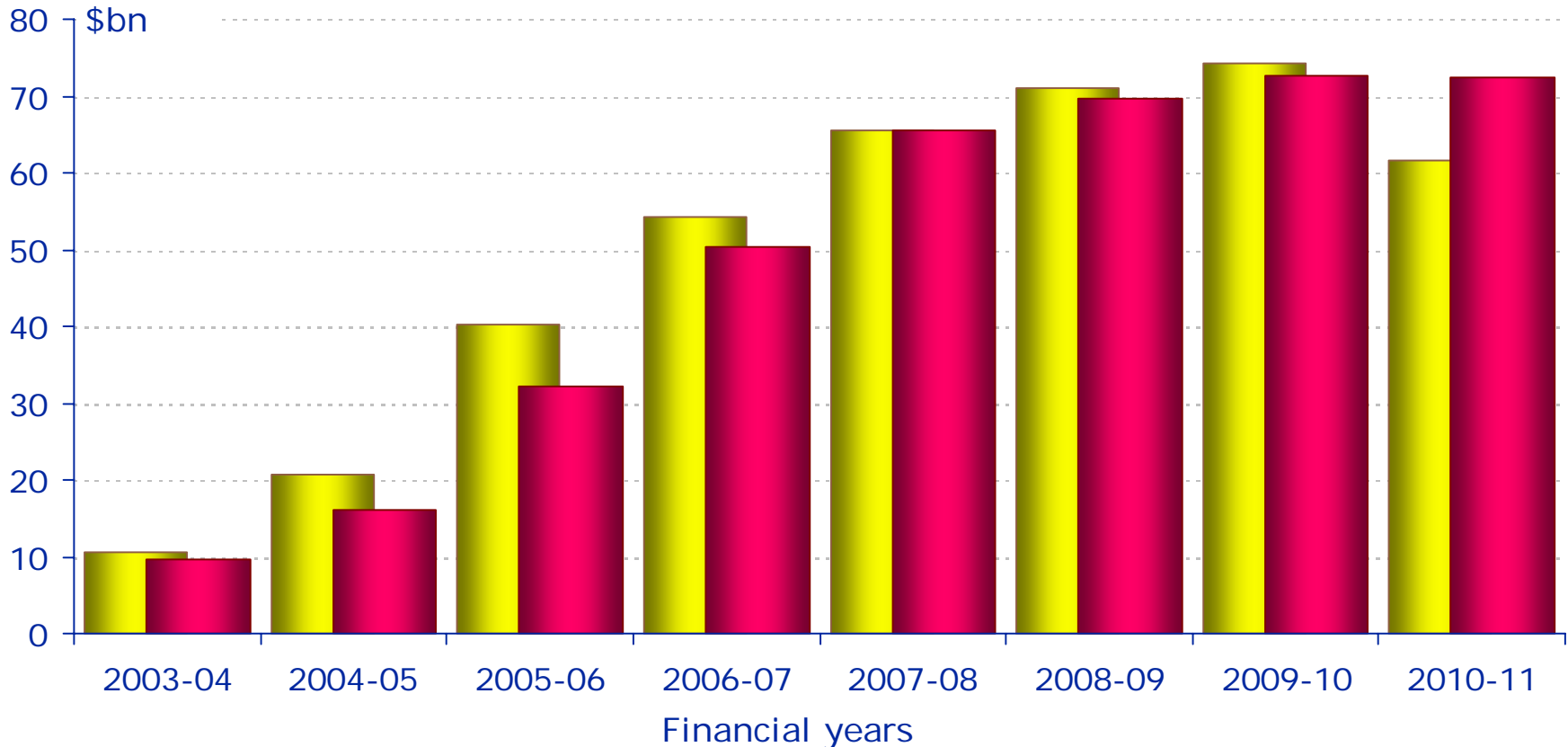
	Net increase in spending (\$mn)					
	06-07	07-08	08-09	09-10	10-11	Total
Personal income tax cuts (incl DSR)		5,325	8,480	8,920	9,190	31,915
Defence & 'national security'	34	1,633	1,466	1,477	1,193	5,803
Transport & infrastructure	-	125	445	2,053	2,127	4,750
Environment	-	172	737	1,398	1,881	4,189
Education & skills	-	721	978	978	969	3,647
Families & older Australians	2,163	673	269	269	269	3,642
Health & aged care	489	255	436	548	600	2,329
Industry assistance	-	139	164	167	653	1,123
Rural Australia	77	158	165	61	59	520
Other	1,468	3,107	3,280	3,174	3,038	14,067
Total	4,231	12,308	16,420	19,045	19,979	71,983

Note: figures in this table are in accrual, not cash, terms.

Sources: Budget Overview and Budget Papers Nos. 1 and 2.

Over the past 5 Budgets, 'parameter variations' total \$398 bn and policy decisions \$388bn

Cumulative net impact on the 'underlying' cash balance of 'parameter variations' and 'policy decisions' over past 5 Budgets

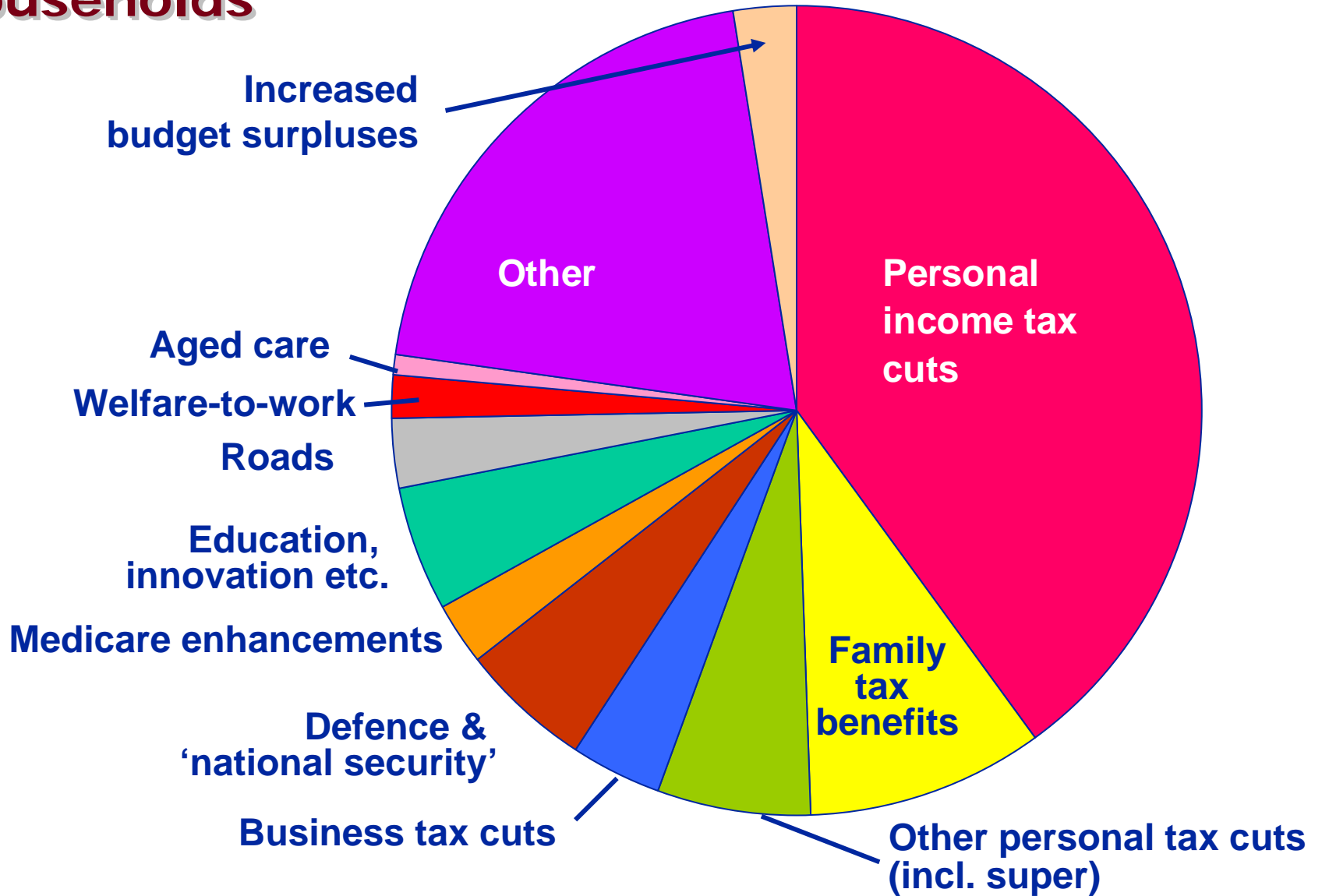


Cumulative impact of: ■ 'Parameter variations' ■ 'Policy decisions'

Source: Table 4, Statement No. 1 in *Budget Paper No. 1* (various years); Economics@ANZ.

See footnote on previous slide for explanation of assumptions used in compiling estimates.

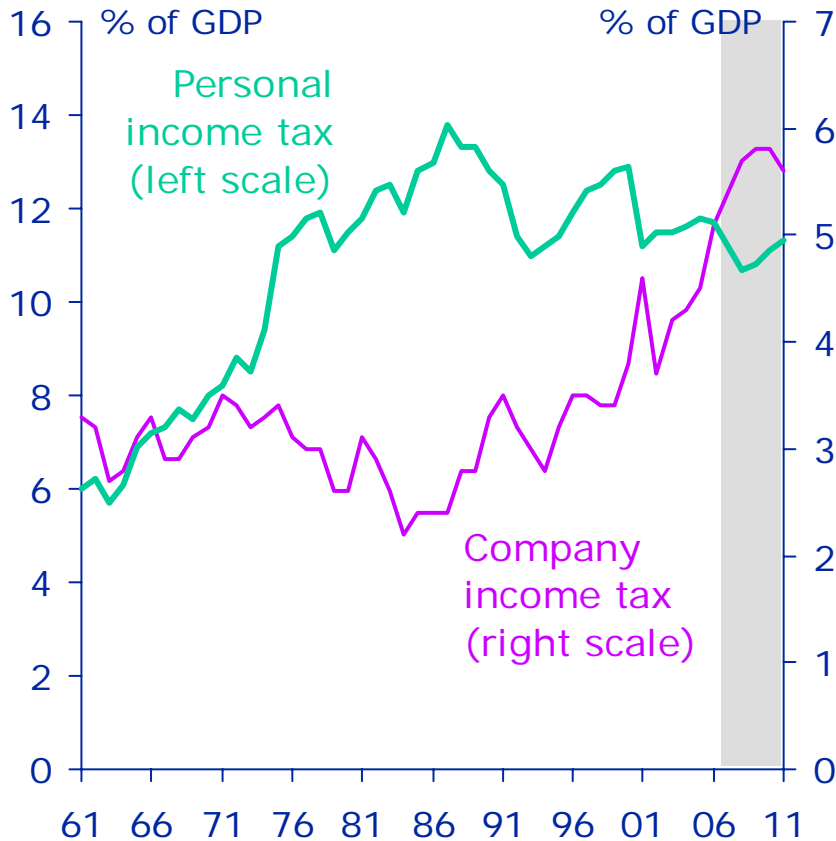
56% of this has been handed over in cash to households



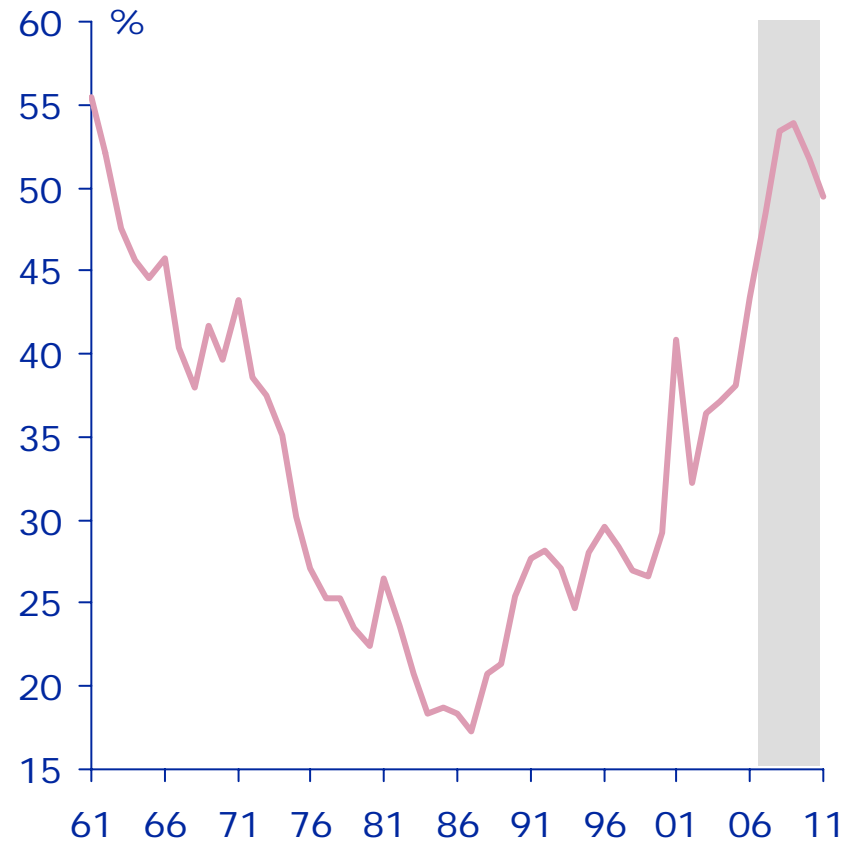
Sources: As for previous slide. Total is A\$398bn over nine years.

Successive Budgets have effectively redistributed income from companies to households

Personal and company income tax as a % of GDP



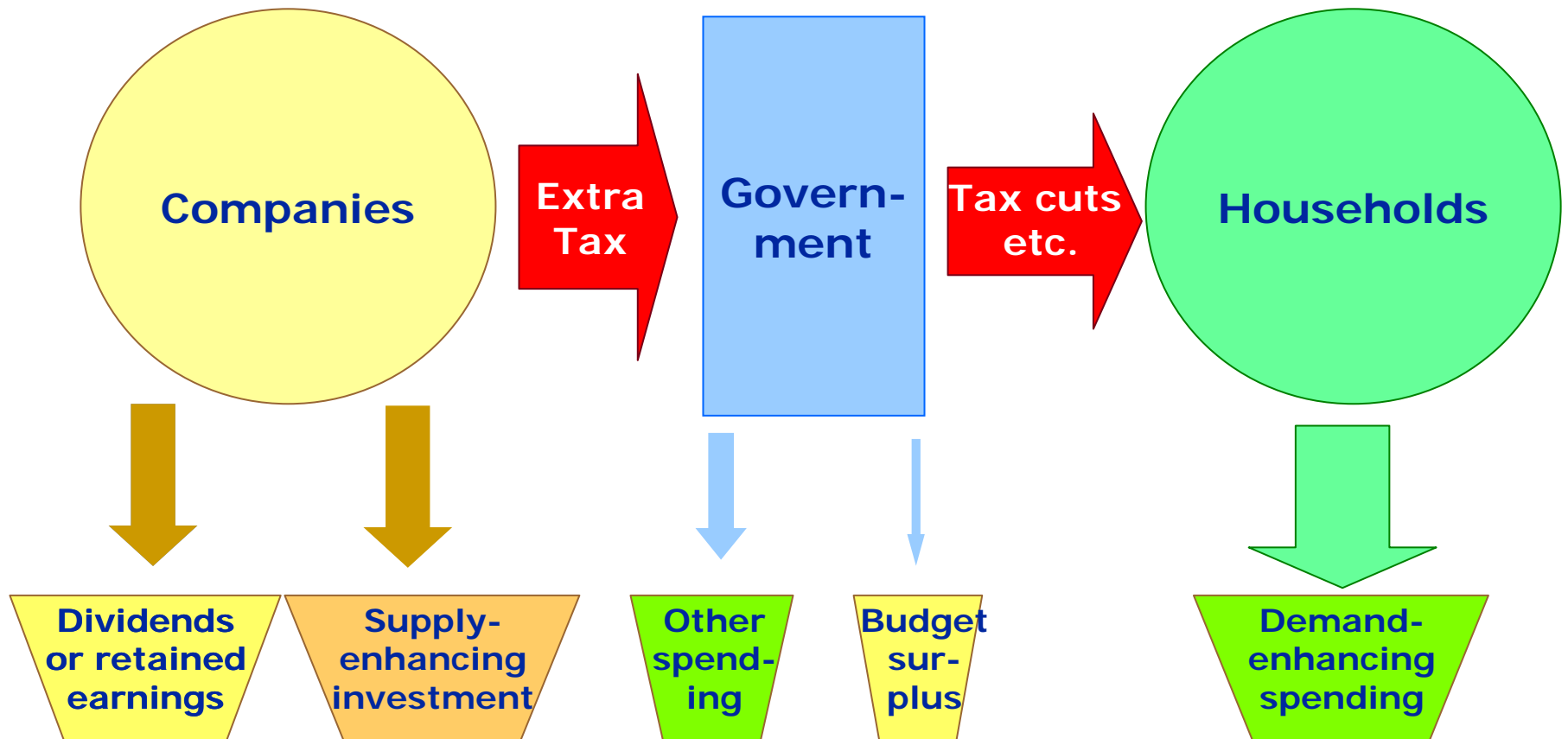
Company income tax as a % of personal income tax



Sources: RBA Occasional Paper No 8, *Australian Economic Statistics 1949-50 to 1994-95* Table 2.17 and Budget Paper No. 1, Statement 5, Tables C4 & C5 (various years).

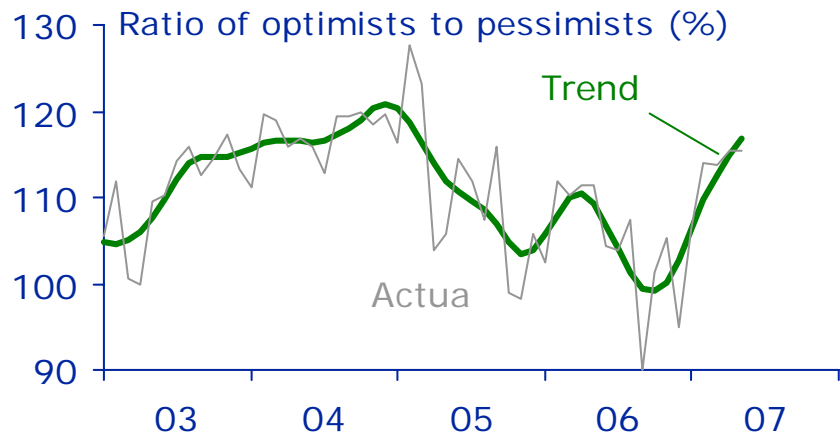
Just because the Budget is in surplus doesn't mean it's not boosting demand

A stylized representation of how the Budget boosts demand even with an unchanged surplus

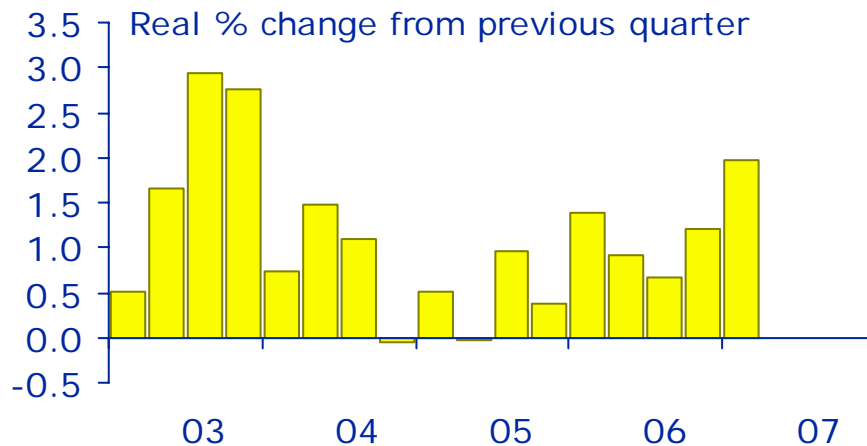


The three interest rate rises since last May have been offset by the tax cuts and other hand-outs

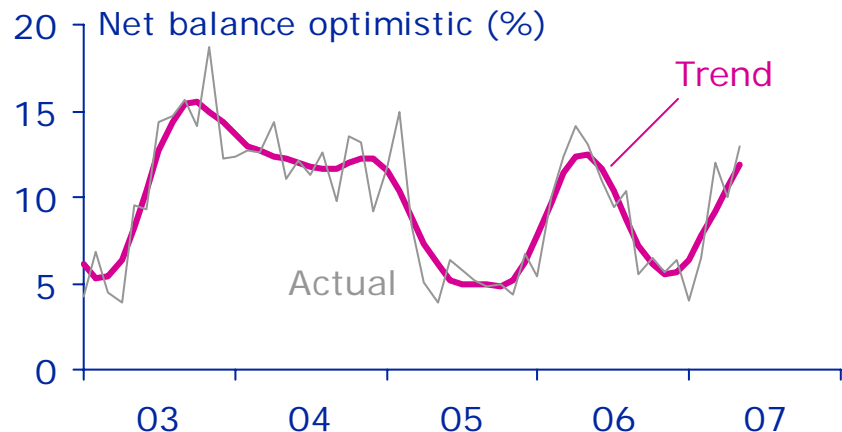
Consumer confidence



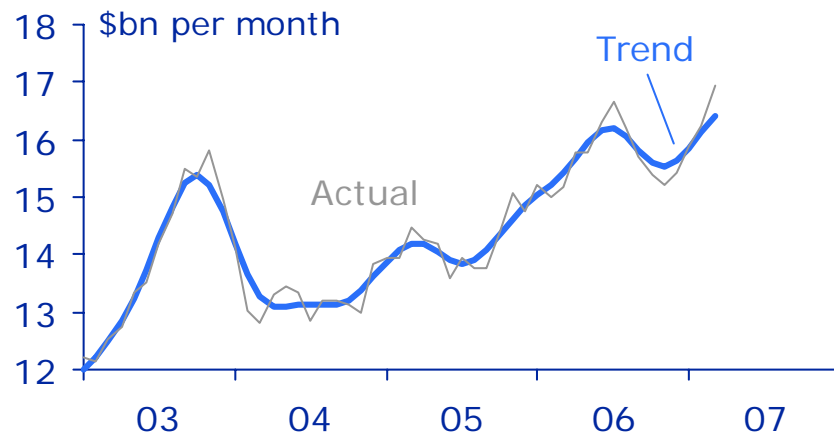
Retail sales volume



Business confidence



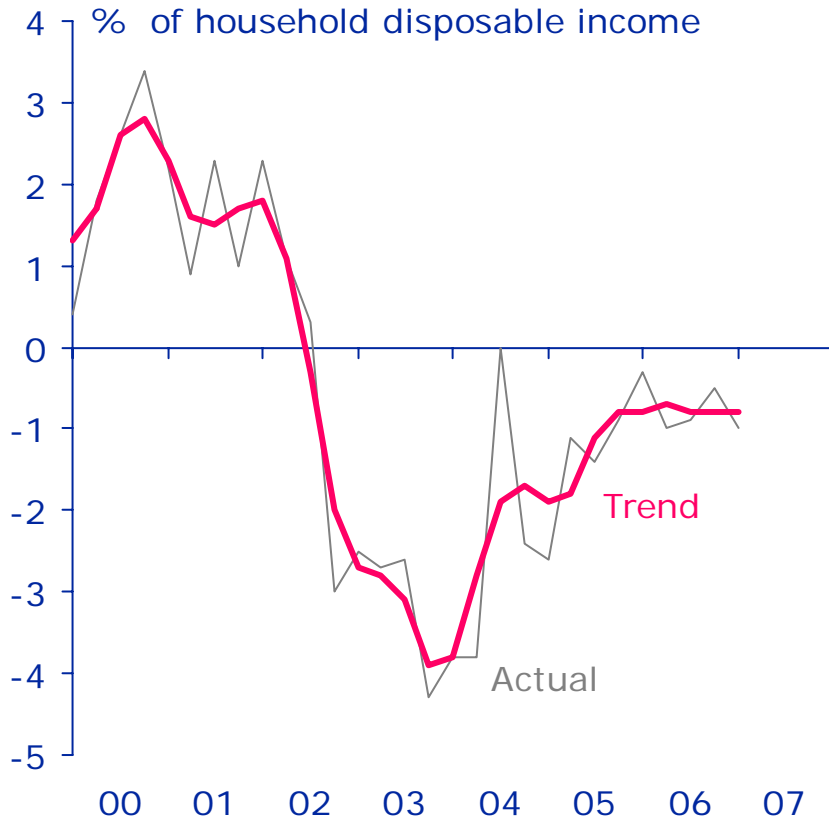
Housing finance commitments



Sources: Westpac-Melbourne Institute; National Australia Bank; ABS.

There's no hard evidence that households saved any significant proportion of last year's tax cuts

Household saving ratio



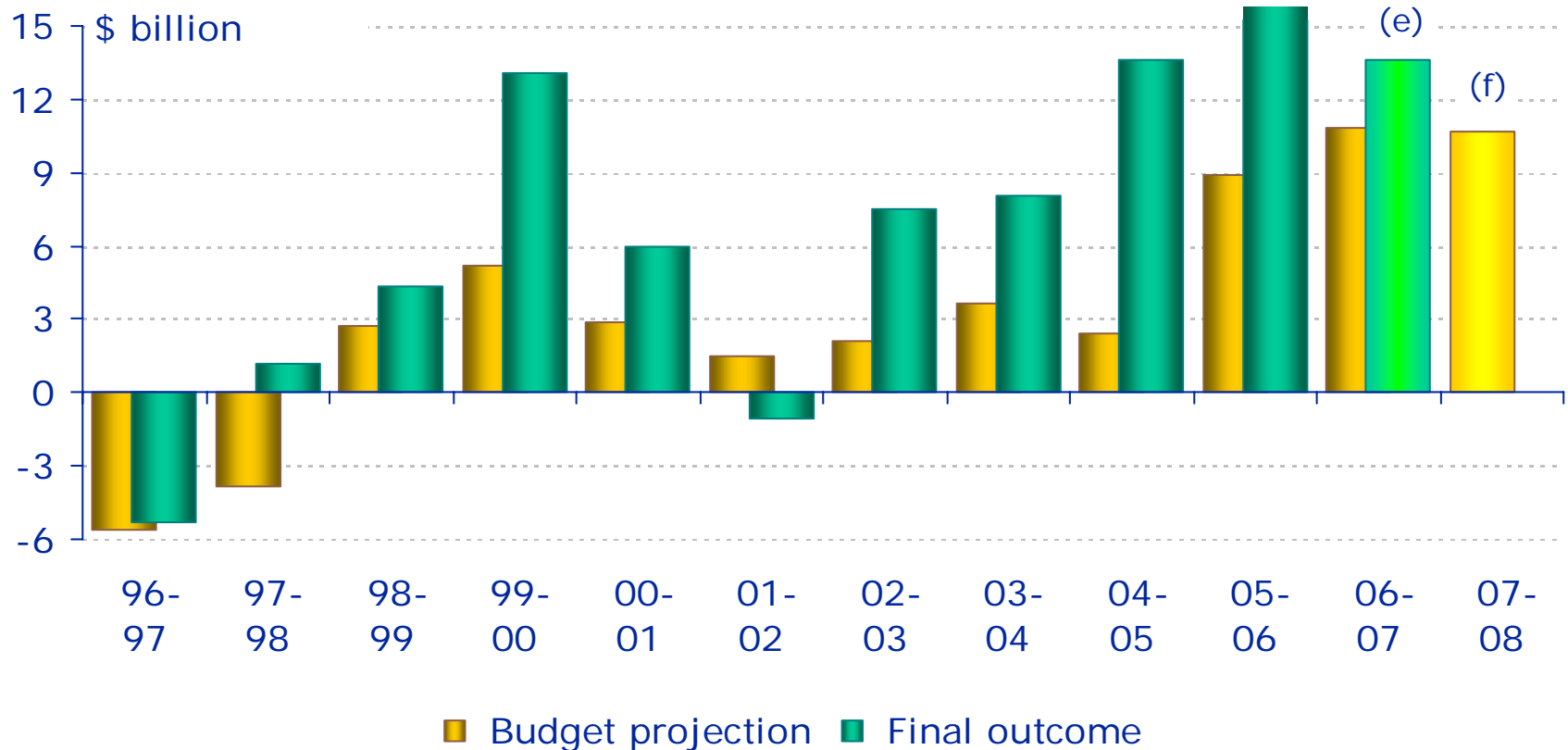
Household credit outstanding



Sources: ABS; RBA.

The government usually under-estimates the eventual cash balance

'Underlying' cash balance – forecast and actual



'Budget projection' is the forecast made in the Budget prior to the commencement of the year concerned. 'Final outcome' is as reported as at May 2007.

Sources: Budget Papers from 1996-97 through 2006-07.

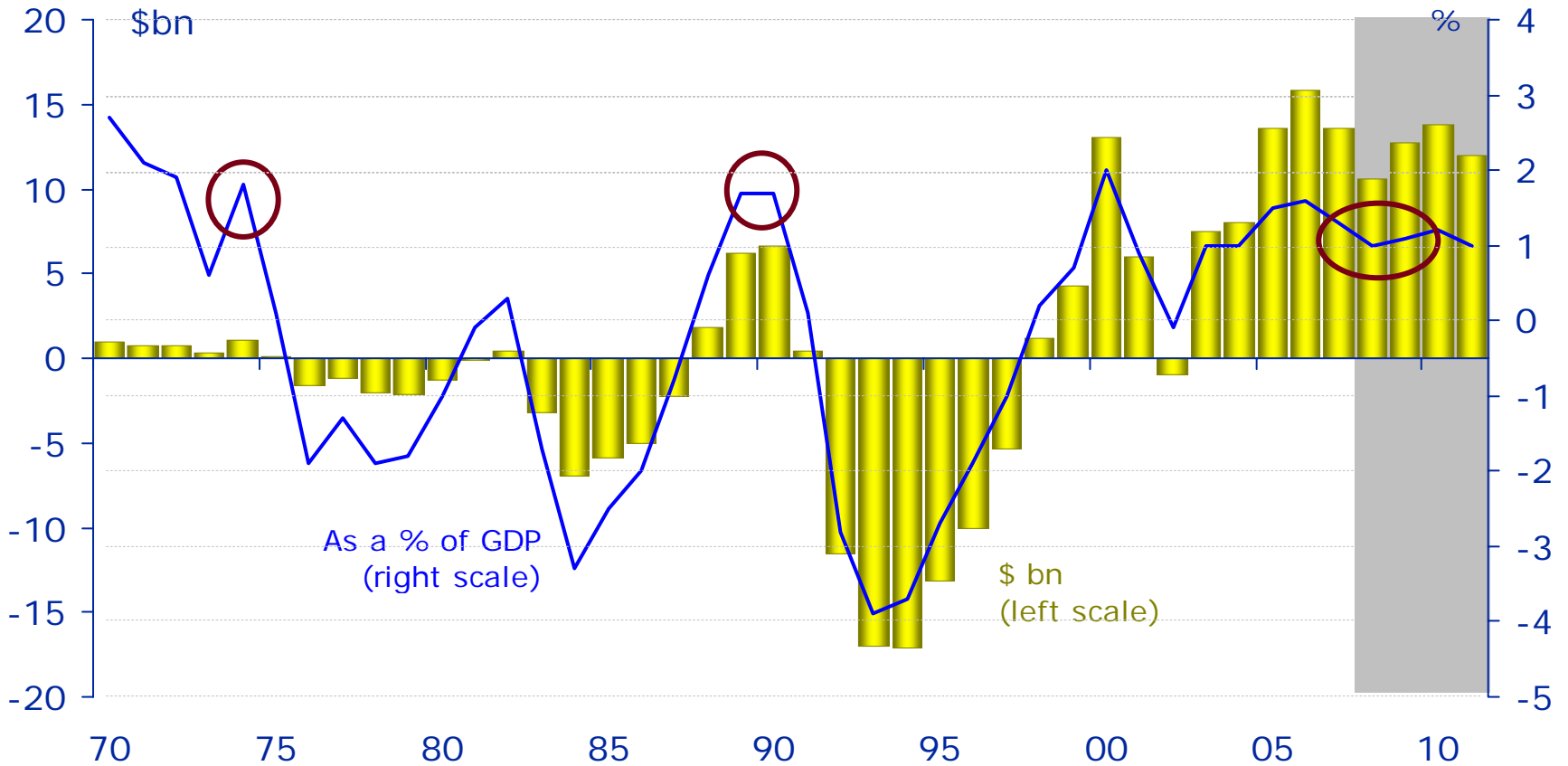
How would ASIC regard a company which gave such inaccurate earnings guidance?

	Estimates of the 'underlying' cash balance (\$million)			
	Initial estimate (prvs May)	Second estimate (December)	Third estimate (May)	Final outcome (June)
1996-97	-5,605	-8,490	-6,856	-5,281
1997-98	-3,853	-2,746	-1,155	1,171
1998-99	2,688	3,267	2,883	4,337
1999-00	5,208	3,431	7,795	13,059
2000-01	2,844	4,329	2,253	5,971
2001-02	1,520	502	-1,193	-1,063
2002-03	2,094	2,141	3,918	7,486
2003-04	3,665	4,635	4,585	8,036
2004-05	2,391	6,206	9,228	13,616
2005-06	8,921	11,452	14,805	15,792
2006-07	10,828	11,827	13,631	
Average 'error'	4,325	3,804	2,686	

Sources: Budget Papers from 1996-97 through 2007-08.

The projected Budget surpluses are smaller than at the same stage of previous business cycles

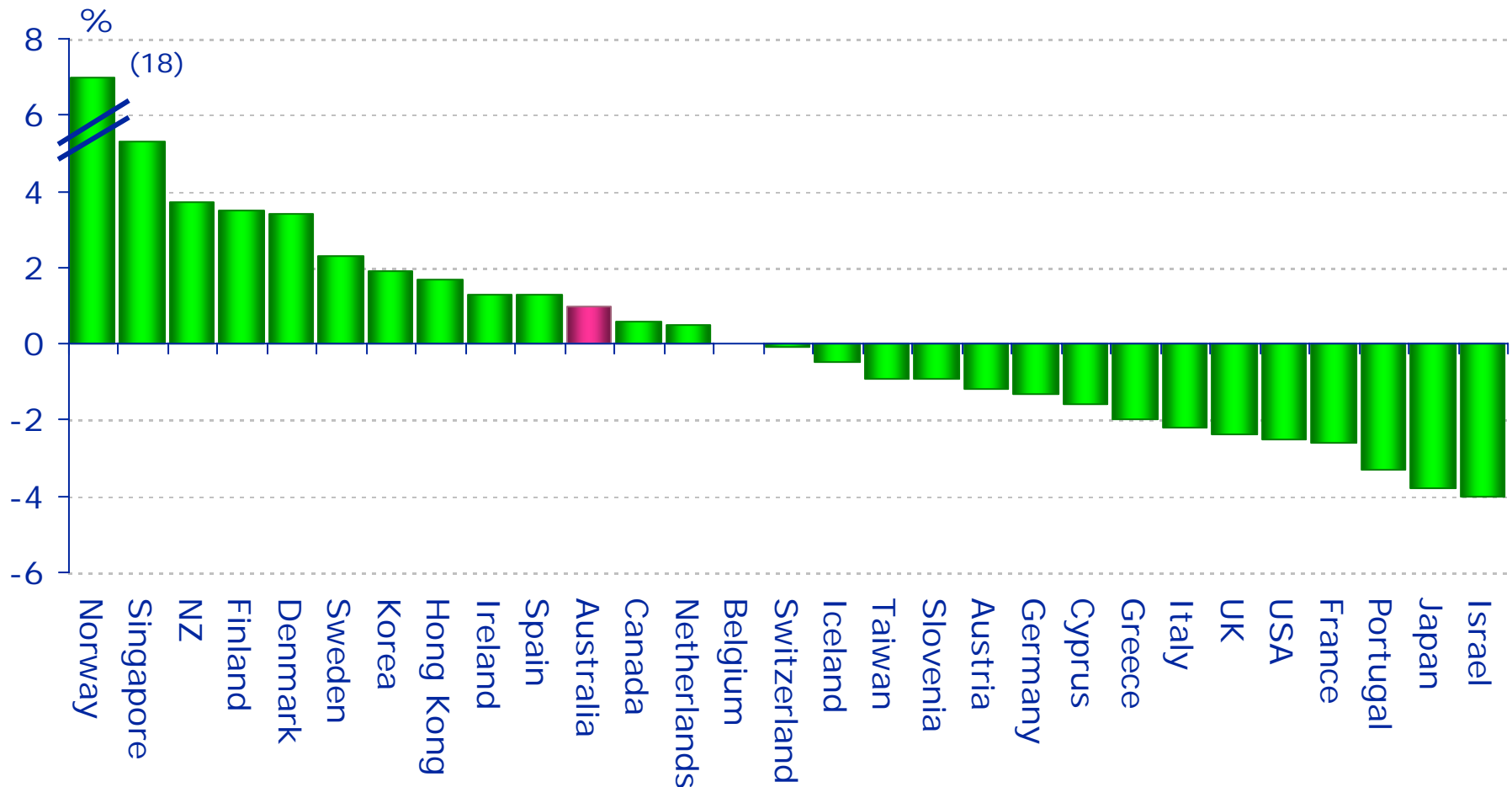
Commonwealth 'underlying' cash balance



Sources: 2007-08 Budget Paper No. 1, Statement 13, Table 1 (and previous issues).

Australia's budget surplus ranks only 11th among advanced economies in 2007

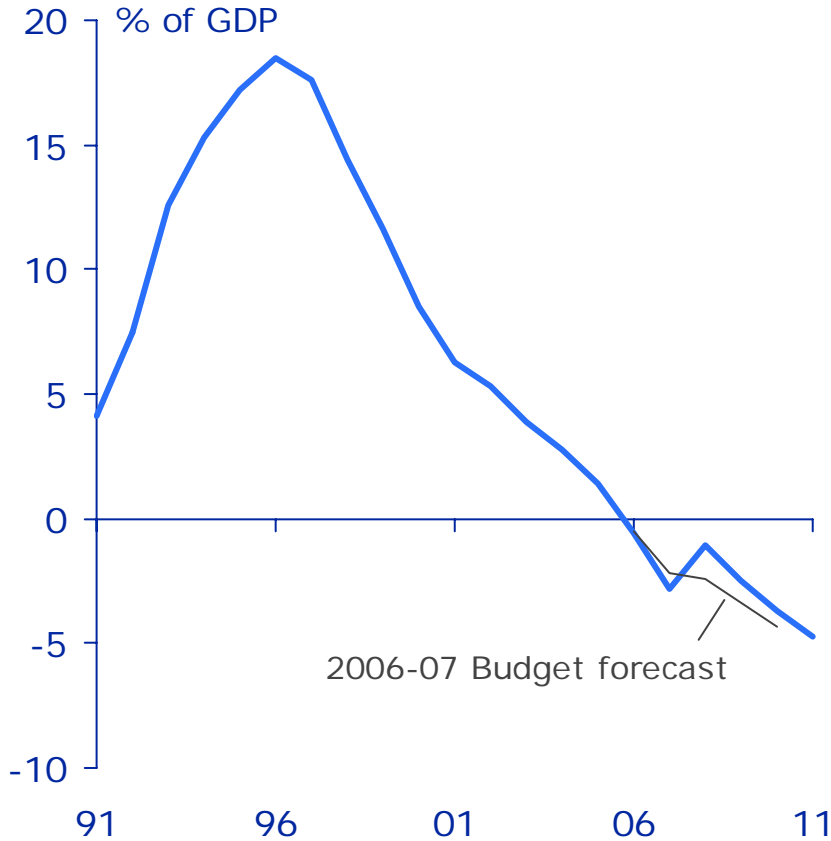
'General government' financial balance
as % of GDP, 2007



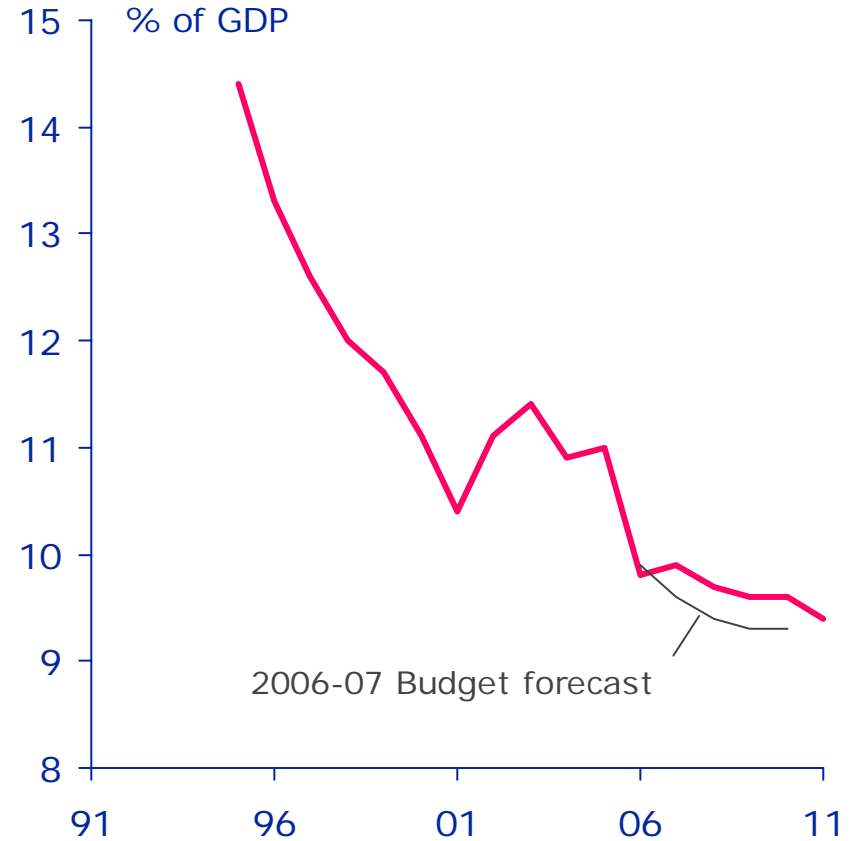
Sources: IMF, *World Economic Outlook* database (April 2007)
and *Budget Paper No. 1*.

Net debt continuing to fall but the unfunded super liability has been revised upwards

Net debt



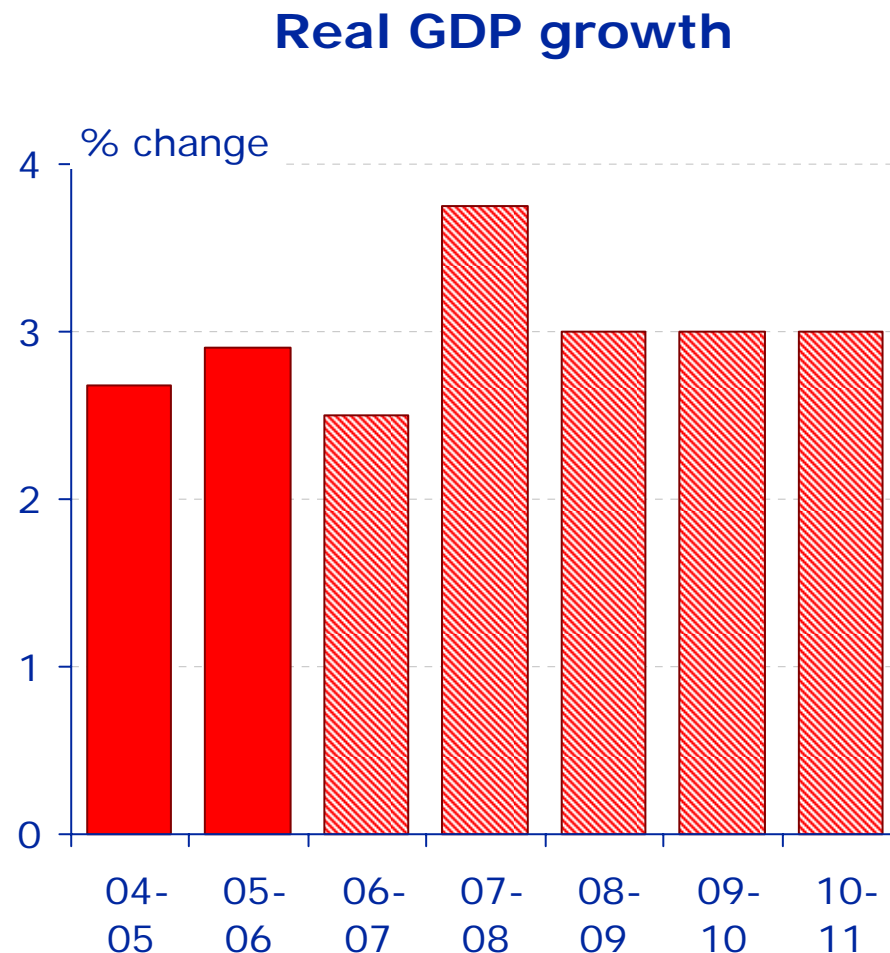
Unfunded superannuation



Sources: 2006-07 and 2007-08 Budget Paper No. 1, Statement 9, Table 2 and Statement 13, Table 3.

Treasury expects growth rebound in 2007-08 then slowdown in 2008-09

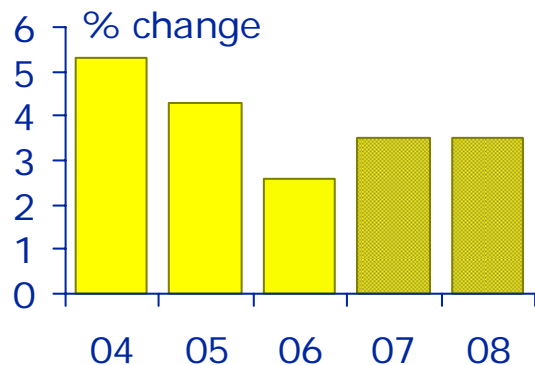
- **Forecast for 2006-07 remains at 2.5%**
 - requires 0.6% growth in March and June quarters
- **2007-08 forecast unchanged at 3¾%**
 - implies 4¼% growth 'through the year'
 - assumes 18% rebound in farm output
 - non-farm real GDP growth forecast to increase from 3% to 3½%
- **Real GDP growth projected to slow to 3% from 2008-09 onwards**



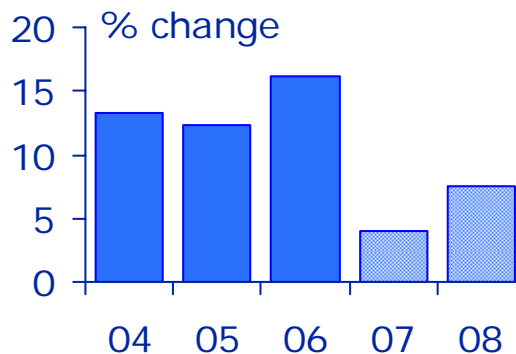
Sources: 2007-08 Budget Paper No. 1, Statement 3, Table 1 and Statement 1, Table 2.

Exports expected to accelerate further while household and public spending remain strong

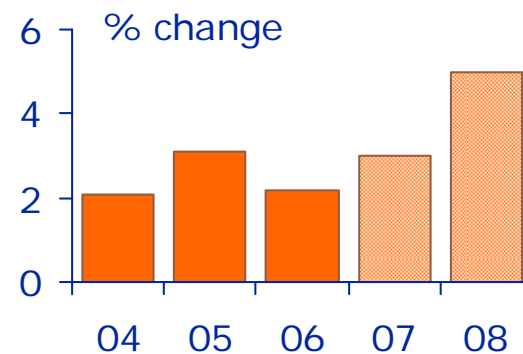
Consumer spending



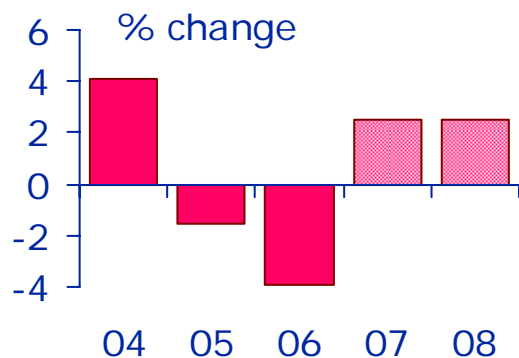
Business investment



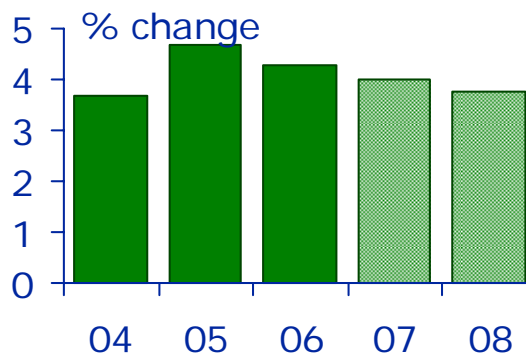
Exports



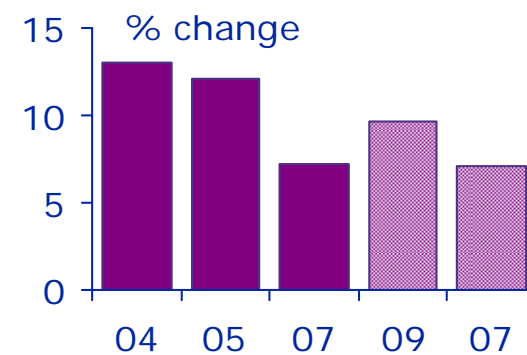
Housing



Public spending



Imports



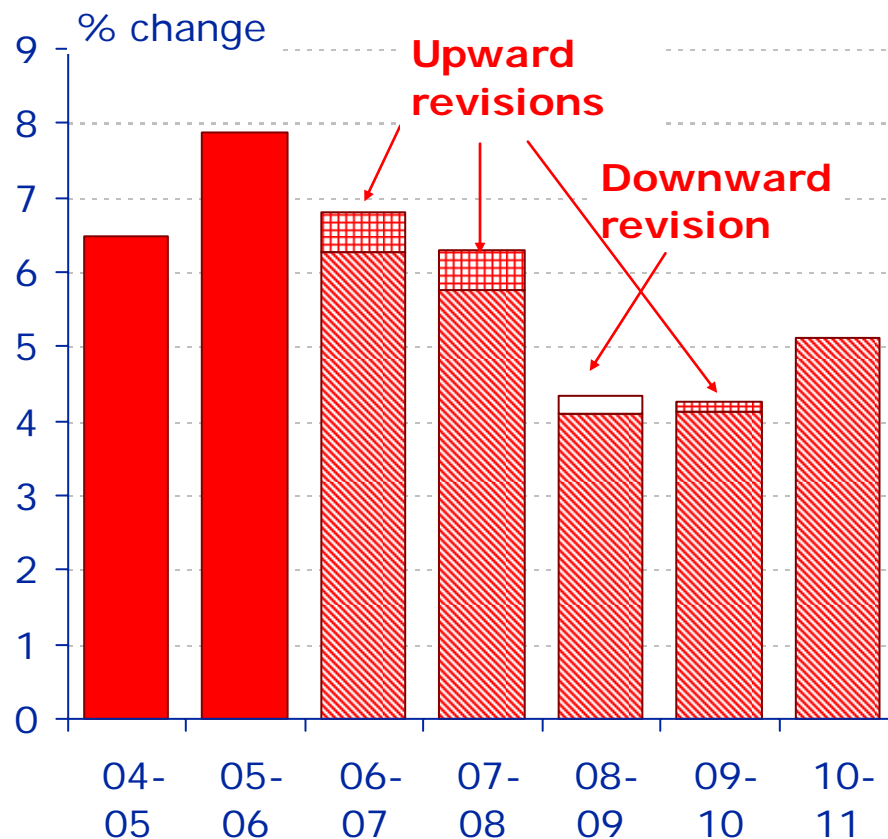
Note: Charts show real p.c. changes for financial years ended 30 June.

41 Source: Statement No. 3, Budget Paper No. 1, Table 2.

Nominal growth (which drives revenue) expected to slow after 2008-09

- Commodity prices have been stronger than expected this year
 - 4¼% rise in GDP deflator boosts nominal GDP growth to 6¾ %
- But non-rural commodity prices are expected to decline over next two years
 - GDP deflator is implicitly forecast to rise by only 2½% in 2007-08 and by 1¼% pa in 2008-09 and 2009-10
 - cutting nominal GDP growth from 6¼ % in 2007-08 to 4¼% pa in 2008-09 and 2009-10

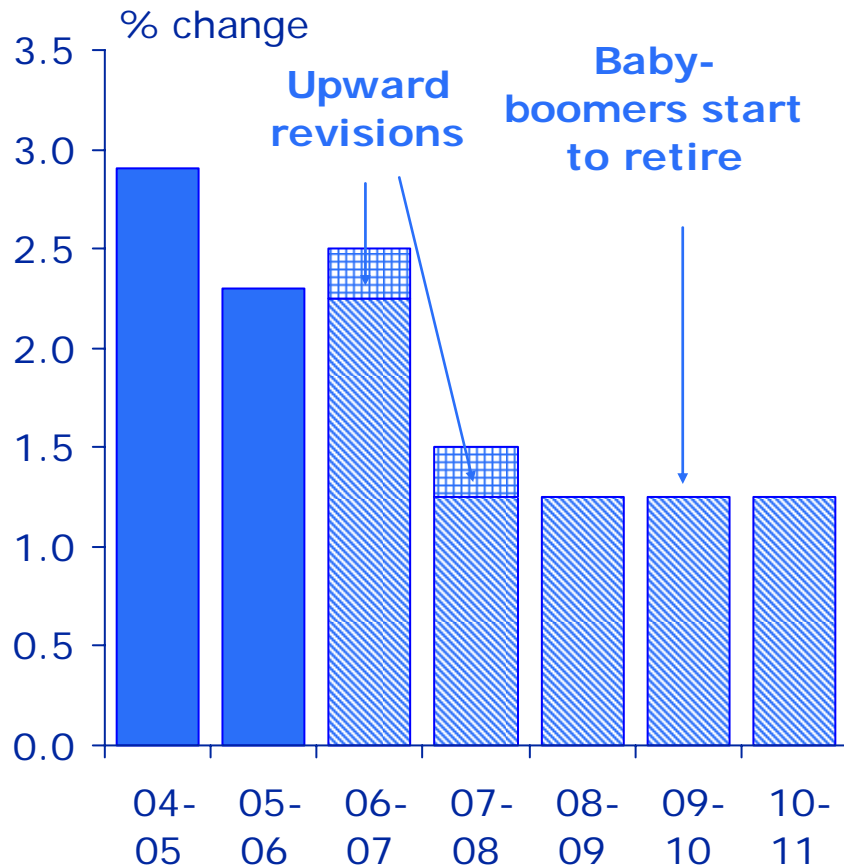
Nominal GDP growth



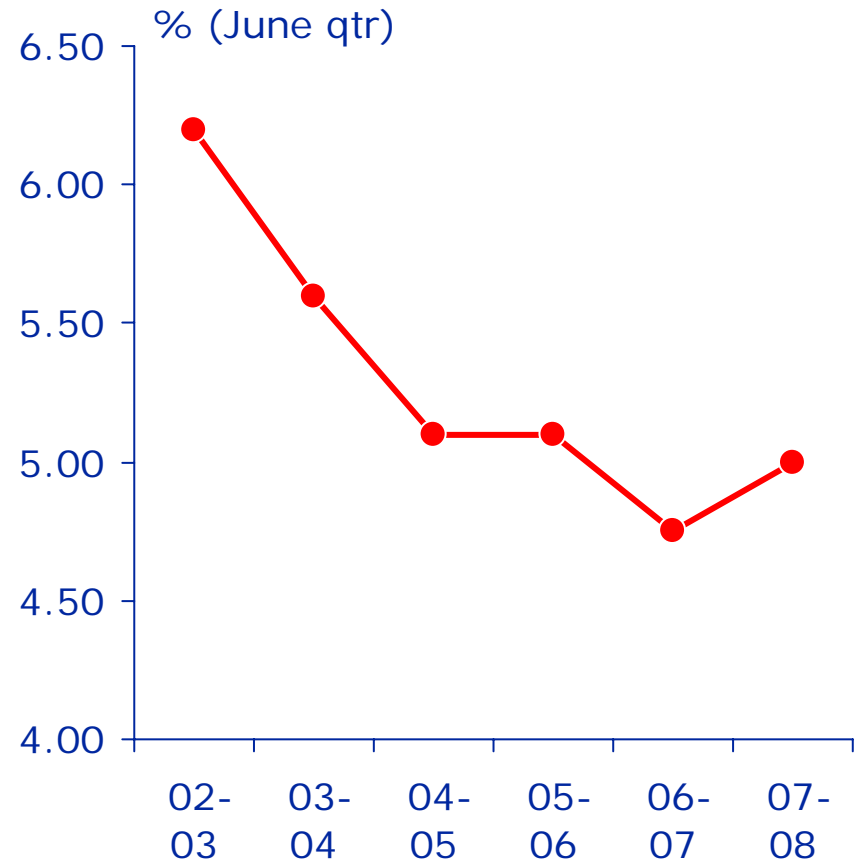
Source: nominal GDP projections inferred from projections of receipts and payments as a pc of GDP in Statement No. 13 of Budget Paper No. 1.

Employment growth is expected to slow, pushing the unemployment rate back up to 5%

Employment growth



Unemployment rate

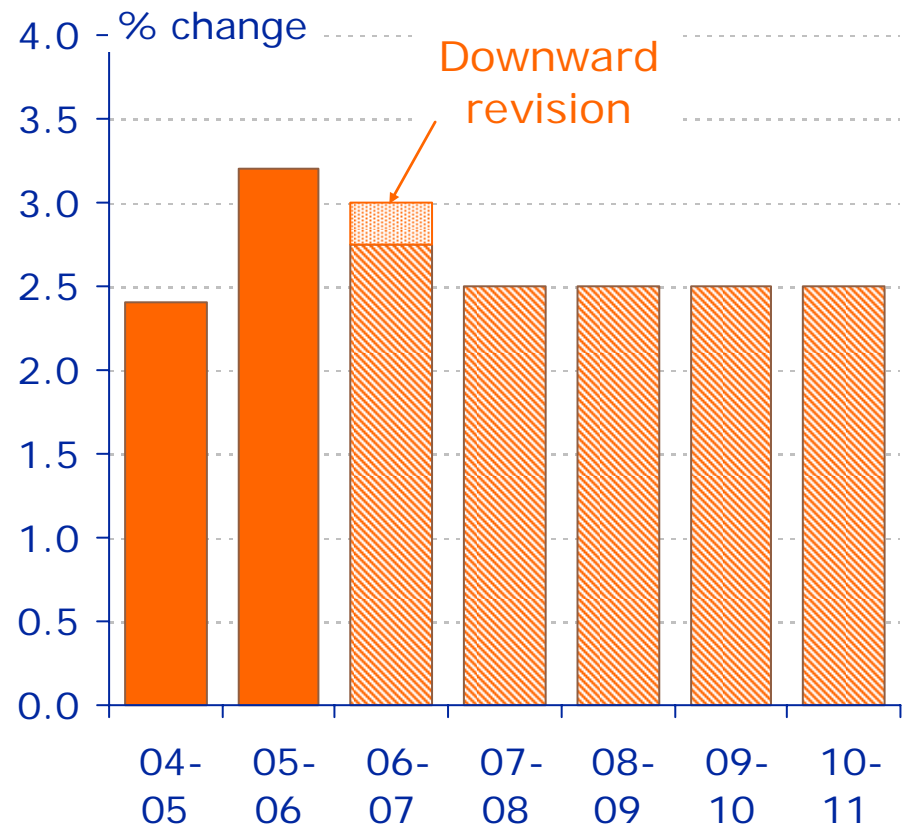


Sources: 2007-08 Budget Paper No. 1, Statement 3, Table 1 and Statement 1, Table 2.

Treasury expects inflation to pick up modestly but remain within the target range

- 'Headline' inflation expected to fall from 2¾% in 2006-07 to 2½% in 2007-08
- Treasury expects nominal unit labour cost growth to ease 'in line with a strengthening in productivity', so that 'underlying inflationary pressures are expected to moderate'
- However rising rents and house purchase costs will put upward pressure on inflation

'Headline' inflation

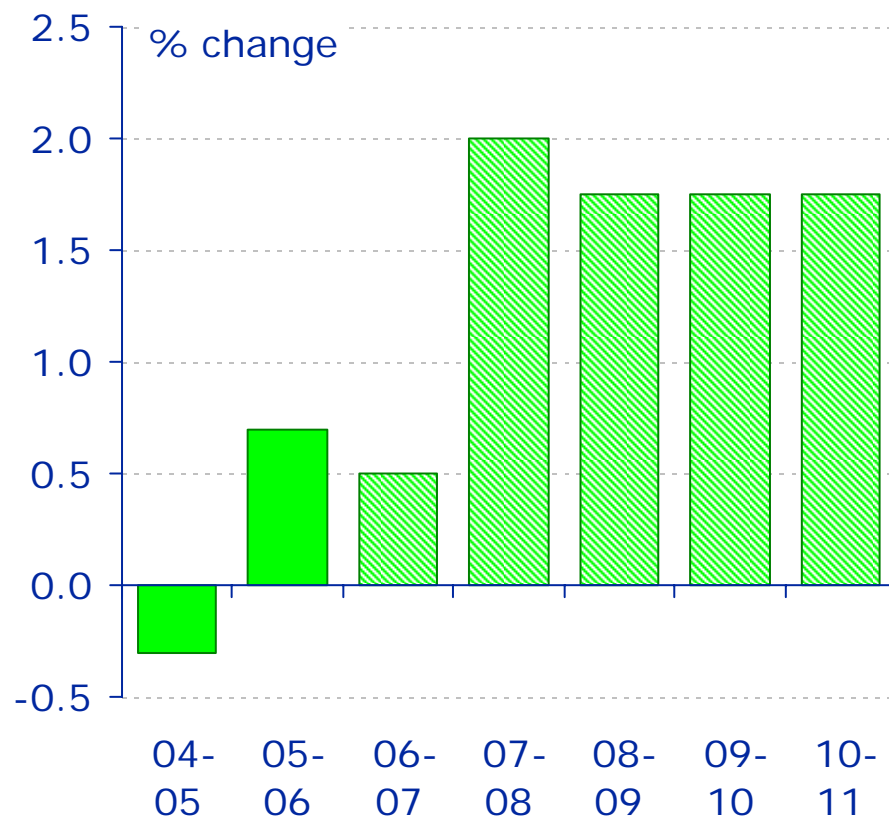


Sources: 2007-08 Budget Paper No. 1, Statement 3, Table 1 and Statement 1, Table 2.

Productivity growth is implicitly forecast to accelerate sharply in 2007-08

- Non-farm product growth of 3½% and employment growth of 1½% in 2007-08 implies that output per person is expected to increase by 2%
 - this would be the strongest since 2001-02
- Thereafter productivity growth is assumed to average 1¾% pa
 - consistent with the long-term average, but below the 2.1% average annual rate attained during the 1990s

Implied 'heads' measure of productivity growth



Sources: 2007-08 Budget Paper No. 1, Statement 3, Table 1 and Statement 1, Table 2.

As in recent years this Budget recycles cash from companies to households

- There are a number of measures in the Budget which do attempt to ameliorate supply-side constraints
 - particularly in the impact of tax scales on incentives to work, and the education, child care and infrastructure initiatives
- ... or which seek to address serious problems
 - for example Indigenous housing
- The 2007-08 Budget continues the now-established practice of re-distributing income from companies to households
 - more than half (by value) of the policy decisions in the Budget put extra cash into household hands
 - this does have implications for domestic demand (because of the different saving propensities of companies and households) even though the surplus is little changed from year to year
 - though these are unlikely to show up in 2007
- The prospective Budget surpluses are (for this stage of the business cycle) not large by Australian historical or contemporary international standards
 - and will inevitably be further eroded by pre-election spending