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Revenue growth is crimped by a swing from consumer spending to investment spending

- **Australia's economy now generates relatively less tax than it used to.** The economic recovery since the GFC hasn't seen a matching recovery in revenues, for two main reasons. **First, before the GFC, families were spending up. And when families spend, they generate more tax: GST, petrol and beer excises, and customs duty.**
- **But now spending is dominated by companies as they invest a fortune in new capacity. And whereas extra spending by families adds to the tax take, extra spending by businesses reduces it.**

Revenue growth crimped by a swing from consumer spending to investment spending

- **That isn't a criticism of the tax system**. The tax system is broadly right to tax the spending of families, and eminently correct to allow deductions for the spending of business.
- **What it really means is the composition of spending in Australia's economy has gone from being very tax friendly ahead of the global financial crisis to being rather less tax friendly today.**

And by a swing from strong capital gains to weak (or negative) capital gains

- **Second, ahead of the GFC the sharemarket was riding high, and so were housing prices**. That pumped up capital gains as we tax wealth as well as income and spending. But the glory days of capital gains are long gone. Australia's sharemarket remains well below where it was ahead of the GFC, while housing prices are only just starting to lift once more.
- **So the 'tax equation' has changed: the same size of the economy is now delivering less tax.** That's part of what Martin Parkinson has been hinting about when he says **"the revenue base has dramatically hollowed"** since the mid-2000s.

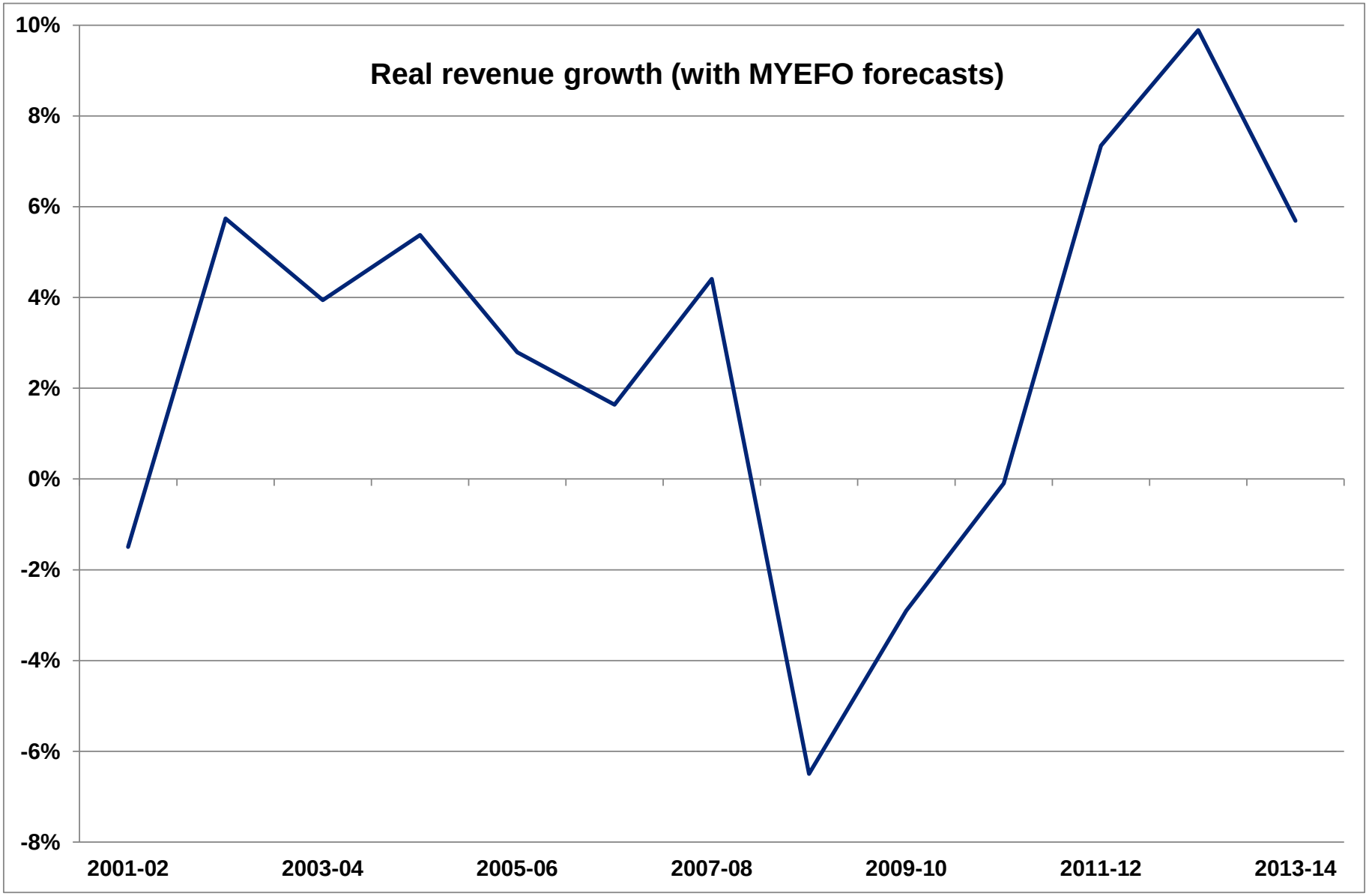
While there are reasonable expectations of progress on NDIS and Gonski

- But wait, there's more.
- **It is also worth remembering that the Government wants to make further savings to fund disability insurance and Gonski school reforms.**
- **That's understandable – those are laudable goals.**
- But it is a reminder that surpluses could remain elusive.

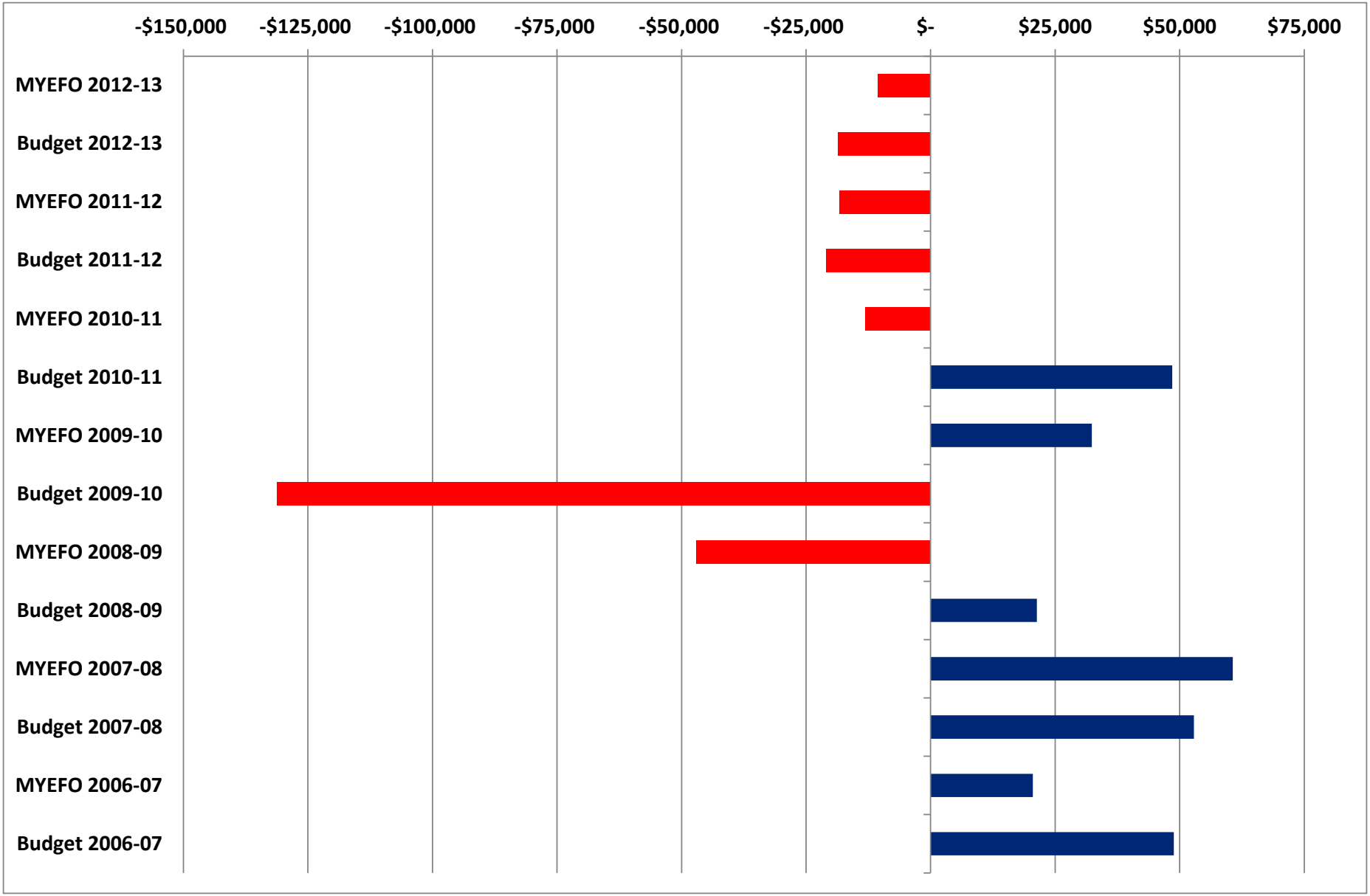
The good news is that revenues are growing faster than you think

- **Yet a bit of perspective is handy. After you knock out inflation, real revenue growth averaged an anaemic 1.3% a year over the decade to 2010-11, held back by an orgy of personal tax cuts on the one hand, and by the GFC and its revenue rainshadow on the other.**
- **However, real revenue growth was a robust 7.3% in 2011-12, and MYEFO projects it to be 9.9% in 2012-13 and a further 5.7% in 2013-14.**
- Those are the best three years for real revenue growth in more than a decade, and they are coming one after the other.

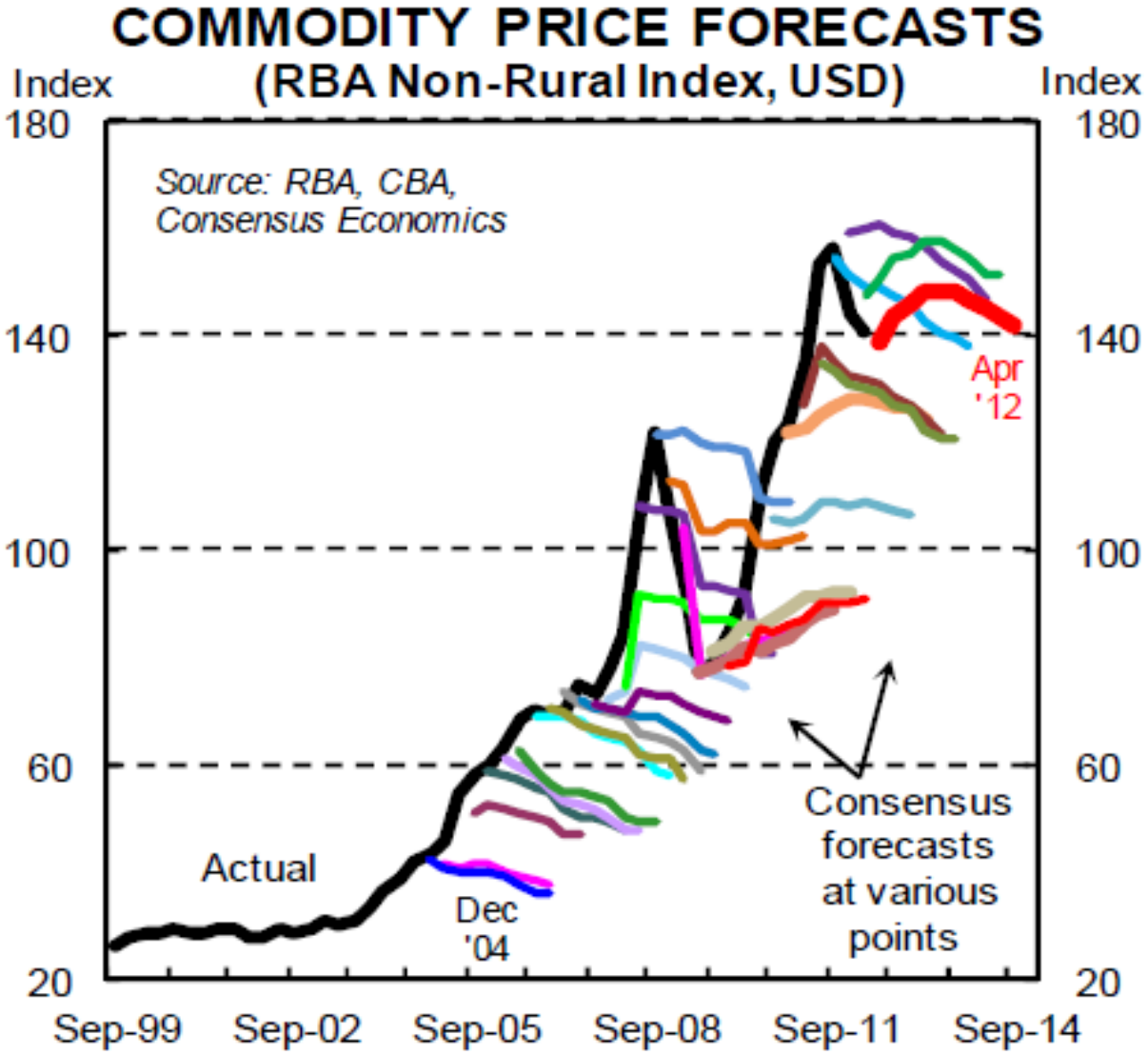
The good news is that revenues are growing faster than you think



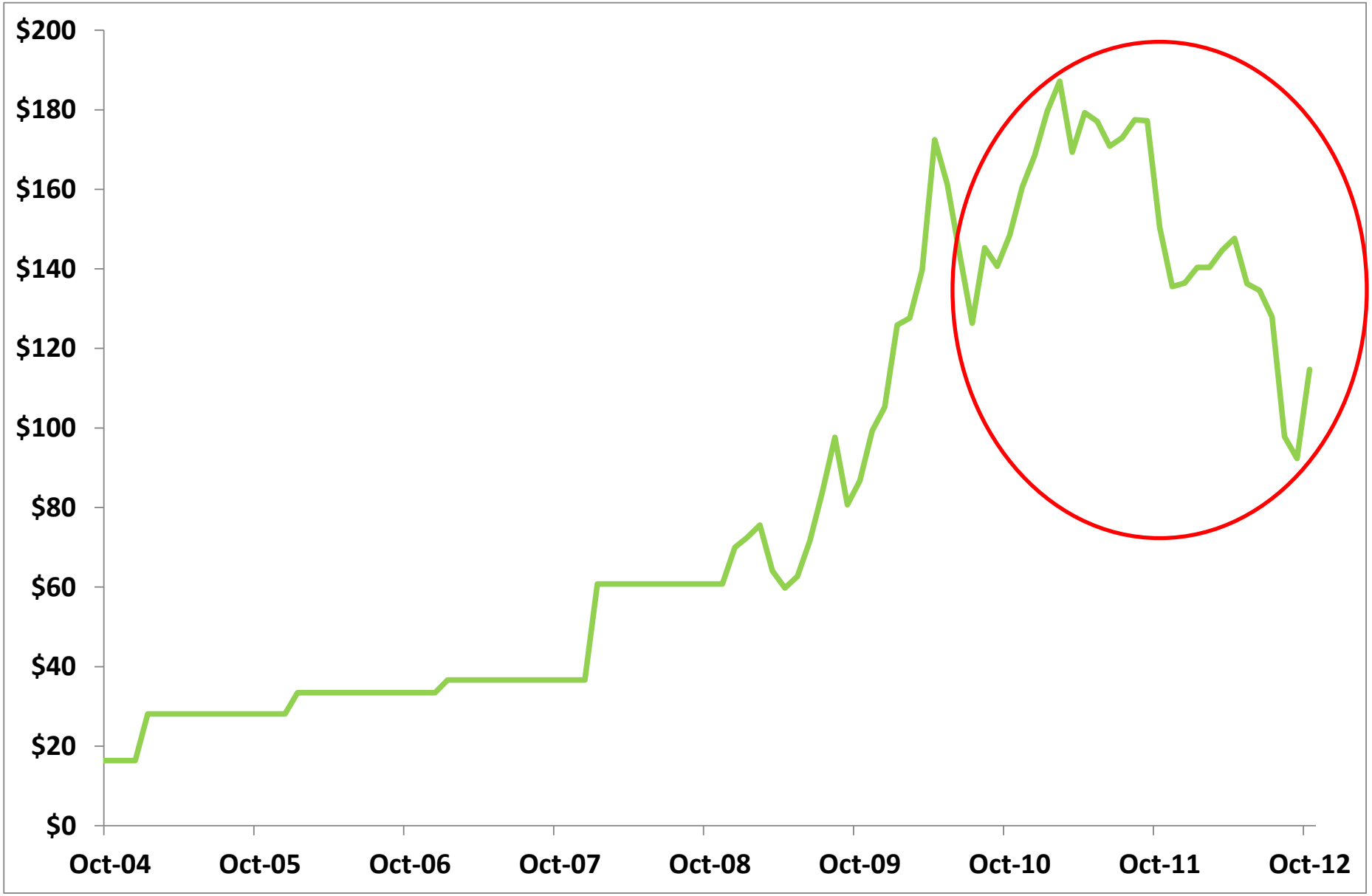
The bad news is “revenue surprises” due to economic developments remain negative



Forecast errors are a function of the terms of trade ... which are a function of China



As iron ore prices slide



And there is a risk of something bigger and badder – consider three scenarios

- **First scenario:** Terms of trade fall 4% relative to the official assumptions. **Impact: Budget shortfall of $7.2 billion by the third year.**
- **Second scenario:** Economy slows to fall 1.7% below baseline, job gains weaken, unemployment lifts and real wage growth eases. **Impact: Budget shortfall of $15.9 billion by the third year.**
- **Third scenario:** The second scenario plus a 17% fall in the terms of trade. **Impact: Budget shortfall of $36 billion by the third year.**

The big picture

- **Up until 2003, unemployment was a handy proxy for the underlying strength of the Budget.**
- Yet unemployment benefits are a very small component of overall public spending. Even more importantly, the key volatility through the cycle is not in spending, but rather in revenue.
- Indeed the only reason why the unemployment rate was a proxy of the structural health of Australia's fiscal finances through to 2003 was that unemployment was a handy proxy for the strength of the wider economy – when it went up, tax revenues went down.

The big picture

- However, the revenue side of the Federal Budget now shows little linkage to shifts in the unemployment rate. Since 2003 there has been a striking lift in national prosperity off the back of a lift in the terms of trade – in particular, higher coal and iron ore prices. That shift in China-driven coal and iron ore prices led to a fundamental improvement in revenues.
- **The best proxy for the underlying health of Australia's Federal Budget is no longer unemployment – it is now coal and iron ore prices.**

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