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Pensions and the Savings Dilemma

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It is a great pleasure to be here, even though we meet at a time of uncertainty in the global economy. The optimism of many forecasters at the start of the year has been replaced by a gloomier consensus. Growth in the US economy is slowing, and despite the determined action of the Fed last week, the prospects for a sustained recovery await resolution of the uncertainties about a war in Iraq. Economic growth this year in the euro area – and particularly in Germany – is slower than that in the US. Japan's economic woes are more serious still, as the second largest economy in the world continues to struggle with deflation and a weak banking sector.

Growth prospects and financing conditions for some emerging market countries have worsened as a result of the weakening of the global economy and increased risk aversion among international investors, caused in part by contagion from the Argentine crisis, and until recently uncertainties associated with the election campaigns in Brazil and Turkey. Reassuringly, the new governments in Brazil and Turkey have each expressed their determination to pursue responsible macroeconomic policies and to continue to implement the essential elements of their country's IMF-supported programs – and in both countries this has had a positive effect on the financial markets.

Fortunately there are some important bright spots in the generally gloomy global outlook. Growth has been strong and sustained in emerging Asia, particularly in China, India, and Korea. China's extraordinary and sustained growth and its rising demand for imports have helped sustain recovery elsewhere in the region. But the fortunes of developing Asia still depend to an extent on external demand – and therefore on the course of the US economy. The Russian economy, and those of its neighbors, have been growing rapidly over the past four years. And the Australian economy is another bright spot, to which I will turn shortly.

I was asked to talk today about "Pensions and Savings Dilemma". The usual role of a visitor from abroad is to sound the alarm bells, to help in the fight against complacency. But the recent performance of the Australian economy, a potential long-term growth rate estimated at around 3¾ percent,[2] and the strength of the public finances, all contribute to make the ageing of the population more manageable in Australia than in the other OECD countries. Add to that the fact that Australia long ago introduced the kind of pension system that is still being debated in other countries, and you will realize that this visitor to Australia cannot bring many lessons about

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[2] *OECD Survey of Australia, 2001.*

pension reform from abroad; instead the rest of the world has much to learn by studying Australia's experience.

Accordingly I do not plan to lecture on how you could do better by following foreign examples; rather I will present an outside perspective on the Australian economy and on its pension and saving issues. I will start by briefly describing the state of the Australian macroeconomy. I will then take up in turn, likely population trends – the so-called demographic time-bomb – and issues associated with the government role in saving; the three-pillar approach to public policy on retirement saving; Australia's approach to the first and the second pillars; and finally, longer-run problems of providing for health care expenses.

1. The Australian economy

I first worked on the Australian economy nearly 20 years ago. Here is what Rudi Dornbusch and I said then:

> "The Australian economy finds itself in early 1984 with high unemployment, high inflation, and large budget deficits. The resource boom has not materialized in any significant way and the outlook is by all accounts discouraging. It is all the more discouraging because the leeway for policy action is obscured by disagreements among economists and, as a matter of strategy, arguments raised by fiscal conservatives."[3]

I'm not sure I would today use exactly the same words we used then to describe the fiscal policies that were being advocated by the fiscal conservatives, but there is no question the Australian economy was not a pretty sight at that time.

Today, by contrast, unemployment, inflation, and the budget deficit are all low. GDP growth since the start of 2000 has averaged 4½ percent – at the top of the developed country league. As a result of prudent macroeconomic policies, set in a strengthened policy framework, and a series of structural reforms, the Australian economy has done exceptionally well in the face of substantial external shocks – despite the Asian financial crisis, the bursting of the U.S. stock market bubble and the subsequent US and global recessions, Australia has sustained the longest expansion, now approaching 11 years, in its modern economic history.

Australia's institutional framework for macroeconomic policy is widely viewed as a leading example of international best practice. The Reserve Bank's inflation targeting regime, with a target of 2-3 percent, has been highly successful. The government has promoted greater transparency in fiscal policy, in accordance with the 1998 Charter of Budget Honesty Act, which includes the government's policy rule of balancing the budget over the economic cycle. Monetary and fiscal measures have been complemented by reforms in product and labor markets. The OECD estimates that these reforms were the principal factors contributing to an increase in

[3] "The Australian Macroeconomy", by Rudiger Dornbusch and Stanley Fischer, in Richard E. Caves and Lawrence B. Krause (eds), *The Australian Economy*, Brookings 1984 (p.74).

Australia's productivity growth by about one percentage point, to an average of 1 ¾ percent in the 1990s.[4]

One consequence of Australia's cautious fiscal policy is that the net debt of the Australian Commonwealth could disappear within a few years.[5] This has prompted an important debate on whether to maintain a stock of government debt. In a different era, over two centuries ago, Alexander Hamilton argued that the creation of a market for government debt would help build the United States' capital markets. More recently, when fiscal projections in the late 1990s implied that the United States' national debt could be extinguished by 2005, a discussion of the issue that now confronts Australia got under way – but it did not get very far before United States fiscal policy reversed and the prospect of the disappearance of the debt receded into the far distance.

The Australian Treasury's recent consultation paper[6] gives the impression its favored option is to use budget surpluses and asset sale receipts to pay down debt and eliminate the Commonwealth Government Securities (CGS) market. On the question of whether government bonds are required to provide a risk-free rate for the private sector, the report suggests that private sector alternatives can do a satisfactory job – and this, via various implicit arbitrage pricing relationships, is surely true. In terms of the role of Commonwealth bonds as a long-term savings vehicle, the discussion document points out that life insurers and superannuation funds hold less than 5 percent of their assets in Commonwealth bonds, while recognizing that this share could rise if the Commonwealth debt were larger. As to the Alexander Hamilton argument – that a government debt is needed to strengthen the financial markets, for example by enhancing the liquidity of those markets – one may argue that the safer course is to maintain the market, because it is uncertain what would happen in its absence.

The assessment that the Australian economy and capital markets *can* survive reasonably well without a CGS market is no doubt correct. However, despite Australia's backdrop of economic and budgetary strength, longer-term demographic projections raise concerns about the long-term issues of growth, savings and pensions. One alternative to closing the CGS market that is noted in the consultation document is for the government to maintain the market and to accumulate financial assets to fund hitherto unfunded public pension liabilities; similarly, future health liabilities could be funded through government accumulation of assets. The prospect of the government maintaining what is in effect a large investment fund certainly raises governance issues, but these are not necessarily insurmountable – and they in any case appear to have been surmounted at the state level in Australia and by a number of other countries.

[4] OECD Survey of Australia, 2001.
[5] The net debt has declined from 20 percent of GDP in the mid-nineties to 5 percent today.
[6] *Review of the Commonwealth Government Securities Market*, Discussion Paper, October 2002.

2. The demographic time-bomb

Another provision of the Charter of Budget Honesty Act is the Intergenerational Report, published for the first time this year, which makes consideration of the long-term fiscal outlook a part of the budget process. The Intergenerational Report is another innovation that should enhance the transparency of Australian policymaking.[7]

As in the rest of the developed world, the pattern of falling fertility rates and rising life expectancy in Australia means that the population is set to age over the next 50 years. Today, Australians aged 65 or over account for just over 12 percent of the population. This share is forecast to rise to 25 percent by 2042. This so-called demographic time bomb has implications for pension provision, as well as increased health care costs. According to the Intergenerational Report, if no changes in policy take place in the interim, the demographic change will require an adjustment in taxes and spending equal to about 5 percent of GDP by 2042.

The dependency ratio – the ratio of those aged 65 or more to those in the 20-54 age bracket – presents another way of looking at the demographic time bomb. The dependency ratio in Australia is forecast to increase from 20 percent to 44 percent over the next 40 years. This sounds like an alarming prospect, but Australia's dependency ratio will still be well below those of continental Europe and Japan – a result of a better starting point and higher fertility and immigration.

More broadly, population ageing is taking place more slowly in English-speaking countries than in Europe and Japan, owing to higher immigration rates and higher fertility rates – even though no advanced country currently reaches the replacement rate of 2.1 children per woman. English-speaking countries also tend to have higher labor market participation rates, though Australia's labor market participation rate is below that of other English-speaking countries.

The demographic time bomb – that with current population trends, and work and retirement patterns, each working person will have to support a greater and greater number of non-workers – can be defused in several ways. The first is for population trends to change, through changes in desired family size, changes in immigration patterns, or both. The economics gives no reason to believe that family size will increase as countries become richer, and as the costs of raising children rises. Nonetheless it is possible that social customs about family size could change in future. Increasing immigration[8] poses many difficult issues, including that of the extent to which current citizens should permit changes in the composition of the population that could change the nature of the society in future. This is not the place to enter that debate,

[7] Critics of intergenerational accounts often point out how sensitive the results are to the assumptions, which they take to imply the exercise is of little value. The sensitivity of the results to the assumptions means that there is a broad range of uncertainty about what will happen in future, and thus that the predictive value of these accounts is small, but the requirement of publishing the accounts provides a valuable discipline and framework of thinking about potentially massive future liabilities and their burdens.

[8] At the global level, immigration is to a first approximation irrelevant to the rate of population growth. But for a long time yet, richer countries will be able to turn to immigration as a potential means for affecting population growth.

but some countries, including the United States and Australia, do rely on immigration, and could permit more.[9] The same could even be true eventually in Japan.

Work and retirement patterns are also likely to change, though not uniformly in a way to reduce the dependency ratio. For as societies become richer, they tend to consume and invest more in education, that is, in producing human capital, which will mean that the age of entry into the labor force will rise, tending to raise the dependency ratio. The retirement age though could increase – there is no divine reason why it should be 65. Indeed, when Bismarck introduced the first state pension in 1880, choosing the age 65, German life expectancy was 45 years. Combined with the possibility of reducing the number of hours spent working each week or year, the retirement age could continue to rise, and thus help reduce the dependency ratio.

Probably more important, changes in productivity will make it possible for economies to operate effectively with higher dependency ratios. As we all know, higher productivity comes from improving economic efficiency, from increases in scientific knowledge, and from investing in human and physical capital. That means that that same desire for education that will raise the dependency ratio will also help make it possible for the dependency ratio to be higher without reducing the living standards of the economy. It also means that an increase in the conventionally measured saving rate,[10]which increases the stock of assets, will make a higher dependency ratio sustainable. Hence the link between saving and the demographic time bomb.

Countries with ageing populations face two broad choices on pension reform. The first, since there are so many unknowns, is to wait until closer to the time when ageing starts to impact current fiscal policy, and make a decision then. These options include paying for obligations to the elderly through borrowing – in effect, borrowing from the future. At first blush, this sounds like an irresponsible choice. But the choice is a difficult one, for future generations will be richer than we are, and as the economist Joan Robinson asked in this context, "What has posterity ever done for me?" The second option is to take action early, despite all the uncertainties about the future.

Of course, the second option is the more sensible. Because of the long lead times, a country that acts early does not have to do as much as it would have to do later: reforms that are phased in gradually tend to cause less political upheaval. Indeed, that is one of the lessons the rest of the world should take from the Australian experience: because it acted a decade or more before other OECD countries, Australia faces less serious problems in keeping its promises to the elderly than will be experienced elsewhere.

Let me take up one more question before turning to pension systems. That is the issue of why societies should, and in any case do, intervene so extensively in the pension area. In the first instance – and this is a technical point – it is difficult to show analytically that the free market necessarily makes the right decisions about the amount society should save. This is where the question of what we owe posterity arises. Second, societies have demonstrated

[9] *Dilemmas Distilled,* the October 2002 CSIRO Technical Report on the consequences of alternative population sizes for Australia, provides a basis for public discussion of the role of immigration.

[10] The conventionally measured saving rate excludes investment in human capital, which is likely to constitute an increasing share of GDP as economies become richer.

repeatedly that they will not accept outcomes in which the elderly are poor and destitute – and given that, there is a free rider problem that requires government action to solve. And third, fiscal policy inevitably has to make decisions about the intertemporal allocation of resources, which means that any serious government has to think about the optimal level of saving.

The Australian national savings rate has been about 18 percent over the last 20 years, with a brief rise to 22 percent in the late 1980s.[11] Across countries, national savings rates have been remarkably constant over time, with most OECD countries falling in a 17-23 percent range. In the euro area, national savings has tended to be a little above the average over the last 20 years while in English-speaking countries national savings tends to be lower than the average; Japan, with a 28 percent national savings rate, is the outlier.[12] Given its relatively low national saving rate, and its long-term balance of payments deficit, the broad-brush conclusion is that Australia would in the longer run be better off with a higher national saving rate.

Let me turn now to public policy on pensions.

3. The three pillars

In 1994, the World Bank published an influential report on pension reform, which recommended an approach based on three pillars of pension provision.[13] The first is a publicly managed pillar, where the primary goal is to provide a safety net that ensures a minimum income guarantee for the elderly. The second pillar is mandated savings, and the third is voluntary savings. The balance between the different pillars would depend on both the country's historical approach to pension provision and on its economic structure and stage of development.

This sounds very simple, particularly in Australia. But there should be no underestimating the political difficulties of pension reform in most countries. In the recent US mid-term elections, candidates backed as far away as possible from earlier plans to "privatize" Social Security. In March this year, an Italian government advisor was shot and killed the day after he wrote a newspaper article calling for pension reform. In 1997, France was brought to a standstill by transport strikes after the government proposed changes to the pension system – with threats of strikes when the government again raised the pension issue this year.

The key difficulty is that the demographic time bomb requires an increased contribution from current and future generations relative to the contributions of past generations. That tradeoff is most vivid in countries that seek to shift from an unfunded, pay-as-you-go, public pension system to a savings-based system. There the government faces the question of how to fund the transition – how to manage the fact that the unfounded system requires the current generation of workers to pay the pensions of the current generation of retirees at the same time as

[11] Housing investment is included in national savings but not directly in household savings measures.
[12] The lower saving rates in English-speaking countries tend to fund shorter retirements. Because of better health and earlier retirements, post-retirement longevity has increased enormously in Europe – with French people living an average of 23 years after retiring and Germans about 20.5 years. That compares, at the low end, with 16 years in the US. Australia is somewhere in the middle, with post-retirement longevity at 19 years.
[13] "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth," by Estelle James, World Bank, 1994.

they are shifting to funding their own retirements. There may well be some social justice to this – for instance, the introduction of the Social Security system in the United States, which has virtually eliminated extreme poverty among the aged, probably benefited most the generation that suffered from the Great Depression and that fought in World War II. This generation surely deserved to benefit. But such arguments do not make reform of the system politically easier.

Australia has already undertaken the key pension system reforms that most of the rest of the industrialized world is now struggling with. The World Bank's policy advice closely matches the current Australian system of pension provision, which combines the Age Pension, a means-tested first pillar pension, with the second pillar – Superannuation Guarantee Contribution (SGC) mandatory savings in personal accounts. As you know, Australia is one of the few countries in the world with a government-mandated private saving scheme. Others include the United Kingdom, Switzerland, and several emerging market countries, among them Chile.

The Age Pension provides benefits that guarantee a minimum standard of living but, crucially, the Age Pension has never been linked to an individual's earning history.[14] It thus comes closest among public pension systems to serving as the first pillar – the pillar that ensures a minimum standard of living for the retired. Currently the Age Pension is the main source of retirement income for most Australian retirees, but this proportion will decline over time, as assets build up in the superannuation funds, since the Age Pension is means tested.

The Superannuation Guarantee was introduced in 1986, with a 6 percent contribution paid by employers as part of the national wage agreement. Superannuation coverage reached more than 90 percent after the government passed legislation in 1991 requiring that all employers make superannuation contributions on behalf of their employees.[15] After this year's rise in the contribution rate to 9 percent, and the shelving of proposals for an additional 3 percent contribution paid directly by employees, there are no further increases mandated under current policy.

The combination of a means-tested basic income guarantee, and the mandatory savings system made universal a decade ago, means that Australia does not face the same level of unfunded pension obligations or the difficulty in funding the transition from a pay-as-you-go public pension system to private savings accounts, that confronts most OECD countries. But the current system, particularly the SGC, can be improved at the margins.

[14] Though there have been numerous attempts to link the Age Pension to earnings over the past 100 years, they have all failed – including the legislation passed in 1938 that was then delayed indefinitely at the onset of World War II ("Mandatory Retirement Savings in Australia," by Hazel Bateman and John Piggott, *Annals of Public and Cooperative Economics* (1998)).

[15] Those on very low earnings are exempted, along with the self-employed.

4. Improving the system

The modest reforms required to the Australian pension system relate chiefly to taxation of the benefits, to measures to encourage work – which is important given the relatively low proportion of older Australians who participate in the labor market, and to how the benefits are paid.

First, there is a strong case for simplifying the taxation of the SGC, as the ASFA among others has argued. It is widely acknowledged that the tax treatment of the SGC is too complicated, with retirement savings taxed, albeit concessionally, as contributions, as earnings and finally when they are taken out as benefits.

Second, there is a gap between the age, 55, at which superannuation benefits are available in a tax preferred manner, and the retirement age for men of 65. This has been partially addressed, since the preservation age is set to rise under current policy from 55 in 2015 to 60 years in 2035. But that will still remain below the Age Pension retirement age. This is probably part of the explanation for the relatively low labor force participation rate for older Australians. There is a case for gradually bringing the age at which Superannuation benefits can be accessed into line with the age of eligibility for the Age Pension.

Third, superannuation assets are available as a lump sum, rather than as an annuity, with lump sums the form in which 80 percent of Australians currently take their benefits. The combination of lump sum payments and an earlier age for pension benefits for SGC, with a means-tested Age Pension, leads to the possibility of double dipping, whereby people spend their superannuation benefits and then rely on the Age Pension. I must confess to a preference for allowing people as much freedom as possible in the use of their savings, but given the low level of the Age Pension, there is a case for encouraging individuals to use at least a portion of their superannuation benefits to purchase a retirement income stream, rather than taking it as a lump sum. In addition, the fact that annuities are not compulsory at present leads to some adverse selection problems in the annuities market.

Fourth, the emphasis in the Australian pension debate in recent years has been on improving competition and efficiency in the superannuation system – particularly in allowing employees to select the fund into which their contributions are paid. This could lead to improved returns and lower fund administration charges, thereby outweighing the increase in marketing costs. But higher returns imply higher risk, and there could be a political backlash in the event of sustained negative returns – which is why enthusiasm for private accounts has diminished in other countries in recent years. In the Australian system, the interaction of the Age Pension and superannuation savings provides important downside protection. But there is a question of whether there should be some limits on the proportion of funds that can be invested in different asset classes.

Fifth, from time to time it will be necessary to revisit the contribution rate to the SGC, to determine whether it should be adjusted to help the SGC better meet its goals.

Nor should the third pillar of pension provision – voluntary private savings – be overlooked. In Australia and in other countries, voluntary private savings will continue to play a large part in providing retirement income. But once the government has specified the first two pillars of the system, its contribution to the third pillar should consist mainly of providing the right structural policies – an efficient tax system that does not discriminate against saving, and a stable and efficient financial system – and a stable macroeconomic environment within which individuals and families will make their own saving decisions.

5. Health care and the savings dilemma

Let me conclude by turning briefly to health care costs. Australia has gone a long way toward dealing with the pension issues that arise from demographic trends. But the ageing of the population, along with remarkable ongoing improvements in medical technology, also raises the question of the budgetary implications of future health care provision and long term care. In Australia, as in most OECD countries, the government plays the major role in funding health services for the elderly. And here, as in most OECD countries, the implications of health care provision for an ageing population have received less attention than the public pension issue.

As mentioned earlier, the OECD forecasts total age-related spending in Australia to increase by 5.6 percent between now and 2050. While pension increases account for 1.6 percent of that change, health care and long-term care expenses are expected to increase by 6.2 percent of GDP, partially offset by a reduction in family benefits and education spending.[16]

Thus, while the question I have been addressing, of pensions and the savings dilemma, is of great importance, Australia has done more than other countries to deal with it. Now it faces the related problem of providing for the costs of care for the elderly. In their latest Article IV consultation, the IMF staff welcomed the Australian government's Intergenerational Report, but expressed concern that the document might be too optimistic on the potential fiscal cost of health care – first because proposed reforms to the Pharmaceuticals Benefits Scheme have been derailed, and secondly because predicting changes in medical technologies is extraordinarily difficult.

In the coming decades, providing health care and long term care as the Australian population ages will require the right mix of public and private provision – of the kind that has already been achieved in the Australian pension system.

Thank you.

[16] It is interesting to note that the estimated fiscal adjustment needed to deal with health care and long term care costs is considerably higher for Australia than for most other OECD countries.