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MILLENNIALS AND SUPER: THE CASE FOR VOLUNTARY SUPERANNUATION

TARGET30
REDUCING THE BURDEN FOR FUTURE GENERATIONS

THE CENTRE FOR INDEPENDENT STUDIES

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Millennials and Super: the case for voluntary superannuation

Simon Cowan

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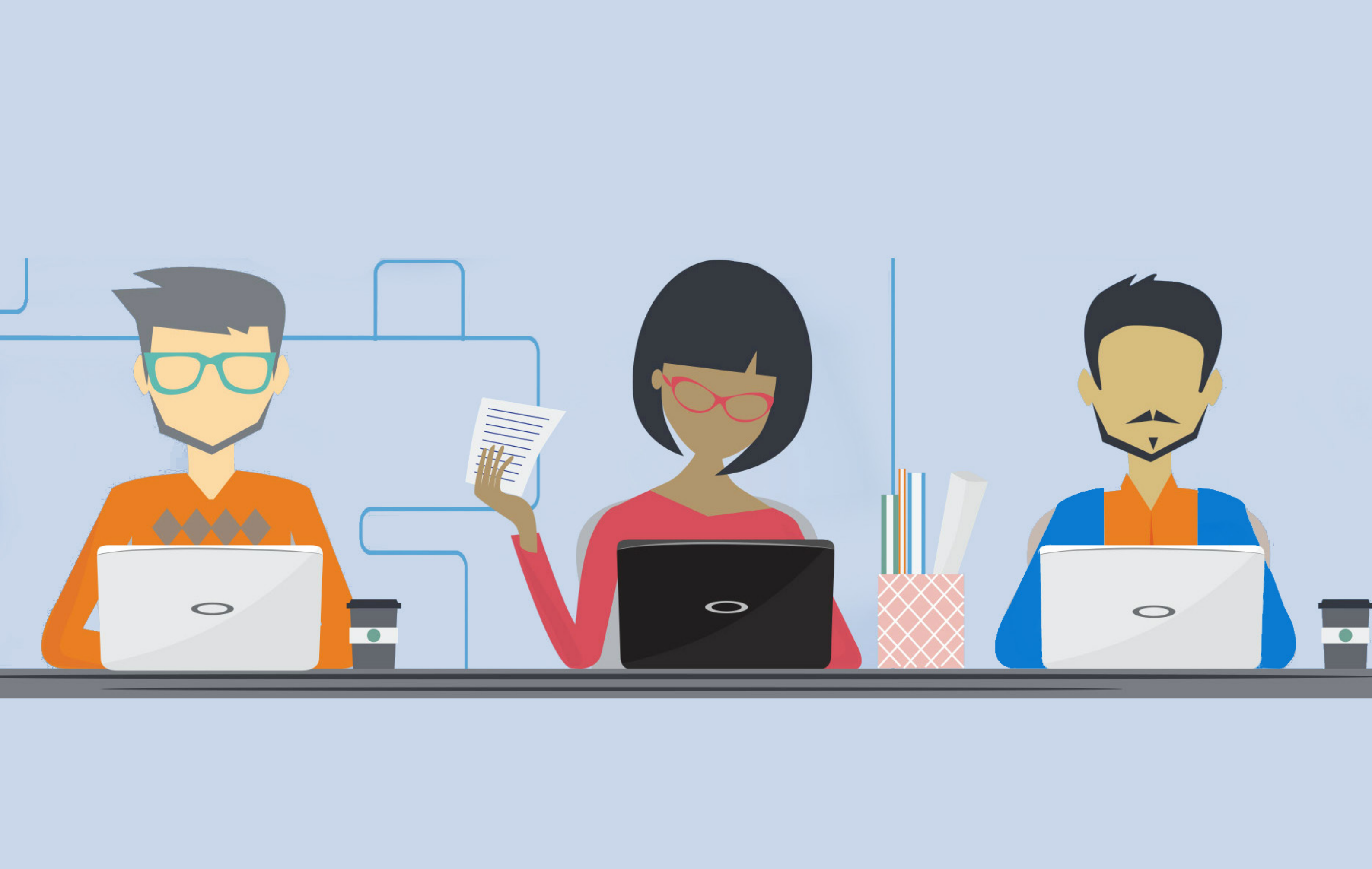


Introduction

Superannuation is a compulsory retirement savings scheme. The problems with the scheme are well known: fees are too high, returns are too low, and the system is not delivering independence from the age pension that might justify the level of intervention required to operate the scheme.

It is not necessary to examine all these problems in detail again. There have been a number of major reviews into the operation of the superannuation system from the Productivity Commission and others. Indeed, the one constant in the superannuation system has been change. Superannuation has been reformed time and time again with little evidence that the fundamental problems can or will be resolved.

That does not mean that superannuation serves no purpose, or should be abolished in entirety. There should be a tax advantaged, long term savings vehicle available to assist people save for retirement.

Yet, aside from questions regarding the fairness of providing tax concessions for high income earners, most of the focus of policy analysis in the superannuation field has been on expanding the system: should the superannuation guarantee rate (the compulsory deduction from wages) be raised to 12%; should superannuation be enshrined in industrial agreements or opened up to competition; who should provide default superannuation options; or should the minimum level at which superannuation is compulsory be lowered.

But questions should be asked about what is forgone in order to have compulsory superannuation, especially the negative impact that super might be having on homeownership rates. This leads to questions like whether compulsory superannuation contributions should be set at the same rate for all ages, or indeed whether the minimum income level at which superannuation contributions kick in should be substantially raised. These issues are equally as important as how the scheme should be expanded.

Arguably the most important question that needs to be answered, assuming superannuation continues to operate largely as it has for the past two decades, is whether the vast majority of the workforce should be compelled to remain in the superannuation system at all.

For millennials in particular, the first generation to enter the workforce with super contributions amounting to nearly 10% of income, these questions are crucial.

This report will explore these questions and look at savings patterns, expected future balances and seek to answer the question of whether superannuation is a good deal for millennials.

Retirement income priorities

When considering the merits of the retirement income system from the perspective of individuals, the relevant issue is what individuals should prioritise in order to have a comfortable retirement. Australia's retirement system is said to rest on three pillars: the age pension, compulsory super, and other forms of savings.

However, from an individual perspective, aside from the quasi-universal age pension, the evidence suggests that the single biggest factor in determining whether you will have a comfortable retirement is whether you own your home.

The 20% or so of age pensioners who are really struggling have a number of characteristics in common. Many of them are older, they are often divorced or their partners have died. They have no super and little savings. And most importantly they do not own their home.[1]

In fact for homeowners and non-homeowners receiving the full rate of the pension, that is to say the same income, homeowners have approximately nine times the net worth of non-homeowners.[2]

You can be comfortable in retirement without a super balance, after all the median super balance in retirement is still zero.[3] It is far harder to be comfortable if you do not own your home, suggesting that in terms of retirement priorities, homeownership should rank above increasing superannuation balances.

At a bare minimum, it is at least arguable that the decision to prioritise homeownership above superannuation is a logical one that should not be discouraged or prevented by law.

Some thoughts on compulsion in public policy

The issue of whether or not government should make laws whose primary effect is to generate a better outcome for individuals by overriding their individual preferences is a perennial one. Paternalism, which is at the core of these policies, has never sat well with the classical liberal tradition, bound as it is to individual liberty.

Certainly, right wing ideologies like conservativism, religious traditions like Judeo-Christian ones, and left wing ideologies like socialism and environmentalism — not to mention public health advocacy — have a much more comfortable relationship with the idea of benevolent paternalism.

Though there are good reasons to oppose much of this paternalism, entering into this debate is beyond the scope of this paper. Suffice it to say, the further government interferes with individual preferences, and the less significant the harm being prevented, the less justifiable government actions are.

It is also worth contrasting paternalism with incentivisation, where government attempts to correct 'bad' behaviour with rewards for doing the right thing. At a minimum, paternalism should be a tool that is reached for only if incentives are impractical, ineffective or unaffordable.

However, even if you accept the philosophical basis for government paternalism, for reasons of public policy efficacy it is still necessary to demonstrate that the paternalism is averting greater harm. Functionally, paternalism relies on government being in a position to better rationally assess what individual priorities should be than individuals themselves.

For example, in order to justify compulsory superannuation, three things should be present:

1. If left to their own devices, the majority of individuals will systemically under-save for retirement;

2. Under-saving for retirement will result in serious harm, presumably serious levels of old age poverty; and

3. The consumption patterns that lead to them undersaving for retirement are not optimal, or rational.

Unfortunately for its supporters, even if you accept that compulsory super clears the first condition, there is strong evidence to suggest that the pension is sufficient to address the issue of old age poverty.[4]

However, little thought has been given to the third condition. It has been assumed that if 1 and 2 hold, that 3 is a given — ie that because people under-save for retirement and because old age poverty is a concern, the right thing to do is to force them to save while they are working.

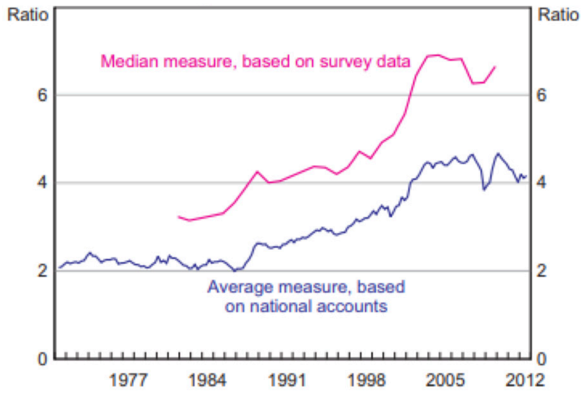
But this should not simply be assumed. Savings priorities may not be as irrational as some assume.

Housing affordability and its potential impact on retirement

The importance of owning a home to living standards in retirement makes recent trends showing the declining rate of homeownership among millennials so concerning.

Though it does not necessarily indicate causation, since compulsory super was introduced in the early 1990s, the ratio of average house prices to incomes has continued to worsen.

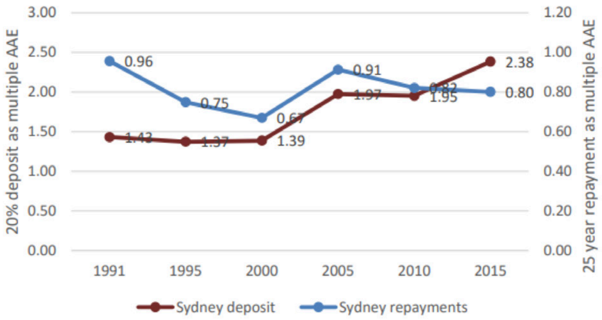
Figure 1: Dwelling Price-to-Income Ratio



Source: Reserve Bank of Australia[5]

There is a significant caveat in relation to the story of diminishing housing affordability. The increasing ratio of house prices to income is at least partially a function of low interest rates. As such, the increased capital cost of housing has largely been offset by the reduced cost of servicing a mortgage as a result of the fall in interest rates. As a result, when considered in terms of the percentage of income taken via your mortgage, affordability has not worsened nearly so dramatically.

Figure 2: Deposits and repayments 1991 to 2015 - Sydney



Source: Australian Institute for Progress[6]

However, the increased capital cost of housing has not been offset by falling interest rates in one very important way: raising a deposit for a home has become a lot harder and it is this more than any other factor that has made it so hard for millennials to buy a home.

The average deposit as a multiple of average earnings almost doubled between 2000 and 2015. And it is here that the interaction with compulsory super matters so much because as millennials are trying to save hundreds of thousands of dollars in order to get on the bottom rung of the property ladder their income is docked nearly 10% to save for their retirement.

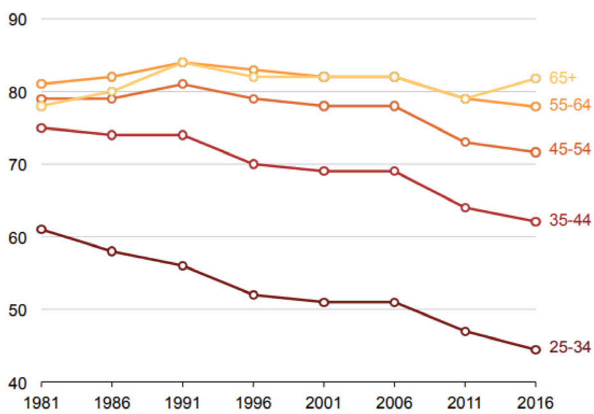
There is little doubt that the massive increase in the deposit required to purchase a home substantially delays property ownership for first time buyers. This means that people will be older when they pay off their mortgage, in some cases substantially so. For some, this hurdle will never be overcome.

Superannuation, especially the increasing guarantee rate, makes that task harder still. In effect this means that, though it is likely that homeownership is more important than accumulating superannuation, the system prioritises superannuation above homeownership.

This can be more clearly seen by the changes in homeownership by age. Since 1991 homeownership rates have fallen across every age group. However, by far the biggest falls have been amongst the 25-34 and 35-44 age groups. The next largest fall has been in 45 to 54 age group, and then the 55 to 64 age group, while 65+ has barely fallen at all.

Figure 3: Home-ownership is falling for younger age groups

Home-ownership rate by age, per cent



Notes: Per cent of occupied private dwellings. Household age group according to age of household reference person. Excludes households with tenure type not stated.

Sources: Yates (2015b) and ABS (2016b); Grattan analysis.

Source: Grattan Institute[7]

This suggests two things. First, the continuing falls in homeownership rates from 2000 onwards (when deposit rates started to rise significantly as a percentage of income in Sydney in particular) show that the deposit gap has an enduring impact on housing affordability, though some people do overcome it in time.

Second, those seeking to get into the property market after the introduction of compulsory super have found it harder.

Of course if your income is sufficient that you can promptly save for a deposit and contribute to superannuation, then this situation is probably in your favour, or at least not significantly to your detriment. If your income is not sufficient to meet both purposes, then the compulsory super system probably makes things worse than they would be if super didn't exist at all.

First Home Super Saver Scheme

In 2017 the government introduced the First Home Super Saver Scheme, which "helps Australians boost their savings for a first home by allowing them to build a deposit inside superannuation, giving them a tax cut."[8]

The scheme allows prospective first home buyers to make voluntary super contributions up to $15,000 a year, and $30,000 in total, that can be accessed to fund the purchase of a home.

The scheme has not proved popular, with just 2,374 people accessing funds in the first 7 months of operation (fewer than 4% of all first home buyers who were granted a home loan during this period).[9] There have also been difficulties reported in accessing funds in a timely manner.[10]

The first point to note is that this in no way addresses the impact of compulsory super on the ability to save for a deposit: it applies solely to voluntary savings in addition to super. As a consequence, it is likely to benefit those who are already likely to buy a home, not those who are unlikely to be able to save enough to do so.

In addition, it's not clear that demand solutions to housing affordability are the optimal response. Restrictions on supply are the major reason for housing affordability issues.[11] While boosting the purchasing power of first home owners may change the composition of those buying a home and allow a few more first home owners to purchase a home, it will almost certainly feed through into higher prices. This drawback would apply to any demand side solution, including allowing access to super savings for a home, or making all super contributions voluntary.

A 1980s industrial model of super doesn't fit changing work patterns

Superannuation is a compulsory deduction of 9.5% of pre-tax wages, which must be paid into a nominated superannuation fund that cannot be accessed until a certain age is reached. Generally contributions are taxed at 15%, though very low income earners and very high income earners have different rules, and there are caps on how much can be contributed each year. Earnings on money in the superannuation fund are taxed at 15% until retirement when earnings are tax free up to a balance cap.

The system is highly regulated and highly regimented, and the rules and regulations are piling up over time.

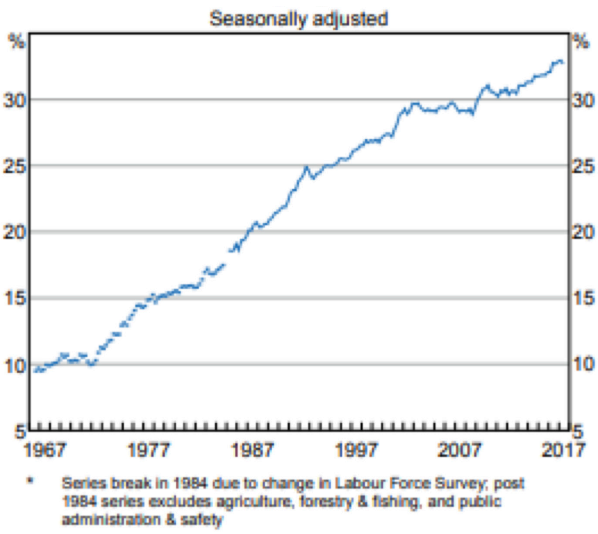
It is unfortunate that regulators have continued this trend of making the superannuation system more and more rigid, as the nature of work itself has become more and more flexible. Of course in part this may be because super came from, and is embedded in, an industrial relations system that evolved to be quite rigid in places.

Regardless of the cause, flexibility is exactly what the superannuation system lacks, and as the nature of work continues to evolve, the risk that super will cease to be fit for purpose can only grow.

The rise of part time work

Even since the broad based super model began to gain steam in the 80s, the nature of work has changed significantly. The biggest change is that the percentage of workers working part time has increased hugely, almost doubling since the start of the 1980s.

Figure 4: Part-time Employment Share

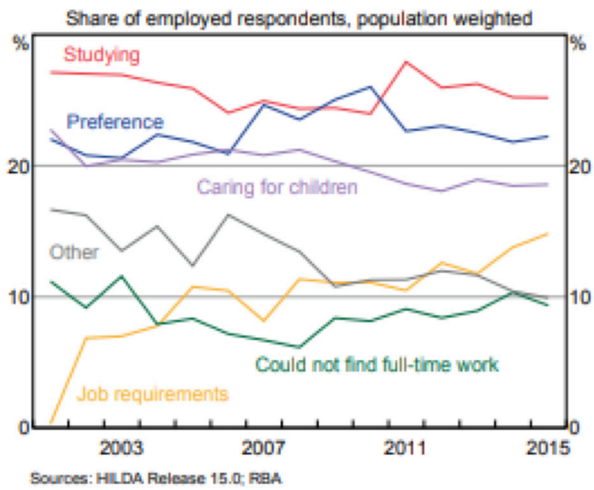


Source: Reserve Bank of Australia[12]

This mirrors the trend in female workforce participation but does not solely reflect the preferences of female workers. In truth, the number of people working part time has increased across the board. This cannot be dismissed as a function of a lack of full time jobs. While many part time workers would like to work more hours, the percentage of part time workers who could not find full time jobs has remained relatively constant for 30 years, despite the number of workers in part time employment doubling.

Regardless of the causes of this shift towards part time work, it has been an enduring trend now for decades. This means that one significant conclusion is inescapable: the rigid model of a single income family, supported by a full-time male breadwinner, no longer matches our typical working family.

Figure 5: Reasons Why People Work Part Time



Source: Reserve Bank of Australia[13]

The impact of part time work on super

What does this mean for super? More specifically, to what extent does the model of superannuation we have now depend on a full-time income?

At a relatively simplistic level, super basically works on the principle that regularly sacrificing small amounts of money over a lifetime of work will add up to a substantial sum of money in the end. It relies on the power of compound interest and regular contributions to add up to more than is sacrificed. This is becoming ever more true given the further limitations on voluntary contributions recently put in place that make it harder for someone to catch up in their 40s and 50s.

What happens when we deviate from that model? Well we can already see the impact of working part time and moving in and out of the workforce in the massive variation between male and female super balances. Estimates suggest that the gap between average super balances for men and women is almost 50%.[14] While no doubt gender pay averages contribute to this differential, other key factors include "women working part-time … and taking extended periods out of the workforce caring for children and other family members."[15] That these factors also contribute to the gender pay gap is hardly surprising.

Some simple calculations can demonstrate just how big an impact some career breaks and working part time can have on your super balance. Using a publicly available super balance projector,[*] we can estimate the balance on retirement of those earning average wages, median wages, and minimum wages.

- First State Super, www.firststatesuper.com.au

Income FTE	Balance FT	Balance PT	Balance FT + Break	Balance PT + Break
$37,000	$213,446	$142,674	$181,347	$122,054
$53,000	$307,883	$206,506	$278,405	$192,492
$82,000	$479,050	$322,203	$403,370	$274,610

Note: these figures are calculated under current settings with a balanced growth option selected, and are dependent on certain assumptions.**

The point of this is not to suggest that these figures are exactly representative of standard career patterns, though many people do take career breaks totalling 5 years, especially mothers with children.

It's easy to see how women, especially mothers, who have career breaks and work part time, have lower super balances than men who work full time. It is important not to let the gender issue obscure the fact that the underlying problem comes from work patterns. Women are more likely to work part time, to take career breaks, and to be paid less, but any man who replicated those work patterns would find a similar super balance at the end of their working life.

Super is gender blind. Working part time for long periods of time, even for someone earning the median wage, results in a substantial reduction in super balance. A relatively short career break also has an impact on balances. When combined the impact on future retirement balances is very large.

And, as technological change increases, it is likely that career changes and breaks, as well as part time work, will be more frequent occurrences in the future than in the past. Moreover polling of millennials suggest they are more open to career changes than their predecessors.

And we already know that this pattern of work delivers substantially lower super balances in the longer term.

The default assumption in response to the gender gaps in super is to propose ways to get women to save more or for government to provide additional payments into super to top up women's balances.[16] This assumption also flows through into responses to general concerns over low balances: that the solution is to raise the super guarantee rate from its current 9.5% to 12%. But that presumes that increasing super balances at any cost is inherently good, an assumption that should be challenged.

Indeed, thus far we've established that superannuation is likely a hindrance to lower middle income earners purchasing a home and that it doesn't meet the working patterns of many of those individuals. The last step is to consider what might those individuals do if not compelled to save for retirement?

Do savings patterns match superannuation?

Although you've always been able to access your super in certain limited circumstances — including medical emergencies and desperate poverty — for the average worker, super has been quarantined for retirement.

The exclusive nexus between superannuation and retirement has been a challenge to proper analysis. Specifically, analysing the efficacy of superannuation as a savings vehicle has largely been ignored in favour of focussing on how effective it is at generating a comfortable retirement.

Yet, in addition to the flaws in superannuation outlined in this paper, there are two other reasons to look at the broader question of whether super is a good savings vehicle.

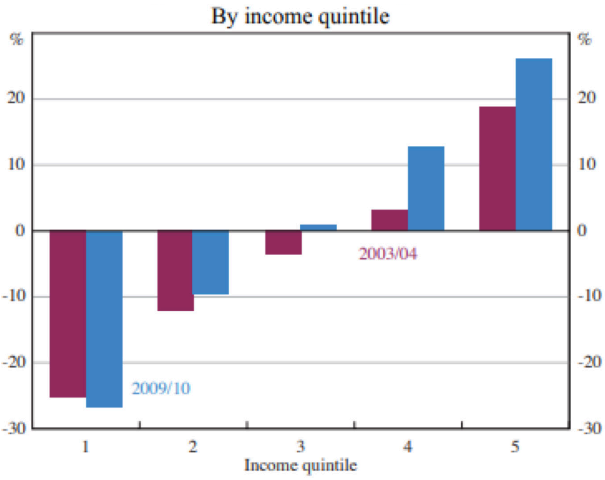
First, as compulsory contributions reach their expected level of 12% of pre-tax income, super contributions will increasingly displace other forms of savings, to the point that super will be the only substantial form of saving for many households.

Second, if we do break the exclusive link between superannuation and retirement (for example to

** Worker is assumed to start relevant work at age 23, with a super balance of $5,000, reflecting casual work prior to this age. Part time work is assumed to be 3 days a week, commencing at age 30. The Break is 5 years from age 30. For Part Time work plus break the break is approximated by delaying the start of work by 5 years, and part time work is assumed to commence at age 35. Person is assumed to retire at age 65, reflecting the fact that the majority of people retire prior to age pension eligibility age allow people to buy a home), there is little doubt that pressure will grow to access superannuation for other reasons. Two obvious candidates are access to additional maternity leave and meeting the costs of supporting a young family. Superannuation might evolve into a sort of personal future fund.[17]

Another way of expressing that point is to ask how well the super system fits our voluntary savings patterns. One thing that is clear is that savings rates vary markedly depending on two factors: age and income.

Figure 6: Household Saving Ratio



Notes: Gross of depreciation; weighted average; age-matched

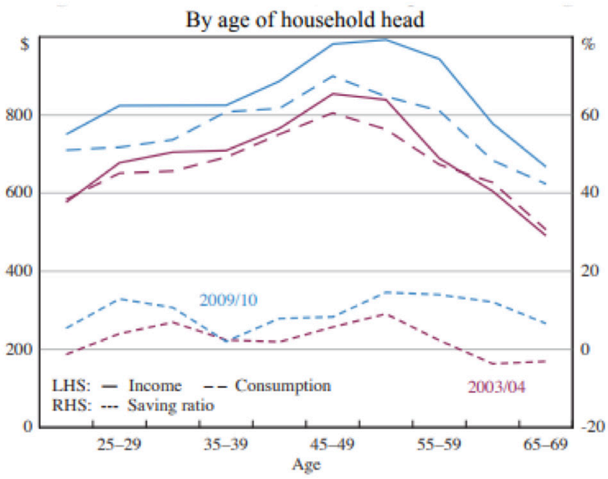
Source: Discussion Paper, Reserve Bank of Australia[18]

What we can also see here is that high income households will save far more than 9% of their income, whereas low income will save far less and indeed their savings rate may be negative. Of course we know that households and individuals move through income brackets over the course of their lives, so we need to be cautious about drawing too many conclusions from a point in time study.

Age patterns are less linear but no less stark. We save more in our 20s when we have relatively few commitments and a rapidly growing income. Many are also beginning to save to try and get into the property market. We save less in our 30s primarily due to increasing consumption required to support a family and the likelihood that one parent will earn less income.

We save more in our 40s and 50s as we prepare for retirement and then in our 60s and 70s and onwards we starting living off those savings (or more accurately the age pension).

Figure 7: Household Savings by Age



Notes: Saving is gross of depreciation; income and consumption are weekly and in 2009/10 dollars; weighted averages across age groups

Source: Discussion Paper, Reserve Bank of Australia[19]

However a simple point emerges: even with compulsory super your savings rates rarely match those mandated by legislation. This suggests that people are working around the system to create much-needed savings flexibility themselves.

While this flexibility may seem like evidence that the compulsory nature of the system doesn't need to change, it is unlikely that the workarounds are efficient or cost-free. An obvious example is someone taking on personal loans, or running up credit card debt, that they can pay off with their super. The interest and fees on those forms of debt are an unappreciated cost of compulsory saving.

However, debts that are paid off with non-super future income can also be seen as a cost of the compulsory nature of the scheme, even lost interest from drawing down other forms of savings. As compulsory super is deducted from income, it must have one of two effects with regard to household consumption. Either consumption must fall to match the lower income level (which is a direct fall in living standards) or consumption must be supported by drawing down savings or taking on debt. Any economic consequences of those decisions must be considered costs of compulsory super.

Not only that but the super system warps savings priorities as well. The presumption of compulsory super is that few would save for their retirement if not compelled to do so. However, given the importance of the home to retirement living, it can be strongly argued that saving for a deposit on a home *is* saving for retirement. And Australians certainly need no compulsion to buy houses.

Superannuation and Family Income Support

A significant theme of this report has been how, by compelling people to save for their retirement in their 20s and 30s, the super system is necessarily diverting resources away from the more important priority of buying a home.

What is less obvious is that this diversion also occurs in relation to the cost of raising a family.

These are secondary, and unappreciated, effects caused by the reduction of income via compulsory savings. Though the role super plays in exacerbating these problems is not acknowledged (or perhaps even understood), both in the case of first home buyers and young families, government intervenes in the market to attempt to provide assistance.

Which means the government helps to create the problems that they are attempting to solve.

State and federal governments provide grants and stamp duty relief for first home owners, as well as schemes like the one described above that allow potential home buyers to save additional funds via super to assist in purchasing a home.

Government does even more to support young families. On top of free medical care, and substantial contributions towards education and child care, the government pays income support in the form of family benefits to many working families. This support costs the budget more, and is available to those with substantially more private income, than unemployment benefits.

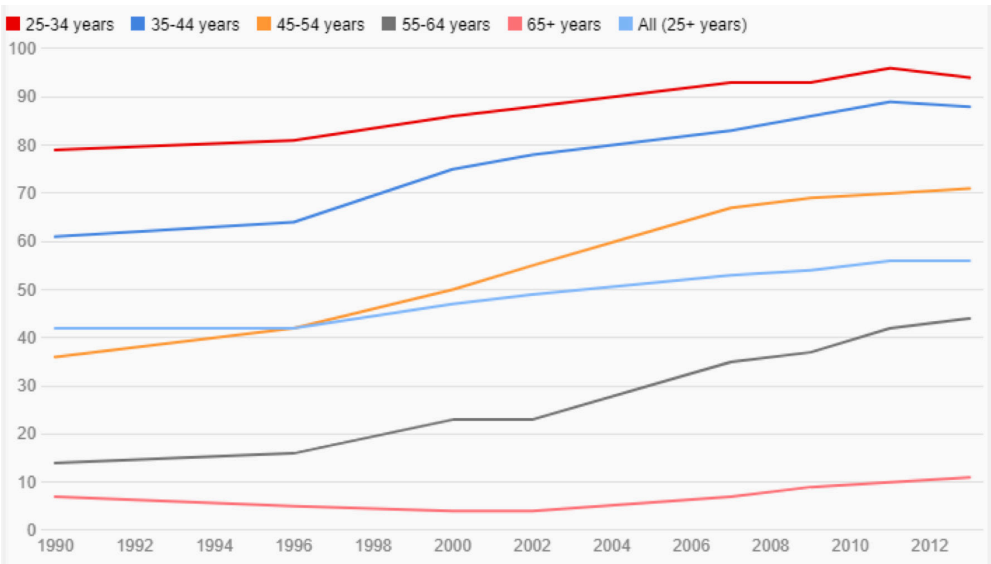
To put this in perspective, a family of four with a single income earner on $75,000 a year pays $7,125 a year into superannuation but receives around $7,500 a year in family tax benefits alone.

Indeed, family benefits are an almost farcical situation, given the government deems a family poor enough to need income support but also compels them to save 10% of their much needed income.

Mortgage debt and its impact on superannuation

As noted above, to a certain extent people can create much needed savings flexibility themselves, even if the super system doesn't allow it, allowing their savings patterns to more accurately meet their needs. One way to do this is to take on debt that will be paid off through superannuation. Not surprisingly, given the other trends in terms of housing affordability discussed above, there has been a significant increase in the amount of mortgage debt held by those moving into retirement.

Figure 8: Rate of mortgage debt (%), Australian home owners, 1990 to 2013



Source: Ong, Wood, Atalay, Cigdem-Bayram[20]

	Men	Women
Superannuation other than that converted to a regular income		
Percentage of retirees with superannuation who had other remaining superannuation (%)	67.8	81.3
Use of other remaining superannuation[a] (%)		
Left it in the superannuation account	59.4	61.2
Invested it in an approved deposit fund, deferred annuity or other superannuation scheme	11.0	9.2
Invested it elsewhere (e.g., bank accounts, shares, property)	17.0	15.2
Paid off debts (e.g., home loan, car loan, business debt)	9.9	13.1
Paid for large expenditure items such as home renovations, holidays and motor vehicles	9.0	8.6
Assisted family members	2.8	5.4
Other	*1.6	*2.3
Retirees who used superannuation to pay off debts		
Mean amount used to pay off debts ($, December 2015 prices)	235,978	120,543
Mean proportion of superannuation used (%)	58.2	70.0

Source: HILDA[21]

The percentage of home owners with a mortgage debt has increased for all groups over the last 20 years but the biggest increases have been in the 55 to 64 age group, the 45 to 54 age group, and the 35 to 44 age group and in that order.

Also worth noting is that from 1990 to 1996 the gap between those aged 55 to 64 and those aged 65+ is fairly narrow, even if it is very slowly moving in different directions. As housing affordability decreases, as the deposit gap widens, and as the compulsory super system takes a greater share of income, the gap between those two groups widens. By 2013 the gap is more than 30 percentage points.

Moreover, evidence suggests that 6% of men and more than 10% of women with superannuation used that superannuation to retire debts. For most of those people this accounted for a significant proportion of their super balances.

One can argue whether this is a good use of superannuation at the individual level but there is little doubt it provides no benefit to the taxpayer. Having provided substantial tax concessions for decades in the hope or expectation that retirees would use this super balance to supplement their income and reduce their dependency on the pension in retirement, 5% to 10% of them immediately used most of their super to pay off debt.

Conclusion

The inescapable conclusion is that superannuation is not a good deal for everyone. There are three key issues, not all of which are directly caused by flaws in the architecture of the super system, that should make us rethink making super compulsory.

The first is that massive increase in house prices in Sydney and Melbourne in particular is likely to have a significant impact on the ability of lower income families to buy a home. It has become much harder to save for a deposit and, as a result, homeownership percentages among younger workers have fallen.

Superannuation, particularly future increases in the guarantee rate, makes it harder to save for a deposit. Given the importance of owning a home for comfort in retirement this is a concerning trend.

The other element that is of particular concern to younger workers is the increase in prevalence of part time work. Working part time for a long period of time, particularly when combined with career breaks, substantially reduces future super balances, as the significant superannuation gap between men and women shows.

Part time work, particularly when shifting between a number of employers, makes it much more likely for a worker to end up with a number of superannuation accounts, another negative for future super balances.

The last element of concern is that the super system does not reflect the savings patterns of lower income workers. Inherent in the compulsory nature of super is the idea that people's saving and consumption choices are irrational, and so need to be corrected or people will under-save for retirement and live in old age poverty.

Not only is the Age Pension an existing solution to this problem, one that is neither eliminated or substantially displaced by superannuation, but there are often good reasons for lower income workers to prioritise consumption over savings, or different savings goals over retirement.

As noted above, one area where compulsory retirement savings are damaging is saving for a deposit for a home. Another area is the additional expenses incurred by a young family. For those who may not be able to afford both, accessing savings to extend maternity leave, or to enable one parent to work fewer days and stay home with their child, is almost certainly preferable to saving for retirement.

A voluntary system, or at a minimum one that has a far higher threshold for compulsory participation, would give millennials and low income workers greater flexibility in their savings choices. This would be a welcome improvement to the current compulsory super system.

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About the Author

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Simon Cowan is Research Director at the Centre for Independent Studies. He is a leading media commentator on policy and politics, frequently appearing on the Sky network, ABC television and commercial radio. He has appeared before a number of parliamentary committees discussing the budget, health policy, and Constitutional issues.

He was head of CIS TARGET30 program that produced a number of reports looking at ways to reduce government expenditure, cut taxes and to make Australia's tax system more efficient.

He authored the leading CIS research reports on pensions and retirement policy, *The Age Old Problem of Old Age: Fixing the Pension* and *The Myths of the Generational Bargain*. His most recent pieces looked at options for welfare reform: with *Welfare reform beyond decades of dependence, 'dole bludgers' and 'double dipping'* focusing on the role of need in the welfare system and *UBI – Universal Basic Income is an Unbelievably Bad Idea* looking at the viability of replacing the system with a basic income.

Related works

Simon Cowan and Matt Taylor, *The Age Old Problem of Old Age: Fixing the Pension*, The Centre for Independent Studies, (Sydney 2015)

Simon Cowan, *Welfare reform beyond decades of dependence, 'dole bludgers' and 'double dipping'*, The Centre for Independent Studies, (Sydney 2017)

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