ASFA Research note: The cost of pensions across advanced economies

- In many advanced economies, poor system design, population ageing and elevated inflation are imperiling the long-term sustainability of retirement income systems.
- For the OECD, average government spending on pension payments will rise from 9.0 to 10.4 per cent of GDP over the next four decades.
- In contrast, in Australia government pension expenditure is relatively low and is expected to decline – from 2.6 to 2.1 per cent of GDP by 2060.
- While many other OECD countries face politically-difficult reforms to improve sustainability of retirement income systems, Australia's system is well placed to face challenges to sustainability.

All advanced economies have a retirement income system. While design differs from country to country, ultimately, retirement incomes are generated from a mix of private savings and benefits that are provided/facilitated by governments.

A key point of differentiation across the OECD is the degree that retirement income systems are fiscally sustainable. That is, under current policy settings, whether a system will demand a high and/or rising share of government expenditure over the long term.

The fiscal cost of a retirement income system typically reflects:

- Benefits paid to retirees (pensions). The fiscal cost is reduced if benefits are fully/partially funded from an off-budget source – typically, a government investment fund to which workers make contributions.
- Tax concessions to encourage private saving for retirement.

In terms of system design, key determinants of fiscal sustainability include the eligibility age for pension benefits, whether benefits are flat or linked to prior earnings, and the degree to which individual's pension benefits are reduced to account for their private income/assets (that is, means tested). The effect of latter, at the system level, is that higher private savings helps reduce government pension spending.

Features of Australia's retirement income system aid its fiscal sustainability. Australia has a slightly higher retirement age than the OECD average, while Australia's flat rate Age Pension is more targeted towards retirees with lower private income/assets than is generally the case than in other OECD countries. Private saving for retirement through superannuation is supported by a variety of tax concessions.

Globally, pressures on fiscal sustainability are building

Over coming decades, in all OECD countries, the proportion of people who are of typical working age will decline, while the proportion of people of retirement age and older will rise. For the OECD as a whole, the proportion of the population aged 65 and over will increase from 17 to 27 per cent over the next three decades.

Typical fiscal pressures associated with an ageing population include lower income tax revenue (compared with the counter-factual of no population ageing), higher expenditure on aged care and healthcare, and higher pension payments.[i]

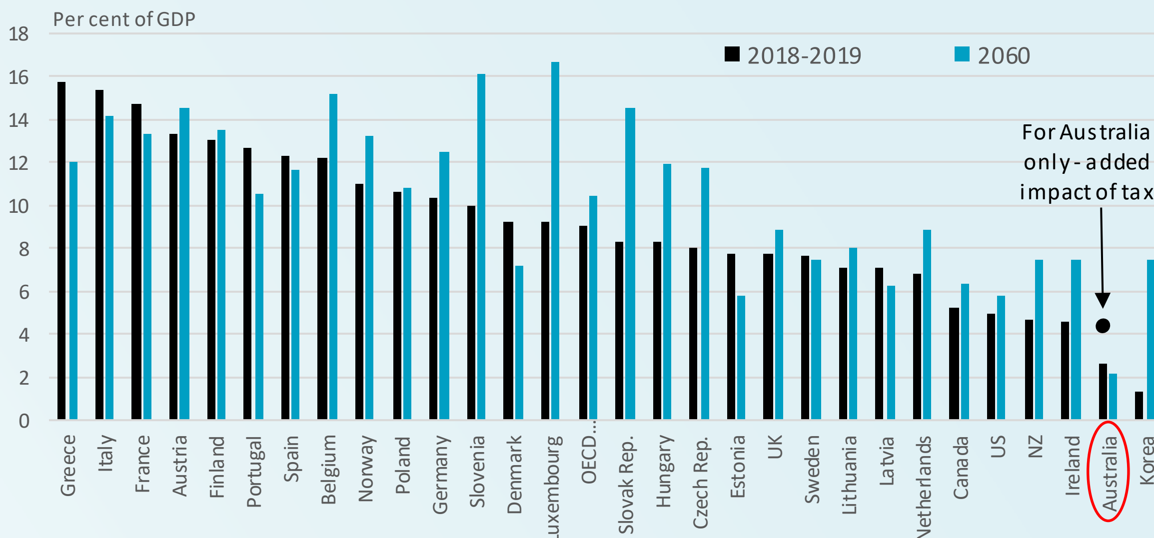
In addition to ageing, the current protracted period of elevated global inflation will exacerbate fiscal-sustainability. For example, it is generally the case that pensions are indexed (to some degree) to measures of consumer prices. All else being equal, the current period of higher inflation will mean a permanent rise in the future cost of pensions.

Pension spending in the OECD to remain high, but low in Australia

In many OECD countries, the interaction between system design and demographic pressures means high and/or rising fiscal pressures – most notably where pension benefits are (or near) universal and/or set at a relatively high level (such as a high proportion of working salary).

Across the OECD, government spending on pensions averages 9.0% of GDP, and is projected to rise to 10.4% of GDP by 2060 (Chart 1).

Chart 1: Government expenditure on pensions



Source: OECD, *Pensions at a Glance 2021* and ASFA calculations.

Countries where spending is expected to increase relative to GDP (in the absence of reform) include Canada, Germany, NZ, the UK and the US. In some other countries, spending is projected to fall but remain at a very high level – such as, France, Greece and Italy.

In contrast, Australia's spending on the Age Pension is relatively low (as a % of GDP) and is expected to decline. The OECD projects that pension spending will fall from 2.6% to 2.1% of GDP (by 2060). This is consistent with the Australian Government's projections.

Many OECD countries, including Australia, offer tax concessions to encourage private saving for retirement. It is difficult to compare the fiscal cost of concessions across countries (as this depends on the specific tax benchmark used). However, when *only* the current cost of Australia's concessions is considered the overall cost of Australia's system is still low (Chart 1, black dot). Looking ahead, the fiscal cost of tax concessions will rise modestly as a share of GDP, given the variety of caps on tax concessions.

Difficult reforms required in some OECD countries

In some OECD countries, the recent inflation spike in particular has sparked public debate on the need to contain future government spending on pensions, and how this should be achieved.

For OECD countries facing sustainability challenges, changes to current policy settings would involve a combination of reduced pension payments and tighter pension eligibility.

In France, the government recently announced a proposed increase in the retirement age – to reduce the high future cost of pensions. Reflecting the difficulty of achieving such reforms, the government has also proposed an increase in the minimum pension for low-income workers (which would partially offset the expected cost reduction from the increase in the retirement age).

South Korea is facing acute population ageing over coming decades, which is projected to lead to a sharp rise in government pension spending (Chart 1). Under Korea's National Pension Scheme, a government investment fund generates inflows/income from worker contributions and investment earnings, and makes payments (outflows) to retirees. Under current settings, payments will exceed income from around 2040. By 2055 the fund will be depleted – at which point, pension payments would be funded from the budget.

Australia will remain well placed

Australia's population is ageing, though to a lesser degree than in many other OECD countries. The latest government projections are for the proportion of the population aged 65 and over to rise from 16% (in 2020-21) to 23% (in 2060-61).[ii] The rebound in immigration to pre-COVID levels will help reduce demographic pressures.

Notwithstanding our ageing population, the design of Australia's retirement income system will ensure its fiscal sustainability. In particular, Australia's superannuation system will boost private retirement savings, and help contain Age Pension spending.

Australia's super system is maturing – with the SG contribution rate scheduled to reach 12% in 2025. As time goes on, people who reach retirement will have received SG contributions at higher rates, for longer periods of time. This will lead to higher balances for workers at retirement (than otherwise would be the case).

Given current system settings (for example, income/assets tests for the Age Pension), the proportion of retirees eligible for either a full or part Age Pension is expected to decline, and reliance on the pension for retirement income will diminish (Chart 2). Ultimately, by 2050, it is expected that around half of retirees will be self-funded.[iii]

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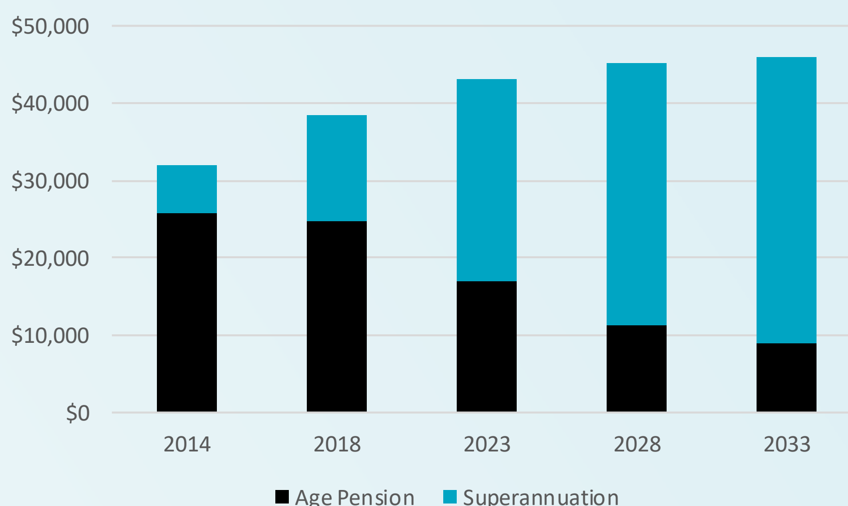
[i] While there will be some offsets from lower spending on education (and other areas), the net fiscal impact of an ageing population for most OECD countries will be negative.
[ii] *2021 Intergenerational Report: Australia over the next 40 years*.
https://treasury.gov.au/sites/default/files/2021-06/p2021-182464.pdf
[iii] ASFA research.

Chart 2: Average retirement income at Age Pension eligibility age (2021 dollars)



Source: ASFA calculations.