STATEMENT 3: FISCAL STRATEGY AND OUTLOOK

This statement assesses the fiscal outlook against the Government's fiscal strategy.

The Government's fiscal strategy aims to ensure fiscal sustainability over the medium term.

The Government's medium-term fiscal strategy involves:

- achieving budget surpluses, on average, over the medium term;
- keeping taxation as a share of GDP on average below the level for 2007-08; and
- improving the Government's net financial worth over the medium term.

The Government is budgeting for an underlying cash surplus for 2008-09 of $21.7 billion (1.8 per cent of GDP), compared with the *Pre-Election Economic and Fiscal Outlook 2007* (PEFO) estimate of $14.3 billion (1.2 per cent of GDP). This honours the Government's commitment to deliver an underlying cash surplus in 2008-09 of at least 1.5 per cent of GDP, while banking upward revisions to tax receipts. All tax receipt revisions ($3.0 billion) since PEFO have been saved and added to the 2008-09 surplus.

All new spending since PEFO in 2008-09, including the Government's election commitments, has been offset by spending cuts. Overall, the Government has made total cash savings of $33.3 billion over four years, including $7.3 billion in 2008-09. These savings more than offset new policy in 2008-09 by $2.0 billion.

Overall, real government spending is forecast to grow by 1.1 per cent in 2008-09 — the lowest rate of growth in nine years.

Appendix A outlines budget accounting policy for the 2008-09 Budget and implications for the financial statements. Appendix B illustrates the sensitivity of the budget estimates to changes in the economic outlook.

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STATEMENT 3: FISCAL STRATEGY AND OUTLOOK

THE GOVERNMENT'S FISCAL STRATEGY

The Government's fiscal strategy aims to ensure fiscal sustainability over the medium term. Sustainability is a core requirement of fiscal policy since government has a responsibility to ensure that it can meet its current and future spending commitments. A sustainable fiscal position provides greater certainty for decision makers, supports broader economic sustainability (including macroeconomic stability) and requires a focus in the budget on policies which strengthen the structure of the economy.

Key elements of a sustainable fiscal strategy

The Government's medium-term fiscal strategy involves:

- achieving budget surpluses, on average, over the medium term;
- keeping taxation as a share of GDP on average below the level for 2007-08; and
- improving the Government's net financial worth over the medium term.

Achieving budget surpluses on average

The Government's fiscal strategy provides necessary flexibility for the budget balance to vary in line with economic conditions. This allows the 'automatic stabilisers' — the tendency for both revenue and spending to vary in line with economic conditions — to automatically contribute to the stability of aggregate demand. Surpluses over the medium term also contribute to a strong government balance sheet.

Keeping taxes below the level of 2007-08

The Government's commitment to keeping taxes on average below the level in 2007-08 of 24.7 per cent of GDP ensures that budget surpluses will be delivered through disciplined spending, not higher taxation. By directing expenditure to priority areas — such as skills and infrastructure — the fiscal strategy can help to achieve the Government's policy priority of ensuring that Australia is investing in the long-term drivers of productivity and competitiveness. Focusing on quality spending, and reducing wasteful expenditure, allows the Government to allocate resources to high priority areas without placing an additional burden on taxpayers.

Improving the Government's net financial worth

Responsible fiscal policy looks beyond the forward estimates period — promoting fiscal sustainability over a much longer period of time. One indicator of the Government's longer term financial position and ability to withstand adverse economic shocks is its available stock of financially liquid net assets. To promote balance sheet sustainability, the fiscal strategy includes a commitment to improving the Government's net financial worth over the medium term.

The Government's commitment to improving net financial worth puts the focus on sustainability, thereby encouraging policies which structurally improve participation and productivity for the long-term benefit of the economy. This forward-looking perspective ensures that expenditure is directed at areas which help to promote the development of Australia's long-term productive capacity, and the wellbeing of future generations.

ASSESSMENT OF THE FISCAL OUTLOOK AGAINST THE STRATEGY

For 2008-09, the Government committed to achieving a surplus of at least 1.5 per cent of GDP to help ease inflationary pressures in the economy. The Government is honouring this commitment by delivering a surplus of 1.8 per cent of GDP. The Government has achieved this by banking upward revisions to tax revenue, rather than spending them. The Government has been highly disciplined in spending, with increases in spending in 2008-09 on election commitments and other priorities more than offset by savings, through cutting ineffective and wasteful programs and delivering administrative efficiencies. This is a responsible fiscal strategy given current economic conditions.

An underlying cash surplus of $21.7 billion is expected in 2008-09 compared with an estimated surplus of $14.3 billion at PEFO. In accrual terms, a fiscal surplus of $23.1 billion is estimated for 2008-09 compared to $13.6 billion at PEFO. The fiscal outlook is for further strong underlying cash and fiscal surpluses in the forward years.

The underlying cash balance is the Government's key fiscal indicator since the cash position has a more immediate impact on the macroeconomy than the accruing position measured by the fiscal balance. The fiscal balance is a better indicator of the longer term economic consequences of government decisions.

Table 1: Australian Government general government sector budget aggregates

	Actual	Estimates		Projections		
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Revenue ($b)	**278.0**	**303.8**	**319.5**	**336.9**	**350.9**	**366.9**
Per cent of GDP	26.6	26.9	25.9	26.2	26.2	26.1
Expenses ($b)	**258.9**	**280.6**	**292.5**	**310.5**	**323.1**	**339.2**
Per cent of GDP	24.7	24.9	23.8	24.2	24.1	24.1
Net operating balance ($b)	19.4	23.3	27.0	26.4	27.8	27.7
Net capital investment ($b)	1.9	2.8	3.9	4.1	4.5	5.1
Fiscal balance ($b)	**17.2**	**20.4**	**23.1**	**22.4**	**23.3**	**22.6**
Per cent of GDP	1.6	1.8	1.9	1.7	1.7	1.6
Underlying cash balance ($b)(a)	**17.2**	**16.8**	**21.7**	**19.7**	**19.0**	**18.9**
Per cent of GDP	1.6	1.5	1.8	1.5	1.4	1.3
Memorandum item:						
Headline cash balance ($b)	26.7	25.4	23.6	20.9	20.5	20.5

(a) Excludes expected Future Fund earnings.

The 2008-09 underlying cash surplus is the largest budget surplus as a proportion of GDP since 1999-2000 and the second highest in 35 years (1973-74). On a consistent accounting basis which includes Future Fund earnings, it is the highest budget surplus as a percentage of GDP since 1970-71. A strong budget surplus ensures fiscal policy is playing its part to take pressure off inflation.

This Budget includes significant savings, many from cutting ineffective and poorly targeted programs and delivering administrative efficiencies. The savings reduce inflationary pressures in the economy, safe-guard the fiscal position against economic shocks and allow taxes to remain at levels consistent with supporting long-term economic growth.

All new policy for 2008-09 since PEFO, including the Government's election commitments, has been more than offset by savings (Table 2). For 2008-09, the Government has identified gross savings of $7.3 billion (of which, $1.6 billion are election commitments) and $33.3 billion over the forward estimates period. These savings from spending cuts and revenue measures more than offset election commitments and other spending priorities across the forward estimates.

Moreover, the Government has met all new expenditure measures in 2008-09 by spending cuts through reprioritising existing programs.

Table 2: Assessment against the fiscal target

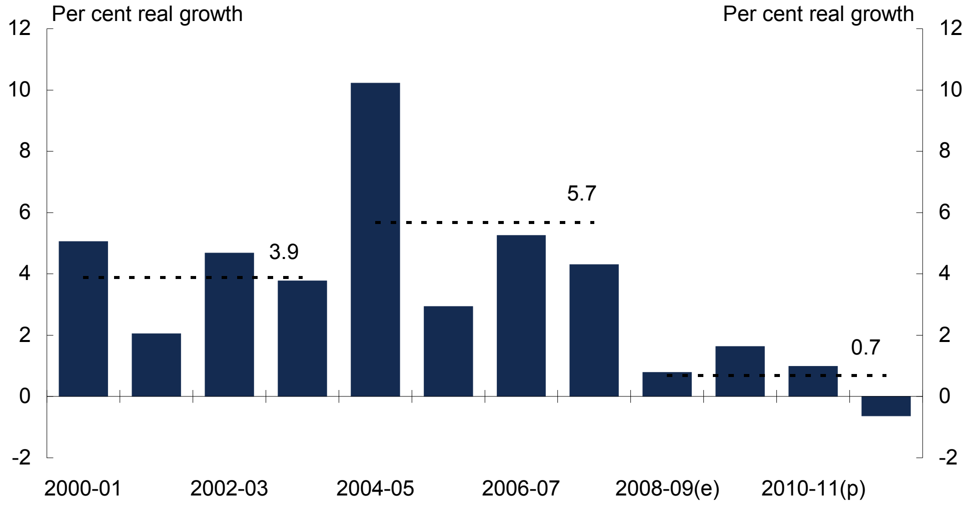
	2008-09 $m
2007 PEFO underlying cash balance	**14,319**
Per cent of GDP	1.2
Effect of policy decisions(a)	
Spending	**-5,261**
Receipts	*13*
Payments	*-5,274*
Savings	**7,257**
Receipts	*1,918*
Payments	*5,338*
Total effect of policy decisions	**1,996**
Parameter and other variations (excluding tax)	**2,426**
Surplus (before banking of tax variation)	**18,741**
Per cent of GDP	1.5
Tax receipt variations	**2,962**
2008-09 Budget underlying cash balance	**21,703**
Per cent of GDP	1.8

(a) Excludes GST receipts and payments of $371 million, which have no net impact on policy decisions.

Real spending is estimated to grow by only 1.1 per cent in 2008-09, down from the estimate at the *Mid-Year Economic and Fiscal Outlook 2007-08* of 2.9 per cent. Spending growth has fallen by about two thirds and is estimated to grow by the slowest pace in nine years. Over the budget and forward estimates period, spending is projected to grow on average by 2.3 per cent a year. This is significantly lower than the 4.0 per cent growth in spending over the preceding four years to 2007-08.

Government operating expenses include spending on wages and salaries of public servants. It excludes transfers (such as pensions), interest payments and government capital investment spending. The Government has significantly reduced forecast growth in real operating expenses, from an average 5.7 per cent over the four years to 2007-08 to 0.7 per cent over the four years to 2011-12 (Chart 1 below).

Chart 1: Government operating expenses

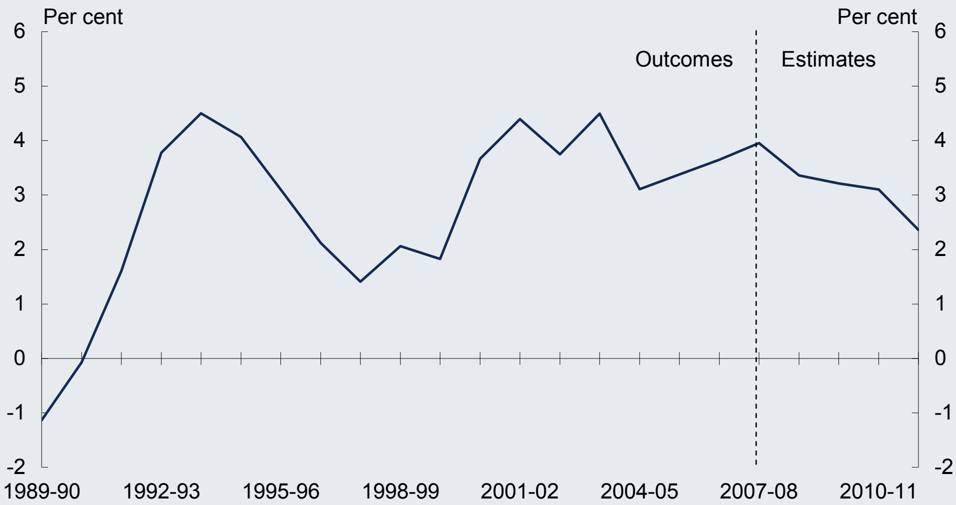


Source: Australian Government Final Budget Outcomes and Treasury estimates.

Box 1: Recent spending trends

At times, past fiscal policy settings have not restrained government spending and allowed large increases in spending growth. Chart A illustrates the growth in real government payments from the early 1990s through to 2008-09 using a moving 4 year average. The growth in payments during the early 1990s reflects an increase in higher social and welfare payments in a period when the economy was generally regarded as being in recession. The rise at the end of the 1990s partly represents an increase in payments associated with the introduction of the GST, while the rise since 2004-05 reflects higher spending financed by increased revenues associated with the commodities boom.

Chart A: Trend growth in real government spending

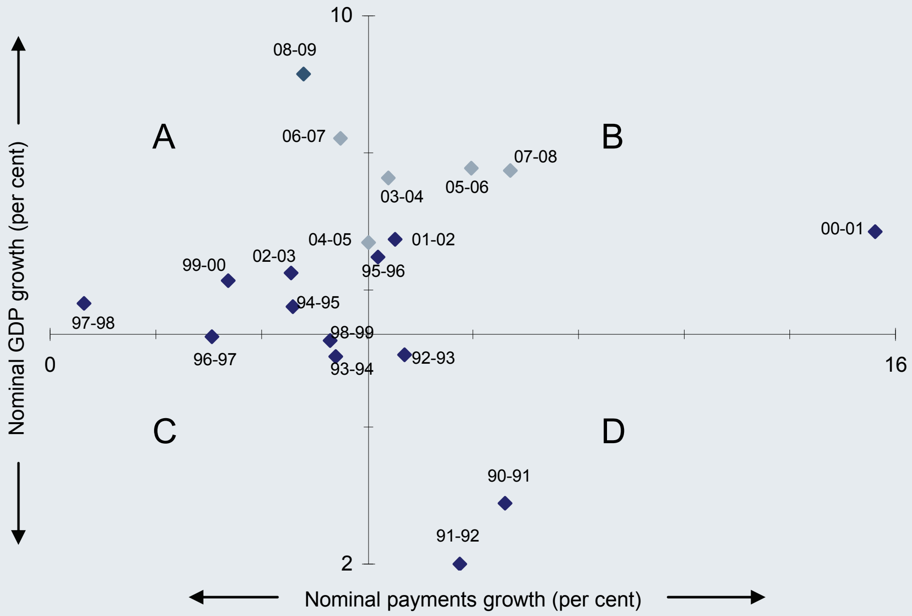


Source: Australian Government Final Budget Outcomes and Treasury estimates.

The 2008-09 Budget aims to ease pressure on inflation by exercising restraint on spending. From 2008-09, real spending is forecast to grow on average by 2.3 per cent per year over the four years to 2011-12. This compares with the previous four year period (to 2007-08) where real spending grew on average by 4.0 per cent per year.

Spending can add to inflationary pressures if it is pro-cyclical; that is, increases in spending stimulate demand in a strongly growing economy. Chart B below shows that spending in 2008-09 is restrained compared to recent spending growth.

Chart B: Spending and nominal GDP growth (1990-91 to 2008-09)



Source: Australian Government Final Budget Outcomes and Treasury estimates.

Chart B plots nominal GDP growth against nominal spending growth over the period 1990-91 to 2008-09. The chart's axes are located at the averages prior to the start of the commodities prices boom in 2003-04 (5.4 per cent for nominal GDP growth and 6.0 per cent for spending growth).

In quadrant *A*, nominal GDP growth is above average and spending growth is below average, which is consistent with a scenario of strong economic growth combined with low budget spending (for example on unemployment benefits). Quadrant *D* shows the opposite scenario, where low economic growth is combined with higher than average budget spending. *A* and *D* are consistent with fiscal policy which is relatively counter-cyclical. In contrast, quadrant *B* has higher than average spending and nominal GDP growth, while quadrant *C* has both below average.

Three of the four outcome years since the start of the commodities prices boom (2003-04 to 2006-07) as well as the estimate for 2007-08 are either inside or on the edge of quadrant *B*, where high nominal GDP growth is combined with high spending growth. By contrast, the estimate for 2008-09 is in quadrant *A*, as a result of spending cuts at the same time as continued strong nominal GDP growth. The 2000-01 growth in nominal payments partly reflects the introduction of the GST.

Cash flows

Variations in the underlying cash balance estimates

In 2008-09, an underlying cash surplus of $21.7 billion is expected, compared with the PEFO estimate of $14.3 billion. Table 3 provides a summary of Australian Government general government sector cash flows.

Table 3: Summary of Australian Government general government sector cash flows

	Estimates		Projections		
	2007-08	2008-09	2009-10	2010-11	2011-12
	$b	$b	$b	$b	$b
Cash receipts					
Operating cash receipts					
excluding Future Fund earnings	291.7	309.0	326.6	340.1	355.4
Future Fund earnings	3.7	3.5	3.2	3.3	3.4
Total operating receipts	295.4	312.5	329.8	343.4	358.8
Capital cash receipts(a)	0.3	0.5	0.3	0.3	0.2
Total cash receipts	295.6	313.0	330.1	343.7	359.0
Cash payments					
Operating cash payments	267.5	278.5	297.8	311.4	326.7
Capital cash payments(b)	7.5	8.8	9.5	10.0	10.0
Total cash payments	275.1	287.3	307.3	321.4	336.7
Finance leases and similar arrangements(c)	0.0	-0.5	0.0	0.0	0.0
GFS cash surplus(+)/deficit(-)	**20.5**	**25.2**	**22.8**	**22.3**	**22.3**
Per cent of GDP	1.8	2.0	1.8	1.7	1.6
less Future Fund earnings	3.7	3.5	3.2	3.3	3.4
Underlying cash balance(d)	**16.8**	**21.7**	**19.7**	**19.0**	**18.9**
Per cent of GDP	1.5	1.8	1.5	1.4	1.3
Memorandum items:					
Net cash flows from investments in financial assets for policy purposes	4.8	-1.5	-2.0	-1.8	-1.8
plus Future Fund earnings	3.7	3.5	3.2	3.3	3.4
Headline cash balance	**25.4**	**23.6**	**20.9**	**20.5**	**20.5**

(a) Equivalent to cash receipts from the sale of non-financial assets in the cash flow statement.
(b) Equivalent to cash payments for purchases of new and second-hand non-financial assets in the cash flow statement.
(c) The acquisition of assets under finance leases decreases the underlying cash balance. The disposal of assets previously held under finance leases increases the underlying cash balance.
(d) Excludes expected Future Fund earnings.

While the 2008-09 underlying cash surplus is $7.4 billion higher than estimated at PEFO, the fiscal balance has increased by $8.4 billion (to $23.1 billion) compared to the PEFO estimate of $14.7 billion. A headline cash surplus of $23.6 billion is forecast for 2008-09, compared with a surplus of $18.3 billion at PEFO. The higher surplus largely reflects the increase in the underlying balance.

Since PEFO, total policy decisions in 2008-09 have had a positive impact of $2.0 billion on the underlying cash balance (see Table 4) and $0.9 billion on the fiscal balance

(Table 5). This difference primarily reflects the timing impacts of government decisions where an expense may accrue in the budget year, but the cash payment may not be paid until a subsequent year. In particular, the Education Tax Refund reduces the fiscal balance by $1.0 billion but has no impact on the underlying cash balance in 2008-09.

Since PEFO, total parameter and other variations have had a positive impact of $5.4 billion on the underlying cash balance and $7.5 billion on the fiscal balance. Part of this difference is due to the variance between tax receipts and tax revenue, reflecting compliance activity, new tax debts arising and the repayment or write-off of past tax debts. These differences will exist for all revenue heads and vary between years. Further, updates in the forecast Future Fund investment portfolio have a positive impact of $0.4 billion on the fiscal balance, but no impact on the underlying cash balance.

Table 4 provides a reconciliation of the variations in the underlying cash balance estimates. The variations driving the changes in the underlying cash balance are largely the same as the variations driving the change in the fiscal balance. Further details are provided in the 'Variations to the fiscal balance' section below.

Table 4: Reconciliation of 2007-08 Budget, 2007-08 MYEFO, 2007 PEFO and 2008-09 Budget underlying cash balance estimates

	Estimates		Projections	
	2007-08	2008-09	2009-10	2010-11
	$m	$m	$m	$m
2007-08 Budget underlying cash balance	**10,637**	**12,712**	**13,812**	**12,447**
Per cent of GDP	1.0	1.1	1.2	1.0
Changes between 2007-08 Budget and MYEFO				
Effect of policy decisions(a)	-3,886	-10,840	-13,859	-17,996
Effect of parameter and other variations	8,083	12,525	17,776	20,638
Total variations	**4,197**	**1,685**	**3,917**	**2,642**
2007-08 MYEFO underlying cash balance(b)	**14,834**	**14,396**	**17,729**	**15,089**
Per cent of GDP	1.3	1.2	1.4	1.2
Changes between MYEFO and PEFO				
Effect of policy decisions(a)	-406	-53	11	-35
Effect of parameter and other variations	-61	-24	-29	-33
Total variations	**-467**	**-77**	**-18**	**-68**
2007 PEFO underlying cash balance(b)	**14,367**	**14,319**	**17,711**	**15,021**
Per cent of GDP	1.3	1.2	1.4	1.2
Changes from PEFO to 2008-09 Budget				
Effect of policy decisions(a)	-2,777	1,996	13	1,874
Effect of parameter and other variations	5,225	5,388	1,945	2,101
Total variations	**2,448**	**7,384**	**1,958**	**3,975**
2008-09 Budget underlying cash balance(b)	**16,815**	**21,703**	**19,669**	**18,996**

(a) Excludes the public debt net interest effect of policy measures.
(b) Excludes expected Future Fund earnings.

Variations in fiscal balance estimates

Table 5 provides a reconciliation of the fiscal balance estimates.

Table 5: Reconciliation of 2007-08 Budget, 2007-08 MYEFO, 2007 PEFO and 2008-09 Budget fiscal balance estimates[(a)]

	Estimates		Projections	
	2007-08	2008-09	2009-10	2010-11
	$m	$m	$m	$m
2007-08 Budget fiscal balance	**9,999**	**11,860**	**14,101**	**13,704**
Per cent of GDP	0.9	1.0	1.2	1.1
Changes between 2007-08 Budget and MYEFO				
Effect of policy decisions(b)	-3,909	-10,766	-13,748	-17,836
Effect of parameter and other variations	8,792	12,548	18,062	21,256
Total variations	**4,883**	**1,781**	**4,314**	**3,421**
2007-08 MYEFO fiscal balance	**14,882**	**13,642**	**18,415**	**17,125**
Per cent of GDP	1.3	1.1	1.5	1.3
Changes between MYEFO and PEFO				
Effect of policy decisions(b)	-387	-64	0	-35
Effect of parameter and other variations	-61	-24	-29	-33
Total variations	**-447**	**-87**	**-29**	**-68**
2007 PEFO fiscal balance (as published)	**14,435**	**13,554**	**18,386**	**17,057**
Per cent of GDP	1.3	1.1	1.5	1.3
Adjustment to recognise GST	1,080	1,165	1,090	1,250
2007 PEFO fiscal balance (includes GST)	**15,515**	**14,719**	**19,476**	**18,307**
Per cent of GDP	1.4	1.2	1.6	1.4
Changes between PEFO and 2008-09 Budget				
Effect of policy decisions(b)				
Revenue	239	2,352	4,098	6,370
Expenses	3,120	1,324	4,204	4,533
Net capital investment	-98	136	77	7
Total policy decisions impact on fiscal balance	-2,784	892	-184	1,830
Effect of parameter and other variations				
Revenue	8,191	6,427	5,128	5,403
Expenses	-859	-3,054	-947	-1,282
Net capital investment	1,338	1,970	3,012	3,505
Total parameter and other variations impact on fiscal balance	7,712	7,512	3,064	3,179
2008-09 Budget fiscal balance	**20,443**	**23,122**	**22,357**	**23,316**
Per cent of GDP	1.8	1.9	1.7	1.7

(a) A positive number for revenue indicates an increase in the fiscal balance, while a positive number for expenses and net capital investment indicates a decrease in the fiscal balance.
(b) Excludes the public debt net interest effect of policy measures.

Variations in revenue estimates

Total revenue in 2008-09 is expected to be $8.8 billion higher than forecast at PEFO.

Policy decisions taken since PEFO increase revenue by $2.4 billion in 2008-09. The major policy decisions affecting revenue include:

- the Government's election commitment to defer tax cuts for the highest income earners, providing savings of $5.3 billion over the forward estimates period;
- $640 million in 2008-09 ($3.1 billion from 27 April 2008 to 2011-12) from increased excise on 'other excisable beverages' (including 'ready-to-drinks') ;
- $564 million in 2008-09 ($2.5 billion from Budget night to 2011-12) from removing the current exemption of condensate from the crude oil excise;
- $226 million in 2008-09 ($2.9 billion over four years from 2008-09) from increasing the Migration Program by providing an additional 31,000 skilled stream places and 6,500 family stream places;
- a special dividend from Australia Post of $150 million; and
- $105 million in 2008-09 ($2.0 billion over four years from 2008-09) from increasing funding for compliance activities by the Australian Taxation Office.

Taxation revenue parameter and other variations have contributed $3.6 billion to this revision. Taxation revenue is expected to be subject to opposing forces. Stronger growth is expected in individuals' incomes, from increased employment and wages, and strong rises in commodity prices contribute to higher company profits and additional petroleum resource rent tax. Offsetting these influences are recent falls in share prices, which are expected to reduce capital gains, and higher interest expenses for business.

Non-taxation parameter and other revenue in 2008-09 is expected to be $2.8 billion higher than forecast in the PEFO, largely reflecting:

- an $814 million increase in the Reserve Bank of Australia's projected dividend (largely reflecting additional realised capital gains by the Reserve Bank);
- a $432 million increase in Future Fund earnings reflecting an increase in interest earnings ($751 million) partly offset by a reduction in estimated dividends ($319 million) due to revisions to the Future Fund's forecast portfolio; and
- an increase in interest received by the Australian Office of Financial Management on its investments.

Further detail on how the revised outlook for the economy has affected individual revenue heads over the forward estimates is provided in Statement 5. An analysis of the sensitivity of the taxation revenue estimates to changes in the economic parameters is provided in Appendix B.

Variations in expense estimates

Since PEFO, estimated total expenses for 2008-09 have decreased by $1.7 billion reflecting increased expenses from new policy decisions of $1.3 billion, offset by parameter and other variations of $3.1 billion.

Major policy decisions since PEFO that have increased expenses include:

- $400 million in 2008-09 ($1.2 billion over five years from 2007-08) to provide eligible schools with new or upgraded computers and communications technology as part of the *Digital Education Revolution*;
- $340 million in 2008-09 ($1.6 billion over four years from 2008-09) for increases to the Child Care Tax Rebate from 30 per cent to 50 per cent for out-of-pocket child care expenses;
- $233 million in 2008-09 ($993 million over four years from 2008-09) for the *Trade Training Centres in Schools Program* to provide facilities to enhance vocational education opportunities for Years 9 to 12 secondary school students;
- $233 million in 2008-09 ($1.9 billion over five years from 2007-08) to provide 630,000 additional training places under the *Skilling Australia for the Future* package to help address skills and labour shortages in Australia; and
- $227 million in 2008-09 ($2.4 billion over four years from 2008-09) for expenses resulting from the additional 37,500 permanent migrants under the Migration Program, comprising $132 million ($1.4 billion over four years from 2008-09) in health, education, employment and other services and $95 million ($1.4 billion over four years from 2008-09) additional GST payments to the states.

The impact of these policy decisions on expenses has been substantially offset by savings, including:

- $634 million in 2008-09 ($959 million over three years from 2007-08) for the termination of the OPEL contract due to OPEL's Implementation Plan not satisfying the condition precedent of the funding agreement;
- $412 million in 2008-09 ($1.8 billion over five years from 2007-08) for the application of the one-off 2 per cent efficiency dividend to departmental funding of Australian Government agencies;
- $307 million in 2008-09 ($1.1 billion over five years from 2007-08) for the abolition of the Access Card project which was to replace existing health and social services cards and vouchers;
- $305 million in 2008-09 of savings from Defence for overseas defence operations;

- $286 million in 2008-09 ($256 million over four years to 2011-12) from the recovery of overpaid compensation paid to the States for the decision to allow certain small businesses and non-profit organisations to pay their GST on an annual rather than monthly or quarterly basis; and

- $232 million in 2008-09 ($960 million over four years from 2008-09) from reduced public health insurance rebate costs as a result of the increases to the Medicare levy surcharge thresholds.

In 2008-09, parameter and other variations have decreased forecast expenses by $3.1 billion since PEFO. This primarily reflects a change in accounting treatments whereby purchases of Defence weapon systems are now classified as capital expenditures rather than expense. The new budget accounting framework is discussed in further detail in Appendix A. The remaining decrease in expenses primarily reflects:

- a $326 million reduction in estimated expenses primarily due to delays in Defence capital acquisition projects;

- a $318 million reduction in estimated expenses for Parenting Payment reflecting an increase in the number of people no longer eligible for the payment due to higher reported incomes;

- a $178 million reduction in estimated expenses for Pharmaceuticals and Pharmaceutical Services driven by a lower than expected growth in usage of a range of drugs on the Pharmaceutical Benefits Scheme;

- a $128 million reduction in estimated expenses for Family Tax Benefit driven by a decrease in customer numbers due to higher reported incomes; and

- the regular draw-down of the conservative bias allowance[1] reducing estimated expenses by around $1.2 billion.

In 2008-09, these decreases in expenses are partially offset by:

- a $562 million increase in estimated expenses for the Disability Support Pension (DSP) reflecting a lower than anticipated movement of customers from the DSP to Newstart Allowance under the Welfare to Work package;

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1 The forward estimates include an allowance for the established tendency of expenses for existing Government policy (particularly demand driven programs) to be higher than estimated in the forward years. To offset this, the contingency reserve includes an allowance based on past experience to preserve the overall integrity of the forward estimates. This allowance, known as the conservative bias allowance, is progressively reduced so that the budget year conservative bias is zero by budget night.

- a $240 million increase in estimated expenses for interest rate subsidies available under Exceptional Circumstances assistance, primarily due to a higher than expected take-up by eligible farmers;
- a $221 million increase in estimated expenses for the Child Care Benefit resulting from higher than forecast use of child care services; and
- a $207 million increase in estimated expenses for Medicare Services reflecting increases in demand for a range of medical services including services provided by general practitioners, pathology services and diagnostic imaging services.

In 2007-08, estimated total expenses have increased by $2.3 billion since PEFO. This reflects new spending of $3.1 billion, including:

- $1.4 billion for the Seniors Bonus to provide a payment of $500 to eligible individuals before 30 June 2008;
- $500 million for additional funding to the States for public hospitals to be delivered through the Australian Health Care Agreements to relieve the pressure on public hospitals;
- $500 million for grants to Australian Universities for capital investment in priority areas;
- $427 million for the Carers' Bonus for a lump sum payment to carers before 30 June 2008, in recognition of their contribution in caring for people with disabilities and the frail aged;
- $100 million for capital funding to the States to build new supported accommodation for those with disabilities; and
- $75 million for the development of feasibility and planning studies for projects to address urban congestion.

The impact of these policy measures on expenses has been partially offset by reductions in estimated expenses due to parameter and other variations, including a $187 million reduction in Newstart Allowance, reflecting a lower number of recipients than previously forecast, and a $177 million reduction in Parenting Payment reflecting an increase in the number of people no longer eligible for the payment due to higher reported incomes.

More detailed information on expenses can be found in Statement 6. A full description of all policy measures since PEFO can be found in Budget Paper No. 2, *Budget Measures 2008-09*.

Variations in net capital investment estimates

In 2008-09, forecast net capital investment has increased by $2.1 billion since PEFO. This primarily reflects an increase of $2.8 billion due to a change in accounting treatment under the new accounting framework whereby purchases of Defence weapon systems are now classified as capital expenditures rather than being expensed. The new budget accounting framework is discussed in further detail in Appendix A.

The impact of the change in accounting treatment has been partially offset by a net reduction in capital investment of $679 million largely comprising:

- a reduction of $923 million reflecting delays in Defence capital acquisition projects, partially offset by an increase of $54 million for various capital projects for the Department of Immigration and Citizenship including investment in information technology systems and refurbishment of accommodation; and

- increases arising from new policy measures of $143 million, including an increase of $125 million for the National Medical Stockpile to replace expiring pharmaceuticals and pandemic vaccines and $21 million for capital purchases for the establishment of First Home Saver Accounts.

Net financial worth, net worth and net debt

Net financial worth measures a government's net holdings of financial assets and can be calculated from the balance sheet by subtracting financial assets from total liabilities. Net financial worth includes debt, but also superannuation liabilities, equity and other financial assets offsetting that liability. Net financial worth is a key indicator of financial sustainability since it is a broader measure of the financial position than net debt. Net financial worth for the Australian Government general government sector is forecast to be -$3.6 billion in 2008-09 and expected to become positive in 2009-10.

Net worth is forecast to be $86.0 billion in 2008-09, compared with $33.6 billion at PEFO. This primarily reflects the Government adopting a new accounting standard at this Budget which requires that defence weapons be treated as an asset (see Appendix A for more information).

Since PEFO, the forecast level of net debt has fallen from -$33.9 billion to -$45.0 billion, largely reflecting a higher than anticipated underlying cash surplus for 2008-09. With negative net debt, the Government is expected to earn net interest receipts of $2.2 billion in 2008-09.

Table 6 provides a summary of Australian Government general government sector net financial worth, net worth, net debt and net interest payments.

Table 6: Australian Government general government sector net financial worth, net worth, net debt and net interest payments

	Estimates		Projections		
	2007-08	2008-09	2009-10	2010-11	2011-12
	$b	$b	$b	$b	$b
Financial assets	183.9	212.1	237.3	256.7	283.6
Non-financial assets	86.7	89.6	93.4	97.8	103.0
Total assets	**270.6**	**301.7**	**330.7**	**354.5**	**386.6**
Total liabilities	**209.8**	**215.7**	**219.3**	**216.2**	**221.5**
Net worth	**60.8**	**86.0**	**111.4**	**138.3**	**165.1**
Net financial worth(a)	**-25.8**	**-3.6**	**18.0**	**40.4**	**62.1**
Per cent of GDP	-2.3	-0.3	1.4	3.0	4.4
Net debt(b)(c)	**-42.6**	**-45.0**	**-65.4**	**-86.5**	**-106.7**
Per cent of GDP	-3.8	-3.7	-5.1	-6.5	-7.6
Net interest payments	**-1.3**	**-2.2**	**-2.8**	**-3.1**	**-5.4**
Per cent of GDP	-0.1	-0.2	-0.2	-0.2	-0.4

(a) Net financial worth equals total financial assets minus total liabilities. That is, it excludes non-financial assets.
(b) Net debt equals the sum of deposits held, advances received, government securities, loans and other borrowing, minus the sum of cash and deposits, advances paid and investments, loans and placements.
(c) The net debt estimates include the expected impact of the Future Fund rebalancing its portfolio allocation by increasing its holding of equities, which are not included in the calculation of net debt.

Box 2: Budget transparency

The 2008-09 Budget includes a number of reforms to fiscal reporting frameworks that allow the community to understand more clearly the Government's fiscal policy and overall financial performance.

The Government has adopted major accounting policy reforms that improve the transparency, reliability and understanding of the budget financial statements. In this Budget, the Government is presenting a single set of financial statements, rather than the three sets presented in previous budgets. Many commentators have noted the confusion and reduced government accountability from presenting financial statements based on three different reporting frameworks — the Australian Bureau of Statistics Government Finance Statistics (ABS GFS), the Uniform Presentation Framework and Australian Accounting Standards (AAS). Further, a single accounting policy framework will apply right through all whole of government budget papers, from the budget to the consolidated financial statements (CFS). Previous budget statements were prepared on a different accounting basis from the financial statements audited in the CFS.

The budget financial statements will comply with both ABS GFS and AAS, except for disclosed departures. ABS GFS remains the basis of budget accounting policy, except where the Government decides to depart because AAS provides a better conceptual basis for presenting information of relevance to users of public sector financial reports. In this Budget, consistent with both AAS and ABS GFS, the goods and services tax is recognised as a Commonwealth tax. Further information on these changes to accounting policy can be found in Appendix A to this statement.

This Budget also includes:

- Fiscal projections for the underlying cash balance going forward 20 years in the medium-term fiscal outlook.
- A more comprehensive analysis of the sensitivity of budget financial aggregates to specific economic scenarios. Further information can be found at Appendix B to this statement.
- Updated and extended historical fiscal data. Further information can be found at Statement 10.

This information is important for budget transparency as it allows analysis of fiscal policy.

Improving budget transparency is an ongoing process. The Government is committed to reforms previously announced as part of *Operation Sunlight*, including better management of tax expenditures, enhanced reporting of long-term fiscal pressures and improved program reviews.

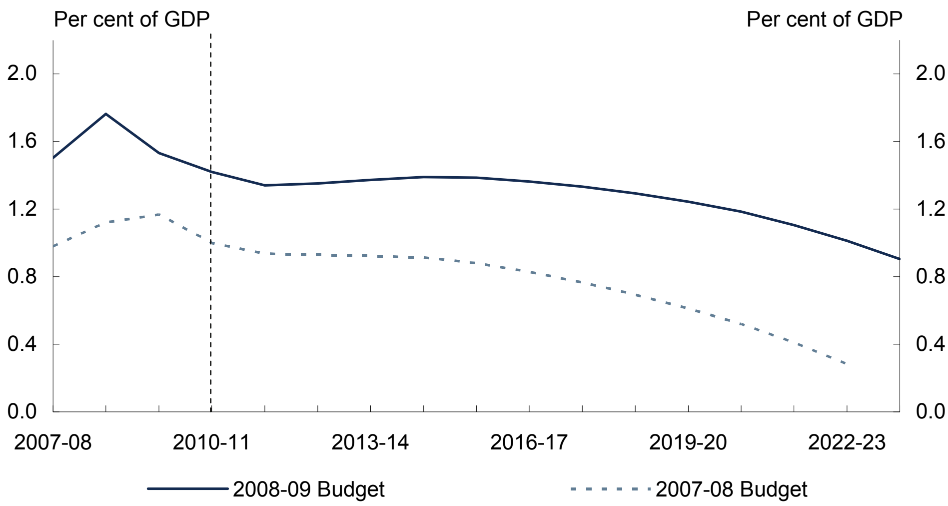
MEDIUM-TERM FISCAL OUTLOOK

Sustainability of public finances is the primary objective of the Government's medium-term fiscal strategy.

Fiscal sustainability is important for broader economic sustainability, including meeting the challenges of an ageing society, dealing with climate change and improving participation and productivity. Maintaining fiscal sustainability is also a core requirement of improving intergenerational equity (Box 3).

Chart 2 below shows that over a 20 year projection period on a consistent underlying cash balance basis, in the absence of policy changes, spending pressures associated with an ageing population increase. These pressures will constrain the capacity of governments to meet the community's future needs. Targeting policies towards expanding the productive capacity of the economy, through investments in skills and infrastructure, is the key to raising productivity and prosperity to meet the challenges of the future. Lifting the real growth rate of the economy in sustainable ways increases the ability of governments to finance future spending, as well as directly improving the wellbeing of Australians.

Chart 2: Fiscal projections over the medium term



Source: Treasury projections.

These projections are based on the same estimation methodology used in the second Intergenerational Report 2007 (IGR2), except net interest payments are included and IGR2 growth rates for spending apply from the end of the current forward estimates period. Like IGR2, revenue is assumed to remain at a constant percentage of GDP from the end of the forward estimates period. The projections incorporate the effect on the forward estimates of the 2008-09 Budget, which lowers the expense starting point for the projections. Structural effects on spending growth rates for the Government's policies in this Budget have not been included and will be updated following the full estimates review process normally conducted as part of the next Intergenerational Report.

Box 3: Economic and fiscal sustainability

Economic sustainability requires resources to be allocated in a way that improves the expected wellbeing of current and future generations, with no generation suffering lower wellbeing than any past generation. This recognises that people tend to aspire to higher living standards, a cleaner environment and less risky economic circumstances for both current and future generations. Rather than simply maintaining existing levels of wellbeing, in practice a more sustainable economy is one that provides well founded expectations of persistent improvements in wellbeing through time.

To be sustainable, an economy needs to improve both efficiency and intergenerational equity. A more efficient economy — with high levels of productivity and participation — is able to satisfy a higher level of overall wellbeing. Intergenerational equity means future generations should always expect to be no worse off than previous generations.

Policies which support economic growth are more likely to meet both the efficiency and equity elements of sustainability. A more efficient, growing economy is likely to improve the chances of achieving a more equitable society. More resources means governments are better able to redistribute within and between generations. Current generations may also feel inclined to maintain the wellbeing of future generations if their own wellbeing is improving. Economic growth is generally of benefit to current and future generations.

A key way governments impact on economic sustainability is through their fiscal policy. In particular, fiscal sustainability is important for delivering sustainable improvements in living standards over time. Fiscal sustainability can be defined as the ability of government to manage its finances so it can meet its spending commitments, both now and in the future. When governments do not manage their finances in a sustainable manner, economic growth and ultimately the services that the government provides the community suffer. The wasting of scarce resources reduces economic sustainability.

Fiscal sustainability can be assessed by looking at the expected path of spending in the future and what that implies for taxes, as well as the risks around that path. A fiscal policy focused on sustainability provides greater stability and certainty of future tax burdens and is likely to lead to better long-term decision making, encouraging investment and economic growth.

APPENDIX A: A NEW BUDGET ACCOUNTING FRAMEWORK

The Australian Government has adopted a new accounting and financial reporting framework for the 2008-09 Budget. This framework improves transparency and the accountability of government financial reporting.

Background

Under the *Charter of Budget Honesty Act 1998* (the Charter) the Australian Government is required to produce financial statements that are based on two external reporting standards: the Australian Bureau of Statistics (ABS) Government Finance Statistics (GFS) and the Australian Accounting Standards (AAS).

The previous Government adopted the ABS GFS (with certain departures) as the basis for its primary budget financial statements, with the AAS statements also produced and presented as a separate statement in Budget Paper No. 1. In addition, financial statements under the Uniform Presentation Framework, agreed to by the Commonwealth and States, were included in each budget publication. This meant that three separate sets of financial statements were prepared and published at each Budget, Mid-Year Economic and Fiscal Outlook and Final Budget Outcome (FBO). Each of these financial statements measured the same economic activities of the Commonwealth but reported different key financial aggregates.

In 2002, the Financial Reporting Council (the body established by the Australian Government to oversee financial reporting in Australia) directed the Australian Accounting Standards Board (AASB) to harmonise the ABS GFS and AAS frameworks. In October 2007, the AASB issued *AASB 1049 Whole of Government and General Government Sector Financial Reporting* as the standard to harmonise these two frameworks.

The new accounting standard

AASB 1049 has made significant progress in harmonising ABS GFS and AAS. In particular, where there was previously choice in the treatment of some transactions under AAS, AASB 1049 now prescribes the ABS GFS treatment be adopted provided that the choice is not inconsistent with other Australian accounting standards. Further, government financial information prepared according to AASB 1049 is now more closely aligned with the presentation prescribed under the ABS GFS framework. For example, AASB 1049 has introduced the concept of a 'statement of other economic flows' into the operating statement for changes in economic value during a period resulting from price and volume changes. Most importantly, AASB 1049 recognises the general government sector as a reporting entity outside of the normal requirement to base the reporting entity on the concept of control.

However, the new standard does not fully harmonise the two frameworks. Instead, AASB 1049 prescribes AAS measurement of budget aggregates on the face of the financial statements with reconciliation in the notes to the ABS GFS measurement of budget aggregates. These reconciliation notes are likely to cause confusion since they imply that a single economic concept can have more than one measurement basis. For example, AASB 1049 would require the Government to show a AASB cash surplus in the cash flow statement and an ABS GFS cash surplus in the notes.

There are a number of other areas where the new standard is not well suited to the Australian Government's financial management framework. For example, the AASB 1049 requirement for the general government sector FBO to be released with the whole of government consolidated financial statements (CFS) would reduce the timeliness of government financial reporting. The *Charter of Budget Honesty Act 1998* requires that the FBO be released by the end of September, whereas the CFS is not generally released until December after final audit clearance. The Government will continue to engage with the AASB with the aim of addressing these issues.

The Government's accounting policy

The Government has decided that the budget financial statements will continue to be based on ABS GFS, subject to departures where AAS provides a better conceptual treatment for specific items. The ABS GFS is a financial reporting framework specifically designed for economic analysis of the public sector by the International Monetary Fund. Importantly, given the Australian Government's key role as a manager of the macroeconomy, ABS GFS fiscal aggregates are consistent with measurement principles underlying the National Accounts.

The Government's budget accounting policy means that:

- the Government will fully comply with AAS and ABS GFS where each framework is in mutual agreement;
- where there are differences in the frameworks, the Government will only depart from ABS GFS where AAS provides a better conceptual treatment meeting the needs of users of public sector financial reports; and
- departures will be limited to complying with either ABS GFS or AAS. Importantly, this rules out departures from both, such as excluding GST from the Commonwealth financial statements.

The accounting policy has a number of consequences for the presentation of the financial statements that improve transparency. The Government will produce only one set of financial statements, down from the three sets produced in previous budgets. Further, a single accounting policy framework will apply right through all whole of government budget papers, from budget to the consolidated financial statements.

A single set of financial statements will comply with the requirement under the Charter for financial information to be based on both frameworks with all the departures disclosed. In practice, the ABS GFS presentation has largely been retained along with most of the previous departures from ABS GFS. The most significant changes are some new departures in moving from ABS GFS to the AASB 1049 treatment where the latter provides a conceptually superior accounting basis for measuring or presenting information in the financial statements. The Government has also removed a significant departure from both ABS GFS and AAS by recording the GST as a Commonwealth tax. A list of the departures and the reasoning for them is outlined at Note 2 of Statement 10.

Overall, the new accounting policy results in no changes to the underlying cash balance, while net worth improves by $31.6 billion, largely due to adopting the AASB 1049 requirement for defence weapons to be treated as an asset. The most significant departures from ABS GFS are likely to be eliminated as the GFS framework is updated. For example, recent updates to the Systems of National Accounts require defence weapons to be treated as assets. Since ABS GFS depends on the SNA framework, this change is likely to flow through to ABS GFS.

These reforms will allow the community to better hold governments accountable for their budget decisions. A single set of financial statements will reduce confusion among users, while for the first time preparing the audited CFS on the same accounting policy basis as the budget will improve financial accountability. Adopting ABS GFS as the basis for accounting policy will ensure that the financial statements continue to reflect the specific needs of users of public sector financial reports. Avoiding departures from both frameworks and opting for AAS where it is conceptually better will improve the accuracy of the financial statements. Overall, the Government's reforms will significantly simplify the presentation of Australian Government financial reports, while improving the financial information that is available to the Parliament and the general public.

Appendix B: Sensitivity of Budget Estimates to Economic Developments

The estimates contained in the Budget are based on forecasts of the economic outlook. Changes to the economic assumptions underlying the budget estimates will impact on receipts and payments, and hence the size of the underlying cash balance.

This section examines the impact on receipts and payments of altering some of the key economic assumptions underlying the budget estimates. Tables B2 and B4 illustrate the sensitivity of key components of receipts and payments to possible variations in the economic outlook. The two scenarios considered are:

- Scenario 1: a 1 per cent reduction in nominal GDP due to a fall in the terms of trade.
- Scenario 2: a 1 per cent increase in real GDP driven by an equal increase in labour productivity and labour force participation.

The economic scenarios provide a rule of thumb indication of the impact on revenue, expenses and the underlying cash balance of changes in the economic outlook. They represent a partial economic analysis only and do not attempt to capture all the economic feedback and other policy responses related to changed economic conditions. In particular, the analysis assumes no change in the exchange rate, interest rates or discretionary policy. The impact of the two scenarios on the economic parameters would be different if the full feedback response on economic variables and likely policy actions were taken into account. The analysis does not aim to provide an alternate picture of the economic forecasts under these scenarios, but instead gives an indication of the sensitivity associated with different components of revenue and expenses to changes in the economy. As such, the changes in the economic variables and their impact on the fiscal outlook are only illustrative.

The impacts shown in the tables below are broadly symmetrical. That is, impacts of around the same magnitude but in the opposite direction would apply if the terms of trade were to increase or if real GDP were to decrease.

Scenario 1

The first scenario involves a permanent fall in world prices of non-rural commodity exports, which causes a fall in the terms of trade, consistent with a 1 per cent fall in nominal GDP by Year 2. The sensitivity analysis evaluates the flow-on effects on the economy, the labour market and prices. The impacts in Table B1 are highly stylised and refer to per cent deviations from the baseline levels of the respective economic parameters.

Table B1: Illustrative impact of a permanent commodity price fall consistent with a 1 per cent fall in nominal GDP in Year 2 (per cent deviation from the baseline level)

	Year 1 per cent	Year 2 per cent
Real GDP	0	-¼
Non-farm GDP deflator	-¾	-¾
Employment	-¼	-½
Wages	0	-¼
CPI	0	-¼
Company profits	-3	-3
Consumption	-¼	-½

Assuming no change in exchange rates or interest rates, the fall in export prices leads directly to a lower non-farm GDP deflator (from the exports component of GDP) and lower domestic incomes. Lower domestic incomes cause both consumption and investment to fall, resulting in lower real GDP, lower employment and lower wages. The fall in aggregate demand puts downward pressure on domestic prices.

In reality, a fall in the terms of trade would be expected to put downward pressure on the exchange rate, although the magnitude is particularly difficult to model. In the event of a fall in the exchange rate, the real GDP effects would be dampened through the stimulus to the external sector, and there would be some offsetting upward pressure on prices.

Given these assumptions, the overall impact of the fall in the terms of trade is a reduction in the underlying cash balance of around $1.9 billion in Year 1 and around $4.8 billion in Year 2 (see Table B2).

Table B2: Illustrative sensitivity of the budget balance to a 1 per cent reduction in nominal GDP due to a fall in the terms of trade

	Year 1 $b	Year 2 $b
Receipts		
Individuals and other withholding taxation	-0.5	-1.9
Superannuation taxation	-0.1	-0.1
Company tax	-1.3	-2.7
Goods and services tax	-0.1	-0.2
Excise and customs duty	-0.1	-0.1
Other taxation	0.0	0.0
Total receipts	**-2.0**	**-5.0**
Payments		
Income support	0.1	0.1
Other payments	-0.2	-0.3
GST payments	-0.1	-0.2
Total payments	**-0.2**	**-0.4**
Interest change on surplus change	-0.1	-0.3
Underlying cash balance impact	**-1.9**	**-4.8**

On the receipts side, the fall in the terms of trade results in a fall in nominal GDP which reduces tax collections. The largest impact falls on company tax receipts as the fall in export income reduces company profits. Lower company profits are expected to flow through to lower Australian equity prices, reducing the collection of capital gains tax from individuals, companies and superannuation funds.

A slowing of the economy results in lower aggregate demand which lowers employment and wages. For these reasons, individuals' income tax collections fall and the reduction in disposable incomes leads to lower consumption which decreases GST receipts (and decreases GST payments to the States by the same amount) and other indirect tax collections.

On the payments side, a significant proportion of government expenditure is partially indexed to movements in costs (as reflected in various price and wage measures). Some forms of expenditure, in particular income support payments, are also driven by the number of beneficiaries.

The overall estimated expenditure on income support payments (including pensions and allowances) increases due to a higher number of unemployment benefit recipients. This is partly offset by lower expenditure on other income support payments (especially age pensions) reflecting lower growth in benefit rates flowing from lower wages growth. At the same time other payments linked to inflation fall in line with the reduced growth in prices.

The lower underlying cash balance also has a negative interest impact in both years due to interest forgone from reduced surpluses.

As noted above, under a floating exchange rate, the depreciation of the exchange rate would dampen the effects of the fall in the terms of trade on real GDP, meaning the impact on the fiscal position could be substantially more subdued. Also, to the extent that the fall in the terms of trade is temporary rather than permanent, the impact on the economic and fiscal position would be more subdued.

Scenario 2

The second scenario involves a combination of an equal 0.5 per cent increase in the participation rate and in labour productivity, resulting in a 1 per cent increase in real GDP by Year 2. Once again, the sensitivity analysis evaluates the flow-on effects on the economy, the labour market and prices. The impacts in Table B3 are highly stylised and refer to per cent deviations from the baseline levels of the respective parameters.

The 1 per cent increase in real GDP increases nominal GDP by around the same amount but the magnitude of the effects on receipts, payments and the underlying cash balance differ from the first scenario because this variation in the outlook affects different parts of the economy in different ways.

Table B3: Illustrative impact of an ongoing equal increase in both labour productivity and participation consistent with a 1 per cent increase in real GDP in Year 2 (per cent deviation from the baseline level)

	Year 1 per cent	Year 2 per cent
Nominal GDP	¾	¾
Non-farm GDP deflator	-¼	-¼
Employment	½	½
Wages	¼	¼
CPI	-¼	-¼
Company profits	1¾	1¾
Consumption	1	1

The increase in labour force participation and labour productivity have the same impact on output, but different impacts on the labour market. Higher productivity leads to higher real GDP and higher real wages, while an increase in the participation rate increases employment and real GDP. Imports are higher in this scenario, reflecting higher domestic incomes.

Since the supply side of the economy expands, inflation falls relative to the baseline. The fall in domestic prices makes exports more attractive to foreigners, with the resulting increase in exports offsetting higher imports, leaving the trade balance unchanged. The exchange rate is assumed to be constant.

The overall impact of the increase in labour productivity and participation is an increase in the underlying cash balance of around $2.8 billion in Year 1 and around $4.1 billion in Year 2 (see Table B4).

Table B4: Illustrative sensitivity of the budget balance to a 1 per cent increase in real GDP due to an equal increase in both productivity and participation (per cent deviation from the baseline level)

	Year 1 $b	Year 2 $b
Receipts		
Individuals and other withholding taxation	1.5	1.7
Superannuation taxation	0.0	0.1
Company tax	0.8	1.6
Goods and services tax	0.4	0.4
Excise and customs duty	0.4	0.4
Other taxation	0.0	0.0
Total receipts	**3.0**	**4.1**
Payments		
Income support	0.0	0.1
Other payments	-0.1	-0.2
GST payments	0.4	0.4
Total payments	**0.3**	**0.3**
Interest change on surplus change	0.1	0.3
Underlying cash balance impact	**2.8**	**4.1**

On the receipts side, individuals' income tax collections increase because of the rise in the number of wage earners and, additionally, higher real wages. The stronger labour market also increases superannuation fund taxes through greater contributions (including compulsory contributions) to superannuation funds. The increase in personal incomes leads to higher consumption which increases GST receipts (and increases GST payments by the same amount) and other indirect tax collections.

In addition, the stronger economy results in higher levels of corporate profitability, boosting company taxes. Higher profits are assumed to increase Australian equity prices, generating additional capital gains tax from individuals, companies and superannuation funds.

On the payments side, overall estimated expenditure on income support payments (including pensions and allowances) is slightly higher reflecting higher benefit rates flowing from higher wages growth. Higher income support payments are offset by a fall in other payments linked to inflation due to the lower growth in prices.

The higher underlying cash balance also has a positive interest impact in both years due to interest earned from higher surpluses.

To the extent that the increase in productivity and participation are temporary rather than permanent, the impact on the economic and fiscal position would be more subdued.