Australian Government
The Treasury

Fiscal Policy

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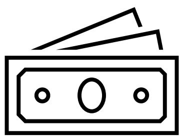
Friday, 22 August 2025

Explaining……….Fiscal Policy

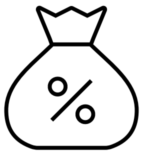
- What exactly is fiscal policy? What are the tools of fiscal policy?
- What are the primary objectives of fiscal policy?
- How does the government operationalise fiscal policy? What is the Budget process?

What is Fiscal Policy?

- The government has two levers to determine fiscal policy:



Spending



Taxation

- The government has to make choices about its aggregate fiscal position and which spending and tax decisions to take.
- Spending and taxation to:
  - **Allocate resources** (e.g. public goods, internalise externalities, address monopolies and imperfect information)
  - **Redistribute resources** (marginal income tax system, social security, lending)
  - **Stabilising the economy** (e.g. automatic stabilisers, discretionary spending during COVID-19)

Australia's Fiscal System

The **Federal Government** raises money through taxing incomes, spending and businesses.

Federal matters such as:

- Medicare
- Defence
- Immigration
- Foreign policy

State/Territory Government receive more than half their money from the federal government and also collect taxes.

State matters such as:

- Roads
- Housing
- Prisons
- Public transport
- Police and ambulance services

Local Councils collect taxes (rates) from all local property owners and receives money from the federal and state governments.

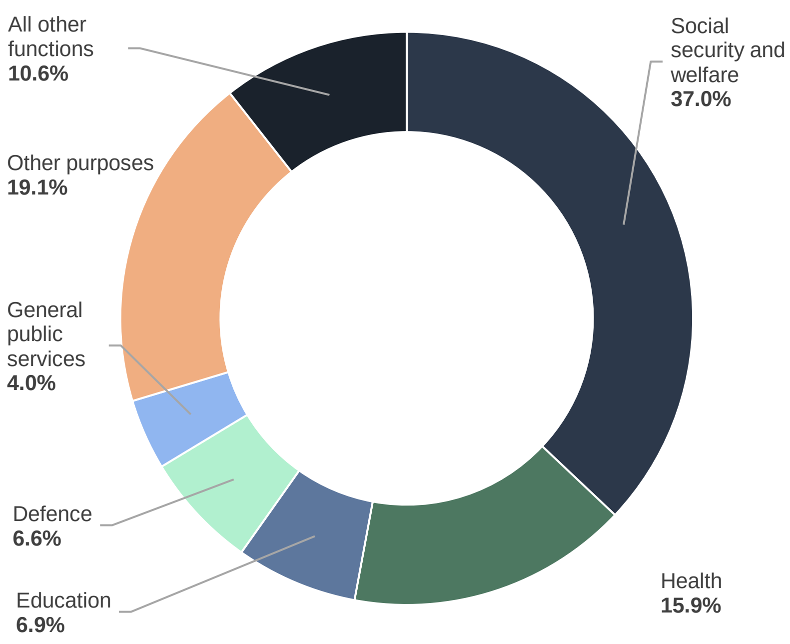
Local matters such as:

- Town planning
- Sewerage
- Local roads
- Rubbish collection

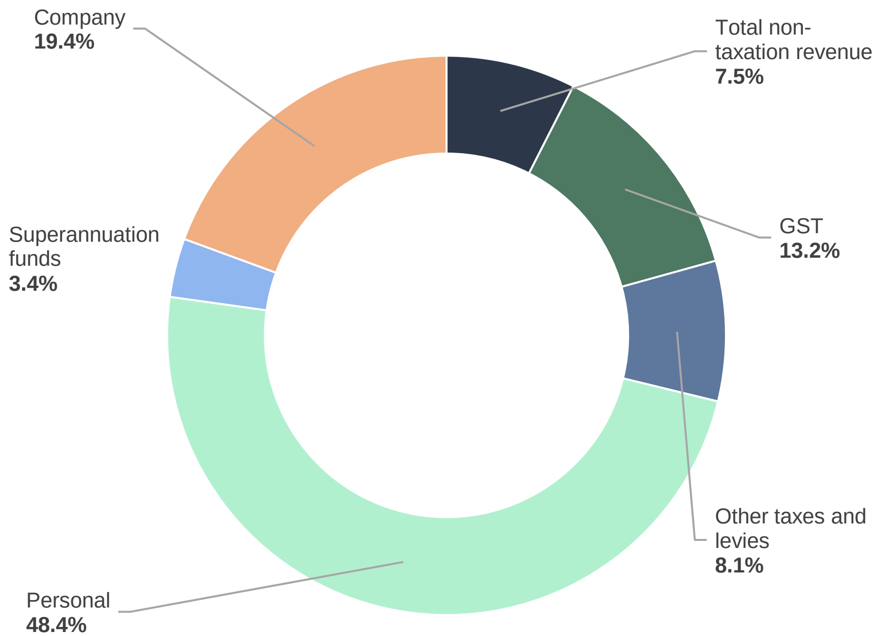
The Tools of Fiscal Policy

Government Expenditure and Revenue

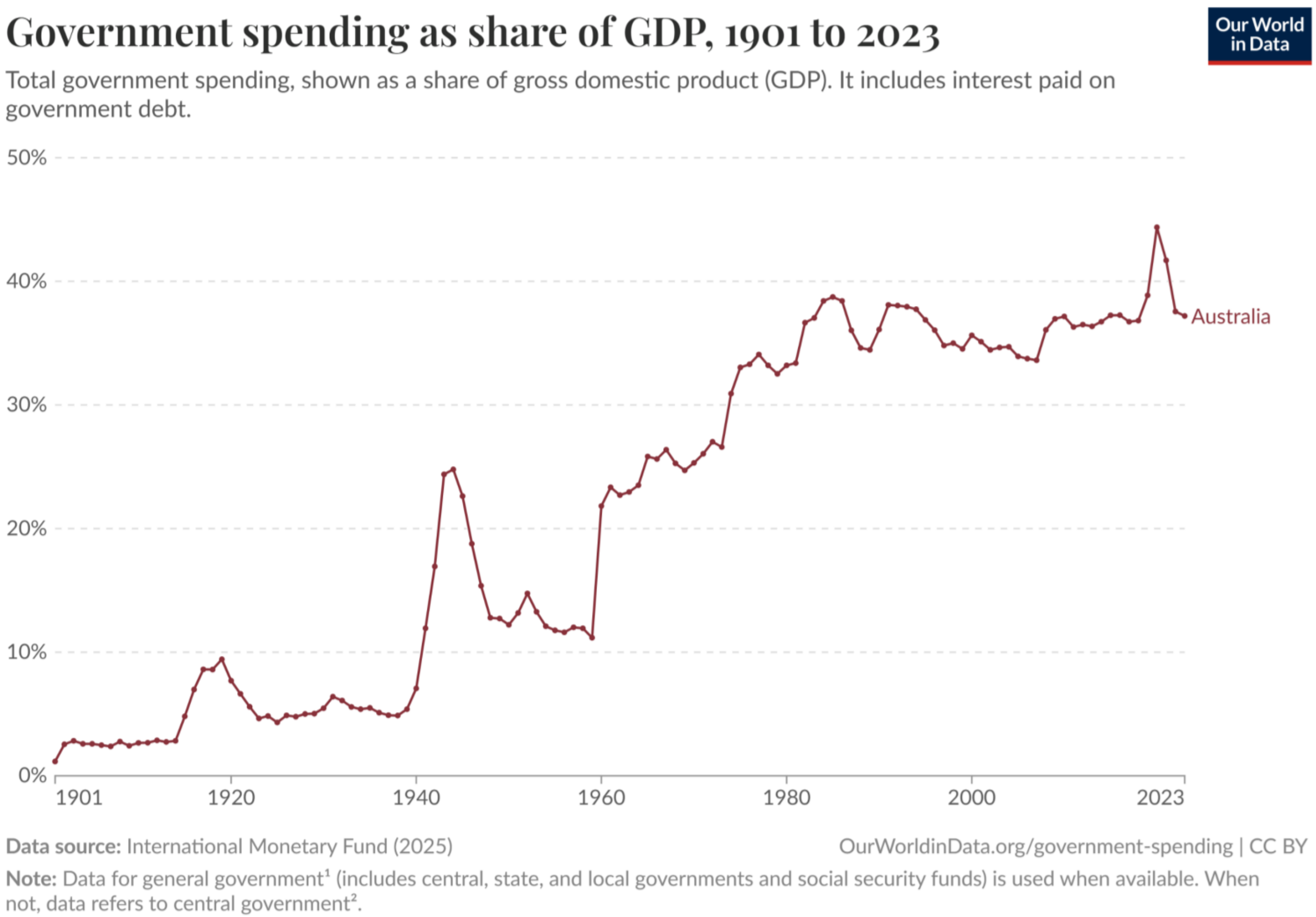
Panel A: Federal Government spending by function ($786 billion)



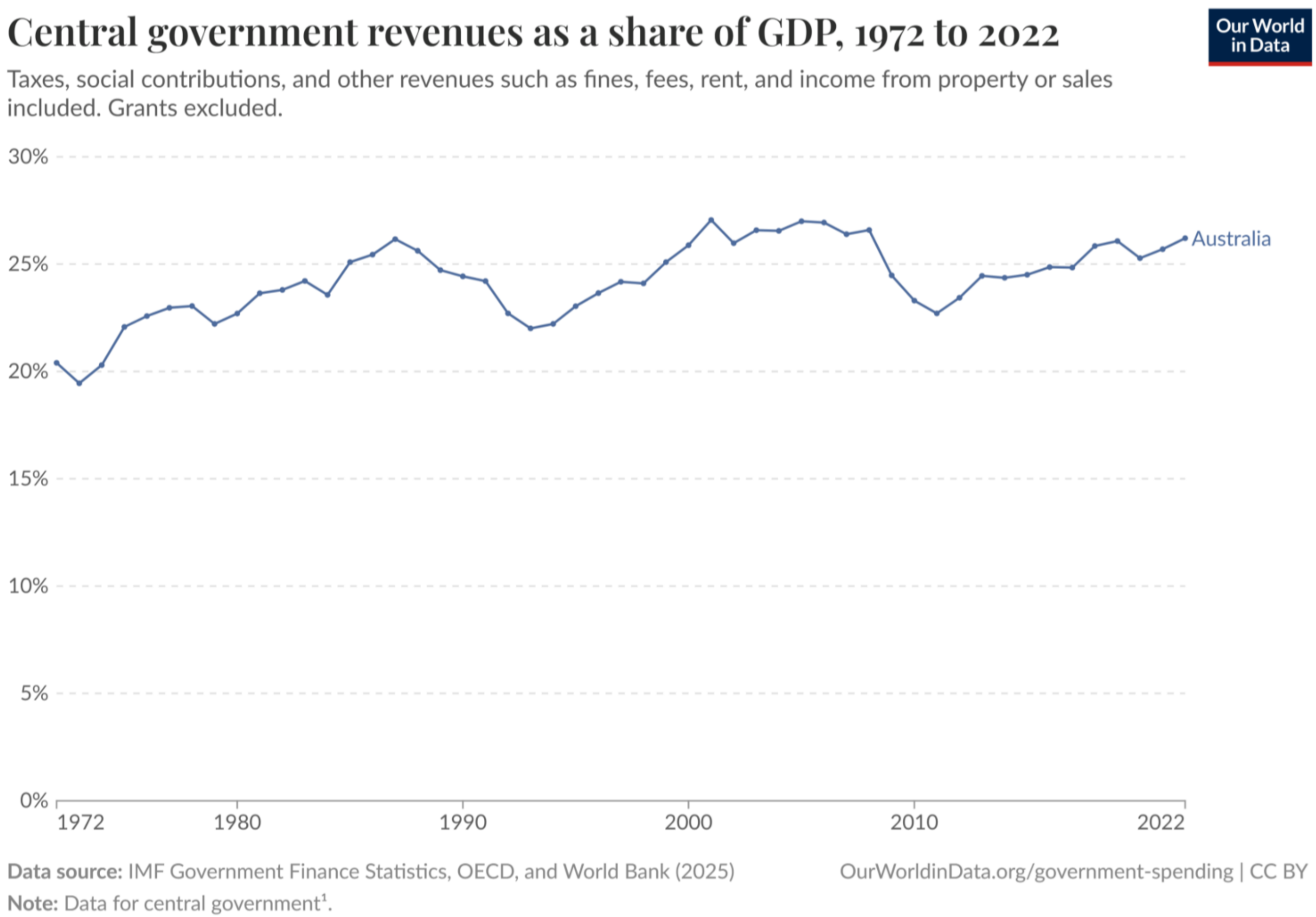
Panel B: Federal Government revenue by source ($750 billion)



Government Spending



Government Revenue



Economic and fiscal strategy in the Budget

- Guides Budget priorities: spending, revenue, debt and investment
- Supports AAA credit rating and long-term fiscal resilience
- Medium-term outlook (6-7 years): provides flexibility to manage shocks (e.g. COVID-19)
- Found in Budget Paper No. 1

In the Classroom

Teaching Activity

Using Budget Paper No.1:

Activity 1: Either individually or in small groups, read the Contents to decide which page and section may contain the relevant information to answer the questions below.

Activity 2: Select one section from one of the Contents pages that interests you and a friend, and together read these pages more closely. Prepare a summary or mind map on an A4 page to display on a classroom wall so you can inform and discuss the contents with your classmates.

Activity 3: Using the relevant Budget documents, answer the following questions:

- *Statement 3: Fiscal Strategy and Outlook*, when is the Federal Government's debt (as a per cent of GDP) expected to peak? How do Australia's debt levels compare to other advanced economies?
- *Statement 4: Revenue*, identify a tax and research (using other sources) when it was introduced and why. Why are the receipts from some taxes forecast to increase while others decrease?
- *Statement 5: Expenses and Net Capital Investment*, identify which government expense (by program) is expected to increase fastest over the forward estimates period.

The Role of Fiscal Policy

Allocation of Resources

Allocation of resources

Correcting market failures
Providing public goods
Internalising externalities
Supporting competition
Fixing information imbalances

Investing in the economy
Funding roads, ports
and education

In the Classroom

Teaching Activity

Identify whether the following activities have positive or negative **externalities**:

- Provision of education services.
- Use of roads.
- Production of pollution and carbon emissions.

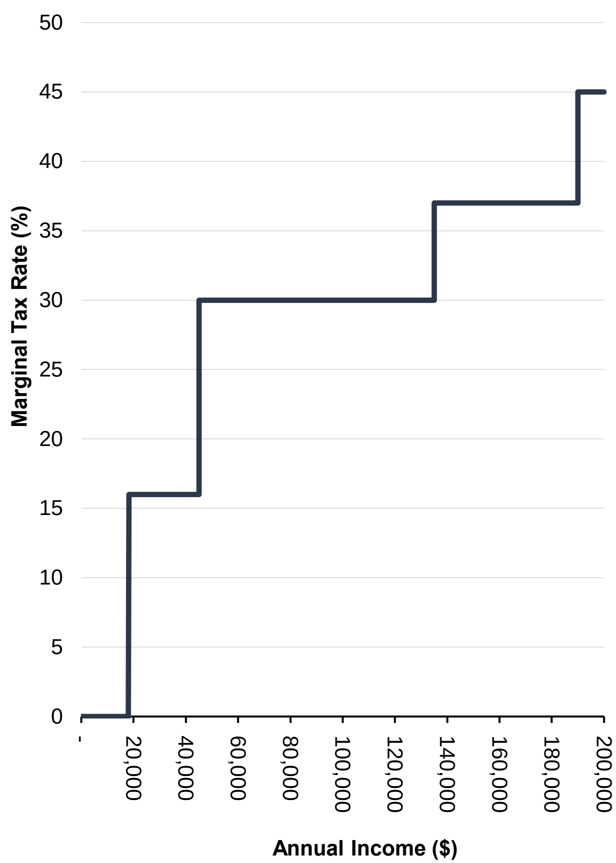
Explain how current or past government spending or taxation decisions may have helped to internalise these **externalities.**

Redistribution of Resources

- Fiscal policy shifts income from those with more resources to those with fewer to create a more equitable distribution of resources.
  - Progressive income taxes and a social security system that provides targeted support to cohorts such as older Australians and the unemployed are the primary tools of redistribution.
  - Australia's Gini coefficient is a measure of income inequality where 0 indicates perfect inequality and 1 inequality. It falls from around 0.45 to 0.33 after taxes and transfers are considered.
- Governments must balance the needs of supporting people today with the needs of future generations.
  - This is important as the 2023 Intergenerational Report projected that number of Australians aged 65 and over could more than triple, and the number of Australians aged 85 and over could more than double, over the next 40 years.

Redistribution of Resources

Marginal income tax rates at different income thresholds, 2024–25



- Australia's progressive system is designed so that people with higher incomes pay a greater amount of tax on they earn above certain thresholds, but everyone benefits from lower rates applied to the initial portions of their income
  - This means that an individual's average tax rate will be lower than their marginal tax rate, but increase with their income.

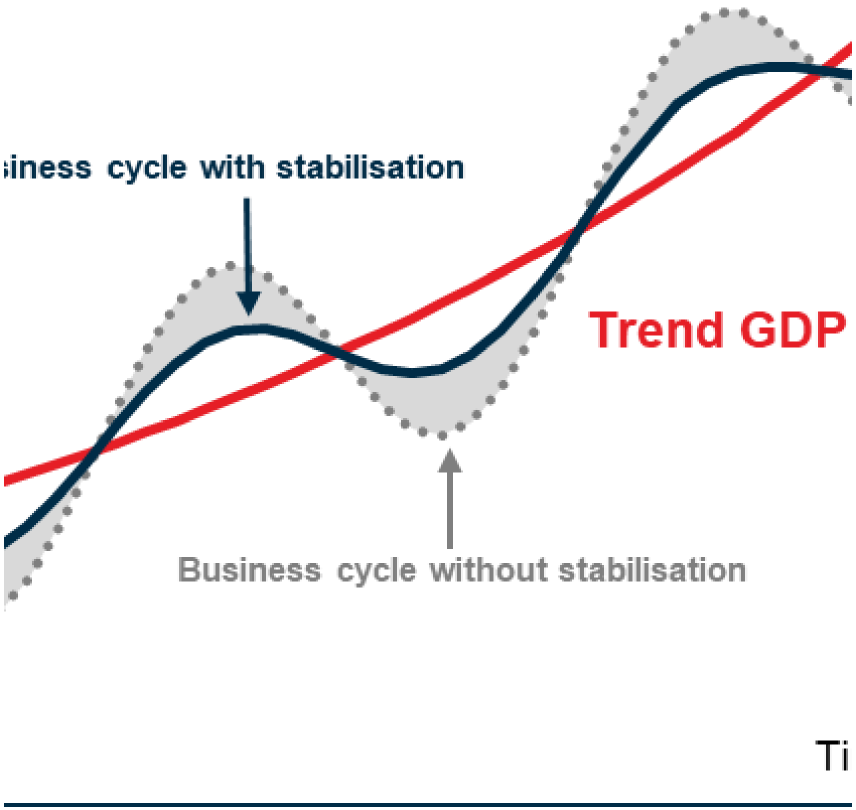
In the Classroom

Discussion Question

Redistribution of resources by governments is often discussed and debated by people and in the media. What debates have you seen and what do you think of the arguments used?

Locate some current and reliable news articles to form a view of the redistribution. Do you think its fair? Do you think it makes economic sense?

Stabilisation of the economy



- **Fiscal policy** works alongside **monetary policy** to smooth out the business cycle to reduce its extremes.
- It can **stimulate** the economy in downturns and act as a **handbrake** in upturns.
- Increased stability in economic conditions allows households, businesses and governments to plan ahead and make long-term decisions like where to invest and how many people to hire.

Stabilisation of the Economy

Non-discretionary spending (automatic stabilisers)

Occurs automatically without the need for new policy decisions each year:

- Unemployment benefits
- Age Pensions
- Interest payments on government debt

Discretionary spending

Decided through the annual budget process based on policy priorities:

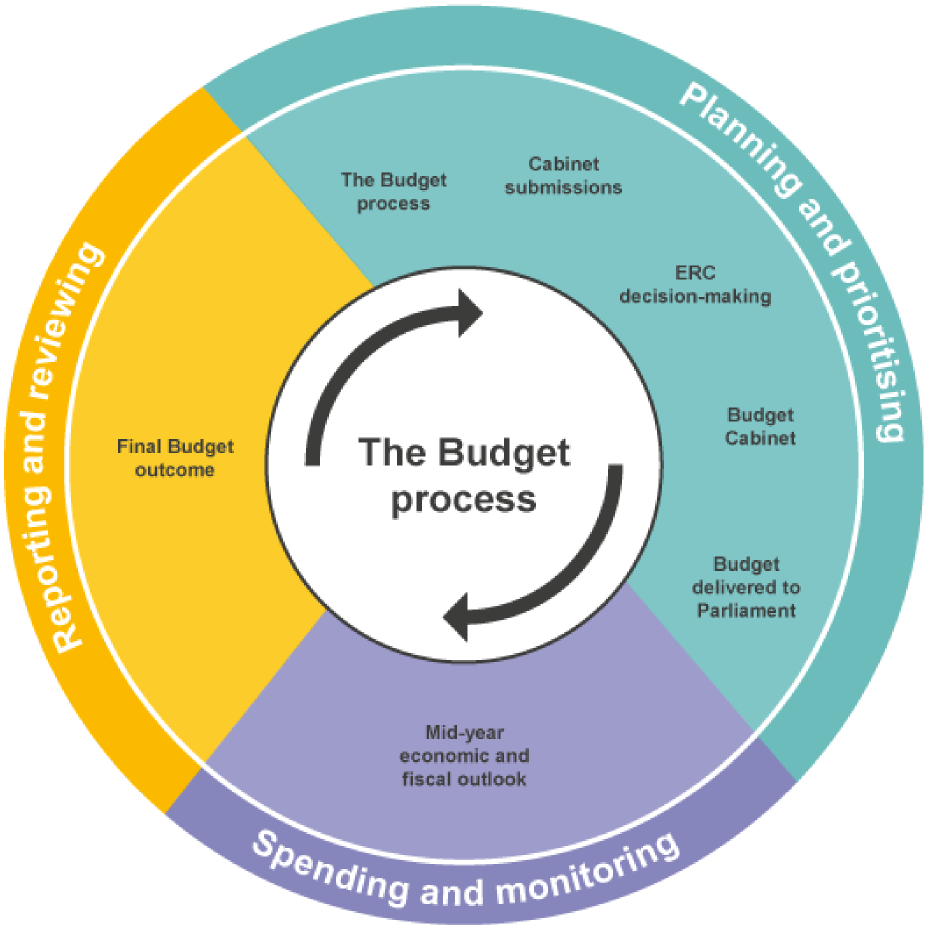
- Defence spending
- Infrastructure projects
- Stimulus packages in response to economic crises (GFC, COVID-19)

In the Classroom

Discussion Question

If a government enters into discretionary fiscal policy to increase household incomes (for example, by decreasing taxes or providing subsidies), then this is expected to lead to more economic activity when the additional income is spent. What features of a household should make them more likely to spend or save this income? (*Hint: research the* ***marginal propensity to consume***).

The Budget process



ERC: the Budget decision-makers

Prime Minister (Chair)

Treasurer (Deputy Chair)

Deputy PM/Minister for Defence

Minister for Foreign Affairs

Minister for Finance

Minister for Health and Ageing/ Minister for Disability and NDIS

Minister for Infrastructure, Transport, Regional Development and Local Government

Minister for Employment and Workplace Relations

Assistant Treasurer/ Minister for Financial Services

- The **Expenditure Review Committee** (ERC), a sub-committee of Cabinet, focuses on matters with financial implications.
    - ERC evaluates policy proposals by weighing up the different issues.
- ERC Ministers are supported with advice on Budget proposals by their departments.

Budget Rules and Principles

- The *Charter of Budget Honesty Act 1998* sets out principles and requirements that guide the government's management of fiscal policy.
  - Requires that a Budget is produced once a year and a MYEFO is required within 6 months of the last Budget.

- The Budget Process Operational Rules are a set of mandatory rules that outline the management of the Budget and related processes.
  - Support the implementation of the Government's priorities to be consistent with the Economic and Fiscal Strategy.
  - Guide the development of ERC policy proposals.

Summary

- Fiscal policy is an important macroeconomic tool that helps allocate and redistribute resources and stabilise the economy.
- Treasury has a key role to play as the lead economic adviser in both advising on and implementing fiscal policy.
- Treasury's aim is to achieve strong and sustainable economic and fiscal outcomes for Australians.

Treasury Student Engagement Team

- University and high school engagement
- Research
- Council on Federal Financial Relations (CFFR) Diversity in Economics Working Group
- Explainers

Thank you for listening

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Back pocket

Government Borrowing

- The Government finances its activities through receipts or borrowing.
- When payments exceed receipts (a deficit), the Government borrows by issuing bonds known as Australian Government Securities (AGS).
  - Because bonds pay interest to investors, issuing them creates an ongoing cost for the Government, with regular interest payments made in addition to repaying the bond’s face value at maturity.
  - The market also affects the value of these bonds. When yields change, the price investors are willing to pay for AGS moves in the opposite direction, influencing how costly it is for the Government to issue new debt.
- Issuing more AGS adds to Australia’s gross debt and interest costs, while budget surpluses can be used to repay existing debt.

Government Spending and Revenue Over Time

- Government spending, as a share of GDP, has trended upward since Federation.
  - Providing more services e.g., Medicare and NDIS
- Government Revenue, as a share of GDP, has also trended up since federation.
- The primary sources of tax revenue have shifted.
  - In 1901 Government Revenue largely came from excises and customs duties.
  - Today, personal income tax is the largest source of Government revenue.

Fiscal Policy - impact on the economy

- **Keynesian Economics**: Increased spending and tax cuts to boost aggregate demand, reduce unemployment, and stimulate economic growth – or conversely fiscal tightening to lean against strong growth
- **Individuals**: Fiscal policy affects individuals through changes in taxes and government spending, influencing disposable income, job opportunities, and access to public services.
- **Long-Term Focus**: Fiscal policy is suited for addressing long-term economic stability and goals - with the exception of extreme scenarios (e.g. COVID)
- **Potential growth**: Government spending and taxing polices can increase the supply potential in the economy, increasing the long-term growth rate (e.g. new infrastructure, incentives to work, skills)

Setting the Government's Budget Priorities

Why is it important?

- Limited resources require the Government to decide what issues are most important

What informs Government priorities?

- Internal and external factors:
  - Economic and fiscal conditions (e.g. economic upturns/ downturns)
  - Global/domestic events (e.g. COVID-19, foreign wars, natural disasters)
- Election commitments / Government's policy agenda
- Pre-Budget Submissions from the Australian public

When are these set?

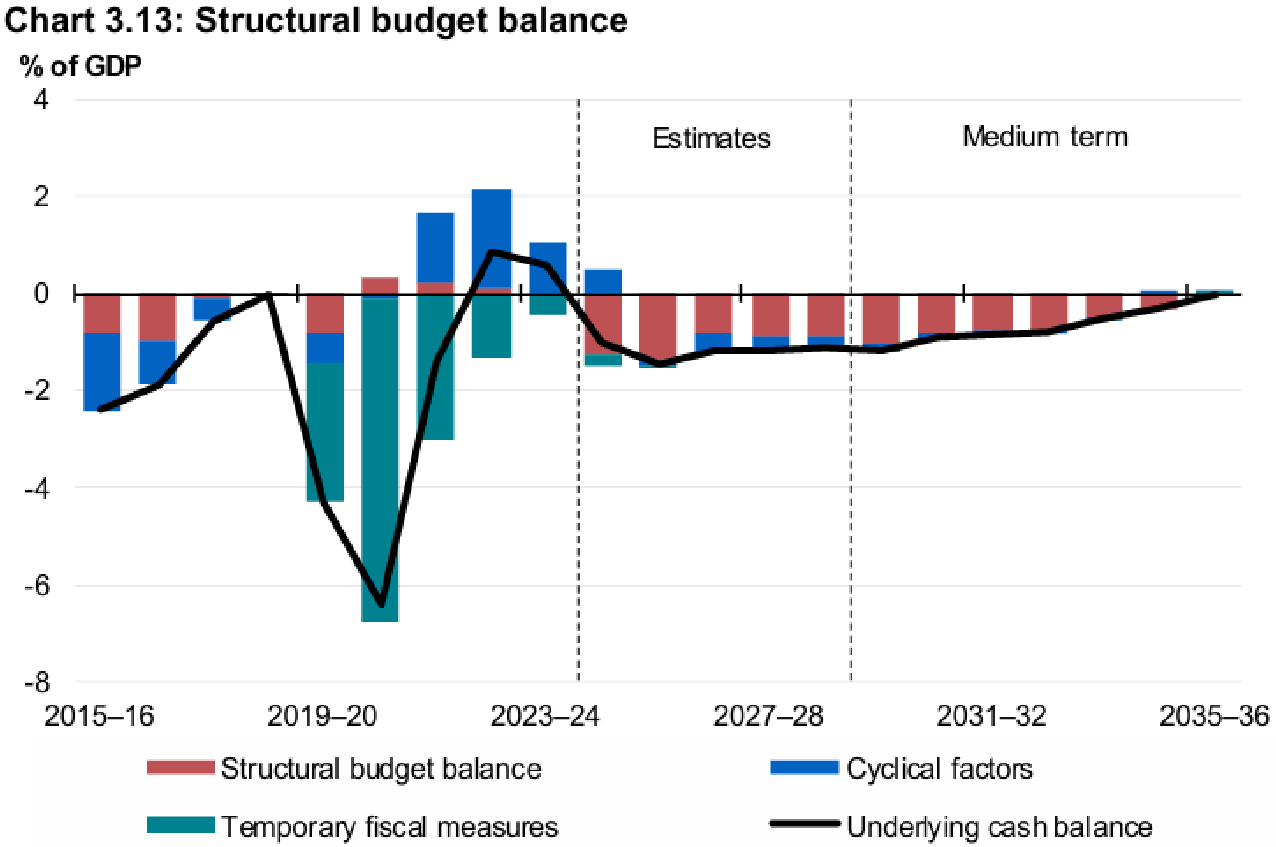
- Generally, before a Budget and Mid-Year Economic and Fiscal Outlook (MYEFO) process commences
- Priorities may be revisited during a Budget or MYEFO process

Placeholder for stakeholder engagement/anticipate policy issues

- In the lead up to a Budget, Treasury receives Pre-Budget Submissions from stakeholders, both representative bodies and individuals.
- Where Treasury is responsible for policy (e.g., taxation and financial markets), we actively engage with stakeholders to understand industry experience.
- Where appropriate, insights that we receive from stakeholders will help inform the advice that we provide to Government.

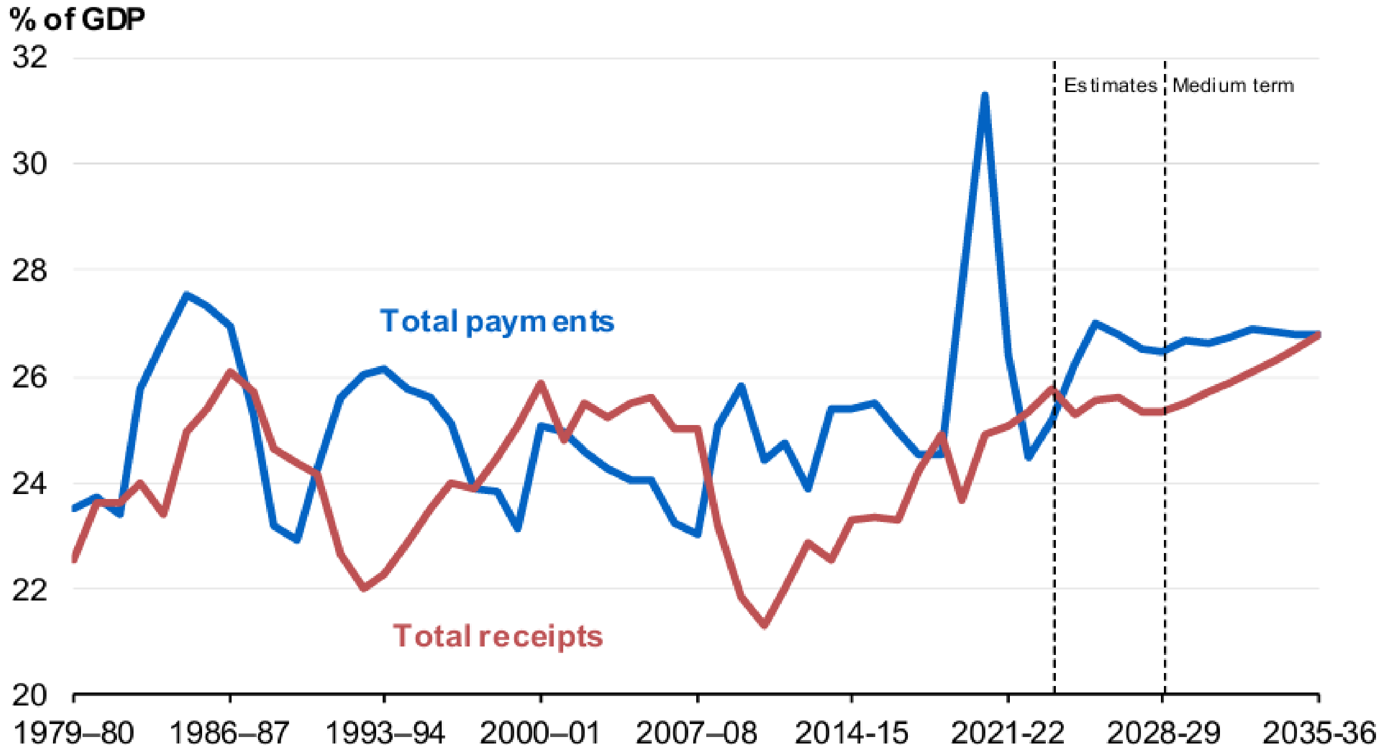
Fiscal policy and the outlook

The budget balance



- Expected to return to deficit in 2025, with a deficit of 1.4% of DP in 2025-26. The structural budget balance will remain in deficit over the medium-term, before returning to equilibrium.
- Growth in payments is projected to lead a deficit (more on in later slides)

Payments and receipts

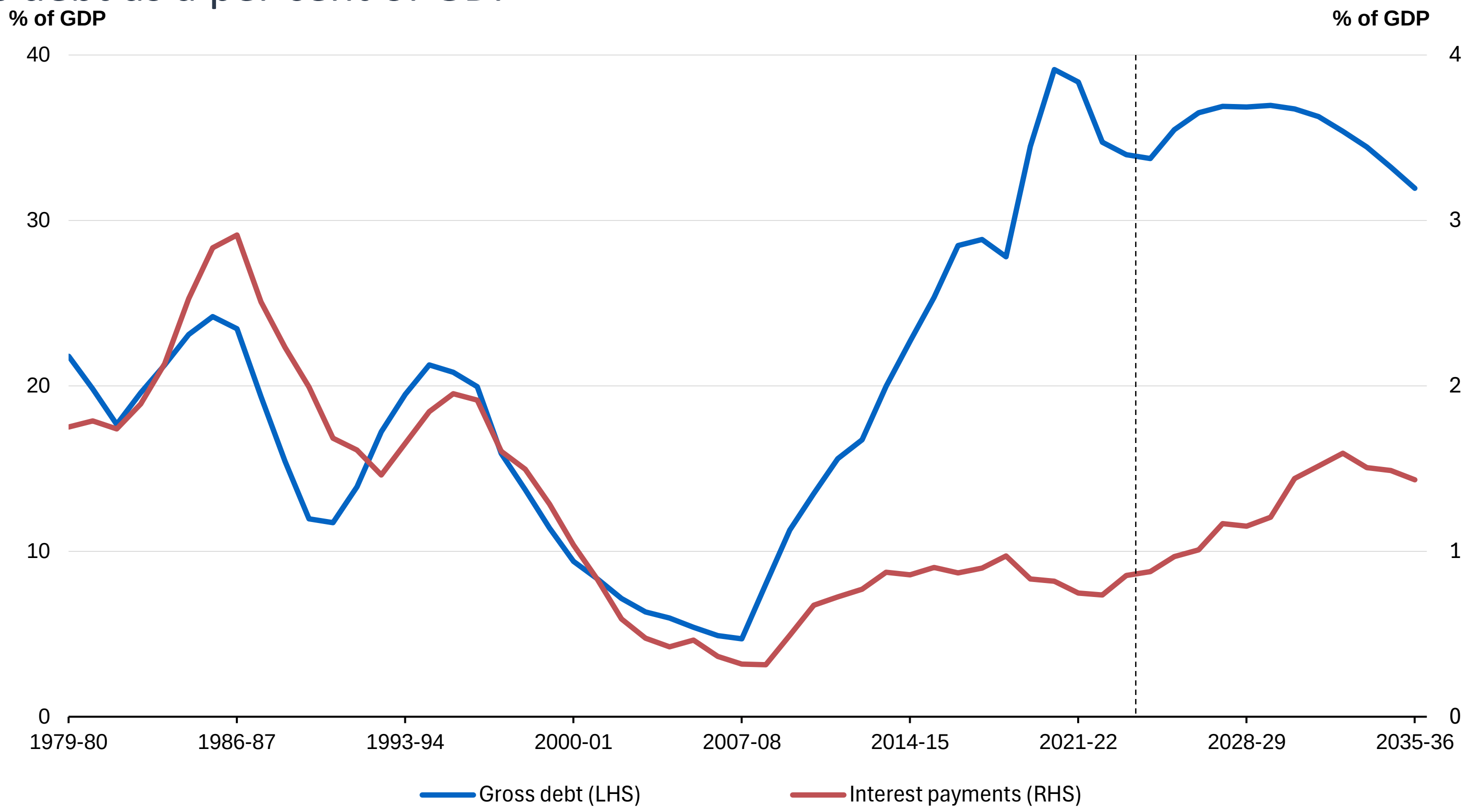


Source: Treasury.

- Payments as a share of GDP are expected to remain broadly consistent, peaking at 27.0 per cent in 2024-25, before falling to 26.8 per cent in 2035-36.
- Total receipts as a share of GDP (including taxation and non-taxation receipts) are expected to increase from 25.3 per cent in 2028-29, to 26.8 per cent in 2035-36.
- Increase in tax receipts due in part to bracket creep.

Budget sustainability to 2035-36

Gross debt as a per cent of GDP



- Gross debt is estimated to be 35.5 per cent of GDP ($1 trillion) in 2025-26.
- Total interest payments as a share of GDP is estimated to be 1.0 per cent in 2025-26, and increase to 1.2 per cent across the forward estimates.
- Interest payments reflect both the size of debt and the yields on government bonds.

Economic Conditions and Budget Parameters

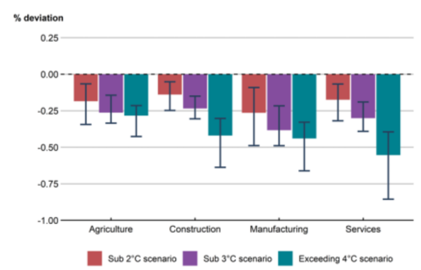
- The state of the economy has a big influence on the Budget.
  - It affects how much tax is collected and how much is being spent.
- Treasury forecasts the economy so the Government knows its financial position before it makes policy decisions.
- What economic measures are most important to the Budget?
  - Is the economy growing – are we making more goods and services?
  - How many people have jobs or are unemployed?
  - Are incomes growing?– such as people's wages and business's profits
  - How fast are prices changing? – prices of things people consume or prices for our exports.

Climate and Energy Analysis in the Intergenerational Report

Selected physical climate risks

- Analysis of macroeconomic and sectoral impacts for three physical climate effects:
  - Temperature and humidity on labour productivity.
  - Temperature, rainfall and CO2 concentration on crop yields.
  - Temperature on international tourism.

Chart 5.3 Potential change in output across sectors from direct labour productivity impacts of higher temperatures across climate scenarios, 2023 to 2063

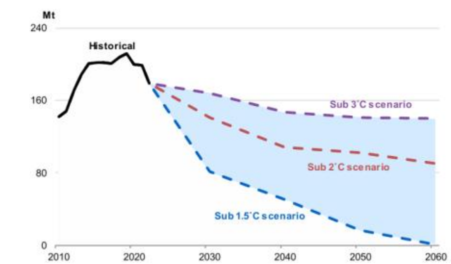


Note: Error bars indicate the variation in modelling output using temperature pathways from select Global Circulation Models. Global Circulation Models project the global climate system and potential future pathways for climatic variables such as temperature, rainfall and CO_2 concentration under different climate scenarios.
Source: Treasury.

Impact of global energy transition on commodity demand

- Global demand shifts will reshape industry and present risks and opportunities.
- Analysis presented changes in demand for:
  - Demand for Australian seaborne thermal coal export volumes
  - Global demand for refined lithium.

Chart 5.10 Potential demand for Australian seaborne thermal coal export volumes under different global emissions reduction pathways

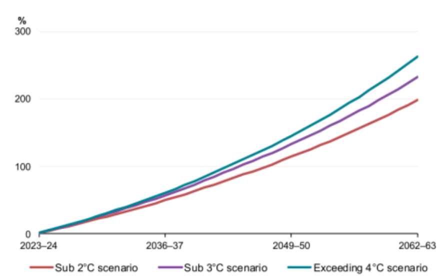


Source: Treasury calculations based on Wood Mackenzie and IEA global demand and supply data, 2023.

Increases to Disaster Recovery Funding and Arrangement costs

- Natural disasters will increase pressure on government budgets as natural hazards become more frequent and severe.
- Analysis projected future Commonwealth expenditure under the Disaster Recovery Funding Arrangements (DRFA) under different climate scenarios.

Chart 5.7 Australian Government expenditure on the DRFA, total percentage change

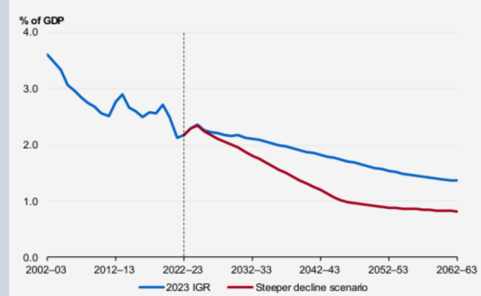


Note: The projected expenditure presented in the chart reflects the growth in costs under different climate scenarios. Actual costs in any given year are likely to vary significantly from projected costs. Appendix A5 provides further details.
Source: Treasury.

Fuel Excise and Electric Vehicle Uptake

- Net zero transformation - shift from internal combustion engine vehicles to electric vehicles.
- Analysis of impact on commonwealth fuel excise revenue from shift to electric vehicles.

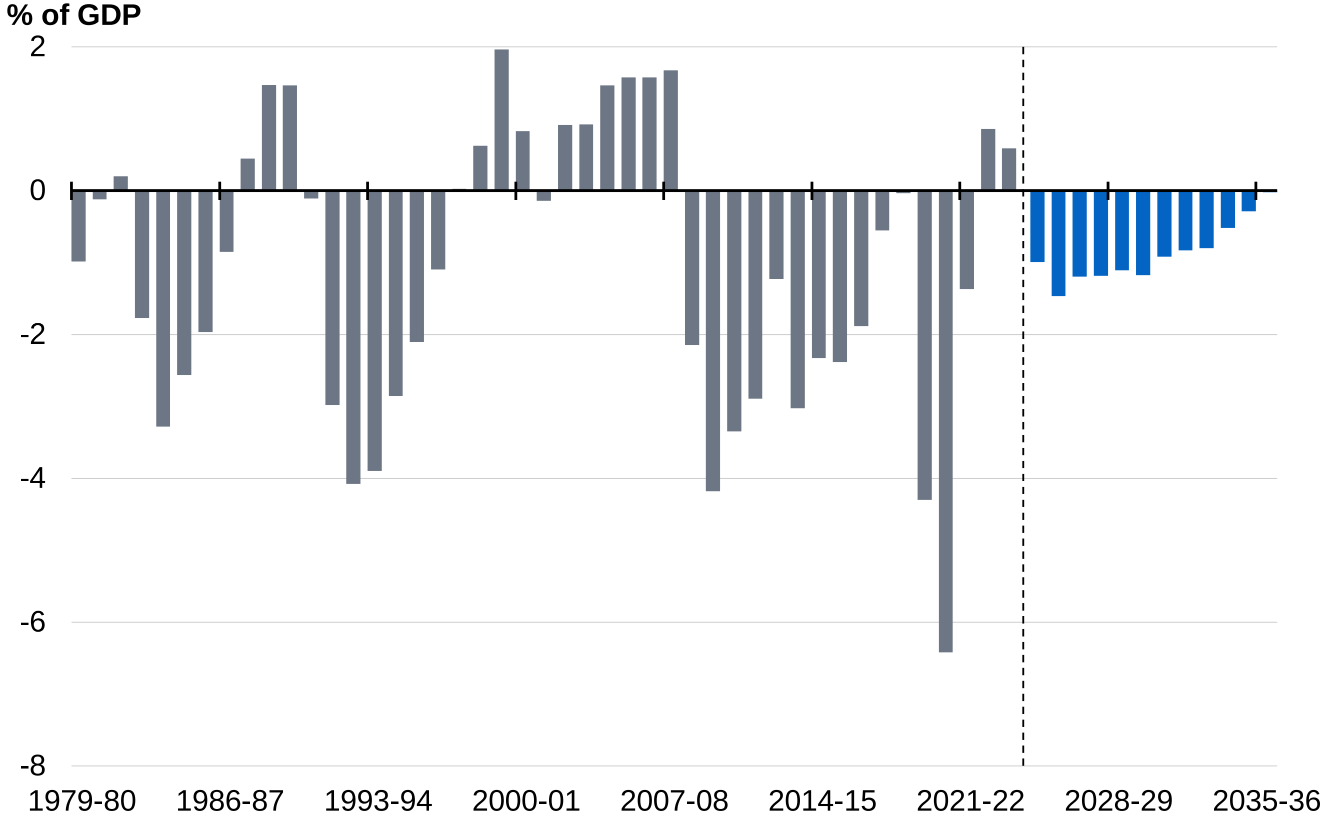
Chart 8.1 Indirect tax receipts (excluding GST)



Source: Treasury.

Budget bottom line

Underlying cash balance as a per cent of GDP



- The underlying cash deficit is forecast to peak at $42.1 billion (1.5 per cent of GDP) in 2025-26, before improving to $36.9 billion (1.1 per cent of GDP) in 2028-29 and returning to balance in 2035-36.

Chart 1: International comparison of general government gross debt (2025)

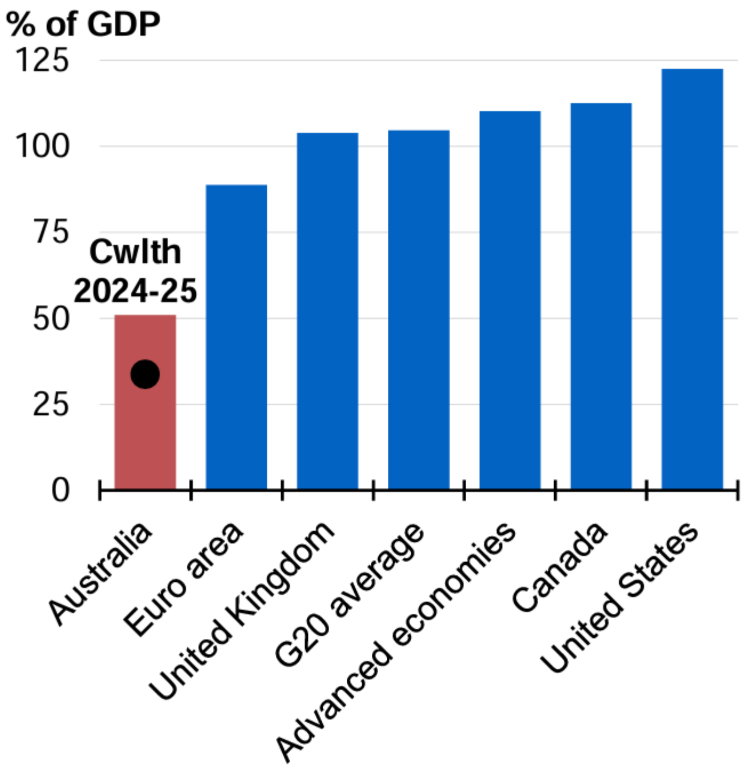
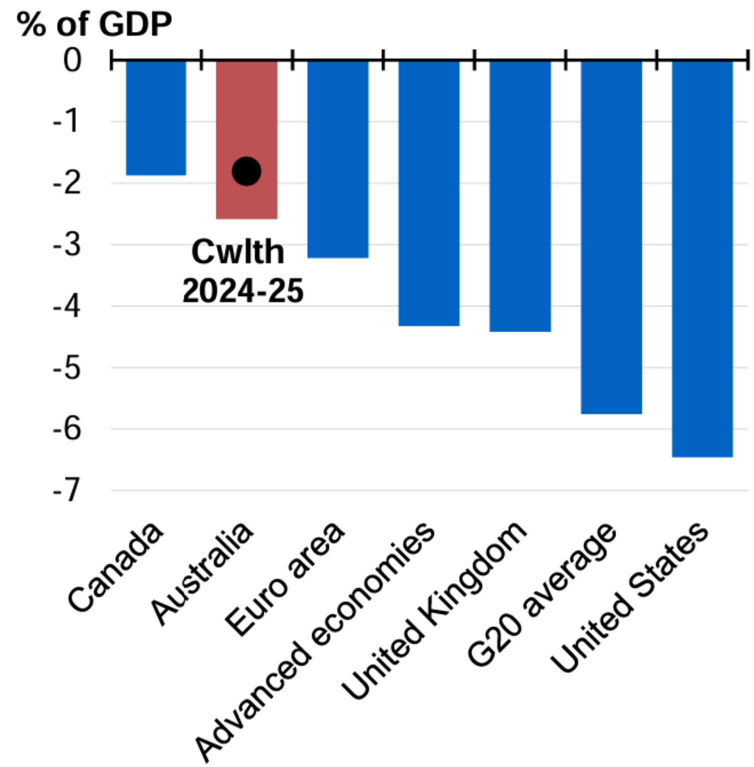
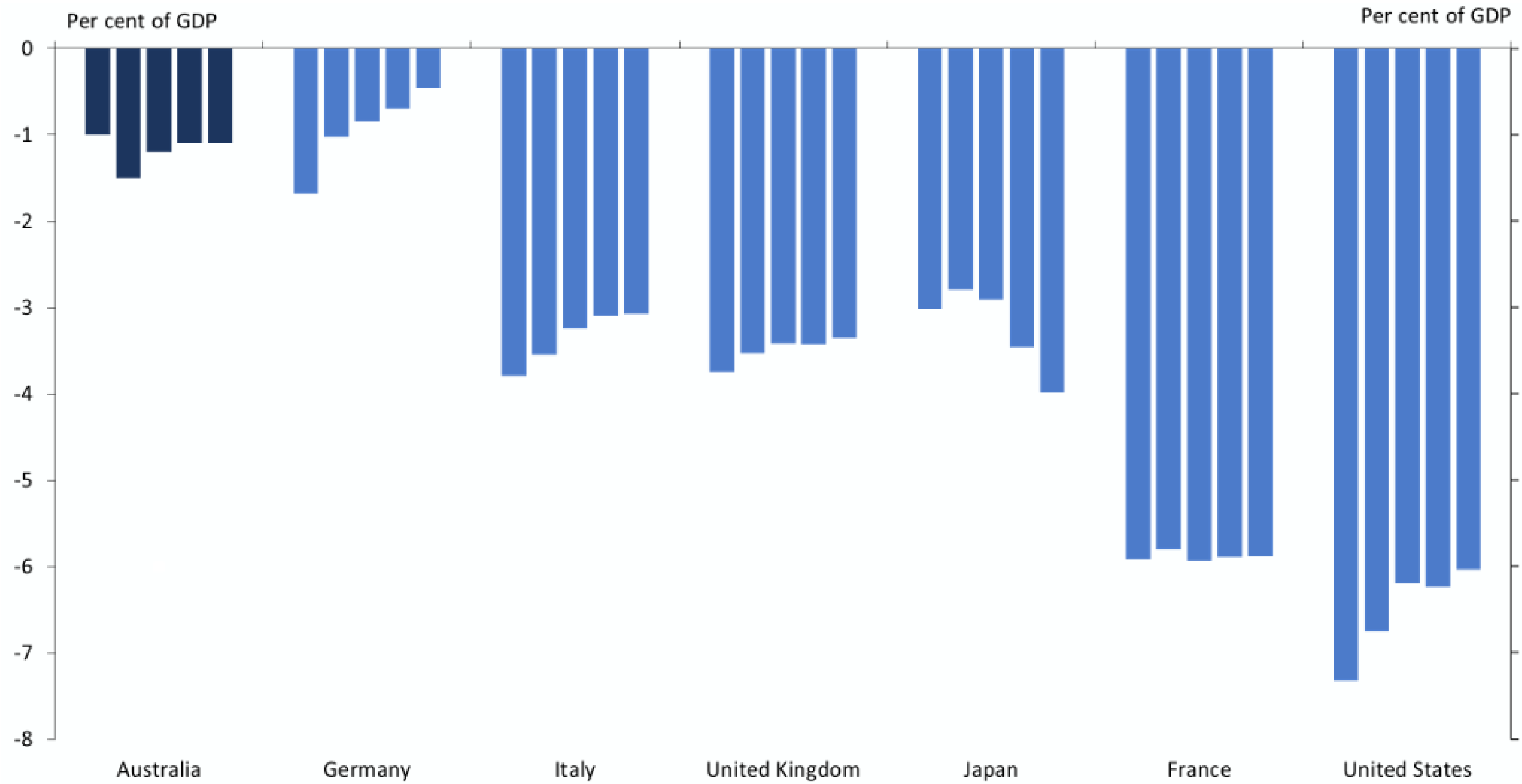


Chart 2: International comparison of general government fiscal balance (2025)



Comparison of government budget balances

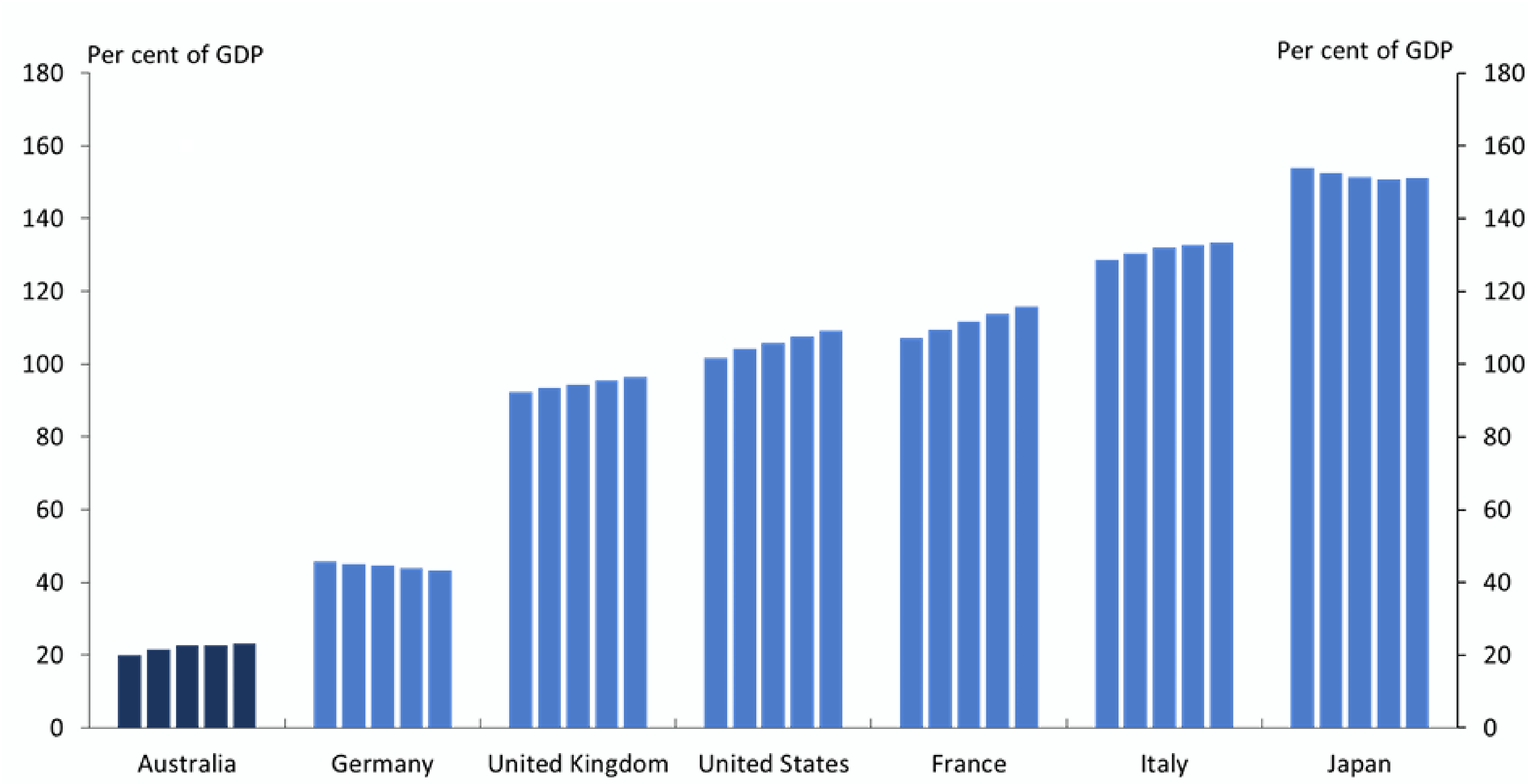
2025 to 2029 (forecast)



Source: Treasury – Budget 2025-26, IMF Fiscal Monitor October 2024. The forecasts for the comparison countries are as of October 2024 and do not take into account recent spending updates.

- As a share of GDP, Australia's budget deficit is low relative to other advanced economies.

Comparison of government net debt



Source: Treasury – Budget 2025-26, IMF Fiscal Monitor October 2024.
Note: Australian data is for the Australian Government general government sector for financial years commencing 2024-25. Data for all other countries are for total government and refer to calendar years commencing 2025.

- As a share of GDP, Australia’s net debt is low relative to other advanced economies.

Chart 2.9: Real GDP growth

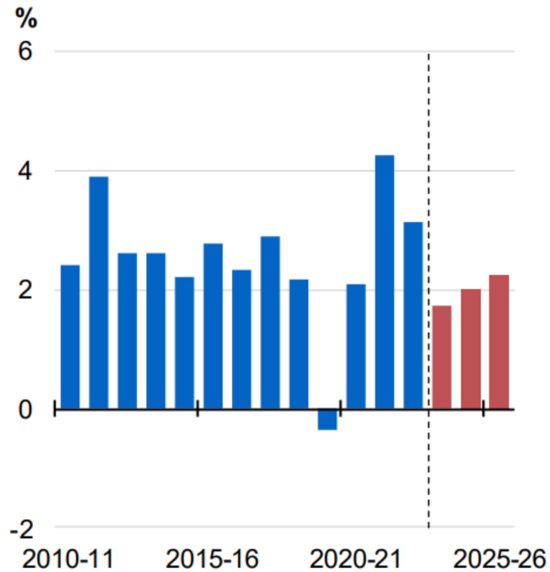


Chart 2.20: Headline inflation

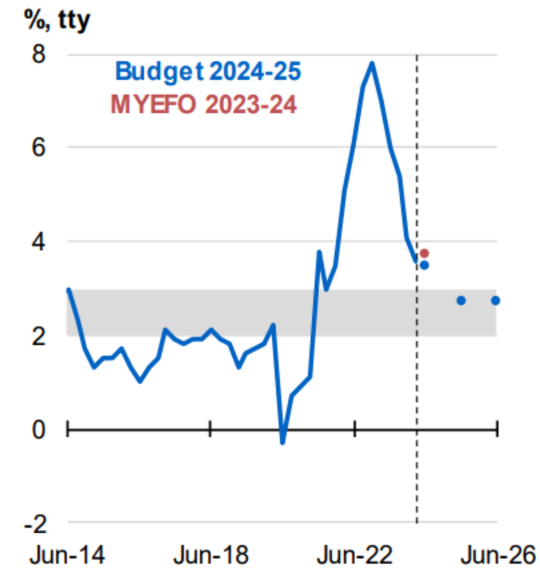


Chart 2.22: Unemployment and underemployment rate

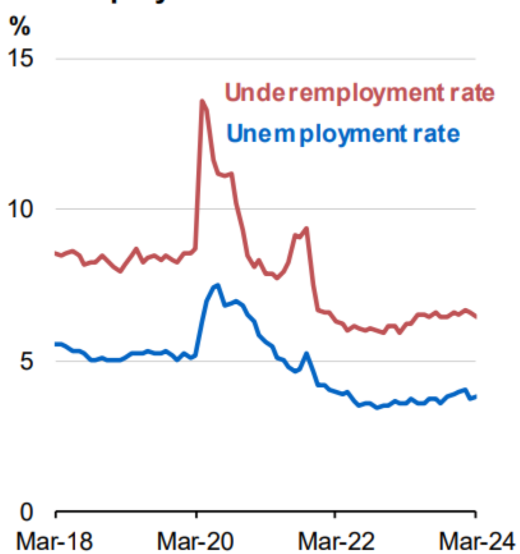
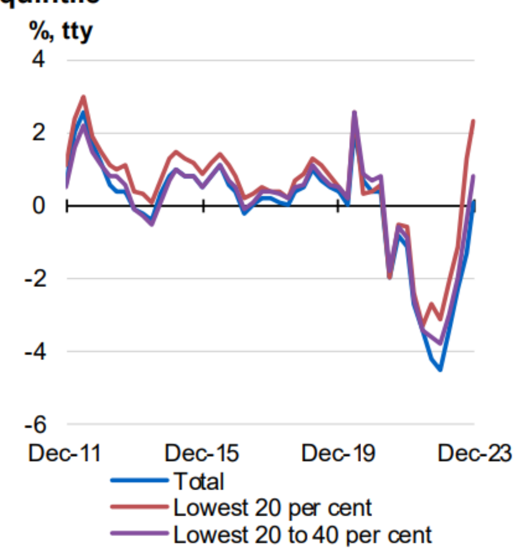


Chart 2.25: Real wage growth by income quintile



Budget: Behind the Scenes

Did you know?

The Federal Budget is typically released each May. It sets out the government's planned spending, revenue, and policy priorities for the coming financial year.

Behind the scenes, the Budget is prepared over many months with the support of the Treasury, the Department of Finance and other government departments.

After the Budget, two key updates provide transparency and accountability:

- The Mid-Year Economic and Fiscal Outlook is released at the end of the calendar year (mid-financial year). It updates the Budget based on the latest economic conditions and reflecting government decisions made since the Budget was released.
- The Final Budget Outcome is released after the end of the financial year and contains actual financial outcomes rather than estimates.

Treasury’s Role

- Treasury is the Government’s lead economic adviser.
- We provide advice from a ‘whole of economy’ perspective to the Treasurer and Government as input into their decisions.
- Governments (or Parliaments) make the decisions.
- We implement policies and programs that have been decided by the Government and Parliament.
- Our aim is to achieve strong and sustainable economic and fiscal outcomes for Australians.
- Treasury does this through one arm of macroeconomic policy: **fiscal policy**.

Allocation of Resources

- Resource allocation is generally determined by private markets but can be supplemented by government action in cases of market failure.
- Common market failures relate to the under/over-supply of goods with positive/negative externalities.
  - Fiscal policy acts to internalise externalities through using payments or taxes to influence prices such that they better reflect benefits/costs across the economy.
- Market failure also arises where there is limited competition or an information imbalance.
  - Governments generally address this through regulation.
- Governments can improve the economy's capacity to grow through investing in infrastructure, education and health.
  - Government activity can create a deadweight loss if it crowds out private activity.