Intergenerational fairness

This document is based on discussions at the CEDA Council on Economic Policy (CCEP) meeting held 20 March 2015. It does not necessarily reflect the views or opinions of any individual in attendance unless specifically cited. This summary does not reflect the unanimous views of all participants. Individual views may differ from the statements made in this summary.

CEDA's Council on Economic Policy (CCEP) March 2015 meeting began with a discussion of the current economic and political climate and, in particular, the reasons behind the inability of the government to pass reforms and communicate the reasons for reform to the public. Members noted the following as potential contributors to the current predicament:

- The lack of a consistent narrative or story from the government;
- The lack of focus on jobs and on what reform can deliver;
- The lack of intellectual rigour in policymaking; and
- The lack of impetus for reform due to relatively favourable economic conditions.

During a discussion about the state of the economy, particularly the challenges we are facing as we transition away from the mining investment boom, CCEP members identified the following areas of concern where CEDA could play a role in providing thought leadership:

- The role of the services export sector, including higher education in Australia;
- Identifying what the top six to 10 biggest threats to Australia are with a view to create and support impetus for reform;
- Exploring what the medium-term story is when it comes to the economy, including where the jobs will be and what kind of economic climate we might be operating in during that timeframe.

This was followed by a presentation on Burma's economic development by Nay Chi Win, Head of Burma's National League for Democracy's Research Unit. He noted that Burma's economy and institutions are still fairly basic, albeit progressively becoming more developed. Institutions, however, continue to lack transparency, with corruption and bribery, illegal border trading and black markets for currencies being the norm. The military continues to be entrenched in politics and in corporations – as an example, only those who have served at least a decade in the military qualify for the presidency of Burma. Property rights are minimal or non-existent – as an example, agriculture is a major sector in Burma but farmers are not allowed to own their lands. On the flip side, however, there has been some progress made – private banks have been allowed in Burma since the late 1990s and there has also been some development within the telecommunications sector.

The remainder of the meeting was devoted to a presentation on intergenerational fairness by John Daley, CEO of Grattan Institute, followed by a discussion on the issues presented, summarised below.

Unsustainability of government budgets

Australian government budgets have been unsustainable for seven years and there is both a revenue and an expenditure problem. On the expenditure side, spending on older households has been a substantial cause of the problem, although some progress was made during the Rudd-Gillard era in terms of removing some middle-class welfare.

The Treasurer is under increasing scrutiny and pressure over his budget improvement promises. However, the government would need to be lucky to achieve the budget surplus they are promising in the next five years.

History shows that over the last six years, governments' forecasts of the budget position have been more positive than the actual position. This is likely to be the case for the Hockey Budget as well – Grattan models have not replicated the increased income tax receipts predicted in budget documents.

A worrying recent budget strategy trend has been to forecast a surplus outside the political timeframe of the government of the day, which is not conducive to driving budgetary reforms which are inevitably politically difficult. A better strategy would be to budget for a healthy surplus in the short-to-medium term as was the case during the Costello years.

Age-related expenditure problems

Rising spending on older Australians is a dominant pressure on budgets. Age-related expenditure (such as the age pension, health expenditure on older Australians and aged care) has been rising faster than GDP. Most Australians under 65 are net payers to the government (that is they pay more tax than they receive in benefits) or small net recipients of government payments. However, those aged 65 and above have consistently been net recipients, with the average benefits received per household rising quite substantially over the last six years. While this is partly due to higher receipts, it is also because older households are now paying less income tax than 20 years ago due to superannuation tax concessions.

Governments spend more on older households than on younger ones primarily due to cash payments (the age pension) and health expenditure, with government spending per person escalating rapidly from the pension age. While health expenditure (Commonwealth and State) per person has more or less doubled across all age groups between 1988-89 and 2009-10, it has increased much more in absolute terms for those aged 70 and above. Commonwealth spending on aged care has also almost doubled in the last 10 years.

Policy choices have been driving the rise in health and pension expenditure, rather than demographic factors. More, improved and new services (per person) were the biggest contributor to the rise in health expenditure between 2003-2013, while growth in age pension expenditure was mainly due to rate increases and eligibility broadening. This is not well-recognised in the Intergenerational Reports, and all of them have incorrectly assumed that the non-demographic growth in health expenditure would taper off.

Health expenditure policy choices should be explored to reduce the burden on the public purse. Some of the most promising opportunities are encouraging prevention, and integrated care of chronic conditions, rather than patient co-payments.

Wealth

While most households in 2009-10 have more wealth than households of a similar age in 2003-04, young households (25-34) are accumulating less wealth than their predecessors. This is reflected in lower home ownership rates and larger mortgages compared to other cohorts. Given that over half of household wealth is typically held in property and that housing is becoming less affordable for younger cohorts, wealth is a concern for younger people.

This lower wealth accumulation for those aged 25-34 may reflect greater participation in higher education – they are starting to accumulate wealth later in life, and the returns are not yet reflected in their wealth. However, there is some evidence that the returns to higher education are lower than they used tobe.

Despite having lower wealth, less in home assets and larger loans than their predecessors, younger Australians tend to have more in superannuation. They also save more than their predecessors – the drop in wealth cannot be explained by lower savings. In fact, every age group is saving more now than they were in 2003-04, with the savings rate (which includes superannuation) for those aged 25-34 more than doubling to almost 13 per cent of disposable income.

Housing affordability

Housing affordability is a contentious policy issue, particularly given the importance of property to the wealth of Australians. There are many different methods to determine affordability. Some members are concerned that there are problems in comparing a stock (i.e. the house) with a flow (i.e. income). However, others suggested that it is legitimate to compare house prices with the total expected lifetime earnings – and a reasonable proxy is average full-time earnings multiplied by the number of working years. The ratio of the index of real house prices to real average full-time earnings was close to 1:1 between 1970 and 1997. After 1997, real house prices started breaking away and rising at a much faster rate than real average full-time earnings, with the ratio now being 2:1. As a result, those who bought a house prior to 1997 got a massive free kick (albeit during a period of high interest rates) that is unlikely to be repeated. Younger cohorts missed out on the windfall of buying a house before 1997.

This generated a debate among members around interest rates and housing affordability. Baby boomers grew up in a generation when the rule of thumb for long-term interest rates was 10 per cent. Nowadays, the rule of thumb is five to six per cent. However, the fact remains that house purchasers today will spend more years paying back the principal despite lower interest rates. The proportion of disposable income required to service mortgages may be lower now than five years ago, but they are higher than 15-20 years ago, despite lower interest rates today.

There are other factors at play. For example, there has been some financial products innovation which has led to lower transaction costs and interest-only loans are more accessible than before – which could have affected housing demand. The quality of housing has also changed, with the current housing stock being of higher quality, and on average, larger.

However, if we are serious about housing affordability, then the supply side cannot be ignored, as it often is in public debate. Any government who is serious about addressing affordability would need to use supply side levers. Most, if not all, members agreed with this even though there were differing views about the metrics of housing affordability and the pre-1997 free kick and its associated cohort effects.

Economic growth and budget deficits

It is widely believed that long-term economic growth is a given, particularly since we've experienced about 60 years of constant overall growth. However, there have been two previous generations with no net growth in income per capita, one lasting 25 years between 1850 and 1875 (with movements in some individual years but overall zero net growth) and another lasting 45 years beginning in the 1890s (with the caveat that it included World War I). This shows that it is possible to go through two generations without any net growth in incomes (i.e. absolute dollars in the bank). It is therefore important to question whether productivity growth will maintain the levels of the last few decades, as predicted by the Intergenerational Report, for example. Another way of looking at this question is to ask about the rate of technology growth in the future. This is important when forecasting budget positions, for example.

A budget deficit of 2.5 per cent of GDP implies imposing a debt of $10,000 on younger households every year as someone has to pay it back eventually. This is what the government is referring to when it talks about 'intergenerational theft'. Income growth alone will not solve the problem, especially as we enter a period of low growth in nominal incomes as the mining boom slows and terms of trade fall.

In the past (1950-2000), debt has been paid back by those who owned assets at the time (baby boomers and their parents) but also through inflationary pressures. The practice of governments to get out of debt through inflation (essentially a 'get out of jail free' card) has unclear distributional effects that need to be discussed and assessed – the old are likely to be disproportionately affected for example as are those who are self-supporting via superannuation.

International perspectives

In the UK, those born between 1983 and 1987 earn less than their predecessors at the same age and the wealth story is even worse. In the US, the income of those aged 24-34 is lower than it was for their predecessors 40 years ago. Further, despite overall higher life expectancy, the poor in the US are not living longer. In fact they are the first generation in history who will most likely not live as long as their parents did (assuming health technology does not change), partially due to obesity and poor health. The wealth story is also dismal, with median wealth declining and the lowest quintiles going backwards.

The US and the UK are doing much worse compared to Australia, especially when it comes to income – in Australia, real incomes have been rising for all age cohorts. This has implications for Australia's international competitiveness given our position as a high-wage nation. We can only compete on the global stage if our wages and dollar are lower. However, the exchange rate is the only realistic mechanism since wages have historically been sticky here, even in times of crises.

Age pension, superannuation and budget repair

Responsible budget repair would disproportionately affect older households with more assets. Attractive options include better targeting of age pensions, superannuation and asset taxation.

We need to question the need to incentivise wealthy people to save, particularly those wealthy people (about 20 per cent of retirees) who were always going to save to maintain their lifestyle into retirement. There are basically three main groups of retirees: those at the bottom who don't own houses and are doing poorly, those in the middle, the ones we shouldn't be touching, and those at the top who are doing very well, a group we should have a hard look at.

Most voluntary contributions to superannuation are made after reaching 60 years old and there is evidence that older people continue to save in retirement (without incentives), including those on the age pension. A third of those on the age pension are net savers, and another third maintain their savings – this is particularly true for those who own a house and are in a couple. The story is very different for single households and particularly single women without any superannuation, and for those who do not own houses.

There is a lot of debate around the age pension assets test, particularly how income and assets interact, and whether to include the home in the assets test. However, there are relatively few households with low income and high assets. In any case, giving pensions to people who own a lot of assets is akin to a taxpayer-funded inheritance scheme. There should be a way to devise a test to ensure that those who need the pension (for example, to put food on the table) get it while those who would essentially use it to fund their children's inheritance don't.

Choosing a narrative

The discussion identified numerous areas of concern when it comes to intergenerational fairness. An appropriate narrative or story is required to create momentum behind the issues identified. For example, on the issue of intergenerational fairness and the importance of home ownership for wealth, going after older Australians saying that they've had it too good would be a poor narrative. A better, slightly exaggerated narrative would be to say "your kids are going to suffer; they will never be able to afford a house."