PART 4: FISCAL STRATEGY AND OUTLOOK

THE GOVERNMENT'S FISCAL STRATEGY

Given the extraordinary economic developments in recent months, the immediate and overriding priority for fiscal policy at the current time is to support economic growth and jobs. The Government is working to support domestic demand in the face of a global recession. This will necessarily impact on the Government's budget balance, moving the budget into a deficit position across the forward estimates.

Australia is much better placed than most other countries to undertake fiscal stimulus. In responding to the global recession with the economic stimulus package, the Government is meeting its commitment made by the G20 member countries, including Australia, to provide timely stimulus to domestic demand while maintaining a sustainable medium-term fiscal strategy.

As soon as the economy recovers and grows above trend, the Government will take action to return the budget to surplus as soon as practicable (without jeopardising the recovery). The Government will act to deliver savings in government spending. Australia's future economy will be strengthened by the investments being undertaken now, supporting future tax revenues and enhancing the economy's resilience.

Key elements of a sustainable framework

The Government's medium-term fiscal policy strategy is:

- achieving budget surpluses, on average, over the economic cycle;
- 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's fiscal strategy aims to ensure fiscal sustainability over the economic cycle. A sustainable fiscal position provides greater certainty for decision makers, supports broader economic sustainability, and requires a focus on policies which strengthen the structure of the economy — helping to secure future prosperity.

These medium-term fiscal policy objectives also provide sufficient flexibility for the Government to use fiscal policy to support jobs and growth. The medium-term strategy does not require that the budget remain in surplus in every year of the economic cycle.

The Government's Nation Building and Jobs Plan has been crafted with a view to striking the right balance between supporting demand in the short term, and delivering a sustained investment in the economy in the longer term. The Plan promotes a sustainable economy, and through it sustainable government finances, by supporting medium term growth and productivity.

To ensure that growth is supported in a way that is consistent with the medium-term fiscal strategy, the Government will:

1. *Support the economy: the fiscal strategy for 2008-09 and 2009-10*

As Australia enters an economic slowdown of uncertain extent and duration, it is important that the Government continues to support the economy by:

- allowing the variations in revenue and expenditure, which are naturally associated with slower economic growth, to drive a temporary underlying cash budget deficit; and
- using additional spending to deliver timely, targeted and temporary stimulus, with the clear objective of other budget priorities and new policy proposals being met through a re-prioritisation of existing expenditure.

2. *Return the budget to surplus: the fiscal strategy as the economy recovers*

The Government reaffirms its commitment to achieve budget surpluses, on average, over the economic cycle.

As the economy recovers, and grows above trend, the Government will take action to return the budget to surplus by:

- allowing the level of tax receipts to recover naturally as the economy improves, while maintaining the Government's commitment to keep taxation as a share of GDP below the 2007-08 level on average; and
- holding real growth in spending to 2 per cent a year until the budget returns to surplus.

The immediate priority: supporting the economy

As discussed in Part 3, there are challenging times ahead for the Australian economy. There is no quick fix to the global financial crisis, and many of its effects are yet to be fully felt.

The weakness in the Australian economy is expected to be broad-based. Household consumption, dwelling investment, business investment and exports are all forecast to be weak in 2008-09 and 2009-10. Business investment, which has held up well to date, is likely to decline sharply.

In this context, it is important that fiscal policy continues to bolster the economy. Discretionary fiscal policy will temporarily add to the deficit in order to support economic growth. Importantly it does not lock in a permanent increase in government spending.

Allowing the automatic stabilisers to support the economy …

A key element in the Government's medium-term strategy is that the budget balance should be able to vary in the short term with economic conditions.

The change in the economic outlook since the 2008-09 Budget has significant implications for the Budget. Abstracting from new policy decisions, expected tax receipts have now been revised down by a total of around $115 billion across the forward estimates since the 2008-09 Budget, with more than $75 billion of this revision occurring since *Mid-Year and Fiscal Outlook 2008-09* (MYEFO).

In particular, the dramatic slowing in China's growth is resulting in an unwinding of the commodities boom. Just as rapid growth in the terms of trade since 2003-04 boosted revenues that underpinned substantial surpluses, falling commodity prices are now eroding forecast revenues. Tax receipts as a share of the economy are now expected to fall from 24.6 per cent in 2007-08 to 23 per cent in 2008-09 and it is expected to be 23 per cent in 2011-12.

Were the Government to offset these variations it would be contributing to — rather than leaning against — the macroeconomic instability arising out of the global crisis. Allowing the automatic stabilisers to flow through to moderate the downturn is a necessary and responsible approach in the current circumstances. Leveraging the Government's strong balance sheet to support the economy is also appropriate at this time.

While the movements in the automatic stabilisers will result in the budget moving temporarily into deficit, Australia's fiscal position remains strong. This is particularly evident when our net debt situation is compared with that of other advanced economies.

… and providing further fiscal stimulus as required

One of the reasons for maintaining a surplus when economic conditions are strong is to allow space for fiscal policy to support demand when conditions weaken.

Since September 2008, the Reserve Bank of Australia (RBA) has substantially lowered interest rates. In some other advanced countries, interest rates have already been reduced to very low levels. In comparison, there remains relatively more scope in Australia for the RBA to independently consider further interest rates reductions. However, given the extraordinary global circumstances, monetary policy action alone will not be sufficient to restore growth in a reasonable timeframe. Indebted households and firms are using interest savings to restore their balance sheets and low confidence is muting the effect of low interest rates on consumer and business demand.

In this context, and as the prospect of an export-led recovery diminishes as our trading partners enter recession, fiscal policy takes on an increasingly important role. In this situation it is critical that the Government deploy its strong balance sheet to support growth and jobs.

Throughout the global financial crisis, the Government has stayed ahead of the curve, taking decisive and early action where necessary to support jobs and growth. The $42 billion Nation Building and Jobs Plan, discussed in detail in Part 2, continues this trend. The Plan represents an investment of $28.8 billion in schools, housing, energy efficiency, roads and regional infrastructure and support to businesses. Immediate stimulus will also be provided by the payment of bonuses through the tax and transfer system.

The Government will continue to monitor the economy closely, and is committed to taking further steps to support growth and jobs if required.

As the economy recovers: returning the budget to surplus

The Government remains committed to the medium-term fiscal strategy, and in particular to keeping the budget in surplus, on average, over the economic cycle.

The investments made through this package will strengthen our future economy, and through it the sustainability of government finances. It is also important to note that the fiscal stimulus package has been carefully developed to ensure that it does not lock in increases in baseline government spending.

As soon as economic growth returns to above trend levels, the Government will take action to return the budget to surplus as quickly as economic conditions permit.

Allowing tax receipts to recover naturally …

As economic growth returns to above trend levels, there will be a natural recovery in the level of tax receipts without any policy changes. The Government will ‘bank’ any improvement in tax receipts associated with economic recovery, allowing this to flow through to improve the budget position.

... and reprioritising spending to fast-track the return to surplus

As economic growth returns to trend levels, the Government will review spending programs to reduce the levels of real growth in government spending to 2 per cent per annum.

All areas of government spending will be examined with a view to finding efficiencies and opportunities to better target programs while continuing to honour the

Government's commitment to provide 3 per cent real growth per year on average in Defence's underlying funding base to 2017-18. The Government will also continue its efforts to deliver greater efficiencies across the public sector.

FISCAL OUTLOOK

The Australian Government's underlying cash balance for 2008-09 has been revised to a deficit of $22.5 billion. In accrual terms, the fiscal balance has been revised down to a deficit of $22.4 billion for 2008-09.

Table 4.1: Australian Government general government sector budget aggregates[(a)]

	Estimates			
	2008-09		2009-10	
	MYEFO	UEFO	MYEFO	UEFO
Underlying cash balance ($b)(b)	**5.4**	**-22.5**	**3.6**	**-35.5**
Per cent of GDP	0.4	-1.9	0.3	-2.9
Fiscal balance ($b)	**5.8**	**-22.4**	**7.1**	**-33.3**
Per cent of GDP	0.5	-1.9	0.6	-2.8
	Projections			
	2010-11		2011-12	
	MYEFO	UEFO	MYEFO	UEFO
Underlying cash balance ($b)(b)	**2.6**	**-34.3**	**6.7**	**-25.7**
Per cent of GDP	0.2	-2.7	0.5	-1.9
Fiscal balance ($b)	**6.7**	**-31.5**	**10.1**	**-23.9**
Per cent of GDP	0.5	-2.5	0.7	-1.8

(a) Budget estimates published in the February 2009 *Updated Economic and Fiscal Outlook* are based on same external reporting standards used in the 2008-09 Budget and MYEFO. Net financial worth will be updated in the 2009-10 Budget.
(b) Excludes expected Future Fund earnings.

Given the sharp deterioration in economic conditions and the imperative to develop the stimulus plan to support the economy, the Government has released the *Updated Economic and Fiscal Outlook* to set out its revised fiscal strategy and an update of its economic forecasts and key fiscal aggregates.

The fiscal strategy statement in the *Updated Economic and Fiscal Outlook* is consistent with the *Charter of Budget Honesty Act 1998* (the Charter). The Charter also provides a framework for the conduct of government fiscal policy that is based on public scrutiny of fiscal policy and performance. Consistent with this objective, the *Updated Economic and Fiscal Outlook* explains the impact of the global recession on the economic outlook and key fiscal measures. The Government will release a complete economic and fiscal outlook, including full financial statements and a statement of risks in the 2009-10 Budget.

VARIATIONS IN THE UNDERLYING CASH BALANCE

The 2008-09 underlying cash balance is lower than estimated at MYEFO by $27.9 billion. Receipts (excluding Future Fund earnings) have been revised down by $10.3 billion as the continuing weakness in the international economic outlook, and its consequent impact on the Australian economic outlook, reduces the income of businesses and individuals and lowers consumption. Downward revisions to taxes have been broad based, with almost all tax receipts now expected to be lower.

At the same time, payments have increased by $17.5 billion as the Government takes action to support economic growth and jobs, as well as allowing the automatic stabilisers to work in countering the economic downturn.

Table 4.2 provides a reconciliation of the variations in the underlying cash balance estimates.

Table 4.2: Reconciliation of Australian Government general government sector underlying cash balance estimates

	Estimates		Projections	
	2008-09	2009-10	2010-11	2011-12
	$m	$m	$m	$m
2008-09 MYEFO underlying cash balance(a)	**5,365**	**3,595**	**2,640**	**6,689**
Changes from 2008-09 MYEFO to UEFO				
Effect of policy decisions(b)	-18,037	-18,365	-11,655	-5,435
Effect of parameter and other variations	-9,816	-20,753	-25,314	-26,937
Total variations	**-27,853**	**-39,118**	**-36,970**	**-32,372**
2008-09 UEFO underlying cash balance(a)	**-22,487**	**-35,524**	**-34,330**	**-25,683**

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

Policy decisions taken since the 2008-09 MYEFO have reduced the underlying cash balance by $18.0 billion in 2008-09 and $18.4 billion in 2009-10.

Over the same period, total parameter and other variations have reduced the underlying cash balance by $9.8 billion in 2008-09 and $20.8 billion in 2009-10.

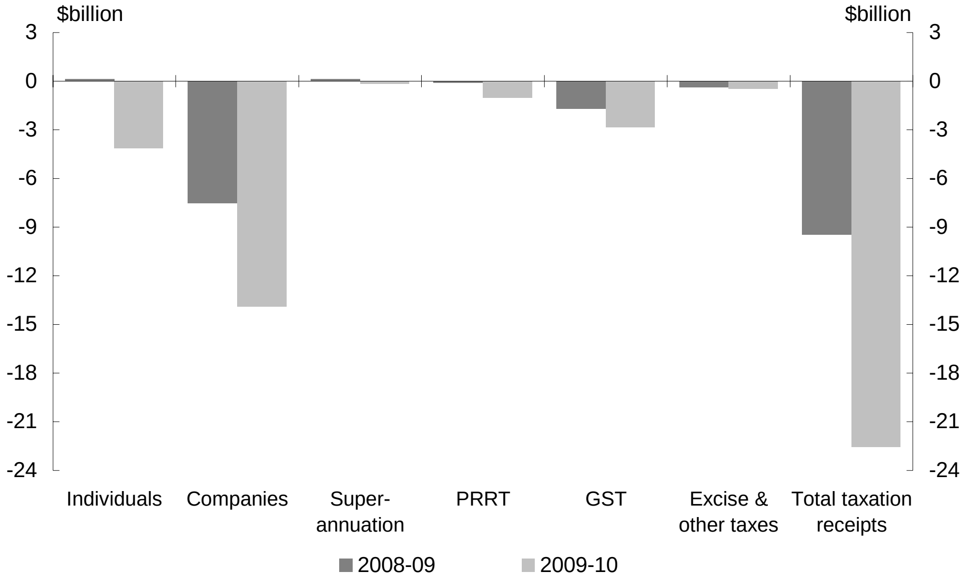
Since the MYEFO, parameter and other variations have led to taxation receipt estimates being revised down by $9.5 billion in 2008-09, $22.6 billion in 2009-10, $21.8 billion in 2010-11 and $21.9 billion in 2011-12 (and a total of around $75 billion over the full forward estimates period). This significant reduction in receipts reflects:

- falls in profits of companies, unincorporated businesses and petroleum resource projects from a range of factors including weaker demand, forecast further declines in commodity prices (reflecting the weaker outlook for world growth), weaker asset prices and rising bad debts;

- weaker wage and employment growth and weaker outlook for income from interest and dividends from 2009-10 affecting income tax on individuals;
- weaker consumption growth affecting taxes on consumption (GST, luxury car tax, customs and excise duties); and
- further falls in equity prices, in Australia and internationally, and lower than anticipated house prices affecting capital gains tax, which is a component of income taxes on individuals, companies and superannuation funds.

As a consequence, the largest revisions have been made to company tax, which has been reduced by $7.5 billion in 2008-09 and almost $14 billion in 2009-10 (and nearing a total of $50 billion over the forward estimates). Other significant revisions have been made to taxes on individuals’ income (down $4 billion in 2009-10), GST (down $1.8 billion in 2008-09 and $2.8 billion in 2009-10) and petroleum resource rent tax (PRRT) (down $1 billion in 2009-10). Chart 4.1 shows the revisions to receipts since MYEFO.

Chart 4.1 Revisions to receipts since MYEFO



Tax receipts have also been revised down slightly in 2008-09 and 2009-10 to reflect expected increases in tax debt (that is, taxes that are overdue), primarily relating to individuals, unincorporated businesses and payers of GST.

The underlying cash balance is largely unchanged in 2008-09, but reduced in 2009-10, as a result of parameter and other revisions to total payments. The primary cause of this variation has been the slowing of the Australian economy. Most notably the need to provide additional support to those most adversely affected by the global crisis has increased expected Newstart and Age Pension payments. In addition, payments under the Pharmaceutical Benefits Scheme and Medicare Benefits Schedule have been revised upwards in 2008-09 and 2009-10.

VARIATIONS IN THE FISCAL BALANCE

The 2008-09 fiscal balance is lower than estimated at MYEFO by $28.2 billion, largely reflecting a decrease of $9.3 billion in revenue and an increase in expenses and net capital investment of $18.9 billion.

Table 4.3 provides a reconciliation of the fiscal balance estimates.

Table 4.3: Reconciliation of Australian Government general government sector fiscal balance estimates[(a)]

	Estimates		Projections	
	2008-09	2009-10	2010-11	2011-12
	$m	$m	$m	$m
2008-09 MYEFO fiscal balance	**5,842**	**7,123**	**6,713**	**10,085**
Per cent of GDP	0.5	0.6	0.5	0.7
Changes between 2008-09 MYEFO and UEFO				
Effect of policy decisions(b)				
Revenue	-449	-1,102	5,611	5,437
Expenses and net capital investment	19,194	18,645	17,070	10,774
Total policy decisions impact on fiscal balance	-19,643	-19,747	-11,459	-5,338
Effect of parameter and other variations				
Revenue	-8,840	-19,241	-23,172	-24,354
Expenses and net capital investment	-288	1,434	3,538	4,312
Total parameter and other variations impact on fiscal balance	-8,552	-20,675	-26,710	-28,666
2008-09 UEFO fiscal balance	**-22,353**	**-33,299**	**-31,456**	**-23,920**
Per cent of GDP	-1.9	-2.8	-2.5	-1.8

(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 decisions.

Policy decisions

Policy decisions taken since MYEFO have reduced the fiscal balance by $19.6 billion in 2008-09. Major policy decisions affecting the fiscal balance over the forward estimates period include:

- the Nation Building and Jobs Plan which will reduce the fiscal balance by $41.6 billion over four years;
- the COAG reform agenda which will provide additional funding to the States and Territories to support key service areas including healthcare, education, vocational education and training, affordable housing and disability services, reducing the fiscal balance by $15.2 billion over five years; and

- the December Nation Building Package, reducing the fiscal balance by $2 billion over four years.

Appendix A provides a full list of policy decisions taken since the 2008-09 MYEFO.

Parameter and other variations

Revenue

Parameter and other revisions to total revenue have reduced the fiscal balance by $8.8 billion in 2008-09 and $19.2 billion in 2009-10.

Since MYEFO, there have been very large downward parameter and other variations to estimated tax revenues in all years as the economic forecasts have been revised down substantially following continued global financial turmoil, a weaker global economic outlook and sharp falls in commodity prices. This has resulted in reductions in estimated tax revenue of $8.4 billion in 2008-09 and $21.2 billion in 2009-10 (with slightly larger declines in the projection years).

Company tax estimates have been reduced sharply since MYEFO owing to much lower expectations for company profits and recent soft tax collections pointing to current taxable profits slowing quickly. Forecast corporate gross operating surplus has been revised down significantly, particularly as forecasts for further declines in commodity prices have reduced profit expectations for miners, and the financial sector continues to deal with the impact of the global financial crisis. In addition, company profits are being eroded by falls in capital gains, increases in other market-linked investment losses (especially in the finance sector), higher levels of bad debts and weaker consumption. Company tax is forecast to be $7.5 billion lower than the MYEFO estimate in 2008-09 and $14 billion lower in 2009-10 (and similar amounts in the projection years).

Lower oil prices and production are expected to reduce profits from projects subject to PRRT. PRRT revenues are expected to be slightly lower than the MYEFO estimate in 2008-09 but fall by around $1 billion in 2009-10.

Individuals' income tax estimates in 2008-09 are broadly in line with the MYEFO forecast but have been revised down by $3.5 billion in 2009-10. From 2009-10, lower forecasts for growth in employment and wages are expected to reduce tax on wages and salaries by almost $2 billion per year. In addition, a weaker outlook for profits earned by unincorporated businesses, property income (mainly interest and dividends) and capital gains have reduced forecast individuals' income tax by almost $2 billion in 2009-10 and greater amounts in the projection years.

Since MYEFO, there have been significant falls in equity prices, in Australia and internationally, following continued global financial turmoil and a weaker global economic outlook. In late January, the Standard & Poor's ASX200 index traded below

3,400 points compared with just below 4,000 points in late October. In addition, house prices have fallen in recent quarters.

GST estimates have been revised down by around $1 billion in 2008-09 and around $2 billion in 2009-10 following downward revisions to forecasts of consumption and new dwelling investment.

Reduced forecasts of consumption have also led to reductions of more than $250 million per year in aggregate estimates of all other indirect taxes (excise and customs duties, luxury car tax, and wine equalisation tax). In particular, reduced demand for vehicles has led to significant reductions in estimates for customs duty and luxury car tax.

Partially offsetting the effect of the parameter changes on revenue in 2009-10 is the RBA dividend which is expected to increase largely as a result of gains realised from its operations in the foreign exchange market. Projections of the dividend beyond 2009-10 have been revised down considerably, in part reflecting the sharp decline in market and policy interest rates around the world in recent months.

Expense and net capital investment

Parameter and other revisions to expenses and net capital investment are expected to improve the fiscal balance by $288 million in 2008-09 and reduce the fiscal balance by $1.4 billion in 2009-10. This variation in estimated expenses primarily reflects:

- a higher than previously anticipated increase in the number of people claiming Newstart, increasing forecast expenses by $206 million in 2008-09 and $1,095 million in 2009-10;
- an upwards revision in both the number of age pensioners and the average payment amount resulting in forecast expenses rising by $76 million in 2008-09 and $451 million in 2009-10;
- an expected increase in Family Tax Benefit expenses of $218 million in 2009-10 as a result of a higher number of claimants;
- higher than expected use of child care resulting in Child Care Tax Rebate expenses rising by $150 million in 2008-09 and $100 million in 2009-10;
- higher than forecast Disability Support Pension expenses of $101 million in 2008-09 and $166 million in 2009-10 as a result of higher than expected beneficiary numbers;
- an upwards revision to Youth Allowance expenses of $52 million in 2008-09 and $163 million in 2009-10 reflecting higher than expected average payments and an increase in the number of claimants;

- an anticipated increase in the cost of the Pharmaceutical Benefits Scheme and Medicare Benefits Schedule expenses of $657 million in 2008-09 and of $510 million in 2009-10. This increase is largely owing to stronger than previously expected demand for pharmaceuticals, the Parliament's decision to continue the Chronic Disease Dental Scheme and higher than anticipated demand for medical services;

- an upwards revision to estimated fuel tax credit expenses of $359 million in 2008-09 and $216 million in 2009-10 consistent with a higher than previously forecast number of recipients of the program;

- a revised estimate of the accruing public sector superannuation liability that is expected to reduce civilian superannuation expenses by $277 million in 2008-09 and increase forecast expenses by $76 million in 2009-10; and

- a downwards revision to estimated GST expenses to state and territory governments of $1.7 billion in 2008-09 and $2.8 billion in 2009-10 reflecting an anticipated fall in consumption spending.

VARIATIONS IN NET DEBT

The Australian Government general government sector net debt for 2008-09 is estimated to be -$16.2 billion (-1.3 per cent of GDP). Net debt is expected to increase across the forward estimates to 5.2 per cent of GDP in 2011-12.

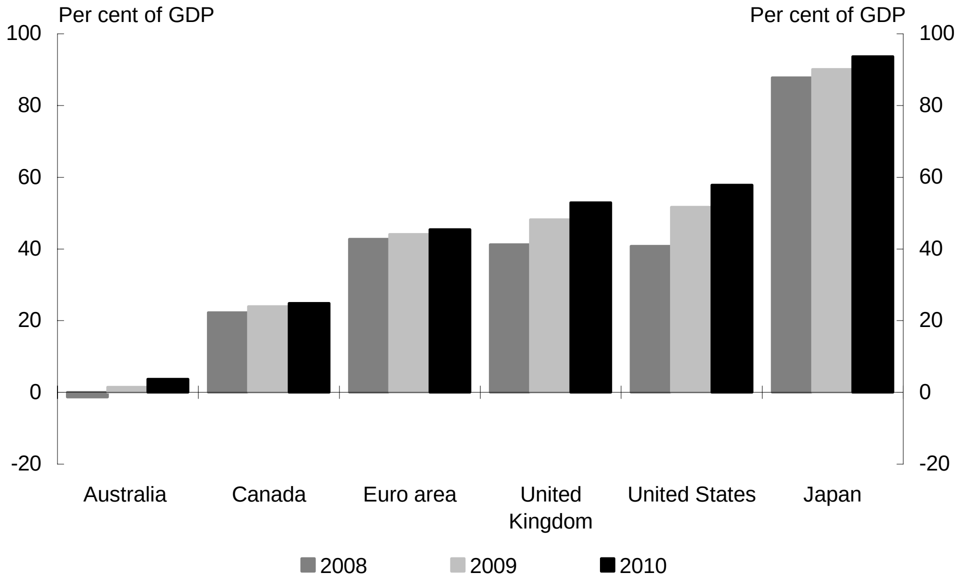
The Government will finance the projected budget deficits by issuing Commonwealth Government Securities (CGS). For this purpose the Government will seek to amend the *Commonwealth Inscribed Stock Act 1911*.

The overwhelming majority of the increase in net debt is due to the collapse in tax receipts resulting from the deteriorating global economic outlook and the unwinding of the commodities boom. A secondary impact is the increase in payments typically associated with a slowing economy. A third component is the Government's temporary stimulus measures put in place to support growth and jobs.

As the economy recovers and grows above trend, the Government will take action to return the budget to surplus. These surpluses will be drawn upon to retire debt as rapidly as economic circumstances permit.

Australian Government net debt remains very low by international standards. The average net debt for OECD countries in 2010 is estimated to be around 45 per cent of GDP. Chart 4.2 below illustrates the strength of the Australian Government's net debt position compared to other industrialised countries.

Chart 4.2: Net debt selected countries 2008-2010



Source: Treasury, HM Treasury, Congressional Budget Office, OECD Economic Outlook 84. Data refer to calendar years except Australian data are for the Australian Government general government sector and refer to financial years from 2008-09, and UK data refer to financial years from 2008-09.

Australian Government net debt is also low in comparison to the overall level of private sector indebtedness in the economy. Over the past 12 years private foreign net debt rose from $123 billion (24 per cent of GDP) to $616 billion (53 per cent of GDP). As has been shown over many years the level of Australian net foreign debt is sustainable and not a constraint on growth.