

STATEMENT 2: FISCAL OUTLOOK

This statement summarises the main budget aggregates for the Australian Government general government sector.

The fiscal outlook for Australia remains strong, with the Government forecasting an underlying cash surplus of \$8.9 billion in 2005-06. Across the forward estimates, the Government has maintained the budget in a strong surplus position after providing for personal income tax cuts of \$21.7 billion and a \$3.6 billion welfare reform package.

The Government's sound fiscal management will see further reductions to net debt across the forward years. The continued strengthening of net worth through strong surpluses and initiatives such as the Future Fund leaves government finances well placed to deal with the medium-term fiscal pressures projected in the Productivity Commission's recent report on the *Economic Implications of an Ageing Australia*.

This Budget provides for around \$16 billion to be allocated to the Future Fund in 2005-06.

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STATEMENT 2: FISCAL OUTLOOK

The fiscal outlook for Australia remains strong, with the Government forecasting its eighth budget surplus. Across the forward estimates period, the Government has maintained the budget in surplus after providing \$21.7 billion of personal income tax cuts, \$3.6 billion on a *Welfare to Work* package to improve work incentives and labour force participation and \$2.5 billion to abolish the superannuation surcharge.

BUDGET AGGREGATES

An underlying cash surplus of \$8.9 billion is expected in 2005-06 compared with an estimated surplus of \$4.5 billion at the *Mid-Year Economic and Fiscal Outlook 2004-05* (MYEFO). Underlying cash surpluses are projected to continue across the forward estimates.

In accrual terms, a fiscal surplus in 2005-06 of \$7.4 billion is forecast compared to \$3.5 billion at MYEFO. Fiscal surpluses are expected to continue across the forward estimates.

Table 1: Australian Government general government sector budget aggregates^(a)

	Actual	Estimates		Projections		
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Revenue (\$b)	187.6	202.7	214.5	222.9	233.4	245.3
Per cent of GDP	23.1	23.5	23.1	23.0	23.2	23.1
Expenses (\$b)	182.0	195.0	206.1	214.8	225.4	236.6
Per cent of GDP	22.4	22.6	22.2	22.2	22.4	22.3
Net operating balance (\$b)	5.6	7.7	8.4	8.1	8.0	8.8
Net capital investment (\$b)	0.7	0.7	1.0	0.6	0.0	-0.3
Fiscal balance (\$b)	4.8	7.0	7.4	7.5	8.0	9.0
Per cent of GDP	0.6	0.8	0.8	0.8	0.8	0.9
Underlying cash balance (\$b)(b)	8.0	9.2	8.9	7.9	8.5	9.3
Per cent of GDP	1.0	1.1	1.0	0.8	0.8	0.9
<i>Memorandum item:</i>						
Headline cash balance (\$b)	7.6	7.9	7.9	18.2	18.6	19.4

(a) All estimates are based on Government Finance Statistics (GFS) standards, but with goods and services tax (GST) revenue collected on behalf of the states and territories netted off revenue and expenses.

(b) Excludes expected Future Fund earnings from 2005-06 onwards. For further explanation refer to Statement 2 Box 1 and Statement 8.

VARIATIONS TO THE FISCAL BALANCE ESTIMATES

The upward revision of \$3.9 billion in the 2005-06 fiscal surplus since MYEFO largely reflects higher than anticipated revenue from companies, small unincorporated

businesses and personal investors. This is partly offset by the impact of personal income tax cuts and the Government's *Welfare to Work* package.

Table 2 provides a reconciliation of the fiscal balance estimates between the 2004-05 Budget, the 2004-05 MYEFO and the 2005-06 Budget.

Table 2: Reconciliation of 2004-05 Budget, 2004-05 MYEFO and 2005-06 Budget fiscal balance estimates

	Estimates		Projections	
	2004-05	2005-06	2006-07	2007-08
	\$m	\$m	\$m	\$m
2004-05 Budget fiscal balance	698	712	2,291	2,619
Per cent of GDP	0.1	0.1	0.2	0.3
Changes between 2004-05 Budget and MYEFO				
Effect of policy decisions(a)				
Revenue	-11	-401	-1,115	-1,025
Expenses	1,646	2,943	3,250	3,367
Net capital investment	227	116	104	172
Total policy decisions impact on fiscal balance(b)	-1,885	-3,460	-4,469	-4,564
Effect of parameter and other variations				
Revenue	6,303	6,514	6,486	7,237
Expenses	-142	16	-919	-1,418
Net capital investment	330	254	244	133
Total parameter and other variations impact on fiscal balance(b)	6,115	6,245	7,161	8,522
2004-05 MYEFO fiscal balance	4,929	3,497	4,984	6,577
Per cent of GDP	0.6	0.4	0.5	0.6
Changes between MYEFO and 2005-06 Budget				
Effect of policy decisions(a)				
Revenue	-35	-3,472	-6,675	-7,662
Expenses	932	2,040	3,041	3,201
Net capital investment	12	251	166	83
Total policy decisions impact on fiscal balance(b)	-978	-5,763	-9,882	-10,946
Effect of parameter and other variations				
Revenue	3,258	10,486	11,986	11,725
Expenses	272	456	-598	-690
Net capital investment	-66	354	228	44
Total parameter and other variations impact on fiscal balance(b)	3,053	9,676	12,356	12,372
2005-06 Budget fiscal balance	7,003	7,410	7,458	8,003
Per cent of GDP	0.8	0.8	0.8	0.8

(a) Excludes the public debt net interest effect of policy measures.

(b) 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.

Variations in revenue estimates

Total revenue for 2005-06 has been revised up by \$7.0 billion since MYEFO, reflecting higher estimated revenue from companies, personal investors and small

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unincorporated businesses. These upward revisions have been partly offset by the impact of the Government's decision to provide further personal income tax cuts.

Policy decisions since the 2004-05 MYEFO are expected to reduce taxation revenue by around \$3.5 billion in 2005-06 and around \$26.1 billion over the forward years. The major policy decisions affecting revenue over the four year period 2005-06 to 2008-09 are outlined below.

- The personal income tax cuts taking effect from 1 July 2005 and 1 July 2006 will reduce revenue by \$3.1 billion in 2005-06, and \$21.7 billion over the forward estimates period.
- The abolition of the superannuation contributions and termination payments surcharge for contributions made from 1 July 2005 will reduce revenue by \$650 million in 2006-07 and \$2.5 billion over the forward estimates.
- The removal of the 3 per cent tariff applying to business inputs imported under a tariff concession order, effective from 11 May 2005, will reduce revenue by \$36 million in 2004-05, \$290 million in 2005-06 and \$1.3 billion over the forward estimates.
- The extension of the eligibility criteria for the mature age worker tax offset will reduce revenue by \$70 million in 2005-06 and \$295 million over the forward estimates period.
- A four-year income tax exemption for temporary residents for most foreign source income, including capital gains, commencing from July 2006, will reduce revenue by \$50 million in 2007-08 and \$105 million over the forward estimates.
- Changes to the capital gains tax treatment of non-resident investors in Australia will reduce revenue by \$50 million in 2005-06 and \$230 million over the forward estimates.
- Recognition for tax purposes of certain currently unrecognised business capital expenditures ('blackhole expenditures') from 2006-07 will reduce revenue by \$35 million in 2006-07, increasing in later years, to a cost of \$205 million over the forward estimates.
- Changes to the capital allowance treatment of film copyright to ensure the application of the effective life depreciation regime, with effect to expenditures after 1 July 2004, will reduce revenue by \$15 million in 2005-06 and \$175 million over the forward estimates.
- Abolition of the foreign loss and foreign tax credit quarantining, with effect from the first income year after Royal Assent, will reduce revenue by \$25 million in 2007-08 and in 2008-09.

Parameter and other variations are expected to increase revenue in 2005-06 by \$10.5 billion, relative to the MYEFO forecasts. These upward revisions reflect the flow on effect of a stronger expected revenue base in 2004-05 and a significant upward revision to nominal GDP growth in 2005-06.

- Relative to MYEFO, nominal GDP growth for 2005-06 has been revised up by $1\frac{3}{4}$ percentage points to $7\frac{1}{2}$ per cent – despite a slight downward revision to real GDP growth – reflecting significant increases in estimated growth in the GDP deflator as a result of recent increases in commodity export prices (see Box 3, Statement 3).
- These increases are expected to lift corporate profits significantly in 2005-06, which – due to the timing of company tax collections – will boost revenue in both 2005-06 and 2006-07. Reflecting this, estimated company income tax revenue for 2005-06 has been revised up by \$4.7 billion since MYEFO, and by a further \$3.8 billion in 2006-07.

The Budget estimates also incorporate adjustments to forecasting methodology to align the estimates more closely with recent experience (see Box 1, Statement 5). These adjustments affect the gross other individuals, refunds for individuals and company income tax revenue heads and generally increase estimated revenue from MYEFO for 2005-06 and the projection years.

Relative to MYEFO, estimated total revenue for 2004-05 has been revised up by \$3.2 billion, largely owing to higher expected revenue from wage and salary earners, personal investors and small unincorporated businesses.

More detail on how the revised outlook for the economy has affected individual revenue heads over the forward estimates period is provided in Statement 5. A full description of all policy measures since MYEFO is provided in Budget Paper No. 2, *Budget Measures 2005-06*.

Variations in expense estimates

Since MYEFO, estimated expenses for 2005-06 have increased by \$2.5 billion reflecting the impact of new policy decisions of \$2.0 billion and parameter and other variations of \$0.5 billion.

Major policy decisions since MYEFO that have increased expenses include:

- \$430 million in 2005-06 (\$2 billion over the five years from 2004-05) to increase the maximum rate of Family Tax Benefit Part B, as announced in the *Extra Assistance for Families* election commitment;

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- \$207 million in 2005-06 (\$797 million over four years) to continue assisting the Solomon Islands Government in the restoration of law and order and broad-ranging economic, governance and public sector reforms;
- \$177 million in 2005-06 (\$211 million over four years from 2004-05) for the deployment of additional troops to provide security and training in Southern Iraq;
- \$174 million in 2005-06 (\$211 million over three years from 2004-05) to continue the Australian Defence Force contribution to stabilisation and reconstruction activities in Iraq (Operation Catalyst);
- \$170 million in 2005-06 (\$3.5 billion over four years) for the *Welfare to Work* package to increase workforce participation and reduce welfare dependency while retaining a strong safety net for those in need;
- \$115 million in 2005-06 (\$500 million over five years from 2004-05) for the grants component of the Australian-Indonesia Partnership for Reconstruction and Development Package to help Indonesia restore health, education and local government services in the worst tsunami affected areas, and improve economic governance and public administration. This is in addition to the \$500 million in concessional loans over five years to be directed to reconstruction and rehabilitation of major infrastructure across Indonesia; and
- \$112 million in 2005-06 (\$579 million over four years) to continue funding for quarantine border protection programmes delivered by the Australian Quarantine and Inspection Service, the Australian Customs Service and Biosecurity Australia.

Major policy decisions reducing expenses include:

- a \$139 million reduction in 2005-06 (\$1 billion over five years from 2004-05) due to changes to listing arrangements for pharmaceuticals which will see a price reduction of at least 12.5 per cent when the first new brand of an already listed medicine is added to the Pharmaceutical Benefits Scheme; and
- an \$84 million decrease in 2005-06 (\$335 million over four years) resulting from the withdrawal of the funding offer to state and territory governments to extend concessions to Commonwealth Seniors Health Card holders.

In 2005-06, parameter and other variations have increased forecast expenses by \$0.5 billion since MYEFO largely reflecting:

- a \$588 million increase in estimated civilian superannuation expenses, largely due to higher nominal interest expense reflecting changes in the estimate of the Consumer Price Index;

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- a \$398 million increase in Defence expenses reflecting an increase in the estimated non-farm GDP deflator, which is used to index Defence operating expenses;
- a rephasing of \$300 million by the Department of Defence of its major capital equipment acquisition programme from beyond the forward estimates period into 2005-06 to meet current funding requirements, including from expected improvements in performance in the delivery of the Defence Capability Plan;
- a \$232 million increase in expenses administered by the Australian Taxation Office resulting from a change in accounting policy which recognises certain payments in the year of accrual rather than the year of payment;
- a \$220 million increase in expenses due to a reclassification of Defence Housing Authority expenses following the adoption of the Inventory Accounting Standard which has resulted in expenses being recognised for the purpose of Government Finance Statistics;
- a \$200 million increase in Energy Grants Credit Scheme expenses, flowing on from higher than forecast claims activity in 2004-05 due to expected increases in the mining and road transport sectors; and
- a \$70 million increase in Private Health Insurance Rebate expenses, primarily resulting from higher than expected premium increases and levels of insurance coverage.

The above increase in expenses is partially offset by:

- a \$439 million reduction in anticipated Newstart Allowance and Youth Allowance expenses, largely due to the stronger labour market reducing the expected number of unemployment benefit recipients;
- a \$120 million reduction for Superannuation Guarantee Programme expenses, primarily due to delays in processing claims;
- a \$69 million reduction in expenses for the Cleaner Fuels Grant Scheme due to a lower than forecast take-up of bio-diesel production grants;
- the removal of the provision for the implementation of election commitments now reported as policy measures; and

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- the regular draw-down of the conservative bias allowance¹ reducing estimated expenses by around \$1 billion each year from 2005-06.

In 2004-05, estimated expenses have increased by \$1.2 billion since MYEFO. This largely reflects new spending of \$932 million including \$314 million for a one-off lump-sum payment to eligible carers and \$212 million towards the Family Tax Benefit Part B package. Parameter and other variations have increased expenses by \$272 million and include a \$1 billion increase in expenses administered by the Australian Taxation Office resulting from a change in accounting policy, partially offset by other variations including a \$140 million underspend associated with the delayed deployment of Australian Federal Police staff to Papua New Guinea.

More detailed information on expenses can be found in Statement 6. A full description of all policy measures since MYEFO can be found in Budget Paper No. 2, *Budget Measures 2005-06*.

Variations in net capital investment estimates

In 2005-06, forecast net capital investment has increased by \$605 million since the 2004-05 MYEFO. This represents the combined effect of:

- new policy measures of \$251 million, including \$56 million largely to ensure the *Welfare to Work* reforms are supported by high quality information technology, \$42 million of additional investment in improved security for Australian diplomatic missions, \$16 million to continue assisting the Solomon Islands Government in the restoration of law and order and broad ranging economic, governance and public sector reforms, and \$11 million for the deployment of additional troops to provide security and training in Southern Iraq; and
- parameter and other variations of \$354 million, largely due to a \$195 million revision in estimated Defence Housing Authority sales, \$101 million in capital investment by the Overseas Property Office and a further \$34 million investment for the construction of the Christmas Island Immigration Reception and Processing Centre. These increases are partially offset by sales in the Defence Property Sales programme estimated at \$89 million.

In 2004-05, estimated net capital investment has decreased by \$54 million since MYEFO, largely reflecting parameter and other variations.

1 The forward estimates include an allowance for the established tendency of existing government policy (particularly demand driven programmes) 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 forward estimates. This allowance, known as the conservative bias allowance, is progressively reduced so that the budget year conservative bias allowance is zero by budget night.

More detailed information on net capital investment can be found in Statement 6. A full description of all policy measures since the MYEFO can be found in Budget Paper No. 2, *Budget Measures 2005-06*.

CASH FLOWS

In 2005-06, an underlying cash surplus of \$8.9 billion is expected, compared with the MYEFO estimate of \$4.5 billion. The improvement in the underlying cash surplus is largely due to the same variations that affect the fiscal balance. From 2005-06 onwards, the exclusion of Future Fund earnings lowers the underlying cash balance relative to the fiscal balance.

Box 1: Budget treatment of expected Future Fund earnings

The Government has announced that it will establish a Future Fund to offset superannuation liabilities that would otherwise be a burden to future generations.

The Government is reporting the underlying cash balance excluding Future Fund earnings from 2005-06 onwards because the earnings will be reinvested to meet future superannuation payments and are therefore not available for current spending. However, Future Fund earnings are included in the fiscal balance because superannuation expenses relating to future cash payments are recorded in the fiscal balance estimates.

The rate of return on the Future Fund investments will depend on the actual asset allocation across different asset classes. Once the enabling legislation has passed, the Future Fund Management Board will be responsible for investments in accordance with a broad investment mandate. In the absence of an investment mandate, the budget and forward estimates assume the initial investment of seed capital will earn a return equal to yields on other term deposits held by the Government.

Expected Future Fund earnings are separately identified in the Australian Government cash flow statement in Statement 2, Appendix B and the historic tables in Statement 13.

Table 3 provides a summary of Australian Government general government sector cash flows.

Table 3: Summary of Australian Government general government sector cash flows^(a)

	Estimates		Projections		
	2004-05 \$b	2005-06 \$b	2006-07 \$b	2007-08 \$b	2008-09 \$b
Cash receipts					
Operating cash receipts	202.2	214.2	221.7	232.3	244.1
Capital cash receipts(b)	0.4	0.3	0.2	0.3	0.2
Total cash receipts	202.7	214.5	221.9	232.5	244.2
Cash payments					
Operating cash payments	190.9	202.0	210.4	220.7	231.9
Capital cash payments(c)	2.6	3.1	2.5	2.3	2.0
Total cash payments	193.4	205.1	213.0	223.0	233.9
Finance leases and similar arrangements(d)	0.0	0.0	0.0	0.0	0.0
GFS cash surplus(+)/deficit(-)	9.2	9.4	8.9	9.5	10.3
Per cent of GDP	1.1	1.0	0.9	0.9	1.0
<i>less</i> Future Fund earnings	0.0	0.5	0.9	1.0	1.1
Underlying cash balance(e)	9.2	8.9	7.9	8.5	9.3
Per cent of GDP	1.1	1.0	0.8	0.8	0.9
<i>Memorandum items:</i>					
Net cash flows from investments in financial assets for policy purposes(f)	-1.3	-1.5	9.3	9.1	9.0
<i>plus</i> Future Fund earnings	0.0	0.5	0.9	1.0	1.1
Headline cash balance	7.9	7.9	18.2	18.6	19.4

(a) Cash flows are derived from the accrual GFS framework excluding GST.

(b) Equivalent to cash receipts from the sale of non-financial assets in the GFS cash flow statement.

(c) Equivalent to cash payments for purchases of new and second-hand non-financial assets in the GFS cash flow statement.

(d) 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.

(e) Excludes expected Future Fund earnings from 2005-06 onwards. For further explanation refer to Statement 2 Box 1 and Statement 8.

(f) Under the cash budgeting framework, these cash flows were referred to as net advances.

Table 4 provides a reconciliation of the variations in the underlying cash balance estimates.

Table 4: Reconciliation of Australian Government general government sector underlying cash balance estimates

	Estimates		Projections	
	2004-05 \$m	2005-06 \$m	2006-07 \$m	2007-08 \$m
2004-05 Budget underlying cash balance	2,391	1,587	3,438	4,501
Changes from 2004-05 Budget to MYEFO				
Effect of policy decisions(a)	-1,728	-3,355	-4,423	-4,541
Effect of parameter and other variations	5,543	6,227	6,682	7,625
Total variations	3,816	2,872	2,259	3,084
2004-05 MYEFO underlying cash balance	6,206	4,459	5,697	7,584
Changes from MYEFO to 2005-06 Budget				
Effect of policy decisions(a)	-744	-5,755	-9,377	-10,687
Effect of parameter and other variations	3,759	10,678	12,556	12,600
Total variations	3,015	4,923	3,179	1,912
less Future Fund earnings	0	462	943	997
2005-06 Budget underlying cash balance(b)	9,221	8,921	7,933	8,500

(a) Excludes the public debt net interest effect of policy measures.

(b) Excludes expected Future Fund earnings from 2005-06 onwards. For further explanation refer to Statement 2 Box 1 and Statement 8.

While the 2005-06 fiscal balance has increased by \$3.9 billion since MYEFO, the underlying cash balance has increased by \$4.5 billion. This difference between the change in the underlying cash balance and the fiscal balance largely reflects increased superannuation expenses and Australian Taxation Office administered expenses resulting from a change in accounting treatment which affect the fiscal balance but not the cash balance. These differences are partly offset by Future Fund earnings, which are included in the fiscal balance but excluded from the underlying cash balance.

Headline cash balance

A headline cash surplus of \$7.9 billion is now forecast for 2005-06 compared with a surplus of \$3.0 billion at MYEFO. The increase in the headline cash surplus estimate since MYEFO largely reflects the increase in the underlying cash balance plus the inclusion of expected Future Fund earnings.

NET DEBT AND NET WORTH

With the budget remaining in cash surplus in 2005-06 and the forward years, further falls in net debt are expected. From its peak of 19.1 per cent of GDP in 1995-96, net debt is estimated to fall to \$6.1 billion (0.7 per cent of GDP) by the end of 2005-06. Net interest payments are also expected to fall over the forward estimates.

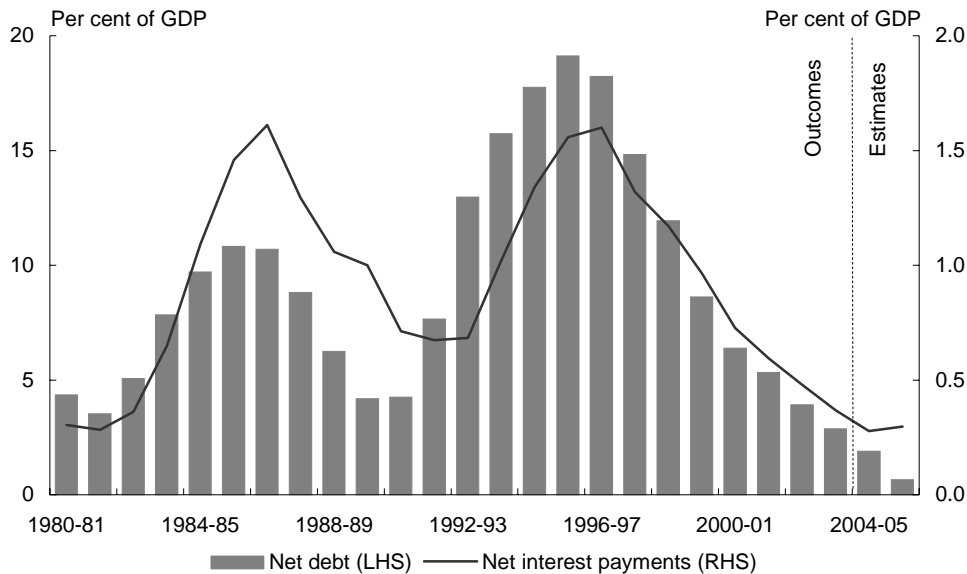
Table 5 and Chart 1 provide a summary of Australian Government general government sector net worth, net debt and net interest payments.

Table 5: Australian Government general government sector net worth, net debt and net interest payments

	Estimates		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
	\$b	\$b	\$b	\$b	\$b
Financial assets	119.4	127.9	138.5	151.5	163.4
Non-financial assets	41.3	42.4	43.1	43.0	42.8
Total assets	160.6	170.3	181.6	194.5	206.2
Total liabilities	194.7	198.1	202.0	208.2	212.1
Net worth	-34.1	-27.8	-20.4	-13.7	-5.9
Net debt(a)(b)	16.3	6.1	-14.0	-34.6	-56.4
Per cent of GDP	1.9	0.7	-1.5	-3.4	-5.3
Net interest payments(c)	2.4	2.8	1.2	-0.2	-1.3
Per cent of GDP	0.3	0.3	0.1	0.0	-0.1

- (a) 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.
- (b) Includes the impact of the further sale of the Australian Government's shareholding in Telstra, but may change as a result of the establishment of the Future Fund.
- (c) Australian Government cash interest payments less cash interest receipts. The 2005-06 estimates include the recognition in cash terms of the capital growth on inflation indexed bonds maturing in that year.

Chart 1: Australian Government general government sector net debt and net interest payments



Source: Data are from ABS Cat. No. 5513.0, Australian Government Final Budget Outcomes and Treasury estimates.

Australia's net debt is at low levels and is projected to fall over the forward estimates period. The net debt projections have improved considerably since MYEFO, reflecting larger than anticipated cash surpluses.

Australia's net debt position compares favourably to other industrialised countries. The ratio of Australia's total general government sector net debt to GDP is among the lowest in the OECD and is considerably lower than in Europe, Japan and the United States (see Statement 1).

Having peaked at \$8.4 billion in 1996-97, net interest payments are expected to decline to \$2.8 billion in 2005-06, representing annual interest savings of around \$5.7 billion.

Net worth is expected to improve from -\$34.1 billion in 2004-05 to -\$5.9 billion in 2008-09, mainly reflecting cumulative surpluses in the forward estimates. The prospects for net worth mean the Government's finances are well placed to deal with emerging fiscal pressures.

MEDIUM-TERM FISCAL OUTLOOK

Importance of fiscal sustainability

Delivering sustainable fiscal policy is a key requirement of good government. By not living beyond its means, the Government prevents costly burdens being placed on future generations. Further, when governments are fiscally responsible, they provide a secure investment environment that encourages growth.

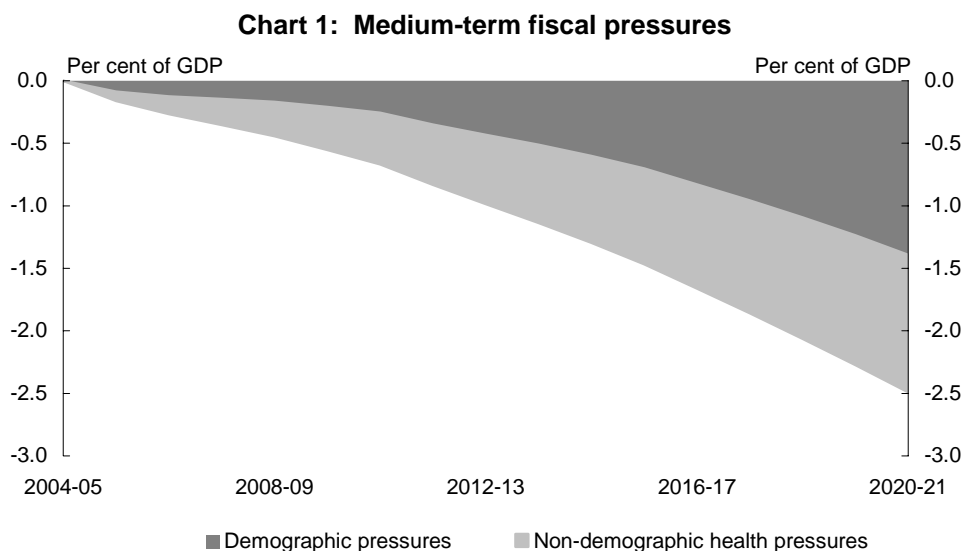
By reducing debt to manageable levels, the Government has put its finances in a sound position and generated substantial savings that can be directed to other purposes. However, sustainable fiscal policy is more than just prudent reduction of past debts. It involves managing all elements of the balance sheet – such as the unfunded superannuation liability – and a forward-looking strategy to address the looming fiscal pressures yet to affect Government finances.

The Government recognised the importance of fiscal sustainability by committing to the regular release of the Intergenerational Report, with the first report in 2002 foreshadowing a significant fiscal gap opening over the long term. The Government is committed to managing these fiscal pressures by implementing pro-growth policies that raise productivity and encourage greater participation in the economy. The Government complements this by taking a long-term view when managing the fiscal outlook. Without making moderate reforms today, more drastic policy solutions will become inevitable in the future.

Medium-term budget pressures

While the current budget position is strong, significant fiscal pressures will emerge beyond the forward estimates period. Demographic change is expected to lead to both lower taxation receipts – due to falls in workforce participation – and higher payments, mainly for pensions and health care. In this budget, the GDP projection in 2008-09 has been lowered by $\frac{1}{4}$ per cent, reflecting the initial step of recognising slowing economic growth from the ageing of the population. Medium-term pressures are generated from rising health care costs, relating to increasing demand for health services, technological advances and demographic change.

While these fiscal pressures are most evident over the long term, they will have significant effects within the next ten years. The Productivity Commission’s report on the *Economic Implications of an Ageing Australia* suggests that a fiscal gap of around 1.5 per cent of GDP will emerge by 2015-16; equivalent to \$13 billion in today’s terms. A breakdown of the impact of these fiscal pressures is reflected in Chart 1 below.



Source: Productivity Commission, 2005, *Economic Implications of an Ageing Australia*.

Improving fiscal sustainability

The Government already has a strong record on fiscal sustainability by reducing net debt by an estimated \$90 billion, from 19 per cent of GDP in 1995-96 to 0.7 per cent of GDP in 2005-06. This has freed up interest savings of around \$5.7 billion annually that can be applied to other fiscal pressures. In addition, the Government has released a series of packages designed to lower fiscal pressures over the medium to long term.

The Government’s currently unfunded superannuation liability to employees is the largest liability on the balance sheet at around \$91 billion in 2004-05. By establishing the Future Fund, the Government has pre-committed resources to meet future

superannuation payments. As Future Fund earnings are not available for other spending, they are excluded from the underlying cash balance. Funding superannuation now will reduce future pressures on the budget at a time when the Government will need to face the spending challenges of an ageing population.

In addition to establishing the Future Fund, the Government has closed entry to the Public Sector Superannuation Scheme to limit future growth in the liability. Overall, these reforms ensure that superannuation costs are not passed onto future generations at a time when other demographic pressures emerge.

Also in this budget the Government has announced a comprehensive reform package that will improve the outlook for workforce participation and place the welfare system on a more sustainable basis. New obligations to seek part-time work will ensure that those who are able to work do so. The combination of improved payment and income test arrangements, a new compliance regime that encourages people to meet their obligations and funding for a range of new and expanded services will increase participation by moving people out of welfare and into work.

Also, the introduction of the Child Care Tax Rebate and the provision of additional child care places assist parents returning to the workforce after having children. Together, these packages will lead to greater workforce participation that strengthens both the overall economy and the Government's finances over the medium term.

Healthcare costs currently represent 18 per cent of the Government expenses and will continue to grow strongly in the future. In particular, expenses for the Pharmaceutical Benefits Scheme increased by 11 per cent in 2003-04, reflecting higher general demand for health services – an effect that will be compounded through demographic change. The increase in PBS patient co-payments, the mandatory 12.5 per cent price reduction for generic drugs as well as the raising of the Medicare Safety Net thresholds are directed to returning healthcare to a sustainable footing so that future generations can also enjoy high quality health services.

APPENDIX A: REPORTING STANDARDS

The *Charter of Budget Honesty Act 1998* requires that the budget be based on external reporting standards, and that departures from applicable external reporting standards be identified.

The major external standards used for budget reporting purposes are:

- the Australian Bureau of Statistics' (ABS) accrual Government Finance Statistics (GFS) publication *Australian System of Government Finance Statistics: Concepts, Sources and Methods* Cat. No. 5514.0, which in turn is based on the International Monetary Fund (IMF) accrual GFS framework; and
- Australian Accounting Standards (AAS), including AAS 31 *Financial Reporting by Governments*.

The operating statement and balance sheet include an adjustment to take account of the estimated impact of the Australian Equivalents to International Financial Reporting Standards (AEIFRS) on Australian Government general government sector reporting. There is no immediate direct impact on the underlying cash balance and the GFS surplus/deficit in this statement and in Statement 9. There is an impact on both the fiscal balance and net worth in this statement and in the general government sector of Statement 9. The AEIFRS reporting requirements and impact on the AAS Statement of Financial Performance and Statement of Financial Position are outlined in Note 2 of Statement 10.

The Budget tables, with the exception of tables in Statement 9, do not include goods and services tax (GST) collections and equivalent payments to the states. However, under the *Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations*, all GST receipts are appropriated to the states and territories and thus are not available for expenditure by the Australian Government. Because the Australian Taxation Office collects GST as an agent for the states and territories, GST receipts are not shown as Australian Government revenue. Estimates of GST receipts are provided in Table 2 of Statement 8.

ABS GFS requires that provisions for bad and doubtful debts be excluded from the balance sheet. This treatment has not been adopted because excluding such provisions would overstate the value of Australian Government assets in the balance sheet (and would, therefore, be inconsistent with the market valuation principle).

The AAS financial statements currently record IMF Special Drawing Rights (SDRs) as a liability. This is consistent with AAS. The GFS statements also record SDRs as a liability. However, in accordance with the IMF's GFS manual, IMF SDRs are not treated as a liability in ABS GFS although they are treated this way in other IMF documentation. In view of these differences, the current approach will remain in place

pending further consultation with the IMF, and developments in train to harmonise GFS and AAS.

Similarly, the GFS financial statements currently adopt the AAS treatment for circulating coins. Under this treatment revenue is recognised upon the issue of coins and no liability is recorded, as there is no legal obligation requiring coins on issue to be repurchased by the Australian Government. However, in ABS GFS, coins on issue are treated as a liability and no revenue is recognised. The current accounting treatment will remain in place pending further consultation with the IMF, and developments in train to harmonise GFS and AAS.

The ABS GFS also requires defence weapons be treated as expenses. Defence weapons inventories are recorded as capital investment rather than expenses until such inventories can be reliably identified and measured. This treatment does not affect the underlying cash or fiscal balances.

In order to ensure the reporting of reliable AAS and GFS budget estimates and outcomes, taxation revenue is recognised the earlier of when an assessment of a tax liability is made or cash payment is received by the Australian Taxation Office or the Australian Customs Service. This method is permitted under both GFS and AAS when there is an inability to reliably measure taxation revenue at the time the underlying transactions or events occur. Accordingly, for most categories of taxation revenue, there is a short lag between the time at which the underlying economic activity giving rise to the tax liability occurs and when the revenue is recognised. Longer lags of up to a year occur for some elements of company and superannuation funds taxation.

Additional information on the reporting standards and budget concepts is provided in Statement 8.

APPENDIX B: BUDGET FINANCIAL STATEMENTS

The budget financial statements consist of an operating statement, balance sheet, cash flow statement and statement of other economic flows (reconciliation of net worth) for the Australian Government general government sector. The budget financial statements are based on GFS standards with the exception of the divergences discussed in Appendix A.

Table B1: Australian Government general government sector operating statement

	Estimates		Projections		
	2004-05 \$m	2005-06 \$m	2006-07 \$m	2007-08 \$m	2008-09 \$m
Revenue					
Taxation revenue	190,201	201,267	208,999	218,798	230,120
Current grants and subsidies	0	0	0	0	0
Sales of goods and services	4,828	4,965	5,194	5,330	5,363
Interest income	1,562	2,000	2,853	3,997	5,025
Dividend income	3,146	3,312	2,952	2,357	1,852
Other	2,929	2,967	2,884	2,924	2,966
Total revenue	202,666	214,511	222,882	233,405	245,326
Expenses					
Gross operating expenses					
Depreciation	1,892	2,140	2,252	2,341	2,361
Superannuation	2,487	2,363	2,409	2,434	2,479
Salaries and wages	11,922	12,617	12,828	13,164	13,668
Payment for supply of goods and services	45,246	48,395	50,538	52,858	54,020
Other operating expenses	2,814	2,584	2,618	2,770	2,917
<i>Total gross operating expenses</i>	<i>64,362</i>	<i>68,100</i>	<i>70,645</i>	<i>73,567</i>	<i>75,444</i>
Nominal superannuation interest expense	4,882	5,713	5,594	5,821	5,947
Other interest expenses	4,131	3,851	3,774	3,761	3,574
Other property expenses	0	0	0	0	0
Current transfers					
Grant expenses	37,203	40,559	40,742	42,293	42,892
Subsidy expenses	6,470	6,560	6,697	6,936	7,466
Personal benefit payments in cash	74,478	77,545	83,258	88,742	97,033
Other current transfers	0	0	0	0	0
<i>Total current transfers</i>	<i>118,151</i>	<i>124,664</i>	<i>130,697</i>	<i>137,972</i>	<i>147,390</i>
Capital transfers	3,486	3,754	4,097	4,279	4,213
Total expenses	195,012	206,081	214,806	225,400	236,568
Net operating balance	7,655	8,430	8,076	8,005	8,758
Net acquisition of non-financial assets					
Purchases of non-financial assets	2,487	2,920	2,392	2,429	2,104
<i>less</i> Sales of non-financial assets	<i>364</i>	<i>285</i>	<i>174</i>	<i>250</i>	<i>188</i>
<i>less</i> Depreciation	<i>1,892</i>	<i>2,140</i>	<i>2,252</i>	<i>2,341</i>	<i>2,361</i>
<i>plus</i> Change in inventories	<i>374</i>	<i>340</i>	<i>473</i>	<i>273</i>	<i>270</i>
<i>plus</i> Other movements in non-financial assets	<i>47</i>	<i>185</i>	<i>178</i>	<i>-111</i>	<i>-89</i>
Total net acquisition of non-financial assets	652	1,020	617	1	-264
Net lending/fiscal balance(a)	7,003	7,410	7,458	8,003	9,022

(a) The term fiscal balance is not used by the ABS.

Table B2: Australian Government general government sector balance sheet

	Estimates		Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09
	\$m	\$m	\$m	\$m	\$m
Assets					
Financial assets					
Cash and deposits	927	288	459	210	143
Advances paid	19,314	20,536	22,001	23,921	26,059
Investments, loans and placements(a)	31,066	38,096	56,389	77,150	96,186
Other non-equity assets	17,147	17,856	19,477	21,336	23,410
Equity(b)	50,895	51,137	40,166	28,854	17,570
<i>Total financial assets</i>	<i>119,351</i>	<i>127,913</i>	<i>138,493</i>	<i>151,472</i>	<i>163,368</i>
Non-financial assets					
Land	4,863	5,161	5,119	5,027	4,973
Buildings	13,894	14,008	14,263	14,428	14,536
Plant, equipment and infrastructure	8,411	8,578	8,716	8,546	8,256
Inventories	5,299	5,570	5,989	6,228	6,463
Heritage and cultural assets	6,698	6,739	6,766	6,787	6,808
Other non-financial assets	2,085	2,341	2,207	2,006	1,762
<i>Total non-financial assets</i>	<i>41,250</i>	<i>42,397</i>	<i>43,060</i>	<i>43,022</i>	<i>42,798</i>
Total assets	160,601	170,310	181,553	194,494	206,166
Liabilities					
Deposits held	365	365	365	365	365
Advances received	0	0	0	0	0
Government securities(a)	61,452	59,284	59,106	60,932	60,633
Loans	5,595	5,164	5,190	5,212	4,912
Other borrowing	224	189	158	124	90
Superannuation liability	91,071	95,578	98,801	101,997	105,168
Other employee entitlements and provisions	7,605	7,812	7,918	8,080	8,266
Other non-equity liabilities	28,416	29,699	30,436	31,493	32,655
Total liabilities	194,727	198,089	201,974	208,201	212,088
Net worth(c)	-34,126	-27,779	-20,421	-13,708	-5,922
Net debt(d)	16,328	6,080	-14,031	-34,649	-56,389

(a) For 2005-06 and the forward years, the netting of assets — investments, loans and placements — and liabilities — government securities — has been removed so that both lines are now reported on a gross basis.

(b) Equity includes the valuation of the Telstra shareholding, which is valued at the average of the daily share price over a 90-day period, except in the sale years where the valuation is based on the expected sale price.

(c) Net worth is calculated as total assets minus total liabilities.

(d) 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.

Table B3: Australian Government general government sector cash flow statement^(a)

	Estimates		Projections		
	2004-05 \$m	2005-06 \$m	2006-07 \$m	2007-08 \$m	2008-09 \$m
Cash receipts from operating activities					
Taxes received	186,205	197,829	204,975	214,781	225,895
Receipts from sales of goods and services	5,015	5,165	5,385	5,526	5,565
Grants and subsidies received	0	0	0	0	0
Interest receipts	1,460	1,828	2,649	3,783	4,789
Dividends	3,808	3,632	2,952	2,357	1,852
GST input credits received by general government	2,908	2,844	2,882	2,976	3,018
Other receipts	2,849	2,926	2,875	2,851	2,938
Total operating receipts	202,246	214,224	221,717	232,275	244,057
Cash payments for operating activities					
Payments for goods and services	-48,518	-51,455	-53,809	-56,082	-57,310
Grants and subsidies paid	-45,200	-49,195	-50,285	-52,167	-52,753
Interest paid	-3,856	-4,587	-3,808	-3,534	-3,450
Personal benefit payments	-73,664	-76,487	-82,415	-88,071	-96,604
Salaries, wages and other entitlements	-16,508	-17,102	-17,371	-18,002	-18,693
GST payments by general government to taxation authority	-120	-120	-122	-123	-124
Other payments for operating activities	-2,988	-3,079	-2,635	-2,730	-2,958
Total operating payments	-190,855	-202,026	-210,443	-220,710	-231,892
Net cash flows from operating activities	11,391	12,198	11,273	11,565	12,165
Cash flows from investments in non-financial assets					
Sales of non-financial assets	416	291	175	250	188
Purchases of non-financial assets	-2,579	-3,102	-2,549	-2,313	-2,011
Net cash flows from investments in non-financial assets	-2,163	-2,812	-2,374	-2,063	-1,823
Net cash flows from investments in financial assets for policy purposes	-1,317	-1,518	9,286	9,054	9,022
Cash flows from investments in financial assets for liquidity purposes					
Increase in investments	-7,456	-7,217	-18,306	-20,751	-19,023
Net cash flows from investments in financial assets for liquidity purposes	-7,456	-7,217	-18,306	-20,751	-19,023
Cash flows from financing activities					
Advances received (net)	0	0	0	0	0
Borrowing (net)	188	-1,579	-30	1,928	-481
Deposits received (net)	0	0	0	0	0
Other financing (net)	-1,306	288	322	18	72
Net cash flows from financing activities	-1,118	-1,291	291	1,946	-408
Net increase/decrease in cash held	-663	-639	171	-249	-67
Net cash from operating activities and investments in non-financial assets	9,227	9,387	8,899	9,502	10,342
Finance leases and similar arrangements ^(b)	-7	-4	-23	-5	-4
GFS cash surplus(+)/deficit(-)	9,221	9,383	8,876	9,497	10,338
less Future Fund earnings	0	462	943	997	1,054
Equals underlying cash balance	9,221	8,921	7,933	8,500	9,284
<i>plus</i> net cash flows from investments in financial assets for policy purposes	-1,317	-1,518	9,286	9,054	9,022
<i>plus</i> Future Fund earnings	0	462	943	997	1,054
Equals headline cash balance	7,904	7,865	18,163	18,550	19,360

(a) A positive number denotes a cash inflow; a negative sign denotes a cash outflow.

(b) 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.

Table B4: Australian Government general government sector statement of other economic flows (reconciliation of net worth)

	Estimates		Projections		
	2004-05 \$m	2005-06 \$m	2006-07 \$m	2007-08 \$m	2008-09 \$m
Opening net worth	-37,803	-34,126	-27,779	-20,421	-13,708
Opening net worth adjustments(a)	-1,741	0	0	0	0
Adjusted opening net worth	-39,544	-34,126	-27,779	-20,421	-13,708
Change in net worth from operating transactions	7,655	8,430	8,076	8,005	8,758
Change in net worth from other economic flows					
Revaluation of equity(b)	1,301	261	322	-19	4
Net writedowns of assets (including bad and doubtful debts)	-2,226	-1,447	-1,650	-1,693	-1,306
Assets recognised for the first time	23	94	80	58	58
Liabilities recognised for the first time	0	0	0	0	0
Actuarial revaluations	-937	0	0	0	0
Net foreign exchange gains	-384	0	0	0	0
Net swap interest received	180	102	96	77	70
Market valuation of debt	-195	371	303	257	148
Other economic revaluations(c)	2	-1,463	131	29	53
Total other economic flows	-2,236	-2,083	-717	-1,291	-973
Closing net worth	-34,126	-27,779	-20,421	-13,708	-5,922

- (a) Decrease in net worth arising from a change in recognition of family tax benefits and other expenses from a cash to an accrual basis.
- (b) Revaluations of equity reflect changes in the market valuation of commercial entities, including a change in the value of the Telstra shareholding which is valued at the average daily share price over a 90-day period, except in the sale years where the valuation is based on the expected sale price. This line also reflects any equity revaluations at the point of disposal or sale.
- (c) Largely reflects revaluation of assets and liabilities and Australian Equivalents to International Financial Reporting Standards adjustments.

APPENDIX C: SENSITIVITY OF EXPENSES AND REVENUE TO ECONOMIC DEVELOPMENTS

A guide to the sensitivity of the forward estimates of expenses and revenue due to variations in economic parameters in 2005-06 is provided in Table C1. It is important to note that the sensitivity analysis gives only a 'rule of thumb' indication of the impact on the budget of changes in prices, wages and other parameters. In each case, the analysis presents the estimated effects of a change in one economic variable only and does not attempt to capture the linkages between economic variables that characterise changes in the economy more broadly.

Table C1: Sensitivity of expenses and revenue to changes in economic parameters

	2005-06	2006-07	2007-08	2008-09
	\$m	\$m	\$m	\$m
Expenses				
Prices	1,310	860	900	920
Wages	120	410	450	470
Unemployment benefit recipients	250	250	260	270
Safety Net Adjustment	40	150	240	340
Revenue				
Prices	50	110	110	110
Wages	1,570	1,690	1,800	1,930
Employment	1,080	1,150	1,240	1,320
Private final demand	280	290	300	300
Profit	340	560	610	650

EXPENSES

On the expenses side, the sensitivity analysis of the estimates provides for the following assumptions about changes to four broad groups of parameters. An increase in any of the parameters considered will lead to an increase in expenses and a decrease in any of the parameters will lead to a reduction in expenses.

Prices

All price growth rates are assumed to change by one percentage point in the September quarter 2005 and to remain unchanged subsequently, with wage and salary growth rates left unchanged through the Budget and forward years.

- The effect of a change in prices is due to the indexation of Australian Government expenses and a large one-off impact on superannuation liabilities in 2005-06, which in turn impacts on the superannuation interest expense.

Wages

All wage and salary growth rates are assumed to change by one percentage point in the September quarter 2005 and to remain unchanged subsequently, with all price growth rates left unchanged through the Budget and forward years.

- The effect of a change in wage and salary growth rates is largely due to the Government's commitment to maintain selected pensions at a minimum of 25 per cent of Male Total Average Weekly Earnings. The wages effect in Table C1 above does not include changes to wage and salary payments in Australian Government departmental expenses.

Unemployment Benefit recipients (includes Newstart Allowance and Unemployed Youth Allowance recipients)

The total number of recipients is assumed to change by 5 per cent in the Budget year and the following years.

Safety Net Adjustment

The Safety Net Adjustment determined by the Australian Industrial Relations Commission is assumed to change by \$2 per week in 2005-06 and the following years.

- About \$50 billion of expenses in 2005-06, comprising agency departmental expenses, other Australian Government Own Purpose Expenses and Specific Purpose Payments to the states of a departmental expense nature, are indexed to weighted averages of movements in the Consumer Price Index and the Safety Net Adjustment.

REVENUE

On the revenue side, the sensitivity analysis of the estimates provides for the following assumptions about changes to five broad groups of parameters. An increase in any of the parameters considered will lead to an increase in revenue and a decrease in any of the parameters will lead to a reduction in revenue.

Prices

All price deflators are assumed to change by one percentage point at the start of the September quarter 2005, with wage deflators left unchanged.

- A change in prices affects revenue primarily through changes in other excise.

Wages

All wage and salary growth rates are assumed to change by one percentage point from the beginning of the September quarter 2005, with price deflators left unchanged.

- A change in wage and salary growth rates affects revenue through changes in gross income tax withholding and fringe benefits tax.

Employment

The level of employment is assumed to change by one percentage point from the beginning of the September quarter 2005, with no change in the composition of employment.

- A change in employment affects revenue through increases in gross income tax withholding.

Private final demand

The level of private final demand (consumption plus investment) is assumed to change by one percentage point from the beginning of the September quarter 2005, with no change in the composition of demand.

- A change in private final demand affects revenue primarily through changes in excise and customs duty collections.

Profits

The level of company profits is assumed to change by one percentage point from the beginning of the September quarter 2005.

- A change in the level of company profits affects revenue through changes in company tax collections.

