Chapter 3: Long-term budget projections

Overview

Population ageing will create pressure for increased spending, particularly in the demographically sensitive areas of age related programs and health. Health costs will also escalate as a result of technological enhancements and rising demand for better quality health services. Population ageing, by reducing the proportion of working age people in the population and hence potential economic growth rates, will also reduce Australia's capacity to fund these spending pressures.

Unless action is taken to increase the growth potential of the economy and ensure spending is sustainable, spending will exceed revenue and result in a fiscal gap of 2¾ per cent of GDP by 2049–50.

If steps were not taken to close the fiscal gap over time, it is projected that net debt will emerge in the 2040s and grow to around 20 per cent of GDP by 2049–50. Acting now to address fiscal pressures posed by ageing will minimise the fiscal adjustments required in the future.

The Government's fiscal strategy will make an important contribution to addressing these fiscal pressures. Full implementation of the fiscal strategy, by constraining spending growth to real growth of 2 per cent in years when the economy is growing above trend until the budget is in surplus, would deliver a permanent structural improvement in spending of around 1 percentage point of GDP from 2015–16.

3.1 Promoting fiscal sustainability: contribution of the medium-term fiscal strategy

Small adjustments now to minimise the spending pressures of an ageing population will reduce the size of the fiscal adjustments required in the longer term. The medium-term fiscal strategy when fully implemented will make a significant contribution to addressing these long-term ageing pressures. The key elements of the Government's medium-term fiscal framework are:

- achieving budget surpluses, on average, over the economic cycle;
- keeping taxation as a share of GDP on average below the 2007–08 level; and
- improving the Government's net financial worth over the medium term.

Consistent with this framework, the Government has committed to:

- supporting the economy while the economy is below trend;
- as the economy recovers and grows above-trend, taking action to:
  - allow tax receipts to recover naturally as the economy improves; and
  - limit real annual growth in Government spending to 2 per cent until the budget returns to surplus.

Implementation of the fiscal strategy is projected to reduce spending permanently by about 1 percentage point of GDP from 2015–16 onwards.

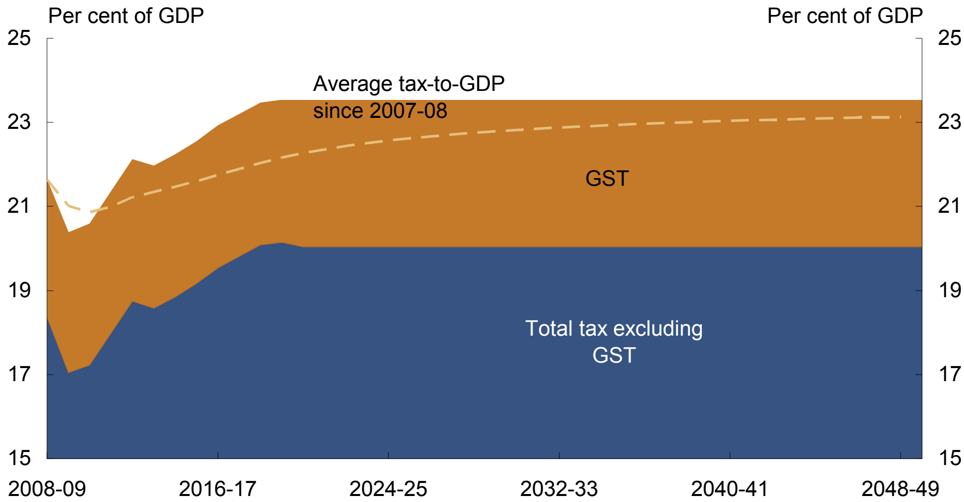
3.2 Revenue

IGR 2010 assumes, in the long run, a constant tax-to-GDP ratio of 23.5 per cent. This rate is based on the historical average since the introduction of the GST. This methodology is similar to that used in previous IGRs. Appendix C sets out the methodology and the rationale for a constant tax-to-GDP assumption.

The global financial crisis has resulted in a significant fall in current revenues as a proportion of GDP. With recovery of the economy, revenues are expected to recover. From 2010–11, tax revenues are projected to increase in line with the economic recovery out to 2019–20, when they reach the long run tax-to-GDP ratio assumption. This is consistent with the Government's fiscal strategy.

The projected revenue path is shown in Chart 3.1. The tax-to-GDP ratio is projected to recover from 20.4 per cent of GDP in 2009-10 to 23.5 per cent of GDP in 2019–20.

Chart 3.1: IGR tax receipt assumptions



Source: *Mid-Year Economic and Fiscal Outlook 2009–10* and Treasury projections.

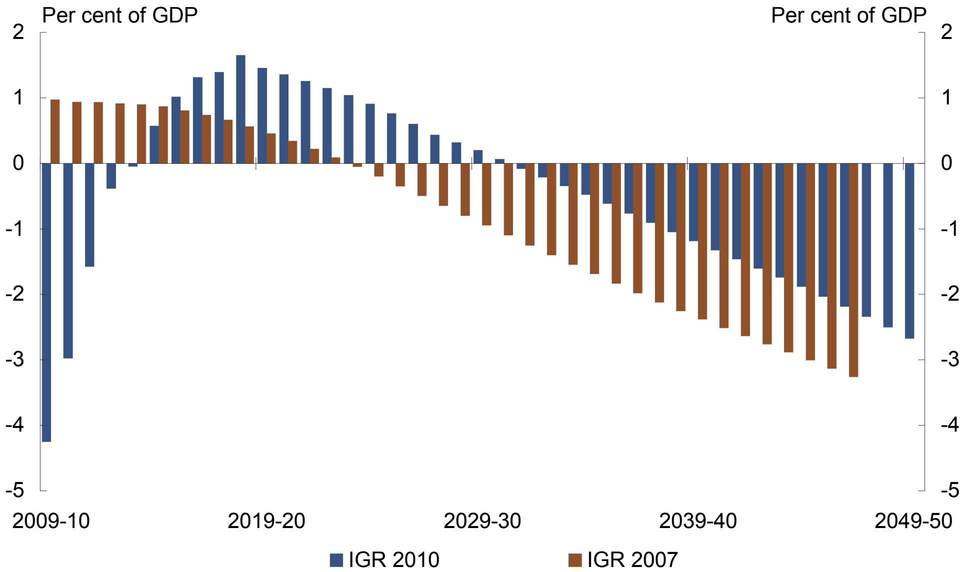
3.3 Ageing pressures will reduce fiscal sustainability

The fiscal gap is the gap between spending and revenue that needs to be closed to address the fiscal pressures of an ageing population (Chart 3.2).

From 2018–19 onwards, when revenue exceeds spending by around 1.6 per cent of GDP, ageing and health pressures are projected to lead to a gradual deterioration in government finances. A fiscal gap is projected to emerge in 2031–32 and grow to around 2¾ per cent of GDP by 2049–50.

This is an improvement on the fiscal gap of 3¼ per cent of GDP projected in IGR 2007. The Government's fiscal strategy of restraining real spending growth to 2 per cent in years when the economy is growing above trend until the budget returns to surplus (in 2015–16) makes a significant contribution to this improved outcome, along with the more gradual pace of ageing than previously projected.

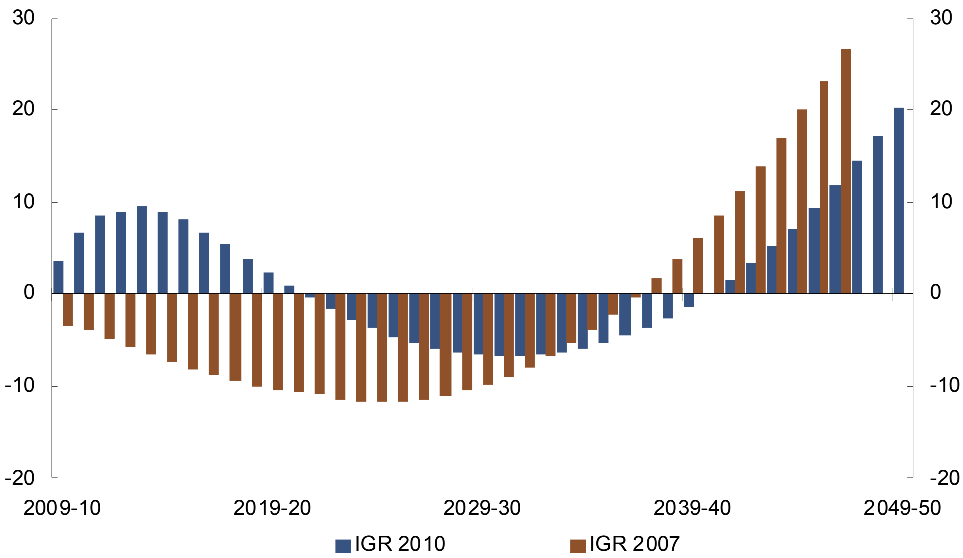
Chart 3.2: Projected fiscal gap



Note: Fiscal gap is the gap between government receipts and payments, excluding interest receipts and payments. It is equivalent to the primary balance.
Source: Treasury projections.

If a fiscal gap of 2¾ per cent of GDP were to develop, it is projected that net debt would re-emerge in the 2040s and rise to around 20 per cent of GDP by 2049–50 and continue to increase beyond this time (Chart 3.3).

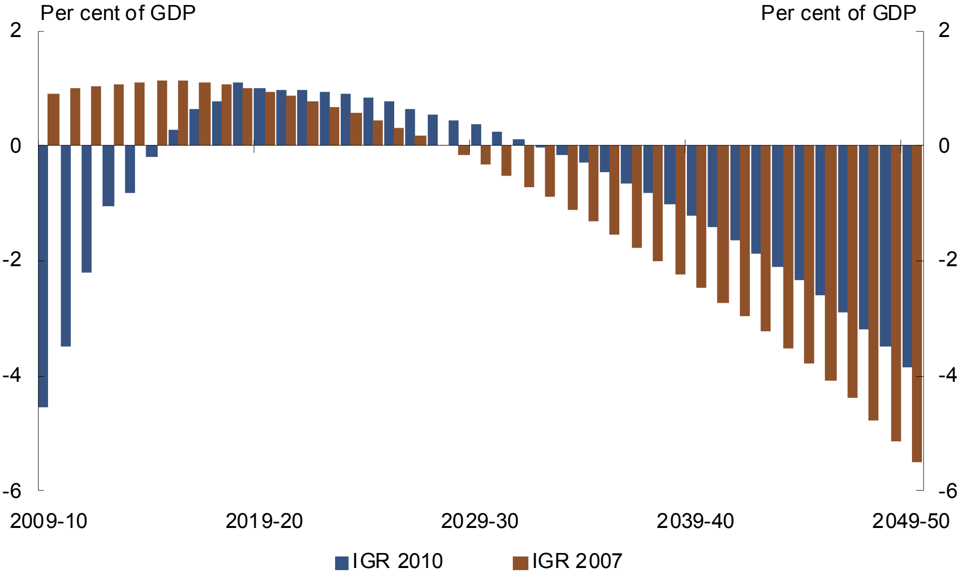
Chart 3.3: Projected path of net debt



Source: Treasury projections.

Similarly, if steps were not taken to close the fiscal gap over time, it is projected that the underlying cash deficit would be 3¾ per cent of GDP by 2049–50 (Chart 3.4). The difference between the fiscal gap and the underlying cash deficit is an indication of the costs of delaying policies to reduce spending growth now in response to ageing fiscal pressures.

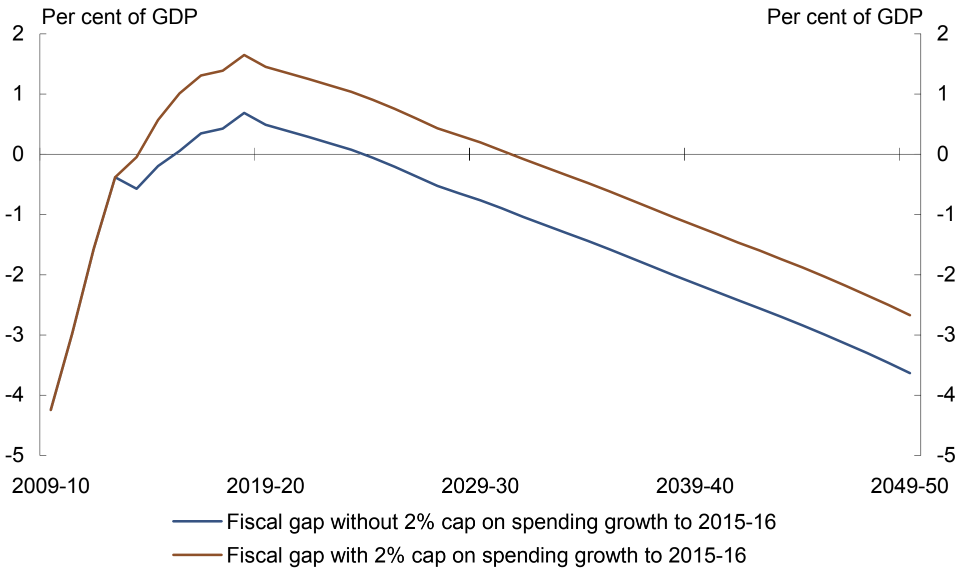
Chart 3.4: Projected underlying cash balance



Source: Treasury projections.

The fiscal strategy delivers a substantial contribution to long-term fiscal sustainability. Without the fiscal strategy, ageing of the population would result in a wider fiscal gap (3¾ per cent of GDP rather than 2¾ per cent of GDP) (Chart 3.5). As a result, the projected underlying cash deficit would be 3½ percentage points of GDP larger by 2049–50 than would be the case with the fiscal strategy.

Chart 3.5: Projected fiscal gap with and without the fiscal strategy



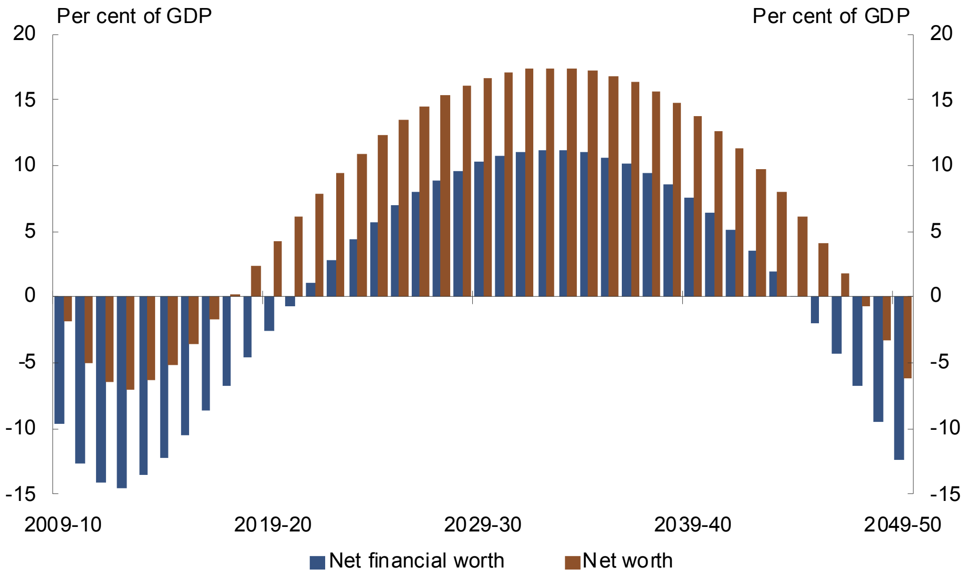
Source: Treasury projections.

3.4 Net financial worth and net worth

Net financial worth is a broader indicator of fiscal sustainability than net debt because it includes government borrowing, superannuation and all financial assets. Net worth is broader again as it includes non-financial assets.

As a result of an ageing population, net financial worth is projected to peak at around 11 per cent of GDP in 2032–33 before gradually deteriorating to around negative 12 per cent of GDP by 2049–50 (Chart 3.6). Net worth is projected to follow a similar path, falling to around negative 6 per cent of GDP in 2049–50.

Chart 3.6: Projected path of Australian government net financial worth and net worth



Source: Treasury projections.