

2007-08 Federal Budget

The federal government expects to run an underlying cash surplus of \$10.6 billion in 2007-08, equating to 1.0 per cent of GDP, down from \$13.6 billion (1.3 per cent of GDP) in the current 2006-07 financial year. The expected surplus this financial year is \$2.8 billion higher than it was expected to be when last year's budget was unveiled, and \$1.8 billion higher than it was expected to be as recently as December in the mid-year economic and fiscal Outlook (MYEFO) - both upgrades mainly courtesy of stronger than expected economic growth.

Faced with overflowing coffers thanks to a once in a generation (if not two or more) peak in Australia's terms of trade, Canberra has attempted to share its embarrassment of riches without overtly and significantly increasing the risk of another cash rate increase either later this year or in 2008. Have they got the mix right, and if so, how have they done it?

The answer to the first question is almost, but not quite, because a net \$3 billion (0.3 of a percentage point of GDP) fiscal stimulus when upside inflation risks remain live (albeit less pronounced than they were before the most recent CPI) clearly has the potential to be one of a range of factors that in time tip the scales in favour of a bit more fine tuning of monetary policy.

Even before we get to 2007-08, the budget includes new net spending of \$3.9 billion before the end of the current financial year, although \$1.1 billion of it is a doubling of the superannuation co-contribution for low income earners, which will not fuel inflation - if anything, to the extent that it induces eligible wage earners to forgo current consumption to maximise the co-payment, it will take some of the steam out of inflationary pressures. Most of the rest comprises a \$500 per person bonus payment to seniors (\$1.3 billion); bonus payment to carers (\$390 million); and \$451 of earlier repayments of child care rebates.

From the first pay packet of 2007-08, personal income tax cuts, costing \$5.3 billion annually, will be enjoyed mainly by low income earners, while the annual cost of personal tax cuts rises to \$8.3 billion in 2008-09, when middle to high income earners get another round of tax cuts. Moreover, as well as earlier child care payments (costing a total of \$1.4 billion over the 5 years to 2010-11), a 10 per cent increase in child care rebates from 2007-08 will cost \$143 million in that year, and a total of \$548 million in the 4 years to 2010-11.

Any or all of the above could, depending on whether the tax cuts/increased payments are spent or saved, add to inflationary pressures depending on how robust economic growth is in 2008 and beyond, and, importantly, whether the Australian economy is, by then, still operating close to full capacity.

So to the extent that Canberra has at least minimised the risk of a serious clash between monetary and fiscal policy, how have they achieved it (ie the second question)?

- Firstly, by assigning \$5 billion of this financial year's surplus to establish a Higher Education Endowment Fund (HEEF), attached to the already established Future Fund, the **earnings** of which (estimated at \$3.4 billion in the 4 years to 2010-11) are earmarked for universities' capital works and research (\$1.7 billion); vocational education and training (\$638 million); schools (\$579 million); improvements to teacher quality (\$264 million) and improvement to access to higher education (\$222 million). And also ...
- By assigning \$3 billion of the well publicised \$10 billion water security scheme to the next 4 years;
- By spending an extra \$5.8 billion on defence in the next 4 years, \$4 billion of which is for the purchase of super hornet fighter aircraft; and ...
- By announcing a range of other initiatives, including support for rural Australia, increased overseas aid and spending on Indigenous Australians and a *Securing the future of aged care for Australians* package.

The Future Fund itself is still very much alive and well, having been started with \$18 billion two budgets ago, getting another \$13.6 billion from the 2005-06 budget surplus and \$17.6 billion from Telstra sale proceeds. But given that Canberra also expects to tip more from the second instalment of Telstra proceeds into the Fund, it is now making only a loose commitment to ... "consider a transfer to the Fund from the 2006-07 Budget surplus once it is realised".

If the \$4.8 billion assigned to the AusLink 2 road funding project (which is really just an extension of the existing AusLink 1), the clutch of new spending/tax cut measures add up to a chunky \$57 billion in the 5 years to 2010-11.

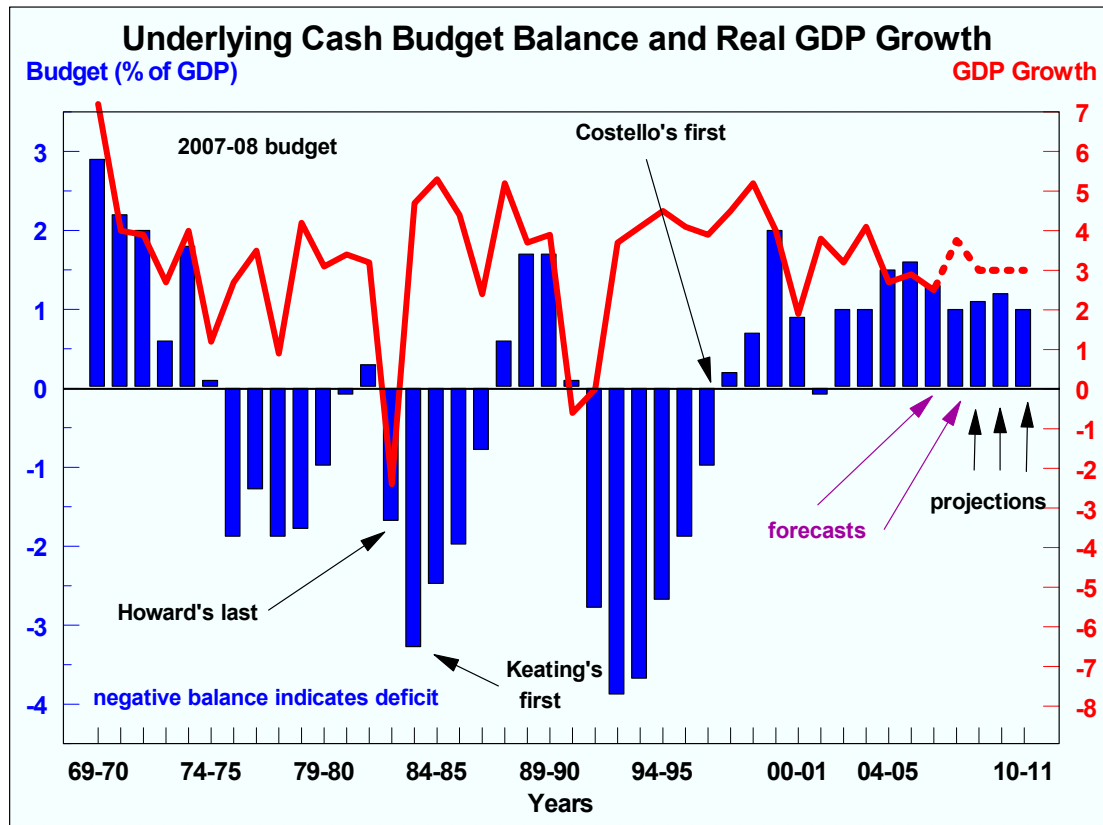
As always, Canberra's capacity to dole out its largesse depends crucially on the economy's capacity to deliver revenues and limit outlays. Real GDP is expected to grow by 2½ per cent this year, then ramp up to 3¾ per cent in 2007-08, before settling at 3 per cent in each of the next 3 years to 2010-11. Treasury had broken with tradition last year by diverging from the trusted 3 per cent in the out years, daring to go all the way to 3¼ per cent in 2008-09 and 2009-10, but both of those years have been clipped back to 3 per cent, the earlier year in part because growth in 2007-08 is now expected to be a bit higher than it was last year.

All components of domestic demand are expected to pull their weight in 2007-08, including business investment even though the cycle is mature and the level of investment is already at a high base. Household consumption is forecast to grow at a solid 3½ per cent, but net exports are again expected to clip growth (by half a percentage point - less of a drag than the 1¼ percentage points the excess of imports over exports is expected to subtract from GDP growth this financial year).

Treasury has also reverted to tradition by assuming a return to normal conditions down on the farm in 2007-08, which is expected to account for around 0.5 pf a percentage point of the expected 3¾ per cent growth in GDP.

Treasury expects the unemployment rate to average 5 per cent in 2007-08, up from 4¾ per cent this year, and to stand at 5¼ per cent at the end of June 2008. CPI inflation is forecast at 2½ per cent in 2007-08, and 2¾ per cent in the year to June 2008, the latter of which is smack in the middle of the RBA's forecast range for both headline and underlying inflation in the year to June 2008.

As the federal election approaches, the budget itself may not, in fact probably is not, the last word on the trade-off between monetary and fiscal policy - yes, there is one - in 2008. Given that Canberra is giving nothing more than "consideration" to the transfer of a portion of the 2006-07 surplus into the Future Fund, the scope for both sides to engage in a fiscal full of dollars bidding war in the lead-up to the poll itself is more than trivial.



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