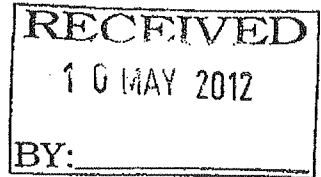




COPY



The Hon Warren Snowdon MP
Minister for Veterans' Affairs
Minister for Defence Science and Personnel
Minister for Indigenous Health
Minister Assisting the Prime Minister on the Centenary of Anzac

Mr Robert Oakeshott MP
Member for Lyne
PO Box 1112
PORT MACQUARIE NSW 2444

4 MAY 2012

Dear Mr ^{Rob}Oakeshott

Thank you for your representation of 30 August 2011 to the Minister for Financial Services and Superannuation, the Hon Bill Shorten MP, on behalf of [redacted] and [redacted] concerning, in the main, the indexation of military superannuation pensions. As this matter falls within my portfolio responsibilities, your representations have passed to me for response. I apologise for the delay in responding.

Your correspondents raise a number of issues, including the fact that they had to contribute towards their Defence Force Retirement and Death Benefits (DFRDB) pension, the vesting of the Defence Forces Retirement Benefits (DFRB) Fund, the Defence Force Retirement and Death Benefits Amendment (Fair Indexation) Bill 2010 (the Fair Indexation Bill), the use of the Consumer Price Index (CPI) for indexing military superannuation pensions, the Review of Pension Indexation Arrangements in Australian Government Civilian and Military Superannuation Schemes (the Matthews' Review), the cost of changing indexation arrangements, the taxing of military superannuation pensions and the denial of equity to veterans reflected in the *Veterans Entitlements Act 1986*.

Superannuation is a key element of the competitive remuneration and conditions of service package for Australian Defence Force (ADF) members. Each of the military superannuation schemes were tailored to meet the unique requirements of military service and provide generous benefits compared to those of many other superannuation schemes.

Some of your correspondents refer to the fact they were required to contribute 5.5 per cent of their salary towards their DFRDB pensions. However, up until 1983, they could claim a tax deduction (or in some years tax rebates) for the amount they contributed for superannuation or paid as premiums for an annuity from life insurance cover, subject to a maximum cap.

When superannuation contributions/life insurance premiums exceeded the maximum cap in a particular year before 1983, the excess was counted towards the undeducted purchase price (UPP) of the pension/annuity to which those contributions were made. The UPP was the amount contributed towards the purchase price of a pension or annuity for which the person was not eligible to claim a tax deduction in a particular year.

A portion of the UPP could be claimed as a deduction to reduce the pension or annuity income in the person's tax return. Those DFRDB scheme members who retired prior to the introduction of the 'Better Super' tax changes on 1 July 2007 were able to take advantage of the tax laws that applied at the time the benefits were received.

If DFRDB members did not contribute, then it is highly likely the benefits eventually payable would be less because the employer contribution towards the final benefit was actuarially determined on the understanding of joint contributory obligations. The DFRB scheme was financed partly by member contributions and partly by Government subsidy. Member contributions were paid into the DFRB Fund and the contributions and earnings met a proportion of the benefit payable.

As there was insufficient funds in the DFRB Fund to meet the individual benefits payable, the member contributions and earnings in relation to the particular member that were in the DFRB Fund were transferred to the Consolidated Revenue Fund (CRF) and the benefits were paid to the member from the CRF.

The Joint Select Committee, appointed to enquire into and report on the DFRB Legislation (the Jess Committee), identified that only some 20 to 28 per cent of benefits payable under the DFRB scheme were funded by member contributions and earnings on those contributions. The Committee recommended that the DFRB scheme be closed, that the DFRB Fund, which stood at \$154 million at 30 June 1972, transfer to the Commonwealth and that the Commonwealth guarantee benefits under the then proposed DFRDB scheme and meet all costs not covered by member contributions.

The Australian Government Actuary was asked by the DFRB Board to provide a report on the assets of the DFRB Fund at the date of the scheme closure. A surplus was found to exist in relation to existing pensioners at the time and the excess, with interest, was distributed to those pensioners.

A deficit was found in respect of contributing members who were transferred to the DFRDB scheme and this deficit was funded by the Government. As a consequence, there was no amount to be distributed to contributing members and they were not asked to pay extra to fund the identified deficit.

At about the same time as the DFRB Fund was transferred to the Commonwealth, the superannuation fund for Federal politicians was also transferred to the Commonwealth for basically the same reasons.

The basic premise in the letters from your correspondents and in the current 'Fair Go!' campaign to change indexation arrangements is that the Government changed the method of indexing the age pension in 1997 to maintain the purchasing power of the age pension. This is incorrect.

The 1997 change, which ensured the maximum basic rate of the single adult age pension, after indexation, did not fall below a rate equal to 25 per cent of male total average weekly earnings, was made to honour an election commitment that pensioners would share in increases in community living standards. This had been a policy objective of successive Governments since the early 1970s. In other words, the change was related to the age pension as an income support payment, not superannuation as a condition of employment.

At the time of making the change, the Government acknowledged that indexing the age pension by the CPI ensured that the real purchasing power of the pension was maintained. In his second reading speech for the Social Security and Veterans' Affairs Legislation Amendment (Male Total Average Weekly Earnings Benchmark) Bill 1997, the then Minister for Science and Technology said:

Pensions [that is, single adult age pensions] are indexed twice a year—in March and September—according to movements in the CPI, ensuring that the real purchasing power of the pension is maintained (emphasis added). However, CPI indexation, by itself, may not enable pensions to keep pace with changes in the living standards of the rest of the community. By legislating to maintain the single rate of pension at 25 per cent of male total average weekly earnings, the government is demonstrating its commitment to ensure that pensioners share in increases in community living standards (emphasis added).

Proponents for a change to indexation maintain a view that Mr Matthews' Review is 'flawed'.

Mr Matthews undertook a comprehensive examination of the purpose of pension indexation in occupational superannuation schemes and considered whether the current CPI pension indexation methodology in the Government's schemes should be changed.

Mr Matthews' report took into account the Review's terms of reference, other matters raised in over 190 submissions from individuals and ex-Service organisations and matters raised at hearings held in Canberra, as well as material provided to the Review regarding the compilation of the CPI. He also considered the original purpose of the current indexation methodology and the various earlier reviews that had considered that methodology.

Mr Matthews said that the purpose of CPI indexation for civilian and military pensions has never been to ensure that those pensions keep pace with community standards. He said that to do so:

... it would need to be generally accepted that an employer retains a responsibility to compensate former employees for improvements in productivity, as reflected in salary rises, which occur after an employee leaves them. This is not a generally accepted responsibility in Australia.

He found no conclusive evidence that the CPI understates inflation as it affects Australian households in general. This finding was supported by the view expressed in a paper prepared for the Review by the Australian Bureau of Statistics that the CPI *is a robust measure of general price inflation for the household sector and the best available broad measure of changes in the cost of living faced by Australian households*. I understand that this view is still current.

The Pensioner and Beneficiary Living Cost Index is a by-product of the CPI and it was introduced as an indexation factor for income support pensions in September 2009. This index is still being refined and was recently updated from the September 2011 quarter. The Government will continue to monitor progress of the use of the Pensioner and Beneficiary Living Cost Index.

In his Review, Mr Matthews noted that changing the indexation arrangements would come at a significant cost. Appendix J of Mr Matthews' Report of his Review estimated the financial impacts of two alternative pension indexation methodologies, namely indexation:

- at the same rate as that for the base rate of the age pension; and
- by the higher of the CPI or the increase in Male Total Average Weekly Earnings.

The estimates in the Matthews Review were based on a commencement date of 1 July 2009. Updated estimates for a change to indexation arrangements from 1 July 2011 are available on the Department of Finance and Deregulation (Finance) website at:

www.finance.gov.au/superannuation/UpdatedEstimates.html

The costing figures being relied on by those supporting a change to the indexation arrangements have been prepared by Mr Peter Thornton, who is an independent researcher and commentator on matters relating to public sector superannuation and I understand, a member of the Defence Force Welfare Association (DFWA).

Mr Thornton's figures have not been prepared in line with professional actuarial or accounting standards and have not been peer reviewed. They do not stand up to the principles of sound fiscal management nor do they stand up to the public scrutiny any Government's fiscal strategy is required to undergo as part of the Charter of Budget Honesty.

Officers from Finance, the Department of Defence and actuaries for the Government's superannuation schemes met with representatives of the DFWA, including Mr Thornton and the Superannuated Commonwealth Officers' Association (SCOA) on 28 June 2011 to discuss a number of matters relating to the indexation of military superannuation pensions. Mr Thornton's responses to the Senate Committee report on the Fair Indexation Bill and to the updated cost estimates were discussed and the actuaries also explained the basis of their advice to Government.

The Minister for Finance, Senator the Hon Penny Wong, wrote to Colonel David Jamison (Retd), the National President of the DFWA and to Dr Annette Barbetti, the President of SCOA, on 21 October 2011 indicating there is nothing in Mr Thornton's material that has caused the actuaries to reconsider their assumptions or that would impact the actuarial advice they have provided to Government.

Senator Wong said she would be happy to ask the actuaries to review any actuarial advice the DFWA and/or SCOA may have received. Neither the DFWA nor SCOA have provided any advice for review to date.

Senator Wong also said the Government acknowledges that there may be secondary impacts from changes to indexation arrangements (commonly referred to as 'clawback') and said these are disclosed on the Finance website. However, she pointed out that these secondary impacts are highly sensitive to assumptions made about the personal circumstances of individuals.

There has been some suggestion that the cost of changing indexation arrangements have been exacerbated because the Government has included costs for changing the indexation arrangements for pensions paid from the schemes applying to Australian Public Service employees and members of the Military Superannuation and Benefits (MSB) scheme.

While members of the Australian Public Service are employed on different terms and conditions to those that apply to ADF members, the indexation of pensions payable to them and to ADF members are all based on upward movements in the CPI.

This is the 'common denominator' between the schemes and there have generally been uniform changes across the schemes in relation to indexation. The Government will provide for all its employees equitably in regard to indexation of Commonwealth superannuation pensions. Only considering discrete groups within the public sector is not an option.

The unique nature of military service is reflected in the military superannuation schemes, the benefits for which are set out in either legislation or Trust Deed/Rules. Each of the military superannuation schemes provide members with life time indexed pensions and also death, invalidity and reversionary benefits which are not generally available from accumulation schemes that are the 'norm' in the private sector.

In particular, the DFRDB superannuation scheme is generous compared to most other government and private sector schemes. It was specifically tailored for military service and amongst other things, provided benefits payable after 20 years service. DFRDB members can access their benefits before anyone else in the community (that is, before reaching their preservation age, which varies between age 55 and 60 depending the member's year of birth).

The DFRDB pension was not intended to be the sole lifelong income source for those who were still of working age when they ceased service, either through choice or due to rank retirement age - the general trend has been some 75 per cent were under 45 years of age when they ceased service, and 40 per cent of those were between 35 and 40 years of age.

Servicemen and women who completed a career in the military and then went on to further careers had the benefit of an additional superannuation payment over that period of their employment. In comparison, the majority of the community is precluded from accessing superannuation benefits until preservation age is reached, which ranges in age from 55-60.

For those personnel who return to military service to undertake Reserve work on continuous full-time service and are in receipt of a DFRDB pension, there can be substantial superannuation benefits flowing from their Reserve service where it exceeds 12 months.

One of the special provisions of the DFRDB superannuation scheme is that it provides for the payment of benefits after 20 years service, irrespective of the age the member ceased service. DFRDB members also had the option to commute a part of their superannuation into a lump sum. DFRDB members could commute up to five times their annual pension rate, in exchange for a reduction in their pension. This option was exercised by over 99 per cent of members.

Two significant factors that have affected the level of DFRDB superannuation payments are the ability to leave after a relatively short period of service and the commutation option. In addition, the average DFRDB superannuation pension can be misleading as the superannuation pension may not account for the totality of a retiree's retirement income (and assets).

Superannuation payments are different in purpose to other government payments. As the age or service pension is a safety net benefit, the Government has decided that it is appropriate to index these pensions in a different way to superannuation payments it might provide as an employment benefit. The age pension, which is available from 65 years of age, is generally the principal or only source of income for many older Australians who qualify for it.

This is not the case for DFRDB superannuants who, depending on other income/assets, are able to access additional financial assistance at 65 years of age through the age pension. For those veterans with qualifying or war-like service, the service pension is available at 60 years of age. The spouse of these veterans is also eligible for the partner service pension. For most superannuants currently in receipt of the age or service pension, any change in indexation arrangements will not alter the fact that they will still receive these pensions.

In regard to taxation of military superannuation pensions, as I have indicated, DFRDB members were able to take advantage of the taxation arrangements that were in place when they took their benefit. They are also now entitled to claim a tax rebate equal to 10% of their DFRDB pension which is paid from an untaxed source. That is, if the DFRDB pension is say \$23,000, they would be entitled to a tax rebate of \$2,300.

The employer superannuation contributions for the military superannuation schemes are largely unfunded, that is, the Government pays its employer contributions when the superannuation benefit falls due for payment. This has effectively been the funding arrangement for all Government superannuation schemes since their inception (and the DFRDB scheme relies heavily on the untaxed CRF for paying the bulk of the benefit).

Taxation on employer contributions in the military schemes is recovered when the superannuation benefits are paid (that is, when employer contributions are made). Since 2007, no tax is applied to member funded benefits or to benefits that arise from a member's 'after tax' contributions.

As indicated above, aligning the indexation arrangements for Commonwealth superannuation schemes with those applying to the age/service pension would come at a significant cost.

The Coalition introduced the Fair Indexation Bill into the Senate last year to change the indexation of superannuation that was neither fair nor equitable. The Senate did not pass the legislation and the reasons for not supporting the Bill included:

- the DFRDB indexed pension is available, at any age, after 20 years of service (the majority of the rest of the community is precluded from accessing superannuation benefits until preservation age is reached);
- the employer superannuation contribution rate during the service period is higher than for other government employees; and
- during their period of service, members of the ADF have access to service allowances, other salary related and disability allowances, ADF specific leave, housing, health, family support and compensation arrangements.

The Opposition never committed to this indexation policy during more than 11 years in Government because they knew they couldn't afford it. Their proposal would not apply to anyone who joined the services after 1991, thus ignoring the vast majority of current serving ADF members. The Labor Government is committed to providing an equitable and fiscally responsible competitive remuneration package for all current and retired members of the ADF.

The *Veterans' Entitlements Act 1986* (VEA) consolidated, rationalised and simplified the entitlements available to members of the veteran community. The Bill for the Act was introduced into Parliament following one of the most extensive processes of consultation that had ever been undertaken by any Government at the time.

The VEA Bill was drafted around the recommendations made by the Advisory Committee on Repatriation Legislation Review, which was constituted by representatives of the Returned Services League, Legacy, the War Widows' Guild and the Australian Veterans' and Defence Services Council. Ninety-five per cent of the Committee's 292 recommendations were incorporated in the VEA Bill.

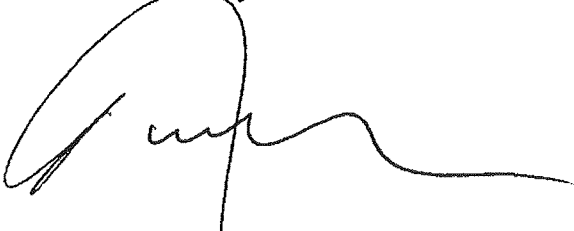
The VEA defines the roles of decision-makers and what, if any, discretion they may exercise and is interpreted by the Courts in a beneficial way to veterans in relation to the benefits and services it provides. It operates on the basis of ensuring fair and balanced treatment and aims to provide certainty and consistency for pension claimants. The decisions and actions of delegates under the VEA are impartial and must be consistent with the principles of natural justice.

Where a pension claimant or applicant is dissatisfied with a decision of the Repatriation Commission, they have a right to seek an internal review, or formal review by the Veterans' Review Board, which is an independent statutory body established under the VEA. A person dissatisfied with the decision of the Veterans' Review Board can ask the Administrative Appeals Tribunal to review the decision.

If it is considered that an error of law has been made, either in the interpretation or application of the VEA, an appeal can be lodged with the Federal Court. This system of review ensures fairness and equity in the overall decision making process.

I trust that this information explains the Government's position on this matter for you.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Warren Snowdon', with a long horizontal flourish extending to the right.

WARREN SNOWDON

