

# AUSTRALIAN FEDERAL BUDGET

2010/2011

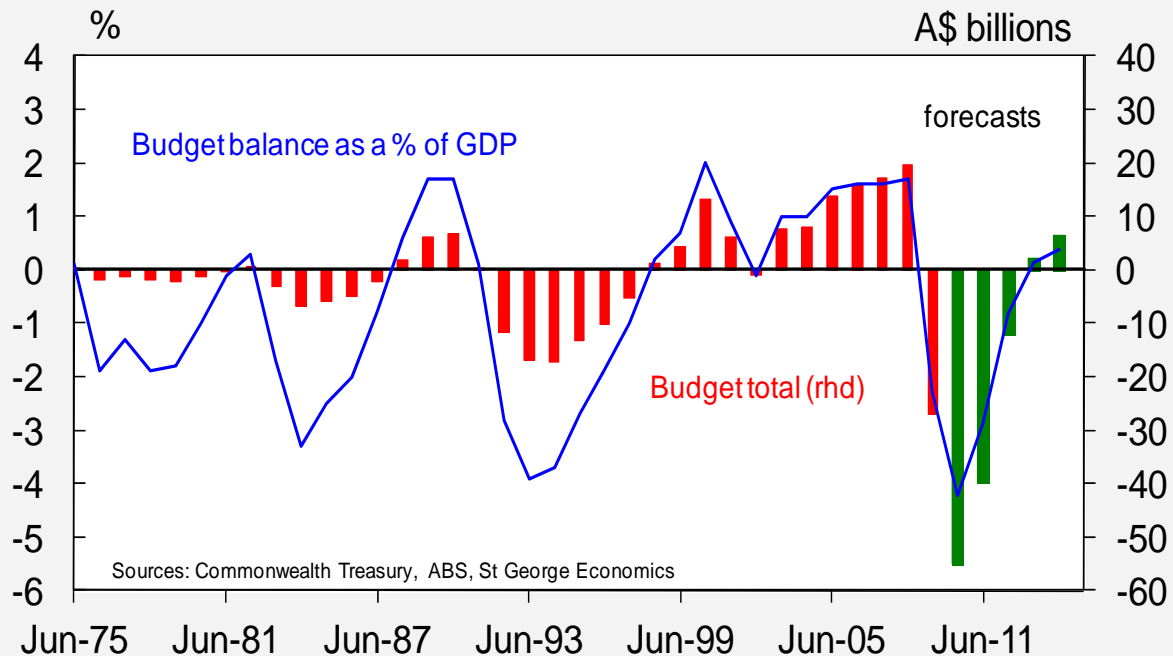
12<sup>th</sup>, May 2010

- As broadly expected, the Government forecast a significant improvement in revenue resulting in smaller deficits for the near term with the budget turning to a small surplus in 2012/13, three years earlier than forecast in the Mid-Year Economic and Fiscal Outlook (MYEFO).
- The economic recovery is expected to gather momentum with GDP forecast to grow at 3¼% in 2010/11 and 4% in 2011/12 which results in a much lower than expected unemployment rate.
- The forecast peak in net debt is now much lower and occurs earlier at 6.1% of GDP in 2011/12 compared to the earlier forecast of 9.6%, a favourable outcome in comparison to the major advanced economies.
- As earlier announced the Government is introducing a Resource Super Profits Tax (RSPT), a reduction in Company Tax, to be introduced a year earlier for SMEs, and modest income tax cuts. The Government also announced a discount for interest income up to \$1,000 per individual, a simplification of PAYE tax returns and a boost to superannuation contributions.
- Health reform remains a top priority. Making sure that the allocation of the additional \$5bn over 5 years funding goes to achieving better outcomes, and is not just absorbed in cost allocation, will be a huge test.
- The Government announced a number of new investment funds including a Renewable Energy Future Fund and a new infrastructure fund to be funded by the RSPT.

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# Australian Federal Budget



## BUDGET OVERVIEW

### THE BIG PICTURE

The Australian Government's fiscal position has improved significantly from the official estimates presented in the November Mid-Year Economic & Fiscal Outlook (MYEFO). This is on the back of a much stronger economic outlook, driven largely by a sharp rebound in global prices for the key commodities of iron ore and coal.

The budget is expected to be back in surplus in 2012/13 - three years earlier than expected at MYEFO. The Government has allowed the bulk of the windfall from the improved economic outlook to flow through to the bottom line. The resulting fiscal outlook, which compares favourably with other advanced economies, should provide some confidence to global financial markets.

The Government is forecasting a budget surplus of \$1.0bn (0.1% of GDP) in 2012/13. That is a \$16.9bn improvement from that forecast in MYEFO. Stronger economic growth forecasts provide a \$19.6bn boost to the budget position in that year, while the net cost of policy decisions in 2012/13 is just \$2.6bn. Looking ahead, the budget surplus is expected to widen to \$5.4bn (0.3% of GDP) in 2013/14.

In terms of the near-term forecasts, the budget deficit is estimated to be \$57.1bn in 2009/10. That is only \$0.6bn less than MYEFO with company tax losses representing a near-term headwind. The budget deficit narrows to \$40.8bn in 2010/11, which is \$5.9bn less than in MYEFO. We would note that fiscal policy has a contractionary impact on the economy in 2010/11 of 1.5ppts (that is, the budget deficit narrows by 1.5% of GDP from that in 2009/10). The budget deficit is forecast to be \$13.0bn in 2011/12 (see page 4 for key fiscal numbers).

We view the Government's economic forecasts, which underpin these fiscal projections, as broadly credible. Nevertheless, were there to be a sharp fall in global commodity prices in the next four years the fiscal numbers would have to be downgraded.

The Government has announced a range of spending and savings measures in what is expected to be an election year. Note that 16 April 2011 is the latest possible date for an election. The net impact of policy decisions in the 2010 Budget is modest. Net new initiatives

cost \$2.1bn in 2009/10, \$3.0bn in 2010/11 but in 2011/12 savings measures fully offset spending measures. In the 2012/13 year the net cost of measures is \$2.6bn.

The Government limits the net impact of spending measures by achieving significant savings / increases in taxation. Notably, in the outer two years, there are sizeable "savings" measures - with the major savings measures worth in aggregate \$7.5bn in 2012/13 and worth a hefty \$16.3bn in 2013/14. As already announced by the Government in their initial response to the Henry Tax Review, the resource rent tax will raise \$3bn in 2012/13 and \$9bn in 2013/14.

The Commonwealth Government's net debt profile has improved significantly from what was an already manageable net debt position projected in MYEFO. Net debt is forecast to rise from 3.2% of GDP (\$42bn) at June 2010 to a peak of 6.1% of GDP (\$91bn) at June 2012. That is well below MYEFO's projection of a peak of 15.3% of GDP (10% of GDP) in 2013/14 and well below the 1990s peak of 18% of GDP.

## THE ECONOMY

Australia is expected to build on its resilient economic performance in 2009 with robust growth over the next two years. The Government has again raised its forecasts. Growth is now expected to come in at 2% for 2009/10 rising to 3¼% in 2010/11 and 4% in 2011/12. Jobs growth of 2¼% in 2010/11 and 2% in 2011/12 is expected to push the unemployment rate to 5% by June 2011 and 4¾% by June 2012. Indeed, the Government expects the economy to approach 'full capacity' in 2011/12.

The forecast reflects a smooth transition from stimulus-assisted expansion to one supported by a recovery in private sector activity. The withdrawal of fiscal stimulus is estimated to detract about 1ppt from GDP growth in 2010. An upturn in private demand is expected to gain strong support from improving conditions abroad – world growth is forecast to rise a solid 4¼% in 2010 despite lingering drags from balance sheet repair, fiscal consolidation and recent financial turbulence. Treasury expects Australia's terms of trade to rebound 25% by mid-2010 adding \$30bn to national income. A small -¾% correction is pencilled in for 2011, although world growth maintains its 4¼% pace.

In terms of domestic demand, this transition will see a slowing in public demand growth (from 7¼% in 2009/10 to just 1% in 2010/11 and a slight contraction in 2011/12) more than offset by a steady acceleration in private final demand from an estimated 1¾% rise in 2009/10 to 4½% growth in 2010/11 and 6% in 2011/12. Within the private mix, consumption is expected to show a steady acceleration to 4% growth in 2011/12 but investment is expected to be more mixed over the forecast period with a solid broad-based rise in year one giving way to a more divergent performance in year two as slowing dwelling investment is more than offset by step up in business investment growth to strong double-digit rates, reflecting a ramp-up in the next round of resource projects.

Overall, the Government's forecasts are broadly in line with our own view expect for 2011/12 where they appear more optimistic compared to our own expectations for growth to remain closer to trend at 3½%. Most of the wedge comes from the outlook for the consumer. We expect consumption growth to remain more subdued at 2.6% in 2010/11 and 2.9% in 2011/12 reflecting lingering consumer caution and rising interest rates. This is neutralised in year one by our more constructive view on investment (dwelling investment in particular is forecast to rise 14%) but is more apparent in year two. No doubt part of this reflects a more benign inflation assessment by the Government – CPI inflation is forecast to flatline at 2.5%.

We note in the outer years, 2012/13 and 2013/14, the Government assumes real GDP growth of 3.0% and nominal growth of 5.5%. These numbers are arguably plausible when compared with historic averages but of course the timing of the next cyclical downturn is always a matter of debate and hence a risk to the forecasts.

## THE BOND SUPPLY

The total stock of Commonwealth Government Securities (CGS) on issue at end June 2010 is expected to be \$154bn, and net issuance of CGS in 2010/11 is expected to be around \$55bn. The value of Treasury Bonds on issue at end June 2010 is expected to be around \$125bn. Treasury Bond issuance in 2010/11 is expected to be around \$56bn. The Australian Office of Financial Management, having recommended the issuance of Treasury Indexed Bonds in

2009/10, is projecting further issuance in 2010/11. The face value of Treasury Indexed Bonds on issue at end June 2010 is expected to be around \$11bn, with 2010/11 issuance expected to be around \$4bn. The face value of Treasury Notes on issue at end June 2010 is projected to be around \$11bn, and the Budget notes approximately \$10bn of Treasury Notes will be kept on issue at all times to maintain a liquid market. Aussie Infrastructure Bonds will be part of CGS issuance, aiming to finance \$300mn of investment in NBN Co in 2010/11. The AOFM is considering offerings of Aussie Infrastructure Bonds for household investors also.

## KEY BUDGET NUMBERS

### Budget Aggregates AUDbn

	2008/09(a)	2009/10	2010/11	2011/12	2012/13	2013/14
GDP	1.3	2.00	3.25	4.00	3.00	3.00
Nominal GDP	6.7	2.75	8.50	5.75	5.50	5.50
Unemployment (Jun qtr)	5.7	5.25	5.00	4.75	5.00	5.00
Cash balance, \$bn *	-27.1	-57.1	-40.8	-13.0	1.0	5.4
% of GDP	-2.2	-4.4	-2.9	-0.9	0.1	0.3
Revenue, % GDP	23.2	22.0	22.4	23.5	24.1	24.1
Expenses, % GDP	25.1	26.2	25.1	24.2	23.8	23.6
% chg, real	12.7	4.9	0.9	-0.6	1.7	1.9
Net debt, \$bn	-16.1	41.8	78.5	90.5	93.7	90.8
% of GDP	-1.3	3.2	5.6	6.1	6.0	5.5
* Underlying cash balance						
Sources: ABS, Budget Papers, St.George Economics						

### Major Policy Initiatives in 2010/2011 Budget AUDbn

Major policy initiatives in 2010 Budget			
AUDbn	2010/11	4 Years*	Comment
<b>Spending measures</b>			
Health & hospitals reform	1.056	5.605	Overhaul of State/Commonwealth funding of hospitals
Renewable Energy Future fund	0.042	0.652	Leverage private funds, get renewable power to mkt.
Cutting company tax to 28% by 2014/15	-	2.85	Boost investment attraction, SMEs get early bite.
Other tax relief	0.001	2.99	Low incomes to see rise in effective tax free threshold.
Savings & superannuation	0.028	3.682	Super cont. up to 12% from 9%; breaks for small depositors.
Infrastructure Fund	-	1.435	A further attempt to boost productive potential.
Defence & security	0.341	2.095	Border protection; quarantine; ODA; aviation security.
<b>Savings measures</b>			
Resources taxation reform	-	12	Pro-cyclical tool to capture share of boomtime profits
Cigarette tax	1.13	4.98	An old favourite: tax the price inelastic goods.
PBS & Medicare threshold	0.156	2.13	Raising the income threshold; re-pricing of drugs.
'Reprioritisation'	0.244	2.145	The ubiquitous efficiency dividend?
Superannuation	0.066	0.824	Indexation pause; changes to co-contributions.
Greater compliance	0.301	2.152	Cash economy & greater GST compliance

## MAJOR THEMES

A year ago the Government made a commitment to constrain itself to 2% real growth in spending when the economy returned to an above trend pace. A less concrete commitment was that all new initiatives would have to be funded by savings. With net policy initiatives of just \$1.4 billion they have come surprisingly close. So theme number one is that to spend you must also save – a little different from the years of milk and honey prior to the GFC.

### HEALTH REFORM

The Government, in co-operation with the States, has made reforming the health system a top priority. Most would agree that there is a need for better outcomes. At the same time, there is a need for greater efficiency, with the health budget one of the fastest growing areas of public

expenditure. The United States example is instructive as to the risks. US per capita health spending is almost double the amount of the average OECD economy, yet its life expectancy is actually below average among its peer group. Making sure new funds go towards achieving higher quality outcomes, rather than being absorbed in cost escalation, will be a huge test. The 2010 Budget (following on from negotiations at COAG over recent months) allocates just over \$1bn in the coming year and upwards of \$5bnn over 4 years.

### **MINING PROFITS TAX**

The centrepiece of the Government's first wave of tax reform in response to the Henry Tax Review is the introduction of a 40% resource rent tax – called a Resource Super Profits Tax (RSPT) from 1 July 2012. The first full year of introduction, 2013/14, will raise a net \$9bn. That is net of refunding state government royalty taxes. Note that the tax is on that portion of profits deemed to be "super", not on the entire amount. Think of it as a progressive income tax, where the mining companies creep into a higher bracket when commodity prices are high. An important question that needs to be debated is the threshold determining the definition of "super". A rate determined by the return on bonds (essentially risk free) is too low given the costly and risky nature of the extraction industries. A more reasonable benchmark would be the growth of profits in the non-mining, non-financial sectors. The bond rate method would be administratively "cleaner", but the latter may be fairer. It is also reasonable to debate if such a targeted cyclical tax is a useful complimentary policy tool to the far more blunt monetary policy tool of interest rates.

### **REDUCTION IN COMPANY TAX**

The company tax rate is to be reduced from 30% to 28% by 2015. Small business are to benefit from company tax cuts from 2012. There are also generous write off concessions for small business. The lowering of the tax rate will put Australia closer to, but still above, the OECD average. It will also widen the gap between Australia and Canada, a competitor for foreign investment in the resources sector. Yes, the miners will benefit from this reduction on their "non-super" earnings. The Government estimates that this reduction will increase GDP by 0.4% in the long run.

### **BOOST TO SUPERANNUATION**

Retirement savings are to be boosted, with the superannuation guarantee rising from 9% to 12% by 2019/20. There will be two smaller steps of 0.25%, in 2013/14 and 2014/15, followed by steps of 0.5% in the following five years.

### **TAX REFORM: A SECOND TERM ADGENDA**

The Government announced a package of tax measures to be introduced in the second term. The main thrust is tax breaks for savings and moves to simplify the tax system by lessening the need to file tax returns. However, the initiative in relation to interest income is modest, being capped at a very low \$1000. Also, the Government had previously legislated for modest income tax cuts on 1 July 2010 – this delivers about \$450 a year to someone earning \$60,000.

### **A NEW INFRASTRUCTURE FUND**

Proceeds from the RSPT will create a new infrastructure fund. The fund will grow over time, with estimated inflows of more than \$5.6 billion over the next decade, beginning with \$700mn in 2012-13. In addition, the Government announced \$1 billion to renew rail networks and \$661mn for the Skills for Sustainable Growth strategy.

### **INVESTING IN RENEWABLE ENERGY**

The Government announced a new \$652mn Renewable Energy Future Fund, which will be part of an expanded \$5.1bn Clean Energy Initiative. The Fund will leverage private sector investment to support renewable energy projects, and the development and deployment of low-emissions technologies.

## GOVERNMENT ECONOMIC FORECASTS

	year average		
	2009/10	2010/11	2011/12
Private consumption	2.75	3.5	4
Dwelling investment	3	7.5	4
Business investment*	-2.0	7	12.5
Private demand*	1.75	4.5	6
Government*	7.25	1	-0.5
Final demand	3	3.75	4.5
Stock contribution	0.75	0.5	0
GNE	3.75	4.25	4.75
Exports	1.5	5	6
Imports	5	9	8.5
Net exports contribution	-0.75	-1.0	-0.75
GDP	2	3.25	4
Nominal GDP	2.75	8.5	5.75
Employment	2.5	2.25	2
Unemployment rate (Jun qtr)	5.25	5	4.75
Participation rate	65.25	65.5	65.5
CPI	3.25	2.5	2.5
WPI	2.75	3.75	4
Terms of trade	-3.75	14.25	-3.75
Current account, % of GDP	-4.75	-3.75	-5.0
	<b>2009</b>	<b>2010</b>	<b>2011</b>
World growth	-0.6	4.25	4.25

# St.George Forecasts

End Period:	2009			2010			2011	
	Q2	Q3	Q4	Q1	Q2 (f)	Q3 (f)	Q4 (f)	Q1 (f)
RBA Cash Rate, %	3.00	3.00	3.75	4.00	4.50	4.75	4.75	4.75
90 Day BBSW, %	4.15	4.35	4.14	4.32	4.80	5.00	4.95	4.95
3 Year Bond, %	4.75	5.00	4.65	5.08	5.35	5.50	5.75	6.00
3 Year BBSW, %	5.45	5.70	5.42	5.45	5.67	5.80	6.05	6.30
10 Year Bond, %	5.70	6.00	5.56	5.64	5.80	5.90	6.10	6.30
AUD/USD	0.8064	0.8828	0.8977	0.9158	0.92	0.95	0.92	0.90
USD/JPY	96.36	89.70	93.02	93.44	94	95	100	105
EUR/USD	1.4033	1.4640	1.4321	1.3474	1.35	1.36	1.38	1.40
GBP/USD	1.6458	1.5982	1.6170	1.5147	1.53	1.57	1.60	1.67
USD/CHF	1.0859	1.0363	1.0352	1.0602	1.07	1.08	1.07	1.08
USD/CAD	1.1623	1.0695	1.0532	1.0160	1.01	1.02	1.01	1.00
NZD/USD	0.6457	0.7232	0.7228	0.7090	0.72	0.74	0.78	0.75
USD/CNY	6.8305	6.8264	6.8271	6.8259	6.80	6.78	6.75	6.72
USD/SGD	1.4474	1.4097	1.4049	1.3997	1.39	1.38	1.38	1.37
AUD/EUR	0.5746	0.6030	0.6270	0.6797	0.68	0.70	0.67	0.64
AUD/JPY	77.70	79.19	83.50	85.57	87	90	92	95
AUD/GBP	0.4900	0.5524	0.5550	0.6046	0.60	0.61	0.58	0.54
AUD/CHF	0.8757	0.9148	0.9290	0.9709	0.98	1.03	0.98	0.97
AUD/CAD	0.9373	0.9442	0.9450	0.9305	0.93	0.97	0.93	0.90
AUD/NZD	1.2489	1.2207	1.2420	1.2917	1.28	1.28	1.18	1.20
AUD/CNY	5.5081	6.0263	6.1290	6.2512	6.26	6.44	6.21	6.05
AUD/SGD	1.1669	1.2445	1.2610	1.2818	1.28	1.31	1.27	1.23

Source:

Bloomberg for historical data

Notes:

- i) Cash rate and bond rate forecasts are effective 30 April 2010
- ii) Exchange rate forecasts are effective 30 April 2010
- iii) AUD cross exchange rates have been rounded

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