Managing the risks of ageing: the role of private pensions and annuities within a comprehensive retirement policy for New Zealand

Susan St John

A thesis submitted in
partial fulfillment of the requirements
for the degree of Doctor of Philosophy,
The University of Auckland

2003

Abstract

Approaching retirement, individuals are confronted by a range of future risks and uncertainties. The primary worry is insufficient income and the associated danger of outliving one's capital. New Zealand has a unique approach for reducing this risk, comprising a universal state pension supplemented by voluntary unsubsidised saving. This simple model meets poverty prevention objectives, but middle-income baby-boom cohorts may struggle to achieve their income-replacement aspirations. The modest capital they have saved to supplement the state pension is exposed to the risks of inflation, poor investment outcomes, growth in living standards, and increasing longevity.

They will enter retirement with significantly less private pension provision than previous generations and while they may hold a high proportion of their assets in owner-occupied homes, this equity is not readily accessed. They and their families also face the risk that they might require costly long-term residential care in old age. Women are likely to be particularly affected, not only as the spouses of men needing care, but, because of greater average longevity, they have a higher propensity to need long-term care themselves.

Pension design and annuity markets are neglected areas of inquiry in New Zealand. In part this is because international pressures to privatise the state pension by setting up compulsory savings schemes in the private sector have been resisted. This thesis outlines the historical, practical, political and theoretical factors that explain the demise of private pensions and annuities. This provides a record of international interest as New Zealand is the first developed country to institute a tax neutral environment for retirement saving.

While the New Zealand model is largely a credible one, there are significant shortcomings. This thesis examines whether economic theories can cast new light on what should be done and finds the experimentation of a pragmatic kind that has gone on historically precludes highly theoretical or ideological policy solutions. Normative judgements about well-being and distribution cannot be avoided.

An integrated approach to reforming the New Zealand system is explored, based on the advantages of linking certain kinds of insurance. A substantial role for the state is

inescapable; especially in the annuities market, which, it is argued, should be developed to play a significant role in retirement policy options. A state-guaranteed life annuity linked to long-term care insurance financed by a combination of cash and home equity is proposed, subsidised by intragenerational transfers from the retired population. This reform proposal builds on the existing pre-retirement saving policy and keeps the state pension as the cornerstone. The pay-off is improved welfare for middle-income retirees, greater economic efficiency, lower fiscal cost, and improved equity both across and within generations. A greater credibility for the New Zealand model in international forums is also likely to follow.

Acknowledgments

I would like to thank Professors Bryce Hool and Tim Hazledine for their supervision and encouragement. I owe a debt of gratitude to Claire Dale and Scott Fargher for their very helpful input and their timely assistance. I thank Michael Littlewood for many discussions on superannuation and for ongoing dialogue on the public policy issues raised in this thesis. I am indebted to Trish Marsters of the Department of Economics for editing this thesis and to many colleagues and friends, here and overseas, for their patience and support.

I am particularly grateful to my father, Lindsay Adams for the constant encouragement and for reading, editing and commenting on early drafts. I have been provided with a superb role model of how to age successfully and how it is possible to live a highly productive and participatory retirement with the aid of an inflation-adjusted pension in addition to New Zealand Superannuation.

Table of Contents

Part I: Background and context

Table of Tables

Table of Figures

Glossary of Acronyms

ACC	Accident Compensation Corporation
ASFONZ	Association of Superannuation Funds of New Zealand
CAD	Current Account Deficit
CEU	Core Economic Unit
CMV	Current Market Valuation
DB	Defined Benefit
DC	Defined Contribution
EET	Exempt/Exempt/Taxed
ELA	Enhanced Life Annuity
ELAC	Enhanced Life Annuity Corporation
EPDV	Expected Present Discounted Value
ETT	Exempt/Taxed/Taxed
FBT	Fringe Benefit Tax
FWT	Funds Withdrawals Tax
GAAP	Generally Accepted Accounting Principles
GSF	Government Superannuation Fund
GST	Goods and Services Tax
HEC	Home Equity Conversion
HECM	Home Equity Conversion Mortgage
HER	Home Equity Release
HES	Household Economic Survey
HHL	Helping Hand Loan
IIB	Inflation-Indexed Bond
IRD	Inland Revenue Department
MTR	Marginal Tax Rate
MWR	Money's Worth Ratio
NDC	Notional Defined Contribution
NIT	Negative Income Tax
NPV	Net Present Value
NZS	New Zealand Superannuation
NZSF	New Zealand Superannuation Fund
OECD	Organisation for Economic Co-operation and Development
PAYG	Pay-As-You-Go
PLA	Purchased Life Annuity
RAM	Reverse Annuity Mortgage
RFRM	Risk Free Return Method
SPIA	Single Premium Individual Annuity
SG	Superannuation Guarantee (Australia)
SSCWT	Specified Superannuation Contribution Withholding Tax
TTE	Taxed/Taxed/Exempt
TIAA-CREF	Teachers Insurance and Annuity Association - College Retirement Equities Fund

1 Introduction and synopsis

Until recently the international literature on private pensions has been preoccupied with the accumulation phase of preparing for retirement.[1] The vehicles for this accumulation are occupational schemes, compulsory saving schemes, and personal plans. The focus has been on coverage of the workforce; the relationship with any public pension arrangement; the role of tax-subsidisation; how these schemes are or should be administered, regulated and made accountable; and their effects on national saving and the macro economy.

There has, however, been a shift in focus. Much more attention internationally is now being paid to the decumulation phase of retirement saving (J. Brown, Mitchell, Poterba & Warshawsky, 2001; James & Vittas, 2000b; Mitchell & McCarthy, 2002; Wadsworth, Findlater & Boardman, 2001; Wallister, 2000; Watson Wyatt, 2002). The pressing issue is how one's capital can be managed to provide income for the whole of one's future lifetime, when that period decumulating capital is now often as long as the time spent accumulating it while in the workforce.

This new emphasis has come about partly because more people are coming into retirement with substantial savings from mature savings schemes, and partly because of increased life expectancy. It also reflects a profound shift in the design of private pensions during the last few decades (Disney & Johnson, 2001). Under this shift, best described as from defined benefit towards defined contribution schemes, individuals carry the risks of poor investment decisions (Bodie & Crane, 1999). In a defined contribution plan, their retirement nest egg is entirely determined by what they and perhaps their employer have contributed, along with any accumulated dividends, capital gains and interest. In contrast, under the older style company and government employee defined benefit schemes, the employer provides a pension. The pension promise must be honoured whether investments perform as expected or not, therefore the employer carries the risk, not the employee.

---

[1] For a compilation of the pension literature see *The Foundations of Pension Finance* Volumes I &II, Bodie & Davis (2000); and for a comprehensive coverage of private pension policies and regulatory issues see the *OECD Private Pension Series* OECD (2000a, 2000b, 2001b, 2001c), and *Pension Systems and Retirement Incomes across OECD Countries,* Disney & Johnson (2001).

For some time, the imminent shift in the age composition of the population has underpinned most public pension discussions. In many OECD countries, fiscal pressures will be exacerbated by over-generous social insurance pensions and by a general tendency to earlier retirement by successive cohorts. Pensions are not the only problem. There is an increasing recognition of other costs associated with demographic ageing, particularly those of health and long-term care (OECD, 1998, p.23).

In 1960, just 15 per cent of the population in OECD countries was aged over 65 years. By the end of the 1990s this ratio had risen to 21 per cent and by 2030 it is expected to be 35 per cent (OECD, 1998). While the demographic profile is younger in New Zealand than for the OECD as a whole, the baby-boom bulge aged 35-55 years in 2000 will begin to sharply affect retirement numbers from 2010. By 2050 it is expected that the numbers aged over 65 years will more than double to 1.18 million to become 25.5 per cent of the total population. The total population itself is projected to increase only marginally from 3.9 million today to around 4.6 million (Statistics New Zealand, 1999b).[2] With major implications for health costs, improved longevity will see an even more rapid growth in the older age groups. One in every four older persons will be aged over 85, and living past the age of 100 will become common.[3] This major demographic transformation holds implications not just for taxpayers who must fund pensions and health costs, but also for the quality of life of older people themselves and their families. There is a small 'window of opportunity' here, as in other countries, for well thought-out strategies to be put in place before reforms become much more painful (OECD, 1998, p.18).

The obvious response to the approaching 'crisis', as it is often described, is to explore ways to reduce the dependency of the old on the young. Here, policies to encourage later retirement, better health, lower state pensions, and reduced expectations all have

---

[2] Based on medium projections (series 4) that assume during the next 100 years that New Zealand women will have 1.9 children each on average, life expectancy at birth will increase by 7 years for males and 6 years for females, and net immigration gain will be 5000 people a year (Statistics New Zealand, 1999b).

[3] By mid century it is expected that there will be about 544,000 persons aged 65-74, their numbers double; 436,000 will be aged 75-84, their numbers treble; 307,000 will be aged over 85, their numbers increase sevenfold; 12,000 will be over 100, a forty fold increase (Statistics New Zealand, 1999b).

their place. More radical reforms, variously advocating a stronger role for individual accounts and private management of public pension schemes have been advanced in many countries. International agencies such as the OECD and the World Bank have stressed, among other policies, the need for reducing the pay-as-you-go (PAYG) element in public pension design by increasing the pre-funded element; including moves to clearly separate the poverty alleviation objective from that of income replacement.[4]

While these reforms reduce the risk to the state, their success in reducing the burden on the young may ultimately depend on whether they improve economic growth in output of a useful kind.[5] Although these reforms are often promoted as good for people preparing for their retirement, their ultimate function may be to bring about the reduction in claims on future output necessitated by an ageing structure and a lack of growth.

The World Bank influence has accelerated the worldwide shift to defined contribution plans in the overall retirement saving mix and this, in turn, has deepened annuities markets in many countries. In contrast, the potential role of annuities in the retirement decumulation phase in New Zealand has barely been raised in discussions on superannuation to date.[6] In part, this is because New Zealand has persisted with its unique retirement income policies comprising a basic flat-rate taxable universal state pension, called New Zealand Superannuation, and unsubsidised voluntary saving. In doing so, New Zealand has implicitly rejected the reforms favoured by the OECD and the World Bank.

Nevertheless, as in other countries, defined contribution schemes are replacing defined benefit schemes in the private sector.[7] Far fewer people coming into

---

[4] See, for the two major works from each on this issue, *Averting the Old Age Crisis*, World Bank (1994) and, *Maintaining Prosperity in an Ageing Society*, OECD (1998).

[5] Growth of bureaucracy, managers and financiers, may improve GDP but may not improve standards of living.

[6] Superannuation is a term peculiar to Australasia with the term pensions used in other countries. Superannuation for individuals in New Zealand may comprise the state pension, private pensions and annuities, lump sums and any other sources of savings used for retirement.

[7] The recent international 'bear' market in shares has exposed serious actuarial deficits in many major defined benefit schemes and accelerated closures of these schemes (The Economist, 2003).

retirement have access to either an annuity or a private pension.[8] The tax neutral treatment of superannuation saving since 1990 has been one of the negative factors impacting on private pension and annuity provision in New Zealand. As well as the shift to defined contribution schemes, in contrast to international trends, coverage by employer superannuation schemes has been declining, along with the value of employer subsidies for most earners.

From time to time the New Zealand model has been considered in international debate, but more as an object of international curiosity than as a model to be emulated (see, for example, Johnson, 1999).[9] Nevertheless, the tax regime for private saving for retirement is of interest to other countries because of its cost advantages, the equity implications, and its relative simplicity. One of the little appreciated consequences of the New Zealand approach, however, is that a tax neutral approach precludes the right to regulate retirement saving for social purposes. This means there is no potential, for example, to legislate for the purchase of an annuity from the retiree's lump sum.

Thus few retirees of the baby-boom generation will have a private pension as a life-long income supplement to their state pension. Importantly, many may fail to achieve full protection against the longevity risk, the investment risk, the inflation risk, and the risk of costly long-term care in old age. New Zealanders have traditionally had a very high proportion of their assets in owner-occupied homes, in part because home ownership is treated more favourably for tax purposes than are other investments. Unfortunately one's own home is not usually a source of readily accessed liquidity that can be drawn on to finance the additional costs of retirement. As with the almost non-existent annuities market, home equity release schemes are rarely used.

Compared to other countries, New Zealand's simple retirement income system based on a universal state pension is very effective in meeting poverty prevention objectives (St John & Ashton, 1993; St John & Gran, 2001; St John & Willmore, 2001).

---

[8] An annuity is an annual income stream purchased from a Life Office with an individual's lump sum. Annuities can be paid for life (life annuities) or for a fixed term (term annuities). Pensions are group annuities paid from company, government or group retail schemes.

[9] More recently, developing countries have shown interest in the New Zealand model as a possible alternative to the World Bank model. This was discussed at a forum at the United Nations conference on Financing for Development at Monterrey, Mexico, 19-22 March 2002.

Women, in particular, are treated favourably in the New Zealand public pension system compared to their counterparts in countries like the United Kingdom (Ginn, Street & Arber, 2001). There are however uninsured longevity risks for women. Women have a longer average life expectancy than men, they reach retirement with lower average additional extra savings, and are far less likely than men to have access to a private pension.[10] They may therefore be vulnerable for long periods of their old age to the risks of inflation, poor investment and declining living standards.

As privatisation of social security systems becomes the preferred solution to rising pension costs, many countries appear slow to grapple with poor coverage issues.[11] Internationally, New Zealand may be at the forefront by providing a minimum guaranteed basic income for all residents aged over 65, thus comprehensively meeting the poverty alleviation objective. But for those whose pre-retirement income is above the lowest deciles, the New Zealand model falls short of meeting even modest income replacement objectives. For the libertarian or neo-liberal such a gap is not viewed as a failure. Rather, if the state has provided the basic floor then individuals should be free to organise any income replacement above this if they choose to do so. Yet there are compelling arguments that the market fails to meet the legitimate income insurance requirements of many middle-income people. In addition the market fails to offer viable insurance for the costs of long-term care and suitable mechanisms for releasing the equity in owner-occupied homes. This thesis develops the argument that this market failure provides the justification for the state to play a substantial role in facilitating the income replacement objective and in ensuring the availability of insurance for catastrophic expenses in old age.

There is another potential problem in the New Zealand model. Universal basic pensions of the New Zealand type have many advantages, but sit oddly in the context of an otherwise residual welfare state. A state pension to all of those aged 65 and over, regardless of whether they are still working or have substantial income and

---

[10] At age 60, New Zealand women are expected to live to an average of 83.9 years compared to 80.2 years for men (Statistics New Zealand, 2002c).

[11] For example, in Chile the participation of workers fell from over 70 per cent in the old social security scheme to around 50-55 per cent in the 1980s and 1990s under the new privatised scheme. In many countries the provision of a minimum pension guarantee is tied to contributions in the second pillar leaving large gaps in the social safety net (Willmore, 2001).

assets, along with new legislation to remove asset testing for long-term residential care is unlikely to be acceptable to a working age generation burdened by student debt, by a failing health system, and high costs of accommodation (St John, Dale, O'Brien, Blaiklock & Milne, 2001; St John & Rankin, 2002).[12]

The New Zealand Superannuation Fund, discussed in section 2.7, will become an increasingly large asset on the state's balance sheet at the same time as the asset presented by student debt grows alongside. The size of this fund, how it is invested, and the overall intergenerational implications may yet prove destabilising (St John, 2001b). Increasingly bitter conflicts over resource shares can be expected, especially if the economy fails to recover strongly from the slow growth and population loss of the late 1990s. The challenge will be to retain the simplicity and security of a basic income for all aged over 65, while facilitating more intergenerational equity.

While New Zealand has rejected privatisation of the state pension as an answer to either the fiscal costs of ageing or the aspirations of retirees, new thinking on the role annuitisation might play deserves examination (St John, 2002b). This thesis proposes a reform to the decumulation phase of retirement saving which integrates public and private provision and is compatible with the New Zealand model.

As Barr (2001) cautions, any reform needs to fit with the changed environment of the 21st century. A growing diversity of family relationships including divorce, remarriage, de facto and same sex relationships, and issues around workforce mobility, both nationally and internationally all have implications for pension reform and insurance design. Any such reforms will take time to implement and gain acceptability, but should be in place as soon as possible if New Zealand is to improve expected outcomes for both workers and retirees.

> *Successful reforms will bring large rewards. They would avoid major fiscal problems, improve living standards and the quality of life, and result in a more equitable, cohesive society. The temptation to delay action is strong, but the message that the OECD seeks to communicate as widely as possible on behalf of its member governments is that solutions will be much more difficult and painful if needed reforms are postponed.* (OECD, 1998, p.3)

[12] The legislation removing asset testing was promised for 2002, but the introduction of the Bill was postponed reflecting controversy in Government about its long-term cost (see section 4.4.2).

New Zealand has few forums for debate on pensions let alone the other issues associated with ageing. Nevertheless, in the past New Zealand has been innovative in the design of social policy and may again provide an experimental laboratory for solutions to some of the seemingly intractable insurance problems of retirement and old age. The remainder of this chapter presents a detailed overview of the thesis.

1.1 The background and context: Part I

To a large extent, social reform is conditioned by the historical experience of the country, and this is true for New Zealand's approach to pensions. Understanding this history and the politics surrounding pensions is necessary to inform policy development. To this end, Part I of this thesis provides a brief historical overview of the unique New Zealand policy mix in public and private pensions, health and old age care.

Chapter 2, sections 2.1 – 2.4, provides a history of the state pension in New Zealand: its origins; the major social security reforms of 1938; post war expansion of the role of the state pension including the introduction of National Superannuation in 1976; and the reform period of 1988-91. The dramatic policy swings that culminated in the multi-party agreement known as 'The Accord' in 1993 and the renaming of the state pension as New Zealand Superannuation are then outlined in sections 2.5 and 2.6 along with a discussion of the critical importance of the surcharge in the Accord agreement.

The turn of the Century introduced a new phase in public superannuation policy with the introduction of the principle of pre-funding under the New Zealand Superannuation Act 2001. The emergence of the fund, the political controversies and economic implications are discussed in section 2.7. International comparisons are made in the next section in order to place the New Zealand approach to public pensions in a wider context. A summary assessment of New Zealand Superannuation is made in section 2.9. The final section concludes that while there has been marked volatility and intense debate over the state pension, it has proved remarkably durable. Yet there are lessons from history. In particular, the record shows that unilateral shifts in pension policy are unlikely to be successful.

The introduction in chapter 3 sets out a brief history of private pensions while section 3.2 outlines the highly significant tax changes based on the principle of tax neutrality

that were implemented between 1988 and 1990. These tax changes, including the failure to actually achieve and maintain tax neutrality, are important in explaining the demise of employment-based superannuation schemes described in section 3.3. Coverage under these schemes, including the now closed Government Superannuation Fund, has continued to fall with far-reaching implications for the future retirement of the baby-boom generation. Many low and middle-income workers now face substantial tax disadvantages as members of superannuation schemes. The issues are complex and attempts to grapple with the problem have floundered, although new endeavours are promised for 2004. As precursor to examining reforms for the decumulation phase of retirement saving, section 3.4 outlines a possible solution to these seemingly intractable problems.

The private annuities market is analysed in sections 3.5 and 3.6 to see if annuities currently available in New Zealand are good value for money. The Money's Worth Ratio (MWR) is the expected Net Present Value of a given annuity as a fraction of the actual market price for that annuity. Estimates of MWRs for New Zealand annuities sold during the 1990s suggest that for the person of average longevity, annuities have become an increasingly poor investment. The local market continues to decline rather than grow with few indications of interest in promoting new forms of annuities. Section 3.7 describes how policies to unlock the equity in home ownership have not developed from their tentative beginnings. These trends are in contrast to the picture of growing interest in annuities and home equity release schemes in other countries.

Chapter 4 examines other risks of the retirement phase that are not met by the standard state pension. The role of supplementary assistance, healthcare provisions and long-term care issues are outlined in sections 4.1 - 4.3. An increase in 'user pays' for healthcare has not resulted in wider coverage by private insurance, while long-term care insurance has been largely unobtainable. The current means test for long-term care subsidies is found to fall short of meeting criteria of equity, efficiency and marital neutrality. As in the case of the tax treatment of superannuation, there are some immediate reform issues that require attention. These are addressed in section 4.4 where an improvement is proposed in the context that a means test must remain if long-term care insurance is be fostered and encouraged. This becomes a critical part of the reforms proposed in Part III of this thesis.

In chapter 5, sections 5.1 - 5.5 provide an overview of the wealth and income distribution among the retired and the working-age population from the available, albeit limited, data. This information together with evidence from a new Living Standards Survey (section 5.6) suggests little cause for immediate concern of income inadequacy among those currently retired. Furthermore, the analysis in section 5.7 shows that there has been a marked redistribution to those over 65. The tax reductions of 1996-1998, the restoration of the indexation formula in 2000 and return to universal pensions with the abolition of the surcharge in 1998 disproportionately benefited high income and high wealth superannuitants.

Section 5.8 explores the likely future for the baby-boom generation who will retire between 2010-2030. These cohorts can expect an even longer retirement on average than their parents. A significant number will have experienced a poor labour market in their late working age and may have spent considerable time on a welfare benefit. The analysis is indicative that many low-decile baby-boom retirees will have difficulty in maintaining even modest lifestyles in retirement. This suggests that the maintenance of a sound state pension will be critical for their living standards.

Middle-income cohorts are likely to find that the state pension supplemented by their limited cash savings provides an insufficient income replacement. They are likely to have significant equity in their own homes and are the group currently most affected by asset testing for long-term care in later life. It is this group, located approximately in the fifth to ninth income deciles who have the most to gain from the reforms suggested in Part III. Meantime, as chapter 5 concludes, there are serious policy issues surrounding the intergenerational acceptability of the universality of the state pension itself.

Chapter 6 concludes Part 1 by putting the New Zealand model into the context of international discussions on pension reforms. Many international debates have centred around the World Bank multi-pillar model as set out in section 6.2. Section 6.3 postulates the New Zealand model as a credible alternative to the World Bank model. The way in which other countries encourage and support private pensions is discussed in section 6.4. Of particular importance, the role of tax concessions and their cost is examined in section 6.5. Good public policy does not depend solely on good analysis, nor is logical implementation of agreed policy inevitable. There is an important political dimension to the pension debate, as discussed in section 6.6.

While the New Zealand model is assessed as having credibility in the concluding section, there are significant gaps, especially with respect to the role of private pensions. The lack of an agreed policy process following the demise of the 1993 Accord is highlighted as a particular threat to policy stability.

1.2 The economics of pensions and annuities: Part II

In the second part of this thesis, the traditional models of pension provision are examined, and their limitations in analysing broad policy options are discussed. Section 7.2 outlines the basic pension dependency model and discusses what an optimal distribution would look like. This basic model underpins cost projections of parametric changes such as to the age of eligibility, the level of pension, and targeting. Section 7.3 sets out the overlapping-generations model based on the work of Samuelson (1958) and the way in which the relative rates of population growth, wage growth and real interest rates affect the merits of PAYG versus pre-funded pension schemes. The World Bank model belongs to this genre of overlapping-generations models as outlined in section 7.4. Recommendations for a privatised second pillar scheme of mandatory saving have flowed from this model but there is far from a consensus on these recommendations as the critiques of this model indicate.

While an economics framework can provide a valuable perspective on the nature of the burden imposed on the young when the population is ageing, models of inter-temporal spending and saving widely applied to social security debates in the US, uncritically transposed to policy debates in other countries, can be less useful tools. Rates of return arguments have been influential in suggesting that there has been unjustified redistribution across generations. The conclusion that current workers face low rates of return and should therefore save for themselves is critiqued along with a discussion of the costs of pre-funded schemes including transitional costs of a shift to such schemes.

An underlying premise of chapter 7 is that normative judgements about equity cannot be ignored as they are at the heart of public pension policy. The use of generational accounts, a popular part of the pension literature (see for example Auerbach, Baker, Kotilkoff & Walliser, 1997; Kotlikoff, 1992), is outlined in section 7.5. The concept of ‘generational equity’ discussed in section 7.5 makes the strong assumption that

succeeding generations should shoulder equal burdens, and may be unhelpful in the New Zealand context.

Section 7.6 introduces the concepts of in-period intergenerational equity, intragenerational equity, and intergenerational dependence more common in European discussions. These concepts are concerned with the actual costs and fairness of sharing available resources at a point in time, rather than rates of return across time to particular individuals, generations or cohorts. The term *intergenerational equity* is taken to mean fairness between today's generations, namely the retired and the working age populations at a point in time.

Section 7.7 distills the lessons from the theoretical approaches to find guidance for directions in public policy and cautions against the uncritical importing of debates from other countries such as the US. The chapter concludes that while there is an extensive theoretical literature on the economics of pensions the implications for policy are not easily drawn.

The case for a fundamental shift in New Zealand policies, based on policy inferences drawn from conventional models of pension systems is not proven. The Long-Term Fiscal Model provides a transparent and powerful accounting tool with which to project the future fiscal burdens of the ageing population (The New Zealand Treasury, 2001a; Woods, 2000) but a clearly stated normative dimension is also needed.[13] A strong public policy framework is required that emphasises not only efficiency and other criteria but also intergenerational and intragenerational concepts of equity. In Part III, intergenerational equity is taken as an important criterion for policy development.

Chapter 8 explores the standard economics literature on insurance, relevant to issues of protection in older age. Unfettered non-mandatory annuities markets do not provide optimal insurance for people entering or in retirement for a number of broadly accepted market failure reasons. These include the uncertainty of changing longevity, the problems of unexpected inflation, adverse selection and discrimination, investment and institutional risk. As outlined in section 8.2, adverse selection is a

[13] The Fiscal Responsibility Act 1994 requires projections for 10 years in advance. New Zealand has a unique approach to the presentation of the Crown Accounts with a statement of both financial performance and financial position based on Generally Accepted Accounting Principles (GAAP).

major source of market failure because, in non-mandatory annuity markets, purchasers are more likely to have greater average longevity than the public at large. Yet discrimination mechanisms may be neither practical nor legal.

Adverse selection, the inflation risk, the investment risk, the mortality risk are aspects of market failure that help explain why voluntary private annuity markets are so under-developed. Other reasons for the lack of demand in New Zealand include the perception that the state pension itself provides an adequate annuity, and the desire to leave a bequest for family members. On the supply side, a lack of reliable actuarial data and the tax regime make annuities risky products.

The role for state intervention discussed in section 8.3 is based on extensive market failure and the costs to individuals and taxpayers who bear the outcomes of that failure. Making the purchase of annuities compulsory is one possible intervention, but is not possible in a tax-neutral saving environment and therefore not open to New Zealand policymakers.

Section 8.4 discusses the issues of health and long-term care insurance and how market failure also explains the lack of suitable private products. Several countries have tried to grapple with various social insurance approaches to long-term care as briefly outlined in section 8.5. Marrying the risks of out-living one's capital or making unintended bequests with the risk of requiring long-term care may have the potential to overcome some of the problems inherent in private markets for life annuities and long-term care insurance. The emerging literature on intragenerational social insurance and the integration of long-term care insurance and life annuities (see, for example, Chen, 2001a; Murtaugh, Spillman & Warshawsky, 2001; Warshawsky, Spillman & Murtaugh, 2002) is covered in section 8.6 and developed in proposed reforms in Part III of this thesis.

1.3 Improving outcomes for middle income retirees: Part III

Part III focuses on practical issues of redesigning policy to improve on the New Zealand model for the baby-boom generation. The risks faced by middle-income New Zealanders are addressed in the context of the actual and likely projected wealth and income distribution of the older population set out in Part I.

Chapter 9 establishes a framework for designing new policy, clarifying possible objectives of policy and criteria for policy change in section 9.2 and assessing the limitations of current New Zealand policies against these objectives and criteria are in section 9.3. Section 9.4 analyses the value of New Zealand Superannuation as a life annuity and concludes that it represents substantial wealth, but alone it does not provide enough real income replacement for middle-income people.

Chapter 10 proposes a new product, the Enhanced Life Annuity, (ELA). The ELA is a real gender-neutral life annuity that increases by an appropriate factor when the retiree is assessed as in need of long-term care. An individual at age 65 purchases the ELA using their accumulated cash saving and, in suitable cases, a share of home equity. The ELA augments the state pension, protecting the individual against the risk of living longer than expected, and helping to meet other expenses of a middle-income retirement including the costs of long-term care. The gains accrue both to the individual who is assumed to be risk averse, and desires to smooth consumption over the lifecycle, and to the working age population, because the risks of old age are borne intragenerationally to a greater extent than is the case currently. Some tentative estimates of the capital cost of the ELA for men and women are derived using the 1995-97 Life Tables for New Zealanders in section 10.3. Different interest rate assumptions and different assumptions about the size of the increase once the need for long-term care is established are used to derive alternative estimates.

The values of gender-neutral annuities based on these estimates appear to compare favourably with annuities that are currently available, especially for women, although the estimates of the ELA do not include overheads or a profit margin. The ELA does provide a real annuity, however, as well as insurance for long-term care, so that compared to a conventional annuity of the same starting value, the ELA would be perceived as the more valuable product.

The ELA requires subsidisation as well as intragenerational risk sharing. If the annuities market is to develop at all from its current primitive status, the state may have to adopt a major provider role, at least initially. This thesis argues that New Zealand can justify subsidisation of the annuities market to achieve certain well-defined goals. In contrast to pre-retirement tax subsidies, these subsidies may be more effective and equitable and, it is argued, can come from the retired as a group themselves.

It is proposed that the finance for the subsidies to this market comes from an intragenerational contribution. This provides a semi-social insurance basis for the ELA while also allowing some pre-funding if desired and an additional source of finance to pay for the long-term care subsidies of low-income retirees. The politics of the state pension make the reintroduction of income testing difficult, but it is argued that an affluence test of some kind is well justified and may be acceptable if viewed as an intragenerational contribution. Section 10.3 explores the design of such an intragenerational contribution with some tentative estimates and outlines the advantages, including gains in intergenerational equity that would follow. The chapter concludes with an evaluation of the ELA against the objectives and criteria set out in the policy framework in chapter 9. Chapter 11 finalises the thesis with conclusions and an overview.

1.4 Summary

New Zealand is the only OECD country to entirely remove all tax concessions for the accumulation of savings for retirement. There are good reasons for this, but New Zealand must now grapple with the problem that many people will come into retirement with lump sums and illiquid assets such as property with neither the skills nor the inclination to manage these assets to provide supplementary income.

A case is made in this thesis for the state to support annuities in a variety of sophisticated ways that are consistent with the unique framework chosen by New Zealand, which includes tax neutrality for pre-retirement saving. In particular, the proposed 'Enhanced Life Annuity' links insurance for long-term care with lifetime annuities, financed by accumulated cash sums supplemented in appropriate cases by a share of equity locked up in owner-occupied housing.

The primary aim of the ELA is to ensure more certainty of income for middle-income baby-boom retirees, especially in light of the lack of private, inflation-adjusted pensions for this group. The middle-income group, occupying the space between rich and poor, are most affected by the changed circumstances arising from ageing, retirement and reduced income. The lowest deciles are protected by the state pension, while the highest deciles have sufficient wealth to look after themselves. While the ELA is not gender specific it could be particularly significant for women whose quality of retirement is often at risk from lack of access to supplementary income.

The pay-off for the reforms set out in Part III is improved welfare for middle-income retirees, greater economic efficiency, lower fiscal cost, and improved equity both across and within generations. A greater credibility for the New Zealand model in international forums is also likely to follow.

Part I: Background and context

2 The New Zealand state pension

Every country has its own traditions of provisions for the income risks in old age. A sense of this history is necessary to understand the constraints and possibilities of change. This chapter focuses on the development of pension policy and the political dimensions to policy debates in New Zealand.

Despite a widespread international perception that New Zealand's welfare state is well developed, the history illustrates the recurring tensions between the goal of poverty alleviation (which implies a minimalist safety net only) and income maintenance (which implies some degree, at least, of earnings-replacement insurance). The emergent flat-rate universal pension, with little other government involvement in private supplementation, is an uneasy compromise between these goals. Chapter 3 details the decline of employment-based superannuation and analyses the deficiencies of the New Zealand annuities market. Chapter 4 outlines the policies which address the broad risks of old age in New Zealand including the need for long-term care. In contrast to the universal state pension, policies for long-term care in old age involve highly-targeted subsidies.

Chapter 5 provides an overview of the income and wealth position of today's retirees and speculates on the likely shape of the distribution once the baby boomers come into retirement between 2010 and 2030. Chapter 6 concludes Part I of this thesis and places New Zealand in the context of the international debate on pension reform.

2.1 The origins of the state pension

In the mid 1800s large numbers of settlers began arriving in the newly acquired British colony, and in 1898 New Zealand introduced one of the world's first old age pension schemes.[14] Thomson (1998) argues that in spite of New Zealand's reputation as the 'cradle of civilization' or 'social laboratory of the world' in terms of the early

[14] Denmark had put in place a means-tested old age pension in 1891.

development of the welfare state, the move to wide collective responsibility was both reluctant and late.[15]

The new settlers in fact reflected the anti-welfare mood that had emerged strongly in late 19th century Britain.[16] When the largely young and hardy immigrants from the old country came to New Zealand the dominant idea was that individuals should be self-reliant and families should care for their own.

Early laws formalised the concept of family responsibility. Various 'destitute persons' laws imposed obligations on the relatives of the needy and deductions from wages by employers were often enforced for this purpose. While the workhouses and the Poor Law were hated parts of the old country and not explicitly recreated in New Zealand, other strictures such as charitable aid had much the same impact. The tensions between encouraging self-reliance and providing state assistance resulted in much rhetoric about independence and private thrift.

> *Terms such as 'self-reliance', 'mutual aid', 'prudence', 'moderation' and 'thrift' enjoyed a hallowed place in nineteenth century thinking, and perhaps nowhere more than in New Zealand.* (Thomson, 1998, p.35)

The late 19th century exemplified the conflict between the need for security and stability, which invariably requires some state action, and the virtue of independence from the state, which logically must require none. In Britain, insurance mechanisms then, as now, were the 'self reliance' response to potential adversity. Membership of friendly societies grew in the late 19th century providing limited health and sick pay benefits. But these societies soon became actuarially unsound and faced insolvency as the original members aged and thus imposed higher costs than had been anticipated. In the UK the failure of these private collective arrangements put markedly more

---

[15] In Thomson's words, we have had "a rather arrogant view of history and our own hallowed place in it" (1998, p.1) .

[16] The early part of the century in that country had seen an emphasis on collective provision for the aged, as exemplified by pensions provided by the local parishes. But by the late 19th century the "relentless logic and endless repetition of the reform arguments" had resulted in cuts to pensions and a freezing of the parish lists (Thomson, 1998, p.15). The intent was more self-reliance and family responsibility, but, in practice, the outcome was ever increasing numbers in workhouses. Yet, as Thomson argues, even the workhouses were a collective response to the problems of poverty, and in being so they moderated the harshness of the reforms.

pressure on the workhouses and Poor Laws. But later, as elsewhere, the failures of private collective arrangements became the incubator for proposals for state old age pensions, compulsory saving and social insurance schemes.

Germany and UK extended membership of friendly societies by adopting compulsory social insurance, making them a part of the state. But friendly societies were not as strong in New Zealand and were not the basis of the new state involvement in the same way. Thomson (1998, p.51) attributes the failure of the state to sponsor an extension of friendly societies to the colonists' attitudes:

> *The colonists strove for independence and private property and they favoured individual savings endeavours over which each could retain maximum freedom and control. The friendly societies did not sit easily along side this.*

More recently, the 1990s saw a revival of the idea that everyone should save individually for old age. For example, in a report sponsored by the New Zealand Business Roundtable, (Green, 1996, p.xi), it was claimed:

> *Historically, voluntary assistance through charities and mutual aid associations supplemented by a minimum safety net provided by the state offered superior protection because it attended not only to material needs but also to character.*

In contrast to these nostalgic and romanticised memories, Thomson describes the precarious nature of these financial arrangements and their frequent insolvency, thus providing a critical rebuttal of such uncontrolled and unregulated private institutions for saving.

In New Zealand early state involvement was limited to the 1898 Old Age Pension Act, the purpose of which was at least in part to reward past contributions to the country's development. Unlike social insurance approaches begun earlier under Bismarck in Germany there was no attempt to relate the pension to an individual's paid work history.

Even following the introduction of the old age pension, anti-welfare sentiment remained strong. So strong, in fact, that throughout much of the first 30 years of the 20th century, only around 30 per cent of those eligible by age for the pension collected it. Only non-Asiatics of good moral character and sober habits of the age of 65 who had lived in New Zealand for at least 25 years and passed strict means tests were eligible (Thomson, 1998 p.162). And while the pension was a clear move away from

notions of charitable aid towards a sense of rights and long-term support, by the 1930s it was apparent that benefits were meagre and insufficient (McClure, 1998).[17]

2.2 The social security reforms of 1938

The Great Depression exposed the inadequacies of the social safety net for the population at large and highlighted the need for pension reform**.** The Social Security Act of 1938 was a broad social programme based on the newly elected Labour government's vision of the needs and rights of citizenship. There were two pensions for the aged. The major form of support was the Age Benefit at age 60 which, like its predecessor, was income and character tested (Thomson, 1998, p.165). The other was a universal flat-rate benefit (Universal Superannuation) for all citizens over the age of 65. Universal Superannuation initially was minimal, but was gradually increased so that by 1960 the two pensions were at parity. At age 65, those receiving the income-tested Age Benefit could continue to receive it, or elect to take the taxable Universal Superannuation instead. Benefit increases were typically made near elections and were not specifically related to increases in inflation. However, between 1939 and 1970, benefit levels rose by considerably more than increases in the Consumer Price Index (Royal Commission of Inquiry on Social Security in New Zealand, 1972).

A critical economic insight is that the welfare state has been as much about insurance for the middle classes as about the relief of poverty (Barr, 1998, 2001). The welfare state, bearing the 'cradle to grave' image that originated in the Social Security Act of 1938 can therefore be viewed as not only a response to the relief of hardship but also as a practical answer to obvious failures of private insurance markets. The risks of old age ill health and unemployment exposed by the Great Depression required a social insurance approach broadly inclusive of all citizens.

[17] Nevertheless, the conditions for the receipt of the pension were progressively relaxed so that by 1925 the pensioner's home was exempt from the means test and by 1937 the residency requirements had fallen to 10 years. Around 1970, the legal requirement that children maintain their parents was abolished and pensions were no longer subject to tests of moral deserts (Thomson, 1998).

2.3 Postwar expansion[18]

2.3.1 Labour's earnings-related scheme

In the post-war period it was widely accepted by New Zealand's two major political parties that the state had a vital role to play in the development of a small, isolated economy. Rather than setting up social insurance schemes for pensions, as had become common in other western countries, the tradition of a non-contributory, flat-rate pension for all citizens was continued. By the early 1970s concerns arose that only a minority had access to additional pensions from employment-based private plans. These schemes had been largely the preserve of those who worked for government or large companies. Moreover, the existing schemes had problems of lengthy vesting, lack of inflation adjustment of the final pension, and lack of portability, among other deficiencies. A state-run, earnings-related pension scheme was proposed to provide some continuity of income in retirement through wide coverage, full vesting, and inflation proofing of final pensions.

In 1975 the Labour government implemented a pre-funded, state-run, earnings-based, contributory scheme under the New Zealand Superannuation Act (1974). Once the New Zealand Superannuation scheme had matured (after 40 years) New Zealanders would have had a two-tier system, consisting of a flat-rate Universal Superannuation supplemented by an inflation-adjusted annuity purchased from their individual account balances at age 65. While the fund was state controlled, the scheme was based on actuarial principles and was 'defined contribution' in character.[19] The government was committed however to meeting the cost-of-living adjustment of the annuity payment. This aspect would be funded on a pay-as-you-go (PAYG) basis and thus required an ongoing commitment from current taxpayers.

Once the scheme was fully implemented, contributions were to be 4 per cent of wages for both the employee and employer. It was difficult for people to determine their

---

[18] This section, and the next, draws on previous work (Ashton & St John, 1988; St John, 2001c, 2001d; St John & Ashton, 1993; St John & Gran, 2001).

[19] As observed in chapter 1, defined contribution superannuation schemes are those where the final pension is based on the contributions made and the earnings on these contributions. Defined benefit schemes provide a final pension based on a formula that usually relates the size of the pension to the length of membership and final years of salary.

future benefits under the contributions-related pension, since it was tied to individual contributions and the earnings of the fund, not easily predicted over a working life.

Low-income earners and/or those without a conventional 40-year, full-time working history could not expect a generous supplement to the first tier Universal Superannuation. In 1975 only about one third of New Zealand's paid labour force was female and thus eligible to participate in the earnings-related pension. The design of the scheme reflected an expectation that the breadwinner would use 'his' pension to provide for both himself and his wife who would usually be financially dependent.

Criticism of the scheme quickly emerged in the political environment of the 1975 election year (Booth, 1977; Collins, 1977). Opposition focused on the prospect of state control over a vast pool of investment capital. Women were unhappy that, on average, they would receive lower annuities than men.[20] Lower annuities would increase their reliance on Universal Superannuation, which over time was likely to diminish in relative value. Survivor benefits, important because of women's greater likelihood of outliving her spouse, were not generous, and ceased on remarriage (Milne, 1977). Little redistribution was possible because actuarial equity rather than social adequacy was the goal (St John & Ashton, 1993). The plight of the currently retired who had seen their savings seriously eroded by inflation remained unaddressed as this scheme would not have provided full benefits until it matured after 40 years.

The National Opposition attacked Labour's new pension system based on these criticisms, offering a simpler, more generous pension that was particularly attractive to women. Nine months after its introduction, a newly elected National government dismantled the contributory New Zealand Superannuation scheme and refunded contributions.

[20] If a woman temporarily left paid work to raise children, she would inevitably receive an annuity with a lower wage replacement compared to the average man (Milne, 1977). Differences in life expectancy would also make a woman's annuity smaller than a man's, even when both had saved the same capital sum in the fund.

2.3.2 National Superannuation 1977-1989

The National government replaced the old income-tested Age Pension and Universal Superannuation with a single, more generous, state pension called National Superannuation. National Superannuation was PAYG, funded from general taxation without a dedicated contributory basis or separate fund. It was an individual taxable entitlement payable at age 60 if residential requirements were met. It was set at 80 per cent of the gross average weekly wage for a married couple and 48 per cent for single pensioners and thus could be described as 'defined benefit' in character. Many features, including the individual basis of the pension (whereby a married person received one half the gross married rate, taxed in his or her own name), were hailed as 'good for women'. While there was no income test, it was taxable and by 1982 a high top marginal tax rate (increased from 60 per cent to 66 per cent) substantially reduced the net value of National Superannuation for the better-off (see section 2.6).

National Superannuation addressed many criticisms of Labour's earnings-related scheme. Contributions were earnings-related (to the extent that income taxes paid was based on wages earned) but the final pension benefit was flat-rate and taxable, yielding a progressive benefit structure that helped women and the low paid. In contrast to the previous scheme introduced by Labour, the retired benefited immediately as everyone from the age 60 was entitled to a significantly larger pension. Problems of poverty among the aged virtually disappeared.

One of the significant features was the generosity, not only to women and those who had not been in the paid labour force, but to those who had not yet retired, as there was no earnings test. National Superannuation was available to every older resident, whether he/she had been in the workforce or not. It was simple to understand and people could easily predict the pension they would receive. It could be seen as a precursor to a basic income, and similar in effect to negative income tax, as it was provided to all in the context of a highly progressive tax structure (see section 10.4.1).

The inclusive objective of 'participation and belonging' for welfare provisions rather than the mere relief of poverty had been emphasized by the Royal Commission of Inquiry on Social Security in New Zealand (1972). Following this report, innovative policies in the 1970s included the introduction of a no-fault accident compensation scheme, a new benefit for sole parents and, as described, the expansion of universal pensions for all over the age of 60.

2.3.3 The decline of National Superannuation

As a relatively small exposed trading nation the New Zealand economy suffered badly from the 1970s oil shocks, and by the late 1970s confidence that post-war affluence would continue was diminished. It was clear that some of the largesse of National Superannuation was unsupportable and would increasingly become so. In the first of several modifications, the *net* married couple rate of National Superannuation became 80 per cent of the average *net* wage in 1979 (see Figure 1).

Labour returned to government in 1984, with a wide-ranging market-led reform agenda driven by the ideal of "a state system that reflected the goals, management structure and ethics of the private sector" (Castles & Shirley, 1996, p.98). For a decade or more the economy was restructured along free market lines, state enterprises were privatised, and the welfare state overhauled with new emphasis on the targeting of social provisions of all kinds.[21]

The Labour Party promised prior to the 1984 election that it would not further 'water down' the universal pension. But in 1985, the Labour government imposed a surcharge on National Superannuitants of 25 per cent on all other private income over an exempt amount. The effect of this surcharge was to claw back the value of state pension for those with significant private incomes (see section 2.6 for discussion). Thus National Superannuation was no longer universal (although it had always been taxable as income) but was essentially income-tested, albeit the test allowed a high-income exemption. Reactions to the surcharge were strong, not only because Labour broke a campaign promise, (Castles & Shirley, 1996; St John, 1992, p.129), but also because the principle of entitlement to a universal pension based on notions of past taxes paid had been eroded.

2.4 The reform period 1988-1991

Between 1988 and 1990 government flattened the tax scale and abolished all tax subsidies for saving (see also, section 3.2 and St John & Ashton, 1993, pp.21-45). The intent of removing privileges from certain classes of saving was to encourage a better allocation of resources. Life insurance companies and other institutions which

[21] These changes are well documented (for example Boston & St John, 1999; Dalziel, 1999; Easton, 1997a, 1997b; Jesson, 1999; Kelsey, 1993, 1997; St John & Rankin, 1998).

had benefited from the tax-favoured status of superannuation saving were not seen by Treasury as dynamic investors, and it was argued their dominance in directing savings flows explained, at least in part, New Zealand's poor returns to investment. At this time, various compulsory savings schemes, including social insurance, were also investigated, debated and considered (St John, 1992, p.31). However, as in the debates to come, the concept of compulsion did not find favour and the simple and traditional basic public pension proved durable and popular.

Unprecedented increases in unemployment placed new pressures on social welfare benefits in the late 1980s. These had been designed for largely temporary income assistance in a fully-employed economy. Traditional welfare benefits such as sickness, domestic purposes (sole parent) and unemployment were subject to tight income testing, while additional welfare assistance was subject to wider tests of means, including asset testing. The rise of the New Right and the demolition of the traditional welfare state in the 1990s portended a return to the values of the 'world without welfare' of the past.[22] The rhetoric emphasised self-reliance, choice and fairness based on an earned right not an entitlement. Welfare benefit cuts were announced in 1990 and targeting of government assistance of all kinds increased markedly (Shipley, 1991). In this process, National Superannuation was to be changed into a welfare benefit with a high abatement rate for other income (see section 2.4). While public outrage saw the reversal of the legislation for National Superannuation, other parts of the welfare system were to remain tightly targeted and stigmatizing to recipients (Boston, Dalziel & St John, 1999; St John & Rankin, 1998). The conflict and inconsistencies between different parts of the welfare system were to persist and finally intensify in 1998 when the pension once more became universal as discussed further in section 5.7.

[22] But Thomson's early 'world without welfare' depended crucially for its success on the state playing an active role in other ways. Land and home ownership was actively encouraged by state assistance, while for much of the early period, massive government public works made employment readily available. Of course, neither of these underpinnings were apparent in the 1990s, making the New Right exhortations to self-reliance for all a somewhat empty rhetoric.

2.5 New Zealand Superannuation and the Accord

Following the reversal of the 1991 budget decision, the National government appointed the Task Force on Private Provision for Retirement "to report on policy options to encourage greater self-reliance of retired people". An improved voluntary regime for private provision for retirement and the continued integration of public and private retirement income through the surcharge was recommended. Once again the case for compulsory contributions was carefully examined and rejected along with any idea that tax subsidies should be reintroduced (Report of The Taskforce on Private Provision for Retirement, 1992).

In 1993 a multiparty agreement known as The Accord (appended to the Retirement Income Act 1993) was signed by the three major parliamentary parties: National, Labour and Alliance,[23] cementing in the voluntary tax neutral arrangements for private saving. National Superannuation, renamed New Zealand Superannuation, was to continue as a flat, taxable pension of between 65 to 72.5 per cent of the net average wage for couples, linked to private saving by a surcharge or by progressive taxation with similar effect (St John, 1999b, p.285; St John & Ashton, 1993, p.168).

The security and stability offered by the Accord was challenged in 1996 by the formation of a coalition government. In principle, both National and Labour could (and should) have refused to negotiate on matters of superannuation in the coalition talks of 1996 with Winston Peters, leader of New Zealand First, pointing to the 1993 Accord as the agreed way to make such decisions. They faced the classic prisoner's dilemma however, as negotiations were kept secret and any party that failed to compromise on this issue faced a possible disadvantage. The emerging coalition document between New Zealand First and National agreed to the abolition of the surcharge and a referendum on compulsory saving, from which point the Accord did not appear to have a future.

The leader of New Zealand First had insisted on a referendum on compulsory saving which he claimed would enable New Zealand to 'buy back the family farm' and 'make retirees better off'. If these were indeed the objectives, there was serious design problems with the compulsory option put before the public in 1997 (see

[23] Later, in 1994, these three were joined by the United Party.

section 7.4.2). Amid much acrimony, the public overwhelmingly rejected the compulsory savings proposal by a vote of 92.8 per cent (St John, 1999b).

In the meantime, the framework set out in the Accord was endorsed by a comprehensive review (Periodic Report Group, 1997a). This review was the first of the periodic reports required under the Retirement Income Act 1993. This review suggested that parametric changes to the age, the level and the introduction of some kind of integration such as formerly had been provided by the surcharge could be considered in the medium term (see section 10.4.1). It also suggested that the Accord process needed to be revived and suggested a framework for political stability to be re-established (Periodic Report Group, 1997b).

2.6 The role of the surcharge

One of the crucial elements undermining the 1993 Accord was the agreement to abolish the surcharge. Understanding the policy significance of the demise of the Accord requires an understanding of the history of means or income testing.

As outlined above, the universal pension became subject to a surcharge on a retiree's other income over an exempt amount in 1985. The surcharge was applied until the net amount of the state pension was clawed back in full. The imposition was bitterly resented. Few superannuitants understood the complicated calculations involved as it was an indirect adjustment to the pension, not one based on a straightforward means test as applies, for example, to the age pension in Australia (St John, 1991).

Significantly, only 10 per cent of pensioners effectively paid back all of their National Superannuation through the surcharge and three quarters of pensioners were not affected at all (St John & Ashton, 1993, p.17). Reflecting their low likelihood of having a high private income, few women were directly affected by the surcharge. Because the surcharge was based on individual not joint income, married women could still receive the pension in their own right, even when their husband's income was high. The exemption amount was also on an individual basis, although a married couple could amalgamate their exemptions. Consequently, if one partner did not fully use his/her exemption, the other partner could use the remainder. This surcharge feature gave married couples an advantage compared to single people, maybe

balancing the married person's disadvantage of having a lower National Superannuation rate and exemption.[24]

When in 1986 the top tax rate was reduced from 66 per cent to 48 per cent and then to 33 per cent in 1988, the surcharge could be rationalised as restoring some progressivity to the tax system, at least for pensioners. The surcharge was, nevertheless, very contentious and National promised to repeal it when they came to power in 1990. Instead, after the election, measures were announced that would transform the public pension into a tightly targeted welfare benefit. Public outcry subsequently forced the government to back down and restore the original public pension, but one with a higher surcharge and a rapid rise in the age of eligibility to 65 over a 10-year period (St John, 1992).

The abolition of the surcharge in 1998, even if the support of all the political parties was finally obtained, was a critical factor in the demise of the Accord. The surcharge had been the glue holding the left and right together. It represented a hard won compromise between, on the one hand, a universal pension come what may as desired by the left, and on other hand, a means-tested, subsistence benefit as desired by the right. The pension became vulnerable to attack as abolition of the surcharge left only lowering the level or raising the age of entitlement as mechanisms to save costs.

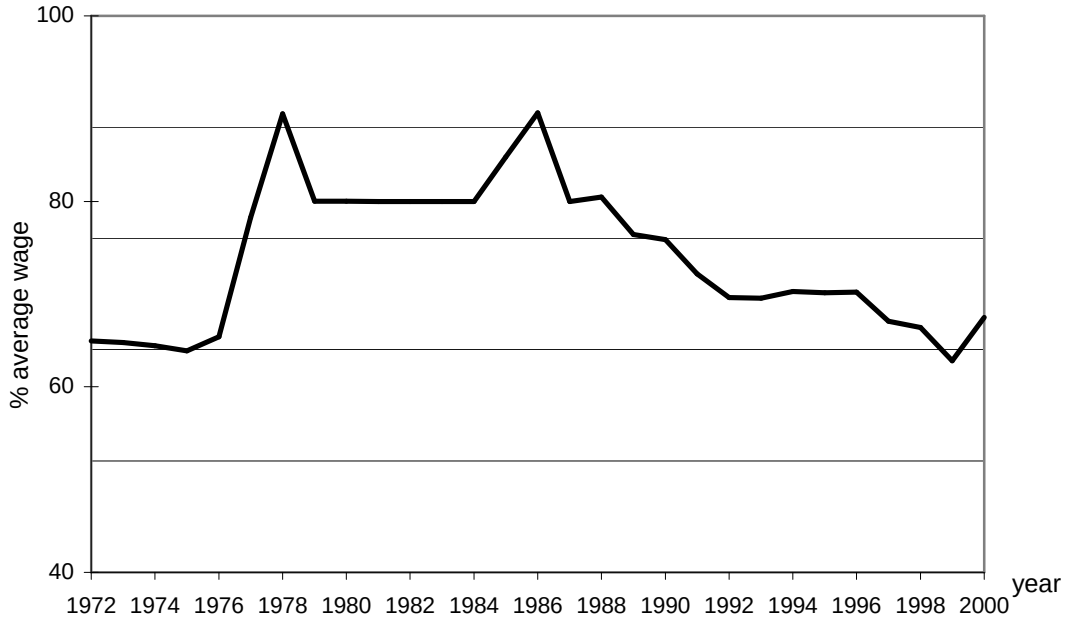
That vulnerability was well demonstrated in late 1998. The indexation provisions under the Accord had required that New Zealand Superannuation be adjusted by prices, but once the floor of 65 per cent of the net average wage (for a couple) was reached then price indexation should be replaced by wage indexation to maintain the 65 per cent relativity. In a surprise move, just when the wage-band floor had been reached, National announced the reduction of the wage band floor to 60 per cent.

Figure 2.1 below shows the way in which the indexation formula had resulted in a decline in the relative value of New Zealand Superannuation over the 1990s until the floor of 65 per cent was breached in 1998. The revenue formerly provided by the surcharge was about $300m a year (Periodic Report Group, 1997a, p.48) and lowering the floor to allow the relativity to drop over time was one way to claw back around the same amount of foregone revenue. Of course the distributional

[24] For details of the surcharge see Table 5.11 in chapter 5.

implications of the change to the floor were quite different from that of the surcharge.[25]

Figure 2.1: Net rate of pension for a couple as a per cent of net average earnings (men and women) 1972-2000



Source: Derived from Preston (2001b)

The sudden unilateral announcement of the change to the floor was universally condemned. Any vestiges of security that the public had that there was an Accord process for agreed and measured change disappeared. The change to the floor lacked any underpinning of data about living standards and was made entirely without consultation.[26] There was no longer any secure link to wages as there was nothing to prevent further reductions to the floor once the 60 per cent level was reached. The Asian crisis was cited as the justification, but later National accepted that a political mistake had been made.[27]

---

[25] Some evidence of poverty among the elderly was emerging as the relative value of the pension fell (Stephens, Frater & Waldegrave, 2000).

[26] The Periodic Report Group's 1997 report recommendations were ignored throughout 1998.

[27] National now support current arrangements for New Zealand Superannuation at no less than 65 per cent of the net average wage at age 65 for a married couple (for example see election speeches at http://www.national.org.nz).

After election in 1999 the Labour/Alliance government immediately reversed the change to the wage band floor, which had seen the pension for a married couple fall to 62.8 per cent of the net average wage as illustrated in Figure 2.1 above. From April 2000 the net pension of a married couple was returned to just over 65 per cent of the net average wage, restoring confidence that the public pension would once again move in tandem with the average wage.[28] While the Labour/Alliance government also raised the top marginal rate of tax on income from 33 per cent to 39 per cent, there was no suggestion of a return to any kind of income testing such as that provided by the surcharge.

2.7 The emergence of the New Zealand Superannuation Fund

The Labour party campaigned on their own superannuation policy in 1999 essentially dismissing any prospects for a resuscitation of the Accord. After the election, their plans for introducing an element of pre-funding into the state scheme culminated in the New Zealand Superannuation Act 2001. This Act comprises three parts: Part 1 sets out the entitlements to New Zealand Superannuation; Part 2 establishes the Fund; and Part 3 sets out miscellaneous provisions including the mechanisms for making changes.

The Green, National and Act parties voted against Part 2 of the Act that provides for the fund. The Labour/Alliance vote was insufficient to ensure the passage of the Bill but they were joined by the sole Parliamentary member of the United party and the New Zealand First party. The New Zealand First leader, Winston Peters, was again to play a crucial role. In return for support pivotal for the passage of the Bill through the House, he required rewording of clause 73, Part 3 of the Act to make it clear that the fund could be transformed into individual accounts at some time in the future.[29]

Most commentators are bemused by what appears to be the confusion of a single tier New Zealand Superannuation which is highly redistributive, with a second tier

[28] The relativity became around 67 per cent as the government was determined to raise the couple rate of pension by a meaningful amount of approximately $20.

[29] Specifically the effect of the changes negotiated with Winston Peters are that the 'Guardians of the Fund' will have to report back within one year rather than two and that, instead of reporting on options generally, they should report specifically on the best means of allocating the Fund among individual accounts.

supplementation based on one's own contributions. Few commentators understand how the fund could be divided among the population when New Zealand Superannuation is a universal basic flat-rate provision (see, for example, New Zealand Business Roundtable, 2001, p.13).[30]

The Long-term Fiscal Model projects a significant increase in government expenditure (excluding financing costs) of around 7 percentage points in Gross Domestic Product (GDP) by 2050 (Davis & Fabling, 2002). This arises from additional pension and health expenditures and an eventual decline in the labour force. This expected fiscal pressure is the basis of the pre-funding policy.

The Minister of Finance, Dr Michael Cullen, has described the nature of the fund as "smoothed pay-as-you-go". The fund is expected to ease the transition from pensions costing a net 4 per cent of GDP to a cost of 9 per cent of GDP by the year 2050 as the demographic profile changes and the proportion of the population aged over 65 rises from 12 per cent to 26 per cent (Statistics New Zealand, 1999b). Funds build up for around the next 25 years when they will be run down along with fund earnings to meet part of the costs of New Zealand Superannuation from that time.[31] In the meantime the fund is to be managed at arms length by a board of appointed trustees called 'Guardians of the Fund' who will use professional fund managers to invest the money both domestically and abroad. It is expected that the actual investment of the accumulated funds will not occur until late 2003 by which time investment strategies will have been clearly established.

While Officials have downplayed any significant macro implications from the fund, (see, for example, Treasury, 2000a), Dr Cullen argues that the counterfactual to setting aside some of the projected surpluses would be tax cuts. He claimed these would be bad for the economy. The fund would enable higher national saving

---

[30] There is much debate in countries like the US around the need to introduce individual accounts into social security however these schemes already have a contributory basis. Even so there are some almost insurmountable problems with little likelihood that the objectives US advocates think they will achieve can be achieved by such reforms (see Aaron & Reischauer, 1998; Geanakoplos, Mitchell & Zeldes, 1998; P. Orszag, 2001).

[31] There are a series of working papers that detail the assumptions and the projections for the fund, see for example, The New Zealand Treasury, (2000b).

Also see Treasury web site: http://www.treasury.govt.nz/

compared to the counterfactual of tax cuts, and augmenting national saving should take the pressure off the Current Account Deficit (CAD) (Cullen, 2000).[32] It was also argued that by allowing the fund to invest in a diversified way including overseas financial assets, the government would improve the financial position of the Crown as a whole.[33] While it could be argued that the government could diversify its assets without the need to set up the fund, the fund was claimed to have the additional benefit that it would "give people confidence that New Zealand Superannuation could be paid in the future" (Cullen, 2000).

The contributions to the fund required each year are based on a forty-year rolling horizon, and critically depend on the assumed rate of return in the fund. The expected tax smoothing is shown in Figure 2.2 below where a 9.4 per cent gross return is assumed. Davis and Fabling (2002) consider the efficiency cost aspect of tax smoothing and conclude that evening out the tax rates minimises deadweight losses[34] and for a base set of assumptions, produces significant welfare benefits compared to running a balanced budget. But as illustrated in Figure 2.3, the impact of tax smoothing is sensitive to the assumptions about gross returns. The lower the projected rate of return, the higher taxes must be until 2025, for lower net gain once the fund begins to run down.

Any gain from tax smoothing is conditional on strong fiscal discipline so that 'expenditure creep' does not become a problem in the face of an improving balance sheet. It is also dependent on the assumption that government's investment of the surplus will generate returns significantly above the costs of borrowing.

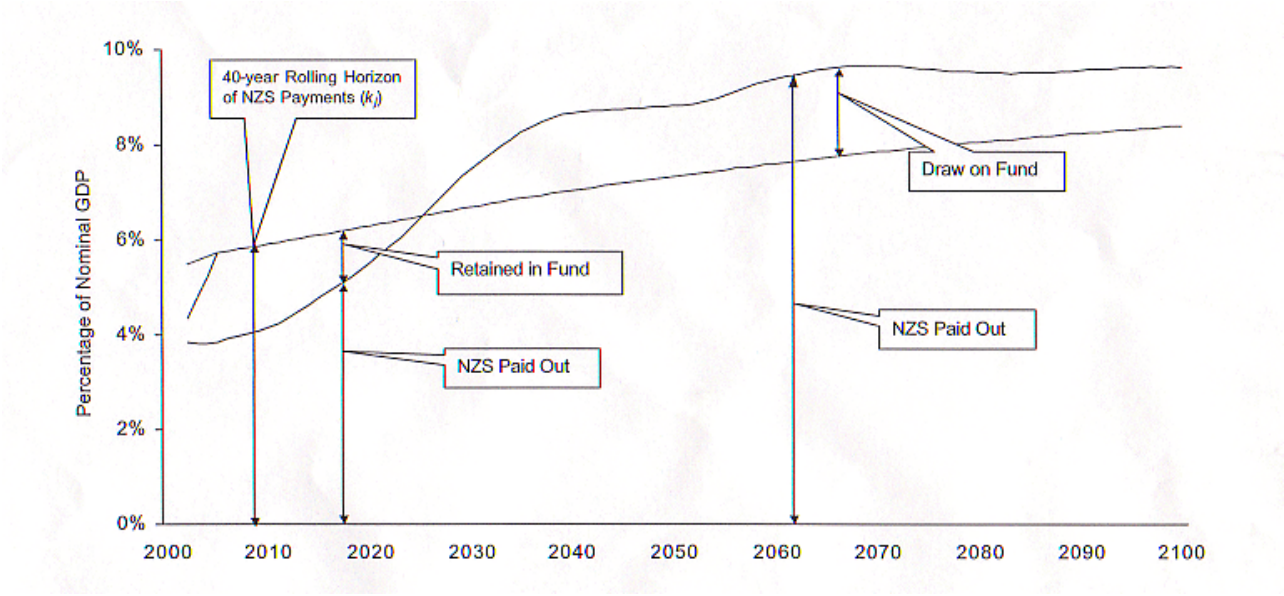
---

[32] The concern about the CAD and the need to address it with more saving is not however reflected in all Treasury working papers (for example, Kim, Hall & Buckle, 2002).

[33] Already there had been moves to free the Government Superannuation Fund (for state sector employees) from restrictions on international asset holdings.

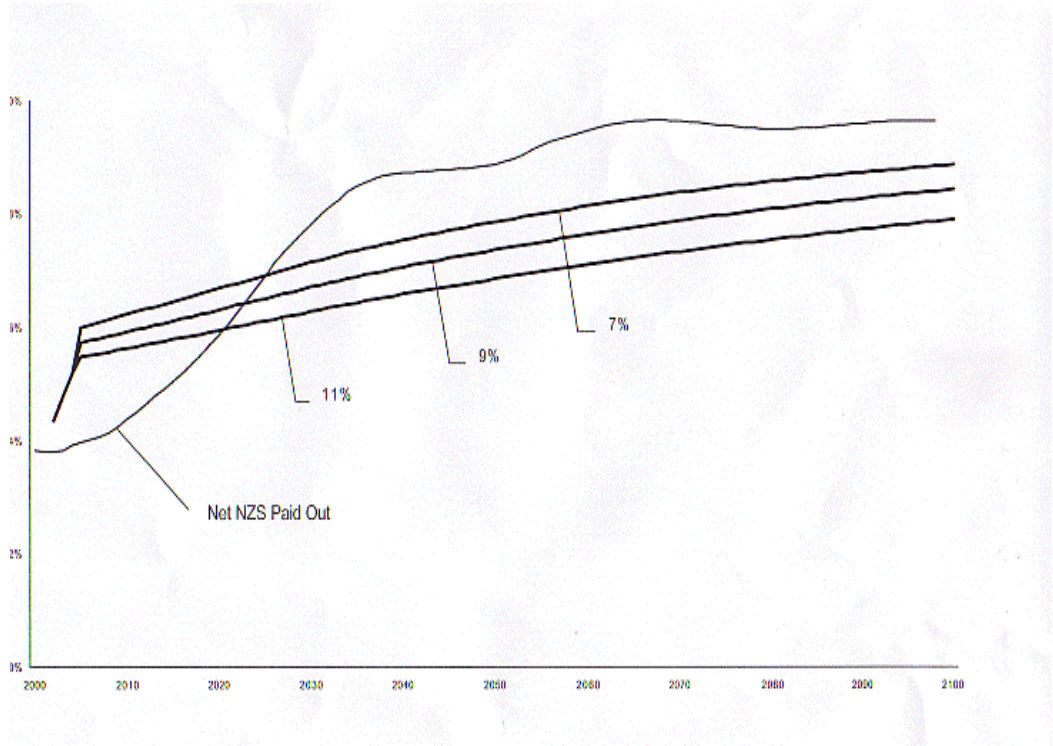
[34] This is because the deadweight loss of a tax is thought to increase by more than the proportionate rise in the tax rate (Davis & Fabling, 2002, p.3).

Figure 2.2: The New Zealand Superannuation Fund projected contributions



Source: McCulloch and Frances (2001)

Figure 2.3: Effect of different assumptions about expected returns on the path of the required contribution rate



Source: McCulloch and Frances (2001)

2.7.1 Criticisms of the New Zealand Superannuation Fund[35]

The imperative to generate a high rate of return and an emphasis on overseas equity markets is risky. The issues are complex but a continuing bear market in international equities might prove damaging, at least in the short-run, to the prefunding policy as it now stands.

On the basis of expected savings alone, the modeling suggests that the Crown should follow a particularly aggressive investment strategy. However the volatility of the investment returns should also be considered (Davis & Fabling, 2002, p.11). The conclusion reached by Davis and Fabling (2002, p.12) that "…only a government with a very low risk tolerance could justify moving away from a strategy of investing all primary surpluses in foreign equities" is a strong one. Their conclusions also depend on stability in future government commitment to the strategy of tax smoothing. A poor first few years would increase political pressure for a change in strategy. They note that even modest expenditure creep could quickly erode the welfare gains from tax smoothing.

Political consensus has not emerged. Opposition from all shades of the political spectrum has so far been vociferous. There is fundamental scepticism as to the purpose of the Fund and whether it can deliver on the promises claimed for it.[36] The objectives of the legislation are not found in the Act itself, but have been reflected in numerous speeches and press releases from the Minister of Finance[37], for example:

> *The basic intention of the scheme is to provide a sensible and secure basis for the long-term provision of the first tier of retirement income.* (8/2/01)
>
> *The Fund will allow us to maintain a universal pension that guarantees a basic minimum standard of living for superannuitants. It will finally give superannuitants some certainty about what the government will be able to provide for them. And they will know that they have to provide for*

---

[35] This section draws on commentary and submissions to the select committee, including those made by author, see http://www.geocities.com/nzwomen/SusanStJohn

[36] The select committee commentary released 12th June 2001 makes the view clear however that the fund cannot, and should not, be taken to mean that debate on superannuation is over, or that all the design issues have been resolved.

[37] See website of the Minister of Finance: http://www.executive.govt.nz/minister/cullen/index.html

> *themselves if they want a higher standard of living than New Zealand Superannuation offers.* (14/12/00)

Critics have wondered how a scheme that is expected to provide at most 14 per cent of the cost of the scheme[38] could ever provide such certainty or security. It is also clear that while the contribution to the Fund is the first call on the operating surplus in the government's budget, the need to contribute to the fund means that borrowing for other capital, including student loans, is higher than it would otherwise be.[39] The intent has been, clearly, to implement the fund and entrench it so that it would be difficult to dislodge:

> *My view is that the great and enduring consensuses on superannuation policy, like those in the USA and in Australia, have followed rather than led new schemes. They have followed by the law of political gravity. As the funds have grown, and as they have been seen by the population as a whole to be a clear indication of where their pensions are going to come from, they have become too strong a force to try and deny.* (Cullen, 2001a)

Other critics point to the opportunity costs of the fund. Money invested in the Fund may be at the expense of many other worthwhile fiscal goals (Donald, 2001; English, 2001). There is still a further concern that projected surpluses are based on a too optimistic growth outlook and that the Fund implies a fiscal straight jacket.[40]

Rising structural surpluses as projected to the year 2006 indicates that the government's fiscal stance is set to become more contractionary. The export sector is

---

[38] The controversy over the actual saving achieved hinges on how the tax revenue from the fund investments is treated. The Minister of Finance insists that this revenue is part of the return to the fund so that the funds should supply not 14 per cent, but around 25 per cent of financial costs of New Zealand Superannuation. Either figure is conditional on the assumed rate of return being achieved.

[39] The growth of gross and net debt provoked claims that the government is borrowing to invest in the fund. In the 2001 budget, of the $19.3 billion invested over the forecast period, there is a $7.6 billion shortfall to be made up with increased borrowing and run down of marketable securities and deposits. Gross debt increases by $4.8 billion and net debt by $2.9 billion. A refinancing of Crown entity debt (accounting change only) accounts for $1.4 billion. The 2002 Budget shows an improved operating surplus.

[40] These criticisms were particularly pertinent following the slowdown in the world economy post 11th September 2001 events. A strengthening economy was delivering higher than projected surpluses by the end of 2002 (Minister of Finance, 2002b).

expected to be the engine of growth.[41] Should the optimistic growth scenario not be sustained, it may not be sensible macroeconomic policy to set aside the budgeted amounts for the Fund. Section 44, Part 2 of the Act implies that a shortfall in contributions in one year to the Fund needs to be made up in following years. But the danger is that the economy may remain weak so that the catch up for the next years may be impractical. In this case the whole edifice of certainty and security is threatened.

Likewise, high returns to fund earnings have been assumed in the projections that may prove unrealistic. The 2002 Budget projections are based on a projected gross return of 9.4 per cent for example, and the projected effects are sensitive to this optimistic assumption as shown in Figure 2.3 above. If the promise of not increasing taxes for current payments of New Zealand Superannuation cannot be met, it is questionable whether the public will continue to believe the New Zealand Superannuation Fund enhances their security.

Debates about the division of future output between the old and the young, about the size of shares and the shape of New Zealand Superannuation are not resolved by this Act. While it might appear that the Fund and its earnings, by supplementing tax revenue, can reduce the burden on workers, the effect is illusory. Regardless of where funding comes from the cost of the pension is the same, as is the implied sacrifice of the working-age population. The cost is the consumption of the old. The revenue of the Fund could be used to meet the needs of the young: a point made clearer by imagining the Superannuation Fund is not ring-fenced for superannuation, but simply represents additional assets on the state's balance sheet (paid for by the sacrifice of all workers).

It is highly questionable that there is widespread agreement of the primacy of the needs of the elderly over the needs of other groups as the government has asserted. New Zealand has a serious problem of child poverty. At the margin, investment in the younger population may be a much better safeguard for the future of retirement pensions than siphoning off money for the Fund.

---

[41] Supporting this, New Zealand had its first quarterly Balance of Payments current account surplus for 7 years in June 2001. However by the end of 2001 the prospects for commodity prices internationally looked less rosy and by mid 2002 the exchange rate was rising steadily.

> *Increasingly, the obligation to pay into the superannuation fund will constrain the ability of government to increase either social welfare benefits or family payments. While there may be good arguments to support fiscal prudence, and the fund may prevent the further damage done by tax cuts, intergenerational conflicts have not been discussed. One outcome of the superfund may be a neglect of children's increased levels of poverty.* (St John et al., 2001, p.21)

The New Zealand Treasury envisages that the Fund would eventually run down to zero. But capital withdrawals require the sale of assets. As opposed to only using the income from the assets, asset sales to fund current expenditure could have undesired macroeconomic effects and may require adjustments such as higher taxes elsewhere. Once the assets are sold, the share of GDP required for the permanently older population has to all come from tax.

Income from Crown assets to supplement taxation may indeed have a helpful role to play. If there are genuine surpluses in booming economic conditions, it may be highly desirable that the government buys assets and puts them on the balance sheet. The arguments that question the fund are not arguments against fiscal prudence. Strengthening the balance sheet may indeed enhance national saving and be preferable to inappropriate tax cuts. The pressure might therefore be lifted from monetary policy with lower interest rates than otherwise would be the case. By some tenuous connections, the CAD might be lower and the economy might improve. Business confidence may also be enhanced if the state invests in the domestic sharemarket or in needed infrastructure. Overall the quality of investment may improve. Critics of the fund have pointed to the alternative uses of the money, such as reducing debt, which may be a surer way to reduce interest rates and have a beneficial macro impact, especially in light of falling returns in international equity markets.

If fiscal prudence is justified it does not require placing a ring around New Zealand Superannuation Fund assets, reserving their use for New Zealand Superannuation specifically. Nevertheless, the argument can be made that the fund may be what it takes for the public to accept that tax cuts for the baby-boom generation are not warranted. Unfortunately the Act and the accompanying political comments may give the impression that the Fund itself guarantees the pension.

Part 1 of the Act sets out the existing parameters of New Zealand Superannuation, leaving little flexibility for its future modification. Commitment to the 65 per cent net

of average wage floor for a married couple is made, but even that, and certainly other parameters of the pension may need to change over time.[42] Part I also locks into place the entitlement of each person, whether working or not, whether wealthy or not, to a generous universal pension. The equity implications are further discussed in section 5.7 of this thesis. While Part 1 of the Act has attracted political support in the short term, it is difficult to see how it can be the basis of long-term agreement in light of the obvious social inequities. While intergenerational conflict is likely, reduction of the pension rate, or making payment of it conditional on social welfare means testing, would raise other problems such as the prospect of increased poverty among the aged and poverty traps.

The original Accord and the regular six yearly reviews provided a process for measured change. It is not clear what role these reviews now play, nor is the status of the Retirement Income Act 1993 clear, as much of is superceded by the New Zealand Superannuation Act 2001. The provision of consultation with the signatories as set out in Part 3 of the Act before changes can be made provides an inadequate substitute for an Accord process. It does not, for example, imply that consensus will be sought, nor that there is an independent chair for the process. Yet the history suggests that a reasonable degree of consensus must be the firm basis for ongoing stability and certainty. Some clear guidelines for achieving political consensus were set out in *Building Stability*, the report of the Periodic Report Group (1997b), but these have been ignored to date.

2.8 International comparisons

International comparisons on the size of public pensions show that New Zealand spends only a moderate proportion of GDP on public pensions, and even with the demographic changes of the next decades this spending is not projected to become the problem it will be in many European countries (Periodic Report Group, 1997a, p.103).

---

[42] There are also several immediate design issues. The 1997 Periodic Report Group for example, thought that marital status should not determine the rate of an individual's New Zealand Superannuation. Single people who share accommodation have the same economies as a married couple and it is hard to see why they are treated differently.

Government spending as a percentage of GDP is often taken to be an indicator of fiscal prudence. There are constant voices in New Zealand that insist the public sector is too large using measures of government expenditure (for example, Bates, 2001). However, official figures from the OECD, given in Table 2.1 below, show that New Zealand is not unusually large on this measure with only 9 out of 29 countries showing a lower spending ratio. Serious measurement issues abound however. Public sector accounting measures of fiscal deficits, taxes, pensions, average tax burdens, average tax rates and size of the state can be quite misleading and can have mischievous effects when used in policy debates.

> *[A]verage tax rates measured using aggregate data in a number of cases generate misleading indicators of the tax burden… Average tax rates for corporate income should be neglected, given the many statistical and conceptual difficulties raised by current estimation procedures. Policymakers should be fully aware of measurement problems and other limitations underlying such figures, should they be fielded to shape the public policy debate.* (OECD, 2002, p.11)

Some comparative figures and projections for expenditure as a percentage of GDP on public pensions for selected OECD countries are provided in Table 2.2. There are a vast number of caveats that need to be made before conclusions are drawn about how well one country is doing compared to another. Countries with strong mandatory pension schemes that are managed in the private sector have public pension schemes that look comparatively small. Yet as argued by Heller (1998), funds that build up surpluses and then run them down can have macroeconomic effects that are just as important as conventional public surpluses and deficits. Thus mandatory private savings schemes may mimic the outcomes for publicly managed schemes and the fact they are mandatory implies considerable state involvement.

> *...if the policy choice is a funded [defined contribution] scheme, there are strong arguments to be made that it should be classified in the public sector (even if managed by private sector agents under public regulation) and not lost in the accounts of the private sector.* (Heller, 1998, p.23)

Table 2.1: Government revenue and expenditure as a percentage of GDP in OECD countries

	Government revenue % GDP	Government current expenditure % GDP
Slovak Republic	53.8	56.3
Sweden	56.9	55.1
Denmark	54.9	52.4
France	48.1	48.5
Greece	50.2	48.3
Belgium	48.2	48.0
Austria	47.3	47.3
Finland	48.7	46.4
Germany	44.5	44.8
Italy	44.9	44.6
Norway	51.0	43.9
Netherlands	44.2	43.2
Canada	43.4	42.5
Poland	42.5	39.6
Portugal	38.6	38.3
Luxenbourg	45.0	38.0
United Kingdom	39.3	37.8
Czech Republic	38.9	37.0
New Zealand	**40.5**	**36.4**
Spain	37.2	35.9
Iceland	38.2	34.3
Switzerland	34.4	34.2
United States	32.8	32.7
Australia	33.3	31.9
Japan	31.6	30.0
Hungary	29.8	29.8
Ireland	34.5	29.3
Korea	26.1	17.1
Mexico	19.4	17.0
Average	**41.3**	**39.3**
Median	**42.5**	**38.3**

Source: Derived from OECD (2001a)

Table 2.2: Projected pension spending (per cent of GDP)

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	**5.9**	**4.8**	**5.2**	**6.7**	**8.3**	**9.4**	**9.8**
UK	4.5	4.5	5.2	5.1	5.5	5.0	4.1
US	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Source: Disney and Johnson (2001)

Table 2.1 and Table 2.2 show, for example, a lower spending ratio for Australia, a country that is often used in New Zealand comparisons. However, just thinking about the accounting treatment of pensions alone, there is an understatement in the case of Australia. First, their compulsory second tier provision is not counted. Second, pensioners on the age pension pay no tax while New Zealanders pay full tax on the first dollar of state pension income. Third, the considerable value of tax incentives for private provision is not counted as government spending. Fourth, and often overlooked, pensioners in Australia are covered for medical care under the social insurance programme 'Medicare'. This covers 85 per cent of the scheduled fee for general practice and specialist consultation over and above free public hospital care (McCallum, 1999, p.96). Most older people are not required to contribute through the 'Medicare' levy as their incomes are too low. In New Zealand, pensioners carry more of the costs of their own care (see section 4.2).

The debate in New Zealand about the size of the public sector and the need for reductions in tax and government spending is an ongoing one.[43] In regard to international comparisons such as given in Table 2.1 and Table 2.2 above, the correct measure of government spending is hotly contended. The New Zealand Business Roundtable (Kerr, 2001) has preferred to use statistics on general government outlays (current and capital), rejecting the simpler ones in Table 2.2.[44] Yet all these measures, by including spending on transfers, are flawed. Transfers are analogous to negative taxes, and the similarity between a transfer, a tax reduction (in the scale) and tax expenditures are little acknowledged. In fact they can be equivalent ways to achieve the same social goals but with very different accounting implications.[45]

> *Groups of citizens or particular activities are favoured when they are exempted from payment of taxes. These 'tax expenditures' give the illusion*

---

[43] See for instance, the debate in *The Independent* between St John and Kerr in 2001/2 available at: http://www.geocities.com/nzwomen/SusanStJohn

[44] It might be noted that the New Zealand Business Roundtable use a total spending to total GDP ratio for the OECD rather than the more informative simple average (St John, 2002a).

[45] A tax expenditure is the revenue foregone from allowing specific tax rebates, exemptions, or deductions that have an effect equivalent to a direct payment from the Crown. Because the direct payment would be counted as government spending, tax expenditures artificially reduce the size of government spending. The costing of tax expenditures is controversial as discussed later in section 6.5.

> *that the State is smaller in terms of revenue or expenditure, and distort inter-country comparisons.* (United Nations, 2002, p.40)

None of the measures, even the one preferred by the New Zealand Business Roundtable, indicate that New Zealand is out of line compared to other OECD countries. It is true that a country like Ireland, which has had a successful growth experience, appears to have a very low government expenditure/GDP ratio. But the fall in the ratio over time is the result of high growth, not aggressive state expenditure pruning. The use of tax expenditures in Ireland to encourage private pensions also makes the ratio appear lower than a full measure, as discussed further in section 6.5.

2.9 Assessment of New Zealand's state pension

The New Zealand state pension has numerous advantages compared with other public pension systems:

- It is remarkably simple.
- As entitlement is based on residency and not on joint income or contributions to the paid workforce, it copes well with social change such as divorce, separation, remarriage and widowhood. Social insurance schemes based on the contributory principle generally fare poorly in these areas.
- It acts as a basic income and is flexible in the light of labour market reforms that have promoted more casual, part-time, and low-paid employment.
- It is effective in meeting poverty prevention objectives (see chapter 5). It is egalitarian and promotes social inclusion. For low-income retirees it may provide an adequate replacement income, allowing 'belonging and participation'.
- It is flexible enough to allow parametric changes to ensure it is broadly fiscally sustainable in light of the ageing of the population.

The thesis is concerned with the provision of income additional to New Zealand Superannuation for middle-income retirees. It is noted that New Zealand Superannuation as an annuity has highly desirable characteristics. It protects individuals against the longevity risk, including gains in potential longevity, the investment risk of poor returns or of loss, the inflation risk because of indexation provisions, growth in general living standards given the link to average wages. From

the perspective of fiscal cost it has the advantage over conventional annuities in that there is no guarantee period. New Zealand Superannuation is very unusual internationally and provides a clear example of how basic income can prevent poverty and promote social inclusion.

2.10 Summary

The history of policy development since the 1970s strongly suggests that unilateral changes to policy do not work. The lesson is that it is not a question of finding the 'best' model internationally and applying it, but one of edging forward cautiously with broad all-party support on agreed goals. While the basic system of a sound state pension supplemented by voluntary saving has so far proved remarkably resilient to knocks, unfortunately any basis on which the 1993 Accord may be reconvened has been almost totally destroyed (St John, 1999a), and the events of the last few years, including the latest controversial move to set up a fund for New Zealand Superannuation, portends more political dissension in the future.

The tensions and issues in the 2000s reflect both the demographic changes and the history outlined in this chapter. New Zealanders have shown a historical predilection for their simple pension system, a fondness for real estate rather than annuities and pensions (to be discussed in chapter 3), and have firmly dismissed the idea of compulsory savings. The state pension, New Zealand Superannuation is a success story on many fronts as summarized in section 2.9, but one of the serious deficiencies of the New Zealand system has been a relative neglect of private provision. The next chapter examines in more detail the history of the place of additional pension income in retirement.

3 Private pensions and annuities in New Zealand

3.1 Introduction

Chapter 2 described how 19th century colonial New Zealand was a society that emphasised the virtues of self-help and thrift. The early friendly societies were an example of collective provision, albeit an unsatisfactory one. Some employee pension schemes existed of which the Bank of New Zealand scheme, begun in the 1880s is the most well known[46] and there was an early government scheme for state employees. In general there was little growth in company schemes, until tax incentives were introduced in the early 20th century (Ashton & St John, 1988; Thomson, 1998). The National Provident Fund (NPF) was set up in 1910 to encourage low and middle-income people with subsidies to provide for some of life's contingencies, especially a pension from age 60. Thomson (1998, p.57) suggests this scheme was not very popular because of the lack of lump-sum provisions and lack of inflation-indexing of the pensions:

> *Life insurance proved much more attractive to New Zealand than did joining the NPF… But settlers would only take out life policies for lump-sum benefits - the purchase of annuities had no attraction at all.*

Life insurance often via an endowment policy was the savings vehicle of choice,[47] winning over friendly societies and private pensions, though New Zealanders were never great insurers, preferring above all, investment in real estate. As far as annuities were concerned, there was little interest despite the Government Annuities Act 1869 which encouraged the sale of annuities.[48] Thomson speculates as to the reasons for the lack of appeal of annuities, suggesting myopia, lack of understanding of the needs of old age, more pressing needs for the money and the attraction of lump sums. The

---

[46] See Quigley (1988) for a full history of the Bank of New Zealand superannuation scheme.

[47] Life insurance policies generally pay out to survivors only, while endowment polices mature at a certain age providing a lump sum.

[48] In 1886, the first year of insurance statistics, 9152 life insurance policies were issued but just 9 annuities. In 1929 life insurance paid out was 50 times greater than the amount paid out as annuities (Thomson, 1998, p.62).

argument that the state pension made an annuity unnecessary is dismissed as not fitting the history.

As in other countries, pension coverage was first provided to employees of the large companies and government employees. The chief beneficiaries of company-based employment tax incentives were long-term career, same company, white, male, high-income employees.[49]

The Government Superannuation Fund was established in 1948, amalgamating several previous schemes for public sector employees. By the early 1970s the contributor base was wide, covering employees in the state owned railways, airline, telecommunications sector, and in education, the army, the judiciary, and diplomatic and parliamentary service. The intent was to reward longer serving employees and provide a dignified retirement at a suitable age. By 1976, membership had peaked at 130,000 and there were about 30,000 beneficiaries (Atkinson, 2002, p.8). Reflecting concern about the impact of inflation on fixed pensions in 1969, automatic inflation adjustment to pensions was introduced for new retirees. Some adjustments were also made for existing pensioners.

3.2 Tax neutrality and the tax reforms

By the 1980s the income tax base had become narrower as the result of various tax reliefs and exemptions. This in turn had resulted in high average and marginal rates. In 1984 the top marginal tax rate for personal income tax was 66 per cent on incomes of over $38,000, although avoidance by the better-off was common.

In 1986, the wholesale sales tax was abolished and replaced by a broad based 10 per cent Goods and Services Tax (GST). In contrast to value added taxes in most other countries, GST was neutral between goods as it was introduced at a single rate with few exemptions. This was accompanied by a flattening of the marginal income tax rate schedule and the expansion of targeted tax rebates for those on low-incomes. GST allowed the higher income tax rates to be lowered, thus reducing incentives to

[49] For a pre-1988 review of private pensions in New Zealand see Thomson (1998); St John & Ashton (1993); Ashton & St John (1988).

evade and avoid income tax.[50] As discussed in section 2.6, a series of tax changes saw the top marginal tax rate reduced from 66 per cent to 48 per cent in 1986 to 33 per cent in 1988, with the top rate of personal income tax aligned to the company rate. The double taxation of dividends was eliminated when full imputation was introduced in 1988.

In December 1987, far-reaching reforms to the tax and regulatory treatment of private superannuation schemes were announced. When fully implemented in 1990, New Zealand was the only OECD country not to treat private savings for retirement differently from other forms of saving. Rather than the traditional tax-exempt status given to contributions made to superannuation schemes by employer, employee or both, contributions were made out of tax-paid income, just like depositing money in a bank. Fund earnings, rather than being tax-free, were taxed, just as interest earned on money deposited in a bank is taxed. Finally, just as withdrawing money from a bank account is capital, not income, no tax would apply at this stage.[51]

The changes were radical, but were consistent with the broad philosophy of 'the level playing field' approach being applied elsewhere in the tax system and the economy itself. Under these policies, any tax preferences, regulations, tariffs, subsidies, or controls were regarded as costly distortions, adversely affecting work effort, savings and growth.

3.2.1 The debate over taxing superannuation

A complete review of the tax treatment of superannuation and life insurance with the "objective of moving towards a more rational tax regime" was announced in the 1984 Budget (Minister of Finance, 1984 p.19). The rationale was that the tax concessions for superannuation (and to a lesser extent life insurance) were costly in terms of foregone tax revenue. This loss was estimated to add about 2.5 percentage points to the average personal tax rate for all taxpayers.

---

[50] Among other measures, the Fringe Benefit Tax (FBT) was introduced in 1985 as a base broadening measure to close loopholes by capturing most of the non-cash income provided by way of company cars, low interest loans and other business perquisites.

[51] Both New Zealand and Australia have moved away from the idea that end benefits only should be taxed. Countries with traditional EET models, (see Table 3.1), watch the Australasian approach with interest, but it is New Zealand whose model has been the purest.

It was also claimed that high-income earners, usually male, had generally appropriated the benefits of such concessions at the expense of other taxpayers. More fundamentally, such concessions were believed to contribute to saving and investment distortions, inflexibilities in the labour market and avenues for tax avoidance. Those Life Offices and other institutions that had been the recipients of large amounts of funds had an unfair competitive advantage that was inconsistent with the government's goal of tax neutrality.

Professionals in the superannuation industry were generally in agreement that the previous arrangements were ineffective and inequitable, but most wanted the regulations improved, not tax concessions abolished completely. The Government however had come to the conclusion that a consistent income tax treatment was the solution. A promised period of consultation with the industry did not eventuate and the decision to abolish all tax concessions, including those applying to existing schemes, was announced in late 1987.

Under the new scheme, contributions to saving plans were made out of after-tax income so that contributions may be described as 'taxed' (T). Income accruing as fund earnings is taxed (T) at the company rate of 33 per cent (the top individual marginal tax rate), while withdrawals from the fund are exempt from tax (E). In the terminology used in the subsequent debate, the traditional expenditure tax treatment involves an (EET) regime or Exempt/Exempt/Taxed while the new income tax treatment of saving involves a Taxed/Taxed/Exempt (TTE) regime as shown in Table 3.1.

Table 3.1: Different tax treatments of superannuation

	Expenditure tax treatment (prior to Dec 1987)	Income tax treatment (by 1990)
Contributions	Exempt	Taxed
Investment income	Exempt	Taxed
Withdrawals	Taxed	Exempt
	EET	TTE

A complex and uncertain time for private superannuation followed the December 1987 announcement. Arguments that a change to existing schemes involved retrospective legislation fell on deaf ears. The Government could point to many other reforms undertaken in the 1980s that also entailed retrospective measures. A short

transitional regime for previously tax-favoured schemes was supposed to be sufficient to allow the smooth adjustment to the new tax environment. There were just two years between the announcement of the new regime and its full implementation.

There were winners and losers with schemes given a one-off opportunity to write down the value of pensions, now to be paid tax-free. The write down provision was to recognise that new earnings on all funds accumulated would be taxed at the full 33 per cent rate of tax. In practice, large windfall gains were enjoyed by pensioners of many company schemes, and to a lesser extent by government employees. These gains arose in large part because the accumulated funds to date would now be paid out tax-free. But also, the one-off write down in gross pensions did not eventuate for those schemes that were in strong actuarial surplus and the government pension write down did not fully offset the gains made by the tax-free status of pensions (St John & Ashton, 1993, pp. 36-40).[52]

By 1 April 1990 the new tax regime was fully operational with the Income Tax Amendment Act 1989 and the Superannuation Schemes Act 1989 providing the necessary taxation and supervisory legislation.[53] Schemes became 'registered' by the Government Actuary rather than 'approved' as previously for tax concession purposes.

New Zealand's tax regime for retirement income saving no longer distinguished between pension and lump-sum schemes. The registration of schemes was not related to tax treatment but attempted to provide some degree of supervisory control and protection for members. With no tax concessions, there was no restriction on the amount of the employer's contribution, nor did restrictions apply as to how scheme benefits were to be received, although the trust deed could specify such details. However the ideal of neutrality, with respect to the tax treatment of superannuation, was to be severely compromised in 1996 when the middle-income tax rate was

[52] The revenue foregone by the switch to TTE was substantial. Other countries emulating the New Zealand approach would do well to consider a one-off lump-sum tax on accumulated fund earnings, as suggested by Munnell (1992).

[53] The Superannuation Schemes Act 1989 emphasises the responsibilities of trustees and applies equally to schemes that are sponsored by employers and those offered to the public as retail schemes.

reduced to 21 per cent, and again in 1999 when the top tax rate was lifted to 39 per cent as described in section 3.4 below.

3.3 The demise of company pensions

As might have been predicted, the years following the tax changes resulted in declines in membership and closure of schemes. In 1997, the first review of retirement incomes policies as required under the Retirement Income Act 1993 noted that while many employers were likely to play some role in the provision of retirement planning "there has been some question about the extent to which they will continue to offer superannuation itself" (Periodic Report Group, 1997a, p.183).

The Government Actuary's figures on membership of occupational schemes presented in Table 3.2 clearly show that there has been a marked reduction in scheme membership since 1990. There has also been a sharp fall in the number of schemes reflecting a high number of terminations and cashing out of benefits. Many employers have also been shifting out of employer-sponsored schemes to master or multi-employer schemes, in order to save on administration and other compliance costs.

Table 3.2: Active membership of occupational schemes

Year	Private (000's)	Government (000's)	Labour force (000's)	Private % of Labour force	Total % of Labour force
1990	273	60	1,480	18.5	22.6
1991-2	-	-			
1993	273	61	1,475	18.5	22.6
1994	258	59	1,532	16.8	20.7
1995	254	58	1,608	15.8	19.4
1996	247	55	1,670	14.8	18.1
1997	244	52	1,731	14.1	17.1
1998	233	50	1,732	13.5	16.4
1999	222	49	1,741	12.8	15.6
2000	217	46	1,766	12.3	14.9

Source: Government Actuary **(***2001a***)**

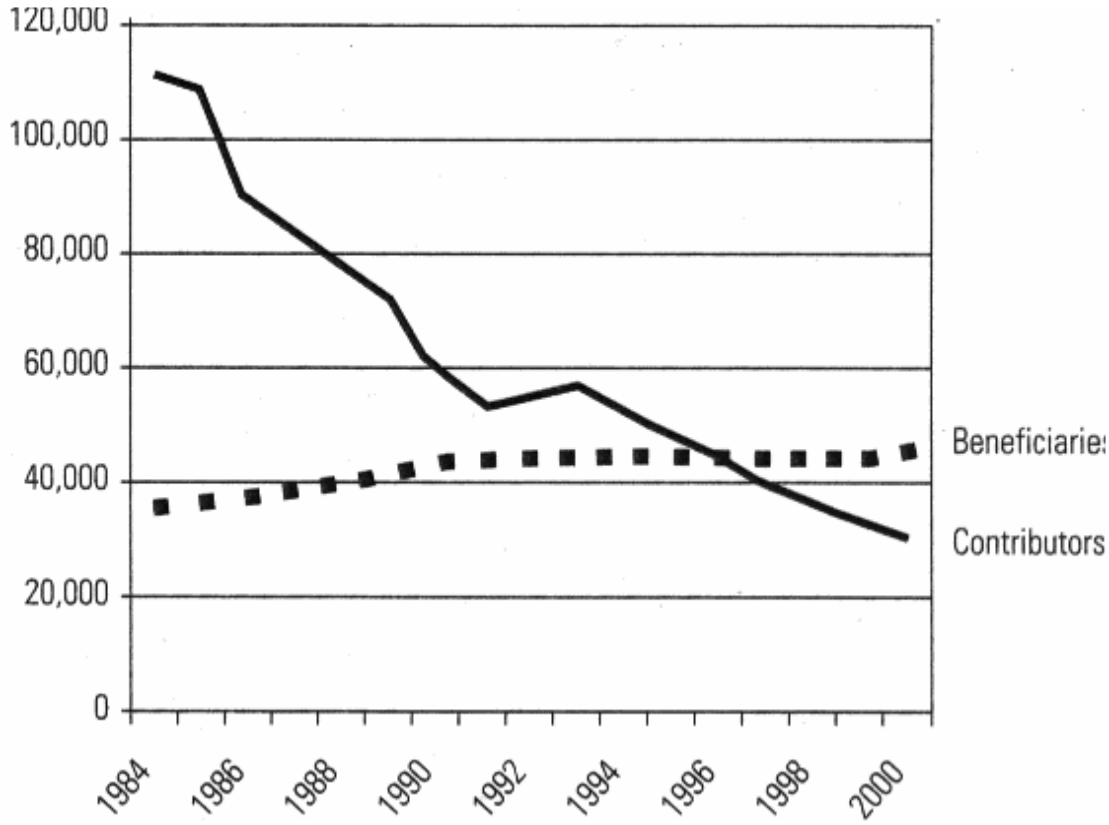
Active membership of private sector employer and government employee schemes dropped from 22.6 per cent of the employed labour force in 1990, to 14.9 per cent in 2000.[54] Over the same 10-year period, total assets in private sector employer-

[54] Coverage in private employer schemes declined since 1990 from 18.5 per cent to just 12.3 per cent while coverage in the public sector dropped from 4.1 per cent to 2.6 per cent following the closure to new entrants of the Government Superannuation Fund in 1992.

sponsored schemes have increased minimally from $9.5 billion to just $10.6 billion, a fall of 8 per cent in the value of assets in real terms.

The old Government Superannuation Fund (GSF), which closed to new members in 1992, had been in decline since its heyday in the 1970s. By 2000 there were only 31,245 contributors and the number of beneficiaries under the scheme far outweighed the active members as illustrated in Figure 3.1. Replacement schemes for the state sector had 12,162 members (Government Actuary, 2001a). The GSF has $3.45 billion of assets (as at June 2000), with a net present value of unfunded pension liabilities of approximately $8 billion.

Figure 3.1: Government Superannuation Fund membership 1984-2000



Source: Atkinson (2002)

As occupational schemes have fallen in coverage and importance since 1990, retail schemes have grown by 46 per cent in terms of members and 80 per cent in terms of assets over the decade (see Table 3.3). Excluding the GSF, they hold $8 billion of total assets or 41 per cent of total funds in registered superannuation schemes.[55] Many of the members of these schemes will be retired or may belong as well to employer-

[55] The assets per member of retail schemes are $17,862 in contrast to $43,598 for employer schemes.

based schemes and there may be some double counting in the total membership figures as given in Table 3.3. Retail schemes have been popular with older people, largely because of their tax treatment when the National Superannuation surcharge applied. When the surcharge was removed in 1998 (see section 2.6) the incentive to contribute to these schemes diminished.

Table 3.3: Types and importance of registered superannuation schemes 1990-2000

Nature of the scheme	Number of Schemes		Assets $ billion		Membership (000s)	
	1990	2000	1990	2000	1990	2000
Private[1]	508	60	0.058	0.032	550	94
Employer 1	2,242	694	9.5	10.6	*311	*248
Employer 2[2]	0	8	0	0.25	0	12
Retail[3]	113	127	1.5	8	236	448
Total	2,863	889	11.0	19	547	708

Source: Government Actuary (2001a)

Notes: 1. Private schemes are those set up by individuals for themselves and family. Employer 1 schemes are employer sponsored private schemes including the National Provident Fund (NPF).

2. Employer 2 schemes are public sector schemes that were set up after the closure of the GSF.

3. Retail schemes are those schemes available to the general public.

**These figures include 34,644 pensioners for 1990 and 28,735 for 2000.*

3.3.1 Pensions in retirement

The majority of pensions currently in force (approximately 47,000) are from the GSF, as shown in Table 3.4.[56] Pensions paid to members of private occupational schemes have fallen to just under 29,000 in 2000, from nearly 35,000 in 1990. While there were also 5,333 pensioners in retail schemes, up from 1,103 in 1990, many of these pensions have arisen out of National Provident Fund (NPF) public schemes and are of only small value (Government Actuary, 2001b).

The decline in the membership of employer-sponsored registered schemes excluding the GSF is illustrated in Table 3.5. Between 1990 and 2000 membership in defined benefit scheme fell 24 per cent, while that in defined contribution schemes fell 18.6 per cent. The Government Actuary's analysis of a survey of private employer-subsidised defined benefit schemes showed an average pension was being paid of just $6326.

For the GSF, the average annual inflation-adjusted joint life pension for a retired male member is $14,204 and for a female is $9,875. Average pensions paid to single

[56] Some of these are paid to younger dependents.

people and to spouses are smaller at $7,142 for males and $6,570 for females (Government Actuary, 2001b). These are not large amounts and the median can be expected to lie below the average. With the closure of the GSF and the trends identified since 1990, far fewer New Zealanders can be expected to have even a modest pension in retirement in the future.

The shift to defined contribution plans from defined benefit plans in New Zealand reflects not just the changed tax environment, but also a world-wide trend (Disney & Johnson, 2001, pp.23-27).[57] Admirers of the traditional pension arrangements may deplore this shift, but labour market changes probably make it inevitable. Barr (2001) for example argues, albeit reluctantly, that the new realities of the modern world: increasing globalisation; labour market mobility; different family structures including more divorce, combine to make defined contribution plans more practical. The growing problem is what to do with the lump sums so generated, driving the increased attention to the annuities market.

Table 3.4: Government Superannuation Fund as at June 2000

	Female	Male	Total
Armed Forces	352	2,734	3,086
General scheme, excluding Islands	5,934	11,620	17,554
General scheme, Islands only	388	475	863
Police	265	2,623	2,888
Prison Service	28	214	242
Total active contributors	**6,967**	**17,666**	**24,633**
Pensioners	17,675	29,356	47,031
Deferred pensioners	162	4,999	5,161

Source: Government Actuary (2001b)

Table 3.5: Membership of defined benefit and defined contribution schemes*

	Defined Benefit		Defined Contribution		Total	
Year	1990	2000	1990	2000	1990	2000
Total assets ($m)	6,691	6,160	2,817	4,479	9,508	10,640
Total members	101,217	77,175	209,524	170,540	310,741	247,715

Source: Government Actuary (2001a)
**Includes NPF but not GSF. Includes pensioners (28,600 in 2000) as well as active members.*

[57] In Canada, the UK and the Netherlands however 90 per cent of members still belong to DB plans (Disney & Johnson, 2001, p.21).

Changes to the taxation regime have ensured that, far from there being any concessions associated with employer superannuation, there are now tax disadvantages as discussed in section 3.4 below. Coupled with reporting and disclosure obligations, these are seen as onerous and are changing the traditional view of the role of the employer in providing superannuation schemes directly. The fluidity of the labour market, increased casual employment/self employment, higher part-time work of both men and women, and contract work also call into question the appropriateness of the design of the traditional employment-based schemes with long vesting periods. As more flexibility in the labour market has made the defined benefit final salary schemes less relevant, defined benefit schemes have been slow to adapt as trends on vesting show:

> *…defined benefit schemes tend to have longer vesting periods. In 1996, only 30 per cent of members were fully vested after 10 years. In fact, in 46 per cent of defined benefit schemes it took 20 years or longer for members to become fully vested (compared with just 1.3 per cent of defined contribution schemes). There has been no clear trend towards shorter or longer vesting in defined benefit schemes.* (Periodic Report Group, 1997a, p.18)

In 2001 the Association of Superannuation Funds of New Zealand, ASFONZ, surveyed private schemes and found that the vesting periods appear to be shortening although the sample surveyed is limited. They found that compared to 1998, fewer schemes in 2001 were open to new members; fewer encouraged employees to join or make it a condition of appointment. Significantly fewer were designed to pay out in the form of pensions (down to 25.3 per cent from 88.9 per cent) and of those that paid pensions, 72.2 per cent allowed for a full conversion to a lump sum. Just 18.7 per cent[58] of schemes surveyed allowed salary sacrifice which is designed to give upper income earners the ability to exploit the difference between their marginal rate of 39 per cent and the superannuation tax rate of 33 per cent (current tax treatment is detailed below in section 3.4).

Overall the trend has been a sharp decline in occupational schemes generally and 'total remuneration' packages have become more common. In these, income is grossed up and the employee chooses the nature of the savings instrument and how much to save in it, while the employer's role may be minimal or advisory only.

---

[58] It should be remembered this is a small survey and there were only 72 responses to this question.

Private pension schemes now cover a relatively small fraction of the working age population, with access to generous employer-subsidised schemes remaining highly biased towards men. Table 3.6 below shows the numbers and percentages of men and women who make contributions to private superannuation schemes, occupational and personal. It is clear that men are much more likely to make contributions, and of greater amounts. Table 3.6 does not however give information about the nature of the schemes, nor the contribution that may be made by the employer on an employee's behalf. It is safe to assume, however, that the higher income contributors are more likely to have matching or greater contributions from employers. The figures in Table 3.6 relate to 1995/1996 and hence are likely to be on the high side of the current situation.

Table 3.6: Private superannuation contributions by age and sex, 1995/96

Age	Total number of people (000's)	% of age group making contribution
Men		
15-24	207.5	3.7
25-34	205.4	18.2
35-44	237.9	24.0
45-54	180.4	35.8
55-64	127.5	18.8
65 or over	144.9	*0.7
Total	**1,103.6**	**17.4**
Women		
15-24	215.0	3.0
25-34	257.7	10.6
35-44	248.9	11.9
45-54	182.3	18.5
55-64	126.0	8.6
65 or over	194.4	--
Total	**1,224.3**	**8.8**

Source: Statistics New Zealand (1997)

***Because of sampling error, numbers under 5,000 may not be reliable*

Private sources of income from investments are an important proportion of total pensioner income as illustrated in Table 3.7 below. But few retirees have a private pension from an occupational plan, as discussed above, and fewer still can expect to have one in the future. Men are much more likely to have significant occupational pension income than are women as can be seen from an examination of the lower half of Table 3.7. Overall, only around 15 per cent of individuals over 65 had income from an occupational pension scheme or a private pension in 1996. As shown in Table 3.8

by 2000 only 12.3 per cent of recent retirees aged 65-69 had such income. This is less than those with such income for all age bands from 70 and over and supports the thesis that new cohorts entering retirement are less likely than previous ones to have pension or annuity income.

Women are far less likely to belong to a superannuation scheme and those who do belong contribute far less than men (and hence receive far less in terms of employer subsidies). In 2002 it is estimated that only 70,000 employed women have employment-based superannuation, or just 8 per cent of the employed female workforce.[59] If employment-based superannuation affords one of the best ways of saving for retirement this bodes ill for the future.

Table 3.7: Proportion of people aged 65 and over with income from private sources and private pensions, as proportion of yearly income, 1995/96

	Men	**Women**	**Total**
Numbers aged 65 and over	143,500	193,000	336,400
Per cent with private income			
<25 % (total income)	54.4	71.7	
25-49 %	20.5	18.6	
50-75 %	17.6	7.3	
>75 %	7.4	2.4	
Total	**100**	**100**	
% with income from private superannuation			
<25 % (total income)	7.8	3.8	
25-49 %	6.4	4.9	
50-74 %	7.2	0.9	
>75 %	----	---	
Total % with private superannuation income	**21.4**	**9.6**	**14.7**

Source: Derived from Statistics New Zealand (1997), Table 20.

Note: The table excludes those with no regular income, and is based on the Household Economic Survey that excludes those living in institutions.

[59] Author's calculations.

Table 3.8: The receipt of income from private superannuation and annuities by age

	Numbers with income from private super/annuities age								
	50-54	55-59	60-64	65-69	70-74	75-79	80-84	85+	Total
Male	1,581	3,552	7,209	9,810	10,185	8,949	5,076	2,799	49,161
Female	924	2,211	6,363	5,922	6,360	6,024	4,518	4,143	36,465
	Percentage of population in age group with private superannuation income								
Total	**1.1**	**3.2**	**8.8**	**12.3**	**14**	**15.8**	**15.7**	**14.3**	**8.4**

Source: Census 2001

3.3.2 Regulation

Internationally, occupational schemes are regulated with respect to vesting, preservation indexation, and portability. The general idea is that unfettered pension markets are unlikely to operate in the interests of the individual and the economy (World Bank, 1994, p. 194).[60] These regulations also have their own costs and may encourage moral hazard. New Zealand has avoided their use. Rather than tight regulation, New Zealand has tended to adopt a full disclosure approach as consistent with free market reforms.[61] Occupational pensions come under the minimal requirements of the Superannuation Act 1989. Schemes must also meet the information and disclosure requirements of the Securities Amendment Act 1996 and the Investment Advisors (Disclosure) Act 1996 (Periodic Report Group, 1997a, p.191).

A critical tension exists between the need to regulate and control, for the protection of the members, and the advantages that employers perceive from providing employer-subsidised schemes in the first place. Too much regulation, especially against the interests of employers, may run the danger of killing the goose that lays the golden egg. The World Bank (1994, p.198) identifies several reactions by employers that may be less than helpful to the economy, including that they may:

- give less on the job training because they may be less able to lock in workers;

[60] Some countries provide a guarantee for pensions (for example, up to a specified ceiling in the US under the US Pension Benefit Guaranty Corporation). In the UK there is no formal protection but there was some compensation provided to the victims of fraud in the Maxwell case.

[61] However, disclosure is accompanied by regulation in other countries, for example, The Netherlands have a single board for regulation that works successfully (World Bank, 1994, p.195).

- use wage enhancements, not pensions as a way to give higher compensation leading to higher wage inequality;
- encourage more short term or contract workers, so that fewer workers are covered and/or;
- shift from defined benefit schemes to defined contribution schemes whereby risk is shifted from employers to workers .

3.4 Tax issues in the 2000s

The tax regime adopted by New Zealand in 1990 (TTE) for retirement saving works best for superannuation schemes if the tax rate system is fairly flat. That way, the contributions tax applied to employer contributions, the tax on fund earnings and marginal tax rate of contributors are all similar.

However, once the middle-tax band was lowered in 1996 and 1998 as shown in Table 3.9 there were big disparities between taxes paid in superannuation funds and the marginal rates actually faced by middle-income earners. Employer contributions (under a withholding tax) and earnings in the fund are taxed at 33 per cent and thus the regime is tax penal for anyone on only a 21 per cent tax rate.[62]

Despite the best endeavours of a working party (TOLIS, 1997) to resolve this issue, there were no easy answers and the problem continues, doubtless contributing to the fall off in membership of employer-sponsored superannuation schemes.

Table 3.9: New Zealand tax schedule for personal income tax

Bracket	Effective marginal tax rate*		
	1988-1996	1/7/98-1/4/00	From 1/4/00
$0-9,500	15	15	15
$9501-30,895	28	21	21
$30,895-38,000	33	21	21
$38,001-60,000	33	33	33
$60,000+	33	33	39

Source: Inland Revenue Department

**Includes the low-income earner's rebate*

[62] In addition there may be capital gains tax to pay where funds are deemed to be trading. Individuals who invest on their own account may be exempt from such a tax.

When in 2000, the top tax rate was raised to 39 per cent, superannuation schemes actually became tax advantaged to those earning over $60,000. The Taxation (FBT, SSCWT and Remedial matters) Act 2000 imposed a fund withdrawals tax (FWT) to reduce the ability of high-income people to use superannuation vehicles as a short-term way of avoiding the 39 per cent rate.

Significant tax advantages for high-income superannuation fund members comprise both a saving of 6 per cent on employer contributions and 6 per cent on fund earnings tax, with further advantages that accrue in passive schemes exempt from capital gains tax. For example, a $20,000 employer contribution alone saves $1,200, which provides an initial 6 per cent return on the investment. The fund withdrawals tax has some important administrative complexities for employers but is not onerous in its impact on employees as there are wide exemptions to its provisions (Woodbury, 2000). Thus it is likely that there will be increased use of 'salary sacrifice' among high-income earners to exploit these advantages. Rather than a 'level playing field', the outcome has been that the highest paid are helped by significant tax advantages while the tax penal treatment of those who pay tax at a marginal rate of 21 per cent remains unresolved.

No easy answer to this dilemma exists. Attribution or imputation of employer contributions and fund earnings to individual members to be taxed at their own MTR would be highly complex under any scheme structure, but especially for defined benefit schemes. There is also the problem that the abatement of family assistance measures would apply to the amount attributed for some members with children where effective marginal tax rates can be over 50 per cent.[63]

Introducing a flat 27 per cent tax, say, for all superannuation schemes would help the middle-income groups, but benefit the top earners even more. Almost certainly such a tax rate would require a raft of stiff regulations to be imposed to make sure that superannuation schemes genuinely met the objective of improving income in retirement. If these regulations are not in place, there can be little to justify what might be subsidisation of very short-term saving, or lump sums in retirement.

[63] Section 3.4.1 discusses a possible way out of this dilemma.

The Minister of Finance acknowledged that there are very few incentives of any kind available for individuals to save through retirement-focused vehicles such as superannuation schemes. The net result is that financial savings are low, and the form that savings take is economically inefficient. In 2001 the Government reviewed the basis on which private savings are taxed or otherwise encouraged within the parameters that:

> *...any incentives would have to meet the requirements that they were fiscally affordable, did not crowd out other government spending and added to overall savings levels, rather than merely shifting the form of savings'.* (Cullen, 2001b)

Dr Cullen initially proposed a 'parallel option' to the current taxation regime for superannuation, under which contributions continue to be paid from taxed income, investment earnings are tax free, and benefits are partially taxed. This is referred to as TEt (or Taxed, Exempt, and partially taxed) compared to the current TTE.[64] There would be a limit on the annual contributions and a limit on the amount that could accumulate within the scheme. The scheme would be required to lock in the benefits for a period or until a specified age is attained and to provide a portion as a pension.

There were concerns in the industry that compliance would be difficult and would require new schemes that are distinct from existing schemes. A major tax review in 2001, chaired by Rob McLeod did not recommend the reintroduction of tax incentives for private saving (McLeod, 2001). The committee did not, however, solve the problem of the over-taxation of Superannuation for the majority of workers. It recommended a two-step income tax scale (18 and 33 per cent) to replace the existing four steps (15, 21, 33, and 39 per cent). This would result in an even bigger marginal tax rate disadvantage than before for middle-income members of superannuation schemes. Significantly, the committee made no attempt to quantify the effects of their recommendations on the income distribution.

A report of officials noted that it was difficult to ascertain the exact goals government wanted to achieve and that none of the options examined (tTE,TET,Tet) were able to meet all the objectives the government sought (The New Zealand Treasury, 2001b).

---

[64] Contributions to schemes continue to be paid from after-tax income (T); scheme earnings are exempt from tax until withdrawn (E); and the withdrawal of capital contributions is tax-exempt, but earnings on those contributions are taxed when withdrawn (t).

As in the past when tax incentives have been considered (Periodic Report Group, 1997a; Report of The Taskforce on Private Provision for Retirement, 1992) it has been difficult not to conclude that the advantages are likely to go to the people who least need an incentive to save, and that overall savings are unlikely to be enhanced. On balance the Treasury report indicated that if a tax incentive were to be reintroduced then a very limited one (with a cap on contributions of $1000-2000) with an upfront incentive was best:

> *Officials do not suggest that an upfront incentive is likely to make savings more realistic for many low to middle-income households. Such an incentive scheme is simpler to promote and explain however, which may increase its utilization amongst households with little to no current savings. While no incentive may be likely to appreciably increase savings, Officials prefer a tTE scheme to a TET or TEt incentive because it would result in fewer harmful distortions to investment patterns, it would have a lower fiscal cost and it would create less room for avoidance and tax planning behaviour.* (The New Zealand Treasury, 2001b, p.1)

The Labour/Alliance government continued to discuss saving incentives, but in January 2002 it decided that tax incentives for private saving would not proceed in the current year after all citing reasons of fiscal tightness.

> *[Those consulted] agreed that the best option was a tTE system under which fund contributions would be taxed at a reduced rate. But Treasury estimates that the costs of introducing this would range from $50m to $171m a year depending on the design details. The government simply does not have this kind of money available in the 2002 Budget.* (Cullen, 2002)

In February 2002, the National party announced its policy to reintroduce tax incentives. The shape of these would appear to reflect the minimal tTE model proposed by Treasury. Then in the May Budget, the government endorsed the status quo of no upfront tax incentives, but also signalled two ideas to resolve the over-taxation of superannuation schemes:

> *The first is to reduce the employers' specified superannuation contributions withholding tax for those earning under $38,000 to their statutory marginal tax rate. The alternative is to extend the present 6 per cent concessional rate enjoyed by those earning over $60,000 a year to all income earners. It is my intention that one or other of these changes will be introduced from 1 April 2004.*
>
> *The government is not considering upfront tax incentives. These are likely to have to be very large - with fiscal costs running to many hundreds of millions of dollars a year - before they have any desirable effect on overall*

> *savings. Their abolition in the mid-1980s represented sensible tax policy on both equity and efficiency grounds.* (Minister of Finance, 2002a)

To extend the 6 per cent advantage to low-income people without further advantaging high-income people would be difficult. It is now clear that the tax on fund earnings is not to be included in any change but would remain at 33 per cent. If a genuine 6 per cent advantage is to be offered to contributions made by employers for the lower and middle-income groups, the legitimate question is whether there is to be any social pay-off expected for the fiscal and administrative costs involved.

In the meantime the tax neutrality goal remains elusive for another significant reason. Housing as an investment is comparatively tax-advantaged, enjoying a TEE treatment in most cases. The imputed rental for home-owners is not taxed, and the capital gains on homes and many rental properties are tax-free. Despite the best endeavours of the McLeod Committee who examined the case for taxing imputed rent and discussed advantages that might flow from a Risk-Free Return Method (RFRM), there has been no political activity to pursue these issues (McLeod, 2001).

3.4.1 Reform of the accumulation phase of superannuation

It is not an exaggeration to claim that New Zealand's tax problems in the traditional, employment-based superannuation schemes are virtually insoluble. As outlined above once the idea of a flat tax scale was abandoned, the ability to tax contributions and fund earnings at the individual's marginal tax rate disappeared. Most suggested ways to deal with this problem are much too complex, as the delay over their implementation suggests. The delays in turn have further diminished the attractiveness of employer-subsidised schemes.

New Zealand has adopted tax neutrality with respect to saving and there is little momentum for abandoning this goal. Once tax incentives are removed it becomes more obvious that a reinstatement of them would favour the people who already save. Given the unattractiveness and costliness of a radical change such as to EET or some variant, and the dubious nature of the impact of such a change on either national or private saving, New Zealand should reform existing tax penal provisions so that the goal of tax neutrality is actually achieved.

The options are either to reform the tax scale by flattening it, or to restore tax neutrality by a tax credit system. Flattening the tax scale has a range of distributional

implications that are difficult to resolve. Not even the McLeod committee (2001) recommended a flat tax scale, although they favoured the concept, and there has been little evidence of political interest in a return to the flatter tax scale of pre-1996. The option of a tax credit approach is therefore more practical, but it is very difficult to do this in a traditional employer-subsidised scheme. It may therefore be simplest to regard the traditional employer-subsidised schemes as a thing of the past, abandon salary sacrifice options and encourage a total remuneration approach at all levels. Defined benefit schemes, already disappearing would remain under the current tax arrangements, but diminish in importance over time.

The main role of the employer might be to facilitate contributions from total remuneration. The employer may also want to play a paternalistic role to ensure that the extra income goes into a superannuation scheme. In that case, rather than give increased income to employees, the employer would make a direct contribution to a defined contribution plan. The withholding tax paid would be attributed to the employee, and the gross contribution added to the employee's total income.

Taxpayers on 39 per cent tax rate would have extra tax to pay at the end of the year, just as they do when their interest at the bank is taxed at 33 per cent. This would solve the complex problems of administering the SSWCT as discussed in section 3.4 and restore vertical equity to the system by removing the advantage currently enjoyed by those on a tax rate of 39 per cent.

Those on a 33 per cent tax rate would have no adjustment to make, while those on the 21 per cent rate would get a refund. There may be a few tax payers on the statutory rate of 21 per cent who would have to pay back some of their family support tax credits because the extra declared income would be in the abatement range attracting either the additional 18 per cent effective tax applicable on joint income over $20,000, or the additional 30 per cent for joint income over $27,000. The concern that this would be unfair is technically misplaced as all income whether saved or not should be captured for the abatement of family support. For example, if money had been placed in the bank, gross interest would be included in the income used to determine entitlement to family support. It would be possible, nevertheless, to disregard the attributed gross income in the family support abatement calculation, which requires a separate joint return in any case. In reality there are likely to be few low-income employees with children who are affected, largely because this group

tend to have limited disposable income and they are less likely to have superannuation saving.

Fund earnings could remain taxed at 33 per cent, but the concession enjoyed by passive funds in which capital gains are not taxed could be extended to all funds. The average tax paid on most funds' total earnings would then be much lower than 33 per cent.[65] This might satisfy the demands that there needs to be some advantage to employment-based superannuation. Better-off members will get the most advantage as they have the most savings tied up in these schemes, but they lose the 6 per cent gain in the taxation of their contributions and their extra advantages may be recouped in an income test on the state pension when they retire (discussed later in section 10.4.1).

There are many arguments that such changes alone will not be sufficient to rekindle interest either from the employer or from the employee in employment-based schemes. Knox (2001) for example argues for a new ETT age-related rebate.[66] An alternative approach consistent with the suggestion for total remuneration might be to mandate that employers offer facilities for automatic deductions to reformed TTE defined contribution superannuation schemes, and sponsor an aggressive education campaign aimed at employees.

3.5 Annuities in New Zealand

Low and middle-income retirees may have most of their capital locked up in illiquid home equity. This partly reflects the incentive to save through mortgage repayment rather than in traditional superannuation products. Those with cash sums are likely to find it increasingly difficult to know how to manage them as they face a potentially longer length of retirement and a risky investment environment. Other countries are grappling with the growing issue of what to do with the lump sums generated in their expanded defined contribution schemes. This is driving the increased attention to the

---

[65] I am grateful to Michael Littlewood for pointing out how concessional the tax treatment of passive funds is once an average tax rate is considered. Perhaps as little as 1-2 per cent of total earnings are dividends.

[66] Even if such a rebate were to be acceptable politically, it would not materially affect the retirement of most of the baby-boom generation, the focus of this thesis. It may also require integration with the state pension and importantly, regulation over the form in which the benefits are taken in retirement.

annuities market as discussed in more detail in chapter 8. In New Zealand, the concept that government should pay attention to how people cope with their lump sums has, thus far, been an alien one.

While diminishing in importance, occupational superannuation has always had a place in New Zealand. In contrast, the place of individual annuities in the New Zealand retirement market has been ambivalent at best. Estimates from the Industry show that annuities-based funds account for only an estimated $300m to $400m out of an estimated $40b of managed funds in New Zealand. Table 3.10 shows the minimal growth in the annuities market with just 5641 policies in force in 2001. The average value of annuities in 2001 is just $4999.

Table 3.10: Annuities in New Zealand 1987-2001[67]

December Year	Value of annuities in force $m	Policies
1987	22.4	3,522
1988	19.8	4,264
1989	22.8	4,846
1990	24.5	4,428
1991	34.4	4,694
1992	34.7	4,704
1993	39.6	5,521
1994	38.3	5,400
1995	39.6	5,297
1996	36.5	4,853
1997	28.1	6,079
1998	28.9	6,008
1999	28.7	5,896
2000	33.7	5,719
2001	28.2	5,641

Source: Investment Savings and Insurance Association of New Zealand, http://www.isi.org.nz/

Financial assets, such as managed funds, deposits in banks, etc are only a part of household wealth. Holdings of non-financial wealth are much more significant. The Westpac Trust saving indicators, presented in Table 3.11, indicate net household wealth for September 2001 excluding the business sector, is around $200b. Bayliss (1996, pp.3-5) included housing and business assets, to estimate a total gross household wealth of $450b and net assets (excluding debt) of around $400b for

[67] Nine life offices have offered annuities but only four: AMP, Colonial, Royal & Sun Alliance and Tower were actively selling them in 2002. Invincible Life (Now S.A.I. Life Limited) offers reverse annuity mortgages, (RAMs) as discussed in section 3.7.

1995.[68] Of this, managed funds comprise approximately 10 per cent and annuities about 0.1 per cent of the total.

Table 3.11: Household net worth statistics, September 2001

	$ b	% of total assets
Total gross assets	277	100.0
Cash and term deposits	45	16.2
Managed funds	39	14.1
Other	23	8.3
Housing stock	170	61.4
Total liabilities	74	
Net worth total	203	
Financial net worth excluding housing	99	

Source: Morning Star & New Zealand Institute of Economic Research (2001)

The reasons for the underdevelopment of the market relate to inevitable market failures detailed in section 8.2 below. Lack of quality, long-term bonds for investment is one factor. More importantly the annuities market does not have the benefit of mandatory purchase, as in the UK, nor is there a strong culture of annuitisation of wealth as the historical overview in chapter 2 revealed. Annuities provide little by way of commission, as there is no need for an agent's ongoing monitoring and advice, and are hence unlikely to be marketed strongly.[69] They are inflexible, lack full inflation indexing. Moreover low and middle-income people also suffer over-taxation on the earnings of the supporting fund.

Few members of superannuation schemes, if any, purchase an annuity, and while there are some financial advisors who are fond of annuities there is little sign that the market will spontaneously develop.[70] The main business has arisen from superannuation schemes winding up and cashing out their pensions to provide purchased annuities. There is evidence of pricing with low or even negative rates of

[68] The total net worth of New Zealanders was estimated from a net worth survey to be around $370b in 2001 (Statistics New Zealand, 2002a).

[69] Only life insurance companies offer annuities. Under current law, setting up a life office is as simple as lodging a $500,000 bond with the Public Trust

[70] Mary Holm, *New Zealand Herald*, writes frequently about them. Various fund managers and life companies have spoken from time to time about their potential in New Zealand (Davies, 2000).

interest to discourage business, and some companies are selling only a handful of policies a year.[71]

3.6 Analysis of annuity rates in New Zealand

Aon Consulting New Zealand Ltd collects statistics from the providers of annuities with data going back to 1993. Between 1993 and 2002 the numbers of active suppliers of annuities fell from 9 to 4. Typically the annuities offered are life annuities with remaining capital repaid to the deceased estate if death occurs within ten years. However, individual companies will price tailor-made annuities. The usual variants are joint life and a fixed annual adjustment for inflation of say 2 per cent per annuity. Table 3.12 gives annuities for men and women aged 55 and 65 as at August 2001 from the four major providers, purchasable from a capital sum of $10,000 and $100,000 respectively. There is considerable variation in the annuity payable for a purchase price of $10,000 and $100,000. For any given month, rates differ markedly by

- Size of contract
- Gender
- Company

While it might be expected that $10,000 would buy an annuity that is one tenth as large as one purchased for $100,000 it is typically only round 92-93 per cent of this as shown in Table 3.12. This suggests that fixed costs of annuity provision are high and that small annuities are particularly unattractive to suppliers. On the demand side, it is hard to see what the market would be for a small annuity, as the better off, long-lived would spurn them, and the less wealthy, short-lived would find them a bad bargain. Indeed, as expected, there are few sales in this range. There is considerable difference between the annuity paid to men and that paid to women for the same capital sum because women on average live longer. Table 3.13 illustrates the gender gap more clearly showing that mean annuities for women are around 87 per cent that for men at the same age.

[71] Sun Alliance Life had sold three annuities in the first four months of 2000, which "almost makes us market leader", quipped managing director Tim Sole, reported by Davies (2000).

Table 3.12: Tax paid annuity per year (10-year guarantee), purchase price $10,000 and $100,000 August 2001

	Male Lives Aged		Female Lives Aged	
$/ year	55	65	55	65
AMP	497.76	647.88	450.96	584.64
	5,494.08	6,963.36	5,038.20	6,340.44
Sovereign Assurance	565.80	703.68	506.88	615.96
	6,018.96	7,396.92	5,429.04	6,520.32
Royal Sun Alliance	537.12	657.6	483.6	578.88
	6,105.96	7,350.48	5,553.00	6,538.88
Tower Employee Benefits	592.88	725.74	530.49	641.71
	6,121.97	7,483.52	5,482.59	6,622.38

Source: Aon Consulting New Zealand Ltd (1993-2002)
Benchmark interest rates: 5 years 6.53 per cent, 10 years 6.68 per cent.
Purchase price $10,000 and $100,000 respectively.

The spread between companies at a point in time is large as Table 3.13 shows for the month of December 1993. For a male aged 65 the largest difference between companies was $546 in annual annuity, which is around $8,400 over 15.5 years of average life expectancy for men. For women for the same month, the difference between the largest and smallest annuity is $554, or over $10,500 for 19 years of an average life expectancy.

Table 3.13: Gender and company variability of annuities provided in New Zealand, purchase price $100,000, age 65, December 1993

Company	Men $ pa	Women $ pa	Difference $ pa
AMP	8,360	7,430	930
Colonial Mutual	8,800	7,839	961
Metropolitan Life	8,439	7,544	895
GRE	8,321	7,335	986
National Mutual	8,461	7,495	966
NZI Life	8,547	7,604	943
Prudential	8,254	7,285	969
Sun Alliance Ltd	8,623	7,623	1000
Tower Corporation	8,597	7,608	989
mean	**8,489**	**7,529**	**960**
median	**8,461**	**7,544**	**917**
Standard deviation	*171*	*168*	

Source: Aon Consulting New Zealand Ltd (1993-2002)

Over the period 1992-2001, the worst a male would have done is to buy from AMP in December 2001 (annuity of $6,963) and the best is to buy from AMP in October 1994 (annuity of $9,786). The difference in annual annuity is $2,823 or $43,756 over 15.5 years average life expectancy. For a female the worst is $6,310 in December 2001 from Royal Sun Alliance, the best is $8,874 from AMP in October 1994. The difference in annual annuity is $2,564 or $48,716 over 19 years of average life expectancy.[72]

The money's worth ratio (MWR) is the ratio of the expected present value of annuity payments to the premium paid in the market for that annuity and is always less than one. MWR studies were pioneered in the US (see amongst others, Finkelstein & Poterba, 1999; Poterba & Warshawsky, 1999) and are a growing feature of pension studies (for example, Congressional Budget Office, 1998; Doyle, Mitchell & Piggott, 2001; James & Vittas, 2000a). Factors such as administration, marketing and profit costs and the choice of interest rate to discount future payments influence the MWRs.

There are two ways to think of MWRs: from the perspective of an annuitant who is likely to be in a pool that has greater average longevity than the population at large, and the perspective of the average member of the public. The first perspective requires the use of special annuitant life tables and provides a calculation of the size of overheads and other costs.

The latter perspective, investigated here, requires the use of general Life Tables and reflects the additional cost of adverse selection. Mean annuities for men and women aged 65, purchase price $100,000, using the December results in each year from 1993-2001 are summarised in Table 3.14 and Table 3.15. Table 3.16 gives the net present value (NPV) of mean annuities with a 10-year guarantee based on the after-tax, 10-year benchmark interest rate using standard mortality tables for 1995-97. In principle, the NPV estimates an actuarially fair price for the general population, excluding any overhead costs.

The difference between The NPV and the purchase price of $100,000 can be attributed to cost loadings for marketing and profit, adverse selection, which causes the longevity of the annuitant pool to differ from that of the general population, and

[72] Figures are unadjusted for inflation.

Table 3.14: Value of an annuity, purchase price $100,000: 1993-2001 December months

Men at age 65

Company	1993	1994	1995	1996	1997	1998	1999	2000	2001
AMP	8,360	9,618	8,883	8,735	8,548	8,014	7,687	7,569	6,963
Colonial Mutual	8,800	9,636	8,617	8,414	8,493		7647	7,260	7,161
Metropolitan Life	8,439	9,440	8,748						
GRE	8,321	8,803	9,292						
National Mutual	8,461	9,517	8,351	8,159	7,823				
NZI Life	8,547	9,604	8,841	8,631					
Prudential	8,254	9,366	8,545	8,545	8,383	7,903			
Sun Alliance Ltd	8,623	9,743	8,915		8,598	8,016	8,059	7,660	7,187
Tower Corporation	8,597	9,530	8,706	8,793	8,596		8,070	7,953	7,258
Spread-low-high	546	940	941	834	775	111	412	693	295
Mean	**8,489**	**9,473**	**8,766**	**8,546**	**8,407**	**7,978**	**7,866**	**7,611**	**7,142**
Median	**8,461**	**9,530**	**8,748**	**8,588**	**8,521**	**8,014**	**7,873**	**7,615**	**7,174**
standard deviation	*171*	*275*	*266*	*233*	*297*	*65*	*230*	*285*	*126*
interest rate 5 year	5.95	8.99	7.16	6.88	6.8	3.72	6.91	6.41	5.95
interest rate 10 year	6.29	8.95	7.02	7.03	6.68	5.56	7.08	6.34	6.44
After-tax risk-free rate	4.2	6.0	4.7	4.7	4.5	3.7	4.7	4.2	4.3

Source: Aon Consulting New Zealand Ltd (1993-2002)

Table 3.15: Value of an annuity, purchase price $100,000: 1993-2001 December months

Women at age 65

Company	1993	1994	1995	1996	1997	1998	1999	2000	2001
AMP	7,430	8,702	7,946	7,801	7,609	7,075	7,090	6,957	6,340
Colonial Mutual	7,839	8,688	7,652	7,460	7,523		6,777	6381	6,310
Metropolitan Life	7,544	8,581	7,872						
GRE	7,335	7,828	8,331						
National Mutual	7,495	8,581	7,409	7,211	7,139				
NZI Life	7,604	8,694	7,907	7,783	7,435				
Prudential	7,285	8,428	7,601		7,683	6,944			
Sun Alliance Ltd	7,623	8,775	7,923	7,601	7,606	7,078	7,190	6,782	6,389
Tower Corporation	7,608	8,499	7,709	7,796			7,153	7030	6,411
Spread-low-high	504	947	922	590	544	134	376	649	101
Mean	**7,529**	**8,531**	**7,817**	**7,609**	**7,499**	**7,032**	**7,053**	**6,788**	**6,363**
Median	**7,544**	**8,581**	**7,872**	**7,692**	**7,565**	**7,075**	**7,122**	**6,870**	**6,365**
standard deviation	*168*	*285*	*285*	*266*	*263*	*233*	*238*	*290*	*196*
interest rate 5 year	5.95	8.99	7.16	6.88	6.8	3.72	6.91	6.41	5.95
interest rate 10 year	6.29	8.95	7.02	7.03	6.68	5.56	7.08	6.34	6.44
After-tax risk-free rate	4.2	6.0	4.7	4.7	4.5	3.7	4.7	4.2	4.3

Source: Aon Consulting New Zealand Ltd (1993-2002)

Table 3.16: The money's worth ratio of annuities, $100,000 purchase price: 1993-2002

a) Men *

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Mean annuity $	8,489	9,473	8,766	8,546	8,407	7,978	7,866	7,611	7,142
After-tax 10-year interest rate (%)	4.2	6.0	4.7	4.7	4.5	3.7	4.7	4.2	4.3
NPV annuity ($)	95,624	93,103	94,957	92,574	92,492	93,545	85,208	85,733	79,817
Money's worth ratio	**0.96**	**0.93**	**0.95**	**0.93**	**0.92**	**0.94**	**0.85**	**0.86**	**0.80**

b) Women*

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Mean annuity $	7,529	8,531	7,817	7,609	7,499	7,032	7,053	6,788	6,363
After-tax 10-year interest rate %	4.2	6.0	4.7	4.7	4.5	3.7	4.7	4.2	6.44
NPV annuity $	94,860	92151	94,256	91,748	92,030	92,790	85,044	85,569	79,494
Money's worth ratio	**0.95**	**0.92**	**0.94**	**0.92**	**0.92**	**0.93**	**0.85**	**0.86**	**0.79**

Source: derived using New Zealand Life Tables 1995-1997

**Annuity cost at an after tax 10-year benchmark interest rate*

an allowance for expected improvements in longevity. The ratio of the present value of the annuity stream to the premium paid gives the MWR.

The data in Table 3.16 show that over the 1990s, the MWRs of annuities in New Zealand has fallen considerably for both men and women. In contrast, MWRs have been generally improving in other countries (Wallister, 2000). In part, the time dimension to a downward trend in MWRs in New Zealand may reflect a growing awareness of improving longevity on the part of providers,[73] but is also likely to reflect antipathy to this low profit and risky product by suppliers, and extreme apathy from purchasers for whom money in the bank looks a much sounder idea. As observed above, annuities are inflexible, lack full inflation indexing, and low and middle-income people suffer excess taxation on the earnings of the supporting fund.

Table 3.17 shows the expected present value for the mean annuity for men and women since 1998 (data from Table 3.16) using the after-tax rate of interest of 21 per cent rather than the 33 per cent tax rate. The actuarially fair purchase price of the average annuity for women for 2001 falls from $79,494 to $74,749 and the MWR falls from 79 per cent to 76 per cent.

Table 3.17: Money's worth ratio, annuity purchase price $100,000: the impact of using a 21 per cent tax rate 1998-2001

	1998		1999		2000		2001	
	men	women	men	women	men	women	men	women
After tax interest (%)	4.4	4.4	5.6	5.6	5.01	5.01	5.1	5.1
NPV of annuities ($)	88,463	87,070	79,606	78,744	80,571	79,742	75,034	74,749
Money's worth ratio	**0.88**	**0.87**	**0.80**	**0.81**	**0.81**	**0.80**	**0.75**	**0.76**

Source: Based on data from Aon Consulting New Zealand Ltd (1993-2002)

Compared to the actuarially fair price for an annuity based on a risk-free rate of return, 10-year guarantee, no profits, no overheads, and using average population longevity, current annuities seem expensive. In 2001, both men and women pay approximately 20 per cent, or $20,000 over the NPV, rising to around $25,000 if they are on the 21 per cent tax rate rather than the 33 per cent rate. Women receive

[73] Calculations use Life Tables for 1995-1997. Mortality rates for the general population have improved since then. Life Offices will use special annuitant Life Tables and may factor into these an allowance for future improvements in mortality.

annuities that are around 11 per cent less than men's, but live longer on average and thus draw on them for longer. Because women tend to live longer, they are affected for longer by the consequences of buying the annuity at the wrong time or from the worst priced company.

3.6.1 Thin markets

The results of the above section can be taken as indicative only, especially for the later years when the data is sparse. It is hard to interpret MWRs when they may be biased by pricing to deter purchasers. If special annuitant Life Tables are used, MWRs are higher, showing better value for existing annuitants who have better longevity than the average members of the population. The intent here has been to show that the market is now priced to be a clear deterrent to the average member of the public, which may have policy implications for the role of the state.

The underdevelopment of the annuities market in the case of New Zealand is possibly related to the perception that the state pension adequately performs the role of an annuity and in the lack of any mandatory requirements to take an annuity from superannuation schemes. It is also likely to reflect severe informational asymmetries, a small population, a punitive tax regime, a do-it-yourself mentality to investment, unattractive pricing, ignorance as to the role of annuities and a lack of wealth accumulation apart from the family home on retirement.

The bequest motive is another significant reason for the lack of demand for annuities. An unfair annuity cost due to adverse selection and overheads can interact with an intentional bequest motive (Friedman & Warshawsky, 1990). An expectation of a bequest may also be used to elicit the desired caring family behaviour towards the older person. Expensive medical costs may be another reason for maintaining non-annuitised wealth, especially long-term care in the absence of social or private insurance (Wallister, 2000).

Annuities that increase a set amount each year are sometimes sold but are likely to appear unattractive in terms of the starting annuity value. Annuities that increase by a fixed percentage each year do not address the danger of unanticipated inflation (see discussion in section 8.2.4). In a country the size of New Zealand, competing insurance markets have a small pool of annuitants and there is little reliable actuarial

data on annuitants on which to base pricing of simple annuities, let alone a range of products.

3.7 Reverse home mortgages

There is little international evidence of the success of schemes that provide access to the capital tied up in owner-occupied housing, known variously as Reverse Annuity Mortgages (RAMs), home equity conversion loans (HEC), or home equity release (HER) schemes. In the US only 1 per cent of eligible homeowners over 62 avail themselves of a home equity release scheme (Eschtruth & Tran, 2001).[74] Of the schemes that are available, various problems make them unattractive on both the demand and supply side. These include a desire on the part of the old to leave bequests, mistrust of institutions for long-term contracts and a failure to provide protection from inflation. There are high costs for suppliers especially if recipients fail to maintain their houses and live longer than expected.

The main reverse mortgage scheme in the US, the Home Equity Conversion Mortgage (HECM), was introduced by the US government in 1989 and enjoys bi-partisan support. Private providers of these loans are protected by a government guarantee that makes them attractive. The guarantee is funded collectively by an insurance premium paid by the borrower. Borrowers can choose among many payment options and can modify decisions when necessary, giving maximum flexibility, an important feature for older persons.

Other government interventions in the US market include the provision of free or low-cost, state-approved counselling to prevent costly mistakes and fraudulent practice. Chen (2001b) notes that the market for HECMs while small is growing, with new lenders entering the market. There are other providers of reverse mortgages outside the government guarantee scheme, and growing use of these instruments is expected (Chen, 2001b).

Among reasons for the slow development of the US market, Caplin (2002) notes the complex psychology of these products. Reverse mortgages may be associated with

[74] Home improvement loans and deferred property taxes are also offered at the state and local government level. These too unlock some of the illiquid capital and are a form of home equity release (Chen, 2001b).

anxiety about losing the home should there be a prolonged period of ill-health and residential convalescence. Counselling itself may invoke feelings of distrust and uncertainty, while the lack of friends with experiences of these products also induces suspicion. On the supply side moral hazard is a major issue. A deteriorating property combined with the accumulated loan that outweighs its market value puts all the costs of deferred maintenance onto the provider (Caplin, 2002, p.240).

There has been little interest in New Zealand in these types of instruments for financing general income needs in retirement (Davey, 1998; Report of The Taskforce on Private Provision for Retirement, 1992). In 1990 the New Zealand Housing Corporation experimented with a pilot home equity conversion scheme called "Helping Hand Loans", (HHLs). These HHLs were payable only for housing-related costs: repairs, maintenance, alterations, rates and insurance. The lump sum or regular advances with interest did not have to be repaid until the property was sold or the borrower moved to another abode. The take-up rate was low even though the payments did not affect National Superannuation entitlement.[75] Widowed and single elderly people on low-incomes were the ones most interested and at that time this group received subsidised interest rates. The pilot was judged a success and there was potential to extend it, but it was overtaken by other housing reforms in 1991 (Davey, 1998; Report of The Taskforce on Private Provision for Retirement, 1992).

The insurance company Invincible Life Assurance (now S.A.I. Life Limited) was New Zealand's first, and to date, only company to offer reverse annuity mortgages as detailed in Table 3.18. Under a RAM, a mortgage is raised over the home of the older person and used to provide an annuity. The fees and costs are all deferred until the mortgage is discharged.

The older person retains ownership and occupancy rights and may sell the property and repay the mortgage at any time. The amount that is repayable never exceeds the fair market value of the property. A joint annuity can ensure that a surviving spouse continues to receive the annuity. There are no restrictions on the use of the annuity, but the property must be in good repair and insurance and rates payments up to date.[76]

---

[75] Housing New Zealand received only 150 applications or serious enquiries, amounting to only 0.4 per cent of eligible households. Around one in three went on to take up a loan during the pilot.

[76] More detail is available at http://www.sai-life.co.nz/rams.htm

Table 3.18: Reverse Annuity Mortgages (RAMs) available from S.A.I. Life

RAM® FLEX: This product is the most flexible in terms of the applicant's age, changing the annuity and the amount of equity used.
A RAM® FLEX does not provide a life time annuity but as long as an annuitant remains in their home they can continue to receive an annuity - a minimum of $100 a month is available.
RAM® FLEX is available to senior homeowners aged 65 years and over with an unencumbered property. The level of current market valuation (CMV) should be at least $80-$90,000. The monthly annuity can be stopped, restarted, reduced and in some cases increased. The debt against the property rises in direct proportion to the annuities received and the costs accrued. A premium of 11 per cent on the debt outstanding is calculated monthly and compounded at 31 March each year.

RAM® SURE: This product provides a life-time annuity and an initial claim of up to 10 per cent of the CMV of the property. It is suited to those who want the security of a regular fixed annuity payment until they, and or their spouse die. Applicants need to be aware that when they move from their home the mortgage must be repaid. The life annuity will continue and be paid to them wherever they live.
RAM® SURE is available to senior homeowners between 65 and 75 years with a property valued at over $100,000. A minimum sum assured is payable and should the annuitants die prior to receiving this, the balance will be paid to their estate.
One of the major differences between the RAM® FLEX and RAM® SURE is the purchase of the life annuity policy. When a RAM® SURE application is accepted a loan advance of up to 60 per cent of the CMV of the security property is made to purchase the life annuity policy. The effect of this is to take a much larger proportion of the equity of the home at commencement. Clients need to be aware of this when planning how long they will reside in their property.

RAM® TERM: This product is similar to the RAM® SURE as it provides a life time annuity and requires the property value to be at least $100,000. The major difference with this RAM® is that the mortgage must be repaid by the tenth anniversary of the contract. RAM® TERM is available to homeowners between 55 and 75 years of age. It is suited to those who own a second property over which the mortgage can be secured, or those who have investments which will be maturing within the ten years thereby providing funds to repay the mortgage. The benefit of RAM® TERM is that up to 25 per cent of the CMV can be made available as an initial claim at commencement.
In RAM® SURE and RAM® TERM interest is calculated monthly at the rate of 9 per cent per annum and compounded at 31 March each year.

Source: From S.A.I. Life Ltd (2002): http://www.sai-life.co.nz/rams.htm

The setup costs, legal costs, reinsurance contingency levy,[77] property valuation costs and policy mortgage costs can be paid up front or rolled up and deferred. Table 3.18 outlines the three different products offered by S.A.I. Life Limited. In 2002, only 200 policies are in force. Of these, few involve a purchase of a life annuity.

In the example given on the S.A.I. Life Limited web page, a couple aged 70 and 69 respectively, with a home valued at $125,000 request an initial claim of $5,000 and a monthly annuity of $100. The amount outstanding, including costs of the policy for years 5, 10 and 15 of the contract are given in Table 3.19. The premium owing increases faster than the value of the home, assuming a compound annual growth rate of 2 per cent.

Table 3.19: Reverse Annuity Mortgage: RAM flex example

Year End	Estimated Home Value Based on 2% Compounded Growth Rate ($)	Estimated Premium Owing on policy ($)
5	138,010	27,083
10	152,374	58,396
15	168,234	106,840

Source: http://www.sai-life.co.nz/rams.htm

Other institutions have been slow to offer home equity products to older people. The Taranaki Savings Bank (TSB) however offers a revolving credit facility to their long-term customers to provide a flexible source of additional finance. In essence it comprises an overdraft ceiling related to the value of the house that can be drawn down as required with the interest charged against the overdraft.

The potential for HEC/ER schemes is high. Given New Zealanders' penchant for property, especially owner-occupied real estate, the potential remains relatively untapped. There has also been very little, if any, public discussion about the use of such instruments to provide finance for long-term care. There are important aspects of government involvement which suggest a market is unlikely to develop spontaneously:

[77] The Reinsurance Contingency Levy is a charge included in the premium/mortgage for the purchase of the annuity policy. It has been introduced to protect the policy holders' annuity should they live beyond their actuarially calculated life expectancy and S.A.I. Life's liability under the policy of insurance. http://www.sai-life.co.nz/rams.htm

> *The image of HEC/ER has been tarnished by some schemes failing and gaining unfavourable publicity, so marketing HEC/ER products demands a considerable investment in time and effort. Potential clients require a great deal of explanation and reassurance (implying a 'welfare' aspect that may not be compatible with profit-driven enterprise). A broader and more balanced public debate may also help dispel many of the negatives and improve the confidence of potential providers.* (Davey, 1998, p.vii)

3.8 Summary

In summary, while the New Zealand system is based on the principle of tax neutrality in saving, the return to more progressive taxation has seen this principle violated with respect to superannuation schemes. The tax neutral regime for private pensions has not been achieved, and there are serious declines in employment-based superannuation.

While there are short-term fixes to the anomalous tax treatment of employer-subsidised superannuation schemes that should be implemented without delay, as discussed in section 3.4.1, the introduction of significant tax incentives for saving schemes raises many complex issues. On balance, the arguments in this chapter and in section 6.4.1 below would not support their re-introduction in New Zealand.[78] They would be unlikely to achieve increased saving, either private or national, they would favour people who would have saved anyway, and their fiscal costs imply higher average taxes on the working age population. Even at best, they could have only a limited impact on the baby-boomers' retirement incomes given that the first cohort reaches 65 in just seven years time. To have any impact at all there would need to be tight rules and regulations surrounding the form in which retirement saving could be taken adding to the complexity of this option.

While not providing any argument for their re-introduction, the lack of tax incentives of any kind has resulted in little focus on the decumulation phase of retirement saving. The annuities market is very underdeveloped, with the current annuities offering poor value for money for the average New Zealander. The debate around annuities is almost non-existent, and the potential for home equity release schemes is not being realised in any significant way. The lack of emphasis on the role of inflation-indexed

[78] There is possibly an argument that tax incentives for superannuation could achieve more neutrality between housing and superannuation. The first best, and least costly, way to achieve neutrality however is to reform the tax treatment of housing (McLeod, 2001).

savings bonds, either retail or wholesale in New Zealand may also be attributed to a lack of attention to the decumulation phase of retirement.

In debate over the past decade there has been little acknowledgment that tax incentives, by allowing regulations, could be used to secure wider social goals. This may be because New Zealanders are reluctant to revisit that world of rules and regulations. Thus there has been virtually no discussion of how tax incentives if accompanied by appropriate regulation might exert a socially beneficial influence on the nature of the retirement saving. Indeed the power to ensure regular income as opposed to lump sums may be the only economic justification. To date, annuities and pensions and their interaction with the state pension and other aggregated expenditure have been ignored.

It is argued in Part III of this thesis that one of the advantages of the tax neutral approach to retirement saving accumulation is that it leaves open the possibility of transparent government subsidisation of the decumulation phase to meet explicit social goals. Rather than concentrating on pre-retirement saving, a re-invigorated annuities market including a method of releasing home equity is required. A strong role for the state is implied to help the older population manage the risks they face in retirement, as discussed further in section 8.3. In contrast to tax incentives for the accumulation phase of retirement saving, subsidisation of annuities may offer attractive social advantages.

4 Support for old age needs in New Zealand

Accepting the arguments set out by the OECD (1998), this thesis takes a holistic view of all the risks associated with old age and the provisions that can be made for them. High housing costs, ill health, disability and the need for home-care assistance, or residential care, all have a profound impact on the quality of life and the adequacy of any pension arrangement an older person may have. They also have profound implications for projected age-related spending along with pensions themselves.

In most countries, long-term care in particular has been relatively neglected and New Zealand is no exception. The historic development of long-term care policy is far less satisfactory than that of policy for the state pension as outlined in chapter 2. Those unfortunate enough to need long-term residential care face a punitive regime for income and asset testing of state assistance which sits oddly with the universal approach to the state pension itself.

4.1 Supplementary assistance

Because New Zealand Superannuation (NZS) has been set at a level that has allowed for 'belonging and participation' rather than mere subsistence, additional means-tested income supplements have been little used, as the summary of the various components of cash benefits shown below in Table 4.1 indicates. Less than 15 per cent of people over pension age receive some income from the state in these forms. And less than 1 per cent claimed a special needs grant for food in the year ended March 1997.

Very few superannuitants receive other add-on benefits such as the special needs grant. About 14 per cent of pensioners receive a disability allowance, on account of their own or a dependent child's disability. Home ownership is high among the retired with only about 14 per cent living in rented accommodation. Only 11 per cent of those on New Zealand Superannuation pay more than 25 per cent of their disposable income on housing costs compared to 72 per cent of those on benefits and 32 per cent of all households (Periodic Report Group, 1997a, p.36). Those who qualify for the accommodation supplement (3 per cent of older men and 5 per cent of older women) receive a payment based on their actual rent, on the maximum set for the region, and

on income and cash assets. About 1.3 per cent of all pensioners are also in receipt of rent tenure payments designed to protect them from the move to market rents in housing policy (Periodic Report Group, 1997a, pp. 36-37).

Various modest concessions are available at the local level, such as for transport, cinema, and library services but these are insignificant in the overall picture, and far diminished from their role in the 1970s and their current role in countries like Australia (St John & Ashton, 1993).

Table 4.1: Sources of state income available to pensioners 1996/97

Payment	Type	Cost $m (% of GDP)	% pensioners in receipt	Criteria
Basic pension	Flat rate	5.1	86 (women)	Residency
NZS or Veterans[1]	General tax based	(5.4)	86 (men)	
Disability allowance	Non-contributory	82 (0.08)	14 overall	Income-tested
Accommodation Supplement	Non-contributory	45 (0.05)	5 (women) 3 (men)	Means-tested Income and assets
Special needs/ advances/grants	Non-contributory	<2	1.5 overall	Means-tested

Source: Department of Social Welfare Statistics Report 1997 fiscal year; The Budget Economic and Fiscal Update 1997; St John (2001c).

Note: Most people receive New Zealand Superannuation but a small number (1.4 per cent) who qualify have opted for the veteran's pension instead as it does not have an income test. Some do not pass the residency test; some of those eligible, until 1998 paid the pension back to the state via a surcharge on other income; and some did not claim New Zealand Superannuation as their income was too high.

4.2 Healthcare provisions

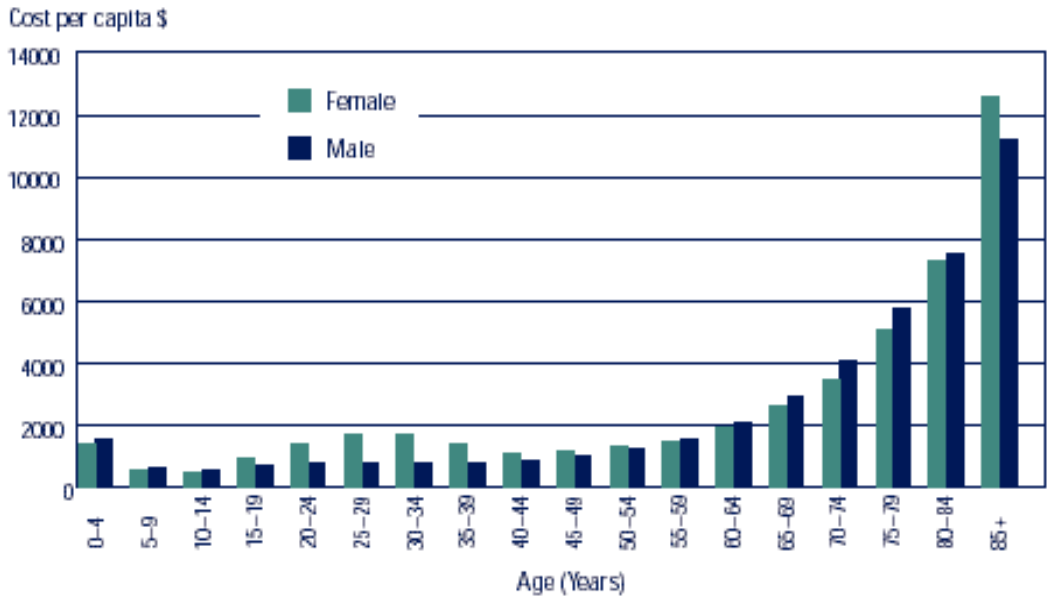
New Zealand provides significant non-financial benefits to pensioners in the form of free or subsidised healthcare. In this respect, social insurance can be judged to exist for health expenses, although not on the scale of a country like Australia. Primary medical care is not provided free at the point of use to all residents, but a community services card is available to those on low incomes and a high use card for those with chronic illness. New Zealand Superannuation recipients do not automatically qualify for the community services card, but their relatively low-incomes mean that about three-quarters hold one. This entitles them to a higher subsidy for visits to the General Practice and for prescription subsidies.[79] As demand for all health services has

[79] For example, a typical charge for a General Practice consultation might be $25-30 instead of $40-$45. Prescription charges also apply and specialist services are excluded from the subsidy.

increased in the last two decades, access to the public health system for many formerly widely available services, such as cataract operations has diminished markedly, moreover, insurance companies have excluded many by sharp premium rises in recent years.[80]

Of total health expenditure which is currently about 6 per cent of GDP, 37 per cent of this is for people over 65. As illustrated in Figure 4.1 those aged 75-79 require 10 times more public funding per person than those of younger ages, while those over 85 require thirty times (National Health Committee, 2000, p.7).

Figure 4.1: The health costs of different age groups



Source: Dyson (2002)

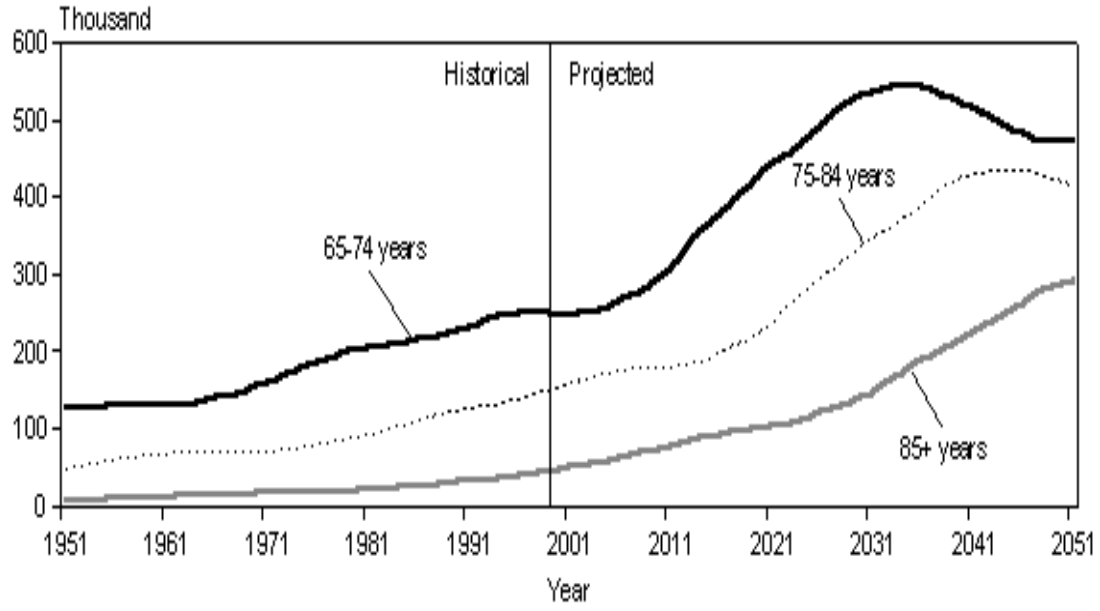
The OECD cautions that the picture of increasing incidence of disability as the population ages is exaggerated. "The relative prevalence of severe disability at a given age has tended to decline over time especially for ages 60-80." (OECD, 1998, p.90). In other words, as people live longer, this period of high cost is shifted to a later stage

[80] For example, New Zealand's largest health insurer Southern Cross Healthcare introduced a 45-64 year age band in 2001 to reduce cross subsidisation from younger to older members, and raised premiums for about 300,000 members up to 30 per cent with further increases signaled. Only one in three New Zealanders have insurance compared to one in two, a decade ago (Riordan, 2001).

of life.[81] Nevertheless, in spite of some optimism that healthcare costs and long-term costs will not mushroom uncontrollably, the OECD expects costs to rise by 10-20 per cent in the next 15-20 years (OECD, 1998, p.97).

While older people may live longer and healthier lives, there will be vastly more of them at older ages by mid-century. In New Zealand as shown in Figure 4.2, there will be a very rapid growth in the numbers over 65 years and in those aged over 85 years, whose numbers are expected to increase seven fold. By 2051 centenarians are expected to increase 40 fold from 300 to 12,000 (Statistics New Zealand, 1999b). Thus the sheer growth in numbers suggests that the financing of long-term care for those over 85 is likely to be a major policy issue by mid century.

Figure 4.2: Projections of numbers of older people aged 65-74, 75-84, 85+



Source: Statistics New Zealand (1999b).

4.3 Use of residential and long stay facilities

Since the 1960s there has been a marked decline in the number of elderly people in hospitals compared to the number in residential homes as detailed below in Table 4.2. The projections suggest this trend may continue as rest homes become the repository of the infirm and disabled, leaving the more able-bodied to be cared for in their own

[81] These expectations and trends are very important in mitigating the growth of dependent older people over time to a manageable number. The expected growth in dependent older people over the next 25 years falls from a projected 50 per cent to 15 per cent under these assumptions.

homes. The Ministry of Health estimates around 32,000 older New Zealanders were in long-term care in 2001.[82] Census figures show that around 6 percent of those over 65 are in long-term care (final column of Table 4.2).

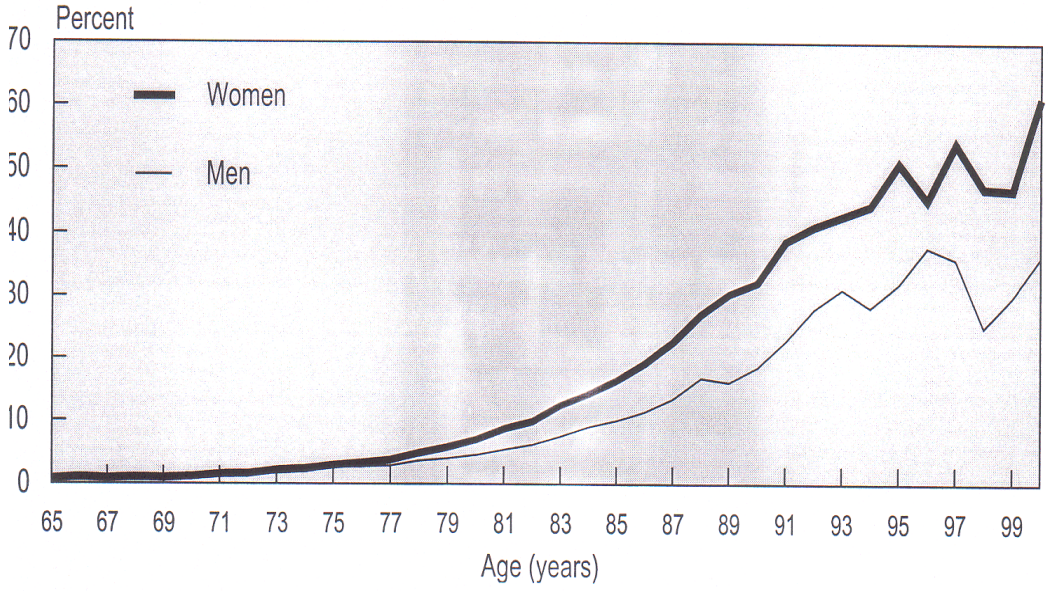
Table 4.2: Percentage of those aged over 65 in long-term residential care

Type of institution	1966 (%)	1996 (%)	2001 (%)
Rest home	<2.0	4.9	5.3
Hospital	4.3	<2.0	0.6
Total	6.3	6.9	5.9

Source: Statistics New Zealand (1998) and Census 2001

Figure 4.3 shows the probability of being in rest homes increases dramatically by age. In 1996, 1.3 per cent of those aged 65 to 74, 5.7 per cent of those aged 75 to 84, and 24.5 per cent of those aged 85 and older lived in a residential home. Almost half of all residents in residential homes in 1996 were 85 years or older (Statistics New Zealand, 1998). Of those that enter long-term care, 19 per cent die within 3 months, and 40 per cent within 12 months. The average length of stay is 1.7 years. Three in every four elderly residents in a residential home are women.

Figure 4.3: Elderly people living in residential homes by age and sex (1996 census)



Source: Statistics New Zealand (1998, p.46)

[82] As at 1 July 2001, there were 1186 dementia care, 9559 long-stay hospital, and 23,412 rest home beds (Ministry of Health, 2002b). Disability Support Services (DSS) has estimated that over 65 per cent of its funding, i.e. $875m for 2001/02, is for persons aged over 65 (Ministry of Health, 2002a). Of this the bulk of the funding is for long-term care.

4.3.1 The costs to the state of long-term care

The mechanism for rationing expensive residential care in New Zealand is the age care assessment procedure. An older person is classed in one of four stages of care with means-tested subsidies available on a daily rate if rest home or hospital care is required. Table 4.3 gives the subsidy rates and the contract rates based on the Auckland region.

Table 4.3: Means-tested daily rate subsidies for long-term care

	Dependency level	Daily subsidy $	Contract rate[1] $
Stage 1	Some	35.93	57.96
Stage 2	Moderate	46.66	68.77
Stage 3	Severe	66.00	88.83
Stage 4	Hospitalisation	89.71	132.65

Source: Ministry of Health (personal communication)
Note: The contract rate includes New Zealand Superannuation from the resident.

The cost of services for the elderly for 1998/99 was $648.2m, distributed between different services as set out in Table 4.4. Long-term care subsidies ($402m) are driven by the assessment process, rather than capped. The total costs of long-term care are funded by equal share of out of pocket private/public contributions with about two thirds of residents qualifying for a full or part subsidy.[83] These subsidies were last adjusted in 1997, and providers have struggled since then to maintain services.[84]

Table 4.4: Estimated expenditure on disability support services for people aged 65 and over: 1998/1999

Type of service	Per cent expenditure
Residential care	62.7
Assessment treatment and rehabilitation	19.7
Home support and caregiver support	11.9
Disability needs assessment	1.3
Respite care	0.7
Other	3.7
Total	100.0

Source: Ministry of Healt, (2002b)

[83] The out of pocket private contribution may also involve a delayed caveat on the family home, whereby care costs are funded by the state and refunded when the resident's house is sold or the estate is settled.

[84] A petition was presented to parliament in early 2001 outlining the providers' concerns.

By 2000/01, public expenditure on rest home/continuing hospital care subsidies had increased to $426 million from $402 million in 1998/99, despite the static daily rates as set out in Table 4.3 (Ministry of Health, 2002b). However the costs are projected to increase much more rapidly from 2030 when the baby-boom generation starts requiring long-term care. The subsidy costs are expected to roughly quadruple to $1.6 billion (1998/99 dollars) by 2050. Should the asset test for long-term care be removed, the fiscal costs to the Crown would be substantially compounded. The implications of this impending legislation are discussed below in section 4.4.2

4.4 Income and asset testing of long-term residential care

Subsidies for long-term residential care are available on a means-tested basis under Section 69 of the Social Security Act 1964. As with other aspects of policies for the elderly, study of history promotes an understanding of how political developments have driven policy and how they may constrain future policy development. The history of income and asset testing is set out in the appendix to this chapter, along with the current dimensions to the means test.

In contrast to New Zealand Superannuation, none of the parameters of the subsidy and means test for long-term care are automatically indexed. Once the asset test establishes that assets have been suitably exhausted, all personal income earned, up to a cap of $636 a week, an amount unaltered since 1994, must go towards paying for care. Income from a partner is also included over an exempt amount as described in the appendix to this chapter.

4.4.1 Unresolved policy issues[85]

For those who are actually running down their assets to pay fees, asset stripping with the cap of $636 a week may take a little longer than without it. Nevertheless, for those families affected, the means test is severe. Wealthy residents requiring expensive care, who can pay high fees entirely out of the income from their assets, have been able, since 1994, to retain more of their income since the cap was introduced. As the cost of intensive hospital care may exceed $1000 a week, the cap effectively subsidises their further asset accumulation. This may then be bequeathed

[85] This section draws on St John (1994).

in full, as all estate duties were abolished in 1992 and there is no inheritance tax in New Zealand.

Another issue concerns the use of the married couple as the unit for the income and asset test. In the last two decades social change has been rapid with increases in two-earner households and much more diversity in family types. The means-testing regime depends on stereotypes and assumptions about the family and marriage that are less relevant to a growing number of people.[86]

Under the asset test, the married person in care with a spouse in the community is still treated better than a single person with a non-marital partner or other close companion. The discrimination is reversed for the income test. Unless classified as a defacto spouse, the income of a person living with the single person who goes into care is not taken into account. For 'married' couples (including de facto but not same sex) joint income must be used to pay for the partner in care.

The spouse at home must contribute all his or her 'unearned' income over and above income on exempt assets. The income test applies regardless of whether or not the $45,000 exempt under the asset test has actually been accumulated. Even if this capital sum is available at the time when long-term care is required, the spouse in the community may have to replace assets such as the car, and pay for repairs and maintenance. Thus the exempt sum may be used up before retirement and the restrictions on what may be earned make it unlikely that a younger spouse would be able to save for retirement. To put the exempt sum of $45,000 in perspective, it would provide a woman with a life annuity of little more than $3000 at age 60.

Some of the other anomalies of the existing scheme are obvious. The family home is exempt, so long as the spouse or dependent child continues to live in it, no matter what its value. A couple with one partner in care, without a family home but with cash assets must run these down to $45,000. However, if they owned a valuable home, $45,000 and other exempt investments they would be eligible for the full subsidy. Funds in registered superannuation schemes are not counted in the asset test even though in modern schemes they are often not locked in. A private pension is partly a

[86] Under the Human Rights Act 1993, discrimination is now illegal if it is based on family or marital status, but until an amendment was passed in 2002 the government itself has been above this provision.

return of capital but only features in the income test, where one half is counted. In the income test children are considered dependent only if school age, which is inconsistent considering many older parents are supporting children up to the age of 25 in the tertiary sector.[87]

Under current administrative rules, gifts in excess of $5000 for each of the five years prior to accessing the subsidy may be included in the asset test. Thus the ability of an older person to balance out obligations and responsibilities to family members may still be compromised in a way that causes considerable pain and unfairness.

Asset testing may also have a marked disincentive effect on saving for retirement for some people, far greater than that engendered by the surcharge on New Zealand Superannuation. The spectre of asset testing and the fear of departmental probing may encourage an inappropriate early divestment of assets with an unfortunate loss of autonomy for the older person. There is little information on the extent of the increased use of trusts to avoid the asset test but anecdotal evidence suggests that it is rising with many elderly people being talked into such arrangements without fully realising the implications.[88] There are several books on trusts that quite openly describe the ways in which the asset testing rules may be avoided (for example, see Holmes, 1997). To the extent that trusts are more widely used as an effective means of asset protection, the more arbitrary and ineffective asset tests become as a means of funding long-term care (Frawley, 1995).

4.4.2 Proposal to remove asset testing

New Zealand long-term care policies have been politically divisive. Draft legislation was expected in mid 2002 to fulfill an election promise made by Labour to remove asset testing, but has been delayed until 2003 as politicians grapple with the implications. It is unlikely that removal of asset-testing alone can resolve the anomalies without creating more problems. A renewed emphasis on the income test

---

[87] In addition there are serious inconsistencies with the way in which same sex couples are treated under this means test, and how they are treated under the Property (Relationships) Act 1976.

[88] Implications include alienating one's assets and control over them too early in retirement. The gifting of assets may not result in reciprocal care by family members, who may in time 'forget' their obligations.

for example is needed at minimum, with loopholes closed and imputation of income from non-cash assets applied.

Indications are that the fiscal cost of the full removal of the asset test is likely to be unpalatable in the current climate. Thus it is expected that the changes will be phased in slowly to soften the initial costs. One suggestion is that, initially, only the first 13 weeks will be exempt from an asset test. This suggestion will hardly meet the expectations of Grey Power and other lobby groups who have been holding the government to its promise.[89] Another possibility being explored is to exempt the family home from the asset test. This in turn raises a number of conundrums such as how to treat people who have financial assets rather than their own home.

Official projections of the cost of removing the asset test which incorporate demographic change were not available in late 2002. The relevant cabinet papers (of which there are about 15) and requests for information under the Official Information Act by interested parties have been refused. Government politicians have, however, referred to costs of the full removal of asset testing as rising from over $200m initially to $300m in 2009/10 and $500m in 2020/21.[90] Others in the industry believe that these projections are much too conservative. In the meantime there is disquiet about the possibility that assessment for long-term care will become even more stringent with an inappropriate emphasis on community-based care under the "ageing in place" strategy.

The fiscal pressures associated with removal of asset testing may also reduce other worthwhile government spending, or require higher taxes, again impacting on the community and working-age population. If asset testing is abandoned it is likely that the criteria for accessing long-term care needs will tighten even further, the bare minimum level of care will continue to fall, and user pays charges will increase for the basics as well as additional extras.

Longer term, the removal of asset testing makes even less sense. As discussed in section 4.3, subsidy costs under present policies are expected to roughly quadruple to $1.6 billion (1998/99 dollars) by 2050. The removal of asset testing will impact most

[89] Grey Power is an organisation of retired people. Web site: http://www.greypower.co.nz/

[90] Personal communication from Ministry of Health, 16 November 2002, quoting Hon Ruth Dyson, Hon Lianne Dalziel and Hon Jim Anderton.

severely on the government's budget from 2030 as the first of the baby-boomers reach 85. There are likely to be serious intergenerational conflicts if asset-rich old people expect to have their care paid for by the asset-poor of working age.

4.4.3 Reform of income and asset testing for long-term care

The principle that people use their own saving to take care of themselves in old age should not be easily dislodged. Thus the imminent introduction of the abolition of asset testing needs careful reconsideration. The draft legislation is unlikely to indicate any compensatory recoup of the lost revenue by means of an income test that imputes income to assets. At the end of 2002, the only indications of the shape of the legislation were found in an unpublished post-election briefing paper from the Ministry of Health:

> *The proposed Bill will change the current means testing regime for long-term care by progressively removing the asset test. The first step involves a waiver of asset testing for the first thirteen weeks in care. The waiver period increases progressively by adding an additional 13 weeks at least every three years, until asset testing is fully removed in the medium term.*
>
> *Because people would expect to pay living costs if living in their own home, the income test is to be retained as the way people contribute towards some of the cost of their long-term care.*

This kind of reform does nothing for those already in care or for those that fall outside the minimal exemptions outlined above. It may preclude the adjustment to the current regime that is necessary. The biases in the asset test against single people and in the income test against married people are in much need of rectification.

The Property Relationship (1976) Act could be used to provide an asset division at the time of one partner needing long-term care. While one spouse is alive in the joint family home, the half share of the one in care could be exempt from the asset test, and the share assigned to the remaining spouse on death. The asset test would then be individually based, and protect the assets of the spouse at home. The spouse is very often female and younger, and needs to provide for her own retirement. With the matrimonial property split, she does not need to face the prospect of having drastically reduced assets in old age. The income test should also be an individually-based one that does not confiscate the spouse's earnings above an unadjusted low exemption as at present.

To be discussed in detail in chapter 10 there is merit in considering an integration of insurance for longevity and long-term care. This proposal requires that the obligation for individuals to meet a substantial portion of the costs of their care must remain. The current cap of $636 was set in 1994 and has been unadjusted for inflation. It is now considered to bear a less realistic relationship to the actual costs of long-term care, with either the state making up the difference, or the individual facing user pays charges for extras that might be more properly regarded as core services. It would be sensible either to do away with or index the cap, and offer protection through the approach suggested in chapter 10.

If it is decided to proceed with the removal of asset testing for long-term care, it will be imperative that some of the lost revenue is recouped by a redesign of the income test. Income from non-income earning assets, unit trusts and family trusts would need to be imputed to the individual. Under either asset or income testing, and in the proposed reintroduction of a surcharge-like income test discussed in section 10.4.2, the treatment of trusts must be dealt with.

4.5 Discussion

Policies of recent governments have abolished death duties on the wealthy, persistently favoured the high-income earner in tax policy and failed to implement a proper capital gains tax such as applies in virtually every other developed country. The wealthy can accumulate assets unimpeded while a small group of very unfortunate middle-income New Zealanders and their families are subject to punitive fees extraction because they require long-term residential care.

As the OECD (1998) suggests, long-term care is a normal risk to be shared between the working and the older generation. Most countries have not begun to grapple with this issue:

> *Older people, especially very old people, require more frequent medical care and far more long-term care. There is ample evidence that more efficient ways of curing and caring are feasible for older patients. While the long-term care system is much less costly than the healthcare system, it is in more need of reform. Reforms should aim at better integration of health and long-term care, more equitable access to care, and improved protection against the financial risks associated with disability.* (OECD, 1998, p.83)

This section has emphasised the growing costs of old age care and the various anomalies in the current means test. A direct contribution from individuals for their long-term care will always be required and is a reason why people should be expected to save for their own retirement. Nevertheless, the funding of long-term care of the elderly in New Zealand is highly inequitable. The legislation to end asset testing is likely to compound rather than reduce existing inequities and overlap with other provisions.

Many of the features of long-term care make it an unlikely candidate for private insurance (see section 8.5) so it is not surprising that it is not available in New Zealand. In particular, those most in need are the ones most unlikely to be able to pay an actuarial premium. Women live longer than men and have fewer resources and are much more likely than men at each age over 65 to be in long-term care as was illustrated in Figure 4.3. Thus the state, through some kind of social insurance mechanism must provide at least for the poorest. The long-term care subsidy paid for from general taxation performs this role.

This subsidy has been unadjusted over long time periods and has become less financially viable for institutions especially where the level of dependency is high. The thresholds for the income and asset tests are not inflation-adjusted, nor is there regular consideration of the way the costs of other things such as housing and healthcare may change over time. The removal of asset testing, while politically popular with older people, is likely to increase rather than ameliorate the underfunding problem currently faced by providers. When the means test for rest homes was first introduced a far greater proportion of those in care were in need of hostel rather than custodial care. Nowadays the level of care is much more medically based, intense and expensive. A recent report, (National Health Committee, 2000, p.4) notes:

> *[T]he 20 year trend of increasing severity and complexity of the health needs of older people on admission to long-term facility care, which has accelerated over the past five years; funding of these services has not increased to reflect the increased costs of providing long-term care for these people.*

The major beneficiaries of the removal of the asset test will be those whose assets do not earn cash income. While some of those middle-income New Zealanders who suffer from the current arbitrary provisions will gain, many who by virtue of their

wealth might have been expected to fund their own long-term care needs will also benefit, along with their descendants whose inheritances may be higher. Those who have sheltered income and assets in trusts already avoid the asset test. But this reflects more that the existing arrangements are ineffective and inequitable and are in need of reform, rather than supporting the case for the removal of asset testing. Moreover the problems will be compounded once the baby-boom generation enters very old age from 2035. Part III of this thesis explores these issues further and suggests a more equitable and certain approach to funding is required, through development of an annuities market tied to insurance for long-term care needs.

Appendix Chapter 4: Means-testing of long-term residential care in New Zealand

Subsidies for long-term residential care are available on a means-tested basis under Section 69(F) (A) of the Social Security Act 1964. Prior to 1993, older people needing residential care were subsidised according to the type of care facility entered, rather than the level of support needed. The means test for those entering long-term residential care in private hospitals was therefore different from that for people entering rest homes. Those in private geriatric hospitals were expected to pay whatever they could towards their fees while those in public geriatric hospitals did not have any form of income or asset test. They did, however, have their New Zealand Superannuation reduced to a token 'pocket money' amount after 13 weeks. The perceived unfairness that those with the same support needs were making differing contributions to the cost of their care became the rationale for the 1993 changes.

The 1993 regime subjected all *new* residents in long-term residential or hospital care to the same income and asset test. The model was that previously used for the Rest Home Subsidy Scheme with some relaxation of the asset threshold levels. Previously only those receiving a rest home subsidy were income and asset-tested, now those in geriatric hospitals (private or public) faced an asset test for the first time. After a review, a maximum personal contribution of $636 per week was introduced in 1994 for care in all long stay institutions including private and public hospitals as long as that care was appropriate to the needs of the person concerned.[91] The Regional Health Authority (now restructured) was to pick up any extra costs.

Asset test for the residential care subsidy[92]

In 1994 the threshold for asset testing for married couples with one spouse in long stay care was increased from $20,000 to $40,000 with house, car, personal effects and

[91] There is evidence of a much greater degree of need being required before the old person qualifies for a subsided place in the 2000s.

[92] Means-testing also applies to younger people aged 50-65 who have old age related medical conditions, provided they are single and with no dependents.

prepaid funerals (up to $10,000) remaining exempt.[93] A single person without dependent children could retain only $6500 with no exemption for the family home. A married couple both in care, were effectively treated as two single people with a joint exemption of only $13,000.

In response to concerns about people caring for or living with an elderly person, but who were neither a relative nor a dependent child, two further changes were made in 1995. Older people who entered care on or after 1 October 1995 could recognise past caregiving by gifting up to $5000 per year for up to five years retrospectively. Interest-free loans became available to non-core family members so they could live in the home after the older person had died. There is no income or asset test for that person receiving the loan, but in order to qualify the person must have lived in the home or jointly owned the home with the elder person for at least five years. Those whose house counts as part of the asset test are unlikely to qualify for any subsidy, but an interest free loan can be made. A caveat is placed on the sale of the home and the loan is repayable on the sale of the home or on death.

Under the December Coalition Agreement (1996) income and asset testing for those in public hospitals, and asset testing for long-stay geriatric private hospital care was to be abandoned from 1 October 1998. In the meantime the Coalition Government was dissolved and instead, the new adjustments to the targeting regime were made from 1st December 1998. Exempt assets for the subsidy were raised to $45,000 for a married couple where one is in care and $15,000 for a single person ($30,000 for both in care). Included in assets are cash, investments, shares, loans (including to trusts) and house chattels and car for those without a partner or dependent child living in the home. Prepaid funeral expenses are not counted, up to $10,000 each, but gifts made in the past 5 years of more than $5000 a year are included.

Income test for the residential subsidy

In principle, the income test is only applied once the asset test has been administered and the applicant's assets are appropriately exhausted. All personal income earned up to $636 a week, an amount unaltered since 1994, goes towards care. Income includes

[93] Any realisable assets such as holiday home, caravan cars, boats are included in the asset test along with financial assets of deposits, shares and bonds.

New Zealand Superannuation or other welfare payment and other pensions from overseas, less a personal allowance, accident compensation, business or investment or income from a family trust. One half of regular payments from registered private superannuation schemes, endowment life insurance and annuities count as income (providing yet another reason for the historic unattractiveness of annuities, see section 8.2). Income from a partner is also included but not the partner's income from New Zealand Superannuation and income support. There is an exempt amount allowed for 0-1 dependent children of $28,927, 2 children, $32,740, 3 or more children, $36,553 (these amounts were set in 1993 and since then have not been adjusted).

For those in care receiving New Zealand Superannuation, a non-indexed amount of $28.30 is allowed to be retained, and a clothing allowance of $200.44 a year. A spouse on New Zealand Superannuation or other income support also gets an increase of $28.30 a week to help with costs of visiting.

5 Living standards and the distribution of income and wealth among the old

5.1 Introduction

A clear picture of the income and wealth distribution among the retired, those close to retirement, and in the whole population, is required to inform policy development. This section draws on data from a variety of sources, including a new Net Worth survey carried out in 2002 (Statistics New Zealand, 2002a, 2002b), and a Living Standards survey carried out in 2001 (Fergusson, Hong, Horwood, Jensen & Travers, 2001).[94]

Conceptual and other problems abound in the measurement of the income and wealth distribution. It must be decided whose income and wealth to measure, the married couple or the individual; how to treat the inflation portion of interest income and how to apportion assets held in trusts. In assessing the income distribution, the line between a capital receipt and a revenue receipt is often unclear. Withdrawals from managed funds and superannuation schemes, for example, are capital in nature (under the TTE treatment), but reflect the underlying income earned as well. Moreover, imputed-rentals on owner-occupied dwellings are not included in the usual household income surveys, nor are capital gains.

In this section these caveats need to be kept in mind, with the further problem that New Zealand has less well developed data than is collected in many other countries. Most of the data comes from one-off surveys rather than longitudinal studies, and sample sizes are usually too small to allow any detailed analysis. For this reason New Zealand partakes in international comparative studies with considerable difficulty as was the case in the New Zealand contributions to Johnson (1999) and in the New Zealand chapter, (St John, 2001c) in '*Pension systems and retirement incomes across OECD countries'*, Disney and Johnson (2001).

[94] Also draws on St John (2001c).

5.2 Income distribution among the whole population

Over the past two decades in New Zealand, real incomes of the majority of the population have fallen. While the mean real equivalised disposable income of New Zealand households rose marginally between 1982 and 1998, a considerable variation in experience for different deciles of the income distribution was observed (Mowbray, 2001). [95] As shown in Table 5.1, the top decile of household equivalent disposable income rose dramatically (36 per cent), while the lowest 8 deciles all experienced significant falls.

Table 5.1: Means of household equivalent disposable income in deciles

Deciles	1982	1998	% change
1	11,522	9,557	-17.0
2	17,875	16,793	-6.0
3	20,535	18,728	-8.7
4	23,891	21,539	-9.8
5	27,710	25,785	-6.9
6	32,071	30,654	-4.4
7	37,025	36,295	-2.0
8	43,157	43,730	-1.3
9	50,483	53,419	5.8
10	67,057	91,291	36.0
All households	**33,139**	**34,789**	**4.9**

Source: Mowbray (2001)

The data for mean equivalised disposable household income by main income source is given in Table 5.2. These figures show that those whose predominant income source is from wages and salary or self-employment have fared best, with an increase of 10 per cent and 15 per cent respectively.

Those on benefits have also seen an overall 8.4 per cent gain. All others, including those whose main source of income is superannuation, have declined. Using data by type of resident rather than by main income source, Mowbray (2001, p.62) shows superannuitant households had 75 per cent of the mean income of all households in 1982 but only 66 per cent in 1998. A likely major reason is the fall in the relative level of New Zealand Superannuation over this period (see Figure 2.1 in chapter 2).

[95] Equivalised data is income after taxes and benefits, adjusted for household size using an equivalence scale. In the case of New Zealand, the revised Jensen scale is used (Statistics New Zealand, 1999a).

Table 5.2: Mean equivalent disposable income of households by major income source, 1982 and 1998 ($1998)

Main income source	1982 $	1998 $
Wages and salary	36,818	40,474
Self-employment	38,644	44,413
Benefits	15,597	16,914
Superannuation	21,213	20,379
Other	39,594	38,284
All households	**33,139**	**34,789**

Source: Mowbray (2001)

5.3 Income distribution of those over 65

Table 5.3 shows the numeric distribution of those over 65 in the overall income distribution, as given by the Household Economic Survey 2000/1. If the distribution mirrored that of the rest of the population, about 40,000 would be expected in each income decile (this comparison is illustrated below in Figure 5.1). Those over 65 are under-represented in the lowest two deciles where business loss income affects the measured mean incomes in the total working age population. Just over 70 per cent of those over 65 inhabit deciles 3, 4 and 5, while they are again under-represented in higher deciles.

Table 5.3: Distribution of income of those 65 and over by deciles of total population

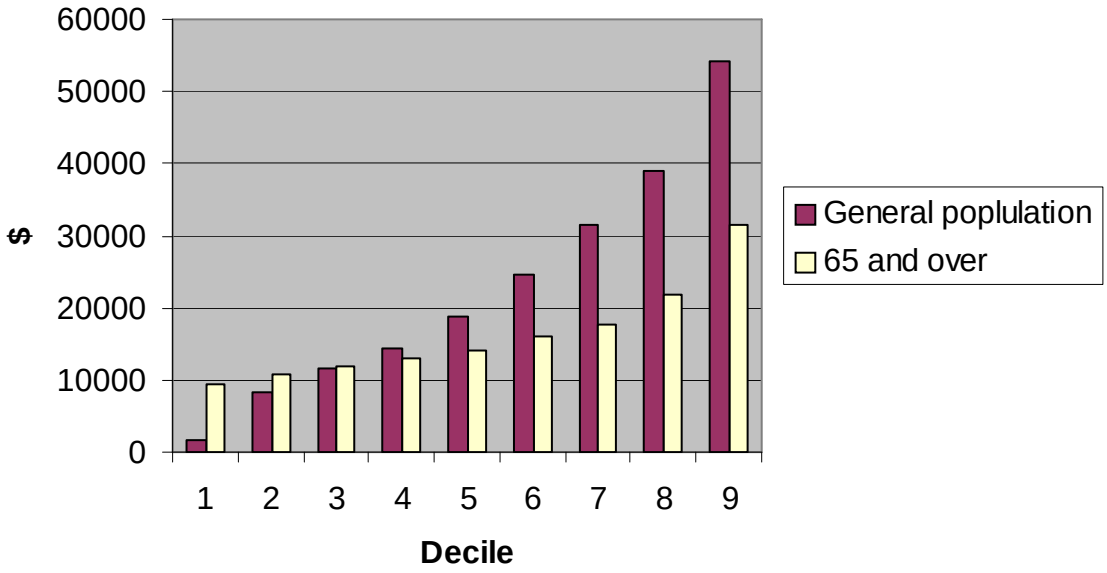
Total personal income	Deciles of total population	Population aged 65-74	Population aged 75+	Population aged 65+
Loss, $0-1600	1	4,800	-	4,800
$1,600-8,399	2	6,800	-	6,800
$8,400-11,499	3	60,000	34,500	94,500
$11,500-14,499	4	61,100	44,300	105,400
$14,500-18,799	5	42,000	51,400	93,400
$18,800- 24,699	6	16,000	19,000	35,200
$24,700-31399	7	16,000	7,700	23,700
$31,400-39,099	8	8,800	6,200	15,000
$39,100-54,099	9	7,800	5,400	13,200
$54,100+	10	7,200	5,300	12,500
All income groups		**230,800**	**175,700**	**406,500**

Source: Statistics New Zealand (2001)

From the first two rows of Table 5.3 it can be seen that 11,600 people aged 65-74 are in the lowest two deciles, possibly because of negative self-employment income. While this younger 'old' age group might be expected to be better-off than those aged over 75 because a higher percentage of them are still working, this effect is not observed in these data.

Figure 5.1 compares the decile distribution of income for those over 65, to that of the general population over 15. The picture confirms a much flatter distribution for the 65 and over age group. The 9th decile's upper limit of $31,500 for those over 65 confirms that the distribution favours the top decile, but to a lesser extent than for the whole population.

Figure 5.1: Income distributions of those over 65 compared to the total population, upper limit of first nine deciles



Source: Derived from Household Economic Survey 2001/1, Table 26

The income of households with an occupier aged over 65 is predominately derived from New Zealand Superannuation (56 per cent), while investment and other private sources (27.5 per cent) and employment (12 per cent) are the other two major sources of income. Women are more reliant on New Zealand Superannuation than men with 72 per cent of them receiving at least three-quarters of their income from New Zealand Superannuation compared to 54 per cent of men. The importance of New Zealand Superannuation is illustrated by the fact that just 7 per cent of men and 2 per cent of women receive less than a quarter of their income from this source (Statistics New Zealand, 1997).

As observed in chapter 3 and illustrated in Table 3.7, less than 15 per cent of those over 65 have any income from a private pension or annuity. Of those who do have private pension income, women have far less than men and many have only small pensions. It can be inferred that pensions paid to women include a large number of spouses' pensions rather than pensions earned by them in their own right.

There is little official information on the distribution of other income or non-New Zealand Superannuation income. In 1996 the Department of Inland Revenue conducted a survey of non-New Zealand Superannuation pension income in conjunction with the policy development on the surcharge. Private pension income was counted as one half income just as it had been treated for surcharge purposes. Table 5.4 shows that non-New Zealand Superannuation income is highly skewed, with the average well above the median income. Moreover at the highest income decile, the average of $41,970 is one and a half times as high as the median, indicating that, relatively speaking, the top 5 per cent of incomes are very high indeed.

Table 5.4: Distribution of non-New Zealand Superannuation income, individuals over 65, 1996

Aged 65 and over Decile	Income at start of decile boundary ($)	Median ($)	Income Average ($)
1	0	0	-677
2	0	0	0
3	0	0	0
4	0	77	123
5	411	862	882
6	1,465	2,121	2,158
7	2,933	3,868	3,885
8	5,028	6,831	6,914
9	9,249	11,967	12,274
10	16,853	27,193	41,970
Whole population >65		**1,464**	**6,753**

Source: Periodic Report Group (1997a, IRD background report)

In summary, the older population has a much more compressed range of income, and a much flatter distribution than the overall population, due in part to the equalising effect of New Zealand Superannuation, and in part to the loss of employment income. Nevertheless the distribution is still markedly unequal. The top decile of the over 65 year-old population, especially the top 5 per cent have relatively high incomes. However, it should be noted that a number of those over 65 whose declared income is low, may have used trusts to protect their assets, making income and wealth distributions less reliable (see section 10.4.2).

5.4 The wealth distribution

Holding of net assets by those 65 and over are on average modest. In 2001, a survey of living standards provided some limited information about assets and their

distribution. Information on assets of all kinds was obtained for 87 per cent of single 'core economic units', or CEUs. and 84.8 per cent of partnered CEUs (Fergusson et al., 2001).[96] This survey, summarized in Table 5.5 shows that three quarters of single CEUs have savings and investments less than $37,500 and the median is only $7500. For partnered CEUs, the figures are higher as would be expected, but more variable with three quarters having assets (apart from their own home) of less than $100,000 with a median of $37,500. The report observed:

> *The findings indicate a population with relatively low levels of financial resources.* (Fergusson et al., 2001, p.ii)

Table 5.5: Estimated total value of savings and investments of CEUs, (excluding own home)

Value ($000)	% of Single CEUs n=1407	% of partnered CEUs n= 1244
<1	30.6	20.9
1-5	13.7	7.8
5-10	11.6	7.6
10-15	7.3	5.5
15-25	8.6	9.2
25-50	9.0	12.3
50-100	7.3	9.7
100-150	3.3	6.0
250-200	2.3	4.1
200-250	2.0	3.6
250-300	0.7	1.9
300-350	0.9	2.7
350-400	0.7	1.6
400+	2.1	7.0
Median value of investments	**$7,500**	**$37,500**

Source: Fergusson et al., (2001, p.50)

The majority of those who own their own home, own mortgage-free (Fergusson et al., 2001, p.51) but only 68 per cent of single respondents and 86 per cent of couples were homeowners in this survey. Nevertheless a substantial number, 6.6 and 6.0 percent respectively live in a house owned by a family trust, and a further 9.3 and 2.0 percent respectively live in a house owned by family members. Fewer than 13 per cent of singles and 6 per cent of couples pay rent to private landlords or local/state authorities. Median accommodation costs (mortgage, rental rates, body corporate

[96] The unit is based on the status of the individual or couple, not the household they live in.

fees) for single and partnered CEUs were only $20 and $23 a week respectively, with 90 percent paying less than $95 and $75 a week respectively.

Table 5.6 also draws on the Living Standards survey and shows the median value of homes for those who own is $125,000 for single CEUs and $175,000 for partnered CEUs. These, and figures from the 2002 dedicated Net Worth survey discussed below corroborate the story of a low mean and median net worth and an unequal distribution.

Table 5.6: Government valuation for CEUs owning their own home

Value ($000)	% single CEUs	% partnered CEUs
<25	0.3	0.2
25-50	3.0	1.8
50-100	23.8	14.6
100-150	30.2	21.3
15-200	18.4	21.4
200-250	12.2	15.6
250-300	6.6	11.9
300-350	1.5	4.8
350-400	0.8	3.0
400+	3.2	5.3
median	**$125,000**	**$175,000**

Source: Fergusson et al., (2001, p.52)

The Net Worth survey (Statistics New Zealand, 2002a, 2002b) provides the most comprehensive view of the holding of wealth yet available. The survey interviewed 2,392 individuals and 2,982 couples. Weighted up to the whole population these represent 930,900 individuals and 855,900 couples. While the size of the survey precludes a detailed breakdown by age, and some of the cells in the tables have very high margins of error, the survey represents a benchmark and for the purposes of this thesis provides a rough estimate of the liquidity and amount of assets people have in retirement and in the decades immediately preceding retirement. Tables from the Net Worth survey pertinent to this chapter are appended to this chapter.

Table 5.7 summarises data from Table 5.15 (see appendix to this chapter), and shows the percentage of the 65 and over population who hold assets in various bands of net worth. Half have net worth under $112,800. This is compared with the pre-retirement age group 45-64 in row two of the table. For both populations approximately three quarters of both populations are located in the range from $20,000 to $500,000. For both groups the median is well below the mean, suggesting a concentration of wealth at the top end of the distribution.

Table 5.7: The net worth of those over 65 and those aged 45-64

Individuals	% Under $20,000	% $20,001-$100,000	% $100,001-$500,000	% Over $500,000	Mean $	Median $
Over 65	15.9	29.6	47. 3	7.2	186,400	112,800
45-64	14.5	25.5	50.8	9.2	220,900	140,000

Source: Statistics New Zealand (2002b)

Table 5.8 below is based on Table 5.16 in the appendix and confirms the conclusions of the Living Standards Survey (Fergusson et al., 2001) that median value of residential property is low. The results for many of the other asset holdings surveyed have a very wide margin of error as relatively few respondents in each age band owned them.

The median wealth held in trusts is recorded as the amount still owed to the individual as settlor. While median amounts are relatively high, the numbers of people affected are a tiny fraction of the total population. The Net Worth survey (Statistics New Zealand, 2002a, 2002b) found that only about 5 per cent of those over 65 have trusts and only 7 per cent of those aged 45-65. But there is another group who has set up trusts where all the debt has been forgiven and so their interest in the trust is not recorded in this survey. It can be assumed that the majority of those who live rent-free, about 3.6 per cent of those over 65, are living in houses they formerly owned, and are now fully owned by the family trust.

Table 5.8: Median value of wealth held for those over 65 who own selected asset classes

Age	Property $	Super-annuation $	Bank deposits $	Other Financial Income $	Business $	Trust $
Individuals 65+	135,000	..	8,000	35,100**	0**	57,000**
Couples 65+	171,000	100,000**	10,600	32,200**	16,500**	400,000**
Individuals 45-64	154,000	35,000*	2,200*	8100**	115,000**	150,000**
Couples 45-64	206,000	49,100	5,500	21,600*	40,000**	300,000**

Source: Statistics New Zealand (2002b)
*Notes: * and ** denotes high sampling error; .. denotes data too unreliable to be recorded*

5.4.1 The role of inheritances

Inheritances and to a lesser extent gifts can be an important resource for some people (Stroombergen & Rose, 1998). Bequests, especially of real estate, may be relatively higher in New Zealand due to the lack of opportunities to annuitise wealth (see section 3.5). Nevertheless, only limited data is available and that from the Household Economic Survey (HES) excludes real estate. Table 5.9 shows the probability of

either receiving income from inheritances or from gifts over the course of a year is low. However, this data does not show the probability of such receipts over a life-time, which is much higher.

Table 5.9: Mean probabilities of receiving gifts and inheritance or making gifts

	Receiving inheritances	Income from gifts	Spending on gifts
Probability	2.8%	7.3%	5.9%
Mean	$15,000	$2,300	$2,100

Source: Stroombergen & Rose (1998, p.viii)

5.5 Housing and living arrangements

Table 5.10 confirms the high rates of home ownership for those over 65. Based on the HES, 36 per cent of the total household population owns their homes without a mortgage, a further 31 per cent own with a mortgage. Home ownership is much more concentrated among those aged over 65. In this group, 83.6 per cent own their own home, of which 77.2 per cent own without a mortgage. It can be inferred that younger households on average have lower standards of living than the older age group at the same points in the income distribution, once housing costs are taken into account. Those over 80 are less likely to own their own home.

Table 5.10: Tenure of dwelling for persons over 65, 2000/2001

	Rent paid	Rent-free	Mortgage	Mortgage-free	All tenures
Numbers of persons (000s)					
Males aged 65+	15.9	7.7	14.1	142.9	180.6
Females aged 65+	35.9	6.8	11.9	171.2	225.9
Total 65+	51.8	14.5	26	314.1	406.5
% of those 65+	12.7	3.6	6.4	77.2	100

Source: Statistics New Zealand (2001)

Significantly, there is a greater likelihood that women will be single and live alone especially if aged over 80. In addition, 13 per cent of women over 80 are renting. However, even at the younger age group 65-79, 10 per cent of men and women are renting. It is to be expected that those who have the highest housing costs are more likely to be experiencing hardship if they are living on the New Zealand Superannuation pension alone (Statistics New Zealand, 2001).

5.6 Living standards of today's retirees

New Zealand does not have an official poverty line, but unofficial estimates indicate that over the past 15 years the incidence of poverty has been relatively low for those over 65. For example, using a 60 per cent net of housing costs, equivalised disposable income as a poverty line, about 23 per cent of the population would be identified as poor in 1998, but only 11 per cent of superannuitants fall below this line. Yet this percentage is creeping up, having been estimated at only 7 per cent for 1988 (Ministry of Social Policy, 2001b).

In the late 1990s, the relativity of New Zealand Superannuation (NZS) to the average wage dropped as illustrated in Figure 2.1 in chapter 2, so that more of the elderly appeared below the 60 per cent median income level (Stephens et al., 2000, p.29). Around this time concerns were voiced in the community about the re-emergence of poverty among those with no other income apart from New Zealand Superannuation, with high housing costs a significant social issue. Though the floor of New Zealand Superannuation was restored to 65 per cent of the net average weekly wage for a couple in 1999 (see section 2.6), this floor now represents the same relativity as in the 1970s when there were significant poverty problems among the aged. The Living Standards survey (Fergusson et al., 2001), discussed in section 5.4, found that low-income bears a modest relationship to material living standards, but other factors such as savings and investment, accommodation costs, economic life stresses, ethnicity and education are also important factors.[97]

The Living Standards survey concluded that:

> *Overall, the results show that most older people were doing relatively well, with any restrictions relating to more "luxury" oriented items (such as holidays away from home or overseas). The results also suggest that a small minority (less than 5 per cent of this sample) had quite marked material hardship and restrictions, and a further 5-10 per cent of respondents were experiencing some economic difficulties.* (Fergusson et al., 2001. p.iii)

The position of those in the total population aged 65 and over appears to be somewhat better than for younger people who report more material restrictions and difficulties.

---

[97] Recent behavioural economics research suggests that analysts have worried somewhat needlessly about retirees having too little in retirement as satisfaction appears to be higher than economic theory might suggest given reduced consumption (Aaron, 1999).

This suggests that the goal of participation and belonging is being met for the old better than for the young. The study attributes this to three factors: wants and needs lessen as people get older in retirement; those aged 75-85 have had a more favourable life history than younger cohorts and there may be some factor common to surviving into old age relating to lifestyle or capability. The survey concludes that income support has been successful in protection from hardship. The findings also suggest:

> *…a number of policy criteria (income, savings and investments, accommodation costs, etc) that might be used to target supplementary assistance for the minority of older people facing particular financial hardship.* (p.v)

These policy implications need care, but suggest that today's policies have achieved the primary objective of poverty prevention tolerably well. Other beneficiaries and families whose incomes have not been fully indexed to prices have fallen further behind (St John, 2001a). The picture given by the income data above is that pensioner incomes are more compressed than those of the rest of the population, but still highly skewed to the top end. Housing is an important component of living standards and the omission of imputed income from housing must affect income comparisons.

5.7 Redistribution to those over 65 throughout the 1990s

Universal pensions raise concern about equity between generations. As the traditional universal welfare state retreats, working age taxpayers are paying more directly for their own healthcare and education and other social provisions than did the currently retired when they were young. In fact, almost all parts of the social benefit system outside of New Zealand Superannuation have become tightly targeted with income and means tests (St John & Rankin, 1998; 2002). In contrast to the full indexation of New Zealand Superannuation, (NZS), children's tax credits have been unadjusted since 1996 and have eroded significantly since 1986, providing one of the explanations for the rapid rise in child poverty in New Zealand (St John, 2001a; St John et al., 2001).

Nevertheless Figure 2.1 in chapter 2 showed that since the late 1970s the generosity of the state pension has been slowly scaled back. This reflects deliberate changes to the formula, such as in the late 1970s when, instead of 80 per cent of the gross average wage, the net NZS for a married couple became 80 per cent of the *net* average wage, and later in the 1980s, when the wage band of 65-72.5 per cent of the net average

wage was adopted. After briefly falling below 65 per cent in 1998 when changes were made to the floor, the 65 per cent level is once again protected by the New Zealand Superannuation Act 2002. It should not be forgotten that raising the age of eligibility for New Zealand Superannuation to 65 from 60 in just ten years (1992-2002) was also a way of reducing generosity. Section 5.8 below suggests that this is one factor which increases the likelihood of hardship for new cohorts of retirees, many of whom may find their resources depleted by the time they reach age 65.

In spite of the decline in the relative level of the pension, there are several aspects of NZS that make it generous, especially to those in the highest deciles. After 1982, when the net pension was at 80 per cent of the net average wage for a couple, those on high incomes could retain only 34 per cent of the gross pension. In 1985, a surcharge was applied to other income (see section 2.6) to provide a degree of clawback and restore some progressivity for the older age group, especially when the top rate of tax came down from 66 per cent to 48 per cent in 1986 and then to 33 per cent in 1988. However, the removal of the surcharge for 1997/98 meant that high-income individuals could hence retain 67 per cent of the gross pension. The history of the surcharge and its eventual demise is set out in Table 5.11.

While those with no other resources saw a relative decline in their pension (as shown in Figure 2.1), better-off superannuitants became much more generously treated during the mid to late 1990s. Many of these superannuitants had also gained from the removal of all death duties in 1992 and the failure to implement a proper capital gains tax. From 1996 they also gained from:

- The reduction in the middle tax rate from 28 per cent to 21 per cent (see section 3.4).
- The movement of the top threshold for the top tax rate from $30,875 to $38,000.
- The abolition of the superannuation surcharge in 1998.
- The decision to reverse the indexation changes of 1998, cementing the pension of at least 65 per cent of the net average wage for a married couple.

Table 5.11: Surcharge assessments and surcharge parameters since 1985

Income year ending March	Amount of surcharge assessed ($ m)	Number assessed (000s)	% subject to surcharge	Exemption threshold for single person ($ p.a.)	Exemption threshold for couple ($ p.a.)	Rate of surcharge (%)
1985/86	167	107	21.9	6,240	10,400	25.0
1986/87	175	106	22.4	7,202	12,012	24.5
1987/88	209	136	28.3	7,800	13,000	18.0
1988/89	257	147	30.3	7,800	13,000	19.0
1989/90	314	171	34.5	7,202	12,012	20.0
1990/91	306	136	26.7	7,202	12,012	20.0
1991/92	287	129	25.0	7,202	12,012	20.0
1992/93	347	152	31.1	4,160	6,240	25.0
1993/94	311	141	27.9	4,160	6,240	25.0
1994/95	289	134	28.5	4,160	6,240	25.0
Estimates and forecasts						
1995/96	320	145	31.5	4,160	6,240	25.0
1996/97	324	145	32.0	4,550	6,825	25.0
1997/98	22	72	16.1	10,296	15,444	25.0
1998/99					**Surcharge abolished**	

Source: Periodic Report Group (1997a, p.48)

To illustrate the impact of these changes, Table 5.12 calculates the gains in net income for a married couple under various assumptions. Column 1 shows the non-NZS income for each individual in the couple and column 2 shows the annual disposable income this represents at pre 1996 tax rates (see Table 3.9). At this time there was a 25 per cent surcharge applied to income over $3,412 per married person.[98] Later, the surcharge exemption was liberalised for 1997/8 as illustrated in Table 5.11 before being entirely abolished. Column 3 shows the effect of the surcharge and pre 1996 tax rates on disposable income, while column 4 considers the disposable income position for each individual post 1998, when the new tax rates were fully in place and the surcharge had been withdrawn.

[98] Married couples had the ability to amalgamate their exemptions but this example will assume that income is earned equally by both partners. There are different rates of New Zealand Superannuation for married, single and living alone (see Table 9.1). The married rate is used in this section, following the recommendation of the 1997 Periodic Report Group who argued there was no case for a separate single rate and that the married and the single rate should be aligned. The living alone supplement recognises additional costs of living alone.

Table 5.12: The immediate gains to couples over 65 from 1996-1998 tax changes

Married person's other income	Disposable Income without NZS pre 96 tax rates	Disposable income with NZS and surcharge pre July 96	Disposable income without surcharge post July 98	Individual gain after tax	Weekly gain per couple
0	0	8,331	8,430	99	4
5,000	4,250	11,534	12,380	846	33
10,000	8,435	13,884	16,330	2,446	94
15,000	12,035	16,234	20,280	4,046	156
20,000	15,635	18,584	24,230	5,646	217
25,000	19,235	20,735	28,180	7,445	286
*30,000	22,835	22,835	31,896	9,061	349
35,000	26,229	26,229	35,246	9,017	347
40,000	29,579	29,579	38,596	9,017	347
45,000	32,929	32,929	41,946	9,017	347

Source: Author's calculations
*Note: *The level at which the 1996 surcharge cuts out*

The difference between columns 3 and 4 indicates the immediate nominal gains from the changes (unadjusted for inflation). The gains shown in the final column are for a couple in which each spouse earns the same non-NZS income. The maximum gains were almost $350 per week for couples jointly earning other income of more than $60,000. Those with no or little other income gained very little from the tax cuts and nothing at all from the abolition of the surcharge.

The indexation of NZS means nominal gains have become larger as time goes on. Table 5.13 shows the impact of this for the 2002 data. Gains at the top end however were modified by the introduction of the top tax rate of 39 per cent from $60,000 in 2000. While the greatest nominal gains by 2002 are $385 a week for couples on a joint income of $60,000, these gains slowly decline at higher income levels. In contrast to the effect of the surcharge, the clawback provided by the top tax rate of 39 per cent is minimal indeed.

As Table 5.13 shows, a couple on a joint income of $140,000 from other sources is $334 a week better off than in 1996. Of this, $267 can be attributed to the removal of the surcharge.[99] The argument that the higher tax rate of 39 per cent performs the same function as a surcharge is incorrect as a couple would need to have a joint

[99] The net pension for a married person who is taxed at 39 per cent is $6931, or $13,862 for the couple.

income in excess of $350,000, before the 6 per cent clawback effect of the 39 per cent tax rate has the effect of eliminating their net pension.[100]

Table 5.13: Gains for couples on New Zealand Superannuation 1996-2002

Married person's other income	Disposable income without NZS pre 96 tax rates	Disposable income with NZS and surcharge pre July 96	Disposable income without surcharge April 2002	Individual Gain after tax 2002	Weekly gain per couple 2002
0	0	8,331	9,546	1,215	47
5,000	4,250	11,534	13,496	1,962	75
10,000	8,435	13,884	17,446	3,562	137
15,000	12,035	16,234	21,396	5,162	199
20,000	15,635	18,584	25,346	6,762	260
25,000	19,235	20,735	29,296	8,561	329
*30,000	22,835	22,835	32,843	10,008	385
35,000	26,229	26,229	36,193	9,964	383
40,000	29,579	29,579	39,543	9,964	383
45,000	32,929	32,929	42,893	9,964	383
50,000	36,279	36,279	46,161	9,882	380
55,000	39,629	39,629	49,211	9,582	369
60,000	42,979	42,979	52,261	9,282	357
65,000	46,329	46,329	55,311	8,982	345
70,000	49,679	49,679	58,361	8,682	334

Source: Author calculations
**The level at which the 1996 surcharge cuts out*

The degree of tax progressivity of the current system is low despite the top rate of 39 per cent because of the first tax threshold of 15 per cent. The difference between the amounts clawed back in tax on New Zealand Superannuation for the pensioner with no other income and those in the top 5 per cent of the distribution is only 24 percentage points. The wealthiest of those over 65 on the top tax rate of 39 per cent get nearly three-quarters of the pension of the least wealthy. This contrasts sharply with the surcharge when the highest earners, including those still in the full-time workforce were effectively excluded. It should be noted that for many wealthy older people the top rate of 39 per cent rate is easy to avoid. Hence, in many cases the maximum rate of tax they actually pay may be 33 per cent or less.

[100] This argument was used by the Labour Party in 1996 to justify universal pensions. They claimed that increasing the top tax rate would raise the same revenue as the surcharge and hence not contravene the Accord that required a surcharge or progressive tax with equivalent effect. The bitter political controversy that followed this move to unilateral policy development is reviewed in St John (1999b).

5.8 The period 2010-2030

The problems identified for today's low-income retirees are likely to intensify for the baby-boom generation of retirees. The 32.5 per cent of the average wage for low-income retirees may be less satisfactory than before, because of fewer opportunities for full-time work prior to retirement, the run-down in assets during the wait to reach the higher age of eligibility, the loss of employment-based pensions, lower mortgage-free home-ownership.

The fortunes of the baby boomers as they enter retirement from 2010 will be closely related to the current fortunes of those aged 36-56 years and how successful they are in the years just prior to retirement when they are 60-64. The snapshot picture given in Table 5.14 reveals that one in three of the population aged 60-64 in 2001 relied on an income-tested benefit. While some of this represents a transitory need, the incidence of those on benefits indicating more long-term need for assistance such as sickness, invalids, under-age spouse pension, domestic purposes benefit is over 80 per cent. This might be as expected if the capacity to work declines with age through ill-health but it means that full-time work is an unlikely future outcome for these people. For those on benefits in the age group 50-59, over 70 per cent are on benefits that are not linked to work search. If the incidence of long-term unemployment among those on the unemployment benefit is also high, as indicated by research from Massey University (McGregor & Gray, 2002; Thomson, 2001), the picture is one of reliance by a sizeable minority of those aged 40-64 on the welfare system.

Table 5.14: The incidence of welfare dependency for those aged 40-64

Age	Mean population 2001	Numbers on social security benefits 30/6/01	% on income-tested benefits	Numbers on long-term residential-sickness, widow, DPB or invalids benefits	% of those on benefits on long-term non-un employment assistance
40-49	537,405	74,799	14.0	55,024	73
50-59	418,431	61,115	14.6	43,773	72
60-64	154,569	52,081	33.7	42,821	82

Source: Derived from Work and Income New Zealand (2001), Census 2001 and Ministry of Social Development data.

While the improved economic climate since the Census of 1996 has seen the proportion of New Zealanders in their 50s in full-time work increase from 50 per cent to 59 per cent, the proportion of those aged 55-65 in full-time work is only 45 per cent

(60 per cent for men and 31 per cent for women) (McGregor & Gray, 2002). McGregor describes the major negative psychological and well-being impacts of the lack of secure full-time employment on the older unemployed as one of creating a problem of "serious social exclusion".

As welfare benefits are considered to be below subsistence level and the abatements for other income is harsh, the long-term reliance by this group on such benefits is problematic.[101] Those who have spent any length of time on these benefits are likely to reach retirement with their assets and earnings potential in a highly depleted state.

The late middle age cohort, aged 46-56 today, has had an even more varied experience in terms of employment. The surge in increases in high incomes for professionals, administrators and business executives and the influx of younger retirees when this cohort retires is likely to increase the proportion of well-off and high earners over 65.[102] A sizeable minority of this group have also benefited from speculative gains via property, with no capital gains tax, no death duties or inheritance taxes. Thus in twenty years' time, the top end of the income distribution of the retired is likely to become even more attenuated.

5.9 Summary

Given that the level of income provided by the state pension provides a low replacement rate for average workers and is no more than a basic amount, other regular income is needed if living standards of many of the old are not to fall precipitously. This thesis argues that those in the middle of the income distribution are likely to fare less well than before. They are far less likely to have a subsidised employment-based pension, especially an inflation-adjusted one, suggesting this group on average is likely to experience lower living standards in retirement than in the past.

As discussed further in Part III the New Zealand system currently offers little longevity insurance for middle-income people such as might be provided by a well

---

[101] The unemployment benefit abates at 70 per cent for income (joint income if the benefit is for the couple) over $80 a week, an amount unaltered and unindexed since 1988.

[102] Of course this is offset to some extent by the rising longevity that sees an increase in numbers surviving into old age.

functioning annuities market, other than for those few with an indexed pension from the now closed Government Superannuation Fund or from a large company pension. Moreover there is little insurance against a drop in relative living standards for those with non-indexed pensions if there is real wage growth or inflation.

On the whole, the current retired population is faring well relative to the rest of the population. The NZS, which, at least until recently, has been generous, must take the credit for the lack of indicators of serious poverty among the aged. While there is no indication this pension provides too much for those with few other resources, and indeed may prove inadequate for many of the new cohorts of retirees, making NZS fully universal has important equity implications. There has been a large redistribution in favour of the highest income and wealth group in the context of a general declining income picture for the working age population and young people. As the first baby-boom cohorts and those now in their 60s (the group currently aged 45-64) come into retirement it can be expected:

- There will be increasing conflicts over the payment of a generous amount of state pension to those still working or with substantial assets and income. The top 20 per cent of those aged 45-64 hold 60 per cent of the net worth of that group (Statistics New Zealand, 2002a, p24). Median net worth is well below mean net worth and the indications are that the wealth distribution among those over 65 will become more weighted in favour of the top quintile group.
- The middle-income group, of those now aged 45-64, will enter retirement with only modest assets on average. Median net worth of this group including homes is only $140,000. The high proportion of those currently aged 60-64 who are supported by a social welfare benefit suggests many people who may have formerly expected a comfortable middle class retirement will not have their aspirations met.
- While the question of assets diverted to trusts complicates the net worth picture, a large group of low-income and low-wealth people will subsist, many for a long time in retirement on the state pension and not much else. Around 40 per cent of those aged 45-65 own less than $100,000 of net worth including their own home

These issues of equity will be addressed in Part III of this thesis.

Appendix Chapter 5: Net Worth Survey results

Table 5.15: Net worth of all individuals by age group

Age Group	Net Worth									
	Negative	$0-$20,000	$20,001-$50,000	$50,001-$100,000	$100,001-$200,000	$200,001-$500,000	$500,001 or more	Total	Mean	Median
									$	$
							Number of People			
Individuals[(2)]										
18-24 years	118,900	133,200	** 13,900	..S	** 3,900	..S	..S	274,100	** 5,200	** 0
25-44 years	77,000	120,400	* 38,500	* 20,600	* 29,000	* 18,100	** 8,300	311,900	* 66,900	** 8,400
45-64 years	* 15,300	35,000	* 14,100	* 22,300	39,300	43,000	* 18,600	187,600	201,600	118,600
65 years and over	** 4,100	* 28,100	* 11,000	23,200	41,900	35,700	** 13,300	157,300	197,100	120,900
Total	215,300	316,600	77,600	68,700	114,100	97,200	41,600	930,900	97,900	10,300
Individuals in couples (half of couple net worth)										
18-24 years	* 30,600	* 27,200	** 7,300	** 5,200	-	-	-	70,400	** 7,600	** 400
25-44 years	81,100	160,700	126,800	137,100	123,100	107,800	* 26,700	763,200	115,500	53,300
45-64 years	* 17,900	49,500	65,600	105,400	146,100	184,700	56,200	625,400	226,600	148,400
65 years and over	** 3,100	* 29,900	25,000	62,100	69,300	47,300	* 16,200	252,800	179,700	105,800
Total	132,700	267,200	224,600	309,800	338,500	339,900	99,100	1,711,800	161,200	86,400
All individuals										
18-24 years	149,500	160,400	* 21,200	** 7,800	** 3,900	..S	..S	344,500	** 5,700	** 100
25-44 years	158,000	281,000	165,300	157,700	152,100	125,900	* 35,000	1,075,100	101,400	35,300
45-64 years	* 33,200	84,400	79,600	127,800	185,400	227,700	74,800	813,000	220,900	140,000
65 years and over	** 7,100	58,000	36,000	85,200	111,200	83,000	* 29,500	410,100	186,400	112,800
Total	347,900	583,800	302,200	378,500	452,600	437,100	140,600	2,642,700	138,900	60,000

Source: Statistics New Zealand (2002b) Table 9.01

Notes: ..S denotes cell contains fewer than five respondents and is suppressed for quality reasons

** denotes a relative sampling error of greater than 30% and less than or equal to 50%; use data with caution*

***denotes a relative sampling error of greater than 50%; data is too unreliable for most practical purposes*

Table 5.16: Information on nature of assets and value

Age Group	Asset Type													
	Property[2]		Superannuation		Bank Deposits[3]		Investments with Other Financial Institutions[4]		Business		Trusts[5]		Mäori Assets[6]	
	Number of People	Median ($)	Number of People	Median ($)	Number of People	Median ($)	Number of People	Median ($)	Number of People	Median ($)	Number of People	Median ($)	Number of People	Median ($)
Individuals[7]														
18-24 years	** 8,800	** 77,300	** 7,100	** 3,400	240,900	** 500	* 23,200	** 3,000	** 3,800	** 9,600	..S	..S	** 5,900	** 35,000
25-44 years	106,200	125,000	60,500	** 6,000	266,100	* 800	* 37,700	* 8,500	* 20,600	** 20,000	** 3,000	** 200,000	* 8,700	** 15,000
45-64 years	121,900	154,000	40,300	* 35,000	169,800	* 2,200	48,700	** 8,100	* 15,800	** 115,000	** 5,500	** 150,000	* 9,300	** 9,200
65 years and over	105,500	135,000	..S	..S	151,900	8,000	43,700	** 35,100	** 1,200	** 0	** 4,600	** 57,000	** 1,900	** 1,600
Total	342,400	139,000	108,800	** 12,000	828,700	1,200	153,400	* 10,000	41,300	** 30,000	* 13,300	** 101,700	25,800	** 15,000
Couples[8][9]														
18-24 years	* 8,500	** 127,000	** 4,800	** 3,400	31,800	* 800	** 3,800	** 3,800	** 1,500	** 15,000	-	-	** 600	** 45,000
25-44 years	251,900	175,000	147,300	18,000	346,200	2,300	113,100	7,500	87,500	* 50,000	* 15,600	* 270,000	* 10,500	** 15,000
45-64 years	241,300	206,000	117,800	49,100	294,000	5,500	138,400	* 21,600	73,800	** 40,000	* 27,200	** 300,000	* 10,500	** 15,000
65 years and over	98,400	171,000	** 2,800	** 100,000	121,100	10,600	53,200	** 32,200	** 5,900	** 16,500	* 7,700	** 400,000	** 2,400	** 12,000
Total	600,100	183,500	272,700	30,000	793,100	4,000	308,500	* 13,500	168,600	* 50,000	50,500	* 300,000	24,100	** 15,000

(1) Counts are whether respondent owned at least one such asset type, ie: if they owned three properties this is counted as one property response with a corresponding value totaled from all three properties.
(2) One count is given for property ownership. The count is taken from ownership of any of the following: house living in timeshare, holiday homes, rental, overseas, commercial, other residential property.
(3) All bank accounts in credit and bonus bonds.
(4) The count of bank deposits excludes those who had a total zero balance for their accounts. 35,900 individuals and 11,500 couples had total bank accounts with a zero balance.
(5) Count and value is only those where the trust owes the respondent (the value that is still legally an asset to the respondent).
(6) The count is regardless of whether the respondent could provide a value. Fifty two per cent of respondents were unable to provide a dollar value.
(7) A respondent who was not living with a partner.
(8) Respondent and partner living in the same household. The couple was interviewed as a single unit.
(9) Respondent's age group

Source: Statistics New Zealand (2002b), Table 4.02

6 New Zealand: a unique model in an international context

This chapter pulls together some implications and conclusions from previous chapters that have discussed the unique approach taken by New Zealand to public pensions, private pensions and annuities. It draws heavily on the 'World Bank model as first set out in *'Averting the old age crisis'* (World Bank, 1994) as an indication of popular international thinking on pension reform issues. The differences and possible deficiencies in the New Zealand approach are highlighted. The theoretical justification for the World Bank approach is detailed in section 7.4 in chapter 7, Part II of this thesis which also explores critiques of this model that have implications for New Zealand.

6.1 International context

Public schemes adopted by developed countries in the early 20th century were either of the New Zealand variant - an old age pension provided on the basis of means - or social insurance based on the contributory principle. By the start of World War II, national insurance contributory schemes were common and further expanded after the war, becoming ever more generous in coverage and level. A fast growing population and real wage growth contributed to the success of PAYG social insurance schemes. By this means successive cohorts gained, in what Samuelson described as "the greatest Ponzi game ever contrived" (World Bank, 1994, p.105).[103] A dramatic expansion of social insurance schemes in Europe, Japan and the US, left Australia and New Zealand as the only two countries persisting with a system based on a flat-rate, tax-funded, non-contributory pension.

The conditions for a successful social insurance scheme of the European type came to an end with slower population growth, ageing, and increasing longevity. In 1994, the World Bank identified a crisis in pension provision for many developed countries (World Bank, 1994, p.138). It also warned of a problem for less developed countries

[103] Charles Ponzi was notorious for his financial borrowing pyramid schemes in the 1920s and 1930s in the US.

as they adopted similar pension systems. These schemes, it was claimed often failed to protect the old while they acted to deter private sector growth.

> *The idea is to assist in the selection and design of policies that facilitate growth and enable the old to secure an equitable share of that growth.* (World Bank, 1994, p.3)

PAYG social insurance schemes can have redistributive goals built into their defined benefit formulae and indeed this is often seen as one of their advantages. But often the redistribution turns out to have been unintended and undesirable in practice (Gora & Palmer, 2001).[104] The World Bank (p.20) notes how redistribution often favoured the rich. This arises from the formula applied to final pensions, with many schemes paying earnings-related pensions. The rich benefit the most as they tend to live longer and thus enjoy their pensions for longer.

Most public pension plans are defined benefit in character and PAYG, but some have reserves or are prefunded to some extent. Most of these reserves earned a negative rate of return in the 1980s, leading to the suspicion that publicly managed funds were not a good idea (World Bank, 1994, p.127).[105] The surpluses associated with funding are easily dissipated and the existence of the fund can allow for further wasteful government spending. Clearly, the issues are controversial, and:

> *[I]t is difficult to resolve [the funding] issue, since empirical studies lack an unambiguous counterfactual.* (World Bank, 1994, p.129)

6.2 The World Bank multi pillar approach

The 'World Bank Model' as it has come to be known, is based on the separation of three pillars of provision of retirement income.[106] The first pillar (Pillar I) has a strong redistributive goal to meet poverty prevention objectives, and involves the mandatory provision of a basic pension. The second pillar (Pillar II) is a mandatory savings plan

---

[104] Thus redistribution often favours married people and those with dependents as much as those on low-incomes who receive a higher than actuarially fair pension based on their contributions.

[105] Peru had a return of negative 37 per cent rate in the 1980s. Reserves in many Latin American countries were badly invested especially in housing and loans.

[106] Major reforms to pension systems that have taken place with the aid of the World Bank have been undertaken in Latvia, Poland, Hungary, Argentina, Mexico, Colombia, Peru, Uruguay and Bolivia. The Bank has also provided technical assistance to China, Russia, Turkey, Thailand, Korea, Kenya, Morocco and Egypt (www.worldbank.org).

privately managed and fully funded, ideally personal and thus fully portable, rather than occupationally based. The third pillar (Pillar III) is voluntary saving that may be supported with tax concessions to provide supplementary savings.

This multipillar approach involves a shared responsibility for income support in old age; the Pillar I providing protection against the risks of inadequate income in old age in an uncertain world; Pillar II facilitating income smoothing; and Pillar III allowing additional protection. A critical element in the three-pillar approach is the idea that the risks associated with any one approach to insurance in an uncertain world are best met by spreading the risk, or diversification. Single pillar public schemes are seen as risky. The World Bank promulgation of the multipillar model has been unequivocal:

> *Reliance on individual pillars will vary with a country's circumstances over time, but every country should have a multipillar system.* (World Bank, 1994, p.15)

6.2.1 Pillar I

Exactly what the World Bank has favoured in Pillar I has been the subject of some speculation (St John & Willmore, 2001). In setting out the way these pillars interact, it is not clear whether the first pillar should be a basic universal minimum income, or means tested in some way. But one characteristic should be that it should not provide earnings-related benefits. In discussing the role of Pillar II, the claim is "… a successful second pillar should reduce the demands on the first pillar" (World Bank, 1994, p.16), implying some integration or means test will be necessary.

In principle, Pillar I should redistribute and meet the poverty alleviation role. It should also allow the state to institute some protection from inflation, but in practice this has only occurred spasmodically. Many countries have Pillar I arrangements that are not fully comprehensive because in some way they are linked to entitlement to a Pillar II pension. In Chile, much lauded by the World Bank, only about 50-55 per cent of workers are covered through their connection to the second pillar (Willmore, 2001). Schemes that try to meet the objectives of Pillar I by means of a guaranteed minimum pension in Pillar II may benefit some low-income workers, but leave those outside the formal workforce unprotected.

The reforms to Pillar I deemed necessary by the World Bank include making them flat-rate or means-tested, rather than earnings-related or to give a minimum pension guarantee at a realistic level, indexed to prices or a combination of prices and wages.

The age of retirement should also rise with life expectancy, and there should be a broad base for contributions rather than payroll taxes with low ceilings. If there are reserves, they must be kept separate and investment diversified or funds eliminated. Funding if it must occur should be off-budget and not in government bonds,[107] but even then the World Bank suggests that chances of political interference are high.

As noted in section 5.9, New Zealand has been successful to date in meeting poverty prevention goals with the first pillar of New Zealand Superannuation. Even in 1994 there was a grudging recognition that a universal basic flat-rate pension, such as New Zealand Superannuation, has merit as Pillar I:

> *The universal flat benefit is given to everyone of pensionable age, regardless of income, wealth or employment history, as in New Zealand and the basic pensions paid by the Nordic countries. Administratively, this is the simplest structure, with the lowest transaction costs, for the public pillar—an important advantage in developing countries with limited institutional capacities and incomplete record-keeping systems. It avoids the disincentive to work and save inherent in means tested plans. Its universal coverage helps ensure that the poverty reduction objectives are met, provides a basic income for all old people (coinsuring against low investment returns or high longevity), and might receive broad political support.* (World Bank, 1994, p.240)

6.2.2 Pillar II

The mandatory Pillar II is the hallmark of the World Bank model. According to the World Bank, Pillar II funds have clear advantages: these funds are more able to diversify risk and have economies of scale; contributions are less likely to be evaded and costs are borne by the worker. However they need to be accompanied by protections for the lower paid via either a minimum pension guarantee or safety net Pillar I.

In mandatory individual savings plans, the investment risk is carried by the individual and there is no formal insurance, but there may be broad regulation of what the funds invest in. The implication is that private sector fund management is superior to public management of Pillar II, (a point challenged by P. Orszag & Stiglitz, 2001).

---

[107] These of course have to be redeemed and imply higher taxes in the future or cuts to other government spending.

Mandatory savings plans have generated relatively high levels of assets (World Bank, 1994, p.209).[108] Whether this rapid growth has been desirable is debatable. Pension funds in general may have had too much power over governance of companies and may have demanded higher dividends than has been efficient or appropriate (Hutton, 1995, p.215). In events of the early 2000s, many pension plans both public and private have dramatically lost value from investments in international equity markets.

One of the critical factors surrounding mandatory schemes is that workers are required to purchase an annuity on retirement thus exposing them to the vagaries of the expected interest rate at the point of retirement (see section 3.6). Administration costs of these schemes can be expected to be high, but the World Bank asserts they have fallen in countries like Chile due to "economies of scale and learning by doing and competition" (World Bank, 1994, p.225).

The view of the World Bank appears to have moved on a little, from a hard line position on Pillar II to acknowledge the difficulties of implementing a Pillar II for many countries (James, 1999; World Bank, 2001). It has become apparent that coverage of those in the informal sector in privatised systems may be difficult.

> *We argue that contributory insurance for many of these workers, particularly for low-income workers, is neither feasible nor desirable. If the contribution rate is borne by workers, it may reduce their take-home pay at a point in the life cycle when they need more income rather than less; and if borne by employers it may reduce the number of jobs in the economy. If efforts are made to increase nominal coverage for these workers, under a scheme where benefits closely depend on contributions, the result may be greater evasion rather than greater effective coverage.* (James, 1999, p.3)

In particular there has been growing concern about meeting the objective of poverty prevention over the need to expand private mandatory accounts:

> F*uture work on pension reform will focus on the provision of retirement benefits for people in the informal sector and on old-age income support for the life-time poor through public non-contributory schemes and community support.* (World Bank, 2001, p.32)

---

[108] There is however some evidence of over-saving (for example Singapore) and also concern about recession and lack of protections. Employment can be affected as shown in Singapore when an attempt was made to lift the contribution rate to 50 per cent in 1984.

Prior to 1994 only Chile (in 1981) had replaced its PAYG social insurance scheme with mandatory private saving in schemes supplied by competing providers. Since then the World Bank Model has become the dominant model in Latin American countries.[109] In Chile, Pillar II comprising privatised mandatory savings accounts provides a minimum pension guarantee of 25 per cent of the average wage, but only for workers who have contributed for 20 years or more. The state tops up the accounts to meet this minimum, thus low-income workers who meet the 20-year requirement may gain little advantage from extra years of contribution. For those who fall outside of Pillar II, a small means-tested social assistance benefit of approximately 12 per cent of the average wage may be paid (James, 1999).

The Superannuation Guarantee was introduced in Australia on 1 July 1992, making Australia one of the first countries, along with Chile and Switzerland, to introduce private mandatory defined contribution saving. Employers are required to contribute 9 per cent of salaries into a superannuation fund. The accumulated capital is portable and fully vested in the employee's name and preserved until age 55, when it may be taken as a lump sum or a pension.[110] More than 80 per cent of superannuation benefits including those from public sector employment are paid as lump sums. For private sector employees, the figure is around 90 per cent, so the role of pensions and annuities is very limited (Knox, 2000).

Australia has been more successful than other countries with mandatory private savings schemes in establishing a broad adequate Pillar I provision. But if the point of the mandatory Pillar II is to save costs on Pillar I, the Australian scheme is poorly integrated. Most commentators are extremely vocal in condemnation of the costly and complex tax regime for contributions in the Pillar II.[111] Grandfathering of tax

---

[109] Other Latin American countries have emulated this example for example Argentina, Columbia and Peru. The World Bank notes other countries such as in Africa are going the other way, towards PAYG and away from national provident funds.

[110] The age of preservation is to be raised over time.

[111] This tax regime known as 'ttt' refers to the tax treatment in which contributions, fund earnings and withdrawals are all taxed, but usually at a lower marginal tax rate than would normally apply to the individual.

treatments and a complex tax surcharge for higher income members on the fund earnings further complicates the picture (Knox, 2001).

6.2.3 Pillar III

In all countries, voluntary personal saving is an important part of the overall outcomes for retirement incomes. These savings are fully pre-funded by nature (in contrast to second pillar employee-based schemes which may need regulation to achieve full pre-funding) and they are personally owned and are not usually plans sponsored by employers. Often these are also supported by tax concessions, which are most likely to have been appropriated by higher income persons as discussed in section 6.4.1.

In countries such as the UK, the US and Canada, personal or individual pensions have become increasingly popular. Thus Registered Retirement Saving Plans (RRSPs) introduced in 1957 in Canada, Individual Retirement Accounts (IRAs), introduced in 1974 in the US, and Approved Personal Plans (APPs) in the UK have flourished.[112] Admittedly these plans have all been tax advantaged. The intent has often been to extend tax privileges to individuals who are not members of occupational schemes.[113] Critically such tax privileges allow rules to be made about the type of access and specify any taxes to be paid on withdrawal.

6.3 Alternatives to the World Bank model

The World Bank model has been described as resolving the dichotomy between what has been seen in the literature as two competing approaches. The first is the PAYG 'defined benefit' public pensions, and the second is the pre-funded 'defined contribution' private schemes. As Gora & Palmer (2001) point out, the dichotomy is

---

[112] The age profile of those with APPs favours the 20-30 years age group reflecting recent policy in the UK. This differs from that of personal plans in other countries where those in the 50-60 age bracket are most likely to be contributors.

[113] The Canadian RRSPs have assets more than two thirds of those in occupational schemes, the treatment is EET and an annuity must be purchased by the age of 71 years. IRAs (or Keogh plans for the self employed) in the US are also EET, with a cap on contribution and penalties for early withdrawals. IRAs are expressly for those without occupational plans, and low-income people can claim some tax relief on their contributions. There are rules about early withdrawals but since 1998 penalty-free withdrawals are now permitted for first home purchases and higher education purposes (Johnson, 1999, p.38).

less clear-cut in practice as some PAYG schemes have large reserves while some privately managed schemes are defined benefit.

A major challenge to these models is the Notional Defined Contribution scheme (NDC) such as Sweden has introduced (see Holzmann & Palactos, 2001). A NDC scheme entails individual accounts that are credited with a rate of return that depends on the growth of the wage base. The scheme, nevertheless, remains PAYG so that pre-funding does not apply. The idea is that each cohort will receive an annuity that reflects the size and productivity of that cohort and its longevity.

It is the New Zealand system with a well-developed universal Pillar I and voluntary Pillar III supplementation that poses the biggest challenge to the World Bank model. Individual accounts in Pillar II schemes can be costly to administer, especially if they are decentralised and privately managed, as the Chilean scheme (Hemming, 1998) and the UK experience has proved (Emmerson & Johnson, 2001).[114] It can be argued that the New Zealand model has a lot to offer, particularly in the case of developing countries, but also for countries like the UK grappling with reforms of complex Pillar II arrangements (St John & Willmore, 2001; Willmore, 2000).

6.4 Role of private pensions

This section abstracts from the concept of a division between Pillars I and II to examine the role of private pensions.[115] All OECD countries, other than New Zealand, subsidise private schemes with tax concessions of various kinds. Growth of these funds has been rapid with assets under management in these funds large in relation to GDP (World Bank, 1994, p.167). In many industrialized countries occupational (employment-based) pensions have become more significant for high-income workers than social security. Regulation of these schemes has also grown as the counterpart to the provision of tax incentives.

---

[114] The UK reforms can be also be interpreted as edging towards a Pillar I/Pillar III approach while the Pillar II (SERPS) is de-emphasised. While the UK Pillar I is less comprehensive and generous than in New Zealand, far more public intervention has been directed at Pillar III.

[115] These may be employment-based and/or employee-subsided, known as occupational schemes, or personal, individual-based schemes.

While there are controversial issues in determining the effect on saving as discussed in section 6.4.1), it is widely believed that these funds are significant in providing the long-term capital necessary for development, underpinning stock markets, and expanding new financial instruments. Internationally, the importance of private pensions is growing, making the declining trends in New Zealand (outlined in section 3.3) unusual (Disney & Johnson, 2001, p.19). Table 6.1 gives an indication of the size of pension funds in selected countries and the extent of coverage. The wide coverage of the workforce in Australia reflects compulsory membership, and in the Netherlands collective agreements ensure membership (Johnson, 1999, p.29). The low percentage of pensioners in Australia and Japan of those actually receiving pensions arises because pension plans largely provide lump sums.

Table 6.1: Occupational pension coverage, selected statistics

	Pension funds (% of GDP) 1996	% of pensioners receiving private benefits	% of working population covered
Australia	32	20 men 7 women	87
Canada	43	54 men 31 women	47 men 42 women
Germany	6	21 women 7 men	42
Italy	3	Negligible	Negligible
Japan	42	10	90
Netherlands	87	76 men 23 women	90
New Zealand*	14	21 men 10 women	17
UK	75	66 men 32 women	48
US	58	48 men 26 women	44

Source: Disney(2001, Table 1.8, p.20)
*Note: * Figures for New Zealand are for 1996, see Table 3.2 for recent figures.*

Overall, occupational plans cover about one third of workers in OECD countries (World Bank, 1994, p.165). In countries, especially the UK, the US, Canada, Denmark and Ireland where there are large occupational pensions sectors, Johnson (1999) notes it is evident that:

- pension coverage is much higher in the public sector;
- employees of large companies are far more likely to have coverage than small companies;

- coverage is more common among both males and union members;
- none of the countries with private pensions see them as providing more than half of the pensioner's retirement income;
- couples get the biggest share while single, divorced, widowed women get the lowest;
- pension income is more important for younger pensioners than for older ones.[116]

Johnson (1999) also claims that the traditional final salary (defined benefit) plan is poorly adapted to the needs of a modern economy primarily because the formula relates to the last years of employment salary and thus favours the long stayers over early leavers. Compounded by a lack of indexation of accrued benefits for early leavers and vesting rules, this tends to lock workers in and impede labour mobility. Although employers bear the investment risk, employees may not be protected from the risk of inflation once pensions are being paid, or from employer insolvency.[117] Without public intervention to reduce these costs it is therefore unsurprising that defined benefit schemes have declined in many countries, not only New Zealand. Any relative success of defined benefit schemes in other countries can be attributed to the changes in practices usually brought about by laws and regulations which reduce these problems.

Employment-based schemes have strong advantages including economies of scale and reduced problems with adverse selection that can plague personal pension plans and make them too expensive for some workers. This is true especially where schemes are mandatory at the industry or company level. In some countries occupational schemes have indeed become mandatory and hence comprise a formal Pillar II as in Australia and Switzerland and 'quasi mandatory' as in Denmark and The Netherlands. The UK and Japan have opt-out provisions for the earnings-related part of their public

[116] In the case of New Zealand the opposite is likely to be the case.

[117] There are many examples of defined benefit schemes that have failed employees through company insolvency, for example Enron in the US or through fraudulent misappropriation, for example by Robert Maxwell in the Mirror Group Pension Fund in the UK.

pensions.[118] Successful occupational schemes tend to be those with wide coverage or compulsion, surrounded by regulations on indexation, portability and vesting rules that make schemes more individualised and flexible in a changing world.

When employers use pension plans to lock in employees, the resulting lack of portability and low vesting of employer contributions may make these plans less attractive for the average worker. Industry wide plans offer some portability within the industry and multi-employer plans have developed in some high turnover sectors such as construction (World Bank, 1994, p.168).

The chief alternative to occupational plans is personal saving schemes. To some extent the switch to personal plans in some countries, for example the UK, reflects the new more casual and uncertain working environment for many people. While not explicitly stated, this uncertain labour market environment which has been particularly acute under the market-based 'New Right' reforms of past decades may explain the underlying lack of political interest in occupational schemes in New Zealand.

6.4.1 Distributional issues

It is clear that in many countries the distributional outcome of employment-based plans is regressive. Their chief advantage is overcoming the market failure that otherwise would see middle and high-income people unable to purchase annuities at a fair price. It thus helps support the income continuance objective and prevents the income distribution flattening too much in the middle.

Yet occupational plans probably do contribute to a skewing of the income distribution if wages do not fall to offset pension contributions made by employers. Thus pensions can be a disguised way of getting higher wages in a less visible way. In other words:

> *…access to generous occupational pensions increases the real income of the favoured recipients and influences the overall distribution of income and welfare - in an inefficient and probably non-equalizing way.* (World Bank, 1994, p.186)

---

[118] International comparisons of different schemes are complex, not only because of different definitions and statistical collection problems but because coverage and levels are likely to differ markedly over any given population. For a summary of the major features of different countries, see Preston (2001a).

6.5 International debate over tax expenditures

Tax expenditures on occupational pensions are large, as is the potential cost of any government guarantee that might apply.[119] The advantage of tax concessions, rather than claims that they increase saving, is more that such concessions allow regulations that in turn may overcome informational deficiencies and other perceived weaknesses of retirement saving schemes. Most importantly, regulations are needed to ensure that tax concessions produce a useful and lasting social benefit and do not become dissipated in fraud or captured by high-income people as a tax haven. Tax advantages are believed to also aid compliance and though they are not needed for mandatory plans, they may aid the acceptability of compulsory saving and lower the possibilities of evasion. Regulations may also specify the actuarial assumptions to be followed, but most governments do not tightly control the nature of investments.

Internationally there is an appreciation that the various tax expenditures underpinning a vibrant occupation pension system usually carry a high fiscal cost (World Bank, 1994, p.199). But as observed above, in large part, these tax expenditures have facilitated state involvement in order to achieve social objectives. For this and other reasons "government intervention has thus turned out to be essential and inevitable after all" (World Bank, 1994, p.199). Nevertheless, there is a growing appreciation that tax incentives are costly, they accrue to high-income people and they remain a largely unscrutinised part of government's fiscal activities (Hughes, 2001; Knox, 2001; Sinfield, 2000).

In the case of Ireland, tax relief disguises approximately 1.2 percentage points of pension expenditure (Hughes, 2001, p.39). Thus, in comparing Ireland with New Zealand, official expenditure on pensions and government spending in general is understated. Despite the high cost of tax relief, only about one third of those working in Ireland are covered by an occupational scheme, and while coverage is almost complete in the top 2-3 deciles of employees ranked by weekly earnings, coverage is

[119] For example, such as to inflation-proofing of pensions under contracted-out arrangements for Pillar II in the UK.

"rather poor for low-income employees… and virtually non-existent for the bottom income decile" (Hughes, 2001, p.47).[120]

Not withstanding the view that tax incentives are expensive, the way in which they should be valued has been controversial in the literature. While calculating the tax revenue foregone may appear, in principle to be a straightforward matter, in practice it depends on where the money would otherwise have been invested. Thus the counterfactual to pensions saving may be saving in some other tax-advantaged way, such as residential housing. In contrast to the conventional pension scheme tax treatment of TTE described in 3.2, owner-occupied housing in most countries enjoys a TEE treatment. While housing is purchased out of after-tax income (T) there are usually no taxes on imputed rental, while part of mortgage interest may be tax deductible (E), and usually no capital gains tax applies on sale (E).[121] In New Zealand, the conclusion that an increase in housing investment is likely to result from reducing or removing tax incentives for financial saving is justified. Two major real estate booms in the mid-1990s and early 2000s have been accompanied by a stagnant sharemarket and a declining coverage of occupational superannuation.

The second measurement issue is that the fiscal cost should be assessed in net present value terms allowing for both the taxes paid on any emerging pension and the costs saved through integration with any publicly provided pension. The calculation is the net present value of taxes foregone on both employee and employer contributions, and taxes on fund earnings, less the net present value of taxes recovered when pensions are paid. In cases where there is a sharply progressive tax system, pensioners may face much reduced tax rates on retirement, and the revenue foregone will be higher.

---

[120] Hughes reports that the cost to the Exchequer of tax relief as a fraction of direct expenditures on state pensions (contributory social insurance and non-contributory social assistance) has steadily risen from 10.2 per cent in 1980 to 66.3 per cent in 1997. It is expected that the introduction of Personal Retirement Saving Accounts as recommended by the Pensions Board will accentuate the inequities already in the system.

[121] There are other advantages often associated with investment in rental housing including the full deductibility of nominal interest costs and rental losses that may be offset against other income while any capital gain on eventual sale may be fully tax-free as is often the case in New Zealand.

In the case of Australia, tax concessions are complex and their measurement has indeed been controversial.[122] The Australian Treasury estimates the cost of tax expenditures each year and projects these as shown in Table 6.2.

Table 6.2: Costs of Australian tax concessions

	1997-98 ($m)	1998-99 ($m)	1999-00 ($m)	2000-01(a) ($m)	2001-02(a) ($m)	2002-03(a) ($m)	2003-04(a) ($m)	2004-05(a) ($m)
Costs								
1 Under taxation of employer contributions(b)(c)	3820	4250	4550	4300	4530	5080	5340	5610
2 Deduction for self-employed/unsupported	200	220	220	190	190	190	190	190
3 Under taxation of fund earnings	5740	4850	5270	4300	4340	4550	5150	5460
4 Under taxation of unfunded lump sums(d)	570	570	570	490	490	490	490	490
5 Superannuation rebate - low income earners	20	15	15	15	15	15	15	15
6 Superannuation rebate - low income spouse	0	10	10	10	10	10	10	10
7 Frozen indexation and CGT discounts for funds	-	-	-	200	370	460	540	630
Sub-total(e)	10350	9915	10635	9505	9945	10795	11735	12405
Offsets								
8 Tax on funded pensions	(f)	(f)	(f)	(f)	(f)	(f)	(f)	(f)
9 Tax on funded lump sums before 1/7/83	30	25	25	20	20	20	20	20
10 Tax on funded lump sums from 1/7/83	400	380	400	420	440	470	490	510
Total offsets	430	405	425	440	460	490	510	530
Total tax expenditures	9920	9510	10210	9065	9485	10305	11225	11875

Source: The Commonwealth Treasury, 2001, Table B1: Estimated tax expenditures through superannuation tax concessions, 1997-98 to 2004-05. website: http://www.treasury.gov.au/

Table 6.2 shows the cost of superannuation tax concessions amounted to $9.1 billion in 2000/1 or approximately 1.5 per cent of GDP. This figure does not include any indirect costs, such as the public and private costs of regulation (for example ensuring lock-in revisions and pensions as the income stream). Such estimates also make no allowance for reduction in entitlement to the age benefit, but as Eddy and Gower (2000, p.16) discuss, current policies have not been conducive to producing saving on the old age pension. In the jargon used in Australia, 'double dipping' has been encouraged whereby pension savings are accessed at a young age and used up quickly so as to increase entitlement to the means-tested state pension.

[122] For a discussion of these issues in the case of Australia see Brown (1993)

The Australian Treasury also suggest that their estimates be treated cautiously, bearing in mind higher possible offsets in the projected years:

> *The estimate of the tax expenditure in the forward projections is not necessarily indicative of the cost of the superannuation concessions over the long-term: the taxes on superannuation pensions and lump sums could be expected to provide a greater offset to the cost of the under-taxation of contributions in future years, when there are larger numbers of taxpayers drawing down their superannuation savings relative to the numbers in the accumulation phase; and the current superannuation tax concessions will have an (intended) impact on certain direct budgetary expenses in future years, particularly age pension payments.* (The Commonwealth Treasury, 2001)

The reintroduction of tax incentives for private saving has often been raised in public discussions in New Zealand. To date there has been little appetite to restore the traditional tax approach for retirement saving to that followed in other countries. One of the problems is that it becomes transparent that the beneficiaries of the reintroduction of tax breaks would be largely those who need it least. New Zealanders have also been well schooled to believe that such tax subsidisation has to be paid for by higher taxes elsewhere. Tax incentives have not been a burning issue of political debate.

Section 3.4 described the current political discussions on tax incentives in New Zealand. At a local conference Knox (2001) proposed a rebate targeted by age, heavily weighted to the young in order to change behaviour. Along with other such suggestions, however, this one begs the public policy question ‘what is the goal?’. Knox argued that long-term saving is desirable, as is a ‘savings mindset among the young’. Knox also suggests that tax-advantaged saving must be locked in and at least one half used to provide income in retirement. The difficulty is that any tax concessions given today, conditional on an annuity purchase in 40 years time, requires a much more vigorous approach taken to the security, efficiency and pricing of the annuities market.

6.6 Political elements

The wide range of different approaches that operate successfully in many different countries suggest that the mix and shape of policies is not necessarily the critical factor. One model does not necessarily translate successfully to another country with different traditions and culture. Nicholas Barr - one of the most influential

economists in pension debates - drew three main conclusions from his study of pension reform (Barr, 2000):

- The key variable is effective government;
- From an economic perspective the difference between PAYG and funding is second order;
- The range of potential choice over pension design is wide

In the New Zealand context the point that Barr makes about political sustainability is important.

> *Reform does not end when the legislation is passed, but needs continuing commitment from government, both for technical reasons, to ensure necessary adjustments to reform proposals as events unfold, and for political reasons, to sustain continuing political support. Reform which is regarded as a single, once-and-for-all event runs the risk of neglect, discredit and eventual reversal. A third element is the depth of political support. It is not enough for the top echelons of government to understand the reform proposal. The idea and its implications must be shared and understood throughout government and administration. Without that depth of shared understanding, the original plan risks being implemented badly or, at worst, actively subverted by lower levels of government or administration.* (Barr, 2000, p.25)

The economy must be managed in a way conducive to the objectives of the reforms, whatever mix of pillars, public or private, is chosen. In addition the government must be prepared to operate an effective, possibly expensive regulatory regime over financial markets. Attacking the myth that 'private pensions get government out of the pensions business', Barr argues the case for effective government for both state and private schemes:

> *Effective government is essential whichever approach to pensions is adopted. The problem of government failure is most obvious in the case of PAYG schemes built on fiscally irresponsible promises, coupled with an inability to collect contributions. Results include inflationary pressures and political instability. However, private pensions are also vulnerable. Fiscal imprudence leads to inflation which can decapitalize private funds; and inability to regulate financial markets creates inequity, and may also squander the efficiency gains which private pensions are intended to engender.*(Barr, 2000, p.3)

6.7 Summary: the New Zealand model

New Zealand has avoided many of the fiscal traps of the social insurance schemes of other countries. The reforms put in place to moderate the costs of the New Zealand public pension to date have been to the existing scheme rather than a dramatic switch to a World Bank type of approach.[123] Part II will examine whether the World Bank model is based on a sound economic framework that offers New Zealand a superior approach.

The model for meeting the risks of old age in New Zealand emphasises a strong Pillar I with egalitarian outcomes. If the purpose of the Pillar I is to ensure a satisfactory living standard for all and prevent poverty while minimising disincentives to save, New Zealand has scored well in the past. However it must be increasingly clear to new retirees that the state pension alone now provides a very basic standard of living only, and only for those who own their own homes. The analysis of median wealth in Chapter 5 indicated that many New Zealanders appear to have little additional wealth accumulated for old age, apart from their rather modest homes. In the face of increased user pays for health and long-term residential care, among other services that are more highly subsidised elsewhere, the future could be bleak for many retirees. At the same time, at the top end of the distribution, older people are very well-off indeed compared to others in the same generation and compared to most working age people. This calls into question the universality of the state pension especially in light of the low top tax rate and the ability of higher income people to evade and avoid the top tax rate of 39 per cent.

The demise of company pensions and the thin annuities market (see Chapter 3) must be viewed with concern. This may portend a collapse in the middle of the income distribution for retired people and preclude middle-income retirees from their reasonable aspirations for continuance of economic status into retirement.

Annuitisation of wealth is cost efficient in principle as it enables intragenerational sharing; those who die young do not pass their remaining estate to their heirs, but it goes back into the annuity pool to provide pensions for those who live the longest

[123] Notably these comprise changes to the age of eligibility and the level of the pension.

time.[124] Compared to an individualised system in which each retiree must try to accumulate enough to last them for their entire retirement, annuitisation removes the longevity risk of living longer than the average and enables a larger annual pension for any given rate of return and capital sum than would be prudent for the individual acting alone. One of the deficiencies in the New Zealand system, especially as the replacement rate given by the state pension is low by international standards (Disney & Johnson, 2001) must be the lack of pensions for middle-income earners. This gap will become more serious as fiscal pressures for state spending on long-term residential and healthcare for the elderly increase as the population ages.

The lack of political consensus, while seeming thus far not to have jeopardised the basic pension system, remains a potential threat. There are no apparent signs of a political consensus emerging, for example, the introduction of prefunding in 2002 does not have wide political support, and the debate around the reintroduction of tax incentives has no clear focus. The possibility of intragenerational sharing of resources has received little attention. There is both a lack of income insurance for middle-income people and a policy failure to view the broad risks of old age together. These issues are brought together in the discussion in Part III of this thesis where some overall reforms are explored to improve the New Zealand model for the 21st century.

[124] A short guarantee period for payment of the annuity can overcome the aversion to taking the risk that one might die young and lose the full capital sum. The state pension in New Zealand does not have a guarantee period, but most private annuities do.