

Addressing Impacts of Population Ageing on Labour Force Participation

Strategic Policy Group Preliminary Report

**Department of
Treasury and Finance**

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Preface

This preliminary report is based on ongoing research undertaken within the Strategic Policy Group and has been prepared for Victorian Workforce Participation Taskforce.

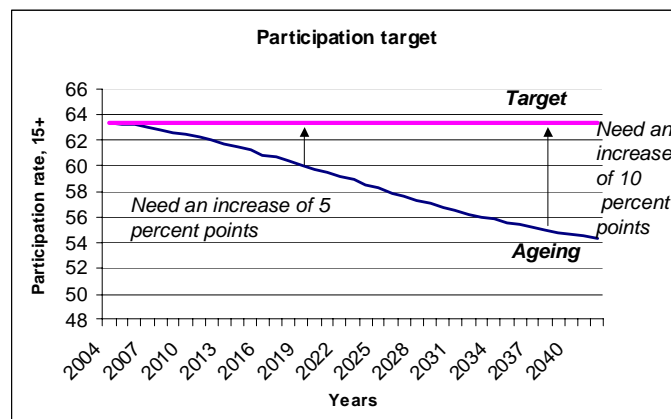
A more detailed report is undergoing further preparation and will be released in due course

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1 The Participation Problem

Projections of labour force participation rates (LFPR) in Australia over the next forty years suggest that without policy changes or significant changes in the labour supply behaviour of different age and gender groups, the ageing of the population will lead to a reduction in aggregate labour force participation rate, approaching ten per cent. For example the labour force participation rate in Victoria, for those aged 15 and over, will fall to about 54 per cent from its current level of about 64 per cent if nothing is done. Figure 1 shows the likely fall in aggregate participation that will occur in age-gender participation rates and suggests a target for government action to stop the decline.



The Commonwealth Treasury's *Intergenerational Report* and the Victorian Department of Treasury and Finance's *Shaping a Prosperous Future* both identified raising the labour force participation rate as an important policy challenge¹. If labour force participation rates fall in line with the above-mentioned projections, economic growth is likely to be reduced and the associated capacity of Commonwealth and state governments to meet the rising fiscal burden that is expected over this period, due largely to rising health costs, will be diminished.

The Victorian Department of Treasury and Finance (DTF) commissioned two studies (Dawkins et al 2004 and Weller 2004)², to provide evidence that would help to identify policy drivers for federal and state governments seeking to maintain aggregate labour force participation rates at around current levels. Five major policy drivers emerged from the studies:-

- Improving educational attainment;
- Delaying retirement;

¹ Commonwealth of Australia (2002), *Intergenerational Report 2002-03*, Budget Paper No. 5, May (www.budget.gov.au/2002-03/bp5/html/index.html) and Department of Treasury and Finance (2003) *Shaping a Prosperous Future*, Victoria

² Dawkins P, Lim G and P Summers (2004), *The Impacts of Population Ageing on Labour Force Participation*, Final report to the Department of Treasury and Finance; and Weller, S (2004), *Non-regulatory Impediments to the Labour Market Participation of Mature Workers*, Final report to the Department of Treasury and Finance.

- Improving childcare services;
- Undertaking welfare reform; and
- Improving health outcomes.

In this paper we discuss the development of policies in each of these areas by both Commonwealth and state governments. We begin in section 2 by defining what we mean by labour force participation. In section 3 we outline the five policy areas that are most efficacious for raising aggregate participation above what would otherwise be the case. The responsibilities and opportunities for the Commonwealth and the states are discussed in relation to each of the five policy areas in section 4. In the final section we outline a framework for developing priorities for policy development, and project how such policy development might lead to change in aggregate labour force participation.

2 Aggregate Labour Force Participation

The labour force participation rate (LFPR) measures the proportion of a defined population that is in the labour force (i.e. employed or actively looking for employment). In Australia, the common definition of aggregate LFPR is the proportion of the population aged 15 and over who are employed or unemployed, where 'employed' includes full-time and part-time workers. The aggregate LFPR is the sum of the LFPR of specific age-gender groups weighted by the proportion that each of those groups comprise within the aggregate population.

The Australian (and Victorian) population is ageing, reflecting both the current trends of lower fertility rates and longer life spans – neither of which are new phenomena – and the transitional effect of the baby boom generation³ beginning to reach retirement age (which represents a large demographic shock). An ageing population will result in aggregate LFPR declining. This is because older people have low LFPR relative to younger people, and due to population ageing, will become an increasing proportion of the population⁴.

While in the past, trends in age and gender specific LFPR have increased aggregate LFPR, without further specific policies these will not counter the negative impact of population ageing in the future. Accordingly Victoria's aggregate LFPR, on no-policy change, is expected to decline from around 64 per cent in 2003-04 to 54.4 per cent in 2041-42. The expected decline in aggregate LFPR is of broadly similar magnitude across Australia.

One of the main approaches to countering the effects of population ageing is to increase age and gender specific LFPRs across the population at large, and in Australia there is scope for doing this. First, while Australia's working age LFPR is above the OECD average, when compared with the top 20 per cent of (selected) OECD countries, male and female LFPRs are lower for all age groups greater than 25 years old. This differential increases significantly at age 55, before reducing at age 65 and over⁵.

Second, specific groups have low LFPRs. These include women with children, older people, and disabled people.

There are three potential benefits from maintaining aggregate LFPR in the face of population ageing. These are faster economic growth, growth of working age labour supply mitigating specific labour shortages, and increasing equity. Modelling by DTF suggests that, with unchanged labour productivity growth, maintaining participation is likely to raise economic growth by half a percent per year relative to growth that would occur if participation was allowed to fall. Higher rates of participation will enable faster responses to

³ Those born between 1946 and 1965.

⁴ Some definitions of LFPR are restricted to the population aged 15 to 65, called the working age population. In these definitions ageing has two effects; a fall in the working age population as a proportion of the total population, and an increase in the average age of the working age population. Because from about 30 onwards, participation falls with age, both effects lead to reduced aggregate participation.

⁵ Controlling for differences in age-gender population proportions.

skill shortages. Finally, since incomes of workers are higher than those of people dependent on welfare, higher participation is likely to reduce inequality.

3 Policy Options to Maintain Aggregate LFPR

The Melbourne Institute, commissioned by the Victorian Department of Treasury and Finance, undertook econometric analysis of the drivers of aggregate participation. The analysis suggested five supply areas were most influential – improving educational attainment, welfare reform, delaying retirement, improved childcare services and improved health.

The Melbourne Institute then constructed a scenario to illustrate how policy might aim to maintain aggregate LFPR in the face of population ageing. The scenario proposed that under certain assumptions and by focusing on five supply side policy areas, there is potential to increase age-gender LFPR and thereby maintain aggregate LFPR at or near its current rate.

The factors that influence LFPR are considered for each policy area.

3.1 Improving educational attainment

The OECD and Australian empirical studies showed education is a significant influence on LFPR. Improving educational attainment could be achieved by focusing on:

- youth educational outcomes – completion rates for year 12 or equivalent have the greatest incremental improvement on the LFPR (compared with leaving school early). Further qualifications also lead to increases in the LFPR.
- adult educational outcomes – adult education has proven to be an effective means to retain workers or enable their re-entry into the labour force. There are two groups who can benefit: those wishing to maintain current and relevant skills (primarily those already in the labour force); and those with a skills deficit (primarily those out of the labour force or in the labour force but disadvantaged/marginalised).

3.2 Delaying retirement

The OECD and US empirical studies showed that actuarially neutral public pension systems (ie retirement income systems), defined contribution superannuation schemes and increasing the age-pension age all positively influence the LFPR.

Additional influences on the LFPR of voluntary retirees include a preference for leisure, social norms, social relationships in the workplace, job satisfaction and job flexibility.

Further influences on the LFPR of involuntary retirees include compulsory retirement, workers' compensation, skills and abilities (including lack of recognition of skills), poor health, caring responsibilities, retrenchment, recruitment and employer attitudes, age discrimination, workplace interactions, discouraged worker effects and individual attitudes.

3.3 Improving childcare services

There is potential to increase the labour force participation of women with children, especially young children, both lone parents and partnered women. In an examination of this issue, Wooden (2004)⁶ has concluded that the major issue that needs to be confronted, to make work and family more compatible, is affordable high quality childcare. However there is contradictory evidence regarding the extent to which childcare availability increases the LFPR. Nevertheless there does appear to be unmet demand, and difficulties experienced by parents in managing sick children and the costs of childcare.

3.4 Undertaking welfare reform

The most important effects on a welfare recipient's LFPR are the relationship between the level of the pension and the minimum wage, and the level of the effective marginal tax rate. Additional influences on the LFPR of welfare recipients include their greater tendency to have low educational attainment and/or a disability.

3.5 Improving health

The Australian empirical studies show that health does influence the LFPR, and that poor health has a greater negative impact on the LFPRs of older men and women than of younger men and women. Whilst the incidence of poor health increases with age, many causes of ill-health are not age-related and are associated with factors such as social circumstances, drug usage, or past occupational circumstances and hazards.

⁶ Wooden, M (2004) 'Work and Family' in P Dawkins and M Steketee (eds) *Fresh Thinking: Next generation policies for the New Australian government*, Melbourne University Press

4 Responsibilities and Opportunities to Maintain the Aggregate LFPR

In this section we consider the opportunities and respective responsibilities for the Commonwealth and the states to develop policies in relation to each of the five drivers of aggregate participation.

4.1 The Commonwealth

The empirical evidence and above discussion (under each policy area) of the influences on LFPR, suggest that the Commonwealth Government has substantial leverage over labour force participation decisions. This includes leverage the Commonwealth has over the main macroeconomic aggregates such as employment and inflation which primarily effect demand for labour. However in the following we focus on the Commonwealth's influence over specific policy options concerned with labour supply.

4.1.1 Improving educational attainment and health

Traditionally school and technical and further education (TAFE), and health have been areas of primary state government jurisdictional responsibility. The Commonwealth has been a major funder of tertiary education and aspects of health, and more recently of school and technical education. It has also recently signalled a preparedness to provide some education and health services directly, such as technical education. In its capacity as a funder and provider, the Commonwealth has an interest in improving educational attainment and health and consequently in improving participation.

4.1.2 Delaying retirement

The most important instruments for delaying retirement are the settings of the tax, superannuation and pension systems. The Commonwealth has responsibility for these.

4.1.3 Undertaking welfare reform

The most important effect on a welfare recipient's LFPR is:

- the relationship between the level of the pension and the minimum wage – the so called replacement rate. Some argue that compared with the United States, Australian pensions are high relative to the minimum wage, depressing the incentive to work; and
- the effective marginal tax rate - the loss of benefit upon increasing work hours may outweigh or nearly outweigh increased income from wages.

4.1.4 Improving childcare services

In the childcare sector the Commonwealth Government is responsible for:⁷

- Subsidising users - subsidising users in respect of the cost of child care (such as Child Care Benefit), other payments and, in some cases, the direct provision of child care services. It is also facilitates access to subsidies by providing information and advice to parents and providers about the availability of Commonwealth funded services and some state and territory funded services.
- Subsidising providers - subsidising providers and increasing quality by providing information, support and training to service providers through funding to organisations; and subsidising providers by providing operational and capital funding to some providers.
- Quality standards - influencing standards by developing a quality assurance system for child care outside school hours; and controlling the quality of child care by funding the National Child Care Accreditation Council, which administers the Quality Improvement and Accreditation System (QIAS) for long day care centres and the Family Day Care Quality Assurance program for family day care centres. (Compliance with these quality systems is mandatory for the services in question to be eligible for government funding).
- User access - increasing access through planning the location of services in conjunction with other levels of government.

To maintain aggregate LFPR, the Commonwealth Government can, for example, increase the Child Care Benefit to mitigate increases in the cost of childcare for families and/or increase family day care and outside school hours care places, both of which are currently capped in each state.

4.2 The States

The states also have influence over each policy area, and therefore have the opportunity to increase age-gender LFPR and maintain aggregate LFPR. The states may influence each policy area through four instruments:

- provision of services/ funding – some services provided by government increase the ability and opportunity for individuals to participation in work;
- regulation – government may guide the way in which business is done and influence both the vigour and growth of businesses; and the conditions under which employment occurs;
- as an employer – the government is a major employer in its own right and may be an exemplar setting conditions which encourage participation; and
- provision of information – government may influence participation by providing information about employment to both employers and employees.

We consider the use of these instruments in relation to the five policy options.

⁷ ACIL Tasman & Jaguar Consulting October (2004) (Unpublished paper), *Cost impacts of social regulation - Part C Childcare paper*, Australia, pp5-6.

4.2.1 Improving educational attainment

To maintain the aggregate LFPR, the states can consider opportunities for improving education outcomes using the instruments:

- Provision of services/funding to improve:
 - youth educational outcomes, specifically the completion of Year 12 or equivalent, and further qualifications; and
 - adult educational outcomes, both for those maintaining skills and with a skills deficit.
- Provision of information to:
 - promote the benefits to individuals of life long learning;
 - promote the benefits to employers of providing on the job training;
 - publicise the range of education and training options available, and the career opportunities they provide;
 - ensure ease of navigation through the education and training system; and
 - strengthen linkages between the education system and the labour market.

4.2.2 Delaying retirement

To maintain the aggregate LFPR, the states could consider opportunities for delaying retirement or encouraging retirees to return to the labour force, using the instruments:

- As an employer
 - Workplace environment – ensuring all state government workplaces are conducive to older workers remaining in employment or encourages retirees to return to the labour force.
 - State Superannuation Schemes – reviewing and where appropriate revising state superannuation schemes to remove barriers to delayed retirement of older state employees. However any amendment to the rules, and subsequent benefits from any increase in the LFPR, would need to be weighed against the cost implications for the state.
- Regulation
 - Workers' compensation – ensuring workers' compensation regulation does not unnecessarily impede LFPR of older workers. Consideration could also be given to working with insurers to address issues associated with the availability and affordability of income protection insurance for (self-employed) older workers.
 - Equal Opportunity Acts (or equivalent) – relaxing the process for obtaining exemptions under the Act for those employers who wish to target specific disadvantaged groups for recruitment.
- Provision of information to:
 - assist employers in retaining and attracting older workers by:

- publicising methods that minimise the possible impact of older workers on workers' compensation premiums and/or productivity; and
- publicising successes/failures in managing ageing state public sector workforces.
- counsel individuals on the benefits of remaining in or returning to the labour force.

4.2.3 Improving health

To maintain the aggregate LFPR, the states could consider opportunities for improving health, using the instruments:

- Promotion, provision or funding of preventive health services - to foster improved health status.
- Regulation, including:
 - Occupational Health & Safety (OHS) – broadening OHS focus to encompass a more holistic and strategic approach to managing workforce health.
 - Externalities – further regulating against externalities that adversely affect health.
- Provision of information – to reduce ill-health (eg promotion of healthy living).

4.2.4 Undertaking welfare reform

To maintain aggregate LFPR, the states could consider opportunities for welfare reform, using the instruments:

- Provision of services/funding, including:
 - Disability services – improving labour force outcomes for disabled welfare recipients
 - Education system – improving access to education by welfare recipients.
 - Employment services – improving labour force outcomes for welfare recipients. This could include considering the broader applicability of models, such as Victoria's WorkCover and Transport Accident scheme's 'return to work' initiatives, in assisting disabled welfare recipients into work.
 - State concessions – reviewing and reforming state concessions that may inhibit the labour force participation of those on pensions and benefits.

4.2.5 Improving childcare services

To maintain the aggregate LFPR, the states could consider opportunities for improving childcare services, using the instruments:

- As an employer – provide childcare services for employees or reserve places in existing childcare settings.
- Regulation
 - Childcare regulation/rules – including an assessment of whether regulations are impeding childcare services from being created or remaining viable (eg do

minimum play space requirements discourage the provision of childcare services?); unduly affecting the affordability of services; or affecting the capacity of service providers to respond to the needs of families (eg as a result of inflexibility in service types or delivery means). A reduction in regulation should of course be weighed against any diminution (real or perceived) in quality.

- Other regulation/rules - an assessment of whether there are any state rules/regulations (not directly related to childcare) that inhibit informal unregulated childcare (eg that provided by grandparents, friends etc).

5 Concluding Comments

In the final section we outline a framework for ranking policies which might lead to the development of priorities for government action. The section concludes with some projections of the possible effect of imposing policy reforms on aggregate participation.

5.1 A framework for ranking policies

In developing policies to maintain aggregate participation rates states have to consider the likelihood of success. Some methods will be more effective than others. The following two-step framework is suggested as a means of ranking policy priorities:

- Identify *the relative contribution of each supply side policy option to maintaining the aggregate LFPR* – incorporate the ranking of each policy option's contribution to maintaining the aggregate LFPR, despite population ageing, as identified under the policy scenario by the Melbourne Institute.
- Identify *the state influence over each policy option* – for each policy option, consider what instruments the state has available that could influence the outcome. The instruments available to the state government for implementing policy options are those with either a direct influence (provision of services/funding, regulation and as an employer) or indirect influence (provision of information). Each instrument might be allocated a weighting to reflect the potential influence it has on the policy option. For example, a low weighting would indicate an instrument with limited influence over that policy option (those instruments with indirect influence, by definition, are given a weighting of one) and a high weighting would indicate an instrument with significant influence.

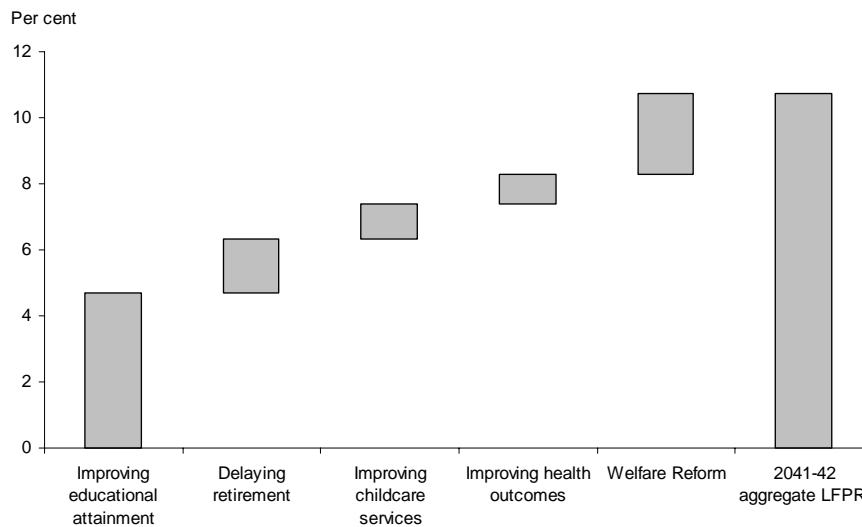
The ranking would be obtained by bringing together the index of relative contribution and the index of state influence to determine the final ranking of state policy priorities.

5.2 Projections of the potential contribution of five policy areas

The Melbourne Institute⁸ constructed a scenario using reform in the five policy areas, which suggested that under certain assumptions, there is potential to increase age-gender LFPR and therefore maintain aggregate LFPR at or near its current rate, despite population ageing. The cumulative impact of these measures on Victoria's 2041–42 aggregate LFPR is illustrated in Figure 2.

⁸ The Melbourne Institute of Applied Economic and Social Research, 2004, Alternative scenarios provided to the Department of Treasury & Finance, based on methodology described in Dawkins et al 2004.

Figure 2: Policy contribution towards improved aggregate LFPR in 2041-42



The figure suggests that the most promising long-term policy is to raise the educational attainment of Victorians – this is assumed to raise the aggregate labour force participation rate by as much as about 5 percentage points above what it would otherwise be in 2042. The next most promising strategy is to tackle welfare, with policies aimed at delaying retirement, increasing the availability and affordability of quality childcare and improving the general health of the population also having important, lasting positive effects on labour force participation.

5.3 Further considerations and analysis

Achieving the increases in aggregate participation shown in Figure 2 will require a much more detailed analysis of particular measures than has been possible to develop in this paper. In particular the nature and development of policy will require consideration of jurisdiction, economic net benefit, equity and timing.

The earlier discussion has indicated that some measures are more within the scope of the Commonwealth Government (such as the welfare reform measures and any consideration of the tax or transfer system) while others are within the scope of the state governments.

Perhaps more importantly, each potential policy measure needs to be subject to rigorous scrutiny with quantification of benefits and costs and comparison with alternatives. In identifying policy priorities, the state needs to weigh the marginal cost of pursuing a policy option and/or employing a certain instrument, against the marginal benefit of increasing the LFPR. The distribution of costs and benefits between the Commonwealth and state governments also needs to be investigated.

The framework should also be sensitive to equity concerns. Some groups are more disadvantaged than others and in identifying policy priorities, so there needs to be an acknowledgement that the different approaches to maintaining aggregate LFPR may have different flow-on effects. For example encouraging second income earners or welfare recipients into the labour force both improve aggregate LFPR, but generate quite different equity outcomes.

Timing is also an issue. Some policy options necessarily precede others and some policy options take time to bear fruit.

- *Precedence* – for example, the states may consider using the public service as exemplars for the management of ageing public service workforce. It follows (particularly since the Victorian public service is more aged than the rest of the population) that measures for delaying retirement may need to be implemented with greater urgency in the public service and precede development of policies in the private sector; and
- *Lags in the effects of policy options and/or instruments* – for example, improving child care may enable immediate increases in participation while improving levels of education are likely to have effect over a much longer period.

In conclusion, this paper has found that there is considerable scope to raise overall LFPR in the states and Australia above what would otherwise occur in the context of population ageing. The most effective strategies to achieve this need action by both Commonwealth and state governments.