

PART I: MAINTAINING SUSTAINABLE GOVERNMENT FINANCES

Broadly defined, sustainability requires the maintenance of appropriate economic, social and environmental conditions through time to ensure the wellbeing of future generations is not compromised by the activities of the current generation.

The overarching objective of the Government's economic policy is to improve the wellbeing of Australians in a way that can be sustained over time. This relates to both the current generation of Australians and future generations. The Government's policy framework aims to ensure that economic, social and environmental policies complement each other to bring about sustainable improvements in wellbeing.

This report assesses the financial implications of continuing current Government policies over the next four decades. The focus is on the long-term consequences of current policy commitments on the overall budget balance.

Achieving underlying cash balance, on average, over the longer term is consistent with stabilising nominal levels of Commonwealth general government net debt, as the underlying cash balance in a period is broadly similar to the change in net debt.¹ Moreover, maintaining budget balance, on average, is also consistent with improving Commonwealth general government net worth over time (assuming the Commonwealth's capital stock grows).²

THE BENEFITS OF SUSTAINABLE GOVERNMENT FINANCES

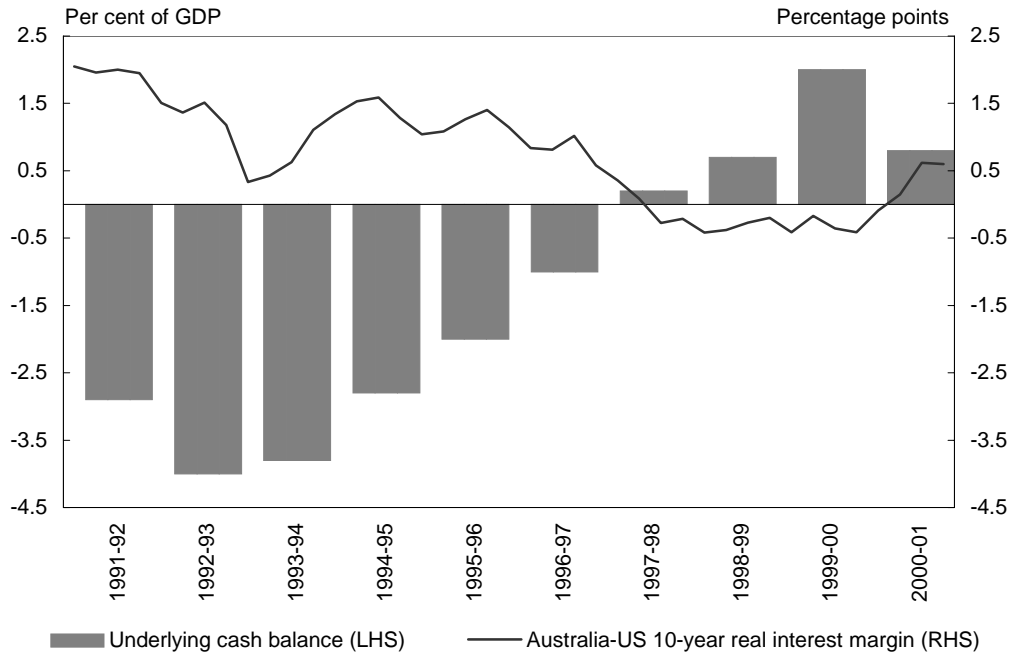
Fiscal sustainability is an important precondition for long-term improvements in living standards and also assists the pursuit of social and environmental objectives. In particular, fiscal sustainability:

- raises the prospects for higher living standards by promoting stronger and more consistent economic growth. This is achieved through lower interest rates (Chart 9 shows how Australian interest rates have improved relative to the United States since the return to budget surplus), an enhanced environment for investment and a reasonable degree of stability in the overall tax burden;

1 The underlying cash balance does not precisely correlate with changes in the level of net debt, largely because equity transactions (such as the privatisation of government business enterprises) affect net debt but are excluded from the calculation of the underlying cash balance.

2 The achievement of budget balance, on average, over time will stabilise government liabilities in nominal terms. Provided that the Commonwealth is undertaking some investment (net of depreciation and capital sales), the Commonwealth's assets and net worth will rise over time.

**Chart 9: Budget balance and long-term real interest margin
Australia and the United States 1991-92 to 2000-01**



Note: Expected inflation data is calculated as the long-term bond rate less index bond yields.
Source: RBA Bulletin (various) and Treasury.

- reduces the risk of major fluctuations in the living standards of Australians as a result of international economic shocks. Australia is a small, open economy with a highly traded currency, reliance on foreign investment and a relatively high level of private net external debt. Achieving fiscal sustainability improves investor confidence, thereby reducing the economy's vulnerability to changes in investor sentiment. For example, during the Asian financial crisis, the Commonwealth's strong fiscal position was very important in maintaining financial market confidence and shielding Australia from instability;
- improves the government's capacity to respond to unforeseen circumstances, such as a natural disaster;
- ensures that the government can continue to provide essential goods and services that the private sector does not provide sufficiently. For example, the government provides income support payments, funds for hospitals, schools, clean air and water; and
- promotes fairness in the distribution of public resources between generations of Australians. This is known as intergenerational equity. Fiscal sustainability promotes intergenerational equity by ensuring that the level of government debt passed onto future generations is appropriate. Fiscal outcomes that lead to the

ongoing accumulation of debt, without funding socially productive investments, transfer the cost of paying for the lifestyle of the current generation to future generations.

THE GOVERNMENT'S APPROACH TO FISCAL SUSTAINABILITY

Sustainable government finances can be promoted through careful planning and sound decision-making. This requires the development of a policy framework that is characterised by:

- a disciplined approach to budgeting;
- transparent reporting of intentions and outcomes, including the longer-term cost of policy decisions; and
- accountability for decisions and results.

In pursuing fiscal sustainability, the Government has put in place a robust fiscal framework to encourage careful planning and sound decision-making. Key elements include the *Charter of Budget Honesty Act 1998* and the medium-term fiscal strategy.

The Charter provides for greater discipline, transparency and accountability in fiscal policy. It requires the Government to outline its fiscal strategy and report on the progress made towards achieving the stated fiscal objectives. This strategy is to be based on the principles of sound fiscal management stated in the Charter (Box 1).

The Charter also requires the Government to explicitly outline its fiscal strategy. This Government's medium-term fiscal strategy is to maintain budget balance, on average, over the course of the economic cycle. Within the strategy, the Government has identified supplementary objectives:

- maintaining fiscal surpluses over the forward estimates period while economic growth prospects remain sound;
- not increasing the overall tax burden from its 1996-97 level; and
- improving the Commonwealth net worth position over the medium to longer term.

The Government does not have an explicit net debt target. However, under the Charter, the Government must maintain Commonwealth general government net debt at prudent levels. Furthermore, achieving the fiscal strategy will result in a stable level of nominal net debt and a falling level of net debt as a proportion of GDP as the economy grows over time.

Box 1: *Charter of Budget Honesty Act 1998*: Principles of sound fiscal management

Fiscal policy should be directed to maintaining the ongoing economic prosperity and welfare of the people of Australia and therefore should be set in a sustainable medium-term framework. To meet these objectives, a government should frame its fiscal strategy in accordance with the following principles of sound fiscal management. The government should:

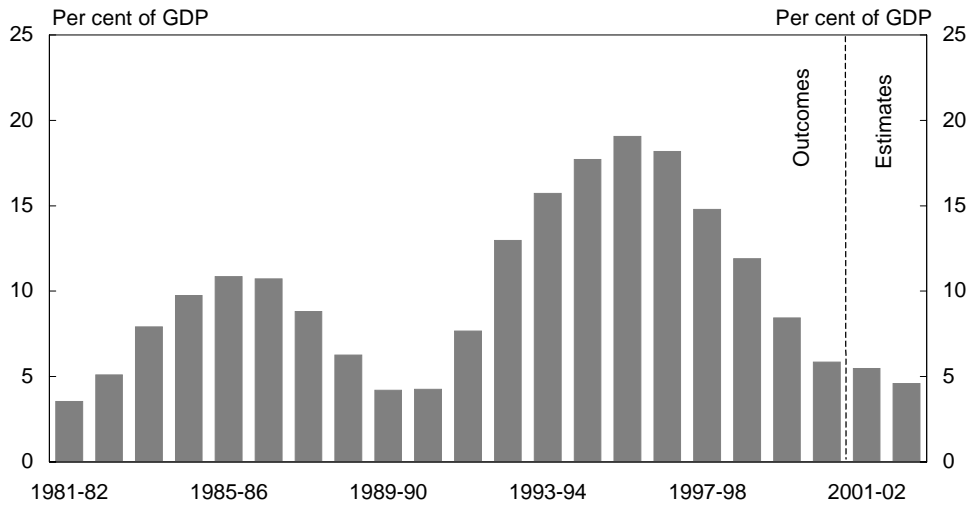
- manage prudently the financial risks the Commonwealth faces, including by maintaining Commonwealth general government debt and contingent liabilities at prudent levels;
- ensure that fiscal policy contributes to achieving adequate national saving and, as appropriate, to dampening cyclical fluctuations in economic activity, taking account of the economic risks the nation faces and their impact on the Commonwealth's fiscal position;
- pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of tax burden;
- maintain the integrity of the tax system; and
- ensure that policy decisions consider their financial effect on future generations.

THE GOVERNMENT'S RECORD IN ACHIEVING FISCAL SUSTAINABILITY

When the Government came to office in 1996, the Budget was in deficit by around \$10 billion or 2 per cent of GDP, despite several years of strong economic growth. Commonwealth general government net debt also had increased significantly.

Since then, the Government has placed public finances on a more sustainable footing. Cumulative surpluses have reduced Commonwealth general government net debt from around \$96 billion or 19 per cent of GDP in 1995-96 to around \$34 billion or 4.6 per cent of GDP in 2002-03 (Chart 10).

Chart 10: Commonwealth general government net debt



Source: ABS Cat. No. 5501.0 and 5513.0, Commonwealth Final Budget Outcomes and Treasury estimates.

