Australia's Budget

Federal Budget 2012/13: Surplus or bust

Making Sense of it

The Federal Budget is hardly the most riveting document you are ever likely to read. Sure you know it's important, but the problem is that it's a huge document with countless facts, figures and tables. And when it comes to analysis, economists seem to be writing for other economists; and accountants writing for other accountants.

It's always important to remember that it is just a budget, the same that any household or company would prepare. Assumptions are made; forecasts are taken.

For instance the first forecast for the 2011/12 budget outcome was made in May 2008 and a surplus of $18.9 billion was projected. By May 2009 that estimate had blown out to a deficit of $44.5 billion. The deficit for the twelve months to March was just above $38 billion and the latest estimates project a deficit near $44 billion for the current financial year.

But at the end of the day most people want to know what's in it for them. It doesn't matter whether you are a student, pensioner or CEO of a major company.

So we have decided to make this analysis different.

Sure, there are the usual tables, graphs, facts and figures. But we reckon that there are only three questions most people want answered and that's where we will be concentrating:

- **Did the Government get it right?**
- **What does it mean for Australia?**
- **Who are the winners and losers?**

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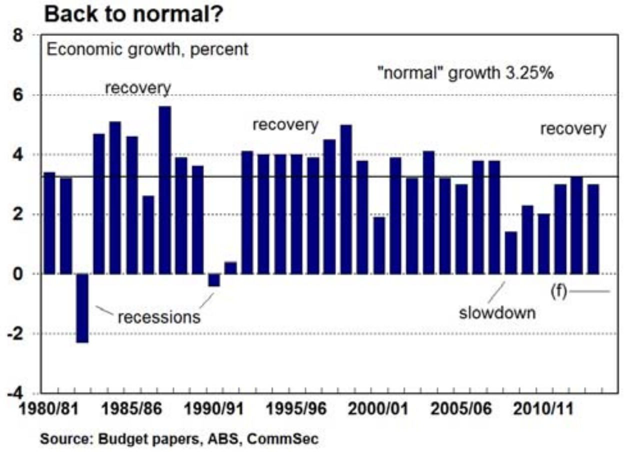
1. The Analysis

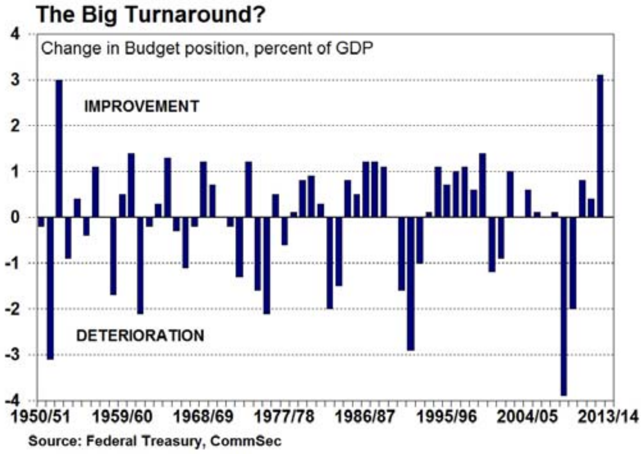
First things first

- This year (2011/12) the budget deficit is tipped to hit $44.4 billion (3.0 per cent of our economy or GDP). Last November, a deficit of $37.1 billion was expected.
- Next year (2012/13) a surplus of $1.5 billion (0.1 per cent of GDP) is expected.
- If the projected surplus is achieved, it will be the biggest one-year improvement in the budget bottom line in 60 years (since 1952/53).
- Revenues are tipped to rise by 11.8 per cent in 2012/13 while real spending is tipped to fall 4.3 per cent.
- Net government debt is expected to peak at 9.6 per cent of GDP in the current year (2011/12).

Did the Government get it right?

- This is very much a Labor budget. This is a clever budget. But it is by no means a horror budget. But at the end of the day, the Government has indeed scaled its mountain – the budget is back in the black, and indeed surpluses are tipped to gradually build over the next four years.
- So the major question of most people's lips is how they managed to conjure up budget surpluses, seemingly from nothing. Because there are few, if any, nasties. No headlines screaming cigs up, beer up, grog up. Unless you are travelling overseas – and who isn't? You will be paying an extra $8, but that hardly breaks the back. Travellers will also only be able to bring in 50 cigarettes duty free rather than 250. I suppose a case of the Government looking after our health. And high income earners lose their superannuation perk – but they aren't battlers, they won't miss it.
- So how did the Government manage to achieve the apparently unachievable – turning a budget deficit of $44 billion or 3 per cent of GDP, into a small surplus? Something that hasn't been achieved in 60 years. In large part it has been achieved by cancelling, revising or delaying proposed programs or initiatives.
- For instance the mooted 50 per cent tax discount on bank account interest is gone. The proposed standard deduction for work expenses is also gone.
- Of course the major change is the company tax cut. That is also gone as well, but in essence it has been replaced. Businesses miss out, but the benefits of the mining boom will be spread to families instead.
- And, as previously announced, spending on defence will be cut. Or perhaps I should say that "efficiencies and programming" will be realised to the tune of $5.4 billion over the next four years. Foreign aid is another casualty, although increased spending is "delayed" not cancelled.
- So a clever budget with delays, deferrals and cancellations of measures. But also a very Labor budget. Of course the budget is inherently a political document as well as an accounting or economic document. Any spending goes to the "vulnerable" or to the battlers. And any nasties as such are grouped under headings such as "improving fairness", "better targeting spending" or "reprioritising".
- Initiatives are few but there is more money to families with school kids. There is a new Disability Insurance scheme and a new Dental Health Scheme.





- And at the end of the day the surpluses are being achieved by policy decisions, not relying on changes in economic assumptions to work the magic. Policy decisions will improve the budget bottom line by $5.8 billion in 2012/13. And indeed policy changes improve the budget bottom line in the two following years.
- While clever, that doesn't mean that the numbers won't come unstuck. It won't take too much bad economic news for the black ink to turn red. And while some of the tough decisions have been shelved in this budget, they will need to be revisited over time.
- It is hardly a visionary budget but it certainly is a budget that meets the Government's objectives.

What does it mean for Australia?

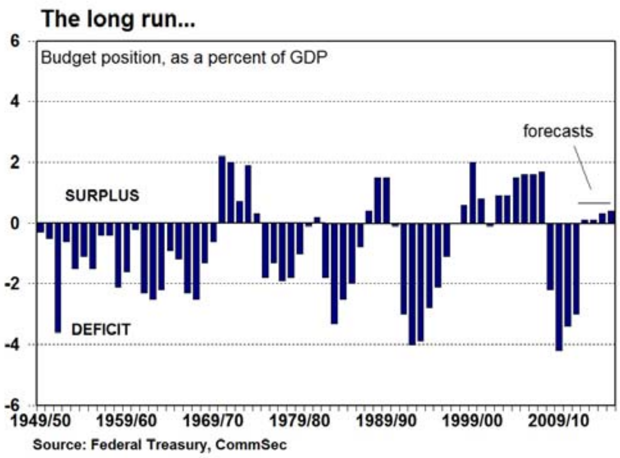
- The economy is not at risk from a "horror" budget. Because spending isn't being slashed, merely delayed, deferred or cancelled. But dollars are being taken out the economy. Fiscal policy is contactionary, so on balance the Reserve Bank can proceed with further rate cuts if desired.
- Australia already had one of the smallest budget deficits of advanced nations and one of the smallest debt positions. And that position has been enhanced. If the Government is successful in its goal, it will have achieved something remarkable – a huge turnaround in the budget bottom line in one year. Something that hasn't been achieved for 60 year. And it will be the first advanced nation to produce a budget surplus after the Global Financial Crisis.
- Still, given the riches that have been bestowed on Australia from the industrialisation in China and the accompanying resources boom, it is right and proper that Australia emerges first from the rubble of the GFC as it was one of the few economies not to have gone into recession.
- While the Government isn't progressing with the company tax cut, this is not an issue that it can abandon completely. Australia's company tax rate remains above those of many advanced nations. To maintain competitiveness a cut in the company tax rate must remain on the radar screen.
- The Government claims that the Budget sends a strong message of confidence. And on that point we tend to agree. Families complain that they are doing it tough. Utility costs are rising, structural change has meant that jobs are being cut, while others are created, and there is uncertainty about the new carbon tax, the mineral resource tax and about the outlook for Europe. The last thing families needed was a "horror" budget with the primary aim of pushing the budget into surplus quickly.
- The carbon tax is coming, but with all the compensation being applied, the impact will be muted. This may be good news for families, but if people are being largely compensated for the tax changes, what is the prompter to change their behaviour – to drive more efficient use of energy? Largely nothing. Is that a problem? Ask the Greens.

Who are the winners?

- Low income families with school children benefit from the SchoolKids Bonus.
- Small Business gains from loss carry-back provisions. From July 1 businesses will be able to write off $6,500 in new equipment. Businesses also can claim $5,000 on cars acquired after July 1.
- Sport: more money is being allocated to redevelopment of sporting grounds.
- Infrastructure: but most spending isn't until 2014/15 at the earliest
- New Aged Care System: but little in the way of new spending in 2012/13.
- Regional Australia benefits by more money spent on roads, schools and hospitals.

Who are the losers?

- Companies lose out as they won't be getting the proposed tax cut – this now goes to families.
- High income earners lose their Superannuation concession.
- The Defence industry carries the burden of spending cuts over the next four years.
- Travellers: departure tax goes up.
- Some workers claiming "living away from home allowances".
- Smokers: cut in duty free allowance on cigarettes.



2. Spending & Savings

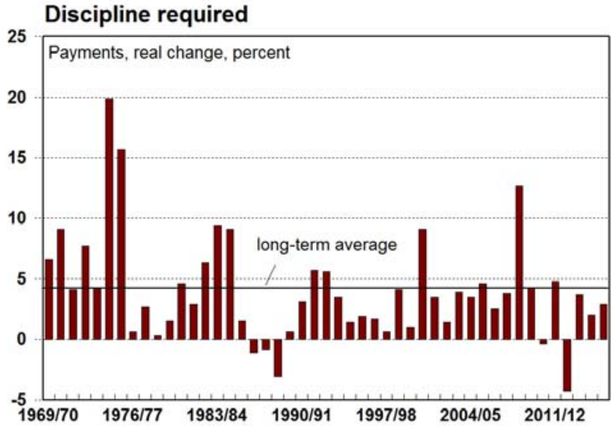
First things first

- Government payments are expected to fall by 4.3 per cent (after inflation) to $364.2 billion.
- Government receipts are expected to rise by 11.8 per cent (before inflation) to $368.8 billion.
- The Government has commited to keep real spending growth to 2 per cent a year, on average, until surpluses are at least 1 per cent of GDP.

What is included in the budget (quotes taken largely in full from Budget papers)

Spreading the benefits of the boom

- $1.8 billion to increase Family Tax Benefit Part A for all eligible families, commencing 1 July 2013
- $1.1 billion for a new Supplementary Allowance for the unemployed, students and parents with young children, on income support, with the first payment commencing March 2013
- In addition, an extra $2.1 billion over five years on a new Schoolkids Bonus, paid directly to eligible recipients
- From 1 July 2012, more than tripling the tax-free threshold from $6,000 to $18,200, freeing up to 1 million Australians from the need to lodge a tax return



Source: Budget papers, CommSec

First steps towards a National Disability Insurance Scheme

- $1 billion over four years for the first stage of a National Disability Insurance Scheme
- 10,000 participants will start being assessed from July 2013, increasing to 20,000 participants from mid-2014

Helping business to invest

- Allowing companies to carry-back tax losses so they get a refund against tax paid in the previous year in 2012-13, increasing to two years from 2013-14, providing a tax benefit of up to $300,000 per year
- From 1 July 2012, delivering tax breaks for small business, like the increase to the instant asset write-off threshold to $6,500

Investing in key health services

- $515.3 million to improve dental services and strengthen the future dental workforce
- Delivering 76 major new regional health infrastructure projects across Australia, worth $475 million
- Investing $61 billion in 2012-13 in Australia's health care system, an estimated 37 per cent increase on 2007-08 levels
- An additional $19.8 billion in reforms to public hospital funding over the period to 2019-20

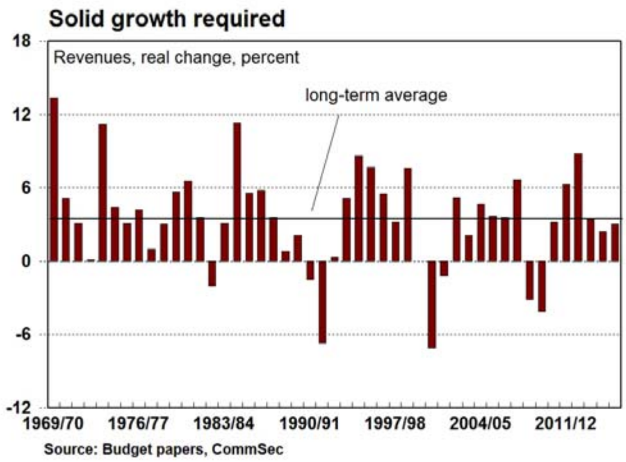
Building an aged care system for the future

- A $3.7 billion package to ensure a better, fairer, more sustainable and nationally consistent aged care system
- Increasing the number of Home Care packages by nearly 40,000, to nearly 100,000, over the next five years

2. Spending & Savings (continued)

What is included in the budget (continued)

Building a more productive workforce



- $1.75 billion National Partnership Agreement on Skills Reform as agreed at COAG in April this year
- Investing an additional $225.1 million in Jobs, Education and Training Child Care Fee Assistance
- An additional $101 million of new skills measures to improve quality and better support mature age workers

Building productivity by investing in nation building infrastructure

- Investing over $36 billion in roads, rail and ports over six years to 2013-14.
- $3.6 billion to duplicate the Pacific Highway by 2016, conditional on agreement with the NSW Government
- $350 million per year for the Roads to Recovery program
- $232 million towards the Torrens and Goodwood rail project in Adelaide

Identified Savings

The Government has identified around $33.6 billion of savings in this Budget over the five years to 2015-16. Savings include:

- not proceeding with lowering the company tax rate, which was due to commence from the 2013-14 income year, nor the early start to lowering the company tax rate for small businesses, which was due to commence from 2012-13. The Government was not able to secure the necessary Parliamentary support and for this reason the decision not to proceed with the company tax cut will now help fund initiatives to spread the benefits of the resources boom to help families on low and middle incomes and support business investment. This measure is expected to increase cash receipts by $4.6 billion over the five years to 2015-16, which includes a reduction in receipts from the unwinding of the associated growth dividend;
- not proceeding with the standard deduction for work-related expenses and the cost of managing tax affairs, which was scheduled to commence on 1 July 2013, as the Government is pursuing other simplification measures, such as trebling the tax free threshold. This will increase cash receipts by $1.6 billion over the four years to 2015-16;
- deferring the higher concessional contribution caps for individuals over 50 with superannuation balances below $500,000 to 1 July 2014, which was due to start on 1 July 2012, increasing cash receipts by $1.4 billion over the four years to 2015-16;
- increasing cash receipts by $1.1 billion over the four years to 2015-16 by providing $106 million over four years to the Australian Taxation Office (ATO) to increase the ATO's collections of outstanding taxation debts and superannuation guarantee charges. This has no impact in fiscal balance terms;
- further reform to the fringe benefits tax concessions for living-away-from-home allowances and benefits by limiting access to the concessions. This measure increases cash receipts by $1.0 billion over the four years to 2015-16;
- reducing the higher tax concession for superannuation contributions of very high income earners, increasing cash receipts by $1.0 billion over the four years to 2015-16;
- extending the 2010-11 Budget measure to fund additional GST compliance activities to promote voluntary compliance by a further two years, increasing cash receipts by $1.1 billion over the four years to 2015-16; and
- not proceeding with the 50 per cent tax discount for interest income which was due to commence on 1 July 2013, saving $795 million over the four years to 2015-16.

➢ 2. Spending & Savings

What is included in the budget (continued)

<u>Outcome, Payments & Revenues</u>

BUDGET BOTTOM LINE

	2010/11a	*2011/12e*	*2012/13f*	*2013/14f*	*2014/15f*	*2015/16f*
Underlying Cash Balance - $B	-$47.7	-$44.4	$1.5	$2.0	$5.3	$7.5
% of GDP	3.4	3.0	0.1	0.1	0.3	0.4
Net debt	$84.5	$142.5	$143.3	$144.9	$140.1	$131.6
% of GDP	6.0	9.6	9.2	8.9	8.1	7.3

Source: Budget Papers

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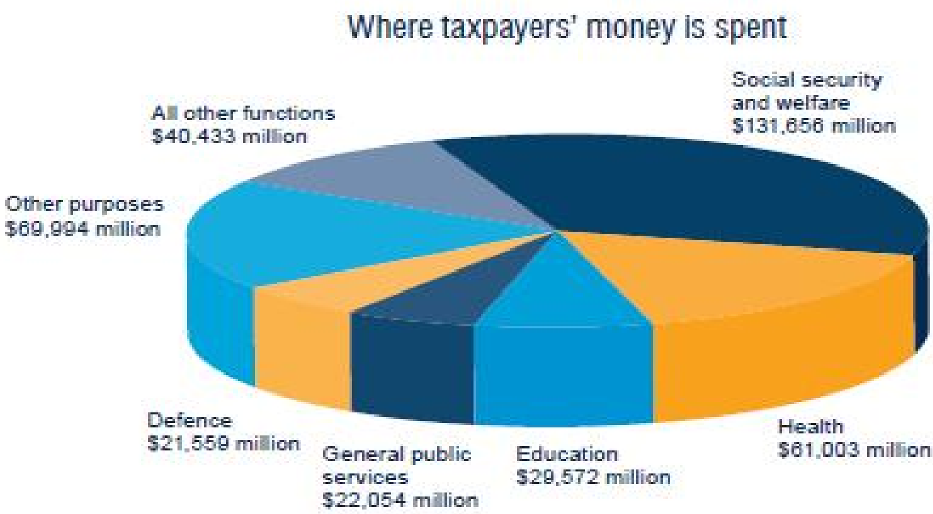
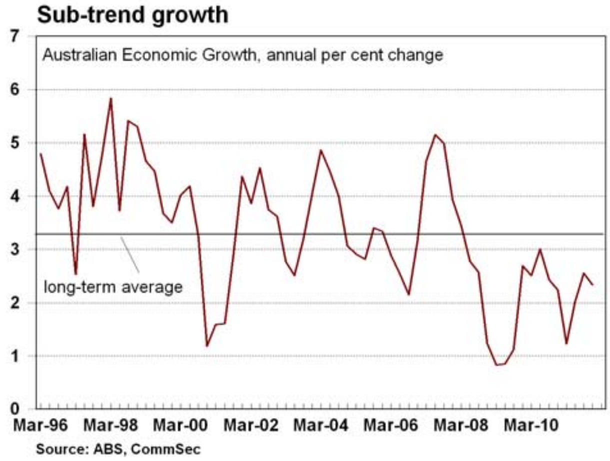


3. The Economy

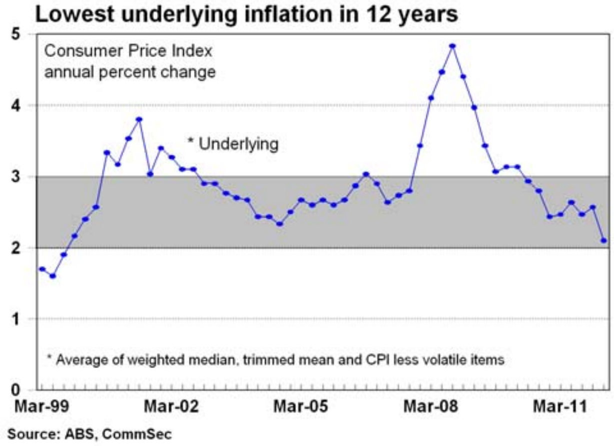
	Last Year 2010/11	This Year 2011/12	Next Year 2012/13	And 2013/14
Economic Growth (% change)	*2.0*	*3.00*	*3.25*	*3.00*
Inflation (% change)	*3.6*	*1.25*	*3.25*	*2.50*
Wages (% change)	*3.8*	*3.50*	*3.75*	*3.75*
Unemployment (%, June quarter)	*4.9*	*5.25*	*5.50*	*5.50*

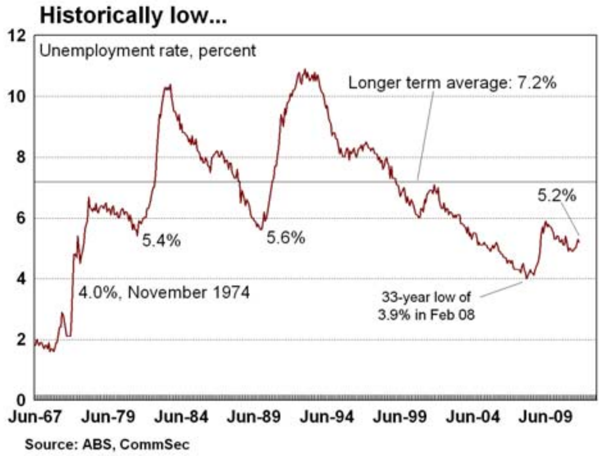
Are the assumptions reasonable?

- In last year's budget, Treasury expected the economy to grow by 4.0 per cent in 2011/12. It probably will grow at a far slower rate around 2.8 per cent. Most of the slowdown can be put down to uncertainty. The European Debt Crisis has spooked consumers and businesses alike. Then there is the uncertainty caused by structural change in the economy, movements in the currency, new taxes and political uncertainty. Similarly Treasury's 4.75 per cent unemployment forecast was too low while the 2.75 per cent inflation forecast will prove way too high. So how will it go this year?
- Treasury tips the economy to lift towards "trend" growth of 3.25 per cent in the coming year (we tip 3.3 per cent; RBA 3.0-3.50 per cent) with the jobless rate near 5.50 per cent (CommSec 5.0-5.5 per cent) and inflation around 3.25 per cent (CommSec 2.75 per cent, RBA 2-3 per cent).



- Nominal GDP – an important driver of government revenue – is tipped to grow by only 5.0 per cent in 2012/13 after 5.5 per cent growth estimated this year and 8.3 per cent in 2010/11. We think this assumption is conservative.
- Last year the government said a surplus was required as the economy faced capacity constraints. No such focus this year. The Government expects the jobless rate to soften to 5.5 per cent by June quarter 2013 from an estimated 5.25 per cent in June quarter 2012.
- The government is making conservative assumptions for coming years. So to ensure surpluses are achieved, the government is forced to make a real contribution to the budget bottom line. Policy decisions are tipped to improve the budget bottom line by $5.8 billion in 2012/13; by $7.6 billion in 2013/14; and by $7.2 billion in 2014/15. By contrast economic parameter variations will worsen the budget bottom line by $7.7 billion in 2012/13; by $9.3 billion in 2013/14; and by $7.6 billion in 2014/15.

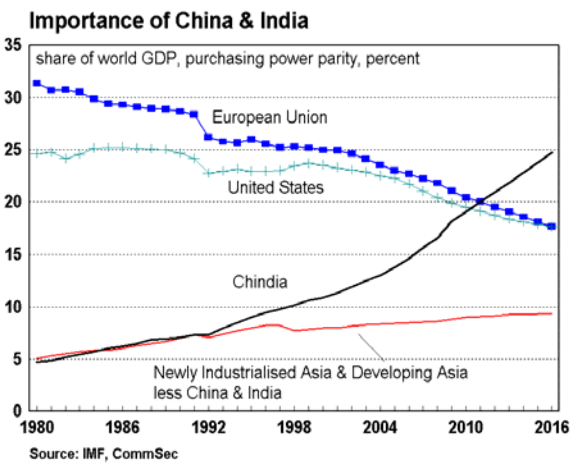


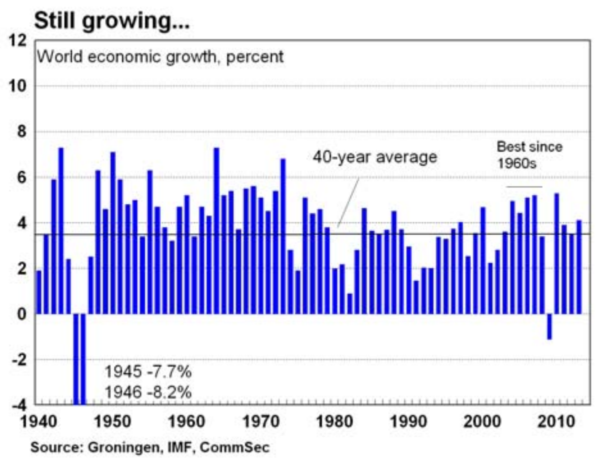


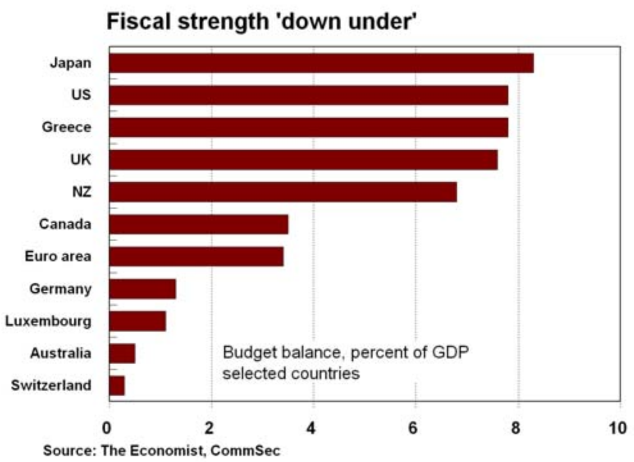
4. Global backdrop

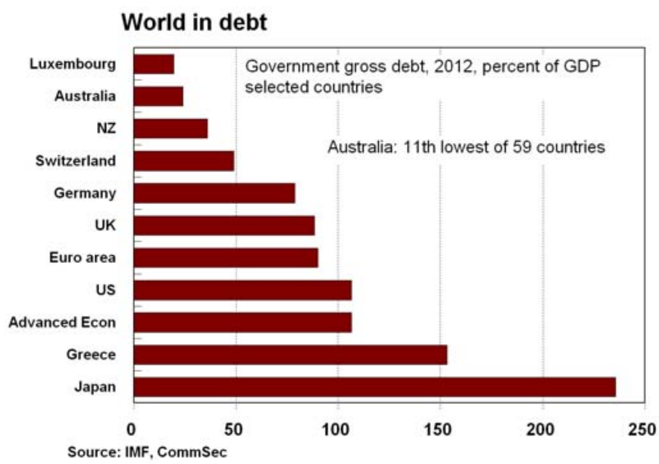
"Trend" global growth

- The International Monetary Fund (IMF) recently upgraded forecasts for the global economy. After expanding 5.3 per cent in 2010 and 3.9 per cent, growth of 3.5 per cent is tipped in 2012 and 4.1 per cent in 2013.
- The forecast for 2012 was lifted 0.2 percentage points and the 2013 forecast lifted a smidgen – 0.1 percentage point. While 3.5 per cent is slower than previous years, it is actually the average growth rate achieved over the past 30 years.
- How can this be given the sluggish US economy and European Debt Crisis? Well effectively the policymakers had become too negative. The US economy continues to grind out an economic recovery. And then there is Developing Asia, streets ahead of other regions and underpinned by solid growth in China and Asia. Developing Asia is tipped to grow by 7.3 per cent this year with the next fastest region being Middle East & North Africa and the Commonwealth of Independent States, both with projected growth of 4.2 per cent.
- The main risks? While China & India together are bigger than the European Union, financial markets are still fixated on high budget deficits and debt as well as geopolitical uncertainty in the latter, constraining global growth. China is also a risk. While policymakers have successfully engineered a soft landing, now the judgement is of the right amount of stimulus to be applied to keep the expansion going.
- And then there is the United States. The economy is recovering, but historically high budget deficits and unemployment and excess supply in the housing market have to be addressed and as such represent risks to the economic expansion. In addition, official interest rates remain close to zero, making difficult to stimulate the economy, although policymakers haven't ruled out another round of "quantitative easing" (purchasing securities in exchange for cash to boost liquidity). The November elections constitute the political risk.









5. Future Fund and GST

Government investments

- When the budget was last in surplus, the Coalition government set up various investment funds. We tend not to hear much about these funds, but the investments have performed solidly over the past year. The value of all the nation building funds stands at $92.2 billion, covering a large portion of Federal Government Net Debt.
- The **Future Fund** was set up to provide for the unfunded superannuation liabilities of Commonwealth public servants. As at March 2012, the Future Fund stood at $77.1 billion, up $4.1 billion over the past year or 5.6 per cent.

Investing for the future

Assets at March 31 2012

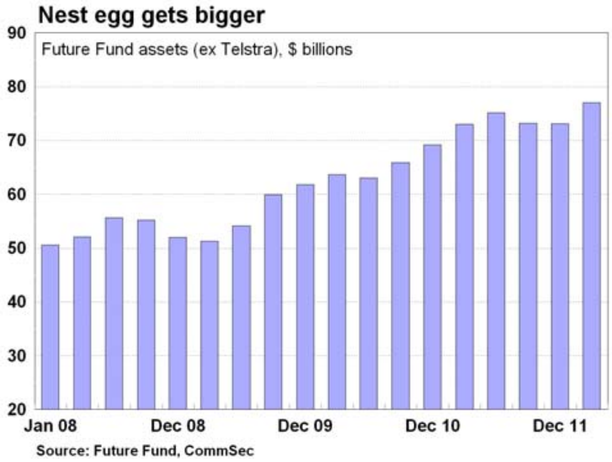
	$ billion
Future Fund	$77.05
Education Investment	$4.56
Building Australia	$6.70
Health & Hospitals	$3.92

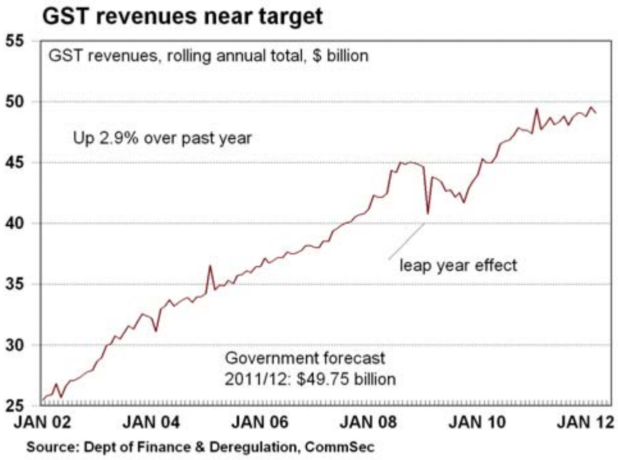
Source: futurefund

- The **Building Australia Fund** was set aside for "the creation or development of transport, communications, energy and water infrastructure and in relation to eligible national broadband matters. As at March 2012, the Building Australia Fund stood at $6.70 billion.
- The **Education Investment Fund** is set aside to make payments for education infrastructure. As at March 2012 the Education Investment Fund has assets of $4.56 billion.
- The **Health & Hospitals Fund** was established to enhance the Government's ability to boost our health infrastructure. As at March 2012, the Health & Hospitals Fund stood at $3.92 billion.

Goods and services tax (GST)

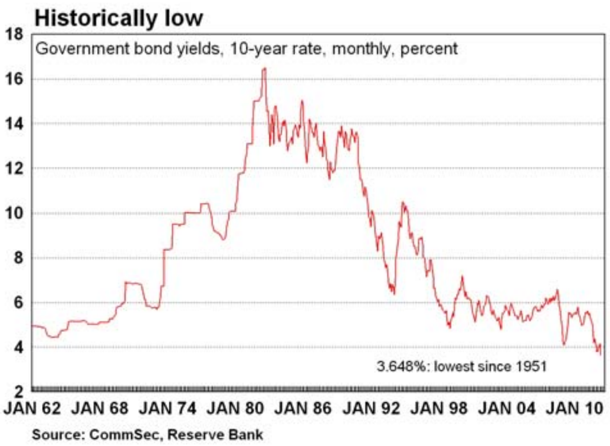
- To some extent this is the "forgotten" tax. Despite the fact that the GST is the third biggest revenue generator behind personal tax and company tax, it tends not to feature in budget analyses. All of the revenue goes to the states and territories so it certainly has a major influence on the ability of governments to spend across the community.
- Annual GST revenues peaked at $45 billion in August 2008 and then fell to almost $41 billion in February 2009 with the slowdown in consumer and business spending during the GFC. Revenues recovered over 2009/10, hitting $47 billion in September 2010. Apart from a blip to $49.45 billion in February 2011, GST receipts have been slowly climbing, hitting record highs of $49.55 billion in the year to February before easing in the latest month.
- Receipts from the Goods and Services Tax stood at $49.1 billion in the twelve months to March, up 2.9 per cent on a year ago. The Government projects GST receipts to rise by 5.7 per cent ($2.6 billion), reflecting growth in taxable consumption and dwelling investment as well as increased compliance measures.
- In the projection years, GST receipts are expected to grow by 5.6 per cent ($2.7 billion) in 2013/14 and 5.1 per cent ($2.6 billion) in 2014/5 and 4.8 per cent ($2.6 billion) in 2015/16, in line with trend growth in consumption.

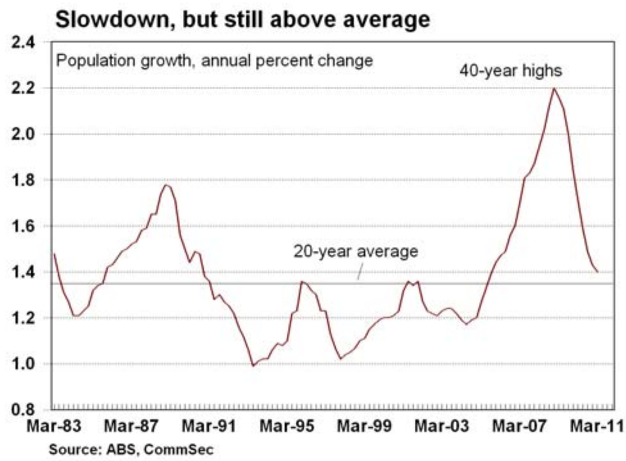


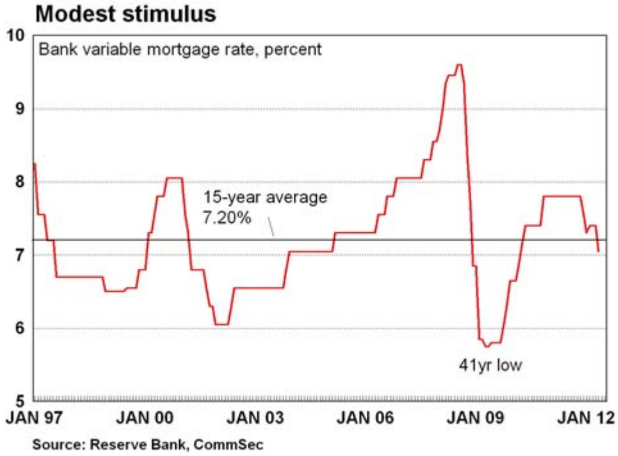


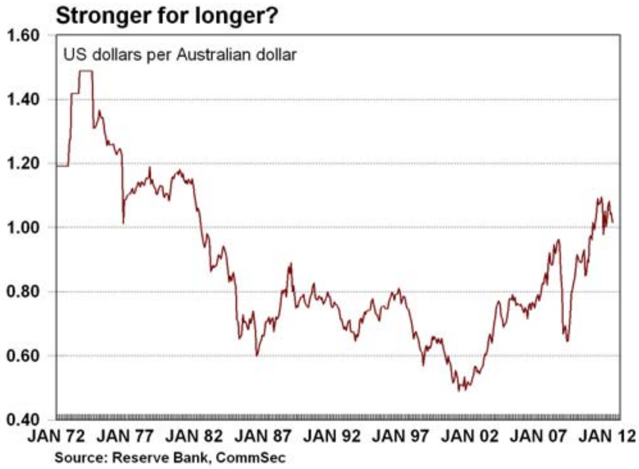
6. Facts & figures

Size of the Australian economy	**$1,442 billion**
Australia's global ranking	**13th**
Australian government receipts (2013e)	**$368.77 billion**
Australian government payments (2013e)	**$364.21 billion**
Government net debt (2013e)	**$143.3 billion (9.2% GDP)**
Current economic growth	**2.3%**
"Normal" economic growth	**3.00-3.25%**
Australian population growth	**1.4%**
Current inflation rate	**1.6%**
Current unemployment rate	**5.2%**









7. Impact – Rates, $A, Shares

Interest rates

- Fiscal policy is contractionary. In other words the deficit is shrinking, meaning that the Federal Government is removing cash from the economy. Because the deficit is shrinking, and the Reserve Bank currently believes that the economy needs stimulating, it will continue to lean in favour of further rate cuts – all things being equal.
- But the latest budget figures don't make it more likely, or less likely, that the Reserve Bank will cut interest rates again. There are numerous factors in the mix – and most are arguably more important.
- While the budget deficit is expected to shrink, the scale of the reduction would have already been assumed by the Reserve Bank in making its forecasts for economic growth and inflation. And, in turn, all this would have been taken into consideration with the latest decision to slash cash rates by 50 basis points (half a percentage point). Only if the Reserve Bank was "surprised" by the scale of the budget tightening would it be more inclined to cut rates further in coming months.
- To a large extent the Government would be hoping that its single-minded focus on achieving a budget surplus (tight fiscal policy) would lead the Reserve Bank to offset the impact through easier monetary policy.
- We are currently pencilling in a 25 basis point rate cut in August.

Australian dollar

- No major impact. Foreign investors would be comforted by the government's spending discipline. Certainly, if successful, Australia will be the first major advanced nation to restore its budget accounts to surplus following the Global Financial Crisis. But it will be achieved by a combination of spending discipline and sustained economic expansion. The best way to improve the bottom line is to grow revenues at the same time as being disciplined on spending. It's a point that European governments can learn from.
- Our CBA strategists tip the Aussie dollar at US108 cents in September, US109 cents in December and US110 cents in March 2013. However the risk in the short-term is that the ongoing European Debt Crisis will put downward pressure on the Australian dollar and push it to parity or even below against the US dollar.
- Over the second half of 2012 it is assumed that there will be some stabilisation of the European Debt Crisis, further grinding recovery of the US economy and firmer economic growth in both Australia and China. Our currency strategists assume that these factors will drive the Aussie dollar higher through late 2012 and early 2013.

Sharemarket implications

- Retailers: no major handouts but no nasties either. Continued economic growth and increased employment over time will support consumer spending. But Treasury expects consumer conservatism to continue. Household spending growth of 3 per cent is tipped in 2012/13 and 3.0 per cent in 2013/14 after estimated growth of 3.25 per cent this year.
- Defence: the Government will achieve savings in the Defence portfolio of $5.5 billion over four years, including through deferring some Defence acquisitions, adjusting the Defence capital equipment program and delivering further operating efficiencies, while delivering priority 2009 Defence White Paper capabilities.
- Transport: nation building infrastructure to total $4.066 billion over the five years to 2015/16 but no major spending until 2014/15.
- Finance: Government won't proceed with 50 per cent discount on tax paid on bank deposit interest.
- Finance: Reduction of higher tax concession for contributions of very high income earners
- Health – new Aged Care system. Spending of $1.55 billion over five years to 2015/16. New National Disability Scheme. New Dental Health Scheme. Changes to Net Medical Benefits Offset from 2013/14. New regional hospitals
- Construction: Closure of tax breaks for Green Buildings
- Small business: Loss carry-back provisions; write off of $6,500 equipment; write off $5,000 on cars.