REFORMING THE AUSTRALIAN RETIREMENT SYSTEM: MANDATING INDIVIDUAL ACCOUNTS

By Steven A. Sass*

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Executive Summary

Australia's new retirement income system combines two components. The first is the Age Pension — a means-tested allowance, funded out of general government revenues, which was put in place as a welfare program in 1908. After its expansion in the 1970s, the Age Pension has become more of a universal entitlement with a claw back that reduces, then eliminates, benefits for upper-income recipients. The second component is the Superannuation Guarantee (SG) — a mandatory defined contribution savings program put in place in 1992, which takes 9 percent of earnings. Preexisting employer defined benefit pension programs are also adopting the SG's defined contribution format.

The new system emerged somewhat inadvertently in response to lengthening retirements, rising prosperity in the postwar era, and a general demand for more ample retirement incomes. This initially led to the expansion of the Age Pension. Reformers then added the SG program to boost retirement incomes, increase national saving, and control the growth of government expenditures. Given these objectives, the reforms appear generally successful.

Nevertheless, the new Australian system has its shortcomings. The SG program, with its mandatory contributions and fixed administrative costs, is burdensome for low-wage workers who need current income to purchase necessities and were assured a reasonable retirement income from the Age Pension alone. The risks inherent in individual account programs are also a problem. In the Australian set-up, intergenerational variation in investment returns and the lack of annuitization of account balances at retirement make the elderly especially vulnerable.

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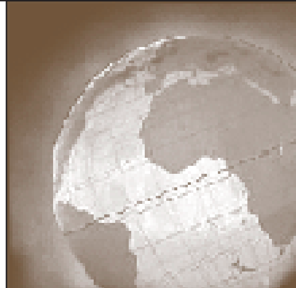

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

A Series of Global Briefs

This brief is the second in a series that profiles national retirement income systems and their response to the impending demographic transition. Modern retirement is an outgrowth of industrialization and the transfer of a nation's workforce from family and communal production to organized wage employment. The transition created an enormously productive economy. But wage workers face increasingly uncertain employment prospects as they age, and eventually a complete loss of earnings. Only rarely can a worker's savings offset this loss of wages. So governments, employers, and unions responded by organizing formal retirement income systems.

The maturation of these systems over the past half-century has made retirement a generally secure and well-defined stage of life. Thanks to extended longevity and ever-earlier withdrawals from the workforce, retirements now last about twenty years, on average, and are widely perceived as one of the great blessings provided by modern industrial society. But declining fertility and rising longevity has placed this blessing at risk.

Each nation's retirement income system has emerged out of its particular history and ideological commitments. Thus, the roles played by social security, employer pensions, individual savings, and continued work vary dramatically. Each nation's response to the current challenge reflects this institutional set-up and its economic prospects, social commitments, and ability to reform large and complex institutions.

The retirement income challenge is generally framed as a financing problem, requiring benefit cuts, larger contributions, increased saving, and/or higher-yielding investments. But the challenge is fundamentally a labor-market problem, involving the work/retirement divide and even continued work when "retired." So in addition to reviewing financial reforms, the series focuses on initiatives that redefine the labor-market opportunities and incentives that older workers face and the role of work as a source of old-age income; whether the reforms to date are consistent with this redefinition; whether they are sufficient; and what remains to be done.

The interaction between the SG and Age Pension programs has perhaps created the system's thorniest challenges. The tax and regulatory treatment of SG accounts and the effect of SG balances on the Age Pension means test have created a financial planning nightmare and significant distortions in the allocation of assets. As the SG program matures and balances mount, perhaps most troublesome is the incentive created to retire early, live off one's accumulated assets, and then claim a larger means-tested Age Pension. The impetus to strengthen the retirement income system by expanded saving could thus have the unintended effect of diminishing work at the end of a worker's career and producing significantly less retirement income than would otherwise be the case.

The new Australian system presents perhaps the clearest example in the industrial world of a retirement income system 1) substantially dependent on funded individual accounts and 2) without the social insurance mechanisms found in nearly all other industrial nations. It is widely accepted by the Australian public and has been praised by the World Bank, among others, as a model for other industrial nations. The Australian system nevertheless faces serious challenges that directly flow from its combination of individual savings accounts and a means-tested allowance. The system is still in its formative phase and will clearly evolve in the future. Whether it can successfully address these challenges remains to be seen.

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Creating Retirement

Australia's first retirement income programs were employer "superannuation" pension plans created in the nineteenth century. Australia was then a collection of British colonies and these plans were modeled on British employer practice. As in Britain, government agencies, large corporations, and financial firms offered pensions to build a career managerial workforce. The pension served as *compensation* — given in return for a long and faithful career and allowed workers to retire on a comfortable income at a set retirement age. As most workers readily accepted this offer, these pensions also functioned as *severance* payments, allowing employers to terminate workers when their productivity typically fell well below the amount they were paid.[1]

These nineteenth-century plans supported just a very small portion of Australia's elderly. The great majority relied on savings, and then on family or local charities, if they could no longer work or find employment. The depression of the 1890s put tremendous stress on the elderly, reducing employment opportunities, savings, and the community's charitable resources. A consensus then emerged that the problem of old-age poverty required a governmental response and Australia's two most populous colonies, Victoria and New South Wales, proceeded to create public pension programs for the elderly. When Australia became independent in 1901, its new constitution explicitly allowed the government to establish a national pension plan. Using the design established in Victoria and New South Wales, the new government created its "Age Pension" in 1908, and the program continues to this day.[2]

The Australian Age Pension, like most public programs introduced at the time, was a means-tested welfare program targeting old-age poverty. It was explicitly designed "to assist the poor but to do so in a way that would not undermine self-reliance."[3] The program provided a basic allowance to residents 65 or over, who were of "good character," had lived in Australia at least twenty-five years, who satisfied complex racial requirements (mainly designed to exclude indigenous Australians, Pacific Islanders, and Asians not born in Australia), and whose income was below a specified threshold. About 30 percent of the racially eligible elderly qualified. They got £26 a year — a welfare-level allowance — reduced pound-for-pound by either income or equivalent net assets above a specified minimal amount.[4] The government reduced the eligibility age for women to 60 in 1910 and in time also dropped the "character" and racial requirements.[5]

Prior to World War II, three efforts were made to replace the Age Pension with a more generous employment-based social insurance program, similar to those in many other industrial nations.[6] Legislation was actually enacted in 1938 to create a social insurance scheme, to be implemented in 1939. But the outbreak of war shifted public resources to the military.[7]

Australia introduced the means-tested Age Pension in 1908 as a welfare program targeting the elderly poor.

In the postwar era, pressure to enlarge Australia's retirement income system grew more insistent. The elderly accounted for half of Australia's poor. Increased longevity also made retirement a new and increasingly lengthy period of life — one requiring all Australians to have a reliable source of income to replace earnings from work. The postwar prosperity had also created the resources needed to provide such an income.[8]

The initial response was to expand the Age Pension program. In 1969, the ruling Coalition (Conservative) government extended benefits to a much larger portion of the population by adding a "taper" to the means test. It now cut benefits by fifty cents instead of dollar-for-dollar for income above the specified threshold "free area." The Labor Party came to power in 1972 and raised benefits from around 22 to 27 percent of male total average weekly earnings (MTAWE) and eliminated the means test for individuals over age 70.[9] When the Conservatives returned to power in 1976, they eliminated assets from the means test.[10]

These initiatives changed the character of the Age Pension program. The great majority of the elderly now began to receive Age Pension benefits (or the closely related Service Pension benefits for combat veterans).

1 Bateman and Piggott 1997.

2 Seager 1910; Commonwealth Treasury 2001.

3 Commonwealth Treasury 2001.

4 The pensioner's home was excluded from the asset test in 1912 (Commonwealth Treasury 2001).

5 Commonwealth Treasury 2001; Seager 1910.

6 Social insurance schemes require all workers to contribute, generally a set percentage of earnings up to a specified ceiling, and pay retirement benefits according to a formula based on a worker's contribution record and without a means test. Social insurance programs generally absorb or minimize the welfare function of assuring a basic old-age income using benefit formulas that provide high replacement rates (the contemporary continental European model) or that give low-wage workers higher allowances per amount contributed (the U.S. model). Nevertheless, social insurance programs, based as they are on employment, have problems providing a retirement income to the disabled, caregivers (primarily women), or low-wage workers with sporadic attachment to the labor force (Whiteford and Stanton 2002).

7 Bateman and Piggott 1997.

8 Commonwealth Treasury 2001.

9 Recognizing that single people required higher benefits than individuals living as couples, the government had increased benefits for singles in the 1960s to 60 percent of the combined married rate. The benefit for individuals living as couples is thus 83 percent (5/6ths) of the single person rate.

10 Commonwealth Treasury 2001; Bateman and Piggott 2000; Whiteford and Stanton 2002.

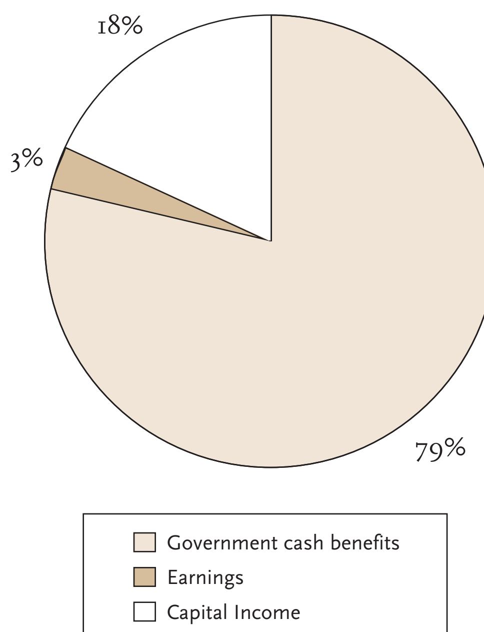
By 1980, 80 percent collected a full or partial benefit and the figure is much the same today.[11] Succeeding governments maintained benefits at about 25 percent of MTAWE, until this figure was set by statute in 1997.

The Age Pension provides among the highest *minimum* old-age incomes in the industrial world: the median annual wage, including women workers, is actually about 75 percent of MTAWE. So the Age Pension replaces about 33 percent of the median worker's gross earnings. Including the "tax offset" for seniors that fully shelters the Age Pension, the program replaces nearly 45 percent of the median worker's after-tax earnings. Pensioners are also entitled to significant transport, medical, and utility benefits. And 70 percent of the elderly own their home and have no mortgage payments. The expanded Australian Age Pension thus "is actually closer to a demogrant, with a progressive income-test to exclude the relatively well-off."[12] What was once a *welfare* grant to the poor had become a form of *compensation*, claimed by the great majority as a matter of right in return for a lifetime's contribution to the nation.[13]

The expansion of benefits also made the Age Pension a more powerful instrument of *severance*. Between 1970 and the early 1980s, when the government expanded the program, the labor force participation of older Australians fell sharply. This was a difficult economic period, characterized by oil shocks, growing competition from newly industrializing nations, two serious recessions, and slack demand for labor. For workers aged 65 and over, the Age Pension provided a reasonable minimal income. The program's means test and "take it or lose it" benefit also acted as a powerful incentive to retire: a worker's effective compensation for remaining on the job was the worker's wage less taxes, work-expenses, *and* the foregone Age Pension benefit. For earnings within the taper, a worker was effectively taxed 50 percent — via the loss in Age Pension benefits — *before* accounting for income taxes and the direct and indirect costs of working.[14] Because of the falling demand for labor and the expansion of the Age Pension program, earnings only accounted for 3 percent of old-age income in 1986, as seen in Figure 1, versus 12 percent fifteen years earlier.[15]

The Age Pension means test also created an incentive for younger workers to retire early: workers who left the labor force prior to age 65 could consume the assets and income that would be taxed at a 50 percent rate, via the means test, once they became eligible for Age Pension benefits. The effect of this incentive, however, is difficult to gauge. Between 1970 and 1985, labor force participation fell from 77 to 43 percent for men aged 60 to 64. The dominant factors, however, were probably the difficult economic conditions and the availability of Service Pensions at age 60 for combat veterans of the Second World War. Participation in this age group continued to fall after prosperity returned and the veterans of the Second World War had retired. But the continued weak market for older workers, especially for those with limited education, and the expanded availability of disability benefits and special "mature age allowances" for long-term unemployed workers between the ages of 60 and 65, are widely seen as responsible for this continuing decline in participation. A similar pattern of early withdrawal is seen in most industrial nations, which do not have means-tested retirement benefits. The early-retirement effect of the Age-Pension means test thus could be more latent than real.[16]

Figure 1: Sources of Retirement Income for Households Where the Head Is 65 or Older, 1986



Source: King et al. 1999, using ABS Income Survey data.

[11] Of the 18 percent of the elderly who did not collect an Age Pension in 2000, one-third worked. Only 12 percent of the elderly thus had assets or "unearned income" above the means-test maximums (Commonwealth Treasury 2002).

[12] Whiteford and Stanton 2002, p.15.

[13] Whiteford and Stanton 2002; Commonwealth Treasury 2001 and 2002; Bateman and Piggott 2000; King et al. 1999; Rein and Turner 2001.

[14] The "free area" in the early 1970s was equal to the full Age Pension benefit. In 1976 the Age Pension was indexed to wages while the free area remained constant in nominal terms. By 1991 the "free area" has fallen to about 28 percent of the Age Pension benefit. It was then indexed to inflation (Whiteford and Bond 1999).

[15] OECD Labour Market Statistics 2003; King et al. 1999.

[16] Edey and Simon 1996; OECD Labour Market Statistics 2003.

While the expanded Age Pension now provided a relatively generous minimum old-age income, it was designed as a safety net, not a program to replace the pre-retirement earnings of the elderly population. The incomes of the elderly nevertheless clustered around the Age Pension level, and this generally involved a significant decline in living standards through the increasingly lengthy period of retirement. As the need for more adequate retirement incomes grew apparent, Australians came to recognize that the nation's welfare approach to old-age incomes had reached its limit. The result was a series of initiatives that would shift "retirement income policy away from poverty alleviation through the minimalist age pension towards income maintenance through contributory" retirement income programs.[17]

As retirement became a well-defined stage of life, the Age Pension became the dominant source of retirement income.

In 1972 — the same year Age Pension benefits were raised above 25 percent of MTAWE — the Labor government created the Hancock Commission to review the nation's old-age income system. The commission's report, issued in 1976, proposed the creation of an earnings-based social insurance program that could provide higher benefits, especially to middle and upper income workers. However, the Coalition returned to power in 1975. It rejected the Hancock proposals, citing the heavy contribution burden on low- and moderate-income workers.[18]

Worsening economic conditions, which contributed to the take-up of Age and Service Pension benefits, were also a factor in this rejection of social insurance. Australia's traditional manufacturing industries were in decline and large "twin deficits" had emerged — one in the nation's trade balance and the other in the government budget. To bring these deficits under control, the government sought to cut public expenditures and increase national saving. This was not the time to create a large public pension program, financed on a pay-as-you-go basis, that could undermine private saving incentives. Indeed, the new government found it necessary to scale back the nation's existing pension program by tightening up on the means test. It reinstituted an income test on all age groups. It also froze the "free area" threshold in nominal dollars, even though inflation was running over 10 percent, to reduce benefits and eliminate allowances paid to better-off retirees. The Labor government reinstituted an asset test in 1985, to reduce benefits paid to the farmer and small business constituents of its political rival. The Australian Age Pension program, the basic structure of which has changed little since then, is presented in Table 1.[19]

Table 1. Age Pension Benefits and Means Test, 2003

Full rate benefit (Benefits indexed to greater of CPI or male average earnings.)

Single rate:	A$11,448 per year	
Married rate:	A$9,555 per year per person	

Benefit subject to whichever test results in a lower benefit (Free area thresholds indexed to annual movements in the CPI.)

Income test:

Pension withdrawn at the rate of 40c for each A$1 of private income in excess of a free area of :[20]

Single rate:	A$58 per week
Married rate:	A$102 per week

Asset test:

Pension withdrawn by A$1.50 per week for every A$1,000 of assets above the following thresholds:

	Single	Married
Homeowner	A$145,250	A$206,500
Non homeowner	A$249,750	A$311,000

Source: Centrelink 2003.

[17] Commonwealth Treasury 2001; King et al. 1999.

[18] Commonwealth Treasury 2001; Bateman and Piggott 2000.

[19] Bateman and Piggot 1997; Commonwealth Treasury 2001; Whiteford and Stanton 2002.

[20] The government reduced the taper rate to 40 percent in 2000, when it introduced a 10 percent value-added tax that effectively raised retail prices by that amount. Wages, and thus contributions and the full Age Pension benefit, could be expected to adjust to this rise in retail prices. But the government had to lower the taper rate to keep pensioners more-or-less whole (Bateman and Piggot 2001; Rein and Turner 2001).

The Reform Agenda

While the recommendations of the Hancock Commission were not accepted, the report and the discussion it generated established an agenda for reform:

Provide More Adequate Old-Age Incomes

The Age Pension was originally designed as a *welfare* program providing a basic allowance to a small percentage of the elderly population. It was not designed to maintain the incomes of the majority over lengthy periods of time. The expansion of the program between 1969 and 1976 allowed most Australians to claim at least a partial Age Pension benefit and live in modest comfort. But aside from the small number with assets or pensions from employer plans, the elderly had few other significant sources of income.

Control Public Expenditures on the Elderly

Australia's Age Pension was not expensive compared to public old-age income programs in most other industrial nations. It absorbed 2.9 percent of GDP in 1980, considerably below the old-age social insurance expenditures of most other OECD nations. Nor did Australia face sharply rising costs due to population aging. The nation was relatively young and old-age dependency (the proportion of adults aged 65 and over to those younger than 65) would hit 25 percent only in 2030, a decade after most other OECD nations. So the effect of the demographic transition on government budgets did not drive reform. Cost was nevertheless important: it was the major factor preventing the adoption of social insurance, in cutting back the Age Pension program, and in encouraging the search for alternative programs.[21]

Policymakers also focused increasingly on pension tax expenditures — the foregone government revenues used to support private retirement plans. These expenditures were quite significant and benefited a relatively small number of well-to-do Australians.[22]

Reduce Disincentives to Work and Save

The Age Pension was designed as a *welfare* program that used a means test to identify needy beneficiaries and provide them with a basic old-age allowance. An unintended consequence of such programs is that they discourage work and saving by reducing or eliminating benefits as these activities generate income. The addition of the taper and the increase in benefits extended this disincentive to nearly all Australian households: income within the taper was effectively taxed 50 percent, via the loss in Age Pension benefits. Australians could avoid this tax by saving less. They also had a clear incentive to use their savings and lump-sum distributions from employer plans to fix up their house and stock up on autos, washing machines, and consumer durables; transfer funds to children; and purchase specially-designed financial instruments and otherwise arrange their financial affairs to maximize Age Pension benefits. These responses had various deleterious effects. They undermined the effectiveness of the Age Pension means test, unnecessarily increased government expenditures, distorted resource allocation, and reduced retirement incomes. Reformers in the 1980s were primary concerned with the effect on the government budget and trade deficits and in depressing capital formation and long-term economic growth. As the reforms matured, concerns grew over potentially adverse labor market effects of the Age Pension means test.[23]

The New Australian System

As the Coalition government tightened access to Age Pension benefits and moved away from social insurance, initiative in retirement income policy shifted to the private sector. The government set up a task force to explore the expansion of private plans, which issued its report in 1983. The Australian labor movement meanwhile stepped up demands for expanded coverage under employer-based plans, generally multi-employer "industry plans" in which the union had a strong if not dominant voice. By the early 1980s, this union campaign helped lift overall pension coverage to 42 percent of the workforce.[24]

The catalyst for change was the return of a Labor government in 1983. Labor had advocated an expanded old-age income system and had close ties to the unions, which were then campaigning for coverage under employer plans. So Labor adopted the Coalition tack of using private employer plans to address the nation's old-age income problem. While promoting union pension demands, Labor also sought "to put into place a framework for retirement income policy, rather than allow a patchwork set of ad hoc arrangements to develop."[25] Through legislation, and by working with the unions in Australia's centralized wage bargaining process, the government fashioned such a framework.

[21] Bateman and Piggot 2001; Edey and Simon 1996.

[22] Commonwealth Treasury 2001; Bateman and Piggot 1997.

[23] Bateman and Piggot 1997; Commonwealth Treasury 2001.

[24] Bateman and Piggot 1997; Commonwealth Treasury 2001; Whiteford and Stanton 2002.

[25] Commonwealth Treasury 2001.

Within a decade, this initiative would create Australia's distinctive new national retirement income system.[26]

Australia mandated individual retirement savings accounts to raise retirement incomes and reduce reliance on the Age Pension.

The government's key leverage point was the annual negotiation over the national standard labor contract. In 1986, the government collaborated with the unions to win a 3 percent "award superannuation" contribution in lieu of a comparable increase in wages.[27] After the High Court ruled in 1989 that pensions could indeed be included in the wage-setting process, award superannuation contributions were widely included in renegotiated labor agreements. As a result, participation in employer plans reached 72 percent of wage and salary workers by the end of the 1980s. Because these contributions were a direct substitute for wages, and because a centrally negotiated contribution figure had to be uniform across industries and firms, the plans to emerge from this initiative were overwhelmingly individual account defined contribution arrangements, with the funds invested collectively in employer or industry-wide funds, with employee participation.[28]

While proceeding along the collective bargaining track, the government also addressed the larger "framework for retirement income policy."[29] It enacted regulations requiring full and immediate vesting of award superannuation contributions; equal labor-management representation on the boards overseeing the new superannuation award "industry" funds; and a "prudent man" investment management standard.[30]

The government also reformed Australia's truly unique system of retirement plan taxation. As in many other countries, employer contributions to retirement plans were tax deductible, investment income was tax exempt, and benefits taxed to the beneficiary upon receipt. *But* if workers took their benefit as a lump sum at retirement, only five percent of the total amount was subject to tax. As the highest marginal tax rate was then 60 percent, the entire accumulation could pass to the beneficiary after paying 3 percent or less. In addition to avoiding taxes, a lump sum payout allowed beneficiaries to use or invest these funds in ways that maximized access to Age Pension benefits — a practice known as "double dipping." This became more attractive with the expanded availability of Age Pension benefits. Given the favorable tax treatment and double dipping opportunities, the great majority of Australians covered by employer plans took their benefit as a lump sum.[31]

To discourage double dipping and the use of superannuation plans as a vehicle for tax avoidance, the government totally revamped retirement plan taxation and tightened up the means test.

- In 1983, the government imposed a 15 percent tax on payouts created by contributions made after that date. Amounts received before age 55 — the designated "preservation age" — were assessed an additional 15 percent tax, as were distributions above an indexed amount (c.A$112,000 in 2001).
- To reduce the tax loss resulting from the introduction of the award superannuation program, the government in 1988 placed a 15 percent tax on both contributions and investment income. Due to these changes, pension contributions, investment income, and payouts are now all subject to tax.[32]
- Perhaps the most important measure against double dipping was to tighten up the Age Pension means test with the introduction of "deeming" in 1990. Deeming imputed income on assets that otherwise showed little or no returns, such as checking accounts and non-dividend producing stock, and thus created a far more meaningful evaluation of "means."

The result of these measures was a curb on pension tax expenditures and improved targeting of Age Pension benefits. It also created an enormously complex — indeed nearly unintelligible — taxation and means-testing system.[33]

The final step in the development of the new Australian system was to increase funding. When the award superannuation program was introduced in 1986, it was understood that the 3 percent contribution was the first installment of a program to set aside 9 percent or more in a superannuation fund. A 3 percent contribution could not generate very much retirement

[26] Commonwealth Treasury 2001; Bateman and Piggot 1997.

[27] Substituting pension contributions for increased cash wages increased saving, which helped lower inflation, interest rates, and the nation's widening trade deficit.

[28] Bateman and Piggot 2001; Commonwealth Treasury 2001.

[29] Commonwealth Treasury 2001 p.78.

[30] Commonwealth Treasury 2001.

[31] Commonwealth Treasury 2001.

[32] The "tax expenditure" on superannuation plans in 1986 was estimated at A$8.6 billion, well over half the A$13 billion spent on the Age Pension (Rein and Turner 2001). While these figures are not exactly comparable – the tax expenditure figure refers to revenues lost primarily on people of working age while the Age Pension expenditure refers to spending on the smaller number of people of pension age – they indicate the magnitude of pension tax expenditures within Australia's retirement income system. Despite the new levies, superannuation plans continued to offer significant tax advantages, especially for high earners. In part for this reason, the government imposed a 15 percent surcharge on contributions for individuals with incomes above a specified indexed amount (A$99,000 in 2001), with the tax phased out for individuals with incomes below a lower indexed amount (A$81,000 in 2001) (Commonwealth Treasury 2001).

[33] Commonwealth Treasury 2001.

income. And, as individual account programs involve high overhead costs, the burden of handling such small sums was also quite onerous. So the government and the unions proposed a 6 percent contribution in the 1989 national wage-setting negotiations. The agency overseeing the negotiating process balked, however, citing spotty compliance with the existing 3 percent contribution program.[34]

The government, at this point, decided to abandon the collective bargaining approach. In 1991, it enacted the Superannuation Guarantee (SG) mandatory program, to be put in place the following year. The government now required employers to make a pension contribution, rising to 9 percent of covered earnings by 2002, on earnings between A$5,400 and A$80,000 (indexed to A$105,000 in 2001).[35] The resulting funds would typically be invested collectively, in a company or industry fund overseen by employer and employee trustees. The Labor government in 1995 proposed an additional 3 percent contribution from employees, matched by a 3 percent contribution from the government. But the return of the Conservatives in 1996 ended this initiative.[36]

This Superannuation Guarantee program — the direct extension of the negotiated award superannuation program of the 1980s — is now the core of Australia's retirement income system. The means-tested Age Pension and voluntary employer plans remain critically important to lower and higher paid workers, respectively. But the SG, and the regulatory framework developed over the past twenty years, is the centerpiece of the Australian retirement income system.

Will the Reforms Succeed?

Provide More Adequate Old-Age Incomes

Yes, over time. The Superannuation Guarantee will create a significant retirement income asset in addition to the Age Pension and voluntary employer programs. Voluntary employer programs provide significant benefits only to a small percentage of older Australians. Workers need to remain with their employer for 15 to 20 years prior to retirement to accrue a meaningful pension. So the reforms represented a major expansion in the nation's private retirement income system. By diversifying retirement income sources to include capital market investments, the SG program insulates the elderly from political shocks and could make their income more secure than in an expanded public system.

The mandated savings should significantly increase old age incomes, but the Age Pension will remain a critical income source.

The Retirement Income Modeling Unit of the Australian Treasury (RIM) has projected the retirement income provided by the SG program when the program matures — when workers have contributed over their entire careers.[37] As shown in Table 2, the median worker who earns a constant 75 percent of MTAWE, and who contributes at the 9 percent rate over a 40-year career, is projected to get a nominal (non-inflation-proofed) SG annuity at age 65 equal to about 90 percent of the full Age Pension benefit. While this produces a 30 percent loss of Age Pension benefits due to the means test, the combined after-tax retirement income replaces 66 percent of final after-tax earnings. As the Age Pension is indexed to wage growth while the real, after-inflation value of the nominal SG annuity steadily declines, this median worker would see a steady rise in Age Pension benefits. This worker is projected to collect 92 percent of full Age Pension benefits over the projected 18 years of retirement, with the two programs together replacing 83 percent of final after-tax earnings. The effect of the SG program should thus be a substantial increase in retirement incomes.[38]

[34] Bateman and Piggott 2000.

[35] Accruals in funded defined benefit plans are a permissible substitute, but require an "actuarial benefit certificate" indicating that participants receive equal or greater value than they would under the SG program.

[36] Whiteford and Stanton 2002.

[37] The RIM model assumes a 4.5 percent real return on assets, 1.5 percent growth in real wages, inflation at 2.5 percent, retirement at age 65, a 25 percent dissipation of superannuation guarantee assets at retirement, and the investment of the remainder in an actuarially fair nominal annuity.

[38] For workers earning 100 percent of MTAWE, the two programs together would initially replace an estimated 54 percent of final after-tax earnings and an estimated 73 percent of final after-tax earnings over the 18 years of retirement (Commonwealth Treasury 2002).

Table 2. Retirement Income in the New Australian System

Australian Treasury Model

Retirement income for a worker with median earnings (75 percent of male total average weekly earnings) who contributes 9 percent of earnings to Superannuation Guarantee account over a 40-year career.*

	Income as % of Full Age Pension Benefit	Replacement Rate (% of Pre-Retirement Earnings)
Retirement income at age 65		
Superannuation Guarantee Annuity Income	90%	
Age Pension benefit after application of the means test	70%	
Combined retirement income	160%	
Pre-Tax Replacement Rate		53%
After-Tax Replacement Rate		66%
Retirement income across expected lifetime		
Age Pension benefits after application of the means test	92%	
Combined After-Tax Replacement Rate		83%
*** Parameters**		
The full Age Pension benefit is equal to 1/3 median earnings.		
Real rate of return on assets	4.5%	
Real rate of wage growth	1.5%	
Rate of Inflation	2.5%	
Retirement at age 65		
25 percent of assets dissipated at retirement; the remainder invested in an actuarially fair nominal annuity.		

Source: Commonwealth Treasury 2002.

Workers nevertheless bear significant financial risks in such individual account programs. Even if the Treasury's estimates prove accurate on average, there should be a significant dispersion of results both within and between generational cohorts. The means-tested Age Pension reduces this risk, as do the "prudent man" investment standard and the control of investment policy by pension fund trustees in most SG plans. But there has been a shift to greater employee choice and smaller funds, and this increases the dispersion of individual results: individual account programs have an inherent trade-off between individual choice and security, and the trend in Australia has been toward greater choice and risk. Nor are workers protected against the possibility that their cohort will experience unusually poor investment returns.[39]

The most serious financial risk in the Australian system could be in the decumulation process — in the lack of inflation proofing and annuitization of SG balances. Without inflation proofing and annuitization, the elderly face the risk of consuming their assets too quickly, or of consuming too little. The government has tried to induce annuitization using tax incentives and the rules of the Age Pension means test. But the response has been disappointing. Some experts thus expect that Australia will at some point mandate the annuitization of at least a portion of SG account balances.[40]

39 Bateman and Piggot 1997.

40 If Australia mandated annuitization, it would have to decide whether to mandate gender-neutral annuity rates. Women tend to have lower lifetime earnings, and therefore lower SG accumulations. They also have greater expected longevity. Gender-specific annuity rates would thus result in retirement incomes that were far lower for women than for men. One Australian observer noted that low-wage workers also have low expected longevity. Mandatory annuitization that fails to take this into account would, in effect, transfer income from the poor to the rich. (King et al. 1999; Bateman and Piggott 2000).

Control Public Costs

Yes. Australia currently allocates a fairly low 3 percent of GDP to its public Age Pension program. The Treasury's RIM Unit projects this expense to rise to 4.7 percent of GDP by 2050 as the population ages. But without the SG program, Age Pension expenditures would be about a half a percentage point higher. Because of the income generated by the SG program, the share of the elderly receiving no Age Pension benefit is projected to rise from 18 percent today (including 6 percent who continue to work) to about 25 percent in 2050; those on a partial benefit to increase from a quarter to about 40 percent; and those collecting a full Age Pension benefit to fall from over half to about a third.[41]

Offsetting these savings in government expenditures is the cost of subsidizing the SG program through generous tax favors. While the tax changes of the 1980s significantly reduced the government's revenue loss, the Treasury's projections show tax expenditures on the SG program exceeding reductions in Age Pension expenditures through 2020.[42]

These cost estimates assume: 1) that the government can counteract efforts to circumvent the means test (or limit circumvention to the 25 percent "dissipation" of SG assets at retirement assumed in the RIM model); and 2) that workers accumulate SG balances more or less as projected. The government has indeed closed various loopholes in the means test through deeming and similar initiatives. Whether individuals get the projected SG retirement incomes depends on the financial risks discussed above and whether workers will indeed work and save for about 40 years and retire, as projected, at age 65.

Reduce Disincentives to Work and Save

Yes and no. The Superannuation Guarantee overcomes the disinclination to save for old age rather directly — through a government mandate. Some workers will reduce other saving to offset SG contributions. Pension tax subsidies will also increase the government's deficit and decrease government saving. After accounting for these effects, however, the Treasury estimates that the SG program increased national saving by 1.2 percent of GDP in 2001. After including the projected reduction in Age Pension expenditures, which reduces government deficits and increases government saving, the Treasury estimates an increase in national saving equal to 3.6 percent of GDP in 2020. As a measure of capital deepening, the SG program, the maturation of preexisting employer plans, and changes in the tax treatment of lump sum payouts has boosted retirement accumulations from 3 percent of GDP in 1972 to 75 percent in 2001, and they are projected to exceed 115 percent of GDP by 2020.[43]

SG contributions are mandatory. But they seem to generate far less resistance, and are less of a disincentive to work, than mandatory contributions to social insurance programs. Employers make these contributions, so they are a less visible reduction in take-home pay. Workers are also less likely to view contributions to their own retirement account as a tax to be avoided — as a payment without an incremental benefit received in return. The bull market of the '90s and the rapid buildup of individual account balances, which most workers expected to access as a lump sum at retirement, also helped acclimate workers to the program.

SG contributions have nevertheless been burdensome for low-wage workers who need much of their earnings to purchase necessities and who are assured a reasonably comfortable retirement via the Age Pension alone. Overhead costs also run high in individual account programs and take a proportionally bigger bite out of the smaller contributions and accumulations of low-wage workers, which are often held in many different employer plans. Women (and men) who leave the labor force to care for children and other family members face similar problems. Their discontinuous employment history tends to lower their wages and contributions and to generate accounts with many different employers. Workers often lose track of such small accounts — one third of all accounts are already "lost" — and this further increases the cost of the SG program and its disincentive to work.[44] The government has responded by relaxing SG contribution requirements for low-wage workers; by offering additional subsidies; by capping administrative costs on small SG accounts; and by requiring the division of superannuation rights in a divorce. It is too early, however, to evaluate the effectiveness of these initiatives.[45]

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41 Commonwealth Treasury 2002; Bacon 1999.

42 Bateman and Piggot 2001.

43 Bateman and Piggott 2000.

44 Linda Rosenman (2002) notes that Australia's rejection of national identity numbers, like U.S. Social Security numbers, is a major factor contributing to the problem of lost accounts.

45 To ease the burden on low-wage workers, the government now provides an 18 percent rebate for contributions up to A$3,000 for spouses earning up to A$10,800, with the contribution amount phased out, dollar-for-dollar, for earnings between A$10,800 and A$13,800. It proposes allowing workers earning less than about A$11,000 to opt out of the SG program; and to offer a "co-contribution" of up to A$1,000 for workers with incomes up to A$20,000, phased out for workers earning more than $32,500. To control administrative costs, the government limits fees on accounts less than A$1,000 to investment earnings and offers "holding accounts" for sums too small to generate enough income to cover these charges (Bateman and Piggott 2000; Commonwealth Treasury 2001, 2002).

Perhaps the most serious challenge to the Australian retirement income system could be the powerful *severance* incentives unintentionally created by the interaction between the Age Pension and the maturing SG programs. As discussed above, the Age Pension means test provides an incentive for workers to retire prior to age 65, live off their savings, and then collect a larger Age Pension benefit. Australian men do retire from work on average at age 62.3. Most experts, however, view the Age Pension's early-retirement incentive as more latent than real: Military Service Pensions and disability and special unemployment benefits are nevertheless the primary sources of income supporting early retirements. Retirement plans and capital income are also important income sources. So as workers accumulate increasingly large SG balances, the incentive to retire early and double dip should become increasingly powerful.[46]

Australia's thorniest challenge could be the adverse effect of the Age Pension means-test on incentives to work and save.

To counter the early-retirement double-dip incentive, the government tightened the link between the SG and Age Pension programs by raising the SG preservation age from 55 to 60 by 2025. This change will cut the gap between the two programs in half, from ten years to five.[47] But the impact on early-retirement double dipping could be small as the bulk of the time spent in *Age Pension*-induced retirement comes between the ages of 60 and 65.[48, 49]

Other options for countering the system's *severance* incentives include the mandatory annuitization of SG balances (which creates an income stream more readily subjected to the Age Pension means test) or the outright elimination of the test.

If SG balances were annuitized (or if the means test used the annuity-equivalent figure to calculate benefits), opportunities to game the system and double dip would be significantly reduced. However, Australians have long resisted mandatory annuitization. They clearly view retirement plan balances in lump-sum terms and have insisted on their right to access these funds.

Australians have also come to see Age Pension benefits as a broad-based entitlement — as *compensation* for contributing to the nation during their working careers — not means-tested *welfare* for the poor. But with the maturation of the SG program, two-thirds of the elderly are projected to lose some or all of their Age Pension entitlements via the means test.[50] Some observers argue that this could put the means test at risk. If the electorate eliminates means testing, it would also eliminate the system's early retirement incentive. But the policy would increase benefits for the well-to-do at a significant cost to the government. So eliminating the long-established means test, without countervailing measures, is far from likely.[51]

[46] Scherer 2002; Australian Bureau of Statistics 1998.

[47] The government also eliminated all access to SG assets prior to the preservation age (replacing the onerous 30 percent penalty). As the Age Pension eligibility age for women will rise from 60 to 65 by 2014, the gap for women will remain at five years, equal to that for men (Bateman and Piggot 1997).

[48] The primary sources of "early retirement" income have been generous disability and unemployment benefits. The disability benefits are asset tested. So the build-up of significant SG assets, available at age 60, would reduce reliance on public funds and discourage the use of the disability program as a pathway out of the labor force. Means-testing "mature age" unemployed benefits would have a similar effect. So raising the SG preservation age to 65, eliminating the gap with the Age Pension program, would exclude SG assets from the disability and a "mature age" benefits means tests.

[49] Bateman and Piggott 1997.

[50] Today, about 45 percent of the elderly lose some or all of their Age Pension benefits due to the means test. Once the SG system matures, the Treasury's projections show that about two-thirds of the elderly will lose some or all of their Age Pension benefits. Only 18 percent collect no Age Pension benefits, and of these a third are still at work. Many will also collect benefits toward the end of their lives as income from investments and private pensions, net of inflation, tends to decline with age.

[51] Rein and Turner 2001.

Conclusion

Australia has developed a truly unique retirement income system using two quite different components. The Age Pension originated at a time when the provision of old-age income was a *welfare* problem. This program then evolved into something of a universal demogrant with its own progressive income tax. The Superannuation Guarantee, and the employer plans that have increasingly adopted its individual account format, reflect the most contemporary approach to retirement income design.

Many Australians had hoped that the SG program would be dominant in the nation's retirement income system — that the savings plan would generate enough retirement wealth that the Age Pension could return to its original safety net function. This might have been plausible had the program expanded beyond a 9 percent contribution. But under the current set-up, the Treasury RIM projections have only 25 percent of the elderly collecting no Age Pension benefits. Forty percent would be on the taper — where their incomes are effectively taxed at a 40 percent rate.[52] And SG income, of course, carries much more risk. So even after the SG program matures, the Age Pension will remain critically important to the great majority of the elderly population.

The Australian system thus will remain quite complex: all means-tested programs are messy and bureaucratic. Australia's system of pension taxation is a marvel of complication. And individual account programs are expensive to administer, especially for small accounts and small employers. Financial planning to manage the investment of lump sum distributions, to reduce taxation, and to increase Age Pension entitlements, is thus a large and rapidly growing industry — and represents significant additional cost in the operation of Australia's national retirement income system. Another hidden cost is the stress within families over intergenerational transfers and the division of SG-generated assets, especially where adult children act as financial executors for their elderly parents.[53]

Most troublesome is the early retirement incentive created by the interaction between the two systems. Australian men currently withdraw from the labor force at age 62.3 — significantly earlier than the age assumed in the Treasury model. Workers are now accumulating significant balances in their SG accounts — assets that could support an early retirement or be subjected to an Age Pension haircut. In the Treasury model, the projected 40 percent of the elderly on the taper will have a clear incentive to retire early and double dip. So will many of the projected 25 percent who could retire at age 65 without claiming a benefit — but who could also choose to retire early, run down their assets, and become eligible for an Age Pension. Workers who respond to this incentive and retire early — even at the age that Australian men currently retire — will take their productivity out of the economy and increase the burden on those who remain. As one expert observed, "the longer-term success of the system in meeting its objectives will depend critically on whether these leakages can be contained, by discouraging the use of lump-sum benefits to finance early retirement and by encouraging labor-force participation in the 55-65 age group."[54]

Australia has put in place a new system that promises a replacement income, not a minimal allowance, and does so in a truly unique fashion. The system is still in its formative phase and will continue to evolve. One challenge will be to reduce its tremendous complexity. Another is to set the work/retirement divide at age 65 and counteract incentives to dissipate assets and retire early. A third is to control investment risk during asset accumulation and then translate the accumulated savings into a reliable retirement income stream. The long-established Age Pension could well become a universal (non means-tested) benefit. The Superannuation Guarantee might become less of a tax-sheltered savings vehicle and more of a money-purchase pension plan that automatically annuitizes account balances into retirement income streams. But the basic structure of Australia's new retirement income system has taken root. Whether it proves to be better than traditional social insurance approaches is yet to be determined.

52 See footnote 6.

53 Rosenman et al. 2002.

54 Edey and Simon 1996, p.25.

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