Ageing Gracefully:

An Overview of the Economic Implications of Australia's Ageing Population Profile

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Commonwealth Department of
Health and
Aged Care

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Prepared for the
Commonwealth Department of Health and Aged Care

February 2000

Foreword

This paper has been publicly released by the Commonwealth Department of Health and Aged Care as part of the Department's Occasional Papers: New Series. The purpose of the series is to promote informed public debate on some key policy questions confronting Australia in the area of health and aged care.

This paper's authors are Peter Crowley and Greg Cutbush, two economists in the Canberra office of ACIL Consulting Pty Ltd. Both have worked in government and both have wide-ranging experience advising governments, international agencies and private sector clients on economic policy issues. Brief profiles of the consultants and the company can be found at http//:www.acilconsulting.com.au.

While grateful for comments and suggestions from Philip Hagan and senior colleagues in the Department, the authors are responsible for the material presented. The views expressed are not necessarily those of the Commonwealth Government.

Comments and queries would be welcomed and should be addressed in the first instance to the authors at ACIL Consulting: phone (02) 6249 8055; fax: (02) 6257 4170; e-mail: g.cutbush@acilconsulting.com.au or p.crowley@acilconsulting.com.au.

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Contents

Tables

Figures

1. The big issues

Many people are asking whether Australia can afford the higher dependency rates that population ageing and early retirement may bring.

The profile of the Australian population is ageing.[1] That is to say, the proportion of the population aged 65 years and over is rising and is projected to rise further over the next fifty years. Demographers say the group aged 65+ is likely to increase from around 12 per cent today to around 25 per cent by the year 2051. The median age is projected to rise from 34 years today to around 40 years in 2021 and to 44 years by 2051. Moreover, there has been a trend towards earlier retirement and, if this trend continues, it will compound the effects of ageing on the dependency ratio.[2]

Can Australia provide adequate living standards for the growing number of persons in the aged and other dependent groups without seriously undermining the living standards of the general community?[3]

1.1 Concerns about ageing

For example, concerns are often expressed that ageing will require vastly greater tax burdens to fund …

There are concerns that the increasing proportion of the aged in the population relative to those of employable age could place severe strains on government budgets, necessitating higher tax burdens on a diminishing number of workers. According to some commentators, our ability to support the aged will be undermined by labour shortages as more and more people enter retirement. The wealth generated by the dwindling worker class will need to be spread across more and more dependants. How will these people provide for their own retirement under an increasing burden of having to support older generations? The burden of rising taxes may undermine economic incentives, economic efficiency and therefore the performance of the Australian economy.

(a) retirement incomes…

…(b) aged care expenditures

The private cost of caring for the aged is also likely to increase, either because family members are forced to leave full or part-time employment or families are forced to incur the expense of paid outside help to assist in the caring process.

1 This is a consequence of the post Second World War baby boom, declining post-war fertility, immigration of working age persons and increased longevity.

2 Generally taken to be the ratio of the number of persons aged 65 years and over to the number of persons younger than 65 years.

3 Put more correctly, what will we have to give up to meet our responsibilities to care for these groups in the community.

..and (c) public health outlays.

There are concerns about a projected increasing national health bill combined with a rising number of those who draw more heavily on health services. It is feared that dual strains will arise because the group that uses health services the most also contribute the least to both Medicare and to private health funds (under 'community rating' practices).[4]

Commentators in other countries are also expressing an urgent need for policy reform …

Ageing is generally considered to be more pronounced in higher per capita income OECD countries than in developing countries. Nonetheless, since 1994 the World Bank has pushed population ageing as a key issue for developing countries (World Bank, 1994). The Bank has argued that the ageing phenomenon is occurring at the same time as traditional community and family based support is weakening and formal programs are beset by rising costs that will require rising tax rates, undermining economic incentives and economic growth. It has noted that countries like China are ageing more quickly than many realise – China's over-60 population is expected to double from 9 to 18 percent of the population in 30 years, a transition that took a century in France and Britain. In addition, the Bank cites some alarming figures on the implicit pension debt amongst nations - Uruguay and Hungary head the list with pension debts in the mid 1990s of 296 percent and 213 percent of GDP respectively! (World Bank, 1997)[5]

...and if the problem hits our trading partners, our economy will suffer.

World wide ageing, by undermining future growth in the world economy and thereby world trade growth might also have the potential to undermine economic growth in Australia. This would be a threat to the ability of the economy to provide better living standards for Australians. Even if Australia can cope with the increasing burden of its own aged population, there remains the possibility of imported problems – to a significant degree, our own growth depends on how well other countries are faring.

1.2 Policy responses

Policy is moving towards greater private provision.

Overseas and in Australia, in anticipation of an increasing public welfare bill, governments have attempted to shift the responsibility for aged care from the public sector towards the private sector and to individuals themselves. Governments may have been somewhat precipitous in these actions, as we will explain later in this paper.

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4 This is the practice of charging the same premium irrespective of the likelihood of receiving a claim; there has now been a move to adopt 'lifetime community rating' for private health insurance, whereby premiums rise with joining age — and this will go some way to addressing the problem.

5 World Bank (1997) p57, especially Table 3.2.

Massive intergenerational wealth transfers are in prospect and …

At the same time as ageing is contributing to a rising cost of supporting the aged, massive wealth transfers from the aged baby boomers to their heirs are in prospect. According to an EPAC paper (Clare and Tulpule, 1994), the largest intergenerational wealth transfer in Australian history will take place in the first few decades of the next century. This is not as big a statement as it sounds, given that Australia's population will be larger and wealthier than ever before at that time. Furthermore, the split between consumption and wealth transfer will depend in part on government policies. Continuation of a readily available pension would increase the wealth transfer, but would mean higher taxes for the working generations. By contrast, tighter means-testing would see greater financing of retirement income out of personal wealth. Inheritances would be reduced, but so too would the burden of taxation.

… some of this transfer could be used to pay for aged support.

While a demographic certainty, ageing is also an economic issue.

The policy implications of Australia's ageing population were addressed at a recent conference hosted by the Productivity Commission (1999).[6] The Commission did not draw any overall conclusion about the extent of the problems that ageing implies. It simply made the point that if the changes caused by ageing are as dramatic as some analysts have predicted, there is an urgent need to introduce appropriate policies with sufficient lead-time. Equally, if the implications of ageing are less severe, the policy urgency is less, it said.

Policy distortions, not ageing, are the real concerns. They could make things worse …

This conclusion does not take us very far. But this was a conference intended to highlight the issues - there were 70 participants and 17 papers given over two days. It used a roundtable format for discussions and included representatives of all relevant disciplines and sectors. The volume of conference proceedings extends to more than 500 pages.

In this paper, our purpose is to assess the arguments and come to a point of view. We conclude that the impact of population ageing has been overstated by many commentators, particularly by demographers. Some commentators have verged on the hysterical, threatening to divert the attention of the community and its policy makers from more important and more pressing social and economic issues.

We say that the implications of ageing are well within the capacity of the economy to absorb and need not involve any significant hardships for the general population or for the aged, even if policy settings remain as they are. Indeed, as some of its conference participants recognised this is not really the important policy issue.

... and their removal could generate substantial benefits.

In policy terms, the main concern should be to remove impediments to the ability of the economy to generate the best possible living standards for all Australians, of all ages. The extent of any difficulties arising from

6 The proceedings are in Productivity Commission (1999).

the ageing of the population will be exacerbated if there are no changes to a number of discriminatory policy measures affecting such things as retirement and savings incentives, education and training, and the demand for health and aged care services. Correction of these distortions would generate substantial social and economic benefits, even in the absence of an ageing trend.

To repeat, we have concluded that what may well be a demographic 'certainty' — the ageing population — does not translate into an economic certainty of an increased aged burden for society. As will be explained below, our view is that the extent of the future transfer from workers necessary to support dependent groups in the community depends on a variety of economic variables each of which will adjust, for the most part automatically, to offset emerging pressures.[7]

The economic and social contributions of the aged need to be fully appreciated.

Probably the biggest insight which leads one to this view is that the aged are not passive economically. Most of the doomsayers fail to recognise the breadth of services the aged contribute to the community.[8] Besides the more obvious active roles of the aged in supplying land, labour, capital and management they also supply some less directly observable services which are directly substitutable for market services, or are services that support the ability of other members of the family and the community to earn income.

Policy adjustments could ease the burden and would benefit all of us.

Policy reforms could offset any rising burden. There is a range of adjustments that Australian governments could implement in the years ahead that could allow the economy to meet the costs of aged care more efficiently and with minimal dislocation. Areas of particular importance include labour market policies, education and vocational training, policies affecting savings and investment performance (including superannuation), financial market policies, tax burdens generally and taxation of savings in particular. Policies towards the taxation of inheritances and underlying assumptions about what should be legitimately passed on to the kids need to be reassessed.

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7 Many commentators forget that an economy is a living, breathing organism, not a page in an accounting ledger. Kick it and it will fight back.

8 Moreover, as noted by the Productivity Commission, there are both costs and benefits associated with an ageing population:

> "However unwelcome ageing may be to individuals, it should be recognised as a sign of success for society as a whole. Improvements in life expectancy resulting from better health and aged care mean that more people than ever can look forward to a productive and fulfilling later life. While these growing numbers pose some policy challenges, they also constitute an asset and an opportunity. Elderly Australians embody a wealth of knowledge, experience and understanding which is valuable in economic as well as human terms. Their contribution to the wellbeing of the nation has the potential to expand if underpinned by appropriate policies. In this sense, it is important to consider not only the costs, but also the benefits of population ageing, and how they can be better harnessed." (*ibid*, Introduction, p3)

There is political opposition to difficult reforms.

Revisiting policies in these areas will challenge deeply held convictions in the community and present difficult political choices. The political realities associated with an increasingly influential aged lobby will need to be taken into account.[9]

1.3 Structure of this paper

The paper has three more sections which look at ageing trends, their implications for public and private expenditures over the next 50 years and what this means for policy.

In the following section (Section 2) we examine trends in the population age structure and, assuming things remain as they are, what this might imply for the level of dependency on the public sector and on workers. We also look at the public and private cost of aged and health care and some projections. We conclude by making an assessment of the extent of the 'problem'.

In the section after that (Section 3) we examine the key factors that will be driving the aged care bill over the next fifty years. We also examine how governments could amend policies to allow the economy to better provide for dependent groups in the community while at the same time achieving rising living standards in the general community.[10]

The final section (Section 4) restates our general findings and touches briefly on avenues in which policies could be improved.

Throughout the paper we have taken it as given that the Australian community has a responsibility to adequately provide for its aged. At another level, Australia also wishes to have an aged care bill that is a manageable as possible and equitable arrangements for paying it.

2. Population ageing and its implications

Population projections demonstrate that, under a wide range of assumptions, there will be a significant increase in both the number of people and the proportion of the population entering retirement age over the next fifty years. The trends do not change substantially with plausible scenarios about fertility rates, rates of net immigration or life expectancy. While all these variables could change in unforeseen ways, it seems inevitable that Australia's future population structure will shift towards the aged and away from the young.

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9 The baby boomers have always been a politically active and influential generation. First they supported the cause of youth, then the middle aged and middle class cause and, increasingly, they will exert their influence in the pursuit of their own benefit as they enter into retirement. The Flower may be wilting but the Power remains.

10 That is, provide better for all groups in the community.

Let us see what the projections tell us about outlays on the aged.

The implications of the ageing population structure that are the focus of this paper concern the cost imposed on the community — in terms of both public and private outlays — to support the growing number of retired Australians.

2.1 Demographic trends

In 50 years time the median age will be about 10 years older (ie 44) and one quarter of us will be over 65.

As we said at the start, the profile of the Australian population is ageing. This is a consequence of the post Second World War baby boom, declining post-war fertility, immigration of working age persons and increased longevity.[11] The expected trends are as follows (see Figure 1):[12]

- the proportion of the population aged 65 and over is projected to rise from around 12 per cent today to 18 per cent by the year 2021, reaching 25 per cent by the year 2051;
- the proportion of the population age between 0 and 14 years is expected to decline from 21 per cent in 1998 to 17 per cent in 2021 and 16 per cent in 2051;
- the proportion of the population aged between 15 and 64 years (th is expected to fall from 67 per cent to 65 per cent in 2021 and to 60 per cent in 2051; and
- the median age is projected to rise from 34 years today to around 40 years in 2021 and 44 years by 2051.

The age 'dependency' ratio is also affected by factors such as retirement age and life expectancy.

Two additional statistics are of interest to the consideration of the implications of the ageing population and, more generally, to dependency ratios. Over the past decade there has been a trend towards earlier retirement, often involuntary, and life expectancies have been rising. This has particular implications for health and aged care expenditures:

- the proportion of the population aged 45 to 64 years (the workers) is projected to increase from 22 per cent today to 25 per cent in the year 2051; and
- reflecting increased life expectancy, the proportion of the population aged more than 85 years is expected to rise from 1 per cent today to around almost 5 per cent by the year 2051.

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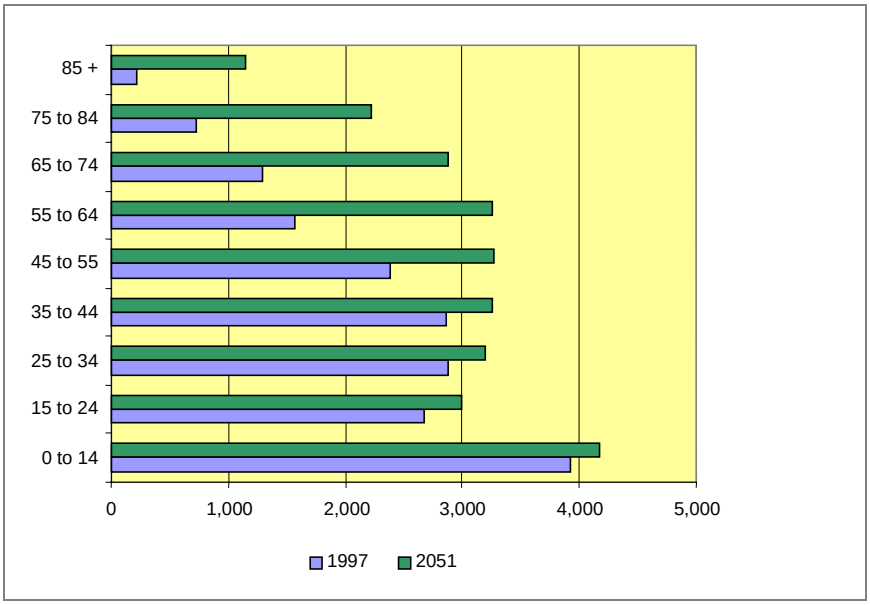
11 The desire for smaller families, and the underlying economic determinants of that desire, have also caused a shift in the age distribution towards older groups.

12 These trends are based on Australian Bureau of Statistics population projections, Series II. See Australian Bureau of Statistics (1998). For discussions of ageing trends see Clare and Tulpule (1994), McIntosh (1998), Rothman (1998) and Walker (1997).

That there will be an ageing population structure is pretty clear.

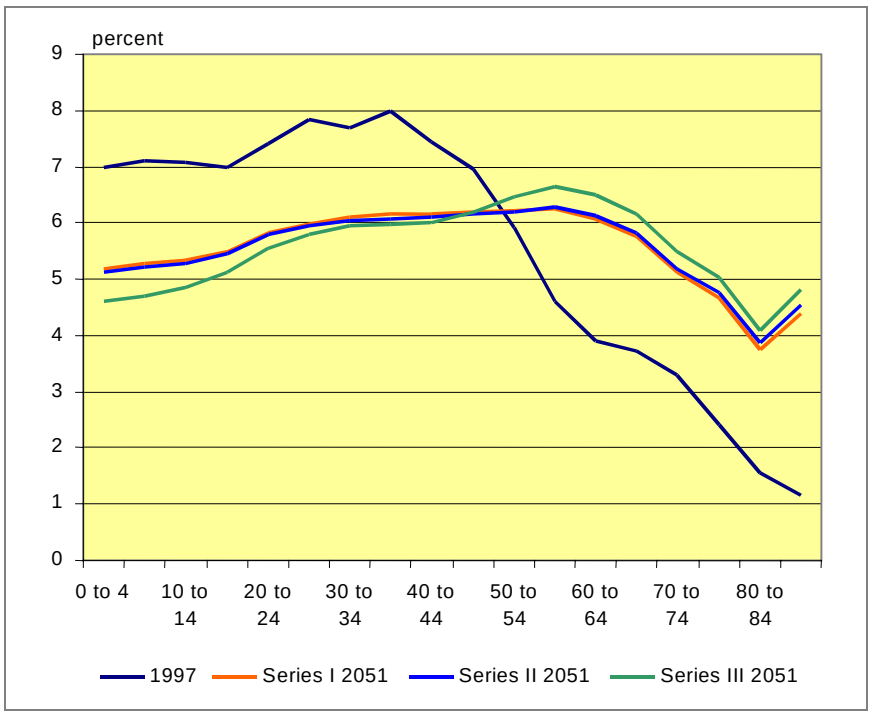
Population projections are somewhat sensitive to assumptions made about fertility rates, mortality rates and life expectancy, and net immigration. However, variations in the assumptions about these factors do not substantially change the expectations of a general trend towards an ageing population structure. This is seen in Figure 2 in which three ABS population projection series, embodying varying assumptions about migration and fertility, are depicted. The proportion of the population aged 65 years and over in 2051 varies between 23.7 per cent, for the high fertility, high immigration Series I, to 25.6 per cent for the low fertility, low immigration Series III. The proportion of the population in the working age group, 15 to 64, is broadly similar for all three series.

Figure 1: Projected population by age groups (ABS Series II)



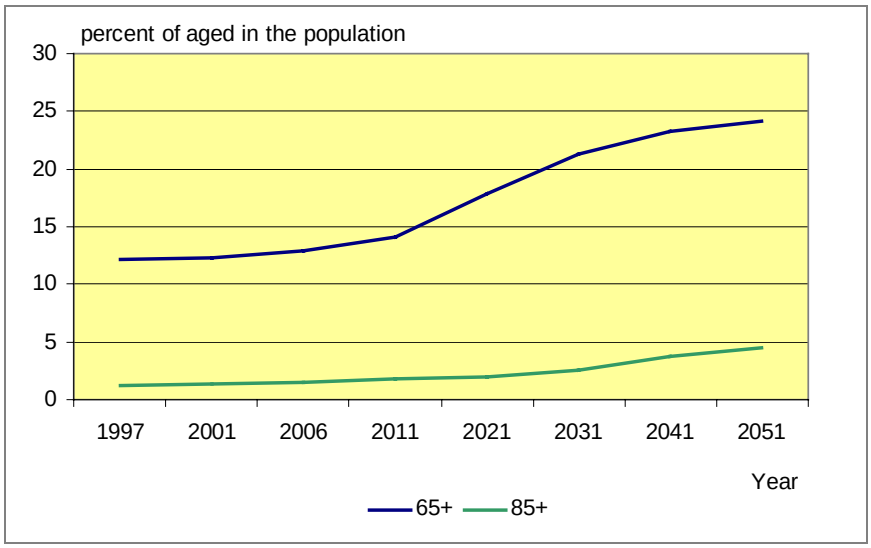
Source: Based on data from Australian Bureau of Statistics (1998). The vertical axis refers to the various age groups. The horizontal axis measures the number (in thousands) of people in each group.

Figure 2: Changing Australian age profile under different scenarios: 1997 and 2051



Source: Based on data from Australian Bureau of Statistics (1998).
Note: the three series are based on different assumptions concerning fertility, mortality and immigration rates. Series I is based on a total fertility rate of 1.75 and net overseas migration of 90,000 a year, Series II is based on a fertility rate of 1.75 and net migration of 70,000, and Series III is based on a fertility rate of 1.6 and net migration of 70,000.

Figure 3: Projected growth in proportion of aged in the population



Source: Australian Bureau of Statistics (1998),

The baby boomers will create a 'bubble' of new 65 year olds in about ten years time. If life expectancy lengthens, the number of people 85+ will grow most.

The ABS population projections indicate that the highest rate of growth in the over 65 age group will occur between 2010 and 2020, when the peak of the post war baby boom generation[13] enters this age group.

Life expectancy assumptions are important to projections of the proportion of the aged population, and in particular for projections of the number of the very old (aged 85 +). This group is particularly important to expenditures on aged care and health.[14] Since 1985, the greatest rate of ageing has occurred in the over 80 age group, which increased by 48 per cent in the decade to 1994. According to the ABS, the proportion of the population in the 85 plus age group will reach 5 per cent by 2050 compared to around 1 per cent today (see Figure 3).

2.2 Growing dependency

2.2.1 Australia

Superannuation researchers have been projecting dependency ratios in recent years.

The major policy issues arise because of what these trends imply for dependency between groups in the community. Rothman, a researcher at the Retirement Income Modelling Unit in the Commonwealth Treasury, has used the RIMGROUP model to project both medium term and long term aggregates for Australia's aged.[15] These projections include dependency ratios, the costs of aged and veterans' pensions, the aggregate assets of the aged compared with the aggregate assets of the superannuation system (important, as the aged derive income both from labour and from capital owned) and projected costs of health care in Australia. The projections have been done for each year of the projection period, 1992 to 2060, separately for each cohort.

The outlook is mixed. Rothman, for example, has projected that dependency will come back to 'normal' in 50 years time.

Rothman projects a number of dependency ratios. The results of these projections are summarised in Figure 4. Ratio 1 is the ratio of the number of persons aged 65 years and over to the number of persons aged 18 to 64. This standard aged dependency ratio is projected to rise from 0.19 in 1994-95 to 0.20 in 2005-06 to 0.3 in 2024-25 and reach 0.39 in 2059–60.

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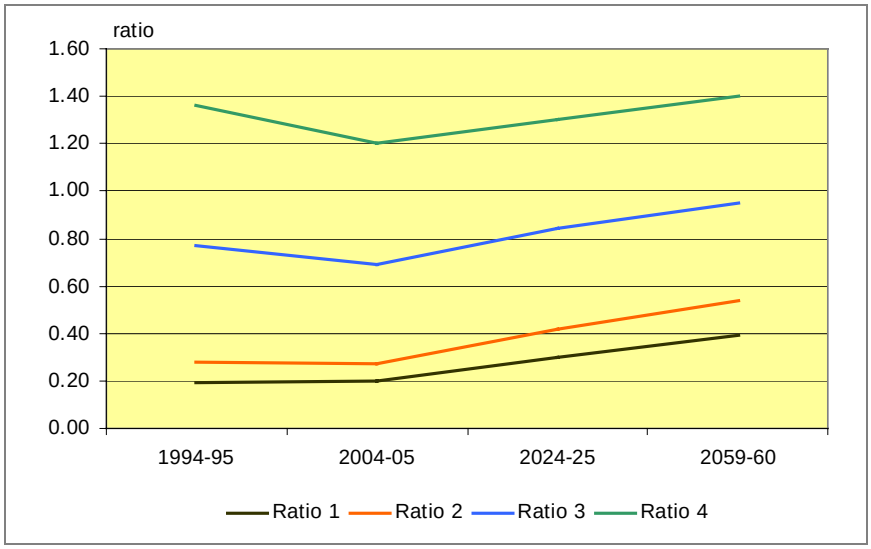
13 The baby boom generation is a term used to refer generally to those born between 1945 and 1960.

14 The life expectancy for an Australian has risen from 57 years in 1900 to 78 in 1996, an increase of 37 per cent (Walker 1997). Future increases in life expectancy are hard to predict but there may be a biological maximum life expectancy and, as this is approached, the scope for improvement may diminish. Yet life expectancies by 2050 of over 90 are not improbable. The increased life expectancy has been due to improved nutrition and hygiene, improvements in medical knowledge, and decreases in deaths due to unnatural causes. Recent gains in life expectancy have been most marked for the middle aged and older age groups (Goss *et al*, 1994). These developments have resulted in rapid growth in the 75+ age group.

15 According to Rothman (1998), RIMGROUP is a comprehensive cohort projection model of the Australian population. The model has population and labour force components. It tracks superannuation savings, estimates non-superannuation savings, and calculates tax payments and expenditures, social security payments and the generation of other retirement income. Detailed descriptions of the RIMGROUP model are contained in Rothman (1997) and Gallagher (1995). One important limitation of the model is that macroeconomic linkages are exogenous (ie imposed) rather than endogenous. For example, the rate of unemployment is not affected by the stock of superannuation savings and retirement rates.

Figure 4: Comparison of various predicted dependency ratios



Source: Based on data presented by Rothman (1998).

Ratio 2 is the ratio of the number of persons aged 65 years and over to the number of workers, in all age groups, employed. From its level of 0.28 in 1994-95, this ratio initially falls to the year 2005-06, reflecting the assumption of the RIM projections of an increase in labour force participation rates. Subsequently, the ratio rises to 0.42 in 2024-25 and reaches 0.54 in 2059-60. The way Rothman sees it, the rise in labour force participation rates may provide a brief period of respite before issues concerning increased aged dependency 'start to bite'.

Ratio 3 is the ratio of the number of persons aged 65 plus and persons not working (unemployed) to persons working. The ratio predicted by Rothman falls from 0.77 in 1994-95 to 0.69 in 2004-05, again reflecting increased labour force participation rates. However, beyond 2004-5 the expected ratio increases strongly, to reach 0.84 in 2024-25 and by 2059-60 reaches 0.95.

Ratio 4 is the ratio of the number of persons of all ages not working to the number of persons of all ages working. It projected value falls from 1.36 in 1994-95 to 1.2 in 2004-05. It then rises to 1.3 in 2024-25 and 1.4 in 2059-60. The increase in this ratio is relatively modest, reflecting the expected continuation of today's observations that the rise in aged dependents is offset by a fall in young dependents.

Another team has found that the retired /working ratio will climb steadily from 1.4 now until it reaches 1.6 in 50 years time (ie 60 retired people for every 100 workers).

Bacon and Gallagher (1996) calculate a retired dependency ratio, defined as the ratio of persons retired to those actually working. They project this will rise from 1.4 to 1.6 in 2050. This means for every 100 workers, there will be 60 retired persons.

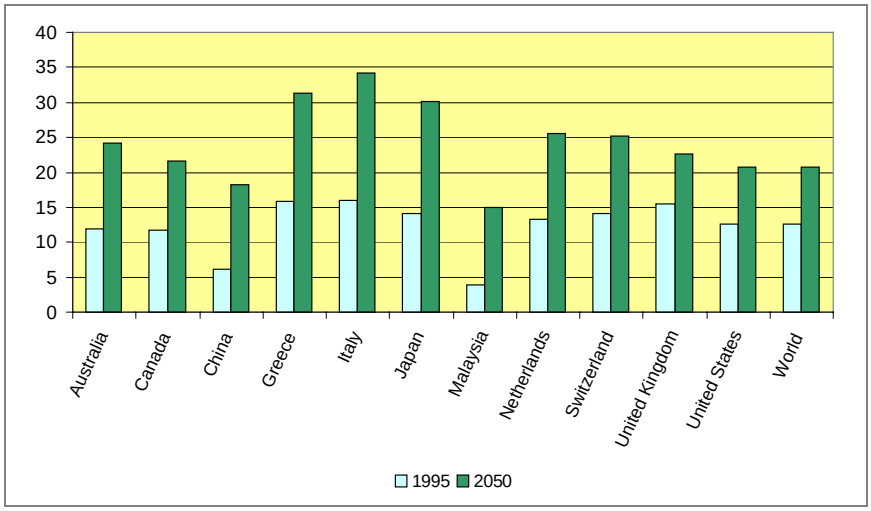
2.2.2 The international experience

Many European countries have one and a quarter times the percentage over 65 that we have, but Canada and the US are much the same as ourselves.

The ageing population structure Australia is experiencing is common to most developed economies and many developing countries. According to McIntosh (1998), in 1950 between 8 and 9 per cent of the populations of North America, Europe and Australasia were aged over 65 years. By 1995, the aged accounted for around 12 per cent of the populations of Australia and Canada, 13 per cent of the US, and over 16 per cent in European countries such as Italy, Greece, the UK and Sweden. The ageing trend is projected to continue into the future, with the ranks of the aged swelled by the post World War II baby boom generation.

Figure 5: Proportion of population aged over 65 years: selected countries

By 2050, researchers say the percentage over 65 in Australia will have risen above that in North America, but will remain well below that in Greece, Italy and Japan.



Source: Australian Bureau of Statistics (1998).

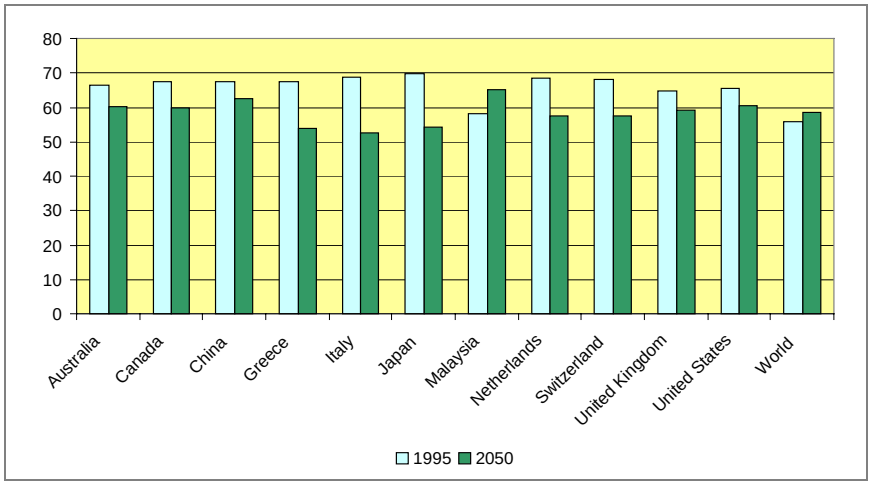
Projected changes in the population structure of a sample of countries are presented in Figure 4 and Figure 5. In all the OECD countries, one can see occurring both an increase in the proportion of the aged population and a decline in the proportion of the population in the traditionally defined working age group, from 15 to 64 years of age. In terms of the proportion of 'workers', the projected decline is much less pronounced in Australia than in many European countries and in Japan.

The European 'experiment' with ageing to date may contain lessons for us in the future.

It has been noted that many European countries have already managed substantial ageing of their populations without crisis. This may have been because of rapid growth in the labour force, particularly with increased female participation. Given physical limits to the size of the

labour force, the impact of ageing populations may be greater in the future.

Figure 6: Proportion of population aged between 15 and 64 years: selected countries



Source: Australian Bureau of Statistics (1998)..

Across OECD as a whole, the proportion of the population of traditional working age will drop… Australia shares this trend.

According to Shigehara (1997) the number of people of working age will fall in many countries over the next few decades. Between now and 2030, the working population will fall by as much as 17 per cent in Japan and 24 per cent in Germany. For the OECD as a whole, by 2030 the number of people of working age (15 to 64) for every person of retirement age (over 65) will be cut in half, from about 5 to 2.5 (or to put it the other way around, from 20 people 65+ for every 100 workers to 40 people 65+ for every 100 workers). The fall in the proportion of the population of working age is expected by Shigehara to be much less pronounced in Australia than the OECD average. In 2031, the number of Australians of working age will be around 20 per cent higher than in 1997. However, if we look beyond 2031 (Shigehara's horizon) to 2050 (the ABS horizon) the difference with the rest of OECD is less marked.

The UK has already lived through its age 'time-bomb'

In the UK, a Royal Commission on aged care funding, recently examined ageing issues.[16] The Commission noted that the ageing phenomenon is not new, but has occurred throughout the past century. According to the Commission, from the turn of the 20th Century, the number of older people in the UK has risen by around 400 percent. It has doubled since 1931. The Commission projected this trend to continue to about 2030 when the population will stop growing, as a result of past falls in birthrates.

16 The United Kingdom Royal Commission on the Funding of Long-term Care for the Elderly (1999).

> "In a sense the UK has already lived through its demographic 'timebomb' earlier in this century. The future is much more manageable."[17]

Similarly, the Australian population has aged substantially over the past century.

Examining the various projections, it can be safely concluded that the Australian population will age significantly over the next 50 years. However, when dependency rates are examined, the trend is less clear. The growing number of older Australians will be offset, in terms of its effects on dependency rates, by a falling number of young dependents. The proportion of Australian of working age will remain fairly constant. This is in contrast to a number of other countries where the working age proportion of the population will fall significantly.

Having said that, it is not clear that the situation warrants the assessment Johnson made at the Productivity Commission's conference in March 1999:

> "Australia has managed, either by historical chance or brilliant foresight, to avoid the most pressing public pension finance problems faced by many OECD countries. The means-tested basis of the aged-pension, together with the compulsory old-aged savings introduced with the Superannuation Guarantee, mean that Australia faces very low rates of public pension expenditure growth together with a rapidly expanding private pension asset base. The combination comes close to the 'ideal type' of pension structure advocated by the World Bank (1994)." (p.23)

To be fair, Johnson himself qualifies this statement later in his paper.

17 *Op cit,*. page 6.

2.3 The cost to governments of supporting the aged

2.3.1 Main components

The Commonwealth spends nearly 10 per cent of Australia's GDP on social security - about one third of it on specific programs for the aged. Pensions, housing and health are the 'big ticket' items

Services and financial assistance for the aged are provided by all tiers of the public sector (federal, state and local government) and the private sector (both the informal, non-profit and profit sub-sectors). Apart from family, the public sector is the major source of age-related services and assistance. A proportion of payments and benefits received by the aged is from *general* welfare programs, so a total picture of public funding for the aged is difficult to obtain.

The major specific or targeted items of Commonwealth Government funded benefits and services available to the aged include pensions, rent assistance, residential services, public housing, medical and pharmaceutical benefits, acute care hospital services and home and community care programs. State Governments also provide a range of health, housing and welfare services for the aged. The major categories of Commonwealth aged-related expenditures are listed in Table 1.

In 1998-99, Commonwealth social security payments totalled about $53 billion (see Table 2). This constituted around 39 per cent of total Commonwealth outlays, or around 9.3 per cent of gross domestic product (GDP). Of this, total payments targeted specifically to the aged accounted for around one third. By 1998-99, just the aged-related expenditures of the Commonwealth Government had risen to around 13.5 per cent of total Commonwealth outlays or around 3.2 per cent of GDP. Nonetheless, Commonwealth assistance to those of working age (including families, the sick, the unemployed and the disabled) accounted for $29 billion in expenditures, about twice the amount spent on the aged.

All components are growing faster than GDP.

Below we will focus on the cost of the main classes of aged care expenditures to the public purse. It is also recognised that significant private expenditures are incurred by the private sector, including the families and voluntary supporters of the aged. The major areas of public funding growth with the ageing population have been age pensions, health care, housing and aged care. The outlook for each of these areas is addressed below.

Table 1: Major aged related outlays of the Commonwealth Government

	1997-98 (estimate)	1998-99 (budget)	1999-00 (estimate)
	$ million		
Age pensions and allowances and partner allowance	13,617	14,413	14,993
Residential care subsidies			
Low care needs (hostels)	694	723	758
High care needs (nursing homes)	2238	2262	2310
Home and community based provisions	852	1018	1086
Total	17401	18416	19147
Percent of total Commonwealth outlays	13.4	13.5	13.1
Percent of GDP	3.1	3.2	3.3

Source: Commonwealth of Australia, Budget Papers, relevant years. These figures are the latest available that group outlays according to these categories. While more recent data could be obtained, the general direction of the trends is unlikely to be much different.

Table 2: Major social security outlays of the Commonwealth Government

	1997-98 (actual)	1998-99 (estimated)	1999-2000 (budget)
	$ million		
Assistance to the aged	14,768	15,655	16,237
Assistance to veterans and dependents	4,508	4,563	4,639
Assistance to people with disabilities	6,264	6,740	7,236
Assistance to families with children	14,306	14,845	15,709
Assistance to the unemployed and sick	6,761	5,853	5,784
Assistance to young people	0	1,994	1,976
Other welfare programs	968	918	911
Aboriginal advancement programs	1,058	1,119	1,153
General administration	1,844	1,836	1,616
Recoveries and repayments	-55	-67	-66
Total	50,420	53,458	55,284
Percent of total Commonwealth outlays	39.8	39.1	37.7
Percent of GDP	9.1	9.3	9.6

Source: Commonwealth of Australia, Budget Papers, relevant years.

2.3.2 Pensions

More than 70% of Australians aged 60+ receive a pension. Some 84% of aged-pension age people receive some help.

The social security system provides income support to the aged, the disabled, the unemployed and child supporters. Age related income support in Australia is provided in the form of the age pension, wife pension, the partner allowance and the mature age allowance.[18] In 1997-98, age pension outlays by the Federal Government amounted to around $14 billion dollars, accounting for the most important source of income for retirement income (over 70 per cent of Australians aged 60 plus received pension payments). Currently some 84 per cent of people of age pensionable age receive some income support either from the Commonwealth's general welfare and veterans' support agencies.[19]

The RIMGROUP model says pensions will grow from 3% of GDP now to 4.5% in 50 years time.

Rothman (1998) employed the RIMGROUP model to generate projections of the cost of age and veterans pensions as a percentage of GDP, under a range of assumptions. Under a base case scenario, pensions rise from about 3 per cent of GDP now, to 4.5 per cent of GDP in the year 2049-50.[20] Alternative scenarios are also presented. Without the superannuation guarantee (SG), the increase would be from 3 per cent to 4.8 per cent of GDP. With a universal pension, the increase would be from 3.7 per cent to 6.4 per cent of GDP. Increasing the pension from 25 to 30 per cent of average weekly ordinary time earnings would see the proportion of GDP allocated to pensions rising from 3 per cent to 5.3 per cent.

These results are sensitive to varying degrees to a range of factors. They include the rate of dissipation of lifetime savings, the rate of draw down of the capital component of investments (and the consequent level of bequests), the age of retirement, the deeming rate policy (deemed income flows from investments rather than actual flows) and investment patterns and mixes.

2.3.3 Age-related public health care and housing

Effect of longevity on national outlays

The effect on longevity on the demand for aged care remains a puzzle.

The ageing of the population profile has implications for future outlays on health expenditures, both public and private, as well as for publicly subsidised housing and for aged care. How important increased life expectancy is as a driver of such outlays is not so clear.

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18 All payments are subject to both income and assets means tests.

19 McIntosh (1998).

20 The base case assumes the continuation of voluntary superannuation savings and the superannuation guarantee, with persons indexed to average weekly ordinary time earnings, but with threshold levels for income and assets tests indexed to the CPI.

Many existing publicly-funded aged services were developed at a time when life expectancy was shorter than it is today. Now many people live well into their 80s and this is expected to become the norm in the future with advances in medical science and healthier lifestyles.

People are now living well into their 80s. After 65 they become big users of health services - about three times the average…

On average, older persons tend to be higher users of health services. Compared to the rest of the population, persons aged over 65 years, have per capita health expenditure around four times higher, are admitted to hospitals more often and stay longer and have expenditure on pharmaceuticals some 2.5 times higher.[21] Moreover, the health costs of the aged group tend to be concentrated on the over-75 years age group, projected to be the most rapidly growing. In 1993-94, according to McIntosh (1998), 35 per cent of the total expenditures of the health system was on people over 65, at a time when this group comprised less than 12 per cent of the population.

… but it cannot be concluded that greater longevity means a bigger aged care outlay

On current estimates, a woman of 65 years today has a 39 per cent probability of using a nursing home and a man has a 25 per cent probability (Lui 1998)[22]. The average costs of nursing home care are around $30,000 a year for each nursing home place (Department of Health and Family Services, 1998).[23] But whether they might have encountered similar costs when they lived shorter lives is open to question. The data needed to answer this puzzle are not readily to hand. The data we need are not easily found, partly because so much of the commitment is unpaid.

Much the same issue arises with other components of aged care besides health. Again good data are hard to find, not the least because in many of these areas, the public sector share of outlays is relatively small.

In 1997 for example, it has been said the ‘private profit’ sector provided 50 per cent of beds in high care facilities, the ‘non-profit’ sector 38 per cent and the public sector the remainder (McIntosh, 1998). One estimate that has been produced is that in 1997-98 aged care services accounted for 0.7 per cent of GDP, with residential care accounting for 76 per cent of this. However, this figure does not capture the provision and cost (in terms of money, time and effort) of aged care services provided by families, friends and other unpaid carers.

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21 Australian Institute of Health and Welfare (1998).

22 Lui (1998).

23 Commonwealth Department of Health and Family Services (1998).

Commonwealth spending on aged care

National outlay on residential (not home based) aged care are about $3 billion a year.

The Commonwealth Government has a number of programs directed to aged care. These include subsidies to nursing home facilities and programs to assist and care for the aged in the home. The Home and Community Care Program provides frail aged persons with subsidised home delivered services such as home help, personal care, meal services and home nursing services. In the 1999 Budget, the Government announced additional funding to support carers. While there has been a trend in recent years towards home based care rather than institutional care, subsidies to residential care facilities remain a major Commonwealth Government outlay. Such subsidies amounted to $2.9 billion in the 1998-99 budget (76 per cent of this amount was for high care, nursing home facilities).

Commonwealth and state spending on public housing for the aged

Commonwealth and State spending on public housing for the aged is falling away.

According to McIntosh (1998), 82 per cent of Australians aged over 60 years live in owner occupied dwellings, 12 per cent live in rented dwellings (about equally divided between private and publicly owned dwellings) and the remainder live in hospitals, nursing homes, retirement villages and other establishments. In 1998 only around 6 per cent of the aged or 138,000 people, lived in residential care facilities (nursing homes and hostels).

Since the 1996-97 Budget, when the Pensioner Rental Housing Program was incorporated into a general funding category, there has been no separate aged housing program. Around 6 per cent of the aged occupy public rental housing provided under the Commonwealth-State Housing Agreement to low income individuals and families. According to McIntosh (1998), most aged public housing tenants took up residence in their younger years.

Public aged health care outlays

The general public sector health bill is rising and the aged health care bill is rising even quicker.

There has been a number of projections of health costs relative to GDP. The projections are uncertain because of future changes in technology, lifestyles and social preferences. Expectations concerning future growth in public sector health outlays range widely. The National Audit Committee forecasts an increase from 9 to 16 per cent of GDP by the year 2016. EPAC is expecting an increase to only 11 per cent of GDP over this period. The Australian Institute of Health and Welfare forecasts a decline in health expenditures relative to GDP over this period.

One view of it is that the public aged health care bill could rise from about 3% of GDP now to about 6% in 50 years time.

Another view is that allowing for health service productivity growth, there might be little if any growth in health outlays at all as a proportion of GDP in the next 50 years.

According to McIntosh (1998), the proportion of health care expenditure directed to the aged could rise from around one third today to over 50 per cent by the year 2050. Currently health expenditure accounts for 8.1 per cent of GDP with aged health care accounting for around 2.7 per cent of GDP. Health care expenditure may rise to 11.1 per cent of GDP in 2051, according to McIntosh, implying that aged heath care expenditure could rise to 5.6 per cent of GDP by 2051.

Rothman (1997) used the RIMGROUP model to project total health outlays (public and private) as a proportion of GDP for each age cohort.[24] If health costs are assumed to increase in real terms at an average annual rate of 2 per cent,[25] total health costs (public and private) are projected to increase to 17 per cent of GDP by 2041 compared to around 8.5 per cent in 1997-98. That is, according to this source the share of GDP devoted to health costs is expected to double over the period. If a 1 per cent increase per year in real health costs is assumed, total health costs as a share of GDP will only rise to 10.4 per cent of GDP by the year 2041.

This suggests that, provided the rate of increase in the price of health care services is contained by greater cost consciousness and better technology, the ageing population structure need not imply a significant increase in the proportion of health care expenditure in GDP. The RIMGROUP model projections are very sensitive to assumptions concerning the likely increase in the real price of health care services. In cost terms any price increases compound the quantity effects of the ageing population.

The Department of Health and Aged Care (1999) has developed a health cost model that has been used to estimate the contribution of an ageing population to health costs.[26] The model estimates the following relationship under a number of assumptions:

HC = n X p X e X c

The number of people in an age cohort is denoted by n, p is the proportion of people in the cohort who use a health service, e is the average number of episodes a year and c is the average cost per episode (in base year prices). The Department assumes morbidity remains constant over time.[27] Costs per episode are also assumed to be constant in real terms and the average number of episodes is unchanged. The effect of these assumptions is that projected health costs may be

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24 The basic method is to apply recent health costs for a given age group to the projected numbers in that group at some point in the future, together with assumed rates of increase in health costs above general inflation, per person in each age group.

25 That is at an average rate of 2 per cent above the rate of inflation.

26 Commonwealth Department of Health and Aged Care (1999).

27 That is, the proportion of people win each cohort who use a health service does not change over the projection period.

overstated if there is an improvement in the health of the population over time or if there are productivity gains in health services. By holding these factors constant, a feel for the influence of population ageing alone on health expenditures can be gained.

A fairly stable picture of aged health outlays as a proportion of GDP comes from a number of sources.

Using the Department's health cost model, .the projected annual real increase in the cost of health care due to the combined effects of both the increase in the general population and the increase in the proportion of older people in the population reaches a maximum of 1.8 per cent in 2015 but declines to about 0.5 per cent by the year 2051. The annual increase due to ageing alone peaks at 1.1 per cent in the year 2015 and falls to 0.3 per cent by the year 2051. Given the likely pace of real GDP growth over the period, the ageing population does not imply an unmanageable health cost burden.

The Department also provides projections of the effects of population growth and ageing on acute care costs (hospital admissions). According to the model, the ageing population profile has the effect of raising the annual rate of increase of hospital costs from around 0.5 per cent in 1997 to a peak of 1.3 per cent in 2015, but thereafter a decline to 0.2 per cent in 2051 occurs. The model says ageing will increase real hospital costs by around $4 billion (in current dollars) a year by 2051, mainly due to the increase in the number of people over 65 years. Although expenditure on acute care will increase, the projected annual rates of increase are below the projected annual rate of growth in real GDP. In this sense, the costs due to population increase and the ageing population appear to be sustainable.

2.4 Is ageing likely to create a major public sector problem?

2.4.1 Identifying the key factors

How big a problem is the potential growth in the costs of supporting and caring for the aged?

Under current policy settings, including current pension and superannuation arrangements, and given the ageing population structure, the age pension bill and other costs of supporting the aged will certainly rise over the next 50 years. Whether or not this is likely to be a problem depends partly on the extent to which those over 65 years need to rely on the public sector to provide income support.[28] It will also depend on the

[28] Projections of superannuation assets may not adequately measure the capacity of the current working population to support themselves in their retirement. According to Argy (1997), the age hump only appears around 15 years from now and extends for 30 to 40 years after

Continued

ability of the economy to support a growing number of aged dependents at socially acceptable living standards, without significantly reducing the potential for improved living standards for the rest of the community.

Life expectancy, the health status of the elderly and regulations have been identified as key determinants of the size of the public sector's commitment to aged care.

Walker (1997) examined the impact of Australia's ageing population structure on age related public expenditures. Key factors identified include changes in life expectancy[29] and the health status of the elderly, social attitudes and government regulations concerning retirement, wealth accumulation and intergenerational wealth transfers, caring for the aged by families, governments and voluntary workers, and the extent to which economic growth could be relied upon for financing any additional public costs associated with ageing.

Treasury modelling suggests the implications of ageing for the budget will not be earth shattering.

The fairly simple models available suggest that even if aged pension outlays rose from the current 3.2 per cent of GDP to 4.5 per cent of GDP (as predicted under the RIMGROUP base case scenario), this would not be earth shattering. The models indicate that even under relatively pessimistic rates of economic growth, the economy would generate sufficient income to meet this bill and to provide for very substantial increases in average standards of living at the same time.

Indeed, given that most of the available models miss a number of key dampening influences, the outlook appears fairly benign.

However, the actual outlook is even better than this. The work cited earlier indicates that provided inflation in the cost of health service provision is contained to about 1 per cent a year in real terms, general increases in GDP should be sufficient to ensure the health costs incurred on behalf of the aged do not increase significantly at all as a share of GDP. The public cost of caring for the frail aged, under an unchanged policy scenario, may increase significantly in absolute terms as the number of aged increase. However, under a 'worst case' scenario this is unlikely to impose an unaffordable burden on the economy in general and new taxes (such as modest rates on inheritances), or tighter means tests (such as including part of the value of the family home in the recognised asset base), would still be available if it were decided that the public sector should recoup some of its costs.

In addition, it is likely there will be a number of behavioural adjustments that the simple models do not capture which will serve to soften the actual outcomes relative to those projected. For example, all types of decisions - from those about the timing and number of offspring, to those about education, career direction, diet, lifestyle and retirement location - are likely to be affected by any uncertainty about whether Parliaments will

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Continued

that. Between now and 2015, private savings appear set to rise substantially because this is the peak saving period for the baby boom generation.

29 The ABS predicts that by the year 2051, the life expectancy of a new-born Australian male will be 81 years and a new-born female 86 years. Many would regard these figures as conservative given past increases in life expectancy, evidence of increasingly healthy lifestyles and the rate of growth of knowledge.

tolerate historical levels of public support for the aged. Such responses will have a dampening effect on emerging crises.

Some more ideas of this type are discussed below.

2.4.2 Complications with the notion of dependency

Dependency is a term that needs to be carefully defined.

While the focus of this paper is on the cost of caring for the aged, this cannot be assessed in isolation of developments in other areas of public welfare outlays and private sector support to dependent groups in the community.

Ageing will be a direct cause of dependency only if those not working are entirely reliant for income on those working.

The key ratio of interest ought to be the ratio of those generating income to the total population that these groups must support. Ageing will be a direct cause of dependency only to the extent that those not working are reliant for income on those working.

In practice there is a range of means of earning income; from labour or from assets such as shares, savings (superannuation and other), real estate and other productive assets. Given the substantial income-earning assets of many non-working individuals and the possibility that these assets will grow over time, the actual dependency may not increase over the next fifty years to the extent that a simple dependency ratio based on those in paid work to those not would suggest. Moreover, with superannuation now more widespread and with growing real incomes, the proportion of the retired population needing to rely fully or even partially on the pension will decline, even allowing for some tendency for people to rearrange their affairs in order to qualify.[30]

More aged means more jobs for the young and cuts in several categories of expenditure.

There is every likelihood that the ratio of those working to the total population (and the burden on the former) will not change very much between today and the year 2051.[31] For example:

- If the demand for labour rises in line with the overall level of economic activity, the growth in the aged group is likely to be accompanied by an offsetting decline in the unemployed (both young workers and more mature workers) as labour markets begin to tighten.
- Reinforcing this, the growing proportion of the population retiring will put downward pressure on unemployment rates.

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30 Currently some 84 per cent of people of pensionable age receive some income support from the Commonwealth's social security and veterans agencies. The age pension has always been a means tested and flat rate and this will act to constrain growth in future outlays.

31 As the reader will recall, the RIMGROUP model projects that the ratio of the number of persons of all ages not working to the number of persons of all ages working, falls from 1.36 in 1994-95 to 1.2 in 2004-05. It then rises to 1.3 in 2024-25 and 1.4 in 2059-60. This ratio was 1.35 thirty year ago, in 1968-69 and has since fluctuated significantly with the unemployment rate.

- Among other things, these influences should see public sector outlays to support unemployed workers and their families falling over time.
- Another area in which public sector outlays could fall with the ageing population structure is assistance to families with children. Two trends behind this would be lower rates of fertility and rising per capita wealth and income.
- Many regard Australia's family assistance programs to be 'middle class' welfare. There would appear to be some scope for better targeting such programs towards the truly needy rather than providing pocket money for mid-range income families.
- Apart from the welfare budget, there may be other declines in expenditures relative to GDP as a result of the ageing population structure. Total expenditure on education is projected to decline as a proportion of GDP because of the smaller proportion of young people in the population. This decline is unlikely to be completely undermined by increased educational demands of older persons or increases in the unit costs of education. In any case, the social rates of return from public and private expenditures on education of workers of all ages can be very high, certainly higher than the social rates of return associated with welfare payments.
- Law enforcement costs and the costs of crime may also decline to the extent that a more mature population is more law abiding. At the same time however, an ageing population may create more potential targets for crime and raise the general level of fear of crime in the community.

None of the published projections seems to take proper account of these offsetting factors.

All things considered, we say the outlook is fairly rosy.

In our view, increases in government and private outlays to support a growing number of aged persons may be significantly offset by declining government and private outlays to support the young and the unemployed and declines in outlays on services upon which the young tend to draw more heavily. Certainly *government* support for young people is destined to fall.[32]

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32 In recent years, employed workers tend to have been caught between the dual strains of supporting both their dependants and their parents. Gregory, for example, has reported that partly due to increased time in education, over the last two decades the real labour earnings of younger workers have fallen relative to those of middle aged workers, contributing to growing youth dependency within the family. Government support, by contrast is becoming more selective:

> "Over the last fifty years or so governments have increasingly accepted responsibility for income transfers that in previous times were the province of the family. There has been some questioning as to whether these trends should continue and there is some evidence that government is attempting to reduce its responsibility. Australian governments, for example, have introduced more extensive family income testing before providing young adults with income support such as unemployment benefits. Family income testing for education support for young adults is also being extended.: (Gregory, 1999).

In addition to this, even if the welfare budget does increase, so too will the means of the community to support dependents. If GDP were to grow at a the fairly modest average rate of 2 per cent a year in real terms over the next 50 years, in the year 2050, Australia's GDP, in today's dollars, will be almost three times as high as it is now.[33] The average Australian income will be more than double in real terms. If Australia were to achieve a GDP growth rate of 2.5 per cent, real per capita GDP in the year 2050 would be 2.7 times what it is today. In these circumstances, Australia could comfortably afford to support a growing dependent population, while at the same time allowing workers unprecedented opportunities for material comfort.

That is the case, even if current policies continue.

Therefore, even if current policies remain in place, it is highly unlikely that Australia will face an intolerable burden in caring for the growing aged group. Overall dependency ratios may not change all that much. All we may observe is that the average dependent will be a little greyer and less sprightly than today. The economy is already supporting a much higher level of dependency than twenty years ago. It looks as if we will have a smaller age-related expenditure blowout than the rest of OECD.

As indicated earlier, the OECD also concludes that, compared to many other countries, the problems faced by Australia are not severe. According to the OECD, Australia's expenditure on social security and public health is not particularly high compared to many other OECD countires. It projects that Australia will remain among the lowest in the OECD. In fact, the OECD considers Australia to be one of few countries likely to experience only a minor increase in public debt due to ageing over the next 30 years. This is more because our pensions are means-tested than because of differences in age structure.

We think a crisis is very unlikely

The conclusion we draw from the above is that it is highly unlikely that future growth in expenditure to support the aged will place a significant strain on the economy.[34] Even under fairly pessimistic scenarios, the ageing population structure does not translate into a large increase in public sector outlays relative to GDP or total government expenditure. Moreover, the changing population structure and rising real incomes will see a decline in the demand for public support in other areas. There are

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33 This is a modest forecast. Over the past thirty-five turbulent years, Australia's real GDP grew at an average annual rate of 3.6 per cent. It has grown at an average annual rate of 3.3 per cent in the 1990s. A case could be argued that GDP growth in the future might be even stronger than this. The Australian economy, following a prolonged period of microeconomic reform, is judged by many to be far leaner, more efficient and more internationally competitive than during much of the past thirty years or so. A recent paper by Parham (1999) demonstrates a sharp improvement in Australia's productivity performance.

34 Johnson (1999) reached a similar conclusion.

> "… much of the alarmist discussion of the consequences (particularly the economic consequences) of ageing is overblown. It is possible to develop enormously pessimistic or enormously optimistic scenarios; often the difference … depends upon slightly different initial conditions which are magnified by compound growth over three or four decades." (p 28).

also a number of programs over which the government has considerable discretion. These programs could be better targeted to the needy in the community. Economic growth will provide the opportunity for the number of persons in need to decline. However, the concept of what is 'needy' is relative and we would guess that the community's view as to what is a minimum socially acceptable living will rise over time as higher living standards in the general community are achieved.

2.4.3 Reasons not to be complacent

… but there is no sense being complacent.

While the above conclusion may be reassuring, it does not justify complacency as the future could hold all sorts of possibilities that may make our assessment a severe understatement of the extent of the problem. For example, life expectancy could increase to well beyond the 80 or so years that many experts consider a biological ceiling (although that presumably would also imply a longer 'working' life too). More disturbingly, the baby boomers in their old age may decide to exercise their electoral muscle and vastly expand aged benefits at the expense of the working population.

The boomers may vote themselves a windfall, for example.

By some standards current levels of support for the aged and other dependents, in any case, already impose a large burden (in the form of high tax rates and other private costs) on the community. While few would argue that the aged should not be looked after, there may be ways to achieve even higher standards of support at lower cost to the community. It may be that this could be achieved through a re-evaluation of respective private and public responsibilities and a re-evaluation of government policies, particularly those with the potential to reduce employment and savings incentives.

So why not take some safety measures.

In the next Section we consider a range of factors which will determine the extent to which the aged care bill is likely to rise in the future. The key areas we consider are:

- the choice between public and private provision of retirement incomes;
- developments in the demand for health and aged care services, the supply of such services and efficient methods of meeting the cost of such services.
- the scope for labour markets to generate sufficient opportunities for persons to save for their retirement: in particular opportunities for mature workers and for retired persons to supplement their savings with income from employment;
- incentives and disincentives facing individuals to save and provide for themselves in retirement;
- the nature of financial and non-financial intergenerational transfers; and

- the impact of the growing number of aged on future rates of economic growth.

3. Strategic issues

The are several ways aged dependency on public payments might be reduced.

Governments in Australia and overseas have responded to the prospect of growing age dependency through policies designed to shift the responsibility for retirement incomes and aged care from the public to the private sector (that is, from taxpayers in general to individuals taking advantage of these services).

In terms of retirement income, this objective could be pursued through changes to superannuation policy including increases in compulsory payments, reducing the rate of tax on superannuation contributions and earnings, increases in the preservation age or restrictions on lump sum payments. The aged pension could be made less attractive and harder to qualify for. Options for the latter include raising the pensionable age from, say, 65 to 70, lowering income and assets tests, and providing financial incentives for later retirement.[35]

3.1 The 'stickiness' of pension outlays

Fiddling with superannuation and the pension age won't affect aged pension costs much in the short term.

An important finding of the Rothman (1997) study cited earlier was that age pension costs are only sensitive in the longer term to policy changes such as changes to the superannuation guarantee levy and increases in the retirement age. The reason for this is that the flow of new pensioners, upon which the changes would impact are a relatively small proportion of the stock of retired persons. Simply put, it takes a long time to turn over the stock of pensioners and many in that stock are hanging on a lot longer these days. Policies (operating at the margin) therefore take a long time to have their full effects.

For example, a gradual increase in the pensionable age or providing incentives to defer retirement will not have a significant immediate impact on total pension payments because the group affected will be small relative to the total number of pensioners. An increase in the superannuation levy will increase assets of those retiring in the future. However, any additional assets change the pensions over the lifetime of the new retirees rather than immediately. Moreover, the pension income test withdrawal rate is 50 per cent (not 100 per cent) and, depending on the extent of means testing, some of the impact of the policy may be on the more wealthy who do not get a pension but do pay tax.

35 The Federal Government has recently introduced such a scheme to provide financial incentives for later retirement.

Proposals to delay access to superannuation contributions and to delay the payment of the pension are all well and good in theory, but they assume that most individuals have the capacity to save to provide an adequate income to meet the needs of their retirement. If this is not the case, and the trend towards earlier, often involuntary retirement continues, older workers will simply spend longer times on other forms of social welfare payments waiting for the aged pension.

3.2 Lifetime earnings, savings and retirement

3.2.1 Widening involvement in super schemes

You could halve the proportion of GDP spent on pensions in 30 years time by cutting eligibility from the present 70% to 30%.

Compulsory superannuation contributions are designed to reduce the level of dependency on the aged pension. Private superannuation savings will play a major role in constraining future growth in pension outlays. Currently some 84 per cent of people of age pension age receive some income support either from the Department of Health and Aged Care or from Veterans Affairs.[36] According to the OECD (1996), as quoted by Walker (1997), if pensions in Australia were targeted so that only 30 per cent (rather than 70 per cent currently) of the population qualified for the aged pension, pension expenditure as a share of GDP would fall from 3.2 per cent to 1.7 per cent by 2030.[37]

Dependency on the pension is probably dropping.

The level of dependency on the public sector for retirement incomes is likely to have declined over time with rising real incomes and with growing wealth of the current working and newly retiring population. Moreover, as argued in the next section, superannuation may to a degree substitute for other forms of saving to provide for retirement.

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36 Presumably provided Australia is able to stay out of global conflicts, pensions and other payments to veterans will decline over the next decade or so, as many of the Second World War diggers and their spouses pass on.

37 OECD (1996).

3.2.2 The superannuation shortfall

Compulsory super, introduced in 1992, is now paid by 90% of workers. Superannuation assets are rising but it will take a long time for the public sector pension burden to wind down because many superannuants face low super payouts.

The superannuation guarantee, introduced in 1992, applies to around 90 per cent of workers. The total of assets under the Australian superannuation system is currently around $317 billion. Using the RIMGROUP model, Rothman (1997) projected that superannuation assets will be $595 billion in 2005 and $1,580 billion by 2020.

Average superannuation pay-outs to retired persons will rise substantially over the next few decades. In 1997-98, the average superannuation payout was around $52,000, estimated to provide extra income of about $2,000 after pension reductions and tax. This is expected to rise to around $10,000 dollars by the year 2015-16. These projections indicate that an increasing proportion of older people will either be less dependent on public support (that is draw only part of the full pension) or independent of public support. To these assets must be added other financial assets and real estate assets.

However, while the proportion of the population dependent on the aged pension will certainly fall in the future, it will be a long time before the burden of income support for the aged has been entirely shifted to the private sector.

Table 3: Projected average superannuation pay-outs

Year	Average payout $	Ratio of payout to average financial assets	Estimated extra annual financial income $	Extra income after pension and tax reductions $
1997-98	52,241	0.9	2,012	2,012
200-01	69,484	1.2	2,874	2,737
2005-06	93,083	1.3	4,054	3,191
2010-11	115,051	1.3	5,153	3,662
2015-16	216,281	1.9	10,214	5,504

Source: Rothman (1998

The contribution of superannuation to meeting the costs of aged income support depends on the lifetime earning of workers and the amounts they are able to afford for superannuation over and above the guarantee levy. Low-income workers and particularly those who are periodically unemployed may find it very difficult to provide for their own retirement. A simple example is illustrative.

Compulsory super will not end the dependency of low income workers …

Based on an annual income of $36,000, around average weekly earnings, the minimum superannuation contribution (9 per cent) would be $3,240 a year. Assuming the worker's wage rises in line with the rate of growth in real GDP per capita of, lets say 1.5 per cent per year, over a forty-year

working life this implies an accumulated retirement fund of around $255,000 in today's dollars (assuming a 4 per cent net real annual rate of return). Invested at a 4 per cent real rate of interest, this would generate an income of $10,213 a year in today's dollars. While this is above the current pension, it is only around 16 per cent of likely average weekly earnings in 40 years time. Currently the pension is around 25 per cent of average weekly earnings (and there is little reason to think it will fall below that proportion in the future). .

… and to some degree it may increase their dependency!

Superannuation is not without its risks. With many funds charging a fixed fee (which shifts investment risk to individuals) plus a percentage fee, performance needs to be 6 per cent or better year-in-year-out for investments to maintain their real value of the contributions.[38] It is therefore quite possible that many workers will see the value of their small superannuation contributions eroded over time. Many low-income earners find their small, forced super savings can barely meet the fixed parts of fund fees. The calculation above assumed relatively successful long-term investments whereas the reality is that many less well managed funds will return much less than this to contributors and many will fail. Under current policy settings, the support of many retired workers will therefore continue to be the responsibility of government.

Our calculations above for the average worker assumed uninterrupted employment and contributions over an entire working life. In fact, most workers are below the average and many cannot expect to be continually employed. The labour market realities today are that the average person faces the prospect of prolonged unemployment at the beginning of their working lives and prolonged unemployment from their mid 40s.[39]

3.2.3 Scope for more competitive super funds

Our super funds may not be as efficient as they should be.

Dixon (1999) comments on a recent policy initiative in the United Kingdom that imposed standards on superannuation funds including a ceiling charge of 1 per cent of the value of the pension.[40] This may be unrealistically low, and we would not advocate such regulation, but it does highlight the relatively high charges by Australian funds. On the surface, superannuation would appear to be a competitive business in Australia and individuals have the option of establishing their own funds.

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38 According to Dixon (1999), the situation is somewhat worse than this. The typical private superannuation plan can involve entry fees of up to 5 per cent and fund management expenses, commonly described as Management Expense Ratios of 2 per cent a year or more.

39 Long term unemployment, defined as periods of unemployment of a year or longer, is a persistent problem in Australia. In 1990-91, the long-term unemployed accounted for 21 per cent of the total number of workers unemployed. This peaked at 36.6 per cent in 1993-94 and has since remained near or above 30 per cent (see ABS, 1999). In 1997-98, over 247,000 workers were unemployed for a year or more.

40 Daryl Dixon (1999)..

However, it might be a good idea to subject the industry and relevant legislation to the scrutiny of a National Competition Policy legislative review to identify any impediments to competition and any protective arrangements that may contribute to excessive charges. A quite small reduction in charges can contribute substantially to the value of a superannuation asset over a long period.

3.2.4 How to deal with savings incentives

Incentives to save deserve review...

It is hardly surprising that governments have been concerned about the relatively low level of savings and investment in Australia, including savings to fund retirement incomes. Such concerns were behind the introduction of the superannuation guarantee. Yet, as we have said, whether this guarantee actually raises savings, either in general, or specifically for retirement, is debatable. This underlines the importance of looking at the whole incentives picture – that is, both the incentives to save and the incentives to dissipate savings.

The classic example of an incentive to dissipate savings is the pension. The existence of a pension provides a safety net and, if individuals are confident of a continuation of such public support, this may undermine incentives to save for retirement[41].

…but the best approach is to remove the offending distortions, not to seek to offset them with new measures.

As a general point, in our view the search for and reform of particular distortions to savings behaviour is likely to be a more fruitful approach to policy than undertaking 'big-picture' comparisons of Australian and overseas savings rates and applying sweeping 'corrective' measures to close the perceived gap. In the past, insufficient domestic savings (alleged to be evident in comparisons of Australia with other OECD countries) were often put forward as a rationale for running tight Commonwealth budgets, ie for 'increased public saving.'

The international comparisons approach is not very rigorous and can lead to error.

Reasons adduced for the gap have included 'other policies' (previous budget deficits, double taxation of interest income, exclusion of the family home from capital gains tax, aged pensions, aged concessions and means tests for them). But sometimes these known distortions have not been seen as fully explaining the gap, almost as if to say that Australians must have some kind of character defect. FitzGerald (1993 and 1996), for example, has persistently advocated on this basis that governments should take the remedial intervention route and, specifically, run significant surpluses on their net recurrent spending.[42]

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41 A standard retirement strategy has been, and probably still is, to take a lump sum, buy a place at the coast and a nice car, and blow the rest on a world tour. If you survive the tour, apply for a pension.

42 FitzGerald (1993) and FitzGerald (1996).

In our view, the alleged savings crisis is an unwarranted pretext either for high taxation, or for introducing any compulsory domestic savings scheme.

3.2.5 Retirement trends

Early retirement and other factors which shorten working lives are important considerations.

The effect of the ageing population on the social security bill would be compounded if the trend towards earlier retirement were maintained into the future. The official figures on this are partly illusory, because many (if not most) who would call themselves 'retired' remain active economically - managing investment portfolios, consulting, financing other family members, and so on. But as a general observation, many persons are retiring at age 55 and even earlier. Moreover, there is a general reluctance by employees to hire persons over 45 years of age.

According to Walker (1997), surveys have found employers have a strong preference for younger workers and many regard 45 to 55 years as older workers. In 1997, 77 per cent of men and 87 per cent of women had already retired from full time work five years before reaching pensionable age.[43]

Labour market regulations are unlikely to be helping.

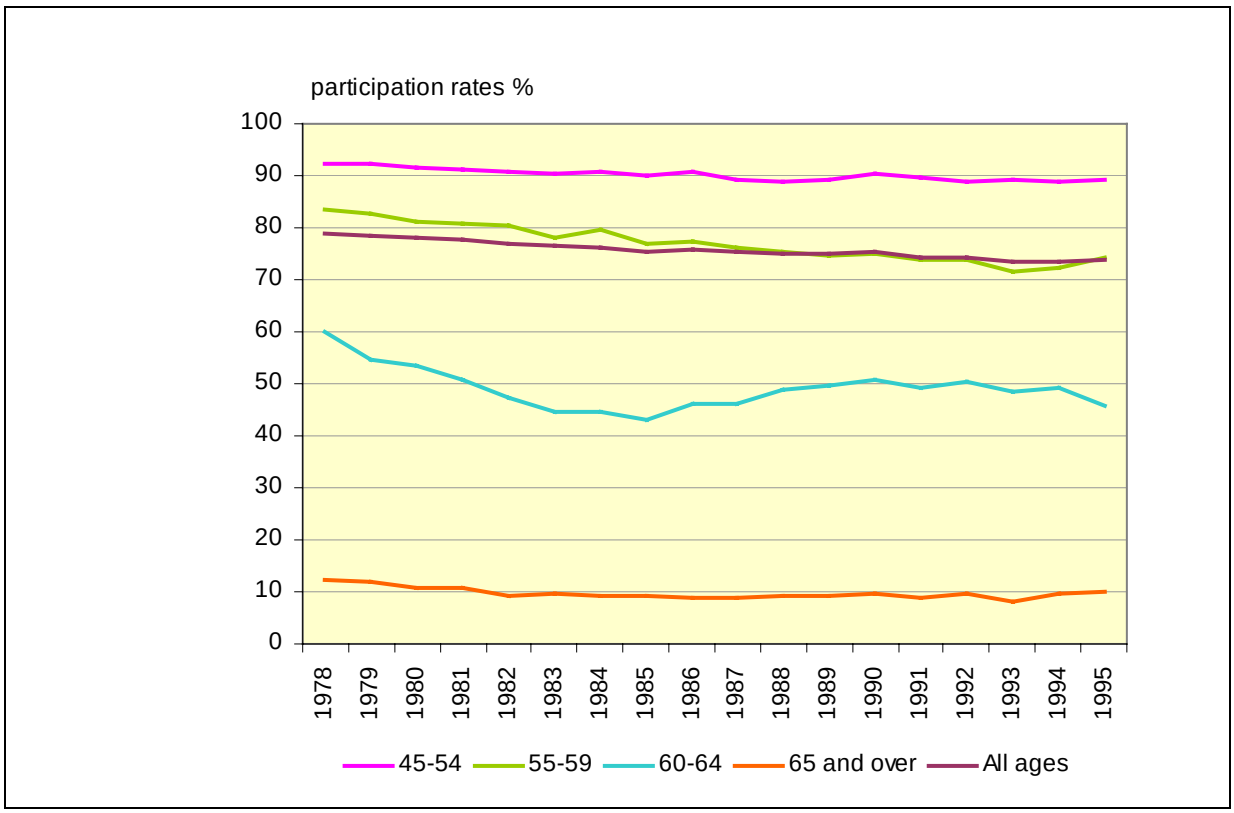
Inflexibilities introduced by labour laws are likely to be diminishing the employment prospects of mature workers. The ease with which they can qualify for unemployment benefits and other forms of social security may be one contributing factor. Perhaps more mature workers would be kept (or taken) on if rates and conditions in industrial awards could be varied more readily. We will return to this subject in a moment (in Section 3.3).

The 1980s drop in participation rates of mature aged males has been well documented

During the 1980s, participation rates among older males fell significantly, relative to the labour force participation rate of all males. However, participation rates for older males have been relatively stable since the beginning of the 1990s (see Figure 7).

43 Based on data in ABS, *ibid*.

Figure 7: Labour force participation rates 1978 to 1999: Males



Some people will be 'retired' for 30 years.

Increased longevity and earlier retirement mean that some individuals could be out of the workforce for 30 years or more, a similar period to that spent in the workforce. While not directly affecting the age pension bill, those involuntarily retired without the means to support themselves need to be supported by public welfare payments. This would involve unemployment benefits or a mature age allowance in the period prior to qualifying for the aged pension. Moreover, earlier retirees with means to support themselves will need to stretch their retirement savings over longer periods raising the likelihood that they will need draw a pension in later years of their lives. Their working lives may be too short to support themselves and their families and save sufficient amounts to pay for their retirement. Truncated working lives, often unplanned, may also disrupt retirement savings plans or preclude saving for retirement, inevitably adding to the pension bill.

Many would have preferred to keep working

Research has shown that many would have liked to remain in the workforce (most redundancies are involuntary) and people have retired in response to incentives provided by government policies.[44] Many workers feel there are strong pressures to retire early: social attitudes, employer preferences and government policies.

3.3 Further scope for labour market reforms

3.3.1 General tightening of the labour market

Labour markets could be tighter in the years ahead.

The future direction of public sector support for the unemployed or involuntarily retired older workers and younger unemployed workers depends very much on what happens in labour markets. Notwithstanding the regulatory impediments referred to above, there is some expectation that labour markets will tighten in the years ahead, given projected slower rates of growth in the labour force.[45] One would expect employment opportunities for older workers and even the aged (65+) to increase over time as the supply of younger workers declines in relative terms. This would be expected to provide greater employment opportunities for workers of all ages, including older workers and part-time employment opportunities for older, able persons. Important influences here will be the rate of net immigration,[46] declining fertility rates, slower growth in female labour force participation (already high) and labour market reforms.

It is interesting to consider employment developments over the past thirty years or so. This has been a period characterised by strong growth in the labour force (the demand for jobs) and almost equally strong growth in employment. Over the period 1964-65 to 1997-98, employment grew by 60 per cent, but was not sufficient to absorb growth in the labour force of 68 per cent, with the result that there was substantial unemployment for most of the past 25 years. In the years ahead, the rate of growth of the labour force is expected to slow. If growth in economic activity translates

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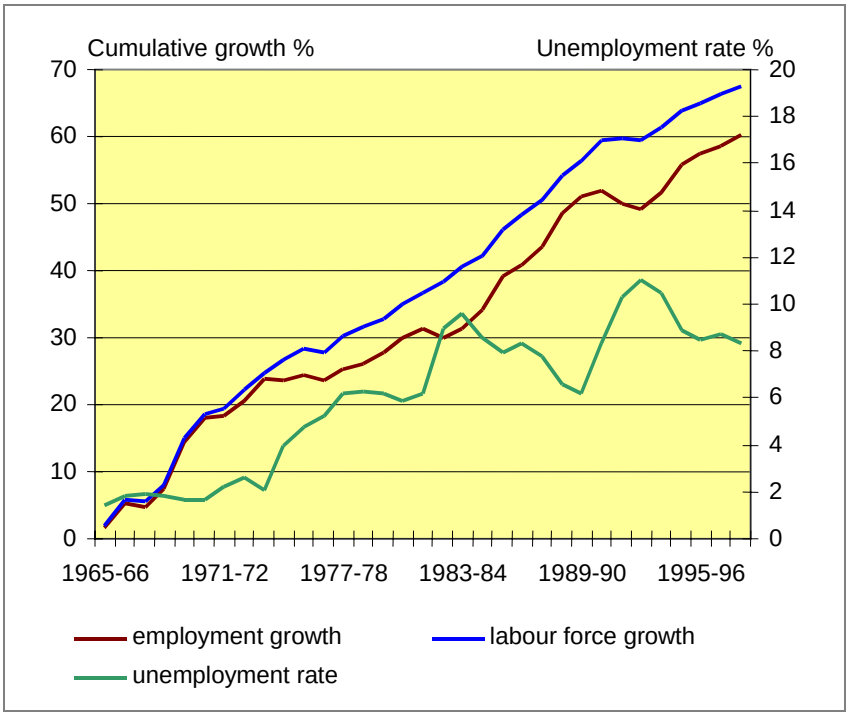
44 In many OECD countries, governments addressed rising unemployment in the 1970s and 1980s with policies designed to encourage workers to retire earlier. Rather than focussing on policies to raise the overall demand for labour, governments adopted short-sighted policies for which the wider community will pay for some time to come.

45 Over the past thirty years, a period of relatively high unemployment, there has been a rapid growth in the supply of labour with strong growth in new labour force entrants, particularly with increased female labour force participation. The rate of growth of new entrants to the labour force is expected to fall over the next few decades.

46 The ABS population projections discussed above did not appear to be very sensitive to changes in the rate of immigration. This is because the number of immigrants, even under high net immigration scenarios, is a relatively small proportion of the total population. There is debate over whether high rates of net immigration contribute to unemployment problems. Certainly immigrants add to the supply of labour and, if wages rates are fairly rigid, this could cause some excess supply of labour. On the other hand immigrants tend not to be idle and bring with them valuable human and financial capital. Moreover, their demands for goods and services add to local market demand, stimulating production and employment.

to similar rates of growth in employment as in the past, it could be expected that unemployment would decline in the future.[47]

Figure 8: Unemployment and labour force growth



Source: Australian Bureau of Statistics (1999).

3.3.2 Likely contributors to mature aged unemployment

The modern reality in the Australian labour markets is that relatively large groups of workers, particularly the young, the unskilled and mature workers, face long periods of unemployment. Employment prospects for mature workers are relatively grim (for example, those in the 56 to 64 age group). Labour market flexibility is a key issue and, as indicated above, both social security and industrial provisions are implicated.

If labour prices were flexible, population changes wouldn't affect unemployment rates, or at least not for very long.

From an economic perspective, efficiently functioning labour markets would be expected to match, more or less, the supply of jobs with the demand for jobs, with the exception of a small proportion of unemployable workers and short-term periods of unemployment and job search. An efficient world can be envisaged in which workers throughout their lives are able to sell their labour at a market-determined price. Even

47 Although the vagaries of the business cycle and macroeconomic stabilisation policy could prove us wrong.

the aged would be able to engage in part-time and full-time work to supplement their retirement incomes if they chose and were able to do so.

In some professions the inflexibilities imposed by regulations are still quite marked.

Industrial awards do not apply everywhere. They are probably most binding in the teaching, health care, telecommunications and transport services areas. Minimum pay rates and professional regulations governing employment in these sectors have the effect of pricing the least skilled out of the market. Moreover, pay scales are still related to age or length of service in some of these vocations (especially in teaching), a factor likely to especially mitigate against mature age employment. Compulsory retirement ages are still observed[48]. An excess of forced redundancies is the result.

The personal distress caused by forced redundancies is well recognised.[49]

Australia's stomach for labour market reform has often been questioned.

The falling participation rates of mature-aged workers can be viewed as part of a more general trend in which the distribution of work has been becoming more diverse. In particular, as a general thing compared with twenty years ago, more are now working longer hours while more are also working shorter hours, or not working at all. This has troubled the theorists and labour economists have looked at various formulae for how Australia might achieve a "more equitable" distribution of work. In a 1997 paper[50], for example, Dawkins dismissed the 'job sharing' approach to remedying unemployment[51]. But he also portrayed the solutions which most economists would suggest — achieving a faster rate of economic growth or abolishing unemployment benefits, social security and minimum wages — as either "daunting" or "obviously socially and politically unacceptable". He conceded "some degree of deregulation of the labour market could prove beneficial", and suggested allowing "greater freedom for employers and employees to negotiate their employment arrangements than has been generally possible under the Australian award system" (p.19). Yet he ended on a pessimistic note,

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48 It might make sense to have compulsory retirement ages if employees have permanent tenure, but their relevance in a world of contract employment is hard to see.

49 .The House of Representatives Standing Committee inquiry into mature aged workers has received some interesting suggestions from some redundancy 'victims'. One submission in mid-February 2000 which caught the media's attention went as far as to suggest that words like "young" and "dynamic" be banned from recruitment and company advertisements because they reinforced negative perceptions of older people. The submission was made by a mature aged woman whose senior lecturer position at a university had been abruptly terminated in 1996 and whose husband, a former telecommunications officer, had suffered a similar fate four years earlier. She said statistics do not reveal the true extent of the problem because many older but proud unemployed such as themselves used their savings rather than register for unemployment benefits.

50 Dawkins (1997)

51 Defiantly, John Quiggin (Quiggin, 1999), another academic, has recently sought to revive the 'job-sharing' approach as a solution to unequal working hours and unemployment - advocating that the Government introduce compulsory 6-weeks leave for all employed workers which, he says, "would be equivalent to a 4 per cent wage increase and could easily be phased in over a couple of years." Few economists would be willing to propose an increase in the cost of labour as a cure for unemployment. The accepted orthodoxy, with labour as with other things, is that raising prices will decrease the quantity sold.

concluding that Australia was probably not willing to accept the effects on income distribution of a deregulated wage system of the kind experienced in the US.

Whether on not one agrees with his US analogy, to some extent Dawkins 1997 assessment has already been overturned by events.

Recent reforms have restored some flexibility, but old habits die hard.

Recent labour market reforms in Australia have restored some flexibility to labour markets and to the extent they are successful, one would expect rates of unemployment amongst young and old to fall. But there still seems to be a tendency for redundant workers to be denied the chance to renegotiate their remuneration. Moreover, for those who stay, the rules appear to encourage a focus on retraining rather than on a pay adjustment And in that field, a common assumption seems to be that the retraining ought to go on in a subsidised government institution. For one thing, it is difficult to find a persuasive externality reason for subsidising them and for another, government-funded retraining schemes are likely to crowd out better tailored privately-provided services (whether 'on the job,' or at an outside establishment), in the same way as publicly funded education can crowd out privately funded education. Thus from an economic standpoint, there would seem to be plenty of labour market rules that warrant review.

We would like to see more research on mature-age unemployment.

3.3.3 Other biases against mature aged workers

If for no other reason than for its potential importance to the burden of aged care on society, there is a need to examine why markets seem to reject the services of older workers in particular and to identify any policy or institutional factors that may be artificially raising the attractiveness of younger workers relative to older workers, including those beyond retirement age.[52] It is interesting to ponder why at a time when the regulatory basis of youth unemployment has captured everyone's attention, so little empirical research seems to be directed towards the equivalent mature age unemployment issue.

Heavy public subsidisation of education is probably a bias against mature workers.

One conjecture worth exploring is that the heavy public subsidisation of education is operating as a serious bias against mature age employment. For example, the cost of tertiary education is subsidised by the public sector, albeit at a lesser rate than in the recent past. This means that graduates demand lower wages upon entering employment as the costs they incur in gaining an education are subsidised. Effectively, this subsidises employment of younger workers. The educational subsidy may also induce employers to turn over labour at a faster rate, particularly

52 There is also a need to obtain an accurate gauge of the income earning activities of these older workers as many who appear to be out of the official workforce statistics may nevertheless be actively engaged in part-time work or be running their own income earning enterprises.

in occupations characterised by rapid growth in knowledge and technological change. If the price of labour is subsidised, even if the productivity of workers does not decline with age, there may still be incentives to replace the workers more frequently than would be efficient from society's point of view.

Ill-advised macroeconomic management must take some of the blame.

To place the influence of demographic trends in true perspective, there is also a need to face up to the real causes of job lay-offs. We have discussed lay-offs due to redundancies or for considerations relating to the relative cost of labour to that of other inputs. However, the business cycle is also a major source of labour shedding. Poor macroeconomic management policies pursued in the past must wear much of the blame for the current stock of unemployed workers. The cost of economic recession, in terms of discarded business activities and productive physical and human capital, cannot be understated. Such downturns create large pools of unemployed and, with growth in the labour force from new entrants, large numbers of productive workers can be made idle and unproductive over relatively long period.

More employment means more growth too.

Apart from the distressing burden which unemployment causes for those out of work, there are wider implications. The potential loss of national income due to leaving productive resources idle is a subject that has received little attention. Self evidently, if 10 per cent or more of the labour force is not actively engaged, GDP will be substantially below its potential, reducing the community's ability to afford to support those who have become genuinely less suited to employment through age or incapacity.

Most people know faster growth will boost employment. Fewer seem to appreciate that fuller employment would itself promote growth.

Like the OECD, we see sound economic performance as a key factor determining the ability of economies to meet the growing costs of supporting an ageing population. This is certainly the case in Australia. Sound policies will contribute to stable economic growth, fuller employment and greater income earning capacity to meet living expenses and to save for retirement and higher returns in equity and financial markets. By contrast, policies which 'create' unemployment are both a direct burden on mature sections of the population and an indirect burden because of the way unemployment reduces the economy's ability to care for those who need its support.

3.4 Intergenerational transfers and the contributions of older people

3.4.1 Recognising the active economic contribution of older Australians

Casual observers probably under-estimate the economic contribution of the aged.

The question of whether we can afford to support the growing number of aged raises concerns that the contributions of the aged to community living standards may not be adequately measured,[53] appreciated[54] and utilised by the community. As we have argued earlier, older generations are likely to become less dependent financially on the wider community because of their greater wealth compared to previous generations. They are also likely to be stronger, fitter, more educated and more productive than earlier generations. They will have valuable services to trade on markets, both formal and informal. The extent to which they are able to supplement their retirement savings with paid work will depend on labour market developments and the strength of the economy generally.

Apart from serving as paid labour, individuals can make other equally important contributions to the community. Dependence implies a one way trade. This is not necessarily the case, as can be seen from the important contributions made by voluntary carers. Routinely, older people can be seen providing services such as aged care, care for the disabled, educational services, counselling, financial and advice, services to the environment, entertainment and many other areas. Presumably these individuals see a compensating benefit (in-kind, if not financial) to the costs they incur in the work that they do.

3.4.2 How some measures can crowd-out the economic role of the aged

The household can be viewed as a production unit.

The community derives utility from a wide range of goods and services, only a subset of which are traded exclusively on the market. To see this, it is useful to consider the economics of the ordinary household. Nobel

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53 The standard national income accounting concepts such as GDP, abstract from several economic contributions to community well-being.

54 There may be some truth in the common observation that other communities, and more particularly communities in the past, have placed a greater value on the contributions of older generations than we do at present. In part it may be a market led outcome. Media advertising, for example, seems to promote a 'cult of youth'. This may change as markets and disposable incomes shift with the ageing of the baby boom generation.

However, it seems likely that attitudes to the aged have been affected by government policy. In particular, social welfare programs, by shifting the costs of supporting the aged from individuals and families to the state are thought by many economists to have undermined incentives for families to take a greater responsibility for the care of the aged.

Prize-winner Gary Becker has been one of the leading researchers in this area. He developed the concept of the household production unit.[55]

Becker explained how households allocate tasks.

He recognised the importance of implicit contracts and other 'non-market' attributes of the activities performed by household members. Household management of time in particular was highlighted, with the recognition that members have a stock of time that can be allocated to working, raising children, managing and undertaking necessary household activities, watching television and a range of other leisure activities in accordance with its value to the group.

As many households have allocated increasing proportions of their limited time resources to paid employment (through both parents working and working longer hours), they have sought to expand their time resources by purchasing time from others. This has created growing demand for such home services as child minding services, housework, home maintenance and repairs. There has been a substitution away from self-provision towards market provision in many activities, providing increasing employment and opportunities for individuals to supplement other sources of income.

Within households, the aged typically provide a number of time-intensive services both for monetary and in-kind reward

The aged provide an important source of supply of these types of services. These services can either be engaged on a market and be paid for, or older members of the family can be drawn upon to perform the services, perhaps for reward in money or reciprocal services. Without any aged persons, these activities would need to be performed but at great cost to the formally recognised 'employed'. Not all aged people wish to cut the lawns of their children or look after their kids. However, the growing aged profile should be recognised as providing a substitute source of time to perform necessary activities that contribute to living standards.

Well-meant government policies may undermine the household market for aged people's services.

In the absence of any government policy measures, households could be expected to allocate their resources of time between competing activities (labour, household activities and recreation) on the basis of the relative utility that households expect to gain from time spent in each activity. Comparative advantage is an important concept even in the household and activities will tend to be allocated according to this concept (for example, the higher income worker may go out to work whereas the person who expects to earn less in paid employment may stay home and perform household activities). Government policies which change the

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55 An edited collection of Professor Becker's writings can be found in Febrero and Schwartz (1995). The book contains 26 previously published articles by Becker, reprinted in honour of his sixty-fifth birthday. It groups the articles under six headings: foundations of human behaviour; family, marriage, and fertility; discrimination; law; politics; money and macrobehaviour and has Becker's personal overview (comprising his Nobel Lecture on the economic way of looking at behaviour). Becker is both a Professor of Economics and a Professor of Sociology at the University of Chicago. Arguably Becker's most important work to date has been the book (first published in 1981 but enlarged in 1991) entitled 'A Treatise on the Family' (Becker, 1993).

relative costs of these activities may bias choices in ways that undervalue the services of the aged family members. Child minding subsidies reduce the cost of paid childcare and therefore reduce the attractiveness of substituting grandparents for paid care. Income taxation based on individual income rather than household income can also induce a greater supply of labour from the household (two people working rather than one)

This is not the place to argue all the pros and cons of such family welfare or tax policies, but we note that such policies can distort incentives in a way which reduces the value that families and the broader community place on the contributions of older persons.

3.4.3 How some measures affect the incentives for care

Responsibilities are muted by pensions and subsidised aged care.

Government subsidies for care of the aged can undermine the incentives for families to bear full responsibility for older family members. Public support can crowd out private sources of support. If older persons did not have access to a publicly funded pension and subsidised aged care, the need and the incentives for people to support the aged would be greater. There are certainly reasons to expect that this would refocus the minds of many on their responsibilities. Moreover, the lower tax burden would raise the financial resources they had at their disposal to support the aged. Such an initiative might also restore recognition of the cost saving potential of the aged and encourage the substitution of the services of older persons for household services currently purchased on the market.[56]

The great number of small households may partly be a response to the way the family home is exempted from capital gains tax and pension means tests.

The number of separate households has increased in Australia with higher divorce rates, greater geographic mobility of family members, increased income and wealth and a range of changes in social preferences. Many older persons prefer to maintain a separate residence and an independent lifestyle. So do many children. However, to some extent the cost of separate lives is subsidised by the general taxpayer through a range of policies. For example, the taxation treatment of capital gains on family homes reduces the cost of housing. If pensions were not available or if governments attempted to recoup part of the costs of aged pensions and aged care through estate taxes, there might be a greater incentive for the aged to reside with other members of their families.

56 For those more motivated by financial reward, consider the boost in incentives to coddle the aged if prospective inheritances were reduced by the full cost of aged care services provided by government as pensions.

3.4.4 Suggested reviews

Biases against aged participation in the economy and disincentives to private care should be reviewed.

Whether within or outside their immediate families, older members of the community provide valuable market and non-market services to the community. An increase in the supply of these services could reduce the amount the rest of us need to spend to achieve the same living standard or quality of life.

Far from being totally dependent on younger generations, the aged can make valuable contributions in the market place, in households and in the wider community. The time has come when governments should:

- examine social welfare policies to ensure they do not discriminate against the aged and undermine recognition of the value of services the aged can contribute to the community: and
- review measures that reduce private incentives to support the aged.

In relation to the second of these, it should be remembered that the 'crowding out' of private incentives for aged support can arise both from a 'buck passing' effect and from the way the burden of public funding for these programs reduces taxpayers' capacity for private provision.

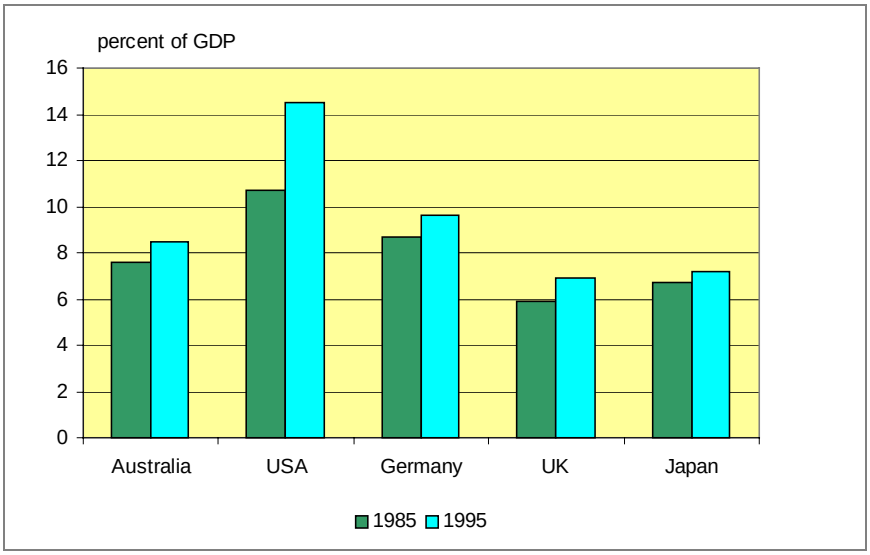
3.5 Ageing and health expenditures

3.5.1 General rises in health outlays

The escalating health care bill is not an ageing issue as such.

An escalating health care bill relative to GDP is not inevitable. Australia's health care expenditure relative to GDP is compared with a number of other OECD countries in Figure 9. Australian health care expenditure is well below that in the US and in Germany but higher than in a number of other OECD countries.

Figure 9: Percentage of GDP spent on health care: selected countries



Source: Australian Bureau of Statistics (1998).

It is difficult to draw firm conclusions from international comparisons of health outlays. Per capita health expenditures depend on a wide range of factors specific to each country. However, given that the populations of the countries in Figure 9 are of different age profile, one could conclude that ageing does not inevitably lead to increased health costs. There is clearly a wide range of factors involved, many of which are subject to influence by government.

Table 4: Health expenditures and population age: some international comparisons

Country	Proportion of population aged 65 years +	Health expenditure to GDP
Australia	11.9	8.5
USA	12.6	14.5
Germany	Find	9.6
UK	15.5	6.9
Japan	14.1	7.2

Source: OECD (1996).

Some indication of the likely effect of the ageing population on health costs can be obtained by examining past trends in Australia (and in overseas countries). While such an exercise is not undertaken here, a number of observations can be made.

The rise in public health expenditure is not commensurate with the ageing trend.

Australian health care expenditures currently account for around 8.5 per cent of GDP compared to 7.8 per cent in the mid-1980s. An important factor underlying this increase has been a real increase in the cost of health care services, averaging around 2 per cent a year during this period. The Australian population has already aged considerably over the past decade or so, yet there has not been a commensurate increase in health costs if the increase in the price of health services is factored out. Past patterns of service use suggest factors such as the increasing use and cost of health technologies, increasing consumer demand for health services and overall population growth have been more influential factors than ageing.

People at large are causing the increased public health outlays.

Continually rising health expenditures as the population ages is not inevitable. This relationship depends on a wide range of factors that affect health services including the demand for health services, the types of health services delivered, advances in medical science and the cost of supplying services. The projections outlined above are very sensitive to assumptions concerning factors including life expectancy, the general health and degree of independence of the aged, the affects of advances in medical science and technology on health and health costs, the effects of lifestyle improvement, the demand for health services as incomes rise and as health consciousness increases and the future rate of increase in the price of health services.

3.5.2 Harnessing pricing and competition

Governments have plenty of means of controlling health cost increases.

A number of factors affecting future health care expenditures will be within the influence of governments. In particular governments can influence:

- the efficiency of the industry delivering health services (for example via competition policy); the methods by which payment is made for health services (that is, the relative importance of direct payments (co-payments) by patients as opposed to payment from public or private insurers);
- government policies concerning minimum availability of health services;
- the direction of public and private funding towards different areas of public health (eg preventive as opposed to curative); and
- the allocation of research funds which will affect the magnitude of the overall returns from innovations in terms of improved community health.

Reform of the health care system, research funding procedures, etc may be capable of affecting the future trend in health care costs.

The two key economising tools will be pricing and competition

Key economic factors that will drive future health care expenditures will be:

- the role that prices are allowed to play in conditioning demand and inducing adequate levels of investment in health care facilities; and
- the role of competition between existing participants and potential new participants in containing cost increases.

The payment mechanism will be of critical importance to determining the rate of growth in demand for health services.

4. Conclusions and suggested policy directions

Our conclusion is that aged care will be affordable over the next 50 years.

It is always difficult to see ahead more than a few years and certainly more than fifty years. However, the conclusion we have reached about Australia's ability to cope with the progressive ageing of the population is that, even under current policy settings, the projected aged care bill will be affordable. Aged people will remain economically active. They and the rest of the economy will adjust to emerging pressures as the proportion of the aged in the population increases. In particular, savings will continue to accumulate, aged participation in labour markets will rise and economic growth will sustain the economy's capacity to assist those who need some support.

The doomsdayers are using simplistic models.

Alarmist reports on this subject, to the extent that they are based on any analysis at all, appear to be based largely on what economists know as 'identities' rather than on truly 'behavioural' models. Identities are encountered in introductory classes on national accounting. They set out the arithmetic relationship which exists between variables *ex post*. Because identities do not (and do not seek to) build in a 'story', complete with interactive terms which describe how changing one variable may affect all others, when manipulated algebraically they are poor predictors. To understand the economic impact of ageing, it is necessary to consider a great number of interactions, most of which in this case work to *moderate* the economy-wide effect.

Several reforms could be undertaken to simultaneously provide greater security for the aged and a healthier economy.

That said, governments could usefully remove a number of impediments to help the economy adjust efficiently to the ageing population profile. Taking steps to promote more efficient labour and financial markets would help minimise any dislocation. Moreover, just because the aged care bill is *unlikely* to be an unsustainable burden does not mean there is room for complacency. There are a number of plausible scenarios under which the public welfare budget could expand dramatically. Resisting initiatives which treat the aged as if they are drones and keeping on with reforms to make the economy work more smoothly would be a useful form of insurance against that.

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