

**THE COSTS OF RUNNING
AUSTRALIA'S
RETIREMENT INCOME SYSTEM**

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EXECUTIVE SUMMARY

- The “three pillars” of the Australian retirement income system have not always been designed and developed as part of a grand plan, but each of the pillars through a combination of good design and luck is making an effective and affordable contribution to overall retirement income provision.
- However, refinements, enhancements and further administration cost control are both desirable and possible.

The Age Pension and other social security payments

- Public assistance for the aged is significant and growing, but as yet is at relatively modest levels by international standards.
- Commonwealth income maintenance for the aged amounted to some \$18b in 1997-98, 3.3 per cent of GDP. By the standards of most developed countries (the OECD average is 9 per cent and rising) and even some developing countries, this is a very low percentage.
- However, if accrual accounting concepts were applied then total future pension obligations for the current ageing population structure might have a capital value of the order of \$600b. This is an accruing obligation that must be addressed.
- Commonwealth and State governments are beginning to address unfunded liabilities for superannuation entitlements of their own employees, but such liabilities amounted to a staggering \$180b in 1996-97.
- Costs of raising the taxes currently needed to fund the payments and the running costs of the Age and Veterans Pensions are significant but not excessive. On one reckoning the costs of raising taxes could amount to an additional \$2.7b applicable to Age and Veterans Pensions. Administration costs at around \$180 m (around 1 per cent of payments) for the various programs are modest in comparison.

Employer and member contributions to superannuation

- In aggregate terms total employer and member contributions for superannuation amount to just under 6 per cent of GDP, with Superannuation Guarantee (compulsory) contributions amounting to some 3 percentage points. The other 3 percentage points are attributable to more or less voluntary contributions.
- Administration costs for superannuation funds vary markedly between funds of different types, and funds of different sizes within a particular fund grouping. ASFA survey results suggest a range of administration costs from less than \$0.40 per member week to over \$20 per member per week for a few funds.
- Adjusting for the member numbers in various types of fund suggests total administration costs of around \$900m a year in 1996-97 for the 6.6m superannuation accounts in corporate, public sector and industry funds. At less than \$140 per account per year on average, the costs are not high and compare well with the costs of administering social security payments. However, the cumulative cost of multiple accounts held by fund members can be significant.
- Retail superannuation funds, including master trusts, tend to have relatively high administration costs given the level of services they provide and their higher selling costs. (Competitive pressures may be bringing down these costs). Applying a weekly administration cost of \$3.50 per member week suggests total administration costs of \$1.1b for such funds. Administration costs for excluded funds might amount to some \$200m in aggregate.
- All up, it seems likely that aggregate administration costs for superannuation funds was of the order of \$2.2b in 1996-97, around half a per cent of GDP.

Investment costs

- The cost of investment management as a percentage of assets generally decreases with the size of an investment mandate, although investment mix also has an impact on costs.
- Investment costs for medium to large funds range from over 0.5 per cent of assets down to less than 0.3 per cent of assets. Competitive pressures are also driving these costs down.
- Aggregate investment costs for corporate, industry and public sector funds would have been of the order of \$415m a year in 1996-97.
- Investment costs for retail funds and master trusts tend to be relatively high, in part due to the greater investment choices and switching options often available. An average investment cost of 1.9 per cent of assets suggests total investment costs for retail funds of \$1.4b in 1996-97.
- With total investment management charges of nearly \$2b a year and growing its not surprising that there is a high level of interest in superannuation funds management by overseas-based financial institutions and by Australian-based institutions seeking to diversify their activities. Competitive pressures in terms of more suppliers of investment services and trustee desire to minimise costs, including through use of indexed funds and other low cost approaches, will help contain investment costs.
- The lower administration and investment costs are the better retirement benefits will be.

Cost of prudential regulation and of losses due to fraud

- Costs of prudential regulation for non-excluded funds is around \$31m a year, which while a small proportion of total costs in the sector is relatively high by international standards and has grown markedly with APRA and ASIC taking over the roles of the former ISC.
- Total losses due to fraud in superannuation funds have amounted to only \$25m in total over the ten years to 1998. Levels of fraud are low in both absolute terms and relative to other countries.

The cost of tax concessions for superannuation

- Seriously flawed Treasury estimates put the cost of superannuation tax concessions at \$8.7b in 1996-97. In contrast more conceptually sound estimates prepared by Access Economics which take into account future benefits through reduced social security requirements indicate that superannuation was overtaxed by \$1.7b in 1995-96.

INTRODUCTION

The three pillar approach has become, at least for those interested in retirement income provision, just as much a staple of their reading material as Goldilocks and the Three Bears has for bedtime reading in the nursery. *Averting the Old Age Crisis* (World Bank, 1994) may never attract quite the same readership as a traditional children's story, but it contains as many (or more) moral messages as most children's fables. The World Bank, as a bonus, also sets out policies and principles that many countries are aspiring to follow in providing income protection for the old and promoting economic growth more generally.

For the very few of you who might have missed it, the Australian version of the three pillars mantra goes along the lines:

- **provision of an adequate public safety net;**
- **compulsion of self-provision** based on a set level of contributions for those in the labour force at the very least; and
- **encouragement of self-provision** (by way of superannuation or other savings preserved until retirement).

ASFA's Blueprint for a Retirement Income Policy (ASFA 1998a) describes in some detail the current structure of our system and how it might desirably develop. ASFA also has some views on preferred directions for tax reform (ASFA 1998b).

A number of countries have adopted a three pillars approach, and a few have had a good attempt at constructing at least two of the pillars. However, there have been tears before bedtime in some cases as either costs have blown out and/or expected benefits have not been delivered. To mix in another fable, in some countries rather than a benevolent grandmother being behind one of the pillars there has been a big bad wolf dressed up instead.

Particular instances that come to mind include Chile and the United Kingdom. Chile still remains the pinup of some of the right wing analysts in the United States, but for others the gloss of the early success of the Chilean arrangements has been removed by constant churning of members between funds, high expense ratios (particularly selling and marketing costs), a clustering of investment returns, and a less buoyant domestic stockmarket. The United Kingdom's flirtation with more individual retirement income arrangements also led to excessive churning of members, high expense ratios and crippling compensation claims against those responsible for the mis-selling.

The Australian system continues to attract interest, fortunately because of its inherent good design rather than because of any recent failures. We have a regular stream of visitors through the ASFA offices wanting to know more about it. Some of these are refugees from a northern hemisphere winter, others are foreign finance sector carpetbaggers after a slice of the action, but most really want to know how effective our system is, what it is hoping to achieve, and what its costs are. This latter question on costs is a hard one to answer, and this paper is an attempt to bring together some of the available and not-so-available information on this.

The paper will examine in turn each of the three pillars of our system, and will also attempt to add up the total costs.

Some caution is needed in interpreting the numbers. Some of the numbers are on a cash flow basis, others are on an accrual basis, others relate to capital costs, yet others are running costs, some are transfers, and there are both inter- and intra-generational implicit and explicit transactions. Additionally, there is fair scope for cost shifting between the various pillars, and this is not always acknowledged when individual estimates are disseminated.

For instance, the Commonwealth Treasury prepares estimates of the costs of the tax revenue foregone due to concessional tax treatment of retirement savings (Treasury 1997). While these estimates have a number of measurement peculiarities (as will be discussed later in the paper) a major conceptual problem in interpreting them is that more expense now in tax foregone, means less expenditure on Age Pensions in the future, at least if preservation of benefits arrangements are adequate. The manageable cost of social security payments to the aged in Australia can thus have as much to do with the success of the other two pillars as with favourable demographics and a well designed and run social security system.

Analysts such as those with what is now the Retirement Income Modelling Unit in the Commonwealth Treasury do attempt to take such inter-relationships into account through the use of discounted cash flow analysis, amongst other techniques (Willis 1995 etc). However, it would be fair to say that the complexity of the links and the uncertainty of size, if not the direction of some of the relationships between the pillars, can make it difficult to make an assessment of overall costs and benefits. To help fill this gap ASFA recently commissioned Access Economics to prepare a report on the cost of superannuation tax concessions (Access Economics, 1998).

Interestingly, what few cost estimates we have from government generally come after, rather than before a policy is announced. It may be as much due to luck as to good management that our retirement income system is shaping up as well as it is!

The following sections present the available information on the costs of the Australian retirement income system. An assessment of the overall costs is also provided, though care is needed in interpreting such estimates.

THE PUBLIC SAFETY NET: AGE AND VETERANS PENSIONS

Government payments

The Age Pension is payable to women aged 61 years and over (increasing to 65 years by 2014) and to men aged 65 and over subject to 10 years residency and means testing. As shown in Table 1, total government expenditures on the Age Pension in 1997-98 are estimated at \$13,400m, and are budgeted to rise to \$14,136m in 1998-99. There are about 1.7m Age Pensioners.

Table 1: Australian Retirement Incomes and the Social Security System

	1997-98	1998-99 Budget	1999-00 Estimate
Age Pension	\$13,400m	\$14,136m	\$14,662m
Disability and War Widows' Pension	\$1,897m	\$1,992m	\$2,091m
Veterans Pension	\$2,588m	\$2,558m	\$2,537m
Total	\$17.8 b	\$18.7 b	\$19.3 b

Source: Commonwealth Budget Paper No 1, 1998-99

Any estimate of public funded retirement income provision also needs to take into account the costs of Veterans Pensions and Disability Pensions for Australian war veterans and War Widows' Pensions. Out of the 160,000 or so disability pensioners, the vast bulk are World War II veterans of advancing years, as are their widows. Recipients of Service Pensions, which are available from age 60 for males and from age 56 increasing to 60 for females, by definition have retirement status.

Thus, the \$2.6b spent on service pensions is basically retirement income provision. The \$1.9b spent on Disability Pensions and War Widows' Pensions can be similarly regarded. While there are some peacetime and recent conflict disability pensioners included in the expenditures, these persons could also be regarded, in most instances, as retired from the labour force.

All up, Commonwealth income maintenance for the aged (apart from its own former employees) amounts to some \$18b in 1997-98. While a significant sum, this is only 3.3 per cent of GDP.

By the standards of most developed countries (the OECD average is 9 per cent and rising) and even some developing countries, this is a very low percentage. There are a number of reasons for this.

Benefits are strictly means tested on the basis of both income and assets¹. At 25 per cent of AWE (and less than this for each of a married couple) the maximum publicly funded benefit in Australia is also quite low, compared to most other countries. It is not unusual for other countries to have higher percentages and a link to individual prior earnings, although admittedly, only a small percentage ever achieve high retirement incomes.

¹ Access to the Age Pension and other Commonwealth income support is subject to not very onerous residency requirements, with no requirement for prior payment of Commonwealth income taxes or social security contributions.

Australia also benefits from having relatively favourable demographics. Along with strong post-War migration keeping the structure young, we have a significant number of baby boomers moving through and paying taxes, but not yet drawing Age Pensions. It is now about as good as it gets in demographic terms. There is not a big number of young people moving through the education system (and, in any event, we have HECS to make the young pay their way for post-secondary studies out of future earnings) and the baby boomers are yet to hit retirement. This will not last, but the sky is falling in relatively slowly.

Demographically based projections suggest that in the future there will be an increase in the relative burden of the Age Pensions bill. In my previous life at EPAC, I projected (Clare and Tulpule 1994) that by the year 2031, Age and Veterans Pension expenditures would rise by 1.4 percentage points of GDP. More recent RIM projections on a slightly different basis project a similar increase (National Commission of Audit, 1996; Rothman 1998).

In current dollars each percentage point of GDP amounts to some \$5.5b, which is a large number. Hopefully, a period of 30 or more years adjustment will help cover the costs, and there are other expenditures, such as education, which are likely to decrease because of demographic changes. Health expenditures are more of a worry, with EPAC estimates (1994) projecting an increase in public health expenditures of around 2 percentage points of GDP. The Commission of Audit obtained a rather scary projection of a 6 percentage point increase in costs, assuming the ever continuing increases in the usage and cost of public health services. While control of health costs is a genuine concern, these latter health cost projections are, in my view, unduly alarmist. As well, cost control rather than just working out how much can be afforded, will be part of the solution.

While strictly not a retirement income matter, responsibility for health care costs of the aged is still a major issue for retirement income policy. If the government does not cover the health costs of the aged, or a large proportion of them, then higher retirement incomes will be needed to ensure adequacy of income. The extension of the Commonwealth Seniors Health Card eligibility in the last Budget, at a cost of \$50m or so a year, was important for enhancing the welfare of self-funded retirees and for removing a disincentive for self-provision. There is both anecdotal and more structured evidence that many individuals place a high value on the Health Card and will go to some lengths, including asset wasting, to obtain it.

Accrual accounting and costs of the Age Pension

Current treatment of Age Pension costs is purely from cashflow. The only obligations considered are current year ones in terms of both tax revenue and expenditures. The relevant accounting standard (ED62, based on Australian Statement of Accounting Standards (SAC) 4) does not recognise social security pensions as liabilities for the purposes of financial statements. The passing of legislation and establishment of a grant program are not regarded as creating present obligations for a government. This is the accounting position, even with the legislated obligation to pay the Age Pension at 25 per cent of AWE.

The Commission of Audit published an estimate prepared by the Commonwealth Actuary of the value of accrued superannuation entitlements for Commonwealth employees as at 30 June 1995, namely \$69.3b. A part of this accrued liability would have been made concrete with redundancies and retrenchments in the Australian

Public Service. An equivalent estimate of unfunded liabilities for a State government is \$A14.6b for Victoria. Rice (1998) reports unfunded State superannuation liabilities in respect of public servants at \$111b as at June 1997.

Significant sums in ongoing expenditures by Commonwealth and State governments underlie such estimates. In 1996-97, for instance, the Commonwealth Government paid \$3,359m in superannuation payments to ex-employees and contributions to funds outside the general government sector. In the same year NSW made equivalent payments of \$1,732m and Victoria \$1,337m (ABS, Labour Costs, Cat 6348.0).

If accrual accounting concepts were applied to Age and Service Pensions, then on the basis of a current Commonwealth pensions bill of \$18b, future obligations attached to current pensions have a capital value of around \$180b, assuming an annuity factor of 10. This calculation also is in accord with more detailed calculations conducted by Rice (1998) which estimated the present value of Age and Veterans Pensions and Rent Relief at \$172b.

If the pension "liability" attached to the expectations of all Australians about future Age Pensions was calculated then total future pension obligations might have a capital value of the order of \$600b.

However, in a situation where demography and pension levels are fairly constant there are reasonable grounds not to adopt accrual accounting. The Age Pension has been in place since 1909 with those paying taxes having an expectation of the Age Pension being in place for them in the future. Some people argue that this amounts to an implicit funding arrangement, with the expectation that future real incomes growth will generate the taxable capacity to pay for rising real Age Pensions. An alternative view is that a funded scheme with investment of the funds in growth financial instruments such as equities offers a potentially better outcome in terms of pension levels, because the real return on equities has, over a long period, approached 10 per cent per annum. Meanwhile, real income growth underlying taxable capacity has increased by only 1 or 2 per cent per year (Shipman 1997).

In essence what we have at the moment is a system with unfunded (or more accurately funded on a pay as you go basis from taxation) public pension liabilities at around 100 per cent of GDP and growing as the population ages. On the other hand retirement benefits under the second and third pillars are largely funded (apart from some public sector schemes), with total assets projected to grow from a current level of around 60 per cent of GDP to around 110 per cent of GDP by the year 2020 (Rothman 1998).

Administration costs

Age and Veterans Pensions are relatively cheap to administer. Records of contributions and earnings rates do not need to be recorded. Most of the processing, apart from regular electronic funds transfer, occurs at the entry point to the system. Seventy five per cent of pensioners are on the full rate and most stay there for most of their time on the pension. Exit from the system is usually on death.

The overall ratio of administration costs to benefits paid is approaching 4 per cent for the Department of Social Security (as the Department responsible for contracting Centrelink), but Age Pensions are much cheaper to administer.

On the basis of past published information, the costs of administering the Age Pension come in at around 1 per cent of benefits paid. A similar figure would apply to Veterans Pensions. This is equivalent to around \$90 per pensioner per year. However, there are indications that this figure might be revised downwards to some degree by Centrelink when it completes a review of the current allocation of costs to programs that it administers.

In aggregate, total administration costs for social security retirement income payments are of the order of \$180 million per year.

There may be some upwards pressure on these costs as more Age Pension recipients have significant private income, particularly when the private income is in a form such as annuities where relatively complex means testing is applied. The social security system is also latching on to the superannuation assets of the long-term unemployed aged over 55, but not yet eligible for the Age Pension. This has costs for both social security provision and the individuals concerned.

There are other costs. The revenue needed to finance social security payments does not just walk in the door of the Australian Taxation Office. The ATO has administration costs, and there are significant compliance costs in paying income and other taxes. Pope 1997 suggests that, on average, administration costs are of the order of 1 per cent of revenue and compliance costs are a further 14 per cent or so of revenue. For some taxes, such as the superannuation contributions tax surcharge, these figures would be much higher.

Raising the \$18b in revenue that is needed to pay Age and Veterans Pensions has significant collection and compliance costs. On one reckoning these could amount to an additional \$2.7b applicable to Age and Veterans Pensions. Any thorough accounting of total costs should take these costs into account, especially if the costs of privately administered schemes are being compared.

Compliance costs are, however, common with all other government expenditures.

COMPULSORY AND VOLUNTARY RETIREMENT SELF-PROVISION

Employer and member contributions

Contributions to superannuation funds in the calendar year 1997 were \$31b, up from \$28.1b in the previous 12 months. Superannuation Guarantee contributions by employers was around \$15b, with another \$5b in employer contributions and \$11b as contributions by fund members themselves. During the December quarter employers contributed \$4.9b, up 4.9 per cent on the 1996 December quarter. The \$3.1b aggregate employee contribution was up 41.5 per cent over the same period.

These ISC estimates of contributions may be picking up some transfers between funds of superannuation balances in that the reported aggregate contributions are a little high compared to ABS Labour Cost survey data and ATO income of funds data. For instance the ABS reports total employer superannuation contributions of \$15.9b in 1996-97 compared to the ISC estimate of \$18.1b. The ABS estimates that superannuation contributions amounted, on average, to 5.9 per cent of total labour costs in the private sector and 8.1 per cent of total labour costs in the public sector (ABS Cat.6348.0).

Preliminary estimates suggest that, on average, employee 'top up' contributions into superannuation amount to some 4 per cent of aggregate wages and salaries. The proportion of employees making a 'top up' contribution increases with average income level, ranging from around one-third of employees aged 45 and over on relatively low wages, to around 75 per cent for those in the same group on relatively high wages. The level of contribution as a percentage of salary tends to fall with income, however. This most likely reflects higher income earners having greater access to salary sacrifice arrangements, where employers making contributions directly, and employees, receive the greater tax benefits of such direct contributions.

In aggregate terms total contributions amount to just under 6 per cent of GDP, with SG contributions amounting to some 3 percentage points. The other 3 percentage points are attributable to more or less voluntary contributions.

It might be coincidental but,

Each of the three pillars currently comes in at a cost of around 3 per cent of GDP each year.
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In looking to the future, there may be some tendency for each of the costs to drift up, both in absolute terms and as a percentage of GDP. Demographic pressures will impact on the Age and Veterans Pension costs; the Superannuation Guarantee increased from 6 per cent to 7 per cent on 1 July 1998 and will eventually rise to 9 per cent. Voluntary contributions might also rise in response to measures such as the spouse contributions rebate and the savings rebate (although it should be noted that both the Coalition and Labor are both promising to abolish the latter from 1 July 1999).

The contributions tax surcharge can be expected to depress the rate of growth in contributions from those most able to make them. As well, both the Coalition and Labor are promising (threatening) to make the surcharge bite harder and more reliably

by requiring employers to report fringe benefits on group certificates and to include the value of such benefits in surchargeable income. However, there may also be upward pressure driven by a lack of faith in the benefits to be delivered through social security, along with rising expectations as to what would be an adequate retirement income for increasing numbers of babyboomers.

Administration costs of corporate, public sector, and industry funds

Given the diverse nature of privately managed superannuation funds and the lack of any requirement to report details of total administration costs, only limited information is available on administration and investment costs.

One source is the Member Services and Administration Cost Survey (ASFA 1998c) undertaken in July 1997 by the Trustee Best Practice Committee of ASFA. The survey had a sample of 102 funds, with 67 of these being corporate funds and the remainder split between public sector and industry funds. Only two retail funds responded, and for reasons of confidentiality and reliability of sample, their results will not be published.

The survey results suggest that in 1996-97 administration costs, on average, were \$4.40 per member per week for the funds surveyed. This was a substantial increase from the average cost incurred by the same funds five years earlier. While a higher level of service would be part of the explanation, the majority of respondents identified higher compliance costs, including those associated with the superannuation tax surcharge, as a major factor.

The average for all funds covers a considerable range of costs, with some funds incurring costs of less than \$0.40 per member per week while others had administrative costs of more than \$20.00 per member per week. A number of variables occur, such as fund category, number of members, type of benefit, service charges, and internal/external management. The combination in which these variables exist account for most of the variation in the management costs of funds. (It should be noted that \$20 or more per week charge was outside the range for most other funds and was for a small, defined benefit scheme with the cost paid by the employer). APRA figures suggest that as at June 1998 the weighted average of administration costs for surveyed accumulation funds with total assets over \$60 million was \$1.35 per member per week (APRA Bulletin, June Quarter 1998).

Adding these various figures is a bit difficult given that the ASFA survey sample was not stratified by size and type of fund, but:

It suggests total administration costs of around \$900m a year in 1996-97 for the 6.6m superannuation accounts in corporate, public sector and industry funds when allowance is made for actual numbers in each type of fund. At less than \$140 per account per year on average, the costs are not high and compare well with the costs of administering social security payments.

However, at a cost per account of \$140 per year and given multiple account holdings, which are common in the current system, costs can mount up for individuals and society as a whole.

Fund Size

The concept of economies of scale is one that appears to hold true, particularly when applied to the administration of superannuation funds. Funds with a larger membership, even when offering more services, appear to hold a significant competitive advantage over smaller funds.

The following figures drawn from the ASFA survey clearly show these scale effects on administration costs and in particular, reveal substantial diseconomies of scale for funds with fewer than 10,000 members (Table 2).

Table 2: Administration Costs, per member per week, 1996-97

No. of Members in Fund	Minimum	Maximum	Average
Less than 1,000	\$1.65	\$20.75	\$6.67
Between 1,001 and 10,000	\$0.83	\$10.75	\$4.18
Between 10,001 and 30,000	\$0.70	\$1.84	\$1.30
Between 30,001 and 100,000 Members	\$0.53	\$2.72	\$1.00
More than 100,000 members	\$0.37	\$1.80	\$0.89

Master Trusts

Master trusts account for around a quarter of retail superannuation assets and, for the purposes of this paper, will be taken as being typical of the retail part of the sector. They are certainly growing strongly within this sector.

In the year to June 1997, the assets of master trusts increased by 31 per cent, making master trusts one of the fastest growing avenues for the investment of superannuation monies. With small to medium businesses increasingly seeking to outsource their superannuation commitments, evidenced by the contraction of small corporate funds at a rate of 10 per cent per annum, the likelihood of continuing growth trends for master trusts appears strong. However, with a number of industry funds moving to public offer and placing more focus on marketing, industry funds may also pick up some of this market. Employee choice and disclosure of fee arrangements under choice of fund could also impact on the growth of master trusts, not necessarily favourably.

In June 1997 the ISC reported that the operating expenses per member account per week for master trusts were \$3.23 compared to \$0.65 per week for industry funds. The higher distribution overheads (through a network of financial planners and accountants), more sophisticated and frequent reporting systems and greater member

investment choice options offered by master trusts explains, in part, the higher expenses (Table 3). While master trust expenses were higher than those for industry funds, they are on a level comparable to corporate and some public sector funds, although it should be noted that many of the latter are defined benefit rather than the defined contribution of almost all retail offerings.

In some areas of the finance sector there are moves to reduce administration costs through mergers, greater use of technology and use of processing centres but such developments are yet to have a marked impact on the administration costs of master trusts.

Table 3: Comparison of Retail Master Trusts and Industry Funds, 1995-96

	Master Trusts	Industry Funds	All large Funds
Assets per member account	\$15,747	\$2,955	\$11,300
Operating expenses per member account	\$3.23 per week	\$0.65 per week	\$1.60 per week

Source: ISC Bulletin, June 1997

Applying a weekly administration cost of \$3.50 per account to all retail superannuation accounts suggests total administration costs for retail funds of nearly \$1.1b a year in 1996-97.

A charge of this order does not seem unreasonable, given typical administration and management charges (Table 4). It would be fair to say that fees paid in regard to some retail superannuation products, particularly ongoing investment management and administration fees, are less transparent than desirable. The Australian Securities and Investments Commission (ASIC) Deputy Chairman Peter Day has claimed with some justification that there are many leading investment houses “failing to show fees and expenses charged to their customers’ accounts, often not clearly showing or explaining investment returns which relate to income earned or market value gains, and providing almost no analysis of charges or returns in \$dollars or on a percentage basis, on the face of the statements of account” (ASIC 1998).

Table 4 also indicates significant entry charges for master trusts. While some members might use a discount broker or pay for advice on an hourly basis and receive the benefit of a rebate for these charges, most retail customers would pay some entry or exit fee when investing in a retail product.

Administration costs of excluded funds

The administration costs of excluded funds are significant. There were over 160,000 excluded funds as at June 1997. Each had to pay for a trust deed and establishment costs, perhaps totalling more than \$1,500. Annual costs are a levy of \$200 paid to the regulator (see below) and audit and tax return fees can be anything between \$650 and \$2000 a year. At \$1,200 per fund, this comes to an aggregate \$200m or so a year.

Aggregate administration costs of voluntary and compulsory retirement savings

Aggregating the figures for the various types of fund suggests total administrative costs of \$2.2b in 1996-97.

That is less than half a per cent of GDP, and somewhat less than the administrative and compliance costs of raising revenue for and administering Age and Veterans Pensions.

Table 4: Employer Sponsored Superannuation Master Trusts

Fee Type	FUND 1	FUND 2	FUND 3	FUND 4	FUND 5
Contribution Fee	Up to 5% contributions. Rebate of 0.5% on contributions >\$50K pa, up to 2% transfers	Up to 5% regular. Up to 4% rollovers or lump sums	Between 1% and 5%	Up to 4.5%	Up to 5%
Exit Fee	Nil	Exit or draw down \$60	Benefit Payment \$50	Benefit Payment \$60	Nil
Administration Fee/Asset Management Fee	First \$250k: 1.4% Next \$250k: 1.2% Excess : 1.0%	First \$100k: 1.25% Next \$150k: 0.9% Next \$250k: 0.6% >\$500k : 0.1%	First \$100k: 1.75% Next \$150k: 1.5% Next \$250k: 1.25% >\$500k : 0.75%	First \$150k: 1.5% Next \$150k: 1.3% Next \$250k: 0.9% Next \$250k: 0.5% Balance : 0.4%	First \$50k : 1.5% Next \$50k : 1.25% Next \$150k: 0.9% Next \$750k: 0.6% Excess : 0.4%
Trustee Fee	Up to 0.5% of fund balance	Nil	Inclusive	0.25% of fund balance	0.095% pa of plan
Switching Fee	1 free per year, then 0.5% of assets switched	1 free per year, then \$30 per switch	1 free per year, then \$30 per switch	1 free per year then, \$60 per switch	Nil
Investment Fee	0.2-1.0% depending on manager (included in unit price)	0.25-0.93% depending on manager (included in unit price)	0.3-1.35% depending on manager (included in unit price)	0.43-1.28% included in unit price	0.5-1.38%: varies with investment option
Member Fee (member pa)	\$65	\$54	\$48	1-20k: \$46.80 1-50k: \$42.60 51k+ : \$40.80 No member fee if member account >\$75k	\$30

Source: Investor Source

INVESTMENT COSTS

The cost of investment management (expressed in terms of a percentage of assets) generally decreases with size of assets, although investment mix will also have an impact. As a result, lower investment management fees can be negotiated for larger investment mandates. There are significant differences between wholesale and retail management expense ratios.

The ASFA survey indicated that for funds with under \$100m of assets, the weighted asset average is around 0.52%, while funds with assets of between \$100m and \$500m average about 0.35%. The average investment cost for funds with assets in excess of \$500m was 0.28% of assets. The weighted average was 0.27%.

Applying this to the total assets of corporate, industry and public sector funds (\$154b at June 1997) suggests aggregate investment costs of \$415m a year in 1996-97.

This estimate could be a conservative one, for while very large funds have low investment management costs, rates of 0.6% or so are not unusual for pooled market-linked or equity funds when amounts invested are \$100m or less (InTech Asset Consulting September 1998).

International comparisons are difficult, but Australian investment costs are comparable, if not cheaper, than in the United Kingdom and the USA where charges on investments of the order of \$200m to \$300m are usually of the order of 0.4% to 0.6% per cent for active managers or multi-manager specialist structures with different managers for different asset classes, but can go as low as 0.1% for huge mandates or index tracking. Specialist overseas equity mandates tend to be more expensive given higher information and transaction costs. Investment management costs tend to be lower in the UK than in the USA, but some firms charge similar fees in each market in which they operate. Management charges also can have a performance component, and some funds will bargain down fees if an investment manager's performance has been poor (Pensions Management, September 1998; Pensions World, May 1998).

In comparison to these wholesale rates, investment charges for retail investments tend to be much higher (Table 5). Management expense ratios of between 1.75 per cent and 2 per cent are typical for Master Trusts. They are also likely to be of at least this order for investment products underlying insurance company retail superannuation products.

Applying a rate of 1.9 per cent to total retail superannuation assets of \$73b under management as at June 1997 suggests total investment costs of \$1.4b per year in 1996-97.

The table also shows that management expense ratios for retail investment products in Australia tend to be at the high end of the scale by the standards of other countries with well developed financial sectors (Table 6). However, while a number of major overseas financial organisations have been entered the Australian market, most of such interest has been in the wholesale end of the market, particularly large mandates. Servicing relatively small retail investors is a relatively high cost exercise

when a range of choices is involved. Economies of scale might assist in reducing costs, with this achieved both through market growth and mergers and takeovers within the sector. Information technology and systems improvements also might aid in bringing down costs.

Table 5: Management and Trustee Fees

Managed Investment	Management Fees (% of total assets)	Trustee Fees (% of total assets)
Australian Shares	1-2.45%	0*-0.9%
International Shares	0.75%-3%	0.04-0.17%
Australian Fixed Interest	1.0%-1.75%	0*-0.16%
International Fixed Interest	1.0%-1.6%	0.07-0.125%
Cash	0.75%-1.5%	0*-0.125%
Listed property	1.0%-2.4%	0.05-0.16%

Source: FPG Research. Some monthly fees may also be applicable

* Some companies may incorporate the trustee fee into their management fee.

Table 6: Retail unit trust charges for selected countries (percentage of investment)

	Typical Sales Charge	Typical MER
Australia	0-5	1.75-2
Canada	0-5	1.75-2
Germany	2-5	<1
Japan	2-3.5	1-1.5
United Kingdom	3-5	1.25-1.5
United States	0-5	0.5-2 (1.05 per cent asset-weighted avg)

Source: Financial System Inquiry Final Report

Investment management charges are also incurred for excluded funds, but many excluded funds invest directly. ISC figures (ISC Bulletin June 1997) suggest that 30 per cent of excluded fund assets are in cash, with a further 25 per cent in direct and indirect property and 25 per cent in equities. As recent reaction to Budget measures dealing with allowable investments by super funds shows, a fair proportion of this property, equities and other trust interests are investments in related businesses and domestic housing and other assets used by the fund member or members.

Given this investment mix, it might be reasonable if not conservative to apply a management expense ratio of the order of 0.25 per cent.

This suggests investment costs of \$85m a year for the \$34.7b of assets held by excluded funds at June 1997.

With total investment management charges of nearly \$2b a year and growing, it is not surprising that there is a high level of interest in superannuation funds management by overseas-based financial institutions and by Australian-based institutions seeking to diversify their activities.

MANAGEMENT OF BENEFITS

Benefit payments from superannuation funds during 1997 totalled some \$20.6b. Of this total, some \$16.6b represented lump sum payments, with \$4b pension payments (largely from public sector funds).

Benefit payments were up by 21.5 per cent compared to the previous 12 months. Both retirements and retrenchments contributed. The higher growth of benefit payments as compared to contributions led to net contributions being down marginally for 1997 compared to 1996, but at \$11.1b the net contributions were still considerable.

Clearly, a distinguishing characteristic of the Australian superannuation system at the benefit end is the prevalence, at least at the present time, of lump sum payments rather than income streams. Traditionally, lump sums were seen as both more tax effective, and a more reliable benefit option. Since the early 1980s, increasing taxation of lump sums and other government measures has sought to redress the balance, with only limited success.

Some of the main reasons for continued attraction of lump sums are:

- flexibility in using lump sums for capital items or other purposes;
- access to lump sums at early retirement (available from age 55);
- optimisation of eligibility for the Age Pension;
- certainty that the entire superannuation benefit is received by the contributor;
- flexibility in estate planning.

Managing your lump sum from retirement through to death or exhaustion of the lump sum certainly has costs, but these costs are outside the scope of this paper, which deals with retirement income products as such.

Despite the general preference for lumps sums, there has been a growing interest in income streams as part of overall retirement income. This interest has been fanned by the development of new products which address some of the perceived disadvantages of lifetime pensions, as well as some preferential treatment of traditional pensions in the superannuation tax regime and Age Pension means testing. Accordingly, a greater proportion of retirement incomes are being managed by the retirement incomes industry.

Income stream products

There are three main categories of income stream or pension-like products, i.e:

- traditional fund pensions;
- life office annuities;
- allocated pensions and annuities.

Estimates available on the importance of traditional pensions and annuities, and allocated pensions indicate that in 1992-93, less than one per cent of retirement income came from allocated pensions, two per cent from immediate annuities, and eight per cent from traditional superannuation pensions. By contrast, 66 per cent of retirement income was provided by government pensions, and over 20 per cent from non-superannuation investment income.

No statistics are available on the value of pension assets held by superannuation funds. However, in the December quarter 1997, pension payments by corporate, industry and public sector funds amounted to \$847m, compared to retirement lump sum payments in the same quarter of \$2,525m. On this basis, annual pension payments would be over \$3b a year.

Funds under management in the traditional annuities market reached \$3.7b by 31 December 1997, according to information provided by the Australian Retirement Income Stream Association (ARISA). This represented a growth during the previous 12 months of 12 per cent. Gross sales in the 12 months were \$959m, only 16 per cent of which was for life annuities, with the remainder for term-certain annuities.

Total allocated income stream assets (pensions and annuities) were just over \$12b by December 1997, of which allocated pensions represented \$9.4b. Sales in the sector for the 12 months, at just over \$3.5b, were more than three and a half times those of traditional superannuation annuities.

Funds under management for Life Office annuities offered outside the superannuation system were \$4.6b in December 1997, a 19.6 per cent increase from the previous year. Sales over the previous 12 months were \$1,427m.

Cost structure of income stream products

The range of fees and charges varies considerably between products. For allocated pensions/annuities, these might include some or all of the following:

- Contribution charge (entry fee): from 0% to 5%, depending on size of deposit. Some may be rebated to investor.
- Administration fee: e.g. \$6.25 per month
- Income payment fees: e.g. \$3 per payment
- Withdrawal fees: e.g. \$60 per buy/sell, or 1% to 4% of withdrawal reducing over time.
- Switching fees: e.g. \$20 per switch, or buy/sell spread.
- Investment Management fees: ranging from 0.6% to 2.5% of assets, depending on investment choice.
- Other: e.g. trustee costs from 0.2% to 0.35%.

While it is difficult to strike an average out of this array of charges given that each charge will vary according to individual circumstances and choices, the average administration and investment costs are likely to be in the order of three per cent per annum, and in some cases will be well in excess of that figure.

THE COST OF TAX CONCESSIONS

The Tax Expenditure Statement prepared each year by the Treasury claims that the revenue that the government forgoes as a result of what are described as tax concessions for superannuation currently exceeds \$8b. Their estimates for future years are just as large (Table 7).

Table 7: Treasury estimates of tax expenditures on superannuation

1996-97	1997-98 estimate	1998-99 estimate	1999-00 projection
\$8,700m	\$8,490m	\$8,720m	\$9390m

The major components of the superannuation tax concessions set out in the Tax Expenditure Statement were a claimed under-taxation of employer contributions, under-taxation of fund earnings, and under-taxation of unfunded lump sums. Whilst the aggregate figures obtained are impressive in their size they are also excessive and do not actually reflect the overall effect of superannuation on taxation receipts.

The Tax Expenditure estimates equal the revenue which would have been collected if superannuation contributions and income had been taxed at the full marginal rate of every member, less the tax revenue actually collected.

One of the major problems of the Tax Expenditure estimates is that the estimate is an immediate measure, and does not take any of the long-term effects of the Retirement Income Policy into account.

For instance, future balances and the associated tax base would be much smaller if higher taxation applied along the way. Other problems with the Tax Expenditure Statement estimates for superannuation tax concessions include:

- The calculations do not include the trade-off between short-term costs and long-term benefits. In the early years the growth in the coverage of superannuation will increase the cost to taxpayers in terms of foregone revenue. However, in the future superannuation will bring rewards for government, including a decrease in Age Pension expenditures.
- No allowance is made for any increase in tax revenues as superannuation payouts increase in size. Tax is deferred, not eliminated.
- In the benchmark it is assumed that the behaviour of individuals in terms of savings and consumption decisions would not change if the tax arrangements were changed. In effect, it is assumed that people would continue to place what they had been putting into superannuation into normally taxed investment such as bank accounts. In fact, without tax concessions for superannuation the bulk of discretionary superannuation savings that were previously made would go into concessionally taxed investments, or be used for immediate consumption.
- High returns associated with long term managed savings in the form of superannuation are seen as increasing the cost of the tax concessions, rather than

reducing future claims on the government for retirement income support through the Age Pension.

Given these shortcomings of the Treasury estimates, ASFA, IFSA, the Australian Stock Exchange and the FPA commissioned Access Economics to undertake a study of the real impact of superannuation tax concessions using a more equitable (but sound theoretical and practical) benchmark than the one currently used by Treasury (Access Economics 1998).

The report, released in September 1998, indicates that Treasury calculations “artificially pump up” by billions of dollars their estimate of the cost to revenue of superannuation tax concessions. The report also points out that superannuation will save government money in the longer term through expanding the tax base and limiting future social security needs and expenditures.

Access Economics concludes that superannuation was “_____ to the tune of \$0.6 billion in 1993-94, \$1.4 billion in 1994-95 and \$1.7 billion in 1995 - 96. In contrast Treasury has claimed that super was “_____ by an amount in the order of \$8 billion.

The four bodies have called on Treasury and government to revise its benchmark or to release the two benchmarks simultaneously. This would be consistent with the Principles of Sound Fiscal Management of the Charter for Budget Honesty . The Charter calls for fiscal policy contributing to adequate national savings, policy to have regard for financial effects on future generations and for contingent liabilities to be kept at prudent levels. As indicated earlier in this paper, Age Pension payments are developing as one of the largest contingent liabilities for government.

Adoption of a taxation of benefits benchmark is, arguably, a more realistic benchmark than that currently used by Treasury, as individuals do not gain any access to the value of their superannuation until a benefit payment is made.

It is the standard taxation approach adopted in other countries, with New Zealand about the only exception.

Support for an expenditure tax approach to evaluating the cost of tax concessions is supported by a number of respected economic analysts, including Geoff Carmody (Carmody 1998) and Dr Vince FitzGerald of Allen Consulting.

Superannuation has become more a cash cow than a burden on the tax system. In 1988-89 only \$7 million was raised from superannuation funds, but by 1997-98 this had risen to \$2,960m, and it is expected to be about the same in 1998-99.

Tax compliance costs

Compliance costs for this taxation of funds and for those receiving superannuation benefits are quite significant. Taxing at the fund level has some advantages in terms of efficiency of collection, albeit at a substantial cost in terms of equity and foregone incentives for individuals. Unfortunately, with the contributions surcharge we have the worst of both worlds.

ASFA and industry estimates (Moodie 1998) suggest compliance costs for superannuation funds of around 30 per cent of revenue of \$470m in the first year of operation of the surcharge. The ATO was allocated \$16m for administration costs associated with the surcharge. At 3% of revenue this is around three times the average ATO administration costs for revenue collection. (The surcharge/tax is a rather strange piece of public policy - by design or accident it plucks the tax goose in a way which generates the maximum squeals and discomfit for both the goose and the plucker!)

In addition to the compliance costs incurred by funds, there also are substantial compliance costs for individuals receiving superannuation benefits.

The complexities of the tax treatment of eligible termination payments which are accounted for by superannuation lump sum payments also leads to considerable compliance costs. There were around 650,000 recipients of eligible termination payments. If each paid an average of \$50 for tax advice and return preparation in regard to such payments, there would be total compliance costs of over \$30m per annum.

Costs of prudential regulation

The cost allocations underlying levies raised on superannuation funds to pay the costs of prudential supervision and consumer protection are a bit rubbery. The ISC raised, and APRA intends to raise, more than \$45m a year in revenue from superannuation funds, but the distribution of the costs and revenues between types of funds is subject to transitional arrangements and future consultation with the sector (Tables 8 and 9).

Table 8: Revenue proposed to be raised

	1997-98	1998-99	1999-2000
Excluded funds	\$33.6m	\$34m	\$2m to \$9m
Non-excluded super funds	\$13.8m	\$22.1m	\$31m
Life and general insurers	\$6.1m	\$8.3m	\$11.7m
Banks	\$270m	Nil	\$10m plus

Table 9: APRA and ASIC Levies

Type of Fund	1997-98 levy	Levies for 1998-99	Possible for 1999-2000 (Scenario 1)
Excluded fund	\$200	\$200	<\$50
Small (less than \$500,000 assets) fund	\$200	\$200	\$1,000
Large super fund	0.04% of assets (actually \$200 for each \$500,000), max \$14,000	0.04% of assets, max \$39,000	0.04% of assets, max \$76,000
Life insurer	\$70,000	0.02% of assets, min \$5,000, max \$148,000	min \$55,000, max \$200,000
Banks	\$270m in lost interest on non-callable deposits	\$10m in aggregate to be paid by Reserve Bank	\$10m in aggregate paid by the banks - 0.002% of assets,

As recently as September 1997 the ISC indicated that the costs attributable to funds with less than \$500,000 in assets (over 99 per cent of such funds being excluded funds) was \$9m, around \$60 per fund.

By May, 1998 the cost of regulating all excluded funds, as estimated by the ISC, had shrunk to a total of \$1.5m, equivalent to \$9 per excluded fund per year. That is, the ISC (now APRA) claimed that 97 per cent of the funds it regulates account for only about 5 per cent of the costs of supervising super. This is even more odd, given that APRA is proposing that it charge a minimum of \$1,000 for supervising a small fund with less than \$500,000 in assets in 1999-2000, but the costs for the ATO for supervising a self-managed (excluded) fund with similar assets will only be \$9.

Excluded funds remain a revenue source for government. The Government says it wants merely to recover costs with an eventual levy of less than \$50 per fund, but for the time being it is still continuing to pull in over \$33m a year from excluded funds, compared to regulatory costs of either \$9m or \$1.5m a year, depending on which ISC measure you use.

Regulatory costs of prudential supervision of superannuation funds are not cheap by international standards. Typical regulatory costs in other developed countries are usually less than one basis point on assets, compared to the levy on most superannuation funds of four basis points. However, it should be acknowledged that superannuation funds in Australia receive a high degree of prudential supervision. This arguably helps assure a level of confidence in the system.

Costs of fraud

Australia is well below the level of international averages for corporate fraud. A KPMG International Fraud survey showed that South Africa and the United States had close to the highest rates of fraud, with Australia in the bottom half of the international fraud league table.

Identified cases of fraud in Australian super funds have been opportunistic, rather than systematic. According to APRA, over the ten-year period to June 1998 identified losses to superannuation investors amounted to only \$25 million in total. This amounts to 0.007 per cent of total assets of \$340b as at March 1998.

Industry, corporate and public offer funds have not had significant levels of fraudulent activity. Their members have been protected, as have customers who have acted upon the advice of licensed financial advisers. Retail type products are well supervised, and there are provisions for compensation in place. The SIS Act sets out 95 offences for misuse of funds and other wrongdoing, with penalties up to \$200,000 and 5 years imprisonment for individuals, and fines of \$1 million for corporate trustees.

While the allocation of the incidence of losses due to fraud is never an easy matter, the SIS legislation also provides the Treasurer with the power to levy superannuation funds in order to provide restitution to any defrauded super fund members when this is considered to be in the national interest. Post-Wallis amendments restrict this discretion even further, but it is not a power which has been used frequently, if at all, to date.

Most losses suffered by superannuation account holders have occurred where self-managed (excluded) funds have invested in wholesale fund products or direct investments, or when lump sums have been taken on retirement and then invested elsewhere. They have not been of an order or in a form which has been judged by the Treasurer to justify compensation.

CONCLUSIONS

This paper has presented a large amount of information, and more information is still required to round out the picture in some areas in terms of the costs of the system. However, some broad and preliminary conclusions follow:

- Each of the three pillars of Australia's retirement income system is substantial but affordable, with national income representing three per cent of GDP (and growing) flowing to each of the pillars, i.e. the safety net, compulsory contributions and voluntary savings. However, savings will need to adequately meet likely expectations of future generations.
- Administration costs of social security payments are relatively low, but could blow out if the system is made too complex, or individual tax contributions have to be recorded.
- Administration and compliance costs of raising the tax revenue needed to fund Age and Veterans Pensions are considerable, with deadweight costs in this area of several billion dollars a year. In contrast, while private retirement income provision through funded schemes has both administration and investment costs, investment returns make this worthwhile.
- Administration costs of large industry and public sector accumulation schemes are very low. High administration cost schemes run by retail providers and by companies for their employees will need to either reduce their costs, or justify them in terms of additional benefits provided to members.
- Complex compliance requirements imposed by the government have led to significant increases in administration costs of funds and compliance costs for members and employers.
- Investment management costs at the wholesale level are at a modest level, but at the retail level are relatively high in both nominal terms and compared to overseas funds. These higher costs will need to be justified in terms of benefits provided by way of higher returns and/or greater options, or be reduced over time by increased competition.
- Total administration and investment costs of retirement income provision of around one per cent of GDP per year are not excessive, but the lower they are, the better the retirement benefits will be.
- Costs of prudential regulation of superannuation funds are blowing out, and are relatively high by international standards.
- Private management of funds has not led to any significant level of fraud or loss of member benefits.

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