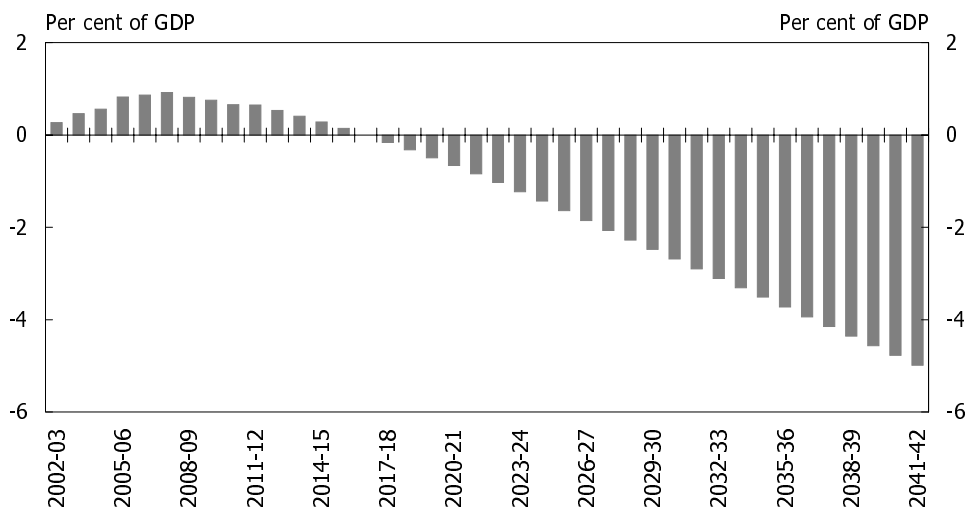


## PART IV: OVERALL RESULTS

### Aggregate impact

The projections of Commonwealth spending and revenue show that current trends in spending are likely to lead to significant fiscal demands with spending starting to exceed revenue in around 15 years. By 2041-42, the gap between spending and revenue is projected to grow to around 5.0 per cent of GDP (Chart 30).

**Chart 30: Projections of the fiscal pressure**



Source: Treasury projections.

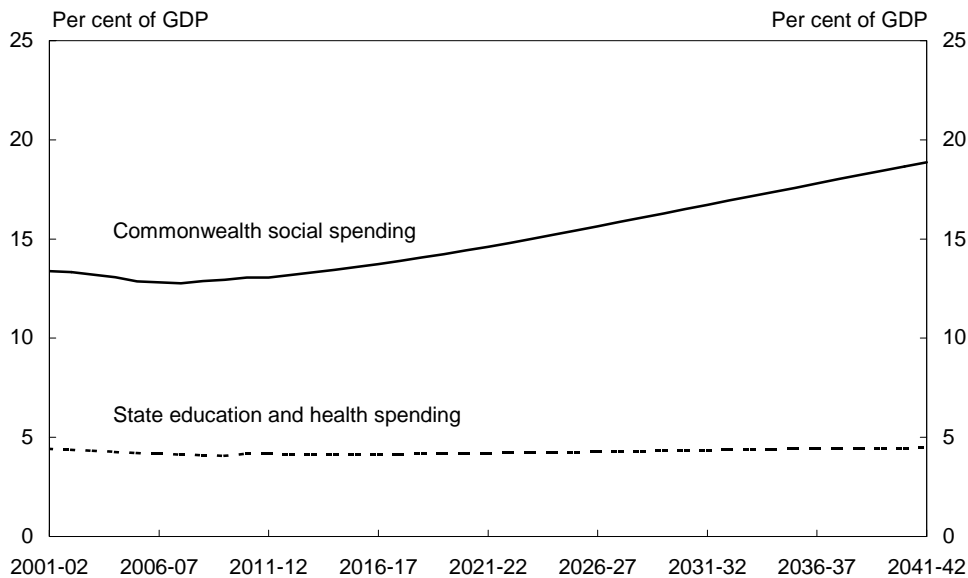
By 2041-42 Commonwealth spending is projected to be 27.4 per cent of GDP. These spending projections incorporate the health, social safety net payments to individuals, education and government superannuation spending projections from Part III (Table 13). The diverse nature of other areas of Commonwealth government spending makes it difficult to project this spending based on trends. Spending as a proportion of GDP may increase in some areas, while spending in other areas may decrease. Consequently all other spending is assumed to remain the same proportion of GDP to 2041-42 as is currently forecast for 2005-06. This is 8.3 per cent of GDP.

Revenue projections assume that total revenue will remain constant at 22.4 per cent of GDP from 2005-06.

Previous studies of population ageing<sup>1</sup> have concluded that the Commonwealth is likely to face greater pressure for increased social spending than State and Territory governments. This is because Commonwealth social spending is more concentrated on the aged than State expenditure and because Commonwealth health programmes have shown higher non-demographic growth. For example, the Commonwealth has responsibility for age pensions and nursing homes, while 25 per cent of State and Territory spending is on education.

Chart 31 provides an indicative comparison of projections of Commonwealth social spending and State and Territory health and education expenses.

**Chart 31: Projections of Commonwealth social spending and State and Territory health and education spending**



Source: Treasury projections.

For the Commonwealth, increased health and age pension spending should be partly offset by CPI-indexed unemployment payments and family payments and, to a lesser extent, by education spending (Table 13).

<sup>1</sup> For example, Social Welfare Policy Secretariat 1984 and Department of Community Services and Health 1990.

**Table 13: Projections of Commonwealth demographic spending (per cent of GDP)**

	2001-02	2006-07	2011-12	2021-22	2031-32	2041-42
Health and aged care	4.7	4.8	5.1	6.2	7.9	9.9
Age and Service Pension	2.9	2.8	2.9	3.6	4.3	4.6
Disability Support Pension	0.9	0.7	0.8	0.8	0.9	0.9
Parenting Payment (Single)	0.6	0.6	0.6	0.6	0.6	0.6
Unemployment allowances	0.8	0.8	0.7	0.6	0.5	0.4
Family Tax Benefit (Parts A and B)	1.6	1.3	1.2	1.1	1.0	0.9
Total payments to individuals	6.8	6.3	6.2	6.8	7.2	7.4
Education	1.8	1.8	1.7	1.6	1.6	1.6
Unfunded government superannuation	0.6	0.5	0.5	0.5	0.4	0.3
<b>Total</b>	<b>13.9</b>	<b>13.3</b>	<b>13.6</b>	<b>15.1</b>	<b>17.1</b>	<b>19.2</b>

Source: Treasury projections.

Commonwealth health and aged care spending is projected to grow significantly, due to the increasing cost of new procedures and medicines, with the ageing of the population also increasing demand for health spending. Technological change and income effects generally drive the increases in real health spending per person.

The expected slight decline in Commonwealth education spending as a proportion of GDP is because younger people will comprise a smaller proportion of the overall population. The projections assume that education participation rates and real costs per student will increase.

Commonwealth spending on Age and Service Pensions also is projected to increase significantly over the next four decades. However, the projected increase in spending is smaller than for most other industrialised countries because the Australian pension has a maximum rate that is not related to an individual's earnings, and is means tested. The projected increase in Age Pension spending as a proportion of GDP is partly offset by the projected decrease in payments which grow more slowly because they are indexed by the CPI rather than wages. These include unemployment allowances and significant components of family payments.

## Alternative scenarios

Significant uncertainty surrounds the assumptions underlying the report's projections and their impact on government finances. Accordingly, the results represent a plausible central case and should not be viewed as specific forecasts. Even so, exploring the impact of varying some key assumptions suggests the projected size of the budget pressures is reasonably robust to changes in the underlying assumptions.

The demographic assumptions probably are least uncertain, as they are based on relatively stable long-term trends. Greater uncertainty surrounds the assumptions about productivity and spending.

Plausible variations in the assumptions were developed to illustrate the impact on GDP and where effects were significant, on Commonwealth spending (Table 14). A detailed discussion is provided in Appendix B. The impact on revenue has not been examined, as generally revenue growth corresponds to GDP growth, and this can be expected to continue.

**Table 14: Assumptions underlying sensitivity analysis**

	Base case	Lower	Higher
Mortality			
Male life expectancy (years) in 2042	82.5	-	83.9
Female life expectancy (years) in 2042	87.5	-	88.5
Fertility (total fertility rate)(a)	1.6	1.5	-
Net migration (number of people per year)	90,000	80,000	135,000
Full-time labour force participation			
of older male workers	64.9% in 2011-12	-	68.1% by 2011-12
Labour productivity growth	1.75%	1.2%	2.0%
Unemployment rate	5%	4%	6%
Non-demographic health costs growth(b)	-	2.5%	3.0%

(a) Represents the number of children a woman would bear during her lifetime if she experienced the current age-specific fertility rates at each age of her reproductive life.

(b) The annual real rate of growth per person age-adjusted. The health base case uses the component rather than the aggregate model.

Scenarios that involve a higher proportion of people in older age groups, a lower proportion of people employed relative to the population, lower productivity growth, higher unemployment and higher growth in the cost of programmes increase future pressures on government spending (Table 15).

**Table 15: Impact of alternative scenarios in 2041-42 (percentage points)**

<b>Factors that increase budget pressure</b>					
	Lower mortality	Lower labour productivity	Higher unemployment rate	Higher health cost growth	
Annual labour force growth	neg	0	0	0	0
Annual real GDP growth	neg	-0.55	neg	0	0
Annual real GDP per person growth	-0.04	-0.55	neg	0	0
Aged to working-age ratio	1.5	0	0	0	0
Child to working-age ratio	neg	0	0	0	0
Spending impact (percentage points of GDP)					
Health	0.17	**	**		1.52
Aged care	0.12	**	**		0
Age and Service Pension	0.18	0.02	**		0
Other payments to individuals	0.01	0.20	0.07		0
Education	neg	0.03	**		0
<b>Total</b>	<b>0.48</b>	<b>0.25</b>	<b>**</b>		<b>1.52</b>
<b>Factors that decrease budget pressure</b>					
	Higher labour force participation (older workers)	Higher migration	Higher labour productivity	Lower unemployment rate	Lower health cost growth
Annual labour force growth	0	0.22	0	0	0
Annual real GDP growth	0.01	0.20	0.25	neg	0
Annual real GDP per person growth	0.01	neg	0.25	neg	0
Aged to working-age ratio	0	-2.4	0	0	0
Child to working-age ratio	0	0.1	0	0	0
Spending impact (percentage points of GDP)					
Health	-0.10	-0.25	**	**	-0.46
Aged care	-0.02	-0.13	**	**	0
Age and Service Pensions	-0.08	-0.28	-0.01	**	0
Other payments to individuals	-0.03	neg	-0.03	-0.07	0
Education	-0.02	-0.01	-0.01	**	0
<b>Total</b>	<b>-0.25</b>	<b>-0.67</b>	<b>-0.05</b>	<b>**</b>	<b>-0.46</b>
<b>Factors that have an uncertain impact</b>					
	Lower migration	Lower fertility			
Annual labour force growth	-0.07	-0.10			
Annual real GDP growth	-0.06	-0.10			
Annual real GDP per person growth	-0.01	-0.03			
Aged to working-age ratio	0.7	0.6			
Child to working-age ratio	-0.1	-1.3			

Note: In the productivity scenarios health and aged care spending is assumed to increase to the same extent as the productivity-based wage increase. The potential impact of productivity growth on the cost of health care is difficult to quantify and has not been included here.

Source: Treasury projections.

## **Factors that increase budget pressure**

### ***Lower mortality rate***

In the lower mortality scenario more people live to older ages. However, it takes around 30 years to affect significantly the numbers of people in the older age groups.

Projected government spending increases gradually, by almost 0.5 per cent of GDP by 2041-42, due to higher spending on health and aged care, Age Pensions and other payments to individuals.

Spending on health and aged care is projected to increase, due to an increase in the number of people over 65 and an even greater increase in the number over 85. However, as population changes take time to develop, the impact develops slowly. The increase in health spending is due mainly to the growth in PBS subsidies as these are more sensitive to an increase in the older population than other health spending. This is because older people tend to use far more medicines than other age groups. The increase in aged care spending reflects the large increase in the numbers of the very old (aged over 85), the age range where nursing home usage and cost per head of population is highest.

Spending on Age and Service Pensions increases, as more people are receiving these pensions, but projections of the other social safety net payments to individuals do not change significantly.

### ***Lower productivity growth rate***

The low productivity growth scenario assumes an average productivity growth rate of 1.2 per cent per year, replicating the average growth rates of the 1980s, which were well below the long-term average.

Lower productivity growth would increase spending as a proportion of GDP, primarily because growth in GDP would slow. This is largely because payments to individuals which are indexed to the CPI would be a greater proportion of GDP. This occurs because with lower GDP growth the gap between CPI and nominal GDP growth is reduced. Payments to individuals which are linked to productivity through wage indexation (such as Age and Disability Support Pensions), and spending in areas strongly linked to productivity and wage growth (such as health, aged care and education) would increase in line with GDP. Consequently, spending in these areas as a percentage of GDP would change little as a result of changes in productivity levels.

### ***Higher unemployment rate***

The central scenario assumes the unemployment rate reaches 5 per cent by 2007-08. The alternative scenario considers the impact of higher unemployment, reaching 6 per cent by 2006-07 and remaining constant. In the short term, higher unemployment would lower GDP growth. Government spending would increase because more people would depend on government payments for income, particularly unemployment allowances; this would increase fiscal pressure.

### ***Higher health cost growth***

The projected level of health costs is very sensitive to the choice of growth rate in non-demographic health costs. The higher growth (3.0 per cent) case is in line with growth experienced over the last 12 years, if the impact of the Private Health Insurance Rebate is excluded. This increases health costs, in comparison to the central scenario, by 1.5 per cent of GDP by 2041-42. (For more detail see Part III Health and aged care.)

The crucial implication of this analysis is that non-demographic growth arising from new technology and increased use and costs of services impacts the projections much more than plausible changes in the demographic and economic assumptions, such as decreased mortality and increased labour force participation of older workers.

### **Factors that decrease budget pressure**

#### ***Higher labour force participation rate***

An increase in the labour force participation of older workers (or any group of workers) would decrease future fiscal pressures because it reduces the need for income support and increases GDP. Higher labour force participation also allows people to accumulate greater superannuation enhancing their health and lifestyle in retirement.

Overall, higher full-time labour force participation of older men, under this scenario, would reduce projected government spending by 0.25 per cent of GDP by 2041-42, principally by increasing GDP. This reduced spending is mainly in health and Age Pensions.

However, this only captures first order effects, and does not capture any potential second order effects, such as changes in health or health service use of the additional older workers who remained in the workforce for longer.

#### ***Higher productivity growth rate***

The high productivity growth scenario assumes that the average growth rates in the 1990s will continue, with annual growth of 2.0 per cent. Higher productivity growth would tend to reduce future budget pressures, by increasing GDP and by lowering CPI-indexed programmes as a proportion of GDP. It also increases private incomes to a greater extent, which may increase demand for services, in areas such as health and aged care.

#### ***Lower unemployment rate***

This scenario assumes that unemployment reaches 4 per cent by 2009-10 and remains constant after that. This would lead to higher GDP growth in the shorter term. Government spending, particularly on unemployment allowances, would be lower, decreasing fiscal pressure.

### **Lower health cost growth**

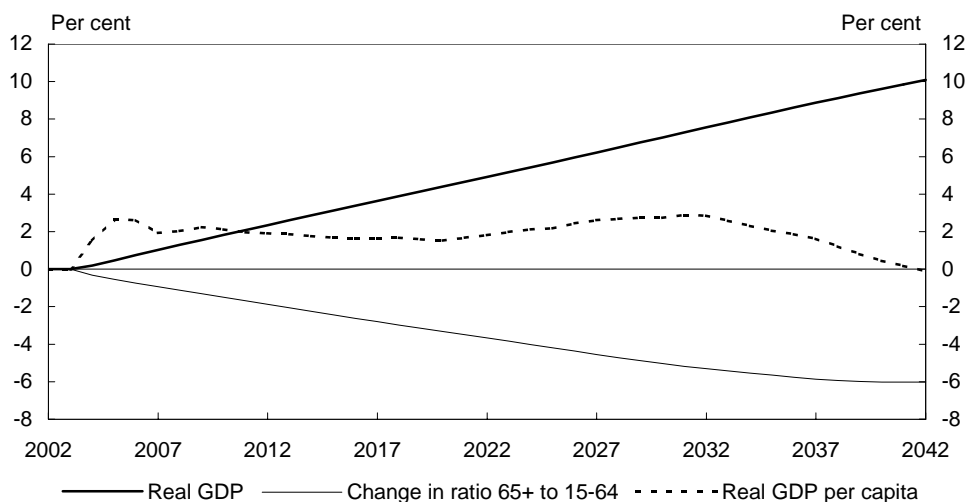
As indicated, the projected level of health costs is very sensitive to growth in non-demographic health costs. The impact of changing the assumed growth rate is tested by decreasing the average annual non-demographic growth rate for all health spending to 2.5 per cent. This can be interpreted as a drop of 0.1 percentage points from the central scenario which broadly corresponds to a non-demographic growth rate of 2.6 per cent. The lower growth rate decreases projected health costs by 0.5 per cent of GDP by 2041-42.

### **Higher migration rate**

The higher migration scenario assumes a net migration rate of 135,000 people per year. The effects of increased net migration depend on which components of the migration intake change (skilled, family reunion or humanitarian) and the age-gender profile of migrants. Skilled migrants, for example, would generally find employment more quickly and be less reliant on government services than other migrants. For this scenario migrants are assumed to experience the same fertility, mortality, employment and productivity rates as Australian residents of the same age. Higher migration would tend to increase growth in the labour force and thus in GDP. The composition of the migrant intake also influences spending.

As immigrants are younger on average than the resident population, the increased migration scenario results in a decline in the aged to working-age ratio over the next four decades and a 10 per cent increase in GDP by 2041-42 (Chart 32). This increase in GDP results in government spending on health, aged care and Age Pensions falling as a percentage of GDP. The effect is reduced over the longer term as the immigrants themselves begin to age.

**Chart 32: Impact of increasing migration by 50 per cent**



Source: Treasury projections.



## **Factors that have an uncertain impact**

### ***Lower fertility rate***

In the central scenario the fertility rate falls to 1.6 per cent by 2042. The lower fertility scenario assumes the fertility rate will fall to 1.5 per cent by 2042.

Lower fertility leads to slower growth in the labour force in around 20 years. This leads to lower GDP growth and a lower ratio of those of labour force age to those not of labour force age. This may increase the pressures on government spending relative to GDP growth, although spending in some areas would decrease. Family payments would be around 0.03 per cent of GDP lower by 2041-42. Changes in education spending would be small, as any change in fertility is projected to develop slowly. The effects on spending on unemployment payments, Disability Support Pensions and health are less certain. A reduction in the population of labour force age may decrease the unemployment rate. Health spending may decrease due to a reduced need for maternity and neonatal services.

### ***Lower migration rate***

The lower migration scenario assumes a net migration rate of 80,000 people per year. The effects of lower net migration would depend on which components of the migration intake changed. Lower migration would tend to lead to lower growth in the labour force and GDP. The size and composition of the migrant intake would also influence spending.

## Assessment of sustainability

The spending and revenue projections in this report suggest that governments will need to make policy adjustments to maintain a sustainable fiscal position over the next four decades. The outlook over the next decade is positive, with the budget projected to remain in surplus. However, the projections for the central scenario suggest the government would need to make a fiscal adjustment of around 5.0 per cent of GDP by 2041-42 to maintain budget balance. This fiscal adjustment could take the form of reducing spending growth through policy change, imposing higher taxes on future generations of taxpayers, or combining these approaches.

### **Uncertainties surrounding the necessary fiscal adjustment**

Considerable uncertainty surrounds the projections of the size of the likely fiscal adjustment. In particular, the economic and demographic assumptions which underpin the projections of demographically-driven spending are uncertain. For example, labour shortages arising from an ageing population may increase the labour force participation of older workers. This would delay retirement and increase this group's incomes, reducing the budgetary impact of population ageing.

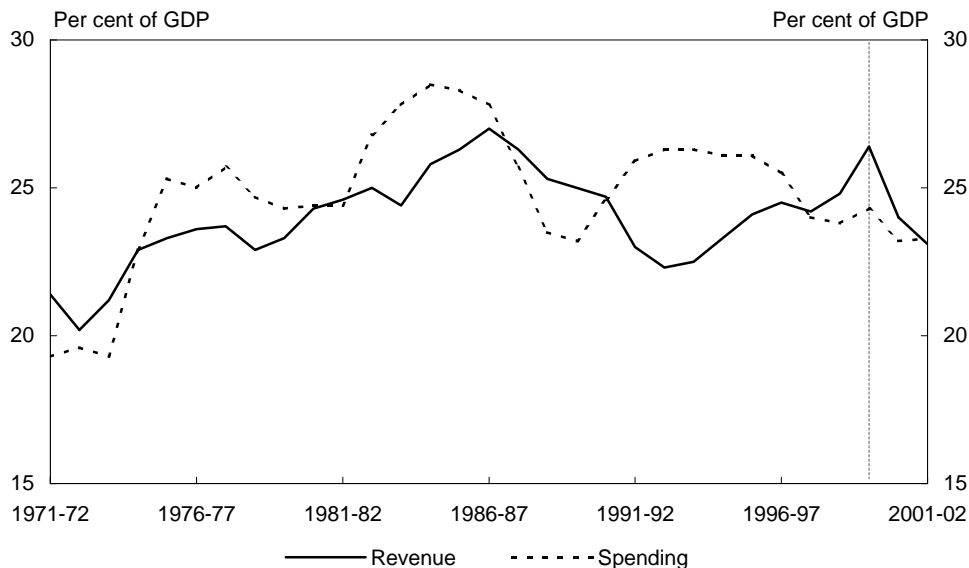
In addition, the projections assume that non-demographic spending and total revenue will remain a constant share of GDP over time. However, pressure to increase non-demographic spending in various areas (for example, the environment and defence) may increase spending on these programmes as a share of GDP.

The report's central scenario suggests spending pressures will rise in around 15 years. However, early policy action would help prevent the need for more severe policy changes in the future. Therefore governments must continue to consider the long-term fiscal implications of policy decisions.

### **Assessment of the adjustment task in a historical context**

An adjustment of around 5.0 per cent of GDP by 2041-42 represents a significant challenge. While governments have achieved fiscal adjustments of a similar size on occasion, most changes in spending appear to be largely cyclical and are not maintained over time (Chart 33). In the past, total spending has diverged 5.5 per cent of GDP from the 30-year average of 24.6 per cent of GDP. Total revenue has diverged 3.9 per cent of GDP above the 30-year average of 23.9 per cent of GDP.

**Chart 33: Historical total Commonwealth general government spending and revenue**



Note: There is a break in the series between 1998-99 and 1999-00. Data for the years up to and including 1998-99 are consistent with the cash ABS GFS reporting requirements. From 1999-00 onwards, data are derived from the accrual ABS GFS reporting framework. Due to methodological and data-source changes associated with the change, time series data which encompasses measures derived under both cash and accrual accounting should be used with caution.

### **A continued focus on sound budget management and planning**

Recognising future pressures on government finances highlights the importance of maintaining the current rigorous fiscal and budgetary framework. This framework has been central to achieving Australia's current strong financial position. In the future, a strong fiscal and budgetary framework will assist in containing the size of a fiscal adjustment.

Nevertheless, recent OECD work shows that compared with other OECD countries, Australia faces relatively moderate long-term fiscal pressure.<sup>2</sup> Many OECD countries face higher potential age pension burdens than Australia because their public pension schemes are related to an individual's earnings or are universal, and because the schemes are not sufficiently pre-funded.

However, there is no room for complacency. To maintain the flexibility to deal with long-term spending pressures, governments must retain the current disciplined approach to fiscal policy and the medium-term fiscal strategy. Intergenerational considerations partly prompted the Government to adopt the medium-term strategy in

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<sup>2</sup> Dang, Antolin and Oxley 2001.

1996, and its efforts to return the budget to surplus and reduce debt have helped to lay a sound foundation for long-term fiscal sustainability. It will be important to maintain this approach in the future, including while demographic and other longer-term spending influences remain relatively favourable over the next decade.

The Government can improve the economy's capacity to manage future increases in social spending or other longer-term expenditures by continuing to pursue policies that boost long-term economic growth. This includes promoting productivity growth, labour force participation and by facilitating job creation to reduce unemployment. Already, the Government has adopted policies to achieve this (for example, labour market reforms, the macroeconomic policy framework and welfare reform). However, it must continue to focus on this as a key priority. Tax reform is also important in terms of providing a robust tax base that will grow in line with the economy.