IGR 2010: Challenges and Priorities for Australia

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Introduction

Good morning.

It is a pleasure to be with you.

CEDA is an important forum. It provides an opportunity for people from a diverse range of backgrounds and experience to come together to discuss the challenges and opportunities that Australia will face over coming decades.

I have been asked today to focus on the 2010 Intergenerational Report and some of the challenges and opportunities that are highlighted by the report.

It seems like quite a while since the IGR was released by the Treasurer. Yet it was only back in January of this year.

The report is aptly titled *Australia to 2050: future challenges.* I say aptly, because that is exactly what an IGR is about. It is about future challenges.

Identifying future challenges so that policy, across a broad range of portfolios, can be developed with a strategic eye to the needs of the future.

It is about stimulating broad public debate and ensuring the policy formulation process contemplates not just short-term considerations, but also the issues that could have substantial implications for the wellbeing of future generations of Australians.

The role of the IGR – a framing document

I think of the IGR as a framing document, a document to motivate discussions around the key challenges we will face over coming decades.

It is important to understand, however, that the IGR is an analytical tool, based on assumptions and projections. It does not forecast where we think we will be, or should be, in 40 years time.

Rather, it takes current economic and demographic trends, and current government policies and policy settings, and projects forward the implications of a continuation of those trends, policies and settings.

While many people focus on the “point” projections contained in the report, and how they compare with previous IGR “point” projections, it would be safer to focus on the broad path of the pressures outlined in the report. Yet it is difficult enough to base a narrative on precise numbers, far more so on plausible ranges of many numbers, so I hope you will forgive me for what might seem like a bit of ‘false precision’ from time to time.

Since the first IGR in 2002, IGRs have been used as a tool for raising awareness of the challenges presented by an ageing population.

IGRs have also influenced thinking more broadly, with the 3Ps decomposition of the supply-side drivers of GDP and GDP per capita - population, participation and productivity - being used to guide government decision-making and debate across a range of policy areas.

Notably, raising labour force participation rates as a way of reducing the fiscal pressures associated with an ageing population is a proposition that has gained widespread acceptance.

The latest report has, correctly, focused on productivity growth as the key to sustained economic growth and improving GDP per capita.

Public debate also has extended to the first ‘P’, population; putting the size of Australia’s future population and its trajectory into focus – and, more specifically, drawing attention to the challenges and opportunities that accompany a rapidly growing population.

This is something to be welcomed. Careful planning for Australia’s future population - whatever its size - will be central to improving the wellbeing of Australians.

The latest report also builds on previous IGRs with a discussion of environmental challenges, sustainability and wellbeing. Importantly, it highlights how wellbeing is a multi-dimensional concept that goes beyond material living standards.

Key conclusions of the IGR

Allow me to recap for you some of the key conclusions of the 2010 IGR.

Australia’s population is expected to continue to grow and age over the next 40 years.

We currently have a population of around 22 million people with about 13½ per cent of those (less than 3 million) aged 65 and older. By 2050, the population is projected to grow to nearly 36 million people with nearly 23 per cent of the population (more than 8 million) aged 65 plus. This projection is not a forecast and it is certainly not a target based on any particular policy approach. It is, instead, a projection, based on a continuation of long-run trends in fertility, mortality and net overseas migration.

Thinking about the population projections in a slightly different way, there will be only 2.7 people of working age to support each Australian aged 65 years or over by 2050, compared with 5 working age people per aged person today, and 7.5 in 1970.

Of course, this is just one way to think about dependency. For example, unpublished projections indicate that for every adult without employment - excluding fully self-funded retirees - there will be only 1.8 people in employment in 2049-50, a fall from 2 currently.

This is a modest deterioration when compared against the ratios presented in the IGR. However, regardless of how dependency is measured, an ageing population is expected

to lead to a deterioration in dependency ratios, with adverse implications for economic growth.

In the IGR, long-term projections of economic growth are, as I have already noted, a function of population, participation and productivity - the 3Ps framework.

Specifically, real GDP growth per capita is a function of the proportion of the population of working age (that is, aged 15 or more), average hours worked by people of working age, and average output per hour worked.

Projections of the 3Ps are determined by demographic and economic assumptions.

The proportion of the population of working age has risen steadily over the past 40 years – from 71 per cent to 81 per cent – and is projected to rise even further over the next 40 years – to 83 per cent. But among those of working age, the proportion in the age bracket with the highest rates of labour force participation – that is, aged 15 to 64 – is set to fall substantially – from 83 per cent today to about 73 per cent in 2050. As this proportion falls, average rates of labour force participation will also fall.

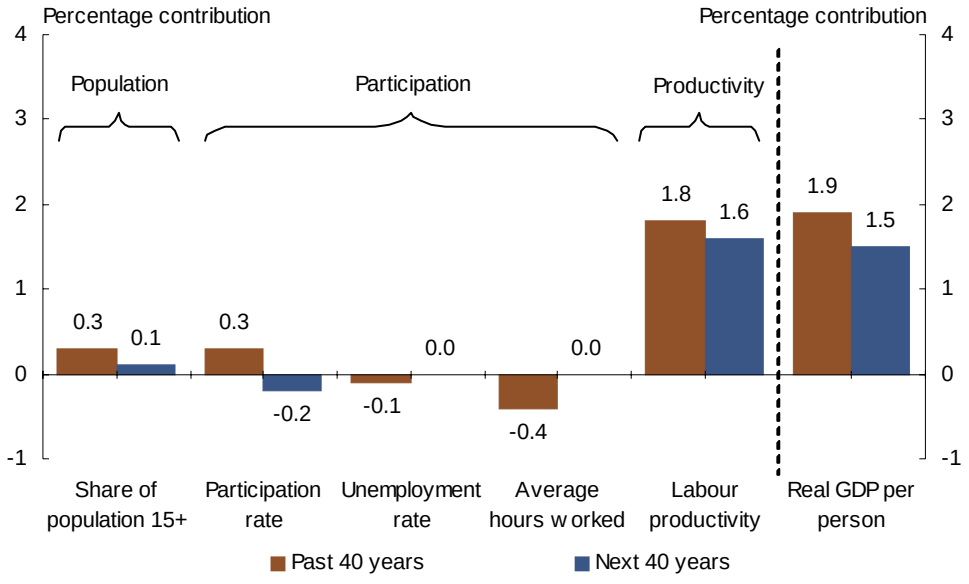
Ignoring productivity growth rates for the moment, that fall in labour force participation drives a projection of slowing rates of growth in GDP per capita.

Even with strong population growth, GDP growth will also slow. Thus, we project average annual GDP growth of 2.7 per cent over the next 40 years compared with 3.3 per cent over the previous 40 years.

Real GDP per capita is projected to average 1.5 per cent growth over the next 40 years compared with 1.9 per cent over the past 40 years.

Looking at the individual contributions of population, participation and productivity gives us a picture of what is driving past and future growth in living standards (Chart 1).

Chart 1: 3Ps of real GDP per person



As I have noted already, over the past 40 years the proportion of the population aged 15 or more years has grown steadily. This demographic development was driven by a dramatic fall in the birth rate in the late 1960s and 1970s. Abstracting from any impact on workforce participation rates and labour productivity, this population ageing would have lifted GDP per capita by about 0.3 percentage points a year. As I have also noted already, over the next 40 years, the proportion of the population aged 15 or more is projected to continue to increase – though not as rapidly. Again abstracting from any impacts on participation and productivity, future population ageing would add about one-tenth of a percentage point to annual GDP per capita growth.

Of course, population ageing cannot really be assumed to have no consequences for workforce participation rates. Broadly, over the past 40 years the increase in the proportion of the population aged 15 or more was associated with an increasing proportion of the population being of prime working age. That is one of the reasons – though not the only reason – why past population ageing was associated with a higher average rate of workforce participation; higher rates of female participation were

another reason. Looking ahead over the next 40 years, however, those of prime working age are going to fall as a proportion of the population aged 15 or more, acting as a drag on rates of workforce participation.

Thus, whereas higher rates of workforce participation added about 0.3 percentage points a year to GDP per capita growth over the past 40 years, participation rates are projected to fall over the next 40 years, subtracting about 0.2 percentage points from annual GDP per capita growth.

Over the past 40 years there were also significant, largely non-demographic, developments in respect of the unemployment rate and average hours of work which had an impact on GDP per capita growth – taken together, subtracting about one-half of a percentage point a year. Looking ahead, we see the unemployment rate coming down a little from its present cyclically high level – which will be positive for GDP per capita growth – with no change in average hours of work.

The standard IGR methodology for productivity growth is to assume that the 30-year historical average, in this case 1.6 per cent, will continue over the 40 year projection period.

In aggregate, the impacts of population and participation will be largely offsetting, leaving productivity as the major driver of future growth in real GDP per person over the next 40 years.

Assessments of fiscal sustainability usually focus on trends in government spending and revenues expressed as proportions of GDP. The projections contained in the IGR are consistent with the Government's commitment to keep the tax-to-GDP ratio below its 2007-08 level of 23.6 per cent.

The behaviour of the ratio of government spending to GDP depends upon what happens to nominal GDP per capita – thus far, we have explored what happens to real GDP per capita – and upon what happens to nominal government spending per capita. Indeed, the change in the ratio of government spending to GDP is simply the difference between the change in nominal government spending per capita and the change in nominal GDP per capita.

We are projecting that nominal government spending per capita will grow at a faster rate than nominal GDP per capita, so that over the next 40 years government spending

will exceed revenue by about 2¾ per cent of GDP – excluding interest payable on additional public debt.

That is not large by international or historical standards. But that is not the point. A fiscal gap of that order points to a significant accumulation of public debt that could, at some point, prove difficult to reverse.

Challenges

Fiscal sustainability

Fiscal sustainability is a key theme of IGRs.

Near-term, budget settings can have a substantial influence on the projected path of public finances over even a long period of time.

Thus, the 2010 IGR demonstrates that by returning the budget to surplus in 2012-13 and committing to maintain a 2 per cent annual cap on real spending growth for some years, the medium-term fiscal strategy will make a significant contribution to addressing longer-term fiscal challenges.

This is not to say that, in light of the medium-term fiscal strategy, an ageing population no longer presents a threat to

fiscal sustainability. Rather, what it demonstrates is that adjustments made now can reduce the need for larger adjustments later.

Over a longer time period, ageing of the population will still contribute to pressure on government spending and fiscal sustainability.

The IGR projects total spending to increase to 27.1 per cent of GDP in 2049-50, around 4¾ percentage points higher than its projected low point in 2015-16. In today's terms, that's the equivalent of adding around $60 billion a year to government spending.

Around two-thirds of the projected increase in spending over the next 40 years is related to health; reflecting pressures from ageing, increasing community expectations and the funding of new technologies.

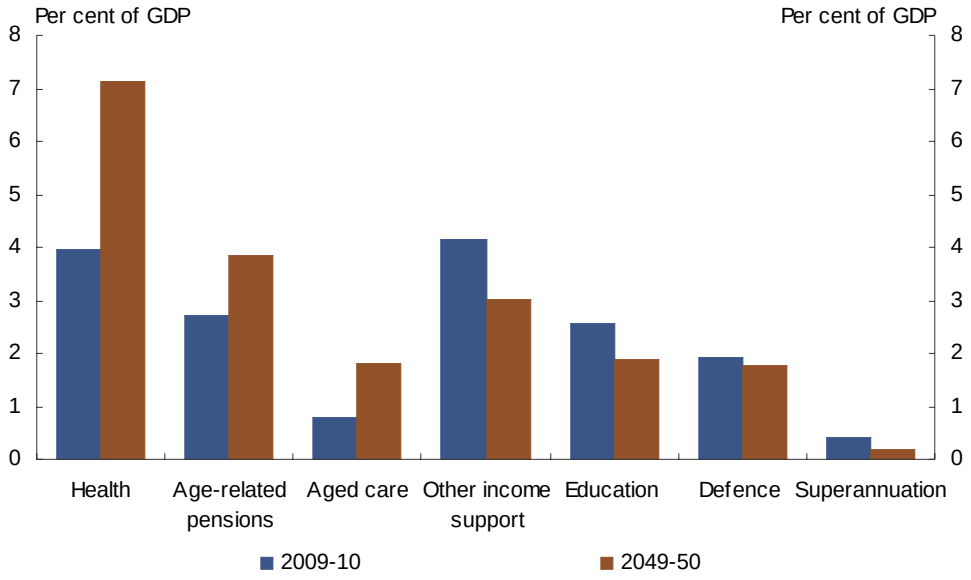
Growth in spending on age-related pensions (Chart 2) and aged care is also significant, both as a proportion of GDP and in real spending per person.

Currently, about a quarter of Australian Government spending is directed to health, age-related pensions and aged care. The IGR projects that Australian Government

spending on these functions will increase significantly over the next 40 years, pushing their share of spending to almost one-half.

As a proportion of GDP, spending on health is projected to rise from 4.0 per cent to 7.1 per cent. Age-related pensions and aged care are projected to rise from 2.7 per cent and 0.8 per cent of GDP to 3.9 per cent and 1.8 per cent in 2049-50.

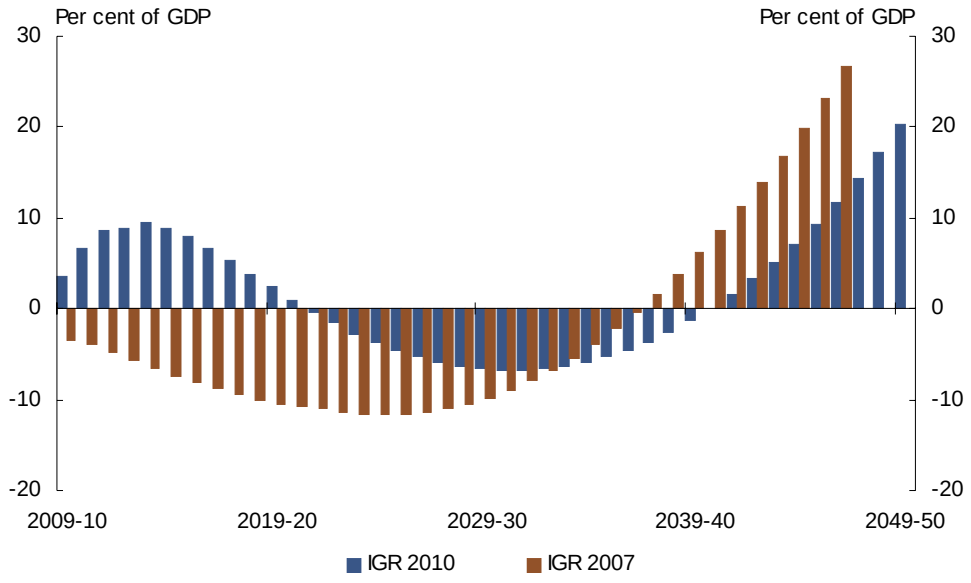
Chart 2: Projections of Australian Government spending by category (Per cent of GDP)



As I have noted, excluding public debt interest, the IGR projects a fiscal gap of 2¾ per cent of GDP (or around $30 billion in today's dollars) by 2049-50.

With a fiscal gap of this size (Chart 3), it is projected that net debt will emerge in the 2040s and grow to around 20 per cent of GDP by 2049-50.

Chart 3: Projected path of Australian Government net debt (Per cent of GDP)



Including the interest costs of rising net debt, an underlying cash deficit of 3¾ per cent of GDP is forecast by 2049-50.

Australia's population

I have noted that the IGR projects Australia's population to reach 36 million by 2050. I will emphasise again that this figure is a projection that reflects trends in fertility, mortality and net overseas migration. It is not a forecast. Nor is it a target.

While the population is projected to get bigger, its average rate of growth is projected to slow slightly to 1.2 per cent annually over the next 40 years, compared with the 1.4 per cent per annum experienced over the past 40 years.

Nevertheless, a population expansion of this order presents a number of challenges and opportunities for the Australian economy and society.

A key challenge will be the sustainable provision of the social and economic infrastructure needed to support a growing population, including the urban environment, transport, housing and service delivery networks.

An even greater challenge will be ensuring environmental sustainability – in which we have a poor track record, it must be said. That is not to say that population growth of this magnitude cannot be sustainable – rather, that it will test us. Certainly, it will be important for a coordinated suite of polices to be developed across all levels of government in a carefully considered and measured manner.

I would now like to unpack a few of these key challenges and opportunities.

Cities

Australia has one of the most urbanised populations in the world. 75 per cent of the population live in cities with populations over 100,000, with capital cities currently comprising around two-thirds of the nation's population.

By 2026, an additional 4½ million people are projected to live in the capital cities and by 2056 this figure will rise to an additional 10½ million people.

These projections raise a number of questions about what our future cities will look like, where population growth will be strongest, and how our cities will function.

Answering these questions with sustainable approaches will not be easy.

Cities offer a range of "economies of scale", or agglomeration, benefits. Indeed the IGR notes that cities require less fixed infrastructure per capita relative to rural areas because of the economies of scale that accompany infrastructure networks.

However, increasing population density can lead to congestion costs that potentially offset these benefits.

Careful planning and design of infrastructure networks, such that the agglomeration benefits of cities are harnessed and congestion costs are minimised, will be central to ensuring that our cities continue to remain liveable.

Such planning will focus on achieving a sustainably high level of investment in public infrastructure, as well as reforms to ensure existing infrastructure is more effectively utilised.

The latter will invariably require getting greater competition and better pricing in key infrastructure markets – such as water, electricity and transport networks.

Growth of our cities also will have implications for environmental sustainability and the wellbeing that is obtained from the environment.

For example, if our aim is to preserve or increase the contribution that the environment makes to wellbeing, we will need to consider how we house larger urban populations without risking further species extinction and a loss of biodiversity on the fringes of major population centres.

This will not be easy – particularly when the trend over the past two decades has been towards significantly larger houses with fewer people in them.

The establishment of Infrastructure Australia in 2008 has helped with the task of planning and designing the infrastructure networks required for the future.

The recent creation of a Major Cities Unit within Infrastructure Australia to specifically develop and implement measures to improve the sustainability, liveability and productivity of Australia's major cities is a positive step.

Housing

Planning and designing infrastructure networks to support a growing population will also need to give consideration to the housing needs of a larger population.

Planning for the housing needs of a larger population is not just about building more houses. It is also about making sure the supply-side response to increased housing demand is as efficient as possible and that it, too, occurs in a sustainable manner.

Addressing inefficiencies will be central to improving housing affordability and achieving equitable housing outcomes.

The COAG agenda for housing supply and affordability reform is focused on improving the efficiency of the housing market.

More specifically, the agenda is examining the housing supply pipeline, and government policies that affect housing – such as charges that may act as barriers to supply.

Service delivery

A larger, ageing, population will place pressure on government service delivery.

Population ageing will drive up demand for services related to seniors and aged care, while changing patterns of population settlement will have implications for the geography of services provision.

For example, new services for seniors, and especially aged care, will need to be located in particular parts of the country and most probably in the fast growing south-east corner of Queensland and the north-east of NSW.

Furthermore, demand for higher quality and a greater range of services is expected to increase in line with rising income levels, changing preferences and technological improvements.

To meet the expectations of improved service delivery in a fiscally sustainable manner, a modern service delivery network will need to be developed.

Such a network would need to use existing resources more efficiently, including through a more sophisticated utilisation of technology and information networks.

Environment

The IGR also placed a renewed focus on environmental sustainability and sustainability more broadly.

Sustainability is concerned with ensuring that the wellbeing of future generations is at least as high as that of the current generation.

The environment offers direct and indirect benefits to wellbeing. It contributes directly via the health benefits and enjoyment that it generates. Indirectly, it is an important input to production.

While the benefits offered by the environment are relatively clear in concept, individuals rarely incorporate the full environmental costs of their actions into decision making. For that reason, there is a substantial role for governments to play in ensuring that the use of the environment today – including the external impacts of non-environmental activities – does not act to reduce the wellbeing of future generations.

Equity

The last challenge I would like to touch on today concerns equity.

It is perhaps the most important challenge that we will face in coming decades. This is because many among the raft of challenges that I have outlined impact disproportionately on the more disadvantaged parts of our communities.

Notwithstanding an ageing population, GDP per capita is projected to continue to grow over the next 40 years, albeit more slowly than the previous 40 years. This means that governments will need to continue to make decisions about how the benefits obtained from a growing economy are distributed.

There is a case for ensuring that the tax and transfer system and labour market policies advantage those on the lowest private incomes, while also encouraging labour force participation.

Governments will also need to focus on increasing access in a range of areas – such as education, health, and employment opportunities.

Access to opportunity in these areas is a key dimension of wellbeing – especially because it has the potential to help reduce entrenched disadvantage across generations.

For example, we know that Australians from low socio-economic backgrounds are more likely to experience poorer education outcomes, with these outcomes tending to persist across generations.

This suggests that improved access to education can help to reduce intergenerational disadvantage.

Addressing impediments to participation in education and training is a key component of the Government's Social Inclusion Agenda.

Opportunities

As I mentioned in my opening remarks, the IGR 2010 provides an insight into some of the challenges that, if left unaddressed, could have substantial adverse implications for the wellbeing of future Australians.

Among those challenges, there are opportunities. And population growth, in particular, presents a number of opportunities. I will touch on these briefly.

Skilled immigrants can support economic growth and higher living standards by adding to the skills base of the labour force and contributing to productivity growth.

Labour force growth can also help to offset the budgetary effects of an ageing population to some extent.

And labour force growth could assist in managing structural changes that the Australian economy may experience in coming decades, such as those brought about by a sustained rise in the terms of trade.

Some elaboration of this last point might be helpful: To maximise the benefits of a higher terms of trade, the share of our factors of production allocated to the resources sectors will need to increase. A sustained increase in the

size of the labour force can ameliorate the adjustment required in other sectors of the economy that would otherwise need to shrink.

Conclusion

The IGR 2010 has confirmed that population ageing will have a noticeable impact on GDP per capita growth, and on fiscal sustainability, over the coming decades.

Getting near-term budget settings right will be central to placing government finances on a sustainable long-term path. In this sense, an effective medium-term fiscal strategy will continue to play an important role in framing long-term revenue and spending decisions.

The IGR also reported that Australia's population will continue to grow strongly. A larger population will present a complex mix of long-term challenges that are multi-dimensional in their scope, and have the potential to affect the wellbeing of future generations in negative ways if not handled sensibly.

But a larger population also creates opportunities. In particular, it could - if approached properly - assist in managing some of the pressures of an ageing population by

providing the skills and innovation needed to underpin continued economic growth.

It may also help to ameliorate some of the structural change likely to be associated with a sustained rise in our terms of trade.

Importantly, by confronting the challenges associated with an ageing and growing population early, and harnessing the opportunities, we can position the Australian economy on a sustainable growth path. That is to say, we can ensure that the wellbeing of future generations of Australians is at least as high as the wellbeing we enjoy today.

Thank you.