

## 2008-09 Budget Preview

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## Comment

The first Budget of the new Labor Government will be brought down in what are, as Treasurer Wayne Swan has repeatedly said, challenging economic circumstances. Australia's economy is being buffeted, in a way which has few if any parallels elsewhere among its peers, by two powerful sets of global forces: the continuing rapid growth and industrialization of China (which, on balance, is a net positive for Australia), and the global 'credit crunch' triggered by the US housing market meltdown and which has brought the US economy to the cusp of recession (which is, of course, a negative for Australia). At the same time, Australia has also experienced a significant acceleration in inflation, to its highest 'underlying' level since the early 1990s, which has in turn prompted a substantial tightening of monetary policy since the election.

In framing this year's Budget, the Treasurer and his colleagues have to make assessments about the relative strength and persistence of these forces. This is no easy task. And it's not made any easier by the fact that the Government is also bound by the political commitments it made during last year's election campaign, including personal income tax cuts totalling \$31bn over the four years of the forward estimates period. Understandably, the Government feels duty-bound to honour these in full, even though (in our view) there is a strong case on purely economic grounds for doing otherwise. However, that adds to the requirement for the Budget to include measures which will offset the stimulus which the tax cuts and other election promises will provide to domestic spending, if it is to fulfil the Treasurer's subsequent oft-repeated promise that it will 'exert maximum downward pressure on inflation and interest rates'.

The 'starting point' for framing the 2008-09 Budget – based on the Pre-Election Economic and Fiscal Outlook published during the election campaign, adjusted for the net effect of the Government's election promises, is an 'underlying' surplus of \$12.8bn (or 1.1% of GDP) in the coming financial year, rising to \$15.3bn (1.2% of GDP) in 2009-10 and easing back to \$13.6bn (1.1% of GDP) in 2010-11.

Since then, the Prime Minister, the Treasurer and Finance Minister Lindsay Tanner have all indicated that the Budget will be aiming for a surplus of 1½% of GDP, before allowing for any 'windfall' revenue gains from further increases in export commodity prices, and that this target would be achieved by making expenditure savings of \$3-4bn.

The Pre-Election Economic and Fiscal Outlook projections assumed, among other things, real GDP growth of 3½% in 2008-09 and 3% per annum thereafter, and nominal GDP growth of 6½% in 2008-09, 4½% in 2009-10 and 4% in 2009-10 (the difference between real and nominal GDP growth is the movement in the implicit price deflator of GDP, which is in turn importantly influenced by assumptions about movements in the terms of trade, that is, export prices relative to import prices).

Treasury is likely to have revised down its forecast for real GDP growth in 2008-09, to around 2¾-3%. However the recently-announced huge increases in coal and iron ore export prices suggest that, even allowing for a downward revision to the forecast for real GDP growth, the forecast for growth in nominal GDP in 2008-09 may be revised upwards to around 8%. This is important because it is nominal GDP growth which drives the revenue side of the Budget, rather than real GDP.

Higher commodity prices will boost company tax collections by a further \$10bn in 2008-09

A surplus of \$20bn in 2008-09 is readily achievable without any policy action

The test of this Budget will be the extent to which policy – not windfall revenue gains – contributes to slow growth in demand

Measures that introduce means tests to currently universal benefits would generate significant savings

We estimate that the prospective increases in coal and iron ore prices will boost the Government's company tax collections by at least \$10bn in 2008-09. The sharp fall in share prices since November last year is likely to have adversely impacted revenue from capital gains tax and taxes on superannuation fund earnings (as the Treasurer has been at pains to point out in recent weeks), but it would be surprising if this amounted to more than around \$4bn in 2008-09.

Thus, without taking account of other possible 'parameter variations' (such as those resulting from stronger-than-expected employment growth during the current financial year, which should boost personal income tax revenues), the Government should be able to produce a surplus of at least \$20bn (1¾% of GDP) without making any 'policy decisions' (to reduce outlays or lift revenues).

Of course, if that were to be the sum total of the Budget, then although it would represent a partial departure from the practice of the previous Government of simply handing over all of the 'parameter variations' to households in the form of tax cuts or increased benefit payments (which is part of the reason why Australia now has an inflation problem), it would nonetheless be difficult to portray it as one which 'exerted maximum downward pressure on inflation and interest rates', or which would help to shield 'working families' from the possibility of further increases in their mortgage repayments.

Thus, the real test of the Budget, from a policy perspective, will be the extent to which it incorporates decisions which will materially contribute to the task of slowing the rate of growth in domestic demand, and thus relieve monetary policy of the sole responsibility for containing inflationary pressures which it has borne up to this point.

And there is considerable scope for making 'policy decisions' of this nature. The previous Government showed very little fiscal discipline in its final two terms. As two Treasury officers pointed out in the most recent edition of Treasury's *Roundup*, the number of 'policy decisions' taken in the Budget context more than doubled between 1997-98 and 2007-08, but the proportion of them which had a savings component fell from around one-third to less than 2%.<sup>1</sup> As a result, growth in government spending in recent years has been exceeded only by that under the Whitlam Government (in 1972-75) and immediately following the recessions of 1982-83 and 1990-91. We've been saying the same thing for years, but hopefully it carries more weight with the Government when Treasury officers say it.

There was similar laxness on the revenue side. 'Tax expenditures' (that is, special treatment of particular categories of taxpayers, incomes or expenditures which result in a loss of revenue), which had been running at \$29-30bn per annum in the early years of this decade, are now estimated to cost \$51bn in the current financial year, compared with an estimate of less than \$39bn when first made for 2007-08, in the 2004 Tax Expenditures Statement.

The Government could thus easily attain savings of at least \$4bn per annum by revisiting some of the decisions made by the previous Government in its last two terms. Press reports indicate that the Government has been considering means-testing some of the more costly benefits introduced by its predecessor, such as the 'baby bonus' and the Family Tax Benefit. We would applaud any such measures. Measures of this nature would be far more effective in restraining growth in domestic demand, and in spreading more equitably the 'pain' involved in doing so, than gimmicks such as arbitrarily-chosen across-the-board reductions in government spending. And the political costs of courageous decisions of this nature are likely to be much less at the beginning of a newly-elected government's term, than when it has been around for a while.

Indeed, to paraphrase something George W. Bush said after he was re-elected in 2004, the Rudd Government has a lot of 'political capital', and next week's Budget is the perfect time to spend some of it.

<sup>1</sup> Kirsty Laurie and Jason McDonald, 'A Perspective on trends in Australian Government spending', *Economic Roundup*, Summer 2008 (The Treasury, Canberra), pp. 27-49.

## Budget details

**This year's Budget, as in previous years, is awash with cash**

Notwithstanding Treasurer Swan's concerted effort to manage expectations, he, like his immediate predecessor, finds himself in the rather happy position of managing a budget awash with cash.

It is true that the world has changed markedly since the last fiscal update was handed down during the election campaign in November last year. The outlook for the global and Australian economies has deteriorated as financial conditions have tightened, and the local share market is now well and truly into 'bear' territory, down around 20%. All other things being equal, this would result in slower growth in tax revenues, particularly for capital gains tax, and stronger growth in expenses as transfer payments rise.

But all other things aren't equal. The outlook for commodity prices – particularly coal and iron ore – has improved markedly. Recent contract settlements point to a 210% increase in coking coal prices and 125% increase in thermal coal prices in 2008-09, against earlier expectations that the price cycle had peaked. Meanwhile, early indications are that iron ore miners will achieve at least a 71% increase in prices this year. Beyond 2008-09, while most commentators still expect prices to ease, expectations for price falls are being pared back. All of this means more money for the budget bottom line through higher company taxes and resource royalties. In addition, the labour market has proved to be more resilient than previously expected, leading to stronger income tax collections and slower growth in unemployment and welfare benefits.

**Windfall gains from the ongoing commodity price boom swamp the effects of a slowing economy**

The stimulatory effect of the upside surprise on commodity prices and the labour market swamp the contractionary effect of the weaker economic outlook on the budget bottom line. We estimate that in 2008-09, net 'parameter variations' since PEFO will add \$9.75bn to the cash surplus, reflecting a \$17.25bn boost from higher than expected commodity prices and the stronger labour market, that is only partly offset by a \$7.5bn subtraction from the weaker economy and equity market. Between 2007-08 and 2010-11, the net stimulus to the budget cash balance relative to PEFO is forecast to be in the order of \$26½bn!

### Estimated changes in Budget aggregates since PEFO

	2007-08 (\$mn)	2008-09 (\$mn)	2009-10 (\$mn)	2010-11 (\$mn)
<b>PEFO underlying cash balance</b>	<b>14367</b>	<b>14319</b>	<b>17711</b>	<b>15029</b>
Net effect of ALP election commitments	-186	-1551	-2404	-1395
<b>Post-election Budget balance</b>	<b>14181</b>	<b>12768</b>	<b>15307</b>	<b>13634</b>
'Parameter variations' since election as a result of:				
- weaker economic growth	-500	-3500	-6000	-7500
- financial market turmoil	-250	-4000	-5500	-6000
- stronger labour market	2500	3250	3500	3600
- higher commodity prices	2000	14000	15000	16000
Net 'parameter variations'	3750	9750	7000	6100
<b>Cash balance after 'parameter variations'</b>	<b>17931</b>	<b>22518</b>	<b>22307</b>	<b>19734</b>
Net effect of policy decisions since the election*	-69	1518	3307	1234
<b>Estimated cash balance</b>	<b>18000</b>	<b>21000</b>	<b>19000</b>	<b>18500</b>
<b>% of GDP</b>	<b>1.6</b>	<b>1.7</b>	<b>1.5</b>	<b>1.4</b>

\*Note: 'Net effect of policy decisions since election' is derived as a balancing item.

Source: ANZ Economics and Markets Research

The government is likely to identify significant savings in the budget...

...and spend every cent of it elsewhere!

A new fund for infrastructure seems the most likely destination for the bulk of the surpluses

The government will revise down its outlook for real economic growth...

...and will (optimistically) project inflation to have peaked

Ideally, in the current macroeconomic environment, the government would save every extra cent of these windfall 'parameter variations' and perhaps even help the Reserve Bank in its efforts to curtail inflationary pressures by actually reducing spending. This ought to be eminently achievable given the significant fat that developed in the federal budget over latter half of the previous government's period in office. We have already nominated some low hanging fruit such as the baby bonus and the Family Tax Benefit, which, if means tested, would generate significant savings for the budget. In addition to other measures that have been announced such as higher taxes on 'alcopops' and the promised savings across a swathe of government programs identified by the new government's razor gang, a contribution of at least \$10bn across the four-year forecast horizon could be expected.<sup>2</sup>

But that seems unlikely to occur. Already the government has announced significant new spending on social security and welfare, education, health, water and the environment. And that's not even taking account any new measures in the Budget. It seems likely that the government will spend every cent of its identified savings (in which case it's not savings!) and then some. Overall, we expect the net effect of new policy decisions to reduce the budget bottom line by around \$6bn over the four years from 2007-08.

To be fair, this isn't too bad considering the previous government's track record of spending every single cent of the windfall gains it received. The new Rudd Government is at least likely to save the majority of its windfall gains. But if our expectations are right, it will not be able to claim that it did everything it could to reduce pressure on inflation and therefore interest rates.

Notwithstanding this, budget surpluses are likely to be significant: over the four years from 2007-08, we estimate the surpluses will total \$82.5bn. With net debt now eliminated, a natural question emerges as to what the government will do with all of this money. The most likely candidate for the lion share of the surpluses is a new fund for infrastructure that has already been dubbed in the media, the 'Building Australia Fund'. This would work in much the same way as the funds set up by the previous government, including the Future Fund, the Higher Education Endowment Fund and the Health and Medical Investment Fund, which are also candidates to receive some of the surpluses. These funds have the distinct advantage in the current environment of utilising public funds in a way that provides significant medium to long term returns without putting pressure on demand and inflation in the short term.

## Economic outlook

We suspect the Government's forecasts will be typically conservative, although to be fair this is arguably the right approach for policy-setting given the unusually high level of uncertainty over the global and local outlook at the moment. No doubt the Government will project that the impact of recent interest rate rises will offset the opposing force of a booming terms of trade (as well as further income tax cuts!). We project that this will see the Government revise down its economic forecasts for 2008-09 to 2¾% from the 3½% presented at MYEFO. This is a little stronger than ANZ's current growth forecasts, with the Government probably slightly more optimistic over global growth (and thus exports).

We will be closely watching the Government's forecasts for the CPI, terms of trade and non-farm GDP deflator. These forecasts will indicate (1) How effective the Government thinks the current level of interest rates will be in easing Australian inflation and (2) whether the government has fully accounted for the impending export commodity earnings windfall. On the former, we suspect the Government's inflation forecasts will be substantially upwardly revised, but contain a similar track to the RBA's current view, i.e. that inflation will ease towards the top of the RBA's 2-3% target band over 2009. We suspect the

<sup>2</sup> Treasurer Swan this week announced that the Budget would contain 649 individual decisions on spending cuts.

Government will forecast inflation to moderate to 3¼% through the year to June-2009. Such a forecast would allow the Government to readily make a case for interest rates to remain on hold for the rest of this year. Note that this would be *below* the RBA's and ANZ's forecast for inflation to still be at 3½% through-the-year to June-2009.

The government will adopt a more cautious outlook for commodity prices

Just as the Government's forecasts for CPI inflation are likely to look a little low to us, so too the Government's forecasts for the terms of trade are likely to be a little conservative. We expect the Government will forecast the terms of trade to rise by a strong 12% in 2008-09, slightly below ANZ's forecast for a 13½% rise. While the Government is likely to have taken full account of the massive increases in coal and iron ore commodity prices for 2008-09, we suspect our forecasts for other (rural and non-rural) commodity export prices are a little more bullish

So the upward revision in nominal GDP growth could still look conservative

Lower forecasts for both the CPI and the terms of trade would imply that the Government's estimate of the gross non-farm deflator will also be a little lower than ANZ's forecast of a 6¼% rise in 2008-09. This suggests that the Government's forecasts for nominal GDP growth – which of course is what drives the Budget's revenue projections - will be a little lower than ANZ's forecast of 8½% next year. Such a conservative forecast for nominal GDP once again will give the Government leeway for potential fiscal slippage without missing the 2008-09 Budget surplus forecasts, or indeed to achieve the preferred outcome of a stronger than expected budget surplus at the end of the 2008-09 fiscal year.

#### Expected Budget economic forecasts

	2007-08			2008-09		TTY to Jun-09	
	MYEFO	Budget *	ANZ	Budget *	ANZ	Budget *	ANZ
GDP	4¼	3½	3½	2¾	2½	2½	2½
CPI	2¾	3¼	3¼	3¾	4	3¼	3½
Employment	2¼	2¾	2¾	2	1¾	1½	1½
Wages	4¼	4¼	4¼	4¼	4¼	4	4¼
Terms of trade	1¼	5	5	12	13½	4	5
Gross non-farm product deflator	2¾	4¼	4¼	5½	6¼	4	4½
Nominal GDP	7¾	7¾	7¾	8	8½	6½	6¾

\*ANZ's expectation of the Treasury's Budget forecast  
Sources: Commonwealth Treasury and ANZ

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