

POLICY ➤ PROGRESS

Superannuation and Retirement Savings

**Three Essays by
Peter Harris**

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Foreword

by David Choat (Director, Policy Progress)

This pamphlet collects in one place a trio of essays that Policy Progress was proud to publish online from economist Peter Harris about a very timely set of issues.

National's decision to suspend contributions to the New Zealand Superannuation Fund last year renewed fears about the sustainability of Superannuation. There are concerns, including amongst some progressives, that perhaps our ageing population means that we cannot afford to maintain the current wage relativity and universal entitlement from the age of 65 indefinitely.

This is an important issue for progressives (and all New Zealanders) to debate, and there's no one more qualified to write about it than Peter. He has a long involvement with these issues from his time as economist for the Council of Trade Unions and later as economic adviser to Dr Michael Cullen. Following that, he went on to chair the Savings Product Working Group, whose report was the founding document for what evolved into the KiwiSaver scheme. His views on superannuation, savings and retirement are always worth hearing and considering carefully.

Good policy process – the case of New Zealand Superannuation

There is a disturbing tendency to evaluate government policies and programmes in terms of how much government spending they involve, often in relation to a potentially volatile comparator like GDP. The Brash Taskforce was the worst offender on this front, but similar sentiments pervade recent reports from the Treasury, the IMF, the World Bank and the Business Roundtable. Policy prescriptions derived from this “standard” reflect poor policy process and are based on almost zero real analysis.

A standard victim of this shallow analysis is the state funded New Zealand Superannuation scheme:

“Paying a generous pension to everyone turning 65 . . . does not seem to fit very well with a serious focus on lifting material living standards . . . Other Western countries have state pensions of one form or another. Those schemes are typically quite a bit less generous . . . than New Zealand’s . . . the relatively favoured position of the elderly in New Zealand is

fairly firmly established.” etc etc¹

Having asserted the “generosity” of the scheme, the prescription is obvious: scale it back to “reasonable” or some other acceptable standard.

But is the analysis sound? The key here is the concept of the “state”, in this case in relation to “state pensions”. Economics is simply about how a given set of resources are used, when there are options for using them in different ways. “The state” as an economic agent can tax and spend and clearly impact the form of resource use. But it can do much more: passing laws that dictate what individuals and firms have to do with a set portion of their incomes; putting obligations on other layers of statutory authority like local government and so on. It is the combination of these exercises of statutory authority that defines the role of the state.

Even then, that must be located in its proper context. For example, the level of state pensions needs to be related

¹ All of those quotes are from the Brash Taskforce (2025 Taskforce), *Answering the \$64,000 question: Closing the income gap with Australia by 2025: First Report and Recommendations*, page 90, <http://www.2025taskforce.govt.nz/firstreport/index.htm>.

to average life expectancies: for different groups, and over time. A state pension is more or less generous depending on if it is taxed or not. It also matters what that pension has to cover: how many other services are provided free or at heavily subsidised rates to those above a certain age. While most pensions are indexed, it makes a great deal of difference to the value of those schemes whether they are indexed to price, or average wage movements.

A comprehensive survey of all of these dimensions of “state pensions” in OECD countries has been carried out by Edward Whitehouse and Monika Queisser for the OECD.²

Admittedly this is a bit dated (2007), but the essence of the analytical approach remains valid. The report makes the very key observation that it is not sufficient to simply judge pensions policy in fiscal terms: social sustainability is also a crucial consideration: especially in relation to pensioner poverty.

² Edward Whitehouse and Monika Queisser, *Pensions at a glance: public policies across OECD countries*, OECD, 2007, <http://mpa.ub.uni-muenchen.de/16349/>.

Taking selective measures from that report almost defeats its very point: we really should look at measures comprehensively. However, constraints on length require me to do just that: this is more of a taste of what proper analysis should traverse.

The report shows that workers on average earnings in OECD countries can expect their post-tax pension to be about 70% of their earnings after tax. The countries with the lowest net replacement rates tend to be those that have just basic pension schemes. New Zealand's is the fifth lowest in the OECD at 42%. That is a bit above Ireland's (39%) and about the same as for the UK. The United States have slightly higher net replacement rates of around 52%.

A comparison with Australia is interesting. Because NZS is the only mandatory part of our state pension scheme, it delivers 100% of retirement income. In Australia, the mandatory employer contribution means that only 46% of their retirement incomes come from the comparable element. A consequence, however, is that even if our scheme is far less generous, it is also more equitable.

In Australia, a person on half of the average wage will get 84% of that (net) in retirement, not much above 81%

for the New Zealand equivalent. A person on the average wage would get 56% in Australia, 42% here. On twice the average wage the Aussie gets a 41% replacement rate through the mandatory state pension system: compared to 23% here.

Michael Cullen used to say that basic income security in retirement was the least that the citizens should expect from their governments in a developed economy: but it was also the most they should expect. The state should not aim to replicate in retirement incomes earned during working life (for both equity and efficiency reasons).

“Pension wealth – the present value of the future stream of pension payments – is the most comprehensive indicator of pension promises. It takes into account the level at which pensions are paid, the age at which people become eligible to receive a pension, people’s life expectancy and how pensions are adjusted after retirement to reflect growth in wages or prices.”³

³ Monika Queisser and Edward Whitehouse, *Pensions at a glance: public policies across OECD countries*, OECD, 2005, p. 17, <http://mpra.ub.uni-muenchen.de/10907/>.

Pension wealth in New Zealand is 6.1 years for men and 7.1 years for women, compared to 8.1 and 9.4 years for the respective OECD averages. In Australia they are 7.3 and 8.4.

“Generous?” On what measure?!

By any standard, New Zealand Superannuation is affordable and sustainable. A programme that costs at peak no more than 10% of GDP is both. The legitimate question is whether that is the priority that the citizens want. Debate that by all means, and debate how it is to be funded, but please, as a matter of analytical rigour, do not prejudice the path of that debate by making the assertion that our scheme is “generous”.

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Why compulsory savings should not be on the agenda

“Compulsory Kiwisaver” is bubbling up on the agenda, the latest being a call for it at the recent stock exchange AGM. It is easy to see why the NZX wants it. Not only does it add liquidity to the capital market, but somebody else (the government) does all the hard work – and carries all the cost – in raising the capital, collecting it, distributing it to investment agencies and regulating providers. The quintessential “free lunch”!

There are four strong reasons to resist making Kiwisaver compulsory:

- If the government is going to tell people how to allocate a part of their incomes, compulsion would almost certainly have to be backed by some form of compensation and protection, either through extended tax concessions and/or capital guarantees, and intrusive regulation and supervision of providers. This increases the chances that a larger proportion of Kiwisaver balances will simply be savings transfers (as savers chase the

bigger subsidies and extended protection), not net new savings.

- There is a risk that with compulsion, savings levels could actually be artificially capped. The government is telling me to save, therefore it is also by implication telling me how much to save. (It knows better than me).
- With compulsion, rules are required for withdrawal (emigration, hardship, matrimonial property settlements, ill-health etc). These become incredibly complex and arbitrary, and tend to generate resentment, which works against promoting a savings culture.
- Compulsion tends to be inequitable because it captures a portion of savings that some people make reluctantly (otherwise a voluntary system would be sufficient) and transfers it to preferred providers, who are typically quite well paid: it takes money off people who don't want to use it that way to support the earnings of finance industry employees.

The net effect is a small – or potentially minimalist – increase in savings levels, won at considerable fiscal

cost, excessive regulatory prescription on both saver and provider, and much more complexity.

Worse though, it sets up the pre-conditions for ending or scaling back the flat rate, universal New Zealand Superannuation. If people have to save, there is a perception that this is because NZS is on the way out. There can be no other legitimisation of compulsion. If people **want** to save (to augment NZS) that is entirely a private matter. The perceptions and the politics work to divide opinion and diffuse commitment to defending NZS.

Remember that NZS is fundamentally equitable: it does not try to replicate in retirement the inequities that emerge during working life, it protects those (typically women) who live longest, it fences inflation risk off and it compensates (in part) for the fact that some retirees leave paid work with few financial assets. It is though, barely adequate as a retirement income. It is not generous.

Augmenting it is an entirely legitimate choice, but it is a private choice.

Last week, my son had a letter from his KiwiSaver

provider reminding him that as a part time worker (he is a student) he had not qualified for his full tax credit, and that if he wanted it he would need to make an additional contribution before the end of the tax year. Sadly, his response was that he had better do that because the whole point of KiwiSaver was to replace the existing pension!

This compulsion thing is corrosive. NZS is worth saving.

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Super: time for a change?

The recent Retirement Commission/ Institute of Policy Studies workshop on retirement income and intergenerational equity⁴ reached three roughly uncontested conclusions, at least in respect to the New Zealand Superannuation scheme.

It is very effective at minimising poverty among the elderly. (Just how effective is contestable, but “the best in the world” is basically true). It is relatively cheap by international standards. It is not particularly effective in maintaining in retirement the incomes people earned when working. So we know it is effective and efficient. It also protects the retired from inflation and longevity risk. (It is “the gold standard” as one international participant put it).

We should celebrate, not lament, the fact that it does not replicate in retirement all of the market inequities of working life. That should never be a role for the

⁴<http://ips.ac.nz/events/Upcoming%20events/Retirement%20Income%20Conference.html>.

government. Countries that try to do that typically impose some form of compulsion on savings, and compensate with tax concessions on said savings. The net effect is no discernable reduction in pensioner poverty, a significant increase in the fiscal costs of retirement income policy, and a fair bit of transfer of savings into tax advantaged or legally obligatory vehicles, rather than an increase in savings levels. The policy becomes less efficient, and, if it ends up displacing some or all of universal tax funded pensions, less effective and more inequitable. (Advocates of compulsory KiwiSaver please note).

If there is an efficient and effective programme in place, it would seem to me that there has to be a high standard of evidence needed to erode it. The “evidence” tended to revolve around demographic projections suggesting that in 2060, there would be four people 65+ for every ten of working age, compared with only two now. That is a rhetorically powerful, but analytically bankrupt, comparison.

If this “ratio” is definitive as an indicator of fiscal sustainability, we have a problem that is of an order of magnitude greater than whether NZS is affordable.

There will be fewer people of working age for every hospital patient, school pupil, university student, police officer, prison inmate, kilometre of road needed to be built, and so on. Admittedly, with most of those, the numbers that taxpayers need to support is not increasing at the same time, except for health, where dependency might well be increasing at an even greater rate.

The fact is that it is GDP that drives the tax base, and the tax base that determines the affordability of any and everything.

Changes in the demographic structure have to impact on GDP growth to be at all relevant to the debate, and then to a material extent. All we had at the workshop was a much less scary suggestion that changes in the demographic structure would reduce trend GDP growth from 3 to 2 percent per annum. But how robust is this projection?

My (admittedly sketchy) understanding of the Treasury model that reaches such conclusions is that it derives GDP growth trend changes through a projection of hours worked and an assumed rate of productivity growth. If that is wrong, I make no apology. My point is

that if the public is being asked to buy into major shifts in (effective and efficient!) fundamental life cycle income supports, it should be based on more than “trust Treasury”.

A fifty year projection of trends is not just heroic, its nuts. Think **back** fifty years. Ignoring the EU, globalisation, China etc etc, consider just two technological changes that impacted trends since then: the pill and the computer. They fundamentally shifted birth and labour force participation rates and productivity. Policy based on projections of 1960s demographic, participation and productivity trends would have produced a (with hindsight) laughable prescription.

Even now, labour force participation rates for the 65+ age group show a steeply rising trend. We need a better understanding and more effective monitoring of factors that are driving the tax base, and changes in the demographic structure might well be one such. But it is manifestly not the only one, and almost certainly not the most important one.

My suggestion? Establish a very high evidential threshold for trashing key public welfare programmes. The more

effective those programmes are judged to be, the higher the threshold needs to be set. Monitor and adjust in line with evidence, not theoretical or speculative projections. Consider all options, not just a cut in the programme. With NZS, we are talking about a 3-point-something of GDP increase in the cost of sustaining it. Cracking down on rampant and systemic tax avoidance, pre-funding, and ultimately a small increase in some tax rates seem to be much less socially disruptive options.

Right now, the case for fundamental changes to New Zealand Superannuation, like the war in Iraq, has not been made.

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About the Author

Peter Harris is an economist who specialises in public policy, the labour market, and primary industry issues. He has been Economist for the Council of Trade Unions (CTU) and economic adviser to Dr Michael Cullen. Peter was also chair of the **Savings Product Working Group**, whose report was the founding document for what evolved into the KiwiSaver scheme.

About Policy Progress

Policy Progress is a policy ‘think-site’ devoted to developing and supporting progressive initiatives and ideas in Aotearoa–New Zealand.