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**Deputy Prime Minister**
**Treasurer**

**ADDRESS TO THE AUSTRALIAN BUSINESS ECONOMISTS' BREAKFAST**

**Sydney**
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# THE REVENUE BASE AND THE 2012 BUDGET

*** CHECK AGAINST DELIVERY ***

Thanks, Stephen [Halmarick], for that introduction, and thank you for the opportunity to speak today. It's always a pleasure to get into the often complex and really rigorous economic analysis that I know this audience more than any other is engaged with on a daily basis.

We have discussed before in this forum some very serious subjects, like tax reform a couple of years ago and, the year before that, measuring the impact of the GFC on our outlook. And now, almost four years on from the GFC, and just over a month out from the big night in May, I want to make three very important and related points:

One, that getting the Budget back into surplus is economically imperative in a turbulent new global economic era.

Two, this surplus will be much harder to achieve because of substantial revenue write-downs and historically low tax levels, coming from global turbulence and longer term structural changes to the revenue base.

Then three, that this all forces us to make substantial savings in the Budget, consistent with the strict discipline that has seen our fiscal position applauded right around the developed world.

## 1. The economic case for surplus

Now, for too long there has been a misleading and ill-informed claim doing the rounds that our determination to reach surplus is a political strategy, and not an economic imperative. This is rubbish – there are compelling reasons why the economics of surplus in 2012-13 make so much sense.

In the face of the worst global recession in around 80 years we stepped in to support demand. This ensured our economy did not go into recession, virtually the only developed economy not to. And it saved hundreds of thousands of Australians from the unemployment scrap heap.

But just as it was right to step in and support demand when it is needed, it is right to step back and provide space for the private sector to grow – and that is what we have been doing. Or as I have put it previously: you can't be a Keynesian on the way down, but not on the way back up. And in an economy moving back towards trend growth with relatively low unemployment and a record pipeline of investment, it is appropriate for the Government to be returning the budget to surplus.

As you can see in the first chart, mining investment is driving record levels of total capital expenditure in the economy, which is expected to reach a staggering $173 billion in 2012-13.

**CHART 1: Capital expenditure increasing to record levels**


Source: ABS Catalogue Number 5625.0.

So our fiscal strategy ensures we won't be adding to the price pressures of a strengthening economy experiencing a once-in-a-generation investment boom.

I believe that's why the IMF supported our strategy in their September World Economic Outlook. It commended our stimulus package at the time of the GFC, and they now recognise that getting back into surplus is the right move. The IMF also acknowledges a surplus, and I quote, "will increase fiscal room and take pressure off monetary policy and the exchange rate".

Returning to surplus provides more flexibility for the Reserve Bank to respond to any further developments in the global economy. Maintaining our credible fiscal policy also sends a strong message of confidence to investors across the world in uncertain times.

With healthy public finances, low inflation, low debt and low unemployment, we are already the envy of many other advanced economies. It is our consistent and credible approach that has seen Australia achieve the AAA credit rating from all three major agencies for the first time in our history. We are now one of only 8 sovereigns to be awarded the coveted AAA with a stable outlook by all three major credit rating agencies.

The key to our success has been sticking to a strict fiscal strategy outlined at the onset of the global crisis. This strategy has carried us through the worst economic downturn in memory in better shape than almost everybody else. And being prepared for the risk of further deterioration in the global economy is not an abstraction but a practical necessity as the past four years have shown us all too clearly.

In short, balancing the Budget is appropriate for an economy returning towards trend growth, it is Australia's best defence in these times of global economic uncertainty, and it’s the right strategy for the future. So that’s my first point.

## 2. Influences on the Budget bottom line

My second point is that a number of influences – both contemporary and structural – are combining to make that surplus much more difficult to achieve. I want to go through these influences in some detail, beginning with the short term factors.

In the December quarter of 2011, we witnessed perhaps the worst bout of global financial instability in the years since the GFC. As the European sovereign debt crisis escalated, Italian and Spanish bond yields hit euro-era highs and a number of advanced economies contracted, including Germany, the UK, Japan and Italy.

Domestically in the December quarter, the dollar remained high despite the decline in the terms of trade, and consumers remained cautious.

The combination of these factors, which were all at least partly influenced by global instability, meant that incomes were softer – most evident in the 6.5 per cent decline in company profits.

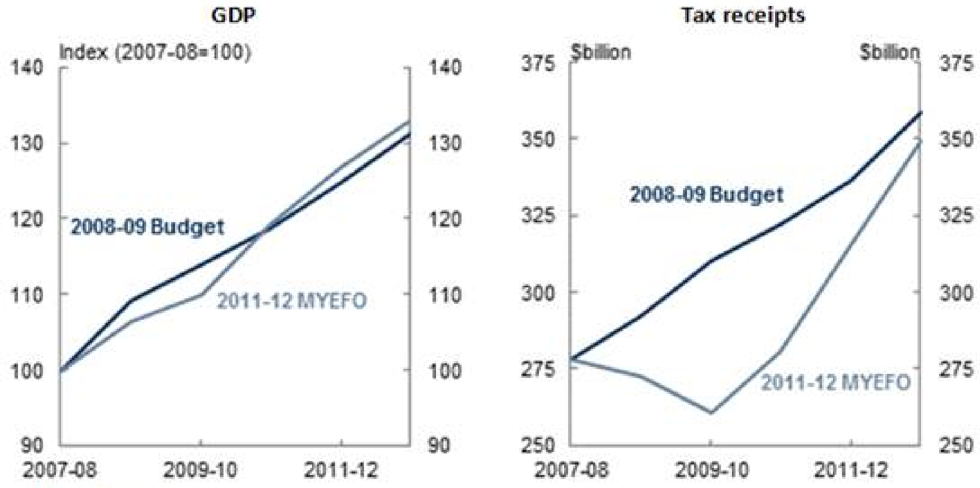
So despite our strong fundamentals, heightened global turmoil towards the end of last year has had a big impact on government revenues. And while the global economy has shown recent signs of stabilisation, and the news from the United States has been positive, the threat of financial contagion from Europe’s sovereign debt crisis lingers.

On top of this, we also can’t discount the chance of an oil price shock as an additional risk to global growth. But beyond these contemporary risks, government revenue is also influenced by structural changes to the tax base over time.

When it comes to the structural underpinnings of the revenue base, we are in a tough new world. This is a crucial point: even if we were to witness an enduring global recovery, we should not expect to see a similar recovery in revenues.

The chart shows that the economy has recovered the lost ground from the GFC but revenues have not. This is not sufficiently understood, so let me run through it in detail.

**Chart 2: Change in estimates of GDP and tax receipts**




Source: Treasury.

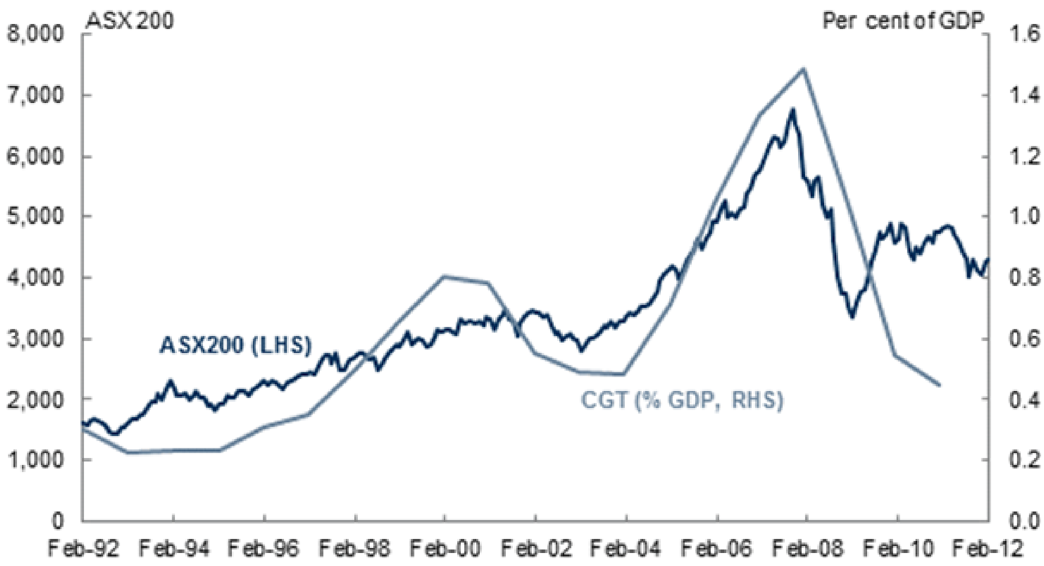
There is no question that revenues were at an unsustainable peak in the period leading up to the GFC. In this period, we saw the first big commodity boom combine with strong equity prices, a maturing capital gains tax system with strong receipts, and a low household saving rate. In revenue terms, it appeared the best of times, but it was not destined to last.

The GFC hit all our revenue heads, as production, consumption, profits and employment all tumbled. The tax-to-GDP ratio fell 4.2 percentage points to 20.0 per cent. Compare this with the Howard Government’s peak of 24.2 per cent, and we’re looking at a massive write-down in tax receipts across the board. In fact, it was the biggest reduction in the tax-to-GDP ratio since the 1950s. About 80 per cent of this reduction was due to parameter variations, and 20 per cent due to policy changes.

Revenue write-downs were a big part of the 2011-12 Budget and MYEFO. And I can tell you today that further write downs are expected to be made at the 2012-13 Budget.

Collections, particularly relating to company profits, have been lower than expected. In part, our lower tax take reflects reduced tax receipts following the GFC, but it’s projected to remain below the previous Government's record highs even as the economy recovers.

**Chart 3: Tax-to-GDP**




It's expected to rise to an average of 22.8 per cent over the two years from 2013-14. This is around 1 percentage point below the average during the pre-crisis commodity boom. That might not seem like a huge variation, but this one percentage point equates in 2014-15 to around $17 billion.

If we'd maintained the tax-to-GDP ratio at the level we inherited, the tax take would be over $21 billion higher in 2012-13. That would give us a surplus of over $23 billion next year.

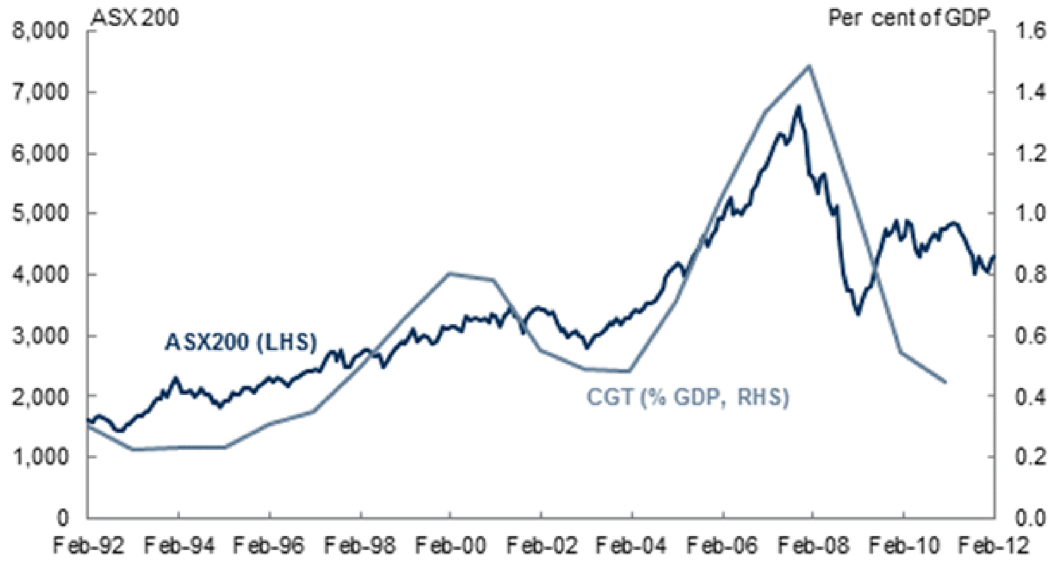
It's important to break that down further, and look at what has happened post-GFC to some of our key revenue sources. Because I think we're witnessing a structural change in the tax base and not just the lingering effects of the crisis.

**Capital gains tax**

Consider capital gains tax. Through the 1990s and early 2000, CGT, if you look through cycles, was gradually increasing. But it became one of the fastest growing revenue sources in the boom years of the mid 2000s.

Capital Gains Tax as a share of GDP tripled in the five years from 2002-03 to 2007-08, from 0.5 to 1.5 per cent. This was primarily the result of rapidly growing asset markets, particularly in housing and equities, with some contribution from the falling away of tax-exempt assets that predated 1985. You can see the trends mapped onto ASX performance, as in Chart 4.

**Chart 4: ASX performance and CGT-to-GDP ratio**




Then the GFC hit. By 2010-11, CGT was back at 0.5 per cent of GDP. This represents a fall of $11 billion compared to the peak in 2007-08.

In the aftermath of the crisis, asset markets have remained sluggish. The ASX200 has been relatively flat over the last two to three years. House prices have also moderated significantly over the past 12 months. And there's an unprecedented stock of losses that remain to be absorbed by future gains before tax will be payable – which will probably take until at least 2014-15 and maybe longer.

CGT receipts are predicted to recover, but remain within their pre-boom range and not to reach their pre-crisis share of GDP. There has been a structural shift here. And in hindsight, it's clear that the growth in asset prices in the mid 2000s which fuelled the growth in CGT, was not sustainable, and not a sensible benchmark for forecasting purposes.

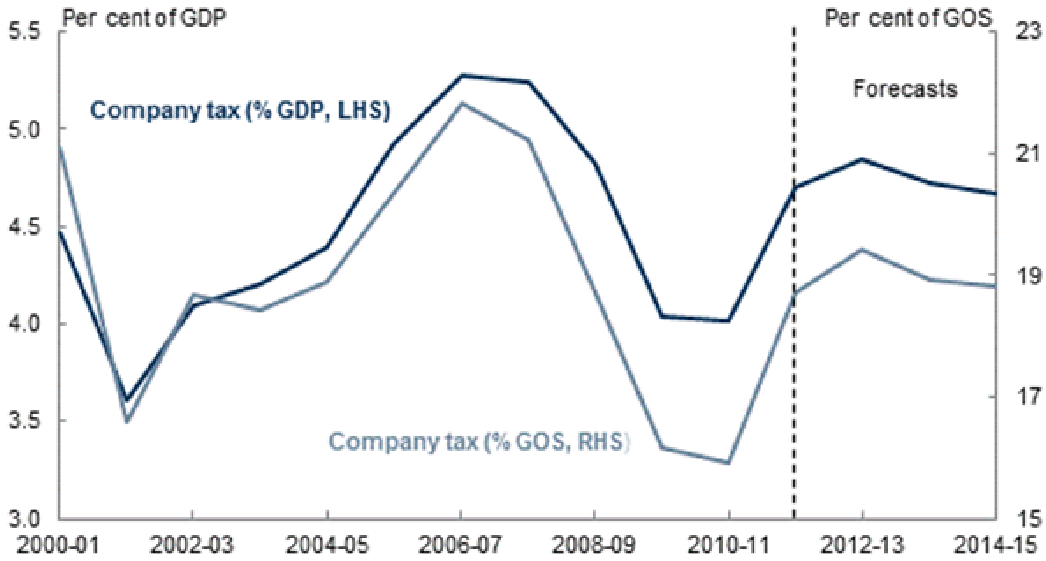
**Taxes on profit – company tax and resource rent tax**

There's also a perceptible shift in taxes on profit. Company tax and resource rent taxes account for roughly a quarter of commonwealth taxes (excluding GST). Like CGT, they boomed in the mid-2000s and fell rapidly with the onset of the GFC.

The bulk of the tax receipts write-down post GFC can be explained by write-downs in company tax. Out of a total write-down of $140 billion, company taxes contributed around $90 billion over the five years to 2012-13.

Even though the economy has been recovering for a while, the improvement in profits hasn't yet been fully reflected in company tax.

**Chart 5: Company tax as shares of gross operating surplus (GOS) and total GDP**




This is partly because of lags in the company tax system, and partly because losses accumulated during the GFC are now being claimed against current profits.

Claiming of losses is expected to subtract around $8 billion from receipts between 2010 and 2013. The weak capital gains tax outlook also has a dampening effect here. But with the economy moving back towards trend growth, you'd normally expect these factors to gradually start washing out of the system.

Text book economics tells you that faster economic growth translates into faster revenue growth, as the automatic stabilisers kick in. But in our current circumstances, we can't fully rely on the automatic stabilisers to fill the budget coffers as the economy shifts up a gear. So while returning to trend growth makes returning to surplus appropriate, it doesn't necessarily make it easy.

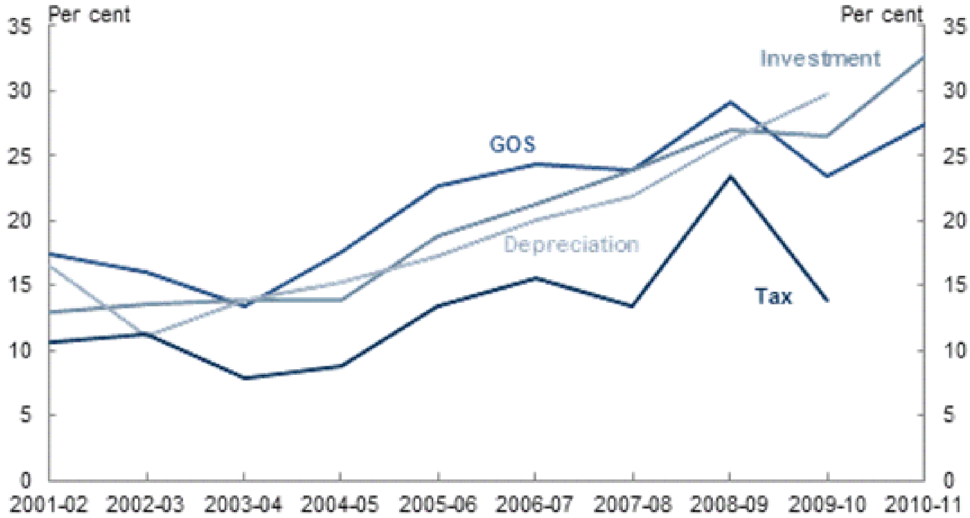
To understand the relationship between growth and revenue, you need to look at the specific drivers of growth, and these are fundamentally different to what they were prior to the GFC. Simply put, the consumption boom that characterised the years leading up to the GFC has been replaced by an investment boom, driven by the mining sector. It's this changing structure of our economy which means that we can expect a lower share of corporate tax to GDP for some years to come.

While the first phase of the mining boom was largely driven by the expansion of existing projects, mining boom mark II has also been driven by a dramatic increase in new projects. This has given rise to unprecedented levels of new business investment, which is expected to reach 50-year highs in 2012-13.

Mining investment as a share of GDP rose from 1 per cent to 3 per cent over the last decade, and it is expected to reach new highs in 2012-13, at over 8 per cent. It's this investment boom in the mining sector that is also contributing to structural change in our revenue base.

As we know, mining pays a relatively low rate of company tax compared to its share of the economy. Mining companies currently account for about 30 per cent of corporate gross operating profits, but only around 15 per cent of corporate tax receipts. Tax receipts from the industry are affected by high depreciation deductions, reflecting the rate of investment in the industry. What this means is that growth in the mining share of corporate Australia keeps the tax-to-GDP ratio down. And our massive pipeline of investment means that the tax deductions available to the mining sector are historically high, and depreciation deductions are already trending up (as you can see in Chart 6) and will accelerate over the next 5 years. This unprecedented level of investment will increase deductions in this sector for many years to come.

**Chart 6: The mining sector's share of GOS, capital expenditure, company tax, and depreciation[1]**




This breakdown in the normal relationship between economic growth and revenue is being compounded by the structural change associated with the mining boom.

As you know, the historically high terms of trade and the mining boom have given rise to sustained strength in our dollar, which continues to be an acute pressure point for key sectors outside resources.

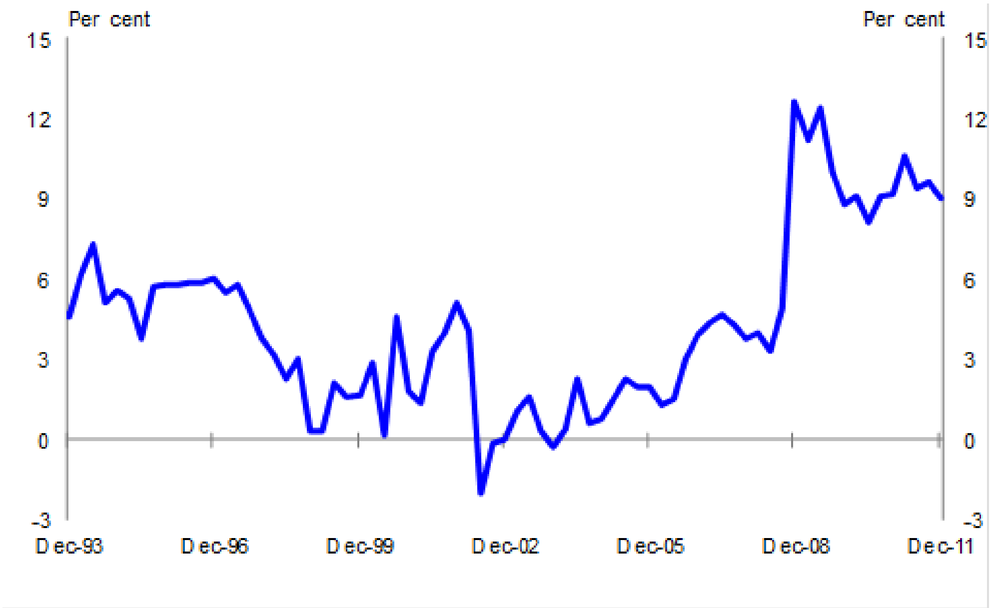
The exchange rate is a much more powerful force now compared to the pre-GFC period. While the exchange rate only averaged around 78c to the USD over the five years to 2008-09, it has been between about 95 and 110 cents since late 2010. This has put significant pressure on the profitability of some sectors, like manufacturing, retail, tourism, to name a few.

In addition to the mining investment boom and the structural changes that come with it, company tax receipts have also been affected by a structural shift in the behaviour

[1]GOS and investment is sourced from ABS publications. Mining GOS is derived from 'mining GOS & GMI', and assumes the GMI component is negligible. Tax and depreciation are sourced from ATO taxation statistics, which is reported on an income year basis. 2010-11 data is not yet available. 'Depreciation' is calculated as the 'deduction for decline in value on depreciable assets' plus 'immediate capital expenditure deduction'

of consumers. This is a lasting legacy of the GFC that has been reinforced by ongoing global uncertainty.

**Chart 7: Household saving ratio**




As the Chart shows, the jump in the household savings ratio coincided with the onset of the GFC, and has hovered at historically high levels ever since. So despite the high terms of trade and solid income growth, households have a lower appetite for debt, are more cautious in their spending and are taking the opportunity to consolidate their balance sheets. This has meant that we've seen a decline consumption growth. In the three years prior to the GFC, consumption grew at an average annual rate of 3.7 per cent, fuelled in part by strong credit growth, but since then consumption has grown by an average of 2.3 per cent a year.

The GFC was really a watershed moment when it came to the attitudes of consumers – and we're very unlikely to return to the debt-fuelled, low-saving, pre-crisis world anytime soon. This, along with the sustained high dollar, means that non-mining sectors are not generating sufficient growth in company tax receipts to offset the revenue drag from growth in mining investment.

**Tax policies**

One of the key things that this analysis shows is that our predecessors embedded long term structural damage to the budget that we have been working to address and will need to continue to do. We have already taken important steps to improve the sustainability of the revenue base.

The best example here is the MRRT, which will deliver a fairer and more efficient balance of the taxation burden across our economy. But there are other examples like the recent reforms to the living-away-from-home allowance and car fringe benefit rules, and the phasing out of the Dependent Spouse Tax Offset. All together, these measures account for about 0.7 per cent of tax-to-GDP in the year 2014-15.

A final point to make on revenue is about the tax laws themselves. A number of recent court decisions have gone against the Australian Taxation Office, which exposes weakness in specific parts of the law. We're looking at these to see where we can make the tax system more robust, more sensitive to complex transactions, and better at deterring people from tax avoidance.

Of course, maintaining a competitive tax-to-GDP ratio is more conducive to investment, jobs, and growth, and this is obviously a good thing. We inherited a tax-to-GDP ratio of 23.7 per cent and have kept the tax take substantially lower than that ever since.

It was Stephen Koukoulas who reminded us that while we never exceeded the tax-to-GDP ratio that we inherited, Howard and Costello exceeded that level in six of their last eight years in Government. But what it does mean we need to be very disciplined in how we spend our money. And this brings me to the third and final point I want to make today.

**3. Finding substantial savings in the Budget**

Because the surplus is a vital economic objective and because revenues are being written down, we need to find even more substantial savings in the Budget than we had earlier anticipated. I'm not talking about slash-and-burn. I'm talking about responsible additional savings, satisfying our economic objectives and delivering on the fiscal strategy best-practice we've established over recent years, and which the world applauds.

The savings we find in this Budget will be consistent with the discipline that has been the hallmark of the Budgets we've delivered. Remember that in the four Budgets since 2008-09, we have identified over $100 billion of savings. On top of that, we identified at MYEFO something like $11.5 billion of savings over the forward estimates. Many of these decisions are on the payments side, and they'll deliver benefits to the budget bottom line beyond the forward estimates. Some good examples were the reform of family payments and health services; and reductions in the cost of Government administration.

It's important to remember that our saves have been about directing spending to where it's most needed, making room to increase spending on important things like education, frontline health services and jobs. And because we've already made some tough saves in earlier Budgets, the savings get harder each time. That's why I've described this Budget lead-up as the most difficult.

The reality is that we will need to cut and cancel existing programs if we are to meet our targets, and we'll need to redirect some spending to where it is needed most. I can also tell you there won't be a lot of new spending in this Budget.

No doubt there will be many stories in the papers speculating about saves between now and Budget. Many of them will be wrong. What I can tell you is that whatever saves we make, they will be about making room for our priorities, and making good on our commitment to strict fiscal management.

**Conclusion**

Maintaining fiscal discipline is not for the faint-hearted, especially given the global and structural factors I've talked about today. The days of shovelling out bounty from the boom are long gone. We live in very different times. We govern for very different times.

The world is changing – Asia is growing, the US and Europe are rebuilding, and new technology is changing our lives. Those forces are reshaping our economy, with boom times for some and acute pressures for others.

Our budget will deal with today's challenges and build the foundations for the future. At its core will be the surplus which is our country's best defence in these times of global uncertainty, sending a message to the world about our strong economy at a time of dramatic change.

Thank you and I look forward to your questions.