

STATEMENT 2 — ECONOMIC AND FISCAL OUTLOOK

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STATEMENT 2 — ECONOMIC AND FISCAL OUTLOOK

PART I: ECONOMIC OUTLOOK¹

OVERVIEW

The Australian economy should continue to record solid economic growth, low inflation and a further reduction in the unemployment rate in 1998-99.

Economic growth will slow over the course of 1998-99 as a consequence of the economic and financial difficulties being experienced by some of Australia's Asian trading partners, including Japan. Growth in activity will be supported by continuing strong growth in domestic demand, underpinned by favourable fundamental influences. GDP is forecast to grow by 3 per cent in 1998-99, following estimated growth of 3¾ per cent in 1997-98. In the absence of the downturn in Asia, Australia's GDP growth in 1998-99 would likely have exceeded that estimated for 1997-98.

The economic crisis in Asia will have an adverse effect on both export volumes and prices, and the resultant reductions in exporters' incomes will affect outputs and incomes in associated industries. It is important, however, to keep in perspective the likely impact on Australia's export prospects of developments in specific markets. Allowance needs to be made for the diversification of Australian exports in recent years and the capacity for exporters to divert sales to alternative markets, especially in the light of a more competitive exchange rate. The Asian crisis will also affect confidence, resulting in slower growth in business and consumer spending than would otherwise be the case. But not all of the influences from events in Asia will be negative. In particular, Australia has benefited from the reallocation of world capital flows which has contributed to higher equity prices and lower bond yields in the long-established markets. In addition, the depreciation of the Australian dollar against most currencies outside Asia has offset the decline in world commodity prices and improved the competitiveness of Australian firms. These developments will support domestic activity.

Some of the factors which encouraged strong growth in domestic demand in 1997-98 will continue to have an influence in 1998-99. Low interest rates, stemming from reductions in the official cash rate and greater competition among lenders, will support private sector activity, particularly dwelling and business investment. Strong growth in consumption is expected, supported by continuing solid employment growth as well as a transitory boost from gains to consumers as a result of the AMP Society demutualisation.

Employment growth should remain firm, supported by recent and prospective growth in non-farm activity and the unemployment rate is forecast to fall to around 7¾ per cent in the June quarter 1999.

¹ In this Statement, unless otherwise specified, monthly and quarterly data are expressed in seasonally adjusted terms. The current price GDP (Income) measure is used as the nominal measure of GDP, while GDP (Average) is the constant price GDP series used.

While a modest rise in underlying inflation is expected as recent increases in import prices flow through into retail prices, it is expected to remain within the 2 to 3 per cent band. Some moderation in wage growth is forecast.

The current account deficit is forecast to rise to \$31 billion, or 5¼ per cent of GDP, reflecting the weaker international environment and continuing solid domestic demand growth.

The uncertain nature of the international economy, particularly the state of the Japanese economy, poses a considerable risk to the outlook for the Australian economy in 1998-99 and beyond. As usual, weather conditions will be crucial for the farm sector with further widespread rainfall required to achieve the assumed average seasonal conditions.

Table 1: Domestic Economy Forecasts^(a)

	Outcomes(b)	Estimates	Forecasts	
	1996-97 Year Average	1997-98 Year Average	1998-99 Year Average	Four quarters to June 1999
Panel A - Demand and Output(c)				
Private consumption	2.4	5	4	3 1/2
Private investment				
Dwellings	1.1	12	10	8
Total business investment(d)	17.4	8	6	5
Non-dwelling construction	18.5	-4	9	8
Equipment	16.9	13	5	3
Private final demand(d)	4.5	6 1/4	5	4
Public final demand(d)	0.0	3 3/4	2 1/4	1
Total final demand	3.6	5 3/4	4 1/4	3 1/2
Increase in stocks(e)				
Private non-farm	-0.4	0	1/4	0
Farm and public authority	-0.5	1/2	0	0
Gross national expenditure	2.7	6	4 3/4	3 1/2
Exports of goods and services	10.1	3 1/2	2 1/2	6
Imports of goods and services	12.3	12	9	8
Net exports(e)	-0.4	-2 1/4	-1 3/4	- 3/4
Gross domestic product (Average measure)	2.7	3 3/4	3	3
Non-farm product	2.3	4	3 1/4	3
Farm product	15.1	-5	-1	3
Panel B - Expenditure Excluding Transfers and One-off Transactions(c)(f)				
Total business investment	13.2	13	8	5
Non-dwelling construction	13.2	1	10	9
Equipment	13.2	19	6	4
Public final demand	2.3	1 3/4	1	3/4
Increase in stocks(e)	-0.3	0	1/2	0
Gross national expenditure	3.2	5 3/4	4 3/4	3 1/2
Exports of goods and services	7.4	5 1/4	2 1/2	6
Panel C - Other Selected Economic Measures				
Prices and wages				
Consumer Price Index (12 th series basis)	1.3	0	2 1/2	2 3/4
- Treasury 'Underlying' measure (12 th series basis)	2.0	1 1/2	2 1/2	2 3/4
Gross non-farm product deflator	2.3	1 1/2	3	3 1/2
Average earnings (national accounts basis)	4.9	4 3/4	4 1/4	4 1/4
Labour market				
Employment (Labour Force Survey basis)	1.1	1 1/4	1 3/4	1 3/4
Unemployment rate (per cent)(g)	8.7	8 1/4	8	7 3/4
Participation rate (per cent)(g)	63.5	63 1/4	63 1/4	63 1/4
Household income and saving				
Real household disposable income	3.8	3 1/2	3 1/2	3 1/4
Household saving ratio (per cent)	4.7	3 1/4	2 3/4	
External accounts				
Terms of trade(h)	1.6	-1 1/2	-1 1/4	1 1/4
Current account balance				
\$billion	-17.7	-25	-31	
Percentage of GDP	-3.4	-4 1/2	-5 1/4	

(a) Percentage change on preceding year unless otherwise indicated.

(b) Calculated using annual original data.

(c) Average 1989-90 prices.

(d) The ABS has recently advised that it is likely to treat the \$2.4 billion sale of the Dampier to Bunbury gas pipeline by the WA Government in 1997-98 as the sale of a second-hand fixed asset. If so, this would act to lower forecast public investment with an offsetting boost to private investment, although the forecasts in Panel B would be unaffected.

(e) Percentage point contribution to growth in GDP (Average).

(f) Transfers are net second-hand asset sales from the public sector to the private sector. One-off transactions are gold sales by the Reserve Bank of Australia, 'lumpy' imports of aircraft, ships and satellites and exports of ANZAC frigates.

(g) The estimate in the final column represents the forecast level in the June quarter 1999.

(h) Adjusted to exclude computer import prices.

THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

Financial crises in several countries in East Asia and renewed weakness in the Japanese economy have brought a deterioration in the outlook for global economic growth in 1998. Continuing solid, but more sustainable, growth in North America and a consolidation of growth in Europe is, however, expected to support world growth of 3 per cent in 1998. The world economy is expected to improve in 1999 to growth above the average level since 1970. Inflationary pressures are expected to remain subdued in major industrial countries.

Table 2: Economic Indicators for Selected Countries and Groupings

	GDP Growth(a)				CPI Inflation(b)			
	1996	1997	1998(e)	1999(e)	1996	1997	1998(e)	1999(e)
United States	2.8	3.8	2¾	2	2.9	2.3	2	2½
Japan	3.9	0.9	¼	1¼	0.1	1.7	½	¼
Germany	1.4	2.3	2¾	2¾	1.5	1.8	1½	2¼
OECD(c)	2.8	3.1	2½	2½	4.3	3.7	3½	3
World(d)	4.1	4.1	3	3¾	-	-	-	-
East Asian MTP(f)	7.1	6.2	2	4	5.2	3.6	7¾	6¼
Total MTP(g)	4.9	3.9	1¾	3	3	2.5	3¾	3¼

(a) Major Trading Partners (MTP) GDP growth is calculated using Australian merchandise export trade weights.

(b) The GDP deflator in the case of the OECD. MTP CPI inflation is calculated using Australian total merchandise trade weights.

(c) OECD *Economic Outlook* 63 historical and forecast figures.

(d) IMF *World Economic Outlook May 1998* historical and forecast figures.

(e) Unless otherwise stated, forecasts are Treasury forecasts.

(f) Australia's East Asian MTP are China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.

(g) East Asian MTP, Canada, France, Germany, Italy, Japan, New Zealand, the United Kingdom and the United States comprise Australia's total MTP.

Source: Various national statistical publications, OECD, IMF and Treasury.

The East Asian Crisis and Regional Outlook

A feature of world economic developments in 1997 of particular relevance to Australia was the financial turmoil which affected the East Asian region, especially Indonesia, Korea and Thailand. The onset of the crisis in the second half of 1997 was marked by sharp declines in currency and equity markets, as a sudden loss of confidence by investors in the face of accumulating evidence of underlying economic difficulties precipitated a large outflow of capital from the region. Following concerted international action, the situation in the countries concerned has generally stabilised. There has been a significant recovery in currency and equity markets, although to levels still well below those prevailing before the crisis.

The origins of the regional crisis can be traced back to underlying structural weaknesses in the financial sectors of a number of countries, together with large-scale capital flows and policy weaknesses, which led to over-heating of economies in the region, the emergence of major imbalances and an asset price spiral in the commercial and industrial property sectors. Private investment in the affected economies was financed increasingly by short-term, unhedged, foreign borrowings. The subsequent collapse in currencies left many borrowers unable to repay and service remaining foreign currency denominated loans.

The downturn exposed underlying weaknesses in corporate governance, lending practices, prudential and supervisory standards and a lack of transparency. Corporations and financial institutions carried excessive foreign borrowing exposures. Lending practices gave insufficient weight to profits and debt servicing capacity and placed too great a reliance on commercial property and other asset backing as collateral, or reflected government use of 'directed' lending to favoured industry and infrastructure projects.

Measures to deal with the weaknesses revealed in financial sectors are core requirements of the International Monetary Fund (IMF) supported programmes for Indonesia, Korea and Thailand. In addition, these programmes recognise that a return to sustained growth will be promoted by other structural reforms, including reductions in barriers to trade and direct foreign investment, acceptance of the need for transparent and arms-length dealings between government and business, the dismantling of monopolies, and the commercialisation and sale of state-owned enterprises.

The financial and currency market fall-out has impacted on activity in the region, with an abrupt slowing in growth, a corresponding rise in unemployment and higher inflation. There has been considerable disruption of trade flows and trade credit, and widespread banking and business failures. The sharp contraction in domestic demand associated with the loss of confidence and corrective action has already contributed to a noticeable improvement in current account balances, aided by some pick-up in exports from improved competitiveness. The full impact of developments in the region is expected to be felt in 1998-99, with a modest rebound in activity forecast for the second half of 1999.

The shape and timing of economic recovery will depend upon both the scale of the task confronting the troubled economies and the responses of the governments concerned. The outlook depends on how vigorously necessary reforms are implemented by governments and the time it takes to re-establish financial stability and lock in the competitive gains from lower exchange rates. A noticeable pick-up in activity in Korea and Thailand should be apparent in 1999, after flat or negative growth in 1998. In Indonesia, where the deterioration has been more severe, the turnaround may take longer. In all three countries inflation is expected to rise sharply in 1998 before starting to moderate in 1999.

The outlook for Japan is a matter of concern. Not only is Japan heavily exposed to regional developments, its domestic economy is experiencing substantial weakness and showing no signs of an early turnaround. Weak consumer and investor confidence point to the prospect of little or no growth in Japan in the year ahead — although a range of government fiscal initiatives announced should provide some impetus to domestic demand. Export growth is expected to weaken in the face of weaker regional economic conditions in particular, but import growth is expected to slow significantly as a result of subdued domestic demand. In net terms, the external sector's contribution to growth in Japan will remain positive, but weaker, in 1998.

Substantial policy challenges face Japan. Its problems are essentially structural in nature and long standing, overlaid by major macroeconomic imbalances associated with a shortage of domestic demand. The economy is struggling with a substantial public debt burden, a still substantial asset price overhang, a weakened financial sector, low productivity growth and a rapidly ageing population. While some progress has been made on structural reform, including the financial sector reforms that commenced on

1 April 1998, and deregulation of the telecommunications and transport sectors, there continues to be a need to advance regulatory reform on a broad front.

The economic conjunction in Japan has demanded a re-assessment of macroeconomic policies, strongly urged by other major industrial countries. With only marginal scope to further reduce interest rates, fiscal settings have been made more expansionary in a number of steps since October 1997. The most recent package foreshadows tax cuts and additional spending of yen 16.7 trillion, equal to about 3¼ per cent of GDP. An issue facing the Japanese government is the task of striking a balance between providing short-term stimulus to economic activity and pursuing medium-term fiscal consolidation plans.

China's growth is expected to slow from the 8.8 per cent recorded in 1997, reflecting some easing in domestic demand, a build-up in inventories, a commercial property overhang in some regions and a slowing in export growth and foreign direct investment. The government has given repeated assurances that it will not devalue the currency which it sees as an important contribution to helping restore regional stability. This will, however, place more of the burden for meeting the official growth target on domestic activity.

In New Zealand, growth in activity slowed to 2.2 per cent in 1997 as the pace of domestic demand growth declined from its previous high rates and net exports continued to detract from growth. Domestic demand is expected to remain subdued in 1998 largely as a result of the effects of high real interest rates domestically and of weaker external demand on income growth.

Developments and Outlook in Other Regions

Prospects for North America and continental Europe remain positive and underpin a continuing sound international environment in spite of the weakness in Asia.

The resilience of the expansion in the United States is impressive — with growth in GDP of 3.8 per cent in 1997, the strongest in 9 years. As a consequence, the unemployment rate has fallen to its lowest level in 24 years. The health of the United States economy, in part, reflects sound fundamentals. The budget has been returned to surplus, inflation expectations have fallen, and both headline and core inflation remain at historically low levels.

Growth in activity has been driven by strong private consumption and investment spending which in turn has supported robust employment growth. In 1998, growth in industrial production is expected to slow from recent rapid rates in response to weaker domestic demand, lower net exports to Asia, and inventory adjustments. The combined effects of a significantly stronger currency and weaker export demand from Asia should result in an increased net export detraction from growth this year. With an expected slowdown in economic activity and weaker corporate profitability, investment expenditure should increase more slowly through 1998 and into 1999.

There are some risks to the United States outlook. The economy is operating at close to full capacity, and there are some signs of a pick-up in wage costs. The strength of the US dollar and the expected increase in cheaper imports from Asia should help to contain

these pressures in 1998. Inflationary pressures, however, are likely to mount without a slowdown in the United States economy to more sustainable levels. In addition, some widening of the current account deficit is expected, which could give rise to trade tensions. The stock market has grown strongly, increasing the possibility of a sizeable correction; any such development could have important consequences for global financial markets.

The outlook in continental Europe seems positive, supported by favourable macroeconomic settings. There appears to have been substantial fiscal consolidation and convergence to a low inflation and low interest rate environment as countries prepare for the commencement of the European Monetary Union. With the expansion being only relatively recent, there is the prospect of a further pick-up in growth as private consumption consolidates and business investment expenditure strengthens. This is expected to outweigh any slowdown in net exports resulting from weaker Asian demand. Despite the improved outlook, structural reform will remain a priority in continental Europe in tackling high levels of unemployment within the unified currency framework.

The United Kingdom economic cycle, like that in the United States, is at an advanced stage. In response to a stronger currency and the tightening of monetary policy over the past 18 months, growth is expected to slow from the 3¼ per cent recorded in 1997 to a more sustainable rate in 1998.

Substantial shifts in current account balances of countries in different regions are likely to occur in 1998. For the United States and Europe, strong domestic demand and strong currencies will act to reduce surpluses or increase deficits, while weak domestic demand but increased export competitiveness will strengthen current account positions in East Asia. It will be important that such a development be seen as part of the adjustment to events in Asia within the framework of a continued favourable global outlook and not as evidence of major bilateral structural distortions. Any resort to trade action, for example, would harm the adjustment process and also affect the interests of countries not directly involved, such as Australia.

THE EFFECT OF INTERNATIONAL DEVELOPMENTS ON THE DOMESTIC ECONOMY

The financial and economic crisis in Asia will have a significant influence on the Australian economy in 1998-99. The most obvious effects will be on export volumes and prices, resulting in lower levels of exporters' incomes than would otherwise be the case, with consequent impacts on output and employment elsewhere in the economy. However, as is already evident, the exchange rate will also be affected by these developments, in part influencing the manner in which the overall impact is shared throughout the community. A lower exchange rate than otherwise would have occurred will tend to lessen the impact of lower world demand and prices on exporters' incomes while increasing the impact on consumers through higher import prices. There will also be other financial sector implications to consider, in particular the already observable tendency for lower bond yields. In addition, there will be indirect effects, not only as the impacts in the trade sector flow through into related sectors but also more generally as a result of impacts on household and business confidence. While the timing and magnitude of these effects are subject to uncertainty, it is important to keep in perspective the impact on Australia's overall export prospects of developments in specific markets.

Direct Effects on Export Volumes

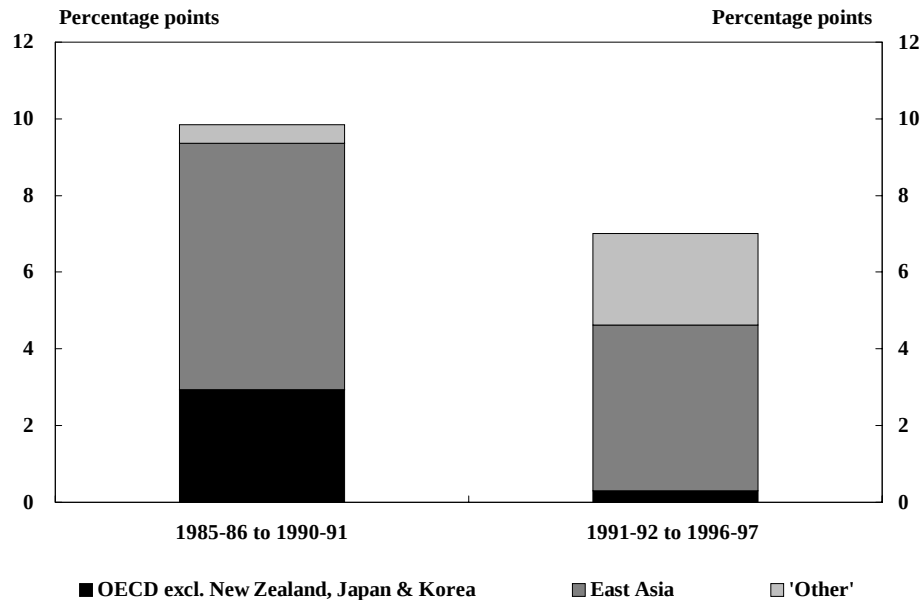
Factors Influencing Export Growth

Australia has a diverse range of exports covering rural and non-rural commodities, manufactures and services. Not surprisingly, reflecting this diverse base, there are a great many factors affecting Australia's export performance. As a result, attempts to analyse the direct impact on Australia's exports of developments in Asia using a simple framework based on export shares to the region and expected movements in GDP are likely to produce misleading results. In the past, such a framework has not provided a good basis for forecasting growth in Australia's export volumes, either to specific markets or in total.

There are several important factors that this simple framework does not incorporate. For instance, it does not allow for diversification of trade and the diversion of exports to alternative markets. These features have been characteristics of Australia's export performance throughout the 1990s. As indicated in Chart 1, the importance of various markets in contributing to growth in Australia's merchandise exports has varied over the 1980s and 1990s. During the 1980s, the importance of the non-Asian OECD countries to Australian export growth diminished; a trend that continued in the 1990s. In the 1980s, exporters found new markets in the rapidly growing East Asian economies. But the contribution to total export growth from those markets has declined in the 1990s, particularly in recent years. During the 1990s, markets outside the OECD and East Asia have contributed more significantly to growth in Australia's exports.²

² Included in this group of other countries are New Zealand, Fiji, Papua New Guinea, the Indian sub-continent, South Africa, the Middle East, Eastern Europe, the former Soviet Union, and South America.

Chart 1: Contributions to Merchandise Exports Growth, by Destination



Source: ABS data on the Department of Foreign Affairs and Trade's STARS database.

The recent strong growth in markets outside the OECD and East Asia has been broadly based. Very strong rates of growth have been sustained during the 1990s for exports to the Oceania countries (particularly New Zealand but also, more recently, Fiji and Papua New Guinea) and to South Africa. Complementing this over the past few years has been a strong acceleration in exports to the Indian sub-continent and a sharp reversal of the previous downward trend in exports to the Middle East and non-OECD Europe. In recent years, of all the countries in this 'other' grouping, only exports to South America have not kept pace with or exceeded previous average rates of export growth.

The relative strength of export growth to these emerging markets in the 1990s is also apparent across the major export classifications. Exports of non-rural commodities to this group increased on average over the 1990s at a double digit rate, with some slight acceleration in the past two years. This is faster than the overall growth in non-rural commodities over this period. Exports of manufactures to 'other' countries have increased by more than 16 per cent per annum since the mid 1980s, with slightly faster growth in the past two years. In comparison, exports of manufactures to all countries increased at a similar rate to this up to 1994-95, but there was a significant deceleration in the subsequent two years. Exports of rural products to these 'other' countries have increased significantly in the past two years, reversing an earlier downward trend. This outcome largely reflects increased cereal exports to the Middle East.

The diversification of export markets which has contributed to Australia's export growth in recent years demonstrates that it is inappropriate to view trade shares as being fixed. This is particularly important in the current international environment of weaker demand in East Asia but stronger growth in the United States, Europe and the rest of the world. Such a situation may well result in even greater diversification of Australia's export markets, although the speed with which individual exporters can establish alternative

markets will vary. Nevertheless, as outlined below, greater diversification is likely to be encouraged by recent exchange rate movements.

A further factor that needs to be considered in assessing the impact of developments in East Asia on Australia's exports is that GDP growth in specific export markets has not proved to be a good indicator of growth in Australia's exports to those markets. Demand for many rural commodities tends to be influenced more by movements in population and changes in tastes and the stage of economic development than by any indicator of output or income. Demand for non-rural commodities tends to be related to trends in industrial production which, depending on the maturity of the economy and the relative importance of the services sector, might display a cyclical pattern somewhat different from that of GDP growth or growth in domestic demand in particular markets. In the case of some Asian economies in particular, many Australian exports are intermediate inputs into local production which is exported elsewhere; GDP growth in these economies will be an inappropriate indicator of the resultant demand for Australian exports.

Related to the above, a key factor influencing Australia's exports to any market will be the relative competitiveness of Australian producers. This will be important both in determining the aggregate level of exports and its distribution across countries. The relevant measure of competitiveness will include not only Australian production costs but also transport costs and exchange rate relativities, and will be affected by the presence of subsidies offered by competitors. More subjective factors will also be important, including desires to maintain stable trading relationships.

A particularly important aspect to be taken into account when considering the impact of developments in specific markets is the importance of supply considerations in influencing the performance of commodity exports. Rural exports are a good example of this, where farm production has been the main influence on the volume of Australia's exports in the short term rather than developments in any market. As a relatively low cost producer, Australia has the ability to vary sales to other markets as supply circumstances dictate for the majority of rural exports. Supply considerations are also an important influence on changes in exports of non-rural commodities.

The total amount of Australian production exported, and its distribution across countries, will thus be determined by a range of factors, and not simply GDP growth in specific markets. Importantly, export shares will be the final outcome of the process, not the principal determinant.

Impact of the Slowdown in Asia

Having regard to the above factors, in aggregate, **rural commodity** exports are likely to be less affected than many other exports as a result of developments in Asia. This is because the volume of rural exports is primarily supply-determined, with relatively low levels of responsiveness to variations in income growth in countries of destination. However, within this overall picture, there are individual rural commodities where demand from Asian economies will be seriously affected and where there is little opportunity of finding alternative markets; examples include exports of live cattle and horticultural products.

With demand for rural exports in aggregate relatively unaffected by developments in the troubled Asian economies, the main influence on the growth of rural exports in 1998-99 will be weather conditions and production. Although farm production is estimated to have fallen in 1997-98, it is likely to have remained at a high level; concerns in early 1997 about the impact of adverse weather conditions were largely unrealised due to timely rainfall which resulted, for example, in above-average levels of cereals production. The assumption of average seasonal conditions for 1998-99 implies a slight decline in rural production, although again the level of production is expected to remain high by historical experience. Coupled with a relatively low level of carry-over stocks at the end of 1997-98, this production profile suggests that rural export volumes should decline by around 1 per cent in 1998-99, following a small increase in 1997-98.

As noted previously, supply factors are also a very important determinant of the volume of **non-rural commodity** exports. This is particularly relevant at present, with strong growth in mining investment resulting in significant increases in supply capacity. Moreover, the recent decline in world prices for non-rural commodities has been largely offset by the depreciation of the exchange rate, with the result that the domestic currency returns to commodity producers have been maintained, if not increased, and this has encouraged continued high rates of capacity utilisation.

While East Asia has been the major market for Australia's exports of non-rural commodities, the homogeneity of many of the products and the fact that they are freely traded on established world markets means that there is considerable scope to divert sales to other markets. To some extent this diversion has been occurring within Asia; for example, some producers have increased sales of bulk commodities to Taiwan and China to compensate for reductions in sales to Japan and Korea. Alternatively, the diversion might occur in relation to markets less directly affected by developments in Asia; the continuing solid growth forecast for OECD industrial production — influenced by the favourable outlook for overall activity in the United States and Europe — is of particular importance in this regard. In addition, the substantial nominal depreciation of a number of Asian currencies will help to sustain export growth from these countries, which will cushion the impact on those Australian non-rural commodity exports — especially the bulk ores — that are intermediate inputs in Asian export production. However, the eventual effect will depend on the ability of the Asian countries to convert nominal exchange rate depreciation into sustained competitiveness improvements.

While there is scope to divert Australia's commodity exports away from the troubled Asian economies, the overall demand for Australia's commodity exports will be influenced by the fact that world activity and world industrial production will be adversely affected by developments in Asia. As a consequence, the volume of non-rural commodity exports in 1998-99 is forecast to grow modestly, by around 2 per cent (after abstracting from the boost to exports in 1997-98 from Reserve Bank gold sales in the September quarter 1997).

Exports of **elaborately transformed manufactures** (ETMs) are more sensitive to changes in income in countries of destination than either rural or non-rural commodities, and are thus more susceptible to adverse impacts from the slowdown in Asia. However, Asian economies have been of relatively less importance as destinations for such products than is the case for commodities. A factor contributing to ongoing strength in exports of manufactures during the 1990s has been the ability of Australian

manufacturers to compete vigorously in terms of prices. Highlighting a willingness to accept lower margins to increase export sales, the relevant export price index in Australian currency terms has fallen throughout the 1990s in an environment of subdued increases for domestic output prices. This practice is expected to continue over the year ahead. Moreover, the net effect of recent bilateral exchange rate movements has been broadly to maintain the overall competitiveness of Australian producers, although their competitiveness relative to some Asian producers will have declined significantly. Overall, developments in Asia have significantly weakened the outlook for ETM exports. The volume of ETM exports is forecast to grow by around 7 per cent in 1998-99, compared with an average growth rate of 16 per cent over the past decade.

Services exports are also sensitive to changes in income in importing countries, and therefore will be significantly affected by the downturn in Asia. Indeed, outcomes have already been adversely affected, particularly in relation to tourism receipts, as a result of a sharp fall in Asian visitors. However, it is likely that reduced visitor numbers from Asia will eventually be partially offset by increased arrivals from other markets (particularly North America and Europe) as a result of exchange rate movements which have improved Australia's competitiveness in those markets. The continuing relative strength of North America and Europe will also help sustain growth in business service exports. As with ETM exports, growth in overall services export volumes is forecast to be significantly weaker than the average experienced since the mid-1980s; a rise of 3 per cent is forecast for 1998-99, compared with an average growth rate of 8 per cent over the past decade.

In summary, while it is important to keep the developments in Asia in perspective, and not rely on simple frameworks based on fixed trade shares, the volume of Australia's exports will be adversely affected by the financial and economic crisis in Asia. The extent of the impact will vary across export categories. Abstracting from the effect of irregular transactions (such as gold sales and the export of ANZAC frigates), exports of goods and services are estimated to increase by 5¼ per cent in 1997-98 and are forecast to increase by 2½ per cent in 1998-99. By contrast, the average rate of growth over the previous decade was around 7 per cent.

This outlook, however, remains uncertain. A weaker world environment than currently forecast could result in a more pronounced easing in export growth than expected. Conversely, the ability of Australian exporters to continue diverting sales to less affected markets could mean that exports remain more resilient than forecast.

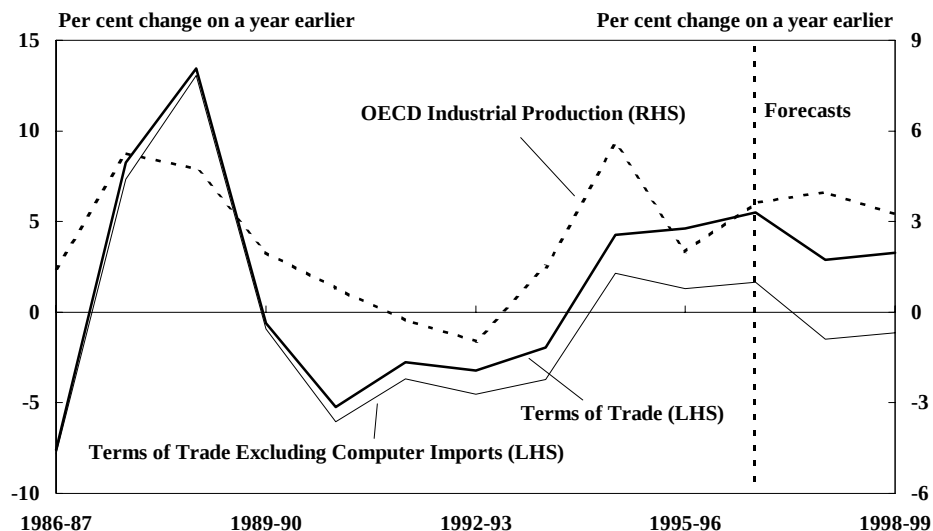
Direct Effect on Export Prices

A weaker external environment will not only adversely affect export volumes, but will also impact on export prices. This downward pressure is already evident, particularly in relation to commodities. Since the onset of the financial crisis in Asia, world prices for commodities of importance in Australian trade, expressed in either SDRs or US dollars, have fallen by around 8 per cent. Although the price falls to date have been sharp, they are not large by historical standards, and a reasonable degree of stability has been evident since mid-January 1998. Some further weakness in world commodity prices cannot be ruled out, but underlying support should be forthcoming if the continuing solid growth expected in OECD industrial production (excluding Japan) throughout 1998 and 1999 eventuates. For Australia, the decline in world commodity prices to date has been

entirely offset by exchange rate movements. In Australian dollar terms, commodity prices in April 1998 were around 4 per cent higher than at the onset of the crisis, and at a level which compares favourably with the average experience of the 1990s. As noted above, these developments provide encouragement for commodity producers to maintain production rates, and also have been a major factor supporting the terms of trade.

In analysing movements in the terms of trade (as currently published) it is necessary to allow for the effect of changes in computer prices.³ The rapid fall in computer prices, combined with the increasing importance of computers within Australia's imports, has a major depressing influence on the growth in overall import prices. An indication of this effect, both in recent years and as forecast, can be gained by comparing the estimated changes in the terms of trade, both including and excluding computer imports, shown in Chart 2. Abstracting from computers, the terms of trade fell sharply late in 1997, principally the result of the exchange rate depreciation feeding into higher import prices. It is likely that the terms of trade (abstracting from computers) weakened further during the first half of 1998; exchange rate induced increases in import prices early in the year are likely to have been combined with falls in Australian dollar denominated commodity prices (in part reflecting falls in negotiated coal prices for export to Japan). The terms of trade index (abstracting from computer imports) is forecast to rise gradually during 1998-99, reflecting the expected ongoing strength in OECD industrial production. Allowing for the effect of continuing significant declines in computer prices, solid increases in the published terms of trade are expected for both 1997-98 and 1998-99.

Chart 2: The Terms of Trade and OECD Industrial Production



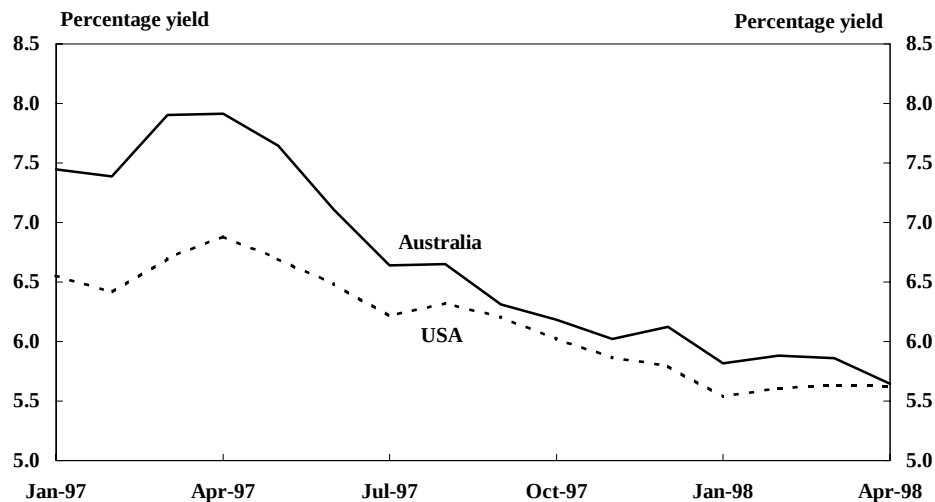
Source: ABS Cat. No. 5302.0, OECD and Treasury.

³ The ABS is in the process of introducing chain-linked volume indexes for national accounts estimates. For items where computers are relatively important, chain-linking will provide different estimates of rates of growth from those currently published. Those items particularly affected are equipment investment, imports of goods and services and the terms of trade.

Financial Linkages

Australia appears to have benefited from the shift of world capital flows from a number of the Asian economies to more stable markets. Partly reflecting this 'flight to quality' and an ongoing favourable inflation outlook, long-term bond yields in Australia have continued to fall over recent months. The yield on 10 year government bonds has fallen by around two percentage points over the past year. At the same time, the differential between Australian and US 10 year bond yields has narrowed further, falling from around 100 basis points a year ago to be near parity recently (Chart 3), and the Australian stock market has risen accordingly. If sustained, higher stock prices and lower bond yields should have a stimulatory effect on domestic spending, helping to offset the negative impact on activity resulting from weaker export growth.

Chart 3: 10 Year Interest Rates for Australia and the United States



Source: Reserve Bank of Australia.

As noted earlier, the depreciation of the exchange rate against the US dollar has been important in offsetting declines in world commodity prices and maintaining domestic currency returns to commodity producers. The Australian dollar has also depreciated against the currencies of the other major industrial countries and appreciated against the currencies of the East Asian countries. The former group of countries are more important to Australia as a source of imports while the latter set of countries has been an important destination for Australia's exports. Accordingly, these exchange rate movements have led to an unusually large gap between the export-share and import-share weighted exchange rates, with the export-share weighted exchange rate rising by around 7 per cent in the March quarter compared with a 2 per cent increase in the import-share weighted exchange rate.

By itself, the higher export-share weighted exchange rate suggests that there has been a deterioration in competitiveness. However, other exchange rate measures indicate a modest improvement in competitiveness over the past year that will help stimulate Australian exports. An exchange rate index constructed using multilateral trade weights allows for changes in competitiveness arising from exchange rate movements against those countries which compete against Australia in world markets. Although volatile in

recent months, this 'third-country' export-share weighted exchange rate has depreciated slightly over the past year, indicating a small improvement in Australia's competitiveness. The depreciation against the US dollar has also provided a boost to competitiveness, given that a large proportion of trade contracts are written in US dollars.

Indirect Effects

Any direct impacts on export volumes or the terms of trade will be reflected in sectoral incomes, with consequential indirect effects on expenditures, output and employment. A more uncertain, but equally important, channel through which weaker external conditions can impact on domestic activity is through a decline in business and consumer confidence.

Business surveys show a significant decline in business confidence over the past six months. At the same time, however, most such surveys indicate that actual trading performance has continued to improve. At this stage, it would appear that business decisions are related more to actual outcomes than to sentiment. Short-term employment expectations remain firm and reported job vacancies continue to rise. Year-ahead capital expenditure plans also remain firm, showing no downgrade in response to the decline in confidence.

There has been some recent volatility in surveys of consumer confidence, with increased pessimism evident in relation to consumers' perceptions about the state of the economy. However, perceptions about consumers' own financial positions remain sound and at a level which is comparable with the average experience of recent years. Recent indicators of consumer spending have been mixed, but the continuing strong growth evident in consumer credit suggests that any increased uncertainty is yet to have a significant impact.

Nevertheless, it is likely that consumer and business confidence will continue to be influenced by substantial media reporting of the 'Asia crisis'. This uncertainty may result in lower levels of private sector expenditures than would otherwise be the case, magnifying the overall effects of developments in Asia on domestic activity. Such effects are inherently difficult to estimate, both in terms of magnitude and timing. Nevertheless, some allowance has been incorporated in the forecasts, but with impacts on decision-making assumed to be more pronounced for business than for households.

In summary, the Asian crisis will have a significant impact on domestic economic activity. Lower export incomes and indirect effects on investment, consumption and employment growth will produce a substantial detraction from economic growth. In the absence of developments in Asia it is likely that the momentum in domestic activity evident in much of 1997 would have continued to build. That would have resulted in very strong growth in 1998-99, most likely stronger than the estimated outcome for 1997-98 of 3¾ per cent.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

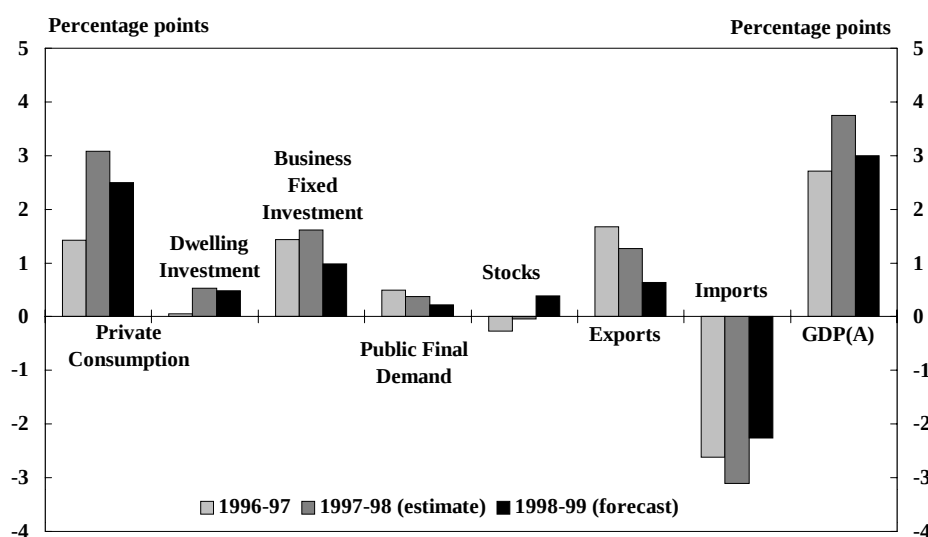
Forecasting Assumptions

The forecasts for the domestic economy have been developed in the context of the international environment outlined previously. In line with usual practice, it is assumed that nominal exchange rates remain broadly unchanged from average levels reached in recent months. The farm sector forecasts have been prepared on the assumption that seasonal conditions result in average yields across the range of major commodities.

Demand and Output

Solid economic growth is expected in 1998-99, although lower than in 1997-98, as continued strength in domestic demand cushions the negative effects from developments in Asia. Private demand growth is expected to remain robust, supported by favourable economic fundamentals: inflation is low; interest rates are low with part of the stimulus from declines in interest rates still to be felt; capacity utilisation is at a relatively high level; the balance sheets of the household and corporate sectors remain in good shape; the construction cycle is yet to reach its peak; and stock levels should be more responsive to movements in sales.

Chart 4: Contributions to GDP Growth^(a)



(a) Adjusted for transfers and one-off transactions as noted in Table 1.
Source: ABS Cat. No. 5206.0 and Treasury.

Private Consumption

Private consumption growth is expected to remain strong in 1998-99, although easing somewhat from the rapid pace of 1997-98. Helping to limit the extent of this slowdown will be a likely boost to expenditure by households from the demutualisation of the AMP Society (see Box 1).

BOX 1: THE EFFECT OF THE AMP DEMUTUALISATION ON PRIVATE CONSUMPTION

The demutualisation of the AMP Society involves the Society's listing on the stock exchange with members receiving shares in AMP in exchange for forgoing membership rights in the mutual society. After the listing, which is scheduled for mid-1998, AMP shareholders will be able to sell their shares, if they choose.

Since most AMP members are unlikely to have placed a monetary value on their membership in the mutual society, the shares they receive are likely to be viewed by them as a windfall gain. If members sell their shares, this gain will take the form of cash, while if they retain their shares, their perceived value of wealth will rise. While the sale of AMP shares will be matched by corresponding purchase transactions, the latter will be a reallocation of the financial assets of the purchasing parties. Part of the gains to AMP members is likely to be used to finance additional expenditure by households, with most of the impact expected to occur in 1998-99. Depending on the exact nature of the expenditure, it is possible that some household spending on home improvements would be classed in the national accounts as investment in alterations and additions rather than consumption.

This boost to consumption is likely to be similar to the recent United Kingdom experience, where consumers increased their expenditure using part of the gains from a number of large demutualisations. These consumers spent most money on home improvements, holidays and travel and household durables.⁴ Around one-third of shares were sold in the months after listing, with around one-third of the proceeds used to finance additional consumption. Almost no members spent their gains in advance of the demutualisation.

Using the United Kingdom experience as a starting point, current market estimates of the total value of the shares to be issued suggest that the gains from the demutualisation could finance a considerable amount of additional consumption expenditure in 1998-99, with some analysts indicating the impact could be of the order of $\frac{1}{2}$ percentage point of consumption growth. Such estimates are very uncertain, depending not only on the value of capitalisation of AMP upon listing but also on the behaviour of shareholders; given this, and the economic climate in which the demutualisation will be occurring, the additional assumed consumption effect is more conservative.

Growth in real after-tax labour income is expected to be slightly lower in 1998-99 than in 1997-98, as a result of slightly higher inflation and a slowing in wage growth. However, growth in real household disposable income is expected to remain broadly unchanged. Slower labour income is expected to be offset by interest income growth as the effect of the earlier falls in deposit interest rates fades.

⁴ Robert Fleming Securities Limited, *Economic Comment: Consumer Windfalls*, 13 August 1997. See also the November 1997 Bank of England *Inflation Report*.

Despite the forecast for firm growth in household income, the household saving ratio is expected to decline in 1998-99 to around 2¾ per cent, a little lower than the average ratio over the 1990s to date. The dip in saving is largely explained by increased consumption funded out of the gains from the AMP demutualisation. These types of gains are excluded from the national accounts measure of household disposable income and are therefore not included in the national accounts estimates of saving.

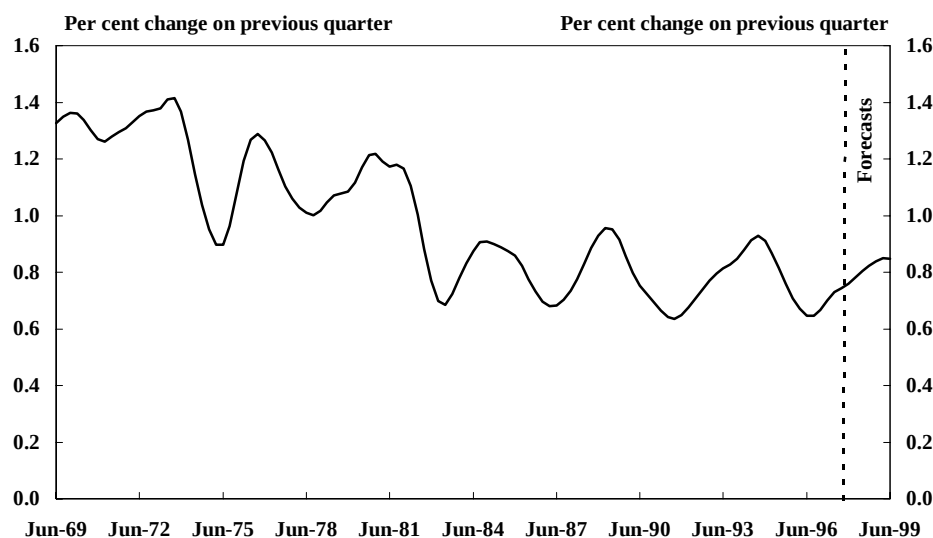
Dwelling Investment

Dwelling investment is expected to grow at a rapid pace in 1998-99, the second year of rapid expansion during this upturn. However, the pace of growth is expected to ease in the second half of 1998-99, as the demand for housing is satisfied by the increase in the dwelling stock. Developments in Asia are also expected to exert some dampening influence on activity in the medium-density sector during the course of the year.

The strength of the housing sector reflects high levels of housing affordability, mainly reflecting the very low level of housing interest rates. The standard bank variable mortgage interest rate is currently 6.7 per cent, the lowest level since 1970, and some introductory rates offered by lenders are considerably lower.

Cumulative increases in dwelling investment of the magnitude forecast are not uncommon during expansion phases of the housing cycle. Indeed, the implied growth in the dwelling capital stock is consistent with past experience (see Chart 5). Compositionally, however, forecast growth in dwelling investment is expected to be somewhat different to past cycles, with a significantly higher real average unit value of dwelling commencements in this upturn. Slower population growth across key household forming age cohorts than in previous dwelling cycles is expected to constrain the number of dwelling commencements in the current cycle. Against this, the historically high real average unit value of dwelling commencements reflects a long-term structural trend toward larger dwellings and also the weaker demand by first-home buyers in this upturn relative to previous experience.

Chart 5: Dwelling Net Capital Stock^(a)



(a) Trend data.
Source: Treasury estimates.

Business Investment

Transfer of ownership of assets can have a significant impact on published estimates of business investment and public final demand. This has been the case in recent years, as is evident from a comparison of the information in Panels A and B of Table 1.⁵ Such asset sales will have no impact on aggregate activity, but can provide a misleading view of movements in individual components. For this reason, it is preferable to abstract from such influences when interpreting fundamental movements in economic activity.

Growth in business investment (exclusive of asset sales) is expected to ease from the double-digit rates of growth experienced in recent years, with this deceleration being particularly marked through the year to the June quarter 1999. A number of fundamental influences will continue to act as a stimulus to investment: surveyed and estimated levels of capacity utilisation are at above-average levels; nominal interest rates are at low levels, with competition between lenders leading to recent falls in lending rates to small business; real interest rates have fallen over the past year; and profitability remains supportive. However, growth in business investment will be constrained by the effects of the Asian crisis on corporate profitability and capacity utilisation. The recent weakening in business confidence as a result of the Asian crisis is also likely to result in some deferral of investment plans.

The balance between these opposing forces is difficult to forecast with any precision. However, the initial investment intentions for 1998-99 from the ABS *Private New Capital Expenditure (CAPEX) Survey* remained quite firm, despite being collected in

⁵ The recent sale by the WA Government of the Dampier to Bunbury pipeline has not been incorporated in the 1997-98 estimates in Table 1 since at the time of preparation of the forecasts it was uncertain whether the ABS would treat the transaction as the sale of a second-hand asset or a going concern.

January/February at the height of uncertainty about developments in Asia. Normally, in subsequent surveys, these initial investment intentions would be significantly increased as businesses firmed up plans for the actual budget year. The outlook of continuing solid, though easing, growth in investment in 1998-99 is somewhat conservative, in that it assumes a less pronounced expansion of intended investment in subsequent surveys than is normally the case in periods of solid economic growth. The assumed lower realisation of initial intentions seems appropriate in an environment where uncertainty is likely to remain significant.

Investment intentions data from the CAPEX survey provide some information on how positive investment fundamentals and the effect of Asia may translate into investment on an industry basis. The survey data indicate solid growth in business investment in 1998-99 is likely to be concentrated in the services sector, with mining investment expected to plateau after doubling over the past four years. Investment in manufacturing is expected to fall. The importance of the services sector for business investment reflects its importance to the whole economy: it accounts for around 70 per cent of GDP.

In terms of the components of business investment, equipment investment growth is expected to slow in 1998-99 after a number of years of strong growth. While growth should remain solid in line with favourable investment fundamentals, slower growth reflects in part the direct and indirect effects of the Asian slowdown and the natural maturing of the equipment investment cycle. Equipment investment is forecast to slow sharply over the course of 1998-99; abstracting from asset sales, equipment investment is forecast to increase by 4 per cent in the year to the June quarter 1999, compared with the double-digit rates of increase in recent years.

Non-residential construction investment is also expected to slow through 1998-99, but not as markedly as equipment investment. The amount of work in progress and yet to be completed is at a very high level, with a large amount of mining and infrastructure projects under way. This will support a continued high level of activity for some time, despite some Olympics-related projects nearing completion during 1998-99. Approvals are on a rising trend, and leading indicators such as finance approvals point to continued increases in the short term, further adding to the pool of work to be done. The longer planning schedules involved in construction projects suggest that delays and deferrals associated with the effects of developments in Asia are likely to be less evident during 1998-99 than will be the case for equipment expenditures.

Public Final Demand

Abstracting from asset sales, growth in public final demand is expected to continue to slow in 1998 99, largely reflecting slower growth in public consumption.

Public investment in 1997 98 was significantly affected by asset sales. Abstracting from these, public investment in 1998-99 is expected to fall by about the same rate as in 1997-98, with falls evident at both levels of government. Commonwealth government investment will be influenced by continued falls in public trading enterprise investment. State and local investment is expected to fall as Olympics-related spending abates and as some State government infrastructure programmes run their course.

Public consumption is expected to grow more slowly in 1998-99 reflecting slower growth at both the Commonwealth and State government levels, consistent with fiscal consolidation objectives.

Non-farm Stocks

Private non-farm stocks are expected to contribute around $\frac{1}{4}$ percentage point to GDP growth in 1998-99 after a zero contribution in 1997-98 and a modest detraction in the previous year. The stocks-sales ratio has fallen sharply over recent quarters as sales growth has outstripped growth in stocks. This resumption of a sharp downward trend suggests that any earlier excessive holdings of stocks have now been eliminated, leaving businesses in a position whereby continuing solid growth in sales will be quickly reflected in production outcomes. There is also a possibility that current stocks-sales ratios are below desired levels, in which case a level of stock accumulation in excess of that forecast could be in prospect.

Farm Sector

In 1998-99, on the usual forecasting assumption of average seasonal conditions, the level of gross farm product is expected to remain broadly unchanged, only slightly lower than the most recent peak in farm production in 1996-97. However, there is some variation in the outlook for the main components of farm production, with lower grain production and livestock slaughterings expected to be partly offset by a larger wool clip as some rebuilding of the sheep flock takes place.

Net Exports

Net exports should make a large detraction from GDP growth in 1998-99, though by a slightly smaller magnitude than that in the previous year. Export growth is expected to weaken further in response to international developments (as discussed above), while import growth should remain strong.

The volume of goods and services imported increased at a rapid rate in 1996-97, and a similar rate of increase is estimated to have occurred in 1997-98. A number of factors contributed to this strength: continued strong growth in domestic demand in both years, but particularly in 1997-98; the composition of demand being relatively import-intensive, due to strong growth in consumption expenditure and equipment investment; and a lagged response to relative price movements which, through the course of 1996-97, favoured imports rather than domestically produced goods. Continued strength in domestic demand in 1998-99 is expected to underpin ongoing strong growth in import volumes. However, some easing of growth is in prospect. Domestic demand growth itself is forecast to increase at a slightly less rapid rate. Moreover, the composition of demand growth — with a relatively stronger contribution from construction investment than was the case in the previous year — should also have some dampening influence on growth in the imports-sales ratio. Further, higher import prices stemming from the recent depreciation of the Australian dollar against the currencies of the major industrial countries, including the United States, should act to dampen the effect of strong domestic demand.

Wages

Wage growth in the year to the June quarter 1999 is expected to be slightly lower than growth in the year to the June quarter 1998. The slowing in aggregate wage growth reflects some moderation of enterprise bargaining outcomes more than offsetting a slightly faster pace of award wage growth flowing from the April 1998 Australian Industrial Relations Commission (AIRC) safety net decision.

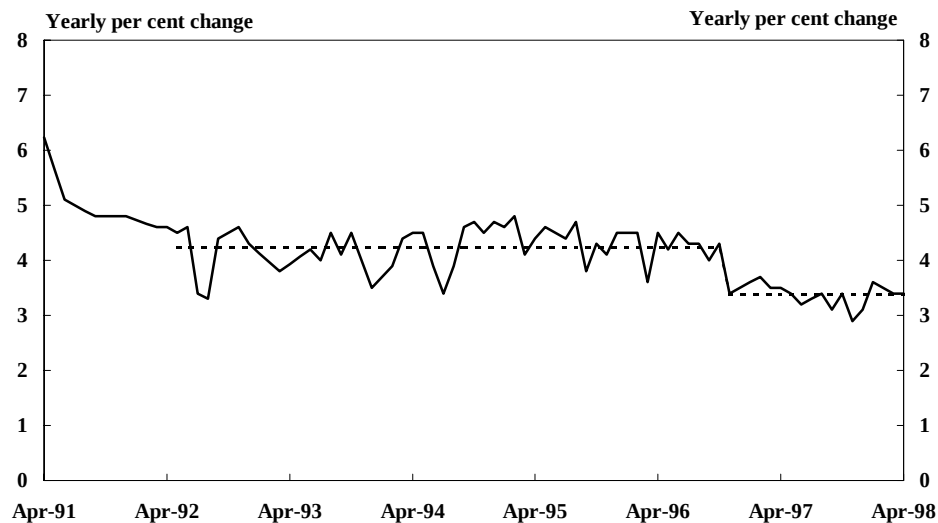
The legislated increase in Superannuation Guarantee contributions made by employers from 6 to 7 per cent on 1 July 1998 will contribute to growth in average earnings (on a national accounts basis) in 1998-99.

Prices

The underlying inflation rate is expected to rise over coming quarters, gradually returning to the Reserve Bank's monetary policy target range of 2 to 3 per cent and remaining in that band throughout 1998-99. By the June quarter 1999, the underlying inflation rate is forecast to reach 2¾ per cent, but with no signs of acceleration. Headline inflation is expected to increase in line with underlying inflation, also reaching 2¾ per cent by the June quarter 1999.

The prospect of continuing low inflation is reflected in low consumer and investor inflation expectations, with median consumer inflation expectations currently near a record low (see Chart 6).

Chart 6: Median Consumer Inflation Expectations



Source: Melbourne Institute of Applied Economic and Social Research, *Survey of Consumer Inflationary Expectations*.

The forecast gradual rise in inflation during 1998-99 primarily reflects the lagged pass-through into retail prices of the higher import prices which resulted in the latter part of 1997 and in early 1998 from depreciation in the Australian dollar against the currencies of major industrial countries. Another factor contributing to the rise is higher

nominal unit labour costs, primarily resulting from a cyclical slowing in productivity growth. Acting in the opposite direction will be the moderating effect of some easing in demand pressure.

Higher import prices are also expected to lead to a gradual increase in broader measures of inflation, such as the gross non-farm product deflator.

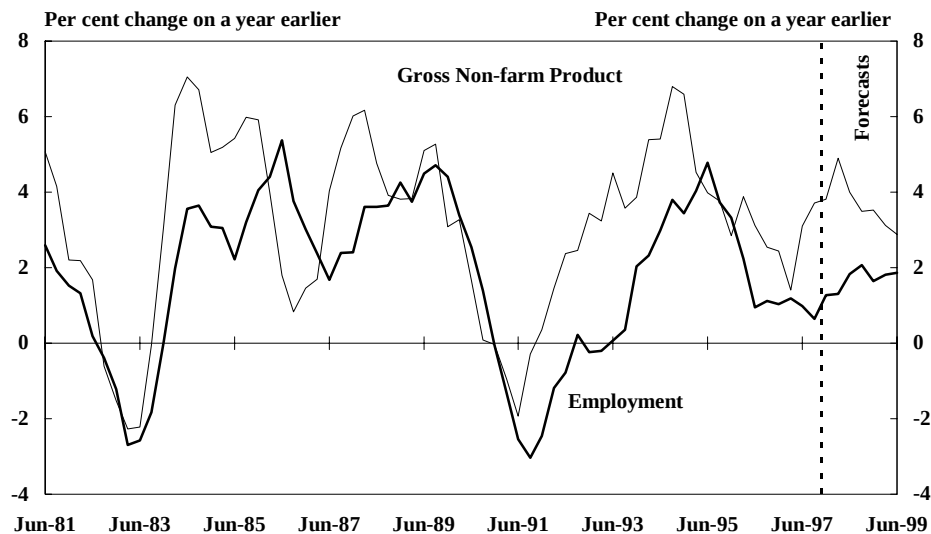
The Labour Market

The labour market is forecast to continue to improve in 1998-99, with further solid employment growth and a small fall in the unemployment rate expected.

Employment growth strengthened during 1997-98 and this momentum is expected to be carried through into 1998-99, underpinned by recent and prospective growth in non-farm activity (see Chart 7).

The outlook for continued solid employment growth is supported by the current high levels of job vacancies, with the ANZ series at around its highest level in three years and the ABS series at its highest level since the series commenced. Continued strong growth in job vacancies suggests that the recent drop in surveyed business confidence has not had an appreciable effect on firms' intentions to hire more staff.

Chart 7: Growth in Employment and Non-farm Activity



Source: ABS Cat. Nos. 5206.0 and 6202.0.

After growing strongly throughout 1997-98, labour productivity is expected to slow over 1998-99, as employment growth responds with a lag to the easing in output growth.

The unemployment rate is forecast to fall to 7¾ per cent by the June quarter 1999, its lowest level since the December quarter 1990.

The strong increase in employment in 1997-98 translated almost fully into a decline in the number of unemployed, as the participation rate remained broadly stable. The participation rate is forecast to rise slightly during 1998-99 in response to modestly improving employment opportunities. Housing affordability also appears to be an important factor in the decision whether or not to participate in the workforce. In this regard, the ongoing high level of housing affordability and its impact on existing mortgage repayment obligations might mean that the stimulus to labour force participation continues to be less than would otherwise be the case.

The Current Account Balance

The current account deficit is expected to increase to around \$31 billion, or 5¼ per cent of GDP, in 1998-99. This anticipated rise is due to lower net export volumes and an increase in the net income deficit, partly offset by an increase in the terms of trade. The widening of the deficit is expected to be concentrated in 1998 with some narrowing occurring in 1999. As a per cent of GDP, the outcome for a particular quarter will be higher than that forecast for the year as a whole.

Statement 3 of this document compares the forecast increase in the current account deficit with past current account deficit episodes.

Uncertainties Surrounding the Outlook

The events in Asia over the past year or so highlight some of the uncertainties associated with economic forecasting. While there was some awareness of the policy shortcomings of the Asian economies, along with the threat they posed to economic stability, the timing and extent of the financial and economic crisis was not predicted. The unpredictability of these developments underlines the difficulty of appropriately incorporating risks to the economic outlook, but at this stage three broad issues warrant consideration: the direct and indirect effects of international developments; the extent to which weather conditions might depart from 'normality'; and the extent to which current monetary conditions might underpin greater strength in domestic spending than forecast.

As outlined above, the downturn in Asia is an important factor impacting on the domestic outlook. However, the extent and timing of this impact is particularly uncertain, partly because it relates to the outlook for world activity itself. While there now appears to be greater stability in financial markets in most of the troubled Asian economies, the full effects of developments on real activity are still to be felt in these economies. Of particular concern is the outlook for Japan. A sharper and more protracted weakening in Japan than currently forecast could have significant impacts on world industrial production, with consequent implications for the volume and prices of Australian exports. This would be especially so if weakness in Japan was combined with a more pronounced slowing toward sustainable growth in the United States and weaker than expected growth in Europe. Furthermore, a tightening in monetary policy in the United States and/or a sharp correction in stock prices could have significant implications for financial markets in other countries. Conversely, activity in the United States has continually surprised on the upside for some years without introducing sustained inflationary pressures, and may continue to do so over the next year. In addition, the strengthening of growth in Continental Europe may gather further pace than expected in

response to current relatively accommodating monetary settings. The outlook for international activity thus seems to be finely balanced.

There are necessarily uncertainties about the magnitude and timing of the impacts of these international developments upon the Australian economy. While the forecasts allow for a significant adverse direct impact, various factors could result in the impacts being overestimated. In particular, increases in supply capacity, continuing high Australian dollar returns to commodity producers, continued competitiveness of Australian exporters and their proven ability to expand sales into emerging markets may lead to export outcomes being higher than expected. Uncertainties surrounding indirect influences are also very large, and difficult to assess. Further weakening in business and consumer confidence could obviously result in lower levels of private sector expenditure than currently assumed. However, while events in Asia have already resulted in a decline in business confidence, the impact to date on expenditure plans appears to be modest. In particular, short-term employment expectations remain firm and year-ahead capital expenditure plans show no signs of deferral. If actual trading performance continues to grow solidly, as forecast, it could be that continuing high levels of private sector uncertainty fail to impart a constraining influence on overall activity to the extent incorporated in the forecasts.

The prospect of drought continues to pose a risk to farm production, though useful rains occurred during April throughout much of south-east Australia and the Bureau of Meteorology is cautiously optimistic about relatively normal rainfall patterns in the longer term. Nevertheless, follow-up rains are still required to ensure average seasonal conditions are achieved. If this does not occur, farm production could be lower than forecast, with flow-on effects to rural exports and GDP growth.

For private sector activity as a whole, the extent of the stimulus to private demand from current monetary conditions is an important uncertainty. The reductions in the official interest rate in 1997, competition-induced reductions in market interest rates and the decline in bond yields will all have a positive effect on activity in 1998-99. Some uncertainty relates to the extent of stimulus that should be incorporated in the forecasts, with the possibility existing that impacts on activity will be stronger, and more persistent, than assumed.

PART II: FISCAL OUTLOOK

OVERVIEW

The underlying balance is expected to be in surplus by \$2.7 billion or 0.5 per cent of GDP in 1998-99 — the first surplus since the early 1990s. Increasing surpluses are projected for the outyears, consistent with the medium term fiscal strategy (see Table 3). By 2001-02, the underlying budget balance is projected to be in surplus by around 2 per cent of GDP, a turnaround of over 4 per cent of GDP on the \$10.3 billion deficit in 1995-96.

The large headline surpluses in prospect reflect both the move into underlying budget surplus and equity asset sale proceeds, including those from the Government's decision to sell the Commonwealth's remaining equity in Telstra.

Table 3: Summary of Budget Aggregates

	1997-98		1998-99	1999-00	2000-01	2001-02
	Budget	Revised	Estimate	Projection	Projection	Projection
	\$million					
Revenue						
Tax	129433	130827	138172	146371	155595	165956
Non-tax	3918	4621	6086	4928	4605	5140
Total	133351	135448	144258	151299	160200	171096
Underlying outlays	137204	136603	141570	146566	151586	156508
Underlying balance	-3853	-1155	2688	4733	8614	14588
<i>Memorandum items:</i>						
Net advances	-10276	-13920	-16027	-18772	-12856	455
Headline balance	6423	12765	18715	23505	21470	14133
	Real growth on previous year (per cent)					
Revenue						
Tax	2.0	2.6	2.6	3.4	3.6	4.1
Non-tax	-27.0	-12.6	27.9	-21.0	-8.9	9.0
Total	0.9	2.0	3.4	2.3	3.2	4.3
Underlying outlays	-1.4	-0.9	0.6	1.0	0.8	0.8
	Per cent of GDP					
Revenue						
Tax	23.8	24.1	24.0	23.9	24.0	24.1
Non-tax	0.7	0.9	1.1	0.8	0.7	0.7
Total	24.5	24.9	25.0	24.7	24.7	24.9
Underlying outlays	25.2	25.1	24.6	24.0	23.4	22.8
Underlying balance	-0.7	-0.2	0.5	0.8	1.3	2.1
<i>Memorandum items:</i>						
Net advances	-1.9	-2.6	-2.8	-3.1	-2.0	0.1
Headline balance	1.2	2.3	3.2	3.8	3.3	2.1

The economic forecasts and projections underpinning the budget estimates are discussed in detail in Part I of this Statement and the major economic parameters are presented in Table 4.

Table 4: Major Economic Parameters (percentage change from previous year)

	Forecasts		Projections		
	1997-98	1998-99	1999-00	2000-01	2001-02
Real GDP(A)	3 3/4	3	3 1/2	3 1/2	3 1/2
Employment(a)	1 1/4	1 3/4	2 1/4	2 1/4	2 1/4
Wages(b)	4 3/4	4 1/4	3 1/2	3 1/2	3 1/2
Headline CPI	0	2 1/2	2 1/2	2 1/2	2 1/2
Underlying CPI	1 1/2	2 1/2	2 1/2	2 1/2	2 1/2

(a) Labour Force Survey basis.

(b) Average earnings (national accounts basis).

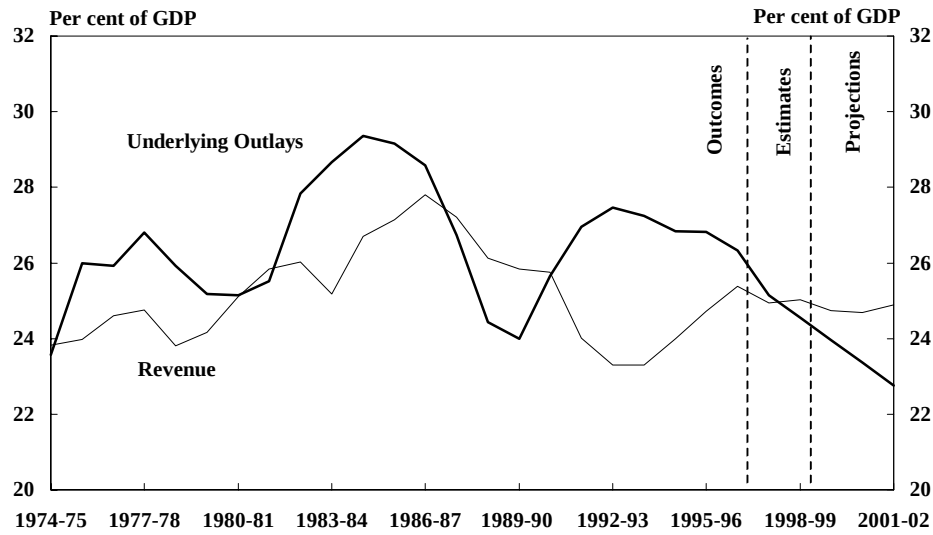
The projections for the period from 1999-2000 to 2001-02 are prepared solely as a basis for Budget figuring and do not represent forecasts.

A range of factors may change the budgetary outlook in future years. Appendix A contains a Statement of Risks which details risks that may have a material effect on the fiscal outlook. One factor influencing the fiscal outlook will be variations in the economic parameters. A discussion of the estimated sensitivity of the outlays and revenue estimates to changes to the economic parameters is provided in Appendix B to this Statement.

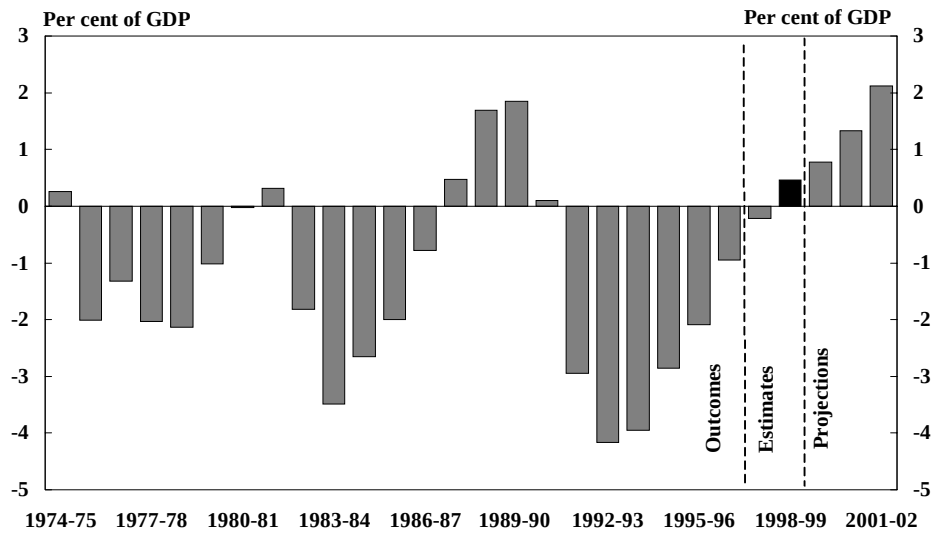
As shown in Chart 8, improvements in the underlying balance derive principally from falls in underlying outlays as a proportion of GDP. By 2001-02 they are expected to reach 22.8 per cent of GDP — their lowest level since the early 1970s. This reflects the focus placed by the Government on outlays restraint in implementing its programme of fiscal consolidation in the 1996-97 and 1997-98 Budgets. Revenue as a proportion of GDP is expected to remain relatively stable over the forward estimates period. The tax burden projected over that period is lower than in the late 1980s, when underlying surpluses were last recorded.

Chart 8: Underlying Budget Aggregates

Panel A: Budget Sector Revenues and Outlays



Panel B: Underlying Budget Balances



OUTLAYS

Table 5 provides estimates of budget sector outlays for 1997-98 to 2001-02.

Table 5: Estimates of Budget Sector Outlays

	1997-98		1998-99	1999-00	2000-01	2001-02
	Budget	Revised	Estimate	Projection	Projection	Projection
Underlying outlays (\$m)	137204	136603	141570	146566	151586	156508
<i>Real growth on previous yr (%)</i>	-1.4	-0.9	0.6	1.0	0.8	0.8
<i>Per cent of GDP</i>	25.2	25.1	24.6	24.0	23.4	22.8
Net advances (\$m)	-10276	-13920	-16027	-18772	-12856	455
Outlays (\$m)	126928	122684	125543	127794	138730	156963
<i>Real growth on previous year (%)</i>	-3.4	-5.8	-0.6	-0.7	5.8	10.4
<i>Per cent of GDP</i>	23.3	22.6	21.8	20.9	21.4	22.8

Over the period 1998-99 to 2001-02, underlying outlays are expected to:

- in real terms, increase only slightly in each year after declining slightly in 1997-98; and
- as a proportion of GDP, decline from just over 25 per cent in 1997-98 to 22.8 per cent in 2001-02.

Headline outlays (ie underlying outlays plus net advances) decrease slightly in real terms in 1998-99 and 1999-2000, but increase strongly thereafter. The decreases in earlier years reflect the proceeds from asset sales (particularly receipts from the sale of the Commonwealth's remaining equity in Telstra) which decline sharply in 2001-02.

Table 6 reconciles the outlays estimates between the 1997-98 Budget, the 1997-98 MYEFO and the 1998-99 Budget in terms of policy decisions and parameter and other variations.

Table 6: Reconciliation of Changes to Budget Sector Underlying Outlays since the 1997-98 Budget

	1997-98 \$m	1998-99 \$m	1999-00 \$m	2000-01 \$m
Underlying outlays at 1997-98 Budget	137204	140786	144947	148219
Changes from 1997-98 Budget to 1997-98 MYEFO				
Effect of reclassifications(a)	-46	-11	0	0
Policy decisions	395	566	733	1242
<i>of which</i> public debt interest impact of measures	3	24	58	124
Revision to economic parameters				
Unemployment benefits	-367	-303	-227	-311
Prices and wages	-21	-426	-666	-667
Interest and exchange rates	11	53	-17	-17
Public debt interest	-486	-976	-1001	-1274
Sub-total: revisions to economic parameters	-863	-1652	-1911	-2269
Programme specific parameters	414	502	753	1007
Slippage in 1997-98 Budget decisions	7	-1	-3	-3
Other revisions	239	25	745	623
Sub-total: programme specific parameter and other variations	660	526	1495	1627
Total parameter and other variations	-203	-1127	-416	-642
Total variations	146	-572	317	600
Underlying outlays at 1997-98 MYEFO	137350	140214	145264	148819
Changes from 1997-98 MYEFO to 1998-99 Budget				
Effect of reclassifications(a)	21	-58	6	6
Policy decisions	156	1385	1526	1862
<i>of which</i> public debt interest impact of measures	0	26	94	184
Revision to economic parameters				
Unemployment benefits	-38	-59	-85	-110
Prices and wages	64	362	205	159
Interest and exchange rates	1	284	214	220
Public debt interest	-163	-237	-195	-140
Sub-total: revisions to economic parameters	-137	350	139	129
Programme specific parameters	-376	595	670	1307
Slippage in 1997-98 Budget decisions	0	4	0	-6
Other revisions	-412	-919	-1039	-530
Sub-total: programme specific parameter and other variations	-787	-320	-369	770
Total parameter and other variations	-924	29	-229	900
Total variations	-746	1357	1302	2768
Underlying outlays at 1998-99 Budget	136603	141570	146566	151586

(a) See Appendix E for details on classification changes.

The outlook for underlying outlays was broadly unchanged between the 1997-98 Budget and the MYEFO. Lower numbers of unemployment beneficiary recipients, an improved outlook for inflation and lower public debt interest payments reduced outlays significantly in all years. These were only partially offset by higher outlays as a result of adverse changes to programme specific parameters (associated with higher than expected levels of Disability Support Pension and a higher than expected demand for medical services by veterans and dependants) and other estimates variations.

Since the MYEFO, the estimates for underlying outlays have been increased for all years other than 1997-98. In 1998-99 and 1999-2000, the increases primarily reflect the impact

of new policy decisions while, in 2000-01, there is also a significant contribution from net parameter variations including, specifically, further adverse changes in programme specific parameters. While programme specific parameter variations also contribute to higher outlays in 1998-99 and 1999-2000, these factors are more than offset by other estimates variations including the regular drawdown in the conservative bias allowance.

The major influence on programme specific parameters has been an increase in the estimated number of clients seeking disability support payments. Other factors affecting programme specific parameter changes reflect increases in client numbers and/or higher average rates payable on family payments.

Over the full year since the 1997-98 Budget, in total, the outlays estimates have increased in all years except 1997-98, generally reflecting the cost of policy decisions which, in 1998-99 and 1999-2000, more than offset significant public debt interest savings. In 2000-01, both policy decisions and parameter variations, over the past year, contribute to the estimated increase in outlays.

Conservative Bias Allowance

The forward estimates are based on decisions already made and economic projections. They also include an allowance for the established tendency for spending on existing Government policy (particularly for demand-driven programmes) to be higher than estimated. This allowance, known as the conservative bias allowance (CBA), is included in the forward estimates at the beginning of each budget year and gradually reduced as the budget estimates are finalised so that the Budget year CBA is zero.

At the time of the 1997-98 Budget, the CBA was based on 0.75 per cent of headline outlays in the first forward year, increasing in each following year. Following a review of the accuracy of this allowance, this figure was increased to 1.0 per cent of underlying outlays in the first forward year, increasing in each following year. The increases were factored into the 1997-98 MYEFO estimates.

Since the MYEFO, further adjustments have been made to the CBA in 2000-01 and 2001-02 to improve the overall accuracy of underlying outlays in the outyears.

Outlays Measures

The 1996-97 and 1997-98 Budgets provided for substantial net outlays savings over the budget and forward estimates period. The 1998-99 Budget provides for some moderate net new policy spending.

- Policy decisions taken since the MYEFO (up to and including the 1998-99 Budget) increase underlying outlays by around \$1.4 billion in 1998-99, \$1.5 billion in 1999-2000, \$1.9 billion in 2000-01 and \$1.5 billion in 2001-02.
- In total, net outlays measures since the 1997-98 Budget increase underlying outlays by \$2.0 billion in 1998-99, \$2.3 billion in 1999-2000, \$3.1 billion in 2000-01 and \$2.6 billion in 2001-02.

Table 7 provides a summary of the major outlays measures affecting underlying outlays.

Major new outlays spending measures since the 1997-98 Budget include:

- increased funding for health, including the Australian Health Care Agreements with the States and Territories;
- Care and Support for Older Australians;
- programmes for the young unemployed;
- a package of measures included in the Industry Statement *Investing for Growth*;
- funding for the Advancing Australia agricultural package;
- measures to reduce Australia's greenhouse gas emissions; and
- extension of the Gold Card to eligible World War II veterans.

Despite the considerable savings already identified in the 1996-97 and 1997-98 Budgets, additional savings have been identified in a number of areas including:

- the dividend from Department of Finance and Administration (DoFA) restructuring;
- lower tender prices in the employment services market;
- improving compliance activities under the Pharmaceutical Benefits Scheme; and
- agreement with the diagnostic imaging profession to limit servicing costs while improving access to magnetic resonance imaging services.

A full description of all 1998-99 Budget outlays measures can be found in Part I of *Budget Paper No. 2*.

Table 7: Major Outlays Measures Introduced Since the 1997-98 Budget

Description of Measure	Effect on Underlying Outlays			
	1998-99 \$m	1999-00 \$m	2000-01 \$m	2001-02 \$m
SPENDING MEASURES				
<i>Measures introduced since the 1997-98 MYEFO</i>				
Establishment of the Australian Securities and Investments Commission	15	12	12	12
Establishment of the Australian Prudential Regulation Authority	26	28	24	24
Enhancing mutual obligations for unemployed young people including literacy and numeracy training	100	85	81	81
National Illicit Drugs Strategy - measures	27	28	28	21
Australian Health Care Agreements - increased funding	242	309	437	524
Additional health funding	35	84	97	102
Staying at Home - Care and Support for Older Australians	28	62	86	103
Extension of Seniors Card Eligibility	26	53	55	57
Additional funding for Year 2000 compliance	126	0	0	0
Extension of the Gold Card to eligible World War II veterans	70	145	138	126
Additional funding for entitled veterans' hospital services	150	150	150	150
Link War Widows' Pension to the benchmark of 25% of	23	35	47	59
Further Youth Allowance measures	58	42	32	27
Extension of real per capita guarantee on Financial Assistance Grants to the States	0	0	191	196
Tourism Package - funding for promotion and development	12	12	12	13
Continuation of National Asian Languages and Studies	25	17	0	0
Other(a)	473	601	655	230
Sub-total	1437	1663	2046	1726
<i>Measures introduced up to and in the 1997-98 MYEFO</i>				
Revisions to Austudy Means Test	43	44	46	47
A replacement nuclear research reactor for Australia	6	12	32	67
National Illicit Drugs Strategy - measures	29	28	23	19
Introduction of a Youth Allowance	49	34	29	29
Enhanced package of measures to reduce Australia's greenhouse gas emissions	34	39	41	30
Member choice & Commonwealth superannuation arrangements	12	40	290	320
Delay income test for residential aged care and exempt existing residents	55	38	29	24
Extension of Export Market Development Grants for two years	0	0	150	150
Additional funding for innovation programmes	43	143	225	260
Agriculture - Advancing Australia	77	71	52	21
Amendment to allow rent assistance to sub-tenants in public housing where relevant State Housing Authority is notified	56	57	59	60
Other(a)	173	245	298	136
Sub-total	577	752	1273	1163
Total spending measures	2014	2415	3320	2888
SAVINGS MEASURES				
<i>Measures introduced up to and in the 1998-99 Budget</i>				
Changes to the Migration Programme - focus on skills	-8	-15	-27	-40
Dividend from departmental restructuring - DoFA	-3	-25	-26	-26
Maximising effectiveness of Pharmaceutical Benefits Scheme	-3	-21	-22	-22
Non-economic loss compensation payments	1	-9	-20	-21
Diagnostic imaging package including improving access to magnetic resonance imaging services	-2	-18	-29	-31
Savings in employment services market	-36	-37	-37	-38
Other	-13	-31	-54	-84
Total savings measures	-63	-156	-215	-261
TOTAL IMPACT OF ALL MEASURES	1951	2259	3104	2627

(a) Includes public debt interest impact of decisions.

REVENUE

Table 8 provides estimates of budget sector revenues for the period from 1997-98 to 2001-02.

Table 8: Summary of Budget Sector Revenue

	1997-98		1998-99	1999-00	2000-01	2001-02
	Budget	Revised	Estimate	Projection	Projection	Projection
Total tax (\$m)	129433	130827	138172	146371	155595	165956
<i>Real growth on previous yr (%)</i>	2.0	2.6	2.6	3.4	3.6	4.1
<i>Per cent of GDP</i>	23.8	24.1	24.0	23.9	24.0	24.1
Non-tax (\$m)	3918	4621	6086	4928	4605	5140
<i>Real growth on previous yr (%)</i>	-27.0	-12.6	27.9	-21.0	-8.9	9.0
<i>Per cent of GDP</i>	0.7	0.9	1.1	0.8	0.7	0.7
Total revenue (\$m)	133351	135448	144258	151299	160200	171096
<i>Real growth on previous yr (%)</i>	0.9	2.0	3.4	2.3	3.2	4.3
<i>Per cent of GDP</i>	24.5	24.9	25.0	24.7	24.7	24.9

Over the period 1998-99 to 2001-02, total revenue is expected:

- in real terms, to rise steadily through all years; and
- as a proportion of GDP, to remain relatively stable through the outyears.

Table 9 reconciles revenue estimates at the time of the 1997-98 Budget, the 1997-98 MYEFO and the 1998-99 Budget in terms of policy decisions and parameter and other variations.

Table 9: Reconciliation of Budget and Forward Estimates of Revenue in Aggregate

	1997-98 \$m	1998-99 \$m	1999-00 \$m	2000-01 \$m
Revenue at 1997-98 Budget	133351	142383	150330	158911
Changes from 1997-98 Budget to MYEFO				
Policy decisions	3	-73	-113	-244
Parameter and other revisions	1250	362	45	528
Total variations	1253	289	-69	283
Revenue at 1997-98 MYEFO	134604	142672	150262	159194
Changes from 1997-98 MYEFO to 1998-99 Budget				
Effect of reclassifications(a)	1	0	1	1
Policy decisions	5	106	44	-317
Parameter and other revisions	839	1480	992	1322
Total variations	844	1586	1037	1006
Revenue at 1998-99 Budget	135448	144258	151299	160200

(a) See Appendix E for details on classification changes.

At the time of the MYEFO, the revenue estimates were revised upwards for all years except 1999-2000. While policy decisions reduced estimated revenues in all years from 1998-99, this effect was — with the exception of 1999-2000 — more than offset by parameter and other revisions.

Variations in the period since the 1997-98 MYEFO improve the revenue outlook in all years. Policy decisions since MYEFO have only a minor positive impact in 1998-99 and 1999-2000 and detract from revenues thereafter. Parameter and other variations are the primary factor driving revenues higher in all years. Within tax revenues, these principally reflect increases in anticipated other individuals tax receipts. In 1998-99, there is also a significant positive contribution from non-tax revenues, including higher dividend receipts.

Overall, there have been only moderate increases to the revenue estimates since the 1997-98 Budget, amounting to \$1.9 billion in 1998-99, \$1.0 billion in 1999-2000 and \$1.3 billion in 2000-01.

Revenue Measures

In keeping with the Government's commitments, the 1998-99 Budget does not introduce new taxes or increase existing taxes.

Table 10 provides a summary of the major revenue measures. Key revenue measures include:

- additional expected revenue associated with the continued operation of the Australian Taxation Office's (ATO) High Wealth Individuals Taskforce;
- changes to the taxation treatment of Year 2000 compliance and computer software expenditure;
- a reduction in the provisional tax uplift factor from 6 per cent in 1997-98 to 5 per cent in 1998-99;
- implementation of previously announced initiatives for the automotive and information technology industries;
- enhanced visa processing and border monitoring; and
- cost recovery arrangements associated with the establishment of the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority.

A full description of all 1998-99 Budget revenue measures can be found in Part II of *Budget Paper No. 2*.

Table 10: Summary of Revenue Measures Introduced Since the 1997-98 Budget

Description of Measure	Effect on Revenue			
	1998-99 \$m	1999-00 \$m	2000-01 \$m	2001-02 \$m
MEASURES INTRODUCED SINCE THE 1997-98 MYEFO				
<i>Tax Avoidance and Minimisation</i>				
ATO High Wealth Individuals Taskforce	100	100	-	-
Amendment to Item 192 of the Sales Tax (Exemptions and Classifications) Act 1992	50	50	50	50
Other	..	..	..	5
<i>Information Technology</i>				
Year 2000 compliance expenditure and taxation of software	-30	-205	-295	-520
Tariff reductions on information industry inputs	-52	-28	-5	-5
<i>Anomalies</i>				
Beneficiary tax rebate for CDEP participants	-7	-7	-7	-7
Taxation treatment for spectrum licences	-8	-8	-8	-8
<i>Cost recovery</i>				
Changes to visa application charges for non-Electronic Travel Authority visitor visas	40	38	42	47
Supervision and funding arrangements for self-managed superannuation funds	-	-19	-19	-19
Establishment of the Australian Prudential Regulation Authority	4	39	29	30
Establishment of the Australian Securities and Investments Commission	8	14	14	14
Increase in the Passenger Movement Charge	10	21	23	24
1998-99 Migration Programme - visa application charges	2	9	13	13
Stevedoring levy	25	25	25	25
Other	4	6	5	5
<i>Other Measures</i>				
Increased charges to carriage service providers for the purchase of certain telecommunications numbers	30	30	30	30
Automotive Competitiveness and Investment Scheme	-	-	-200	-400
Deductibility of donations to political parties and independents	-	-18	-12	-15
Provisional tax uplift factor	-75	-	-	-
Other	5	-2	-3	-3
Sub-total	106	44	-317	-735
MEASURES INTRODUCED UP TO AND IN THE 1997-98 MYEFO				
<i>Tax Avoidance and Minimisation</i>				
Trust distributions to superannuation funds	15	15	15	15
<i>Anomalies</i>				
Capital Gains Tax (cost base provisions: transitional measure)	-60	-70	-	-
<i>Cost recovery</i>				
Other	-7	-7	-7	-7
<i>Other Measures</i>				
Abolition of non-callable deposits	-	-	-200	-200
Resolution of residence status for certain persons in Australia	10	1	..	..
Extension of Offshore Banking Unit concession	-9	-16	-16	-16
TRADEX	-15	-30	-30	-30
Other	-7	-6	-6	-6
Sub-total	-73	-113	-244	-244
TOTAL IMPACT OF ALL MEASURES	34	-69	-562	-979

BUDGETARY IMPLICATIONS OF THE SALE OF TELSTRA

The sale of the Commonwealth's remaining equity in Telstra has been included in the budget figuring throughout the budget papers, in accordance with the Government's decision to seek an electoral mandate to fully privatise the telecommunications carrier. This section explicitly identifies current estimates of the expected budgetary impact.

While the proceeds of equity asset sales affect only headline outlays — and the headline balance — there are indirect implications for the underlying balance from debt servicing cost savings associated with the use of proceeds to reduce Commonwealth general government net debt, dividends forgone and the costs of sale.

The estimates of the impact of the sale are highly dependent on assumptions made regarding: the structure, timing and proceeds of the sale; expected sale costs; dividends forgone; yield assumptions; and financial management strategies. It is assumed that all proceeds are used to reduce Commonwealth general government net debt. The current estimates will change as processes for the sale are progressed, and should not be seen as committing the Government to a specific sale process or timing.

Table 11 provides estimates of the potential budgetary implications of the sale of the Commonwealth's remaining equity in Telstra as included in the current budget and forward estimates.

Table 11: Budgetary Impact of Sale of Two Thirds of Telstra

	1998-99 \$m	1999-00 \$m	2000-01 \$m	2001-02 \$m
Sale costs	-70	-265	-245	0
Net income(a)	42	232	457	699
Underlying budget impact(b)	-28	-33	212	699

(a) Includes both interest effects and dividends forgone.

(b) A negative figure on balance items indicates a deterioration in the underlying budget balance.

The following assumptions have been made:

- sale proceeds broadly in line with estimates of the current market price for Telstra instalment receipts;
- sale costs of \$580 million, largely falling due in 1999-2000 and 2000-01;
- a net income effect comprising the balance of:
 - the loss of dividend payments to the Commonwealth as a result of the sale; and
 - the interest effects associated with reductions in net debt.

Any change to the assumed sale arrangements underpinning the analysis can be expected to affect the budget and forward estimates.

As shown in Table 11, the effect of the Telstra sale in the outyears is for positive net income effects to broadly offset initial sale costs. Positive interest effects can be expected to be large and to peak beyond the forward estimates period.

The Government's decision to sell the Commonwealth's remaining equity in Telstra is based not on the budgetary effects, but rather on broader economic considerations.

The Government believes that the sale of the Commonwealth's remaining equity in Telstra will provide an unprecedented opportunity for Australians to buy into — and share in the benefits deriving from — a strongly performing Australian company.

The Government believes that sale of equity in Telstra represents an historic opportunity to reduce Commonwealth net debt.

APPENDIX A: STATEMENT OF RISKS

OVERVIEW

The forward estimates of revenue and outlays in the Budget incorporate assumptions and judgements based on information available at the time of publication.

A range of factors may influence the actual budget outcome in future years. The Charter of Budget Honesty requires these to be disclosed in a Statement of Risks in each Budget. The purpose of this report is to increase the transparency of the fiscal projections.

Events which could affect fiscal outcomes include:

- changes in economic and other parameters;
- matters which have not been included in the fiscal forecasts because of uncertainty about their timing, magnitude, or whether they will eventuate; and
- the realisation of contingent liabilities.

Economic and Other Parameters

Some degree of uncertainty attaches to budget time and forward estimates for both revenues and outlays.

The major factors influencing expected outlays and revenues in any year are typically changes in forecasts of economic and non-economic parameters. Differences between the economic parameter forecasts and outcomes have not caused any clear bias toward understatement or overstatement of outlays and revenue — and therefore the budget balance. The sensitivity of the estimates to major economic parameters (but not other parameters) is discussed in Appendix B.

Differences in non-economic (programme specific) parameter forecasts and outcomes, however, have been strongly biased towards an understatement of outlays in recent years. Programme specific parameters are specific assumptions underpinning specific programme estimates eg client numbers and/or average rates payable on family payments, family tax payments and disability support pension programmes. A conservative bias allowance is made in the contingency reserve for each year, in part to account for this tendency (see the outlays discussion in Part II for more detail on this issue).

The projected values for programme specific parameters are determined jointly with the relevant spending portfolio, drawing on trends in actual payments and information which the portfolio is able to provide on the impact of policy changes on the programme estimates.

Fiscal Risks

Fiscal risks are general developments or specific events which may have an effect on the fiscal outlook. In some cases, the events will simply raise the possibility of some fiscal

impact. In other cases, some fiscal impact will be reasonably certain, but it will not be included in the forward estimates because the timing or magnitude is not known. Fiscal risks may affect both outlays and revenue and may be positive or negative.

Specific sources of fiscal risk include:

- litigation currently before the courts; and
- possible Senate rejection of budget measures.

Some fiscal risks are reflected in the Outlays Contingency Reserve and are therefore included in the aggregate outlays figuring. The Contingency Reserve is an allowance included in aggregate outlays to reflect anticipated events which cannot be assigned to individual programmes at budget time. These items are also not included in the Statement of Risks. Fiscal risks in the Contingency Reserve include expected running costs carryovers from 1998-99 to 1999-2000, and allowances for the established tendency for estimates of some programme expenditure to be overstated in the budget year and understated in the forward years.

As part of its decision to sell the Commonwealth's remaining equity in Telstra, the Government has announced it will apply the overwhelming majority of sale proceeds to debt reduction, and has said some of the proceeds will be used to deliver a 'social bonus'. As the details of this social bonus expenditure, including timing, amount and portfolio involved, are yet to be determined, no provision has been included in the forward estimates.

Matters that are not currently under active consideration by government, or pressure from interests outside the government for changes in spending levels, are not treated as fiscal risks.

Details of known fiscal risks which may have an impact on fiscal forecasts, but are not reflected in the forward estimates in the 1998-99 Budget, are provided below.

Contingent Liabilities

Contingent liabilities differ from fiscal risks in that they are generally more readily quantifiable and clearly defined.

Contingent liabilities are defined as costs the Government will have to face if a particular event occurs. They include loan guarantees, non-loan guarantees, warranties, indemnities, uncalled capital and letters of comfort.

The Commonwealth's major exposures to contingent liabilities arise out of legislation providing guarantees over certain liabilities of Commonwealth controlled financial institutions (ie the Reserve Bank of Australia (RBA) and the Export Finance and Insurance Corporation) and the now fully privatised Commonwealth Bank of Australia. Other substantial non-loan guarantees include guaranteed payments from Telstra Corporation Ltd to the Telecom Superannuation Scheme.

The strategies for managing these exposures are aimed at ensuring the underlying strength and viability of the entities with respect to which guarantees have been provided so that the guarantees are not triggered. Similar strategies apply to entities not subject to explicit guarantees.

Other arrangements are in place governing the entering into, and monitoring of, contingent liabilities such as indemnities and uncalled capital. Uncalled capital is primarily associated with international financial institutions such as the International Bank for Reconstruction and Development, the Asian Development Bank and the European Bank for Reconstruction and Development. Arrangements concerning uncalled capital are approved by Parliament and reports on the institutions are provided annually by the Government to Parliament.

Consistent with Australian Bureau of Statistics (ABS) standards, transactions concerned with the management of international reserves and the monetary system are classified as financing transactions (and do not impact on the budget balance). Therefore, contingent liabilities (and assets) with the International Monetary Fund (IMF) are not shown here.

DETAILS OF FISCAL RISKS AND CONTINGENT LIABILITIES

Fiscal risks and contingent liabilities with a possible impact on the forward estimates greater than \$20 million in any one year, or \$40 million over the forward estimates period, are listed below. Information on fiscal risks takes account of decisions of Parliament and other developments up to the close of parliamentary business on 8 April 1998. In general, information on contingent liabilities is based on information provided by departments and agencies and is current to 31 March 1998 (or a later date as indicated where that information is available). However, for the guarantees under the *Commonwealth Bank Sale Act 1995* the latest reliable information available on the balance of guarantees outstanding was at the end of June 1997.

Information on contingent liabilities is provided in annual financial statements of departments and non-budget entities.

Fiscal Risks — Outlays

Defence

Litigation cases in train — Department of Defence

The Department of Defence is involved in several cases covering a wide range of litigation where either the cases have not been heard, or damages and costs have yet to be awarded. The litigation involves claims before the Human Rights and Equal Opportunity Commission, and claims relating to HMAS Stalwart, HMAS Voyager, asbestos litigation, and alleged defective administration by the Department. The value of these claims is \$49 million.

Finance and Administration

Asset Sales

The Government's asset sales programme has a significant impact on the Commonwealth Budget through proceeds from sales (in most cases impacting largely on the headline budget balance), the cost of implementing sales, the reduction in public debt servicing charges and the loss of any future dividends from the enterprises/assets no longer being owned by the Commonwealth.

The estimates of the proceeds from asset sales are based on current market information. However, the actual amount realised will depend on the market conditions at the time of sale. The estimates of sale costs are based on experience in selling other Commonwealth assets and enterprises. Both the proceeds and the costs of sales estimates are highly dependent on assumptions about how the sales might be structured. Savings in public debt interest depend on the structure of sales, net proceeds received and the manner in which the proceeds are applied to reducing net debt.

The major asset sale provided for in the 1998-99 Budget figuring is the sale of the Commonwealth's remaining equity in Telstra Corporation. Draft legislation to facilitate the sale is currently before the Parliament.

Other significant asset sales included in the 1998-99 Budget are:

- ADI Limited;
- National Railway Corporation Limited;
- National Transmission Network;
- Australian National Line Limited;
- oversight the collection of the second instalment for the sale of shares in Telstra Corporation;
- the Commonwealth's domestic office estate (that which has already been identified for disposal but is yet to be sold); and
- overseas staff accommodation (stand alone, non-representational).

Member choice and Commonwealth Superannuation Arrangements

New superannuation arrangements for Commonwealth employees have been provided for in the budget and forward estimates. These new arrangements involve the closure of the Public Sector Superannuation Scheme (PSS) from 1 July 1998 and the choice for employees of either a complying superannuation fund or a Retirement Savings Account. The impact of incorporation of the new superannuation arrangements in the estimates has been to bring forward future superannuation liabilities for existing employees in the amounts of \$12 million in 1998-99, \$40 million in 1999-2000, and \$290 million in

2000-01, without increasing the superannuation costs to employers. It therefore represents no net cost to the Budget on an accruals basis.

The bringing forward of these outlays is subject to legislation before the Parliament and, depending upon Parliament's consideration of the Bills, the timing of some or all of the outlays could be delayed.

Health and Family Services

Australian Health Care Agreements

The Commonwealth has offered the States and Territories new funding arrangements to replace the existing Medicare Agreements which expire on 30 June 1998. The offer is based on a funding formula in which the Commonwealth shares financial risk in relation to changes in the private health insurance participation rate and changes in the measured national average output cost for public hospital treatment. Under this formula, the Commonwealth payments to the States and Territories vary after 1998-99, by about \$85 million a year for every one percentage point change in the private health insurance participation rate relative to the 1998-99 level, and by about \$45 million for every one percentage point change in the measured hospital cost, relative to the budget assumption of 0.5 per cent.

Major new listings — Pharmaceutical Benefits Scheme and Medicare Benefits Scheme

A joint agreement between the Treasurer, Minister for Finance and Administration and the Prime Minister is required when the cost of listing a new drug on the Pharmaceutical Benefits Scheme is over \$10 million. Similarly, new medical services costing more than \$10 million a year need to go to Cabinet before listing on the Medical Benefits Schedule. New drugs can only be listed after an assessment of comparative effectiveness and value for money. New medical services are considered by the Medical Services Advisory Committee before listing. The listing of new high cost drugs and services has the potential to increase Commonwealth outlays by up to \$200 million over the four years to 2001-02.

New Resident Classification Scale for Residential Aged Care

As part of the Government's aged care reforms a new Resident Classification Scale (RCS) has been developed and implemented. The RCS is used to assess the need of each resident for care and the appropriate level of subsidy. It replaces two separate instruments previously used in nursing homes and hostels and was designed to be cost neutral. However, there is a risk that the measured dependency of residents under the RCS will be greater than was originally expected. An initial review has identified a number of differences between the predicted and actual distribution of residents across RCS categories, but modelling based on data over a longer period than the first three months is necessary before the quantum of the risk can be firmly established. As an illustration of the magnitude of the possible impact, if outlays were 1 per cent higher as a result of the new instrument, the impact would be about \$30 million per annum.

Litigation cases in train — Department of Health and Family Services

The Department of Health and Family Services is involved in around 90 cases covering a wide range of litigation, where either the cases have not been heard or damages and costs have yet to be awarded. The litigation involves Creutzfeldt-Jakob disease, Acquired Immune Deficiency Syndrome, Rehabilitation Services, Hepatitis C, benefit payments, defective products, the Professional Services Review Scheme, and the Department as an employer. It is not possible to quantify the liability arising from the cases.

Immunisation funding mechanism

Agreement between the Minister for Health and Family Services and the Minister for Finance and Administration is required when the cost of new vaccines under the immunisation funding mechanism is between \$10 million and \$20 million. Cabinet approval is required when this cost is over \$20 million. Future vaccine technology will result in new vaccines substituting vaccines already in use (eg multivalent vaccines which combine several vaccines into one), and as a consequence will result in higher unit costs of vaccine within the routine schedule. Given the nature of current vaccine technology, and the possible introduction of new vaccines required for a full cohort and several doses, specific vaccine costs cannot be precisely quantified at this stage. However, the inclusion of new essential vaccines within the routine schedule between 1998-99 and 2001-02 has the potential to increase Commonwealth outlays by up to \$120 million in total over the four years.

Industry, Science and Tourism

Diesel Fuel Rebate Scheme — major litigation

Legal action through the Administrative Appeals Tribunal and the Federal Court is being pursued by a range of companies involved in quarrying activities for payment under the Diesel Fuel Rebate Scheme in respect of diesel fuel used in the extraction of sand and rock undertaken prior to 1 July 1995. Possible claims on the Commonwealth from a successful legal challenge could amount to some \$90-\$100 million. The likelihood of this liability arising has diminished as a result of the Commonwealth's success in a recent action. The *Excise Act 1901* and the *Customs Act 1901* were amended with effect from 1 July 1995 to remove sand and rock extraction from eligibility under the Scheme.

Textiles, Clothing and Footwear (TCF) assistance package

In response to the Industry Commission report on the TCF industries, the Government has announced a pause in tariffs at levels scheduled for the year 2000. A TCF investment programme was also announced. As at 31 March 1998, the timing and the details, including the cost, of the investment programme had not been established.

Primary Industries and Energy

Exceptional circumstances and drought relief

Additional expenditure on drought relief is subject to climate variability which cannot be predicted with any degree of certainty. The number of Exceptional Circumstances Relief

Payment recipients and exceptional circumstances interest rate subsidies approved will vary significantly each year, depending on the severity of drought and other exceptional circumstances conditions.

Prime Minister and Cabinet

Native Title cost sharing

The Commonwealth has previously offered to assist States and Territories in meeting compensation costs associated with their validation of past acts under legislation complementary to the *Native Title Act 1993*. Following the High Court's *Wik* decision, the Commonwealth offer has been extended to cover intermediate period acts and future acts arising under the 10-point plan. The extent of Commonwealth payments to the States pursuant to this offer will depend on the compensation liabilities arising from actions by the States to acquire native title rights. Those liabilities cannot be quantified at this time. The Commonwealth has also offered to assist States and Territories with the costs of alternative arbitral bodies and regimes approved under the Act. The extent of this assistance will depend on decisions to establish such bodies and regimes, the timing of their recognition and the extent of their use. Negotiation of financial assistance agreements with the States is unlikely to be completed until the Native Title Amendment Bill has been passed.

Separation of Aboriginal children from their families in the Northern Territory

Earlier laws, policies and practices led to the separation of many Aboriginal and Torres Strait Islander families. Legal actions are under way against the Commonwealth concerning the separation of Aboriginal children from their families in the Northern Territory. The plaintiffs are claiming damages and if any or all of the actions are successful, the Commonwealth may be liable for payments.

Social Security

Possible Social Security Agreement with Greece

The Government is continuing negotiations with Greece on a social security agreement which would cover those people who have lived part of their working lives in both countries. Depending on its terms, such an agreement would cost Australia an estimated \$25 million a year. If agreement on the terms is reached in 1998, it would not commence before July 1999 at the earliest.

Youth Allowance and related measures

The Youth Allowance, a new social security payment to be implemented on 1 July 1998, will provide an integrated income support payment for young people which will be available regardless of whether a person is in education, training, unemployed or sick.

The legislation package to provide for the Youth Allowance and the transfer of programme elements for older students from the portfolio of the Minister for Employment, Education, Training and Youth Affairs to the portfolio of the Minister for Social Security, is contained in two Bills. The first of these, the Social Security

Legislation Amendment (Youth Allowance) Bill 1997, is awaiting Royal Assent. However the second Bill, the Social Security Legislation Amendment (Youth Allowance Consequential and Related Measures) Bill 1998, passage of which is critical to the implementation of Youth Allowance, is not scheduled for debate in the Senate until 12 May 1998.

In addition, final incorporation of programme elements such as fares allowance, the Student Financial Supplement Scheme and the Youth Allowance actual means test depend on approval of disallowable instruments and tabling of regulations. This subordinate legislation cannot be tabled in Parliament until passage of the Social Security Legislation Amendment (Youth Allowance Consequential and Related Measures) Bill 1998.

Any legislative impediment to the full implementation of the Youth Allowance and related measures would constitute a potential fiscal risk to the forward estimates.

Abolition of Employment Entry Payment and Education Entry Payment

The measures that abolished the Employment Entry Payment and Education Entry Payment were rejected by the Senate in December 1996. A new bill to re-present these measures has been in the Senate since June 1997. The Bill is unlikely to be considered until later this year and, as a result, may cause a further delay of the planned implementation date. If the Bill is not passed, the forward estimates will need to be increased to exclude the savings from these measures.

Transport and Regional Development

Compensation claims — finalisation of acquisition of properties for the Second Sydney Airport at Badgerys Creek

Compensation claims relating to disputes arising from the compulsory acquisition of properties acquired for the proposed Second Sydney Airport at Badgerys Creek which have not been finalised at 31 March 1998 give rise to a risk of \$41.1 million. The properties were acquired under the *Lands Acquisition Act 1989*.

Northern Territory Government loans

Loans of the Northern Territory Government (Private Treaty Loans, Public Loan Flotations, and Private Placement of Northern Territory Stock) are covered by Commonwealth guarantee under sections 47 and 47A of the *Northern Territory (Self Government) Act 1978*. As at 31 March 1998, the value of these loans was \$162.2 million.

The payment of interest on the money borrowed by the Northern Territory Government is also guaranteed. As at 31 March 1998, no interest payments were overdue.

Treasury

Australia's involvement in the International Monetary Fund (IMF) assistance to Indonesia and the Republic of Korea

In response to recent instability in regional financial markets and economies, Australia has offered to provide bilateral financing in support of IMF programmes in Indonesia and the Republic of Korea. Australia has agreed to provide supplementary financing or 'second tier' financing of up to \$US1 billion in each case. This financing would be provided via a loan on a non-concessional basis that would be repaid to the Commonwealth. Whilst no funds have yet been disbursed to these two countries, the forward estimates provide for \$US300 million for Indonesia and \$US330 million for the Republic of Korea, as required, in 1997-98 and 1998-99 respectively. Amounts additional to this — and up to the \$US1 billion agreed by the Government — constitute fiscal risks to the headline forward estimates.

Australia's involvement in the International Monetary Fund (IMF) assistance to Thailand

In response to recent instability in regional financial markets and economies, Australia has offered to provide bilateral financing in support of the IMF programme in Thailand. This support has taken the form of a currency swap between the RBA and the Bank of Thailand for \$US1 billion which is being drawn down over a three-year period and repaid. In the event of default, the ability of the RBA to maintain the dividend stream projected in the forward estimates may be affected.

Fiscal Risks — Revenue

General risks

The forward estimates of revenue are subject to a number of general pressures which can result in risks to revenue collections. These general pressures include: tax minimisation and avoidance, including through the exploitation of tax expenditures; financial innovation; internationalisation; developments in communications technology and workplace arrangements; salary sacrifice arrangements; and court decisions. These pressures may result in a shift in the composition of revenue collected from the various tax bases and/or a change in the size of the tax base. The revenue forecasts make what is believed to be an appropriate allowance for these factors, given the data available.

Tax minimisation and avoidance involves the use of provisions and 'loopholes' in the tax law which were not intended by policy-makers. With evidence of greater taxpayer focus on tax avoidance and minimisation schemes, and in the absence of closing these off, the revenue base will shrink relative to that projected in the forward estimates. The Government is committed to addressing these problems through its fundamental tax reform programme which has, as one of its aims, the formation of a simpler and fairer tax system. At the same time, the Government will continue to take legislative action to close off such schemes as they are identified. In addition, the Australian Taxation Office (ATO) will continue to undertake extensive compliance enforcement work, including pursuing matters through the courts, to maintain the integrity of the tax system.

Financial innovation has increased dramatically during the past two decades and the tax system has generally not kept pace with these innovations. Consequently, uncertainty has arisen over the application of existing laws to new and often complex financial arrangements. Also the scope for tax minimisation and avoidance through the application of financial arrangements has expanded. An Issues Paper on the taxation of financial arrangements was released by Treasury and the ATO in December 1996. The paper has provided a vehicle for ongoing consultations between officials and taxpayers as to an appropriate basis for any reforms in this area.

The **internationalisation** of the Australian economy also introduces a general risk to the forward estimates of revenue. Income tax collections from capital are subject to increasing downward pressure due to increasing 'tax competition' among jurisdictions and 'profit shifting' in the context of the relatively free international flow of capital. The ATO is undertaking a series of compliance improvement measures to ensure that Australian companies deal with their international parties at 'arms length'. Income tax collections from labour are also coming under increasing downward pressure as a rising proportion of labour becomes more internationally mobile and subject to tax competition. The further integration of economies also means the integrity of each country's tax system will increasingly rely on international co-operation on tax matters.

Developments in **communications technology**, such as the Internet, also raise a general risk to the forward estimates of revenue. Such developments may allow the purchase or sale of an increasing number of goods and services — including the provision of labour services — in a way which avoids the traditional tax bases (and indeed most alternative, reasonably sophisticated, tax bases). Such developments pose a major challenge in tax system design in most countries. The ATO has sought to raise awareness of the issue in its December 1997 publication *Tax and the Internet*. Further, Australia will be participating in the October 1998 OECD Ministerial Conference on Electronic Commerce in Ottawa at which an international co-operative approach to regulating 'e' commerce will be discussed.

Developments in workplace arrangements may also affect taxation collections. Australia's tax system is characterised by a progressive system of personal income tax rates, combined with a flat company tax rate. Typically, the top marginal tax rate has been higher than the company tax rate. The divergence between the rates of personal and company tax provides an opportunity for some individual taxpayers, who would otherwise be subject to progressive marginal rates of tax, to derive income through a corporate structure. This may allow an individual taxpayer to take advantage of features of the corporate tax regime (for example, a lower company tax rate) which are not available to individual taxpayers. In response to such activity (termed 'alienation of personal services income'), the Commissioner of Taxation is taking appropriate steps to safeguard the intended operation of the law, including testing the law in the courts.

Salary sacrifice arrangements involve employees agreeing to forgo part of the remuneration they would otherwise receive in the form of salary or wages in return for benefits of a similar value. The objective of Fringe Benefits Tax (FBT) is to ensure that where an employee receives less salary and wages in exchange for a fringe benefit, the employer is subject to FBT on the benefit provided. Where FBT is payable (and costs to the employer are fully deductible), the total level of tax received by the Government (income tax and FBT) is generally the same as if an equivalent amount was provided in

gross salary and wages. In this case there is no cost advantage for the employer to provide fringe benefits rather than an equivalent amount of wages and salaries. This does not apply, however, in respect of employers where the FBT applies in part or not at all. In this case, salary sacrificing represents a risk to revenue. Salary sacrificing may also be used to defeat income tests on social security and other benefits as well as surcharges, for example those relating to superannuation and Medicare. As with other areas of the tax system which can be used for tax minimisation, the Government reviews the operation of the FBT on an ongoing basis to ensure that it is meeting its objectives.

Court decisions also increase the risk that revenue will be lower or higher than anticipated. Court decisions can affect the interpretation of tax legislation and, in the absence of Government action, can significantly change the level of revenue collected under that legislation.

Tax expenditures are often at risk of being exploited in an unexpected manner, which can also have a significant effect on the forward estimates of revenue. The Government receives a steady stream of calls for new tax expenditures to be granted. As a general proposition, the granting of further tax expenditures will lead to the downward adjustment of the forward estimates of revenue. Equally, the winding back of existing tax expenditures will generally require the upward adjustment of the forward estimates of revenue. In the future, all tax expenditures will be subject to ongoing monitoring and evaluation to determine whether they remain relevant to meeting the Government's priorities (see Appendix C to this Statement).

Apart from the above-mentioned general risks, which could have a cumulative impact over time, there are general risks to the forward estimates which could have a significant effect in any one year but not necessarily a cumulative effect over time. In any one year, revenue will be influenced by a number of factors, including, for example, the degree to which companies and individuals realise losses and capital gains, the valuation of stock, the utilisation of specific tax expenditures and taxpayer behavioural responses to revenue measures. Such factors can have a particularly significant effect on company tax collections and the revenue forgone through tax expenditures. Generally, such factors are not, by their nature, able to be forecast with a high degree of certainty.

Specific risks

There are also a number of specific risks to revenue that are currently the subject of ongoing analysis and evaluation by the Treasury and the ATO. Such risks include, for example, specific tax minimisation and avoidance schemes. Early detection and Government response to such risks is desirable. It would be inappropriate to explicitly identify such current specific risks until the Government is in a position to respond to the risks. To do so may compromise the Government's policy response and magnify the downside risks to the forward estimates of revenue.

The Government has announced a number of measures to date which have already been factored into the forward estimates of revenue but are yet to be passed by Parliament. Should the passage of legislation relating to these measures be delayed, amended or rejected, the forward estimates would need to be adjusted. Two important measures from the 1997-98 Budget are still awaiting passage through the Senate. The Government announced in the 1997-98 Budget, measures to address the unintended usage of franking

credits through **dividend streaming arrangements and trading in franking credits**. In the 1997-98 Budget, the Government also announced changes to the taxation of **distributions disguised as loans from private companies**. If these measures are not passed, as announced, there will be an impact on future revenue collections.

Contingent Liabilities — Quantifiable

Communications and the Arts

Telstra Corporation Ltd — loan guarantee

The Commonwealth has guaranteed loans taken out by Telstra Corporation Ltd. The principal amount covered by the guarantee as at 31 March 1998 was \$275.1 million.

Australian Broadcasting Corporation

The Commonwealth has guaranteed loans by the Australian Broadcasting Corporation. The principal amount covered by the guarantee as at 31 March 1998 was \$223.6 million. These loans were largely used to meet costs relating to the construction of premises for the Corporation at Southbank (Melbourne) and Ultimo (Sydney).

Special Broadcasting Service

The Commonwealth has guaranteed loans taken out by the Special Broadcasting Service. The principal amount covered by the guarantee as at 31 March 1998 was \$39 million. These loans were used to pay for refurbishment and enhancement of the Corporation's premises at Artarmon in Sydney.

Commonwealth Indemnity Scheme

The Commonwealth has provided indemnities to the owners of artworks against loss of, or damage to, those artworks whilst they are on loan to galleries participating in exhibitions organised under the Scheme. The global limit set by the Government on indemnities is \$1 billion. The actual amount indemnified as at 31 March 1998 was approximately \$261.2 million.

Defence

Defence Housing Authority

Private sector borrowing by the Defence Housing Authority is explicitly guaranteed by the Commonwealth under section 38 of the *Defence Housing Authority Act 1987*. The value of outstanding loans guaranteed at 31 March 1998 was \$60 million.

Military compensation

Contingent liabilities exist in relation to military compensation claims to the value of some \$188 million. These outstanding claims include long term incapacity payments, permanent impairment payments, medical, rehabilitation and death payments, and also includes long term Incurred But Not Reported (IBNR) payments. These long term IBNR

payments are included as a contingent liability because payment is contingent upon the fact that an officer has to place a claim, and the Department of Defence does not have an obligation to pay a claim.

Employment, Education, Training and Youth Affairs

Commonwealth Loan Guarantees — Group Training

The Minister for Employment, Education, Training and Youth Affairs is authorised to issue Commonwealth guarantees on a limited number of loans made to Commonwealth endorsed Group Training organisations by commercial lenders in the period 1 July 1998 to 31 December 2000. These guarantees facilitate the provision of additional apprenticeship and traineeship positions by the employers on the Department of Employment, Education, Training and Youth Affairs' register of endorsed Group Training organisations. The maximum value of loans outstanding is capped at \$30 million.

Commonwealth Loan Guarantees — Student Loan Supplement Scheme

The Student Loan Supplement Scheme is a voluntary loan scheme which enables tertiary students to obtain additional financial assistance to enable them to meet their living expenses while studying. The loans are negotiated with the Commonwealth Bank of Australia Ltd and guaranteed by the Commonwealth. As at 31 March 1998, the value of such loans was \$1,188 million. From 1 July 1998, most of this scheme will be administered by the Department of Social Security.

Immigration and Multicultural Affairs

Adult Migrant English Program (AMEP) — teacher redundancy costs

Under the terms of a 1993 memoranda of understanding between the Commonwealth and the States, the Commonwealth may be liable for some costs incurred by state AMEP service providers associated with redundancy packages for a proportion of their permanent teaching staff. The Department of Immigration and Multicultural Affairs is currently negotiating with state AMEP service providers to extinguish this liability.

Industry, Science and Tourism

Australian Industry Development Corporation (AIDC)

As at 15 April 1998, AIDC contingent liabilities totalled \$246 million in respect of guarantees and credit risk facilities. The Corporation's other guaranteed borrowings, which total \$2,234 million, have now as a result of arrangements associated with the sale of certain assets of AIDC Ltd to UBS Australia Ltd, a wholly owned subsidiary of Union Bank of Switzerland, been offset by holdings in Commonwealth Government securities and certain hedging instruments guaranteed by UBS Australia. They have thus been netted off the gross borrowings to determine the contingent liabilities above.

Export Finance and Insurance Corporation (EFIC)

The Commonwealth guarantees the due payment by EFIC of money that is, or may at any time become, payable by EFIC to any person other than the Commonwealth. As at 31 March 1998, the contingent liability totals \$6,648 million, comprising contracts of insurance and guarantees (\$3,119 million), liabilities (\$724 million) and national interest provisions (\$2,805 million).

Primary Industries and Energy

Snowy Mountains Hydro-electric Authority (SMHEA)

The *Snowy Mountains Hydro-electric Power Act 1949* provides that borrowings by the SMHEA may be guaranteed by the Commonwealth. The Authority has issued inscribed stock at a discount to finance capital works of the Scheme. The borrowings are subject to explicit Commonwealth guarantees. As at 3 April 1998, the face value of guaranteed borrowings was \$212.5 million, with the net amount guaranteed (excluding unamortised discount on the issue of inscribed stock) being \$117.6 million.

Wool International

Under Section 53(7) of the *Wool International Act 1991*, the Commonwealth underwrites borrowings of Wool International for the management of the wool stockpile. Contingent liabilities to Wool International totalled \$336 million at 31 March 1998. Sources of borrowings include domestic and overseas commercial borrowings. Wool International is reducing this debt through the sale of the stockpile. The target date for the payout of debt is by the end of 1998.

Australian Wheat Board (AWB)

Under the *Wheat Marketing Act 1989*, the Commonwealth underwrites borrowings by the AWB that fund advance and related payments from the wheat pool up to a maximum of \$3,759 million. Borrowings are repaid as the wheat pool is sold. The percentage underwritten by the Commonwealth is set at 85 per cent of the estimated aggregate net return on the wheat pool. The Commonwealth's responsibility for the underwriting of borrowings ceases after the 1998-99 season's pools are finalised.

There is also an additional borrowing guarantee for a total principal of \$20 million for the AWB, which allows for the payout of equity in the 1990-91 pools to assist growers who were in financial difficulties at the time (following a fall in international wheat prices).

Queensland Fish Management Authority

The Commonwealth guaranteed a loan up to a maximum of \$40.9 million to encourage the restructuring of the Northern Prawn Fishery. There is still \$6.9 million outstanding to be paid off within three years. The loan was taken out by the Queensland Fisheries Management Authority on behalf of the Commonwealth to buy back surplus boat units from the fishery with repayment to be made by the industry through levies.

Treasury

Guarantees under the Commonwealth Bank Sale Act 1995

Under the terms of the *Commonwealth Bank Sale Act 1995*, the Commonwealth has guaranteed various liabilities of the Commonwealth Bank of Australia, the Commonwealth Bank Officers' Superannuation Corporation (CBOSC) and the Commonwealth Development Bank.

The guarantee for the Commonwealth Bank of Australia relates to both on and off-balance sheet liabilities. Of the existing contingent liability, 34 per cent involves off-balance sheet liabilities. As at 30 June 1997, the balance of the guarantee was \$104,174.1 million, a reduction of \$220,830.6 million on the previous year.

The guarantee for CBOSC covers the due payments of any amount that is payable to or from the Fund, by CBOSC or by the Bank, in respect of a person who was a member, retired member or beneficiary of the Fund immediately before 19 July 1996. Total accrued benefits at 30 June 1997 have been valued at \$4,022 million following an actuarial review. The outstanding value subject to the guarantee is estimated to be \$4,017 million.

As of 1 July 1996, the Commonwealth Development Bank ceased to write new business and no additional liabilities are being incurred. The existing contingent liability will gradually decline with the retirement of existing loans and exposures. The revised estimate for the balance of this guarantee was \$482 million as at June 1997.

Reserve Bank of Australia (RBA) guarantee

This contingent liability relates to the Commonwealth's guarantee of the liabilities of the RBA. The major component of RBA liabilities relates to Notes (ie currency) on Issue. This treatment of Notes largely relates to the historical convention of the convertibility of Notes to gold — coins are not treated as a liability in the Commonwealth's accounts. At 15 April 1998, Notes on Issue totalled \$21,874 million.

The other major liability consists of deposits with the RBA by the banking sector. At 15 April 1998, these deposits amounted to \$6,002 million. The large decrease from 30 June 1997 to 15 April 1998 is principally due to the decrease in the value of exchange settlement accounts held with the RBA by the banking sector. In total, the guarantee for the Reserve Bank was \$32,523 million as at 15 April 1998.

Uncalled Capital Subscriptions — international financial institutions

This liability relates to the value of the uncalled portion of the value of the Commonwealth's shares in the International Bank for Reconstruction and Development (\$US2,769.5 million — estimated value \$A4,249.0 million at 22 April 1998), the Asian Development Bank (\$US2,477.5 million — estimated value \$A3,801.0 million), and the European Bank for Reconstruction and Development (\$US81.7 million — estimated value \$A125.3 million).

Workplace Relations and Small Business

ANL Ltd — \$100 million promissory note facility

In order to enable ANL to trade in an orderly fashion, the Commonwealth has guaranteed access to a promissory note facility of up to \$100 million. Only \$50 million has been drawn down by ANL under this facility.

Maritime Industry Reform

The Commonwealth has undertaken to provide a guarantee of up to \$250 million on borrowings by the Maritime Industry Finance Company (MIFCo) to finance redundancy related payments in the stevedoring and maritime industries subject to certain conditions. As at 6 May 1998, the Commonwealth has not signed any such guarantee.

Contingent Liabilities — Unquantifiable

Attorney-General's

Australian Federal Police Adjustment Scheme (AFPAS)

Under section 30(2) of the *Australian Federal Police Act 1979*, all Australian Federal Police (AFP) appointees who complete a fixed term appointment are entitled to a payment upon separation from the organisation. The entitlement is payable subject to, and in accordance with, eligibility conditions determined by the Commissioner of the AFP. Funding has been provided for the costs expected to be incurred over the next five years, but actual expenditure is subject to the number of staff separations.

Communications and the Arts

Telstra Corporation Ltd — Superannuation Guarantee

Telstra Corporation Ltd has agreed to make additional employer contributions to the Telstra Superannuation Scheme. The Commonwealth has guaranteed that it will cover any benefits that may have to be paid from the Fund in the event that the Telstra Superannuation Scheme or Telstra is ever bankrupted and wound up.

Defence

HMAS Melbourne compensation

The recent decision in the Mewett case which went against the Commonwealth may be used by up to 900 crewmen of the HMAS Melbourne, in relation to the Voyager incident, to lodge claims against the Commonwealth. There is no basis for quantifying potential claims (92 have been lodged to date).

Finance and Administration

Superannuation Act 1976 and the Public Sector Superannuation Scheme (PSS)

Under the *Superannuation Act 1976* (for the Commonwealth Superannuation Scheme (CSS)) and the PSS Trust Deed and Rules and determinations made under them, the Commonwealth guarantees payment of the amounts of members' contributions and productivity contributions with interest allocated to those amounts by respective Boards of Trustees.

The CSS and the PSS guarantee the accrued contributions and interest so there cannot be a negative crediting rating on invested funds. The funds maintain a reserve which covers the possibility of negative returns. The Commonwealth has not had to make a payment in relation to this guarantee.

Sale of ADI Limited

An indemnity was provided on 15 January 1998 to ADI Directors, officers and employees in respect of claims and legal costs that may arise from assistance provided to the Commonwealth in relation to the proposed sale of the Commonwealth's shares in, or the business or assets of, ADI. The indemnity is ongoing.

Review of the Commonwealth's beneficial shareholding in the Australian Submarine Corporation

An indemnity was provided on 17 February 1998 to Mr Barry A C Hilson and BACH Pty Limited in respect of claims and legal costs that may arise from assistance provided to the Commonwealth during the conduct of the review of the Commonwealth's shareholding in the Australian Submarine Corporation. The indemnity is ongoing.

Sale of the former Department of Administrative Services Business Units

Eight business units of the former Department of Administrative Services (DAS) were sold in the second half of 1997. The businesses were DAS Distribution, Works Australia, Asset Services, Australian Operational Support Services, Australian Property Group, Interiors Australia, DAS Centre for Environmental Management and DASFleet. The sales agreements incorporate warranties and sale price adjustments. Commonwealth liabilities for these matters are limited in accordance with sales contracts.

Indemnities relating to other Asset Sales

Indemnities have been given in respect of a range of other asset sales. Details of these indemnities have been provided in previous Budget and MYEFO papers. A summary of these indemnities is provided below.

- Aerospace Technologies of Australia (ASTA) Pty Ltd — a number of indemnities have been given to the purchaser of ASTA to protect ASTA and the purchaser from any reasonable losses or liabilities incurred in respect of actions of ASTA prior to, or at the time of the sale, or from circumstances arising from the sale. These indemnities were issued on 20 June 1995 and will not extend to any claim which

either accrues, or is made, more than four years after that date or is for an amount less than \$100,000.

- Australian Industry Development Corporation (AIDC) Limited — an indemnity was provided on 30 May 1996 to the Directors and nominated officers of AIDC Ltd and the AIDC Corporation to indemnify them against claims and reasonable costs in respect of assistance provided with the sale on 3 February 1998. Indemnities have been provided to the purchaser against claims from employees, claims relating to premises and tax liability arising before the sale contract was signed.
- Commonwealth Funds Management (CFM) and Total Risk Management (TRM) — an indemnity has been provided to the Directors and certain officers of CFM and TRM to indemnify them against certain claims in relation to assistance given to the Commonwealth in the sale process. This indemnity was issued on 28 August 1996. The Commonwealth has indemnified the purchaser of CFM from certain losses and liabilities as a result of the exercise of powers under the *CFM Sale Act 1996* and against any stamp duty payments related to the transaction other than the basic share transfer duty.
- Avalon Airport Geelong Pty Ltd (AAG) — indemnities have been given to the purchaser of AAG to indemnify them and AAG against certain liabilities and claims arising out of the actions of AAG prior to the sale, or relating to Avalon Airport prior to closing.
- CSL Ltd — indemnities have been given to Potter Warburg/Price Waterhouse on 14 October 1992, and to Arthur Anderson on 7 June 1993 for circumstances relating to performance of the consultancy in the sale of CSL Ltd. An indemnity has been given to CSL Ltd on 14 September 1992 to protect CSL Ltd from any claim made against them for breach of confidentiality as a result of CSL Ltd having provided information to the Commonwealth.
- Lease of Federal Airports Corporation (FAC) Airports — indemnities have been provided to:
 - Ernst & Young on 15 July 1996 to indemnify them against legal costs incurred in respect of their obligations for legal compulsion to disclose;
 - the Board of the FAC on 3 October 1996 to replace the extension of Finance Direction 21 to FAC Board members;
 - Mallesons Stephen Jaques on 13 September 1996 to indemnify them in relation to all reasonable costs incurred in complying with any requests or directions by the Commonwealth; and
 - BZW Australia Limited on 18 August 1995 to indemnify them against legal costs and disbursements incurred in respect of BZW's obligations for legal compulsion to disclose.
- Moomba Sydney Gas Pipeline — an indemnity has been given to East-Aust Pipeline Ltd on 30 June 1994 against losses sustained due to a claim by an employee of the

Pipeline Authority for negligence or accrued salary or other entitlements arising prior to the 'Transfer Day'.

- Snowy Mountains Engineering Corporation (SMEC) — an indemnity has been given to Tinbury Ltd on 21 October 1993 against certain liabilities and costs which they may suffer from the Commonwealth's non-observance of any of the express representations, warranties, covenants or undertakings contained in the sale agreement.
- Commonwealth Bank Public Share Offer — in 1996 the Commonwealth provided an indemnity to the Commonwealth Bank, its directors and certain officers to cover the civil liability in relation to providing assistance to the Commonwealth in the offer context.
- Partial Sale of Telstra Corporation — Telstra Scoping Study — An indemnity has been provided on 23 September 1996 to the present and certain former Telstra directors and officers to protect them against certain liability incurred in connection with the Telstra Sale Scoping Study.
- Partial Sale of Telstra Corporation — Telstra Share Offer — indemnities were provided in 1997 to:
 - present and former directors, and certain executives of Telstra to protect them against certain liabilities in connection with a Telstra Sale Scheme; and
 - to Telstra Corporation to protect against:
 - (i) certain liabilities which may arise in connection with a Telstra Sale Scheme; and
 - (ii) any penalty or additional tax within the meaning of Division II of the *Income Tax Assessment Act 1936* or any loss or cost incurred by Telstra arising from the payment of Franking Deficit Tax or Franking Deferral;
 - the international underwriters to the Telstra Share Offer to protect them against any Australian documentary, stamp, transaction or registration or similar taxes;
 - the Joint Global Coordinators and Lead Managers to protect them against any claim arising from the acts of other parties where the Commonwealth requires them to rely on those acts in the performance of the consultancy services;
 - the Telstra Instalment Receipt Trustee and its directors to protect against certain losses and liabilities arising from performance of its functions under the Trust Deed governing the administration of the instalment payment;
 - the Bank of New York and its Custodian to protect them against certain losses that may arise in the performance of their obligations relating to the issuing of Interim American Depositary Receipts in the United States of America; and

- to Coopers & Lybrand and Price Waterhouse by the Telstra Instalment Receipt Trustee, on behalf of the Commonwealth, in relation to performance of certain of their functions as the Instalment Receipt Registrar and Manager of the Instalment Receipt Trustee, respectively.
- Australian Multimedia Enterprise (AME) — an indemnity, effective from 3 July 1997, has been provided to the Directors and Chief Executive Officer of AME to indemnify them against certain costs in respect of assistance provided by the director for the purposes of investigating or conducting the sale of AME.
- Housing Loans Insurance Corporation (HLIC) — the sales agreement, effective on 15 December 1997 incorporates warranties, indemnities and sale price adjustments. Commonwealth liabilities for these matters are limited by total value and, in some cases, are also limited to time.

Indemnities for banks

The Commonwealth has indemnified a number of banks in Europe and North America and the RBA against loss and damage arising from the acceptance of certain Commonwealth cheques bearing a facsimile signature having been impressed thereon without the authority of the Commonwealth.

New Commonwealth Insurable Risk Managed Fund

Under the current non-insurance policy, the Commonwealth is exposed to risks with the operations of agencies, such as government departments, under the *Financial Management and Accountability Act 1997*. These risks cover loss or damage to property, consequential losses, court awards and out of court settlements, for which the costs are met from existing agency appropriations or supplemented as required from the budget.

The Government proposes to replace its non-insurance policy with one of self-insurance via a managed fund, with effect from 1 July 1998. Commonwealth insurable risks that are not currently insured will be systematically identified and costed, and the risks will be funded by provisioning over time. The managed fund will produce better risk management and therefore reduce costs over time.

Similarly, the insurable risks of some bodies under the *Commonwealth Authorities and Companies Act 1997* within the general government sector will also be progressively covered by the new managed fund from 1 July 1998. Premiums will be charged by the fund to cover the long-term cost of risk and associated administrative costs and an allowance has been made in the Budget and Forward Estimates to cover the expected payment of claims to these bodies. However, given the unpredictable nature of insurable risk, it is possible that this estimate could be exceeded in any particular financial year.

Foreign Affairs and Trade

Australian Trade Commission

Under the *Australian Trade Commission Act 1985* the Commonwealth guarantees payment by the Australian Trade Commission of money that is payable to any person other than the Commonwealth.

Health and Family Services

CSL Ltd

CSL Ltd is indemnified against claims made by persons who contract specified infections from specified products and against employees contracting asbestos related injuries. CSL Ltd has unlimited cover for most events that occurred before the sale of CSL Ltd on 1 January 1994, but has more limited cover for a specified range of events that might occur during the period of the current contract. Given the open-ended nature of some of the indemnities, damages and risk cannot be quantified.

Transport and Regional Development

Civil Aviation Safety Authority (CASA) — indemnity in relation to the Authority's safety regulatory functions

Under a Deed of Agreement, CASA is indemnified against claims incurred in carrying out its responsibilities for aviation safety regulation. Under existing arrangements, this indemnity is subject to annual renewal on payment of an annual premium by CASA to the Commonwealth. The current CASA safety regulatory indemnity expires on 5 July 1998.

Civil Aviation Safety Authority (CASA) — indemnity to officers of the Authority administering the Carrier's liability insurance requirements

An indemnity has been given to those officers of CASA who administer the carrier's liability insurance requirements under Part IVA of the *Civil Aviation (Carrier's Liability) Act 1959* and complementary state legislation. This indemnity is unquantifiable and no expiry date has been set.

Tripartite Deed relating to the sale of Phase 1 Airports

The Tripartite Deeds between the Commonwealth of Australia, airport Lessees and Lessees' financiers provide for the Commonwealth to 'step-in' as airport operator in defined circumstances. The potential liability of the Commonwealth in the event varies considerably with the specific factors leading to such an action.

If the Commonwealth entered into possession of an airport site it could seek to recover its costs from a number of sources, including airport revenues.

Sale of the Australian National Railways Commission (AN) and National Rail Corporation Ltd (NR)

An indemnity has been provided to each of the Commissioners of AN in relation to their assistance for the purposes of the sale of AN, its business units or assets, including the provision of information about AN at the request of the Commonwealth or its advisers.

An indemnity has been provided to Directors and certain specified officers of NR in relation to their assistance during the Scoping Study into the possible sale of the Commonwealth's equity in NR, including the provision of information about NR at the request of the Commonwealth or its advisers.

Treasury

Housing Loans Insurance Corporation (HLIC)

The Commonwealth guarantees the liabilities of the HLIC which provides mortgage insurance to lenders. Whilst it is possible to measure the total value of all insurance contracts on the HLIC's books at any given time, this does not realistically reflect the potential risk to the Commonwealth. The HLIC has never suffered a claim for the total value of any insurance contract in its 30-year history; claims amounts on policies usually amount to 10 to 20 per cent of the policy value.

Workplace Relations and Small Business

ANL Ltd

The Commonwealth has issued a guarantee for all ANL's major lease facilities. If the risk materialised, the full termination value of the leases may be largely offset by the value of ANL's lessor loans and the value of assets that ANL would assume in the event of termination of the leases.

ANL Ltd Board

An indemnity for ANL Board members was provided to protect against civil claims relating to employment and conduct as a director of ANL Ltd and subsidiary/associated companies. This indemnity is unquantifiable and no expiry date has been set.

Australian Maritime Safety Authority (AMSA) — in relation to ship-sourced marine pollution.

In the normal course of operations, the Authority is responsible for the provision of funds necessary to meet the clean-up costs arising from ship-sourced marine pollution. The Commonwealth has agreed that the Authority's responsibility be limited to a maximum outlay of \$10 million. The Authority entered into a stand-by loan facility for this purpose. In the event of costs above that limit, funds will be provided by the Commonwealth. The Commonwealth's risk is unquantifiable. In all circumstances, the Authority is responsible for making appropriate efforts to recover the costs of any such incidents.

Possible increased workers' compensation costs to the Commonwealth

In December 1997, the NSW Court of Appeal found that Commonwealth employees, who were previously considered to be covered solely by the provisions of the *Safety, Rehabilitation and Compensation Act 1988*, could choose to claim compensation under State workers compensation legislation (the case is *Telstra Corporation v Worthing & Anor*).

The Commonwealth has applied to the High Court for leave to appeal this decision; the hearing is scheduled for 19 May 1998. The Australian Government Solicitor advises there are good prospects of the High Court overturning the Court of Appeal's decision.

If the Court of Appeal's decision is not overturned, the Australian Government Solicitor considers that there is some risk, although probably not a substantial risk, of Commonwealth exposure to financial liability under State workers compensation legislation.

APPENDIX B: SENSITIVITY OF FISCAL AGGREGATES TO ECONOMIC DEVELOPMENTS

Table B1 provides a guide to the sensitivity of the forward estimates of outlays and revenue to variations in economic parameters in 1998-99. It is important to recognise that such guides provide only a 'rule of thumb' indication of the impact on the budget of changes in prices, wages and other parameters.

Table B1: Sensitivity of Fiscal Aggregates to a 1 Percentage Point Increase in Economic Parameters

	1998-99 \$m	1999-00 \$m	2000-01 \$m	2001-02 \$m
<i>Outlays</i>				
Prices	270	540	610	660
Wages	80	300	330	340
Unemployment benefit recipients	280	280	280	280
Safety Net Adjustment	80	160	240	320
<i>Revenue</i>				
Average earnings	980	1060	1140	1230
Employment	660	710	760	820
Company income	20	220	190	200
Other individuals income	0	150	110	110
Consumption	260	280	290	300
CPI	30	140	150	150
Imports	40	50	50	60

On the outlays side, the sensitivity analysis of the estimates provides for the following assumptions about changes to four broad groups of parameters:

- prices — all price deflators are assumed to increase by one percentage point at the start of the September quarter 1998, with wage deflators left unchanged;
- wages — all wage and salary rates are assumed to increase by one percentage point from the beginning of the September quarter 1998, with price deflators left unchanged;
- unemployment benefit recipients (includes Newstart Allowance and unemployed Youth Allowance recipients) — the total number of recipients is assumed to increase by 5 per cent from the beginning of the September quarter 1998; and
- Safety Net Adjustment — the Safety Net Adjustment determined by the AIRC is assumed to increase by \$2 per week in the budget and forward years from the 1997-98 financial year.

Projected outlays respond to changes in economic parameters through a variety of mechanisms. For example, the Government's decision to maintain pensions at 25 per cent of Male Total Average Weekly Earnings (MTAWE) means that projected spending on pensions will depend not just on changes to the CPI, by which pensions have been indexed for some time, but also on expected changes in the level of MTAWE.

In addition, about \$26 billion of underlying outlays, comprising running costs, other Commonwealth Own Purpose Outlays of a running cost nature and Specific Purpose Payments to the States of a running cost nature, are indexed to weighted averages of movements in underlying inflation and the Safety Net Adjustment (SNA) determined by the AIRC.

The items affected by prices and wages have been re-examined since the 1997-98 MYEFO. This has resulted in a compositional change between the sensitivity of prices and wages. In addition, the Government has introduced the Youth Allowance which has had the effect of reducing unemployment benefit recipients.

The number of unemployment benefit recipients, and therefore the total spending on benefits, are affected by economic growth and employment growth. However, the relationship between GDP growth and unemployment benefit recipients is highly variable and difficult to quantify. For this reason, Table B1 only includes the impact of changes in the number of unemployment benefit recipients (ie Newstart Allowance and unemployed Youth Allowance recipients) on the estimates.

On the revenue side, the figures show the estimated impact of a one percentage point change in a range of economic variables in 1998-99 as a whole. The CPI is assumed to increase by a quarter of one percentage point at the start of each quarter in 1998-99.

Differences in impact over the years reflect:

- the full-year impact of variations in parameters not occurring until the year following the variation;
- the effect on revenue collections of variations in company and other individuals income occurring largely in the year following the receipt of income; and
- for variations in most economic parameters, the flow-through effect of a higher (or lower) base in a year on revenue collections in subsequent years.

APPENDIX C: TAX EXPENDITURES

OVERVIEW

This appendix discusses the revenue impacts associated with concessional taxation treatment of specific groups and/or activities.

Individuals and businesses derive financial benefits from various tax concessions. These concessions are usually delivered by tax exemptions, deductions, rebates or reduced rates. They can either reduce or delay the collection of tax revenue. The Government can use taxation concessions to allocate resources to different activities in much the same way that it can use direct expenditure programmes. For this reason, and noting their direct impact on the underlying budget deficit, these tax concessions are generally called 'tax expenditures'.

A feature of the Government's Charter of Budget Honesty is the requirement to publish an overview of tax expenditures as part of the budget.

Following a review of existing tax expenditures, first announced in the 1996-97 Budget, the Government has decided to undertake periodic monitoring and evaluation of all tax expenditures through normal budget processes to ensure they deliver Government assistance in an effective manner.

AGGREGATE TAX EXPENDITURES

Table C1 shows estimates for the period 1994-95 to 2001-02 of the aggregate tax expenditures that have been identified and costed in the *Tax Expenditures Statement 1996-97* (TES), which was published in December 1997. The availability of new information and decisions taken since the TES was published have led to a re-estimation of actual costs and forward projections for aggregate tax expenditures.

Table C1: Aggregate Tax Expenditures 1994-95 to 2001-02

Year	Superannuation (\$m)	Other Tax Expenditures (\$m)(a)	Tax Expenditures Total (\$m)	Tax Expenditures as a proportion of Outlays (%) (b)	Tax Expenditures as a proportion of GDP (%)
1994-95	5770	10459	16229	13.1	3.5
1995-96	8315	9972	18287	13.9	3.7
1996-97	8700	10626	19326	14.2	3.7
1997-98 (est)	8490	10335	18825	13.8	3.5
1998-99 (est)	8750	11841	20591	14.5	3.6
1999-00 (proj)	9420	13240	22660	15.5	3.7
2000-01 (proj)	10060	14183	24243	16.0	3.7
2001-02 (proj)	10740	15395	26135	16.7	3.8

(a) These aggregates do not include measures allowing delayed payments of tax.

(b) Outlays are reported on an underlying basis.

There are a number of major considerations in analysing aggregate tax expenditures.

- These aggregate figures will understate the total cost to revenue of tax expenditures. The TES does not provide a comprehensive listing of all tax expenditures, and some of those which are identified have not been costed due to a lack of data.

- Tax expenditures in the form of delayed tax payments (such as depreciation allowances which defer tax revenue collections to a later date), have been excluded from the estimates of aggregate tax expenditures. There is a considerable number of such arrangements in the tax system and, collectively, they lead to substantial revenue loss and economic inefficiency. They are, however, difficult to cost. Without such estimates it is not possible to aggregate timing tax expenditures with other estimates on a consistent basis.
- The increasing focus on tax expenditures in recent times has led to an enhanced effort to estimate the cost of more tax expenditures. However, this can make interpreting aggregate trends more problematic given the inconsistent coverage of tax expenditures over time.
- Changes over time in methodology and available data used for calculating the cost of particular expenditures means that there can be quite large revisions of tax expenditure estimates. Therefore, particular tax expenditure estimates may not be strictly comparable from year to year.
- Forward projections for the outyears can be subject to considerable uncertainty. Caution should be exercised when trying to draw strong conclusions on longer term trends.

Bearing these considerations in mind, Table C1 shows that the net cost of aggregate tax expenditures which provide a benefit or penalty to taxpayers (excluding timing measures), has increased by around \$1 billion in the year to 1996-97. As a result, the ratio of tax expenditures to underlying budget outlays increased to 14.5 per cent in 1996-97, with it projected to rise to almost 17 per cent by 2001-02.

While tax expenditures are expected to rise as a proportion of outlays, they remain relatively stable as a proportion of GDP reflecting, in many cases, the fact that they are closely related to income growth.

TAX EXPENDITURES BY FUNCTIONAL CATEGORIES

Table C2 compares the costs of identified tax expenditures in 1996-97 with underlying outlays by functional category. The functional categories are the same for outlays in this Statement.

The aggregates for a number of tax expenditure categories are only approximations as some tax expenditures do not lend themselves to easy categorisation. For example, it may not be possible to determine precisely which industry sectors have accessed tax concessions which are available to all industries. Tax expenditures that cannot be classified as belonging to a particular functional category are aggregated in the 'Not Allocated to Function' category.

Table C2 indicates there is considerable variation in the importance of tax expenditures to particular sectors of the economy. For example, while a relatively small level of assistance was provided through tax expenditures to the Education sector, about 96 per cent of the total Government assistance to the Fuel and Energy sector was provided in the form of tax expenditures.

The most significant category of tax expenditures was Social Security and Welfare, accounting for \$13.4 billion, or about 70 per cent of total tax expenditures. This compares with the next largest category (Mining and Mineral Resources other than fuels, Manufacturing and Construction) at \$1.7 billion or about 9 per cent of total tax expenditures.

Table C2: Aggregate Tax Expenditures and Direct Outlays by Functional Category, 1996-97

Functional category	Tax Expenditures \$m(a)	Budget Outlays \$m(b)	Total \$m
<i>General Public Services</i>			
Legislative and Executive Affairs	<1	489	489
Financial and Fiscal Affairs	-	1804	1804
Foreign Economic Aid	123	1718	1841
General Research	-	1158	1158
General Services	5	77	82
Government Superannuation Benefits	-	1419	1419
Defence	66	10054	10120
Public Order and Safety	-	1226	1226
Education	29	10321	10350
Health	529	19196	19725
Social Security & Welfare	13401	49602	63003
Housing & Community Amenities	211	1138	1349
Recreation and Culture	42	1375	1417
Fuel and Energy	610	27	637
Agriculture, Forestry and Fishing	354	1903	2257
Mining and Mineral Resources other than Fuels; Manufacturing; and Construction	1722	1653	3375
Transport and Communication	25	1655	1680
<i>Other Economic Affairs</i>			
Tourism and Area Promotion	70	86	156
Labour and Employment Affairs	15	2945	2960
Other Economic Affairs, nec	813	335	1148
<i>Other Purposes</i>			
Public Debt Interest	-	9402	9402
General Purpose Inter-Government Transactions	-	18229	18229
Natural Disaster Relief	-	20	20
Contingency Reserve	-	-	-
Asset Sales	-	101	101
Not Allocated to Function	1311	-	1311
Total	19326	135933	155259

- (a) Aggregate cost of tax expenditures in functional categories are derived by summing individual tax expenditure costings.
(b) Outlays are reported on an underlying basis.

APPENDIX D: HISTORICAL BUDGET AND NET DEBT DATA

This appendix provides historical data and forward estimates for budget sector underlying outlays, revenue and underlying balances; and for Commonwealth general government net debt.

Table D1 provides details of the budget aggregates for the period 1960-61 to 2001-02. The underlying budget balance is revenue minus headline outlays excluding net advances to other sectors. Net advances comprise net loans from the budget (new policy loans and advances less repayments) and net equity injections (injections/purchases of equity less equity sales). Classification differences and revisions, as well as changes to the structure of the budget, can impact on comparisons over such an extended period. In particular, there are some classification differences in the data relating to the period prior to 1976-77. This means that data for the earlier period may not be entirely consistent with that for 1976-77 and later years.

Table D2 provides details of tax, non-tax and total revenue for the period 1960-61 to 2001-02. These revenue data are compiled on a consistent basis from 1976-77.

Other factors which affect the comparability of budget aggregates between years are:

- adjustments in the coverage of agencies included in the accounts of the Commonwealth budget sector;
- transfers of taxing powers between the Commonwealth and the States;
- other changes in financial arrangements between the Commonwealth budget sector, Commonwealth non-budget sector agencies and the State/local government sector; and
- changes in arrangements for transfer payments where tax concessions or rebates are replaced by payments through the social security system. This has the effect of increasing both revenue and outlays as compared with earlier periods, but not changing balances. Changes in the opposite direction (tax expenditures replacing outlays) reduce both outlays and revenue.

While approximate adjustments can be made to identify trends in budget aggregates on a generally consistent basis, the further back this analysis is taken, the less manageable that task becomes.

A detailed discussion of the comparability of budget aggregates since 1960-61 is provided in Statement 5 of *1992-93 Budget Paper No. 1*.

Further details of the coverage of the budget sector and the changes in the classification of budget transactions are provided in Appendix E of this Statement.

Table D3 provides Commonwealth general government net debt data for the period 1974-75 to 2001-02.

Table D1: Commonwealth Budget Sector Revenue, Underlying Outlays and Underlying Balance

	Revenue			Underlying Outlays			Underlying Balance	
	Estimate \$m	% Real Growth	Per cent of GDP	Estimate \$m	% Real Growth	Per cent of GDP	Estimate \$m	Per cent of GDP
1960-61	3204	9.6	21.1	2654	5.1	17.5	551	3.6
1961-62	3262	-0.6	20.9	2941	8.2	18.9	321	2.1
1962-63	3356	1.3	19.9	3105	3.9	18.4	250	1.5
1963-64	3725	9.3	19.9	3437	9.0	18.4	289	1.5
1964-65	4349	12.4	21.1	3765	5.5	18.3	584	2.8
1965-66	4774	6.6	22.1	4220	8.8	19.5	554	2.6
1966-67	5088	2.9	21.3	4766	9.0	20.0	322	1.4
1967-68	5583	5.3	21.9	5258	5.9	20.6	324	1.3
1968-69	6228	6.5	21.7	5712	3.8	19.9	515	1.8
1969-70	7157	9.3	22.5	6188	3.0	19.5	969	3.0
1970-71	8093	6.6	23.0	7251	10.4	20.7	841	2.4
1971-72	8913	3.0	22.7	8060	4.0	20.5	853	2.2
1972-73	9471	-0.2	21.1	9189	7.1	20.5	281	0.6
1973-74	11978	10.8	22.3	10965	4.5	20.5	1012	1.9
1974-75	15431	5.9	23.8	15266	14.4	23.6	165	0.3
1975-76	18365	2.6	24.0	19904	12.4	26.0	-1539	-2.0
1976-77	21546	5.1	24.6	22701	2.2	25.9	-1156	-1.3
1977-78	23601	1.3	24.8	25541	4.0	26.8	-1940	-2.0
1978-79	25814	2.5	23.8	28125	3.2	25.9	-2311	-2.1
1979-80	29793	4.7	24.2	31046	0.2	25.2	-1253	-1.0
1980-81	35320	7.4	25.1	35349	3.2	25.1	-29	0.0
1981-82	41010	4.0	25.8	40513	2.7	25.5	497	0.3
1982-83	44879	-1.5	26.0	48024	6.7	27.8	-3144	-1.8
1983-84	49308	2.9	25.2	56147	9.5	28.7	-6839	-3.5
1984-85	57989	10.6	26.7	63761	6.8	29.4	-5772	-2.7
1985-86	65278	5.8	27.1	70097	3.3	29.1	-4819	-2.0
1986-87	73553	4.8	27.8	75628	0.4	28.6	-2075	-0.8
1987-88	81558	3.3	27.2	80138	-1.3	26.7	1420	0.5
1988-89	88796	0.2	26.1	83040	-4.7	24.4	5756	1.7
1989-90	95995	1.5	25.8	89113	0.8	24.0	6881	1.9
1990-91	98093	-2.1	25.8	97692	5.0	25.7	400	0.1
1991-92	93509	-6.5	24.0	104976	5.4	27.0	-11467	-2.9
1992-93	95062	0.3	23.3	112061	5.4	27.5	-17000	-4.2
1993-94	100747	5.0	23.3	117814	4.2	27.2	-17067	-3.9
1994-95	110430	8.5	24.0	123563	3.8	26.8	-13133	-2.9
1995-96	121688	7.2	24.7	131966	3.9	26.8	-10278	-2.1
1996-97	131031	5.1	25.4	135933	0.5	26.3	-4902	-0.9
1997-98 (estimate)	135448	2.0	24.9	136603	-0.9	25.1	-1155	-0.2
1998-99 (estimate)	144258	3.4	25.0	141570	0.6	24.6	2688	0.5
1999-00 (projection)	151299	2.3	24.7	146566	1.0	24.0	4733	0.8
2000-01 (projection)	160200	3.2	24.7	151586	0.8	23.4	8614	1.3
2001-02 (projection)	171096	4.3	24.9	156508	0.8	22.8	14588	2.1

Table D2: Commonwealth Budget Sector Taxation Revenue, Non-Taxation Revenue and Total Revenue

	Tax Revenue			Non-Tax Revenue			Total Revenue		
	Estimate \$m	% Real Growth	Per cent of GDP	Estimate \$m	% Real Growth	Per cent of GDP	Estimate \$m	% Real Growth	Per cent of GDP
1960-61	2851	10.0	18.7	353	6.4	2.3	3204	9.6	21.1
1961-62	2862	-2.0	18.4	400	10.6	2.6	3262	-0.6	20.9
1962-63	2915	0.2	17.3	441	8.5	2.6	3356	1.3	19.9
1963-64	3257	10.0	17.4	469	4.7	2.5	3725	9.3	19.9
1964-65	3835	13.4	18.6	514	5.5	2.5	4349	12.4	21.1
1965-66	4209	6.6	19.5	564	6.5	2.6	4774	6.6	22.1
1966-67	4485	2.8	18.8	603	3.2	2.5	5088	2.9	21.3
1967-68	4952	6.0	19.4	631	0.4	2.5	5583	5.3	21.9
1968-69	5533	6.7	19.3	694	5.0	2.4	6228	6.5	21.7
1969-70	6391	9.9	20.1	767	5.1	2.4	7157	9.3	22.5
1970-71	7221	6.5	20.6	872	7.2	2.5	8093	6.6	23.0
1971-72	7934	2.8	20.2	979	5.0	2.5	8913	3.0	22.7
1972-73	8468	0.3	18.9	1003	-3.8	2.2	9471	-0.2	21.1
1973-74	10907	12.8	20.3	1071	-6.4	2.0	11978	10.8	22.3
1974-75	14211	7.1	21.9	1221	-6.3	1.9	15431	5.9	23.8
1975-76	16933	2.7	22.1	1432	1.1	1.9	18365	2.6	24.0
1976-77	19783	4.7	22.6	1763	10.3	2.0	21546	5.1	24.6
1977-78	21469	0.3	22.5	2132	11.8	2.2	23601	1.3	24.8
1978-79	23514	2.6	21.7	2300	1.1	2.1	25814	2.5	23.8
1979-80	27539	6.3	22.3	2255	-11.1	1.8	29793	4.7	24.2
1980-81	32769	7.8	23.3	2551	2.5	1.8	35320	7.4	25.1
1981-82	38058	4.1	24.0	2952	3.7	1.9	41010	4.0	25.8
1982-83	41239	-2.5	23.9	3640	11.0	2.1	44879	-1.5	26.0
1983-84	45065	2.3	23.0	4243	9.2	2.2	49308	2.9	25.2
1984-85	53208	11.0	24.5	4782	6.0	2.2	57989	10.6	26.7
1985-86	59248	4.7	24.6	6030	18.5	2.5	65278	5.8	27.1
1986-87	66881	5.0	25.3	6672	2.9	2.5	73553	4.8	27.8
1987-88	75465	5.1	25.2	6093	-14.9	2.0	81558	3.3	27.2
1988-89	83897	2.3	24.7	4899	-26.0	1.4	88796	0.2	26.1
1989-90	91343	2.2	24.6	4651	-10.8	1.3	95995	1.5	25.8
1990-91	93225	-2.2	24.5	4867	0.2	1.3	98093	-2.1	25.8
1991-92	87970	-7.4	22.6	5539	11.7	1.4	93509	-6.5	24.0
1992-93	89434	0.3	21.9	5627	0.3	1.4	95062	0.3	23.3
1993-94	94024	4.2	21.7	6722	18.4	1.6	100747	5.0	23.3
1994-95	105687	11.3	23.0	4743	-30.2	1.0	110430	8.5	24.0
1995-96	116386	7.1	23.7	5302	8.7	1.1	121688	7.2	24.7
1996-97	125815	5.5	24.4	5216	-4.0	1.0	131031	5.1	25.4
1997-98 (estimate)	130827	2.6	24.1	4621	-12.6	0.9	135448	2.0	24.9
1998-99 (estimate)	138172	2.6	24.0	6086	27.9	1.1	144258	3.4	25.0
1999-00 (projection)	146371	3.4	23.9	4928	-21.0	0.8	151299	2.3	24.7
2000-01 (projection)	155595	3.6	24.0	4605	-8.9	0.7	160200	3.2	24.7
2001-02 (projection)	165956	4.1	24.1	5140	9.0	0.7	171096	4.3	24.9

Table D3: Commonwealth General Government Net Debt^(a)

	Commonwealth general government net debt	
	Estimate (\$b)	Per cent of GDP
1974-75	-0.8	-1.2
1975-76	0.7	0.9
1976-77	1.8	2.0
1977-78	3.6	3.8
1978-79	5.7	5.2
1979-80	6.9	5.6
1980-81	7.0	4.9
1981-82	6.5	4.1
1982-83	9.7	5.6
1983-84	16.5	8.4
1984-85	22.3	10.3
1985-86	27.1	11.3
1986-87	29.0	11.0
1987-88	27.4	9.1
1988-89	22.0	6.5
1989-90	16.1	4.3
1990-91	16.9	4.4
1991-92	31.1	8.0
1992-93	55.2	13.5
1993-94	69.9	16.2
1994-95	83.5	18.1
1995-96	95.8	19.5
1996-97	94.4	18.3
1997-98 (estimate)	82.9	15.3
1998-99 (estimate)	64.6	11.2
1999-00 (projection)	43.2	7.1
2000-01 (projection)	23.1	3.6
2001-02 (projection)	9.6	1.4

(a) Data for 1987-88 to 1996-97 are from ABS *Public Sector Financial Assets and Liabilities* (Cat. No.5513.0). These data take into account the reclassification of universities from the general government sector to a separate multi-jurisdictional sector. Data for years prior to 1987-88 are Treasury estimates which do not exclude universities. The adjustment for universities has only a negligible effect on the estimates.

APPENDIX E: CLASSIFICATION ISSUES

This appendix:

- discusses the conceptual basis for the classifications used in Commonwealth budget statistics and differences from Government Finance Statistics (GFS);
- in accordance with the Charter of Budget Honesty, identifies departures of the budget presentation from external reporting standards; and
- shows the impact of classification changes since the 1997-98 Budget.

STATISTICAL CONCEPTS

In presenting budget statistics, the standards established by the Australian Bureau of Statistics (ABS) in its *Government Finance Statistics: Concepts, Sources and Methods* (Cat. No. 5514.0) are generally adopted. This standard draws on features of the 1968 United Nations publication *A System of National Accounts* (SNA) and the 1986 IMF publication *A Manual on Government Finance Statistics*. A revised version of the SNA standard was issued in 1993, but this has not yet been incorporated into ABS Government Finance or National Accounts statistics. The IMF standard is currently being revised.

The Commonwealth, States and Territories have an agreed framework — the Uniform Presentation Framework (UPF) — for the consistent presentation of government financial information on a GFS basis. The data provided in Appendix F are consistent with this framework.

Sectoral Classifications

As shown in Diagram 1, the Commonwealth non-financial public sector may be viewed in two ways:

- budget/non-budget sectors; and
- general government/public trading enterprise (PTE) sectors.

Commonwealth financial enterprises, such as the Reserve Bank, are currently excluded from Commonwealth government statistics in line with ABS practice.

The term government business enterprise (GBE) is not an ABS concept but is used by the Commonwealth to describe a group of companies and authorities, located mainly in the PTE and public financial enterprise (PFE) sectors, which trade goods and/or services in the market with a prime objective of earning a commercial return. Government trading enterprises is a term used in the Council of Australian Governments context and refers to the commercial activities of the Commonwealth, States and Territories.

Diagram 1: Commonwealth Non-financial Public Sector

	BUDGET CLASSIFICATION	GFS CLASSIFICATION
Commonwealth Non-financial Public Sector	Budget Sector (eg DEETYA, DSS)	General Government Sector (includes budget sector and non-budget general government entities)
	Non-budget Sector — Non-budget General Government Sector (eg ABC, CSIRO)	
	— PTE Sector (eg Australia Post)	PTE Sector (eg Australia Post)

Commonwealth Budget Sector

Traditionally, the budget and mid-year statements have mainly presented transactions between the Commonwealth budget sector and other sectors of the economy, including transactions with non-budget Commonwealth entities. The Commonwealth budget sector consists of those departments and agencies whose day-to-day transactions are recorded in the Official Commonwealth Public Account (CPA), whether via the Consolidated Revenue Fund, Loan Fund, Commercial Activities Fund or the Reserved Money Fund.

Transactions between budget sector agencies — such as payments of fringe benefits tax, customs duty and interdepartmental charges — are identified but netted out when calculating total budget outlays or revenue. Only transactions into and out of the CPA impact on budget outlays and revenue.

Excluded from the budget sector are many Commonwealth government authorities, such as CSIRO and the ABC, that operate outside the CPA through their own bank accounts. Although they may depend on appropriations from the Commonwealth budget in some cases, they are classified as part of the non-budget sector. Budget payments to them are classified as transfers to the non-budget sector. The ABS refers to this budget/non-budget distinction as the administrative sector classification.

ABS Government Sectors

The ABS GFS provides an alternative classification which allocates government units according to their role in providing market or non-market services. This approach recognises the different organisational focus of market oriented units by separating general government units that supply mainly non-market services from PTEs and PFEs, which provide market goods and services.

This standardised classification system facilitates direct comparisons between governments in Australia and allows the impact of total government activity to be measured relative to other sectors of the economy.

PFEs are currently regarded as outside the scope of ABS GFS. However, under the UPF, historical financial enterprise statistics will be phased in by all jurisdictions once the ABS has included PFE information in the GFS (currently proposed from 1998-99). This will provide a more complete coverage of the public sector. Associated with this change is the reclassification of State central borrowing authorities to the PFE sector.

The ABS has reclassified universities from the general government sector of the relevant jurisdiction to a new multi-jurisdictional general government category. This change was introduced in the *1997-98 Government Financial Estimates* (Cat. No. 5501.0) published in November 1997. The data in Appendix F and Statement 7 reflect the new classification.

Since 1989-90, effectively all budget sector activity has been classified to general government. The general government sector also includes non-commercial government agencies that operate through private sector bank accounts, such as the ABC and CSIRO (referred to as the general government non-budget sector).

Outlays, Revenue and Financing Transactions

Government sector transactions can be viewed from an economic perspective and categorised into underlying outlays, revenue, net advances and financing transactions.

Underlying outlays exclude net advances (ie net policy lending and net equity transactions) from headline outlays. Except in relation to PTEs, underlying outlays measure the net cost of providing goods and services generally allocated through collective political choice rather than through the operation of the market.

User charges are offset against relevant payments in calculating underlying outlays. The alternative treatment of classifying user charges as revenue would increase both underlying outlays and revenue and inflate the reported cost of providing public goods and services.

Revenue is the primary means of funding government activities, with any shortfall funded through borrowings or a rundown of financial assets (financing transactions). It comprises tax receipts (net of refunds) and non-tax receipts (interest, dividends etc) but excludes receipts from user charging, sale of assets and repayments of advances (loans and equity). Revenue therefore measures the value of the resources, other than borrowings, raised by a government to fund outlays.

The difference between total underlying outlays and revenue is the level of the reported underlying balance. The difference between headline outlays and revenue is the headline balance. The rationale for focussing on underlying outlays and balance measures is included in *1997-98 Budget Paper No. 1*.

Financing transactions do not affect the balance and are referred to as below-the-line transactions. (Underlying outlays and revenue transactions are referred to as above-the-line transactions.) Financing transactions are undertaken to finance the deficit or invest the surplus. They consist of borrowings and changes in holdings of financial assets such as cash or investments (excluding advances).

Other Classifications

Information in the Budget Papers is also classified in the following three ways:

- the *functional* classification brings together outlays directed towards like objectives or purposes. It thus facilitates presentation of information on the basic purposes of Government activities and on the total resources devoted by the Commonwealth to those purposes;
- the *economic* type classification is designed to facilitate the study of the economic impact of Commonwealth transactions and to provide the means of grouping transactions for inclusion in ABS GFS and the Australian National Accounts. This classification scheme defines the concepts of outlays, revenue, financing transactions and the budget balance. Outlays are further divided into current and capital classifications; and
- the *portfolio* classification refers to the aggregation of outlays according to the Minister who has prime administrative responsibility. Because portfolio responsibilities change over time, it is not possible to provide information in an historical series.

CONSISTENCY WITH EXTERNAL REPORTING STANDARDS

The Budget Papers have been developed to accord with public sector accounting standards and GFS concepts and methodology. The Charter of Budget Honesty requires that departures from these external reporting standards be identified.

Data consistent with GFS are provided in tables contained in Appendix F. However, the recent ABS reclassification of net advances from capital outlays to financing transactions has not been incorporated in these tables.⁶ Consequently, these tables show a separate adjustment for net advances to derive outlays and deficit estimates comparable to those provided in the ABS GFS.

The Budget Papers focus mainly on budget sector data which depart from GFS or public sector accounting standards in the following respects.

- As indicated above, budget sector data are not equivalent to general government data, as they omit non-budget agencies such as the ABC.
- Exclusion of net advances (paid) from outlays in ABS GFS is consistent with the exclusion of net advances (paid) in the underlying budget outlays data, but not in the headline budget outlays data.
- To maintain consistency with the public net lending concept in the National Accounts, underlying balance measures used in the Budget Papers do not take account of certain payments such as PTE superannuation provisions by the

⁶ The ABS reclassification of net advances to financing transactions was first reflected in the 1996-97 *Government Finance Statistics, Australia* (Cat. No. 5512.0) published by the ABS in April 1998.

Commonwealth budget sector. These items — increases in provisions — are classified as financing transactions. While ABS GFS statistics also classify these payments as financing transactions (ie not as outlays), they do take account of these transactions to derive their deficit estimates.

- The treatment of finance leases in budget sector data differs from that set out in *Australian Accounting Standard 17*. Under that standard, the asset and liability associated with a finance lease are brought to account in the financial records of the lessee. A finance lease is recognised where substantially all of the risks and benefits of ownership pass to the lessee.

Budget sector data have been adjusted for these differences to derive the general government sector data presented in Appendix F.

Safety Net Revenues

The ABS has decided that the Commonwealth taxes introduced to replace the State franchise fees invalidated by the High Court decision on 5 August 1997 should be treated as State and Territory taxes for the purposes of GFS. This reflects the fact that the safety net arrangements represent a State and Territory tax imposed and collected by the Commonwealth at the request, and on behalf of, the States and Territories. This classification has been used in the Budget Papers. These taxes are netted out of the Commonwealth sector and attributed to the relevant State and Territory sectors. The safety net arrangements have no net impact on budget revenue apart from administrative costs. Any refunds by the States and Territories to producers or wholesalers are treated as corrective (negative tax) transactions.

CLASSIFICATION CHANGES FOR THE 1998-99 BUDGET

Budget classification changes can affect historical reporting. Consequently, comparisons between budget publications from different years can be misleading, and these data need to be treated with caution. All changes to the application of the functional and economic type classifications for the 1997-98 Budget are outlined in Table E1 and Table E2. As can be seen from these tables, historical data published in this document is broadly consistent with previous publications. The major changes are listed in the footnotes.

From 1 July 1998, it is proposed that payments under the AUSTUDY programme will be replaced by the Youth Allowance (for students aged under 25 years). This involves a transfer, rather than a reclassification, of outlays estimates from the Education function to the Social Security and Welfare function and therefore this transfer is not reflected in Table E1.

Table E1: Effect of Reclassification by Function since the 1997-98 Budget (\$m)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Published 1997-98 Revenue	98093	93509	95062	100747	110430	121688	129625	133351	142383	150330	158911
Classification Changes	0	0	0	0	0	0	0	1	0	1	1
1997-98 Revenue on 1998-99 Classification Basis	98093	93509	95062	100747	110430	121688	129625	133352	142383	150331	158912
Published 1997-98 Underlying Outlays	97690	104973	112059	117810	123559	131961	136481	137204	140786	144947	148219
Legislative and Executive Affairs(a)	-71	-15	-2	-3	9	7	8	10	5	5	5
Financial and Fiscal Affairs(b)	-13	-3	-2	1	-4	1	0	2	-1	-1	-1
Foreign Economic Aid	0	0	0	0	0	0	0	0	1	0	0
General Services(a)(b)(c)(e)	50	-7	-27	-25	-30	-32	-37	-37	-26	-25	-25
Social Security and Welfare(d)	2	3	3	4	4	5	4	5	5	5	6
Fuel and Energy(e)	0	0	1	3	4	5	5	0	-4	-4	-4
Transport and Communication(f)	0	0	0	0	0	1	3	4	4	4	4
Other Economic Affairs, nec(c)(f)	33	25	30	25	21	18	21	21	22	22	22
Asset Sales(g)	0	0	0	0	0	0	0	-30	-75	0	0
Total Underlying Outlays Classification Changes	2	3	3	4	4	5	4	-25	-69	6	6
Of which:											
Classification changes as at 1997-98 MYEFO	0	0	0	0	0	0	0	-46	-11	0	0
Other classification changes post-1997-98 MYEFO	2	3	3	4	4	5	4	21	-58	6	6
1997-98 Underlying Outlays on 1998-99 Classification Basis	97692	104976	112062	117814	123563	131966	136485	137179	140717	144953	148225
Memorandum items											
Classification changes to net advances	-2	-3	-3	-4	-4	-5	-4	25	69	-6	-6
Classification changes to headline outlays	0	0	0	0	0	0	0	0	0	0	0

- (a) Comcar operations reclassified from General Services to Legislative and Executive Affairs.
(b) Australian Valuation Office operations reclassified from General Services to Financial and Fiscal Affairs.
(c) AUSLIG operations reclassified from General Services to Other Economic Affairs, nec.
(d) Refugee-assisted passage costs reclassified from Net Advances within the same function.
(e) Receipts for electricity generation on the Indian Ocean Territories reclassified from Fuel and Energy to General Services.
(f) Petroleum Products Freight Subsidy reclassified from Other Economic Affairs, nec to Transport and Communication.
(g) Asset sales reclassified from Net Advances within the same function.

Table E2: Effect of Reclassification by Economic Type since the 1997-98 Budget (\$m)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Published 1997-98 Revenue	98093	93509	95062	100747	110430	121688	129625	133351	142383	150330	158911
Classification Changes	0	0	0	0	0	0	0	1	0	1	1
1997-98 Revenue on 1998-99 Classification Basis	98093	93509	95062	100747	110430	121688	129625	133352	142383	150331	158912
Published 1997-98 Underlying Outlays	97690	104973	112059	117810	123559	131961	136481	137204	140786	144947	148219
Final Consumption Expenditure(a)(c)	23	30	28	34	34	38	44	23	78	82	82
Subsidies(b)	0	0	0	0	0	0	0	0	20	0	0
Current Grants Paid(b)(c)	-24	-29	-32	-36	-36	-34	-41	-15	-47	-26	-27
Capital Outlays on Goods, Land and Intangibles(d)	0	0	0	0	0	0	0	-30	-75	0	0
Capital Transfer Payments(a)	3	3	7	7	6	0	1	-3	-45	-51	-50
Total Underlying Outlays Classification Changes	2	3	3	4	4	5	4	-25	-69	6	6
Of which:											
Classification changes as at 1997-98 MYEFO	0	0	0	0	0	0	0	-46	-11	0	0
Other classification changes post-1997-98 MYEFO	2	3	3	4	4	5	4	21	-58	6	6
1997-98 Underlying Outlays on 1998-99 Classification Basis	97692	104976	112062	117814	123563	131966	136485	137179	140717	144953	148225
Memorandum items											
Classification changes to net advances	-2	-3	-3	-4	-4	-5	-4	25	69	-6	-6
Classification changes to headline outlays	0	0	0	0	0	0	0	0	0	0	0

- (a) Payment to National System of Reserves and National Rivercare reclassified from Capital Transfer Payments to Final Consumption Expenditure, and refugee-assisted passage costs reclassified from Net Advances to Final Consumption Expenditure.
- (b) Payment to Sydney Organising Committee for the Olympic Games reclassified from Current Grants Paid to Subsidies.
- (c) National Vegetation Initiative reclassified from Final Consumption Expenditure to Current Grants Paid.
- (d) Asset Sales reclassified from Net Advances to Capital Outlays on Goods, Land and Intangibles.

APPENDIX F: COMMONWEALTH GOVERNMENT SECTOR STATISTICS

In accordance with the requirements of the Charter of Budget Honesty, and the UPF for the consistent presentation of financial information, this appendix provides, on a GFS consistent basis:

- budget and forward estimates for the Commonwealth general government underlying balance and its major components;
- equivalent budget year data for the Commonwealth PTE sector and consolidated non-financial public sector; and
- budget year data showing outlays by purpose and taxes, fees and fines for the consolidated non-financial public sector.

COMMONWEALTH GENERAL GOVERNMENT SECTOR

This section presents estimates of the underlying balance — and the revenue and outlays components — for the Commonwealth general government sector. A description of this sector and its relationship to the budget sector can be found in Appendix E.

Table F1 is presented on the same basis as the budget sector estimates provided elsewhere in the Budget papers so as to provide an estimate of the underlying balance broadly consistent with the ‘public net lending’ concept in the national accounts. Estimates for underlying balances in Table F1 will differ from the deficit estimates in Table F2 because the former do not take account of increases in provisions (see discussion in Appendix E).

Table F1: Summary of General Government Aggregates (\$m)

	1997-98	1998-99	1999-00	2000-01	2001-02
	Revised	Estimate	Projection	Projection	Projection
Revenue	135502	144321	151348	160278	171175
<i>Per cent of GDP</i>	24.9	25.0	24.7	24.7	24.9
Underlying outlays	136528	141543	146518	151665	156549
<i>Per cent of GDP</i>	25.1	24.6	24.0	23.4	22.8
Underlying balance	-1026	2778	4830	8613	14626
<i>Per cent of GDP</i>	-0.2	0.5	0.8	1.3	2.1
<i>Memorandum items:</i>					
Net advances	-13806	-15991	-18709	-12793	519
Headline balance	12780	18769	23539	21406	14107
<i>Per cent of GDP</i>	2.4	3.3	3.8	3.3	2.1

Table F1 shows that the Commonwealth general government sector underlying balance is expected to move into surplus in 1998-99, consistent with expected movements in the budget sector. The general government sector underlying balance is projected to strengthen further in the following years with the surpluses continuing to grow as a percentage of GDP.

GOVERNMENT FINANCE STATISTICS

This section presents Commonwealth financial data on a GFS basis, consistent with the UPF. Five statistical tables are presented below, showing:

- transactions by economic type for the Commonwealth general government, PTE and consolidated non-financial public sectors;
- Commonwealth consolidated current and capital outlays by purpose; and
- the taxes, fees and fines received by the Commonwealth consolidated non-financial public sector.

The tables were produced by the Department of Finance and Administration in consultation with the ABS. The ABS sign convention is adopted, where a negative deficit represents a surplus. This is in contrast to the presentation of the budget balance elsewhere in this document where a negative balance represents a deficit.

Consistent with ABS practice, transactions between the Commonwealth general government and PTE sectors are included in Table F2 and Table F3 but are removed from Table F4 as they are internal transactions within the Commonwealth non-financial public sector. Table F4 records the net operating surplus of the PTE sector as part of the revenue of the Commonwealth government sector. This is irrespective of whether that net operating surplus is actually remitted to the parent government.

Transactions between the Commonwealth non-financial and PFE sectors are included in all tables. These transactions include income transfers such as dividends paid to general government, net advances paid by general government to PFEs and taxes paid by PFEs. Any unremitted elements of PFE net operating surplus are excluded from Table F4.

The general government deficit adjusted for net advances shown in Table F2 differs from the underlying deficit measure used elsewhere in the Budget Papers in that it is adjusted for increases in provisions in respect of PTE superannuation. The two measures also differ as a result of the different treatment of certain transactions noted in Appendix E. As noted in Appendix E, the treatment of net advances in these tables differs from GFS.

Net debt in GFS is the excess of gross debt (including deposits held, advances received and other borrowings) over selected financial assets (including cash and deposits, advances paid and other lending). The net debt measure is limited in that it does not include accrued employee liabilities, other financial assets and liabilities (particularly equity holdings), and physical assets.

The net debt data in Tables F2 to F4 are based on historical capital values, with movements driven principally by cash transactions such as borrowings and receipts of equity sales. Net debt is calculated as the stock of net debt in the previous year plus the deficit adjusted for net advances plus net equity transactions. The 1996-97 base net debt figures have been obtained from the ABS publication *Public Sector Financial Assets and Liabilities*, 30 June 1997 (Cat. No. 5513.0).

Table F2: Economic Transactions of Commonwealth Government (\$m)

	1997-98	1998-99	1999-00	2000-01	2001-02
	General Government (a)				
Outlays					
Current Outlays					
Final consumption expenditure (b)	27032	28651	30060	32128	33809
Interest payments	8465	7979	7203	6346	4766
Subsidies paid to public trading enterprises	446	430	391	234	237
Personal benefit payments	58159	60442	63027	65550	68435
Current grants	37524	38244	39853	41079	42686
Other transfer payments	2721	2675	2683	2705	2840
<i>Total current outlays</i>	<i>134346</i>	<i>138422</i>	<i>143217</i>	<i>148043</i>	<i>152773</i>
Capital outlays					
Expenditure on new fixed assets	917	852	818	985	1121
<i>Plus</i> Expenditure on secondhand assets (net)	<i>-1160</i>	<i>-525</i>	<i>-148</i>	<i>-21</i>	<i>17</i>
<i>Equals</i> Gross fixed capital expenditure	<i>-243</i>	<i>327</i>	<i>670</i>	<i>964</i>	<i>1138</i>
Expenditure on land and intangible assets (net)	-176	129	111	164	148
Capital grants	2597	2657	2522	2489	2485
Advances paid (net)	-13806	-15991	-18709	-12793	519
Other capital outlays	3	7	-1	6	5
<i>Total capital outlays</i>	<i>-11624</i>	<i>-12871</i>	<i>-15408</i>	<i>-9171</i>	<i>4295</i>
Total outlays	122722	125551	127809	138872	157068
Total outlays (excluding net advances paid)	136528	141543	146518	151665	156549
Revenue					
Taxes, fees and fines	130827	138175	146374	155597	165958
Interest received from public trading enterprises	83	77	37	9	9
Interest received from other enterprises	964	1065	1857	2291	2819
Other revenue	3628	5005	3080	2381	2390
Total revenue	135502	144321	151348	160278	171175
Financing and deficit measures					
Borrowing (net)	-10978	-18453	-21660	-20376	-12399
Increase in provisions (net)	-1238	-976	-990	-1006	-1058
Other financing transactions (net)	-564	658	-889	-24	-650
Total financing	-12780	-18770	-23539	-21406	-14107
<i>Less</i> Increase in provisions (net)	<i>-1238</i>	<i>-976</i>	<i>-990</i>	<i>-1006</i>	<i>-1058</i>
<i>Equals</i> Deficit	<i>-11543</i>	<i>-17794</i>	<i>-22549</i>	<i>-20400</i>	<i>-13050</i>
Of which					
Current deficit	82	-4923	-7142	-11229	-17345
Capital deficit	-11624	-12871	-15408	-9171	4295
<i>Less</i> Advances paid (net)	<i>-13806</i>	<i>-15991</i>	<i>-18709</i>	<i>-12793</i>	<i>519</i>
<i>Equals</i> Deficit adjusted for net advances	2263	-1803	-3840	-7608	-13569
Net Debt	82871	64582	43244	23131	9562

- (a) The general government sector is the combination of the budget and non-budget sectors after elimination of transactions internal to that sector and adjustments to the budget sector as outlined in Appendix E.
- (b) Includes an allowance for parameter revisions contained in the budget sector contingency reserve.

Table F3: Economic Transactions of Commonwealth Government (\$m)

	1997-98	1998-99
	Public Trading	Enterprises
Outlays		
Current outlays		
Interest payments	1027	1016
Other current payments	3359	4251
<i>Total current outlays</i>	<i>4386</i>	<i>5267</i>
Capital outlays		
Expenditure on new fixed assets	4900	4439
<i>Plus</i> Expenditure on secondhand assets (net)	-306	-154
<i>Equals</i> Gross fixed capital expenditure	<i>4594</i>	<i>4285</i>
Expenditure on land and intangible assets (net)	-41	36
Capital grants to other levels of government	0	0
Advances paid (net)	0	0
Other capital outlays	-409	-202
<i>Total capital outlays</i>	<i>4145</i>	<i>4119</i>
Total outlays	8531	9386
Total outlays (excluding net advances paid)	8531	9386
Revenue		
Sales of goods and services	26463	27734
<i>Plus</i> Subsidies received	402	393
<i>Less</i> Operating expenditure	21438	22121
<i>Equals</i> Net operating surplus	<i>5427</i>	<i>6006</i>
Interest received	190	159
Capital grants received	4	20
Other revenue	28	21
Total revenue	5648	6206
Financing and deficit measures		
Advances received (net)	79	-687
Borrowing (net)	193	1261
Increase in provisions (net)	2692	3129
Other financing transactions (net)	-81	-522
Total financing	2883	3181
<i>Less</i> Increase in provisions (net)	2692	3129
<i>Equals</i> Deficit	<i>191</i>	<i>52</i>
Of which		
Current deficit	-3950	-4047
Capital deficit	4141	4099
<i>Less</i> Advances paid (net)	0	0
<i>Equals</i> Deficit adjusted for net advances	191	52
Net Debt	9464	9516

Table F4: Economic Transactions of Commonwealth Government (\$m)

	1997-98	1998-99
	Consolidated Government (a)	
Outlays		
Current outlays		
Final consumption expenditure	27032	28651
Interest payments	9410	8919
Subsidies paid to public trading enterprises	446	430
Personal benefit payments	58159	60442
Current grants	37524	38244
Other current payments	3637	4207
<i>Total current outlays</i>	<i>136207</i>	<i>140893</i>
Capital outlays		
Expenditure on new fixed assets	5817	5291
<i>Plus</i> Expenditure on secondhand assets (net)	-1466	-679
<i>Equals</i> Gross fixed capital expenditure	4352	4612
Expenditure on land and intangible assets (net)	-216	166
Capital grants	2593	2637
Advances paid (net)	-13885	-15304
Other capital outlays	-406	-195
<i>Total capital outlays</i>	<i>-7562</i>	<i>-8085</i>
Total outlays	128645	132808
Total outlays (excluding net advances paid)	142530	148113
Revenue		
Taxes, fees and fines	129812	137361
Net operating surplus of public trading enterprises	5427	6006
Interest received	1154	1224
Other revenue	2228	3119
Total revenue	138621	147710
Financing and Deficit measures		
Borrowing (net)	-10785	-17192
Increase in provisions (net)	1454	2153
Other financing transactions (net)	-644	137
Total financing	-9975	-14902
<i>Less</i> Increase in provisions (net)	1454	2153
<i>Equals</i> Deficit	-11429	-17055
Of which		
Current deficit	-3867	-8970
Capital deficit	-7562	-8085
<i>Less</i> Advances paid (net)	-13885	-15304
<i>Equals</i> Deficit adjusted for net advances	2455	-1751
Net Debt	92336	74099

(a) The consolidated Commonwealth sector is the combination of the general government and PTE sectors after elimination of transactions internal to that sector.

Table F5: Outlays by Purpose of Commonwealth Government (\$m)

	1997-98	1998-99
	Consolidated Government	
Current Outlays		
General public services	8314	8677
Defence	9713	10279
Public order and safety	1007	957
Education (a)	10267	9055
Health	20727	22256
Social security and welfare (a)	49706	53034
Housing and community amenities	91	157
Recreation and culture	1127	1161
Fuel and energy	966	1025
Agriculture forestry and fishing	1874	1844
Mining manufacturing and construction	429	436
Transport and communications	1876	2397
Other economic affairs	2927	2819
Other purposes	27184	26795
Total Current Outlays	136207	140893
Capital Outlays		
General public services	-57	635
Defence	-13	-212
Public order and safety	39	33
Education	1053	1143
Health	35	55
Social security and welfare	201	230
Housing and community amenities	488	916
Recreation and culture	64	93
Fuel and energy	73	38
Agriculture forestry and fishing	-345	-222
Mining manufacturing and construction	-35	20
Transport and communications	-7144	-10943
Other economic affairs	131	96
Other purposes	-2052	33
Total Capital Outlays	-7562	-8085

- (a) From 1 July 1998, it is proposed that payments under the AUSTUDY programme will be replaced by the Youth Allowance (for students aged under 25 years). This involves a transfer of outlays estimates from the Education function to the Social Security and Welfare function.

Table F6: Taxes, Fees and Fines of Commonwealth Government (\$m)

	1997-98	1998-99
	Consolidated Government	
Taxes on income profits and capital gains		
Income and capital gains levied on individuals	70290	75010
Income and capital gains levied on enterprises	21644	22997
Other	1040	1070
Total	92975	99077
Taxes on employers payroll and labour force	3196	3316
Taxes on property	5	0
Taxes on provision of goods and services		
Sales tax	14090	15090
Excises and levies	13590	13760
Taxes on international trade	3640	3670
Total	31320	32520
Taxes on use of goods and performance of activities	436	446
Fees	1848	1963
Fines	33	39
Total taxes fees and fines	129812	137361