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The complex Australian consumer spending problem

A key foundation of the Reserve Bank of Australia's (RBA) optimistic economic outlook is a revival of consumer spending which has been incredibly weak. Indeed, despite more rapid population growth, consumer spending has been weaker over the past 2 years than it was in the period including the early 1990s recession.

The growing view among economists and the RBA, however, is that the extended period of weakness is poised to end as income tax cuts, smaller price rises and, eventually, lower interest rates revive the Australian consumer.

But while income tax cuts and lower interest rates will help a little, they probably can't overcome three structural factors that mean consumer spending is likely to remain disappointingly subdued for the foreseeable future.

The nasty sting in the tail of the revised Stage 3 tax cuts

The first challenge for consumer spending is the sombre outlook for wages. Private sector wages grew at an annualised pace of just 2.8% in the June quarter of 2024, which was less than inflation. But then we need to account for the pernicious effects of bracket creep, a problem exacerbated by the revisions to the Stage 3 income tax cuts.

While the revised tax cuts provided more support to lower-income earners, the trade-off was that anyone earning more than $135,000 now pays a marginal tax rate of 37%. In practice, this means someone earning $135,000 who gets a 3% wage rise next year, will see their after-tax income increase by just 2½%. So, even if the RBA achieves its inflation target, these households won't experience any increase in real wages at all. That is not a supportive backdrop for consumer spending.

The rising tide of rent seekers

The rising share of people renting, large rent increases and uncertainty about the future path of rents also weighs on consumer spending. The relationship between rents and consumer spending is, however, complex as rent is the largest component of consumer spending, at 22%. So, more renters and higher rents mechanically boost consumer spending. But when rents grow more quickly than income, people reduce spending on other items by more, so this is a net drag overall.

Of course, most Australian landlords are households so rising rents also boost household income which is a potential offset. But rising rents are essentially a transfer of income from typically less-affluent households who spend most of their income (i.e. have a high propensity to consume) to mainly wealthier households who are less budget constrained. Again, the net effect is to weaken consumer spending.

The lucky households with mortgages

Finally, we come to the fortunate people who have managed to break into the housing market. Unless these people were blessed with wealthy parents who bought the house for them, they will have taken out a large mortgage. And while mortgage rates are lower today than in the early 1990s, house prices were 2½ times income in 1991 compared to 6 times income today.

This matters because more households are approaching retirement with a hefty mortgage. This is partly because people are buying their first home later in life as it takes longer to save a deposit. But is also because wage growth is much weaker than during the 1980s, 1990s or early 2000s. As a result, people can't pay down their much-larger mortgages as quickly as previous generations could. So, when these people do get any free cash flow, they use it to pay down debt rather than spend it.

The bottom line is that structural headwinds facing Australian consumers hold important implications for a wide range of people: retailers, retail property owners, state governments reliant on GST receipts and the RBA itself. First, it suggests that the largest part of the Australian economy – consumer spending – will grow more slowly than it did in the past. Second, that the effects of monetary policy are not symmetric: tighter monetary policy will curb spending more than looser policy will boost it. Last, it highlights that the time has come for us to abandon the idea that we should only rely on monetary policy to manage the economy.

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