

Submission to the House of Representatives Standing Committee on Employment and Workplace Relations in respect of their inquiry into increasing participation in paid employment

Ian M McDonald
Professor of Economics
University of Melbourne
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This submission to the inquiry into increasing participation in paid employment draws on a body of research on the implications of ageing for the future performance of the Australian economy that I have produced in collaboration with Professor Ross Guest of Griffith University. The research, which is published in professional economics journals, comes to a number of conclusions that are relevant for the inquiry.

Preceding the terms of reference of the inquiry is the statement that "Australia must increase participation in work if we are to maintain our economic growth rate in the context of the impact of the ageing of the population". The comments below are predicated on the view that the value to Australians of economic growth is that economic growth can deliver an increase in living standards, that is consumption per person. In general, increased working hours are not valued for their own sake, but for the extra consumption which they may enable. My comments show that the ageing population is not a threat to living standards because living standards may be reasonably expected to grow at a healthy rate even although the population will age.

My comments also address the issue of the future tax burden of an ageing population. If the tax burden in future were thought to be huge, then encouraging increased employment participation may be thought to be justified. However, I will show that this line of argument is ill considered.

1. Even when the inevitable ageing of Australia's population is factored in, living standards are projected, on fairly uncontroversial assumptions, to increase by about 35% in the next 25 years and 84% in the next 50 years, see Guest and McDonald (2001), (2002). These projected increases are affected little by assumptions about either the future rates of fertility or immigration, even though changes in these rates affect the rate of growth of employment. It is true that were the age structure of the population to remain unchanged there would be an additional increase in living standards of 8% in the next 25 years (and an additional 23 % in the next 50 years). Nonetheless, as the numbers above show,

even with the ageing population factored in, the forecast increases in future living standards are substantial. Consequently, when discussing the economic conditions to be faced by people in Australia in the future, we should not lose sight of the fact that people in the future will be substantially better off than we are today. This fact should temper calls for sacrifices in living standards today aimed at improving even more the living standards of people in the future.

2. The impact on living standards in the future of increasing employment participation are insignificant. This surprising result is explained in Guest and McDonald (2001), (2002). For example, consider the impact of increasing the retirement age. In Guest and McDonald (1999) the impact on living standards of a gradual increase in the retirement age of men to 66.7 years and of women to 65.4 years is calculated. These increases are based on increases in life expectancy projected by the ABS. They are calculated to maintain the proportion of life spent in retirement at a constant ratio. The effect of this is to increase living standards in the next 25 years by an additional 0.7%, a tiny addition to the 35% improvement should retirement ages remain at their current levels. Should the retirement age increase by more, to 68.1 and 66.6 years for men and women respectively, then living standards would increase by a further 0.2% in the next 25 years, again a tiny amount.
3. An important but rather subtle effect that helps to explain the relatively low increase in living standards that result from increased working hours is the Solow effect, named after Nobel Laureate Robert Solow. Cutler, Porterba, Sheiner and Summers (1990) were the first researchers to show the importance of this effect for calculating the effects of ageing. The Solow effect shows that higher employment growth rates require additional capital stock with which the extra employees can work. In order to provide this additional capital stock, some of output has to be diverted from consumption to investment. Consequently, the growth in living standards is less than it would be if such a diversion were not required to maintain the capital/labour ratio.
4. Much of consumption expenditures by old people is supported through government intervention. The main areas of government intervention to support the old are the payment of aged pensions and the large government role in the health sector. Consequently, there is an understandable concern about the implications for government outlays in the future of an increase in the

proportion of old people in the future. Higher employment participation and faster economic growth may be aspired to in order to reduce the problem of financing these government outlays. However, this is a weak argument because the projected increases in government outlays due to ageing are small; the richer population in the future will be able to finance these increases without difficulty; and in as far as health expenditures per person could blow out, it is more efficient to focus on the health sector directly rather than to increase employment participation. These points are now explained in more detail.

5. The Intergenerational Report (IGR), Australian Government (2002), projects, under unchanged government policy, an increase in Commonwealth government outlays of 5.3 per cent of GDP by 2041-42. However, there is good reason to conclude that the IGR overstates the growth in Commonwealth government social outlays. This is so because of the method used to project outlays on the Pharmaceutical Benefits Scheme (PBS). In the IGR, outlays on the PBS are projected to increase from 0.6 per cent of GDP in 2001-02 to 3.4 per cent of GDP by 2041-42. This large increase, about one half of the total projected increase in Commonwealth government outlays, reflects an uncoupling of PBS growth from GDP growth. On the basis of historical trends, the IGR projects that outlays on the PBS will grow at 5.64 per cent per person per year, some 4 percentage points greater than the projected growth rate of GDP. As a result, PBS spending blows out for projections over a long time-period. To illustrate the impact of such extrapolation, at these relative growth rates, the PBS scheme would account for a little over one third of GDP by 2100 and 100 per cent of GDP by 2126. This is discussed in Guest and McDonald (2003).
6. By contrast, projections in the IGR for growth in government-provided aged pensions are, in as far as we can make any guesses about the future, reasonably certain. There is a good basis on which to make projections of aged pensions as a percentage of GDP. First, there is bipartisan agreement that pensions should be at 26% of average weekly earnings. So, as GDP per worker and thus wages increase, pensions will rise automatically. Were productivity growth to slow, then the increase in pension payments per person will also slow. Second, under Australia's means-tested system, the pension payments from the public purse will be affected by the growth of superannuation payments. However, given

that a significant component of super is related to wages by the 9% compulsory super charge and that the rest of super payments are fairly stable as a percent of wages, the effect projected by the IGR of superannuation on government pension payments as a per cent of GDP is soundly based. Third, there will be demographic change which will increase the proportion of pensioners in the population. However, there is little uncertainty about the future value of this proportion. For example, consider the effect of large variations in fertility. A total fertility rate (TFR) of 1.75 implies 2.6 working age per old person by 2041-42. If the TFR falls by the very large amount, say to 1.3 for the next 40 years, the ratio of working age per old person falls only slightly, to 2.4. Consequently, variations in future fertility will not cause much variation in old age pension payments by government. Therefore, for pensions, the basis on which an increase in payments equal to 1.7% of GDP by 2041-42 is made is fairly sound. Crucially it is based on ratios, namely the 26 per cent of average weekly earnings and the nine per cent compulsory super charge, ratios that are thought to be desirable now and are likely to continue to be seen as desirable in the future.

7. We can see from the IGR that the cost of the current aged pension policy, even taking into account ageing, is not likely to cause its broad-based community and party support to change. The revenue requirement to support the current aged pension policy is moderate and can easily be borne by the increasingly well-off Australian people.
8. The future growth in health expenditures is more uncertain than is the growth rate for aged pensions. This is because of uncertainty about the amount and cost of health services to be provided to each aged person, not uncertainty about the number of aged people. There is a fear that rapid growth in productivity in health, through the discovery and development of new methods of treatment, will create a massive increase in the demand for health services per person, an increase that outstrips the decreasing cost per unit of service. However, dealing with increases in the demand for health services is not a problem that can or should be tackled by measures aimed at raising employment participation. That would be an indirect approach that does not get to the heart of the matter – the sensible allocation of resources to health. To not address the direct cause and to instead increase employment participation risks

putting the Australian people on a treadmill of rising employment to support health services that become poorly and extravagantly organised.

There is an argument related to employment participation that is valid. (I have not researched this topic). Some retirement schemes are actuarially unfair in that they encourage retirement at young ages. For example, in the public service and in teaching, retirement is encouraged at age 54 years and 11 months. This is bad because it is unfair to those who continue to work. People should not be penalised in this way for continuing to work. However, this unfairness has nothing to do with the ageing population.

In addressing the terms of reference, it is important to keep in mind that standards of living in Australia will rise even with an ageing population and with no new policies to increase participation in paid employment. It would not be fair to ask people today to make sacrifices to enhance even more the living standards of people in the future.

References

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