

Australian Productivity Commission Inquiry into the Superannuation System.

Submission Alex Finch:

1. ***Can Australia still afford super today?***
2. ***Has Compulsory Super contributed to our infrastructure deficiency and household debt bubble?***

Some very rich countries have accumulated large savings in super while others, like Germany and Japan have vast savings, *just not in super*. In 2014, according to a TowersWatson Global Pension Assets Study, the oil rich Netherlands had \$1457 billion USD in super (166% of GDP), more than any other European country except for the UK (\$3309 billion USD, 116% of GDP); oil rich Canada had \$1526 billion USD (85% of GDP), and Australia had \$1675 billion USD (113% of GDP). Germany, although one of the richest countries in the world only had *14% of GDP* in super, France *just 6% of GDP*. It's interesting to note that those countries with the highest super savings - the UK, Netherlands and Australia - are also considered to have the most unaffordable housing.

Australia has managed to save \$2 trillion in Super but simultaneously also accumulated over \$1 trillion in *net* external debt (that the others don't have), and we've also short-changed ourselves with an infrastructure deficit of at least \$1 trillion (needed to reach Canadian, German, French, UK or even Spanish standards). The IMF would probably say that's still a manageable economy for Australia – no risk to the AAA rating on that maths.

The IMF may however have overlooked another problem: Australia's "employment-creation" model. This problem becomes clearer by comparing Australia with another resources-rich country – Canada. In Australia during the mining boom, we generously employed over one million people more than we could actually afford to pay, in stark contrast to Canada for example (see below). Effectively, I would argue that for some time now, we have been forced to pay some wages in Australia by continuously just borrowing money from overseas (in other words, it's not just real estate debt causing the blowout) – and we continue to borrow!

For decades now Australia has been in the business of offering jobs to migrants (mostly after they completed a degree at any of our many universities). It all worked well and also helped create a relentless demand for construction workers, but we're at a tipping point, Australia's business model has a flaw – *we can no longer afford to keep hiring student/migrants* – and that may have a knock-on effect. To make matters worse, we pushed our minimum wage about 30% higher than in Canada (PPP-adjusted; Goldman Sachs' "Wages World Tour 2013"). *Not only did we offer more jobs than Canada, but we also offered higher wages!*

Now that the mining boom has gone bust, I can see the risk of unemployment in Australia rising to 12%, especially if China does experience a financial crisis of it's own – that risk is very real now.

Creating many new migrant-jobs caused a housing price bubble, but so did super, which I will try to explain. Most European countries put a lid on any developing bubbles, keeping housing affordable, while our policies seemed to feed the bubble. In the last 50 years property values in Australia have been compounding by an astonishing +8.5% pa, at times undervalued, but now grossly overvalued for an isolated resource exporting country like Australia. The problem is, you can't use the delusion of "dwelling-wealth" to pay wages.

When Paul Keating created compulsory super he effectively reduced the government's ability to fund infrastructure spending and to deliver affordable housing (explained below). We'd need to spend at least a trillion dollars today just to get our infrastructure up to Canadian or European standards.

Letting the excess one million workers go now, would push unemployment very high, but continuously borrowing more to pay their wages, is also not an option. We may need to consider at least temporarily cancelling compulsory super contributions altogether and simultaneously increasing personal income taxes by the same amount, so that money currently going to super-savings each month, instead goes straight to the government to pay for the wages of all those newly created public servant jobs. That way the government instantly has an extra \$80 billion annual revenue, which it will desperately need, mainly for wages, until the inevitable, coming recession is over. We simply can't afford super-savings anymore. We need to sacrifice the future savings earmarked for super, to pay the wages of all the newly created jobs.

Germany's unemployment hit 12% in 2005, a consequence of the deep recession they suffered in 2003 following the boom years of their reunification. We should look to German, today one of the wealthiest countries in the world, for guidance. It's all about finding the money now to keep people employed. The German government implemented very unpopular and far-reaching labour-market reforms in 2005 which forced real wages lower. We should also look at Canada's economy to help understand the reasons for our own current dilemma.

Cancelling super would also mean pay-ins go to zero, putting existing super assets at risk of fire-sales, but as long as annual payouts (\$62 billion in 2015) can be mostly covered by income on existing super assets (while restricting lump-sum payouts), the risk of triggering any fire-sales of those existing concentrated superfund investments could be avoided and assets protected.

As for our commodities producers, they misread China's massive 2008 stimulus package as being permanent and ramped-up production, but it is the end of the supercycle for commodities and mining profits will hug the production-cost curve, producers barely recouping their own invested funds. There will be little left for the rest of Australia. Living in denial, like the CEOs of some of our mining companies, wont help. Hope is not a plan.

To better understand how Australia's economy has changed over the last two decades, it helps to compare it with the economy of another fully developed resource-rich country like Canada. There are many astonishing similarities and unfortunately a few major differences between the economies of these two countries. For example, their currencies have performed remarkable in tandem, both going from around 60c US in 2003, to about \$1.10 in 2011, and then falling back to 70c in 2015. (The argument was always, once our dollar falls we will be more competitive internationally, but against Canada nothing has changed).

Australia and Canada are almost like parallel universes, both starting with very similar initial conditions about two decades ago (before the mining boom), but just a few diverging policy parameters have led to substantially different final outcomes today.

One profound difference in outcomes since 1999 is that while household debt to disposable income might currently be very high in both countries (Australia 180%; Canada 165%), Net External Debt (or Net International Investment Position NIIP) is much higher in Australia

today. In fact, Canada has gone from being a debtor nation of about minus \$200 billion CAD to a creditor nation of plus \$288 billion CAD today, while Australia tripled its net debt during that time to about minus \$900 billion AUD. Australia's net foreign debt is now much larger than Brazil's, a country of eight times our population. Per capita we are now one of the worst debtors in the world, relying solely on the kindness of foreigners. Canadian households might have high debts too, but they are able to borrow the money from other Canadians, while Australian households had to borrow from overseas – that makes a big difference. And our foreign debt just keeps growing. Australia's very high net foreign liabilities make us very vulnerable to a liquidity crunch and financial crisis should the carry trade reverse.

With our massive \$2 trillion of superannuation savings, why did we still have to borrow so much from foreigners - unlike the Canadians?

To explain this you need to look at the one major initial policy difference between Australia and Canada – immigration intake. Over the last 16 years (1999 – 2015) Australia decided to grow its Labour Force by +2% pa while the workforce in Canada grew by just +1.4% pa. That extra 0.6% pa in Australia created 1.12 million jobs more here than the equivalent in Canada, however the drop in our productivity makes the logic and affordability of creating so many extra jobs questionable.

I would argue that while +1.4% pa would have been sustainable (as in Canada), growing the labour force by +2% pa for 16 years may have been grossly excessive. One could argue that Australia's foreign debt has tripled, despite a 1-in-100 year terms of trade boom, because we have been paying for the wages of those extra one million jobs by borrowing money offshore. I would further argue that these one million extra jobs may prove unsustainable – there is no money to pay for these wages. Unemployment will need to rise.

About 50% of all recent employment increases in both Canada and Australia have been in the public sector industries (Statistics Canada, Economic Insights Fall 2015). In Australia almost 40% of all jobs created in 2015 were in Health (BoFA). Now the government is looking desperately for money, trying to figure out how to pay the wages of a million extra workers (compared to Canada). Canada does not have this wage problem – that's where we are different!

As the Canadian and Australian dollars both devalued by over 30% in 2014/15, Canada's net foreign debt (NIIP) improved substantially while ours got worse. Why? Both countries have large foreign liabilities, but Canada also has large foreign asset holdings - we don't. *One could easily argue that Australian investors and superfunds have had a clear home bias with just 15% of superfund assets invested overseas in 2012. That was very, very poor judgement – any amateur knows you shouldn't put all your eggs in one basket.* With the carry trade pushing the dollar above parity to the US-dollar in 2012, it was a 1-in-30 year opportunity to take advantage and diversify overseas – an opportunity Canadians took advantage of, but sadly our superfunds mostly did not.

According to a TowersWatson study, Australia's total pension assets were worth \$1670 billion USD in 2014, and today they are worth only \$1400 billion USD (\$2T AUD). All Australian assets were devalued by 30% when the dollar fell in 2014/15 – including the value of 85% of our total super-assets.

After the Aussie dollar hit a staggering US\$1.10, ABC's Alan Kohler wrote on 9 May 2011: "Don't be misled by last week's commodities crunch, the Australian dollar is heading higher – much higher". People were talking \$1.20. In fact, the Aussie dollar fell off a cliff soon after. Generally, clever risk management was nowhere to be found in Australia's super industry. The ASFA Dec 2015 Superannuation Statistics show that still today, only about 25% of the \$2 trillion in super, is invested internationally (mostly because the lowly 15% invested overseas earlier, has almost doubled in value thanks mainly to the falling dollar).

I believe, having 85% of all our superfund assets invested in Australia up until recently, has possibly also distorted our economy. It no doubt pushed up the value of our banks and probably helped create our house price bubble. I find it interesting that our \$2 trillion super roughly equals our \$1.5 trillion total household debt. It's like we just went out and borrowed the money back, that was taken off us for compulsory super-contributions, like a merry-go-round. Australians "bet the house", and then some, on housing. Effectively the average household today has a debt of say \$160,000, but super worth say \$200,000. Does that make us better off? Does that make us rich? Does that mean we could afford to grow our workforce at double the rate of most other developed countries?

I find also, that there is a conflict of interest when superannuation money (25% controlled by unions) is used to purchase CBD office towers for example (directly or indirectly), at arguably inflated prices, being built by large construction firms with close ties to powerful unions. A major tower was built in Sydney (just before the Sydney Olympics) and sold to a very large listed property trust with large superfund-shareholders. Was this a good investment? Well at the time larger towers could have been purchased in Manhattan for the same price. In 2009 this huge property trust lost 90% of its value on the stock market and never regained all that much. How does a property trust lose 90% of its value? There seems to be some sort of behind-the-scenes connection between superfunds, property trusts, developers, unions, talkback shock-jock gurus and local governments. If any super-money is lost, no one seems to ask many questions. Most people, even highly educated people, have no clue as to what their super accounts are exactly invested in.

Did you know that some schools in Australia still have classrooms without air-conditioning! European countries use a different system. There is no such thing as a classroom that's not heated in Europe. In Europe usually about 50% of GDP is government spending – yes, taxes are very high there and almost immediately spent; most countries have almost no super (in 2014 Germany's pension assets were worth less than a third and France's only a tenth of Australia's super), BUT, in Europe those high taxes pay for world class hospitals, schools, transport systems, entertainment and lots more. People are living great lives there without the need for super. To argue that most European countries have high government debts, ignores the fact that most have almost no *net* foreign debt.

In many countries in Europe government infrastructure and services spending goes even much further than many realise. Government-subsidised "Hotel Wellness Centres" offer discounted, all-inclusive, package deals throughout the year, *that even pensioners can afford*, which include hotel accommodation, all meals, and use of multi-million-dollar health/spa centres. Spending just a few days at such a centre can do wonders for people, especially retired people, and contributes to a healthier, happier society with less stress, less crime. I can buy a carton of beer in Germany or Austria for \$17 AUD (even though their GST is 20%), and private health insurance is actually worth having there – almost no Gap, they usually pay for everything. It's actually cheaper for me to live in Europe for 3 or 4 months of the year,

which I've been doing most years now. On a recent 4-Corners report young Australians were buying drugs because it was cheaper - they "couldn't afford a few beers anymore". Our Tax system is a mess and super may be part of that mess. Unions control about 25% of all super assets in Australia (\$500 billion) yet there is fundamentally no difference between them investing some of that money in infrastructure, or the government doing it through taxes.

And how much do these superfunds spend on advertising? And why? – they're at it all the time!

Where I live near Terrigal NSW there are now many multi-million dollar homes, no doubt made possible by our policies of lower-taxation compared to Europe, but there is nothing to do on the Central Coast (apart from visiting a club or pub, to 'lift the spirits'). Sydney is not much better. Unlike overseas, our local and state governments have little money to contribute financially toward functions and festivals to promote a stronger community spirit. People are bored – sitting in their big mansions, isolated, and soon to live off their meagre super savings, unable to afford to stay at a hotel, or go to a decent restaurant. I recently spent \$70 on breakfast for two at the local surf club (no alcohol incl.). This is crazy stuff. Billionaire Stan Druckenmiller drew gasps from an audience of New York's wealthiest investors at a packed investment conference in 2013 when he described how expensive it was to dine-out in Australia. He argued that central banks "addicted to carry" were buying Australian bonds, the same way they "got sucked into sub-prime".

Rather than look at super in isolation, please allow me to present to you some details that may shed light on where I believe our tax/super policies may have distorted our economy. My argument is that money set aside for super-savings could perhaps have been better used to make housing more affordable and for improved infrastructure. Let me explain. I've been to Europe many times, and last year I bought a 70sqm apartment on the 11th floor in the heart of Graz, Austria's second largest city, with great views of the city centre, for just 115.000 Euro! I was even able to borrow 100.000 Euro at just 2% pa to finance the deal. Including all stamp duty, solicitor, bank and agent fees etc I paid less than \$200.000, while back in Australia people are borrowing up to \$800.000 to negative gear just one property. The cheapest one bedroom units in Sydney now cost over \$500.000, and in Melbourne over \$300.000. Now that's a bubble. Why so cheap in Europe, you might ask?

Well, Germany, Austria and many other European countries may have little super, but they have a policy that if dwelling prices and rents are seen increasing too quickly, the governments impose a cap on certain rent increases and also use taxpayers money (that, under different policies, otherwise might have become super-savings) and immediately pay for the release of land, and the development of subsidised, but high quality new residential dwellings, in sought after locations, with low "cost-covering" rents, built by non-profit housing construction companies that hire subcontractors and organise the projects. These are not Housing Commission Homes – which are also supplied in Europe – but rather high quality dwellings with rent/buy options and very low mortgage rates, available to mostly lower income families.

Only the fact that taxes are higher in Europe and there is little compulsory super, makes this possible. These policies keep dwelling prices and rents in check – putting a lid on bubbles. A consequence of these policies is that there is less speculation and so dwellings tend to be generally smaller in Europe. Owning an apartment or house in Australia, with twice the floor area of an average European dwelling (under the motto "buy the biggest you can afford to

maximise your capital gains”), is of little benefit if our acute household debt-levels (or the fear of “missing out” for those not in the game) are leading to an epidemic in stress-related domestic violence and family breakdowns. In Europe, higher taxes have diverted money away from speculators and produced more affordable housing, to the detriment of developers. Higher taxes have helped governments control housing affordability and rents in Europe, while in Australia, lower taxes (and higher super) have indirectly contributed to much higher house prices, higher rents, more debt and more stress.

In 2001 a private developer in Austria told me they were lucky to make 10% profit on any residential development. Developers and investors here will immediately argue that this socialist system stifles progress and hinders animal spirits. I would call myself a capitalist and have always believed that European style socialism has many flaws, but I have to admit, I’ve changed my mind a little recently having seen the progress in Europe compared to Australia. Developers don’t get rich in Europe, they do in Australia. That’s great if you’re a developer in Australia, but it also leaves the average family in Australia with the largest household mortgage debt in the world.

As for our infrastructure, the longer we wait, the more expensive it gets. Having invested about 30% of our super assets in cash and bonds is probably not really clever. Warren Buffett wrote in his 2011 letter to Berkshire shareholders that bonds and cash are “among the most dangerous of assets – their beta may be zero, but their risk is huge”. Just think about it, instead of this 30% super-cash (\$600 billion) going to the government as taxes (like it does in Europe), which could have all been spent on infrastructure by now, delivering a return to society, instead it’s sitting in banks somewhere earning maybe 2%. It’s a bit like a family investing in gold, when they really need to have their roof fixed.

But do we really need more infrastructure? Anyone suggesting Sydney is running out of land needs his head read – supply is being restricted to keep prices high. Greater Sydney with a population of almost 5 million covers *12,368 square kms*, but in reality about 2 million people are squeezed into an area of just 12kms radius or 500sqkms around the Harbour Bridge (the size of Vienna or Hamburg), and another 2 million are squeezed into another small circle of about 12kms radius around Parramatta, and it’s a half hour drive to get 10kms in any direction. It’s kind of funny really – unless you’ve actually tried it. We can’t afford high-speed trains, or metros, because they are not viable in Australia – so goes the argument. OK, so we’ll just keep using the few existing old lines from last century – it’s no wonder people are frustrated. What people don’t realise is that when you have practically only roads and no rail/metro, servicing over 1,000,000 people in the “affluent” Mosman, Northern Beaches and Eastern Suburbs districts for example, then every car travelling to the beach or into the city, needs to find a parking space, and buses are very slow and tedious. Even just going to the beach now cost \$6/hour to park – better to stay at home. Most international cities have got fabulous high-speed infrastructure that their citizens are using today – instead we’ve got cash in super for when we get old!

What has this all got to do with super? It’s telling me countries that don’t have compulsory super seem to be doing just as well as us, if not better.

In 2014 the IMF sent a team to Australia to assess our economy and surprise surprise, just like the RBA, they found no sign of a housing price bubble here. In stark contrast, just look at the difference in Germany, where the Deutsche Bundesbank brought out an 18-page report on house prices in 2013, where they argued that dwelling prices in Germany were 10%

overvalued and in the larger cities up to 20% overvalued, having only risen for 3 years after 15 years of stagnation. Yet today, the median apartment or house in Germany, one of the richest countries in the world, is still far cheaper to rent or buy than in Australia.

After increasing only modestly since 2000, rental prices in the German housing market increased significantly in some regions of Germany during the last five years due mainly to higher demand. Politicians felt compelled by this to intervene in the market. A cap on rent increases was decided upon in Sept 2014 by the Federal Cabinet and adopted by the Bundestag in March 2015. This limit on rental prices applies to designated areas with tight housing markets (currently includes the entire city of Hamburg and entire metro of Berlin). Apartments rented for the first time after Oct 2014 are not subject to this limitation, or following comprehensive modernisation. These limitations may deter some developers, but that's where the government steps in to supply affordable housing for everyone, using money that might otherwise have been earmarked for super. If Germany's Reserve Bank thinks it has a bubble – Look at us! that's not a bubble, *this is a bubble!*

It's not entirely clear to me whether all this is a better system, it just seems better to me now. If super-savings were put aside for a rainy day.....well, I think the rain might be coming to Australia.....

Alex Finch