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An In-Depth Analysis of The Australian Retirement Plan

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Abstract

The United States faces many problems regarding the longevity of the Social Security program. With the program entering a deficit in 2020, it has become quite clear that the program needs some dramatic changes. One of the proposed solutions to this issue is switching to a similar system to the retirement system in Australia which is known as the Superannuation Guarantee. Advocates of the system hope that this system will not only be able to fix all the longevity issues that come with Social Security, but they also claim that it will result in overall increased savings for the average retiree. On the other hand, critics of the system claim that this system would result in increases for the upper class while making lower class citizens lose out on savings. There are also many questions about how the system would even be implemented in the United States. This paper will go into detail on the Australian System and the benefits and problems that come with its implementation and compare that to the current social security system.

Key Words: Economy, US Economy, Australian Economy
Categories: Retirement, Payout, Social Security

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Introduction to the Australian System

For a long time, the Australian Retirement Plan was modeled after the United States's Social Security program. However, in the 1980s, Australia was forced to switch to completely remove this pension plan and replace it with the system they have today due to the inability to meet budget requirements. Today, this program is known as the Superannuation Guarantee and continues to be modified and expanded. The plan was created in order to solve problems such as low worker participation in savings or pension plans, dependence on social security leading to lower national savings and slowing down economic growth, and a growing elderly population threatening to overrun the social security system and cause it to fail. (Mitchell, 1997)

Under the Superannuation Guarantee, each Australian citizen who is paid $450 or more each month is required to set aside 9.5 percent of their annual income and put it into a fund of their choice. These payments are made 4 times annually by the quarterly due dates. If a payment is not made on time a superannuation guarantee charge must be paid. It is also important to note that the superannuation guarantee is non-tax deductible. Each citizen can choose from a total of 137,808 funds to place their money into. Citizens also have the ability to add more than the required amount into the reserve if they would like to. (Probasco, 2020) Upon retirement, each citizen will receive a steady stream of annual income, which would amount to a minimum of 2-3 times the amount that they would have received under the original Social Security System. The Superannuation Guarantee has already led to a 3% increase in overall savings rates and lower total government spending.

Current Problems with Social Security

The current American Social Security system has a few different sustainability issues. In 2020, social security entered a deficit for the first time in the history of the program (Rae, 2019). This has largely been caused by a problem that did not exist when the system was first founded in 1935. The senior population has increased heavily from only 7.5 million in 1935 (SSA, 2021) to 54 million in 2020 (Census, 2021). The changing demographics of the US have caused challenges that the founders of social security could never predict. As the senior population of the US continues to increase, the burden of social security will continue to escalate for working citizens. However, the senior population is not the only demographic factor that works against the sustainability of the system; increasing life expectancy has also put major pressures on the system. At the time of Social Security's founding, the average American life expectancy was 62 (factoring in high mortality rates) while benefits would only start to be paid out by 65 (Klein, 2019). However, in 2020, the average life expectancy was 79 years old (Statista, 2020) while social security benefits would start to be paid out at age 66 (Probasco, 2019).

Volume 1 Issue 3
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This means that even though the average life expectancy in the US has increased by nearly 17 years; the age at which social security benefits are paid out has barely changed. This has created a second strain on the system as people who live longer will now be receiving benefits for longer.

In addition to the demographic changes that present issues on social security, the system also struggles due to the program's sheer cost. Due to the aforementioned change in demographics, social security recipients make up the largest portion of the US population ever seen, and we are likely to see the worker to social security recipient ratio fall from 2.8 in 2010 to 2.1 in 2030 (Williams, 2018). This means that the cost of paying an average of nearly $18000 yearly (Whiteman, 2019) for benefits is going to be split amongst only 2 workers instead of the previous 3 workers. Each American worker will need to pay a hefty sum of $9000 for the social security system by 2030 instead of the $6000 they have been used to paying since 2010. This is all money that workers could have saved in order to pay off a mortgage, pay for their child's tuition, or save for their own retirements.

In addition to the hefty cost, the program has also been unable to sustain itself off of current government funds. The Trustee fund created in 1983 is soon set to run out of the nearly $3 trillion worth of funds by 2035 (Nino 2020). Due to the enormous burden of this program, the government is faced with two main choices if they wish to get rid of social security: they can either increase taxes to continue to pay for this program, or decrease/change benefits to make the program more affordable. Neither of these options would likely be a very popular one with government officials, nor with the average American. All of these limitations have been exacerbated by the coronavirus shutdowns as the national debt has increased by nearly $5 trillion in less than a year. An economic recession would also mean less tax revenue to pay for social security.

Potential U.S. Specific Drawbacks

With the implementation of the Australian system, there are several distinctive drawbacks respective to the United States. The Australian Retirement plan calls for citizens to pay 9% of their annual income into their retirement funds (12% as of 2020) (Agnew, 2013), with citizens also having the choice to put in more as they wish. This creates the potential problem of the rich investing more money in the fund and some argue, these tax breaks may cost the authorities more in revenue than the money saved from lower welfare payments. One possible way to fix it is to raise the minimum mandatory percentage to twelve percent, however, this is going to bring in another potential problem. The percentage of Australian citizens living below the poverty line was 10.5% (Semega, 2020) in 2019. For an Australian to be considered below the

Across The Spectrum of Socioeconomics
Volume 1 Issue 3
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poverty line, their annual income must be equal to or below $12,490 (ASPE, 2019) If rates are raised to 12%, these people will be left with $10,991, which averages to $916 per month. This is most likely not going to be able to support a person's basic need when they need to cover basic living expenses such as rent, mortgage payments, utilities, maintenance, food, clothing, insurance, taxes, installment payments, medical expenses, support expenses when the individual is legally responsible, and other miscellaneous expenses (Cornell 2021). This is even more true in times of recession such as the Coronavirus outbreak of 2020, which has made every penny count; therefore most people are going to struggle with putting another 12% of their income into their retirement fund.

Another problem is that since everyone is going to be guaranteed a high rate of return, the economy is going to be more sensitive to inflation. Citizens receive monthly installments over their lifetimes, which could result in money running out if the individuals live too long. Therefore if the system were implemented in the US, older Americans are going to be like how older Australians were "heavily exposed to longevity, inflation and investment risks," Agnew wrote (Eisenberg, 2013).

Another potential problem could be citizens investing in multiple funds, which leads to more and unnecessary fees and life insurance premiums. This is caused by people who switch jobs constantly, where some jobs automatically enroll into funds but do not roll their old account into the new one. Similar situations happened in Australia and the government review body identified 10 million duplicate accounts that racked up $2.6 billion a year in unnecessary fees (Burgess, 2020). This seriously harms Australian citizens because if they turn in 9% of their annual income, they already have less money to spend on daily expenses and if they still have to suffer from extra unnecessary fees, they will rack up even more expenses, which also means less money to spend on daily necessities.

A final issue to consider is the implications of another recession in the United States sometime in the future. The American economy tends to have large unemployment numbers in response to a recession and it is vital to ponder what outcomes the implementation of the Australian Retirement plan has. For example, during the 2008 recession, unemployment peaked at 10% in October of 2009 and about 30% of households owned by people over age 40 said they were more than two months behind on their mortgage, in negative home equity, foreclosure, or unemployment between November 2008 and January 2010 (PRB, 2010). In such scenarios, the Australian Retirement System would be rendered useless for the duration of the recession where people would be unable to add to their account, and also the amount made on the account would be in jeopardy depending on what funds were invested in.

Payout

Under the superannuation program, Australia has nearly $2.2 trillion in pension funds. This makes the Australian pension fund the 3rd largest in the world, despite the fact that the Australian economy is only 13th on world rankings. This shows how the Australian system has significantly outperformed that of other nations with significantly larger economies. This high payout becomes even more evident when examining the average superannuation account budget. For the average Australian who is 15 years or older, the superannuation budget was $168,500 and $105,400 for men and women, respectively (Superannuation, 2019). Considering the average net worth of an American household is $97,000, this means that the average Australian Retirement fund alone has a greater value than the whole net worth of the average American. This difference becomes even more clear when considering the total wealth of the average Australian adult vs. that of the average American. Australia is the wealthiest country with a population over 10 million, with the median income per adult sitting at $181,400 vs. America's $65,900. This massive difference in wealth is largely due to the superannuation fund which allows Australian citizens to retain much more of their wealth.

The vast differences in payout can also be modeled by a superannuation calculator using the average incomes of both nations. This is a very good way to calculate the large variance in the payout of the current American system vs. what could be achieved under the Australian model.

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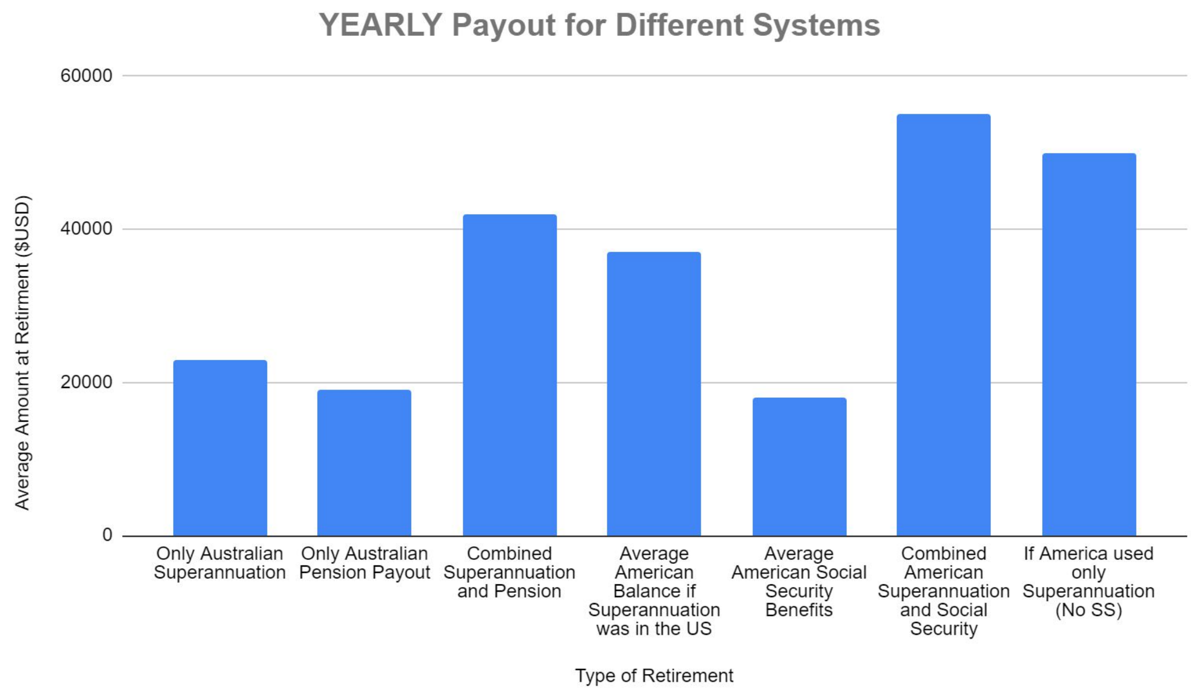
Results:



We found the results of different retirement systems and the yearly payout they would create. All of the values have been converted into US Dollars to avoid any possible confusion in values. The yearly payout for all three superannuation statistics was assuming a 7.5% withdrawal rate which is the average superannuation interest rate. The average Australian Superannuation fund at the retirement age of 65 was valued at around $300,000 (Superannuation, 2019). This puts the annual withdrawal rate at around $23,000 per year. Full benefits for the Australian Pension system (assuming you are a single person) are paid out at around $19,000 per year (Drury, 2020). This pension is paid for by fees on superannuation funds along with employee and employer taxes. Most Australians receive the superannuation and pension plan, although benefits do go down when assets exceed a certain point. This means that the median Australian retiree receives the Superannuation plan and reduced pension payments. We put this combined number at around $42,000. Using the Australian government's superannuation calculator, we found that the average American would retire with a $491,000 superannuation balance. Assuming the same withdrawal rate, Americans could receive $37,000 from a superannuation fund. The current American Social Security system, which is paid for by a 6.2% employee tax and a 6.2% employer tax, gives $18,000 in average annual benefits. If Americans received both superannuation and social security (SS), this would mean nearly $55,000 paid out annually in senior benefits. Finally, if Americans paid 12.4% into

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a superannuation fund instead of the 12.4% into social security, it would come out to a superannuation balance of $620,000 by the age of retirement at 67. Assuming the same 7.5% withdrawal rate, this would put the payout rate at $50,250 per year. However, it is important to note that without the 1% fee necessary to pay for pension plans such as social security, and the higher average rate of return for American equities, it would be very likely for the average American superannuation balance to exceed $1 million at the age of 67. This would make some annual payout rates get to $75,000.

Method:

American results were found using the Australian government's superannuation calculator. We used the average retirement age of 67, average OECD salary of $63,000, and a starting work life of 20 years old. We first used all the same preset metrics as Australian superannuation to find the $491,000 total. In order to calculate the American system relying solely on superannuation, we changed the presets to incorporate the 12.4% tax currently paid for social security. In order to get the final $1 million figure, we eliminated the 1% fee associated with paying for the pension system and we also increased returns by 1% as American equities outperform Australian equities by about 1% every year.

Issues:

One issue in this calculation was the lack of clear information on how different values of assets affect Australian pension payout. For this reason, all figures regarding Australian pensions were rounded down to account for this. Second, the annual payout can be determined by the individual, meaning that some can choose to withdraw 50% of their account in one year, while others choose to withdraw 4%. We chose the 7.5% figure as this is the average return rate for the funds. It is important to note, however, that most people would likely take out more than the 7.5% figure in order to use up more of their hard-earned money or to pay for unseen expenses. Lastly, it is important to note that the future can never be predicted completely correctly, so these figures could change greatly within 10 years.

Solutions to the Problems of this System

Given the several U.S. specific complications with implementing the Australian system, some solutions can be implemented to better its efficiency and effectiveness in the long term and with certain case scenarios like the COVID-19 pandemic. These solutions include flexibility, limiting payment of older citizens, risk management, and making reasonable fees for changing retirement plans.

In situations where people have a lower income and live in a paycheck to paycheck fashion, they will not be able to afford superannuation fees or put away the money required for retirement according to this system, especially in times when many people are struggling financially like during the COVID-19 pandemic. Thus, certain adjustments to the system must be made to alleviate these issues. These adjustments center around payment flexibility and include providing the option to delay superannuation fees until a certain point or having lower payment options for those with a lower income.

Next, to combat the possible inflation due to people living longer, payment options could be changed after people pass the average life expectancy. Some possible changes that could be made are that payments for senior citizens over the average life expectancy will either have less frequent payments in order to account for this inflation. Then, fees associated with an account for transferring jobs must be uniform regardless of financial status. Additionally, after accumulating a certain amount of fees, future fees will be applied in lower percentages.

Lastly, for difficult financial times and recessions, there can be an option to keep a small percentage of the portfolio that is kept in liquidity and not invested. This percent would be taken from each payment in a small amount so that over time it would add up and be used or invested at a later date.

Similar Systems Around the World

Other than Australia's Superannuation Guarantee and America's Social Security, there also exist various other options on how to best create a sustainable pension plan for our seniors. One such example, the Netherlands' pension system, is considered the best in the world. It is very similar to the US's social security system in that it relies heavily on taxes. However, it differs from social security in that the taxes for the Dutch system are nearly 18% of one's income, one of the highest rates in the world. The Dutch also have a very strict system for qualifying for benefits as you would have needed to work for 50 years to receive full contributions, and any time spent living outside the nation can decrease your eligibility (Maunder 2020). In addition to the government pension, nearly 90% of employers offer a private pension. The average public pension payout is $19,200. This is higher than pension payouts of Australia and America, however, Australians receive superannuation payout which can push their actual payout past $40,000, far higher than the Dutch. In addition to the much higher payout, Australians only pay 9.5% of their income to the superannuation fund, lower than 12.5% in American social security, and far lower than the Dutch 18%. This means that when it comes to the actual cost of each system, the Australian system is still more effective. Another accurate comparison to the Australian system is the US 401k system. With an average account

Volume 1 Issue 3
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balance for the 60-69 age group sitting at around $200k, it still lags behind the Australian balances but it is important to note that most Americans put 7-8% (Cheng, 2020) of their earnings into a 401k while Australians must pay a minimum of 9.5% of their earnings into superannuation. However, going by the same calculation metrics as before, this would mean that the average American would have a yearly payout of $33k when receiving Social Security and a 401k. This is still behind the Australian payout of $42k.

Conclusion

Just as Australia's retirement system improved in quality when they switched to the Superannuation Guarantee, the United States would see great improvements in quality and longevity with a switch to a similar system. A system like the one in Australia would allow for retired Americans to have more money while lowering government spending and saving the United States from going into a deficit on its retirement program. Although the Australian superannuation program does have some flaws such as risks of inflation and those living under the poverty line losing income which they may need to pay bills and survive, the risk is relatively low compared with keeping the social security system the United States has today. With social security entering a deficit this year, the problems with social security have grown more obvious and imminent. Not only does the Australian retirement system solve the issue of longevity that social security lacks, but it would do so while also increasing the average savings retirees would receive just as it did in Australia.

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