8 December 2004

Ageing Impacts Study
Productivity Commission
Collins Street,
Melbourne, Vic, 3000

By email: ageing@pc.gov.au

Dear Sirs/Madams

Re: Draft Report on the Economic Implications of an Ageing Australia

The following submission provides additional information on areas covered in the previous submission following the release of the PC's draft report.

The PC has a baseline labour productivity growth rate of 1.75% per annum (page 5.1).

Measuring productivity growth
How has growth in disabled pensioners affected measured productivity growth in the past? If the government is successful in getting people off disability pensions and back into the workforce, how would this affect measured productivity?

Have low levels of R&D and training in the past had a positive effect on measured historical productivity (while in the longer term it will have a negative effect)?

Other questions about the sustainability of productivity growth
In his previous submission, the writer listed some major questions for consideration in relation to the sustainability of productivity growth. The following provides additional information:

Doubts about the contribution from IT: BusinessWeek magazine states*: "some Fed policy makers are questioning how much longer the efficiency miracle can go on. They see signs of a slowdown in the torrid pace of technological innovation in the computer and chip industries, advances that propelled productivity in the last decade. And they wonder if those are harbingers of less vigorous gains ahead… Economist admit there is much they don't understand about productivity"* (as quoted in The Australian Financial Review, "US efficiency miracle may be fading", 15/11/04). In the same article, BusinessWeek does say that others (including policymakers in the Fed) are *"upbeat about the long-term outlook"* (on productivity).

One crucial question is: can the productivity enhancements brought forth by the computer revolution be replicated the next 40 years from future computer innovations? In the view of this writer, the answer is probably NO. Computers have already allowed businesses to either introduce or improve accounting systems, benchmarking, business and financial analysis, business planning, marketing management, field workforce management, electronic funds management, online banking, robots, supply chain management, reengineering, Cad-Cam, bar-coding, etc. The marginal productivity returns that will become available from future computer advances are likely to decline over time.

Doubts about the contribution from infrastructure: Concerns are regularly expressed that Australia's infrastructure is being run down, and that this will threaten future productivity growth and also transfer the burden of restoring infrastructure to future generations. The Economics editor of The Australian wisely stated: *"If we are going to have a national debate* (i.e. about the adequacy of, and spending on, infrastructure), *let it proceed from an informed inquiry by, say, the Productivity Commission and not be driven by the vested interests of construction companies, property developers, merchant bankers, engineers or the National Party"* (The Australian, Alan Wood, "It's worth spending time to find facts", 13/11/04).

Doubts about the effect of changes in the labour market: According to Richard K Lester: *"The flexibility to hire and fire at will that such a strategy offers (as well as its generally lower costs) has proved very attractive to many American firms. But this path, too* (i.e. as well as outsourcing), *has its drawbacks. Firms that follow it are often constrained to producing low-end products and services because the human resource base on which they depend lacks either the skills or motivation to achieve the levels of innovativeness, quality, and service needed to compete in higher-value, more profitable products markets"* ("The Productive Edge", Richard K Lester, page 270).

Australian employers' increasing reliance of part-time, casual and contract labour may not auger well for innovation and productivity growth in the longer term.

Doubts about the ability of employers to provide adequate training: Education is a corner stone of productivity growth. Yet it appears many businesses lack the initiative or inclination to train staff. The business sector is now talking about skill shortages. This has occurred despite relatively slow growth in hours worked by the Australian workforce, due apparently to a greater reliance on casual, contract and part-time workers (many of whom receive little, if any, training).

Refer below to Mr. Lester's suggested policies to promote a more flexible workforce.

Doubts about the contribution of policy: Allen Fells and Fred Brenchley wrote in The Australian Financial Review that government *"reform malaise has set in"* (AFR, "Governments must grasp nettle of lasting reform", 11/11/04). They seem to hope that the PC's agenda may provide an incentive for Howard to grasp *"a unique place in the history books"*. This writer believes that the PC must provide governments with more compelling reasons for reform.

Other issues

The PC has already pointed out that *"public savings are expected to decline"* over the next 40 years (page 4.21). This could contribute to a rise in interest rates, which could adversely affect future investment and productivity. Comments by the Federal Treasurer suggest that future governments may rely on borrowings (rather than taxes) to fund the cost of ageing. According to The Australian Financial Review, the Federal Treasurer "rejects tax rise to pay for ageing" (AFR, "Costello rejects tax rise to pay for ageing", 29/11/04).

It appears that when economic uncertainty takes hold, it can sometimes have a considerable adverse effect on investment and productivity. In this writer's opinion, policy makers should, at the least, ensure that policy is sustainable and is framed and implemented with consideration both means and ends.

At the moment, there is considerable uncertainty about the future course of the U.S. and global economies. According to Robert J. Samuelson*: "The (U.S.) economy must now move ahead without the powerful afterburners of soaring stocks or rapidly falling interest rates. These were the final chapters of the Age of Inflation. It's over. What comes next is anyone's guess"* (Washington Post, Robert J. Samuelson, "the End Of the Age Of Inflation", 2/12/04). Such words from a reputed economist are concerning, not the least because they impute a course of the economy which is utterly imponderable. Economists understand that the economy is almost impossible to forecast, but they normally are prepared to give a view (and probably hedge it). But for such a reputed economist to show resignation in such a publicly way is strange to say the least.

There is also considerable uncertainty about the future course of the Australian economy. The Governor of the Reserve Bank painted some grim, albeit contingent, scenarios in August 2003 and in November 2004.

As a percentage of GDP, Australia's current account deficit and foreign debt are among the highest in the advanced world, as is the ratio of household credit to household income. Australia is one of the only, or the only, advanced country where households are dis-saving. Domestic policy makers seem to have been oblivious to domestic imbalances and seem to be hoping that sustained growth in the global economy will take over from an expected decline in domestic demand. If the global economy turns down, Australia faces very trying economic conditions (as illuminated by the Governor of the RBA in August 2003).

The question is: how will this affect businesses' access to, and cost of, debt and capital in future? Once the ratio of credit to GDP exceeds 100%, the ratio will rise each year unless growth in the value of credit is slower than growth in the value of nominal GDP.

The total value of credit in Australia now exceeds 138 per cent of GDP. Based on an assumption that GDP rises by 6 per cent in nominal terms in the ensuing year, the credit/GDP ratio must rise if credit outstanding grows by more than 2.5 per cent. Then, in the year after that, credit must grow at an even slower rate to avert a further rise in the credit/GDP ratio.

The Reserve Bank expects that credit growth will slow to around the rate of growth in nominal GDP. That offers little comfort when credit, largely household credit, continues to subsume the economy.

The contribution of entrepreneurship and R&D capital to productivity growth

"Entrepreneurship tends to be stronger in more youthful populations, says Sylvester Schieber, research director at Watson Wyatt, an actuarial firm" (The Economist magazine, "Old Europe", 30/9/04).

Entrepreneurs of start-up companies offering new technologies (e.g. dotcoms) are often relatively young. Young entrepreneurs are usually reliant on other people who have significant experience in their chosen field (e.g. accountants, bankers, lawyers, marketers and coaches), but the young entrepreneur is often the source of much new economic activity (or productivity enhancing activity).

Corporate Culture

Innovative companies tend to have cultures that promote rapid change and, often, frenzied working environments. This can often be a more attractive environment for younger workers.

"…British supermarket chain Tesco was first mover to the Internet, not only ahead of retail competitors but also ahead of most other companies of any kind, and its leaders attributed this to its culture. Tesco has built an organisational structure that supports constant change. Its leaders are young, fast and dynamic. A flattened hierarchy allows their energy to permeate all the way down to the front lines in the form of 'hungry twenty-five-year-old store managers'" (The Drucker Foundation Wisdom to Action Series, "leading for Innovation", 2001).

<u>Relative productivity of current workers</u>

Inherent physical and mental capabilities

According to The Economist magazine: *"For most workers, decreased abilities* (from ageing) *will lead to lower productivity… experience only counts for so much…This tilt is becoming steeper: technological change puts a premium on adaptability, and a discount on experience. Even those employees who remain highly productive will be likely to shine only in a narrow field…ratings suggest that workers in their 30s are the most productive and hardworking, with scores falling thereafter"* (The Economist, "Over 30 and over the hill", 24/6/04).

It is possible that as people age, they become more set in their ways and may be less inclined or able to try to do things a different (innovative) way.

The Commonwealth Government seems to want more flexible working arrangements in the higher education sector (i.e. by requiring institutions to offer workplace agreements). This indicates that the government may consider "secured tenure" is not optimal in providing quality education. If so, this suggests that "secured tenure" is not good for motivation.

Motivation

In his previous submission, this writer provided arguments as to the effect of ageing on motivation in the workplace.

Older workers appear less willing to move to another city or town to work (even if the move would gain a promotion).

What if younger generations develop lower levels of motivation when compared to previous younger generations? The Australian Financial Review reported on a study commissioned by the American Business Collaboration, which found that Generation X and Y college-educated men wanted to work fewer hours and attain more responsibility, compared with comparable generations 10 years earlier (The Australian Financial Review, Catherine Fox, "Generation X: at home and happy", 23/11/04).

If ageing results creates labour shortages and in more offshoring activity, how would this affect productivity (and the balance of payments)?

Cross sectional earnings as a proxy for workers' relative productivity

This writer stated in his previous submission that care needs to be taken when using incomes as a measure of "productivity", and provided some reasons for this.

The Economist magazine has stated*: "PAY and productivity, it is generally assumed, should be related. But the relationship seems to weaken as people get older"* (The Economist, "over 30 and over the hill", 24/6/04). In the same article, The Economist magazine quotes a Norwegian demographer as saying *"Younger workers are underpaid and older workers are overpaid relative to their productivity".*

Further Considerations:

- **Institutional arrangements.** Are Australia's institutional arrangements and structures optimal in promoting innovation within institutions and in promoting policies that encourage innovation outside the institutional framework. If not, changes should be made. For example, would there be advantages in splitting the PC into two separate organisations which compete for work and funding? Should the Commonwealth Government also seek competing bids from private consultants? Should the PC avail the services of private contractors?

- **Education Reform:** Education is another area where there are overlapping roles and responsibilities between governments. The Commonwealth Government's proposed involvement in technical colleges, and its increased involvement in funding private schooling would appear to increase the level of "overlapping" in education.

- **Workforce reform:** According to Richard K Lester: *"The United States is generally regarded as having one of the most flexible labour markets of any advanced country…benefits should be made much more portable. Individual skill grants, or tax deductible individual training accounts modeled after today's individual retirement accounts would also help flexibility"* ("The Productive Edge", Richard K Lester, page 282).

- **Housing:** The Australian Housing & Urban Research Institute's submission to the House of Representatives Standing Committee on Environment & Heritage (October 2003) provided long-term projections of housing demand. This may be assistance in the PC's work in several areas, such as conveyancing taxes, infrastructure spending, public housing expenditures). As the population ages, the turnover of housing may slow.

- **Budget/Actual**: Has the PC factored in known variations to budgeted spending or income levels? For example, the cost of the Commonwealth Government's Medicare Plus safety net scheme *"is rising sharply, according to figures released during the election campaign… more than double the original policy"* (Australian Financial Review, "Medicare safety net proves to be good medicine", 28/10/04).

Again, I look forward with great interest to reading the PC's final report on the economic implications of an ageing Australia.

Yours faithfully

Nigel Fitzpatrick