AUSTRALIAN CHAMBER OF COMMERCE AND INDUSTRY

Future Fund Bill

ACCI Submission to the Senate Economics Committee

February 2006

LEADING AUSTRALIAN BUSINESS

BACKGROUND

1. The Australian Chamber of Commerce and Industry (ACCI) has been the peak council of Australian business associations for over 100 years.
2. ACCI is Australia's largest and most representative business association.
3. Through our membership, ACCI represents over 350,000 businesses nationwide, including:
   - Australia's top 100 companies
   - Over 55,000 medium sized enterprises employing 20 to 100 people
   - Over 280,000 smaller enterprises employing less than 20 people
4. These businesses collectively employ over 4 million people.
5. ACCI's 37 member organisations include the State and Territory Chambers of Commerce and Australia's leading national employer and industry associations. Our members represent all major sectors of Australian industry including small employers and sole traders as well as medium and larger businesses.
6. A list of ACCI members is attached.

SUMMARY

The Government has announced that it will set up a Future Fund which will invest surpluses to finance the superannuation of government employees (these liabilities are currently unfunded). The Government argues the Fund will "increase national savings, offset unfunded superannuation liabilities and maximise the Government's net worth."[1] The Treasurer argued that:

> This is the most dramatic response to the intergenerational report which we can now put in place as a consequence of Australia's strong economic position. We will be setting future generations up by funding the liabilities that are being incurred today, with money from today, rather than leaving the future generations to fund it.[2]

ACCI does not support the policy of a Future Fund, as we consider that the money devoted to such a fund is better spent on reform priorities, such as reforming taxation. As ACCI argued in 2005,[3] we have a number of concerns with the proposal for the Future Fund, in particular:

- the money put into the Fund is not available for other reforms, particularly to the tax system;
- the Fund will only have a limited effect on national saving;

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1. A Strong Economy, A Strong Future, The Howard Government Election 2004 Policy 'Investing in the Future', page 4.
2. Treasurer, Press Conference Treasury Place Melbourne, Friday 10 September 2004
3. ACCI (2005) "The Future Fund is Not the Best Use of Budget Surpluses", ACCI Review, June 2005, Number 124, pages 8-11.

- the superannuation of public servants is not the most important problem facing current or future Budgets;
- the money in the Fund could be diverted to uneconomic investments and spending;
- international experience suggests the need for a Future Fund in Australia is limited; and
- prominent independent commentators have argued against the Future Fund.

Additionally, we have a number of concerns about the legislation as it is currently drafted. In particular, the Bill does not address concerns that the Government could unduly influence the Fund's investment strategy, and the need to set up a separate body to manage the Fund has not been established.

BACKGROUND

The Inquiry

The Senate Economics Legislation Committee has asked for submissions into the *Future Fund Bill 2005* (the Bill). The Bill was referred to the Committee on 8 December 2005 for inquiry and report by 21 February 2006.

The Bill has the following functions:

- Establishing a Future Fund with the aim of accumulating financial assets sufficient to offset the Government's unfunded superannuation liabilities, which are expected to reach $140 billion by 2020.
- Providing for seed capital of $18 billion to be transferred to the Fund in 2005–06. In coming years, additional funds will come from realised budget surpluses and proceeds of asset sales.
- Establishing a Board of Guardians who will have statutory responsibility for managing the investments of the Fund and will decide how the Fund is to be invested. The Board will be supported by a Future Fund Management Agency, which will be responsible for the operational activities associated with the investment of the Fund.

Government Debt and Assets

The Australian Government has substantially reduced its net debt over the last decade: from $95.8 billion in 1995-96 to a forecast of -$1.3 billion in 2005-06 (ie the Government is forecast to be in a net asset position). The Government has forecast a net worth (assets minus debts) in 2005-06 of -$26.7 billion, and they expect this to become positive in 2008-09.

The Government decided in 2003 to retain the Commonwealth Government Securities Market, arguing that this decision would promote Australian financial markets, reduce the cost of capital and reduce the vulnerability of the financial sector during periods of instability. However, ACCI did not support this decision, because a free market is able to develop alternatives to government debt at low cost. We also argued that the retention of a debt market would have limited, if any, effect on the cost of capital or the vulnerability of the financial sector.[4]

If the debt market were not retained, the Government would have a forecast $1.3 billion to invest in 2005-06. However, the retention of the debt market means the Government has a much larger amount to invest. The Government borrows money through the bond market and then invests these funds.

Currently the Government deposits these funds with the Reserve Bank of Australia (RBA), which results in churning of interest, as the Government both receives interest on deposits and pays interest on the bonds it has issued. The value of deposits with the RBA will increase over time as the Government moves into a net asset position.

Instead of continuing this practice, the Government is proposing to invest its financial assets through the Future Fund, rather than make deposits at the RBA. The Fund will invest in debt, as well as equity and property, meaning it is likely to produce a higher return than the current strategy.

In this sense, the Future Fund is an improvement over the previous practice of investing money at low rates of return. However, the need for the Government to invest at all has not been substantiated and will in fact have substantial costs as shown in this submission.

Use of money from the Future Fund

The Future Fund will provide for the retirement incomes of public servants.

Currently, the superannuation costs of public servants are unfunded and are paid when they fall due. As a result, the Government has incurred a substantial liability for paying the future superannuation of public servants: the current estimate is $94.6 billion dollars. This liability is not included in the net debt/ worth figures above.

The Government has indicated that funds will not be withdrawn from the Future Fund until the value of the Fund covers all of the unfunded superannuation liability and that when this happens the withdrawal can only be used to meet superannuation payments.[5] However, future governments could abandon either, or both, of these restrictions.

ANALYSIS

ACCI has a number of concerns with the Future Fund proposal, as outlined below.

Diversion of money from other uses

The Future Fund effectively is a tax increase (or a foregone tax reduction), because the money allocated to the Fund is unable to be returned to taxpayers as tax cuts. The establishment of the Future Fund will mean that the money deposited into the

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4. More details on the ACCI argument are available from our submission to the Review of the Government Securities Market, available from our website at http://www.acci.asn.au/text_files/submissions/CGS_MarketDec%2002.pdf

5. See 2005-06 Budget Paper 1 at page 1-16.

fund cannot be used for other purposes, in particular tax reform. The implicit higher tax due to the Future Fund means a delay in tax reform, increasing the problems in the current system.

In ACCI's Taxation Reform Blueprint[6], we argue that tax reform (particularly cutting high marginal tax rates) will:

- Improve the economy's efficiency, growth and competitiveness;
- Ensure Australia can meet long-term challenges, such as the ageing of the population;
- Promote innovation, risk taking and entrepreneurship;
- Encourage investment in human capital (education and training);
- Encourage the migration and retention of skilled people in Australia; and
- Reduce tax avoidance and evasion.

Tax reform will mean a larger and more efficient economy, increasing Government revenue in the long run[7] and making it easier for Governments to pay public sector superannuation when required. A larger economy will not mean a substantial increase in public sector super liabilities. Conversely, foregoing tax cuts will mean the economy is smaller and less able to afford future costs, including public sector superannuation.

Therefore, investing surplus funds in tax cuts is likely to produce a higher return than investing in the Future Fund.

National Savings

National savings is made up of two components, *public* and *private* savings. The sum of the two is equal to national savings. A policy to increase aggregate savings through public savings (for example a public superannuation fund) will not automatically cause national savings to increase if private savings decrease. Therefore, the Future Fund may have a limited impact on national savings if private individuals make decisions that offset attempts by the Government to increase savings. Private dissaving can substantially offset higher Government saving[8].

ACCI supports policies that reduce barriers to savings. We consider that tax cuts can encourage savings, particularly by reducing taxes on the returns to saving (such as interest and capital gains). However, devoting money to the Future Fund means that the money cannot be used for tax cuts. It has not been shown that the Future Fund will generate higher savings than other alternatives, particularly tax cuts.

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6. Available from ACCI's website at: http://www.acci.asn.au/TaxBluePrintMain.htm
7. Some examples of tax cuts that generated more revenue in the long run are detailed in the articles The Case for Flat Taxes, and The Flat-Tax Revolution from The Economist, 14 April 2005.
8. See Comley, Anthony & Ferguson (2002) "The effective of fiscal policy in Australia - selected issues", Treasury Economic Roundup, Winter 2002, available at www.treasury.gov.au/documents/382/PDF/3bank.pdf

ACCI considers that reductions in taxes will encourage productive saving, which would benefit Australia. There is no guarantee that the Future Fund will invest productively.

In any case, it is paternalistic of the Government to suggest that individuals spend their money poorly and force them to save through the Future Fund.

That said, ACCI does support measures that remove barriers to saving. If there are taxes or regulations that restrict saving, these barriers should be removed, rather than creating another distortion (higher taxes) to increase saving.

It is notable that the Australian Government Actuary has stated:

> *A side from national saving, there is no other reason to consider the funding of superannuation schemes for Commonwealth Government employees.*[9]

This leaves the Future Fund with little support from the Government Actuary.

It could be argued that Australia should be similarly saving the (allegedly) substantial revenues from our current mining boom. There are a number of problems with this argument:

- Revenues have grown strongly in recent years. However, an analysis by the Treasury (2005-06 Budget Paper 1, page 5-7) showed that the mining boom was only one reason for the strong revenue growth – other reasons include privatisation, capital gains, lower stocks of losses carried forward, increased compliance, dividend imputation and increased incorporation. These other reasons for strong revenue growth will not be affected by the end of the mining boom.

- Treasury forecasts show that revenue is not expected to fall substantially when the mining boom ends. The revenue forecasts for future years assume that the mining boom will end by about 2008 (see Budget Paper 1, Box 7 on page 3-33), but revenue and surplus forecasts do not appear greatly affected, see table below.

The elusive effect of the end of the mining boom on tax revenue and Budget surplus

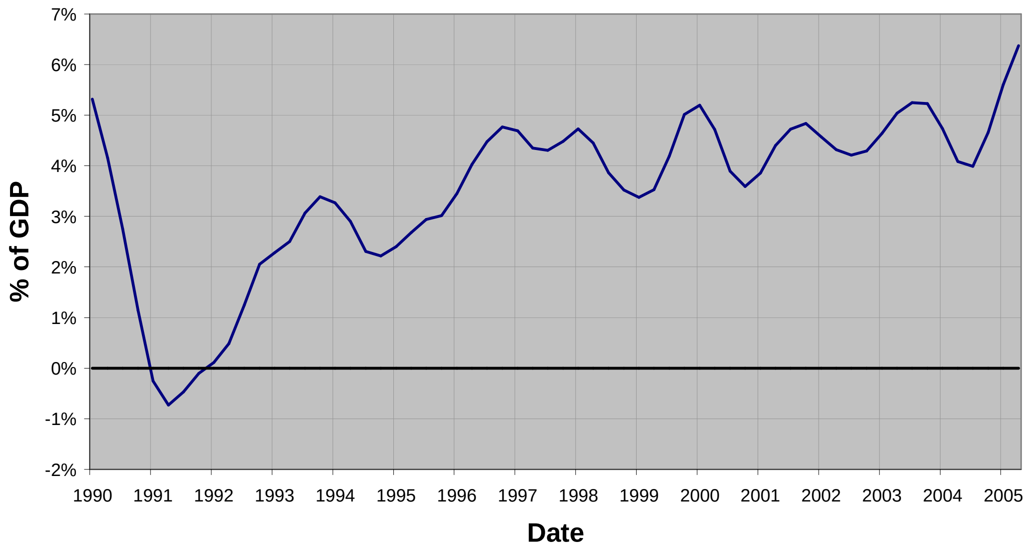
	2006-07	2007-08	2008-09
Revenue growth over previous year	4.0%	4.8%	4.9%
Surplus ($bn)	9.7	10.1	10.7

Source: Mid-year Economic and Fiscal Outlook 2005-06, Table 5

- The national saving level is already at recent highs (since 1989). It is therefore not clear why the Government needs to add to this savings, see chart below.

9. Ibid.

National Savings as proportion of GDP



Source: Australian Bureau of Statistics National Income, Expenditure and Product Cat No 5206, table 1

The need to fund public sector super

Australia is facing a number of long-term challenges, particularly the ageing of the population and strongly increasing health care costs, but not public sector super. These challenges were examined in the Government's Intergenerational Report (IGR), released in 2002. The IGR conclusions were largely supported by a Productivity Commission report, released in February 2005.

TABLE 1

Trends in Selected Budget Expenditures[10]

Budget Item	Cost in 2001-02 (% of GDP)	Estimated cost in 2041-42 (% of GDP)	Change (% points of GDP)
Pharmaceutical Benefits Scheme	0.6	3.4	+2.8
Total Aged Care	0.7	1.8	+1.1
Age and Service Pensions	2.9	4.6	+1.7
Unfunded Government Superannuation	0.6	0.3	-0.3

As shown in the table above, ageing and health expenditures will increase substantially over the next forty years[11], while the costs of public service super are

10. Modified from the IGR (2002) The Intergenerational Report, Appendix A: Demographic Spending Projections (per cent of GDP), page 69.

set to decline. This shows that public service superannuation is hardly the most important fiscal pressure facing Australia in coming decades.

Although ACCI is not advocating that Future Fund income be spent on health or other policy areas, it is unclear from these numbers why the Government should chose to provide for superannuation and not for other costs, which are going to increase strongly.

Investment strategy

The Government has not yet decided on an asset allocation strategy for the Future Fund. However, it would be reasonable to assume that it will invest in debt, equity, property and other assets. If the Fund diversifies appropriately, it should invest in a wide range of assets, including overseas.

The Government has indicated that the Future Fund will be run by an independent agency, preventing Government influence over decision-making. Nevertheless, we believe that it would be difficult to ensure that future governments could not interfere in the Future Fund. The members of the Board are not allowed to be employees of the Commonwealth (subsection 38 (4)). However, the *Future Fund Bill 2005* allows a significant level of Government involvement, for example:

- All Board members are appointed by the relevant Ministers[12] (subsection 38 (2));
- Board members may have their appointment terminated by the Ministers (under the terms of subsection 44);
- The Board is bound by the "Investment Mandate", which consist of written directions from the Ministers (subsection 18 (1)); and
- The Board must keep the Ministers informed (subsection 55).

These provisions may in themselves not mean that the Government will be participating in decision-making; however, it provides a means of influence for Ministers if they wish.

Therefore, there are substantial risks that the Fund's asset allocation will be suboptimal. There will be political pressure for the Future Fund to invest locally rather than overseas, or to intervene in specific markets and invest in projects that may not produce a good return. This will reduce Fund returns and increase Fund risk. The example of WA Inc shows how Government-directed investment can often go very wrong.

As argued in ACCI's infrastructure policy, there are a number of problems with Government investment, including:

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11. Although recent trends suggest that health and ageing costs may not increase as quickly as originally thought, because the growth in pharmaceutical costs has slowed and the birth rate has increased.
12. The 'Ministers' being the Treasurer and the Finance Minister, subsection 5.

- The Government is less responsive to market needs than the private sector, because the private sector has to make a profit while the Government does not.
- The Government is less efficient at construction, development and operation than the private sector.
- Government investment can be swayed by political considerations, meaning investment can be very inefficient.
- Governments may have political constraints on its ability to finance some worthwhile investments (particularly large ones).
- Government involvement in infrastructure can mean underinvestment in the longer term (for example, not enough is spent on maintenance). Those sectors where the capital stock is most deficient are those where governments remain the dominant suppliers[13].

In addition, if the Fund is not adequately diversified, there is a risk that the Fund will be a substantial player in particular markets and the operations of the Fund will cause disruption to those markets. In addition, the Government will be under political pressure to use its share votes to influence company policy, perhaps to the detriment of other shareholders. This risk is greater if the Fund has a large investment in Australia.

Finally, when money in the Fund is withdrawn, there is a risk that the government of the day will use these funds for unproductive spending. It has been argued that money withdrawn from the fund can only be used to pay for public sector super. However, the payment of public sector super out of the Fund means the Government would have more money free for other purposes, including unproductive spending.

By contrast, we argue that providing the funds to private individuals as tax cuts will ensure that government interference will be minimised. Generally, poor investment decisions by individuals have smaller consequences than poor decisions by Governments.

There is also the issue of voting on shares. It is not clear how the Fund will use the voting rights attached to shares. There is pressure on institutional investors to vote on share holdings – the same pressure will occur for the Fund. In 2003, fund managers voted on 92 percent of company resolutions[14]. However, if the Fund does vote, how will it vote? There will be pressure on the Government and hence the Fund for voting to follow the wishes of particular interest groups, such as pro-development, anti-development, pro-union, anti-union and so on. The idea of the Government (implicitly or explicitly) telling a company how to run its business is of some concern to ACCI and its members.

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13. AusCID (2005) Submission to Exports and Infrastructure (Fisher) Taskforce, page 9
14. IFSA (2003) Fund managers raise bar on corporate governance, Press Release 14 August 2003.

International experience

Internationally, countries such as Norway, New Zealand and Ireland are already providing funds for future superannuation liabilities. However, the need for funding superannuation is different in Australia, due to its projected future liabilities being relatively low. Australia does not face the budget or debt constraints of the above countries.

Australia's old-age pension liabilities are about 3.0 per cent of GDP and by 2050 will rise by 1.6 percentage points of GDP, to 4.6 per cent. New Zealand's pension liabilities are 4.8 per cent of GDP, and will rise by 5.7 percentage points to 10.5 per cent, while Norway's will rise from 4.9 per cent of GDP to 12.9 per cent, according to OECD projections.[15]

These figures cover pensions, not public sector superannuation. As noted in table 1 above, the expected costs of superannuation are much lower and are set to shrink substantially (0.6% of GDP in 2001-02, set to shrink to 0.3% of GDP by 2041-42).

Opinions of independent commentators

In 2003, the former Secretary to the Treasury, Ted Evans, stated that the basis for the Future Fund was weak, and that

> *… the greatest contribution that today's population can make to the living standard of future generations is to ensure that today's policies are directed towards maximising future GNP. It may well be that Australia's future GNP could be maximised by setting aside certain of today's tax revenue in a well-managed intergenerational fund – though I doubt it. … It may just as well be that future GNP would be maximised by leaving the tax revenue in the hands of its present owners, to invest as they will.*[16]

The current Secretary to the Treasury, Dr Ken Henry, argued in May 2004 that the Government should adopt a strategy that promotes growth now, rather than saving for future expenses:

> *the pro-growth strategy accepts, at least implicitly, that the nation will be better able to support an ageing population in the future if individuals, rather than governments, are today's principal decision makers in respect of both the level of capital accumulation and its allocation.*[17]

Professor Peter Saunders from the Centre for Independent Studies (CIS) has also opposed the creation of the Fund in the report *Twenty Million Future Funds*.[18] Professor Saunders argued that the Future Fund would not alleviate the pressures of escalating costs of age pensions and public health care, and argues that reduced taxes would be more effective, as it would encourage the population to create their own savings and care for their own needs.

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15. Alan Wood (2004) "Not so simple Simon", The Australian, 7 September 2004.
16. Ted Evans, presentation to Pursuing Opportunity and Prosperity Conference, 14 November 2003, available from www.melbourneinstitute.com/conf/pop2003/pdffiles/TedEvans-S.pdf
17. Dr Ken Henry (2004), speech to Australian Business Economists, May.
18. Peter Saunders, (2005) "Twenty Million Future Funds", Issue Analysis, Centre for Independent Studies, 21 December 2005.

Professor Saunders has an alternative proposal that the $60 billion forecast to make up the Future Fund in 2007 should be redistributed to "permanent residents in Australia (children as well as adults) … [to] provide everyone with their own personal 'future fund' (PFF) worth around $3,000."[19] The major idea behind such funds is to reduce the dependence of individuals on the Government, and provide them with self-reliance, as well as reduce Government costs of welfare as well as 'churning' costs.[20] This could be achieved in three ways:

- *Income security during periods of joblessness: Income from one's PFF could be used to cover short periods of joblessness, rather than having to apply to Centrelink for the dole. This would reduce the stigma of unemployment and strengthen job-search activity.*
- More responsibility for our own health: People might choose to use their funds to pay for GP visits, pharmaceuticals, or health insurance deductibles up to an agreed annual cost limit. In return for reducing their use of Medicare, they would be able to make tax-free contributions into their funds.
- Asset accumulation for the future: An annual tax-free savings allowance could help younger people invest in their PFF in order to purchase a first home, to buy education and training, or to set up a business.[21]

In ACCI's view, an even better use for funds would be to reduce taxation levels.

OPERATING PRINCIPLES

ACCI opposes the creation of the Future Fund and does not support the legislation establishing such a Fund. However, if the Fund is created, it should be set up to minimise the problems outlined above. The legislation should ensure:

- operation of the Future Fund is at arm's length from the Government;
- transparency in all matters of the Fund;
- investment in productive assets only; and
- diversification to reduce risk, increase returns and reduce Fund dominance of any market.

Furthermore, it must include access and drawdown provisions, which ensure that money from the Fund can exclusively be used for appropriate purposes. These purposes are outlined in Schedule 2, subsection 2.

Management of investments by ComSuper

Instead of establishing a new agency to manage the Fund, the Government could engage ComSuper, who already makes investments to pay for public service super,

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19. Ibid, page 8.
20. These are the costs that occur when taxes paid to the Government are redistributed directly to the income earner, known as 'churning'.
21. Centre for Independent Studies (2005) "Report Calls For 20 Million Future Funds", Centre for Independent Studies, Media Release, 21 December 2005, available from: http://www.cis.org.au/Media/releases/releases%202005/M211205.htm

and has therefore already acquired knowledge and expertise in the field. It also meets all of ACCI's tests for operation as stated above; it operates independently from the Government, is transparent and diversified and is required to operate to the benefit of members only. However, the Government has rejected this option.

A number of arguments have been raised against the use of ComSuper.

Firstly, it is argued that the fiduciary duty of the Future Fund is to taxpayers, whereas the duty of ComSuper is to scheme members. However, it is likely that it will *improve* the operation of the Fund if its duty were to scheme members. As outlined above, we have concerns that Government direction of the fund will cause misallocation of investments. If the investments were held on behalf of ComSuper members, they would be ultimately responsible for the investment decisions. If the funds were vested in ComSuper members, then they would have an incentive to invest the funds wisely. As noted above, we have concerns that the Government does not have adequate incentive to invest money appropriately.

Another argument against management by ComSuper is that the Fund is not taxable, whereas ComSuper is. However, this could easily be overcome by making the Fund taxable. While this will increase the administrative costs imposed on the Fund, this could easily be offset by the lower costs of using ComSuper compared to setting up a new agency.

In addition, making the Fund tax exempt means its investment decisions may be biased against investments that pay franked dividends or have foreign tax credits. Taxable entities value franking credits and foreign tax credits, whereas untaxed entities do not. The Bill provides for the Fund to receive a refund of franking credits (not foreign tax credits) but this reintroduces complexity which was designed to be removed by making the Fund untaxed.

So making the Fund tax exempt either introduces a bias into investment decision making, or will require complexity which will largely (or completely) offset the benefits of making the Fund tax exempt.

Of course, making the Fund taxable will reduce its (after tax) earnings and increase Budget tax revenue, but we do not consider this to be a problem as we oppose the principle of the Fund anyway.

Investment in infrastructure and other assets

The Future Fund should not be *required* to invest in any particular asset class, such as infrastructure, as this will reduce returns. We support the Fund investing in infrastructure, as long as this produces an appropriate economic return. It should not invest in uneconomic assets.

If Government investment in infrastructure is warranted, this should occur through normal Budget processes. We consider that the current infrastructure constraints can largely be addressed by facilitating private sector investment, rather than through substantial Government investment.[22]

Ministerial direction

ACCI is concerned with the Ministerial involvement in the appointment and dismissal of Board Members, as well as the seemingly direct involvement of the Ministers as to the investments of the Future Fund. We would like to see a greater independence from the Government. We have strong concerns with excessive Government involvement (see above).

Primarily, it is concerning that the responsible Ministers are asked to make directives with regard to "maximising the return earned on the Fund over the long term, consistent with international best practice for institutional investment; and … *such other matters as the responsible Ministers consider relevant*." (subsection 18(2)(a) and (b) emphasis added)

CONCLUSION

The Government's Intergenerational Report indicates that public sector pensions are set to halve as a proportion of GDP by 2041. Therefore, it will be easy for future Governments to fund superannuation liabilities when they fall due. We therefore emphasise that a Future Fund **is not needed** to cover these liabilities.

In addition, we have established that the Fund is likely to have limited impact on national savings, and we are concerned that there are substantial risks that Fund assets may be misused. Furthermore, international experience does not support the need for a Fund in Australia and independent commentators are sceptical of the Fund's benefits.

ACCI does agree that the Government should increase national savings, productivity, growth and investment by putting surpluses to their best use. However, we disagree that the Future Fund is the best use of surpluses.

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22. Further details of ACCI's policy on infrastructure investment is available from ACCI's submission to a House of Representatives inquiry into regional rail and road networks and their interface with ports, available from ACCI's website: www.acci.asn.au

ACCI MEMBERSHIP

ACT and Region Chamber of Commerce and Industry
Australian Business Ltd
Business SA
Chamber of Commerce and Industry Western Australia
Chamber of Commerce Northern Territory
Commerce Queensland
Employers' First ™
State Chamber of Commerce (New South Wales)
Tasmanian Chamber of Commerce and Industry
Victorian Employers' Chamber of Commerce and Industry
Agribusiness Employers' Federation
Air Conditioning and Mechanical Contractors' Association of Australia
Association of Consulting Engineers Australia
Australian Beverages Council
Australian Consumer and Specialty Products Association
Australian Entertainment Industry Association
Australian Hotels Association
Australian International Airlines Operations Group
Australian Made Campaign Limited
Australian Mines and Metals Association
Australian Paint Manufacturers' Federation
Australian Retailers Association
Housing Industry Association
Insurance Council of Australia
Investment and Financial Services Association
Master Builders Australia
Master Plumbers and Mechanical Services Association Australia
National Electrical and Communications Association
National Retail Association Limited
NSW Farmers Industrial Association
Oil Industry Industrial Association
Pharmacy Guild of Australia
Plastics and Chemicals Industries Association
Printing Industries Association of Australia
Restaurant and Catering Australia
Standards Australia Limited
Victorian Automobile Chamber of Commerce