Saving the Future: Can the under-40s afford to grow old?

A consistent observation from the economists is that many Australians haven't saved enough to retire. So if the current generation isn't saving, then what about the next generation coming through? **HAZEL BATEMAN** looks at this issue.

The under-40s (or the cohort aged 25–44) are the first to have been exposed to some form of compulsory retirement saving throughout their working lives, first with productivity award superannuation from 1986, and then under the Superannuation Guarantee introduced in 1992.

THE LIFECYCLE THEORY OF CONSUMPTION AND SAVING

The starting point is the lifecycle theory of consumption and saving under which households are assumed to want to smooth their consumption over their lifecycle. In doing so, they are required to decide how much to consume and how much to save in each period based on a range of factors including past, current and future income and wealth, and rates of return.

Actual household behaviour may differ from this optimal plan for two main reasons. First, the calculations required to work out how much to consume or save in each period over a lifetime are difficult. Economists, actuaries and other professionals have trouble working this out using complicated optimisation models and their detailed knowledge of the rules and regulations surrounding retirement income provision. Secondly, even if the correct savings rate were known, households may fail to save, because of a lack of self control, since this requires them to reduce current consumption in favour of future consumption, or because they just procrastinate and fail to take action.

TESTING THE THEORY

Polling of a sample of under-40s commissioned by Finsia and conducted by Crosby Textor entitled Finsia's 'Saving the Future' poll (hereafter referred to as Finsia's poll) is used to test the extent to which the attitudes and behaviour of the under-40s corresponds to the lifecycle theory of saving and consumption. Findings include:

- The idea of the lifecycle theory of saving and consumption is alive and well, with 82% of the under-40s polled reporting that they consider it important to save for retirement. However, fewer are putting the idea into practice, with only 6% reporting that they were prepared for retirement and only 32% reporting some degree of preparedness.
- Finsia's 'Saving the Future' polling suggests departures from the lifecycle model as a result of short sightedness or procrastination:
  - Accommodation and housing, rather than retirement saving, is the dominant financial goal for over 50% of those polled, and property is ranked as the dominant retirement savings option.
  - Despite significant awareness of arrangements to increase superannuation coverage, the take-up is low. For example, only 12% of those who indicate that they are not prepared for retirement make additional superannuation contributions, despite 77% of this group indicating that they were aware of the option. As well, 68% of those indicating that they were not prepared for retirement stated that they would not be contributing for their retirement without compulsory superannuation.
- Finsia's "Saving the Future" polling also suggests departures from the lifecycle model due to complexity, with many of those who indicated that they were not prepared for retirement also indicating unrealistic expectations in terms of: the savings required to generate an adequate retirement income, their likely reliance on public support, the age at which they expect to retire from full-time work, or the likelihood that they would work in retirement. However, a large proportion of those polled who indicated preparedness for retirement held quite realistic expectations.
- Finsia's "Saving the Future" polling identifies the following characteristics of those persons who do not consider themselves to be prepared for retirement (and are therefore not behaving as suggested by the lifecycle model). Of this group:
  - 57% are female;
  - 73% are earning less than $50,000 pa;
  - 60% are working part time or on a casual basis or are not employed:
  - 63% are at the younger end of the cohort (aged 25–34); and
  - 67% have less than $100,000 in personal assets.
- Finally, Finsia's "Saving the Future" polling suggests that preparing for retirement is even more important

for under-40s women than it is for under-40s men: 84% of under-40s women reported that preparing for retirement was important, compared to 80% of the men). However, fewer under-40s women than men reported that they were actually prepared for retirement (29% compared to 35%) and 57% of the under-40s polled who indicated that they were not prepared for retirement were women.

LEARNING FROM OVERSEAS EXPERIENCE

Similar departures from the lifecycle model of saving and consumption are evident in analysis of 401(k) plans in the US (the US version of private defined contribution pension plans). Automatic enrolment with opt-out policies, on a plan by plan basis, is proving to be an effective way of expanding coverage. There is now increasing support for a national policy of so-called "automatic 401(k)s" – for example by the Brookings Institution, which argues that "In most 401(k) plans, workers do not participate unless they actively choose to. Under an automatic 401(k) they would participate unless they actively chose not to" (Gale, Iwry and Orszag 2005, p. 1).

In New Zealand, insufficient saving for retirement is being addressed with the introduction of Kiwisaver from July 2007. This is a savings scheme with automatic enrolment and an opt-out feature. Other design features include a minimum of 4% employee contributions, a one-off lump sum government contribution and withdrawals for first home purchase.

Kiwisaver is also being used as a model by The UK Pensions Commission, which has recommended the introduction of a National Pension Savings Scheme (NPSS) – a national savings scheme with automatic enrolment and an opt-out feature.

The US experience with individual 401(k) plans indicates that automatic enrolment with an opt-out feature will increase coverage.

However, automatic enrolment is putting increasing pressure on adequate design of the defaults for contribution rates, asset allocation and withdrawals. The short sightedness or procrastination which hindered participation in the absence of automatic enrolment, also hinders any adjustments once enrolled.

INTERNATIONAL REFORMS MUST BE CONSIDERED IN CONTEXT

None of the US, NZ or UK have a mandatory retirement saving scheme such as the Australian Superannuation Guarantee and only New Zealand provides a non-contributory public age pension.

- In the US, retirement saving comprises a public pension (social security) – which for the very poor may be topped up by social assistance benefits – occupational pensions covering around 45% of workers, and tax favoured individual retirement saving accounts (IRAs).
- In New Zealand, retirement income comprises a universal public pension (called NZ superannuation), home ownership, and for public sector employees the State Sector Retirement Savings Scheme, since 2004. New Zealand has no mandatory retirement savings scheme, and less than 15% of workers are covered by voluntary occupational pensions. In the absence of tax preference for saving, a government contribution and incentives for first home purchase were included to enhance public support for Kiwisaver.
- Current retirement incomes in the UK comprise a contributory public pension (which is far less generous than Australia's age pension) and a non-contributory Pension Credit plus a variety of retirement income schemes – including public earnings related pensions (SERPS or S2P), occupational DB or DC pensions, personal pensions and stakeholder pensions. There are concerns about adequacy in the UK due to the falling real value of the public pension (which is indexed to the maximum of the CPI and 2.5%, rather than wages) and disincentives to save inherent in the design of the Pension Credit. As well, those who have not "contracted out" of SERPS or S2P may not be covered by private pensions.

CONCLUSION

Finsia's polling indicates that less than one third of the under-40s are prepared for retirement, despite the widespread belief that it is important to save for retirement.

Finsia's polling suggests that the retirement saving of the under-40s is suboptimal due to short-sightedness or procrastination and the complexity of the calculations required to formulate an appropriate savings plan.

The under-40s polled were more focused on short-term financial goals, and despite widespread knowledge of (then) current schemes to increase retirement savings, the take-up of such schemes was low.

It is possible that the 2006 Budget proposals to remove superannuation benefit taxes, increase the flexibility of superannuation and reduce the complexity associated with superannuation benefits will not have a large impact on the attitudes and behaviour of the under-40s, many of whom will not be retiring for 30–40 years.

The overall aim of policy development and service delivery should be to bring the idea of the lifecycle theory of saving and consumption into practice. Automatic enrolment schemes (with an opt-out feature) complemented by universal access to sound retirement planning advice should be considered as a way to address the short-sightedness and procrastination and complexity evident in the retirement planning of the under-40s. J

As part of Finsia's Saving the Future campaign and in preparation for the Summit on 5 July 2005, Finsia invited Dr Hazel Bateman from the UNSW Centre for Pensions and Superannuation to prepare a paper based on Finsia's polling research of the under-40s (conducted by Crosby|Textor). For further details on the Summit please visit www.finsia.edu.au.

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