Superannuation: an approach to reform

Submission to Retirement Income Review

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Introduction

My submission reflects my role as a lecturer in behavioural economics and long interest in public policy issues, and not the views of any particular interest group or political party. As suggested in the submission guidelines, I have limited myself to a few pages but would be happy to elaborate if this would help.

The primary argument for a compulsory superannuation scheme is that individuals left to make their own decisions are likely to regret not having saved more by the time they reach (or approach) retirement age. This myopia (or excessive discounting of the future) is a well-established phenomenon in behavioural science and neuroeconomics.[1] Secondary, and more contentious, justifications are increasing national savings, developing financial markets and reducing the cost of the age pension.

The terms of reference refer to the importance of three factors which I have interpreted as follows;

- "allows Australians to achieve adequate retirement incomes"; here the key word is *adequate*, which could be taken at one extreme as a subsistence income (perhaps as reflected in some social security payments[2]) and at the other extreme as allowing at least the same amount of consumption expenditure as before retirement.[3]
- "is fiscally sustainable"; the two main aspects here are the fiscal cost of superannuation tax concessions and the cost of the age pension;
- "provides appropriate incentives for self-provision in retirement"; here the key word is *appropriate* as any pension or compulsory superannuation system will reduce incentives for self-provision to some extent.

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[1] See, for example, Wilkinson, N & Klaes, M 2018, *An Introduction to Behavioral Economics*, Palgrave, 3rd edition, Chap 8 or Cartwright, E 2018, *Behavioral Economics*, Routledge, 3rd edition, Chap 4.

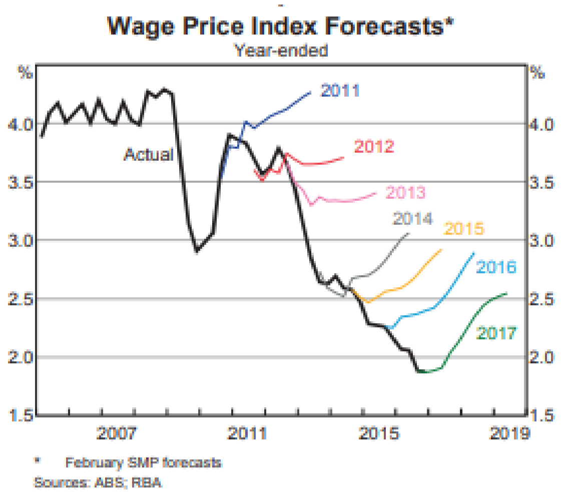
[2] Newstart is too low a benchmark, as it assumes (incorrectly in many cases) that people will only be on it for a short while before finding work. The age pension might be a guide to community values.

[3] As Peter Martin has pointed out, the more generous of the 'standards' prepared by the Association of Superannuation Funds of Australia allows for an overseas trip every two years, dining out etc and represents a standard of living governments do not intervene to support while people are working; https://theconversation.com/5-questions-about-superannuation-the-governments-new-inquiry-will-need-to-ask-124400

A suggested approach

The conceptual framework I would advocate the panel adopting is as follows;

- state clearly their assumptions (and the reasons for them) on the key parameters for determining the optimal proportion of income an individual should save for retirement. These parameters are:
    1. the proportion of pre-retirement income that it is desirable to have as a post-retirement income. This is likely to be less than 1, as retirees for example no longer need to spend on commuting or buying work clothes and with more time to prepare meals themselves have less need to buy prepared meals. They are also likely to be making smaller (if any) mortgage interest payments. This assumes that increased consumption of health care is either modest or covered by public provision. (It could also incorporate a discount rate; the extent to which people regard their well-being in the future as less important than their current well-being.)
    2. the length of life after retirement. Currently life expectancy at age 65 is around 22 years for women and 20 years for men. It is likely to be somewhat higher by the time that people joining the workforce now reach retirement age.
    3. the rate of return on assets accumulated in a superannuation fund. With nominal yields on 10-year government bonds dropping back under 1 per cent, the yield on bonds maturing in 2047 only 1½ per cent and the yield on long-term indexed bonds around zero[4] (as at 30 January 2020), expected returns now would be substantially lower than has traditionally been assumed. (This assumes that returns on equities are higher than that on bonds by a fairly constant risk premium.)
    4. the proportion of time during potential working life that an individual is not working, due to e.g. education, family responsibilities, unemployment or illness.
    5. the growth of real incomes over the time an individual is in the working age population; unexpectedly low nominal wage increases over recent years mean that the longer-run growth in real incomes might be lower than has traditionally been assumed.



Source: Bishop, J & Cassidy, N, 'Insights into low wage growth in Australia', *Reserve Bank of Australia Bulletin*, March quarter 2017.

- using a mean expected value for these parameters, an average optimal rate of saving for retirement can be calculated.

[4] https://www.rba.gov.au/statistics/tables/#interest-rates

- a sensitivity analysis can be conducted using higher and lower assumptions for the key parameters and estimated probabilities applied to them. This will then generate a range of values for the optimal rate reflecting the inherent uncertainty. It is likely that the range will span from under the current 9½ per cent and 12 per cent target for 2025 to considerably above it. An example is the recent work by Khemka and Warren.[5]
- a similar sensitivity analysis can be conducted acknowledging that people are different and so the optimal rate will differ across them.
- at this point the role of the age pension as a 'safety net' needs to be considered. If the mean assumptions turn out to be incorrect (e.g. returns are lowered than expected or longevity increases more than expected), then there will be greater use made of the age pension. It is a political decision how much risk of higher expenditure on the age pension is acceptable.
- the role of any 'externalities' (the extent to which an individual increasing their own superannuation contributions adds to the wellbeing of other people) should be added to the analysis. The superannuation system has contributed to increasing private sector saving (although the cost of tax concessions mean the contribution to national saving will be considerably less) and to the development of the funds management industry. It may make it easier for Australian firms to attract long-term funding. Depending on the estimated strengths of these effects, they would argue for aiming for a higher contribution rate to superannuation. My view is that these effects are likely to be relatively small. Higher superannuation contributions also reduce the taxes other citizens will need to pay to fund the age pension, which does need to be included in the calculations. Some studies argue this effect is small[6] but this is a question the panel could usefully address.
- once an optimal rate (or a distribution of optimal rates) for superannuation contributions has been determined, the question becomes the most efficient means of achieving it. The main choice is the mix between compulsion (the superannuation guarantee levy) and incentives (the concessional tax treatment). The level and availability of the age pension will also be relevant. This analysis needs to allow for the leakage; that an increase in compulsory superannuation will be partly offset by a reduction in voluntary saving. The estimate in the consultation paper (p 22) of between 70 and 90 per cent of an increase in compulsory superannuation being truly additional seems about right.[7]

A 'nudge' alternative

An alternative to a compulsory scheme would be a 'nudge', a concept from behavioural science. A default contribution could be set but individual workers left able to opt (partly) out of it. For example, the default could be 12 per cent but an individual could be allowed to choose only 9 per cent and instead have an additional 3 per cent in immediate wages. They would, of course, forego the concessional tax treatment of superannuation on this 3 per cent. Such an approach would appeal to those of a libertarian cast of mind as a compromise (presumably they would prefer no compulsory superannuation at all). But given the myopia to which I refer above, I

[5] https://theconversation.com/the-uncomfortable-truth-about-super-theres-no-one-size-fits-all-contribution-130193

[6] https://theconversation.com/myth-busted-boosting-super-would-cost-the-budget-more-than-it-saved-on-age-pensions-119002

[7] It agrees with the conclusion of the most detailed study of which I am aware, by Reserve Bank economist Ellis Connolly; https://www.rba.gov.au/publications/rdp/2007/pdf/rdp2007-08.pdf.

would not recommend it. On this issue, I prefer a degree of 'evidence-based paternalism' over 'libertarian paternalism'.

Fairness issues

The panel's consultation paper rightly refers to equity or fairness as an important aspect in assessing how the system is performing. There are clearly distributional aspects of retirement income policy. A valid criticism of the current structure of tax concessions is that they unduly benefit the wealthier. Not only are the wealthy more able to make voluntary superannuation contributions, but their higher marginal tax rate makes the 15 per cent concessional rate on superannuation more valuable to them. Figure 4 in the consultation paper makes this clear.[8] This regressive feature of the tax concessions should be changed!

Another distributional question arises from the incidence of higher compulsory superannuation. If higher superannuation payments come out of corporate profits which would accrue to shareholders (either as dividends or as capital gains), then there is a distribution towards those on lower incomes. But most studies conclude that ultimately higher superannuation contributions are at the expense of wage increases. A recent example is work by Coates, Cowgill and Mackey from the Grattan Institute.[9] Employer superannuation contributions are therefore a deferred wage payment rather than an additional benefit.

An alternative: universal basic income

Another, more radical, approach would be replacing the age pension and superannuation schemes (and other social security payments) with a universal basic income; an equal payment to all (adult) citizens, with no means or work test. This concept, which can be traced back at least to Thomas More's *Utopia* in 1516, has been promoted both by the libertarian right (who see it as replacing welfare) and the progressive left (who see it as supplementing it).

Advocates see it as not just simpler but fairer and encouraging more community engagement.[10] Critics say the numbers do not add up without either cutting benefit levels or infeasibly and undesirably increasing taxation.[11] There have been trial programmes in various parts of the world which may shed light on its desirability.

It would be worth further analysis from the panel.

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[8] I did not find the criticisms of the chart in the submission from the Centre of Independent Studies convincing.
[9] https://theconversation.com/think-superannuation-comes-from-employers-pockets-it-comes-from-yours-130797; https://grattan.edu.au/report/no-free-lunch/
[10] https://www.greeninstitute.org.au/wp-content/uploads/2017/06/Views_of_a_UBI_Aust.pdf
[11] http://www.andrewleigh.com/speech_how_can_we_reduce_inequality_anu_crawford_school_of_public_policy?utm_source=TractionNext&utm_medium=Email&utm_campaign=Insider-Subscribe-210417