Abstract

The Australian system has managed to provide remarkably high real returns to many contributors which is, after all, the bottom line in assessing the results of such a system. It has done this despite imposing administrative costs which appear to be rather high, even by the standards of other countries imposing mandatory private superannuation savings. To this extent, the system must be assessed as a resounding success.

Nonetheless, feasible reductions in administrative and investment costs, currently running at about 1.3% of total assets under management, could see final benefits for many members raised by as much as a quarter or even one-third.

This paper outlines several options for reform ranging from the relatively small to full government organisation through a new Office of Superannuation. In all case however it is envisaged that opting out of the SG tier will continue to be possible for schemes paying superior benefits. The option of full government organisation of the system would require much consideration as to governance provisions which would minimise political interference in the running of the fund. Those who do not believe that such interference is avoidable will not, of course, support such a plan, although they might support some of the less drastic options considered. By the same token that scheme holds out the potential to maximise the cost savings potentially available.
1.1 Cost of the current Australian system

The Australian mandatory superannuation guarantee (SG) system has provided very high real rates of return to contributors – on one estimate an average of 6 - 8% pa real, after costs - and has the potential to continue paying these, in marked contrast to some pay-as-you-go contributory schemes where high initial returns to the first generation of participants are gradually eroded as the scheme matures. But this achievement brings with it some hidden costs, and future high returns are far from assured.

It is well known that compliance costs of the existing system are quite high, not only for the industry itself but also for individuals forced to make difficult choices in the face of bewildering complexity. Fees paid to advisers are only the tip of this particular iceberg.

It is less well known that the system also has quite high administrative costs relative to total funds under management. While Chile has been regarded as very expensive system, administratively (there are front-load costs of roughly 15-20%, equivalent to an annual cost of around 1% of assets\(^1\)), Australian costs appear to be as high or possibly higher than these. Our costs are also higher than in countries like Switzerland and Sweden\(^3\), which also have elements of mandatory savings in their national retirement income systems. Australian costs are certainly large enough to significantly reduce final payouts to individuals over time, and this effect will become much more obvious if current high rates of real return are not sustained.

Data on administration costs was first provided by ASFA’s\(^4\) research on “The costs of running Australia’s retirement income system” (Clare 1998). While costs per member in larger funds tend to be relatively modest (at $140 pa per account), “the cumulative costs of multiple accounts held by fund members can be significant” (p2). Total investment management charges were “$2b a year and growing…” (p3). Costs for retail funds and master trusts in particular tend to be high, at an average of 1.9% of assets. Cost of prudential regulation and losses due to fraud were comparatively insignificant at around $30-35m a year. The total comes to $4.2 billion pa.\(^2\)

This paper found that aggregate administration costs for superannuation funds were around $2.2 b in 1996-97, around half a percent of GDP, with investment costs of a similar order. Clare argues that “Total administration and investment costs of around one per cent of GDP per year are not excessive…” (p24). Despite reservations about the survey data on which this

\(^{1}\) Bateman (1999) cites a figure of .78%.

\(^{2}\) Diamond (1998 p54) cites the charge ratio for a “typical provider” in the UK as 24%, indicative of a management expense ratio in excess of 1% of assets per annum.

\(^{3}\) I have seen a cost ratio of 0.4% cited for Switzerland, but cannot source this. For Sweden, see text.

\(^{4}\) Association of Superannuation Funds of Australia. This is the industries’ peak group.

\(^{5}\) There are problems with the sampling and estimation used in this survey:

- Only 105 fund administrators replied from 705 who were approached – a response rate of 15%
- ASFA notes that the survey effectively covers 1003 funds with 47 per cent of superannuation fund members, but they do not show that the sample is actually representative of funds or members – in particular there is no check on whether the sample is biased towards those with large costs;
- The survey of funds under-sampled the high cost funds under $50m, and increased the overall estimate by using multiplying factors ranging from 256 to 39 for funds with under $50 million in assets.
The possible introduction of choice of fund legislation in Australia\textsuperscript{12} has ambiguous implications for costs. On the one hand it might help reduce costs by increasing competition. There are those in the industry who argue that this is already happening, in anticipation of the legislation. On the other hand choice of fund might become a source of increased costs arising from marketing, churning of accounts, commissions and the like.

Bateman argues that "...the Australian arrangements (which currently mandate employer choice of fund) are significantly less costly than the similarly designed Chilean arrangements (which mandate employee choice of fund)..." (1998 p99). However it is not clear that this argument is justified by the data\textsuperscript{12}. Diamond argues that, in part because of higher administrative costs, "the increased choice which would be likely to be present with privately organised accounts may be as likely to be harmful to the worker as helpful..." (1999 p23).

Using 6% gross real yield as a benchmark, and including the impact of fund taxation, I calculate that over a 40 year working life someone earning $20,000 pa would accumulate $185,000 at a net return of 5%, but only $145,000 with a net return of 4%. The difference is 22%.

This rough calculation is consistent with that of Orszag and Stiglitz (1999), who note that under a privatised system... "costs tend to be significantly higher because of advertising expenses, the loss of economies of scale, competitive returns on financial company capital, and various other additional costs... Such costs would, over a 40-year work career, consume about 20 percent of the value of the account accumulated over the career." It is also consistent with Bateman's (1999) estimates. Bateman shows that over a 40 year contribution period a 1% asset charge reduces final accumulation by 22.1%, and a 2% charge by 38.7% (see her Table 1.A).

Orszag and Stiglitz go on to note that: "Experience from both Chile and the United Kingdom is consistent with these predictions and indicates that a decentralised system of individual accounts involves significant administrative expenses" (1999, p30). For more extensive discussion, see their fn 82). Murtah et al, taking into account interaction effects which include the costs of job change and the costs of converting into an annuity on retirement, estimate that "on average, between 40 and 45 percent of the value of individual accounts in the UK is consumed by various fees and costs" (cited in Orszag and Stiglitz p31)\textsuperscript{14}. (Note that this figure applies to only the individual account sector in the UK, and also includes the cost of converting final benefit to an annuity in the private market. It cannot therefore be generalised as a cost of private superannuation in that country.)

1.1.1 What is the lowest feasible administrative charge?

This might not be a significant objection if there were no cheaper alternatives: but there are. In terms of the costs of investment management, studies in the US and the UK indicate that there is no significant gain from active as compared to passive (index tracking) management techniques (Klumpes 1997). Indeed, this must be intuitively obvious when one is thinking about returns from the market as a whole. And passive funds are shown to have, on average, very much lower costs than actively managed ones — in some cases as low as \textsuperscript{0.1}-0.2% of
funds under investment. In Australia this would represent some $40-80m pa, compared to the $2.4m now spent.

In terms of the cost of administration, the relevant benchmark might be a national social insurance scheme paying earnings-related benefits. Alternatively one might wish to aggregate the administrative costs of the ATO (1% of revenue on average) and those of the age pension system around 1% of benefits paid, or some $90 per pensioner per year ($180m pa). Social security would be cheaper, however, without means testing: the OASDI scheme in the US costs $US 10 per participant, or $16 per participant (Diamond 1999 p3). However social security payroll taxes are not individually identified in that system, this is a potential source of additional costs in any individual account system.

In the US, the Advisory Council on Social security has estimated that, with individual accounts, centralised management and restricted investment options, administrative costs would amount to roughly 10 basis points per year. This cost ratio of 0.1% would reduce the ultimate value of the individual account by only 2%, as compared with the 22% reduction implied by a 1.0% cost ratio.

More recent estimates suggests that the costs of a centralised system may be somewhat higher, but in any case they appear likely to be a fraction of those prevailing under a decentralised approach. Diamond (1999, p2) describes a low cost/low services government-organised plan and estimates that it might cost $US 40-50 per worker per year.

Abstracting from compliance costs, it seems possible that a single national scheme could be administered in Australia for around $760-400m pa. Together with minimum investment costs of say $60m1, a single national scheme could be run for around $450m pa compared with $4.5b pa for the existing system. This represents 14% of funds under management compared with the current 1.4%. On these figures the average loss in final accumulations declines from around 25% to 3%, and the average gain in retirement lump sums could therefore be as high as 30%.

Could such a national scheme be designed to replicate the existing mandatory private superannuation system, and create better value for investors? This issue is examined below.

1.2 Approaches in other countries

The UK Office of Fair Trading (1997) considered these issues in their “Report of the Director-General’s Inquiry into Pensions”. They recommended that a “Designated Personal pension” (DPP) be introduced which would be an alternative for those who did not wish to join an occupational pension scheme. The DPP would have the following characteristics:

- An underlying investment in a portfolio of equity shares
- Passive fund management
- Some gearing, and systematic reduction in gearing as the individual approaches retirement age
- Expenses fixed as a proportion of fund value
- An annuity purchased on the open market, index linked and with equal rates for men and women

Note that DPPs would be provided by the industry, however: government’s role would be restricted to certification and regulation.

The UK Government (1999), in its Pensions Green Paper (“A new contract for welfare partnership in pensions”) and subsequent legislation (Welfare reform and pension bill 1999) appears to have taken on board some of these recommendations in the form of the proposed “Stakeholder pensions” for those outside of, or wishing not to partake of, occupational schemes. Stakeholder pension will be of the defined contribution (DC) type and have the following features:

- Employers who do not provide an occupational scheme will be required to provide access to a SP and collect contributions through their payroll systems (thus reducing costs of marketing and collecting contributions)
- Cost to be kept low by using a collective structure (like occupational schemes)
- A “clearing house” so that employers could make payments to other nominated schemes (The clearing house would pass the money on to each scheme)
- Minimum standards to be defined
- A simple charging structure, expressed as a percentage rather than a flat-rate sum
- Limit on the permitted level of charges
- Members can stop and re-start contributions, and transfer in and out without penalty

Stakeholder Pensions, despite extensive regulation, are still very different to the DPPs recommended by the UK Office of Fair trading. Both, moreover, are very much privatised solutions, although they need to be understood in the context of the mixed UK system involving options to opt out of a state earnings-related pension into either company or individual accounts.

Sweden has adopted an innovative approach to individual accounts. All mutual funds in the country are free to participate providing they negotiate a fee agreement with the public agency which administers the system and maintains all records. While workers will be able to select among various funds, contributions will be aggregated and moved by the government agency in large blocks, allowing it to capture economies of scale and bargaining power, thereby reducing administrative costs. Sales commissions will be discouraged because funds will not have information identifying their members, although mass advertising is still possible (James et al, 1999 p4).

Bolivia has also used a wholesale approach: it auctioned off the money management rights of its DC pillar to two investment companies in an international bidding process that took into account past performance and future fees. Choice is very constrained, although expected to increase in the future.

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15 Clare 1998 p8. ATO compliance costs are high, however; on one estimate, 14% of revenue. One assumes, however, that ATO compliance costs would not be higher than those for superannuation contributions generally.

16 This is not comparable with the Australian administration cost, which is only for those receiving payments.

17 Based on 0.1% of total superannuation funds. This is consistent with the US Thrift Savings (TSP) Plan for federal employees. Investment management fees are roughly 1/100 of total costs – Diamond 1999 p4.

18 These figures are more than a rough guide, since the SG tier currently amounts to only 12% of total superannuation funds. The figures quoted are meant to be a guide to the costs of a fully mature system. I am pleased to see that this estimate equates with that of Diamond, on the assumption that there are 8 million workers, and the cost is $50 (Aus) per worker per year.
Singapore and Malaysia offered no choice until recently. They required all their workers to put their DC contributions into publicly managed central provident funds. Administrative costs are low, but so too have been returns. "Partly for this reason, Singapore recently allowed workers to opt out of this central fund and invest their balances above a specified level in privately managed accounts. About 25 managers are authorised to handle these accounts. Collections and over-all administration remain centralised" (James et al p5).

To summarise: a continuum in funded DC pillars exists, ranging from high choice and high cost in the retail market (e.g. Chile), more constrained choice (but lower costs) through the institutional market (Sweden, Bolivia), to practically no choice at all (Singapore and Malaysia until recently).

1.3 Options for reducing administrative costs in Australia

A range of options exists, ranging from the comparatively minor through to quite major reforms involving a large degree of state intervention in the SG tier. I have not included choice of fund in this list since, as explained earlier, its implications for administrative costs are unclear.

1.3.1 Better account consolidation

Clare (1999) outlines a range of options for consolidating member accounts, in recognition that the average cost per accounts is $115 pa and that multiple and lost accounts are common. These include:
- More intensive use of tax file numbers (TFNs) and other data matching mechanisms
- Allow transients to take small account balances with them when they leave the country
- Require employers to more thoroughly establish identity of employees, to reduce use of false names and redundant accounts
- Regulation of exit fees. "Nearly 50% of accounts are in retail funds, and many of these charge significant exit fees. Lowering or eliminating exit fees would assist consolidation of accounts"

This last option takes us into the general class of options concerned with fee disclosure and regulation, discussed below.

1.3.2 Fee disclosure regulations

These became popular in the UK following the widespread mis-selling scandals under former opted-out private pensions. The idea is to require that all up-front, on-going and exit costs be disclosed in a standard format allowing for easy comparison of superannuation investment costs as between various providers. However devising an appropriate and easily comprehensible format is not necessarily an easy task.

While disclosure is obviously a good thing, whether this approach would be efficacious is open to debate. The report of the UK Office of Fair Trading (1997) noted that "The disclosure regime for charges introduced in January 1995 has had some effect on eliminating high charging products though, as noted elsewhere in this Chapter, a number of products of doubtful value remain on the market" (Vol.1, p76).

1.3.3 Changes to fund governance structures

Bateman (1999) notes the very large differences in costs between industry superannuation funds run by trustees representing both employers and workers, and master trusts. In her numerical assumptions the retirement accumulation from the average industry fund is reduced by 11.2% (equivalent asset charge is 51%), while that for the average master trust is reduced by 32.7% (asset charge is 17.6%). She speculates "... that the large differential... can be explained by a combination of differences in governance, historical ethos, institutional practices and industry structure... A particular difference relates to fund governance" (p18, 19). In particular industry fund trustees are sympathetic to low cost mandatory retirement saving, whereas master trusts have a straightforward profit motive. Further, industry funds historically have a captive membership, whereas master trusts operate in the retail market for member accounts and therefore face higher marketing costs.

Bateman appears to favour an approach of setting mandatory contributions net of administrative charges (as they are, for example, in Chile), in order to overcome what she sees as a principal-agent issue. While Australian employers are currently responsible for fund choice, they have little incentive to choose the fund that will maximise net-of-charges returns. This issue is addressed in industry funds by the governance structure and ethos of low-cost retirement saving.

However Bateman notes that the unique governance and cost advantages associated with Australian industry funds may be changing as such funds increasingly opt to become public offer funds (p25).

1.3.4 Regulation of charges

Some countries such as Bolivia, Sweden and the UK have taken the approach of regulating charges. The Swedish approach (like the Bolivian) also involves centralised collection and contracting to wholesale providers, and is discussed separately below.

The new UK "Stakeholder Pensions" will be heavily regulated as to costs. The green paper "Partnership in pensions: a new contract for welfare" proposes that there be a simple charging structure, where charges are levied either as a percentage of contributions or accumulated funds. The Government has decided on the latter 11. It is interesting to note that one of the largest providers, the Prudential, is reported to have decided to pull out of this market because of the low margins provided.

1.3.5 Government organisation of the SG pension tier

Diamond makes a central distinction between government-organised and privately-organised accounts. "The term government organised accounts [is] used to denote individual accounts in which the government arranges for both the record-keeping for the accounts and the investment management for the funds in the accounts - whether these functions are performed by government agencies or by private firms under contract to the government... The term privately organised accounts [is] used to denote individual account systems in which individuals directly select private firms to do the record-keeping and investment management" (1999 p1).

Diamond concludes that privately-organised individual accounts are very expensive for satisfying the basic purpose of social security. "Since I think that government-organised accounts can be reasonably insulated from political interference, that the increased choice that would be present with privately organised accounts may be as likely to be harmful to the worker, as helpful, and that greatly increased regulation is [necessary], I consider privately-organised accounts to be dominated by government-organised accounts" (1999 p23-4).

I present here a proposal for government organisation of the SG tier, with the option for employers to opt out if their company schemes guaranteed at least equivalent benefits. In practice this will not be easy to test, and it might be that opting out would be allowed as long as net contributions were at least at the SG level. In other words contracting out would only be allowed to those schemes where the employer shouldered the administrative and investment management costs. People leaving contracted-out schemes could have their accumulated assets transferred to the central fund.

This scheme is, in effect, a form of national superannuation which is fully funded and based on the DC principle. The proposal has several objectives:

1. To drastically reduce administration costs, and the incidence of multiple accounts
2. To improve the net returns to investors
3. To eliminate inter-fund variability in returns (and hence reduce investor risk)
4. To provide a better asset-risk profile for investors.

An Office of Superannuation (or some such name) would be created to receive all benefits from contracted-in SG payments. All multiple accounts would be amalgamated. The office would sub-contract all administration of benefit receipt and payment to existing service agencies. It would also contract out fund management, as described below.

The motivation for such intervention is market failure related to the high cost of acquiring information and decision-making skills. Just as the rationale for mandatory retirement savings is that individuals do not do a good job of looking out for themselves when it comes to retirement planning, "it seems right to recognise that many people will not do a good job of choosing a financial intermediary for retirement savings as well". It also recognises that an equilibrium solution in private markets can involve substantial mark-ups, together with the selling costs that are encouraged by such markups. Diamond notes that "this view of markets as having markups and variation primarily because of consumer lethargy is clearly different from the [traditional] perspective that consumers are choosing the best option in an array of competitive firms..." (1999 p18).

Sub-contracting administration is not essential to the proposal. There are also arguments for centralising administration in a single government body, like Medicare or Centrelink. Diamond notes that the costs of social security in the US are "very low compared to private firms doing similar activities... this is not a special US outcome, but a common feature of many national pension schemes in advanced countries" (1999 p19). However an argument for subcontracting in the Australian context is that there are many private firms already set up to do this type of work, and with relatively low cost structures.

While passive fund management appears attractive in theory, as the investment strategy of the OOS, - it being well understood that funds, in aggregate, cannot outperform the market - a major problem is "index to what?". The Australian sharemarket, for example, represents around 1.5% of total world stockmarket capitalisation. (This is not nearly such a big problem in the US, where a fund indexed to the S&P, for example, would represent quite a big chunk of total world assets.) Another possibility is a worldwide index such as the Morgan Stanley (MSCI), but it is unlikely that government or the community would accept such a low proportion of total assets being invested in Australia, and in such a small range of companies.

In reality any passive investment strategy would need to involve somewhat arbitrary decisions about what indexes to put in the basket, and what proportion of the total they should occupy.

I suggest that, instead, the Office would sub-contract the whole of the investment activity, initially with investment managers determined on the basis of their existing market share. Funds smaller than, say 1% of the total would be excluded. Their share would be invested with a passive fund manager. In each annual review, investment managers (including the passive managers) could have their share of the total increased or reduced by up to 1 percentage point based on their rolling average 10 year net performance. New funds could bid for business based on the same formula. Ideally, the formula for increasing or reducing a fund's share would be decided at the outset, and be allowed to operate mechanistically thereafter.

The fund's administrative activities would be limited to contracting for services and reallocating investment shares based on pre-established relative performance criteria. In other words it would be a small policy advisory, research and contract administration body.

In order to reduce investment risk and volatility, the fund would create a reserve fund from returns in excess of the long-term average (using an implicit tax rate of say 50%) and subsidise returns falling below that average (at the same rate). A pre-determined formula should be adopted for this averaging process, similar for example to that used in the Commonwealth Government's PSS pension scheme. This allows the accumulation of up to 5% of assets as a reserve fund, which is used to offset negative returns in any year.

The larger the reserve fund, the more risky can be the asset profile of the main fund, and the higher the average returns achievable. For this reason a reserve fund as high as 10 or even 20% of assets might be contemplated. The Government would need to act as insurer in the initial years, until an adequate reserve fund was built up. This indicates that the indicative average return should be set conservatively, to begin with. A real rate of 5% might be reasonable, at least until the reserve was fully built up.

The OOS would be able to sell variable annuities with returns based on the averaged underlying performance of its investment portfolio. A problem with this approach is that it might squeeze out the private annuities market. One solution might involve the Government fund acting as re-insurer for funds wishing to sell annuities on a comparable basis.

Obviously a lot of work would need to go into ironing out such details. Nonetheless the basic proposal appears to have considerable merit. It offers the potential for

- Significantly increased net returns to SG account holders
- Reduced volatility and investment risk

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20 In the US Vanguard's 500 index fund, which mimics the benchmark Standard and Poor's 500 Index, has recently achieved US$ 100 billion assets under management. "The success is due to the inability of active managers to outperform the S&P 500 Index" ("Vanguard's milestone", AFR 15 Dec 1999. p.36). See also Klumpes 1997.
Much reduced decision-making costs for individuals and firms (in my view a much under-rated aspect of total compliance costs)

Much improved annuity returns. It might also provide a basis for mandating annuity purchase. "The least cost approach would be automatic annuitisation of these funds according to rules set by legislation" (Diamond 1999 p8).

1.3.5.1 Likely impact on the superannuation industry
On the figures presented in Table 1 this proposal would have the eventual effect of wiping out the high cost sectors (industry and retail) while leaving most of the public sector funds, and possibly a large part of the corporate sector, still operating. On the June 1998 figures this would represent a total saving of $3,364 million pa, offset by a likely Office of Superannuation cost of $230 million (say, 0.2% of $115 billion in assets), for a net saving of $3,134 million pa. This would leave the annual cost of the whole system at $1(1,113+226) = $1,340 million, representing a quite reasonable 0.4% of total funds under management.

1.3.6 Political risk vs investment risk
Probably the biggest concern with the proposal for government-organised accounts is that political risk would replace investment risk as the main factor creating sub-market returns to individuals. Governments have had a terrible record at running large national investment and provident or superannuation funds, mainly investing monies in their own bonds. Bateman notes that "for mandatory public retirement saving, the issue is the potential for low investment returns (albeit with lower risk) due to the likelihood of directing investments, particularly in low yield government bonds. It is not surprising, therefore, that the actual investment returns for public funds management...has not matched the returns of their private counterparts" (1998 p96).

Similarly James et al argue that 'a centralised fund...can be much cheaper because it achieves scale economies without high marketing costs, but gives workers no choice and hence is subject to political manipulation and misallocation of capital' (1999, abstract).

Willmore and Bertucci note: "Without privatisation, the funded, defined-contributions system is a provident fund, and this is not the model that reformers have in mind! Reformers are

23 Annuitisation of lump sums is not mandatory in Australia, although there are various tax and social security means test provisions encouraging their use. Nonetheless take-up remains very low.

24 Bateman's low estimates for the cost of industry funds contrast with Clare's figures, reproduced in Table 1. Ross Clare has responded: 'The short answer is that Hazlitt's work is based on charges, mine is based on the actual costs incurred by funds. For instance earnings rates can be trimmed by investment management costs even though there may not be a specific charge levied on member accounts. At the retail level our methodology might give similar costs for a retail product compared to an industry fund. However, actual charges and net earnings rates for the retail product will reflect the profit the provider is taking out.'

Industry funds are cheaper to run and have lower charges than most (all?) retail products, but the margin may not be as great as Hazlitt's work suggests." (private communication, 15 Dec 1999).

Hazel Bateman replies: "One reason why my results may differ from Ross's is that I calculate costs over the entire accumulation phase - while Ross looks at costs for a given year. Currently industry funds charge somewhat close to $1 per account for administration. Currently - when accounts are small in size, this translates to a much larger proportion of total assets than such a flat rate charge would do over an entire working life. Due to the differing short term impacts of front and back loaded charges and the differing charge regimes applied by the alternative superannuation funds, I think it is important to consider costs and charges over the long term, rather than at a point in time." (private communication, 17 Dec 1999).

adamant that individual accounts must be privately managed. Why? Essentially because they do not believe that the public sector will competently invest workers' savings" (1998 p3).

This issue is addressed explicitly by Orszag and Stiglitz ("Political economy myths #10 - Investment of public trust funds is always squandered or mismanaged") they cite, for example, Munnell and Sunden (1999) who re-examined the evidence on state and local pension funds in the US, and concluded: "In short, the story at the state and local level is that while in the early 1980s some plans sacrificed returns for social considerations, plan managers have become much more sophisticated. Today, public plans appear to be performing as well as private plans (cited in O&S 1999 p39). The same comment might be made of superannuation funds covering public employees in Australia, who have become extremely competitive (witness the investment performance of the Commonwealth Superannuation Scheme in recent years).

O&S also note that "countries are experimenting with institutional arrangements - such as independent boards and clear legislative mandates to avoid political investing - to protect trust funds from political pressures" (p38), and "One potential conclusion from this literature is that public pension funds with sound corporate governance protections - independent boards and sources of financing, along with a clear legal mandate to pursue competitive returns - may avoid some of the pitfalls associated with pension fund investing" (p39). The proposal outlined above provides for a model which is consistent with this advice.

1.3.7 Government organised accounts in private sector

For those who find full government organisation too risky, James et al propose a system of "constrained choice" which is "much cheaper than the retail market and only slightly more expensive than the single centralised fund. It obtains scale economies in asset management and record keeping while keeping marketing costs low and allowing significant worker choice that will help insulate it from political interference" (1999 p2). "Specifically, contributions would be collected...through a public agency or private clearing house. (Possibly 'piggy-backed' on an existing tax collection.) These intermediaries would then allocate the funds according to worker choice, among a limited number of money managers chosen in a competitive bidding process" (1999 p23). Subsequently an open entry system could be phased in, in which companies agree to restrict their fees in return for a right to participate.

"The cost savings to participants come largely from efficiency gains - exploiting economies of scale in asset management, avoiding duplicate collection systems and fragmented record-keeping systems, reducing marketing expenses, and providing incentives to economise on communication costs... Employing passive managers in the early phase would further reduce costs" (James et al 1999 p32). Reducing expenditures on marketing, in particular, avoids a cost zero-sum game, paid for by workers, which is not serving any socially useful purposes. Most marketing is designed to persuade, not inform.

This plan looks very like the new Swedish system. "The long run steady state...is likely to be 14-18% of assets annually for a passively managed investment strategy...only slightly higher than a centralised scheme (0.4-6.5%). It is much less than the expected return to saving or the cost of voluntary or mandated individual accounts in retail markets (3.2-1.5%)" (James et al 1999 p4).
James et al argue that, compared to a centralised fund with no choice, the extra costs imposed by the constrained choice model are negligible, providing that a modest level of service is chosen for record-keeping and communicating with participants. But there may in any case be good public policy reasons for simplifying and limiting choice, especially at the beginning of the new system when many participants are saving and undertaking major investment decisions (apart from their home) for the first time in their lives. Studies have repeatedly found that the average investor is not very sophisticated in financial matters; for example 50% of the US public were found not to know the difference between a stock and a bond. This may be an argument for education campaigns; it may be a better argument for keeping choices simple in the first place.

1.3.8 Residual Government scheme

The idea here is to make it possible for employers to fulfil their SG obligations through a simple residual scheme which would replace the existing penalty tax on those not paying SG benefits. If this scheme were sufficiently cheap to run, and returns attractive, it might gradually increase in importance, as a cheap option for many small employers. The scheme could also function as a repository of funds for those changing jobs, in this way supplanting the many Approved Deposit Funds which often pay relatively poor rates of return.

Currently, compliance with the SG is enforced by requiring employers not providing for their employees to pay a penalty tax equal to the SG obligations otherwise due. These monies are then placed in accounts for the relevant employees. This system acts as an incentive to pay normal SG contributions because such contributions are tax deductible, whereas the penalty tax is not.

The proposed new system would provide an incentive for employers to opt in to, not out of, the default option. It could therefore be expected that its use would grow to become quite substantial over time.

1.4 Conclusion on administrative costs

The Australian system has managed to provide remarkably high real returns to many contributors which is, after all, the bottom line in assessing the results of such a system. It has done this despite imposing administrative costs which appear to be rather high, even by the standards of other countries imposing mandatory private superannuation savings. To this extent, the system must be assessed as a resounding success.

Nonetheless, feasible reductions in administrative costs could see final benefits raised by as much as a quarter or even one-third. Such potential gains are not often to be found in economics and, where they can be found, ought to be vigorously exploited.

These costs appear to reflect the rather ad hoc manner in which the SG tier was introduced into the Australian system. No inquiry into the likely administrative and compliance costs was ever undertaken, in marked contrast to the US system where debate on options for social security reform has taken such issues very seriously, and produced policy options specifically addressed to them. Accordingly, much of the discussion in this paper has drawn on the US literature.

This paper outlines several options for reform ranging from the relatively small to full government organisation through a new Office of Superannuation. In all case however it is envisaged that opting out of the SG tier will continue to be possible for schemes paying superior benefits. This means that transitional difficulties are minimised as far as possible, although it must be conceded that the option of full government organisation of the system would require much consideration as to the transition, and to governance provisions which would minimise political interference in the running of the fund. Those who do not believe that such interference is avoidable will not, of course, support such a plan, although they might support some of the less drastic options considered. By the same token that scheme holds out the potential to maximise the cost savings potentially available.
United Kingdom (1999) "A new contract for welfare: partnership in pensions"

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### Table 1 - Breakdown of Administrative and Investment Costs by Type of Fund: June 1998

<table>
<thead>
<tr>
<th>Type of Fund</th>
<th>Members (000)</th>
<th>Assets ($ Billion)</th>
<th>Est. Assets Over 97-98 (d)</th>
<th>Admin Costs ($m) per Member $</th>
<th>Admin Costs Total Inv. ($m)</th>
<th>Total Costs ($m)</th>
<th>Total Costs Per Member $</th>
<th>Total Costs Per Asset $</th>
<th>Total as %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>5,476</td>
<td>24.1</td>
<td>22.2</td>
<td>470</td>
<td>86</td>
<td>310</td>
<td>780</td>
<td>142.44</td>
<td>4,049</td>
</tr>
<tr>
<td>Corporate</td>
<td>1,292</td>
<td>64.3</td>
<td>59.2</td>
<td>161</td>
<td>125</td>
<td>320</td>
<td>481</td>
<td>372.29</td>
<td>45,786</td>
</tr>
<tr>
<td>Public Sector</td>
<td>2,839</td>
<td>79.6</td>
<td>73.2</td>
<td>153</td>
<td>54</td>
<td>95</td>
<td>248</td>
<td>87.35</td>
<td>25,795</td>
</tr>
<tr>
<td>Retail (a)</td>
<td>6,300</td>
<td>89</td>
<td>81.9</td>
<td>1071</td>
<td>170</td>
<td>1513</td>
<td>2584</td>
<td>410.16</td>
<td>12,997</td>
</tr>
<tr>
<td>RSAs (b)</td>
<td>250</td>
<td>0.5</td>
<td>0.5</td>
<td>23</td>
<td>92</td>
<td>5</td>
<td>28</td>
<td>112.00</td>
<td>1,840</td>
</tr>
<tr>
<td>ERFs ©</td>
<td>1,600</td>
<td>1.3</td>
<td>1.2</td>
<td>21</td>
<td>13</td>
<td>10</td>
<td>31</td>
<td>19.38</td>
<td>748</td>
</tr>
<tr>
<td>Excluded</td>
<td>334</td>
<td>42.4</td>
<td>39.0</td>
<td>220</td>
<td>659</td>
<td>105</td>
<td>325</td>
<td>973.05</td>
<td>116,790</td>
</tr>
<tr>
<td>Total</td>
<td>18,400</td>
<td>358</td>
<td>329.4</td>
<td>2120</td>
<td>115</td>
<td>2360</td>
<td>4480</td>
<td>243.48</td>
<td>17,900</td>
</tr>
</tbody>
</table>

(a) excluding RSAs and ERFs  
(b) RSAs - Retirement Savings Accounts  
© ERFs - Eligible Rollover Funds  
(d) Clare's asset figures relate to June 1998. Here they are estimated for 1997-98 using a conversion factor of .92.  
Source: calculated from Tables 1 and 2 in Clare 1999.
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