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Submission to the legislative Council – subcommittee – Retirement Benefits Fund unfunded liability - enquiry.

My submission addresses your terms of reference, and is provided from a position of an understanding, at a detailed level of the Defined Benefits Superannuation system and a high level of technical competence with Superannuation Law.

1.1 History of the Defined Benefit Fund liability:

Firstly I would like to draw to the committee's attention, the basis of why this unfunded liability has grown to the point where it will now start to consume an ever-increasing amount of the cash of the Tasmanian government.

If this was not the case, then there would be no enquiry by the Legislative Council.

It may be that Parliament would assess that those ever increasing cash diverted to public sector super payments should be more properly directed to education and health care funding.

This is the Political question.

But how is this scheme been allowed to get out of control?

In the 1920s, there was a general movement throughout Australia to provide for government employees by way of superannuation retirement funding, and, this was primarily done in order to attract government employees, as wages for those employees were less than similar wages in the private sector.

We should remind ourselves that the bulk of government employees in those years, were railroad employees, road workers and construction workers. There were very few white collar positions.

Actuarially, the longevity of the average employee after age 65 years was around 12 years.

This saw the defined benefit superannuation scheme's set up with a 40 year term of employment qualification for a maximum benefit of 67% of average final salary over the previous three years.

Salary movements were relatively minor in the period 1930 -1939.

World War II arrived which saw some 650,000 Australian males and females join the defence Force, and a large number of these soldiers sailors and airmen, were in the age range 18 to 20 upon joining, and at war's end in 1945 with the de-mobilisation, the average age returning to the public sector workforce was thus at the entry age of 24 to 27 years.

The public sector especially in Tasmania was no different, transiting from a war economy back to a peacetime economy and at the same time in order to make allowances for new staff joining the government in various capacities, the RBF Defined Benefits superannuation scheme length of qualifying service was changed to allow for this.

This is the defined benefits fund change to a 35 year scheme option, where the average age of entry was 25 years, with an assumed retiring age of 60.

The contributions to these two scheme levels were for the 40 year scheme; 5% of salary contributed by the employee; for the 35 year scheme, 8% of salary contributed by the employee.

The matching component of government contribution was notional and thus unfunded and certainly untaxed.

This of course accrues a tax bill for the public servant member at retirement and the RBF pension is not tax free as other superannuation pensions are tax free post age 60 years. This disadvantages those public sector retirees who are eligible for partial Centrelink support. The committee should reflect that Centrelink payments after age 65 are taxable.

The period 1970 to 1975 saw substantial changes to superannuation law in Australia and a reduction in the age of retirement to 55 years.

Superannuation law was changed for persons born before 1960, and on a sliding scale to those born in 1965, the retirement age moves from age 55 to age 60. These retirement ages are built into the superannuation law and as a result have seen a range of options provided by government including return to work pensions.

This saw a change to the defined benefit scheme once again with the introduction of the 30 year scheme option, which required a contribution from the member or employee of the government of 11% of salary. Again the government contribution was not funded, being notional, and again untaxed.

Again the future tax liabilities for the public servant beneficiary were not explained to the beneficiary nor were they given a choice of funds option. Such Choice of funds options compels the State of Tasmania to contribute real cash to the member's fund of choice at 9.5% of salary. Ultimately this is a cheaper option government than meeting the cost of pensions on emerging cost basis.

None of the National superannuation options are available to persons who are members of the Retirement Benefits Fund defined benefit scheme.

The scheme remained confined and in the year 2000, the defined benefit scheme was terminated for new employees.

The new employees were provided with the same option as everyone else in Australia, that being, an accumulation superannuation account.

There was indeed no reason for the Government to provide any further superannuation support as there were over 60 super funds to choose from.

Longentivity Issue:

During the period of time since the start of the RBF defined benefit scheme (the 1930s), diet, health care, and medical advances have meant that the statistical age of death across the community in Tasmania is around 84.5 years for males and about 85.7 years for females.

Hence the actuarial base of the defined benefits scheme, saw in 1930, a pension being paid for around 12 years, and in 1960 the pension being paid for 12.47 years this rose in 1990 to 15.41 years and in 2007 was 18.54 years.

Future Life expectancy from 2018 is estimated to see pensions being paid for around 21.6 years'.

So from a design base of 12 years of pension payments, when the scheme first commenced, to a pension payment liability of 12 years, we now have a pension payment liability of 21.6 years.

In other words the liability on the Taxpayer has increased by 55%.

This liability is thus exponential and fully exposes the Government to meeting the CPI costs of the benefits annually without any remission.

This is the fundamental reason that the defined benefit scheme will now begin to consume more and more of the state revenue, at an increasing rate far above inflation. There will be more pensioners who will live much longer and at much higher aggregate FAS3 salary numbers.

Actuarially the rates of contribution by government have jumped dramatically.

There is another reason for this in that the economic risk on the fund is borne by the government not the member.

This means in a period of low investment returns and low interest rates that the cost to government of the scheme increases exponentially.

The Committee has noted in it's terms of reference that the rising costs of $74 million over a three-year period, will either require $74 million of savings by way of reduced public sector output, or the sale of $600 million of government assets to reduce loan indebtedness, in order to fund the $74 million needed to pay public servant superannuation liabilities.

It is a stark choice.

In fact the $74 million is a very conservative number and more likely to be closer to $100 million.

In essence if nothing is done, it will force the closure of schools and one of the larger hospitals in order to fund the outlays.

1.2. Lack of funding by government

Historically in Tasmania, there has been a little political will to fund the superannuation indebtedness of the state defined benefit scheme for the public sector.

Given the very small revenue base of the State of Tasmania; the fact that it is a chronic mendicant state; and a further fact that the public service has been used as a jobs generator for many cycles of government; there has been little spare revenue to consider setting aside funds to meet the emerging liabilities of future pension payments. This process is not attractive to either major party in Government who see this function as entirely the responsibility of their political opponents and thus will defer of dismiss any action to correct a long standing problem.

Now that the liabilities are growing ex-potentially, and the growth revenue potential of the Tasmanian government in a slowing economy nationally and locally, is going to be minimal, these liabilities will begin to hurt the budget in outlay ratio terms.

Although the government business enterprises have also liabilities for this defined benefit fund liability of their older employees, a reading of their balance sheets sees the liabilities again as notional and unfunded, being supported by the government business enterprise assets, but funded on (as is the case in government general), on emerging cost basis.

2.1 Reasons for the increased funding shortfall.

Defined Benefit Scheme pensions were seen by the private sector in Australia as being a bottomless pit, which could not be accurately estimated in terms of liability.

From 1975 onwards, especially when the Corporations Act changed liability requirements, private sector companies terminated all of the defined benefit superannuation funds nationally within a very short space of time.

The reason they terminated these funds was because they could not support in cost terms the ex-potentially nature of the pension liability. In the private sector, accounting is unlike the government accounting where cash is irrelevant to the government.

In the private sector these liabilities had to be funded with real money, and this detracts from the fundamental use of shareholder funds, and thus the defined benefit schemes were closed primarily because future shareholder funds would be at risk as the liabilities and the superannuation funds could not be controlled.

The reason they could not be controlled was that salaries and wages were correctly reflective of the market.

As the market price of particular occupations rose, especially for those occupational classification where shortages were substantially apparent, the superannuation liabilities rose ex-potentially, and thus were unable to be quantified. The Private sector simply got rid of that liability.

However the public sector did not bother with any consideration to long-term liabilities, being entirely focused on an annual budget, and a three yearly or for yearly election cycle.

It was not until a federal government actuarial report on its own defined benefit fund liabilities hit the Cabinet table with a thud, that the response of the government was structured, immediate, and set up in such a way as to make the funds being set aside and un-touchable in political terms.

This is called the *Federal Future Fund* which has an independent board, presently headed by the **Honourable** Peter Costello, and in effect is not part of the government.

The funds are for the payment of emerging costs of Federal employee defined benefit obligations.

I note here that Tasmania has no future fund. This would be an option for the Tasmanian Parliament to consider as it would quarantine the liability within the future fund, which could have the loan funds directed into its accounts to be invested, repaying the loan and meeting the future liabilities of each individual member of the superannuation fund.

This future fund can be legislated in such a way as to require an absolute majority of both houses of Parliament to change the legislation, as does the Federal Future Fund Act.

Gaining such support would be remote.

I also note that the Honourable Ruth Forrest MLC, a brave person, doggedly pursued the previous governments in relation to the superannuation provision account, which in the end turned out to be smoke and mirrors.

Tasmania has no funds set aside in cash, or real assets, to support the payment of the public sector superannuation liabilities on emerging cost basis.

Thus the funding shortfall has several recent acceleration factors and these are;

1. Public service pay rises of around 20% during previous Labor/Green governments.
2. Classification creep, which provides for salaries for government positions, that are *substantially higher* than similar jobs in the private sector, and this is been allowed to occur over the last 10 years.

Thus it is estimated that these two factors have added in gross terms to the long-term liability of over $1 billion, and now is making itself felt in cash flow terms as some of these employees retire.

2.2 Further reasons for the funding shortfall.

A further generator of retirement funding growth is the concept built into the schemes called final average salary or FAS.

This to some degree has generated an institutionalised rort, whereby persons considering retirement within organisations, are given favourable treatment in relation to additional salary by way of higher duties allowances and even promotion, in order to increase their final average salary, over the last 3 years of their public service working life.

This of course increases the liability of the government, and at the point of writing, I can find no evidence of any accountability criteria for salary increases above CPI in the last three years of employment Tasmanian Public Sector employees, who have an entitlement to a defined benefit fund pension from the Retirement Benefits Fund.

3.1 The risks and implications of the current and any future increases in employer contributions to the government's budgetary position.

Tasmanian Public Service Super Scheme is set to decimate the state budget.

This has been accelerated by the reduction in public sector employment, and is awaiting the impact of some 40% of the present public sector who will retire over the next 8 to 10 years.

The Retirement Benefits Fund liability has now become a current liability rather than at deferred liability, it will as a real emerging cost need to be supported in cash.

As you say it will increasingly impact in real terms, the budget of the State of Tasmania over the next 4-9 years.

I should note here that the defined benefit scheme was terminated for new entrants in the year 2000, primarily due to the fact that the costs of the scheme had escalated faster than the Government could fund it, by setting aside present cash to meet future cash drawings on the scheme.

The actuarial forecasts were scary, but have been ignored in the political context of the budget of Tasmania.

The other reason that it was terminated, was that the actuary in estimating the costs of the scheme pointed out to the Government of Tasmania, that the assumptions that applied in 1935 in terms of how long potential pensioners lived; had blown out from 72 years to 83 years.

Rather than having to fund 12 years of pension benefits the Government was faced with funding an average of 20 years of benefits and each year the costs compounded with indexing.

For an simple example and one easily understood by the average Tasmanian Taxpayer, we will take a public servant who retires at age 60 with an average final salary of $70,000. The public servant will receive a pension of 67% of the $70,000 being $46,900 per annum usually indexed to the CPI. Assume a CPI of around 3%.

This means the pension benefit rises to around $84,700 over the 20 year period of the life of the pensioner.

Fair enough you say.

However the Public Servant has only contributed between 5 to 11% of his or her salary into the scheme since they commenced employment.

The personal contributions are nowhere near high enough to generate the level of capital that would secure this long term benefit, and the co-contribution from the Government has not been contributed at all, leaving the Retirement Benefits Fund with a deficiency of funds to pay pensions in the order of $5.8bn and rising ex-potentially.

To meet a payment of the level presently paid to public servants, the contribution would need to be 11% by the public servant and 15% by the Government in actual cash, with the funds set aside and invested over the term of the public servants employment of some 30 years.

Presently to generate a pension for 22 years at $49,500 capital of some $650,000 would be needed.

This would need the Tasmanian Government equivalent of the Future Fund. It could not be raided by any government to fund recurrent outlays. However there is little political will to do this.

Along the way Governments have been made well aware of this liability that is presently met on what the Tasmanian Treasury calls an **"emerging costs basis".**

This is Treasury Department speak for "*We have no idea of what the costs will be year on year*", but we assume that this would be being fully dependent upon retirements and deaths. In other words they cannot control retirements.

For example the present pressure on budgets across the State Service, will see pressure on older frontline managers and higher paid public servants to retire.

They will be paid incentives to do so in order to meet the present annual budget cash deficit which in 2014 was about $450m on the consolidated fund.

If you strip out the counting of Federal capital payments counted as income in the 2011-2014 fiscal year this is the present level of the actual deficit.

This is a simple expedient, but one that will now reverberate into the bowels of the consolidated fund of the Government in future years.

Simply put for every $100m of salaries saved by voluntary redundancies it is likely that the "emerging costs of the RBF Superannuation defined benefit pension fund will rise by $50m indexed each year."

Therefore if the Government reaches the target (possible) of 3,000 FTE public sector employees less than four years ago, and assuming 50% of the separations are from Public Servants who are members of the RBF defined benefit scheme (a fair bet) then using the average salary of $70,000 for say 1500 public servants ($105,000,000) the RBF budget impact will be $70.35m.

They have fewer public servants but in essence they are still paying for 67% of them.

However this is not where the real impact will be felt.

3.2 The coming Tsunami of RBF Defined Benefit Fund retirements.

Presently 24.81% of the Tasmanian Public Service is over 55 and of that number 9.93% is over 60.

The one reason that there have not been mass retirements is that the majority of these staff are women who had no access to super until the 1970's.

Thus they are maximising their retirement benefits and will now start retiring.

Once the 55-65 group start retiring, (and I note here that there is no incentive for a member of the RBF on the defined benefits fund who has reached maximum entitlement to continue to work), there will be a sustained impact upon the Consolidated fund of the Tasmanian Government, with the cash required to fund the pensions rising at the rate of up to $60m per annum.

In effect the discretionary spending of the Tasmanian Government once this starts to ramp up will be at an end.

The effect will be so great in year on year terms, *that some of the present programs of Government will need to be terminated to pay for the pensions.*

Most governments will simply endeavour to ignore this reality, but unfortunately with the present federal tax base now in some distress, due to the reduction of commodity prices and oil prices in particular, the impact on the corporate tax base has been substantial.

The impact upon state budgets of a reduction in mining and resource royalties has also been substantial.

This will not change in the short term.

There will be a low interest rate environment for many years to come and this is not good for the Government's actuarial position with the liability.

Thus the chances of state governments receiving additional federal funding to pay for Public Service Superannuation Liabilities are probably somewhat, remote.

Indeed there is pressure to change the GST allocations of the mendicant states which would put enormous pressure upon Tasmania and decimate public sector employment.

3.3. How to reduce the impact and the actuality of these costs.

There are a number of options that any Government can take to reign in these costs:

Among them are:

1. **Terminate the access to defined benefit pensions** and convert the member account to an accumulation account where the member funds their own retirement by way of an allocated pension or withdrawals of lump sum superannuation and thus takes the economic risk.

   This would require borrowings by the State but would be far cheaper than exponentially rising liabilities being paid for out of up front budget cash. There would need to be a once only approval of the Loan Council of Australia, in order to set this up placed within the future fund of Tasmania. The committee is aware I am sure that all borrowings of the Tasmanian government need to be agreed to by the Loan Council, made up of the Federal Treasurer and the Treasurers of all the States.

The cost of the borrowings would be known in advance and paid for accordingly with hard figures in budgets.

People would say that the government has a legal liability to a defined benefit pension, but this be changed simply by the state of Tasmania legislating such a change as it is the sovereign body in its own right. In reality you can do what it likes.

2. **Terminate indexation on present "in force" defined benefit pension accounts above $40,000.00**

   There is no requirement to index anything and the choice will be stark.

   Either the pension continues as a non-indexed benefit, or it is capped for indexing at $40,000.
   This is a fair outcome and one which would reduce the upward pressure on liabilities for the Tasmanian government. It will also encourage pensions to take the termination option for the pension in lieu of continuing with a non indexed government liability pension.

   The Government at the same time could allow a pensioner to terminate their Defined Benefit Pension and take a lump sum equivalent paid to a superannuation retirement savings account of their choice. This may for some pensioners improve their fiscal outlook.

3. **Modify the pensions** so that the benefit reduces with age from 67% of salary indexed to 50% of salary indexed.

4. **Modify the pension so that the benefit is capped at 50%** of final salary with a $100,000 lump sum tax free benefit and is not indexed over $40,000.

5. Offer a ***once only opt out transfer out of the defined benefit scheme*** converting the pension to superannuation accumulation account and cash, for those existing defined benefit pensioners, and for those employees who wish to move their funds to their own self managed super fund.

3.4 What happens if nothing is done?

Tasmania is a mendicant state, which in essence means, that it does not generate enough taxation revenue, in order to support the level and size of public sector services that are presently delivered. It has an aging population and there is nothing other than the tourism industry to attract younger Tasmanian's into staying and working.

It presently has a struggle with maintaining Health Services.

It requires a minimum of 65% of its revenue to be provided as a base figure from the Commonwealth of Australia, and this is made up of various components including grants, GST, and special purpose payments.

States where the population is growing much faster than Tasmania's, and who have large and unavoidable infrastructure requirements to support the citizens of those states, will capture in the future, a larger share of the tax base.

Tasmania will have to fend for itself, and in doing so will have to make political choices that it has not had to make in the past.

These political choices will not be Labour, Liberal, or Green, but they will be choices between schools open, hospitals open, or public servant superannuation pensions being paid.

When the political choice is a hospital that is to be close to pay for public service superannuation, the vast majority of Tasmanian's who receive no public service superannuation, will make a political choice and force the government of the day to act.

There is very little time to ponder these issues as some action needs to be taken and it is best being a staged approach to getting the liability under control.

Staged choices:

It is better to have a step-by-step approach, or staged reform and change of the RBF defined benefit pension system, than it be part of an acrimonious decision cycle whereby there is no considered change cycle.

Perhaps a change cycle of staged choices could be implemented in the near term as follows;

1. **Provide an option to existing defined benefit pensioners** to **opt out of the pension** that they currently have, for receipt of a lump sum superannuation benefit fully tax paid to the superannuation savings account of their choice.
2. **Provide an option for future defined benefit pensioners** to opt out of the pension that they currently have, for receipt of a lump sum superannuation benefit fully tax paid to the superannuation savings account of their choice.
3. **Limit indexation on existing and future defined benefit pensioners** present pensions and future pensions to nil once the pension payment exceeds $40,000 per annum.

4. **Set a definite timeline say 30th of June 2018**, whereby defined benefit pensions will no longer be paid even if a person has an entitlement, but will be converted automatically to an accumulation fund, tax paid, and upon retirement, or before retirement this can be rolled over to a superannuation retirement savings account of the choice of the member.

Ultimately these four options will **terminate government liability on an emerging cost basis** for superannuation payments for the Tasmanian Public Sector, and **transfer these to a known liability basis annually,** given the loan funds needed to pay for the pensions.

It will terminate the economic liability being borne by the Government which it should not and cannot afford to continue to support such a liability, at the expense of social infrastructure.

This change although dramatic and in some cases providing significant changes to retirement planning for various members of the state service, is the only way forward.

The state can afford to borrow the funds to pay out the liabilities to existing pensioners, and will need to create a quarantine by legislating for a Tasmanian Future Fund that will support the borrowings and manage the liability, but those present defined benefit pension liabilities will have to be terminated, and not continue that as an open-ended unfunded from year to year to drain on the Tasmanian taxpayer.

If this continues to escalate to such a point that the taxpayer by his political voice, forces the government of the day to terminate these pensions unilaterally, and this will create substantial difficulties for some retired public servants in relation to the extent that living.

Of course there will need to be changes to the defined benefit scheme as it stands, or else there will be ultimately a choice between funding a hospital or fund the public service super scheme.

The voters will inevitably go with the hospital.

Summary:

The Tasmanian Government has a budget impact of substantial proportions for the RBF pension explosion approaching it head on. There will be no escape, unless the defined benefits pensions are terminated

Sale of assets to fund this RBF pension impact is not an option as the State Tax base is so limited that endeavouring to gain indexed tax outcomes for future maintenance of Government services, without retaining the Government business enterprises that operate in the market, is not an option.

The only option is to terminate the Defined Benefit pensions.

The Tasmanian Government is a sovereign body in its own right and can determine its own way forward, and in this case it is nothing more than a condition of service that can be changed by

Parliament. The idea of some court saying that the Government cannot change a superannuation scheme to one that is the national standard is remote.

If action is taken then the obvious involuntary termination of the scheme when funding is unable to be continued will occur.

This has happened elsewhere in the world and may happen here if no action is taken.

I am happy to attend the committee in a formal hearing to further my submission and to answer at the hearing any further questions that the members may have.

Mervin C Reed FAICD FChFP AAFA JP
Chartered Financial Adviser

30th of March 2016.