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Why Australia's Pension System is Not a Good International Model

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Abstract

In this paper, the author challenges claims attributed to two UK pensions experts, that Australia's pension system is worthy of praise and emulation. The author describes the mismatch between the pensions system introduced by the Australian government and the associated system for regulating it and protecting members' interests. He says that as a result of this mismatch, there is virtually no pressure to ensure that members derive optimum benefits from their pension funds, and accordingly he predicts that the present system will fail to adequately provide for most members' retirement, with the result that the national government may still be called upon to significantly fund the retirement incomes of an ageing population.

Why Australia's pension system is not a good international model.

1.0 Introduction

Some overseas commentators such as Goode and Ellison (Hely, 1990) have praised Australia's pension system. Unfortunately such comments are misleading. Australia's pension system may be better than those in some other countries (depending on the perspective one takes) but there are compelling arguments that Australia's pension system is very seriously deficient. Given the ageing population in many western countries, the notion of a system which will enable relevant democratically elected governments to overcome the untenable burden of funding aged pensions from a declining proportion of the population, without explicitly raising taxes to the level necessary, must be welcome news. That is what Australia claims to be doing. It is unfortunate that it is not true. This paper explains why.

Instead of using the term "superannuation fund" which is the Australian vernacular, this paper uses the term "pension scheme" because (a) this paper is addressed to an international audience, and (b) the latter term is used in the United States of America and in the United Kingdom, rather than the former term. The term "superannuation fund" is used in Australia because (a) many Australians take their superannuation benefits in the form of a lump sum rather than as a pension. The Australian government has provided various tax incentives to dissuade retirees from taking lump sums, but has stopped short of legislating to stop them. (b) the term "pension" was usually used in reference to the raft of non-contributory payments by the government to aged persons, war veterans, invalids, etc., and (c) the term "annuity" was used instead on "pension" to refer to regular payments from a contributory pension scheme. More recently, it has become politically correct in Australia to refer to most social security payments, including unemployment payments, as "pensions". This paper is not about those types of pensions. It is about contributory arrangements for self provision of retirement income.

2.0 Outline of Australia's pension system

The Senate Select Committee on Superannuation (SSCS, 1992 pp.10, 11) reported the following:

1974 32% of Australian workers were covered by superannuation

1979 43% of Australian workers were covered

1983 47% (approx.) of full time workers were covered, and 9% (approx.) of part time workers were covered.

1988 the above percentages began increasing significantly

1990 the rate of increase significantly escalated

Later the Insurance and Superannuation Commission (ISC, 1996) reported the following coverage.

1995 81% of workers covered - 95% coverage for full time employees, and 72% for part time employees.

The increase in coverage is a statistic that the Australian government is proud of and it suggests that the relevant policy has been a very effective response to the problem of funding old age pensions for an ageing population. The next section of this paper describes why the reality is different.

There is no statutory requirement for self employed Australians to contribute to a pension scheme. However, with some exceptions, Australian employees are members of pension schemes either by virtue of employer contributions under the Superannuation Guarantee Charge Act (SGCA) or because of the industrial award or agreement under which they are employed.

At present the employer contribution under SGCA is 7% of salary/wages but this will increase to the current maximum of 9% by 2002/3. Under SGCA and associated legislation employers are required to contribute the relevant percentage of salary/wages to an employee pension scheme or alternatively be levied a superannuation guarantee charge. The incentive to "voluntarily" contribute is that voluntary contributions are tax deductible to the employer, whereas the SGC is not. In addition, employers required to pay the SGC are also charged administration fees and interest on arrears. This part of Australia's pension arrangements is administered by the Australian Taxation Office (ATO). After collection of any SGC, the ATO then arranges to transfer the relevant

amount to individual employees' pension schemes, or in the case of small amounts, it may be temporarily held in the ATO's Superannuation Holding Accounts Reserve (SHAR).

Very low income earners can opt to receive the relevant cash rather than have their employer contribute under SG arrangements. Similarly employers do not have to make SG contributions for (part time) staff: earning less than $450 per month; staff under 18 years of age and working less than 30 hours per week; staff over 70 years of age.

Even though the relevant federal government chose not to call it a tax, SG contributions could be regarded as a special purpose tax on employees ie. one similar to the USA's social security tax. Similarly they did not call it an impost on employees, even though the Labor treasurer at the time said (sic) that future increases in employees' wages could take into account employers' contributions to employee pension schemes (Dawkins, 1992).

The reasons for not calling it a tax include: at the time of introducing the new scheme, it was politically more palatable to lower income earners, unions and a Labor government, to call it a charge on employers rather than a tax on employees; income taxes cannot discriminate and so imposing a tax on employees without imposing a comparable tax on self employed persons would be unconstitutional. This approach was also used again when later the coalition federal government introduced the superannuation "surcharge" - a tax on superannuation contributions of high income earners. However, the federal Labor government that introduced compulsory contributions to pension schemes did not want to defer all of the tax on the income that employees forfeited to pension schemes, and so they began taxing contributions to superannuation funds made by employers (on behalf of employees). The other income of pension schemes was also taxed at 15%. The contributions tax was set at 15%. A further 15% payable when retirement benefits were eventually paid. The latter 15% did not apply to the employee contributed component of pensions. Subsequently the tax rules were again changed so that no tax was payable on small pensions and small lump sums, and higher tax was payable on "excess" components of larger retirement payments.

If employers contribute to employee pension schemes under an award or industrial agreement and that contribution at least equals the relevant SG percentage, then they are deemed to have satisfied their SG obligations.

Self employed persons can voluntarily contribute to a pension scheme and can claim a tax deduction of up to $3000 for same. (Employees cannot claim a tax deduction for their contributions). A small tax concession is also available for any person contributing to a pension scheme for a spouse with a very low income, and a very small tax concession is available for pension contributions by very low income earners.

Australian pension schemes can be classified in various ways. For example the ISC (now called the Australian Prudential Regulation Authority) is the join regulator of the Australian pension industry, along with the Australian Securities and Investments Commission. Excluded schemes are regulated by the ATO. APRA classifies schemes as (ISC Annual Report 1995/96, p.74):

corporate	(ie. schemes operated by employers solely for their employees)
industry	(ie. those which nationally cover employees in a particular industry. These are likely to be dominated by relevant unions)
public sector	(ie. those operated by various levels of government)
retail	(ie. those which are operated by insurance companies and other profit oriented entities, and which basically invite any member of the public to join them eg. self employed persons, and small employers. These are also know as public offer funds.)
excluded	(ie. these have less than 5 members and are allowed certain regulatory concessions.)

(NB. the bracketed descriptions above are those of the authors, not descriptions provided by the ISC.)

In addition, each of the above categories of pension scheme can be either defined benefit schemes or defined contribution schemes. A small proportion of funds are hybrid schemes - ie. partly defined benefit and partly defined contribution. Defined benefit schemes are schemes under which the dollar amount of members' benefits are

determined according to a formula set out in the constitution of the scheme. These are usually based on highest average salary of individual members, or on their final average salary for the relevant three year period. Defined contribution schemes (also known as accumulation schemes) are those under which the dollar amount of members' benefits are determined by contributions plus a share of net income of the scheme after taking into account transfers to or from any internal reserves. This type of scheme is favoured by the unions because they are fairer to the majority of members. Not surprisingly industry, retail and excluded schemes are usually defined contribution schemes, with public sector schemes having the highest proportion of defined benefit schemes (about 75%, though that is decreasing).

At 30.6.1996, Australia had 140,000 pension entities consisting of 137,000 pension schemes (approximately 96% of which are excluded funds), 2,700 approved deposit funds, and 295 pooled superannuation trusts. The largest 1100 schemes held 85% of Australia's superannuation assets, and 77% of schemes each held less than $250,000 in assets. In 1995/96 the number of excluded funds grew by 25% (ISC annual report, 1996).

In 1986 as part of the accord between the Australian government and the union movement, instead of the federal Industrial Relations Commission granting workers a 3% wages increase, it was agreed that employers would pay 3% into pension schemes for employees under relevant industrial awards. This was an early government move towards implementing a retirement incomes policy to cope with an ageing population. Since many Australians did not work under an industrial award, the arrangement did not give contributory pension coverage to many employees. To overcome this deficiency in their retirement incomes policy the Australian government introduced the Superannuation Guarantee Charge Act and associated legislation in 1992.

Since it had effectively embarked upon a regime of forced employer/employee contributions to pension schemes in 1986, the Australian government was obliged to either provide a government operated contributory pension scheme or alternatively provide statutory regulation of private sector contributory pension schemes. The government chose the latter and accordingly introduced the Occupational

Superannuation Standards Act in 1987. Because of deficiencies in this legislation, it was replaced by the (current) Superannuation Industry Supervision Act (SIS) in 1993. In fact Australia's contributory pension arrangements are regulated by several acts, but SIS is the major one. Some of the other legislation is briefly referred to later in this paper.

3.0 Why Australia's pension system is not a good one

This section of the paper will describe why Australia's pension system is not a good system (a) from the government's perspective and (b) from a scheme members' perspective

3.1 From the government perspective

From the above it is clear that a major component of the Australian government's retirement incomes policy is compulsory contributions to pension schemes by Australian employees (directly or indirectly). These contributions are compulsory under either an industrial award (or similar), or under the SGCA.

One objective of that retirement incomes policy is for Australians to provide their own retirement income, rather than being dependant on a government old age pension. While the government proudly points to the high proportion of employees covered by a contributory pension scheme, the reality is that :

(a) it will take some 40 years for the policy to be fully operational because the present dollar level of coverage per person (as distinct from % of workers with some coverage) is grossly inadequate for most of the new entrants to contributory pension schemes.

(b) even when the present government policy reaches maturity after 40 years, the level of compulsory contributions (maximum of 9% in 2001 and thereafter) will not provide an adequate level of retirement income. Fitzgerald (1993) suggests that the level of contributions should be about 18% of income. To counter this deficiency, the Labor federal government had proposed matching (on a dollar for dollar basis) the pension scheme contributions of/for low income earners. However, when they lost the federal election in 1995, the new coalition government scrapped that aspect of the federal retirement incomes policy.

(c) the system of compulsory contributions does not cover self employed persons (unless they are "employees" of their own company) and does not cover very low income earners and those in receipt of social security pensions (the latter being a high proportion of the Australian population).
(d) as described below, the system implemented to regulate Australia's compulsory contributory pension scheme does nothing to ensure optimum returns and hence optimum benefits will be derived by members.

In addition to the above, the government is on the horns of a dilemma. The more it forces Australian workers to contribute to pension schemes, the less disposable income those workers have to spend and stimulate/maintain the Australian economy. Even worse, the burgeoning funds in pension schemes are inflating share prices and eventually there will have to be a major stock market "correction" and huge amounts will be wiped off accrued pension benefits.

3.2 From a member perspective

From the member perspective, Australia's pension system is grossly deficient and as a consequence sub optimal benefits will be derived, thus ensuring continued dependence on government funded social security. The reality of this is reflected in the pressure from various sources, for sustained high level of immigration to fund the shortfall. Unfortunately, at best, this is simply deferring the problem not solving it.

The root cause of the sub-optimal returns being derived by members of Australia's pension schemes is the mismatch between system implemented (which some referred to as privatisation of Australia's pension system) and the relevant regulatory arrangements. The present contributory pensions system has been described by the relevant regulator as "market oriented (Roberts et al, 1994) but the relevant legislation ensures that the system cannot be market oriented, but rather that it is undemocratic, protects under performing and/or dishonest trustees, fails to protect members, and does not foster optimal performance.

Australia's pension system is not market oriented because the fundamental attribute of a market economy is perfect competition. Australia's pension system does not even

have imperfect competition let alone perfect competition. This is because perfect competition assumes informed consumers and freedom of entry and exit from relevant markets. At present, in the Australian pension "market", employees do not have a choice of whether they are members of a pension scheme and certainly do not have a choice of scheme to be in. The present federal government has tried to bring in choice of pension scheme legislation but as yet that has not occurred. The proposed legislation requires employers to give employees limited choice of scheme (from at least four types of scheme) or unlimited choice. The relevant decision rests with employers, not with employees. No choice and limited choice seem rather strange since many employers pay their staff by electronic funds transfer to individual bank accounts. The argument for doing this included the security costs of paying in cash or by cheque. Therefore, if it is more convenient for employers to pay staff electronically via individual bank accounts, it should also be convenient to electronically transfer pension scheme contributions electronically to any designated scheme's bank account. This leaves one to speculate that it is the pension industry which is reluctant to see this "innovation". At present pension scheme contributions go to the scheme agreed to by the employer and relevant union, even though the majority of employees may not be union members. Under such a cosy arrangement, there is little pressure for optimal performance by the relevant scheme. If members were free to change schemes then this would put pressure on trustees to provide optimal service and returns.

Over 94% of Australian pension schemes are trusts (Quinlivan, 1994). In virtually all of those cases, the trustees are not elected or not directly elected by the members. Thus the typical scenario for an Australian pension scheme is that members have no choice about being a member and do not elect the trustees. That scarcely sounds democratic. The relevant legislation requires that half of the trustees must be employee representatives and half must be employer representatives. The requirement to have half of the trustees represent employers has been strongly criticised (eg. ALRC, 1992; Scheiwe, 1997). In addition, there is no requirement for election of trustees because that legislation only makes reference to "appointment" of trustees, not "election" of same. Having half of the trustees as member representatives was heralded as a prudential safeguard because previously there was no requirement for any employee representatives. Unfortunately the situation may in reality have changed very little if the

employer representatives are financially aware but the employee representatives are not financially aware. There are no knowledge pre-requisites for appointment as a pension scheme trustee and so different levels of relevant knowledge among trustees is a real possibility, especially where many trustees are appointed simply because they are union officials rather than because they have particular financial skills. Such appointments may provide unqualified people with significant direct remuneration and other perquisites, but leave the members inadequately represented and protected.

Except in excluded schemes, trustees cannot be directed by the members and generally are not liable for their financial mismanagement. Pension schemes are not required to hold annual general meetings as companies (for example) are required to do, and so superannuants have less rights and protection than shareholders. Company annual general meetings are important because members receive and can debate the accounts, receive the audit report and question and appoint the auditor, elect or vote out directors, set the directors' remuneration, etc. Members of Australian pension schemes have none of those rights and none of the relevant protection. It could be argued that most members are not financially literate enough to benefit from an AGM (eg. Quinlivan, 1993). That may be true at present, partly because members have no choice about the fund they are in and are denied the other normal rights of an investor. Hence they see little point in taking an interest. If there were choice then members would be more interested and could learn by attending annual general meetings and at least listening. This would generate substantially more ongoing discussion among members about their pension schemes. The difference between the rights of Australian shareholders and the rights of Australian pension fund members is quite astounding and simply serves to protect under performing schemes and under performing trustees.

Despite more than a decade of legislative innovation and reform, many Australian superannuants can still be cheated by their own pension scheme eg. by trustees misusing their power to withhold (ie. put in reserves) an unspecified amount of defined contribution schemes' income (provided this is permitted by the relevant trust deeds). By various means, the membership of such funds can be run down until all of the reserves are paid to the intended few remaining members who derive substantially

better reserves than other former members of the same scheme. A similar scam is possible in funded defined benefit schemes, especially in times of wages restraint which Australia has experienced for over a decade. This scam involves cross subsidisation between scheme members (Scheiwe, 1996). This occurs because benefits in a defined benefit scheme are based on either final average salary or highest average salary. Senior management are most likely to be the greatest beneficiary of the cross subsidisation because they are the most likely to gain significant salary increases while restricting increases in wages and salaries of the majority of members of these employer sponsored funds (Scheiwe, 1997).

The annual reports of Australia's pension industry regulator show the extremely small proportion of pension schemes that it was able to review in light of the limited resources at its disposal. Even if it did find mismanagement of funds, it could not tell members, unless it launched a prosecution, because of the secrecy provisions in the relevant legislation (Scheiwe, 1999). The relevant SIS provision was revoked in mid 1998 but a similar provision still exists in the superannuation guarantee legislation. Thus members are not in a position to monitor the management of their own pension schemes (Scheiwe, 1996b)and the relevant regulator is knobbled as well.

There was established a Superannuation (Resolution of) Complaints Tribunal under a relevant statute. However, that legislation also severely restricted members' right to complain to that independent arbiter. For example, the tribunal could not hear complaints about the format of a pension scheme, even if it was an unfair one like those described above (Scheiwe, 1999b). Its capacity was even further reduced in 1998 by a court decision which ruled that the relevant legislation was in part, unconstitutional.

The accounting standard under which most large superannuation funds prepare their financial reports is so controversial that it has not been given statutory backing (Klumpes, 1994). That standard has been described as an accounting enigma (Scheiwe, 1993), because it rejects several other Australian accounting standards, is inconsistent with generally accepted accounting principles, and with the Australian accounting conceptual framework. The outcome of this situation is that the full raft of relevant

accounting standards is not applied to pension schemes, but are, for example, applied to Australian companies. For example, there is no consolidation of the accounts of the pension scheme and its associated companies, and there is no statutory requirement to apply the related parties accounting standard (Scheiwe, 1999c). Thus many pension fund members don't know the total remuneration paid to trustees from the various entities associated with their pension fund. Also, the level of assurance provided by the audit of Australian pension schemes is lower than that provided for companies. This is because the audit opinion states that the financial statements "present fairly" (with simply means they comply with applicable accounting standards, no matter how few there are). In contrast the audit opinion for companies states that the financial statements give a "true and fair view ...." (which means that they are not misleading) (Scheiwe, 1999d).

While the relevant legislation requires trustees to formulate and give effect to an investment plan, that legislation is virtually unenforceable and as scheme failures show, it really provides members with no protection (Scheiwe, 1999). Because of the wording of that legislation there is no requirement for trustees to optimise investment returns, with the result that many trustees set investment goals very low, and applaud their own performance in various ways, when those goals are achieved. The result is that members ultimately derive retirement benefits far less than those that they should receive.

Unfortunately many pension scheme members seem to assume that their schemes are being well managed in their best interests and that their golden egg will be there when they retire. The relevant legislation encourages such a false sense of security because it requires the reporting of investment return. That return does not include indirect investment costs, may include unrealised gains in market value of assets, and ignores cross subsidisation in defined benefit schemes and reserving in defined contribution schemes. The result is that the return members actually derive may be far less than the reported investment return.

Clearly Australia's pension system is very seriously flawed and could not be considered as a model by any other country.

4.0 Why has this happened?

One can only speculate as to how this unsatisfactory situation came about.

First, the blind faith attitude to pensions by many Australians means that politicians tend not to give it a high priority. In contrast, the superannuation industry is a powerful and well organised lobby group, because they have such a vested interest in avoiding real reform of the industry eg. by making it truly market oriented.

Second, pensions involve fairly complex law and basically only those who work in the industry receive relevant education. Accordingly legislators rely on the latter for advice in formulating policy and introducing relevant law. Hence the law has been written to suit those who it is intended to regulate, that is, there has been regulatory capture.

Similarly, equal employee representation on pension scheme trustee boards became jobs for the boys (ie. union officials) so that the federal government of the day was able to get its legislation introduced without massive industrial disputes. The outcome is that many employees are still not represented on relevant boards by people with appropriate expertise or diligence. Thus many pension scheme members are deriving sub-optimal returns and the government will not achieve optimal relief from funding aged pensions.

Finally, it appears that the government may have been as much concerned about using pensions legislation to establish an Australian pool of investment funds (to alleviate balance of payments problems) as it was with retirement incomes. This may partly explain why it is so slow to reform the present pension system.

5.0 Conclusion

The conclusion one must reach from the above is that it is necessary for there to be very substantial reform in the Australian pension industry if it is to be fair, perform optimally, and achieve the government's objectives of its retirement incomes policy. This means years of upheaval are still to occur. Accordingly. Australia's pension system should not be used as a model by any other country.

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