NSW Government Submission to the Commonwealth Treasury on Australia's Demographic Challenges

(May 2004)

The New South Wales Government welcomes this opportunity to make a submission on the discussion paper, "Australia's Demographic Challenges".

The submission includes some discussion of: the impact of an ageing population on NSW Government finances; the importance of cooperative approaches to intergovernmental finances; whether higher participation and productivity alone will ease fiscal pressures; and some issues raised by the NSW Office of Ageing related to specific policy measures announced in the "A More Flexible and Adaptable Retirement Income System" paper.

The NSW government acknowledges the importance of the direct and indirect roles governments can play in lifting economy-wide participation and productivity.

A more detailed NSW Government response will be made to the Productivity Commission research study into ageing.

Putting New South Wales in the Picture

Using mid-point ABS projections, the NSW population is projected to have an age structure similar to that nationally, particularly in terms of the aged dependency ratio. However, in terms of population growth, New South Wales is projected to be below the national average. This is due mainly to assumptions regarding interstate migration. The NSW population share is projected to decrease by 1 percentage point, from 33.6% to 32.6%, over the next 40 years.

As a result, the need for New South Wales to address the anticipated demographic challenges from a growth perspective is significant, perhaps more so than for Australia. From a living standards perspective and from a fiscal perspective, the challenges are around national levels, though the currently strong fiscal position of New South Wales provides a sound platform from which to address these issues.

Fiscal Impacts at State Government Level

The Commonwealth Intergenerational Report (2002) highlights that a significant fiscal burden is likely to be placed on the Commonwealth if no policy adjustments are made. It also suggests that the impact of the ageing population on state governments is likely to be negligible. The Commonwealth is responsible for the majority of health and welfare services where, due to ageing and higher demand, spending pressures are expected to emerge. For state governments, the Commonwealth argues, spending pressures should ease due to the impact of (past and prospective) lower birth rates on primary and secondary education expenses.

The Commonwealth's reasoning is debatable. We believe there will be significant fiscal pressures emerging on state finances due to ageing of the population and increased demand for state government provided services as living standards improve. Recent studies lend some support to this conclusion, including:

- Recent preliminary work by the Productivity Commission (2004) finds that the cost of state and territory funded healthcare is projected to rise from around 1.9 percent of GDP in 2001-02 to 3.3 percent of GDP by 2050-51. The main reason is that the cost of hospital services (a state responsibility) is strongly age-related. Average costs for a male aged 65-74 are about 20 times those for a male aged 15-24. This is similar in nature to the higher costs in the Pharmaceutical Benefits Scheme as expected at the Commonwealth level in the IGR.

- Access Economics (2004) also shows that the ageing of the population would impact both the Commonwealth and the state governments, but the fiscal deterioration for the state governments is estimated at around half that of the Commonwealth.

- The Victorian Department of Treasury and Finance (2003) published a report similar to the Commonwealth IGR, reporting that an ageing population would impose a substantial level of fiscal burden on the Victorian Government.

Preliminary analysis by NSW Treasury shows a significant fiscal burden is likely to emerge for the State over the next 40 years, albeit somewhat less than that likely to be experienced by the Commonwealth. For example, NSW Government expenditure on health and education services is projected to increase by 2.4 percent of NSW GSP over the next 40 years if no policy adjustments are made.

Major reasons for significant impacts at the state level include:

- the state health sector, mainly comprising hospital services, is sensitive to the ageing population structure and subject to cost inflation pressures similar to, though to a lesser extent than, the Commonwealth;

- although the relative size of the public student population has continuously fallen, inflationary pressures on the per student unit cost of education services are projected to rise continuously, more than offsetting the service population impacts. Technology impacts similar to the health case, an increasing community expectation of higher quality education services and a need to meet costly demands from a wide variety of disadvantaged students are also expected to be persistent in the public education area; and

- unlike the Commonwealth case, the state revenue base relative to the state economy size is expected to decline due to the impact of the ageing of the population on employment, property turnover and GST revenues (which will decline as GST-free spending on health services rises as a share of total personal consumption spending).

Importance of Cooperative Approaches to Intergovernmental Financial Relations

Assuming that there will be spending pressures for states raises the issue as to what extent these pressures will be reflected in state budgetary or federal budgetary pressures. For example, the NSW Treasury modelling shows that the fiscal results for states are very sensitive to assumptions regarding funding of Specific Purpose . Payments (SPPs). To the extent higher state spending pressures are reflected in higher SPPs, then there will be clearly less fiscal pressure on the States and even more on the Commonwealth. Vice versa, the determination of SPPs represents a major fiscal risk to the state governments.

- Both the Commonwealth and the states are exposed to increasing fiscal pressures. Recognising that there are a number of portfolio areas where the Commonwealth and the states share funding responsibilities, it is becoming increasingly important to adopt integrated and collaborated approaches to policy development in order to minimise fiscal risks and ensure sustainable and effective service delivery.

In the absence of integrated approaches, it is quite possible that any policy to boost labour participation and productivity will become ineffective as a measure to reduce future fiscal pressures.

Will higher participation and productivity alone ease fiscal pressures?

The Discussion paper favours higher labour force participation and higher productivity as a way to address future fiscal pressures. A country with higher living standards than otherwise should be better able to accommodate such pressures. That said, there is an issue that as living standards rise, so too does the community's expectation of the quantity and quality of government services. To the extent that occurs, the impact of higher growth rates on fiscal pressures will be offset.

- In a recent working paper Gruen and Garbutt (2004) raise an issue related to rising community expectations. This issue is raised in terms of a possible link between the increase in health costs and the level of per capita GDP or real income. They show international panel data supporting a positive relationship.

- In another recent study, DoHA (2003) also reported a close interaction between community expectations, demand and ageing.

- NSW Treasury's research work highlights the importance of the management of community expectations. Sensitivity analysis regarding the extent of community expectation (in technical terms, the income elasticity of health and other government spending), shows that fiscal pressure is insensitive to economic growth if the real income elasticity of government spending is greater than 0.5.

Community expectation is a subtle concept from a policy point of view and is thus difficult to subject to policy influence. That said, recognising it as an issue suggests that there can be limits to the effectiveness of policies designed to solely increase labour participation and productivity.

Improved General Government Service Delivery

As Gruen and Garbutt (2004) indicated, public sector wage claims without offsetting productivity improvement would reduce the effectiveness of the boost of labour participation and economy-wide productivity in addressing the anticipated demographic challenges.

According to the NSW Treasury model, as discussed above, state-wide productivity improvement will not by itself improve the projected fiscal gap the NSW government faces unless community expectations are tightly managed. On the other hand, labour productivity improvement in the general government sector relative to the whole economy will provide undeniable improvement.

Being able to provide the same volume of service output with less labour input would clearly lessen the cost of providing the services. Alternatively, and more plausibly given the projections, the higher demand for the volume of services could be met with lower than otherwise labour inputs. A ½ percentage point relative improvement in general government sector productivity each year would compound to relative costs being some 22% lower than otherwise over a forty year time span.

In fact NSW model projections show that the base case fiscal gap of 2.4% of NSW GSP generated from the area of health and education services could be entirely eliminated by an annual increase in general government productivity of about 2.4%. This is 0.6% greater than the assumed economy-wide productivity growth of 1.75%. Of course delivering on such productivity gains year after year, while facing demands for improved quality of services may prove demanding, but sustained productivity improvement in the general government sector would seem to be an essential part of the process of adjusting to the fiscal pressures ahead.

In addition to productivity improvement, general government cost growth can be reduced via slower growth in input costs such as for wages, capital and other costs.

Slower than economy wide wage growth in general government employee wages would not be sustainable over the long term as wage relativities would become distorted. One important conclusion on the wages side is that if additional productivity improvements are more than reflected in higher wages, then the beneficiaries of the productivity improvements become government employees and not the State's taxpayers (the capital owners).

The areas where the Commonwealth and the States share funding responsibilities have the potential to achieve a substantial improvement in efficiency of service delivery.

Issues Related to Proposed Policies

In the Discussion and the Policy Paper, there is a lack of discussion about potential financial inequality emerging in older age as income becomes linked to former workplace performance through superannuation and the relative financial disadvantage of some population cohorts (women, indigenous people and those from culturally and linguistically diverse backgrounds), becomes more visible. There is a risk that the Aged Pension will become a safety net for the minority. Such issues are well discussed in a study by the Social Policy Research Centre (1999).

New market-linked products increase the complexity and the financial insecurity faced by older people, particularly those with low financial literacy, at a time when there is a reduced capacity to understand and adapt to them. Retirees who receive relatively large superannuation payouts from which to provide their income for the next 20-30 years are likely to be unprepared for this responsibility. The vulnerability of self-managed retirement incomes is yet to be tested with the anticipated baby boomer wealth. A recent ANZ Bank study (2003) found that people seventy years and above, particularly women and people living in rural areas, were over-represented in the 20% of people with the lowest financial literacy, tested against their individual need and circumstances[1].

As both the number and ratio of older people increases, inequality across generations, within the older population and across regions where older people live will become a legitimate policy issue.

[1] The 20% with lower financial literacy skills have difficulty with: reading bank statements; understanding the purpose of saving; using budgets; forecasting irregular major financial outlays; understanding the purpose of insurance and difference between long and short-term needs; knowing about consumer rights; and accessing assistance when things go wrong.

References

Access Economics (2004), Intergenerational Modelling for Australian Families, a report submitted to The Association of Superannuation Funds of Australia.

ANZ Bank (2003), *Survey of Financial Literacy,* May 2003, conducted by Roy Morgan Research.

Banks, G. (2004), An Ageing Australia: Small Beer or Big Bucks? Productivity Commission, presented to the South Australian Centre for Economic Studies, Economic Briefing, Adelaide, 29 April 2004.

Commonwealth Treasury (2002), *Intergenerational Report*; Commonwealth of Australia.

Department of Health and Ageing (2003), Trends in Hospital Activity: Australia 1991-92 to 2000-01, Occasional Papers: New Series No15, July.

Gruen D. and M. Garbutt (2004), The Long Term Fiscal Implications of Raising Australian Labour Force Participation or Productivity growth, The Commonwealth Treasury Working Paper 2004-01, April

Thompson, M. (1999), *Women and Retirement Incomes in Australia*, Social Policy Research Centre Discussion Paper No. 98.

Victorian Department of Treasury and Finance (2003), *Shaping a Prosperous Future*, April.