pensioncommentary

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The coming debate on New Zealand Superannuation – the review process

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For the last 40+ years, New Zealand Superannuation has been the classic political football. We now have different political parties and other commentators suggesting changes to NZS to reduce the expected future cost. The usual suggestions include raising the pension age, reducing the amount and some form of means-test.

However, the Prime Minister says that NZS will not change while he remains the country's leader. That being the case, we can only prepare ourselves for the national debate the country needs to have on an age pension that is fit for the 21st Century. There is quite a lot to do before that debate can start.

1. Introduction – a short history of NZS

New Zealand Superannuation is one of the simplest Tier 1[3] pensions in the developed world. Every New Zealand resident qualifies for 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 a net 66% of the net national average wage for a married couple and about 42% for a single person who lives 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.

NZS has remained largely unchanged since 1998 but, as *PensionBriefing 2008-5*[4] described, change had been a constant factor of both state and private provision since the mid-1970s. There were four main change-periods:

- **before 1975:** the public and private pension environment stayed relatively unchanged for 30 years. The Tier 1 age pension (means-tested from age 60) and

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[2] An RPRC *PensionCommentary* is an opinion piece designed to provoke discussion on an issue of public significance. The views expressed in this commentary are the author's, not the RPRC's.
[3] The World Bank (1994) analysis used three 'Pillars' to describe the architecture of countries' retirement income arrangements but 'Tiers' illustrate the make-up of retirement incomes more naturally. Tier 1 is the pension to which all citizens are entitled, usually with qualification conditions. Tier 2 describes the compulsory retirement income scheme that lives on top of (and sometimes eventually replaces) Tier 1. Australia's Superannuation Guarantee (SG) scheme is an example. Tier 3 is everything else including voluntary saving schemes (such as KiwiSaver), occupational schemes and all the other ways that individuals save for retirement. Others, including the World Bank itself, have suggested more complex labelling systems but the 1994 three-part description is sufficiently detailed for this purpose.
[4] Retirement Policy and Research Centre (2008) accessible here.

universal superannuation (taxable from age 65) remained largely intact while the level of benefits gradually increased. 1974 marked the passing of the legislation that introduced the compulsory Tier 2 'New Zealand Superannuation Scheme' in 1975.

- **1975 to 1987-90:** 'National Superannuation' starts, payable from age 60 and the compulsory Tier 2 scheme is scrapped. The 'surcharge' on other income makes the Tier 1 pension income-tested (1985) and tax breaks for private provision are withdrawn.
- **1990-2007:** The National government attempts to extend the income-test (1991); the first Task Force (1992) and an 'Accord' helped to restore political stability. Subsequent reviews in 1997, 2003, 2006 all confirmed the basic framework.
- **After 2007:** KiwiSaver starts with tax breaks to encourage saving for retirement at Tier 3. The 2007, 2010 and 2013 reviews supported the overall retirement income structure.

PensionBriefing 2008-5 concluded:

> "New Zealand has had a generally unsatisfactory history of changes in the retirement income environment. In fact, over the roughly 30 year period covered by this *PensionBriefing*, New Zealand has probably experienced more changes or proposed changes to both public and private provision than any other developed country. In this area of public policy, New Zealand does not have a proud record."

Since 2008, further changes have been made to KiwiSaver and we are now up to KiwiSaver Version IV in the eight years since KiwiSaver started on 1 July 2007 (St John, Littlewood and Dale 2014).

2. A principles-based, research-led national discussion

PensionCommentary 2015-1 Re-designing New Zealand Superannuation[5] suggested that New Zealand has never had a principles-based, research-led debate on any of the key design features of the NZS arrangements. The fact that there will eventually be about twice as many superannuitants as now and that the net cost of NZS will grow from 4.2% of GDP to an expected 6.7% by 2060 should be sufficient grounds to initiate a full review. The risk tomorrow's pensioners face is that taxpayers in 2060 might decide that a net 6.7% is too high a price and they will change NZS. Such a change can happen overnight.

However, *PensionCommentary 2015-1* suggested that higher expected costs should not be the only prompt for a complete review:

> "Even if we think that 2060 taxpayers might accept a net 6.7%, we should still undertake the proposed review. Any government policy and its fiscal and economic consequences should be subject to regular review, no matter how politically damaging that might be. Superannuation has been a difficult issue for more than 40 years…New Zealand needs to think of a new way to discuss the design of NZS. The present process is not working."

PensionCommentary 2015-1 described the ten 'major' design elements and seven 'minor' issues that needed review. The cost of a 21st Century age-pension should be considered only after the initial design decisions for an 'ideal' scheme are made. This is the 'benefits

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[5] Retirement Policy and Research Centre (2015) accessible here.

first' approach to pension design[6]. Cost matters, of course, but only once preliminary design decisions have been made. If the expected cost of the 'ideal' scheme might prove too high for taxpayers in 2060, then the 'ideal' scheme must be trimmed to ensure its long-term sustainability.

PensionCommentary 2015-1 suggested that none of a line of recent reports over the last six years had come close to the suggested first principles, research-led review that NZS now needs.

3. The government's approach

Since its election in 2008, the government has been clear – it campaigned in 2008 on the basis that, if there were any changes to NZS, the Prime Minister would resign. Two recent statements confirm that position:

> "There won't be a referendum. The National Party is clear on super – the age should stay at 65 and the entitlement at 66 percent (of the average wage)." – John Key 24 February 2015 (reported here)

The Finance Minister Bill English went further. He was reported (*National Business Review* 27 March 2015) as saying that the government "shouldn't prepare for the aging population":

> "So I am pleased that, in the past five or six years, because of a rational promise by the prime minister which almost nobody agreed with, we haven't had to waste any time in retirement commissions…or arguing about retirement policy"…
>
> "There are only two fiscal answers to the aging population: pay fewer people or pay them less. That's it! Whether you are 83 or three years old, you need a robust growing economy."

4. What do others suggest might be done?

2015 is not an election year – what the other political parties think about possible changes to NZS were last expressed in the 2014 election campaign. Here, briefly, is what they said:

- **Labour** (see here): The annual pension would stay as is but the state pension age will increase from 65 to 67 between 2020 and 2032. A means-tested transition benefit will help those between ages 65 and 67. Contributions to the New Zealand Superannuation Fund will resume.
- **Greens** (see here): The current rates of NZS will stay, as will age 65. There should be a review of possible flexible starting ages.
- **New Zealand First** (see here): The current rates of NZS will stay, as will age 65. However, the full pension will be payable only after 45 years' residence in New Zealand between ages 20-65. A proportionate amount will apply for shorter periods.
- **Maori Party** (see here): There was no mention of NZS-related policies in the official 2014 policy document. For the 2011 election, the Maori Party said it wanted the state pension age lowered to 60 for "groups whose life-expectancy is lower than average". The pension will be means-tested (see here).

[6] The *PensionCommentary* describes the less-preferred 'cost first' approach as starting with an assumption that the expected cost of NZS must be cut because the expected 6.7% will be too high. The *PensionCommentary* questions that assumption.

- **Act Party** (see here): The state pension age will be gradually lifted to age 67 from 2017 and pension increases linked to prices rather than prices with an average wage-linked floor. A means-tested parallel to NZS will support those in need. The New Zealand Superannuation Fund will be dismantled.
- **United Future** (see here): Current rates of NZS will continue with an adjustment to the inflation linkage (looking forward rather than back). 'FlexiSuper' will pay rates based on the selected starting age – lower for ages 62-65 and higher for ages 65-70.

Some of those views have changed since the election. For example, Labour's new leader Andrew Little has said that Labour's policy for the 2017 election should not include raising the state pension age to 67: "I've made a judgement that the superannuation policy and the capital gains tax policy have been problems for us and are two reasons why people haven't voted for us, and therefore we need to review them" (see here). The Act Party now says it wants the design of NZS to be referred to a "non-parliamentary expert group" and that the new design should be the subject of a referendum (see here).

This summary of the various parties' varying positions illustrates the policy frustrations of the last 40 years. All parties seem to think that policy on NZS is 'whatever it takes to get elected this year'. In National's case, that means not talking about NZS, presumably to avoid frightening the horses. The history of each party's retirement incomes' policies (on both public and private provision) does not bear close examination. For the reasons discussed next, this is unsatisfactory and the process needs to change so the public can be assured that policy will be guided by principles rather than political expediency.

5. Why the government is wrong

When governments set their spending priorities, they balance competing claims on economic output by everyone, including pensioners. In theory, those decisions can change every year; in practice they don't because a stable policy environment allows everyone to make private decisions more 'rationally'. So, decisions about the way in which, for example, unemployment benefits are calculated and who is entitled to receive them do change but remain relatively stable despite being administered by different governments. Similarly, businesses need stable economic policies that allow them to make long-term investment decisions.

The state pension (NZS) is different. We know that most retirees currently depend on NZS for most of their retirement income (Perry 2014) and that position is unlikely to change over coming decades. We also know that financial preparation for retirement is a multi-decadal project. That doesn't mean, as some in the financial services industry suggest, that we should be putting money into saving products for 20-40 years but it should mean taking a long-term view of what we want our own retirements to look like, financially.

A paid-off house to live in during retirement is probably the single most important part of that financial preparation. Next most significant is having a range of occupational skills, or a willingness to learn new skills, that allows career flexibility in the years leading up to 'retirement' and then through the 'younger old-age' periods. Being able to work reduces the pressure on financial savings in two ways – it increases the saving period and reduces the period over which the retiree depends on those savings for income.

Next, when people decide how much they need to save for a financially secure retirement, they should treat NZS as the foundation for their expected incomes after they stop work. That's why Note 3 on page 1 of this *PensionCommentary* suggests that NZS should be described as 'Tier 1' – the underpinning income on which the retiree can depend. All other decisions (house, career, retirement date and other financial provision) will build on that.

The government is partly correct when it says "There are only two fiscal answers to the aging population: pay fewer people or pay them less." (Bill English, Minister of Finance, reported 27 March 2015). However, that should not be the end of today's discussion. We need to send early signals to New Zealanders age 40 and over as to who those "fewer people" might be or how much "less" NZS might be.

What's missing from Bill English's comment is that we also need to wonder what the implications of making no changes to NZS might be. The Treasury expects the net cost of NZS to be 6.7% of GDP by 2060. Is allowing NZS to continue unaltered a realistic alternative strategy?

Not talking about NZS isn't the answer. Just focusing on reducing the cost isn't the answer either. If we are to give at least 25 years' notice (to today's 40 year-olds) of what NZS might look like after 2040, we need to start the discussion earlier, rather than later. We need to give today's 40 year-olds at least that 25 years' notice - anything less puts unnecessary pressure on savers.

6. The political reality

The Prime Minister has said many times that NZS will not change while he leads the government. For example, in 2009 he said:

> "There will be no change to superannuation payments for New Zealanders... If superannuation was to be cut...I will resign as prime minister and I will resign as member of Parliament." (reported 11 March 2009 – see here).

In response to the Reirement Commissioner's 2013 Review that called for an increase in the state pension age, Mr Key said:

> "What the Retirement Commissioner is saying is, basically, 'you should work longer and you should get less.' Well that's OK, except we don't agree with that. We've modelled it. It's in our 10 year forecast. We've looked into our 20 year forecast. We don't have a crisis in New Zealand Super." (reported here).

The National Party's 2014 election policies (see here at page 4) stated that National would "…maintain the link between Superannuation and 66 per cent of the average wage…[and] National will keep the eligible age for Superannuation at 65."

Given the personal commitments that John Key has made and also the political capital that National has invested in this issue, it seems most unlikely that the government will look at NZS while John Key remains Prime Minister. That covers the period until 2017 at least and, if there is a further National-led government, possibly until as late as 2020.

In the meantime, New Zealand might receive a similar commitment from the Labour Party, given Andrew Little's recent call for more 'popular' policies, as noted above.

We cannot expect to start a productive discussion about the future of NZS before, at the earliest, 2020. By then, the Treasury estimates that net NZS will cost a net 4.4% of GDP and is expected to rise to a net 5.4% by 2030[7], a 29% increase over the next 15 years. There therefore seems little point in continuing to call for changes to NZS until debate becomes possible, politically.

7. What needs to be done next

While the government may have successfully sidelined NZS for the next five years or so, there is much to be done in the meantime. Even if a debate were now possible politically, we do not have enough data to run an informed discussion on all aspects of the design of NZS that were noted in *PensionCommentary 2015-1*.

For example, setting the state pension age balances a number of health, social and labour market issues. Age 65 was set in 1898 and, aside from a brief period at age 60 (1977 to 1992) has been unchanged, unresearched and undebated for 117 years. We have very little information on the New Zealanders' transition from fulltime work to fulltime retirement. While those decisions will be made at present in the context of the current age 65, we still need to understand what's happening and what might happen if the age were to change. To prepare for the needed 2020 debate, we should start to frame and gather the required data.

There are varying data gaps for nearly all the design issues associated with NZS and listed in *PensionCommentary 2015-1*. For completeness, those issues are summarised:

- Universal pension (as now) or means-tested (assets, income or both)?
- Age 65 or later? What about earlier?
- After 10 years' residence, or more?
- How much should NZS be for a couple?
- How should NZS be re-valued each year? Why is there a floor?
- Should NZS be pre-funded in full, partially (as now) or 'pay-as-you-go'?
- Should single pensioners get more?
- Which overseas pensions should be deducted under section 70?
- Should ACC recipients also get NZS (that is not the case now)?
- Should there be 'approved' absences overseas, as now?
- How much should the 'hospital rate' be?
- Should overseas residents be entitled to any NZS?
- How should all this be reviewed? The present three-yearly review by the Retirement Commissioner seems not to be working.
- Then there will need to be agreement on the transition between current and future benefits (if changed).

Separately, there are significant holes in the data that measure other relevant aspects of New Zealanders' behaviour. For example, we do not have a clear picture of home-ownership rates and the recent trends in rental tenure[8].

Again, what evidence we have seems to suggest that New Zealanders are saving enough for retirement[9]; also that KiwiSaver might not be making much difference to the total

[7] Source: *New Zealand Superannuation Fund Contribution Rate Model* (2014) The New Zealand Treasury, accessible here.

[8] See *PensionBriefing 2013-4: Census 2013- shortcomings in questions about housing* here; and *PensionBriefing 2013-7: Census 2013 – is home-ownership really falling?* here.

amount of savings[10]. Private saving behaviour is relevant to the issue of the size and starting age for NZS in the future.

We should start by listing all the information we need for a research-led debate on NZS on the basis that the debate will start in, say 2020. Then we need to start gathering that data. We also need to talk to each of the political parties about this. The political lessons of the 1990s on superannuation influence their published positions but they may be willing to at least allow the data gathering to begin.

8. A public process

The 2020 debate should be open to all, including the political parties. It will be founded on the best available information and its aim will not be to cut costs but rather to test the resilience of NZS to changing demographic conditions. The review's objective should be nothing short of a consensus on all the key design components of NZS for the 21st Century.

There is usually an assumption in calls for a review of NZS benefits that they will have to be cut. That may be required but the 2020 review might be needed just to restore New Zealanders' faith in the future sustainability of the simplest, most effective state pension arrangement in the developed world.

A separate similar review should look at KiwiSaver and other private provision for retirement.

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[9] See for example: *Household Wealth and Saving in New Zealand: evidence from the longitudinal survey of family, income and employment* (2012) by Trinh Le, John Gibson and Steven Stillman, New Zealand Economic Papers (accessible here); *Saving Rates of New Zealanders: A Net Wealth Approach* (2009) by Grant Scobie and Katherine Henderson, New Zealand Treasury (accessible here) and *Are Kiwis saving enough for retirement? Evidence from SOFIE* (2009) by Trinh Le, Grant Scobie and John Gibson, New Zealand Economic Papers (accessible here).

[10] See *KiwiSaver and the Accumulation of Net Wealth* (2014) by David Law and Grant Scobie, New Zealand Treasury, accessible here.

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