2008-09 Budget preview
Swan diving into a sea of inflation

• New Labor Treasurer Wayne Swan delivers his maiden Budget speech at 7pm on Tuesday, 13 May – this is the first budget by a Labor government for 13 years.

• Treasurer Swan has committed the government to delivering a Budget surplus equivalent to 1.5% of GDP (about $18 billion). The Budget surplus for 2008-09 is likely to be at least $20 billion.

• The Treasurer will have to appear to hand down an austere budget to show that the government is serious about fighting inflation, while also handing out buckets of cash to low and middle income earners via the tax cuts.

• The Treasurer must reinforce to financial markets and the electorate that the new government is a credible manager of the economy, traditionally the badge worn by the previous government, not by Labor.

• A potentially huge issue for markets would be any reference in the Budget speech to the government changing the RBA’s inflation target range to, presumably, a higher range.

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New Labor Treasurer Wayne Swan delivers his maiden Budget speech at 7pm on Tuesday, 13 May – this is the first budget by a Labor government for 13 years. Mr. Swan, a novice in Government and as Treasurer, must perform a precarious high wire act. Financial markets demand that he deliver a healthy Budget surplus, while the electorate demands that he simultaneously deliver the promised support for “working families” and income tax cuts – it would be political suicide to back out now. At the same time, he must trim the bloated fat that inevitably accumulated over 12 years of Coalition government.

To do so, the Treasurer will essentially take from the rich, via higher luxury taxes, and give to the poor in the form of lower taxes, increased rebates and targeted new spending. The Treasurer simultaneously will have to appear to hand down an austere budget to show that the government is serious about fighting inflation, while also handing out buckets of cash to low and middle income earners via the tax cuts.

The most challenging budget background for years

One theme the Treasurer will attempt to hammer home during his Budget speech is the assignation of blame to the previous government for fiscal profligacy and, as an extension, high inflation. The government will portray itself as stepping in with welcome fiscal restraint to help solve the inflation problem and make life easier for “working families”.

With the Australian economy slowing, global growth sagging, inflation accelerating, and financial markets still in turmoil, however, framing this Budget will have been a particularly challenging task. The Treasurer must reinforce to financial markets and the electorate that the new government is a credible manager of the economy, traditionally the badge worn by the previous government, not by Labor.

Figure 1: The Budget balance

To do this, the Treasurer must promise to tuck away future surpluses, which likely will average 1.5% of GDP over the out-years, rather than spray them around the electorate ahead of the next election in 2010. Treasurer Swan has committed the government to delivering a Budget surplus equivalent to 1.5% of GDP (about $18 billion). The surge in company tax receipts (up 106% since 2002), owing partly to the soaring terms of trade, however, helped along by expenditure restraint, mean this should be a doddle. In fact, the Budget surplus for 2008-09 is likely to be at least $20
billion. The estimated 28% rise in the terms of trade this year alone will add up to $15 billion to government coffers.

**Veneer of austerity … masking a massive tax cut**

The challenge, though, will be framing a credible Budget for the out-years, given the difficult economic circumstances and the extensive lost of Labor’s existing commitments. In particular, the Government tied one hand behind its back by “ring-fencing” the GST from change, protecting the vast education and health budgets from the “razor gang” scouring the books for expenditure savings, and promising little change to middle class welfare arrangements, which are crying out for reform. Of course, the government also promised generous personal income tax cuts over the next three years.

These policy strictures mean the government has limited options in this Budget, and must make significant savings in policy areas not ring-fenced. Spending, in particular, became unnecessarily bloated under the previous Coalition government.

**Economic environment – “inflation, inflation, inflation …”**

The back-drop to this Budget is the most challenging for some time – the economy clearly is slowing, financial markets remain in turmoil, unemployment has started to rise and the world’s largest economy is flirting with recession. On the flipside, however, Australia’s terms of trade, which already is at a 50-year high, is likely to rise another 28% in 2008 alone. This will mean that company tax receipts will be cushioned against falling profits owing to weaker domestic economic growth.

![Figure 2: Revenue and expenditure](source)

Since being elected last November, Treasurer Swan and Prime Minister Kevin Rudd repeatedly have highlighted the extent of Australia’s inflation problem. In response, the Government has made clear that austerity will be the name of the game on Tuesday week. The revelation in the Q1 CPI data that Australia’s inflation problem is even more acute than most people believed means the need for fiscal austerity is even greater.

In a recent speech in Canberra, Treasury Secretary Ken Henry indicated the Budget would include a downgrade to Treasury’s forecasts for economic growth and upgrades to Treasury’s forecasts of inflation. In the pre-election economic and fiscal
outlook statement released last November, Treasury forecast GDP growth of 3.5% and inflation of 2.75%. The government’s growth forecast is likely to be closer to 3%, and the inflation projection probably will be 3.75%. Mr. Henry also said that estimates of a budget surplus of $30 billion were too high.

Budget parameters – plenty of cash in the coffers

The huge bounce in tax revenue owing to firm domestic economic growth and, in particular, soaring company tax receipts, and more careful management of expenditure, relative to the previous government, mean that Treasurer Swan should be able to deliver a budget surplus of at least $20 billion for 2008-09, about 1.6% of GDP. This would be a significant improvement on the “rubbery” estimate of a $17 billion surplus released recently. In the out-years, the budget is likely to show projected surpluses averaging 1.5%, in line with the government’s long-term commitment.

Table 1: Economic forecasts

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PEFO is the Pre-election Economic and Fiscal Outlook released in November 2007.

Revenue growth has been firm owing to higher company tax receipts, but receipts from superannuation tax flows and capital gains tax have fallen, owing partly to recent weakness in equity markets. Rising interest rates and slower growth in the domestic economy probably will squeeze company tax receipts from here, but the soaring terms of trade will cushion earnings from the mining sector.

On expenditure, Finance Minister Lindsay Tanner, who heads the government’s “razor gang”, has targeted savings of between $3-4 billion for 2008-09 alone.

Likely revenue measures – tax cuts (but not for all)

The Government has limited its options on revenue by making commitments not to adjust the 10% rate of the GST. The government recently announced a tax increase for “alco pops”, but has its hands tied by the pre-election commitment to provide yet more personal tax relief. There are likely to be revenue changes in a number of portfolios, including the following measures, some of which already have been leaked or announced by the government:

- delivery of the promised personal income tax cuts for 2008-09, and commitment to further tax breaks in 2009-10 and 2010-11. The tax cuts are
worth $7 billion in 2008-09, and $131 billion across four years. The tax relief will accrue mainly to lower and middle income earners.

- From July 2008:
  - The threshold for the top 45% personal tax rates will rise from $150,000 to $180,000. This will be worth $50 per week for someone earning at least $180,000 per year.
  - The lower threshold for the 40% tax rate will rise from $75,000 to $80,000. This will be worth $21.15 per week for someone earning $80,000 per year.
  - The upper band of the income threshold for the lowest 15% tax rate will rise from $30,000 to $34,000 and the lower band of the 30% tax rate will rise from $30,001 to $34,001.
  - Tax cuts for those earning more than $180,000 per year will be deferred, at a saving to the budget of $3 billion over the forward estimates. These savings will be directed into an education tax refund for all families receiving family tax benefit A.

- The government probably will reinforce its six-year tax plan, which aims to flatten the income tax system by 2013-14 to reduce from four to three the number of tax rates, at 15%, 30% and 40%.

- increased tax rates on alcohol. Press speculation has centered on higher taxes on beer and wine, following the recent increase in the tax on pre-mixed drinks. The price of beer could rise by as much as 50 cents per glass. Wine prices could rise by 65 cents per glass. The most likely change, however, is that the wine excise will rise, with the beer excise left unchanged.

- confirmation of the 70% rise in the tax on “alco pops”, which should raise an additional $2 billion over four years.

- a 2.5 cent per pack rise in the excise on cigarettes. This could raise as much as an additional $400 million per year.

- confirmation of the increase in the child care tax rebate that was announced earlier this year. The tax rebate for eligible families was raised from 30% to 50%.

- a plan to link the Future Fund to a public-private partnership as an accelerator to infrastructure needs under Infrastructure Australia.

- confirmation of the education tax rebate program announced before last year’s election, at a total cost of $1 billion.
changes to the tax arrangements on large, luxury cars to discourage people from driving fuel—inefficient vehicles. The fringe benefits tax arrangements are most likely to change, rather than the import duties. This allows the changes to be sold as green measures rather than a tax on the rich.

changes to the taxation arrangements of futures options granted to higher income earners. The measure will close a loophole that allows recipients to choose when and at what value, they will pay tax.

the provision of more colour on the planned carbon trading and tax arrangements, which are scheduled to come into force in 2010.

Likely expenditure measures – razor gang delivers

The government’s bean counters have been going through the books with a fine tooth comb searching for spending fat that can be trimmed. Pet projects of the previous Coalition government are obvious targets. As with the likely revenue measures, many initiatives have been leaked or announced pre-budget:

formal provision of a 3% annual real increase in the $20 billion defense budget. The cost will be $2.4 billion over four years. It is unclear how this sits with a later commitment to shave $10 billion from the defense budget over the next decade.

additional funding to back up the government’s earlier promise of providing laptops to school students. State governments have baulked at having to fund peripheral costs like software, maintenance, cabling, etc.

more funding to alleviate Australia’s chronic infrastructure crisis – further funding for “nation building” projects like roads, power and other transport.

more funding for measures to address skilled labour shortages, including training and transition to employment initiatives.

partial means testing of Family Tax Benefit B, a high-profile Howard government initiative, as the opening gambit in what is likely to be an extended crack down on bloated middle class welfare. At the moment, FTB B is not tested against family income.

$300 million to provide a cheap source of finance to aged care providers and $100 million to boost aged care services, in line with earlier announcements. The government also may announce further aged care initiatives, but in the out years of the budget forecasts.

$100 million of additional funding for ASIC. Earlier, the government announced a $130 million cut to the corporate regulator’s budget, but this has been reversed.

provision of funding to account for the recently announced changes of legislation for same sex marriages. The changes have implications for both taxation and welfare payments.
$25 million for extra law and order, and health services in Aboriginal communities in the Northern Territory.

an extension of the $400 million for a one of carers’ payment made in 2008-09, along with further colour on a possible extension of the $1.3 billion senior’s bonus paid in 2008-09.

at least $500 million of additional funding for public hospitals, including initiatives already announced.

confirmation that the baby bonus will rise to $5,000 from 1 July, which costs $1 billion per year, and that it will be means tested for higher income earners.

$500 million to establish a green car fund, in line with an earlier announcement by the Industry Minister.

confirmation of a substantial increase in funding for water infrastructure, much of which was announced last week. The measures will include:

  - The provision of $500 rebates for each household that installs a water tank.
  - $3 billion to allow water to be bought back and returned to the Murray Darling river system.
  - $5.8 billion for the establishment of sustainable irrigation and further return of water to rivers.
  - $1 billion for an urban water and desalination program.
  - $300 million for small town urban water infrastructure provision.

the government also probably will announce substantial expenditure savings, including:

  - confirmation of the cancellation of the private contract signed by the previous government to provide regional Broadband.
  - operational savings of up to $5 billion following the “razor gang’s” examination of the government’s finances. This probably will include the returns from the 2% efficiency dividend imposed on all federal departments.
  - confirmation of the $643 million of savings already announced.
  - a $400 million cut to the CSIRO’s budget, mainly in research programs.
  - streamlining of official travel with, for example, Parliamentarians being forced to redeem frequent flyer points.
Possibly, inclusion of the $4.7 billion saved on the regional broadband network.

**Superannuation**

The government will provide more details on its initiative to foster a culture of savings, including:

- more colour on the “Learning for Life” account concept that can be tapped to fund training and education. This initiative emerged from the recent 2020 summit in Canberra.

- the government may release a mini budget later this year aimed specifically at superannuation policies. One aim may be to use superannuation to soak up the additional liquidity provided by the mid-year personal tax cuts.

**What will not be in the Budget – ring-fencing ad nauseum**

The following measures, some of which have been pushed by the various lobby groups, are unlikely to be included in the Budget.

- any change to the 10% GST rate. The Prime Minister and Treasurer have reinforced the ring-fencing of the GST in recent public comments.

- changes to the government’s current tariff arrangements. Press speculation indicates that the current arrangements to lower tariffs again in 2010 are under review.

- there will be no changes to the 9% superannuation levy, even though Labor’s policy platform carries a long-term target of 15%.

- no additional personal income tax cuts in addition to those already announced. RBA officials probably would not take kindly to the government pouring further fiscal fuel onto the economy’s fire, which RBA rate hikes are supposed to be dousing.

- no wholesale scaling back of middle class welfare arrangements (with the exception of means testing FTB B) - this will come later. In 2008-09, welfare payments are likely to have cost $99 billion, just under 40% of all expenditure.

- no changes to the first home owners’ grant. There was speculation that the government might announce a means testing of payments.

- no changes to the petrol excise arrangements. Reductions are expensive and the impact can be swamped by rises in crude oil prices.

- no wholesale change to the $46 billion health budget, which the Prime Minister has ring-fenced against expenditure savings.

- no major changes to the $15 billion education budget as part of the government’s “Education Revolution”.

- no cut to the 30% company tax rate - the Australian Industry Group has called for a 25% tax rate, which could cost as much as $11 billion per year.
- no cut to the $6.6 billion budget within the defense portfolio for the purchase of Hornet fighter jets.

**Bond issuance**

Government bond issuance has been averaging $5 billion per year since 2003. Issuance in 2008-09 is likely to be approximately $5.2 billion. The government is likely to announce a number of initiatives to boost liquidity, including:

- an increase in the size and/or frequency of bond issuance. The government also may announce a more consolidated program of bond issuance to boost market liquidity; and
- the Australian Office of Financial Managements probably will be allowed to except from counter-parties semi-government bonds, rather than just Treasury bonds, to boost liquidity.

**Financial market implications**

- For bond and currency markets:
  - bond investors will be looking for the size of projected surpluses and bond issuance.
  - foreign exchange investors will be looking for any references to the inflation target.

- For equities:
  - **Resources.** More colour on the introduction of a carbon trading scheme earmarked for 2010 would positively impact companies with domestic gas exposure (e.g. STO, QGC, AWE and WPL). The imposition of a carbon trading tax would be negative for the likes of BSL and OST given the amounts of greenhouse gas produced at their plants. The provision of additional details would facilitate planning to meet future obligations relating to the scheme (e.g. the feasibility of BSL cogeneration plant at Port Kembla) and whether any exemptions apply to their greenhouse gas emissions.
  - **Retail.** Personal income tax cuts should benefit retailers of higher-end consumer discretionary stocks (e.g. HVN, JBH, BBG and DJS). Consumers will resume spending on plasma TVs, gaming consoles, and luxury consumer apparel. Rising interest rates and elevated petrol prices may mean, though, that consumers choose to save more of their tax cuts compared to in previous years. The rise in the baby bonus will benefit WOW and WES as parents stock up on newborn staples from K-Mart, Target and Big W.
Food and Beverages. The confirmation of a 70% rise in the tax on RTDs is bad news for FGL and LNN; these stocks will, however, benefit from any rotation into beer. CCL would also suffer as it manufactures and distributes some RTD labels. Agricultural companies (e.g. GNC, AWB and ABB) should favour from increased government spending on buying back water rights in the Murray-Darling Basin (MDB). The MDB is over irrigated and the buyback of water will make future allocations of irrigation less certain. This will drive a shift from rice and cotton into seasonal broadacre crops less reliant on irrigation, such as wheat; thus, benefitting grain companies. A further $5.8bn in spending on the establishment of sustainable irrigation and $1.0bn for urban water desalination and water recycling plants will benefit construction and environmental engineering firms (e.g. LEI, UGL and COF). Providers of water tanks and equipment (e.g. ALS, WES, and GUD) will favour from the $500 rebate to households that install water tanks.

Building Contractors and Developers. Any increase in funding for infrastructure to assist in alleviating bottlenecks at ports and improving roads, power and other transport will be welcomed by the resources services sector and companies including LEI, UGL, DOW and BLD.

Health and Aged Care. Budget initiatives for increased aged care services of around $300m are an incremental positive for BBC. Additional funding for public hospitals of at least $500m should have a limited impact on private hospital operators (RHC), provided there is no significant expansion in capacity for the public hospital system.

Telecoms. The Government has committed $4.7bn in invest in a national broadband FTTN (fibre-to-the-node) network. Further details regarding pricing and whether the Government will have an equity stake will be of interest to TLS and SGT who are both in competition for the tender. The concern is that total expenditure for the project has been underestimated, meaning that more government funding will be necessary.

Superannuation. Previously, the Government expressed its intention to increase the 9% superannuation levy to 15%. Any increase in the amount of the mandatory superannuation payment will be a fillip for the funds management industry through increased net fund inflows. Those likely to benefit would include AMP, AXA, IFL and COU.

Left field - debate over the RBA’s inflation target range

A potentially huge issue for markets would be any reference in the Budget speech to the government changing the RBA’s inflation target range to, presumably, a higher range. There has been speculation that the Government should revisit the recent agreement that reinstated the 2-3% target range. Pushing the target range up when
inflation is running well above the existing target, however, would seriously damage the RBA’s credibility.

It is, therefore, likely that the Treasurer instead announces a review of the target, rather than an adjustment to the target range. If raising the target range is, indeed, favoured within government, it probably will not be discussed on Budget night - it would distract attention away from the government’s fiscal agenda.
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