

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

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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.

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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 |
| 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 & Vitas, 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 to 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, Kotlikoff & 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 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 alongside 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 expansion¹⁸

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 (Shiple, 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.

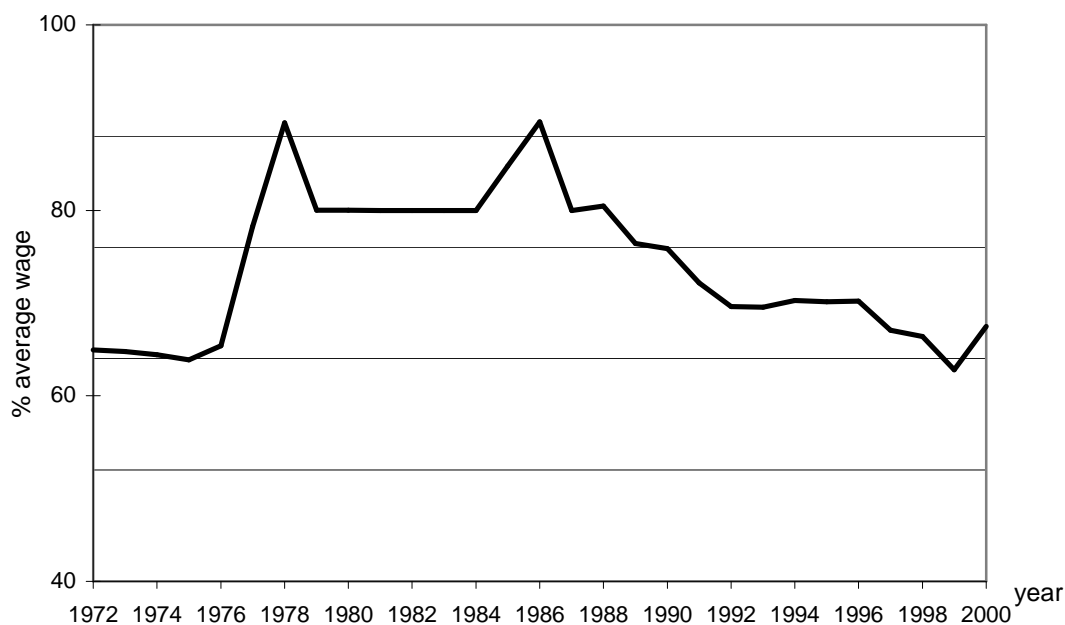
That vulnerability was well demonstrated in late 1998. The indexation provisions under the Accord had required that New Zealand Superannuation be adjusted by prices, but once the floor of 65 per cent of the net average wage (for a couple) was reached then price indexation should be replaced by wage indexation 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 losses³⁴ 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.

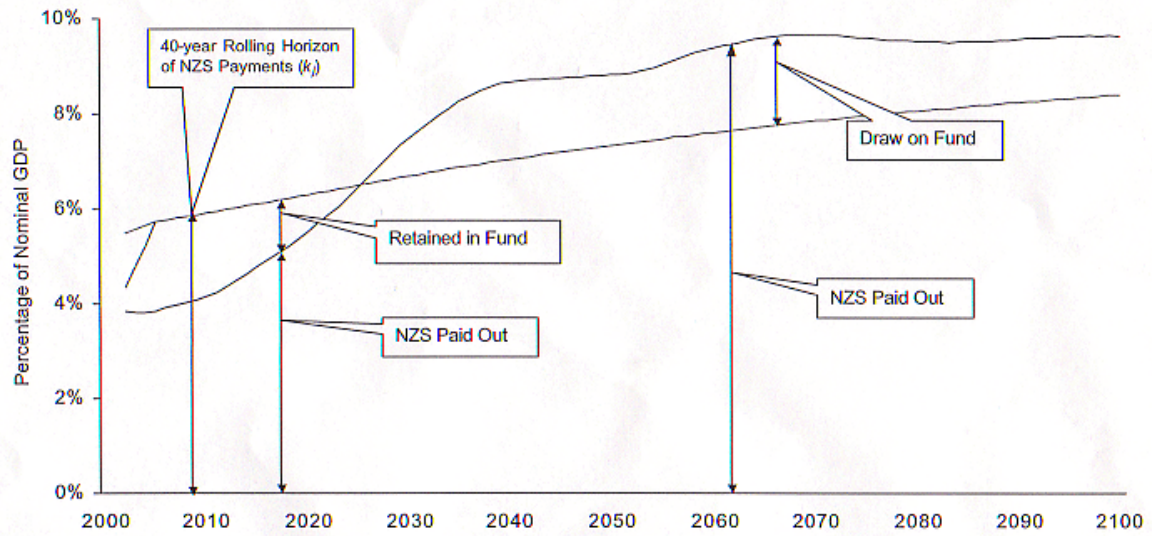
Any gain from tax smoothing is conditional on strong fiscal discipline so that ‘expenditure creep’ does not become a problem in the face of an improving balance sheet. It is also dependent on the assumption that government’s investment of the surplus will generate returns significantly above the costs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

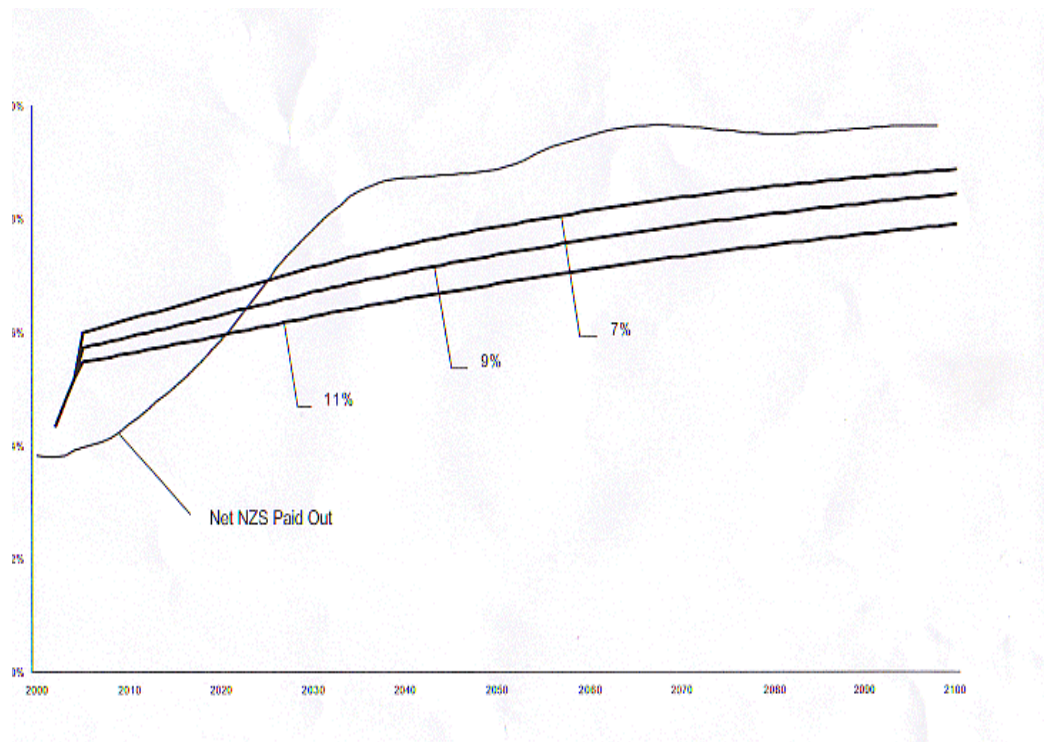
³⁴ This is because the deadweight loss of a tax is thought to increase by more than the proportionate rise in the tax rate (Davis & Fabling, 2002, p.3).

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 Fund³⁵

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 Finance³⁷, 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 scheme³⁸ 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 |
| Luxembourg | 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.