

# *The 2015 Intergenerational Report – A snapshot*

Last week, the Australian Government delivered the fourth Intergenerational Report (IGR).

PwC's snapshot outlines the main findings of the IGR and its insights on the future for our country, the implications for the fiscal health of the Federal Government and the case for tax reform.

How will Australia be affected by an ageing population? How will we support substantial population growth?

What will be the focus of Government spending in 2055?

What does this mean for tax reform and the Federal Budget?

*March 2015*

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# 1 *Australia in 2055*

The Australian Government has delivered the fourth Intergenerational Report, five years after the previous iteration in 2010.

While the primary purpose of the report is to provide an indication of future fiscal conditions, the IGR also provides a snapshot of what sort of society Australia will be in 2055.

## **Australia's population**

Australians will be older in 2055. This appears starkest in the oldest age categories. In 2055, there will be close to two million people aged 85 or over; almost five per cent of the population. There will also be 40,000 people over 100 years old, a nine-fold increase on today and swamping the 122 centenarians in 1974-75.

A substantial factor behind the increased numbers of elderly is increases in life expectancy. A man born today can expect to live 91.5 years, a woman 93.6 years. For those born in 2055, life expectancy will be an even higher 95.1 and 96.6 years for men and women respectively.

The net result of this ageing that there will be only 2.7 people aged 15 to 64 for each person over 65 years. This is down from the current 4.5 people and a massive drop from the 7.3 people in 1975.

Of the older population, a greater proportion will be working. There will be 17.3 per cent of over 65s in the workforce, compared to 12.9 per cent today. As such, the ratio of under to over 65s may not be the best measure of whether there is a sufficient tax base to support the ageing population.

More women will also be working, with participation increasing from 66 per cent to 70 per cent over the next 40 years.

The combination of increasing life expectancy and high immigration will mean a much more populous Australia in 2055. The expected 39.7 million Australians is a 60 per cent increase on today.

Despite the warnings implicit in the IGR, Australians in 2055 will be much wealthier. Real income per person is projected to be \$117,300 in 2054-55, compared to \$66,400 today. However, this increase in wealth is a slowdown on growth over the previous 40 years. Further, income growth may be even lower if the productivity assumptions in the IGR are not met.

## **Supporting a larger, older population**

The increased number of elderly will require substantially more aged care places; 955,000 aged care places in 2055, compared to the 252,000 places available in 2012.<sup>1</sup>

These places will need to deal with a substantially higher level of dementia. About 10 per cent Australians over 65 years old have dementia. At this rate, the number

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<sup>1</sup> Based on Australian Government target of 113 places per person over 70 years of age

of Australians with dementia would increase from 308,000 people in 2011 to 890,000 people in 2055.

Even though the focus of the IGR tends to be on the aged, there is substantial population growth in all age groups. This affects the number of students and schools, with another 5,000 schools required in 2054-55 to cater for the 2.1 million extra students.<sup>2</sup>

Population growth over the next 40 years will also have major infrastructure implications. The increase of 15.9 million people is 3.3 times the current population of Sydney or 7.1 times that of Brisbane. Infrastructure of that scale will need to accommodate them. If car ownership continues at current rates, Australian cities will have 11.9 million more vehicles than on the road today.

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<sup>2</sup> Based on numbers of school aged students and assuming average school size remains constant.

## 2 *Australia's fiscal future*

The IGR contains analysis based on three scenarios for Federal fiscal policy. These are called 'previous policy', 'currently legislated policy' and 'proposed policy'.

The analysis of previous policy departs from the practice in previous IGRs. Framed as "policies left in place by the former government" in the Treasurer's release speech, the previous policy scenario is based on the Commonwealth's budget position before the 2014-15 Federal Budget. As such, it includes actions by the current government to remove the mining and carbon taxes and cancel some savings measures.

The currently legislated and proposed policy scenarios reflect the budget position based upon those laws currently enacted by Parliament and the position if all policies of the current government were implemented.

### *A warning*

The currently legislated policy scenario results in a fiscal deficit of 5.8 per cent of GDP in 2054-55. This projection closely reflects PwC's recent analysis of Australia's position,<sup>3</sup> projecting a deficit of 6.5 per cent of GDP in 2050 (Table 1).

The projected deficits in this scenario lead to a net debt position of 57 per cent of GDP in 2054-55, again similar to PwC's projection of 56 per cent of GDP in 2050. A major component of the deficit is interest payments on the net debt, with the primary cash deficit excluding interest payments being a smaller 2.4 per cent of GDP.

The proposed policy scenario sees the budget return to surplus in 2019-20 and remain in surplus through to 2045-55. The government would have an overall net surplus at that point.

**Table 1 The fiscal gap**

Budget area	Percentage of GDP 2014-15	Percentage of GDP 2054-55		Percentage of GDP 2049-50	
		Currently legislated	Proposed policy	2010 IGR	PwC projections*
Underlying cash deficit	2.5%	5.8%	-0.5%	3.8%	6.5%*
Net debt	15.2%	57.2%	-15.0%	20.2%	55.7%
Primary cash deficit (excl. interest)	1.8%	2.4%	0.0%	2.7%	4.5%

Source: 2015 Intergenerational Report; 2010 Intergenerational Report; PwC analysis

Note: PwC projection is based on current legislation. PwC also uses operating cash balances rather than underlying cash.

<sup>3</sup> See PwC (2015) 2014-15 MYEFO Update, Available at <http://www.pwc.com.au/tax/assets/MYEFO-Update-13Feb15.pdf>

Beyond interest payments, increased spending in four major areas drives the deterioration in Australia's financial position in the IGR's currently legislated policy scenario (Table 2):

- Health spending increases from 4.2 per cent to 5.7 per cent of GDP, although non-demographic factors primarily drive the increase. Only 10 per cent of the increase is due to demographic change, with higher incomes and health sector wages and new technologies more important factors.
- The NDIS is phased in, with expenditure increasing from 0.1 per cent to 1.1 per cent of GDP over the forecast period.
- Pension outlays increase due to an increasing proportion of people of pension age.
- Aged care expenditure also increases with the ageing population.

The proposed policy settings eliminate the deficit primarily through targeting spending in two areas:

- Education spending in the proposed policy scenario is half that under the currently legislated scenario. The reductions are achieved through, among other things, changes to indexation of school and higher education funding, and higher education reforms such as increasing student contributions and increasing interest on HELP debts.
- Pension eligibility age and indexation are proposed to be changed.

One other major change worth noting relates to health. Health expenditure is markedly lower under the 2015 IGR's currently legislated and proposed policy scenarios than in the 2010 IGR. This is largely due to changes in hospital funding and private health insurance rebates in the previous Federal Budget, which raises the question of how the states and territories will address the hospital funding gap.

**Table 2 Components of the fiscal gap**

Budget area	Percentage of GDP 2014-15	Percentage of GDP 2054-55		Percentage of GDP in 2049-50	
		Currently legislated	Proposed policy	2010 IGR	PwC projections*
Health	4.2%	5.7%	5.5%	7.1%	7.1%
NDIS	0.1%	1.1%	1.1%	NA	NA
Education	1.7%	2.0%	1.0%	1.9%	4.9%
Pensions	2.9%	3.6%	2.7%	3.9%	4.1%
Aged care	0.9%	1.7%	1.7%	1.8%	NA
Payments to individuals	4.5%	3.4%	3.2%	3.0%	4.5%

Source: 2015 Intergenerational Report; 2010 Intergenerational Report; PwC analysis

Note: PwC projection is based on current legislation. PwC health projection includes NDIS. PwC's incorporation of aged care expenditure into its projections is not directly comparable to that in the IGR.

# 3 Modelling the future

The future described in the IGR is uncertain and heavily dependent on the assumptions used to derive the projections.

## Life expectancy

One of the most material changes relative to previous IGRs is a change to the life expectancy methodology. Previous IGRs used ‘period life expectancy’, which is the expected lifespan of someone who has the same mortality rate at each stage of their life as someone of that age today.

However, technological and other changes will reduce mortality rates in the future. ‘Cohort life expectancy’ accounts for these changes and is used in the latest IGR, resulting in materially higher life expectancies. For instance, for males and females born in 2014-15, improvements in mortality rates are anticipated to add 10.8 years and 8.8 years respectively.

There was a large increase in life expectancy between the first and second IGRs, reflecting decreased mortality rates. Period life expectancy is then essentially flat through the next three IGRs, with the large increase in the 2015 IGR reflecting the change to a cohort life expectancy methodology (Table 3).

**Table 3 Shifts in demographic assumptions**

	Total fertility rate (children per woman)	Net overseas migration (persons)	Period life expectancy at birth in 2050 (years)		Cohort life expectancy at birth in 2055 (years)	
			Males	Females	Males	Females
IGR1 (2002)	1.6	90,000	83.2	88.2		
IGR2 (2007)	1.7	110,000	87.6	90.2		
IGR3 (2010)	1.9	180,000	87.7	90.5		
IGR4 (2015)	1.9	215,000	87.5 (88.1*)	90.1 (90.5*)	95.1	96.6
ABS Series B (2013)	1.8 (from 2026)	240,000 (from 2021)	84.4	87.7		

Source: 2015 Intergenerational Report; 2010 Intergenerational Report; 2007 Intergenerational Report; 2002 Intergenerational Report; ABS Population Projections

Note: The bracketed life expectancies are the period life expectancies for 2055 as reported in the 2015 IGR.

The use of cohort life expectancy is also a contrast to use of period life expectancy by the ABS in its population projections.<sup>4</sup> PwC’s population projections are based on the ABS’s medium scenario.

## Migration

Australian net overseas migration peaked at 300,000 people in 2008-09, and in 2013-14 was 212,700 people. The IGR assumed entry will continue at that level, although given the presence of occupational caps and other restrictions, entry could likely be increased if the government desired.

<sup>4</sup> ABS (2013) 3222.0 - Population Projections, Australia, 2012 (base) to 2101

The assumption of constant 215,000 net overseas migration annually from 2018-19 effectively results in declining migration as a proportion of total population, falling to just over 0.5 per cent per year in 2054-55. Given the effect increasing migration could have on ameliorating the effects of population ageing, it may not be realistic to assume that government would not use this lever.

The net migration assumption in the IGR is lower than the ABS's medium scenario assumption of 240,000 people per year. However, as in the IGR, the ABS assumption of a constant level of migration results in migration being a declining proportion of total population.

### **Population**

Despite the differences between the 2015 IGR assumptions and those underpinning the ABS medium scenario population projection, the total population projections for 2055 are around 40 million in both cases. Higher migration in the ABS projections is effectively counteracted by lower fertility and lower life expectancy assumptions in the IGR.

### **Participation**

The ageing of the population leads to a decrease in workforce participation, with only 62.4 per cent of those aged 15 years and over participating in the workforce in 2054-55. This is a decline from 64.6 per cent in 2014-15 and the peak of 65.5 per cent in 2008-09. This is despite continued increases in workforce participation for 15-64 year olds, increasing from 76.2 per cent today to 79.3 per cent in 2054-55.

PwC is more pessimistic about participation rates, projecting participation of 61.0 per cent among those aged 15 years and over in 2049-50. This difference stems from the IGR's assumptions of much stronger workforce participation by women, and the positive effect of welfare and education reforms on participation. To the extent these optimistic assumptions are not met, participation will be lower than the IGR has forecast.

### **Health expenditure**

As seen in Table 2, the expenditure components for health, education, pensions and payments to individuals are higher under the PwC modelling assumptions than in the IGR. There are substantial differences in assumptions for most expenditure components.

Health expenditure from 2027-28 onwards in the IGR is based on an aggregate model that assumes non-demographic growth trends, while PwC assumed that health expenditure is linked to the individual components including the PBS, MBS, hospitals and private insurance. When coupled with an implicit IGR assumption that there will be no need to cover the hospital funding gap created in the previous Federal Budget, the projected health costs in the IGR appear optimistic.

### **Education expenditure**

For education, the IGR has factored in a trend towards enrolments in non-government schools. PwC assumed the mix of schooling of government and non-government schools will not change. To the extent the IGR assumption of a transition to non-government schooling does not occur, the IGR projections will underestimate education expenditure.

# 4 The case for tax reform

The IGR contains little analysis or consideration of tax reform, beyond noting that a better tax system is needed to improve productivity and participation. The report states that Australia needs lower, simpler and fairer taxes, although lower taxes may not be realistic unless even more drastic action is taken on spending.

## The IGR's tax assumptions

All scenarios in the IGR are based on an assumption that taxation will be a constant 23.9 per cent of GDP from 2020-21. Given progressive income tax brackets and increasing worker wages, a constant level of taxation implies bracket creep is handed back to taxpayers through regular tax cuts. This is likely not a realistic outcome, particularly if there is any budget stress.

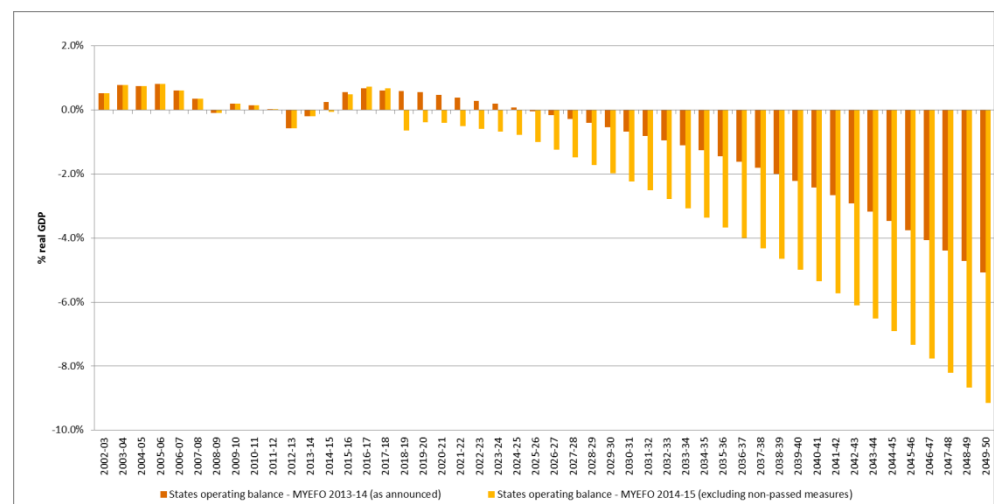
Possibly even less realistic is the assumption that GST will form a constant 3.4 per cent of GDP, slightly above the 2014-15 level of 3.3 per cent. Given changing demographic profiles, and that health and education expenditure is increasing at a faster rate than other expenditure areas to which GST applies, it may be optimistic to assume that the GST base will not be eroded. Any increase in savings rates will also reduce tax receipts from the GST.

The assumption of stability in taxation also hides the highly cyclical nature of many of the current tax sources, particularly company tax receipts.

## State and territory taxes

While the IGR is focused on the Commonwealth Government's fiscal position, the states and territories also face a long-term fiscal challenge, particularly given health and education are largely their responsibility. That part of the improvement in the fiscal situation between the IGR's previous and currently legislated policy scenarios is due to reduced funding of state and territory hospitals exacerbates this situation (Figure 1).

**Figure 1 Operating balances, state and territory governments, % of GDP**



Source: PwC analysis



Given the states and territories receive funding through the GST, erosion of the GST base further threatens their fiscal sustainability. Many state and territory taxes are also highly cyclical. As such, tax reform must address both Commonwealth Government, and state and territory taxation.

### **Addressing income and expenditure**

Most of the spending measures that form the basis of the IGR's proposed policy scenario require Senate support. Given it is questionable whether many of these measures will pass, tax reform must be considered in addition to spending measures to rebuild Commonwealth Government budgets and prevent ongoing deterioration of the fiscal position.

### **Tax reform is part of the intergenerational solution**

Comprehensive tax reform, covering Commonwealth, state and territory government taxes can contribute positively to productivity and economic growth, while stabilising our fiscal position. It is a key component of a broader reform agenda to improve the competitiveness and flexibility of the Australian economy, drive innovation and reduce inefficient expenditure growth.

The Government's commitment to a White Paper on the reform of Australia's Tax System is an important part of this process. Tax reform is not easy. To ensure its success, all governments, along with political, business and community leaders, will have to work together to help the community understand the need for change, what it means for them, and how a balanced and well considered reform package will support the prosperity of Australians today and into the future.

***Let's talk***

For a deeper discussion of how these issues might affect your business, please contact:



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