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**THE ASSOCIATION OF SUPERANNUATION FUNDS OF NEW
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"MAKE SUPER SIMPLE"

**FROM ENTITLEMENT TO NEEDS:
ABANDONING NEW ZEALAND'S LAST THINK
BIG SCHEME**

ROGER KERR EXECUTIVE DIRECTOR NEW ZEALAND BUSINESS ROUNDTABLE	CHRISTCHURCH 9 AUGUST 1998
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FROM ENTITLEMENTS TO NEEDS: ABANDONING NEW ZEALAND'S LAST THINK BIG SCHEME

1 Introduction

Over the life of the coalition government there have been four major events in the superannuation debate. First, a referendum on the retirement savings scheme (RSS) was held in September last year. Secondly, the 1997 Periodic Report Group (PRG) submitted its two reports on the five-yearly review of the retirement income policy framework. Thirdly, the government abolished the superannuation surcharge from 1 April 1998. Finally, the Investment Savings and Insurance Association (ISI) issued in June its report on retirement savings, *A Wake-up Call*. As a further development, the level of commitment to the Accord appears to have weakened.

On the face of it, recent events could suggest that superannuation policy is in some disarray. A more detached view suggests this is not necessarily the case.

2 What has been established?

The most important point on which there is now wide agreement is the one that the Business Roundtable has emphasised all along, namely, the central importance of economic growth. The need to improve the economy's growth performance is the main message of the ISI report. It provides a good platform from which to move forward.

The ISI observed that the conclusions which flow from its research "seem stark and obvious". The report argues that it is necessary to raise the rate of economic growth, remove impediments to savings and investment, and limit government spending. It states that these policy areas need to be addressed "without delay". The view of the PRG that adjustment could be delayed was correctly judged to be too complacent. Overall community welfare, including that of future retirees, is best safeguarded by addressing superannuation arrangements earlier rather than later. In keeping with this view, the OECD has advised member governments to take action now to maintain prosperity in an aging society.

The ISI recognises that the material living standards of future retirees will largely depend on the volume of goods and services produced by those in employment. People cannot eat dollar notes in their retirement. They must be able to exercise claims over real goods and services. The retired elderly are ultimately dependent on a productive economy to meet their material needs.

In the past few months the IMF, the OECD and credit agencies have all commented adversely on New Zealand's economic performance. The IMF noted that growth has slowed, the structural fiscal surplus has been reduced, private saving is low, competitiveness has deteriorated and the large current account deficit makes New Zealand vulnerable to external shocks such as the crisis in Asia. Business organisations have been making the same points.

Since the mid-1990s New Zealand has not maintained an active growth strategy. The annual rate of growth has been slowing since 1995 and this year may see a standstill. We are not within sight

of achieving the goals of 3.5–5 percent growth (National) and 6 percent (New Zealand First) targeted by the coalition partners. This performance bodes ill for future living standards, including those of the elderly.

The most important step the government could take to advance the income security of all New Zealanders would be to reactivate a bold growth strategy. The major policy errors since the mid-1990s have been the blowout in government spending and the virtual standstill on microeconomic reform. MMP has compounded the problem. We are seeing a string of low quality decisions such as the Clayton's package of \$300 million of spending cuts, the draconian interventions in the electricity market, the backward moves on the Auckland Regional Services Trust and the failure to reform labour legislation, to name just four in the last two months. The backdown on employment law will mean unemployment will continue to rise. The recent OECD report on New Zealand noted that we are no longer on a path of convergence with higher income OECD countries. Living standards for all age groups will be unsatisfactory if policies are not adjusted in ways consistent with the ISI's emphasis on enhancing growth.

The second point that has been established is that a compulsory savings scheme is not a credible policy option. The argument over the RSS was not about public versus private provision. The underlying premise was that private provision should increasingly be the norm and the issue was whether it should be compulsory or voluntary. That argument has been settled, at least for the foreseeable future.

The third premise of future debate is that income tax concessions for retirement savings are also off the agenda. The argument for concessions has been examined on many occasions over the last decade and it has never withstood close scrutiny. The Todd Task Force, the parties to the Accord and the PRG all concluded against tax concessions. The research commissioned by the ISI also noted the importance of neutral tax arrangements. The report stated that "If investment funds are flowing into particular areas because of tax or regulatory reasons ... then overall returns [to the community] are lowered." Tax concessions for retirement savings are incompatible with a sound growth strategy.

However, it is most certainly the case that taxes, particularly income taxes, discourage savings. The best way to address this problem is to keep government spending, and hence the tax burden, low. The recent loss of fiscal discipline must be reversed. Much current spending is poorly targeted and of low quality. Given sound overall economic management and robust growth, the ratio of government spending to GDP could be reduced to under 20 percent over the next 5–10 years. Government spending is the true tax burden, and such a reduction would constitute a large tax cut. There is no doubt that the current tax burden in New Zealand creates an environment that is hostile to savings.

There are grounds for placing greater weight on GST relative to income tax. An income tax distorts the choice between present consumption and saving. People are discouraged from saving for their retirement because of the cumulative impact of income tax on salaries and wages and on the returns from what they save. In contrast, GST treats current consumption and savings on the same basis. Moreover, a broad-based consumption tax like GST generally treats savings and investment uniformly whereas tax concessions favour particular classes of savings, investment products and institutions.

As government spending is lowered, income tax rates should be reduced faster than the rate of GST. The income tax scale should also be flattened by reducing the top personal and company rates of tax. The deadweight cost of taxes increases more than proportionately as marginal rates of tax increase. A more uniform tax scale would avoid complexities like TOLIS and provide wider efficiency benefits.

In addition to these specific areas of progress in the superannuation debate, community attitudes and most aspects of policy towards retirement incomes have been moving in the right direction for some years. There is now broader acceptance that, for the majority of people, retirement income should be a personal responsibility, not a taxpayer one. This acceptance is likely to grow: young people appear to look less to the government to provide them with a living than their parents have typically done. The cost of New Zealand Superannuation (NZS) has been reduced by raising the age of eligibility and lowering its level relative to wages. The Accord provided a more predictable policy environment.

The removal of the surcharge is the exception to this trend. Many commentators have, however, recognised that its abolition was unwise. The Christchurch *Press* observed in an editorial that the coalition government's search for \$300 million of expenditure savings could be achieved in one stroke if the surcharge were restored. It noted that only 16 percent of superannuitants were affected by the surcharge and they were all earning annual incomes of over \$45,000 (single) and \$75,000 (married). The *Press* wrote that: "Although not popular, the surcharge was accepted by many in the community as fair." Some ministers have also acknowledged that NZS should in future be means tested.

3 What is left to be addressed?

With the primacy of economic growth established and compulsion and tax concessions sidelined, the way has been cleared to 'make super simple'. The key outstanding issue to be resolved is the design of the safety net.

This issue is usually discussed in terms of the level and qualifying age for NZS and whether it should be provided on a universal or targeted basis. But behind that choice is a deeper argument: whether superannuation is a matter of entitlement or needs. Grey Power views superannuation as an entitlement and, as such, it argues that it should be universal. All recent reviews – the 1988 Royal Commission on Social Policy, the Todd Task Force, the PRG and the ISI's report – view superannuation as needs-related and part of the general welfare system.

Several arguments have been advanced for an entitlement approach to superannuation and benefits. One is that welfare should be provided on a universal basis as a badge or right of citizenship. Another is that a universal entitlement should be given to citizens to avoid stigma, to compensate victims of misfortune and to enable people to achieve the level of consumption required to participate in society. Means testing is not always rejected by those who endorse citizenship theory. The 1972 McCarthy Royal Commission on Social Security, for instance, adopted a citizenship perspective in discussing benefit levels but endorsed the continuation of income tests.

In his book *From Welfare State to Civil Society*, David Green argues that universalism intensifies the corruption of vote-buying and middle class subsidies. "Where," he asks, "is the concern for social solidarity in telling people that they can enjoy many benefits at the general expense?" According to Green, a notion of universal entitlements "breeds division and antagonism" rather

than social cohesion. Moreover, an appeal to citizenship and the assertion of rights to welfare do not take us far in establishing sound policies. They are of little help, for instance, in deciding in what circumstances people should be supported by taxpayers, who should be supported, to what level and on what basis.

A large proportion of the tax revenue that is raised to finance universal entitlements is returned to the same taxpayers in the current period or at a later time. This income 'churning' results in high levels of tax with associated deadweight costs that reduce economic growth. For this reason, needs-based support is usually preferred on the grounds that it is least harmful to the economy. Moreover, the transfer of income from people on low and moderate incomes to those who are well off is inequitable.

A needs-based approach to superannuation is the historical norm in New Zealand. The legislation that introduced the old age pension almost exactly 100 years ago was tightly drawn and few received assistance. Applicants for a pension had to satisfy numerous requirements. They had to be at least 65 years of age – a high qualifying age relative to life expectancy at that time – and to possess little or no property or other income. By 1940 only half of all people who satisfied the age criterion qualified for a pension.

The age of eligibility for the age benefit, which replaced the old age pension, was set at 60 for men and women on the introduction of the social security system in the late 1930s. The level of the benefit was increased but it remained modest. In 1945, for instance, the weekly age benefit was equivalent to a day and a half of a labourer's pay and was broadly equal to the family benefit paid to a mother of three children. The means test was retained. It included an asset test which was not abolished until 1960.

Only three-quarters of all elderly people qualified for a state pension of any sort in 1950. A modest universal superannuation scheme had been introduced in 1940. It was intended over many years to replace the age benefit with a non-means tested and taxable payment for residents over 65 years of age. In the meantime universal superannuation was to run alongside the age benefit. The age benefit, in effect, was to become universal at age 65. However, it was not until 1960 that the rate of universal superannuation reached that of the age benefit. Even then, the age benefit was tax free whereas universal superannuation was taxable. With a highly progressive tax structure and a top income tax rate of 60 percent, taxable universal superannuation was in some ways like a targeted supplement to the age benefit.

After the short-lived funded scheme introduced by the third Labour government, the character of New Zealand's safety net was dramatically changed for the worse by the introduction of National Superannuation in 1977. National Superannuation was an unfunded, non-contributory, universal scheme payable at age 60. It was set at a much higher level than the former age benefit. The generosity of the scheme and an increase in the proportion of superannuitants in the population eventually led to the introduction of the surcharge and to other measures to contain its cost.

This quick historical tour indicates that the long-run tradition in New Zealand has been to view income security in retirement as part of the general safety net. Unlike the approach of many other countries, benefits have always been flat-rate rather than income-related and with the brief 1970s exception, schemes have been non-contributory. Moreover, for most of this century means testing has been an integral part of New Zealand's support for the elderly and other welfare arrangements.

It is often asserted that the retired have paid for NZS through their past taxes. Grey Power, for instance, recently argued that "New Zealand's senior citizens have paid their dues" and that "3.7 billion dollars was ripped away from retired New Zealanders during the life of the surcharge." These claims are utter nonsense and their barefaced repetition should be condemned by politicians.

The truth is that successive governments have funded publicly provided superannuation out of current tax revenue, including the short-lived social security charge and tax. They have been pay-as-you-go schemes. An investment fund to finance future public pensions has never been established.

As far back as the 1967 Ross Committee and the 1972 McCarthy Royal Commission, official inquiries were pointing out that annual social security contributions were falling well short of the level needed to fund current pensions and other social security benefits, and they were subsequently scrapped. The McCarthy Commission, for example, stated that:

... although a special Social Security Fund was established to receive the 5 percent (later 7 percent) contribution (or social security tax), this fund was never actuarially funded according to private insurance principles and was never sufficient to meet the total cost of the scheme. It was thus not a true insurance scheme. The basic principle was that people should contribute according to their means and receive benefits according to their needs and not in relation to the amount of their contribution.

There is nothing wrong with funding a safety net out of current tax revenues, but the idea that NZS is something different – more like an entitlement – is an illusion.

In his book *Selfish Generations*, David Thomson of Massey University has examined whether the welfare benefits that the present generation of retirees will receive over their lives will be matched by the taxes that they pay. The former are broadly defined to include social security cash allowances, education, housing, health and other government services. While such calculations raise difficult conceptual and measurement issues, I am not aware of any major challenge to Professor Thomson's general findings. These are that the older generations in New Zealand systematically benefited at the expense of those that came later. He finds, for instance, that the average ratio of lifetime welfare benefits to taxes for a person born in 1930 will be almost 1.8 to 1.

By contrast with an entitlement approach, a needs-based approach to a safety net emphasises individual responsibility. The role of the government is to help people who cannot help themselves and who cannot be supported in other ways. A needs-based approach is generally more equitable and efficient than an entitlement approach because people on low to modest incomes are not taxed to increase the incomes of retired millionaires. In the case of the next group, the broad category of middle-income earners, a non-targeted benefit results in the government taxing one group of people only to return the money to people in a similar category, with all the compliance, administration and deadweight costs associated with such 'churning'. A strong argument can be made that it is only the category of low income earners or those without resources who should be the object of public policy, on either efficiency or equity grounds, through targeted assistance.

Viewed in safety net terms, it is hard to see how the government's welfare responsibility for people in old age differs from its role in respect of those facing other lifetime contingencies, namely to

protect people from hardship. Families are normally expected to be responsible for providing for their own incomes, and the role of the government is limited to providing an adequate income to those without other means in the event of sickness, invalidity or unemployment.

The basic dilemma in designing a safety net is easily stated. Besides its other limitations, a universal scheme is very costly, it imposes a high tax burden and is a drag on growth. Its perceived advantage from a savings perspective is that it avoids the problem of a high effective marginal tax rate on retirees' other income that can arise with targeting – the so-called 'savings disincentive'. This effect, however, is likely to be outweighed by the higher tax rates and greater disincentive to savings associated with an expensive universal scheme which apply to the whole population of taxpayers. Conversely, a targeted scheme imposes a lesser fiscal burden and is less harmful to economic growth. The best way of avoiding excessive marginal tax rates with a targeted scheme is to get overall tax requirements down, to set the benefit at an appropriate level, and to begin phasing it out at a realistic threshold.

The PRG headed in the direction of a needs-based approach. In its interim report, which is to be read alongside its final report, the PRG stated that it supported targeting and regretted the "impending abolition of the surcharge." In its final report it suggested five options which essentially boil down to three: a universal benefit, a part-universal/part-targeted benefit, and a targeted (income- and asset-tested) benefit. There are no sound efficiency or equity grounds for a universal benefit, and the fiscal costs and deadweight losses associated with such a scheme are large. Given that conclusion, it follows that part-universal and part-targeted options make no sense either.

With proper political leadership, I believe there is a good prospect of achieving a public consensus around the idea of a needs-based safety net just as there is solid public support for a state role of last resort in other welfare settings. There are sound equity arguments for such a role. Most people are happy to help people who need help, but are not keen on seeing their taxes going to those who do not. Equity and efficiency arguments for other approaches, such as those involving universal payments, are weak and stand little chance of being politically sustainable over the long run. There may be a case for limiting the impact of targeting on those in or near retirement, but new cohorts of retirees should be given a clear signal about the basis on which they should make their retirement plans.

4 Conclusion

The resolution of the choice between an entitlement- and a needs-based approach to the design of a safety net is the main outstanding issue in retirement income policy. The ISI is pointing in a needs direction – it has said that the issue will be part of the next stage of its work. Universality is essentially another of New Zealand's unfortunate Muldoonist legacies – another think big scheme. Like the others, it should be abandoned; its new lease of life this year will hopefully be brief.

The surcharge was not the best way of re-establishing a needs-based approach. The Labour government adopted the surcharge as a roundabout way of avoiding breaking the letter of its election promises. National also broke an election promise on the issue. The political costs that have been paid for not confronting the issue up-front have been heavy. It is time we had the maturity to approach targeting directly. A sound safety net should be designed having regard to factors such as the qualifying age, the levels of NZS, income abatement rates and asset tests. Australia has achieved a political consensus on an income- and asset-tested safety net and there is

no reason why New Zealand could not do likewise. Doing the necessary analytical work and promoting such a consensus should be a priority for the ISI, ASFONZ and other interested parties.