Fiscal Objectives, Targets and Risks: Options to Improve Victoria's Fiscal Framework

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Abstract A transparent fiscal management framework supports sound government decision making and public accountability. This article examines the Victorian Government's framework of fiscal objectives, targets and risks over the past 10 state budgets. It assesses this framework against international best practice benchmarks, and finds it has not been clear or cohesive. Components of the framework are spread throughout the budget papers, and are vague, making objective assessment of performance difficult. The article identifies options to strengthen the framework, including clearer fiscal performance reporting, better alignment between objectives and targets, more durable fiscal targets, a consolidated statement of risks, and longer run forecasting. As Victoria's net debt climbed following the COVID-19 pandemic, a transparent fiscal framework has never been more important.

[1] This Article is based on paper published by Parliamentary Budget Office, *Fiscal Objectives, Targets and Risks: Options to Improve Victoria's Fiscal Framework*, Parliament of Victoria, 2021 Accessed at: https://pbo.vic.gov.au/files/PBO%20-%20Fiscal%20objectives%20targets%20and%20risks.pdf.

INTRODUCTION

Victoria's net debt has tripled since the start of the COVID-19 pandemic, reaching $89.6 billion in December 2021, and is forecast to rise to $162.7 billion by June 2025.[2] The state lost its AAA credit rating with both major rating agencies in 2020-21, which was seen as a cornerstone of state government financial management for decades. While the economy is now rebounding strongly, state finances have a significantly reduced capacity to absorb additional shocks if further risks materialise. It has never been more important that the government uses a transparent fiscal management framework.

In this article, we examine the framework of fiscal objectives, targets and risk assessment in Victorian budget papers over the past 10 years, drawing on best practice benchmarks in the International Monetary Fund (IMF) *Fiscal Transparency Code and Handbook*.[3] Fiscal objectives and targets are widely accepted as a foundation for transparent fiscal management. They help guide government budget decisions by setting constraints on planned fiscal outcomes over a defined period, and support public accountability by enabling comparison between planned and actual outcomes. Assessment and management of fiscal risks is also essential to a transparent fiscal framework, communicating uncertainties around the fiscal outlook and helping to limit fiscal disruption if risks materialise.

We find that Victoria's fiscal management framework in recent budgets has not been clear or cohesive. Fiscal objectives and targets, and performance reporting against them, are dispersed across different budget papers. Most long-term objectives have no targets to guide policy or measure performance, and fiscal targets have been modified or abandoned when economic and fiscal circumstances have changed. The government modified or abandoned most of its fiscal targets following the impacts of

[2] Department of Treasury and Finance, *Victorian Budget 2021/22 – Mid-year Financial Report*, Parliament of Victoria, 2021. Accessed at: https://www.dtf.vic.gov.au/sites/default/files/document/2021-22%20Mid-Year%20Financial%20Report.pdf; and Department of Treasury and Finance, *Victorian Budget 2021/22: Budget Update*, Parliament of Victoria, 2021. Accessed at: https://www.dtf.vic.gov.au/state-budget.

[3] International Monetary Fund, *Fiscal Transparency Handbook*, 2018. Accessed at: https://www.elibrary.imf.org/view/IMF069/24788-9781484331859/24788-9781484331859/ch04.xml; International Monetary Fund, *Fiscal Transparency Code*, 2019. Accessed at https://www.imf.org/external/np/fad/trans/Code2019.pdf.

the COVID-19 pandemic, and there are now fewer and less clearly defined objectives and targets.

Assessments of risk are also spread across the budget papers, with no consolidated assessment of the wider risks to Victoria's fiscal outlook or clear outline of how the budget strategy is managing risk. Crucially in the current fiscal environment, the budget's 4-year forecasts are not sufficient to show when the government expects net debt to peak or stabilise. The absence of longer-run forecasts means it is not possible to assess the layered fiscal impacts of COVID-19 and the substantial transport infrastructure program.

We identify options to improve the framework based on IMF guidance.[4] In particular:

- for clear and cohesive objectives and targets, the government could report progress in a central location, provide more specific timeframes, and set short term targets to measure progress against long-term objectives;
- for more credible targets, the government could design targets to be durable through economic cycles, and consider enshrining well-designed targets in legislation;
- for a more comprehensive assessment of risk, the government could publish a consolidated statement of fiscal risks, include an assessment of the most significant risks to the fiscal outlook, and publish probabilistic forecasts for key fiscal variables; and
- longer-term (10-year) fiscal projections, and a periodic intergenerational report projecting long-term demographic and workforce trends, would enable assessment of long-term policy impacts.

These options are discussed further below.

[4] The Public Accounts and Estimates Committee (PAEC) of the Victorian Parliament scrutinises the government's budget papers for transparency and accountability each year in its budget estimates inquiry. PAEC has made 6 recommendations in recent budget estimates reports that are directly relevant to options identified in this advice, but the government has either not supported or not acted upon them. See PBO, *Fiscal Objectives, Targets and Risks*, Appendix 1. Accessed at: https://www.parliament.vic.gov.au/paec/publications.

BACKGROUND AND CURRENT FRAMEWORK

Fiscal objectives and targets

Fiscal objectives and targets – also called fiscal rules – generally focus on debt, budget balance, revenue or expenditure, but may cover a range of variables. 'Fiscal objectives' generally refer to qualitative fiscal goals, and 'fiscal targets' to quantitative fiscal goals. For example, a fiscal objective is to ensure a sustainable net operating balance over the medium term, while a fiscal target is to ensure the net operating balance is at least $100 million in each year of the budget and forward estimates. Both are most effective when they remain in place over an extended period, allowing subsequent comparison against actual outcomes achieved.

The *Financial Management Act 1994* (Vic) sets out legislative requirements for Victoria's framework of fiscal objectives and targets. It requires that the Victorian budget:

- specifies long-term financial objectives
- sets 'short-term financial objectives' and 'fiscal targets for key financial measures' for the budget year and the subsequent 3 years, or forward estimates. [5]

The government publishes an updated fiscal strategy and assessment of risks in compliance with these requirements as part of each state budget and budget update.

Table 1 – Framework of fiscal objectives and targets in the Victorian Budget 2021/22[6]

Category	Objectives / targets
Long-run financial objectives	Sound financial management: Victoria's finances will be managed in a responsible manner to provide capacity to fund services and infrastructure and support households and businesses in the economic recovery at levels consistent with sound financial management Improved services: Public services will improve over time Building infrastructure: Public infrastructure will grow steadily over time to meet the needs of a growing population

[5] *Financial Management Act 1994* (Vic) s23G(d).

[6] Dept Treasury and Finance, *Victorian Budget 2021/22*.

Category	Objectives / targets
	Efficient use of public resources: Public infrastructure will grow steadily over time to meet the needs of a growing population A resilient economy: Public sector resources will be invested in services and infrastructure to maximise the economic, social and environmental benefits
Targets for key financial measures	A net operating cash surplus consistent with maintaining general government net debt at a sustainable level after the economy has recovered from the coronavirus (COVID-19) pandemic General government net debt as a percentage of GSP to stabilise over the medium term General government interest expense as a percentage of revenue to stabilise in the medium term Fully fund the unfunded superannuation liability by 2035
Sustainability objectives	An operating cash surplus will be achieved before the end of the forward estimates The operating deficit will reduce over the budget and forward estimates

Assessment of fiscal risks

Fiscal risks are potential shocks to government revenues, expenditures, assets, or liabilities, causing actual fiscal outcomes to deviate from central forecasts. If risks materialise, they may in turn affect achievement of, or progress towards, fiscal objectives and targets. Assessment and management of fiscal risks communicates the uncertainties around the central outlook and helps a government to proactively manage disruption to the budget if risks materialise. The OECD report *Best Practices for Managing Fiscal Risks* classifies fiscal risks into 5 categories:

- macroeconomic risks – from either cyclical or structural changes in the economy, e.g. an economic downturn in major trading partners
- policy or program risks – that tax collection or spending controls do not work as planned, e.g. higher than expected take up of a government program
- uncertain budgetary claims – risks from commitments or obligations that are uncertain or impossible to measure, e.g. guarantees, indemnities and legal claims
- balance sheet risks – associated with assets and liabilities owned by the government, e.g. equity shareholdings or loans

- debt risks – associated with holding debt, e.g. changes to interest and foreign exchange rates.[7]

Macroeconomic risks generally have a greater potential to disrupt the fiscal outlook than other risks, as they have broader impacts to the budget balance. They potentially affect revenue streams over multiple forecast years and may require increased expenditure to support the economy.

The *Financial Management Act 1994* (Vic) sets out legislative requirements for Victoria's consideration of risk. It requires:

- prudent management of financial risks as a principle of sound financial management
- preparation of a statement of risks as part of the fiscal strategy in the budget papers. [8]

Table 2 – Framework of risk assessments in the Victorian Budget 2021/22[9]

Risk type	Content
Macroeconomic risks	Global and domestic economic risks to Victoria's economic outlook. Modelled fiscal impacts from a renewed COVID-19 outbreak. Sensitivity of fiscal projections to one per cent changes in economic variables.
Policy and program risks	General risks to revenue, expenditure and asset investment, and specific fiscal risks.
Uncertain budgetary claims	Quantifiable and non-quantifiable contingent assets and liabilities, such as from guarantees, indemnities and warranties, and legal proceedings and disputes.

[7] Organisation for Economic Cooperation and Development, 'OECD Best Practices for Managing Fiscal Risks', 2021. Accessed at: http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=GOV/PGC/SBO(2020)6&docLanguage=En.

[8] *Financial Management Act 1994* (Vic) s23D. See also PBO, *Fiscal Objectives, Targets and Risks*, Appendix 2 which provides the *Financial Management Act 1994* (Vic) requirements for fiscal objectives, targets and risk assessment.

[9] Dept Treasury and Finance, *Victorian Budget 2021/22.*

Risk type	Content
Balance sheet and debt risks	Interest rate risk, foreign currency risk, equity price risk, credit risk, liquidity risk.

FISCAL OBJECTIVES AND TARGETS

This section considers the framework of fiscal targets and objectives in Victorian budgets over the past 10 years and identifies options for improvement based on IMF guidance.[10]

REPORTING PROGRESS IN A SINGLE, CENTRAL LOCATION

The IMF *Fiscal Transparency Handbook* states:

> The budget documentation should include a section that clearly states each target or rule, discusses historically the extent of compliance with, or deviations from, the rules, and how the budget forecasts are consistent with them.[11]

The Victorian Budget 2021/22 lists fiscal objectives and targets, and reports on progress against them in various locations across the budget papers (Table 3). It would help readers to understand how outcomes and forecasts are tracking against objectives and targets if future budgets consolidate all fiscal objectives and targets in a central location – most likely in Budget Paper 2 as part of the budget strategy discussion. This section would also report systematically on progress against targets in the same location and show how the projections over the budget year and forward estimates align with achievement of the objectives and targets.

[10] For a summary of Fiscal Transparency Code principles and practices relating to fiscal objectives, targets and risks, see PBO, *Fiscal Objectives, Targets and Risks*, Appendix 3.

[11] IMF, *Fiscal Transparency Handbook*, p. 76.

Table 3 – Location of objectives and targets in the budget papers[12]

<table>
<tr><th>FMA required objectives and targets</th><th>Location of objectives and targets</th><th>Location of reporting performance</th></tr>
<tr><td>Long-run financial objectives</td><td>Budget Paper No. 2 ‘Strategy and Outlook’, Table 1.2</td><td>No quantitative targets for reporting</td></tr>
<tr><td>Targets for financial measures</td><td>Budget Paper No. 2, ‘Strategy and Outlook’, Table 1.3</td><td rowspan="2">Victorian Budget Financial Report, Chapter 2 – General Government Sector Outcome, ‘Fiscal Objectives’</td></tr>
<tr><td>Short term financial objectives</td><td>Budget Paper No. 5 ‘Statement of Finances’, Chapter 1</td></tr>
</table>

SETTING FISCAL TARGETS WITH SPECIFIC TIMEFRAMES

The *IMF Fiscal Transparency Handbook* states:

> A fiscal objective carries considerably more weight if it is to be achieved by a specified date, rather than being stated as an open-ended commitment. Good practice is to establish intermediate milestones to determine with precision if progress is being made year by year to reach the fiscal objective.[13]

Prior to 2015-16, Victorian’s fiscal targets had specified timeframes, whether on an annual basis – such as ‘a net operating surplus of at least $100 million’ – or set for a specific year – such as ‘general government net debt reduced as a percentage of GSP over the decade to 2022’ (Table 4). However, since 2015-16, the ‘targets for financial measures’ have mostly referred to the ‘medium term,’ without stating the period that the ‘medium term’ refers to. Setting fiscal targets for Victoria with more specific timeframes would provide greater guidance for decision makers and public accountability. These could follow the Australian Government budget which specifies the 'medium term' as 10 years, and would preferably include intermediate milestones to measure year by year progress.

[12] Dept Treasury and Finance, *Victorian Budget 2021/22*.

[13] IMF, *Fiscal Transparency Handbook*, p. 76.

Table 4 – Targets for financial measures, comparison over time[14]

	2012-13 to 2014-15 budgets	2015-16 to 2019-20 budgets	2020-21 to 2021-22 budgets
Net debt	General government net debt reduced as a percentage of GSP over the decade to 2022	General government net debt as a percentage of GSP to be maintained at a sustainable level over the medium term	General government net debt as a percentage of GSP to stabilise in the medium term
Net operating balance	A net operating surplus of at least $100 million and consistent with the infrastructure and debt parameters	A net operating surplus consistent with maintaining general government net debt at a sustainable level over the medium term	None
Net operating cash surplus	None	None	A net operating cash surplus consistent with maintaining general government net debt at a sustainable level after the economy has recovered
Infrastructure investment	Infrastructure investment of 1.3 per cent of GSP (calculated as a rolling 5-year average)	None	None
Superannuation liabilities	Fully fund unfunded superannuation liability by 2035		

BETTER ALIGNING WITH GOVERNING LEGISLATION

The *IMF Fiscal Transparency Handbook* states:

[14] PBO, *Fiscal Objectives, Targets and Risks*. Note: This figure contains all targets formally identified in Table 1.3 of the Strategy and Outlook budget paper from the past 10 budgets. It does not include goals that budgets mention in discussion of fiscal strategy but do not formally identify as targets.

> Clarity about fiscal policy objectives is critical for guiding the budget process and holding the government accountable for its strategies and priorities. It enables ex post comparison of what was achieved and thus holds the government accountable for its performance.[15]

Of the 3 sets of fiscal objectives and targets outlined in the Victorian budget, 2 sets (long-term financial objectives and targets for financial measures) clearly align to requirements in the *Financial Management Act 1994*. However, it is not clear whether the third set (the 'sustainability objectives' in the 'Statement of Finances') corresponds to the requirement for short-term financial objectives (Table 5). *Budget Paper 5: Statement of Finances* Appendix C,[16] which outlines how the budget complies with legislation, states that Strategic Outlook Chapter 1 and Statement of Finances Chapter 1 comply with Sections 23E-G, but provides no further detail. It would be clearer if the names of each set of objectives and targets aligned directly to the legislative requirements.

Table 5 – Legislative requirements for objectives and targets

Financial Management Act 1994 Section 23G	Objectives, targets and budget location
(1) A financial policy statement must—	
(a) specify the government's long-term financial objectives within which financial policy for the financial year to which the budget or budget update relates and the following 3 years will be framed	Long-term financial management objectives in Strategy and Outlook Budget Paper No. 2, Table 1.2
(d) specify, for the financial year to which the budget or budget update relates and the following 3 financial years	It is not clear whether the budget provides specific short-term financial objectives. They may be the 'sustainability objectives' in the Statement of Finances Budget Paper, Chapter 1
(i) the government's short-term financial objectives	
(ii) the targets for each specific key financial measure	'Targets for financial measures' in Strategy and Outlook paper, Table 1.3

[15] IMF, *Fiscal Transparency Handbook*, p. 73.

[16] Dept Treasury and Finance, *Victorian Budget 2021/22*, Budget Paper 5: Statement of Finances Appendix C.

ALIGNING LONG-TERM OBJECTIVES WITH SHORT TERM OBJECTIVES AND TARGETS

The Victorian budget has five long-term financial management objectives, but four of these have no corresponding short-term objectives or targets to guide policy or measure performance (Table 6). This limits both the capacity of the long-term objectives to inform decision-making and public scrutiny of progress against them. Setting targets to measure progress against the long-term financial management objectives would benefit both capacity of the long-term objectives to inform decision-making, and public scrutiny of progress against the objectives.

Table 6 – Alignment between objectives and targets, Victorian Budget 2021/22[17]

Government priority	Long-term financial management objectives	Fiscal sustainability objectives	Targets for financial measures
Sound financial management	Victoria's finances will be managed in a responsible manner to provide capacity to fund services and infrastructure and support households and businesses in the economic recovery at levels consistent with sound financial management	An operating cash surplus will be achieved before the end of the forward estimates	A net operating cash surplus consistent with maintaining general government net debt at a sustainable level after the economy has recovered from the coronavirus (COVID-19) pandemic
		The operating deficit will reduce over the budget and forward estimates	
			General government net debt as a percentage of GSP to stabilise over the medium term
			General government interest expense as a percentage of revenue to stabilise in the medium term

[17] PBO, *Fiscal Objectives, Targets and Risks*, Table 6.

Government priority	Long-term financial management objectives	Fiscal sustainability objectives	Targets for financial measures
			Fully fund the unfunded superannuation liability by 2035
Improved services	Public services will improve over time	None	
Building infrastructure	Public infrastructure will grow steadily over time to meet the needs of a growing population	None	
Efficient use of public resources	Public sector resources will be invested in services and infrastructure to maximise the economic, social and environmental benefits	None	
A resilient economy	Increase economic resilience by supporting an innovative and diversified economy that will unlock employment growth, long-term economic growth and productivity in Victoria	None	

ENHANCING DURABILITY OF TARGETS THROUGH THE ECONOMIC CYCLE

The *IMF Fiscal Transparency Handbook* states:

> To provide a credible anchor for decision making, fiscal objectives must have been in place long enough, at least a period of three or four years, and any changes to specified fiscal targets/objectives should have been undertaken only under the respective escape clauses under the fiscal rule.[18]

Some of Victoria's objectives and targets have remained in place for significant periods – for example, the target to eliminate the unfunded superannuation liability by 2035 has been in place since the 2000-01 budget. However, the government has modified

[18] IMF, *Fiscal Transparency Handbook*, p.76.

or abandoned several objectives and targets when economic and fiscal circumstances have changed. For example, the government changed the net debt sustainability objective three times in five budgets before dropping it in the 2020-21 budget. They have often not remained in place for a sufficient period to be useful or credible. Table 7 shows the evolution of the 'sustainability objectives' listed in the Statement of Finances Chapter 1 over the past ten budgets.

Table 7 – Sustainability objectives, comparison over time[19]

Fiscal outcome	2012-13 to 2014-15 budgets	2015-16 budget	2016-17 to 2018-19 budgets	2019-20 budget	2020-21 budget	2021-22 budget
Net debt	None	Net debt as a percentage of GSP reducing from the commencement of the budget year to the end of the forward estimates period	Net debt to GSP no greater than its peak over the last 5 years by the end of the forward estimates	Net debt to GSP will be not greater than 12 per cent over the medium term	None	
Net operating balance	A net operating surplus of at least $100 million	Net operating surpluses in each year over the budget and forward estimates			The operating deficit will reduce over the budget and forward estimates	
Operating cash balance	None					An operating cash surplus will be achieved before the end

[19] PBO, *Fiscal Objectives, Targets and Risks*, Table 7. Note: This figure contains all sustainability objectives identified in Chapter 2 of the Statement of Finances from the past 10 budgets. It does not include goals mentioned in fiscal strategy discussion but not formally identified as sustainability objectives.

Fiscal outcome	2012-13 to 2014-15 budgets	2015-16 budget	2016-17 to 2018-19 budgets	2019-20 budget	2020-21 budget	2021-22 budget
						of the forward estimates
Expenses	None		Expenditure growth no greater than revenue growth, on average, over the budget and forward estimates		None	

In the Victorian Budget 2020/21 – the first to reflect the impacts of the COVID-19 pandemic – the government modified or abandoned most of its fiscal targets.[20] In the Victorian Budget 2021/22 it set one new fiscal target – for the operating cash surplus. There are now fewer and less clearly defined fiscal objectives and targets than prior to the pandemic. The government also modified its 'long term financial objective' of sound financial management in the 2020-21 budget, removing the reference to maintaining a AAA credit rating just prior to losing it.

The Victorian Government could draw on principles of 'second generation' targets to increase the lifespan of its targets. Second generation' targets were developed after the Global Financial Crisis following widespread international lack of compliance with fiscal targets. They are designed to allow governments to sustain government spending through economic downturns, while containing debt levels over the economic cycle.

The IMF report, *Second Generation Fiscal Rules: Balancing Simplicity, Flexibility and Enforceability,* recommends three guiding principles for fiscal targets:

- A debt anchor – this is a medium-term objective for net debt, usually expressed as a percentage of GSP, which may allow a buffer for debt to rise to facilitate responses to future shocks such as natural disasters or recessions.
- One or two operational rules – these are short-term targets, usually for the net operating balance (for example, the budget balance not to exceed a specific percentage of GSP) or expenditure (for example, capping real or nominal

[20] Dept Treasury and Finance, *Victorian Budget 2021/22*.

expenditure growth). Operational rules can also apply to a structural budget balance, which adjusts for the economic cycle by separating structural and cyclical movements in the budget position.

- Escape clauses can help a fiscal target remain in place over a longer period, because an economic shock will trigger the escape clause rather than abandonment of the target. Escape clauses should define the conditions under which a government must revert to following the operational rules.[21]

Case study: Iceland's fiscal target framework[22]	
Debt anchor	A general government debt ceiling of 30% of Gross Domestic Product.
Operational target	The fiscal deficit to be less than 2.5% of Gross Domestic Product in each year, with the fiscal balance in surplus over a 5-year period.
Escape clause	Fiscal balance objectives may be departed from for up to 3 years in case of economic shocks, national crisis or other circumstances that cannot be remedied by available measures.

LEGISLATING SPECIFIC FISCAL TARGETS

All Australian state jurisdictions have legislated requirements to set fiscal objectives and targets. However, only NSW has taken the further step of legislating specific fiscal targets. The *Fiscal Responsibility Act 2012* (NSW) legislates maintaining a AAA credit rating as the overarching objective. It also legislates that annual growth in general government expenses is less than long-term average general government revenue growth, elimination of the unfunded superannuation liability by 2030, and a review of

[21] International Monetary Fund, 'Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability', 2018. Accessed at: https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2018/04/12/Second-Generation-Fiscal-Rules-Balancing-Simplicity-Flexibility-and-Enforceability-45131.

[22] PBO, *Fiscal Objectives, Targets and Risks*, p. 10.

the legislation after five years, including fiscal objectives and targets.[23] Internationally, the United Kingdom and Germany have legislated specific targets at the national level, alongside British Columbia and the German states at the subnational level.

The Victorian Government could consider enshrining well-designed fiscal targets in legislation, with a schedule for regular review. Legislating targets provides advantages of increased visibility and accountability, because once legislated, a target is more likely to influence debate and decisions on fiscal policy, and governments cannot change or abandon targets without a parliamentary vote. Legislating targets can also embed a requirement for regular and orderly review.

The main disadvantage of legislating targets is the potential to cement drawbacks of fiscal targets in general, such as having a narrow focus (for example, including not factoring in the cost or the purpose of borrowing), exacerbating cyclical economic variations by placing arbitrary restraints on expenditure, and encouraging manipulation of fiscal outcomes with a focus on performance against targets rather than achieving the overarching strategy. This can be managed by ensuring that targets are well-designed, flexible and reviewed regularly.

ASSESSMENT OF FISCAL RISK

This section considers the framework for risk assessment in Victorian budgets over the past ten years and identifies options for improvement based on IMF guidance.[24]

Consolidating the statement of risks

The *IMF Fiscal Transparency Handbook* states:

> An increasing number of countries produce summary reports in the form of a fiscal risk statement as part of their budget documentation… A comprehensive fiscal risk statement helps to identify possible gaps and to ensure full coverage of

[23] *Fiscal Responsibility Act 2012* (NSW) s3(1).

[24] PBO, *Fiscal Objectives, Targets and Risks*, p. 10, Appendix 3.

> risks. Its content should reflect the key fiscal risks facing a country and their evolving circumstances.[25]

The Victorian budget papers currently assess different types of risk in multiple locations across the budget papers – macroeconomic risks, policy and program risks, uncertain budgetary claims, balance sheet risks and debt risks (Table 8). This makes it difficult to assess Victoria's aggregate exposure to fiscal risks, or to identify systematic relationships and interactions among risks. A consolidated statement of risks could provide a more comprehensive and transparent discussion of risks, whether in an extended appendix to the Strategy and Outlook paper, or as a separate budget paper.

[25] IMF, *Fiscal Transparency Handbook*, p. 99.

Table 8 – Location of risk assessments, Victorian Budget 2021/22[26]

Risk type	Content	Location
Macroeconomic risks	One-page description of global and domestic economic risks to Victoria's economic outlook	Budget Paper No. 2: Strategy and Outlook, Chapter 2
	Nine-page appendix outlining modelled fiscal impacts from a renewed COVID-19 outbreak, and sensitivity of fiscal projections to one per cent changes in economic variables.	Budget Paper No. 2: Strategy and Outlook, Appendix A
Policy and program risks	Five pages describing general risks to revenue, expenditure, asset investment and specific fiscal risks.	Budget Paper No. 2: Strategy and Outlook, Chapter 4
Uncertain budgetary claims	Eight pages on quantifiable and non-quantifiable contingent assets and liabilities, such as from guarantees, indemnities and warranties, and legal proceedings and disputes.	Budget Paper No. 4: Statement of Finances, Chapter 6
	Six pages of additional information on contingent assets and liabilities.	Victorian Budget 19/20: 2019-20 Financial Report, Chapter 4
Balance sheet and debt risks	Eleven pages on interest rate risk, foreign currency risk, equity price risk, credit risk, liquidity risk.	Victorian Budget 19/20: 2019-20 Financial Report, Chapter 4

The *IMF Fiscal Transparency Handbook* also states:

> In addition to the disclosure of fiscal risks, it is useful to provide an explanation of how these risks have been taken into consideration in setting the government's overall fiscal stance, and what policies the government is pursuing to reduce and manage these risks. [27]

A consolidated statement of risks could include a comprehensive discussion of how the fiscal strategy is managing the main risks. This would outline how the government has

[26] PBO, *Fiscal Objectives, Targets and Risks*, Table 8.

[27] IMF, *Fiscal Transparency Handbook*, p. 107.

considered the risk profile in developing the overall fiscal strategy, the level of risk the government is willing to bear, and policies to mitigate key risks.

ASSESSING MAGNITUDE AND LIKELIHOOD OF CRITICAL RISKS

The *IMF Fiscal Transparency Handbook* recommends:

> …disclosing the likelihood of risks materializing, in addition to quantifying the government's gross exposure. This practice provides a more realistic picture of how risks might impact on the budget and a better estimate of the policy changes that might be required during the budget year to keep to the government's announced fiscal target… In cases where estimates of the probability of realization are too difficult, risks may be classified into categories (e.g., probable, non-remote, and remote) based on judgements about their likelihood.[28]

Recent Victorian budgets have outlined useful analyses of selected macroeconomic risks (Table 9). For example, the Victorian Budget 2021/22 provides risk assessment associated with a protracted recovery from COVID-19. However, these risks are discussed individually, making it difficult for readers to understand how these risks compare and relate to other budget risks. Furthermore, while the budget provides sensitivity analysis for net operating balance and net debt to economic variables such as GSP and employment, these are not linked to specific risks.

A consolidated statement of risk which indicates magnitude and likelihood for key risks would provide a more complete assessment of the main risks to the outlook.

[28] IMF, *Fiscal Transparency Handbook*, pp. 106-107.

Table 9 – Macroeconomic risk assessments, comparison over time[29]

Budget	Risk scenarios	Description
2011-12 to 2012-13	None	
2013-14 to 2016-17	2006-07 – economic growth exceeding expectations	Past deviation from forecasts – higher-than-expected economic growth and revenue outcomes in 2006-07 (pre-GFC boom)
	2008-09 – global financial crisis	Past deviation from forecasts – lower-than-expected economic growth and revenue outcomes in 2008-09 (GFC recession)
2017-18	A global trade shock	Negative trade shock to the world's major trading economies – the United States, China and the European Union
	Labour supply scenarios	Positive shocks to population growth and labour force participation rate
2018-19	Downturn in household consumption and dwelling investment	Negative shock to the household sector through weakening in national household consumption and dwelling investment
	Sustained high labour force participation	Labour force participation rate is higher than the central forecast
2019-20	Downturn in Victorian population growth	Negative shock to national net overseas migration by 75,000 persons relative to the base case
	A lower trend rate of unemployment	The non-accelerating inflation rate of unemployment (NAIRU) is 0.5 percentage points lower than the base case assumption.
2020-21	A deep and enduring coronavirus (COVID-19) pandemic throughout all of 2021	Lower global growth reduces demand for Victoria's exports and leads to an extension to international border restrictions and a delayed recovery in net overseas migration.

[29] PBO, *Fiscal Objectives, Targets and Risks*, Table 9.

Budget	Risk scenarios	Description
2021-22	A protracted global recovery	Delay to the global vaccine rollouts leads to further outbreaks, slowing the global recovery with shocks to trade, migration, education, tourism, business investment and dwelling investment.

PROBABILISTIC FORECASTS FOR KEY BUDGET AGGREGATES

The IMF advises that:

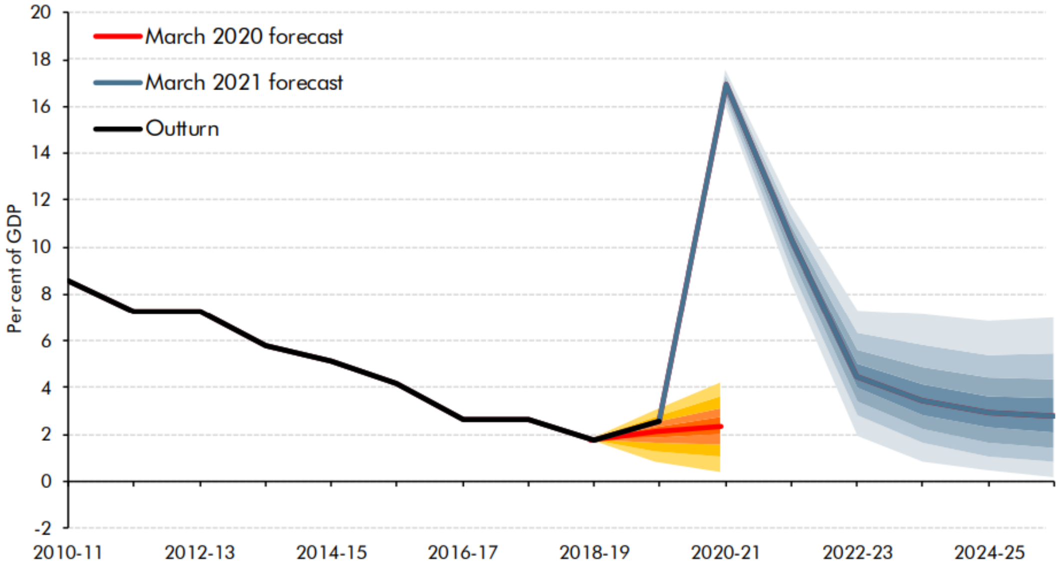
> The most sophisticated forms of macro-fiscal risk analysis present probabilistic fiscal forecasts that provide a set of confidence intervals around the government's central fiscal forecast. These probabilistic forecasts typically take the form of 'fan charts' to illustrate the degree of uncertainty inherent in the forecasting process as well as the distribution of risks above and below the government's central prediction.[30]

Publishing a single central forecast for key fiscal variables can create an impression that the state's fiscal outlook is more predictable than it really is, and that forecast models are more reliable than they really are. Probabilistic fiscal forecasts demonstrate the inherent uncertainty around the central fiscal projections. They present a range of different outcomes that have varying degrees of probability, although they generally do not predict rare, high impact events such as the global financial crisis or the COVID–19 pandemic.

To provide greater information around the risk outlook, Victoria could consider providing probabilistic forecasts based on the standard deviation of previous forecast errors. These could be similar to the Australian Government budget, which provides probabilistic forecasts for selected macroeconomic and fiscal aggregates in the budget year and the first year of forward estimates, or the United Kingdom Office of Budget Responsibility, which publishes probabilistic forecasts over the full forward estimates (Figure 1).

[30] IMF, *Fiscal Transparency Handbook*, p. 103.

Figure 1 – Probabilistic forecast for public sector net borrowing[31]



Source: UK Office of Budget Responsibility.[32]

LONGER-TERM FISCAL PROTECTIONS

The IMF recommends longer-term projections of budget aggregates even at the 'basic' compliance level:

> …countries should produce projections of the fiscal balance and public debt obligations over a decade into the future. These projections can take the form of a relatively simple debt sustainability analysis, where realistic assumptions about the primary fiscal balance, GDP growth rates, and interest rates are used to project how public debt will evolve. This analysis can be used to identify whether

[31] UK Office of Budget Responsibility, 'Economic and fiscal outlook', 2021. Accessed at: https://obr.uk//docs/CCS207_CCS0221988872-001_CP-387-OBR-EFO-Web-Accessible.pdf; Parliamentary Budget Office p. 16.

[32] Note: The darkest line shows the median forecast. Each shaded area represents ten per cent probability bands. Taken together, the four pairs of shaded bands show the central 80 per cent of the probability distribution, leaving a 20 per cent chance the outcome will lie outside the range of the fan chart.

> public debt is on a sustainable or increasing path and, by incorporating some sensitivity analysis, can also provide guidance on how public debt will evolve under less favourable conditions.[33]

The Victorian budget papers currently publish 4 financial years of fiscal projections – the budget year and forward estimates. Longer-run projections are necessary to show when, and at what level, the government expects Victoria's net debt to peak or stabilise. The Victorian Budget Update 2021/22 forecasts net debt to keep rising to $162.7 billion (27.9% of Gross State Product) by 30 June 2025, the end of the forecast period.[34] Longer-run projections would also enable assessment of the long-term fiscal implications of policy and infrastructure decisions. For example, the current practice of 4-year forecasts is not sufficient to assess the implications for future expenditure on the Suburban Rail Loop – the government expects the east section alone (Cheltenham to Box Hill) to cost between $30.0 and $34.5 billion over coming decades.[35]

The IMF also recommends that at an 'advanced' compliance level:

> The government regularly publishes multiple scenarios for the sustainability of the main fiscal aggregates and any health and social security funds over at least the next 30 years using a range of macroeconomic, demographic, natural resource, or other assumptions. [36]

This approach has been adopted in the Australian Intergenerational Report, as outlined under the *Charter of Budget Honesty Act 1998* (Cth), and the NSW Intergenerational Report, as outlined under the *Fiscal Responsibility Act 2012* (NSW). Ideally, the Australian Government would work with state governments to produce an intergenerational report that covers both levels of government. In the absence of such arrangements, the best approach is for Victoria to develop a state-level intergenerational report, similar to NSW.

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[33] IMF, *Fiscal Transparency Handbook*, p. 108.

[34] Dept Treasury and Finance, *Victorian Budget Update 2021/22*.

[35] Victorian Government, 'Suburban Rail Loop: Business and Investment Case', 2021. Accessed at: https://bigbuild.vic.gov.au/__data/assets/pdf_file/0004/578281/SRL-Business-and-Investment-Case.pdf; Dept Treasury and Finance, *Victorian Budget 2021/22*.

[36] IMF, *Fiscal Transparency Handbook*, p. 13.

CONCLUSION

Setting and achieving fiscal objectives and targets is challenging. We respect each government's right to specify its financial management targets and long-term objectives in a manner consistent with the requirements of the *Financial Management Act 1994* (Vic). However, we consider that the Victorian budget papers could present the state's fiscal strategy in a more cohesive way, more in keeping with the stated accountability purpose of the Act.

To allow Victorians to better understand the government's fiscal strategy and performance, the government could better align long-term and short-term goals, give more specific timeframes, and provide clearer reporting on progress. These measures would also provide a more cohesive set of anchors to guide government decision making. To increase the lifespan and credibility of its targets, the government could design them to be durable through economic cycles, and consider enshrining them in legislation with a schedule for regular review.

A comprehensive fiscal strategy identifies, assesses and manages fiscal risks. If fiscal risks are realised, the longer-run strategy may remain largely unaltered, even if short-term targets are not achieved. For greater transparency and accountability, the government could publish a consolidated statement of the main fiscal risks. Longer-term forecasts, combined with meaningful risk scenarios, would provide insight into whether public finances are sustainable, and how they might evolve under less favourable conditions.

When, and at what level, is Victoria's net debt expected to stabilise as the economy reacts and recovers from COVID-19? What are the long-term cost implications of current infrastructure policy decisions? These are the types of questions that longer-term forecasting can shine light on.