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**Book**

# Embracing a super model : the superannuation sky is not falling

ECONOMIC POLICY

# EMBRACING A SUPER MODEL

## The superannuation sky is not falling

**Jenesa Jeram**
**Foreword by Michael Littlewood**

THE NEW ZEALAND INITIATIVE



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### About the New Zealand Initiative

The New Zealand Initiative is an independent public policy think tank supported by chief executives of major New Zealand businesses. We believe in evidence-based policy and are committed to developing policies that work for all New Zealanders.

Our mission is to help build a better, stronger New Zealand. We are taking the initiative to promote a prosperous, free and fair society with a competitive, open and dynamic economy. We are developing and contributing bold ideas that will have a profound, positive and long-term impact.

## ABOUT THE AUTHOR

Jenesa Jeram is a Research Fellow at The New Zealand Initiative focusing mainly on social issues, welfare and lifestyle regulations. Since starting at the Initiative as a research assistant in 2013, Jenesa has written and co-authored many reports on a range of topics.

Her reports *The Health of the State* and *Smoke and Vapour* discussed the evidence and ideology behind certain public health regulations, including smoking and sugar taxes, and continue to receive acclaim in New Zealand and overseas.

Jenesa has presented at several conferences, and she has been on television and radio. Her opinion pieces have also been widely published, including in *The New Zealand Herald*, *Stuff*, *The Spinoff* and *The Otago Daily Times*. Her writing is occasionally witty.

She has a Bachelor of Arts with first class Honours from the University of Otago, majoring in politics, philosophy and economics.

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# Foreword

There is a lot to like about this report because the author celebrates what's good about New Zealand Superannuation (NZS). New Zealand has one of the best Tier 1 public pension schemes in the developed world, but we got here by accident. We need to look at what we do and what we can do better. As the report emphasises, it's not just about NZS and its recipients but also about other community interests. The long-term sustainability of any pension system ultimately depends on community consensus, so this wider view is essential.

I used to think New Zealanders should be forced to save for retirement and that NZS should be income/asset-tested, as in Australia. I just assumed tax breaks for private provision were a good idea. My 15 months on the 1992 Task Force for Private Provision changed my mind on all these because of the evidence presented to me. I now think the government should deliver the 'best' Tier 1 pension possible, within acceptable, long-term spending limits, and should then level the tax and regulatory playing fields for private provision. This report looks at the first leg of that double; I hope The New Zealand Initiative turns its attention to the second leg.

Michael Chamberlain and I published "The Missing 2016 Review" in 2017, and this report draws on some of our comments. One of our major laments was the absence of good, long-term data on issues associated with nearly all the things that matter in discussions on financial provision for retirement. We don't even know what proportion of New Zealand's dwellings are occupied by their owners, or whether that proportion is falling. Great data featured as #2 on our list of nine essential priorities (after policies that enhance economic growth).

So it is with NZS. We identified the 13 benefit design components that go to make up today's NZS. New Zealand has never had a research-led debate about any of those components. We have had any number of reports on NZS' future but none has ever looked properly at every single aspect of the scheme's design, considering each element's design and analysing alternatives. That shortfall is partly because we don't have the data to answer the questions that need answering. We identified those 14 questions about NZS in "The Missing 2016 Review" (along with another 111 questions about other things we need to know).

This report concludes that NZS in its present form is sustainable. I agree – and also agree that this is no reason to keep what we have, though it's a nice 'problem' to have. Sure, we have the best Tier 1 scheme in the world, but it can definitely be made better. 'Better' might also mean 'cheaper' but that doesn't necessarily follow – nor does it need to.

**Michael Littlewood**
Principal Editor, www.PensionReforms.com
Honorary Academic, Retirement Policy and Research Centre
University of Auckland

# Headline Collage

Super Fund contributions secure generational legacy[1]

**Generation Doom fear for NZ Super**[2]

*"Many young people don't believe NZ Super will be there when they eventually retire."*

Kiwis must save to avoid 'fiscal timebomb'[3]

**NZ sitting on superannuation timebomb: Treasury**[4]

NZ baby boomers are building a banana republic, and no one gives a shit[5]

*"This isn't a question of economic theory. It's a question of maths."*[6]

**'Do the maths, it's unaffordable': former chief economist returns to commentary**[7]

*"No one's talking about it. As an issue it's disappeared but it's an issue that the longer we defer don't do anything the greater the cost is going to be on the next generation."*

**NZ superannuation unaffordable – expert**[8]

*"It should be a warning that New Zealand is now the only country still paying a universal superannuation regardless of the asset wealth or income of the recipient…All other countries have changed their system because it is simply unaffordable."*

*"We are going to have to save more from our own resources and rely less on government."*[3]

1. Grant Robertson, "Super Fund contributions secure generational legacy," Labour Party, Press release (14 December 2017).
2. Rob Stock, "Generation Doom fear for NZ Super," *Stuff.co.nz* (3 May 2015).
3. NBR Contributor, "Kiwis must save to avoid 'fiscal time-bomb'" *The National Business Review* (21 May 2012)
4. Claire Trevett, "NZ sitting on superannuation timebomb: Treasury," *NZ Herald* (30 October 2009).
5. David Seymour, "NZ baby boomers are building a banana republic, and no one gives a shit," *The Spinoff* (28 November 2016).
6. ANZ's chief economist Sharon Zollner in Jason Walls, "Treasury boss Gabriel Makhlouf says the age of superannuation entitlement 'probably should increase' to help manage what an economist calls NZ's 'looming fiscal time-bomb'," *Interest.co.nz* (1 June 2018).
7. Cameron Bagrie in Hamish Rutherford, "'Do the maths, it's unaffordable': former chief economist returns to commentary," *Stuff.co.nz* (13 February 2018).
8. "NZ superannuation unaffordable – expert," *NZ Herald* (3 July 2017).

# Executive Summary

> *The question of providing pensions for the deserving aged is a subject which has puzzled the leading minds of the age. It is a problem that has engaged the attention of thinking men of the day, and of days gone by, and in the Mother-country it has been practically admitted that they are unable to deal with it in a satisfactory manner.*[1]
> —Premier Richard Seddon (1898)

There is a lot to celebrate about New Zealand's universal public pension system. It is simple, efficient, and relatively cheap, while protecting our elderly from material hardship. To date, the pension system has proved both effective and affordable.

But it is also clear New Zealand's publicly funded pension scheme – New Zealand Superannuation (NZS) – will cost more as our population gets older and lives longer. The dependency ratio of the population aged 65 and over to the working-age population (15–64 years) will rise from 20 per 100 in 2011 to 39–51 per 100 in 2061.[2] If no changes are made now to spending, taxes or responses to debt, the gross cost of NZS is projected to rise from around 5% in 2015 to 8% in 2060.[3]

New Zealand is not alone in facing an ageing population and the associated future fiscal pressures. Other countries have introduced pension system reforms to ease fiscal pressures, and there are plenty of opinion pieces urging New Zealand to do the same.

However, this report argues that the policy conversation is much more complex in New Zealand than as portrayed in the media.[4]

First, the laudable aspects of NZS are rarely acknowledged in public conversation today. This is a great shame, as radical reform risks losing the best parts of the model. Second, the best evidence at hand does not point to an inevitable or looming fiscal crisis for NZS but does suggest the current levels of taxes and/or spending will need to change. Third, the future regressivity of NZS as a redistributive tool is a more pressing concern than the future affordability of NZS.

As the population ages, NZS has the potential to direct a greater proportion of government spending from the poor to the relatively wealthy, or from those in need to those who are able to financially support themselves. NZS might technically be affordable, but the opportunity costs of its funding must be considered – especially if taxpayers' money could be spent more efficiently, or directed to more needy groups.

This report recommends tweaks to NZS that preserve the best parts of the model while managing the concerns that NZS might increasingly become a tool for regressive redistribution:

- Link the pension age to health expectancy to maintain a relevant relationship between retirement and receiving NZS.
- Index NZS to CPI only rather than CPI and wages. This will ensure gains from productivity growth are not eroded by rises in the cost of NZS.

1. Richard Seddon, "Old Age Pensions Bill," *New Zealand Parliamentary Debates* (1898), 535.
2. Statistics New Zealand, "National population projections: 2011(base)–2061," Website (accessed October 2018).
3. New Zealand Treasury, "He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2016).
4. See headlines collage for some illustrative examples.

- Contributions to the NZ Super Fund should not come at the expense of paying down debt.

This report recognises that the future 'affordability' of public services and welfare benefits is based not only on the costs of these services but also the size of the economy. This report recommends putting greater emphasis on productivity growth as the means of affordability, rather than being distracted by red herrings such as the NZ Super Fund.

Because NZS is currently the main source of income for most retirees in New Zealand, this report focuses on the long-term sustainability of that entitlement. However, other sources of retirement income (and the policies that incentivise/disincentivise investment) also affect reliance on NZS.

Finally, although warnings that the superannuation sky is falling are most likely to grab headlines, grappling with pensions is by no means a new issue. Since its inception, the public pension has been the subject of political debate. And so it should be. The pension will ultimately reflect the preferences of the voters and the economic constraints of the day. But signalling small changes that can make a measurable difference, and signalling those changes well in advance, increases the likelihood that the policies made today will stick.

Chapter 1 gives a brief history of the pension in New Zealand and describes how different value judgments can lead to different policy preferences for NZS.

Chapter 2 highlights the aspects of NZS that are worth celebrating. These include NZS' contribution to low material hardship rates, how NZS is more affordable, simpler and more efficient than pension schemes in many OECD countries, and the mechanisms for fiscal prudence to ensure NZS costs do not result in debt spirals.

Chapter 3 looks at possible future issues with the NZS by examining how the demographics might change in the future, and the future costs of NZS if historical trends continue. But these projections entail a degree of uncertainty, and there are risks and benefits in waiting to see what happens.

There is an additional future concern apart from affordability. Public choice helps explain the electoral incentives political parties respond to, and why political expediency may trump economic efficiency. Expected changes in voting demographics only exacerbate this dilemma. The problem is not affordability but the risk that NZS may become an increasingly regressive redistributive tool.

Chapter 4 makes policy recommendations on tweaking NZS in specific areas to preserve the best parts of the model while managing the risk of regressive redistribution.

This report recommends two changes to NZS to ease regressivity issues in redistribution without radically changing incentives: raising the age of NZS eligibility by linking it to health expectancy, and adjusting NZS to the CPI rather than CPI *and* wages.

Chapter 5 makes broader recommendations on how to ease the affordability of NZS. Though there might be a perception that the NZ Super Fund will help meet the future costs of NZS, the Fund is a red herring. The Fund will not reduce the future costs of NZS or make it more affordable, and governments should pay down debt before resuming contributions to the Fund. Meanwhile, greater and sustained productivity growth can make NZS more affordable in the future.

The report concludes that conversations about NZS affordability and reform have largely distracted from a different issue: the opportunity costs of preserving the NZS model as it exists today. Just because we can afford NZS now does not mean it will be the best redistribution of resources in the future.

CHAPTER 1

# The life of a Super model

## 1.1 A short history of the public pension

The basis of New Zealand's public pension system can be traced to the *Old Age Pensions Act 1898* introduced by Premier Richard Seddon. The pension "was the only strictly 'welfare' measure of any lasting importance in the first period of legislative activity in the [eighteen] nineties,"[5] and was funded by general taxation.

The age of eligibility under the original pension system was 65. Unlike today, the system itself was far from universal, covering just over a third of the 65-plus population.[6] It was incrementally extended to include widows, Māori war veterans, miners and the blind.[7]

Eligibility was asset and income tested, and based on a 'good character' test. The 'good character' test excluded criminals, drunkards and wife deserters, thus making a judgment between the deserving and undeserving poor.

There were few elderly people in New Zealand's early days, with those aged over 65 comprising only 1.3% of the Census population in 1881. With the average life expectancy for males being 54, fewer than half were expected to reach the pension age of 65.[8]

The *Old Age Pensions Act* signified a shift in welfare policy in New Zealand from one largely based on personal and communal responsibility to government provision. Historian David Thomson describes some 'unease' with the pension but little strong opposition: "Most hesitation centred on the fear that core social values, of self-reliance and thrift, were being abandoned, with ruinous consequences for individuals, families and nation."[9]

The purpose of the Act, as set out in the preamble, was as follows:

> Whereas it is equitable that deserving persons who during the prime of life have helped to bear the public burdens of the colony by the payment of taxes, and to open up its resources by their labour and skill, should receive from the colony a pension in their old age.[10]

From the outset, the purpose of the Act caused confusion. Criticism was aimed at the varying interpretations of what constituted "deserving," as well as whether need or merit was the predominant criterion for eligibility.[11] Based on a study of parliamentary records and other historical documents, Gaynor Whyte found that two major points caused tension: poverty and merit were seen as contradictory, and the

5. A.H. McLintock (ed.), "History of Monetary Benefits," from An Encyclopaedia of New Zealand, *Te Ara – The Encyclopedia of New Zealand* (1966).
6. David Preston, *Retirement Income in New Zealand: The Historical Context* (Office of the Retirement Commissioner, 2008).
7. A.H. McLintock (ed.), "History of Monetary Benefits," op. cit.
8. David Preston, *Retirement Income in New Zealand: The Historical Context*, op. cit.
9. David Thomson, *A World Without Welfare: New Zealand's Colonial Experiment* (Auckland: Auckland University Press with Bridget Williams Books, 1998), 162.
10. Old-age Pensions Act 1898 (62 VICT 1898 No 14).
11. Gaynor Whyte, "Old-age pensions in New Zealand 1898–1939," Master of Arts in History thesis, Massey University (1993).

notion of the pension as a form of reward further complicated understanding.[12] Even the use of the term 'pension' was controversial as some argued it was deliberately done to differentiate the payment from the more 'shameful' beneficiaries of charity.[13]

In 1911, a National Provident Fund was set up as a voluntary contributory scheme, but also subsidised by the government. Contributions to the Fund could be used to provide pensions from age 60 (which was an earlier age of eligibility than the public pension), as well as other benefits. However, the Fund purportedly only enjoyed limited success, as historian Michael Bassett argues:

> The bulk of New Zealanders were demonstrating that they were not particularly provident, believing by this time that the State, in times of need, would probably provide at least minimal support. The public's growing confidence in the State was not misplaced.[14]

The *Social Security Act 1938* extended and increased pensions, and withdrew the means test for superannuation and medical benefits. Importantly, the term '[welfare] benefit' was substituted for 'pension' and 'allowance' to emphasise the contributory nature of the health service (where contributions to the health service were levied on income, but entitlements were not linked to contribution).[15] An Age Benefit was also introduced which would be income tested and payable to those over 60. The Age Benefit was not taxed, but the pension was.

National Superannuation was introduced in 1977 to replace the dual Age Benefit/universal pension system, and provided the basis of the present system.[16] National Superannuation was payable at age 60, and the gross rate was 70% of the average ordinary weekly wage (to be increased to 80% from August 1978) for a married couple, and 60% of the married rate for a single person.[17] These rates have varied over the years to keep the pension affordable at the margin, though:

> … the spend and nature of the changes also produced considerable public concern over pension issues, a period of intense review of policy alternatives, and a search for political consensus on a more stable longer-term pension policy.[18]

The age of eligibility for National Superannuation was gradually increased from 60 in 1992 to 65 in 2001. The period 1991–2001 saw a sharp rise in labour force participation rates for older people.[19] Some of this rise would have involved people immediately affected by the rise in eligibility age, and who did not have a 'cushion' of private savings to allow them to retire at the original, earlier age.[20] However, this response may not necessarily be repeated in the future if there are differences in households' private savings accumulation, or if changes are announced with enough warning.

Today, the pension, known as New Zealand Superannuation (NZS), is paid to those who are over 65 and meet the citizenship/residency requirements. New Zealand's relatively low levels of elderly poverty have largely been attributed to the availability of NZS. It is not means tested, so

12. Ibid.
13. Ibid.
14. Michael Bassett, *The State in New Zealand: Socialism Without Doctrines?* (Auckland: Auckland University Press, 1998), 100.
15. A.H. McLintock (ed.), "History of Monetary Benefits," op. cit.
16. Ministry of Social Development, "Description of New Zealand's Current Retirement Income Policies," Periodic Report Group 2003 Background Paper (Wellington: 2003).
17. Ibid.
18. David Preston, *Retirement Income in New Zealand: The Historical Context*, op. cit.
19. Roger Hurnard, "The effect of New Zealand Superannuation eligibility age on the labour force participation of older people," Working Paper 05/09 (Wellington: New Zealand Treasury, 2005).
20. Ibid.

it also has the advantage of not disincentivising work. That being said, employment while receiving NZS does affect income tax rates, and therefore the total compensation received in-hand.

NZS is indexed to the CPI and the average ordinary time wage. Though there were some back-and-forth policy changes in the 1990s on the 'floor' of the pension to wage ratio, it has generally been around 65–66% after tax of the after-tax average ordinary time wage.

Another significant change that affects the cost of NZS are changes in the top income tax rates. The top tax rate when National Superannuation was introduced in 1977 was 60% and increased to 66% in the early 1980s.[21] Today, the top income tax rate is 33%. The top tax rate affects the amount of tax revenue collected by the government to pay for public services (including NZS), and the proportion of wages from employment that can be retained (creating incentives/disincentives to work).

A possible way of addressing the effects of redistribution to the wealthy is through a surcharge. An NZS surcharge was applied from 1985 to 1998 to other income so that the amount received by NZS was abated. The application of the surcharge meant zero percent of gross NZS was retained by the top income earners. The surcharge effectively acted as a kind of means testing, but it had perverse consequences. As Don Brash argues:

> The surcharge was so deeply resented by those who felt that they were being penalized for prudently making provision for their own retirement – often after paying relatively high income taxes during their working lives – that there were quite determined efforts to avoid paying it. And avoiding the surcharge wasn't terribly difficult, so that for many people the surcharge became a voluntary tax.[22]

A determined effort to avoid the surcharge is purportedly one of the main reasons for the rise of family trusts in the 1990s.[23] This is just one example of how NZS policies, particularly means-testing policies, can entail perverse incentives.

The NZ Super Fund was set up in 2001 with the stated goal "to smooth the costs of the demographic transition to an older age structure, with the aim of pre-funding emerging New Zealand Superannuation entitlements."[24] The Super Fund would invest taxpayer contributions to partially pre-fund the future costs of NZS to smooth the future net fiscal costs of NZS over time.[25] Contributions would be funded by taxpayers, but subject to political discretion. For example, the National-led Government paused contributions for eight years to get the government's books back into surplus after the fiscal costs of the Canterbury earthquakes and the Global Financial Crisis.

The Treasury is required to calculate an annual capital contribution to the Fund required from the Crown. It is calculated "at the rate that, if

21. Retirement Policy and Research Centre (RPRC), "Universal New Zealand Superannuation and Tax: Implications for Sustainability," Pension Briefing 2009–5 (Auckland: University of Auckland Business School, 2009).

22. Don Brash, "Challenges for New Zealand's Future Pension System," Speech to the Asset Allocation Summit in Auckland (21 June 2010).

23. Martin Hawes, "Can we rely on NZ Superannuation?" *Stuff* (7 June 2015).

24. Commission for Financial Capability (CFFC), "Focusing on the Future: Report to Government" (Auckland: 2013), 17.

25. David Preston, *Retirement Income in New Zealand: The Historical Context*, op. cit.

the same rate of contribution (as a percentage of GDP) was to be provided over the next 40 years, would be enough, along with the accumulating Fund and its investment returns, to meet the expected cost of New Zealand Superannuation entitlements over that forty year period."[26] Yet provisions in the *New Zealand Superannuation And Retirement Income Act 2001* allow government to contribute a lesser amount. The government will begin drawing from the Fund from around 2035/36. However, the Fund is not projected to peak in size until the 2080s.[27]

A final event of note in New Zealand's retirement income policy landscape is the establishment of the Commission for Financial Capability (CFFC) in 1995 (then referred to as the Retirement Commission)[28] and overseen by the Retirement Commissioner. Among various functions, the Retirement Commissioner reviews the country's retirement income policies every three years.

This report refers extensively to the Commission's most recent review in 2016 and the 2013 review, which is more comprehensive and better referenced.[29] Also referred to extensively is the substantive reply to the Commission's 2016 review by actuary Michael Chamberlain and pension researcher Michael Littlewood.[30]

26. The New Zealand Superannuation and Retirement Income Act 2001 paraphrased in Guardians of New Zealand Super Fund, "The NZ Super Fund and the Partial Pre-Funding of Universal Superannuation" (Auckland: Commission for Financial Capability, 2016), 7.
27. Treasury model figures cited in the Commission for Financial Capability (CFFC), "Focusing on the Future: Report to Government," op. cit.
28. The Commission for Financial Capability (CFFC) has undergone several name changes since its inception, namely, the Centre for Financial Literacy and Retirement Income and the Retirement Commission. For the sake of simplicity this report refers to all iterations by the current name, though many still prefer to refer to the office as the Retirement Commission.
29. Commission for Financial Capability (CFFC), "Review of Retirement Income Policies" (Auckland: 2016) and "Focusing on the Future: Report to Government," op. cit.
30. Michael Chamberlain and Michael Littlewood, "The Missing 2016 Review: Building Trust for Life Beyond Work" (2017).

## 1.2 Different value judgments lead to different policy preferences

> *Throughout social security [welfare] history the old have gained the most. The community has assumed that the old, more than any other group, suffer hardship, and are worthy, deserving people.*
> —Margaret McClure [31]

Deciding whether changes to NZS need to be made, when those changes need to be made, and what changes need to be made ultimately depends on societal values. These complexities help explain why retirement policy has been – and remains – such a contentious topic.

Evidence will, of course, inform policy design. But not all policy preferences can be empirically tested. For example, a policy for preventing poverty in old age would need to assess the income required for a minimum standard of living, and judgments would need to be made on whether administering a benefit based on need (means-testing) is more effective and cost efficient than a universal benefit when administration costs are taken into account. But unless a judgment is made on what NZS should achieve and what societal values it should reflect, it is impossible to determine what evidence is needed in the first place.

Treasury outlines several policy options that could reduce future costs. And these costs need to be considered alongside judgments on who should receive NZS (recipients) and what level NZS should be relative to wages (replacement rate). Table 1 shows these options. There are numerous changes that could be made to the current NZS model. But a decision also has to be made about what percentage of NZS spending and net debt as a ratio of GDP is acceptable.

31. Margaret McClure, "A Civilised Community: A History of Social Security in New Zealand 1898–1998" (Auckland: Auckland University Press, 1998), 260, cited in Kirstie Ross, "Can New Zealand sustain its 119-year-old pension scheme as the population ages?" *Te Papa* Blog (9 March 2017).

### Table 1: Effects of potential NZS changes from 2017 to 2050

| Changes | NZS (% of GDP) | Net debt (% of GDP)[32] | Replacement rate | How to make NZS affordable |
|---|---|---|---|---|
| Current NZS policy | 8.0% | 223% | 33% | (Current policy) |
| Eligibility age rises incrementally to 67 in 2023 | 6.5% | 201% | 33% | Reduces recipients and keeps replacement rate |
| Indexation (CPI + 1 percentage point) | 6.9% | 211% | 28% | Keeps recipients and reduces replacement rate |
| Indexation (CPI only) | 5.0% | 166% | 20% | Keeps recipients and reduces replacement rate |
| Targeting: Top income quartile only receive ½ NZS | 7.0% | 185% | 33% or 17% | Keeps recipients and reduces replacement rate |
| Targeting: Top income quartile receive no NZS | 6.0% | 147% | 33% or 0% | Reduces recipients and reduces replacement rate |
| Lower wage floor from 66% to 60%[33] | 7.4% | 201% | 30% | Keeps recipients and reduces replacement rate |

Source: Matthew Bell, Gary Blick, Oscar Parkyn, Paul Rodway and Polly Vowles, "Challenges and Choices: Modelling New Zealand's Long-term Fiscal Position," Working Paper (Wellington: New Zealand Treasury, 2010).

Note: 1) Current policy: A couple 65 and older receive after-tax payments at least equal to 66% of the after-tax average wage; 2) Net debt uses the historic trends fiscal scenario with only NZS changing; and 3) Replacement rate is the ratio of the before-tax (couple) NZS payment to the before-tax average wage.

As Table 1 shows, a variety of options entailing a variety of outcomes exist.

## The direction of redistribution

Public pensions, like other welfare benefits, require redistribution through the tax system. Some of this redistribution will be directed towards older people who are financially struggling and/or are unable to earn an income to meet a basic standard of living (progressive redistribution). However, some of this redistribution will be directed to people who are relatively well-off: those who have low housing costs, are in a higher salary band, and have accumulated wealth (regressive redistribution and tax churn). Therefore, at least some of the redistribution involved with NZS will be from the relatively poor to rich.

Though not all welfare benefits are a redistribution from rich to poor, there are reasons to be dubious of middle-class welfare (let alone redistribution from poor to rich). Middle-class welfare involves tax churn: Taxpayers receive back some of the taxes they pay in the form of public services or benefits. There are efficiency losses when this happens, and the 'excess burden of taxation' refers to the comparison between the economic costs of a tax, including the costs of behavioural distortions, and the revenue collected by the tax.[34] If efficiency is an important value, then tax churn should be avoided. The middle and upper classes would be better off if they were

32. As will be discussed later in this report, it is highly unlikely that debt levels would ever get that high given the existing fiscal prudence mechanisms. However, these debt projections are useful in a relative sense to understand the impact of different policy changes.
33. Rate is for couples.
34. John Creedy estimated that when the tax rate doubles, the deadweight cost of taxation quadruples. See John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," Working Paper 03/29 (Wellington: New Zealand Treasury, 2003).

**Table 2: Agree it is the government's responsibility to provide and ensure decent living standards (%)**

| | 1990 | 1993 | 1996 | 1999 | 2002 | 2005 |
|---|---|---|---|---|---|---|
| **Elderly** | 94 | 93 | 94* | 93* | 93* | 96* |
| **Unemployed** | 58 | 70* | 67* | 67* | 56* | 61* |

*Unweighted data. Data from New Zealand Election Study 1990, 1993, 1996, 1999, 2002, 2005.

Source: Louise Humpage, "Radical change or more of the same? Public attitudes towards social citizenship in New Zealand since neoliberal reform," *Australian Journal of Social Issues* 43:2 (2008), 215–230.

able to keep more of their own money in their pocket (rather than receiving it back in the form of welfare benefits), and poorer people would be better off as benefits could be better targeted to those in need.

But even if one generally believes that taxes should be redistributed from rich to poor (and not the other way around), means-testing still might not be economically efficient or significantly reduce the fiscal burden. Means-testing might simply incentivise people to exit the workforce earlier than they would in order to receive the pension, or they might go to significant lengths to hide their assets as they did when the highly unpopular NZS surcharge was in effect. The costs of administration might also outweigh potential savings if a majority of those who are eligible for the pension are assessed to be in need.

People will also differ on their views on redistribution. It appears that voters might prefer welfare for the elderly over welfare for other age groups. Results from the New Zealand Election Study (NZES) series show that significantly more respondents agree it is the government's responsibility to provide and ensure decent living standards for the elderly than for the unemployed (see Table 2).

Meanwhile, a different survey of the public's attitudes towards NZS found that 88% of respondents[35] agree or strongly agree that NZS is an earned right, and only 17.23%[36] agree or strongly agree that the government should focus greater attention on meeting the needs of dependants other than the aged.[37]

All this matters for societal values regarding progressive/regressive redistribution. It could be the case that a majority of the public are not concerned about taxes being redistributed to the relatively well-off. Equally, they might not be too worried that the taxes they pay/have paid to receive NZS could have come at the expense of tax cuts to keep more of their own money in their pocket.

But it could also be the case that respondents are not aware of all the relevant information and evidence. This includes the current material hardship statistics where the elderly fare much better than other age groups, information on how people are likely to behave if means-testing were introduced, and the costs of tax churn.

## Personal responsibility

Notions of personal responsibility also matter. Compulsory savings have the potential to reduce the fiscal costs of NZS, and eventually could even render the universal pension unnecessary. Those who believe that individuals should retain the freedom to make their own decisions about

35. N = 512.

36. N = 516.

37. Melodie Jo Gribben, "Social attitudes towards the New Zealand Superannuation Scheme: A manifestation of normative intergenerational justice," Thesis in fulfilment for Master of Arts in Sociology, Massey University (2009).

retirement savings and financial security would argue against compulsory private savings regimes (such as those in Australia or Chile). Meanwhile, those who believe people should be personally responsible for their retirement income and not rely on the government might support compulsory savings regimes. Both arguments for and against compulsory savings appeal to concepts of personal responsibility.

But as this report argues in Chapter 2, pension systems that purport to be private can still rack up significant fiscal costs, and might not be the most economically efficient. This is especially so when transition costs (shifting from a public regime to a private one) need to be taken into account.

Consistency of value judgments must also be considered.

If the major policy concern is that fiscal costs will rise in the future and the costs will be borne by a diminishing pool of taxpayers, then it is surely worthwhile to scrutinise the costs and efficiency of the health system at least as much as NZS. Why is it that health spending does not receive nearly the same amount of scrutiny about sustainability? There may even be the potential for overlap between policy treatment of retirement savings and future health costs. Compulsory savings schemes are one example of how governments might ease fiscal pressures for both pensions and health, by shifting responsibility to the individual.[38] Is there any particular reason it is desirable for individuals to take greater personal responsibility for their retirement income but not their future health costs?

On the other hand, NZS might be viewed as a legitimate claim on taxes paid throughout one's working life. In which case, even those who believe people ought to be personally responsible might make an exception once people reach retirement age.

Helpfully, values regarding compulsion and means-testing have been publicly tested – and have been rejected – in the recent past. One of the most recent key events to elicit public sentiment on NZS changes occurred in 1997 with the referendum on introducing a Compulsory Retirement Savings Scheme (CRSS). The details of the referendum were as follows:

> A Compulsory Retirement Savings Scheme (CRSS) was designed and put to the voters, involving contribution rates rising from 3 to 8 per cent of income between 1997–98 and 2002–03, matched by an "equitable programme of tax cuts". It provided for retirement annuities to be paid at age 65, which were to be purchased from individual contribution accounts with the Government providing capital "top ups" for those who had been unable to reach the required CRSS savings target. Over time the buildup of CRSS annuities was to be matched with a phase down in New Zealand Superannuation.[39]

The reasons for administering the referendum will be familiar: the CRSS could be one solution for easing the future fiscal costs of NZS. The policy solution is more drastic than many of the policy tweaks to NZS that are being proposed today. After a public awareness campaign to communicate the (somewhat complex compared

38. Sir Roger Douglas and Robert MacCulloch propose a model of compulsory savings combined with lower taxes. The savings accounts would fund health, retirement and risk-cover (such as unemployment). The government would still fulfil the role of 'insurer of last resort'. Roger Douglas and Robert MacCulloch, "Welfare: Savings not Taxation," Department of Economics, Working Paper Series 286 (University of Auckland, 2016).

39. David Preston, *Retirement Income in New Zealand: The Historical Context*, op. cit.

to universal NZS) policy design,[40] the CRSS was rejected in the referendum by 91.8% of voters.

This is possibly the best example of the electorate directly revealing their preferences regarding radical change.

### Intergenerational fairness

Judgments about intergenerational fairness also lead to different policy preferences. Intergenerational fairness involves many aspects, including (but not limited to):

- the economic development and technological progress inherited from the previous generation
- the level of public debt inherited from the previous generation
- the level of redistribution between generations
- the care and services different generations receive when they are unable to work (both public and private care)
- the extent to which generations fully fund their own retirement.

Additionally, people might disagree on whether different generations have any obligations or responsibilities to each other at all.

There also needs to be a discussion on what responsibilities, if any, the current government and taxpayers have towards the taxpayers of, say, 2060. Intergenerational equity, after all, is a preference, not an obligation. Besides, if each generation improves on the economic performance and technological developments of the previous generations, then every younger generation is likely to benefit simply from those advancements.

And even for people who are concerned about future generations of taxpayers, it might be worth conceding that decisions made today are not binding (and allowing some flexibility is desirable). Chamberlain and Littlewood argue that rising NZS costs are essentially a problem for the taxpayers of 2060, not the taxpayers of today as the taxpayers of today cannot bind those of tomorrow. The real question, according to the authors, is this:

> … if we worry about what the cost of NZS might be in 2060, why aren't we questioning today's cost? Taxpayers spend a net 4.2% of GDP today – that's more than $11 billion. Is that a good use of taxpayers' money? Have we got the design of NZS right?[41]

Inequality between age groups and the implications of redistribution matter too. As life expectancy and health outcomes improve, NZS will increasingly (it is already doing so to a certain extent) provide transfers to the relatively well-off. As the natural retirement age rises (the age at which people are unable to work), these transfers to the relatively well-off will become even more pronounced.

Rather than focusing on fiscal projections and what changes might be needed in the future, a better starting point might be to question whether the current costs are justified in the government's budget. Costs as a ratio of GDP also matter. Would the rising gross cost of NZS still be of concern if the costs as a percentage of GDP were not rising as fast?

40. Despite being technically complex, the results of a Colmar Brunton Survey found that by the beginning of the referendum voting period, 98% of respondents were aware of the referendum and 83% of respondents believed they knew enough to make an informed choice. David Preston, "The Compulsory Retirement Savings Scheme Referendum of 1997," *Social Policy Journal of New Zealand Te Puna Whakaaro* 9 (1997).

41. Michael Chamberlain and Michael Littlewood, "The Missing 2016 Review: Building Trust for Life Beyond Work," op. cit. 19.

### Universal policy vs individual differences

The place of NZS in the wider welfare system needs to be considered too. Is old age poverty different from other forms of poverty, and if not, what justifies the universal administration of NZS compared with means-testing other benefits?

On the other hand, the NZS model might be the most efficient way of administering the pension if the age of eligibility is strongly linked with an inability to work.

The issue of raising the age of eligibility for NZS is another example where decisions are not clear-cut once value judgments are accounted for.[42] Though general life expectancy has been increasing, a universal approach would not adjust for differences in the health and fiscal costs of different ethnic groups (where those who live longer will draw on NZS for a longer period of time). An argument could be made that the age of eligibility should be adjusted depending on ethnicity-specific life expectancy because that would arguably be more fair (though such an argument disregards variations within ethnicities). However, others argue that such discrimination is undesirable, including the Retirement Commissioner:

> My son's half-Samoan – he gets it [the pension] early or he doesn't, because he's got a palagi mum? You know, what a message to our young Māori and Pacific. What, I'm supposed to tell him he'll get super early because his life expectancy might be shorter?[43]

Views about whether age of eligibility for NZS should be adjusted for life expectancy will depend in part about beliefs about what people are 'entitled' to and how much consideration should be given to fiscal costs. After all, people already differ on the extent to which they draw on public services and welfare benefits (they differ in their contributions in taxes too). Is there a reason NZS should be any different? On the other hand, if NZS is viewed as a kind of longevity insurance (ensuring people do not outlive their savings), then adjusting for different life expectancies makes sense.

There are also differences in the kinds of work people do, where those working in jobs that require physical labour might struggle more to continue working than others in office jobs. Improvements in health and life expectancy will not necessarily make these jobs any easier for older workers. And the labour market might not be flexible enough or there might not be enough demand for workers to switch to other kinds of jobs. Yet such differences in the types of employment do not necessarily explain why the NZS age should not be raised. There are other forms of welfare benefits that could or should be made available to those who cannot work because of ageing and disability. Few would argue that people who are unable to work should still be forced to work. But the judgment that NZS should be made available to those unable to continue work, rather than ensuring the welfare system meets the needs of those people until the pension age kicks in, will depend on people's views on the particular purpose and nature of NZS.

42. For an illustrative round-up of the various viewpoints and issues to consider, see Bryce Edwards, "Political roundup: The case against raising the age of superannuation," *New Zealand Herald* (8 March 2017). This is an issue where viewpoints do not fit neatly into traditional ideological divisions (like left-wing and right-wing).
43. Dan Satherley, "Bill's 'balls' deserve applause – Retirement Commissioner," *Newshub* (6 March 2017).

### Box 1: A note on surveying value judgments

Though numerous surveys have been completed on NZS knowledge, preferences and expectations, this report does not strongly rely on those results. That is because most surveys gathering public opinion on NZS changes do not adequately present the relevant trade-offs of the different policy pathways. Likewise, surveys on what changes people expect are of little use if the public are not well-informed.

Further, a lack of understanding of NZS policy issues might be symptomatic of a greater ignorance of policy issues in general. It is also worth noting that naivety about even the basics of NZS make the value of asking these same people about their future expectations on NZS more dubious.

## 1.3 Concluding remarks

Issues regarding the pension's purpose, adequacy and criteria for entitlement have been debated since its inception.

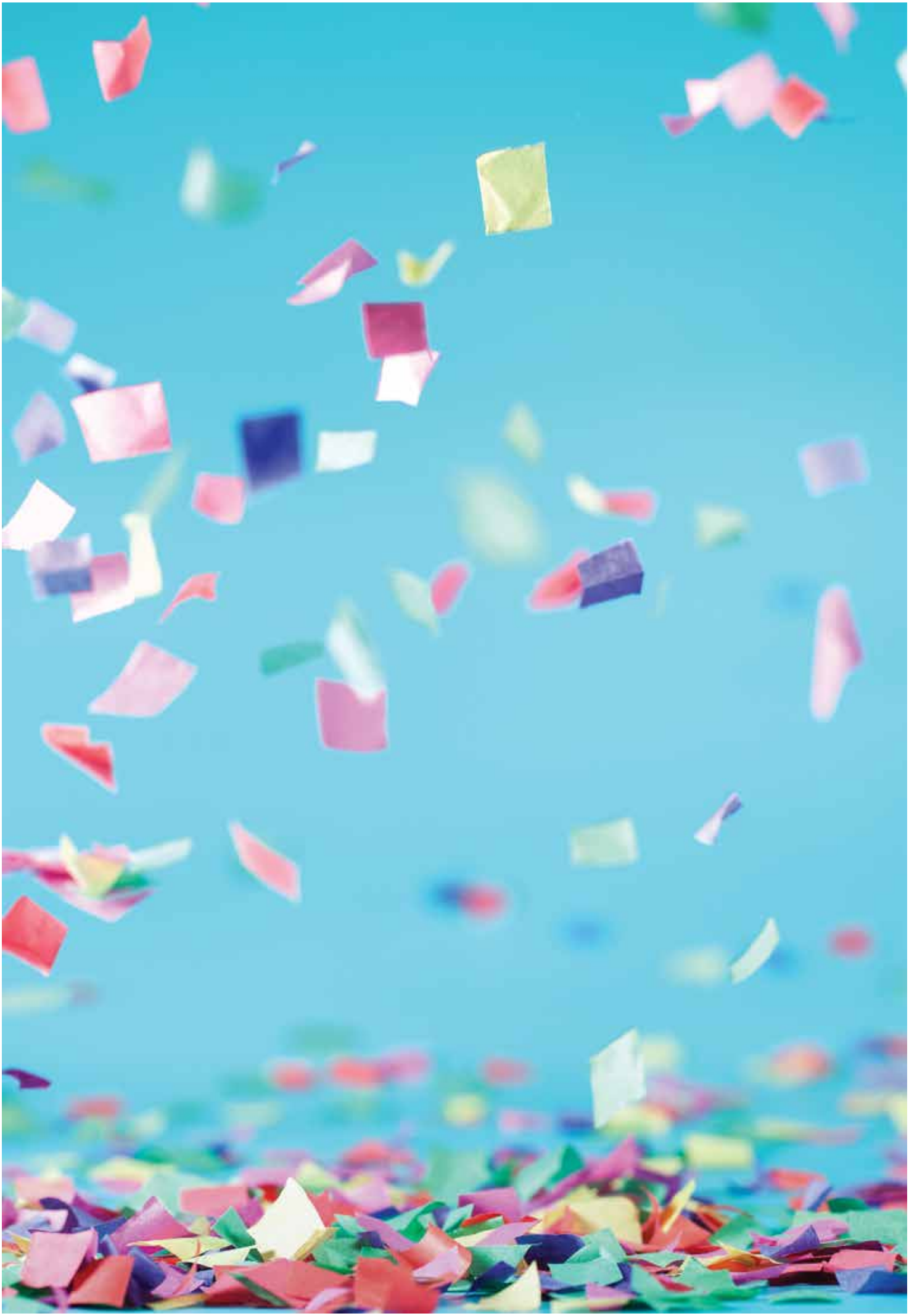
Interestingly, the age of eligibility is the same as it was in 1898, even though the proportion of the elderly to the general population has grown since then, and health and longevity have improved.

Though making changes to the NZS model today seems politically impossible, changes have historically been made due to fiscal necessity and changing public expectations. On the flipside, the implementation of the NZS surcharge shows that policies with perverse incentives are unlikely to achieve their desired effect.

This report has outlined just a handful of different value judgments that might guide different policy preferences.

Though this report later argues that NZS might become an increasingly regressive tool for redistribution, and that changing voter demographics will make even incremental changes difficult, these observations too rely on value judgments.

Policies today cannot bind the taxpayers of 2060. Ultimately, the taxpayers of 2060 will vote on the pension system they prefer and can afford.



CHAPTER 2

# Celebrating the Super model

There are many laudable features of the NZS model. In fact, New Zealand's pension model is arguably one of the best in the world. New Zealand has relatively low elderly material hardship rates, both domestically and compared to other countries. NZS is also less costly than many pensions in the OECD, despite being unique in offering a universal non means-tested public pension. Universality also means NZS is simple and efficient to administer, and it incentivises employment and additional saving so that people can take greater responsibility for their financial futures.

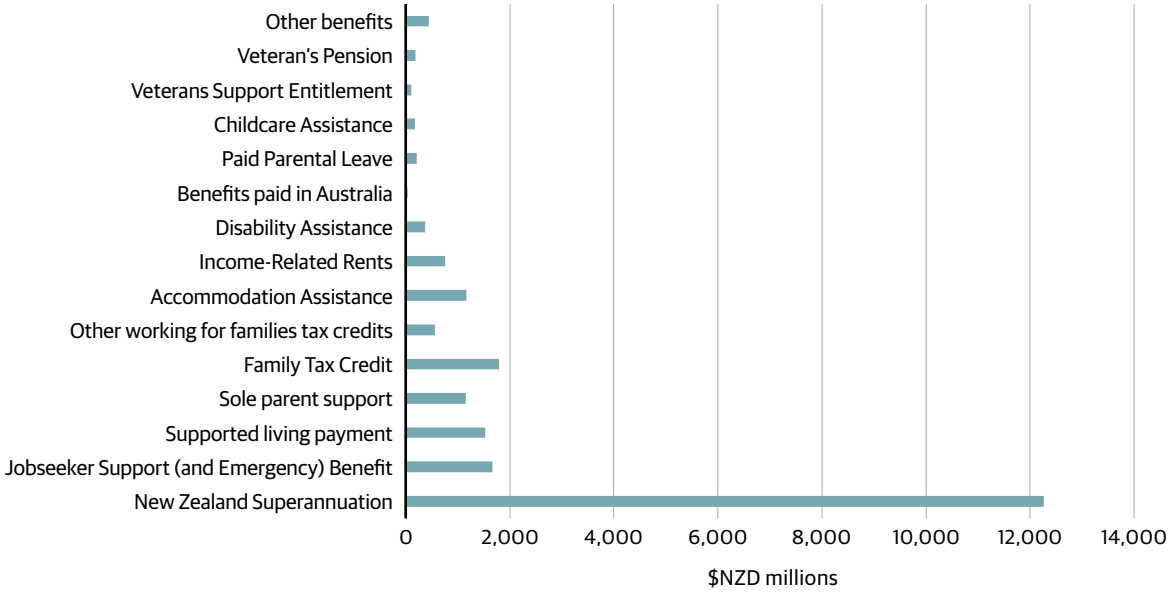
Finally, New Zealand is an advantageous position to make the necessary changes to NZS if fiscal challenges arise. Though the fiscal mechanisms in the *Public Finance Act* have nothing to do with the NZS model per se, it can shape views on whether NZS is 'affordable' or 'unaffordable'. That is because the *Public Finance Act* offers a safeguard of sorts to ensure funding NZS will not be at the expense of crippling debt, and that the risks of crippling debt should be signalled well in advance through Treasury's long-term fiscal projections.

## 2.1 Low material hardship rates

> *A new principle has been introduced by this Act: citizens of the Dominion are insuring themselves against the economic hardships that would otherwise follow those natural misfortunes from which no one is immune.*
> —Prime Minister Michael Joseph Savage (1938) on the Social Security Act[44]

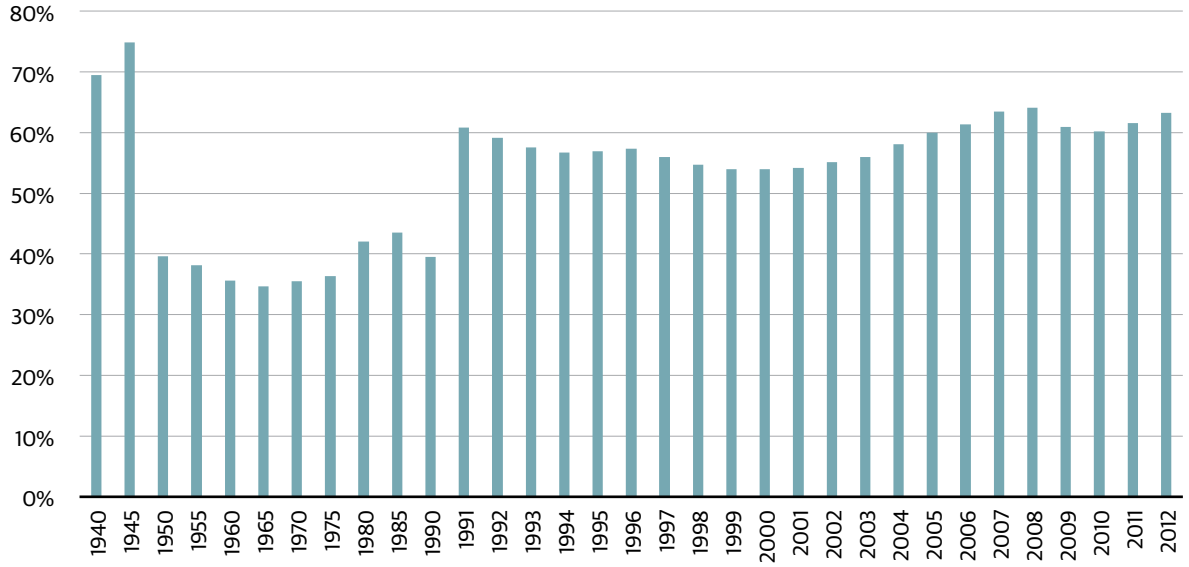
44. Almon F. Rockwell, "The New Zealand Social Security Act," *Social Security Bulletin* 2:5 (May 1939).

**Figure 1: Core Crown expenditure on welfare benefits and superannuation (2016)**



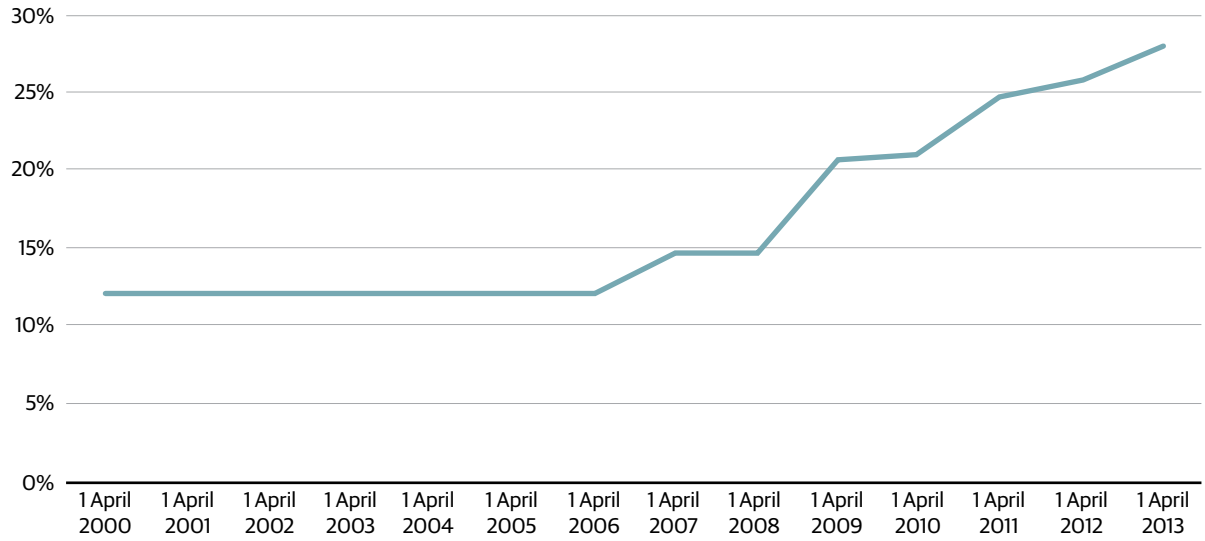

Source: New Zealand Treasury, "Fiscal time series core Crown expense tables," Website (2016).

### Figure 2: NZ Superannuation recipients as percentage of all beneficiaries (1940–2012)




Source: Ministry of Social Development, "The Statistical Report 2012," Overall trends in the use of financial assistance – Numbers receiving assistance (Wellington: New Zealand Government, 2012).

### Figure 3: Margin of NZ Superannuation above Invalid's Benefit (2000–13)




Source: Roger Hurnard, "Setting and adjusting the rates of New Zealand Superannuation: A submission to the Commission for Financial Literacy and Retirement Income on the 2013 review of retirement income policies" (2013).

Universalism and the indexing of NZS to wages makes it a unique part of our welfare system. But it comes at a cost. Expenditure on other welfare benefits pales in comparison to government expenditure on NZS (see Figure 1).

In sheer numbers, NZS recipients constitute a significant percentage of all beneficiaries. That proportion is only likely to grow with an ageing population (Figure 2).

NZS also differs from other welfare benefits as it is indexed to CPI *and* average ordinary time wages, so it will rise as wages rise. Other welfare benefits are adjusted primarily to CPI.

To illustrate how the difference in how NZS is indexed plays out compared to other benefits, Figure 3 shows the margin of difference between a couple eligible for NZS and a couple eligible for the Invalid's Benefit (IB). From 2006, average wages have risen at a greater rate than inflation, leading to differences in the payments received.

Are these costs worthwhile?

Though expenditure and uptake of NZS might be out of step with other aspects of the welfare system; NZS has arguably played an important role in keeping elderly poverty rates low. There are many ways of measuring poverty in New Zealand, though the most commonly used are relative income measures.[45] Relative income measures do not give an accurate representation of living standards and are especially less useful for ascertaining the living standards of elderly populations.[46] Depending on the income threshold used (commonly referred to as the 'poverty line'), poverty rates for pensioners can fluctuate dramatically.[47]

Home ownership is also a factor that needs to be considered, where after-housing-cost income measures reveal fewer elderly people in poverty than if a before-housing-cost measure was used.[48] That is because though the elderly might earn relatively lower regular incomes, they also face lower housing costs as many own their own homes and have paid off their mortgages by the time they reach pension age. For other population groups, including households with children, the relationship is reversed where the poverty rate is higher using after-housing-cost measures than before-housing-costs.[49]

Rather than incomes, a more revealing measure of elderly poverty rates is the material deprivation measure.[50]

The material deprivation measure looks at 'deprivations' such as whether a household can keep the house adequately warm, or face unexpected expenses of $1,500, or have regular leisure activities.[51] These 'deprivations' can change over time and by place, based on societal expectations. The EU13 is one way of measuring material hardship, and is used in this report as it allows for international comparisons. The EU13 measure considers 13 'lacks' or deprivations. A household suffering 5 or more deprivations is counted as suffering "standard" material deprivation, while a household that goes without 7 or more would be considered to be in "severe" material deprivation.

45. See, for example, New Zealand Press Association (NZPA), "Low elderly poverty ranking disputed," *Stuff* (9 April 2009). In the article, the dispute around poverty rankings centred around using different relative income measures.
46. Poverty measures that define the poverty line as a percentage of the median wage (income measures) can lead to large variations in the poverty rates of elderly. That is because a large proportion of the population is reliant on NZS as a sole source of income, and NZS levels are indexed as a proportion of the average ordinary time wage. Therefore, income measures may not be reflective of hardship.
47. This is known as the 'pensioner spike' and it is particularly sharp when using a before-housing-cost measure. The poverty rate for pensioners would be close to zero if a 50% threshold is used, but the poverty rate jumps to 31% if a 60% threshold is used. These fluctuations do not reflect dramatic changes in actual living standards. For a fuller explanation see Bryan Perry, "Household Incomes in New Zealand: Trends in Indicators of Inequality and Hardship 1982 to 2016" (Wellington: Ministry of Social Development, 2017), 164.
48. Ibid. 161–173.
49. A previous New Zealand Initiative report found that rising housing costs were a major contribution to income inequality in New Zealand. Bryce Wilkinson and Jenesa Jeram, "The Inequality Paradox: Why Inequality Matters Even Though It Has Barely Changed" (Wellington: The New Zealand Initiative, 2016).
50. Material deprivation measure can be more illustrative than income measures, but it is not perfect. It does not indicate why households may be struggling, and requires public buy-in to be meaningful.
51. These are deprivations (enforced lacks) of the EU13 measure, though other non-income measures are also available, with varying lists of deprivations.

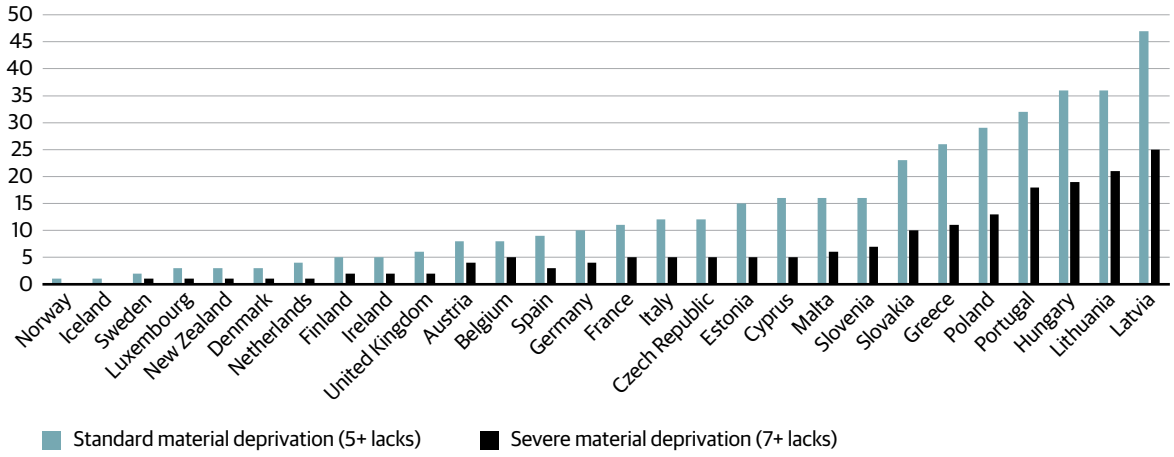
Table 3 compares the hardship rates for different sub-groups using the EU13 measure.

### Table 3: Material hardship by sub-group (2008)

| | "Standard" EU13 hardship (%) | "Severe" EU13 hardship (%) |
|---|---|---|
| **All** | 11 | 4 |
| **0–17** | 18 | 8 |
| **65+** | 3 | 1 (approx.) |
| **2 parent household <65** | 11 | 4 |
| **Solo parent household <65** | 35 | 17 |
| **Couple <65** | 5 | 2 |
| **European (total)** | 8 | 3 |
| **Maori (total)** | 24 | 9 |
| **Children (market income)** | 11 | 4 |
| **Children (welfare benefit)** | 51 | 24 |

Source: Bryan Perry, "The Material Wellbeing of New Zealand Households: Trends and Relativities Using Non-Income Measures, with International Comparisons" (Wellington: Ministry of Social Development, 2017), 35.

### Figure 4: Elderly (65+) material deprivation rates using EU13 measure: New Zealand and EU countries (2008/09)




Source: Bryan Perry, "The Material Wellbeing of New Zealand Households: Trends and Relativities Using Non-Income Measures, with International Comparisons" (Wellington: Ministry of Social Development, 2017), 20–21.

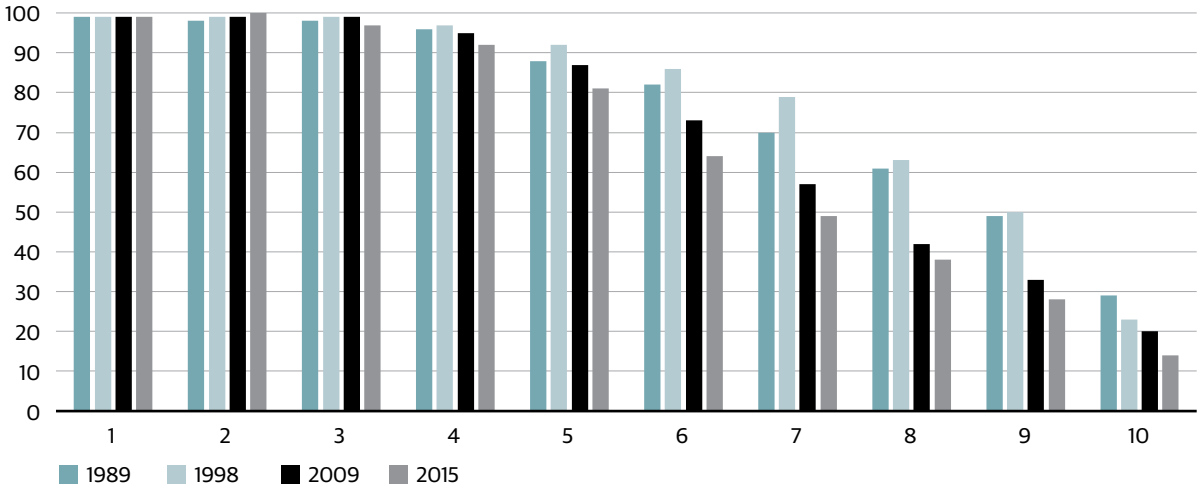
The standard material deprivation rate for superannuitants is 3%, compared with 11% for the whole population and 18% for households with children.[52]

The living standards of the elderly can also be measured by specific deprivations. According to one such indicator, the elderly are less likely to put up with feeling cold because of costs.[53]

52. Bryan Perry, "The Material Wellbeing of New Zealand Households: Trends and Relativities Using Non-Income Measures, with International Comparisons" (Wellington: Ministry of Social Development, 2017), 35.

53. The specific wording of the indicator was: "Forced to put up with feeling cold to keep costs down to pay for other basics a lot." Responses from the Household Economic Survey (2015) cited in Bryan Perry, "The Material Wellbeing of New Zealand Households," op. cit. 80.

**Figure 5: Proportion of gross income of older New Zealanders (66+) coming from government transfers (almost entirely NZS and Veterans pension)**




Source: Bryan Perry, "Household Incomes in New Zealand: Trends in Indicators of Inequality and Hardship 1982 to 2016" (Wellington: Ministry of Social Development, 2017), 169.

Only 4% of those aged over 65 report having to put up with the cold to keep down costs, compared with 22% of solo parents, 30% of beneficiaries with dependent children, and 7% of the population.

Additionally, elderly material deprivation rates are low by overseas standards.

Figure 4 compares New Zealand's material deprivation rate to EU countries. The most recent available statistics show that only Norway, Iceland, Sweden and Luxembourg have lower material deprivation rates for the elderly.

As mentioned earlier, NZS arguably plays an important role in keeping people out of poverty. However, the relationship between NZS and low material hardship rates can only be arguable because there is no relevant counterfactual. If NZS did not exist, or did not exist in its current form, it is not known how many people would fall into poverty and how many people would make up the shortfall with private savings or other forms of income. The existence of NZS affects incentives and behaviour, and behaviour will change if those incentives are removed.

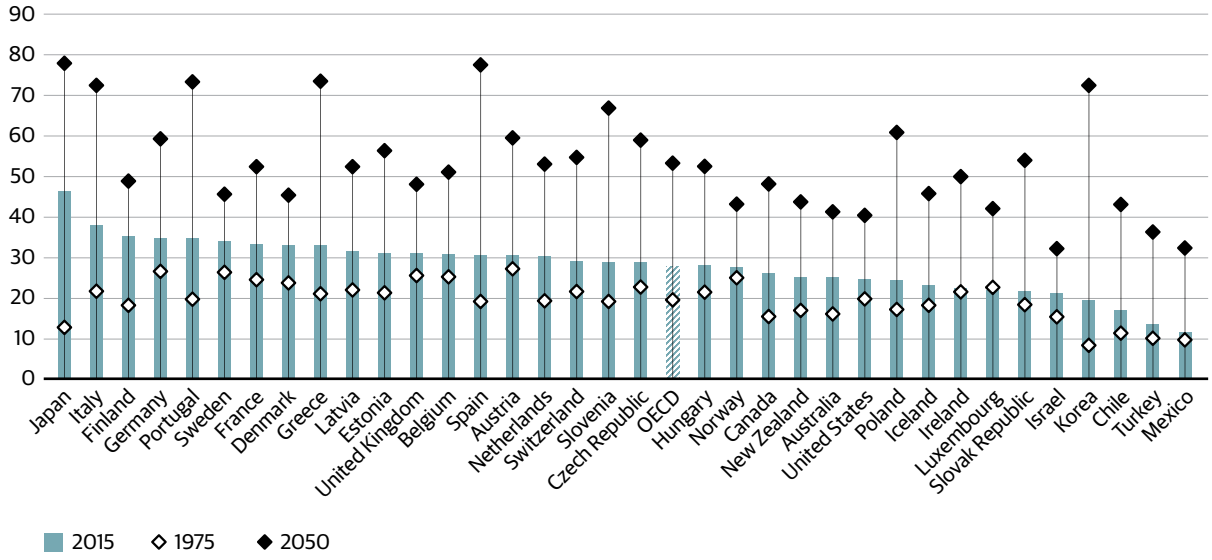
Nevertheless, it is noteworthy that New Zealand has low rates of elderly material hardship even though a significant proportion of the elderly rely on NZS as a sole or major source of income.

In 2015,[54] NZS provided nearly all the income (98%) for the poorest 40% of that population, and there has been little change in these proportions since 1989. The same survey found that half the respondents reported less than $200 per week (per capita) from sources other than NZS and other government transfers.[55] In Figure 5, the deciles are calculated by ranking all 66+ people on their incomes, and then dividing into deciles, so the deciles are not for the whole population. Decile 1 is the lowest income household group while decile 10 is the highest. The graph shows that for the richest eighth and ninth decile together, 30% of their income was from NZS.

Any changes to NZS must be considered against likely changes to the welfare of the elderly, especially if the elderly are pushed into hardship.

54. The most recent set of data available.
55. Bryan Perry, "Household Incomes in New Zealand," op. cit. 168.

### Figure 6: Old age dependency ratio




Source: OECD, "Pensions at a Glance 2017: OECD and G20 Indicators" (OECD Publishing, 2017), 21, using data from United Nations, "World Population Prospects: The 2017 Revision" (2017).[56]

## More affordable than many OECD countries

Only a handful of countries administer a universal pension, including Mauritius, Namibia, Botswana, Bolivia, Nepal, Samoa, Brunei and Kosovo.[57] One might assume that universal public pensions are more expensive than means-testing or compulsory private systems.

However, supposedly private retirement income systems can involve significant public funding. Though eligibility might not be universal, governments can still spend on means-tested public provision and minimum pensions for contributory systems, and provide generous tax relief for retirement saving.

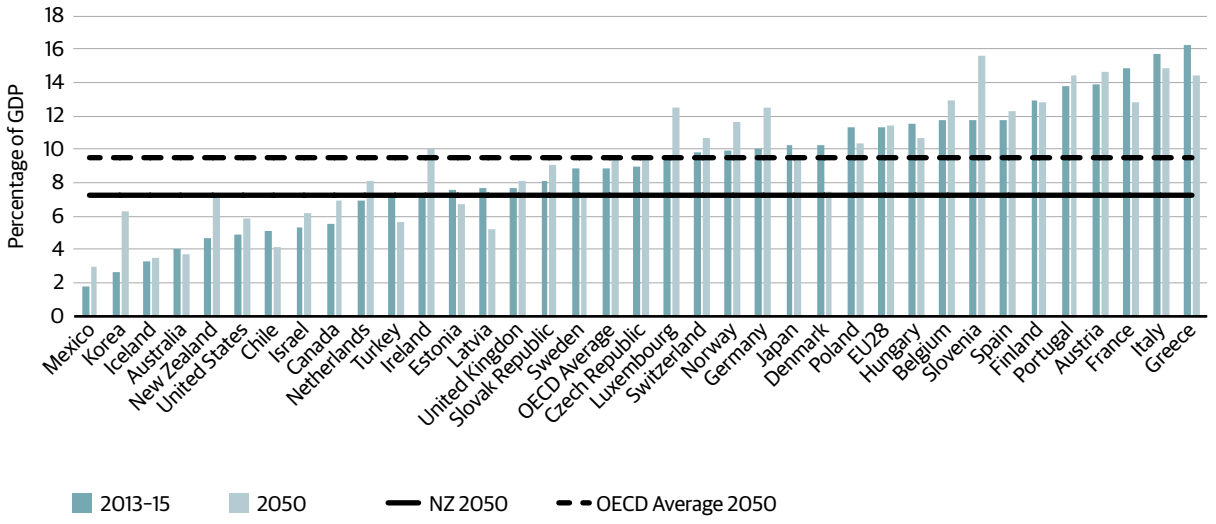
It is interesting, then, to see how New Zealand's spending stacks up against other OECD countries.

As shown in Figure 6, the rise in projected dependency ratios is occurring worldwide (and at different rates); New Zealand is comparatively better off than many countries. In Figure 6, the dependency ratio refers to the number of people older than 65 per 100 people of working age (defined as those aged 20–64). Japan, Italy, Portugal, Greece, Spain and Korea will face far greater dependency ratios than New Zealand by 2050. Few countries face significantly lower dependency ratios than New Zealand.

The projected public expenditure on pensions by 2050 also puts New Zealand on the lower end of the spectrum of OECD countries. Suggestions that New Zealand is heading towards a fiscal crisis are overblown.[58] The gross cost of NZS in 2050 is still less than the average public expenditure on pensions in 2013–15 for many OECD countries.

56. The authors of the OECD paper note that old age dependency ratios will differ depending on the source used, and that the UN data was chosen for comparison purposes. The main countries affected by the differences (between the UN data and Eurostat) are Spain, Austria and Latvia.
57. The term "universal" is handy but a "universal non means-tested pension" is more accurate. See Larry Willmore, "Universal Pensions for Developing Countries," *World Development* 35:1 (2007).
58. Michael Littlewood rightly points out that "public expenditure on pensions" does not even reflect the full fiscal costs as most assessments and country comparisons do not take into account tax breaks for private pensions, and some do not adjust for the taxes paid on the pensions (net vs gross costs). Michael Littlewood, "We all have to talk about New Zealand Superannuation," *Pension Commentary* 2012–3 (Retirement Policy and Research Centre, 2012).

Figure 7: Projections of public expenditure (gross) on pensions (2013-15 and 2050)




Source: OECD, "Pensions at a Glance 2017: OECD and G20 Indicators" (OECD Publishing, 2017), 147.

New Zealand's public expenditure on pensions (as a proportion of GDP) by 2050 is comparable to those of Canada and Sweden, and is below the OECD average (Figure 7). Notably, projections of public expenditure on pensions as a percentage of GDP do not mirror projected age dependency ratios. Korea, for example, faces lower public expenditure on pensions than New Zealand despite expecting a much greater dependency ratio. Keep in mind when comparing countries that some countries (like Germany) are already more advanced in population ageing, so their projected pensions in 2050 will reflect different stages of that process.

There has been some discontent that New Zealand's pension levels are not as high as other OECD countries.[59] For example, New Zealand has lower pension[60] replacement rates by earnings (gross and net) compared to other OECD countries. New Zealand pension's net replacement rate by earnings is 43%, compared to the OECD average of 63%. On the higher end, India, the Netherlands and Turkey have net replacement rates ranging from 99% to 102%.[61]

But note that these assertions compare all pensions (universal schemes, means-tested schemes and compulsory contributory schemes) where there is greater variation in the level of pension received. In fact, it is arguable whether NZS was ever designed to smooth income and living standards between working life and retirement. As Peter Harris argues, "… the New Zealand system explicitly transfers all responsibility for maintenance of living standards in retirement – again with the important caveat of being above a minimum standard of living – on to the individual."[62] Harris also points out that NZS might incidentally (but not intentionally) have the effect of income smoothing for poorer households because of the low incomes earned pre-retirement.

59. Tamsyn Parker, "New Zealand has one of least generous pensions: OECD report," *New Zealand Herald* (4 April 2018).
60. Here, figures refer to mandatory public and private pensions, but not voluntary pensions which are reported on separately by the OECD.
61. OECD, "Pensions at a Glance 2017: OECD and G20 Indicators" (OECD Publishing, 2017), 109.
62. Peter Harris, "New Zealand's Retirement Income Framework: Trends, Continuity, Change," Background paper prepared for the 2013 review of retirement income policy (2012).

Nevertheless, as other experts have pointed out, such comparisons risk conflating "generosity" with poverty alleviation.[63] For example, Australia offers similar 'net pension replacement rates by earnings' but suffers much higher levels of elderly income poverty.[64]

It is common for New Zealand to be compared with Australia, which has a compulsory private superannuation system (known as the Superannuation Guarantee) and a means-tested public pension. The costs of New Zealand's universal public pension will exceed the costs of Australia's means-tested public pension, with New Zealand's costs increasing by 3% of GDP between 2010 and 2050, compared with Australia's 2.2% of GDP.[65] However, many experts neglect to include the cost of tax expenditures for Australia's contributory system. According to one calculation, the costs of Australia's contributory schemes are almost equal to the costs of the public pension (1.6 and 1.7% of GDP, respectively).[66]

Incentives for older workers to remain in the workforce also matter for the expected future tax take, especially in the future as traditional dependency ratios increase. The universality of NZS works favourably in this respect as it does not disincentivise work or earning income from other sources. A 2009 survey in Australia found that 1 in 5 pensioners who wanted to work had turned down part-time employment because they would face a pension cut.[67] In a comparison of Australian and New Zealand systems, Ross Guest argues that the lower labour force participation rate for Australians aged 55–64 could be partly attributed to the tax-free superannuation accessible by people aged 60 and over. Further, Guest argues that Australians are drawing down their (contributory) superannuation savings tax-free at the age of 60 to be eligible for the Age Pension (which is publicly funded but means-tested).[68]

## 2.2 Simplicity and efficiency

The administration of NZS is distinct from other parts of the welfare system.

Unlike other welfare benefits, eligibility for NZS is not means-tested (it is not linked to employment status, income or assets), nor is it based on need. The only requirements are that recipients must be of pension age (65 and over), a permanent resident or citizen, and must have lived in New Zealand for a certain number of years before reaching the age of eligibility. The payment received is dependent on relationship status, receipt of other welfare benefits, receipt of overseas pensions, and tax code. Other forms of financial assistance are also available on top of NZS for those in need.[69]

So is there any special reason NZS is administered universally while other aspects of the welfare system are based on targeted assistance to those most in need?

63. This was the point made by Susan St John, director of Auckland University's Retirement Policy and Research Centre. Tamsyn Parker, "New Zealand has one of least generous pensions: OECD report," op. cit.
64. "Using a poverty line of 60 per cent of median income for equivalised households after housing costs, the poverty rate for people over 64 in New Zealand was 7 per cent in 2011, which is considerably lower than the 34.9 per cent for Australia in 2009–10." Ross Guest, "Comparison of the New Zealand and Australian Retirement Income Systems: Background paper for the 2013 review of retirement income policy by the Commission for Financial Literacy and Retirement Income" (2013).
65. Ibid. Note that these figures are from 2010 and therefore outdated. However, the point here is to illustrate the differences in costs. The differences between New Zealand and Australia should not change considerably unless there are major changes in productivity.
66. Ibid.
67. Ibid. Referencing a survey by National Seniors Australia (2009).
68. Ibid.
69. Work and Income New Zealand, "Extra financial help you may need," Website.

### Box 2: Is the success of NZS 'proof' that a Universal Basic Income should be applied more broadly?

NZS can essentially be understood as a Universal Basic Income (UBI) for the elderly. Observers may rightly question whether a UBI for the entire population might be similarly effective in reducing overall poverty levels.

There is reason to be wary of applying a UBI more broadly. A UBI for the general population is a very expensive way of assisting the poor where more targeted interventions would be more feasible. It comes down to a matter of cost.

Kevin Milligan's "Basic Income Impossible Trinity"[70] explains the dilemma well. There are three desirable features of basic income programmes: a large basic transfer, a low phase-out rate to incentivise work, and a similar cost to the existing system so that taxes don't rise significantly.[71] Milligan's argument is that any system can only have two of these three features. Having all three would be impossible.

A UBI for the general population would therefore need to sacrifice one of the following:

1. A generous transfer
2. Incentives/rewards for employment
3. No significant rise in taxes.

That means the UBI must result in one of the following scenarios. If the transfer is not generous, then it might not alleviate poverty or improve the living standards for households compared with more targeted assistance. If there are fewer incentives/rewards for employment, the economy will be unsustainable. If taxes must rise, then the policy might not receive electorate support, and if it does the policy would result in tax churn to some degree.

Economists have long pointed out that the efficiency of the NZS system is largely due to its administrative simplicity and that it does not introduce some perverse incentives or moral hazards that would arise in different systems or models.

NZS does not disincentivise employment, unlike other pension schemes where payments are steeply affected by employment status or earnings. Though NZS payment levels are affected by employment, the actual NZS level is low enough that there are still incentives/rewards for employment.

The lack of income or wealth means-testing also means people can invest or continue employment without worrying it will make them ineligible for NZS. This means people can take greater responsibility for their financial futures and live on an income that is most suited to their living standards preferences.

When the NZS surcharge was introduced, people went to great lengths to avoid paying it by administratively hiding their assets (see Chapter 1). In comparison, a lack of wealth means-testing is administratively simpler, given the huge variety in assets people can hold and the variety of ways assets could be hidden. Not to mention that incomes – thus eligibility – can fluctuate, which contributes to administrative complexity.

Means-testing can therefore be inefficient, ineffective and costly.

70. Kevin Milligan, "Everyone talks about basic income. Here's why they don't implement it," *The Globe and Mail* (22 February 2017).
71. Luke Kawa, "Note to Swiss: Basic income plans have a basic flaw," *Bloomberg.com* (25 May 2016).

## 2.3 Mechanisms for fiscal prudence

The final strength of the NZS system has nothing to do with the system itself. However, mechanisms for fiscal prudence are a safeguard against the crippling debt faced by other countries with ageing populations. Paying for NZS should not result in large and ever-expanding debt.

Governments should not be able to run a string of fiscal deficits for a prolonged period of time. As those who lived through the economic reforms of the 1980s and 1990s will attest, the period of fiscal consolidation after a long run of fiscal deficits can be an economically and personally painful time. Unemployment, low wages and limited public services are just some of the ways sharp economic reforms affect people's lives.

New Zealand's political and economic history shows the need for such institutions, and the painful consequences that can occur if those institutions are not strong. The *Public Finance Act 1989*, combined with an extended period of strong economic growth, has been recognised as contributing to New Zealand entering the Global Financial Crisis with historically and internationally low levels of debt.[72]

The *Public Finance Act* has enhanced the transparency of government spending, tax and debt expectations, and sets expectations that the government will maintain prudent debt levels and run fiscal surpluses on average over time. The Treasury must also report on the long-term fiscal forecasts based on current policy settings. The *Public Finance Act* is possibly one of New Zealand's most important fiscal institutions for encouraging fiscal responsibility.

The Act includes the following debt expectations:

- Reducing total debt to prudent levels to provide a buffer against factors that may adversely affect the level of total debt in the future. Until prudent levels of debt have been achieved, the government must ensure that total operating expenses in each financial year are less than total operating revenues in the same financial year.
- Once prudent levels of total debt have been achieved, maintaining those levels by ensuring that, on average and over a reasonable period of time, total operating expenses do not exceed total operating revenues.[73]

The long-term fiscal projections produced by Treasury (cited later in this report) are also a result of the *Public Finance Act*. Treasury is required to produce a long-term fiscal position at least every four years, covering at least 40 years into the future. It is tasked with setting the short-term and long-term (at least 10 years) fiscal objectives for total operating expenses, total operating revenues, operating balance, total debt, and total net worth. These principles are reasonably broad, leaving it up to the government of the day to decide how 'prudent' and 'reasonable period of time' are defined, and whether the target debt level should be defined in gross or net terms (for example, assets in the Super Fund and student loan advances would affect net debt levels).[74]

To repeat, these standards are separate from the NZS model. But they do provide some context for why and how the NZS model should change if it needs to. Under these provisions, New Zealand is in an advantageous position

72. Tracy Mears, Gary Blick, Tim Hampton and John Janssen, "Fiscal Institutions in New Zealand and the Question of a Spending Cap" (2010).

73. New Zealand Treasury, "A Guide to the Public Finance Act" (Wellington: New Zealand, 2005).

74. Teresa Ter-Minassian, "External Review of the Treasury's Fiscal Policy Advice: New Zealand" (Washington, DC, 2014).

to contemplate and understand the long-term consequences of policy decisions and changes.

## 2.4 Concluding remarks

NZS is distinct from other parts of the welfare system due to its universalism, but this is not necessarily a criticism. Compared to other age groups, elderly poverty rates (measured by material deprivation) are relatively low. This is understandable as NZS provides a guaranteed income, and most elderly face lower housing costs than the rest of the population.

Whether elderly poverty rates would rise if there were changes to NZS is impossible to definitively conclude, as people respond to incentives.

NZS is also distinct on the world stage by offering a universal benefit at a relatively lower cost compared to many OECD countries. In fact, the projected future costs of NZS in 2060 are still lower than the costs of some OECD countries' pensions today.

On a practical level, NZS is also administratively simple and efficient. It does not disincentivise employment or savings/investment, so people are better incentivised to take charge of their own financial futures.

And finally, there are mechanisms in place to ensure policymakers know well in advance whether changes to NZS need to take place. The *Public Finance Act*'s tools for managing fiscal prudence mean that funding NZS should not come at the expense of taking on crippling debt.

CHAPTER 3

# Will the model get ugly with age?

As this report has mentioned earlier, the *Public Finance Act* sets expectations that Treasury will produce short-term and long-term fiscal objectives, and a long-term fiscal statement. Treasury's long-term fiscal statement provides fiscal projections, which this report describes. The projections show that under current policy settings (and assuming certain growth rates and debt responses), the costs of NZS are likely to increase as a proportion of GDP.

The interpretation of Treasury's projections, however, ought to be treated with care. The projections are based on a set of assumptions that may or may not eventuate. This report describes how such uncertainty should then affect policy conclusions. Making some changes now could do more harm than good.

On the other hand, there is also potential harm in waiting too long to make certain changes. People need time to financially plan and adjust to any signalled changes to pensions, while making changes to the system might become harder as the voting population ages and votes in their own self-interest.

## 3.1 NZS costs likely to increase with changing demographics

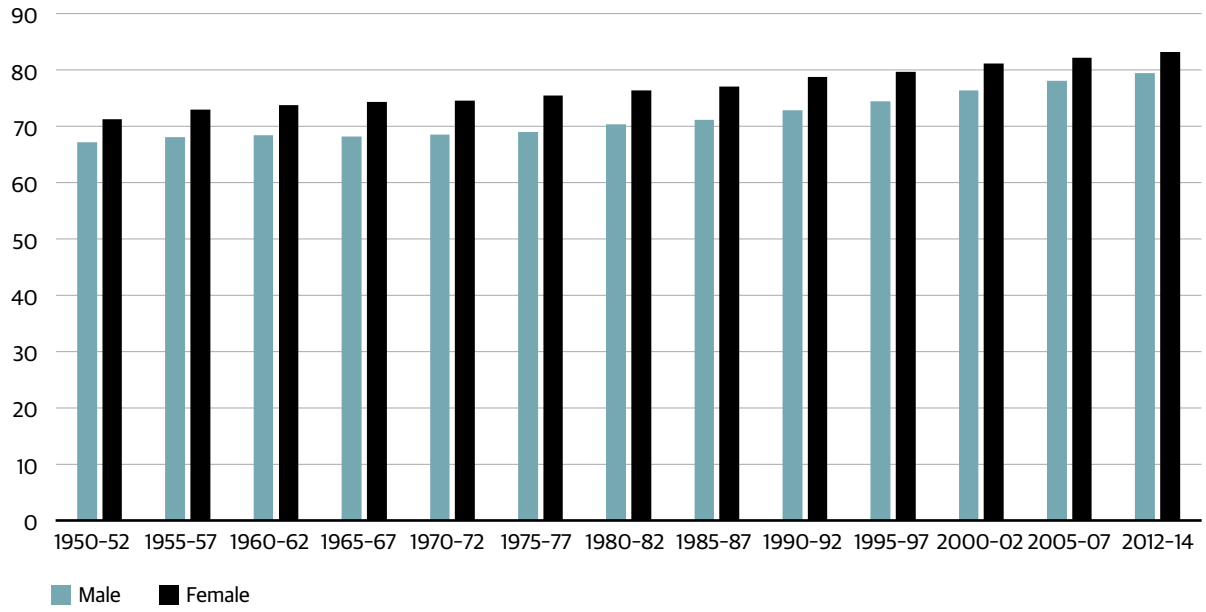
Nobody can predict the future with certainty. But fiscal and demographic projections can provide some idea of what the future might look like if certain trends materialise. Particularly uncertain are future trends in aspects like immigration and fertility rates, which will affect the size and demography of the population.[75] Fiscal projections will also be uncertain because of factors such as future trends in productivity and GDP growth. But the point of fiscal projections is not to predict the future. It is to illustrate the long-term implications of specified trends if nothing changes.

The population is living longer, and life expectancy is likely to continue to increase (Figure 8).[76] Increased life expectancy has implications for NZS, as people are likely to claim NZS for a longer period of time. Expected longevity needs to be understood by both policymakers and the public, as retirement savings might need to last people longer than previous generations (depending on the age of actual retirement from the workforce and years of healthy life).

People are living longer while fertility rates decline, meaning that the elderly population is likely to grow at a much faster rate than other age cohorts (see Figure 9). It is important to keep in mind, though, that age demographic trends differ by ethnicity, with population ageing more pronounced in European populations (see Figure 10).

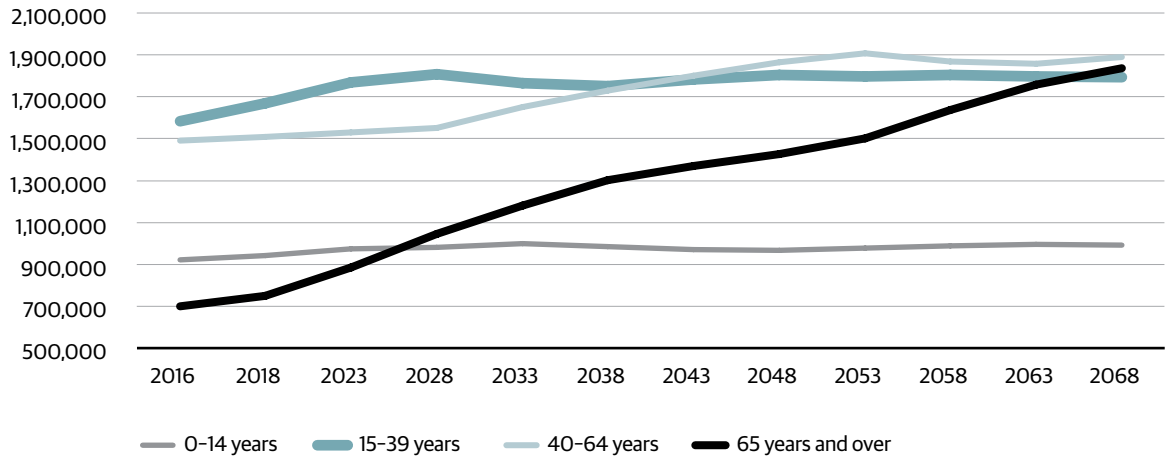
75. Fertility rates can be influenced by improvements in artificial fertility research, ethnic composition, and changes in social expectations. However, historical trends for fertility rates in developed countries tend not to fluctuate dramatically. Statistics New Zealand produces stochastic projections and includes a number of 'what if?' scenarios to capture the potential relative effects of immigration, fertility and mortality. See Statistics New Zealand, "Population projections tables," Website (page updated 8 September 2017).
76. Though the rate of increase might differ from historical trends.

## Figure 8: Life expectancy at birth for males and females




Source: Statistics New Zealand, "Life expectancy," Website (accessed July 2018).

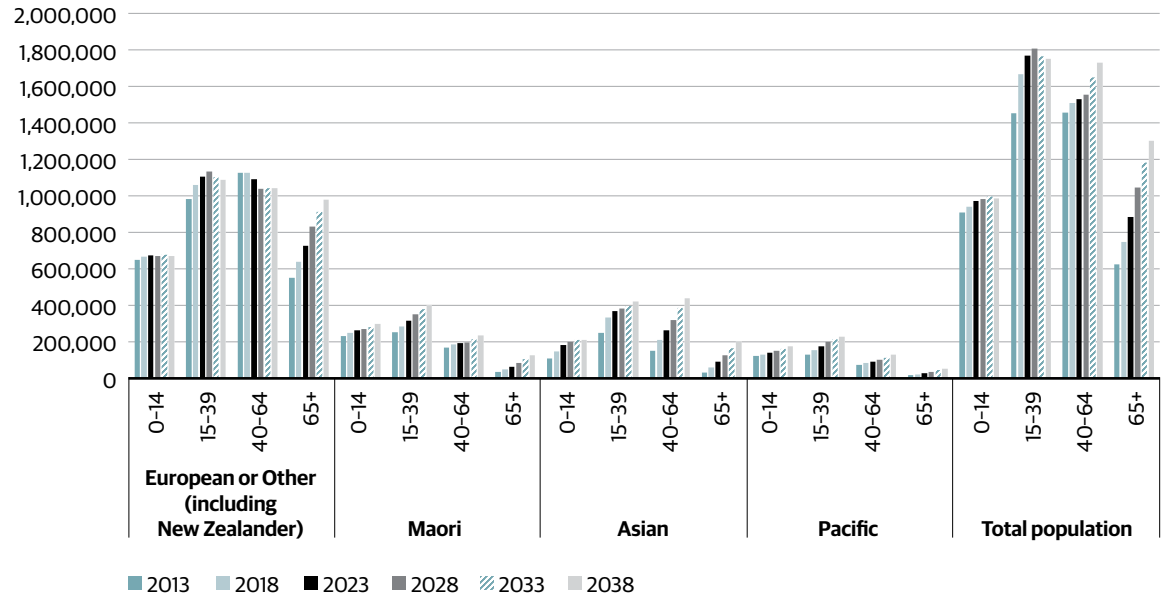
## Figure 9: Population projections by age group (2016-68)




Source: Statistics New Zealand, "National population projections, by age and sex, 2016(base)–2068 50th percentile median scenario," Website (accessed July 2018).[77]

77. An explanation of the 'median scenario' and methodology for the population projections can be found on the Statistics New Zealand website. Statistics New Zealand, "Population projections tables," Website (page updated 8 September 2017).

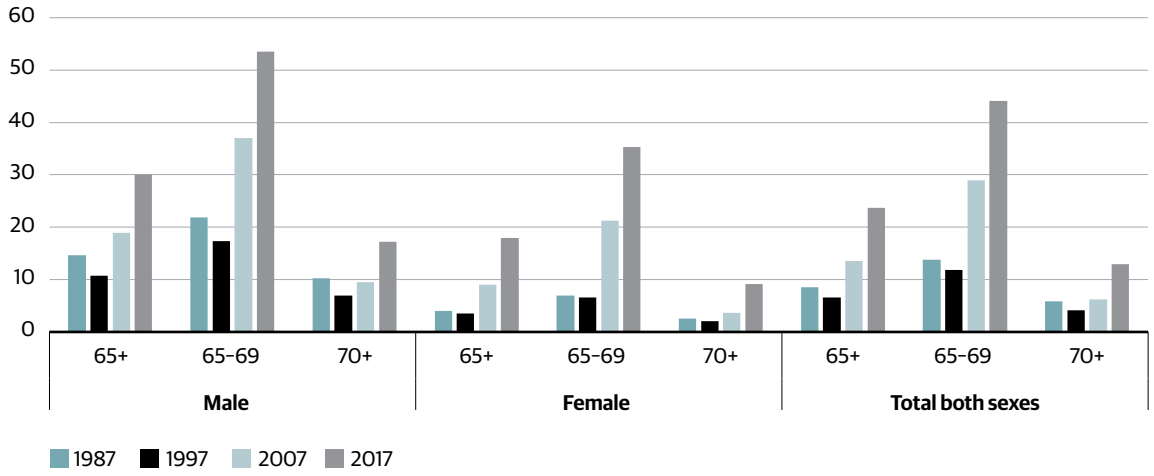
## Figure 10: Population ageing by ethnicity




Source: Statistics New Zealand, "Dataset: Subnational ethnic population projections, by age and sex, 2013 (base)–2038 update, medium projection," Website.

Increased longevity and improvements in health have implications for the workforce too. Older people are generally staying in the workforce for longer (in practice, this depends on the industry and the physical nature of the work). As technology improves and labour-saving technologies are developed, future trends in employment may or may not reflect what has happened in the past. The employment rate for older people has been rising, with a significant proportion of people still working between the ages of 65 and 69. Figure 11 shows this rise, and also encompasses a rise in the age of eligibility for NZS from 60 to 65 between 1992 and 2001.

## Figure 11: Employment rate for older people




Source: Statistics New Zealand, "Household labour force survey – Labour force status by sex by age group (Annual–Jun)," Website (2018).

Table 4: Projections for "Historical Spending Patterns" scenario (per cent of nominal GDP)

| | 2015 | 2030 | 2045 | 2060 |
|---|---|---|---|---|
| **Healthcare** | 6.2 | 6.8 | 8.3 | 9.7 |
| **New Zealand Superannuation (NZS)** | 4.8 | 6.3 | 7.2 | 7.9 |
| **Education** | 5.3 | 5.4 | 5.5 | 5.7 |
| **Law and order** | 1.5 | 1.4 | 1.4 | 1.4 |
| **Welfare (excluding NZS)** | 4.2 | 4.5 | 4.7 | 4.7 |
| **Other expenses** | 6.3 | 6.7 | 6.7 | 6.7 |
| **Debt-financing costs** | 1.6 | 2.2 | 5.3 | 11.0 |
| **Expenses** | **30.0** | **33.3** | **39.1** | **47.1** |
| **Tax revenue** | 27.6 | 28.6 | 28.6 | 28.6 |
| **Other revenue** | 2.3 | 2.4 | 2.4 | 2.5 |
| **Revenue** | **29.9** | **31.0** | **31.0** | **31.1** |
| **Operating balance** | -0.1 | -2.3 | -8.1 | -16.0 |
| | | | | |
| **Primary expenses** | **28.4** | **31.1** | **33.8** | **36.1** |
| **Primary balance** | **0.5** | **-1.2** | **-4.0** | **-6.3** |
| | | | | |
| **Capital expenditure** | 0.7 | 0.9 | 1.0 | 1.0 |
| **Net debt** | 25.1 | 32.5 | 94.0 | 205.8 |
| **NZSF assets** | 12.2 | 21.0 | 25.1 | 31.7 |
| **Net debt incl NZSF** | 12.9 | 11.5 | 68.9 | 174.1 |
| **Net worth** | **13.8** | **16.1** | **-41.3** | **-146.3** |

Source: New Zealand Treasury, "He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2016).

One way of measuring this is through dependency ratios. Statistics New Zealand projects that the dependency ratio of the population aged 65 and over to the working-age population (15–64 years) will rise from 20 per 100 in 2011 to 39–51 per 100 in 2061.[78] Of course, dependency ratios refer only to age, and not necessarily the realities of the future workforce or future tax collection. The *traditional* worker pool might be shrinking, but if older people are working longer or are paying taxes at a higher rate, the age dependency ratios might not reflect the tax/spend dependency ratios.

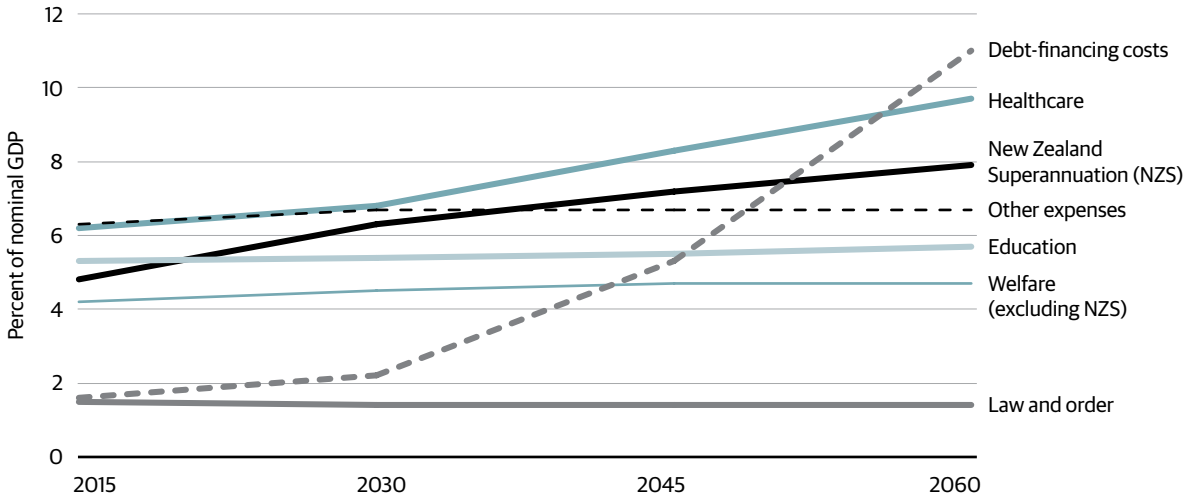
As can be expected from the best available demographic projections, the costs of NZS will grow as more people draw on the benefit, and for longer. Table 4 shows the Treasury's fiscal projections for 2060 based on historical spending patterns, but it excludes a government response to deficits and debt.[79] It therefore shows how fiscal costs could increase if debt levels are not stabilised (a debt stabilisation scenario will be discussed later in the report).

By 2060, gross NZS expenditure could grow from around 5% of nominal GDP today to

78. Statistics New Zealand, "National Population Projections: 2011(base)–2061," op. cit.

79. New Zealand Treasury, "He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2016).

Figure 12: Treasury public expenditure projections for "Historical Spending Patterns" scenario




Source: New Zealand Treasury, "He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2016).

nearly 8%. That is not as high as health care expenditure, which could climb from around 6% of GDP in 2015 to nearly 10% by 2060. If debt is not stabilised, debt financing costs alone could climb from 1.6% to 11% by 2060.[80]

All in all, this scenario sees Crown Financial Statements shifting from a positive net worth of 13.8% of GDP to a negative 146.3%.

Under this scenario, the government would be running a deficit of -16% of GDP by 2060, and public spending would be funded by debt. To put things in perspective, the size of the deficit is larger than the costs of education, law and order, and welfare (excluding NZS) combined.

Of course, these figures alone do not show that NZS (even NZS at current settings) is unaffordable. What they do show is that the costs of NZS and health care will rise, with debt financing costs rising rapidly from 2030, if other spending and taxes do not change from historical patterns.

80. Ibid.

## But what we still don't know matters a lot

Treasury's historical spending scenario is based on a certain set of assumptions that may or may not eventuate, and the long-term effects of this particular set of variables.

But as the Office of the Auditor-General argues, it is "difficult to imagine" that the historical spending scenario assumptions (spending continues to exceed revenue and finance costs increase significantly as operating deficits are funded by debt) would hold over 40 years. These assumptions move away from the *Public Finance Act 1989*, which sets expectations for fiscal responsibility:

> The duration of these assumptions reduces the reasonableness of the outlook and potentially the confidence that users have in the 2016 Statement's main messages – particularly when we look at how government finances have moved in the past.[81]

81. Controller and Auditor-General, "Commentary on He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position" (Wellington: 2017).

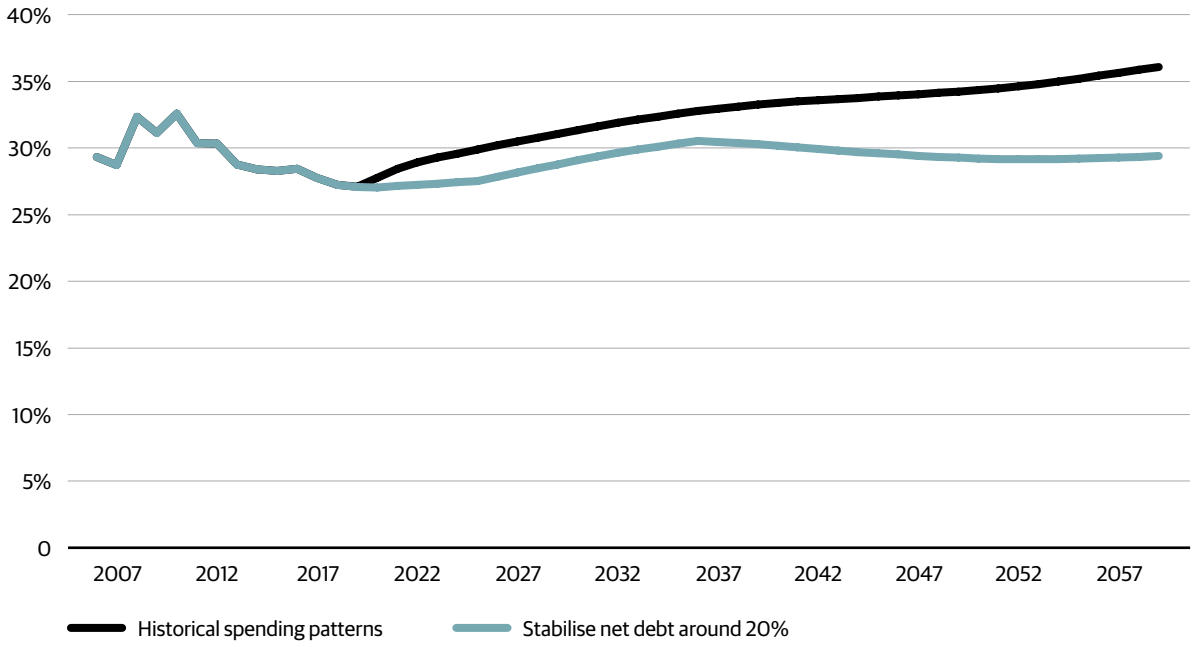
Importantly, Treasury's 'historical spending' scenario assumes that the government will not respond to deficits and debt. This is simply not feasible, given the safeguards of the *Public Finance Act*. In reality, the -16% deficit projected in Treasury's historical spending scenario would need to be addressed by raising tax revenue or cutting spending. The deficit would also be much smaller as debt-financing costs would not rise to the levels projected.

The Treasury's latest fiscal projections include a scenario where net debt is stabilised (see Figure 13). By keeping debt relatively low, operating fiscal stabilisers (temporary increases in financing or debt) are more feasible. These temporary fluctuations allow the government to respond to economic cycles and shocks without having to make sharp adjustments in spending and/or taxes to balance the budget in a single year.

In a scenario where net debt is stabilised, it is assumed that successive governments will operate fiscal policy so that net debt averages around 20% of GDP across the projection period. The gap between the two pathways would be even greater if the historic spending projection included debt financing costs. Figure 13 assumes NZS remains at current settings because it is determined by legislation, so other public spending would need to be reduced to keep debt low.

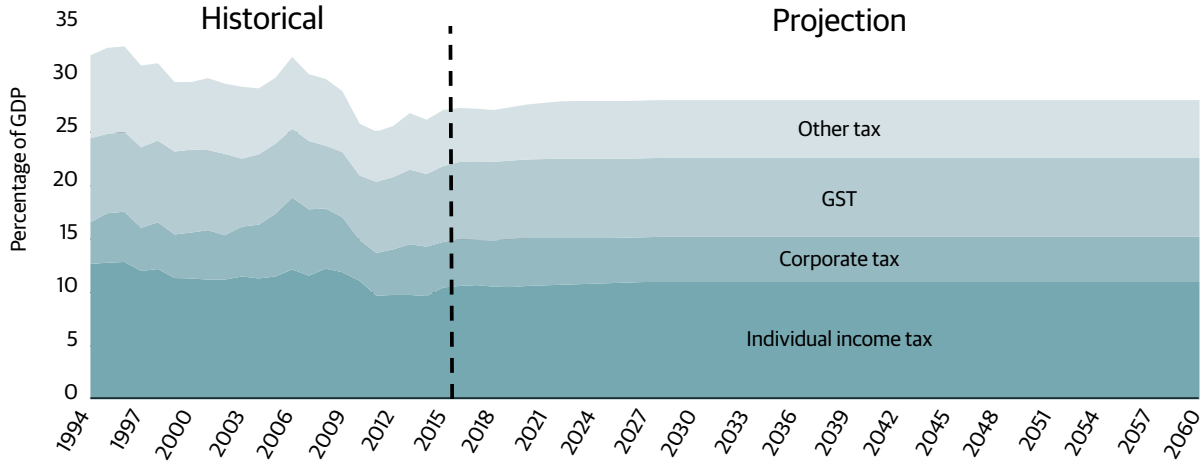
Treasury's long-term fiscal projections also hold the government's tax base constant as a share of GDP over the projection period, though this assumption is not reflective of the longer term. In Figure 14, the Office of the Auditor-General illustrates the historical trends of the government's tax base (up to 2015) compared with the projections (from 2015).

**Figure 13: Stabilising net debt in the long term: Expenses-to-GDP (excluding debt financing)**




Source: New Zealand Treasury, "He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2016).

**Figure 14: Government tax base as a proportion of GDP — historical and projected**




Source: Controller and Auditor-General, "Commentary on He Tirohanga Mokopuna: 2016 Statement on the Long-Term Fiscal Position" (Wellington: 2017). Based on figures from New Zealand Treasury, "He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2016).

Tax revenue and tax paid on NZS can affect the cost of NZS, as reflected by the gross and net costs of NZS. Under a historical spending scenario, Treasury projected that by 2060, gross NZS expenditure could grow from around 5% of nominal GDP today to nearly 8%. However, these figures do not take into account the tax paid on NZS. The cost of NZS net of tax (net cost) is around 4% in 2018/19 and could grow to around 6.7% in 2060.[82]

Finally, greater than expected economic growth also matters a great deal to these projections. In 2014, the projected gross cost of NZS by 2017/18 was 5% of nominal GDP, but the actual gross cost for the period was 4.7%.[83] These changes can affect the projected costs in 2060.[84]

Christopher Ball, John Creedy and Grant Scobie looked at the long-term fiscal projections for New Zealand under uncertainty.[85] They argue:

> …it is sometimes suggested that the discussion of uncertainty surrounding fiscal projections merely provides a distraction from the main message – usually seen as the need for immediate action. However, it is argued here that recognition of the considerable uncertainty involved is indeed a crucial part of the "message" and itself raises important policy questions.[86]

The authors found that once uncertainty was introduced into the long-term model, there were extremely large variations in the debt ratio over a 40-year period to 2053. Variabilities in productivity growth, the world interest rate, and growth rates of per capita expenditure categories (for example, 'health and education' and 'other social expenditure') can lead to very different outcomes in the debt-to-GDP ratio by 2053.

82. New Zealand Treasury, "New Zealand Superannuation Fund Contribution Rate Model," *Budget Economic and Fiscal Update 2018* (Wellington: May 2018).
83. New Zealand Treasury, "New Zealand Superannuation Fund Contribution Rate Model," *Budget Economic and Fiscal Update 2014* (Wellington: New Zealand Government, May 2014).
84. New Zealand Treasury, "He Tirohanga Mokopuna: 2016 Statement on New Zealand's Long-Term Fiscal Position," op. cit. and New Zealand Treasury, "New Zealand Superannuation Fund Contribution Rate Model," op. cit. Though the 2018 projections are the most up-to-date figures available for NZS, this report will continue to refer to the 2016 projections in the Long-Term Fiscal Position to compare with other spending and revenue categories.
85. Christopher Ball, John Creedy and Grant Scobie, "Long-Run Fiscal Projections under Uncertainty: The Case of New Zealand," Working Papers in Public Finance, Working Paper 12/2015 (Wellington: New Zealand Treasury, 2015).
86. Ibid.

So what could potentially be driving this uncertainty?

John Creedy and Kathleen Makale use stochastic projections to measure the uncertainty of future social expenditure.[87] By 2061, the mean ratio of expenditure to GDP is expected to rise from 25% to 28%. However, there was a large range of uncertainty where the 5th percentile projected an expenditure to GDP ratio of 22.5%, and the 95th percentile projected the ratio at 35%.[88] The authors found that much of the uncertainty in future projections can be contributed to uncertainty regarding future unemployment, labour force participation rates, and productivity growth. Higher rates of labour force participation and lower health costs produced lower average ratios of expenditure to GDP. Uncertainty regarding demographics contributed only negligibly to the uncertainty range.

### Policymaking under uncertainty

Given the degree of uncertainty about the future, governments must decide whether to act now or wait to collect more accurate and useful information. Delaying policy changes (fiscal adjustments) could increase the size of the adjustment needed to sustain a given public debt target.

Raising taxes is one option for avoiding future debt.

Tax smoothing – by raising costs in an early period to fund future costs at a time when tax revenue is likely to be lower – can be difficult to predict. Therefore, raising taxes to cover the future costs of population ageing has its risks. If taxes are not raised enough, or not raised early enough, then the public services and government functions that are either essential or expected might not be able to continue. However, if taxes are raised too early or by too much, taxpayers might feel discontented as they will have borne an unnecessary burden.

Ball and Creedy examined the extent to which standard tax smoothing is affected by the uncertainty over whether the need for extra expenditure will arise, and what that level of expenditure will be. Using simplified models, Ball and Creedy found that the potential rise in future expenditure as a proportion of income needs to be relatively large before the cost of 'waiting to see what happens' is sacrificed. The major determinants of optimal tax smoothing policy were not risk aversion, but the size of the potential future tax-financed (publicly funded) cost, and its associated probability:

> … while the time profile of the population age distribution can be predicted with a reasonable amount of confidence, it is difficult to know how markets will respond. The question therefore arises of how much, if any, tax smoothing to use, by raising current taxes to build up a fund.[89]

There are costs, then, that might not be fully compensated if policymakers get the estimates wrong. As the New Zealand Initiative argued in a previous report commenting on the same paper, the costs of raising taxes prematurely would also increase if the excess revenue was used to increase low quality operating spending, "as seems likely under New Zealand's current fiscal arrangements."[90]

87. John Creedy and Kathleen Makale, "Social Expenditure in New Zealand: Stochastic Projections," Working Paper 13/06 (Wellington: New Zealand Treasury, 2013).
88. Ibid.
89. Christopher Ball and John Creedy, "Tax Policy with Uncertain Future Costs: Some Simple Models," Working Paper 13/07 (Wellington: New Zealand Treasury, 2013).
90. Bryce Wilkinson and Khyaati Acharya, "Guarding the Public Purse: Faster Growth, Greater Fiscal Discipline" (Wellington: The New Zealand Initiative, 2014), 14.

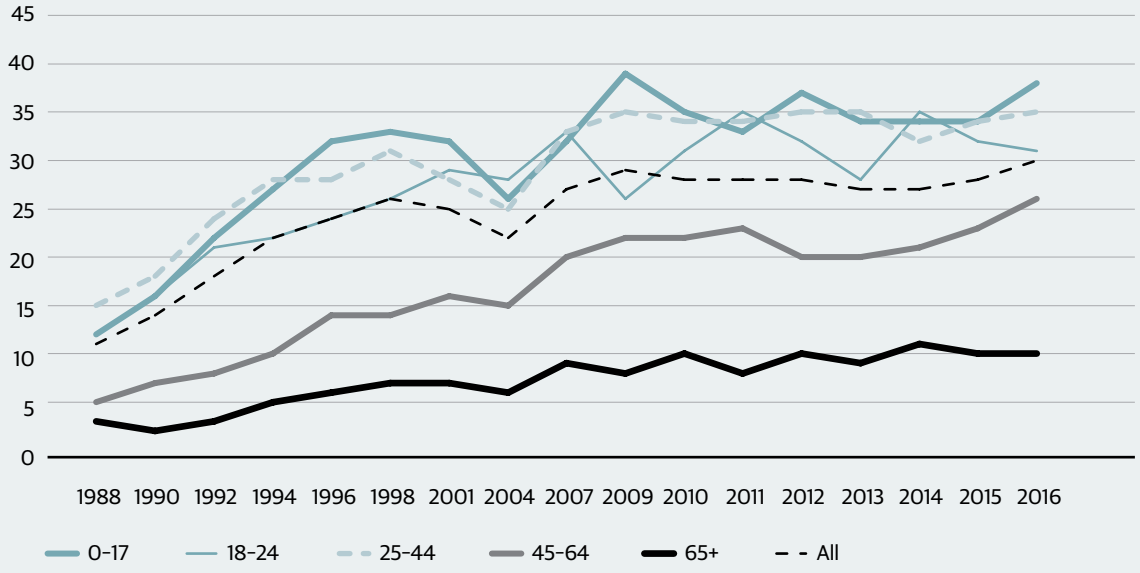
## Box 3: A note on home ownership

Historically, the retired population have faced the lowest rates of housing cost pressure. One way of measuring this is through the outgoing-to-income (OTI) ratio, where high housing costs are considered those greater than 30%. Though the proportion of elderly facing high housing costs is increasing, the overall rate is still significantly lower than households with individuals in younger age brackets.

Yet historic rates of home ownership in New Zealand do not predict the future. We currently face a housing affordability crisis that has put home ownership out of reach for younger generations. A New Zealand Institute of Economic Research (NZIER) paper found an intergenerational gap in the 'purchasing power' of first-home buyers compared to two decades ago. In the 1990s, first-home buyers could have saved a deposit and paid off their mortgage in under 30 years compared to at least 50 years in 2013.[91]

The long-lasting effects of delayed home ownership and how it affects the retirement living standards of younger generations remain uncertain. Some of the currently occupied houses will be handed down to younger generations as inheritances, or will eventually be put on the market. Younger generations might also have different sources of wealth (KiwiSaver is an obvious example) compared to previous generations, so the overall implications of possibly lower home ownership rates in old age are unclear.

### Figure 15: Proportion of individuals in households with housing cost OTIs greater than 30%, by age group (1998–2006)




Source: Bryan Perry, "Household Incomes in New Zealand: Trends in Indicators of Inequality and Hardship 1982 to 2016" (Wellington: Ministry of Social Development, 2017).

91. Shamubeel Eaqub, "The Home Affordability Challenge Suite of Policy Reforms Needed in New Zealand," Working Paper 2014/4 (NZIER, 2014).

But there are potential harms in cutting spending to public services too, especially services that are effective and essential. Making the wrong cuts to public spending could have instant and negative effects on people's lives.

So policymaking under uncertainty requires balancing the benefits of acting early to avoid radical shifts in policy later, and the risks of making unnecessary changes under uncertainty that cause harm.

As New Zealand Council of Trade Unions economist Bill Rosenberg argues, the most important action in this moment is consistent monitoring of the situation:

> There will never be a last word on this subject. We should continue to review the situation, keeping a watch on both the adequacy of our people's retirement income and the cost of it. But New Zealand is lucky enough that we don't have to make urgent decisions to manage the cost of New Zealand Superannuation.[92]

## 3.2 The will of the people

> *Every election is a sort of advance auction sale of stolen goods.*
> —H.L. Mencken

### Public choice theory

Public choice theory applies economic analysis to politics. According to public choice economist Dennis Mueller, "… the distinguishing characteristic of public choice is the assumption that individuals in the political arena as in the marketplace behave rationally and in their own self-interest."[93]

It is for this reason governments can expand the welfare state, and the public can vote for more benefits for themselves, even if the long-term costs are unsustainable. Governments can take on public debt to satisfy the voters of today, while passing on the real costs to the taxpayers of tomorrow.

In a democracy, voting is a way for the public to express and pursue their own – often conflicting – interests. That does not necessarily mean people are selfish, just that they vote according to their preferences (including their moral/ethical considerations).

Getting public buy-in is one way of ensuring policy reforms will survive changes in government. If the public are not on board, there is a strong incentive for opposition parties to overturn unpopular policies, even policies that are necessary for the health of the economy.

This is understood as the 'process norm,' where "a tax/transfer system is sustainable and fair if it is the outcome of a continuing democratic consensus."[94] If a system is seen to be unfair, then the electorate will vote for change.

But getting public buy-in does not necessarily lead to the most economically efficient policies.

Public choice economist Bryan Caplan recognises a complication with achieving public buy-in for policy change: the myth

92. Bill Rosenberg, "Economist Bill Rosenberg runs the ruler over NZ Super cost predictions, and argues it's not as scary as we've been told; Calls for a proper debate on population policy," *Interest* (4 April 2017).

93. Known as the rational voter hypothesis. Dennis Mueller, *Public Choice III* (Cambridge University Press, 2003), 304.

94. Michael Wolfson and Geoff Rowe, "Aging and Intergenerational Fairness – A Canadian Perspective," Statistics Canada, Paper prepared for the 29th General Conference of the International Association for Research in Income and Wealth (2006).

of the rational voter.[95] Of most relevance is the observation that voters tend to favour government intervention and political initiatives because they underestimate the benefits of the market mechanism. Caplan argues that voters tend to indulge their preferred beliefs (irrational biases) because the costs of false beliefs do not fall on one individual but are spread across the population. Voter bias appears to be the rule, not the exception.

From an economist's perspective, they are rational in their 'irrationality': Voters will not spend time improving their knowledge of political or economic affairs unless there is an incentive to do so.

This matters in a policy area like retirement savings where there is already a disconnect between voting for policy change and experiencing the implications of those policies. If voters are criticised by behavioural economists for failing to think about their own future, then how are voters supposed to think about the political future, which is even more abstract?

Rather than blame politicians for inaction or expect politicians to make 'brave' decisions on behalf of constituents, public choice theory explains why public opinion matters. Voters need to be well-informed of the implications of their voting preferences, and the hidden costs.

### Ageing voter demographics

An acknowledgement of the incentives faced by voters and politicians could be a cause for concern as the population ages.

If changes to retirement policy are needed, the electorate needs to financially prepare well in advance. While experts differ on exactly how much notice soon-to-be retirees need, the Commission for Financial Literacy and Retirement Income (formerly the Retirement Commission and now the Commission for Financial Capability) proposal suggests giving 10 years' notice of any change required.[96]

It is hard to convince voters to 'give up' entitlements willingly. It is even harder to convince the electorate to give up the 'entitlements' they need to afford a basic standard of living. As the population ages and genuine need develops, it will become even harder to make changes to NZS or roll back entitlements.

The retired and older people about to retire are also traditionally more likely to vote than younger cohorts. Figure 16 shows the voter turnout of different age cohorts for the last two elections. It was widely predicted that 2017 might see a significant uptick in young voter turnout because of the change in Opposition leader from Andrew Little to Jacinda Ardern. While 2017 did see a slight increase in younger voter turnout, older voters showed up in greater numbers in both 2014 and 2017.[97]

Though voting demographics may change as incentives change in the future (younger people may feel more incentivised to vote in the future, for example), there will still be a growing proportion of elderly as the population ages.

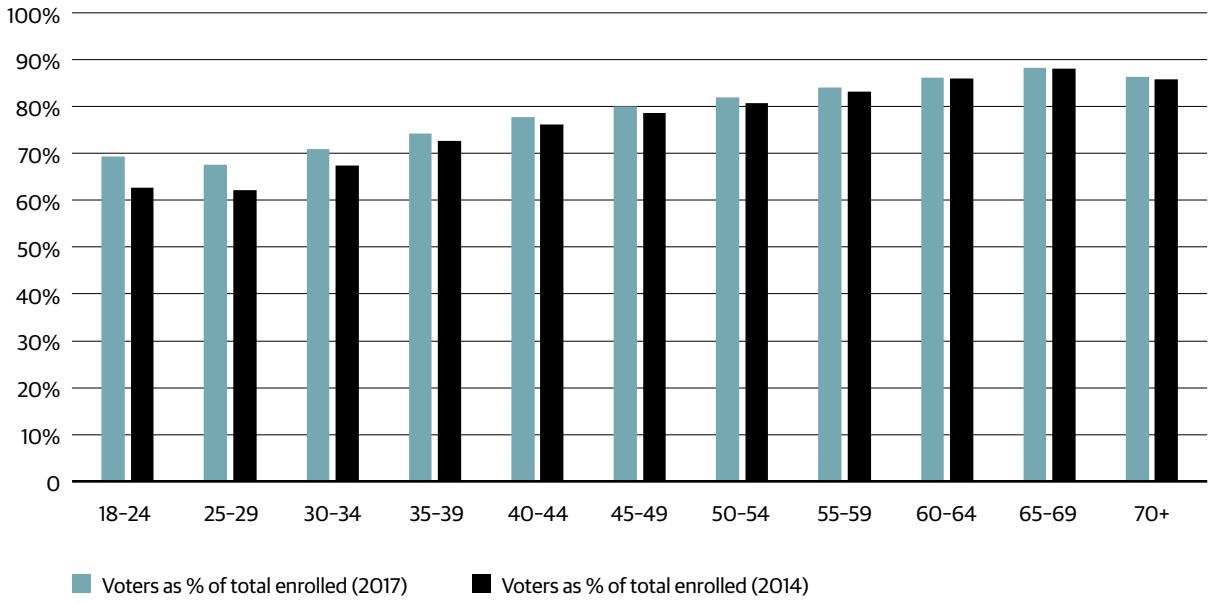
Of course, this is not to say voters are only motivated to protect benefits for themselves. They will be guided by their own moral and ethical considerations. But it is much harder for governments to make changes to the pension if recipients are fully dependent on such benefits and have no other alternatives. It is easier if people have time to financially prepare and arrange other alternatives.

95. Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton University Press, 2008).

96. Commission for Financial Capability (CFFC), "Focusing on the Future: Report to Government," op. cit.

97. Electoral Commission, "Election turnout up for all age groups," Website (2017).

Figure 16: Voter turnout by age cohort (2014 and 2017)




Source: Electoral Commission, "Election turnout up for all age groups" (2017), Website.

## Future redistribution effects

As this report has argued, material hardship among the elderly in New Zealand is low compared to other groups. This is occurring at the same time as concerns about child poverty are rising.[98] If these trends continue, and NZS recipients grow in number, then NZS will increasingly become a transfer from poorer households to the relatively well-off. This would be a form of regressive redistribution.

Even if this transfer does not occur (if NZS recipients pay more in tax than they receive in benefits), paying for NZS means taxpayers' money cannot be spent elsewhere. There is an opportunity cost for all public spending. If the ageing demographic of voters is more likely to preserve benefits for themselves, other age groups might miss out, regardless of need.

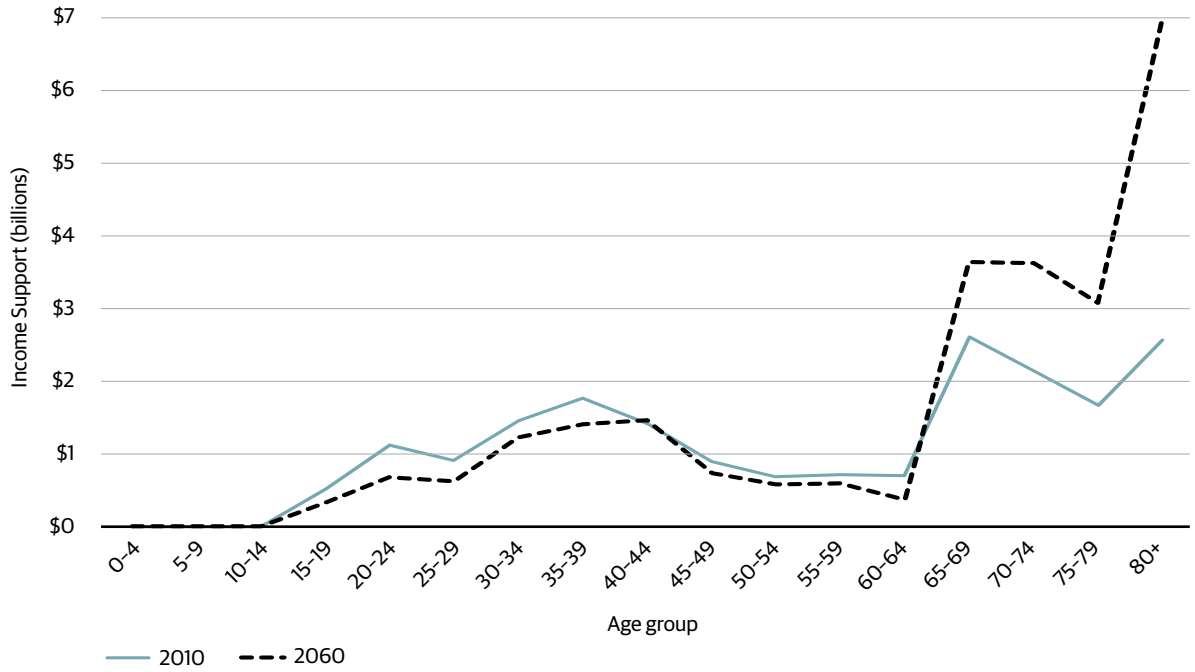
To illustrate, consider the distribution of income support (cash benefits) spending by age group for 2010 and 2060 (see Figure 17). Cash benefits include welfare benefits, Working for Families, housing subsidies, and NZS.

Even when tax payments are taken into account, projections based on current tax and spending policies show that the elderly will still be net recipients (rather than net taxpayers). By 2060, if no changes are made to taxes or spending, the implication is that there will be more spending on the elderly population than the working-age population will contribute in taxes. Figure 18 compares the net fiscal impact by age group in 2010 and 2060.

The question, then, is not whether NZS is affordable but whether the direction and/or level of redistribution is desirable. As Chapter 1 argues, this will ultimately require a value judgment. But such a value judgment can and should be informed by evidence.

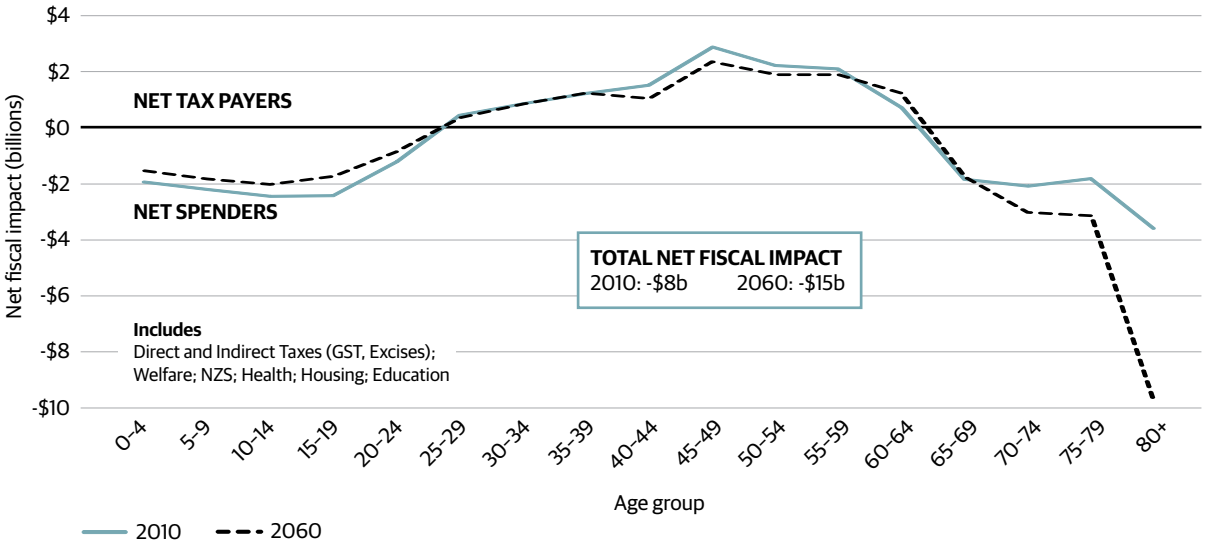
98. Simon Collins, "Income gap between children and elderly widened faster in NZ – OECD report," *New Zealand Herald* (21 May 2015); Susan St John, "Labour's power policy rewards elderly rich," *Newsroom* (24 January 2018).

## Figure 17: Distribution of income support spending by age group (2010 and 2060)




Source: Omar A. Aziz, Christopher Ball, John Creedy and Jesse Eedrah, "The Distributional Impact of Population Ageing," Working Paper 13/13 (Wellington: New Zealand Treasury, 2013).

## Figure 18: Net fiscal impact by age group (2010 and 2060)




Source: Omar A. Aziz, Christopher Ball, John Creedy and Jesse Eedrah, "The Distributional Impact of Population Ageing," Working Paper 13/13 (Wellington: New Zealand Treasury, 2013).

## 3.3 Concluding remarks

It is almost certain that New Zealand's ageing population will increase, as will the future costs of NZS. But those arguing that there is an indisputable case for reforming NZS misunderstand the purpose of the 'historical spending' scenario produced by Treasury.

The historical spending scenario is not a prediction of the future, but an illustration of the long-term implications of a defined set of trends. Scenarios of uncontrollable spiralling debt are unlikely to occur with the existing mechanisms New Zealand has in place to manage fiscal prudence.

And managing fiscal prudence means decisions have to be made around spending and taxes. That doesn't necessarily mean NZS is affordable – it is simply a matter of managing priorities and trade-offs.

Making unnecessary changes to taxes or essential public spending could cause harm in a context of uncertainty. And in this case, there is reasonable uncertainty.

On the other hand, waiting too long to make changes to NZS could also cause harm as voter demographics change, and more aged people become dependent on the current model. The public needs accurate information about fiscal challenges that lie ahead, and strong signalling about proposed changes.

Waiting too long also poses a challenge for governments facing an ageing electorate, where voters have an incentive to protect or increase their benefits and entitlements.

Affordability should not be the main concern about NZS in the future. The main concern should be that NZS could become a tool for redistribution from poor to rich.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79,953.
77,549.
75,107.
70,10
TOTAL INTERES
TOTAL PAYMEN
Payment

## CHAPTER 4

# Keeping the model beautiful

As the above sections have shown, there does not appear to be a clear case for urgent or radical change to NZS. The above sections have also described the features of NZS that are laudable. However, even if change is not urgent, it could be desirable.

Judgments on the affordability of NZS will also be values based. Though NZS might technically be affordable, the question is whether it is the most effective and efficient use of public spending.

This chapter looks at how New Zealand can both preserve the best parts of NZS, while avoiding harmful and unnecessary changes to policy.

Administering a universal public pension might be considered inefficient and unaffordable as it is provided to those who are not in need and involves some redistribution from poorer households to richer households.

The efficiency of the system is improved by closely tying age eligibility to the ability to work. That is why this report recommends linking pension age to health expectancy.

To address the problem of redistribution from the poor to rich, this report recommends indexing NZS to inflation rather than wages. As history has shown with the unpopular and ineffective NZS surcharge, means-testing encourages perverse incentives. Yet the current NZS system also introduces the perverse incentive of not to save for retirement. Linking NZS to CPI ensures a base level of income for those who would struggle to save for retirement, and it creates an incentive to save for people who can afford to and prefer a more comfortable standard of living.

### 4.1 Link the age of eligibility to health expectancy

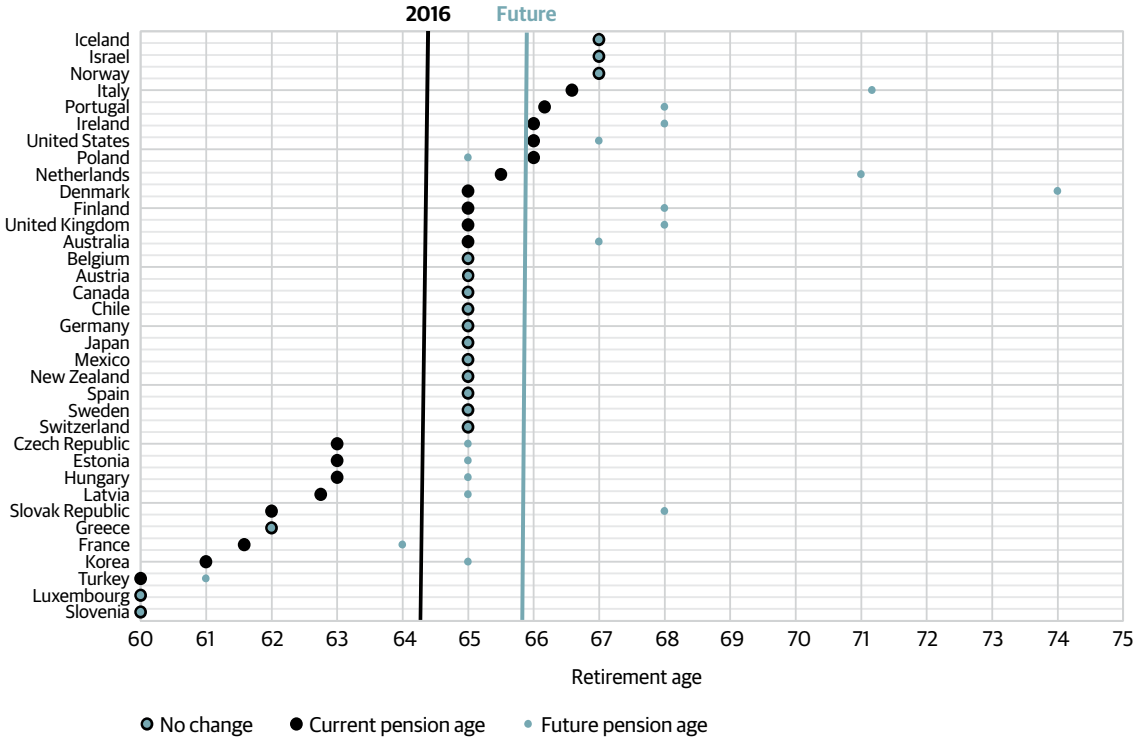
Over the last decade, many OECD countries have raised the age of pension eligibility in response to ageing populations (keeping in mind that many countries are much more advanced than New Zealand in their population ageing).[99] Though 65 remains the norm across the OECD, many countries (particularly advanced economies with ageing populations) are setting the trend for policy change. These countries will differ greatly in the scope of pension benefits and the public/private funding of them. Denmark, Italy, Finland, the Netherlands, Portugal and the Slovak Republic have linked pension ages to life expectancy.[100]

Figure 19 shows the planned changes in pension age for OECD countries.

One option for lowering the cost and improving the efficiency of NZS is to link NZS eligibility to average health expectancy. Health expectancy refers to the years lived in good health. Linking to health expectancy should raise the age of eligibility and ensure the model remains up to date.

99. OECD, "Pensions at a Glance 2017: OECD and G20 Indicators," op. cit. Though it should be equally noted that over the previous two years before the report was published, three countries (Canada, Czech Republic and France) have reversed previously adopted reforms.
100. Ibid.

## Figure 19: Current and future pension ages in OECD countries for men




Source: OECD, "Pensions at a Glance 2017: OECD and G20 Indicators" (OECD Publishing, 2017).

## Table 5: Estimated fiscal savings for each year in NZD billions

| | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 | 2033 | 2034 |
|---|---|---|---|---|---|---|---|---|---|
| **Reduction in NZS spend ($ b)** | 0.000 | 0.363 | 0.751 | 1.148 | 1.529 | 1.962 | 2.442 | 2.973 | 3.560 |
| **Reduction in NZS spend (%)** | 0.00% | 1.5% | 3.0% | 4.3% | 5.4% | 6.5% | 7.7% | 8.9% | 10.0% |

Source: Estimates provided by Treasury, published in Commission for Financial Capability (CFFC), "Review of Retirement Income Policies" (Auckland: 2016).

A recent Ministry of Health report found that though New Zealanders are living longer, they are doing so in poorer health.[101] Both life expectancy and health expectancy have increased between 1996 and 2016, but health expectancy has been increasing at a slower rate. Between 1996 and 2006, life expectancy at birth for males increased by 3.3 years and 2.4 years for females. In the same period, health expectancy increased by 2.5 years for males and 1.8 years for females. Meanwhile, the years spent living in poor health increased by 1 year for males and 0.7 years for females.

Health expectancy gives a more accurate impression of the years people are capable of work, though it will not capture differences in the type of work, demographic determinants, and other factors that affect individual health expectancy.

Of the many possible policy options to reduce the future costs of NZS, raising the age of eligibility to 67 is one of the most commonly presented.

101. Ministry of Health, "Health and Independence Report 2017: The Director-General of Health's Annual Report on the State of Public Health" (Wellington: New Zealand Government, 2018).

Though raising the pension age is a good start, raising the age to 67 is as arbitrary as keeping the age at 65. If there is a long lead-in time, a pension age of 67 might be out of line with health and retirement trends by the time it is implemented. Linking the pension age to health expectancy is one way to broadly tie eligibility to the ability to work.

The Commission for Financial Capability recommends raising the age of eligibility to 67 by 2034, which will reportedly reduce NZS costs by around 10% ($3.56 billion) a year (Table 5).[102] Following a 10-year notice period, the age of eligibility would rise by three months each year starting in 2027 and ending in 2034.[103] The 10-year lead-in times, and incremental increases, mean that today's retired people will not be affected by the changes, nor would those who are near retirement.

Before the 2017 election, the National government had announced a change to the pension age, after years of pledging non-reform.[104] Then Prime Minister Bill English announced an increase in the age of eligibility for superannuation from 65 to 67. The policy would have a long lead-in: It would take place in 20 years' time (from July 2037), and would see the age of eligibility rise by six months annually until the policy is fully implemented by 2040. This differs from the Commission for Financial Capability's recommended lead-in time of 10 years.

The Cabinet Paper for the policy change reports that once fully implemented in 2040/41, approximately 113,000 fewer people will receive NZS at any one time, compared to no policy change. The gross cost of NZS would be approximately $4.3 billion per year by 2040/41, saving around 0.6% of GDP.[105]

Even then, the policy would have only been legislated after the election and still be vulnerable to the fact that in the next 20 years, Parliament could overturn the policy. In any case, it did not even come to this: The new Prime Minister Jacinda Ardern has committed to keeping the pension age as it is.[106]

The timing of this policy would have meant the Baby Boomers (born 1946–64) would have retired, Generation X (born 1965–80) would have faced the transition, and millennials (born 1981–97) would have faced the full brunt of the age change. The long lead-in time had been criticised as politically convenient as it avoids disadvantaging the older cohorts who are most likely to vote and fails to address Baby Boomers and Generation X being likely to carry a large fiscal price tag because of their large populations.

This criticism was investigated by economist Norman Gemmell.[107] Gemmell found that "despite much popular rhetoric, the inter-generational 'fiscal transfer' due to population ageing is associated only to a limited extent with the Baby Boomer phenomenon."[108] Modelling by Treasury found that though there was indeed a 'baby boom,' the impact 40 or 50 years down the track on the 65+ dependency ratio was relatively

102. The Commission for Financial Capability reviews the government's retirement policy settings every three years (the next review is due in 2019). The Commission reports its findings to the government, though it is not obliged to take those recommendations on.
103. Estimates provided by Treasury, published in the Commission for Financial Capability (CFFC), "Review of Retirement Income Policies" (Auckland: 2016).
104. John Key had said he would not raise the pension age as long as he was Prime Minister. When he stood down in December 2016 and Bill English became Prime Minister, many commentators recognised this as a way for the government to get out of that straitjacket. For example, see BusinessDesk, "NZ retirement age in question with Key exit," *National Business Review* (5 December 2016).
105. Office of the Minister of Finance, "Cabinet Paper: New Zealand Superannuation" (2017).
106. Jeff Bell, "Jacinda Ardern 'would resign' before raising retirement age," *Newshub* (2017).
107. Norman Gemmell, "Reforms to New Zealand Superannuation Eligibility: Are They a Good Idea?" Working Papers in Public Finance, Working Paper 08/2017 (2017).
108. Ibid.

small.[109] Gemmell argues that "the increasing upward trend in the 65+ ratio from around 2010 is not substantially due to the earlier baby boom. Rather it is due to the various medical and other advances…"[110] Population ageing is not a one-off phenomenon, but it will be ongoing rather than just due to the retirement of Baby Boomers. For this reason, Gemmell suggests there is still value in National's policy, and that there are still notable savings to be made even if greater savings are possible if the policy had started earlier.

Longevity is, of course, heterogenous. People age at different rates. This heterogeneity will have redistributive and efficiency consequences and could affect the extent to which pension systems are welfare-enhancing. For a pension system to be considered welfare-enhancing it ought to redistribute income across life-cycles (lifetime consumption smoothing) and generations, create a risk pool to address uncertainty of death (risk pooling), and redistribute income from rich to poor.[111] Though pension systems that are highly responsive to longevity heterogeneity (by offering different rates or different ages of eligibility) might lower the costs of the system, they might also be subject to greater political resistance and introduce perverse incentives to game the system.[112] For example, offering different pension rules for different groups may cause public unrest.

This report makes no specific recommendations on how regularly the pension age should be reviewed. A balance would have to be kept between ensuring the pension age rises (or falls) to meet the needs of changing demographics, and ensuring the public have enough time to financially adjust to signalled policy changes. A good rule of thumb might be to ensure that any changes to the pension age have a lead-in time of at least 10 years.

There might be concern about raising the age because inevitably there will be some older workers who will suffer, particularly those in labour-intensive industries.[113] However, the current pension age at 65 is still an arbitrary choice of age. Clearly, there will be people aged 60 or 63 who are incapable or who would struggle with continuing work. At least linking the pension age to health expectancy is a more efficient means of administration when many are working beyond the age of 65.

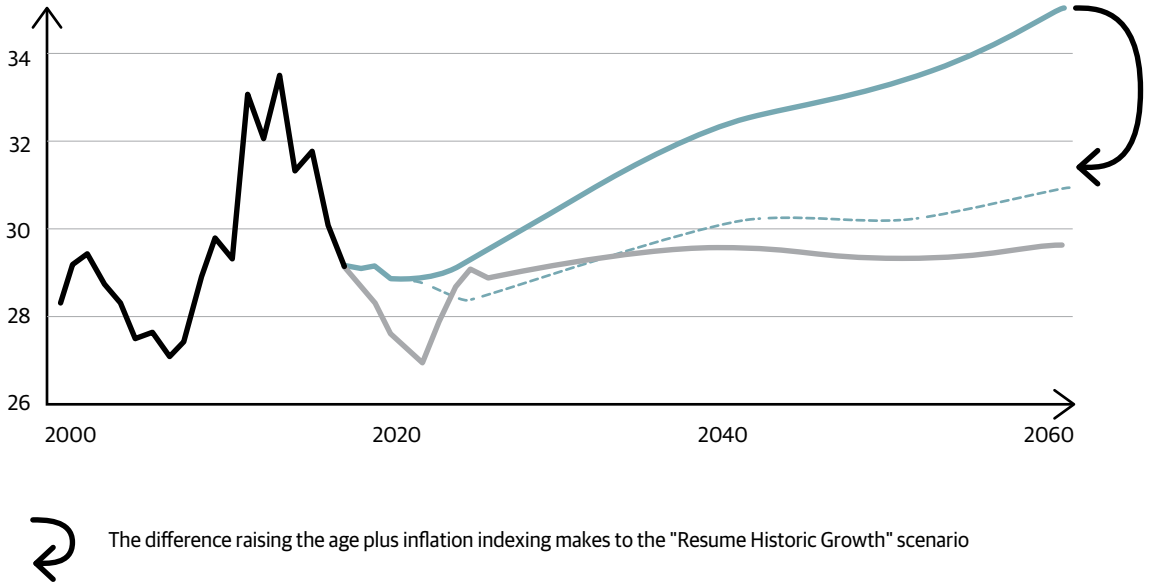
For those who cannot work, alternative means-tested welfare support should be provided. But to ensure the universal NZS system remains efficient (and therefore a responsible use of limited fiscal resources), there must be a link between entitlement and ability to work.

## 4.2 Link NZS payments to CPI

NZS is currently indexed to both inflation and the average ordinary time wage. As this report has noted, this differentiates NZS from other welfare benefits. This report recommends decoupling NZS from rises in wages as a way of ensuring productivity gains reduce the costs of NZS. This report makes this recommendation with the assumption of continued real median wage growth, which is why this report later also recommends a strong focus on productivity.

109. Treasury argues, "The important point is that from 2050 or so onwards, when the bulk of the baby boomers have died, the aged dependency ratio is still twice as large as it is now." Paul Rodway, "Long-term Fiscal Projections: Reassessing Assumptions, Testing New Perspectives," Draft paper for the long-term external panel (2012), 16.
110. Norman Gemmell, "Reforms to New Zealand Superannuation Eligibility," op. cit. 8.
111. Mercedes Ayuso, Jorge Miguel Bravo and Robert Holzmann, "Addressing Longevity Heterogeneity in Pension Scheme Design and Reform," Discussion Paper No. 10378 (IZA Institute of Labour Economics, 2016).
112. Ibid.
113. Unions are particularly prominent opponents of change. Peter Conway, "NZCTU Response to Focussing on the Future – Discussion Document 2013 Review of Retirement Income Policies" (New Zealand Council of Trade Unions, 2013).

Figure 20: Impact of raising the age of eligibility plus indexing NZS to CPI only




Source: New Zealand Treasury, "Affording our Future: Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2013).

It has been argued that indexing NZS to just CPI might increase elderly poverty rates.[114] But that is only because 'income poverty' is actually a measure of inequality. Inequality might very well increase, but this policy's effect on material deprivation rates are less certain. Technically, elderly material deprivation rates should not be adversely affected unless indicators for material deprivation change (as it is still a relative measure).

The Treasury's 2013 Long-Term Fiscal Position states that the real purchasing power of NZS should remain the same while the real purchasing power of wages would increase. This policy option would remove most of the projected increase in costs for NZS.[115] The 2013 Treasury Long-Term Fiscal Position also showed different projected spending paths, including a scenario where the pension age is raised to 67 where the pension age is raised to 67 and NZS is indexed to CPI only.

The dotted line represents the policy change scenario, the teal line the historic spending scenario, and the grey line the scenario where spending maintains 20% net debt and the tax take remains constant at 29% of GDP (see Figure 20).

Though the future level of NZS might not be adequate as a sole source of income for many, especially compared with NZS rates today, it is difficult to conclude outright how people will behave and adjust their private retirement savings to meet this gap. The fact that a significant proportion of elderly New Zealanders rely on NZS as their sole source of income is a result of incentives as much as preferences and ability. Changes to NZS will change the incentives for private savings. Drawing on historical trends of private savings and reliance on NZS to predict

114. The Commission for Financial Capability, for example, recognises that changing the indexation of NZS might increase income poverty unless that change was complemented with a rise in private savings through KiwiSaver. Commission for Financial Capability (CFFC), "Focusing on the Future: Report to Government," op. cit.
115. New Zealand Treasury, "Affording our Future: Statement on New Zealand's Long-Term Fiscal Position" (Wellington: New Zealand Government, 2013).

responses to changes in NZS policy is therefore unhelpful. This report has already discussed that preferences for the direction of redistribution requires a value judgment. Re-indexing NZS might lead to a growing gap in living standards (but not necessarily an increase in real hardship) between the working and retired.

Changing the indexation of NZS should still prevent the elderly from real hardship (as the current model does), and it should ensure access to a constant bundle of goods comparable to those accessible during the retiree's working life. Though the benefits of enhanced productivity growth will not be shared under this setting, it is down to value judgments to determine whether NZS should provide for these enhanced benefits or whether private savings should be expected to fill this gap.

The costs of continuing to administer a higher level of universal NZS must be considered against administering a lower level of NZS but offering additional targeted financial assistance (for example, in the form of the accommodation supplement) for those in need. The uptake of KiwiSaver will also mean that historic rates of relying on NZS as a sole source of income might not continue in the future.

In his submission to the Commission for Financial Capability's 2013 review, Hurnard recommends that changing the NZS indexation formula could preserve the most celebrated aspects of the NZS model while reducing costs. Hurnard recognises (and this author agrees) these celebrated aspects as:

- Universality
- Longevity risk protection
- Avoids disincentives to save
- Avoids disincentives to continue working or earning income
- Maintains social cohesion
- Provides an effective safety net.

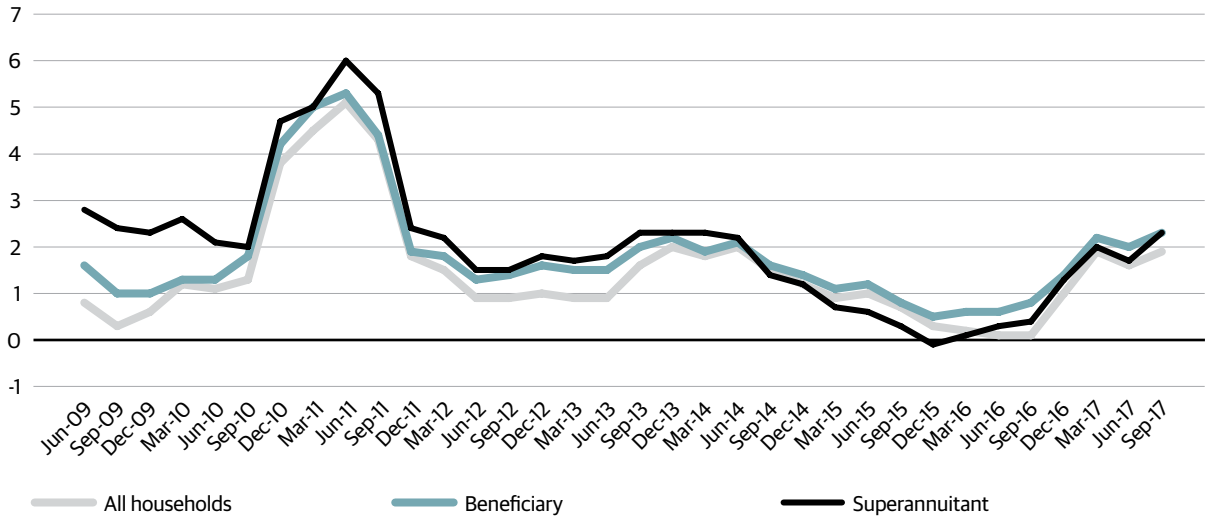
Hurnard argues that re-indexing NZS could maintain the above celebrated aspects while constraining the entitlement from expanding. The fiscal savings could then be channelled into other social programmes (like health care or housing) or used to reduce fiscal debt.[116]

If linking to general inflation is undesirable, an alternative is to index NZS specifically to the household living costs of superannuitants. Statistics New Zealand currently produces a living-costs price index. Though similar to general inflation measures, the living-costs price index looks at the inflation experienced by different groups, including superannuitants.[117] This measure would adjust for superannuitants consuming more of certain goods and services and less of others. Therefore superannuitants may face greater cost pressures than the general population (and vice versa: superannuitants might face lower cost pressures in other areas). Figure 21 shows the annual percentage change in household living costs for different groups.

Though superannuitants are typically in the low-spending category, in September 2017 they faced the highest inflation out of all household groups, mainly because of the rising costs of home ownership.[118] These include the costs of local authority rates and home insurance. Superannuitants also spend more on health insurance, and are therefore more greatly affected by changes in price compared to other household groups.

116. Roger Hurnard, "Setting and adjusting the rates of New Zealand Superannuation: A submission to the Commission for Financial Literacy and Retirement Income on the 2013 review of retirement income policies" (2013).
117. Statistics New Zealand, "Living-costs explorer," Website (2017).
118. Statistics New Zealand, "Poorer households face higher inflation," Website (October 2017).

Figure 21: Annual percentage change, household living costs price indexes




Source: Statistics New Zealand, "Poorer households face higher inflation," Website (October 2017).

## 4.3 Concluding remarks

The future 'affordability' of NZS is a bit of a misnomer. Anything can technically be affordable if the right sacrifices are made. A better way of thinking is considering the relevant opportunity costs and the consequences of maintaining the NZS model in its current form.

Chapter 3 argued that it is likely the redistributive effect of NZS will likely be increasingly regressive. This chapter makes recommendations to address this issue.

First, the pension age should be linked to health expectancy as a more efficient proxy of 'need.' Rather than a one-off rise in the pension age, linking to health expectancy is more responsive to improvements in health and longevity. Though some demographics might be disadvantaged due to the change, alternative support should be available for those who are unable to continue working until the new age of eligibility.

And second, NZS should be indexed to CPI rather than wages to ensure the gains from productivity growth are fully realised. If NZS continues to be linked to wages, then any gains in wage growth will also increase the costs of NZS. Indexing NZS to CPI can keep NZS costs down while ensuring a minimum standard of living for recipients, and will ensure the gains from productivity growth are fully realised.

CHAPTER 5

# Shelter from the (fiscal) storm

## 5.1 The Super Fund is a red herring...

Though some might be led to believe that the NZ Super Fund is an important means of easing the future costs of NZS, the reality is that at its very best, the Fund may very partially smooth the incidence of costs.[119] The government's ability to pay for NZS or anything else depends on productivity.

The Super Fund should not be relied on to reduce the future costs of NZS (it cannot do that), and contributions to the Fund should not come at the expense of paying down debt. Though the previous government has been criticised for pausing contributions to the Fund, paying down debt ought to be the priority.[120]

The NZ Super Fund was introduced at a time when the government was running a string of fiscal surpluses. It was set up to smooth the cost of NZS over time (see Chapter 1). The establishment of the Fund could be understood as a way for the government to demonstrate fiscal responsibility, while avoiding offering tax cuts that would have been inconsistent with the government of the day's objectives. As Don Brash describes:

> Of course, while this may have made political sense – pointing to a gradually filling piggy bank is easier than pointing to a gradually diminishing debt, and is doubly attractive when that piggy bank can be erroneously described as in some sense guaranteeing New Zealand Super for decades ahead – this made no economic sense at all. No prudent household with a mortgage would use temporary cash surpluses to buy shares in New York or petrol stations in New Zealand.[121]

Offering tax cuts in times of (structural) economic surplus would, of course, give people more choices about how their money is distributed between the present and the future.

By 2080, the Fund is projected to cover 11.8% of the cost of NZS, assuming contributions to the Fund restart and that National's proposed changes to the age of NZS eligibility were enacted. After including the projected tax paid by the Fund, it is projected that the Fund could cover, in total, 19.8% of future superannuation costs by 2080.[122]

The Fund does not reduce the total cost, nor will the investment performance of the Fund. Chamberlain and Littlewood observe several problems with partially pre-funding NZS through the Super Fund. This report acknowledges three of the most salient points.

119. Guardians of New Zealand Super Fund, "The NZ Super Fund and the Partial Pre-Funding of Universal Superannuation," op. cit.
120. The Labour Party not only criticises National for suspending contributions to the Fund, but misleadingly claims that contributions to the Fund will secure its future. Andrew Little, "Labour secures the future for NZ Super," Press release (Labour Party, 18 July 2017).
121. Don Brash, "Challenges for New Zealand's Future Pension System," op. cit.
122. Guardians of New Zealand Super Fund, "New Zealand Super Fund Annual Report 2017" (2017).

First, it constrains future decision-makers as the existence of the Fund and taxpayer contribution to the Fund increases expectations that those taxpayers will have access to Super by the time they retire, and could make policy changes to the pension difficult. Having a Fund earmarked for NZS reflects political motives, rather than practical ones. Other future costs like health are likely to increase too. Earmarking the Fund simply makes it harder for governments to use the money in areas that need it the most and can make it harder to respond to unexpected expenses.

The Super Fund might also be questioned on the grounds of whether the fund reflects a desirable function of government. Economist Michael Reddell argues that the intergenerational investment model based on tax revenue cannot be likened to investment models for natural resources like oil:

> We aren't Norway or Abu Dhabi, managing for an intergenerational perspective, oil wealth that has been turned into cash. All the money put into the NZSF has either been raised from taxes or borrowed. There isn't a pool of money that naturally needs investing. Rather, the government has established a high-risk investment management subsidiary to punt on world markets. That simply isn't – and never has been – a natural business of government.[123]

Second, it is 100% leveraged. "Investing in the presence of debt is exactly the same as borrowing to invest… That's because, at any time, it could sell those assets and repay debt. The government has effectively raised a mortgage of about $35.5 billion (April 2017) on New Zealand's total assets (including the NZSF's assets) to invest in financial markets."[124] Such leveraging magnifies risk.

And third, there are no particular grounds for pre-funding NZS but not other government programmes like health and infrastructure.[125]

The existence of the Fund raises the expectation to taxpayers that NZS can continue in its current form. Given taxpayers of today have contributed to the Fund, there might be disappointment if future changes to NZS are made.

Chamberlain and Littlewood point out that investing in the Fund while in debt is like borrowing to invest. But even if governments were only investing during periods of surplus, the opportunity cost must be considered. Is it more efficient to invest in the Fund, or to implement tax cuts so that individuals have a better opportunity to prepare for their financial futures?

Economic modelling by Christopher Ball, et al. explores the optimal timing of tax policy in the face of projected debt increases (as the Treasury's projections do).[126] Ball, et al. looked at two scenarios: when there is certainty of the future and when there is uncertainty over a 40-year horizon. As this report has argued, there is significant uncertainty about the future. The authors found that even if there was certainty, tax smoothing to achieve a final debt target results in a loss of welfare compared with the optimal tax policy of tax rates falling slightly in early years, then rising gradually in subsequent years.

123. Michael Reddell, "Defenders of the NZSF," *Croaking Cassandra* Blog (16 March 2017).

124. Michael Chamberlain and Michael Littlewood, "The Missing 2016 Review – Building Trust for Life Beyond Work," op. cit. 30.

125. Ibid.

126. Christopher Ball, John Creedy and Grant Scobie, "Optimal Timing of Tax Policy in the Face of Projected Debt Increases," Working Paper 16/02 (Wellington: New Zealand Treasury, 2016).

The taxes paid today go into the Fund, but there is no guarantee that future taxes will be lower than they would have otherwise been. An alternative, of course, is simply to cut taxes during times of surplus and raise taxes in the future if they are needed. Withholding taxes to pay for contributions to the Fund limits individuals' ability and preferences to save for their own retirement.

There might be a good reason for keeping the NZ Super Fund, but it has nothing to do with smoothing the costs of Super.

Contributions to the Fund might be a more politically acceptable way for government to act frugally during times of surplus, when they might otherwise be tempted to spend cyclical surpluses. The risky alternative would be to spend the excess revenue on off-the-cuff vote winning policies like Labour's interest-free student loans policy and Working for Families package announced during the 2005 election campaign. Though such policies might be considered 'affordable' during economically buoyant times, they quickly become expensive and require further tax hikes during economic downturns.

In this sense, setting taxpayers' money aside in the Fund rather than spending it on policies that become increasingly unaffordable could be the most fiscally responsible thing to do given political imperatives.[127]

However, the opportunity cost of paying down debt is more fiscally responsible, and the opportunity cost of enabling tax cuts gives individuals more choices and security over their financial futures.

## 5.2 ... what really matters is productivity growth

The rising gross costs of NZS are only part of the equation when considering future affordability. Equally important is economic growth. The strength of the economy and labour market can help the country prepare for the future by raising national income per capita, regardless of what is happening with the pension system.

The New Zealand Initiative has produced research emphasising the importance of higher labour productivity growth to help fund the future projected growth in government spending.[128] Authors Bryce Wilkinson and Khyaati Acharya pointed out that the Treasury's projection models do not build in the effects of policy changes on productivity growth. Supplying the model with different values for future productivity growth has a material effect on the fiscal projections. Those alternative projections illustrate the importance of policies to raise future productivity growth such as:

- Increasing labour force participation by raising the NZS age of eligibility
- Improving educational outcomes
- Stimulating investment
- Improving the clarity of goals for public sector spending programmes, and greater accountability for achieving them
- Tax reform and decreasing churn in the tax-benefits system.

Raising productivity is by no means a simple recommendation. The Productivity Commission specifically exists to grapple with how to resolve New Zealand's low long-run productivity.[129]

127. The situation described is hardly ideal, as the Super Fund would still be spent towards a policy that has become increasingly expensive, especially during economic downturns. However, one must consider that things can always get worse: Governments face natural incentives to spend more.

128. Bryce Wilkinson and Khyaati Acharya, "Guarding the Public Purse," op. cit.

129. For an accessible short primer for the issues at hand and possible next steps see Paul Conway, "Can the Kiwi Fly? Productivity Lift-off in New Zealand," *International Productivity Monitor* 34 (Productivity Commission, 2018).

The future effects of population ageing on labour productivity are also not well known, as the magnitude and direction of the effects are unclear in theory and evidence.[130]

Faster rates of productivity growth relative to increases in the real interest cost of government borrowing can allow increased government spending without falling into a public debt spiral like the one projected under Treasury's historic spending scenario.

## 5.3 Concluding remarks

Uncertainty about the future does not mean government can sit back and not prepare. In fact, uncertainty is the very reason it is important for government to prepare. Even if no changes are made to the NZS model itself, raising productivity growth will reduce the future costs of NZS.

There might be political reasons to keep the Super Fund, but the Fund should not be understood as a way of reducing the future cost of NZS. It simply shifts those costs. Contributions to the Fund must be considered against the opportunity costs: paying down debt and putting more money in taxpayers' pockets.

Reliance on the Fund is also a red herring for what can really reduce the future costs of NZS: productivity growth. Raising productivity growth is a way of making NZS (and everything else) more affordable, and gives future governments more options and flexibility to adjust to changing economic and political circumstances.

130. Ross Guest, "Population Ageing and Productivity: Implications and Policy Options for New Zealand," Working Paper 13/21 (Wellington: New Zealand Treasury, 2013).

# Conclusion

New Zealand is one of a handful of countries in the world to administer a universal public pension. New Zealand's pension system is also comparatively affordable compared to many OECD countries. On the face of it, the current NZS model appears to be both efficient and effective.

However, this has not stopped many commentators from calling for urgent or radical changes to NZS to avoid a looming fiscal time bomb.

This report has shown that claims of funding NZS will lead to a fiscal crisis are premature. Though the gross costs of NZS will increase over time, many factors will determine its affordability. Reassuringly, New Zealand's *Public Finance Act* also places the country in a more favourable position for managing fiscal prudence. Besides, the projected costs of NZS in 2060 are still lower than the costs of many OECD pension systems today.

There is a saying "if it ain't broke don't fix it". The NZS model is certainly not broken. And there are some laudable aspects of the NZS model that policymakers might want to keep.

But there are opportunity costs to any spending decision. As the population ages, there is a risk NZS could increasingly become a transfer from the poor to the rich.

The timing of implementing changes to NZS also matters. Changes that are implemented too early and prove to be unnecessary can cause harm. Given there is a notable degree of uncertainty regarding future projections, the risks of getting radical policy change wrong are real.

On the other hand, waiting too long to implement necessary changes can also cause harm, as the public needs time to financially adjust to any proposed changes. And changes are only likely to become more difficult as voters age and become more dependent on NZS.

In light of these challenges, this report makes some recommendations focused on preserving the best aspects of the NZS system while making small tweaks to ensure the model remains efficient.

This report recommends linking the NZS age of eligibility to health expectancy, and indexing rises in NZS to inflation. Both changes will enhance the efficiency of the model while managing issues of regressive redistribution.

Further, this report recommends that conversations about the future affordability of NZS (or health, or any other public good or service) need to put productivity front and centre. Reducing debt and improving productivity growth ought to be given greater priority for securing New Zealand's fiscal future. Though the Super Fund might be a more fiscally responsible tool rather than increasing government operational spending during economically buoyant times, its role in smoothing the future costs of NZS is likely to only be marginal.

Of course, the future of NZS will ultimately be decided by the taxpayers of the day depending on their value preferences and what the government can afford. But if voters today agree that efficiency and progressive redistribution are aspects of the NZS model worth promoting, changes can be signaled today.

The affordability of NZS might be uncertain, but the opportunity costs are not.

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There is a lot to like about this report because the author celebrates what's good about New Zealand Superannuation. New Zealand has one of the best Tier 1 public pension schemes in the developed world, but we got here by accident. We need to look at what we do and what we can do better. As the report emphasises, it's not just about New Zealand Superannuation (NZS) and its recipients but also about other community interests. The long-term sustainability of any pension system ultimately depends on community consensus, so this wider view is essential.

...

This report concludes that NZS in its present form is sustainable. I agree – and also agree that this is no reason to keep what we have, though it's a nice 'problem' to have. Sure, we have the best Tier 1 scheme in the world, but it can definitely be made better. 'Better' might also mean 'cheaper' but that doesn't necessarily follow – nor does it need to.

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