

Executive Summary

Over the past 40 years, Australia has enjoyed strong economic performance, underpinned by a growing population and a series of major reforms.

This economic success has greatly enhanced our quality of life. Average incomes have doubled in real terms since 1975, with this increased wealth shared broadly across the community.

As a result, Australian families enjoy access to a well-functioning health system, good schools, a strong social safety net and options for recreation and leisure that our grandparents could only dream about.

All Australians share aspirations for economic security and an even more prosperous future — a better place for our children and the generations beyond.

But it is not enough that we share this aspiration. We need to make choices today to build a strong and resilient economy and lay the foundation for future prosperity.

1. How will Australia change over the next 40 years?

Chapter 1 of this report outlines projections of the three long-run drivers of economic growth in Australia: our population, participation in the workforce and improved productivity.

Understanding how these drivers of economic growth are likely to change over the next 40 years will inform the action governments must take to build jobs, growth and opportunity.

Population

Australia's population is projected to change and grow over the next 40 years. The changing size and structure of our population is important as it influences how quickly our economy and our incomes grow, and therefore the rate at which our future living standards will increase.

Australians will live longer and continue to have one of the longest life expectancies in the world. In 2054-55, life expectancy at birth is projected to be 95.1 years for men and 96.6 years for women, compared with 91.5 and 93.6 years today.

In 2054-55, there are projected to be around 40,000 people aged over 100. This is a dramatic increase, well over three hundred times the 122 Australian centenarians in 1974-75.

Not only will Australians live longer, but improvements in health mean they are more likely to remain active for longer. 'Active ageing' presents great opportunities for older Australians to keep participating in the workforce and community for longer, and to look forward to more active and engaged retirement years.

The structure of Australia's population will also continue to change. This has important implications for the demand for health and aged care services and retirement incomes.

A greater proportion of the population will be aged 65 and over. The number of Australians in this age group is projected to more than double by 2054-55 compared with today.

Both the number and proportion of Australians aged 85 and over will grow rapidly. In 1974-75, this age group represented less than 1 per cent of the population, or around 80,000 people. In 2054-55, it is projected that 4.9 per cent of the population, or nearly 2 million Australians, will be aged 85 and over.

There will be fewer people of traditional working age compared with the very young and the elderly. This trend is already visible, with the number of people aged between 15 and 64 for every person aged 65 and over having fallen from 7.3 people in 1974-75 to an estimated 4.5 people today. By 2054-55, this is projected to nearly halve again to 2.7 people.

Fertility is assumed to remain at around the 2013 rate of 1.9 births per woman. The total fertility rate has remained relatively steady since the late 1970s.

Based on patterns of migration, fertility and life expectancy (mortality), Australia's population is projected to grow at 1.3 per cent per year, which is slightly below the average growth rate of the past 40 years. If this were to occur, the population would reach 39.7 million in 2054-55, up from 23.9 million today.

Net overseas migration has a significant impact on population projections. Net overseas migration is mainly comprised of permanent migration (including skilled and family) and temporary migration (including temporary skilled and students). The central assumption of this report is that net overseas migration will be 215,000 people a year beyond the current forward estimates, which is based on current permanent migration intake settings.

The permanent migration intake, which was increased significantly during the mining boom, is reviewed each year in the context of the budget to reflect evolving economic and social circumstances. Temporary migration (including temporary skilled and

students) has also been an important driver of increases in net overseas migration over the past decade.

Participation

Participation refers to the proportion of the population of people aged 15 years and over who are actively engaged in the workforce.

The community and economy will benefit from opportunities to support older Australians who want to work, as well as boosting opportunities for women, young people, parents and people with disability to participate in the workforce. This can be achieved through policies that support people who choose to stay in the workforce for longer, or re-enter it sooner after a temporary absence.

Over the next 40 years, the proportion of the population participating in the workforce is expected to decline as a result of population ageing. A lower proportion of Australians working will mean lower economic growth over the projection period.

By 2054-55, the participation rate for Australians aged 15 years and over is projected to fall to 62.4 per cent in 2054-55, compared with 64.6 per cent in 2014-15.

That said, female employment is projected to continue to increase, following on from strong growth over the past 40 years. In 1975, only 46 per cent of women aged 15 to 64 had a job. Today around 66 per cent of women aged 15 to 64 are employed. By 2054-55, female employment is projected to increase to around 70 per cent.

Nonetheless, Australia's female participation rates remain lower than some other advanced economies such as Canada and New Zealand, and more can be done to encourage women to enter and stay in the workforce. Policies that help to continue to boost female participation will help Australia achieve an even higher level of future prosperity.

As Australians live longer and do so in better health, more Australians will continue to lead an active lifestyle and participate in the workforce after they reach traditional retirement age.

Participation rates among those aged 65 and over are projected to increase strongly, from 12.9 per cent in 2014-15 to 17.3 per cent in 2054-55. This represents a significant opportunity for Australia to benefit more from the wisdom and experience of people aged over 65.

Productivity

Of the three key drivers of economic growth, productivity has historically been the most important to Australia's economic performance. Put simply, productivity is about working more efficiently or producing more or better quality goods and services with the same level of resources.

Australia has enjoyed periods of high productivity growth, which have contributed to growth in incomes and high living standards.

For every hour average Australians work today, they produce twice as many goods and services as they did in the early 1970s. It is no coincidence that average income per person has also broadly doubled in this period.

Technology is changing the way we interact with each other and how we live our lives. It is changing the face of business, markets, governments and social engagement.

In the 1970s, the Internet, mobile phones and social media did not exist as we know them today. Now they are integral parts of our lives and IT-related industries employ nearly as many people in Australia as the mining industry.

Technological advances, such as advanced robotics, 3D printing and self-navigating vehicles have the potential to unlock quality of life improvements.

Harnessing future opportunities to support innovation, adopt new technologies, facilitate foreign trade and investment and foster competition can boost future productivity growth and living standards.

Government policy settings will be very important to helping individuals, businesses and governments take full advantage of opportunities from technological developments so that productivity growth is maintained, or even improved.

During the 1990s, Australia's productivity growth was especially high, with an estimated average of 2.2 per cent growth per year. This has been widely attributed to economic reforms during the 1980s and 1990s. These reforms created more competitive and flexible markets in which businesses became more efficient and innovative, and new and improved technologies were adopted.

More recently, our productivity growth has slowed, with an average of 1.5 per cent growth per year observed through the 2000s.

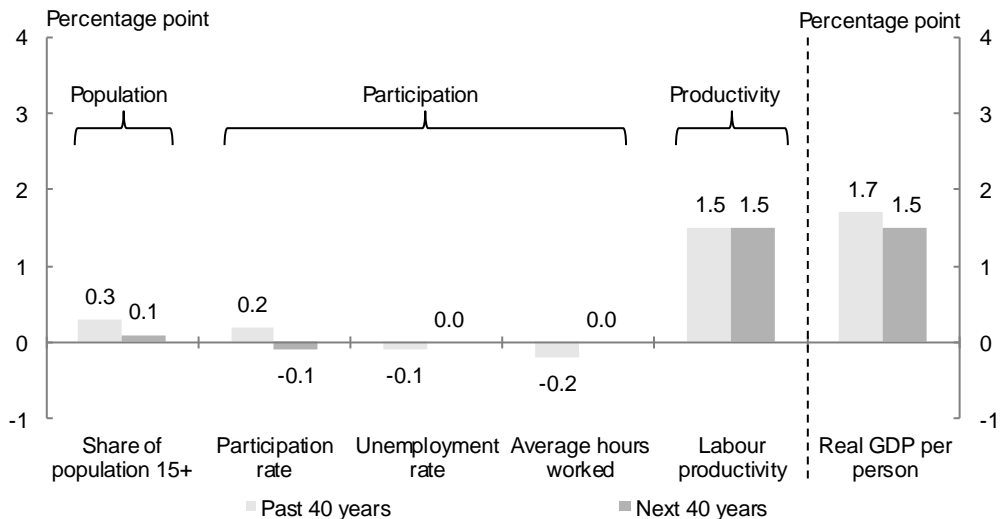
This report takes historical productivity growth as a guide, and assumes that average annual labour productivity growth over the next 40 years will be 1.5 per cent. Reforms to enhance productivity over the next 40 years will be crucial if we are to achieve the growth in living standards we have enjoyed since the mid-1970s.

Economic projections

Taken together, population, participation and productivity drive the economic growth projections in this report.

With an ageing population, economic growth is projected to be slightly slower over the next 40 years than over the past 40 years. Slower growth is due to slightly lower projected population growth and declining participation rates.

Chart 1 Components of real GDP growth per person



Source: ABS cat. no. 5206.0, 6202.0 and Treasury projections.

However, it is important to acknowledge that the past 40 years include an unprecedented 23 year stretch of unbroken economic growth that is continuing.

This has only been matched by one other advanced country, the Netherlands, which experienced close to a 27 year stretch of unbroken economic growth between 1981 and 2008.

It is also important to keep in mind that the long-term projections look through business cycles and assume a smooth growth path through to 2054-55. In reality, it is almost certain that any economy will go through such cycles over a 40 year time period. However, the outlook to 2054-55 will not be driven by these cycles, but by the underlying trends in population, participation and productivity.

The average annual growth of real GDP is projected to be 2.8 per cent over the next 40 years compared with 3.1 per cent over the past 40 years. Average annual growth in real GDP per person is projected to be 1.5 per cent over the next 40 years compared with 1.7 per cent over the past 40 years.

National income growth is expected to slow more markedly than real GDP growth as the decline in the terms of trade takes place during the current decade and the construction phase of the mining boom ends.

Real gross national income (GNI) per person is the measure of how much we earn, not just what we produce. Real GNI per person is projected to grow at 1.4 per cent over the next 40 years, compared with 1.9 per cent over the past 40 years. If this level of growth is achieved over the next 40 years, the annual average Australian income will increase from \$66,400 today to \$117,300 in 2054-55 in today's dollars.

Over the next 40 years, changes in the share of population aged 15 and over are projected to make a small positive contribution (0.1 percentage points) to average annual GDP growth per person. This is less than its contribution over the past 40 years.

Increasing participation rates contributed 0.2 percentage points to average growth over the past 40 years. Over the next 40 years declining participation is projected to detract 0.1 percentage points from average growth.

This report illustrates why, over the next 40 years, ongoing improvements in Australian living standards will remain primarily contingent upon continually improving our productivity, and require us to take every opportunity to increase participation rates.

Environment

The environmental changes that unfold over the next 40 years will affect Australians' quality of life across a range of dimensions.

It is difficult for individual governments to control or affect the collective and cumulative impact of human activity globally, but there is a role for the Australian Government to continue in its efforts in leading and coordinating domestic environmental policies to drive better environmental management and economic growth for the generations to come.

Economic growth and strong environmental outcomes are complementary objectives. Policies that create strong economic growth and a sustainable budget will mean that governments are better placed to invest in environmental protection. Additionally, protecting the environment can also contribute to economic growth, particularly in sectors such as tourism.

2. Government budgets over the next 40 years

Chapter 2 explores the current state of the Australian Government budget and how economic and demographic trends are projected to impact the budget over the next 40 years.

The fiscal position contained in the 2014-15 Mid-Year Economic and Fiscal Outlook (MYEFO) is the starting point of this report. Three scenarios are presented to illustrate the long-term sustainability of alternative policy settings:

- The scenario '**previous policy**' shows fiscal projections associated with the set of policies in place prior to the 2014-15 Budget.
- The scenario '**currently legislated**' shows fiscal projections on the basis of laws passed by the Australian Parliament. It shows the anticipated fiscal outcomes based on the current state of play, given that a range of policies the current Government announced in the 2014-15 Budget remain unimplemented.
- Finally, the scenario '**proposed policy**' shows fiscal projections based on the full implementation of the policies of the government of the day. This scenario follows the usual practice of presenting fiscal projections on the basis of announced policy (as taken to the 2014-15 MYEFO), and assumes all outstanding measures are implemented.

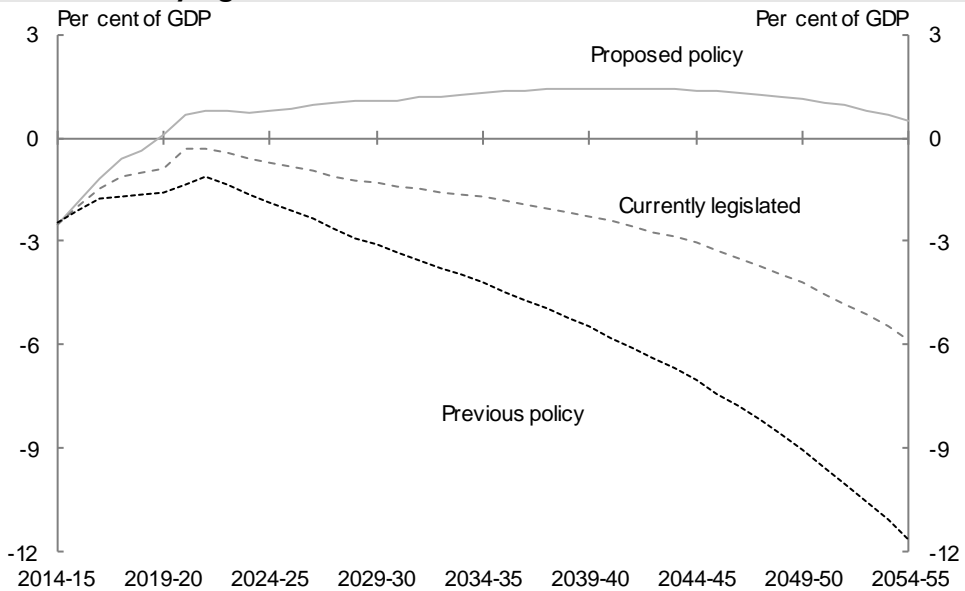
The first two scenarios show an unequivocal deterioration in fiscal sustainability. The third scenario shows that the Government's current set of policies would bring the budget back to a sustainable path over the medium to long term.

The scenarios show that repairing the budget is possible, and is well underway. However, the policies currently legislated would not see the budget in surplus at any point over the next 40 years. If all outstanding measures — or alternatives of similar value — were implemented, the budget would be on track to a sustainable surplus.

Fiscal aggregates

Under the ‘previous policy’ scenario, by 2054-55, the underlying cash deficit is projected to reach 11.7 per cent of GDP (\$532.8 billion in today’s dollars) (Chart 2). However, considerable progress has been made under the ‘currently legislated’ scenario with the underlying cash deficit projected to almost halve to around 6 per cent of GDP (\$266.7 billion in today’s dollars) by 2054-55. The ‘proposed policy’ scenario projects the underlying cash balance to improve from a deficit of 2.5 per cent of GDP in 2014-15 to a sustained surplus from 2019-20 to the end of the reporting period.

Chart 2 Underlying cash balance



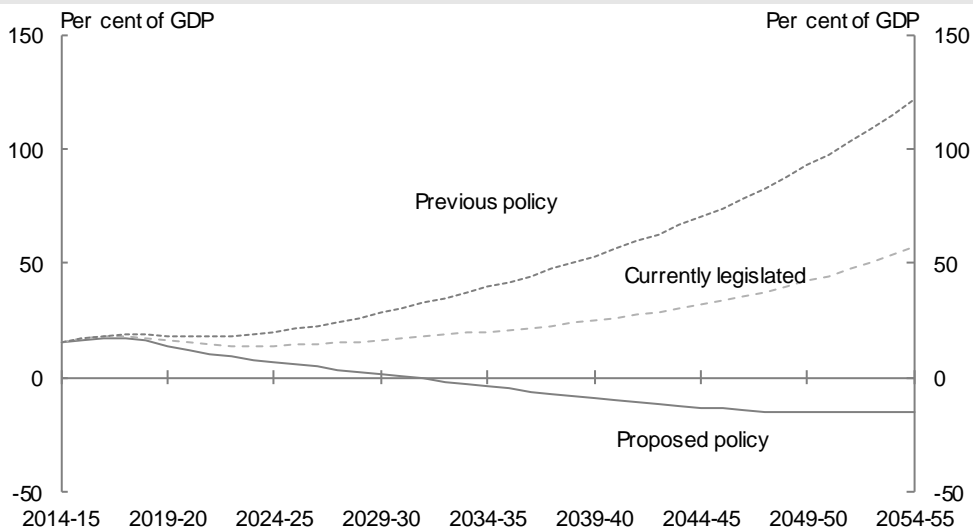
Note: Net Future Fund earnings are included in projections of the underlying cash balance from 2020-21.
 Source: Treasury projections. Projections assume trend economic growth from 2021-22 to 2054-55.

Similarly, under the 'previous policy' scenario, net debt is projected to reach 122 per cent of GDP (or \$5,559 billion in today's dollars) by 2054-55 (Chart 3).

The 'currently legislated' scenario projects that net debt would more than halve to 60 per cent of GDP (or \$2,609 billion in today's dollars).

If the 'proposed policy' scenario were to eventuate, net debt would decline from 15.2 per cent of GDP in 2014-15 to be zero by 2031-32, after which the Australian Government is projected to begin accumulating assets utilising underlying cash surpluses.

Chart 3 Net debt



Note: The projections of net debt include net interest payments.

Source: Treasury projections. Projections assume trend economic growth from 2021-22 to 2054-55.

The debt levels in both the 'previous policy' and 'currently legislated' scenarios would negatively impact economic growth, waste significant resources on interest payments, and leave Australia exposed in the event of an economic downturn. Ireland's experience during the Global Financial Crisis, which saw gross debt reach 124 per cent of GDP in 2013, is a warning of how rapidly government balance sheets can deteriorate in the face of large economic shocks.

In contrast, the 'proposed policy' scenario would afford scope for future governments to reduce taxes and make productivity-enhancing investments to improve the resilience of the budget to future economic shocks.

Nevertheless, we are living beyond our means. The Australian Government is currently spending over \$100 million a day more than it collects, and is borrowing to meet the shortfall.

Government expenditure

The report outlines in detail the projected trends in the main items of government spending.

Over the next 40 years, Australian governments will face increasing fiscal pressures as the population grows and ages. The report considers the anticipated patterns of spending across the programs most affected by demographic factors: health expenditure, Age and Service Pensions and aged care funding.

Based on 'previous policy', the ratio of payments to GDP would have been on track to reach 37.0 per cent in 2054-55. This would be dramatically higher than the historic high of 27.6 per cent in 1984-85. If left unchecked, this would mean drastic future cuts to payments, higher taxes, or both.

Australian Government real **health expenditure** per person is projected to more than double over the next 40 years.

Australian Government health expenditure is projected to increase from 4.2 per cent of GDP in 2014-15 to 5.5 per cent of GDP in 2054-55 under the 'proposed policy' scenario. In today's dollars, health spending per person is projected to more than double from around \$2,800 to around \$6,500. State government expenditure is also expected to be significantly higher.

If no changes to policy had been made, health expenditure was on track to reach 7.1 per cent of GDP in 2054-55 under the 'previous policy' scenario.

The report explains how non-demographic factors, including higher incomes, health sector wages growth and technological change, are more significant drivers of the projected increase than demographic changes. The area of largest growth is Medicare services, which is projected to increase by over 15 per cent per person in real terms over the next decade.

Payments made through **Age and Service Pensions** are projected to increase each year. In today's dollars, spending per person is projected to increase from almost \$2,000 in 2014-15 to around \$3,200 in 2054-55. As a share of GDP, these payments are expected to broadly stabilise. This is as a result of the structural changes to indexation and age of eligibility proposed in the 2014-15 Budget.

Age and Service Pension payments are currently equal to 2.9 per cent of GDP. In the 'proposed policy' scenario, this is projected to stand at 2.7 per cent of GDP in 2054-55, when real incomes per person will be much higher. If the structural changes to indexation and age of eligibility are not implemented, spending is projected to continue rising over the period, reaching 3.6 per cent of GDP by 2054-55.

A significant change over the past 40 years has been the increase in the number of people accessing aged care services. The Australian Government provides **aged care funding** for residential aged care and a range of community care services, including care in the home. Australian Government expenditure on aged care has nearly quadrupled since 1975. Expenditure is projected to nearly double again as a share of the economy by 2055, as a result of the increase in the number of people aged over 70. Specifically, under the 'proposed policy' scenario, expenditure is projected to increase from 0.9 per cent of GDP in 2014-15 to 1.7 per cent of GDP in 2054-55, and from \$620 to \$2,000 in real, per person terms.

A range of Australian Government programs provide income support to individuals, for example Family Tax Benefit and the Disability Support Pension. Successive governments have taken steps to make payments to individuals more sustainable.

Total Australian Government **payments to individuals**, excluding the Age and Service Pensions, are projected to fall as a proportion of GDP as a result of changes in the structure of the population and rising incomes. This result is in line with the 2010 Intergenerational Report. Under the 'proposed policy' scenario, expenditure is projected to fall from 4.5 per cent of GDP in 2014-15 to 3.2 per cent of GDP in 2054-55. If the 2014-15 Budget measures remain unimplemented, projections in the 'currently legislated' scenario show that expenditure on payments to individuals are projected to fall less, to 3.4 per cent of GDP by 2054-55.

In aggregate, Australian Government spending on **education and training** is projected to be maintained in real terms per person over the reporting period. Once higher education and vocational education loans are also taken into account, the amount the Australian Government provides per person (in today's dollars) is projected to rise from \$1,500 in 2014-15 to \$1,900 in 2054-55.

Total government spending on the **National Disability Insurance Scheme (NDIS)** is projected to increase rapidly from less than 0.1 per cent of GDP in 2014-15 to 1.1 per cent in 2019-20. Spending on the NDIS is then projected to be broadly stable at 1.1 per cent of GDP between 2019-20 (when fully operational) and 2054-55. The Australian Government's contribution is projected to grow as a proportion of the total NDIS spending, increasing from under 55 per cent in 2019-20 to around 75 per cent in 2054-55.

Consistent with government policy, **defence** expenditure is projected to remain at 2 per cent of GDP through to 2054-55.

Revenue

The Australian Government collects the majority of Australia's taxation revenue. The largest source of taxation revenue for the Australian Government is income taxes, comprising taxes on both personal income and corporate income. The Australian Government also taxes goods and services.

The composition of Australian Government taxes and heavy reliance on income taxes has remained largely unchanged since the 1950s. Over the past fifteen years, some modest compositional changes in tax revenue have occurred partly as the result of movements in commodity prices and policy changes (for example, the introduction of the GST).

Tax receipts are projected to continue to recover following the Global Financial Crisis. Under current policy settings, the tax-to-GDP ratio would reach the long-term assumption of 23.9 per cent of GDP in 2020-21. This is expected to be largely driven by 'bracket creep', which occurs when rises in nominal income from employment and investments push people into higher income tax brackets over time. Bracket creep will entail an increase in the personal income tax burden. Beyond 2020-21, projections of tax receipts are assumed to remain capped at a constant 23.9 per cent of GDP. This ratio of tax-to-GDP reflects the average of the period 2000-01 to 2007-08.

Although projections in this report have been prepared on the basis of the current tax settings, a better tax system would help Australia to take advantage of global opportunities and improve economic growth.

In recent decades, financial deregulation, the growth of multinational companies using global supply chains and the increasing digitisation of global commerce have all transformed the economic environment in which tax systems operate. This is putting strain on the tax system in Australia, as well as all around the world. Other economies are responding with reforms that reduce the average burden of corporate tax, while also addressing global tax avoidance activities. Australia's reliance on corporate income taxes is amongst the highest in the developed world and significantly higher than key regional competitors.

Bracket creep and higher personal income taxes also impact on participation incentives for some people. Increases in workforce participation will have a strong influence on future economic growth, alongside productivity improvements.

Governments need to manage carefully the taxes collected from Australians and ensure that they are allocated judiciously and prudently. Unchecked government spending would require even higher taxes or severe future spending cuts, posing difficult allocative decisions for subsequent governments.

Superannuation

The superannuation system helps Australians enhance their retirement incomes, and supplement or reduce reliance on the Age Pension.

Employers are currently required to make minimum payments equivalent to 9.5 per cent of an employee's salary to a superannuation fund, to help the employee save for retirement. This rate is scheduled to rise to 12 per cent between 1 July 2021 and 30 June 2026.

Total Australian superannuation assets have increased strongly since compulsory superannuation was introduced in 1992. At the end of 2013-14, total superannuation assets were \$1.84 trillion, around 116 per cent of GDP. As the superannuation system matures and wages grow, total Australian superannuation assets are expected to continue to increase and make a growing contribution to national savings.

As more Australians receive compulsory superannuation contributions for longer periods of their working lives, they are likely to retire with higher superannuation balances. This will have important implications for reliance on payments made through the Age Pension.

An ageing population also underlines the importance of considering the overall adequacy of our retirement incomes system — which combines compulsory and voluntary superannuation, and the Age Pension as a safety net. The Government will consider several aspects of the superannuation system as part of the review of the tax system. The Government is also considering improving the way in which the superannuation system transforms savings into retirement income streams.

Major balance sheet items

The Australia Government currently has a gross debt of around \$360 billion, equivalent to around 22 per cent of GDP, and it is continuing to rise. Without stabilising and reducing this debt, the 'previous policy' scenario shows that future generations will not only have to fund their own government services, they will be funding the services used by Australians today.

Without the Government's budget repair strategy, the 'previous policy' scenario projects gross debt will reach \$5,707 billion in today's dollars, and 125 per cent of GDP by 2054-55. With budget repair efforts reflected in the 'currently legislated' scenario, gross debt projections have halved to \$2,820 billion in today's dollars, and 61.8 per cent of GDP by 2054-55.

If all policy measures were implemented, as in the 'proposed policy' scenario, Australia would be on course to pay off this debt. Gross debt is projected to peak at 26.1 per cent of GDP in 2016-17 and is projected to decline as it is paid off.

Once the budget returns to balance, new debt issuance will no longer be needed to finance government activities. However, the Government is committed to a well-functioning and liquid debt market. In this report, government debt on issue is assumed to be maintained equivalent to 13 per cent of GDP from the late 2020s.

The Australian Government's public sector defined benefit superannuation liability is expected to decline from around 10 per cent of GDP currently to less than 2 per cent of GDP by 2054-55. This reflects the phase-out of defined benefit superannuation schemes in favour of self-funding accumulation schemes. Around \$400 billion of Australian Government superannuation payments between 2020 and the mid-2040s will be funded from the Future Fund.

3. Preparing for the future

Chapter 3 prompts consideration of the policy settings required to build jobs, growth and opportunity and ensure that Australians continue to enjoy higher living standards over the next 40 years.

The annual growth in real GDP is projected to average 2.8 per cent over the next 40 years, compared with 3.1 per cent over the past 40 years.

Continued steps to boost productivity and encourage higher workforce participation will be critical to driving this economic growth. Budget repair must also be delivered to stabilise and reduce debt, and position governments to respond to any future economic shocks.

To enhance both productivity and participation, Australia will need a better tax system to deliver taxes that are lower, simpler and fairer. A well-structured tax system can assist in making Australia a more attractive place to invest, boost economic growth and create new jobs. The forthcoming review of the tax system will provide a longer-term, considered approach to tax reform.

To ensure government expenditure is sustainable and better targeted, particularly as we face major demographic change, governments need to focus their efforts on achieving the efficient provision of services.

Different levels of government need to work together as efficiently and effectively as possible. The Government is working with the States and Territories to produce a White Paper on the Reform of the Federation to clarify roles and responsibilities. The objective is to reduce and end, as far as possible, waste, duplication and second-guessing between different levels of government.

It will be critical to continue to support workforce participation, and there are many opportunities to do so. A number of existing policy measures are designed to support the participation of mature age job seekers, people with disability, youth, women, prospective parents, and parents. Other measures are designed to assist the unemployed into work. Encouraging higher participation requires constant and ongoing reform commitment from the Government and all Australians.

Australia's future productivity performance will be influenced by technological developments, both domestically and abroad, which create new possibilities for production. As a net importer of technology, the pace of global innovation and Australia's ability to absorb technological advances from abroad and convert them into new business opportunities will be particularly important.

It is also important that government policies facilitate the development of new markets, and allow businesses and the public sector to harness innovation. The Government's policy agenda will support productivity growth by helping to position Australian

businesses to be flexible, competitive and robust in the face of dynamic global conditions. To this end, the Government is:

- making and facilitating investments in critical aspects of Australia's infrastructure;
- delivering three new free trade agreements with South Korea, Japan and China, and negotiating other agreements, including negotiations with India and the Gulf States;
- reducing the complexity and scale of the compliance burden on business through a continued focus on red and green tape reduction;
- establishing the Digital Transformation Office with the objective of delivering government services digitally from start to finish to better serve the needs of citizens and businesses;
- undertaking a comprehensive review of Australia's workplace relations framework to ensure the existing laws are meeting their objectives and contributing to productive, rewarding, competitive, and harmonious workplaces;
- considering its response to the final report of the inquiry into the performance of the Australian financial system (the Murray Inquiry); and
- expecting to receive the final report of the review of competition policy in March 2015.

The fiscal projections in this report show that progress has been made to repair the budget. However, the task is incomplete.

Without the Government's proposed policies, or alternative savings measures, the budget will not return to surplus at any point over the next 40 years and net debt will rise to almost 60 per cent of GDP by 2054-55, or \$2,609 billion in today's dollars.

The projections highlight the importance of placing the budget in the strongest possible position to meet whatever challenges the future may bring. Continued budget discipline together with policies that promote growth will help to avoid the need for a sharper adjustment in the future and to afford quality government services in the years to come.

The 2015 Intergenerational Report shows that we can have a positive and more prosperous future if we plan for tomorrow, today.