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**Old-Age Income Security:
Australia Tries a Different Way**

by

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The AARP Public Policy Institute, formed in 1985, is part of the Policy and Strategy Group at AARP. One of the missions of the Institute is to foster research and analysis on public policy issues of importance to mid-life and older Americans. This publication represents part of that effort.

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Foreword

Australia's approach to retirement-income security consists of a means-tested benefit known as the age pension, and a fairly new mandatory employer-funded pension system called the superannuation guarantee. Unlike most other high-income countries, Australia has never had an earnings-related social insurance pension system.

Financed by general revenues, the age pension pays a flat amount to anyone who qualifies, and most people do. The superannuation guarantee requires employers to contribute an amount equal to 9 percent of workers' earnings to individual accounts for their workers.

Although the introduction of a very liberal means-tested retirement benefit along the lines of Australia's seems unlikely in the United States, proposals to make Social Security eligibility contingent on having income and/or assets below a certain level occasionally surface in discussions of how to restore long-term solvency to the Social Security system. Mandated employer-provided occupational pensions have been proposed as a means of fostering retirement income security in the United States, especially among workers in small businesses. The Bush Administration has also suggested Social Security reform that would involve private accounts whose benefits would replace some of the income from the traditional payroll-financed benefit. Might the experience of Australia provide insights into the feasibility of means-testing social insurance benefits as well as the impact of mandated, largely defined contribution occupational pensions on the ultimate well-being of the aged?

Old-Age Income Security: Australia Tries a Different Way by James H. Schulz, Professor Emeritus of Economics at Brandeis University, explains how Australia's retirement-income operates, discusses the issues that have arisen around both means-testing and mandated occupational pensions, and considers the relevance of Australia's approach to the United States. Schulz highlights in particular the shift in responsibility for retirement-income protection from the collective or public to the individual, which apparently enables politicians to say that Australia's benefits programs are fiscally sustainable. Nonetheless, as Schulz notes, benefit adequacy under the new system remains a question.

Old-Age Income Security: Australia Tries a Different Way is one of several AARP Public Policy Institute papers that examine aspects of social security reform in other countries. The other papers deal with voluntary carve-outs in the United Kingdom, recent developments with partial privatization and individual accounts in Chile, and the financing policies of the Canada Pension Plan and the Quebec Pension Plan.

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Table of Contents

Foreword.....	i
Executive Summary	iv
Introduction.....	1
The “Two-Legged Stool”	2
“We Don’t Need Social Security”	4
Employer-Sponsored Pensions in Australia.....	6
Dramatic Action: The Superannuation Guarantee.....	8
The Structure of the Superannuation Industry	10
Investment Returns	11
Assessment of the Australian Approach to Date	12
Integration Problems: Incentives and Disincentives.....	13
The Age Pension and Changing Tax Provisions.....	15
Retirement Income Adequacy.....	16
The High Costs of Administering Plans	18
Complexity and Choice.....	21
Informed Choice	23
Implementation of Choice.....	26
Conclusions: What Lessons for the United States?	26
Means-Testing Creates Problems	26
“It’s Administrative Costs, Stupid!”	27
But Are the Pensions Sustainable?	27
Uninformed Choice Is No Choice.....	28
Caveat Emptor (Let the Buyer Beware).....	29
Financial Industry Self-interest Comes to the Fore	29
References.....	30

List of Tables

Table 1. Comparison of Means-Tested Federal Programs in Australia (Age Pensions) and The United States (SSI), March 2005	3
Table 2. Changing Pension Eligibility Age for Women in Australia, 1938-2005	4
Table 3. Percent of Workers Covered by Defined Benefit and Defined Contribution Pension Plans, 1982-2000.....	7
Table 4. Plan Information in the Superannuation Industry, 2004.....	10
Table 5. Rates of Return for Sample Superannuation Funds, 2004.....	12
Table 6. Hypothetical Cases of Integration.....	14
Table 7. Types of Charges on Superannuation Accounts in Australia, 2005	20
Table 8. Estimated Expenses for an Average “Industry Fund” and a Typical “Master Trust,” 2001	21

List of Figures

Figure 1. Percentage of Australians at the Age of Eligibility Receiving Public Benefits, 1966-2000	6
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Executive Summary

Introduction

The Australian approach to retirement (with no earnings-related Social Security old-age benefit program) is unlike that in most other countries in the world. This report explains the Australian system, discusses the issues that have arisen, and points out the potential relevance of the Australia approach to the on-going debate in the United States.

Almost every country in the world has some sort of safety net program that provides support to the elderly poor. Australia is no exception—its program is the means-tested “age pension.” The Australian age pension has a liberal income test and a very liberal asset test. The Australian asset test for a homeowning couple allows assets of up to A\$217,500 (US\$165,300) before there is any reduction of the age pension paid out. Moreover, assets can go up to A\$485,000 (US\$368,600) before the age pension “disappears” completely. Similarly, the age pension benefit is reduced by the income test if income goes above the “tax free” range. Currently, a couple can have total income up to A\$57,852 (US\$43,968) before the partial age pension “disappears.” (The conversion of Australian dollars into American dollars was at the exchange rate on July 21, 2005: 1 A\$ = 0.76 US\$.)

Originally, requirements for the age pension (which began in 1909) were quite stringent, but over the years there has been a steady and seemingly inexorable process of age pension liberalization. This relaxation of criteria reached a zenith in 1976 with the total abolition of the asset test component of the means test (later reinstated). The 1976 change expanded payments (including veterans’ service pensions) to nearly 90 percent of the “age eligible” population.

The Superannuation Guarantee

Prime Minister Bob Hawke made a surprise announcement in his 1991 federal budget presentation. Hawke called for the creation of a *mandatory* employer-funded pension system—to be called the “superannuation guarantee charge” (SG). This legislation required employers to make pension contributions for almost all employees based on the earnings level of the employee. These new contributions were to be paid into existing pension funds or, if necessary, new funds.

SG took effect on July 1, 1992. All employers without equivalent pension plans for their employees were required to pay a minimum of 3 percent of an employee’s salary into an individual superannuation account. The law specified that the level of mandatory employer (only) contributions would progressively increase to a maximum of 9 percent. The higher level was reached in 2002, where it remains today. As a result, close to 90 percent of Australian workers—almost all full-time workers and three-quarters of part-time workers—have superannuation coverage.

Integration Problems

Probably the most important issue related to retirement income policy that Australia currently faces is how to successfully integrate the age pension with the newer SG mandate. The Institute of Actuaries of Australia, for example, states that “at present there is a basic conflict between the two pillars of the [retirement] system. The superannuation system is designed to encourage *saving* for retirement. In contrast, saving is discouraged by the age pension system.” Thus, these major retirement programs are not, as one would like, complementary but rather competitive with one another.

In the past, individuals have sought to avoid the loss of benefits by:

- Taking their superannuation benefits as a lump sum and using the money to fund voluntary early retirement living expenses until reaching the age pension eligibility age.
- Reducing assets by putting pension payouts and savings into home improvements (since the value of the home one lives in is not counted in the asset test).
- Purchasing specially designed investment instruments that produce little income or sheltered income, and thereby help their owners qualify for the maximum age pension.
- Not working after reaching the age pension eligibility age, so that earned income does not offset age pension benefits.

Apart from the integration of the age pension with the SG, another issue that arises is whether the 9 percent SG rate will produce adequate income in retirement. Many pension experts think it will not. In 2002, for example, the Australian Senate Select Committee on Superannuation addressed the question.

Based on extensive hearings, review of several independent modeling efforts, and various staff investigations, the committee concluded that “the available evidence demonstrates that the current arrangements for superannuation may not provide an adequate income in retirement for most people and that strategies need to be identified to address the shortfall.”

In this regard, there is concern in Australia regarding the special situation of women and how they will fare economically under SG. Faced with broken work histories, typically lower earnings, disadvantages resulting from divorce, and longer life expectancies, there is a fear that there will be problems for older women in the future. A particular worry is how the exemption that excludes SG payments for persons earning less than A\$450 a month will affect women.

Related to adequacy concerns is another problem area (especially regarding small funds). The administrative costs charged for managing pension funds in Australia are often very high, significantly reducing the ultimate pension received.

When the superannuation guarantee was originally established, the law allowed the employer to determine (“nominate”) an investment vehicle into which the money would go. The majority of employees found themselves in either industry-wide funds or public-sector funds. In 1995, however, the opposition Liberal National Coalition announced (just prior to winning the 1996 election) its intention to introduce greater freedom of choice for superannuation contributions. There then followed eight years of debate over “choice” proposals.

It was not until 2004 that a choice amendment was passed by the Australian Congress. Since July 1, 2005, most Australian workers have been able to choose among competing superannuation funds to manage their individual accounts’ assets, rather than having employers select a fund for them.

The law requires workers to choose among the available funds that are regulated by the Australian Prudential Regulation Authority. Employees are expected to conduct their own research and, hence, to assume all the risks. They are allowed to switch plans, but only once a year. Employers are not held liable for any losses that result from employees changing funds.

Everyone, including the federal government, recognizes that to make good choices, employees must have a basic understanding of investment alternatives. Research shows, however, that typically workers have a relatively low understanding of many basic financial investment concepts. This calls into question their ability to make informed choices among various financial institutions and investments. Aware of this issue, the government has launched a Consumer and Financial Literacy Taskforce. This organization is charged with developing plans to improve levels of consumer knowledge.

Conclusion: What Lessons for the United States?

Means-testing Creates Problems.

Australia’s history with the age pension warns the United States to be very cautious about shifting to greater reliance on means-testing. In Australia, it has been difficult to keep benefit levels low. Moreover, as discussed above, integration problems have generated huge complexities and perverse labor force and financial behavior. In Australia there is a whole range of other benefits that are means tested—such as rent assistance and a utilities allowance. In addition, state and local governments use the Pension Concession Card (issued to persons receiving the age pension) as a way of identifying people who are eligible for a variety of local services at reduced rates. When all of these benefits are taken into account, the marginal tax rate imposed on individuals who no longer qualify for the age pension rises to as much as 87 percent.

“It’s Administrative Costs, Stupid!”

As in other countries, the administrative costs of operating private pensions in Australia vary greatly from plan to plan and can be very high (especially in small and/or retail plans). This experience reminds us that projections of likely future rates of return

must be scrutinized closely. Rates of return are often advertised without deducting a realistic amount for marketing, administrative costs, and investment management fees.

But Are the Pensions Sustainable?

The Australian approach shifts retirement income protection from collective to individual responsibility and thereby shifts the burden of providing income for retirement (the “national pension bill”) away from government budgets onto the budgets of employers or households. Although politicians can proudly declare that government benefit programs are now fiscally “sustainable,” there remains the important question of benefit adequacy under the new system.

Uninformed Choice Is No Choice.

The Australian experience indicates that countries should give great attention to the realities of consumer financial literacy. Even if this problem is acknowledged, Australia is finding it difficult to take sufficient action (in sufficient time) to deal effectively with the issue.

Finally, in Australia as in the United States, there is concern about the “crisis” resulting from population aging and the unsustainability of public expenditures. The aim has been to “wake up” voters regarding old-age financing issues and to enlarge support for pension reform. However, issues related to pension reform and privatization are extremely complex and confusing to the ordinary citizen. Therefore, great effort must be made to insure that there is an informed political debate before making major changes in pension policy.

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Introduction

For more than a half century, almost all of the industrialized countries of the world have dealt in a similar way with the challenge of providing income in old age. The similarities in various countries were so great that “the way” was given a name—economic security in old age was provided by the “welfare state.”

The basic approach (often called “the three-legged stool”) was, first, to provide each citizen with basic protection from a collective public pension program called Social Security. Using social insurance principles, the economic risks facing individuals that are associated with financial planning for retirement were shared and thereby reduced; and pension benefits that helped to provide adequate income in retirement were guaranteed. Second, to deal with those situations where individuals for one reason or another still found themselves with incomes below poverty, means-tested old-age income safety nets were operated by governments (as they had been in many countries for centuries). And finally, employers and the public were encouraged to supplement the generally minimal benefits from Social Security with income generated by private pensions and personal savings.

Today, welfare state programs are under challenge. Many people want to institute a very different approach that would minimize or eliminate the Social Security leg of the stool and rely almost exclusively on a non-collective (individualized) private approach. This approach would utilize “defined contribution plans” and operate through individualized personal accounts. As we all are aware, a serious debate over this proposed radical change in approach is underway in the United States, with the new way supported by the President, many business executives, and some economists, among others. Also supportive are many ordinary citizens, worried that because of what some say is a pension “crisis” they will never get promised Social Security benefits. For other individuals, however, their support comes from liking the general idea of “taking control” of the economic decisionmaking related to planning for their retirement.

In this debate over how to provide retirement income, one of the questions receiving increased attention is the experience of countries that have already adopted (to a greater or lesser degree) the basic approach being proposed in the United States. Three countries have received most of the attention: Chile, which was the first nation to abolish a Social Security program in favor of the new approach; Great Britain, which gave people the option to choose whether to rely mostly on public pension programs or their own “personal pension”; and Australia, which has mandated defined contribution pensions for almost all workers.

The Australian retirement system (with no earnings-related Social Security old-age benefit program) is unlike that in most other countries in the world. This report explains Australia’s approach, discusses the issues that have arisen, and points out its potential relevance to the on-going debate currently raging in the United States.

The “Two-Legged Stool”

Almost every country in the world has some sort of safety net program that provides support to the elderly poor. Australia is no exception: their program is called the “age pension.”

Table 1 compares the means-tested federal programs in Australia and the United States. When they think of “welfare programs” aimed at reducing poverty, Americans are likely to think of programs providing very low benefits that are means-tested. For example, in the United States, the Supplemental Security Income program (SSI) has both income and asset tests that bar eligibility for any benefits if either of the maximum test levels is exceeded. In 2005, the American asset test for a couple was \$3,000. Any unearned income and part of any earnings are deducted so that, in general, the most one can get (*combining SSI and any other income*) is \$6,948 a year if single and \$10,428 if a couple—amounts that are below the official government poverty level for older persons.¹

In contrast to the meager, “tight-fisted” benefits in the United States, the Australian age pension has a much more liberal income test and a very liberal asset test. The Australian asset test for a homeownership couple allows assets of up to A\$217,500 (US\$165,300) before there is any reduction of the age pension (and assets can go up to A\$485,000 (US\$368,600) before the age pension “disappears” completely).² Similarly, the age pension benefit is reduced by the income test if income is above the “tax free” range, but at a reduction rate less than 100 percent. Currently, a couple can have a total income up to A\$57,852 (US\$43,968) before the partial age pension “disappears.”³

¹ Excluded from the income test is the first \$20 of most kinds of non-work income and some work income (the first \$65 and 50 percent of all other work income).

² The asset test does not apply in both the United States and Australia to the home in which one lives. The U.S. program also excludes the value of household goods up to \$2,000, an automobile up to \$4,500, and life insurance (with a face value up to \$1,500).

³ The conversion of Australian dollars into American dollars in this paper was at the exchange rate on July 21, 2005 (1 A\$ = 0.76 US\$).

Table 1
Comparison of Means-Tested Federal Programs in Australia (Age Pensions)
and The United States (SSI), March 2005

	Australia ^a	United States
Exempt Income (annual)	A\$5,631 (couple, per year) (US\$4,280)	Unearned income: \$0 Earnings: \$780 + 50% above
Benefit Reduction on Income Over Exempt Amount	40% (20% for each individual in the couple) Total income from all sources up to A\$57,852 (US\$43,968) before all of the age pension benefit is eliminated	100% on all unearned income
Level at Which No Pension Is Received	Single A\$34,603 (US\$26,298) Couple A\$57,852 (US\$43,968)	Single \$6,948 Couple \$10,428
Asset Test ^b	Up to A\$217,500 (couple, full benefit) (US\$165,300) Up to A\$485,000 (partial benefit) (US\$368,600)	\$3,000 (couple)
Single Benefit ^c	A\$12,418 (US\$9,438) <i>Partial benefits</i> are paid to persons with income or assets above the “free” areas	Up to \$6,948
Couple Benefit ^c	A\$20,737 (US\$15,760) <i>Partial benefits</i> are paid to person with income or assets above the “free” areas	Up to \$10,428

Source: Department of Human Services, Centerlink, 2005.

a. 1 A\$ = 0.76 US\$ on July 21, 2005.

b. In Australia, the value of the “family home” is excluded, but other real estate (such as businesses and farms) is included. Also included are cars, boats, recreational vehicles, personal effects, and household contents. A higher asset test threshold and limit applies to those who do not own a home.

c. In Australia, age pension income is taxable income unless it is the only income.

The Australian age pension is adjusted regularly with movements in prices and periodically by *ad hoc* increases. Legislation was passed in 1997 by the Howard Coalition government that set benefits to about 25 percent of “average weekly earnings.” The resulting pension amount is just over the semi-official poverty measure often used for policy purposes—“the Henderson poverty line.” This practice reflects a long-standing consensus in Australia that the age pension should be set at a level that keeps people out of poverty.

The age pension is available at age 65 for men and historically at age 60 for women. However, the eligibility age is slowly rising for women (see Table 2) and will ultimately be the same as the current eligibility age for men.

The difference between the Australian age pension and the U.S. SSI program requires an explanation. Why are they so different? The simple answer is that Australia does not have a social insurance type of income support program. Instead of the three-legged stool analogy described above, the Australian system is like a two-legged stool with one huge leg (the age pension) and a second very long leg (composed of what is called the “superannuation guarantee” [SG] and various other individual and group pension/savings plans).

Table 2
Changing Pension Eligibility Age for
Women in Australia, 1938-2005^a

Birth Date	Age of Eligibility
July 1, 1938 to December 31, 1939	61.5
January 1, 1940 to June 30, 1941	62.0
July 1, 1941 to December 31, 1942	62.5
January 1, 1943 to June 30, 1944	63.0
July 1, 1944 to December 31, 1945	63.5
January 1946 to June 30, 1947	64.0
July 1947 to December 31, 1948	64.5
January 1949 and later	65.0

Source: Age pension laws.

a. All women except veterans.

“We Don’t Need Social Security”

But the answer to the “why” question is really more complex. Historically, Australia was confronted with growing problems related to income security for the aged at about the same time as the United States (the early 20th century). However, Australia responded to the need sooner. In Australia, the search for a more appropriate way to deal with the income needs of people in old age culminated in a *national* income-support program—the age pension—which came into operation in 1909.

The age pension was initially designed to redistribute income only to the poor, using general government revenue. It was meant to provide the aged poor with a minimum subsistence income (supplementary to any provision for old age the elderly may have been able to make for themselves). Unlike the social insurance approaches developed in Europe, Canada, and the United States, Australia started out and has relied continuously on the means-tested age pension. From its beginning up to today, the age pension continued to be financed by general revenues from the central government.

Australia did consider, from time to time, the alternative European “contributory” approach. That is, serious thought was periodically given to establishing a pension program based on social insurance principles. In fact, “prior to World War II, three efforts were made to replace the Age Pension with a more generous employment-based social insurance program ... [and] legislation was actually enacted in 1938 to create a social insurance scheme but later rescinded” (Sass 2004). And again in 1972, the Labor

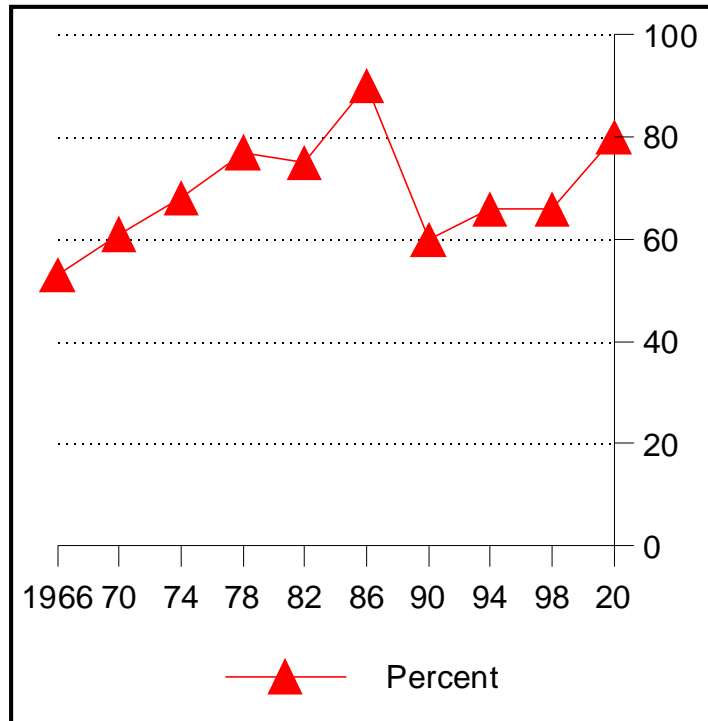
government appointed a commission to review the old-age income provisions. Called the Hancock Commission, its 1976 report recommended a social insurance program. However, the proposal was rejected by the Coalition government that took over from Labor in 1975.

So how did the more liberal age pension benefits arise? In the early days of the program, quite stringent eligibility criteria were applied. But this did not last very long. The strict rules and very minimal benefits gradually gave way to *a continuous process of expansionism*. This change was encouraged by rising public and community expectations, the increasing problems faced by older workers in finding and keeping jobs, longer life expectancy, and a growing entitlement mentality (encouraged along by the introduction of a major entitlement program providing benefits to war veterans).

Thus, over the years there was a steady and seemingly inexorable process of age pension liberalization. This liberalization process reached a zenith in 1976 with the total abolition of the asset test component of the means test (later reinstated); this 1976 change expanded eligibility to nearly 90 percent of the older population (counting persons receiving the age pension or the veterans' service pension). The need to satisfy only an income test to establish eligibility for ostensibly selective provision was seen by many observers at the time as propelling the system even further along a long-term liberalization path characterized by what Australian researcher Sheila Shaver (1984) has called the drive toward "incomplete universalism."

Figure 1 shows the proportion of Australians at the age of pension eligibility who were receiving the age pension or veterans' benefits. In the 1980s and 1990s, a number of steps were taken to try to reverse the liberalization trend and to restrict age pension eligibility. Beginning in 1985, for example, the asset test was reintroduced and eligibility dropped. However, a year later about two-thirds of the elderly were still receiving a full or partial age pension. Hence, what started out to be a highly selective program for the most needy turned out to be a more general and very liberal program for most older persons throughout Australia.

Figure 1
Percentage of Australians at the Age of Eligibility Receiving
Public Benefits^a, 1966-2000



Source: Whiteford, 2000 and Department of Family and Community Services, 2000.

a. Percent receiving public payments, population at age pension eligibility ages: Men ages 65 and over and women ages 60 and over.

Of course, the costs of the age pension were (and still are) large. It was the rising costs of this nearly universal benefit (and projections of costs in the future) that were a major factor in focusing national attention on private pension options.

Employer-Sponsored Pensions in Australia

In Australia, employer-sponsored pension plans are referred to as “occupational superannuation” schemes. Private pensions covered less than half of the workforce in Australia prior to World War II. Private pension plans introduced in the early years were largely confined to white-collar government workers, employees of financial organizations, and workers in large manufacturing concerns. Most of these initial plans were designed to provide benefits to a very select group of salaried (typically male) employees, primarily high-income ones. Moreover, as Table 3 shows, two decades ago the majority of these employees were covered by defined benefit plans, but a dramatic shift has occurred (discussed below).

Table 3
Percent of Workers Covered by Defined Benefit and
Defined Contribution Pension Plans,
1982-2000

	Defined Benefit	Defined Contribution
1982-1983	82%	18%
1995-1996	19%	81%
1999-2000	14%	86%

Source: Treasury, 2001.

In the early years, employers, unions, and the government had become increasingly interested in expanding pension coverage. Australia experienced a rapid growth of private coverage in the latter half of the 1970s and the 1980s, as pensions became an industrial issue. Thirty-two percent of employees belonged to superannuation schemes in 1974. This grew from 45 percent in 1982 to around 70 percent by the end of the decade (Schulz and Borowski forthcoming). Nearly half of this coverage, however, was in plans for government employees.

Until relatively recently, most private pension plans were employer-based. It became increasingly common, however, for multi-employer plans to appear as new plans were created. In large part, this trend was a product of growing demands by the then-powerful Australian labor movement. Starting in the late 1970s, unions began pushing for both expanded coverage and for improvements in the benefit levels.

From the beginning, there has been one feature of Australia's occupational superannuation plans that has distinguished them from social insurance and the employer-sponsored pensions found in most other industrialized countries—that is, the form in which retirement benefits are paid. The most common type of private pension payout in Australia has been the lump-sum payment, although government schemes have always been annuity-based, as were a few of the first private plans. In contrast, it was not until recent years that this option became widely available in most private pension plans in the United States.

Union interest in pensions waxed and waned over the post-World War II period. However, there was a recurrent view held by many in the labor movement that union members should have the same access to pension plans that many non-union employees had. Resentment about the prevailing situation grew over time.

Matters came to a head in the early 1980s when the building unions decided to negotiate a pension plan for their members. In 1984, the Building Unions' Superannuation Scheme (BUSS) was established, triggering a renewed interest by many other unions in the superannuation issue and options. Both the Australian Council of Trade Unions (ACTU) and the Labor government at the time hailed the BUSS as a prototype for general trade union action. And at the ACTU Congress, delegates were urged to demand from employers direct union involvement in the administration and establishment of superannuation funds.

A key development in 1986 was the “national wage case hearing” before the Arbitration Commission (at the time, a central wage-fixing authority for the whole country).⁴ The government supported organized labor’s request that pensions should be part of employer-employee negotiations and that pension plans could be established in lieu of wage increases. The result was that superannuation coverage increased to almost 70 percent of all employees by the end of the 1980s. Around the same time, a important law was passed that required savings accumulated in superannuation funds to be both portable and preserved until age 55 (Borowski, 2005).

There then followed a period when economic conditions were generally poor. Unions became torn between focusing on increasing wage levels or on nonwage issues such as pensions. Eventually, sensing that a strong push for higher wages was fruitless, the ACTU demanded expansion of superannuation. In fact, the ACTU made their future cooperation on the matter of wage restraints conditional on “universal coverage” of workers under superannuation plans (Borowski 1991).

Dramatic Action: The Superannuation Guarantee (SG)

The Prime Minister, Bob Hawke, made a surprise announcement in his 1991 federal budget presentation. Hawke called for the creation of a *mandatory* employer-funded pension system—the “superannuation guarantee charge.” This legislation required employers to make pension contributions for almost all employees to be based on the earnings level of each employee. These new contributions were to be paid into existing pension funds or, if necessary, new funds.

Up to this time, there was no economic situation or policy consensus that dictated that a decision be taken to mandate universal private coverage. Rather, as Olsberg points out, Labor’s decision to take this action was part of a broader government policy to portray itself as a party of orthodox monetarism and fiscal restraint (Olsberg 1997a). That is, the SG was one way for leaders in the Labor party to demonstrate to the voters an ideological shift toward greater reliance on market forces and the economic liberalist approach to macro-economic management.

However, another interpretation of what happened is that the unions found it too difficult to achieve wider coverage for pensions and higher rates of contributions through the industrial relations system. They saw as a solution to this dilemma government action, that is, relying on the taxation power of government (Treasury 2001).

Still another reason is given by Bryan (2004). Citing the FitzGerald Report, Bryan argues that a “core rationale” for the new approach was concern that there was not enough *national saving* occurring to help deal with the aging of the population. “A stark choice was faced: either the government needed a greater claim on national savings via taxation to fund a public pension scheme, or private saving for old age had to be

⁴ “Australia long ago evolved a highly idiosyncratic system of industrial relations in which, for great swathes of the economy, not just detailed pay scales, but hours of work, tea breaks, holidays, sick pay and many other conditions—in all, a breathtaking list of 20 ‘allowable areas’—are centrally determined” (*The Economist*, 2005).

mandated to reduce the burden on the state's future welfare budget. The latter choice prevailed and compulsory superannuation commenced.” (Bryan argues, however, that there has been considerable controversy in Australia about the nature and impact of something called “national saving.”)

Supportive unions also saw pension initiatives as a way to demonstrate their concern for workers in retirement and also found it compatible with their goal of mobilizing savings for “job-creating local investments” (Bryan 2004). In contrast, many employers had initially opposed the union demands that their members be covered by superannuation.

One segment of business, however, not surprisingly viewed superannuation as a opportunity. Olsberg (1997a) writes that “the insurance industry, for so long a bastion of conservatism and anti-trade-union attitudes, unexpectedly became enthusiastic supporters of union and government initiatives” in this area. She argues that “the extension of occupational superannuation throughout the workforce and the establishment of many new superannuation funds created a much-needed source of business and profitability.”

SG took effect on July 1, 1992. All employers without equivalent pension plans for their employees were required to pay a minimum of 3 percent of an employee's salary into an individual superannuation account. The law specified that the level of mandatory employer (only) contributions would progressively increase to a maximum of 9 percent. This level was reached in 2002, and it has not been changed. As a result, today close to 90 percent of Australian workers—almost all full-time workers and three-quarters of part-time workers—have superannuation coverage (Stanford 2003; ASFA 2004a).

Most, but not all, workers now are covered by the superannuation guarantee. Employers do not have to make contributions for the following categories of workers:

- Employees who earn less than A\$450 in any calendar month;
- Employees aged 70 or over;
- Employees under 18 years of age who work fewer than 30 hours per week;
- Non-resident employees paid for work done outside of Australia; and
- Employees working temporarily in Australia for an overseas employer and who are covered by a Bilateral Superannuation Agreement.

Superannuation contributions must be paid by the employer into a complying superannuation fund at least every quarter, with the monies going into personal accounts, or it must be demonstrated that the cost of a defined benefit entitlement being provided for an employee is at least equal to the SG amount. When the SG first began, employers were required to advise each employee of the contribution amount and superannuation fund that the money has been paid into, so that any errors could be detected quickly. Because of employer complaints, however, this requirement was abolished.

In the beginning, each employer chose the fund for his or her employees, or decided whether to allow an employee to choose it. In some cases industrial awards or agreements specified the fund or funds that could be used. This all changed on July 1, 2005 (see below).

The Structure of the Superannuation Industry

In understanding Australian retirement income issues, it is very important that one have a basic knowledge of the superannuation industry's complex structure. Table 4 provides a list of the basic types of plans and their relative importance.

Table 4
Plan Information in the Superannuation Industry, 2004

Plan Type	Number of Funds Dec. 2004	Number of Accounts (in millions)	Assets (in A\$ billions)
Corporate	1,006	1.03	65
Industry Plans	97	8.77	100.2
Public Sector	40	2.66	119.8
Retail ^a	234	13.96	230.4
Small ^b	299,919	.55	155.8
TOTAL	301,346	29.97	693 ^c

Source: ASFA, 2004.

a. Includes Retirement Savings Accounts.

b. Plans with five or less members.

c. Includes an additional \$22 billion in annuities, life office reserves, etc.

The first Australian plans to appear (in the middle of the 19th century) were state plans covering public sector employees. These were closely followed by corporate funds designed for white-collar workers. In the early years, the plans were mostly defined benefit, but as Table 3 indicates, this changed in later years to more workers having defined contribution plans.

Retail funds appeared later, established by life insurance companies to initially provide personal superannuation products for individuals. With the introduction of "award superannuation" in the 1980s and the superannuation guarantee in 1992, there was a rapid growth in retail funds that covered members from across a number of unrelated employers in a single industry. Although many initially drew their membership from agreements between employers and unions, now such funds primarily draw members by directly competing in the marketplace.

In recent years, so-called industry funds have been established. These are not-for-profit funds (formed by union and employer associations) that operate either within specific industry sectors or across all industries (in various states or in the country as a whole).

Finally, mandatory coverage of small employers, combined with favorable tax treatment of superannuation, led to the introduction and growth of "small fund plans"

(defined as plans with five or fewer members) and the establishment of Retirement Savings Accounts (designed as a low-cost option).

Bateman (2003) describes the current structure of funds as follows:

This landscape is constantly evolving. There is increasing consolidation among standard superannuation funds as employers “contract out” their superannuation obligations (previously delivered via corporate funds) to the retail sector and mergers take place in the industry funds and public sector funds... Simultaneously there has been immense growth in the number of small superannuation funds.

Funds range from only one member to those with more than a million members. However, nearly 90 percent of funds have fewer than 20 members, and only 8 percent have more than 100 members (Bateman 2003). One statistic dominates all others in describing the superannuation sector—99.6 percent of superannuation funds and nearly 68 percent of assets are in defined contribution plans (Bateman 2003).

Total assets in the funds were estimated by the Australian Prudential Regulation Authority (APRA, 2005) to be A\$649 (US\$493) billion in September 2004. Almost one-fifth of the assets are invested overseas, and a little more than half of the funds invested domestically are invested in equities.

Investment Returns

One might ask, what financial returns have employees been getting on their fund investments? In answering this important question, there is a tendency to look at current rates of return, but we know that financial markets go up and down. In Australia, for example, many plans experienced negative returns (of up to 17 percent) in 2002 and 2003 (Bryan 2004). As Greg Tanzer, Executive Director of Consumer Protection for the Australian Securities and Investments Commission (ASIC), points out, “predicting performance can be very difficult, which is why many people look to past performance. However consumers have often been presented with figures quoting past investment performance that were short-term, and of little help in judging performance” (ASIC 2005).

As an organization created to provide unbiased information to investors, the ASIC regularly furnishes performance data for funds in Australia. Table 5 shows rates of return for a sample of SG plans.

These estimates are updated every six months by the ASIC using data from four major rating agencies that collect performance information on a broad spectrum of superannuation funds. The major objective of the ASIC is to produce a series of long-term performance figures (for the last 5 and 10 years) for typical superannuation fund investment options so that individuals can compare the performance of their particular fund with the averages for many funds.

Table 5
Rates of Return for Sample Superannuation Funds, 2004^a

	Growth	Balanced	Capital Stable ^b	Capital Guaranteed ^c
December 31, 2004				
For Last 5 Years	3.9 - 5.5% ^d	2.1 - 5.2%	4.2 - 5.6%	3.8 - 5.0%
For Last 10 Years	6.0 - 8.5%	5.4 - 8.8%	5.5 - 7.2%	4.3 - 5.6%
June 30, 2004				
For Last 5 Years	3.6 - 5.4%	3.0 - 5.3%	3.7 - 6.2%	3.8 - 5.2%
For Last 10 Years	6.4 - 7.9%	6.2 - 8.0%	5.5 - 6.7%	4.9 - 5.7%

Source: ASIC, 2005.

a. Based on surveys by four independent rating companies over a wide sample of fund areas. Self-managed funds and defined benefit funds are excluded. Fund percentages are after regular management fees have been deducted.

b. Capital stable funds invest 60 to 70 percent in fixed interest financials and cash.

c. Capital guaranteed funds by law must invest 100 percent in deposits with Australian deposit-taking institutions or in capital guaranteed life insurance policies.

d. The lowest and highest average returns are shown as reported by the rating services (which do not tabulate the same funds). The average returns are weighted according to the value of funds being managed by each entity within each category (“asset weighted”).

Often the performance figures that are presented in the media and by financial firms are returns before fees and charges are deducted. The returns in Table 5, however, are the returns after these costs have been deducted.

Assessment of the Australian Approach to Date

There is a wide divergence of views with regard to the success of the Australian approach. One of the most positive evaluations is given by Mitchell and O’Quinn (1997) of the Heritage Foundation, an American think-tank that strongly advocates privatization:

Privatization has been a huge success in Australia: Workers will be able to retire with higher incomes, the government has significantly reduced long-term budget pressures, and the economy will benefit by a dramatic increase in savings. Like other nations around the world, Australia recognized in the 1980s that replacing the government's tax-and-transfer old-age retirement scheme with a private retirement system based on mandatory savings was a win-win proposition. Because Australia is in many ways politically and demographically similar to the United States, American policymakers would be well advised to learn the lessons of Australia's successful reforms.

In contrast, Steven Sass (2004) at the Center for Retirement Research at Boston College has observed:

The Australian system ... 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 presents significant additional cost in the operation of Australia’s national retirement income system.

In assessing the Australian experiment, it is useful to distinguish between two sets of issues. First are the issues arising from the key retirement planning role played by the means-tested age pension program in Australia. (Remember that this aspect of the Australian system is unique among developed countries.) Second are the issues arising from the major role now played by private pension accounts.

Integration Problems: Incentives and Disincentives

Probably the most important issue related to retirement income policy that Australia faces is how to successfully integrate the age pension with the newer SG mandate. The Institute of Actuaries of Australia (1998) points out that “at present there is a basic conflict between the two pillars of the [retirement] system. The superannuation system is designed to *encourage saving* for retirement. In contrast, *saving is discouraged* by the age pension system” (emphasis added). The two major programs are not, as one would like, complementary, but rather they are competitive with one another.

A little history is necessary to understand what has been happening. Before employer-sponsored pensions were a significant factor in Australian retirement, it was the age pension that produced retirement income for all but the rich. “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,”⁵ Sass (2004).

As discussed above, the age pension is means-tested on the basis of income and assets, whichever test gives the lowest pension. Let us look first at the *income test*. As the income of older Australians increases, the level of exempted income approaches a maximum income test ceiling. For a couple this is A\$5,631 (US\$4,280). If a couple has income above that ceiling, the age pension benefits going to them decline (the amount of reduction depends on the level of income). Beyond the ceiling, the age pension is reduced for a single person by 40 cents for every dollar that income exceeds the allowable limit (for couples it is 20 cents from each of their pensions, 40 cents in total, for every dollar). Thus, if a person has money from a sufficiently large superannuation pension, and receives sufficient investment income from it, he or she begins to lose age pension benefits at a relatively high marginal tax rate (40 percent). On top of that, the individual may have to pay a personal income tax.

Alternatively, individuals can lose age pension benefits because of the *asset test*. For couples with assets over the maximum, the age pension is reduced by A\$3 every two weeks for every A\$1,000 over the asset limit. However, the maximum levels are very high. They vary by home owning status, with higher amounts of assets permitted for

⁵ Sass (2004), based on the views of Whiteford and Stanton (2002).

persons who are not homeowners. The “lower” asset limit (see Table 1) for a homeowner couple was A\$217,500 in 2004 (US\$165,300).

As American analysts Martin Rein and John Turner (2001) point out, there is a purely Australian context surrounding the asset test, a context that makes Australia very different from the income security “culture” in other countries. The asset test in Australia is more a way of excluding the *top earners* than it is a strategy for earmarking benefits for the *most needy*. Historically, as Rein and Turner put it (2001), “the purpose of the asset test [was] to ensure that pensions are not payable to very wealthy people who have arranged their affairs to qualify under the income test.”

Many countries have problems with integrating a means-tested program with other benefit programs. All kinds of strange situations result as the programs encourage changes in behavior. Table 6 compares two hypothetical Australian cases and shows how someone can become *worse* off if he or she saves *more* in a superannuation fund.

Table 6
Hypothetical Cases of Integration

	Case I	Case II
A. Superannuation Plan	A\$149,500	A\$310,500
B. Allocated Pension Inc.	A\$9,522	A\$19,777
C. Age Pension Benefit	A\$12,069	A\$0
Combined Income (B + C)	A\$21,591	A\$19,777

Source: Dunsford and Rice, 2004.

In Case I, the superannuation accumulation in the pension fund is A\$149,500. In Case II, the accumulation is much larger (A\$310,500). Both examples assume that these savings are used to purchase what in Australia is called an “allocated pension.” An allocated pension is an investment option offered by the private sector that allows a person to convert superannuation savings (or other savings) into a flexible, regular income stream at retirement. That is, the individual rolls over the superannuation lump sum into an investment account that accumulates investment earnings, and from which he or she draws regular income payments (within minimum and maximum limits set by the Australian government each year). A variety of different pension portfolio options are available, with varying degrees of risk.

In the examples, the income flow from the allocated pension determines the level of age pension benefits. In the first case, the numbers produce a large age pension and a total income of A\$21,591. In the second example, the large superannuation accumulation produces a large allocated pension income flow, which (applying the income test) is large enough to reduce the age pension to zero. The result: Case II produces a lower income, penalizing the individual for saving more through a superannuation plan.

The age pension means tests, together with the growth in the number of employer-sponsored pensions and the income coming from them, has created a growing tension and has changed behavior. Consider that the highest marginal tax rate for the income tax in Australia is 48.5 percent and then that the marginal tax rate embodied in the age pension

is 40 percent. Fortunately, a person rarely faces the highest potential cumulative rate, but the effective withdrawal rate is often as high as 70 percent.

There is no longer a need to speculate that perverse pension incentives are operating in Australia; actual behavior and experience over the years have removed all doubt. The debate is rather over the magnitude of the perverse incentives, the implications for retirement policy, and how to change current law.

In reaction to the means test, individuals have sought to avoid the loss of benefits by:

- Taking lump sum superannuation benefits to fund voluntary *early retirement* living expenses, using the superannuation benefits until reaching the age pension eligibility age. (In Australia, this behavior is called “double dipping.”)⁶
- Reducing assets by putting pension payouts and savings into home improvements (given that the value of the home one lives in is not counted in the asset test).
- Purchasing specially designed investment instruments that produce little income or sheltered income, and thereby help their owners qualify for the (maximum) age pension.⁷ For example, there are currently investments called Market Linked Income Streams that produce significant income but, at the same time, help their owners qualify for the age pension through a 50 percent asset test exemption.
- Not working after reaching the age pension eligibility age, so that earned income does not offset age pension benefits.

The Age Pension and Changing Tax Provisions

In a series of legislative changes (in 1984, 1988, and 1996), the Australian government imposed taxes on both contributions to (i.e., deposits into) superannuation funds and pension fund earnings. It also substantially reduced the relatively liberal tax benefits related to superannuation fund payouts (Schulz and Borowski forthcoming).⁸ These actions resulted in a very substantial reduction in the benefits that would have otherwise accrued to retirees from their plans. The taxes were instituted to offset some of the sizable forgone revenues (what economists call “tax expenditures”) associated with

⁶ Statistics on this practice are difficult to obtain, and experts disagree on the extent of this behavior.

⁷ A popular money management web site, for example, states: “There are ways to reduce your taxable income and/or assets to maximise your entitlements. You should consult a certified financial planner, who is also a member of the Financial Planning Association, before you consider such strategies, which include buying allocated pensions or allocated annuities, lifetime or complying pensions, gifting and the purchase of a funeral bond” (Weekes (2003).

<http://moneymanager.smh.com.au/articles/2003/02/03/1044122303203.html>.

⁸ Initially, lump sum payments were taxed at a concessional rate. This rate was then reduced with the introduction of the contributions tax.

the government's encouragement of private plans—for example, making employer contributions to superannuation funds tax deductible.

The \$A5.8 billion (\$US4.4 billion) in tax revenue on superannuation was 3.3 percent of total federal revenues in 2003 (ASFA 2004b). Given this sizable magnitude, state and local governments in Australia have become increasingly loathe to forego the revenues derived from the taxing of superannuation (Schulz and Borowski forthcoming). However, here again, we see that federal government policies are working at cross-purposes. On the one hand, the government is trying to raise revenues, and on the other hand, it is trying to facilitate and encourage a retirement system that will provide adequate income in old age. *Unfortunately, tax policies in this area have been in constant flux for many years and have become more and more complex.* Sass (2004) calls it “a marvel of complication.”

As far as old-age income security is concerned, however, many pension experts in Australia argue that the current tax policies make it difficult for individuals to accumulate sufficient assets to produce adequate retirement income (especially given the relatively low 9 percent maximum contribution level). Thus, not surprisingly, assessment of future pension adequacy is a major issue debated in Australia.

Retirement Income Adequacy

On March 27, 2004, Melbourne's oldest and well-respected newspaper, *The Age*, published an editorial entitled “This Problem Needs a Grander Vision” (Edwards 2004). The problem the newspaper was concerned about was dramatically changing demography, an aging Australian nation, and the possible “inadequacy of savings to fund most baby boomers in retirement.” The editorial went on to say, “For many retirees, the 9 percent compulsory Superannuation Guarantee will not provide a retirement income sufficient to match expectations.” Many people, including numerous pension experts, agree with that conclusion.

A look at the research to date, however, indicates that the answer is not so clear. The adequacy of pension income in future years has been debated for a long time; and it is clearly a major topic for continuing research and debate among policymakers, employers, and employees.

In 2002, the Senate Select Committee on Superannuation addressed the question and issued an authoritative “report on the adequacy of tax arrangements for superannuation and related policy”(SSCS 2002). Based on extensive hearings and various staff investigations, the committee report stated the following conclusion: “The available evidence demonstrates that the current arrangements for superannuation may not provide an adequate income in retirement for most people and that strategies need to be identified to address the shortfall.” The committee noted the high degree of consensus among hearing witnesses that the desirable target for a person with average earnings was a 70 to 80 percent replacement rate of pre-retirement earnings. It then concluded from the various modeling studies presented in testimony that this objective could not be reached for most retirees in future years. And in the near term, the committee pointed out that

most baby boomers (currently moving into retirement) will not have had the benefit of a full working life under the SG and will have to rely heavily on the age pension.

The Senate committee's conclusions were not supported, however, by the Treasury in its presentation before the committee. The Treasury (2002) reported findings from a retirement income study using the department's "Retirement and Income Model" (RIM). The Treasury concluded, based on the findings of the RIM simulations, that the SG system in conjunction with the age pension would "provide a spending replacement rate for an individual on median earnings of 72 per cent after 30 years of contributions and 77 per cent after 40 years. These replacement rates, the Treasury argued, are conservative in that no allowance is made for superannuation contributions above the SG or for additional private savings outside of superannuation."

The Treasury predicted, however, that in 2050, even with a lifetime of savings under SG, the age pension would "continue to provide the principal means of support for a large proportion of Australian retirees, that the proportion of people aged 65 and over receiving a full rate pension in 2050 will fall to around one third, and that the proportion of people not receiving the pension will rise to around 25 per cent. The proportion of people receiving a part-rate pension is expected to increase to around 40 per cent" (Treasury 2002).

Alternative simulation modeling results were submitted to the Senate committee by the Association of Superannuation Funds of Australia (ASFA), results that contradicted the Treasury findings. Based on their simulation modeling results, ASFA (2002) concluded that "the Superannuation Guarantee over plausible periods of paid work will deliver retirement incomes significantly greater than the Age Pension, but at the current capped SG rate retirement incomes will be significantly lower than the needs and expectations of those currently employed." A debate between the Treasury and ASFA followed their submissions, focusing on the differences in the assumptions and methodology used by each model, with the Institute of Actuaries of Australia weighing into the debate in support of the ASFA methodology.

Still another major research endeavor on the adequacy question was commissioned by CPA Australia and carried out by Australia's National Centre for Social and Economic Modelling. The report of this research points out that in recent years there has been great improvement in current and future retirement income adequacy. However, CPA Australia (2004) agrees with the ASFA that the current SG rate of 9 percent will "not be enough for many people to be able to maintain their standard of living in retirement."

As a result of adequacy concerns, it is often suggested in Australia that additional SG contributions need to be made by employers, employees, and/or the government. In 1995, the Labor government proposed (but did not enact) that the SG rate be increased to 15 percent, using a 3 percent co-contribution by both the government and employees. Borowski (2005) points out that more recently "former Prime Minister Keating ... and major stakeholders (such as the ACTU and the superannuation industry) continue to advocate raising the SG by a further 6 per cent to 15 percent ..."

Instead the government has allowed and encourages voluntary “add-ons.” The current law allows employees to make personal contributions into the superannuation plan. These additional contributions are voluntary in most industries. (In 2000, one-third of all employees aged 15-64 made such contributions) (Australian Bureau of Statistics 2002). Since July 2003, the government has been matching employee and self-employed contributions with government co-contributions. Currently, individuals with total incomes of \$A28,000 (US\$ 21,280) or less can receive a maximum co-contribution of A\$1,500, based on \$1.50 from the government for every \$1 contributed. Co-contributions decline as income increases, phasing out completely for total incomes of \$A58,000 (US\$44,080) or more.

There is much interest in Australia regarding the special situation of women and how they will fare economically under SG. Faced with broken work histories, typically lower earnings, disadvantages resulting from divorce, and longer life expectancies, there are questions about what the future holds. Of particular concern (since many women earn little in their jobs) is how the exemption that excludes SG payments for persons earning less than A\$450 a month will affect women.⁹ The paradox here is that the A\$450 exemption from SG was legislated because it was feared that the SG would be too big a burden on low-income working people who have great difficulty meeting their daily living needs *before* retirement.

The High Costs of Administering Plans

As the privatization and defined contribution pension plan debate has played out around the world, one consensus has emerged among most researchers. There is general agreement that the costs of operating privatized systems tend to be high, and as a result, this creates a major problem for retirement income planning. Still, given that general consensus, there remains a wide difference of opinion on *specifics*—for example, with regard to exactly how high the costs actually are, how serious the problem is, and what the policy implications are. The research to date is inconclusive.¹⁰ However, the preponderance of expert opinion sees these costs as a major problem for defined contribution plans around the world.

Hence, bringing these costs down has been a priority of policymakers in countries with both voluntary and mandatory defined contribution plans. As Fox and Palmer (2001) point out, one trend, driven by the desire to reduce administrative costs, is to have the contributions into defined contribution pensions transferred initially to the national government, rather than sending the funds directly to the financial manager. This has the advantage, they argue, of making compliance monitoring easier and reducing costs through economies of scale in record-keeping. Additional cost containment measures that have been suggested include placing more constraints on moving funds from one financial manager to another, and limiting worker choice in the number of investment options.

As in the rest of the world, the matter of Australian administrative costs related to private plans is controversial. Perhaps the views that have received the most national

⁹ See, for example, the discussion in Olsberg (1997b).

¹⁰ See the interesting discussions of this issue by various authors writing in Holzmann and Stiglitz (2001).

attention are those from a spirited debate between Hazel Bateman and Ross Clare. Bateman is a Senior Lecturer in the School of Economics, University of New South Wales, and has been researching issues related to the superannuation industry for many years. Clare is a researcher and high-level official working for the superannuation industry trade organization—the Association of Superannuation Funds of Australia. Clare is the author of a major research monograph responding to findings on pension costs reported by Bateman.

The Australian Consumers' Association (2005) gives an excellent summary of the issues and describes the debate that occurred as follows:

In late 2001 she [Bateman] published a paper on disclosure of superannuation fees.¹¹ One figure in that paper—which showed that the average level of fees and charges was 1.7 percent of assets—captured a great deal of attention. It provoked a rejoinder from the Association of Superannuation Funds of Australia (ASFA) claiming that average fees were only 1.3 percent of assets. The debate was also raised in the letters and columns of the financial press.

Analysis of the work by Bateman and ASFA shows that the discrepancy results from differences in data (ASFA had the benefit of more recent data), definitions of what constitutes a fee, and how an average is calculated (in technical terms, what weighting is used). But we may well ask why there is such a fuss about a difference of only 0.4 percent, and why there is concern at all with what look like small figures.

There are two explanations. First, fees of one or two per cent are highly significant. And second, the “average” means little, for while most Australians belong to funds with reasonably low fees, some are in funds with very high fees... [Fees are high] because of marketing costs and the need to return a profit to their owners ... There is also the valid claim that fees as a proportion of assets are high because balances are low. If so, we should see some reduction in the percentage over time, but there will still be a premium for marketing costs and profit. ... While most Australians are covered by corporate or industry funds with reasonably low management fees—from 0.4 to 1.4 per cent of assets—an increasing number rely on what are known as retail funds, with much higher fees. There are few funds charging the industry average.

One interesting part of Ross Clare's response to Bateman is his comparison of costs in different countries:

International comparisons of fund administration and investment costs are not easy to come by, but one source suggests that the range of costs for *defined benefit* funds in the USA is between 0.3% to 0.7%, and for *defined contribution* funds it is between 0.2% and 0.8%. ASFA and APRA estimates suggest that the range of costs in Australia does not go quite so low, with the bulk of employees in

¹¹ Hazel Bateman, “Disclosure of Superannuation Fees and Charges,” Paper prepared for the Australian Institution of Superannuation Trustees (August 2001).

funds with cost ratios around 1%, with some public sector funds having cost ratios of 0.5% or lower. Differences in the scale of funds would appear to make the Australian funds slightly more costly on a percentage of assets basis. The relative complexity of Australian tax and regulatory requirements also would add slightly to Australian costs (Clare 2001)¹² (emphasis added).

Indeed, administrative costs vary greatly among superannuation funds. Table 7 lists the different types of fees that are levied in Australia, and Table 8 shows the typical expenses related to two common types of funds. Master trusts are provided directly to individuals (often through financial planners). A master trust allows a client to choose from a menu of fund companies and types of funds. A central account with consolidated reporting is established, and individuals can switch money between the various funds offered (often paying a switching fee).¹³ Industry funds are sponsored by two or more employers and are a repository for employer SG contributions.

Table 7
Types of Charges on Superannuation Accounts in Australia, 2005

Charges
<p>Superannuation funds have different combinations of charges but typically do not charge all that are listed below.</p> <ul style="list-style-type: none"> • Contribution fee: whenever a contribution is made to an account. • Withdrawal fee: when money is taken out of an account. • Termination fee: when the full amount is withdrawn from an account. • Management charges: costs for managing the investments. • Administration charges: costs for operating the fund. • Investment charges: costs related to making investments, including the fees charged by the product issuer. • External management charges: fees paid to investment managers and other external expenses for investing the assets. • Additional service charges including fees to switch between investment options and adviser fees. • Some retail superannuation funds, particularly those offered by banks and financial planners (including master trusts), may also charge for fees or commissions paid to agents. (This charge is not always extra but sometimes is included in combination with the entry, administration, and exit fees.)

Source: Author's compilation.

A recent survey by SuperRatings (Motor Trades Association of Australia Superannuation Fund, 2004), a firm specializing in information and research on industry funds, found that on average “industry fund” account balances grew faster than “master

¹² In private correspondence, Clare states that he estimates around 97 percent of workers making compulsory superannuation contributions are in funds with fees of 1 percent or less, with the most expensive costs being related largely to voluntary saving arrangements organized by financial planners.

¹³ Master trust arrangements that are set up by an employer covering multiple employees are generally much cheaper than individual pensions.

trusts” by A\$309 over 1 year, A\$1,842 over 3 years and A\$4,029 over 5 years. Based on these findings, SuperRatings concluded that over a 40-year working life:

Australians could be more than 37 percent better off in an industry fund based on existing fee structures, even if both funds returned the same investment performance. This is equivalent to having almost \$68,000 more (in today’s dollars) in their superannuation account at retirement. In general, industry funds have a lower cost structure, don’t pay any sales commissions, and don’t need to pay dividends to shareholders. As a result, they can offer lower fees and charges than retail funds.

Table 8
Estimated Expenses for an Average “Industry Fund” and
a Typical “Master Trust,” 2001^a

Average “Industry Fund”	Typical “Master Trust” (sold on an individual basis, rather than as part of an employer plan)
Administration charge of A\$47.84 per year	Contribution fee of up to 4.5% of each contribution
Investment management fee of 0.3- to 0.7% of assets	Member fee of A\$42.36 to A\$70.80 per year
	Asset administration fee of up to 0.95% of assets
	Investment management fee of 0.04 to 1.08%

Source: Bateman and Piggott, 2001.

a. Estimates are based on average charges calculated by Bateman and Piggott for 1998-99.

One SG problem area in Australia was identified early and action was taken. Charges typically have a much bigger impact on (a) those with low earnings, (b) those who work part time, and (c) those who work part year or irregularly over their lifetimes. The majority of these workers are women. To help deal with this problem, the SG law states that fees on accounts with balances of less than A\$1,000 cannot exceed the investment gains credited to the account during the year.

Although the debate regarding the marketing, administrative, and financial management costs of the “old” superannuation guarantee system continues, Australia has just embarked on the implementation of a major change to the system (effective July 2005). This change has major implications for the cost issue and much more.

Complexity and Choice¹⁴

All over the world, pension “systems” for old age tend to be very complicated. And it is true that complexity is one of the most dominant characteristics of privatized

¹⁴ Much of the opening portion of this section is taken from Schulz (2000b).

pension systems. Australia is no exception. A number of Australian pension experts have referred to Australia's system as "the retirement maze," referring to the astonishingly complicated retirement income decisions that must be confronted by each individual. In describing this maze, Atkinson, Creedy, and Knox (1995) point out that, theoretically, the alternatives faced by people in Australia are becoming infinite and require some sort of decisionmaking strategy that will make retirement income planning manageable. In the words of David Ingles (1999), a researcher at Australian National University, "how an unsophisticated investor is meant to find his or her way through this maze is not at all clear; it must provide quite a challenge even for professional advisers."

When the superannuation guarantee was originally established, the law allowed the employer to determine ("nominate") an investment vehicle into which the money would go. The majority of employees found themselves in industry-wide or public-sector funds.

In 1995, the opposition Liberal National Coalition announced (just prior to winning the 1996 election) its intention to introduce greater freedom of choice for superannuation contributions. A detailed plan was presented as part of its 1997 budget. Under the Coalition government's proposal, employers were to be required to offer workers a choice from among five or more complying funds or Retirement Savings Accounts. However, after consultation with interested parties, especially employers, the Coalition modified its proposal to reduce the minimum number of funds an employer must offer to four but to also create an alternative option—allowing "unlimited employee choice."

The Coalition government put the new choice modification on a fast-track for implementation. It found out, however, that it could not meet its own deadlines. The reason was that numerous and complex political and technical issues arose.

The major arguments for choice made by the proponents were ideological and political. For example, David Connolly, Director of Superannuation and Government Relations at Phillips Fox Actuaries and Consultants, argued before the Senate Select Committee on Superannuation:

Having instituted a compulsory environment for the collection of superannuation, the next step in the process is to say to people, "if the government is going to require you to contribute to your retirement income, surely it is not unreasonable that you should have some say as to where those funds go." There is no justification for over-riding employees' right to choose the fund into which their contributions should be paid (Connolly, 1998).

Thus, the choice proposal was firmly grounded from the beginning in the premise that individuals should have as much freedom as possible in deciding who would manage their accounts.

However, another argument (to some, an equally important argument) was the need to promote competition among the financial firms managing the funds. Based on

traditional assumptions about how economic markets operate and what they can accomplish, many advocates saw choice as a way of promoting competition and efficiency in the retirement pension market; it was hoped that choice in the retirement pension market would lower the costs of services and encourage a more efficient industry by consolidation of small firms into bigger ones.

This argument for lowering costs was challenged by many witnesses who appeared before the Senate Select Committee on Superannuation when the committee studied the issue. The main concern voiced was that there would be greater marketing costs and additional administrative costs associated with people switching from one fund to another (as has certainly been the case in Chile and Great Britain). As Ross Clare (2005) put it, “you do not reduce costs of supermarkets by allowing/encouraging people to shop at convenience stores.”¹⁵

What was relatively clear initially from an ideological and conceptual standpoint became more politically and administratively complex as interest groups reacted to emerging issues. For example, many employers resisted the change because of the potential administrative burden and concern about possible legal liabilities if investment choice decisions resulted in worker hardship. However, after eight years of discussion, the choice amendment was passed in 2004.

Informed Choice

To work well, any pension program that allows for a choice of financial managers depends on interested and informed consumers and on the existence of competing pension products that can be evaluated by buyers. As the many problems that have occurred in Britain remind us, this may be a difficult set of demands to meet. In the United Kingdom, an apathetic and often bewildered public was encouraged to switch into inappropriate plans by commission-driven sales people. The result was a scandal of major proportions and an estimated £11 billion in restitution payments.¹⁶

Australia has not been immune to financial losses related to retirement planning. For example,

On 15 March 2001 the major companies in the HIH Insurance Group were placed in provisional liquidation ... Formal winding-up orders were made on 27 August 2001—the corporate equivalent of death. By then the deficiency of the group was estimated to be between \$3.6 billion and \$5.3 billion. If the ultimate shortfall is anywhere near the upper end of that range, the collapse of HIH will be the largest corporate failure Australia has endured to date. ... The collapse of HIH has reverberated throughout the community, with consequences of the most serious kind ... Retirees who invested their superannuation or life savings in HIH shares to fund their retirement have been left with nothing (Australian HIH Royal Commission, 2003).

¹⁵ Comment by Ross Clare in private correspondence with the author in 2005.

¹⁶ For detailed information about the UK experience, see Schulz (2000a).

In 2001, National Textiles and Ansett Airlines both came under severe economic pressures and could no longer function. The ultimate result in the National Textiles case was an A\$11 (US\$8.4) million bailout by the federal government to pay various benefits owed to former employees. In the Ansett case, about 16,000 employees lost their jobs overnight and were told that the company could not pay much of the leave benefits, redundancy payments, or superannuation claims due to workers. However, court decisions and government action (including a \$10 surcharge on all airline tickets) eventually allowed the company to pay a sizeable portion of the obligations owed to these workers. On April 1, 2005, however, the acting “Ansett Administrator” announced that the company expected to be able to pay only A\$663 million of the total A\$760 million due workers.

According to Jon Stanford (2003), the collapse of HIH resulted in “shaken confidence in nonbank financial service providers ... The revelations of the Royal Commission into the collapse of HIH revealed a sorry story of greed, incompetence and dishonesty as well as very lax prudential supervision.”¹⁷ Some would say, however, that Stanford’s characterization of the fall-out from these collapses is too extreme. Fortunately, such financial breakdowns have been few in number (which is small consolation, however, to those investors affected). More important, superannuation funds are currently protected against fraud or theft. If such a loss occurs in a particular fund, there is compensation of up to 90 percent of the loss, financed by a general levy on all superannuation funds.

Unfortunately, fraud and scams are quite common in the broad financial sector, of which superannuation is only a small part. The Australian Securities and Investment Commission (ASIC) is a government organization set up as a consumer protection regulator for financial services. In 2004, Professor Berna Collier, a commissioner of the ASIC, reported that:

ASIC sees numerous instances of consumers who have lost money, often at least partly the result of uninformed decisionmaking about finances. Research shows that financially illiterate consumers have more difficulty choosing appropriate financial products for their needs; they are more likely to fall victim to scams and rip-offs; and they often respond to financial difficulties in ways that result in even more problems. In Australia, ASIC's investigations into scams have revealed losses of up to \$800 million over the last 3 years, and this is probably a conservative estimate. (Collier, 2004)

Fortunately, with only a relatively few exceptions, these scams have nothing to do with superannuation funds. These funds do not invest in pyramid schemes, get involved in what are called “international prime debt shakedowns,” or buy shares from “boiler room” salespeople who call on the telephone. However, given that most people need to supplement their pensions with private saving, the problems plaguing the financial industry are extremely relevant for retirement policy. Also, the publicity related to these scams and

¹⁷ Stanford also discusses the failure of three other superannuation funds that resulted in significant losses to 36,000 members.

industry failures almost certainly impacts upon the insecurity and often unwillingness of individuals to make investment decisions related to superannuation funds. For example, in past years only 10 percent of Australian employees offered a choice in how their money was to be invested actually made any choice¹⁸ (Bowman, 2003).

Moreover, there has been general agreement in Australia that the introduction of choice must be accompanied (some say “preceded”) by institutional mechanisms that educate people with regard to the decisions they must make. That is, the retirement income products need to be provided with sufficient and reliable information to allow consumers to make good decisions.

Unfortunately, no pension system in the world today (public or private) has come close to achieving the goal of informed choice. The history of private pension systems in country after country demonstrates how serious the problems are. First of all, studies show that ordinary people lack an understanding of basic financial concepts. For example, a survey by Australian ANZ Bank found that 85 percent of people surveyed said that they knew that high returns generally meant high risk. But when presented with an investment advertised as having a return “well above the market rates *at no risk*” (emphasis added), 47 percent of these same people said they would invest in this suspicious offering (Ray Morgan Research 2003).¹⁹

Also, most individuals are typically not very interested in pension matters until they get close to retirement. And few are willing to pay out significant amounts of money to acquire information and/or professional advice about financial planning. Therefore, given the complexity of the financial decisions that must be made, many often search for easy (and/or seemingly cheap) answers to very difficult questions. Unfortunately, there are many unscrupulous and/or incompetent persons who say they know all the answers and are only too eager to make the decisions “easy.”

But there is an even more fundamental problem. Simplistic arguments that promote choice as a way of realizing consumer sovereignty in free markets ignore the nature and characteristics of the product and its market. Consumer choice in buying pensions is very different from buying groceries, clothes, CDs, etc. The product is technically complex and requires a huge investment of time to achieve a minimal level of understanding. “Retirement is not like buying a cup of coffee,” said economist Joseph E. Stiglitz, a 2001 Nobel Prize winner. “It’s not something you get to do over and over again and learn from your mistakes” (Gosselin, 2005).

As a result, buyers are at an extreme disadvantage when dealing with salespeople. Moreover, the consumer cannot easily determine the quality of the product, with quality often determined only by the historical performance of funds and fund managers over a long period of years. Since decisions about where to place one’s money are generally made infrequently, there is little learning that is associated with “living with the product.” Given the ease with which sellers can (often superficially) differentiate their product from

¹⁸ Quoting Philippa Smith of the ASFA.

¹⁹ The ANZ Financial Literacy Research was conducted by Roy Morgan Research and involved development of a framework for measuring financial literacy in Australia and a survey of 3,500 adults.

those of competitors, there are often wide differences in the pricing of pension products and services—differences that are often difficult for the buyer to detect or evaluate.

Implementation of Choice

Despite these big issues, the debate over dramatically expanding choice has ended in Australia. Since July 1, 2005, most Australian workers have been able to choose among competing superannuation funds to manage their individual accounts assets, rather than having their employers select a fund for them. The new law will *not* apply to (a) workers covered by defined benefit plans, (b) civil servants, or (c) workers with pension plans that are covered under specific awards, industrial agreements, or special statutes that deal with superannuation. The law requires workers to choose among the available funds that are regulated by the Australian Prudential Regulation Authority. They are expected to conduct their own research and, hence, to assume all the risks. Employers must direct worker contributions to their chosen funds within two months of their decisions. Employees failing to make a choice will have their contributions directed to a default fund of the employer's choosing. Employees will be allowed to switch plans, but only once a year, and employers will not be held liable for any losses that result from worker decisions to change funds.

Many fears have been voiced about problems that may arise, including:

- That possible unclear language in fund description and disclosure documents will conceal hidden fees that could significantly erode retirement savings.
- That poor financial literacy among the public will lead some people to invest too conservatively and others to take too much risk.
- That employers will be burdened with additional administrative costs, the need to acquire new software, and the expense of training employees in administrative departments in order to comply with the new provisions.

The federal government has recognized the increased need for financial literacy and has launched the Consumer and Financial Literacy Taskforce. This organization is charged with developing plans to improve levels of consumer knowledge. But clearly such action is too little and too late—given the magnitude of the problems discussed above and the fact that the new system has already begun.

Conclusions: What Lessons for the United States?

Means-Testing Creates Problems.

One frequently hears people in the United States say that public benefits for old age should be better targeted—that instead of universal benefits, we should deny benefits to the rich and others who do not need them. Means-testing is proposed as the best mechanism to achieve this result.

Australia's experience warns us to be very cautious about shifting to greater reliance on means-testing. In Australia, it has been difficult to keep benefit levels low. Moreover, as discussed above, integration problems have generated huge complexities and perverse labor force and financial behavior. Finally, Australia is a country where there is a whole range of generous benefits that are means-tested. For example, an individual who is eligible for the age pension is also eligible for

- the pharmaceutical allowance,
- rent assistance,
- a remote area allowance,
- the telephone allowance,
- child-related payments, and
- various utility allowances.

State and local governments in Australia also use the "Pension Concession Card" given to all individuals found eligible for the age pension. The card is used as a way of qualifying people for the various services at concessional rates. These state concessions are in areas such as transportation, utilities, motor vehicle registration, and water and property tax rates. When all these benefits are taken into account, the marginal tax rates imposed on individuals can rise to as much as 87 percent (Senate Community Affairs References Committee 2004).

"It's Administrative Costs, Stupid!"

As in other countries, the administrative costs of operating private plans in Australia can be very high. The promises that advocates of privatization make regarding future rates of return must be scrutinized closely. Rates are often presented that do not deduct a realistic amount for marketing, administrative changes, and investment management fees. These expenses are high in Australia and all of the countries that have switched to the private defined contribution approach, with administrative costs consuming as much as 15 to 30 percent of contributions (Holzmann and Stiglitz 2001).

In addition to costs, there is another emerging administrative problem: the matter of lost accounts. The Australian Taxation Office estimates that there are already about 2.5 million lost accounts and \$A2.4 billion held on behalf of superannuation fund members who cannot be found by the fund holding the money.²⁰

But Are the Pensions Sustainable?

A 12-nation study ranked Australia as the country that is the least vulnerable to the rising old-age dependency costs that are paid by government (Jackson and Howe,

²⁰ The Australian Tax Office statistics are reported by Bateman and Pigott (2001).

2003). Australia's retirement income strategy of mandating superannuation and rolling back public income support (the age pension) is often held up as an approach that other countries should seek to emulate (Harris 2004).

It is true that privatized systems provide good political cover for those governments unwilling to face up to the fact that as populations age, some national output for consumption will inevitably have to shift from the younger cohorts to the more numerous older persons in the country. And, given the differences in the way income support is provided among young and old (parental support versus pensions), we should not be surprised by the need for some necessary increases in taxes (especially payroll taxes) to facilitate and finance the shift. On the other hand, privatization changes retirement income protection from collective to individual responsibility and thereby transfers the burden of providing income for retirement (the "national pension bill") away from government budgets onto the budgets of employers or households. Then politicians can proudly declare that government benefit programs are now fiscally "sustainable" (whether they are adequate or not).

However, employers (facing global competition and very low overseas wage levels) are increasingly unwilling to accept more responsibility in this area. Hence, the bulk of the shifting burden will fall increasingly on individuals. Yet history is clear that a retirement policy based on individuals accepting most of the responsibility for retirement income needs is probably doomed to fail, which is one of the reasons why collective public and private pensions were introduced in the first place.²¹ Is there reason to think that the results this time based on individual self-help will be different? How should individuals handle the new retirement environment?

Some people reply that there is a simple answer to that question: people now live longer—therefore, they can work longer. And given rising pension costs, they should work longer. Again, it is said by critics that this view ignores the lessons of history that teach us that everyone has been (and likely still is) in favor of older persons working longer except *employers, unions, younger workers, and the older workers* themselves! That is, there is currently little political support among *all* the relevant groups for promoting work by the elderly. Critics argue, therefore, that unless there is retraining and/or meaningful and well-paying jobs available for older workers later in life, the "work longer" solution is a cruel hoax on the public and, if jobs are simply "assumed," may relegate millions of the future elderly to a life of poverty.

Uninformed Choice Is No Choice.

Those who argue the virtues of freedom of choice in investing for retirement often ignore the realities of poor consumer financial literacy. Even if the problems are acknowledged, advocates almost never think that this problem should stand in the way of protecting people's "freedom of choice." Nor will they allow it to stand in the way, say some cynics, of the welfare of the financial investment industry, which stands to reap huge rewards for providing the services necessary in a privatized system.

²¹ See, for example, the chapter on "Reasons for Creating Mandatory Retirement Programs" in Thompson (1998, pp. 25-36).

In Australia, the choice among funds is just beginning. The experience in Australia and other countries, however, regarding financial literacy indicates that informed choice is not likely to happen in the majority of cases. To merely call for more education is no answer to the problem—at least in the short run.

Caveat Emptor (Let the Buyer Beware)

Australia instituted privatization with almost no legal oversight structure to protect the interests of consumers. Very slowly over recent decades policing and protection has evolved through government regulatory bodies. But, as in other countries (including the United States), fraud and incompetence have resulted in losses by investors, often with no possibility of recouping the lost financial benefits.

Financial Industry Self-interest Comes to the Fore.

The political history of the superannuation reforms in Australia looks very similar to the scenario developing in the United States. As in America, most Australian employers were slow to provide pension coverage to employees, especially those who were not white-collar high earners. And again, as in the United States, a high proportion of the uncovered employees worked for small businesses.

So the Superannuation Guarantee was established despite employers' lack of enthusiasm and, in many cases, their hostility. Union enthusiasm in Australia for superannuation was fueled in the 1980s by the spiral upward of stock prices, but was dampened by the stock market crash in October 1987.

As Olsberg points out, “the support by the insurance industry of union and Labor government’s demands for occupational superannuation created a coalition that previously would have been considered ideologically unsustainable.” In Australia, according to Olsberg, insurance companies and other financial management firms “now earn extraordinarily lucrative management fees from the administration of the superannuation funds” (Olsberg 1997b).

As in the United States, statements by Australian politicians and the media about the “crisis” resulting from population aging and the unsustainability of public expenditures were used to “wake up” voters regarding old age financing issues and to enlarge support for reform. In all of this, the advocates of mandatory superannuation were operating in a political environment where the whole issue of pension reform and privatization was extremely complex and generally confusing to the ordinary citizen.

In any event, there have been dramatic changes in Australia’s retirement income system over recent years, changes that many in Australia call “revolutionary.” And as this new system evolves and is tested in Australia, it provides (despite the many significant country differences) useful, practical information that is clearly relevant for the ongoing pension discussions currently taking place in the United States.

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