BULLETIN

25 August 2023

Australia: 2023 Intergenerational Report Some observations on the IGR budget scenario

The 2023 Intergenerational Report (IGR) is the 6th in a series of such reports, dating back to 2002.

It is a government document, from the Treasurer of the day. The 280 page report is prepared by the Department of Treasury.

The IGR sets out a budget scenario reminding and informing the community of potential budget challenges over the decades ahead.

The familiar theme is that with Australia's ageing population, there will be upward pressure on expenditures and downward pressure on revenues – combining to create a budget challenge.

The budget scenario in the IGR is informed by both current budget pressures and potential emerging pressures, associated with anticipated key structural shifts over coming decades.

In the 2023 edition, five powerful forces are identified as continuing to shape Australia's economy over the coming decades: population ageing; rising demand for care and support services; climate change and the decarbonisation transformation; expanded use of digital and data technology; and increased geopolitical risk and fragmentation.

The scenario is reliant upon several key assumptions, which we discuss below.

The scenario is "static", in that it assumes that policy settings remain broadly unchanged and makes little in the way of allowance for behavioural changes and responses.

Here, we make some overview observations on the budget scenario in the 2023 edition of the IGR.

IGR 2023 Scenario: budget deficit widens to -2.6% of GDP in 2062/63

The IGR projects the budget out for the next forty years, to 2062/63.

The long-term projects begin from 2034/35.

Prior to that, the IGR adopts the latest official budget numbers – taken from the May 2023 Budget.

The May 2023 Budget numbers cover the period to 2026/27, as well as "medium-term projections" to 2033/34.

The budget position is projected to be in deficit in each of the forty years, from 2023/24 to 2062/63.

That follows a one-off surplus in 2022/23, estimated in the May Budget to be 0.2% of GDP (with a subsequently announced "preliminary outcome" of 0.9% of GDP).

The budget deficit is at -0.5% of GDP in 2023/24 (as in the May 2023 Budget) and is at -0.5% of GDP some 21 years later, in 2043/44. The deficit averages -0.6% of GDP over this period.

Then, from 2044/45, the budget deficit gradually widens – as the adverse impacts of an ageing population become more apparent – to be at -2.6% of GDP in 2062/63.

While the upside budget surprise for 2022/23 is acknowledged in the report, it does not feed into the projections.

We note that the fiscal forecasts in the 2023 May Budget are on the conservative side, as we discussed in our budget update article, released on August 4.

We see the scope for the budget to remain in surplus in 2023/24, albeit a small one, in the order of $11bn, representing a $25bn (1.0% of GDP) improvement on the May Budget forecast. Thereafter, we anticipate that the budget will return to deficit, with still some upside relative to the existing official profile.

Our view recognises the stronger starting position for the budget position, as well as incorporating less cautious commodity price assumptions than in the May Federal Budget and is informed by the ongoing resilience of the labour market. It is premised on a no policy change basis and on current official costings for existing programs.

The scenario framework and key assumptions

The budget framework in the IGR is the usual one of the 3 P's: population, participation, and productivity.

Overlaid on this are projections of expenditure pressures.

Economic growth is projected to be an average of 2.2% a year over the next 40 years.

That is a material step down from the average of the previous 40 years of 3.1%.

We note that the slowdown in trend growth is well underway.

Economic growth averaged 2.6% over the decade prior to the pandemic. Over that 10 year period, 2010 to 2019, GDP per capita grew by an average of 1.0% and population growth averaged 1.6%.

In the 2023 IGR, Australia's population growth is projected to grow at an "average" of 1.1% a year. Note, this is an "average".

Population growth slows over the 40 year horizon, moderating from 1.4% in 2026/27 to be at 0.8% in 2062/63. The natural increase in population slows as the population ages and the IGR assumes that migration levels are held constant in number terms from 2031/32 (at 235,000 annually) – hence migration makes a smaller contribution to growth over time.

Productivity growth is projected to be 1.2%, "consistent with the 20 year average". That assumption has been marked down from the 1.5% in the 2021 edition, which was "consistent with the 30 year average at that time".

The IGR notes that this view on productivity growth is a technical assumption, "It does not capture the impact of future policy changes, or shifts in the global and domestic economy …".

We note that a concern on the productivity front is the apparent stalling of productivity over the 3 years post covid – that is, there appears to be no increase in productivity since the end of 2019.

As to the participation rate, the ageing of the population is a key consideration and concern. For budgets, the higher the employment-to-population ratio the better – currently, it is at record high.

The IGR projects the participation rate to decline gradually from 66.6% to 63.8% in 2062/63, as the population ages.

We note that the 2023 IGR shows the projected participation rates across the 6 editions of the IGR. What is noticeable is that the path for the participation rate has been progressively upgraded in each of the reports, reflecting a progressively higher actual starting point. To date, the IGRs broadly (and incorrectly) assume that the participation rate will trend lower from the most recent actual.

This is an example of changing behaviour, adapting and responding to the shifting circumstances, which the IGR does not capture.

Taken together, these assumptions for the 3Ps generate average growth in real GDP per person of 1.1%. That figure is in line with the outcome of the decade pre-covid, the 1.0% we noted above.

Another key force shaping the budget position and outlook is the terms of trade, a key determinant of national income.

The IGR assumes that the terms of trade is flat – that is "income growth from 2026/27 is driven by real GDP growth alone as movements in the terms of trade cease to contribute to changes in real income growth".

The Report acknowledges considerable uncertainty around this, noting that "the global energy transition and other economic developments will shift demand and supply trends and change the products, prices and volume of goods demanded from Australia".

Scenario projects expenses to rise, revenue assumed flat

The IGR reminds and informs us of rising structural expenditure pressures – reflecting the ageing of the population, along with pressures from existing programs (as already highlighted in the Federal budget).

In the Scenario, payments are projected to increase by 3.8ppts, from an estimated 24.8% for 2022/23 to 28.6% of GDP in 2062/63.

The IGR assesses that demographic ageing causes around 40% of this increase.

As identified previously, in the annual Federal budget, around existing programs and spending, the five fastest growing payments are health, aged care, the NDIS, interest on government debt, and defence.

Combined, these payment categories increase from around third of total government payments today to around one half by 2062/63.

As highlighted above, the IGR budget scenario is largely static. It projects forward known expenditure pressures, overlaid with pressures emerging from key structural changes – notably, the ageing population.

We note that for fiscal policy and budgets, it is always the case that spending demands are infinite and the ability and willingness to pay is finite. Budgets are always an exercise in prioritising spending, both the aggregate level of spending and the mix of that spending. Behaviours and programs will respond and adjust informed by agreed spending priorities – dynamics which are not captured in the IGR scenario.

On the revenue side, technical assumptions are key.

Tax receipts are projected to grow to 24.4% of GDP over the medium-term to 2033/34, consistent with the projections in the May 2023 Budget.

Tax-to-GDP is then assumed to remain at this level over the remainder of the period, to 2062/63.

As is always the case, as an economy evolves and shifts, the revenue base will need to evolve and shift with it – with revenue sources adjusting to a new mix of expenditure, production, and income.

The Report notes that indirect sources of revenue associated with fuel and tobacco excise are expected to decline, with the decarbonisation of the economy and shifting consumer preferences.

Personal income taxes are projected to increase as a share of GDP, consistent with and limited by the technical assumption for the tax-to-GDP ratio.

Debt levels remain at manageable levels

We note that debt levels remain at manageable levels in the IGR scenario.

By way of context, net debt at June 2023 was estimated in the May Budget to be 21.6% of GDP (a figure which is likely a little on the high side given the improved budget position for 2022/23).

That outcome is down from a covid related high of 28.5% of GDP as of June 2021 and is a little above the decade average of 19% from 2012/13 to 2021/22, but a notch above the longer term average, which is around 10%.

The Scenario has net debt heading lower, to be at 14% in 2042/43, going sideways to 15% at 2052/53, and then lifting to 25.2% at 2062/63.

Gross debt starts at 34.9% of GDP, moderates to 23.3% at 2052/53 and then makes a partial rebound to be at 32% at 2062/63 – that is, gross debt ends the 40 year period a little below current levels.

Associated with this debt profile, debt servicing costs are manageable, but not insignificant.

Interest payments as a share of GDP hold broadly steady for the bulk of the period, starting at 1.0% of GDP in 2025/26 to be at 1.1% some 30 years later and then edge higher to be at 1.4% in 2061/62.

By way of context, the historic average for the 1980s and 1990s was higher, at 2.0%, stepping down to 0.7% for the period 2000/01 to 2021/22.

Alternative scenarios

The 2023 IGR acknowledges that there are a range of potential scenarios – with the inclusion of summary results for a few alternatives: higher and lower for each of the 3 Ps, (population, participation, and productivity).

The report states, that: "the productivity assumption has large effects on economic and fiscal projections".

If the 2023 edition of the IGR were to assume productivity growth of just 0.3% higher, 1.5% (as in the 2021 edition) rather than 1.2%, then the budget deficit in 2062/63 shrinks from a projected 2.6% of GDP to 1.0% of GDP.

As noted above, the IGR states that the view on productivity is a technical assumption. "It does not capture the impact of future policy changes, or shifts in the global and domestic economy ..".

With the ageing of the population, labour becomes scarce, and the incentive is to boost investment, to increase the capital-to-labour ratio and lift productivity. The IGR scenario does not incorporate this dynamic.

More generally, productivity dynamics and forces are always complex – likely more so in coming decades, with the impacts of climate change. The IGR notes that with climate change there will likely be a hit to productivity – with more working days lost due to the increased prevalence of more extreme weather conditions.

Productivity remains a key focus of debate and policy. The Productivity Commission released their 5 Year Productivity Inquiry on March 17 2023 and the Treasurer has emphasised that the government is: "committed to a range of productivity-enhancing investments and reforms" and that "We will deliver productivity gains by investing in our people and their abilities, from fixing our energy markets, and from making it easier to adapt and adopt technology, so it works for us and not against us".

On national income and the terms of trade, the IGR assumes a flat terms of trade. How commodity prices track over the coming decades will have a material impact on the budget profile. The terms of trade profile is particularly uncertain as the economy decarbonises.

There are other risks and challenges to the budget outlook beyond the assumptions around the 3Ps.

The revenue base will, as is always the case, need to evolve and change with the changing structure of the economy. This will require active policy decisions.

The risks around the decarbonisation transition, with potential upside costs to this process, and climate change may potentially be understated.

A positive risk is the increase in the average retirement age, with women and men working longer and government policy to encourage such change.

Notwithstanding the risks and uncertainties, the IGR achieves what it sets out to do – to remind and inform us of the potential budget challenges over the decades ahead.

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