ANZ Federal Budget Report

2008-09 Budget: A reasonable first effort

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Our Vision:

For ANZ Economics and Markets Research to be the most respected, sought-after and commercially valued source of economics research and information on Australia, New Zealand, the Pacific and Asia.

Overview

- The underlying cash balance is expected to be in surplus to the tune of $16.8bn (1.5% of GDP) in 2007-08, and $21.7bn (1.8% of GDP) in 2008-09. Thereafter, surpluses are projected to remain around, or a little below, the 1.5% of GDP mark.
- Policy initiatives since the election have been fully funded through spending cuts and some additional tax measures. In all, the Budget contains spending cuts and tax increases totalling around $35bn over the five years to 2011-12, largely but not totally offset by new policy decisions totalling around $32bn.
- These calculations don't include the additional income tax cuts which come into effect from 1 July, at a cost to revenue of nearly $47bn over the four years to 2011-12.
- There have been further substantial windfall revenue gains from expected strong rises in commodity prices as well as stronger growth in personal income tax from increased employment and wages. These will deliver an additional $5.4bn in 2008-09 and a total of $9.4bn over the three years to 2010-11. All of this has been saved.
- The Budget embodies a very modest tightening of fiscal policy and as such is more appropriate for the circumstances than recent Budgets have been. It wont *add* to upward pressure on interest rates as the previous government's last few Budgets did – but nor can it really be said that the Budget "exerts maximum *downwards* pressure on interest rates".
- The government's forecasts suggest the economic environment for Australia will become more problematic over the next year, with a significant slowing in growth and employment but still-high inflation.
- Because this is only a mild fiscal tightening and, as such, doesn't do much on its own to dampen domestic demand, the RBA will still likely see the balance of risks to inflation tilted to the upside. We still think the most likely scenario is "rates on hold" for the rest of this year, and well into 2009; but, as the RBA has warned twice this month, should domestic demand fail to slow as it expects, or elevated inflation expectations start to feed into faster wages growth, then the Bank may have no choice but to raise rates again.

Key Budget aggregates

	2007-08 (f)	2008-09 (f)	2009-10 (p)	2010-11 (p)	2011-12 (p)
Underlying cash balance					
$bn	16.8	21.7	19.7	19.0	18.9
% of GDP	1.5	1.8	1.5	1.4	1.3
Fiscal balance					
$bn	20.4	23.1	22.4	23.3	22.6
% of GDP	1.8	1.9	1.7	1.7	1.6

Source: Budget Papers

Saul Eslake
Chief Economist

Assessment

Wayne Swan has had to put together his first Budget in more challenging economic circumstances than those which confronted Peter Costello in framing his last four Budgets. Both the international and domestic economic outlooks are more uncertain - the former because of the global credit crunch and its impact on the outlook for economic growth in the United States (in particular), and the latter because of the unexpected acceleration in inflation and the significant tightening of domestic financial conditions over the past nine months.

Treasurer Swan's first Budget strikes good balance

In the face of those uncertainties, the 2008-09 Budget strikes a reasonably appropriate balance. It projects a Budget surplus of $21.7bn or 1.8% of GDP for 2008-09, 0.6 of a ppt more than envisaged by the outgoing Coalition government just before last November's elections, and does so through a combination of policy decisions producing net savings of $2bn (about 0.2% of GDP) and adding to the surplus, rather than spending or giving away (as was the previous Government's wont), and favourable 'parameter variations totalling nearly $5.4bn. For the remainder of the forward estimates period, the Budget projects surpluses in the range of $19-20bn or 1.3-1.5% of GDP, marginally higher than those envisaged before the last election, though with policy decisions making a smaller contribution to the larger surpluses in the out-years than in 2008-09.

The Government's ability to foreshadow larger surpluses has been enhanced by further upward revisions to revenue projections, although these were somewhat smaller over the past six months (around $25bn over the four years to 2010-11) than over the corresponding periods of the last two Budget cycles, owing partly to lower revenues from capital gains and superannuation fund taxes than previously forecast (we wouldn't be surprised, however, if the revenue projections in this Budget again turned out to err on the low side). And the erosion of fiscal discipline during the final years of the Coalition Government created plenty of opportunities for Finance Minister Lindsay Tanner to find ways of making savings.

New policy decisions have been more than offset by spending cuts and tax increases

In all, the Budget contains spending cuts and tax increases totalling around $35bn over the five years to 2011-12, largely but not totally offset by new policy decisions totalling around $32bn – although from 2009-10 onwards the impact of new policy outweighs the impact of the savings measures.

Note that these calculations *don't* include the additional income tax cuts which come into effect from 1 July, at a cost to revenue of nearly $47bn over the four years to 2011-12. That's because these tax cuts were initially decided upon by the outgoing Coalition Government just before the release of the Mid-Year Economic and Fiscal Outlook on the first day of the election campaign, and are thus included in the 'baseline' from which the net effect of policy decisions by the Rudd Government is calculated; the Rudd Government's decision to defer the tax cuts promised by the Coalition for taxpayers in the top tax bracket is credited as a policy decision in this Budget saving $5.3 billion over four years (and is the largest single saving decision in the Budget, although it has no impact on the projected outcome for 2008-09).

Tax cuts will stimulate the economy, but, all up, the Budget is unlikely to put additional upward pressure on interest rates

Although we are still inclined to believe that the tax cuts will provide a stimulus to domestic demand that isn't necessary in an economy that is about to enter its eighteenth year of continuous growth, and in which 'excess demand' is a significant contributor to inflationary pressures, we accept that the Government felt obliged to keep its election promises. And the Reserve Bank is likely to have (at least implicitly) factored their stimulatory impact into its monetary policy deliberations. So it would be wrong to argue that the tax cuts will put *additional* upward pressure on interest rates.

That being so, the 2008-09 Budget can be portrayed as embodying a *moderate* tightening of fiscal policy. And that's a distinct change from the Budget's of previous years, which we've consistently argued, have, through the net impact of the policy decisions contained within them, amounted to an ill-timed loosening of fiscal policy.

The specific savings decisions are a mixture of the bold and the unadventurous. The decisions to means-test the 'baby bonus' and Family Tax Benefit Part B (for stay-at-home-spouses), effectively denying them to families with annual incomes in excess of $150,000, are especially praiseworthy as an attempt to improve the targeting of such measures. Indeed the pity is that there wasn't a broader assault on so-called 'middle-class welfare'. On the other hand, we're a bit sceptical of the one-off 'efficiency dividend' which is projected to save over $400mn a year from agency running costs and represents the largest single expenditure saving in the Budget. Previous experience with such measures suggests that they are actually a way of avoiding hard decisions about what programs should be cut, end up being pushed down to the lowest level of management possible, and more often than not result in reduced efficiency and standards of customer service.

The government has increased spending on the priority areas of the environment, education, health, housing affordability and indigenous affairs

Nonetheless, these and other savings have allowed the Government to fund other important priorities, including climate change, education, dental health, housing affordability and Indigenous disadvantage. There's also a fillip to Australia's funds management industry through reductions in the withholding tax rate on property income and capital gains (though not interest) paid to foreign investors.

One other notable aspect of the Budget is that it has created a more compelling vision of how it will deploy the enlarged surpluses which it is projecting over the next four years.

One of the reasons why the previous Government felt obliged to 'hand over' the revenue windfalls generated by the commodities boom in the form of tax cuts and increased spending may have been because, once they had 'paid off' the Commonwealth's net debt, they couldn't think of any alternative use for those surpluses than defraying the hitherto unfunded liability for retiring public servants' pensions. Although that was an appropriate thing to do, it was unlikely ever to win widespread public support for the notion of paying more in tax was spent on public services. In its final six months in office, the Coalition Government did finally start to designate part of its surplus for longer-term expenditure priorities in higher education and medical technology.

Budget surpluses will be parked in a number of new funds to finance infrastructure, education and health projects

This Budget takes that approach a quantum leap further, by allocating $20bn to a new 'Building Australia Fund' to finance longer-term spending on infrastructure, $10bn into a 'Health and Hospitals Fund' and $5bn into a new 'Education Investment Fund' (to which the $6bn previously allocated by the Coalition Government to its Higher Education Endowment Fund will be added). These are exactly the sort of purposes for which government should be (and should have been) seeking to 'save' some of the windfall revenues associated with the current commodity boom.

Finally, this Budget includes some noteworthy initiatives to improve the transparency of financial reporting. At long last, the GST has been recognized as a Commonwealth tax, consistent with the advice of the Auditor-General and the Statistics Bureau. The sometimes confusing presentation of the Budget using three different sets of accounting frameworks has been simplified. And there is a more helpful discussion of the sensitivity of the Budget aggregates to alternative economic scenarios, including a fall in the terms of trade.

In sum, this is an appropriate Budget for challenging economic circumstances. It doesn't add to upward pressure on inflation and interest rates, as recent Budgets have done; nor does it take undue risks with a more uncertain outlook for economic growth than at any time in the past five years. It acknowledges that bringing inflation down will entail some sacrifices (including a rise in the unemployment rate), but attempts to spread those sacrifices more fairly than would have been the case if the task of slowing domestic demand had been left to monetary policy alone (as it has been up until now).

Having brought down an 'appropriate' Budget for current circumstances, and having kept faith with the voters who installed it at the last election, it is very much to be hoped that the Rudd Government will be willing to spend political capital more adventurously in the two Budgets before the next election.

Tony Pearson
Deputy Chief Economist

Budget details

Not a bad start

Treasurer Swan's first Budget delivered large surpluses and additional spending funded by spending cuts elsewhere

Wayne Swan's first Budget was promised to be tough. There was much pre-Budget rhetoric – subsequently backed up in the Budget Speech - about the need to remove stimulus from the economy to take pressure off inflation and interest rates, so as to "deliver for working families". And so the centrepiece of the Budget was a working families support package costed at $55bn over four years. And all the policy initiatives were claimed to be "fully funded".

However we need to be careful in interpreting this. Most of the announced spending was comprised of the Labor version of the Liberal personal income tax cuts announced prior to the election and included in the Pre-Election Economic and Fiscal Outlook ($46.7bn over four years). These tax cuts were not funded from savings achieved elsewhere, but rather represented the spending of windfall revenue gains deriving from the ongoing commodity price boom as they were known at the time of the PEFO.

The cost of policy initiatives since the election is significantly less and amounts to around $5bn in 2008-09. These have been completely offset through a range of small reductions in expenses elsewhere, increases in taxes (e.g. the luxury car tax was increased from 25% to 33%) and deferral of personal income tax cuts for high income earners.

But the largest measure in the Budget remained the tax cuts promised at the election, and these were not offset by spending cuts

So the government can quite correctly claim that policy changes in this Budget are fiscally neutral (in fact they are slightly contractionary in that they contribute to a small increase to the Budget surplus). And that allows the government to also claim that it has saved the windfall gains in revenue worth $5.4bn in 2008-09 and $9.4bn over the three years to 2010-11. On this point the government is to be commended as it displayed a refreshing resolve after the last two spendthrift terms of the previous administration.

However, if we wanted to be pernickety there are a few of points on which we could quibble.

The first is that the neutral policy decisions in part entail an income transfer from higher income to lower income households. With lower income recipients having a higher marginal propensity to spend, this broadly 'cash neutral' transfer is likely to lead to increased household spending.

The second is that some of the "savings" involve the achievement of increased efficiency dividends from government authorities. A 2% efficiency dividend is expected to yield $1.8bn in savings over five years. This is easy to promise but not always easy to deliver.

But the most telling criticism is that the Labor government has essentially maintained the spending decisions of the previous Liberal government made prior to the election, which were included in the Mid-Year Economic and Fiscal Outlook. These involved extra spending and tax cuts of $10.8bn in 2008-09 and a total of $42.7bn over the three years to 2010-11. As noted above, all of this additional largesse was to be funded from windfall revenue gains. The new labour administration could have reversed these decisions – the money has not yet been spent. But for the most part it has not done so, and in particular has proceeded with its own variation of personal income tax cuts, with the main difference being a deferral of tax cuts for the highest income earners. Making good its election promises is laudable. But proceeding with the tax cuts adds to household disposable income and inevitably spending, at a time when the government claims to be doing everything it can to moderate spending and inflationary pressures in the economy.

A truly restrictive Budget would have cut spending to fund part of the policy decisions since the last Budget

A truly restrictive budget would have cut spending to fund at least in part the policy decisions made since the last Budget. But that would have entailed a budget surplus of a magnitude which would have been politically difficult to defend. On balance the underlying cash surplus of $21.7bn is commendable. It is not a bad place to start.

Parameter changes deliver further massive revenue gains

The Government has once again found itself awash with windfall revenue gains

The government has once again found itself awash with windfall revenue gains. Parameter variations will deliver an additional $5.4bn in 2008-09 and a total of $9.4bn over the three years to 2010-11. This reflects further expected strong rises in commodity prices contributing higher company profits and additional petroleum rent tax, as well as stronger growth in personal income tax from increased employment and wages. Offsetting this will be reduced capital gains from recent falls in share prices, and higher interest expenses for business. Total taxation gains are worth $3.6bn in 2008-09. Non-taxation revenue will also be stronger, reflecting an increased dividend from the Reserve Bank ($814mn), an increase in Future Fund earnings ($751mn) and an increase in interest received by the Australian Office of Financial Management. Expense reductions have also delivered additional revenue of $3.1bn since PEFO in 2008-09.

All of these gains have gone straight to the bottom line, and that is to be applauded

None of these windfall gains have been spent; they have gone straight to the bottom line. And that is to be applauded.

Policy decisions broadly neutral

There was a range of spending initiatives covering education, trade training, skills, health, child care, and additional migration. These were substantially offset by savings from among things a one-off 2% efficiency improvement in government agencies, savings in defence, reduced public health insurance rebate costs, and means testing of Family Tax Benefit Part B and the baby bonus. But total expenses did nevertheless increase.

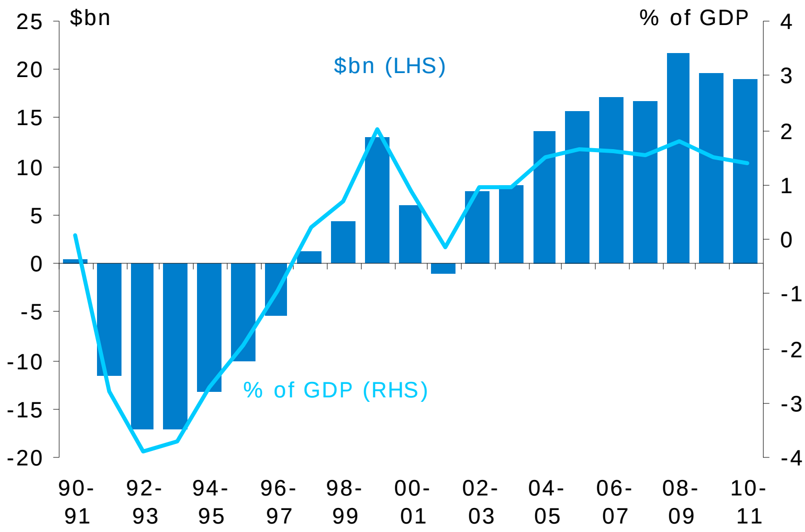
Fiscal neutrality was only achieved through increases in taxation revenue. Policy decisions increased revenue by $2.4bn, and included deferral of income tax cuts for high income earners, increased excise on “other excisable beverages” (the ‘alcopop’ tax), and increased compliance activities by the Australian Taxation Office. See *Key Policy Measures at a Glance* on page 12 for a more comprehensive listing.

Reconciliation of general government underlying cash balance estimates

	07-08	08-09	09-10	10-11
	$bn	$bn	$bn	$bn
2007-08 Budget	**10,637**	**12,712**	**13,812**	**12,447**
Policy decisions	-3,886	-10,840	-13,859	-17,996
Parameter and other variations	8,083	12,525	17,776	20,638
Total changes	4,197	1,685	3,917	2,642
2007-08 MYEFO	**14,834**	**14,396**	**17,729**	**15,089**
Policy decisions	-406	-53	11	-35
Parameter and other variations	-61	-24	-29	-33
Total changes	1,804	975	867	-185
2008-09 PEFO	**14,367**	**14,319**	**17,711**	**15,021**
Policy decisions	-2,777	1,996	13	1,874
Parameter and other variations	5,225	5,388	1,945	2,101
2008-09 Budget	**16,815**	**21,703**	**19,669**	**18,996**

Source: Budget Papers

Solid underlying cash surplus in 2008-09



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

Economic forecasts

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A soft landing

The government is forecasting a soft landing in the Australian economy. A slowdown in GDP growth to a little below trend in the coming year is expected to be enough to significantly reduce Australia's current strong inflation pulse.

The Government is forecasting Australian economic growth to slow from a strong 3½% in 2007-08 to a below-trend pace of 2¾% in 2008-09, as the impact of the recent significant tightening in monetary policy, slower global growth and financial market turbulence offsets the boost from another large terms of trade rise. This slower economic growth is expected to lead to a significant softening in both employment growth and, more notably, inflation. The Government is now forecasting inflation to ease sharply from 4% through the year to June 2008 to 3¼% through the year to June 2009. This is still above the RBA's 2-3% target band.

The Government expects tighter financial conditions will offset the higher terms of trade

In a move to be commended, the Government has also, for the first time, published forecasts of nominal GDP growth. This variable is crucial to the Budget process as it drives revenue growth. Moreover, nominal GDP growth is of particular interest at present, given that it captures the stimulus to national incomes from the terms of trade, and thus highlights one of the major upside risks to real economic growth. Unsurprisingly, the Government is now forecasting nominal GDP growth to accelerate to a massive 9¼% in 2008-09. If achieved, this would be the fastest rate of nominal GDP growth since 1989-90 and further highlights the powerful inflation risks confronting policymakers in Australia at present.

And that this will cause inflation to ease sharply

As usual, the Government has adopted 'projections' (i.e. long-run averages) for the key economic variables from 2009-10 to 2011-12. This means a projection of 3% for real GDP growth, 2½% (the mid-point of the target band) for inflation. While this is accepted practise, this year it has forced the Government to adopt a potentially unrealistic outlook for the CPI and thus potentially nominal GDP in 2009-10. Most forecasters, including the RBA, expect inflation to remain above 3%, and thus above the Government's 'projection' over 2009-10. Moreover, the Government's projection for nominal GDP, at 4¼% in 2009-10 and 2010-11 compared with the 'usual' 5¼% in 2011-12, is already biased down due to the Government's assumption that the projections assume a two-year step down in non-rural commodity prices. While arguably defensible, it is nevertheless interesting to note that the Government has chosen to make a (downward) adjustment to nominal GDP but not an (upward) revision to the CPI in the projections period. Practically speaking, with the ink barely dry on this year's Budget, this process means there is already upside risk to the Government's Budget revenue projections for 2009-10!

Government Forecasts - Major Economic Parameters

	Forecasts		Projections		
	2007-08	2008-09	2009-10	2010-11	2011-12
GDP	3½	2¾	3	3	3
Employment	2½	1¼	1¼	1¼	1¼
Wage Price Index	4¼	4¼	4	4	4
CPI [(a)]	4	3¼	2½	2½	2½
Nominal GDP	7¾	9¼	4¼	4¼	5¼

[(a)]Through the year growth to the June quarter
Sources: Budget Papers and ANZ

Even as nominal GDP growth hits a 21-year high!

Some points of difference

We are in broad agreement with the Government that tighter financial conditions will help to offset the terms of trade and produce slower growth and easing inflation in 2008-09. However, there are some crucial differences in our view around the causes, timing and degree of these twin slowdowns.

The Government is relatively optimistic on economic growth, especially business investment

The Government is more optimistic on the outlook for economic growth, largely reflecting a more positive view on household consumption, dwelling investment and particularly business investment. We concede our outlook for household consumption is probably a little conservative, especially given this Budget's tax cuts. However, we believe the Government's outlook for dwelling investment and especially business investment look overly ambitious, given (a) the impact of financial market turbulence and higher funding costs on local businesses and (b) capacity constraints. We expect extremely tight labour and product markets will continue to limit growth in residential and non-residential construction activity.

But sees a notable softening in the labour market

The government is less optimistic about the outlook for employment. We are comfortable with our view that capacity constraints and skills shortages will encourage labour hoarding, such that employment growth will not slow particularly sharply as the economy slows. Recent business surveys, which show employment demand continuing to hold relatively firm compared with previous downturns, support our view.

The Government's inflation forecasts look optimistic

Despite a stronger outlook for growth, but perhaps because of the weaker outlook for employment, the Government is more optimistic about the pace at which Australian inflation can ease in the coming year. The Government expects slower domestic demand, an increase in the economy's supply capacity (as a result of higher business investment presumably) and higher farm production (which is expected to dampen food prices) as generating the relatively sharp slowdown in inflation in its forecasts. The Government's import price profile might be little more favourable than ANZ's, simply reflecting different exchange rate outlooks. The Government uses a technical assumption of an unchanged exchange rate (that is, we think they do, but unusually, they haven't explicitly stated it in this Budget). In contrast, at ANZ we are forecasting the A$ to track lower in 2008-09, raising import prices and adding to inflation.

Regardless, we think this is a 'best-case scenario' forecast. Given rising administered costs (e.g. utilities and public services), continued relatively high wage growth and rising rents, as well as sharply slower, but not collapsing domestic demand, it is extremely difficult for us to get our inflation figures down to the Government's forecasts without some major 'adjustments'.

Finally, an un-conservative terms of trade outlook!

The Government is more optimistic about the 2008-09 terms of trade. This is most likely explained by different import price profiles. As outlined above, ANZ's

And a fairly sanguine global growth outlook

forecast for the A$ to move lower raises import prices. This provides some offset to the impact of higher export commodity prices in the terms of trade. Or perhaps the Government, sick of criticism about 'conservative forecasting', has simply chosen to go with the upper end of market expectations for this variable!

The Government has a more sanguine global growth outlook, particularly vis-a-vis Australia's trade partners. Notably the budget anticipates a continuation of above-trend global growth, whereas we are forecasting slightly below trend growth. Similarly, the budget anticipates an acceleration in real GDP growth for Australia's trade partners in 2009, whereas we are forecasting a continued slowdown.

A comparison of our forecasts points to crucial differences in the causes, extent and timing of the slowdown in growth and inflation

Australian economic forecasts[a]

	2007-08		2008-09	
	Government	ANZ	Government	ANZ
Demand and output				
Consumption	4½	4¼	2¾	2¼
Dwellings	2½	1¾	2	¼
Business investment[b]	9½	8	8½	3½
Non-dwelling	8½	6¾	5½	2½
Plant and equipment	9½	7½	11	3¼
Priv. demand[b]	5¼	4¾	4	2½
Public demand[b]	4¾	4¾	3	4½
Changes in inventories [c]	¼	¼	-¼	0
GNE	5½	5¼	3½	2¾
Net exports[c]	-2	-2	-1	-¼
Exports	3	2¼	6	4¾
Imports	11	10¼	9	5¼
GDP	**3 ½**	**3 ½**	**2 ¾**	**2 ½**
Nominal GDP	**7 ¾**	**7 ¾**	**9 ¼**	**8 ½**
Other indicators				
CPI [d]	4	4	3½	4
Employment	2½	2¾	1¼	1¾
Unemployment rate (%)	4¼	4¼	4½	4¼
Wage price index	4¼	4¼	4¼	4¼
Terms of trade	4¾	5	16	13½
Current account (% of GDP)	-6¼	-6¼	-5	-4
Major trading partners growth	3¾	3¾	4	3½
Global growth	4	3½	4	3½

(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.
(d) Through the year growth to the June quarter for 2006-07 and 2007-08. 2008-09 is year-average.
Source: Budget Papers and ANZ

A closer look at inflation

New policy differences should have a relatively negligible direct impact on inflation

Given the current environment, it is important to consider whether tonight's policy decisions have any direct implications for the inflation outlook. Personal income tax cuts aside (these will have *indirect* effects on prices), the *direct* impact of policy decisions on Australia's inflation rate from tonight's Budget looks small, in the order of less than ¼ of a ppt over 2008-09. At this stage, this is unlikely to materially change our inflation outlook.

The biggest impact to inflation could come from lifting the income threshold for the 1% Medicare Surcharge from $50,000 to $100,000 for singles and to $150,000 for couples. The Government claims this policy will affect more than 1 million taxpayers. Private health premium increases are regulated, but given the likely sudden drop in demand as a result of this policy-change, it is reasonable to expect that the government will allow for some acceleration in premium increases, as well as potentially pharmaceutical prices, over 2008-09. We estimate these changes could add as much as 0.2ppt to the CPI in the March quarter 2009.

Implications for monetary policy

All new initiatives announced in tonight's Budget have been fully funded within the budget allowing the surplus to growth with extra revenues. Given that the RBA knew that income tax cuts would be delivered as part of the ALP's election promises, the neutrality of new spending decisions will be welcomed at the RBA.

Income tax cuts will still stimulate domestic spending

Nevertheless, the implementation of tax cuts means that fiscal policy will continue to be stimulatory to the domestic economy in 2008-09 even though the surplus is one of the largest in recent times at 1.8% of GDP.

This only complicates the economic outlook for the RBA. Past rate hikes and difficult international financial conditions are starting to slow the economy. Strong export prices and tax cuts are likely to offset this. The issue is how these opposing forces will play out over the year ahead. For the RBA to be comfortable that inflation will return to its target band over the next two years, the economy has to slow to non-farm GDP growth of 1.75% in calendar 2008. There is nothing in this budget that will make this outcome more likely.

Overall, the budget doesn't deliver enough to completely eliminate the risk of another interest rate rise

We are finding it increasingly difficult to get our non-farm GDP growth forecast down to the RBA forecast of 1.75% through the year to December 2008. While we retain our view that the RBA cash rate is on hold for the rest of this year, we believe that if interest rates are going to move in the next 6 months, it is likely to be up.

Comparison of Economic Forecasts

	Four quarters to June 2009		
	Government	RBA	ANZ
GDP	2 ¾	2¾	2½
Non-farm GDP	2	2¼	2¼
CPI	3 ¼	3½	3½
Underlying Inflation	3 ¼	3½	3½

*ANZ's expectation of the Treasury's Budget forecast
Sources: Budget Papers, RBA and ANZ

Impact on business

Julie Toth
Senior Economist

For business and industry, the key focus of this Budget is improving capacity and productivity in terms of labour, skills, transport and communications. Significant policy measures aimed at climate change and water resources will eventually affect all businesses, but will initially be felt most by utilities and rural businesses. These measures were announced well before the Budget and include the $2.3bn climate change measures and the $12.9bn national water package.

The Budget's focus on skills and training will be welcome by all business

The key area of new spending that will potentially benefit all businesses is in education and training. Many of these measures were announced prior to the Budget or relate to election commitments. They are worth a total of $5.9bn over the next five years and include an extra 630,000 vocational training places and trades training in schools. The benefits of this restructured education and training effort will potentially flow to all businesses, but are likely to take many years to be felt on the ground. More immediately, the government announced an increase in skilled migration places of 31,000 in 2008-09, taking the total permanent skilled migration places available to 133,500 for the year. The temporary skilled visa category (visa 457) will also be upgraded, although the number of places available may not change.

There are few, if any, changes to general business regulation arising from this Budget. The current non-final withholding tax of 30% for foreign investors in certain classes of property and capital funds is to be replaced with a reduced final withholding tax of 22.5% in 2008-09, reducing to 7.5% from 2011-12. For businesses with employees, tighter Fringe Benefits Tax exemptions (primarily on laptops) and depreciation arrangements for computer software (lengthening depreciation claims to four years) will raise an estimated $179mn in 2008-09 and $2.7bn to 2011-12. Employee share schemes will also be amended so as to close a perceived loophole around the timing of tax assessments for them.

For agricultural and regional businesses, the main spending initiatives from this Budget are those relating to the $12.9bn national water plan, although some of this money is to be allocated to urban water projects as well. Separate to this, the 'Farming Future' program, includes $60mn to help farmers respond to climate change and $55mn for hardship assistance due to climate change. The planned national broadband network is expected to extend broadband coverage to 98% of Australian population and businesses.

In residential housing, affordability continues to make headlines. The Government is introducing special savings accounts for first home buyers (worth $1.2bn), subsidies for investors in low cost rental properties and housing infrastructure grants for new housing developments. All of these measures can be expected to provide a small boost to the residential construction sector, but it remains to be seen whether they can materially affect the supply of low-cost housing. In the non-residential construction, the big news will be the new 'Building Australia Fund', which will pay for new national transport and communications infrastructure out of current and future budget surpluses.

The transport sector will benefit from increased public infrastructure investment in road, rail and ports, but heavy vehicle road user charges are to be phased up over several years. This will cost the trucking industry an additional $40mn in 2008-09, rising to $190mn in 2011-12.

There are significant measures to reduce greenhouse gas emissions

This Budget includes $2.3bn worth of measures aimed at tackling climate change over the next five years. Much of this is targeted at the energy sector, including $500mn for 'clean coal' generation projects, $150mn for an energy innovation fund and a solar institute and $240mn for a 'clean business' program.

For most retailers, there are no changes to GST or other retail taxes. The exceptions are increased taxes for ready to drink alcoholic beverages and luxury cars. Ready to drink alcopops will now be taxed at the same (higher) rate as bottled spirits. For new car retailers, the 'luxury' car tax will increase from 25% to 33% for new passenger cars costing more than $57,000. The Government expects this to raise an additional $130mn in 2008-09.

For automotive fuel retailers, there will be no change to taxes and charges, but a national Fuelwatch scheme will commence in December 2008. This will require all petrol stations to notify their prices to the ACCC daily, for the following day. LPG and diesel prices will also be monitored informally. This scheme will cost $20.9mn over 4 years to implement.

Private health insurers will be adversely affected by the increase in the Medicare Levy Surcharge threshold

Of the service industries, the most directly affected by this Budget is the health sector. Health insurance companies are likely to suffer reduced membership due to the increase in the Medicare levy thresholds, which will make an estimated 400,000 people no longer liable for the Medicare Levy Surcharge. For public hospitals and health services there is a new 'health and hospitals reform plan', which will increase spending on preventative health, aged care and indigenous health as well as public hospitals. The Health and Hospitals Fund — like the Education Investment Fund — will provide capital investment in public hospitals, health facilities and research projects.

Sally Auld
Co-Head of Australian Economics and Interest Rates Research

Financial market implications

Financial market reaction

The Government's underlying cash surplus for 2008-09 was better than expected, coming in at $21.7bn. Bond market reaction to the Budget release was muted. The Jun-08 bank bill futures contract was unchanged, while the 3-year bond futures contract fell 1bp to 93.745. The 10-year bond futures contract was unchanged at 93.81. There was more action in the currency market; the Australian dollar rallied slightly to US$0.9442 just after the release but was then sold back down to the US$0.94 level.

We think the net effect of the spending and tax cut measures in 2008-09 will still be stimulatory for the domestic economy. However, the market appeared very reluctant to read too much into the Budget in terms of implications for monetary policy.

Bond Issuance Programme

The Australian Office of Financial Management's (AOFM) bond issuance program for 2008-09 will remain in line with the Government's aim to maintain liquid and efficient Treasury bond and bond futures markets. Interestingly, the Budget papers noted that:

"As demonstrated over recent months, the markets for Treasury Bonds and Treasury Bond futures contracts provided important anchors for Australia's financial system as it responded to the impact of credit and liquidity concerns sparked off by the sub-prime housing crisis in the United States of America."

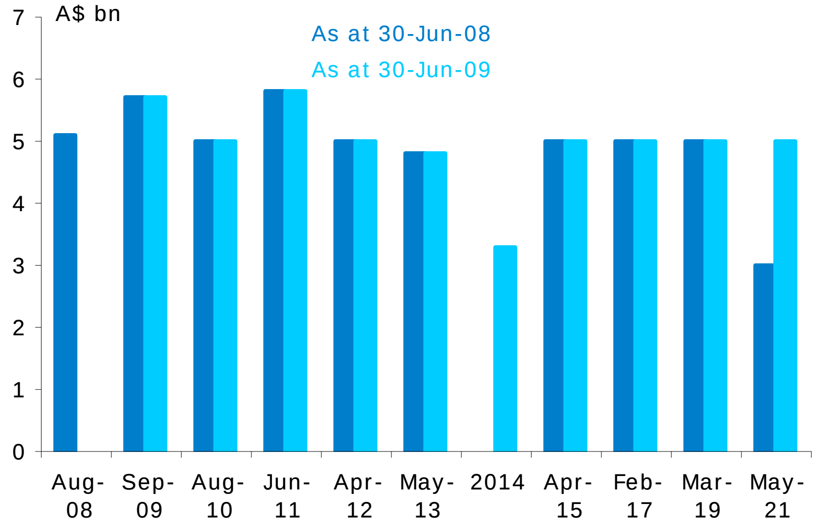
The future of the Commonwealth bond market has finally been decided in favour of retaining it.

We take this as an explicit acknowledgement that debate over the future of the Commonwealth Government bond market has been finally been decided in favour of retaining the bond market.

Our calculations suggest that the size of the ACGB market is likely to remain broadly stable over the next 12 months at a little over $49.5bn. Gross issuance in 2008-09 will amount to $5.3bn. This issuance will be directed towards a further $2.0bn of the May 2012 bond, and $3.3bn of a new June 2014 bond.

Taking into account maturities and Australian Government holdings, net issuance in 2008-09 will be around $0.2bn. This will take the amount of Australian Commonwealth Government Bonds (ACGBs) on issue to $49.6bn by 30 June 2009. We expect the maturity profile of ACGBs to look as follows:

Australian Commonwealth Government Bonds



Source: ANZ Economics and Markets Research

The Treasury also noted that the three lines of inflation linked bonds are expected to mature "without replacement". Currently, there are around $6bn of these securities on issue. The first bond to mature will be $1.5b of the August-2010 bond.

Withholding tax on semi-government bonds and AGCBs stays

There was no material change to the withholding tax arrangements for semi-government bonds or ACGBs. The only change announced in the Budget was an intent to reduce the 30% non-final withholding tax rate on Australian managed investment trusts to 7.5% over the next three years.

Three new funds established; Future Fund in good shape

Three new funds were announced in the 2008-09 Budget, designed to finance infrastructure investment in the transport, communications, education and health areas

Three new funds were announced in the 2008-09 Budget, designed to finance infrastructure investment in the transport, communications, education and health areas. The funds will be established by January 2009 and the Government has committed to placing $40b into these funds in 2007-08 and 2008-09. The funds are named the Building Australia Fund (transport and communications), the Education Investment Fund (which subsumes the existing Higher Education Endowment Fund) and the Health and Hospitals Fund.

The Future Fund, which was established to offset the Government's unfunded superannuation liabilities, will receive a further $3.9b injection (from the $6.6b that is to be received from the Telstra 3 sale due in this month). The Government notes that "…the Future Fund will now be on track to fully fund superannuation liabilities for Australian Government employees by the target date of 2020."

Key policy measures at a glance

Families and older Australians

- Tax cuts worth $46.7bn over four years, as per the Government's election commitments.
- A 50% Education Tax Refund worth $4.4bn over four years.
- An increase in the Child Care Tax Rebate from 30% to 50% at a cost of $1.6bn.
- A $2.2bn package covering First Home Saver Accounts, a National Rental Affordability Scheme and a new Housing Affordability Fund.
- $719mn to close the life expectancy gap between Indigenous and non-Indigenous Australians, including $321mn for the Northern Territory Emergency Response in 2008-09.
- Extension of 'one-off' lump sum payments of $500 for older Australians, $1000 for Carer Payment recipients and $600 for Carer Allowance recipients, at a cost of $1.8bn in 2007-08.
- Introduction of income tests for the Family Tax Benefit Part B and Baby Bonus, essentially restricting access for families in which the principal income earner earns more than $150,000 per annum.
- Increase in the Medicare Levy Surcharge income threshold from $50,000 to $100,000.
- An increase in the luxury car tax rate from 25% to 33%, generating additional revenue of $555mn over four years.
- Increase in excise on 'ready to drink' alcoholic beverages worth $3.2bn over five years.

Education

- $2.5bn over 10 years for the Trade Training Centres in Schools Program.
- $1.9bn over five years to deliver up to 630,000 additional training places.
- $1.2bn over five years for the Digital Education Revolution to deliver computers and communications technologies to all Year 9-12 students.
- $577mn to improve literacy and numeracy outcomes for students.
- HECS initiatives for maths and science students at a cost of $626mn, and $500mn by 30 June 2008 to upgrade university facilities.
- The establishment of an Education Investment Fund (which will absorb the previous government's Higher Education Endowment Fund), which will receive an initial endowment of $5bn funded in addition to the $6bn already in the HEEF.

Health

- An immediate allocation of $1bn to relieve pressure on public hospitals.
- A $3.2bn National Health and Hospitals Reform Plan, including $781mn on dental health, $600mn to reduce elective surgery waiting lists, $390mn to upgrade hospital and community health infrastructure, $275mn for GP Super Clinics and $249mn for the National Cancer Plan.
- The establishment of a Health and Hospitals Fund with an initial allocation of $10bn funded from the 2007-08 and 2008-09 Budget surpluses.

Climate Change and Water

- Measures worth $2.3bn over five years from 2007-08 to reduce greenhouse gas emissions. This includes $381mn for a National Clean Coal Fund, $228mn for a Renewable Energy Fund, $240mn for the Clean Business Australia program and $150mn for an Energy Innovation Fund. Also included are measures to help households to reduce emissions such as the Green Loans program ($300mn) and the Low Emissions Plan for Renters ($150mn).
- A $1bn program to attract investment in desalination, water recycling and major storm water capturing projects.

Infrastructure

- Establishment of the Building Australia Fund, with an initial allocation of $20bn, funded largely from the 2007-08 and 2008-09 Budget surpluses.

Innovation

- $251 over five years to establish Enterprise Connect Innovation Centres to connect businesses with new ideas and technology.
- $326 million over four years to fund four year Future Fellowships and $209 million over four years to double the number of Australian Postgraduate Awards.
- $500mn for the Green Car Innovation fund to encourage the development and manufacture of low-emission vehicles in Australia.

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