Australian Council of Public Sector
Retiree Organisations Inc. ABN 74 202 015 642

Peak Council representing Commonwealth, including military, State, Territory and other public sector retirees.

19 Drevermann St Farrer ACT 2607

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Submission to the Review of Pension Indexation Arrangements in Australian Government Civilian and Military Superannuation Schemes

ACPSRO is the peak council for eleven organisations representing retired civilian and military public sector workers from the Commonwealth, State and Territory governments. The number of people represented by our grass roots organisations is in the region of 700,000. When their dependants are taken into account the people we are speaking for number about 2 million Australians or 10% of our population.

Commonwealth civilian and military retirees are not asking for special or favoured treatment. These are the people who have protected Australia and what it stands for and they rightly believe that the Government should protect their standard of living in retirement – to do less contradicts the promises of fairness and decency made by the Prime Minister during the last election campaign.

The Review's Terms of Reference

Neither ACPSRO nor its member organisations were consulted on the Terms of Reference for this review.

The Terms of Reference concentrate too much on issues of quantification while the policy decision for the Government is one of fairness and equity. Quantification was not an issue (and is still not an issue) in the improvement of indexation afforded to age pensioners. The annual cost of age pensions is approximately 5 times that of Commonwealth and military pensions. This ratio will continue to increase with the decline in the cost of the closed Commonwealth defined-benefits schemes and the increase in the number of age pensioners.

We believe the taxation treatment of public sector pensions should have been included.

When the Government introduced the arrangements for *Simpler Super* it introduced a 10% tax offset for pensions paid from untaxed funds. The offset did not benefit the many public sector retirees who receive only modest incomes. The average Commonwealth pension is less than $23,000 pa. For those on higher pensions, any private income continues to be taxed on top of pension income, something that no longer happens for pensions paid from taxed funds. In addition, government pensions cannot be split with a spouse for tax purposes, something that can be done for pensions from taxed funds.

The Issue

The proper indexation of CSS, PSS and military pensions is fundamentally a question of fair behaviour by the Commonwealth towards its past employees.

In the period prior to the late 1980s, the experience of retirees receiving a Commonwealth employment pension was that CPI indexation more or less allowed them to maintain a standard of living that kept pace with community living standards. At that time the widely accepted view amongst the Commonwealth's employees was that retirement pensions though not generous were protected from increases in the cost of living. The Commonwealth did not disabuse its servants of that view.

From the end of the 1980s, indexation based on the Australian CPI has failed year in and year out to even roughly approximate rising costs and improving community living standards.

There seem to be two feasible explanations for the change in the behaviour of the Australian CPI.

Refining the Estimation of the CPI. The first of these is that the ABS has progressively refined its methods for estimating the CPI. This view is given credence by the debate that took place in the mid 1990s in the USA over whether or not the then prevailing methods of estimating the CPI overstated it. An expert Commission in the USA reported in 1996 that prevailing methods overstated the CPI by about 1.1 percentage points per year of which more than half was attributable to inadequate downward adjustment for new products and improvement in the quality of products.

However, in contrast to the USA experience, there is no evidence that the ABS has ever felt the need to make major changes to its methodology for assessing the CPI. The ABS papers for the 13th, 14th and 15th reviews of the CPI show that it has always been conscious of the need for thorough corrections to raw price data. Appendix 2 to the ABS "Information Paper: Issues to be considered during the 13th Series Australian Consumer Price Index Review", issued in May 1997, provides a spirited defence of the ABS methods. In respect of quality adjustments the ABS said[1]:

> The identification and quantification of quality change accounts for a significant proportion of the resources devoted to the construction of CPIs. While theoretical systematic approaches to quantifying quality change do exist, most notably the use of hedonic regression techniques, these approaches are invariably costly and rarely lend themselves to timely adjustment. Most statistical agencies therefore fall back on relying on the expert judgement of the statisticians compiling the CPI. The ABS is no different in this regard.
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> The ABS has a number of strategies in place to minimise quality adjustment bias. ……….. In the first instance, the ABS employs permanent field staff in each capital city for the collection of prices by direct observation. These staff have been specifically trained to identify any changes in the physical or other characteristics of products and to report the details along with the price information. Second, the ABS maintains a proactive program of interviews with manufacturers and importers to both identify forthcoming changes in product specifications and to obtain information to assist in quantifying current and future quality changes. Third, the staff responsible for making the assessment of quality change are assigned responsibility for specific areas of the index in order to gain expertise in specific market segments and to ensure, as far as possible, consistency in adjustments over time.

The preparation of the CPI involves many adjustments for changes in quality and these adjustments require difficult judgements about the value of changes in physical or other characteristics of products. There is considerable scope in this for things to go awry as will be discussed below.

Adjusting the CPI for changes in Product Quality. The second and more obvious explanation for the apparent change in the behaviour of the CPI is associated with the flood of consumer durables imported into Australia from Asia in recent years. Many of these goods are products of, or rely in large part on, the revolution in consumer electronics. Invariably the price for these products has been steadily declining over many years while quality has been just as steadily rising. The impact on the CPI has been twofold.

The declining shelf price for these products has acted as a significant brake on the CPI. Increases in the CPI due to price increases in the largely import-protected service sector have been offset by the falling shelf prices of imported products. In that respect, one might observe that the restraint thereby imposed on the CPI did not disadvantage retirees. All consumers stand to benefit from the reduction in the shelf price of these products.

But substantial reductions to the CPI due to the improving quality of these products is an altogether different matter.

Quantitative data about the reduction in the Australian CPI because of improving quality in products is not available. However the US Bureau of Economic Analysis has published information about the extent to which it estimated that the price of personal computers declined between 1994 and 1998. It estimated that the price fell by 33.3% pa, of which 7.7% pa was due to a fall in the shelf price and a phenomenal 25.6 % pa was due to improving quality[2]. The estimates of the reduction in the price of personal computers in Australia in those years would not have been largely different.

If we assign a shelf price of $2000 to a personal computer in 1994, the above figures mean that in 1998 the shelf price had fallen to $1452 and the quality corrected price had fallen to $396.

On the basis of these figures a retiree would be better off continuing to live in 1994. At that time he/she could purchase a computer, albeit of modest quality, at the prevailing community standard. There is no way that retiree could buy a computer, no matter how debased the quality, for $396 in 1998. This suggests that the quality correction, at least in this instance, has reduced the retiree's standard of living in absolute terms below the 1994 level.

It is relevant that quality corrections to prices flow directly through the National Accounts into reduced inflation and enhanced productivity. The example quoted above has been criticised by the Europeans who think that the USA has thereby over estimated its growth in productivity[3]. It is not the intention here to express a view on that debate, still unresolved. But it does highlight the problems that flow from using an index, intended as a measure of pure price movements, for the indexation of pensions.

Unhappily the example quoted above may have been repeated again and again for other products. The preconditions appear to be:

1. a product that is superseded by a new model,
2. the old model is taken off the market, and
3. the manufacturer claims dramatic quality improvements for the new model.

Over the past fifteen or more years, the country has been literally hosed with products that meet these conditions. In each case there is a distinct risk that the associated downwards quality corrections to the CPI may have reduced a retiree's standard of living in absolute terms below that which prevailed when he/she retired.

Retirees must live in the real world. Whether or not a retiree's standard of living has been reduced in absolute terms is of less importance than the certainty that it has been reduced in terms relative to contemporaneous standards of living. The CPI basket contains many elements which have been corrected to a quality level no longer available in the market, motor cars, televisions, white goods etc etc. But retirees do not have the choice of buying other than current models for these products and for which manufacturers endlessly claim improved quality. At best, retirees are locked into a standard of living that belongs to an increasingly distant past, a past that is no longer accessible to them. Inevitably they sink more and more into dependency on the age pension, an outcome few expected during their working lives and which is contrary to the Government's original intention in requiring them to subscribe to its superannuation schemes. This is neither fair nor equitable.

The CPI is a price index and not a basis for Indexation

In the past the CPI fulfilled the dual roles of being a price index and a basis for indexation. In recent years there has been significant decline in the acceptance of the CPI for the latter purpose.

- In January 1993, the then Government decided that CPI indexation of the age pension, the method of indexation that had prevailed for many years, had become inadequate. The increases in CPI no longer resulted in sufficient increases to allow aged pensioners to live respectably. It set a floor level for the age pension of not less than 25% of Male Total Average Weekly Earnings (MTAWE). That floor level has prevailed in the determination of the age pension ever since and was passed into legislation in 1997.
- In 2002, the Reserve Bank of Australia's Officers Superannuation Fund Board of Trustees reviewed the method of indexing the pensions of its members. As a result, the RBA changed from an annual indexation linked to the CPI to half-yearly indexation based on the change in MTAWE.

Neither of these changes would have been made if the CPI had remained a reasonable reflection of changes in the cost of contemporary standards of living. The changes were made because people with access to privileged information knew that the CPI had become an inadequate reflection of those costs.

Other changes that indicate that the nature of the CPI has been changing are:

- In the past the CPI was frequently used in contracts as an index for adjusting future costs or penalties. Today that has been largely replaced by special purpose indices prepared by specialist firms in the private sector.
- In recent years the ABS has emphasised that the CPI measures 'pure' price change and does not measure changes in the cost of living.

Altogether, it is clear that the continued use of the CPI for the indexation of civilian and military pensions cannot be justified.

Other Considerations

There are two arguments that are often used to deflect attention in this matter.

The first of these is that the age pension system provides a safety net for those whose retirement incomes become inadequate. Adding insult to injury, the purveyors of this line frequently observe that this safety net is indeed properly indexed as already noted above. People who entered the employment of the Commonwealth and accepted modest levels of remuneration, frequently worked very long hours, tolerated measured rates of promotion, were compulsorily required to contribute to the then prevailing superannuation schemes and were constantly loyal to their calling, should not have to seek assistance from the age pension in retirement. Their expectation, encouraged by the Commonwealth, was that their superannuation would provide adequate financial security in retirement.

The second argument is that proper indexation of civilian and military pensions would be very costly for the Commonwealth. The other side of the same coin of course is that the steady erosion of retirement pensions has been enormously costly to retirees.

If the Commonwealth had treated its employees more fairly, it would have made equivalent changes to the way its employee pensions were indexed at the same time that it made changes to the way that the age pension was indexed, in January 1993.

A completely equitable approach to making good what has happened since 1993 would require the Commonwealth to:

1. make good the losses that retirees have suffered since 1993,
2. reset present pension levels to the corrected level, and
3. apply proper indexation from now on.

Our claim however is limited to the future application of a system of indexation for Commonwealth pensions that matches the percentage changes in the age pension.

Previous Consideration

The foregoing and many subsidiary arguments have already been put to and considered by three Senate Inquiries (April 2001, December 2002 and March 2008). The Deputy Chairman of the first two of those enquiries was Senator the Hon. Nick Sherry, now the Minister for Superannuation and Corporate Law and the Minister that has commissioned this enquiry.

All three enquiries endorsed changing indexation for civilian and military pensions so as to make them consistent with how the age pension has been kept in step with the cost of living since January 1993.

The Senate Inquiry that reported in March of this year had this to say:

> 3.96 As discussed earlier in this chapter, it is unclear why retirees receiving government payments are subjected to different indexation mechanisms. Although this has clear implications for the Government's budget, this practice is inconsistent with principles of equity and fairness, and undermines the maintenance of the comparative value of many retirees' incomes.

and

> 8.35 The committee recommends that:
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> (i) the Government review and standardise the indexation methodology of pensions, social security and other government retirement benefits to ensure they maintain their relative levels. In particular, the Government should note limitations highlighted during the inquiry about the use of the Consumer Price Index ....
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> (ii) the review should ······.
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> (iii) .... to ensure immediate relativity, the Government should index Commonwealth funded superannuation benefits and the military pension to Male Total Average Weekly Earnings or the Consumer Price Index, whichever is the higher, as is currently the practice with the age pension.

As this most recent Senate Inquiry has so tellingly put it: the issue is not about cost or computation. It is about fair behaviour by the Commonwealth towards its past employees.

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[1] Australian Bureau of Statistics 1997, *Information Paper: Issues to be considered during the 13th Series Australian Consumer Price Index Review*, Catalogue No. 6451.0, Appendix 2, paras 31 & 32.

[2] J. Steven Landefeld and Bruce T. Grimm, *A Note on the Impact of Hedonics and Computers on Real GDP*, Bureau of Economic Analysis, Survey of Current Business, December 2000. p. 20.

[3] Angus Maddison, *The World Economy: Historical Statistics*, OECD Development Centre, 2003. p. 80.