The Future Fund

Introduction

On 10 September 2004, the Treasurer announced that a Future Fund would be established to fund the Commonwealth’s unfunded superannuation liabilities. He also released a paper titled ‘Investing in the Future’ which outlined the proposed Fund.1 The Treasurer has confirmed that details of the Fund will be announced in the 2005–06 Budget.2 This paper considers aspects of this proposal based on the information available. It does not examine the pros and cons of the decision to establish the Fund.

The proposal

The stated aim of the Fund is to fully underwrite the unfunded superannuation liability by 2020.3 Superannuation liabilities accruing under the Commonwealth Superannuation Scheme (CSS) and the Defence Force Retirement Benefit Scheme (DFRDB) are completely unfunded. Liabilities accruing under the Military Superannuation and Benefits Scheme (MSBS) and the Public Sector Superannuation Scheme (PSS) are only partly funded. Funding and payment of benefits is on a pay-as-you-go-basis.4 Together these schemes make up 95 per cent of the Commonwealth’s superannuation liabilities.

Part of, or all, future budget surpluses will be used to build up a balance in the Fund which will be invested in diversified financial assets. The Fund will be overseen by a statutory authority and the investments managed by external managers. The Treasurer and the Minister for Finance and Administration will be the responsible Ministers. Payments from the Fund will generally not begin until after 2020, although this will depend on financial circumstances leading up to that time. No other details are as yet available.

The proposal follows steps that state governments have taken to fund their unfunded public service liabilities. State governments have adopted two strategies: closing defined benefit schemes to new entrants, and injecting capital into the schemes. The Productivity Commission has noted that capital injections are likely to be the only means of fully funding liabilities in the near future of schemes that have recently been closed.5 The Future Fund will set aside capital against the liabilities of defined benefit schemes, which the Commonwealth has closed (DFRDB, PSS and CSS), as well as the ongoing liabilities arising from the MSBS.

Why a Future Fund?

What are the reasons for setting aside a potentially significant amount of capital in the Future Fund, since the option remains for the government to continue to pay public service superannuation on a pay-as-you-go basis? The OECD has noted that channelling budget surpluses into the Future Fund will reduce the call on the budget in coming years. This will allow the allocation of future revenues to priority areas such as health.6 This makes sense if there will be relatively fewer tax payers in the future, as apparently will be the case due to the ageing of the population.7

Obviously, the amounts directed into the Future Fund will not be available for government spending or tax reductions. This reduces the standard of living of the current generation of taxpayers. In essence, the Future Fund means forgoing consumption now for consumption in the future. An aspect of this is that the current generation of taxpayers will face a double burden in that they will finance both the current and future generations of public service superannuants. This is a feature of any transition from a pay-as-you-go system to a funded system.

Such considerations should be put into perspective. Any effects of the Future Fund are also features of the private superannuation system. The likely size of the Future Fund is a lot smaller than the size of current and future superannuation and retiree investments. The size of the Future Fund in 2020 may be about $126 billion (see below). As at the end of the September 2004 there were about $648.9 billion in superannuation assets alone,8 and they continue to grow at a rapid rate. These assets will not simply disappear upon retirement, as many retirees will invest them to support themselves in retirement.

Alternative approaches to funding pensions

Other countries seem to have adopted two broad approaches to funding their unfunded pension liabilities. The first is where the government establishes a separate account for each person. The government may or may not deposit money into these accounts to establish them. The individual or their employer contributes to these accounts. The government’s liability is restricted to guaranteeing a minimum level of benefits. In effect, the separate public service pension entitlement becomes an entitlement of the national pension scheme. The Chilean government took this approach in 1981,9 as did the Swedish government in 1999.10 Based on the available information, Australia will not take this approach.

The second approach is for the government to guarantee the full entitlement to a person’s retirement benefits, but pre-fund all or part of those benefits with savings from different sources. Norway, for example, is taking this approach (see Box).11 The scope of the Australian Future Fund is more limited than in other countries whose funds are for national pension schemes. No other country seems to have arrangements that are limited to public service pension liabilities.
Lessons for Australia

Two issues that arise from overseas experience are the stability and the level of contributions. Both are issues, for example, in the French arrangements (see Box). Initial calculations are that, given a five per cent annual rate of return, contributions to the French Pension Reserve Fund would have to be about EUR8.9 billion each year until 2020. Given that the French budget is in deficit and the sources of funding for the Reserve Fund are erratic, this target appears to be somewhat ambitious.

Future Fund issues

Fiscal and monetary policy

The Future Fund proposal raises several issues. As in France, the level of contributions and fluctuations in that level will be issues for the Future Fund. Indeed, the Future Fund will be an additional constraint on fiscal policy. First, the Budget will generally have to be in surplus. A risk is that the need to maintain surpluses to contribute to the Future Fund will result in pro-cyclical fiscal policy when anti-cyclical fiscal policy is warranted. A commitment to a certain surplus annually could impose deflationary pressures on the economy. Second, the surpluses will have to be of a sufficient magnitude to fund the liability. Should the Budget be in deficit, surpluses in other years will have to be higher to offset the deficit.

Budget surpluses drain liquidity from the private sector. Some mechanism is required to return liquidity to the system. To date, that has been the Reserve Bank’s role to a large extent. Repaying government debt is one mechanism. But the scope for continued use of this mechanism is dwindling, so new mechanisms will have to be employed. The setting up of the Future Fund is a means of using the surplus to buy private assets and so return liquidity to the private sector.

Will budget surpluses be enough?

It is not possible to calculate accurately the amount that may be needed to be placed in the Future Fund to completely meet the Commonwealth’s unfunded superannuation liability. However, it is possible to make a rough estimate.

Assuming that unfunded liabilities are growing at about two percent a year and taking the projected liability of $99.7 billion in 2007–08 as a starting point, the unfunded liability in 2020 would be around $126 billion (all figures are in 2005 dollars). Assuming a five per cent annual increase in unfunded liabilities, the liability would be about $179 billion in 2020.

With these figures in mind, it is possible to estimate the annual contributions needed to completely fund these liabilities. Taking the currently available Commonwealth superannuation balances of about $7.7 billion in 2004, assuming an annual earnings rate of five per cent, and that the fund begins operation in 2004 annual contributions would need to be about $6.1 billion if the target is $126 billion, and about $8.3 billion if the liability is $179 billion in 2020.

Obviously, the higher the earnings rate, the less the contribution needed. For example, assuming an annual average earnings rate of eight percent and that the liability is $179 billion in 2020, the required annual contribution would be about $6.7 billion.

These estimates are extremely simple, and do not take into account all relevant factors. Further, estimates of outstanding unfunded liabilities depend on a range of variables such as wages growth, inflation, earnings rates and the like. As such, not too much reliance should be placed on these figures. That said, contribution rates of about $6 billion to $8 billion a year may be ambitious. This could change if, for example, the Government were to invest some or all of the proceeds from the privatisation of its remaining stake in Telstra in the Future Fund.

Asset prices and corporate governance

The OECD has noted the potential for investment in the Future Fund to affect asset prices and influence corporate governance:

Allowing government funds to invest their funds in domestic and foreign equity markets may cause large shifts in capital flows, to the extent that investments are made abroad, and domestic assets would need to be purchased with care so as not to distort either relative prices or to influence corporate governance.

Relative prices

At first sight, the OECD’s statement about the effects of Future Fund investments on domestic asset prices are cause for concern. But it should be remembered that currently, net contributions to superannuation funds are running at about $5.8 billion a quarter and that this figure is growing. Add to this the monies that retirees reinvested on retirement, and it can be seen that large sums are already flowing into investment markets. If annual Budget surpluses are in the order of $3 billion in the near future (as they have been in recent years), any effect on domestic asset prices may be modest.

The OECD’s concern about the effects of capital flows overseas may also give rise to concern. On the other hand, Australian companies and investment funds have been investing abroad for decades, and overseas investment is part of normal prudent investment practice. Further, if asset price inflation in domestic investment markets is to be avoided overseas investment of these monies may be necessary.

Corporate governance

As noted in the box on the following page, New Zealand does not allow its fund to take a controlling stake in an entity. The intent seems to be to ensure that investment is for portfolio purposes only. While a similar provision could apply to the Future Fund, outsourced investment management, under publicly available investment mandates, would assist in preventing the perception, or the occurrence, of the Future Fund being seen as a tool of government to attain certain outcomes.

Directed investment

Norway requires that the investments of its Petroleum Fund be made in a socially responsible manner. In the Australian context, there are likely to be calls for the Future Fund to invest in particular asset classes such as infrastructure, emerging technologies and even housing. Any consideration of these issues has to take account of, first, the desirability of directed investment and second, the extent to which investment in these sectors, via the superannuation system, already occurs.
On the issue of desirability, there are several reasons the Future Fund should not be used to direct investment into politically-favoured sectors. First, financial markets are generally efficient at directing resources to different sectors. Second, if governments wish to direct additional resources to a sector over and above those provided by financial markets, the Future Fund would be an indirect way of doing so when more direct methods are available.19 Third, using the Future Fund to favour particular activities would reduce transparency. If governments wish to subsidise a particular sector, the most transparent way is often to fund the subsidy through the Budget. That said, some guidelines will be required.

Information covering the whole of the superannuation industry on how much is invested in infrastructure and venture capital is not currently available. However, investment vehicles for these sectors are available and some superannuation funds have set up direct links with research institutes to fund promising technical innovations to the commercial stage.20 There is no reason to prevent the managers of the Future Fund from investing in these areas, providing normal commercial practices are followed.

Conclusions

The Future Fund is in line with trends overseas and in the Australian states to fund currently unfunded schemes. In large part, this is in response to the budgetary challenges that ageing populations pose. The Future Fund potentially will have important economic and other consequences and raises some major issues.

Further analysis will have to await the release of additional details in the 2005–06 Budget. This should answer questions such as whether the Government intends to commit a certain amount to the Future Fund annually or only when the Budget is in surplus.

Finally, it is worth noting that the Future Fund is one of several options open to the Government as a means of spending Budget surpluses. They include accumulating other financial assets, financing infrastructure, direct injection of some funds into the partly funded Commonwealth superannuation schemes (PSS and MSBS) and investing in education and other social infrastructure.

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**Box: Some other countries’ schemes**

There may be lessons to be learnt from overseas experience.21 The following examines arrangements in countries with two features in common with the Future Fund, namely, where the investments are centrally-managed, and the central government exercises arms length supervision over these funds.

**France.** A Pensions Reserve Fund (FRR) was set up in 1999 with the aim of building up reserves to buttress the sustainability of the pay-as-you-go system. The aim is to pay into the FRR around €4.5 billion annually until 2020, when it should total over €152 billion. Payments will then be made to the various occupational pension schemes to help keep them balanced, lighten the future financial burden generated by the ageing of the population, and share the cost more evenly between generations.22 The FRR has been financed by surpluses from the National Old Age Insurance Fund for Wage Earners, the Old Age Solidarity Fund, additional taxes on private assets, and contributions from savings banks and the Deposit and Securities Fund plus infrequent cash injections. Some funding will come from asset sales: starting in 2000, the bulk of the revenue generated by the sale of licenses for third generation cellular telephones will also be contributed to the FRR. Despite this, the FRR revenue base has drawn criticism for being piecemeal and unstable.23 Currently the Fund’s assets are about €19.2 billion. The FRR is subject to the requirement that it invest in socially responsible investments. Apart from this, there do not seem to be any limits on where, and in what, the FRR can invest. A supervisory board with broad authority, made up of members of parliament and representatives of labour-management partners, oversees the fund.24 The assets cannot be drawn against until 2020.

**Ireland.** The National Pensions Reserve Fund (NPRF) is designed to meet part of the costs of social welfare and public service pensions from 2025 (money accumulating in the NPRF cannot be drawn until then). By law, the government must set aside and invest one per cent of GNP in the NPRF. The government may also make additional contributions where circumstances allow. At the end of 2002, the value of the NPRF was €7.4 billion.25 The NPRF is free to invest in all classes of asset (except Irish government bonds). The NPRF is controlled and managed by the National Pensions Reserve Fund Commission, which has discretionary authority to determine and implement an investment strategy based on commercial principles and subject to prudent risk management. The National Treasury Management Authority was appointed to act as the Commission’s agent.

**New Zealand.** The New Zealand Superannuation Fund (NZSF) is designed to partially provide for the future cost of superannuation payments. As the cost of payments escalates, the government will progressively draw on the NZSF to smooth the impact on its finances. The government expects to draw the equivalent of between 15 to 20 per cent of the annual cost of superannuation payments beginning around 2025. When income tax on investment income is taken into account, the net fiscal impact of the NZSF is expected to exceed 30 percent of payment costs for several decades. The government expects that after 2005, the NZSF will continue to grow in nominal terms.26 The government will allocate, on average, $NZ2.2 billion a year over the next 20 years. Capital contributions are planned to cease in the mid 2020s. As at 30 June 2004, the NZSF’s assets were about $NZ4.0 billion. There are few limits on where the NZSF may invest. But the NZSF may not borrow, and it may not control another entity (in practical terms this limits it to holding no more than 20 per cent of an entity’s voting capital).27 The NZSF is governed by a separate Crown entity called the ‘Guardians of New Zealand Superannuation’. External fund managers invest funds under supervision.

**Norway.** Norway’s Petroleum Fund was established in 1999. It has two main purposes.28 One is to limit the adverse effect of oil revenues on other sectors of the economy (the so-called ‘Dutch disease’). A rise in the real exchange rate resulting from oil exports has the potential to curb growth of other exports and in the import-competing sector by making exports more expensive and imports cheaper. (Norway has also set an annual inflation target of two and a half percent as part of the measures to combat its case of the Dutch disease).29 The second purpose is to act as a long-term savings vehicle to cope with expenditures arising from the ageing population. Transfers from the fund are limited to four percent of the capital a year, which is equal to the estimated long-term real rate of return from the fund.30 The fund is also a tool to ensure the transparent use of the petroleum revenues. All revenue from the sale of North Sea oil is directed into the fund. This capital is invested outside Norway to counter any rise in the real exchange rate resulting from oil exports (capital outflows cause the exchange rate to depreciate). Investments are subject to ethical guidelines. An environmental sub-fund is part of the portfolio.31 The central bank (Norges Bank) manages the fund.
Endnotes


3. Liberal Party of Australia, op. cit.

4. The term ‘pay-as-you-go’ means that monies to meet pension liabilities are drawn from consolidated revenue as and when they are needed.


11. OECD, *Economic Surveys: Norway*, June 2004, p. 73 ff. Even with the revenue generated by the Petroleum Fund and contributions from the current National Insurance Fund, Norway’s prospective pension bill will not be covered and further reforms of pension entitlements are under consideration.

12. A pro-cyclical fiscal policy is one that moves in the same direction as the economy, for example, when the government cuts spending when the economy is contracting. If a surplus has to be maintained for the purposes of contributions to a Future fund, this may withdraw resources from the economy at a time when additional government spending was warranted.


15. Total of funds under management in the Public Sector Superannuation Scheme and the Military Superannuation and Benefits Scheme as at 30 June 2004. The monies partly fund the payments to the members of the respective schemes. Funds under management in the Commonwealth Superannuation Scheme are vested in the members, and are not available to fund part of the unfunded liability of that scheme. No funds are invested under the Defence Force Retirement Benefits Scheme.

16. 2004 was chosen as the base year to start these projections because information on the government’s current assets backing the unfunded superannuation liabilities was only available as at 30 June 2004.


19. More direct methods may be direct tax breaks for the particular economic activity or industry, an industry plan or direct grants to a particular company.


21. The OECD has noted that there are few lessons to be learned about the regulation and administration of such a fund. It could also be because other countries have a social insurance model for the provision of retirement income. Australia’s system is not based on the social insurance model. See OECD *Economic Surveys: Australia*, op. cit., p. 60.


