Australian Government

Department of Defence

SUBMISSION TO THE

SENATE FINANCE AND PUBLIC ADMINISTRATION COMMITTEE INQUIRY INTO THE

DEFENCE FORCE RETIREMENT AND DEATH BENEFITS AMENDMENT (FAIR INDEXATION) BILL 2010

Introduction

The Defence Force Retirement and Death Benefits Amendment (Fair Indexation) Bill 2010 (the Bill) seeks to change the index for military superannuation pensions received by Defence Forces Retirement Benefits scheme and Defence Force Retirement and Death Benefits scheme pensioners aged 55 years and over. The Bill proposes that this group of military superannuants receive the best of three indexes, the Consumer Price Index, Male Total Average Weekly Earnings or the Pensioner and Beneficiary Living Cost Index.

Comments on the Bill

The methodology for the indexation of military superannuation pensions is a sensitive issue for former Australian Defence Force members. As a minimum, they expect that the chosen form of indexation will maintain the purchasing power (offset price increases) of their superannuation pensions.

Equally, former Defence Australian Public Service employees receiving superannuation pensions through the two Commonwealth superannuation schemes, (the Commonwealth Superannuation Scheme and the Public Sector Superannuation scheme), are likely to consider that they should receive at least comparable indexation for their pensions.

In his December 2008 Review of Pension Indexation Arrangements in Australian Government Civilian and Military Superannuation Schemes (the Matthews Review), Mr Trevor Matthews examined, among other things, whether the current method of indexation by the Consumer Price Index should be changed. In his report, Mr Matthews made observations relevant to the merits of different indexes. He commented that Age and Service pensions, which are safety net payments provided by the Government, are different benefits provided for different purposes than those of military (and civilian) superannuation pensions. This led him to conclude that it was therefore appropriate for them to have different indexation methodologies.

Mr Matthews also observed that:

> *"The purpose of pension indexation for both the civilian and military schemes should be to continue to protect indexed scheme pensions from the effects of inflation and not to provide pensioners with a share of productivity increases."*

He concluded his report with four recommendations. The first two recommended that military (and civilian) superannuation pensions continue to be indexed against inflationary price increases and that the same methodology apply to both. His third recommendation stated:

> *"That pensions for the Australian Government civilian and military superannuation schemes* ***continue to be indexed by the [Consumer Price Index] as the most suitable index to protect pensions against inflationary price increases available at this time.****" (emphasis added)*

His final recommendation was that the Government could consider an alternative index if a robust index which reflects the price inflation experience of superannuants better than the Consumer Price Index becomes available.

On 13 January 2011 the Australian Government Actuary (the Actuary) provided Defence with an analysis of the increased costs involved in changing from current indexation by the Consumer Price Index to the methodology proposed in the Bill. The analysis indicated that the Bill, as drafted and amended, does not deliver indexation for the best of the Consumer Price Index, Male Total Average Weekly Earnings and the Pensioner and Beneficiary Living Cost Index. Instead it falls short of that objective.

The Actuary's assessment was that if the Bill is implemented on 1 July 2011, there will be an immediate increase to the unfunded superannuation liability of $6.2 billion. In the first four years it will have an estimated impact of $175 million to the underlying cash and $1.7 billion to the fiscal balance. These costs increase over time. By way of example, in 2025-26 the underlying cash cost will be $400 million.

Defence operates within a capped budget funding model. Defence is required to find offsets for any new policy initiatives within its extant budget with the exception of Government initiated policy changes and "no win no loss" funding for Defence Operations.

The Committee would be aware that Defence, in delivering Force 2030, is undertaking a Strategic Reform Program. The Strategic Reform Program will generate gross savings of approximately $20 billion, which will be reinvested in current and future military capabilities. Strategic Reform Program savings are planned to reach steady state by 2015-16 at which time Strategic Reform Program savings will be in the order of $2.4 billion per annum.

Any change to the indexation arrangements for military superannuation will result in an additional pressure on the Defence budget as no funding is currently provisioned in the budget for such a change, which will need to be offset from existing program outcomes.

During the debate of the Bill, it was argued that the $175 million through the forward estimates could be achieved by reducing the growth of the Australian Public Service full-time equivalents in the Department of Defence by 33 per cent. It was claimed that this would see the number of staff in the Department of Defence, including the DMO, grow in size by 8.3 per cent instead of 12.6 per cent.

Defence's Australian Public Service workforce is programmed to grow over the years 2011-12 to 2013-14 to meet the requirements of Force 2030 and the Strategic Reform Program. As outlined in the 2010-11 Portfolio Additional Estimates Statement, the Australian Public Service workforce is scheduled to grow from its 2010-11 size of 20,870 (including DMO) to 22,824 by the end of 2013-14, an increase of 1,954 or 9.4 per cent. A reduction in Australian Public Service numbers will require further efficiencies to be found within Defence to enable delivery of ongoing programs.

The drivers for the growth are the development and implementation of new capabilities introduced by the 2009 White Paper and the financial savings measures under the Strategic

Reform Program associated with the conversion of contractors and non-operational military positions to less costly Australian Public Service positions.

Military superannuation is an element of the competitive remuneration and conditions of service package provided to Australian Defence Force members. Other elements available to Australian Defence Force members in addition to salary and allowances common in the wider community, include service allowance, other salary related and disability allowances, overseas and locality allowances, ADF-specific leave, and housing and removals that reflect the special nature of military service. Specific health, family support and compensation arrangements that operate under separate legislation are also in place. Furthermore, special remuneration and other conditions are determined on a case by case basis by the Minister for warlike and operational service.

The military superannuation schemes are designed to specifically reflect the unique nature of military service. Benefits paid under the military superannuation schemes are based on length of service and salary. The Defence Force Retirement and Death Benefits scheme is a pension based scheme. Members who discharge after 20 years are able to take an immediate lifetime pension based on 35 per cent of the member's salary at discharge. These pensions, which can be taken as early as 38 years of age, continue to be paid even if the former member returns to the workforce. The percentage of final salary increases with each year of service. For example at 30 years, the pension is 51.25 per cent of final salary and at 40 years, 76.5 per cent.

The Military Superannuation and Benefits Scheme is a lump sum scheme based on length of service and average salary over the final three years of service. Lump sums can be converted to pension at rates more generous than available in the wider community. In line with contemporary arrangements Military Superannuation and Benefits Scheme, in general, cannot be taken before attaining age 55.

The proposed Bill has limited impact on the majority of Australian Defence Force members. Only pension recipients aged 55 and older in the Defence Forces Retirement Benefits and the Defence Force Retirement and Death Benefits superannuation schemes will benefit from the Bill. It does not affect the 15,193 Defence Force Retirement and Death Benefits pension recipients under age 55 and the 7,684 existing pensioners under the Military Superannuation and Benefits Scheme (as at 30 June 2010). These members have been subject to the same unique nature of military service that this Bill seeks to recognise and it is difficult to determine the policy (as opposed to age and cost) basis for not including them.

Both the Defence Force Retirement and Death Benefits scheme and the Military Superannuation and Benefits Scheme already provide benefits well in excess of the community standard. Defence currently pays notional employer contributions of 33.4 per cent and 29.1 per cent respectively for these schemes. The community standard is currently 9 per cent. The Actuary has advised that under the Bill, Defence's notional employer contributions for the Defence Force Retirement and Death Benefits scheme would increase to 40.6 per cent, increasing Defence's contribution by $18.7 million in the first year, but decreasing over time. This is a further direct cost on the Defence budget. Further offsets would need to be identified in addition to any found to cover the underlying cash impacts to government.

In summary, any requirement that Defence fund the changes proposed by the Bill will significantly impact Defence funding for ongoing programs.