

# Initial assessment of the 2008-09 Federal Budget

## ANZ Budget Night dinner

13<sup>th</sup> May 2008

Saul Eslake

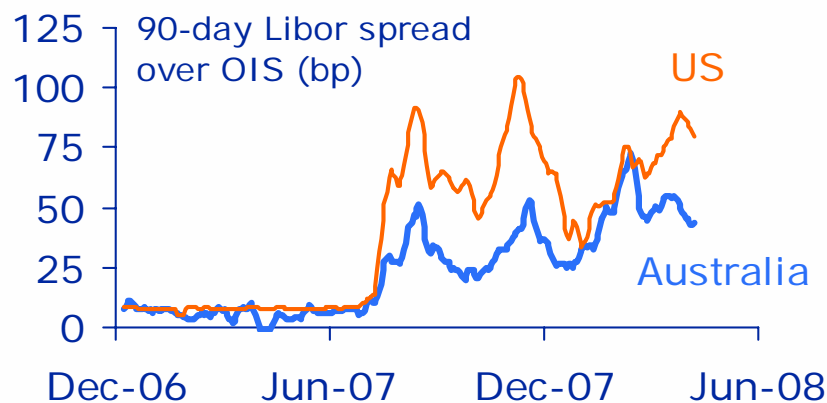
with the assistance of  
Riki Polygenis & Alex Joiner



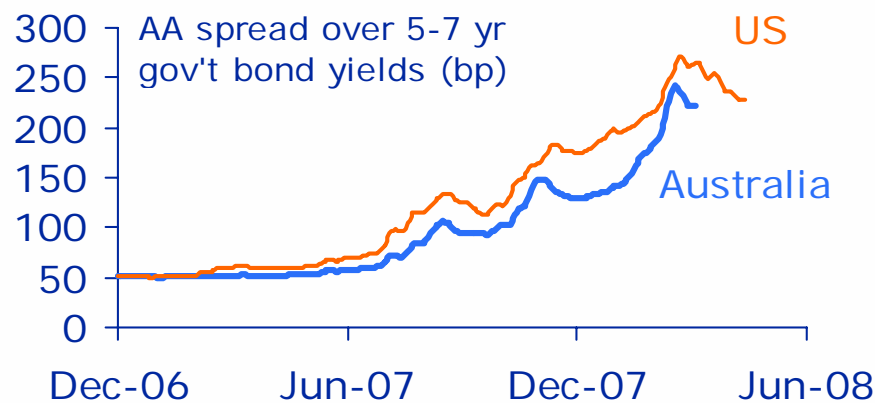
# The economic and political context

# The 2008-09 Budget has been brought down against the background of a serious global financial crisis

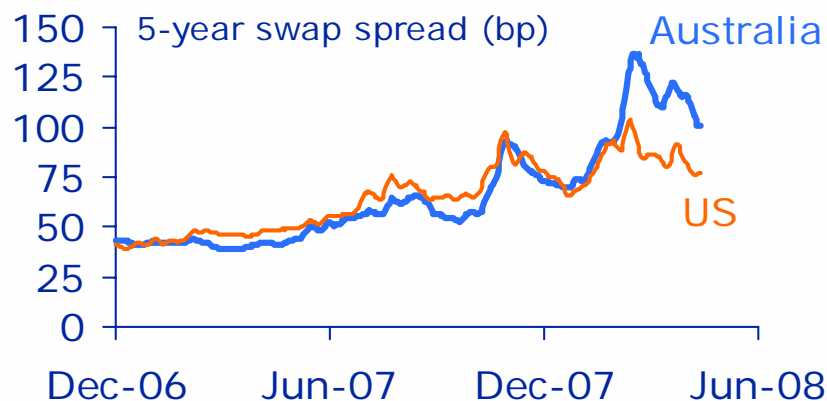
## Banks' short-term funding costs



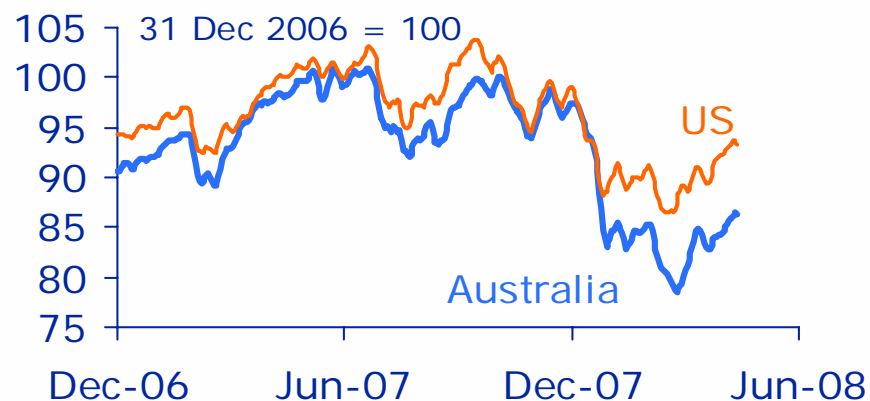
## Corporate bond yield spreads



## Banks' long-term funding costs



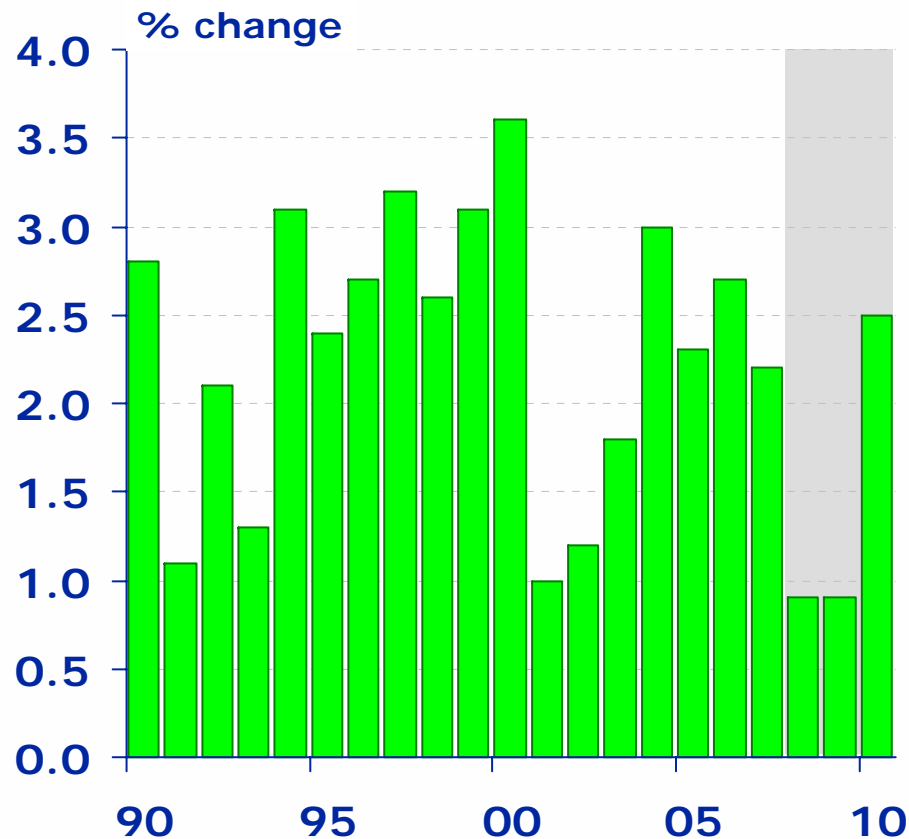
## Share prices



# The financial crisis *may* be easing, but its full effects on major industrialized economies are yet to be felt

## Real GDP growth

### 7 major advanced economies

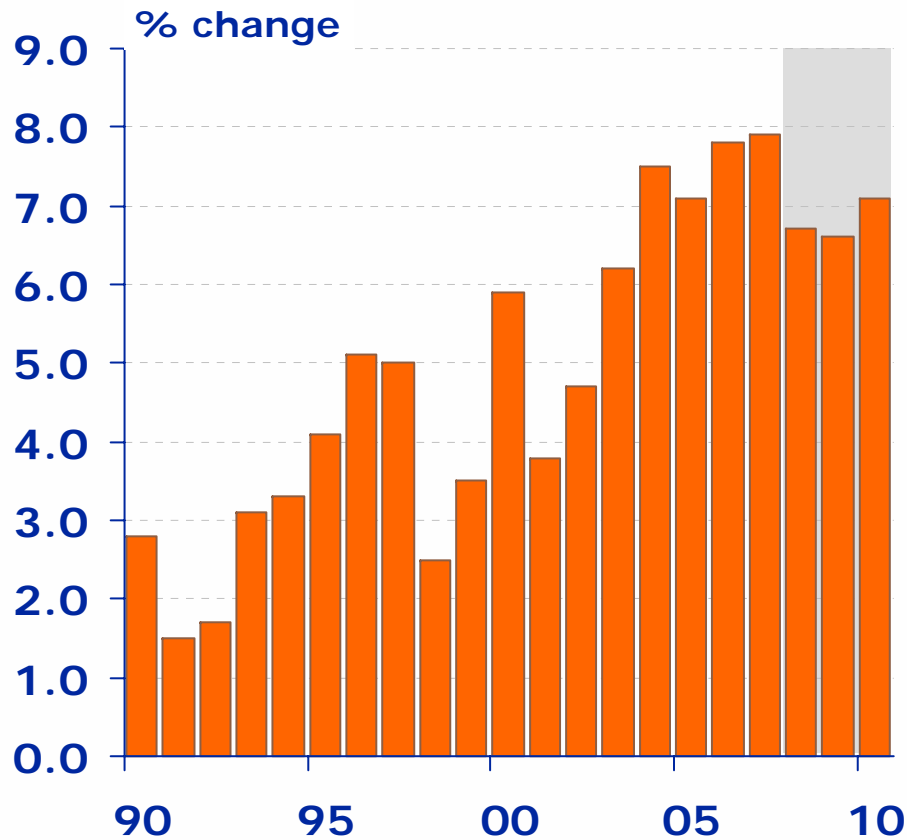


	2007	2008	2009
US	2.2	$\frac{3}{4}$	$1\frac{1}{2}$
Euro area	2.6	$1\frac{1}{2}$	$1\frac{1}{2}$
Japan	2.1	$1\frac{1}{4}$	$1\frac{1}{2}$
OECD	2.7	$1\frac{1}{4}$	$1\frac{1}{4}$

# In the developing world, by contrast, strong economic growth is continuing ...

## Real GDP growth

### Developing economies

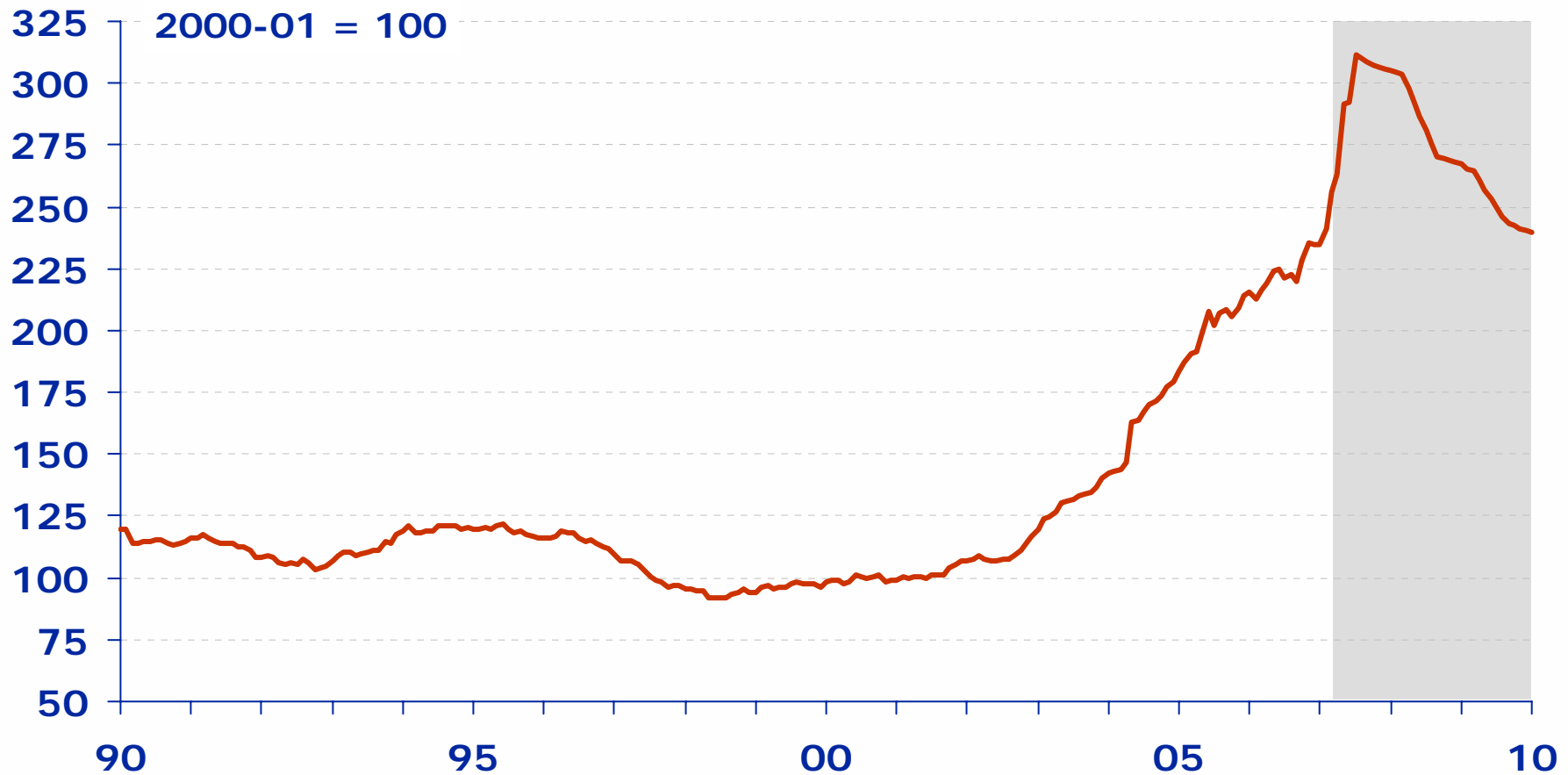


	2007	2008	2009
China	11.4	10	9½
India	7.9	7½	7¾
Other East Asia	5.8	4¼	4¾
Australia's MTPs*	5.2	3¾	4
World	5.0	4	4

\* Major trading partners

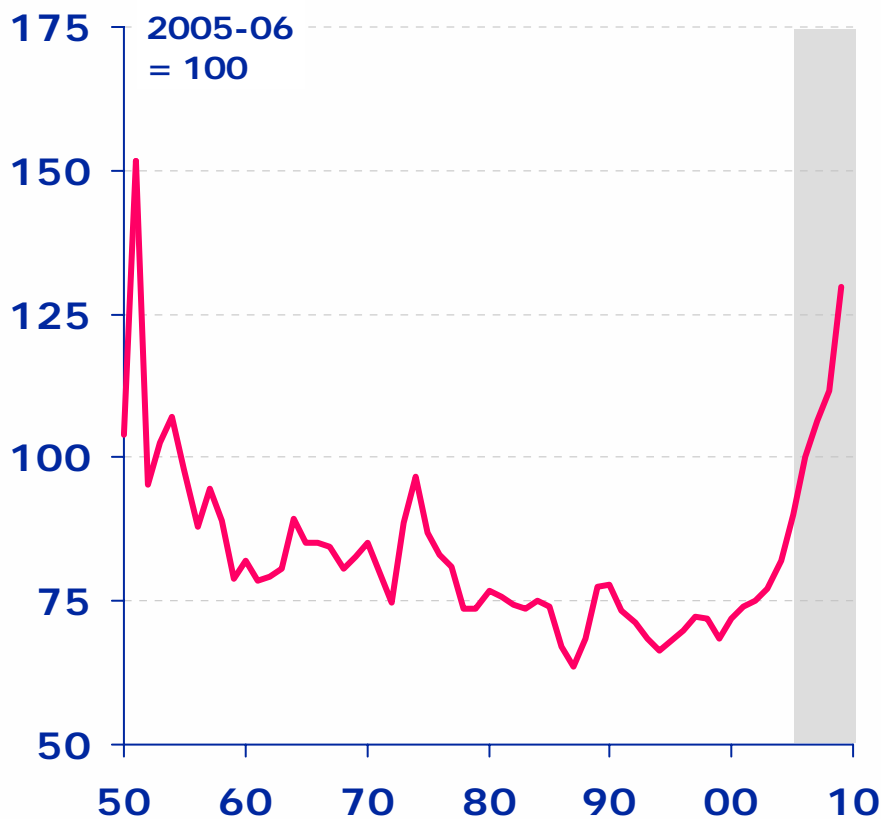
... and will prolong the commodities boom for at least another year ...

### Australian export commodity prices (US\$ terms)

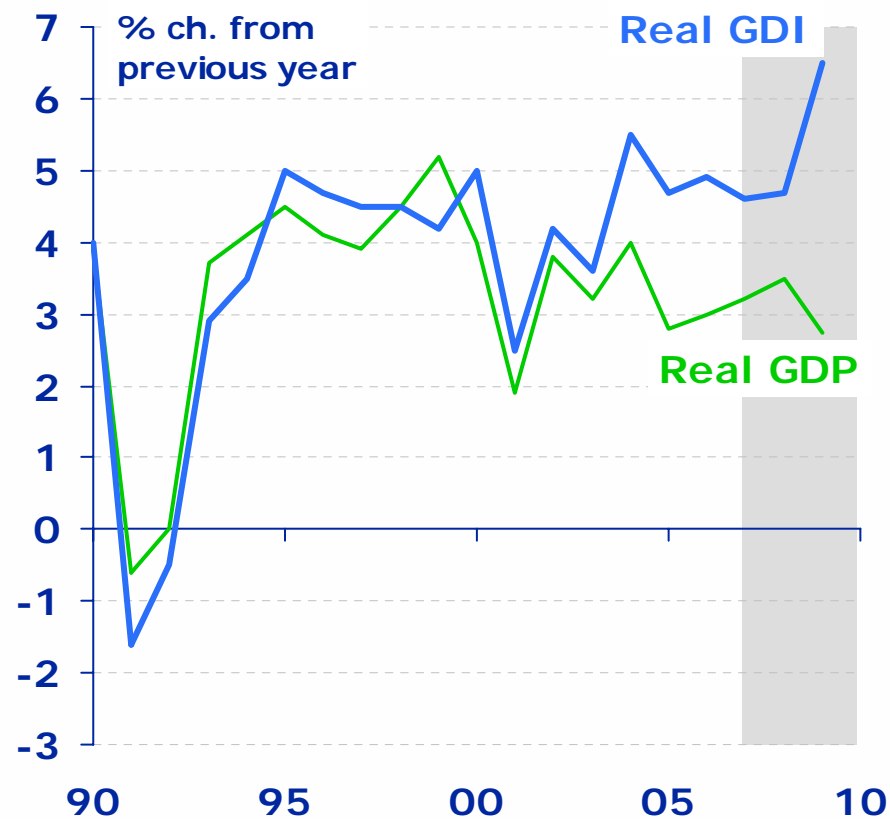


... providing a further huge boost to Australia's national disposable income ...

Australia's terms of trade (ratio of export to import prices)

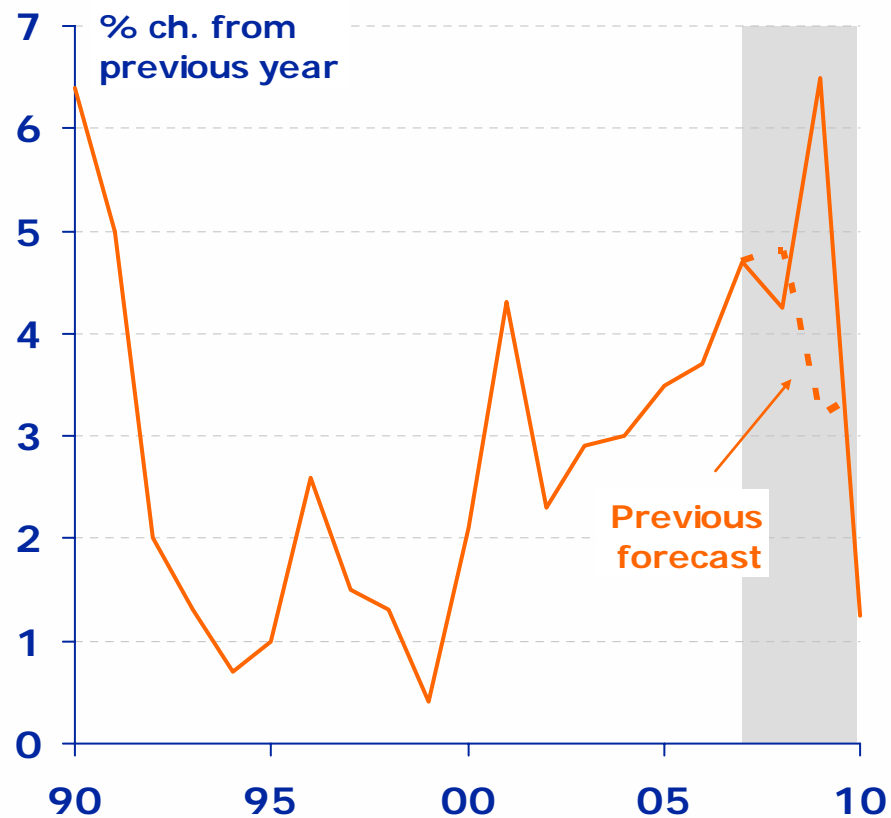


Real gross domestic income (GDI) and product (GDP)

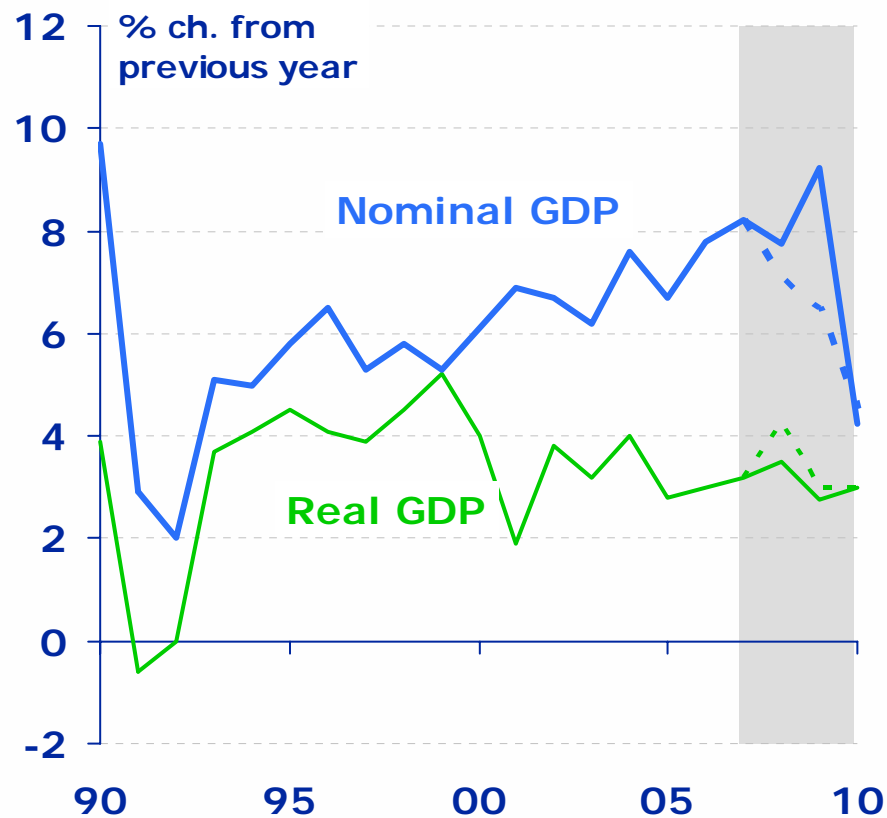


## ... and pushing real and nominal GDP growth in opposite directions

### Implicit price deflator of GDP

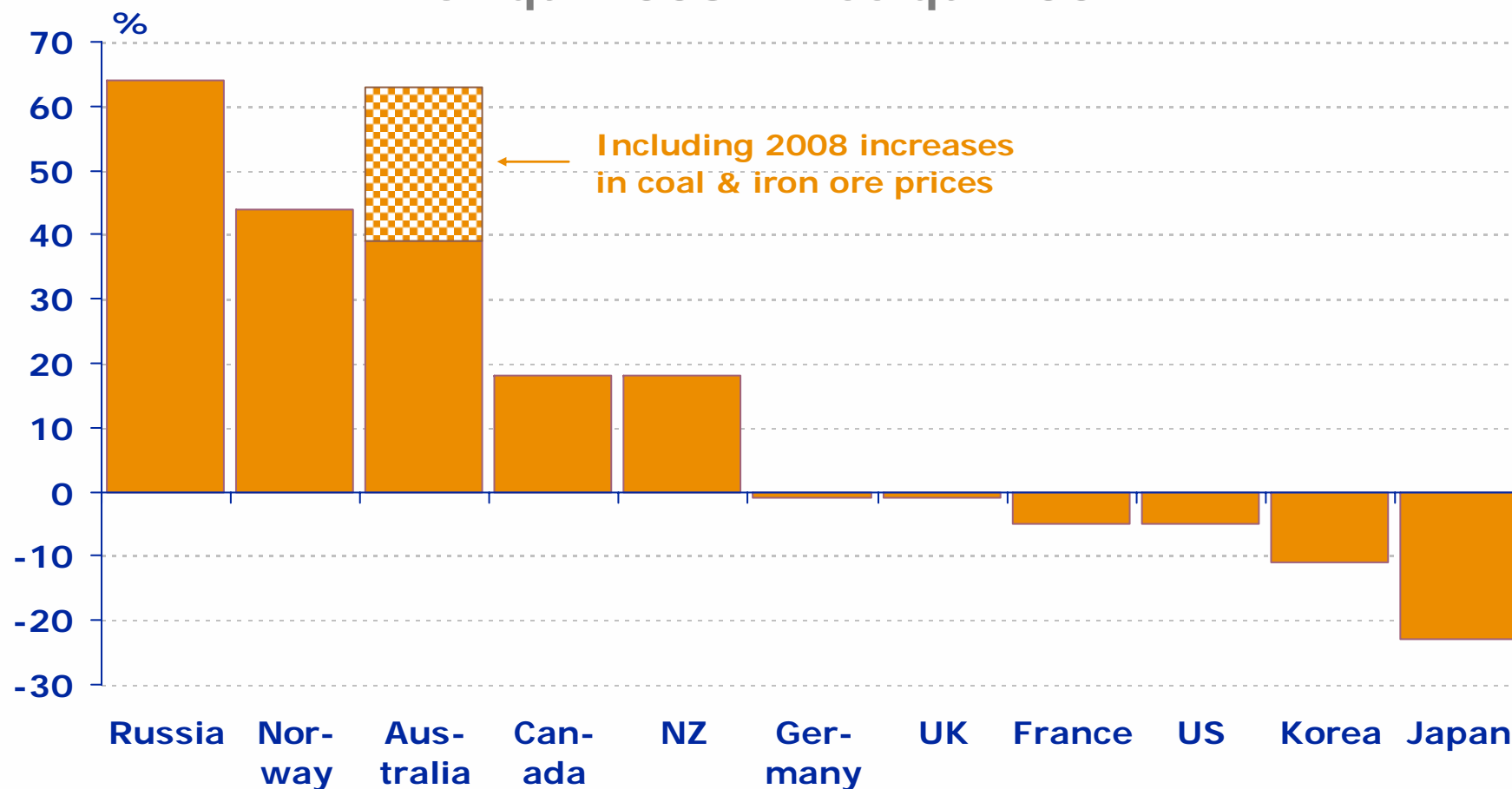


### Real and nominal GDP



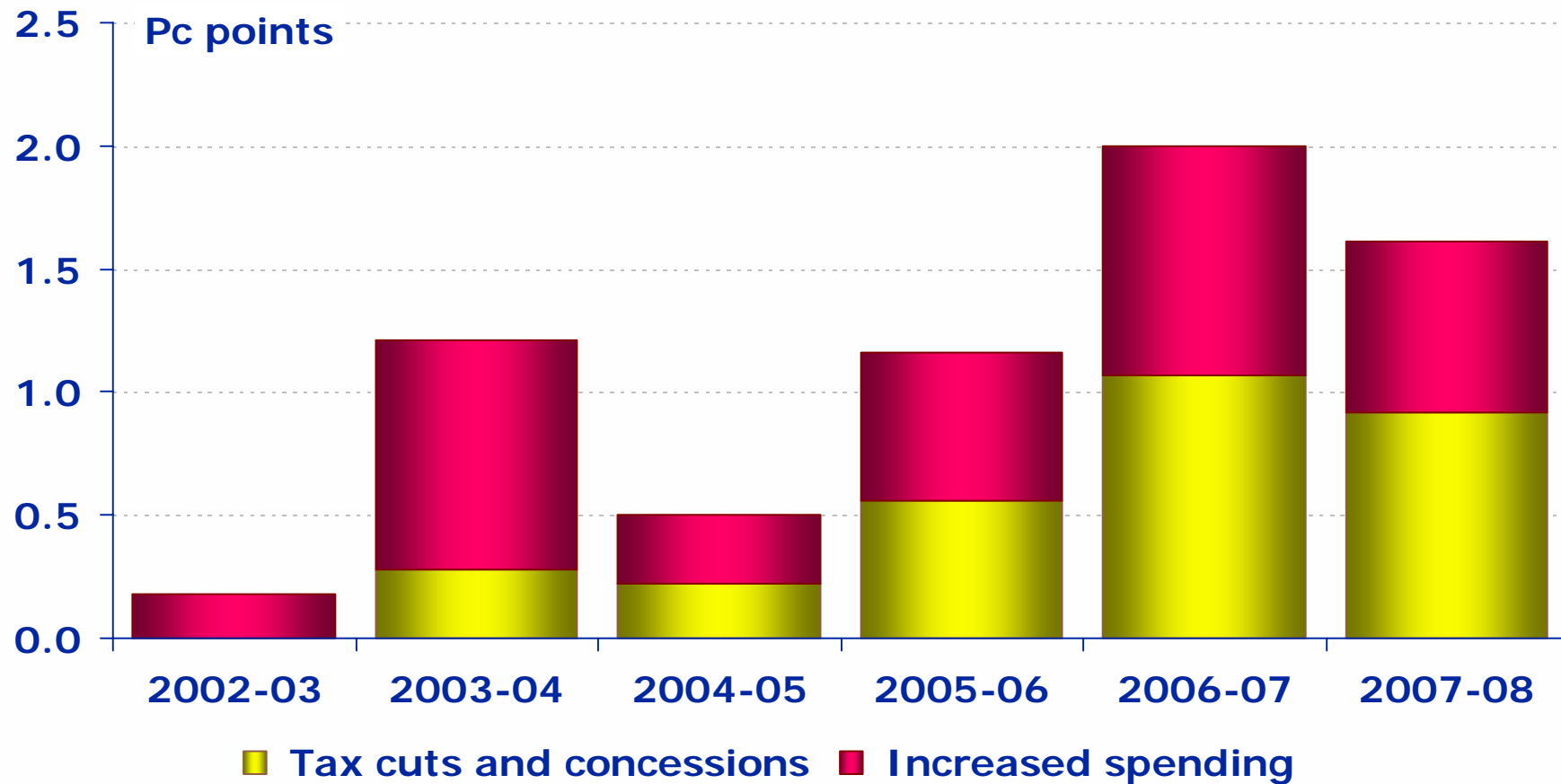
# Australia's has gained more than most economies from rising commodity prices

Changes in the terms of trade,  
Mar qtr 2003 – Dec qtr 2007



# Successive Federal budgets have provided additional stimulus to income and spending

Contribution to change in GDP  
of Budget policy decisions



## Treasury's view of recent trends in government spending

"The recent growth in spending stands out, along with the growth in spending under the Whitlam Government in 1974-75 and the increased spending following the recessions in 1982-83 and 1990-91 ... particularly ... given Australia has experienced 17 consecutive years of real growth."

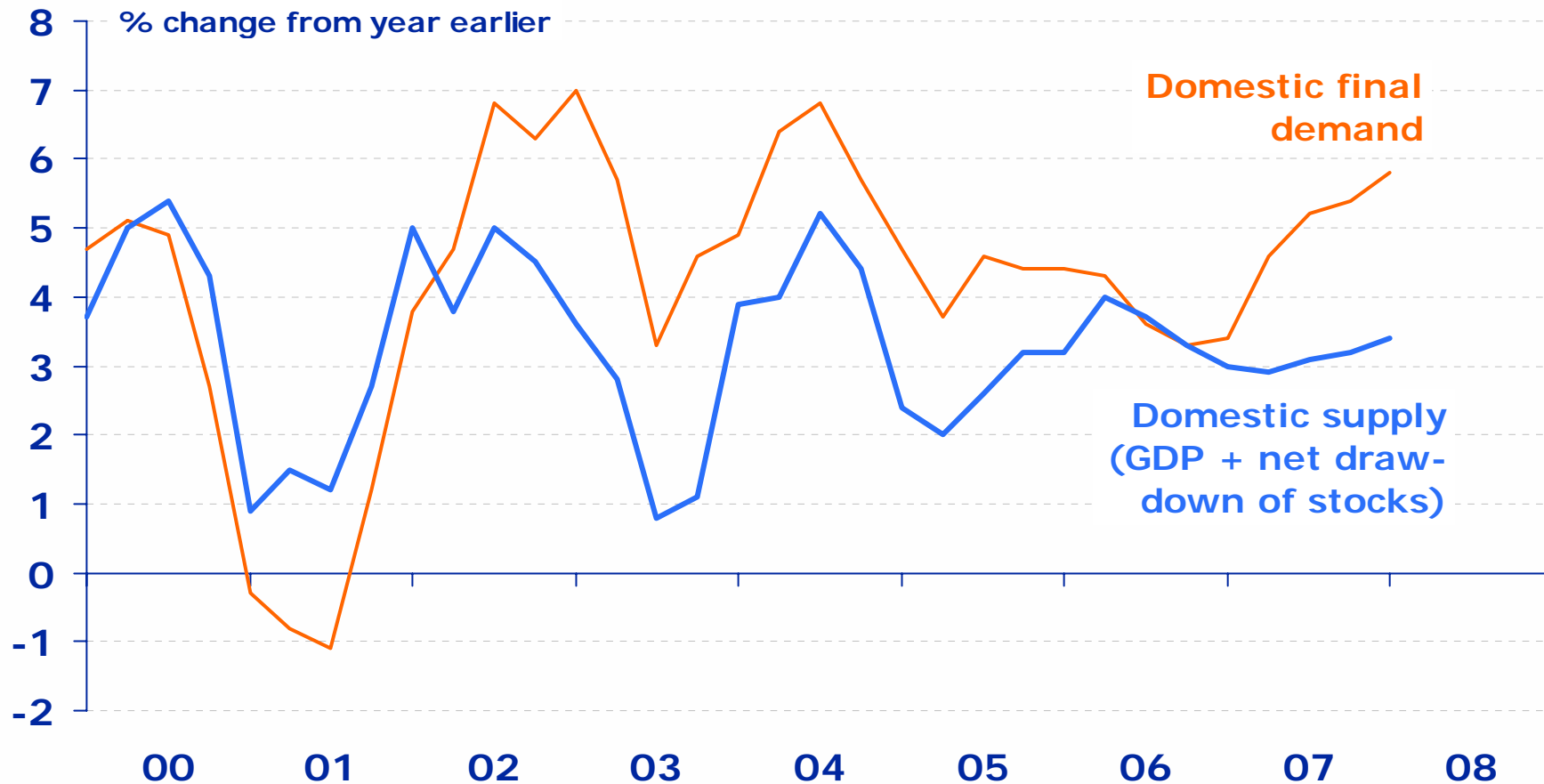
"... the number of decisions announced in the Budget or Budget updates ... has more than doubled over the past decade ... in 1997-98, close to a third of all measures had a savings component, whereas more recently savings measures have averaged 15% of total measures."

"... since 1997-98 ... tax expenditures have grown by 51% in real terms"

("A perspective on trends in Australian Government spending", Treasury *Economic Report*, Summer 2008, pp 27-49.

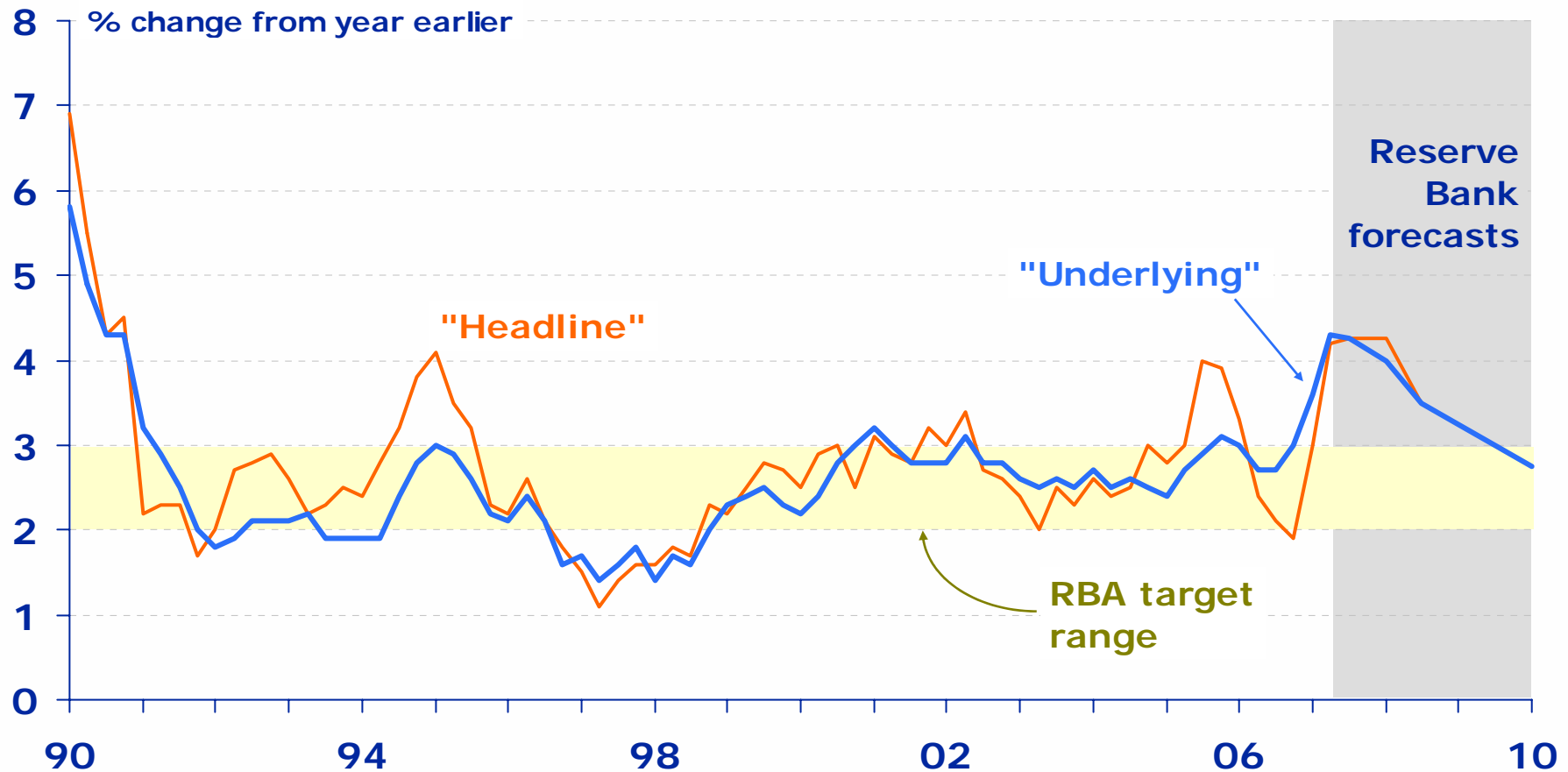
# Not surprisingly, growth in domestic demand has exceeded growth in supply by a widening margin

## Domestic demand vs 'supply'



# Australia's 'underlying' inflation rate is now at its highest level since inflation-targeting began

## Consumer prices

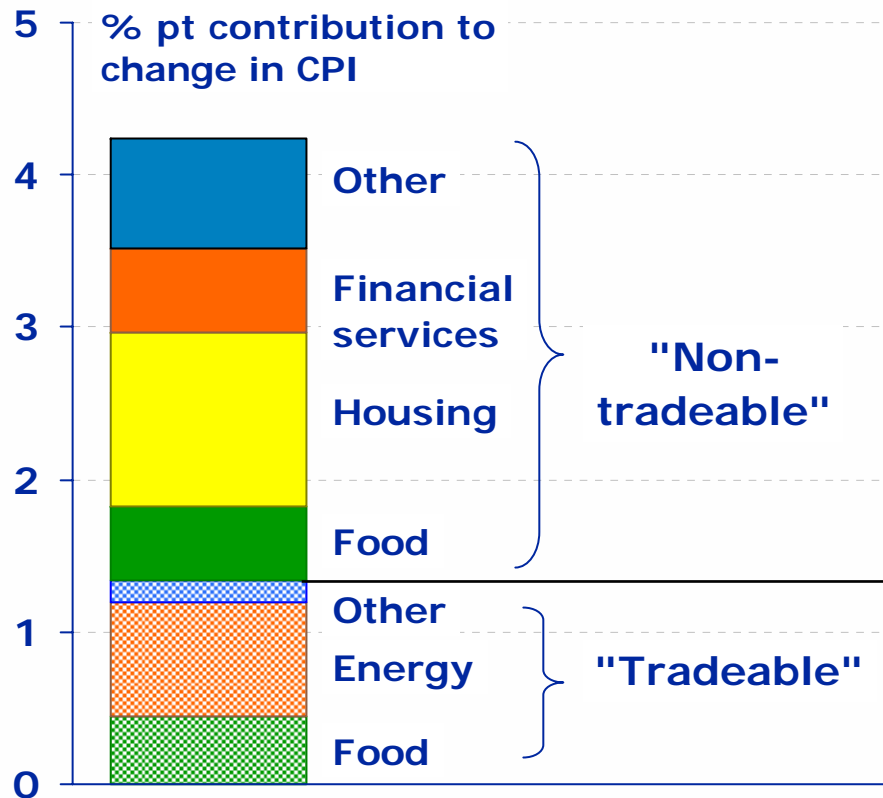


Note: excludes impact of introduction of GST and major health policy changes.

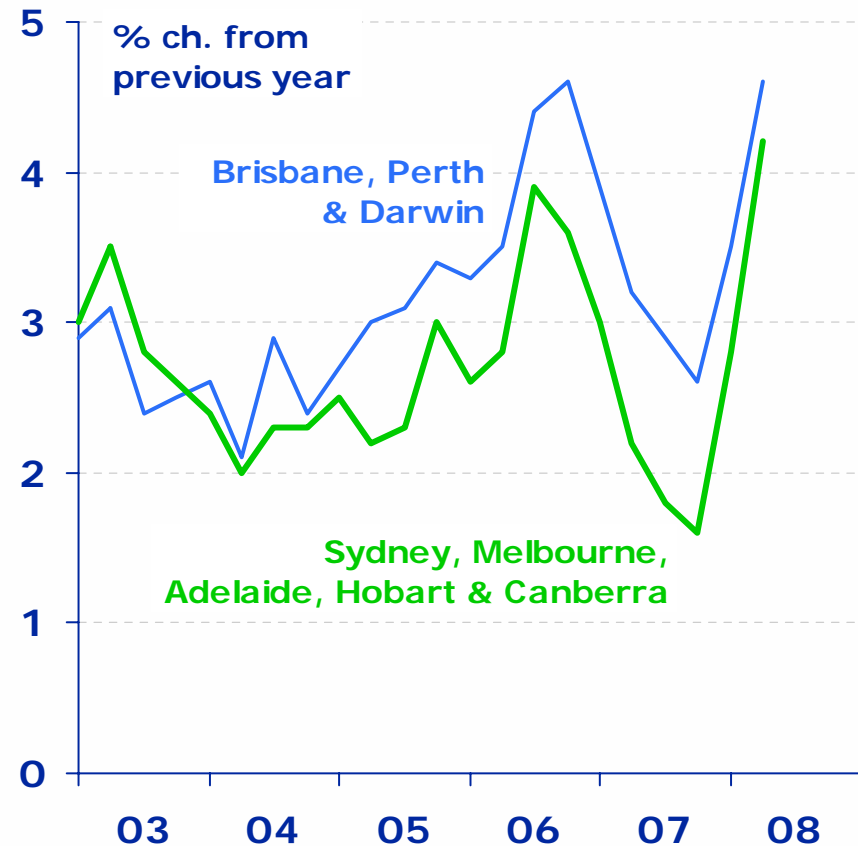
Sources: ABS; RBA.

# The rise in inflation has been broadly-based, and not solely due to global forces or in resource-rich States

Contributions to 'headline' inflation, year to March quarter 2008

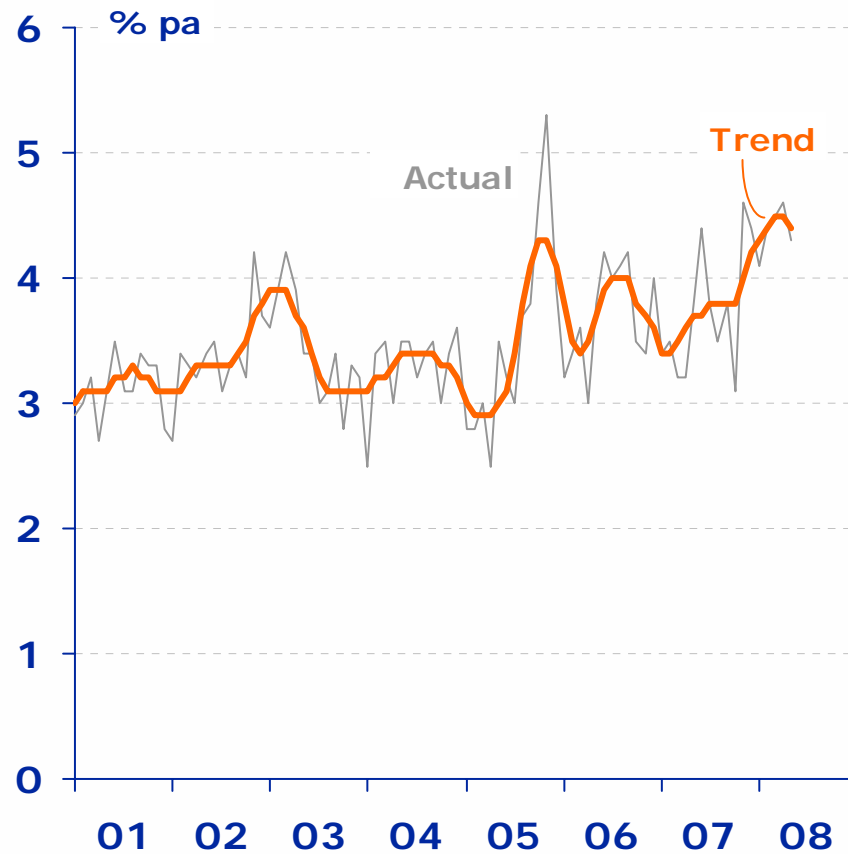


'Headline' inflation, resource boom cities vs others

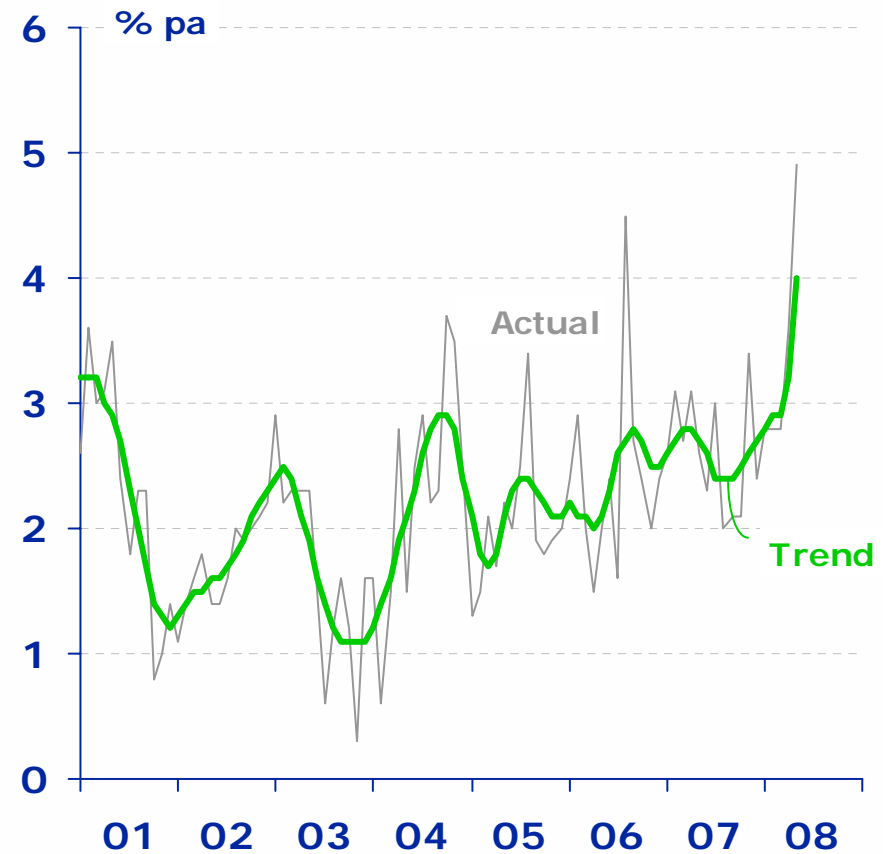


# The Reserve Bank is particularly concerned at the uptrend in inflation expectations

## Household inflation expectations

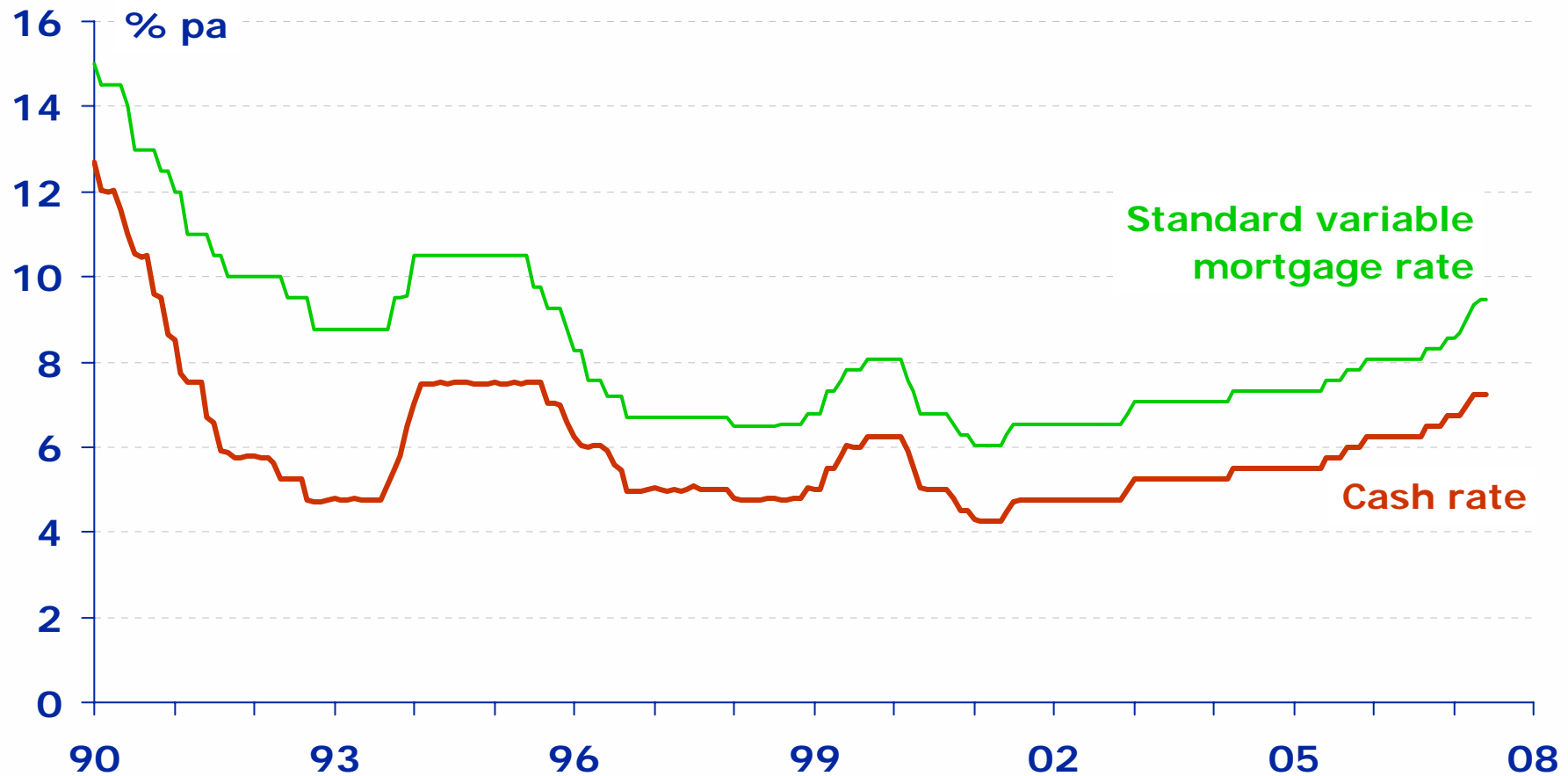


## Business selling price expectations



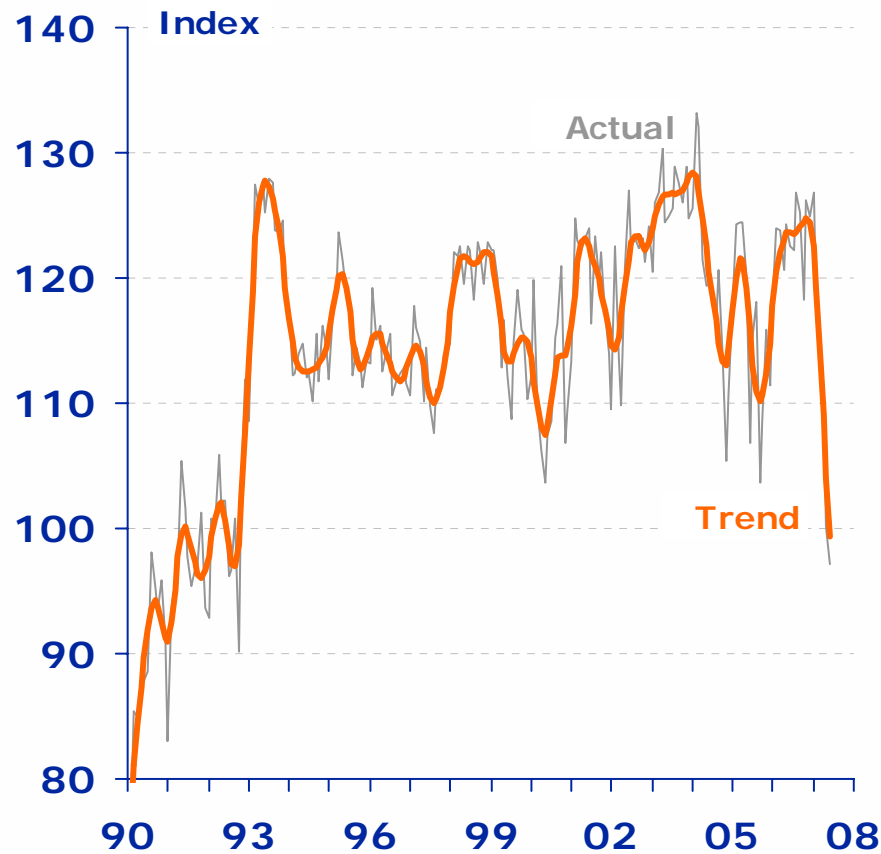
# So far, monetary policy has shouldered the entire burden of responding to rising inflation

## Australian interest rates

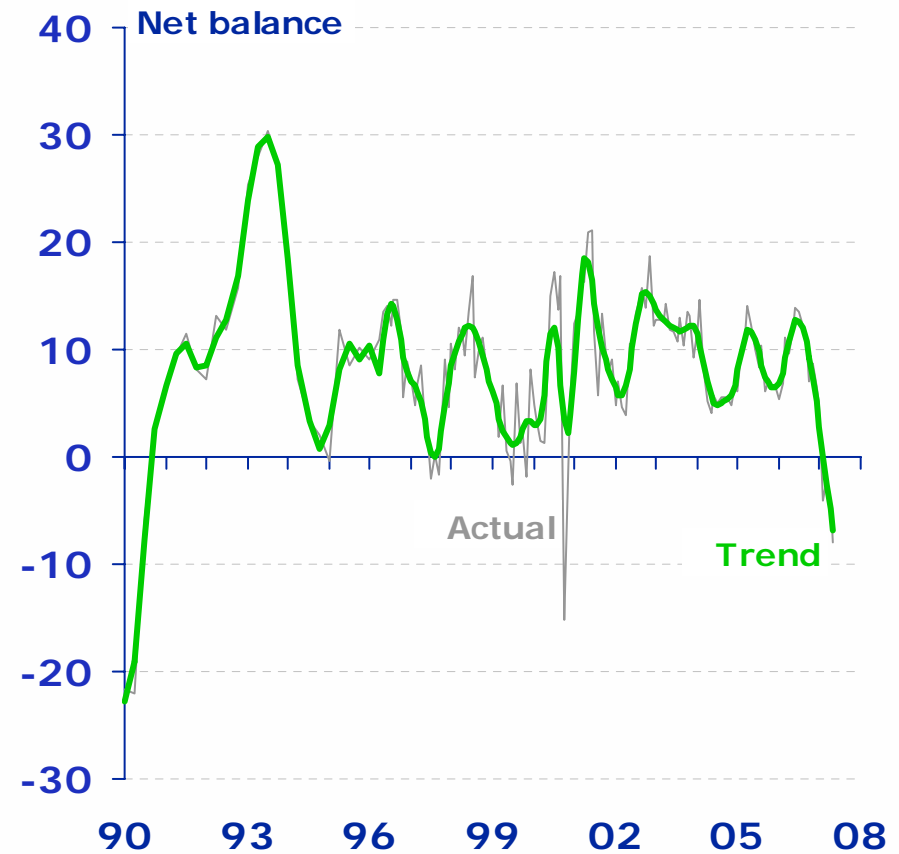


# Tighter financial conditions and global uncertainty have contributed to sharp falls in confidence

## Consumer confidence



## Business confidence



## And of course there are also political considerations

- **Kevin Rudd and Wayne Swan are determined to keep all of their pre-election promises (including tax cuts)**
  - no distinction between 'core' and 'non-core' promises
  - and no breaking the 'L-A-W' on promised tax cuts
- **First budget of a newly-elected government**
  - opportunity to blame previous government for inherited problems
  - and to show how the new government will be different
- **First budget after an election**
  - only opportunity (given the three-year electoral cycle) to take 'courageous' policy decisions
- **Other political trade-offs**
  - for example desire to help 'working families' cope with rising costs of living ...
  - ... vs desire to demonstrate credentials as 'fiscal conservatives'

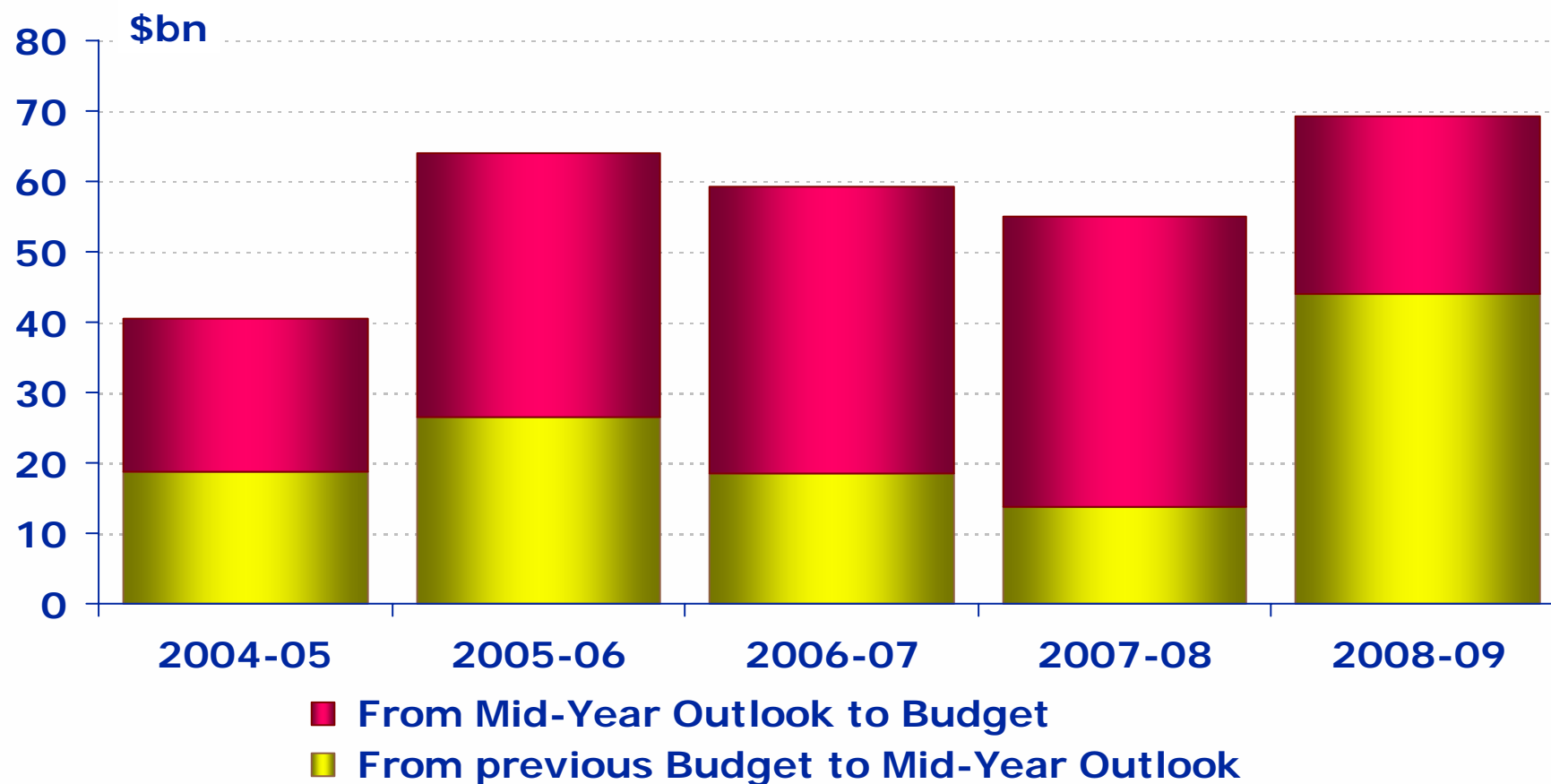
# The Budget's key decisions – and how they have been funded

## What do the words in the Budget speech and statements indicate about priorities?

Word or phrase	No of times used in -	
	Budget Speech	Budget statements
'Working families'	13	19
'Inflation'	17	66
'Productivity'	3	76
'Infrastructure'	9	254
'Investment'	11	436
'Interest rates'	1	35
'Climate change'	5	25
'Reform'	8	81
'Promises' or 'commitments'	27	77

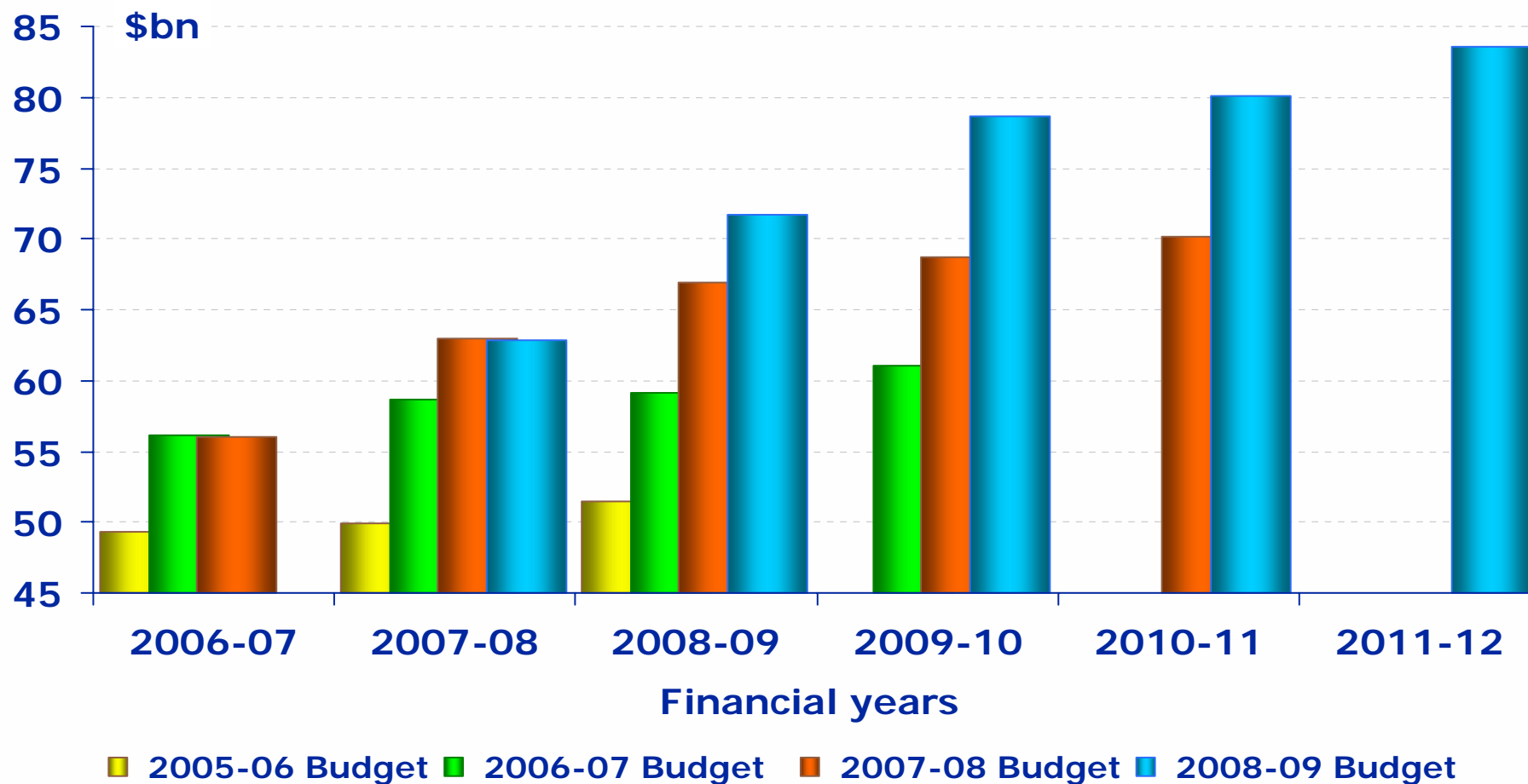
## Revenue estimates have again been revised upward, but by less than in previous Budget cycles

'Windfall' revenue gains\* from Budget to Budget  
(over 4 years from current fiscal year)



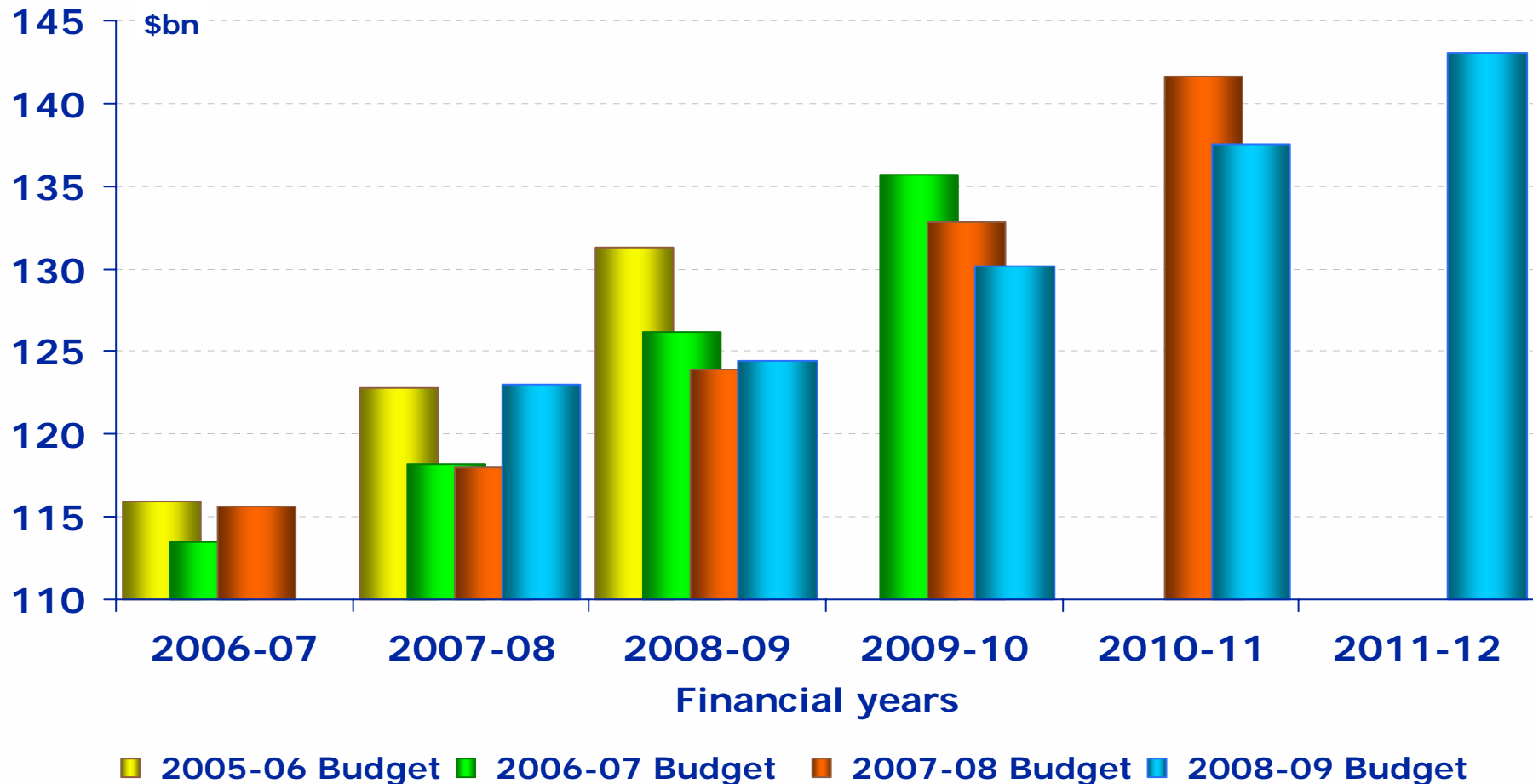
# Projections of company tax collections are still being revised upwards ...

Successive Budget estimates of company tax revenues



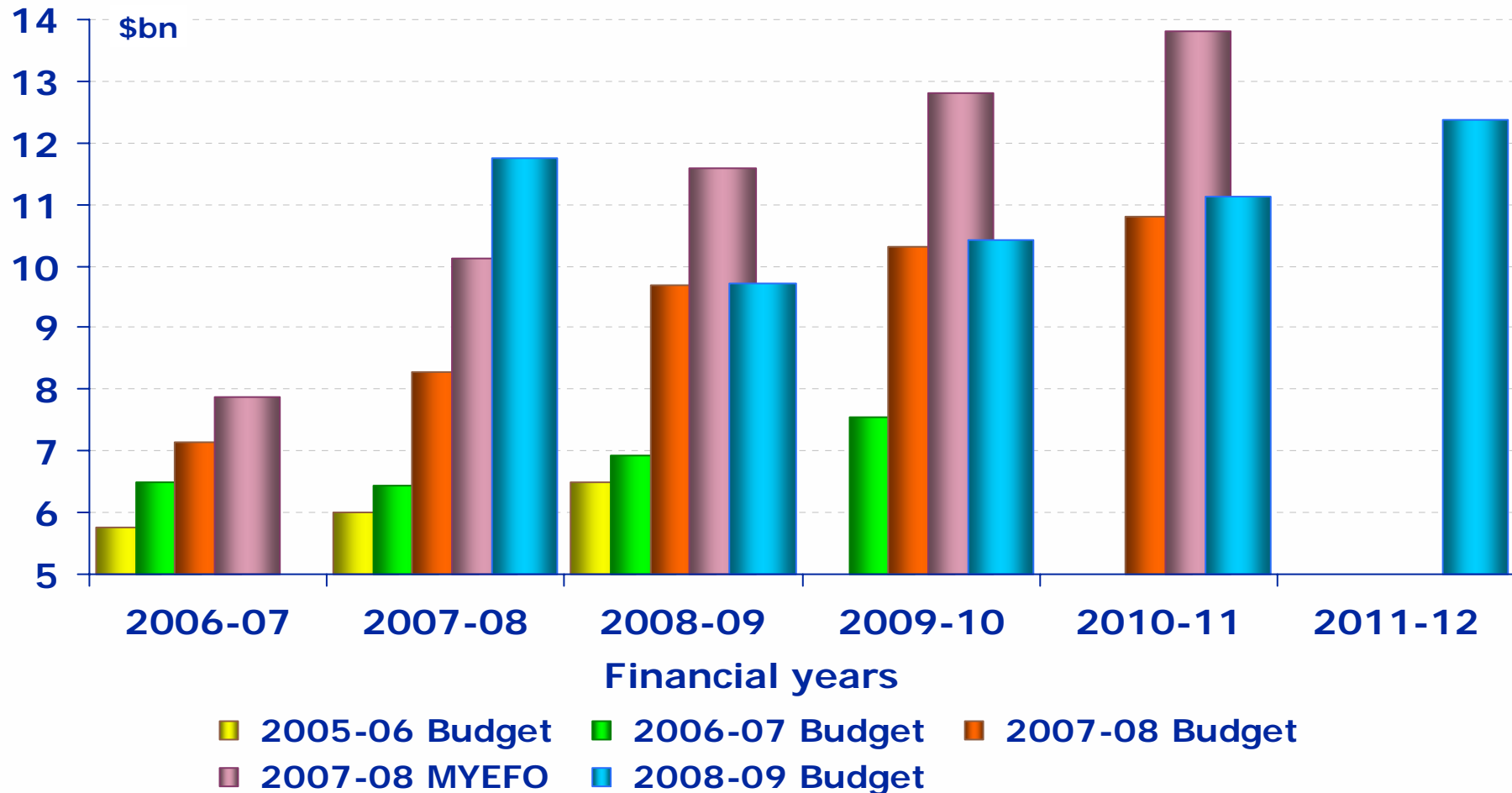
... while projections of personal income tax revenue are still being lowered (by tax cuts)

Successive estimates of personal income tax revenues



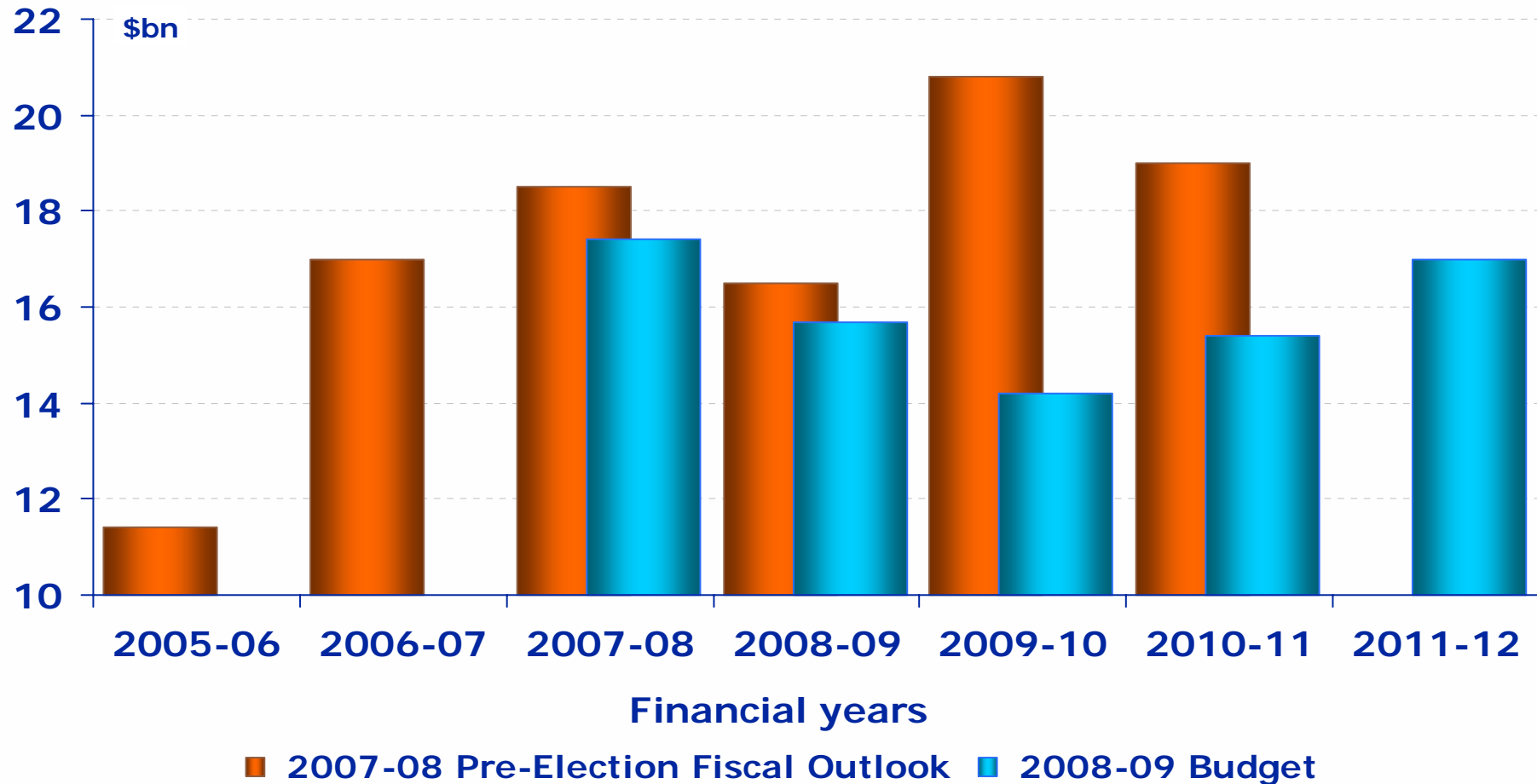
# Estimates of revenue from taxes on superannuation funds have been revised down since the election ...

## Successive estimates of super fund tax revenues



## ... as have estimates of capital gains tax revenues

### Successive estimates of capital gains tax revenues



*Note:* chart shows estimates in cash terms. Projections of capital gains tax collections have not previously been published. *Source:* Budget Statement No. 5 Box 3.

## 'Policy decisions' have been self-funded, while revenue windfalls have been 'banked'

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

	07-08	08-09	09-10	10-11	11-12	Total
As at May 2007	10.6	12.7	13.8	12.5	17.5	+67.1
'Parameter variations'	+8.0	+12.5	+17.7	+20.6	+20.6	79.4
'Policy decisions'	-4.3	-10.9	-13.8	-18.0	-18.0	-65.0
As at October 2007	14.4	14.3	17.7	15.0	14.9	+76.3
'Parameter variations'	+5.2	+5.4	+1.9	+2.1	+2.1	+16.8
'Policy decisions'	-2.8	+2.0	0.0	+1.9	+1.8	+2.9
As at May 2008	+16.8	+21.7	+19.7	+19.0	+19.0	+96.2

*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. Also note that the tax cuts originally proposed by the Howard Government are included in the pre-October 2007 'policy decisions' row, while the savings from the Rudd Government's decision to defer the proposed cut in the top tax rate are in the pre-May 2008 'policy decisions' row.

\* Economics@ANZ estimate. *Source:* Budget Statement No. 3, ANZ calculations.

**Nonetheless, the net effect of policy measures is very small (and still expansionary if tax cuts are counted)**

### Saving and new policy measures in the Budget

	07-08	08-09	09-10	10-11	11-12	Total
<b>Saving measures -</b>						
Cuts in top tax rate	-	-	1.2	2.0	2.2	5.3
Other	1.3	7.3	6.1	7.5	7.2	29.4
<b>Total</b>	1.3	7.3	7.2	9.5	9.4	34.7
<b>New policy</b>	-4.1	-5.3	-7.2	-7.6	-7.6	-31.8
<b>Net saving</b>	-2.8	2.0	0.0	1.9	1.8	2.9
as a % of GDP	-0.25	0.16	0.00	-0.14	-0.13	-0.05
<b>Tax cuts</b>	-	-7.1	-9.8	-13.9	-15.9	-46.7
<b>New policy incl. tax cuts*</b>	-2.8	-5.1	-9.7	-12.0	-14.1	-43.8
as a % of GDP	-0.25	-0.41	-0.75	-0.90	-1.00	-0.68

\* Excludes 'saving' from deferring cut in top tax rate.

Source: Budget Statement No. 3, ANZ calculations.

## Major policy decisions: revenues

	Net change in revenues (\$bn)					
	07-08	08-09	09-10	10-11	11-12	Total
Personal income tax cuts*	-	-7.1	-8.6	-11.9	-13.7	-34.3
'Alco-pops' etc. excise	0.1	0.6	0.7	0.8	0.9	3.2
Condensate excise	0.1	0.5	0.6	0.6	0.6	2.5
ATO compliance	-	0.1	0.3	0.8	0.8	2.0
FBT exemptions	-	0.2	0.3	0.4	0.5	1.4
Software depreciation	-	0.0	0.3	0.7	0.3	1.3
Luxury car tax	-	0.1	0.1	0.1	0.1	0.6
Airport tax	-	0.1	0.1	0.1	0.1	0.5
Withholding tax cut	-	0.0	-0.1	-0.2	-0.2	-0.6
Medicare surcharge	-	-	-0.2	-0.2	-0.2	-0.7
<b>Total (incl. other)</b>	<b>0.2</b>	<b>-4.8</b>	<b>-5.7</b>	<b>-7.6</b>	<b>-9.2</b>	<b>-27.0</b>
<b>Total in Budget Papers†</b>	<b>0.2</b>	<b>+2.4</b>	<b>+4.1</b>	<b>+6.4</b>	<b>+6.6</b>	<b>19.8</b>

28 \* Personal income tax cuts including those approved by Coalition before election, net of deferral of cuts for high-income earners by Rudd Gov't. †Excluding Coalition tax cut.

## Major revenue decisions

- **Income tax cuts**
  - 30% threshold lifted from \$30K to \$37K by 2010
  - 40% threshold lifted from \$75K to \$80K and rate dropped to 38% from 2009 and to 37% by 2010
  - 45% threshold lifted from \$150K to \$180K from Jul 08
  - Low Income Tax Offset (LITO) changes lift effective tax free threshold from \$11K to \$16K by 2010
  - deferral of tax cuts for those over \$180K saves \$5.3bn over 4 years
- **Luxury car tax**
  - Sales tax on vehicles costing over \$57K rises from 25% to 33% (revenue of \$555mn over four years)
- **Medicare levy surcharge threshold lifted from \$50K to \$100K**
  - Cost to revenue of \$600mn over four years
- **Increased excise on 'ready-to-drinks'**
  - \$3.1bn over four years to fund preventative health programs
- **Remove FBT exemptions for on-premises meals and employer-provided work-related items (incl laptops, PDAs) unless used primarily for work purposes**
  - \$1.3bn additional revenue over four years

## Major revenue decisions (continued)

- **Increased 'passenger movement charge'**
  - \$459mn of additional revenue over four years
- **Increased 'compliance activities by ATO'**
  - \$2bn over four years
- **30% non-final withholding tax on distributions to foreign investors to be replaced (for countries with which Australia has exchange of information agreements) with**
  - 22.5% from 2008-09
  - 15% from 2009-10
  - 7.5% from 2010-11 onwards
- **Comprehensive review of the tax system**
  - everything except rate & base of GST, and tax-free superannuation income for over-60s
  - discussion paper released by end-July 2008, final report by end-2009

## Major policy decisions: spending

	Net change in outlays (\$bn)					
	07-08	08-09	09-10	10-11	11-12	Total
Education tax refund	-	1.0	1.1	1.1	1.2	4.4
Other 'education revol <sup>n</sup> '	0.6	2.6	3.1	3.4	3.8	13.6
Health & hospitals	0.7	0.6	0.7	0.8	0.5	3.3
Child care tax rebate	-	0.3	0.4	0.4	0.4	1.6
Seniors & carers bonuses	1.8	-	-	-	-	1.8
Housing affordability	-	0.2	0.4	0.6	0.9	2.2
Climate change	-	0.1	0.3	0.3	0.2	1.0
'Efficiency dividend'	-0.1	-0.4	-0.4	-0.4	-0.4	-1.8
Scrap Access Card	-0.2	-0.3	-0.3	-0.3	-0.2	-1.2
Means testing	-	-0.2	-0.2	-0.4	-0.5	-1.2
Axing Coalition programs	-0.2	-0.8	-0.9	-0.9	-0.9	-3.7
<b>Total (incl. other)</b>	<b>+3.0</b>	<b>+1.3</b>	<b>+4.2</b>	<b>+4.5</b>	<b>+4.8</b>	<b>+18.0</b>

31 \* Personal income tax cuts including those approved by Coalition before election, net of deferral of cuts for high-income earners by Rudd Gov't. †Excluding Coalition tax cut.

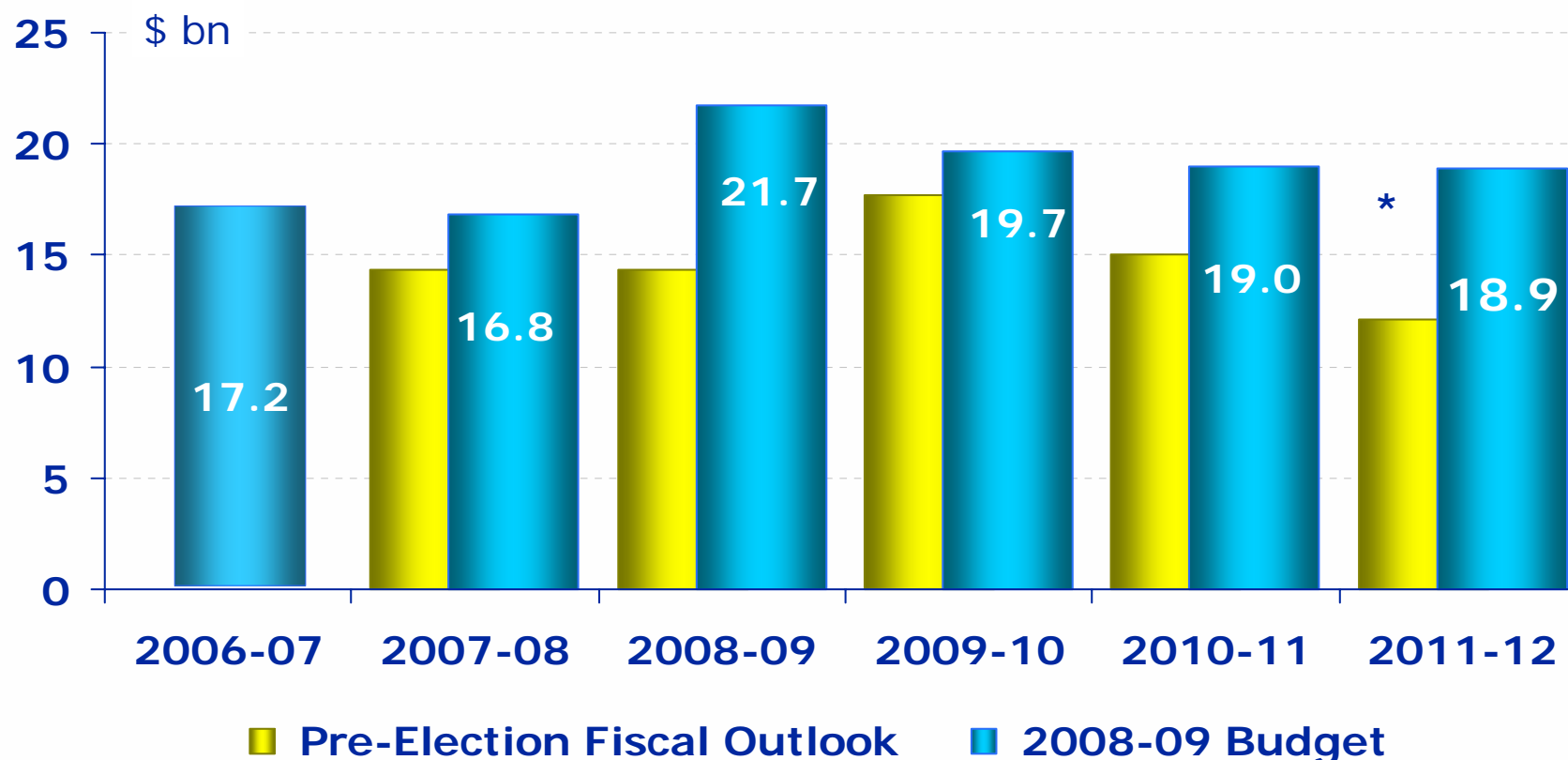
## Cabinet must have agonized over these ones ...

Abandoned / cancelled program	Saving
Australian National Rugby academy	25.0
Fishing Hall of Fame	3.0
Making Canberra's Constitution Ave a boulevard	44.6
National Training Centre for Aerial Skiing	2.5
Regional Partnerships <del>Repts</del> Grants	236.2
Illicit Drugs in Sport advertising campaign	32.5
Illicit Drugs & Mental Illness advertising campaign	9.7
Citizenship Test advertising campaign	19.8
Continence Management advertising campaign	3.0
<b>Total of above</b>	<b>376.3</b>

# The Budget's bottom lines

# Projected cash surplus 1.8% of GDP in 2008-09, then declining towards 1.6% of GDP by 2011-12

## 'Underlying' cash surplus



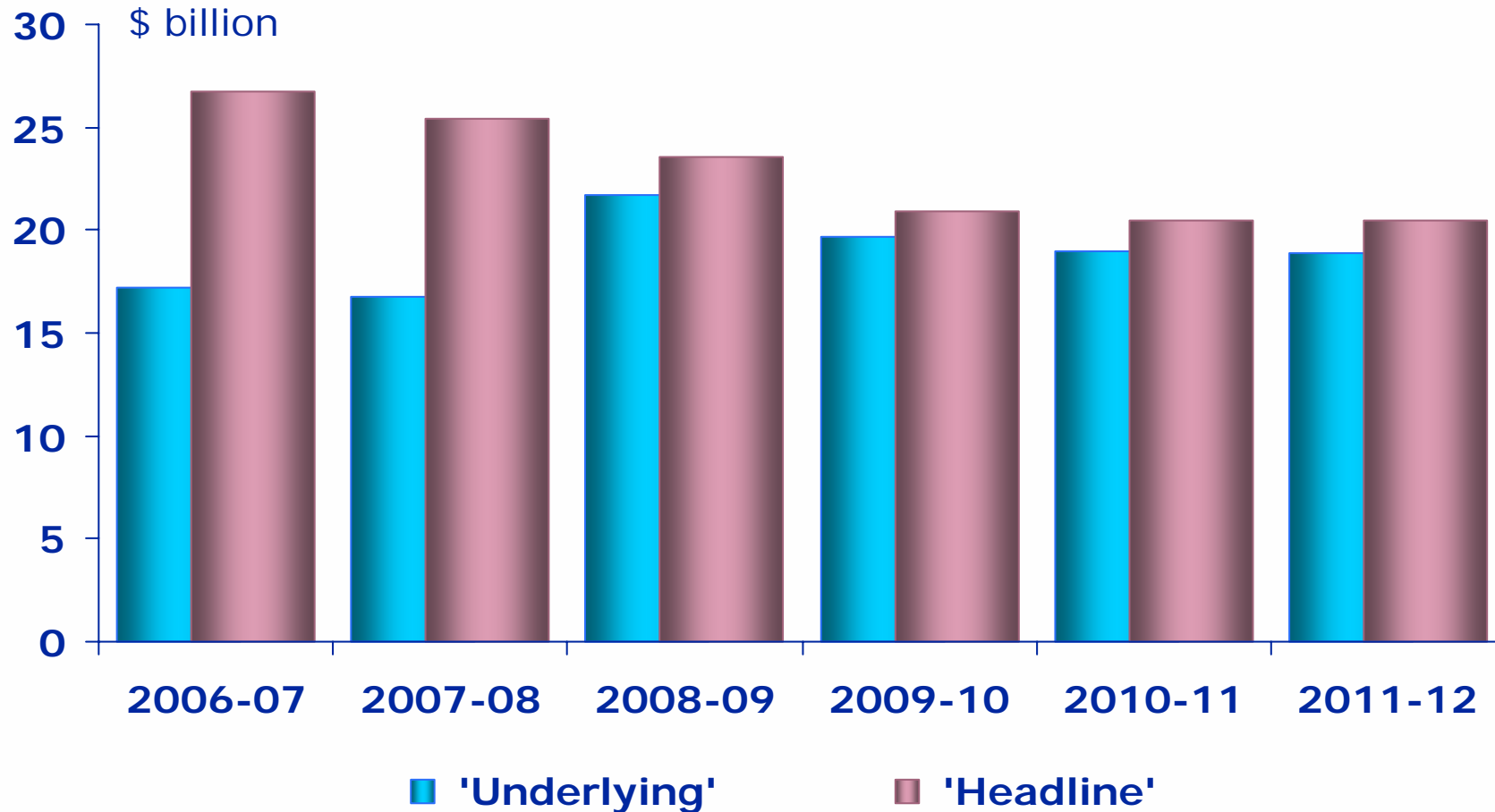
The 'underlying' cash surplus is the cash surplus net of sales of financial assets and net advances to State and Territory governments. \* ANZ estimate

## ASIC probably wouldn't let a company get away with giving such inaccurate earnings guidance

	Estimates of the 'underlying' cash balance (\$million)			
	Initial estimate (prvs May)	Second estimate (December)	Third estimate (May)	Final outcome (June)
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	13,630	17,208
2007-08	10,637	14,834*	16,815	
<b>Average 'error'</b>	<b>4,734</b>	<b>3,369</b>	<b>2,707</b>	

# With no major asset sales, there's little difference between the 'headline' and 'underlying' surpluses

## 'Underlying' and 'headline' cash surpluses

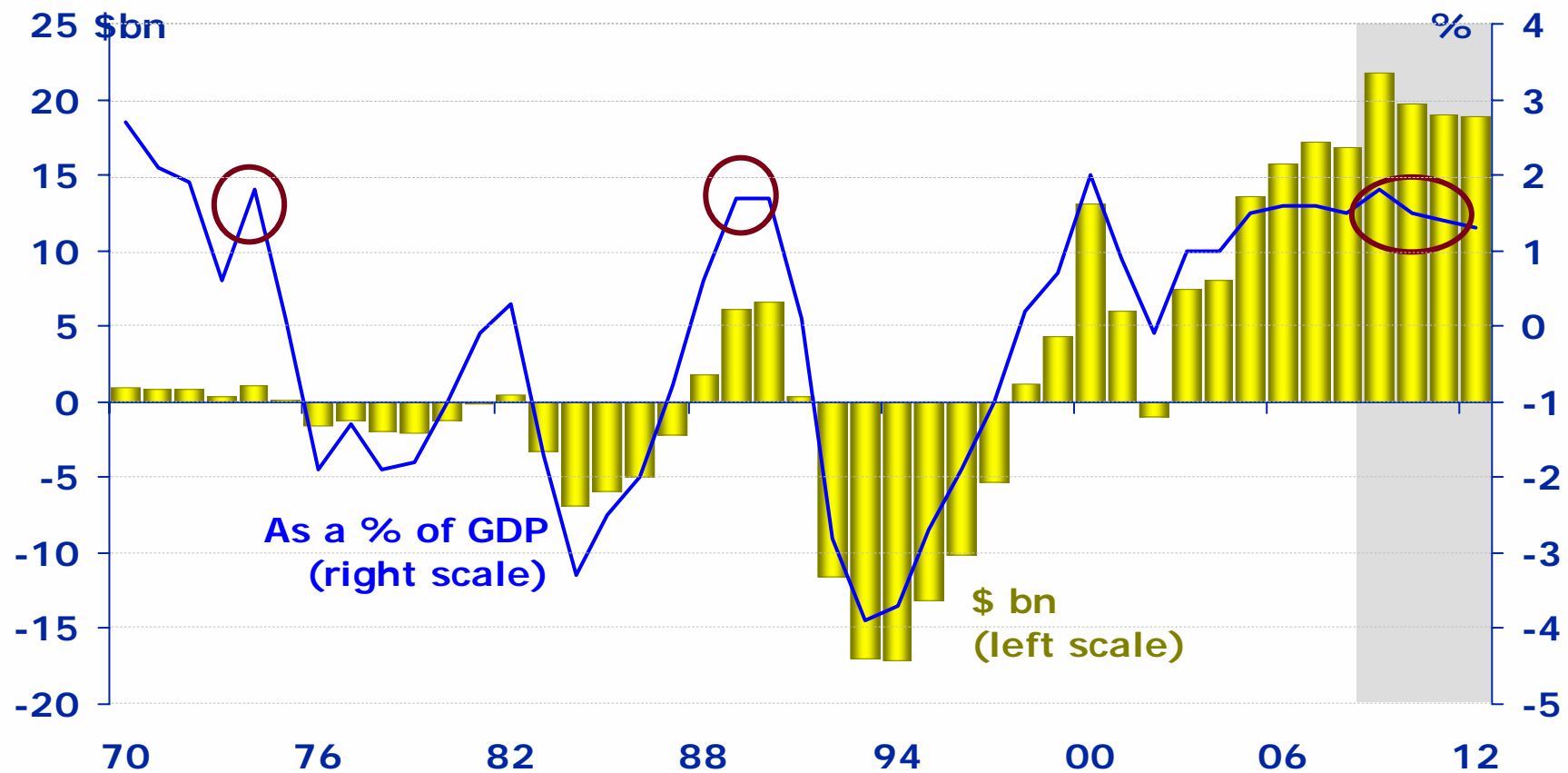


## How these surpluses will be used

- **'Building Australia' fund**
  - \$20bn over two years
- **Education Investment Fund**
  - \$5bn in 2008-09
  - Plus \$6bn from previous government's Higher Education Fund
- **Health and Hospitals Fund**
  - \$10bn in 2008-09
- **To be administered by Future Fund guardians**

# Projected budget surpluses are smaller than at previous commodity cycle peaks

## Commonwealth 'underlying' cash balance



# Treasury's economic outlook for 2008-09 and beyond

# Key assumptions and influences on the 2008-09 forecast

## Assumptions

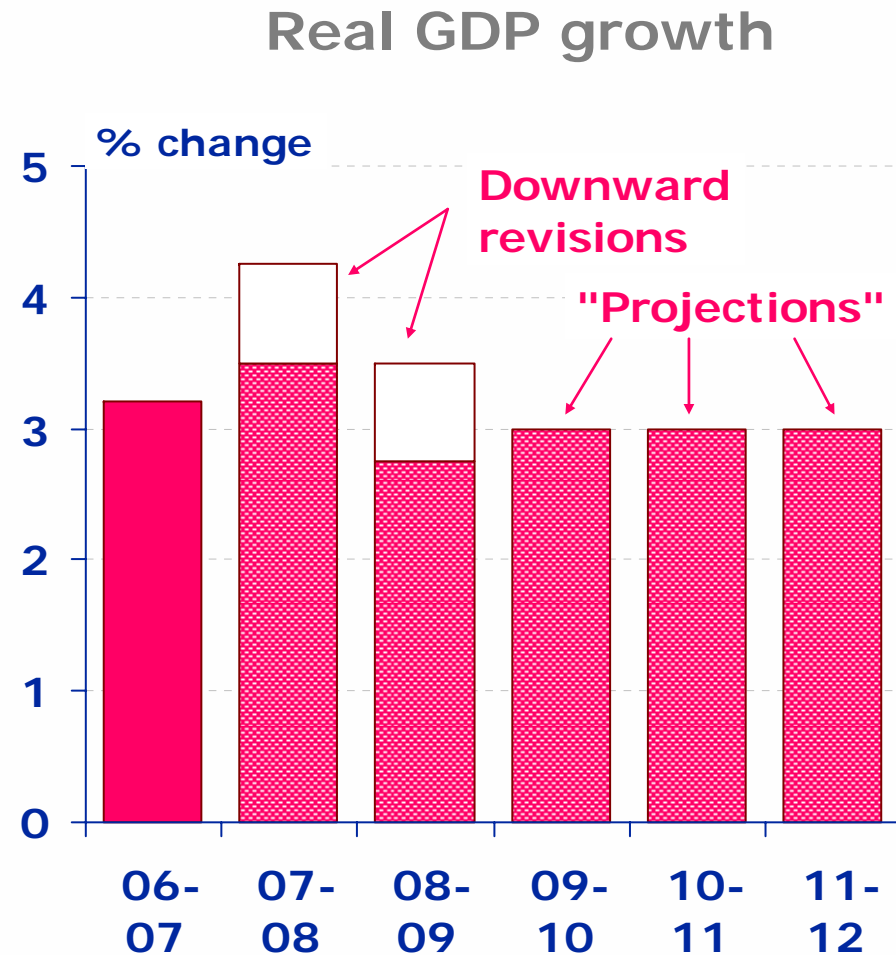
- World economic growth slows from 5% in 2007 to 4% in 2008 and 2009
- Oil prices average 'remain unchanged at current levels' (~US\$115 / bbl)
- Assumes 'average seasonal conditions' in rural areas, but accounts for lower water storage levels
- A\$ averages around TWI 71 (~US93¢)
- Interest rates 'remain unchanged at current levels'

## Growth drivers

- TOT forecast to reach new highs leading to an acceleration in domestic incomes
- Upward trend in export volume growth, due to resource and rural exports
- Continued growth in business investment to lift production capacity
- Household spending growing slows to 2¾% pa in 2008-09
- Modest growth in dwelling construction, mostly in alterations and additions

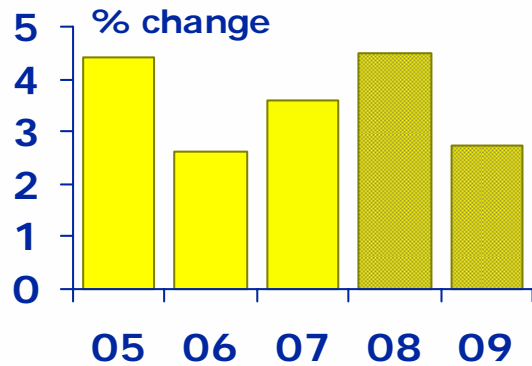
## Treasury's forecasts for growth in real GDP have been revised downwards

- **Forecast for 2007-08 cut from 4¼% to 3½%**
  - requires 0.5% growth in March and June quarters
- **2008-09 forecast revised downwards from 3½% to 2¾%**
  - slightly above RBA forecast of ~2½%
  - implies growth 'through the year' of 2¾%
  - non-farm GDP growth forecast at 2¼% cf. RBA ~2%
- **GDP growth of 3% pa assumed for 2009-10 and beyond**

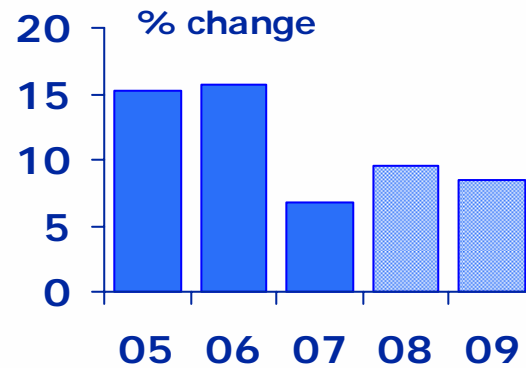


# Private (household and business) demand expected to slow moderately in 2008-09

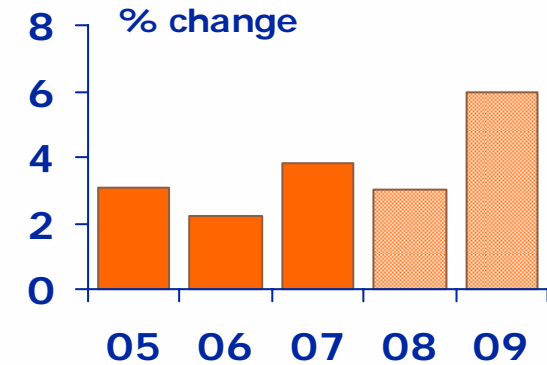
### Consumer spending



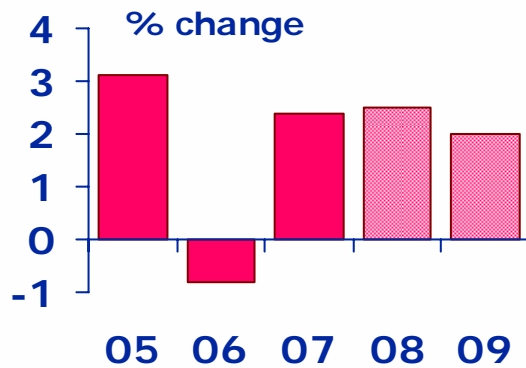
### Business investment



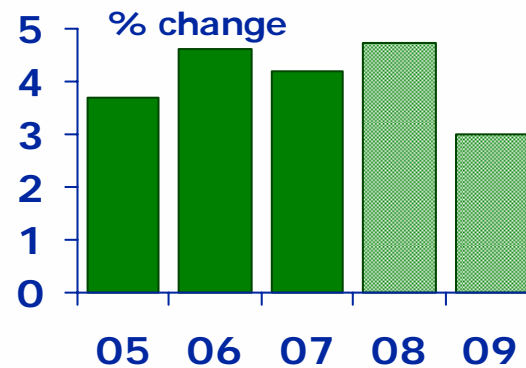
### Exports



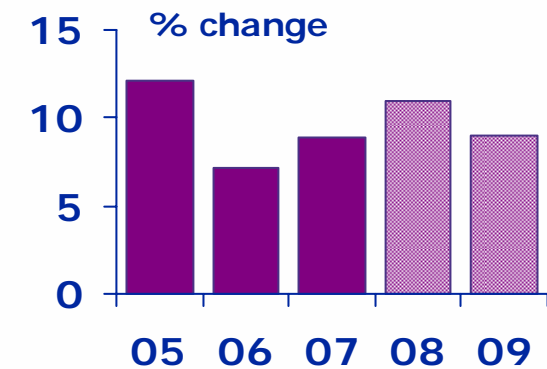
### Housing



### Public spending

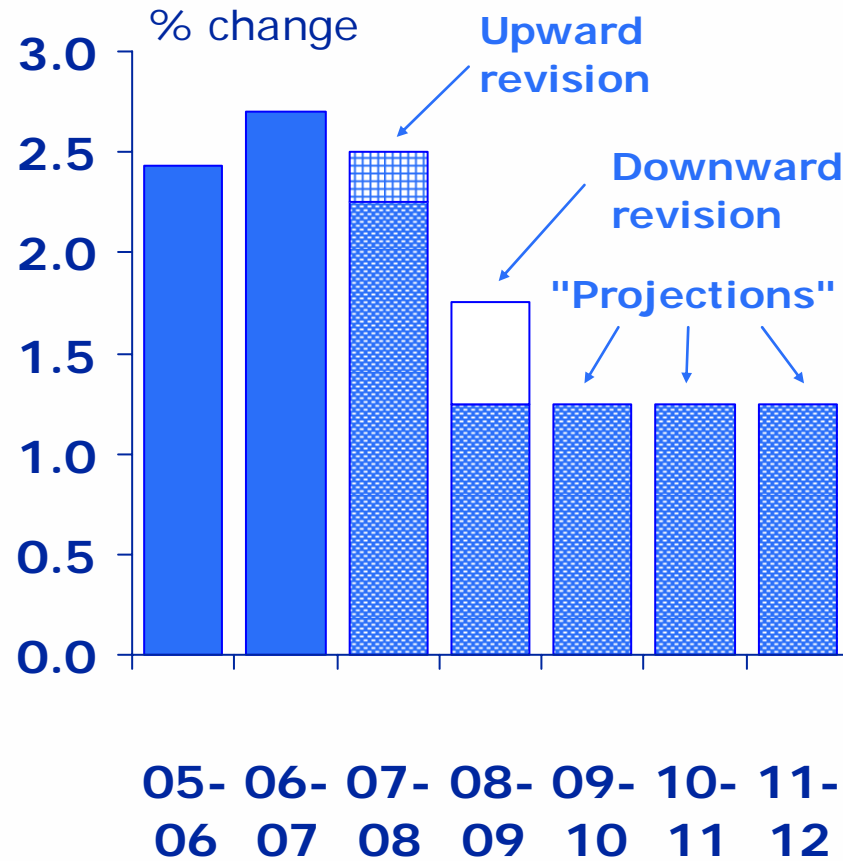


### Imports

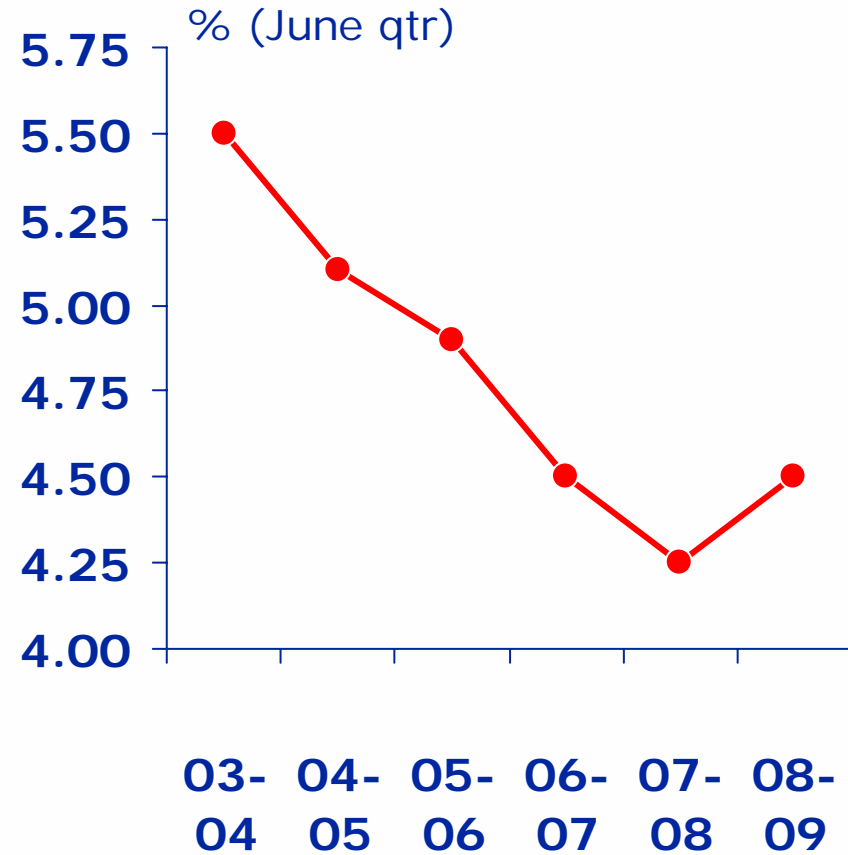


# Unemployment forecast to head back up to 4½%, but remain low

## Employment growth



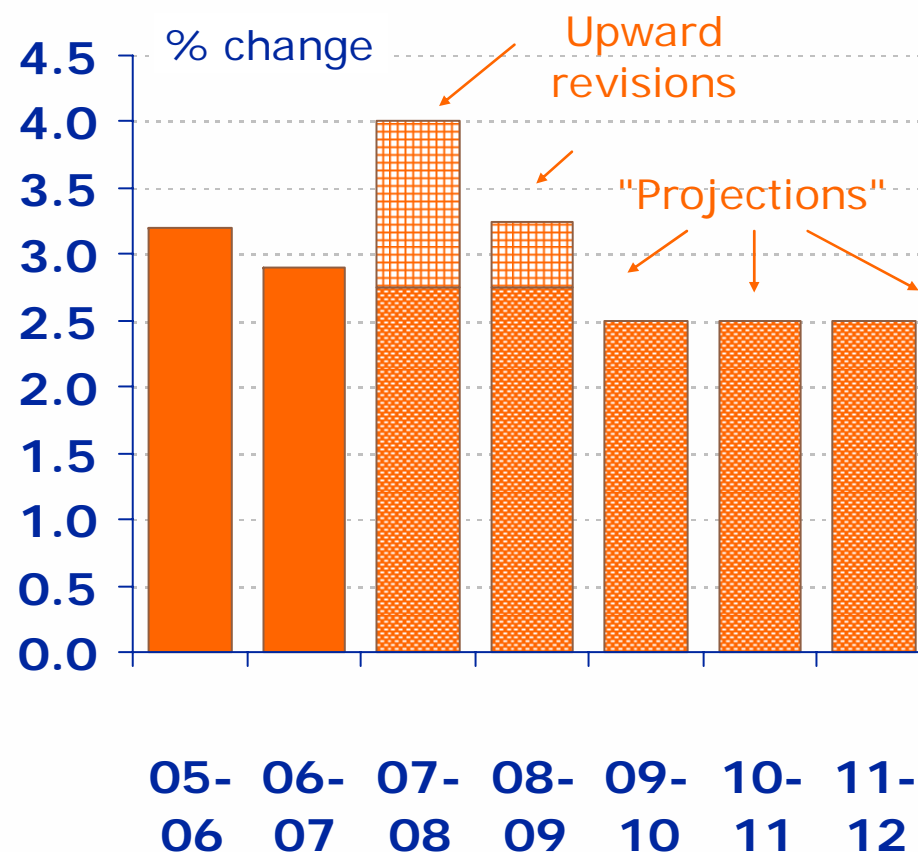
## Unemployment rate



# Inflation forecasts have been revised sharply upwards

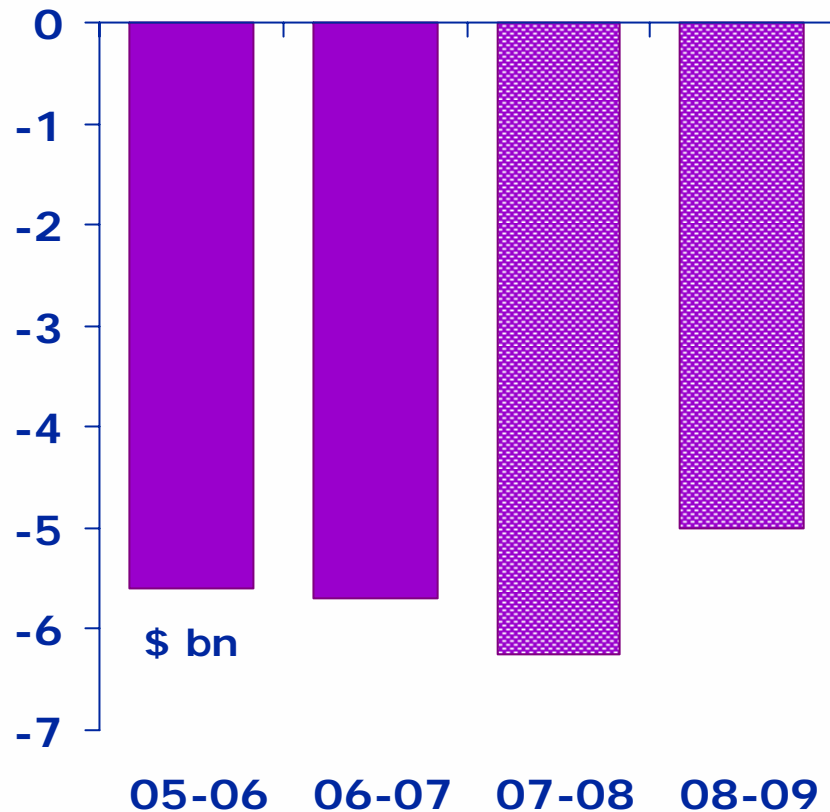
- **2007-08 'headline' forecast revised up from 2¾% to 4%**
  - implies June quarter rate still above 4%
- **2008-09 'headline' forecast revised up from 2¾% to 3¼%**
  - implies inflation over year to June quarter 2009 of 3¼%
  - Underlying inflation expected to track headline inflation
  - Slightly lower than RBA forecast of 3½% over year to June quarter 2009
- **2009-10 onwards are 'projections', not 'forecasts'**
- **Wages growth assumed steady at 4¼%**

'Headline' inflation



## Current account deficit will narrow next year thanks to higher export prices and slower imports growth

Current account balance



- Deficit to narrow from 6¼% of GDP in 2007-08 to 5% of GDP in 2008-09
- Exports to grow 6%
  - driven largely by resources exports as major investments come on stream
  - rural exports also expected to pick up
- Import growth rapid at 9% (from 11% in 2007-08)
  - reflecting ongoing strength in business investment
- Terms of trade to rise 16% in 2008-09 but then ease over remainder of projection period
- Higher net interest and profit payments abroad partly offset improvement in trade balance

# Assessment and conclusion

## Does the Budget truly exert 'maximum downward pressure on inflation and interest rates/?

- Slightly higher than expected Budget surplus
- Largely as the result of continued revenue windfalls
- New policy decisions have been fully funded
- Although there hasn't been a ruthless assault on government spending
- No net stimulus to domestic demand
- The Budget doesn't add to upward pressure on interest rates – but doesn't do anything to lower them either
- Budget provides a politically saleable vision for investment of surpluses