The problems with the 2008 *Matthews Inquiry*

By Dr Annette Barbetti

The Matthews Inquiry resulted from a promise the Labor Party made when in Opposition prior to the 2007 election. It promised a review by an independent expert of the pension indexation arrangements for Commonwealth superannuation pensions. It did this despite no less than three Senate inquiries having previously recommended a change to the existing arrangements.

There were a number of problems with the "Review of Pension Indexation Arrangements in Australian Government Civilian and Military Superannuation Schemes", hereinafter referred to as the Matthews Inquiry.

The *Terms of Reference* for the Inquiry were:

1. The occupational nature of the schemes;
2. The form and value of the benefits;
3. The indexation of similar defined benefit schemes in Australia;
4. Interaction with Government safety net benefits; and
5. The full cost to the Commonwealth.

Failure to consider the taxation of the superannuation pensions

Throughout the Matthews Inquiry, SCOA insisted that the tax treatment of Commonwealth superannuation pensions be taken into account, as required by the second of the *Terms of Reference.*

By failing to consider the tax treatment of Commonwealth superannuation pensions, Matthews interpreted the terms of reference too narrowly and failed to deal adequately with all the terms of reference other than the third (and even there he failed to mention that most of the State public sector superannuation pension funds are taxed funds, which means that State superannuants pay no tax on their super pension once they reach age 60, unlike the majority of Commonwealth superannuants).

The second of the *Terms of Reference* referred to "the form and value of the benefits", and was clearly intended to refer to the actual value of the benefits in the hands of the recipients, i.e. the after-tax value of those benefits, but Matthews chose to interpret it differently.

The Inquiry should have considered the peculiar and inequitable tax treatment of Commonwealth superannuation pensions, deemed to be pensions from an "untaxed" source, and should have addressed such questions as:

1) the rationale for deeming the Commonwealth superannuation pension funds to be untaxed funds;
2) the case for treating Commonwealth superannuation pensions as a separate head of taxation; and
3) the unfair treatment of Commonwealth superannuation pension income in the income tests for the Low Income Tax Offset, the Senior Australian Tax Offset and the Commonwealth Seniors Health Card.

Matthews could not examine properly the interaction with Government safety net benefits such as the Age Pension, the Low Income Tax Offset, the Senior Australian Tax Offset and the Commonwealth Seniors Health Card because he refused to take the tax treatment into account. Similarly, he did not provide any estimates relating to the income tax revenue arising from taxation of the pensions, and so did not estimate the full cost of the inadequate range of options that he considered.

A number of witnesses to the Inquiry pointed out that the Inquiry should have dealt with the tax treatment. Matthews replied that the Henry Tax Inquiry, which was then in progress, would deal with the taxation issues, so his Inquiry would not be considering them. However, the Henry Tax Inquiry did not do so, even though, in 2007, the Senate Economics Committee had recommended that those superannuation pensions should be treated as a separate head of taxation.

Other problems in the report

Matthews ignored the effects of technological change, he confused price inflation with increase in the cost of living, he made out-of-context quotations from the 1973 Pollard Report (see below) without regard to Pollard's obvious intent; and repeated without question a number of vague assertions made in the Department of Finance and Deregulation's submission to the Inquiry, even though those assertions were presented without explanation or supporting data.

Consequences of the adjustment of the Consumer Price Index for technological change

When Pollard wrote his report in 1973, the rate of technological change was not as great as it is today and more of the goods consumed by Australians were produced in Australia. Pollard believed that wages were increasing faster than the Consumer Price Index (CPI) because of increases in labour productivity, ignoring other factors such as labour supply and demand, and technological change. However, since 1973, there have been significant changes in the way that wages are determined and in the way that the CPI is compiled. The centralised wage-fixing system was replaced by enterprise bargaining in 1997, which meant that the former tight nexus between the CPI and the basic wage was broken.

In 1973, the Australian Bureau of Statistics (ABS) adjusted few, if any, prices for technological change, now referred to as quality adjustments, (although it did make adjustments for changes in packaging, etc) and used the acquisitions approach for compiling the CPI.

In 1986, the ABS adopted the outlays approach appropriate to the CPI's then principal purpose of adjusting pension incomes. From 1998 onwards, the ABS has used the acquisitions approach, which has a different treatment of durable goods such as housing, because its principal purpose is to measure pure price inflation. In addition, the reference basket of goods and services contains many high-technology goods that were not in the 1973 basket. In fact many of them had not even been dreamed of in 1973. For example, personal computers were not added to the reference basket until 2005, but Government departments are now assuming that everyone has access to a computer, as evidenced for example by the lack of tax tables in the Taxpack, etc.

When they compile the CPI, the ABS now adjusts, mostly downwards, the prices of things like computers for technology improvements, which often means that the consumer cannot actually buy a computer as cheap as the one in the CPI reference basket, so must perforce either increase their cost of living or do without something else so that they can buy a new computer.

Government regulations also force manufacturers to make technological improvements. Examples include airbags in cars, dual-flush toilets, etc. A true cost of living index would not discount prices for technological improvement. The ABS estimates that it discounts about

1% of prices for quality improvement. This might sound quite insignificant but if the 1% of prices includes that of large items such as motor vehicles and other high cost items, it can drag down the CPI to a level that does not reflect the actual prices we pay for goods and services. Nobody knows exactly what affect this discounting might have on the final value of the CPI, because the ABS says that it does not have much information about it, but US sources suggest that it may make a difference of up to 1% a year. That does not sound much, but it compounds over time. The Matthews Report should have taken those practical realities into account, but it did not, despite having full access to ABS advice.

Matthews misrepresented Pollard's view that Commonwealth superannuants should get a better deal than Age Pensioners

In Section 3.3 of his Report, Matthews quotes Pollard as concluding: "*I see no relationship between the rate at which the Government may choose from time to time to increase welfare pensions and the rate of increase which it should apply to pensions payable to its own retired employees. The former pensions relate to what the community … regard as the minimum amounts necessary to maintain social service pensioners at a reasonable minimum standard of living … With occupational pensions, the level of benefit is determined by the rules of the scheme, and the adjustment mechanism is solely concerned to ensure that the intent of these rules is not lost through inflationary price increases*". However, in 1977, when the Fraser Government decided to use the CPI to index Commonwealth superannuation pensions, Cabinet documents show that it was to give them the same indexation as the Age Pension.

Matthews uses the above quotation to support his contention that the indexation of Commonwealth superannuation pensions does not have to match the community standard for retirees, the indexation of the Age Pension. In other words, his view was that those who worked for many years to earn their pensions require less protection of their living standards than those who only have pensions because they need welfare, not because they earned them.

However, when Pollard made the above remarks in March 1973, he was not saying that at all. He was arguing that Commonwealth superannuation pensions should be indexed by 1.4 times CPI, but should not exceed the percentage increase in Average Weekly Earnings (AWE). Now, in March 1973, the Age Pension had not been indexed since 1944. In other words, Matthews was saying that Commonwealth superannuation pensioners had a right to have their pensions indexed to maintain purchasing power but welfare recipients did not. It should be noted that in 1973, the Whitlam Government was very keen that pay and conditions of service in the Australian Public Service should be leading the way towards better pay and conditions for all workers. Pollard also said: "*The Commonwealth, as a good employer, should show a lead*." Matthews conveniently overlooked that too.

Who should benefit from increases in national productivity?

Matthews' key argument was that retired Commonwealth and Defence superannuation pensioners did not need or deserve any share in the productivity improvements enjoyed by the nation's workers. He said: "*Any enhancement of such indexation arrangements would constitute reward for no additional service*."

There is ample evidence from the ABS's 1997 Time Use Survey that retirees continue to make a valuable contribution to their country's welfare in retirement. They work as volunteers in community organisations, they help care for elderly parents and relatives, and provide unpaid childcare for their grandchildren so that their sons and daughters and their partners can work longer hours in paid work. Many retired public servants and members of the armed forces have particular skills of benefit to community organisations. Mathews was silent however on the justification for productivity benefits flowing on to Age Pensioners who have mostly left the workforce, and receive wage based pension indexation.

Matthews quoted approvingly from 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*."

By 1974, Pollard had changed his mind about his earlier recommendation of 1.4 times CPI. He now wanted CPI indexation, most likely for reasons of cost (the Whitlam government's finances were not looking so good). He had found that, in 1974, only 24% of people in the private sector had superannuation cover, compared to 58% of the public sector; and the Age Pension had not yet been benchmarked to MTAWE, although the Whitlam government had said that it was an aspirational goal.

Applying Pollard's logic to the present situation, it can readily be seen that almost everyone over Age Pension age, other than those in defined benefit super schemes indexed to the CPI, is receiving the benefit of productivity gains (if indeed there have been any recently)[1] . That is because they might have access not only to an Age Pension benchmarked to Male Total Average Weekly Earnings (MTAWE), but also untaxed superannuation from a taxed superannuation fund, or earnings from investment in shares (now with imputed franking credits) or real estate. Matthews should have come to the conclusion that there was therefore a good case for at least MTAWE indexation of Commonwealth superannuation pensions. But he did not. He did not even look at the evidence.

Which index is most appropriate for Commonwealth superannuation pensions?

Matthews quotes Pollard's view that that the index should maintain purchasing power. However, he did not answer the obvious question: "Relative to what?"

It appears that Matthews thought that it would suffice to maintain purchasing power relative to one's standard of living immediately after retirement (because that is all that CPI indexation allows for). However, that is not practically possible, since the community standard of living has been improving over time, and the standard of living of retirees would fall further and further behind community standards.

Another problem is that of patterns of expenditure. As they grow older, people spend less money on work-related expenses, childcare and education and more on medical expenses and pharmaceuticals. The CPI weights are based on the pattern of expenditure of the whole population, and are hardly likely to reflect the typical expenses of older people.

In Chapter 7 of his report, Matthews stated that: "*the main alternative to the CPI was the Alternative Living Cost Index (ALCI) for self-funded retirees*". He made no attempt to explain why he thought that. Readers of his report could reasonably conclude that he was just repeating what the Department of Finance and Deregulation had said in their submission to the Matthews Inquiry. They did not explain why they believed it either.

There are two problems with the assumption that the ALCI for self-funded retirees is the appropriate one. Firstly, although the ALCIs are based on the outlays approach rather than the acquisitions approach, the prices are still adjusted for technological change in the same way as in the CPI. Secondly, household expenditure patterns depend on household income as well as age. The average self-funded retiree household in the 2003-4 Household

[1] According to the ABS, there has been no increase in labour productivity in the ten years from 2000/2001 to 2010/2011.

Expenditure Survey (the basis for the ALCI weights) had an income of $80,000 a year, significantly more than twice the average Commonwealth superannuation pension. Given the small pensions of many Commonwealth superannuants, particularly the military pensioners and their widows, it would have been more reasonable to recommend that the Government should obtain some information about the average expenditure patterns of Commonwealth civilian and military superannuant households so that the weighting pattern for a more appropriate index (or indexes) could be determined. Lower income superannuant households could reasonably be expected to have household expenditure patterns similar to other part Age Pensioners.

The ALCI for Age Pensioners tends to rise faster than the CPI.

Inadequate consideration of the form of the benefits

Although the *Terms of Reference* had included “the form and value of the benefits”, the Matthews Report did not address the inadequate range of investment options provided by the funds, the absence of any financial advice to members of the funds, and the comparatively poor services provided to pensioners, including the failure to allow members to salary sacrifice and the lack of account-based pensions to provide retirees with more flexibility. Because members of these funds have only one chance to take a lump sum, at retirement, many of them would choose to take a lump sum even if the indexation were improved. Note also that only PSS pensioners have the option of purchasing an indexed pension with their lump sum; CSS pensioners can only purchase a non-indexed pension.

Fair treatment for those who had taken a lump sum

In the PSS scheme, the basic age retirement benefit is a lump sum. Members can convert 50% or more of their lump sum to an indexed pension that is payable for life. Melville and Pollard, in their 1974 report, came to believe that superannuation pensioners could maintain their purchasing power by investing their lump sum, so it was necessary to index their pension by CPI only. Matthews was aware of their view, and even referred to it.

However, Matthews put forward the argument that improving the indexation of superannuation pensions would be unfair to employed people who miss out on wage increases. It is difficult to understand his concern. Most people would think that employed people who thought that they were underpaid could just work harder or look for another job. Matthews also thought that improved indexation would be unfair to those who had already chosen to take a lump sum, but those who had taken a lump sum would have invested it and most of them would have achieved a better rate of return than the CPI, even if they had just put the money into a fixed deposit at a bank. If, for example, they had put the money into real estate, they would be way ahead.

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