

**THE FISCAL AND ECONOMIC
OUTLOOK**

**ADDRESS TO THE AUSTRALIAN BUSINESS
ECONOMISTS**

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KEN HENRY

SECRETARY TO THE TREASURY

THE FISCAL AND ECONOMIC OUTLOOK

This year, I want to address three topics. I will say something about the short term macro-picture, including some words about the risks to our forecasts. I then want to say something about the medium-term fiscal strategy. And I will conclude with some remarks about longer term challenges and the progress that has been made in addressing those challenges.

Short-term performance and prospects

Domestic economy

We see growth in 2003-04 being a little stronger than we had been forecasting twelve months ago ([Chart 1](#)), with a slightly weaker contribution from the farm sector and marginally stronger non-farm GDP growth. Reflecting strong domestic demand growth and a weak trade performance, with net exports detracting 2¼ percentage points from growth, the CAD is now expected to average 5¾ per cent of GDP in 2003-04. Looking ahead to 2004-05, we see a rebalancing of growth, with domestic demand growth slowing from 6 per cent to 3¾ per cent, and net exports detracting a considerably smaller ½ percentage point from GDP growth. The CAD is forecast to fall to 5 per cent of GDP.

Consumer price inflation continues to be muted, in part due to the currency appreciation of the past two years. The non-traded components of the CPI have been growing relatively strongly in recent times, dominated by project housing construction costs and drought-related food prices. These effects should diminish through 2004-05.

The main domestic risk to our forecasts is the one we have been talking about for some years now: the way in which the property boom unwinds. And questions remain about the quality of the recovery in the farm sector. Our 2004-05 forecasts are predicated on an assumption of average seasonal conditions, but continuing dry conditions in the south-east of the country point to considerable downside risk on that front.

International economy

When I addressed you last year I noted that the world economy, which twelve months earlier had been showing signs of recovery, was disappointing on the downside.

But 2003 turned out to be quite a bit stronger than we had been thinking. And there is a lot of confidence that growth is strengthening as we move through 2004. Twelve months ago we thought the world would grow by about 3½ per cent in 2004, with the United States growing by a marginally slower 3¼ per cent. In last week's Budget we lifted those numbers to 4½ per cent and 4¾ per cent respectively. No doubt about it, our view on the numbers has changed by a considerable amount. Moreover, we would see the near-term risks as being evenly balanced.

And yet, if we compare the medium-term risks that I referred to in last year's address with those identified in this year's *Budget Statement No 3*, we see striking similarity. The major economies continue to face significant structural imbalances that could prove to be a drag on growth for some time: the United States twin deficits continue to set records; the Japanese debt overhang refuses to recede; and Europe continues to exhibit widespread structural rigidity.

Global security tensions continue, too, to overshadow world growth prospects.

Adding to those risks identified last year, we see risks posed by high and volatile oil prices and a lack of progress on multilateral trade liberalisation.

Significantly, despite a consensus view around a robust international recovery, none of the world's major central banks has raised official interest rates in the last twelve months – not in the United States,

not in the Euro Area, and not in Japan. Indeed, the US Fed cut rates by 25 basis points on 25 June last year, and the ECB cut official rates by 50 basis points on 5 June.¹

But official rates will rise as the recovery proceeds, as highly expansionary monetary policy settings are normalised. In the US there is the likelihood of strengthening price growth as excess capacity is gradually wound down, oil price increases feed through and the days of importing deflation from China come to an end. Bond rates may also be put under upward pressure around the world because of pronounced imbalances in major economy fiscal positions. The consequent higher cost of debt capital could be problematic for emerging markets and developing countries.

Medium-term fiscal strategy

Let me quote from a representative article on the fiscal stance that appeared in last Thursday's *Australian Financial Review*:²

Economists warned yesterday that the federal government's decision to plan for smaller than expected surpluses worth \$7.4 billion over the next three years left little margin for error in the event of an unexpected downturn.

They said a slump could easily erode the pool of funds available to the Treasurer, Peter Costello, for his spending spree.

Economists were also critical of the fiscal extravagance in the budget, particularly at a time when economic growth was running strongly at a rate close to its long-term average.

According to this piece economists reckon that the government should be planning for larger surpluses, for two reasons: First, growth is strong, so fiscal policy is too loose; and second, if that analysis turns out to be wrong, then the projected surpluses are so small that the budget could move, inappropriately, into deficit.

Chart 2 presents, for each of the last four budgets, the underlying cash balance estimate and projections for each of the three forward estimates years. The final column contains the budget-time estimate for year average GDP growth. You can see, immediately, a clear advantage in the piece of commentary just considered: it could have been used after every one of those budgets. Perhaps it was; I haven't checked.

But none of us should be surprised by these sorts of fiscal projections. The medium-term fiscal strategy is to maintain budget balance, on average, over the course of the economic cycle. The question is this: just what sort of surpluses would you expect this strategy to deliver in the 13th, 14th, 15th, and 16th years of an economic expansion, with growth at or around trend, and general government net debt standing at less than 3 per cent of GDP?

Even so, there has been some understandable debate about the fiscal stimulus implicit in the budget. Judging by what has been written on the topic, this is tricky stuff. And indeed, it is. Chart 3 might help us think through an answer.

Since a calculation of fiscal stimulus involves a comparison of the fiscal stance in one year with the stance in some other year, the trickiest thing is judging when to start the analysis. An obvious starting point is the 2003-04 *MYEFO* estimate of the 2003-04 budget balance published last December. This chart shows that estimate and the projections for the out-years. Then, as now, we were projecting an economy growing at or around trend.

¹ The Bank of England and the RBA have, however, raised rates above their levels of 12 months ago – in both cases by 50 basis points.

² Cherelle Murphy, "Less margin is left for error", *AFR*, 13 May 2004, p. 10.

As you can see from the chart, in December last year the Government intended that the 2004-05 surplus be 0.1 per cent of GDP smaller than the 2003-04 surplus, implying a fiscal stimulus in the year 2004-05 of 0.1 per cent of GDP. This is labelled "A" in the chart. I don't recall there being overwhelming commentary, in December, to the effect that the fiscal stance implied by this line was inappropriate, given the growth rates then being forecast.

But move forward five months, and we see the estimated surpluses confronting the Government in the pre-budget period; that is, prior to any discretionary decisions having been taken. The pre-budget position revealed an unanticipated fiscal tightening in 2003-04 of 0.56 per cent of GDP, labelled "B" in the chart; followed by an additional fiscal tightening of 0.18 per cent of GDP in 2004-05, labelled "C"; with increasing contractionary effect over the forward estimates.

Finally, we can draw in the estimates contained in last week's budget, incorporating all discretionary decisions announced in that document. Significantly, the real growth forecasts underlying these numbers are the same as at *MYEFO*.

The first thing to note is that the estimated surplus for 2003-04 is right back where it was in December; 0.6 per cent of GDP. We have estimated that the discretionary decisions taken in last week's budget will have the effect of exactly undoing the contractionary effect that we now think has been occurring since *MYEFO*. The second thing to note is that we are now estimating that the 2004-05 surplus will be less than the 2003-04 surplus by the amount labelled "D", implying a fiscal stimulus in that year of 0.3 per cent of GDP.

But we figure that "D" would understate the 2004-05 fiscal stimulus implied by the budget because the discretionary unwinding of the apparent fiscal contraction occurring in 2003-04 will impact in the last several weeks of the year.

According to Ross Gittins, 'the burning question of the hour (is) what's the biggest vote-buying budget in living memory likely to mean for the strength of demand and hence interest rates?'³ What Ross would want to measure is the impact, in the next twelve months, of the budget decisions on the aggregate demand for domestically produced goods and services. Presumably, that calculation should include some amount of the additional spending estimated for the remainder of this year.

How much of the 2003-04 spending should be included is a matter for judgement. Some of it has to be interpreted as undoing an unanticipated contraction that would otherwise occur; then, as Alan Wood noted in this morning's *Australian*,⁴ some of the remainder will be saved, some will 'leak' into imports and the rest will multiply into further spending elsewhere in the economy throughout 2004-05. A figure of around one-half of a percentage point of GDP seems to us to be a reasonable estimate of the fiscal stimulus contained in the budget.

Progress on longer term challenges

With the *2002-03 Budget* the Government released an *Intergenerational Report* that projected an increase of a little more than 5 percentage points over the next 40 years in the ratio of Commonwealth government spending to GDP. This statistic summarises the fiscal challenge posed by demographic change.

The *Intergenerational Report* was followed up in last year's *Budget Statement No 4* with an analysis of the broader economic challenges posed by demographic change, addressing the likely future sources of growth and appropriate policy responses. And in February this year the Treasurer released an important document, *Australia's Demographic Challenges*, that set out in some detail the pathways for future policy reform.

³ Ross Gittins, 'Costello's verboten subject: fiscal policy', *Sydney Morning Herald*, 17 May 2004.

⁴ Alan Wood, 'Stimulus could become a pain', *The Australian*, 18 May, 2004, p.15.

This year's budget makes tangible progress in addressing the demographic challenge. Importantly, it affirms a strong commitment to a pro-growth strategy – built around workforce participation and labour productivity – as the preferred means of addressing the fiscal challenges posed by population ageing. This is highly significant, for the emphasis that it places on supply-side policy reform.

Budget Statement No. 1 (at p.1-8) notes that 'participation and productivity measures that contributed an additional half of a percentage point to average annual GDP per capita growth would prevent government spending from increasing as a proportion of GDP as the population ages'.

This could be achieved by maintaining the 1990s rate of labour productivity growth and halving the projected decline in the labour force participation rate.

And the *More Help for Families* package emphasises the important link between participation and productivity and social programme design.

From this emerges a tantalising medium-term challenge for structural and social policy reform: to pursue participation and productivity improvements that support GDP per capita growth sufficient to avoid the need for an increase in the tax to GDP ratio over the next 40 years.

Curiously, the Government's commitment, in this budget, to a pro-growth strategy for meeting the demographic challenge has been overlooked by commentators, with some even suggesting that the Government is no longer concerned with the issues raised in the *Intergenerational Report*.

So there would appear to be a case for my spending some time outlining the basis of the pro-growth strategic approach to the demographic challenge.

A convenient means of understanding the drivers of the fiscal impact of population ageing is provided by a 'factoring' of public spending to GDP into a ratio of two quotients: in the numerator, public spending per capita; and in the denominator, GDP per capita. This is shown in [Chart 4](#).

Over the next 40 years, due to demographic and other influences on the budget, public spending per capita – our numerator – will grow in real terms by about 120 per cent. But GDP per capita – our denominator – will grow by only 80 per cent. As a consequence, the ratio of public spending to GDP will grow by a little more than 20 per cent, from about 25 per cent to a little over 30 per cent.⁵

Most of the increase in our numerator – some 70 of the 120 percentage point increase in public spending per capita – is explained by non-demographic factors; specifically by non-demographic increases in the cost of public health expenditures. But this does not mean that demography is not the big story here.

The first point to note is that if we could achieve 120 per cent growth in per capita GDP over the next 40 years we could fund the higher public spending per capita without the need to change spending or taxing programmes.

Second point: in the last 40 years we have managed GDP per capita growth of 140 per cent.

And the third, and crunch, point is that the gap between past growth of 140 per cent and projected growth of 80 per cent is more than fully explained by demography ([Chart 5](#)): Population ageing contributed 40 of the 140 percentage points growth in GDP per capita over the past 40 years, and it will detract 30 percentage points from future GDP per capita growth. That is, were it not for population ageing, GDP per capita would have grown by 100 percentage points over the last 40 years and would be projected to grow by 110 percentage points over the next 40 years.

⁵ The percentage point increase in GDP per capita is not simply the difference between 120 and 80, but rather $(120-80)/1.8$.

Judging by some of the commentary around the budget, the demographic impact on past trends in GDP per capita and public spending per capita is not well understood – even though two years have now elapsed since the release of the *Intergenerational Report*. Yet it is fundamental to an understanding of our future prospects and a weighing-up of alternative policy responses.

The next four charts illustrate some population dynamics, using a simple, highly stylised, model of four overlapping generations. Each generation lasts for 20 years, children are produced by the second generation of ‘young worker’ age, and everybody dies at age 80.⁶

Chart 6 presents the steady state population distribution with a fertility rate of 3.4, which is close to the fertility rate that obtained in Australia when the post-war baby boomers were being born. Each generation is 70 per cent larger than its parents’ generation. People aged 20 or less make up 46.8 per cent of the population, while people of retirement age (61 to 80) make up only 9.5 per cent of the population. 43.7 per cent of the population are of prime working age: 21 to 60. The total dependency ratio – ratio of children plus retirees to workers – is a large 128.8 per cent.

The key population determinant of GDP per capita is the proportion of the population of working age. And the key demographic determinant of public spending per capita is the total dependency ratio.

Now suppose the fertility rate collapses from 3.4 to 1.7, which is about the present rate in Australia. Chart 7 illustrates the population distribution in the first generation following this collapse. The most notable impact is that the proportion of the population made up of children falls from 46.8 per cent to 30.5 per cent. The number of children is only 85 per cent of the number in their parents’ generation. The proportion of the population of prime working age increases from 43.7 per cent to 57 per cent. This is good news for GDP per capita. The total dependency ratio falls from 128.8 per cent to 75.3 per cent. This is good news for public spending per capita.

In the second generation following the collapse in the fertility rate GDP per capita prospects and public spending per capita burdens look even better. As Chart 8 illustrates, people of prime working age now make up 58.5 per cent of the population. And the total dependency ratio is a low 70.9 per cent.

We are only a few years away from the end of this second transitional generation. In the next generation the transition to a new steady state, with a fertility rate of 1.7, will be complete.

Chart 9 shows what that future will look like. The most obvious change is that the older workers of today become the retirees of the future. The proportion of the population of prime working age collapses from 58.5 per cent to 49.4 per cent. And the total dependency ratio climbs from 70.9 per cent to 102.6 per cent. The substantial increase in the total dependency ratio explains the demographic component of the increase in public spending per capita projected in the *Intergenerational Report*. But it is the collapse in the proportion of the population of working age that is going to drive our GDP per capita prospects. As explained earlier, these two developments drive the 5 percentage point increase in prospective public spending to GDP.

This year’s *Budget Statement No 1* notes that the fiscal challenge posed by these demographic developments may be addressed in four ways.

Refer again to Chart 4. The first three approaches address our numerator – public spending per capita.

The first approach is to lift the average tax burden over time to fund higher public spending as it emerges. There is also a more extreme version of this approach, which ‘front-loads’ the tax burden. It would hold the average tax burden higher than it needs to be to fund current spending, in order to build up a ‘war chest’ to fund future budgetary pressures. Ross Gittins has advocated just this approach, writing last week in response to the budget that: ‘you might have thought [the Treasurer would] want to salt away any surplus revenue he came by – as the New Zealanders are doing – so as to ease the

⁶ A fuller treatment of these issues was presented to the Business Symposium of the Conference of Economists, Adelaide, 4 October 2002.

pressure later on.’⁷ This approach involves intergenerational tax smoothing, achieved by building an ‘intergeneration fund’ now that can be called on in the future to finance higher public spending.

The second approach is to reduce the rate of growth of public spending per capita. This is the approach favoured by Alan Kohler, for example. Indeed, writing in the weekend’s *Sydney Morning Herald*⁸ Alan claimed that ‘(t)he ageing of the population has just two solutions: cut spending by reducing the old age pension and/or subsidies for drugs and nursing homes, or start putting money aside now. Superannuation is part of the answer because it will means-test retired people out of a full pension, but the big problem is health care, not the pension’.

The third approach is to postpone the need to increase taxes or cut spending by accumulating public debt for as long as possible.

The fourth approach is more ambitious. It focuses on our denominator – GDP per capita. It recognises that lifting future GDP per capita performance can help to address the prospective increase in the ratio of public spending to GDP.

As I have noted, this year’s budget affirms a commitment to this fourth approach. It commits the policy strategy to the pursuit of faster GDP per capita growth. And it recognises that this commitment will have significant implications for the design of structural policies and social programmes.

At issue here is a quite profound public policy choice – as profound as any of the great policy debates of the 1980s.

Frankly, it surprises me that the debate hasn’t generated a good deal more interest.

In the hope of sparking something, let me venture a few observations about the pro-growth strategy.

First observation: The pro-growth strategy rejects the first approach, involving an increase, over time, in the average tax burden. And it certainly, therefore, rejects the rather more extreme proposition – advocated by Ross and others – that we should run higher average tax burdens now. Indeed, it would see such an approach as being inconsistent with both its means – higher workforce participation and higher labour productivity – and its ends – higher GDP per capita growth. Public infrastructure issues aside, the pro-growth strategy accepts, at least implicitly, that the nation will be better able to support an ageing population in the future if individuals, rather than governments, are today’s principal decision makers in respect of both the level of capital accumulation and its allocation.

These issues were addressed by my predecessor, Ted Evans, in remarks made to the *Towards Opportunity and Prosperity* conference hosted jointly by the *Melbourne Institute* and *The Australian*, last year.⁹ Here are some of the comments he made – I am paraphrasing a little:

The idea (of an intergeneration fund) is soundly enough based in the field of personal finance and it might make some political sense in the field of public finance. But its basis in economics is weak. It may not do much harm but it will detract attention from what must be done.

Let us be clear that the ability of future generations, and their governments, to meet the needs of their day will be entirely dependent upon the size of the economy they command at the time – that is, the size of GDP then or, more precisely, of Gross National Product (GNP).

⁷ ‘Budget 2004’, *Sydney Morning Herald*, 12 May 2004, pp. 1, 10.

⁸ Alan Kohler, ‘Treasurer makes a big mess worse’, *Sydney Morning Herald*, 15 May, 2004.

⁹ Ted Evans, ‘The Budget Constraint’, University of Melbourne, 14 November 2003.

Hence the greatest contribution that today's population can make to the living standard of future generations is to ensure that today's policies are directed towards maximising future GNP.

It may well be that Australia's future GNP could be maximised by setting aside certain of today's tax revenue in a well-managed intergeneration fund – though I doubt it. More to the point I doubt that the question has even been addressed in those terms.

It may just as well be that future GNP would be maximised by leaving the tax revenue in the hands of its present owners, to invest as they will.

Second observation: The pro-growth strategy rejects the third approach to the demographic challenge, for the same reason that it rejects the first approach. Accumulating public debt as the costs of an ageing population hit the budget simply means even higher, deferred, future tax burdens.

Third observation: The pro-growth strategy does not, in itself, offer a view on the approach that should be adopted with respect to the evolution of aggregate public spending per capita. For example, it leaves room for a debate about the contribution that a higher aggregate level of public infrastructure spending – hard or soft – might make to participation and productivity, and hence to GDP per capita. I am going to say immediately that, important as it is, I have no intention of entering this debate publicly myself.

But while the pro-growth strategy does not take a view on aggregate public spending per capita, it most certainly does take a view on the individual components of public spending – including the type and geographical location of infrastructure spending. It evaluates public spending programmes in terms of their implications for GDP per capita growth. Let me move on, then, to that topic.

Budget Statement No 1 sets out the '3-Ps' that drive GDP per capita: population, participation and productivity. [Chart 10](#) is taken from page 1-8 of *Budget Statement No. 1*. I spent some time in last year's address going through this chart. I won't repeat that today. I would, however, encourage you to read *Budget Statement No. 1* to understand how this thinking about longer term drivers of GDP per capita performance has become central to the fiscal strategy.

The pro-growth response to the demographic challenge largely accepts the population story described above – a declining proportion of the population being of prime working age. It focuses, then, on the other two elements: participation and productivity. In doing so, it makes tangible progress on the reform pathways set out in the February statement, *Australia's Demographic Challenges*.

That document identified three dimensions of a reform strategy to lift workforce participation: lifting the capacity of people to undertake work; improving work incentives; and supporting the development of more flexible work options.

The centre-piece of this year's budget is a package of enhanced family payments and tax cuts. Significantly for the pro-growth strategy, the package reduces effective marginal tax rates (EMTRs) in important areas: cutting the marginal tax rate from 42 per cent to 30 per cent for those with taxable incomes between \$52,000 and \$63,000¹⁰; cutting the marginal rate from 47 per cent to 42 per cent for those with taxable incomes between \$63,000 and \$80,000; and cutting the withdrawal rate on family tax benefits from 30 per cent to 20 per cent, building on the earlier cut from 50 per cent.

Continued reductions, over time, in EMTRs will be important to enhancing incentive – to boosting workforce participation, especially of older workers, the internationally mobile and females.

By international standards, our higher marginal tax rates cut in at quite low levels of income. And our income support payments are subject to a much higher than normal extent of means testing. These

¹⁰ In the income range \$62,500 to \$63,000 the marginal tax rate is cut from 47 per cent to 30 per cent.

features of the Australian tax-transfer system, implying extraordinary progressivity, reflect political choice.

Chart 11, constructed from the figures published in the *More Help for Families* document released with the budget, illustrates this extraordinary progressivity. The chart is drawn for a single income family with one child aged under five, before the tax and family benefit changes announced in the budget. As private income increases from \$10,000 a year to \$100,000, disposable income increases from \$26,307 to \$67,613. A ten-fold increase in private income increases disposable income two-and-a-half times.

What produces this outcome is a highly progressive tax-transfer system. This line shows taxes payable, net of income support and family payments. Note that this family type – one income and one child – pays negative net taxes until private income rises to about \$32,000.

Some of you will be interested to know that much the same outcome could be generated, up to an income of \$100,000, from a negative income tax with a flat rate of 58 per cent. The size of that rate illustrates the progressivity caused by the interaction of our tax and transfer systems.

Consider Chart 4 one more time. As we contemplate the fiscal implications of population ageing we might draw some comfort from the fact that our targeted system, especially as it applies to the age pension, will limit the rate of growth in public spending per capita – our numerator.

But this very same progressivity, through its impact on participation and productivity, is restricting growth in our denominator, GDP per capita. The pro-growth strategy for addressing the demographic challenge emphasises the importance of structural and social policy design, identifying a central role for policies that enhance participation and productivity. The pro-growth strategy asserts that the question that has to be asked is not whether we can afford to cut EMTRs, including the higher marginal tax rates, but whether we can afford not to.

Conclusion

As I have said on earlier occasions, we have the time to develop policies to address the demographic challenge. It didn't all have to be done last Tuesday night – even if quite a lot was done on that occasion.

Indeed, as I have also said on earlier occasions, the future reform task – exploring the participation and productivity implications of our structural and social policies – is immense; at least as significant as what has been achieved in the past twenty years.

Chart 1


Domestic forecasts

1

	2003-04		2004-05	
	2003-04 Budget	2003-04 MYEFO	2004-05 Budget	
GDP	3¼	3¾	3¾	3½
Farm	25	27	20	4
Non-farm	2¾	3	3¼	3½
CAD	5¼	5¾	5¾	5
CPI	2¾	2¼	2¼	2

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Chart 2


Budget estimates (\$b)

2

Budget	Budget year estimate	Projections for forward estimates			Estimated GDP growth rate
		FE year 1	FE year 2	FE year 3	
2001-02	1.5	1.1	4.1	7.4	3¼
2002-03	2.1	3.7	4.6	7.1	3¾
2003-04	2.2	1.3	1.2	4.7	3¼
2004-05	2.4	1.6	3.4	4.5	3½

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Chart 3

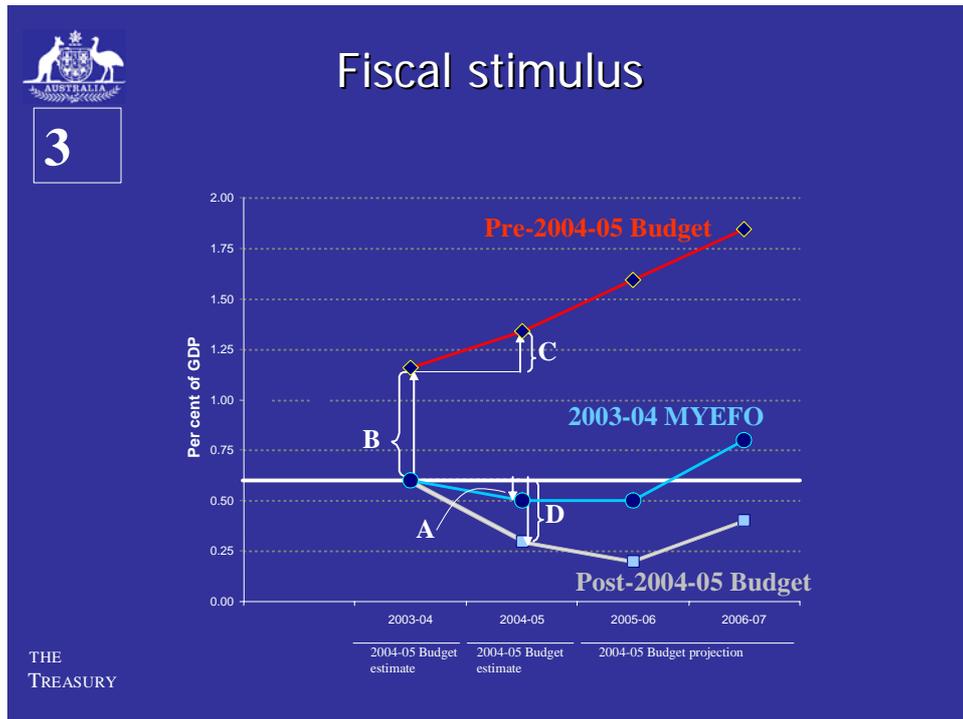


Chart 4

The fiscal challenge

$$\frac{G}{GDP} = \frac{G/P}{GDP/P}$$

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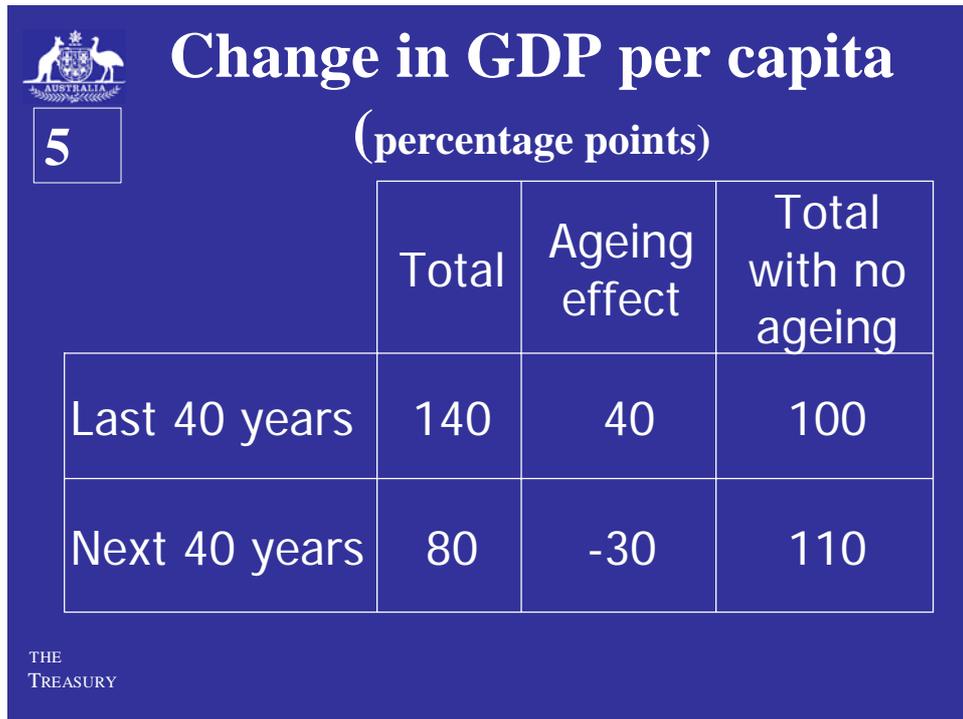
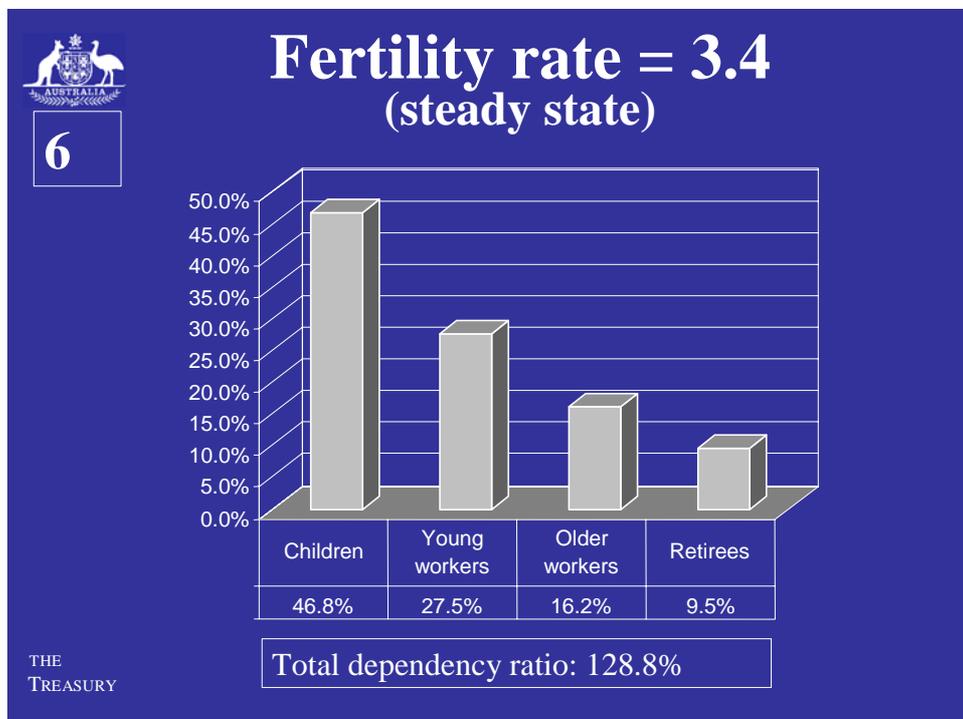
Chart 5Chart 6

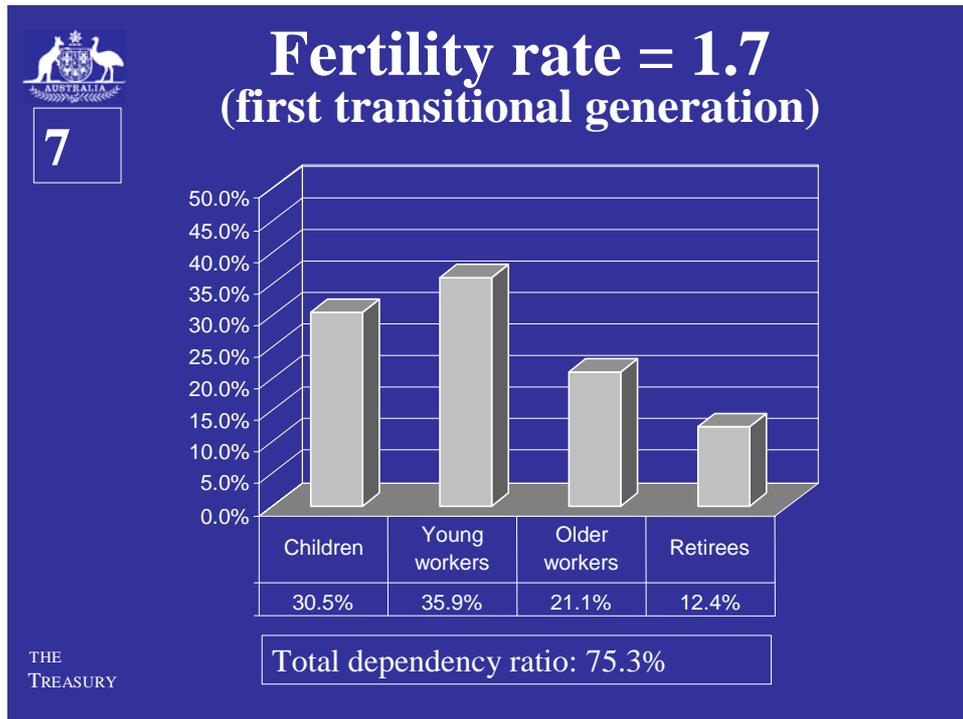
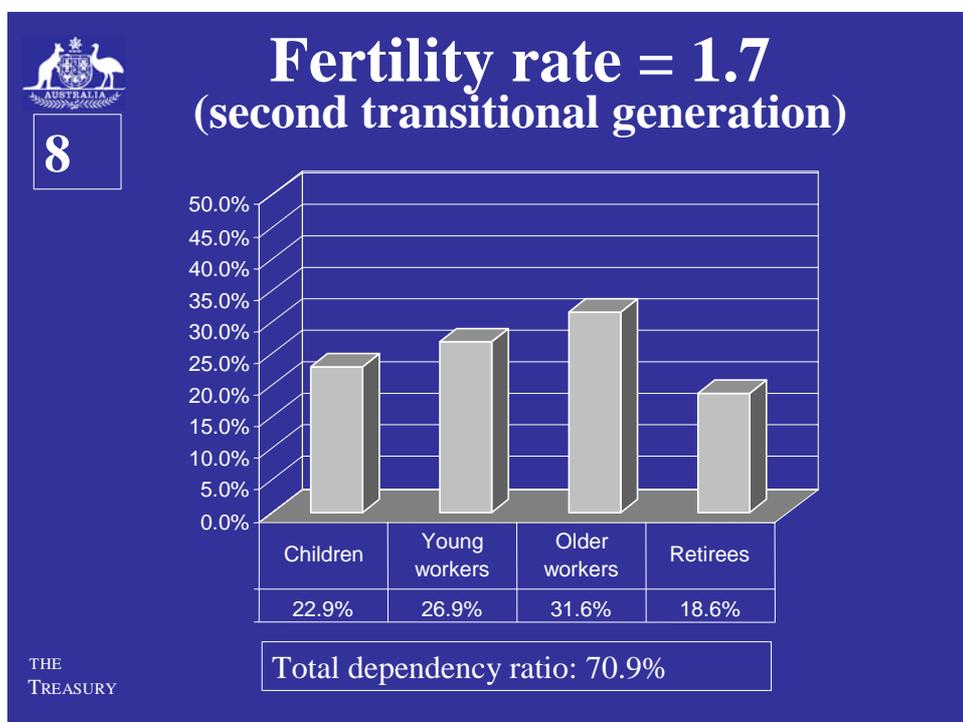
Chart 7Chart 8

Chart 9

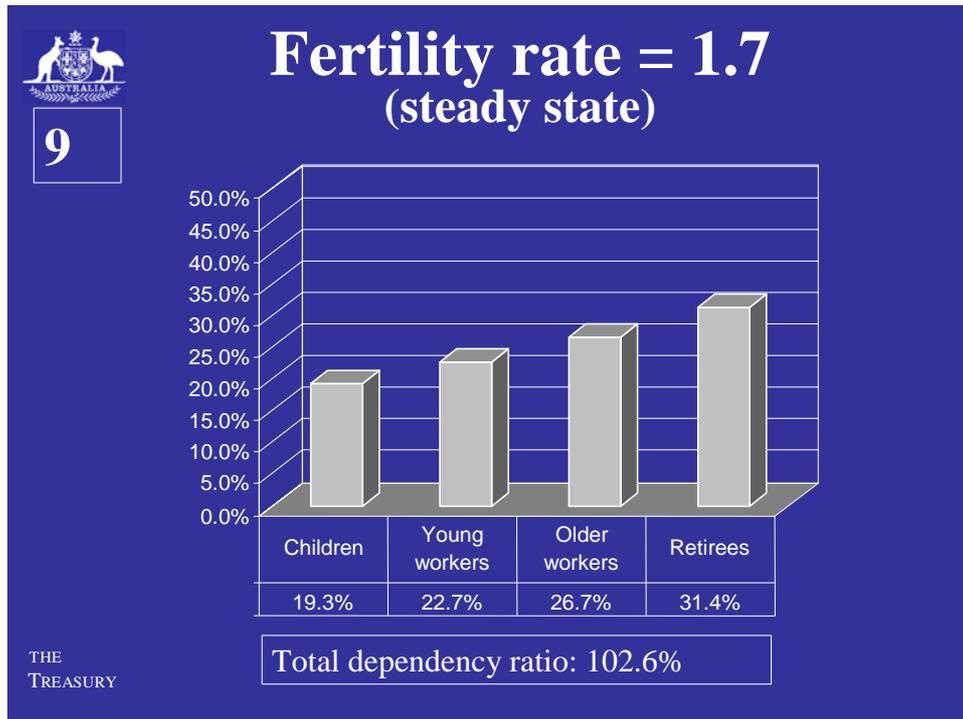


Chart 10

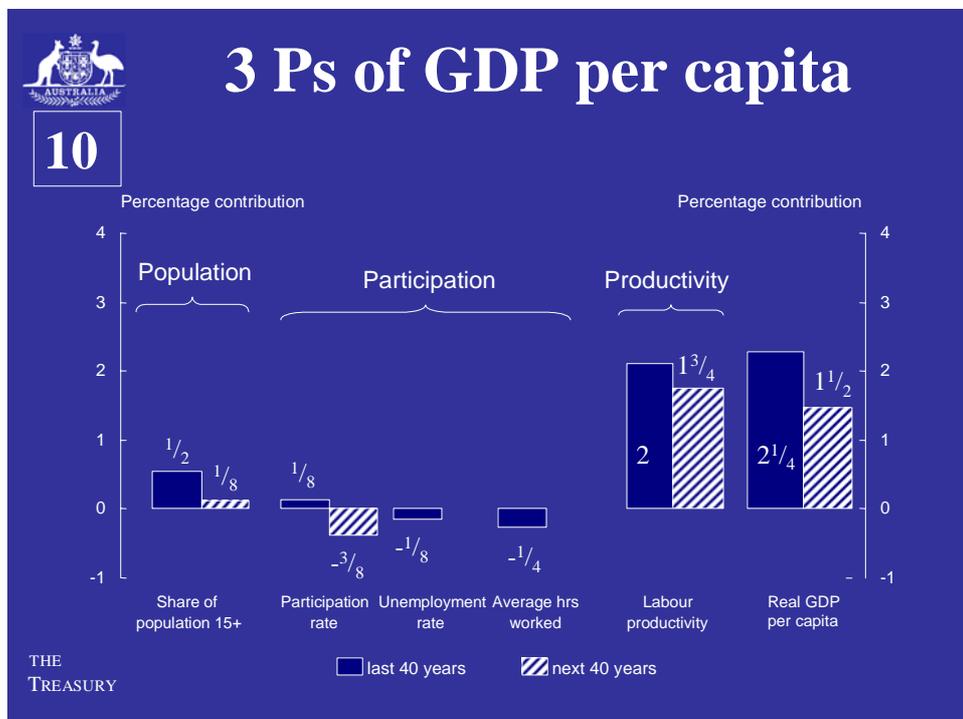


Chart 11

