The assessment of retirement income system options

A paper for the External Panel on the Treasury's Long-Term Fiscal Statement

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Contents

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Abstract

Drawing on the work of the 2010 Retirement Income Report, this paper argues that there are eight policy objectives that need to be considered when designing a retirement income system. The two major policy instruments under the current system, New Zealand Superannuation and KiwiSaver, each have their own areas of focus and work in a complementary way to help achieve the objectives of the system to the extent possible within an overall funding constraint. Because not all these objectives are fully consistent with each other, trade-offs and political compromises inevitably need to be made. Ideally, the system reflects the trust and relative importance that citizens place on addressing certain concerns and achieving each of the objectives.

Pension reform involves revisiting some historically significant issues and trade-offs among competing policy objectives:

- Should the publicly provided pension be universal or targeted on need?
- What should be the balance between social protection and earnings replacement?
- Can income support for the transition from work to retirement be improved?
- Should there be an early or late retirement pension option?
- What degree of linkage should there be between public pension provision and private saving?

This paper examines three possible future directions that retirement income policy might head as a result of a search for fiscal savings and longer-term system sustainability. Three representative examples are analysed: a compulsory retirement saving scheme, a dual structure for public provision, and a scaled-back version of the current system.

Evaluating structural change to the retirement income system needs to ensure not only that the fiscal burden of pension provision is manageable but that each of the eight policy objectives and concerns are adequately addressed. Where particular attention has been placed on some objectives at the expense of others, we need to be confident that this reweighting accords with the values and priorities of the population at large and is accepted as a fair solution.

For this reason, attention needs to be given not only to the conventional cost analysis of options but also to issues such as how to balance the messages about public pensions ensuring income security in old age and the need for self-provision through saving, how each option affects the wellbeing and personal freedom of different groups, whether the adjustment burdens are fairly shared, a wide range of potential behavioural responses to changes in incentive structures and finally, the timeframe for implementation, including the design of any necessary transitional assistance measures.

Introduction

> *"The search for financial affordability, political sustainability and a broad public consensus on the overall fairness of the system requires that the tensions and trade-offs among [eight retirement income policy objectives] be recognized, since that is often why particular aspects of a policy's design are the way they are" - 2010 Review of Retirement Income Policy, p62*

The fiscal cost of pensions in New Zealand is projected to increase, under current policy settings, as a result of several factors:

1. **Demographic factors**, both *numerical ageing* (longer average life expectancies among each age cohort) and *structural ageing* (the ripple effect of different sized birth cohorts as they enter working age and then move into retirement). In short, structural ageing means that there will be a lot more people, i.e. the post -WW2"baby boomers", reaching pension eligibility age over the coming decade, and numerical ageing means that both they and others can expect to survive longer and so receive their pensions for more years, on average, than people did in the past.
2. **Universal entitlement** to New Zealand Superannuation (NZS) at standard rates of payment. This implies that nearly every surviving member of each age cohort will receive NZS irrespective of their income or assets, so that no alteration in the distribution of incomes or assets will reduce the coverage or average amount of NZS paid[2].
3. **The indexation of NZS payments**. The operation of the "wage band" formula for adjusting NZS rates each year suggests that a positive trend of real average wage growth in the economy will translate into the same real growth rate of NZS per pensioner.

Points 2 and 3 imply that a strategy to increase the real rate of growth of the economy does not automatically solve the problem of the rising fiscal cost of pensions. We cannot "grow our way out" of the fiscal conundrum, under current policy settings, since a proportion of any revenue dividend from growth is automatically committed to paying a larger, indexed, pension to a growing proportion of the total population.

The prospect that the government's fiscal position will become increasingly difficult to manage over the longer term provides the primary motivation for the External Panel to consider the need for retirement income reform. It is refreshing that the horizon, timetable and process for examining this question are set over a longer period than has typically been the case in the past and this augurs well for a positive outcome.

This paper is in four parts. Part 1 discusses the way in which retirement income policy reform has commonly been done in New Zealand and the problems that can arise with this approach. It proposes a framework of eight objectives or policy concerns that need to be mixed and matched with policy instruments. Part 2 takes a closer look at each of the eight objectives, while Part 3 discusses some key points of tension and trade-off among them. Finally Part 4 considers the different ways in which pension policy might evolve in response to longer term fiscal and demographic pressures and suggests a process for evaluating some possible reform packages.

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[2] This broad claim disregards possible variations in the proportion of older people who meet the residence test for eligibility, or in the proportion of people receiving the married person, single living alone and single sharing rates of NZS.

Part 1: Fiscal pressures and the process of pension reform

Over the past 35 years New Zealand has made several large changes in its retirement income policies. As a generalization I would argue that most of these changes have been driven by "urgent" fiscal or economic considerations, most have focused on New Zealand Superannuation (NZS) as the policy instrument, with short lead times to implementation and some have been subjected to modification or even complete reversal at a later date.

Programmes that support long-term saving for retirement and provide income flows to older people are natural candidates for trimming when forecasts suggest a prospective fiscal problem. I suggest there are several reasons for this:

- These are one of the largest items of government expenditure, so even relatively small percentage reductions can represent big dollar savings;

- The basic simplicity of the entitlement formulae for NZS and the subsidy rules around KiwiSaver make the legislative changes and estimates of fiscal savings appear relatively straightforward. Options to alter parameter values can be easily modeled and costed. In comparison, the redesign of more complex public assistance programmes might be seen as a much more risky and daunting policy decision, since they might involve detailed consideration of staffing requirements, training, service quality, the form of delivery, the use of administrative discretion and the prediction and evaluation of outcomes and take-up. Similarly, programmes that require the participation of private sector providers also face uncertain negotiating and monitoring costs and outcomes from the government's perspective.

- It has often been the case that a government wished to introduce a spending or tax policy change in the context of Budget secrecy. From a process point of view the number of agencies, policy analysts, advisers and lawyers required to achieve this is perhaps the smallest, per dollar of cost or saving, in the case of a pension parameter change than for any other area of policy, and the time required and risk of a leak is, arguably, less. Of course, the absence of scrutiny and public consultation on a major policy change carries its own risks.

Pension policy reforms that are driven by these motivations should, however, be treated with a healthy dose of caution. Demographic changes mean that a proportion of the rising expenditure on these programmes can be attributed to volume growth, but this fact alone should not necessarily trigger a requirement to counteract all volume growth, since the composition of the population that the government is elected to represent is changing. Rather, demographic changes should signal that prospective fiscal adjustments are going to involve shifts in the incidence of costs and benefits across different subgroups of the population. They are also likely to result in a change in the future rate of economic growth and its incidence on households and cohorts of individuals.

In order to succeed over the medium term, such adjustments need to be bedded in properly. Their introduction needs to be recognized as a potential source of social tension, requiring open communication, a clear explanation of the likely impacts on different groups and of the reasoning behind the shift, appealing to notions of fairness as well as enlightened self-interest.

These impacts are not confined to the sort of static, instantaneous "winners and losers" analysis that is produced for decision makers and is commonly the focus of media and political attention at the time of the policy announcement. Decision makers and commentators should also attempt to compare and contrast the variation in resources, wellbeing, contributions and choice sets facing different individuals, family types and life stages before and after the proposed policy changes. In this way, the underlying longer-term purpose and nature of the trade-offs can be more fully exposed to public scrutiny.

The policy area of saving and pensions is where people hold a significant stake in their own futures. If changes are seen to be unfair or unaffordable, it opens opportunities for political policy reversal, as we have seen on occasions in New Zealand. Therefore, for any major reform in this area to succeed requires the inclusion, participation, understanding and consent of a wide cross-section of the population, including if possible agents acting for future generations.

Not only social cohesion, but public trust and credibility are essential ingredients. There is a danger that players in the political system can focus so much on trying to achieve social cohesion and consent while maintaining popularity that they resort to obfuscation and framing issues in different ways to different audiences. I have argued elsewhere[3] that public statements on NZS and KiwiSaver are sending mixed messages because they are aimed at two distinct audiences with quite different life cycle experiences and concerns regarding income adequacy. This risks a rise in cynicism, opportunistic political and institutional behaviour, a loss of social cohesion and an unwillingness to address the longer term fiscal challenges of an ageing population. A clearer articulation of retirement income policy objectives and trade-offs, greater attention to raising financial literacy levels and more transparent reporting of investment returns all have a part to play in improving the situation.

This paper covers some questions that are important to ask before embarking on any significant modification or more thoroughgoing reform of our retirement income system. It draws particularly on the thinking that lay behind Chapters 3 and 6 of the 2010 Retirement Income Report and subsequent analysis of more recent developments, such as the 2011 Budget changes in KiwiSaver rules.

These questions are:

- What are the policy objectives and concerns that are important when considering the design of a retirement income system for New Zealand?
- How do various policy instruments and parameter settings address, or fail to address, these concerns, and what combinations of instruments are complementary?
- Does the current system reflect the attitudes and values of New Zealanders today? Are these significantly different (for historical, social or cultural reasons) from those that might underpin other countries' pension designs, and does this matter?
- What are the critical areas of interface between retirement income policy design and other economic and social policy areas, and how might these be dealt with when evaluating the merits of different system options?
- What are the main system options and trade-offs involved in ensuring a sustainable retirement income system and what is the recommended approach to evaluating the merits of each?

[3] Hurnard (2011)

Policy objectives and concerns

A common approach when assessing retirement income policy is to use general economic criteria such as efficiency, equity and fiscal sustainability[4] to indicate whether there is a case for improving or changing the existing system. In the context of this paper, however, we ask a rather different question: what precisely is the purpose of retirement income policy? What outcomes are sought when citizens entrust a government to set up and operate a retirement income system on their behalf? Only when we are clear on this matter can attention then move to assessing system options that might achieve these outcomes efficiently and then, finally, to trading off potential cost savings against the expected underachievement of outcomes.

It is inevitable that commentators and advocates will hold a range of views on what the expected outcomes from retirement income policy are and what emphasis is being placed, or should be placed, on them. For example Richard Hawke has asserted[5] that the retirement income system in New Zealand is attempting to address three major objectives: relief of poverty, recognition of the aged, and deferred income, but at the same time it entails a large and increasingly inequitable inter-generational transfer of financial wellbeing.

It has been argued that New Zealand's overall saving rate is poor and that if policy change can increase retirement savings, then that would ease our balance of payments problems and improve our economic growth performance. The macroeconomic argument for raising savings rates has been used in the context of analysing the merits of KiwiSaver, one of the instruments of retirement income policy. For example, the Savings Working Group (SWG) set up by the government to stimulate public discussion and understanding on issues of national saving called for decisive steps to increase the rate of national saving and lift productivity. It made 11 recommendations specific to the design of KiwiSaver, with a further four options to be considered (Savings Working Group (2011)). Some, but not all, of these suggestions were picked up in the 2011 Budget announcement.

This should not, however, be taken to mean that a primary purpose of retirement income policy is to increase the rate of national saving. Arguably that might be an indirect benefit from KiwiSaver[6], but it is worth noting that the objectives of KiwiSaver as set out in its legislation make no reference to national saving, productivity growth or debt reduction goals. Instead they refer to encouraging individuals' long-term savings habits, consumption smoothing and financial independence in retirement.

The 2010 Review of Retirement Income Policy introduced an analytical framework comprising eight objectives or "models" that may be of concern when policy is being designed and debated[7]. The inspiration for this framework came from considering the wide range of stimulating presentations and viewpoints at a conference "Retirement Income and Intergenerational Equity" that was run by the

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4 For example these three criteria were used by the 1997 Periodic Report Group.

5 Hawke (2005), p 131.

6 The SWG saw the primary objective of retirement income policy as the avoidance of poverty, but "in effect, we look at whether a second objective – lifting national saving – can be added to the primary objective of providing adequate retirement incomes. It seems likely that any success with respect to this second objective could also have positive consequences for the first objective. That is, it may result in retirement incomes being provided on a more sustainable basis." (Op cit p 73)

7 Retirement Commission (2010) p 53–58 briefly describes each of the models and provides a short history of their application in New Zealand.

Retirement Commission and the Institute of Policy Studies in mid-2010. This paper expands on some aspects of the Commission's framework.

The eight objectives are summarized in Table 1 and may be thought of as desired outcomes. These outcomes are not confined to income flows or wealth accumulation, although these are clearly important for many of the models. They encompass a range of important psychological, social and civic as well as economic outcomes. Outcomes such as high subjective well-being, the absence of social conflict, a sense of community cohesion and support, fulfilling work, skill acquisition, control over one's destiny and avoiding sudden shocks and surprises are all part of the picture alongside the more conventional policy goals of rising material living standards and poverty relief.

The Review noted that overarching the concentration on specific policy objectives and the selection of policy instruments is the need for any changes to the system as a whole to be accepted by all stakeholders as both fair and sustainable over an extended period of time. This requires a process for keeping the future costs manageable and a broad public consensus on the overall effectiveness and fairness of the system for all the stakeholders, including vulnerable groups and future generations of children, workers and retirees, whose voices are sometimes not easily heard.

Table 1: Multiple retirement income policy objectives and design foci			
Model name	**Objective or concern**	**Design focus**	**NZ historical examples**
Income support	Alleviating poverty and financial hardship in old age, usually by guaranteeing a minimum level of income	Needs-tested income support to enable community participation, not portable outside NZ.	1938 Age Benefit; 1972 Royal Commission on Social Security's measure of hardship
Citizenship dividend	Promoting and reinforcing social cohesion and the inclusion and ongoing participation of older people in the community by recognizing, in a general way, the productive efforts and social contributions made by senior citizens from all walks of life	Standard payments and equal entitlement	1938 Universal Superannuation; 1977 National Superannuation; SuperGold Card for discounts and concessions
Wellbeing	Facilitating the enjoyment of positive and active ageing, through an integrated set of policies aimed for example at a safe and healthy living environment, opportunities for paid and voluntary work, lifelong education and access to a range of valued services	Employment and education opportunities for older people, flexible work; protection against elder abuse	Government Positive Ageing Strategy; absence of work/income test for NZS
Voluntary saving	Encouraging and enabling citizens to exert personal responsibility, informed choice and control when managing their own retirement saving	Financial literacy, financial market regulation, transparency, trust, tax-neutral environment	1992 Todd Task Force and 1993 Multi-party Accord advocated a non-subsidised, voluntary saving regime.
Lifetime consumption smoothing	Maximizing the expected lifetime utility of each individual's income, by enabling savings out of mid-life earnings (i.e. reduced consumption) to be converted into a flow of income in retirement (i.e. a consumption opportunity) that permits him/her to enjoy a relatively constant standard of living throughout life	A compulsory or incentivised saving programme with annuitisation; off-shore portability. Alternatively, a Notional DC scheme funded as PAYG	1975-76 New Zealand Superannuation Scheme; 1997 Referendum on new compulsory retirement savings scheme (defeated);2007 version of KiwiSaver
Cohort self-funding	Intergenerational equity, by ensuring that the costs of government services and transfers received by each generation throughout its lifetime matches in some way the amount of taxes it has paid, so that one generation does not bequeath debt to the next	Equal cost-sharing across generations; partial pre-funding or fully self-funded DC scheme	2001 NZ Superannuation Fund - partial pre-funding of future NZS costs
Risk pooling	Insuring individuals against the "risk" that they will live longer than the average life expectancy of their cohort, by ensuring that their income needs will continue to be met for however long they live	Well-functioning annuities market, inflation proof bonds; guarantee of public pension	Mixed wage/price indexation of NZS standard rates.
Fiscal restraint and investment	Using conventional macroeconomic policies to raise productivity and growth rates in order to generate the resources that will increase average living standards, with spillover benefits for older people	Limits on government pension spending; raise age of eligibility for NZS; drop wage indexation	1991 fiscal retrenchment package froze NZS rates and raised the eligibility age.

Mixing and matching the instruments with policy concerns

It is tempting to try to rank the list of objectives in Table 1 by their relative importance. From that it might be possible to distill from the top one or two the essential requirements that a retirement income system must meet, relegating the others to a “nice to have, but not essential” category. However, this is not realistic. There will inevitably be disagreements among stakeholders as to what is important; one person’s bathwater will be another’s baby.

Furthermore, not all these objectives are consistent; a move towards greater focus on one objective can easily militate against the achievement of others. Nor are the objectives absolutes; the outcomes they seek can be met to a greater or lesser degree. This illustrates that the quest for a sustainable consensus should not focus exclusively on fully meeting a single, or even two or three, objectives, without considering the net effect on the whole range of objectives, even if it is agreed that others can be accorded a lower weighting.

It is often the case that policy reform arises from a concern with one or two particular aspects or outcomes in the savings or pension domain and focuses on a single policy instrument to improve them (Box 1). The risk is that, by “fixing” one problem that is important at the time, policy design inadvertently tilts the balance against other inherently important concerns and changes the incidence of benefits and costs among individuals and cohorts in unintended ways. This can in some circumstances generate such a reaction that the policy gets reversed

Box 1: Examples of historical retirement income policy reforms focusing on a single concern or objective and discounting others

- *A desire to achieve social cohesion and equal citizen entitlement drove the introduction of National Superannuation in **1977**. However, the high level of universal payment had a depressing effect on labour force participation and voluntary saving for many years.*
- *A desire for fiscal restraint and more targeted income support drove the **1991** Budget package of measures to freeze NZ Superannuation rates, tighten income testing and increase the age of eligibility. Public adverse reaction to the watering down of a citizenship dividend and fears of avoidance behaviour forced the rapid reversal of the tight income test.*
- *A desire to move towards a greater degree of cohort self-funding contributed to the NZ Superannuation Fund being established in **2001**. Later, a desire for fiscal restraint resulted in government budget contributions to the Fund being suspended.*
- *A desire to facilitate consumption smoothing, particularly among middle-income earners, was a factor behind the introduction of the highly subsidized KiwiSaver scheme in **2007**. Following the 2008 recession a desire for fiscal restraint, while retaining the tenets of voluntary saving, has led to cutbacks in the degree of subsidization.*

The way that different policy instruments interface is also important. There are five major instruments of New Zealand’s retirement income policy:

- New Zealand Superannuation (NZS)

- KiwiSaver (KS)
- Information and education programmes to promote financial literacy
- Financial market regulation
- The New Zealand Superannuation Fund (NZSF)

An analysis of the features of NZS as a policy instrument reveals that it is poor at addressing some of the objectives listed in Table 1. For example, NZS is not designed to achieve consumption smoothing (i.e. an earnings related pension), nor can its PAYG funding address a concern for cohort self-funding, particularly when cohort sizes are fluctuating. On the other hand, NZS is good at achieving other of the objectives in Table 1.

"Notwithstanding the challenge of keeping it affordable, NZS has a number of design features that are attractive.

- It is extremely low cost in an administrative sense because it is funded out of general revenue, requires no individual contribution records to be kept and places no compliance costs on employers. There is no cost in administering an income test or monitoring changes in financial or employment circumstances;

- The absence of an employment or income test means that there are no built-in penalties from earning additional income beyond NZS eligibility age. The present value of future pension wealth embodied in NZS is unaffected by when a worker chooses to retire. This feature helps to explain why New Zealand has one of the highest rates of labour force participation of older people in the OECD.

- Knowing well in advance how much NZS will be worth proves a secure basis for people to judge how much additional income they need to plan for in order to achieve their own desired standard of living in retirement.

- Standard amounts for each person signals fairness and promotes social cohesion.

- NZS covers longevity risk efficiently by providing a known, fully indexed gender-neutral annuity." [8]

Similar claims can be made for KS as a policy instrument. It represents a second tier of voluntary saving on top of the standard NZS and potentially moves some way towards addressing the desire for consumption smoothing and cohort self-funding.

The important point is that NZS and KS are not both aimed at the same set of objectives. The 2010 Review noted that the introduction of KS in 2007 addressed a number of the objectives that are beyond the primary focus of NZS. For this reason it can be seen as a useful complement to NZS, since in combination they help address all eight of the policy objectives listed in Table 1[9].

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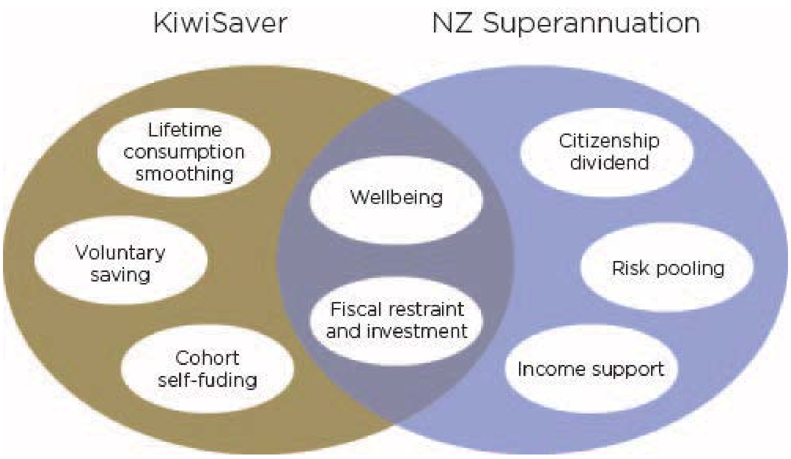
8 Hurnard (2011), p 13.

9 Arguably both NZS and KS promote wellbeing and have some fiscal restraint and invest promoting characteristics. For example NZS has very low administrative costs compared with income-tested or contributory schemes and also has beneficial labour market characteristics, while KS funds are available for capital investment.



A similar analysis of the other three policy instruments suggests that they too are important means for progressing some of the objectives and can be seen as supporting NZS and/or KS in their achievement. For example:

- Information and education campaigns are key ways that citizens can build the financial decision making skills needed to make the most of a voluntary saving scheme, improve their sense of wellbeing and operate the decumulation phase of savings in a way that manages their longevity risk;
- The NZSF introduces into NZS an element of cohort self-funding to the extent that today's taxpayers contribute to the Fund that will eventually finance a portion of their pension.

To summarise the argument of this section, there are essentially two major policy instruments, NZS and KS, supported by three others, that are complementary in addressing the eight objectives of retirement income policy. However, an important issue is that both NZS and KS are costly and are competing for public funding. Although it is feasible to trim back the scale of each to restrain the overall fiscal cost of the system, the trade-offs to be made will reflect the weightings given to the various objectives.

The adjustments – whether simply scaling back some of the parameters of the current schemes or replacing some elements with something quite different – need to be done very carefully because of the range of interests involved. It is common for policy changes to occur when attention is drawn to the concerns of different constituents/ cohorts and the views of financial market, social and business interests. Also the external environment, economic crises, trends and fashions, can affect the focus of attention.

Part 2: A closer look at the eight objectives

This section examines the eight objectives in more depth. Its purpose is to consider why each objective is regarded as important (and from whose perspective), the key model assumptions and design issues behind each objective and the properties of the main candidate policy instruments. It considers the extent to which full achievement of the objective can impact the total cost of a pension system and what might be sacrificed if that cost has to be trimmed back. Changes from the current system would likely involve income or wealth redistribution and transition costs and so these are also noted. Points of complementarity and tension with other objectives are considered further in Part 3.

The "Income support" objective

The objective of providing income support for older people is primarily to do with the alleviation of need[10], or poverty relief, although it can also be taken to refer to a desire for income redistribution more generally. The World Bank's multi-pillar model of pension systems has as its "zero pillar" a basic or social pension, universal or means tested, that addresses the goal of poverty relief. The Bank has argued that in countries where pension coverage and administrative capacity are high, the zero pillar can serve as a safety net and should be means tested[11]. However, they also note that some pension systems, such as New Zealand's, operate effectively with a universal social pension (i.e. NZS) and a third pillar of voluntary savings.

Whether receiving a regular flow of income under a public pension programme would be sufficient to achieve the goal of alleviating need depends on the actual level of income provision (adequacy) and also the nature of the need and whether the programme's coverage is accurately targeted at those in need:

> *Adequacy* Income adequacy is typically judged by reference to some benchmark amount of income, taking into account family characteristics, existing levels of a family's income or assets and the changing costs of purchasing a bundle of consumer items. The benchmark may be expressed as an absolute standard of living or as a fraction of the living standard attainable by a representative family. New Zealand's system of categorical income-tested benefits for working-age people is generally of the "absolute" kind, i.e. adjusted annually for CPI inflation, but with no formal link to average earnings or incomes of the population generally. By contrast, the level of NZS is set to a relative, not an absolute benchmark of income adequacy and is considerably higher than the level of other benefits.
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> *Nature of need* Low income may not be an efficient indicator of hardship and deprivation among older people; some health, transport and community services are provided free of charge and not necessarily bought out of income. Also, the cost of meeting needs such as shelter is highly variable depending on location and whether housing is owned debt-free, rented at a subsidized or market rent, or shared with others.

[10] "Need" may be interpreted in a number of ways, including low current income (poverty), material deprivation, financial hardship and an inability to access important services.

[11] Holzmann and Hinz (2005).

Thus the nature of need varies from person to person and will not always be able to be met by assuming that the recipient of a regular income transfer can or will use it to acquire goods or services themselves. The 2010 Review noted that hardship among older people is probably less related to a lack of basic income and more to specific situations where expenses are high, for example, costs related to accommodation, healthcare, disability, family obligations or debt servicing. In some cases, costs arising from a lack of financial knowledge, budgeting skills or from behaviours such as addictions or financial exploitation by others are difficult to manage.

Target efficiency From an efficiency point of view the ideal coverage of a programme concerned to alleviate need would be one that delivered the "right" amount of income top-up only to those in need, i.e. a guaranteed minimum income that required the least amount of transfers[12]. Of course there are many reasons why this ideal cannot be met in practice, including the administrative and client compliance costs of collecting accurate information on incomes and needs, the likelihood that very tight income targeting will trigger deliberate avoidance behaviour and the adverse effect on incentives for saving and income earning by those facing close to 100% effective marginal tax rates[13]. Because of these factors, the fiscal savings from adopting tight targeting, compared with the higher overall cost of a less tightly targeted pension scheme can easily be overestimated, as can our confidence that using income as the indicator is capturing need accurately.

The Accommodation Supplement (AS) is a formula-based payment to low-income earners, including some superannuitants, that provides a partial offset for high accommodation expenses, whether in the form of rent or board payments or mortgage servicing costs. It illustrates the point that a targeted supplementary assistance programme can help to improve the matching of income support to needs[14]. In this case, however, considerable thought needs to be given to the nature of the need being addressed, the appropriate amount of assistance to be provided and target efficiency of its design[15].

How well is NZ meeting the income support objective?

When it comes to assessing how well New Zealand meets the goal of an income support system for older people, using conventional assessment measures, the answer is clear. We have the lowest income poverty rate among people aged 65+ of any country in the OECD: just 1.5% of older people have incomes less than 50% of median household disposable income, compared with the OECD's

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[12] An example of a tightly targeted scheme was the Guaranteed Minimum Family Income (GMFI) tax credit for low income families. On the other hand Guaranteed Retirement Income (GRI), the forerunner to NZS, was a universal payment to older people, with an overlay of light targeting via the NZ Superannuitant Surcharge.

[13] The reaction of the public to the 1991 Budget attempt to introduce significantly tightened income testing for superannuation, including a change from an individual to a joint couple basis of assessment provided a salutary lesson to the government of the day; the proposal was rapidly abandoned.

[14] The 2010 Review, p71, notes that the poverty rate among people aged 65 and over is only 3% for those living in their own home with no mortgage, but 47% for those who are paying rent.

[15] Elements such as the accommodation cost trigger point, subsidy rate, regional cost caps, the income abatement rate and the exclusion of state house tenants need to be selected very carefully because they can influence the behaviour of tenants, boarders and landlords and the availability, location and quality of rental properties.

average income poverty rate for 65+ of 13.5% [16]. Furthermore, the OECD notes a number of common patterns:

- poverty rates are higher among older people than for the population as a whole;
- a greater proportion of older women live in poverty than older men;
- old-age poverty rates increase with age.

However, somewhat surprisingly the data for New Zealand shows the opposite pattern in each case: higher poverty rates among the non-old, older men and the younger old.

The reason for our low old age poverty rate relates to the universal eligibility to NZS and its relatively high standard rate of payment, which ensures that nobody who is eligible for NZS has an income below the OECD's benchmark.

It would appear therefore that our pension system has succeeded in meeting fully the income support objective and that there would be room to lower the real level of NZS (in order to improve the long term affordability of the system without materially harming this goal.

But a warning is in order. As noted above, low income is not a particularly good indicator of need and there are a number of older people who, on alternative measures of hardship, are extremely vulnerable[17]. For them, alleviating need is not a matter of relaxing some income test or raising the rates of NZS, which would be a very blunt and costly way to reduce poverty among vulnerable people with atypical circumstances and subject to particular risks. It requires a more nuanced and sophisticated approach to assessment and service delivery. Assistance that is targeted at the risk factors themselves, such as long term disability or living alone in rented accommodation, is more likely to succeed. The coverage of the public health system and the way in which the rest home care sector is structured and funded is an important consideration.

The "Citizenship dividend" objective

This objective is about maintaining social inclusion and cohesion by recognising, in a general way, the productive efforts and social and civic contributions made by citizens from all walks of life. This public recognition can be argued to have both an intrinsic and instrumental value. Building trust, respect and cooperation among citizens of all ages through this type of implicit social contract might arguably help lower the costs of transactions, raise overall life satisfaction and reduce the risk of civil unrest.

One low-level way to do this is via the use of special "senior citizen" discounts or subsidised prices for certain goods and services, such as public transport or pharmaceuticals. The design and selection of such discounts may be motivated by other policy objectives, such as "wellbeing" (eg health and leisure products) or "income support" (products most likely to be used by vulnerable people or those in hardship). Where the range of subsidised products is quite wide, however, as with the Super Gold Card, the purpose of the scheme can be said to include the citizenship dividend.

[16] OECD (2011), p149.

[17] See for example the discussion in Retirement Commission (2010) on living standards and vulnerable groups, p 70-76.

Another, more substantial option is to provide a standard pension from a standard age, as is done with NZS. The 2010 Review notes that it can be argued that this removes any stigma that might be attached to applying for a targeted benefit while at the same time it avoids any suggestion that wealthier people might receive a larger public pension than poorer, when all are equally valued citizens.

Seen from another perspective, universal entitlement also signals that “successful” people are not unfairly penalised for being successful by losing an entitlement that their own efforts contributed towards. NZS is an individual entitlement and this serves to reinforce the idea of citizenship and personal contribution, unrelated to one’s marital status, social position, occupation or role in the family.

The purpose of the citizenship dividend is to promote social cohesion and reciprocity. For this to succeed it has to be recognised that the dividend is fairly distributed among the citizenry. If eligibility is set at too high an age, then a significant proportion of New Zealanders will not live long enough to receive it, despite having contributed to society during their working lives. Furthermore, groups with below average life expectancy (eg Maori and Pacific people) will be over-represented among the “disenfranchised” group. This poses a potential threat to the fairness of the dividend’s coverage and social cohesion it is intended to engender.

The problem is exacerbated when the amount of the dividend is high, relative to the alternative sources of income support available to those who are below the eligibility age but may be unable to work. A similar problem in assessing fairness arises when a high rate of payment is combined with a longer than average life expectancy among some groups, such as European females.

This suggests that the recognition of “contribution” may work best in fostering social cohesion when it is broadly based (to avoid the social exclusion of those who are ineligible) and set at an amount low enough to avoid significant disparities due to differential life expectancies. Gareth Morgan’s “Big Kahuna” suggestion of paying a universal basic income to everyone over the age of 18 is perhaps one version of where the logic of this objective might lead.[18] Recognition of citizenship in this case would start at the age of legal responsibility, avoid the difficulties of setting an arbitrary “senior age” and would be a more inclusive programme.

It is of course a matter of considerable debate whether it is important for public policy to recognise the lifetime contributions of older citizens and if so, what level and form such recognition should take, bearing in mind that it requires the understanding and consent of voters and taxpayers of all ages. The intergenerational social contract that lies behind these types of policies is unwritten and I am unaware that there has been much formal analysis of their effectiveness in maintaining trust and social cohesion. It would be helpful to know whether a larger citizenship dividend is more resistant to being changed, because many people have a stake in it, or whether it is vulnerable because of the fiscal burden it places on the current generation of taxpayers.

The “Wellbeing” objective

The policy objective of enhancing wellbeing is to enable older people to enjoy more successful and fulfilling lives than might occur when the policy focus is simply on the provision of a basic income in

[18] Morgan (2011)

retirement. It recognizes that people's subjective wellbeing is affected by a range of factors, many of which can be affected by the way public policy is designed and operated.

The 1988 Royal Commission on Social Policy attempted to gain an understanding of what wellbeing means to New Zealanders by distilling the thousands of submissions it received. It commented:

"New Zealanders of the eighties have said that they value an atmosphere of community responsibility and an environment of security. For them social wellbeing includes that sense of belonging that affirms their dignity and identity and allows them to function in their many everyday roles." [19]

Another attempt at describing wellbeing and how it inter-connects with the development of economic and social capabilities was made in the Treasury's 2001major research report "Towards an Inclusive Economy". That report saw economic participation as a key channel through which individuals achieve wellbeing. Increased income and assets expand opportunities and choice and provides the means to purchase those goods and services that are needed for participation in society. They also contribute directly to wellbeing through the sense of self esteem, identity, self-confidence and sociability that they provide. However, wellbeing derives from a number of other factors in addition to income, such as family ties, health and education, security and the quality of the environment. It also depends on the state of the wider society in which people live, which will depend on factors such as social cohesion and inclusion, the wide availability of opportunities, trust among people and groups, good governance structures and high quality public goods and services.[20]

For the purposes of the current paper our focus is particularly on the wellbeing of older people, but the foregoing applies to them as much as to working age people. A policy package seeking to improve the overall wellbeing of older people should therefore address these factors.

Continuing employment

For many older people, extending opportunities for paid work and/or voluntary service can result in a more fulfilling life. New Zealand's retirement income system contains several features that create stronger incentives on older workers to remain in the labour force than exist in most other countries. These features work both to avoid penalizing those who choose to work beyond NZS eligibility age and to discourage early retirement[21]:

- No legislated compulsory retirement age, nor are employers permitted to specify a mandatory retirement age in employment contracts;
- No requirement to retire from paid employment in order to receive NZS;
- No income test that would cause an individual's or their spouse's earnings to abate the amount of his or her pension. This means that the effective marginal tax rate applying to an additional non-pension income (earnings or investment income) is simply the normal marginal tax rate of the pensioner[22];
- No option to receive NZS at a reduced rate prior to reaching the standard eligibility age;

[19] The April Report, Volume II, p472

[20] Distilled from Treasury (2001) p18-19.

[21] Hurnard (2005)

[22] Having NZS as the basic tier of income may push a superannuitant with other income into a higher marginal tax bracket, but this effect on the incentive to earn additional income is relatively minor compared with the effective marginal tax rate that would apply if NZS was income tested and abated against earnings.

On the other hand, the size of the NZS pension is significant for a low-income older worker and this can act as a strong inducement for them to retire once they reach eligibility age. According to OECD (2011) p125, the net pension replacement rate in New Zealand for someone with just half the mean individual earnings is 79.4%[23], which is close to the OECD average for that low-income group. For people on average or higher incomes, our flat rate pension structure means that the net pension replacement rate is much lower and New Zealand's ranking is near the bottom of the OECD.

Having a fixed age of eligibility for NZS and no income or employment test can be a two-edged sword with regard to work incentives. For people with few financial assets, reaching age 65 brings into sharp focus the tension between the income and substitution opportunities offered by NZS. Because of individual circumstances, health status etc and work/leisure preferences, some will choose to substitute the pension for earnings and cut back their employment substantially, while others will take the opportunity to remain in paid work and enjoy the higher material standard of living made possible by the rise in their income.

Having this choice should enhance overall wellbeing.

Statistically we can expect there to always be a step down in labour force participation rate and hours of paid work at the age when people become eligible for NZS, but in light of the New Zealand system's particular features listed above, the spike in retirement at that particular age is not as striking as one might expect. New Zealand continues to have one of the highest rates of labour force participation among people aged 65-69 in the OECD[24].

The "Voluntary saving" objective

This objective places value on people having the freedom, and taking personal responsibility, to make their own, informed decisions about their financial futures. By emphasizing a desire for people to be able to make choices about how they wish to manage their financial lives this objective links with Amartya Sen's conceptualization of freedom as a key criterion of a successful civil society and with the "wellbeing" objective, since being able to exercise informed choice and control are seen as part of wellbeing. In order for personal responsibility to be exercised effectively it may need to be supported by a programme of financial education and the provision of unbiased factual information.

The voluntary saving objective links back to the analysis of three possible options carried out by the 1992 Task Force on Private Provision (known as the Todd Task Force). The Task Force advocated a non-subsidised, voluntary saving option in preference to an incentive option based on tax concessions or a funded compulsory saving scheme. For this reason, this paper takes the voluntary saving objective to refer to a desire for personal financial choice and responsibility within a "neutral" long-term savings environment, i.e. without special tax concessions for private pension contributions or a mandatory requirement to save for retirement.

> *"…we approach private provision for retirement as ultimately a personal responsibility, within a wider context which includes public provision…while a person may derive part or all*

[23] Note that with no income or employment test this individual can retire at 65 on nearly 80% of their previous earnings, or continue working and receive nearly 80% more income (or reduce their work hours and earnings and still receive the same, or more, income). These choices are not available in countries where the basic pension is income tested.

[24] OECD (2011) p42.

> *of their private retirement income from an employment-based scheme, this does not alter our views on the ultimate responsibility for private provision."*[25]

It is important to note that this objective does not aim to have voluntary saving as the sole means by which retirement income provision should be made. Rather, the Task Force saw it as the preferred policy environment in which individuals can top-up their public pension through private provision of additional income and to an extent that best suits their own circumstances.

Note that the case for valuing voluntary retirement saving does not assume that it will elicit an "optimal" amount of saving in a macroeconomic sense.

The "Lifetime consumption smoothing" objective

The standard life-cycle theory model of saving in economics treats saving and dis-saving as a means towards the objective of smoothing consumption over a person's expected lifetime, since maintaining a uniform rate of consumption is deemed to be the way rational decision makers can maximize the utility of that consumption.

One might ask, if it is rational and optimal for people to smooth their lifetime consumption, why don't they seem to achieve this fully in practice? Is there any particular role for public policy to help facilitate this outcome if it is not happening in the way the theory suggests it should? The answer seems to be that people may be trying to achieve their highest level of wellbeing but human frailty, misjudgement and confusion often get in the way:

> *"Real people do not follow logically consistent choice and decision protocols. By now abundant experimental and real-world observed evidence – buttressed by common sense – confirms that individuals do not always think and act in ways consistent with the standard, and limited, axioms of rational choice"*[26].

Several possible policy approaches to dealing with this conundrum have been proposed. If one regards lifetime consumption smoothing as a desirable policy objective, then there are potentially different degrees of intervention that could be considered, summarised in Table 2.

One approach is to refrain from any special intervention, on the grounds that if individuals are to realize their full potential then they must be free to err in making important decisions. Under this view individuals' personal liberty trumps a well-meaning but misguided policy intervention to "correct" a behavioural mistake. Instead, policy emphasis should be on providing personal financial education and information programmes, avoiding price distortions and ensuring that financial markets run efficiently.

A second approach, "libertarian paternalism", suggests that savings choices can be framed in such a way that people will be more likely to do what is in their best interests, as they themselves judge it. For example, moving from an "opt in" to an "opt out" system for joining a long term savings scheme

[25] Task force on Private Provision for Retirement (1992), p 23.
[26] McCaffery and Slemrod (2005)

could be said to improve the chances that people's cognitive biases will nudge[27] them towards the welfare-improving decision to join and stay in the scheme, without reducing their freedom to choose.

Table 2: Typology of private savings regimes

Degree of paternalism	Approach	Features	Example
Minor	Educative	Tax neutral, voluntary, opt-in	Todd Task Force recommended regime
Minor	Nudge	Automatic enrolment with opt-out	KiwiSaver early design version
Moderate	Subsidy	Voluntary, with subsidies	KiwiSaver current version
Major	Compulsion	Fully funded, mandatory saving scheme	1975 NZ Superannuation Scheme; 1997 Compulsory Retirement Saving Scheme proposal put to referendum
Major	Notional DC	Funded as PAYG, but payout linked to lifetime contributions	Swedish NDC system

A third approach is for the government to use financial incentives to encourage people to undertake the type and level of saving behaviour that is believed to be in their best interests, where it appears that without such subsidies or tax breaks this would not occur. This is the approach currently adopted with KiwiSaver. A problem with this approach is that it is impossible for a central agency to determine precisely which people are saving in a sub-optimal way and then to devise a subsidy regime that elicited the "correct" saving behaviour from each person in an efficient and cost effective way.

For example, KiwiSaver has the specified objective of encouraging a long-term savings habit and asset accumulation *by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement*[28] , i.e. it is intended to target people who are currently off-track to smooth their consumption over the rest of their lives. The evidence indicates that many people who are not in this situation (particularly those over the age of 50 and children under 18) are benefiting from the government's KiwiSaver subsidies, making the programme's target efficiency poor.

A fourth approach to achieving the consumption smoothing objective is to make saving for retirement compulsory under a fully funded scheme. An advantage of this approach is that, provided any subsidies were removed at the same time, it would reduce the direct fiscal costs of subsidies and help achieve the "cohort self-funding" objective at the same time by linking retirement benefits to an individual's own lifetime contributions. Furthermore, it creates the opportunity for the universal basic pension to eventually be replaced by a targeted safety net programme to top-up the retirement incomes of those who have low qualifying annuities. This would provide a way of reducing the direct fiscal cost of NZS still further.

There are a number of disadvantages to this approach that would need to be factored into any assessment. Administrative, regulation, compliance and other economic efficiency costs could be substantial, depending on the scheme design. The compulsory aspect of a scheme will tend to raise expectations that the returns will be underwritten, thereby introducing an element of risk to the

27 The term "nudge" was coined by Richard Thaler and Cass Sunstein in their book of the same name.
28 Extract from the objectives of KiwiSaver as set out in the KiwiSaver Act 2006, emphasis added.

government. A further financial risk to the government could arise if annuitisation of accumulated balances was to be made compulsory, consistent with the model underlying the consumption smoothing objective[29]. This could occur because of the thinness of the annuities market in New Zealand and the likely demand for the government to make available suitable long-term indexed bonds and to subsidise gender neutral annuities[30].

Finally, a fifth approach is to retain a pay-as-you-go funding system, but to determine individual pension amounts based on a person's contributions, as indicated perhaps by their lifetime earnings, with adjustments for their age at retirement and the estimated life expectancy of their particular birth cohort. Thus notional defined contribution (NDC) pensions are a PAYG analogue of funded DC pensions. Barr comments "if a country wishes to have an element in its pension system that offers fairly pure consumption smoothing there are circumstances where NDC might be more appropriate than funded DC."

The "Cohort self-funding" objective

The objective of cohort self-funding appeals to the equity of having each generation getting back from the government no more or less than they have contributed. A concern arises where the voters of one generation commit the next generation to transfer a greater amount of resources to fund their retirement pensions than they themselves generated during their working lives. Under a pay-as-you-go funding system, it is the taxes paid by today's workers that fund today's retirees, so this situation can arise when one generation is larger than the next or succeeds in voting itself too large a pension.

The problem is signaled when forward projections of the fiscal cost of public pensions show a rising trend that is higher than projected fiscal revenue (under the assumption of no change in current tax policies). This implies that unless the cost is trimmed, then it will require a tax increase or extra borrowing to pay the pension bill and both of these funding options will hardly impact on those receiving the pension.

It should be noted that the cohort self-funding objective has to do with inter-generational equity and not with the degree of any income redistribution among people within the same generation, which is a concern of the income support objective[31].

There are technical difficulties in trying to resolve a perception of unfairness or unequal burdens across generations.

- First there is the matter of how broadly to cast the net: should any measure of benefits include all government services received by each generation (including health, education and infrastructure) and the total taxes they paid, or focus just on pensions?

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29 Note that if annuitisation is not mandatory, then problems of adverse selection and moral hazard arise and people could choose to spend their savings quickly and fall back on the basic income guarantee.

30 The challenges of creating a well functioning market for annuities in New Zealand are discussed in Hurnard (2007). That paper also uses as a case study the set of annuity-based policy rules that were included in the design of the proposed compulsory retirement savings scheme (RSS) that was put to a public referendum in 1997, to illustrate the degree of government intervention and assistance required to ensure that the annuities market could operate well.

31 Andrew Coleman, in arguing for a SAYGO system, notes that it could operate as a flat rate scheme (like NZS), an earnings related scheme, a defined contribution scheme, or something else.

- Second, should differences in the average wealth and living standards of each generation affect society's assessment of one generation's ability and willingness to pay for the pensions of their parents' generation? Furthermore, we do not know how the life course of an unborn generation will evolve.
- Third, how do future generations get to have a voice in the funding decision and how altruistic or self-interested might they be? Will they simply decide to cut the pensions of their parents' generation or be willing to maintain their living standard?
    - Note that the shrinking family size, increasing ethnic diversity and a widening distribution of income and wealth among the population could all be contributing to a weakening of social cohesion and national identity. It could be increasingly harder for a retired generation to appeal to the following generation to voluntarily support the maintenance of their living standards.
    - The role of the "citizenship dividend" could arguably be invoked to help in the brokering of some sort of understanding of an implicit inter-generational social contract.

The prospect is that funding the pensions of the "baby boom" generation as they fall due will require the next generation of workers to pay a higher tax rate.

Possible policy responses to improve inter-generational equity

Indirect, partial pre-funding through the NZSF

A possible policy instrument for responding to this is the NZ Superannuation Fund, which can be thought of as a way to shift some of this future liability back on to the baby boomers themselves provided an annual government contribution to the Fund is made using the taxes of today's taxpayers. However, there are no contributions being made from the Budget at the moment and even if there were, they would be likely to be financed by borrowing rather than tax increases, and so would not redistribute the burden back to today's taxpaying baby boomers.

Cutting pension costs differentially

Another response would be to reduce the fiscal cost of the baby boomers' pensions. It is important to note, however, that the way this is done (eg through raising the age of eligibility or lowering the relative rate of pension) could differentially impact across generations and affect perceptions of whether it is a fair adjustment. In this regard, the prospect of the next generation building up sizeable KiwiSaver balances to top-up their NZS might make them prefer the cost of pensions trimmed via a lowering in the relative level of NZS rather than by a significant increase in the age of eligibility.

Another approach is to legislate for an automatic adjustment mechanism whereby changes in certain drivers of pension costs would trigger a change in entitlements. For example, increases in the forecast life expectancy of a cohort might trigger a rise in the age of pension eligibility. As a further enhancement, adjustments might also be made for the overall size of each cohort, so that the burden on the average sized working age cohort of financing the pensions of a larger, retired cohort could be equalized by further reducing the pensions of the latter group.

Full cohort self-funding

The most extreme policy move towards cohort self-funding would be to completely replace the current PAYG system with a fully funded scheme. The transition to such a scheme would however take a very long time and raise considerable problems.

The introduction of KiwiSaver into the policy mix represents a modest step towards partial cohort self-funding. How far it is worth travelling in that direction is a matter for debate, but it is worth noting that a shift towards a defined contribution scheme is also changing the incidence of risk away from the government and on to the individual saver. The implications of this for the attainment of other retirement income policy objectives and for the overall acceptability of the system need to be carefully considered.

The "Risk pooling" objective

The objective of pooling longevity risk is to protect the living standards of pensioners in the event that they live well beyond the average expected life span of their cohort. Longevity risk is a policy concern because if a person has no pension and has exhausted their financial assets by the time they had expected to have died, then they face the prospect of extreme hardship for the rest of their lives. This prospect is even worse if individuals face special and ongoing costs for their accommodation, health and welfare.

Essentially a commercial risk pooling arrangement allocates the returns from an invested pool of assets to the pool members in proportion to the size of their stake and the length of time they survive. This may be done by paying an annuity to each surviving member. In countries with major contributory pension schemes, the annuitisation of maturing savings balances is a key step in securing a guaranteed income in retirement that will extend over the rest of the saver's life.

However, the insurance market for providing retirement annuities faces a number of problems that in some cases can severely limit its efficiency, effectiveness and coverage. These problems affect both the supply and demand side and include:

- The pricing of annuities, because it is difficult to forecast accurately the changes in mortality rates and to adjust to fluctuations in market interest rates.
- Restrictions placed on insurance companies against differentiating risk groups on some characteristics such as gender and ethnicity that would help them to counter the risk of adverse selection.
- Limited supplies of suitable long-term and index-linked securities to match the long-term structure of annuity liabilities.
- A conservative regulatory regime to protect the solvency of insurance companies, which can adversely affect their profitability and reduce the demand for annuities.
- The complexity of annuity products and public perceptions that they are poor value for money.
- People have difficulty in understanding and deciding on the trade-offs to be made under a risk pooling arrangement.
- Possible adverse tax and regulatory treatment of annuities in comparison with other assets, such as housing.

It is commonly a requirement under mandatory contributory saving schemes that at least a proportion of the accumulated individual balances be converted into an annuity at retirement, since the whole objective of these systems is to replace earnings with a comparable level of pension in retirement. Because of the problems with annuity markets listed above, there is an obligation on the government that mandates the system to ensure that suitable annuities are available. Meeting this obligation can in some cases involve a considerable cost to the government[32].

In light of the foregoing difficulties and challenges with private market annuities it is important to recognize that, in comparison, the NZS pension itself is a very effective annuity. It covers longevity risk (up to the level of a basic income) and is fully inflation adjusted. Its payment rates are also gender-neutral.

These features of the current system go a long way towards meeting the basic requirements of the "risk pooling" objective. They do not, however, guarantee that those whose retirement income is higher than the basic pension level will have that additional income protected against longevity risk. With the prospect of accumulated KiwiSaver balances becoming a significant part of retirees' portfolios in the future, the policy question will arise as to whether and how compulsory annuitisation of these balances should operate.

It might be argued that a degree of compulsory annuitisation is justified, since the government has committed a considerable amount on KiwiSaver incentives for the purpose of raising living standards in retirement (i.e. consumption smoothing) and not just for the purposes of instant gratification or bequeathing to others.

On the other hand it might also be argued that people should be free to decide how best to manage the risk of losing any higher standard of living as a result of surviving to a great age. Some people may place priority on preserving their capital for bequests and accept a lower pension income as the price they are willing to pay. The initial layer of well-protected, indexed income for life provided by NZS makes it easier for middle income retirees to consider a wider range of reasonable investment and wealth decumulation strategies, should they find standard annuities unattractive[33]. Why should the government become more involved in influencing this second tier of retirement financing decisions, particularly when the annuitisation market appears imperfect?

The "Fiscal restraint and investment" objective

The outcome sought from the "fiscal restraint and investment" objective is higher living standards for New Zealanders generally as a result of improvements in macroeconomic performance. The basic idea is to prevent public sector activity from diverting too many of the resources that could be used more productively by the private sector and thereby increase the growth rate of output and incomes in the economy overall. Higher living standards are therefore expected to be achieved through prudent fiscal and monetary management, well functioning, efficient markets and access to investment capital and a skilled, well managed labour force.

[32] See the discussion in Hurnard (2007) p13-14 on cost and government assumption of risk inherent in the design of standard annuities under New Zealand's 1997 compulsory retirement saving scheme referendum proposal.

[33] There is a large menu of choices and decumulation strategies available, including deferring purchase of an annuity until a much later age, see Hurnard (2007) p21.

If pension costs were to be trimmed back by the government, then workers would be incentivized to make up their expected pension shortfalls by increasing their own rates of saving. Alternatively, the introduction of a compulsory saving scheme would in theory not only do away with the need for taxpayer funded savings incentives but also increase the overall amount of funds available for investment in productive ventures.

One might question why an economic policy objective of fiscal restraint and increasing investment should be included among other objectives that are more specifically concerned with the design of retirement income policy. The answer is that imposing a degree of sacrifice today in return for an expected payoff in terms of more security in retirement for later generations draws attention to the responsibility of today's generation to avoid passing on a legacy of structural imbalances, rising debt and falling output per capita that would leave future retirees in a worse situation than their parents and grandparents.

In a sense this responsibility highlights the concerns behind the income support, citizenship dividend, wellbeing and risk pooling objectives (which are normally interpreted as matters affecting today's voters) but applies them in the interests of future generations. Fiscal responsibility, like sustainable economic and environmental management, is a matter of considering the interests of future generations alongside those living today.

Note, however, that there are risks and an important timing issue involved with this type of argument. It requires a willingness on the part of both current and prospective pensioners to release some of the resources that are committed under current policy settings. Furthermore, there can be no guarantee that the economic policy prescription will be properly implemented, that all the players will react as predicted by the theory, or that the hoped-for sustained growth in national income will eventuate within a reasonable timeframe.

Beyond these uncertainties lies the problem of how to ensure that any proposed future redistribution of the income gains from a growing economy will be acceptable to those primarily responsible for creating that growth dividend. The people earning the income in 20 or 50 years' time will be drawn from different cohorts, they may have strong or weak identification with the concerns of the baby boom generation and their wealth may be more or less concentrated than today's wealth distribution. Indeed, if world environmental and economic conditions deteriorate, their average living standard may be lower than that enjoyed by the baby boom generation. Will a future generation of earners show a willingness to take collective responsibility for maintaining the living standards of older people to the same degree?

Having fiscally sustainable policy settings is essential. However, trading off current pension entitlements for the uncertain benefits of bequeathing a growth dividend to a future generation is a difficult prospect. It will require an element of trust, altruism and straight talking across today's generations.

The funding of pensions

The three reform options to be examined in Part 4 entail different degrees of pre-funding of pensions. The case for each option does not, however, rest on the merits or otherwise of pre-funding as a financing strategy. The focus is on how each reform might deal with the policy issues and trade-offs that will arise when an attempt is made to ensure the longer-term sustainability of the pension system.

This paper does not examine in detail the debate over whether a major change in the way pensions are funded would represent a useful reform option from the point of view of retirement income policy. Instead it follows the lead of Barr (2006) in suggesting that the debate between PAYG and funding, though important, is not central to addressing population ageing. It may be true that greater reliance on funded pensions could promote growth and hence help with the retirement income “problem”, but Barr concludes that the relationship between funding and growth is neither simple nor automatic: funding may or may not increase saving, and an increase in saving may or may not increase output.

Furthermore, Barr argues that while private pensions can reduce public pension spending in the longer term once the schemes are mature, in the shorter term their introduction is likely to increase budgetary pressures, since if workers’ contributions go into their individual pension accounts, they cannot be used to pay for the pensions of the older generation[34]. For this reason the argument that funded schemes do better than PAYG systems if real returns exceed real wage growth, is not necessarily true in a country that already has a PAYG scheme and is considering moving to a funded scheme[35].

The essential point is that if pension entitlements are deemed to be unaffordable, then the way to deal with this is either to generate additional resources through growth or to change the entitlements in some way to meet the budgetary constraints, not to change the way they are funded.

34 Barr (2001) Myth 4: *Funding reduces public spending on pensions*.
35 Op cit Myth 8: *Funded schemes do better than PAYG systems if real returns exceed real wage growth*.

Part 3: Issues and trade-offs

Retirement income policy settings at any given time tend to reflect an historical public consensus that assigns greater importance to some of the eight objectives and concerns than to others. Even if this consensus appears to be reasonably stable at the moment, we should expect the policy objectives and concerns to be re-weighted and re-evaluated from time to time in light of changing social values, economic conditions and the emerging life experiences of each generation as it ages.

It is clear that retirement income policies need be revisited, in some form or other, within the coming decade if only because of the implications for the government's budget of their rising cost. It is difficult at this stage to predict the outcome of the future public debates over whether to modify the present system or move to another system, but a purpose of this paper is to help prepare the groundwork.

The following sections discuss some issues and trade-offs that need to be weighed up when considering modification or possible redesign of the retirement income system. Typically these issues illustrate the tensions among several of the policy objectives discussed in Part 2. The chosen "solutions" should reflect the decision makers' judgement, informed by public consultation and debate, on the relative merits of the considerations on each side of the argument. At the end of the day, however, these "solutions" need to be bundled up into a coherent policy package.

Issue 1: The basic pension guarantee – universal entitlement or targeted on need?

The concerns of "citizenship dividend" and "income support" in New Zealand can be traced back more than 100 years to the Old Age Pensions Act of 1898, which stated:

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

Several elements in the rationale for an old-age pension – merit, contribution, belonging and need – were alluded to in the 1898 legislation[36]. Forty years later in 1938 the introduction of a "universal superannuation" entitlement that was distinct from income-tested Age Benefit served to explicitly separate the elements of merit and contribution from those of belonging and need. This matching of different concerns with different policy objectives has twice been confirmed by official commissions of inquiry, in 1972 and 1988, as a sensible way to proceed.

Instead of continuing with a dual system to recognise merit and need separately, New Zealand has however since 1977, with brief exceptions, adopted a single policy instrument to express both. National Superannuation and its later successor NZS have been presented as recognition of older people's past contributions as citizens irrespective of their current financial needs, while at the same time being set high enough to provide a basic standard of living for someone with no other income. This combination of universal entitlement and a relatively high payment rate has created concern that NZS imposes too great a burden on taxpayers and will become fiscally unsustainable as the proportion of older people in the population increases.

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[36] Royal Commission on Social Policy (1988), Volume III, Part 2, p 498.

The problem is exacerbated by the indexation formula for NZS. The rates of NZS will increase in real terms, assuming real average earnings increase over time, whereas income tested benefits are fixed in real terms.

It is important that the two elements of the rationale for NZS be disentangled when debating or promoting any changes and that other linked policies (such as KiwiSaver, the social security system and health, housing and community services) are fully factored in, so that people are clear about how the objectives of income support and citizenship dividend are being addressed.

This does not necessarily mean the basic pension should be split into separate instruments. There are costs in administering a means test on older people and arguments around its disincentive effects on saving, investing and employment that make a single universal payment an attractive option despite its higher direct fiscal cost.

Issue 2: The policy goals of social protection versus earnings replacement

The OECD's taxonomy of pension systems is based on what it sees as the two main goals of public pension systems: first the **social protection** goal to prevent destitution in old age by redistributing income towards low income pensioners, and second, the **earnings replacement** goal to help workers to maintain their living standards after retirement. These goals broadly correspond to two of the eight objectives listed in this paper: "income support" and "lifetime consumption smoothing".

The OECD notes that most countries pursue both goals in their overall pension policy, but that there is a large variation in the balance of emphasis between the two. New Zealand is at one extreme because it has historically placed a heavy emphasis on the goal of social protection rather than earnings replacement (Box 2).

Box 2: Progressivity of pension benefit formulae

In the design of mandatory pension schemes, OECD countries place differing emphasis on the roles of insurance and redistribution. The progressivity index summarises the relationship between a pension and earnings when working. The index varies from 100 under a "pure basic" scheme (paying the same benefit regardless of a person's earnings history and other income), to zero under a pure insurance scheme (paying the same earnings replacement rate to all workers when they retire).

The average progressivity index across OECD countries is 37. New Zealand and Ireland are the only countries with a index of 100. Regional differences are striking, with an average index of 80 in Anglophone countries where public pensions tend to be strongly progressive, In southern European countries, by contrast, the average index is just 8, indicating a very strong link between earnings and pension benefits.

Source: OECD (2011), p 136.

This public policy emphasis found expression in the influential 1972 Royal Commission of Inquiry into Social Security in New Zealand, which concluded:

> *"The community's first responsibility for income maintenance is to give benefits which will enable its dependent sections to reach an adequate standard of living. This can best be done by a system of selective flat-rate benefits and allowances.*
>
> *Adopting an earnings-related benefit system would not help those sections of the community to whom it owes its first responsibility. On the contrary their interests would most probably be prejudiced.*
>
> *However desirable it may be for individuals to maintain their customary earnings and status, the community is not, and should not become, responsible for securing this status, particularly by imposing a compulsory scheme."*[37]

Notwithstanding a number of recent initiatives to encourage a degree of earnings replacement through personal savings it is important to remember that the public policy goal of social protection has for many years ranked clearly ahead of the goal of earnings replacement. It can be expected, therefore, that if there were to be a change in this ranking, it would only come about following an extended period of consultation and public debate.

Issue 3: Income support for the transition to retirement

Although NZS is defined as a "benefit" in the Social Security Act it differs significantly from the other, categorical, income-tested benefits. This reflects its philosophical underpinnings as more than a system of social protection designed to facilitate people's return to the paid work force.

There is a clear break in the income support system when someone becomes eligible for NZS, irrespective of the age at which they actually choose to retire or become unable to work. NZS provides significantly higher rates of payment than any of the categorical benefits (Table 3), a more generous annual adjustment formula, no reciprocal obligations such as a requirement to seek paid work, an individual entitlement (no joint assessment of partners' income or assets) and no abatement of entitlement against other income.

Table 3 shows how a 64 year old **non-beneficiary**, whether working or retired, stands to receive a sizeable increase in their weekly income, with no change in their living circumstances, at their next birthday. Similarly, on turning 65 a **beneficiary**'s financial situation is significantly improved overnight because he or she transfers from one part of the income support system to another. On the other hand, if they do not meet the NZS long-term residence requirement, then their income-tested welfare benefit conditions will continue unchanged beyond age 65.

The question arises whether there should be a more graduated transition between the two support systems for older adults, affecting for example the level of income support, the degree of conditionality attached to assistance and the degree to which a partner's financial circumstances are factored in to the assessment of need.

[37] Royal Commission of Inquiry (1972), p181

Table 3: Changes in the quantum of government weekly income support at age 65

Individual's circumstances	Up to age 64 (categorical benefit)	Age 65 and beyond (NZS)
Single adult and living alone		
Employed	$0	$389
Retired from labour force	$0	$389
Unemployed and seeking work	$205	$389
Sick	$205	$389
Invalid	$256	$389
Married, (with a spouse aged <65 earning $40,000)*		
Employed	$0	$294
Retired from labour force	$0	$294
Unemployed and seeking work	$0	$294
Sick	$0	$294
Invalid	$0	$294

Source: MSD benefit rates and conditions as at 1 April 2012, net of income tax.
** This level of spousal earnings places a benefit applicant beyond the cutout point under the joint income test, giving them a zero entitlement to any benefit.*
Note: Assumes the individual meets the New Zealand residence qualifications for NZS.
Figures do not include any supplementary assistance that may also be available, depending on individual circumstances.

People's health status, circumstances, needs and prospects vary widely as their cohort ages, and it might be seen as unfair that they are all subject to the same fixed age-based benchmark for transferring from conditional to unconditional income support.

There are several possible approaches to creating a fairer transition, depending on the weight one assigns to the values of universality, needs based assessment and individual choice. Possible solutions might include:

- A graduated transition path from welfare to pension, offered universally and based simply on a band of chronological age, say between age 55 and 75, during which conditionality is progressively reduced and assistance rates increased. The numbers receiving income support at each age would gradually rise;
- Early entitlement to NZS based on an individualised assessment of the condition of a person who is below age 65, for example whether their physical or mental wellbeing, caring responsibilities or survival prospects make it unreasonable to expect them to remain committed to paid employment up to age 65. This process might resemble an assessment of qualification for a categorical benefit, but its operation could be more difficult if the qualifying rules are flexible and require the use of administrative discretion.
- Offering people the choice whether to receive NZS at a lower rate of payment starting before age 65, knowing that they will stay on that lower rate indefinitely. The idea here is that if people can assess their own needs, capabilities and life expectancy more accurately than anyone else, then those who would benefit most from this option could self-select into an early, discounted pension. This option is discussed further in Issue 4 below.

- Recasting NZS as a dual system (see Issue 1) comprising an income-tested age pension[38] for basic income support, which interfaces with the existing categorical benefit system at an earlier age, and a smaller, universal "citizenship dividend" pension to recognise contribution, available from a specified higher age. This option (selected as Option B in Part 4 of this paper) would represent a return to the structure recommended by the 1972 and 1988 commissions of inquiry.

Issue 4: Should pensioners be offered an early and/or late retirement option?

When a pension is framed as an "earned entitlement" or a "right" this opens up a debate on whether that entitlement should be available in a range of different forms, rather than a standard vanilla product. Specifically should people be offered a choice as to when they wish to take up their pension "entitlement"? In New Zealand, Jonathan Eriksen, Don Brash, Peter Dunne and others have proposed versions of this choice in respect of NZS (in some cases in combination with an increase in the standard age of eligibility).

Box 3: Promoting early retirement: the US experience

The original legislation creating the US Social Security program did not allow workers to claim benefits before the standard eligibility age of 65 years. According to Munnell and Sass (2012) the option to claim benefits as early as age 62 was first granted, in 1956, to women only. The reason was to allow married women, who were typically the younger member of the couple, to retire and claim benefits at the same time as their husbands. Congress made the option available to all women so as not to discriminate against unmarried women.

Note that the original motivation for this option in the US related to a conventional social objective of the time – wanting couples to be able to retire together and not require a wife to continue in paid employment after her husband retired. It was not a matter of extending individual freedom of choice for its own sake or of preventing economic hardship for those physically unable to continue working until age 65[39].

Five years after the US early retirement option was granted to women, Congress extended it to men. This change was made during a recession, in 1961, which made early retirement an attractive policy option for handling the prospect of high unemployment. Thus the original social policy motivation was supplemented or supplanted by a political/economic one: to ensure that jobs were available for new labour market entrants by facilitating older workers to take early retirement.

The motivations for allowing early and late retirement options are varied. Early retirement has been used in some countries to open up job vacancies for younger workers in a tight labour market situation. Alternatively early retirement might be facilitated to ease the hardship of the vulnerable (Issue 2) or for a broader social policy reason, such as to help offset the effects of sub-population

[38] This might be only lightly income tested like the Australian Age Pension or more heavily income-tested like New Zealand's historical Age Benefit.

[39] In New Zealand, provided the older spouse is eligible for NZS, the choice of a couple to retire on a pension at the same time is partially accommodated via an optional, jointly and quite heavily income-tested payment of NZS at a lower rate than if they were both eligible. Once the younger spouse becomes eligible for NZS in her own right, the system reverts to paying two standard pensions.

group differences in life expectancy, or to enable women to retire at the same time as their husbands (Box 3).

The promotion of late retirement on the other hand often appeals to the need to extend the labour supply and avoid losing workers' valuable skills and experience. More generally it is seen to offer a range of wider economic and individual wellbeing benefits:

> *"By encouraging people to stay in the workforce for longer it would have fiscal benefits in terms of higher tax revenue and probably lower health costs given that there is evidence that people who remain employed are often healthier, physically and mentally, than those who have left the workforce."* [40]

There is overwhelming evidence that the financial incentives embedded in pension systems affect retirement behaviour. The OECD recently produced a detailed analysis of the many ways in which different countries' pension rules affect the incentives to retire[41]. It showed a wide variation (both positive and negative) in these incentives across the OECD[42].

This is a complicated issue. The OECD argues that the aim should be to have a pension system that neither subsidises, nor excessively penalises, early retirement.

Determining the age/pension amount trade-off

The proposal to offer people a choice of when to draw a pension usually treats the pension as if it was a net present value wealth entitlement at the normal eligibility age and the government was indifferent as to when it was claimed, since the expected pension payout would be the same, provided that the schedule of rates offered was calculated on an actuarially fair basis.

However, the net present value of the pension *ex post* is very variable among individuals because of variations in their age at death. This should sound a warning about the likely effects of adverse selection; people will tend to select an option based on their own (probably better informed) assessment of their life expectancy[43] and this will increase the long term cost of the scheme or lead to actuarially unfair options being offered in an attempt to counter the adverse selection effect.

Also, if NZS payment choices are to be gender neutral (as implied by many of the proposals), then the rates offered will not be strictly actuarially fair. One may ask whether any other social value judgments or economic considerations are going to be brought to bear by a government in setting the rates[44]. For example, the rate schedule might be deliberately tilted in favour of later take-up (i.e. an unfairly large premium on NZS rates where people claim their pension at an older age) because that might help keep more people in the workforce or would create short term fiscal savings by delaying payments.

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40 Don Brash: speech to an Auckland business group, July 2010.

41 See OECD (2011) , Part 1, Chapter 3.

42 New Zealand is classified as completely neutral, because gross pension wealth under NZS is quite independent of when one chooses to retire.

43 Indeed, if early claiming were to be offered, some people who will not have lived to the standard eligibility age would be able to claim discounted NZS, which would represent a fiscal cost if the rate paid was higher than the income-tested benefit amount they might otherwise have receiverd.

44 For example the 2011 proposal by the UnitedFirst Party would have NZS discounted by 6% per year of age for earlier retirees, but inflated by 10% per year of age for later retirees.

Differentiated payments and social cohesion

The case for offering flexible choice may be stronger in the case of earnings-related defined contribution or defined benefit schemes where individuals have varying contribution records and accumulating pension wealth, such as KiwiSaver. In this environment the fact that one person's early retirement pension is different from another's normal pension does not breach any pre-existing "principle" of equal sized individual monthly pension entitlements.

In contrast, NZS, which does incorporate this principle, might be seen as being more fundamentally impacted by an early retirement option scheme that resulted in different monthly pension payments going to each person depending on when they chose to claim their entitlement. One might ask whether New Zealanders would regard it as fair if wealthy retired people typically receiving a higher publicly funded pension than poorer retired people (because they chose different start date options) while at the same time the wealthier are likely to have additional retirement income from private sources, including KiwiSaver.

The case for persevering with a standard individual payment of NZS from a fixed age of eligibility appeals to citizenship, certainty, longevity risk protection and social cohesion arguments, whereas the more flexible choice approach appeals to the values behind the voluntary saving model, such as personal responsibility and having a financially literate population.

Issue 5: Interactions between public policy and voluntary saving

From a fiscal perspective, increased private saving for retirement would seem to offer several advantages. An increase in the degree of self-provision for retirement could ease the pressure on the government to expand public pension entitlements and might even allow a degree of expenditure reduction if public pension entitlements were to be abated against private income.

The challenge is, of course, how to actually achieve such an increase in private retirement income provision without using expensive incentive mechanisms or creating market distortions from a mandated saving scheme. The discussion of options under the "lifetime consumption smoothing" objective in Part 2 touched on the problems with using these devices. There is no guarantee that a significant increase in net private saving will occur, because of displacement of existing forms of saving. Furthermore, attempts to extract fiscal cost reductions by income testing public pension payments are likely to be met by a range of avoidance behaviours by savers, as happened in 1991.

The optimal degree of interaction between public and private provision of retirement income has been the subject of considerable debate over the years and is likely to remain a central issue for any future reform consideration. Since the earlier linkage between them has been removed (Box 4) there has been growing appreciation in some quarters of the efficiency advantages of maintaining a clean separation[45]. Others are inclined to reintroduce some element of income testing[46].

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[45] For example the Retirement Commission endorses the non-income testing of NZS and has suggested that fiscal savings be achieved by amending NZS in other ways.

[46] For example, Susan St John advocates a light income test on NZS similar in scope to the old surcharge.

Box 4: Political consensus on the interaction between public and private provision

The August 1993 Accord on Retirement Income Policies was a negotiated political agreement among all the parties in Parliament at the time and came after a prolonged period of policy switches and political wrangling following an abortive attempt in the 1991 Budget to change from moderate interaction (via the Surcharge) to very tight interaction (via a direct, joint couple income test). The proposed change did not go ahead and the 1992 Todd Task force endorsed the status quo. The Accord was the way in which almost all of the recommendations of the 1992 Todd Task Force could be agreed and implemented.

The Accord spelled out its purpose (to achieve consensus on retirement income policies) and stated a number of broad principles, including:

*1.4 **Voluntary private provision of retirement income** – People should be encouraged to save for their retirement through the availability of appropriate savings products, supported by education and the provision of information about retirement matters; but should not be compelled by law, or given tax incentives, to do so.*

*1.5 **Provision for retirement to be both private and public** – Retirement income should continue to be provided in an integrated way from both private savings and public funds.*
This latter principle was elucidated in section 2.4.1: The net amount provided from public funds for a retired person should reduce as that person's total income increases.

The broad political consensus represented by the Accord enjoyed only a relatively short life. Over the ensuing five years the surcharge was completely phased out, restoring NZS to a universal flat rate pension and, arguably breaching section 2.4.1 of the Accord. Other features of the Accord remained more or less intact for many years despite the Accord having been abandoned.

It was not until 2007 that the Accord's principle of no tax incentives for retirement saving began to be challenged, when the government included significant financial incentives into its newly launched KiwiSaver scheme.

The degree of interaction between public and private retirement provision policy is a key consideration when evaluating how a public pension design aimed at satisfying other objectives might affect the voluntary saving objective. The design of the public pension system itself and the tax and regulatory regime under which private saving for retirement occurs can all have a positive or negative effect on voluntary saving. Among the mechanisms through which this interaction may occur are:

- **The level at which the public pension is set.** Voluntary saving to top-up the public pension is a more attractive option when the basic pension is seen to be relatively low. At a higher level, more people would find it pointless to save, or may not make the effort to plan for their future, believing that the government has taken on the whole responsibility.
- **Whether there is a de facto income test on the public pension**. This could lower the effective rate of return on private savings. If the income test is severe, it could even result in economically inefficient hiding or transfer of assets and other avoidance behaviours.
- **The eligibility rules for the public pension**. If the eligibility age is relatively high (and the safety net for welfare benefits is significantly less generous) then people wishing to retire before that age have a strong incentive to save for that purpose.
- **The presence of policies to incentivize or subsidize private saving**. If these policies involve a substantial fiscal cost, this is a potential threat to the fiscal viability of public pensions. The economic value of any expected net increase in aggregate saving resulting

from the incentive regime needs to be assessed against the prospect that public pension entitlements might have to be trimmed in order to meet the cost of funding the incentives.

- **Investment in financial literacy and information.** For a given level of public pension, the amount of private saving for retirement can be expected to be higher where there are clear and objective financial reporting rules and a financially confident population that understands the risks and payoffs from voluntary saving in a well regulated market.

Part 4: Assessing options

Additional cost pressures will come onto the pension system over the next few years as the number of superannuitants starts to increase and the momentum will pick up in the 2020s. Depending on the relative importance placed by the government of the day on pensions as against other taxation and spending options, fiscal responses could involve full preservation of pensions but large adjustments elsewhere in the budget, or different degrees of change in pension policies themselves.

This paper is concerned with the broad directions of possible pension policy change, assuming that some change is contemplated for reasons of long-term fiscal affordability and political sustainability. It is less focused on any particular target amount of cost reduction, since that remains to be determined and in most instances the parameters of any system can be scaled up or down. However it does recognise that it is the net fiscal impact of a whole pension change package that needs to be assessed; some elements can be boosted if others are trimmed back.

These final sections therefore look at three possible future structures for the retirement income system in New Zealand. Each option accords a somewhat different importance to the eight objectives and concerns that were presented in Part 2 and this flows through into the way each approaches the issues and trade-offs presented in Part 3.

A major challenge will be to judge whether the set of values and priorities that underlie the design of each option are a reasonable reflection of the values held by New Zealanders across the demographic spectrum. This is particularly important for options that entail considerable change from the current structure.

Finally the paper offers a checklist of points to consider when evaluating the options.

Possible future structures

Based on New Zealand's history with retirement income policy experiments and the nature of recent national and international debates, one can envisage (at least) three ways in which policy might evolve. Whichever new direction eventuates, it is likely to have resulted from a process of public debate and analysis that reflected the concerns of the day. The three structures that are discussed here have each been advocated previously for New Zealand and versions of each have benefited from considerable analysis in the past. The three possible structures are:

A. A compulsory retirement saving scheme
B. A dual structure for the public pension
C. A scaled back version of the current system

It is not intended to go into these structural options in any depth here. The aim is to draw attention to those aspects of each structure that reveal the relative weight being given to the eight objectives from Part 1 and the positions they take on the issues that were raised in Part 2.

A: Compulsory retirement saving scheme

The primary reference example for this structure is the compulsory Retirement Savings Scheme (RSS) that was put to a public referendum in September 1997. The National/ NZ First coalition agreement at that time had committed the government to ensure the best scheme was designed for the referendum. A group was set up in the Treasury to advise the then Treasurer (Hon Winston Peters) whose Party had proposed the idea.

A key consideration for the design was to reduce the government's long-term NZS funding requirement and this was done by allowing the income from annuitised savings balances to replace NZS. As the scheme matured, government spending on superannuation was projected to fall away significantly[47]. It needs to be remembered, however, that the scheme relied on the ability of the government to make a series of tax cuts reaching up to 8% of income in the initial years of its implementation to help people meet their contributions without significant changes in disposable income[48]. The net fiscal impact of the RSS was not expected to become positive until much later.

Contributions[49] were to be made by individuals, helped by a proposed programme of annual tax cuts, into competing private sector funds (as with KiwiSaver but without the subsidies) and invested in a diversified portfolio, subject to regulatory oversight. Contributions were only compulsory on incomes above a specified minimum amount. Furthermore, contributions could stop once a saver's balance had reached a specified target amount.

The target amount of savings was set high enough to allow a person to purchase a standard, whole of life, inflation-indexed annuity at the level of NZS[50]. Those whose savings balances failed to reach that target would receive a top-up amount from the government that would allow them to purchase the standard annuity.

Although it was heavily defeated in the 1997 referendum, the RSS's design details were recognised by the World Bank as technically among the best it had seen, because it sought to address many of the criticisms that are sometime raised against compulsory saving schemes.

A number of features of the scheme relate to the policy objectives and the issues that were raised in Part 2.

Issue 1 - the basic pension guarantee: universal or targeted

The standard RSS annuity to be provided at retirement (age 65) was guaranteed to be at least as good as the rate of NZS at the time of retirement. However, the cost to the taxpayer would be restricted to any top-up that may be required to meet a shortfall in individuals' savings. In effect, the compulsory contributions from individuals' own incomes would provide the means by which their entitlement to taxpayer assistance could be proportionally withdrawn.

Thus the policy emphasis would shift from taxpayers funding a universal flat rate payment (the "citizenship dividend" objective) to funding top-up grants targeted to meet a minimum basic income (the "income support" objective).

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47 Treasury's long-term fiscal model projections in the publicity material in New Zealand Government (1997), p14 showed NZS expenditure as a percentage of GDP on a steeply declining path as the RSS matured and by 2059 it was projected to be just over 2%, compared with 12% in the absence of the RSS.

48 Op cit, p8. Nevertheless, Appendix 4 showed a considerable number of wage earners and social welfare beneficiaries would face a reduction in their disposable incomes.

49 The contribution rate was to start at 3% of income and increase over the first few years of the scheme to 8%.

50 Women had the same RSS savings target, despite a standard annuity being more expensive for them to purchase because of their longer average life expectancy. In order to preserve gender neutrality, the government would pay women a top-up amount to enable them to purchase the same annuity as men.

Issue 2 - social protection versus earnings replacement

Compulsory savings schemes shift the relative policy emphasis towards earnings replacement and the objective of “lifetime consumption smoothing”. Social protection is basically preserved, but slightly weakened because the RSS minimum guaranteed annuity would be indexed only to inflation, rather than to average weekly earnings as with NZS.

The shift towards the lifetime consumption smoothing objective was deliberately limited by removing the compulsion to save once a person had reached the target amount of savings. Beyond that point, saving reverted to being a matter of voluntary choice. In this way, the RSS still recognised the value of the “voluntary saving” objective, but assigned it a lower weighting.

Issue 3 – the transition to retirement

The RSS scheme would remain clearly distinct from the welfare benefit system, with 65 remaining a fixed age of qualification to receive the new standard annuity, as under the current system. People from overseas retiring here without fully meeting the years of residence test could claim a proportionate government top-up for purchasing their annuity. This might be regarded as a modest blurring of the benchmark for recognising the past contributions of New Zealanders to civic and economic life and is another signal of some shift away from the current rationale for NZS.

Issue 4 – early and late retirement options

The RSS scheme did not allow flexibility to claim an early retirement annuity. In keeping with the scheme’s focus on targeting income support, the present system of income tested benefits for people under 65 would remain.

With regard to later retirement, people who continued to work beyond age 65 were still required to purchase an annuity when they turned 65 and any government top-up they required would be calculated at that time. They could however elect for that annuity to be deferred[51]. By adopting a requirement for compulsory annuitisation at a fixed age, the scheme was clearly focused on helping private annuity providers minimise the problems and costs associated with adverse selection and moral hazard.

The RSS guaranteed that each cohort would receive via an annuity at least the amount of NZS payable in the year they turn 65. Because of the difference in the indexation used for NZS and annuities, this implies that over time different age cohorts would start to receive different standard annuity amounts and the scheme would start to diverge from the principle of equal pension amounts to everyone over age 65.

Issue 5 – interactions between public policy and voluntary saving

It is likely that a scheme like the RSS would create offsetting reductions in voluntary saving, so the total pool of national saving might not grow as much as expected. Furthermore, there would be a strong incentive on those who do not expect to reach the target saving level to try to avoid the compulsory contribution requirement, since each additional dollar contributed under the RSS acts to reduce the top-up from the government.

[51] No government income support would be available while someone is deferring their annuity.

B: Dual structure for the public pension

This option harks back to the conceptual structure of the 1938 Social Security Act and its subsequent endorsement by the 1972 Royal Commission on Social Security, chaired by Sir Thaddeus McCarthy. For 40 years to 1977, age benefit and universal superannuation provided an income tested benefit at 60 and an untested, (initially) smaller universal provision at 65[52].

Both the 1972 and 1988 royal commissions argued that, provided there was an income-tested age benefit sufficient to protect against poverty and allow older people to participate with dignity, a universal payment in old age that recognizes merit and general contribution (i.e. a citizenship dividend) does not necessarily need to be set at the same level.[53] Indeed, the 1988 royal commission went as far as to recommend that the rate of universal superannuation should be set at half the rate of an income-tested age benefit.

A generic example of a dual structure option, drawing on some of the observations and recommendations from the two royal commissions, would have the following features. Examples of possible parameter values, given in square brackets, are taken from the 1988 royal commission's recommendations. These should definitely not be taken as the final word however, since the policy environment and economic conditions have changed since the time of their report.

The structure would comprise:

- A means-tested age benefit, available to qualifying people [at age 65]. The rate of payment and its annual adjustment would be similar to the current NZS.
- Closer integration of working age benefits and the retirement benefit. For reasons of fairness and adequacy some changes would be made in rates and conditions of other categorical benefits that support people not yet eligible for age benefit who are unable to participate in the labour force over an extended period [including relaxation of a work test for people unemployed for more than 12 months, a living-alone allowance, some relaxation of abatement and perhaps removal of the joint income test on couples].
- A second tier universal superannuation payment available at a later age [68 years] and paid at a lower rate [half the rate of age benefit].
- A tax-neutral, unsubsidised environment for voluntary saving. In practice this might involve phasing out the present government subsidies on KiwiSaver.

This structure would reduce the long-term cost of public provision by reducing the level of the universal component of the public pension, increasing the age at which universal superannuation became available and removing subsidies on voluntary saving. There would be some partially offsetting costs from raising the level of income support for people approaching retirement age.

Issue 1 - the basic pension guarantee: universal or targeted

The dual system would restore the basic pension structure to the way it operated prior to 1977.

52 The system that applies today might be considered to be a version of a dual system – an income tested benefit available before age 65 and a universal pension from age 65. However the relative rate structure is quite different, as can be seen from Table 3. An income-tested unemployment or sickness benefit pays only 53% of the level of NZS (in the case of a single person living alone).

53 The 1972 Royal Commission noted that although the gross payment rates of age benefit and universal superannuation were at that time the same, the latter was taxable, giving a lower amount in the hand. The Commission supported retaining rough parity but only as long as the adequacy of age benefit and other benefits were not thereby prejudiced.

> *"In many ways we found that the emotionally-charged question whether social security should be selective or universal is really a non-issue. There can be no clear-cut choice between the two; both seem to have a place, as they already have in New Zealand"*[54]

However, by reducing the generosity of the universal component this option places increased emphasis on the objective of income support. Recognizing the contribution of the elderly through a citizenship dividend remains an objective, but the level of that recognition is reduced in comparison with the goal of social protection.

Issue 2 - social protection versus earnings replacement

This option accords a clear policy priority to the income support objective over lifetime consumption smoothing. By advocating a "pure" form of voluntary saving, this option places the responsibility for smoothing consumption firmly back on the individual.

Issue 3 – the transition to retirement

This option invests in improving the integration between the benefit and pension systems. This reinforces its focus on income support and the objective of improving wellbeing by providing more realistic choices for people with employment limitations.

Issue 4 – early and late retirement options

The age of eligibility for universal superannuation would rise under this option. The choice to retire earlier is made more feasible under this option through the relaxation of a work test for a categorical benefit for older people, but the income test for age benefit will tend to make it unattractive for people with higher earning capabilities to retire early.

For those earning above average wages, the incentive to continue working (and saving) to a later age could be increased as a result of the lowering of the rate of the universal payment, relative to the current structure of NZS.

Issue 5 – interactions between public policy and voluntary saving

The dual pension structure effectively differentiates between two groups of earners:

- People with good lifetime earnings prospects. They will receive a clear signal that universal superannuation provides a guaranteed but very modest base of retirement income, on which it is their responsibility to build sufficient private savings to enjoy a comfortable retirement.
- People with relatively low lifetime earnings prospects, for whom the age benefit offers the best chance of a modest but comfortable retirement. They will have little incentive to save during their working life and it will make more sense for them to use their current income to meet essential needs at the time.

Arguably, in comparison with a compulsory saving scheme, this provides a fairer and more efficient solution to the problem of allocating income to consumption or saving over the life cycle among a diverse population with different priorities and preferences.

54 Royal Commission of Inquiry (1972), p14.

C: Scaled back version of the current system.

This third possible future structure contains essentially the same components as today's system but with some modifications designed to reduce its projected fiscal cost while retaining its key features. The reference example is based on recommendations to modify NZS taken from the 2010 Review of Retirement Income Policy (Chapter 6), supplemented by some cost reductions in the KiwiSaver programme intended to support the overall fiscal affordability of the system[55].

Under this example, scaling back the current system would involve the following suggested changes:

- Move the NZS indexation formula from de facto wage indexation to a mix of price and wage indexation.
- A gradual increase in the age of eligibility for NZS, from 65 to 67 over the period 2020 to 2033.
- The introduction of a transitional, means-tested benefit for people potentially affected by the rising age of eligibility for NZS.
- Progressively remove government incentives and subsidies on KiwiSaver, while retaining its automatic enrolment with the choice to opt-out.
- Invest more heavily in financial literacy and public information flows in order to improve planning, budget management and investment decision-making skills in a tax-neutral environment.

Issue 1 - the basic pension guarantee: universal or targeted

This option retains the existing universal pension structure, thereby preserving the current high value placed on equal entitlement and social cohesion and avoiding the costs associated with changing to means testing entitlements.

Issue 2 - social protection versus earnings replacement

Social protection remains a clear priority ahead of earnings replacement. But the idea of an adequate living standard requiring a guaranteed minimum income in a fixed relativity to average weekly earnings has been modified in the light of evidence that the material living standards of older people is on average better than the population as a whole. The discussion in Part 1 on the income support objective noted that hardship among older people is probably less related to the lack of a basic income than to more specific situations. The 2010 Review (Chapter 4) suggested that measures targeted at risk factors are more likely to succeed in reducing poverty among vulnerable groups of older people.

The proposal to invest in budgeting and financial management skills is another way in which Option C promotes a broader interpretation of what social protection requires.

This option, like Option B, advocates a more level playing field when it comes to private saving for retirement and places increased importance back on the voluntary saving's objective of people taking personal responsibility for planning and managing their financial futures.

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[55] The 2010 Review did not make any recommendations to change the KiwiSaver scheme but instead proposed that it be more thoroughly assessed at the time of the Retirement Commissioner's next report, due in 2013. In the meantime the 2011 Budget announced several changes to the scheme. This option builds from the post-Budget version of KiwiSaver.

Issue 3 – the transition to retirement

As part of the scaling back of the current system, the effect of the rise in NZS eligibility age on people nearing retirement would be cushioned by a transitional benefit. Furthermore the gap between benefits and NZS rates would not continue to expand at the same rate as under the current structure. The gap would however remain larger than is proposed under Option B.

Issue 4 – early and late retirement options

There would be little change in the current system's incentives to retire early or late.

Issue 5 – interactions between public policy and voluntary saving

In preserving the flat rate, non-income tested NZS, Option C would continue the current structure's weak interaction between public pensions and voluntary saving. People would not be disinclined to save by the prospect that this would affect their public pension entitlement. Given that many KiwiSaver members are in a default scheme, the removal of government subsidies might not result in a significant drop-out rate, although some voluntary contribution rates might decline.

The evaluation process

The three future policy structures discussed in the previous section are summarized in Table 4 in terms of the changes each appears to make to the weightings of the eight objectives or concerns of retirement income policy. If other structures or reweighting patterns were thought to be practicable, then they could also be subjected to a similar analysis.

Table 4: Reweighting of policy objectives under three possible future structures

Objective/concern	A: Compulsory saving	B: Dual pension system	C: Scaled back current structure
Income support	Slightly downgraded	Upgraded	Slightly downgraded but refocused
Citizenship dividend	Disregarded	Retained but downgraded	Broadly unchanged
Wellbeing	Slightly downgraded; restricted choice	Slightly upgraded	Broadly unchanged
Voluntary saving	Downgraded but partially preserved	Significantly upgraded	Upgraded
Lifetime consumption smoothing	Upgraded, but limited	Slightly downgraded	Slightly downgraded
Cohort self-funding	Upgraded	Upgraded	Broadly unchanged
Risk pooling	Upgraded for high earners; slightly downgraded for basic incomes	Downgraded for high earners; maintained for age benefit recipients	Broadly unchanged
Fiscal restraint and investment	Upgraded over the longer term	Upgraded	Upgraded
Other issues	*Investment risks shifted from government to individuals.* *A 40 year mixed system transition.*	*Difficult transition for dropping the universal superannuation rate.*	*Relatively easier transition and cross-age buy-in.*

From the eight objectives or concerns listed in Table 4 one can perhaps think of the first four as being broadly "social" in nature, with the last four being "economic or technical". Table 4 suggests that the compulsory saving structure would entail an overall shift in weightings from social to economic/technical concerns. The dual pension structure shows a more mixed pattern of reweighting, while the scaled back current structure shows less reweighting overall, as would be expected.

All three of the structures are judged to pay increased attention to the "fiscal restraint and investment" objective. This follows directly from the purpose of the exercise which was based on a perceived need to make the current system more fiscally affordable in the long term.

Where does this type of analysis lead us? Table 4 shows how different future retirement income structures might entail changes in weightings being assigned to various public policy objectives and concerns. It does not, however, offer any insight on whether New Zealanders collectively would accept such a reassignment of values. Nor does it recommend any specific process of public consultation and coalition-building that could lead to a new structure being widely accepted.

Part 1 of this paper discussed the challenge of achieving stable pension reform, especially change that involved a shift in the incidence of costs and benefits. This needs to be kept in mind when considering the issues listed in the final row of Table 4.

Kiwi priorities, attitudes and values

In his recent book "Fairness and Freedom: A history of Two Open Societies: New Zealand and the United States", historian David Hackett Fischer explores how the foundational values of these two nations ("liberty/freedom" in the US and "fairness" in New Zealand) help explain the different trajectories of legal and social development each has taken and why the relative emphasis accorded to liberty and fairness in each country continues to influence their political and social choices.

The point here is that the design of major public policy cannot automatically draw on examples from other national settings without considering whether there are deeply held values that restrict their applicability to New Zealand.

Even an appeal to the notion of fairness as the way to judge the merits of a policy may be unhelpful since, as Fischer points out, many different ideas of fairness have been voiced by New Zealand interest groups and parties across the political spectrum and New Zealand has a highly developed language of fairness[56]. Furthermore, restructuring in New Zealand has seen a concern for more open and free institutions being blended with and added to a tradition of fairness and natural justice[57].

It will require considerable effort and skill to figure out just where New Zealanders of various ages and backgrounds are likely to stand on any particular pension reform proposal. Even the resounding rejection of the compulsory saving proposal in the 1997 referendum does not necessarily indicate the attitudes of people today, since other political factors were at play at the time.

[56] Fischer (2012) p 5-14. Fischer claims that his is the first book to be published on the history of fairness.

[57] "The main finding in this history of restructuring might be summarized in a sentence. New Zealand added liberty and freedom to fairness and justice; the United States added liberty and freedom to freedom and liberty" Op cit, p 473.

A brief evaluation check list

Evaluating structural change to the retirement income system needs to ensure not only that the fiscal burden of pension provision is manageable but that each of the eight policy objectives and concerns are adequately addressed. Where particular attention has been placed on some objectives at the expense of others, we need to be confident that this reweighting accords with the values and priorities of the population at large and is accepted as a fair solution.

Evaluation therefore needs to be made using a range of ratings and criteria, including the following.

The story line

Are the messages about income security in old age and the need for self-provision clear and consistent? Is there understanding of the issues among both working age adults and retired people?

Happiness

What are the expected effects of a pension reform on overall wellbeing and personal freedom among each group affected? Note that wellbeing can be as much in the anticipation and pursuit (self-determination) of future gratification and in the challenge (facing the risk of failure) of seeking happiness than in reaching an end-state[58]. Thus aspects of voluntary saving may also contribute to happiness.

Fair sharing

What is the incidence of the costs and benefits resulting from restructuring? Note that adjustment burdens need not necessarily be shared equally, but neither should they be focused solely on one previously advantaged group. Similarly, if the gains from the reform are concentrated only on a previously disadvantaged group it will be difficult to achieve broad acceptance[59].

Incentives and behavioural responses

Has the assessment of a reform fully factored in the likely behavioural effects of changes in incentive structures? This assessment may need to include not just labour market, retirement and savings responses but also potential lobbying behaviour to resist change, and behaviours to avoid targeting mechanisms, overseas migration and volunteering behaviour, family bequest decisions and so on.

Implementation and transition

Is the time frame for implementation and transition realistic? What are the risks associated with rapid versus slow transition paths and how much transitional assistance should be provided and to whom? Is there a greater risk of policy reversal under a rapid or a gradual implementation timeframe?

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[58] Schubert (2012)

[59] The 2010 Review of Retirement Income Policy deliberately proposed a range of policy changes partly for these reasons.(p 117)

Conclusion

It is clear that, under current policy settings, public expenditure on pensions (mostly NZS, but including KiwiSaver subsidies) is going to absorb an increasing share of the budget over the next several decades. This is just one component, albeit a major one, of the long-term fiscal outlook that the external panel has been asked to test.

Changes in the size and composition of the budget could affect resource claims, the distribution of income and wealth, migration, relative prices and New Zealand's competitive position and growth prospects. Assessing the economic implications, merits and long-term sustainability of different overall fiscal strategies are matters that the external panel and the Treasury will be considering.

It is not the job of this paper to argue for any particular priority to be placed on adjustments to pension policies as against adjusting other spending or taxation policies and parameters. It needs to be kept in mind, however, that a significant change in any of these components of the Budget will interact with others so that the eventual impact on individuals' welfare could be significantly different from the first round effect. For example, the way in which public health spending or housing assistance is reviewed has clear implications for the assessment of whether a particular level of pension will meet its objectives.

Instead, the aim of this paper has been to highlight the issues that arise with changes that are driven by a concern with the fiscal cost and long-term sustainability of retirement income policies. The size and time profiles of the spending reductions that are sought are of less immediate concern for this paper than the direction of reform, since it is the direction and type of reform that will determine what sort of pension structure New Zealand will end up with.

For that structure to be sustainable it will need to continue to satisfy the expectations of the majority of citizens that it meets its more important objectives. This could require occasional reassessment and re-evaluation.

The three possible future structures presented in Part 4 were chosen to illustrate how assigning different relative weights to the eight policy objectives could deliver quite different results. These would include differences in the level and distribution of retirement incomes across age cohorts and among individuals with different working age incomes and life expectancies. At the same time, each possible structure carries its own risks and uncertainties in terms of the employment, earnings, saving, investment and retirement responses of New Zealanders. The effect of these responses, interacting with other policy settings and the external economic environment, on productivity and growth needs to be modeled carefully.

It needs to be emphasized that other reform options are possible and could be subjected to the same sort of analysis and evaluation as suggested in Part 4.

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