The Treasury

New Zealand Superannuation Information Release

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[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

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THE TREASURY

Kaitohutohu Kaupapa Rawa

Treasury advice on retirement income policy

June 2014

Why are we talking about retirement income policy... again?

- **Treasury intends to include broad recommendations on retirement income policy in the *Briefing to the Incoming Minister***. We want to outline our recommendations for you now on a 'no surprises' basis.

- **These recommendations represent Treasury's first best advice on retirement income policy.** We have conducted a robust internal debate in order to reach these recommendations. There is substantial – but not universal – support across Treasury for the position we have reached.

- **We want to highlight the key judgements underpinning our advice.** Retirement income policy is subject to competing goals and ultimately requires decision-making under uncertainty. We want to be clear and upfront about the judgements we applied to make these recommendations.

- *We welcome your comments and questions on our advice, and would be happy to provide you with further supporting analysis at your request.*

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Focus of section

Retirement income policy is subject to multiple competing priorities

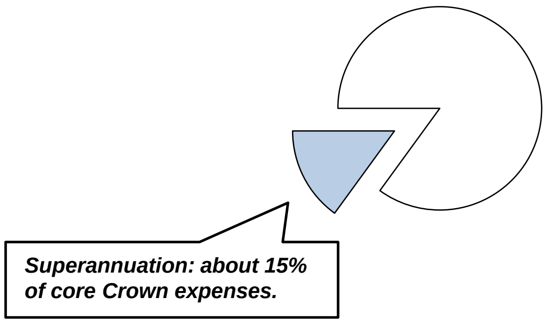
Social welfare

- Retirement income policy is primarily a social welfare intervention. The reason why it exists is to minimise economic insecurity in retirement.

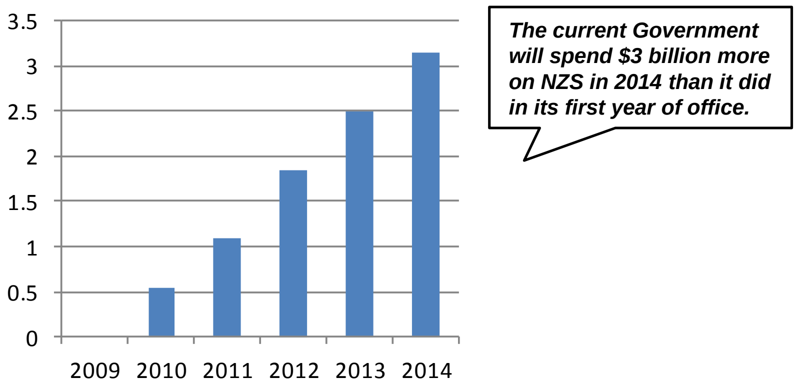
Fiscal

- But retirement income policy also accounts for a substantial proportion of Government expenditure, and is a major driver of past and future increases in Government spending.

Distribution of core Crown expenses
Percent



Cumulative increase in net NZS expenditure
$billion



Macroeconomic

- Retirement income policy is also one important influence, among many, on our national saving performance.

So, in meeting its core social welfare goals, retirement income policy must also respond to the Government's broader fiscal and macroeconomic goals.

Our policy settings also reflect our unique national values and priorities

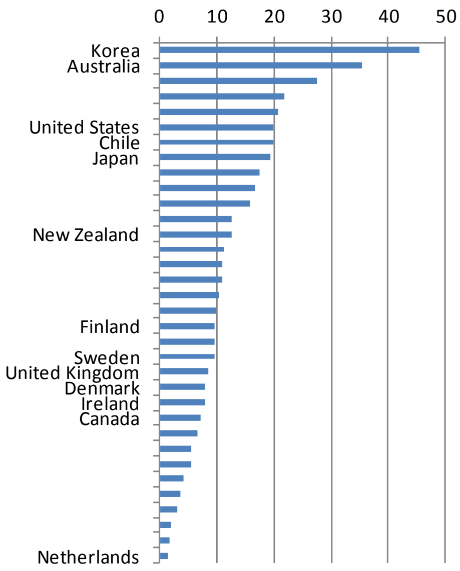
Key setting	Description	New Zealand values	International approaches
NZ Superannuation (NZS)	• A universal pension from age 65: all receive the same NZS rate, regardless of income. • Subject to residency criteria, but no means-testing or contribution requirements.	• All citizens should receive a dividend from their lifetime contributions to NZ society and economy – regardless of how much they earn.	• Universal pensions are rare. State pensions are means-tested or calculated via earnings-related social security contributions in most OECD countries.
Financial literacy	• A strong emphasis on supporting private decision-making on retirement saving, primarily through the Commission for Financial Literacy and Retirement Income.	• The State's role is to alleviate poverty, not force individuals to maintain a certain standard of living in retirement. • Assumption that individuals are best-placed to make decisions about their financial well-being	• Most OECD countries intervene substantially to help individuals maintain their usual standard of living in retirement, via mandatory saving schemes or earnings-related State pensions.
KiwiSaver	• A retirement saving scheme into which salary and wage-earners are enrolled when they start a new job. • No requirement to save via KiwiSaver, but Govt intends to enrol all non-members as fiscal conditions allow. They may opt out after enrolment.	• Break with historical policy when introduced in 2007: it supports consumption smoothing beyond what is needed to alleviate poverty, and rests on a behavioural case that individuals do not always save optimally for retirement.	• KiwiSaver is perceived internationally as an exemplary design. It is inspiring policy change in the UK and Ireland.

Our unique approach actually generates good social & fiscal outcomes

Social welfare

- New Zealand has **moderate rates of old age poverty** relative to other OECD countries.
- Also, despite the absence of a mandatory private saving scheme, the best evidence we have suggests most New Zealanders are saving adequately for their retirement.
- As a result, **retirement income adequacy** is not as pressing a concern for policy in New Zealand as it is in other countries.

Income poverty rates of older people, 2011
Percentage



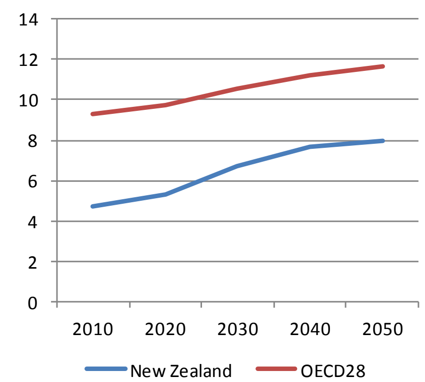
Fiscal

- New Zealand's pension system has **low fiscal costs**.

> ***In fact, New Zealand is forecast to spend <u>less</u> on public pensions in 2050 than the average OECD country spent in 2010.***

- New Zealand's tax expenditure on retirement saving is also low. In some countries (e.g. Australia), tax expenditure is almost as large as direct public expenditure on pensions.

Gross cost of public pensions
Percentage of GDP

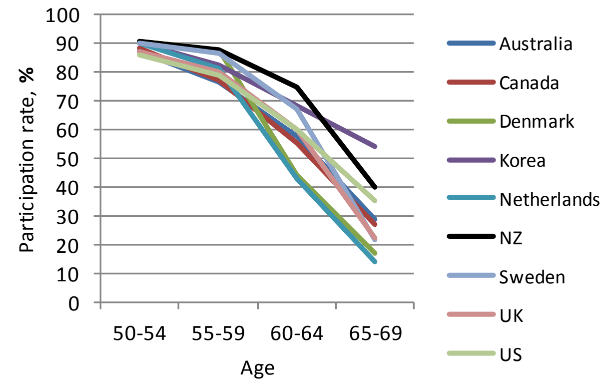


Our policy settings also encourage individuals to work and save

Incentives to work

- There are **minimal distortions** to labour market incentives.
- NZS supports high rates of labour force participation by older people because NZS income is not subject to means-testing or contingent on retirement from employment.

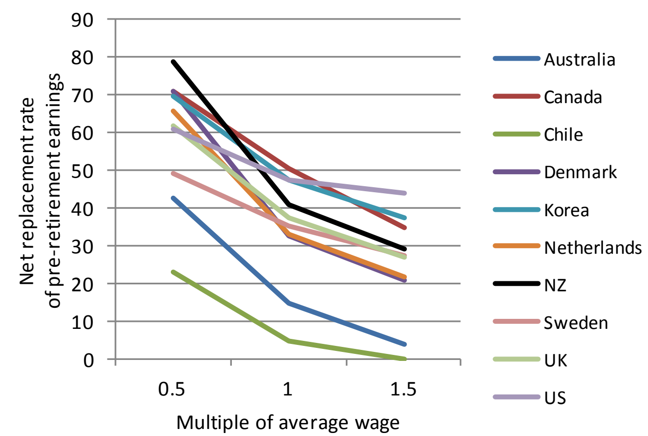
Labour force participation rates by age, 2011
Percentage



Incentives to save

- Retirement income in NZ is funded via public PAYGO and SAYGO (for NZS) and voluntary private SAYGO (e.g. KiwiSaver).
- The heavy reliance on PAYGO to fund NZS will reduce saving, but the design of NZS actually incentivises higher income-earners (who have a bigger impact on national saving) to save more for their retirement...
- ... because the flat-rate NZS entitlement replaces a smaller proportion of their pre-retirement income, so they must save more voluntarily to maintain their standard of living in retirement.

Net replacement rates, public pension schemes
Percentage of pre-retirement income

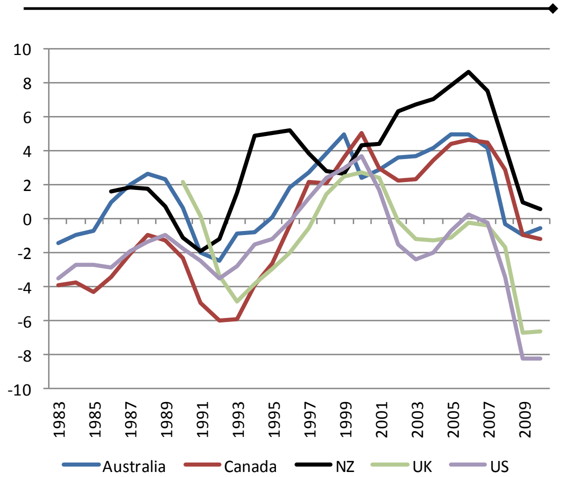


But New Zealand's rate of national saving is low

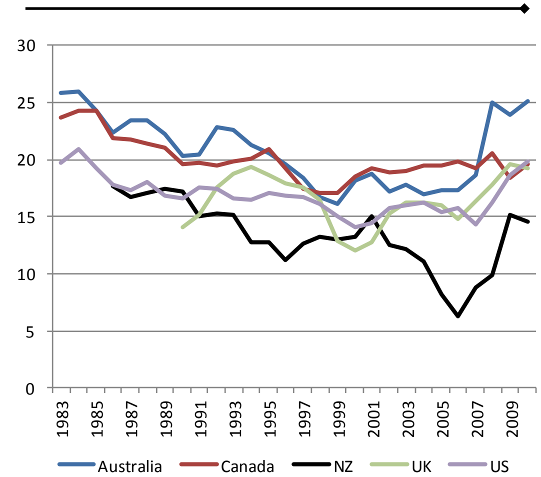
Outcomes

- New Zealand has a low rate of national saving relative to other OECD economies. Our saving performance is primarily driven by private saving behaviour (although there is some correlation between public and private saving rates).

Gross public saving
Percentage of GDP



Gross private saving
Percentage of GDP



Influences

- How can this be if the design of NZS encourages voluntary private saving?

The answer is that retirement income policy is not the only influence on saving behaviour. Other influences include demographics, macro variables (e.g. inflation and the terms of trade), and Government policy in areas like health, welfare and taxation. It is very difficult, however, to isolate the impact of individual influences on saving outcomes.

- Also, there is no doubt that the design of our retirement income policy settings could go further in encouraging or mandating private saving for retirement.

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Focus of section

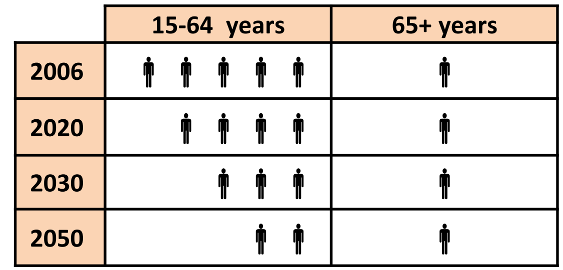
Item
Policy context
Challenges and opportunities
Solutions

Demographic change will challenge our policy settings

Intergenerational equity

- Over time, the number and average life expectancy of retirees is increasing.
- The result: each pension will be need to be paid for out of the taxes of fewer working-age people.
- This will place an increasing tax burden on individuals in each succeeding generation. **Is this durable?**

Projected age group ratios



Fiscal sustainability

- The cost of NZS will increase substantially over the next fifty years. The absolute level of expenditure will continue to be low relative to other OECD countries, but this increase will **reduce Government's ability to manage other calls on its resources** unless retirement income policy is reformed or substantial offsetting adjustments are made elsewhere.
- Rapid, ad hoc adjustments in response to this expenditure path may have significant welfare implications.

This challenge is all about choices. How many of our resources do we want as a society to devote to public pensions versus other priorities?

At the moment, this choice is being made by default. The cost of NZS is increasing on automatic pilot as the number of recipients rises and life expectancy increases.

If we decide now that this outcome isn't what we want, we will have time to plan a smoother adjustment path for those who will be most affected by change.

Reform could also improve our saving and investment performance

Efficiency

- NZS is mostly funded on a PAYGO basis, with some SAYGO funding through the NZ Super Fund.
- Additional retirement income is funded on a voluntary SAYGO basis by individuals.
- The PAYGO-based approach to funding NZS is not the most efficient approach to finance the liability and may generate broader distortions across the economy.

So how might greater SAYGO funding of NZS yield efficiency benefits?

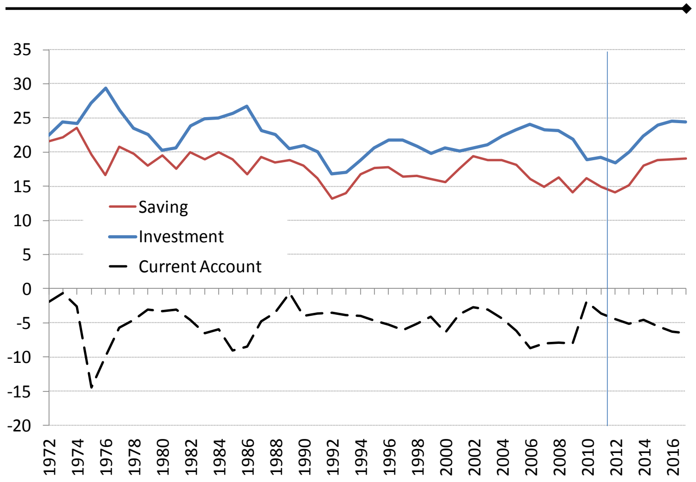
It could reduce the future tax burden, since investment returns are likely to exceed the long-run growth rate of the economy.

It could also improve investment allocation if individuals have adopted unduly conservative strategies to manage investment risk to their own retirement income. Government, a long-lived entity, is better-placed than individuals to invest in long-term, high-yielding assets.

External imbalances

- New Zealand has a high level of net offshore debt due to a persistent gap between national saving & investment.
- These external imbalances imply less resilience to macroeconomic shocks and may have a more subtle impact on economic growth over time.
- Retirement income policy is one influence, among many, on national saving. Policy reform could increase public and private saving.

Gross national saving and investment in New Zealand
Percentage of GDP



The next decade offers a golden opportunity to implement change

- **We have a window of opportunity to effect change**. Over the next decade, New Zealand will be in a demographic sweet spot that will allow us to implement major change with smaller welfare losses for affected generations than will be possible in future decades.

- **Change will hurt, but it doesn't have to hurt so much.** If we act quickly, we can make well-signalled changes that transform the fiscal outlook – and in some cases, the NZS entitlements for affected generations will *still* be greater than the entitlements enjoyed by current NZS recipients.

- **We need to start on the groundwork for change.** Reform in this area requires long lead times, since people need time to adjust and adapt. Change within a decade requires action now.

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Focus of section

There is a wide range of options to effect change

In order to develop informed recommendations, we began our analysis by conducting a high level scan of the full range of options.

Options for consideration

- NZS: raise age of eligibility *and potentially link to longevity*
- NZS: reduce the rate *i.e. change the indexation methodology for NZS*
- NZS: increased public SAYGO *i.e. resuming / increasing contributions to NZSF*
- Private SAYGO: abated against NZS

Note: These options are not mutually exclusive

Options to be excluded

- Fundamental change *e.g. revisiting the basis for age-based pensions*
- Income/asset testing for NZS
- Alternative NZS models *e.g. PAYGO notional accounts, PAYGO defined contribution schemes, flexi-super, social security tax...*
- Other eligibility requirements for NZS *e.g. residency...*
- KiwiSaver incentives

Out of scope

- In-kind benefits *e.g. health, GoldCard*
- Other welfare payments
- Taxation of savings & investment income

  Wider tax system changes

We can provide you with a summary of the judgements that underpinned our scan at your request.

We used the living standards framework to decide which options to assess more deeply – but added another criterion on the tractability of each option, given constraints on resources and timing.

We developed six options in detail to explore different policy directions

	Option		Summary description
Reform of NZS parameters	a)	Raise age of eligibility to 67	Age of eligibility gradually increases from 2020 onwards.
	b)	Adjust age of eligibility for longevity	Age of eligibility gradually raised from 2020 onwards so the average individual in each annual birth cohort can expect to receive NZS for the same proportion of their life.
	c)	Lower the wage floor	NZS rates gradually transition from the current benchmark (66% of the average wage for couples) to 50% of the average wage. Takes effect from 2025 onwards.
Public SAYGO	d)	Greater pre-funding	Resume contributions to the NZ Superannuation Fund (NZSF), funded by a 1% tax on income.
Mandatory saving schemes	e)	‘Abated’ scheme	Mandatory savings balances are used to reduce lifetime NZS entitlements at a 25% abatement rate. Mandatory balances must be annuitised to replace lost annual NZS payments. Contributions are 6% of income and begin in 2020.
	f)	‘Supplementary’ scheme	The age of eligibility for NZS is rapidly raised to 70. Mandatory saving balances are used to fund a bridging pension between the ages of 65 and 70. All individuals must access the bridging pension from the age of 65. The Government provides a top-up at a 100% abatement rate for any individuals whose mandatory balances are insufficient to fund the bridging pension. Contributions are 6% of income and begin in 2020.

The public and private SAYGO schemes are illustrative only. They are not intended to represent Treasury’s ‘ideal’ design. Instead, they are intended to have sufficient depth to allow us to explore the key trade-offs in recommending a broad direction for policy.

Adjusting the age for longevity stands out as the single best option

We used criteria developed for the Long-Term Fiscal Statement to assess the options against the Living Standards Framework.

Assessment criteria	Option (a): Raise age to 67	Option (b): Adjust for longevity	Option (c): Lower the wage floor	Option (d): Greater prefunding	Option (e): Abated scheme	Option (f): Supp. scheme
Sustainability for the future						
Fiscal sustainability	↑↑	↑↑	↑↑	↑↑	↑	↑↑
Economic growth						
Labour force participation	↑	↑↑	↑↑↑	↓	↓	↓↓
Private saving	↑	↑↑	↑↑↑	↓	↑	↑↑
Public saving	n/c	n/c	n/c	↑↑	n/c	n/c
National saving	↑	↑↑	↑↑↑	↑	↑	↑↑
Increasing equity						
Intragenerational equity	↓	↓↓	↓↓↓	↓	↓↓↓	↓↓↓
Intergenerational equity	↑	↑↑	↑↑	↑↑	↑↑	↑
Social infrastructure						
Policy durability	↑	↑↑	↓↓↓	n/c	↓↓	↓
Compliance	n/c	n/c	n/c	↓	↓	↓↓
Ease of administration	↓	↓	n/c	↓	↓↓↓	↓↓
Reducing risks						
Resilience against external imbalances	↑	↑↑	↑↑↑	↑	↑	↑↑
Resilience against economy risk	↑	↑↑	↑↑↑	↑	↑	↑↑
Resilience against investment risk	↓	↓↓	↓↓↓	↓	↓	↓↓
Resilience against longevity risk	n/c	n/c	↓↓↓	n/c	↓	n/c

All assessments are relative to the status quo.
↑ = better ↓ = worse n/c = no change

Our preferred option is to adjust the age of eligibility for longevity.

Longevity adjustments will:

- Resolve permanently fiscal pressures associated with longevity increases.
- Allow for a more balanced mix of (public) PAYGO and (voluntary private) SAYGO funding.
- Increase national saving.
- Fairly distribute costs across generations.

However: We would support a one-off increase in the age as a second-best policy if adjusting for longevity is not politically feasible.

We can provide you with the full details of our options analysis at your request.

The case for further change relies on broader macro considerations

Problem	Impact of longevity change	Impact of further change	Judgement
Fiscal pressure	• Substantially reduces fiscal pressure and places NZS on a permanently different expenditure trajectory.	• All of the other options will further reduce fiscal costs. • But how much should retirement income policy bear the brunt of fiscal adjustment to demographic change?	• There is not an obvious fiscal case for further change.
Intergenerational equity	• Reduces entitlements that current generations *would* have received. • But, if we move quickly, the entitlements that affected generations *actually* receive will still be greater than current entitlements.	• Reducing entitlements further (through abatement or lowering the wage floor) will generate absolute losses in relative entitlements. • But how much should current generations bear the costs of demographic change?	• There is not an obvious intergenerational case for further change.
Efficiency & external imbalances	• Stronger incentives to work and save. National saving expected to increase significantly over time. • But New Zealand's starting position is low rates of national saving and low stocks of capital.	• All of the other options will further increase national saving – some significantly so. • However, some of the options will reduce incentives to work.	• Given New Zealand's starting position, we <u>should</u> consider further change to support saving and capital accumulation, so long as the costs and risks are acceptable.

We support public SAYGO funding in addition to adjusting for longevity

Options	Benefits	Costs and risks	Judgement
Public SAYGO	• Risk diversification: reduces NZS economy risk. • Efficiency: public SAYGO can allow for a more efficient investment strategy if individuals are adopting unduly conservative strategies to manage idiosyncratic risk. • External imbalances: useful tool for managing the cycle. • Efficiency: single large fund generates economies of scale.	• Private saving will reduce even as national saving rises. • Higher investment risk for Crown. • Political economy risk: will future Governments raid the Fund or use it as an excuse to run looser fiscal policy? • Timing of costs and benefits: short term costs are certain, but will long term benefits be realised?	• Requires a judgement that our institutional frameworks are robust enough to quarantine the Fund from other pressures. • This is a line call, but the risks associated with modest pre-funding are unlikely to outweigh the benefits. • We would support modest pre-funding.
Mandatory saving schemes	• Increase in private saving (unlike public SAYGO). • Consumption smoothing: mandatory schemes can help those who do not save optimally for retirement due to behavioural factors.	• Compromises key strengths of existing policy settings (progressivity, incentives to work, ease of administration). • Measures to mitigate negative impacts likely to reduce public and private saving generated by scheme. • Policy durability: schemes will not generate expected fiscal savings if the abatement mechanism breaks.	• Mandatory schemes have major costs & risks. • Absence of major income adequacy problems, and existence of KiwiSaver, substantially undermine behavioural case for mandatory saving. • We do not support a mandatory scheme, on its own or in conjunction with any other option.

***Note*: We do not consider lowering the wage floor as an option here because of its significant impacts on old-age poverty.**

There are four key judgements sitting beneath our recommendations

	Impact of alternative judgements	When would we change our judgement?
Judgement 1: National saving goals should not dominate other policy goals.	• Placing more weight on national saving goals would strengthen the case for the wage floor option and the SAYGO options.	• If raising national saving were deemed to be an overriding national priority and no other policy levers were available to achieve the outcomes we sought.
Judgement 2: We place a strong weight on welfare impacts.	• Placing less weight on welfare impacts would strengthen the case for the wage floor option and the private SAYGO options.	• If current policy settings imposed an unmanageable fiscal burden. • If raising national saving were deemed to be an overriding national priority and no other policy levers were available to achieve the outcomes we sought.
Judgement 3: We do care about impacts on future generations.	• Placing less weight on the interests of future generations would weaken the case for all of the options, and particularly for the SAYGO options.	• If current generations suffered a substantial but temporary shock to their lifetime earning potential (e.g. war, pandemic, economic depression).
Judgement 4: KiwiSaver is already a good response to behavioural concerns	• The case for a mandatory saving scheme would strengthen if we thought that KiwiSaver responded inadequately to behavioural constraints against saving.	• If new evidence emerged that KiwiSaver was inadequate or ineffective.

We think our recommendations are fair, durable and effective.

- **Fairness and durability are crucial to the success of policy reform.** Previous changes to retirement income policy that did not work within the grain of New Zealand's values and institutions have failed to endure.

- In the *Briefing to the Incoming Minister*, we will recommend:

    - **Adjusting the NZS age for longevity.**
    - **Restarting contributions to the NZSF as fiscal conditions allow.**
    - **Maintaining KiwiSaver as a vehicle for voluntary private saving.**

- We have also identified one major gap in existing policy settings – regarding the decumulation of KiwiSaver balances. We intend to assess whether there is a need for Government intervention in this area in the medium term.

- **Overall, our recommendations build on the strengths of existing policies and, we think, fairly distribute the costs of change.** We welcome any comments or questions you may have on them, and would be happy to provide further analysis or information at your request.