"Will we be able to afford a healthy old age?"
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I have often thought that economic research and medical research have a lot in common. Researchers in both groups like to think of themselves as applying scientific methods to better understand the human condition. Both recognise that individuals can be very different, and research approaches need to recognise that. But both disciplines also tend to believe that commonalities across people in their 'condition' are worth searching for, and 'treating' where necessary.

More surprisingly perhaps, just as medical research is associated with identifying and treating diseases, so economists describe a number of economic conditions as 'diseases'. One of these is especially relevant to the question posed above: will we be able to afford a healthy old age? More on that disease in a moment.

Recent estimates from Treasury's Long-Term Fiscal Model suggest that, if past health care and treatment cost trends persist, and with an ageing demographic profile, public health care spending will grow substantially in future. More of us will move into older age ranges needing extra age-related care, so that overall public spending on health is predicted to take a growing share of our national income - from less than 7% of GDP now to over 11% by 2060.

In fact, closer inspection of the Treasury figures reveals that most of this projected cost increase is not due to ageing at all. This is partly because of some research which suggests that the high health costs of looking after the elderly only come in the last couple of years of life, regardless of how long we live. Our extra years of life are essentially 'good quality' years.

The other good news story is that it seems the health costs of those last few years may actually be lower when we die off in our 80s and 90s rather than in our 60s and 70s, as was more typical in the past.

So what is driving up health care costs in future if it isn't so much to do with ageing? The answer lies in one of those economic diseases—more precisely, "Baumol's disease", named after the American economist who first highlighted the phenomenon in the 1960s.

The essence of Baumol's insight, first applied to public spending on the arts rather than healthcare, was simple. Publicly-funded activities are often highly labour intensive, he argued, so it is hard for them to improve their labour productivity. Without much capital for employees to work with, especially the new technologies embodied in new capital, public sector productivity growth will tend to lag behind much private sector activity that is more capital-intensive.

But, improving productivity elsewhere in the economy means rising wages there. And in order to compete for that labour, public services generally have to raise wages too, regardless of how public sector productivity is progressing. The result? Public service output costs more over time compared to its private sector counterpart. Baumol's cost disease sets in.

Baumol's initial illustration of this for the arts (it is hard to improve the productivity of a string quartet, he argued!) has been observed for a broader range of publicly-funded services. And despite numerous measurement problems, there is a fair amount of agreement that the sorts of things that public spending 'produces' – like health care – become relatively more expensive over

time. Recent estimates of public sector productivity growth put it at around 0.3-0.6% per year, whereas equivalent numbers for the private sector average around 1.2-1.5%.

So, it looks like even if we just want to enjoy the same levels of real health care provision in the future as now, we need to devote a greater fraction of our national income to it. And, of course, it is quite possible that society will demand more and better health care in future too.

This raises some tricky questions, such as: will the declining working population be prepared to pay the extra tax to keep retirees in good enough health to enjoy their retirement? Could new health technologies reduce the costs of future treatment? The answer to the first question is not clear but much may depend on how fast the Kiwi economy grows over the next several decades. For the second, past trends are not encouraging. Medical discoveries have tended to expand the range of treatments available for various conditions but often at increased cost per treated patient.

Ah well, as you ponder this, at least you can now listen to that string quartet on your iPod …