

RESPONSE TO THE MATTHEWS REPORT BY PETER THORNTON

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The Honourable Lindsay Tanner, MP
Minister for Finance & Deregulation
Parliament House
Canberra ACT 2600

Dear Minister,

A RESPONSE TO THE MATHEW'S REPORT AND THE GOVERNMENT'S SUBSEQUENT ENDORSEMENT

INTRODUCTION

As one of the individual respondents who made a submission to the Mathew's Review, I must say that I was extremely disappointed by the lack of depth and the superficial analysis presented in the Matthews Report (to be referred to forthwith as 'The Report'). Given this situation, and the Government's subsequent unqualified endorsement, I now feel compelled to offer the following response.

GENERAL

From the outset, The Report appears to set an agenda to favour the status quo by using the 1973-74 assertions of Pollard/Melville; in that the CPI is the mechanism of choice because the long term aim of indexation is to only protect the '*purchasing power*' of benefits as opposed to the Government providing any specific '*productivity gains*'¹ (or mixture thereof) to Government provided retirement benefits.

Unfortunately, I believe that the Review Team has failed to recognise and adequately analyse the multidimensional changes that have occurred in (not least) the CPI over time and has failed to understand the nuances and the implicit underpinnings, which would have undoubtedly influenced Pollard/Melville's determination. This is because in their day:

*'the CPI [historically] was developed with the principal purpose of providing input to the highly centralised wage and salary determination process then existing in Australia'. and that 'Successive CPI reviews have served to ensure that refinements to the index have resulted in a measure increasingly more suited to its principal purpose.'*²

However, the ABS concluded in 1997 that '*the tight nexus between movements in the CPI and wage and salary adjustments no longer exists.*'³

¹ Mathew's Report., p. 13-14

² ABS, *Outcome of the 13th Series Australian Consumer Price Index Review 1997*, Para 19., p. 5.

³ *Ibid.*, Para 36., pg 9

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The Report seems to have missed this very salient point; that the CPI was an extremely important mechanism to centralised wage arbitration and subsequently helped to arrest the erosion of Commonwealth retirement benefits from not only the ravages of price inflation but indirectly; the erosion of community wide income relativities. Therefore, the changes made in and leading up to 1997 have failed to protect and maintain Commonwealth/Military Retirement benefits from erosion over time⁴. This has been the main argument and complaint of Commonwealth and Military retirees and their representatives

In addition, and contrary to The Report's assertion, most individuals and representative bodies **HAVE NOT** discounted the CPI as an important component for indexation purposes; they have instead recognised over many years, which has been equally qualified by three separate Senate enquiries that a hybrid indexation mechanism was / is needed to maintain retirement benefits in line with historical precedents⁵.

Whilst the CPI is an important and generally stable mechanism to protect the 'purchasing power' of retirement pay, The Report fails to acknowledge that the CPI can be vulnerable to significant price swings in any one element of the index, which in effect could skew the final result. This was clearly evident in July of 2007 where Commonwealth retirees received a 0% increase in their benefit because the price of a single good (i.e. Bananas) had decreased by such an amount as compared to the previous period that it offset the price rises of all other index items, particularly petrol. This situation created considerable angst and financial suffering within the Commonwealth retirement community but this event would have been mitigated if a hybrid indexation mechanism had been in place.

As an adjunct to the foregoing, The Report maintains an adherence to Pollard's 1974 assertion that *'National productivity gains would only be a necessary criterion for adjusting superannuation pensions if it were established that such gains generally flowed to all retired persons throughout the community through the medium of superannuation pension updating'*⁶. This was a fair call in 1974 because only 24% of people in the private sector had super cover as compared with 58% in the public sector. However, this situation has progressively changed over time whereby in June 1988, 51.3% employed persons were covered by Superannuation and by June 2007; Superannuation assets totalled \$1153.3bn, representing 119% of GDP, and supporting 90% of the population⁷.

With this in mind, Community wide productivity gains have increasingly become an integral part of the Superannuation landscape and particularly so since the introduction of salary sacrifice arrangements. Whilst not strictly "pension updating" per se, the tax effective nature of salary sacrifice together with the tax free treatment of private super benefits after age 60 has indeed provided the private sector with (notwithstanding the recent affects of the Global Financial Crisis) a significant multiplier effect in the value of Superannuation benefits. These favourable arrangements have directly negated (in part) Government revenues and community wide obligations (based on gross tax receipts) to fund social security payments; yet the private sector will be eligible to draw maximum welfare benefits if they remain within the assets and income thresholds. This very point negates the Report's assertion that the

⁴ i.e., the CPI alone has failed to maintain relativity with contemporary Commonwealth / Military salaries and more broadly that of community wide income standards.

⁵ This is the reason why most proponents have argued for a CPI / MTAWA / AWOTE hybrid solution, with most requesting an indexation measure of CPI or MTAWA, whichever is the higher.

⁶ Matthews Report, Chap 3., pg 13

⁷ http://www.aph.gov.au/library/pubs/BN/2009-10/Chron_Superannuation.htm

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Government's Notional Employer Contribution Rate (NECR) for Commonwealth benefits is high by private sector standards, because it fails to recognise that salary sacrifice arrangements together with the Superannuation Guarantee has directly and indirectly increased the private sector NECR over time⁸. In fact, one could argue that these tax effective arrangements have created a situation where the Commonwealth has inadvertently assumed a portion of the Private Sector's NECR.

Commonwealth and Military personnel on the other hand were not generally afforded salary sacrifice facilities until well after it had been introduced more broadly into the general community (i.e. not until earlier this decade). Irrespective of this, the Government has "Triple dipped" on its former employees in having them: pay full marginal tax; pay after tax contributions into a compulsory Government Super fund; and to continue to pay full marginal tax on benefits received in retirement⁹.

Whilst The Report mentions that reduced salaries were a concern¹⁰ (i.e. lower salaries were a form of sacrifice for a mature retirement benefit), it states that it was unable to verify these claims. Whilst I concede that military salary data was difficult to obtain for an individual respondent within the submission period¹¹, it's incredulous that the Review Team was unable to obtain detailed data over the 5 month period of the Review.

Whilst military salaries data may not have been readily available, the Review Team could have extracted broader Commonwealth salaries data from the ABS because this data was / is used in part for the construction of MTAWE and AWOTE indices¹². Obtaining historical data would have confirmed what was generally known and accepted over time: that Commonwealth and Military salaries were well below that of the general community for many years, which resulted not least in some of the governments employees' (particularly military personnel) having to draw on welfare because they were assessed as being below the poverty line.

Nevertheless, evidence of low military incomes is implied (when compared on average to Commonwealth Retirees) in the NECR figures detailed in Table 2.4¹³ and in the final benefits now being paid to Military Superannuants as depicted in Table 2.3¹⁴. It is a sad indictment that after 20+ years of dedicated service that the average frequency distribution (i.e. the median) of retirement benefits received by Military Retirees (and that of Commonwealth retirees also) is not much better than the single rate of old age pension. This significantly discounts The Report's assertion that 'military schemes provide features that recognise their members' contribution to their country'¹⁵.

⁸ Notwithstanding Note 20 of the report, the Private Sector NECR will be greater than the 9.5% stated in the report.

⁹ Full Marginal tax is paid but a 10% offset is acknowledged at age 60. However, this is no substitute for receiving a tax free income stream as afforded to the rest of the community.

¹⁰ In addition to Dr. Knox's testimony, I also raised this issue in my submission, particularly with respect to military salaries.

¹¹ Historical military salary data was not readily available from the Defence Force Remuneration Tribunal, the Department of Defence or the ABS.

¹² Military Salaries data is explicitly excluded from these indices, because historically, Defence would not release the information to the ABS on some unfounded notion that the information was classified, which is nonsense!

¹³ Mathew's Report., Chapter 2., p 9.

¹⁴ Mathew's Report., Chapter 2., p 7

¹⁵ Mathew's Report., Chapter 8., sub-section 8.2., p 44.

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This last point is equally exposed in Chapter 4, where The Report's analysis encompassed a number of foreign public sector schemes in order to broaden the analysis from an international perspective¹⁶. The Report refers to a number of US Military and Civil Service schemes' stating in the main body of the document that the indexation of those schemes was by CPI only¹⁷. Whilst this is technically correct, the Review Team failed to provide any depth and acknowledge that US Military personnel **WERE NOT** required to contribute to their retirement pension schemes and that these schemes generally paid 50% of final salary at 20 years, and up to 75% after 30 years of effective service, not to mention life time access to free medical services, access to PX and Commissary facilities and free international travel on "Space Available" aircraft¹⁸.

The Civil Service Retirement System (CSRS) did require employees to contribute to the CSRS but employees were in turn not required to contribute to Social Security, presumably because the US Government has a conscience in not "double dipping" on their most important resource, their employees.

By comparison, and just focusing on older Australian military schemes, personnel had to pay a compulsory 5.5% after tax contribution into DFRB/DFRDB¹⁹ but on retirement only received 35% after 20 years, with a 51.25% achievable after 30 years of effective service, with no additional benefits available. In addition, if personnel didn't complete a minimum of 20 years effective service then they received nothing back except their contributions without interest²⁰. Military Officers under these schemes also suffered an additional impost (if they qualified for retirement pay) by incurring a detriment of 3% of their retirement pay for each year they retired before their prescribed notional retiring age.

On another matter, The Report appears to give greater credence to the advice offered by Actuary's, particularly from the Department of Finance. It seems to discount the opinion of our Representative Bodies and/or other independent investigations that have been commissioned.²¹ Whilst I don't begrudge Mr Mathew's in seeking expert opinion, one does become somewhat frustrated and despondent by the disparity of unfunded liability projections that have continually emanated out of the Department of Finance and their commercially contracted consultants²². I can understand how responsible Ministers must feel when presented with large inconsistent figures that don't necessarily tell the whole story.

¹⁶ Mathew's Report., Chap 4, Pages 18-19. Mathew's stated a need to make some comparison because there were limited examples of Defined Benefit Schemes within Australia to draw an analysis from.

¹⁷ The Report does make some cursory but important observations in the notes about structural adjustments to some of the later schemes (i.e. a base rate adjustment in REDUX at age 65), which seems to elude Matthews in his final deliberation of the fairness of Australian Military Schemes.

¹⁸ Commissary and PX facilities are where personnel can shop to buy goods and services at wholesale prices, which are free of both state and federal taxes. International Space A travel is afforded to all retired personnel and/or their families.

¹⁹ MSBS does not easily equate to the older US Military pension schemes.

²⁰ Matthew's Report, Annex D., Note 147, pg 53. This note is a little misleading, in that interest did not accrue for contributions made. However, interest was payable on the productivity benefit component of a members account.

²¹ The 2002 NATSEM Report which was commissioned by SCOA. Also, Dr. David Knox was instrumental in the Military Superannuation Review and represented a number of issues, particularly the issue of low salaries in the Matthews review.

²² It would appear that the Department of Finance relies heavy on Mercer Australia Pty Ltd for the bulk of their analysis.

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As a case in point, in a 2003 Senate Estimates Committee²³, Senator Conroy expressed considerable concern about the figures derived in the 2003 budget papers. A lengthy debate ensued over the “*actuarial revaluation*” / “*error*” of unfunded superannuation liabilities, which had been revised up by \$4.6B. In reading the Hansard, I think it would be fair to say that the Committee didn’t obtain a straight and consistent answer from Finance on that day.

In another stark example, the ‘*2008 Long Term Cost Report of the CSS and PSS*’ states that the discrepancy in the unfunded liability figures between the 2005 and 2008 was due in part to a ‘*change in calculation methodology*’ and ‘*using actuarial assumptions that differ from those used at the last actuarial investigation*’²⁴. It’s incredulous that the long term cost of unfunded liabilities for the PSS and CSS has now supposedly burgeoned from \$67B in 2005 to over \$80B in 2008: nearly a 17% differential “error” in 3 years; on the basis of changes in assumptions and calculations (??). Given the considerable consternation from Estimates in 2003, I’m sure Senator Conroy would have heart palpitations over these figures!

In regards to The Report, Finance is quoted as saying that “clawback” would only amount to 15%, where as in 2005 the Australian Government Actuary (AGA) estimated that it would be approximately 25% and NATSEM calculated a 2002 a figure of 37-58%. All the Review could say is that it couldn’t qualify if the NATSEM figures were correct and gave no reference to the AGA figure. Wasn’t the Review supposed to qualify the “full [net] cost” of indexation in order to comply with the last item of the TOR?

Furthermore, and as you are aware, the Actuary for the Future Fund is required to report the Target Asset Levels²⁵ of the Future Fund as per Schedule 3 of the Act. Dr. David Knox provided the following figures on the 8 May 2008²⁶:

- 2007-08 \$90.1 billion, 2008-09 \$93.2 billion, 2009-10 \$96.3 billion

These figures were subsequently derived from actuarial data from all of the major Commonwealth funds and were also inclusive of actuarial projections for: the Parliamentary Contributory Superannuation Scheme; the Judges’ Pension Scheme, and the Governor-General Pension Scheme, which were outside of the Matthews Review’s TOR. However, The Report quotes Finance as stating that:

*‘As at 30 June 2008 the Australian Government’s unfunded superannuation liabilities totalled \$100.3 billion.’*²⁷

How can a 10% differential error occur within 6 weeks when two Actuarial entities are supposedly using the same data and assumptions? I would lay odds that Dr. Knox is closer to the mark; and he used a larger data set than was analysed by the Matthew’s Review!

Delving a little deeper, and with regards to the ‘*change in calculation methodology*’ (apparently due to the adoption of the Australian Accounting Standard AASB 119), the AGA had the following to say in 2005:

²³ Hansard., Finance & Public Administration Committee – Estimates, dated 28 May 2003., pg F&PA 503.

²⁴ *PSS and CSS Long Term Cost Report 2008 – Mercer.*, Para 1.4., p3

²⁵ The target asset level represents the amount that is expected to offset the present value of projected unfunded superannuation liabilities.

²⁶ Future Fund Actuary Letter., *Target Asset Level Declaration*, dated 8 May 2008

²⁷ Mathew’s Report., Chap 7., Para 7.4., p 42.

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'The valuation methodology and assumptions required under AASB 119 differ in some respects from the methodology and assumptions used in this report. In particular, the AASB 119 requirement to use a Government bond rate at the reporting date as the interest rate is likely to result in changes in economic assumptions from year to year. All else being equal, movements in interest rates will lead to volatility in reported liabilities under AASB 119.'

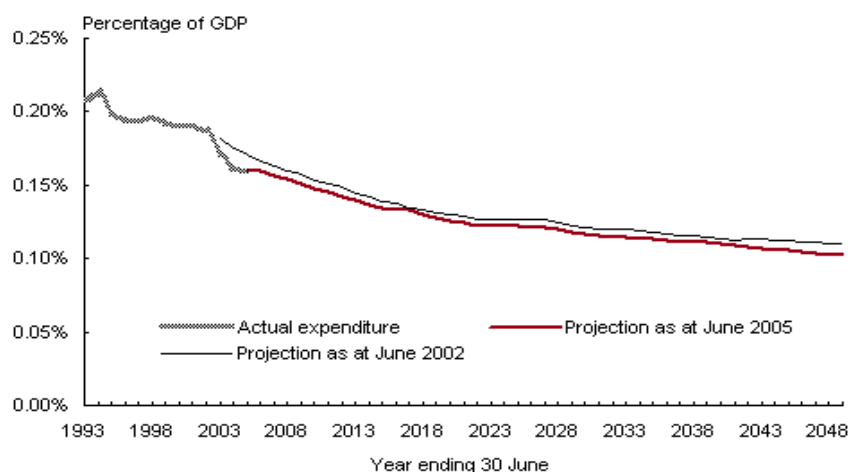
*The current report is focussed on the financial implications of the military superannuation arrangements over the long term and, in my view, is a more appropriate document for this purpose than the Department of Defence Financial Statements.'*²⁸

The AGA reaffirms this matter in his 2009 report for the 2008 LTCR of MSBS and DFRDB where he states:

*'The purpose of the triennial reviews is to assess the financial position of the schemes over the long term. Estimates of the net present value of the unfunded liabilities have also been produced on an annual basis for inclusion in the Department of Defence Financial Statements. These annual estimates are calculated in accordance with Australian Accounting Standard AASB 119 and are not directly comparable to the estimates provided here.'*²⁹

From my perspective, the AGA's statements together with their approach to calculate and present information of the unfunded liabilities, both actual and projected, as a percentage of GDP, seems to be the most unambiguous and pragmatic approach seen. Also, and notwithstanding the complexity of assumptions made, there seems to be no aversion by the AGA in taking into account offsets such as "clawback" and "Future Fund" assets to provide a net estimate of the long term costs as a percentage of GDP. The graph below clearly shows the trend of actual expenditure and the future projection of unfunded liabilities over time³⁰.

Actual and projected Commonwealth outlays as a percentage of GDP - 2005³¹



²⁸ Australian Government Actuary – Summary – 2005 Long Term Cost Report for MSBS & DFRDB, p viii., dated 30 June 2006.

²⁹ Australian Government Actuary – Summary – 2008 Long Term Cost Report for MSBS & DFRDB, Ch 1., Para 1.5., p 2., dated 30 June 2009

³⁰ Australian Government Actuary – Summary – 2005 Long Term Cost Report for MSBS & DFRDB, p 26-27., dated 30 June 2006.

³¹ AGA – 2005 Long Term Cost Report for MSBS & DFRDB., pg 21, dated 30 Jun 2006

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By comparison, the information presented by Finance over the years and particularly for this review appears to be rubbery and inconsistent, which brings into question the credibility (and oversight) of those undertaking and reporting on such matters³², and by implication, the Review Team's credibility in the acceptance of this data without performing its own due diligence.

Perhaps the Government should commission the AGA to run the sums and produce a single set of consistent and realistic projections that we can all consider and debate upon.

CONCLUSION

Whilst one could write infinitum on the matters listed above and perhaps others not readily considered, I believe I have presented a number of serious issues that are grounds for the Government to reconsider its unqualified endorsement of the Mathew's report and to reopen negotiations with our representatives for improved retirement benefit indexation.

However, if the Government persists with its endorsement then it will be morally and legally obligated, without equivocation or reservation, to amend the wage based indexation mechanisms that are afforded not least to the Judicial and Parliamentary pension schemes. This is because Mr. Mathew's fundamental premise is that the Government should not afford retired members of the Commonwealth with '*a share of productivity increases*'³³ earned by current and future employees. As such: How can the Government now justify allowing retired Judges and Politicians a share of the '*productivity increases*' earned by past, current and future judicial and parliamentary members?

To not retract the Government's endorsement of the Mathew's report and reopen negotiations will only perpetuate the hypocrisy of former governments in not fairly and equitably addressing the matter of retirement benefit indexation. It would also result in approximately 600,000 Commonwealth/Military contributors and retirees holding the current and future Government(s) squarely liable to a claim of discrimination in the highest court (i.e. the Privy Council³⁴) let alone the court of public opinion and the ballot box.

With the foregoing in mind, I would appreciate the Government's earliest consideration and written response to this matter please (to save a lot of wasted effort on your part or that of your staff, just a one line response as to whether or not you will retract your endorsement and reopen negotiations will suffice).

Yours faithfully

Original Signed and mailed

PETER THORNTON

³² It is revealed in the 2008 report that the Lead Consultant (Martin Stevenson FIAA FIA) compiled both reports. This then begs the question as to why there has been such a large discrepancy.

³³ Matthews Report., 4th Para., p 46

³⁴ Presumably, there would be a conflict of interest in any part of the Australian Judiciary presiding over such a matter.