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Building a Publicly-Sponsored Private Sector Retirement System: Lessons from Australia

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Australia is generally considered to have a strong retirement system. For example, the Melbourne-Mercer Global Pension Index, which assesses the retirement systems of different jurisdictions in terms of adequacy, sustainability and integrity, has consistently found the Australian system to be among the better ones. The system as we know it today started approximately 20 to 30 years ago. It has developed gradually since that time, and has decades to go before it is mature. Nonetheless, it is possible to learn a bit about what has worked and what has not worked to date.

The savings-based part of Australia's retirement income system is known as "Superannuation" or "Super." It is organized around five core elements that policymakers should consider when building an employment-based system:

1. defining the objectives of the system;
2. getting money into the system
(private savings, but also government funds and tax incentives);
3. connecting savers with providers;
4. selecting the retirement benefits available; and
5. anticipating the role of savings on the flow of funds and investment.

The highlights of Super include mandatory savings and near universal coverage within the system. The Australian retirement income system is overall relatively inexpensive at about 6 percent of gross domestic product (GDP), compared to nearly 10 percent in many other OECD countries. Mandatory savings rates, currently 9.5% of a person's wages, are increasing gradually, and are legislated to reach 12% by 2026. For workers beginning their careers in 2026, they will be the first cohort of a mature superannuation system. Outcomes will continue to improve over the coming decades as more people make higher contributions into the system for a longer period of time.

Establish Clear Adequacy Objectives. It is very important to have a clear understanding of what outcomes you want the system to deliver. Doing so allows participants and policymakers to determine how much savings to encourage or require to be contributed into the system and when. It can help direct financial institutions away from strategies that are inconsistent with the social policy objective. It also allows government to understand how it can most efficiently direct tax breaks and other kinds of support. The founders of the Australian system were not as clear as they should have been about the adequacy objectives they wanted to achieve. This was complicated by the different views among the political parties, resulting in significant regulatory and policy uncertainty. The system's rules have changed a lot over the past few decades. More recently, there has been some common ground with both political parties realizing that the tax breaks in the system are not well targeted, because the vast majority of these tax expenditures flow to those who would retire comfortably without such support.

Money Must Come Into the System. Once you have an objective in mind, you need to get the money into the system. There are three options: 1) mandatory savings; 2) defaults such as auto-enrollment; and/or 3) tax incentives. Australia has mandatory savings, which is a very strong platform on which to build a system.

Mandates are based in law and the savings rate is currently 9.5 percent of wages and will rise gradually to 12 percent from 2021 to 2026. Modeling suggests that this might be enough to get to a reasonable retirement income for many workers, if the efficiency of administration and the conversions of savings into retirement incomes can be improved. There is consensus in Australia, however, that a lower savings rate is unlikely in a mature system to result in retirement benefits that meet community expectations for living standards.

Even if you have mandatory savings, this is not self-enforcing. The majority of employers are mindful of and obey the law, but there are some exceptions. While workers are entitled to 9.5 percent Superannuation, aggregate economy-wide mandatory contributions only equaled about 8.4 percent of aggregate wages last year. Australia relies on its tax office, which is kind of like the IRS, to monitor compliance. Monitoring and enforcing employer participation is important.

The Australian system uses tax expenditures and sometimes direct expenditures by government. Initial contributions into and investment earnings in Super are taxed at a flat 15 percent while retirement benefits are tax free. Australia also has high contribution caps. While in the United States there are limits on 401(k) contributions at $18,000 per year, Australia allows consessionally taxed contributions of up to $30,000 for most people, and additional post-tax contributions of up to $180,000 regardless of income. However, policymakers are mostly in agreement that the Superannuation tax benefits are poorly targeted because more of the tax benefit goes to those who will retire very comfortably, whether or not they receive government support. The Australian government has proposed reforms that would effectively reduce or retarget these caps and concessions.

Determine How to Connect Savers with Providers. Australia uses mostly private providers (known as superannuation funds) and there are also public sector funds. With savings flowing into the system, the question is how can policymakers help make sure those savings reach high quality providers?

There are basically three options for connecting savers to providers. First, there is consumer-driven demand, where beneficiaries choose which provider gets their savings. Second, beneficiaries can be defaulted into a fund, which requires government in some way to select or shortlist the eligible default funds. Finally, there is the option of mandating participation in a specified fund. Australia uses a mix of consumer-driven demand and default fund selection. The outcomes for consumer-driven demand have been poor. However, the default fund selection process has worked well with the average default fund consistently outperforming consumer choice funds by around 1 to 2 percent per year on average. The default fund selection process is administered by a government board in the country's industrial relations agency. The board determines a shortlist of eligible default funds for each industry from which employers can choose. This institutional arrangement for allocating members to high-quality default funds is similar to recent World Bank guidance.

The different ways in which savings are connected to providers has significant financial implications for the savers. Australia's default, not-for-profit funds, have on average performed quite well. On the other hand, retail funds selected by consumers and self-managed funds have on average underperformed. The net effect of this performance differential has resulted in a system that today has about $100 billion less in aggregate assets than it could have had.

Determine the Retirement Benefits Provided. This is a current reform topic in Australia. Today in Australia when you reach retirement, generally one of three things can happen with your superannuation: 1) you withdraw your accumulation as a lump sum; 2) you roll your savings into another savings account called an account-based pension and draw income from it; or 3) you can buy an annuity (or some combination of these). Australia's policy around the benefits design is very limited and there are no default settings to anchor consumer choice. Consumers need to make an active choice to roll their accumulated balance into a retirement income product. There are some incentives to buy an annuity because, for people with significant private assets, the amount of Age Pension (which is the government-funded, means-tested, retirement income program) a person receives will usually be higher if those assets are in an annuity (because of how the national pension is means tested).

The dominant product is an account-based pension, which provides income but is exposed to market volatility and might not last for life.

There is growing consensus that the default fund system should be extended in some way to cover retirement income, not just accumulation. There also seems to be increasing recognition that mortality risk pooling needs to be enabled and encouraged. As more policymakers become aware of the difficulty of providing retirement income not just for life, but that is also stable and invested in growth assets, there may be a growing recognition of the need to enable and encourage intergenerational investment risk sharing.

Consider the Economic Benefits of Capital Formation. Funded retirement income systems are primarily concerned with the benefits they provide to members. This is as it should be, but it is also important to keep in mind the larger economic benefits of increased investment and capital formation. The retirement assets today in Australia exceed $2 trillion, with around $100 billion of incoming contribution flows per year. How this money is invested can have a profound impact on the economy. Efficient and effective investment that increases the productive capacity of an economy can improve productivity growth. Productivity growth raises real wages which leads to more savings and lifts the overall strength of the retirement system and improves real living standards.

Lessons for the States. Like many other countries, Australia continues to examine how to improve and strengthen retirement security for its citizens. The experience of building an employer-based program over the past several decades offers some useful lessons for how to design such a system:

1. **Mandatory savings works, but it needs to be monitored and enforced.** In our experience, tax incentives affect where people put their savings, but do not lead to much, if any, increase in savings. Mandatory savings in Australia has actually increased saving.

2. **Tax expenditures need to be targeted.** The Australian government provides tax expenditures of around $30 billion per year into the superannuation system. Currently, the majority of that $30 billion goes to people of higher wealth and income, whose future retirement security has less need for government fiscal support.

3. **Gender equity must be monitored and supplemental policies are likely to be needed.** Many Australian women face an insecure retirement notwithstanding superannuation. The different work patterns between men and women are one of the reasons why. Women are more likely to work in lower paid roles and lower paid fields, are more likely to work part-time or casually, and are more likely to take breaks from paid employment to provide unpaid care for others. If retirement security rests on a wages-based system, then structural differences in employment between men and women can be magnified in retirement unless

policies targeted to address this problem are deployed.

4. **Consumer driven competition has not been effective in connecting savings to high quality providers.** Low levels of financial literacy, the complexity of financial and retirement income product decision making, and cognitive and behavioral biases exist in Australia, as they do in all other countries. There is strong evidence that those consumers who choose for themselves, rather than follow default arrangements, have poorer outcomes.

5. **Consumer driven demand will not ensure that products emerge in the market that will deliver a high stable income.** A retirement income system needs to provide members with regular income that (i) lasts for life, (ii) is stable through financial volatility, (iii) is reasonably predictable as they approach retirement, while also being (iv) as efficient as possible – as in, the beneficiary gets as much income as possible for every dollar they have contributed into the system. The most efficient way to achieve this outcome involves pooling of various risks. In Australia, there is very little policy shaping what happens to beneficiaries at retirement, and there is very little risk pooling taking place. Most people who do not exit the system entirely at retirement put their money into what is essentially an investment account.

6. **The separation of the accumulation and decumulation stage has impaired the successful delivery of lifetime income benefits.** In Australia, there is a bright line distinction between accumulation and retirement, which forces a "point-of-sale" when a beneficiary retires. This represents a challenge if one takes behavioral finance seriously. Australians in accumulation have a product whose benefit is a pot of money the value of which is based on a point-in-time measurement. This focuses members for 40 years on engaging with a pot of money, which makes it harder for trustees and well-intentioned advisors to bring members into efficient retirement income streams because preferences have been shaped around an account balance.

Policymakers in the United States and elsewhere can learn a lot from what has happened in Australia. Australia's superannuation system has some great strengths, with the foundation being mandatory savings and near universal coverage. It is in the process of becoming better at not just managing savings, but delivering retirement income. Australia has experimented with letting beneficiaries choose their own fund and choose their own investments, but the results have been poor, with too much value being captured by for-profit providers.

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