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Mandating Retirement Provision: The Australian Experience

by Hazel Bateman and John Piggott*

1. Introduction

Only three countries rely significantly on what we term private mandatory saving policies for retirement: Australia, Switzerland and Chile. Several other countries, including Mexico, Argentina, Peru and Columbia, have moved in the same direction. Hong Kong plans to implement such a policy from 1999. It is probable that other countries will follow suit, especially in the light of World Bank advocacy of private mandating, and the current U.S. debate on privatizing social security (World Bank, 1994).

This paper focuses on the Superannuation Guarantee, as Australia's mandatory retirement saving plan is called. We begin by laying out its essential features, and offer an account of its genesis. We then critically assess its current and likely future efficacy. So far as possible, we try to relate the Australian experience to that of countries who may be contemplating the adoption of such a policy in the foreseeable future. The paper concludes with a description of the emphases of the current government, whose victory in 1996 is testing the robustness of bipartisan support for the Superannuation Guarantee and its cluster of related policies.

2. What is the Superannuation Guarantee?[1]

Policy outline

The Superannuation Guarantee corresponds to national earnings-related retirement income schemes operating overseas, such as the U.S. Social Security system, or the U.K. State Earnings Related Pension Scheme. However, in the Australian case, mandating has been chosen as an alternative to public provision. Table 1 summarizes its main features.

Introduced in 1992, it mandates employers to make superannuation contributions on behalf of their employees to complying superannuation funds of their choice: employers who fail to do so are subject to the Superannuation Guarantee Charge. These contributions are placed in individual accounts and invested on behalf of the employees.

The arrangements apply to all employers and to almost all employees. Employees earning less than $A450 per month are specifically excluded, and contributions are optional

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[1] This section draws on Bateman and Piggott (1997).

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Table 1:
Features of the Australian Superannuation Guarantee

Established	1992
Contributions (by 2002)	9% employer + (proposed) 3% employee[a]
Funding	Fully funded Individual accounts Many private funds Few investment restrictions
Benefits	Defined contribution Fully vested, portable and preserved to aged 55 (being increased to 60) No early withdrawals Choice of lump sum, pension, annuity – tax incentives to encourage income streams
Statutory coverage	All employees aged 18–65 with earnings > \$A450 month[b] Self-employed not covered
Taxation	Employer contributions tax-deductible Fund income (contributions and earnings) and benefits taxed at concessionary rates
Administration	Perceived to be complex. Member protection rules for workers contributing small amounts
Safety net	Public age pension provided to all elderly residents, subject to income and assets means tests

Notes: [a]The 9 per cent employer contribution is being phased in over the period to 2002. Proposals to introduce a 3 per cent employee contribution and a 3 per cent government contribution have been abandoned.
[b]Employees earning between \$A450 and \$A900 a month may choose contributions or higher wages.

for employees earning between \$A450 and \$A900 per month, on the grounds of high relative administrative costs for small contributions.

The mandatory contributions under the Superannuation Guarantee must be fully vested (i.e., the member is fully entitled to all accrued benefits), fully preserved (i.e., accrued benefits must remain in a fund until the statutory preservation age for access to benefits is reached), fully funded and be paid into a complying superannuation fund.[2] The superannuation funds are managed by a board of trustees, with equal representation of employers and employees. In current practice, the chosen funds are frequently industry-based.

The minimum level of superannuation support is being phased in. The timetable for implementation has been legislated, with the target of a 9 per cent employer contribution to be reached by 2002. It is thought that over this period labour productivity growth will more than offset the impost of the Superannuation Guarantee, so that real wages will not actually fall.

Employees may access the accrued benefits in the form of a lump sum or an income stream upon reaching the preservation age, currently 55. (This is legislated to increase to age

[2] For public sector employers, a government guarantee can substitute for full funding. Well defined benefit schemes count in meeting Superannuation Guarantee obligations provided an actuarial benefit certificate, specifying that the implicit level of superannuation support accords with the requirements, is obtained.

60 by 2025.) Income streams are encouraged by tax incentives, but to date these do not appear to be affecting the long term preference for lump sum benefits (Bateman et al., 1993).

Taxation

The mandatory retirement saving is concessionally taxed, but in contrast to similar arrangements operating elsewhere in the world, taxation applies (at concessional rates) at all three possible points: contributions, fund earnings and benefits. Employer contributions are tax deductible (up to age-determined limits) but are taxed in the hands of the superannuation fund at a rate of 15 per cent.[3] Fund earnings are taxed at a statutory rate of 15 per cent, although this is reduced to the extent that income accrues in the form of dividends or capital gains.[4] Retirement benefits are taxed as well, with the amount of taxation depending on the type of benefit and its size.

Regulation

Superannuation regulation in Australia focuses on what might be termed "product regulation". Information provision concerning products and services, and the competence of those marketing the services, are monitored. Prudential issues, however, are largely left to fund trustees, who are personally liable to fund members for their decisions. They are responsible for the management, operation and investments of superannuation funds. For most funds, the trust boards must comprise equal employee and employer representation. There are few portfolio restrictions. With the exception of a 5 per cent of asset ceiling on in-house investments, there are no asset requirements, nor is a minimum rate of return required.

Relationship with other retirement income pillars

The Superannuation Guarantee co-exists with voluntary superannuation, a public age pension and voluntary saving. These components of retirement provision are illustrated in Figure 1, with Australia's choice from each policy menu in bold.

The Superannuation Guarantee completes Australia's three-pillar structure for retirement income policy. The first pillar is the universal, but means-tested, public pension. This was first introduced in 1908 and in the absence, until recently, of any form of compulsory earnings-related pensions, served as both the social welfare net for the elderly and the major source of income for most retired people. The full rate age pension is currently paid at 25 per cent of male average earnings (for a single retiree) and 40 per cent of male average earnings (for a retiree couple). This is phased out as retirement income and assets provided under the other pillars exceed statutory thresholds.

The pension amounts at June 1998 were \$A9,204.00 pa for a single retiree and \$A15,381.60 pa for a couple. Under the income test, the maximum rate of pension is reduced by 50c for every \$A1 by which other income exceeds a free area of \$A50 a week for a single pensioner and \$A88 a week (combined income) for a married pensioner couple. Payment of

3 Or at the higher rate of 30 per cent for high income earners.

4 Full corporate tax imputation credits are available on dividend income which may be set off against tax on any income, including capital gains and taxable contributions, while capital gains tax is indexed to inflation.

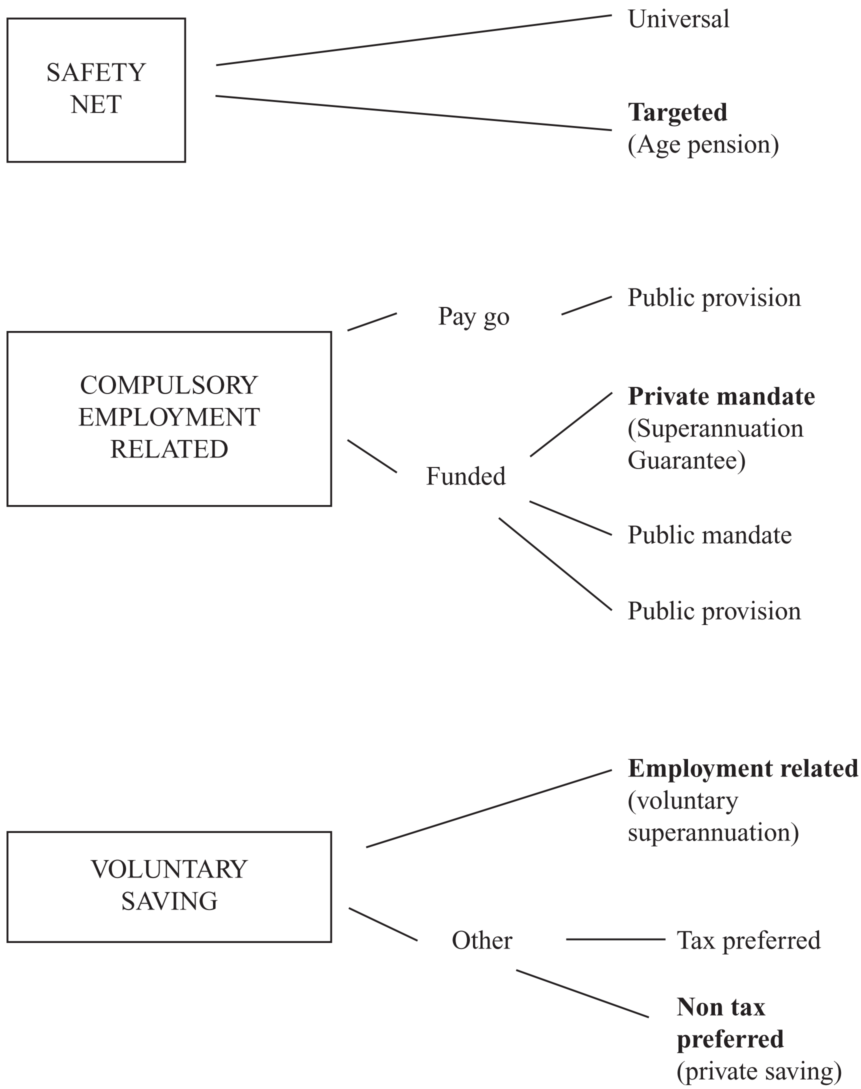

Figure 1: Components of retirement provision

the pension ceases altogether once weekly income reaches $A410.00 for a single pensioner and $A685.00 (combined income) for a married pensioner couple.[5]

The assets test reduces the pension by $A1.50 per week for every $A1,000 of assets above specified thresholds. The family home is exempt, but the thresholds differ between home-owners and non-home-owners. They also distinguish between singles and couples. The

[5] These amounts are for June 1998.

home-owner thresholds at June 1998 were $A125,750 for singles and $A178,500 for a married couple; the corresponding thresholds for non-home-owners were $A215,750 and $A268,500. These income and asset limits are indexed to annual movements in the CPI.

The second pillar is the slowly maturing Superannuation Guarantee and the third pillar is voluntary saving, which includes voluntary (but tax preferred) occupational superannuation.

The major source of income for most current retirees of eligible age is the age pension with around 83 per cent of eligible retirees receiving some age pension, of which around 68 per cent is paid at the full rate (DSS, 1997). This is not surprising with the Superannuation Guarantee in its infancy. But as shown in Figure 2, which summarizes the expected composition of net retirement income with a mature Superannuation Guarantee, the balance will change over coming decades as more Australians reach retirement with long periods of Superannuation Guarantee coverage. (Figure 3, discussed in section 4 below, indicates how age pension outlays are projected to change over time with the introduction of the Superannuation Guarantee.)

International comparisons

The two other countries with well established private mandatory retirement saving policies, Chile and Switzerland, arrived at this policy position from a different starting point, so the transition problems have been different, and the current state of the policy varies as well. Many pairwise comparisons can be made between Australia and the others. But comparing Australia with both the others as a combination, the most important differences are that:

- Australia has no regulations concerning asset allocations or minimum rates of return, relying instead on the trustees in charge of each superannuation fund to act in the interests of their members. Australian law holds trustees personally liable for the competent

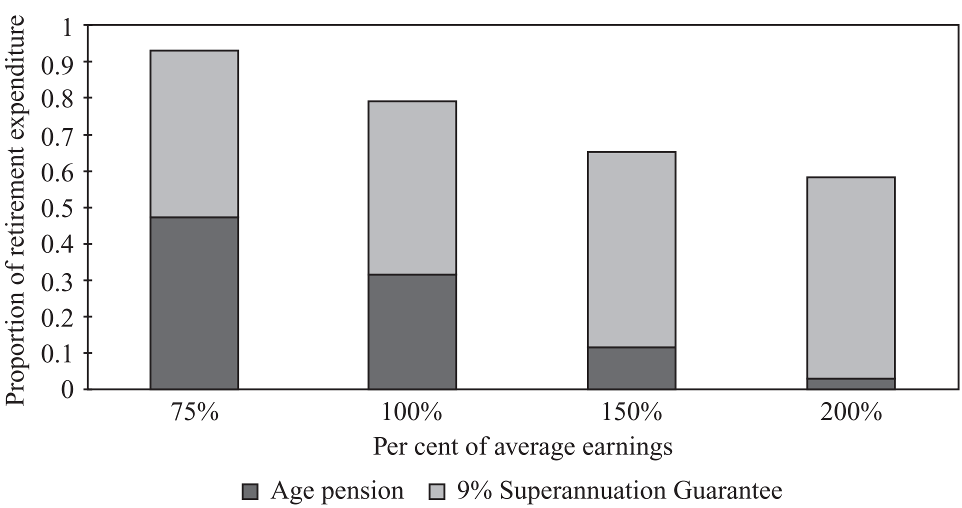

Figure 2: Expected composition of net retirement income
Source: This figure is derived from Willis (1995), Table 1, pp. 10–11.

discharge of this task. Chile and Switzerland both have maximum asset allocations for various types of asset, and rate of return requirements;

- The Australian government offers no minimum return guarantee on the mandated contributions, whereas both Chile and Switzerland offer such a guarantee;
- Australia taxes the mandatory retirement saving at all three possible points while both Chile and Switzerland tax benefits only;
- In Australia, retirees can take their benefits as a lump sum – there is no annuity requirement. Both Chile and Switzerland, and for that matter, almost all other developed countries, require compulsory retirement benefits to be taken as an income stream, usually for life (Chile is an outlier here). Lump sums from superannuation are prevalent in Australia; the life annuity market hardly exists. In the December quarter 1997, $A5.9 billion was paid out in final benefits to private sector retirees; only $A329 million was in the form of an annuity or pension.
- In Chile workers choose the fund manager, in Switzerland employer control predominates, while in Australia this choice is the responsibility of a board of trustees, representing both employers and employees.[6]

3. How (and why) did Australia arrive at private mandating of retirement provision?[7]

Traditionally, Australia has relied on a targeted universal age pension for retirement income, with entitlement based on age (currently 65 for men and 60 for women), residency status, income, and assets, but not on employment history.[8] It is paid from general revenues. Although tax and other concessions have always existed for occupational retirement schemes, participation was voluntary. There was no government policy to compel participation in an employment or earnings-related retirement income scheme, as is typical in other OECD countries. As a consequence, the introduction of mandatory private retirement saving does not entail transition problems of the kinds anticipated in countries with well established public earnings-related pay as you go schemes. The old targeted age pension was simply kept as the first pillar of the new multi-pillar system.

Australia's status as odd man out in this regard seems to have been more a matter of historical and political accident than of any consistent policy stance. It was always recognized that the public age pension alone was not sufficient to fund adequate provision for the retired in a developed and rich society such as Australia's. Between 1913 and 1938, three unsuccessful attempts were made to introduce earnings-related retirement income arrangements similar to those which were proving popular in Western Europe and the Americas. In 1938 Australia even got as far as passing the enabling legislation, but, with the coming of World War II, deferred implementation indefinitely.

A further attempt was made in the early 1970s when the Whitlam Labor Government commissioned a report on retirement income. The resulting Hancock Report also recommended a scheme along the lines of U.S. and European style arrangements but was not

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[6] Although it is planned to allow employee choice of fund from July 1999.

[7] This section draws heavily on Senate (1988).

[8] The female age pension age is currently being increased and will be aligned with the male pension age of 65 by the year 2014.

completed until after the change of government in 1975, and its recommendations were never acted upon.

Support for broad coverage superannuation was then carried by the trade union movement, but the emphasis moved away from national to occupational arrangements. Prominent union leaders argued that superannuation should be a central feature of negotiated industrial conditions. At this time, occupational superannuation remained very narrowly based, confined mostly to the public sector, banking and insurance industries, and middle to senior management elsewhere. The union movement argued that superannuation should be provided to all employees, including casuals and parttimers.

When a Labor Government was elected in March 1983, a major plank in its economic strategy was a continuing contract with the union movement, the "Accord", which survived through Labor's tenure of office. The Accord, along with Australia's then centralized wage determination system, contained the idea of building superannuation contributions into a national centralized wage decision. The idea became reality in 1986, when the Accord Mark II was agreed. The crucial element in that agreement was that while the increase in compensation to employees should be 6 per cent, to keep pace with inflation, half of the increase would accrue in the form of a 3 per cent employer superannuation contribution, to be paid into an individual account in an industry fund. This was known as Productivity Award Superannuation (PAS). This agreement was subsequently ratified by the nation's industrial court, and survived a High Court challenge brought by the Confederation of Australian Industry questioning its constitutionality (Dabscheck, 1989, p.99).

Over the next three years, as individual industrial award agreements were negotiated and ratified under the umbrella of the 1986 national wage case decision, superannuation coverage of employees nearly doubled from 40 per cent to 79 per cent. In the private sector, where superannuation coverage had traditionally been low, it increased from 32 per cent in 1987 to 68 per cent in 1991.

PAS enjoyed surprisingly broad support. It was embraced by the government because it helped to solve two problems. First, the Australian economy was booming, and it was becoming necessary to contain aggregate demand. A full 6 per cent wage increase, consistent with real wage maintenance, was seen as likely to magnify this upswing of the business cycle while payments to the superannuation funds contained demand and inflation. Second, PAS helped to mollify sections of the Labor Party, which had been advocating national superannuation for some time. Further, compulsory saving in the form of superannuation could be seen to address the problem of national saving which was considered to be deficient.

The union movement saw PAS as a method of securing retirement rights additional to the age pension for its membership. It was also able to claim that it had achieved full compensation for inflation. Further, because the industry funds were defined around union membership, unions saw in PAS the long-term prospect of gaining some degree of control over substantial capital funds. Employer reactions were mixed, but were much less negative than might be anticipated because employers also had partial control and PAS was included as part of an agreed overall wage package. PAS contributions were seen, at least in part, as a substitute for higher wage payments.

Experience proved, however, that the PAS was plagued with compliance problems. To overcome these required a separate court case to be mounted for each award, of which there are several thousand. It was not being paid to many employees who were entitled to it and many employees were confused about the nature of their entitlement. Because the awards called for payment to an industry fund, and some unions had not established such funds, employer liability was unclear.

As a result, in 1991 the Australian industrial court rejected an application, supported by both the government and the unions, for a further 3 per cent PAS increment. The government responded by introducing legislation requiring employers to make superannuation contributions to an approved fund on behalf of their employees. This is now known as the Superannuation Guarantee.

In a way, the Superannuation Guarantee can be seen as a way of "privatizing" social security, an initiative which is now being advocated in a number of countries. The driving force behind this general policy thrust is the onset of demographic transition. However, the Superannuation Guarantee did not, so far as we are aware, have its genesis in any such concerns. Australia's means-tested age pension does not have anything like the same implications for future public sector obligations as those which exist in some other countries. Nevertheless, the Superannuation Guarantee's relatively smooth passage through the policy formulation and implementation process reflects a recognition among policy-makers that it partially addressed some of the problems associated with population ageing.

Because no previous employment-related social security scheme was in place in Australia, the standard transition problems associated with "privatization", including the finance of unfunded liabilities, do not arise. However, two features of the Australian transition should be noted. First, the trade union movement was heavily involved in the early stages of the evolution of the Superannuation Guarantee. This had a number of implications: selling the idea to the Australian worker was made easy because the unions wanted it and supported it; coverage is restricted to employees; and many of the superannuation funds designated to receive contributions were "industry funds", coinciding in coverage with particular unions, and in which the 50 per cent required employee trustee membership was effectively 50 per cent union membership. This last consequence has meant that even though PAS has now become the Superannuation Guarantee, independent of wage negotiations, it is still hard to choose other funds, because the 3 per cent PAS must still be paid into the fund designated in the award agreement, and to go elsewhere with Superannuation Guarantee contributions would simply double administration costs.

Secondly, the Superannuation Guarantee used the administrative, legal and financial structures under which the pre-existing voluntary occupational superannuation worked. This meant that the design faults with occupational superannuation, which were not particularly serious because of the low voluntary coverage, applied also to the Superannuation Guarantee. In particular, lump sum withdrawals were permitted from the age of 55, even though the means-tested public age pension is not available until at least 60, and until 65 for most men. This lack of co-ordination and integration between the publicly provided flat rate pension and the private Superannuation Guarantee means that a gap exists where much leakage of retirement saving can occur. It probably encourages early retirement, and also leads to early asset disposal to meet the means test provisions for the age pension. This is the major structural problem in the development of the Superannuation Guarantee as an effective retirement income policy. We return to it below.

4. How well is the Superannuation Guarantee working?

Because Australian private pension policy is in transition, it follows that any assessment of that policy must be contingent on the nature of future developments. Even with this caveat, however, assessment remains an extremely difficult task. This is mainly because while some policy components are developed to a high degree of sophistication, others remain in a more or less primitive state. In this context, it is useful to distinguish between the accumulation and benefit parts of the policy. In broad terms, the Superannuation Guarantee scores well on the accumulation phase, because the mandatory contributions ensure full fundedness and the private basis of the policy helps provide political insulation (Diamond, 1997). The benefits phase is much less satisfactory because income streams are not mandatory.

In the overall structure of Australian retirement income policy, the Superannuation Guarantee takes the role of a national employment-related retirement income scheme. It follows that it should be judged on criteria appropriate to such arrangements. Standard normative public finance focuses on economic efficiency, equity, and administrative efficacy, and these are clearly important. Our judgment on how the Superannuation Guarantee measures up on these criteria is reported in the upper half of Table 2. We discuss them in more detail in Bateman and Piggott (1993).

However, these do not adequately address the needs of the elderly which give rise to the formulation of a retirement income policy in the first place. Standard criteria of this latter kind do not exist, but we have developed a set of requirements, in the spirit of Bodie (1990), which seem reasonable. These focus on the needs of the elderly to be insured against various types of risk. They include coverage, replacement rate, investment, longevity, inflation, and political risk. We explore the extent to which the Superannuation Guarantee meets these criteria.

In a strict sense, the Superannuation Guarantee scores poorly, because of the lack of an income stream requirement. However, it is possible to ask to what extent the policy would be able to deliver on these criteria, given current practice of retirees, and that is the approach followed here.

Our conclusions are summarized in the lower half of Table 2, to which the following discussion refers. Again Bateman and Piggott (1993) provide a more detailed discussion.

Table 2:
Assessment of the Australian Superannuation Guarantee

Efficiency	• Addresses dynamic consistency of preferences and price distortions by compelling saving; but not failure of the annuities market • Enhances private saving • Intergenerational neutrality is adequate
Equity	• Low income earners forced to change intertemporal consumption stream
Administrative efficacy	• Small payments; transfer protocol
Coverage	• Adequate
Replacement rate risk	• Adequate for continuous contributions
Investment risk	• Borne by retiree, but addressed through asset diversification
Longevity risk	• Not covered – no mandatory purchase of life annuities, ineffective incentives
Inflation risk	• Not covered – ineffective incentives for indexed life annuity purchase
Political risk	• Superannuation Guarantee accumulations are well insulated from political risk, except for tax changes, but the public pension safety net remains exposed to government variation

Coverage risk

A mature Superannuation Guarantee will ensure that almost all employees will receive at least some superannuation benefit on retirement. The most important group in the labour force not covered by the Superannuation Guarantee is the self-employed. Neither is this group otherwise required to provide for retirement. Further there is no special provision for those not in the paid labour force.

Replacement rate risk

A standard index of retirement income adequacy is the replacement rate. This is supposed to capture the extent to which working life income is replaced by retirement provision. However, it is less clear what constitutes an adequate replacement rate, or how the replacement rate should vary across different personal circumstances. Actuaries often recommend a 70 per cent replacement rate, but how this should vary with family size, home ownership, and so on is not spelt out. As well, gross income is typically used in calculating replacement rates, although the implication of this ratio for actual replacement will depend upon the income tax regime which is operating.[9]

Official estimates (Willis, 1995, see Figure 2) use an expenditure replacement rate which takes account of pre-retirement superannuation contributions and taxation. Replacement rates have been calculated assuming that a CPI indexed life annuity has been purchased with Superannuation Guarantee accumulation. For workers with an unbroken employment history, replacement appears good, with a 9 per cent Superannuation Guarantee rate generating 78.6 per cent replacement (including both annuity and public pension income) for a male worker who has received average weekly earnings for 40 years and retires at 65. The figure for females is 75.4 per cent. (The corresponding gross of tax replacement rates are 83.8 and 79.3 per cent.) The age pension contributes 36 per cent of male and 41 per cent of female retirement income.

However, replacement rate estimates for those with a broken work history are much lower. Bateman et al. (1994), using a similar approach, estimate that if a woman retires five years earlier, at 60, her replacement rate falls to about 63 per cent.

Investment risk

The Superannuation Guarantee is of the accumulation type, so that investment risk rests squarely with the worker, except insofar as taxation and the targeted age pension introduce government risk-sharing.[10] The means-tested age pension acts as a shock absorber for investment risk for many employees. To illustrate how this helps, Bateman and Piggott (1993) calculate that a 1 percentage point fall in the rate of return (from 4.5 to 3.5 per cent) reduces

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[9] The replacement rates quoted here are based on procedures which differ from conventional practice, and from each other. The "official" estimates (drawn from Willis, 1995) express disposable (average rest of life) retirement income as a proportion of average (over working life) disposable income, where disposable income excludes worker contributions. The rate of return (CPI indexed) is 4 per cent, with 1 per cent real wage growth. The replacement rates we calculate give the present value (measured from the point of retirement) of the net-of-tax retirement benefit, as a proportion of the value of foregone net-of-tax wages that would have been earned had the retiree continued to work. Details are set out in Appendix 1 of Bateman and Piggott (1993). Contributions (employer and employee) are set at 12 per cent of earnings, real wages growth at 1 per cent, and the real (CPI indexed) rate of return (after costs and before tax) at 4.5 per cent. The discount rate is also set at 4.5 per cent.

[10] Superannuation funds hold reserves which can be used to smooth replacement rates between cohorts.

the annuity replacement rate by almost 20 percentage points, but the overall replacement rate only falls by 10 percentage points.

Longevity risk

Australian policy does not require retirees to spread their retirement consumption financed from their superannuation payout. Several undesirable consequences follow. The lack of mandated annuity purchase potentially generates adverse selection in the annuities market, and results in income inadequacy for some retirees in the later years of retirement. Furthermore, it combines with current age pension arrangements to induce the problem of double dipping.[11] (The age pension, however, does offer low level longevity insurance.)

Inflation risk

Even if superannuation regulations were changed to compel life annuity purchase, a non-indexed annuity flow would be subject to inflation risk. Inflation affects the profile of the real value of annuity payments. Because nominal interest rates are higher with (anticipated) inflation, early payments will be greater than under a zero inflation scenario.

As the price increases reduce the real purchasing power of these payments, however, the retiree is exposed to the risk of inadequate income replacement in the later years of retirement. The age pension, which is indexed to the CPI, again militates against extreme hardship, providing some inflation insurance.

Political risk

Because Superannuation Guarantee accumulations rest in the private sector, and are therefore not part of the government budgetary process, they are well insulated against political risk. They are not, however, entirely immune: for example, it is open to any government to increase tax rates on accumulations and/or benefits.

On the other hand, the age pension has the same kind of exposure to political risk as the employment-related paygo public pensions elsewhere in the OECD. Many of the risks that we have listed above are mitigated by the interaction of the age pension with private retirement income and assets. The political risk inherent in the age pension must be borne in mind in interpreting these impacts.

Overall economic impacts: current evidence and projections

Analysis of the economic impact of national pension policy in most developed economies focuses on two markets. Labour market behaviour, and particularly retirement, is seen as being altered through the impact of social security and particular provisions of defined benefit pension plans. The capital market is affected as saving behaviour is altered, especially through the transfers implicit in unfunded retirement provision.

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[11] From a long-term policy perspective, it is desirable to limit access to the age pension because of the upcoming demographic transition. Public retirement transfers will be costly to the next generation of taxpayers, both because the retired will constitute an increasing proportion of the population, and because the great political power of the elderly may lead to increases in real benefit entitlements.

In Australia, the Superannuation Guarantee is not widely thought of as having major labour market consequences. This is because the mandatory contributions, while altering the time profile of labour payments, are not seen as having much impact on overall compensation. This is something of an oversimplification, since once the scheme matures, age pension entitlements will be affected by Superannuation Guarantee accumulations. Further, short-term wage rigidities may lead to increased labour costs resulting from the mandatory employer contribution. The Superannuation Guarantee is widely perceived to operate in the same way as PAS with contributions being substantially offset by reduced wage increases. There is, however, little evidence to support or refute this perception thus far.

In Australia, therefore, attention has focused primarily on national saving. This tendency has been exacerbated by concern with aggregate saving performance. The widely cited FitzGerald Report on National Saving (FitzGerald, 1993) devotes much space to the role of the Superannuation Guarantee in promoting saving performance.

It suggests significantly improved saving rates in the medium term from the introduction of the 9 per cent Superannuation Guarantee, and even greater improvement from the inclusion of a 3 per cent employee contribution. Assuming a 50 per cent saving substitution rate, the combined effect of a 9 per cent Superannuation Guarantee and a 3 per cent employee contribution is projected to raise national saving by almost 1.5 per cent of GDP within 10 years, and almost 2 per cent of GDP within 20 years.[12]

As Figure 3 indicates, the saving comes from a variety of sources. Private saving

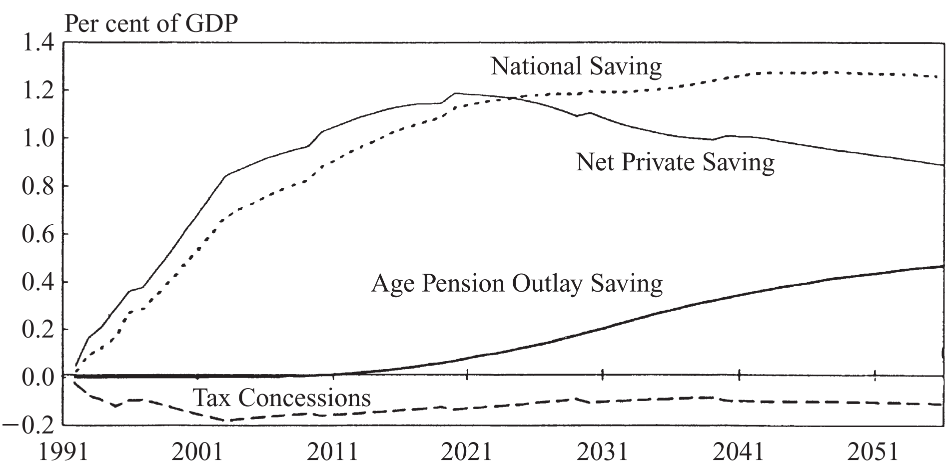

Figure 3: The Superannuation Guarantee: contribution to national saving
Source: Retirement Income Modelling Task Force, unpublished, 1993.
Note: The key assumptions include: a steady state CPI growth of 3 per cent, wages growth of 4 per cent, and a fund earning rate of 7 per cent; marginal savings offset to superannuation of 30 per cent; and a 25 per cent dissipation of accumulated superannuation lump sums at retirement with remainder used to purchase a CPI indexed life annuity.

[12] Note that some 40 per cent of employees, mainly in the higher earnings brackets, were covered by voluntary superannuation meeting Superannuation Guarantee requirements before the introduction of mandatory retirement saving.

improves because of the gradually increasing tax-preferred mandatory contribution, and the earnings thereon, net of saving substitution. Public saving occurs because after some initial period, reductions in the expected age pension obligations exceed the value of tax preferences. (Initially, however, the year on year public saving rate decreases, because of the reduced tax on contributions.)

If these projections are correct, they do indeed reflect a major improvement in saving performance. Net national saving currently stands at only 2.2 per cent of GDP, so a 1.5 percentage point increase represents a 70 per cent acceleration in net saving. Since it is from net saving that new investment is funded, this is the relevant ratio to work with. However, it should be noted that the projections are very sensitive to changes in assumptions about rates of return, saving substitution, and growth rates.

A final point on saving performance concerns the composition of saving and investment. There are two main channels of tax preferred saving in Australia – superannuation, and owner-occupier housing. The latter is excluded from the age pension means test. While evidence is scarce, the structure of incentives is such that owner-occupier housing is likely, in the absence of compulsion, to be chosen as the preferred personal saving vehicle. It may therefore be that the Superannuation Guarantee contributes more to the efficient allocation of economic resources through its impact on the composition of saving and investment, than on aggregate saving performance.

Administrative efficacy

The cost of administering a private sector retirement income policy is of major interest to those countries contemplating the introduction of such a scheme. Australia joins with Switzerland in mandating the employer, rather than the employee, to make contributions. This suggests lower administration and compliance costs, although data are scarce and of poor quality, even when only one country is considered. Comparative cost data are even more difficult to comprehend.

Where Superannuation Guarantee contributions have been paid into industry funds, anecdotal evidence suggests that administration costs have been low. Evidence is less clear on the costs of using other types of funds. Bateman et al. (1995) undertake a very preliminary comparative cost analysis of Australia and Chile, the results of which suggest it is cheaper to implement group than individual control over choice of pension fund. But many methodological difficulties and factual ambiguities remain to be resolved before confidence can be placed in such an assessment.

A number of implementation and administrative problems arose with the introduction of the Superannuation Guarantee which should be briefly mentioned. Of special concern have been the relatively high administrative charges placed on a large number of accounts with small balances – inevitable in an immature system – and the proliferation of multiple accounts as employees move from job to job. (At the moment it is estimated that there are more than two Superannuation Guarantee accounts for every worker.)

Most new contributions generated by the Superannuation Guarantee were placed in industry funds, which tend to operate flat fee structures. As a result, many small accounts were decreasing in value over time, because of administrative charges levied on them. The government responded with the introduction of member protection rules – which require that for superannuation accounts of less than $A1,000, fund administration costs cannot exceed fund earnings, although accounts can be debited for investment losses, contributions tax and insurance premiums.

As well, largely as a result of employer, rather than employee choice of fund, many employees find that they have several superannuation accounts. While this is a particular problem for multiple job holders and transient workers, even employees who change jobs once can be affected through either high fund exit fees or ignorance of their rights to transfer or amalgamate accounts. These problems are expected to reduce in their scale as DC arrangements become more prominent. As well, industry practice for the transfer and amalgamation of superannuation accounts is becoming more streamlined with the introduction of a transfer protocol. Recently, banks have been allowed to set up "retirement saving accounts", which make possible payments to the same superannuation account from a number of different employers. These are not without problems of their own, however – expected returns are much lower than for the conventional Superannuation Guarantee accounts.

Finally, small employers now enjoy the possibility of setting up a superannuation fund for their employees under a "master trust" – covering many employers – and this promises to reduce the administrative and investment costs associated with the implementation of the Superannuation Guarantee.

5. What problems remain, and how can they be addressed?

Coverage and replacement

As we emphasized above, Superannuation Guarantee coverage is confined to employees. It is likely to provide adequate retirement income only for those whose work histories have been more or less continuous. For those with broken work histories, the accumulations can be much less. In addition, coverage at any level remains voluntary for the self-employed, and except for a recently introduced dependent spouse provision, those not in the labour force enjoy no tax-preferred financial saving opportunities whatsoever.

It would appear desirable to extend Superannuation Guarantee coverage to these individuals. In part, their exclusion results from the union-based origins of the policy; in part, the accounting and compound interest properties of defined contribution schemes tell against workers with broken work histories. The first of these is more easily overcome than the second.

In this context, an increasingly important issue concerns the treatment of women within the Superannuation Guarantee structure. Women are seen as relatively disadvantaged by the Superannuation Guarantee because it is an earnings-related accumulation scheme. Women on average earn less than men throughout their working lives, they tend to be concentrated in relatively low paid occupations, and are more likely to have broken work histories. Further, they retire earlier and have a greater life expectancy, so that the (generally smaller) superannuation accumulation has to last longer.

These facts combine to leave women with less of their own superannuation entitlement, and more vulnerable to economic loss in the event of marital or family breakdown, than men. It follows that the benefits of occupational superannuation will fall more heavily to men than to women. Further, while there is a growing tendency for divorce courts to award the primary child carer a greater share of the assets insofar as the primary earner has a substantial superannuation accumulation, as yet this remains unsystematic.

It should, however, be noted that superannuation coverage for women has risen more dramatically than for any other group since the introduction of mandatory superannuation. Between 1987 and 1995 the superannuation coverage for female employees increased from 26 per cent to over 85 per cent. For many of these women, access to superannuation will benefit them, even if it does not benefit them as much as men. A further point is that the age pension acts as a cushion to blunt the relative impact of the Superannuation Guarantee on the retirement income of the less well off. This mechanism is especially important for the economic welfare of retired women.[13]

It will of course require more general social and labour market reforms rather than simply superannuation reforms to address these gender-related equity issues. There are, however, some steps which could be taken which seem to us to help. The first is the establishment of shared Superannuation Guarantee property rights. This would offer some protection for female divorcees who have devoted much of their married lives to non-monetized activity. The second is a requirement that annuities be joint with the retiree's spouse and should have a reversion clause. Whichever partner dies first, the survivor would be entitled to a substantial proportion of the annuity being paid when both partners were alive.

Integration with the age pension, and retirement income streams

Perhaps the most difficult structural problem confronting the Superannuation Guarantee is its linkage with the Australian "first pillar" age pension, and the related question of income stream choice in retirement. As we have already indicated, lump sum withdrawal of superannuation benefits is both permitted and widespread. This, combined with the disparity between the preservation age for superannuation benefits (currently 55) and the eligibility age for the age pension (60 to 65) makes the integration of the Superannuation Guarantee with the age pension problematic. While most retirees dispose of their lump sum benefits prudently, they have an incentive to do so in ways which maximize their age pension benefits. This may involve reduced interest by workers in maximizing investment returns and means test avoidance for workers near the age pension threshold. This can in the last analysis be adequately addressed only by requiring the purchase of an inflation-indexed life income product.

Most analysts believe this will eventually be achieved through compulsion in some form, although the design (a lump sum for the first $x, then compulsory annuity purchase, or compulsory annuity purchase to $y per year, then a lump sum option, to give two possibilities) remains unclear.

In the meantime, the market is drawing out some interesting products. One, which emerged in the mid 1990s, combines what in Australia are called "allocated pensions", and in Chile are termed "phased withdrawals", with a deferred life annuity which begins at age 80, the expected exhaustion age of the allocated pension. The deferred life annuity, sold at age 65, does not cost much, and the retiree retains considerable control over his capital through the 15-year deferral period. A second design, first suggested in the Australian context by Formica and Kingston (1991), and now being actively considered by annuity sellers, is an inflation-indexed annuity with a deductible. Indexation does not cut in until annuity purchasing power has been reduced through a cumulative price level increase of, say, 15 per cent. In the version being considered commercially, the annuity payment then increases to 115 per cent of its

[13] For example, Bateman et al. (1994) calculate that a single career female on average female earnings will be entitled to an Superannuation Guarantee annuity replacement rate of 44.4 per cent of earnings, compared with the corresponding figure for a male of 77 per cent (this is due to fewer years of contribution and more years of retirement). But under current means testing, the male is entitled to only 5 per cent of the age pension, while the female is entitled to 64 per cent.

initial value and stays there until the price level has risen by a further 15 percentage points, at which time a compensating increase in the annuity payment is made once again. This design allows the initial annuity payment to be considerably larger than can be offered with a fully indexed instrument, while at the same time providing inflation insurance against large and unexpected price level movements.

A problem not so far addressed by either policy-makers or researchers in Australia is that of annuity rate risk. If annuity purchase is to be mandatory, then variations in the price of the annuity close to the time of retirement can make a large difference to rest of life income. One possibility is incremental deferred annuity purchase throughout working life along the lines proposed by Brugiavini (1993) (though her analysis is motivated by adverse selection considerations, rather than annuity rate risk). This same idea has been proposed by Boskin et al. (1988). Another possibility is a variable annuity whose value varies with the interest rate or the stock market like a variable rate mortgage.

It is entirely possible that policy will converge with the market – eventually compelling an income product with longevity and inflation insurance properties which nevertheless does not cut into immediate consumption too deeply, and which leaves the retiree with some capital discretion to cope with contingencies such as health expenses. Sooner rather than later, however, some policy initiative will be required on income streams.

Taxation and political insulation

Much avoidable complexity in the Australian taxation of retirement saving is introduced by maintaining three tax bases: contributions, earnings, and benefits. All are taxed concessionally, so it is less the burden of tax than its complexity which is the difficulty here. However, the tax on earnings distorts net of tax returns, adversely affecting asset choice. In addition, earnings taxes probably further encourage early retirement, since it is when retirement is a viable option that the earnings tax bites most severely, reducing the lifetime reward for working another year.

A further point about the separation of superannuation tax rates from the personal tax rate schedule is that political risk is increased – if, as in the U.S., only benefits were taxed at the retiree's marginal rate, then it would be much more difficult for any government to change superannuation taxation unless the personal schedule was also changed.[14]

The complexity of superannuation taxation in Australia stems from the multiple bases on which the tax is levied. Australia is the only country to tax all three of these possible bases. The best option would be to abolish the taxes on contributions and earnings, and to tax benefits at the retiree's marginal rate, as is done in the U.S. for voluntary schemes. The implications for the current budget balance probably render this infeasible. An alternative might be to tax contributions at a flat rate, and tax benefits at the retiree's marginal rate, less the flat rate contributions tax.

Choice

The Superannuation Guarantee requires employers to make superannuation contributions to a complying fund of their choice. Under productivity award superannuation, unions

[14] In the August 1996 Budget, for example, it was announced that the contributions tax on high income earners would increase from 15 to 30 per cent.

have had some say into which fund or funds the mandatory employer contributions must be made but these have been restricted to industry funds. As a result employees face a very limited choice as to where their Superannuation Guarantee accumulations are placed. However 13 per cent of superannuation funds[15] provide for member choice of investments. These accounted for 47 per cent of contributions in 1995–1996 (ISC, 1997).

Member choice of fund has been promoted by the current government, which plans to implement it from July 1999. Industry funds have argued strongly against mandatory member choice of fund, largely on the grounds of its impact on administrative costs, while it has support amongst the superannuation service providers.[16]

Nevertheless, member choice of both fund and investments, with appropriately informed guidelines, would appear to be inevitable if the Superannuation Guarantee, predominantly a defined contribution arrangement, is to develop in the context of a private sector based competitive retirement provision industry.

6. New government – new emphasis

Since the change of government in 1996 the robustness of the bipartisan nature of the Superannuation Guarantee has been tested. The current government carried into office a strong emphasis on family values, and on free choice. Both have been manifested in their subsequent policy initiatives on superannuation.

Policies introduced to improve choice include: allowing persons earning between $A450 and $A900 per month to opt out of mandatory superannuation in favour of higher wages or salary; the introduction of retirement savings accounts as an alternative savings vehicle for small amount contributors; and an extension of the age limit for superannuation contributions from 65 to 70. As well, as discussed above, it is proposed to introduce member choice of superannuation fund from July 1999.

Equity issues have been addressed with the reduction of the perceived tax advantage to high income earners through a contributions tax surcharge of 15 per cent for high income individuals and tighter restrictions placed on the contribution limits for tax deductibility. Both equity and family values were considered with the introduction of an 18 per cent tax rebate for superannuation contributions made on behalf of a low income spouse.

In its 1995 Budget, the previous Labor Government had announced proposals to expand both the amount and coverage of mandatory superannuation. These included an increase in mandatory contributions to around 15 per cent, comprising a 3 per cent employee contribution and a government co-contribution of up to 3 per cent.[17] These proposals have been abandoned by the coalition government and replaced with a 15 per cent tax rebate for voluntary employee contributions.

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[15] Not including "excluded" funds.

[16] As well, a 1995 report of the Senate Select Committee on Superannuation (Senate, 1995) came down in favour of it.

[17] The motivation for the government co-contribution was largely political. Prior to its re-election in 1993 the Labor Government had promised tax cuts, but by 1995 it became clear that these were unfeasible. The expected $A4.5 billion cost of the co-contribution mirrored the aggregate expected cost of the promised tax cuts.

7. Concluding remarks

This paper has sought to explain the Australian version of a mandatory retirement saving policy, the Superannuation Guarantee, and to offer a preliminary assessment of it. The Superannuation Guarantee is seen as completing Australia's second pillar in a three-pillar structure of retirement policy.

The Superannuation Guarantee was legislated in 1992, on a gradually increasing employer contribution rate scale that will reach 9 per cent by 2002. Extensions, including in particular mandatory employee contributions, are foreshadowed but not legislated. It is therefore best seen as a policy which is still evolving.

From this perspective, it is useful to distinguish between the accumulations and benefits components of the policy. The Superannuation Guarantee does well on accumulations, because the mandatory contributions ensure full fundedness and the private basis of the policy helps provide political insulation. On benefits, the policy scores poorly, because retirement income streams are not mandatory.

Many analysts anticipate that as the policy matures, and the aged dependency ratio increases, mandatory income streams will be introduced. This would seem to be essential if the policy is to deliver effective income insurance to retirees. Because of an historical right to take superannuation benefits as lump sums in Australia, mandating retirement income, financed from mandated accumulations, is seen as politically difficult. In the long term, however, the success of the Superannuation Guarantee will depend upon the introduction of such a policy.

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