
FINANCIAL REVIEW
Warning on nation's prosperity

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22 Nov 2013, by Joanna Heath and Jacob Greber

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▶ Income growth to halve ▶ Proposal to raise pension age to 70 ▶ Ageing population to hit budget

Joanna Heath and Jacob Greber

Raising the eligibility for age pensions to 70 could be necessary to avoid a budgetary crisis due to Australia's ageing population, according to the Productivity Commission.

The warning from the government advisory body was backed by Treasury's top economic forecaster, David Gruen, who said Australia faces a sharp slowdown in the growth of national income, a surge in age-related government spending demands, and a squeeze in revenue from the high dollar and lower commodity prices.

Tough decisions would have to be made about spending and taxes, they said, highlighting the difficult task facing Treasurer Joe Hockey to fulfil his promise of a budget surplus of 1 per cent of gross domestic product within a decade.

Even "if we achieve productivity that is similar to its long-run average, the next decade will see the slowest income growth in Australia in half a century, by a lot. It will halve," said Dr Gruen, the head of the macro-economic group at the federal Treasury.

Launching a major study into the policy effects of Australia's ageing population, Productivity Commission chairman Peter Harris said state and federal government budgets faced "inexorable and major impacts" without major changes to policy.

The commission has proposed increasing the eligibility of the age pension to 70 years, as well as finding productivity savings in the health sector and allowing retirees to draw on home equity to help fund aged care costs.

While there was no doubt Australia had a structural budget deficit and needed to act to fix the problem before it became serious, Dr Gruen rejected a theory from prominent economist Ross Garnaut that living standards would likely fall, although he predicted they would grow more slowly.

"There are always risks but I don't see any need for there to be absolute declines in living standards over the next decade," Dr Gruen told a business economists' conference in Sydney.

"But to the extent that living standards grow at roughly half over that period compared to the past five decades ... that is still a significant transition. You are dealing with a world in which your living standards are going to grow significantly slower than at any time you've seen in your lifetime."

Reinforcing Dr Gruen's predictions, the Productivity Commission's report found that the demands of an ageing population would add an extra 6 per cent of gross domestic product to government budgets by 2060 if not dealt with. In today's terms, that amounts to $90 billion.

Changing the eligibility age of the age pension to 70 years would reap $150 billion in savings over the period from 2025-26 to 2059-60 and increase participation rates among older workers by around 3 to 10 per cent, the report found.

Without changes to government policy, the report's authors say net national income per capita will grow by 1.1 per cent a year over the next 50 years compared with 2.7 per cent over the past 20 years.

The number of Australians aged 75 years or over will rise by 4 million from 2012 to 2060, lowering labour participation from 65 to 60 per cent,

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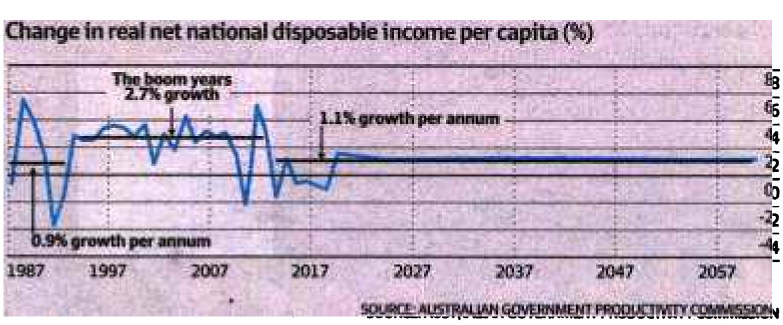

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according to the Productivity Commission. "The bottom line is that the combined cocktail of falling labour supply per capita, a declining terms of trade and poorer productivity growth rates mean that Australians can expect that the growth in disposable income per capita will fall to less than half that of the boom years," the report says.

"A period of truly diminished outcomes is likely to be at hand, unless luck or appropriate policy initiatives intervene."

Dr Gruen warned that to maintain recent levels of income growth in the absence of growing terms of trade and labour participation rates would require labour productivity growth to average 3.2 per cent a year for a decade – something that has never been achieved before.

"Labour productivity is the thing that contributes most to income growth, most of the time," he said.

The commission projects average labour productivity growth will stay around 1.5 per cent a year from 2011-12 to 2059-60, which is also Treasury's base case, and is below what many economists believe is required to ensure future sustainable economic growth.

The capital investment required to meet the needs of the expanded and aged population by 2060 is expected to reach some $38 trillion, five times more than that required over the previous half century.

Addressing the problems could require some uncomfortable reforms from the government including the inevitable increase of some taxes and linking the eligibility age of the age pension to increased life expectancy, the report said. The commission made clear it was not giving recommendations, but suggesting areas of policy that should be looked at.

One innovative suggestion to address the issue could be allowing retirees to draw on the equity in their home to make co-contributions to their aged-care costs, thus reducing the need for age pension payments.

The report makes a conservative estimate that having individuals contribute just half of the annual real increase in home values could reduce government expenditures on aged care by around 30 per cent.

A 5 per cent improvement in health sector productivity, like removing unnecessary regulatory burdens and addressing procurement processes, could reduce the projected budgetary pressures on governments by 0.5 percentage points of GDP by 2059-60.

"The near inevitability of significant fiscal and policy consequences of demographic change seems not to have created much genuine desire for reform," the report reads.

"The preferable time to contemplate the policy implications of these developments is while these near-inescapable trends are still in their infancy."

Labour productivity is the thing that contributes most to income growth.
David Gruen, Treasury

Time bomb

Budget pressures (% share of GDP)

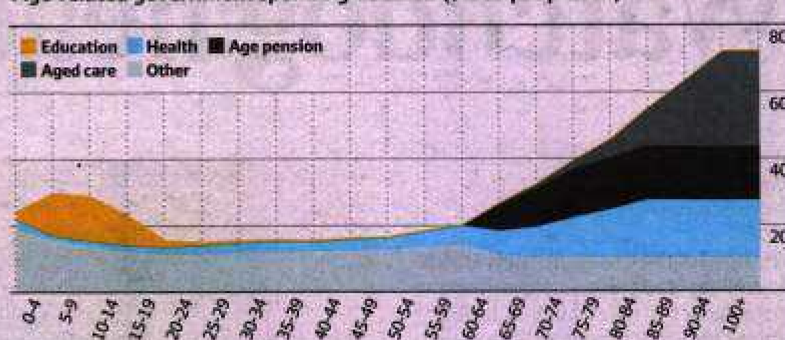
Australian government

	2011-12	2059-60	% change
Health care	4.1	7.0	+2.9
Age pension	2.7	3.7	+1.0
Aged care	0.8	2.6	+1.8
Education	1.9	1.7	-0.2
Other*	11.2	10.2	-1.0
Sum	**20.7**	**25.1**	**+4.5**

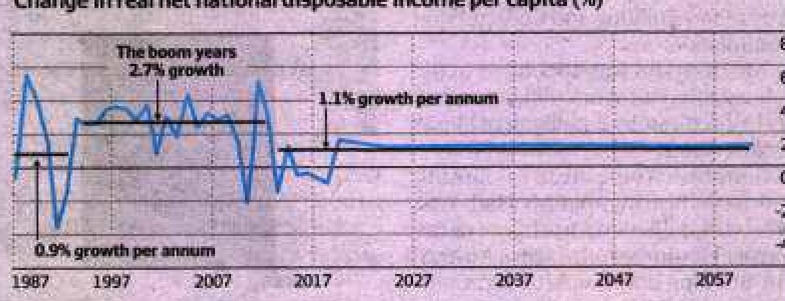
State and territory governments

	2011-12	2059-60	% change
Health care	2.4	3.8	+1.4
Education	3.5	3.2	-0.3
Disability	0.2	0.5	+0.3
Sum	**6.1**	**7.5**	**+1.4**

Age-related government spending 2011-12 ($'000 per person)



Change in real net national disposable income per capita (%)



A period of truly diminished outcomes is likely to be at hand, unless luck or appropriate policy initiatives intervene.

SOURCE: AUSTRALIAN GOVERNMENT PRODUCTIVITY COMMISSION