The Aussie Experience

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Background to Aussie 9% SG

Up until the mid 1980s, the majority of Australians relied almost entirely on the Age Pension as their sole retirement income.

Around 40% of employees had super but only a small proportion of these achieved significant savings. Super was predominately the preserve of public servants and of the white collar males in large corporations.

Union concerns about this low coverage led to bargaining in the late 1980's and resulted in a superannuation contribution of 3 percent of wages being made in lieu of a wage increase in some industries. The idea was to supplement rather than replace the Age Pension.

At the time, it was expected these arrangements would spread to all industries. However, the slow spread of such contributions led to the Australian Government legislating to require employers to make contributions. These contributions, known as the Superannuation Guarantee, were set initially at 3 per cent of wages in 1992 and has gradually increased to 9 percent in 2002.

The 1992 agreement was visionary but was also a product of the circumstances of the day.

If you caste your mind back, it was a period of very high inflation for Australia and the government was very fearful of wage increases exacerbating this. Key union officials were also committed to achieving superannuation coverage for their members – and saw a deferred wage or pension as being an alternative to immediate wage increases.

Employers probably preferred no wage increase, but had no fundamental preference between it being paid as wage or as a superannuation contribution.

So that was the political origins of the Aussie compulsory super – it was seen as a deferred wage and part of a salary package. The historic circumstances pushed the debate into an IR arena and also with union support managed to sidestep any real hysteria about dismantling or "privatising" the social security system.

That said, it has always been important to stress the continued assistance provided by the Age Pension as well as compulsory private savings.

As an aside the regulatory frame of SG is interesting and important.

Keating, the Aussie PM of the day, decided that super and SG contributions should be managed by the private sector but within a strong regulatory frame, stronger than for other financial products.

As I understand it, he considered that the private sector is experienced in managing and achieving stronger long term returns. Perhaps most importantly he considered that the

pool of money should be outside the reach of the government so that it could not plunder, or use, the savings as a convenient ‘pot of gold’ for current needs.

In this context it is ironic to remember that it was also the Keating Government who introduced the 15% tax on employer contributions and 15% tax on fund earnings to create a significant advance revenue stream for the government – more on this later.

The SG is still a relatively young policy and only reached its ceiling of 9% in 2002. The original vision was for this to be topped up by additional personal contributions of 3% and government co-contributions of 3%. Unfortunately these initiatives have not been implemented.

Evaluation of the Australian System

Australian Structure of 3 tiers – is often cited as International Best Practice

1. Age pension (income + asset tested, funded from consolidated revenue – the maximum rate is 26% of AWE, therefore provides a safety net, not income replacement)
2. Compulsory savings from a % of wages
3. Voluntary Savings

The 3 pillar structure is often cited as international Best Practice. I would agree it provides ‘good bones’.

There are a number of other positives and negatives of the Australian system. First to the positives:

Some positives of the Australian experience:

- Extensive coverage
- Boost to savings
- Strong community support
- Improved adequacy of retirement income results

Coverage

With the introduction of the SG coverage improved from 40% in mid 1980’s (mostly white collar/male) to some 87% of all full time and part time workers now. This is a significant reform.

But some of the rules (e.g. SG is not compulsory for people with wages of less than $450 per month and the rules for self employed) mean that coverage is weakest for casual and self employed. The challenge is to extend coverage to these groups.

A challenge is also to provide better coverage for those seeking phased retirement after the official retirement age.

Boost to Savings

Super has boosted national and household savings. It is now the second most important form of savings after the family home. Aussies are quite obsessive about owning their family home and real estate prices more generally. While the home is still the major form of savings, very few people intend to sell their home in retirement. Home equity release schemes are rarely used and options are limited. Thus creating the dilemma of being asset rich/income poor.

A positive feature of super savings is that it helps to diversify the portfolio of assets held by any individual.

As Dr Cullen alluded, there is still some debate as to whether the policy of compulsory super actually increases household savings overall or merely substitutes how people save.

Recent research by the Reserve Bank of Australia concludes that superannuation and SG has added to household savings overall. This is despite the fact that household savings continue to fall. They concluded that the fall would have been much greater if it were not for super savings.

Equity

Importantly, superannuation and the SG is the major savings vehicle for lower/middle income groups and has become a key factor in boosting savings amongst this group. This is an important feature of equity.

For the wealthier 40% of the population, super is not the dominant form of savings – they apparently prefer other voluntary investment options.

- Superannuation makes up around 70% of wealth of the lower part of wealth distribution (but on 20% of the top 40% of wealth distribution).

The SG is also expected to have a positive impact on future government expenditures

It is expected to reduce the reliance on the age pension (as well as improve the adequacy of retirement income).

In a mature system it is anticipated that most people will receive a part age pension (rather than a full pension as is the case now).

[Treasury estimates that without the SG government expenditures on Age and Veterans Pensions would need to be around 4.75% of GDP rather than the 4.5% now estimated for 2040 – a saving of some $4.4billion per annum in today's dollars.]

The SG and "targeted" nature of Australia's age pension means that Australia's future expenditure blow outs should be much more manageable than in many other countries.

However, the reality may not be quite so benign.

While Treasury's Intergenerational Report did a good job in auditing pressures on government expenditure (such as the age pension) it did not factor in the increasing retirement income and lifestyle expectations of future generations and retirees.

This underestimates the likely political pressure and tension that is yet to come as the bulge of baby boomers find that their retirement income savings does not meet their expectations. They will live longer, and their expectations are very different from their parents, grandparents and current retirees. It is a potent political mix. Let's face it, this group are used to getting their own way but their retirement will coincide with a time that government and taxpayers will have difficulty to respond to.

Community Support

But back to the positives, there is strong community support for the Aussie compulsory superannuation policy.

You may find this surprising given that people usually object to anything compulsory and anything that could be seen as another tax.

ASFA has researched this from a number of perspectives. We found that support for compulsory super stands at about 97% - and this is even with the recent experience of negative returns.

The reason behind this support lies in the fact that people:

- understand that they themselves need the discipline to save;
- understand that the community needs the discipline to save.

The notion of a structured, disciplined and compulsory plan appeals in that it can be seen to build up personal wealth and the wealth of the nation and its capacity to meet future demands.

This may sound too good to be true but people understand the "ageing demographics" and their own foibles more than we often give them credit for. To put it crudely, they want to make sure the other buggers save.

Adequacy

So there is strong support for a regular, disciplined and compulsory savings approach.

However, we still have some way to go. The risk is that the current level of super savings will still fall significantly short of what people expect and will need in retirement.

To give you a snap shot:

- 70% of people expect that they will need a minimum of $30,000 a year or more in retirement.
- A recent Senate Select Committee also confirmed that in terms of adequacy 80% of pre retirement expenditure was probably an appropriate target. For some-one on AWE in Australia this translates to about $30,000.
- The problem and gap arises in the fact that the current levels of savings (even with the full age pension) will not deliver these results.

  For some-one on AWE, saving 9%, for 30 years would provide a retirement income of approximately $19,000 (including the age pension).

$19K is certainly a lot better than the age pension, $11K, but it will not meet minimum expectations.

Add to this the fact that the SG policy is still young. Most people haven’t had the opportunity of working for 30 years. Many women never will.

Average lump sum savings currently stand at approximately $75K and are expected to increase to $135,000 by 2020.

A lump sum of around $300,000 is required to sustain a retirement income of $30,000 over 20 years. So that is the kind of savings gap we are looking at.

If we are to meet these expectations, the savings rate we should be looking at over a 30 year working life should be more in the order of 15% of wages, not the current 9%.

Whether we look at this as being a case of ‘a glass half full’ or ‘a glass half empty’ is open to conjecture.

But our research indicates that many people are blissfully unaware of the current savings gap.

Others are aware that they need to do more but aren’t clear about the necessary savings targets. Unfortunately human nature dictates that we don’t want to think about it until retirement is almost upon us (a bit like a student cramming for exams).

This brings me to the lessons to be learnt from the Australian experience.

1. A Clear Target

The 9% SG has become the default savings level for many. If it’s all too hard to think about you go along with what your government, employer or other authority suggests. The 9% SG has become the “default” for many.

We need to be clearer about what our targets are. In the Australian context there is no agreed adequacy target. Without that target it is difficult to have an agreed action plan.

Perhaps employers should be encouraged to set a higher default savings target. Some government schemes do this, e.g. they will set aside an extra 5% of wages unless the employee opts out.

Lesson 1 – Clear target
- Set clear targets for adequacy. (Establish shared responsibilities and a strategy to meet that target)
- Factor in increasing expectations
- Factor in changing work patterns
- Factor in increasing longevity

2. The importance of confidence, stability and joint effort

Even with a compulsory scheme it is essential that there is public confidence in the system and that the government is seen to be doing its bit in supporting individual effort. It is even more important for voluntary savings.

In Australia, the public regard "saving for retirement" as a joint responsibility between employers/government and individuals.

Our research indicates that people understand that they probably need to save more (but are confused about how much). They think employers have done their bit through the 9% SG. They are prepared to do more if the government also comes to the party to better support their effort.

In this regard, there is particular community anger about the taxation on super – especially the front end taxation on contributions and the surcharge. Individuals are noticing the size and impact of the tax take on their super – and consider it to be unfair and undermining their efforts to be more self reliant in retirement.

At the same time, our research has found a growing anger and concern over the governments tinkering with the superannuation rules – and a concern that the rules could change (to their detriment) before they retire. They are worried about locking their money away while this uncertainty remains.

They don't mind change, we suspect, if it assists them. No-one would complain if the rules were made more flexible so you could ease into retirement.

The lesson remains that there needs to be a clear commitment from government, stability of the rules and incentives to create a partnership, or win/win situation, for people to want to lock their money away from long term.

In the Australian context much of the comment and debate has been to:

- Reduce or remove front end taxes; or
- Introduce co-contributions. (A lower cost option for the government, but requiring discretionary income.)

Lesson 2 - Importance of Confidence/Stability/Joint Effort

- Incentives, co-contributions and/or a sense of mutual effort with government does matter
- Provide clear rules/stability
- A disciplined, structured and compulsory plan can work

3. The related negative lesson from Australia is our tax structure – the lesson is keep it simple.

The Australian TTT structure of 15% tax at the contribution, earnings and benefit stage, plus the extra tax surcharge for some, has added immeasurably to the complexity. If the Australian 3 tier structure of savings can be regarded as best practice our tax structure must be regarded as the world's worst practice, since we are the only country to tax super at every stage in its life cycle.

The ideal tax structure is to tax once – preferably deferring tax to the back end when retirement income is taken.

This model is used in a number of countries (including Canada and the US). The advantage is that it allows retirement savings and investment earnings to grow and to be used for the purpose it was intended. For our person on AWE, removing these taxes on contributions and earnings would improve their retirement savings by some $50K. This would help to reduce the savings gap. Taxing at the end allows for individual lifetime equity issues – such as broken work patterns, fluctuating income - to be more easily addressed rather than a year on year approach.

Lesson 3 - Simplicity

- Keep the rules and tax structure simple
- Preferably tax only once – and ideally at the point when retirement income is taken

Saving for retirement is by its very nature a long term strategy.

Compliance Costs

A related issue and lesson relates to the high compliance costs that arise from our complicated tax structure and from the grandfathering of different rules. The litany of changes and disasters in Australia all lead to higher compliance costs.

[The super surcharge is an example in point – this is the additional 15% contributions tax levied on higher income earners (those earning over $94,691). Implementation of this tax required super funds to spend some $140 million in IT systems and costs alone.

The ongoing compliance costs for the funds are estimated to be $76 million in per annum or 11% of all revenue raised.

These costs are borne by all fund members, not just those targeted.]

Lesson 4 - Simplicity

- Don't grandfather rules. Stage changes, sunset clauses or cash out entitlements
- Compliance costs should be as low and cost effective as possible

In the Australian context, the notion of fair play is important.

Lesson 5 – Equity

- Encourage self reliance and integration between pension and private savings
- Encourage the use of retirement income streams, not lump sums
- Ensure equity between individuals, across lifetimes and between generations

*** Act NOW!

But governments (and individuals) tend to think in terms of:

- the need to spend money or tax revenue now.

There is a need to ensure policy, tax structure and method of Government costing or accounts tax expenditures factor in longer term.

Remember the power of compound interest. Delay can be costly. (5 year delay, 3% interest in savings tasks.

Conclusion

I have tried to stick to my brief outlining the lessons from Australia. There are of course a range of debates in Australia as to what should be done next.

I am encouraged by your initiative to hold this forum - and hopefully establish an agreed vision, and determination to tackle the difficult economic, policy and intergenerational issues going forward.

To my mind the themes going forward are:

- Simplification
- Coverage
- Adequacy and sustainability targets
- Integration pillars for savings and workforce changes
- Confidence
    - Accountability
    - Stability of rules
    - Joint effort by government, individuals and other stakeholders