

Paper 2: How at risk is the Budget to the economy?

Report by Access Economics Pty Limited for

The Business Council of Australia

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EXECUTIVE SUMMARY

The first part of this report focuses on whether we are getting an appropriate bang for our buck from the Australian Budget.

But that is not the only vital issue on the fiscal front. A growing problem is that Australia's tax base has become more sensitive to the business cycle (notably via a growing reliance on the corporate tax take) while our spending has become less sensitive to the business cycle (and potentially more sensitive to the political cycle).

That combination means that, if the growth in the nominal economy slows, tougher decisions will be needed to reel in spending, raising the prospect of tax increases and/or larger deficits as an easier policy response.

Is that a risk? Are taxes and spending now more or less sensitive to the business cycle?

This section of the report concludes that:

- ❑ There has been a surge in tax revenues in recent years – mostly in the profit taxes, and particularly in company taxes.
- ❑ The forward estimates of the Australian Budget assume that the boom in the tax take is permanent, and hence so too does the 2007 *Intergenerational Report* (IGR2).
- ❑ Booms always pump up fiscal finances. And they are often assumed to last forever. The official fiscal forecasts emanating from the US at the height of the dot.com boom proved to be wildly optimistic. So too did those in Japan at the height of its late 1980s property boom.
- ❑ The policy response of recent years has been to spend this windfall. And the windfall is still getting larger rather than smaller.
- ❑ But economics – the iron triangle of demand, supply and price – suggests that this windfall will ultimately prove to be temporary.

Using official forecasts from the Mid-Year Economic and Fiscal Outlook released in October 2007, the difference between the post-WW2 average and the forward estimates average for company taxes as a share of national income suggests that the latter are running some \$29 billion a year above 'trend'. That leaves company tax collections rather more vulnerable to commodity prices than the current combination of Treasury forecasting assumptions would imply.

Not all of that \$29 billion will eventually disappear. The structural Budget balance estimation methodology used in Access Economics' model adjusts for the commodity price cycle that has artificially pumped up the corporate tax take in recent years. It takes the difference in nominal national income directly attributable to shifts in the terms of trade away from their longer term average, and then allows 12% of that gap to affect revenues.

That is a conservative adjustment, given Federal taxes account for well over 20% of national income. It suggests that, other things equal, about \$15 billion of revenues in 2008-09 will be attributable to the commodity boom, and that total revenues in 2008-09 will be some \$26 billion over and above where they would be were the economy to be operating at 'trend' levels.

That estimate may be compared with the OECD's. Back in 2006 they noted that, were they to adjust their measure of the 2005-06 structural Budget balance for commodity prices, then it would look worse by 1¾% of GDP (or \$18 billion).¹ However, they go on to note that Federal Treasury thinks that commodity prices are now structurally higher. When they factor in that Treasury assumption (with commodity prices only going half of the way back towards their longer term average), then the OECD notes that the Budget would 'only' be being artificially propped up by ¾% of GDP (or \$8 billion).

- ❑ So the Access Economics methodology sees a potential revenue shortfall of \$26 billion in 2008-09, while the OECD's matching estimates range from \$8-18 billion in 2005-06, depending on how far commodity prices eventually settle back.
- ❑ As commodity prices in 2008-09 are projected to be rather higher than those in 2005-06, those estimates are broadly similar. (By way of comparison, Access Economics' matching estimate for 2005-06 is \$10.6 billion – towards the lower end of the range identified by the OECD.)

Moreover, because the previous Government's fiscal policy so far through this amazing cycle could be summarised as 'spend the lot', that Access Economics estimate also implies that our estimate of the size of the underlying Budget deficit in Australia (as at 2008-09, when the most recently announced round of tax cuts take effect) is \$11 billion.

The resultant message from that figuring is simple: the big tax cuts of recent years are estimated to have left the Australian Budget in structural deficit already – perhaps to the extent of \$11 billion on already announced policies – meaning that good economic times have masked an underlying deterioration in the health of the nation's fiscal finances that we may come to regret.

Access Economics February 2008

¹ OECD's 2006 *Economic Survey of Australia*, at page 34.

1. AUSTRALIA'S INFLATED TAX REVENUES – ARE THEY HEADED FOR A FALL?

The first part of this report focuses on whether we are getting an appropriate bang for our buck from the Australian Budget.

But that is not the only vital issue on the fiscal front. A growing problem is that Australia's tax base has become more sensitive to the business cycle (notably via a growing reliance on the China-driven boom in the corporate tax take) while our spending has become less sensitive to the business cycle (and potentially more sensitive to the political cycle).

That combination means that, if the growth in the nominal economy slows, tougher decisions will be needed to reel in spending, raising the prospect of tax increases and/or larger deficits as an easier policy response.

Is that a risk? Are taxes and spending now more or less sensitive to the business cycle?

Economists have long since recognised the Budget balance at any given time is a function of two factors:

- ❑ **The changing fortunes of the business cycle.** These include, for example, the impact of stronger than trend job levels on personal income tax receipts or the cost of unemployment benefits, or of higher than trend profits on company taxes.
- ❑ **All other influences.** These mainly reflect discretionary moves taken by the Government of the day, such as spending on programs, or cutting tax rates.

That is important, because it means that good economic times could be masking a weak Budget balance – when the economy returns to 'trend', a deficit would be revealed.

To address this issue, economists have developed models of the 'structural Budget balance'.

Both the IMF and the OECD have such models, and issue estimates for Australia (as well as other members). Access Economics does the same. Federal Treasury does not publish its own estimates, and has urged caution on the estimates of others, in part because:

Government revenues in Australia are affected not just by swings in the real economy but also by any significant variations which might occur from time to time in the nominal economy due to, for example, swings in export commodity prices and the terms of trade. These variations affect incomes and hence the income or company tax base. However, existing structural fiscal indicators do not make any allowance for such effects, which can be quite large.²

The latter is important as a sharp upswing in commodity prices has generated a matchingly sharp upswing in corporate tax revenues, a factor not yet accounted for in the IMF or OECD models. This report addresses that issue, using Access Economics' model of Australia's structural Budget balance:

- ❑ The methodology used by the likes of the OECD and the IMF is under review amid the continuing global boom and associated jump in commodity prices.

² *Structural fiscal indicators: an overview*, in Treasury *Economic Round-up*, Autumn 2005.

- Both organisations have noted that there is a case for adjusting the way they estimate structural budget balances to allow for the commodity price cycle (the same concern raised in the Autumn issue of Treasury's *Economic Round-up* in 2005), though neither have taken that step.
- Access Economics' model of Australia's structural Budget balance was enhanced to address this very issue (the impact of commodity prices on the Budget) back in 2005.

This report therefore uses the Access Economics model to try to separate the cyclical froth from the long term fundamentals. That is, it estimates where the Budget would be if the economy were running at trend levels of activity (trend levels – not trend growth rates).

2. THE BUDGET AND THE ECONOMY

The economy affects the Budget, but its effects vary relatively widely across different categories of revenue and spending.

As a simple rule of thumb, taxes respond notably to swings in the economy, whereas spending does not. It is in that dichotomy that fiscal risks lurk.

Table 1 below sets out a number of revenue and spending categories within the Australian Government Budget. The 'share' column refers to the total share of revenue and spending, respectively, accounted for by these different components of the Budget.

TABLE 2-1: THE SENSITIVITY OF THE BUDGET TO THE CYCLE

Revenues	Sensitive to ...	Share	Real cycle	Nominal cycle
Employment-related taxes				
Net PAYG	Employment, progressivity factor and real wages	39%	Moderate	Moderate
Fringe Benefits Tax	Employment and real wages	2%	Moderate	Moderate
Profit-related taxes				
Gross other individuals	Total output, profit share, terms of trade	12%	Moderate	Notable
Companies	Total output, profit share, terms of trade	24%	Notable	Notable
Superannuation funds	Employment, real wages, profit share	3%	Notable	Notable
Petroleum resources rent tax	Output, profit share	1%	Moderate	Notable
Demand and other taxes				
Excise/other indirect tax	Consumer spending	10%	Moderate	Moderate
Customs duties	Imports	3%	Notable	Notable
Other taxes, fees and fines	Output	1%	Moderate	Moderate
Non-tax revenue	Output	6%	Moderate	Moderate
Expenses				
Sensitive to ...				
Unemployment benefits	Unemployment	2%	Moderate	Moderate
Other welfare programs	Unemployment	1%	Moderate	Moderate
Labour and employment programs	Unemployment	1%	Moderate	Moderate

Source: Access Economics, Budget documents

Virtually all of the revenue side of the Budget is sensitive to the economy, whereas little more than one in \$25 dollars on the spending side of the Budget is similarly sensitive. The right hand columns of the table note the degree of sensitivity across these categories to a cycle on the real economy on the one hand and a cycle on the nominal economy on the other.

A 'real economy cycle' may be thought of as a classic cycle: the economy slows, job gains weaken, unemployment lifts and wage growth eases back relative to price inflation:

- ❑ There is usually a relatively larger impact (in proportional terms) on profits and markets and imports. Hence, for example, the profit share and the level of share markets typically fall away in a slowdown.
- ❑ There are relatively smaller impacts on consumer spending and on job growth.

The most cyclically sensitive heads of revenue in a classic slowdown are those most closely linked to profits and asset prices: such as company taxes, taxes on super funds (mostly because these are linked to sharemarket earnings), 'gross other individuals' (a head of revenue which picks up most earning from small unincorporated businesses, plus subcontractors, as well as dividend, rental and interest income) and petroleum resource rent tax (which is also a profit tax, albeit one on a specific sector).

Demand and other taxes (such as the excises) and the employment-related taxes (such as Pay-As-You-Go taxes on wage and salary earners) tend to be less sensitive than the profit-related taxes.

About 70% of revenues are moderately sensitive to a classic cycle, with the remaining 30% notably sensitive. A handful expenses are also moderately sensitive to a classic cycle, mostly because unemployment and related benefits rise.

The second type of cycle nominated in the table – a ‘nominal cycle’ – is one where the classic slowdown is combined with or created by a global slowdown which also leads to a fall in commodity prices.

As this report goes on to spell out in detail, the key sensitivity for the Australian Budget is the risk that commodity prices take a tumble.

Over and above the classic cycle, such a **commodity cycle** could see a very substantial fall in profits and asset prices, which would then reverberate through the profit-related taxes. There would be larger effects on a number of other heads of revenue too. For example, a notable weakening on profits would, with a lag, be likely to further slow employment growth over and above the slowing to be expected in a classic cycle.

Such a commodity cycle would see some 42% of Australian Government revenues notably affected, with the remaining 58% moderately affected. There would be an additional impact on expenses, with a fall in the \$A adding to the cost of overseas purchasing, but lower interest rates providing a small offset (reducing interest expenses, but also interest earnings on the revenue side of the Budget).

2.1 HOW BIG AN EFFECT?

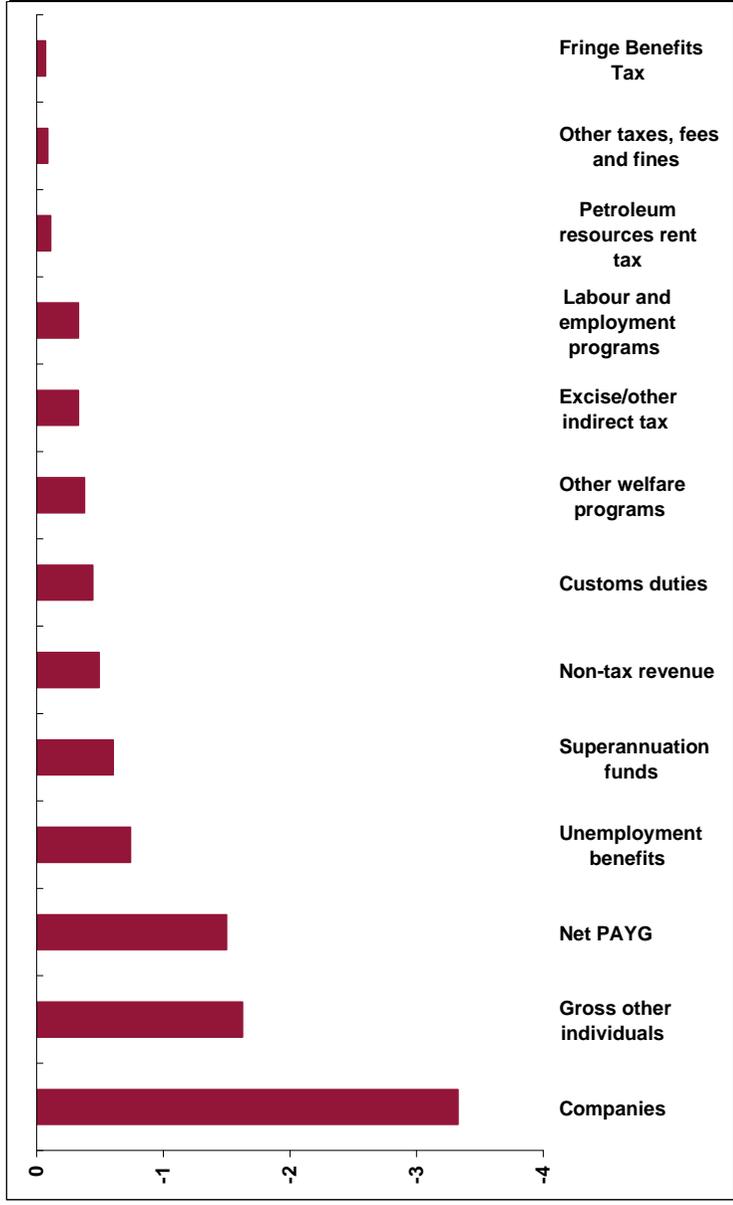
It is relatively easy to calibrate a typical slowdown, as Australia has had many.

For example, over the past quarter of a century the standard deviations in growth rates from the Australian ABS data were as follows:

□ Growth in real consumer spending	1.4%
□ Employment growth	1.6%
□ Growth in real GDP	1.8%
□ Growth in profit share	2.6%
□ Growth in nominal GDP	3.3%
□ Growth in real imports	7.4%
□ The change in the terms of trade	5.6%
□ The change in the level of unemployment	14.3%

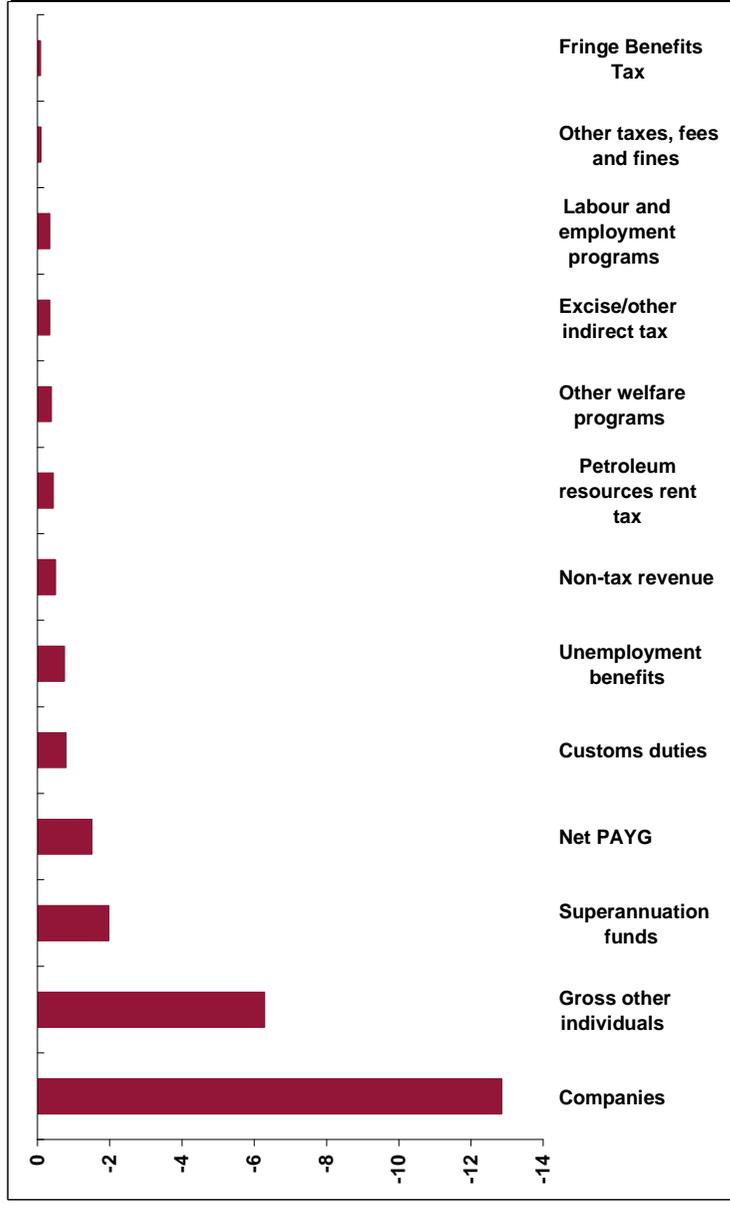
Assuming that a ‘classic slowdown’ sees all of these (except the terms of trade) drop one standard deviation, then the above table implies a total effect on revenue and expenses equivalent to \$10.1 billion in today’s money: a loss of \$8.6 billion on revenues, and an increase of \$1.5 billion on expenses.

FIGURE 2-1: REVENUE LOSSES & SPENDING INCREASES IN A 'CLASSIC SLOWDOWN' (\$BN)



It is harder to estimate the impact of the Budget of a downswing in commodity prices. The next chapter goes on to attempt that in detail – and to note that the Budget’s current forward estimates assume that the good times continue to roll.

FIGURE 2-2: REVENUE LOSSES & SPENDING INCREASES IN A 'COMMODITY CYCLE' DOWNTURN (\$BN)

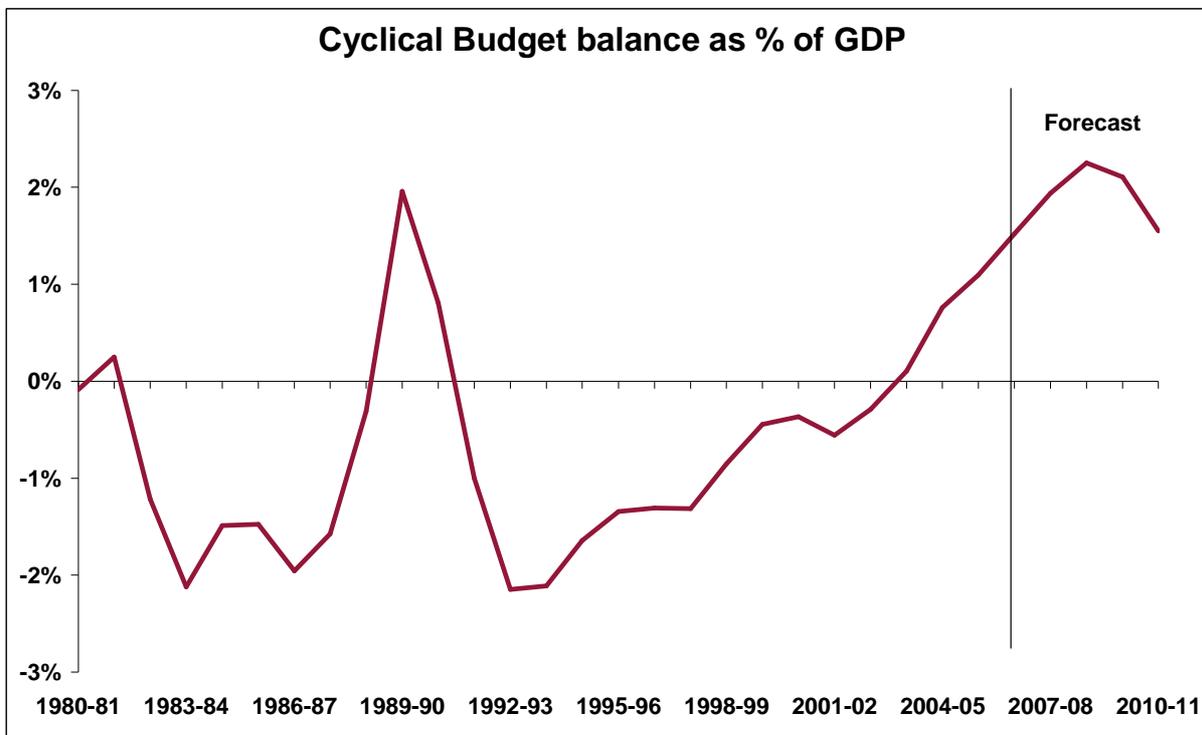


That said, it is worth noting here that adding a fall in the terms of trade of three standard deviations (about 40% of the increase in the terms of trade over the past five years) to the 'classic cycle' above would imply a total effect on revenue and expenses equivalent to \$26.2 billion in today's money: a loss of \$24.7 billion on revenues, and an increase of \$1.5 billion on expenses.

Although the next chapter covers this in greater detail – and in a theoretically consistent manner, rather than the simple rules of thumb used above – that latter loss to the Budget of \$26.2 billion is very similar to Access Economics' \$26.0 billion estimate of the cyclical Budget balance in 2008-09: that is, the extent to which Budget aggregates are artificially outperforming thanks to the strength of the economy.

The current lift in the cyclical balance, seen in Figure 2-3, has been rather slower and more steady than the leap in the cyclical balance in 1989-90, but the latter was slightly larger as a share of the economy at that time.

FIGURE 2-3: CYCLICAL BUDGET BALANCE AS % OF GDP (ACCESS ECONOMICS ESTIMATES)

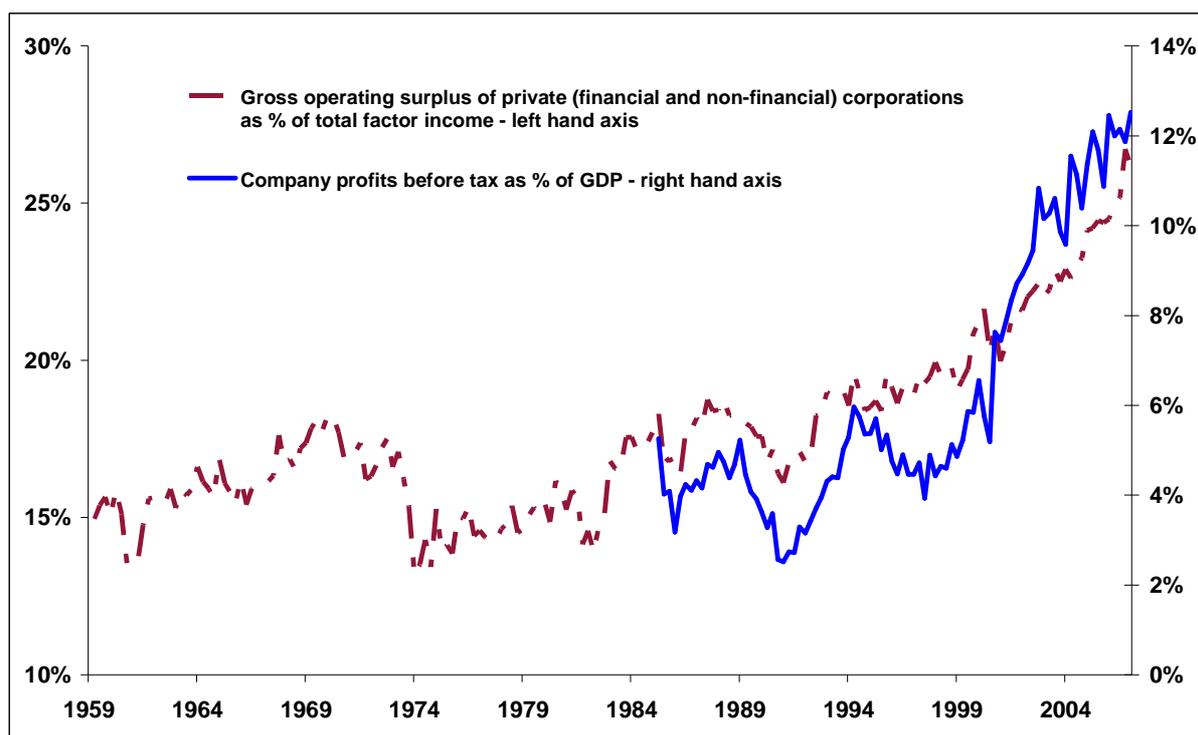


3. THE COMPANY TAX STORY

It is worth starting at the end. Profits have lifted sharply in Australia in recent years. Figure 3-1 shows two different measures of profits. The broader national accounts measure goes back almost 50 years, while the narrower measure³ only goes back two decades.

Both are booming. In times past, for example, cyclical peaks usually saw the ABS measure of company profits before income tax top out at about 6% of national income.

FIGURE 3-1: COMPANY PROFITS TO GDP



Not so this time. That measure is at 12.5%, double its previous best. The improvement is less marked on the broader measure of profits, but both have jumped by a similar share of national income – about 7 percentage points.

The lift in profits to a record share of the economic pie pretty much matches the equivalent leap in national income attributable to the great commodity prices of the last four years. And it has handed an enormous revenue windfall to the Australian Government, mostly via higher company tax receipts, which the previous Government then recycled into a series of personal income tax cuts and family benefits.

That thereby makes an assessment of the likely future of the commodity price boom central to any assessment of the health of Australia's fiscal finances.

³ It excludes the finance and farm sectors and small business.

3.1 COMMODITY PRICES

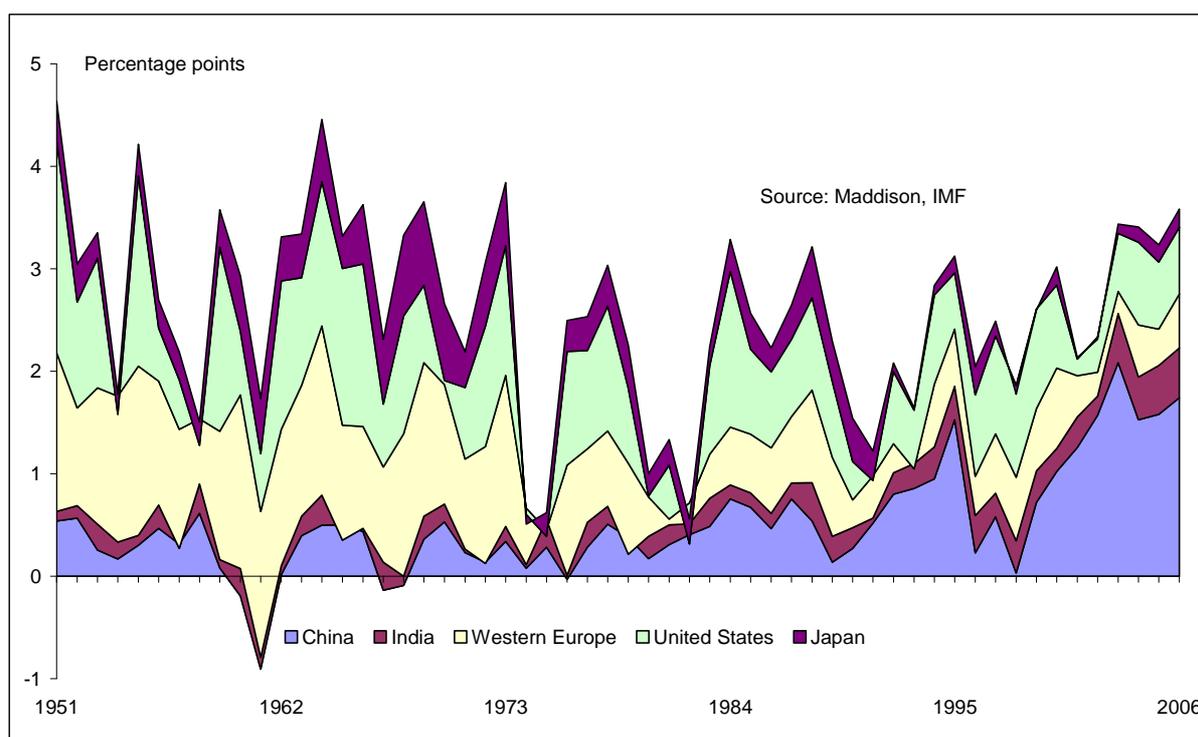
Something unusual is happening to profits in Australia and hence to tax revenues federally because something unusual is happening to commodity prices.

That is why Access Economics concentrates in this part of the report on commodity prices – how they are boosting tax revenues now, but also how any eventual reversal in commodity fortunes would potentially pose big risks to Australia’s economy and Federal finances at some stage.

Indeed, the most important judgement – and uncertainty – underlying medium term Budget projections lies in forecasts of global commodity prices. That is because commodity prices are, at present, the main determinant of the size of Australia’s economic pie. The latter, nominal GDP, is growing as fast as at any time since the late 1980s.

Industrial commodity prices have leapt because half the globe is undergoing an industrial revolution. Global growth is seeing its most sustained surge since the 1960s, and much of that growth is concentrated in commodity-hungry nations such as China (see Figure 3-2)

FIGURE 3-2: CONTRIBUTIONS TO GLOBAL GROWTH



Global growth is great – and looks set to stay great for a while further yet.

Indeed, from a longer term viewpoint there probably is a commodity supercycle underway. Yet that is likely to be in commodity *demand* rather than in commodity *prices*. Chances are global commodity demand is now permanently higher. That is because the demand most relevant to commodity prices is that in the emerging industrial giants of the world, as they are the ones who drive most of the growth in additional industrial production.

Yet that won't save today's commodity prices (and hence today's Australian Budget tax revenue surge from fading) some time in the future.

That is because global growth has been great for quite some time now, and the demand surprise for commodities is increasingly being factored into the supply response of miners and others. For most commodities, supply is still barely bigger than it was a handful of years ago. Yet that is increasingly changing. And when supply does start to catch demand, then commodity prices could fall – perhaps substantially so.

The iron triangle

Demand is only ever half a story. The supply (production) of industrial commodities will eventually catch up to fast charging demand.

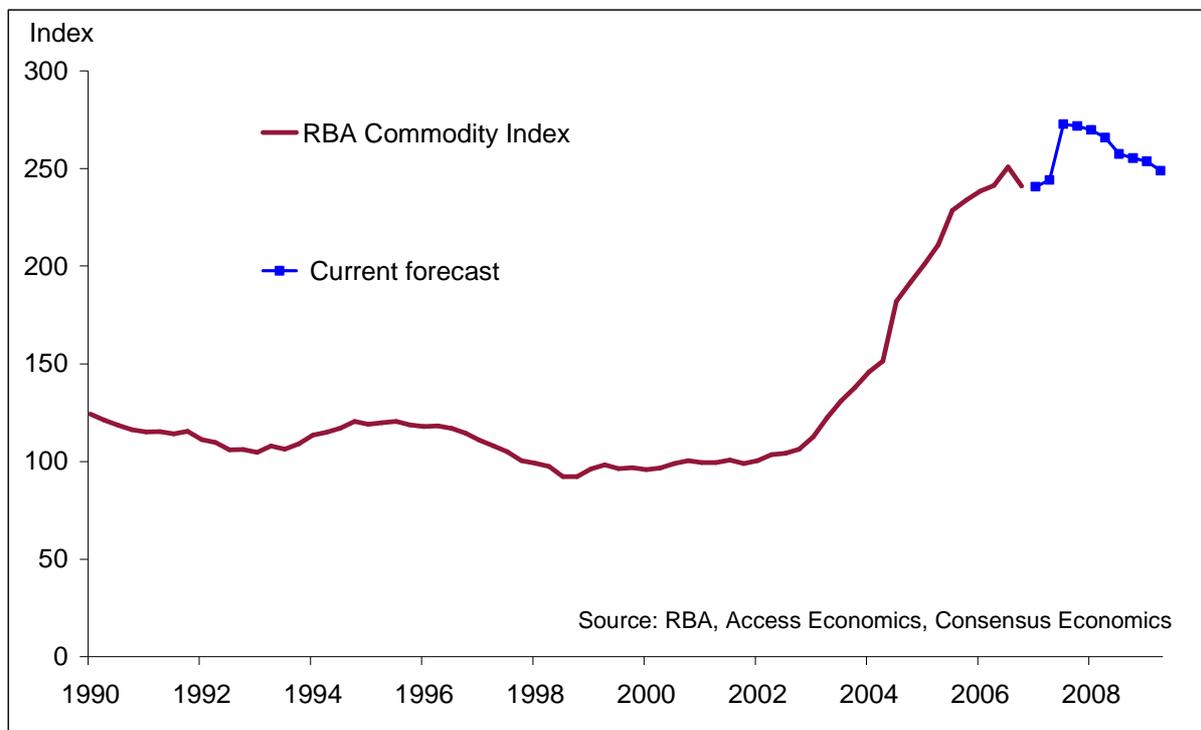
That means that, over the next four or five years, the risks to commodity prices are heavily weighted to the downside. Or, in other words, economics points to an iron triangle connecting demand, supply and price. At any given time two of that troika can boom – but not all three.

Today there is a boom in the demand for and the price of industrial commodities.

As the demand for industrial commodities is particularly price inelastic, the boom in price has been very sharp. Indeed, the average industrial commodity is now two to three times its price of just over four years ago.

However, if supply starts to catch up with demand, then there will be a boom in both demand and supply, but prices may fall substantially. In turn, that suggests that this windfall in commodity prices (and profits and company taxes) will ultimately prove to be temporary.

FIGURE 3-3: CONSENSUS EXPECTATIONS ON COMMODITY PRICES



The consensus view matches Access Economics' – that current industrial commodity prices will subside over several years as miners all over the world finally succeed in getting higher volumes of output to market.

The survey also asks respondents their views on where prices will settle in 'the longer term'. Interestingly, their view on the latter question suggests that they eventually see almost half the increase in prices of recent years being eventually unwound.

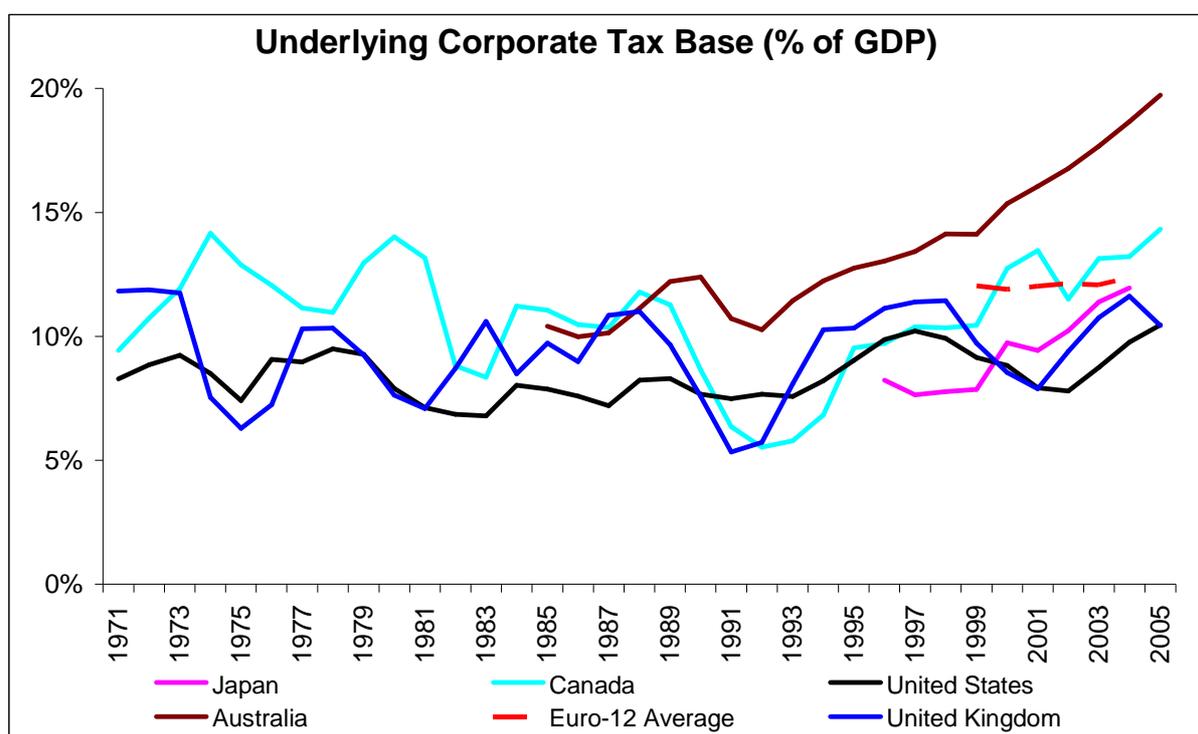
Were that fall in commodity prices to eventuate, it could blow a very large hole in Australian corporate profitability.

3.2 THE CORPORATE TAX BASE

Access Economics used national accounts data to estimate the underlying corporate tax base across various nations. The results are shown in Figure 3-4. It shows that, as a share of GDP, the underlying corporate tax base has trended up over time in Australia.

That trend increase in the Australian corporate tax base as a share of national output accelerated in recent years as the commodity boom evident since late 2002 has pumped up profits. (Indeed, the lift of late is even sharper than it appears here, as the commodity boom also induced an investment boom which, other things equal, reduces measured profitability.)

FIGURE 3-4: CORPORATE TAX BASE AS A % OF GDP



There are a number of reasons for that trend increase in company profits (and hence company tax collections) over time:

- There is a large gap between the top marginal tax rates for individuals and companies, which encourages small businesses and others to incorporate (which has the effect of raising the corporate tax base).

- ❑ The liberalisation of financial markets in Australia in the second half of the 1980s notably boosted the corporate tax base. The financial sector rapidly grew to account for about 40% of the tax base, a ratio it has broadly maintained since the early 1990s.
- ❑ The Federal Treasury has pointed out other factors relevant here too, such as the privatisation of major government business enterprises; growth in capital gains made by companies; the long period of economic expansion which has reduced the stock of carried-forward losses to offset tax payable; the more effective tax compliance activities of the Australian Taxation Office; and increased incentives to pay tax.

However, as important as those factors are, the dominant driver of the lift in corporate profits in recent years has been the China boom and, in particular, higher commodity prices.

Compared with the commodity prices four years ago, that lift in what the world is paying Australia is pumping an extra \$87 billion a year into the Australian economy – the bulk of which has ended up as higher profits.⁴

Note that it has not all been the profits of the miners. For example, the profits of retailers also benefit from a lift in commodity prices via a variety of channels:

- ❑ Higher commodity prices raise the \$A, making the likes of plasma TVs cheaper to buy.
- ❑ Higher commodity prices boost the sharemarket, adding to wealth and hence again to consumer spending.
- ❑ Higher commodity prices boost profits, and a profit boom is a job boom, with the latter also lifting consumer demand.
- ❑ Higher commodity prices boost the tax take, which the previous Government then handed back as tax cuts and family benefits, again boosting consumer spending.

Or, in other words, the lift in commodity prices has spread prosperity through the economy in a number of ways. However, as Figure 3-4 helps to show, the single most common theme has been a lift in profits.

3.3 THE CORPORATE TAX BASE AND THE COMMODITY BOOM

Many analysts have noted this connection, and its particular strength here in Australia.

As the OECD has noted, “The three major OECD commodity producers – Australia, Canada and Norway – are the only OECD countries for which there is a statistically significant (at the 5% level) positive correlation between the terms of trade and the corporate tax share over the last 3 decades.”⁵ Figure 3-5 shows the relationship between tax receipts and the terms of trade for Australia.

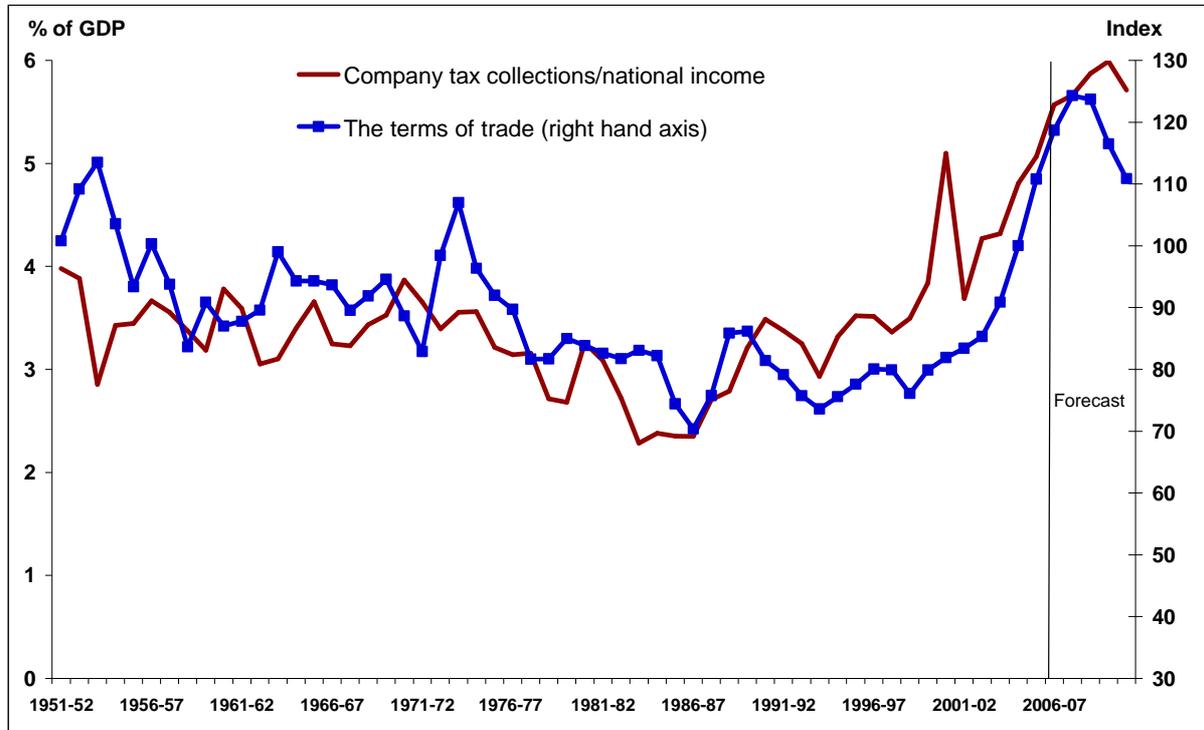
⁴ Paper 1 (*The bang for our buck – is our Federal Budget doing the job?*) notes that revisions to Federal Treasury’s estimates since mid-2002 have seen revenues growing rapidly, resulting in an economy-driven net revenue gain since then of \$87 billion for the 2008-09 financial year. That differs, however, from the above reference to \$87 billion. Although the dollar figure is the same, the reference above is to the direct impact of commodity prices on Australian national income, and covers a different period. (Note that Figure 4-1 later shows that the annual cost of new policies announced since mid -2002 will reach \$85 billion in 2008-09, meaning most of the \$87 billion a year revenue windfall identified in Paper 1 has already been spent).

⁵ *Should measures of fiscal stance be adjusted for terms of trade effects?*, OECD Economics Department Working Papers No. 519, October 2006, at page 16.

The OECD is saying that, when the world gives Australia a pay rise on the commodities we sell, then corporate profits lift as a share of national output, and so too does the company tax take.

Indeed, that is exactly what history seems to be saying – as evidenced in Figure 3-5.

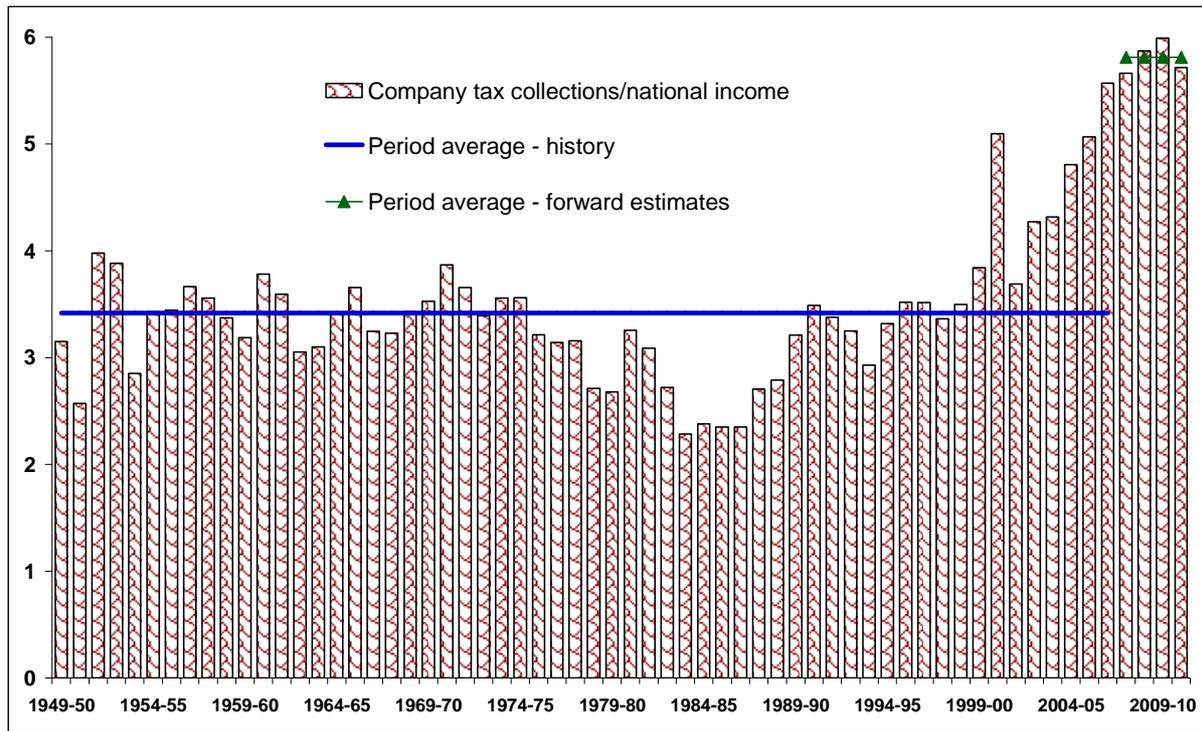
FIGURE 3-5: CORPORATE TAX COLLECTIONS AND THE TERMS OF TRADE



Source: History is from the ABS and Federal Budget papers, forecast is from Access Economics

Figure 3-6 shows company tax collections in Australia as a share of national income over time. Since WW2 the average has been 3.4% of GDP. The average across the forward estimates (as updated in the Mid-Year Economic and Fiscal Outlook released on 16 October 2007) factor in 5.8% of GDP. In 2008-09 dollars, and compared with the post-WW2 average, that is a commodity-driven windfall of \$29 billion of company tax revenue in each year across the forward estimates.

FIGURE 3-6: CORPORATE TAX COLLECTIONS AS A SHARE OF GDP OVER TIME



The strength of Chinese growth is such that the forward estimates may easily be met – indeed, the May 2008 budget may see further upward revisions. However, considerable dangers lurk further out in time.

Mid-Year Economic and Fiscal Outlook and its predecessors have adopted the assumption that coal and iron ore prices fall back in coming years. (In MYEFO, they fall back in 2009-10 and 2010-11.) Yet, despite that assumption, Figure 3-6 shows that company taxes (and it is just as true of ‘taxation of other individuals’) are projected to stay very high.

That is, even though it assumes coal and iron ore prices will fall, Treasury’s revenue forecasts expect the recent revenue boom to continue.

Or, in other words, it suggests that the relationship evident in times past – seen in Figure 3-6 – won’t hold in the future.

Federal Treasury’s view may prove to be true. However:

- ❑ Treasury’s view doesn’t fit with what has happened in history.
- ❑ Rather, the Treasury forecasts in Mid-Year Economic and Fiscal Outlook assume that the perfect storm benefiting revenues in recent years can be maintained across the next several years.
- ❑ Yet, when things are already better than ever before, to project that they will stay that way still may risk a wake up call in a few years.
- ❑ Moreover, the end-point to the forward estimates becomes the starting point of the longer term forecasts that flow into the *Intergenerational Report*. As Treasury has assumed revenue perfection (and was already assuming it at the time the second IGR was prepared and released), that means that official forecasts of Australian tax revenues assume the lift in revenues seen in Figures 3-5 and 3-6 is permanent.

3.4 CHANGES TO FEDERAL TREASURY'S FORECASTING METHODOLOGY

So why are the official forecast figures so optimistic? In the 2005-06 Budget, Treasury made two changes to the way it forecasts tax revenues:

- ❑ First it moved to assume that coal and iron ore prices would fall back to more normal levels in coming years.
- ❑ But, second, and at the same time, it then counteracted the effect of its first change by also assuming profit tax collections will permanently rise faster than profits themselves.

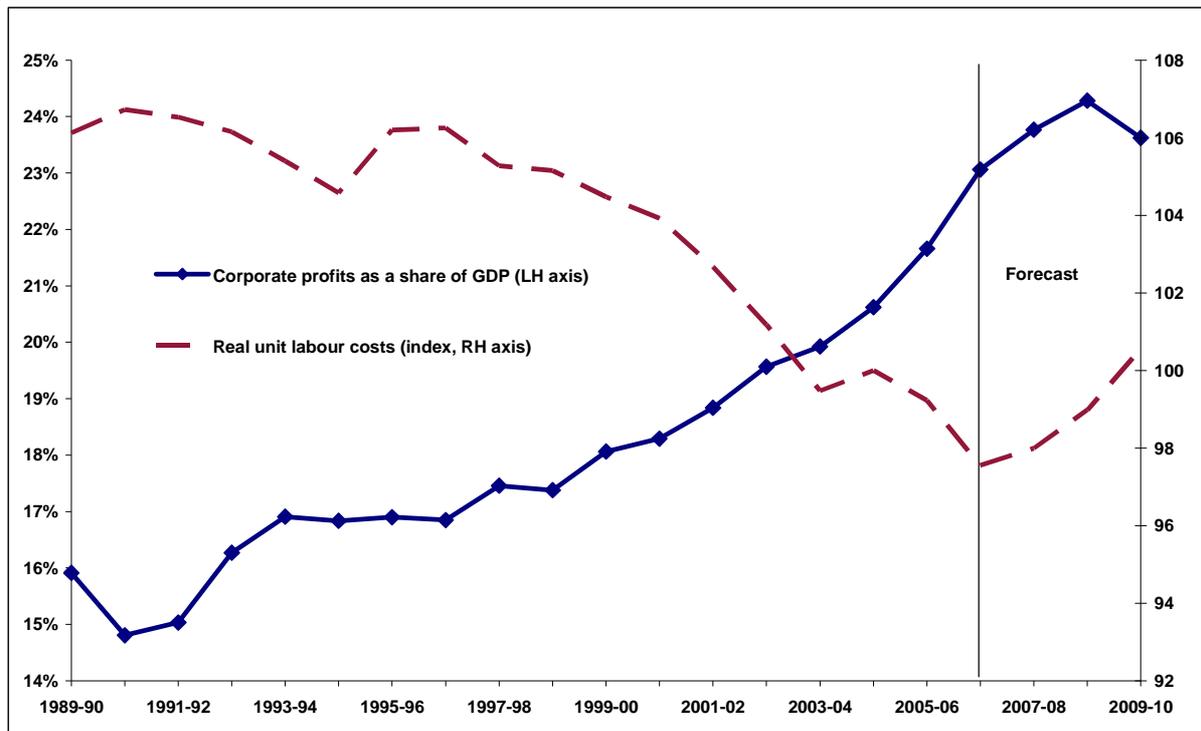
Hence it sees company taxes to GDP remaining very high over time over the forward estimate – a starting point for IGR figuring too – whereas Access Economics sees them eventually falling away, perhaps sharply so.

Either view could prove true five years from now. For the moment, however, profits are still rising. Figure 3-4 shows the broadest measure of corporate profits (gross operating surplus, or GOS) as well as the more narrowly-defined company profits before income tax measure, which is based on an ABS survey that excludes banks, other financial enterprises and farms.

Arguably the clearer indication of current strength comes from the company profit survey. That line in Figure 3-4 shows that past peaks in company profits before income tax as a share of GDP have usually been around 6% of national income. This cycle has easily beaten those past peaks, hitting 12.5%.

There are several important trends in play here. One, as noted, is that small business people are taking advantage of the timing effects available given the difference between the corporate rate of 30% and the top two marginal rates of 40% and 45%.

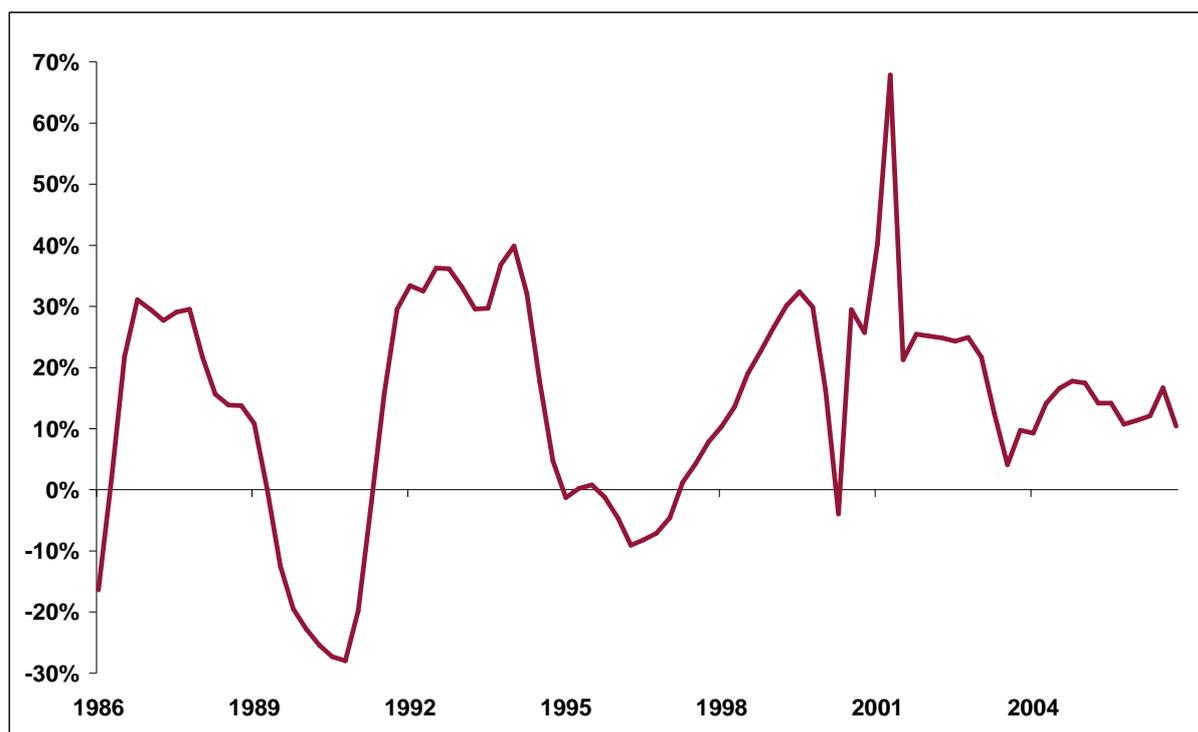
FIGURE 3-7: CAPITAL AND LABOUR CROSS PATHS



Another is that Australia has achieved a degree of additional labour market flexibility since the early 1990s. That process seems to have permanently boosted the profit share at the expense of the wage share. Figure 3-7 shows the corporate profit share of the total national economic pie. It is now higher than it used to be, with an equivalent matching move in the other direction by real unit labour costs.

In addition, two decades of privatisation have cut direct Federal revenue from dividends, but boosted Federal revenue from company income taxes (from the likes of the Commonwealth Bank and Telstra). And, finally, capital gains tax paid by companies has been on the rise since a dip in 2000-01.

FIGURE 3-8: RECENT PROFIT GROWTH



And as Figure 3-8 shows, corporate profits before income tax are still rising – up by a further 10.4% in trend terms over the past year, with every sign of further strength to come in 2008.

However, Access Economics is of the view – and history concurs – that the key driver here is commodity prices. If they stumble, then it will be evident that the huge policy spend of recent years will have been made on the back of a temporary surge in revenues.

4. IMPLICATIONS

The above analysis suggests that the main reason Australian company tax receipts have soared is because underlying profitability has done the same.

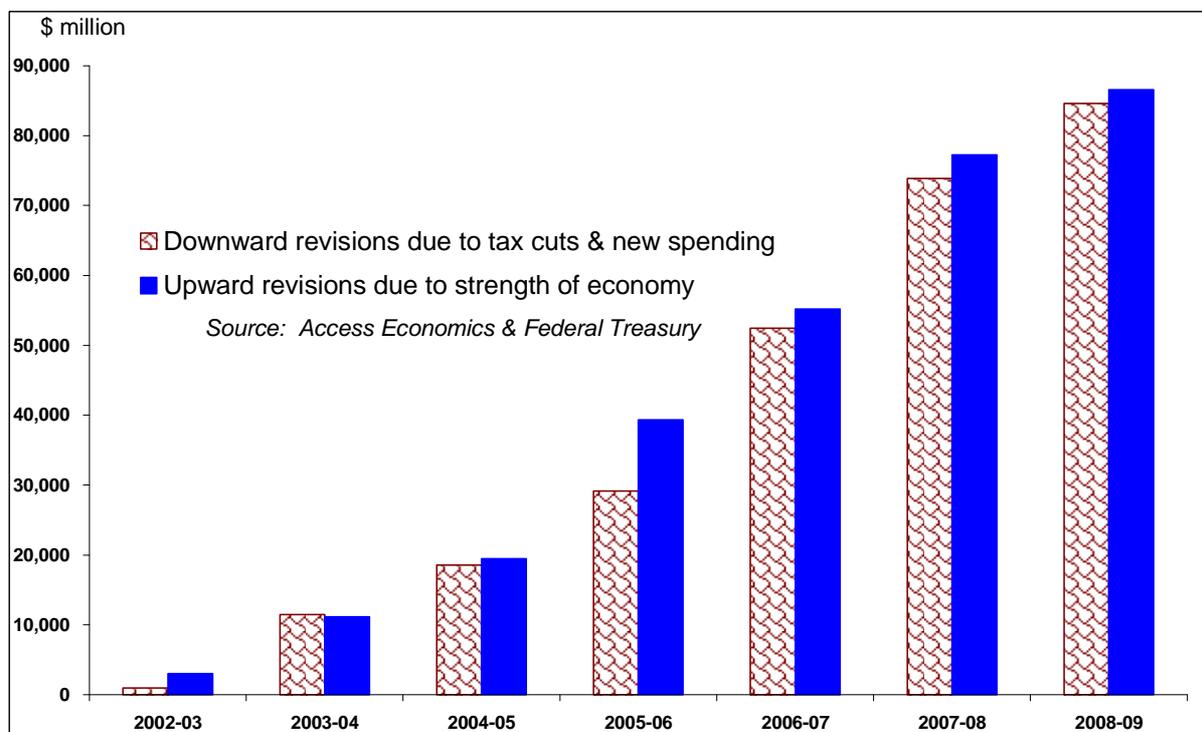
- ❑ In brief, the China boom has led to a surge in commodity prices which has led to a surge in the profit share which has led to a surge in corporate tax receipts that have been recycled (among other measures) into a series of personal tax cuts and increases in family benefits.
- ❑ If the current level of commodity prices were to wane in coming years, then several parts of that economic causal chain would start to work in reverse – profits will come back down and so too will company tax receipts. If this wind back is substantial, it could place the wider Australian Budget under considerable pressure.
- ❑ In essence, the big policy shift of recent years has been financed by the profit boom, and if the latter recedes then there is a risk to Australian fiscal policy making.

4.1 JUST HOW BIG HAS THE POLICY SPEND BEEN?

The China boom keeps getting stronger, and a key side-effect has been that the Federal taxman is reaping an ever larger dividend from it.

That can be seen in Figure 4-1. It winds the clock back to the Budget delivered in mid-2002. The inaugural *Intergenerational Report* was released at the same time. In the five and a bit years since then, Treasury has steadily reacted to the growing China boom by revising up its estimates of strength in the revenue earning capacity of Australia's tax system.

FIGURE 4-1: ANNUAL COST OF NET NEW POLICIES ANNOUNCED SINCE THE 2002 BUDGET



That shows up as steady gains in the 'strength of economy' columns over the years. Compared to the estimates made some years ago, the earning capacity of the Budget next financial year is now \$85 billion better.

But the other columns show that, as fast as the boom in profits has generated a tax windfall, the previous Government parcelled it back out again as tax cuts (which account for a bit more than half of the big policy spend of recent years) and increased spending (notably the 'barbeque stopper' increases in family benefit payments and baby bonuses).

Yet the resultant recent mix of macro policies has seen (1) lax fiscal policies as Federal and State governments have spent their share of the commodity and housing booms, respectively and (2) tight monetary policies as the Reserve Bank attempts to reduce capacity pressure in the economy.

That combination – with one policy accelerating and the other braking – is almost the exact opposite of what is required in an economy with stretched housing prices and a large current account deficit amid a commodity boom.

4.2 DOES FEDERAL TREASURY'S NEW FORECASTING METHODOLOGY STACK UP?

There are good reasons to expect the corporate tax take to rise as a share of the corporate tax base in an extended economic upswing such as the one that Australia has seen for over a decade. Treasury set out some of those reasons at page 5-7 of the 2005-06 Budget Paper 1, and has repeated similar analyses in subsequent budget updates.

It has used reasons such as these to assume an 'accelerator' effect across the forward estimates. This effect assumes that profit taxes will grow faster than profits across the forward estimates. Access Economics disagrees strongly with this change in methodology by Federal Treasury.

There are two main reasons for Access Economics' scepticism:

- ❑ First, there is no evidence of an uptrend in effective company tax rates in Australia. Rather, the underlying uptrend has been largely driven by an increase in the profit share of nominal national income.
- ❑ And, second, there are reasons to believe that some of the factors which have pushed up the profit share of nominal national income of late – notably, the commodity price boom – may reverse in coming years.

4.3 ESTIMATING THE SIZE OF THE REVENUE RISK TO THE BUDGET FROM THE ECONOMY

The structural Budget balance estimation methodology used in Access Economics' model adjusts for the commodity price cycle. It takes the difference in nominal national income directly attributable to shifts in the terms of trade away from their longer term average, and then allows 12% of that gap to affect revenues. That is a conservative adjustment, given Federal taxes account for over 20% of national income. It suggests, other things equal, about \$15 billion of revenues in 2008-09 is directly due to the commodity boom.

However, commodities are not the only driver of this boom in revenues, and there are some indirect effects here too. For example, both employment and consumer spending are above

trend levels at the moment. Allowing for all these effects, cyclical 'froth' in the 2008-09 Budget balance is estimated at \$26 billion – a huge amount.

- ❑ Not surprisingly, the most pumped up among the revenues are the profit taxes – company, superannuation and Resource Rent taxes. These are seen running at around \$13 billion above 'trend' in 2008-09.
- ❑ There is also a degree of outperformance in the personal income taxes on individuals – by about \$5 billion – because pumped up profits have, in turn, generated above trend strength in employment. In brief, a profit boom is a job boom, because strong profits reduce the relative cost of employees, making them a relative bargain, and thereby artificially adding to employment levels.
- ❑ The tax revenue head called 'other individuals' picks up small business profits, as well as taxes on interest, dividends and capital gains. It too is therefore benefiting from the current strength in the economy, and particularly that in profits and in sharemarkets. Access Economics sees it as \$4 billion above 'trend' in 2008-09.

Hence, even though Access Economics expects a cash surplus in 2008-09 of \$15 billion, we estimate that – were the \$26 billion in 'boom effects' to be stripped away – it would show the Australian Budget to be in structural deficit to the tune of \$11 billion in that year.

That estimate may be compared with the OECD's. Back in 2006 they noted that, were they to adjust their measure of the 2005-06 structural Budget balance for commodity prices, then it would look worse by 1¼% of GDP (or \$18 billion).⁶ However, they went on to note that Federal Treasury thinks that commodity prices are now structurally higher. When they factor in that Treasury assumption (with commodity prices only going half of the way back towards their longer term average), then the OECD notes that the Budget would 'only' be being artificially propped up by ¾% of GDP (or \$8 billion).

- ❑ So the Access Economics methodology sees a potential revenue shortfall of \$26 billion in 2008-09, while the OECD's matching estimates range from \$8-18 billion in 2005-06, depending on how far commodity prices eventually settle back.
- ❑ As commodity prices in 2008-09 are projected to be rather higher than those in 2005-06, those estimates are broadly similar. (By way of comparison, Access Economics' matching estimate for 2005-06 is \$10.6 billion – towards the lower end of the range identified by the OECD.)

Moreover, because the previous Government's fiscal policy so far through this amazing cycle could be summarised as 'spend the lot', that Access Economics estimate also implies that our estimate of the size of the underlying Budget deficit in Australia (as at 2008-09, when the most recently announced round of tax cuts take effect) is \$11 billion.

The resultant message from that figuring is simple: the big tax cuts of recent years are estimated to have left the Australian Budget in structural deficit already – perhaps to the extent of \$11 billion on already announced policies – meaning that good economic times have masked an underlying deterioration in the health of the nation's fiscal finances that we may come to regret.

⁶ OECD's 2006 *Economic Survey of Australia*, at page 34.