Keywords: superannuation, Cooper Review, retirement incomes, savings, regulation.

REVIEWING COOPER

In a well-known joke in which a traveller asks, 'How should I get to x?', the answer is, 'If I were you, I wouldn't start from here'. This paper examines the direction of Australian public policy in relation to superannuation, particularly the regulation of the industry. It is as much about 'Where is here?' as the attributes of the desirable destination.

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This paper provides some background on the descriptive, policy and relevant analytical economic dimensions of our current super arrangements. It also briefly describes relevant outcomes of the *Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System* (known as the Cooper Review) and assesses the policy attractiveness of some of the Review's proposals.

In relation to the question, 'Where is here?', the Cooper Review's answer is, 'It is near the hut of a cheaper guide who knows a shortcut'. However, in my view, 'that shortcut doesn't get as high up the mountain'.

Background

Description

Thanks to compulsory super, Australia has about $1 trillion in superannuation assets[1] (which is roughly equivalent to one year's GDP).[2] Regarding the individual pattern, the median balance in 2005–06 was about $25,000, the average a lot higher at $79,000, and distinctly favoured men over women.[3]

The future path (equation of motion) of this stock of super assets depends on:

> contributions, which have run at roughly 7 per cent of GDP over the past decade. In most years, employer contributions have significantly exceeded voluntary contributions from members;[4] and

> gross earnings less the 'intermediary costs' (fees, expenses, commissions etc.) of the superannuation industry less tax.

Super represents about one-fifth of identified net household wealth.[5] Just like the stock of super wealth, the stock of this total wealth grows with saving and net returns. It's useful to think about super split into two logical portions. One portion (for example, dwellings) is immobile, so asset prices and returns depend primarily on local conditions. The other portion, for example, shares (which represent a claim on business capital or fixed interest), is mobile, so returns are primarily determined on world markets.

'System input' policy

There are three familiar pillars to our retirement income system:

> the pension;

> tax-preferred compulsory super contributions, which currently enjoy their own little 'flat tax island'. Labour income paid in virtually any other form is taxed progressively; and

> voluntary contributions and the Government's co-contribution into the earnings tax-preferred super environment.

Figure 1 sets out the budget cost of these pension and co-contribution outlays and labour and capital income tax concessions.[6] It's expensive (totalling around $50 billion or 5 per cent of GDP). The tax concessions cost more than the pension.

Who benefits from this $50 billion expense? Half is spent progressively — the outlays half (for example, the top one-fifth by income of those of pension age) gets no pension. But the tax concessions are exceptionally regressive. Those 8 per cent of persons in the highest tax bracket got about 29 per cent of the labour income (superannuation) tax expenditures in 2005–06. The median tax concession to these people exceeded the median super contribution. The same can be said for the tax concession on earnings. While the median Australian super account in 2005–06 was $25,000, the average self-managed super fund (SMSF), which has fewer than two members, had a balance of $800,000.[7] Guides to SMSF strategy honestly and explicitly treat them as a tax haven vehicle.

If, for example, the tax concessions on super were abolished the pension could be doubled.

From the taxpayers' perspective the policy costs about 5 per cent of GDP each year. What do we get for that? Originally there was a positive real internal rate of return on tax expenditures on super due to lower future pension expenditure. It was around 4.5 per cent.[8] Subsequent changes to tax and pension design have completely obliterated this justification for current arrangements.

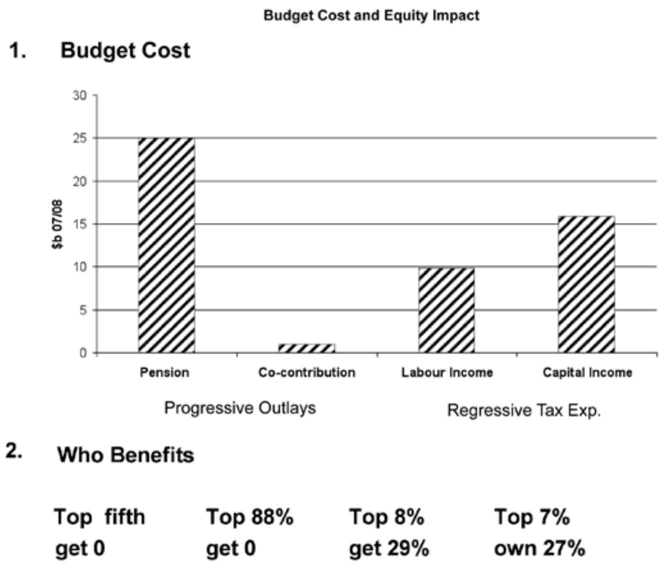
From the social perspective there are two costs: firstly, a very significant negative contribution to intragenerational fairness; and, secondly, the economic efficiency costs of raising $50 billion. Discounting some of the earnings tax concession and using an average efficiency burden of taxation of say, 25 per cent, we are looking at almost $10 billion in terms of the social cost of this policy.

Economic impact on wealth and savings

In relation to saving, the studies are pretty straightforward: compulsion works — a bit better than 50 cents of a dollar compelled sticks. Voluntary savings, however, is unchanged (or perhaps even worse) because of the super regime.[9] People borrow more and save less

Because compulsory contributions are significantly larger than voluntary contributions, there's no question that the original justification for compulsory super (i.e. the need to increase savings) remains a valid argument.

FIGURE 1: *Retirement incomes policy*



in other forms. Because compulsory contributions are significantly larger than voluntary contributions, there's no question that the original justification for compulsory super (i.e. the need to increase savings) remains a valid argument.

The harder thing to judge is the impact on the composition of the stock of wealth — and the return on that stock. In this context there are two important implications of our small open economy with mobile business capital status.

Firstly, wealth owned by Australians is likely to be growing faster because of compulsory super than it would in its absence. But the business capital stock with which Australians work is not. Simply, if we don't want to own it, foreigners will.

Secondly, in the absence of tax-preferred compulsory super, not only would savings be lower but our net wealth would also be likely to be more directed to other tax-preferred immobile assets such as residential housing, lower value range commercial property, agriculture and forestry.

Pre-tax social returns on these asset classes are pushed down (and asset prices up) by tax preferences so that after-tax (private) returns are equalised. The super regime has increased the portion of our wealth invested in fixed interest and local and international equity. The pre-tax social return here is set more by world markets. As tax preferences go, the tax preference for super has a smaller negative impact on overall returns on our wealth. If we save more in the form of super, we own more of the Australian business capital stock and more of the business capital stock of other countries. But we're such a small player in these markets our actions don't alter the pre-tax returns.

It's particularly important to understand regulatory arrangements in super in the light of this second-best tax policy rationale.

Current super regulation is heavily focused on conduct. There is minimal capital requirement regulation nor is there much structural regulation of the 'doctors can't own chemists' sort.

Current regulatory arrangements

From a regulatory perspective, there are three very distinct segments of the superannuation industry:

> *defined benefit funds*, which are in slow decline (and now most are hybrids), although they still represent 15 per cent of assets plus an additional 20 per cent[10] unfunded liability;

> *an APRA regulated retail, corporate, and industry fund sector*, which represents about half the assets, but almost 90 per cent of the member accounts; and

> *an essentially unregulated SMSF sector.* The SMSF sector has a significantly different asset allocation to the APRA regulated segment, with minimal exposure to overseas equity and greater exposure to local property. What regulation there is of this sector focuses on the providers, for example, ASIC regulates financial advisers and financial advisers providing advice to SMSFs. This sector is the most rapidly growing; it represents about one-third of the assets in super but only 7 per cent of the members.[11] It's important not to be misled by the 'self managed' label in relation to this sector. The sector is very fragmented. Only 11 per cent of SMSFs 'self-administer all aspects'. Still, only about one-third receive professional financial advice regarding investments.

Current super regulation is heavily focused on conduct. There is minimal capital requirement regulation nor is there much structural regulation of the 'doctors can't own chemists' sort. In the spirit of the Glass-Steagall Act, it's easy to imagine structural regulation which might achieve public policy aims by reducing conflicts of interest, agency problems and ill-informed decisions:

> advisers can't own packagers;

> asset consultants, research houses and ratings agencies can't do funds management;

> administrators can't own trustee companies;

> margin lending products can only be sold to wealthy investors; and

> industry funds with large numbers of members from particular industries can't overweight their asset allocation to such industries.

This sort of regulation has gone out of fashion. There are a few residual vestiges of it — prohibitions on in-house assets, and separate auditor requirements. In many ways, the hard-earned lessons of generations of industry and financial economists and regulators have been forgotten. The traditional paradigm — 'regulate structure, it determines conduct and thence performance' — has been dispensed with. In its place there is an extensive framework of conduct obligations. For example, APRA-regulated super trustees are required to write, lodge for scrutiny and regularly review, long stories about potential risks their SMSF brethren haven't even heard of.

The Cooper Review

Terms of reference

The terms of reference for the Cooper Review required it to:

2. '… comprehensively examine and analyse the governance, efficiency, structure and operation of Australia's super system … [with the] Review to be conducted around the concepts of the best interests of the member and the maximising of retirement incomes for Australians.'

The Review was explicitly excluded from considering '… system inputs such as the level of super contributions, tax including tax concessions and other exemptions'. These were reserved for the Henry Future Tax System Review.

Gross returns

Recall the 'equation of motion' of the stock of super assets, contributions, returns etc.

The Cooper Review was clearly precluded from considering the tax and contribution dimensions of this equation — 'system inputs'. However, it was not excluded from considering the impact on the retirement income of Australians and the best interests of members of various possible combinations of 'system inputs' and regulatory design features. Nevertheless, in one sentence, the Cooper Review made a choice to exclude from its scrutiny these issues:

> The Review Panel takes the view that wholesale investment markets are fairly efficient and so there are only marginal potential gains in efficiency that can be made through increased gross investment returns. (Cooper Review, Operation and Efficiency, p. 4).

That paper goes on to describe its sole focus on 'intermediary' costs as its intended contribution to improving member benefits. For three reasons, this approach constitutes a significant failure by the review to observe its terms of reference. Firstly, the Review ignores the distinction between private and social gross investment returns. Secondly, pre-tax returns can be very significantly affected by regulatory factors. Thirdly, if regulatory factors influence the asset composition of super portfolios they will influence member returns.

To my mind, the review should have focused far more on gross returns and the design of regulatory structures which enhance these returns. Two examples highlight this point.

Social cost issues are well illustrated by the experience of Nauru, where a tropical paradise was mined for phosphate, turned into a desert, a reasonable pot of wealth was accumulated, but was squandered so the people of Nauru have been left with neither wealth nor enjoyment of their once-pristine tropical island. A Review into the best interests of the Naura population which focused solely on their financial interests would ignore the fact that these concepts are not necessarily synonymous. A further focus on choosing managers for investing the wealth generated based on their fees would also miss the point that it is the returns which matter. Poor investments, done cheaply, do not result in a good outcome.

A second example is more immediate. In the absence of any income tax system, business wealth would be a much more attractive investment than it is at present. Sacrosanct features of our tax arrangements (for example, negative gearing, no tax on the family home, tax preferred capital gains, concessions for agriculture) lead to a bias in our wealth away from business capital. Compulsion, super tax design and prudential regulation of super to redress this problem could have a significant social benefit. Business wealth pays a higher return which doesn't fall because of the super tax preference.

Intermediary costs

At a conceptual level, there are six ways by which public policy might reduce the 'spread' (or intermediation) cost of the super industry by improving productive, allocative or dynamic economic efficiency. They are:

(a) reducing public policy mandated complexity;

(b) reducing excessively high public policy mandated levels of service 'quality' and consequent operating costs (for example, accuracy of administrative record keeping, withdrawal notice periods);

(c) enhancing service provider competition to reduce profit margins;

(d) inducing external economies of scale and scope by, for example, defining universal protocols to lower the IT processing costs of a member moving from one fund to another;

(e) enhancing allocative efficiency, for example, by mandating harmonised disclosure to ease comparison; and

(f) improving dynamic efficiency (i.e. reducing the search cost of introducing products and arrangements which lower costs).

The terms of reference for the Cooper Review encompassed all of these possibilities. However, the Review has shown little interest in (a), (b) and (f). Complexity is discussed and dismissed in a few paragraphs.[12] There is a brief discussion of licensing administrators.[13] There is minimal explicit discussion in relation to (f).

In relation to (c), the Review appears to have a preference for a far more concentrated industry, and it is sanguine about the potential adverse impact of that concentration on the 'spread cost' and dynamic efficiency.

The Review's arguments about the desirability of achieving economies of scale by significantly reducing the number of funds are unconvincing. As the Review notes, in areas where there are significant scale economies (e.g. administration) there are a fairly small number of providers supplying outsourcing solutions. There is greater potential for significant economies of scale in terms of an SMSF operation.

The main focus of the Review was on (d) and (e).

TABLE 1. *Household balance sheet (selected items): stocks and indicative returns*

	Stocks $trillion, June 09	Indicative Real Long-term Private Returns % p.a.		
		Component Assets		
ASSETS	Assets	Immobile	Debt	Equity
Housing (1)	3.7	<3		
Deposits	0.5		3	
Super (2)				
Non SMSF	0.7		3	10
SMSF	0.3	<3	3	10
Shares	0.3			10
Other	0.4	?		
Liabilities				
Borrowing	1.4	3+ bank spread		
Net Wealth	4.5			
Memo				
Operating expenses non SMSF super sector	0.60%			
Value of ecosystem services	?			
Future taxpayer liabilities	?			

Notes: (1) Including durables (2) Excluding unfunded super (3) Assumes real interest rate to lender = 3%, equity premium = 7%

The Review has focused on two dimensions of intermediary costs, and its proposals in this regard are reasonable. But this narrow focus means that the major opportunities for social benefits have been ignored.

The 'Superstream' proposal to 'bring the back office of super into the 21st century' is a clear example of (d). The proposed 'new choice architecture' is an example of (e). While the Super stream proposal seems attractive, the benefits of the 'new choice architecture', referred to as MySuper, are less obvious.

MySuper is a proposal to vary default arrangements at the fund level. To accept default contributions, funds would be obliged to offer a plain vanilla 'MySuper' default strategy. It's not a proposal to vary the way a member gets into a default strategy, i.e. the industrial relations arrangements and employer obligations. Rather it's a proposal for mandatory treatment of people who do end up in a default strategy. It could well represent a major increase in complexity which effectively provides a limited benefit for a few.

It's difficult to see the proposals outlined amounting to any significant change in intermediary costs. Nevertheless, for the purposes of comparison, assume generously that intermediary costs are reduced by 10 per cent per year for every year into the future as a result of the introduction of the Cooper Review proposals. Table 1 sets out selected items of Australian households' aggregate balance sheet as at June 2009.[14] Non-SMSF super assets are about $0.7 trillion.[15] The operating expense of the non-SMSF super sector is estimated at 0.6 per cent, i.e. 60 basis points.[16]

Suppose the Cooper Review proposals could reduce this intermediary cost by six basis points (i.e. 10 per cent). That would represent a one basis point improvement in the return on total wealth (given that non-SMSF super represents about 16 per cent of the $4.5 trillion of household net assets).

Table 1 also sets out across the rows an indicative listing of the 'wholesale' asset composition of each of the 'retail' assets. Further, it sets out an indicative real long-term private return on each of these assets. Because of the design of our tax arrangements we have:

> too much wealth invested in housing, which consequently pays a lower social rate of return than it would in the absence of an income tax system; and

> not enough in bank deposits and shares where the returns are set more on world markets;

Minor changes in super arrangements, which would influence overall household gearing or asset allocation, would dwarf intermediary costs in relation to their impact on total return. If, for example, the Cooper Review proposals resulted in an unintended 0.14 per cent reallocation of household wealth ($6 billion) away from business equity, the benefit of the 10 per cent reduction in the intermediary cost would be cancelled.

Conclusion

The Cooper Review's Terms of Reference required it 'to be conducted around the concepts of the best interests of the member and the maximising of retirement incomes for Australians'.

The best interests of members are not served when private investment returns are earned at the expense of social or environmental costs passed to others. Nor are Australians' retirement incomes maximised. While governance of super can address this issue, the Cooper Review has ignored it.

Retirement income generated by a quantum of saving depends on the stock of wealth accumulated. In turn, that depends on individual asset returns and the portfolio composition of that wealth. So 'maximising retirement incomes' is mostly about the overall portfolio allocation of Australian wealth and the super component of that wealth. It's also about watching the extent to which locally determined tax and regulatory preferred asset class returns fall because of such preferences. Minor changes in super arrangements can have a significant impact on portfolio allocation, regulatory preference, locally determined returns and consequently retirement incomes.

The Cooper Review has largely ignored these issues and focused narrowly on the 'intermediary costs' of the super industry. The most significant public policy impact on 'intermediary cost' is complexity, which the Review has ignored. The Review has focused on two dimensions of intermediary costs, and its proposals in this regard are reasonable. But this narrow focus means that the major opportunities for social benefits have been ignored. ■

Notes

1. Reserve Bank of Australia (RBA) *Bulletin*, Table B20 p. S26, August 2009.
2. ibid. Table G11, p. S85.
3. Rothman and Tellis (2008).
4. ibid. p. 14, p. 19.
5. RBA *Bulletin*, Table B20.
6. Author's estimates based on Budget and other documents. Details are available from the author on request. SMSF figures from *Rainmaker Roundup*, March 2008, p. 3.
7. June 2007, Rainmaker ibid.
8. Pender (1997, p. 61).
9. The Allen Consulting Group (2009), p. 34.
10. See Cooper (2009a) and RBA *Bulletin*, Table B20, p. S26, November 2009.
11. Cooper (2009c, p. 2).
12. See Cooper (2009b, p. 16).
13. See Cooper (2010, p.15).
14. RBA *Bulletin*, Table B20.
15. t = US trillion = 1×10^{12} = one thousand billion.
16. See APRA *Annual Super Bulletin*, June 2009, released Feb. 2010, Appendix Table B, p. 23.

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