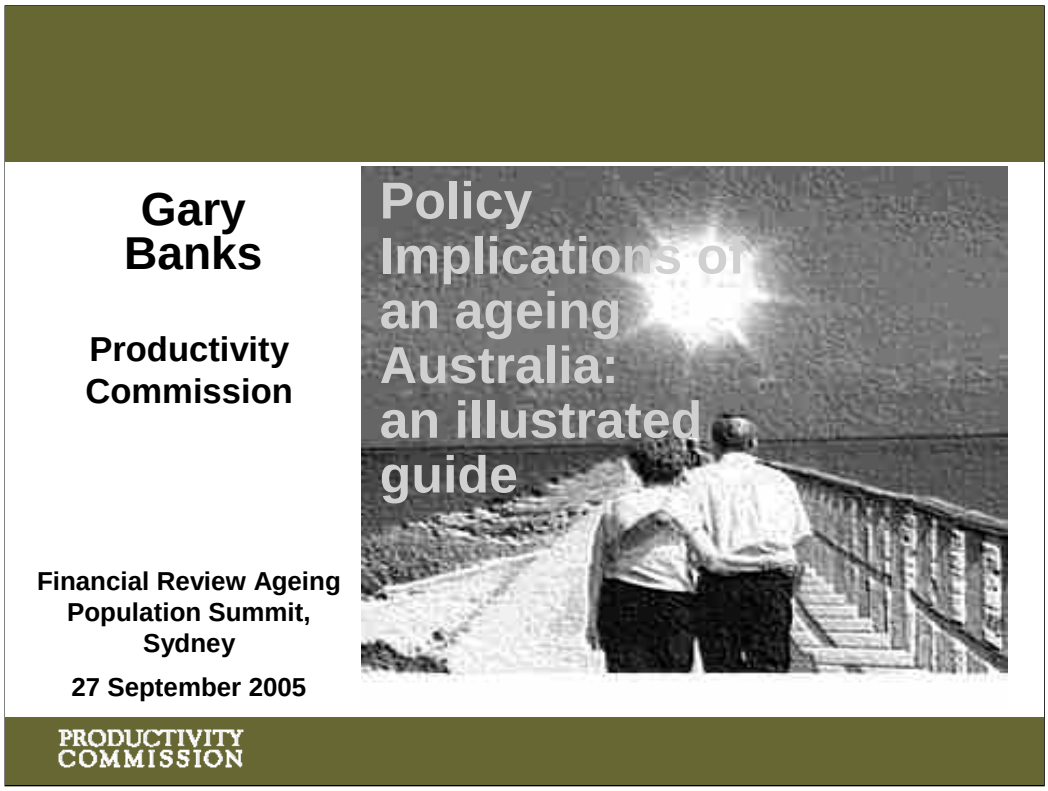
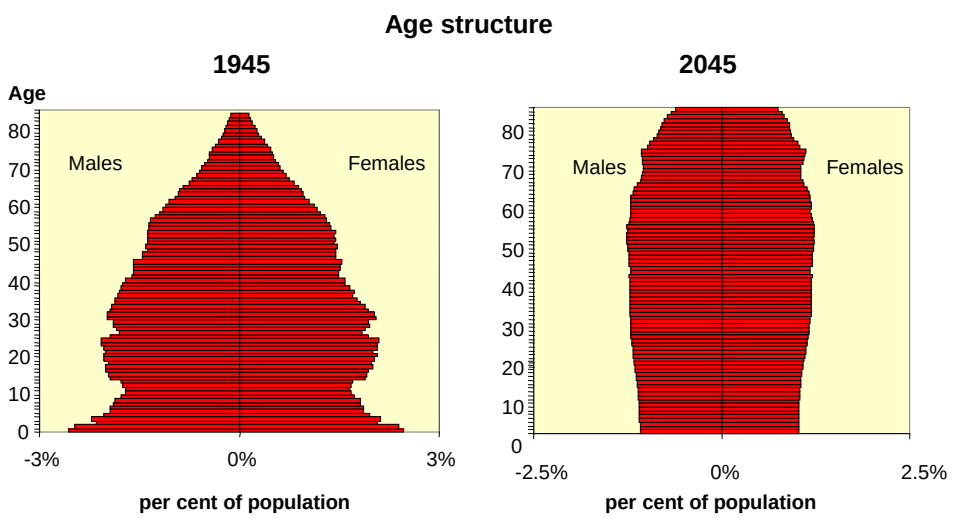


It has been a pleasure to accept the *Australian Financial Review*'s invitation to make a presentation at this conference. The recent trend of our leading newspapers sponsoring public debate on key policy issues in such an active way is to be welcomed and supported. Secondly, the conference is very timely, with senior officials from all governments currently contemplating a future national reform agenda for the Council of Australian Governments' (COAG) consideration early next year. And thirdly, it gives me an opportunity to build on the Productivity Commission's recent report to COAG on this topic by focussing on some of the key policy issues behind the numbers.

But let me first remind you of the scenario that awaits us …

The destiny of our demography: from pyramid to … coffin?

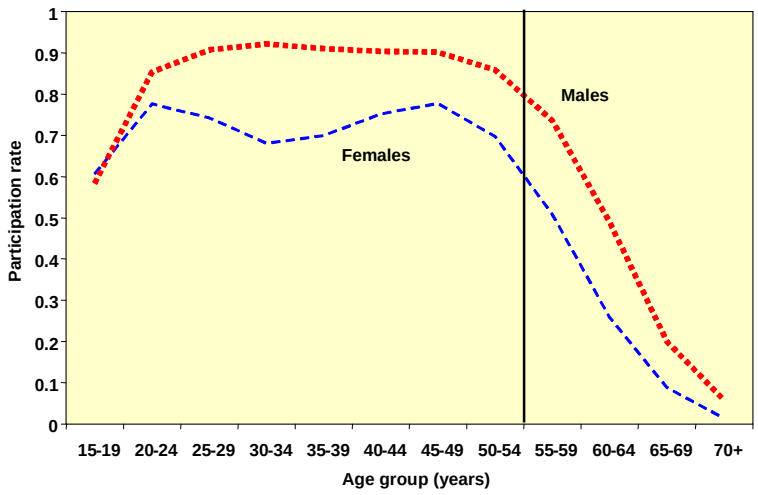


PRODUCTIVITY COMMISSION

Ongoing reductions in mortality and fertility rates in Australia are producing a fundamental shift in the age structure of the population.

Just after the second world war, Australia's age structure was like a pyramid, with a wide base of young people and very few old survivors. Today it looks more like a beehive. But by 2045 our population age structure will rather ominously resemble a coffin.

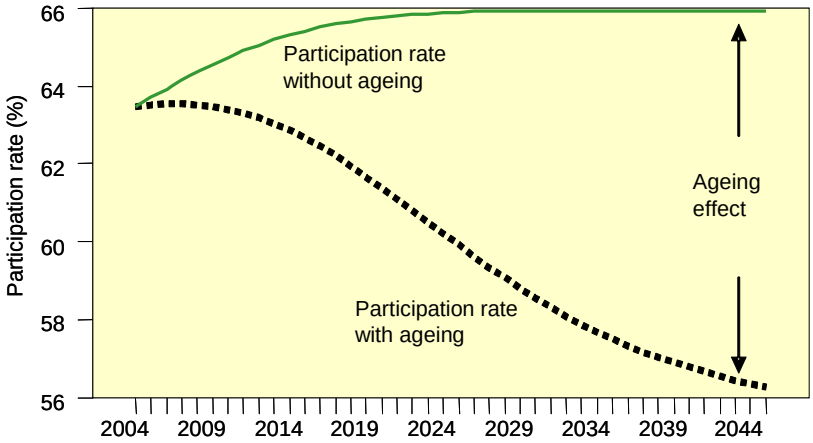
Participation rates decline with age



PRODUCTIVITY COMMISSION

Labour force participation declines strongly after age 55 years, as people retire from the labour market. This means that as more of the population shifts into older age groups, aggregate participation rates will decline. This will occur notwithstanding a continued projected rise in female age-specific participation rates and labour market involvement by older people generally.

Labour participation will fall

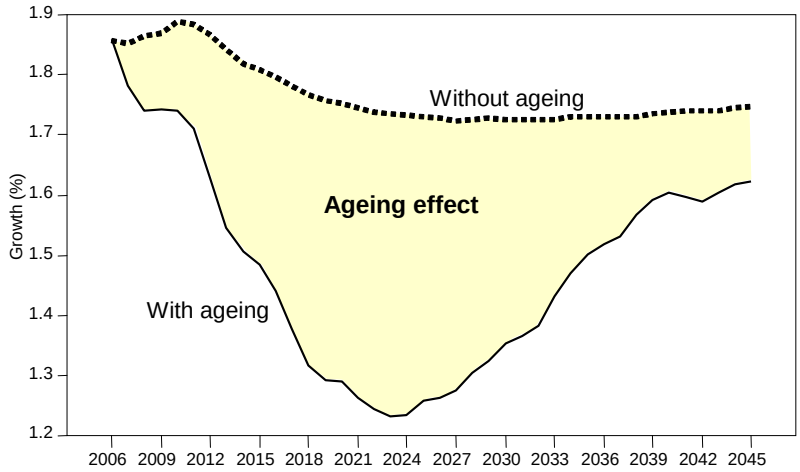


PRODUCTIVITY COMMISSION

Indeed, these demographic changes and trends in age-specific participation rates imply that, in the absence of policy initiatives, aggregate participation would fall from about 63 to 56 per cent over the next 40 years.

From another perspective, participation will be 15 per cent (10 points) lower than it would have been without population ageing.

Economic growth slump ahead

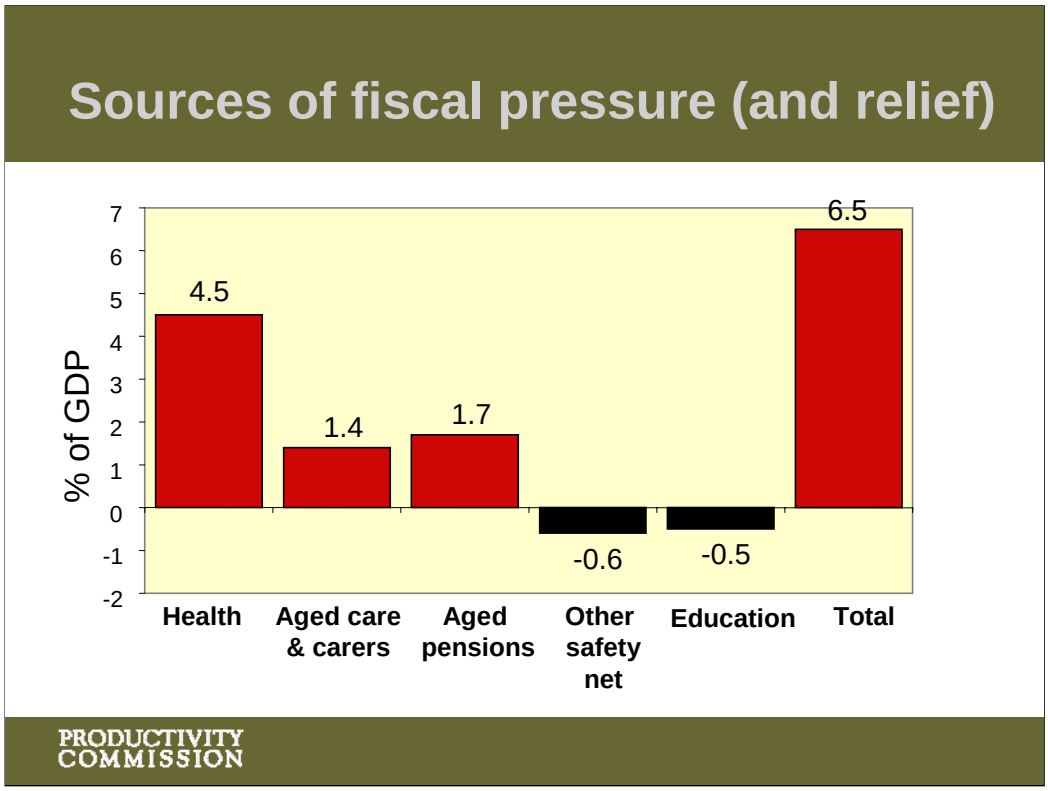


PRODUCTIVITY COMMISSION

The decline in participation will pull down per capita income growth – outweighing the positive ageing impacts of a rising share of the population of working age (fewer young people), a rising employment rate and rising average hours worked.

The scenario in the chart assumes a productivity growth rate of 1.75 per cent per annum (the average of the past 30 years, but less than the 90s 'surge'). Doing better or worse than this is the main risk or opportunity for future growth.

- But regardless of the role of productivity growth, the ageing demographics will pull down per capita income growth. With a productivity growth rate of 1.75 per cent , it will fall to about half its recent rate by the mid 2020s.
- And the accumulated dent in GDP from ageing will amount to $4.1 billion by 2045.

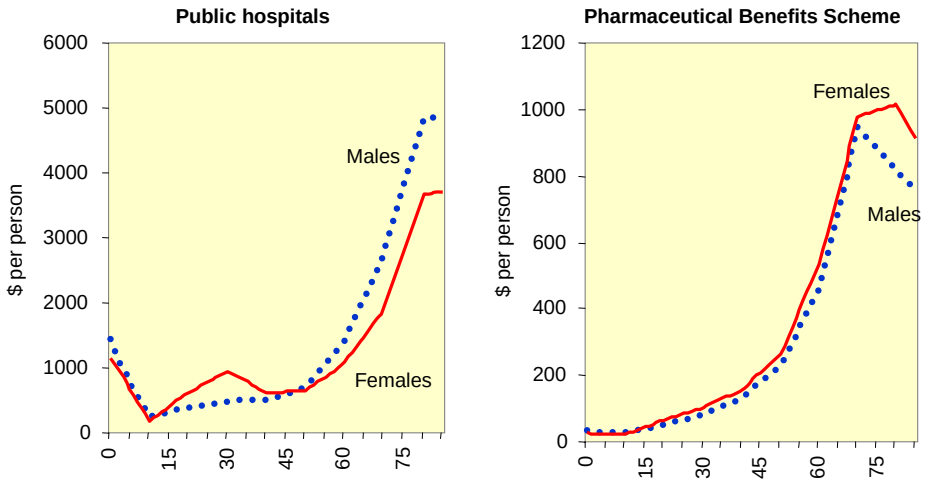


Expenditure in many government spending areas is at least partly dependent on the age structure of beneficiaries.

- In some cases, such as parenting benefits and education, this will reduce spending as a share of GDP.
- But overall, rising age-specific costs combined with demographic change, suggest that total government spending will rise significantly as a share of GDP.

Not all of the future fiscal pressures are due to ageing. In health care for example, new technologies and greater expectations explain around half of the fiscal pressure from this spending area. But the other half reflects ageing. Overall, ageing is the most significant source of pressure across spending areas, with the Commission estimating that ageing accounts for 5.6 of 6.5 percentage points of the future fiscal imbalance.

Medical costs rise with age



PRODUCTIVITY COMMISSION

Cross-sectional data on health costs by different age groups gives us much of the explanation. After age 50, health care costs escalate.

I say that in the knowledge that modelling future health care costs is much more complex than implied by the cross-sectional pattern shown here. For example, it is important, at least in modelling hospital costs, to take account of the fact that a significant share of costs occurs at the end of life. The Commission has taken this into account in its modelling, as well as incorporating a range of other complex features of the health system. But contrary to the beliefs of some, we find that the cocktail of ageing and technological growth mean that health care costs will rise considerably faster than GDP over the next 40 years.

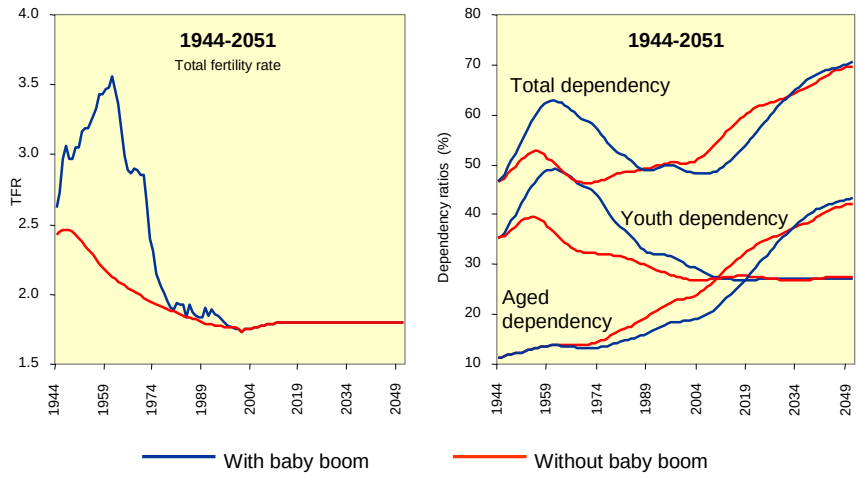
Don’t panic!

PRODUCTIVITY COMMISSION

Some of you may recall the TV Comedy series *Dad’s Army* and Corporal Jones’ admonition not to panic. This was usually the precursor for frenzied disorganisation and general agitation. However, in the case of an ageing Australia we can take these words to heart.

Ageing does not represent a crisis. Nor should it be viewed just as a negative phenomenon for Australia. It is important to put it in perspective.

Don’t blame the baby boomers



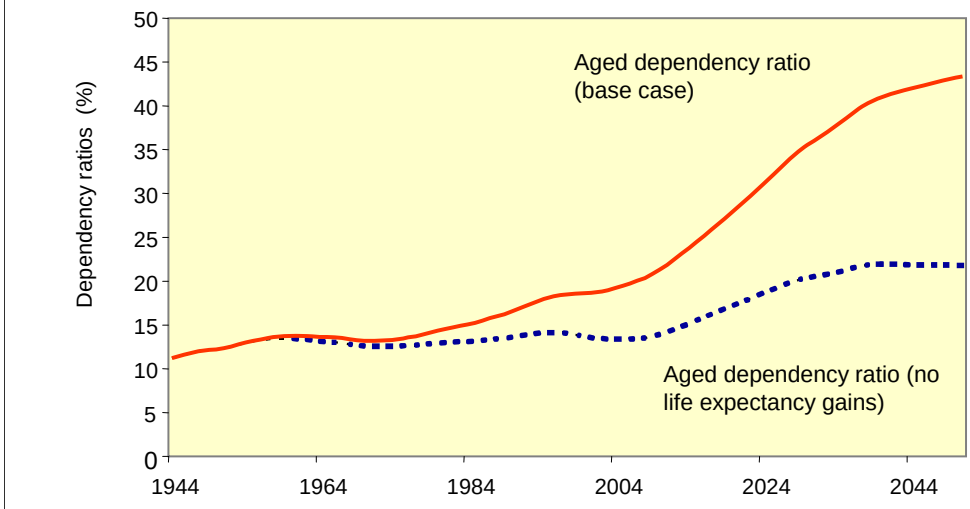
We would have an older society without the post-WWII fertility bulge

PRODUCTIVITY COMMISSION

A starting point for a negative perspective of ageing is that it is like a ‘pig moving through a python’, a rather pejorative simile aimed at the baby boomer generation. This suggests that baby boomers are to ‘blame’ for ageing and implicitly that declining fertility trends are the key determinants of an ageing Australia.

In fact, in the absence of the baby boom, population ageing would have occurred earlier. The baby boom has meant that ageing has been delayed, but that it has an accelerated onset. But long run dependency rates, with or without the baby boom, are almost identical.

Longevity is the main source of ageing



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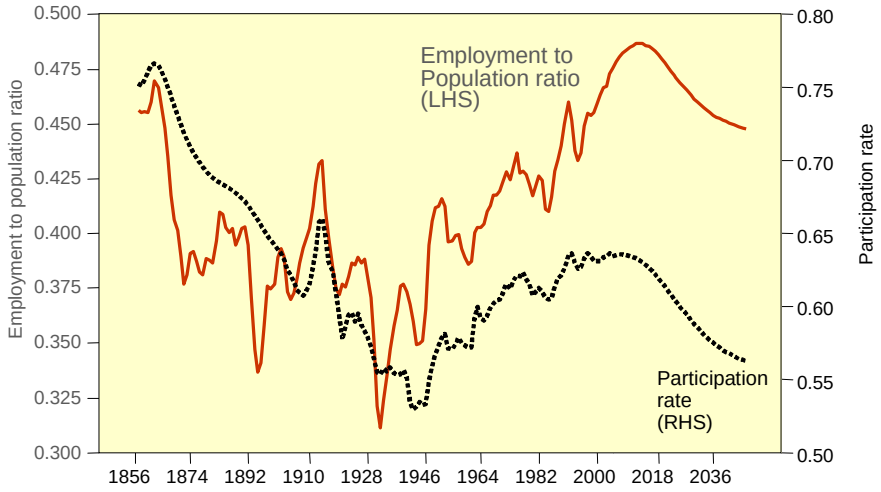
The real 'culprit' of ageing – if we wanted to express it that way – is improved life expectancy. There have been persistently large gains:

- From 1971 to 2002, there was at least a 50% fall in yearly probability of death for every age from 42 years to 77 years for both sexes.
- Males aged 40 today can expect to live to around 84, females aged 40 to around 88 years (based on cohort life expectancies), several years longer than their parents at the same age.

This is something to be celebrated. How many of us would want to see life expectancy fall again? So ageing is a product of success – economically, socially and technologically.

- Populations with low aged dependency ratios typically also have low economic status. Africa provides several examples. (Unfortunately our own indigenous sub-population provides another, as the Productivity Commission's recent work for the inter-government Review of Government Services show.)

The historical perspective



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Any assessment of ageing has to take a long term historical view. Progressive ageing over the last half century has delivered an increased share of the population available to work (because the share of adults and the shares of people of prime working ages has risen). The fall in the participation rate and the employment to population ratio is from a post-war peak. We have benefited from the influence of ageing in past years, particularly from the maturation to working age of the baby boomer generation. The future sluggish labour force growth is the inevitable flipside of an era of past gains.

Moreover, while many commentators focus on the adverse effects of demographic change on labour force participation, the key issue for the economy is employment per capita. That falls a lot less than participation rates over the next 40 years – indeed to levels around that experienced in the mid 1990s.

The employment to population ratio falls less than participation rates because the proportion of people aged under 15 years (who cannot be employed) falls as a share of the population over the next 40 years.

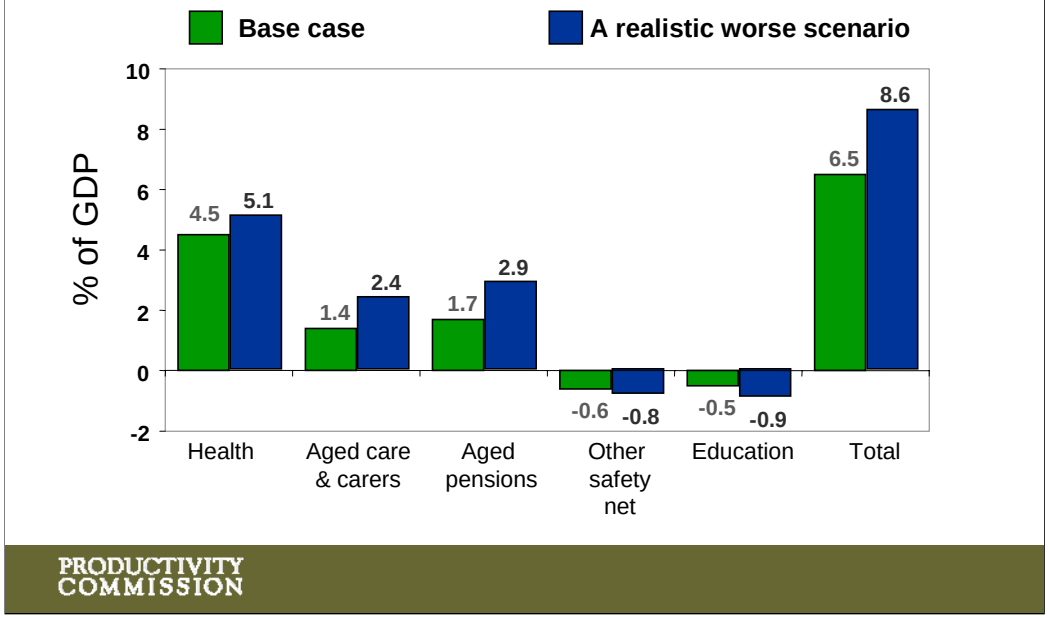
It is also important to note that while ageing will weaken income growth expressed in per capita terms,

- this has no bearing on the lifetime incomes of individuals who are in the workforce;
- moreover, with continued productivity growth, per capita GDP will be double its current *level* in 40 years' time. That swamps the additional costs due to ageing.

It is also the case that Australia is ageing less than many other countries (eg Europe), which in some cases even face depopulation. (The Ukraine stands out with an expected 43 per cent reduction in population size from 2005 to 2050.)

Finally, unlike many European countries and the United States, we do not face a pension crisis because our pensions are relatively low relative to incomes and have non-universal application.

But fiscal sustainability must be resolved

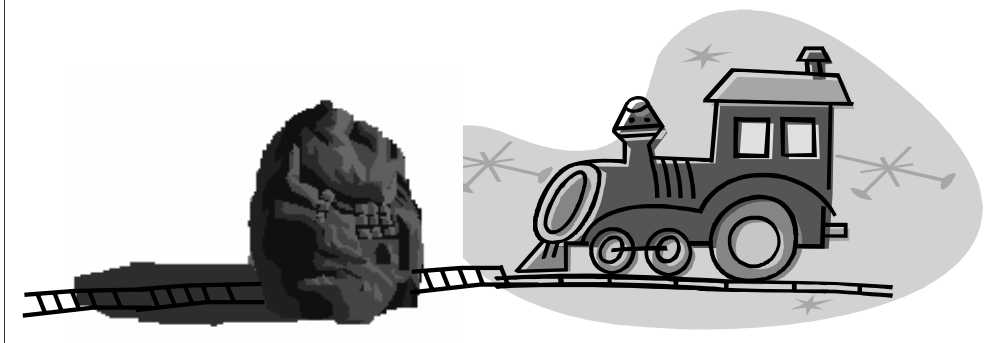


PRODUCTIVITY COMMISSION

But while the 'chicken little' attitude to ageing that is evident in some quarters is misplaced, it remains the case that the trajectory of combined Australian governments' spending will be much higher than that of their revenue, opening up a large fiscal gap.

That fiscal gap presents the major challenge for policy. Indeed, under some plausible assumptions the fiscal gap could be considerably larger than our base projection. That gap **must** be financed.

Projections are not forecasts: a boulder is lying on a rail track!



PRODUCTIVITY COMMISSION

It is important to be clear about what this fiscal gap or for that matter any of the previous projections imply about policy settings. A reasonable analogy is that a boulder is lying on a train track.

A **forecast** says 'Someone will move the boulder'

- This is probably true, but is not very useful for a railway executive (or in our application, policy makers)

A **projection** takes account of present trends and policies. It says 'people will die when the train hits'

- This is useful, because it invites new policies and active debate about which to choose (eg "move the boulder!")

The Commission's report to COAG is based on projections for this reason. We hope that our projections will be wrong, precisely because they will elicit policy responses to ensure that is the case. The question is what sort of policy responses could be envisaged?

Reactive responses

Borrow

Tax

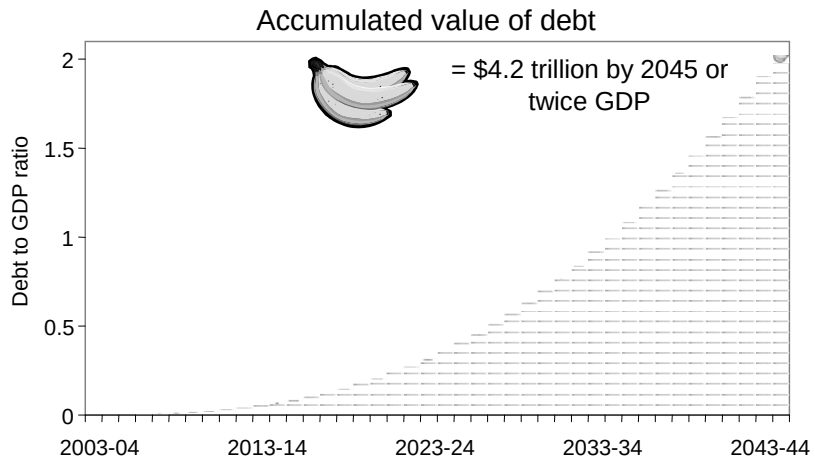
Cut services

User charges

PRODUCTIVITY COMMISSION

If no structural policy measures are adopted, there are only four things that can be done. As we will see, all have some drawbacks. The first is to increase borrowings …

The ‘banana’ republic option



PRODUCTIVITY COMMISSION

Borrowing is a sensible strategy for long term investments or for smoothing wrinkles in income and output. But fiscal pressures from ageing are neither of these. Borrowing to finance the accumulated net fiscal deficits would lead to a debt equivalent to around double GDP by 2045 or about $4.2 trillion. This is a banana republic scenario.

We should also bear in mind that ageing pressures continue well past 2045, so debt would need to accumulate even further. And given that Australia’s ‘steady state’ age structure is likely to be significantly more aged than the present one, it is unlikely that there will be a future period of age-related fiscal surpluses that could finance the debt. So debt would simply translate into deferred taxes, user charges or cuts in services. Given the compounding nature of debt, those deferred obligations would represent a very nasty intergenerational shock.

Reactive responses

Borrow

Tax

Cut services

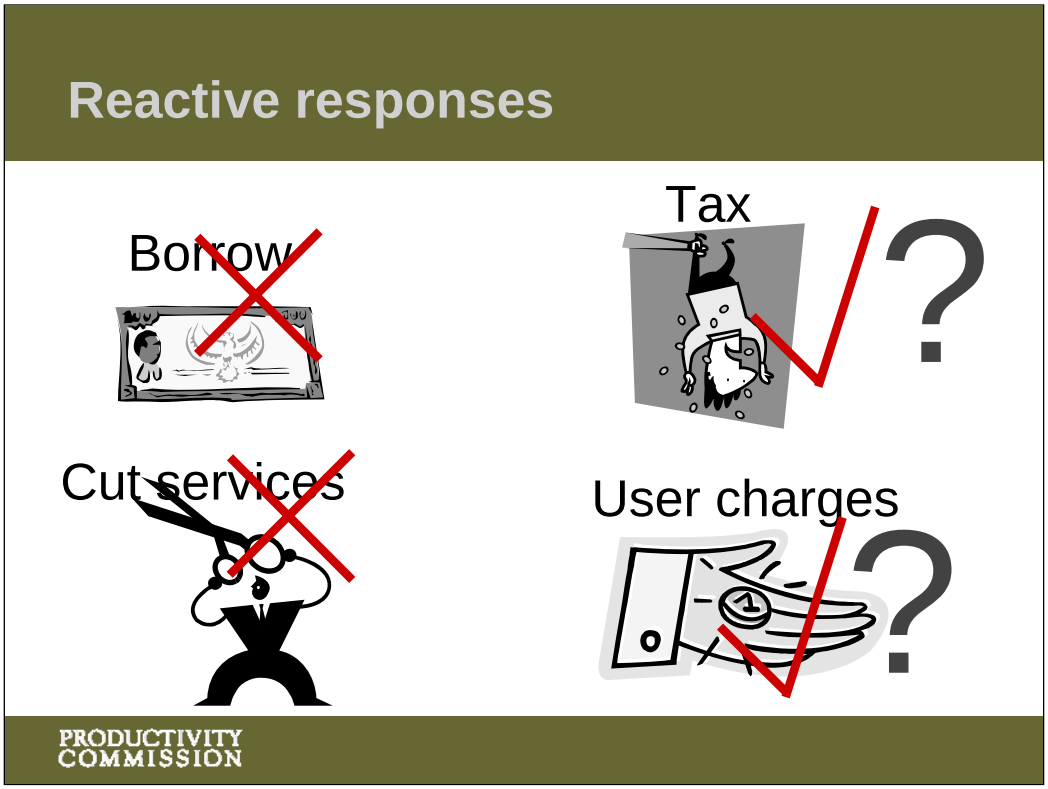
User charges

PRODUCTIVITY COMMISSION

The alternative reactive policy stance is to cut services. This would probably need to involve those services that give rise to the greatest fiscal pressure, such as health or aged care.

Additional rationing might reduce the fiscal deficit, but it would generate its own, less visible deficit in well being. Such cuts would hurt poorer people most and act as de facto user charges for higher income people who would have to pay for private provision.

The politics could turn ugly.



More taxes?

That leaves tax increases and user charges as alternative financing methods.

It seems inevitable that tax will need to play some role in ameliorating the fiscal pressure.

But to cover the whole gap, average taxes would have to rise by over 20 per cent. This could be hard to achieve without adverse incentive effects (especially in a world where skilled labour may be more mobile).

A 'tax as you go' approach to the ever increasing fiscal gaps would require low tax increases soon and high tax increases later, with potential generational inequity and efficiency losses. Some degree of tax rate smoothing by building up reserves - such as the future fund – would ameliorate this.

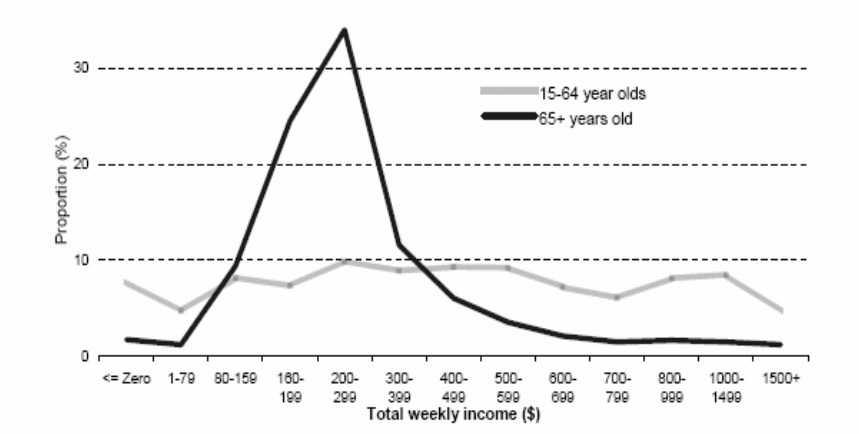
Whatever the amount of the fiscal gap financed through taxes, it underlies the critical importance of increasing the *efficiency* of the tax system for State and Australian Governments. That means *broadening tax bases* – to allow lower tax rates than otherwise – addressing features of the tax system that lead to costly spikes in marginal tax rates and eliminating inherently more distorting taxes.

More user charges?

An increase in user charges may also play a role – but its role is probably limited to a few areas. Significantly raising user charges would be problematic in the biggest spending area (health) without impeding access and worsening outcomes if charges were universal, or without impeding labour supply if charges were means-tested.

Aged care is a prospective area for greater user charges because it usually involves a relatively short period of time and substitutes for some costs that would need to be met anyway (like accommodation). However, apart from the politics, a barrier to user charges in this area remains the low incomes of many old people …

Older people have low incomes…



Source: NATSEM (data close to zero is unreliable)

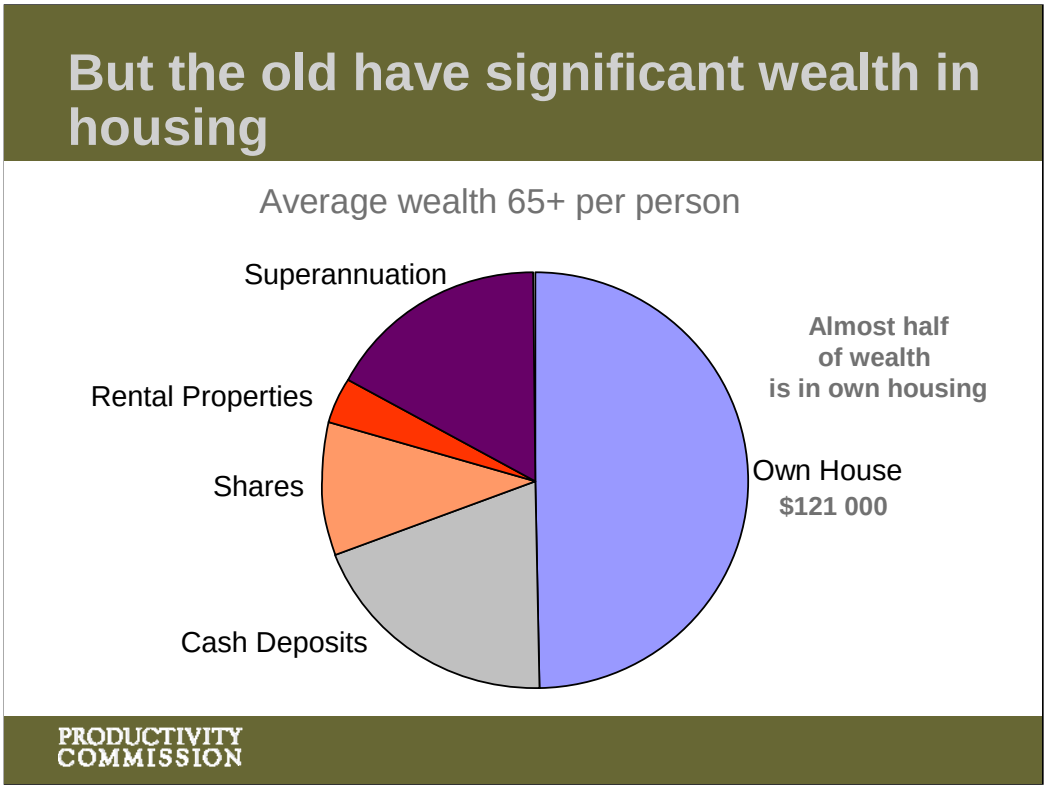
PRODUCTIVITY COMMISSION

Currently only 17 per cent of retirees have private incomes that match or exceed the pension.

Average income for individuals aged 65+ years = $13, 800 p.a. in 2001.

Over time, superannuation balances will increase, generating additional income. However, by the time retirees reach the stage where they need age care they may have substantially run down their super balances.

But the old have significant wealth in housing

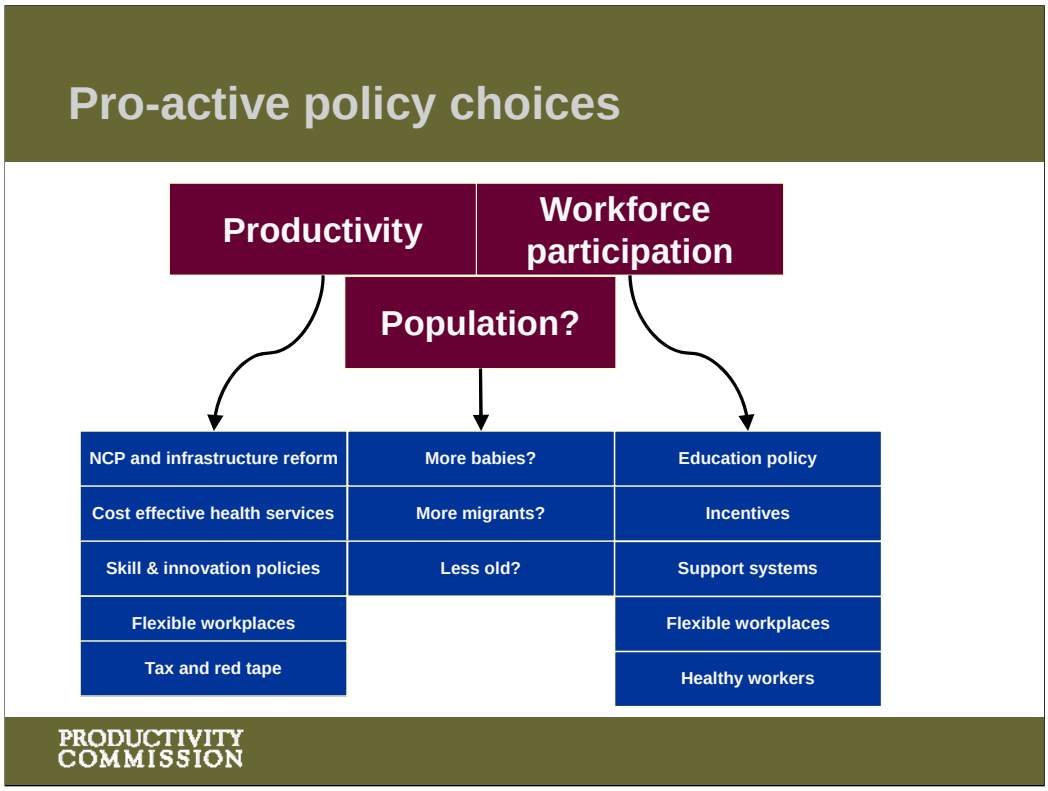


Yet older people have sizeable assets –much of it in owner-occupied housing. Reverse mortgages are a developing financial product that offer some scope for accessing this often otherwise illiquid asset. The income freed in this way could be used to finance current consumption by the old – including areas that would reduce fiscal pressures for the government, such as aged care and local rates.

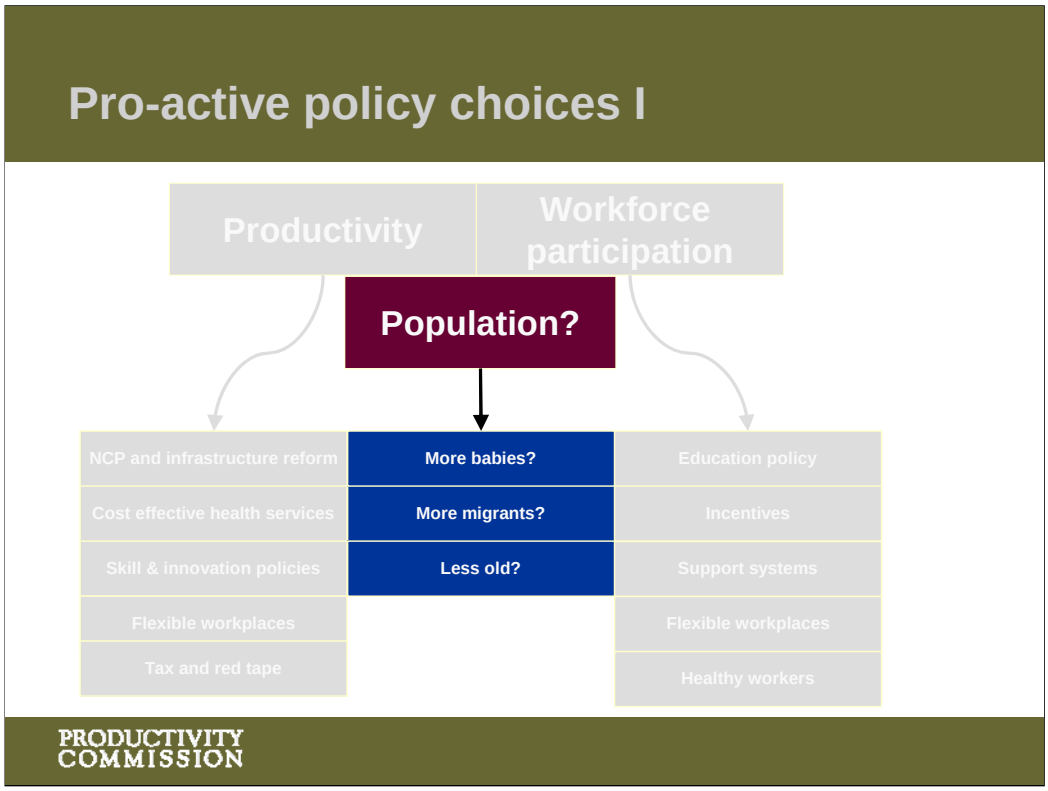
However, the offerings of reverse mortgages are currently relatively thin and take up by the aged is understood to be very small. The products charge high interest rates relative to standard mortgages and can have adverse implications for access to the aged pension.

It is important to establish whether there are regulations or welfare/tax system interactions that act as obstacles to the development of new financial products, whether there is any role for government in the provision of these products, and to see whether any schemes have unintended impacts on people's behavior.

One thing , however, seems likely. Equity withdrawal mechanisms are likely to expand. If they are used to purely finance private consumption by the old without contributing to any of their public costs, their growth could be seen as breaking the generational pact that the young get bequests but pay for the services of the old through taxes. In that instance, more user charging would appear as necessary for both equity and efficiency reasons.



In short, the reactive options all have drawbacks. Fortunately, there are more proactive policy choices in other areas that could serve to alter the structural course of the ageing Australian economy – often termed the 3 Ps – population, participation and productivity. These aim to reduce demographic pressures, increase the size of the economy, and thereby help reduce the fiscal consequences.



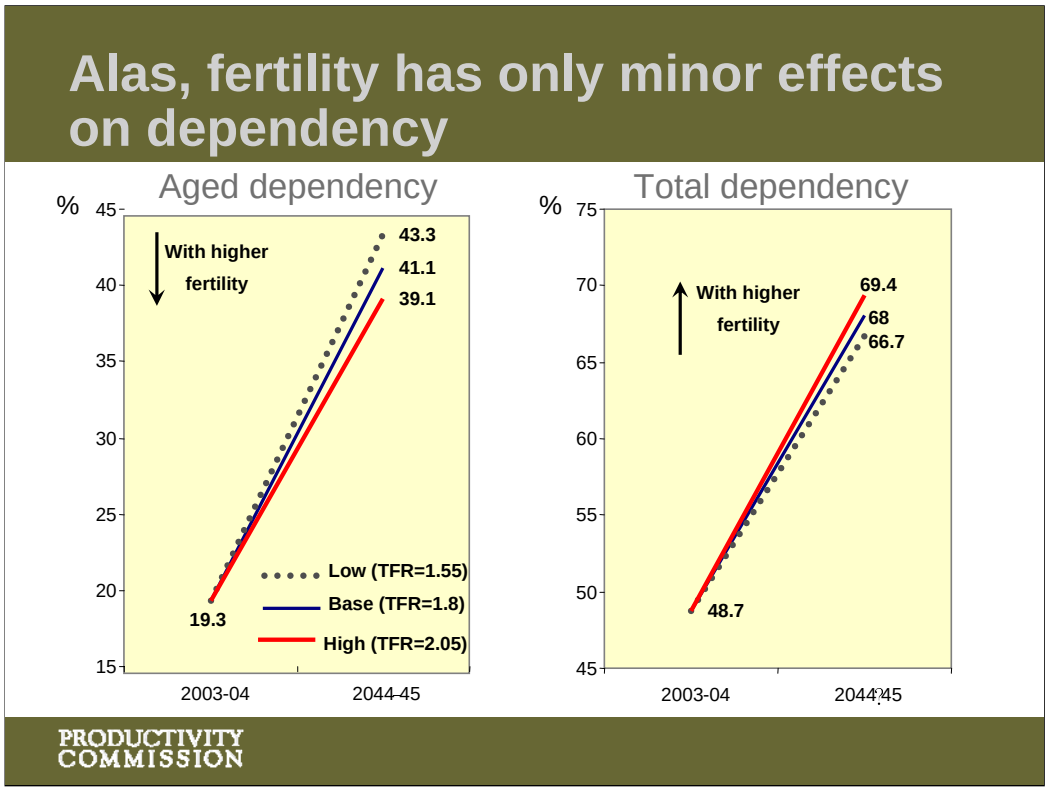
A common starting point for policy focus is population. After all, the source of ageing is demographic, so can we ameliorate it at source?

Is higher fertility the answer?

Photo by Newspix
David Caird

PRODUCTIVITY COMMISSION

It seems intuitively reasonable that since ageing involves a rising share of older people, supplying more young people would be the key to changing our demographic direction. This has been a focus for much media attention.



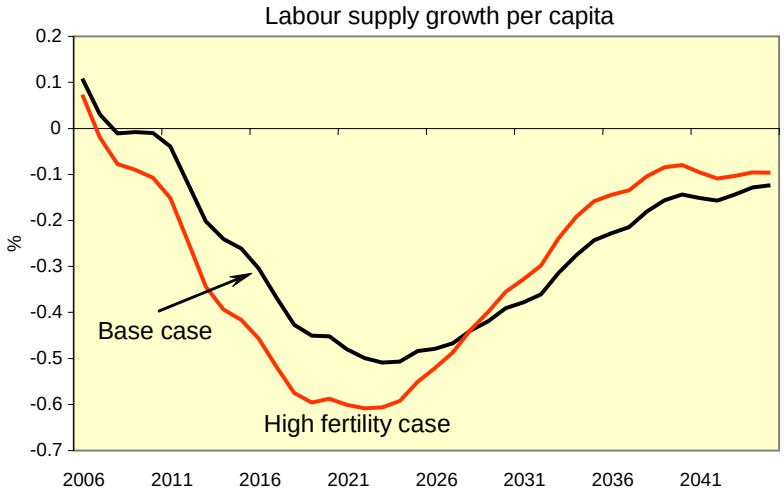
However, raising fertility only works if it is very low. To take an extreme case, if fertility suddenly dropped to zero and we had zero net migration, the whole of today's population would be 'old' in 65 years time and, in 100 or so years, the last survivor could turn off the nation's lights as she expires. In that instance, having more babies would indeed make a difference.

But that bleak scenario is **not** Australia's position. Just as there is no ageing crisis, there is no fertility crisis either. Australia's fertility rate may in fact rise above the current total fertility rate of (the already relatively high) 1.75 babies per woman. The steady decline in the age-specific fertility rate of younger women appears to have stabilised, while, consistent with delayed childbearing, age-specific fertility rates for older women continues to rise. In that context, and with net migration at its current levels, credible higher or lower fertility rates make very little difference to Australia's age structure.

And while increases in fertility lower the aged dependency rate (those aged 65+ on those aged 15-64 years) by a modest amount, they increase the youth dependency ratio by more (those aged 0-14 on those aged 15-64). This implies that an increase in fertility would raise, not lower, overall dependency by 2045.

In any case, fertility is notoriously hard to influence with policy and pro-natalist policies themselves can have further rounds of fiscal effects.

Higher fertility initially makes matters worse



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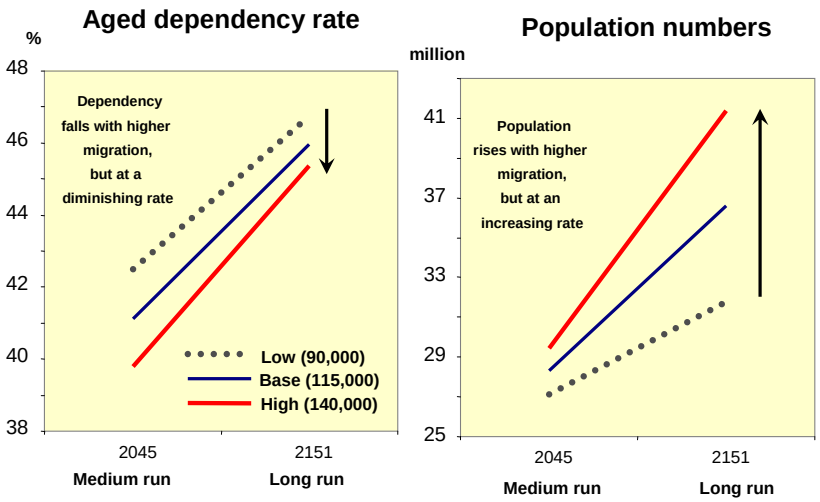
And consonant with that phenomenon, higher fertility also takes it toll on labour supply per capita for about 20 years – reflecting the fact that people aged 15 and under do not work, but do add to the population. Of course, the flip side is a later increase in labour supply per capita, but a fertility shock now would worsen labour supply growth at the time – the mid 2020s – when ageing is also taking its greatest toll on labour supply growth.

Increased migration affects population size more than age structure



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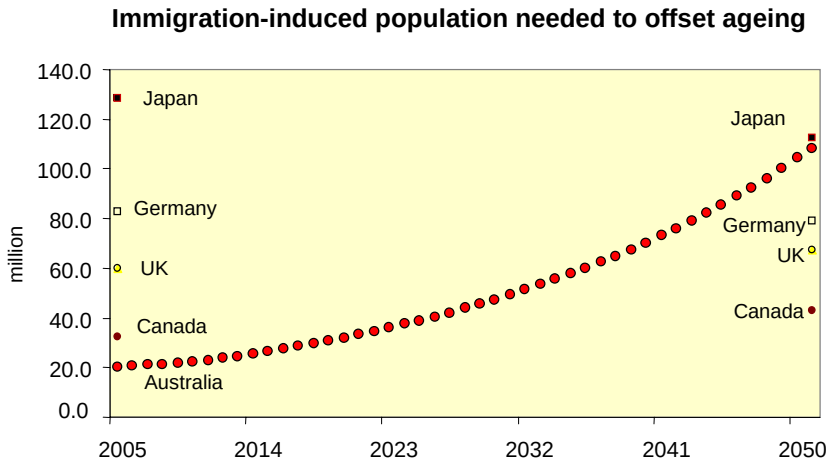
An increase in net migration is also sometimes suggested as a policy solution to ageing. As with fertility, the impact of changes in migration on population age structure is much weaker when existing fertility and migration rates are reasonably high.

Unlike fertility, increased migration lowers total as well as aged dependency.

Migration policy may also play a role in ageing policy – to the extent that it is effectively designed to deal with particular skill bottlenecks that may affect economic growth prospects (although the impacts of such policies on skill formation for 'native' Australians must also be considered).

But one of the biggest constraints on migration policy as a response to ageing is that its effects on age structure diminish with increasing net migration levels, while its impact on population numbers increase. This poses a potential problem for sustainability.

Australia as population superpower



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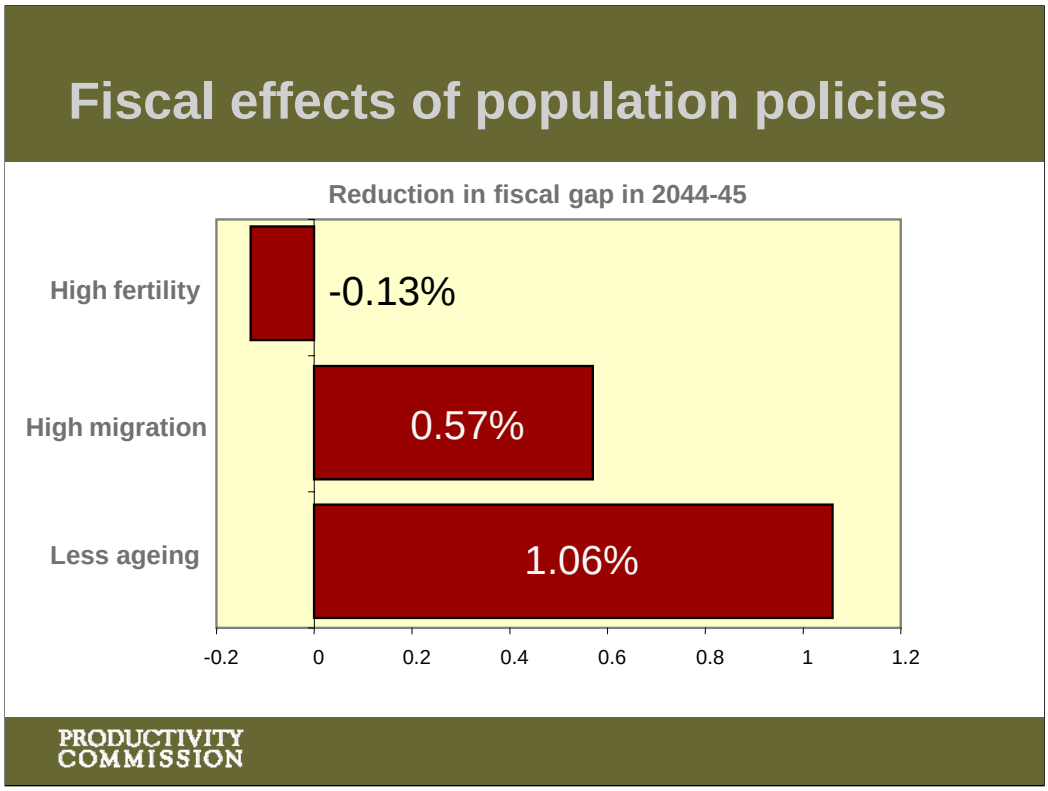
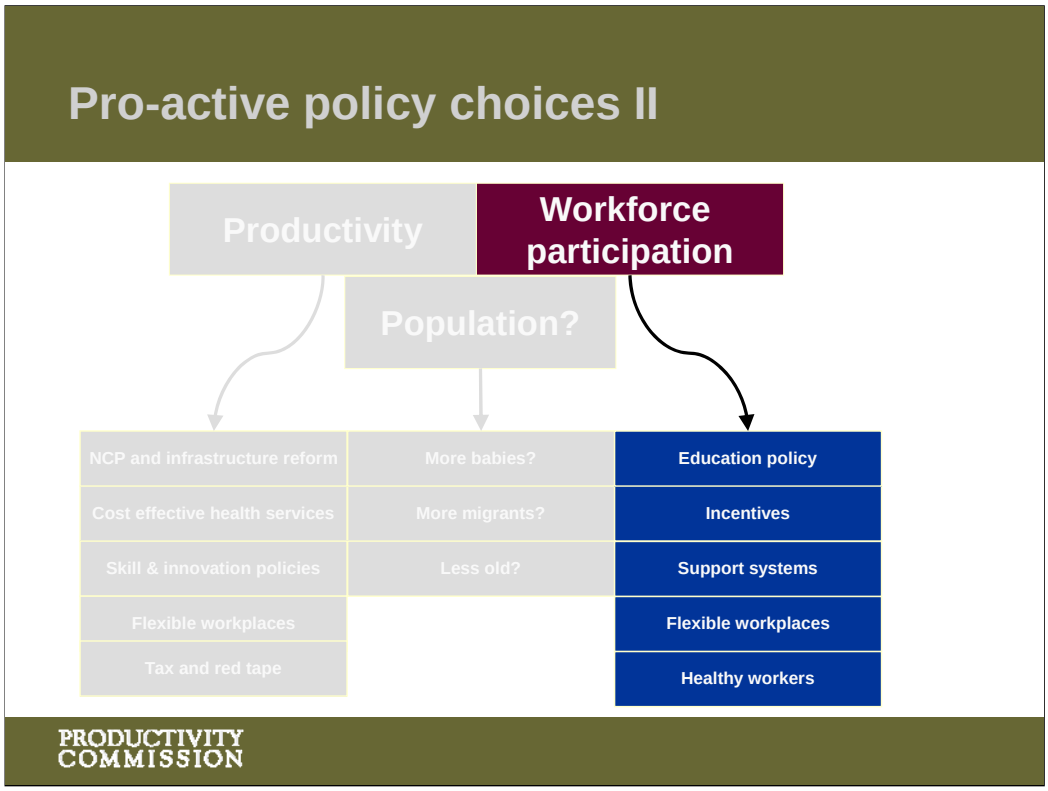
We can demonstrate this by asking the question: “What rate of net migration would be required to completely avert ageing of the Australian population?” The answer is a net migration to population ratio of around 3 per cent. But this would imply massive population growth – indeed, the transformation of Australia to a superpower in population terms.

This is of course an extreme case, but it highlights the bluntness of immigration policy as a tool for addressing demographic structure.



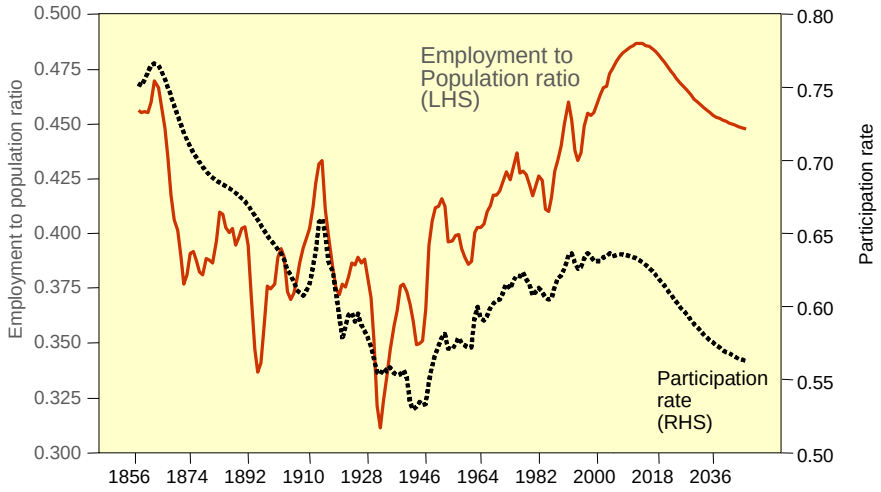
The effects of population policies on Australia's future fiscal position are quite small:

- They are small and negative for increased fertility – mainly because higher fertility stimulates spending to GDP by governments on education, family and parenting payments by more than it suppresses spending to GDP on aged care and health.
- The impacts from increased migration are bigger and at least positive, but would still leave most of the fiscal gap intact. Migration suppresses government spending to GDP for all spending areas, bar other social net payments (for example, family payments and unemployment benefits). Migration also helps the fiscal position relative to GDP by raising economic growth per capita. This helps in areas like aged care, but not in health care. (The health care story is different because the Commission's projections assume that the level of demand for health care is also a function of GDP – a relationship that is very robust over time and across countries. So as GDP rises, so too does spending on health.)
- The biggest bang for a population buck would come from decreasing ageing through reducing longevity – but attractive as this might be for the fiscally obsessed, it has some obvious drawbacks! (This corresponds to the P1 population scenario in chapter 2 of the report, of which a life expectancy at birth for males and females 1.2 and 1.5 years less than the base case in 2045 is the most important aspect).



The second pro-active policy area is labour force participation.

Remember, participation is at an all time high



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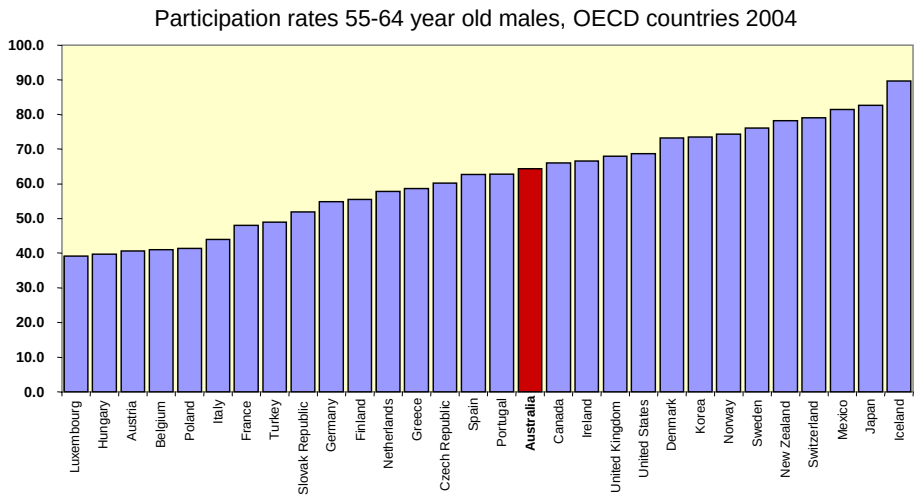
In thinking about participation policies, it is important to remember the economic and historical context. As I showed earlier, labour force participation is at an all time high right now. The projected fall looks bad relative to the present. But it doesn't look so bad relative to some periods in the past.

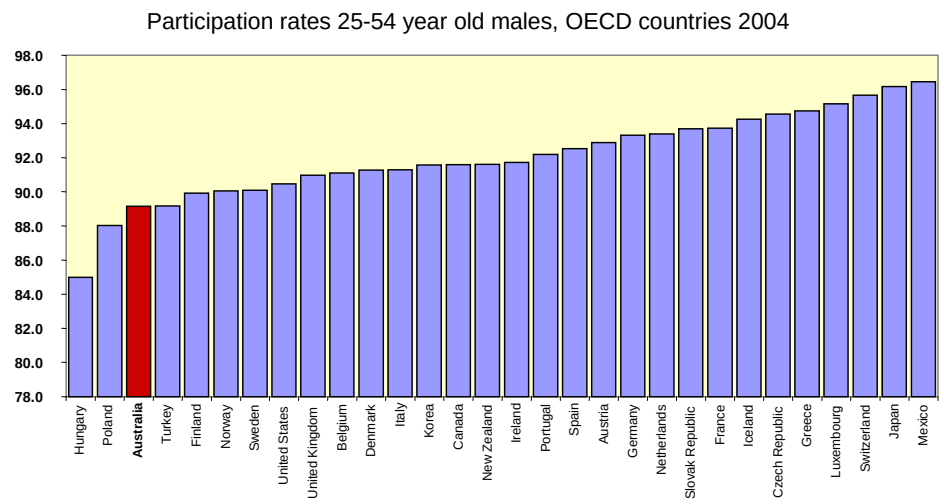
Older males around the median



PRODUCTIVITY COMMISSION

How do we compare internationally? A lot of the focus of emerging ageing policy is on the participation of older Australians. Curiously, this is not the area where Australia's relative performance is particularly poor. Older males are, in fact, a bit above the OECD median – although with participation rates well below New Zealand, for example, which suggests scope to do better.

Prime age males doing badly?



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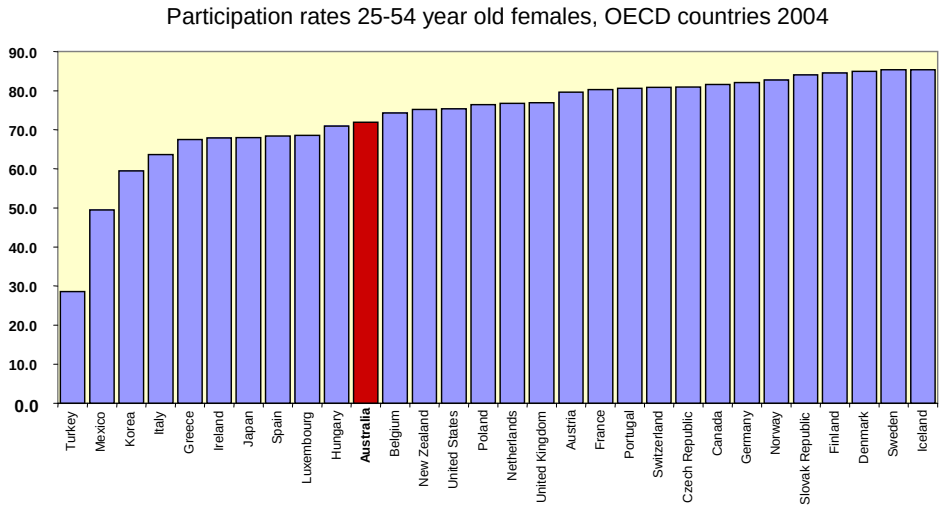
In fact, Australia's standing is lowest for prime age males – where the published participation rates are lower than every OECD country except Poland and Hungary. (These international statistics suffer some limitations that suggest they paint too dire a picture for Australia – though even correcting those deficiencies, as the Productivity Commission researchers have done in a forthcoming report titled 'Men *not* at work', still shows lower than median participation rates).

Prime aged females rank more highly than males



PRODUCTIVITY COMMISSION

Prime aged females do much better in the international rankings than prime aged males – being much closer to the median. And older females, like their male counterparts, have participation rates a bit higher than the OECD median.

Working longer?

PRODUCTIVITY COMMISSION

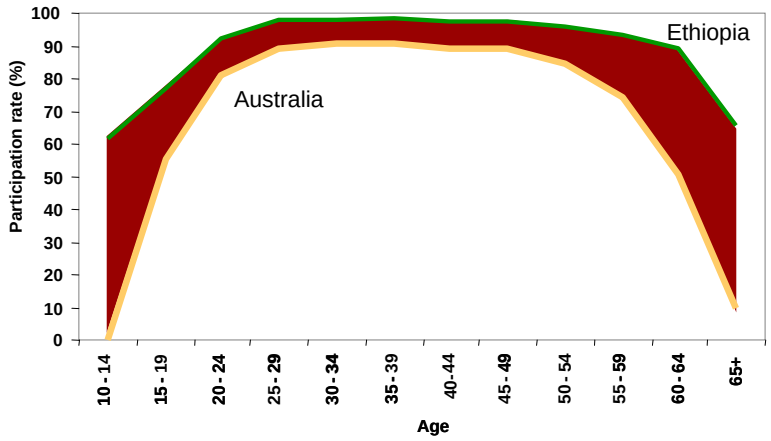
When the Commission's ageing report came out, it was seen by some as advocating a 'work till you drop' policy. In fact, we did not suggest any such thing.

We do think participation is important and that policies need to adapt. We certainly should tackle ageist assumptions, early retirement incentives, myopia by imminent retirees and target those who want a job

But the issue is a lot more complicated than urging people to keep working regardless and pursuing policies to that end.

Productive employment is important at personal and family levels as well for society. But work is not an end in itself – as contemporary discussion about 'work-life balance' makes clear. The real policy issues are about ensuring that work-leisure tradeoffs reflect the fundamentals and are not being distorted by things that policy can usefully do something about.

Poorer societies have the highest participation rates

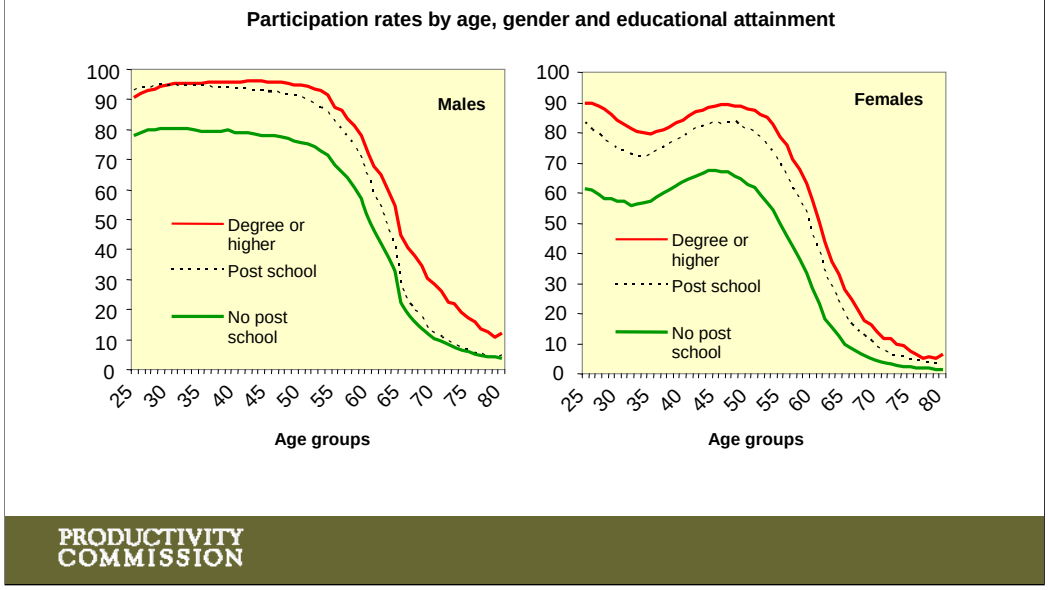


PRODUCTIVITY COMMISSION

We need to remember that those societies with the highest participation rates by the old, tend to be very poor countries. These are indeed ‘work till you drop’ countries, which we do not wish to emulate.

Nevertheless, there are grounds for considering a range of policies to stimulate participation rates. A common starting position is that increased skill levels will be an important contributor to participation rises.

Education raises participation



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The cross-sectional evidence shows that males and females with higher educational attainment rates have greater participation rates at all ages. This suggests that older people's participation will rise in the future as the currently highly educated young cohort ages.

(That said, other factors will clearly also play a role – as they have in producing the dramatic slide in male participation rates in past decades despite their much higher education attainment.)

The cross sectional evidence is also encouraging for policies that increase attainment rates above levels that would otherwise hold. However, the size of the effect is likely to be much less than suggested by the above charts. This is because many of the people targeted by such policies will be different from those that would otherwise get an educational qualification (eg different in ability or motivation). As such, the impacts of education qualifications on labour force participation rates is likely to decline the greater the share of a given age cohort that acquires such qualifications. Empirical evidence supports this contention.

This does not mean that skill development is unimportant – to the contrary, it remains fundamental. But we should be aware that there are limits to its likely benefits for labour participation and ensure that policy approaches take account of the heterogeneity of people and policy does not focus overly on education *duration*.

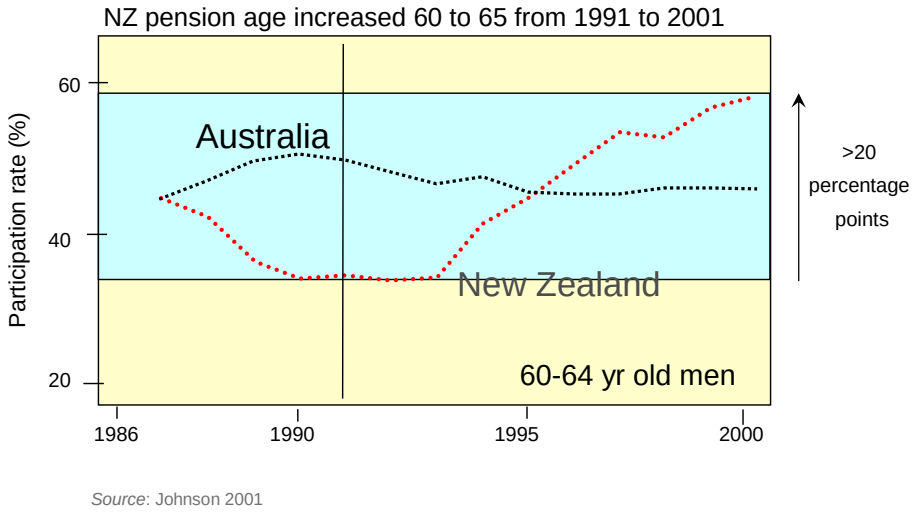
Incentives are a second important area influencing participation rates. Peoples' decisions about work over other activities obviously are strongly influenced by the relative financial rewards.

In poor societies, with no safety nets, the choice is stark. That is not so in developed countries, where the interplay between welfare entitlements and the tax system can create significant distortions to work incentives.

This is a complex area, where it is hard to get the price incentives right without affecting government revenue on the one hand, or equity on the other.

Therefore, we have seen moves to address eligibility for welfare payments, rather than just focusing on rates, for example in areas such as unemployment benefits, Disability Support and parenting payments.

Retirement provisions can have a powerful influence



Source: Johnson 2001

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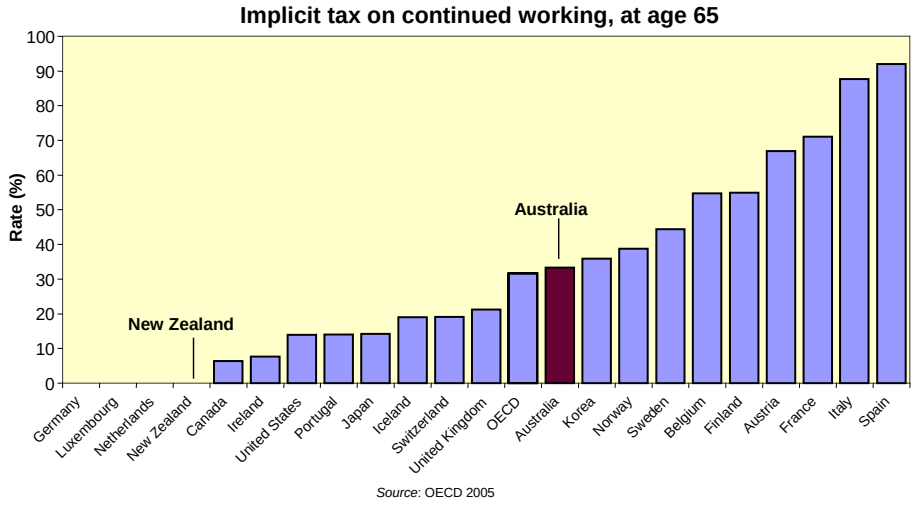
While there are reasons to be careful about advocating further rises in pension eligibility ages, the New Zealand experience provides an interesting natural experiment of the potential impacts. (New Zealand and Australia have comparable cultural backgrounds and institutions and similar per capita incomes.)

In 1991, New Zealand changed the eligible pension age from 60 to 65 for men and women, to be phased in over 10 years. The participation rate of men aged 60-64 years increased by more than 20 percentage points over this period, with a substantial rise for women too.

Participation rates also increased for both sexes for 55-59 year olds – revealing that pension age eligibility casts an incentive shadow on participation by people younger than the eligible age. (This is because people can choose to retire earlier and run down assets or use temporary welfare benefits until they qualify for a pension.)

Retirement income arrangements implicitly tax 'soldiering on'



Source: OECD 2005

PRODUCTIVITY COMMISSION

After the age of pension eligibility, many pension systems impose high effective tax rates on any earned labour income (because these then reduce pension income entitlements). Because New Zealand has a non-means tested universal pension, pension payments are not affected by any earned income. Australia lies around the middle of OECD countries in its effective tax rates.

Retirement income policy is vast and Byzantine, as well as highly politically sensitive. There are no policy 'silver bullets', but several changes likely to reduce work disincentives have been made already by the Australian Government:

- An array of tax offsets are now available for older workers
- The Pension Bonus Scheme, provides a financial incentive to defer access to the pension (even if less than actuarially neutral).
- Changes in superannuation eligibility (including a rising preservation age and work test changes).

But there are some further options to explore:

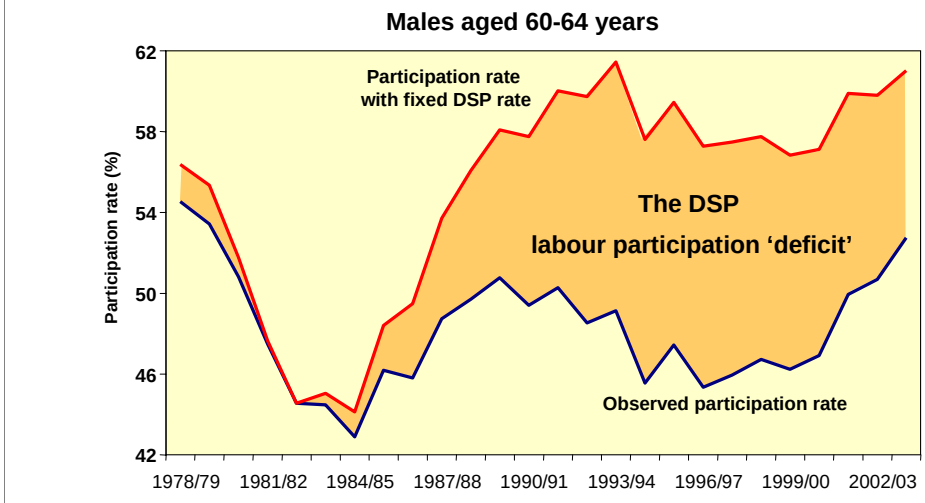
- Requiring persons who seek to access their superannuation before age 65 to take most of it as a pension or annuity. This would reduce subsequent pension outlays and increase participation before 65 years.
- Labour income test thresholds in the Age Pension could be increased to favour participation by people aged 65+, and these thresholds could increase the greater the age of the person.

The difficulty is that any policy amendments have to assess the extent to which altering rules induces a significant increase in participation against providing windfall gains to those who were going to work already (which generate inefficiencies associated with raising the tax revenue and could have equity consequences). They also have to examine unintended impacts in a system which is highly complex and in which retiree behaviour is not always clear.

Support systems are also important in influencing participation by people of all ages. This includes, for example, rehabilitation for injuries to stem inflows into Disability Support Pension. The area of DSP is also one where the previous issue of incentives to participate have undoubtedly played a role in its rapid growth.

DSP benefits are significantly higher than unemployment benefits, include other concessions and have had limited activity requirements.

The expansion in DSP numbers has reduced participation



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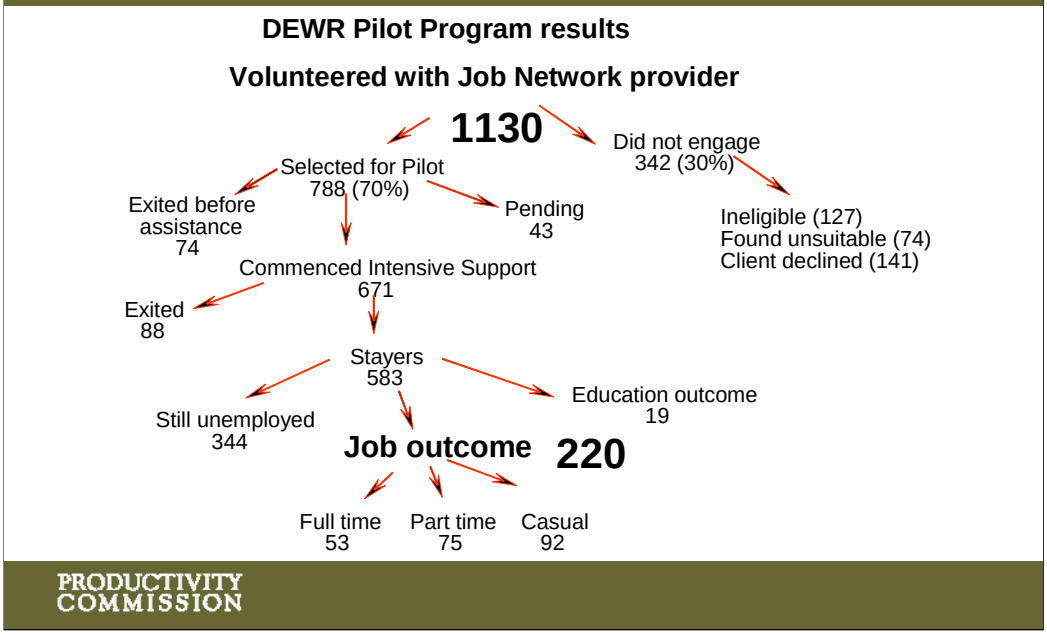
The expansion of DSP beneficiaries explains much of the decline in participation rates for older males. Had the disability rate stayed fixed at its lowest level over the period from 1978-79 to 2003-04, male participation rates would have been around 62 per cent in 2004 instead of the observed 53 per cent.

Exits from DSP into jobs is relatively modest, with many either moving onto the Age Pension or dying.

Getting DSP recipients into work isn't easy



The DSP experience is that it is hard to bring such disadvantaged people back into the labour market, especially once they have been on the benefit for a long period.

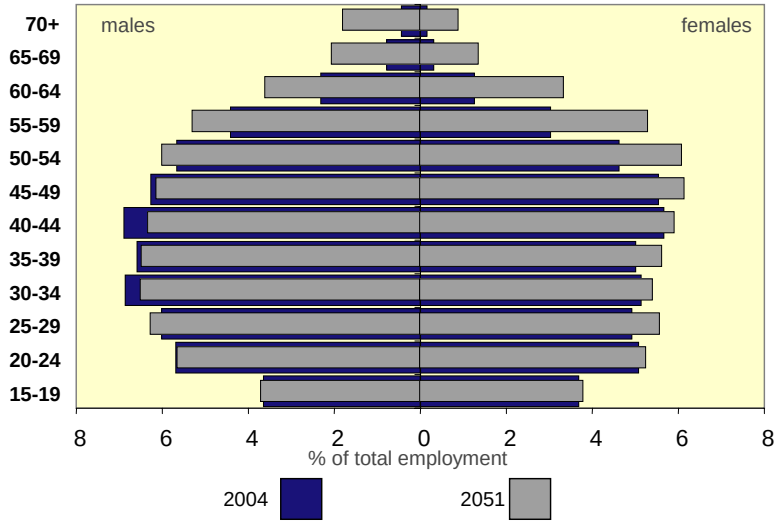
The results of a DEWR pilot program aimed at existing DSP beneficiaries highlights the difficulties. Only one in five of the original (voluntary) applicants got a job. Most of these jobs were casual and part time. This is a good result for the people concerned. But the nature of the outcomes implies that the aggregate economic effects of targeting existing DSP recipients will be relatively modest. The prime aim for any such measures should be social rather than economic.

However, an approach that aims to cut the **inflow** into DSP in the first place could be expected to have a bigger economic pay off – and this is the main thrust of the policy announced during the budget.

We now turn to the issue of flexible workplaces.

It is sometimes suggested that the nature of Australian workplaces will inevitably be transformed by population ageing and that this in turn will require adaptations to workforce design and behaviour to suit these more aged workplaces.

Employees don’t grey much



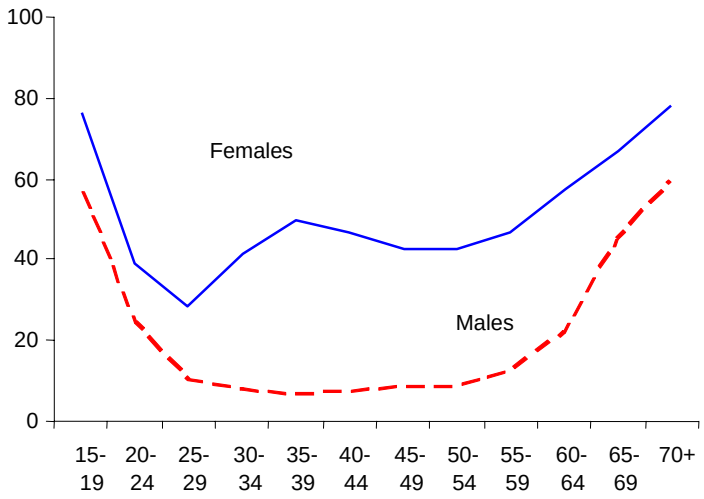
PRODUCTIVITY COMMISSION

In fact, unless policies substantially increase participation rates, workplace age structures will not change very much in the next 40 years. There will be more older workers – indeed the proportion of people aged over 60 years roughly doubles. But their share of the workforce will still be small relative to those aged under 60 years.

The average age of workforce will increase only 2 years, from about 39 to 41 years.

That doesn’t mean that changes may not be needed to retain and attract *more* older workers than previously. However, workplace design is likely to be less important than flexibility in work arrangements.

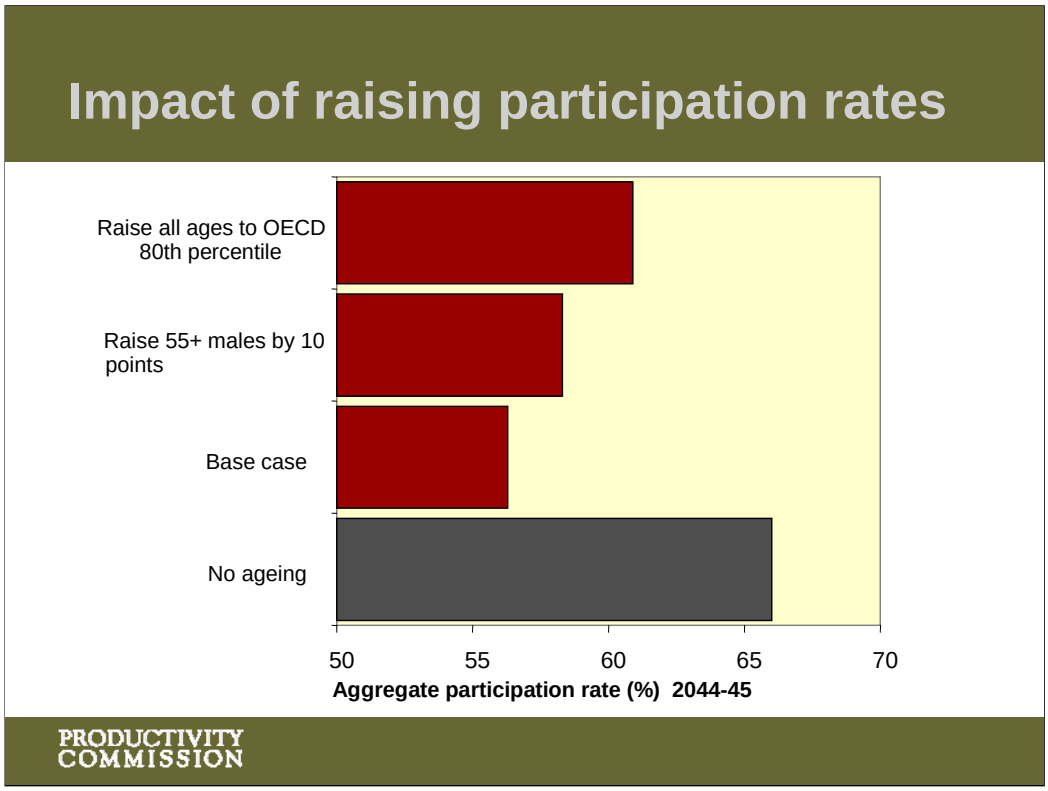
Part-time work rises after age 55



PRODUCTIVITY COMMISSION

For example, the part-time preferences of older workers also underlines the importance of not just thinking of employment opportunities of older people in terms of traditional full time jobs, but ensuring workplaces are not hamstrung in offering non-traditional employment options, such as casual jobs, including by dealing through labour hire contractors.

For example, some large corporates overseas keep track of people who have left full-time employment, but would like sporadic work. They offer jobs to these workers during peaks in demand, allowing them to tap their skills and experience and avoid bottlenecks in production.



Raising Australia's participation rates to a higher ranking in the OECD stakes has the potential to make a significant difference to overall participation rates, especially if it is focussed on all age groups, rather than just older workers.

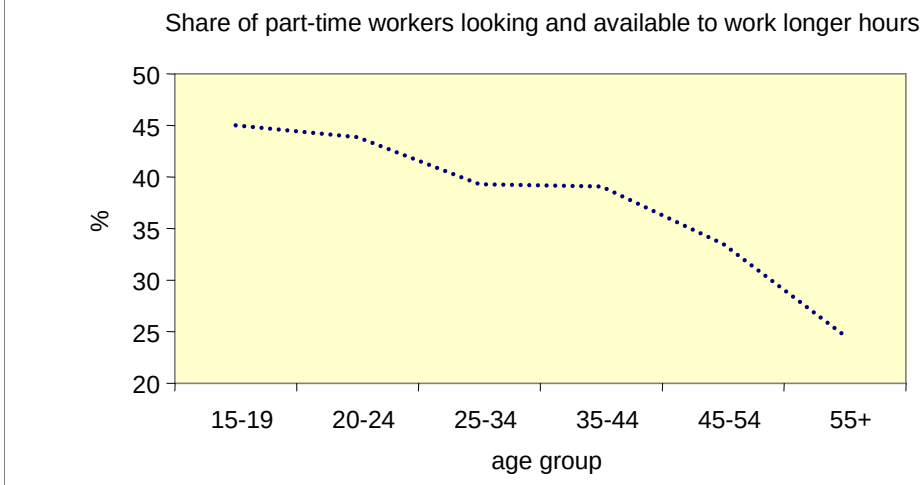
For example, getting Australian participation rates to at least the 80th percentile of OECD rates for each age group would increase participation rates by around 8 per cent (not points). This would halve the gap between the predicted aggregate participation rate in 2045 and that which would have occurred had there been no ageing.

But the impacts on output are likely to be less than this, to the extent that the additional workers are less employable or go to lower productivity jobs. For example, older workers retained or gained are likely to work fewer hours and have lower productivity on average.

Under plausible assumptions, the Commission has found that the 8 per cent increase in participation needed to get Australia to the OECD's 80th percentile, would yield a 4 per cent increase in output per capita.

This is still worthwhile of course and would also generate some fiscal benefits from reduced age pension and DSP outlays.

Some workers want more hours



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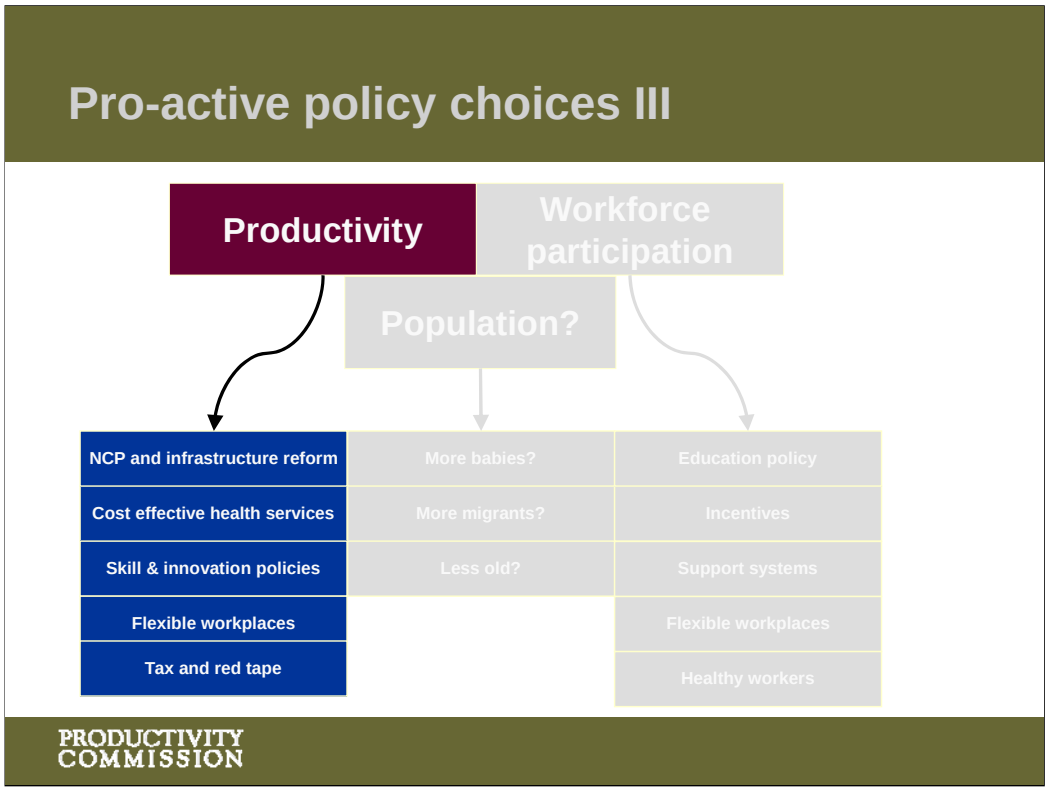
There are of course many people already in part time jobs who would like to work longer hours. Accommodating those aspirations may well be an efficient way of increasing economic output. It is notable that the desire for longer hours falls significantly with age, which also emphasises that policies aimed at labour supply growth should not be focused on older people alone.



Finally, the last P - productivity.

A little extra productivity growth adds up

	Productivity growth rates		
	2.05%	1.75%	1.45%
GDP per capita in 2044-45	$82 000	$73 000	$64 000
Cumulative GDP change over base case	+$4 200bn	..	-$3 800bn

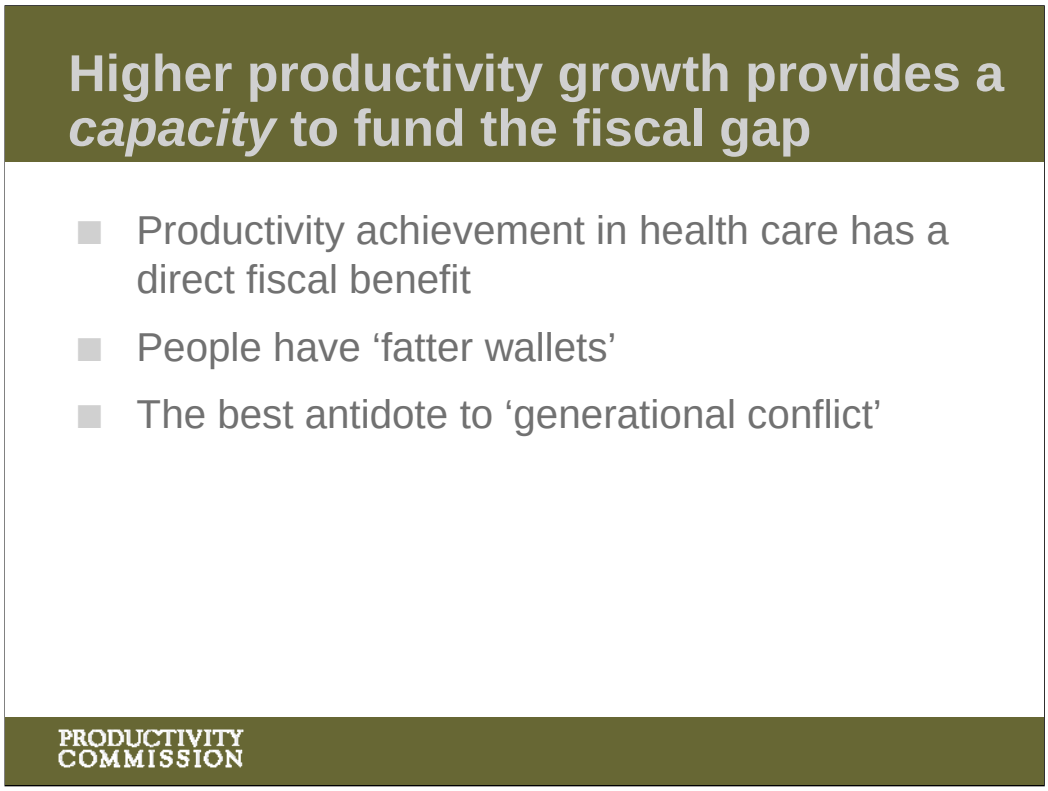
PRODUCTIVITY COMMISSION

Productivity growth has historically been the most important source of economic growth per capita. With lower labour supply growth, its role will be even greater in the future.

Small differences in productivity achievement add up to large changes in per capita GDP and to significant cumulative additional potential lifetime consumption.

For example, if productivity growth could be maintained at the 90's rates (2.05%), the cumulative increase in GDP would offset the decline due to ageing under the 1.75% productive growth scenario.

So productivity growth is the key to future income growth. But in itself, it needn't do much for *fiscal* sustainability. That is because some of the ageing-related costs rise with general productivity (health workers wages) and people's expectations of services rise with income (as in health care).



That said, productivity improvements in the health sector greater than the economy-wide average *would* have direct benefits for the fiscal bottom line. Health reform should be a key part of the ageing agenda.

Secondly, higher productivity growth means greater output and income growth. People have fatter wallets. They can afford to give up more tax to fund ageing, while still having a larger residual after tax income.

If productivity growth was sustained at the rate of the past 30 years, average incomes would roughly double over next 40 years. And they would still be 70% greater than today even if taxes were raised to cover the full fiscal gap. (So productivity growth is the best antidote to any intergenerational conflict.)

In fact, much of this tax financing could occur *without* radical tax policy change. Even were tax thresholds to be inflation adjusted (ie the gains from fiscal drag eliminated), higher productivity results in people progressing to higher tax thresholds as their real income rises. This real productivity effect would cover about half the fiscal gap at present projected productivity growth rates. The higher the productivity achievement, the more the tax coverage of the emerging deficit.

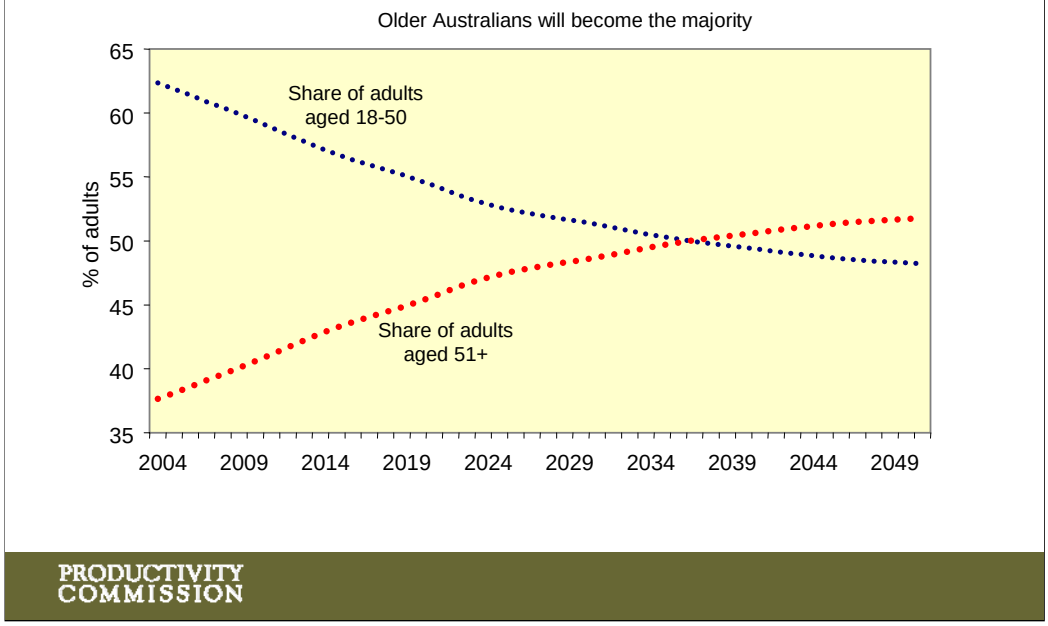
Australia has had a major productivity payoff from past economic reforms. But we have further to go and productivity may be slipping again.

The Productivity Commission's recent report for COAG has identified scope for further gains from a wide-ranging reform agenda. The new agenda is challenging and much of it will require a cooperative approach by all governments, as in the NCP.

However, the issues are complex and there is less agreement about solutions now than in the lead-up to NCP.

The last COAG meeting was encouraging, as few agenda items were taken off the table. However, this needs to be followed through by developing an agenda that includes both actions in the short term as well as further reviews where the best way forward is still not clear or generally agreed. The key, however, is to keep the overall agenda as broad as possible – in particular, including health care reform. Otherwise, reforms are unlikely to be adequate to meet the looming challenges ahead.

Carpe Diem: Electorates are ageing too!



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While the challenges are long term, the political window for change may not be as wide as we might like. The political power of the old will substantially increase in coming years, making it more difficult to put in place policies that re-distribute any of their future consumption to the young. That likelihood, combined with the long lead times for policies (such as those in the retirement income arena) suggests early rather than late reform.

To repeat the mantra of the Productivity Commission's Ageing Report: Ageing can only be conceived as a crisis if we let it become one.