# OVERVIEW

Commonwealth government finances are strong. The Commonwealth Budget recorded an accumulated cash surplus of $23.7 billion from 1997-98 to 2000-01. During this period, Commonwealth government net debt, already one of the lowest among the industrialised economies, has fallen from $82.9 billion to $39.3 billion. This sound fiscal management has provided the platform for vigorous, low inflationary growth — generating jobs and higher incomes for Australians.

Nevertheless, a steadily ageing population is likely to continue to place significant pressure on Commonwealth government finances. In addition, on the basis of recent trends it seems likely that technological advancement, particularly in health care, and the community's expectation of accessing the latest health treatments will continue to place increased demands on taxpayers' funds.

Australia is well placed to meet the challenges an ageing population presents. Australia's superannuation system generates private saving for retirement, complementing an age pension system that is better targeted and more affordable than in many other industrialised countries. In addition, Australia's health system is very efficient by international standards. Furthermore, Australia's social welfare payments are well targeted and government debt is low.

The projections in this report suggest that, if policies are not adjusted, the current generation of taxpayers is likely to impose a higher tax burden on the next generation. The required adjustment in taxes and spending is about 5.0 per cent of GDP by 2041-42, or $87 billion in today's dollars. Governments will need to exercise sound policy management to minimise the tax burden transferred to the next generation, particularly if Australia is to keep its position as a lower taxing and spending country.

Although the ageing of the Australian population is not expected to have a major impact on the Commonwealth's budget for at least another 15 years, forward planning for these developments is important, to ensure that governments will be well placed to meet emerging policy challenges in a timely and effective manner. By maintaining sustainable government finances, the Government avoids compromising the wellbeing of future generations by the activities of the current generation.

Major policy priorities should continue to include both those that increase the economy's capacity to generate revenue, and those that reduce the growth in government spending. Key priorities for ensuring fiscal sustainability should be:

- achieving budget balance, on average, over the economic cycle. Continuing the Government's current medium-term fiscal strategy will ensure Commonwealth government debt remains low as pressures due to an ageing population begin to build significantly around 2020;

- maintaining an efficient and effective medical health system, complemented by widespread participation in private health insurance;

- containing growth in the Pharmaceutical Benefits Scheme (PBS). Rapid PBS growth over the past decade means it could be one of the most significant areas of future spending pressure on the Commonwealth;
- developing an affordable and effective residential aged care system that can accommodate the expected high growth in the number of very old people (people aged 85 or over);
- preserving a well-targeted social safety net that encourages working-age people to find jobs and remain employed;
- encouraging mature age participation in the labour force; and
- maintaining a retirement incomes policy that encourages private saving for retirement, and reduces future demand for the Age Pension.

## FISCAL SUSTAINABILITY

Fiscal sustainability is the government's ability to manage its finances so it can meet its spending commitments, both now and in the future. It ensures future generations of taxpayers do not face an unmanageable bill for government services provided to the current generation.

One of the key requirements for sustainable government financial arrangements is a balanced budget over the medium to long term, given a reasonable degree of stability in the overall tax burden. This objective is consistent with stabilising Commonwealth general government net debt and, if the Commonwealth's capital stock grows, improving net worth.

Maintaining fiscal sustainability improves the prospects for higher living standards, including strong and stable economic growth by:

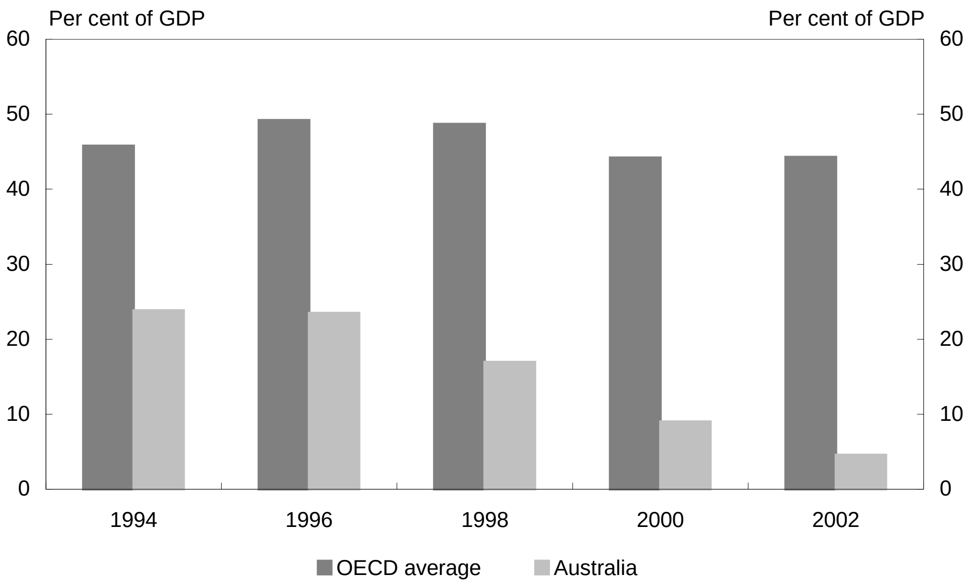
- promoting fairness in distributing public resources between generations of Australians;
- maintaining Commonwealth debt at low levels. This helps maintain low domestic interest rates which, over time, promote private sector investment;
- providing greater stability and certainty of fiscal outcomes, contributing to an environment more conducive to long-term productive investment;
- reducing the risk of Australian living standards fluctuating significantly due to international economic shocks, and providing greater capacity for the government to deal with future uncertainties; and
- ensuring governments continue to provide essential goods and services that the private sector does not provide sufficiently.

Disciplined fiscal policy is critical to achieve a higher growth of GDP per person. It helps maintain low inflation, increases national savings and encourages governments to invest efficiently in people and infrastructure.

Since gaining office in 1996, the Government's fiscal policy has been consistent with its medium-term strategy. From 1997-98 to 2000-01, it achieved an accumulated cash surplus of $23.7 billion. Furthermore, the level of Commonwealth general government net debt has fallen steadily from the 1995-96 peak of 19 per cent of GDP to an expected 4.6 per cent in 2002-03.

Australia's general government net debt position is strong compared with OECD countries (Chart 1).

**Chart 1: International comparison of total general government net debt(a)**




(a) Data are for the total general government sector (that is, the aggregate of all levels of government including the social security sector).
Source: OECD Economic Outlook (70) Dec 2001, ABS Cat. No. 5501.0 (various), 5512.0 (various) and 5513.0 (various), and Commonwealth Government Final Budget Outcomes. For 2002, data is derived from jurisdictions' 2001-02 mid-year reports and Treasury estimates.

## FUTURE PROSPECTS

Over time, various factors may affect significantly the government's fiscal position. In particular, the ageing of the population may create a greater demand for Age Pensions and health and aged care spending. Already the need to keep up with changing technology and community expectations of accessing the most advanced diagnostic tests and treatments are increasing demands on government finances; these are likely to continue.

Consequently, this report focuses on Commonwealth programmes in health, social safety net payments and education, as these are most sensitive to population factors, economic trends and technological advancements.

## Uncertainties

As projections are uncertain, the results indicate a possible future, but within a wide band of uncertainty. The possible future position of government finances is based on extrapolating current policies and projecting demographic and economic trends and assumptions including:

- future population growth rates;
- the ageing of the population;
- future productivity growth rates;
- future economic growth; and
- expected growth in the underlying cost of a range of government programmes (for example, rising health costs accompanying the introduction of new, more expensive treatments).

Even so, an analysis of the sensitivity of the projections to plausible changes in these trends and assumptions shows that the broad policy conclusions still hold.

## Demographic prospects

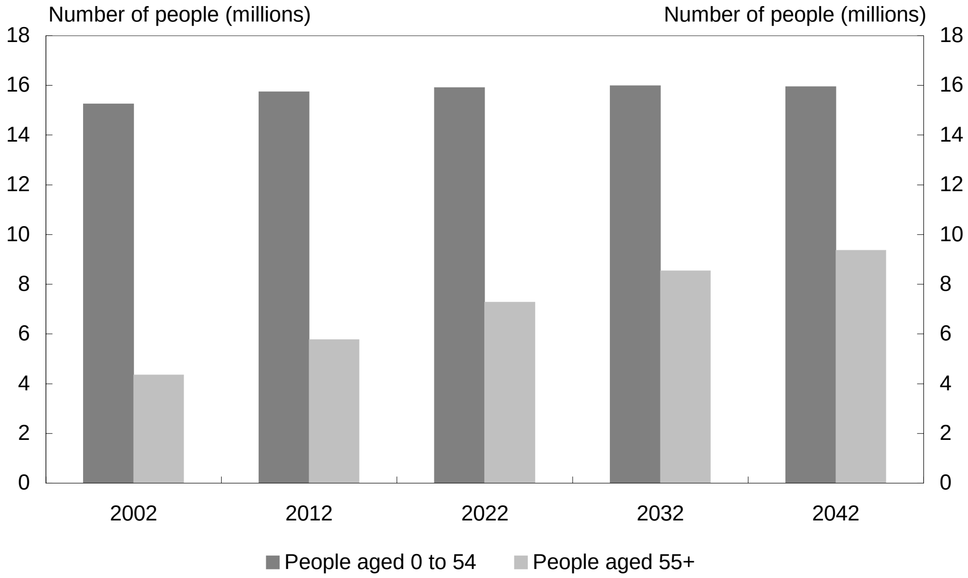
Australia, like other OECD countries, is experiencing an ageing of its population, driven by declining fertility and mortality rates. Since the mid-1970s the total fertility rate of Australian women has been well below the rate needed for population replacement. Over the same period, life expectancy has increased, partly due to high standards of public health.

The number of births per Australian woman is projected to fall from 1.75 in 2000 to 1.6 by 2042. Mortality rates also are projected to fall over the next four decades, leading to significant gains in life expectancy. In 2042, life expectancy at birth for men is projected to be 82.5 years, which is 5.3 years longer than their life expectancy at birth in 2002. In 2042, life expectancy at birth for women is projected to be 87.5 years, which is 4.9 years longer than their life expectancy at birth in 2002.

Net overseas migration slightly offsets the rate of population ageing, as on average, migrants are younger than the resident population. This report assumes net overseas migration will continue to be around 90,000 people per year, with the same age and gender mix as currently.

By 2042, Australia's population is projected to increase by around 30 per cent, to over 25 million people. The number of people aged 55 and over will grow faster than the number aged under 55 (Chart 2).

**Chart 2: Projected population size for selected age ranges**




Source: Treasury projections.

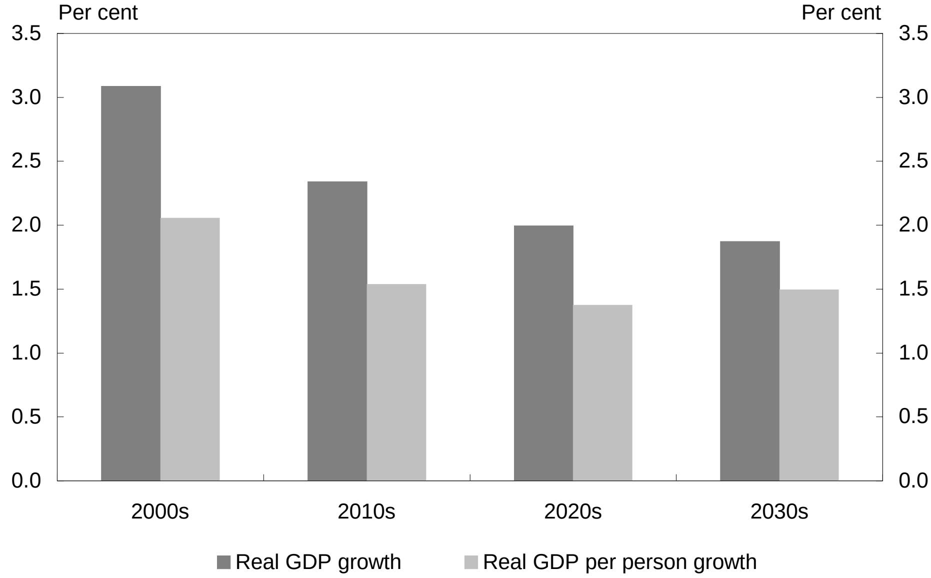
## Economic prospects

Over the next four decades, economic growth is projected to slow relative to the outcomes achieved over the past decade, reflecting lower productivity and employment growth rates. Productivity growth is assumed to return to around its 30-year average, below the growth of the 1990s. Employment growth is expected to slow, reflecting lower labour force growth due to lower population growth and a falling rate of overall labour force participation.

Productivity growth is the key driver of real GDP growth, but is extremely difficult to forecast over the long term. If future labour productivity growth rates differ from the 30-year average, economic growth could vary significantly from that projected.

Real GDP growth per person, a measure of growth in living standards, also is expected to slow over the coming decades, but not as much as the growth rate of real GDP (Chart 3).

**Chart 3: Projected average annual growth in real GDP and real GDP per person**

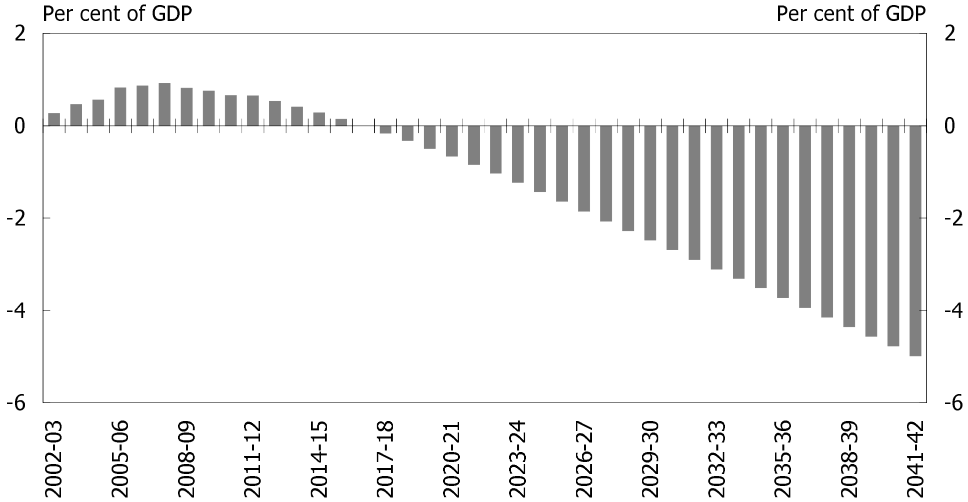



Source: Treasury.

## IMPLICATIONS FOR GOVERNMENT FINANCES

Under current policy settings, over the next decade, Commonwealth revenue is projected to exceed spending. However, after about 15 years, Commonwealth spending is projected to exceed revenue (Chart 4). By 2041-42, the gap between spending and revenue is projected to grow to 5.0 per cent of GDP. To prevent the budget moving into deficit, future generations of taxpayers would face higher taxes, raising around $87 billion more by 2042, or governments would need to reduce the projected growth in spending.

**Chart 4: Projection of fiscal pressure**




Source: Treasury projections.

## Revenue

Over the coming decades, Commonwealth total revenue is assumed to remain constant as a proportion of GDP. However, the projection reflects the expectation that slower population growth will affect labour force growth, personal income tax and GDP in similar ways.

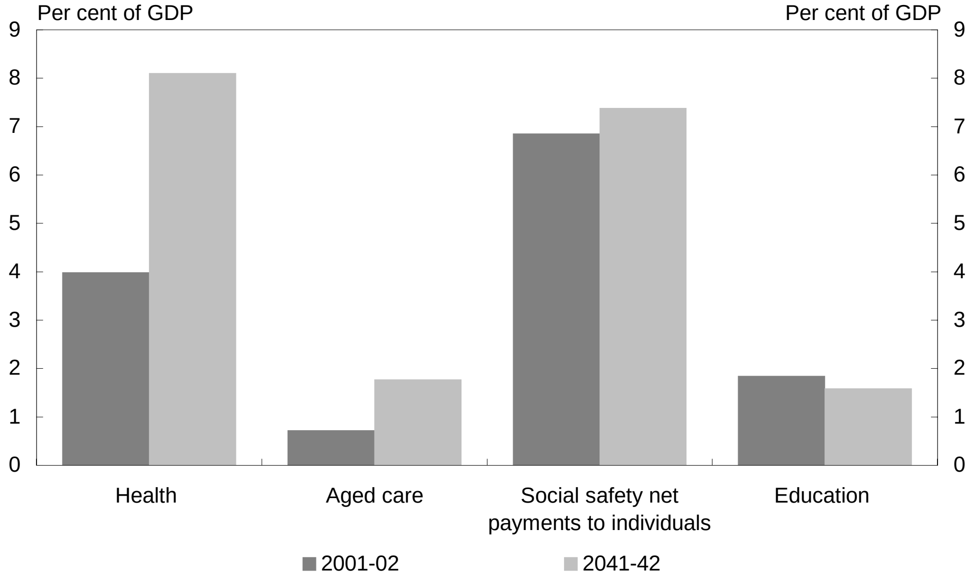
While total revenue has fluctuated around 24 per cent of GDP over the last three decades, it fell substantially as a result of the tax cuts and Goods and Services Tax (GST) introduced under *The New Tax System*. As all GST revenue is passed directly to the States, it is not classified as Commonwealth revenue. Commonwealth revenues are projected to remain at 22.4 per cent of GDP from 2005–06 to 2041-42.

## Spending

Over half of Commonwealth government spending is directed to health and aged care, the social safety net (payments to individuals) and education. All of this spending is sensitive to demographic changes.

Spending on health and aged care accounts for much of the projected rise in Commonwealth government spending over the next four decades. As a proportion of GDP, payments to individuals should increase and education spending should decrease modestly (Chart 5).

**Chart 5: Projected Commonwealth spending by category**




Source: Treasury projections.

Commonwealth spending on government superannuation is projected to decline fairly steadily, from 0.6 per cent of GDP in 2001-02 to 0.3 per cent of GDP in 2041-42. Other areas of government spending are assumed to remain constant (in total) as a share of GDP, even though some will grow more slowly than the general economy, while others will grow at a faster rate. These areas are not demographically driven and include defence, assistance to State and Local governments and the environment. However, the future funding requirements of these policy areas are uncertain and may involve additional pressure on future budgets.

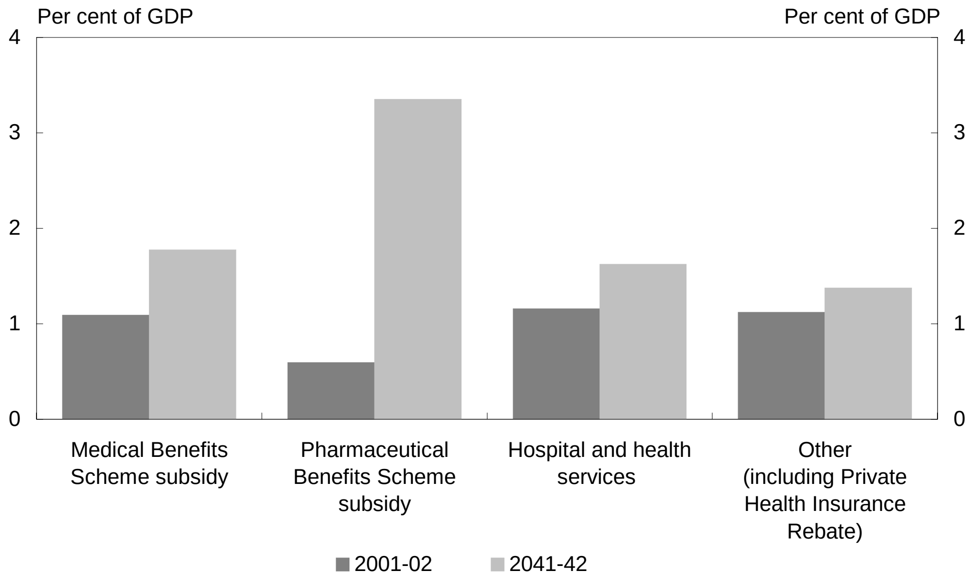
### *Health and aged care*

The Commonwealth is the primary funder of health and aged care services in Australia. It funds Medicare, which incorporates the Medical Benefits Scheme; the Pharmaceutical Benefits Scheme (PBS), which subsidises selected pharmaceuticals; and the Private Health Insurance Rebate. It also contributes to State funding of public hospital services and provides funding to non-government organisations for services such as residential aged care, community care and indigenous health care.

Over the past three decades, Commonwealth health spending has more than doubled, to 4.0 per cent of GDP in 2001-02. In recent years, spending on the PBS has been the fastest growing component. In the decade to 2000-01 PBS spending as a percentage of GDP more than doubled.

Although population growth and ageing affect health spending, these factors account for only around one-third of the recent growth. Much of the growth has come from the demand for new technology and treatments. Australians now expect to access more expensive diagnostic procedures and new (and more expensive) medications listed on the PBS. Unless addressed, these trends are likely to continue to drive health spending over the next four decades, pushing up Commonwealth health spending to 8.1 per cent of GDP in 2041-42. All areas of health spending are projected to increase, with PBS spending projected to rise from around 0.6 per cent of GDP in 2001-02 to 3.4 per cent by 2041-42 (Chart 6), more than a five fold increase in its share of the economy. The reforms to the PBS implemented in the 2002-03 Budget have helped reduce the overall cost of the scheme. Ongoing sound management of the PBS will be required to keep long-term growth in the scheme sustainable, to allow governments to continue providing access to affordable medicines for all Australians.

**Chart 6: Projected growth in components of Commonwealth health spending**



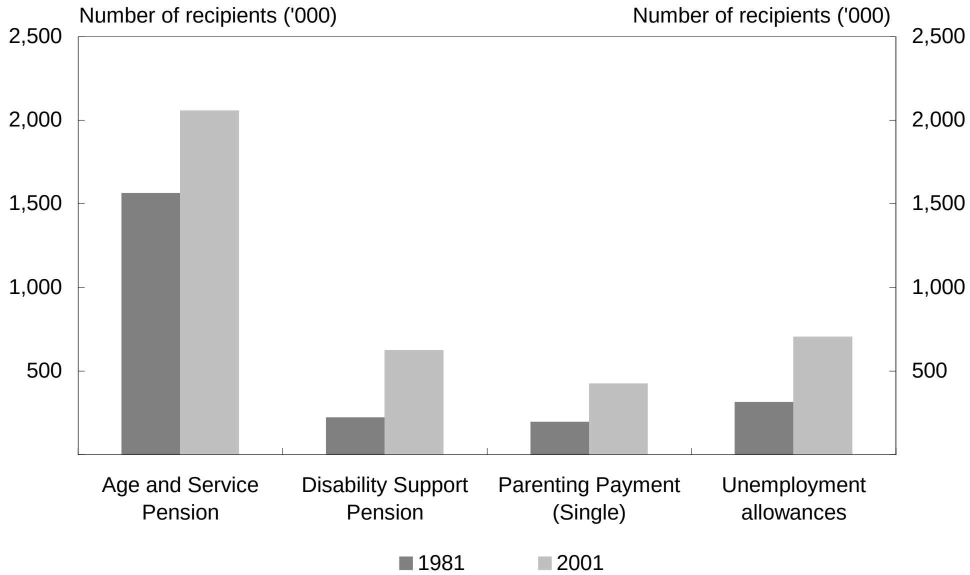

Source: Treasury projections.

As the number of very old people increases, spending on aged care is also projected to increase from 0.7 per cent of GDP in 2001-02 to 1.8 per cent of GDP in 2041-42. Aged care is the most demographically sensitive area of government spending and the number of very old people is expected to increase significantly.

### *Payments to individuals*

Payments to individuals include Age and Service Pensions, unemployment allowances, Disability Support Pension, Parenting Payment (Single) and family payments. These payments account for about a third of Commonwealth spending. The number of people receiving social safety net payments is rising significantly and is a key driver of rising spending on these payments (Chart 7).

**Chart 7: Numbers of recipients of major Commonwealth payments to individuals 1981 and 2001**



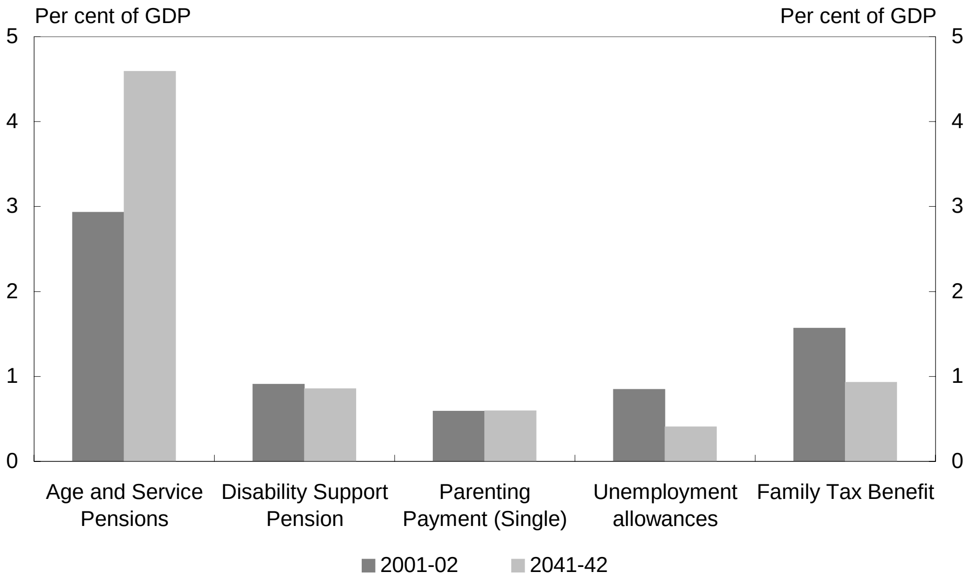

Sources: Department of Social Security annual report 1980-81 and Department of Family and Community Services *Income Support Customers — a Statistical Overview*. Results for 2000 and 2001 are unpublished. Service and War Widows data are from the Department of Veterans Affairs.

Age and Service Pension payments are projected to rise from 2.9 per cent of GDP in 2001-02 to 4.6 per cent of GDP in 2041-42 (Chart 8). By 2041-42, the proportion of the population aged over 65 will be double current levels, significantly increasing the proportion of the population eligible for the Age or Service Pension. However, an increased proportion of retired people drawing incomes from their superannuation savings should help offset this. By reducing the proportion of retired people receiving a full Age Pension, compulsory superannuation should lessen significantly the fiscal pressures on the Commonwealth over the next four decades.

Payments to people of working age — unemployment allowances, Disability Support Pension, Parenting Payment (Single) — as a proportion of GDP is projected to decline, from 2.4 per cent in 2001-02 to 1.9 per cent in 2041-42. This mainly reflects the projected fall in unemployment allowances as the unemployment rate is projected to fall. It also reflects the indexation of unemployment allowances to the Consumer Price Index (CPI) which grows slower than wages and GDP per person.

Payments to families with children are projected to fall significantly as a proportion of GDP, from 1.6 per cent in 2001-02 to 0.9 per cent in 2041-42, as the proportion of the population aged 15 and under declines, and significant elements of family assistance payments are indexed to the CPI.

**Chart 8: Projected Commonwealth payments to individuals by type**




Source: Treasury projections.

### *Education and training*

Commonwealth government spending on education and training accounts for 7 per cent of all Commonwealth spending, with around half of this allocated to government and non-government schools, and around a third to higher education institutions.

In recent years, demands for a more skilled labour force and the desire for education have increased, driving up the rate of participation in the university sector, and in vocational education and training. At the same time, the proportion of the population in the principal age group for education (5 to 24 years) has fallen from 36 per cent in 1972 to 28 per cent in 2002.

Reflecting these trends, Commonwealth spending on education and training, while continuing to grow at a solid rate, is likely to decline as a share of GDP over the next four decades, from 1.8 per cent of GDP in 2001-02 to 1.6 per cent of GDP by 2041-42.