Macroeconomic stabilisation and its implications for personal income tax reform in the lead-up to the 2007 Federal Election†

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Abstract

Recent debates concerning personal income tax reform have been dominated by microeconomic considerations such as the impact of marginal tax rates on labour force participation and the interactions between tax and social policy. In contrast the task of managing the macroeconomy has been left to central bankers and monetary policy. However, after 15 years of economic expansion in Australia there is growing awareness of the short-run "liquidity" effects of fiscal policy – or what Richard Musgrave described as the "stabilisation" role of taxation policy. This paper argues that for the first time in almost two decades these factors are influencing the Australian tax policy debate and are effectively limiting the prospects of radical tax reform.

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I. Introduction

Debates surrounding personal income tax policy are a perennial and perhaps inevitable feature of modern politics as governments and policy makers try to achieve a balance between structural reform objectives, the revenue needs of the state and all important electoral imperatives. One of the reasons why this reform process is both dynamic and ongoing is that the political, ideological and economic context in which policy is being made is constantly changing. Indeed many significant insights can be gained if we cast our eyes above the cut and thrust of the electoral politics of tax reform to focus on the structural context in which policy is made. Alan Fenna’s contribution to this volume pursues this broad theme by highlighting how the appropriate objectives of taxation policy and “reform” are, at least in part, the product of relatively entrenched public sentiments and values (Fenna 2007a). However, it is also important to recognise that reform priorities and political preferences in relation to tax policy are never completely divorced from material interests and prevailing economic conditions.

This article will analyse how broader trends in fiscal policy and prevailing macroeconomic conditions have influenced personal income tax policy in Australia. While there has been a strong shift away from the use of activist fiscal policy as an instrument of macroeconomic management over the past two decades this does not mean that tax policy is insulated from prevailing macroeconomic conditions. Firstly, as is widely accepted, tax systems must be fiscally sustainable across the economic cycle. Secondly, while monetary policy is the principal instrument of macroeconomic management, it is still necessary to remain mindful of the short-run “liquidity” effects of fiscal policy – or what Richard Musgrave described as the “stabilisation” role of taxation policy (Musgrave 1959, 22-25). This paper argues that for the first time in almost two decades the liquidity effects of fiscal policy are influencing the Australian tax reform debate. While public finances are clearly sustainable (indeed they have never been healthier), there are real concerns that cutting personal income tax rates will stimulate domestic consumption and aggregate demand posing inflationary risks in an economy in which some sectors are running at close to full capacity.

This paper sketches the evolution of fiscal policy in Australia before analysing the extent to which macroeconomic conditions are influencing the tax reform debate in the lead-up to the 2007 Federal Election. It argues that inflationary risks, and the sensitivity of both major parties to this risk, will ensure that major personal tax reform proposals remain off the political agenda.

II. Macroeconomic management and taxation policy

Taxation is as old as government, but for most of the last two millennia the scope of tax systems was limited by a combination of administrative (the extent to which taxes could be collected) and political constraints (Tilly 1992). All this changed during the 20th century as the state’s ability to impose mass taxes (such as the personal income tax) increased and demands for the provision of state welfare rose. Overlaying
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such developments was an increasing awareness of the need for macroeconomic management. After the global recession of the 1890s, the excesses of the 1920s and the catastrophic impact of the 1930s Depression it became clear that modern industrial capitalism, especially after the demise of the gold standard, was inherently unstable and that governments should develop means of managing the business cycle so as to avoid the social and economic devastation of the late 19th and early 20th centuries.

In its simplest form the macroeconomic problem involves achieving a balance between aggregate demand and the supply capacity of an economy. During the economic expansions of the late 19th and early 20th centuries, under the gold standard a macroeconomic balance was achieved when recessions resulted in an improvement in the balance of payments such that it increased money supply bringing the economy back towards equilibrium. However political changes in the early 20th century in the form of increased labour market regulation and welfare provision compromised this process and, in the minds of classical theorists at least, contributed to the depth and duration of the Depression (Garnaut 2005, 525). As we all know, Keynesian economic management was one of the major intellectual and policy legacies of the Depression and, despite numerous variations on the theme (Hall 1989), almost all Western governments actively used fiscal policy to manage aggregate demand at some stage in the post-war period.

Central to the Keynesian framework was the "stabilisation function" of fiscal policy which, in Musgrave's seminal text, is defined as "maintaining a high level of resource utilisation and a stable value of money" (Musgrave 1959, 22). Prophetically, Musgrave argued that the need for fiscal stabilisation would continue long after the disruption of the Depression and Second World War had passed.

Contrary to current belief, the inherent tendency to instability may increase rather than decline as the economy develops and gains complexity. At the same time, the social climate grows less tolerant toward the hardships of unemployment, and similar attitudes may develop with regard to inflation (Musgrave 1959, 22-23).

And so, almost 50 years after the publication of The Theory of Public Finance, this view has largely been vindicated. The economy is certainly more complex and achieving price stability has become the central goal of macroeconomic policy and, as this paper will argue, under certain conditions fiscal policy should still play an important stabilisation role.

In the Australian context the foundations of the new Keynesian settlement were set out in the Chifley Government’s White Paper on Full Employment in Australia and the Commonwealth Bank Act of 1945, which committed policy to the active pursuit of full employment (Bell 1997, 76). While it is difficult to dispute that this amounted to a paradigm shift in macroeconomic policy, as Ian Macfarlane recently argued in the 2006 Boyer lectures, the so-called "golden-age" of post-war full employment owed as much to the post-war investment in reconstruction, trade liberalisation and Depression-inspired thrift as it did to activist fiscal policy. Indeed the former Chairman of the Reserve Bank of Australia ("RBA") notes that some "commentators have characterised the economic policy of the 1950s and 1960s as being activist and
very expansionary. It became so later in the period, but for most of the time it was not.” (MacFarlane 2006, 11). Activist fiscal policy may have only been part of the explanation for the post-war boom, but, in combination the expanding role of the state and Keynesian demand management, it resulted in higher inflation contributing to the stagflation and economic disruption of the 1970s and early 1980s. The causes of the economic turmoil of the 1970s are complex and, to an extent, contested. Beyond the inflationary consequences of Keynesian policies under conditions of near-full employment, the approach was subjected to other criticisms which contributed to its demise during the 1970s. Central among these is the argument that it is extremely difficult to implement activist fiscal policies in a timely fashion – once policy makers and political leaders agree that a fiscal stimulus is required it can take months, perhaps even a year or more, before budgets are passed and demand in the real economy increases, leading to what Friedman described as “long and variable lags” (Krugman 2005, 517).

Related to this concern are the direct welfare implications of activist fiscal approaches and the potential for government to ease fiscal policy for electoral reasons rather than to achieve medium term macroeconomic stability. The extent to which fiscal policy has been manipulated for electoral ends has been analysed in the extensive political business cycle literature which followed the seminal work of Nordhaus (1975) (for an overview of this literature see (Eccleston 1998)). Although there is only limited evidence to support the political business cycle theory, its central claims continue to animate discussion about the risks associated with activist fiscal policy.

As a consequence of the events of the 1970s a new consensus emerged, fundamentally changing the goals and instruments of macroeconomic policy. This new framework prioritises price stability as the primary goal of macroeconomic policy, with policy makers managing short-term variations in the business cycle subject to that primary goal (Allsop and Vines 2005). In terms of macroeconomic stabilisation, fiscal policy has very much taken a back seat as increasingly independent central banks have used monetary policy to meet explicit inflation targets. With fiscal policy having been relegated from its stabilisation role, there has been some debate concerning its precise role and the most appropriate framework for its management. In recent times a new consensus has emerged that “good” fiscal policy should focus primarily on ensuring the sustainability of public finances over the medium term, although in recessionary times it is acknowledged that governments should run deficits allowing the automatic stabilisers of fiscal policy to help bring the economy back towards its potential.

Given the recent emphasis on price stability and relatively passive fiscal policy, it is not surprising that tax debates have focused on efficiency and equity issues and how best to structure tax systems to maximise the long run growth potential of an economy. However, this is not to say we can ignore Musgrave’s stabilisation function, as there have been recent examples, both in Australia and beyond, where macroeconomic conditions have demanded a fiscal response with inevitable consequence for taxation policy. The following section briefly outlines the evolution of Australian fiscal policy
over the past two decades with a particular emphasis on the emerging challenges confronting the Australian economy.

III. The evolution of Australian fiscal policy

In a comprehensive review essay Gruen and Sayegh (2005) note that Australian fiscal policy has been broadly consistent with the account provided above because, with the possible exceptions of the recessions of the early 1980s and early 1990s, there has been little evidence of active stabilisation. Indeed the federal budget has tracked within one per cent of the estimated structural balance over the period (See Figure 1). Despite this broad trend it would be a misrepresentation to claim that Australian fiscal policy over the period was passive, with the budget moving between surplus and deficit with the ebb and flow of the economic cycle.

Over the period there have been two instances where macroeconomic conditions have directly influenced fiscal policy with direct implications for taxation policy. The first case was the use of fiscal policy to actively address Australia’s large current account deficit (“CAD”) in the mid-to-late 1980s. Whereas Australia’s CAD had averaged 2.75 per cent over the 1960s and 1970s, a combination of the floating exchange rate, financial deregulation and a declining terms of trade saw the CAD increase to six per cent by 1986, prompting Treasurer Paul Keating’s infamous prediction that Australia risked becoming a “banana republic” unless it improve its external balance. (Bell 1997, 148-151). In line with Keating’s concerns improving Australia’s CAD became a policy priority for the Hawke Labor Government in the late 1980s, with fiscal policy being the main policy instrument used in the fight. At the time it was believed that
tightening fiscal policy would improve the CAD by slowing demand for imports and improving the balance of trade. Also, according to the “twin deficits theory”, net public sector saving should reduce the demand for foreign borrowing helping to balance the capital account.

While there was a radical reassessment of the risks posed by the CAD in the 1990s (although for an interesting contemporary assessment of the issue see Garnaut 2005), the late 1980s not only saw a moderate tightening of fiscal policy with Commonwealth expenditures falling from 30 per cent to 24 per cent of GDP between 1984 and 1989 (Bell 1997, 151), but this was achieved through the introduction of an informal rules-based regime designed to reassure financial markets and the wider electorate. Originally outlined in late 1984, the so-called “Trilogy commitments” were to reduce the federal deficit, reduce federal taxation as a percentage of GDP and to ensure that federal outlays did not grow faster than the national economy. While the “Trilogy” lapsed during the recession of the early 1990s it was significant on at least two grounds. Firstly the “Trilogy” framework established the parameters of the tax reform debate in the mid-late 1980s. Not only was the “CAD crisis” used as a central justification for the Broad-Based Consumption Tax proposed in the Hawke Government’s 1985 Draft White Paper (Treasury 1985), but it also undermined the Howard-led Opposition’s prospects in the 1987 election campaign after commentators dismissed the Coalition’s proposed tax cuts as being stimulatory and economically irresponsible (Eccleston 2004, 95). Beyond this direct impact on the tax debate, the “Trilogy” reinforced a view that fiscal restraint and balanced budgets were the cornerstones of sound economic management, views which continue to resonate with the electorate today.

The second major fiscal challenge to confront Australian governments is that of the aging population. As in most other developed countries, a combination of declining fertility rates and improving life expectancies will result in a significant increase in the proportion of Australians over the age of 65. It is widely argued that this demographic trend will have a number of economic consequences, including posing complex challenges to fiscal policy. Firstly, the aging population will result in lower workforce participation rates reducing the long-run growth potential of the economy. The aging population poses a number of challenges for taxation policy because not only will declining workforce participation erode the personal income tax base over the longer term, but reducing the personal income burden on older Australians is widely regarded as being one of the most effective short-term policy responses to the problem (Gruen and Sayegh 2005, 629). On the expenditure side, the aging population will result in greater demand for pensions, nursing and health services which according to the Productivity Commission (2005) will cost an additional six per cent of GDP by 2045. While these issues have been on the policy agenda since the 1980s, and were important drivers of the superannuation reforms of the period, since the publication of the Treasury’s Intergenerational Report (2002) they have had a major impact on the management of fiscal policy in Australia (Treasury 2002).

The challenges associated with an aging population identified in the Intergenerational Report have prompted the Howard Government to establish a long-term strategy to put fiscal policy on a more sustainable footing. Central here was the
creation of an independently managed “Future Fund” in 2006 to help meet the costs associated with Australia’s aging population. The primary goal of the Future Fund is to accumulate adequate capital to meet the Commonwealth’s unfunded $91 billion superannuation liability so that it does not burden future generations. The Future Fund has been capitalised from a number of sources including asset sales, special seed funding (designed in part to preserve sovereign debt markets) and budget surpluses from the government’s cash account. While the Future Fund is primarily about fiscal sustainability rather than stabilisation per se, it is important to note that the structure of the Future Fund and the allocation of surpluses to it does have some important implications for the stabilisation debate. The significant point here is that the Future Fund represents an innovative vehicle in which cash surpluses can be invested without stimulating short-run consumption.

IV. Australian fiscal policy in practice

What bearing have these developments had on the administration of Australian fiscal policy and what effect do they have on the parameters of the tax reform debate? Firstly, it is important to note that the principles outlined in the Charter of Budget Honesty ("the Charter") allow for significant discretion in the conduct of fiscal policy (see Appendix A). Indeed, some commentators argue that the most significant aspect of the Charter are the provisions which improve the transparency of fiscal policy through the mandatory publication of pre-election fiscal and economic outlooks and updated Intergenerational Reports every five years. In practice the de facto goal of Australian fiscal policy in recent years has been achieving an underlying cash surplus ("UCS") of approximately one per cent of GDP. Not only has the UCS been in the range of 1 to 1.5 per cent of GDP since 2001-02 (Figure 2), but the Federal Treasurer and Prime Minister have repeatedly stated that this is an appropriate goal of fiscal policy, representing a balance between needs of today’s taxpayers and future generations.
Beyond the aggregate objective of achieving a cash surplus of approximately one per cent of GDP, the Howard Government has generally sought to return surplus revenues in the form of discretionary tax cuts or increased family tax benefits rather than introduce new expenditure programs. This tendency to return "surplus funds" to taxpayers in the form of income tax cuts is borne out in aggregate budget data with total Commonwealth expenditure remaining almost constantly within the range of 21.5 to 22 per cent of GDP between 2002-03 and 2006-07 (Australian Government 2007, 8). In clear contrast, other national governments have elected to spend the fiscal dividend of the recent economic expansion. For example, the OECD recently noted that public spending in the United Kingdom under the Blair Labour Government increased by 5.5 per cent of GDP between 2002 and 2006 (OECD 2006). Such data suggests that the Howard Government has been relatively restrained on the expenditure front because, while it may have launched some significant spending initiatives in recent years, such spending has generally been in line with the broader growth of the economy (Henry 2006, 12). Overall recent Australian fiscal policy has been consistent with the objectives set out in the Charter, in that fiscal policy is clearly being conducted on a sustainable basis with significant financial resources now being invested in the Future Fund. What is less clear, however, is the impact of this policy on the goal of macroeconomic stabilisation and whether the challenges currently confronting the Australian economy may require more careful consideration of the impact of fiscal policy on short-run economic activity.
V. Threats to stability and their tax implications

The past decade has seen a period of sustained economic prosperity in Australia and, with the exception of the period immediately after the introduction of the Goods and Services Tax ("GST") in 2000, strong economic growth and steadily declining unemployment. While this strong economic performance can be interpreted as a vindication of the Howard Government's economic management, some analysts have highlighted potential imbalances in the Australian economy which could threaten future economic growth (Fenna 2007b).

Despite Australia's exceptional economic performance over the past 15 years the national economy inevitably faces a number of potential challenges. While some threats are external and can not be prevented with domestic policy, others such as inflationary pressures stemming from capacity constraints can potentially be managed through the prudent use of fiscal policy.

While there is some disagreement between the RBA and Treasury (Uren 2007 a), the former is clearly of the view that inflationary pressures are building in the Australian economy. Some of the most influential evidence of capacity constraints is the fact than the often-cited National Australia Bank Survey of Capacity Utilisation has remained at record highs through 2006 in the mining, construction and utilities sectors (NAB 2007). To quote the recently appointed Governor of the Reserve Bank, Glenn Stevens (2007):

> [o]nce full employment is more or less achieved, the pace of aggregate demand that was earlier desirable … has to slow a bit to be more in line with the rate of growth of the economy's productive capacity. Otherwise we would face the problems of overheating, inflation and eventually a downturn. It is that adjustment to more moderate outcomes for spending and output growth which we have been seeking in Australia in recent years.

Given the economic and political risks associated with tightening monetary policy (especially for the indebted household sector) there is a growing case that fiscal policy can and indeed should be used to temper demand in the Australian economy. Indeed, such a view is being promoted by a number of market economists and is starting to permeate main stream political discourse.

We have noted that in recent years a budget surplus of 1-1.5 per cent of GDP combined with a healthy economic outlook and forward estimates have provided strong grounds for returning surplus funds to taxpayers through pre-election tax cuts. However, there was a good deal of discussion in the lead-up to the 2007-08 Budget ("the Budget") that such a strategy may force the Reserve Bank to increase interest rates. While relatively benign CPI inflation data in the December 2006 and March 2007 quarters (due largely to falling import prices on the back of the rising Australian dollar) gave the Coalition Government room to move, as Megalogenis (2007) points out, the fact remains that the macroeconomic context in Australia is such that the 2007-08 Budget was subject to financial market scrutiny unlike any since the CAD crisis of the 1980s. Clearly the Howard Government's political opponents were hoping that commentators would describe the tax policy changes announced in the 2007 Budget as inflationary so they could accuse the Coalition of giving with one hand while taking away with the other.
VI. Macroeconomic conditions and the 2007 budget

Given the political sensitivity of the issue and the RBA's understandable reluctance to speak outside its official mandate, the central bank has not been willing to provide the government with explicit advice on fiscal policy. Indeed the new RBA Governor, Glenn Stevens, attempted to down-play the issue at a February 2007 Parliamentary Committee hearing when he stated that it was unlikely any election spending spree would have enough short-term impact to enter into the RBA's interest rate calculations (Wood 2007).

In contrast to Steven's diplomatic assessment of the issue, “bank watchers” and market analysts have been more willing to highlight the impact of potential tax cuts on macroeconomic conditions and monetary policy. This was especially true prior to the release of the CPI data for the March 2007 quarter. For example, Stephen Walters of JP Morgan speculated that:

The most likely trigger (for another interest rate rise) is the May budget, which will almost certainly will include sweeteners, given that the government trails the opposition in opinion polls and is desperate to catch up. (as quoted in Murdoch 2007).

So to what extent did macroeconomic conditions generally and the argument that tax cuts might over stimulate demand impact on the 2007-08 Federal Budget? As was widely predicted, the strong economic conditions contributed to buoyant revenue growth with total Commonwealth receipts (excluding the GST) increasing by an estimated 6.1 per cent between 2005-06 and 2006-07 (Australian Government 2007, 36). When combined with historically low unemployment (falling to 4.5 per cent) and stable expenditures there were clearly the fiscal resources available to deliver a relatively extravagant pre-election budget. Yet many analysts commented on the modesty of new initiatives that were announced and the fact that key tax cuts and spending programs were structured to minimise their short-run impact on the economy (McCran 2007, Uren 2007c). More specifically, the Budget announced personal income tax cuts worth $31 billion over the four years of the forward estimates, yet significantly, only the proposal to increase the threshold at which the 30 per cent tax rate would apply from $25 000 to $30 000 would be introduced on 1 July 2007 (at a cost of $5.3 billion). Tax cuts for upper middle and high income earners were announced but would not be implemented until 1 July 2008 (Uren 2007c).

Similarly, on the expenditure side of the Budget aged pensioners and carers received immediate bonus payments, yet a similar one-off doubling of 2005-06 superannuation co-contribution payments was also announced (at a cost of $1.07 billion) which would be quarantined in individual superannuation accounts and thus have little effect on short-run consumption. (Australian Government 2007, 36). The most significant new spending initiative was the announcement of a $5 billion higher education infrastructure trust which would be run under the auspices of the Future Fund. Once again, this was a skillfully crafted policy because it both signaled the Coalition’s long-term commitment to the higher education sector while effectively preventing the Labor Party from putting these funds to alternative uses. In terms of
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macroeconomic stability, the higher education infrastructure trust posed few short-
term risks to the economy because the capital would be managed by the Future Fund
to be made available to universities on the basis of competitive grants.

In terms of the overall fiscal balance the 2007-08 Budget represented a continuation
of the Coalition's established practice in which tax cuts and new spending are
kept in line with the growth of the overall economy, resulting in a cash surplus of
approximately one per cent of GDP. What was unique about the 2007-08 Budget was
that the structure and timing of both the tax cuts and new spending initiatives it
contained were designed to avoid stimulating short-run household spending. While
some market economists believed the Budget posed a minor inflationary risk, overall
financial markets were reassured with futures markets discounting the prospects
of further interest rate increases after budget night (Uren 2007c). Even the Labor
Opposition conceded that the budget would not add to inflationary pressures, with
Kevin Rudd using his official reply speech to bolster his own credentials as a fiscal
conservative (Uren 2007b). While there were clearly tensions between the Howard
Government, the RBA and Treasury in the lead-up to the Budget, insiders argue that
Treasury Secretary Ken Henry used his position on the RBA Board to act as a "highly
effective conduit between the RBA and political government. Able to tell Costello
what monetary policy requires in the budget and to provide Stevens with comfort of
what it will deliver." (McCrann 2007).

VII. Conclusion

Activist fiscal policy of the Keynesian "golden age" may well have passed, with
monetary policy now established as the primary instrument of macroeconomic
management. Yet this does not mean that we can completely ignore the stabilisation
function of fiscal policy which Musgrave described almost half a century ago. This is
especially so when, as in the case in Australia at present, key sectors of an economy
are running at close to full capacity and inflationary risks are building. Under these
circumstances fiscal policy must not only be sustainable, it must also be sensitive to
its potential to stimulate demand in the short-run. Fortunately, for the Australian
economy it seems that there is an awareness of the need to exercise a degree of fiscal
restraint in the prevailing conditions with both major parties calling for restraint and
responsible spending despite the looming federal election.

What then does this mean for tax reform more generally? While it is theoretically
possible to radically alter the structure of the personal income tax base in a revenue
neutral context, the political reality is somewhat different. Based on past experience
radical tax reform packages can only be successfully marketed if they include generous
compensation to ensure that no politically significant groups are worse off and that the
financial benefits of reforms are fairly distributed. For example, while Treasury were
determined that the 1998 GST package would be revenue neutral, Prime Minister
Howard insisted that middle income earners, welfare recipients and the States be
overcompensated to oil the wheels of reform. As a result the package represented an
$8 billion cost to the federal budget in its first year (Eccleston 2004, 136-38). Given
the political need for generous compensation it is almost inevitable that fundamental reform of Australia’s personal income tax base (such as eliminating the 40 per cent and 45 per cent tax rates or the complex effective marginal rate problems) would be expensive. In the present context the problem for policy makers would be the likely impact of such compensation on household consumption and, potentially, interest rates.

Ultimately the analysis presented in this paper vindicates the Howard Government’s approach to personal tax reform in recent years. While the Government’s incremental approach to reform may have disappointed advocates of radical policy change, taken together the cuts to personal income tax rates since 2003 have been significant. In 2003 income above $60,000 was taxed at 47 per cent, whereas from July 2008 the highest marginal tax rate will be 45 per cent and will only apply to income above $180,000. The real virtue of this reform “drip feed” is not only that it is more manageable politically, but that it ultimately poses less of a threat to macroeconomic stability helping policy-makers maintain the low inflation growth which Australia has experienced in recent years.
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References


Appendix

Charter of Budget Honesty Act 1998

Section 5 The principles of sound fiscal management

(1) The principles of sound fiscal management are that the Government is to:

(a) manage financial risks faced by the Commonwealth prudently, having regard to economic circumstances, including by maintaining Commonwealth general government debt at prudent levels; and

(b) ensure that its fiscal policy contributes:

(i) to achieving adequate national saving; and

(ii) to moderating cyclical fluctuations in economic activity, as appropriate, taking account of the economic risks facing the nation and the impact of those risks on the Government’s fiscal position; and

(c) pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden; and

(d) maintain the integrity of the tax system; and

(e) ensure that its policy decisions have regard to their financial effects on future generations.

(2) The financial risks referred to in para (1)(a) include risks such as:

(a) risks arising from excessive net debt; and

(b) commercial risks arising from ownership of public trading enterprises and public financial enterprises; and

(c) risks arising from erosion of the tax base; and

(d) risks arising from the management of assets and liabilities.