



# Reforming the Fair Entitlements Guarantee (FEG) scheme

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## FINANCIAL POLICY BRIEF

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The deficiencies of the Fair Entitlements Guarantee (FEG) Scheme and its predecessors have been apparent ever since the first predecessor scheme (General Employment Entitlements and Redundancy Scheme- GEERS) was introduced in 2001 following a number of large high profile insolvencies (including Ansett). Legal changes proposed to improve the operation of the scheme, as proposed by the current consultation<sup>1</sup>, are warranted. But by focusing only on employee entitlements they miss a bigger, more general, problem (of which non-payment of employee entitlements is a subset), and alternative solutions.

That larger problem can be readily seen by noting that employee entitlements can be thought of as a form of trade credit provided by employees to their employer. Certain payments due are deferred (mostly involuntarily) with no explicit interest paid for provision of that credit. In this regard, employees are in the same situation as other trade creditors who receive deferred payment for supplies of goods and services and face the risk of non-payment. There are many instances where such creditors suffer loss from non-payment, threatening the viability of their businesses – and in turn their ability to make payments to their employees.

The question thus arises of why it is only these forms of “trade credit” for which a compensation scheme exists? The explanation is partly political, but also likely reflects the assumption that other trade creditors are better able to protect themselves against non-payment and suffer relatively less harm than employees (who also lose their current source of income from loss of employment).

Regardless of the validity of that assumption, it is worth considering whether a more general policy approach is warranted. This is particularly the case given a potential trend (facilitated by technological advances) towards labour to be engaged as individual independent contractors rather than employees. Contractors are excluded from coverage by the FEG scheme. As at August 2016 there were approximately 1 million Australians working as independent contractors (about 9 per cent of all employed persons).<sup>2</sup>

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<sup>1</sup> Australian Government *Reforms to address corporate misuse of the Fair Entitlements Guarantee scheme* Consultation paper May 2017 [https://docs.employment.gov.au/system/files/doc/other/consultation\\_paper\\_-\\_reforms\\_to\\_address\\_corporate\\_misuse\\_of\\_the\\_feg\\_scheme.pdf](https://docs.employment.gov.au/system/files/doc/other/consultation_paper_-_reforms_to_address_corporate_misuse_of_the_feg_scheme.pdf)

<sup>2</sup> Australian Bureau of Statistics *Characteristics of Employment, Australia, August 2016* (Cat No 6333.0)

Another notable omission from coverage under the FEG scheme is coverage of unpaid superannuation contributions under the superannuation guarantee. While the amounts owing get higher priority (equal to employee entitlements) than other creditors in an insolvency situation, this provides no compensation when there is a shortfall of funds available. Personal liability of directors for meeting such shortfalls should provide incentives for ensuring such payments are made, and create potential for receiving some compensation, but the extent to which these measures limit such unpaid obligations is unclear. There are no apparent public data available on the extent of unpaid super obligations by failed companies, although a 2010 estimate put the amounts owed by insolvent employers in unpaid superannuation guarantee payments at \$600 million.<sup>3</sup>

It would thus appear that there is at least some case for approaching the issues of unpaid employee entitlements from a more general perspective of protection of “trade creditors”, defined as suppliers of goods and services and labour, against insolvency. It may be that this leads to different approaches for employees versus contractors or suppliers of goods and services, or differential treatment of different types of payments outstanding, but it is not clear that case has been made. Moreover, it is not apparent that a compensation scheme, rather than some form of insurance scheme or other approach is optimal.

Among the issues which could be addressed are the following.

## Priority of Entitlements

In 2001 a *Maximum Priority Proposal* for employee entitlements was announced in parliament, but subsequently rejected in 2004. This would have given employees entitlements over secured creditors as well as unsecured creditors. While the current consultation considers clarifying priority over “circulating security interest holders” (one group of secured creditors) it is not clear why this should not extend to all secured creditors. This was examined by Andersen and Davis (2009)<sup>4</sup> who concluded that there were strong arguments for implementing such a maximum priority proposal.

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<sup>3</sup> Arthur Athanasiou and Mark Gioskos “Ashes to ashes ... the Phoenix no longer rises” *Taxation in Australia*, September 2012.

<sup>4</sup> Jeanette Anderson and Kevin Davis "[Employee Entitlements and Secured Creditors: Assessing the Effects of the Maximum Priority Proposal](#)" *Australian Journal of Management*, 34, 1, June 2009, 51-72.

## A Deferred Benefit Account Scheme

Burrows and Davis (2002)<sup>5</sup> reviewed a number of alternative ways of reinforcing an employee entitlements guarantee scheme to reduce the taxpayer cost and argued for a Defined Benefits (DB) Account Scheme. The DB scheme would require “employers to maintain balances at least equal to reasonable aggregate provisions for entitlements in designated DB accounts at financial institutions”. As proposed by them requiring monthly provisioning, the scheme would only effectively cover annual and long service leave, and not unpaid wages due to a sudden insolvency.

Davis (2009)<sup>6</sup> argued that these approaches are not alternatives but could be part of a more general approach which aims to reduce moral hazard, provide increased managerial incentives and reduce taxpayer cost of an employee entitlement guarantee scheme.

## An Insurance Scheme

Recognising that employees and contractors are involuntary creditors of employers points to the possibility of establishing a funded insurance scheme to cover such creditors, rather than simply having a tax-payer funded guarantee scheme as currently exists. By requiring regular (monthly) contributions by employers into such a fund which are based on assessed risk of future payouts from the fund, costs to taxpayers could be significantly reduced. Moreover, appropriate risk-based pricing could reduce moral hazard and provide appropriate employer incentives. Such risk based pricing could take into account risk mitigation techniques of the employer – such as establishment of a DB account scheme, or obtaining a bank guarantee or other form of private insurance over unpaid entitlements.

This would provide a complement to privately provided trade credit insurance paid by businesses supplying goods and services to insure their accounts receivable from other businesses. This is not generally available to employees who are also “trade creditors” with “accounts receivable” in the form of unpaid entitlements, reflecting issues of scale, information asymmetries, and employee understanding. Whether such schemes provide adequate risk management options for contractors and suppliers of goods and services to firms (or whether such creditors appropriately utilise such insurance) are unclear. Were an insurance scheme established, as outlined above, it could in principle also offer the facility for such trade creditors to separately apply, and pay, for insurance.

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<sup>5</sup> Geoffrey Burrows and Kevin Davis [Protecting Employee Entitlements](#) *Australian Economic Review*, 2003, 2

<sup>6</sup> Kevin Davis [Employees as Creditors: Protecting their Claims](#) *Flinders Essays in Economics and Economic History: A Tribute to Keith Jackson Hancock, Metody Polasek and Robert Henry Wallace* (ed R Schlomovitz), 2009, Wakefield Press, KentTown

## Conclusions and Recommendations

The proposed changes to improve the operation of the FEG scheme focus on modifications to legal arrangements to prevent abuses which exploit the “free” insurance provided and increase consequences for those who attempt to exploit the system. While of merit, such actions can be interpreted as attempting to deal with the symptoms of an unsatisfactory system rather than focusing on modifying that system. In particular, providing “free insurance” in the form of a government guarantee invites moral hazard and increases the cost to the taxpayer of such a scheme. Some of the suggestions advanced in this paper warrant consideration as part of a more thorough review of how to overhaul the system. These go beyond the purely legal issues considered in this consultation and to the economic and financial incentive structures involved in such a scheme. As part of any such review – but also relevant to this current consultation – serious consideration should be given as to why unpaid superannuation contributions and individuals employed as contractors should be excluded from the scheme.

*This Financial Policy Brief was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies*

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