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IIR '98 RETIREMENT SAVINGS UPDATE

**RETIREMENT INCOME POLICY:
WHERE TO FROM HERE?**

**ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE**

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1 Introduction

I suspect many people see the retirement income debate over the past 15 years as a quagmire, a story of broken political promises and never-ending twists and turns with no conclusion in sight. I take a somewhat more positive view. I believe we have come a long way since the shameful electoral auctions over superannuation in the 1970s.

There is now broader acceptance that, for the majority of people, retirement income should be a personal responsibility, not a taxpayer responsibility. There is greater understanding that living standards in retirement are ultimately dependent on the productivity of the economy, not financial arrangements. The cost of New Zealand Superannuation (NZS) has been reduced by raising the age of eligibility, lowering its level relative to wages and – until last year's mistaken decision to scrap the superannuation surcharge – by targeting. The Accord provided a more predictable policy environment.

Last year's referendum on compulsory superannuation was a diversion, but in a curious way it may have been helpful in advancing the debate. As I see it, the argument over the Retirement Savings Scheme (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. What is also encouraging is what happened when people were exposed to the issues. In February last year polls indicated that 60 percent of people supported compulsion and only 22 percent opposed it. Perhaps the only surprising thing about the September referendum is that 8 percent still supported a thoroughly bad concept – but the time for debate was admittedly short. The result should give us confidence that, given proper information, debate and leadership, the community is capable of changing its views and coming to sound conclusions.

Besides the rejection of compulsory savings, there is now no political constituency for tax concessions, which essentially amount to bribing people with their own

money. This is not to say that taxes don't matter for retirement income; quite the contrary, they have large implications for both economic growth and savings. The point is simply that selective concessions, as opposed to general reductions in spending and taxation, are not the way to go.

So another positive feature of the current state of play is that with compulsion and tax breaks out of the way, the debate can now be refocused on the two issues that should have stayed at centre stage, namely economic performance and the nature of the public safety net. The inquiries headed by Jeff Todd have been helpful in steadily bringing these key issues into focus. In the balance of this paper I want to look first at the fundamental issue of economic growth (section 2), to consider in section 3 the present environment for savings, to discuss safety net issues in section 4, and to address briefly the issue of consensus and stability in retirement income policies in the concluding section.

2 The imperative of economic growth

The general economic context of retirement income policies was set out well in an Australian study in the following terms:

The key to providing high incomes in retirement is the pursuit of policies promoting high economic growth. Policies to this end rarely are focused just on retirement and superannuation issues but cover taxation, government spending, government regulations, labour market arrangements, and the incentive and reward structures facing individuals, private business enterprises and governments. With an expanding economy, most people should be able to self-provide for their retirement income, and should face incentives to save and to consume which are level and fair across their lifetime: the basic role of a government pension is to provide a bottom safety net against the problem of aged poverty.¹

To put the point more sharply, people can't eat dollar notes. Those in retirement are ultimately dependent on a productive economy generating the necessary flow of goods and services to meet their needs. The Periodic Report Group (PRG) quoted Federal Reserve Bank chairman Alan Greenspan to make the same point:

¹ Anstie, R, Freebairn, J and Porter, M, 'Superannuation and government aged pension schemes for a dynamic economy', Centre of Policy Studies, Melbourne, May, 1989.

The bottom line in all retirement programmes is physical resource availability. The finance of any system is merely to facilitate the underlying system of allocating real resources ... [Measures are required] to help ensure that there is enough savings to finance adequate productive capacity down the road to meet the consumption needs of both retirees and active workers."²

It also noted the comment of Michael Joseph Savage:

It does not matter how much we try to manipulate the money system we cannot give the people any more than they are able to produce.³

In the absence of a growing volume of goods and services, population ageing will see an intensified political battle over income shares. Governments will not be willing to impose cuts in living standards on the working population and the claims to real resources of those in retirement will be eroded by changes in taxation, inflation or actual cuts in superannuation benefits.

In its Interim Report, which is to be read in conjunction with the Concluding Report, the PRG devoted the opening chapter to the issue of economic performance. It made the point that "all retirement income is ultimately drawn from the economy, whether through public or private provision". It commended policies that lead to low taxes, tax-neutral treatment of saving and investment, competitive financial markets and low rates of inflation as means of fostering growth.

The International Monetary Fund's recent comments on New Zealand's economic performance had a more critical and urgent tone. 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. Its recommendations included a scaling-back of government spending, further deregulation in areas such as producer boards, labour market and welfare reforms and more private sector competition in health.

² Greenspan, Alan, Testimony to the House Budget Committee, 8 October, 1997.

³ Savage, Michael, debate on introduction of the Social Security Bill, 1938.

In the specific context of retirement income policy it advocated early consideration and implementation of measures to reduce the fiscal cost of NZS, by means such as raising the retirement age, reducing the replacement rate and means-testing benefits.⁴ The connection between this last recommendation and a comprehensive approach to retirement income is that a lower fiscal burden resulting from a more modest safety net would stimulate economic growth and safeguard our ability to produce the goods and services needed by the elderly in the future.

The unpalatable truth is that since the early 1990s New Zealand has not maintained an active growth strategy and its economic performance is no longer outstanding. 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 bodes ill for future living standards, including those of the elderly. The most important steps the government could take for the income security of all New Zealanders would be to reactivate a bold growth strategy.⁵

3. The environment for savings

Savings are important for growth and they are the basis for most private retirement income. The environment for private savings has greatly improved since the mid-1980s with the achievement of low inflation, more efficient financial markets, a reduced bias against savings in the tax system with the introduction of the goods and services tax (GST), some moves towards a more restrictive welfare system including NZS, stronger corporate balance sheets and an end to public sector dissavings.

However, there is still much that the government could do to improve the environment for savings and investment. The recent reduction in public savings – the government's operating surplus – is worrying and should be reversed. Together with the rapid increases in public spending, it has clearly been a factor in the widening current account deficit, making New Zealand more dependent on foreign

⁴ International Monetary Fund, Press Information Notice No. 98/1, January 12, 1998.

⁵ See New Zealand Business Roundtable, Moving into the Fast Lane, March 1996 for a fuller discussion of policies for economic growth.

savings. A continuation of this trend would put at risk New Zealand's sovereign credit rating.

Recently there has been considerable debate about the taxation of life insurance and superannuation. The current tax system creates a disincentive to save through these vehicles because savers are taxed at a standard rate rather than their own, often lower, effective marginal tax rate. The government has exacerbated this problem with the first two (1996 and 1998) instalments of its tax reduction programme, which widen the tax scale. The TOLIS (Taxation of Life Insurance and Superannuation) Group considered ways of dealing with this problem but the only satisfactory solution is to resume the earlier moves towards a more uniform tax scale.

Another issue discussed by the PRG is the favourable tax treatment of housing which biases savings and investment patterns. Attempting to 'level the playing field' by increasing taxation on housing would be messy and politically difficult. Again, the best solution would be to flatten the tax scale by reducing the top income tax rates, thus reducing the concessional treatment housing receives. Local authorities should also cease the practice of treating residential ratepayers more favourably than non-residential ratepayers in setting rating differentials in the mistaken belief that businesses benefit from tax concessions on income tax and GST.

Further reductions in income tax, and in particular in the highest effective marginal tax rates, would be beneficial for savings. Ongoing reductions are dependent on a combination of stronger fiscal discipline and faster economic growth to lower the ratio of government spending to gross domestic product (GDP). Lower taxes are themselves conducive to growth, as the PRG noted. Of particular note in the savings context is the high deadweight losses associated with the taxation of capital income. A recent study of the Australian tax system by Professor Erwin Diewert and Denis Lawrence found that the marginal deadweight loss from tax on capital income in Australia is around 50 percent (ie raising an extra dollar of revenue from this source reduces Australia's national income by 50 cents).⁶

⁶ For estimates of the deadweight losses from labour and consumption taxation in New Zealand, see Diewert, W E and Lawrence, D A, *The Marginal Costs of Taxation in New Zealand*, New Zealand Business Roundtable, 1994.

Another impediment to savings noted by the PRG is the recent investment product and investment adviser disclosure regime. The supporters of the regime have argued that it is less heavy-handed and costly than some comparable overseas ones. This misses the point: the relevant academic literature suggests that mandatory disclosure imposes net costs relative to voluntary disclosure and that these regimes are misguided.⁷ Already overseas issuers have decided against offering products in New Zealand and some employer schemes seem likely to be wound up because of the regime. Such developments are hardly conducive to encouraging voluntary saving, and there is a strong case for revisiting the legislation with greater urgency than proposed by the PRG. An obvious first step would be to allow issuers and advisers to contract into or out of the disclosure regime.

Other policies which would encourage private savings include moves towards greater private responsibility for welfare contingencies and private insurance in areas such as health and ACC.

4 The safety net

Because some people will not be able to provide for their own retirement, other forms of income security are required. Arguably family and voluntary sources should be the means of first resort, but the state needs to provide an ultimate safety net.

The debate over the NZS safety net has been clouded by the issue of its 'sustainability'. In my view this is a distraction. Any government spending programme or policy regime, no matter how badly conceived, can be 'sustained', at least for long periods, as even the experience of countries like Cuba and North Korea demonstrates. NZS could clearly be 'sustained' with higher future tax rates, but at the expense of economic growth and higher living standards for all. The PRG report suggests that consideration of some NZS issues can be deferred because the demographic impact of an ageing population is not immediate. The case for addressing superannuation earlier is that overall community welfare, including that

⁷ See Benston G J, *Voluntary vs Mandatory Disclosure, An Evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Advisor Disclosure*, New Zealand Business Roundtable, 1997.

of future retirees, can be increased by doing so. The PRG could have performed a more useful service by explaining why the sustainability issue is a red herring and evaluating NZS as a welfare policy in terms of standard efficiency and equity criteria.

Its report could also have put to rest the myth still propagated by some lobbyists that NZS is a contributory scheme and that retired people have 'paid for their pensions'. It still does not seem to be understood by many that NZS is simply part of the welfare system, and is financed out of current revenues like other benefits. As far back as the 1967 Ross Committee and the 1972 McCarthy Royal Commission on Social Security, official inquiries were pointing out that social security contributions were falling well short of the level needed to fund pensions, let alone all social security benefits, and they were subsequently scrapped. 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 – still leads some people to put forward proposals such as actuarial adjustments to benefits depending on whether people retire before or after the eligibility age. Such proposals only make sense in the context of a contributory pension scheme.

It is clear that the long-run tradition in New Zealand has been to view policies for income security in retirement as part of the general safety net. Unlike many other countries, benefits have always been flat-rate rather than income-related. New Zealand's initial Old Age Pension of 1898 provided benefits at a very modest level to claimants who were 65 or more years of age – a high qualifying age relative to life expectancy at that time. Moreover, the benefit was subject to strict income and assets tests, and to tests of reputable behaviour – there were strong incentives for personal responsibility. Only a minority were dependent on public provision and the cost amounted to around 0.5 percent of GDP – one tenth of today's level. Interestingly, eligibility rules and administration were tightened rather than relaxed over the next few decades, and although some became more liberal with the Labour government's measures of 1938, retirement income policies remained generally sound and stable until the electoral bidding wars of the 1970s.⁸

⁸ For further elaboration, see Thomson, David, *Welfare before the Welfare State*, Auckland University Press, forthcoming.

Viewed thus 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 case of events such as sickness, invalidity or unemployment. The only difference from other benefits is that in the case of old age there is no need for an explicit test of incapacity to earn an income once a certain qualifying age is reached.

The critical elements of any scheme of public provision of retirement income are whether benefits should be universal or targeted, the level of benefits, and the age of eligibility. The PRG also considered whether there was any case for pre-funding the scheme as proposed by the Labour Party. This would involve some of the unsatisfactory features of a compulsory savings scheme, have high deadweight costs, and be open to the same kind of political interference as the 1938 'contributory' scheme. The PRG was surely correct in seeing little merit in it.

- ***Universal vs targeted benefits***

The PRG report suggests five options for the design of benefits but, like the options presented in the Labour government's 1988 discussion document *Income Security for the Elderly*, they essentially boil down to three: a universal benefit, a part-universal/part-targeted benefit, and a targeted (income- and asset-tested) benefit.

Perhaps the only reason why the PRG included the idea of a universal benefit is that the government has unwisely reverted to this policy. As Susan St John, a PRG member, said of the idea of a universal benefit in commenting on the Labour government's document: "It is dishonest to pretend this is an option".⁹ Faced with the realities of office, I suspect many New Zealand First members would now have second thoughts about the decision to implement a universal benefit. There are no sound efficiency or equity grounds for a universal benefit, and the fiscal costs and

⁹ St John, Susan, 'Paying for the Old', NZ Listener, April 1, 1989.

deadweight losses associated with such a scheme are large. The PRG clearly signalled its support for some form of targeting.

From that point on, however, its reasoning seems to become confused. Given the weak arguments for a universal benefit, what is the case for a universal element in any scheme? Reading between the lines, the PRG seems to favour the idea of applying a surcharge or some form of means test to the wealthy; after all, why should a retired millionaire's income be supplemented by taxes on low income workers who are struggling to support their families? But in the case of the next group, the broad category of middle-income earners, all that is happening with a non-targeted benefit is that the government is 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'. It is surely 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.

The only significant advantage of a universal benefit over a targeted benefit is that it is not abated against other income and retirees do not face a 'penalty' for saving. This advantage, however, is more than offset by the higher taxes and therefore general savings disincentives for all taxpayers associated with having to fund a universal scheme. Once we move away from a pure universal scheme, however, the abatement issue arises in all options and there are no advantages from this perspective in retaining a universal element.

The PRG's discussion becomes most illogical when it comes to the straightforward targeted option (Option E). First it says that under this option "[t]he benefit would be abated at a sharp rate". This is quite misleading. There is the same choice of abatement regime to be made under this option as under the other three targeted options; indeed there is more latitude to apply a less sharp rate if desired under this option because the fiscal cost and hence the tax structure associated with it are lower. Secondly, the report illustrates the option by using an effective marginal tax rate of 90 percent. This would be an absurd policy; 90 percent was the rate initially proposed for the 1991 surcharge and rightly abandoned. In Australia the effective marginal tax rate on full-rate pensioners as their benefit is abated is a much more sensible 50 percent. Finally, the PRG states that proponents of full targeting "tend to place less weight on the need to set public provision at a level that allows a reasonable level of participation in, and belonging to the community." This is

nonsensical; the point at issue has nothing to do with universality versus targeting but concerns the level of the benefit, and the choice of level is independent of any of the five options. The misleading and biased presentation of this option is hard to understand.

In my view the arguments against a straightforward targeted benefit do not stand up. It sits logically with the rest of the welfare system which is needs-based; it is the option most consistent with an ethos of individual responsibility; and because it involves the lowest fiscal cost it is the option most conducive to economic growth. It also happens to be the option historically favoured in New Zealand and accepted as the appropriate form of public provision, without significant political controversy, by our nearest political and cultural neighbour, Australia. The Australian scheme includes an assets test which is a logical element of any targeting scheme as experience with the surcharge showed. It is a pity the PRG report does little to advance public understanding of the issue of assets in a targeted regime. It is not difficult to make a case that a person with a million dollars of assets should not be supported by low-income taxpayers.

– ***Level of benefits***

It is also disappointing that the report throws no useful light on the appropriate level of the benefit. NZS remains a generous benefit relative to policies in other countries, as the IMF report implies. A high level of benefit discourages private provision, which the PRG wants. It is hard to see the grounds for a level of benefit higher than the invalids benefit, which is intended to support a person on a long-term basis. Consistent with a safety net approach, the 1988 Royal Commission on Social Policy – hardly a 'new right', 'economic rationalist' group – proposed that NZS should be set at the (lower) level of the invalids benefit. Why the PRG could not bring itself to endorse this recommendation is a puzzle.

There is, of course, a reasonable debate to be had about the appropriate level of all benefits, and there is a further issue concerning moves from one level to another. I would not advocate reductions in benefits for those in or near retirement who are fully dependent on them, with the important proviso that New Zealand doesn't lapse into stagnation or economic crisis again. In that case all bets would be off and, to the extent that its fate was due to bad policies, organisations like Grey Power

which have a record of opposing pro-growth economic reforms would be answerable to their constituents. On the other hand, it is hard to see why future cohorts of retirees should not be required to plan on the basis that public provision will be no more generous than the general safety net.

6- Eligibility age for benefits

The increase from 60 to 65 in the qualifying age for NZS has proceeded smoothly (assisted by some transitional measures). It has been the main reason for the fall in the fiscal costs of the scheme as a proportion of GDP. It has also had the effect of encouraging workforce participation by those over 60, a positive factor for economic growth and arguably beneficial in social terms.

With better health and rising life expectancy there is scope to extend the working life of most people who would otherwise be dependent on NZS beyond 65. People who are in poor health or are otherwise unable to work would automatically qualify for assistance under the general safety net. The 1989 New Zealand Business Roundtable report suggested that the eligibility age should be progressively extended to around 70, although people would, of course, be free to retire earlier on their own savings.¹⁰ Adjustments could be made with changes in life expectancy. Boyd Klap has recently proposed an eligibility age of 72. The PRG included an option of a higher eligibility age in its Interim Report, but proposed a 2015 starting date for increases towards it. Its Concluding Report hinted at a somewhat stronger case for earlier action on equity and other grounds, and suggested the issue should be considered in the 2003 review. The grounds for delay seem weak.

5. Consensus and stability

The earlier Todd Task Force, the Accord process and the PRG have all made positive contributions to a trend in retirement income policies which, as I argued at the outset, has been going broadly in the right direction in the past 15 years. There has

¹⁰ Retirement Income Provision, New Zealand Business Roundtable, March 1989.

also been widespread acceptance of the need for consensus and stability in policies to allow people to plan their lives.

Recently this consensus has unravelled somewhat, and it is important that the previous direction of policy be reinstated. The PRG obviously devoted a lot of its time to the issue of building stability and reconstituting a multi-party agreement. While that is a laudable aim, it may have paid too much attention to the politics of the Accord and the current positions of individual parties and politicians. Just as one illustration of the point: the deputy leader of the Labour Party, Michael Cullen, is on record as favouring targeting but Labour's current policy is for a universal benefit. Which view will win out over time? A preoccupation with the current political environment may carry the risk of overlooking the more fundamental requirements for consensus and stability. The point is that in a democratic system the positions of political parties are not static but change in response to the changing understandings and views of the electorate. A sound public understanding of retirement income issues is therefore the bedrock for any stable regime.

The argument I would make is that the only hope of achieving consensus and stability is to build retirement income policies on a sound conceptual foundation. Policies in the recent past lacked such a foundation and proved unsustainable. Bad ideas like the compulsory savings scheme could not withstand intense scrutiny and debate. Seen in this light, the main role of public inquiries like the PRG should not be to try to stitch together some transitory political coalition. Rather it should be to advance public understanding of what constitutes a sound policy framework for both private and public provision. While the PRG's reluctance to foist 'answers' on the public is understandable, I believe it missed an opportunity to give the public more of the information and analysis needed to help it reach sound and durable conclusions.

In the next round of debate on retirement income policies, I consider that policies to promote economic growth must be brought back to centre stage. New Zealand badly needs a set of policies more conducive to economic growth and labour force participation than we have at present. In respect of private provision, the focus should be on ways to reduce policy-induced impediments to greater private savings, especially through lower taxes to give people more scope to save from higher after-tax income. And in respect of public provision, it seems to me there is a good

prospect of achieving a public consensus around the idea of a public 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 don't. 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.

I see no reason why further moves towards a safety net of the kind outlined in this paper should not be feasible over the next few years. It is hard to argue for more generous public provision for those without resources in old age than for other long-term welfare beneficiaries, and against a higher eligibility age as life expectancies increase. A poll commissioned by Colonial after the RSS referendum found that a quite "high" 43 percent of people favoured a means- or income-tested benefit and 37 percent supported a reduction in its level. As with the change in views during the course of the RSS debate, it seems fair to conjecture that such support would increase given sound information, political leadership and proposals for change which protect vulnerable people and give others time to adjust. If that happened, New Zealand could end up with an improved version of Australia's scheme of public provision which, after earlier controversies, now enjoys broad public and political support. For its part, Australia might one day decide to drop its approach to private provision – based on compulsory savings and tax concessions – which is the subject of endless change and political dispute. On that basis two countries which are culturally close and increasingly integrated socially and politically could arguably achieve the best of all worlds as far as retirement income policies are concerned.

1 Anstie, R, Freebairn, J and Porter, M, 'Superannuation and government aged pension schemes for a dynamic economy', Centre of Policy Studies, Melbourne, May, 1989.

2 Greenspan, Alan, Testimony to the House Budget Committee, 8 October, 1997.

3 Savage, Michael, debate on introduction of the Social Security Bill, 1938.

4 International Monetary Fund, Press Information Notice No. 98/1, January 12, 1998.

5 See New Zealand Business Roundtable, Moving into the Fast Lane, March 1996 for a fuller discussion of policies for economic growth.

- 6 For estimates of the deadweight losses from labour and consumption taxation in New Zealand, see Diewert, W E and Lawrence, D A, The Marginal Costs of Taxation in New Zealand, New Zealand Business Roundtable, 1994.
- 7 See Benston G J, Voluntary vs Mandatory Disclosure, An Evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Advisor Disclosure, New Zealand Business Roundtable, 1997.
- 8 For further elaboration, see Thomson, David, Welfare before the Welfare State, Auckland University Press, forthcoming.
- 9 St John, Susan , 'Paying for the Old', NZ Listener, April 1, 1989.
- 10 Retirement Income Provision, New Zealand Business Roundtable, March 1989.