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Superannuation and small business

Rebecca Benedict

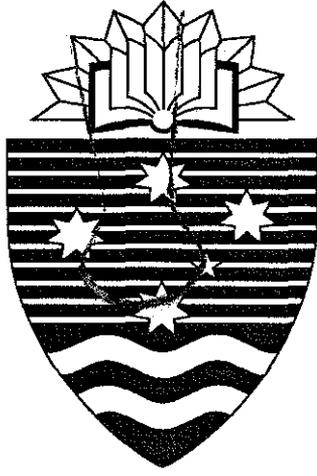
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BOND UNIVERSITY
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**DISCUSSION
PAPERS**

"Superannuation and Small Business"

by

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DISCUSSION PAPER NO 42

JULY 1993

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AUSTRALIA

SCHOOL OF BUSINESS

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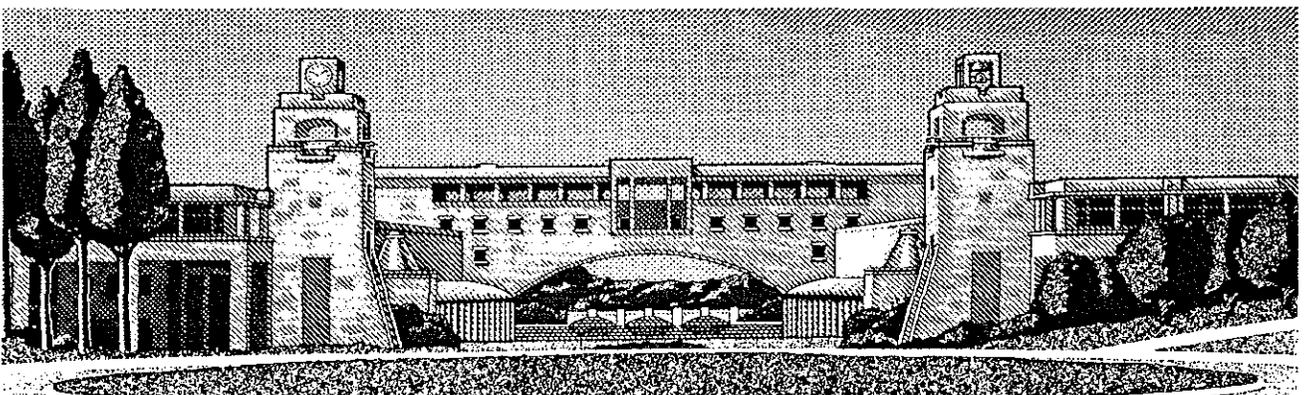
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B O N D U N I V E R S I T Y

Superannuation and Small Business

by

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Introduction

In Australia, there are at least 800,000 small businesses. Small business accounts for 52% of labour force and it generates income of 15% of the GDP. Thus, small business is a very significant sector of the economy. More importantly, small and medium size businesses have been identified as the growth engine of the economy. For future prosperity of Australia, small business will play a significant role. This fact is recognised by the Labor Government in the form of a minister responsible for small business.

An increase in cost for small business is an important detrimental factor in economic growth. Thus, the new schedule of superannuation (which makes superannuation payment compulsory for almost all employees) will have an impact on the small business sector. The Federal Government has recognised this. As a result, the government has set a lower rate of required superannuation payment for small business for the time being (however, later years will see a steeper increase in super payments by small business).

How did superannuation come about to encompass *all* businesses? This is the first issue that we will take a close look at. Then, we will focus our attention to small business. We will report the findings of two sets of surveys that we conducted on small business. Finally, we discuss the implications of our results for future government policy.

A Brief History of Australian Superannuation

To appreciate where we are today in retirement income provision, we need to understand historical changes. The Parliament of the Commonwealth of Australia passed pension legislation in 1908 much before the United States (where the Social Security was introduced in the Great Depression of the 1930s). Curiously, despite the fact that women live longer than men on the average, age of eligibility to receive the age pension has been five years lower for women. A recent report suggests that the Treasury is looking at this issue closely (Dunstan, 1993).

Employer sponsored pension (a precursor of the present superannuation) came even earlier to Australia. In 1862, the Bank of New South Wales introduced a pension scheme for their employees (thirteen years before such a scheme was introduced by the first company (American Express) to do so in the United States). However, the coverage remained very limited.

It has become increasingly obvious to demographers where the population age structure is going. The proportion of population over age 60 is going to increase faster over the next forty to fifty years. For example, in Australia, the proportion of population over 60 in 1980 was 13.3%. By the year 2000, this ratio is going to go up to 15.1% and by 2025, it will be 20.7%. Thus, the proportion of old will grow rapidly in the next fifty years. This is not a problem of Australia alone, among OECD countries, the problem is worse in Japan, the US and Germany (Schulz, Borowski and Crown, chapter 1, 1991).

What would population aging mean for the age pension scheme in Australia? If people retire around the same age in the next century as they do now (or at least do not retire later), and if the per capita income in Australia does not start rising phenomenally (it does not seem likely), only one of two things can happen with the age pension as it is currently funded (i.e., the

current retirees are being paid by taxing current workers every year): (1) pension benefits will be reduced or (2) taxes will increase. At present, in Australia, the age pension is pegged at about 25% of the average weekly ordinary times earning (AWOTE). The political backlash from reduction of pension benefits could be enormous (especially when you consider that: (1) "grey voters" will be about 33% of the eligible voters, (2) more than 70% of those are *totally* dependent on the age pension to fund their after retirement consumption and (3) that elderly voters are more likely to vote). Hence, the future reduction of benefits can be a political minefield for any political party. It can also be argued that a tax increase will hit even more people and thus a tax increase is also politically risky. But, it is a fact that a tax increase will be less visible than a decrease in benefits (as the tax is put on a larger base and hence a smaller per capita number). Thus, it is not clear what is going to happen to the age pension in the future. This may create a policy impasse and result in uncertainty in this government program. Consequently, future retirees will be less certain about the future of the age pension. A recent survey by MLC shows exactly that: younger people (age range 20-25) are more uncertain about the availability of age pension when they retire than older people (age range 50-55). Some interesting interactions between age pension and superannuation are explored by Knox (1991).

Until recently, superannuation coverage has remained patchy. By 1980, most of the government employees had superannuation coverage. However, much of that was unfunded. As a result, today the Commonwealth Government alone has over 80 billion dollars worth of unfunded liability. Among the private sector workers, adequate coverage was restricted mainly for high income earning male professionals (managers, administrators etc.) mostly in large firms with large unions.

The 1980s brought a series of changes. The introduction of occupational superannuation scheme was meant to fund retirement. But there was not compulsion to preserve it till retirement because the payment could be taken as a lump sum at the time of job termination. The amount received from superannuation remained meagre as well. For example, more than half of those receiving lump sum benefits in 1982 was less than \$10,000 - not an amount of money you could comfortably retire on!

To foster the preservation of benefits higher taxes were introduced in 1984 for funds accumulated after July 1, 1983. A flat rate tax on benefits Government's intention of introducing a Superannuation Guarantee Levy commencing on 1 July 1992. OSSA did not have any teeth for non complying employers. In fact, the Department of Industrial Relations estimated that out of 3 million eligible workers, only 2 million were getting any super at contributions differently from post-1983 contributions to superannuation.

In 1988 further changes in tax on superannuation were introduced. A tax rate of 15% was imposed on superannuation fund earnings as well as all. To ensure compliance, the ATO was charged with undertaking the administration of the employers. Initially, a proposal was mooted to introduce taxes on money received at 31.25% before age 55. The Labor Government introduced a series of legislation's which began treating pre-1983 component differently.

In the Government budget, Occupational Superannuation Schemes Act (OSSA) was introduced in August 1989. In this Act, the idea of a tradeoff between wage and super was first mooted. However, before long it became clear that there were severe compliance problem with the 3% superannuation that it stipulated. This dissatisfaction with OSSA became a major impetus for the Federal Government to introduce compulsory superannuation for all workers (Security in Retirement 1992)

Regulation

As the history shows, the development of superannuation in Australia was a piecemeal affair (Bateman and Piggot, 1992). Moreover, it did not have (and it still does not have) any integration with the other piece of the law: the Age Pension. Not surprisingly, regulation in the superannuation industry is in need of a major overhaul. Recent changes have gone some way to meeting this goal. However, it still has a long way to go.

There are three major players in the superannuation game: 1) companies that provide superannuation for the employees, 2) the Insurance and Superannuation Commission (ISC) the government body in charge of regulating the insurance companies and now the Australian Taxation Office (ATO) as the agency in charge of compliance.

FIGURE 1 ABOUT HERE

The Insurance and Superannuation Commission has a very small budget compared with the task it is supposed to undertake on behalf of the workers in companies. Therefore, to undertake the monitoring of the companies, Federal Government had to introduce other bodies into the game. The two natural bodies for this would be the Australian Securities Commission (ASC) and the Australian Taxation Office (ATO). The ASC is already charged with various regulatory functions of companies and The ATO is of course charged with collecting taxes. Hence, it was natural to involve some regulatory functions to the ASC and some to the ATO. However, this process fragments the functions and hence makes it even more difficult to impose a uniform set of regulations across all superannuation funds.

In fact, the picture is further complicated by the Banks and Near Banks (State Financial Institutions) as they are also major providers of different products in the superannuation game. They have not been in the past. But,

with major changes in the offing, the banks will be able to provide a savings book style superannuation account for it's customers

FIGURE 2 ABOUT HERE

There are four broad groups of available super funds: personal super, rollover funds, employer sponsored and industry super. Traditionally, life offices have provided all of these products. But, given that super has become compulsory, and banks and other deposit accepting institutions feel that they are going to lose deposits (as super fund deposits will flow less to banks and other deposit accepting institutions). To grow, banks and near banks need to be bigger players in this market. At present, the bank deposits in Australia are worth about \$200 billion and deposits in super funds is \$170 billion. The amount in super funds is set to increase to \$700 billion by the turn of the century (a more optimistic estimate puts that number to \$1 trillion). Deposits in banks are not set to grow that fast.

The regulation of banks works somewhat differently from other companies that provide superannuation such as insurance companies. The banks are regulated by the Reserve Bank of Australia. Similarly, for Friendly Societies and Credit Unions, the relevant regulatory body is now AFIC (until recently, there was no uniform body regulating all these near banks). The regulatory environment under which banks or near banks work is vastly different from the environment of ISC.

There are major differences in (1) disclosure requirements, (2) capital requirements, (3) investment controls, (4) liability of promoters and (5) taxation treatment.

Hence, there is a question of a level playing field for all the players in the superannuation industry (FitzGerald and Harper, 1992). Banks claim that they are at a disadvantage. They claim that they have to comply with many

more regulations than the life insurance companies in Australia. Of course, the life offices generally do not agree with that!

Current Situation

In the August 1991 Budget, the Treasurer foreshadowed the a 3% super for businesses with a payroll of \$500,000 or less and 5% for businesses with a payroll over \$500,000 . Not only did the government want to introduce this 3/5% tax starting July 1, 1992, it also wanted to increase the tax rates from 3/5% to 9% by the year 2001. Thus, this proposal would make superannuation a major retirement vehicle for workers of future generations. The government has made a huge transition in it's policy towards superannuation: in a decade, superannuation policy has changed from a lump sum handout at the time of retirement to a vehicle for retirement (Dawkins, 1992, p.39).

The Treasury had assumed that it's recommendations would be accepted by Parliament without any significant modifications. However, that was not the case. The effects of recession turned out to be much worse than expected. Unemployment levels and rates rose. Productivity fell. The Confederation of Australian Industries released a study (CAI Industrial Review, 1992) estimating job losses over the next five years that would be due to the increase in on-costs from the proposed increase in superannuation. The Treasury's own model released estimates of job losses from the proposed increase in superannuation. The estimates ranged from 50,000 to 100,000. This result created turmoil among the rank and file of the ALP. However, the Labor members of parliament were not deterred by it. But, in the Senate, the Democrats held the balance of power. Without their support (as it became apparent that the Liberals and Nationals were going to oppose any increase in superannuation in both houses of parliament), the proposed legislation was doomed in the Senate. Thus, the Labor Party had to negotiate with the

acceptable. The Democrats argued that small business was hard hit by the current recession. Hence, the government must not change the superannuation arrangement for companies with a payroll less than \$1m. Even the future increases in superannuation were rolled back. For the companies with a payroll less than \$1m, the prescribed schedule is to stay at 3% till June 30, 1994. The proposed increase to 9% by 2001 was rolled back to 2003. Thus, the Democrats affected the proposed changes in superannuation in three ways: (1) lift the limit from 1/2 million dollars to \$1m for the differential schedule; (2) keep the rate at 3% for companies with payroll less than \$1m until June 30, 1994; (3) lengthen the proposed time limit on increase to 9% from 2001 to 2003. This stance can clearly be seen as a "pro business" one. The ACTU argued (with no result at the end) that even having two separate schedules for different threshold levels of payroll was bad policy. The process disadvantages women, part time employers and generally, the weakest section of the workforce. Unfortunately for ACTU, the support for its position among the so called right to centre factions of the Labor Party was not strong. So, it did not get the support of its position in the Labor Party in Parliament.

Small Business and Super

Small business is being treated differently by the new legislation on superannuation that came into effect on July 1, 1992. However, the views of small business about superannuation was never directly investigated. In this research, we do precisely that. The research questions initially identified were:

- 1) What percentage of small business is meeting existing superannuation requirements?
- 2) How do small businesses choose their super fund?
- 3) Does small business find it difficult to understand and comply with Superannuation?

- 4) What impact are current superannuation commitments having on small business?
- 5) What is the expected impact of the new 1992 Superannuation Guarantee Charge on small business?

Before July 1, 1992, we conducted a survey of small business in south east Queensland about various issues regarding superannuation. Only those small businesses that have full time employees were included in the survey.

The results of the survey is in the appendix 1. Here, we will highlight some of the findings (also reported in Benedict and Sinha (1992)). There were many concerns about superannuation for small business. The common ones were:

1. Safety of superannuation fund money.
2. Running a fund might cost more than the earnings in those funds due to rising fund fees.
3. The existing and proposed Superannuation Guarantee Levy is adding more burden on their businesses, when other regulations and the economy are already making things tough.
4. Managing the super funds is difficult. For example, turnover of employees in small businesses were high. The small business owners found it difficult to keep track of all the past employees as the past employees moved from one job to another and from one place to another. They find it hard to believe that the employees that are moving around can keep track of their funds. And just what exactly is going to happen to unclaimed funds? Is this a means of generating income for the government?
5. The existing super requirements are forcing people to lay off

existing superannuation costs and the new Superannuation Guarantee Levy will only make things worse.

6. The family business owner is concerned about assets tied up in superannuation and whether the supposed benefits will be greater than if they used that money for other investments or assets.
7. It is inequitable - businesses will choose to close or be forced to close due to the excessive costs of compliance.

Some specifics of the survey are discussed below:

We asked how difficult or easy it is to understand and comply with superannuation requirements. Over 30% said that it was "manageable". Another 25% found it to be difficult. About 12% found it to be "impossible".

A significant percentage (19%) said they are currently not contributing superannuation for any of their employees. This means a significant group of employees are missing out on even the meagre 3% super currently in place.

Did they need to take any action in the running of their business to meet the cost of required superannuation contributions? A whopping 44% said they did not take any action whatsoever. Another 38% said they did take some action. This result shows that small businesses are not taking actions on things that are completely anticipated. It could also mean that they are not paying the current 3% (more on this point below).

They were also asked if they felt their business would need to take any action to meet any changes required by the Superannuation Guarantee Levy from July 1992. This time only 17% said they would not have to take any action. Reported action taken or that will be taken fall into the same general areas. What kind of actions are small business taking?

Some found it was necessary to reduce employees or at least not replace

Others have had to reduce staff numbers or have plans to lay off more staff. Some found it necessary to trim overtime. A few said they would stop paying wages above the award rates. Some found it necessary to keep all the employment within the family itself. Many were simply hiring casuals instead of permanent staff to circumvent paying the extra 3%. A number of them felt the existing super has caused them to raise their prices and or reduce their profit margin. A few expressed more drastic actions: (1) closing their business down, (2) make the employees pay for any increase in contributions (by reducing the wages), and (3) close down the existing business and start up with family members only. Finally, we asked them how they would compare the new Superannuation Guarantee Levy with the proposed new superannuation deal in the Fightback! package. Most of them (77%) were not aware of the superannuation option in the Fightback! package at all. A small group of business owners found the option proposed under GST was preferable (10%). Another small group found the comparison difficult (8%). Nobody preferred the option on the proposed Superannuation Guarantee Levy!

We found ignorance about existing or proposed super legislation is massive. Clearly expensive government television commercials about superannuation have left the small business people confused. Similarly, the Opposition too, had failed to convey its message about super to the general public.

A much more cost effective way to communicate with the small business sector would have been to mail out a brochure to small businesses with the help of the Australian Taxation Office to inform them of the impending changes. After all, it is the Australian Taxation Office that is in charge of enforcing the levy.

We found that there is widespread belief among small businesses that they have avoided the existing 3% superannuation payment. They believe that they can do the same with the proposed levy as well. They might end up spending resources trying to do that and at the end gain nothing.

Perhaps the most significant finding from this study was the fact that 83% of the businesses interviewed said they would have to take actions to meet the increases in superannuation charges that are coming. And yet, it was clear that the business owners lacked a fundamental understanding of the changes in the SGC. They did not understand they would have to make contributions to their own funds, that they could not avoid the charge by using part time or casual labour, and that they could not force the employees to pay their own super contributions.

Mandatory super was seen by small business to be just one more piece of excessive regulation and an unnecessary burden (in terms of cost and paperwork) especially during the recession.

One serious concern held by small business was the result of high employee turnover. How can the employees keep track of their superannuation funds? How can the employer make sure the money he has paid for an employees retirement will actually be received by that employee? The Australian culture clearly supports the concept of providing adequate retirement benefits for every Australian. And most employers would agree superannuation should be part of an employment package. What they object to is the timing of such actions and uncertainty about what they may actually end up paying for. For example, consider the current situation of unclaimed funds. Some politicians have hinted that the money might be used for different purposes. Small businesses having a hard time meeting on costs may feel quite strongly that there is no point struggling and working hard to meet super contributions if some of the money will be used for other

purposes. There is the additional fear that if the money is used for other purposes the funds may be lost due to poor management or even fraud.

Small business found ways to avoid the super charge. Many have already let some of their permanent staff go with no plans of replacing them. Another way of avoidance is using secretarial, bookkeeping, and other services from other organisations instead of employing a staff member for that purpose. Many businesses are using casuals only to the threshold of the super charge. Some will simply resort to paying cash wages without additional benefits to avoid the paperwork as well as the cost.

The SGC legislation is in place and probably will not change in any significant way from a small business perspective. So what can be done to reduce the negative impact on small business? One option that should be met with some approval by the small business sector would be to make super contributions for new employees retroactive after a 3 month trial period. The costs are large (in terms of paper work and actual cost) to a small business to hire a new employee who works only a month or two and then leaves. Putting legislation in place that will ensure unclaimed funds are used for retirement benefits only, would at least give employers the security of knowing what they are paying for and how it would be used. The most obvious use of unclaimed funds is to use them as a safety net in case of fraud or the collapse of a specific fund. After all, the purpose of the SGC is to ensure retirement funding is met from sources other than the old age pension.

The survey we conducted early in 1992 was essentially a pilot project and we are about to move into the second stage. Last year we developed a format that works extremely well for telephone interviews. We were able to collect a great deal of information that is typically very difficult to obtain from small business, such as annual turnover. The second stage of our research will

again examine the impact of the SGC on small business as well as studying options that can reduce some of the negative impact on small business.

We have partially tested our stage two survey instrument on a small sample of Gold Coast businesses. Pre-test results highlight issues we need to address to help reduce the negative impact of mandatory super contributions (see below) on small business in a continuing tough economic climate.

1. Mandatory superannuation contributions are an extra and unnecessary burden to be forced upon businesses who are facing tough economic Times.
2. There is a feeling by employers that individuals should be responsible for their own future and at the very least the employees should be bearing the burden of any contributions on an equal basis with their employers.
3. Due to fund charges, legislative changes, and taxes - there is an uncertainty, if not a fear, that the return to the fund owner maybe very poor and may not be sufficient to fund retirement. In relation to poor returns there is a perception that super is an extremely unsafe form of investment (considering the case of Occidental Real Life Offices). Additionally it locks up capital that the individual cannot access to take advantage of more lucrative investment opportunities. It also locks up capital that a business proprietor may have been able to use to fund expansion and employment creation.
4. Casual employees and employees who leave their employer after a few weeks creates an enormous paperwork burden for the business and the employee ends up with very small amounts of money in multiple super funds. There is a question of any benefit accruing to anyone in this case except for the super fund managers.

5. There was also a feeling that the principals and purpose behind the superannuation system will be defeated if the government approves use of super funds for other purposes.

We will continue with our original format using telephone interviewing methods.

APPENDIX 1

SURVEY RESULTS (number of respondents n = 205)

RESPONSES BY SMALL BUSINESS OWNERS - pilot study 1992 (before July 1)

1. What percentage of your income do you contribute to your personal super fund?

0%	14.9%
1-3%	27.7%
4-10%	27.7%
11-20%	10.6%
amount of contribution is based on profit	14.9%
would not indicate amount	4.2%

2. Do you contribute at least 3% superannuation for full time employees?

no	17%	(if "no", question 3 was asked)
yes	83%	(if "yes", question 4 was asked)

3. Do you know about the Superannuation Guarantee Levy requirements?

yes	12.8%
no	4.2%

(skip to question 11 for respondents who answered no)

4. Are your employee contributions going to an employer sponsored fund or an industry fund?

employer sponsored funds	46.8%	(ask question 5)
industry super funds	36.2%	(go to question 6)

5. Is your employer sponsored fund self managed or externally managed?

self managed	8.5%
externally managed	38.3%

6. How did you choose your superannuation fund?
- | | |
|--|-------|
| banker | 10.6% |
| insurance companies | 19.1% |
| financial consultant | 2.1% |
| accountant | 6.3% |
| industry/trade association,
professional society, union | 29.8% |
| other | 14.9% |
7. How hard is it to understand the existing award superannuation requirements?
- | | |
|------------|-------|
| impossible | 12.8% |
| difficult | 25.5% |
| manageable | 31.9% |
| easy | 12.8% |
8. What actions did your business need to take to meet the cost of the mandatory 3% contributions?
- | | |
|--------------------------------|-------|
| no action taken | 40.4% |
| raised prices | 8.5% |
| reduced employees | 12.8% |
| reduced profit margins | 12.8% |
| re-evaluated business position | 10.6% |
| expanded the business | 6.4% |
| cut cost | 8.5% |
| closed business | 2.1% |
- (this was a multiple response question)
9. Are you aware of the changes that the Superannuation Guarantee Levy will have on super contributions from July 1992?
- | | | |
|-----|-------|-----------------------------|
| no | 29.8% | (if "no" go to question 11) |
| yes | 53.2% | |

10 What actions do you think you will need to take to meet the changes from the new Superannuation Guarantee Levy?

no action necessary	17.0%
don't know	4.3%
will raise prices	12.8%
will reduce employees	14.9%
will reduce profit margins	4.3%
will make the employee pay	2.1%
will try to expand business	2.1%
will re-evaluate business position	2.1%
will try to cut cost	10.6%
will close the business	2.1%

(this was a multiple response question)

11. Are you aware of the new superannuation option that will be available under proposed GST or Goods and Services Tax package?

no	74.6%	(if "no" go to question 13)
yes	14.9%	
yes, but not in detail	10.6%	

12. Do you think you would prefer the new GST super option or the current Superannuation Guarantee Levy?

GST superannuation option	10.6%
Superannuation Guarantee Levy	2.1%
neither	2.1%
can't compare them	10.6%

13. What type of business are you in?

34.03%	retailing (e.g. fruit & vege, take-away, boutiques, video hire)
2.13%	wholesale
6.38%	manufacturing
4.26%	personal services (e.g. hairdressers, laundries)
12.80%	construction (e.g. building and trade)
2.13%	finance, investment, & insurance (e.g. investment cons.)
8.51%	property services (e.g. rental properties, surveying)

- 17.00% business services (e.g. accounting, legal, data processing)
- 8.51% health, education, welfare, and community services
- 2.13% transport and storage
- 2.13% communication service (e.g. postal, telegram, telephone)

14. What kind of business structure do you operate under?

- sole trader 8.5%
- partnership 31.9%
- company (incorporated) 57.4%
- other 2.13%

15. How long have you been in this business?

- < 1 year 6.4%
- 1 - 2.99 years 2.1%
- 3 - 5.99 years 12.8%
- 6-10.99 years 23.4%
- > 11 years 55.3%

16. How many full time employees work in your business (including yourself)?

- 1 - 2 employees 8.5%
- 3 - 5 employees 42.6%
- 6 - 10 employees 31.9%
- 11-19 employees 0.5%
- 20-99 employees 8.5%

17. How many part time employees work in your business?

- none 46.8%
- 1 - 2 employees 34.0%
- 3 - 5 employees 14.9%
- 6 - 10 employees 4.3%

18. What is your gender?

- male 91.5%
- female 8.5%

19. What is your age?

21 - 30	2.1%
31 - 40	40.4%
41 - 50	38.3%
51 - 60	19.1%

20. What is the highest level of education you have completed?

< year 10	2.1%
complete year 10	8.5%
between year 10 - 12	4.3%
high school certificate	29.8%
trade/apprenticeship certificate	8.5%
advanced certificate	4.3%
diploma	2.1%
bachelors degree	10.6%
post graduate studies	7.0%
post graduate degree	8.5%
	4.3%

21. Which of the following ranges best describes your annual sales?

\$50,000 - \$100,000	8.5%
\$101,000 - \$200,000	10.6%
\$201,000 - \$500,000	31.9%
\$501,000 - \$1 million	23.4%
\$1 million & 1 - \$5 million	21.3%
> \$5 million	2.1%
refused to answer	2.1%

Figure 1

	ASC	ISC
Regulatory Responsibilities (30 June 1991)	892, 749 companies	166 general insurance 56 life insurance 904 general insurance brokers 46 life brokers 100,000 super funds
Appropriation (1991/92)	\$129.62m	\$14.59m
Number of Offices (30 June 1992)	HO: Melbourne 22 regional	HO: Canberra 2 regional

FUNDING RETIREMENT IN AUSTRALIA

(supervision structure)

RBA -> Banks and near banks <----- AFIC

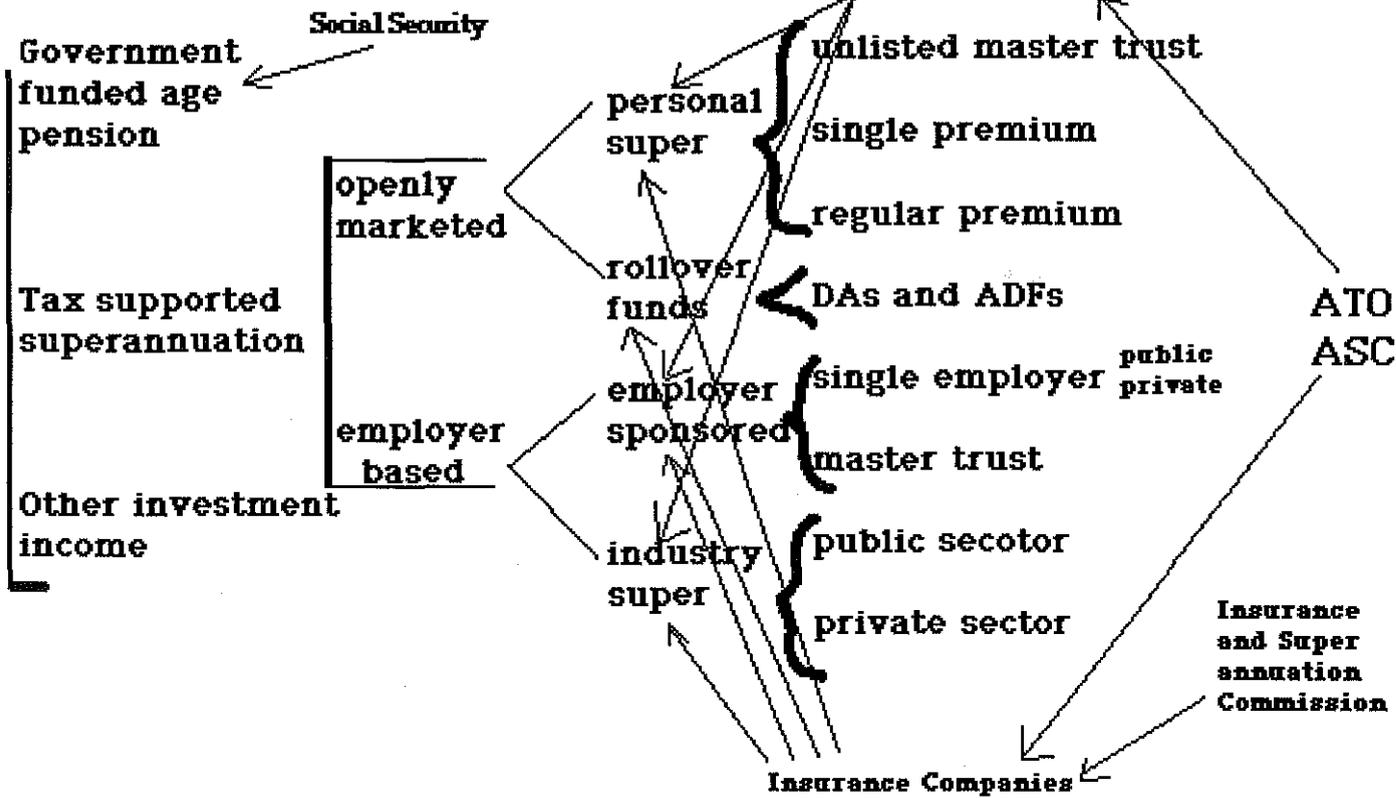


Figure 2

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