

The Allen Consulting Group



Australia's National Saving Revisited: Where do we stand now?

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Report to Investment & Financial Services Association

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Preface

This report examines the state of play in 2007 with Australia's national saving. The issue is a large one, with many dimensions:

- what are the most meaningful measures of saving?
- are we generating enough savings to sustainably fund the strong investment needed for economic growth, or are we too reliant on foreign savings?
- are households saving too little, and running up too much debt?
 - in particular, are Australians, and especially the large baby boomer cohort providing adequately for their retirement? Are Gen X and Gen Y?
 - or are unfair burdens for publicly funded income support, health and aged care being left to the following generations?

Broadly, the key findings of the report are as follows.

- (i) Our *national* saving (by all sectors combined) is a lower percentage of GDP than in the past, despite stronger contributions from governments and business.
- (ii) *Household* saving is the culprit – it essentially collapsed as we moved into this decade, over most of which it has been negative on a *net* basis, associated with a full-blown household *debt binge*.
- (iii) Our *gross national saving* is nevertheless comparable with other English speaking countries, but below average in the OECD group and considerably lower than fast growing Asian economies.
- (iv) Because we need to fund very strong business investment, much of it in the resource sector whose commodities are in high demand, we are drawing heavily on foreign savings and our *external deficit* is near the old 'red line' of 6 per cent of GDP. However, for the foreseeable future, we should be able to continue to access foreign savings on favourable terms. Low domestic saving is thus not a significant issue for funding national investment.
- (v) The nub of the low saving issue concerns *households* and the *intergenerational dimension*. Household wealth has been increasing steadily, but much of it is in houses and equities whose prices appear somewhat inflated. Housing wealth is also not very accessible in retirement, whereas remaining household debt at that stage will reduce superannuation available to fund income. Even before considering that factor, many Australians have inadequate retirement savings.

The present Government and its predecessor have implemented major reforms to superannuation, which have made a very significant difference and will continue to do so, but more remains for policy to achieve – to lift the adequacy of retirement income provision by the baby boomers *and* Gen X and Gen Y, and to ease burdens on future public budgets and future generations of taxpayers.

Acknowledgments

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The project to produce the report was led by Vince FitzGerald and Taleen Shamlian. Others on the team were Tanuja Doss, Andrew Read, Jessie Goldsmith, Paul Locke and Bill Scanlan.

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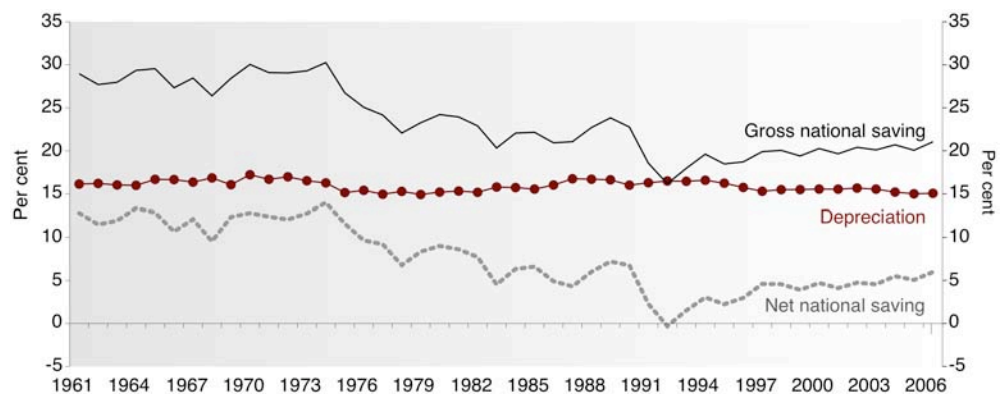
Executive summary

Overview: Why national saving matters

Australia's national saving – the total of saving by households plus businesses (as retained earnings) plus governments (as budget surpluses) – has recently been around 20 per cent of GDP *gross*, or just under 6 per cent of GDP *net* of depreciation (see Figure 1). This is well short of national capital investment, the gap appearing as an external (current account) deficit of nearly 6 per cent of GDP.

Figure 1

GROSS AND NET NATIONAL SAVING (PER CENT OF GDP)



A deficit at that level, particularly when our terms of trade are at extraordinarily high levels, would have rung alarm bells in the past. However since it is largely financing strong investment, much of it to expand production of commodities strongly demanded internationally, it is not at present the prime focus of concern about Australia's saving.

Concern mainly focuses on the fact that, despite initiatives to promote it, saving by households out of current income has collapsed. It has been *negative* on a net basis for most of this decade, and households have been incurring debt rapidly. Some of this debt has been used to acquire assets, mainly houses, but a significant part of it has been financing consumption spending.

Households' wealth has been rising steadily, but much of it is in houses whose market values appear somewhat inflated, and which in any case do not represent a very readily accessible source of funds to provide for retirement.

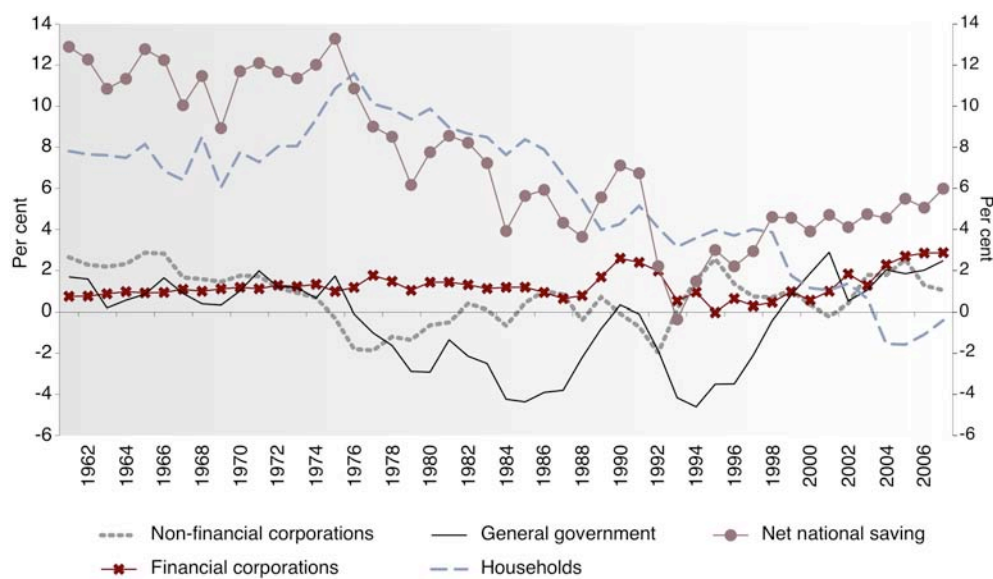
This is the nub of the saving issue: whether Australians, and particularly the baby boomers, are providing adequately for retirement. Thus the main policy issue here is an intergenerational one – will Generations X and Y be saddled with unduly heavy tax burdens? And are they too under-providing?

Saving in Australia: The 'big picture'

In contrast to the experience in the late 1980s and early 1990s when public saving fell sharply reaching a low point of around negative 4.6 per cent of GDP, public saving has averaged around 1 to 2 per cent of GDP over the past decade due to significant fiscal consolidation by Commonwealth and State governments (see Figure 2).

Figure 2

NET SAVING BY SECTOR (PER CENT OF GDP)



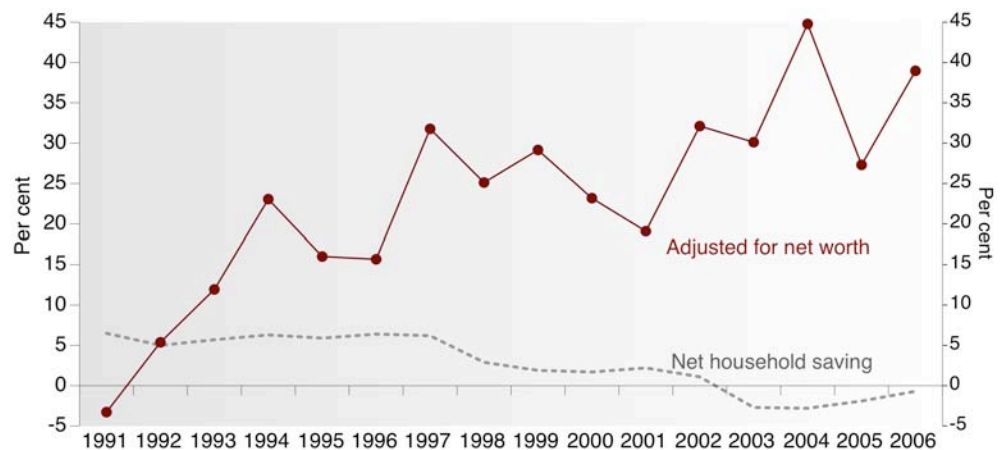
Corporate business sector saving (via retained earnings) has increased in line with corporate profitability, contributing around 80 per cent of the flow of net national saving in recent years.

Household saving as a proportion of disposable income, on the other hand, has been declining in Australia since the early 1970s. Since 2002-03, Australia's net household saving ratio has been negative, which means that households have been borrowing to allow them to spend more on goods and services than they could afford out of their current disposable incomes.

However, the conventional household saving measure may not be the most meaningful measure of household financial stress. Adjustments can be made to the conventional measure of household saving, e.g. to include the effect of changing asset values on the wealth of households (and hence their ability to spend some of that wealth). Whereas Australia's household saving has been declining, household net worth has been rising strongly. On this alternative measure, household 'saving' (or more accurately, net wealth accumulation) has been increasing, reaching 38 per cent of net disposable income in 2006 (see Figure 3, next page). It must be borne in mind, however, that the increase in this measure is largely due to strong, and potentially unsustainable, rises in the prices of houses and to a lesser extent equities.

Figure 3

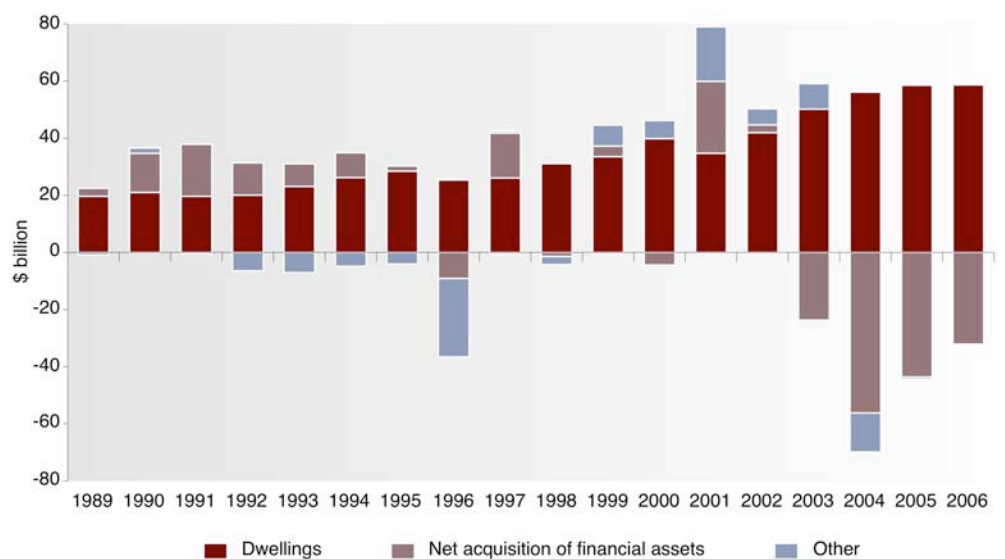
HOUSEHOLD SAVING MEASURES (PER CENT OF DISPOSABLE INCOME)



Moreover, measures of overall household wealth accumulation mask the significant effect of the incurrence of debt over the current decade on the mix between housing wealth, on the one hand, and *net* financial wealth (financial assets less liabilities) on the other. Over this decade, before allowing for valuation effects (unrealised capital gains), household net accumulation of housing assets has been positive and strong, while the incurrence of debt has significantly outweighed the acquisition of financial assets. In effect, increased debt has been offsetting a good deal of the unrealised gains in super funds, *and* will need to be repaid in future (see Figure 4). This significantly changes the picture of what funds will actually be available for income purposes when people retire and pay off debt, noting that housing wealth is typically ‘locked up’ until well after retirement.

Figure 4

NET ACQUISITION OF ASSETS BY HOUSEHOLDS (\$ BILLION)



International comparisons show that Australia's *gross national saving rate* has been the second highest among English speaking countries, although it is below the average of OECD countries, notwithstanding our greater need to fund investment. *Household saving* has declined significantly in all English speaking countries with Australia and the US having the lowest household saving rates, however.

In contrast to industrial countries, saving rates in developing Asian economies have been high and increasing, now significantly exceeding those of industrial countries. Particularly remarkable has been the very sharp increase in saving in China and India.

In short, Australia's major saving issue, as in other English speaking countries (notably the US) is low household saving – negative on a net-basis, but with some comfort to be taken from

- rising net worth, albeit valued at apparently inflated prices; and
- increased spending on some items defined as consumption but which have a degree of investment character (e.g. education).

Patterns of household saving, assets and debt

While household net worth has been increasing, this is largely due to our willingness to take on debt. Throughout the 1980s, the average Australian household owed less than \$50 in debt for every \$100 in income. Over the past 15 years, that figure has more than tripled to almost \$160 in debt for every \$100 of income.

Australians invest heavily in their homes. In 2006, residential real estate represented 57 per cent of households' total assets. Financial assets accounted for 39 per cent, with a majority of this invested in superannuation and life insurance predominantly, of course, the former. The pre-eminence of superannuation as the preferred financial vehicle for household savings is the product of a series of reforms by the Australian Government.

The strong growth in household debt, together with higher interest rates, has resulted in the ratio of household interest payments to disposable income reaching historically high levels. Overall, however, households continue to benefit from the strong economy, and there are at this stage few signs that families are struggling to meet their debt-servicing obligations. But there seem to be pockets of difficulty, and there remains a risk of that the level of debt borne by households might not be sustainable in less prosperous times and could, indeed, amplify a future economic downturn.

Moreover, to the extent that debt is not paid off before retirement, it will eat up accumulated superannuation, leaving less to fund retirement income.

Wealth is distributed very unequally across households in Australia. In 2003-04, the least wealthy 40 per cent of households had an average net worth of \$82 000, and collectively accounted for just 7 per cent of total household net worth. At the other end of the distribution, the wealthiest 20 per cent had an average net worth of \$1.38 million, and collectively accounted for 59 per cent of total net worth.

Australians' spending and saving behaviour is generally consistent with the 'life cycle hypothesis' that individuals prefer to smooth consumption over their lifetime. In 2003-04, baby boomer households (those headed by a person aged 45-64 years) had an average net worth of around \$630 000 — twice as much as the net worth of Generation X households (those with a head aged 25-44 years). On average, baby boomers have both higher assets and lower liabilities.

Another important inequality in the distribution of net worth exists between women and men. In 2002, males held 63 cents of every dollar of Australians' savings. The gap between the sexes grows with age — among baby boomers, men control almost twice as much net worth as women. The current generation of baby boomer women approaching retirement has less than half the level of savings in superannuation than that of their male counterparts. As a result, many women will not have sufficient savings to provide for an adequate income in retirement, and they will need to draw more extensively upon the age pension.

Implications of low domestic saving for the national economy

Given the low national saving rate, this raises the question of whether we are generating enough savings to sustainably fund the strong investment needed for economic growth, or are we too reliant on foreign savings?

Australia's current account deficit has widened to close to 6 per cent in recent years, and it would have been much larger were it not for the 30-year high we are enjoying in our terms of trade.

From a saving and investment perspective, the deterioration in the current account reflects strong growth in capital investment within Australia relative to a modest level of national saving, and particularly, very low household saving.

To finance the current account deficit, Australia relies on foreign savings mainly in the form of debt, on which we pay interest — the net income deficit, i.e. interest and dividends paid to foreigners net of those received from them, has been increasing steadily over the past two decades and is currently running at about 4 per cent of GDP. The stock of net liabilities to foreigners has also been increasing relative to GDP and is now around 60 per cent of annual GDP, although it is only about 10 per cent of our private sector wealth.

The great bulk of the net liabilities is net debt. The vast majority of Australia's foreign liabilities are either held in Australian dollars or hedged to Australian dollars and therefore our exposure to foreign currency risks remains relatively low.

Under current external circumstances, our heavy reliance on foreign savings may not pose significant risks. Our external deficit is clearly to a large extent the counterpart of strong investment, much of it in sectors producing commodities, which are in high demand in international markets. Our terms of trade are high, our dollar is strong, and positive sentiment towards the Australian economy in financial markets is reflected in modest risk premia in the interest rates at which we can borrow.

However, there may be significant consequences from our level of dependence on foreign savings if shocks in the international economy lead to a sharp decline in demand for our exports (and possibly, higher prices for key imports), leading to an adverse shift in sentiment and higher risk premia.

At present and foreseeably, however, these external risks do not appear to pose significant concerns, although they should be kept in view. The issues surrounding our low saving are more domestic and intergenerational, relating to how households' future needs are to be met rather than concerning the ability to finance business capital investment, so long as we are comfortable with a significant degree of foreign ownership.

Do households save too little?

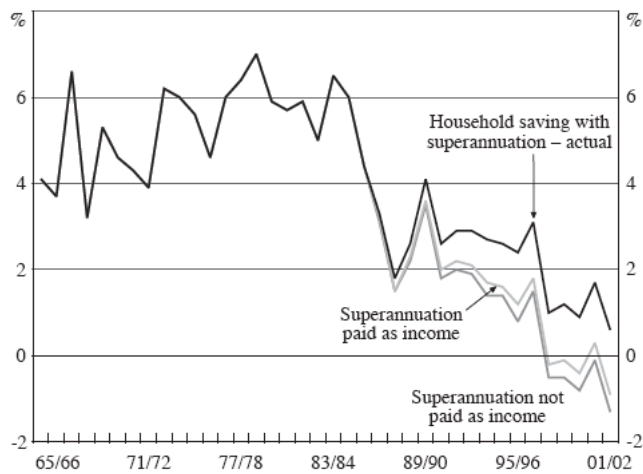
Given the patterns of household saving and the net acquisition of assets, the question is raised whether households are saving too little, and running up too much debt?

- in particular, are Australians, and especially the large baby boomer cohort providing *adequately* for their retirement?
- or are unfair burdens for publicly funded income support, health and aged care being left to the following generations?

In Australia, the major policy initiative to raise saving for retirement has been the introduction of the Superannuation Guarantee, as a major part of a three-pillared approach to retirement income policy. Household financial flows into superannuation have increased significantly in recent years with household assets in superannuation now comprising around 114 per cent of annual GDP.

Whether higher flows into superannuation assets have contributed to or detracted from household saving on a net basis (i.e. whether they have been substantially offset by reductions in other saving and/or incurrence of debt to finance consumption) is more difficult to establish. At first glance, it would not appear to be the case, as household saving has declined at the same time as superannuation assets have increased. However, empirical evidence estimates that the Superannuation Guarantee may have increased the household saving rate by up to 1.5-2 per cent of GDP in 2001-02 (Figure 5, next page). That is, government policies encouraging superannuation have added to both household saving and wealth, albeit that they appear to have been 'swimming against the tide' of other strong factors reducing saving, and disposing people to incur debt.

Figure 5

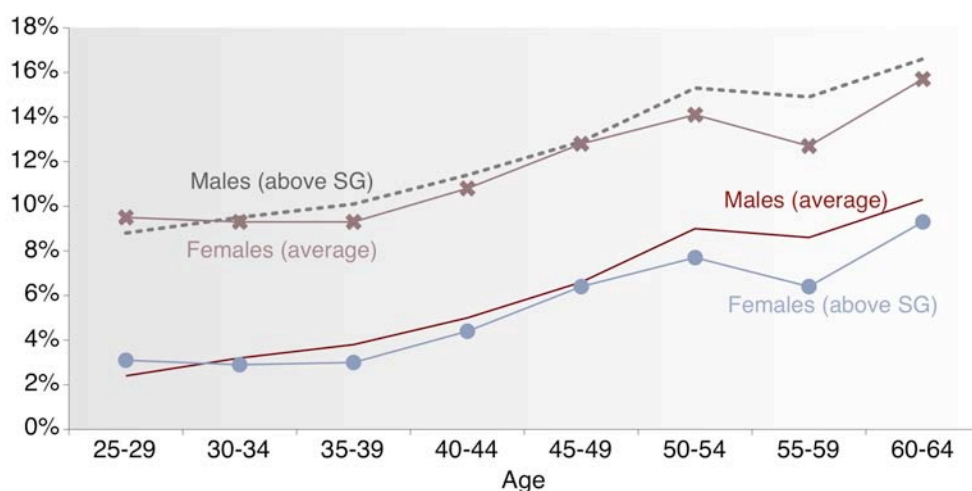
**EFFECT OF COMPULSORY SUPERANNUATION ON HOUSEHOLD SAVING —
SCENARIO ANALYSIS (PER CENT OF GDP)**


The question remains whether saving levels are ‘adequate’ to fund both the current and future generation’s retirement. Studies vary on the extent of under-provision, but even a recent Access Economics study taking into account strong capital gains on household assets shows that one-third of the workforce (3.5 million Australians) will not have adequate incomes in retirement. This is the case even though compulsory contributions via the Superannuation Guarantee and other policies have made a significant difference.

Moreover, to the extent that households leave debt to be paid off after retirement, it will reduce their superannuation available to fund income. Consequently, there may be a ‘retirement savings gap’ as people reach retirement with some estimates suggesting that this gap could be as high as \$823 billion in 2003-04.

One measure proposed is to increase the superannuation guarantee contribution rate beyond 9 per cent to say 12 or 15 per cent. In order to fully fund their retirement savings gap, some estimates suggest that baby boomers (those above 55 years of age) would need to contribute an additional 6.4 to 16.6 per cent of their pre-retirement income and Generation X and Y would need to contribute an additional 2.4 to 9.5 per cent of their pre-retirement income to superannuation (see Figure 6, next page).

Figure 6

REQUIRED ADDITIONAL CONTRIBUTION — AFTER AGE PENSION (PER CENT OF PRE-RETIREMENT INCOME)

While in aggregate there appears to be a ‘retirement savings gap’, several groups within the community face greater challenges with self-provision of retirement incomes. These groups include:

- women;
- the current cohort of retirees (or those close to retiring);
- people under the age of 40 (who have a higher propensity to consume out of current income compared with past generations); and
- self-employed individuals (who would typically invest much of their capital in their businesses until late in life when they expect sales of the business to fund their retirement).

Longevity has been increasing in Australia, in recent decades mainly due to reduced mortality from chronic diseases in middle and older age. Longevity and years in retirement are projected to continue to increase. Given that many people are failing to provide adequately for retirement income now, the implication is that without changed behaviour, retirement savings gaps may grow.

Given the extent of under-provision for retirement, a significant number of people will be reliant on a full or part age pension over the next forty years. The Australian Government has projected long-term fiscal implications of ageing with spending expected to rise (due to ageing) by around 4.75 per cent of GDP by 2046-47.

Without any policy or expenditure changes, this will require an increase in taxes to fund the future fiscal burden. This will place an uneven burden on future taxpayers to support a larger aged population as well as impeding the performance of the wider economy.

While policy measures, such as the Government's Future Fund, go some way to alleviate the burden placed on future generations via expenditures from public budgets, is restricted to funding government employee superannuation and it does not pre-fund the far greater future obligations to age pensioners or other age-related expenses e.g. for health and aged care

However, given a public policy interest in raising people's retirement living standards well beyond 'safety net' levels, policies that aim to support greater private saving for retirement purposes represent the primary policy approach.

Looking forward – What should be on the policy agenda?

In respect of household saving, the key issues include:

- the economic and social risks attaching to high levels of household debt;
- under-provision for retirement, particularly by the large baby boomer cohort, posing both intergenerational equity concerns and concerns that many in that cohort itself may not attain the standards of living in retirement that they aspire to.

This series of major reforms to superannuation by the previous and present Governments (including the Superannuation Guarantee, co-contributions, transition to retirement measures and the recent sweeping reform reducing the taxation of benefits and greatly simplifying super) have made a very significant difference, and will continue to do so, but there remains more for policy to achieve.

In addition to more responsible attitudes to debt, a *combination* of extended participation in work – i.e. phased transition to retirement – and increased saving for retirement through superannuation, targeting younger as well as older cohorts, are the most promising avenues for policy development.

This paper does not canvass policy options in any detail, but an agenda of options for consideration would include:

- responsible borrowing/lending programs, targeting both borrowers and lenders;
- increased mandatory superannuation contributions, with Gen X and Gen Y a particular focus;
- extension of co-contribution incentives to a wider group;
- further initiatives to remove barriers to extended participation in work (phased transition to retirement);
- policies to require or encourage pre-provision for health care in retirement;
- initiatives to facilitate 'unlocking' of housing wealth in retirement; and
- in addition to initiatives aimed at household saving, possible extension of the Future Fund model to provide for additional future expenditures.

Part 1

Trends in national saving

Chapter 1

Overview: Why national saving matters

This chapter provides an introductory overview of issues about Australia's national saving, and a brief guide to the remainder of the report.

Key Points

- Australia's national saving – the total of saving by households plus businesses (as retained earnings) plus governments (as budget surpluses) – has recently been around 20 per cent of GDP *gross*, or just under 6 per cent of GDP *net* of depreciation. This is well short of national capital investment, the gap appearing as an external (current account) deficit of nearly 6 per cent of GDP.
- A deficit at that level, particularly when our terms of trade are at extraordinarily high levels, would have rung alarm bells in the past. However since it is largely financing strong investment, much of it to expand production of commodities strongly demanded internationally, it is not at present the prime focus of concern about Australia's saving.
- Concern mainly focuses on the fact that, despite initiatives to promote it, saving by households out of current income has collapsed. It has been *negative* on a net basis for most of this decade, and households have been incurring debt rapidly. Some of this debt has been used to acquire assets, mainly houses, but a significant part of it has been financing consumption spending.
- Households' wealth has been rising steadily, but much of it is in houses whose market values appear somewhat inflated, and which in any case do not represent a very readily accessible source of funds to provide for retirement.
- This is the nub of the saving issue: whether Australians, and particularly the baby boomers, are providing adequately for retirement. Thus the main policy issue here is an intergenerational one – will Generations X and Y be saddled with unduly heavy tax burdens? And are they too under-providing?
- This paper examines the facts, implications and policy issues.

1.1 Introduction – A brief overview of the issues

This report is about the current state of play with Australia's national saving. Australia's *national* saving comprises not just household, but also business and public sector saving. Overall, our national saving (around 20 per cent of GDP gross, or just under 6 per cent net of depreciation) is significantly lower than our national investment. That is the country has a large external (or current account) deficit – currently around 6 per cent of GDP. This is financed by borrowing from overseas and foreign investment in Australia – direct and portfolio. In other words, as a nation we are drawing heavily on foreigners' savings, rather than our own, to finance the capital investment needed for economic growth. And of course, there is a price – foreigners earn interest on funds lent, which may include a risk premium related to how much we borrow, and dividends and capital gains on investments in Australia that foreigners own, and in many cases, control.

The principal domestic contribution to Australia's external deficit (apart from the high level of investment) is *household* dis-saving — that is, spending by households in excess of current income, financed by incurring debt. Over the past few decades, the household sector's saving patterns have changed dramatically, from generating significant savings out of current disposable income to a situation over this decade of sustained *negative net saving* — notwithstanding major policy initiatives to promote saving, notably in superannuation.

Since households are not only consuming in excess of income but are investing significantly (primarily in housing), this has involved a very large rise in household debt, much of which is in the form of housing finance, together with significantly increased credit card debt. It is true that households have been increasing their net wealth, but this has been largely due to capital gains on their housing and financial assets, gains that may well erode or reverse in real terms in the future. Moreover, wealth tied up in property (particularly owner-occupied houses) is relatively inaccessible, and typically remains so until late in the owner's life — so that it is not as directly relevant to saving for retirement as savings in financial form.

Private non-financial corporations have traditionally raised much of their own investment finance in the form of retained earnings (i.e. their own saving), but when business investment is running strongly — as over recent years — they can become large net borrowers. However as this finance is adding to capacity to produce future income and to service external borrowings, it is not of direct concern. The *general government sector* — which has in some past periods (e.g. as recently as 2000-01) been a net borrower after financing investment, despite typically generating significant positive savings (i.e. surpluses on recurrent budget) — has moved to a sustained positive net lending position over recent years.

In the past, when there has been debate about whether Australian saving is too low, concerns have focused particularly on two issues:

- the current account deficit, in particular, the risks attached to a sustained high deficit. There have, for example, been notions of a 'red line' around 6 per cent of GDP; and
 - intergenerational issues — particularly whether the baby boomer generation is providing for itself sufficiently, or whether it is leaving unduly large burdens to the generations following to support them with taxpayer-funded income support, health care etc.

We consider those issues in turn.

Views about the importance of the *current account deficit* as an economic indicator have varied over time. In recent years, the prevailing view has been that a current account deficit tracing mainly to private sector behaviour is *not* of major concern. However some economists have questioned whether Australia's persistently high current account deficit, or the essentially equivalent National Accounts concept 'net borrowing from overseas' (which has been close to the traditional 'red line' of 6 per cent of GDP for several years now despite terms of trade that are exceptionally strong), points to underlying structural problems in the *domestic* economy. In particular:

- Australia needs sustained strong investment to capitalise on the global commodities boom and maintain the economic growth of the past 15 years. External finance is currently and foreseeably readily available for this investment, at least insofar as it is undertaken by larger corporations able to access the capital markets as well as bank finance. However low domestic saving poses a risk of Australia becoming over-reliant on foreign sources of capital, and vulnerable to changes in international sentiment regarding the Australian economy *if* the current favourable environment for our exports changes adversely. In addition of course, to the extent that foreigners provide the equity capital, they reap the handsome rewards, and foreign ownership of our economy increases.
- The collapse of *household saving* and the dramatic enlargement of household debt poses other risks. An economic slowdown could leave many households unable to meet their debt servicing commitments without severe ‘belt tightening’, i.e. force reductions in household spending, contributing to slowing of the economy and possible recession. There is the risk that the improvement in their balance sheet positions that has encouraged the increased use of debt may reverse, as current very high valuations of property (e.g. Perth houses) or equities revert to more sustainable levels.
- Finally, the *ageing population* poses the need for strong domestic saving on intergenerational equity grounds. If the baby boomers do not save adequately to support themselves during retirement, particularly in the form of readily accessible financial assets, the cost of providing them with income support will fall heavily and unfairly on younger generations, and higher levels of taxation would impede the future economy.

In the context of the ageing population, governments have implemented a range of initiatives to encourage household saving and to contribute public saving towards retirement needs. In the 1990s, the Australian Government legislated for compulsory superannuation contributions rising to 9 per cent of salaries. In 2003, the Government introduced the superannuation co-contribution to encourage lower income people to make a personal contribution to their superannuation fund. The following year, the Government established the Future Fund to meet its own unfunded superannuation liabilities.

Even broader in scope, the New Zealand Government has created a fund to partially provide for the future cost of New Zealand’s taxpayer-funded aged pension system (‘New Zealand Superannuation’).

Australia’s policy initiatives may not be enough, given that household net saving has collapsed. Partly this is because other forces have pulled households in other directions. For example there are now strong incentives in place making it attractive for households to enter into debt, particularly mortgage debt – such as negative gearing and the very favourable taxation treatment of owner-occupied homes.

There may not be grounds for concern to the extent that households incur debt to invest in property assets (other than some concerns at the prices they may be paying). However, quite clearly debt is also being used to finance spending on things that do not produce an economically measurable future flow of services, e.g. popular consumer durables (such as plasma TVs) and consumption spending generally.

Policy options to improve Australia's national saving position should consider both new opportunities to encourage household saving and whether existing incentives that discourage saving and encourage incurrence of debt continue to have a strong rationale.

1.2 This report

As part of its research into retirement incomes and long term savings, the Investment Financial Services Association has engaged the Allen Consulting Group to undertake research into national saving and its role in the Australian economy and community.

This report, part of that research, is structured as follows:

- Part 1 provides an overview of national saving in Australia.
 - Chapter 2 provides a critical review of available measures of saving — how comprehensive and meaningful are they? The chapter also compares Australia's saving performance with overseas countries; and
 - Chapter 3 analyses trends in household saving and accumulation of assets and debt by demographic categories (generation, sex, and income level) and different financial vehicles.
- Part 2 analyses what, if any, goals should be set for Australia's saving, and the policy implications.
 - Chapter 4 assesses whether the level of national saving is sufficient to support investment and growth in our economy — now and into the future;
 - Chapter 5 analyses whether the level of household saving is adequate for funding the retirement incomes and consumption needs of the baby boomer cohort in particular, but also the following cohorts; and
 - Chapter 6 briefly discusses the broad policy implications of these trends.

Chapter 2

Saving in Australia: The ‘big picture’

This chapter provides an overview of the broad trends in Australia’s national saving including developments by sector (public and private, household and business). The analysis also considers wider definitions of saving which take into account changes in net wealth and those categories of consumption expenditure which can be viewed as having investment character (e.g. spending on education). The chapter also summarises the international national saving experience among OECD and Asian economies as a base for comparing Australia’s performance.

Key Points

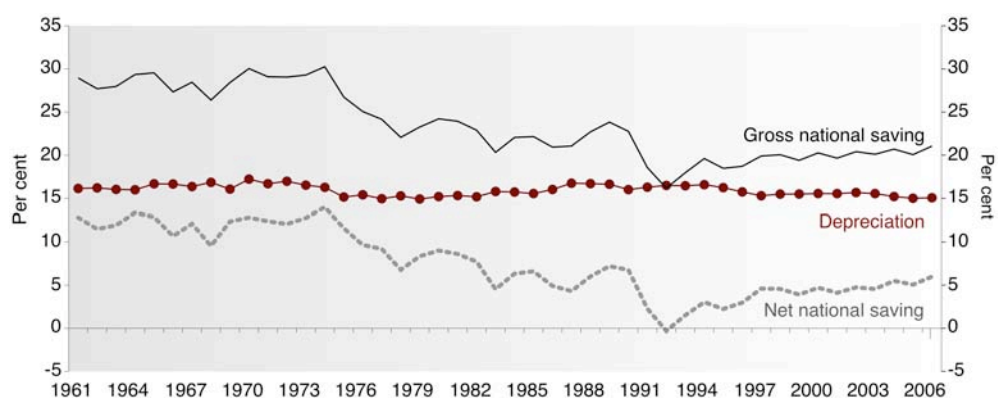
- The *gross* national saving rate (i.e. before depreciation) has averaged 20 per cent of GDP over the past ten years, falling from the levels of around 28 per cent of GDP, which prevailed in the 1960s and 1970s.
- *Net* saving as a proportion of national income has also fallen from 12 per cent of GDP in the 1960s to around 4 to 5 per cent of GDP in the past decade.
- In contrast to the experience in the late 1980s and early 1990s when public saving fell sharply reaching a low point of around negative 4.6 per cent of GDP, public saving has averaged around 1 to 2 per cent of GDP over the past decade due to significant fiscal consolidation by Commonwealth and State governments.
- Corporate business sector saving (via retained earnings) has increased in line with corporate profitability, contributing around 80 per cent of the flow of net national saving in recent years.
- Household saving is the culprit —it essentially collapsed as we moved into this decade, over most of which it has been negative on a *net* basis, which means that households have been borrowing to allow them to spend more on goods and services than they could afford out of their current disposable incomes.
- An alternative concept of household saving calculating the real net change from period to period in households’ ‘net worth’ shows that whereas Australia’s household saving has been declining, household net worth has been rising strongly. On this alternative measure, household ‘saving’ (or more accurately, net wealth accumulation) has been increasing, reaching 38 per cent of net disposable income in 2006. It must be borne in mind, however, that the increase in this measure is largely due to strong, and potentially unsustainable, rises in the prices of houses and to a lesser extent equities.
- Measures of overall household wealth accumulation mask the significant effect of the incurrence of debt over the current decade on the mix between housing wealth, on the one hand, and *net* financial wealth (financial assets less liabilities) on the other. Over this decade, before allowing for valuation effects, household net accumulation of housing assets has been positive and strong, while the incurrence of debt has significantly outweighed the acquisition of financial assets. In effect, increased debt has been offsetting a good deal of the unrealised gains in super funds, *and* will need to be repaid in the future.
- International comparisons show that Australia’s *gross national saving rate* has been the second highest among English speaking countries, although it is below the average of OECD countries, notwithstanding our greater need to fund investment. *Household saving* has declined significantly in all English speaking countries with Australia and the US having the lowest household saving rates, however.
- Saving rates in developing Asian economies have been high and increasing, now significantly exceeding those of industrial countries. Particularly remarkable has been the very sharp increase in saving in China and India.

2.1 Trends in saving in Australia

Policy makers and economic commentators have been concerned for some time about Australia's national level of saving, although the level of concern and debate has varied considerably over time. The broadest measure of saving, the *gross* saving rate (i.e. *before* depreciation), has averaged 20 per cent of GDP over the past ten years, falling from the levels of around 28 per cent of GDP, which prevailed in the 1960s and 1970s.¹ If we focus on the *net* saving rate (that is, *after* deducting consumption of fixed capital, or depreciation), we see a more worrying picture. While depreciation has remained relatively steady as a proportion of GDP, net saving as a proportion of GDP has fallen from 12 per cent in the 1960s to around 4 to 5 per cent in the past decade.

Figure 2.1

GROSS AND NET NATIONAL SAVING (PER CENT OF GDP)



Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 13.

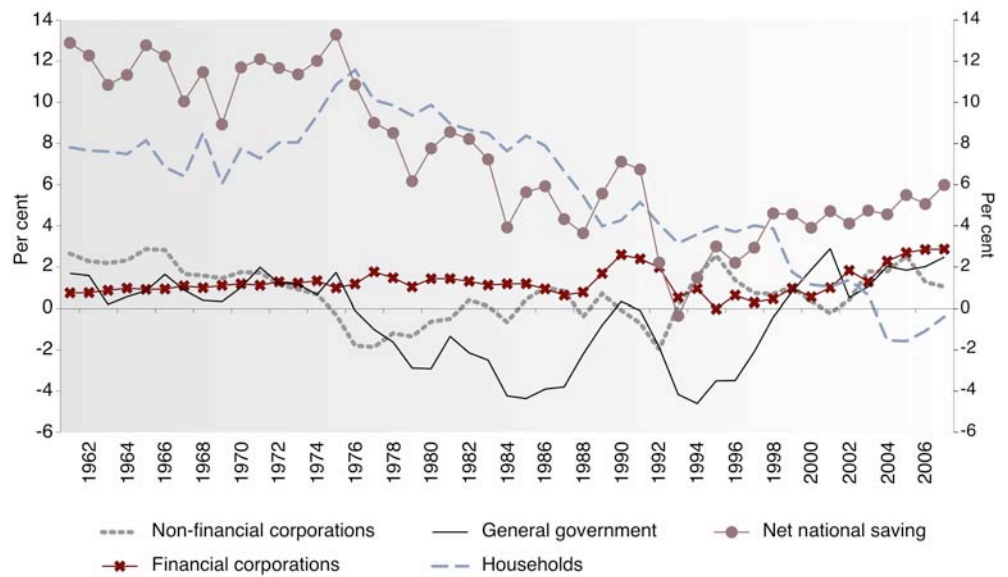
It is useful to segment national saving into its public and private sector components, and to distinguish household and business saving, as levels of saving by the different sectors are driven by different factors (Figure 2.2). In the 1960s and 1970s, public sector saving (specifically, that of general government) averaged around 1 per cent of GDP but fell sharply through the 1980s and early 1990s, reaching a low point of dis-saving, at around negative 4.6 per cent of GDP in 1994. These trends raised considerable concern at the time, with FitzGerald's *National Saving: A Report to the Treasurer* (1993) arguing that the strategy for raising national saving should be focused primarily (but not exclusively) on raising public saving. Since that period, there has been considerable fiscal consolidation by Commonwealth and State governments, with such efforts raising the public saving rate to around 1 to 2 per cent of GDP over the past decade.

¹

In practice, saving cannot be directly measured. Instead, it is calculated as a residual, after estimating income and consumption expenditure, and then taking the difference between these two very large aggregates. As a result, any errors or omissions in the estimate of income and consumption expenditure are amplified in estimates of saving.

Figure 2.2

NET SAVING BY SECTOR (PER CENT OF GDP)



Note: A corporate saving ratio cannot be meaningfully derived because the corporate sector, by definition, does not consume.

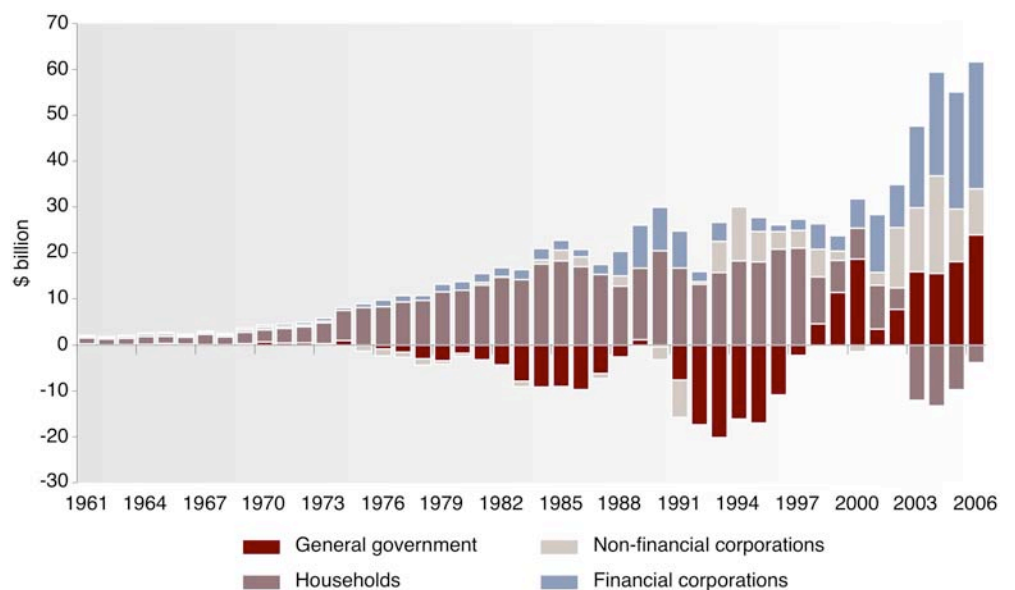
Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 11 and Table 14

Corporations

The contribution made to national saving by financial and non-financial corporations (as retained earnings, less depreciation) has significantly increased in recent years (Figure 2.3). In the early 1960s, the share of net national saving contributed by corporations was around 27 per cent, increasing to around 80 per cent over recent years.

Figure 2.3

NET NATIONAL SAVING BY SECTOR (\$ BILLION)



Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 14.

The increase in the contribution of corporations to national saving can be attributed to corporations enjoying high levels of profitability, which allows them to finance investment substantially from internal sources.

A relatively minor point to note here is that some of the improvement in corporate saving may be contributed by unincorporated enterprises, which are included in the household sector, which cross the sectoral boundary when they incorporate. In recent decades, there has been a significant trend towards corporatisation of Australian businesses, which would shift income and saving out of the household sector and into the corporate sector (Treasury 1999).²

Households

Household saving is the amount that is left over from a household's disposable income after expenditure on consumption goods and services. Household saving as a proportion of disposable income has been declining in Australia since the early 1970s and collapsed going in to this decade (Figure 2.4). Since 2002-03, Australia's net household saving ratio has been negative, which means that households have been borrowing to allow them to spend more on goods and services than they could afford based purely on their income (ABS 2007b).³ Note, however, that this statement is based on 'net' measures which treat depreciation as an expense.

Figure 2.4

NET HOUSEHOLD SAVING AS A PROPORTION OF NET HOUSEHOLD DISPOSABLE INCOME, 1970–2006



Note: Net household saving is defined as net household disposable income less household final consumption expenditure. Net household disposable income is calculated by deducting depreciation (consumption of fixed capital) from gross disposable income. The household saving ratio does not take into account capital gains and losses as these are not considered to be part of household current disposable income. The household sector includes households, unincorporated enterprises and non-profit institutions serving households.

Source: ABS 2007b, *Spotlight on National Accounts, 2007*, Cat. No. 5202.0, Canberra.

From the viewpoint of the adequacy of saving, the picture is slightly more worrying if we consider the contribution that household saving has made over time to the stock of national saving (Figure 2.3). This contribution averaged around 70 per cent

² The last point is cited as one factor explaining the decline in household saving. It is important to note, however, that while this would reduce the saving in the household sector, it would also reduce expenditure in the sector. The incorporation of the unincorporated entities seems to be a minor factor in the large decline of household saving.

³ The ABS (2007) advises that caution should be exercised in interpreting the household saving ratio in recent years, because major components of household income and expenditure may be subject to significant revision.

in the 1960s and 1970s and increased to around 120 per cent in the 1980s (in line with a contraction in the contribution to national saving from the public sector) and has now fallen to *minus* 7 per cent of net national saving in 2006.

2.2 Adjustments to the conventional saving measure

The discussion above is premised on the commonly quoted measure of the household saving ratio, as published by the ABS. It is determined as a residual to net disposable income of households that is not consumed by households in that period.

Conceptually, a ‘purer’ economic concept of saving would be the change in the net worth of households from one period to the next. By contrast the conventional saving measure does not take into account:

- the effect of changing asset values on the wealth of households (and hence their ability to spend some of that wealth); or
- the categorisation of certain expenditures as ‘pure’ consumption items even though they may have at least to a degree the characteristics of an investment (or capital) item. These items include spending on consumer durables, health, and education.

Adjustments can be made to the conventional measure of household saving to include either or both of these sets of factors, and hence to provide a broader picture of net wealth accumulation by households.

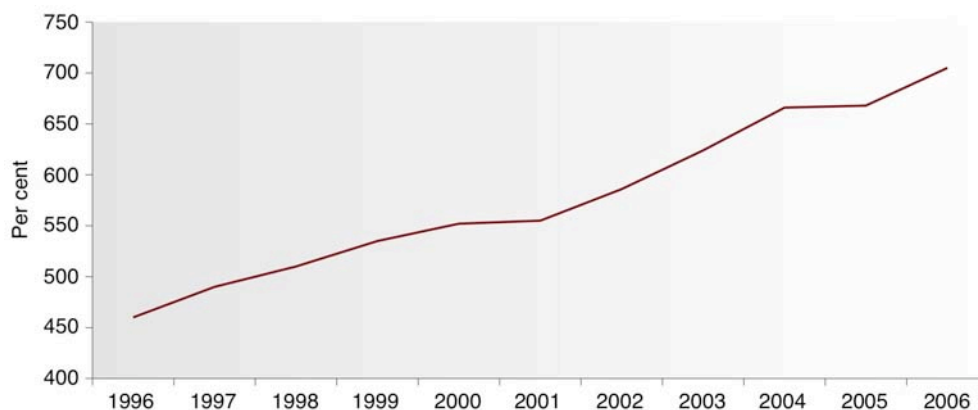
Changes in net wealth

An alternative approach to estimating household saving is to calculate their ‘net worth’, calculated as the value of household assets less liabilities. In some ways net worth is a better indicator of Australians’ financial position, because it takes into account not just saving out of current income, but also capital gains and losses (ABS 2006d, p. 63). Net worth is basically a measure of household wealth, and reflects the stock of saving that households have accumulated over time.

Whereas Australia’s household saving has been declining, household net worth has been rising strongly over recent years. In the 10 years to 2006, household assets (financial and non-financial) rose from \$2040 billion to \$5500 billion, while liabilities rose from \$310 billion to \$1070 billion (both in nominal terms). As a result, household net worth grew by an average of 10 per cent each year. As a proportion of household disposable income, household net worth grew from 460 per cent in 1996 to 705 per cent in 2006 (Figure 2.5).

Figure 2.5

HOUSEHOLD NET WORTH AS A PROPORTION OF GROSS HOUSEHOLD DISPOSABLE INCOME, 1996–2006



Note: The household sector includes households, unincorporated enterprises and non-profit institutions serving households.

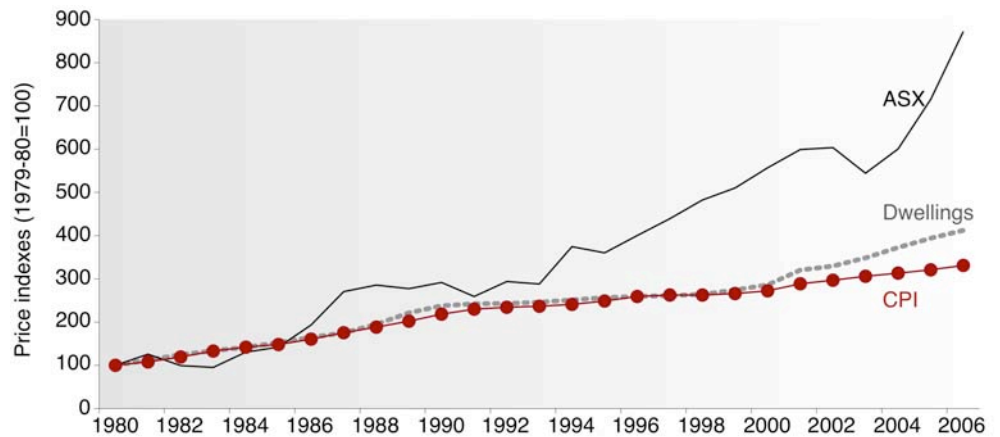
Source: RBA 2007e, Selected assets and liabilities of the private non-financial sectors, Bulletin Statistical Tables, Table B20. <http://www.rba.gov.au/Statistics/Bulletin/index.html>, Accessed 10 July 2007; and ABS 2006a, *Australian System of National Accounts, 2005-06*, Catalogue No. 5204.0, Canberra, Table 46.

As Figure 2.6 shows, net wealth has increased as a result of asset prices of equity and houses growing faster than the consumer price index, giving rise to what is termed a ‘wealth effect’. Many commentators consider that house prices are currently unsustainably high in real terms in some cities, notably Perth, and that some reversion is on the cards. (*Real* house prices do not always rise: they have fallen considerably in some past periods – e.g. roughly halving between the late 1980s and mid 1990s in the major Eastern cities.) Similar observations have been made about recent equity prices. While some of the increase in household wealth over the current half decade may prove ephemeral, however, the wealth effect being experienced currently is no doubt a factor in households spending in excess of their current net disposable incomes.⁴

⁴ Dvornak and Kohler (2007) show that both housing and stock market wealth have a significant effect on household consumption: a permanent \$1 increase in stock market wealth increases long-run annual consumption by 6-9 cents; the same increase in housing wealth increases annual consumption by around 3 cents. With housing assets comprising more than three times that of stock market assets, a 1 per cent increase in housing wealth has an effect on consumption at least as large as that of a 1 per cent increase in stock market wealth.

Figure 2.6

PRICE INDEXES (1979-80 = 100)

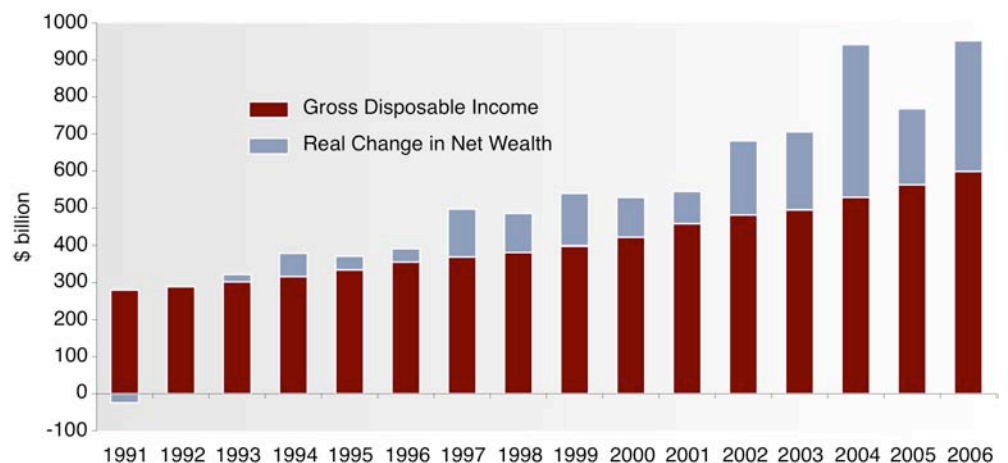


Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 88 and 89; ABS 2007c, *Consumer Price Index Australia June 2007*, Catalogue No. 6401.0, Canberra, Table 7, and RBA 2007, *Share Market, Bulletin* Statistical Tables Table F7, <http://www.rba.gov.au/Statistics/Bulletin/index.html>, accessed on 10 July 2007.

Incorporating the changes in net worth, *gross* household disposable income on that measure has been greater than on the narrow measure in every year since 1992 (Figure 2.7). Over the past five years, changes in net worth have contributed on average around \$276 billion to the average level of disposable income of \$533 billion on the conventional measure. That is to say, household disposable income increases by one-third by incorporating real net changes to asset holdings of households.

Figure 2.7

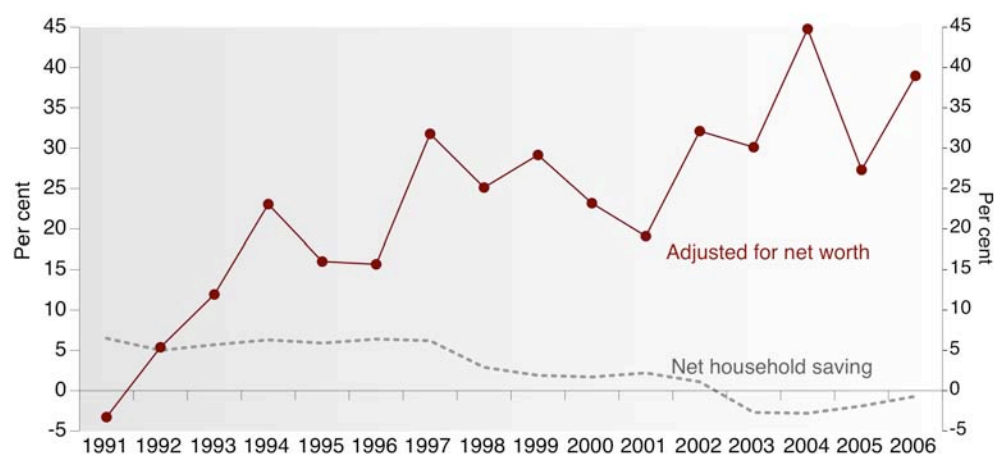
ADJUSTMENT TO GROSS DISPOSABLE INCOME FROM CHANGES IN NET WORTH (\$ BILLION)



Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 48.

An alternative concept of a household saving ratio using the above wider household income definition (which incorporates changes in household net worth) reveals that the saving rate on that base does not appear to have weakened (Figure 2.7). In fact, the household saving ratio based on real changes in net wealth exhibits an overall upward trend over time rising to 38 per cent of net disposable income in 2006.⁵

Figure 2.8

HOUSEHOLD SAVING MEASURES (PER CENT OF DISPOSABLE INCOME)

Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06 Catalogue No. 5204.0*, Canberra, Table 48.

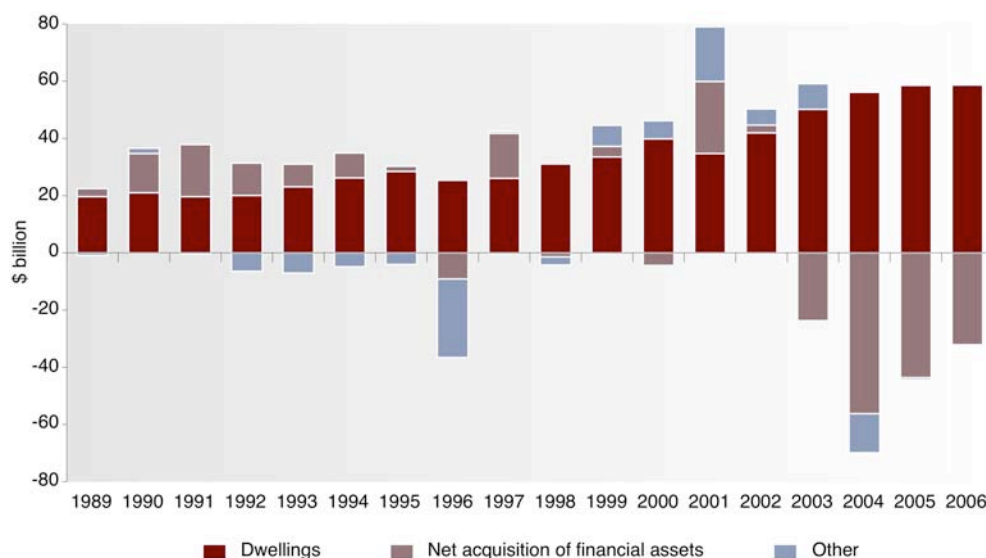
There are several issues with relying too heavily on this wider definition of gross disposable income, however. Firstly, the changes in net worth are not based on realised capital gains but on the paper value of the assets. Secondly, as noted, many commentators consider that both houses and equities are currently overpriced compared with economic fundamentals.

Moreover, measures of overall household wealth accumulation mask the significant effect of the incurrence of debt over the current decade on the mix between housing wealth, on the one hand, and *net* financial wealth (financial assets less liabilities) on the other. Over this decade, before allowing for valuation effects (unrealised capital gains) household net accumulation of housing assets has been positive and strong, while the incurrence of debt has significantly outweighed the acquisition of financial assets (see Figure 2.9 below).⁶ In effect, increased debt has been offsetting a good deal of the unrealised gains in super funds, *and* will need to be repaid in future. This significantly changes the picture of what funds will actually be available for income purposes when people retire and pay off debt, noting that housing wealth is typically 'locked up' until well after retirement.

⁵ Further analysis of this adjustment to the conventional saving measure can be found in ABS 2003, 'Feature Article: New analytical measures of income saving and wealth', *Australian System of National Accounts 2002-03*, cat. no. 5204.0, pp. 13-20.

⁶ The net acquisition of assets by households represent net flows into dwelling and financial assets less debt, and do not take into account unrealised capital gains on these assets. The figures for dwelling asset acquisition do not include ownership transfer costs such as stamp duty, estate agent commissions and other costs.

Figure 2.9

NET ACQUISITION OF ASSETS BY HOUSEHOLDS (\$ BILLION)

Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 49 and 50.

There are also a range of other adjustments that could be made to the conventional measurement of household saving to make a conceptually 'purer' distinction between consumption and investment. These issues relate to:

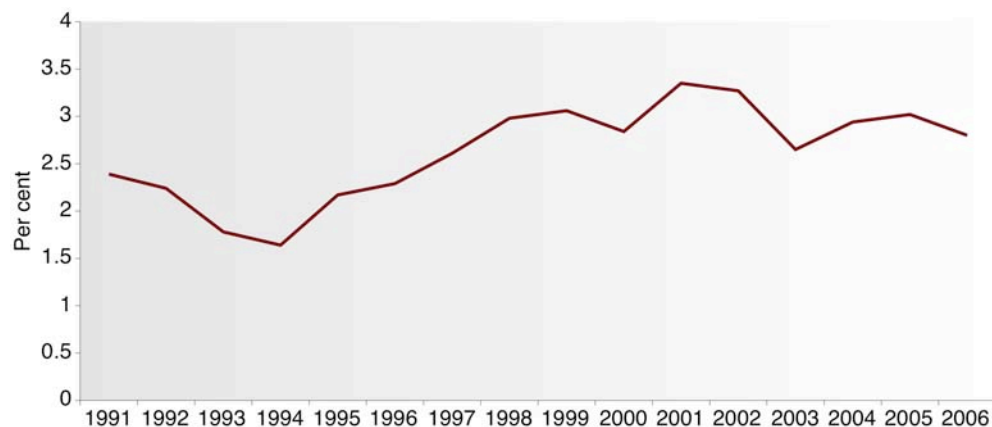
- expenditure on consumer durables, such as motor vehicles and white goods;
- spending which has the character of investment in human capital, such as education; and
- spending on health care (improving future ability to be productive).

These items are classified in the National Accounts as pure consumption spending, even though the benefits of them go beyond the year in which they are purchased. For example, expenditure on education is treated as consumption, but countless studies demonstrate that educational qualifications give rise to future economic benefits (i.e. an increased earning capacity for the individual). In practice, however, to the extent that the expenditure on these items is relatively constant as a share of income, they are unlikely to have an impact on *trends* in household saving.

Consumer durables

Consumer durables provide a household with a stream of benefits over a number of years, such as a family car. Unlike the general government or corporate sectors, which have expenditure on such durables recognised as investment, households expenditure on these items is treated as consumption. Figure 2.10 shows that expenditure on consumer durables increased from 2.1 per cent of net disposable income in the early 1990s to 2.9 per cent of net disposable income in the last few years. These outcomes suggest that increased spending on durables (e.g. plasma TVs, iPods) has been a feature of the current high spending/low saving decade. However the case for treating this spending as part of the flow of national saving seems weak.

Figure 2.10

NET ACQUISITION OF CONSUMER DURABLES (PER CENT OF NET DISPOSABLE INCOME)

Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 48

Human capital

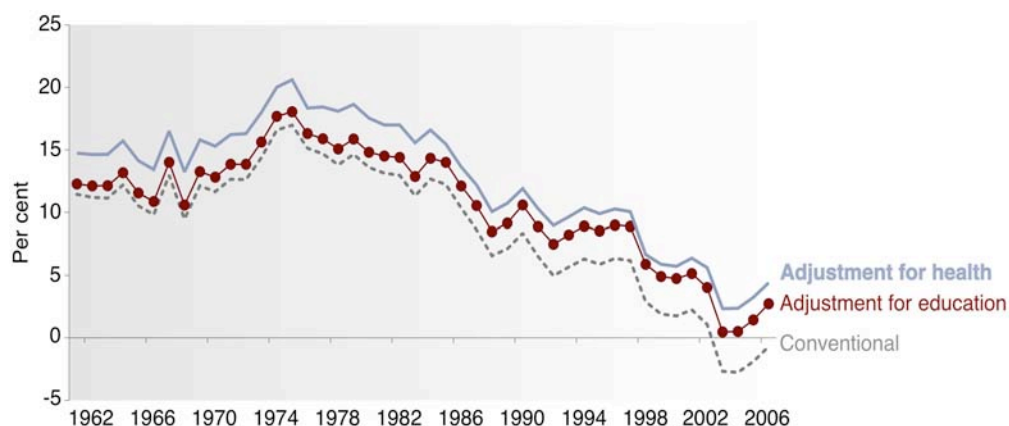
Considering increased expenditure on human capital related services such as health and education may also give a different picture of saving over recent decades as the National Accounts treat expenditure on human capital as final or intermediate expenditure (i.e. as consumption or expense), rather than as an investment.

Household expenditure on health, as a proportion of net disposable income, has increased from around 3 per cent in 1959-60 to 5 per cent in 2005-06 (Australian Bureau of Statistics, 2006a). At the national level, expenditure on health has increased from 8 per cent of national *net* disposable income to 17 per cent for the same years (Australian Bureau of Statistics, 2006a). These trends would suggest that the treatment of such expenditure as consumption may have biased the picture of household saving downwards. It is difficult to disaggregate expenditure on health services between consumption and investment, however. For example, some health expenditures (e.g. on cosmetic surgery) may not add to the person's future productive capacity.

National expenditure on education as a share of net national disposable income has increased from 5 per cent in 1959-60 to 11 per cent in 2005-06. For households, the share of disposable income spent on education has increased from 0.8 per cent in 1959-60 to 3.4 per cent in 2005-06. As with health expenditure, this implies that household saving would be higher with these expenditures treated as investment.

Figure 2.11 shows the impact including health and education may have in measures of the household saving rate.

Figure 2.11

HOUSEHOLD SAVING RATIO ADJUSTED FOR EXPENDITURE ON HEALTH AND EDUCATION

Source: ABS 2006a, *Australian System of National Accounts, Australia, 2005-06* Catalogue No. 5204.0, Canberra, Table 46 and 52.

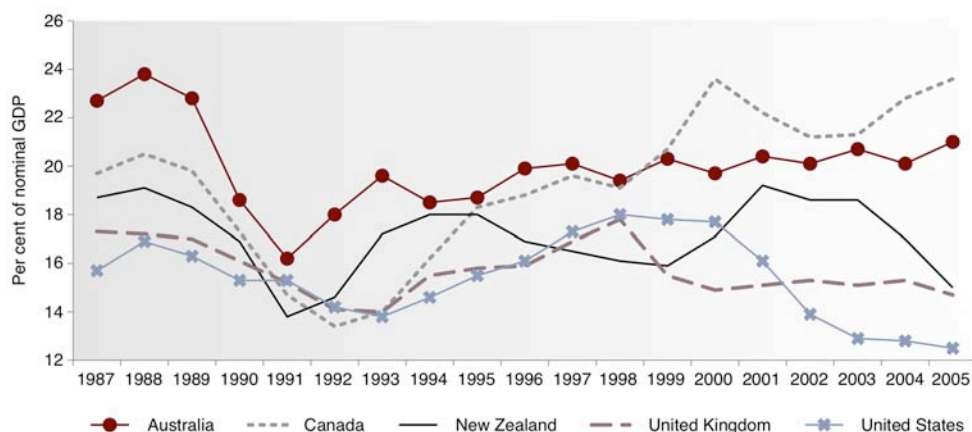
The chart shows that adjusting the household saving ratio for expenditure on health and education would increase the household saving rate in each year over the period from the 1960s. In more recent years, where the conventional measure of household saving ratio is *negative*, the alternative measures show that the household saving rate to have been *positive*, and as much as 5 per cent higher by accounting for health expenditure and around 3.2 per cent higher by accounting for education expenditure. However there is no great change to the overall pattern of steady decline over the 1980s and 1990s into the early years of this decade – or to the appearance of a small degree of recovery more recently.

2.3 International comparisons

Trends in OECD countries

Over the past two decades, Australia's *gross national saving rate* has been the second highest among English speaking countries, following the national saving rate of Canada (Figure 2.12). The global recession of 1991-92 caused gross national saving to fall considerably in all English speaking countries. National saving in Canada has grown strongly and now exceeds pre-recession levels at 23 per cent of GDP. The UK's national saving rate grew strongly after the recession, peaking in 1998 before falling, and is now around 16 per cent. Gross saving in the US and New Zealand have also fallen significantly in this period.

Figure 2.12

GROSS NATIONAL SAVING IN SELECTED ENGLISH SPEAKING COUNTRIES

Source: OECD 2006a.

One explanation for the apparent differences in saving rates between English speaking and other OECD countries is the pattern of government budget balances. Gruen (2005) argues that the Australian, Canadian and New Zealand Governments have all sought to strengthen their budget position in recent years and their overall saving position has been strong as a result. In contrast, the UK and US have maintained budget positions that are little changed or weaker than their longer term average and have seen their saving position deteriorate. In other words, government saving has been a major contributor to the *national* saving position in all English speaking countries, and in Australia's case, positively.

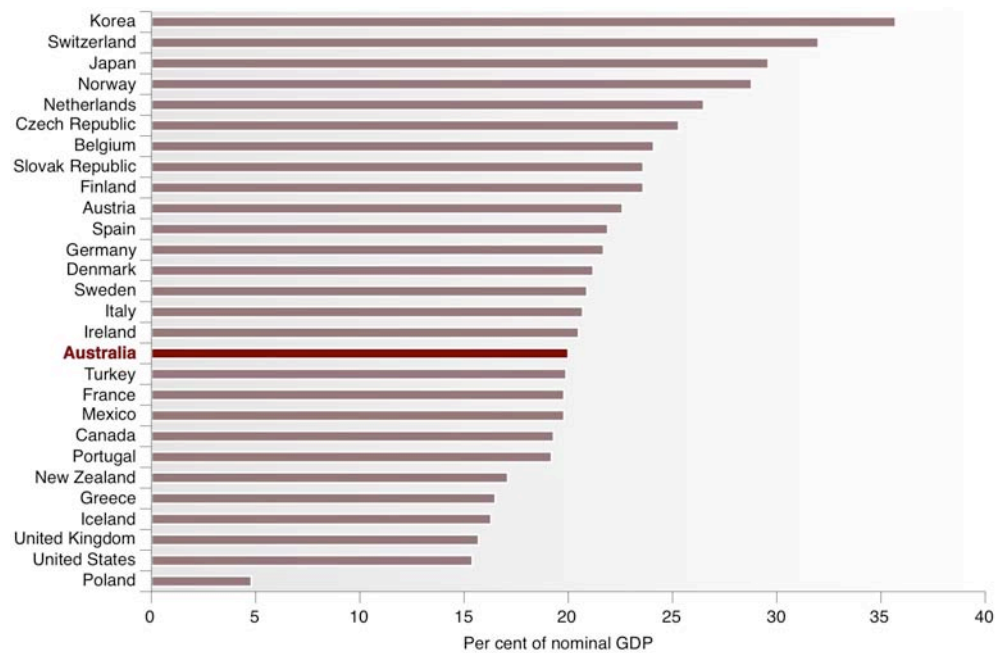
While strong against other English speaking countries, Australia's gross national saving rate is nevertheless below the average of OECD countries in general over the same period, despite the fact that we have particularly strong levels of investment to fund (Figure 2.13). Australia's is ranked 17th out of 28 OECD countries, with the highest gross national saving countries being Korea (35.7 per cent), Switzerland (32.0 per cent) and Japan (29 per cent).

Korea's saving has risen rapidly in recent years from a very low level in early 1960s. This increase is largely attributed to rapid economic growth and faster growth in income (off a very low base) than in consumption, combined with changing demographics, most notably, a decline in dependency ratio (Kang 1994 p. 100; Nam and Kim 2000 pp.112).

Overall, global saving has been trending downward since the early 1970s following the first oil shock, but was then relatively stable until the late 1990s. More recently, however, saving has declined hitting historic lows in 2002 before modestly recovering in the past few years.

Figure 2.13

AVERAGE GROSS NATIONAL SAVING RATE IN OECD COUNTRIES 1987-2005



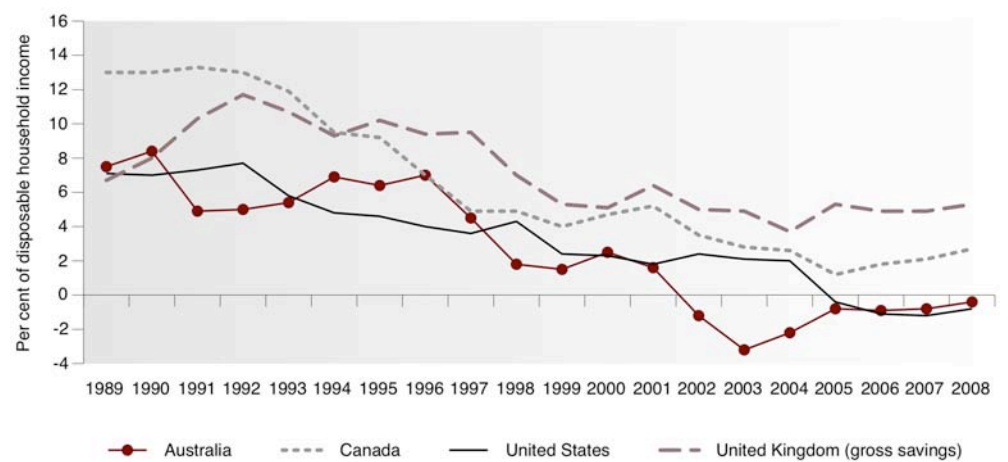
Source: OECD 2006a.

Household saving

While *government* saving in Australia, New Zealand and Canada has been strong over the past few years, the same cannot be said for *household* saving. Figure 2.14 shows household saving rates between 1989 and 2007. Household saving has declined significantly in all English speaking countries with Australia and the US having the lowest household saving rates. The UK's household saving rate has also declined over their period, although not to the same extent as Australia's.

Figure 2.14

NET HOUSEHOLD SAVING RATES IN SELECTED ENGLISH SPEAKING COUNTRIES

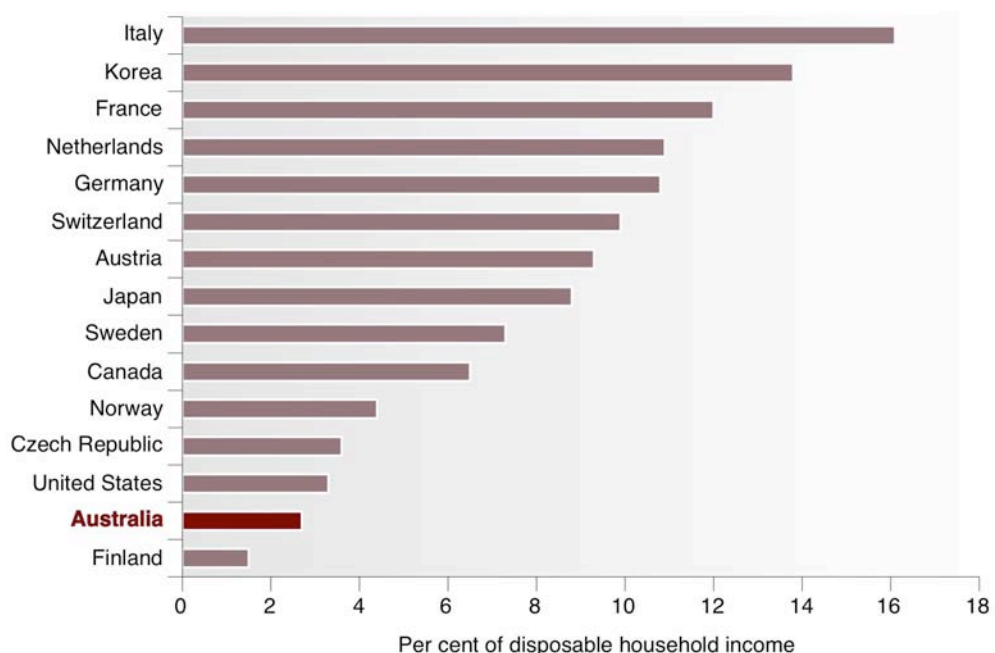


Note: Household saving rates are not provided for New Zealand. UK data shows gross household saving; net household saving is not available.

Source: OECD 2006a.

Figure 2.15 shows the *average* net household saving rate over the period 1989-2007 in all OECD countries for which data is available. Italy has the highest household saving rate (16 per cent) followed by Korea (13.8 per cent) and France (12 per cent) (OECD 2007).

Figure 2.15

AVERAGE HOUSEHOLD SAVING RATE IN OECD COUNTRIES, 1989-2006

Source: OECD 2006a.

The strength of gross national saving in countries with strong government fiscal positions, coupled with declining household saving suggests that without government saving in Australia, New Zealand and Canada, national saving rates probably would have fallen in all English speaking countries over the past 15-20 years. This suggests that there were strong disincentives for private saving in all countries over the period (Gruen 2005, p.9).

Two key related factors have contributed to the decline in household saving in English speaking countries

- financial deregulation; and
- housing booms (RBA 2005).

Deregulation of the financial sector has resulted in easier access to credit to fund additional consumption. Credit driven consumption has meant that households have channelled less money into savings than otherwise would have occurred.

One factor that is common to all English speaking countries is the housing booms over the past decade (Table 2.1). These have been driven by a number of common factors including, credible low-inflation regimes and associated low nominal and real interest rates; and a worldwide savings glut after the Asian financial crisis which drove down real interest rates.

Table 2.1

HOUSE PRICE GROWTH IN ENGLISH SPEAKING COUNTRIES 1997-2005

| Country | House price growth |
|----------------|--------------------|
| Australia | 120 per cent |
| United States | 80 per cent |
| United Kingdom | 160 per cent |
| Canada | 60 per cent |
| New Zealand | 80 per cent |

Source: Gruen 2005

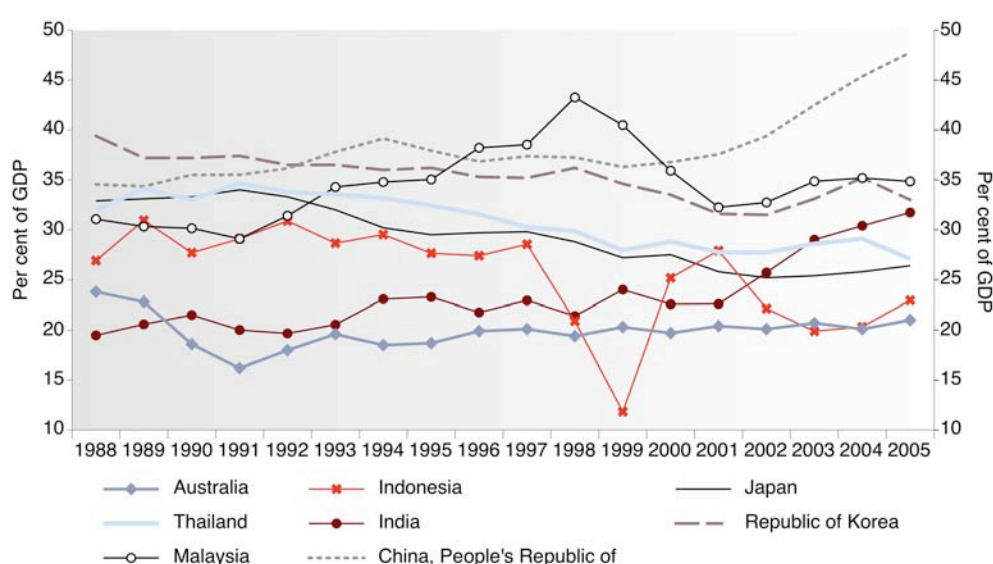
The table reinforces the point made earlier, that while soaring house prices have brought a ‘wealth effect’ stimulating consumption, these prices now appear distinctly inflated in all these countries, as do equity prices.

Trends in Asian countries

In contrast to the industrial countries, saving rates in Asian economies have caught up with and largely overtaken those of industrial countries (when measured against their own GDP; see Figure 2.16). Particularly remarkable has been the very sharp increase in saving in China, especially since 2000. India’s saving rate has also increased significantly over the past decade. Elsewhere in Asia, saving rates remain high, although they have declined since the early 1990s. Thailand’s saving rate fell substantially following the Asian financial crisis, but it moving closer to its pre-1997 rate.

Figure 2.16

GROSS NATIONAL SAVING IN ASIA (PER CENT OF GDP)



Source: OECD 2006a and Asian Development Bank 2007.

After averaging some 35 per cent of GDP during the 1990s, China's gross saving rate has increased sharply to close to 50 per cent of GDP over the past five years (see figure above). This has been accompanied by a smaller – but still substantial – rise in gross capital formation to about 45 per cent of GDP, along with a widening external current account surplus (IMF 2005, p. 96).⁷ A number of explanations may explain this trend: corporate saving has risen sharply since 2000 accompanied by a surge in investment in both state- and non-state owned firms; household saving has remained broadly constant in recent years while government saving has increased markedly, driven by higher revenues. With the exception of China and a handful of other countries, however, Asian economies have experienced a slump in investment in the aftermath of the regional financial crisis. It is estimated that investment rates in East Asia have declined by more than 10 percentage points of GDP since their peak in the mid-1990s and have not rebounded despite a sharp increase in public investment (IMF 2005, p. 94).

In short, while Australia's gross saving rate compares favourably with those of other English speaking countries, but not so well with OECD countries in general – or with the fast growing Asian economies. Australia's major saving issue, as in other English speaking countries (notably the US) is low household saving – negative on a net-basis, but with some comfort to be taken from

- rising net worth, albeit valued at apparently inflated prices; and
- increased spending on some items defined as consumption but which have a degree of investment character (e.g. education).

⁷ Analysis of both saving and investment in China is hampered by a variety of data limitations (IMF 2005, p. 96).

Chapter 3

Patterns of household saving, assets and debt

This chapter discusses trends in household saving in the context of the household balance sheet. It examines where we invest our savings and the distribution of savings and wealth across households.

Key Points

- While household net worth has been increasing, this is largely due to our willingness to take on debt. Throughout the 1980s, the average Australian household owed less than \$50 in debt for every \$100 in income. Over the past 15 years, that figure has more than tripled to almost \$160 in debt for every \$100 of income.
- Australians invest heavily in their homes. In 2006, residential real estate represented 57 per cent of households' total assets. Financial assets accounted for 39 per cent, with a majority of this invested in superannuation and life insurance predominantly, of course, the former. The pre-eminence of superannuation as the preferred financial vehicle for household savings is the product of a series of reforms by the Australian Government.
- The strong growth in household debt, together with higher interest rates, has resulted in the ratio of household interest payments to disposable income reaching historically high levels. Overall, however, households continue to benefit from the strong economy, and there at this stage are few signs that families are struggling to meet their debt-servicing obligations. But there seem to be pockets of difficulty, and there remains a risk of that the level of debt borne by households might not be sustainable in less prosperous times and could, indeed, amplify a future economic downturn.
- Moreover, to the extent that debt is not paid off before retirement, it will eat up accumulated superannuation, leaving less to fund retirement income.
- Wealth is distributed very unequally across households in Australia. In 2003-04, the least wealthy 40 per cent of households had an average net worth of \$82 000, and collectively accounted for just 7 per cent of total household net worth. At the other end of the distribution, the wealthiest 20 per cent had an average net worth of \$1.38 million, and collectively accounted for 59 per cent of total net worth.
- Australians' spending and saving behaviour is generally consistent with the 'life cycle hypothesis' that individuals prefer to smooth consumption over their lifetime. In 2003-04, baby boomer households (those headed by a person aged 45-64 years) had an average net worth of around \$630 000 — twice as much as the net worth of Generation X households (those with a head aged 25-44 years). On average, baby boomers have both higher assets and lower liabilities.
- Another important inequality in the distribution of net worth exists between women and men. In 2002, 63 cents of every dollar of Australians' savings was held by males. The gap between the sexes grows with age — among baby boomers, men control almost twice as much net worth as women. The current generation of baby boomer women approaching retirement has less than half the level of savings in superannuation than that of their male counterparts. As a result, many women will not have sufficient savings to provide for an adequate income in retirement, and they will need to draw more extensively upon the age pension.

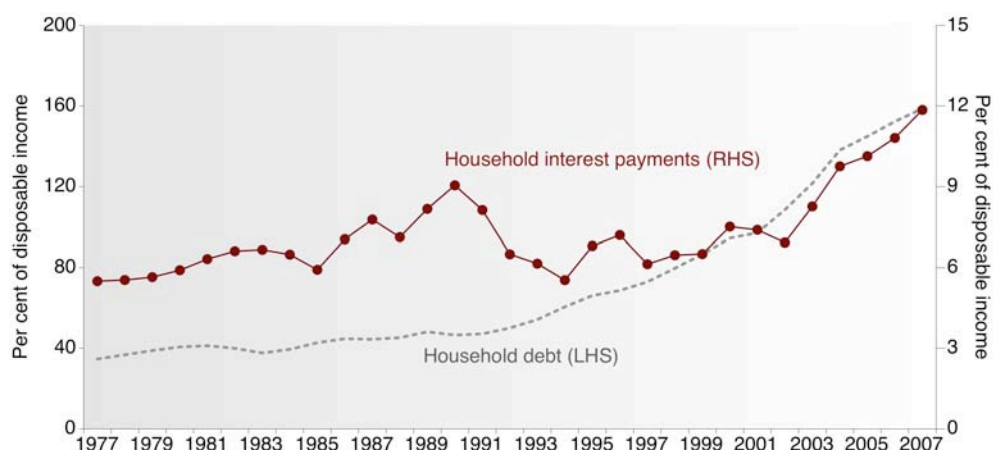
3.1 Borrowing and debt

Australia's declining household saving ratio, discussed in Chapter 2, reflects a significant change in our willingness to take on debt, particularly evident in the current decade. Throughout the 1980s, the average Australian household owed less than \$50 in debt for every \$100 in income. Over the past 15 years, that figure has tripled to almost \$160 in debt for every \$100 of income (Figure 3.1). From having one of the most conservative approaches to debt in the OECD, Australians are now among the heaviest borrowers in the world (Senate ERC 2005, p. 61; RBA 2003, pp. 3-4).

The strong growth in household debt, together with higher interest rates, has resulted in the ratio of household interest payments to disposable income reaching historically high levels of around 12 per cent in March 2007, compared to 6.5 per cent in March 2002 (Figure 3.1). The RBA (2007e, p. 14) attributes the increase in this ratio to a rise in the share of owner-occupier households with a mortgage, as well as strong growth in investor housing loans.

Figure 3.1

HOUSEHOLD DEBT AND INTEREST PAYMENTS AS PROPORTION OF HOUSEHOLD DISPOSABLE INCOME



Source: RBA 2007d, Household finances — selected ratios, Bulletin Statistical Tables, Table B21. <http://www.rba.gov.au/Statistics/Bulletin/index.html>, Accessed 10 July 2007

In line with the increase in household debt, the amount lent to persons by banks has risen dramatically, from \$100 billion in 1991 to \$700 billion in 2007 (RBA 2007a).⁸ Table 3.1 shows that in 2007, the vast majority (85 per cent) of Australians' borrowing from banks is made up of mortgages for housing. Growth in borrowing for investment in housing has been particularly strong. Fixed term loans make up a further 7 per cent, and revolving loans (which includes credit card debt and lines of credit) the remaining 8 per cent. Credit card debt has risen from \$4 billion to \$40 billion over the last 15 years (RBA 2007b).

⁸ This understates total lending as it does not include non-bank sources of finance such as credit unions and non-conforming lenders.

Table 3.1

BANK LENDING TO PERSONS BY TYPE OF LOAN, 1992–2007, \$BILLION

| | April 1992 | April 2007 | Average annual growth |
|---------------------------|--------------|--------------|-----------------------|
| Housing – owner occupiers | 63.7 | 402.9 | 13% |
| Housing – investors | 12.8 | 199.8 | 20% |
| Fixed loans | 17.3 | 45.7 | 7% |
| Credit cards | 4.4 | 39.6 | 16% |
| Other revolving loans | 5.1 | 15.0 | 7% |
| Total | 103.2 | 703.0 | 14% |

Source: RBA 2007a, Bank lending classified by sector, Bulletin Statistical Tables, Table D5. <http://www.rba.gov.au/Statistics/Bulletin/index.html>, Accessed 10 July 2007; RBA 2007b, Credit and Change Card Statistics, Bulletin Statistical Tables, Table C1. <http://www.rba.gov.au/Statistics/Bulletin/index.html>, Accessed 10 July 2007.

A number of factors have contributed to the increased preparedness of Australian households to take on debt:

- *lower interest rates and low inflation* — which allowed households to borrow more when they take out a housing loan;
- *economic prosperity* — Australia has enjoyed a sustained period of economic growth and falling unemployment, which have increased consumer confidence in the economy;
- *rising asset values* — in both equities and residential real estate, which gave many households a feeling of increased wealth (so-called ‘wealth effect’); and
- *financial deregulation* and the accompanying increase in competition, which:
 - pushed down the lending margins of financial intermediaries, causing an additional reduction in mortgage interest rates on top of the reduction provided by the fall in short-term interest rates throughout the economy;
 - have led to financial intermediaries actively chasing the housing borrower and removing many of the quasi-rationing restrictions that were formerly common (for example by providing loans to investors on the same terms as those enjoyed by owner-occupiers);
 - prompted the development of new products, such as home equity loans and mortgages with a redraw facility, which have enabled borrowers to add to their mortgage over time by accessing the equity in their homes (RBA 2003, p. 3);
- growing familiarity with the size of *superannuation balances*, perhaps encouraging people who would once have paid off virtually all debt before retiring to ‘ earmark’ some of their super to pay it off *after* retirement. Of course this leaves less to generate retirement income; and
- the progressive extension of the *social ‘safety net’*, particularly in the areas of family and retiree benefits – which, together with good economic times, would make people more confident of being able to service debt.

These factors also help to explain Australia's very low net household saving rate. Households have been able to borrow on more favourable terms, and have had sufficient confidence in the economy to borrow against the equity in their homes to fund spending on consumption goods. This has raised consumption expenditure above household disposable income, producing negative household saving (on a net basis).

The RBA (2007c, pp. 14-15) argues that while households' interest-servicing burden has risen significantly, households continue to benefit from the strong economy, and the indications are that relatively few families are struggling to meet their debt-servicing obligations. The June quarter 2007 issue of the ING Direct-Melbourne Institute Household Saving and Investment Report, however, suggests that numbers are increasing: the proportion of households falling into debt was 6.5 per cent compared with 3.8 per cent a year earlier, and the proportion dipping into savings to meet household expenses was 9.4 per cent compared to 7 per cent a year earlier. The link to low saving is also apparent: only 46 per cent of households saved outside compulsory superannuation in the quarter, appreciably down on the 55 per cent reported in the June quarter 2006.

There is a risk, moreover, that the level of debt borne by a wider group of households might not be sustainable in less prosperous times and could, indeed, amplify a future economic downturn. This is considered further in Chapter 5.

3.2 Where do we invest our savings?

Australians invest heavily in their homes. In 2006, households owned \$3110 billion of residential real estate. This represented 57 per cent of household's total assets. Households had a further \$2140 billion invested in financial assets (39 per cent of total assets), and \$238 billion in consumer durables such as motor vehicles and household equipment (4 per cent). The share of assets in residential real estate and financial assets has been relatively stable since 1998, with each rising slightly at the expense of consumer durables.

Trends in financial assets

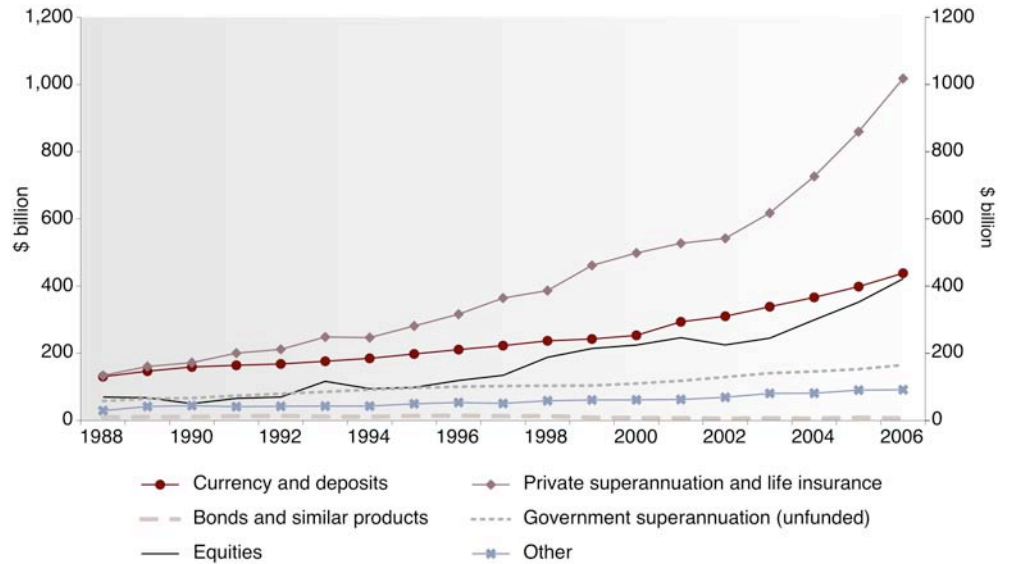
Over the past 15 years, households' saving in financial assets has become heavily directed towards superannuation. From 1988 to 2006, Australian households' holdings of financial assets increased by \$1720 billion, with an average growth rate of 9 per cent each year. This growth includes both new savings and increases in the value of the assets. Over the same period, private superannuation and life insurance grew by \$890 billion (Figure 3.2), accounting for more than half of the total growth. In addition, unfunded government superannuation grew by \$110 billion (6 per cent per annum).

Equities and bank deposits have also been growing substantially, by an average of 9 per cent and 7 per cent each year respectively since 1988. However households' holdings of bonds and similar products have fallen by a total of 25 per cent (1.4 per cent annually) since 1988. Other financial assets rose from \$37 billion to \$91 billion, an average annual increase of 5 per cent.

Overall, superannuation and life insurance now represent 55 per cent of households' financial assets, up from 42 per cent in 1988. The share of assets held in all other categories fell as a result, with the exception of equities which maintained its share of 19 per cent. Currency and deposits have a similar market share as equities, at 20 per cent. Bonds now represent just 0.3 per cent of households' total financial assets.

Figure 3.2

GROWTH IN HOUSEHOLD FINANCIAL ASSETS (\$ BILLION)



Source: ABS 2007a, *Australian National Accounts: Financial Accounts*, Catalogue No. 5232.0, Canberra, Table 15.

The breakdown of investment products for household savings shows that, other than their own home, deposits with banks and similar institutions remain the most popular form of savings (78 per cent) followed by superannuation (63.2 per cent) and direct ownership of shares (31.6 per cent) (Table 3.2).

Table 3.2

FORMS OF CURRENT HOUSEHOLD SAVINGS, JUNE 2007 (PER CENT)

| Asset type | Per cent |
|--------------------------------------|----------|
| Deposits with bank-like institutions | 78.0 |
| Managed funds | 20.4 |
| Cash management trusts | 9.7 |
| Direct ownership of shares | 31.6 |
| Bonds, debentures | n/a |
| Holiday home, investment properties | 18.3 |
| Superannuation | 63.2 |
| Other | 1.4 |
| Don't know | 1.9 |
| No savings | 4.9 |

Note: Percentages may not sum to 100 per cent as household may hold multiple assets.
Source: ING Direct-Melbourne Institute 2007, p. 5.

The rise of superannuation

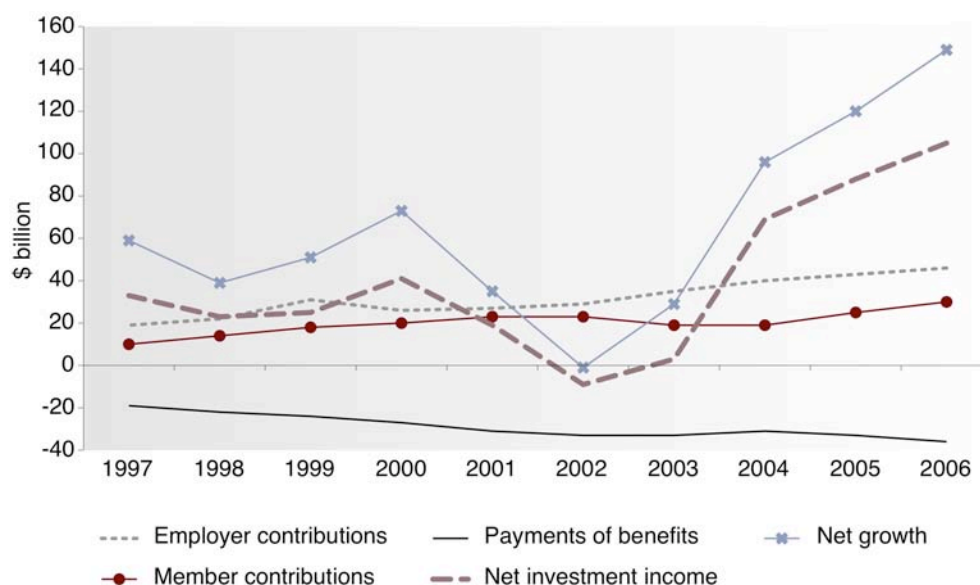
The growth in the value of superannuation is, like other financial assets, determined by three main components: new contributions (deposits), payments of benefits (withdrawals), and returns on the investment. The most variable of these components is the return on the investment. Figure 3.3 shows that over the last decade, the annual 'net investment income' to superannuation has ranged from a low of negative \$9 billion in 2002 to a peak of \$105 billion in 2006.

Both employer contributions and member contributions have grown at a steady rate of around 10 per cent each year. From 1997 to 2002, employer contributions were usually less than \$10 billion greater than member contributions. In 2003 and 2004, however, member contributions stagnated, and the gap with employer contributions became larger. Payments of benefits to members also rose steadily, at about 7 per cent annually.

The strong net growth in Australians' superannuation assets over the past decade owes more to high investment returns than contributions by employers and members. Boosted by the strong returns of the last three years, net investment income has contributed a total of \$396 billion to the growth in superannuation, more than the \$326 billion made in net contributions.⁹ Figure 3.3 illustrates that the *annual* net growth in superannuation follows the pattern of annual net investment income from year to year, but is usually about \$20 billion to \$30 billion larger.

⁹ Net contributions is defined as total contributions plus net rollovers less total benefit payments. Net growth in the value of superannuation is equal to the sum of net contributions and net investment income less operating expenses, tax expenses and other items.

Figure 3.3

ANNUAL CHANGES TO THE VALUE OF SUPERANNUATION ASSETS, 1997–2006

Source: APRA 2006, 'Annual superannuation bulletin', <http://www.apra.gov.au/Statistics/upload/June-2006-Annual-Superannuation-Bulletin.xls>, Accessed 9 July 2007, Table 7.

The pre-eminence of superannuation as the preferred financial vehicle for household savings is the product of a series of reforms by the Australian Government. Since the mid-1980s the Government has introduced several initiatives to promote private saving, primarily in superannuation:

- The first move toward this took place as part of the 1985 Accord negotiations, when it was agreed that a 3 per cent wage increase that was deemed due on productivity grounds should be paid as a superannuation benefit. The Government viewed this as part of a longer term strategy to give superannuation a central role in private saving (Edey and Gower 2000, p. 288).
- In 1991, the Government announced the 'superannuation guarantee levy' (or 'charge') — from July 1992, employers were required to provide most employees with a minimum superannuation contribution of 3 per cent of earnings. The rate increased from 3 to 9 per cent by July 2002. The superannuation guarantee led to a rapid expansion in the percentage of employees with superannuation.
- In 1997, the Government introduced a broadly based savings rebate available to people who made personal superannuation contributions, or who earned net personal income from other savings and investments. The maximum rebate available was \$225 in 1998-99 and \$450 the following year. The rebate was abolished in 2000 as part of the Government's *A New Tax System* reforms.
- In 2004, the Government introduced the superannuation co-contribution scheme, under which the Government contributes up to \$1.50 for every dollar of personal superannuation contributions made by low to middle income earners (up to \$58 000), to a maximum of \$1500 per income year.

- In 2006, choice of superannuation fund legislation was introduced to allow employees the right to choose which superannuation fund their compulsory superannuation contributions are paid into.
- In the 2006-07 budget, superannuation benefits were made tax-free for those people aged over 60. While the primary objective of this measure was to provide an incentive for workers to delay retirement until after age 60, it also had the effect of making superannuation a more attractive saving vehicle.
- In 2007, the Government announced a retrospective, one-off doubling of the government superannuation co-contribution for personal contributions made by eligible persons in 2005-06.

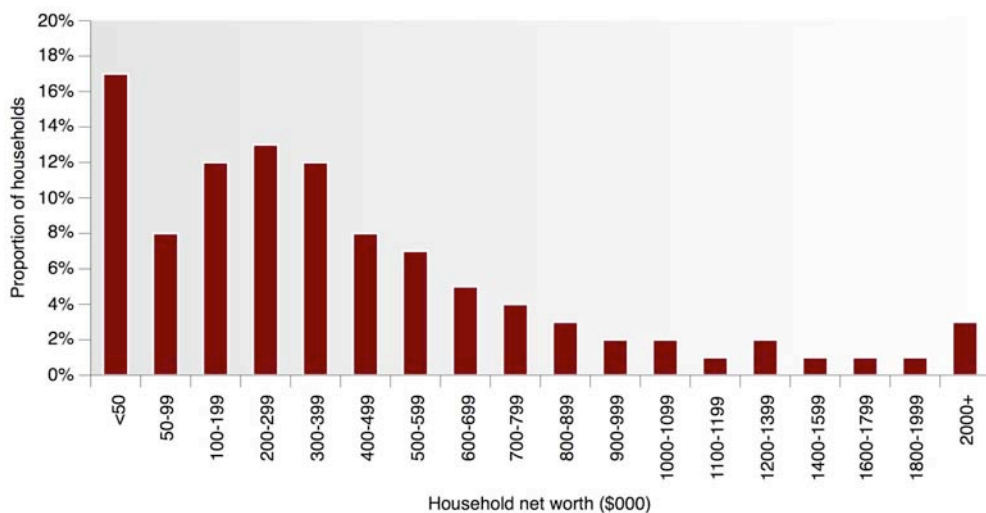
The effectiveness of the policy reforms to promote saving in superannuation, in terms of their impact on overall household saving and particularly, the adequacy of retirement income provision, will be considered in Chapter 5.

3.3 Distribution of saving and wealth

Wealth is distributed very unequally across households. A small proportion of households have high net worth and a large number have relatively low net worth (Figure 3.4). In 2003-04, the least wealthy 40 per cent of households had an average net worth of \$82 000, and collectively accounted for just 7 per cent of total household net worth. Seventeen per cent of households had net worth of less than \$50 000. At the other end of the distribution, the wealthiest 20 per cent had an average net worth of \$1.38 million, and collectively accounted for 59 per cent of total net worth (ABS 2006c, Tables 1 and 6).

Figure 3.4

DISTRIBUTION OF NET WORTH ACROSS HOUSEHOLDS, 2003-04



Note: The net worth categories are not of uniform range.

Source: ABS 2006c, *Household wealth and wealth distribution, 2003-04*, Catalogue No. 6554.0, Canberra, Table 3.

Saving across the life course

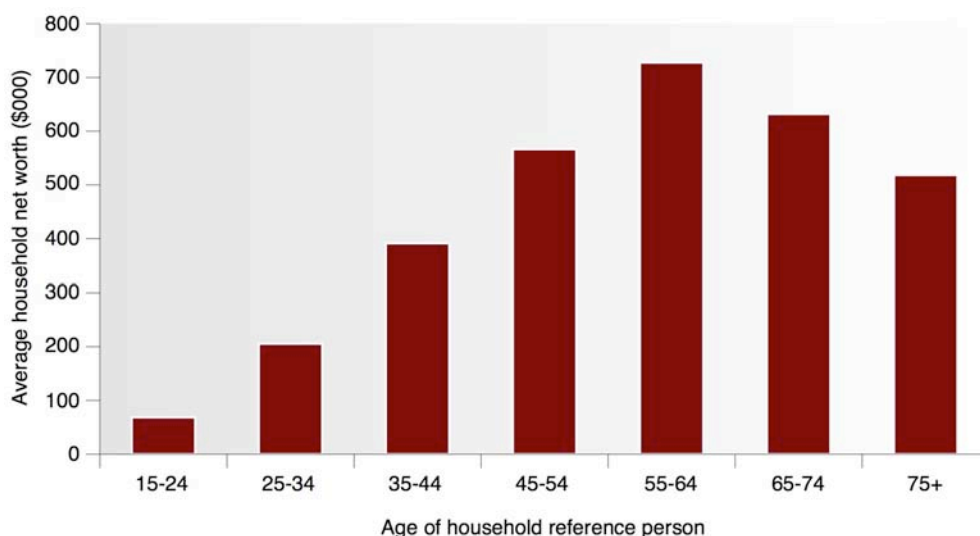
Australians' spending and saving behaviour is generally consistent with the 'life cycle hypothesis' that individuals prefer to smooth consumption over their lifetime. The hypothesis implies that saving rates will typically:

- be low early in life when income is low;
- rise as individuals move through their peak earning years; and
- decline and become negative in retirement as people draw down their accumulated assets (Kulish et al. 2006, p. 4).

The life-cycle hypothesis predicts that our net worth will grow over our working lives. This outcome can be observed in Figure 3.5, which shows the net worth of households headed by people in different age groups. In 2003-04, baby boomer households (those headed by a person aged 45-64 years) had an average net worth of around \$630 000 — twice as much as the net worth of Generation X households (those with a head aged 25-44 years).

Figure 3.5

AVERAGE NET WORTH PER HOUSEHOLD, BY AGE OF THE HOUSEHOLD REFERENCE PERSON, 2003-04



Source: ABS 2006c, Household wealth and wealth distribution, 2003-04, Catalogue No. 6554.0, Canberra, Table 20.

On average, baby boomers have both higher assets and lower liabilities. As they grow older, boomers tend to pay off their debts in the expectation of a reduced capacity to pay off debt in retirement. In 2004, Generation X households bore a total of \$239 billion of Australia's household debt, compared to \$153 billion held by baby boomers (Cassells and Harding 2007, p. 28).

Consistent with the distribution of overall net worth, baby boomers have the greatest amount saved in the value of their home and in superannuation. In 2003-04, the average baby boomer household owned \$300 000 of their home and had over \$109 000 invested in superannuation (ABS 2006c). Families headed by a person aged 35-44 years had an average of \$250 000 saved in their own home, and \$50 000 saved in superannuation. Investing in the family home is the preferred form of saving for all age groups.

Baby boomers also make the largest voluntary contributions to superannuation. Their average contribution of \$38 per week is twice as much as that contributed by Generation X. However boomers' contributions are still less than one-third of their weekly spending of recreation and entertainment (Kelly and Harding 2007, p. 13). In 2003-04, the majority of boomers who had retired in their 50s had superannuation balances of less than \$10 000 (Kelly et. al. 2004, p. 6). At the other end of the spectrum, around 20 per cent had retired with more than \$100 000 in superannuation. This is another example of the uneven distribution of wealth and saving across households. As Kelly et. al. (2004, p. 6) observed:

One small group is retiring with significant assets and continuing to enjoy a high income, while a larger group is leaving the labour force (perhaps involuntarily) with very little, if any, income or superannuation.

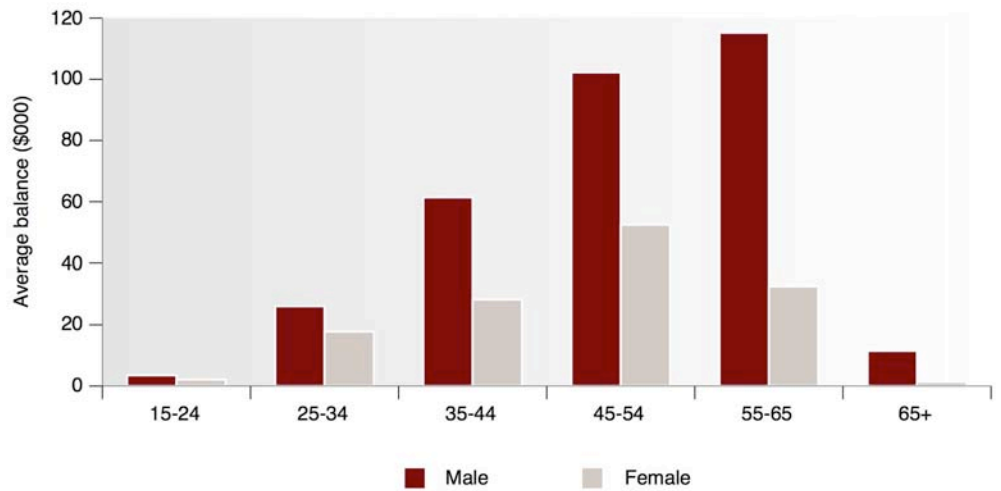
The gender gap

Another important inequality in the distribution of net worth exists between women and men. Unit record data from the Household, Income and Labour Dynamics in Australia (HILDA) survey reveal that in 2002, 63 cents of every dollar of Australians' savings was held by males (FaCSIA 2007). The gap between the sexes grows with age — among baby boomers, men control almost twice as much net worth as women. Two reasons that females save less than men are that many women take a career break for childbirth, and they are also more likely than men to work part time. These factors reduce women's disposable incomes, and lower the amount of savings that they accumulate through compulsory superannuation.

Figure 3.6 shows that the current generation of baby boomer women approaching retirement has less than half the level of savings in superannuation than that of their male counterparts. As a result, many women will not have sufficient savings to provide for an adequate income in retirement, and they will need to draw upon the pension. The adequacy of current household saving levels to fund retirement incomes is examined in more detail in Chapter 5.

Figure 3.6

AVERAGE SUPERANNUATION BALANCES, NON-RETIREES, 2002



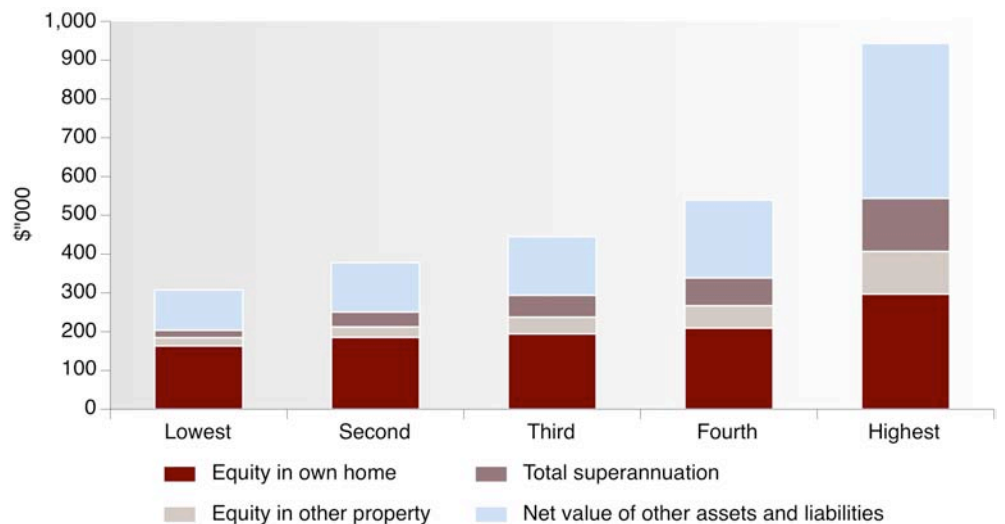
Source: FaCSIA 2007, HILDA unit record data.

Savings rise with income

It is to be expected that households with higher incomes will find it easier to save, and will therefore build greater net worth over time. Figure 3.7 shows that the net worth of households does rise with income. In particular, the average net worth of the 20 per cent of households with the highest disposable incomes is considerably higher than that of all lower-income households.

Figure 3.7

HOUSEHOLD NET WORTH, BY EQUIVALISED DISPOSABLE HOUSEHOLD INCOME, 2003-04 (\$'000)



Note: Equivalised disposable household income is disposable household income adjusted using an equivalence scale. For a lone person household it is equal to disposable household income. For a household comprising more than one person, it is an indicator of the disposable household income that would need to be received by a lone person household to enjoy the same level of economic wellbeing as the household in question.

Source: ABS 2006c, Household wealth and wealth distribution, 2003-04, Catalogue No. 6554.0, Canberra, Table 10.

Households at the lower end of the income range have about 60 per cent of their net worth invested in their own home. As income rises, the average share of net worth in home equity falls, as households direct a greater proportion of their savings into other property, shares, trusts and superannuation. However even the highest-income quintile has 45 per cent of its net worth in home equity.

Part 2

Issues, national goals and policies for saving

Chapter 4

Implications of low domestic saving for the national economy

This chapter considers the implications of low domestic saving – and hence (with current strong investment), high reliance on foreign savings. Will we be able to continue to finance sustainably the levels of investment needed to maintain growth?

Key Points

- Australia's current account deficit has widened to close to 6 per cent in recent years, and it would have been much larger were it not for the 30-year high we are enjoying in our terms of trade.
- From a saving and investment perspective, the deterioration in the current account reflects strong growth in capital investment within Australia relative to a modest level of national saving, and particularly, very low household saving.
- To finance the current account deficit, Australia relies on foreign savings mainly in the form of debt, on which we pay interest — the net income deficit, i.e. interest and dividends paid to foreigners net of those received from them, has been increasing steadily over the past two decades and is currently running at about 4 per cent of GDP. The stock of net liabilities to foreigners has also been increasing relative to GDP and is now around 60 per cent of annual GDP, although it is only about 10 per cent of our private sector wealth.
- The great bulk of the net liabilities is net debt. The vast majority of Australia's foreign liabilities are either held in Australian dollars or hedged to Australian dollars and therefore our exposure to foreign currency risks remains relatively low.
- Under current external circumstances, our heavy reliance on foreign savings may not pose significant risks. Our external deficit is clearly to a large extent the counterpart of strong investment, much of it in sectors producing commodities which are in high demand in international markets. Our terms of trade are high, our dollar is strong, and positive sentiment towards the Australian economy in financial markets is reflected in modest risk premia in the interest rates at which we can borrow.
- However, there may be significant consequences from our level of dependence on foreign savings if shocks in the international economy lead to a sharp decline in demand for our exports (and possibly, higher prices for key imports), leading to an adverse shift in sentiment and higher risk premia.
- At present and foreseeably, however, these external risks do not appear to pose significant concerns, although they should be kept in view. The issues surrounding our low saving are more domestic and intergenerational, relating to how households' future needs are to be met rather than concerning the ability to finance business capital investment, so long as we are comfortable with a significant degree of foreign ownership.

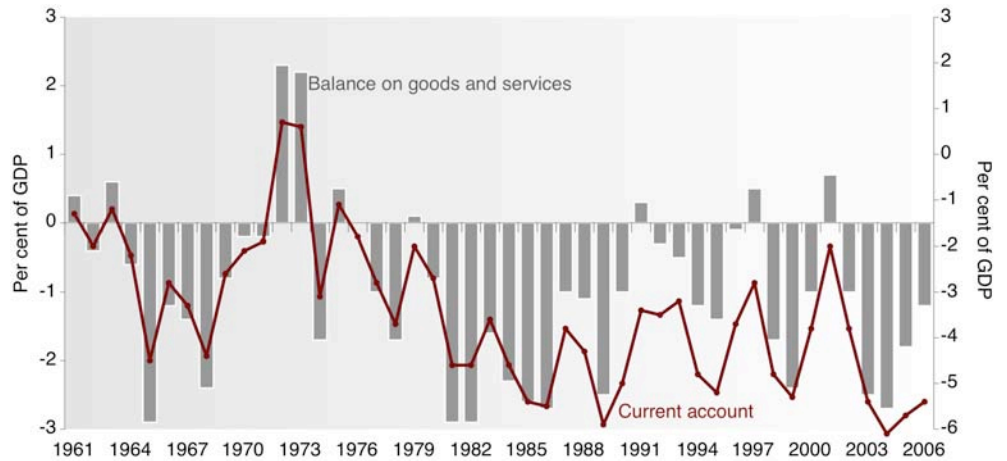
4.1 The current account deficit and foreign liabilities

Throughout the 1990s, concerns about the adequacy of saving in Australia were a very topical policy issue. The general view prevailed that saving rates in Australia were too low, with much of the concern focused on the current account deficit and the growing stock of foreign liabilities, which were seen by many as among the most important economic problems facing Australia. These views were supported by worsening assessments of Australia's credit worthiness during this period by the two main international credit rating agencies, Moody's and Standard and Poors. Hence there was a broad consensus in favour of pro-saving policies.

As Figure 4.1 shows, over the 1960s and 1970s the current account deficit averaged around 2½ per cent of GDP. Since then, it has cycled between about 1½ and 6 per cent of GDP (traditionally regarded as a ‘red line’) and averaged around 4 per cent of GDP through the 1990s until the beginning of this decade, over most of which it has been close to 6 per cent of GDP. The balance of trade in goods and services has also been in deficit for most of this time.

Figure 4.1

CURRENT ACCOUNT AND BALANCE OF TRADE (PER CENT OF GDP)

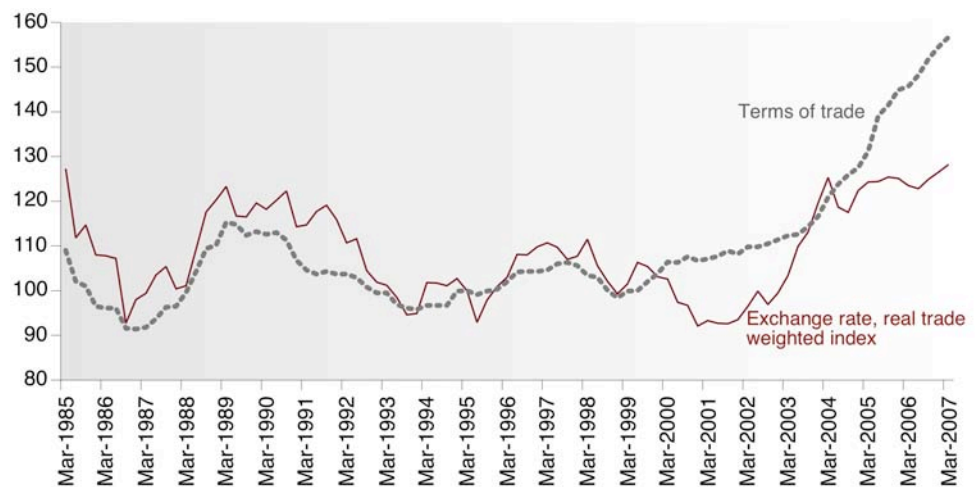


Source: ABS 2007d.

The current account deficit would have been much higher in recent years were it not for the 30-year high in the terms of trade associated with the global boom in mineral commodities, which are of course a major component of Australia’s exports (Figure 4.2).

Figure 4.2

REAL EXCHANGE RATE AND THE TERMS OF TRADE (MARCH 1995=100)



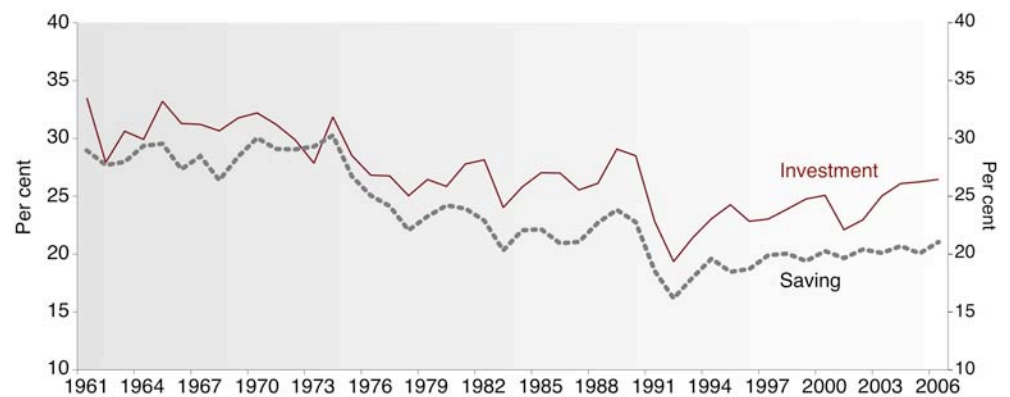
Source: .RBA 2007g

From a saving and investment perspective, the deterioration in the current account is to a large degree the counterpart of strong capital investment within Australia relative to national saving (Figure 4.3). Since 2000, investment on a gross basis has been increasing as a share of GDP and is now around 26 per cent of GDP. In dollar terms, gross national investment exceeded gross national saving by about \$52 billion in 2006.

Gross national saving has remained broadly stable at around 21 per cent of GDP or \$203 billion in 2006. This was in large part because of the strong fiscal position of the government sector and healthy levels of retained profits in the corporate sector (as discussed in Chapter 2).

Figure 4.3

AUSTRALIAN GROSS NATIONAL SAVING AND INVESTMENT

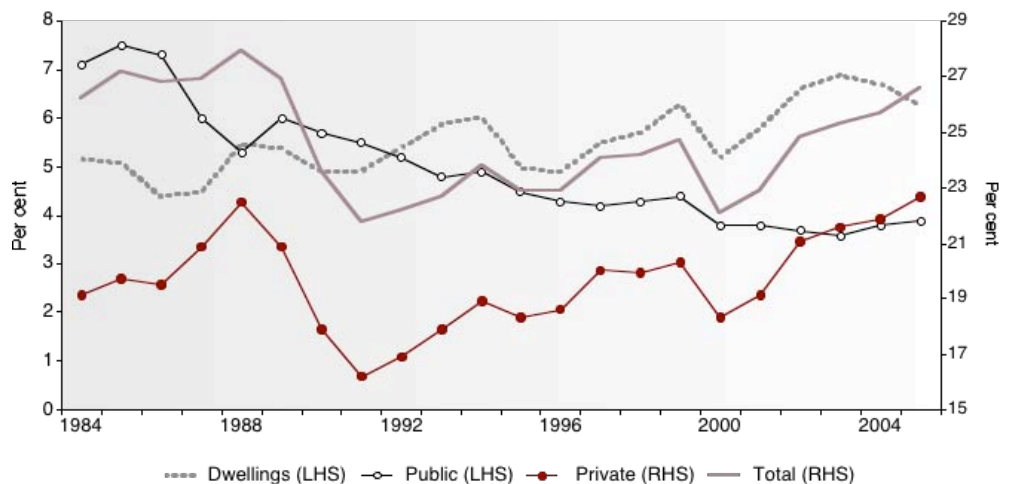


Source: ABS 2006a.

Strong investment over this decade was initially contributed to by strong dwelling investment, but as the decade has proceeded, business investment has been increasingly strong (Figure 4.4). Within that picture, investment in the resource sector has been exceptionally strong.

Figure 4.4

GROSS INVESTMENT (PER CENT OF GDP)



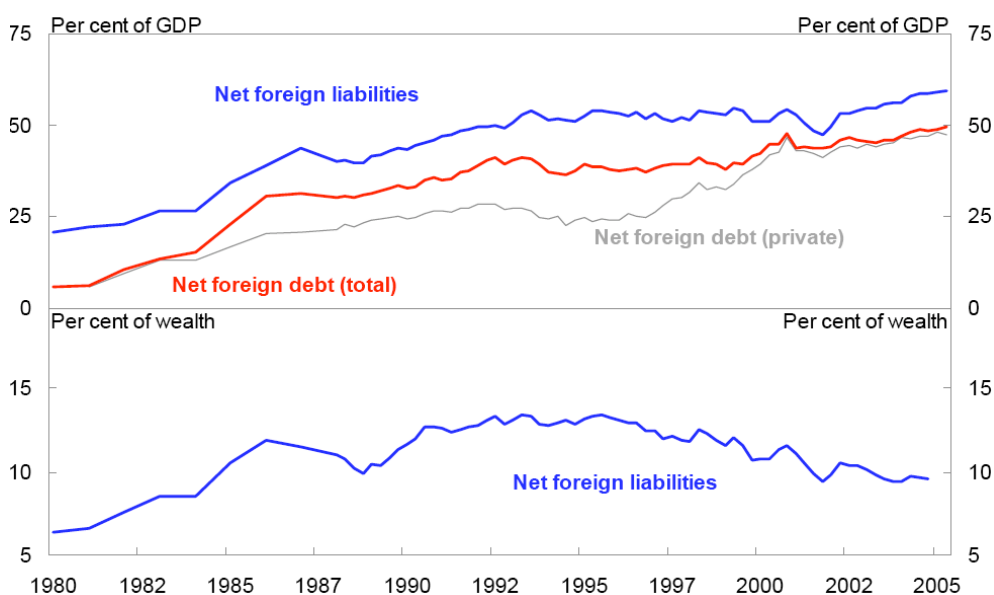
Source: ABS 2006a.

The gap between the balance of trade and the current account deficit is the net income deficit, which is the net outflow of payments on Australia's stock of net foreign liabilities. The net income deficit has been increasing continuously over the past two decades and is currently running at about 4 per cent of GDP. The *stock of net foreign liabilities* has also been increasing and is now around 60 per cent of annual GDP (Top panel of Figure 4.5).

Australia's exposure to foreign currency risks remains relatively low despite the growth in Australia's foreign liabilities. In 2005, RBA and ABS survey found that about 95 per cent of Australian external liabilities were either in Australian dollars or hedged to Australian dollars (RBA 2005a). In other words, only about 5 per cent of Australia's external liabilities involve foreign currency exposure.

An alternative way to present foreign liabilities is as a proportion of private sector wealth (as presented in the lower panel of Figure 4.5). Net foreign liabilities as a proportion of private sector wealth rose steadily over the 1980s and up to the mid 1990s, but the ratio has declined in recent years to 10 per cent of wealth. This is due to Australian private sector wealth increasing as a result of factors such as higher house prices and prices of corporate equities.

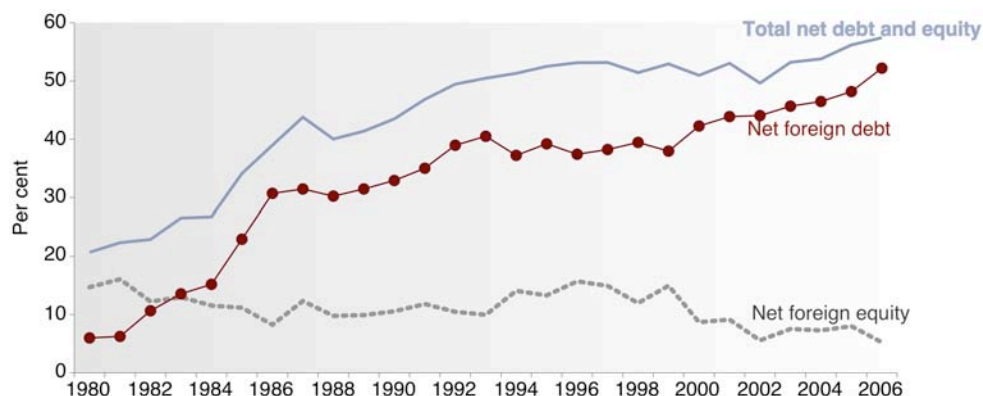
Figure 4.5

NET FOREIGN LIABILITIES

Source: D. Gruen 2005, *Perspectives on Australia's Current Account Deficit*, Keynote address to the Australian Business Economists Forecasting Conference, 13 December.

The composition of foreign investment has also changed over this period. As noted above, most of the inflow of foreign capital into Australia is in the form of debt rather than equity investment (Figure 4.6). In the early 1980s, by contrast, 29 per cent of foreign investment in Australia was in the form of debt, while the remaining 71 per cent was in the form of equity investment in Australian companies. By June 2006, the composition of foreign investment had reversed such that the great bulk (83 per cent) was in the form of debt and only a small share (17 per cent) was in the form of equity investment.

Figure 4.6

FOREIGN INVESTMENT IN AUSTRALIA (PER CENT OF GDP)

Source: ABS 2007d.

4.2 The costs and risks of foreign debt

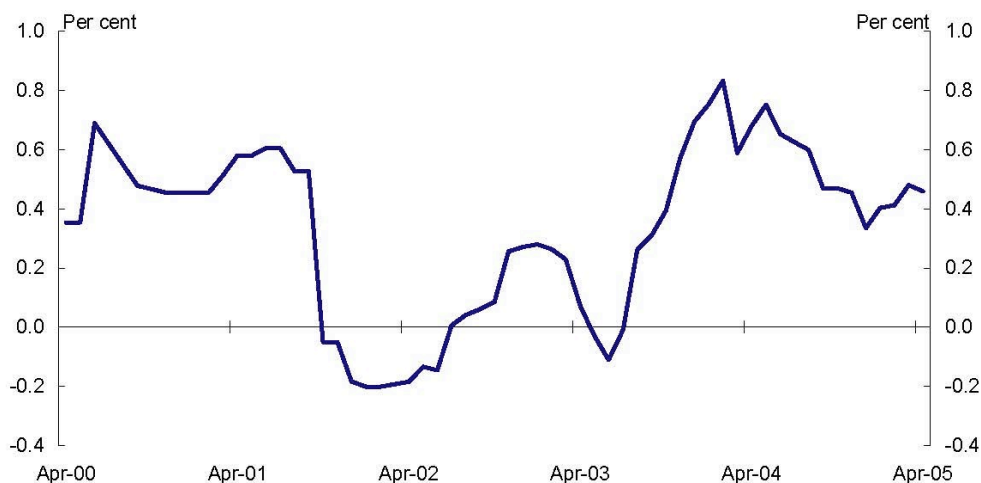
Given the high reliance on foreign savings for investment in Australia, the question that is often asked is: Do the current account deficit and the net income deficit pose financial costs and risks to the Australian economy, both *now* and in the *future*?

One perspective holds that the current account deficit *per se* should not be a concern of policymakers. Instead, the issue should be whether the underlying saving and investment decisions are appropriate in their own terms. This would suggest that running a current account deficit would not pose significant capital risks or that the welfare consequences may not be significant.

One way of looking at this is whether Australia's cost of borrowing internationally may be higher than would be the case if more domestic funds were available. A comparison of the real long-term interest differentials for major sources of foreign investment, such as the United States, can be used as an indicator of the welfare costs of accessing foreign debt rather than our own savings.

Real long-term interest differentials between AAA-rated firms in Australia and the US have been small over the last five years suggesting that the risk premium in the cost of Australian borrowing from foreign lenders has not been high (Figure 4.7). While on average Australian firms do pay an interest rate premium, it has averaged only about 0.4 per cent per annum over the past five years (Gruen and Sayegh, 2005). This reflects the fact that our external deficit can be seen to be, in large part, the counterpart of strong investment in areas that will earn revenues in international markets, particularly those for commodities where demand looks set to remain very strong. Our terms of trade are at historic highs, our dollar is strong and accordingly, financial market sentiment towards Australia is very positive: hence the low risk premia.

Figure 4.7

DIFFERENCE BETWEEN AUSTRALIAN AND US FIRMS' BORROWING COSTS IN THE US CAPITAL MARKET

Source: Gruen and Sayegh, 2005, p.18.

None of this suggests that Australia's current account deficit should be treated as a non-issue. The impressive performance of Australia's economy since climbing out of the 1990s recession has been enabled by the public sector's fiscal consolidation and private sector spending, saving and investment decisions – together, of course, with an extremely favourable external environment. Confidence in the Australian economy in international capital markets has followed, resulting in Australians being able to borrow internationally on good terms.

However, a relatively high current account deficit, particularly when combined with a high stock of external liabilities, does create a degree of vulnerability to external shocks. For example, a major setback to China's growth (which of course does not appear likely at present) and a consequent sharp decline in demand for our commodity exports could lead to an adverse shift in foreign investor sentiment and increased risk premia in the interest rates at which we borrow, as well as dearer imports as our dollar falls.

Even if individual borrowing decisions by the private sector are appropriate, the aggregate risk from external borrowing may be larger than the sum of the risks perceived by individual borrowers. For instance, contagion effects may arise because foreign lenders may view Australia as a whole and not differentiate sufficiently between different borrowers.

At present, however, and foreseeably, such external risks do not appear imminent and are not – in the context of considering the adequacy of our domestic saving – of major concern. Rather the issues posed by our low saving are domestic and intergenerational, and focused on households. There are not at present significant concerns about the ability to finance high levels of business investment in Australia, so long as we are comfortable with a significant degree of foreign ownership.

Chapter 5

Do households save too little?

This chapter assesses the impact of the low household saving rate, focusing on the ageing of the population and the adequacy of retirement income provision.

Key points

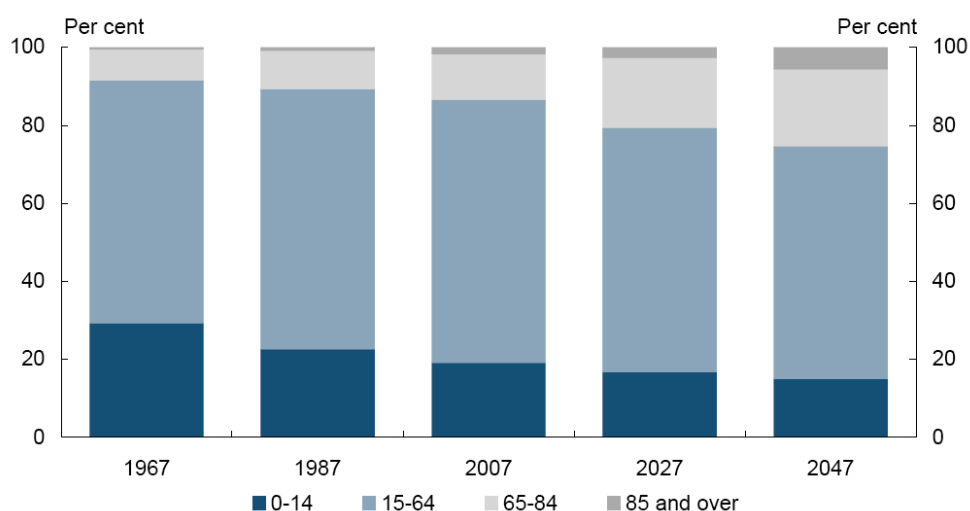
- In Australia, the major policy initiative to raise saving for retirement has been the introduction of the Superannuation Guarantee with household assets into superannuation increasing significantly to around 114 per cent of annual GDP.
- Empirical evidence estimates that the Superannuation Guarantee may have increased the household saving rate by up to 1.5-2 per cent of GDP in 2001-02. That is, government policies encouraging superannuation have added to both household saving and wealth, albeit that they appear to have been 'swimming against the tide' of other strong factors reducing saving, and disposing people to incur debt.
- The more basic concern posed by the current low saving rate is whether households are providing *adequately* for their retirement. Studies vary on the extent of under-provision, but even a recent Access Economics study taking into account strong capital gains on household assets shows that one-third of the workforce (3.5 million Australians) will not have adequate incomes in retirement. This is the case even though compulsory contributions via the Superannuation Guarantee and other policies have made a significant difference.
- Moreover, to the extent that households leave debt to be paid off after retirement, it will reduce their superannuation available to fund income. Consequently, there may be a 'retirement savings gap' as people reach retirement with some estimates suggesting that this gap could be as high as \$823 billion in 2003-04.
- While in aggregate there appears to be a 'retirement savings gap', several groups within the community face greater challenges with self-provision of retirement incomes. These groups include women, the current cohort of retirees (or those close to retiring), people under the age of 40 (who have a higher propensity to consume out of current income compared with past generations) and self-employed individuals (who would typically invest much of their capital in their businesses until late in life when they expect sales of the business to fund their retirement).
- Longevity has been increasing in Australia, in recent decades mainly due to reduced mortality from chronic diseases in middle and older age. Longevity and years in retirement are projected to continue to increase. Given that many people are failing to provide adequately for retirement income now, the implication is that without changed behaviour, retirement savings gaps may grow.
- Given the extent of under-provision for retirement, a significant number of people will be reliant on a full or part age pension over the next forty years. The Australian Government has projected long-term fiscal implications of ageing with spending expected to rise (due to ageing) by around 4.75 per cent of GDP by 2046-47.
- Without any policy or expenditure changes, this will require an increase in taxes to fund the future fiscal burden. This will place an uneven burden on future taxpayers to support a larger aged population as well as impeding the performance of the wider economy.
- While policy measures, such as the Government's Future Fund, go some way to alleviate the burden placed on future generations via expenditures from public budgets, is restricted to funding government employee superannuation and it does not pre-fund the far greater future obligations to age pensioners or other age-related expenses e.g. for health and aged care
- However, given a public policy interest in raising people's retirement living standards well beyond 'safety net' levels, policies that aim to support greater private saving for retirement purposes represent the primary policy approach.

5.1 Population ageing and household saving

Chapter 2 and 3 showed that saving rates in Australia have been in long-term decline, with falling household saving being associated with an increasing household appetite for debt. One explanation for this may be that Australia is currently in the midst of a significant long-term ageing of the population structure, and that with people running down savings late in life, the aggregate saving rate may fall as a result of population ageing itself. Figure 5.1 highlights the projected population for selected age ranges over the next four decades, with the period of most rapid population ageing in Australia projected to occur between 2007 and 2027. A summary statistic of these trends is that the number of persons of working age per person of retirement age in Australia will decline from 5 people at present to only 2.4 people in 2047 (Treasury 2007, p. 17).

Figure 5.1

PROPORTION OF THE AUSTRALIAN POPULATION IN DIFFERENT AGE GROUPS



Source: Australian Government Treasury 2007, *Intergenerational Report 2007*, Commonwealth of Australia, April, p. 16.

The ageing of the population thus raises the question: ‘Will the aggregate household saving rate decline as the population gets older?’ Such predictions of a saving rate decline are usually based on the life-cycle consumption and saving model which predicts that net worth grows over our working lives, and then gradually liquidated in order for us to consume after we retire. Consequently, the aggregation of individual, cohort-specific life-cycle savings profiles may lead to a decrease of national saving rates in an ageing population.

Formal evidence to link age structures to saving in an Australian context is scarce. There are, however, a few studies that suggest that the household saving level is, at the least, unlikely to increase as the larger number of people in the baby boomer generation retires. Connolly and Kohler (2004) find that a demographic variable has no significant impact on the household saving rate in Australia between 1966-67 and 2001-02. Harris, Loundes and Webster (2002) found that a low saving rate appears not to be associated with retirement status — with the youngest and oldest age groups being proportionately represented in the categories of ‘running into debt’, ‘drawing on savings’, and ‘no net saving’. De Brouwer (1999) finds that the Australian consumption function is unaffected by the inclusion of an elderly dependency ratio.

5.2 Household saving and superannuation

The fact is, however, that household saving in Australia has declined dramatically, and therefore a more basic issue is whether, at the *micro* level, household saving is sub-optimal – due to either distortions or problems with individual time preference.

The literature on household saving decisions offers some cause for concern that an under-saving bias may be an important feature of household behaviour. Theorists argue that people choose immediate pleasures and want ‘instant gratification’ instead of waiting for larger rewards. Consumers often display a high degree of impatience and shortsightedness when making decisions about the future. One example is of a person who tends to splurge today and vow to exercise/diet/save tomorrow (Laibson 2005). This sort of attitude induces consumers to follow a path of least resistance, and is therefore argued to create a general bias towards under-saving relative to the optimum.

These theoretical results seem consistent with survey evidence suggesting that households tend to hold illiquid assets (especially houses) and also frequently borrow with credit cards that involve relatively high interest rates (Laibson, Repetto and Tobacman 2003). It also helps to explain why people fail to plan rationally for retirement and/or systematically under-estimate how much saving will be needed to achieve their aspirations. For example, studies in the United States show that of the employees who receive employer-matching contributions in their 401(k) plan, half of the employees contribute below the match threshold, forgoing match payments that average 1.3 per cent of their annual pay (Choi, Laibson and Madrian 2005). Even providing the under-savers with specific information about the ‘free lunch’ had little impact.

The RBA’s overall assessment of the household sector, in the context of its increased propensity to spend to and incur debt to do so, is that, in aggregate, the sector is coping well with the higher levels of debt and interest servicing (RBA 2007c, pp. 16-17). However, there are some limited pockets where financial stress is evident. Areas such as western Sydney are identified as places where households have been adversely affected by the fall in residential property prices, with a disproportionate number of households in this area taking out loans with high loan-to-valuation and debt-servicing ratios near the peak of the house price boom. The Australian Prudential Regulation Authority also concludes that authorised deposit-taking institutions have willing to move out the risk spectrum by loosening their credit standards on households (Laker 2007).

Nevertheless, as noted earlier, heavily indebted households are exposed to the risks of forecast ‘belt-tightening’ and possible loss of home ownership should interest rates and unemployment rise significantly. There is some evidence to suggest that an increasing number of financially distressed households have applied for a withdrawal of cash from their superannuation accounts. The amount released for this purpose increased from \$70 million in 2005 to \$135 million in 2006, with the total being \$32 million in 2001 (Sydney Morning Herald 2007). Almost 14 000 claims for early withdrawal of super due to financial hardship were approved nationally last year, 120 per cent more than in 2001.

The increased household appetite for debt suggest that policies to promote saving are not fully achieving the desired results (or at least their effects are being attenuated by other factors, including the ‘wealth effect’). In Australia, the major policy initiative to raise saving for retirement has been the introduction of the Superannuation Guarantee, as a major part of a three-pillared approach to retirement income policy (summarised in Box 5.1).

Box 5.1

AUSTRALIA’S RETIREMENT INCOME SYSTEM

Australia’s retirement income system is based on:

- a taxpayer funded means-tested age pension for people who are unable to fully support themselves in retirement;
- a minimum level of compulsory employer superannuation contributions made in respect of those in the workforce; and
- voluntary private superannuation and other savings.

The age pension has been the cornerstone of Australia’s retirement income system since 1909. The age pension provides a modest retirement for those people who are unable to fully support themselves. It is not designed to provide a replacement for income achieved over a working life. The age pension will continue to support living standards for the majority of people in retirement.

The maximum single rate age pension is currently \$11,772 per year (\$19,656 for a couple). The actual amount a person receives depends on their other income and assets. The means test underpins the sustainability of the age pension. Under the means test, people who have significant resources must draw on them before calling on the community for assistance through the age pension. These arrangements maintain an equitable, affordable and sustainable age pension.

The Government has legislated to set the maximum single rate age pension to at least 25 per cent of Male Total Average Weekly Earnings, with proportional increases to the partnered pension rate. This guarantees pensioners will continue to share in improvements in general community living standards, as measured by wages.

Compulsory employer superannuation contributions comprise the second pillar of the retirement income system. The Superannuation Guarantee was introduced in 1992 and the ten-year phase in of the Superannuation Guarantee minimum contribution rate was completed on 1 July 2002 with the rate now at 9 per cent.

The Superannuation Guarantee directs some of an employee’s current remuneration into improving their standard of living in retirement. The current rate of 9 per cent provides a balance between employees forgoing current consumption for increases in living standards after retirement. On this basis the Government is not inclined to increase the rate.

The Government believes that individuals should be able to choose whether they wish to make additional savings over and above the Superannuation Guarantee. The Government supports this approach by providing tax concessions for voluntary saving both within and outside of superannuation. This constitutes the third pillar of the retirement income system. Around 27 per cent of employees already receive employer contributions (including salary sacrifice) greater than the Superannuation Guarantee level, while 20 per cent of all employees make voluntary post-tax contributions.

Source: Treasury 2004.

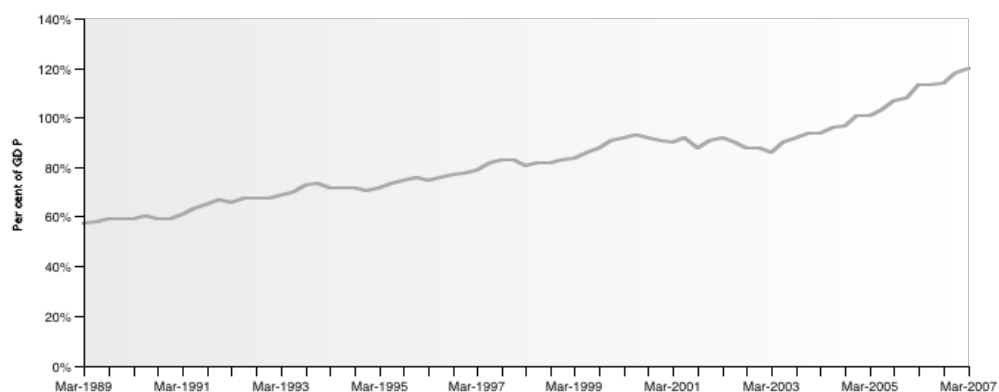
Given the importance that the Superannuation Guarantee has come to play in retirement income policy, it is obviously very relevant to consider the impact that this has had on household saving behaviour.

Compulsory superannuation has certainly had a significant impact on *employee coverage*. Prior to the introduction of compulsory superannuation, around 30 per cent of private sector employees and two-thirds of public sector employees were receiving employer-funded superannuation benefits (Edey and Gower 2000, p. 293). These proportions have now risen, with latest estimates showing that 98 per cent of employees with leave entitlements ('permanent' employees) and 72 per cent of casual employees are covered by superannuation (Treasury 2004, p. 2).

Not surprisingly, households' superannuation assets as a proportion of GDP almost quadrupled in Australia over the past 20 years (Figure 5.2). Estimates suggest that one-third of the rise in household superannuation assets is related to market movements and valuation effects (Connolly and Kohler 2004, p. 3). However, household financial flows into superannuation have also contributed significantly to the increase. Prior to the Superannuation Guarantee, household assets in superannuation comprised around 62 per cent of GDP, with the net flow into superannuation being around 3.3 per cent of GDP every year. Household assets in superannuation now comprise around 114 per cent of GDP.

Figure 5.2

HOUSEHOLD ASSETS IN SUPERANNUATION (PER CENT OF GDP)



Source: ABS 2007a and 2007e.

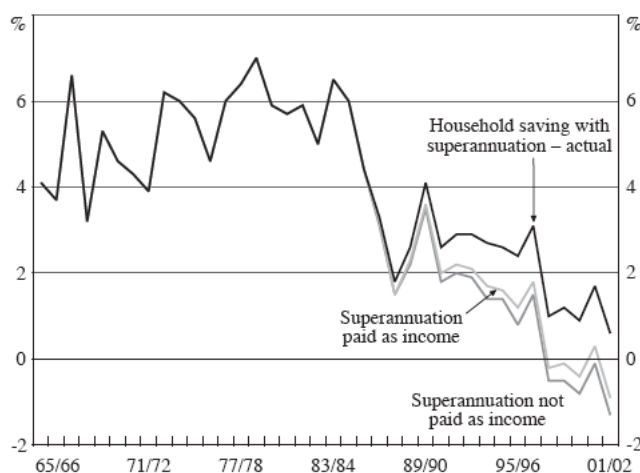
Whether higher flows into superannuation assets have contributed to or detracted from household saving on a net basis (i.e. whether they have been substantially offset by reductions in other saving and/or incurrence of debt to finance consumption) is more difficult to establish. At first glance, it would not appear to be the case, as household saving has declined at the same time as superannuation assets have increased. However, the reduction in household saving may have been influenced by other factors, including general economic conditions, financial deregulation during the 1980s, and other motives that may impact on household saving.

Connolly and Kohler (2004) modelled the impact that superannuation had on household saving between 1966-67 and 2001-02. The study found that only part of compulsory superannuation contributions have been offset by reductions in other saving. The offset was estimated to be around 38 cents in each dollar in superannuation contributions, that is, 62 cents in the dollar is saved additionally. This estimate is in line with other Australian studies.¹⁰ The study also estimated the contributions to voluntary superannuation have roughly been offset by a decrease in other voluntary saving (an offset factor of 130 cents).

The study also estimated the counterfactual saving rate, that is, what the household saving rate would have been in the absence of compulsory superannuation and voluntary superannuation (depicted in Figure 5.3). The analysis shows that compulsory superannuation may have increased the household saving rate by up to 1.5-2 per cent of GDP in 2001-02. That is, government policies encouraging superannuation have added to both household saving and wealth, albeit that they appear to have been ‘swimming against the tide’ of other strong factors reducing saving, and disposing people to incur debt. As suggested earlier, moreover, debt that remains after retirement will effectively reduce superannuation available to fund income.

Figure 5.3

EFFECT OF COMPULSORY SUPERANNUATION ON HOUSEHOLD SAVING — SCENARIO ANALYSIS (PER CENT OF GDP)



Note: ‘Superannuation paid as income’ refers to employers’ superannuation contributions made in lieu of wage rises.

Source: Connolly and Kohler 2004, p. 24.

5.3 Retirement income adequacy

While compulsory superannuation has apparently contributed to increasing the household saving rate, the question remains whether saving levels are ‘adequate’ to fund both the current and future generation’s retirement. The notion of retirement income adequacy has been debated at great length in Australia (for example, Senate Select Committee on Superannuation 2002).

¹⁰ Most estimates of the compulsory superannuation offset in Australia have relied on judgement or extrapolation from the experiences of other countries, with estimates between 30 and 50 cents per dollar (summarised in Connolly and Kohler 2004, pp. 16-17).

The common perception is that Australians, in general, have not saved enough for their retirement and that the current level of compulsory superannuation guarantee contributions will produce an inadequate level of benefits to fund the retirement of current and future generations. This is not surprising — attitudinal studies show that four in ten feel that their current savings will provide the income they want in retirement, but only three in ten are in fact likely to achieve the income they require in retirement (ANOP 2004, p. 5). Moreover, among retirees (under 70 years of age), only one in three considered that their retirement savings met their expectations, such that ‘the reality of retirement is clearly not as rosy as the expectations of it, and the main reasons are financial one’s (ANOP 2004, p. 2).

There are several issues that underlie this conclusion. Opinion is divided on how to measure the adequacy of retirement income, as it depends on the method of defining the method used, either:

- the replacement rate – the post-retirement income expressed as a percentage of a person’s pre-retirement income;¹¹ or
- a budgetary standard – measuring a person’s post-retirement income against what it may cost to live.

Estimates suggest that the level of savings, for today’s working population, falls far short of the savings required for an adequate income in retirement. Work commissioned by Investment and Financial Services Association (IFSA) estimated that the ‘retirement savings gap’ was approximately \$823 billion in 2003-04 (Rice 2005, p. 3).¹² As Rice notes, ‘It is important to note that this amount is not a lump sum that is required immediately, but an amount that would need to be funded over the expected term to retirement of the current workforce’ (Rice 2005, p. 28).

As noted in Box 5.1, most of the current working population will not be dependent solely on their superannuation and other saving, and will, most likely, receive a part age pension. The Australian Treasury estimates that the number of people receiving a full rate pension will fall, however. Currently, around 54 per cent of people of age pension age currently receive a full rate pension; another 28 per cent receive a part-rate pension; and 18 per cent do not receive a pension. By 2050, only one third of people of age pension age are expected to receive a full rate pension, 40 per cent to receive a part-rate pension; and 25 per cent not to receive a pension at all (Treasury 2004, p. 2).

Consequently, the ‘retirement saving gap’ on the estimates by Rice quoted above, may narrow to \$452 billion as a result of government expenditure and access to the age pension (Rice 2005, p. 3). The estimated composition of the retirement savings gap, before and after receipt of the age pension, by gender cohort, is summarised in Table 5.1.

¹¹ Under the replacement approach, there appears to be a high degree of consensus that a desirable net retirement saving target for a person on average earnings is a replacement rate of 70-80 per cent of pre-retirement expenditure (equivalent to approximately 60-65 per cent of gross pre-retirement income). However, it may be appropriate for targeting a higher replacement rate for people earning less than average weekly earnings and a lower replacement rate for those on higher incomes.

¹² These estimates are based on a target of 62.5 per cent of pre-retirement income. In recent times, it appears that the ‘gap’ has narrowed mainly due to government policy incentives to encourage savings including the removal of the superannuation surcharge, the introduction of the co-contribution scheme, consolidation of the superannuation industry (leading to lower fees and smaller erosion of retirement savings) and personal tax cuts.

Table 5.1

RETIREMENT SAVINGS GAP (\$ BILLION)

| | Males | Females | Total |
|--------------------|-------|---------|-------|
| Before Age Pension | 347 | 476 | 823 |
| After Age Pension | 237 | 216 | 452 |

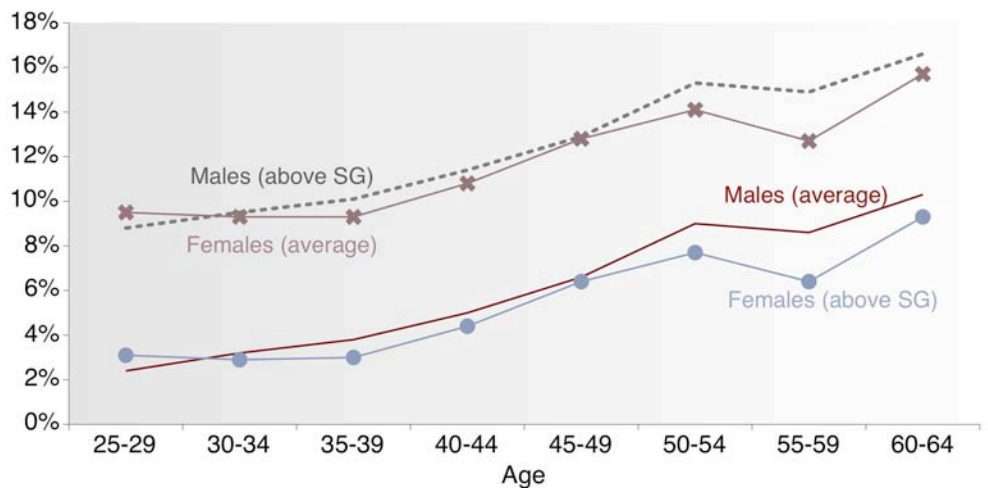
Source: Rice 2005, p.28.

Given the smaller pool of current savings held in superannuation by women (discussed in Chapter 3), it is not surprising then that there is a larger retirement savings gap for women. The lower average income earned and the longer life expectancy of women also contributes to the larger retirement savings gap (Rice 2005, p. 30).

In response to the inadequacy of superannuation savings, one measure proposed is to increase the superannuation guarantee contribution rate beyond 9 per cent to say 12 or 15 per cent. In order to fully fund their retirement savings gap, Rice estimates that baby boomers (those above 55 years of age) would need to contribute an additional 6.4 to 16.6 per cent of their pre-retirement income and Generation X and Y would need to contribute an additional 2.4 to 9.5 per cent of their pre-retirement income to superannuation (Rice 2005, p. 30) — see Figure 5.4. These estimates are in addition to the 9 per cent contribution made through the Superannuation Guarantee and take account of the age pension.

Figure 5.4

REQUIRED ADDITIONAL CONTRIBUTION — AFTER AGE PENSION (PER CENT OF PRE-RETIREMENT INCOME)



Note: The 'average' refers to an additional contribution required in excess of an assumed 11 per cent employer contribution and 4 per cent member contribution.

Source: Rice 2005, p. 30.

The generally lower rate of additional contribution required for females reflects the lower income distribution which increases eligibility for the age pension. However, if the age pension is ignored, a female aged between 25-34 would require an additional 11.6 per cent above the Superannuation Guarantee compared to 10 per cent for males of the same age group (Rice 2005, p. 30).¹³

Rothman and Bingham, in 2004, found that the current rate of Superannuation guarantee contributions, combined with a sufficiently long period in the workforce produced sufficient superannuation balances for those on average weekly ordinary time earnings (AWOTE) to provide a replacement income of between 70 and 79 per cent of average salary for a single male and 94 per cent to 114 per cent for a single female. Further, they found that a single male retiring in 2010 and afterwards, at age 65, and couples retiring in 2007 and afterwards, both at age 65, would generally meet the 'modest but adequate' budgetary standard — which was estimated to cost \$16 930 for a single person and \$23 550 for a couple in 2004 living in Sydney, where both groups owned their home outright (Rothman and Bingham 2004, pp. 9, 14).

These outcomes are far from being accepted by all superannuation commentators. The study by Rothman and Bingham suggests that those who meet certain conditions will achieve an adequate retirement income. These outcomes were achieved assuming access to the age pension, 35 to 40 years in the workforce for a male and 26 years of full-time equivalent work (spread over 40 years) for a female, having superannuation contributions made on their behalf at the prescribed rate, with an adequate return on the funds invested, then the retirees' capital was gradually drawn down over their remaining life.¹⁴ The question is then: who are the groups that do not meet these conditions? The discussion above noted women and those who have not contributed to the superannuation guarantee over their full working life are the two main groups that are currently facing a diminished ability to save adequately for retirement.

As this report was going to press a new study of the adequacy was released by Access Economics, commissioned by AMP: *The AMP Superannuation Adequacy Index report*, 25 July 2007 (Access Economics 2007). The study is based on a large sample of 320 000 individual AMP corporate superannuation customers aged 20-65. It uses a similar standard of adequacy — 65 per cent of pre-retirement gross income — to that adopted by Rice, and takes account of not only the age pension but also non-superannuation assets. It is not clear, however whether this study (or that of Rice) takes account of the negative effect, on available funds to support retirement income, of debt remaining at retirement — a major factor that *this* paper has highlighted. Nevertheless, on the optimistic side, the study shows that *about two-thirds* of the sample will meet the posited adequacy standard. If this finding generalises to the wider population, it is a positive result.

¹³ Evidence to the Senate Select Committee on Superannuation Inquiry into retirement living standards showed a wide agreement that many people would still need to save an additional 3 to 5 per cent on top of the superannuation Guarantee rate of 9 per cent to achieve a target retirement income of 60-65 per cent of pre-retirement earnings (Senate Select Committee 2002, pp. 32-33).

¹⁴ It also assumes that the fiscal ability of the government at the time of retirement will be able to provide the level of age pension required.

However, the authors:

- note (p. 3) the large contribution to adequacy from capital gains which have recently boosted household wealth in current prices (gains which *this* paper has suggested may not be sustained in real terms);
- point out (pp. 2-3) that 3.5 million Australians, or around one-third of the workforce, are not making adequate provision for retirement, and will need to lift their saving ‘if they hope to maintain the targeted standard of living in retirement’;
- state (p. 2) that ‘more than 1.9 million Australians under the age of 40 are already falling behind ...[and]... even if they contribute more to super later in life, some 35% will not meet the target for a comfortable retirement’; and
- observe (p. 2) that ‘among those falling behind, average retirement incomes are expected to fall short ... by ... \$97 a week in today’s terms’.

People aged under 40 years

The Access Economics study thus highlights as a particular concern that those aged under 40 (Gen X and particularly Gen Y) may face reduced capacity to fund their own retirement. This is contrary to the view that over time, the younger age cohorts are more likely to have a lower retirement saving gap as they are the first to benefit from a fully mature superannuation system and their contributions will build up over most of their working lives. These concerns were recently highlighted in an inquiry into improving the superannuation savings of people aged under 40:

The inquiry found that unlike previous generations the under 40s age group believes in the concept of self-funded retirement and they accept their compulsory contribution to a superannuation funded retirement. However, the lifestyle expected in retirement by many under 40s far exceeds that which could be funded from SG savings alone. At their current rate of contributions most under 40s would not meet their retirement income expectations without the aid of a part pension. Additional voluntary savings would be required to bridge this ‘expectations gap’. (House of Representatives 2005, pp. iii-iv).

There are several factors that may be contributing to this: the under 40s age group are more likely to be experiencing the high start-up costs of purchasing an owner-occupied dwelling and the high initial debt on mortgages (and debt in respect of higher education), than any other age cohort. They may also have high personal expenses such as education and family commitments.

In a recent survey of saving attitudes, most people aged between 18 to 44 years of age said that in order of priority, any additional savings would be directed towards a home deposit, investment property or deposit in a bank/credit union. (ING Direct-Melbourne Institute 2007, p. 16). Superannuation was considered to be a fairly low priority for the group.

Evidence also suggests that many people under 40 anticipate a level of retirement income that will exceed the level they will acquire. Superannuation as an attractive investment option is even harder to convince among under 40s given their reliance on debt and credit cards as their most important financial goal (House of Representatives 2005, pp. 27-31).

Furthermore, people under the age of 40 are exposed to more casualised work arrangements than other age cohorts for a variety of reasons, including the relatively higher proportion of these positions on offer than in the past, combining study with work, and women under forty balancing family commitments with shorter hours of paid employment (House of Representatives 2005, pp. 125-32). These arrangements may mean that a person in a casual work arrangement is less likely to accumulate as much superannuation as a full-time employee due to:

- lower wages (below the \$450 per month threshold for employers to contribute to superannuation);
- not enjoying the same rights and entitlements; and
- often having more than one employer.

With a continuing increase in casual employment and fragmented employment profiles, these individuals may be particularly disadvantaged in their access to the compulsory superannuation system, and, there is an issue whether the current superannuation incentives are effective for them.

Self-employed

The self-employed labour force have been recognised as being vulnerable in their ability to accrue superannuation who are not covered by the Superannuation Guarantee, and who would typically invest much of their capital in their businesses until late in life when they expect sales of the business to fund their retirement (House of Representatives 2005, p. 102). As the self-employed are not compelled to contribute to superannuation, many have low retirement saving levels and would be exposed to considerable risk if the business fails, if there are insufficient cash flows or if the proceeds of a business sale are used to fund alternative priorities.

Longevity

One factor, which needs to be considered, and which implies a lower degree of adequacy of retirement provision than otherwise, is increasing longevity. As are citizens of other advanced countries, Australians are living longer than in the past, and the trend to increasing longevity is expected to continue in the future – albeit with some debate about whether there is some ultimate limit. In Australia, life expectancy at birth was 57 years in the decade 1901-1910; by 2000 it had reached 80 years. Demographers identify improvements in health care as the key factors:

During the early part of the [20th] century, the greatest gains were due to reductions in mortality from infectious and parasitic diseases at young ages, while during the later part reduced mortality from chronic diseases at middle and older ages was the dominant factor. Life expectancy at age 50 increased from 25 years in 1950 to 32 years in 2000 (Booth and Tickle 2004, p. 1).

The latter types of factors are the ones that are continuing to operate in this century, and clearly they imply longer years of retirement, and increasingly so as we go forward. The ABS (2006e, p. 8) is factoring further increases in longevity into its population projections, based on a range between two sets of assumptions as follows:

- a ‘medium’ case (declining rate of improvement in life expectancy): life expectancy at birth reaching 84.9 for males and 88.0 years for females by 2050-51; and

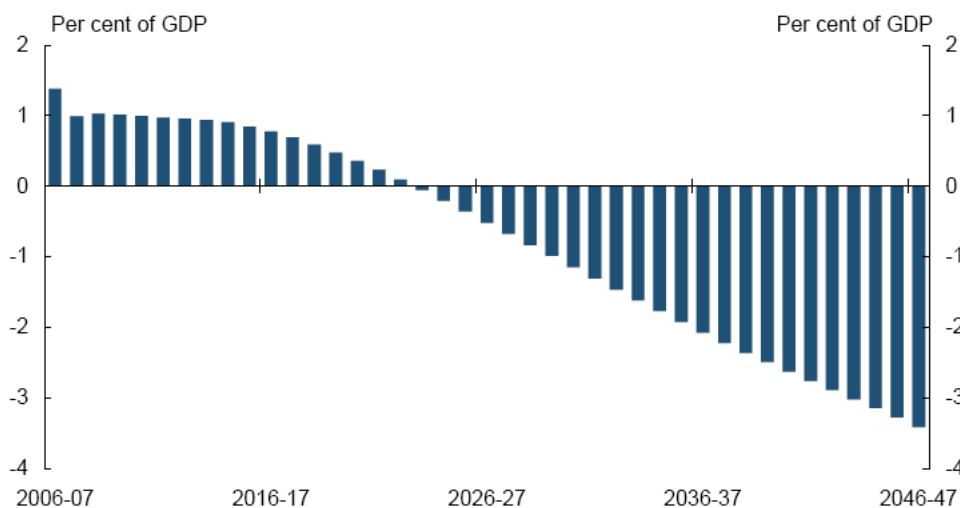
- a ‘high’ case (constant rate of improvement in life expectancy): life expectancy at birth reaching 92.7 years for males and 95.1 years for females by 2050-51.

In the context, as discussed earlier, that many people do not plan adequately for income in retirement, quite clearly the implication is for *increasing* retirement savings gaps as the length of people’s periods spent in retirement steadily lengthens. This serves to underline further the importance of addressing the adequacy issue more effectively. Possible policy directions are discussed in the next chapter.

5.4 Implications for public sector finances

Questions about ageing of the population and the adequacy of provision for incomes and other expenses positively related to age (notably health and aged care) naturally involve the public sector. In order to review the fiscal implications of ageing, long-term projections were produced for Australia and published in the second *Intergenerational Report* (Treasury 2007). The spending projections in that report suggest that, in the absence of policy adjustments, the gap between spending and revenue is projected to grow to around 3½ per cent of GDP (Treasury 2007, p. 80).¹⁵ The fiscal impacts are equivalent to a 2 per cent a year (on average) increase in real Australian Government spending per person over the next forty years (Treasury 2007, p. 78).¹⁶

Figure 5.5
PROJECTIONS OF AUSTRALIAN GOVERNMENT SPENDING PRESSURE (PER CENT OF GDP)



Source: Treasury 2007, p. 80.

¹⁵ While the ageing of the population is expected to contribute to the increase in spending, over two-thirds of the projected increase (in real per capita terms) is driven by non-demographic factors such as the development of new drugs and medical technologies.

¹⁶ There are also likely to be fiscal pressures on State and local government budgets given their involvement in age-related social welfare, community transport and a range of other human services (Productivity Commission 2005). Of course, a major uncertainty in thinking about these issues is the future of productivity growth. It has been pointed out that higher trend productivity growth can significantly ease the burden on future governments from these developments by generating stronger revenue growth.

These demographic trends are not isolated to Australia. In a detailed multi-country study of these issues, Casey *et al* (2003) suggest that all OECD countries face significant weaknesses in general government primary balances of, on average, 6-7 percentage points of GDP over the next forty-five years (Casey *et al* 2003, p. 10). However, Australia is among the better placed since the age pension system is income tested and there are private savings under the compulsory superannuation scheme, thus reducing the number of beneficiaries and the average benefit for those receiving a partial pension (Casey *et al* 2003, p. 9). The Australian Government estimates that without the means test on the age pension, expenses would increase by between \$6 billion and \$7 billion a year (Treasury 2004, p. 1).

The discussion above suggests that without any further policy or expenditure changes, there will nevertheless be an unfair fiscal burden on future generations to support a larger aged population. Minimising this fiscal burden is of prime policy importance, to ensure that future generations enjoy similar (if not improved) living standards relative to the generation currently moving into retirement, and that high tax rates do not unduly restrain economic performance.

A key question to consider is therefore: What policy options are available to government to ensure that fiscal burden is reduced for future generations?

One option available is for governments to borrow to finance investment in public goods that yield future economic returns. However the Australian Government has ruled out raising debt for those purposes:

Accumulating debt is not a sustainable long-term solution, particularly in situations where budget deficits are expected to continue for a period of time, since at some point the debt needs to be repaid. In addition, the compounding effect of interest costs would see net debt rise very rapidly, particularly beyond the projection period. (Treasury 2007, p. 86).

An alternative option to meet the costs shown in Figure 5.5 is to increase taxes in line with increased government outlays. There are, however, several disadvantages to this approach. On intergenerational equity grounds, the only effect of increasing taxes is to shift the burden of funding the spending to future taxpayers who seem likely to face an increased burden of supporting a larger aged population. Secondly, there are additional (efficiency) costs or distortions to the economy from increasing taxes as it may also affect output potential by affecting private saving, investment and labour supply.

This raises the issue of whether intergenerational equity could be advanced by positive net government saving in the period before the bulk of the 'baby boomer' cohort retires, to ensure that 'baby boomers' bear more of the burden of funding their retirements. That is, if a higher level of taxation (than otherwise) were maintained over the next decade or so, with increased surplus invested in an accumulation fund, the income from that fund could be drawn upon to keep taxes lower thereafter.

In 2004, the Australian Government established the Future Fund to meet the unfunded superannuation liabilities for its own employees with the defined purpose of accumulating sufficient financial assets to offset the unfunded superannuation liability by 2020. Currently, these employees' superannuation benefit payments are met from the budget, on a 'pay as you go' basis — that is, directly out of current outlays. Part, or all of, future budget surpluses plus the proceeds from the sale of Telstra, are to be used to build up the Fund, which will be invested in diversified financial assets. Further information about the corporate governance, investment objectives and withdrawals from the Future Fund is summarised in Box 5.2.

The OECD has noted that channelling budget surpluses into the Future Fund is laudable, and will reduce the call on the budget in years to come, allowing greater allocation of future revenues to priority areas such as health (OECD 2006a, p. 61).

Box 5.2

SUMMARY OF FUTURE FUND

How is the Future Fund organised?

The Future Fund was established by the *Future Fund Act 2006* which received Royal Assent on 23 March 2006. The Future Fund Board of Guardians is an independent body that is collectively responsible for making investment decisions and is accountable to the Government for the safekeeping and performance of the assets of the Fund. The Chairman of the Board of Guardians is David Murray AO. He is also the Chief Executive Officer of the Future Fund Management Agency, although in practice the operations of the Agency are overseen by the General Manager.

The Future Fund Management Agency undertakes administrative and operational functions for the Fund and, in particular, acts on the investment directions of the Board. Staff of the Agency are engaged under the Public Service Act 1999.

What returns are expected from the Fund?

The investment returns expected from the Fund are detailed in the investment mandate provided by the Treasurer and the Minister for Finance and Administration.

The Future Fund Act 2006 states that the mandate must have regard to maximising returns on the Fund over the long term, consistent with international best practice for institutional investment and other matters considered relevant by Ministers.

The current mandate sets a target return of between 4.5% and 5.5% above the Consumer Price Index (CPI) measure of inflation over the long term. The Board has interpreted this as an objective to provide a return (net of costs) of at least 5% above CPI over rolling 10 year periods.

It is recognised that as the Fund transitions to a long-term strategic asset allocation, a return lower than this benchmark is expected.

When will money be drawn from the Fund?

Withdrawals from the Fund are governed by the Future Fund Act 2006. The Act allows assets to be withdrawn to discharge unfunded superannuation liabilities after 2020. However, if the assets of the Fund match the present value of the liability before 2020, money can be withdrawn from the Fund for the purpose of meeting superannuation benefit payments.

Money from the Fund is also used to cover the cost of the operations of the Future Fund Board of Guardians and the Future Fund Management Agency.

Source: Australian Government Future Fund 2007, *Frequently Asked Questions*, <http://www.futurefund.gov.au/faqs.html>, accessed 15 July 2007.

Other countries appear to have adopted two broad approaches to funding their unfunded pension liabilities. The first is where the government establishes a separate account for each person. The government may or may not deposit money into these accounts to establish them, and merely guarantees a minimum level of benefits. The individual or their employer contributes to these accounts. The Chilean government took this approach in 1981 (Rodrigo *et al* 1999), as did the Swedish government in 1999 (World Bank 2007).

The second approach is for the government to guarantee the full entitlement to a person's retirement benefits, but to pre-fund all or part of these benefits with surplus revenue from various sources (e.g. in Norway's case, revenue from petroleum).

A summary of overseas experiences in funding pension schemes is provided in Box 5.3.

Box 5.3

OTHER COUNTRIES' PENSION SCHEMES

Ireland

The National Pensions Reserve Fund (NPRF) is designed to meet part of the costs of social welfare and public service pensions from 2025 (money accumulating in the NPRF cannot be drawn until then). By law, the government must set aside and invest 1 per cent of GNP in the NPRF. The government may also make additional contributions where circumstances allow. At the end of May 2007, the value of the NPRF was €20.75 billion. The NPRF is free to invest in all classes of asset (except Irish government bonds).

New Zealand

The New Zealand Superannuation Fund (NZSF) is designed to partially provide for the future cost of superannuation payments. Under law, no capital withdrawal is allowed from the Fund before 1 July 2020. According to current Treasury modelling, capital contributions are likely to cease around 2028, at which time the Government will start to draw on the Fund. The Fund's assets are expected to peak at around 36 per cent of GDP sometime between 2036 and 2039, and will then gradually fall as a proportion of GDP over the ensuing decades. Because capital withdrawals are forecast to always be less than the Fund's income, the Fund is expected to continue to grow in nominal (dollar) terms. The Government will allocate, on average, \$NZ2 billion a year over the next 20 years. As at 31 May 2007, the NZSF's assets were about \$NZ13.3 billion. The NZSF is governed by a separate Crown entity called the 'Guardians of New Zealand Superannuation'. External fund managers invest funds under supervision.

Norway

Norway's Petroleum Fund was established in 1999. It has two main purposes. The Fund has the twofold purpose of smoothing out spending of oil revenues and at the same time acting as a long-term savings vehicle to let the Norwegian Government accumulate financial assets to help cope with expenditures associated with the ageing of the population.

Norges Bank is responsible for the management of the Petroleum Fund, on behalf of the Ministry of Finance. The fund is invested in financial instruments abroad, where 60 per cent of the portfolio is allocated to fixed income instruments and 40 per cent to equities. The equity portfolio has a geographical split of 50 per cent in Europe and 50 per cent in America and Asia/Oceania. As at 31 March 2007, the value of the Petroleum Fund was 1876 billion Norwegian krone.

Sources: Irish National Pension Fund 2007, New Zealand Superannuation Fund 2007, European union 2007, and Norges Bank 2007.

While the Australian Government's Future Fund goes some way to alleviate the burden placed on future generations by population ageing, it does not pre-fund the far greater future obligations to aged pensioners (or other age related calls on the budget, notably for health and aged care), as it is limited to saving for public service pension liabilities. The New Zealand Government's initiative to create a fund to partially provide for the future cost of New Zealand's taxpayer-funded age pension system, for example, is much broader in scope.

5.5 Conclusion

Clearly the issues posed by low household saving, extensive private under-provision for retirement and a long-term fiscal outlook that implies a substantial transfer of burdens to future generations are of significant public policy concern. The next chapter briefly canvasses what options may be available – although it is beyond the scope of this paper to canvass policy options in any detail.

Chapter 6

Looking forward – What should be on the policy agenda?

This chapter summarises the key issues for policy and briefly sketches options that merit consideration for the policy agenda.

Key Points

- The analysis in the previous chapters puts the prime focus for public policy on household saving: public sector and corporate contributions to national saving are at satisfactory levels – although with scope for consideration of whether governments could increase provision for future age-related expenditures on intergenerational equity grounds.
- In respect of household saving, the key issues include:
 - the economic and social risks attaching to high levels of household debt;
 - under-provision for retirement, particularly by the large baby boomer cohort, posing both intergenerational equity concerns and concerns that many in that cohort itself may not attain the standards of living in retirement that they aspire to.
- This series of major reforms to superannuation by the previous and present Governments (including the Superannuation Guarantee, co-contributions, transition to retirement measures and the recent sweeping reform reducing the taxation of benefits and greatly simplifying super) have made a very significant difference, and will continue to do so, but there remains more for policy to achieve.
- In addition to more responsible attitudes to debt, a *combination* of extended participation in work – i.e. phased transition to retirement – and increased saving for retirement through superannuation, targeting younger as well as older cohorts, are the most promising avenues for policy development.
- This paper does not canvass policy options in any detail, but an agenda of options for consideration would include:
 - responsible borrowing/lending programs, targeting both borrowers and lenders;
 - increased mandatory superannuation contributions, with Gen X and Gen Y a particular focus;
 - extension of co-contribution incentives to a wider group;
 - further initiatives to remove barriers to extended participation in work (phased transition to retirement);
 - policies to require or encourage pre-provision for health care in retirement;
 - initiatives to facilitate ‘unlocking’ of housing wealth in retirement; and
 - in addition to initiatives aimed at household saving, possible extension of the Future Fund model to provide for additional future expenditures.

6.1 The issues for policy – a recap

As the previous chapters have brought out, the issues in Australia’s saving focus squarely on *household* saving – by contrast with the 1980s and 1990s public finances are in good shape, as are the balance sheets and generation of retained earnings by businesses.

The main issues are as follows:

- (i) Household debt is at worrying levels from several perspectives, including the implications for families being unable, if interest rates rise significantly and/or the economy and employment turn down, to meet debt service commitments – implying that some families may lose their homes, and some may be hard pressed to afford necessities. ‘Belt tightening’ by households may also exacerbate a downturn.
- (ii) The intergenerational equity dimension is a prime focus, even if the worst risks of high household indebtedness do not crystallise. The issue is that if the very large baby boomer cohort does not save enough to provide adequately for its own retirement, the following generations may bear inequitable burdens. That is, they may face higher tax rates to fund retirement income support, health and aged care for the baby boomers. The same issue arises, of course, as every generation heads to retirement. The baby boomer cohort is of special concern primarily because of its size.
- (iii) A related perspective is that, apart from the issue of intergenerational transfers, every developed society has an interest in seeing all of its citizens enjoy a good standard of living in retirement. The governments of many OCED countries (particularly in Europe) see a public interest in ensuring that most citizens enjoy high levels of income replacement in retirement. That is, through their social security or other retirement income policies, they seek to protect people from suffering a significant fall in their living standards after retirement.

In Australia, as no doubt in other countries, many people underestimate how much they need to save to achieve a given level of retirement income, or simply put it off. A consequence is that many people are disappointed or indeed shocked, on nearing (or reaching) retirement only to discover that they are substantially under-provided and cannot enjoy the income level they expected. Some may be forced to postpone retirement. On the other hand, there are many people who would actually prefer to continue some involvement in work, both for its own sake and to re-balance their financial equation, while still enjoying more leisure – but are unable to find the opportunity to do so.

6.2 Possible policy responses

The successive *Intergenerational Reports* have well outlined the macroeconomic policy imperatives – essentially to expand the ‘three P’s’: population, participation and productivity. This paper does not explore those further in any details but focuses specifically on saving, and retirement saving in particular, while noting that programs to facilitate extended participation in work, beyond traditional retiring ages, can have powerful effects *in conjunction with* programs to promote increased saving for retirement.

As an illustration of the differences that the combination can make, the scenarios depicted in Figure 6.1 below show the difference to a person’s adequacy of retirement provision that would be made by:

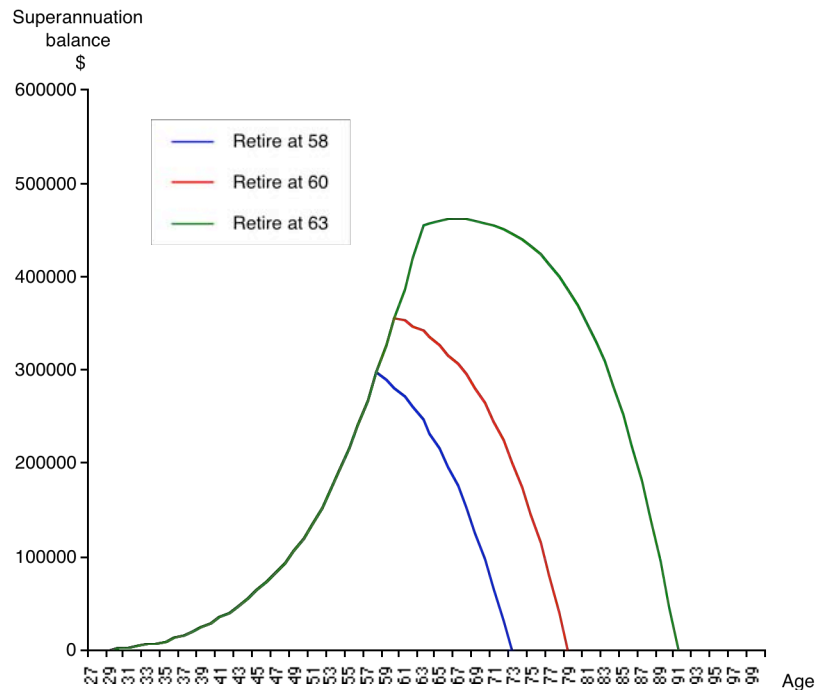
- continuing to *work half-time* for two or five more years instead of retiring at age 58 (in recent years the approximate modal retiring age for males); *and*

- continuing to *salary sacrifice* 10 per cent of salary into super. (In addition to the 9 per cent SGC contributed by his employer, the person is assumed to have sacrificed into super 5 per cent of salary from age 35, increasing this to 10 per cent from age 50.)

The figure shows how long the person’s super will last in each case.

Figure 6.1

BENEFITS OF EXTENDED HALF TIME PARTICIPATION IN WORK, PLUS CONTINUING SALARY SACRIFICE



Source: FitzGerald and Rooney 1999, section 4.1. The illustration is for a male on a salary of \$50,000 at age 58. For details of other assumptions, see source.

The point made by the above illustration, showing that *the extra 2 or 5 years of half-time work ‘buy’ an extra 7 or 23 years of income*, is very simple. The combination of extended participation in work *and* continued saving brings three factors into play together:

- increased contributions into the person’s fund;
- an increased period over which the total amounts in the fund generate earnings; and
- a reduced period of full retirement over which income will be needed.

The Transition to Retirement provisions introduced in 2005 facilitate for many more people, particularly those who could not afford to live on a significantly reduced salary without topping up their disposable income from their superannuation, the possibility of increasing the adequacy of their retirement provision along the lines illustrated above.

The major reforms to the taxation of superannuation announced in the 2007 Budget – abolishing from 1 July 2007 all taxes on benefits paid to retirees over 60 from a taxed fund – will also considerably improve the calculus. These reforms will also strengthen the incentives for people – particularly those approaching retirement – to contribute more to their superannuation savings.

Clearly, the reforms to superannuation arrangements by the previous Government (notably, the Superannuation Guarantee) and the present Government (including co-contributions, transition to retirement provisions and the recent sweeping reform to benefit taxation) have made a significant difference – as the previous chapter discussed. The reforms can be expected to have greater effects in future. For example, the ability to ‘top up’ superannuation provision late in working life via fully deductible contributions up to age 75, and via substantial undeducted contributions, will be particularly valuable for the self employed (including many proprietors of small businesses) – who are not covered by the Superannuation Guarantee, and who would typically invest much of their capital in their businesses until late in life.

Nevertheless it is clear from the data presented in the previous chapter showing extensive retirement savings gaps that there remains more to do to lift the degree of adequacy of retirement provision and to further address the intergenerational fiscal issue.

What should be on the policy agenda now? Possible directions for further development policies directed at saving and related household finances issues include:

- Programs, essentially educative and in consumer protection, encouraging households to be *more prudent* in incurring *debt*; and lenders to exercise more responsibility to ensure debt is within limits that can sustainably be serviced;
- Increased levels of *mandatory contributions to superannuation* (based on the considerations outlined at (iii) above). As noted earlier, the evidence is that this will produce a net increase in provision. It may be particularly relevant to Gen X and Gen Y, who have a high propensity to spend on consumption out of current income (compared to previous generations);
- Extended application of *incentives for co-contributions* – i.e. to somewhat further up the income scale. There is evidence to suggest that the co-contribution scheme has delivered benefits to low income employees, particularly women, and people nearing retirement (Nielson 2005). However, the scheme may not address the problem of low superannuation balances, particularly for women. Again, there is evidence that if strong enough, these incentives work:¹⁷ the issue is to balance this against the cost; and
- Initiatives to facilitate access in retirement to funds locked up in owner-occupied housing – e.g. consumer education and consumer protection programs in respect of reverse mortgage and similar programs, and work with the finance sector to encourage development of better products.

¹⁷ In 2002, IFSA commissioned Eureka Strategic Research to conduct a survey of prospective responses of people in income and other different categories to co-contribution incentives, and the results were modelled by the Allen Consulting Group (presented to the IFSA conference of that year), demonstrating that these incentives do indeed work.

Since apart from general living purposes, substantial funds will be needed for the *health and aged care* needs of the baby boomer generation in their retirement, there is a case for considering policies for pre-funding of those needs specifically. Such policies could involve either a mandatory component or incentives, or some combination.

Consideration of the policies should not be focused solely on saving by households themselves. The Commonwealth has already begun to pre-fund provision for its own obligations in respect of superannuation benefits for its own employees via the Future Fund. It is worth considering whether, as New Zealand has done, there is a case for widening this approach to accumulate resources to help fund future age pension and possibly health and aged care costs. Such an approach would be considered within a long-term fiscal policy framework aiming at maintaining a reasonably constant level of taxation (relative to GDP), on both equity and economic performance grounds.

Appendix A

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