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Chairman
Productivity Commission
35 Collins Street
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Dear Mr Banks

SUBMISSION IN RESPONSE TO THE DRAFT RESEARCH REPORT ON THE ECONOMIC IMPLICATIONS OF AN AGEING AUSTRALIA

The Productivity Commission's draft report on the *Economic Implications of an Ageing Australia* is a welcome addition to the debate on ageing. We thank the Commission for the valuable contribution it has made to our understanding of the economic and fiscal implications of our ageing population.

The report has been considered across a number of areas within the Department of Treasury and Finance, and we would like to provide some further comments as feedback on it. In particular, we believe that the draft report understates the relative financial impact on the States. While we acknowledge that the report covers many issues, and that complex modelling by its nature requires simplifying assumptions, we consider that there are a broader range of cost pressures across different expenditure areas than those considered in detail in the report. Specifically, the draft report appears to give particular emphasis to health and programs with a focus on the aged, and provides less (even simplistic) analysis of other areas, particularly education and law and order. The treatment of specific purpose payments is also a major concern, and there appear to be some anomalies in the modelling. These issues are discussed below.

Specific Purpose Payments (SPPs)

The base case assumption for SPPs (i.e. that these payments will grow in line with service needs) has a major impact on the relative fiscal gaps for the Commonwealth and the States. Given the largely discretionary nature of SPPs, the likelihood that the Commonwealth will experience significant fiscal pressures of its own, and the perceived revenue growth benefits for the States from the introduction of the GST, we consider that these payments present a significant long-term fiscal risk for the States.

Current arrangements also do not suggest a Commonwealth policy of escalating SPPs in line with service needs. For example:

- SPPs for housing, supported accommodation assistance programs and disability services have no demand escalation factor;

- the Commonwealth has reduced real[1] funding escalation under the Australian Health Care Agreements to only 1.3% above age-weighted population growth, well below the average 2.1% above age-weighted population growth used by the Productivity Commission; and

- Commonwealth education funding is reduced if there is an increase in the market share of the private sector (effectively reducing funding per government student, abstracting from cost escalation),[2] even though this migration tends to increase costs per government student (see below).

While the Commonwealth from time to time creates new programs or introduces growth funding, it also terminates funding (e.g. dental program, Building Better Cities, National Competition Policy payments) or reduces funding (e.g. Australian Health Care Agreements, Commonwealth-State Housing Agreements). However, these are essentially ad hoc decisions, and in the absence of a clear long term trend in SPPs (as shown by the Commission's own analysis in Figure J4), it is difficult to justify assuming other than the status quo. In addition, in past years, the Commonwealth has been able to substantially cut general purpose grants as an alternative to cutting specific purpose payments (an option no longer available since the replacement of general purpose grants by revenues from the GST), and as noted above, there are reasons to believe that the Commonwealth is likely to be increasingly reluctant to expand SPPs. [3]

Our experience is also that the Commonwealth is seeking to reduce the need to grow SPPs by imposing increasingly stringent conditions on the States to receive SPPs (e.g. requiring States to grow their contributions to the shared costs of programs). In the most recent example, the Commonwealth has offered to renew the Supported Accommodation and Assistance Program on the basis that States increase their share of funding from 40% to 50%, while the Commonwealth redirects some of its previous funding to an "innovation fund" (effectively cutting funding of existing programs).

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[1] Real costs are assessed in terms of the Commonwealth's "wage cost index" for SPPs, which has
consistently yielded below-CPI outcomes.

[2] This reflects that Commonwealth funding is based on (1) a per student grant escalated annually for cost increases, and (2) a reduction in the grant if there is an increase in the market share of the private sector, even when there is an increase in the number of government school students.

[3] It should be noted that the increase in Commonwealth funding from the introduction of the GST in 2000-01 reflected the need to compensate the States for lost taxes and new expenditures.

Accordingly, we regard the Commission's assumption that SPPs from the Commonwealth Government to the States will rise with underlying service needs as a 'best-case' scenario for the States that is unlikely to be achieved. We believe that it underestimates the potential fiscal pressure on the States, and overstates the financial pressure facing the Commonwealth.

In our view, the Commission should adjust its base case and, in addition, place a greater emphasis on the uncertainty surrounding SPPs, and hence the uncertainty over the relative fiscal pressures faced by the different levels of government, in the body of its report.

Model Results

A glance at Figure 13.2 suggests that there are significant anomalies in the Commission's modelling, that are overstating the impact of ageing on the Commonwealth by 0.5% of GDP and understating the impact on States by 0.1% of GDP. This is suggested by the fact that the base year (2002-03) and 2003-04 results are not in line with what would be expected from the smooth trend in the results from 2004-05 onwards.

This may reflect the use of actual data in the initial years, followed by smooth long term forecasts. This is considered inappropriate, as any individual year will be affected by short-term, transient or cyclical factors. The study is aimed at identifying long-term trends, as opposed to short term influences.

Education

The Commission's forecasts for school education are based on constant participation rates and costs per student growing at the same rate as real incomes. These assumptions are unrealistically conservative, and the cost assumption is inconsistent with historical experience presented in the draft report (showing that school funding per student has exceeded GDP growth).

The pressure for more funding for government schools is widely recognised. Factors not recognised by the Commission's modelling include:

Participation Rates

- the long term policy aim to increase participation rates for the later school years, indigenous persons and the disabled (in particular, jurisdictions are moving towards increasing the age of compulsory attendance in schools);

- increasing emphasis on early intervention programs (i.e. before formal schooling commences) for children at risk;

Cost Factors

- the need for increased resources per student to generate a workforce to sustain the increasing complexity, diversity and technological demands of society;

- reduced scale economies in the long run as the proportion of school aged persons in many communities declines (which can be only partially countered by rationalisation of facilities);

- higher costs per student for State governments due to the drift towards the private sector, reflecting:

  - remaining government students are more likely to have learning difficulties and come from low socio-economic backgrounds; and

  - reduced scale economies for remaining government students;

- pressure to increase resourcing for government schools to retain quality students in the government sector and reduce the drift to the private sector. The need to better compete with private schools is emphasised by the statistics in the draft report showing that growth in government funding for government schools has significantly lagged that for non-government schools.

Social Concessions

The Western Australian Government provides social concessions in the form of rebates, discounts and waivers to improve affordability of key services. In 2002-03, the State Government provided social concessions with an estimated value of around $387 million or around 0.5% of gross State product. Given that eligibility for these concessions is often based on age, demographic change could have a significant impact on the value of these concessions over the long term.

In most studies on ageing, the impact of these concessions is not separately identified, but is captured through escalating portfolio expenditure or revenue values that exclude foregone revenue. While the draft report does make reference to certain concessions (e.g. transport and local government concessions), it does not provide an assessment of the impact of ageing on aggregate concessions. As such, we would welcome any quantitative assessment of the impact of demographic change on these concessions.

Law and Order

The Commission has assumed expenditure growth in line with GDP, reflecting offsetting effects from the declining proportion of younger people, and rising expectations on community safety.

Contrary to this view, our practitioners in the area consider that expenditure pressures will increase, reflecting factors including:

- increased opportunities for crime in a mobile and technologically advanced world;
- increasing threats from terrorism and the manufacture and importation of illicit drugs;
- increased crime complexity, again related to technology (e.g. fraud, identity crime);
- increased sophistication in crime detection and prevention methods;
- increased income inequality and loosening family ties;
- the need to improve law and order services in remote areas of Australia (e.g. indigenous communities); and
- increased urbanisation.

We hope these comments are of some assistance, and look forward to reading the final edition of the Commission's report in March 2005.

Yours sincerely

COLIN MURPHY
ACTING UNDER TREASURER

22 February 2005