

**Pension Reforms and Ageing Populations:
Lessons from Australia**

By

David O. Harris

**Managing Director, TOR Financial Consulting Ltd
1996 AMP Churchill Fellow**

**Testimony before the
House Ways & Means Committee – Subcommittee on Social Security**

16 June 2005

Introduction

Mr Chairman, I am very pleased to appear to discuss social security reform in Australia. As each year passes the need for reform becomes more pressing for many countries as populations rapidly age. Moreover, generous promises linked with social security programs will make it inevitable that radical reforms will have to be considered. This may mean cutting benefits or increasing retirement contributions via taxation. I've described compulsory retirement saving as being the equivalent to the great white shark for those who know they have to deal with the rising tide of ageing. They don't want to confront compulsion but they know that it is 'out there'. Only three countries rely heavily on private mandatory saving policies for retirement, these include Australia, Switzerland and Chile¹. Australia faced the challenge 13 years ago. Not only did we survive, we succeeded. The Australian retirement model offers clear proof that radical pension reform can be achieved and benefit an entire nation. Women, minority groups and 'blue collar' workers, in particular, have seen significant benefits flow to them from having the ability to manage their own retirement savings.

The US has had its own success in generating capital through individual saving. But it has not avoided the current questions around retirement saving: what will be 'sufficient' and what financial instruments will provide it? No-one in the past, when economic and social systems were being formed, could have anticipated the rapid ageing of populations throughout the world.

An overview of Australian retirement system

Australia and the UK stand out as countries that have faced up to the discomfort of significant retirement reforms. Both have taken the route of a more fully funded, defined contribution system but their approaches have differed in terms of politics, or government and the role of organized labor and business. These three vested interests, individually or combined, can encourage or discourage reform.

This fact was well understood when Australia reformed its retirement system in 1987 and 1992. In 1983 the Australian Labor Party led by Bob Hawke MHR came to power. The ALP was determined to deregulate Australia's economy so as to compete more effectively on a world level. A vital ingredient in achieving this goal was a significant reduction in wage growth.

The ALP is fundamentally a social democratic party based on largely collectivist principles. It has strong links with the trade union or organized labor movement through the Australian Council of Trade Unions (ACTU). Superannuation was provided through traditional employer-sponsored plans on a voluntary basis. Surprisingly perhaps it was the trade union movement which began the momentum for changing Australia's retirement system. They saw increasing superannuation coverage as a major priority.

The Old Age Pension was seen as an important source of income for retirees who have limited resources to sustain themselves in retirement. Its impact on Australia's GDP is seen in Table 2. Many older Australians who retired in the past failed to build up sufficient retirement savings; a common perception was that they were entitled to an old age pension after paying taxes all their working life and this view was encouraged by many governments. In the 1980s, however, the Commonwealth Treasury and the Federal Government were not happy with the direction of expenditure on the first pillar of Australia's retirement framework. This concern was compounded by the demographic picture for the next century where the percentage of the population aged over 65 was

expected to rise from 15% of the population to 23% by 2030 and the percentage aged over 85 was expected to more than double from around 2%.

The newly elected Federal Government began by ensuring the long-term viability of the Old Age Pension at its then current level. Maximum payments, by the mid 1980s, were determined through a comparatively stringent income and asset tests. The full pension payment now represents approximately 26% of male total average weekly earnings. Maximum payments per fortnight are calculated on a flat basis and are reduced accordingly, based on income and asset tests. This shift required a strong political resolve. More through timing than luck, though, a popular Federal Government with trade union support was able to convince the nation of the problems Australia would confront in the future if it did nothing about addressing its aging population. This was best summarized in the *Better Incomes: Retirement into the Next Century* statement which expressed a commitment to 'maintain the age pension as an adequate base level of income for older people' but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce¹.

Before the introduction of mandated, second pillar, superannuation accounts, the coverage of superannuation was limited to roughly 40 percent of the Australian workforce. Typically, those covered were employed in middle class, 'white collar' jobs where women and people from minority groups were under-represented. The trade union movement set about convincing the Federal Government that the level of superannuation coverage needed to be extended, via compulsory contributions into individual accounts. Many of the younger trade union officials argued for a more comprehensive system of retirement provision that in effect required all workers to be proactive in contributing and managing their own retirement needs. Some had noted the successes of the national provident funds, as seen in Malaysia and Singapore.

Significant dissatisfaction also existed amongst the labor movement over the extent and coverage of non-management or 'blue collar' workers. Moreover the union movement also realized that comprehensive wage increases were becoming increasingly difficult to successfully negotiate and that deferred savings benefits may be an alternative to simply striving for an increase in workers pay. By the mid 1980s the union movement had shifted its stance whereby it would play a more direct and active role in the day-to-day operations of superannuation, via industry funds. These industry funds, grouped around a particular economic sector of the Australian economy, brought union and employer representatives together as trustees to manage the administration and investment of many thousands of individual retirement accounts. The increasing involvement of the union movement challenged some industry participants' views that administration and investment decisions would be distorted in favor of policies that stressed mutuality rather than economic reality.

There was another reason for the trade union movement's interest in pensions. Between August 1986 and August 1996, the level of trade union membership declined from 46 percent to 31 percent. This coupled with the decline in traditional union-based industries, such as heavy manufacturing, reinforced the unions' enthusiasm for reforms they felt would increase their profile and relevance.

By 1986 circumstances were ideal for the introduction of a widespread employment-based retirement incomes policy. The government insisted that it was in the "public-interest" to have a national, compulsory, employment-related retirement income scheme

¹ Australian Bureau of Statistics, 1998 Year Book Australia (Canberra, Australia: AGPS, 1998), p215

in place². Award superannuation, set at 3% of an individual's yearly income, was introduced. This was paid by the employer in the form of a wage increase granted by the Conciliation and Arbitration Commission, a Federal government body. Newly created industry funds, sponsored by employer and employee organizations in one or more industries, were established to receive the 3% award contributions.

A further 3% round of award superannuation was made in 1990-91 before the government acted more decisively on reform. In August 1991 the Government's indicated its intention to introduce a Superannuation Guarantee Levy from July 1 1992. The Superannuation Guarantee Charge Act 1992 requires all employees to contribute to a complying superannuation fund at a level that increased from 3% p.a. in 1992 to 9% per annum by July 1, 2002. Although support for the reforms was substantial, some opposition was expressed by then Australian Democrats (a minor 'left leaning' political party) leader Senator Kernot who favored a single, government-controlled, national portable system, similar to that of a national provident fund. But the Government's proposed legislation quickly generated wide acceptance through working in 'partnership' with organized labor, business interests and industry associations.

The use of government inquiries or private sector research helped to highlight the inadequacies of Australia's level of retirement system provision. These inquiries were seen to be delivering independent views or recommendations and the Federal Government felt vindicated in implementing a mandated retirement system.

Another means by which the Federal Government was able to engineer significant change to the retirement system was through an effective public education campaign in 1994-1995, co-ordinated by the Australian Taxation Office. The total cost of the campaign was \$AUS 11 million and the message was that the new retirement system would not only benefit the individual but the nation as a whole. With a controlling majority in the Lower House (House of Representatives) and minority parties holding the balance of power in the Upper House (Senate), no real effective delays in the reforms were encountered. The Senate Select Committee on Superannuation, a parliamentary appointed committee was used by the government to hear, interpret or receive objections to the planned reforms and this encouraged a spirit of 'consensus' to be generated amongst many stakeholders of differing political ideologies.

Finally the existence of well established professional industry associations in the form of the Life Insurance Federation of Australia (LIFA), now the Investment & Financial Services Association (IFSA), and the Association of Superannuation Funds of Australia (ASFA), ensured that the consequences of proposed reforms could be simulated and understood by superannuation industry participants and bureaucrats alike. Unlike in Chile, where individual retirement account reforms created a totally new financial infrastructure, much of the superannuation infrastructure in Australia already existed under the voluntary system. Stakeholders and vested interests like life insurance companies supported the reforms based on self interest but also recognized how the existing financial infrastructure would be well placed to implement the government's retirement proposals.

Australian business saw the reforms in terms of nurturing the capital market and the level of national saving. Some concerns were raised over the active involvement of trade unions

² Sue Taylor, 'Australia's Mandatory Occupational Superannuation Regime: An Evaluation of Opposing Claims – Is it a Policy Built on Justice, Fairness and Security in the Public Interest or the Entrenchment of the Power and Privilege of Politically Effective Interest Groups?', (Melbourne, Australia: 1999 Colloquium of Superannuation Researchers, July 8-9 1999), p5

in the day to day operations of superannuation funds but these concerns were alleviated through adjustments in regulatory settings. A major concern for business, after the broadening of compulsion in 1992, was that increased costs would be levied on employers as contributions lifted to 9 percent by 2002. Larger business interests in many cases offered such contributions already on voluntary basis through their in-house corporate superannuation funds, but small business strongly opposed the reforms arguing principally that the increased cost burden linked with an expanded retirement provision would cause many business failures. In fact business played only a moderate role in supporting the government's reform agenda and this was co-ordinated, in part, by large financial providers who would develop or modify the financial infrastructure of such mandated retirement accounts.

Table 1: Details of the Prescribed Superannuation Requirements Linked with the Mandated Second Pillar

	Employer's Prescribed Rate of Employee Support (%)
July 1 1997- June 30 1998	6
July 1 1998- June 30 1999	7
July 1 1999- June 30 2000	7
July 1 2000- June 30 2001	8
July 1 2001- June 30 2002	8
July 1 2002-03 and subsequent years	9

In March 1996, the Labor Federal Government lost office and was replaced by a conservative, Liberal Coalition Government under Prime Minister John Howard. It had been the intention of the Australian Labor Party to further expand the compulsory nature of superannuation by gathering a 3 percent contribution from individual workers and providing an additional 3 percent to certain workers who met pre-defined income criteria. In total this would have meant that many workers' individual superannuation contribution accounts would have been receiving total contributions of 15 percent. Treasury estimates suggest that over a forty-year period these contributions would translate out to be approximately 60 percent of salary on retirement.

The impact of compulsion

The criticisms levelled at Australia's pension system, usually by those who are looking at it from the outside, belong to what I've called the 7 Myths. Typically these run along the lines of:

- 1 Compulsion in Australia started a recession;
- 2 Australia had a successful voluntary second pillar pension framework (so why move to compulsion?);
- 3 After compulsion net savings fell;
- 4 The industry made free with fees and charges;
- 5 Australians make free with their retirement savings – spend the lot and then fall back on the State pension;
- 6 Compulsion was introduced for ideological reasons by the a union backed Labor Government rather than as an answer to socio-economic need;
- 7 The second pillar savings level of 9% is insufficient to replace income.

None of these myths is borne out by the facts. In fact pension adequacy has been

improved in the second pillar and Australia has been proofed against future demographic change. Expensive Defined Benefit plans, the supposed gold standard of some politicians and Employee Benefit Consultancies (EBCs) have become all but extinct. At September 2004 the breakdown of benefit structures included 297,327 accumulation funds, 182 defined benefit plans and 309 hybrid plans. At the same time superannuation coverage of all workers has been maintained at a level of 88%.

Compulsion has dramatically raised retirement savings and improved the future prospects of baby boomer and Generation X retirees. Comparatively low administration costs, wide investment choice and minimal mis-selling have protected consumers from detriment.

One of the reasons why Australia has been so successful in keeping administrative costs low and avoiding the problems associated with mis-selling is through effective and cost efficient regulation. Strict rules govern how superannuation policies are sold and switched. Moreover consumers are required to receive minimum levels of information about the superannuation products at the time of sale and also on a regular basis. Increasingly superannuation account holders are being provided with greater investment choices. Some retail funds for example offer between 5-7 investment choices, and proposed legislation by the Federal Government will force employers to offer choice of funds. Additionally, specialized administration companies have developed services that allow superannuation fund trustees to outsource much of their investment and administrative functions. This intense competition has led, in part, to returns being maximized and administrative fees being minimized.

Sound regulation, transparency and significant improvements in the competency levels of distributors eg. financial advisers and financial planners, has raised public confidence in the retirement system and nurtured a steady increase in the level of voluntary contributions made into superannuation accounts. The Australian government has announced that it will encourage lower income families and workers to bolster their retirement savings via government co-contributions by widening the eligibility criteria for the Government's co-contribution scheme (whereby the Government matches an eligible member's after-tax superannuation contributions dollar for dollar, up to a prescribed annual maximum, and subject to an income test).

Total superannuation assets held by 9.2 million workers now stand at nearly \$649 billion³ (\$US495.4) for just over 9 million workers compared with \$32 billion in 1993. A large percentage of them are invested in equities (49%), interest bearing securities (16%) and 17% or \$108 billion are invested in overseas equities.

Administration costs do continue to be a sensitive issue within the Australian political and financial services environment. These costs can vary widely between the types of superannuation funds found in Australia. An authoritative survey, conducted by the Association of Superannuation Funds of Australia (ASFA), estimated that an average of \$1.28 (\$US0.97) per member per week was made for overall administration costs in 1999-2000. It should be noted that this figure has declined from \$1.66 (\$US1.27) per week two years earlier. Expressed in another way, costs as a percentage of assets in June 2000 were calculated to be 1.29%.

³ Statistics, Superannuation Trends September 2004 Australian Prudential Regulation Authority

Table 2: Projected future state spending on pensions as a percentage of GDP

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	5.9	4.8	5.2	6.7	8.3	9.4	9.8
UK	4.5	4.5	5.2	5.1	5.5	4.0	4.1
United States	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Source: OECD, cited in Johnson (1999)

What we could have done better

Australia has pursued an independent line on taxation of superannuation and one I find hard to agree with. Contributions are taxed at a rate of 15 percent, along with possible additional taxation of 15 percent for members earning over a certain threshold. A further 15 percent is levied on the investment income of each superannuation fund and finally the benefits can be subjected to varying tax treatment of between 0-30%, depending on timing of the contributions. As you can see the Commonwealth Treasury's faith in the politicians getting taxation revenues back from retirees' retirement nest eggs was very low when this taxation approach was adopted in 1992. Continual change to the way superannuation is taxed has caused much confusion for plan participants and trustees and industry associations are pushing for a comprehensive review.

Another negative feature is the sheer volume of accounts. Workers have an average of three, I have four. A new plan for a new job has created unnecessary duplication and administrative cost. Many funds are now seeking to streamline the transfer process by administration protocols.

It has to be said that the system has not delivered benefits to current pensioners whose circumstances have deteriorated over the past 10 years. A state pension indexed to prices and pegged at 26% of male total average weekly earnings has reduced their purchasing. The full benefit of compulsory superannuation reforms will not 'crystalise' until well into this century.

What next?

Around 30% of employees in Australia already have fund choice and the Choice of Fund Act 2004 will give a further 40% of employees this freedom from 1 July 2005. Employers can meet their obligations under the Act by entering into a certified agreement with their employees. If workers do not choose a fund, employers must make contributions to a fund that satisfies the requirement to offer a minimum level of life insurance cover. The level of insurance premiums will not be regulated. Employers will give their workers a standard

choice form which will provide basic information and highlight what should be considered before a fund is selected such as: level of fees and charges and the type of investments a fund offers.

The Howard government's reason for choice of funds is partly ideological in my view but is described as providing a more flexible and adaptable retirement system - one of the benefits should be portability - and more appropriate for flexible workplace arrangements which allow workers to reduce their hours as they approach retirement and to work beyond 65. The new legislation will allow people to access their superannuation from their preservation age without having to retire and it will allow them to develop strategies in transition to retirement for example working part-time and supplementing their income with some of their superannuation. It is not intended to enable people to dissipate their superannuation savings before retirement, however, and the Government is taking measures to ensure that savings are drawn down in a regular and orderly way.

The government has announced further measures to encourage lower income families and workers to bolster their retirement savings via government co-contributions which match after-tax superannuation contributions dollar for dollar up to a prescribed annual maximum and subject to an income test.

Lessons for the US

As indicated, lessons do exist for the US in regard to how Australia has addressed its ageing populations and they can be summarised in five major points:

- Partnership with the trade unions
- Incentives for low income workers and the self-employed
- Information and education
- Cost effective regulation
- Contained administrative costs under the creation of numerous individual retirement accounts

And, finally, persuading all stakeholders that change had to happen and that it was for the benefit of the nation as a whole.

June 2005