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Super chance to reform system

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WHEN Wayne Swan stands up on budget night to commend the increase in the superannuation guarantee, he will be channelling the economist he loves to hate, Friedrich Hayek.

It was Hayek who first advocated mandatory savings to supplement a public age pension. "Once it becomes the recognised duty of the public," Hayek wrote, "to provide for old age, irrespective of whether individuals could have made provisions themselves, it seems an obvious corollary to compel them to provide against those common hazards of life."

But that Hayek advocated mandatory savings schemes should not blind us to the deficiencies of the super guarantee and of our retirement incomes system. With those deficiencies unaddressed, increasing the SG will make outcomes worse rather than better.

Start from the objectives being pursued. Hayek's goal was to offset the pension's effects on incentives to save. As well, ensuring retirees can rely on funds of their own enhances autonomy, dignity and resilience. But that doesn't mean more compulsory saving is necessarily better than less.

True, higher retirement savings now can reduce taxes on future generations, but they do so at the expense of lower current consumption, especially by those paying both for present pensioners and for their own retirement. With productivity and incomes rising, reducing consumption now involves greater sacrifice than reducing it later, making some burden-sharing between generations desirable.

Nor do higher required contributions necessarily translate into greater savings overall.

Employees can offset those contributions by increasing debt, for instance by paying mortgages more slowly.

Raising required contributions makes offsetting more attractive, distorting the structure, rather than lifting the level, of savings.

And those who cannot make such offsets, and place low value on additional savings, will view the contributions as a tax on working, causing some fall in labour supply.

Moreover, even if total savings rise, it is not established that higher savings would increase growth. After all, the justification for cutting corporate tax rates is that we are in a global capital market, in which investments compete for mobile finance. But if so, domestic savings do not determine domestic investment, and claimed growth benefits are spurious.

This is not to deny the merits of mandated savings. But increasing required contributions is hardly a no-brainer.

That the Henry tax review did not recommend them underscores the point. So does the fact that the SG is deeply distorted.

To begin with, the SG, and especially its tax arrangements, are mired in complexity.

The result is a market consumers struggle to understand and in which they are largely passive, tolerating low returns and fees that are stubbornly high.

Those fees aggravate the poor returns, as even a 1 per cent annual account management charge, compounded over 40 years, reduces the amount accumulated by 20 per cent.

At the same time, the SG's interaction with the pension creates distortions of its own.

As a defined contribution scheme, the SG shifts risks on to savers who have few instruments for managing them. Rather, as was apparent in the global financial crisis, the aged pension remains the main safety net for superannuants.

But that safety net's availability can induce savers to choose excessively risky investments. That danger is magnified by pressure from advisers, who charge higher fees for riskier assets, and by the way superannuation is taxed.

The taxes are generally distorting because they tax contributions and accumulation, rather than taxing income when it is consumed. But effective tax rates are especially high on interest-bearing securities, most of whose return simply compensates for inflation. The consequence is that the average equity weighting in our super funds is far greater than in other advanced economies, shifting investment risk on to the public pension.

It is also the public pension that bears the brunt of longevity risk, that is, the risk of living longer than one expected.

Current 60-year-olds could have a life expectancy of around 85 years, far higher than anticipated during most of their working life. Moreover, any given life expectancy implies some 55 per cent of people live longer than that, offsetting deaths at early ages. With a wide spread in age at death, many retirees risk outliving their savings.

That risk could be managed through annuities, but that market has now virtually disappeared. This partly reflects regulatory and tax imposts.

But it is also because the public pension provides a substitute. Indeed, purchasing an annuity with the actuarial value of the aged pension would cost over $500,000, making that entitlement the most valuable financial asset of most Australians.

That the pension plays this role is not necessarily inefficient, as it spreads longevity risk over the population. But it means the annuities market is thin and vulnerable to being used only by those confident of outliving the average. The result is high charges. People seeking a greater assured income than the pension therefore have few attractive options to turn to.

Removing constraints on the annuities market would help, but is unlikely to be sufficient.

Given that, why not allow savers to buy a top-up within the public pension scheme, with contributions cumulating at the bond rate? This would add a contributory, defined benefit leg to our retirement incomes system, improving risk sharing.

Adding such a leg could also create opportunities to encourage higher participation rates.

Instead of complex tax offsets, why not give older workers a cumulating credit for each year they postpone take-up of the pension? That would strengthen work incentives without the blunt instrument of simply increasing the pension age.

Over the course of human history, the odds of living to age 100 have risen from one in 20 million to one in 50 for females in low mortality countries. Partly thanks to Hayek's insight, Australia is better placed than most advanced economies to welcome the economic consequences of that stupendous achievement.

But that is no excuse for avoiding further, far-reaching reform.

Merely increasing mandatory contribution rates, while leaving existing distortions unaddressed, is not the answer. Rather, savers and the community need an efficient retirement income system for the long haul.