Address to the Melbourne Institute's 40th Anniversary Dinner

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Abstract

Demographic issues, particularly related to the labour force participation ratio, in the *Intergenerational Report* and in policy options influencing welfare to work decisions over the next 40 years are discussed.

My thanks to Peter Dawkins for inviting me to speak at this 40th Anniversary Dinner (February 2003) of the Melbourne Institute.

We have heard already tonight of the Institute's abiding interest in policy relevant research. But the Institute is more than a think tank. Under Peter's leadership in particular, it has assumed a key role in facilitating public dialogue on important policy issues – notably those that are at the interface between economics and social issues. Most of you would be familiar with its regular Public Economics Forum meetings in Canberra and Melbourne. And reference has already been made to the Institute's co-hosting, with *the Australian*, of the landmark April 2002 Economic and Social Outlook Conference, *Towards Opportunity and Prosperity*.

Over the last 40 years, the Institute itself has exploited opportunity and enjoyed a fair measure of prosperity. Long may that continue.

This evening, I want to say a little about two related topics: economic challenges raised by the *Intergenerational Report* and welfare to work issues.

The first of these topics is something of a 'natural' for tonight: in reflecting on what has been achieved in the past 40 years we are bound to wonder what the next 40 might have in store for us. And that is what the *Intergenerational Report*, released with the last Budget, is about. Specifically, it provides a basis for considering the Commonwealth's fiscal outlook and identifying some of the more important economic issues associated with population ageing over the next 40 years.

This is ambitious work. Any projection over a 40-year horizon is going to be associated with a high degree of uncertainty. But that doesn't mean that it will be wrong, nor that policy implications drawn from it will be inappropriate.

This point is worth emphasis. Some have sought to raise questions about the *Intergenerational Report* by associating it with the ill-fated *Limits to Growth* project of the Club of Rome published in 1972. The reports have something in common, of course; both contain long-term projections. But that is all they have in common. Were the Club of Rome projections wrong simply because they spanned a substantial time horizon? Hardly. Rather, from the moment the *Limits to Growth* report was published, economists were saying that the projections would be proved wrong because the analysis that produced them was poor.

The *Limits to Growth* experience does not illustrate the dangers inherent in making long-term projections. It merely illustrates that poor analysis produces poor conclusions.

Some of you will see parallels in the debate that Ian Castles and David Henderson are having with the authors of the even more ambitious projections of the Intergovernmental Panel for Climate Change. I haven't noticed Ian or David suggesting that the IPCC projections will be wrong merely because they cover such a long time horizon.

Back to the *Intergenerational Report.* The projections in that document indicate that, from the end of the Budget forward estimates period, on the basis of current policies and trends, the ratio of Commonwealth government expenditure to GDP will be about 5 percentage points higher by 2042 – roughly, increasing from 22 per cent to 27 per cent. To come up with that sort of projection, we had to make judgements about the numerator of the ratio – Commonwealth spending – and its denominator – GDP.

To the numerator first. Our projections have nominal Commonwealth spending increasing almost eight-fold over the next 40 years. Some 80 per cent of this is health related, and about three-quarters of that is due to factors other than population ageing. That is, some 60 per cent of the projected increase in Commonwealth spending is due to non-demographic influences on health expenditure.

Recognising this, you might be tempted to conclude that most of the 5 percentage point increase in the spending to GDP ratio also has nothing to do with demographics. But there you would be in error. To see why, we need to consider what is driving the denominator of our ratio – GDP.

Our projections have nominal GDP growing something less than seven-fold over the next 40 years – averaging about 4¾ per cent a year, made up of real growth of about 2¼ per cent and inflation of 2½ per cent. The spending to GDP ratio grows because the projected rate of growth of spending exceeds the rate of growth of nominal GDP.

It turns out that all that would be needed to prevent an increase in the ratio is an extra one-half of one percentage point a year in real GDP growth: an average of 2¾ instead of 2¼.

And here's the thing. Over the last 40 years we averaged real GDP growth of 3¾ per cent a year – a full percentage point higher than the required 2¾ per cent.

So what's the problem? Why can't we repeat our past performance? And if not that, surely we can at least manage an additional one-half of a percentage point to get us up to the required 2¾. All of the gap between the 3¾ per cent annual growth rate of the past and the 2¼ per cent projected for the future is more than fully explained by demographics.

Make no mistake: Demography is the big story here – not principally because of its impact on spending, although that is not insignificant, but because of its impact on our GDP prospects.

Let's look at these effects a little more closely.

Growth in GDP is driven by growth in three parameter clusters: population, participation and productivity. Population growth provides the pool of working age people from whom the workforce is drawn. The participation cluster determines how many hours of work are actually performed, economy-wide. And productivity determines the volume of goods and services produced by an hour's work.

In much of the remainder of my comments tonight I will be focussing on participation, so I should be clear about the various things that fall into this cluster. The first is the standard participation rate, measuring the proportion of the population of working age that actually wants to work. The second is the standard unemployment rate, measuring the proportion of those who actually have a job. And the third is average hours worked.

In the last 40 years, population factors explained 2 percentage points of the 3¾ percentage point average annual growth in real GDP. That is, if the parameters in our participation cluster - the participation rate, unemployment rate and average hours worked – had not changed, and neither had productivity, we would still have averaged annual growth in real GDP of 2 per cent a year, simply because of the growth in the number of people of working age.

But of course, each of the parameters in our participation cluster did move – and quite appreciably – over the last 40 years. We experienced reasonably strong growth in the participation rate, due overwhelmingly to increasing numbers of females looking for work. But this was offset by an increase in the unemployment rate, and average hours worked declined. Taken together, these participation parameters reduced annual growth in real GDP by about ¼ of a percentage point.

Finally, productivity growth contributed 2 percentage points a year.

Summary, 2 from population growth, less ¼ from participation, plus 2 from productivity gives 3¾ per cent a year for real GDP growth.

In the next 40 years working age population growth will give us only seven-eights of a percentage point a year, as against 2.

The participation cluster will detract three-eights annually, as against ¼. But this detraction will not be due, as in the past, to rising unemployment and declining hours worked – indeed, we expect the unemployment rate to fall, and we have projected average hours worked to remain pretty much where they are now. Rather, the big participation story in the next 40 years is in the participation rate itself – in the proportion of the population of working age who actually want to work. The biggest challenge we confront in this area is that as the workforce ages, the average workforce participation rate will fall because older people are less interested in working. It is as simple as that.

Finally, we are projecting productivity growth to contribute 1¾ percentage points a year to real GDP growth, as against 2 in the past.

Seven-eighths from population, less three-eighths from participation, plus 1¾ from productivity gives 2¼ per cent for average annual real GDP growth.

In our projections, most of the difference between future GDP growth and past experience is due to slower growth in the population of working age and workforce ageing. The big GDP story is a demographic one. And, to repeat an earlier observation, the main reason for the projected increase in the spending to GDP ratio is slower real GDP growth.

Big deal, some say.

So what if the spending to GDP ratio increases by some 5 percentage points over the next 40 years? Why should we care?

Well, the reason the document released with the Budget is called the *Intergenerational Report* is that this generation could indeed decide simply to shrug its collective shoulders and leave the issue to future generations. What it would be leaving to them, of course, is a higher public debt burden that would have to be funded eventually from higher taxes.

Indeed, some people are advocating just this. They argue that just as every generation enjoys a higher standard of living than the last, our children and grandchildren will be richer than us, so we shouldn't be too concerned about forcing them to face up to much higher tax rates than those we have had to confront.

This seems to me to be misguided thinking, for two reasons. First, while it is indeed very likely that our children and grandchildren will have higher average incomes, they will experience much slower annual income growth than us. According to our projections,

whereas real GDP per capita grew at an average annual rate of 2¼ per cent a year over the last 40 years, it will grow by only 1½ per cent a year over the next 40.

But here's the thing. Even with GDP per capita growing at an annual rate of 2¼ per cent, we in the Treasury have not exactly been overwhelmed by queues of increasingly rich Australians lining up to demand that we increase tax rates to take away some of their real income gains. And with GDP per capita growth rates now set to fall, the task of increasing tax rates over time is likely to become even harder.

The second reason why the 'let them have higher tax rates' approach is misguided is that higher tax rates would most likely actually make things worse. To see why, note that we really only have three economic flows that we can tax: labour income, capital income and consumption.

Now who thinks a higher rate of consumption tax is a goer? And who thinks that, in a world of increasingly fierce competition for internationally mobile capital, we can tax that income flow more heavily? And if you answer those questions the way I would predict, then that means we are left with increasing the tax rates on labour income. And here's the crunch: if, as I have noted, workforce participation rates are a major source of the problem, increasing tax rates on labour income is hardly likely to be part of the solution.

No. Those who think a substantially higher tax to GDP ratio is the answer need to think again.

So what is the answer?

Faster growth.

And here the policy choices are really quite straight-forward – at least in concept. In other forums I have explained that there is not a lot we can do to change significantly the prospective rate of growth of the population of working age – at least, not that would have a net positive impact on GDP over the next 40 years. I won't repeat those comments tonight.

But I will say that the areas of participation and productivity are considerably more promising. The latter rests on continued attention to the microeconomic reform agenda and the maintenance of a stable macroeconomic framework. Without diminishing its importance, I don't propose saying anything more about productivity tonight either. Instead, in the few minutes left to me, I want to say a little more about the other area – participation.

Recall that the participation cluster brings together three standard parameters: the participation rate, the unemployment rate and average hours worked.

For 30 of the last 40 years our principal macroeconomic challenge concerned the unemployment rate. For all of the next 40 our principal economic challenge will be the participation rate.

Amongst OECD countries, Australia's total participation rate, at 75.3 per cent, ranks 11th, suggesting there is significant potential to improve it both in the short and medium term. In particular, labour force participation among the mature aged, income support recipients and females is low by international standards.

Labour force participation currently declines sharply with age, from around 80 per cent for people in the 45-54 age cohort, to around 37 per cent for people aged 60-64.

Negative employer attitudes and the generally lower levels of educational achievement and participation in education and training of older workers means that many face far greater barriers to keeping or regaining a foothold in the job market than their younger counterparts. These barriers simply must be addressed.

But we need to ensure also that our policy frameworks do not create incentives for people to retire early. The structure of our retirement income system, our income support system and workplace relations policy are all important here.

Currently, around 2.6 million people of workforce age are in receipt of Government income support payments. This includes the unemployed, people with a disability or who are sick, and sole parents.

Notably, only around 15 per cent of working age income support recipients – some 390,000 of the 2.6 million - are required to look for work. The participation requirements, or lack of them, associated with income support payments influence labour force participation rates. In addition, the structure of income tests and their interaction with the personal income tax system, producing very high effective marginal tax rates in many cases, can impact significantly on the rewards from working, on work incentives, and on participation rates.

As at June 2002, almost 660,000 Australians were in receipt of the Disability Support Pension, DSP. There are now more people on DSP than there are in receipt of Newstart Allowance - unemployment payments.

Income support payments for those of working age have been designed to provide a safety net to families and individuals to help them through periods of reduced earning capacity. They are not intended to discourage workforce participation.

But when one in nine Australians aged between 50 and 64 is on the DSP, I think we can safely conclude that we have something other than a safety net. Indeed, we have to consider whether we haven't created a set of opportunities and incentives to institutionalise voluntary early retirement; to institutionalise non-participation in the labour force. And that is the very opposite of what will be required if we are to respond credibly to the challenges of an ageing population.

Work incentives and participation requirements are key elements of the ongoing welfare reform task. They need to be looked at together – not each in isolation. And I should say here that the interest being shown in these issues by the Institute, and by Peter in particular, is to be applauded.

The challenges posed by the *Intergenerational Report* are considerable. They are not the sort of challenges that demand an immediate response. Rather, they point to the direction of policy adjustment that will be required over time. As in the past, the policy task will be to find ways of enhancing our growth prospects.

This task is not without hope. Far from it. There is, for example, considerable scope to boost the labour force participation rates of Australians of working age, particularly the mature aged, income support recipients and females.

Demography is a big policy story. And the heroes of the story, as it unfolds over the next 40 years, will be the policy responses that address workforce participation issues.

The past 40 years were a time of enormous change in Australia – both economic and social, with challenges aplenty for policy makers and for those engaged in policy-relevant research. The next 40 years promise to be every bit as challenging – and especially so for those who, like the Melbourne Institute, have the courage to tackle those issues at the interface between economic and social policy.

May I congratulate the Institute on its impressive record of achievement over the past 40 years and wish it every bit as much success in the next 40.