Part 4: Sustainability — fiscal policy and economic growth

Overview

The Australian Government's long-term fiscal sustainability has improved since IGR1, although demographic and other factors continue to pose substantial challenges for economic growth and long-term fiscal sustainability.

Ongoing policy reform is needed to manage these pressures and build on the strong foundations of Australian Government economic and fiscal policy frameworks, and the solid economic and fiscal outcomes over recent years.

Strengthening Australia's long-term fiscal position

Australia's current fiscal position is strong by both international and historical standards. The Government has eliminated net debt and is continuing to strengthen its balance sheet by running budget surpluses and accumulating financial assets in the Future Fund. However, intergenerational fiscal pressures pose ongoing challenges for government finances over the longer term. By 2046-47, spending is projected to exceed revenue by around 3½ per cent of GDP.

These projections are based on a number of assumptions and the outcomes may vary depending on how events unfold and what policy choices are made. There are also risks which are difficult to quantify and unforeseen events which will have intergenerational consequences, such as pressures to address environmental issues.

The community faces choices in addressing these fiscal pressures:

- governments could run deficits and increase debt;
- taxes could be increased now or in the future;
- policies could be developed that support stronger economic growth; and/or
- spending growth could be reduced and spending made more efficient and effective.

Accumulating debt is not a sustainable long-term solution, particularly in situations where budget deficits are expected to continue for a period of time, since at some point the debt needs to be repaid. In addition, the compounding effect of interest costs would see net debt rise very rapidly, particularly beyond the projection period.

While it is a matter for future generations to decide how much tax they wish to pay, the fact that taxes collected by the Australian Government have been broadly constant as a share of GDP for 30 years suggests that the Australian community is reluctant to bear a higher tax burden. In designing the tax system, governments need to consider both the costs on the economy of imposing extra taxes and the benefits that public revenue can generate to achieve community goals. Increasing tax rates may reduce economic growth by, for example, discouraging people from working or from investing. On the other hand, improving the tax base may allow higher revenue collections without adverse effects on growth; for instance, by removing incentives for people to undertake inefficient activities or by discouraging people from engaging in activities which harm others.

Policies that aim to support higher economic growth represent a preferred alternative. Higher growth per person directly raises the living standards of future generations of Australians. Growth also increases the capacity of the government (and individuals) to meet increasing demands for public services, not only arising from the ageing of the population, but also for better quality health care and other services.

The government can contribute to raising economic growth prospects by ensuring individuals face the right incentives and markets are able to function efficiently.

However, while lifting labour force participation and productivity will improve future economic growth prospects, the impact on the fiscal gap is less certain. In particular, in circumstances where higher incomes lead to rising community expectations for more or higher quality services, raising economic growth may not be sufficient to manage fiscal pressures. Careful consideration needs to be given to the appropriate design of public policy and the efficiency of the provision of services.

Another possible reason for government spending increasing with income could be because the public sector does not share in productivity gains experienced elsewhere in the economy. Both public and private productivity gains are important for addressing future spending pressures.

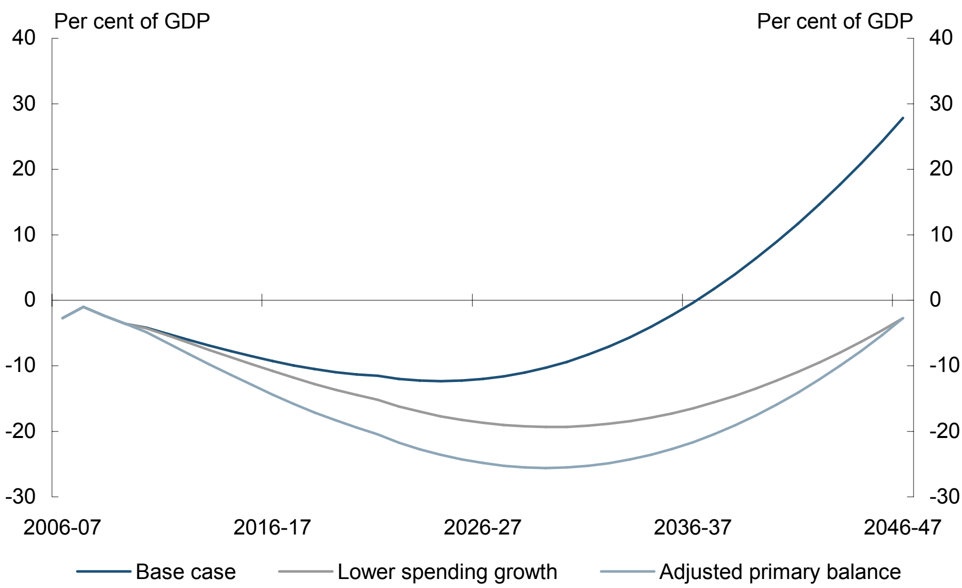
Future spending risks also may be managed by considering alternative approaches which may handle better implicit intergenerational transfers. Issues arising from environmental stress and pressures on natural resources are complex and spending programmes are only one of the ways to address the issues. Greater consideration can be given to the role that market-based mechanisms can play in the overall policy instrument mix to achieve environmental outcomes which are fiscally and economically sustainable.

Given the uncertainty and risks, a prudent strategy to address intergenerational fiscal pressures is both to promote growth prospects and improve the efficiency and effectiveness of government spending. Governments also could consider the potential role of market-based mechanisms in managing spending pressures. Steps taken sufficiently early will avoid large adjustments later.

One way to assess the magnitude of the fiscal adjustment task is through its impact on the projected path of net debt. For example, an immediate increase in taxes or reduction in spending of around ¾ of a percentage point of GDP, maintained over the entire projection period, would see the level of net debt at the end of the projection period remain at around current levels (Chart 4.1). Alternatively, a reduction in the rate of growth in government spending of around ⅕ of a percentage point each year would also result in a similar outcome. However, these scenarios do not take into account the fiscal position beyond the projection period which will continue to impact on net debt.

Fiscal sustainability also requires governments to take a broader view of their balance sheets and fiscal risks, including meeting contingent liabilities. An approach to fiscal policy that focuses on improvements in the balance sheet recognises that many of the fiscal pressures governments face will arise decades into the future. The Australian Government is taking steps to strengthen its balance sheet by building up assets in the Future Fund to offset the Government's superannuation liabilities relating to past and current public sector employees. Funding this liability now improves the Australian Government's net worth and helps reduce future pressures on the budget.

Chart 4.1: Projected path of net debt under alternative spending scenarios



Note: The base case projects average annual spending growth of around 5½ per cent. The lower spending growth scenario assumes that from 2006-07, spending grows each year by around one-fifth of a percentage point less than projected under the base case. The adjusted primary balance scenario assumes an immediate improvement in the primary balance of ¾ of a percentage point of GDP, maintained over the entire projection period.
Source: Treasury projections.

IMPROVING AUSTRALIA'S LONG-TERM ECONOMIC GROWTH PROSPECTS

The economic growth challenge arises directly from the projections of the ageing of the population. Total labour force participation rates are projected to fall reflecting the rapid increase in the proportion of the population aged 65 and over, which will result in lower growth in GDP and GDP per person in the next 40 years than in the past 40 years. Improving the prospects for economic growth is important for raising living standards and wellbeing more broadly, as well as for addressing the fiscal challenge.

Improving prospects for economic growth requires improvements in population, participation and/or productivity — the 3Ps. Changes in these factors affect growth and spending pressures differently. (See the sensitivity analysis in Appendix B.) Increased productivity is most likely to raise GDP per person, although increased labour force participation also could be significant. Increasing the population contributes to increasing GDP, although not necessarily GDP per person, in the projection period. Increasing the birth rate has a positive effect on GDP per person only beyond the projection period when the full benefit for labour force growth takes effect; whereas, increases in skilled migration have a more immediate positive effect on labour force participation and growth in real GDP per person.

An increase in productivity growth of ¼ of a percentage point to 2 per cent per year, for example, could lead to an increase in the level of real GDP per person of around 10 per cent by 2046-47 and would partially offset the projected slowdown in real GDP growth per person over the coming 40 years. In contrast, a return to the average productivity growth in the 1980s of 1.2 per cent per year would reduce the level of GDP per person in 2046-47 by about 20 per cent and lead to an even lower rate of average growth over the coming 40 years. This highlights the importance of further reforms that encourage productivity enhancements.

An increase in labour force participation, say by increasing the total participation rate by 5 per cent by 2046-47, could lead to about a 5 per cent increase in real GDP by 2046-47. Such an increase would bring Australia's participation rates closer to the best in the OECD.

Whether Australia can achieve these higher outcomes over time will depend on the economic conditions at the time, the longer-term forces acting on the economy and the policy choices successive generations make to improve their wellbeing. Many factors will affect these choices.

- Short-term forces affecting the economy and the economic cycle include sectoral risks and opportunities, international economic conditions and unpredictable events such as those associated with security issues.

- Government policy frameworks, including macroeconomic policies, regulatory approaches and the microeconomic incentives arising from tax and spending programmes, influence the behaviour of people and business, and the outcomes achieved.

- Longer-term challenges and opportunities including domestic and international developments in the environment such as natural resource management and climate change (which may have irreversible intergenerational effects) and technology and innovation.

- International developments which are reshaping the world including globalisation of flows of goods, services, and people; trends in policies and regulatory frameworks overseas and in international institutions; and changing political and economic balances, including the rise of China and India.

Policies to improve the prospects for economic growth, mainly productivity and participation, need to be able to handle such changing circumstances and unpredictable events.

In addition, in an intergenerational context, the policy choices made by the current and successive generations need to be sustainable. The wellbeing of successive generations requires sustainable economic, social and environmental conditions. The policy choices made will need to take into account the range of factors which may influence individual and societal wellbeing; balance appropriately all issues so as to manage effectively the conditions now and in the long term; and improve the flexibility, resilience and adaptability of the economy to handle future challenges and opportunities.

Policy directions

A range of government policies affect the three components of growth. It will be important to continue to focus on these over time to address the fiscal and economic sustainability challenges set down in this report.

Decisions by individuals to participate in the labour market are influenced by their capabilities, the incentives in government programmes and the flexibility of the labour market to match job seekers with employment opportunities and pay. Spending programmes which provide income support and the personal tax system need to have appropriate incentives to provide a return for working and to provide support, including in times of unemployment or situations of disability. The capabilities of people can be improved through better health and education. The flexibility of the labour market, the range of jobs, qualifications, hours and rates of pay also influence people's decisions about labour force participation. Continued attention to all of these influences, as well as the maintenance of a strong macroeconomy that maximises employment opportunities, will be necessary.

On the productivity side, the scope for policy influence is more complex and depends on a number of factors. If markets work well, with appropriate regulation, then resources will move to the areas of highest return, and there will be strong incentives for people to build their skills and to invest in better processes and new markets. A range of policies affect the operation of markets: some positively, by addressing market failures such as the lack of information or externalities such as land degradation; and others negatively, by imposing unnecessary costs.

Productivity gains in the past have arisen from policy reforms which have created and opened up markets domestically and internationally in products and services, labour, natural resources and finance. The National Reform Agenda is developing proposals to improve competition in transport, energy and infrastructure, and to reduce the regulatory burdens imposed by the three levels of government. Well-functioning markets will smooth the adjustments in resource allocation for demographic change and other developments. One example is within financial markets where the development of markets and products helps people save for retirement and manage risks while also investing these savings productively.

Further reform is also needed to fully manage pressures on our natural resources and global climate. Well-managed resource use will maintain conditions for future generations and avoid loss of productive capacity from degradation and overuse. A range of policy instruments — spending and taxation programmes, regulation and market-based mechanisms — is needed to manage these issues. International frameworks will also be needed for some issues.

SUMMARY ASSESSMENT OF SUSTAINABILITY AND FUTURE DIRECTIONS

The government's long-term fiscal sustainability has improved since IGR1, although demographic and other factors continue to pose substantial challenges for economic growth and long-term fiscal sustainability. Steps have been taken and ongoing reform will be needed to strengthen Australia's long-term fiscal position and improve the prospects for sustainable economic growth.

Foundations for the future are sound, with good economic growth and stable macroeconomic frameworks. The Australian Government's fiscal position has been strengthened by the creation of the Future Fund and elimination of net debt. Steps have been taken to reform areas of greatest spending pressure, such as health and some income support payments. Reforms of government programmes, such as the Welfare to Work reforms, family support, income tax reductions and superannuation reforms, have been directed to improving the prospects for economic growth.

Further reform processes are in train. The human capital and competition reform streams of the Council of Australian Governments' National Reform Agenda are designed to lift participation and productivity. Further progress is needed to design and effectively deliver reforms, including clarifying appropriate roles for different levels of government.

The full benefits of the reforms recently introduced will emerge over time. Further potential improvements from the reform processes underway can be delivered across all levels of government.

Nevertheless, the fiscal challenges identified in this report will require ongoing attention.