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IS SUPER REALLY SO HARD?

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## IS SUPER REALLY SO HARD?

### Introduction

Many of our politicians act as though retirement income policy is the 'third rail' of New Zealand politics: touch it and you're dead. Arguably, however, the trauma is self-induced. Its sources are largely the broken political promises and abrupt, unforeshadowed decisions on superannuation by governments. But if we stand back and take a longer view, I suggest a considerable measure of consensus has emerged over the last 20 years, at least among those who understand the issues.

To support this claim, which may seem surprising to some, I suggest that the following propositions about retirement income are now relatively uncontroversial:

- (i) The key issue is economic growth. People in retirement are dependent on a productive economy for the real goods and services they need.
- (ii) There should be greater reliance on private provision (personal responsibility) and less on the state (other people).
- (iii) Given what people earn in their working years and the present shape of New Zealand Superannuation (NZS), most people are making rational decisions about saving. Treasury work has established that it would not be logical to expect them to save more. People in the 45-55 age bracket are saving at levels that would enable them to maintain their consumption in retirement. Lower income people who consume at the NZS level would be worse off if they saved more.
- (iv) The present level of NZS is at least adequate. There is no significant problem of old-age poverty as was the case in earlier times; other groups, particularly low-income workers with children, find it harder to make ends meet. The reduction in the benefit from its earlier relationship to average earnings is widely accepted, and

there is no great pressure to increase it beyond the current '65 (percent of average weekly earnings) at 65' level.

- (v) NZS is now properly understood as part of the general welfare safety net, and based on need. It is a fallacy that superannuation is an entitlement because "we paid for our pensions", and this claim is now seldom heard. For the same reason, there is no support for a public earnings-related scheme.
- (vi) The increase in the age of eligibility from 60 to 65 years is well accepted.
- (vii) People at or near retirement should, if at all possible, be protected from any future changes to NZS.

All this seems to me to represent substantial progress. In addition, I think there is considerable if not the same level of agreement on two further points:

- (viii) Compulsory savings schemes have little to recommend them. Superficially, they may seem attractive; polls sometimes suggest people look favourably on compulsion. The problems come when you try to design a practical scheme. Inevitably, it is a chamber of horrors of stunning complexity and subject to interminable changes. None of New Zealand's expert task forces has recommended compulsory savings. A reasonably well designed scheme was promoted by the National-New Zealand First government. Initially polls suggested it had majority support but when voters came to understand it, support collapsed and 92 percent gave it the thumbs down in the referendum.
- (ix) Similarly, tax incentives for savings are a poor policy: they are inefficient, inequitable and don't work. No tax review or retirement income group has recommended them. The National Party was foolish enough to go into the last election promoting a tax incentive, which was probably sufficient evidence to persuade many people that it was not yet fit to govern.

We may not have heard the last of proposals for compulsory savings and tax incentives. But it is now fairly well understood that they reflect partisan politics or vested interests, not the general public interest.

- (x) Finally, there is the Cullen fund. I shall return to this later but whatever view you take of it, there is general agreement that its impact is small. Even finance minister Michael Cullen has acknowledged that future governments may have to make changes to NZS.

Thus, contrary to those traumatised by the 'third rail' syndrome, my view is that the country has moved a long way towards the non-partisan, stable consensus on retirement income policy that most people want. Moreover, we have ended up with a scheme that compares quite well internationally, given the mess many countries' pension schemes are in. Indeed the London Pensions Policy Institute, whose director Alison O'Connell was in New Zealand earlier this year, has commended it as a model for Britain and other countries. I think we owe a debt of gratitude to people like Jeff Todd, Michael Littlewood and Angela Foulkes who have done much in recent years to help get us to this point. The upshot is a solid platform on which last year's Periodic Report Group had a chance to build. The question they faced was no longer: has New Zealand got an unsustainable scheme? Rather, it was: has New Zealand got the best possible scheme for the next 50 years and beyond?

### **Periodic Report Group 2003**

The Periodic Report Group (PRG) was set up as required by the Retirement Income Act 1993, which reflected efforts to promote a broad a-political accord on policy. While many have viewed the process cynically, the Business Roundtable has always attached importance to promoting public understanding and consensus on superannuation. We put some effort into making submissions to the PRG, as did Business New Zealand, whose submissions were on similar lines.

When we met with the PRG members last year, we urged a number of general points on them.

First, we suggested their report should emphasise the positive trends in policy and public consensus on retirement income over the past 20 years, so that outstanding issues could be brought into sharper focus.

Secondly, we stressed the importance of the PRG operating in a non-partisan way, given the Accord background, and not shy away from critically evaluating aspects of government policy such as the Cullen fund.

Thirdly, we noted that although the government was clearly trying to steer the group into relatively narrow areas, such as work-based savings, and away from commenting on its own policies, the PRG's legislative mandate and its terms of reference nevertheless permitted the broad review intended by parliament. In particular, the terms of reference required the group to "make suggestions for the adjustment of any of the Government's retirement income and savings policies in order to enhance the provision of private retirement income." We pointed out that NZS has a powerful influence on private savings decisions, and argued that the PRG was duty bound to grapple with the issue.

Fourthly, given the paramount importance of growth, we submitted that the PRG could not avoid commenting on any government policies that it regarded as anti-growth and recommend superior pro-growth policies. (It was supported by experts who could assist in this task.)

Finally, we said the exercise (for all those involved with it, including submitters) would be a waste of time unless the group produced more than a bland document. To be of any lasting value, it had to 'push the envelope' into areas which would inevitably be controversial.

Judged by these criteria, the report is a disappointment. It reflects the way the government sought to shape the agenda. There was no engagement with criticisms of the Cullen fund made in submissions and by other political parties. The importance of economic growth was recognised but then brushed over. While correctly noting that New Zealand faced no immediate crisis, the report said "there is no room for complacency about the current system's ability to provide for future cohorts [of retirees]". In this context, it mentions possible changes to the age of entitlement for NZS, the rates of

benefit and the case for targeting NZS. However, the report then shies away from any serious discussion of these issues, claiming it “was not within our remit to do so”, even though the terms of reference clearly allowed scope. Having laboured to produce a mouse, the PRG’s report barely made the news reports on the day it was released, and it has already been forgotten.

Before going on to suggest what the PRG should have done to contribute to the retirement income debate, let me acknowledge some positive features of the report.

First, it did not buy into the argument sometimes heard that “the voluntary approach has failed”. As the Treasury research shows, most people are making rational savings decisions, given the incentives created by NZS.

Secondly, the report did at least recognise the central place of NZS in the debate, and it did note that the universal nature of the benefit scores poorly on equity grounds.

Thirdly, it lent no support to compulsion or tax incentives for savings, confirming these are largely dead issues among knowledgeable practitioners. This is to the credit of a group chaired by a representative of the savings industry.

Finally, the report made sensible comments on some minor issues, including work-based schemes and education. It was also sound in not supporting proposals for mandatory prospectuses for work-based superannuation schemes or proposals for mandatory regulation of investment advisers.

### **What the PRG 2003 should have said**

The French have a useful expression ‘deblayer le terrain’, meaning to clear the ground. The PRG ought to have begun by dispelling the pessimism that is sometimes expressed about the superannuation debate in New Zealand, and highlighting how far we have got. We do not compare badly with our Tasman neighbours, for example; in a recent editorial *The Australian* lamented the “dire state of the debate on retirement income” in

Australia, and said “There is ample evidence that Australians are not saving enough to fund our own retirements”, despite the country’s plethora of compulsory arrangements and tax inducements. Then the PRG should have zeroed in on what really matters for the future, namely (i) growth, (ii) the key elements of NZS, (iii) the largely irrelevant Cullen fund and (iv) policies that would make it easier for people to save for their own retirement.

### **(i) Growth**

In respect of growth, the picture is clear-cut. New Zealand now has a much better structured, efficient and flexible economy, largely as a result of the economic stabilisation and liberalisation efforts of governments in the 1980s and early 1990s. These improvements have led to higher productivity and stronger economic growth. However, the country is still falling well short of its potential. Two years ago Michael Cullen said that by the middle of this year it will be clear whether the government is on track to achieving its goal of lifting the per capita growth rate to put New Zealand back into the top half of the OECD income rankings. This year’s budget projections will confirm New Zealand is not on such a track. Further policy improvements to facilitate improvements in business performance are needed to achieve an acceleration of growth.

Economists who should know better sometimes say that the causes of growth are not well understood. However, as a recent International Monetary Fund paper refreshingly argued, “promoting economic growth is simple: *It’s entrepreneurship, stupid!*”<sup>1</sup> Countries that want entrepreneurship to flourish adopt institutions and policies that protect private property through the rule of law, keep levels of taxation and regulation low, pursue stable prices and fiscal discipline, promote open markets and competition, and emphasise rigorous education and the avoidance of welfare. Or as the recent Hong Kong budget put it, ‘big market, small government’.

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<sup>1</sup> Beaugrand, Phillipe, ‘And Schumpeter Said, “This is How Thou Shalt Grow”: The Further Quest for Economic Growth in Poor Countries’, IMF Working Paper WP/04/40.

Retirement income and welfare policy more generally are relevant to such a growth strategy. New Zealand cannot achieve fast growth with government spending at all levels at around 40 percent of the economy. High levels of government spending are a large drag on the economy through the deadweight costs of taxation (which in New Zealand's case are probably in the region of 30-50 cents at the margin for every dollar of revenue raised). Unless the economy grows faster, the goods and services needed by the increasing proportion of the population that is elderly will not be available. All groups in the community therefore have a stake in faster growth, which among other things requires lowering the government spending share in the economy, and hence constraining NZS which is the largest element in government spending.

**(ii) New Zealand Superannuation**

On present projections, NZS is expected to grow from its present level of under 4 percent of gross domestic product (GDP) to almost 8 percent by mid-century. The main options for constraining this growth are changes to the level of NZS, targeting the benefit and increasing the qualifying age.

– ***Level of NZS***

The Organisation for Economic Cooperation and Development (OECD) has described NZS as 'generous'. The level of the benefit is higher than New Zealand's other long-term benefit, the invalids' benefit.

My judgment is that there is not a lot of scope to reduce NZS benefits without creating hardship, but that the ratio of the benefit to average earnings could be allowed to fall over time as incomes grow. The 1988 Royal Commission on Social Policy recommended that NZS should be aligned with the invalids' benefit, and the age pension is aligned with the disability pension in Australia. There is also a good case on equity grounds for focusing on the actual bundle of goods and services that people in retirement need. The benefit could be set on this basis and adjusted from

time to time following an explicit public debate, rather than being indexed to wages (or even prices, as in the United Kingdom).<sup>2</sup>

The level of NZS directly affects the incentives for private savings for retirement. Since many people regard the present level as adequate relative to their living standards in their working years, it is no surprise that they do not save more themselves – the government is doing the job for them. If the benefit were raised, even fewer would save – and vice versa. If we want greater self-responsibility, the level of NZS in relation to average earnings is an issue that we cannot avoid debating.

– ***Targeting the benefit***

NZS is now paid on a universal basis rather than according to need. The long-run tradition in New Zealand since old-age assistance was introduced in the 1890s has been for retirement income benefits to be subject to income and sometimes asset tests. There are no good grounds for requiring the general taxpayer to subsidise people with high incomes or substantial assets, as the PRG observed. None of the earlier superannuation task forces favoured a universal benefit.

Targeting does create disincentives to save for those affected but a universal scheme is costly, involves massive income churning, and creates savings disincentives for all taxpayers. There can be a fair debate about the design of a targeted scheme, but at the very least it is hard to see why those in the top income and wealth categories should be eligible for a welfare benefit. An income and asset test applies in Australia and enjoys broad political support.<sup>3</sup> Is our politics really different?

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<sup>2</sup> For arguments for adopting such an approach, see Buchanan, Cathy and Peter Hartley (2000) *Equity as a Social Goal*, New Zealand Business Roundtable, Chapter 5.

<sup>3</sup> Means testing is an important reason for the lower cost of the age pension relative to GDP in Australia compared to the cost of NZS in New Zealand. The Australian government's 2002 Intergenerational Report put the current cost at 2.93 percent of GDP, rising to 4.59 percent in 2041-42. Another interesting statistic is that earlier Australian Treasury studies had shown that the costs would be only 0.28 percent higher in 2050 if the national superannuation scheme did not exist.

Brian Toohey, 'Long-overdue time to stop long, leisured retirements', *The Weekend Australian Financial Review*, December 24-December 29, 2002.

– ***Age of eligibility***

General economic growth has brought higher incomes and longer life expectancy. It has allowed many people the choice of ending their working lives and retiring on their own savings. People should be free to retire when they choose, but societies with ageing populations are not going to be able to underwrite their living standards on the present basis. Encouraging those who are able to extend their working years to do so is certain to be a common feature of policies in advanced countries in the future.

Already Denmark, Ireland, Iceland, Norway and the United States have implemented or announced plans to raise the age of entitlement to age benefits above 65, and other OECD countries are likely to follow. All these countries are wealthier than New Zealand. We cannot afford to be self-indulgent if we want to join their ranks.

It would make sense to decide well in advance to raise the qualifying age for NZS further, and perhaps to index it to increases in life expectancy. Employment and human rights legislation should be amended to facilitate employment of older workers. Those unable to continue working should be supported by equivalent benefits (such as the invalids' benefit). In effect, all that the government would be saying is that at a certain age – the qualifying age for NZS – work tests for benefits would no longer apply. With a general safety net of this sort, groups with different life expectancies would not be discriminated against.

I do not favour the idea that is sometimes mooted of adjusting NZS on an actuarial basis according to whether a person retires before or after the qualifying age. This proposal fits with the notion of an entitlement or a private superannuation or insurance scheme, not with a safety net concept.

**(iii) The Cullen fund**

The total level of goods and services produced by the economy is the central issue in retirement policy. Money is irrelevant unless the production is there for retirees to buy. From an economic perspective, the difference

between a funded scheme and today's pay-as-you-go scheme is second order.

The Cullen fund only involves a small amount of pre-funding – adequate to cover somewhere between 17 and 25 percent of the annual net cost of NZS as it is drawn down, according to Dr Cullen. Because no changes to NZS, other government expenditures or taxation are proposed, it is largely an accounting exercise with no direct economic impact on the retirement income problem. At most the fund involves a small amount of tax smoothing but this could be achieved more efficiently without the expense and risks associated with the fund by reducing debt further and accumulating reserves to draw on down the track.

The concept also scores poorly on equity grounds. Current taxpayers are being asked to fund both existing retirees and part of their own retirement costs. An Australian academic recently elaborated on this point as follows:

The equity argument is that people should share the tax burden according to their capacity to pay. Because the next generation of taxpayers will have a greater capacity to pay, they should bear a greater tax burden. In evaluating the New Zealand model, ask yourself this personal question: would you prefer that your parents had paid higher taxes so that you could have enjoyed a higher standard of living at their expense?<sup>4</sup>

There is also a moral hazard problem: by creating a false sense of security about the sustainability of NZS, the Fund could discourage private savings. And there is little hope that it will be immune from political meddling – already MPs from at least three political parties have proposed different investment policies. In my view the fund should be wound up as quickly as possible and the proceeds applied to debt reduction. Some have speculated that Michael Cullen's real objective had little to do with retirement income and was really aimed at curbing pressure from within his own party to increase government spending. This laudable goal could be better achieved through explicit spending and taxation limits in the Fiscal Responsibility Act.

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<sup>4</sup> Guest, Ross, 'Myths of an ageing population,' *Australian Financial Review*, 15 March 2004.

#### **(iv) Policies for private savings**

There is no convincing evidence that New Zealand's saving record is poor, either in general or for retirement, given present policies – including notably NZS. The desirable aim of promoting greater private provision requires a focus on NZS. General policies for growth would also raise savings: the evidence suggests that growth promotes savings more than the other way round.

Policy-induced impediments to private saving, especially a high overall tax burden, should also be reduced to give people more scope to save from after-tax income. The income tax in particular penalises savings, and moves to a lower, flatter income tax structure, as recommended by the McLeod Tax Review, are desirable. The focus should be on improving incentives with lower tax rates in general, not specific tax incentives. Improvements in employment law to promote high levels of employment, more restrictive welfare policies and reduced regulatory burdens – including on the savings industry – also have a role to play in promoting private savings.

#### **Conclusion**

The PRG was right to say that “there is no room for complacency” about future retirement provision, but it contributed little to public understanding of desirable policy responses. Yet the challenges are not that formidable. Relative to other countries, New Zealand has a young population, and the ageing of its structure is being mitigated by immigration. Thanks to past decisions, NZS is now a more sensible safety net, and a reasonable level of consensus has been reached on many of the key issues, including the need to protect those who are not in a position to adjust to changes.

Nevertheless, the central issue is not whether we could get by with present arrangements but whether they are the best for New Zealand, given likely future trends. Plainly they are not – judged by various standard public policy criteria they fall short. The PRG states bluntly that “[c]hanges will be necessary” and that New Zealand should use its “window of opportunity before the population begins to age rapidly”. By default, others must now give more substance and urgency to the necessary changes.

I suggest that New Zealand is not being served well by governments that have failed to maintain the momentum of earlier reforms, including on superannuation. Postponing decisions when problems are not immediate leads to a backlog of adjustment and the need for wrenching changes at some point. We have seen that all before. The sooner further decisions are made, even if they are implemented over an extended period, the sooner young New Zealanders will be able to make their own plans and the more secure those in retirement will feel. Notwithstanding the opportunity lost by the PRG, addressing the retirement income problem is not really that hard. Angela MacRae, a very competent Australian superannuation expert who advised both the task forces led by Jeff Todd, has said that if New Zealand took the best bits of the Australian system – its public safety net – and Australia the best bits of New Zealand's – the absence of the paraphernalia of compulsory savings and tax incentives – both countries would have a common system that was the best in the world.

At least in New Zealand's case, that hardly seems a big ask.