

Compulsory Super at 20: 'Libertarian Paternalism' Without the Libertarianism

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Executive Summary

- Australia's approach to retirement incomes policy has three pillars: means-tested age pension, compulsory superannuation, and voluntary saving.
- Compulsory superannuation grew out of centralised wage fixing as a mechanism for managing wage demands in an economy that did not have a nominal anchor.
- Compulsory super has outlived these institutional arrangements and is now motivated primarily by paternalistic considerations.
- The focus of retirement incomes policy has shifted from poverty alleviation to income maintenance.
- In the absence of moral hazard, individuals have a compelling self-interest in avoiding poverty and providing for their desired standard of living in retirement.
- The paternalistic argument for compulsory saving via the superannuation guarantee is weak in the absence of a public interest in addressing under-saving by some individuals and households.
- Compulsory super has thus been further motivated by the need to increase national saving, reduce the current account deficit, and address the fiscal demands of an ageing population.
- Rather than a national saving or population ageing problem, Australia has a public expenditure problem.
- On current projections, the mature compulsory superannuation system will have only a modest impact on future age pension eligibility, augmenting rather than replacing the age pension, while still leaving a large fiscal gap.
- The fiscal implications of population ageing can only be addressed through comprehensive tax and expenditure reform.
- There is a danger that further increases in the compulsory contribution rate could become a politically convenient but ineffective substitute for such reforms.
- Private saving behaviour is said to be subject to moral hazard in the presence of the age pension, giving rise to a fiscal externality. This fiscal externality argument needs to be weighed against distortions to the labour market.
- A well-targeted age pension should not induce widespread moral hazard.
- The large captive tax base represented by compulsory super may feed rather than limit future demands for public expenditure on the part of an ageing population.
- A lack of voluntary saving via super is a rational response to the presence of high transaction and information costs, principal-agent problems, and uncertainty about future government policy.
- These problems are compounded rather than eased by compulsion.
- The creation of a captive market for saving via superannuation effectively precludes the proper functioning of a competitive market.
- The problems with superannuation highlighted by the Cooper review are not the result of market failure but government failure.
- The key issue for public policy is whether compulsory super is the best way of improving retirement incomes and reducing future demands on the federal budget from an ageing population compared to alternative policy measures.
- Compulsory super is not well integrated with the other two pillars of retirement incomes policy: the age pension and voluntary saving.
- Addressing adverse interactions within the three pillars and between the three pillars and the tax system is a preferable policy approach to further increases in the compulsory contribution rate.

- Raising and aligning the preservation and age pension eligibility age and moving the taxation of super back to an expenditure tax basis, combined with the mandatory annuitisation of retirement benefits receiving expenditure tax treatment, would lift retirement incomes and reduce future demands on the budget in a more transparent, equitable and politically robust way than further increases in the compulsory contribution rate.
 - Public policy should aim to merge the second and third pillars of retirement incomes policy into a single pillar built around tax-advantaged long-term voluntary saving via housing and superannuation.
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PETER DIAMOND: The question is not whether anyone saves enough or whether everyone saves enough, but whether there are enough people saving too little for themselves and their families so that a worthwhile mandatory program can be put in place. Of course, this focus is not based on externalities or public goods or market power, but on paternalism. While some may object to such a basis for policy, I find a valuable role for the government in helping people, indeed, in some circumstances, forcing people, to avoid mistakes.¹

ALAN KOHLER: In fact you call it 'libertarian paternalism' in your report. And I must say reading your report it seems to lean toward the paternalism rather than the libertarian.

JEREMY COOPER (Chairman of the 2010 Super System Review):

Compulsory superannuation, which only exists in a very few countries, is very paternalistic. It's saying, well unless we force the population to put money away for retirement they're not going to do it, so we're going to work out what we think their best interest is and we're going to force them to hold back wages which otherwise would be spent on school shoes and petrol and all those important things. When money is held back by the government, that's very paternalistic. So to criticise these ideas because they're paternalistic forgets what the system, what super actually is.

— Interview on *Inside Business*, ABC TV, 18 July 2010

Introduction

Australia's approach to retirement incomes policy has three pillars.² The first pillar is the means-tested age pension, which dates from 1909 and is intended to provide a safety net should the other pillars fail to provide a minimum standard of living in retirement. The second pillar is compulsory superannuation through the superannuation guarantee (SG), which has been in place since 1992 and was preceded by the growth in award-based superannuation from 1986. The third pillar is voluntary saving, including saving via superannuation over and above that mandated by the SG.

The federal government, with the support of the opposition, has undertaken to increase compulsory SG contributions from the current 9% to 12% by 2019–20. The increase will be phased in with annual increments of 0.25 percentage points from 1 July 2013. In this context, it is timely to re-examine the economic case for the second pillar, compulsory superannuation. As the opening quote from Peter Diamond, the 2010 winner of the Nobel Prize in economics, suggests, compulsory saving programs can be motivated on paternalistic grounds. Jeremy Cooper invoked 'libertarianism paternalism' and behavioural economics as the philosophical framework for his review's recommendations to reform default superannuation funds,³ but he also concedes the 'very paternalistic' implications of compulsory contributions in the interview quoted above. Libertarians typically object to government paternalism on philosophical grounds. However, philosophical arguments are not the focus of this monograph. Rather, this monograph is concerned with the economic case for compulsory saving via super. In particular, it questions whether compulsory super is the most effective way of promoting household and national saving and reducing future demands on the federal budget from an ageing population when compared to alternative policy options.

Compulsory super is now a little questioned feature of Australian retirement incomes policy, yet it is partly a legacy of an earlier era of public policy characterised by centralised wage fixing and monetary policy that was not focused on controlling inflation. The introduction of award-based superannuation in 1986 explicitly traded off increases in take-home pay for superannuation contributions in an industrial relations system at risk of a wages breakout and inflationary wage-price spiral. Award-based superannuation was a mechanism for managing demands for wage increases that might otherwise have been destabilising for the economy. The introduction of the SG in 1992 followed the failure of the then Australian Industrial Relations Commission (AIRC) to support an increase in award superannuation when the unemployment rate was in double digits. The SG was also introduced before the formal introduction of inflation targeting by the Reserve Bank of Australia in August 1996. The Reserve Bank's failure to provide the Australian economy with a nominal anchor until the mid-1990s meant that monetary policy was more likely to accommodate inflation pressures arising from the labour market.

The shift to enterprise bargaining since 1991 and the decline in union membership as a share of the workforce, together with the adoption of a formal inflation target, have resulted in a more decentralised labour market, wages more closely tied to productivity, and a less inflation-prone economy. The scope for wage demands to spill over into increased inflation and unemployment has been reduced by these institutional changes, undermining part of the original rationale for the introduction of award superannuation and the SG. Compulsory superannuation has outlived some of the institutional arrangements on which it was originally conditioned. However, it was primarily motivated by the desire to improve household saving and retirement incomes, marking a major shift in the focus of retirement incomes policy from poverty alleviation through the age pension, a legitimate focus of government policy, to income maintenance, implying an expanded role for government. As Vince FitzGerald has noted, 'given a public policy

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interest in raising people's retirement living standards well beyond "safety net" levels, policies that aim to support greater private saving for retirement purposes represent the primary policy approach.¹⁴ Compulsory superannuation has become the centrepiece of this approach.

The economic rationale for compulsory superannuation has changed along with the institutional landscape. Compulsory superannuation was initially motivated by macroeconomic concerns, particularly the perceived need to lift Australia's national saving performance and to narrow the current account deficit. However, these mercantilist arguments were discredited by the 'consenting adults' view of external deficits that emerged in the late 1980s, a view that has increasingly found favour with academics and policymakers. Although mercantilist arguments are still routinely invoked, the macroeconomic rationale for compulsory superannuation has since shifted to concerns about intergenerational equity and long-term fiscal solvency. Economists and policymakers have also made increasing use of microeconomic arguments for compulsion. Compulsory superannuation is seen as addressing moral hazard and fiscal externality problems arising from the first pillar, the age pension. Compulsion is also said to address problems of imperfect information, bounded rationality, and other potential 'market failures' in retirement saving.

The main issue for public policy is whether compulsory superannuation is the best way to secure the objectives of improving retirement incomes and reducing future demands on the budget from an ageing population relative to other policy options. The argument of this monograph is that compulsory superannuation has become a second-best substitute for other policy measures that are potentially more effective in realising these objectives, but may also be politically more difficult to implement. Most of the economic arguments for compulsory superannuation are second-best arguments made on the assumption that first-best outcomes are unattainable. There is considerable scope for public policy to address adverse interactions between the three pillars, the tax system, and public expenditure that will increase voluntary saving, improve retirement incomes, and reduce future demands on the budget without relying on further increases in compulsory SG contributions. A number of existing government policies are working at cross-purposes with compulsory superannuation, reducing incentives for saving for retirement and labour force participation for those around retirement age. As Rafal Chomik and John Piggot note, Australian retirement incomes policy 'is bedevilled by design flaws that have been ignored or made worse by successive governments.'¹⁵ Addressing these design flaws will enable superannuation to better serve the objectives of public policy without making use of compulsion. Increasing the compulsory contribution rate without addressing these design flaws is irresponsible public policy.

The monograph begins by considering some conceptual and measurement issues in relation to household and national saving. It then considers whether Australia has a national saving problem and the role of compulsory superannuation in addressing the fiscal consequences of an ageing population. Having considered some of the macroeconomic arguments for compulsory super, it then turns to microeconomic considerations. The implications of compulsory super for the labour market and household saving are considered. The moral hazard and 'market failure' arguments for compulsion are then examined. Finally, the paper considers the scope for tax reform to enhance retirement saving and reduce future demands on the budget without further increases in the compulsory contribution rate. The monograph concludes by recommending a shift in compulsion from the accumulation to the decumulation stage of retirement saving through the mandatory annuitisation of superannuation benefits that benefit from the tax reforms, which are also proposed here. The second and third pillars of retirement incomes policy should be merged into a single pillar based on a politically robust regime of tax-advantaged long-term voluntary saving via housing and superannuation.

Defining and measuring household and national saving

Saving cannot be measured directly. It is a residual that is derived from the behaviour of other economic variables. Conceptual and measurement problems in relation to these variables will affect the reliability of derived measures of saving. The official data on saving are also prone to significant revisions. These issues make it difficult to answer questions about the adequacy of household and national saving and to determine the effectiveness of policies designed to increase saving.

Saving can be measured as a flow or a stock and is usually expressed as a ratio to other economic variables because the absolute dollar value of saving is not very meaningful in itself. *Gross* or *net national saving* is a flow-based concept derived from the national accounts that can be split into contributions from households, business and government. The *current account balance* measures the difference between gross national saving and investment.

Stock-based measures of saving are based on the value of accumulated financial assets and non-financial assets such as consumer durables and housing. Liabilities can be subtracted from the stock of assets to measure *net worth*. These measures can also be derived for the household, corporate and public sectors and for the country as a whole. Flow-based measures of saving add to or subtract from stock-based measures. The stock-based measures also capture valuation effects such as capital gains on equity securities and other financial assets, as well as the value of the housing stock that are not otherwise picked up by the flow-based measures of saving. Changes in the value of the stock of financial and non-financial assets change household net worth, but also the propensity to save. For example, the positive wealth effect on consumption from capital gains on shares or houses may induce a reduction in household saving.⁶ Failing to account for these valuation effects on the stock of financial and non-financial assets and net worth can give a misleading picture of saving behaviour.

Some of the problems in relation to the definition and measurement of saving can be highlighted by focusing on one of the most widely reported measures of saving, the *household saving ratio*, the ratio of *household net saving* to *household net disposable income* (shown for Australia in Figure 1).

Figure 1: Household saving ratio (%)



Source: ABS (Australian Bureau of Statistics), *Australian National Accounts National Income, Expenditure and Product*, June 2012, Cat. No. 5206 (5 September 2012).

Saving cannot be measured directly. It is a residual that is derived from the behaviour of other economic variables.

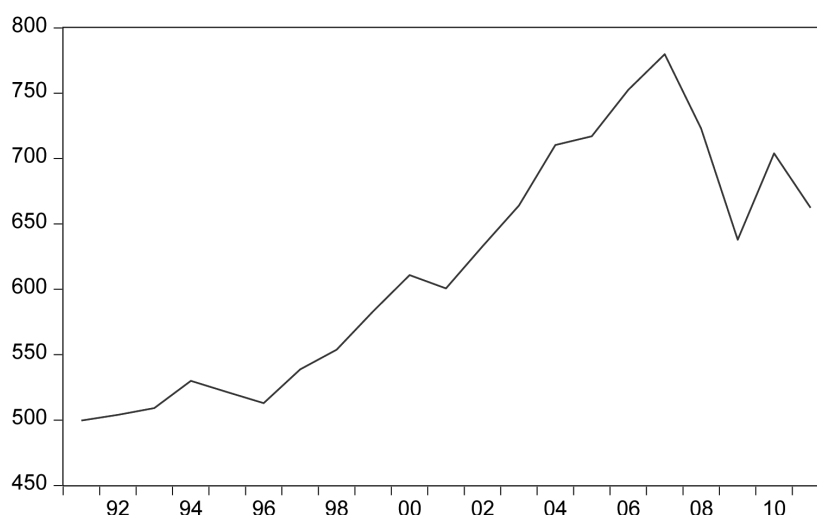
The focus on the measured saving of households neglects the scope for substitution between sectors.

As with other forms of saving, household saving cannot be measured directly. It is a residual derived from the difference between household final consumption expenditure and household disposable income. The contribution superannuation makes to household saving is the sum of net super contributions and the net earnings from super funds.⁷ The definition of consumption from which household saving is partly derived is necessarily somewhat arbitrary and designed to solve a variety of difficult measurement problems facing the statistician in compiling the national accounts. For example, education expenditure is classified as consumption because of the difficulty of translating spending on education into a measure of human capital accumulation that could then be attributed to investment rather than consumption in the national accounts. While an individual may correctly view their spending on education as an investment that will enhance their stock of human capital and future income, the national accounts measure this expenditure as consumption and thus a subtraction from household and national saving. This has the perverse implication that the more Australians spend on education, the more measured saving falls, all else being equal, even though the stock of human capital has increased. While the need for such simplifying assumptions in compiling the national accounts is unavoidable, it highlights the limitations of these national accounts-derived measures of saving.

Household saving can also be misleading because the distinction between the household, corporate and government sectors is an artificial one. The corporate sector is ultimately owned by the household sector (albeit including the household sector in other countries). The government sector is also ultimately attributable to the household sector given its reliance on taxation of households to meet its obligations (corporate taxes can also be attributed to households given their ownership). The focus on the measured saving of households neglects the scope for substitution between sectors. For example, substitutability of government debt and future taxes (Ricardian equivalence) means that increased government saving may be largely offset by private dissaving, making little contribution to overall national saving.⁸

The Australian Bureau of Statistics (ABS) also makes available data on *household* and *national net worth* that can be used to derive net saving rates that reflect changes in real net wealth.⁹ At least until the onset of the financial crisis in 2007–08 and the subsequent European debt crisis, household net saving rates adjusted for changes in real net wealth were far more impressive than what was suggested by the more commonly reported household saving ratio. This resulted in steady gains in household net worth as a share of gross disposable income until 2007, as shown in Figure 2.

Figure 2: Household net worth ratio to gross disposable income (%)



Source: ABS (Australian Bureau of Statistics), *Australian National Accounts National Income, Expenditure and Product*, June 2012, Cat. No. 5206 (5 September 2012).

These data are a better approximation to how most people would think of saving, but receive little attention from commentators. The focus on flow-based measures of household saving is far too narrow. The economic importance of changes in the value of the stock of financial and other assets—and the scope for substitution between different sectors of the economy, between different asset classes and changes in assets and liabilities—demonstrates the need for a more comprehensive view of saving. The empirical evidence on the contribution compulsory super makes to household and national saving and the private and public saving offsets to compulsory super contributions are discussed below. These empirical estimates are subject to the measurement issues discussed above and should be treated with caution.

Does Australia have a national saving problem?

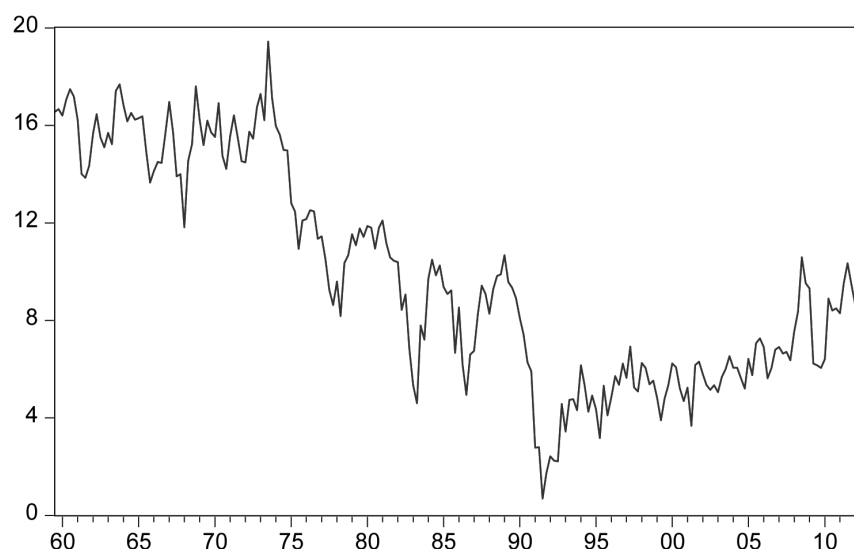
From the time the SG was introduced in 1992, compulsory superannuation in Australia was explicitly designed to address a perceived national saving problem. A 1992 ministerial statement by then Treasurer John Dawkins said growth in superannuation would lead to more ‘Australian funds for investment in Australia. It will diminish our need for foreign borrowing.’¹⁰ Similarly, Treasury’s Retirement Income Modelling Group said:

Increased national saving through superannuation provides an avenue for financing the investment in Australia and to reduce our reliance on foreign savings to finance such investments ... such additional national savings would help relax the current account constraint on Australia’s economic growth performance, permitting faster economic growth without the build-up of foreign debt that results from domestic saving falling short of the levels necessary to finance investment in Australia.¹¹

The 1993 FitzGerald report argued ‘this effect [of compulsory super] on national saving is not simply a ‘by-product’ but is crucial to its effectiveness as retirement incomes policy.’¹²

Australia’s measured national saving trended lower from the early 1970s until the early 1990s, before trending higher, especially in the aftermath of the financial crisis of 2008–09 (see Figure 3).

Figure 3: Net national saving (%GDP)

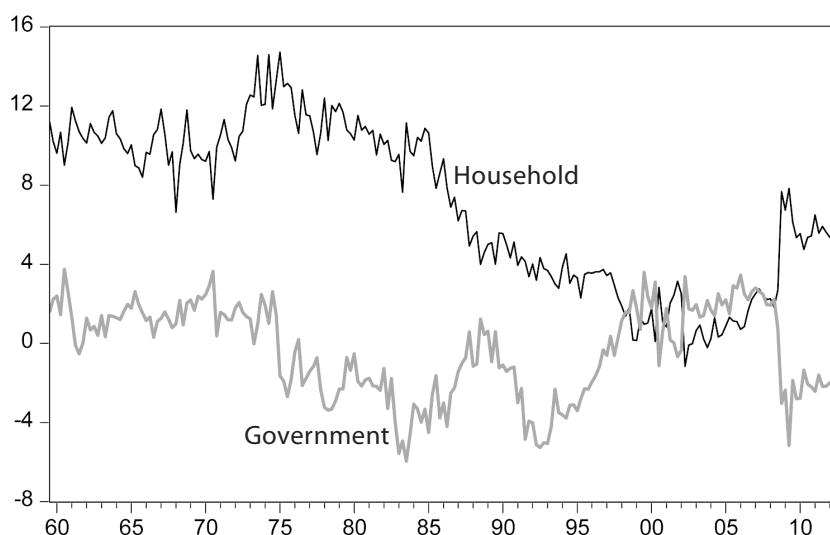


Source: ABS (Australian Bureau of Statistics), *Australian National Accounts National Income, Expenditure and Product*, June 2012, Cat. No. 5206 (5 September 2012).

From the time the SG was introduced in 1992, compulsory superannuation in Australia was explicitly designed to address a perceived national saving problem.

The trend decline in national saving was driven in part by a decline in government saving. Whereas prior to the mid-1970s, general government sector saving had been relatively stable at around 3% of GDP, government saving was negative for significant periods from the mid-1970s to the mid-1990s and deteriorated again as a result of the fiscal policy response to the financial crisis in 2008–09 (see Figure 4).

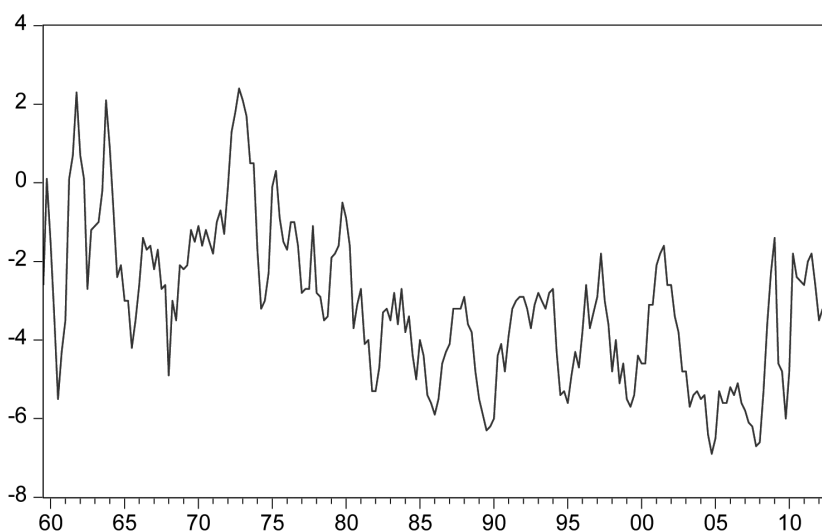
Figure 4: Net saving by sector (% GDP)



Source: ABS (Australian Bureau of Statistics), *Australian National Accounts National Income, Expenditure and Product*, June 2012, Cat. No. 5206 (5 September 2012).

The high saving rates of the 1970s were partly a function of an inflation bias in measured saving, which does not account for the capital transfers between lenders and borrowers that occur in a high inflation environment. Correcting for this bias lowers the measured saving rate during the high inflation 1970s.¹³ The decline in measured saving was also associated with a widening in the current account deficit as a share of GDP, which measures the shortfall between national saving and investment. The current account deficit as a share of GDP also peaked just before the onset of the financial crisis (see Figure 5).

Figure 5: Current account balance (% GDP)



Source: ABS (Australian Bureau of Statistics) *Balance of Payments and International Investment Position, Australia*, June 2012, Cat. No. 5302 (4 September 2012).

The trend decline in national saving was driven in part by a decline in government saving.

However, the trend decline in national and household saving and widening in the current account deficit was not confined to Australia. It was a phenomenon seen throughout the Anglo-American world and associated with increased saving in East Asia and other emerging market economies, giving rise to the so-called global saving glut.¹⁴ This suggests that the decline in measured saving and wider current account deficit was due not only to country-specific factors in Australia but also broader trends in the global trade in capital.

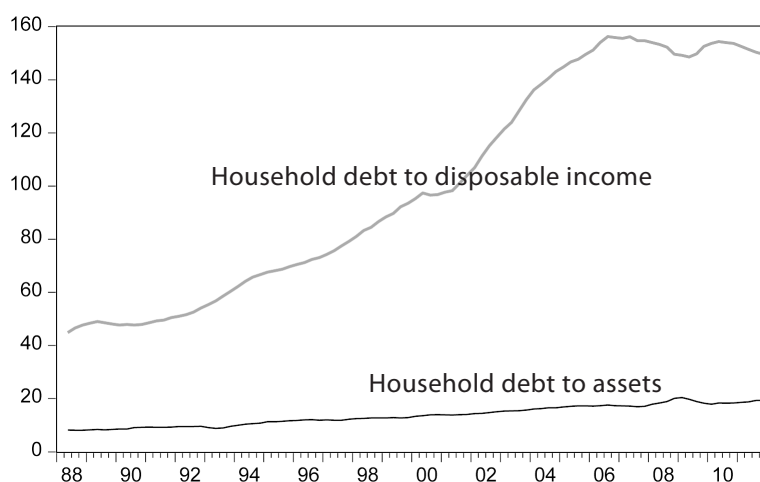
The most significant development in relation to saving in the Anglo-American economies in the two decades leading up to the financial crisis was the widespread deregulation of financial markets, including the removal of interest rates controls, quantitative restrictions on lending, and credit rationing. These measures are sometimes called ‘financial repression,’ which can also take the form of capital controls and directed lending to government.¹⁵ The liberalisation of financial markets in countries like Australia is in contrast to the continued extensive use of financial repression in economies like China where gross national saving has risen above 50% of GDP in recent years.

The reduction in household saving in Australia following deregulation suggests that households were previously prevented from attaining their preferred mix of consumption and saving and the associated mix of borrowing and lending and assets and liabilities. Rather than saving being too low in the years since deregulation in the mid-1980s, it is more likely that household saving had previously been too high because of financial repression. Australia’s supposedly poor performance on flow-based measures of saving was in fact symptomatic of Australia’s successful deregulation of financial markets and adoption of new financial technologies. Financial deregulation reduced the reliance of households on saving for consumption smoothing, allowing more effective use of new consumer credit instruments. The ability to smooth consumption over time is beneficial not only from the point of view of households. Volatility in the macroeconomy is potentially reduced to the extent that households can better smooth their consumption.

Financial deregulation was associated not only with a significant increase in household debt but also an offsetting increase in the stock of financial and non-financial assets. This in turn led to an increase in household net worth that is less apparent from flow-based measures of saving and stock-flow comparisons such as the ratio of household debt to income that attracts the most attention from commentators. The more appropriate comparison is the ratio of the stock of household debt to household assets, which has been relatively stable in recent decades (see Figure 6).

Rather than saving being too low in the years since deregulation in the mid-1980s, it is more likely that household saving had previously been too high because of financial repression.

Figure 6: Ratio of household debt to income and assets, 1988–2011 (%)



Source: RBA (Reserve Bank of Australia), Statistical Tables, *Household Finances—Selected Ratios*, Table B21.

**National
saving need
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Before the financial crisis, RBA Deputy Governor Ric Battellino noted, 'this balance sheet structure is very favourable in terms of maximising long-run accumulation of wealth, because the return on these assets over long terms exceeds the cost of debt by a substantial margin.'¹⁶ This is arguably still true, despite the recent declines in household net worth following the financial and European debt crises. In making the case for further increases in compulsory superannuation contributions, FitzGerald cautioned in August 2007 that households were acquiring too much debt to buy assets such as houses and shares that may be 'overvalued.'¹⁷ However, at least some of this debt accumulation may be driven by the household sector's attempt to dissave to offset compulsory contributions. FitzGerald notes that rising household debt offsets superannuation assets and prospective retirement benefits, but does not emphasise that this offset may be driven by a substitution effect.¹⁸ Increasing compulsory contribution rates also does not address the problem of overvalued financial or housing assets and actually increases the exposure of households to financial assets. It is therefore ironic that FitzGerald argued for an increase in compulsory super contributions on the eve of the financial crisis on the basis of rising household debt levels and apparent overvaluations in financial and other assets! Saving increased in the wake of the 2008–09 financial crisis as households sought to rebuild wealth lost in markets for financial assets, especially equity securities. It is notable that this wealth destruction partly reflected the increased exposure of households to financial assets via superannuation. Australian super funds suffered real losses of around 27% during the financial crisis, mainly due to their exposure to equity markets.¹⁹

The deterioration in current account balances as a share of GDP in the Anglo-American economies during this period reflected the growing specialisation and division of labour spilling across national borders due to the increased liberalisation and globalisation of product and capital markets. This allowed the Anglo-American economies to capitalise on their comparative advantage in investment, while other economies, especially those in East Asia, capitalised on their comparative advantage in saving. However, these global capital flows were also heavily distorted by financial repression in China and the politicisation of housing finance in the United States by government-sponsored enterprises such as Fannie Mae and Freddie Mac.²⁰ By contrast, Australia's capital inflows have been relatively free of domestic policy distortions and finances record levels of business investment as a share of gross domestic product, as well as much-needed housing investment for a rapidly growing population.

Rather than reflecting poor saving performance, Australia's current account deficit is better viewed as a reflection of its superior investment performance and growth potential, as well as its ability to capture international gains from trade in capital through integration with global capital markets. While the growth in external liabilities associated with a current account deficit is a potential issue, this need not be a concern so long as foreign borrowing facilitates growth in national income, wealth and debt servicing capacity. Those who argue for an increase in national saving and a reduction in the current account deficit are effectively arguing that Australia should forgo some of the potential gains from global trade in capital.

It should also be noted that national saving need not constrain domestic investment in an open economy that can borrow internationally, even though there is a correlation between domestic saving and investment rates.²¹ Increased national saving may simply change the composition of saving between domestic and foreign sources, without necessarily increasing investment. To the extent that the cost of capital in Australia is higher than overseas, this shift in the composition of financing for investment could lead to higher domestic interest rates and reduced investment. Malcolm Edey, et al. have suggested that compulsory super contributions compete with bank deposits and may increase banks' cost of funds at the margin.²²

However, if Australia is a price-taker in global capital markets, domestic saving should be seen determining the size of the current account deficit, not the quantity of domestic investment or domestic interest rates. Increased domestic saving (including via compulsory super) will not necessarily lead to more investment or lower domestic interest rates if Australia conforms to the standard assumptions made about a small, open economy. Increased domestic saving could be of benefit if it lowered country-specific risk premiums, but such risk premiums are difficult to observe and likely a function of a wide range of factors apart from external balances.

Those who are concerned by the size of the current account deficit have argued that the growing stock of external liabilities potentially increases Australia's vulnerability to international credit market shocks. Australia's external liabilities are mostly denominated in Australian dollars, greatly reducing the exchange rate risks that are often implicated in financial crises abroad. The Australian economy outperformed the rest of the world through a major international credit market shock in 2008–09, largely because of the structural resilience imparted to the economy after two decades of product and capital market deregulation and liberalisation. It has been suggested that the flow of compulsory super and the stock of superannuation assets provided a source of funds and a buffer against the financial crisis, but it is more likely that the accumulation of financial assets via superannuation, especially equities, increased rather than decreased the exposure of Australian households, and thus the economy, to the external shock from the financial crisis in the American and European banking sectors. As noted previously, the increase in the household saving ratio since 2008 can be viewed as an attempt by households to rebuild the wealth that was lost through superannuation and other financial assets.

The 1993 FitzGerald report, *National Saving*, set a goal of lifting gross national saving by around 5% of GDP to 22%–23%.²³ While the idea of a national saving target was mistaken, FitzGerald was correct in arguing it was more incumbent on Australian governments rather than the private sector to improve their saving performance. Unfortunately, FitzGerald's recommendations for lifting national saving largely focused on measures such as tax increases that raised public saving at the expense of private saving without necessarily increasing national saving. The FitzGerald report became the intellectual foundation for the tax increases in the politically disastrous 1993 federal budget that helped the Keating government lose office at the 1996 federal election. In an August 2007 report for the Investment and Financial Services Association, FitzGerald argued that Australia now has a private rather than a public saving problem, noting that gross national saving had been stable at around 21% of GDP 'in large part because of the strong fiscal position of the public sector and healthy levels of retained profits in the corporate sector.'²⁴ However, this ignores the scope for substitution between these sectors, in particular, the potential for Ricardian equivalence leading to private sector dissaving in response to increased public saving.

Does compulsory superannuation raise national saving? Remarkably, this question was comprehensively addressed only after the introduction of the SG at the instigation of a Senate committee, which then led to the formation of the Retirement Income Modelling Group in the Treasury. The modelling showed a positive contribution to national saving from the SG on the policy settings of the time relative to a counterfactual in which compulsory contributions were paid as wage rises, with 50% of the increased take-home pay then saved into saving accounts. The benefit to individuals was found to be larger than the cost to government. When these benefits were discounted at an appropriate discount rate, their net present value was zero so that the costs of the SG equalled benefits.²⁵ Such modelling is necessarily sensitive to underlying assumptions. For example, these results do not consider the possibility that tax concessions for superannuation lead

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to increases in other taxes or that increased costs to employers reduce their capacity to invest. More recently, Treasury officials David Gruen and Leigh Soding argued that compulsory super increases national saving by around 1.5% of GDP.²⁶ The contribution compulsory super makes to household and public saving is discussed later in this monograph.

The secular rise in average living standards in developed economies demonstrates that even in the presence of large distortions, such as incomplete financial markets, saving was still sufficient in the past to underpin economic growth. Indeed, Ross Guest and Ian McDonald argue that 'from the viewpoint of inter-generational equity, this suggests that the net effect of the distortions to saving historically has been to cause excessive saving,'²⁷ not too little saving. However, this still leaves open the question of the future adequacy of national saving.

National saving and population ageing

Although the debate over the current account deficit in the late 1980s and early 1990s was largely won by the 'consenting adults' view of external deficits, the idea that national saving was inadequate was never entirely defeated. It successfully migrated from concerns about the current account deficit to concerns about population ageing and intergenerational fiscal equity and solvency. In principle at least, Australia could still have a longer-term, intergenerational national saving problem that is distinct from questions about our ability to finance our current levels of consumption and investment spending.

The stylised facts of Australia's ageing population and its potential budgetary implications have been highlighted by the federal Treasury's *Intergenerational Reports* (IGRs) prepared under the Charter of Budget Honesty.²⁸ Successive IGRs have pointed to a large prospective fiscal deficit and a potentially unstable path for net government debt on a 'no policy change' basis over a 40-year horizon. The 2007 IGR noted that 'demographic and other factors are projected to place significant pressure on government finances over the longer term and result in an unsustainable path for net debt towards the end of the projection period.'²⁹ The word 'unsustainable' never appeared in the 2010 IGR, perhaps because it was politically inconvenient for the current government to confess to potentially explosive debt dynamics, even at long horizons. The prospective fiscal gap and associated debt dynamics are potentially a more powerful argument for increasing national saving via compulsory superannuation than concerns about the current account deficit. However, given that these projections already incorporate the expected impact of the mature compulsory superannuation system under current SG contribution rates, they also highlight the failure of compulsory super to fully realise the objectives it has been given by policymakers. This could be taken as an argument for an increase in the compulsory contribution rate, but it does not follow that the proposed increases are the best way to address these prospective fiscal imbalances.

The IGR's fiscal projections are based on the assumptions that tax revenues will remain constant as a share of GDP at 2007–08 levels, while current expenditure programs will continue their existing interactions with an ageing population. It is not an ageing population per se that is driving these projected fiscal outcomes, but the unsustainable government expenditure programs attached to population ageing. Increases in compulsory contributions are designed to reduce future calls on the federal budget by increasing household retirement incomes, and thus, demands on the age pension and other age-related public expenditures. However, this is an indirect, inefficient and potentially ineffective way of containing federal expenditure on an ageing population. The prospective fiscal gap is best closed by reforming expenditure policies to put them on a more sustainable long-term

footing. Expenditure reform needs to be coupled with tax reform to expand the tax base and increase in absolute terms the amount of revenue raised by government without having to increase tax rates and the tax share of GDP.

Tackling this unsustainable public expenditure profile and tax reform requires policy decisions that governments have been slow or unwilling to make. Compulsory super can be viewed as an attempt by government to narrow the prospective fiscal gap without having to take what may be more politically difficult decisions. Compulsory super is potentially seen by some voters as being paid by employers, while the foregone wages and employment and reductions in voluntary saving as a result of the SG may not be transparent to voters. Compulsory super is thus a politically convenient substitute for more transparent policy decisions required to put government expenditure on a more sustainable long-term footing.

The IGR projections are sensitive to the assumptions on which they are based. Future policy changes are likely to be just as important as changes in demographic and other parameters in determining the future size of the fiscal gap. Whether current or prospective levels of national saving are adequate to meet the needs of an ageing population is a difficult question to answer. While an increase in the old age dependency ratio can be expected to raise expenditures in areas such as health, an ageing population can also be expected to spend less on areas such as education, while the level of investment that needs financing may fall. It is far from clear whether population ageing in itself requires an increase in national saving, either public or private. David Cutler, et al. have argued in the US context that ‘the optimal policy response to recent and anticipated demographic changes is almost certainly a reduction rather than an increase in the national saving rate.’³⁰ Guest and Macdonald have simulated the implications of a three and six percentage point increase in the compulsory contribution rate from 9% to 12% and 15% respectively between 1999 and 2050. In their simulation model, living standards decline by 1% or 2% for the first 30 years, after which living standards increase by a similar amount, effectively redistributing consumption from the present to the future. However, these future gains in living standards, when appropriately discounted, result in little net overall gain in living standards. Guest and Macdonald conclude:

Increased living standards in the future do not rely on increases in national saving forced by government policy ... there is not a case for government policy to force people to increase their rates of saving, at least on account of population ageing [and] there is no case for increasing the [superannuation guarantee levy] from its present level.³¹

The increase in the age dependency ratio represented by the baby boomers is not especially large relative to historical experience. The ‘baby boom’ age cohort increased the 0–16 age dependency ratio in the early post-World War II period without blowing out the federal budget because public expenditures as a share of GDP were lower and better contained than today. One does not have to agree with the specifics of the above simulations or their conclusions to recognise that the optimal saving rate in response to population ageing is at the very least an open question and one best left to decentralised private choice rather than central planning by government.

If it is possible for an economy to save too little, then it is also possible to save too much. The potential problem of over-saving is understudied because saving is usually thought to be positive for long-run economic growth, although capital accumulation is subject to diminishing returns. Saving also sounds virtuous, making it difficult for people to believe there could be too much saving. A case study in the dangers of over-saving is Japan. Japan experienced very high rates of saving for much of the post-World War II period because of a combination of government financial repression, mercantilist trade and industry policy, and the anti-competitive

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Forced saving is less sensitive to price signals from financial markets that might otherwise curb overinvestment.

dominance of the government-owned Japan Post as a financial intermediary.³² However, the lack of a competitive market for saving and investment meant that much of this forced saving was misallocated. The Japanese economy became increasingly over-capitalised, depressing productivity and real rates of return, now reflected in very low rates of economic growth and zero nominal interest rates. Forced saving is less sensitive to price signals from financial markets that might otherwise curb overinvestment. Japan has very large budget deficits and high levels of net debt, together with an ageing population. Japan's fiscal problems are partly a symptom of forced saving and low productivity. The Japanese case is cautionary in showing that too much saving driven by government policy can be economically harmful.

The case for increasing national saving assumes that the existing saving rate is suboptimal, but it is difficult in practice to identify what the optimal saving rate should be. Where we can identify specific distortions that lower saving rates these distortions should be tackled directly. Rather than having a national saving problem, Australia has a public expenditure problem arising from the federal budget's exposure to age-related expenditures. As Chomik and Piggot observe, 'If the IGRs and the projected fiscal balances are tools to evaluate the fiscal sustainability of current policy, successive governments have failed to implement policies that will keep budgets sustainable.'³³ An important issue is whether compulsory super is effective in decreasing the budget's exposure to these expenditures over time. This issue is discussed in more detail in the section 'Taxing Super.'

Compulsory super, the labour market, and household saving

As Nicholas Barr and Peter Diamond note: 'It is not possible to have a mandatory system of pensions without distorting the labour market.'³⁴ This leads to a trade-off between efficiency in the labour market and other objectives of public policy, such as poverty relief and raising living standards in retirement. Compulsory super has negative effects on economic well-being because it taxes employment, imposes financial constraints on low income households, and distorts the saving decisions of high income households. For compulsory super to be welfare-enhancing, it would need to correct for myopia on the part of individual savers or households, or market or government failures that result in suboptimal saving behaviour.³⁵ We do not need to know the optimal saving rate to recognise that saving rates may be distorted. The potential problems of bounded rationality, market and government failure are discussed in more detail in the following section. This section considers the implications of compulsory super for the labour market and household saving behaviour, largely following the analysis of John Freebairn.³⁶

Compulsory super has implications for labour demand and supply, wages and household saving. As Freebairn notes, the SG can be viewed as an additional cost of hiring labour, decreasing the demand for labour on the part of employers by the same amount as the compulsory contribution rate.³⁷ Under the strong assumption that employees view compulsory super as a perfect substitute for other saving, labour supply increases and the equilibrium wage falls by the compulsory contribution rate, leaving overall employment unchanged. Employees shift the composition of their saving from non-superannuation to superannuation assets. In this case, compulsory super has benign labour market implications, but also no implications for overall private saving.

A more realistic assumption is that employees view super as an imperfect substitute for other forms of saving because it is more heavily taxed (e.g. compared to saving via housing) or less liquid (e.g. compared to bank deposits). Employees may also

anticipate the implications of additional saving for future age pension eligibility. In this case, the present value of a dollar in compulsory super contributions is less than the value of a dollar in wages. This imperfect substitutability leads to a fall in employment because labour supply increases by less than the compulsory SG contribution rate. The level of saving increases due to imperfect substitutability of superannuation and non-superannuation assets and the composition of saving between these assets changes.

Households will vary in their ability to substitute between compulsory saving via super and other forms of saving. High income households can more readily substitute between compulsory superannuation contributions and other forms of saving, for example, by increasing leverage or running down other assets. Indeed, high income households may do this voluntarily, making contributions above the compulsory contribution rate because tax concessions make super a more desirable form of saving. This may lead these households to save at a lower rate overall because they no longer need to save as much via other less tax-advantaged vehicles to achieve their desired level of net wealth.³⁸

By contrast, low income households that are financially constrained such that they spend all their income and have limited capacity to increase borrowing have less scope to decrease other saving or increase liabilities. Compulsory super can be expected to increase these financial constraints by lowering take-home pay and reducing employment or hours worked. Around 20% to 25% of Australian households are thought to be financially constrained.³⁹ These households will save less via housing as a result of compulsory super. At the margin, some of these households may be forced out of the housing market altogether. Compulsory superannuation contributions force the saving of low income households into more heavily taxed (relative to saving via housing) superannuation assets, although this may still lead to a gain in net worth to the extent that overall household saving is increased. Compulsory super increases household saving mainly by exploiting financial constraints faced by low income households.

As FitzGerald notes, ‘Whether higher flows into superannuation assets have contributed to or detracted from household saving on a net basis (i.e. whether they have been substantially offset by reductions in other saving and/or incurrence of debt to finance consumption) is more difficult to establish.’⁴⁰ FitzGerald’s assumption that debt is used ‘to finance consumption’ neglects the possibility that households are increasing debt to acquire assets or to substitute out of compulsory superannuation. Empirical estimates of the voluntary saving offset to compulsory super contributions range from 17 cents to 75 cents in the dollar.⁴¹ Microeconomic evidence suggests that the offset is smaller for financially constrained households.⁴² The SG was originally expected to have a 50% voluntary saving offset; however, Treasury modelling usually assumes a 30% offset in estimating the contribution of compulsory super to national saving. The estimated contribution to national saving unavoidably relies on various counterfactual assumptions, such as compulsory contributions being paid instead as wages, with saving out of wages going into relatively highly taxed saving vehicles such as bank saving accounts instead of housing. The public saving offset to private saving via super is discussed below in ‘Taxing Superannuation.’ Compulsory contributions raise household net worth to the extent that they increase household saving, especially for low income households, but compulsory super is not necessarily the best way to increase household saving and saving rates relative to alternative policy measures, such as easing the tax burden on saving. If household saving is thought to be too low due to various market or government failures, it is best to tackle these failures directly rather than relying on increases in compulsory contribution rates that exploit the financial constraints faced by low income households.

Compulsory super increases household saving mainly by exploiting financial constraints faced by low income households.

Apart from paternalistic concerns, this moral hazard problem only gives rise to a case for compulsory saving to the extent that it leads to a fiscal externality.

Saving adequately for retirement: Market failure or government failure?

The economic rationale for compulsory super has increasingly shifted from macro to microeconomic concerns. Even in the absence of a national saving problem, saving for retirement might be thought to be inadequate at the level of some individuals or households. Compulsory super might still have a role to play in increasing saving on the part of those considered at risk of under-saving. Peter Diamond argues that 'income in old age is important enough and shortfalls are widespread enough that some interventions seem to me fully warranted.'⁴³ As the opening quote from Diamond suggests, this is a paternalistic argument for compulsory super. In the absence of a moral hazard problem, individuals should already have a strong private incentive to avoid poverty and to provide for an adequate standard of living in retirement. Individuals and households can be presumed to save adequately for their desired level of retirement income, subject to a variety of constraints. The issue for public policy is whether compulsory super solves potential moral hazard problems and addresses these constraints in a more effective way than alternative policy measures.

Compulsory super can be seen as correcting a moral hazard that arises from the availability of the age pension that weakens incentives for voluntary saving.⁴⁴ The age pension may also encourage risky investing, allowing the investor to capture the upside, with the government effectively underwriting the downside⁴⁵ (this may also partly explain the high exposure of Australian superannuation funds to equities). Apart from paternalistic concerns, this moral hazard problem only gives rise to a case for compulsory saving to the extent that it leads to a fiscal externality. There is an obvious public interest in ensuring that those who might under-save in the absence of compulsion do not become a burden on taxpayers and those who do save adequately. This fiscal externality is the main economic (as opposed to paternalistic) argument found in the 'public economics' literature supporting forced saving policies. Indeed, most paternalistic policies in areas such as public health rely on this fiscal externality argument to justify government intervention in private decisions that would otherwise only have private consequences.

However, the fiscal externality is less compelling when considered in conjunction with the role of compulsory saving in distorting the labour market, discussed in the previous section. Stefan Homburg shows that it is generally more efficient to accept the fiscal externality arising from moral hazard in relation to the age pension to avoid the distortion to the labour market from forced saving. This result is sufficiently robust for Homburg to maintain that 'the savings moral hazard argument is generally invalid.'⁴⁶ At the very least, it suggests that the supposed fiscal externality needs to be weighed against the labour market distortion.

The age pension is intended as a safety net and poverty alleviation program. The age pension should not be so attractive as to induce widespread moral hazard. However, under current policies, 80% of people of pension age receive the age pension, with 55% of those receiving the full pension.⁴⁷ This high rate of age pension take-up suggests moral hazard may be an issue, but this argues for tightening eligibility for the age pension and associated benefits, as recommended by the 2009 Harmer review. If the age pension gives rise to moral hazard, it may also be because governments have a credibility problem. People might rationally take the view that future governments will be a soft touch when faced with increased demands from an ageing electorate, making future reliance on the age pension more attractive than voluntary saving for retirement.

Compulsory super contributions can only reduce moral hazard and the resulting fiscal externality to the extent that households are unable to substitute between saving vehicles. Only a minority of households are financially constrained, although

these are also the households most at risk of under-saving due to moral hazard given their prospective age pension eligibility. Aligning the superannuation preservation age with an increased age for age pension eligibility could mitigate moral hazard by reducing the scope for double-dipping (taking superannuation benefits as a lump-sum to maximise age pension eligibility), while also benefiting labour force participation.

Even after the existing compulsory superannuation system has matured in 2047, 76.4% of those of pension age are still expected to receive the pension, with 36% of those still on the full pension.⁴⁸ These projections would seem to fall short of earlier expectations that the mature compulsory super system 'will substantially replace the government age pension.'⁴⁹ This highlights the importance of better aligning superannuation benefits with age pension arrangements to ensure that the incentives for private voluntary saving and labour force participation are maximised and future demands on the budget from the age pension are reduced. As things stand, existing compulsory superannuation contribution rates 'would leave most retired people in the income range where the interactions of the means test with accumulated superannuation, and hence the incentive to engage in double-dipping is most severe.'⁵⁰ Increasing the compulsory SG rate may further aggravate these interactions.

A significant contribution to the fiscal gap identified in the IGRs arises from the increased demands an ageing population makes on the health budget. In the absence of government provision, the need to provide for health-related and other unexpected contingencies is a significant motive for both voluntary saving and private health insurance. Means testing access to Medicare and aligning the means test with age pension eligibility could be expected to increase the number of privately insured and the scope of precautionary voluntary saving, reducing current and future demands on the health budget. Means testing would need to be structured to avoid excessive effective marginal tax rates and disincentives for labour force participation. There is also considerable scope for public policy to pursue efficiencies in the health system to reduce future health care costs.

A well-understood problem with mandatory saving programs is they cannot possibly be optimal given the diversity of individual tastes, preferences, opportunities and life circumstances. Mandatory saving programs will result in some people saving too much, lower labour force participation, and earlier retirement than is socially optimal. Diamond notes that 'forcing people to save too much is more costly than not making it large enough, because some people will save more than the mandate.'⁵¹ He suggests mandatory saving programs should be somewhat smaller than the average optimal saving rate to minimise the cost of inducing over-saving. This argues against the view that the compulsory superannuation contribution rate should be set high enough to guarantee a benchmark retirement income out of superannuation account balances, especially when superannuation is not the only source of saving for retirement.

The adequacy of retirement incomes is usually expressed in terms of income replacement ratios that can be purchased out of superannuation account balances. A 60% to 70% replacement rate is widely recommended, although this rate has no particular basis. The income replacement rate that can be financed out of superannuation account balances is misleading in suggesting that super is the only source of saving for retirement. Desired income replacement rates can be realised through both superannuation and non-superannuation saving. Total superannuation assets are still a small if growing share of overall household assets, including financial assets held outside super, business and housing equity, and consumer durables that yield a flow of useful services in retirement. Retirement incomes may also be augmented by anticipated bequests, downsizing or relocating the family home, reverse equity mortgages, assistance from children, and substituting home production

The income replacement rate that can be financed out of superannuation account balances is misleading in suggesting that super is the only source of saving for retirement.

The creation of a captive market through compulsion already effectively precludes many of the basic mechanisms required for a successfully functioning market.

for market-supplied goods and services. These methods of augmenting retirement incomes are mostly unobservable. Superannuation account balances are thus not a good indication of the adequacy of overall saving for retirement. Moreover, compulsory super may reduce voluntary saving through these other saving vehicles due to the voluntary saving offset already discussed.

There are a wide range of circumstances that may prevent the accumulation of adequate retirement saving, such as unemployment, ill health, business failure, and family breakdown. Compulsory super contributions are likely to add to these pre-retirement hardships by increasing financial constraints, even if they increase retirement incomes. The age pension is a more appropriate safety net in these circumstances. However, as discussed in the next section, the taxation of super can be reformed in a way that effectively shares some of these risks with the government. The fact that compulsory super has only been in place since 1992 should not be viewed as a significant constraint since there are plenty of saving vehicles apart from super that could have been used to accumulate saving for retirement, including tax advantaged saving vehicles such as housing. Indeed, in view of recent superannuation performance, the lack of forced saving via compulsory super before 1992 may even have been an advantage for some recent or prospective retirees.

Apart from life circumstances, there are at least three major constraints that might work against individuals saving adequately for retirement. The first constraint relates to obstacles to rational choice and forward-looking behaviour. Various cognitive biases or bounded rationality may result in decision-making that is myopic, dynamically inconsistent, or otherwise suboptimal. The behavioural finance literature is often invoked to justify compulsion in saving. It should be noted that the moral hazard argument is not compatible with the view that saving behaviour is myopic because it implies rational and forward-looking behaviour (the formal literature distinguishes between 'myopic' and 'rational prodigality'). Yet the moral hazard and myopia arguments are often advanced together. A second source of constraints arises from 'market failures' such as imperfect information and high transaction costs that prevent individuals from being fully informed or acting on available information. A third constraint that has been given less attention is government failure. Government failure arises when government policies have perverse or unintended effects that create incentives for dissaving that offsets compulsory contributions.

The Cooper review invoked behavioural finance and market failure arguments in seeking to account for and remedy many of the problems in Australia's superannuation system. As the review noted, the compulsory nature of super made 'normal consumer demand-led competition more difficult.'⁵² As a result, the existing system 'has struggled to deliver a competitive market that reduces costs for members.' It is often suggested that there is market failure within this framework of compulsion, but the creation of a captive market through compulsion already effectively precludes many of the basic mechanisms required for a successfully functioning market such as the discipline freely choosing consumers impose on producers. The problems highlighted by the Cooper review should be attributed to government rather than market failure, since compulsory super is a product of government policy. The compulsory nature of the SG was outside the terms of reference of the Cooper review, so the review was precluded from addressing this issue.

The potential 40% reduction in fees for the average super fund member the Cooper review claims will flow from its proposed reforms points to considerable inefficiency in superannuation. As the review also noted, 'The efficiency of the sector will have macroeconomic effects.'⁵³ Yet the failure of competition within the framework of a government-mandated captive market for saving via super should

not be surprising. Diamond notes that ‘if mandated workers are just turned loose in the private market, there will be major concerns about both poor investing and high expenses.’⁵⁴ It is noteworthy that the Cooper review found that the part of the superannuation system that ‘is largely successful and well-functioning’ is the self-managed super fund (SMSF) sector, which is subject to a much higher degree of individual choice.⁵⁵

There are a number of ways in which compulsory super might exacerbate rather than alleviate rationality constraints. Compelling saving via superannuation may discourage forward-looking and rational decision-making to the extent that it takes responsibility away from individuals for saving, investing and retirement planning. These problems are compounded by the role of awards and enterprise bargaining agreements in determining choice of fund for many employees. This has undermined the effectiveness of choice of fund reforms announced by the federal coalition at the 1996 federal election and endorsed by the 1997 Wallis inquiry, but only introduced in July 2005 after the failure of earlier choice of fund legislation in parliament. Around 10% of workers have actively chosen a fund and 2% to 4% of members switch fund each year mostly due to workers changing jobs.⁵⁶

It is rational for consumers to minimise the information and transaction costs imposed by compulsion by making default choices. It may also be rational for savers to minimise or avoid saving via super in the presence of these costs. These costs are not in themselves evidence of market failure and are more likely to be a problem for consumers compelled to invest rather than for those who invest voluntarily. Superannuation is also widely acknowledged to suffer from principal-agent problems, which are also exacerbated by compulsion.⁵⁷ The Cooper review has proposed a low-cost default option that will help consumers economise on information and transaction costs, although some international evidence suggests that individuals who opt for default options are more likely to regret their choices subsequently.⁵⁸ A better solution is to increase competition from other voluntary saving vehicles by abolishing compulsion in the accumulation stage of retirement saving so super funds are forced to compete with other saving vehicles and make voluntary saving via super more attractive. It is worth noting that around 20% of employees already make voluntary after-tax contributions to super.⁵⁹ Around 73% of the self-employed have some superannuation despite not being forced to contribute.⁶⁰ This suggests that people will save voluntarily via super given an incentive to do so.

Shortfalls in superannuation account balances relative to those necessary to fund recommended income replacement ratios are also not necessarily evidence of myopia in retirement planning. Superannuation account balances are only one part of overall saving for retirement, and it may be rational to minimise exposure to superannuation as a saving vehicle. Active fund managers often subtract rather than add value to retirement savings by underperforming passive investment strategies.⁶¹ The returns to saving via superannuation are more heavily taxed than the returns to saving via housing. Given that superannuation is a captive tax base and subject to frequent changes in rules and taxation arrangements, savers may rationally discount retirement benefits expected from superannuation saving because of the significant risk of inconsistent policy behaviour on the part of current and future governments. By contrast, saving via housing enjoys much stronger political protection and has enjoyed very stable taxation arrangements as a result.

To summarise this section, some individuals and households can be expected to under-save for retirement. Apart from paternalistic considerations, the main argument for trying to correct under-saving is the fiscal externality thought to arise from moral hazard in relation to the age pension and voluntary saving. It would seem unlikely that a well-targeted age pension focused on poverty relief would by itself give rise to widespread moral hazard in retirement saving. This argument also fails under fairly general conditions when considered in conjunction with the role

Competition from other voluntary saving vehicles can be increased by abolishing compulsion in the accumulation stage of retirement saving so super funds are forced to compete with other saving vehicles and make voluntary saving via super more attractive.

The taxation of superannuation in Australia is widely acknowledged to fail the usual tests of efficiency, equity and simplicity.

of forced saving programs in distorting the labour market, which may give rise to a more serious efficiency cost than the fiscal externality. The high take-up rate of the age pension in Australia may be indicative of a moral hazard and fiscal externality problem, but this can be addressed directly through tightening age pension eligibility requirements, raising and aligning the superannuation preservation age with an increased pension eligibility age, and reducing the scope for double-dipping. Moreover, failure to address these issues will render compulsory super much less effective in addressing the fiscal demands of an ageing population. This is apparent in the modest reductions in future pension eligibility and the prospective fiscal gap currently projected even under the mature super system. Only comprehensive expenditure and tax reform can address the fiscal implications of an ageing population and close the fiscal gap identified in the IGRs.

Under-saving may arise due to adverse life circumstances and opportunities, a lack of forward-looking behaviour (myopia), or various market and government failures. Compulsory super is only likely to add to the adversity experienced by those who are financially constrained. It is a blunt and inefficient mechanism for addressing under-saving to the extent that under-saving is attributable to specific distortions that can be tackled directly. Rather than addressing 'market failures,' compulsory super has arguably made them worse by creating a captive and inefficient market for complex and expensive financial products that underperform passively managed investments and for which government policy may be inconsistent over time. Far from being evidence of myopia, a lack of voluntary saving via super may be a rational response to these problems. The Cooper review highlighted some of these problems and has recommended solutions, but it remains to be seen to what extent these reforms improve the efficiency of compulsory super. A more effective policy approach is to force super to compete with other voluntary saving vehicles by abolishing compulsory SG contributions.

Taxing super

The taxation of superannuation and other saving vehicles has important implications for household saving and retirement incomes. It also has implications for public saving through the federal budget. Taxing super reduces effective contribution rates and the accumulation of saving for retirement. The taxation of super also has implications for labour force participation, especially on the part of those with a marginal attachment to the labour force such as workers around retirement age. The taxation of superannuation in Australia is widely acknowledged to fail the usual tests of efficiency, equity and simplicity.⁶² Reforming the taxation of superannuation and other forms of saving could be expected to improve saving for retirement without the need for further resort to compulsion in the accumulation stage, as well as having significant benefits in terms of increased economic efficiency.

The Henry review argued for an expenditure tax benchmark for tax reform that exempts the return to saving from taxation. Consistent with this benchmark, and in recognition of their positive contribution to lifetime saving, the review argued that saving via both housing and superannuation should remain concessionally taxed. It should be noted that the concessional tax treatment of *saving* via housing does not mean that housing as such is untaxed, as many commentators carelessly suggest. The tax burden on the supply of new housing is considerable. The Centre for International Economics estimates that as much 44% of the price of a new home in Sydney is accounted for by explicit and implicit local, state and federal taxes.⁶³ The Henry tax review recognised the relationship between the taxation of superannuation and effective contribution rates when it recommended halving the tax on super fund earnings to bring effective compulsory contribution rates up to 9% instead of the government's proposal to increase the compulsory contribution

rate from a notional 9% to a notional 12%. The government's proposed increase in notional contribution rates was part of its response to the Henry review.

Tax concessions for saving via housing have often been the focus of ill-informed criticism. The Henry review was correct in arguing that the problem with Australia's tax system is not that saving via housing is taxed too lightly, but that other forms of saving are taxed too heavily. The tax exempt status of saving via housing is in fact model tax policy based on an expenditure tax benchmark. As Bateman, et al. note, housing and superannuation 'are easily the most important long-term saving channels for most individuals ... Granting tax preference to saving through these channels is therefore likely to generate welfare improvements relative to comprehensive income taxation.'⁶⁴

The taxation of saving via housing more closely approximates an expenditure tax benchmark than the taxation of superannuation, which is a hybrid of expenditure and income taxation. It is not surprising that housing remains a preferred saving vehicle in this context. An obvious way to improve saving via superannuation without relying on compulsion is to extend expenditure tax treatment to saving via super to put the taxation of saving via housing and super on a more equal footing. As things stand, compulsory super reduces saving via housing, especially on the part of financially constrained low income households. At the margin, compulsory super will force some low income households out of the housing market altogether. Compulsory super may reduce lifetime saving on the part of these households by diverting their saving into more heavily taxed superannuation assets.⁶⁵ This is an undesirable outcome from an equity standpoint, and a perverse outcome from the perspective of those who originally promoted compulsory super as a way of improving retirement incomes for low income workers.

The taxation of super enjoyed expenditure tax status prior to 1988, when contributions and earnings were exempt from tax with only benefits subject to taxation, which is standard practice internationally. This is a so-called EET regime, where E represents tax exempt and T represents taxable status for contributions, earnings and benefits respectively. From 1988, the taxation of super moved to an internationally anomalous hybrid TTT regime until 2007, when it was changed into a TTE regime in which superannuation benefits were made tax free for those over 60. John Creedy and Ross Guest show that private saving falls in moving from a TTT to a TTE regime undermining the objectives of compulsory super.⁶⁶

Much of the tinkering with the taxation of superannuation—for example, the 1988 changes—has been motivated by a desire to bring forward revenue to meet recurrent expenditure and improve the budget balance at lower political cost relative to raising other taxes. It illustrates the vulnerability of what is a captive tax base to even greater depredations on the part of future governments. As the pool of superannuation assets grows, the temptation for politicians to increase taxes on earnings will also increase. Superannuation could also become a vehicle for financial repression by spendthrift governments—for example, by forcing super funds to hold government bonds. Until 1981, Australian superannuation funds were forced to hold at least 30% of their assets as government bonds, so there is ample historical precedent for such directed lending to government.⁶⁷ The taxation of super to meet revenue demands for recurrent expenditure has been working at cross-purposes with the objectives of retirement incomes policy. Rather than reducing future demands on the federal budget, compulsory super may end up feeding them.

As the government's response to the Henry review makes clear, increases in compulsory contributions can be seen as an attempt to offset the reduction in effective contribution rates that results from the taxation of super fund earnings. The taxation of earnings has adverse implications for labour force participation when policy should be aimed at increasing participation. Australians on average exit the labour market even before becoming eligible for the age pension and exhibit low rates

An obvious way to improve saving via superannuation without relying on compulsion is to extend expenditure tax treatment to saving via super to put the taxation of saving via housing and super on a more equal footing.

of labour force participation by international standards after the age of 65.⁶⁸ This points to significant disincentives to labour force participation that could be addressed through the reforms proposed here.

The concessional tax treatment of super has implications for current and future budgets, although the fiscal cost of these tax concessions is difficult to measure. The Treasury's tax expenditure statements are often misinterpreted by commentators as a measure of the cost of these concessions to the budget when in fact they measure the benefit to taxpayers, a very different concept. Increases in the rate of compulsory contributions do come at a cost to current revenue due to this concessional tax treatment relative to the taxation of foregone earnings, albeit with potential future benefits to the budget from reduced demands on the age pension. This is not necessarily an argument against concessional tax treatment or compulsory super, but it does highlight the need to weigh both their current fiscal costs against likely future benefits.

Revenue foregone through the concessional tax treatment of superannuation must be made up elsewhere in the budget, potentially increasing the tax burden on labour income or other forms of saving. For example, the government's Superannuation Low Income Earners Government Contribution scheme was partly funded out of the introduction of Minerals Resource Rent Tax (although all government revenue is ultimately fungible). David Gruen argues that super tax concessions interact with the government's fiscal strategy to increase both private and public saving. So long as the government is committed to balancing its budget over the economic cycle, revenue foregone through super tax concessions must be offset through savings elsewhere in the budget.⁶⁹ This argument could be made on behalf of any tax concession thought to benefit private saving. However, it also highlights the danger that future governments will be unwilling to maintain concessional tax treatment of super due to the need to make trade-offs elsewhere in the budget. The government's budget constraint cuts both ways. Future demands to increase government expenditure could equally interact with this constraint to reduce private saving through future increases in the tax burden on this captive tax base.

These considerations highlight the need to put the taxation of super in the context of a much broader tax and expenditure reform effort. While the Henry review sought to do this in relation to tax and transfer payments, the review's superannuation tax recommendations were flawed because of their preoccupation with equity rather than efficiency issues.⁷⁰ As Hazel Bateman, et al. note, it is 'futile to expect the taxation of retirement saving to target equity as an independent objective.'⁷¹

An EET regime for the taxation of superannuation has a number of advantages apart from satisfying the expenditure tax benchmark. It back-ends rather than front-ends the tax burden on super, improving superannuation saving while delivering more revenue to government in future years when it will be needed most. It allows for better integration of super tax arrangements with the rest of the income tax system, addressing inequities in the concessional contribution arrangements far more effectively than previous ad hoc efforts that have added complexity and expense to the system. The taxation of benefits means that investment and other risks over the lifecycle are more effectively shared with the government and mitigated by the progressivity of the income tax (although a flatter income tax schedule would also be desirable). An EET regime would improve labour force participation because deferring retirement also defers the tax burden on benefits and gives more time for earnings to accumulate. It would allow super to compete more effectively with other saving vehicles such as negatively geared investment property and increasing voluntary contribution rates. It would reduce the bias to equities in the asset allocations of Australian super funds relative to foreign pension funds that arises from dividend imputation, reducing investment risk. The taxation of benefits is simpler and more transparent compared to the taxation of contributions and earnings,

Revenue foregone through the concessional tax treatment of superannuation must be made up elsewhere in the budget.

increasing the political protection of superannuation saving against ad hoc tinkering and other depredations by government.

The case for compulsion is stronger in the decumulation stage of retirement saving because it helps solve the double-dipping problem. If superannuation contributions are made voluntarily, compulsion in the decumulation stage only affects those who have already made a voluntary decision to save via superannuation. Bateman and Kingston recommend the grandfathered introduction of an EET tax regime for super, with beneficiaries of the regime then limited to taking benefits in the form of lifetime annuities rather than lump-sums. This would help solve adverse selection problems in this market and better insure against longevity risk. As Bateman and Kingston note, 'Australian policymakers have always fallen short of mandatory retirement benefit purchase.'⁷² This has undermined the effectiveness of compulsory contributions in boosting retirement incomes and reducing future demands on the budget.

The government's Superannuation Low Income Earners Government Contribution scheme, which effectively returns the tax payable on SG contributions to low income taxpayers, is a step in the right direction, but it was implemented as an equity measure rather than in recognition of the undesirability of taxing contributions and earnings more generally. A shift to an EET tax regime tied to mandatory annuitisation could be expected to make a much more effective contribution to increasing household saving via super and reduce future demands on the budget than further increases in the notional compulsory contribution rate. It should be noted that this would not necessarily translate into an increase in measured saving rates because the reduced tax burden on saving via super may allow households to achieve their desired level of retirement saving more easily and quickly. The fiscal implications of a shift to EET need to be evaluated based on the broader benefits of an EET regime as outlined above. A net cost to the revenue upfront may be worth incurring to capture these benefits that may be difficult to evaluate in terms of their long-run fiscal implications. Super tax reform also needs to be put in the context of tax and expenditure reform more broadly. As argued previously, the increasing reliance on compulsion to raise retirement incomes has arguably become a second-best and politically convenient alternative to tackling more fundamental tax and expenditure reform. However, compulsory super is vulnerable to inconsistent policy behaviour on the part of governments over time, making it a poor substitute for these reforms.

The case for compulsion is stronger in the decumulation stage of retirement saving because it helps solve the double-dipping problem.

Conclusion

Compulsory superannuation grew out of centralised wage fixing as a mechanism for managing wage demands in an economy that did not have a nominal anchor. It has outlived these institutional arrangements and is now motivated primarily by paternalistic considerations. The focus of retirement incomes policy has shifted from poverty alleviation to income maintenance, with government taking on the expanded role of ensuring that some individuals and households do not under-save for retirement. In the absence of moral hazard, individuals should already have a compelling self-interest in avoiding poverty and providing for their desired standard of living in retirement. The paternalistic argument for compulsory saving via the SG is weak in the absence of a broader and compelling public interest in addressing under-saving by some individuals and households.

Compulsory super has thus been further motivated by the supposed need to increase national saving, reduce the current account deficit, and address the fiscal demands of an ageing population. However, as this monograph has shown, rather than a national saving or population ageing problem, Australia has a public expenditure problem. On current projections, the mature compulsory superannuation system will have only a modest impact on future age pension

The fiscal implications of population ageing can only be addressed through comprehensive tax and expenditure reform.

eligibility, augmenting rather than replacing the age pension, while still leaving a large fiscal gap. This could be taken as an argument for further increases in the SG contribution rate, as currently proposed by the federal government and supported by the opposition. However, the fiscal implications of population ageing can only be addressed through comprehensive tax and expenditure reform. The danger is that further increases in the compulsory contribution rate become a politically convenient but ineffective substitute for such reforms, especially given the absence of compulsion in the decumulation stage to prevent double-dipping.

Private saving behaviour is said to be subject to moral hazard in the presence of the age pension, giving rise to a fiscal externality. However, this fiscal externality argument needs to be weighed against the distortion to the labour market. Moreover, a well-targeted age pension should not induce widespread moral hazard. If moral hazard is a problem, it is more likely because voters know that governments will be a soft touch when faced with demands from an ageing population. The large captive tax base represented by compulsory super may serve to feed rather than limit future demands for public expenditure on the part of an ageing population.

Whereas the moral hazard argument assumes rational, forward-looking behaviour on the part of households, another set of arguments assumes myopic behaviour and other forms of bounded rationality, giving rise to under-saving and thus the need for compulsion. A lack of saving via super can be viewed as an entirely rational response to the presence of high transaction and information costs, principal-agent problems, and uncertainty in relation to future government policy. These problems are compounded rather than eased by compulsion. It is often claimed that there is market failure within the framework of compulsory superannuation, but the creation of a captive market for saving via superannuation effectively precludes the proper functioning of a competitive market. The problems with superannuation highlighted by the Cooper review are not the result of market failure but government failure. As Nicholas Barr and Peter Diamond note, 'Identification of shortcomings of private markets becomes an argument for intervention only when there is good reason to believe that intervention will be sufficiently well executed.'⁷³ While they see retirement saving as a good candidate for such intervention, insufficient attention has been paid to whether governments are also subject to the same problems of myopia and dynamic inconsistency that are assumed to afflict individuals. Indeed, these problems are arguably worse for governments because the costs of bad execution of public policy are not borne by the decision-makers.

Compulsory superannuation has been a largely social democratic project in Australia and was partly inspired by the desire to improve the retirement incomes of low income workers, even though compulsory contributions come at the expense of take-home pay, hours worked, and employment. Ironically, given this concern with equity, compulsory super succeeds in raising household and national saving largely by exploiting the financial constraints experienced by low income households. Whereas financial deregulation eased the financial constraints faced by households, compulsory super imposes a new constraint, forcing low income households into complex and inefficient financial products and volatile asset classes that are more highly taxed than alternative saving vehicles such as housing. At the margin, compulsory super may force some households out of housing altogether. While there is evidence that compulsory super raises household saving and national saving, these findings depend on counterfactual assumptions, the size of private and public saving offsets to compulsory super, and whether public policy will remain consistent in the long run.

The key issue for public policy is whether compulsory super is an efficient way of realising the objectives of improving retirement incomes and reducing future demands on the federal budget from an ageing population compared to alternative policy measures. Compulsory super relies on second-best arguments on the

assumption that first-best policy options are unattainable. It has become a politically convenient substitute for addressing problems in other areas of public policy. And it is not well integrated with the other two pillars of retirement incomes policy and the tax system. Addressing adverse interactions within the three pillars and between the three pillars and the tax system is a preferable policy approach to further increases in the compulsory contribution rate. In particular, raising and aligning the preservation and age pension eligibility age, moving the taxation of super back to an expenditure tax basis combined with the mandatory annuitisation of retirement benefits receiving expenditure tax treatment would lift retirement incomes and reduce future demands on the budget in a more transparent, equitable and politically robust way than further increases in the compulsory contribution rate. Public policy should aim to merge the second and third pillars of retirement incomes policy into a single pillar built around tax-advantaged, long-term voluntary saving via housing and superannuation.

Addressing adverse interactions within the three pillars and between the three pillars and the tax system is a preferable policy approach to further increases in the compulsory contribution rate.

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