SUPERANNUATION: Turbocharging Retirement Incomes
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Addressing an Organisation for Economic Co-operation and Development (OECD)-sponsored conference on pension adequacy, Paul Keating laid out the rationale for the fundamental changes to Australia's superannuation and retirement income system which he presided over both as Prime Minister and Treasurer. He explains Australia's three pillars retirement system: the government-provided age pension; the 9 per cent Superannuation Guarantee Charge or private savings; and the voluntary top-up 'super' contributions. In the address, he says from 1983 he could see that the age pension alone could not sustain an adequate level of income for retirees, particularly when the bulk of the baby-boom generation was leaving the workforce. Paul Keating says most OECD countries have lost at least 25 years in savings by not acting to deal with the intergenerational consequences of ageing. But, because Australia did act, and early, from 1985, he notes that Australia now has a superannuation savings pool of $1 trillion, amounting to over 100 per cent of GDP, an enormous sum for a workforce of ten million people. He reminds his audience that the political class—the politicians—can make all the difference in transformative national schemes of this kind, if they face up to the urgency and are decisive.

When I first began attending IMF, World Bank and OECD meetings in 1983, the big issues then on the agenda related to macroeconomic policy and macroeconomic management.

There was no consensus in those days as to how economic policy might best be managed between Keynesian nostrums of deficit budgeting to fill out overall demand, including the pressure those kinds of policies put on bond markets and interest rates, and the more classical approaches to economic management, which would have preferred every budget to be in surplus with monetary growth tightly constrained.

1970s inflation was still with us, economies were growing at a snail's pace and more often than not, the wage share in GDP had dislocated profits and, with it, investment. Of course, higher unemployment blighted most economies.

These days, two decades later, there is a consensus as to how economies should be managed, where fiscal and monetary policies enjoy a much clearer role in the scheme of overall economic management.

Now, in developed countries, there is as much attention being paid to microeconomic issues such as taxation, education, skills formation, etcetera, as there is to macroeconomic policy. Of course, in the last decade or two, product innovation has played a starring role in the transmission and use of information with its ability to change the way we live while lifting productivity and incomes.

Since this current long economic wave of growth began in 1982, over those 25 years so much has been achieved in world output and wealth.

At the same time, something else has happened. Those of us who were at work in 1982 are 25 years older. If we were born in the 1940s, as so many of the 1980s workforce were, we are at or near retiring age.

The decline in population replacement rates during that period of prosperity has given most western countries an ageing demographic where larger retired and near-retired communities depend or will depend on a relatively smaller force of younger workers to sustain them.

Demographers have been pointing to these statistical absolutes for aeons, yet the great majority of governments in the developed world focused on the macro and microeconomic issues I have just mentioned.

It is only now that governments of some of the major countries are beginning to focus on the enormous out year costs of their pension systems and the sustainability of those systems.

Governments around the world took the attitude that solutions to this problem could be postponed or at least handed on to the next generation of politicians. All sorts of remedies have been wished up: more immigration of younger people, higher participation rates by women in the workforce, older workers staying in employment beyond usual retiring ages, more factor productivity, etcetera.

However helpful some of these remedies or supplementations may be, the costs involved in providing retirement incomes for ever expanding ageing populations is so large as to dwarf the otherwise helpful influences flowing from most of the suggested remedies.

As we know, demographics take a long time to change. Higher workforce participation can provide useful supplementation while older people can work longer until they either tire out or become infirm.

The fact is, most countries have lost 25 important years in savings, a time when, with the combined power of good earnings through three business cycles and compound interest, we might have seen ballooning accumulations which could have been used to improve the adequacy of retirement savings and incomes while augmenting the budgetary provision of public aged pensions.

Implicit in what I am saying is that the greater array of pension arrangements, whether they be public, or public and private, or only private, are unlikely to produce adequate pensions in retirement.

In the modern age, most societies believe they have an obligation to those who have already worked and contributed. More than that, there is the broader commitment to social equity and the avoidance of destitution. Built on those notions is the idea of consumption-smoothing, removing or diminishing that precipitous downward step which, all too often, characterises income in retirement.

I come to this subject with my own experience as Treasurer of the Commonwealth of Australia between 1983 and 1991 and Prime Minister between 1991 and 1996.

During this period, the Labor governments in which I participated and later led, effected a fundamental transformation of the Australian economy, one which has now seen Australia through a fifteen-year continuous expansion. And a low inflationary one at that.

From the beginning, in 1983, I could see that the public pension in Australia, known as the age pension, could not be sustained without income and asset testing and that in the event it was sustained, as the demographics began to deteriorate after 2010, the burden would detrimentally affect the budget and, with it, its regressive intergenerational impact on the young.

I also knew that it was extremely unfair and inequitable that the tax provisions which went to fund the private pension provision, which in Australia is called 'superannuation', for those in the top end of industry and the public sector, was not available to the workforce at large. For I knew that those who were able to access these provisions were in a far better position to smooth their income between work and retirement.

Underpinning that belief was the acceptance that a two-tier or two-pillar retirement income system delivered and was likely to deliver a more adequate and more sustainable income in retirement than the basic government, single-pillar age pension was able to provide.

So, beginning in 1983, I introduced changes to the taxation treatment of taking lump sums which had become an exceptionally tax-effective means of voiding retirement savings early, forgoing the capacity to ever produce annuity income. Two years later, in 1985, having changed those tax arrangements, I was able, in budgetary terms, to afford the movement towards the first occupational-funded private pension provisioning forthe whole workforce.

This first occurred 22 years ago. And in January of this year, 2007, that system crossed one trillion dollars in accumulations. Or, 110 per cent of GDP. A big sum for a workforce of ten million and a population of twenty million.

During this time, the government also adopted the policy of discouraging the growth of employer-provided defined benefit schemes. We could see the time coming when those schemes had insufficient assets to cover their liabilities and where all too often retirees had their benefits, or some part of them, decided by liquidators.

We were not motivated in this to shift risk from employers to employees. Rather, with the disappearance of many companies, either by corporate misadventure or bad management or structural change, the maintenance of defined benefits schemes was making the lot of the corporation far less flexible, though not necessarily improving the likelihood of providing, in the ultimate, the actual benefits so defined.

It is true that working people in accumulation schemes are more or less left to the vagaries of national economic growth and the performance of product and financial markets. But the same influences which bear upon those vagaries also bear upon a corporation's ability to meet the promise of the benefits. It is not easy to insulate anyone over time from the fluctuations of the economic cycle.

In 1985, and in the context of an Accord or broad incomes policy with the trade unions of Australia, I negotiated a national wage settlement, where three percentage points of wages contributed over three years would be allocated to savings, which would be 'preserved' in private pension accounts to age 55, managed by the 'for-profit' financial management industry. When the 3 per cent scheme had reached 60 per cent of workforce coverage by industrial negotiation between unions and employers, in 1992, as Prime Minister, I legislated what is known as the 'Superannuation Guarantee Charge'. The SGC, as it is called, made it mandatory for employers to hold back and put away a total of nine percentage points of the wages and salaries of each employee into their individual superannuation account. These contributions were made in one-percentage-point increments, over a period of nine years. Or, in the 60 per cent of cases where the 3 per cent had already been contributed, an additional six percentage points of wages was contributed over the ensuing nine years. By 2001, the whole workforce had the mandatory nine percentage points of their income being saved annually for their retirement.

In the context of massive reforms to the product and labour markets during that decade, national trend productivity more than doubled to 3 per cent annually.

This meant that there was a 2 per cent real increase in incomes in each year of the 1990s; 20 per cent real in all. The 9 per cent Superannuation Guarantee Charge essentially split off some of that income into savings; that is, workers took home less in cash as the 2 per cent real increase in wages also paid for the superannuation.

That said, this two-pillar approach had and has at its foundation the basic building block of the taxpayer-funded, means-tested, age pension. Because many people were already in their forties or fifties when occupational superannuation was introduced in the mid-1980s, there was not enough time or accumulation to make a dramatic difference to their reliance upon the age pension in retirement.

Nevertheless, to effect a working interface between the age pension and superannuation savings, a pension assets taper withdrawal of a certain amount of pension was set for every $1000 of assets. Based on the current Australian age pension, this would see a single retiree lose all entitlement to the public pension once their assets (excluding their home) reached $494,000 or, in the case of a couple, $785,000.

As mandated and voluntary retirement savings grow, naturally, the asset base of each superannuant will grow, easing their reliance on the taxpayer-provided age pension, while at the same time providing an income in retirement equal to or much nearer the one they enjoyed just prior to retirement.

In fact, if an Australian employee joins the workforce at 22 and retires at 60 and his or her fund earns an average of 6 per cent over the period, that person will retire on or near 70 per cent of average weekly earnings. Today this is around $40,000. At a contribution rate of 15 per cent those retirement savings will fund an income of around 100 per cent of average weekly earnings. At either level, it would mean that such a superannuant would be making no call, whatsoever, on the budgetary provided pension.

The Australian system also has a third pillar. This is voluntary private superannuation and other savings which are encouraged by the concessionality of the Australian tax system. The mandated savings system currently tops out at 9 per cent of all wages and salaries. But employees are encouraged to salary sacrifice so as to add to the 9 per cent wages being put away as savings by their employer. As people get older, naturally, they tend to think more about retirement and are thus more prone to salary sacrifice. The concessionality of the Australian tax system encourages them to do just that.

In short, Australia's retirement income system has a three-pillar structure. A taxpayer-provided age pension or basic safety net; a mandated, fully funded, privately managed occupational contribution scheme; and a voluntary retirement savings system, encouraged and supported by the concessionality of the tax system.

A de facto fourth pillar, as I indicated earlier, is that the Australian retirement income system is not characterised by Defined Benefit schemes, owing to the ambiguity as to who bears the ultimate liability.

This conference is discussing many aspects which relate to pensions and to investment—questions such as the alpha and beta of investment strategies, measurements of risk, questions about private equity, etcetera.

These, no doubt, are interesting subjects. But I am more naturally drawn to issues which have the effect of bulking up savings and which lead to greater pension adequacy.

I think it is important to divine ways in which OECD countries and some developing countries might establish greater private provisioning and preservation in pension systems that can go on to produce adequate annuity incomes in retirement. Certainly, more fully funded ones.

Many countries within Europe are, in population terms, already contracting. That is, they are getting smaller, now. The intergenerational consequences of this are profound. Huge and growing retirement age populations voting with grey power to encourage governments to mount an unconscionable assault on the incomes of the young.

How, at this late stage, can countries begin to move towards greater adequacy of incomes in retirement when fiscal policy is liable to wilt under the load, particularly, with the plurality of our political systems making it so difficult to begin, in any meaningful way, on the pathways to higher levels of private funding?

Let me propose two ways: the wages system and the taxation system.

I have already mentioned the Australian experience with the wages system. While this began industrially, in a negotiation between unions and employers, under a policy encouraged by the government, it finished with the 9 per cent SGC, which is a legislated mandate obliging employers to withhold a proportion of wages and salaries and to deposit those withholdings into individual private pension accounts.

The agreement of the workforce materially helped in this. There is no doubt about that. And the leap in trend productivity also helped. It is easier to put money away if incomes are rising. But, in the end, without the government will, it would not have happened. This kind of mandated legislation can apply across most OECD countries and in some developing countries. It is worth doing even if it takes two years to put 1 per cent of wages and salaries into savings. That is, half a percentage point a year.

What is important here is not the quantum or the increments, but the beginning. Even if it took fifteen years to tuck away 10 per cent of wages as savings, it is worth it.

This would not amount to a dislocatory shift in profits any more than it would an unreasonable allocation of workers' cash to savings.

As with most things, this requires leadership. And what are the key ingredients in leadership? The answer is always the same: imagination and courage.

No point having the imagination without the courage and no point having the courage without the imagination. Political figures add value to the public system by decisiveness. They can cut through the procrastination and the nonsense by actually taking a decision. And by taking it, a lot of the inherent political risk evaporates.

But the problem of retirement savings will not be solved by useless politicians sitting on the egg hoping that before their time is up, someone else will come along to hatch it for them.

And this brings me to the tax system.

All governments by virtue of the impact of inflation on incomes find themselves in the position of collecting 'fiscal drag'. That is, the impact of even modest inflation in lifting incomes in a progressive tax system.

At some point, either through tax indexation with automaticity or by discretionary changes to tax rates, governments end up in the position of having to provide tax cuts. Often those tax cuts simply inflate demand. Often, as in the recent Australian experience, large tax cuts pump demand up such that the central bank is obliged to check the extra activity by imposing higher interest rates.

Those tax cuts would have been much better paid as savings rather than as cash. And in the Australian case, where the budget today is in structural surplus, those tax cuts should have been taken off the Cabinet table and the surplus, and preserved to age 60 years in every tax-paying individual's private pension account.

If one asks the question, in qualitative terms, where are national savings best left—on the Cabinet table for spending ministers to plunder or in the accounts of ordinary working people for their retirement—there is of course, only one answer. Preservation is king!

I suggest this, not for some idea that has never been tested. In fact, I proposed this as Prime Minister in the 1995–96 Australian Budget. In that Budget the government provided tax cuts, paid to the equivalent of 1 per cent of wages, in each of three consecutive years, into every taxpayer's superannuation account.

This would have had the effect of lifting the 9 per cent under my Superannuation Guarantee Charge to a total of 12 per cent. And, to cap it, I had the trade unions of Australia agree that they would oblige workers to make an equivalent payment of one percentage point of wages, in each of the same three years, bringing the total contribution to their pension account to 15 per cent: 9 + 3 + 3. This additional three percentage points from workers was called the 'Co-Payment'.

As it turned out, the incoming Howard government reneged on its promise to maintain the tax cuts. And when the tax cuts went, so too did the Co-Payment and Australia lost six percentage points of wages and wage equivalents in its national savings pool. Instead of being at one trillion dollars as now, we would have been at $1.3 trillion and rising rapidly.

There is, of course, a moral in this: if you want enlargement and innovation in economic ideas, don't go to a conservative government. However that may be, conservative governments are at least supposed to believe in thrift. God knows, they don't believe in much else. But Australia has a conservative government that believes that thrift and savings on this scale should not be within the ambit of worker preference no matter that that preference is actually managed by the 'for profit' financial investment services industry. The Howard government even has the blue suits under suspicion.

Nevertheless, governments around the world are able to direct tax cuts into savings. If one looks at the huge tax cuts under the Bush administration in America, imagine how much better those tax cuts would have been, qualitatively, if they had been paid as savings into the private pension accounts of Americans. With America's savings paucity and its current account imbalance, what a lost opportunity. And as those Americans of my age grow older and nearer retirement, how much more they might have appreciated those savings, had they not turned them to immediate expenditure.

I should make another point about the Australian experience.

The $1 trillion of mandated savings has completely turbocharged the Australian capital markets. You now see Australian institutions roaming the world looking for infrastructure and property deals to feed the growing need for volume and yield.

As Treasurer, in 1985, I removed the double taxation of dividends in Australia. Corporation tax is now paid by the company and the tax credited to the corporation is transferred to shareholders on receipt of their dividends, so as to relieve their personal taxation on that income.

This has completely changed the fashion for dividends in Australia. And if the dividends are substantial and regular, which they are, this naturally fixes the upside price of stock. It also fixes the down side. This has meant that the beta of the Australian stockmarket is far lower than stockmarkets of the United States and Europe.

Each year, an extra $100 billion drops into the lap of the financial investment industry in Australia from the superannuation system. A lot, for a workforce of ten million, but it has to be invested. This is another factor driving the sophistication of the financial services industry, as it looks for opportunities in Australia and, increasingly, around the world.

We always hear a lot from financial planners and investment strategists about savings and investment but it is the politicians who can make the real difference. And it is the politicians who need to grasp the relative immediacy of the coming demographic bulge, with its all too predictable dislocatory consequences.

That is what this debate must be about.