



House of Representatives Committee on Ageing

Inquiry into long term strategies to address the
ageing of the Australian population over the
next 40 years

Submission by the Commonwealth Treasury

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INTRODUCTION

The House of Representative Committee on Ageing is inquiring into and reporting on long-term strategies to address ageing of the Australian population over the next 40 years.

From the perspective of economic policy, ageing has two dimensions:

1. funding of future public expenditure; and
2. broader impact on economic wellbeing and living standards.

This submission considers these issues and identifies a number of broad strategies including policies to lift workforce participation and stimulate productivity in order to increase the long-term growth potential of the Australian economy. This submission also discusses the importance of supportive retirement income policies and effective fiscal management to complement these strategies and contribute to increased living standards.

AGEING OF THE AUSTRALIAN POPULATION

The ageing of the Australian population is due to a decline in fertility starting 40 years ago and improved life expectancy. It will have a number of effects over time:

- First, the number of young (aged 0 to 14) dependent people is projected to fall by around 5 per cent over the next 40 years. This contrasts with the 17 per cent growth in the number of people aged 0 to 14 over the last 40 years. This means that the services provided for young people will not need to expand as quickly as they have in the past 40 years, and may even provide room for reductions in some areas.
- Second, the growth in the number of people of working age (aged 15 to 64) is projected to slow gradually to almost zero per cent by 2042. In 2002 over 67 per cent of the population (13.2 million people) was comprised of people of working age and this proportion is projected to fall to around 61 per cent of the population (15.4 million people) by 2042. Overall, the participation rate in the labour force is also projected to fall, with labour force growth projected to slow to around zero in 40 years.
- Third, the number of people aged over 65 is projected to increase significantly from around 2.5 million in 2002 (over 12 per cent of the population) to around 6.4 million (nearly 25 per cent of the population) in 2042. This will bring into further focus issues associated with retirement incomes and health and aged care. Furthermore, the number of people aged over 85 is projected to almost quadruple (from around 0.273 million in 2002 to 1.13 million in 2042) with these people being the most intensive users of the health and aged care systems.

The *Intergenerational Report*, tabled with the 2002-2003 Budget, looks at long-term issues posed by population ageing. It sought:

‘to look across the generations and identify the challenges which lie ahead for our society and our governments.’ (Treasurer, 2002-2003 Budget Speech).

FISCAL IMPLICATIONS

Australia is better placed than most other OECD countries to deal with population ageing. The *Intergenerational Report* projections indicate, on the basis of current policies and trends, that government expenditure as a percentage of GDP would be 5 percentage points higher by 2042¹. That is, on the basis of current policies and trends, the 2042 government will be faced with an additional funding requirement of around 5 percentage points of GDP. In today's terms, this would be equivalent to an amount in excess of \$35 billion.

Two key components of growth in projected spending are health and social security expenditure. The *Intergenerational Report* projections suggest that Commonwealth health and aged care spending could increase to 9.9 per cent of GDP in 2041-42 from 4.7 per cent of GDP in 2001-02. By far the fastest growing component of health spending is the Pharmaceutical Benefits Scheme, which is projected to grow by 2.8 percentage points of GDP by 2041-42. The projected increase, as a percentage of GDP, in health and aged care spending is more than double that of the next largest component, age and service pensions. Age and service pensions payments are projected to rise from 2.9 per cent of GDP in 2001-02 to 4.6 per cent of GDP in 2041-42.

IMPACT OF AN AGEING POPULATION ON ECONOMIC WELLBEING AND LIVING STANDARDS

The ageing of the population affects the wellbeing and living standards of Australians. Wellbeing involves both material factors, such as the value of goods and services produced in the economy, and non-material factors, such as freedom of choice, complexity of choice, and the sense of fairness from the availability of employment and the distribution of income and wealth. Importantly, it also involves both the wellbeing of present and future generations.

No single indicator can measure wellbeing primarily because individuals have diverse views on the importance of different aspects of wellbeing. For example, some individuals might place greater weight on the presumed interests of future generations or place a higher value on a more even distribution of income than other individuals. Despite this inherent subjectivity, economic analysis can help clarify the possible trade-offs among different components of wellbeing.

A useful proxy for wellbeing is GDP per capita (national output divided by the population). The higher the average GDP per capita in a society, the higher is the average living standard. Therefore, growing the economy faster than its current potential would not only boost average living standards but would also assist in addressing the fiscal challenge.

¹ This is the amount needed to ensure budget balance in 2042, if there are no additional debt servicing implications from budgetary positions in the intervening 40 years. Debt servicing obligations arising from budget deficits in the intervening years would increase this amount.

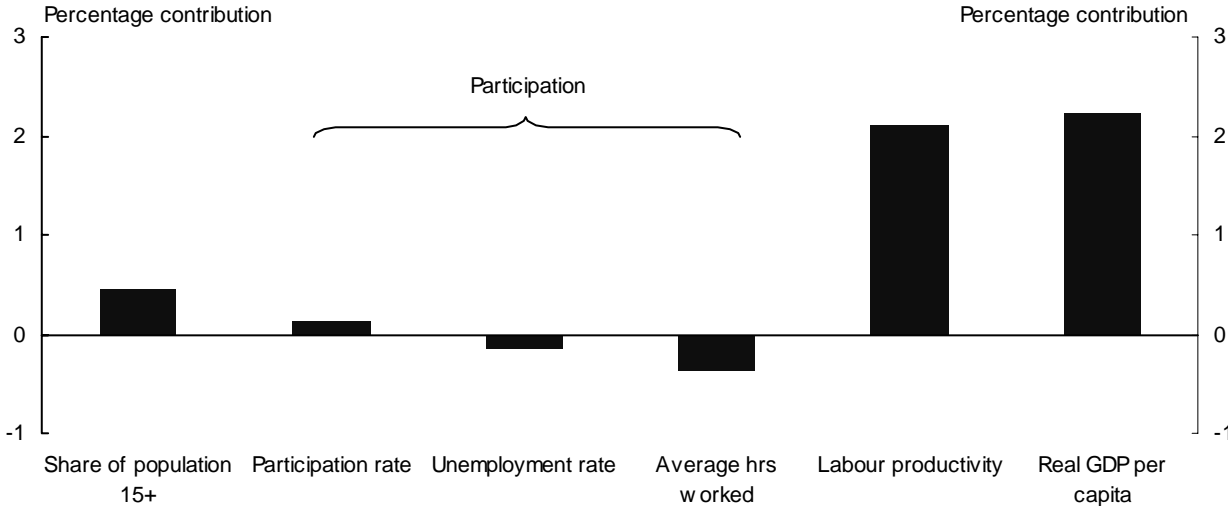
Population, Participation and Productivity

An appropriate framework to examine this challenge is to look at the components of GDP, namely: population, participation and productivity.

- Population growth provides the pool of working age people (measured as those aged over 15) from whom the workforce is drawn.
- Participation characteristics determine how many of the working age population actually are in the workforce (both employed and unemployed) and the average hours worked.
- Productivity determines the volume of goods and services the employed workforce produces for a given volume of inputs.

Over the last 40 years, Australia’s GDP growth averaged 3¾ per cent per year and GDP per capita growth averaged 2¼ per cent per year (see Chart 1 and Diagram 1).

Chart 1: What drove GDP per capita growth in the last 40 years?



Source: Commonwealth Treasury.

Productivity gains contributed 2 percentage points of the 2¼ percent annual growth in GDP per capita. Both additional capital per worker (capital deepening) and more efficient use of labour and other inputs (multifactor productivity) drove this, in roughly equal proportions.

This strong productivity growth arose out of an environment that was formed from extensive market oriented and regulatory reform initiatives over a long period. These initiatives include:

- exposing financial markets to greater competition (especially banking);
- sustaining labour market reform, including greater use of enterprise agreements;

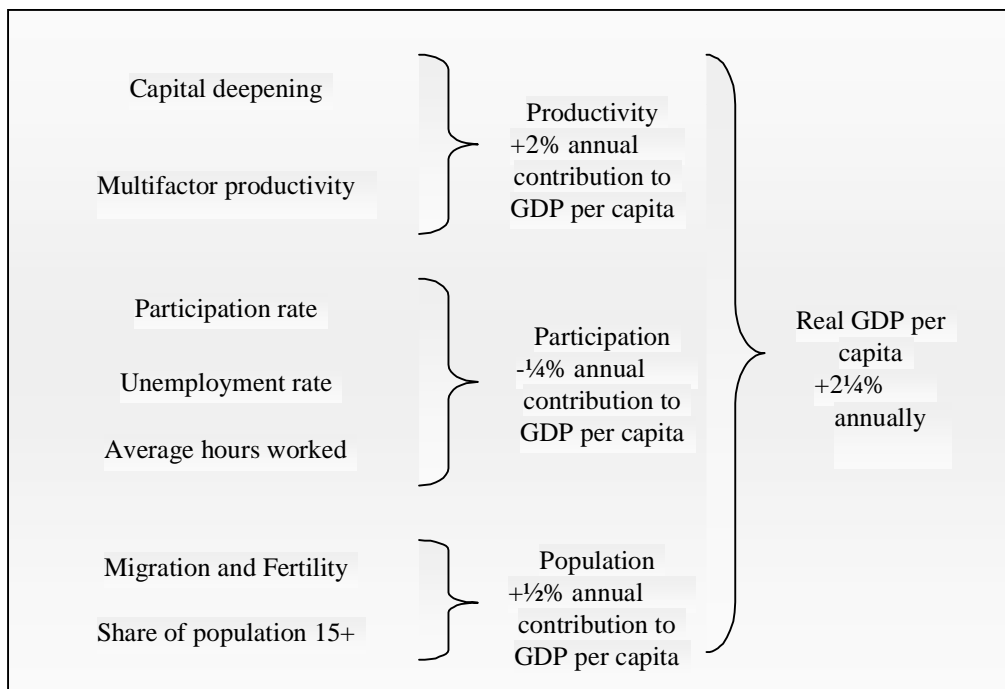
- increasing competition in infrastructure (for example in transport, energy and telecommunications), corporatisation and privatisation of key government business enterprises (for example Qantas, Telstra and the Commonwealth Bank of Australia); and
- strengthening pro-competitive forces by lowering border protection and strengthening the role of the competition institutions.

These reforms liberalised economic activity and strengthened competition to enhance the role of price signals in allocating resources to their most productive uses and have facilitated lower prices for consumers and for business in important sectors such as electricity, rail, freight and ports.

Population factors also supported GDP growth per capita, by increasing the proportion of the population of working age (those over 15). An increase in the working age population increased GDP per capita growth by ½ percentage point per year.

Participation factors had a negative influence on GDP per capita. While the participation rate rose, unemployment also rose and hours worked fell. In net terms, these participation factors lowered GDP per capita growth by about ¼ of a percentage point per year. The subtraction from growth from participation factors is largely the result of past high levels of unemployment and societal trends.

Diagram 1: Factors contributing to GDP per capita growth in the last 40 years



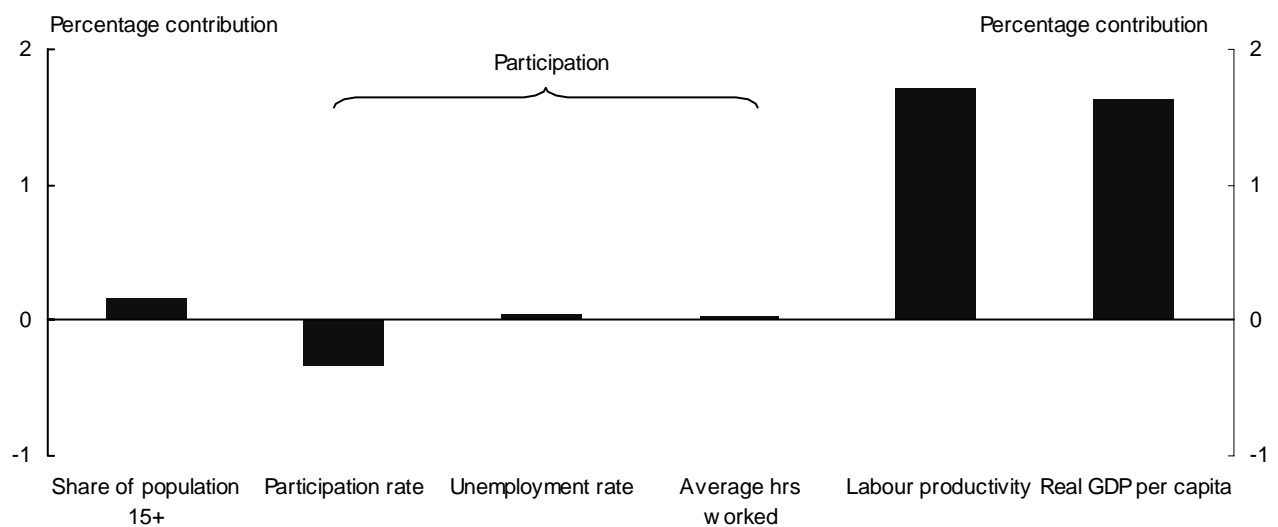
Source: Commonwealth Treasury

Drivers of GDP per capita growth in the next 40 years

Future trends in GDP per capita remain uncertain. Consumption, savings, labour market and investment behaviour will change in response to evolving incentive structures and the advent of new technologies. While the *Intergenerational Report* projections are necessarily uncertain because they are based on projecting current policies and trends, the broad policy conclusions from the projections provide for a range of plausible trends and assumptions.

Over the next 40 years, GDP per capita is likely to grow around $\frac{1}{2}$ percentage point per year slower than in the past 40 years. This is because population factors will contribute less to growth; participation factors will continue to subtract from growth; and productivity is likely to grow more slowly (*Intergenerational Report, 2002, Chart 2 and Diagram 2*).

Chart 2: What will drive GDP per capita growth over the next 40 years



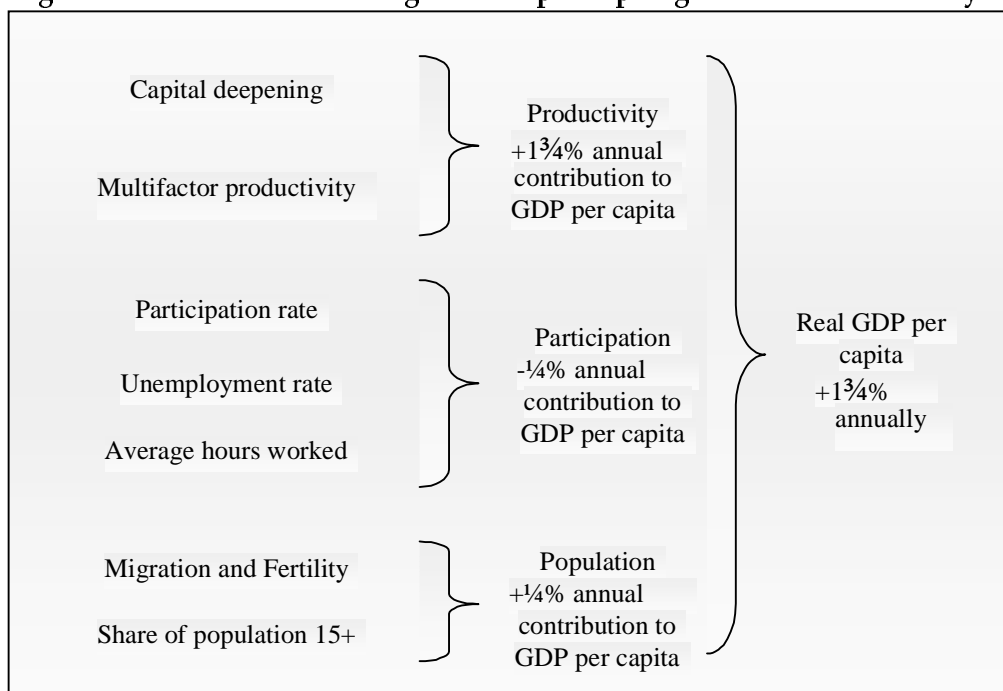
Source: Commonwealth Treasury.

Population factors will contribute less to GDP growth over the next 40 years because the proportion of the population of working age will grow less rapidly than in the past. This is the consequence of lower fertility rates from the 1970s. At current migration levels, lower fertility will also cause the total population growth rate to continue to fall over the next 40 years. While this will reduce GDP growth, it is unlikely to significantly affect GDP per capita.

Participation factors will also continue to subtract from GDP per capita growth as more of the population move into older age brackets, which in the past, have had lower participation rates.

Productivity factors also are likely to contribute less to tomorrow's GDP per capita growth. Productivity growth is assumed to fall back to the $1\frac{3}{4}$ per cent average of the past 30 years (*Intergenerational Report, 2002*). Without further policy reforms, productivity factors may not sustain the $1\frac{3}{4}$ per cent average of the past 30 years, let alone repeat the unusually strong productivity growth of the 1990s.

Diagram 2: Factors contributing to GDP per capita growth in the next 40 years



Source: Commonwealth Treasury

STRATEGIES

Four key strategies to address the fiscal challenge of an ageing population while improving living standards are to:

1. increase workforce participation;
2. increase productivity;
3. have sound and sustainable retirement income policies; and
4. ensure public expenditure is fiscally sustainable.

1. Increasing labour market participation

Increasing labour market participation will assist in meeting the challenges of an ageing population. Amongst OECD countries, Australia's total participation rate ranks 11th suggesting there is significant potential to increase the total participation rate (see Attachment). The labour force participation rates of females across most age groups and both male and female mature aged are also relatively low. For example, males aged 45-55 have an 87 per cent participation rate, males aged 55-60 have a 70 per cent participation rate, and males aged 60-65 have a 47 per cent participation rate.

Future trends in labour force participation rates are uncertain. However, the *Intergenerational Report* projections are based on current participation rate trends adjusted for the ageing of the population. Different age groups have had different labour force participation rates and Australia has experienced significant falls in participation rates once workers reach 55 years of age. Consequently, the *Intergenerational Report* projects a fall in the participation rate for people aged 15 and over from the current level of around 64 per cent to around 56 per cent by the second half of the 2030s.

Labour force participation results largely from choices by individuals and families. Such choices are influenced by capacities like health and education status, discouraged job search (including through involuntary retirement) and by incentives and disincentives which can be shaped by government policy. Measures to strengthen incentives and opportunities to participate in the workforce will impact positively on living standards in Australia.

The benefits from greater workforce participation are significant and include:

- A direct positive impact on GDP per capita. For example, increasing the full-time labour force participation of older male workers aged 45 to 64 by around 3 percentage points by 2011-12 would not only reduce projected government spending by $\frac{1}{4}$ of one per cent of GDP (*Intergenerational Report*, 2002), but also increase GDP per capita.
- As most people's capacity to accumulate retirement savings is dependent on their participation in the workforce, higher participation would tend to lead to higher incomes in retirement as the individual is able to accumulate a larger retirement asset through both voluntary contributions and the Superannuation Guarantee.
- Reduce pressure on government finances such as income support payments for people of working age, and age pension payments would be lower, as people would have saved more for their retirement.

2. The role of productivity growth

Productivity factors are also vital. Increased productivity directly affects GDP per capita and living standards. Additional capital per worker (capital deepening) or an improved combination of the use of capital and labour inputs can boost productivity.

- If future productivity growth rates match 1990s levels (2 per cent per year), the rate of GDP growth would fall from $3\frac{3}{4}$ per cent to average more like $2\frac{1}{2}$ per cent because of the population and participation factors mentioned above. GDP growth per capita would fall from $2\frac{1}{4}$ per cent to 2 per cent in the next 40 years.
- If the moderate productivity growth of the 1980s (1.2 per cent per year) were repeated, then average annual GDP growth would be around $1\frac{3}{4}$ per cent, and growth in GDP per capita would fall to only $1\frac{1}{4}$ per cent in the next 40 years (*Intergenerational Report*, 2002).

Maintaining productivity growth requires continuing both microeconomic reform and a stable medium term macroeconomic framework. Attention to fiscal policies, designed to

achieve low and stable inflation and low interest rates, will facilitate investment and the roll-out of new technologies.

Combining increased participation and productivity

Increased labour force participation and higher productivity growth means that the Australian economy will grow at a faster rate than its current potential. This outcome would increase GDP per capita and hence average living standards. In addition, it would also assist with maintaining fiscal sustainability. For example, if GDP was to be around 20 per cent higher in 2042 than the current growth path suggests, then an additional funding requirement of around 5 percentage points of GDP, as projected in the *Intergenerational Report*, could be financed out of the existing tax to GDP ratio.

3. Sound and sustainable retirement income policies

Australia's retirement income system has three pillars.

- Compulsory employer superannuation contributions through the Superannuation Guarantee;
- Voluntary private savings, including through superannuation; and
- The means-tested age pension and associated social security arrangements.

These arrangements are projected to substantially increase retirement incomes of Australians, in aggregate, over the longer term (Treasury submission to the *Inquiry into Superannuation and Standards of Living in Retirement*, 2002). They are also recognised by the OECD as being efficient and fiscally sustainable. Relative to most OECD countries, the increase in public age pension outlays as a proportion of GDP is expected to rise moderately in Australia over the next 40 years.

Proposed changes to retirement incomes policy should be assessed not only on their impact on the level of retirement incomes, but also other factors that influence wellbeing. In particular, they need to take account of the impact on people's living standards while working and the impact on the government's fiscal balance (which ultimately impacts on the level of taxation and expenditure).

Further information on retirement incomes policy and related issues can be found in the Commonwealth Treasury's submission to the *Inquiry into Superannuation and Standards of Living in Retirement* by the Senate Select Committee on Superannuation.

4. Addressing expenditure needs in a fiscally sustainable way

Providing for adequate income support, health and aged care are key components to address ageing issues. Based on recent trends, Commonwealth spending on health and aged care is likely to grow significantly over the next 40 years. Most of the projected growth in spending results from increased cost and availability of new technology and the growth in the cost and

rate of usage of the health system, with population growth and ageing having a still substantial, but lesser, effect. However, if this growth is not addressed, it will have significant implications for the sustainability of government finances.

Therefore, a major policy priority should be to maintain an efficient, effective and affordable health and aged care system. Recent Government proposals in this area include measures in the 2002-03 Budget to make the Pharmaceutical Benefits Scheme more sustainable. Without sound ongoing management of certain income support, health and aged care programmes, the government of 2042 could face an increased funding requirement that is significantly higher than 5 percentage points of GDP.

SUMMARY

A key objective of the *Intergenerational Report* was to raise community awareness of the issues associated with demographic change. The policy challenge is to take appropriate initiatives in sufficient time to smooth the transition to the needs of an older population. Clearly, a range of strategies will be necessary to address the impact of an ageing population. Through improving labour force participation and productivity, combined with supportive retirement income policies and sustainable fiscal management, Australia can better position itself to address the fiscal and economic consequences of an ageing population. The challenge for government is to maintain an adaptive policy environment that can respond flexibly to the emerging situation, and coordinate policies to ensure they work together to maximise the prospects of growth in GDP per capita and wellbeing.

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The Treasurer, 2002, *The Paths To Increasing Australian Prosperity*, AFR Leaders' Luncheon address, 7 August.

ATTACHMENT

Labour force participation rates for males and females by country (2000)⁽¹⁾

Country	Total	Males	Females
Luxembourg ⁽²⁾	91.2	113.0	68.8
Iceland	87.4	91.9	82.8
Switzerland ⁽³⁾	82.9	95.6	70.1
Norway	80.7	85.0	76.3
Denmark	80.2	84.3	75.9
United States	78.2	84.7	71.8
Japan ⁽³⁾	78.1	92.4	63.8
Sweden	77.4	79.8	75.0
Canada	76.4	82.3	70.4
New Zealand	76.0	84.3	67.6
Australia	75.3	84.1	66.4
Finland	75.2	78.2	72.2
Portugal	75.2	83.6	67.2
United Kingdom ⁽³⁾	75.2	82.8	67.5
Czech Republic ⁽³⁾	73.1	81.3	64.9
Germany	72.9	81.9	63.7
Netherlands ⁽⁴⁾	72.1	82.1	61.8
Austria ⁽³⁾	71.5	80.6	62.2
Slovak Republic	69.9	76.9	63.0
Ireland	68.8	81.2	56.2
France	68.6	75.3	62.0
Poland ⁽⁵⁾	66.2	72.8	59.8
Korea	65.2	75.7	54.3
Belgium ⁽⁵⁾	65.0	72.1	57.8
Mexico	65.0	90.2	42.4
Spain	63.1	75.5	50.7
Italy	61.2	75.6	46.8
Greece ⁽⁶⁾	61.0	74.5	47.5
Hungary	60.0	67.8	52.5
Turkey	51.9	76.5	26.7

Source: OECD Labour Force Statistics 1980-2000, July 2001.

(1) Participation rates are defined in the table as the labour force of all ages as a percent of the population aged 15-64. Participation rates therefore differ from ABS statistics which define the participation rate as the labour force expressed as a percentage of the civilian population aged 15 years and over. Reference period is 2000 unless otherwise stated.

(2) Luxembourg's male participation rate is higher than 100 due to males commuting to work in Luxembourg from neighbouring countries.

(3) 1999

(4) 1997

(5) 1998

(6) 1996