Comments on "Caring for Older Australians"
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In this submission to the Productivity Commission, I will review the recommendations made in Chapters 6 and 7 from the January 2011 draft report with respect to how they fare against seven public policy objectives for aged care financing reform. Many of these points I was able to make at the March 28, 2011, public hearing in Sydney.

An approach consistent with reforms in health care and retirement income

According to the Intergenerational Report, the share of the budget committed to aged care will increase from 3% (2009/10) to 6.6% (2049/50) of total government spending (Australian Treasury, 2010) which, in the out year, is 1.8% of GDP. Given the Government's commitment to limiting overall annual growth in government spending, structural changes in this area are a likely part of future adjustments. Indeed, the discussion of structural reform has begun with the Productivity Commission's current inquiry into aged care.

With regard to both health care and retirement income, the Australian government has taken the approach of moving greater responsibility "off budget" and on to the individual and private sectors through private health insurance subsidies and mandatory superannuation schemes. As aged care services interface with the health care system and aged care financing is closely linked to aged care pensions, it follows then that policymakers are likely to consider the same strategy—i.e. greater reliance on individuals—for addressing the future growth associated with the services needed to care for an ageing population.

The relative roles that the public and private sectors will play in the financing of aged care in Australia, and which strategy should take the lead, are at the centre of this discussion. This includes how to build on the existing aged care funding scheme. Moving responsibility for aged care from public to private, however, does not imply that aged care should be made a product bought and sold entirely under free market conditions. The seminal work of Kenneth Arrow on medical care (1963) demonstrates that, if one does not know when or whether one will need care, and the cost of that care is expensive, then insurance is needed to spread that risk over people. Given what we know about the risks and costs of aged care, Arrow's argument similarly can be applied.

Treating the different components of aged care differently

Making a major contribution to the debate about how to finance aged care, the Productivity Commission demonstrates in their recommendations an understanding that not all insurable risks are created equal. The probabilities and predictability of needing care and associated costs vary greatly from hospital and physician care to residential aged care to dental and allied services. Risk selection issues and moral hazard also vary. Moral hazard for inherently desirable services associated with aged care (say food preparation or lawn maintenance) will be greater than for less desirable services (residential care). The Draft Report wisely shows that the various components of aged care carry with them unequal risks and explicitly recommends treating the different components (housing, health-related services, and personal care) differently. They suggest that the more predictable housing and living costs be moved "off budget" and onto the individual.

If the housing and living expenses share of aged care is to be borne by individuals, there are non-conventional methods that should be explored by the Commonwealth to help fund them. Generally, the idea is to identify creative ways to draw down resources from a person's wealth portfolio. For example, it has been suggested that something akin to the income contingent loans (ICL) involved in Australia's higher education contribution scheme be

developed where the financial repayment contingency is an individual's assets rather than income (Chapman, 2006).

This type of thinking led the Productivity Commission to explore how the home, typically a family's most valuable asset, could be used as a vehicle for financing the private share of aged care services. Housing wealth in Australia represents about half of total private assets (Creighton et al., 2005). Some earlier research has been done to investigate what parameters would make reverse mortgage mechanisms a viable commercial option in this regard (Mitchell and Piggott, 2004). In their draft recommendations, the Productivity Commission has recommended a government-backed reverse mortgage scheme eliminating some of the downsides to relying on private entities.

Then, this leaves the less predictable risks (health-related and personal care) remaining as part of a government system. There are two options for how these remaining risks might be funded: either a new social insurance could be created (an option favored by a number of interested parties) with a dedicated funding stream, or general tax revenues could remain the source of aged care services funding. The Productivity Commission chose the latter approach in its recommendations. With general revenue funding and significant cost-sharing requirements, current aged care programs in Australia have a broad revenue base and spread the financial burden widely across both recipients and taxpayers without using insurance mechanisms per se. In addition, there is no precedent in Australian for social insurance strategies. It is not surprising that the recommendations do not call for a new dedicated funding stream. I will discuss further the implications of this choice below.

Other public policy goals for financing reform: how do the Productivity Commission's recommendations fare?

In addition to limiting overall annual growth in government spending, there are seven other public policy goals that likewise are important and might be considered when examining reforms. These include prevention of individual catastrophic out-of-pocket expenditures, providing a predictable source of public funding so that paying the private share of services does not come as an unexpected surprise, rebalancing the system towards more care at home, controlling costs across both public and private shares, and making sure that the system is efficient, equitable and simple. The first two of these are especially relevant if the financial responsibility for care is shifted from public to private.

Preventing individual catastrophic out-of-pocket spending. The Productivity Commission's recommendations are strong across most of these criteria. In terms of limiting exposure to catastrophic spending, there are explicit recommendations for this. Additionally, their recommendations extend to the housing and living component (which would fall to individual responsibility) by providing a safety net for these expenses. Although a fairly rich picture of the financial status of Australians is available through national surveys such as the Household, Income and Labour Dynamics in Australia (HILDA) and Household Expenditure Survey (HES), a better understanding of the relative income and asset (housing and non-housing) status of aged care users would help policymakers understand the parameters under which more responsibility could be shifted without undue burdens falling on the recipients of care. For example, it would be useful to know not just how much recipients currently have to pay out of pocket for care, but what that amount represents as a percentage of their income and assets and how this would change under the Productivity Commission's recommendations.

Reliability. The recommendations fare less well in terms of reliability or predictability. The public subsidies for aged care are currently paid with general revenues and there is no recommendation for this to change. General revenue funding is less reliable than a dedicated funding stream as it is contingent on the Commonwealth's other spending priorities. Competing with aged care programs for general revenues is a broad set of programs running from education to transportation to environmental protection. Anyone who has participated in mandatory superannuation schemes in Australia over the last five years understands how

unpredictable the rules regarding this can be. Frequent changes in contribution maximums and tax rates have led to great confusion. So too could be the rules regarding the private responsibility associated with aged care.

As the population ages and has an increasing demand for aged care services, these programs will take up a larger proportion of general revenues. This does not necessarily translate into the need for increased taxes as other government expenditures (e.g. education) are expected to go down as the population ages. However, Australia's strong overall future, economic position could be upset by miscalculations made about the future such as input prices associated with aged care services, especially associated with the price needed to compete for labour in a tightening labour market, and the cost of capital. Already, there is industry complaint that subsidies are inadequate to keep the short-term supply of beds in line with planning ratios.

Another concern is that general revenue funding is pay-as-you-go. Pay-as-you-go mechanisms do not allow for spreading the financing burden over time. Consequently, taxes paid by the younger working population of the future will increasingly be committed to services for an older population. Australia expects to see a shifting dependency ratio where fewer working age people are available to support those dependent on government programs (Productivity Commission, 2005). On the basis of intergenerational equity, at a societal level, these taxpayers may be unable or unwilling to continue this commitment.

The alternative is to set up a social insurance/entitlement scheme dedicated to aged care. This would allow for pre-funding of services by building up a trust fund to pay for future needs. Under social insurance, everyone pays into the system and everyone is eligible for benefits. Social insurance strategies, however, are not without their own drawbacks. These include the additional burden that comes during the transition period to this new scheme where current taxpayers are concurrently responsible for both others' present and their own future funding liabilities. Here, questions of sustainability are raised[1]. Finally, government investment of and borrowing against trust funds must be strictly controlled or else unfunded liabilities could emerge.

Rebalancing towards more care at home. There are two separate recommendations from the Productivity Commission's draft report that support rebalancing the aged care system towards more care at home—which, in most cases, is the preferred setting. The first is the most obvious: removing the planning framework that sets 113 operational places for aged care, with 44 high care residential, 44 low care residential, 25 community packages, will likely result in more care at home; both overall and probably as a proportion of all care delivered.

The second is more subtle. Separating the housing components (accommodation and living expenses) from the care component implicitly favors home care and creation of new congregate housing choices *at the margins*. If an aged care user can get the same services at home or in a more desirable congregate housing setting, then they will choose this over residential care in most instances. There are, of course, situations where residential care is the most appropriate setting. But, it is hard not to believe that there is a sizable part of the existing residential care population whose characteristics overlap with the population receiving packaged care at home and that would prefer to be there is that care was available. One could reach this conclusion by examining the residential length of stay information provided by DoHA in the Productivity Commission's draft report (see page 149) that shows a larger than expected right-hand tail to the distribution.

Efficiency. There are two ways of looking at efficiency in the context of this discussion. First, one can measure target efficiency. That is, measures of whether public spending goes to those most in need of care or least able to pay for it (i.e. those who would incur catastrophic out of pocket costs without it). Without better information about current out-of-pocket spending patterns in aged care, I can only speculate on target efficiency from an ability to pay perspective.

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[1] Here, I do not use the strictly economic definition of sustainability, but rather the more general definition found in the Brundtland Report (1987) that suggests sustainability involves "meet[ing] the needs of the present without compromising the ability of future generations to meet their own needs."

However, rigorous assessment of needs as recommended in the draft report should ensure that public spending goes toward those most in need.

The other way of measuring efficiency is to think about what choices are available. Efficiency can be measured by the extent that distortions in decision making are limited. An example might be the distortion created when assets held in the form of a home are not counted in eligibility for the aged care pension, while more liquid assets are counted. In a few ways, the Productivity Commission's recommendations will improve economic efficiency in the aged care system. First, efficiency is improved by equalizing the co-contributions across settings. Second, it is improved by allowing assets associated with housing sales to be invested in government bonds that do not count against the aged care pension eligibility thus mitigating the unequal treatment of home versus liquid assets. Third, requiring that accommodation bonds and charges be presented to users as equivalents will decrease distortions. In all cases, distortions created by government programs are reduced.

Cost control. The general revenue versus social insurance/entitlement distinction also impacts on the ability of government to control costs. General revenue funded programs have greater cost controls because they have to compete with other government spending priorities and these priorities are reviewed on a regular basis. In contrast, because of their "entitlement" nature, it is more difficult to impose cost controls on social insurance programs. People feel like they have paid into the program and they deserve its benefits.

Also, to the extent that co-contributions are intended to make people more cost conscious when using services, the Productivity Commission's recommended design, where those contributions exist for more desirable services (i.e., personal care), will impose greater cost control. Here, we are revisiting the issue of moral hazard and how it differs for the different components of aged care.

Equity. Having people contribute their "fair share" is complex because fairness has many different definitions and can be measured from the perspective of who pays (taxes, insurance premiums, co-contributions) and/or who benefits. As the recommendations are to continue, in part, with general tax revenue funding, and since federal income taxes are progressive, the proposals fare well from the perspective of who pays for the care components.

Although broad-based taxes are easy to use and yield significant revenue, there is a certain logic to funding part of the services with contributions from the people who benefit. It is not just the user of care who benefits from publicly-funded aged care but also their family. Again, the Productivity Commission's recommendation that housing and service costs be treated differently would impact the system's performance in terms of equity. As it has been noted, the cost of housing and related living costs is something that everyone must bear throughout their lifetime. So there is a sense of fairness in recommending that this component of care continue to be borne by the individual. That the Productivity Commission recommends an avenue by which equity in a home can be drawn down to pay for a resident's share of cost helps as well.

Simplicity. The recommendations found in the draft report certainly bring more simplicity to a system that is confusing on many fronts. In particular, recommendations around how co-contributions are set will add to the simplicity of the system and provided a welcome departure from the current structure that varies by pensioner status, low versus high care, and for community services. Making clearer the choice between accommodation bonds and charges also contributes to making the financing arrangements simpler and easier to understand. How co-contributions are collected is an

It may be that some compromise will need to be made to the simplicity of dividing all expenses into three components (accommodation and everyday living, health services, and personal care services) and applying difference principles. Where personal care services (with co-contributions) end and health services (with universal subsidy) begin might not be as clear

cut as one would hope. And, within personal care services, there may be some need for applying different co-contributions to different services to reduce demand for those services.

Final words. There are two additional areas where I would like to issue a word of caution and a call for more data and better research. First is with regards to the assumption that more choice is better. There is recent research into how well people (and, in particular, older persons) are able to choose among complicated sets of options. Both Harris and Keane (1999) and Heiss, McFadden and Winter (2007) show that people's actual choices often do not reflect their true preferences and best interests. People's ability to choose is related to easy-to-understand information. To the extent that the Productivity Commission is hoping for greater choice, these considerations must be taken into account. A new ARC-funded Centre of Excellent in Population Ageing Research at UNSW will, in part, provide research into the kind of Australia-specific choice modeling that would help inform this area.

Second, the government's effort in formulating empirically-supported aged care policies is hampered by a lack of data in three areas: 1) financial status (income and assets) of users of aged care; 2) levels of absolute and relative out-of-pocket spending of current users of aged care services; and 3) levels of moral hazard for home care and residential care.

In the context of understanding how much additional financial burden can realistically be transferred onto users of aged care services, one could link the HES to information about participation in public aged care programs in the community such as the Home and Community Care (HACC) program, the Community Aged Care Program (CACP), and the Extended Aged Care at Home (EACH) program. This would provide vital information in the discussion of how much current users still need to spend out- of- pocket to remain in their homes and what sort of a burden this represents. Unfortunately, the same cannot currently be done with users of residential aged care services as residents of non-private dwellings are excluded from the HES. And, while significant data is collected on the users and providers of aged care in the annual report on the operation of the Aged Care Act of 1997 produced by the Department of Health and Ageing, this data does not include anything related to user finances.

Without surveying the population in residential aged care in a systematic fashion, the calculation of resident contributions towards care and accommodation is far from straightforward and varies by pensioner status, assets and facility practice. An understanding of the current out-of-pocket spending relative to income and assets for current users of residential aged care is too important an issue to not bring to the forefront of data collection efforts in the future.

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