Commonwealth Corporation to administer the SG System

A Response to Australia’s Future Tax System Retirement Income Consultation paper

The authors of the Retirement Income Consultation paper released on 10 December 2008 are to be congratulated for posing the following question in Chapter 4.

> Q4.2 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

These questions go to the heart of what superannuation is intended to provide; a secure income for members of a community no longer able to provide for themselves or a vehicle for the accumulation of a storehouse of wealth that may fall woefully short or extravagantly in excess of retirement needs.

This paper is based on the belief that a retirement income system should be judged simply on its ability to deliver a secure income to individuals over whatever number of years they live between ceasing work and their death.

The Three Pillars

It is frequently maintained that Australia has a three pillar retirement income system.

1. A government provided Age Pension;
2. compulsory savings enforced through the superannuation guarantee system (SG); and
3. voluntary savings (both through superannuation and other sources).

There is a world of difference between the first and the other two. The only difference between the second and the third is that the SG contribution is compulsory. Those contributions are invested in exactly the same Better Super system introduced by the previous Government where the longevity and investment risks and the exposure to a costly advising and funds management industry are exactly the same. It could be argued persuasively that Australia has only a two pillar retirement income system, the Age Pension and an accumulation system defined by Better Super, the contributions to which are partly compulsory and partly voluntary.

This line of thinking and the multi pillar system recommended by the World Bank (see Appendix C to the Retirement income Consultation paper) suggest that consideration might be given to modifying the compulsory SG pillar in a way that improves its value while reducing risks and costs for contributors.

Longevity Risk

The Age Pension has inbuilt insurance against the risk that one may live longer than expected. Individuals however who want to provide for their own retirement must ask themselves, “How much is enough to provide for my retirement?” The answer depends in large part by how long an individual lives, something that none of us know.

An individual’s Better Super account that is sized to be adequate for the “average” retiree will over-provide for retirees who die early and under-provide for retirees who live long. As the population of retirees will be made up disproportionately by retirees who live long disappointment and hardship with Better Super accounts that are just adequate for the “average” retiree will be the norm. To provide satisfaction for retirees who live long Better Super accounts must over-provide for retirees who die early. A most substantial increase in contributions would be needed to cover this outcome.

This unsatisfactory state of affairs can be remedied with significant gain to contributors and no additional cost to the Commonwealth by requiring SG superannuation to be taken only as an annuity. A difficulty in Australia is that the private sector market in annuities is poorly developed. The private sector does not have much interest in the long time horizons that are involved.

Investment Risk

It is useful to look at investment risk in three parts.

Risk of Loss of Capital

The current instability in financial markets is demonstrating clearly that there are real risks involving possible disastrous losses of capital that must be taken into account by anyone intent on accumulating a storehouse of wealth to provide for their retirement. As we are seeing few in our community are able to assess properly these risks. This is a fundamental weakness of the Better Super arrangements.

It might be argued that loss of capital is a risk that is a reality in any capitalistic market. This however will be totally unacceptable to the hundreds of thousands of Australians whose retirement will depend on a combination of the Age Pension and whatever can be provided by the SG system. These Australians will point to the guarantees that the Australian Government has readily provided for bank deposits and will say that at the very least their SG contributions should be accorded a similar guarantee. They will argue that as the SG contributions are compulsory the benefits should also be compulsory.

Risk that income earned by a Superannuation equity will fall

Australians by and large are well adjusted to the variations that occur in the official rate of interest and in the dividends paid on commercial investments. It will not be part of the proposal below that the Commonwealth needs to guarantee a minimum rate of return on SG contributions.

Risk that Retirement Income will be eroded by inflation

A major fear for all retirees is that their retirement income will be eroded by inflation. Any overhaul of the SG system has to come to grips with this issue.

Protecting income from the effects of inflation means more than indexing an income by CPI. CPI these days is a measure or pure inflation and that does not adequately reflect the prices that consumers have to pay for goods and services. The Australian government long ago discovered that CPI indexation for the Age Pension was inadequate. These days the Age Pension is indexed by reference to movements in average weekly earnings.

The Costs of Financial Advisers and Fund Managers

The vast majority of working Australians are ill equipped to manage properly the SG equity created in their name. Better Super has spawned an industry of financial advisers and fund managers that is, as we are seeing, little better equipped.

As well, the charges levied by the industry in a hundred and one ways reduce by staggering amounts the equity that the present meagre 9% pa SG contribution would otherwise accumulate. Employees who change jobs frequently are particularly penalised.

The Industry Funds provide some relief from this bleak assessment but the Industry Funds are deeply embedded in a wider industry where the associated costs are not easy to avoid.

Proposal

The second pillar of Australia's retirement income system should be overhauled as described below.

1. All SG contributions should be paid into a Commonwealth owned superannuation fund hereafter called the corporation. The purpose of the corporation should be to invest contributions in accordance with guidelines specified by the Government. The guidelines could follow those set for the Future Fund. The costs of administering the corporation should be met by the Government.
2. Contributions by individuals should have the same status as contributions made under Better Super, eg contributions would be taxed at 15%
3. An individual's equity in the corporation should enjoy a Commonwealth guarantee in the following senses.
    a. Each year the corporation would advise contributors of their accumulated equity including earnings. That equity would have the status of a deposit in a bank guaranteed by the Commonwealth.
    b. In a downturn, as we are experiencing now, a contributor's equity would not decrease. The corporation would carry the accounting debt thereby created until such time as asset values and earnings recovered sufficiently to eliminate that debt.

    Provided the corporation was managed prudently the Government should never be called upon to inject more than some commencement capital
4. Disbursement to an individual should only be in the form of a lifetime annuity indexed to average weekly earnings. Equity should be converted to annuities by reference to prevailing life tables, expected earning rates and estimates of growth in average weekly earnings. The corporation should not seek to make a profit on those conversions. Once set an annuity would change only in accordance with movements in average weekly earnings.
5. Annuities paid to retirees from age 60 to be tax free and have the same status in the Age Pension system as an account based pension.

Interaction with the Age Pension

Under present arrangements a percentage of present employees on reaching retirement will draw down all or most of their SG equity and deploy it in ways that will maximise their eligibility for the Age Pension. It is debatable whether the raft of tax concessions under Better Super should facilitate that outcome. Surely the object of Better Super is to encourage people to provide for their own retirement with recourse to the Age Pension as little as possible.

Under the proposals put forward in this paper such an outcome will not be possible. Individuals who want to accumulate a store of wealth to draw down to fund capital expenditures on reaching retirement should invest in the third pillar of Australia’s retirement income system. That pillar would not be affected by the proposals put forward in this paper.

The Government should recognise that the proposals put forward here will constrain growth in Age Pension outlays in the future. The quid pro quo for these savings should be a readiness by the Government to meet the administrative costs of the proposed Corporation.

Increasing the 9% should be deferred

It is of course patently obvious that the 9% SG is incapable of providing an adequate retirement income for present employees without supplementation from other sources. Sooner or later the SG contribution will have to be increased, possibly to 15%. That should not happen however until the SG system has been thoroughly overhauled. To increase the SG contribution now would deliver another wave of funds to an expensive industry and make reform even more difficult.

Public Reaction

The financial advising and funds management industry will protest vigorously for obvious reasons. On the other hand the public will easily understand the attractions of the proposal. The major negative will be the prohibition on making cash withdrawals. The appropriate response should be to emphasise the security of the new arrangements and the elimination of administrative charges and costs. Also the third pillar would be available for those who wanted to accumulate an equity that could be easily drawn down.

The Ambachtsheer Proposal

On 2 February 2009 the Australian Financial Review carried an article by Barrie Dunstan that reported that Keith Ambachtsheer, a Canadian who specialises in global pension fund policy, had made an assessment of our SG system. His findings included that longevity risk has been “left in the Australian pension closet”. His solution appears to be that some part of the SG contribution should be automatically channelled into buying longevity insurance through an accredited default fund.

The problem with that approach is that it does nothing to reduce costs. In fact it will add yet another layer of charges.

The Detail

The foregoing provides only a brief outline of the proposal. Some of the details that would need to be addressed are:

- Access to equity in special circumstances, such as death before retirement.
- The option of providing for reversion in calculating an annuity amount.
- Whether or not the proposed corporation should accept contributions that exceed the statutory SG requirement.

The transition also would create a number of challenges. One way of proceeding would be to form the proposed corporation out of an amalgamation of some or all of the existing industry funds.

Costs to the Government

An estimate of the savings that would flow from a reduction in reliance on the Age Pension could only be made with access to sophisticated modelling facilities. But those savings could easily be larger than the costs of administration of the proposed corporation. In that case the impact on future budgets could indeed be positive.

The indebtedness of the corporation to its contributors would be fully funded except during market downturns. During those periods the Commonwealth would have a particular contingent exposure to the corporation. That particular exposure would disappear when markets recovered.

The only remaining issue would be the burden of a broadly stated but explicit Commonwealth guarantee of the debts of the corporation. In times past that might have been an obstacle but in the light of recent events it is something that the Government could not and should not seek to avoid.

The foregoing reflects my personal views only.

Tom Hayes
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