

# Australia's retirement system: Strengths, weaknesses, and reforms

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# AUSTRALIA'S RETIREMENT SYSTEM: STRENGTHS, WEAKNESSES, AND REFORMS

BY JULIE AGNEW\*

## Introduction

Australia's retirement income system is regarded by some as among the best in the world. It has achieved high individual saving rates and broad coverage at reasonably low cost to the government.

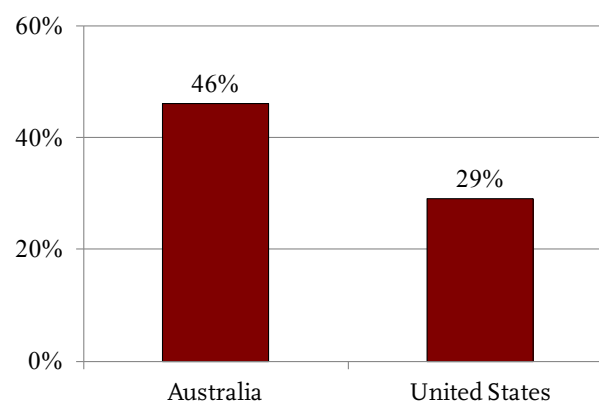
Australia's system does have shortcomings. It is heavily dependent on defined contribution plans and is vulnerable to weaknesses in such programs. Its government old-age pension is a means-tested benefit, which creates potentially troublesome incentives for workers with defined contribution accounts.

This *brief* provides an overview of the system and recent reforms. The first section presents the Australian system. The second section reviews recent reforms, which have focused on the individual account component of the system. The third section discusses outstanding issues. The fourth section offers some potential lessons for the U.S. retirement system. The final section concludes that the recent reforms should strengthen Australia's system and provide lessons to other nations that increasingly depend on 401(k)-type individual accounts.

## The Australian System

Compared to other industrial nations, Australia has low public spending on old-age pensions. It also has high individual saving rates and rapidly growing retirement savings (see Figure 1).<sup>1</sup>

FIGURE 1. GROWTH IN PENSION ASSETS AS A PERCENTAGE OF GDP, 2002-2012



Notes: Figures for 2012 are estimated.

Source: Towers Watson (2013).

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These measures of success are the result of the country's three-pillar retirement system that combines the government's Age Pension program, a mandated Superannuation employer-funded savings account for each worker, and private savings.<sup>2</sup> The major features of each pillar are outlined below.

### *The Means-Tested Age Pension*

The first pillar of the Australian system is the government's Age Pension. Introduced in 1908, the Age Pension is a means-tested benefit funded out of general revenues. It provides a basic income to those with incomes and assets less than specified threshold levels. Singles can get a benefit equal to about 28 percent of the average male wage and couples about 41 percent, with benefits reduced or eliminated as incomes or assets rise above the threshold levels.<sup>3</sup>

Individuals must be 65 to qualify for an Age Pension.<sup>4</sup> Roughly half of retirees get a full benefit, a quarter get a partial benefit, and the remaining quarter receive no benefit because their income and/or assets are too high.<sup>5</sup> The eligibility age will rise to 67 over the next decade.

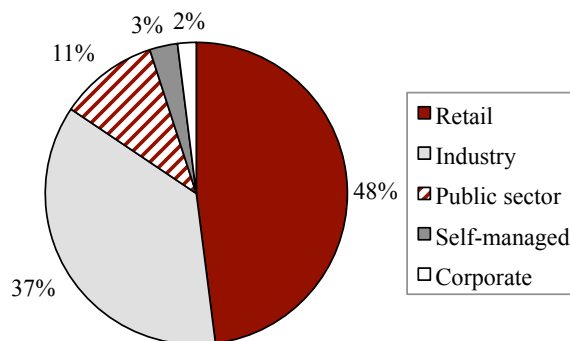
### *The Mandatory Retirement Saving Program*

The second pillar is the mandatory "Superannuation Guarantee" program, created in 1992. The program requires employers to contribute 9 percent of earnings, rising to 12 percent by 2020, to a tax-advantaged retirement plan for each employee age 18 to 70 who earns more than a specified minimum amount.<sup>6</sup> While these contributions could go to a traditional defined benefit plan with specified minimum benefits, they overwhelmingly go to individual retirement savings accounts in a "Superannuation Fund."

Over 90 percent of employed Australians have savings in a Superannuation account, and the total assets in these accounts now exceed Australia's Gross Domestic Product.<sup>7</sup> Legislation enacted in 2005 gave most employees the right to select a Superannuation Fund, which can be organized by a retail financial services company, such as a mutual fund company; by a public or private employer or industry group, which can often negotiate lower fees or enhanced services from financial services companies; or by the individuals themselves in a "do-it-yourself" Self-Managed

Superannuation Fund serving less than five participants. Each of these Funds typically gives workers the choice on how their savings are invested. (See Figure 2 for participation by Fund type, and the Appendix for more information on the Funds.)

FIGURE 2. PERCENTAGE OF PARTICIPANTS IN SUPERANNUATION FUNDS, BY FUND TYPE, 2012



Source: Australian Prudential Regulation Authority (2013).

The employer is the initial fiduciary in the Superannuation program and is responsible for selecting a default Superannuation Fund if a pre-agreed industry or occupation standard does not apply. The Funds, including a Fund the employer might sponsor, are also fiduciaries and are responsible for selecting the menu of investment options and a default investment option for those who make no choice. Workers who choose can often invest their savings in a wide range of assets, depending on the type of Fund, including stocks, bonds, real estate, and "alternative" investments like private equity.

### *Voluntary Saving*

The final pillar in the Australian system is voluntary saving, which includes additional contributions to a Superannuation Fund, called "salary sacrifice," as well as saving outside these tax-advantaged Funds. Only 20 percent of eligible employees take advantage of salary sacrifice programs, and most of those who do are concentrated in the upper end of the income distribution.<sup>8</sup> As mandatory superannuation contributions rise to 12 percent of earnings, the take-up of "salary sacrifice" and other types of individual retirement saving may change.

## Recent System Reforms

Australia has been extremely effective in achieving key goals of any retirement income system. Its Age Pension program has reduced old-age poverty and, because it is targeted, it has done so at relatively low cost to the government compared to other industrial countries. Its Superannuation Guarantee program has generated high and rising levels of saving by essentially the entire active workforce.

All retirement income systems, however, have shortcomings. Over the past five years the government has commissioned several high-profile reviews of its system and has actively sought recommendations on how best to address its weaknesses.<sup>9</sup> Some of these efforts have focused on strengthening the Superannuation Guarantee program, with many reforms designed to help individuals make better investment decisions. The most important of these reforms are discussed below.

### *Strengthening Investment Defaults*

Many Superannuation Funds provide default investment options, and many workers simply accept the default. To ensure that savings of passive decision-makers are invested in an appropriate fashion and to improve the simplicity, transparency and comparability of the default products offered, the government, beginning in 2014, is requiring employers to direct contributions for employees who have not designated a Fund to one that offers a “MySuper product” default. The MySuper product must feature a diversified asset allocation and report fees in a standardized fashion to allow for easy comparisons across products. The fee transparency is expected to lead to reduced fees through competition.<sup>10,11</sup> These products will become available in Funds in July 2013 and by 2017 trustees will be required to transfer all existing default balances to a MySuper product.

The U.S. government also oversees default investment allocations in 401(k)s. Target date funds, the most common approved default option in U.S. plans, are not a popular menu choice in Australian Superannuation Funds. The new requirements, however, have sparked discussions regarding the benefit of including target date funds and their possible role as defaults.

### *Standardizing Risk Disclosure*

Investments involve risk, which many workers find difficult to understand. To address this problem, an industry regulator and many industry groups strongly recommend using a standard format for presenting risks in different investment choices. Since June 2012, that recommended format is the frequency of negative returns over a set time period.

Experimental evidence suggests that this regulator-preferred format results in more consumer mistakes than other formats, such as presenting the range of possible returns.<sup>12</sup> It thus will be interesting to observe how the recommended presentation affects asset allocations. Given the importance of the issue, it will also be interesting to see whether regulators and industry groups recommend a different format if it is shown to produce better outcomes.

### *Improving Financial Advice*

Most plan participants need some financial advice, and the Australian Securities and Investment Commission has shown that workers too often are unable to discern good advice from bad.<sup>13</sup> This has prompted the government to advance its “future of financial advice” initiative to promote the good and drive out the bad.<sup>14</sup> As the financial advice industry has many compensation structures that create conflicts of interest, the government has banned some types of “conflicted” remuneration.<sup>15</sup> On a positive note, the government is promoting an expansion of low-cost “simple advice” and a rethinking of advice delivery models, and has imposed a fiduciary mandate that requires financial advisors to act in their client’s best interest. These reforms, voluntary since July 2012, become mandatory in July 2013.

## Outstanding Issues

The Australian government’s analysis of its pension system highlighted major shortcomings and has resulted in positive reforms. However, outstanding issues remain; the most notable are discussed below.

## *Incentives to Game the System*

Australia's means-tested Age Pension creates incentives to reduce one's "means" in order to collect a higher means-tested benefit. This can be done by spending down one's savings and/or investing these savings in assets excluded from the Age Pension means test. What makes this situation especially problematic is that workers can currently access their Superannuation savings at age 55, ten years before becoming eligible for Age Pension benefits at 65. This ability creates an incentive to retire early, live on these savings until eligible for an Age Pension, and collect a higher benefit, sometimes referred to as "double dipping."<sup>16</sup>

It is not known how large of a problem gaming is today. At this point, superannuation balances are sufficiently low that few workers can feasibly retire early and use these savings as a bridge to their Age Pension benefits.<sup>17</sup> Recent evidence also suggests that individuals are not actively thinking about how to time their retirement. Nor are they generally aware of the ages at which to execute this gaming strategy – such as the age they can access their Superannuation Funds.<sup>18</sup>

Going forward, the gap in eligibility ages will narrow. The age at which workers can access their Superannuation savings will rise to 60 by 2024, when workers must be 67 to collect an Age Pension (See Figure 3). However, incentives to "double dip" could

increase as Superannuation balances grow and more workers have access to funds they could use to retire early, and in the process boost their Age Pension benefit.

## *Low Levels of Financial Literacy*

The government has mandated a minimum level of retirement saving, regulated default investment options and the type of advice Superannuation Funds provide, and has encouraged a standard presentation of risk in Superannuation Fund investment information and an expansion of affordable, unconflicted advice. Nevertheless, workers will need some level of financial literacy to understand and manage their retirement accounts and the level currently appears to be quite low.

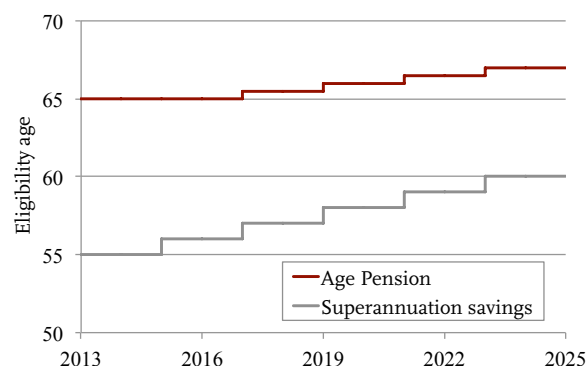
A recent survey, for example, found that over half of respondents incorrectly thought that a balanced mutual fund was composed of risk-free assets or replied "don't know." This finding is disturbing, as the majority of default investment options are balanced mutual funds, and suggests more should be done to help Australians understand their financial options.<sup>19</sup>

## *Weak Annuity Markets*

Current statistics indicate that half of those who accessed their Superannuation Funds in 2012 received a lump sum distribution. Of the remaining half, almost all (98 percent) chose a phased withdrawal product over an annuity.<sup>20</sup> This lack of annuitization makes older Australians heavily exposed to longevity, inflation, and investment risks.

To protect retirees, Australia needs greater annuitization. It also needs new annuity products that stimulate consumer demand and public policies that encourage the annuitization of Superannuation balances. Current regulation inhibits innovation. Greater annuitization would ease burdens on the government's Age Pension program by reducing the ability to spend down balances quickly to "double dip" and by reducing the number of individuals who deplete their savings.

FIGURE 3. EARLIEST AGE OF ACCESS TO AGE PENSION AND SUPERANNUATION SAVINGS, 2013-2025



Note: For any year in which the eligibility ages increase, the increase occurs on July 1. In 2013 only, women are eligible for an Age Pension at age 64<sup>1/2</sup>.

Sources: Australian Taxation Office (2013) and Australian Department of Human Services (2013).

## Lessons for the United States

Australia has a unique retirement income system combining mandated individual savings and a means-tested government pension. Its experience will provide valuable lessons for the United States, which is increasingly dependent on individual account programs and is considering ways to expand pension coverage. The most important lessons are discussed below.

### *Improving Individual Account Programs*

The reforms Australia introduced in its Superannuation Guarantee program address a serious weakness in individual account programs – the limited ability of participants to manage their savings – far more aggressively than recent U.S. initiatives.

- Participants often accept their plan's default investment option. While both the United States and Australia have introduced guidelines for default investment allocations, Australia's greater emphasis on defaults should ensure that their guidelines have a more far-reaching impact.
- Most participants also need good advice and information. While both the United States and Australia have restricted compensation structures that create conflicts of interest, Australia is actively promoting the availability of advice, using standardized information on risks and fees and an expansion of "simple advice," and has imposed a fiduciary mandate on those who advise plan participants.

Australia's experience with these initiatives should improve the performance of individual account programs.

### *Mandatory Retirement Saving*

Australia has achieved nearly full pension coverage of workers through mandatory employer contributions. In contrast, coverage in the United States is a serious concern, especially given the backdrop of a contracting Social Security program. Fewer than half of U.S. workers have any coverage in their current job. Even workers with coverage often have only modest account balances due to low contribution rates.<sup>21</sup> In addition, Australia restricts access to retirement saving *before* retirement, while such access is more open in the United States through cashing out 401(k)s when changing jobs, taking out loans, and making hardship withdrawals. Thus, Australia's experience in establishing broad coverage, accruing substantial assets, and preserving these funds until retirement can provide useful lessons for U.S. policymakers and practitioners.

## Conclusion

Australia's retirement income system has produced high levels of individual saving and broad coverage at relatively low cost to the government. No system is perfect, and key aspects of Australia's system remain a concern. These include the existence of incentives to game the system, weak annuity markets, and low levels of financial literacy.

Australia has recently enacted reforms that should strengthen the individual account component of its retirement income system. These include improvements in plan defaults and the presentation of information and controls on conflicts of interest in the provision of financial advice. Australia's experience with these reforms, and with mandated saving and means-tested programs, provide valuable lessons for the United States, which increasingly depends on 401(k)-type accounts in the context of a shrinking Social Security system.

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# APPENDIX

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## Appendix: Five Most Popular Superannuation Fund Types

- *Retail Funds.* Retail Funds, with 15.4 million members in 2012, are for-profit Funds and are open to anyone. These Funds are run by financial institutions and insurance companies. Investment choice is offered in 73 percent of Retail Funds, which hold 98 percent of all Retail Fund assets.<sup>22</sup>
- *Industry Funds.* Industry funds, with 11.7 million members in 2012, are not-for-profit Funds that are generally open to all. However, some may restrict membership to individuals working in a specific industry. They are run solely for the benefit of their members and include trustee boards with representation from employers and employees. Profits are returned to members' accounts. The great majority are accumulation funds (individual savings funds, not defined benefit pension plans), with investment choice offered in 93 percent of Industry Funds, which hold 99 percent of Industry Fund assets. Investment options are generally limited compared to options in Retail Funds.
- *Public Sector Funds.* Public Sector Funds, with 3.4 million members in 2012, are not-for-profit funds and generally open to Commonwealth, state and territory government employees. Many of these Funds started as defined benefit plans but a majority are now accumulation funds. Investment choice is offered in 74 percent of Public Sector Funds, which hold 99 percent of Public Sector Fund assets.
- *Self-Managed Superannuation Funds (SMSF).* SMSF funds, with 0.9 million members in 2012, are known as "do-it-yourself" Funds because individuals manage their own accounts. A SMSF can have between 1 to 4 members and each member is a trustee. Anyone can set up a SMSF. Unlike other Funds, the Australian Prudential Regulation Authority (APRA) does not regulate these Funds. The Australian Tax Office (ATO) is the regulator. These Funds offer access to a broader range of investments than other funds, including direct property investments.
- *Corporate Funds.* Corporate Funds, with 0.6 million members in 2012, are generally accumulation funds restricted to employees of a specific company, though some allow family members to join and/or allow participants to keep their savings in the Fund after termination from the company. They are not-for-profit funds run by a board of trustees with equal representation of employees and the employer-sponsor. The trustees can manage the investment options directly or have the investment options managed by an Industry or Retail Fund. Investment choice is offered in 47 percent of Corporate Funds, which hold 93 percent of Corporate Fund assets.

TABLE 1: SUPERANNUATION FUND TYPES BY MEMBERS AND ASSETS

Superannuation fund type	Members (in thousands)			Assets (in \$Aud billions)		
	2004	2012	% Growth	2004	2012	% Growth
Retail	13,764	15,408	12 %	\$207.4	\$371.4	79 %
Industry	8,946	11,664	30	\$94.0	\$267.3	184
Public sector	2,707	3,371	25	\$112.1	\$222.7	99
SMSF	524	914	74	\$127.5	\$439.0	244
Corporate	774	551	-29	\$50.5	\$56.1	11

Source: Australian Prudential Regulation Authority (2013).



## Endnotes

- 1 Chomik and Pigott (2012a).
- 2 “Superannuation,” a term not commonly used in the United States, refers to being too old to work.
- 3 Bateman (2010).
- 4 Women had been eligible as early as age 60. Women born between July 1, 1947 and December 31, 1948 qualify at 64 years and 6 months. Beginning with those born January 1, 1949, women will have the same retirement age as men. Australian Department of Human Services (2013).
- 5 Bateman (2013).
- 6 Beginning July 2013, there will be no upper age limit for employer contributions. In addition, the flat rate method of taxation on contributions and earnings has drawn criticism from academics. For more on the debate, please see Chomik and Pigott (2012b).
- 7 Australian Prudential Regulation Authority (2013).
- 8 Bateman (2011). With roughly 70 percent of the population owning their own home, home ownership should be considered Australia’s most important form of voluntary retirement saving (Australian Bureau of Statistics, 2010).
- 9 For an overview of the major reforms, see Chomik and Pigott (2012a).
- 10 Note that age-based and risk-based allocations are allowed. The board of trustees may set the default asset allocations subject to their trustee duties and the MySuper legislation.
- 11 Australian Department of the Treasury (2013a).
- 12 Bateman, et al. (2011).
- 13 Australian Securities and Investments Commission (2012).
- 14 Australian Department of the Treasury (2013b).
- 15 In the United States, the U.S. Department of Labor has proposed a similar type of reform to eliminate payments from mutual funds to financial broker-dealers that may result in conflicted advice to clients with Individual Retirement Accounts.
- 16 Munnell and Sass (2006); Chomik and Piggott (2012b).
- 17 For workers retiring with defined benefit plans, which are typically cashed out as a lump sum amount, the size of Superannuation balances is not the correct measure of “gaming capacity.”
- 18 Agnew, Bateman and Thorp (2013a and 2013b).
- 19 Agnew, Bateman, and Thorp (2013b).
- 20 Australian Prudential Regulation Authority (2013). Statistics report that in June 2012 the dollar amounts being distributed in lump sums and income stream products were essentially equal. Note that these June numbers do not reflect the decision breakdown for new retirees in 2012 because they can include 2012 income stream distributions for individuals who began withdrawing their pension before this year.
- 21 Munnell (2012).
- 22 Statistics related to the proportion of entities offering investment choice and assets in entities offering investment choice are from APRA (2013). These are statistics for entities with more than four members. Therefore, statistics for SMSF Funds are not available.

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