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IN CONFIDENCE

6 September 2000

Chair
CABINET POLICY COMMITTEE

PRE-FUNDING NEW ZEALAND SUPERANNUATION: FUNDING ARRANGEMENTS

Executive Summary

1. This paper is one in a suite of papers on pre-funding New Zealand Superannuation (NZS). New Zealand's population is ageing. We need to start preparing now for the impending bulge in the cost of New Zealand Superannuation (NZS) that will accompany this trend. By setting aside some Crown resources toward retirement income now, while we can afford it, we will be able to smooth out the cost over time.

2. To ensure we can deliver NZS in the future, we must take care that the funds set aside are not available to the government of the day for any purpose other than the payment of NZS. The investment of the proposed Fund for NZS will need to be managed on a prudent commercial basis by an independent Board that is not subject to political direction.

3. The proposed Fund for NZS is not a conventional "fully funded" superannuation scheme that would meet all the future costs of pensions – to do so would require a massive reallocation of government expenditure and would be unrealistic. Rather, the approach is better described as "smoothed pay as you go". It builds up funds for around the next 25 years in order to meet part of the costs of NZS in the future. Eventually, the Fund will be run down.

4. The Fund will also manage the flow of pay as you go funds from the government to the Department of Work and Income for current NZS payments as well as putting aside funds to meet the increase in future NZS costs. In doing so, it will bring together the retirement income provision for all New Zealanders, superannuitants both current and future.

5. This paper seeks agreement to the policy for pre-funding NZS, and to the process for establishing a Fund for NZS. In order to meet our objective of

establishing the Fund by 1 July 2001, it is important that we decide on the key parameters of the scheme. These are set out in this paper.

Introduction

6. Security in retirement is an important issue for all New Zealanders. NZS is the sole source of income for nearly half of those aged over 65 years. People who are now in their working years look ahead to when they will retire as part of an ageing population with real questions about how and whether the state-funded pension will be there for them.

7. Since the Election, I have been discussing and working up the detail of the policy for funding the future costs of NZS. I have received a series of Treasury reports on the details of the establishment of the Fund and its fiscal implications and affordability. These have been compiled into a working document, which is attached. Reference should be made to that document for more detail on specific aspects of the content of this pre-funding proposal. However, it should be noted that parts of that document were originally prepared as early as January 2000, and the precise details of the policy have evolved over the intervening months. Nonetheless, it is a useful reference. The chapter references in square brackets throughout this paper are to the relevant chapters of the working document.

8. In the Budget Policy Statement, we foreshadowed the establishment of a Fund with technical assumptions about contributions to pre-funding over the next three years. In the 2000 Budget's Fiscal Strategy Report, we went into more detail, providing for contributions to the Fund in the ten-year progress outlooks. The 2000 Budget Economic and Fiscal Update included provision for pre-funding in the forecast financial statements. These demonstrate that the proposal is affordable while fully meeting all our other fiscal objectives.

9. We now need to:

- confirm formally the Government's commitment to establishing the Fund;
- make the detailed policy decisions that are required; and
- determine the process for its legislation and implementation.

Why Pre-Fund?

10. We have already agreed to the parameters for NZS entitlements. We must establish a means of findings the costs associated with those entitlements and do so in a manner that provides New Zealanders with a sense of security about the availability of NZS in the future.

The Problem

11. Under current arrangements, annual payments of NZS are expected to rise from their current levels of about 4% of GDP to around 9% of GDP over the

next fifty years. The basic driver in this is that the baby boomers (those born between 1946 and 1965) will all start to receive NZS at age 65 and then continue to receive it for about 17 years on average. The proportion of the population aged over 65 is expected to increase from the current 12% to 25% by 2050. And this is not entirely a temporary bulge. Falling birth rates and increasing life expectancy are expected to result in ongoing superannuation payments being much higher than present levels. *[Chapter 4 Demographics and the Ageing Population]*

12. If we do nothing to prepare for this future, the sustainability of retirement income policy will be called into question. NZS will require an increasing proportion of government expenditure, when there are less people in the workforce to generate the income to pay for it. Although there are now about 6 workers per superannuitant, by 2050 there will be only about 2 workers per superannuitant. It is both unfair and unrealistic to expect the relatively small future proportion of workers-to-superannuitants to have to meet these costs through their taxes at the time, especially while we are much better placed now to save for those future costs.

13. If the tax burden had to rise significantly in order to meet the expected increase in costs, New Zealand would become less attractive as a country in which to live and work. This would just compound the problem.

14. Our objective has to be to make our retirement income policies more financially sustainable. The objective is neatly summarised in the way we are defining sustainable development: "meeting the needs of the present generation without compromising the ability of future generations to meet their own needs" [CAB(00)M17/1D(1)]. We want to put ourselves in a better position to honour the retirement income expectations of present generations without placing an undue burden on the incomes of future generations.

Alternatives to Pre-funding

15. The proposed Fund for NZS is not a conventional "fully funded" superannuation scheme that would meet all the future costs of pensions – to do so would require a massive reallocation of government expenditure and would be unrealistic. Rather, the approach is better described as "smoothed pay as you go". It builds up funds for around the next 25 years in order to meet part of the costs of NZS in the future.

16. Having set NZS entitlements at their current level, pre-funding provides a means of financing the future increases in costs associated with those entitlements. In this way, pre-funding is an adaptation of the existing NZS scheme rather than an entirely new approach to retirement income policy. It augments payments from general taxes, which will continue to meet the bulk of NZS costs.

17. Instead of pre-funding, the Government could finance the future cost of NZS by conscientiously continuing to reduce net borrowing to zero and only then building up net positive financial assets; or establishing a general

government fund of financial assets. Establishing a separate dedicated Fund now rather than first paying down debt is preferred for two reasons.

18. First, having to make explicit annual provision for funding of future obligations brings home to the present the cost of future retirement income obligations. The political reality is that, without that discipline, the demands of current expenditure would be likely to dominate, and continuing to rapidly pay down Crown debt much below the comfortable levels we already enjoy would not receive the same priority. Nevertheless, even with the pre-funding scheme envisaged in this paper, net debt levels will continue to fall as a percentage of GDP over the coming years.

19. Second, I do not pretend that there is any “free lunch” from the higher returns likely to be obtained from investing in risky financial assets. However, there certainly are benefits for the financial position of the Crown as a whole from diversifying its portfolio of assets and liabilities. This Government has already made moves in this area with our recent decisions on the Government Superannuation Fund (CAB(00)M11/1G). While building up a general government fund of financial assets would also achieve this end, it would not give people confidence that NZS could be paid in the future. A dedicated fund would much better provide this confidence.

Wider Implications of Pre-funding

20. The economic implications of pre-funding are not as significant as the economic implications of the retirement income policies being financed - that is, NZS rates and the tax policies accompanying them. Changes to NZS rates and tax policies affect savings, investment and economic growth considerably more than decisions about whether to accumulate financial assets or pay down debt. Pre-funding may mean that the government will hold higher levels of both assets and liabilities than it otherwise would.

21. The economic effect of pre-funding compared to paying off debt will depend on whether the interest paid on government debt is greater than the interest earned on government assets or vice versa. In part, the return earned on assets will be affected by the governance arrangements around the assets and therefore whether or not they are invested for maximum return. The return on funds invested is likely to be higher than interest paid on government debt if the funds are invested in high yielding assets. However, the higher return must make up for the greater risks and higher management costs associated with investing compared to debt repayment.

22. Pre-funding may also have an impact on the economy through any changes individuals make to their savings behaviour as a result of the Fund being established. It is not clear what impact this would have on overall private savings. People may see retirement income policy as more secure as a result of the Fund being established. Greater certainty about public retirement income provision may enable them to better plan their private retirement income provision and may increase savings or lead them to decrease their personal savings if they believe NZS will be adequate to meet all of their retirement income requirements.

23. Pre-funding could also lead to different behaviour by the Government. It may provide a fiscal discipline that debt repayment would no longer provide once debt reaches low levels.

24. In making the contribution to retirement income policy more certain, pre-funding would shift fiscal risks onto other spending policies. This would mean that other policies would bear both a greater proportion of the risk of variability in tax revenue and fiscal demands due to economic shocks, and the residual risk arising from the variability in investment returns on the fund. I see this as an essential element of establishing the appropriate priority of a long-term and stable retirement income policy relative to other spending policies. *[Chapter 3 Implications and Broad Parameters of Pre-funding]* Having said that, where there are exceptional economic circumstances, there will be some flexibility in the amount to be put aside.

Affordability of Pre-funding

25. About $2 billion in excess of the (after-PAYE) cost of NZS will need to be contributed to the Fund per year initially. This will tail off to zero over the next 25 years or so. While affordable in the longer term, when the Budget Policy Statement was prepared in March we considered that this initial requirement could potentially be too much to impose all at once without compromising other short-term fiscal objectives for debt and spending. The interaction between pre-funding and our other fiscal objectives is set out in the accompanying paper, Pre-funding New Zealand Superannuation: Budget Implications.

26. In the longer term, the amount required to be contributed to the Fund beyond that year's NZS payments will decline as the Fund's assets build up. After about 2025, the Government (and taxpayers) will start to reap the benefits of this policy as the Fund is drawn on to partially meet the annual cost of NZS. *[Chapter 12 Modelling the Contribution Rate]*

Key Elements of the Proposed Fund

27. The nub of the pre-funding proposal is to establish an independently managed Fund with sufficient resources to meet the cost of NZS, both in the present and out into the future. It will involve putting aside resources beyond the annual cost of NZS into a Fund for the next twenty years or so, in order to smooth the effects of the demographic bulge on NZS payments later this century. It will by no means "fully pre-fund" future costs of NZS. It would be more appropriately termed a "smoothed pay-as-you-go" system.[1] The Fund will manage payments to the Department of Work and Income for current superannuitants as well as putting aside funds for the future. In dealing with the retirement income requirements of current and future superannuitants, I see the Fund as a mechanism for delivering intergenerational harmony.

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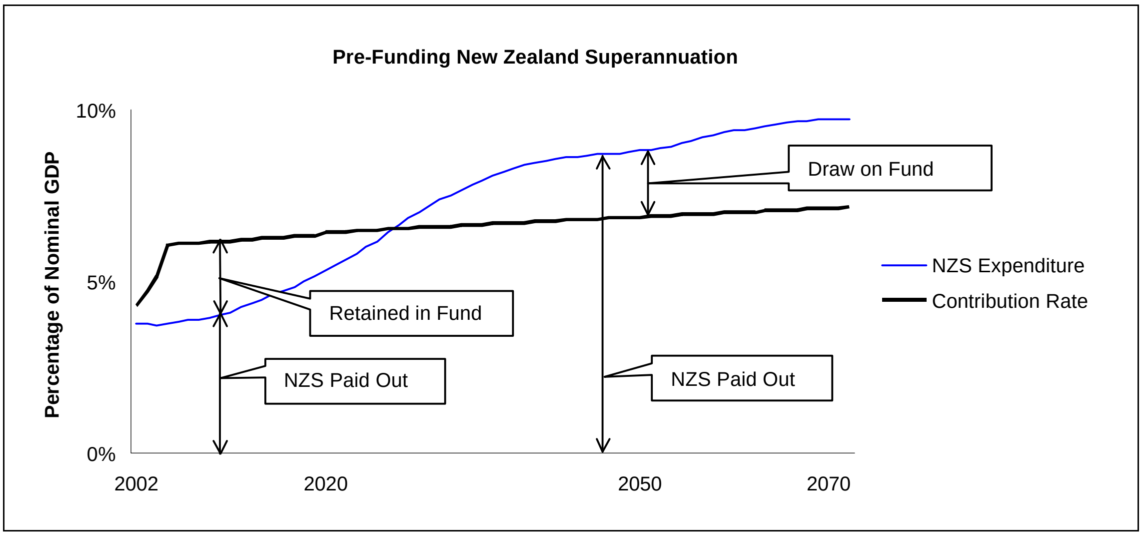
[1] In the distant future, the Fund's assets will be run down and NZS will revert to a fully pay-as-you-go funded system.



28. The Fund would be managed independently, at arm's-length from the government of the day.

29. New comprehensive legislation for retirement income is proposed, encompassing entitlements, funding arrangements, governance and investment objectives. The second Part of the new legislation will cover the parameters for the pre-funding proposal (funding arrangements, Fund governance and Fund investment objectives). It will also set out a process for other political parties to publicly "sign up" to parameters for pre-funding and a process for agreeing changes to these parameters. A similar process will be set out for entitlements in the first Part of the Act (as described in Pre-funding New Zealand Superannuation: Entitlements). Political parties could agree to entitlements or funding arrangements or both.

30. For a Fund to be effective and enduring, it will need to garner wide political commitment. I believe the Fund will attract wider political support once it is established. The sooner pre-funding is introduced and the Fund's balance grows, the more likely it will achieve public support that other political parties will find difficult to ignore.

Funding Arrangements

31. A rigorous process for financing the Fund needs to be established so that there is public confidence that the Government is contributing the appropriate amount to the Fund each year. It is crucial that the contributions to the Fund are linked directly to the future expenses for NZS, so that there is a clear objective that the funding path must meet and so that the public can see when that funding objective is being met.

32. It is proposed that each year, as part of the Budget preparation, the Treasury would calculate the level of annual funding required. This would be on the basis that if the rate were to be held constant as a proportion of projected GDP, it would be sufficient to finance the expected costs of NZS entitlements

(after PAYE tax) over a rolling forty-year timeframe. *[Chapter 7 Contribution Rate Review Process]*

33. In the normal course of events, this is the amount the Government would contribute to the Fund. In exceptional circumstances, the Government may choose to deviate from that “required” rate. If that occurs, full disclosure would be required, including a statement of its implications for future required contributions and how the Government will get “back on track” and make up the shortfall as a part of its long-term fiscal strategy. *[Chapter 7]*

34. The ten-year Progress Outlooks for the 2000 Budget assume that the contributions for the first three transitional years will be less than the full required rate, and that the required rate is met from the fourth year onwards. This carries forward the technical assumptions that were made for the Budget Policy Statement. The actual amount of contribution for the first year will need to be decided as part of next year’s Budget process, but I do not envisage this being less than the $600 million “technical assumption” that was in the Budget Policy Statement.

35. The Fund would provide the Department of Work and Income with the funds to make NZS payments as required and would invest the balance. *[Chapter 7]* After about 2025, the annual NZS payments will start to exceed the annual required contribution to the Fund and the Fund will start being drawn on to help finance the cost of NZS. The exact year this starts will depend on the performance of the Fund over time and on future expectations about the relative cost of NZS. *[Chapter 12 Modelling the Contribution Rate]* To doubly ensure the integrity of the Fund, I envisage that the legislation would prescribe that the Fund cannot be drawn on until after 2020.

Governance of the Fund

36. The Fund would be a portfolio of the Crown’s financial assets managed by an independent Crown entity Board named the Guardians of New Zealand Superannuation. *[Chapter 8 Governance Arrangements for the Fund]* The Government will consult with organisations representing older people, employees, employers and the savings industry to identify people to nominate for the Board. However, members would be required to be appointed on the basis of their commercial expertise, and not as political interest group representatives.

37. The Board would be responsible for managing the Fund on behalf of the government. This would involve investment management of the Fund and ensuring sufficient cash is available for the Department of Work and Income to pay current NZS expenses. The Board would not be responsible for determining the contribution rate nor for determining the policy parameters for NZS entitlements – those aspects would rightly remain with the government of the day. *[Chapter 8]*

38. The Board would have full powers to establish the underlying fund management structure. This would include contracting with professional fund managers who would carry out the day-to-day operation of the Board’s

investment strategy. *[Chapter 8 & Chapter 9 Illustrative Fund Management Structure]*

39. The Board would be subject to the usual accountability and reporting requirements on Crown entities. Its governance arrangements would be consistent with the Crown entity reforms recently agreed by Cabinet (CAB(00)M19/1i(1)). In addition, the Board would be required to produce audited financial statements of the Fund, and to ensure that the financial performance of the Fund can be transparently assessed. *[Chapter 8]*

40. In order to ensure that the right incentives are placed on fund managers to make investment decisions that both are best for the Fund and make wider economic sense, the Fund would be subject to normal taxation rules. *[Chapter 10 Tax Status of the Fund: Tax Avoidance and Investment Behaviour & Chapter 11 Foreign Tax Treatment of the Fund's Investments]*

Investment Objectives

41. The legislation would require the Board to manage the Fund on a prudent commercial basis independently of the Government. The Board of the Fund would not be subject to any routine Government direction. To do so would compromise a key element of the rationale for establishing the Fund. There would be a limited capability for the government of the day to make directions that supplement the "prudent commercial basis" rule, but these would not be able to compromise the independent commercial management of the Fund. *[Chapter 6 Investment Objectives]*

Financial Implications

42. The 2000 Fiscal Strategy Report and Budget Economic and Fiscal Update included provision for future contributions to the fund in excess of ongoing NZS entitlement expenditure. For the first three years of operation of the Fund, they adopted the technical assumptions from the Budget Policy Statement: $600m in 2001/02, $1200m in 2002/03 and $1800m in 2003/04. These remain our working assumptions, however they will need to be reviewed carefully as part of the 2001 Budget process. I do not expect that we would contribute less than these amounts.

43. There will be costs for establishment of the Board during 2000/01. These have not been provided for in the 2000/01 Budget. This will be in the region of $1 - 2 million. Beyond 2000/01, there will need to be an annual appropriation for the expenses of the Board and its secretariat. This will be in the region of $2 million. Further work will be done on determining the ongoing and establishment costs associated with the Board and will be reported to the appropriate Cabinet Committee.

Legislative Implications

44. A Bill will be required to implement pre-funding and to bring together legislation related to NZS entitlements and financing arrangements. The New

Zealand Superannuation Bill (working title) has a slot on the Legislation Programme with a priority ranking of 2. If we are to have the Fund in place and operational by 1 July 2001 we need to have the drafting of the legislation under way as soon as possible. The Bill will ideally be introduced well before Christmas so that the Fund can begin operations by 1 July. Agreement to the policy recommendations of this paper would provide the basis for drafting instructions to be prepared.

45. I will introduce the Bill, but it will include provisions relating to entitlements and payments for which the Minister of Social Services and Employment will be responsible.

46. I do not propose as part of this legislation any changes to the legislation relating to the Office of the Retirement Commissioner, nor to the periodic reports on retirement income policy.

Regulatory Impact Statement

47. The Regulatory Impact Statement attached complies with Cabinet Office Circular CO (98) 5.

Treaty Implications

48. Te Puni Kokiri do not see any Treaty implications associated with pre-funding as it is simply a means of financing retirement income policies. However, there may be issues for Maori associated with current retirement income policies. These are set out in the accompanying paper, Pre-funding New Zealand Superannuation: Entitlements.

Human Rights Act

49. The introduction of new legislation to implement the pre-funding of superannuation will result in current entitlements to superannuation being subject to scrutiny in terms of the Bill of Rights Act and Human Rights Act. The current entitlements raise issues of potential inconsistency with the discriminatory provisions of these Acts. These issues are set out in Pre-funding New Zealand Superannuation: Entitlements. They will need to be considered carefully in the course of developing the legislation. The key point to note here is that, if this discrimination is not justifiable, the Attorney General will be required to alert the House that there is an inconsistency with the Bill of Rights Act at the time of the introduction of the New Zealand Superannuation Bill. These issues, and other entitlements issues, will be open for discussion during Select Committee consideration.

Publicity

50. It will be important to explain the implications of pre-funding to the public – in particular to ensure that people are aware that the changes do not affect their superannuation entitlements. There will also be a range of individuals and organisations with a particular interest in the details of pre-funding. My staff will

work with Treasury to develop a communications strategy in relation to the implementation of pre-funding.

Consultation

51. The following government agencies were consulted in preparation of this paper: Ministry of Social Policy, Office of the Retirement Commissioner, Department of Work and Income, State Services Commission, Government Actuary, Department of Prime Minister and Cabinet, Ministry of Economic Development, Department of Justice, Te Puni Kokiri, Department of Labour, Inland Revenue Department and Ministry of Women's Affairs. The Deputy Prime Minister's advisers were also consulted.

Recommendations

52. There are both policy decisions and process decisions to be made. I recommend that the Cabinet Policy Committee:

Policy Decisions

a. **agree** to establish a Fund for pre-funding of New Zealand Superannuation;

__Funding Arrangements__

b. **agree** that the required rate of annual funding be the amount that, at a constant proportion of projected GDP, would be adequate to meet the expected costs of the entitlements over a rolling forty-year time horizon;

c. **agree** that Treasury be required to publish annually its estimate of the required level of funding for the coming year in the Budget Economic and Fiscal Update;

d. **agree** that, in the normal course of events, the Government would be required to contribute to the Fund at the level estimated by Treasury but that, in exceptional circumstances, the Government may choose to deviate from that required level;

e. **agree** that, if the Government does deviate from the required level of funding, full disclosure would be required in the Fiscal Strategy Report, including a statement of its implications for future required contributions and how it will get back to the required level;

f. **agree** that the Fund shall not start to be drawn on until at least 2020;

Governance

g. **agree** that the Fund be managed by an independent Crown entity Board named the Guardians of New Zealand Superannuation, and that the Board members be appointed on the basis of their commercial expertise;

h. **agree** that the Fund would be subject to taxation;

i. **agree** that the legislation would require the Board to manage the Fund on a prudent commercial basis, independently of the Government;

j. **agree** that there be only limited provision for the government of the day to make directions to the Board, but these would not be able to compromise the independent commercial management of the Fund;

Political Endorsement

k. **agree** that there be provision for political parties in Parliament to sign up to the entitlements, and to the funding arrangements;

Process Decisions

l. **agree** that new legislation be established that brings together in one Act both the entitlements to New Zealand Superannuation and the arrangements for their ongoing funding;

m **note** that the introduction of new legislation to implement the pre-funding of superannuation will result in current entitlements to superannuation being subject to scrutiny in terms of the discrimination provisions of the Bill of Rights Act and the Human Rights Act;

n. **agree** that the Minister of Social Services and Employment and the Ministry of Social Policy be responsible for the provisions of the new Act relating to entitlements and their payment, and that the Minister of Finance and the Treasury be responsible for the provisions relating to funding arrangements.

o. **agree** that the Fund shall commence on 1 July 2001;

p. **direct** the Treasury, in conjunction with the Ministry of Social Policy, to prepare drafting instructions for the legislation and submit them to the Parliamentary Counsel Office;

q. **invite** the Minister of Finance and the Deputy Prime Minister to establish a process for political consultation and consensus.

Hon Dr Michael Cullen
Minister of Finance