STATEMENT 3: FISCAL STRATEGY AND OUTLOOK

This statement outlines the fiscal outlook and how the Government has delivered on its fiscal strategy. Temporary deficits are necessary to support growth while the economy is weak. In this Budget, the Government has fully offset all new spending in 2012-13. This approach is consistent with the Government's medium-term fiscal strategy of achieving budget surpluses, on average, over the medium term.

An underlying cash deficit of $57.6 billion (4.9 per cent of GDP) is expected in 2009-10, compared with the February 2009 *Updated Economic and Fiscal Outlook* (UEFO) estimate of $35.5 billion (2.9 per cent of GDP). The budget deficit is a direct consequence of the global recession, which has had a substantial impact on tax revenues. Since the 2008-09 Budget, tax receipts have been revised down by around an estimated $210 billion over the forward estimates to 2012-13. Consistent with the fiscal strategy, the 'automatic stabilisers' have been allowed to flow through to the budget position, supporting economic growth.

The Government has met its commitment to fund new expenditure through a reprioritisation of existing expenditure. New spending has been offset by the final year of the forward estimates. The budget deficit is expected to halve as a share of GDP by the end of the forward estimates, and in the medium term, the underlying cash balance is projected to return to surplus by 2015-16. This will be achieved through expenditure restraint (holding real spending growth to 2 per cent when the economy recovers and grows above trend) and by allowing receipts to recover naturally with the recovery in the economy. This will ensure that the economic recovery is not jeopardised while at the same time providing a clear path back to surplus.

Australia's budget position remains sound and sustainable. Australia's deficit in 2009-10 is less than half that of the major advanced economies' collective deficit of 10.4 per cent of GDP and considerably smaller than the 8.8 per cent of GDP collective deficit for advanced economies as a whole.

Net debt will remain low by international standards and is projected to decline to 3.7 per cent of GDP by the end of the next decade.

Appendix A illustrates the sensitivity of the budget estimates to changes in the economic outlook. Statement 4 examines a range of indicators to assess the sustainability of Australia's budget position.

Appendix B outlines the methodology underpinning the medium-term economic and fiscal projections

CONTENTS

STATEMENT 3: FISCAL STRATEGY AND OUTLOOK

OVERVIEW OF FISCAL POSITION

Underlying cash deficits are expected across the forward estimates period, with a deficit of $57.6 billion in 2009-10 (4.9 per cent of GDP) expected to fall to a deficit of $28.2 billion in 2012-13 (2.0 per cent of GDP) (Table 1). These deficits largely stem from the natural deterioration in expected tax receipts as a result of the global recession. Compared to the 2008-09 Budget, tax receipts have been revised down by around an estimated $210 billion over the period 2008-09 to 2012-13.

Beyond the forward estimates, the budget is projected to return to surplus by 2015-16 underpinned by the natural recovery in tax receipts as the economy improves and expenditure restrained.

Australia's budget position remains sound and sustainable. Australia's deficit in 2009-10 is less than half that of the major advanced economies' collective deficit of 10.4 per cent of GDP and considerably smaller than the 8.8 per cent of GDP collective deficit for advanced economies as a whole. Significantly, advanced economies will remain in collective deficit into the medium term, with a deficit of 3.9 per cent of GDP in 2014.

Australia's balance sheet is strong, and will continue to be one of the strongest in the world. After peaking at 13.8 per cent of GDP in 2013-14, net debt is expected to fall to 3.7 per cent of GDP by 2019-20. In comparison, net debt in advanced economies will continue to rise to a substantial 80.6 per cent of GDP in 2014.

Table 1: Budget aggregates

	Actual	Estimates			Projections	
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Underlying cash balance ($b)(a)	**19.7**	**-32.1**	**-57.6**	**-57.1**	**-44.5**	**-28.2**
Per cent of GDP	1.7	-2.7	-4.9	-4.7	-3.4	-2.0
Fiscal balance ($b)	**21.0**	**-32.9**	**-53.1**	**-56.0**	**-41.8**	**-30.3**
Per cent of GDP	1.9	-2.7	-4.5	-4.6	-3.2	-2.2

(a) Excludes expected Future Fund earnings.

THE GOVERNMENT'S FISCAL STRATEGY

The Government's fiscal strategy aims to ensure fiscal sustainability over the medium term. During a period of global economic uncertainty, fiscal sustainability becomes increasingly important. A credible fiscal policy, set in a medium-term framework, will facilitate steady growth and help cushion the economy against damaging short-term fluctuations. It promotes confidence and provides greater certainty for decision-makers.

Key elements of a sustainable medium-term fiscal strategy

The Government remains committed to its medium-term fiscal strategy of:

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

These medium-term objectives anticipate that fiscal policy will support economic growth and jobs by allowing the budget to move into temporary deficit during an economic downturn.

To ensure that growth is supported in a way that is consistent with the medium-term fiscal strategy, the Government committed in the February 2009 *Updated Economic and Fiscal Outlook* (UEFO) to a two-stage fiscal strategy:

1. Support the economy during the global recession

During periods of economic slowdown of uncertain extent and duration, it is critical that the Government continues to support the economy and jobs by:

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

2. Deficit exit strategy as the economy recovers

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

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

Delivering on the fiscal strategy

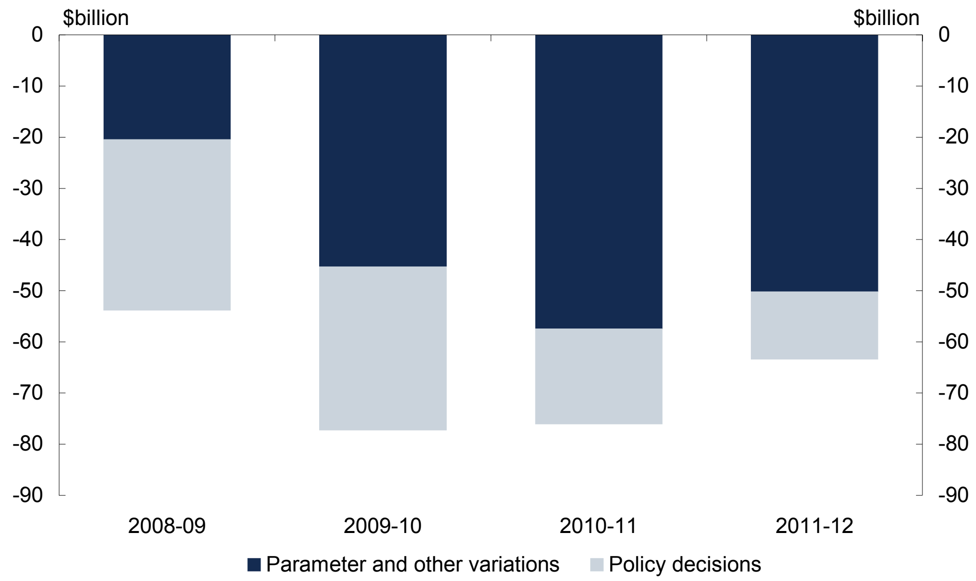
The 2009-10 Budget delivers on the two-stage fiscal strategy of supporting growth now while investing for the future, and returning the Budget to surplus once the economy recovers.

Allowing the automatic stabilisers to support the economy

The change in the economic outlook since the 2008-09 Budget has implications for both the receipt and payment sides of the budget. Much of the deterioration in the budget position is as a result of the revised economic parameters that have lowered forecast tax receipts.

Since the 2008-09 Budget, tax receipts have fallen by around an estimated $210 billion across the forward estimates to 2012-13. This estimate takes into account potential downward revisions to estimated tax receipts in 2012-13. Chart 1 does not include 2012-13 as this Budget reports estimates for 2012-13 for the first time. In this Budget, the government has fully offset new spending in 2012-13.

Chart 1: Variations in the underlying cash balance since the 2008-09 Budget



Variations to taxes and payments (parameter and other variations) represent around two thirds of the total decrease in the underlying cash balance since the 2008-09 Budget over the 4 years from 2008-09, and more than three quarters of the decrease in 2010-11 and 2011-12.

The global recession and collapse in commodity prices are the primary cause of the substantial downward revisions to revenue. These revisions wipe out most of the large revenue gains from strong global growth and rising commodity prices between the 2005-06 Budget and 2008-09 Budget.

Were the Government to offset these automatic variations in taxes and payments it would be contributing to — rather than leaning against — the macroeconomic instability arising out of the global recession. Instead, by allowing the 'automatic stabilisers' of the budget to operate, the Government's fiscal policy is playing a continuing important role in stabilising the economy.

A temporary deficit, financed through borrowings that will be repaid when economic conditions improve, is the only sensible course of action in the current economic circumstances.

Supporting the economy and jobs now, while investing for the future

Discretionary fiscal policy will temporarily add to the deficit in order to support economic activity and employment. The net measures in the Budget raise the level of GDP by ¾ of a per cent in 2009-10.

To support the economy through the global recession, the Government's fiscal stimulus program started with income support and then moved into 'shovel-ready' infrastructure. This Budget marks the start of the next phase — a move into larger and longer term nation building projects.

Investments in road, rail, ports and the national broadband network will support jobs in the short term, and enhance productivity and innovation in the longer term. Also contributing to productivity will be the investment in world-class higher education, hospital systems and innovation. At the same time, the paid parental leave system will support increased participation and income security for pensioner and carers has been enhanced.

As the economy recovers: deficit exit strategy

The Government remains committed to the medium-term fiscal strategy, including keeping the Budget in surplus, on average, over the economic cycle. As soon as economic growth returns to above trend levels, the Government is committed to taking action to return the Budget to surplus as quickly as possible, by allowing tax receipts to recover and limiting growth in real spending. Based on this strategy the budget is projected to return to underlying cash balance surplus by 2015-16.

Allowing tax receipts to recover naturally

As the economy strengthens there will be a natural recovery in the level of tax receipts without any policy changes. The Government will 'bank' any improvement in tax receipts associated with this economic recovery, allowing this to flow through to improve the budget position.

Taxation receipts are currently an estimated 22.0 per cent of GDP in 2009-10, significantly below the 2007-08 level of 24.6 per cent of GDP reflecting the current economic slowdown. There is, therefore, the scope for tax receipts to recover, while maintaining our commitment to keep taxation as a share of GDP below the 2007-08 level on average.

Reprioritising spending to fast-track the return to surplus

The Government has already put in place the foundations to deliver expenditure restraint once the economy returns to above trend rates of economic growth. The Government is delivering on its deficit exit strategy.

New spending has been fully offset in the final year of the forward estimates in cash terms. Real spending growth has been held below 2 per cent in each of 2011-12 and 2012-13 — two years where above trend economic growth has been projected.

The table below shows the net effect of policy decisions taken since UEFO. In assessing performance against the fiscal strategy, the total effect of policy decisions is adjusted to account for the impact of the changed implementation arrangements for CPRS and for amounts that have previously been provided for in the contingency reserve.

Table 2: Delivering our fiscal strategy

	Estimates			Projections	
	2008-09	2009-10	2010-11	2011-12	2012-13
	$m	$m	$m	$m	$m
Effect of policy decisions since UEFO					
Spends	-4,343	-14,457	-11,623	-13,390	-8,369
Saves	89	2,496	5,630	6,438	8,006
Total effect of policy decisions since UEFO	**-4,254**	**-11,961**	**-5,993**	**-6,952**	**-363**
Less Carbon Pollution Reduction Scheme (CPRS)	-3	-2,800	-110	-915	3,655
Add Contingency reserve offsets to policy decisions	10	3,223	3,740	4,726	4,308
Net budget impact	**-4,242**	**-5,937**	**-2,143**	**-1,311**	**290**

In cash terms, the revised Carbon Pollution Reduction Scheme (CPRS) implementation package adversely affects the Budget in 2009-10, 2010-11 and 2011-12, and improves the Budget in 2012-13. This reflects the temporary timing divergence between CPRS expenditures and revenues during the transition period. In assessing performance against the fiscal target, and its contribution to medium term sustainability, these temporary cash effects are disregarded.

In the 2008-09 Budget, provision was made for a number of programs that were reasonably expected to affect the budget estimates. For example, a provision of around $12.5 billion was put aside for nation-building infrastructure. Delivery of these programs which have previously been provided for does not increase expected spending, and as such does not impact on the overall budget position. Accordingly, in assessing performance against the fiscal target, and its contribution to medium-term sustainability, the total effect of policy decisions on the Budget should be adjusted for contingency reserve offsets.

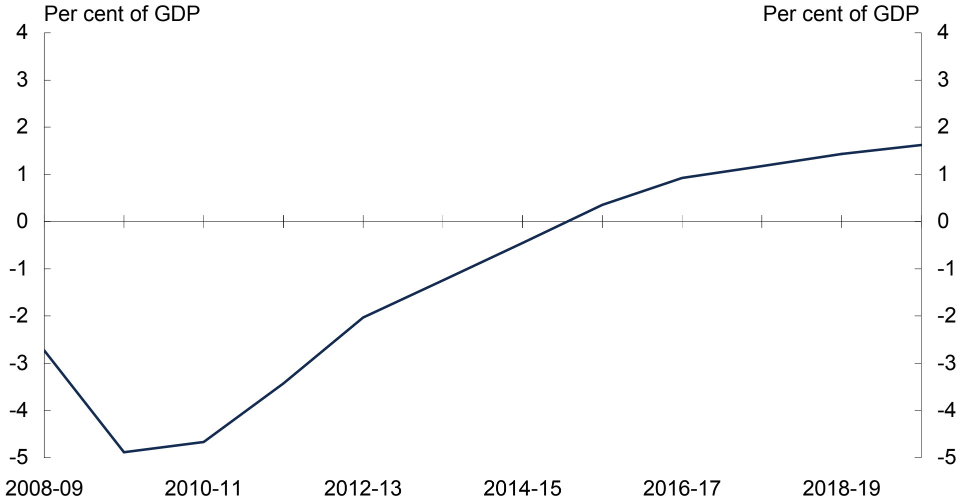
The Government has been prepared to make the hard decisions now in order to position Australia for the future through major structural savings underpinning fiscal sustainability.

A key feature of the Government's pension reform package is the introduction of measures to preserve the medium-term sustainability of the retirement income system, including increasing the qualifying age for the Age Pension and reprioritising spending within the pension system.

To ensure Australia's retirement income system remains sustainable into the future, the Government will reduce the generosity of some superannuation concessions to those with greater private resources. The Government will rebalance its suite of policies supporting private health insurance, so that people with a greater capacity to provide for their own health insurance do so. It will also make changes to the Family Tax Benefit Part A (FTB-A) as part of ensuring fiscal sustainability in the medium term.

Reflecting the projected improvements in receipts and the hard choices to ensure spending is sustainable, the Government projects the budget position will strengthen in the projection years, bringing the deficit down to 2.0 per cent of GDP in 2012-13 (a halving of the 2009-10 deficit). Outside the forward estimates, the projected continued strengthening of the economy will translate to further improvements in receipts. With the Government's continued action to restrain real spending growth to 2 per cent, the Budget is currently projected to return to surplus in 2015-16, and remain in a surplus position for the remainder of the medium-term projections (Chart 2).

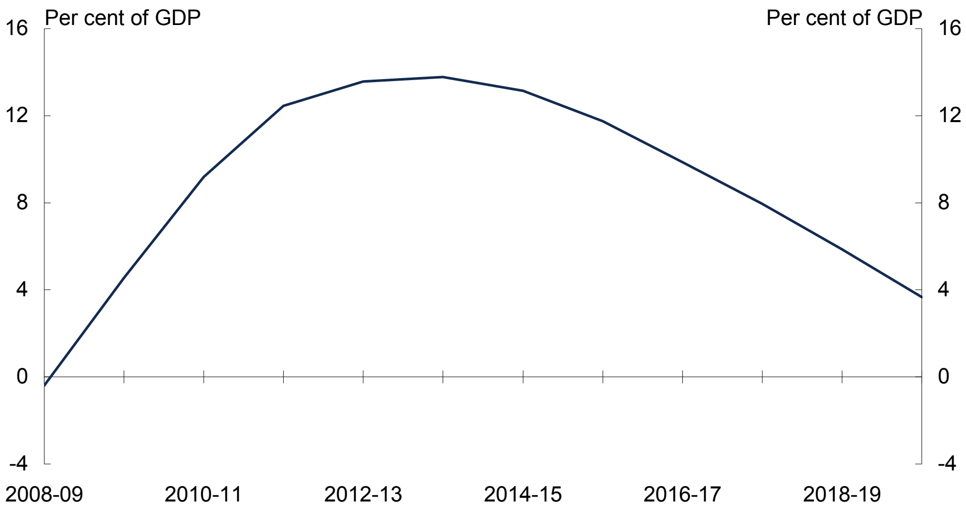
Chart 2: Underlying cash balance projected to 2019-20



Source: Treasury projections.

Net debt will remain low by international standards and will begin to improve once the budget approaches surplus (Chart 3). Net debt is projected to peak at 13.8 per cent of GDP in 2013-14, which is significantly smaller as a proportion of GDP than most other advanced countries. This is considerably lower than the 80 per cent net debt that the IMF predicts for countries such as the US, UK, Germany and France by 2014.

Chart 3: Government net debt projected to 2019-20



Source: Treasury projections.

FISCAL OUTLOOK

An underlying cash deficit of $57.6 billion is expected in 2009-10 compared with an estimated deficit of $35.5 billion at UEFO. In accrual terms, a fiscal deficit of $53.1 billion is estimated for 2009-10 compared to $33.3 billion at UEFO.

Table 3: Australian Government general government sector budget aggregates

	Actual	Estimates			Projections	
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Revenue ($b)	**303.7**	**295.9**	**290.6**	**294.8**	**320.8**	**349.7**
Per cent of GDP	26.8	24.7	24.7	24.1	24.7	25.2
Expenses ($b)	**280.1**	**324.4**	**338.2**	**344.5**	**356.4**	**375.0**
Per cent of GDP	24.8	27.1	28.7	28.2	27.4	27.0
Net operating balance ($b)	23.6	-28.5	-47.6	-49.7	-35.6	-25.3
Net capital investment ($b)	2.6	4.3	5.5	6.3	6.1	5.0
Fiscal balance ($b)	**21.0**	**-32.9**	**-53.1**	**-56.0**	**-41.8**	**-30.3**
Per cent of GDP	1.9	-2.7	-4.5	-4.6	-3.2	-2.2
Underlying cash balance ($b)(a)	**19.7**	**-32.1**	**-57.6**	**-57.1**	**-44.5**	**-28.2**
Per cent of GDP	1.7	-2.7	-4.9	-4.7	-3.4	-2.0
Memorandum item:						
Headline cash balance ($b)	28.2	-35.9	-59.8	-58.9	-48.5	-25.1

(a) Excludes expected Future Fund earnings.

Cash flows

In 2009-10, an underlying cash deficit of $57.6 billion is expected, compared with the UEFO estimate of $35.5 billion. A headline cash deficit of $59.8 billion is forecast for 2009-10. Table 4 provides a summary of Australian Government general government sector cash flows.

Table 4: Summary of Australian Government general government sector cash flows

	Estimates			Projections	
	2008-09	2009-10	2010-11	2011-12	2012-13
	$b	$b	$b	$b	$b
Cash receipts					
Operating cash receipts					
excluding Future Fund earnings	285.6	278.4	285.1	307.3	337.2
Future Fund earnings	3.6	2.9	2.9	2.8	2.8
Total operating receipts	289.2	281.4	288.0	310.1	339.9
Capital cash receipts(a)	0.6	0.6	0.3	0.2	0.2
Total cash receipts	289.8	282.0	288.3	310.2	340.1
Cash payments					
Operating cash payments	308.3	325.6	330.9	340.8	355.6
Capital cash payments(b)	9.5	11.0	11.5	11.1	9.9
Total cash payments	317.8	336.6	342.4	352.0	365.5
Finance leases and similar arrangements(c)	0.5	0.0	0.0	0.0	0.0
GFS cash surplus(+)/deficit(-)	**-28.5**	**-54.7**	**-54.2**	**-41.8**	**-25.4**
Per cent of GDP	-2.4	-4.6	-4.4	-3.2	-1.8
less Future Fund earnings	3.6	2.9	2.9	2.8	2.8
Underlying cash balance(d)	**-32.1**	**-57.6**	**-57.1**	**-44.5**	**-28.2**
Per cent of GDP	-2.7	-4.9	-4.7	-3.4	-2.0
Memorandum items:					
Net cash flows from investments in financial assets for policy purposes(e)	-7.4	-5.1	-4.8	-6.8	0.3
plus Future Fund earnings	3.6	2.9	2.9	2.8	2.8
Headline cash balance	**-35.9**	**-59.8**	**-58.9**	**-48.5**	**-25.1**

(a) Equivalent to cash receipts from the sale of non-financial assets in the cash flow statement.
(b) Equivalent to cash payments for purchases of new and second-hand non-financial assets in the cash flow statement.
(c) The acquisition of assets under finance leases decreases the underlying cash balance. The disposal of assets previously held under finance leases increases the underlying cash balance.
(d) Excludes expected Future Fund earnings.
(e) Under the cash budgeting framework, these cash flows were referred to as net advances.

Table 5 provides a reconciliation of the variations in the underlying cash balance estimates.

Table 5: Reconciliation of 2008-09 Budget, 2008-09 MYEFO, UEFO and 2009-10 Budget underlying cash balance estimates

	Estimates			Projections
	2008-09	2009-10	2010-11	2011-12
	$m	$m	$m	$m
2008-09 Budget underlying cash balance(b)	**21,703**	**19,669**	**18,996**	**18,870**
Per cent of GDP	1.8	1.5	1.4	1.3
Changes between 2008-09 Budget and MYEFO				
Effect of policy decisions(a)	-11,093	-1,634	-966	-810
Effect of parameter and other variations	-5,244	-14,440	-15,390	-11,371
Total variations	**-16,337**	**-16,074**	**-16,357**	**-12,181**
2008-09 MYEFO underlying cash balance(b)	**5,365**	**3,595**	**2,640**	**6,689**
Per cent of GDP	0.4	0.3	0.2	0.5
Changes between MYEFO and UEFO				
Effect of policy decisions(a)	-18,037	-18,365	-11,655	-5,435
Effect of parameter and other variations	-9,816	-20,753	-25,314	-26,937
Total variations	**-27,853**	**-39,118**	**-36,969**	**-32,372**
2009 UEFO underlying cash balance(b)	**-22,487**	**-35,524**	**-34,330**	**-25,683**
Per cent of GDP	-1.9	-2.9	-2.7	-1.9
Changes from UEFO to 2009-10 Budget				
Effect of policy decisions(a)	-4,254	-11,961	-5,993	-6,952
Effect of parameter and other variations	-5,373	-10,108	-16,727	-11,901
Total variations	**-9,627**	**-22,069**	**-22,721**	**-18,853**
2009-10 Budget underlying cash balance(b)	**-32,114**	**-57,593**	**-57,051**	**-44,535**

(a) Excludes the public debt net interest effect of policy measures, and offsets from the contingency reserve for decisions taken. Includes the revised implementation arrangements for the Carbon Pollution Reduction Scheme.
(b) Excludes expected Future Fund earnings.

Variations to the underlying cash balance estimates

The 2009-10 underlying cash deficit of $57.6 billion is $22.1 billion higher than estimated at UEFO.

Policy decisions

Policy decisions since UEFO are expected to increase the underlying cash deficit by $12.0 billion in 2009-10.

Further detail of the impact of these policy decisions on the fiscal outlook is provided in the 'Variations to the fiscal balance' section below. More detail on the decisions can be found in Budget Paper No. 2, *Budget Measures 2009-10*.

Parameter and other variations

Total parameter and other variations since UEFO have increased the forecast of the underlying cash deficit in 2009-10 by $10.1 billion. Since the 2008-09 Budget, parameter and other variations are expected to have a total negative impact of $173 billion on the underlying cash balance in the four years to 2011-12.

Variations in receipts

Parameter and other variations since UEFO decrease taxation receipts by $14.5 billion in 2009-10. The variations primarily relate to receipts from individuals, companies, and GST.

Since the 2008-09 Budget, parameter and other variations are expected to decrease taxation receipts by around $173 billion in the four years to 2011-12.

Non-tax receipts in 2009-10 is expected to be higher than forecast at UEFO, primarily reflecting an increase of $0.9 billion in the estimate of fee revenue from the Guarantee Scheme for Large Deposits and Wholesale Funding arising from growth in guaranteed liabilities over recent months.

Variations in payments

Total payment parameter and other variations have improved the underlying cash balance by $2.7 billion in 2009-10 largely reflecting:

- a drawdown in the contingency reserve for decisions taken of $3.6 billion which have offset policy measures, including in relation to the nation building funds and Northern Territory Emergency Response;
- the impact of lower GST payments to the States of $2.1 billion reflecting a lower estimate of GST receipts; and
- the regular drawdown in the conservative bias provision of $1.3 billion.

These reductions are partially offset by an increase in payments in 2009-10, largely reflecting an expected increase in unemployment benefit recipients, along with an expected increase in recipients for a range of other income support programs.

Variations in fiscal balance estimates

In 2009-10, a fiscal balance deficit of $53.1 billion is estimated, compared with the deficit of $33.3 billion estimated at UEFO. Table 6 provides a reconciliation of the fiscal balance estimates.

Table 6: Reconciliation of 2008-09 Budget, 2008-09 MYEFO, UEFO and 2009-10 Budget fiscal balance estimates[(a)]

	Estimates			Projections
	2008-09	2009-10	2010-11	2011-12
	$m	$m	$m	$m
2008-09 Budget fiscal balance	**23,122**	**22,357**	**23,316**	**22,587**
Per cent of GDP	1.9	1.7	1.7	1.6
Changes between 2008-09 Budget and MYEFO				
Effect of policy decisions(b)	-11,514	-1,350	-842	-821
Effect of parameter and other variations	-5,766	-13,884	-15,761	-11,682
Total variations	**-17,280**	**-15,234**	**-16,603**	**-12,503**
2008-09 MYEFO fiscal balance	**5,842**	**7,123**	**6,713**	**10,085**
Per cent of GDP	0.5	0.6	0.5	0.7
Changes between MYEFO and UEFO				
Effect of policy decisions(b)	-19,643	-19,747	-11,459	-5,338
Effect of parameter and other variations	-8,552	-20,675	-26,710	-28,666
Total variations	**-28,195**	**-40,422**	**-38,169**	**-34,004**
2009 UEFO fiscal balance	**-22,353**	**-33,299**	**-31,456**	**-23,920**
Per cent of GDP	-1.9	-2.8	-2.5	-1.8
Changes between UEFO and 2009-10 Budget				
Effect of policy decisions(b)				
Revenue	-2	-256	-4,990	-631
Expenses	3,294	8,123	2,054	4,941
Net capital investment	246	438	70	52
Total policy decisions impact on fiscal balance	-3,541	-8,817	-7,114	-5,623
Effect of parameter and other variations				
Revenue	-8,019	-13,133	-19,159	-15,214
Expenses	-1,168	-1,958	-2,167	-3,415
Net capital investment	105	-146	393	409
Total parameter and other variations impact on fiscal balance	-6,957	-11,029	-17,385	-12,208
2009-10 Budget fiscal balance	**-32,851**	**-53,145**	**-55,956**	**-41,751**
Per cent of GDP	-2.7	-4.5	-4.6	-3.2

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

Variations in revenue estimates

As a result of the weakening in the Australian economic outlook, revenue for 2009-10 has been revised down since UEFO. Parameter and other variations have reduced revenue by $13.1 billion in 2009-10 since UEFO, with new policy decisions reducing revenue by $256 million.

Most revenue heads have been revised down in 2009-10 since UEFO as nominal GDP is now forecast to contract. The largest revisions occur in individuals' income taxes, company tax and GST. Growth in individuals' incomes is expected to be weaker due to more moderate wage growth and expected falls in employment and unincorporated business and property income. Parameter and other variations have reduced individuals' income taxes by $6.3 billion since UEFO. Company profits are forecast to be lower than at UEFO, mainly reflecting continuing weakness in the domestic economy, resulting in company tax being revised down by $2.8 billion. Lower forecasts for consumption and dwelling investment have reduced the forecast for GST and other consumption tax revenues by $3.5 billion.

Non-taxation revenue in 2009-10 is expected to be higher than forecast at UEFO. The increase since UEFO mainly reflects fee revenue from the Guarantee Scheme for Large Deposits and Wholesale Funding being revised upwards by $0.9 billion in 2009-10 as a result of higher than anticipated growth in guaranteed liabilities over recent months.

Further detail on how the revised outlook for the economy has affected individual revenue heads over the forward estimates is provided in Statement 5. An analysis of the sensitivity of the taxation revenue estimates to changes in the economic parameters is provided in Appendix A of Statement 3.

Variations in expense estimates

Since UEFO, estimated total expenses for 2009-10 have increased by $6.2 billion reflecting increased expenses from new policy decisions of $8.1 billion, offset by parameter and other variations of $2.0 billion (see Table 6).

The reduction in estimated expenses arising from net parameter and other variations includes drawdowns from the contingency reserve, which are recorded as 'other variations'. The drawdown in the contingency reserve includes offsets for infrastructure payments to the States and Territories through the nation building funds, new Official Development Assistance policy measures, policy measures relating to the extension of the Northern Territory Emergency Response and the regular drawdown of the conservative bias allowance.

Major policy decisions since UEFO that have increased expenses include:

- increasing age, carer and disability pensions, as part of the *Secure and Sustainable Pensions* package, by $32.49 a week for full-rate singles and $10.14 a week for full-rate couples (combined) from 20 September 2009, at an expected cost of $2.7 billion in 2009-10 and $14.2 billion over four years;

- extending Australia's defence force presence in Afghanistan for 2009-10, and expanding our engagement there, will increase expenses by $1.1 billion in 2009-10 relative to estimates at UEFO;

- investing in nation building infrastructure through the Building Australia Fund. As this infrastructure is largely funded through grants to the States and Territories, it is expected to increase expenses by $521 million in 2009-10 and by $5.2 billion over four years;

- investing in innovation and higher education, as part of the *An Innovation and Higher Education System for the 21st Century* package of measures, at an expected cost of $917 million in 2009-10 and $6.3 billion over the next four years. This includes spending out of the Education Investment Fund;

- supporting first home buyers through the extension of the First Home Owners Boost, at an expected cost of $486 million in 2009-10 and $539 million over four years;
- investing in improved health infrastructure through the Health and Hospital Fund, which is expected to increase expenses by $465 million in 2009-10 and by $2.8 billion over four years;
- investing in the clean energy initiative, at a cost of $400 million in 2009-10 and $1.3 billion over four years (including funding through the Education Investment Fund);
- continuing the Northern Territory Emergency Response at an expected cost of $310 million in 2009-10 and $807 million over four years; and
- extending the *Solar Homes and Communities Plan* (which provides rebates for the installation of solar panels), which is expected to increase expenses by $272 million in 2009-10.

The impact of these policy decisions on expenses has been partially offset by a number of savings measures, including:

- temporarily reducing the superannuation co-contribution, which is expected to reduce expenses by $385 million in 2009-10 and by $1.4 billion over four years;
- repayment by the States and Territories of overpayments of GST compensation, resulting in a reduction in expenses of $302 million in 2009-10;
- increasing the pension income test taper rate to better target pension payments, which is expected to save $134 million in 2009-10 and $1.6 billion over four years;
- pausing indexation of the upper income thresholds for Family Tax Benefits and the Baby Bonus for a period of three years, which is expected to save $210 million in 2009-10 and $1.4 billion over four years;
- savings in Defence expenses of $2.0 billion between 2010-11 and 2012-13; and
- better targeting of the Private Health Insurance Rebate, which is expected to increase expenses by $125 million in 2009-10 but to reduce expenses by $1.9 billion between 2010-11 and 2012-13.

In 2009-10, parameter and other variations have reduced forecast expenses by $2.0 billion since UEFO. These variations reflect:

- the drawdown of provisions for expenditure from the nation building funds and the national broadband network. In the 2008-09 Budget, provision was made in the contingency reserve for expenditure of $2.5 billion in 2009-10;
- a reduction in GST payments to the States and Territories of $2.1 billion in 2009-10 and by $8.0 billion over four years;
- the drawdown of the conservative bias allowance[1], reducing estimated expenses by $1.3 billion in 2009-10; and
- the drawdown of provision in the contingency reserve for the Northern Territory Emergency Response by $310 million in 2009-10 and by $520 million over four years.

These decreases in expenses are partially offset by:

- an increase in expected interest expenses of $1.0 billion in 2009-10, primarily due to public debt interest costs; and
- higher than previously forecast number of Newstart recipients which, combined with higher than previously expected average benefit payments, has increased forecast expenses by $1.1 billion in 2009-10.

In 2008-09, estimated total expenses have increased by $2.1 billion since UEFO. This reflects expenses parameter and other variations of $1.2 billion, offset by net new spending of $3.3 billion, including:

- investing $1.5 billion in infrastructure, including through the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund; and
- providing the new carer supplement, which is expected to increase expenses by $373 million in 2008-09.

More detailed information on expenses can be found in Statement 6. A full description of all policy measures since UEFO can be found in Budget Paper No. 2, *Budget Measures 2009-10*.

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

Variations in net capital investment estimates

In 2009-10, forecast net capital investment has increased by $292 million since UEFO. This primarily reflects the purchase of assets as part of the National Broadband Network initiative and investment as part of the Infrastructure Package. Further information on net capital investment can be found in Statement 6.

Net financial worth, net worth and net debt

Net debt for the Australian Government general government sector is forecast to be $53.7 billion in 2009-10. Net financial worth and net worth for the Australian Government general government sector are forecast to be -$136.0 billion and -$38.7 billion in 2009-10 respectively. The decline in net debt, net financial worth and net worth primarily reflects the increase in the estimated deficit.

Further details on the balance sheet are outlined in Statement 7 Asset and Liability Management.

Table 7 provides a summary of Australian Government general government sector net financial worth, net worth, net debt and net interest payments.

Table 7: Australian Government general government sector net financial worth, net worth, net debt and net interest payments

	Estimates			Projections	
	2008-09	2009-10	2010-11	2011-12	2012-13
	$b	$b	$b	$b	$b
Financial assets	200.6	207.6	209.4	225.1	238.0
Non-financial assets	93.1	97.3	103.1	108.9	113.7
Total assets	**293.7**	**304.9**	**312.5**	**334.0**	**351.7**
Total liabilities	**283.0**	**343.5**	**402.5**	**461.6**	**506.7**
Net worth	**10.8**	**-38.7**	**-90.0**	**-127.6**	**-155.0**
Net financial worth(a)	**-82.3**	**-136.0**	**-193.1**	**-236.5**	**-268.7**
Per cent of GDP	-6.9	-11.5	-15.8	-18.2	-19.4
Net debt(b)	**-4.7**	**53.7**	**112.2**	**161.7**	**188.2**
Per cent of GDP	-0.4	4.6	9.2	12.4	13.6
Net interest payments	**-0.9**	**1.5**	**4.7**	**6.0**	**7.6**
Per cent of GDP	-0.1	0.1	0.4	0.5	0.6

(a) Net financial worth equals total financial assets minus total liabilities. That is, it excludes non-financial assets.

(b) Net debt equals the sum of deposits held, advances received, government securities, loans and other borrowing, minus the sum of cash and deposits, advances paid and investments, loans and placements.

Appendix A: Sensitivity of Budget Estimates to Economic Developments

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

This section examines the effects on receipts and payments of altering some of the key economic assumptions underlying the estimates. Tables A2 and A4 illustrate the sensitivity of key components of receipts and payments to possible variations in the economic outlook. The two scenarios considered are:

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

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

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

Scenario 1

The first scenario involves a permanent rise in world prices of non-rural commodity exports, which causes a rise in the terms of trade, consistent with a 1 per cent rise in nominal GDP by Year 2. The sensitivity analysis evaluates the flow-on effects on the economy, the labour market and prices. The impacts in Table A1 are highly stylised and refer to per cent deviations from the baseline levels of the economic parameters.

Table A1: Illustrative impact of a permanent non-rural commodity price rise consistent with a 1 per cent rise in nominal GDP in Year 2 (per cent deviation from the baseline level)

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

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

In reality, a rise in the terms of trade would be expected to put upward pressure on the exchange rate, although the magnitude is particularly difficult to model. In the event of an appreciation in the exchange rate, the impacts on the external sector would dampen the real GDP effects, and there would be some offsetting downward pressure on domestic prices.

Given these assumptions, the overall impact of the rise in the terms of trade is an increase in the underlying cash balance of around $1.9 billion in Year 1 and around $5.2 billion in Year 2 (see Table A2).

Table A2: Illustrative sensitivity of the budget balance to a 1 per cent increase in nominal GDP due to a rise in the terms of trade

	Year 1 $b	Year 2 $b
Receipts		
Individuals and other withholding taxation	0.5	1.6
Superannuation taxation	0.0	0.1
Company tax	1.1	3.0
Goods and services tax	0.1	0.2
Excise and customs duty	0.1	0.2
Other taxation	0.0	0.0
Total receipts	**1.8**	**5.1**
Payments		
Income support	-0.1	-0.2
Other payments	0.0	0.1
GST payments	0.1	0.2
Total payments	**0.0**	**0.1**
Interest change on deficit change	0.0	0.2
Underlying cash balance impact	**1.9**	**5.2**

On the receipts side, a rise in the terms of trade results in a rise in nominal GDP which increases tax collections. The largest impact is on company tax revenue as the rise in export income increases company profits. Higher company profits are assumed to flow through to higher Australian equity prices, therefore increasing capital gains tax from individuals, companies and superannuation funds.

The expanding economy results in higher aggregate demand which flows through to higher employment and wages. For these reasons, individuals' income tax collections would rise and the increase in disposable incomes would lead to higher consumption, which in turn results in an increase in GST revenue (increasing GST payments to the States by the same amount) and other indirect tax collections.

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

The overall estimated expenditure on income support payments decreases in both years due to a lower number of unemployment benefit recipients. The decrease in unemployment benefit payments in the second year is partly offset by higher expenditure on other income support payments (pensions and allowances) reflecting higher growth in benefit rates flowing from higher wages growth. At the same time other payments linked to inflation rise in line with the increased growth in prices.

The higher underlying cash balance also has a positive interest impact in both years owing to the lower borrowing requirement and lower public debt interest cost.

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

Scenario 2

The second scenario involves a combination of an equal 0.5 per cent decrease in the participation rate and in labour productivity, resulting in a 1 per cent decrease in real GDP by Year 2. Once again, the sensitivity analysis evaluates the flow-on effects on the economy, the labour market and prices. The impacts in Table A3 are highly stylised and refer to per cent deviations from the baseline levels of the parameters.

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

Table A3: Illustrative impact of an ongoing equal decrease in both labour productivity and participation consistent with a 1 per cent decrease in real GDP in Year 2 (per cent deviation from the baseline level)

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

The decreases in labour force participation and labour productivity have the same impact on output, but different impacts on the labour market. Lower productivity leads to lower real GDP and lower real wages, while a decrease in the participation rate decreases employment and real GDP. Imports are lower in this scenario, reflecting lower domestic incomes.

Since the supply side of the economy contracts, inflation rises relative to the baseline. The rise in domestic prices makes exports less attractive to foreigners, with the resulting decrease in exports offsetting lower imports, leaving the trade balance unchanged. The exchange rate is assumed to be constant.

The overall impact of the decrease in labour productivity and participation is a decrease in the underlying cash balance of around $2.5 billion in Year 1 and around $4.0 billion in Year 2 (see Table A4).

Table A4: Illustrative sensitivity of the budget balance to a 1 per cent decrease in real GDP due to an equal decrease in both productivity and participation

	Year 1 $b	Year 2 $b
Receipts		
Individuals and other withholding taxation	-1.5	-1.6
Superannuation taxation	-0.1	-0.1
Company tax	-0.7	-1.7
Goods and services tax	-0.3	-0.3
Excise and customs duty	-0.3	-0.4
Other taxation	0.0	0.0
Total receipts	**-2.8**	**-4.1**
Payments		
Income support	-0.1	-0.1
Other payments	0.0	0.1
GST payments	-0.3	-0.3
Total payments	**-0.4**	**-0.3**
Interest change on deficit change	0.0	-0.2
Underlying cash balance impact	**-2.5**	**-4.0**

On the receipts side, a decrease in the participation rate causes employment and nominal GDP to decrease. Individuals' income tax collections decrease because of the fall in the number of wage earners and, additionally, lower real wages. The weaker labour market also decreases superannuation fund taxes through lower contributions (including compulsory contributions) to superannuation funds. The decrease in personal incomes leads to lower consumption which results in a decrease in GST receipts (with the corresponding receipts passed on in lower GST payments to the States) and other indirect tax collections.

In addition, the weaker economy results in lower levels of corporate profitability, decreasing company taxes. Lower profits are assumed to decrease Australian equity prices, generating lower capital gains tax from individuals, companies and superannuation funds.

On the payments side, overall estimated expenditure on income support payments (including pensions and allowances) is lower reflecting a lower number of unemployment benefit recipients (as a result of the lower participation rate) and lower growth in benefit rates flowing from lower wages growth. Other payments linked to inflation rise, reflecting higher growth in prices.

The lower underlying cash balance also has a negative interest impact in both years owing to a higher borrowing requirement and higher public debt interest cost.

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

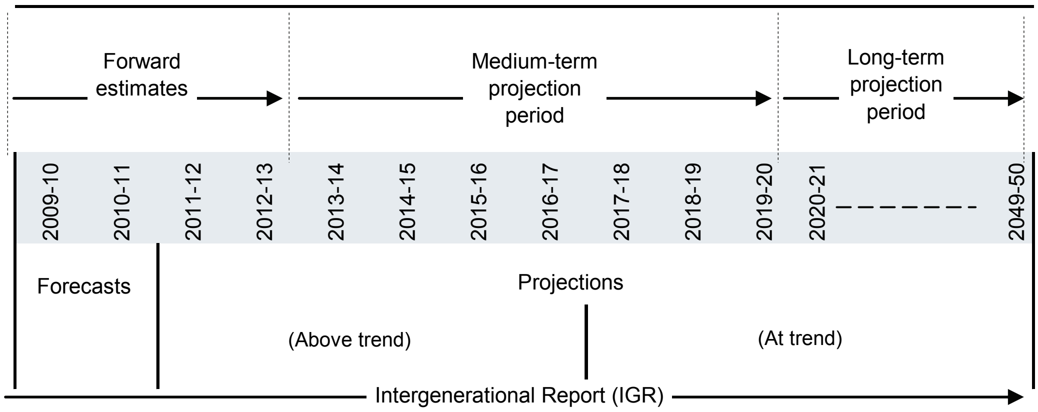
APPENDIX B: MEDIUM-TERM ANALYSIS METHODOLOGY

Medium-term economic projections

The fiscal aggregates in the 2009-10 Budget are underpinned by projections of the economy formulated through updated methodology, under which GDP is forecast to grow below trend in the year following the budget year, and projected to grow above trend in the projection years of 2011-12 and 2012-13 (see Statement 2).

The medium-term projections extend this methodology by projecting GDP to grow above trend for a further four years, having the effect of bringing the unemployment rate down by half a percentage point each year until it reaches the non-accelerating inflation rate of unemployment (NAIRU) of 5 per cent in 2016-17 (Figure 1). This is consistent with the pace of the mid-1980s and mid-1990s recoveries. Once the NAIRU is reached, GDP is assumed to grow in accordance with changes in population, participation and productivity, just as in the intergenerational reports.

Figure 1: Projections methodology in the forward estimates, medium-term projections and Intergenerational Report



Source: Treasury.

The medium-term projections also factor-in a gradual decline in the terms of trade over a ten year period from 2013-14. This reflects a judgment that, despite the recent decline in commodity prices, the terms of trade remain at relatively high levels in historical terms. The phase-down assumes the terms of trade decline by around 15 per cent by 2022-23 — approximately the same level as their average in the *Australia's Low Pollution Future* report (Australian Government, 2008).

Receipt projections

The medium-term receipts are projected by revenue head in a similar way to the forward estimates period, although some simplifying assumptions have been made. The medium-term receipt projections are based on long-term demographic and economic projections, which give key income and employment parameters. While the economy is recovering, this approach is more appropriate than adopting a constant tax-to-GDP ratio (the methodology used in intergenerational reports for long-term tax projections) as it accounts for the operation of the automatic tax stabilisers and incorporates the ongoing impact of policy decisions. In accordance with the Government's medium-term fiscal strategy, the medium-term projections are formulated on the basis that taxation as a share of GDP will remain below the 2007-08 level, on average. Taxation as a share of GDP averages 23.8 per cent over the medium-term period to 2019-20.

Expenditure projections

Spending is projected to grow at 2 per cent in real terms until the budget returns to surplus, in accordance with the Government's fiscal strategy. Once surplus is reached in 2015-16, spending is projected in accordance with the methodology used in intergenerational reports. That is, health, education, payments to individuals, aged care and superannuation costs are modelled to reflect the impact of demographic and other change, while other payments are projected to remain constant as a proportion of GDP. The next intergenerational report, which the Government plans to publish before the 2010-11 Budget, will provide a more detailed exposition of these issues.

Comparison of economic projections with IGR2

The global recession has had a significant impact on the size of the economy in comparison to the projections that underpinned the last intergenerational report (IGR2, released in March 2007). By 2010-11, in real terms GDP is forecast to be more than 5 per cent smaller than where it was expected to be in IGR2. Reflecting the projection assumption of above-trend growth until the economy returns to full capacity, this gap closes rapidly through the medium-term projection period. Higher population growth trends that have established themselves since IGR2 also assist in returning GDP to its previously-projected levels, and ultimately to exceed them.