STATEMENT 4: FISCAL POLICY IN THE CURRENT ECONOMIC ENVIRONMENT

Sound fiscal policy — as embodied in the Government's medium-term fiscal strategy — involves ensuring that fiscal settings are sustainable over the medium term, while allowing the fiscal position to vary in response to economic conditions in the near term so as to contribute to macroeconomic stability.

This Statement highlights the contrast in economic and fiscal circumstances between the pre- and post-GFC periods. Budget surpluses in the years leading up to the GFC were supported by temporary factors that boosted revenue growth, including the high terms of trade, an economy operating for a time above sustainable levels and buoyant asset prices. Temporarily high revenues were used to fund spending increases and tax reductions, weakening the medium-term budget position.

In contrast, the period since the GFC has been characterised by relatively weak growth in nominal GDP and a decline in the tax-to-GDP ratio, which reflects, in particular, an increased share of profits coming from the resources sector and a large fall in capital gains tax. Together, these factors have reduced the Government's tax receipts and created a more challenging fiscal environment.

Recent sizeable revenue write-downs have increased the fiscal adjustment needed to return the budget to surplus. In the current environment, offsetting substantial write-downs in the near term would risk depressing economic growth and undermining jobs growth. The Government's plan to return the budget to surplus, including the long-term savings measures announced in this Budget, strengthens fiscal sustainability on a timeframe that does not risk undermining economic growth or threatening jobs.

This Statement shows that Australia remains well-placed in terms of fiscal sustainability, particularly in comparison to most other advanced economies, reinforced by the Government's clear and credible plan to return the budget to surplus. The budget deficit at present is low as a share of GDP, with the budget projected to return to surplus ahead of most advanced economies. Net government debt as a share of GDP is lower than for almost all other advanced economies, and the net interest burden is also relatively low. This highlights that the Government is striking the right balance between reinforcing fiscal sustainability over the medium term and limiting adverse impacts on economic growth and jobs in the near term.

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STATEMENT 4: FISCAL POLICY IN THE CURRENT ECONOMIC ENVIRONMENT

INTRODUCTION

The global financial crisis (GFC) and its repercussions have focussed attention around the world on the conduct of fiscal policy: in particular, the appropriate balance between short-term support for the economy and medium-to-long term sustainability considerations.

Fiscal objectives are not ends in themselves. They matter because of their implications for employment, incomes and wellbeing. In essence, good fiscal policy entails allowing the fiscal position to vary in response to economic conditions in the near term, while ensuring fiscal settings are sustainable over the medium-to-long term.

By allowing the budget balance to vary with economic conditions, fiscal policy can complement monetary policy in keeping the economy on a stable growth path, with low unemployment and inflation. This will normally occur through the automatic fiscal stabilisers, although a discretionary response may also be warranted in exceptional circumstances.

Sustainability also matters. Sustainable fiscal settings preserve governments' flexibility to use fiscal policy to counter large negative shocks to the economy while keeping governments' borrowing costs low. Maintaining fiscal sustainability over time also allows more stable tax and spending policies, and ensures that future generations do not have to bear the burden of abrupt adjustments.

Although Australia's strong fiscal position means that we do not face a significant tension between these two considerations, many other advanced economies are currently struggling to find the right balance. They have experienced prolonged economic weakness (and consequent weakness in tax receipts) since the GFC, with non-fiscal means of stimulating growth limited because policy interest rates cannot be reduced further or, for individual euro members, because they have no independent monetary policy and exchange rate. Coupled with weak or negative economic growth and high unemployment, this normally provides a strong case for stimulatory fiscal policy.

However, a lack of fiscal discipline over a long period before the crisis, combined with the ongoing fiscal effects of the crisis, have left many other advanced economies with a legacy of very high levels of government debt. These economies also face looming fiscal pressures from population ageing over coming decades. Fears about sustainability have induced many governments to undertake substantial fiscal tightening, often over very short time-frames. This has proved to be strongly

pro-cyclical, exacerbating existing economic weakness, which has in turn hampered achievement of fiscal consolidation objectives.

The recent international experience offers three key lessons for fiscal policy. First, the fiscal position needs to be strengthened sufficiently during good times to allow fiscal policy to respond appropriately to adverse shocks without threatening sustainability. Second, it is important to recognise and manage contingent fiscal risks, such as those stemming from explicit or implicit financial sector guarantees. Third, it is important that governments outline a credible plan to restore sound public finances following large adverse shocks, while varying the pace of fiscal consolidation in response to economic circumstances. This means balancing the requirement to consolidate against the impacts of consolidation — recognising that, in some circumstances, emergency consolidation may be needed to avoid broader economic and fiscal crises. In other cases, too rapid a consolidation may be counterproductive and undermine both full employment and debt reduction goals.

Australia is much better placed to achieve the right balance in setting fiscal policy, due to a track record of prudent fiscal policy, robust financial regulation and strong macroeconomic management and performance, in particular during and since the GFC. The medium-term focus on fiscal sustainability has provided for short-term responses to shocks. Australia's resulting low debt levels, combined with a credible strategy to return the budget to surplus, ensure we have considerable flexibility to respond to changing economic conditions. Nonetheless, retaining that flexibility will require ongoing structural improvement to the budget over the years ahead, as economic conditions permit.

This Statement reports on the sustainability of the Government's fiscal position under a range of internationally-recognised metrics and outlines how the Government intends to maintain the right balance in setting fiscal policy over the short and medium term. The key conclusion is that Australia remains well-placed in terms of fiscal sustainability, particularly in comparison to most other advanced economies, reinforced by the Government's clear and credible plan to return the budget to surplus.

MEDIUM-TERM FISCAL STRATEGY: UNDERLYING PRINCIPLES AND RATIONALE

A key element of the Government's medium-term fiscal strategy is to achieve budget surpluses, on average, over the medium term. This objective allows flexibility to respond to economic conditions in the short term, while maintaining fiscal sustainability over the medium term. Adhering to the surplus objective helps to ensure that net financial worth improves over the medium term, which is another element of the strategy. The strategy also commits to keeping taxation as a share of GDP below its 2007-08 level, on average, so that the surplus objective is achieved through expenditure restraint rather than an increasing tax burden over time.

Flexibility to respond to economic conditions in the short term

The medium-term objective of achieving budget surpluses on average allows flexibility to respond to cyclical fluctuations in economic conditions. Although monetary policy normally plays the primary role in macroeconomic stabilisation, fiscal policy has an important complementary role. There are three aspects to this role.

First, in normal circumstances, fiscal policy plays a counter-cyclical role primarily through the automatic fiscal stabilisers — fluctuations in tax revenue and spending that result from temporary variations in output and employment. It is generally desirable to accommodate the automatic stabilisers, rather than seeking to offset their fiscal impacts, because:

- they respond automatically to dampen economic fluctuations, avoiding the lags associated with discretionary policy (both fiscal and monetary); and
- they should have minimal effect on the medium-term fiscal position as they unwind automatically once the economy returns to full employment.

Second, in circumstances where the economy is hit by a large shock and monetary policy cannot respond with sufficient speed and force, a discretionary fiscal response may also be warranted. This was the case during the GFC, when a large fiscal stimulus was implemented to support the economy. Maintaining this capacity to respond requires a foundation of fiscal sustainability, including moderate government debt levels. Fiscal stimulus measures can deliver lasting benefits beyond the short-term boost to the economy if significant long-term unemployment — and the associated skill atrophy — can be avoided, and if the measures expand the economy's supply potential, as was the case with the infrastructure spending elements of the Government's stimulus measures during the GFC.

Third, in circumstances where substantial fiscal adjustment is needed to maintain sustainability — for instance, due to unanticipated long-lived changes in the economy that adversely affect the budget — it is desirable that the speed of this adjustment and its composition is set to limit adverse impacts on macroeconomic stability. That is, the implications for economic and employment growth need to be considered when contemplating the pace of adjustment — adjustment that occurs too slowly can be as much a threat to medium-term employment and growth as adjustment that occurs too rapidly.

In Australia's case, low levels of government debt provide the flexibility to return the budget to surplus on a timeframe that does not undermine economic growth or threaten jobs. Australia's flexible exchange rate also means that the Reserve Bank can set interest rates that are appropriate to conditions in the Australian economy. Combined with the relative strength of the Australian economy, this means that not only does Australia have a much smaller fiscal adjustment task than most other advanced economies following the GFC, but also that the impact of fiscal consolidation

on economic growth (the so-called 'fiscal multipliers') are likely to be smaller, reinforcing our enviable position internationally (see Box 1).

Box 1 : Fiscal consolidation and fiscal multipliers

The appropriate pace of fiscal consolidation in the period since the GFC has been a contentious issue internationally. This is particularly the case for countries with high government debt but also weak economic growth and high unemployment.

One point of contention has been around the size of fiscal multipliers. There is now considerable evidence that fiscal multipliers — which measure the impact on economic output of discretionary changes in fiscal policy — are likely to be considerably larger in Europe, Japan and the US than in Australia at present (Blanchard and Leigh 2013).

There are three reasons to expect multipliers to remain high in Europe, Japan and the US. First, after deep, prolonged recessions, their economies have considerable unused productive capacity. In these circumstances, fiscal tightening can normally be expected to have a large impact on economic activity by reducing demand further below the economy's productive potential, raising the prospect of so-called hysteresis effects. Second, with nominal short-term interest rates already close to zero and credit channels impaired, there is limited scope for monetary policy to offset the contractionary impacts of fiscal tightening. Third, with many economies simultaneously undertaking fiscal contraction, there is less scope for contractionary effects of fiscal policy to be offset by exchange rate depreciation leading to increased net exports.

So what is the appropriate course of action? The IMF advises in its April 2013 *Fiscal Monitor* that, while countries with limited access to financing have no choice but to front-load fiscal adjustment, the most appropriate course of action for countries that retain the capacity to borrow is to undertake a path of gradual but sustained adjustment that aims at steady progress over the medium term toward a clearly-defined fiscal objective. The Government's plan to return to surplus at a measured pace is consistent with this advice. Box 2 highlights the importance in this regard of articulating a clear and credible medium-term objective for fiscal policy.

The IMF also acknowledges that even with modest up-front adjustment it will be essential to ensure that other policies remain as supportive as possible in order to limit output and employment costs. In particular, monetary policy should remain accommodative for the foreseeable future, and structural policies to expand the supply side of the economy and promote growth should also be pursued. It is also desirable that the composition of fiscal adjustment be designed to mitigate adverse impacts on the most vulnerable, consistent with the Australian Government's approach.

Sustainability over the medium term

The medium-term objective of budget surpluses on average also ensures that fiscal policy remains sustainable, preserving the fiscal space needed for flexibility. Indeed, the objective is tougher than the commonly-used international benchmark for sustainability — that government debt is stabilised as a share of GDP at some level that can be serviced over time. Achieving surpluses on average means that the net debt position improves over time.

The Australian Government's low net debt means capacity to service debt is not an issue. At the expected peak of 11.4 per cent of GDP in 2014-15, the annual net interest burden is only 0.5 of a percentage point of GDP. This is around one-quarter of the G-7 average, even though interest rates are higher in Australia than in the major advanced economies due to the relative strength of our economy.

Nonetheless, consistent with the medium-term fiscal strategy, there are good reasons for Australia to aim higher than just stabilising the debt-to-GDP ratio. This is consistent with a broader concept of sustainability that encompasses not only the government's capacity to service its liabilities into the future, but also its ability to do so without adverse effects on economic performance and intergenerational equity in the face of an ageing population.

First, Australia's reliance on foreign capital is often seen as exposing us to a somewhat higher degree of external vulnerability, notwithstanding that we benefit from importing capital to finance productive investment in excess of domestic saving. This perceived vulnerability is mitigated by a number of factors; including a strong and well-regulated financial system, low public debt, and the fact that our external borrowing is largely in our own currency. Indeed, recent years have seen a material improvement in the robustness of our external funding mix, characterised by an increasing proportion of direct equity investment and a substantial lengthening of the maturity profile of our external debt (see Box 5 in Budget Statement 2). Nevertheless, it is prudent for government to seek to offset at least part of the private sector saving-investment gap by running surpluses over time, given that businesses and households are unlikely to factor their contributions to aggregate risk into their decisions.

Second, future generations will be better placed to deal with longer-term budgetary pressures from population ageing and health costs if we leave them a stronger government balance sheet and sustainable fiscal settings. This is appropriate in terms of intergenerational equity because these pressures partly reflect the costs of future benefits that the current generation will receive. This argument should not be overstated, however, as future generations will also have the benefit of higher standards of living, in part a consequence of investments in technology and ideas made by current and past generations.

Third, Australia's terms of trade are expected to decline from current high levels over time. The budget may also be more exposed to volatility in commodity markets because an expanded resources sector now accounts for a larger proportion of the tax base. This also means that the budget is more exposed to developments in emerging market economies, whose rising demand for minerals and energy has been the key factor driving the rise in the terms of trade and the resources investment boom. While commodity prices remain high this reinforces the case for improving the government's balance sheet over time, both for precautionary reasons and as a way of spreading some of the benefits to future generations.

More generally, improving the government's balance sheet over time provides insurance against unforeseeable adverse shocks in a global environment that may be more volatile than that experienced in the period before the GFC. In addition to allowing automatic stabilisers to be accommodated in the event of adverse shocks, this will allow scope for discretionary stimulus if required.

Box 2: Fiscal frameworks in other advanced economies

The sharp rise in public debt levels across many advanced economies in the aftermath of the GFC has highlighted the importance of clear and credible medium-term fiscal frameworks for retaining market confidence that public finances will remain on a sustainable footing. The existence of such a framework was one of Australia's key strengths during the GFC.

The design and application of medium-term fiscal strategies varies across the advanced economies. The United Kingdom, New Zealand and Germany provide other examples of the use of medium-term fiscal strategies, but not all countries have such frameworks. Furthermore, the application of some medium-term strategies can lead to policies that are not well attuned to economic conditions.

The United Kingdom's fiscal strategy involves a forward-looking target to achieve cyclically-adjusted current balance by the end of a rolling, five-year forecast period (the current balance is the budget balance excluding investment spending, but including depreciation). It also specifies that public sector net debt as a share of GDP should be falling by 2015-16.

New Zealand's 2012 Fiscal Strategy Report sets a short-term objective of returning the budget to surplus in 2014-15, and a long-term objective of bringing net government debt down to no higher than 20 per cent of GDP by 2020.

Germany has a so-called 'debt brake' legislated in its constitution, which mandates that from 2016 onwards the federal government's cyclically-adjusted budget deficit in any given year cannot exceed 0.35 per cent of GDP.[1] The debt brake will apply from 2020 onwards for Germany's regional governments (Länder), who will be required to have structurally-balanced budgets.

On the other hand, some other advanced economies have no articulated medium-term fiscal strategy, in particular the United States and Japan. The IMF has expressed concern in recent years about the absence in both countries of medium-term fiscal consolidation strategies.

FISCAL POLICY IN CHALLENGING TIMES

The Australian economy has come through an extraordinary decade in good shape: the terms of trade boom starting in the early 2000s and the GFC starting in 2008 are amongst the biggest positive and negative economic shocks Australia has faced since the 1930s depression. These challenges have underscored the importance of a fiscal strategy that is flexible enough to assist macroeconomic stabilisation in the short term,

1 It is worth noting that 'cyclically-adjusted' refers to the business cycle in the German economy, rather than in the whole euro area economy. This has implications for the overall stance of fiscal policy in the euro area when there are asymmetric shocks.

while also maintaining a strong focus on medium-to-longer term sustainability in an environment in which the budget is subject to large temporary influences.

Strong global growth and rising demand for Australia's commodity exports from China and other emerging market economies drove a boom in Australia's terms of trade from around 2003-04, with the terms of trade hitting a 150 year high in the September quarter of 2011. The associated boost to national income and resources investment starting in the middle of the decade led to strong growth in demand in an economy that was already close to full capacity. This delivered a massive surge in tax revenues up until the GFC: parameter and other variations increased revenue for 2007-08 by $79 billion (equivalent to around 7 per cent of GDP) between the 2003-04 and 2008-09 Budgets.

In this environment the appropriate role of fiscal policy is twofold:

- to complement monetary policy in containing inflationary pressures, at least by allowing the automatic fiscal stabilisers to increase budget surpluses; and
- to maintain the structural budget position in light of a surge in revenue that could be expected to be at least partly temporary, given that supply responses could be expected to push down commodity prices over time.

Budget surpluses did increase from 0.9 per cent of GDP in 2003-04 to 1.7 per cent of GDP in 2007-08. However, this increase was only a fraction of the surge in revenues, which was largely channelled back into the economy, through increased government spending and tax cuts. From the 2004-05 Budget to the 2007 Pre-Election Economic and Fiscal Outlook, parameter and other variations added $391 billion to expected budget surpluses over the period 2004-05 to 2010-11, while policy decisions reduced surpluses by $314 billion over the same period (Laurie and McDonald 2008).[2]

In hindsight, while Australia's fiscal position in 2007-08 was clearly strong by international standards, the structural position was less robust than the headline numbers implied as these were based on economic, commodity and financial market conditions that were not sustained and are unlikely to be repeated in the foreseeable future. Tax cuts and new spending, funded by temporary increases in the terms of trade and capital gains, led to deterioration in the structural budget position in the lead-up to the GFC. Moreover, by not allowing budget surpluses to increase significantly as revenues surged, government decisions prior to the GFC meant that interest rates had to be higher than otherwise to control inflation in an economy that was showing signs of over-heating.

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2 Some of this estimated gain from parameter and other revisions was not realised because of the impacts of the global financial crisis from 2008-09.

Against this background, the environment for fiscal policy was dramatically transformed from late 2008 by the GFC, which had a significant and immediate impact on tax receipts. The automatic revenue impact of weaker domestic and global growth, combined with weaker asset prices, is estimated to have reduced the budget balance, relative to expectations at the time of the 2008-09 Budget, by $23 billion in 2008-09, $49 billion in 2009-10 and $55 billion in 2010-11 (Budget Statement 4 2009-10). The direct impact of stimulus measures deployed to support demand also detracted from the fiscal position, albeit only temporarily.

The combination of the Government's discretionary fiscal stimulus and automatic fiscal stabilisers — together with a considerable easing of monetary policy, a large fall in the exchange rate, the resilience of our emerging Asian trading partners and measures to support the financial sector — was able to limit the adverse effects of the GFC on Australia. Treasury estimates indicate that, without the stimulus, the Australian economy would have fallen into recession in this period, resulting in a much larger rise in unemployment (Budget Statement 2 2010-11).

The direct fiscal impacts of the stimulus measures in the short-term, therefore, need to be set against the substantial fiscal impacts of the deeper economic downturn that would otherwise have occurred — as well as the broader social impacts of recession and higher unemployment. Such an outcome would have affected the fiscal position not only in the short term, but also in the medium-to-long term because deep recessions have lasting impacts on the economy's supply potential, in particular through increased long-term unemployment and the associated loss of skills.

As the economy has recovered, the key task for fiscal policy has been to return the budget to surplus, consistent with the medium-term fiscal strategy. The temporary stimulus measures have been unwound and spending discipline imposed, with the average payment to GDP ratio over the five years from 2012-13 lower than the average payment to GDP ratio over the previous thirty years. However, this has been occurring in an economic and revenue environment far less favourable than in the period before the GFC, and also less favourable than in some previous fiscal consolidation cycles.

Chart 1 shows that nominal GDP since the GFC has so far grown more slowly than in comparable periods in the 1980s and the 2000s, with only the 1990s cycle exhibiting weaker nominal growth. This gap is expected to widen further over the forward estimates period. By 2016-17, nominal GDP growth in the current cycle is expected to be around 75 percentage points less than over the equivalent period in the 1980s and 30 percentage points less than in the 2000s.[3] As will be detailed in the next section, weaker nominal GDP growth has been reflected in weaker growth in government revenue.

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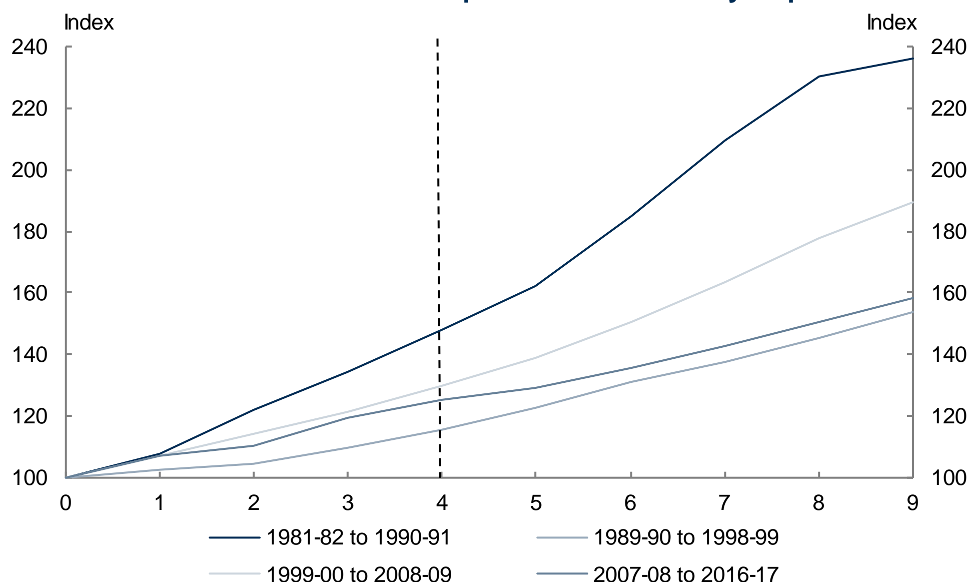
3 Nominal GDP growth was particularly strong in the 1980s, which preceded the establishment of the current low inflation regime, consistent with the 2 to 3 per cent inflation target.

Chart 1: Nominal GDP from previous economic cycle peak



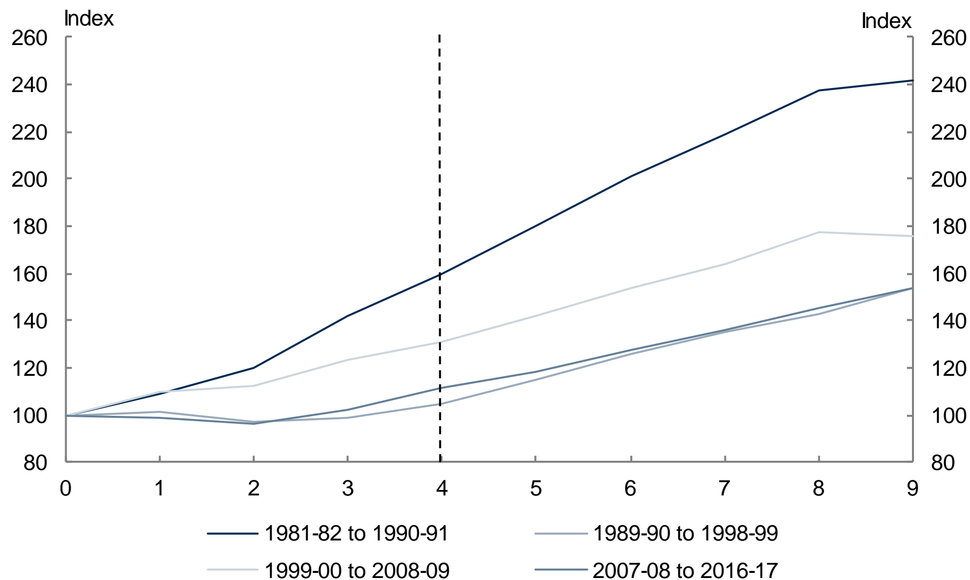
Note: Cyclical peaks (year 0) are based on real GDP relative to a HP filter trend. Current period figures are forecasts/projections from 2012-13 (year 5) onward.
Source: ABS Cat. No. 5206.0 and Treasury.

Importantly, while periods of below-trend real GDP growth can be expected to be offset over time by above-trend periods as the economy returns to full employment, the same cannot be assumed for nominal GDP as there is no mechanism to return prices to any given level following a period of weak price growth.

Weak nominal GDP growth and a reduction in the tax take per dollar of income have resulted in significantly less revenue growth in the post-GFC period than in the 1980s and 2000s, similar to what occurred in the 1990s; a period that saw a marked step-down in inflation relative to prior decades (Chart 2). Less automatic improvement to the budget from revenue has made fiscal consolidation more challenging because larger policy adjustments are needed to achieve the same budget outcome.

Fiscal consolidation in the 1980s, in particular, was made much easier by high inflation, which meant that the budget gained considerably from fiscal drag — the additional tax revenue that results from growth in nominal incomes and the progressivity of the personal income tax scales. In the low inflation environment of the 1990s and now, fiscal drag is much reduced. The fact that weak revenue growth has made fiscal consolidation more challenging is a notable point of commonality between the current period and the 1990s. While current economic circumstances are in many ways very different to the early 1990s, when the economy experienced a deep recession, that period also saw a decline in the terms of trade and weak growth in domestic prices, as well as a significant fall in the tax-to-GDP ratio; factors that have affected revenues recently (as will be shown in the next section).

Chart 2: Receipts from previous economic cycle peak



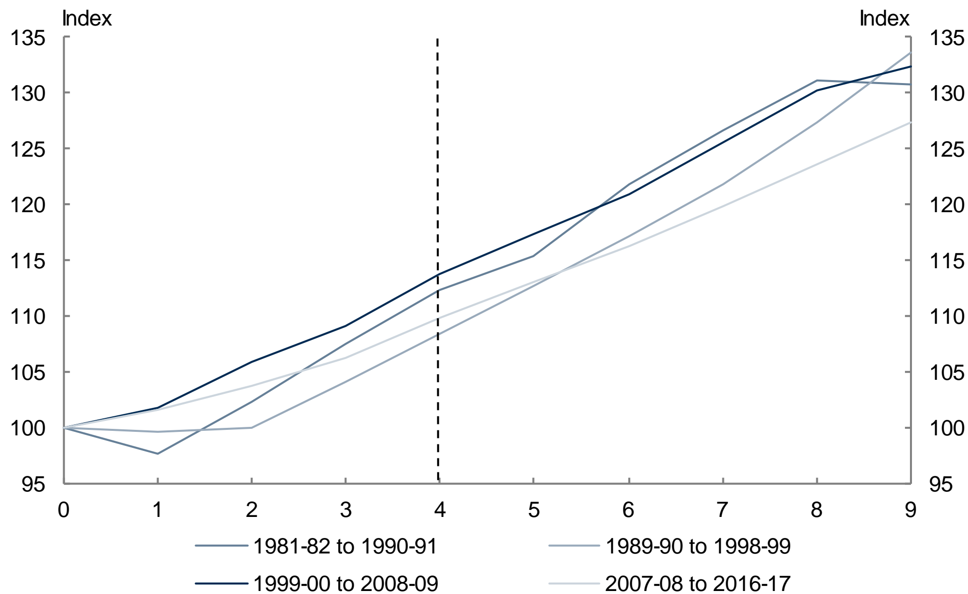
Note: Cyclical peaks (year 0) are based on real GDP relative to a HP filter trend. Current period figures are forecasts/projections from 2012-13 (year 5) onward.
Source: Treasury.

While weaker revenue growth has increased the fiscal adjustment required to return to surplus, other developments have meant that the economy also faces more challenges in absorbing such an adjustment. In normal circumstances, the contractionary impacts of fiscal consolidation can be absorbed because the economy emerges from the preceding downturn with considerable momentum. Previous cyclical downturns have been followed by an extended period of above-trend real GDP growth.

While the Australian economy has performed impressively in the post-GFC period, in marked contrast to most other advanced economies, it is not expected to grow as strongly as in previous fiscal consolidation episodes in Australia in the 1980s and 1990s. This reflects in part the relatively moderate slowdown in the Australian economy during the global downturn, with Australia virtually alone among the advanced economies in avoiding recession. This meant that we did not come out of the GFC with substantial spare capacity, in contrast to the 1980s and 1990s episodes.

Further, the extraordinary nature of the GFC has meant that the economy has faced significant post-GFC headwinds arising from less buoyant global growth, the high Australian dollar and deleveraging by companies and households — a combination of factors that was not present in previous episodes. Chart 3 shows that growth in real GDP from the previous cyclical peak (which takes into account the depth of the downturn) is expected to be lower over the current period than in the previous episodes.

Chart 3: Real GDP from previous economic cycle peak



Note: Cyclical peaks (year 0) are based on real GDP relative to a HP filter trend. Current period figures are forecasts/projections from 2012-13 (year 5) onward.
Source: ABS Cat. No. 5206.0 and Treasury.

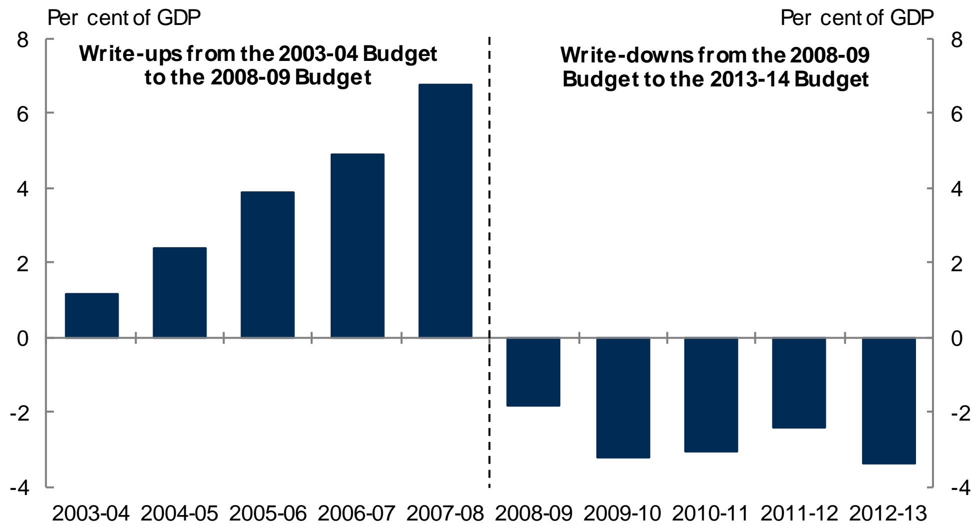
ANALYSIS OF RECENT REVENUE WEAKNESS

The challenges presented by post-GFC revenue weakness for fiscal policy are highlighted by the extent of downward revisions to tax receipt forecasts since the 2010-11 Budget, when a surplus in 2012-13 was initially projected. Tax receipts for 2012-13 are now expected to be $27 billion (around 8 per cent) lower than projected at the time of the 2010-11 Budget, and $23 billion lower in 2013-14. Importantly, tax receipts are similarly lower across the forward estimates, with downward revisions to projected tax receipts since the 2010-11 Budget amounting to $92 billion over the six years to 2015-16.

This is in marked contrast to the pre-GFC period, when revenues were consistently and repeatedly revised up (Chart 4). Over the five years leading up to the GFC, revenue write-ups from parameter and other variations from the 2003-04 Budget to the 2008-09 Budget totalled around $200 billion.[4] Over the five years since the 2008-09 Budget revenue write-downs have amounted to almost $200 billion.

4 'Parameter and other variations', as shown in Table 5 in Budget Statement 3, capture all factors affecting receipts other than policy decisions.

Chart 4: Revenue write-ups and write-downs



Note: Revenue revisions due to parameter and other variations (excluding policy decisions). Left-hand side includes only revisions after 2003-04 Budget. Right-hand side includes only revisions after 2008-09 Budget. Dotted line marks the advent of the GFC.
Source: Treasury.

Weaker nominal GDP

These write-downs to the tax receipt forecasts and projections are due primarily to downward revisions to nominal GDP growth and weaker capital gains tax (CGT) receipts. Nominal GDP broadly captures the level of income in the economy, which is the primary determinant of government revenues.[5]

As discussed in more detail in Budget Statement 2, recent weakness in nominal GDP growth reflects the unusual combination of lower global prices for Australia's key commodity exports and a persistently high Australian dollar, which has contributed to weaker-than-anticipated growth in domestic prices. With commodity prices expected to fall further and domestic inflation to remain subdued, the recent weakness translates into downward revisions to the level of nominal GDP across the forward estimates. Nominal GDP levels across the forward estimates are around 4 per cent lower than projected at the time of the 2010-11 Budget.

While both the timing and pace of the fall in the terms of trade are uncertain, an unwinding has been factored into the forward estimates since 2005. The fact that the terms of trade rose far more than expected boosted nominal GDP and revenue more than was anticipated up to 2007-08; with the terms of trade recently falling more rapidly than anticipated, this has reduced nominal GDP and revenue growth more than forecast.

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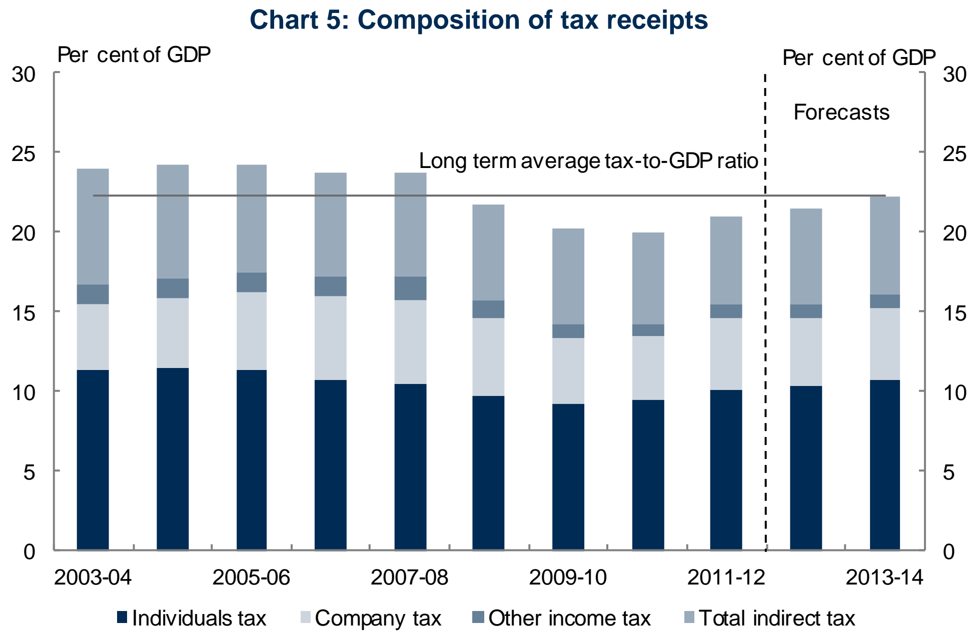
5 Nominal GDP differs from nominal gross national income because of net primary income paid to non-residents (mainly interest and dividends on net foreign liabilities).

Declines in the tax-to-GDP ratio

The downward revision to tax receipts in recent years is also due in part to a lower revenue yield per dollar of GDP. From its pre-crisis level of 23.7 per cent of GDP in 2007-08, the tax-to-GDP ratio fell 3.7 percentage points (around 16 per cent) to 20.0 per cent in 2010-11, the biggest decline in the ratio since the 1950s. This fall reflected declines across a number of categories (Chart 5).

Chart 5: Composition of tax receipts



Source: Treasury estimates.

The tax share of GDP in 2012-13 is now expected to be 1.0 percentage points lower than projected at the 2010-11 Budget and 0.8 percentage points lower than its long-term average. Receipts in 2012-13 would be $16 billion higher than currently forecast if the previously projected tax share had been realised. The tax share is expected to remain well below pre-GFC levels across the forward estimates, reflecting a number of factors, including the enduring impacts of the GFC on CGT receipts (which were at unsustainable levels prior to the GFC), changes in the sectoral composition of profits and the effects of previous policy decisions.

Longer-term changes in the composition of profits

Changes in the composition of the economy can affect tax receipts because average effective tax rates differ between components of aggregate incomes. A key factor in this regard has been the growing share in the economy of the resources sector, which does not pay as much tax per dollar of economic activity as other sectors (measured by

the ratio of tax paid to net operating surplus).[6] Since 2008-09 the ratio of company tax paid to NOS for mining has averaged around 15 per cent, compared to 25 per cent for the corporate sector as a whole.[7] This relatively low ratio reflects a range of factors, including royalty deductions, the capital-intensive nature of mining and the accelerated rates at which investment can be written off for tax purposes. For example, increasing levels of investment in this sector have seen annual mining depreciation growth triple, from around 4.5 per cent in 2003-04 to 15 per cent by 2011-12.

High prices for resource exports have boosted resource sector profits so much that mining's share of corporate gross operating profits has doubled since 2003-04 (Chart 6). The low effective tax-to-NOS ratio means that an increased share of mining profits in total profits and nominal GDP will lower the tax-to-GDP ratio. Despite the forecast decline in global commodity prices, the mining share is likely to remain elevated for some time. Depreciation deductions resulting from the surge in resources sector investment in recent years are also expected to depress tax receipts for some time, although this impact is expected to eventually recede.

Chart 6: Mining share of gross operating surplus

Source: ABS Cat. No. 5204.0 and Treasury.

Another contributor to the recent growth in deductions is the immediate deduction that is available for assets first used in exploration. In this Budget the Government has announced that it will better target these deductions to address abuses while supporting genuine exploration activity.

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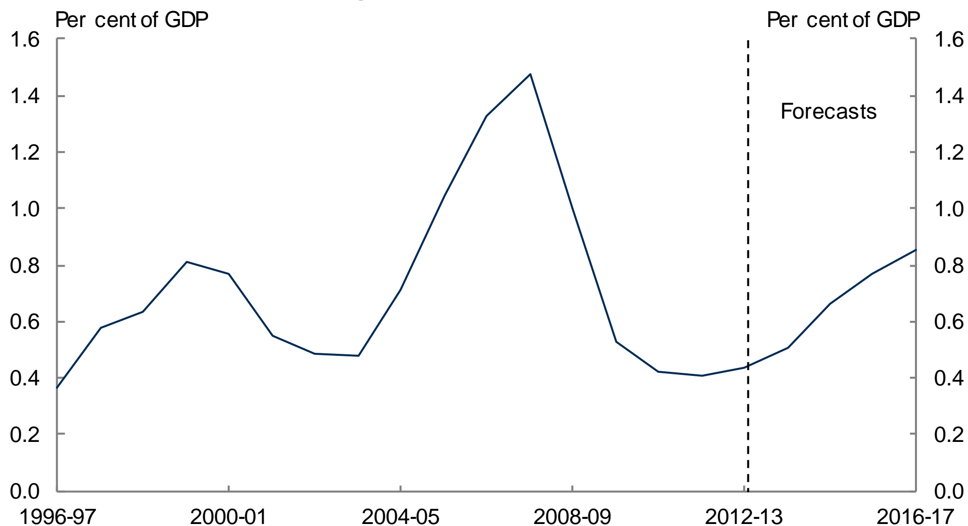
6 Net operating surplus (NOS) is gross operating surplus (the National Accounts measure of company profits) less depreciation.

7 The definition of mining used in this section aligns with the Australia and New Zealand Standard Industrial Classification (ANZSIC) 2006 codes on the Australian Business Register and includes extraction of gas and petroleum.

Lower realised capital gains

Another key reason the tax-to-GDP ratio has been unusually low recently is lower CGT receipts. CGT receipts were unusually high in the years leading up to the GFC, as strong growth in asset prices led to high levels of realised capital gains (Chart 7). The decline in global share prices during the GFC, along with weak asset price growth since, has reduced CGT receipts to less than one-third of these peak levels as a share of GDP. Revisions to CGT receipts have been substantial with forecast CGT receipts for 2013-14 now $10 billion lower than expected at the 2010-11 Budget. While CGT receipts are expected to recover somewhat over the forward estimates, they are not expected to return to pre-GFC levels, which reflected a period of strong asset price growth that is unlikely to be repeated in the foreseeable future (Lowe 2012).

Chart 7: Capital gains tax receipts as a share of GDP



Source: Treasury.

Impacts of policy changes and other factors

Policy changes can also affect the tax-to-GDP ratio. One series of policy changes that is having a particularly large impact on the tax share is the successive large cuts to personal income tax rates implemented between 2005-06 and 2009-10. The average personal income tax rate fell from over 23 per cent of taxable income in the early 2000s to less than 20 per cent in 2009-10 — which meant that the personal income tax system delivered around 15 per cent less revenue for each dollar of taxable income.

While personal income tax collections as a share of GDP are expected to return to early 2000s levels by the end of the forward estimates period, revenue forgone in the interim will have been substantial. For example, tax receipts would have been $14 billion higher in 2012-13 had the average personal tax rate remained at its 2005-06 level, abstracting from any impacts the tax cuts may have had on the personal income tax base.

Other policy changes that have contributed to reducing tax receipts as a share of GDP include changes to superannuation taxation in 2006-07 and business tax and capital gains tax concessions introduced in the early 2000s. The decision announced in the 2006-07 Budget to make superannuation benefits tax-free for retirees aged 60 and over who have already paid tax on contributions and earnings has had substantial enduring impacts on personal tax collections. However, the Government has announced a range of policies designed to reduce tax expenditures over the next decade, including reducing concessions on contributions for very high income earners and capping the tax exemption for earnings on superannuation assets supporting retirement income streams to $100,000 of annual earnings for each individual.

In this Budget the Government has also announced a number of measures to protect the corporate tax base. These measures address a number of tax planning strategies used by multinational enterprises and domestic companies to exploit design flaws, vulnerabilities and unexpected interactions in Australia's corporate tax laws.

In addition to the specific factors that have reduced the tax share in recent years, there are other factors that have eroded the tax-to-GDP ratio over a longer period. A significant long-term factor has been the trend decline in indirect taxes as a proportion of GDP. Indirect tax (excluding GST) collections have fallen from 3.6 per cent of GDP in 2001-02 to 2.5 per cent of GDP in 2011-12.

THE GOVERNMENT'S FISCAL STRATEGY IN RESPONSE TO MEDIUM-TERM CHALLENGES

The combination of flexibility and sustainability embodied in the medium-term fiscal strategy has helped underpin Australia's strong economic performance. Consistent with the principles underlying the strategy, the guiding imperative for this Budget is to reinforce fiscal sustainability over the medium term while limiting adverse impacts on economic growth and jobs in the near term.

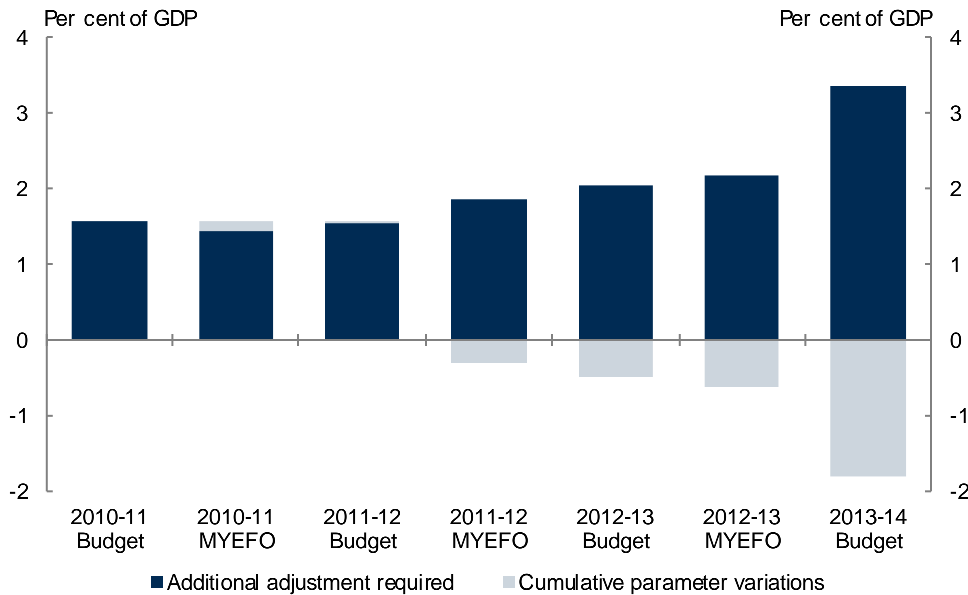
Revenue write-downs have increased the fiscal adjustment needed to return to surplus

This task has been made harder by the revenue write-downs outlined above. Returning to surplus by 2012-13, as previously intended, would have required an improvement in the budget balance of at least 4.2 percentage points of GDP, relative to the deficit outcome in 2009-10. At the time of the 2010-11 Budget, when a surplus was first projected for 2012-13 following the GFC, 2.2 percentage points (around half of the required adjustment) was to be achieved from the expiration of temporary stimulus measures and around 0.5 percentage points was anticipated from the unwinding of

automatic stabilisers as the economy returned to full capacity.[8] The implied fiscal adjustment to return to surplus, over and above the automatic impacts of the economic cycle and the unwinding of the temporary stimulus, was therefore around 1.6 per cent of GDP at the time of the 2010-11 Budget (Chart 8).

Since the 2010-11 Budget, parameter variations have worsened the budget balance, requiring the Government to do more to achieve the same fiscal consolidation. By the time of last year's Mid-Year Economic and Fiscal Outlook (MYEFO), cumulative parameter variations since the 2010-11 Budget had detracted 0.6 per cent of GDP from the budget balance for 2012-13, with revenue write-downs being partially offset by parameter variations to payments. This increased the fiscal adjustment required to achieve surplus in 2012-13 from 1.6 to 2.2 per cent of GDP, with the increase representing the cumulative discretionary savings required to offset parameter variations between the 2010-11 Budget and the 2012-13 MYEFO. Parameter variations since MYEFO have detracted a further 1.2 per cent of GDP, increasing the adjustment required to return to budget surplus by 2012-13 (over and above the impact of automatic stabilisers and the unwinding of temporary stimulus) to 3.4 per cent of GDP; more than double the adjustment originally anticipated.

Chart 8: Fiscal adjustment from 2009-10 required to return to surplus in 2012-13



Source: Treasury.

As recent parameter variations, primarily affecting the fiscal position through receipts downgrades, have increased the adjustment required to return to surplus in 2012-13 to

8 The 2009-10 budget deficit was forecast at the 2010-11 Budget to be 4.4 per cent of GDP. However, as the required adjustment depends on the outcome for 2009-10, the difference between the forecast and the outcome is ignored for the purpose of this analysis.

a size that would have a significant adverse impact on the economy, the Government has decided to defer its planned return to surplus. This decision is consistent with the Government's medium-term fiscal strategy.

Balancing the pace of adjustment with jobs and economic growth

While the Australian economy remains strong, uneven conditions across the economy and the dampening effect of the persistently high Australian dollar have seen the unemployment rate rise moderately since mid-2011. Although GDP growth is expected to be close to trend in 2013-14, the transition under way in the economy is expected to see the unemployment rate rise slightly to 5¾ per cent by the June quarter of 2014. The outlook is also subject to downside risks relating to global uncertainties and the transition domestically to other sources of growth as the resources investment boom recedes.

Tax receipts write-downs and other parameter variations since MYEFO would have required the Government to find further savings of at least 1.2 per cent of GDP to return the budget to surplus in 2012-13. While the savings measures the Government has implemented to date have been designed to minimise adverse impacts on the economy, this becomes harder as the savings task becomes larger and the timeframe to implement becomes shorter. In the current environment, offsetting the revenue write-downs since MYEFO for 2012-13 would risk depressing economic growth, undermine jobs growth and place upward pressure on the unemployment rate. This could lead, in turn, to even lower revenue and increased spending on unemployment benefits, which would work against the planned improvement in the budget. In contrast, the savings measures announced in the Budget will be implemented over a timeframe that limits any drag on the economy.

Monetary policy has provided support for the economy as the Government has consolidated its fiscal position. However, as monetary policy operates with considerable lags it would not be able to offset the effects of a sharp fiscal tightening undertaken over a very short time frame. Monetary policy may also be less effective in an environment in which households and businesses have been reluctant to take on more debt and in which the exchange rate has not been responding as it normally does to reductions in domestic interest rates and the declining terms of trade.

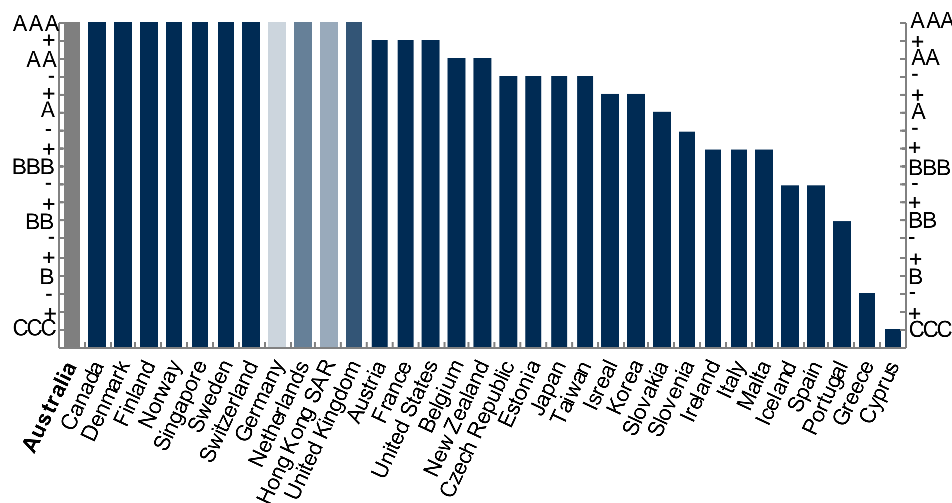
Low debt gives us the flexibility to smooth fiscal adjustment

Australia's low level of government debt means that we retain considerable fiscal flexibility.

Although a later return to surplus means debt will be paid down more slowly than previously expected, when combined with a credible medium-term commitment this should not have significant adverse impacts. Net debt remains low and is expected to peak at 11.4 per cent of GDP in 2014-15. The cost of servicing new debt is also low, with bond yields currently around historically low levels.

Australia is one of only eight countries rated AAA with a stable outlook by all three major rating agencies (Chart 9). Australia's AAA rating means that the Government is assessed as having an extremely strong capacity to meet its financial commitments. Financial markets continue to view Australian government debt as very safe. Credit default swap rates on Australian government debt, which measure the cost of insuring against default, are currently close to those of major advanced economies such as the United States and Germany.

Chart 9: Sovereign debt ratings for advanced economies (Standard & Poor's)



Note: Germany's rating is on negative outlook with Moody's. The Netherlands is on negative outlook with S&P, Moody's and Fitch. The UK is on negative outlook with S&P, and is rated AA+ by Fitch and AA1 by Moody's. Hong Kong is rated AA+ by Fitch and AA1 by Moody's.
Source: Bloomberg.

The relative health of Australia's fiscal position has also increased demand for Australian government securities. Foreign investors hold around 70 per cent of securities outstanding, and the partial information available suggests that a significant proportion is held by official investors, who are more likely to be stable long-term investors.

But fiscal consolidation is still needed over the medium term

The case for phasing in fiscal adjustment in no way diminishes the importance of fiscal consolidation over the medium term.

The need for fiscal consolidation involves more than just returning the budget to surplus, although this is an important first step. The medium-term fiscal strategy requires that sufficiently large surpluses be achieved when economic conditions are favourable to more than offset deficits that inevitably occur in adverse economic circumstances, thereby recharging fiscal buffers to allow for future fiscal stimulus if circumstances require.

When the economy is hit by adverse shocks it is appropriate for the budget to go into deficit to help moderate the impact. But this is only sustainable if fiscal policy operates symmetrically over the economic cycle. Such shocks are inherently unpredictable, but it is prudent to plan on the basis that they will occur periodically, particularly in a more volatile global environment. If we are to retain the flexibility to respond to future shocks, the government's balance sheet needs to be strengthened during good times, as the Government is doing through steps taken in this Budget.

Structural improvement to the budget over time is also important because of the longer-term fiscal challenges arising from population ageing and growth in health costs. The *Intergenerational Report 2010* highlighted that these challenges are no longer far off in the future. Ageing and health pressures have already begun to detract from the fiscal position, while Australia's potential growth rate will soon slow as a result of declining aggregate labour force participation rates. These impacts will only grow steadily over time, as a result of:

- growth in spending on age-related pensions and aged care services owing to the ageing of the population; and
- growth in spending on health, partly reflecting pressures from ageing, but mainly owing to increasing demand for health services and the cost of new technologies.

To that end, the Budget announces a number of measures that improve the fiscal position over the medium and longer term, including measures to protect the corporate tax base from erosion and loopholes, and reforms to family payments. These measures complement long-term savings measures already implemented over recent years to address longer-term fiscal pressures, while making fiscal space for investments in key areas such as education and disability insurance that will deliver long lasting economic and social benefits (Box 3).

In order to shed light on the further fiscal adjustments that might be required in future, the following section presents analysis of the medium-term outlook for fiscal sustainability under the policy settings in this Budget.

Box 3: Savings that endure

The Government's fiscal strategy includes a strong focus on the medium-term sustainability of the budget. When making decisions, the Government considers not only the impact on the forward estimates period, but also the longer-term budgetary effects. This Government was the first to introduce regular reporting on the medium-term outlook in each Budget and MYEFO, reporting on the outlook for the underlying cash balance and net debt beyond the forward estimates.

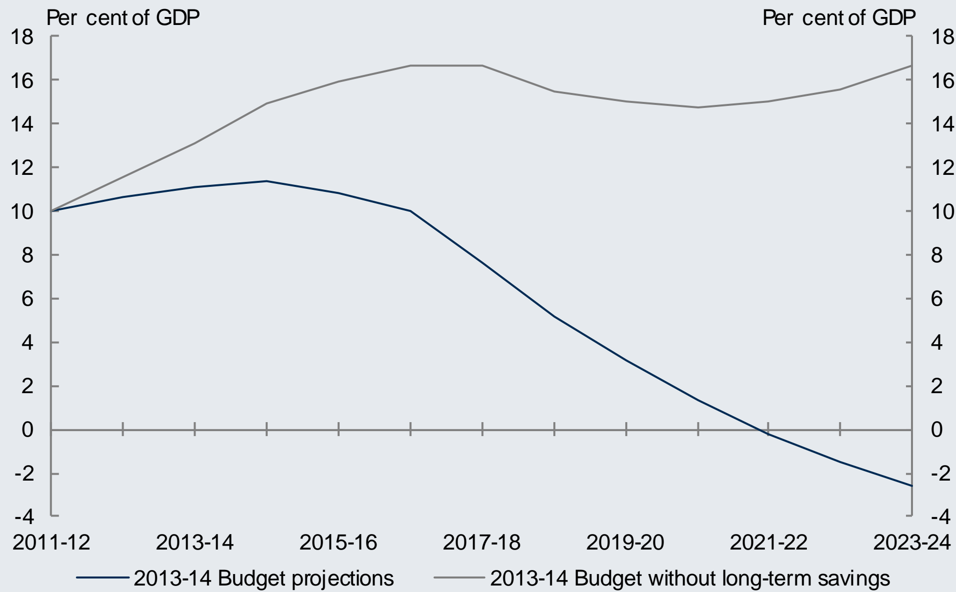
Since its first budget in 2008-09, the Government has made savings decisions that will continue to improve the budget position well beyond the end of the forward estimates. These include increasing the pension age to 67 and reforms to the private health insurance rebate and to the family payments system. These decisions help to improve the structural position of the budget and provide space for significant new priorities, including the National Plan for School Improvement and establishing DisabilityCare Australia, which will deliver long-term economic and social benefits.

Significant new long-term savings in this Budget include:

- the increase in the Medicare Levy to fund DisabilityCare;
- measures to protect the corporate tax base from erosion and loopholes;
- reforms to family payments to improve the sustainability of the system;
- better targeting of the research and development tax incentive;
- ensuring that tobacco excise rates keep pace with income growth;
- phasing out the poorly-targeted net medical expenses tax offset; and
- reforms to improve the fairness, sustainability and efficiency of the superannuation system.

Without the savings made since the 2008-09 Budget the fiscal outlook would not be as strong. The long-term savings the Government has made in this Budget and previously mean that the budget is cumulatively better off by over $300 billion by around 2020 (Chart A).

Box 3: Savings that endure (continued)



Note: To allow comparison with this Budget's medium-term projections, only the part of the savings from 2012-13 onwards is included (for instance, a measure from the 2008-09 Budget only contributes to the savings projection from 2012-13 onwards).
Source: Treasury.

Long-term fiscal sustainability is also assisted by policies that increase long-term growth in the economy. In this Budget the Government has funded the National Plan for School Improvement, which will help to lift productivity and participation by investing in our people. The Budget also provides funding for high-quality infrastructure projects to improve productivity, building on previous investments such as the National Broadband Network. And this Budget funds DisabilityCare Australia that, in addition to providing a fairer system for Australians with disability, will enhance their opportunities for social and economic participation.

Medium-term outlook for fiscal sustainability

Assessing fiscal sustainability involves examining a government's capacity to meet its liabilities without placing upward pressure on interest rates or impeding economic growth. A government's finances can be judged as fiscally sustainable when the government can meet its current and future financial obligations without the need for unrealistically large and disruptive adjustments to tax and expenditure programs.

A government's capacity to meet its liabilities depends on a wide range of factors. These include the level of debt, the values of financial and non-financial assets and liabilities, interest rates and economic growth prospects. Fiscal sustainability also

depends on the extent to which a government's budget position is supported by factors that are permanent or temporary in nature, the quality of institutions and whether a government is in a position to meet any contingent liabilities.

There is no single indicator that adequately captures all of these elements. While a credible plan to return the budget to surplus and low levels of government debt are key, there are also a number of analytical measures that can shed light on aspects of fiscal sustainability. There are arguments for and against each analytical measure, so it is important that an assessment of fiscal sustainability consider the measures collectively, rather than in isolation.

Sustainability assessments begin with the budget balance

A starting point in assessing fiscal sustainability is the trajectory of the underlying cash balance. The GFC led to a substantial deterioration of budget balances in most countries. Australia was no exception, with the operation of the automatic stabilisers and the use of discretionary fiscal stimulus pushing the budget into deficit (although the support to the economy provided by the stimulus partially offset this impact). However, we have fared better than most, as a result of many factors, including the efficacy of our fiscal expansion, which helped limit the economic impacts of the crisis.

As described earlier in this Statement, while the temporary fiscal stimulus measures have since been unwound, the GFC and the resources investment boom have had enduring impacts on the government's tax receipts. Coupled with weakness in nominal GDP growth due to the high Australian dollar and falling global commodity prices, this has seen the underlying cash balance remain in deficit.

The settings in this Budget are expected to return the budget to balance in 2015-16 and to surplus by 2016-17. The plan to return the budget to surplus is clear and achievable. It involves savings measures to address major areas of fiscal pressure in the long term and commitments to constrain growth in real spending and allow tax receipts to recover naturally as the economy grows.

Australia's budget position compares favourably with most other advanced economies (Chart 10). For comparability, Australian data are presented for consolidated general government, including state and local governments.[9] In 2016-17, when the Australian Government budget is projected to return to surplus, the IMF *Fiscal Monitor* projects that only 10 of 30 advanced economies will be in surplus. Collectively, the advanced economies are expected to run a budget deficit of 2.6 per cent of GDP in that year.

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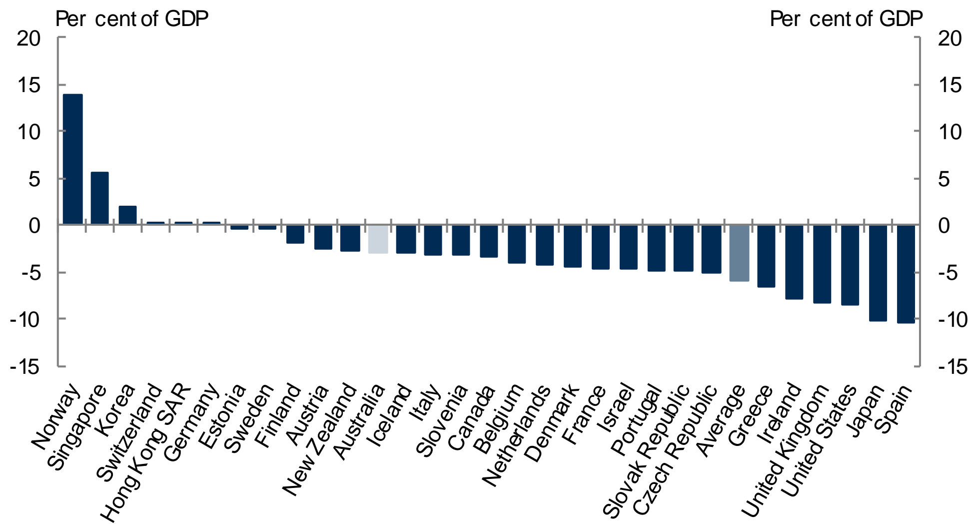
9 Australia's consolidated general government underlying cash deficit is forecast in the Budget to be 2.9 per cent of GDP in 2012-13, compared to an underlying cash deficit for the Commonwealth of 1.3 per cent of GDP.

Chart 10: Comparison of budget balances for advanced economies 2012



Note: Data are for general government (that is, consolidated Commonwealth, State, and local government). Data for Australia are for 2012-13, from Budget Paper No. 3 Appendix C, and will differ from those presented elsewhere in Budget Paper No. 1, which are for the Commonwealth Government only.
Source: IMF Fiscal Monitor April 2013 and Treasury.

Distinguishing between temporary and permanent factors is important

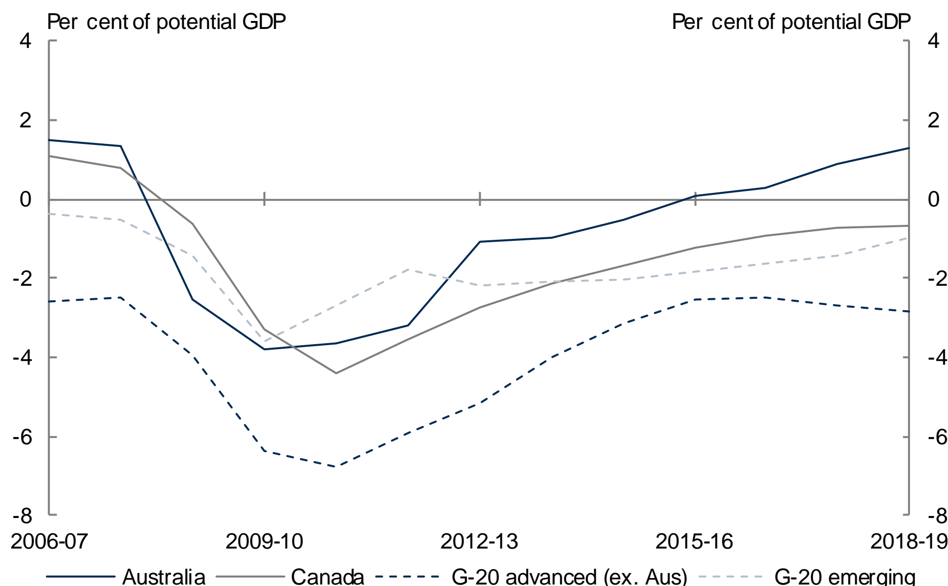
An assessment of fiscal sustainability should also consider the factors driving the budget balance. A common approach is to adjust the budget balance for the impact of economic factors that are considered likely to be temporary. These temporary influences may obscure the underlying fiscal position and, therefore, the extent to which fiscal adjustments might be needed in future to maintain sustainability.

The cyclically-adjusted balance (CAB) estimates what the budget balance would be if the real economy was operating at full capacity, consistent with stable inflation. This provides an indication of the size of the automatic fiscal stabilisers — that is, the cyclical impact on the budget of the economy being either above or below full capacity.

The CAB is widely used internationally, with estimates published by the IMF, OECD and a number of individual countries. IMF estimates, updated by Treasury for the 2013-14 Budget, suggest that Australia is currently in a modest cyclically-adjusted deficit, but that it is in a better position than most other countries, particularly the major advanced economies (Chart 11).[10] Australia's CAB from 2012-13 onward also compares favourably to that of Canada, another commodity-exporting advanced economy that came through the GFC in relatively good shape.

10 The IMF's general methodology for estimating the CAB is outlined in Escolano (2010).

Chart 11: Cyclically adjusted balance



Note: Australian data are for Commonwealth government on a financial year basis. Data for other countries are for total general government and are on a calendar year basis (for example, 2006-07 data are for calendar year 2006).
Source: IMF Fiscal Monitor April 2013 and Treasury.

Estimates of the CAB are sensitive to assessments of an economy's productive potential, which is difficult to estimate in real time. They also need to be considered in the context of Australia's low debt levels, which are discussed in the next section.

Structural budget balance estimates go a step further, adjusting the cyclically-adjusted balance for other economic factors considered likely to have large temporary impacts on the budget. Like the CAB, estimates of the structural budget balance are subject to considerable uncertainty, due to their sensitivity to assumptions and reliance on values of difficult to estimate concepts, such as the output gap and the structural level of the terms of trade. These uncertainties caution against over-reliance on point estimates and emphasise the need to consider a range of plausible estimates. International experience also cautions against the use of CAB and structural balance estimates for setting fiscal policy due, in particular, to the difficulty in making reliable estimates in real time.

The key assumption underpinning structural balance estimates in Australia's case is the long-run assessment of our terms of trade, which have risen significantly over the past decade, largely due to strong growth in demand for Australia's non-rural commodity exports from emerging Asia. While the terms of trade have already fallen from their peak in the September quarter of 2011 and are projected to fall further as global supply of non-rural commodities increases, there is considerable uncertainty around terms of trade projections, including in the medium-to-long term.

It is also difficult to capture the relationship between economic aggregates and revenue, which can vary considerably over time, depending on how different tax bases are affected. This is especially the case when the economy is experiencing large shocks, such as those associated with the resources boom and the GFC over the past decade.

Structural budget balance estimates produced for Australia by organisations such as the OECD indicate that, prior to the GFC, underlying cash surpluses were supported by temporary factors, including the high terms of trade, an economy operating above its long-run potential and buoyant asset prices. This drove a temporary surge in tax receipts that was used to finance spending increases and tax reductions, causing deterioration in the structural budget position.

The GFC led to a further deterioration in the structural budget position, largely due to the Government's temporary fiscal stimulus measures and some of the factors that drove the fall in the tax share of GDP described earlier in this Statement. The fiscal stimulus measures have since been unwound; however, the reduced tax share of GDP continues to weigh on the budget.

Continued improvement in the structural budget position over the short- and medium-term is supported by the Government's long-term savings measures (described in Box 3) and the disciplines imposed by its commitments to:

- allow tax receipts to recover naturally as the economy improves, while keeping taxation as a share of GDP below its 2007-08 level on average; and
- hold real spending growth to 2 per cent a year, on average, until the budget surplus reaches at least 1 per cent of GDP, and while the economy is growing at or above trend.

This will reinforce the sustainability of the fiscal position at a pace that does not undermine economic growth or threaten jobs.

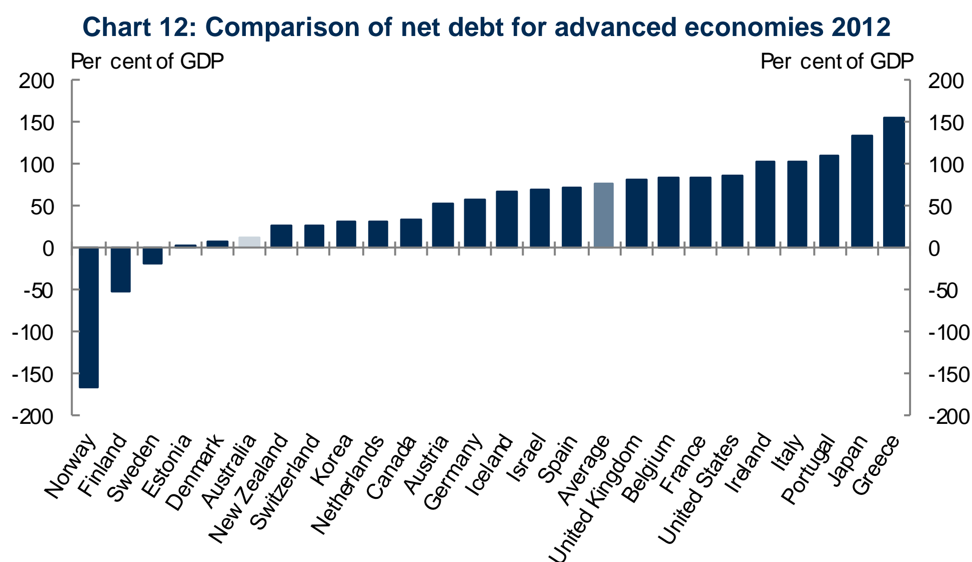
The strength of the government balance sheet is critical

Fiscal sustainability ultimately comes down to the government's ability to meet its current and future liabilities. A common measure of a government's liabilities is net debt. Net debt is preferred to gross debt as it takes into account total debt liabilities as well as debt-equivalent assets held by the government.

The Government's medium-term fiscal strategy takes a broader perspective still, targeting an improvement in net financial worth over time. Net financial worth takes account of financial assets and liabilities not included in net debt, such as equity investments and government employee superannuation liabilities. While more comprehensive than net debt, net financial worth measures are not widely available across countries and therefore fiscal sustainability assessments often fall back onto net debt comparisons.

Chart 12 shows that Australia has retained its strong balance sheet position with much lower debt levels than other advanced countries (these data are also on a total general government basis for comparability).[11] The expected peak in Australia's general government net debt (comprising the Australian Government, state and local governments) of 14.9 per cent of GDP in 2014-15 is around one-fifth of the average level in that year for the advanced economies as a whole and one-sixth of the average level for the G7.[12] Within the advanced economies, only five small northern European economies have stronger net debt positions, out of the 25 advanced economies for which these data are available.

Chart 12: Comparison of net debt for advanced economies 2012



Note: Data are for general government (that is, consolidated Commonwealth, State, and local government). Data for Australia are for 2012-13, from Budget Paper No. 3 Appendix C, and will differ from those presented elsewhere in Budget Paper No. 1, which are for the Commonwealth Government only.
Source: IMF Fiscal Monitor April 2013 and Treasury.

It is also important to take account of risks to the balance sheet from contingent liabilities, which have the potential to significantly affect fiscal sustainability. A key lesson from the GFC is that adverse events that trigger crystallisation of contingent liabilities — in particular, financial system guarantees — can dramatically transform government balance sheets. This highlights the importance of Australia's strong institutions, a resilient financial sector and sound economic management for maintaining fiscal sustainability.

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11 Australia's total consolidated general government net debt is forecast in the Budget to be 13.0 per cent of GDP in 2012-13, compared to Commonwealth net debt of 10.6 per cent of GDP.

12 For Australian Government net debt, the expected peak is 11.4 per cent of GDP in 2014-15. Australian Government net debt levels will be less than one-eighth of the average level for the major advanced economies.

While the number and value of quantifiable contingent risks on the government balance sheet has risen over the past decade, as has the number of unquantifiable risks, these contingent liabilities and other fiscal risks are comprehensively identified and detailed in the budget documents (see Budget Statement 8). Importantly, contingent risks relating to the financial sector are well managed by Australia's robust prudential regulation regime, as attested by the GFC experience and the results of recent financial system stress tests (Laker 2012).

Debt dynamics also matter

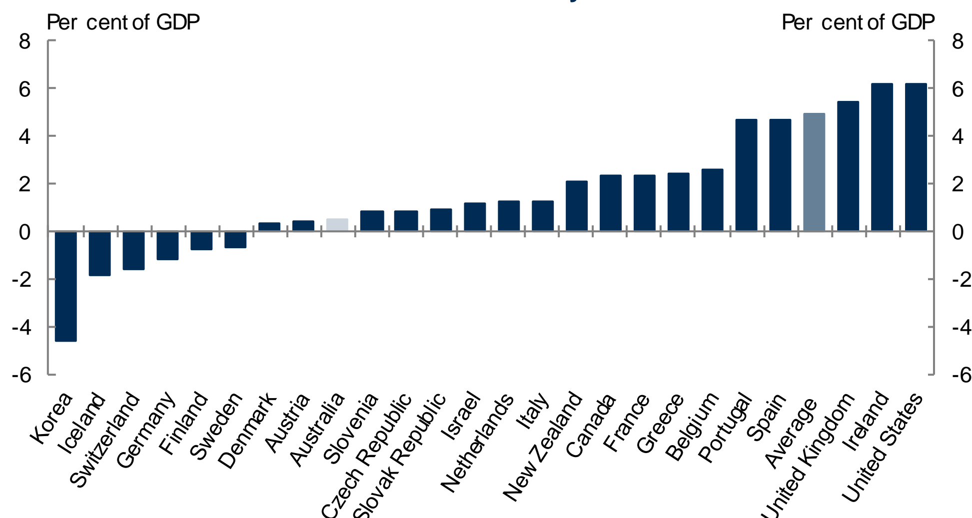
The evolution of government liabilities as a share of GDP is also important for fiscal sustainability. A common approach is to estimate the primary balance required to stabilise debt at a given share of GDP, as an indicator of the adjustment needed to ensure fiscal sustainability. For this purpose, the IMF calculates the cyclically-adjusted primary balance (CAPB) that needs to be achieved from 2020 onward so as to achieve a given debt ratio by 2030.[13]

The latest IMF estimates, updated for the 2013-14 Budget numbers, suggest that Australia faces a smaller adjustment from the current CAPB position to maintain sustainability over the medium-term than most other advanced economies (Chart 13).[14] This reflects a lower starting point for the cyclically-adjusted primary deficit and the debt ratio.

13 The IMF's methodology is outlined in Schaechter et al (2012).

14 This approach is also subject to caveats. In particular, it is contingent on assumed (and somewhat arbitrary) debt targets that vary across countries and does not necessarily provide an absolute benchmark to assess sustainability across countries or across time for the same country (Escolano 2010).

Chart 13: Advanced economies — medium-term adjustment required to stabilise debt-to-GDP ratio by 2030



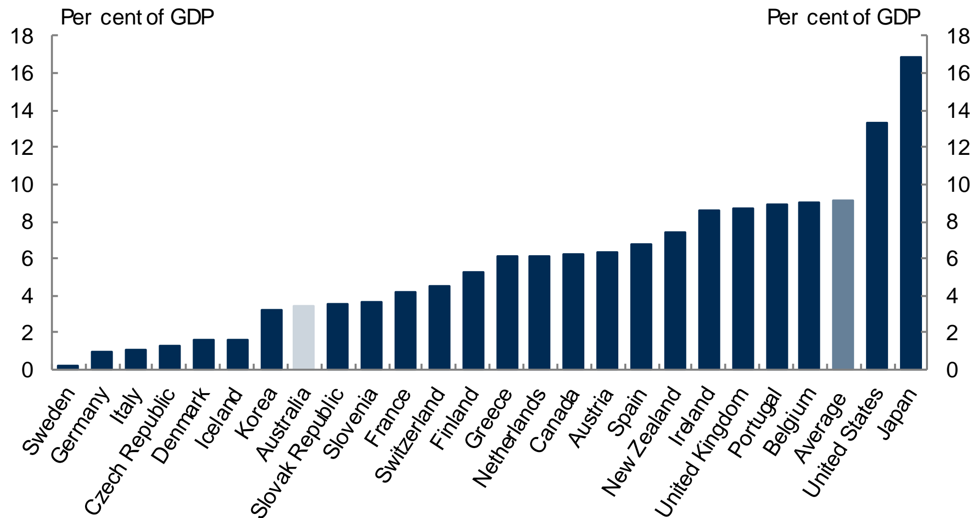
Note: Adjustment required from 2013 CAPB to bring the debt ratio down to 60 per cent (80 per cent for Japan), or to stabilise the ratio at the end-2013 level by 2030 if the ratio is less than 60 per cent. Ratio is for gross general government debt, except for Australia, Canada, Japan, and New Zealand, where net debt ratios are used. CAPB is CAB plus gross interest payments, except for Australia, Canada, Japan, and New Zealand, where CAPB is CAB plus net interest payments. Japan has been excluded from the chart for presentational reasons. Japan's medium term adjustment required to stabilise its debt-to-GDP ratio by 2030 is 16.1 per cent of GDP. Australian data are for Commonwealth government and relate to financial years 2013-14 and 2030-31. Data for other countries are for total general government and are on a calendar year basis.
Source: IMF Fiscal Monitor April 2013 and Treasury estimates.

In interpreting these estimates it is important to bear in mind that they are based on assumptions that have most other economies stabilising their debt ratios at higher levels than Australia. Of the eight countries assessed as having a smaller medium-term adjustment need than Australia, five have higher net debt ratios.

The IMF also calculates a required 'long-term' adjustment, which adds to the medium-term adjustment projected increases in age-related spending — recognising that this will require further savings in order to stabilise the debt ratio. Although the long-term required adjustment is larger than the medium-term adjustment, Australia also faces a smaller adjustment on this measure than most other advanced economies (Chart 14). In addition to the factors explaining the smaller medium-term adjustment, this also reflects a smaller projected increase in age-related spending. Of the seven countries assessed as having a smaller long-term adjustment need than Australia, five have higher debt ratios.[15]

15 This comparison in based on IMF net debt data where these are available, and on IMF gross debt data in the case of the Czech Republic.

Chart 14: Advanced economies — long-term adjustment required to stabilise debt-to-GDP ratio by 2030

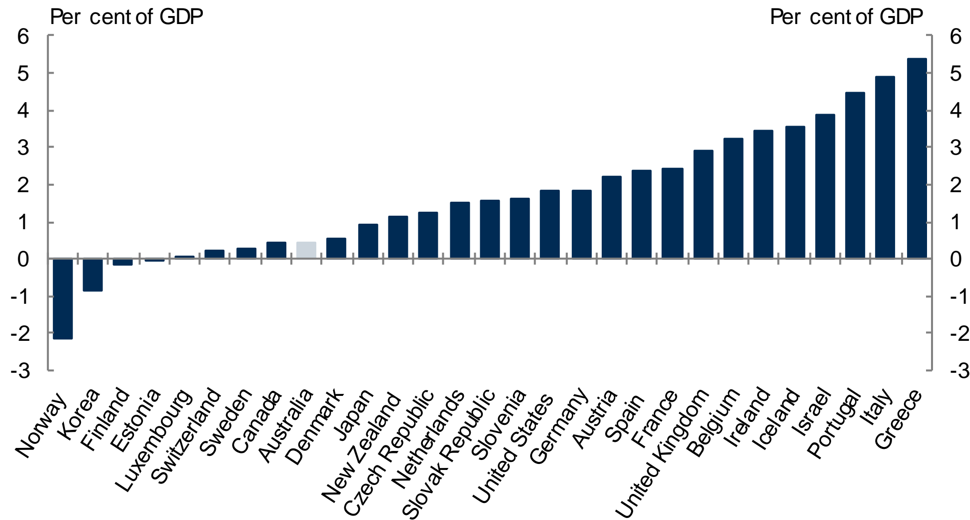


Note: As for Chart 13, with projected increase in age-related spending added to required medium-term primary balance adjustment.
Source: IMF Fiscal Monitor April 2013 and Treasury estimates.

Low debt means low interest payments

Australia's low net debt position is reflected in a relatively low net interest burden, notwithstanding that our stronger economy means that domestic interest rates are not as low as in many other advanced economies (Chart 15). As interest rates in countries like Japan, the United States and the United Kingdom are further below normal levels, this — together with the expectation that debt levels will remain high for some time — means that their budgets are more exposed to rising interest burdens once their economies recover and interest rates normalise.

Chart 15: Comparison of net interest payments for advanced economies 2012



Note: Data are for general government (that is, consolidated Commonwealth, State, and local government). Data for Australia are from Budget Paper No. 3 Appendix C and will differ from those presented elsewhere in Budget Paper No. 1, which are for the Commonwealth Government only. Australian data are for 2011-12, as forecasts of net interest payments for State and local governments for 2012-13 are not available.
Source: OECD Economic Outlook 92 and Treasury.

CONCLUSION

Sound fiscal policy involves ensuring that fiscal settings are sustainable over the medium term, while allowing the fiscal position to vary in response to economic conditions in the near term so as to contribute to macroeconomic stability.

The preceding analysis shows that the Government is striking an appropriate balance. Australia's public finances remain in good shape, with low net debt and the Government's fiscal credibility underpinning a stable AAA credit rating from all three major credit rating agencies. The Government's long-term savings measures and its commitments to limit real spending growth and allow tax receipts to recover naturally will strengthen the sustainability of the fiscal position over time, without undermining economic growth or threatening jobs.

Recent falls in global commodity prices and subdued recovery in financial asset prices following the GFC highlight the extent to which the budget surpluses in the years leading up to the GFC were supported by temporary factors. Conditions in the real economy have also been more challenging since the GFC for those sectors that are not connected to the resources sector. This reflects, in particular, the high Australian dollar and a more cautious approach to spending and borrowing by households.

While the main concern for macroeconomic policy in the pre-GFC period was the risk of inflationary pressures in the context of the largest terms of trade boom in our history, the main priority at present is maintaining solid economic growth and low

unemployment as the resources investment boom reaches its peak and the economy transitions to other drivers of growth.

Recent sizeable revenue write-downs have increased the fiscal adjustment needed to return the budget to surplus at a time when there is a greater risk that further near-term fiscal tightening might slow the economy excessively. Australia's low level of government debt and the credibility of the Government's medium-term fiscal strategy provide the flexibility to phase in the fiscal adjustment over a longer period than previously envisaged.

The Government's plan to return the budget to surplus, including the long-term savings measures announced in this Budget, strengthens fiscal sustainability on a timeframe that does not risk undermining the strength of the Australian economy. This will ensure that Australia maintains a strong fiscal position, including compared to most other advanced economies.

Maintaining fiscal sustainability is not only about implementing savings measures. Fiscal sustainability can also be assisted by policies that increase long-term growth in the economy, contributing to higher revenues. Hence, this Budget also funds critical social and economic reforms in areas such as education, disability care and infrastructure to boost the nation's productivity and set Australia up for future prosperity.

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