

New Zealand: financing retirement

- lessons from the New Zealand Way on necessary reforms

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Abstract

In at least some respects, the pensions “problem” is a reflection of a country’s profile and history. To set this paper in perspective, Table 1 shows New Zealand at a glance. It both explains New Zealand and summarises what this paper defines as the “New Zealand Way” (definitions on page 3).

Table 1

New Zealand at a glance	
Population ²	4.1 million (Sept 2005 est.)
GDP per capita	US\$23,400 (2004 est.) Rank 40 CIA <i>World FactBook 2005</i>
Median age	2005: 35.6 years (est.) 2050: 44.0 years (est.)
Proportion over age 65	2005: 12.2% 2050: 23.0% (est.)
Expectation of life at 65 (2002)	Males: 16.7 years Females: 19.9 years
Total dependency ratio	2005: 56.0% 2050: 66.9% (est.)
Net cost of state pensions ³	2005: 3.8% of GDP 2050: 7.3% of GDP (est.)
Financing of state pensions	Largely PAYG Partly pre-funded
Net public debt ⁴	23.5% of GDP (2005)
Tax treatment - private provision	TTE (the Income Tax Model)
Cost of tax incentives for private provision	Nil

In summary, New Zealand is relatively young (for a developed country); the cost to taxpayers of pensions (both public and private) is relatively low and, although that cost is expected to about double in the next 45 years, is less than what many developed countries pay now in total (including the cost of tax incentives for private provision). New Zealanders are at present neither forced, nor encouraged through tax incentives, to save privately for retirement.

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- a member of the New Zealand Prime Minister’s Working Group on Superannuation 1990.
- a member of the New Zealand Task Force on Private Provision for Retirement, 1991-92.
- author of *How to Create a Competitive Market in Pensions – the International Lessons*, Institute of Economic Affairs (London) 1998.

² Source for population statistics – Statistics New Zealand.

³ Source – New Zealand Treasury The New Zealand Superannuation Fund Contribution Rate Model – because NZS is taxed as income, the estimates allow for tax collected on the pensions.

⁴ Source – *Pre-election Economic and Fiscal Update*, The Treasury, August 2005.

There is some evidence that New Zealanders are behaving rationally and that they will have adequate retirement incomes, including the Tier 1 pension.

Despite all this, the government decided in 2001, without debate, to set up the “New Zealand Superannuation Fund” to build financial assets in public ownership. The NZSF aims to partially smooth the cost of the state pension as the population over age 65 about doubles. This paper suggests that the NZSF is an unnecessary public intervention and fails to address the issues that really matter. It also introduces some avoidable economic and policy risks.

Again without proper debate, the government is introducing a “compulsory, opt-out” Tier 2 arrangement designed along the principles of now fashionable “behavioural finance”. The “*KiwiSaver*” scheme is another needless public policy initiative.

The paper suggests that public policy interventions in capital markets to change saving behaviour are inappropriate, whether they are:

- Central and monolithic (New Zealand’s NZSF, Singapore’s Central Provident Fund and many smaller nations’ “national provident funds”), or
- Central but dispersed (Australia and Chile’s compulsory saving arrangements; New Zealand’s *KiwiSaver*), or
- Indirect and dispersed, through tax incentives for private provision (all countries but New Zealand).

All of these interventions distort capital and labour markets but none of them deals directly with the issues that are central to the potential financial pressures faced by countries with ageing populations.

New Zealand has yet to fully appreciate the significance of what is one of the “universal truths” of retirement benefits financing but is not alone in that. In fact, the cost of retirement benefits is the benefits that are actually paid when they are paid, not contributions that may be set aside in a fund to help pay for them; nor the actuarial estimates today of what might happen decades hence. This “truth” has considerable significance in any debate about the economic impact of ageing populations. Until there is agreement about the amount of future pensions and the basis on which they are paid, there is little point debating how to pay for those pensions.

New Zealand therefore has lessons for other countries about both how to do and how not to do things. On the pensions issue, the paper suggests that the New Zealand Way (the NZSF and *KiwiSaver* aside) deserves international attention.

If a country wanted to look at the New Zealand Way as a reform option, the paper offers a decision-making framework, based on our experience, that can guide the research, debate, consensus-building and monitoring processes needed for a potential solution to any country’s pensions problem.

Definitions

The following expressions are used in this paper in a particular way:

EET - the taxonomy of the way income tax applies to private provision for retirement is summarised by three letters that tag each major movement of money. In this case, the treatment is exempt on contributions (E); exempt on investment income (E) and taxed on benefits (T). Section 6 looks at this.

KiwiSaver - a proposed “compulsory, opt-out” Tier 2 saving scheme that will start on 1 April 2007. See more in section 8 on this.

New Zealand Way – the broad subject of this paper. Generally, it means the provision of a liveable Tier 1 pension as a “Citizen’s Pension”; no compulsory private provision and no other state intervention at Tiers 2 and 3 (such as tax incentives) other than with respect to governance and securities disclosure requirements.

NZS – New Zealand’s Tier 1 pension, “New Zealand Superannuation”. A non-contributory, taxable “Citizen’s Pension”, payable to all over 65 who have satisfied modest residency requirements and without regard for assets or other income. The rules are explained in paragraph 3.2 below.

NZSF – the New Zealand Superannuation Fund, set up by the New Zealand Government and that will partially pre-fund future payments of New Zealand’s Tier 1 pension, NZS. See section 4 for more on the NZSF.

PAYG – Tier 1 schemes throughout the world are largely financed on the “pay as you go” principle that sees current taxes (or “contributions”) collected and paid in that year to current pensioners. Some countries (UK) have a notional “fund” but the future benefits are not pre-funded in any meaningful way. Other countries have “proper” funds (Ireland, New Zealand) but they will make only a modest contribution to expected future costs.

State Pension Age – the age from which public pensions are payable, without adjustment for early or late payment.

Tier 1 – the state normally provides retirement income that is available to all citizens, usually on an income-tested basis. There may also be contribution, work or residence requirements. Generally, Tier 1 is a subsistence level, guaranteed income provided on a **PAYG** basis though there may be the fiction of a fund through which special tax payments (sometimes also called “contributions”) flow. No country has a fully funded Tier 1 – some are partly funded (Ireland, New Zealand).

Tier 2 – employment-related schemes form a second layer of retirement income. They can be voluntary or compulsory (Australia, Chile); private or public (France, Germany) or both public and private (US). Because of tax concessions, they are usually required to provide pension benefits.

Tier 3 – after accounting for Tiers 1 and 2, Tier 3 is everything else that a country (through, for example, tax policies) or individuals might do as preparation for retirement income needs. Tier 3 encompasses a variety of things from building a business for eventual sale (or income), paying off debt, saving through a collective vehicle, direct investment in stocks and bonds, trading down a large family home for a smaller one appropriate for retirement etc. Tier 3 can be tax-favoured as a matter of public policy but that usually only applies to collective investment vehicles such as IRAs in the US.

TTE – part of the taxonomy of the way income tax applies to private provision for retirement (see EET above). In this TTE case, the treatment is: contributions from taxed income (T); investment income taxed (T) and benefits tax-free (E).

Section 1. Introduction

1.1 New Zealand's interesting conclusions

The pensions problem occupies policy makers in all developed countries.

New Zealand is relatively young, small and physically isolated but has come to some interesting conclusions on public policy issues about pensions (both public and private). It is an accidental destination rather than a research-based solution that was reached following wide debate and consensus. Some of the conclusions have relevance to the questions that all developed countries face. New Zealand does not have all the answers; we don't even have everything right yet (and we are still doing some wrong things) but what follows may provoke more international interest in the way we do things.

1.2 The "problem"

The problem is easily enough stated for all developed countries (and others – China, notably). There will be fewer taxpayers supporting more pensioners as the baby boomers move into retirement. The costs associated with the greying of the population (not just pensions but also health and, possibly, housing) will become a larger burden on tomorrow's taxpayers than they are today. More accurately, they will be a larger burden for tomorrow's producers of wealth.

1.3 Change is inevitable

Eventually, leaders must dare to explain the pension issues clearly - if people can see that change is as fair as it is inevitable, they will agree that it should be done – there really is little choice. Everyone must understand that change is inevitable because, as a former Chairman of the US Council of Economic Advisers Herbert Stein once observed, "If something can't go on forever, it won't." On the pensions problem, it can't go on so it will resolve itself.

1.4 Limit the damage

The challenge is to ensure that the disruptive nature of that inevitable change is limited as far as is practicable and that citizens receive clear, early signals as to what might be appropriate action at an individual level. Reducing or even removing barriers to those clear signals should be a key public policy objective. Much of the pensions infrastructure common in developed countries (complex public pension arrangements; tax breaks and even compulsory private provision) dilute or even actively prevent appropriate signals from reaching the key actors in pension decisions (employers, employees and other individuals). That raises the risk of policy failure unnecessarily and increases the probability of future disruptive change.

1.5 Economic growth the only real issue

In the end, however, the only thing that really matters to a country is genuine economic growth. When the producers of wealth fall as a proportion of a population, the average economic position of all must fall, unless we have greater growth. Without that growth, we must contemplate increased poverty amongst either producers or non-producers. Either is unpalatable – both are largely unnecessary.

At the bottom of each recommendation that purportedly solves the pensions problem should be the words "The only thing that really matters is growth; how does this help the country to grow more?"

Section 2. Framework of this paper

This paper is organised as follows:

	Section and pages
2.1 A short history of pensions in New Zealand	
There is first a brief review of the history of retirement income provision in New Zealand. To place this paper in context requires some understanding of where New Zealand came from on the pensions issue.	3: pp 6 to 10
2.2 Tier 1 in New Zealand now partially pre-funded	
Section 4 explains the partial pre-funding regime for Tier 1 established in 2001 and the NZSF that was established to implement that.	4: pp 11 to 27
2.3 What's wrong with pre-funding?	
Section 5 explains why the partial pre-funded regime introduced by the NZSF fails to address the issues that really matter and may even make things worse for New Zealand.	5: pp 28 to 37
2.4 Tax neutrality - why do countries pay citizens to save?	
Because New Zealand has a unique approach to the taxation of private provision for retirement, section 6 describes that tax framework and the reasons for New Zealand's "tax neutral" treatment of retirement saving schemes.	6: pp 38 to 43
2.4 How are New Zealanders responding?	
Section 7 then summarises evidence, from recent studies, that gives some encouraging indications as to how New Zealanders are responding to the New Zealand Way.	7: pp 44 to 50
2.5 The government still wants to govern	
Despite the encouraging evidence described in section 7, the New Zealand government still wants to intervene in New Zealanders' personal saving decisions – section 8 summarises that initiative and explains why it will probably be unhelpful.	8: pp 51 to 55
2.6 A decision-making framework for all countries	
Finally, section 9 outlines a decision-making framework that any country could use to resolve its own issues. The framework is drawn from New Zealand's experience over the last 30 years - other countries do not have to re-learn New Zealand's lessons.	9: pp 56 to 63
2.7 Appendix	
The formula for calculating the government's annual contributions to the NZSF is extracted from the governing legislation.	p 64

Section 3. A short history of retirement income provision in New Zealand⁵

3.1 A chequered history

George Santayana said that “Those who cannot remember the past are condemned to repeat it.” New Zealand has been a relatively slow learner in the development of its retirement income policies and that, in itself, is a lesson for others. Unfortunately, as this paper discusses (sections 4 and 8) we continue to have a less than useful way of implementing change. We therefore continue to make unhelpful additions to the pensions landscape.

The history of the development of New Zealand’s retirement income system initially follows the comings and goings of the two major political parties (Labour and National) under the old “first past the post” electoral system. After 1996, when the “mixed member proportional” (MMP) voting system was adopted, changes have tended to slow and operate at the margins. The broad framework established at the end of the “first past the post” era has remained largely intact.

At a more detailed level, our retirement income history (both public and private) can be divided into five different periods:

3.1.1 Early history - before 1938: A modest Tier 1⁶ benefit started in 1898 for New Zealanders aged 65 and over⁷. The pension was income-tested and was paid only to those of good repute and as long as they hadn’t deserted their families or been in gaol recently. There was also a 25 years’ residence test.

The first Tier 2 scheme (for the staff of the private Bank of New Zealand) preceded the state’s involvement by 11 years, being established in 1887.

The tax status of Tier 2 schemes emerged during the first World War with personal contributions becoming deductible in 1915, investment income tax free one year later and employer contributions becoming deductible in 1921 – by then EET was established.

3.1.2 The “Welfare State” – 1938 to 1972: New Zealand elected its first Labour Government in 1935. The country had paid a high economic price in the Depression. Savings had been decimated and the country, as with many others, was in the mood for social experiments. They came thick and fast, including “Social Security” as it became known. Tier 1 was provided in two ways - a taxable “Universal Superannuation” from age 65 regardless of other income and a more generous⁸, tax-free but income and asset-tested “Age Benefit” that was

⁵ Based on Appendix 2 of the author’s *Will You Still Need Me? A retirement income primer for employers, voters and meddlers* (1997).

⁶ The retirement income components are more logically described as “tiers” rather than the more traditional “pillars”. That’s because people make decisions by building on the tiers sequentially – so “Tier 1” is the universal welfare provision (if any) provided by the state and that underpins all private decisions; “Tier 2” is employment-related provision that can be either state-run (France, Singapore); state-mandated but privately run (Chile, Australia), purely private (New Zealand) or both private and state-run (US). “Tier 3” is everything else, is always private and never mandated.

⁷ In 1898, the average expectation of life for a 65 year old male was only 12.1 years compared with 16.7 years today. Also, many fewer males actually made it to 65 - the average expectation of life at birth in 1898 was only 54.4 years for a male compared with 76.3 today (Source for today’s figures – New Zealand Life Tables 2000-2002).

⁸ In 1938, the “Universal Benefit” was only 14% of the income and asset-tested “Age Benefit”.

available from age 60.

Political debate before the new arrangements started focused on the concept of a scheme where contributors would pay for their own benefits. Without much public debate, the financing switched from “insurance” to “pay as you go” when the government realised that pre-funding wouldn’t deliver on the benefit rhetoric for generations. Political pragmatism provided the compromise but it didn’t stop politicians giving the impression that a special social security tax (actually a tagged income tax) of 7.5% (1/6 in the £1) somehow meant that benefits were now “secure”⁹. Historically, this was important in two ways that revisited politicians of the 1970s and 1980s:

- future voters (often suffering from deliberate myopia) would claim that they had paid their 1/6 in the £1 for whatever the state delivered, even if it were somewhat more generous than the original 1938 benefit.
- political pragmatism has been, and remains, a key element of retirement income policy formation.

Over the next 20 years, Universal Superannuation gradually grew so that by 1960, it was about the same as the originally more generous Old Age Pension, though the tax and income/asset tested differences remained. The asset test was dropped in 1960.

In response to the relatively generous Tier 1, membership of Tier 2 schemes probably never exceeded one third of the working population during this period. Besides, most workers remembered what happened to their (and their parents’) savings in the Great Depression of the 1930s.

3.1.3 Change and more change – 1972 to 1984: Labour was elected in 1972 and a compulsory Tier 2 scheme emerged as a new strategy. The new scheme was poorly structured. All employees and their employers had to contribute (a total of 8% of pay) to a centrally managed, single “New Zealand Superannuation Fund”. However, private schemes could contract out as long as they met the minimum contribution requirements of the central scheme. The whole structure lived uneasily on top of Tier 1 with no real thought as to why the compulsory scheme was needed and what would happen to Tier 1 when the new scheme reached maturity. Central management of the default fund was also a real problem - it would become relatively large, relatively quickly.

The compulsory scheme turned retirement incomes into an election issue.

The National opposition had only to show how long it would take for meaningful benefits to build up in a defined contribution scheme; that people who didn’t work wouldn’t get anything out of it and then announce its alternative - bring the State Pension Age forward to 60 and increase the benefit significantly. It was probably the most expensive election bribe in New Zealand’s history. Labour was routed by National in 1975.

The central “New Zealand Superannuation Fund” was wound up and the old, two stage Tier 1 was swept away by “National Superannuation” that started in 1977. It was a taxable, universal pension, linked to the national average wage. A

⁹ They were, of course, nothing of the sort. The Social Security tax didn’t meet the cost of the then pensions, never mind all the other benefits promised by the new system.

married couple was to be entitled to 80% (after a limited period of residence in New Zealand) while a single person received 60% of that or 48% of the national average wage. The lack of thought given to the new benefit quickly became apparent - each of a couple received 40%. Because that put them both into the lowest income tax bracket at 15%, the couple's after-tax pension was somewhat more than 80% of the after-tax, single person's national average wage. In 1979, that was repaired by changing the formula to an after-tax calculation.

In the meantime, a fiscal crisis was driving the government into a corner.

3.1.4 A consensus gradually emerges – 1984 to 1993: Labour was re-elected in July 1984 - the “socialists” turned out to be nothing of the kind.

The major events of the next nine years from a retirement income perspective were:

- **Budget 1984:** Despite having promised voters that it wouldn't touch the Tier 1 pension (“National Superannuation”), the government introduced income testing (called the “surcharge”)¹⁰. There had been income testing between ages 60-65 up to 1977 but this was the first time it applied potentially to everyone at all ages. The electorate was furious.
- **December 1987:** Without warning or meaningful debate and over the following two years, all tax incentives were removed from Tier 2 schemes and formal Tier 3 schemes. Member contributions lost deductibility overnight and employers' contributions to Tier 2 schemes became subject to Fringe Benefit Tax, effectively losing deductibility immediately.
- **By April 1990:** TTE was now fully effective for Tier 2¹¹. In the meantime, Tier 1's “National Superannuation” changed to “Guaranteed Retirement Income” though there was nothing guaranteed, nor anything markedly different about the way it was calculated. A “Retirement Tax” was also introduced - it supposedly sequestered part of ordinary income tax (the amount needed to pay for Guaranteed Retirement Income). Both changes to Tier 1 were cosmetic, not substantive.

Labour was replaced by National again at the end of 1990. National inherited a government where some hard fiscal decisions still had to be made. To continue the superannuation diary:

- **June 1991:** The relatively gentle Tier 1 income test (the “surcharge”) was replaced by a savage “clawback”. Effective marginal tax rates on private income for nearly all Tier 1 recipients increased overnight to 92.8%. The State Pension Age increased from 60 to 61 in 1992 and then increased by six months in each year to reach age 65 by 2001.
- **October 1991:** The clawback elicited a vitriolic public response and

¹⁰ The “surcharge” had a relatively gentle “gradient”. Eventually, it affected only about one third of pensioners in any way with only about 5% of pensioners losing their Tier 1 pension entirely through the test.

¹¹ Defined benefit schemes were able to renegotiate their promised benefits to take account of the changed tax environment. In practice, most defined benefit schemes reduced their benefits by less than the theoretical amount that the tax changes could have justified. See section 6 for more on New Zealand's tax treatment of retirement savings.

was withdrawn before implementation. A Task Force¹² was appointed to look at the role of private provision for retirement. A separate committee of government ministers and backbenchers was supposed to review the position of public provision (but didn't).

- **December 1992:** The Task Force's final report (of three) recommended that TTE continued for Tier 2. It also recommended a basis for a sustainable Tier 1. Fortunately, that was able to look much like the then existing benefit. The report also made many suggestions to support what it called an "improved voluntary regime".
- **August 1993:** After meeting for five months, the three main political parties signed an historic "Accord".

The Accord essentially agreed with all the recommendations of the Task Force and settled on a long-term regime for both Tier 1 and Tier 2 provision (and formal Tier 3 arrangements). Reviews of that regime were to take place every six years with the first in 1997. The Retirement Income Act 1993 was passed, with the Accord attached as a schedule. A "Retirement Commission" was established to coordinate research and to provide help to individuals who were making saving decisions for retirement.

"National Superannuation" was re-named as the less politically charged "New Zealand Superannuation".

3.1.5 A more settled environment - after 1993: The 1993 election was the first since 1972 that retirement income policies were off the political agenda.

Even in the more vitriolic prelude to the first proportional representation election in 1996, retirement income policy largely followed the spirit of the Accord. However, the main parties weakened on the issue of the income test (the "surcharge"). First it was softened and then, as part of the bargaining to secure New Zealand's first MMP government, National agreed with the much smaller New Zealand First, and without public debate, to abolish it in 1998. New Zealand's experiment with full income-testing for all (albeit with a relatively gentle "gradient") lasted only 13 years.

The Retirement Commission has become the face of a major, long-term education programme through sponsored research and direct education programmes. It is responsible for monitoring New Zealand's retirement income policy framework and providing education to help New Zealanders make informed financial decisions throughout their lifetime so they are better prepared for retirement¹³.

The National Party shamefully neglected the Accord over the 1993-1999 period and failed to consult with other parties on changes to the Tier 1 pension¹⁴. The Accord fell into disrepair and was finally buried in 2004. The six yearly, independent review has also disappeared, being replaced in 2004 by a watered down, though more regular review by the Retirement Commission.

¹² The author was a member of the Task Force.

¹³ For more information about the Commission visit www.retirement.org.nz or its personal finance website www.sorted.org.nz.

¹⁴ Including a failed, unhandy attempt to unilaterally lower the couple's rate from a net 65% of the net average wage to 60% by applying prices-related indexing rather than the then statutory wages-related basis.

3.2 NZS – the present design

Every New Zealand resident qualifies for NZS on reaching age 65. The only test is that the person is actually resident and has been resident in New Zealand for at least 10 years after age 20, with at least five of those years being after age 50. If the test is not satisfied at age 65, the pension will start as soon as the residency qualifications are completed.

There are three main rates of pension:

- For a **couple**, the annual amount is a net 65% of the net average wage¹⁵ and is divided equally, with half being paid to each. Each of the couple must satisfy the residence tests independently.
- For a **single person, sharing accommodation**, the annual amount is 60% of the couple's rate (a net 39% of the net average wage).
- For a **single person living alone**, the annual amount is 65% of the couple's rate (a net 42.25% of the net average wage).

The grossed up equivalent of the net pension is taxed as ordinary income in each recipient's hands. It changes each 1 April in line with changes in the national average wage.

There is no adjusted benefit for early or late "retirements". The pension starts after claiming while other aspects of the welfare system (disability and unemployment) deal with those who stop work before the State Pension Age¹⁶.

Entitlement to NZS ceases if the recipient is out of New Zealand for 13 weeks.

The pension is paid from the government's general funds (including the NZSF described in the next section), there being no identified contribution or tax that specifically supports the payments.

In summary, NZS is a simple, relatively generous, liveable¹⁷ age-based, "Citizen's Pension" that has significantly reduced poverty in old age¹⁸.

Because NZS is paid regardless of other income or wealth (no income-testing¹⁹ or asset-testing, such as Australia uses), any private provision delivers extra income and so gives New Zealanders the best incentive of all to save privately for retirement. They will be better off and can easily see that. Section 7 of this paper suggests that there is some evidence that New Zealanders seem to be reading that signal quite effectively.

¹⁵ Temporarily 66% as a result of the 2005 coalition government negotiations.

¹⁶ The before-tax total cost of unemployment, sickness and invalidity benefits at all ages (not just before retirement) was 1.6% of GDP in 2005/06 (Source: The Treasury's *Long Term Fiscal Model*, 2005).

¹⁷ As long as a retiree owns a debt-free home. There is an income-tested, additional "Accommodation Supplement" for any recipient of a state benefit (young or old). It can apply to both home-owners with a mortgage and renters. The Accommodation Supplement is both income and asset-tested.

¹⁸ About 4% of all aged 65 or more have financial hardship that is officially measured as facing "severe financial difficulties" (from a survey conducted by the Ministry of Social Development in 2001 - *The Living Standards of Older New Zealanders*). By contrast, the equivalent figure for the UK's complex system is 22% (Department for Work and Pensions *Pensioners' Income Series*, available: <http://www.dwp.gov.uk> cited in *Lessons from New Zealand, a Pension Reform Option for the UK*, Alison O'Connell, Pensions Policy Institute, London (2004).

¹⁹ A spouse/partner under age 65 may qualify before age 65 but only on an income-tested basis where all household income is included.

3.3 An accidental journey

New Zealand's policy framework arrived at its present position by accident. That framework says, broadly, that governments have a primary role to lay down Tier 1. They should next make it easy for people to make decisions about the best way to save for retirement. Leaving it to people to make their own decisions is best. They know their own circumstances best.

However, New Zealand's present government has an interventionist air to it when it talks about provision for retirement income and seems unwilling to leave well alone. The proportional representation environment that now prevails means it is naturally constrained but that has not stopped two major recent initiatives. The next section 4 looks at the NZSF; section 8 looks at the Tier 2, "compulsory, opt-out" *KiwiSaver* initiative.

Section 4. Pre-funding public provision – the NZSF

4.1 The partial pre-funding approach

When Labour replaced National as the main party of government in 1999, one of its election promises was the establishment of a central, government-controlled fund to help pay for the future costs of the Tier 1 NZS. Ahead of the decision, there was no public debate on the proposal and no significant economic discussion of the impact or value of the initiative. Despite this, the operative law was passed in 2001.

The NZSF is administered under the New Zealand Superannuation and Retirement Income Act 2001. All money required in respect of NZS (both current benefits and the pre-funding component) flows through the NZSF²⁰.

The amount contributed each year is calculated on a rolling 40-year projection of expected pension payments (after allowing for the NZSF itself and its investment income). The Appendix gives the operative section of the Act that sets the annual amount payable²¹.

During the early years, more taxes will be taken from New Zealanders than will be needed to meet the year-by-year cost of NZS. In that way, the NZSF will build up.

The assets not required to meet the NZS payments in any year are invested by the “Guardians” of the NZSF. There are currently six and they are appointed by the government.

Here is what the Guardians themselves say about their role:

“While accountable to Government, the Guardians operate at arm's length from Government. Under the law, the Minister of Finance may give directions to the Guardians regarding the Government's expectations as to the Fund's performance, but must not give any direction that is inconsistent with the duty to invest the Fund on a prudent, commercial basis. The Guardians must have regard to any direction from the Minister. Any direction given by the Minister must be tabled in Parliament.”²²

The NZSF's assets were \$NZ6.6 billion at 30 June 2005 (about 4.4% of GDP²³) and are expected by 2035-37 to grow to about 42% of GDP (about \$63 billion in today's terms). That is not a lot less than the value of the entire New Zealand share market (\$66 billion in November 2005²⁴) and about 40% of the current net financial assets of all New Zealand households.

The question is whether the NZSF will help or hinder future taxpayers as they pay for the rising costs of an ageing population. Before we look at the asset side of this question (the NZSF's operation), we need to understand the liability side – the expected costs of NZS itself.

²⁰ “Funding of superannuation entitlements under section 45 of the Act amounted to \$6,083,189,000 during the year (2004: \$5,888,739,000) as set out in the Crown financial statements. These capital contributions from the Crown are to meet the expected net cost of superannuation entitlements as determined by the Ministry of Social Development. Against these capital inflow transfers, capital outflow transfers were made to the Ministry of Social Development who [sic] are responsible for the administration of superannuation entitlements.” (Financial Statements, NZSF, 2005 – Note 7)

²¹ The mathematics of the calculation process and outcomes can be seen in *Financing New Zealand Superannuation*, Treasury Working Paper 01/20 Brian McCulloch and Jane Frances (2001).

²² From the NZSF's 2005 Annual Report – available on the NZSF's web site at www.nzsuperfund.co.nz.

²³ GDP to 30 June 2005 was \$NZ149.2 billion.

²⁴ At 29 November 2005; figure from the NZX – it includes foreign companies that are locally listed.

4.2 Cost projections for an ageing population

Until the 1992 Task Force on Private Provision for Retirement, no one had done any work on the future impact on all government spending of New Zealand's ageing population. The 1997 Periodic Report Group refined that 1992 work. Chart 1 shows the results of both the 1992 and 1997 projections.

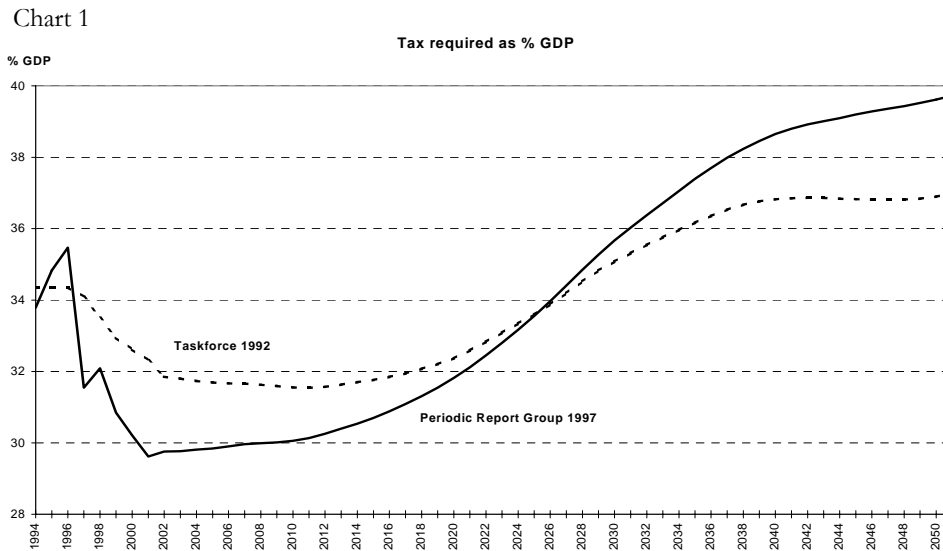
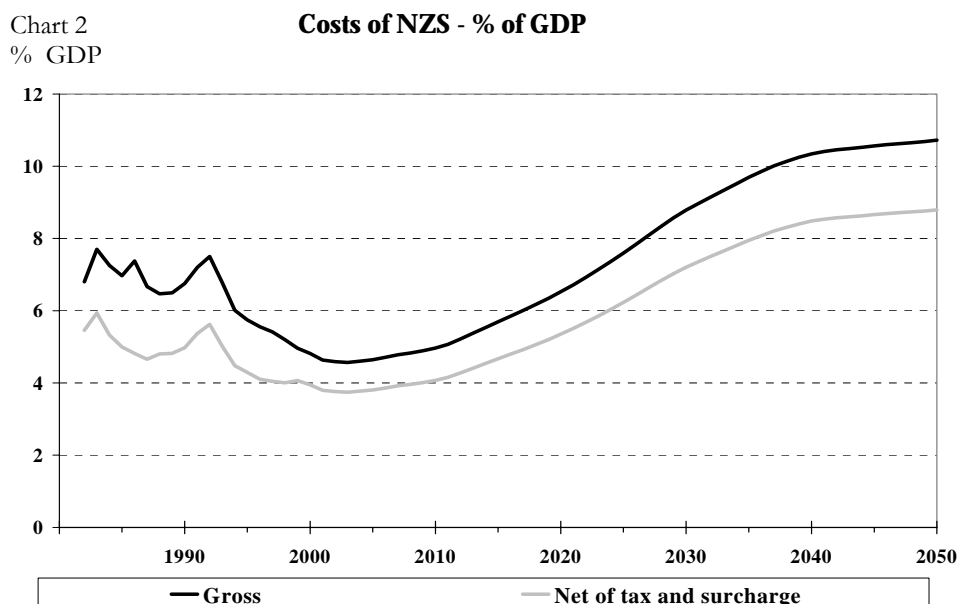


Chart 1 tried to guess what would happen to all government spending (including pensions, education and health) that will be affected by changes in the age structure of the population over the period to 2050. Had the spending patterns of the period to 1996 persisted, we would now be collecting taxes of about 30% of GDP, about 8% of GDP (or \$12 billion) less than now. However, the introduction of the three yearly MMP political bargaining cycle has changed things since 1997. The increased spending patterns of MMP governments mean that taxes are now higher than were expected even by the 1997 Periodic Report Group. This is important in the context of the NZSF because it goes to the heart of the real reason for the NZSF. Section 5 below has more on this.

The two most significant cost influences for future taxpayers are health and NZS. Chart 2 (from the 1997 Periodic Report Group) looked at the cost of just NZS:



NZS is taxed as ordinary income so the lower line (the after-tax costs) in Chart 2 is the one that matters. In 1997 (when the chart was produced) the “surcharge”, or income test, also affected the net cost. Both the 1992 Task Force and the 1997 Periodic Report Group recommended the retention of the relatively “gentle” income test that the surcharge represented. The politics of MMP, however, saw to its demise.

The 1997 Periodic Report Group emphasised that projections over such long periods should be treated with caution:

“.....we know that it is difficult to project with accuracy even a few years out. Projections over the time frames here give an indication of the probable size and scope of the fiscal impact of an ageing population. They are not intended to be a precise measure of expected future outcomes.”²⁵

New Zealand’s expected public pension costs are relatively low by comparison with other OECD countries. On a gross basis, Table 2 shows that four countries (France, Germany, Italy and Poland) now pay more than 10% of GDP for state pensions²⁶. The average unweighted cost in the 21 countries is now 7.4% of GDP and will peak at 10.9% by 2050. Today’s champion (Italy) pays 14.2% of GDP. The chart shows overall patterns for both 2000 and the expected position in 2050:

Table 2

OECD estimates of spending on old age pensions <i>Expressed as a percentage of GDP – changes in percentage points</i>		
	2000 (rank: lowest cost =1)	Percentage points change: 2000- 2050 (rank of total cost)
Australia	3.0 (2)	+1.6 (2)
Austria	9.5 (17)	+2.2 (13)
Belgium	8.8 (15)	+3.3 (14)
Canada	5.1 (7)	+5.8 (11)
Czech Republic	7.8 (11)	+6.8 (19)
Denmark	6.1 (10)	+2.7 (7)
Finland	8.1 (14)	+4.8 (16)
France	12.1 (20)	+3.0 (20)
Germany	11.8 (19)	+5.0 (21)
Hungary	6.0 (9)	+1.2 (4)
Italy	14.2 (21)	-0.3 (18)
Japan	7.9 (12)	+0.6 (6)
Korea	2.1 (1)	+8.0 (9)
Netherlands	5.2 (8)	+4.8 (8)
New Zealand	4.8 (5)	+5.7 (10)
Norway	4.9 (6)	+8.0 (17)
Poland	10.8 (18)	-2.5 (5)
Portugal	8.0 (13)	+4.5 (15)
Spain	9.4 (16)	+1.6 (12)
United Kingdom	4.3 (3)	-0.7 (1)
United States	4.4 (4)	+1.8 (3)
Average	7.4	+3.5

The lowest total 2050 costs, as shown in Table 2, are the United Kingdom (3.6% of GDP) and Australia (4.6% of GDP).

²⁵ From the *Interim Report*, Periodic Report Group, July 1997.

²⁶ According to *OECD Economic Outlook 69* (June 2001). New Zealand is expecting to pay about 10.5% (gross) by about 2050 as Chart 2 shows.

However, comparisons of this kind need to be very carefully done and interpreted.

For example, New Zealand's numbers are the pre-tax cost. NZS is taxed as ordinary income so, as Chart 2 shows, the net cost is the only important number. Some countries' state-provided pensions are either not taxed or are taxed on a preferential basis.

Next, Table 2 projects costs based on a continuation of current policy settings. This is an heroic assumption. The 2050 "champion" is an example. It is clear from the debate currently going on in the UK that the current regime is politically unsustainable and will change²⁷.

Also, even directly comparing individual countries' "top line" numbers is really not possible or requires great care as differences can be subtle. To take one example - we can't directly compare Australia's numbers (an expected total 4.6% in 2050) with New Zealand's (10.5%). The Australian numbers exclude the subsidised services that come with pensioner status (worth presently more than an annual \$A1,400 a pensioner). Australia's numbers also ignore the cost of the compulsory Tier 2. That is an important exclusion because Australia's relatively cheap Tier 1 would probably be politically unacceptable if it were not "taxing" its citizens through the compulsory Tier 2. Through income and asset tests, future Australian governments expect to reduce the direct costs of Tier 1.

Finally, Table 2 also takes no account of the cost of tax subsidies given to savers for private retirement provision at Tiers 2 and 3. That exclusion applies to all the other OECD countries in this comparison but not New Zealand. New Zealand's numbers by comparison are relatively "clean" and count all the current costs of state intervention in retirement income provision (but not the expected costs of *KiwiSaver* – see section 8)²⁷.

However, Table 2 says that New Zealand isn't alone in facing the issues that the pre-funding regime of the NZSF is intended to address.

4.3 The very long-term projections

The Super 2000 Taskforce²⁸ built a modelling tool that was based on the Treasury's Long Term Fiscal Model ("LTFM") used by the 1997 Periodic Report Group. The Taskforce wanted the LTFM refined to include feedback mechanisms into the modelling process.

A new tool (the Policy and Retirement Income Stability Model or "PRISM") was created for that purpose. This let aspects of retirement income policy settings that affect spending, taxes, debt, interest rates, the balance of payments, investment, saving and growth be captured. If done fairly, this highlighted some of the trade-offs implicit in pension decisions and made some key assumptions explicit.

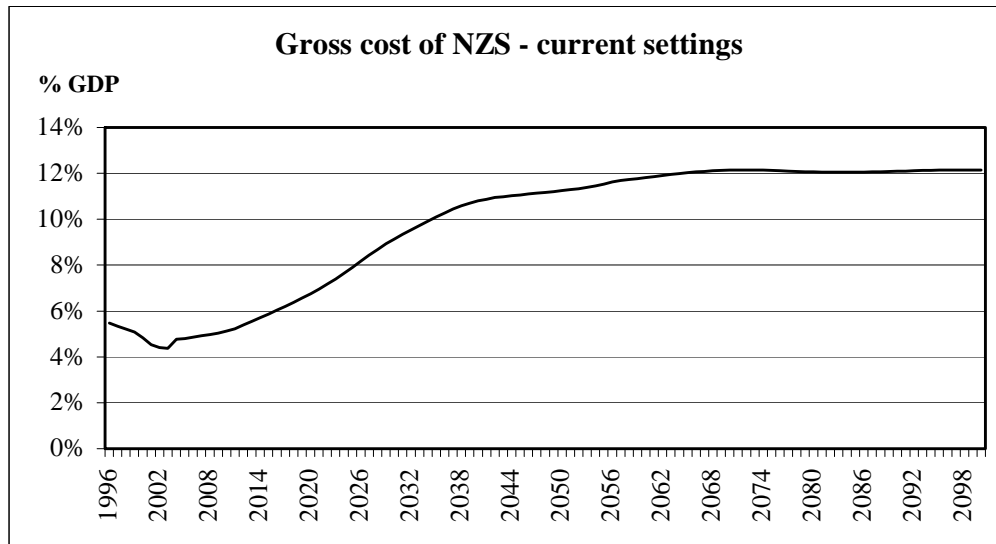
The mere presence of the NZSF will change things in ways that the direct contributions to (and investments by) the NZSF and its distributions cannot directly account for.

For the purposes of the discussion in this section, PRISM allowed the cost of NZS to be modelled through to the year 2100. Chart 3 extends Chart 2 until the end of the century.

²⁷ Nor the income and asset tested "Accommodation Supplement" that applies to all beneficiaries.

²⁸ Appointed unilaterally (without regard to the Accord's provisions) by the National/New Zealand First government in 1999 but disbanded before it reported by the Labour/Alliance coalition elected in 1999.

Chart 3



Source: PRISM model.

In the absence of the NZSF, PRISM showed the gross cost of NZS, that peaks at 12.1% of GDP in 2070, doesn't change over the following 30 years as the NZSF is run down to zero (by 2100, as was originally intended)²⁹.

In introducing the legislation to establish the NZSF, the Minister of Finance said:

“[The proposed legislation] will finally give superannuitants some certainty about what the government will be able to provide for them.”

For the sake of this discussion, let's put the next 100 years to one side because the NZSF won't change the cost of NZS (the benefits paid³⁰) but will change, relatively temporarily, the source of money required each year to pay for NZS.

Any 100-year projections must be heavily qualified. However, the real question we should be discussing in relation to Chart 3 is whether, as a country, we feel comfortable with about one tenth (net) of the country's entire output eventually being transferred from the working population to the retired through taxes and NZS. The answer to that may be “yes” but we should at least discuss it and we have not. The presence or absence of the NZSF doesn't affect that central question. In the very long term, the NZSF will have no effect on this question after the investments have been entirely paid out.

So, will the working population of future generations allow such a transfer to take place? Or will older voters force that transfer on workers? Change in this area will probably happen regardless of both the decisions made in 2001 and the presence, or absence, of the NZSF. The only issue of substance is the pace of change and the impact that change will have on the saving and retirement decisions of future older New Zealanders.

If the NZSF doesn't change the cost of NZS in the face of an ageing population, then unless it makes a measurable addition to economic growth that might not otherwise have been achieved, its provisions cannot increase certainty over the next 100 years.

²⁹ The net cost (allowing for tax paid by superannuitants on NZS) was estimated at nearly 2% of GDP less at about 10.3% of GDP by the end of the century.

³⁰ See paragraph 9.4 for more on this.

4.4 Some alternative strategies

The two biggest influences on the future cost of NZS will be the State Pension Age and the proportion that NZS bears to the national average wage. PRISM lets us see the influence that manipulating just these two elements of NZS could have on future costs.

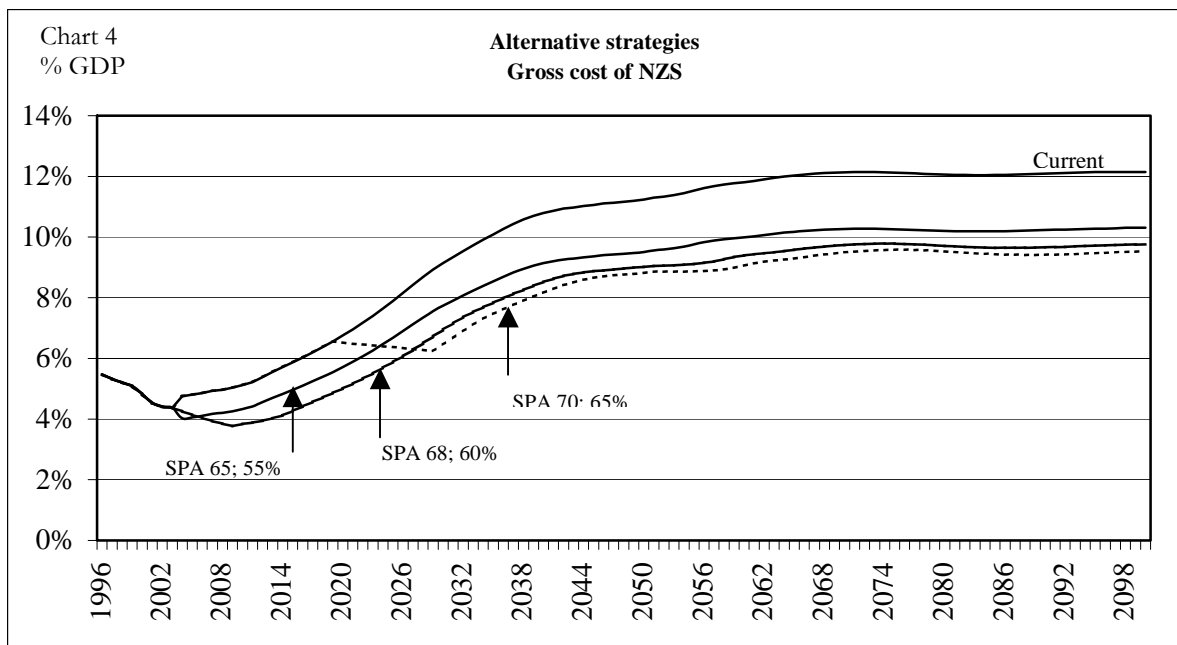
Chart 4 compares three possibilities with the current arrangements:

4.4.1 Increasing the State Pension Age: Chart 4 allows for the State Pension Age to increase by five years (from age 65 to age 70) starting in 2020. The modelled increase in age is six months a year over a ten-year period (as happened when the age was lifted from age 60 to 65 over the period ending in 2001).

4.4.2 Lowering the pension: Chart 4 also shows the impact of an immediate reduction in the married couple's pension from 65% of the national average wage (net to net) to 55%. In practice, any such reduction should not be immediate but should be phased in from, say 2020. Unfortunately, PRISM does not allow that kind of deferred change to be modelled.

4.4.3 Combined age and pension change: Chart 4 then shows the effect of increasing the State Pension Age by three years (from 65 to 68) from 2020, combined with an immediate reduction in the pension from 65% to 60%. In practice, both of these changes should, again, be phased in from, say 2020.

The point of these projections is that the effect of any of them (or any other combination) will eclipse the NZSF as to their impact on the year-by-year call on taxes from future generations of taxpayers (see paragraph 4.7). The chart shows that each of them would reduce the gross cost of NZS from 12.1% to about 10% by 2100.



Notes: source – PRISM. “SPA” is the State Pension Age; the percentage figures (55%, 60% and 65%) refer to the proportion that the married couple's NZS bears to the national average wage (net to net).

Putting aside cost considerations, such benefit design changes may actually be sensible proposals in their own right. Why, for example, would we persist with a State Pension Age of 65 if we knew (or expected) that people didn't want to stop working at age 65 or knew that they were capable of working beyond that age and didn't need the support of

NZS?³¹ Why again would we persist with 65% as the married couple’s pension if we discovered that, to satisfy the government’s welfare obligation (whatever that is), only 60% were needed? Or perhaps 70% may be needed – either way, we should have decent evidence and a proper debate to support the amount settled on. New Zealand has not yet had that debate.

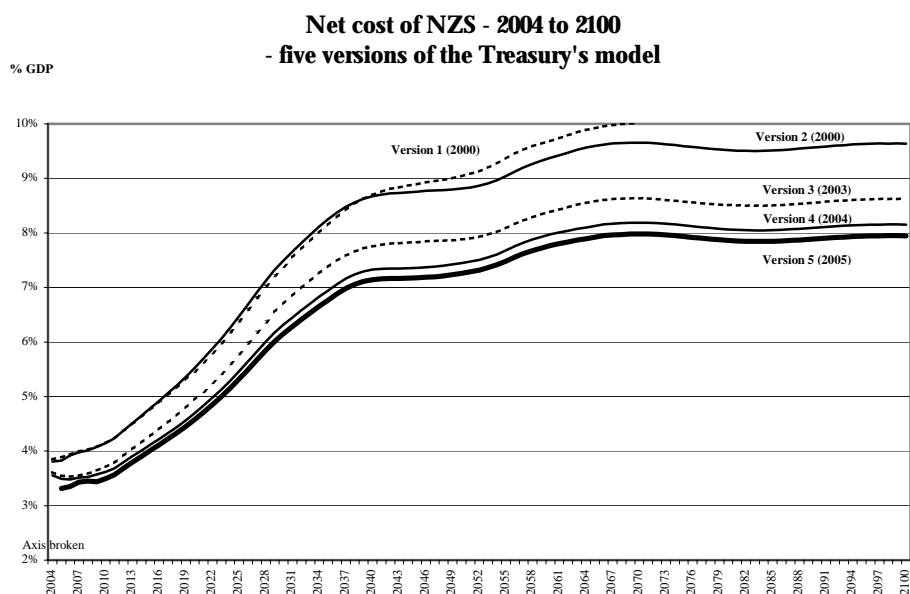
Even if we agreed only that the State Pension Age should increase gradually from age 65 to age 68 over the period between 2020 and 2026, that would cut a gross 1.6% of GDP off the cost of NZS by the time it is fully implemented in 2026³². That single change of three years in the State Pension Age will cut the gross cost of NZS by nearly 20% in 2026. As the underlying cost of NZS increases, the saving reduces (12.5% reduction by 2050; 12.4% by 2100).

As both the 1992 Task Force and 1997 Periodic Report Group emphasised, these kinds of projections give us an indication of overall cost trends and don’t need to be analysed on a “line item” basis. The things we should be talking about are, however, clear.

4.5 Further versions of the Long Term Fiscal Model

The Treasury has refined the original 1992 model that the Task Force developed. Each year, it releases an updated version of the model as part of its Budget processes and provides “best estimates” of all government income and expenditure over the coming decades³³. Chart 5 shows the development of the model’s estimates of the future real cost of NZS (after tax) over the last five years:

Chart 5



The “net cost” was taken before the impact of the NZSF was calculated. In the absence of any change to NZS itself, the “net cost” of NZS will be unaffected by the workings of the NZSF, as explained in the next section 5.

³¹ The US, for example, is increasing the qualification age for Social Security from 65 to 67 between 2002 and 2027. Denmark, Iceland and Norway have also adopted age 67 as their State pension ages.

³² Robert L Brown in *PAYG Funding Stability and Intergenerational Equity* (Transactions of the Society of Actuaries, Volume XLVII, 1995) says that lifting the State Pension Age is the most powerful potential change governments can make to restore “balance” to the funding of PAYG state schemes.

³³ See <http://www.treasury.govt.nz/ltfm/> to download the Treasury’s “Long Term Fiscal Model”.

While the returns received by the NZSF will significantly alter the contribution made by the NZSF each year to the cost of NZS (from both tax and capital – see paragraph 4.1 for the way in which this is calculated), it won't change the overall cost of the benefit, only the source of that cost – the cookie jar that the government of the day reaches into to meet each year's outgo.

4.6 The significance of modelling

The New Zealand long-term modelling work, first started by the 1992 Task Force, is an important part of informing the public about the long-term implications of change. If a country were starting any sort of discussion on the pensions problem, the production of believable long-term numbers on all of a government's expected costs would be the first priority. Pension costs are part of the picture but only a part.

Even after 13 years, New Zealand still does not fully appreciate the significance of these projections. Financial service providers still call for action to meet the cost impact of the ageing population. Many politicians also don't understand the issues because otherwise we would not have the NZSF. The next section 5 analyses why that is so.

4.7 So how is the NZSF going?

The NZSF has now been in place for about three years. The first part of that period was spent putting in place the governance and management structures to satisfy the obligations of the "Guardians" under the New Zealand Superannuation and Retirement Income Act 2001.

The Guardian's 2005³⁴ annual report summarised their responsibility as follows:

"The Guardians' principal duty is to invest the Fund in a prudent, commercial manner. They must maximise investment growth without undue risk to the Fund as a whole, in a manner which avoids prejudice to New Zealand's reputation as a responsible member of the world community, and using best practice portfolio management."

Here, again from the 2005 Annual Report, are the key highlights for the 2004/05 year:

Financial Overview

- Fund assets grew from \$3,985.4 million to \$6,613.5 million;
- Net contributions of \$2,107.0 million;
- Investment income of \$726.1 million (after costs, but before tax).

Investment Performance

- Rate of return of 14.13% [before tax], against risk free rate of return of 6.33%;
- Annualised rate of return since inception of 12.50% p.a. [before tax] against risk free rate of return of 5.88% p.a."

The next Charts 6 to 8 are derived from equivalents in the NZSF's 2005 Annual Report.

³⁴ Available on the NZSF's web site at www.nzsuperfund.co.nz.

Chart 6

Asset allocation as at 30 June 2005

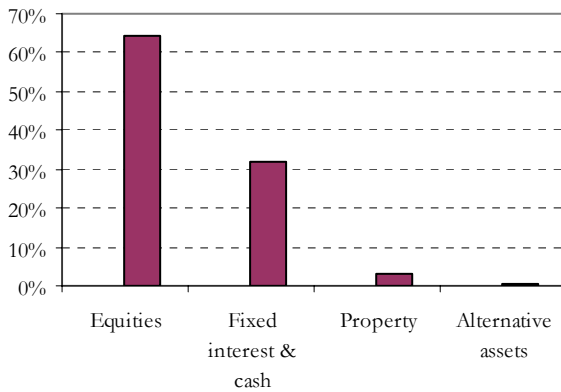


Chart 7

Growth in Fund size (\$M)

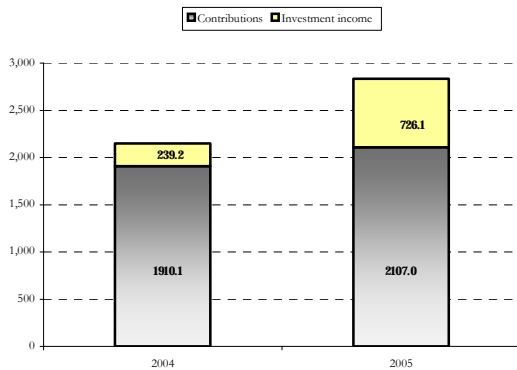


Chart 8

Return against risk free rate (% p.a.)



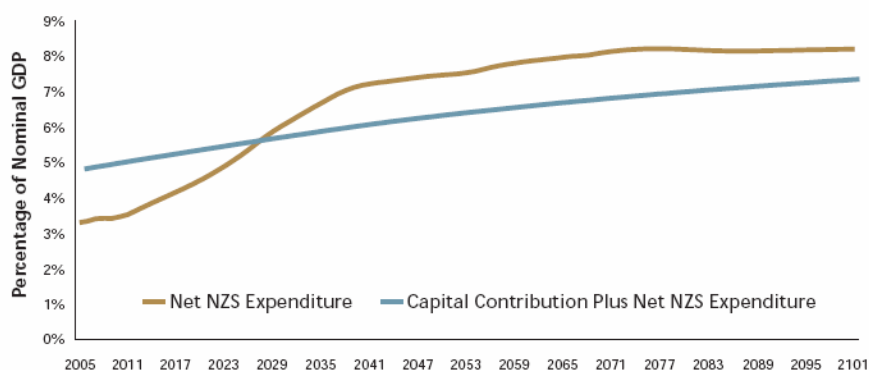
Chart 9 on the next page (again from the 2005 report) shows how the build-up and draw-down are expected to work from 2005 to 2101. The difference between the top and bottom lines before 2029 represent the contributions being accumulated. The difference after 2029 represents the draw-down from the NZSF's assets over the following years.

The calculation process described in paragraph 4.1 produces the relatively smooth contribution line that starts at a little less than 5% of GDP and ends at about 7.5% by the end of the century.

Chart 9

Smoothing the Cost of New Zealand Superannuation

Source: New Zealand Treasury (www.treasury.govt.nz)



The projections are expressed in nominal dollars and that explains the apparently “unbalanced” nature of the chart (seemingly more being paid out than in).

4.8 The expected long-term return

The expected cost of NZS in Chart 9 (the “net NZS Expenditure”) is unaffected by the NZSF’s investment returns but the smoothed cost is. The Guardians themselves estimate the expected returns over the long-term to be a nominal, compound 9.2% per annum before tax. Though this sounds demanding, that will leave just 4.1% per annum as the net real rate (assuming tax at 33% and long-term inflation of 2% per annum). Given the NZSF’s expected strategy (see next), this should be achievable. In fact, anything less will probably give an inadequate reward to taxpayers for the investment risks they have now assumed.

However, the next section 5 suggests that, no matter how estimable all this might seem, it will not deal with the main issues, if any, that New Zealand faces with NZS.

4.9 Where should the NZSF be invested?

Given the presence of the NZSF (and its current support by most political parties), its future investment strategy is of more than passing significance to New Zealand investment markets (and taxpayers!).

The NZSF’s current strategy, summarised in Chart 6, seems to misunderstand its key role. Even its “longer term target portfolio”³⁵, although with significantly reduced exposure to bonds, is unlikely to achieve the NZSF’s potential. Partly, that is a function of the NZSF’s “constitution”, as expressed in the Guardians’ statement quoted in paragraph 4.7. Despite the stated “commercial” objectives, the Guardians need to adopt a different approach.

As a general principle, all the investments of the NZSF should be in businesses (or in direct business assets), not bonds and particularly not government bonds. That’s because

³⁵ Broadly, 40.5% in overseas equities (a traditional strategy here is inappropriate), only 2% in emerging market equities (not enough), 7.5% in New Zealand equities (probably too much), 25% in “alternative assets” (some appropriate, some not), 10% in property (direct property inappropriate; listed shares could be appropriate) and 15% in bonds (inappropriate).

shares in businesses will, over the long-term investment horizon that applies to the NZSF's liabilities³⁶ produce the best long-term returns.

Next, there is the investment distinction between domestic and international investments.

4.9.1 Domestic investments: The only sensible New Zealand-based investments should be in businesses that aim to create new and genuine economic growth. Those businesses will probably be unlisted and are likely to be what is sometimes called “venture capital”.

The NZSF should largely ignore listed shares as buying those is not, in itself, a transaction of economic significance from the growth perspective. It simply replaces an existing owner of those shares by the NZSF (though what the previous owner then did with the proceeds might grow the New Zealand economy).

The NZSF should generally not invest in domestic corporate bonds and should certainly not invest in New Zealand government bonds for much the same reason³⁷.

Also, having such a large investor active in the local, quite small, bond market has significantly reduced liquidity. That creates problems for all other investors. There is only \$8.5 billion (5.7% of GDP) on issue in New Zealand's corporate bond market³⁸. Government bonds are only 23.5% of GDP (see Table 1) so a large buyer in the bond market can both increase the market's vulnerability to adverse effects from financial shocks and reduce financing options for local firms³⁹.

The only possible justification for the NZSF to buy domestic corporate bonds would be if there were deficiencies in the local capital market. That does not apply to New Zealand.

Despite this, the 2005 Annual Report for the NZSF shows that 32.1% of the assets was in cash and bonds with 16% in New Zealand cash and bonds. The Guardians intend the medium term position to be a total of 20% in cash and bonds, falling eventually to 15%⁴⁰.

A large investor in a small market like New Zealand then creates a different problem when investments must be realised to make required payments to the government. Buyers have to be found in a relatively illiquid market. Even bonds that mature probably have to be replaced by alternative lenders. Realisation will probably affect asset prices for both the NZSF and other investors.

³⁶ The 2005 Annual Report describes the time horizon in the following terms “The Fund's key distinguishing features are: the long investment horizon (30-50 years); the lack of need for any liquidity (20 plus years before any withdrawal is envisaged).....”

³⁷ Collecting higher taxes so that an arm of the government (the NZSF) can buy the government's own paper is a circular transaction that offers no prospects of additional growth. Nor does it add to the future security of NZS that, with respect to those bonds, still depends entirely on the ability of future governments to collect tax from tomorrow's taxpayers. The same argument applies, incidentally, to the special Treasury bonds issued to the Trustees of the US Social Security “Fund”.

³⁸ According to Westpac Institutional Bank's monthly report for November 2005.

³⁹ For more on the importance of local bond markets, see *Pumping up the spare tyre*, The Economist, 19 November 2005.

⁴⁰ This is probably for the political and/or cosmetic reasons described on the next page rather than for investment returns. The higher volatility of share returns was given as a reason for a bond component. That component must be at the expense of the expected higher long-term returns from shares.

4.9.2 Overseas investments: Money not invested in New Zealand businesses should all be invested overseas and in shares. There are four possible reasons for this:

- **Returns** – the greater diversity of opportunities overseas is more likely to produce consistently lower-risk returns than are available in New Zealand.
- **Insurance** – the NZSF is, in a way, an insurance against the possibility that the local economy might not deliver the growth to support future payments of NZS. In that situation, the assets to support that “insurance” should be separated from the potential risk of any adverse effects of New Zealand’s economic performance.
- **Indirectly imports labour** – as Nicholas Barr has pointed out⁴¹, exporting capital to countries with a young labour force is a way of importing labour indirectly (without the difficulties that increased immigration might bring). However, the value of that overseas labour can be captured only by investment in businesses⁴².
- **Liquidity** – very large overseas markets will provide liquidity for the relatively large NZSF (by comparison with the local market – the New Zealand share market is less than 0.2% of world markets). That will become important when strategy needs to change or when the draw-down begins.

Overseas investments should then be diversified by economic regions and economic activity to limit the potential damage created by local or industry-specific economic shocks.

Choosing the regions should also have some regard for the local demographic issues. For example, investments in a region that faces the start of the retiring baby boom generation within, say, the next 10 years require the Guardians to understand the economic risks involved in their eventual realisation (not just by the Guardians). Generally, this could rule out significant positions in the regions that represent demographically “mature” developed countries that will tend to reach their investment “tipping point” (from a demographic perspective) earlier than New Zealand.

All overseas investments should be on a “passive” basis. There are two main reasons for this:

- There is little evidence that active managers can consistently add value to index-based returns when measured on an after-fees, after-transaction costs basis;
- Passive strategies are much less expensive to run.

In this context, “passive” does not mean buying the index. It means buying and holding, not buying and selling.

⁴¹ *The Welfare State as Piggy Bank*, Oxford University Press (2001) at page 99.

⁴² New Zealand superannuation schemes already have a large proportion of their assets invested overseas. According to the Reserve Bank, 37.7% of total “managed fund assets” (including superannuation, unit trusts and life insurance arrangements) were invested overseas at 30 September 2005 (Reserve Bank *Managed Funds by asset category – Table C15* at www.rbnz.govt.nz/statistics/monfin/C15/data.html).

Although the suggested strategy makes economic sense, the NZSF's Guardians are unlikely to adopt it because of political considerations. The Guardians' performance will be closely watched and compared with that of local retirement saving schemes that should have quite different investment objectives. Any suggestion of under-performance in a year will become a political issue. Despite the very particular role that the NZSF has in the government's balance sheet, the Guardians cannot afford to produce returns that under-perform the "market".

The Guardians' own expressed target is:

"The success of the Fund's investment strategy will therefore be measured by how much the national balance sheet has grown over and above what a risk free investment programme would have delivered."⁴³

The "expected minimum return objective" set by the Guardians is a more demanding 2.5% per annum over the yield on 90 day Treasury bills over "rolling 20 year periods". However, in the context of its actual strategy, this is a relatively "soft" target and therefore easily achieved. That choice reflects the political risk already described. In fact, the target should aim to achieve the market returns for the sectors the NZSF invests in. Anything less than that should be cause for concern for both the Guardians and taxpayers.

The strategy suggested in this paragraph will have greater volatility than the NZSF's current strategy and that will inevitably mean a periodic, unacceptable level of discomfort for both the Guardians and the government.

However, there are deeper problems with the very concept of the NZSF that section 5 discusses. Before looking at those, perhaps there are other ways of helping an ageing population to understand the financial implications of the pension issues it faces.

4.10 Another way of counting the expected cost – IAS 19

There is a good case for governments to run proper balance sheets (with assets and liabilities identified for the country as a whole) along with expenditure and income accounts⁴⁴. Many developed countries use cash flow statements - and that's no way to run a country any more than it is to run a business.

The fact that partially pre-funding Tier 1 is a bad idea (see the next section 5) doesn't mean the government shouldn't know what Tier 1 might cost in the future. It might even want to express that total cost in today's money. The International Financial Standards Board's IAS 19 ("IAS 19") might offer governments a potential model to monitor those costs year by year.

IAS 19 requires companies to work out the cost of their defined benefit schemes within each year's profit and loss accounts. The company disregards the fact that an external trust might own the assets. The company is instead required to treat the assets and liabilities as if they belong to the company. It is forced to make best guesses about inflation, pay increases, investment income and the discount rate, and to report to their shareholders directly on the state of the scheme. There are rules about the way actuarial gains and losses are amortised (or spread) over longish periods, recognising the long-run nature of the liabilities. The standard also regulates the way that future costs of benefit

⁴³ From the 2005 Annual Report at page 12.

⁴⁴ As far as I know, New Zealand is the only OECD country that has accounts prepared in accordance with Generally Accepted Accounting Principles ("GAAP") and audited by a private firm. It doesn't, however, use IAS 19 for its pension liabilities.

improvements are accounted for.

IAS 19 has two main purposes. First, the people who pay for the benefits (the employer's shareholders) keep an accounting watch on a defined benefit scheme's liabilities – both those that have built up in the past and those that will accrue in the coming year. The second purpose is to work out how much the employer should be allowed to claim as a deductible expense for income tax purposes. That second purpose has no relevance to a government's monitoring the future costs of a defined benefit pensions, like NZS.

Applying the principles of IAS 19 to Tier 1 has some possible advantages:

4.10.1: Confidence: Knowing that the government was maintaining a watch on year-by-year changes to the long term liabilities might give voters and beneficiaries confidence in the sustainability of Tier 1⁴⁵. One of Tier 1's main objectives is to provide a believable foundation for employers and citizens to make appropriate decisions at Tiers 2 and 3.

4.10.2 Flexibility: Tier 1 needs to be flexible because some change is inevitable over the decades. IAS 19 might allow decision-makers to see the long term implications of potential changes, and not just as beneficiaries are about to collect their changed entitlements.

4.10.3 Political constraint: IAS 19 might impose financial constraints on the political process so that the true, long term costs of this year's political "bribes" would be known when change happens rather than, as tends to be the case, when the crisis is about to strike.

However, there are problems with calculations like IAS 19. Their sensitivity to relatively minor changes in the actuarial assumptions is the most obvious. The larger problem is that IAS 19 focuses on the wrong issue.

While IAS 19 provides a potentially interesting dimension to the guesses about the future costs of Tier 1 and/or Tier 2 (if the government is involved there), voters should instead focus more on the kind of information produced in Charts 1 to 5 above – expected cash flows expressed in real terms. That's because governments are not companies with shareholders' needing, at any time, to have some idea of the "fair" present value of their investments. Governments really need to know only that they can realistically extract tax from tomorrow's taxpayers without undue risk to the country's future economic position.

4.11 Generational accounting

On the other hand, so-called "generational accounting" may have some value. This measures the lifetime taxes of all kinds paid by a generation of taxpayers, including income taxes (both wage and non-wage), corporate income taxes, consumption taxes, excise taxes, and local taxes. Transfers are then deducted from this - retirement income, health and unemployment benefits, family and housing benefits and also education. All of these amounts are discounted to present values so that the "fairness" of relative burdens can be compared.

⁴⁵ That way, voters might not be surprised to learn the size of the so-called "implicit pension debt". According to the World Bank (*Pension Reform Around the World*, a presentation by Richard Hinz, 28 April 2003), these implicit pension debts range from as much as about 400% of GDP (Italy) through 350% for Germany, 325% for France, 300% for Japan, 160% for the US and 140% for the UK. Those levels may or may not comfort voters but they may affect their behaviour in any debate about change. On the other hand, those numbers may seem so large and potentially unmanageable that the more likely response is to do nothing.

A report⁴⁶ compared 17 countries (including New Zealand) that have produced “generational accounts”.

Many in New Zealand suggest that tomorrow’s taxpayers will get a worse deal than today’s retirees despite paying more tax today to support the currently retired. The numbers produced in the report don’t support that. The report concluded:

“Of the seventeen countries examined here, five (Japan, Italy, Germany, The Netherlands, and Brazil) have extreme imbalances. Another five (the United States, Norway, Portugal, Argentina, and Belgium) have severe imbalances. Three countries – Australia, Denmark, and France -- have substantial imbalances. Canada’s appears to be essentially in generational balance. The remaining three countries – New Zealand, Thailand, and Sweden have negative imbalances; i.e., their policies, if maintained, would leave future generations facing lower lifetime net tax rates than current newborns.”

Countries that have current policies placing large burdens on young generations are probably vulnerable to future change and it’s as well to know that sooner rather than later.

Governments can use the generational accounting discipline to help explain the long-run impact of current policies and of proposed changes to those policies. It can be part of the confidence-building process that a government should lead (see section 9 for more on this).

However, a significant caution needs to be sounded. Long-run calculations of this kind are crucially dependent on both a continuation of current policies and on the financial assumptions adopted. The discount rate obviously has a crucial influence on the process and small changes in that rate will have considerable leverage on the outcomes. The findings must therefore be treated with considerable care.

4.12 Pensions are like bonds?

Having stated the potential advantages of having “proper” government accounts, a word of caution is necessary about the liabilities side of the balance sheet.

Some suggest that a government’s current “promise” to pay a pension in the future is just like a government bond. They argue that the value of those future payments should therefore be included as debt on the country’s balance sheet⁴⁷.

Future promises to pay pensions are quite like government bonds bought by today’s investors but they are not the same. Governments can and do change the rules on their pension “promises” of all kinds. Also, the “bond holders” of a Tier 1 pension “promise”, even if the rules do not change, have to reach State Pension Age before they start to collect on them. If they die beforehand, the “promise” is usually extinguished. Actuarial calculations can allow for early death in the population as a whole but that will still not turn them into bonds. Putting the two types of liability into the same category actively interferes in a proper discussion as to what might happen to the pension scheme’s design for the future.

The real difference between the two liabilities is one of principle.

⁴⁶ *Generational Accounting Around The World*, Alan J. Auerbach, Laurence J. Kotlikoff and Willi Leibfritz, Institute for Monetary and Economic Studies, Bank of Japan (1998).

⁴⁷ See Laurence J Kotlikoff’s “What Determines Savings?” - Chapter 8 *Economic Impact of Deficit Funding* (The MIT Press, 1989) for a discussion on the various ways that governments dress up taxes, funding and deficits.

Bond markets are at the heart of market-based economies. Bonds are based on formal contracts. Their reliability is crucial to the effectiveness of financial markets. In an open market, bonds issued by a government are “marked to market” on what amounts to a 24 hour, rolling poll of the market’s views on a government’s actions. Governments therefore renege on a bond promise at the risk of significant damage to their local financial markets. Markets see that for what it is: a breach of contract.

Not so for pension “promises”. They function in the political market place. Reneging on a pension promise will probably cause political damage⁴⁸ but need have no effect on financial markets. It may, in fact, improve a government’s standing in those markets.

A pension is not therefore an instrument with the same characteristics as a bond. In any “competition” between a bondholder’s expectation of receiving future interest payments (and repayment of capital on maturity) and a citizen’s expectation of receiving a pension, even if “promised”, the bondholder will have the upper hand. Citizens will probably understand that just as well as financial markets. That explains why, despite New Zealand’s favourable demographic position, many younger New Zealanders say that NZS “will not be there when they make it to age 65”.

So, while the “promise” to pay a pension in the future is quite like the promise to pay bond holders back, it is not the same so there is no need to treat it in the same way on the government’s balance sheet as a sum borrowed, on which interest payments may be due in the meantime and that must eventually be repaid.

It is much more important to understand the expected future cash flows in relation to pensions (and other government programmes such as health, education, defence) than to know what the net present value of all those liabilities (including pensions) might be today. That’s what Charts 1 to 5 illustrate in paragraphs 4.2 to 4.5.

4.13 Political support

The New Zealand government can justifiably claim that most political parties support the NZSF. The major opposition party (National) fell into line ahead of the 2005 election after having previously opposed the idea. However, that change in policy seems to have political expediency rather than principle as its basis. As is the way with pension politics in New Zealand, we must not necessarily expect the NZSF to have the 100 year life that the government expects. That is because there are some difficulties of principle with the idea.

Eventually, New Zealand will have the debate about these issues that we missed in 2001 when the legislation setting up the NZSF was passed. The NZSF will probably not survive the open debate that New Zealand needs. The next section 5 explains why.

⁴⁸ As New Zealand has notably proved – most recently in 1984 (when income-testing on Tier 1 was introduced) and 1991 (when the government tried to introduce the “clawback”). See paragraph 3.1.4 for the explanation of these.

Section 5 The problems with pre-funding Tier 1

5.1 What's wrong with the NZSF?

All the money needed to pay for the future costs of NZS will flow through the NZSF. This is described as a "smoothed pay as you go" way of providing for NZS rather than the "pure" PAYG system that was used for, effectively, 104 years.

There are many things wrong with the NZSF – from the economic to the political. This section analyses the issues. The analysis takes, as its starting point, the previous fully PAYG arrangement. It does not argue, for example, that a fully funded scheme should become PAYG.

5.2 Economic strength matters

The material living standards of people in retirement are largely determined by their ability to consume goods and services. Retirees cannot consume the money represented by public or private savings directly. Those savings must be used to buy goods and services that are produced by New Zealand's working-age population or by workers of other countries (imports). The British economist, Nicholas Barr, memorably expressed this point in these terms:

"Pensioners *do not* eat pound note 'butties' – they use the pound notes to purchase consumption, and it is consumption that matters."⁴⁹

It's New Zealand's capacity to create wealth that matters. The ability to produce goods and services and to buy imports is the key to the living standards of present and future retirees. That doesn't mean that we shouldn't save for retirement; only that financial savings by themselves won't help. It's what's done with those savings (investment and then growth) that matters. The NZSF will probably not help increase the capacity of tomorrow's New Zealand workers to produce more for tomorrow's retirees to consume.

5.3 How do we support the growing elderly population?

An increasing elderly population can continue to be supported at current real income levels only by:

- Boosting future output by increasing the working-age population relative to the dependent population. This can be done in a number of ways such as:
 - immigration⁵⁰;
 - lowering the impact on the retirement/work decisions of NZS by having an income test or by allowing a more flexible State Pension Age⁵¹;
 - increasing the State Pension Age from its present 65;
 - increasing the participation rate in the labour force (such as by reducing unemployment, persuading more citizens to work, lowering the unemployment benefit or making it more difficult to get).
- Constraining current consumption and investing overseas with a view to financing imports in the future.
- Constraining the consumption of the working-age population in future, for example through higher taxes, to make more goods and services available to retirees.

⁴⁹ Nicholas Barr, *Myths My Grandpa Taught Me*, Three Banks Review, No 124, pp 27-55 at p 35 (1979).

⁵⁰ However, immigration tends to import other countries' demographic problems.

⁵¹ NZS is relatively "neutral" from an efficiency perspective as it is paid whether a person works or not. However, it still influences that decision in ways that might not be in the country's best interests.

- Improving productivity through investment in education and training. Our government argues that as productivity rises so do wages (and, therefore NZS because of its link to wages). On this view, increasing the size of the economic cake doesn't help. There are two answers to this. First, increases in capital productivity and innovations raise total factor productivity and can let GDP increase without increasing wages and, therefore, NZS (see the next bullet point). Secondly, the link between real wages and NZS could change as relative incomes increase⁵².
- Increasing the capital stock and its quality (robots have the advantage of not needing pensions) to compensate for the potential labour shortage.

The NZSF does not address the problem of the sustainability of NZS with an ageing population. The NZSF's presence will probably not boost output, raise productivity or constrain the consumption of future workers (once the retired population peaks).

Unless the NZSF takes a significant position in new ventures to build New Zealand's capacity⁵³, the only direct objective that the NZSF might achieve is constraining consumption and investing overseas to finance future imports. In fact, a future historian might discover that this was the main, political reason for the NZSF's establishment.

As Chart 2 (page 13) shows, the cost of NZS was still falling when the government took office in 1999 because of the then increasing State Pension Age. Given the Budget surpluses that recent New Zealand governments were already running, the then Minister of Finance (a relative conservative) probably saw the NZSF as a way of constraining a potentially free-spending, left-leaning coalition government. The NZSF essentially took about \$2 billion of tax revenues off the table⁵⁴.

Some might argue that, regardless of the cost issue, a funded state pension arrangement is more likely to stimulate growth than PAYG scheme providing similar benefits. However, the counter-factual in the case of the NZSF, given the higher taxes that are needed to create the fund, is what taxpayers would have done with the extra taxes they have to pay now. At least some of those taxes would have been saved in ways that might make a greater contribution to growth than the NZSF. Then there are the behavioural effects of the NZSF's presence, the deadweight costs of the extra taxes collected, the political and investment risks, the debt versus investment issue, all of which are covered below.

5.4 Where will the money come from?

The NZSF is used as an accounting device to pass through all the money that is then paid to both existing and future superannuitants. What is not needed to pay for pensions

⁵² In fact, employees' compensation as a proportion of GDP has fallen from about 55% in 1980 to 45% in 1998 (down 18% in only 18 years).

⁵³ According to the NZSF's 2005 report, "alternative assets" (not necessarily in New Zealand) comprised 0.5% of all investments. The Report noted that this proportion is expected to build to 13% by 2007 but eventually will be as much as 25% of assets. "Alternative investments" include infrastructure, private equity (1% of the 2007 13%), commodities, forestry and "absolute return strategies". See paragraph 4.9 for more on this issue.

⁵⁴ Chart 1 (page 13) shows the expected costs of all government programmes based on the first costing model produced for the 1992 Task Force (of which I was a member). In public presentations, the Task Force emphasised that 1992 costs were likely to continue reducing slowly after 2001 (when the State Pension Age reached 65 and until 2011 when the first baby boomers started to reach age 65). The cost would not return to 1992 levels until 2030. We emphasised the dangers of future governments' "filling in the trough" in what we described as the "wavy blue line". Perhaps the NZSF is one way the present government saw of limiting, but not acknowledging, that risk.

today will be left behind to build up into a fund. The transfer to the NZSF of a dollar of tax revenue to pay a dollar of NZS to an existing pensioner involves no change of substance. Total tax, spending and the operating surplus are not changed. In fact, given that the NZSF is one of the government's "pockets", this accounting exercise is pointless.

The transfer to the NZSF of a capital contribution of a dollar (that is, an amount not needed to pay pensions today), assuming no change in overall tax or spending, does not affect the government's operating surplus as such transfers are made after the surplus has been determined. The transfer means that a smaller amount of operating surplus than otherwise would be available to fund capital spending. So, if capital commitments are unchanged, the government's borrowing will be higher than otherwise.

The government's operating surplus is therefore unchanged by either annual expense payments or capital contributions. The surplus is transferred from one government cookie jar to another. The apparent partial funding of NZS is matched by an equal reduction in money available to fund other activities in the future. For instance, general government debt may increase (or not reduce); health capital spending may reduce or there may be less available for education facilities. Peter is robbed to pay Paul. Again there is no change in substance.

5.5 Current workers pay twice

A change from the PAYG approach to a partially funded basis requires workers during the transition to pay twice. Those workers must meet, through their taxes, the costs of NZS for current retirees as at present. In addition, they must fund surpluses that, together with related investment income, will provide partly for their own NZS when they retire. So it is impossible to have a partly funded NZS without increasing taxes and/or reducing spending on NZS or other goods and services like education, health and welfare.

It might be argued that, for the generation that pays twice, there is no real burden as those taxpayers are paying extra to secure their own retirement income. However, that is no answer as they would be the first generation to do that. Something has therefore changed for them, compared with the present (and past) generations. In any event, justifying the double burden on that basis begs the question as to the appropriateness of the current level of NZS for the future.

Nor can the double burden be justified by saying that this would happen with a change from PAYG to a largely privatised system, as occurred in Chile. This argument assumes that the state's obligation should be privatised. After 25 years, the Chilean model now demonstrates some obvious flaws in the principle of relying on private provision to satisfy the state's welfare obligation. Again, the state should make its welfare decisions based on the relative weights that it accords to the various claims on taxpayers of the day. The "right" to future retirement income support at Tier 1 is something that can be satisfied only by tomorrow's taxpayers (and tomorrow's economy) not by today's workers (and other savers).

Anyway, asking today's workers to pay twice (at least partially) for NZS does not help to grow the economy or deliver the other services that the government might want to increase spending on.

5.6 Costs will increase

The cost of any retirement benefit scheme (public or private; defined benefit or defined contribution; lump sum or pension; pre-funded or PAYG) is the benefits that the scheme pays. It doesn't matter how the scheme is paid for – whether from taxes, contributions paid in earlier years or from investment income, other things being equal⁵⁵. The government has recently increased the generosity of NZS⁵⁶ by raising its level relative to wages. That will increase its future cost both because of the increased benefits and the larger number of people who will receive them in the future. On the other hand, the government said it would not increase personal taxes further to finance the NZSF. These two commitments are potentially incompatible with the adoption of a partially funded scheme. The most likely outcome is higher debt than otherwise because surpluses that would be used to reduce debt would be transferred to the NZSF.

In the presence of the NZSF, spending on superannuation, even on a PAYG basis, will increase (or be higher than otherwise would have been the case) without the NZSF. Other spending will need to be cut, if personal tax is not increased. Without the required tax increase and/or cut in spending, the partial pre-funding imposed through the NZSF is essentially the previous PAYG scheme with higher superannuation payments, additional administration costs and a lower surplus than otherwise.

5.7 Funding or PAYG?

The partly funded scheme will not reduce the cost of NZS, other things being equal. A transfer to the NZSF of a dollar today that increases in value with net investment income of, say, 5% a year (before adjusting for inflation) to \$7 in 40 years' time is exactly equivalent to a PAYG payment of \$7 (plus an adjustment for inflation) in 40 years time. In the latter case the taxpayer can invest a dollar today and earn the same investment income as the NZSF to pay his or her tax bill in 40 years time.

Similarly, the transfer of a dollar of personal income tax to the NZSF which increases to \$7 in 40 years time is matched by a dollar plus related forgone earnings elsewhere in the government sector which, other things being equal, can be expected to have an opportunity cost of \$7 in 40 years time.

Contrary to the government's claim at the time the NZSF started, the NZSF provides no additional security about "where the money [for NZS] will come from." It will effectively continue to come from tax revenue. There is no separate source of funding for NZS. The best the government can argue is that the NZSF affects the timing of tax receipts.

There are no compelling grounds for partly funding NZS or similar non-contributory public programmes such as the invalid's benefit or health spending that are presently funded on a PAYG basis. The future funding of these schemes primarily depends on the prosperity of the economy and the government's power to tax⁵⁷.

⁵⁵ There could be feedback effects from, for example, the deadweight costs of collecting more tax than is needed.

⁵⁶ From a net 65% of the net national average wage for a married couple to 66%. This followed negotiations with New Zealand First to form the 2005 MMP coalition government. The increase is, apparently limited to the life of the current government – a maximum of three years.

⁵⁷ The Ministry of Health thinks that health will cost more than 8% of GDP by 2051. By 2100, health spending will be about the same as the net cost of NZS (according to the results from the modelling tool PRISM – see paragraph 4.3 for more on PRISM). If the government is concerned about the future affordability of health care, why is there no similar "smoothed pay as you go" approach to rising health costs? There is no effective distinction between these two demographically influenced programmes.

Private superannuation schemes are not able to tax residents. This is the main reason why they seek to provide security for contributors by fully funding their schemes. Governments face no such problem because of their ability to tax.

The NZSF is in fact an example of a "fallacy of composition". It's a good idea for individuals or employers to put aside money for future superannuation payments. However, it does not follow that what's right for an individual is necessarily right for the country. Building up the NZSF will re-arrange claims on today's economy between earners and non-earners but does not necessarily increase the security of either. Only a stronger economy can do that.

In New Zealand, we do not need to concern ourselves with the argument about whether the rate of return on social security "contributions" is likely to fall in the future because of the demographic changes. We have no separate "contribution" that is, in truth, just another form of tax. The absence of such contributions in New Zealand in fact points up the flaw in the analyses of the implied rate of return from those earmarked taxes in other countries. Section 9 suggests the elimination of such separate collections. However, there is a related issue that needs dealing with.

It might be argued that the NZSF could reduce the cost of NZS if the future population growth rate is less than the rate of return earned on the NZSF's assets. This confuses two ideas. Given that the cost of NZS is the benefits paid, the only effect of the return on the NZSF's assets is to alter the incidence of its cost, not change it.

However, the presence of the NZSF may, in fact, raise the overall cost of NZS (including the NZSF) by more than the previous, purely PAYG arrangements for the following reasons:

- There are the direct risks of investment losses;
- Then there are the administration costs of running the NZSF itself (last year, 0.48% of assets⁵⁸);
- Next, there are the indirect costs such as the dead-weight costs on the economy of collecting more tax today than is needed to meet the government's immediate obligations. In New Zealand, this has been estimated to be 18% of labour taxation (from the "diminished incentives to work, save, invest and take risks")⁵⁹.
- Finally, there are the direct costs of administering the tax system and compliance/avoidance costs that need to be added.

In fact, given that the country's capacity to meet the economic obligations to superannuitants (both public and private) depends on the strength of the contemporary economy, the NZSF will partly disguise one of the safety valves that should regulate the relative equities of competing contemporary claims on that economy. The annual budget process carried out by the government of the day is the most practical example of the way in which those relative equities are resolved year by year. The NZSF will provide a partial barrier for that on-going, self-balancing process. The fiscal and policy pressures imposed on governments by "entitlement-based" programmes illustrate the barriers to needed change.

⁵⁸ From the 2005 Annual Report of the NZSF already referred to.

⁵⁹ W Erwin Diewert and Chris A Lawrence (1994) *The Marginal Costs of Taxation in New Zealand*, New Zealand Business Roundtable, Wellington. Cited in *Some Issues in the Current Tax Debate*, Roger Kerr, New Zealand Business Roundtable, 8 September 2005.

Changing the funding basis of NZS will not save money over the current PAYG arrangements. The NZSF is no more "secure" than the capacity of future governments to tax; rearranging economic claims in today's economy will not better prepare future New Zealanders for the impact of a growing aged population.

5.8 Where will the money be invested?

The extra amount of tax required each year to achieve the government's objective will average about \$2.2 billion a year in today's money during the build up period of the next 20 years. For the reasons described in paragraph 4.8, nearly all of that money should be invested overseas. In fact, at 30 June 2005, a surprisingly high 25.5% was invested locally (with 16% in local cash and bonds).

Over the long term, the New Zealand market will not be able to absorb much of that significant annual amount but, even if it could, there are two main reasons for investing outside New Zealand:

- New Zealand doesn't have sufficient local diversification. We don't have the range of companies and industries in sufficient quantities that such a large pool of assets will require.
- Aside from the modest intergenerational cash flow effects of the "smoothed pay as you go" system introduced by the new arrangements, the NZSF could also help to partially insulate the New Zealand economy from internal shocks. On that basis, it could act as a form of economic insurance fund. Just as it makes no sense for the New Zealand's Earthquake Commission's Fund to be invested in New Zealand⁶⁰, so too the NZSF should be diversified away from the economy that could most directly affect the future affordability of NZS.

Investing such a large amount overseas raises a number of issues:

5.8.1 Balance of payments impact: First, there is the immediate impact on New Zealand's balance of payments as the money flows overseas⁶¹. Then, the impact will be reversed as the money comes back into New Zealand to help finance the consumption of tomorrow's retirees.

5.8.2 Timing of draw down: Next, the citizens of all other developed countries face similar but, in most cases, more serious ageing issues than New Zealand. Just as we will want to be drawing down on the NZSF to meet payments to superannuitants, other baby boomers around the world will already have started their draw-downs.

Some commentators say that such a co-ordinated withdrawal of money from markets to pay for retirement consumption will have a significant, negative impact on asset values around the world. Shifting the investment response to the ageing issue from individuals to the government, as the NZSF arrangement suggests, doesn't change that risk but could magnify it. Individuals are more likely to respond rationally with their own money to this issue than can governments that make

⁶⁰ Because the New Zealand economy's ability to meet compensation for earthquake losses could be compromised by the earthquake itself.

⁶¹ There has been recent local concern about the high value of the New Zealand dollar and the adverse effects that is having on our export sector. Were it not for the extra selling pressure created by the NZSF's investments going overseas, it is possible that the dollar could be even higher than now.

decisions about taxpayers' money and that aren't directly accountable for the outcome.

5.8.3 Helping other countries out: Lastly, investing overseas in portfolio investments might help other countries grow their capital stock. That may help those countries to deal with their own ageing populations but shouldn't New Zealand prefer to grow its own capacity rather than those of its competitors? If we wanted to do that, shouldn't we be letting New Zealanders themselves invest that money in their own businesses? It is unlikely that political appointees (the NZSF's Guardians) will make better, more relevant investment decisions with other people's money than New Zealand citizens would make with their own.

In fact, it could be argued that the government has actively decided not to allow citizens to invest in New Zealand Inc. (at least to the extent that they would have done so with their own money) because it concluded either that the required rates of growth will not be available in the local economy or that it wants to limit the risk of inadequate growth resulting from individual decisions. Only other economies will offer the needed returns so the NZSF will withdraw potential investible capital from taxpayers.

On the other hand, it is possible that the government did not consciously make that decision. Needless to say, it was not debated.

The final investment issue concerns the "debt versus investment" argument. For individuals, paying off debt before investing for retirement income is a sensible strategy. In New Zealand, the most important reason for that is tax – under the TTE regime (see the next section 6), it's very difficult for future after-tax investment returns to exceed the cost of personal debt that is probably not tax-deductible. However, reducing risk is also important. Given the volatility impact of gearing (and the need to pay the debt holder a fixed return), paying off debt also reduces a family's exposure to risk. Reducing debt is akin to obtaining a guaranteed net return on investment equal to the cost of debt.

Much the same arguments apply to the NZSF but this time, in the government's balance sheet. Investment logic says that returns from investing in shares should be higher over the long term than the cost of debt. However, they might not be. The risk that after-tax returns might be less than the cost of debt should favour the repayment of debt over portfolio investment. This argument should also preclude the inclusion of any government debt (bills or bonds) in the NZSF's portfolio. Maintaining debt in the government's balance sheet while investing in other governments' debt (or especially New Zealand government debt) through the NZSF just doesn't make investment sense.

Anyway, maintaining existing debt in the government's balance sheet while, at the same time, building up the NZSF is the same as borrowing to invest. If it's a good idea to maintain sovereign debt at 20% of GDP (as the government intends), why not double the amount of debt to, say, 40% of GDP and invest it all through the NZSF? If that doesn't sound sensible then neither is the government's decision to leave debt at 20% while building the NZSF.

Like most "single answer" solutions to public policy issues, the unintended consequences of the NZSF are that:

- It will probably increase New Zealand's exposure to risk in the short run (balance of payments; interest rates vs. portfolio returns) and also in the long run as we reach our peak retirement income demand period later and less severely than most other developed countries.
- Its indirect investments in other countries' businesses are more likely to produce lower returns for New Zealand than would be produced for the country if New Zealanders made their own decisions with their own money.

5.9 The investment process

The government requires that the NZSF be managed independently of the government on a "commercial" basis. All the risk will, however, remain with the government in the first instance (and ultimately with taxpayers) because the level of NZS payments will continue to be determined by the government. The cost of those future payments will not be directly related to the level that would be actuarially prudent, given the levels of the NZSF and income tax.

Over time, political pressures will influence the NZSF's investment strategy. For example, will the NZSF really be allowed to invest unlimited amounts overseas? Will it be required to hold New Zealand government debt (a silly idea), or will it be allowed to invest in companies that engage in politically controversial businesses like strip mining, unsustainable logging⁶² or stem cell research? How many worthy local "investments" like new bridges, schools or motorways will eventually form part of the NZSF's portfolio, regardless of the current rules (which may preclude those)?

The government directly acknowledged this potential. In introducing the enabling legislation, the Minister stated:

"Because the Board will be independent from the Crown, it will be required to *have regard to* rather than *give effect to* directions from the government."

Despite the apparent independence of the so-called "Guardians"⁶³ it doesn't take much imagination to see the potential for the politicisation of the investment process.

In a separate illustration of this, one fund manager told me at the time that it would not publicly criticise the legislation that introduced the NZSF, despite what it thought, because of the potential fund management business that the NZSF represents in New Zealand's tiny market.

Because of almost inevitable political interference and the potentially politicised nature of the NZSF, the returns from the NZSF may be lower than they should be. It is too early to say whether that will be so. The most recent year's return was 14.1% before tax. Although the Guardians thought that was a very good result, it was not markedly different from the results of other, much smaller retirement funds (to the extent it is possible to rank the NZSF in the small New Zealand market). It also fails to account for the wider deadweight costs of higher taxation incurred by the economy in creating the contributions paid to the NZSF.

⁶² The Guardians' rules of engagement have contemplated this difficulty. The Guardians must invest "... in a manner which avoids prejudice to New Zealand's reputation as a responsible member of the world community" (from the 2005 Annual Report) - in other words, nothing to embarrass the politicians.

⁶³ The same speech stated "[The Guardians] will be required to manage the Fund on a prudent commercial basis - in a manner that is consistent with best portfolio management techniques, and consistent with maximising the Fund's returns without bringing undue risk to the Fund as a whole."

5.10 Another version of compulsion

Labour, the main coalition partner in the present government, campaigned vigorously against the proposed Compulsory Retirement Savings Scheme in 1997⁶⁴. It objected to the idea that the government should force New Zealanders to save particular amounts in specified ways.

The NZSF is compulsory retirement savings in another guise. The government is still telling New Zealanders where their retirement savings should be invested. But this time, the government knows better than New Zealanders who should invest the money and who should own that. The 1997 proposal at least had the virtue of letting savers have some choice over the money manager for their savings – not so with the NZSF.

The government cannot explain any fundamental difference in principle between the NZSF and what Labour opposed in 1997.

5.11 The lessons of history

History is also against the NZSF. The 1938 social security “charge” (1/- in every £1 or 5%) was intended to fund the contributory health and welfare programmes that were charged to the Social Security Fund in terms of the Social Security Act 1938. Legislation passed by Labour in 1958 credited the successor to the charge (the Social Security Income Tax of 1/6 in every £1 or 7.5%), to the Consolidated Fund to which social security and all other spending was then debited.

The separate tax was eventually abolished on the recommendation of the Ross Committee because it reflected “an artificial splitting of tax receipts” and social security spending had consistently exceeded the level of the tax⁶⁵. History will eventually be repeated with the NZSF. Despite current political support, the NZSF is vulnerable because it was imposed with no substantive debate about its merits.

5.12 The impact on individual saving decisions

People are more likely to save for retirement themselves if they doubt the future sustainability of NZS or if they think it won't be enough. The government has said that the NZSF would put an end to that uncertainty.

Increased certainty on the future shape of NZS is an essential part of the retirement income framework suggested in section 9. However, in another example of the law of unintended consequences that often afflicts modern government, the mere existence of the NZSF and its seemingly substantial appearance may induce New Zealanders to save less than they would otherwise have done. The Treasury gave that advice to the government when the NZSF was introduced.

The problem in this connection is that the NZSF is no answer to the NZS affordability issue for the reasons already stated. So, the existence of the NZSF may lead New Zealanders to save less while at the same time it fails to address the issues of

⁶⁴ In the 1997 Referendum, the compulsory proposal (that looked quite like the Chilean model) was defeated 92% to 8% on an 80% turn-out of the electorate (the turn-out in the 1996 election itself was only 78.4%). The idea of having the Referendum was the result of a post-election deal done between National (that was opposed to the idea but needed the votes of its smaller coalition partner) and New Zealand First (that still supports compulsion). The alternative to the Referendum was apparently a compulsory scheme with no choice about whether it would proceed. New Zealand got off lightly with only a referendum.

⁶⁵ Ross, L N and others (1967), *Taxation in New Zealand: Report of the Taxation Review Committee*, Government Printer, Wellington, pp 108-110.

sustainability that really matter. If we want New Zealanders to save more and if we want more certainty on the shape and sustainability of NZS, then the NZSF is unlikely to help.

Total “saving” (in financial investments of the kind the NZSF buys) may therefore, despite conventional wisdom, be less in the presence of the NZSF than if it did not exist.

5.13 The macroeconomic issue

Economists might argue that, from a macroeconomic perspective, a pre-funded public pension is the same as a pre-funded private pension system with no public pension. This then suggests that, if there is to be a Tier 1 pension (as argued in Section 9), it is better for it to be pre-funded because, it seems, that is what the equivalent private arrangements would have done.

That assumes both public and private provision have the same role at a microeconomic level. Section 9 suggests that Tier 1 is really little different from the state’s other welfare obligations (health, housing, other income support payments). It concludes that any state-provided pension should be PAYG. The state should instead concentrate on doing the things that only it can do – deciding on the level of welfare support from time to time and extracting taxes to deliver that support is a proper government function. Financial savings for the retirement income needs of citizens is not. A government that competes with the private sector in this function (or even contracts it out to the private sector) misunderstands its role. Adverse, unintended consequences (some of which have already been described) are likely to make things worse for tomorrow’s retirees, despite the government’s best intentions.

5.14 Politicising the problem

David Thomson has argued⁶⁶ that the history of the welfare state since the 1930s has been a direct response to the needs of the baby boom generation and its parents. From birth, education, household formation, housing, health care and retirement income provision for their parents, David Thomson says that the baby boomers are the “selfish generation”.

Arguably, the NZSF could be seen by future taxpayers as the last roll of the dice by the baby boomers. A group of self-interested politicians (almost all of whom are members of the “selfish generation”) attempted to lock in benefits that the country may subsequently discover it can't really afford, or simply doesn't want to pay.

The growing NZSF will be the most visible manifestation of that last gasp. As it becomes by far the largest pool of investment capital in the country⁶⁷, it will be an ever-present symbol of what is already the largest single claim on taxpayers' resources. The NZSF will, in fact, become an impediment to any needed change and that is probably what the government intended.

The NZSF will tend to politicise the whole issue of a sustainable NZS. In other words, as the most visible flagship of the selfish generation, it is more likely to increase uncertainty than reduce it.

⁶⁶ In his book *Selfish Generations; The Ageing of New Zealand's Welfare State*, Bridget Williams Books, 1991.

⁶⁷ It is expected to reach about 42 % of GDP at its peak.

Section 6. Tax neutrality – why do countries pay citizens to save?

6.1 Tax reforms – a vital component of the New Zealand Way

All developed countries, apart from New Zealand, offer tax concessions to encourage their citizens to save for retirement. Governments apparently do this because they think that people should be sent a powerful signal to look after themselves in retirement. This section suggests that New Zealand has it right and that all other countries do not.

6.2 The taxonomy of tax

The two letters “T” and “E” neatly summarise how different countries treat saving for retirement from a tax perspective.

The almost universal international treatment of private provision at Tiers 2 and 3 is **EET**. In this case, the first letter “**E**” says that contributions are tax favoured. They are largely deductible for the calculation of income tax (though there may be limits). In the case of an employer, the contributions to a retirement savings scheme in respect of an employee are also not treated as indirect income in the employee member’s hands. Remuneration paid through contributions has, therefore, a higher after-tax value than direct pay.

The second letter “**E**” signifies that the investment income is free of tax for both the fund that manages the money and the members in respect of whom the money is managed. The final letter “**T**” says that the retirement benefit is taxed as income in the members’ hands.

This type of treatment is sometimes called the “**expenditure tax model**” – benefits are taxed when spent rather than when earned.

In some countries, a reduced level of tax may apply to one or more of the movements of money – the taxonomy normally shows this as a lower case “t”. So, Australia’s treatment can be characterised as “**t t t**”⁶⁸. Some tax is collected with each movement of money, albeit at a reduced (or favoured) level.

Since 1990, New Zealand has had the **TTE** treatment for Tiers 2 and 3. Contributions are made from after-tax income (and if necessary are deemed to be income in the employee members’ hands); the manager of the money pays tax on the investment income and the benefit is deemed to be tax-paid capital whether paid as a regular income or as a lump sum. Benefits are taxed as they accrue rather than when they are spent. Only New Zealand adopts this “**income tax model**” for formal retirement saving schemes⁶⁹.

Before the tax reforms of the late 1980s in New Zealand, retirement saving schemes also had preferential EET tax treatment. Pure lump-sum schemes were also tax subsidised, but less generously since the early 1980s – the treatment was tEE as the contributions that an employer could make on a favoured basis were capped.

⁶⁸ A discussion seems to have started in Australia to change that to Eet.

⁶⁹ Though TTE is typically the tax treatment applied to ordinary bank accounts in most countries – bank accounts are another “unfavoured” way of saving for retirement.

Table 3 summarises the two treatments.

Table 3

Different tax treatments of retirement saving

	Expenditure tax treatment	Income tax treatment
Contributions	Exempt	Taxed
Investment income	Exempt	Taxed
Benefit	Taxed	Exempt
	EET	TTE

6.3 The regulatory consequences of reform

After 1990, New Zealand’s tax regime for retirement income saving no longer favoured retirement saving schemes⁷⁰. With no tax concessions, the government could no longer justify intervening in benefit design issues - no restrictions could be applied to how scheme benefits were to be received, although schemes themselves could specify such details. Also, there could be no restriction on the amount of the employer’s or members’ contributions. Rather than controlling contributions, benefits and governance, New Zealand adopted a full disclosure approach to the regulation of formal retirement benefit schemes⁷¹.

New Zealand is the only OECD country that confers no special advantage on private savings that are particularly for retirement.

6.4 So tax incentives increase saving?

Given New Zealand’s unique, hands-off approach to the tax treatment of formal retirement saving schemes⁷², one might have expected that other countries’ very expensive tax regimes for Tiers 2 and 3 were supported by evidence that they actually worked. In fact, it is surprising how few countries actually count the cost of tax incentives for retirement saving⁷³. Unless the cost is known, it’s difficult to see how anyone can say whether the cost is justified.

In the context of the issues covered in this paper, this information gap is very significant. Tax incentives are very expensive – both directly and indirectly. If a country faces unacceptable demographic pressures from future pension costs, removing or limiting the cost of incentives for private provision could change the equation. For the reasons covered in this section, removing incentives might also be a good idea anyway.

One might also have expected more international interest in the outcome of New Zealand’s unique approach, given that it has been in place for now 15 years. But I haven’t come across anyone who has been able to show that tax incentives actually increase national saving (if that’s their objective) or improve the quality of savings (if that’s the alternative aim). The most that economists seem to be able to say is that the impact of incentives on national saving is unclear and may even be negative – in other words, incentives may actually reduce national saving.

⁷⁰ This change was part of a general move to broaden the tax base and lower tax rates.

⁷¹ An indication of the practical effects of that is the size of the governing legislation in New Zealand for formal retirement saving schemes – a mere 55 pages. That might be thousands of pages in a typical tax-advantaged regime. The UK’s Pensions Policy Institute estimates that there are 3,500 equivalent pages in the UK.

⁷² Leaving aside the *KiwiSaver* scheme discussed in section 8 below. As explained later, a *KiwiSaver* feature will be so-called “sweeteners”, apparently because they are modest in size. They are still incentives though their modest extent will probably produce an equally modest effect.

⁷³ As far as I am aware, only three countries do this – Australia, Ireland and the UK. New Zealand doesn’t need to.

There are many studies that draw attention to this apparent myopia in the debate on public pension policy. I will quote just two of those.

“The evidence presented in this paper for IRAs in the US, and TESSAs and ISAs in the UK, suggests that, at the most, only relatively small fractions of the funds going into tax-advantaged savings vehicles can be considered to be ‘new’ saving. As such, the best interpretation of the evidence is that such policies are expensive ways of encouraging savings. In addition, to the extent that the reshuffling of assets leads to a reduction in the tax liabilities without any real change in economic behaviour, there is some deadweight loss associated with such policies. Additionally, since those with the greatest reshuffling possibilities are the wealthiest members of society, these policies will typically have some distributional impact.”⁷⁴

The UK’s Pensions Policy Institute summed up the effect of incentives for the UK:

“But the effectiveness of tax incentives is unproven. There is no evidence that tax incentives increase the overall level of saving. Incentives may change the way in which people save, diverting savings into pension funds. But tax incentives have not been effective in generating enough pension saving for future pensioners.”⁷⁵

Concentrating on the quantum issue means we do not need to worry about the tax-timing effect of consumption versus income taxes. If EET does not stimulate immediate saving, as seems to be the case, the relative immediate worth to the state of TTE (versus the deferred value of EET) rules out the principle justification for offering incentives in the first place.

If governments collected all (or even most) of their revenue in consumption taxes, there would perhaps be a greater justification for EET. But taxes on income form the bulk of developed countries’ tax revenues. In an income tax environment, EET is concessionary and a costly concession at that.

6.5 The other problems with incentives

The absence of proof of the efficacy of tax incentives should, alone, be sufficient to stop the concept of concessions in its tracks. But it’s not the only thing that’s wrong with financial incentives to save for retirement.

6.5.1 Regressive: Tax incentives favour the rich. For a start, the rich normally pay tax at higher rates in the typical progressive regime so any concessions are therefore worth more to them (and cost other taxpayers more). Secondly, because the rich earn more, they can both save more and also have greater flexibility in re-arranging their affairs to take maximum advantage of the concessions. Here is an example of this from the UK:

“There is a remarkably upside-down distribution of the tax benefit: at least half of the tax subsidy on contributions alone goes to the richest ten per cent of taxpayers, with a quarter going to the top 2.5 per cent (Agulnik and Le Grand, 1998, p. 410⁷⁶). This ‘strongly regressive pattern’, Agulnik and Le Grand point out, leaves the bottom ten per cent of taxpayers with just one per cent of the tax benefit.

The tax privileges for pensions, therefore, constitute particularly unequal ‘upside-down benefits’ - that is, they confer more advantage to the better-off and provide very little for those who are most vulnerable to poverty. This is a form of ‘reverse

⁷⁴ Orazio P. Attanasio, James Banks and Matthew Wakefield *Effectiveness of tax incentives to boost (retirement) saving: theoretical motivation and empirical evidence*, Institute for Fiscal Studies, December 2004.

⁷⁵ *Tax Relief and Incentives for Pension Saving*, A report by the Pensions Policy Institute for Age Concern England (2004)

⁷⁶ Agulnik, P., and J. Le Grand, 1998, *Tax Relief and Partnership Pensions*, Fiscal Studies, Vol. 19, No. 4, November, pp. 403-428.

targeting' which runs totally counter to the government's reforms through Minimum Income Guarantee and Pension Credit to target help on those most in need."⁷⁷

6.5.2 Distortionary: Tax breaks for particular forms of saving distort saving decisions. While the preponderance of evidence on the “quantum” issue (paragraph 6.4 above) favours the “re-arrangement” rather than the “increase” explanation, there is little doubt about the directional influence of incentives. All countries that favour saving for retirement through the tax system impose rules about where or how those savings should be invested⁷⁸. There are several different types of distortions created.

First, trustee arrangements are usually mandated by the tax authorities so that assets are kept separate from the saver's other savings or from the employer's business assets. The presence of a trust favours investment in large, relatively liquid investments that satisfy fiduciary requirements. This probably means that most businesses (in New Zealand, most employees work for small, unlisted businesses⁷⁹) cannot form part of the trustee pool's investment assets. Money that might be better invested by the owners in their business instead finds its way into tax-favoured institutional funds.

Secondly, other restrictions can apply to the assets approved schemes can buy – some countries have relatively detailed lists of permitted investments.

Another structural distortion created by subsidies is that "approved" vehicles are favoured for new savings business over other vehicles that might actually be better for the country. While there may be competition between suppliers of services to approved vehicles, competition between approved vehicles as a whole and all other 'unfavoured' vehicles is reduced. The need for approved vehicles to perform well (by comparison with 'unacceptable' saving alternatives) will reduce.

In fact, tax incentives may actually encourage inefficiencies and allow savers to be more tolerant of performance inadequacies, administrative inefficiencies and higher costs⁸⁰.

6.5.3 Higher regulatory costs: The structure of the tax concessions has led to a very large investment in tax-favoured savings that is locked up in approved schemes. That investment is the present value of the future tax receipts the government will collect when the benefits are paid. It belongs to tomorrow's taxpayers and it has to be locked up, being let out only under controlled conditions. So, incentives cost a lot to administer because regulatory fences need

⁷⁷ Adrian Sinfield, *A Bigger Blank Cheque For the Tax Privileged. A Response to the Treasury and Inland Revenue Consultation Document, "Simplifying the taxation of pensions: increasing choice and flexibility for all"* the United Kingdom, May 2003.

⁷⁸ I come from a country that gets a lot of its income from farming activities that aren't subsidised by taxpayers so I see parallels with the inanities of farming subsidies around the world. If 85% of the average farmer's income comes from taxpayers (Switzerland); if farmers have to supply map references for all their fields and then tell the government three times a year what they are doing in those fields (Europe); if there is one bureaucrat for every five farmers (the US), you can be sure that a lot of farming activity is about protecting the tax base and not about growing things that consumers might actually want. The same applies to tax-driven saving schemes.

⁷⁹ About two thirds of New Zealanders work for employers with fewer than 50 employees.

⁸⁰ The commissions paid by Chilean providers in their compulsory Tier 2 arrangements illustrate this point. Apparently (The Economist *Ageing model requires facelift* 10 November 2005), Chileans don't seem to care about the commissions despite their unjustified size, probably because they cannot avoid them.

to be built around the favoured savings so that they are applied to the purpose for which the concession was given. Given the potential arbitrages possible between favoured and unfavoured vehicles, there is also a significant regulatory effort needed to maintain those regulatory fences.

6.5.4 Higher taxes: Higher than necessary income tax rates are another cost of tax incentives. It is not possible to give a concession to savers without either increasing the tax burden elsewhere, increasing government borrowing or reducing the government's expenditure in other areas. The first two of these alternatives directly increase present or future taxes while the third reduces the worth of government services that would otherwise have been supplied. In summary, everyone's taxes have to be higher to pay for the concession. However, the burden is borne more heavily by those taxpayers who, because of their low incomes or circumstances, have no realistic chance of saving for their own retirement.

6.5.5 Benefit financial providers: Finally, the financial services industry favours concessions because many studies have shown they have a very powerful influence on where people save; they are locked in and the institutions themselves capture part of the value of the concession through higher costs. So, if the New Zealand experience is any guide, any suggestion of reviewing the status of existing concessions will provoke a strong reaction from that sector.

6.6 Helping to bridge the demographic gap

Because of their high cost, getting rid of tax incentives may, on its own, help to solve a country's future fiscal dilemma. In Ireland, tax incentives cost about the same as the cost of Tier 1. In Australia, incentives cost 60% of the cost of Tier 1 (2001/02); in the UK it is about 29%⁸¹. These are significant amounts of money.

The 1992 New Zealand Task Force on Private Provision for Retirement⁸² rejected tax incentives for the reasons I have summarised. It also rejected compulsory private provision for another list of reasons. It concluded that letting New Zealanders make their own decisions in this area is more likely to be better for New Zealand and New Zealanders than alternative policy options. If other countries looked at the issues in the same way that we did, they would probably come to a similar conclusion.

However, New Zealand was precipitate in the way in which this major change was introduced. As explained in paragraph 6.5.3, the tax system has a large investment in tax-favoured savings. It has given up collecting tax on some or all of the contributions and investment income of retirement income assets in part-exchange for tax on the final movement of money – the benefits paid under the EET model. When New Zealand made the change from EET to TTE over 1987-1990 (see paragraph 3.1.4 above), that investment was essentially ignored.

A defined contribution pension scheme that had been accumulating assets on the EET principle until 1987 became, with respect to accumulated benefits, EEE.

⁸¹ The UK and Ireland numbers are derived from *Private Pensions and Equity* by Gerald Hughes, Economic and Social Research Institute (2002). The Australian number is from an estimate by the Australian Tax Office for 2001-02.

⁸² The final report, *The Way Forward*, was published in December 1992 and can be seen at: http://www.retirement.org.nz/1991_92_private_provision_taskforce.html

Defined benefit pension schemes renegotiated benefits in recognition of the higher cost of contributions and the reduced value of investment income but were not required to give any recognition to the changed status of the accrued benefit – the fact that what would have been “T” had become “E”.

In both respects, significant wealth was transferred, apparently without thought (certainly without recognition or debate), from tomorrow’s taxpayers to today’s members.

If another country contemplated a similar change, it would be reasonable for the government to make a one-time charge on the assets of a retirement savings scheme to recognise the fact that the tax system will no longer see any revenue from the emerging benefits. On that basis, Alicia Munnell recommended⁸³ that US schemes pay a special tax equal to 15% of assets. That is probably less than the tax that would otherwise be collected, given a continuation of EET. It might, however, make the cost of change less painful for today’s politicians.

The next section 7 looks at the evidence as to how New Zealanders have reacted to the freedoms that now unconstrained choices about retirement income provision have allowed them.

⁸³ *Current Taxation of Qualified Pension Plans: has the time come?* Alicia H Munnell, New England Economic Review, March/April 1992.

Section 7. The New Zealand Way – how are New Zealanders responding?

7.1 The traditional “macro” evidence

At first blush, it might seem as though New Zealanders aren't good at saving - the overall household saving numbers look terrible; we put too much into our homes and second houses; we don't have enough invested in productive assets; we've borrowed too much⁸⁴ and we won't have enough to live on in retirement. We must be in trouble.

It's true that New Zealand's so-called “household saving rates” look dismal. What they seem to show is that, since 1993, household expenditure has apparently outstripped incomes for each of the last 12 years. However, these numbers don't measure “savings” directly. They measure the difference between two very large streams of money – income that comes into households and spending that goes out. Not all of either of those can, in fact, be measured. For our present purpose, the results are therefore unreliable.

“Saving” normally means money put aside for a rainy day, not the difference between income and expenditure or “money not spent”. If the often-quoted numbers were truly measuring dissaving since 1993 then New Zealand households would by now have entirely exhausted their financial resources⁸⁵.

However, that's clearly not the case - the “look around and see” test easily beats the official numbers on this point. As an Auckland economist said recently, if the numbers look incredible, it's possible they may just be unbelievable. International comparisons of this so-called “household savings” measure are common. Despite that, if we really want to answer the question “Are households saving enough for retirement”, the macro numbers do not really help us to understand the usual meaning of “saving” or “savings”.

7.2 What is “enough” retirement saving?

There are several ways of looking at whether New Zealanders are saving “enough”. Recent work by the New Zealand Treasury has come up with a different and illuminating look at how we are actually doing⁸⁶.

Before summarising the conclusions of the work, I need to explain a couple of things. First what is “enough” retirement saving? If you were asked whether you were saving “enough” specifically for retirement, the most important issues for you individually should be:

- When do I want to retire?
- How much will I need to spend in retirement?
- How long will I live after I retire?

Scobie, Gibson and Le (the authors of the Treasury paper) based their work on the 2002 *Household Saving Survey* produced for the Retirement Commission by Statistics New Zealand⁸⁷. They have mined this large database (covering 5,400 “economic units” or

⁸⁴ Household “financial liabilities” have risen from 49% of net household income in 1978 to 145% by 2004 (*Household financial assets, liabilities and wealth* – New Zealand Reserve Bank).

⁸⁵ See the paper at <http://www.treasury.govt.nz/workingpapers/2002/twp02-02.pdf> for more on this.

⁸⁶ *Saving for Retirement: New Evidence for New Zealand* by Grant Scobie, John Gibson and Trinh Le, New Zealand Treasury Working Paper 04/12.

⁸⁷ Available on the Retirement Commission's web site at www.retirement.org.nz

households) to estimate what the participants might actually get to live on in retirement, given their assets and liabilities at the time of the survey in 2001.

For all the participants, Scobie, Gibson and Le answered the three key questions as follows:

7.2.1 Retirement age: All would retire when NZS starts (age 65).

7.2.3 Retirement income: Everyone would try to spend the same on consumption after retirement as before. In other words, their standard of living would stay about the same. The usual assumption would see net retirement income at 60-70% of pre-retirement net income. Assuming 100% builds a margin into the calculations.

7.2.3 Time in retirement: Everyone would survive for the average expectation of New Zealanders at age 65 (adjusted for sex and ethnicity). Importantly, everyone would also know that – in other words, they would consume all their assets during their retirement and not “run out” or have anything “left over” when they died. However, they would not “eat the home” – the value of the principal residence would pass to the next generation as an inheritance.

These are all relatively conservative assumptions. Although some will be forced to retire before age 65, many will work on after NZS starts. For example, 25% of New Zealanders aged 65-69 already work and that proportion is likely to rise and stretch into older age groups.

Again, most would expect their level of consumption to drop after retirement. Finally, not having to “eat the home” means that there is effectively an emergency fund if things go wrong in retirement.

7.3 The key findings

With that introduction here are the key findings:

“Typically we find that the actual saving rates do in fact exceed the rates needed for maintaining living standards in retirement. This reinforces our tentative conclusion that there is no apparent gross under-saving for retirement especially in the older age cohorts.

The results apply to broad groups within which there will be a distribution of people some of whom would likely not be saving at a rate to maintain their real standard of living in retirement. The results in no way imply that every individual is saving “adequately”.

Here, in a bit more detail, are the authors’ main conclusions:

7.3.1 Little evidence of undersaving: Tentatively, there is little evidence that New Zealanders are under-saving for retirement.

7.3.2 NZS plays a crucial role: NZS plays a crucial role in this conclusion – a significant proportion of New Zealanders’ expected retirement wealth is in the payments of NZS that they will receive.

7.3.3 Consistent results across different groups: There is little difference in average net retirement wealth across males and females and little difference across the age cohorts in projected retirement wealth (including, again, current levels of NZS). Both these conclusions were unexpected – until now, received wisdom was that females would have less net retirement wealth (low lifetime incomes and long retirements) and also that older employed New Zealanders (the “selfish generation”) would be better off than younger New Zealanders.

7.3.4 Possibly saving more than needed: Based on indications of actual saving behaviour from the separate *Household Expenditure Survey*⁸⁸, New Zealanders may be saving, on average, a bit more than they need to smooth consumption from work to retirement, assuming that NZS stays at current real levels. The conclusion also broadly applies if the State Pension Age were either reduced to 62 or increased to age 68. There are expected differences in these two cases but they are relatively insignificant.

7.3.5 A conservative approach to “quantum”: The “excess” savings (noted in conclusion 7.3.4) could be seen as precautionary in that people don't know exactly when they are going to retire, how long they are going to live or what their health will be like after they retire. So having a bit “in reserve” makes sense.

7.3.6 Those who can't shouldn't: Those who can't or aren't saving really don't need to. The poor can't afford to save and are, in any event looked after by the state, based on the consumption test adopted in the research. At the other end, the rich don't need to save. They already have enough put aside for retirement and anyway, we don't need to worry too much about them.

7.4 A disconnect between macro and micro?

Despite apparently awful macro economic data (household saving rate; balance of payments deficits and much higher levels of debt), it seems that New Zealanders might understand the key issues where it really matters – at a micro level. Despite dire pronouncements, New Zealanders seem to be responding rationally to the public policy signals they are receiving⁸⁹. While this does not necessarily mean that New Zealanders are behaving optimally from the country's overall perspective, it is not easy to see how a government might be able to impose a different or “better” view of an “appropriate” allocation between present and future spending (what economists call improving “inter-temporal efficiency”).

For the last 15 years or so, the government has in fact taken a “hands off” approach to private provision and has said, effectively, that it is up to New Zealanders to decide for themselves when, how and how much to save at Tiers 2 and 3. In short, the Treasury research finds (unsurprisingly, in my view) that New Zealanders do seem to have a collective sense of what they ought to be doing about retirement provision. People really do generally seem to be the best judges of their own welfare.

In fact, I do not think it is possible to answer the question about citizens' preparedness for retirement from a macro perspective. The apparent disconnect that I have described shows that it can be done properly only at a micro level.

7.5 So, New Zealanders don't need to worry?

Does this mean that we don't need to worry about this subject any more? Not at all.

For a start, the Treasury research assumes that New Zealanders will keep doing the things they are doing from now until retirement.

⁸⁸ Available on the Retirement Commission's web site at www.retirement.org.nz.

⁸⁹ Interestingly, similar conclusions have emerged from equivalent studies done in the UK and the US. For the UK, see *Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England* James Banks and others, Institute for Fiscal Studies, October 2005. For the US, see John Scholz and Ananth Seshadri of the University of Wisconsin: *Are Americans Saving "Optimally" for Retirement?* (January 2004) and, more recently (September 2005), *Lifetime Earnings, Social Security Benefits, and the Adequacy of Retirement Wealth Accumulation* by Eric Engen, William Gale and Cori Uccello.

Next, NZS has a crucial significance in all this. For most New Zealanders, NZS constitutes the bulk of their retirement wealth. The research shows that for many, it is their entire retirement wealth. There is nothing wrong with that except that New Zealand has not yet had a debate about the size and shape of NZS from, say, 2020 onwards. That debate should start soon and the research emphasises the importance of doing that now and not in 20 years. That's so younger New Zealanders can take a sensible view on what they need to save privately to top up NZS.

However, we can take some comfort from the research. It's much more interesting to find out what New Zealanders are doing as opposed to what they say they are thinking or what we suppose they might be doing or what financial service providers say citizens ought to be doing.

It also questions whether those who support a tax break for retirement saving or even a compulsory saving scheme or other direct intervention (such as *KiwiSaver*) have any justification for such expensive, intrusive (and probably ineffective) policy changes. If New Zealanders are, generally, already saving "enough", why would we pay them (through an incentive) or force them, or even encourage them to save more? It seems not to make sense.

7.6 Other saving numbers

The New Zealand Reserve Bank also publishes wealth numbers (wealth at and in retirement is the only number that really matters on the "saving enough" issue at a micro level). They show that the wealth of New Zealand households has grown from about 2.8 times net disposable income in 1979 to about 5.4 times in 2004⁹⁰.

These numbers must be treated with caution. First, they present average numbers that disguise a full view of households (the median and distribution around that will give a clearer view). Very large numbers at the top end can significantly affect averages.

Secondly, the Reserve Bank's numbers allow for all debt, including money borrowed on the home that is actually used to finance a business. Banks estimate that 10-20% of all mortgage debt is used for that purpose. However, the value of any business, like a farm or forestry, not listed on the Stock Exchange is not included in the household's assets. So the Reserve Bank counts the liability but not the asset. In New Zealand, a land of small businesses, that is a significant omission.

The Reserve Bank's wealth numbers therefore really count only those assets and liabilities that can be easily measured. It's better than nothing, but it's not really good enough. Good quality information (and plenty of it) is the only way of properly informing a debate on retirement income issues of the kind contemplated by section 9 below.

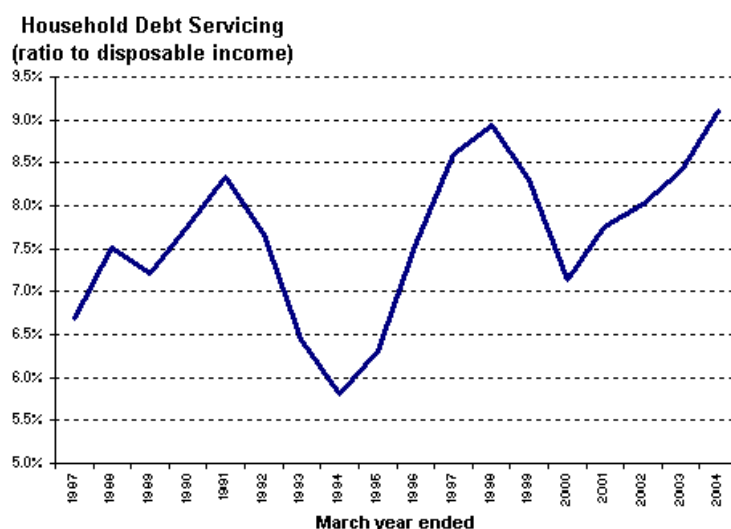
7.7 More on debt

New Zealanders worry about the increasing debt levels of households. New Zealand households are not alone in this regard. The issue in the present context is whether we need to be concerned at the present levels. Are they likely to affect the standard of living of future retirees?

⁹⁰ See <http://www.rbnz.govt.nz/statistics/monfin/household.xls> for the updated numbers on the Reserve Bank's web site.

What really matters, from an income and saving perspective, is the cost of debt and its relationship with incomes. On that score Chart 10⁹¹, does not suggest any particular cause for alarm.

Chart 10



Households are spending more on their debt as interest rates hit a seven year high in New Zealand but the cost of debt servicing does not seem overly high in relation to incomes and that bill is not out of line with other countries. The equivalent figures are about 8% in the UK, 9% in Australia and 13% in the US⁹².

7.8 “Tentative” conclusions so far – ‘come in SoFIE’

The authors of the Treasury study emphasised some crucial words in their findings. They described them as “tentative”; as “indications” of what may be the case⁹³.

They are important, necessary qualifications because the findings are based on the best information we have. That information is better than many countries’ equivalent data but it is still not good enough to allow us to be more certain about their implications.

That’s one of the reasons why the extensive “Survey of Family Income and Employment” (SoFIE) is now under way⁹⁴. Over the next eight years, New Zealand will gradually uncover what is really happening.

SoFIE is a more extensive study than the 2001 Household Saving Survey and it is also a longitudinal study. It will track 15,000 “economic units” (households) over at least eight years. Because of what we have learned from the first work in this area, SoFIE should give us a better picture as to whether New Zealanders are in fact “rational”. In, perhaps, 3-4 years we might be able to confirm some of the Treasury’s “tentative” findings. The first asset numbers have just emerged from SoFIE but they are still raw and require proper analysis.

⁹¹ From *Time to Raise Taxes*, Gareth Morgan Investments newsletter, 3 November 2005.

⁹² According to Spicers’ *Household Indicators*, March 2005

⁹³ In fact, they say that “More unequivocal results must await better data and methodologies; improved measures of household saving levels, and the application of micro-simulation models which are more suited to capturing uncertainty about health status, employment, incomes and life expectancies will improve our understanding of household saving behaviour.”

⁹⁴ For more information on SoFIE, see <http://www.stats.govt.nz/additional-information/survey-of-family-income-employment/default.htm>.

7.9 Wisdom of the crowds

Many commentators on the saving adequacy issue speak as though we should leave all this complicated stuff to the experts, be they politicians, their advisers, policy analysts or industry leaders. As ordinary consumers, we can't possibly make sensible decisions on our own because we really don't understand what might be in our own best interests. So someone else has to do it for us, or force us to it.

That attitude lies at the heart of Australia's and other countries' compulsory superannuation schemes, President Bush's proposed Social Security reforms in the US and the proposed *KiwiSaver* scheme (more on that in the next section 8). Much of the debate in almost all developed countries seems to be centred on these kinds of issues. There is, for example, no other real justification for a compulsory Tier 2 scheme such as Australia's.

In New Zealand, we have had a "hands-off" approach for about 20 years and here are what seem to be the outcomes:

- We seemingly don't have a retirement savings gap.
- About 78% of the retired population live in their own debt-free home⁹⁵.
- Based on surveys, retirees seem, on the whole, quite contented.
- We have a relatively small incidence of poverty in old age⁹⁶.

How come we seem to have worked out all by ourselves what we need to do?

A 2004 book, called *The Wisdom of Crowds* by James Surowieki, may answer this central question. Generally, crowds can come to quite sensible conclusions about complex issues, possibly because there are so many of them working on the problem.

Surowieki lists four key things that allow the wisdom of crowds to become apparent in problem-solving - independence, diversity, decentralisation and aggregation. These all potentially apply in abundance to the topics at the heart of the retirement saving issue (at a micro level). But that wisdom can be distilled only if individuals make their own, independent decisions – not, however, if they have people telling them what to do or paying them to behave in a particular way. That's when we tend to get unintended consequences – economists might call them market distortions.

It seems a paradox that, in the highly regulated, hugely complex, deeply subsidised, extremely expensive retirement saving industry in the UK, some argue that there is a retirement savings "gap" while others express concern about "major gaps which exist in the current state system for people with interrupted careers and caring responsibilities"⁹⁷. Whereas in deregulated, "hands off" New Zealand, we have neither a retirement savings gap nor significant pensioner poverty after 20 years of "free market" policies⁹⁸.

⁹⁵ The *Household Economic Survey* from Statistics New Zealand (2003-04) shows that about 84% of New Zealanders who are "retired" live in their own homes and 93% of those have no mortgage.

⁹⁶ A survey conducted by the Ministry of Social Development in 2001 (*The Living Standards of Older New Zealanders*) showed that only 4% faced "severe financial difficulties". Of the total sample of 3,060 respondents, 89% described their income as "adequate" and only 6% described their overall living standards as "low" or "fairly low".

⁹⁷ *New Pension Settlement for the Twenty-First Century – The Second Report of the Pensions Commission*, November 2005.

⁹⁸ Given the presence of Tier 1. The "citizen's pension" NZS, paid to all without regard for assets or other income could, of course, be seen by some as decidedly not "free market".

Surowieki probably wouldn't think this at all strange - neither should we. Nor should we be surprised that the UK has been looking seriously at the New Zealand model⁹⁹. The UK has apparently figured out that what they do there isn't working and what we do here might be.

7.10 In conclusion ...

In summary, the message of this section is that we need good information before we can really understand what individuals are doing about saving for retirement.

So far, the hands-off approach of the New Zealand Way seems, tentatively, to be working.

That has not, however, deterred our interventionist political process from having another go at telling us all what we should be doing. More on the new *KiwiSaver* next.

⁹⁹ Regrettably, it seems as though the UK might be taking too close a look at *KiwiSaver* with an equivalent *BritSaver* – the “National Pension Saving Scheme”. That would be a mistake.

Section 8. More change on the way – politicians still feel the need to govern

8.1 Why *KiwiSaver*?

Despite the generally good news described in the last section 7, our government still feels the need to govern; to intervene in the way that New Zealanders make their retirement saving decisions. It will introduce a work-based savings Tier 2 scheme known as “*KiwiSaver*” that is intended to start on 1 April 2007.

This initiative is apparently in response to relatively low levels of participation in formal Tier 2 schemes. Participation rates were never high, even when they had an EET tax treatment (probably never more than 33%) but they now stand at only about 16% of the workforce. The government thinks this needs to change although, based on the evidence, it is hard to see any other justification.

Those who support *KiwiSaver* tend to believe that the only “proper” Tier 2 scheme is one that locks the benefits up until retirement. In an EET environment, a government could justify limiting access in that way to protect the tax system’s “investment” in the up-front, on-going concessions (see paragraph 6.5.3 above). There is no similar justification in a TTE environment and the government has not even attempted to justify “lock up”. Savers will probably be more realistic.

8.2 The shape of the scheme as announced

KiwiSaver’s basic features are, in summary¹⁰⁰:

8.2.1 Eligibility

- *KiwiSaver* applies to all employers except where they offer an alternative qualifying plan.
- All new employees aged 18-65 (regardless of the level of their pay) are automatically enrolled on starting work.
- New employees, having been enrolled, can opt out.
- Existing employees do not have to join.

8.2.2 Vehicle

- Employees who join (or, more accurately, who do not opt out) must select an approved “provider” or will be allocated a default provider.
- An employer can nominate a default provider for all employees.
- Employees can change providers at their option.
- The Inland Revenue Department (“IRD”) will collect all contributions to limit compliance costs for both employees and employer. It will forward them to each employee’s chosen provider.

8.2.3 Contributions

- Employees will pay through the tax system: either 4% or 8%, as they elect, of all taxable pay, including overtime, bonus and incentive payments.
- An employee’s contributions start after eight weeks of employment.
- The government will pay an upfront contribution of \$1,000 on joining – a so-called “sweetener” (not a tax incentive, you understand).

¹⁰⁰ Summary derived from Aventine Consultants’ newsletter *KiwiSaver – what is it?* (June 2005) – the original is at <http://www.mcanz.co.nz/news/KiwiSaver%20-%202015.06.2005.pdf>

- The government will also pay part of the annual administration costs on a basis yet to be set. This may be negotiated separately with each provider.
- Employers can, but will not be required to, contribute either through the IRD or directly to the employee's nominated provider.

8.2.4 Benefits

- The provider can pay benefits only from age 65, for housing assistance (see 8.5 below), on hardship grounds or following permanent emigration.

8.3 The *KiwiSavers* scheme in practice

Apart from automatic enrolment, employees may become *KiwiSavers* at any time and make voluntary contributions. New employees can opt out by notifying IRD 2-4 weeks after starting a new job. The IRD must notify the employer of the opt-out otherwise deductions begin on the pay day after eight weeks with the employer.

Contributions will be at 4% of all taxable pay, but the employee can opt for a higher rate of 8%. No other choices are possible. Members can stop contributing in five year contribution holiday "tranches" after a minimum initial three months of contributions. Automatic contributions resume if the member does not renew the cessation.

The IRD will hold contributions for eight weeks after they start to allow employees time to get advice and choose a provider. Contributions will receive "use of money" interest from the IRD while it holds the contributions.

The self-employed and beneficiaries can become *KiwiSavers*, choosing their own contribution rate and frequency.

For a scheme to be a *KiwiSaver* "provider", it must be a registered superannuation scheme and comply with the contribution and benefit requirements described.

8.4 Three types of *KiwiSaver* scheme

There will, in fact, be three types of scheme under the *KiwiSaver* regime:

- "**default providers**" - a probably "limited" group that will be chosen by the government after a tender process ("designed in part to negotiate lower fees");
- "**qualified providers**" - other providers that an employee can choose as the *KiwiSaver* provider.
- a "**default scheme**" – chosen by an employer from amongst default and qualified providers as its own default provider. An employer does not have to choose a default scheme. If it does not, the "default provider" regime will apply.

If an employee does not make a provider decision (and does not opt out), the IRD will nominate a provider through a "randomised" selection process from amongst only the default providers. However, if the employer has nominated its own default scheme, the contributions will be credited to that scheme in the absence of an employee's own choice of a different "qualified provider".

8.5 *KiwiSaver* linked to home ownership assistance

KiwiSaver schemes can also offer a "housing deposit assistance" scheme. This will help "low and middle-income earners":

- to buy their first home (that must be owned for a minimum period);

- with “purchase price caps” (set by region to recognise price differentials), and
- with a “household income cap” (possibly \$100,000 a year for a couple).

The assistance will be available after three years’ contributory membership and will be \$1,000 for each year of contributory membership (to a maximum of five years). The maximum subsidy of \$5,000 will be first available only after 2012 (five years after the 2007 start date) and will be paid by the government directly, rather than through the *KiwiSaver* scheme itself.

8.6 Two technical flaws

New Zealand’s public policy head has been turned by the results of studies from the US based on “behavioural finance”¹⁰¹. They seem to show that ordinary employees don’t understand what decisions to make about Tier 2 schemes (whether to join; how much to contribute; what investment strategy to choose)¹⁰². Too much choice is seen as preventing employees from making **any** decisions, never mind making **appropriate** decisions. The research typically shows higher rates of joining if employees are “guided” by default choices – to join; to pick a “realistic” contribution level and a “sensible” investment strategy – but then to give employees the opportunity to change those decisions. Again, the research typically shows that employees tend not to move away from the default selections.

In the New Zealand context, there are two flaws that will follow our importing the US research uncritically:

8.6.1 New Zealanders are probably saving enough: Section 7 of this paper has shown that New Zealanders may already be saving enough for retirement. Based on the preliminary research, it seems that we might not need the helpful “guidance” of the “compulsory, opt-out” *KiwiSaver*.

Interestingly, this flaw was not even referred to in the report that recommended the *KiwiSaver* framework¹⁰³. Apparently, low participation rates in Tier 2 schemes were evidence enough that New Zealand employees (and employers) were behaving inappropriately. The authors of the report have since been unable to justify this curious gap.

8.6.2 The tax and subsidy issues: In the US, Tier 2 schemes are heavily tax-subsidised. It is not hard to demonstrate that an employee who doesn’t join a Tier 2 scheme will be worse off financially than one who does. That is particularly the case where the employer subsidises contributions to the Tier 2 scheme, as is often the case. If the employee did not join, (s)he would miss out on a piece of the available remuneration. Despite that, many make the seemingly irrational decision not to join or, more accurately, fail to make the decision to join.

¹⁰¹ See, for example, *Lessons from Behavioral Finance for Retirement Plan Design*, Olivia S. Mitchell and Stephen P. Utkus, Pension Research Council Working Paper 2003.

¹⁰² One of the reasons the decisions seem so complex in countries like the US is the plethora of rules created by increasingly complex tax and regulatory environments. That’s a problem New Zealand savers do not face.

¹⁰³ *A Future for Work-based Savings in New Zealand*, Savings Product Working Group (2004) – the full report can be seen at www.beehive.govt.nz/ViewDocument.aspx?DocumentID=20918

Because of our unique TTE environment, the same is usually not the case in New Zealand (joining being unquestionably good). First, there are none of the generous tax concessions available in the US.

Secondly, Tier 2 schemes, even if available are not always subsidised. Probably only one third of all New Zealand employees even have the opportunity of joining a workplace scheme, subsidised or not. There is to be no requirement for employers to subsidise their employees' contributions to *KiwiSaver* (as has been recommended for the equivalent arrangement in the UK¹⁰⁴). In fact, the only subsidies will come from taxpayers in the shape of the "sweetener" (the opening \$1,000) and on-going administration fee subsidies¹⁰⁵.

Lastly, under our tax-neutral TTE regime, an employee is almost always better off repaying private debt, such as house mortgages (where, again, there are no tax preferences for interest payments) rather than saving through a Tier 2 scheme. The only exception to this general rule is where the Tier 2 scheme is subsidised. As stated, that is relatively uncommon. So, it would be possible to measure the financial loss to employees each year by joining *KiwiSaver* rather than repaying debt. Unfortunately again, this issue was not even mentioned by the authors of the report that recommended *KiwiSaver*.

8.7 Will *KiwiSaver* help?

If *KiwiSaver* is enacted as announced¹⁰⁶, it will change New Zealand's retirement saving landscape, perhaps partly in ways that its architects might not have expected. The government has given a clear message that it wants to encourage people to save for retirement in particular ways and that, if people start on that process, the government wants to ensure that the savings are applied to that particular purpose (only for retirement or to help buy a first home).

Whether those objectives will be achieved depends partly on the detail yet to emerge and on how New Zealanders respond.

Section 7 has shown that New Zealanders might be responding sensibly to the retirement saving issues created by the New Zealand Way. Quite why New Zealand needs *KiwiSaver* has not been discussed but, as is common with these kinds of issues, we will endure the change without substantive debate and with no clear evidence of the need for change.

KiwiSaver will probably be a retirement saving failure like equivalent schemes in the UK ("Stakeholder Pensions") and Ireland ("PRSAs")¹⁰⁷.

KiwiSaver should attract many members who join just for the up-front \$NZ1,000 taxpayer-provided subsidy, then go on a perpetual contribution holiday leaving taxpayers

¹⁰⁴ The report issued by the "Turner Commission" *A New Pension Settlement for the Twenty-First Century* (November 2005) recommended that, if employees join, they must contribute the equivalent of 4% of their pay above a threshold and the employer must then contribute 3% to a new "National Pension Savings Scheme". A benefit worth about an additional 1% of pay will come from tax relief.

¹⁰⁵ The government has estimated that *KiwiSaver* will cost about \$167 million in each of the first three years (0.1% of GDP) and \$100 million a year after that (*Budget 2005 Savings Package: Work Based Savings Scheme*, Budget paper 6 April 2005). That is likely to be a significant under-estimate but no-one really knows what might happen as no survey work has been done on the likely take-up or on-going costs.

¹⁰⁶ We will not see draft legislation until early 2006.

¹⁰⁷ Despite very generous tax incentives in both countries. *KiwiSaver*, by contrast, proposes an extremely modest "sweetener".

to pay the administration fees for inactive *KiwiSaver* accounts. This should be good business for efficient financial service providers but won't do anything for the country.

Despite what the government says, the best evidence we have shows that New Zealanders seem to be saving enough for retirement¹⁰⁸. If the conclusions of section 7 above are reinforced by New Zealanders' behaviour once *KiwiSaver* is fully in place, we must expect adjustments to their other saving behaviour to allow for the impact of *KiwiSaver*. Any other response would seem irrational.

KiwiSaver will be good for some employees but that will come at a large cost to employers, financial service providers and taxpayers.

Given the scale of the proposed intervention, one might have anticipated a trial roll-out to identify the communication, administration and regulation issues before we all have to comply. That will not be happening but that's the way we tend to do things in New Zealand.

¹⁰⁸ A government minister stated publicly in July 2005 that he did not believe the Treasury's numbers (discussed in section 7). He did not, however, offer any alternative evidence in support of the proposed intervention.

Section 9. Learning from New Zealand’s experiences – a suggested decision-making framework¹⁰⁹

9.1 The problem with formulaic “solutions”

The traditional medicine for the pensions’ ailment is that what countries need is more, preferably compulsory, defined contribution, funded pension schemes and fewer defined benefit, “pay as you go” or unfunded schemes. That is generally what the World Bank thinks should happen¹¹⁰. The ideal answer in this connection is, seemingly, a “three pillar” model in which approximately equal contributions to citizens’ retirement income provision come respectively from the state, compulsory employment-related arrangements and personal, tax-advantaged savings.

However, not all that different countries do now is bad. Unfunded, defined benefit promises are not necessarily “bad”. On the other hand, funded, defined contribution arrangements aren’t necessarily “good”. Encouraging (or even forcing) employers to join in with more Tier 2 provision may not be the best way forward. It is certainly not the only way forward.

Describing alternative strategies in the World Bank’s black and white way avoids some important points of principle that this paper has already canvassed. It also risks polarising opinions unnecessarily. Polarised views are usually more difficult to turn into a lasting consensus than are genuine differences of opinion. These last can usually be resolved by research-based debates that political opportunists prefer to avoid.

So, what are the real issues and how might we go about resolving them?

9.2 Saving = investment = growth?

The first, supremely important issue is that if developed countries are to have fewer workers relative to the economically inactive retired, each country’s economy needs to grow and become more efficient than it is today. That is not necessarily a criticism of where they are today – it is simply an inevitable consequence of the changing economic shape of all these countries. More must eventually be produced by fewer.

The retired will need services like shelter, food and clothing to survive. The more retired people that each country has in the future, the more services, in aggregate, they will need and will seek from tomorrow’s providers of those services. They will be making demands on tomorrow’s economy that can be met only by persuading tomorrow’s workers to give up their own claims for those same services.

If the working population does not want to let that happen (votes matter in a democracy) or if a country doesn’t grow enough to accommodate its retired people’s expectations as to what they think are reasonable claims on future production, then all pensioners’ claims must reduce. That means pensions (both public and private) must come down in real terms. The retired just won’t have as many services to live on.

¹⁰⁹ This section is based on a paper written by the author for the UK Pension Policy Institute’s web page at www.pensionspolicyinstitute.org.uk

¹¹⁰ *Averting The Old Age Crisis, Policies to Protect the Old and Promote Growth*, Oxford University Press, The International Bank For Reconstruction, 1994. More recently, the World Bank seems to have had second thoughts on this as the news from South America confounds its earlier expectations – see *Old-Age Income Support in the 21st Century – the World Bank’s Perspective* (2005) by Robert Holzmann and others (<http://www1.worldbank.org/sp/incomesupportfiles/OldAgeSupportPrelimWeb.pdf>). A more complex “five pillar” model attempts to mould the World Bank’s interventionist preferences to the real world.

So, if a country has a future pensions problem then it has to grow more than it is growing today. Everything that it does about its ageing population should first answer the question “How will this help us grow more than now?” All the rest is about cutting tomorrow’s economic cake one way or another and that’s really about who has the power to decide the size of the slices. In the end, that’s not necessarily the politicians. That’s because the modern economy has different ways of forcing adjustment on the unwilling, if adjustment were necessary.

For example:

- unexpected inflation can transfer wealth from savers to workers;
- prices for particular services that the retired need will adjust according to the laws of supply and demand – a rising demand without a commensurate increase in supply will increase the real price of that service;
- there is only so much income tax that, mainly, workers are prepared to pay¹¹¹;
- capital will move to another jurisdiction if the owners of that capital think the present risks are not justified by the expected returns;
- the young will move from a country where they believe their aspirations cannot be met to another where they think their living standards will be higher.

There are other ways as well.

All these adjustment mechanisms will help “solve” the pensions crisis if the real issues are not addressed now. However, the economy that these natural solutions will leave behind may not be what today’s voters would want to pass on to the next generations. The consequential costs of such forced changes can be very disruptive.

Will more savings in financial products like pension schemes, the US-style 401(k) plans, the UK’s “stakeholder pensions” or New Zealand’s *KiwiSaver* help to resolve this issue? We don’t know but the answer is, surprisingly, “possibly not”. They may even become part of the problem. The owners of those savings will defend their position in the almost inevitable future fight over economic realignment.

If countries asked their advisers whether more pension savings really might help, the best answer that they will probably come up with is that people start saving once growth starts. In other words, while saving might be a good idea, there may not be too much of a connection between financial savings, investment and growth.

So, when people talk about encouraging or even forcing their citizens to save in “good” ways with “approved” institutions, they should answer a few questions. Will more financial savings (with banks or insurance companies) help the country grow today and tomorrow? If the initial answer to that is “yes” then that implies a present shortage of capital. Is that really true?

Most developed countries have open economies with access to world capital markets so an increase in the amount of local capital available is unlikely to be the solution to the pensions problem that a country faces. The price charged by the present owners of capital will indicate whether there is a shortage of development capital – are “free”

¹¹¹ “Social security” contributions (of the kind favoured in Europe and the US) should be included here as they are another form of tax on incomes. However, they tend to be regressive (the poor pay relatively more than the rich) and with fewer exemptions than ordinary taxes on income. That seems difficult to justify on policy grounds and, in fact, is a perverse outcome.

interest rates really so different from the rest of the developed world? If not then more “good” savings are unlikely to help resolve the demographic crisis.

If countries change the rules to encourage or even require people to reduce consumption today¹¹² in exchange for financial balances in banks, life insurance companies or pension schemes¹¹³, will they actually save more? The answer to that question is likely to be equivocal so looking for proof of this from other countries that encourage or require such behaviour is a good first step. For example, in a compulsory Tier 2 environment, savings in formal Tier 2 (and possibly Tier 3) schemes will be higher than in the absence of compulsion. However, the proper question is whether overall savings will be higher. Employees must be expected to reduce their other savings in response to a requirement to save in the particular compulsory vehicle.

Perhaps, instead, voters in developed countries should be asking if there are ways in which their country might grow more effectively than it does now? The answer to that is almost certainly “yes”. If we widen the debate in this way, the answers might include growth-enhancing policies like privatisation, reducing all taxes (especially taxes on income, including “Social Security contributions”), improving the education system, helping citizens get their businesses started and grow those, improving public infrastructure such as roads, water, telecommunications and so on.

Voters should also ask for proof that centrally driven decisions on where, when and how much people should set aside from their incomes today as saving specifically for their retirement are more likely to be better for their country than letting them make their own saving and investment decisions. I have already shown that this strategy seems to be working in New Zealand (section 7) and I have suggested (paragraph 7.9) that we should not be surprised a large group of individuals can develop a rational response to what looks like a complex issue.

In the end, the only central and common issue in relation to the pensions problem is economic growth. Any other issue in relation to the pensions problem is of the second, rather than first order.

9.3 Welfare issues

Having addressed the primary issue of growth, the debate about ageing populations should then separate welfare from other issues. A country’s citizens may need to save more and more saving may help the country to grow more but, regardless of that, welfare issues take initial precedence in the next part of the debate that any country should have about the pensions issue.

There is no necessary connection between private provision and welfare (which includes how we treat the old who can’t look after themselves). Forcing earners to save may reduce the future welfare burden but not necessarily (Australia). It may even replace the future welfare benefit for those fortunate to work and save enough (Chile¹¹⁴). However, even if there were such a forced saving regime, or any other private provision, each country must first make decisions about the universal, underpinning welfare obligation. Here’s how to do that.

¹¹² Putting to one side the economic contraction that will follow such a reduction in consumption.

¹¹³ Or even in the centrally managed funds like the NZSF, Australia’s *Future Fund* or Ireland’s *Social Welfare Pension Reserve Fund*.

¹¹⁴ There are, however, signs emerging from Chile that, despite 24 years of a ground-breaking Tier 2 scheme, not enough workers are saving enough to have retirement incomes that are greater than the modest, underpinning Tier 1 pension. More complex changes must now be expected in Chile as the government tries to make citizens do what, apparently, they would prefer not to (or cannot afford).

9.4 The shape of Tier 1

The cost of any retirement benefit scheme (lump sum or pension; public or private; pre-funded or unfunded; defined benefit or defined contribution) is the benefits that the scheme eventually pays. It doesn't matter how the scheme describes the benefits, who pays for them or when/how they are paid for, the "cost = benefits" rule is a universal truth. "Contributions" are not synonymous with "cost" – only "benefits" have that distinction. "Contributions" may, but need not reflect the pace at which the cost is funded – they do not, however, have any role in defining that cost. Only benefits do that.

If a country faces an unacceptable future burden created by an ageing population then, unless retirement incomes (both public and private) reduce in real terms, it is not possible to lessen that burden on tomorrow's economy, if that's what a country decides it must do. So it doesn't much matter whether the pensions are public or private; funded or PAYG. As section 5 has demonstrated, what really matters is the size of the Tier 1 benefit, not that it is PAYG or partially pre-funded.

Everything in this next stage of the debate should first focus on the scale and shape of the benefits that the underpinning Tier 1, welfare scheme promises. Once a country has made initial benefit design decisions, we can look at the long-term costs and how they might be distributed both over time and among the groups of people who will pay them. If we don't like the results of those calculations, the discussion may loop us back to looking at the benefits again.

Here is how to run the debate in any country. It should proceed in the following order:

9.4.1 Blank sheet: First, put to one side for a moment what the country does now about "retirement" income and other support for the old. We'll start with a blank sheet of paper (but will return to today's issues later as part of the transition process). We need to decide what we might want for new entrants to the workforce, if we had a free hand. This is the "green fields" approach to benefit design.

9.4.2 The inevitable Tier 1: The country must decide what to do about any of its citizens if they have no or "not enough" (whatever that means locally) income when they reach an age that means they can't reasonably work. It doesn't matter why they don't have enough – it could be through low lifetime incomes, ill health, divorce, unemployment or a simple lack of savings, even if self-inflicted.

These last (the "self-inflicted") are the so-called "free riders" that people often worry about. However, in today's democracies, it's too late to worry why old people don't have enough to live on – they still have a vote. In our welfare states, the fact that they don't have enough to live on is all that really matters in a debate about Tier 1. We can't punish the poor of any age by letting them starve. Even if the morality of that were untroubling, they, their champions and their children all have votes.

So, in a modern democracy, there will always be a Tier 1 no matter what a country does about other retirement income issues.

Having accepted that as a starting point, the questions that need answering are as follows - when should the Tier 1 pension start? How much should it be? Who should get it? When should it stop? How should it be protected against inflation? Do people get pensions based on marital status, on work history, on

income levels, on contribution history or do they instead get them based on need? Perhaps this basic Tier 1 pension shouldn't be paid to people who don't "need" it (and each country needs to decide what "need" means) but a country can reasonably decide otherwise.

In this part of the debate, you can't ignore what the government and/or citizens do about health and housing for the old. These issues influence the potential amount needed in retirement for a minimum, "acceptable" standard of living. For example, countries that have high levels of occupier-owned housing have more flexibility in dealing with their retirement income issues than do those with low levels of home ownership. That's because pensioners who aren't homeowners have to pay rent. If they can't afford the rent, that becomes part of the debate about the design of Tier 1.

If the Tier 1 issues are addressed in this way, the outcome of this debate will probably be something that looks a bit like our own NZS¹¹⁵ - this is a comment on process rather than on philosophy. Because Tier 1 is, by definition, an underpinning guarantee of an income in old age from the state, it will also be a defined benefit pension of some kind. Only the state can reliably deliver such a provision because of its power to tax.

9.4.3 Paying for Tier 1: The "universal", underpinning Tier 1 should almost certainly be unfunded. It's simply cheaper and more efficient to do it that way. So, it shouldn't be pre-funded, even partially (Ireland, New Zealand); have a notional fund (the UK); nor should it have an identified contribution (such as in France or the UK).

Instead, Tier 1 should be paid out of current tax revenue where the rich tend to pay more tax than the poor. That means it should be subjected to the same regular cost reviews as other expenditure, such as the amounts the government spends on defence, education or unemployment¹¹⁶. The costs could possibly be accounted for in both the country's balance sheet and income & expenditure accounts¹¹⁷ (having those would be nice as well). Those costs must then be regularly monitored.

All developed countries need decent, believable, long-term numbers to ensure their citizens understand the issues and the trade-offs when agreeing on the shape and cost of Tier 1.

9.4.4 Tiers 2 and 3: Once a country has agreed on its welfare obligation at Tier 1, it's difficult to see what further business a government has involving itself in the private saving and retirement decisions that its citizens then make. Each country should instead stand back and let its employers and individuals decide what they want to do at Tier 2 (employment-related provision) and Tier 3 (all other provision)¹¹⁸.

¹¹⁵ Now sometimes referred to in the international debate as a "Citizen's Pension" where the entitlement is based on age and citizenship or residence rather than work history, contributions or income.

¹¹⁶ Those reviews must recognise the long-term role that Tier 1 plays in the retirement planning decisions citizens make. The cost reviews of Tier 1 should therefore have a long-term perspective – 50 years is a good target (rather than the next election).

¹¹⁷ Though I suggest in paragraph 4.10 above that this is, perhaps, not particularly useful.

¹¹⁸ The consequences of this withdrawal from Tier 2 involvement are significant for many countries. It would mean removing any contributory, pay-related link in the basic state pension. It would also see the state withdraw from any involvement in employment-related Tier 2 schemes that are popular in Europe

Why not think of letting people take charge of their own retirement provision? Most citizens are sensible people who have their own best interests at heart. They might decide to look after their retirement by building a business, paying off debt, getting an education (education = higher income = increased ability to self-provide) or even having children. All of these are more likely to be better for a country's growth prospects than a financial balance in a bank or an insurance company.

Taking this "hands off" approach at Tiers 2 and 3 would mean:

- getting rid of expensive, distortionary, ineffectual, inequitable tax incentives for private saving as used by all developed countries except New Zealand. Section 6 has already dealt with this.
- staying away from expensive, intrusive, distortionary forced saving schemes (Chile, Australia, Singapore)¹¹⁹.
- strengthening the reporting requirements for private saving schemes in the state's "consumer protection" role.
- stepping up the state's information and education role so that citizens know where to go for help and what to ask when they get there.

Saving for retirement is a great idea but it's difficult to understand why, through tax incentives and/or compulsory private provision (even "compulsory opt-out" arrangements like *KiwiSaver*), public policy should send a message:

- that "this much" saving is good but "that much less" is bad;
- that this type of saving is "good" and that type is "less good";
- that you should save "now" and not "then".

The Government's best intentions by intervening in these decisions will probably be punished in expensive, unexpected ways by citizens and by markets. That will lead to further intervention and more unexpected results – and so it will go on. That's possibly why the US has ended up with 57 different ways (true) in which retirement savings are treated for tax and regulatory purposes.

Citizens should instead tailor these decisions to suit their personal preferences. They will almost certainly need some help to understand the issues but, beyond that, it's difficult to see how the state can add any value to their decisions.

Why don't we trust the judgements of individuals when they decide what they should do with their own money? In aggregate, those decisions are likely to be better for their country (make it grow more) than any, more traditional, alternative. Do governments really know better than citizens what to do with citizens' own savings? Having set the groundwork at Tier 1, it is difficult to see

and the US. That withdrawal cannot be immediate and will need necessarily complex, long-run, transitional provisions. But it should still happen, despite that complexity.

¹¹⁹ The only logic for forced private saving is to reduce or replace the state's obligation at Tier 1 (as in Chile). In that case, it's really only a timing and cost distribution issue. I think it is better if the state dealt with the welfare obligation when and if it arises and let its citizens and employers make their own saving and investment decisions in the context of that welfare strategy. In Chile's case, there was perhaps another justification. In 1981, Chile's capital markets had been devastated by inflation and poor economic policy settings. Installing a compulsory Tier 2 and constraining investment options helped to restore order to capital markets. Having achieved that objective, a compulsory Tier 2 is no longer needed on that account.

why public policy should influence citizens' decisions in one saving direction rather than another.

9.4.5 Transition: Once a country has decided what it wants to do for new entrants to the work force, it needs to decide how to get from here to there. The following issues will affect the speed of the transition:

- fiscal constraints;
- citizens' present expectations and current plans;
- the quality of the debate on the options.

The transition period should be as long as possible and mostly, that will be driven by money or, more probably, a lack of money from about 2015 onwards. A long transition is a "good thing". That's because citizens have constructed their private saving arrangements in the current environment and it takes a long time to change those meaningfully. It would be nice if the new rules affected only new entrants to the workforce but the challenges that most developed countries face means that they probably don't have that luxury.

The present heavy involvement of many countries in Tiers 1 and 2 will probably make the transition provisions long and complex no matter what they decide to do about future reform. In many mainly European countries, it will probably need to be longer and more complex if the New Zealand Way were adopted (a Citizen's Pension at Tier 1 and withdrawal from any financial involvement at Tier 2 and Tier 3).

9.5.6 Consensus: Each country should aim for nothing short of a consensus on all of the above issues. That will probably require a different way of making decisions on these issues than is traditional in the adversarial, political environment of most western democracies. Politicians should probably not lead the national debate. If New Zealand's experience provides any lessons, voters tend not to trust politicians on pensions and the "truth" somehow comes more easily from an apolitical panel of experts who involve the public (and the politicians) in the decision-making process.

New Zealand has also demonstrated another inevitability – financial service providers have a vested interest in maintaining what amounts to the status quo in most jurisdictions. Pronouncements by providers are more likely to oppose change rather than support it. As long as the reform process is based on good evidence and an open debate, such self-interested pressure can be resisted.

Arriving at the initial answers is only the start of that story.

Part of the required consensus will review the outcomes of those answers on a regular basis (say, every five years) to make sure that things are turning out roughly as expected. That again should be a public inquisitorial, rather than a political, process. So the process should not be led by a politician or worse, by the government of the day. Regular reviews will build confidence in the likely outcomes. They will reduce the possibility of political opportunism and should raise the quality of future debates on policy outcomes. Those are all "good things"¹²⁰.

¹²⁰ A "stronger" version of New Zealand's Retirement Commission (www.sorted.org.nz) is a useful model to start and continue this process.

9.6 In conclusion

The likely outcome of the reform process suggested in this section 9 means that governments will do what they are, or should be, good at and will leave everything else to the various markets for labour and capital to do what they are good at. For example, governments have no particular investment management expertise; individuals probably know best when they want to retire and employers probably know best how much (and how) to pay their employees. Governments can generally add no value to decisions in any of those key areas.

Any alternative strategy is likely to produce sub-optimal growth outcomes. As I have said, if ageing countries do not experience the economic growth that is necessary to support their growing inactive populations, then the pensions dilemma will be “solved” informally and, probably, disruptively.

Pensions (both public and private) are a huge, complex, subtle and very, very expensive subject. As is often the way, if we break the problem down into manageable pieces, the issues are easier to see and resolve. Over-arching them all is the economic growth issue.

Whatever the outcomes in any country, if the debate follows the suggested framework, everyone will understand the issues more clearly and the answers that emerge from the reform process are more likely to stick over decades. There is no need to repeat the experience that we here in New Zealand have had to put up with from our leaders over the last 30 years.

Forced saving into approved, tax-favoured financial products that many commentators favour simply won't cut the demographic mustard if dropped on to most countries' current pension arrangements. The same, I suggest, applies to saving that is forced on citizens by centralised, monolithic arrangements like our NZSF or by centrally dictated but dispersed arrangements like *KiwiSaver*. These types of solution will not really help countries with the costs of demographic change as they probably won't make the countries grow more than now.

In my view, that's just not good enough.

Appendix

The NZSF – calculating the annual contribution

Section 43 of the New Zealand Superannuation and Retirement Income Act 2001 specifies the amount which the government must contribute to the NZSF each year.

Here, in full, is the section concerned:

“43 Amount of required annual capital contributions

The required annual capital contribution for each financial year is –

$$\frac{a}{100} \times \text{that year's GDP} - b$$

where

a is the percentage of that year's GDP that, if the same percentage of the GDP that is projected for each of the next 40 years were contributed (by way of either or both of annual required capital contributions and annual expense payments under section 45) each year for the next 40 years, would be just sufficient, taking into account the Fund balance at the start of that year and projected Fund investment income over the next 40 years, to enable the Fund to meet the expected net cost of New Zealand superannuation entitlements payable out of the Fund over the next 40 years

GDP is the projected annual gross domestic product of New Zealand

b is the expected net cost of New Zealand superannuation payments payable out of the Fund in the year

Net cost is the net cost of New Zealand superannuation entitlements net of any tax deduction made or required to be made under the PAYE rules in the Income Tax Act 2004

Next 40 years means the financial year for which the required annual capital contribution is being calculated plus each of the following 39 financial years.”