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AUSTRALIA'S PRIVATIZED RETIREMENT SYSTEM: LESSONS FOR THE UNITED STATES

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Like the United States, Australia has been confronted by a dual crisis in its government-run old-age pension system. Benefits payments to an aging population threatened to consume ever larger amounts of Australia's budget according to projections in the 1980s, yet the Australian Social Security system clearly was unable to provide an adequate income for retirees.

In 1986, in an effort to address these serious problems, a left-of-center Labor government began to implement an innovative retirement system based primarily on mandatory private savings in plans called "superannuation[1] funds." This system, which in 1992 became known as the Superannuation Guarantee, continued to be modified and expanded and now features three key elements. First, workers contribute a set percentage of their income through their employer to private savings plans. By 2002, when the system is fully implemented, all workers will be required to set aside 9 percent of their income in a superannuation fund of their choice (see Appendix 1). This mandatory savings can be augmented by tax-favored voluntary contributions. Second, upon retirement, workers will have accumulated a large nest egg from which to draw a secure and comfortable annual income. Third, a safety-net program guarantees that all retirees will receive an income that at least matches the income they would receive under the original government-run program.

1 In Australia, the term superannuation refers to funded retirement income plans.

Even though Australia's private retirement savings plan is still very young, it is quite popular. The benefits which have begun to materialize herald a significant long-term improvement in the Australian economy. For example:

- **More income for retirees.** In the future, average-wage workers should be able to retire with two to three times the income they would have had under the original government-run system, depending on the level of additional voluntary savings and the earnings performance of the superannuation funds.
- **Increased national savings.** The overall savings rate could climb by more than 3 percent of gross domestic product (GDP) by 2020. Already, private savings in superannuation funds have skyrocketed, rising from Au$40 billion[2] (US$28 billion) in 1985 to Au$304 billion (US$240 billion) as of June 1997.
- **Reduced pressures on the budget.** Because eligibility for taxpayer-financed age pensions is now means-tested,[3] the higher incomes made possible by privatization will lead to substantial budget savings. Government spending on age pensions will reach only 4.72 percent of GDP in 2050, one-third less than would have been needed had the government chosen to provide an American-style universal Social Security retirement benefit. (In the United States, Social Security retirement outlays are expected to consume 5.59 percent of GDP by 2050.)

The United States faces many of the same challenges that Australia confronted in trying to ensure an adequate retirement income for its aging population.[4] The U.S. Social Security system is expected to begin running a deficit by 2012. As the baby-boom population approaches retirement, policymakers grapple with a serious dilemma: How can they reform Social Security to give American workers a comfortable and secure retirement while addressing the system's massive long-term deficit?

As a model for reform, Australia's transition from a government-run benefits program to a system based on private savings was a resourceful answer to the challenges the Australian government faced. Like similar privatization efforts in Chile and Great Britain, Australia's system offers legislators in the United States several key lessons for reforming the troubled Social Security system.[5]

2 For the purposes of this discussion, all amounts will be given in Australian (Au) dollars first, with their equivalent value in U.S. dollars following, at the average exchange rate in March 1997 of Au$1.00 = US$0.7888.

3 Means-testing refers to policies that restrict government benefits to those with lower incomes.

4 Daniel J. Mitchell, "Creating a Better Social Security System for America," Heritage Foundation *Backgrounder* No. 1109, April 23, 1997.

5 For more information on reform in other nations, see Louis D. Enoff and Robert E. Moffit, "Social Security Privatization in Britain: Key Lessons for America's Reformers, Heritage Foundation *Backgrounder* No. 1133, August 6, 1997; Daniel Finkelstein, "The Policy and Political Lessons of Britain's Success in Privatizing Social Security," Heritage Foundation *Committee Brief* No. 30, September 29, 1997; and Jose Piñera, "Empowering Workers: The Privatization of Social Security in Chile," Cato Institute *Cato's Letters* No. 10, 1995.

WHY AUSTRALIA HAD TO REFORM ITS PENSION SYSTEM

The government-run old-age pension system in Australia was created in 1909 to help lower-income retirees. The government progressively began relaxing means-testing and moving toward a universal age pension after World War II.[6] By 1983, all Australians over the age of 69 received a full age pension regardless of income, and the rules for men 65 to 69 years old and women from 60 to 69 years old were so lax that almost all of them qualified for a full age pension as well.

This Social Security system was just one part of a massive expansion of government's role in the Australian economy between 1901 and 1983. Among other things, policymakers tried to promote industrial development through high tariffs and subsidies to manufacturers. The government nationalized most energy, telecommunications, and transportation companies. It also created a highly centralized system of wage bargaining, known as the Award System, in which employer organizations, labor unions, and the government jointly established wages and working conditions across entire industries based on concepts of "social justice" rather than on market conditions. The economic impact of these policies, not surprisingly, turned out to be negative. Australia's per capita GDP went from the highest in the world in 1900 to 14th by 1980.[7]

This long-term decline, as well as fears of a more immediate economic crisis, drove the newly elected Labor government in 1983 to implement fundamental changes in Australia's economic policies. Then-Treasurer Paul Keating best summarized the challenges facing Australia:

> We must let Australians know truthfully, honestly, earnestly, just what sort of international hole Australia is in.... If this government cannot get...a sensible economic policy, then Australia is basically done for. We will end up being just a third rate economy.... Then you are gone. You are a banana republic.[8]

As part of the new Labor government's comprehensive economic reform program, the Social Security system was given a thorough re-examination. Prime Minister Bob Hawke and Treasurer Paul Keating found that government policy discouraged private savings and left too many Australians dependent on Social Security age pensions as their primary source of retirement income. Moreover, these policies were causing adverse consequences for the nation's economy. The dire problems confronting Australian policymakers included the following:

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6 Over time, Australia incorporated age pensions into a broader system that also provided income support payments to the disabled, the unemployed, and low-income families. Unlike Social Security in the United States, which is funded through dedicated employer-employee payroll taxes, the Australian Social Security system is funded from general federal revenue primarily through an individual income tax, a company income tax, and a wholesale sales tax. Although Australian states levy payroll taxes on employers, state payroll taxes are unrelated to the Australian Social Security system. In addition, age pension payments are not related to earnings, as they are in the U.S. Instead, the payments are a flat amount equal to approximately 25 percent of the average earnings for male workers. Married couples receive a flat rate benefit equal to approximately 40 percent of the average wage.

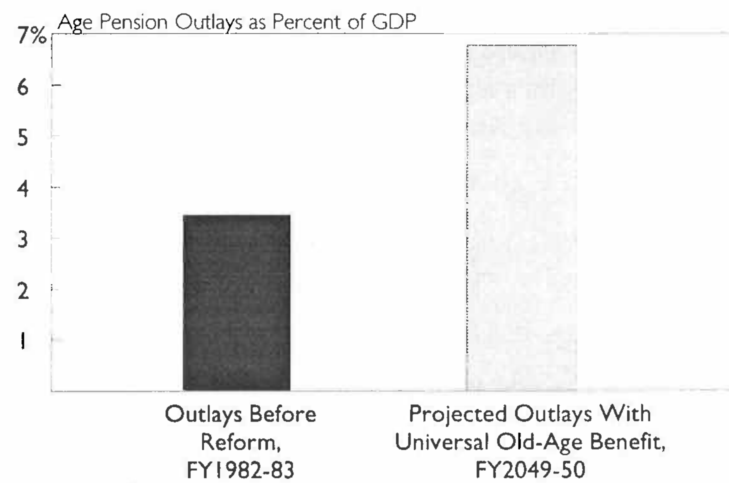
7 Paul Kelly, *End Of Certainty: The Story of the 1990s* (St. Leonard's, New South Wales: Allen-Unwin, 1994).

8 The "banana republic" comment was made during a radio interview with John Laws on May 14, 1986.

- Less than 40 percent of all workers participated in public or private pension plans (superannuation funds) before 1983, and coverage was limited to government employees, financial sector workers, professionals, and senior business executives.[9]
- Accumulated retirement savings generally could not be transferred from one employer's superannuation fund to another when an Australian changed employment.
- This lack of portability, along with the preferential tax treatment of lump-sum distributions—95 percent of lump-sum distributions from superannuation funds were tax exempt—often meant that superannuation merely provided high-income Australians with a way to acquire virtually tax-free income upon changing employment.
- Dependence on Social Security age pensions contributed to reduced national savings and depressed economic growth. Indeed, Australia's national savings rate had declined from an average of more than 25 percent in the early 1970s to 16.1 percent in fiscal year 1991–1992.[10]
- The population was growing older. From 1994 to 2051, the number of Australians 65 or older will climb from 11.9 percent to about 23 percent of the total population.
- The growth in the aging population also means that dependence on Social Security age pensions would threaten long-term fiscal stability. Age pension payments consumed 3.44 percent of GDP in FY 1982–1983 and were projected to rise dramatically as the population aged, potentially reaching 6.8 percent of GDP by FY 2049–2050 if Australia continued on the path to a universal age pension like the U.S. Social Security program.[11]

Chart 1

Under the Old System, Government Old-Age Pension Outlays as a Share of GDP Were Expected to Double



Source: Retirement Income Modeling Unit, Australian Treasury.

9 *Saving for Our Future*, statement by Ralph Willis, M.P., Treasurer of the Commonwealth of Australia, May 9, 1995, p. 1.

10 The Australian government's fiscal year runs from July 1 through June 30. See V. W. FitzGerald, *National Savings: A Report to the Treasurer*, June 1993, p. 2.

11 *Ibid.*

THE PRIVATE SAVINGS SOLUTION

To address these serious problems, the Labor government decided to restructure Australia's retirement policy. Policymakers decided that a new system should satisfy three goals:

1. **Provide** more retirement income for future retirees,
2. **Increase** national savings, and
3. **Reduce** long-term pressures on the budget.

The government concluded that the best way to achieve these goals was to reduce the scope of government tax-and-transfer schemes and instead promote greater individual reliance through a system of mandatory private savings. As a result, the Labor government took the following steps during its 13 years in power:

- **Means-testing of age pensions.** In 1983, the Labor government reversed the trend toward a universal old-age pension and strengthened means-testing for age pensions. The existing income-based means test was extended to Australians age 70 or over. A new asset-based means test also was imposed (see Appendix 2).
- **Superannuation portability and penalties for pre-retirement withdrawals.** To encourage Australians to preserve their superannuation savings until retirement, two new rollover vehicles were created in 1983—approved deposit funds and deferred annuities. These vehicles allowed Australians to keep their superannuation savings when they changed jobs. In addition, a 30 percent tax was imposed on lump-sum withdrawals from superannuation funds before age 55.
- **Award Superannuation.** In 1985, the Labor government reached an agreement with Australia's chief labor organization, the Australian Council of Trade Unions, to seek a universal 3 percent contribution for each employee to a superannuation fund in lieu of a general wage increase through the Award System. In 1986, the Industrial Relations Commission endorsed this agreement and incorporated this employer mandate into all future labor contracts. As of July 1991, 72 percent of all employees were covered by Award Superannuation.
- **Superannuation Guarantee.** In 1992, the government introduced the Superannuation Guarantee (SG) to expand Award Superannuation to cover virtually all workers.[12] Under SG, every employer is required to contribute a prescribed minimum on behalf of each employee to a superannuation fund. The required minimum contribution was set at 3 percent of an employee's earnings in FY 1992–1993 and will rise gradually to 9 percent by 2002–2003.[13] Savings in superannuation funds are fully vested and portable between employers. Under current law, savings in superannuation funds must be preserved until retirement after age 55.[14]

In March 1996, Australians elected a Liberal Party-National Party coalition government which made further reforms in the system in May 1997. These included:

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12 The few remaining exclusions include workers under age 18 and over age 65, temporary foreign workers, and those with very low incomes.

13 The superannuation requirement applies only to the first Au$90,360 of income. For income above that level, the decision to save is voluntary.

- **Tax relief.** To promote additional non-compulsory private savings, the tax burden was lowered on savings. During the 1998–1999 fiscal year period, individuals will be allowed a 7.5 percent tax credit of up to Au$225 (about US$177) and a 15 percent tax credit in 1999–2000 and beyond of up to Au$450 (US$355). These credits will apply to savings income and/or additional voluntary contributions to superannuation accounts.[15]

- **Consumer choice.** Private-sector workers were given the right to choose a fund from at least five options into which their employers would deposit their superannuation savings. As of July 1, 1998, these options must include (1) any relevant industry superannuation fund, (2) any corporate superannuation fund, (3) at least one retail superannuation fund, and (4) a new kind of superannuation fund—the Retirement Savings Account (RSA)—provided by the bank or financial institution receiving an employee's pay. RSAs are low risk/low return capital guaranteed funds offered by banks, building societies, credit unions, and life insurance companies.[16]

- **More retirement income.** To maximize the amount of savings in each superannuation account (and therefore the size of the annuity that could be purchased), early hardship withdrawals are prohibited, and the preservation age before which no withdrawals could be made will be raised from 55 in 2015 to 60 by 2025.[17]

- **Gender neutrality.** The government age pension program was modified to ensure equal treatment for men and women. Currently, women may receive age pensions at age 61 while men must wait until age 65. As of 2013, neither sex will be able to qualify for the government safety-net program until age 65.[18]

RETAINING THE SAFETY NET

Although there is a strong consensus in Australia that individuals should be responsible for saving for their own retirement, a safety net will remain in place to ensure that no one will be worse off under the privatized system. In effect, every retiree is guaranteed an age pension equal to 25 percent of the average worker's wage—exactly what was available before privatization.[19]

Moreover, the means-testing provisions for the government age pension are extremely generous. Even though almost all retirees will have some income from their superannuation savings, more than 33 percent of senior citizens in 2050 will get a full age pension from the government.[20] All told, a full 75 percent of the elderly population in 2050 will

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14 The Labor government also had plans for additional mandatory savings. It decided in 1995, for instance, that all employees would begin making mandatory co-contributions of 1 percent of earnings in FY 1997–1998, rising to 3 percent of earnings in FY 1999–2000, to their superannuation accounts. The government simultaneously proposed matching this contribution with a government contribution of up to 1 percent of an employee's FY 1998–1999 earnings, rising to 3 percent of earnings in FY 2000–2001. These projected changes were repealed by the coalition government elected in 1996.

15 *Budget Measures, 1997–1998*, Australian Treasury, May 13, 1997, pp. 186–187.

16 *Ibid.*, pp. 189–191.

17 *Ibid.*, pp. 192–194.

18 *Budget Measures, 1996–1997*, Australian Treasury, May 1996.

19 Married couples under the old system received an age pension equal to 40 percent of the average worker's wage.

20 Preliminary projections by the Retirement Income Modeling Unit of the Australian Treasury, by facsimile to authors.

have their private savings income supplemented by full or partial government benefit payments.[21]

These generous payments reflect Australia's primary goals in adopting mandatory superannuation: boosting retirement incomes and increasing national savings. Reducing government spending was a lower priority. And while there will be significant long-term budget savings, they will not be nearly as large as they could have been with a stricter means-testing policy, a more rapid implementation of the SG savings mandate, and elimination of the gap between the SG preservation age and the qualification age for age pension payments.

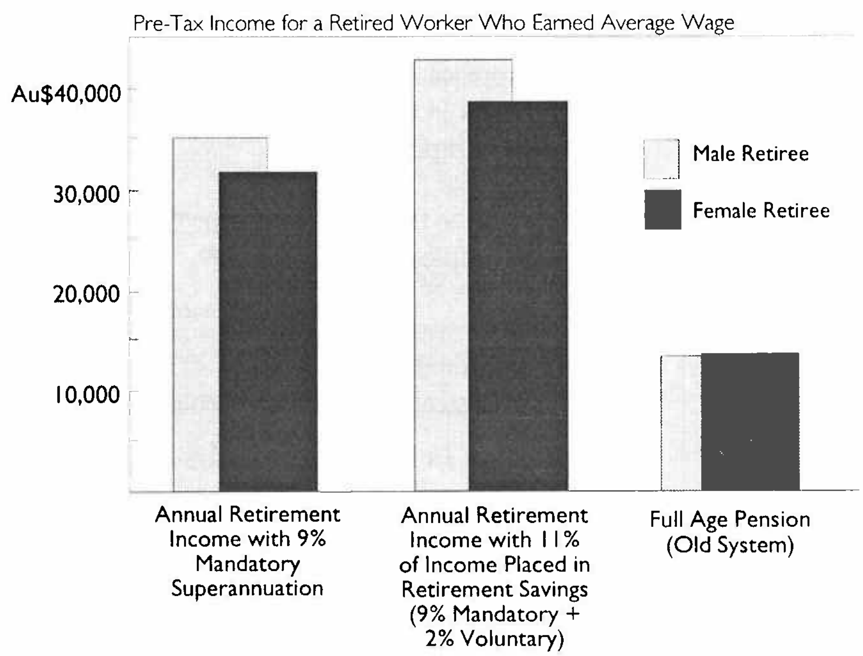
THE RESULTS OF SUCCESSFUL REFORM

By every possible measure, the Australian move to privatization thus far must be considered a success. The Labor Government had committed itself to establishing a system that would satisfy three major goals: providing more income for retirement, increasing savings, and reducing long-term pressures on the budget. As the following information illustrates, Australia is well on its way toward achieving those goals.

More Income for Future Retirees

Chart 2

Average Annual Real Retirement Income from Australia's Privatized System is Significantly Higher Than Previous System



Notes: One Australian dollar= U.S.$ 0.788. Income levels based on a 40-year working life with retirement at age 65, 5 percent annual real return on superannuation investments, 3 percent real return on annuity, all calculations are on a pre-tax basis. Difference between male and female workers is based on differences in longevity, not pre-retirement income.
Source: Retirement Income Modeling Unit, Australian Treasury.

Increasing the level of private savings will result in significantly higher retirement income for Australian workers. Predicting exactly how much higher is, of course, difficult because retirement income under the private system will depend on the earnings performance of the superannuation funds as well as the level of additional voluntary contributions. Yet even pessimistic scenarios show that privatization will boost old-age income substantially.

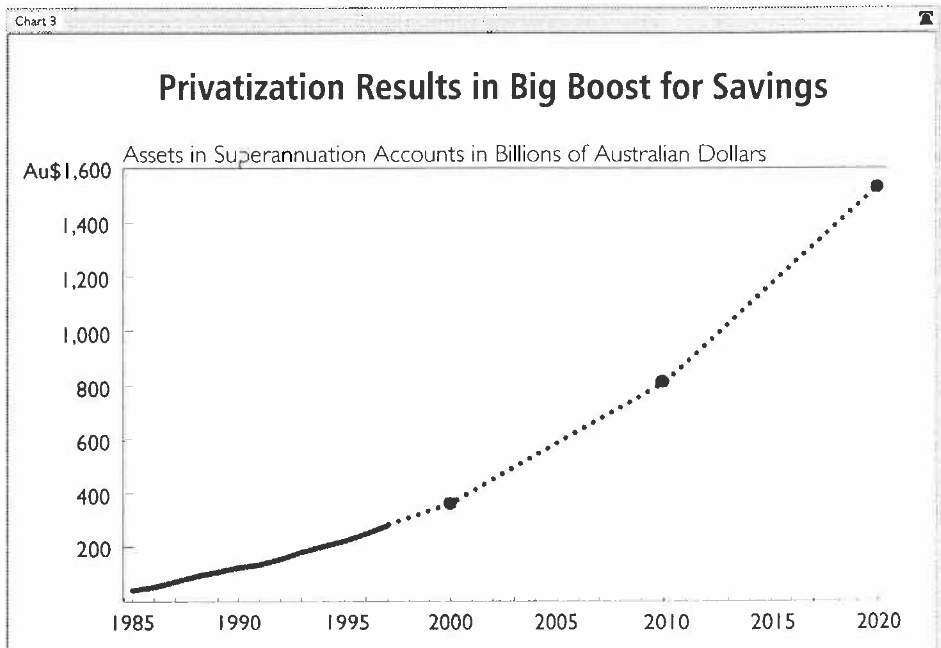
The Australian Treasury's Retire-

21 *Ibid.*

ment Income Modeling Task Force, for instance, computed that average-wage workers who made no voluntary contributions and earned only 4 percent in real returns each year (a modest figure, since the average over the last 10 years has been 5.5 percent) will be able to retire with nearly twice as much income as they would have had under the old government-run system.[22] More realistic assumptions, such as higher average returns and some degree of voluntary savings, have demonstrated that privatization easily could mean more than twice as much, and perhaps about three times as much, retirement income for the average Australian worker. As Appendix 3 illustrates, the benefits for different demographic examples are similarly startling.

Increasing National Savings

The amount of funds in superannuation accounts has soared from 17 percent of GDP in 1985 (Au$40 billion) to more than 55 percent of GDP in 1997 (Au$304 billion). By 2020, superannuation assets are projected to reach more than 100 percent of GDP (Au$1,525 billion, or US$1,202 billion).[23]



Source: Retirement Income Modeling Unit, Australian Treasury. For more information, see official RIM website, *http://www.treasury.gov.au/organisations/rimtf/*

Policies to boost the level of voluntary savings also seem to be highly successful. One-third of superannuation deposits in the most recent reporting period, for instance, came from unforced employee contributions.[24] All told, superannuation is projected to increase Australia's national savings rate by at least 3 percent of GDP.[25]

A Reduction in Long-Term Budget Pressures

Age pension reform and the growth of superannuation funds will have a long-term positive impact on Australia's fiscal position. Before reform, Australia had an almost universal age pension. The Australian Treasury's Retirement Income Modeling Task Force

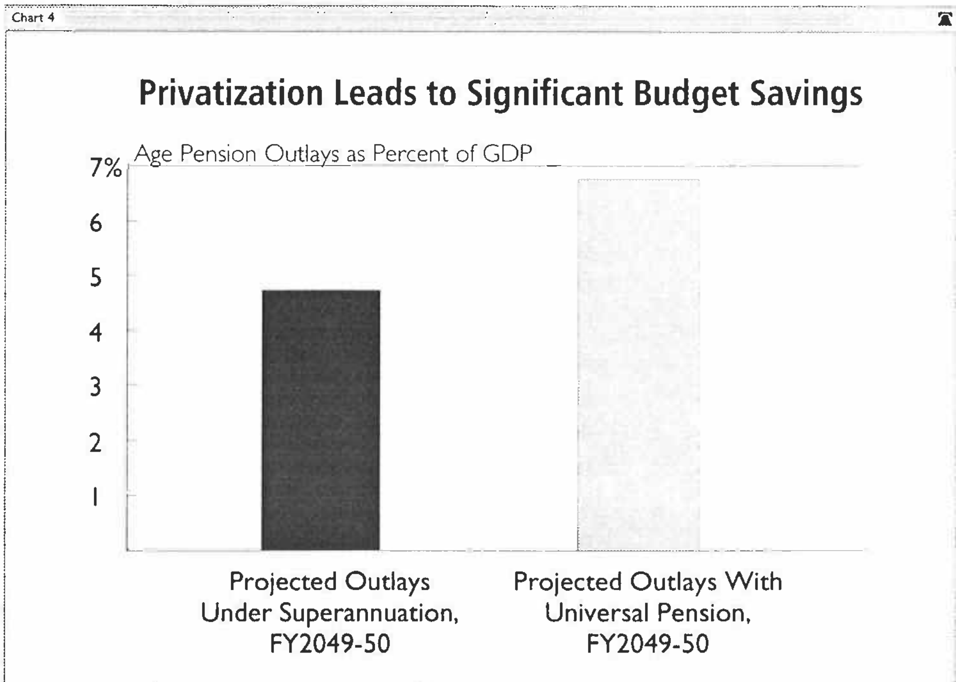
22 *Ibid.*

23 George P. Rothman, "Aggregate Analysis of Policies for Accessing Superannuation Accumulations," available at the Retirement Income Modeling Task Force Web site: *www.treasury.gov.au/organisations/rimtf.*

24 Media release, Insurance and Superannuation Commission, July 6, 1997.

25 Data supplied to authors by Vince FitzGerald. See also Phil Gallagher, "Assessing the National Saving Effects of the Government's Superannuation Policies," available at the Retirement Income Modeling Task Force Web site: *www.treasury.gov.au/organisations/rimtf.*

estimates that outlays for a universal age pension would have consumed 6.76 percent of GDP in FY 2049–FY 2050.[26] Because the Labor government strengthened means testing for age pensions and initiated the Superannuation Guarantee, however, age pension outlays will be only 4.72 percent of GDP in FY 2049–FY 2050.



Source: Retirement Income Modeling Unit, Australian Treasury.

POTENTIAL FUTURE CHANGES

Australian policymakers are largely satisfied with the core components of their newly privatized retirement system. Across the political spectrum, legislators understand the flaws of the old government tax-and-transfer scheme and recognize that private savings can provide a more comfortable and secure retirement for the nation's senior citizens. Nonetheless, some features of the new system continue to provoke debate, and it is certainly possible that changes may be made in the near future. The issues that are most likely to attract reform are:

- **The tax treatment of superannuation.** The coalition government announced that it will conduct a complete review of Australia's tax code. Many lawmakers believe the tax laws are needlessly complex and impose unnecessarily harsh penalties on work, savings, and investment. It is therefore possible that, as part of comprehensive reform, Australia might choose to follow the lead of other nations with private retirement systems and abolish taxes on superannuation contributions and annual fund earnings, taxing withdrawals upon retirement instead.[27] In other words, rather than impose the 15 percent tax on workers' contributions made by employers as well as the high income surcharge, it might make contributions to superannuation funds tax deductible. Moreover, both the 15 percent tax on interest and dividend income in superannuation funds and the 15 percent tax credit on withdrawals after retirement would be repealed. These changes would accelerate the accumulation of assets within members' superannuation funds during their working years and reduce

26 Data supplied to authors by the Treasury's Retirement Income Modeling Task Force.

27 This tax treatment (deductible contributions and taxable withdrawals) is known as the "IRA approach" to savings. Another simple and neutral tax regime for long-term savings is to tax superannuation contributions, but then to impose no tax on earnings and eventual withdrawals. This "municipal bond approach" is economically equivalent to the "IRA approach." Neither approach, of course, makes the mistake of taxing the annual earnings of the fund.

their dependence on the age pension after retirement. This approach would also ensure that the Australian tax code does not put a disproportionately heavy burden on income that is saved.

- **A mandate that superannuation assets be used to finance retirement income.** Australians can manipulate the current system in two ways to increase their age pension payments from the government. First, the gap between age 55, when SG benefits can be withdrawn, and age 65 (age 61 for women), when age pension payments commence, could tempt some Australians to use their superannuation funds to finance early retirement and then rely on taxpayer-financed age pensions after age 65. The coalition government previously agreed to raise the SG preservation age from 55 in 2015 to 60 in 2025, but this leaves a gap of five years. Pension experts advocate eliminating this gap to prevent citizens from "double-dipping." In addition, current law allows retirees to make large lump-sum withdrawals from their superannuation funds. This may tempt some workers, even those who work until age 65, to dissipate their retirement funds by purchasing "big ticket" consumption items immediately and then relying more heavily on taxpayer-financed age pensions. In order to ensure that retirement savings are used for retirement income, the government may decide to require that at least a portion of superannuation funds be used to purchase an annuity which would provide a minimum level of income in regular increments over time.

PARALLELS TO PRIVATIZED RETIREMENT SYSTEMS IN CHILE AND BRITAIN

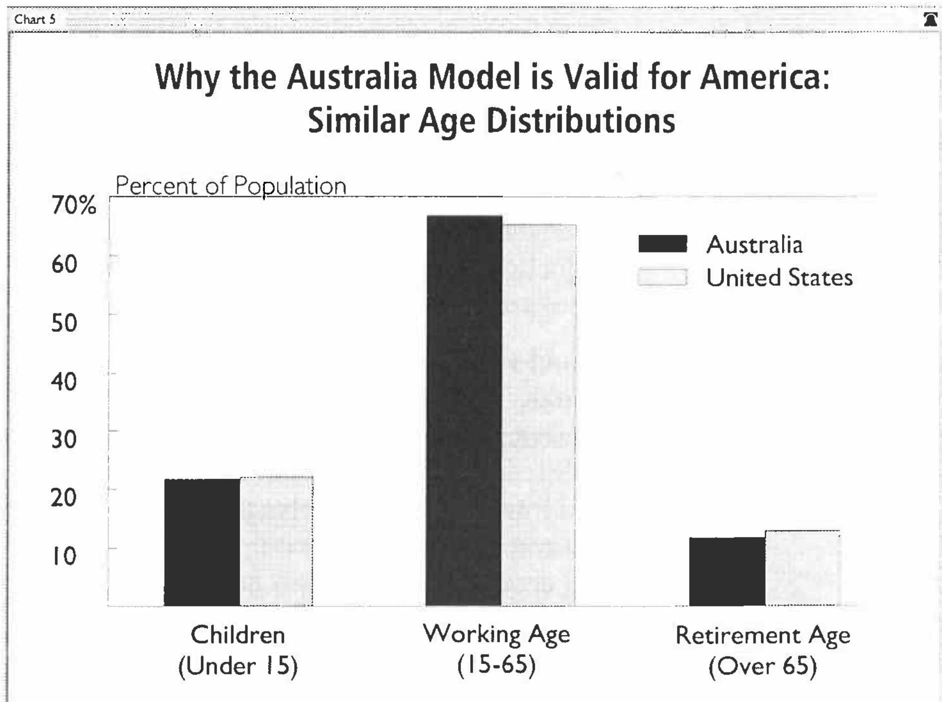
As various nations around the world rush to privatize their retirement systems and secure retirement income for their senior citizens, Americans continue to fear for the future of their Social Security system. Reformers can learn much from studying what other countries are doing. And though an exhaustive comparison of the systems is beyond the scope of this paper, it is worth noting how Australia's system compares with those of Chile and Great Britain, two other countries whose privatization efforts have attracted considerable attention.

Chile privatized its old-age system in the early 1980s, replacing a tax-funded income-transfer scheme with a system based on mandatory individual savings. The amount of savings mandated for retirement accounts in Chile is 10 percent, which is quite similar to Australia's 9 percent superannuation charge. Chile's system, however, has advantages and disadvantages. On the positive side, Chile imposes a simple and neutral tax treatment on retirement savings. Moreover, it imposes the savings mandate directly on the worker instead of using the employer as a middleman. Since labor economists are virtually unanimous in recognizing that employer-financed benefits (such as payments into pension funds) come out of worker compensation, the Chilean approach deserves applause for its honesty. However, Chile's pension funds are subject to excessive regulation, a drawback which has the effect of limiting diversity and creating higher than necessary administrative costs as funds compete for customers on the basis on non-performance criteria.

Britain has a two-tiered retirement system. The first tier is an almost universal flat-rate benefit provided by the government. The second tier depends on earnings, and workers can choose to use the government system or select a private pension alternative. Only 17 percent of workers have elected to stay in the government-run program thus far, while 73 percent have decided to divert 4.6 percentage points of their payroll tax into a private fund. Two differences between Australia's system and Britain's are worth highlighting. First, the system in Great Britain is best categorized as partial privatization (though the Labor government may propose more complete privatization sometime next year), while Australia's has been more sweeping. However, Australia's privatized system, like Chile's, does not compare favorably in terms of tax treatment. The British government does not tax contributions to the accounts or the annual earnings of the accounts. Instead, it imposes one layer of tax at the time of withdrawal.

LESSONS FOR AMERICAN SOCIAL SECURITY REFORMERS

The United States and Australia are similar in many respects. In Australia, 11.9 percent of the population is 65 or older, compared with 12.7 percent in the United States. Both are high-income, developed countries with stable democratic governments. The overall size and structure of their governments are also similar: General government outlays in 1996 were 36.9 percent of GDP in Australia and 35.8 percent of GDP in the United States. It is therefore reasonable to surmise that reformers in the United States would draw lessons from the Australian experience in reforming Social Security.



Source: Organization for Economic Cooperation and Development.

Indeed, when Australia's Labor government first embarked on this policy, it faced obstacles that are not unlike those that exist in the U.S. It had, for instance:

- 1.6 million retirees receiving government age pensions, a large majority of whom were apprehensive about any change in the existing system, and
- A highly skeptical working-age population of 8.4 million employees, many of whom doubted that politicians would make changes that would enhance their retirement.

Nevertheless, Australia overcame these challenges through an innovative privatization program combining mandatory contributions to private pension plans with means-testing of Social Security age pension benefits.

Some of the steps Australian policymakers took are applicable to the United States as well. To reform the Social Security system successfully, U.S. policymakers should:

1. **Be honest about the shortcomings of the current system.** The Labor government issued a series of reports, culminating in *Security in Retirement—Planning for Tomorrow Today* in 1992, which stressed that working-age Australians could not expect the federal government to provide them with adequate retirement incomes in the future.[28]

2. **Appeal to self-interest.** Australian leaders Bob Hawke and Paul Keating stressed that superannuation was the key to obtaining higher retirement incomes. In other words, working-age Australians needed to accumulate far greater private savings than they had in the past if they were to be secure in their retirement years.

3. **Appeal to national interest.** The Labor government reminded Australians about their country's low national saving rate compared to other developed countries, informing them that age pension reform and the Superannuation Guarantee, along with other macro-economic and micro-economic reforms, would accelerate Australia's economic growth and create new job opportunities.

4. **Protect existing beneficiaries.** Policymakers realized that benefit reductions for existing retirees or those near retirement would be a major political liability for reform. Even though benefit reductions would generate immediate budget savings, such outlay reductions would jeopardize the immense long-term benefits to citizens and the nation from privatization.

5. **Avoid relying on appeals that the reform is needed to balance the government's books.** The fiscal benefits from introduction of the Superannuation Guarantee were presented almost as an afterthought in Australia. Unlike in the United States, where politicians focus on the need for individuals to sacrifice through higher payroll taxes and lower benefits to solve the federal government's fiscal problems, discussions in Australia stressed how comprehensive reform would benefit individuals by accelerating economic growth now and increasing retirement incomes later.

There are many other features of the Australian system that offer valuable lessons to Social Security reformers because the two countries are so similar. But it is also worth noting the differences between the United States and Australia. One big difference is that it is easier to change government policy in a parliamentary system, in which one party generally controls all the levers of power, than in a presidential system of checks and balances. Australia has a unique mixture of British parliamentary and American constitutional traditions,[29] so it is not as easy for Australia to change policies as it is for other parliamentary nations such as Great Britain. Nonetheless, it is still easier to make policy changes than it would be for policymakers in the United States with its presidential system of checks and balances.

28 Statement delivered by John Dawkins, M.P., Treasurer of the Commonwealth of Australia, June 30, 1992.

29 Like the United States, Australia has a written constitution, a federal system in which states delegate specific and limited powers to Canberra, and courts with the power to rule specific acts of the federal or state parliaments unconstitutional. Like Great Britain, Australia has a responsible government under which the Prime Minister and state Premiers must command majority support in the lower houses of their respective parliaments. Australia has a Senate elected by the people through a proportional system. Because Australian governments seldom command a majority in the Senate, Prime Ministers—like U.S. Presidents—are forced to bargain with independent minor party and opposition Senators to secure enactment of their programs.

Pension reform in Australia was facilitated as well by the Award System of highly centralized collective bargaining. Indeed, the unions were one of the biggest advocates of using private savings to boost retirement income. Although this system of collective labor negotiations has been partially deregulated since 1996,[30] it helped the Labor government to introduce mandatory private retirement savings to the workforce. Needless to say, such a system does not exist in the United States.

Finally, the U.S. and Australian governments fund their Social Security retirement benefits through different methods. Australia funded its old system, and pays for the safety net portion of the new system, out of general tax revenues. In the United States, Social Security benefits are financed through payroll taxes. This significant difference actually could prove to be an advantage for reformers in the United States since policymakers could privatize the system by diverting some or all of current payroll taxes into private accounts, rather than by trying to impose a new savings mandate on American workers.

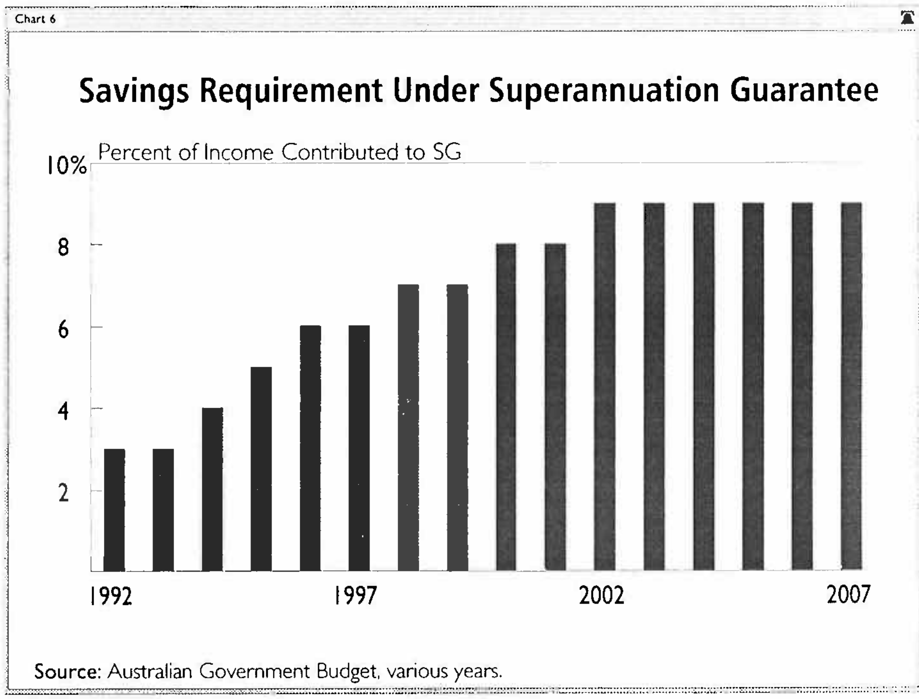
CONCLUSION

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

30 Australia's competitiveness is still hampered by the remnants of centralized labor markets, which helps to explain why unemployment remains over 8 percent. Along with high marginal tax rates, further deregulation of labor markets continues to be a challenge for Australian policymakers.

APPENDIX 1
How Australia's Superannuation Guarantee (SG) Works

Annual Savings Requirement. Currently, 6 percent of income must be saved in a superannuation fund. This rate will rise to 7 percent on July 1, 1998; 8 percent on July 1, 2000; and 9 percent on July 1, 2002. The charge is imposed on the first Au$90,360 (US$71,273) of pre-tax cash employment compensation; it is adjusted annually to keep pace with inflation (see Chart 6).



Collection of SG charge. Employers are responsible for withholding superannuation charges and depositing them in a fund selected by the worker. The burden of the charge clearly falls on the worker since it is part of total employee compensation, much as the individual income tax in the United States is a burden on workers even though it normally is withheld and sent to the Internal Revenue Service by employers.

Types of SG funds. According to the March 1997 Insurance and Superannuation Commission *Bulletin*, there are 137,808 superannuation funds in Australia.

- **Excluded funds.** The majority of all superannuation funds are small self-managed pension plans, known as excluded funds, containing fewer than five members. Taken together, excluded funds have 228,000 members and control 10.5 percent of all superannuation assets.
- **Trustee-managed funds.** In contrast, 16.1 million Australians are members of larger, trustee-managed superannuation funds. There are four types of trustee-managed funds: corporate, industry, public-sector, and retail.

    1. **Corporate funds** typically are set up by large private-sector employers. These funds have 1.4 million members and control 20.9 percent of all superannuation assets. The number of corporate funds is declining as more employers are meeting the SG mandate through retail funds.
    2. **Industry funds** are sponsored jointly by multiple employers and labor unions in an industrial sector. These funds, originally set up to receive the 3 percent Award Superannuation contributions, now have 5.7 mil-

lion members and control 6.3 percent of all superannuation assets.

3. **Public-sector funds** are established for employees of federal, state, and local government. They have 2.55 million members and control 23.2 percent of all superannuation assets. Some public-sector funds are not fully funded.

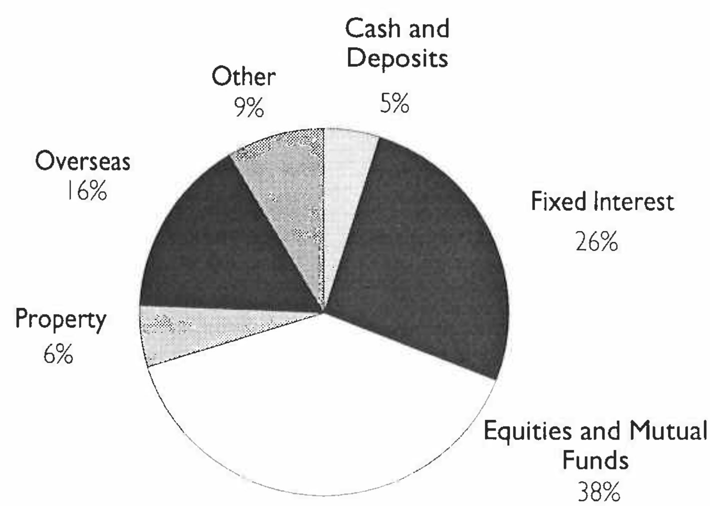
4. **Retail funds**, or public offer funds, are provided by financial institutions such as banks, insurers, and securities firms. Sold through intermediaries to those eligible to contribute to superannuation funds or holding superannuation savings for retirement, they typically are organized as master trusts, allowing members to direct their contributions among a number of mutual fund investment options. Currently, the 402 retail funds have more than 6.5 million members and control 24.2 percent of all superannuation assets.

Annuities. About 15 percent of superannuation assets are held by life insurance companies, usually on behalf of retirees.

Today, most corporate funds as well as almost all excluded, industry, and retail funds are defined contribution plans in which the member bears the investment risk. Many public-sector funds remain defined benefit plans in which the sponsoring employer is liable for pension payments to retirees regardless of whether accumulated contributions and earnings in the fund are sufficient to cover the pension payment liabilities. In March 1997, only 16 percent of all member accounts were in defined benefit funds. However, because most public-sector funds are defined benefit plans, 52 percent of all assets held by non-excluded funds were in defined benefit funds.[31]

Chart 7

Distribution of Superannuation Assets



Source: Insurance and Superannuation Commission, March 1997.

SG asset allocation and return. Overall, SG assets are allocated under management as shown in Chart 7. The Insurance and Superannuation Commission (ISC) reports that the average real rate of return for all superannuation funds was 5.5 percent for the 10 years ending on June 30, 1996.[32]

31 David M. Knox, unpublished manuscript, University of Melbourne, July 1997.

32 "Superannuation Investment Performance," *Insurance and Superannuation Bulletin*, Insurance and Superannuation Commission, Canberra, September 1996, p. 19.

SG regulation. Superannuation funds fall under the supervision of the Insurance and Superannuation Commission to ensure that fund managers do not engage in self-dealing or other forms of imprudent behavior. The ISC takes a light-handed approach, relying primarily on a high degree of disclosure of funds' policies and performance to members. Other than a 5 percent ceiling on in-house investments, the government imposes virtually no regulations or restrictions on the investment decisions of superannuation funds.

SG taxation. The tax treatment of superannuation is needlessly complex and excessive. Employees must pay a 15 percent income tax on employer contributions to their superannuation accounts. Workers earning more than Au$70,000 (approximately US$55,216) must pay an additional surcharge of up to 15 percent on employer contributions to their superannuation accounts.[33] Workers also must pay a 15 percent income tax on any interest or dividend earnings in their accounts. Withdrawals from superannuation accounts upon retirement are subject to Australia's income tax less a 15 percent credit. This credit is designed to partially offset the taxation imposed on both the original contributions and fund earnings.[34]

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33 The surcharge is 1 percent for each $1,000 of taxable income exceeding $70,000, up to a maximum of 15 percent for taxable incomes exceeding $85,000.

34 For lump-sum withdrawals under a reasonable benefit limit of Au$434,720 (US$342,907), a tax rate of 16.7 percent (30 percent income tax plus a 1.7 percent medicare levy less a 15 percent tax credit) is applied. For lump sums exceeding the reasonable benefit limit, the marginal income rate (including the medicare levy of 1.7 percent) is applied. For annuity purchases under a reasonable benefit limit of Au$869,440 (approximately US$685,814), annuity payments are taxed at the marginal income rate less a tax credit of 15 percent. The 15 percent tax credit does not apply to the portion of annuity payments attributable to the amount exceeding the reasonable benefit limit or to lump-sum withdrawals exceeding the reasonable benefit limit.

APPENDIX 2
Australia's Government Benefits Payments and Means-testing Provisions

Age Pension Benefits

	Maximum Biweekly Payment
Single	Au$347.80 (US$274.34)
Couple (each)	Au$290.10 (US$228.83)

- Age pensioners may also receive rent or residential care assistance, a pharmaceutical allowance, a telephone allowance, or a remote area allowance.

Income and Assets Tests

- The pension rate is calculated under both income and assets tests. The test which results in the lower rate is applied.
- Social Security payments are not counted as a part of income.

Income Test	Full Age Pension if biweekly income is equal to or less than	No Age Pension if biweekly income is equal to or more than
Single	Au$100.00 (US$78.88)	Au$806.40 (US$636.09)
Couple (combined)	Au$176.00 (US$138.83)	Au$1,347.20 (US$1,062.67)

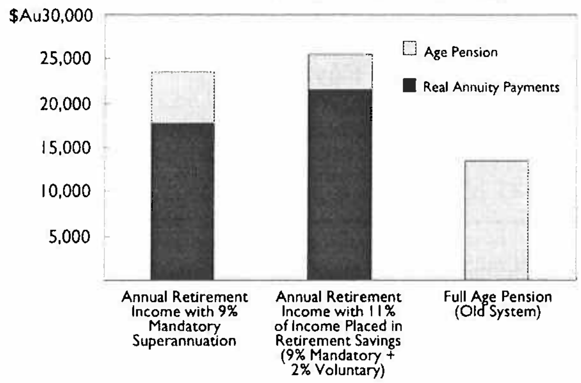
- The effective marginal tax rate on income over the amount for the maximum payment is 50 percent (single) and 25 percent (each for a couple).

Assets Test	Full Age Pension if assets are equal to or less than	No Age Pension if assets are equal to or greater than
Single, homeowner	Au$125,750 (US$99,192)	Au$243,500 (US$192,073)
Single, non-homeowner	Au$215,750 (US$170,184)	Au$333,500 (US$263,065)
Couple, homeowner (combined)	Au$178,500 (US$140,801)	Au$374,000 (US$295,011)
Couple, non-homeowner (combined)	Au$268,500 (US$211,793)	Au$464,000 (US$366,003)

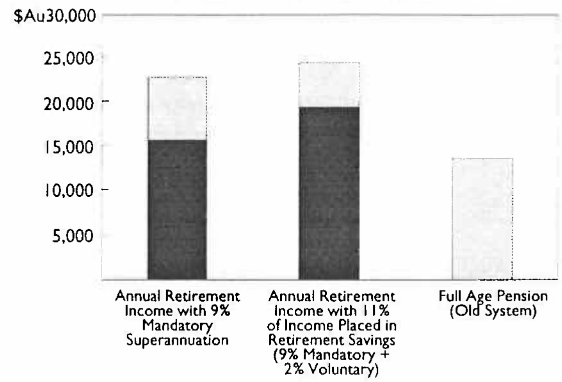
- The effective marginal tax rate on assets over the amounts for the maximum payment is 7.8 percent.

Case Studies: Average Annual Retirement Income for Selected Income Groups

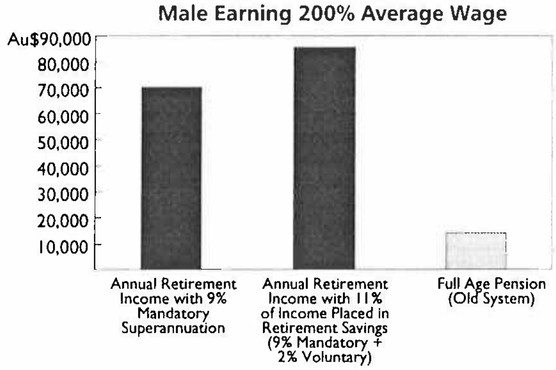
Male Earning 50% Average Wage



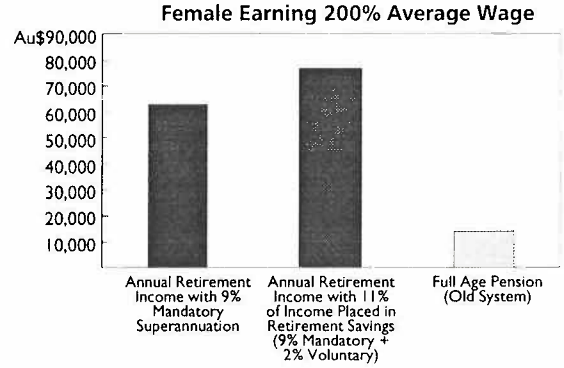
Female Earning 50% Average Wage



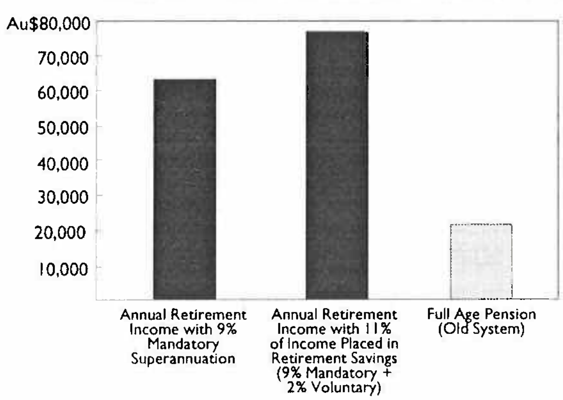
Male Earning 200% Average Wage



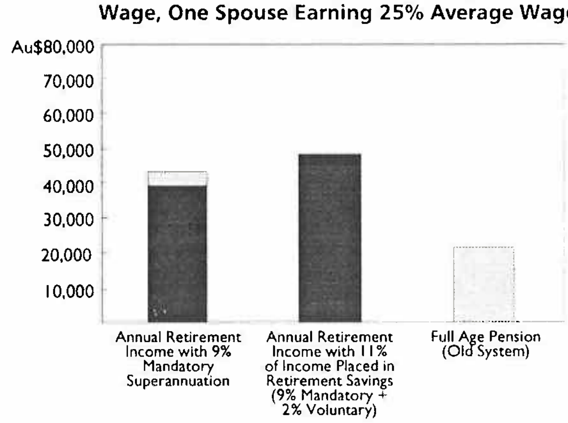
Female Earning 200% Average Wage



Married Couple, Both Earning Average Wage



Married Couple, One Spouse Earning Average Wage, One Spouse Earning 25% Average Wage



Notes: One Australian dollar= U.S.$ 0.788. Income levels based on a 40-year working life with retirement at age 65, 5 percent annual real return on superannuation investments, 3 percent real return on annuity, all calculations are on a pre-tax basis. Difference between male and female workers is based on differences in longevity, not pre-retirement income.

Source: Retirement Income Modeling Unit, Australian Treasury.