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We all have to talk about New Zealand Superannuation

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New Zealand Superannuation costs taxpayers, after-tax, about 3.7% of GDP at present. With the expected doubling of the age 65+ population, that cost is expected to be a net 6.7% of GDP by 2050. This *PensionCommentary* puts that change in an international context. How much might be 'too much' for age pensions?

Whether or not the expected cost is 'affordable', we all, including the government, need to talk about that now, not in ten years.

1. Introduction – what we have works (at present)

New Zealand has one of the simplest retirement income systems in the developed world. KiwiSaver aside, the main component is New Zealand Superannuation (NZS). Every New Zealand resident is entitled to NZS from age 65 as long as they have been resident:

- at least 10 years after age 20, including
- at least 5 years after age 50.

NZS provides at least 66% of the net national average wage for a married couple and about 47% for a single person living alone. It is adjusted annually to reflect changes in inflation but with an underpinning link to the national average wage. The grossed up amount is taxed as ordinary income.

KiwiSaver aside (again) there are no expensive, complex tax breaks for private provision of retirement income. Whether KiwiSaver should retain its remaining incentives is at least questionable.

On most measures, New Zealand's retirement income arrangements currently seem to 'work' quite well. NZS delivers enough income to keep nearly all over-65s out of poverty. In fact, an OECD comparison ranked New Zealand 'top equal' measured by the lowest poverty levels amongst the retired populations of its member countries (OECD, 2008)[3]. Before KiwiSaver, New Zealanders also seemed, on average, to be making appropriate supplementary provision for their retirements (Scobie and Henderson, 2009).

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[2] An RPRC *PensionCommentary* is an opinion piece designed to provoke discussion on an issue of public significance. This *PensionCommentary* is based on work done by the author for presentations to the remuneration clients of AON Hewitt in April 2012. The author thanks Susan St John and M. Claire Dale for their helpful comments and suggestions on earlier drafts but the views expressed in this commentary are the author's own.

[3] The OECD comparison was based on a measure of 'poverty' as being earnings for an over 65 household of less than 50% of local median household incomes, after housing.

We need to be very careful about imposing any changes, particularly as those approaching retirement will have made their financial plans on the basis of the way things are. Such plans typically have to be made and implemented over a decades-long, pre-retirement period.

The real issue then is that we all need to discuss changing our retirement income settings, in particular with respect to NZS.

2. What about the 'silver tsunami'?

Most public commentary about the impact of our ageing population starts with the assumption that New Zealand cannot afford to maintain current levels of NZS. For example, a recent article by the *New Zealand Herald's* Economics Editor, Brian Fallow, headlined it *Super a fiscal bomb waiting to explode.*[4] Apart from the known increases in the number of pensioners, New Zealand has apparently a particular version of the 'problems' faced by every country, even those labelled as 'developing'. According to the *Herald*:

> "Superannuation is a particularly large fiscal problem in New Zealand because the way we fund retirement income is unusually heavily reliant on a taxpayer-funded pay-as-you-go pension."

The article concluded first that the government should return to a fiscal surplus as quickly as possible and to resume contributions to the New Zealand Superannuation Fund (at a higher rate than before). However, Littlewood (2010) suggested that the government should not pre-fund NZS because it made no real difference to the future affordability of NZS and, in the meantime, created unnecessary investment risks for taxpayers. The cost of NZS will be the benefits actually paid, in the year they are paid. It follows that the way NZS is financed, including through the mechanism of the New Zealand Superannuation Fund, does not really affect the 'affordability' issue[5].

Secondly, Brian Fallow concluded:

> "The other main implication of the long-term fiscal threat from our current superannuation regime is that it is craven irresponsibility for the Government to refuse to even talk about changing the entitlement parameters."

The central issue is *how much* we will pay, and *to whom* we will pay it, rather than *how* we will pay for it. On that, Brian Fallow was correct. New Zealand needs a conversation about "changing the entitlement parameters", even if that discussion leads to a conclusion that we *can* afford what we have now. Fallow, however, assumes we have to change NZS because New Zealand cannot afford what we have. What is the evidence for that common assumption?

3. How scary is our demographic future?

We know that New Zealand's population and workforce are both ageing; and that both NZS and healthcare costs of the age 65+ group to taxpayers are likely to more than double as a percentage of GDP from the present level. Some say that, based on these

[4] Thursday, 10 May 2012; see here for the original *New Zealand Herald* article.

[5] By contrast, the Savings Working Group supported the NZSF's role and recommended "the continuation of the NZ Superannuation Fund, and consideration of contributions to the Fund on average across the economic cycle to maintain the unfunded liability at a stable percentage of GDP." Savings Working Group (2011) at p. 16.

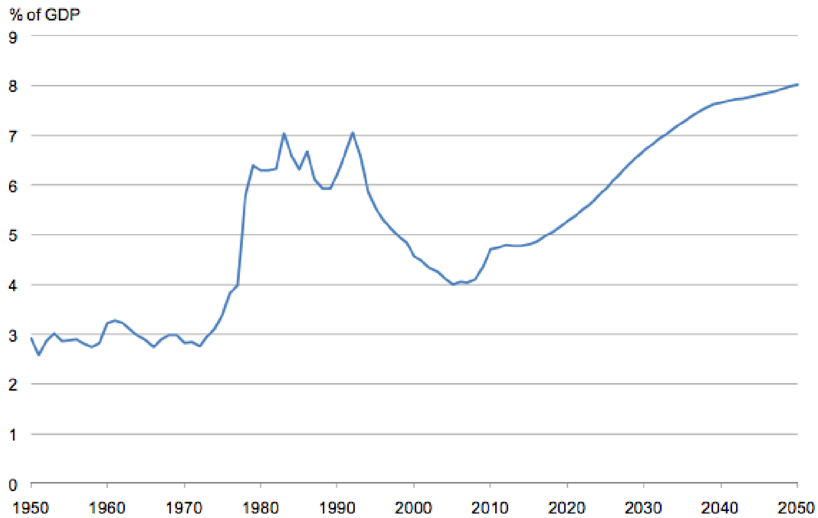
broad statistics alone, we cannot afford current rates of NZS so that cutbacks are inevitable as we face the 'silver tsunami'. In addition, the proportion of the 'working age' to support this major shift will fall:

> "The unprecedented demographic trends mean the old-age dependency ratio – the ratio of people aged 65 and older relative to the working-age population aged 15 to 64 – rises from 19% in 2009 to 42% by 2050. The… ratio of people 65 and older to those between 15 and 64 more than doubled in the 100 years to 2000, and will do so again in the next 50 years." (The Treasury, 2009, p. 18)

Chart 1 puts New Zealand's *future* NZS costs into an historical perspective, showing the gross cost of what we now call NZS over 100 years from 1950 to 2050. Allowing for the income tax payable by pensioners, the net cost is currently about 1% of GDP less than the 4.7% shown in the chart for 2010.

By 2050, according to the Treasury's 2009 projections, the gross cost will be about 8% with the net cost at about 6.7% of GDP on the basis that NZS, tax and other settings do not change (and that GDP increases at an average 3% a year).

Chart 1: NZS spending under current policy (before tax)



Source: Bell, Blick and others, New Zealand Treasury (2010), Chart 8.2

Chart 1 shows that, as a percentage of GDP, the expected gross cost of New Zealand Superannuation in 2050 will be only 1 percentage point more than it was in both 1984 and 1991 when it reached 7% of GDP. So, in a way, we have almost been there before.

The chart also demonstrates the power of benefit design. The gross cost of the pension was about 3% of GDP for 25 years (1950 to 1975). From 1977, after what was then called 'National Superannuation' became payable in full from age 60 without an income test, the cost suddenly increased, more than doubling in real terms in only seven years[6]. The cost then reduced after 1984[7] as a result of benefit cutbacks but really started falling when the state pension age increased from 60 to 65, starting in 1992 and ending in 2002.

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[6] The age pension's increasing cost was probably one of the issues that prompted the 1991 'mother of all budgets' from the new National government. It tried unsuccessfully to convert 'National Superannuation' into a fully income-tested, *welfare* benefit as well as increasing the state pension age to 65.

[7] The graphed changes in the early 1980s illustrate first, the switch from a pension based on the pre-tax national average wage to post-tax; then an increase to compensate for GST's introduction in 1986.

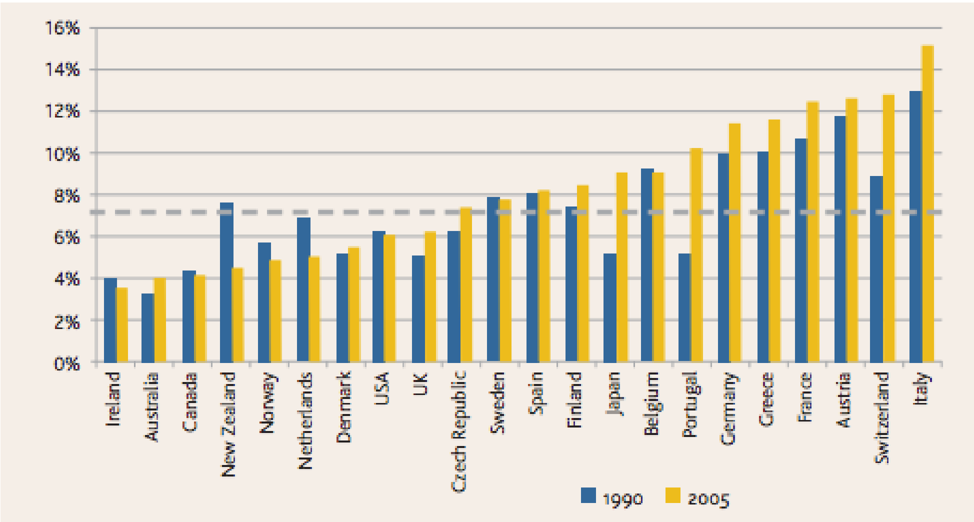
If New Zealand decided that a gross cost of 8% by 2050 would be too high, our history shows that the remedy is easily implemented and the fiscal effects can be rapid and very powerful. The politics of change are another matter, as the current government effectively acknowledges by refusing to put the topic of NZS on the agenda for discussion.

> "The Government is committed to these settings and I have said many times that I would rather resign rather than change them." (Key, 2009)

3. How does the cost of NZS compare: 1990 and 2005?

By changing the benefit design of NZS 20 years ago, New Zealand improved its comparative cost position against its OECD 'neighbours'.

Chart 2: Government expenditure on old age benefits, including compulsory private pension schemes[8]



Source: Crossan, D (2010) at p.112; data from the OECD's *Pensions at a Glance 2009*

Chart 2 shows the gross cost of old age benefits as a percentage of GDP across 22 developed countries for both 1990 and 2005. The dotted line is the (simple) average of all 22 countries for 2005.

The age benefits in some countries are not treated as 'income' for tax purposes or, as in the US, receive favoured treatment so the gross cost is usually used to compare countries. New Zealand's pension is taxed so a comparison of net costs, if that were possible, would be more meaningful.

For 1990, NZS was shown at a gross cost of about 7.5% - the 12th least expensive of the 22 countries[9]. As discussed above, that cost had fallen to about 4.5% by 2005. New Zealand's gross cost of old age benefits had dropped to the 4th least expensive of the 22 by 2005.

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[8] Comparing countries' pension arrangements is always difficult and that is true of costs as well. The reported costs to the OECD include, in some cases, the cost of occupational Tier 3 pensions paid to the government's own former employees. However, the data do not include the cost of tax incentives for private provision. Similarly, because some but not all countries tax the age pension, gross costs only are shown. The net costs will be less for some, including New Zealand. The specific numbers may not be directly comparable but the overall relationships are clear.

[9] In 1990, New Zealand had a 'surcharge' on other income that was effectively an income-test on NZS. The gross cost of NZS would not allow for the effects of the surcharge.

While Canada, Australia and Ireland looked less expensive in 2005, the cost of tax breaks for private retirement saving was not included in the measurements. In Australia's case, that now adds about 3% of GDP to pension costs, about the same as the government spends on the Age Pension itself (Davidson, 2012). New Zealand didn't have KiwiSaver in 2005 but the cost of tax breaks in 2011 for KiwiSaver were about 0.5% of GDP.

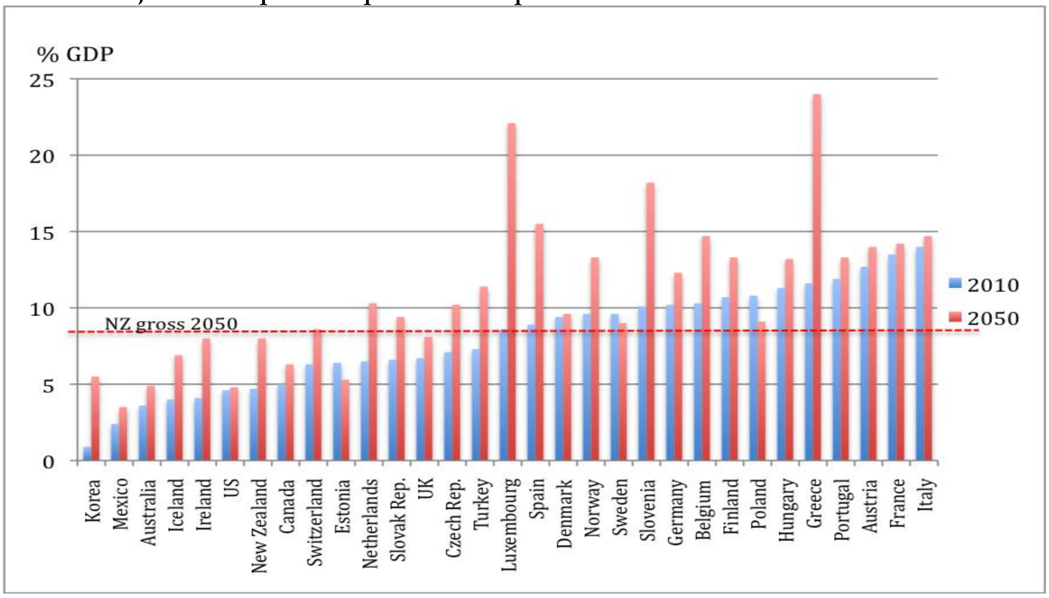
4. Comparing pension costs 2010 and 2050

The OECD's *Pensions at a Glance 2011* updates Chart 2's comparison of current costs and includes expected future public pension costs across member countries.

Chart 3 compares those costs in 2010 and the expected costs in 2050.[10] The estimates allow for changes that some countries have made to their pension arrangements and that will be effective by 2050. Other countries have changed their benefit rules since 2010.

The countries are sorted in the chart by the current (2010) cost.

Chart 3: Projections of public expenditure on pensions 2010 and 2060



Source: data derived from *Pensions at a Glance 2011*, OECD

The dotted line in Chart 3 shows the position expected for New Zealand in 2050.

A gross cost of 8% of GDP by 2050 (net 6.7%) will be a large share of New Zealand's expected economic output in 2050, much larger than 2010's gross 4.7% (net 3.7%).

Chart 3 shows that in 2010, 15 of the 30 countries in Chart 3 already paid more than 8% of GDP in pensions (using the more conservative gross cost comparison). On the chart's numbers, 23 of the 31 countries will be paying more, gross, in age pensions by 2050 than New Zealand, with Greece expecting to pay a clearly unsustainable 24% of GDP.

Using the same results, the unweighted 2050 average gross cost of age pensions of the countries shown in Chart 3 is expected to be 11.4% of GDP[11].

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[10] Chile, Israel and Japan did not supply data for the table in the OECD report from which Chart 3 was derived.

New Zealand faces a significant fiscal challenge with the expected increase in the cost of NZS. Charts 2 and 3 place that challenge in an international context. We might draw comfort from the greater cost increases faced in other countries but, as suggested below, that context gives New Zealand no grounds for complacency.

4. Projections over 40 years

Projections of expected expenditures and future growth rates are 'best guesses', not actual estimates. In *How much will New Zealand Superannuation really cost?* (Retirement Policy and Research Centre, 2010), we analysed the results of seven versions of projections made by the Treasury's *Long Term Fiscal Model* (LTFM) between 2000 and 2009 and observed:

> "…it is clear…that the expected future real cost of NZS measured in the nine years covered by the LTFM calculations has actually fallen, benchmarked against GDP. In fact, the 2050 estimate of the expected net cost of NZS has reduced from 9.0% of GDP in V1-2000 to 6.7% of GDP in V7-2009 (a reduction of 25.6%). Most of that is attributable to the real improvement in GDP (+37.4% in 2050…). While it is true there is an "accelerating ageing of the population", this had been expected in earlier estimates of the costs of ageing."

We concluded that the Treasury's projections:

> "…emphasise the importance of economic output and, for the security of today's and tomorrow's pensioners, increasing that output at a faster rate than the latest version of the LTFM presently projects. For many more reasons than just the affordability of NZS, how to make New Zealand more productive should be at the centre of discussions about the economic implications of an ageing population."

It is easy to question projections over 40 years and more when it seems difficult to estimate what might happen in the next year or so. The underpinning trends are, however, clear. The number of people entitled to NZS on its current terms will more than double; so too will the expected costs[12].

5. What do others think?

The *New Zealand Herald* is by no means alone in suggesting that New Zealand has to face up to changes in NZS. A selection of other views includes:

The Retirement Commissioner's *2010 Review* looked at several possible changes to NZS and concluded:

> "The long-term sustainability of NZS needs to be assured by taking a responsible view of the way the major cost pressures that will come onto the public pension system in the 2020s should be handled. The proposed future modifications to NZS in this Review[13] are not focused on helping to correct fiscal imbalances over the next several years.

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[11] As before, the comparison ignores the cost of expensive tax breaks for private provision at Tiers 2 and 3.

[12] The number of people age 65 and over was 565,000 in 2010 (National Population Estimates, Statistics New Zealand). That is expected to grow to 1.3 million by 2050. Another estimate (Jackson 2011) sees the age 65+ age group growing by 61% between 2011 and 2026, "the most profound annual increment in numbers aged 65+ years of the OECD countries."

[13] The three suggested changes to NZS were a shift in the annual increase from a CPI adjustments but with a direct underpinning link to national average wages to one based on an average of CPI-measured inflation and wages; a gradual increase in the state pension age from 65 to 67, phased in between 2020 and 2033 accompanied by a transitional, means-tested benefit for those affected by the increase in the state pension age.

> Instead, they anticipate the longer-term structural, particularly demographic, pressures that will arise in the following decade." (Crossan 2010, p.10)

The Treasury's 2009 report *Challenges and Choices* tip-toed around recommendations about the future of NZS. It looked at the fiscal implications of different design changes in the context of a discussion about all major aspects of government spending over coming decades, concluding:

> "Earlier sections have discussed the kinds of adjustments that are likely to be required in other government spending areas to ensure a sustainable long-term fiscal position. Some of these changes will require significant shifts in the way government services are provided and in expectations about what services will be provided. Changes to eligibility and entitlements for NZS that reduce its total cost would reduce the extent to which other public services would have to adjust." (The Treasury 2009, p. 55)

More generally, and in relation to overall government spending over coming decades, the Savings Working Group concluded:

> "The conclusion is that without significant policy change to the relationships between spending and population, or tax rises (with negative flow-on effects on growth), deficits will steadily increase and debt mount further. This will damage growth prospects, and increase the country's external vulnerability." (Savings Working Group 2011, p. 56)

Other commentators have been more direct in calls for reductions in NZS payments.

6. A needed debate?

This *PensionCommentary* does not address specific aspects of possible changes to NZS but rather the much narrower question of whether all New Zealanders need to engage in the discussion about the size and shape of NZS over the coming decades. Is the government correct when it suggests that the design of NZS does not need to be addressed until the next decade?

If we are to be guided by what other countries expect to be spending on pensions over the next 40 and more years, New Zealand does not seem to be facing a demographically induced 'crisis'. To describe the issue as a "fiscal bomb" (as *The New Zealand Herald* did) seems an overstatement. There is time to change things gradually, if that is what we decide to do.

International comparisons might give us comfort on New Zealand's relative position today and apparent relative position into the future, however what other countries might experience by 2050 is not the central issue. Instead, New Zealand needs this debate today for at least four reasons:

(a) **No government spending should be exempt from review:** Any government policy and its fiscal consequences should be subject to regular review, no matter how damaging that review is, politically. Superannuation has been a difficult issue for nearly 40 years. Perhaps that means New Zealand needs to think of a new way of reviewing the design of NZS. It is currently one of the largest single items of government spending and its design has significant implications for taxation levels, saving decisions and labour force participation decisions by older New Zealanders. These points suggest that we all need to talk about NZS.

(b) Taxpayers of 2050: We know that, by 2050, a single government programme (NZS) will cost an amount that will be equivalent to about one twelfth of New Zealand's total economic output as measured by GDP (8% on a gross basis). Some suggest it will be more. We also know that health-related costs of the ageing population are likely to about double. The proper question today is whether we expect taxpayers of 2050 to be willing to meet those costs. If the answer to that question is either 'no' or 'possibly not' then New Zealand must debate that issue now. With respect to financial provision for retirement, savers today need as much notice as practicable of the possibility of any significant change to the design of NZS so they can make appropriate adjustments to their own retirement saving plans. In the end, taxpayers of 2050 will have the final say and, if they so decide, the design of NZS will change relatively quickly, just as happened in 1992 (when the state pension age began increasing from 60 to 65).

(c) Confidence undermined: There is an increasing group of commentators, including the government's own advisers, suggesting that New Zealand needs to debate the design of NZS with a view to reducing benefits.[14] Those calls are likely to increase as more baby boomers move into retirement. The uncertainties those calls create will undermine New Zealanders' faith in the sustainability of NZS. If a full discussion on NZS leads to modest, well-heralded changes, confidence can be retained. Most younger people today, if prompted, say they expect not to receive NZS at all by the time they reach state pension age. That is unrealistic, even on pessimistic assumptions about the future of NZS. If they are acting on their opinions, that might lead to inefficient decisions about private provision for retirement. They might, for example, over-save for retirement income, reducing current consumption and slowing growth.

(d) Options for change toward sustainability. Reducing the gross amount of NZS and increasing the age of entitlement are not the only possible options. A research-led debate on the future sustainability of NZS should be open to exploration of all the possible options for change, including the different benefits for married couples and those sharing accommodation, the link to the national average wage, the treatment of immigrants and emigrants and whether there should be means-tests. There has never been a research-led debate and consensus on any of the NZS benefit provisions[15]. Now is the time to start an open process towards consensus.

7. In conclusion

There is usually an assumption in calls for a review of the NZS benefits that they will have to reduce in future. International comparisons at least question that assumption but do not, and should not, preclude a full, research-led, national debate on the size, shape

[14] The main opposition Labour Party suggested in the 2011 election campaign that the state pension age should increase from 65 to 67. It now thinks that the current levels of NZS are unsustainable and that New Zealand needs to start a discussion on how NZS might be changed. The Green Party's election policy, on the other hand, supported the status quo though expressed itself to "…be open to there being a national discussion around how we best provide superannuation and how we best look after older New Zealanders." (Radio New Zealand 2011)

[15] Specifically, there has never been a research-led, national discussion since 1898 on any of the following: the state pension age, the primary qualifications for benefit, the basis for calculating any of the rates (married couple, single-living-alone, single-sharing-accommodation), the regular review basis, the treatment of immigrants and emigrants and the way in which the costs are met (PAYG, pre-funded).

and implications of the current benefit design of NZS. That debate may lead to a consensus that supports a continuation of the present arrangements but it may not. The sooner that debate happens, the better.

The suggested review process is needed to restore New Zealanders' faith in the future sustainability of the simplest, most effective state pension arrangement in the developed world.

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