Mixed messages: the future direction of New Zealand's retirement income policies

Roger Hurnard[1]

Paper presented at the 19th Colloquium of Superannuation Researchers, University of New South Wales, Sydney, 14-15th July 2011

Abstract

The balance among New Zealand's public pension policy objectives appears to be shifting. Until comparatively recently, the focus of retirement income provision policy was almost exclusively on guaranteeing a general, tax-funded, basic and universal, flat-rate public pension via New Zealand Superannuation (NZS), with other saving to supplement NZS being seen as a matter of personal choice outside the responsibility of government or the taxpayer. This approach has been challenged by a new policy focus on incentivising a higher rate of saving among the general population and assisting individuals to generate top-up income in retirement that will provide them with a living standard comparable with that enjoyed during their working lives.

This shift in policy emphasis raises challenges for the overall consistency, sustainability and effectiveness of New Zealand's retirement income policy. Debating the merits of alternative policy instruments is complicated because appeals to multiple policy objectives mean that the criteria and justifications tend to shift and the stakeholders talk past each other.

Public statements on NZS and KiwiSaver are sending mixed messages because they are aimed at two distinct audiences with quite different life cycle experiences and concerns regarding income adequacy. This risks a rise in cynicism, opportunistic political and institutional behaviour, a loss of social cohesion and an unwillingness to address the longer term fiscal challenges of an ageing population. A clearer articulation of retirement income policy objectives and trade-offs, greater attention to raising financial literacy levels and more transparent reporting of investment returns all have a part to play in improving the situation.

[1] The author is a private consultant on public policy issues and was directly involved in the preparation of the Retirement Commissioner's 2010 Review of Retirement Income Policy, published in December 2010. This paper draws heavily on the analysis in that Review, but also comments on more recent developments, in particular changes announced in the 2011 Budget. As a result, the views expressed here are solely the author's and not necessarily those of the Commissioner or the Retirement Commission.

Mixed messages: the future direction of New Zealand's retirement income policies

Roger Hurnard

Outline

1 Introduction

This paper examines a conundrum of retirement income policy. How in an uncertain world can members of a society maintain confidence in the future fairness, stability and sustainability of one of the government's largest public policy programmes?

The existence of multiple stakeholders, policy objectives and concerns provides a fertile source of confusion and opportunities for problems and solutions to be framed in many different ways at different times and for different audiences. This makes the maintenance of a public consensus and a long-lasting mandate for retirement income policy particularly challenging. Without such a broad consensus and mandate, pension rules risk being subject to tinkering and reversal and to accusations of favouritism. At the other extreme they can become regarded as so sacrosanct – retirement income as the "third rail" of politics - that emerging problems with the system are left unaddressed until they require major surgery.

This paper focuses on the evolution of New Zealand's retirement income policy, which has some unusual features. Countries with different social, economic and political backgrounds and pension systems will not necessarily face the same specific issues, but many are struggling with the same fundamental challenges.

Despite a number of sharp shifts in policy[2], or perhaps in light of the political experiences of reaction and reversal, the basic structure of the public pension system – a universal flat-rate indexed pension coupled with voluntary savings - has remained surprisingly stable over the past 35 years. What is perhaps even more surprising is that this structure continues to be significantly different from the standard, three-tier pension arrangements seen in most other countries.

The next section of this paper describes the basic structure of retirement income policies in New Zealand and the historical context in which policies have evolved. In particular, the introduction of KiwiSaver in 2007 represented a major shift from a neutral to an incentivised regime for voluntary retirement saving.

Section 3 describes the way in which diverse policy objectives have been weighed, traded off and incorporated into this structure. Section 4 contrasts the concerns of people close to or in retirement with those of the younger generation. It argues that addressing these contrasting concerns in the public arena has led to confusion, mixed messages and unrealistic expectations. A final section discusses ways in which policies might evolve in the future.

2 Retirement income policy changes in New Zealand

With regard to financial preparation for retirement, New Zealand is in a somewhat different situation from many other countries because of the structure of its public pension system. In particular, New Zealand has no mandatory saving scheme.

The centerpiece of the system is New Zealand Superannuation (NZS), a simple, non-contributory public pension funded from general tax revenue. NZS pays a flat-rate basic pension with no income test, asset test or employment test. In this respect it differs from Australia's Age Pension, which is paid at a somewhat higher standard rate but is both income and asset tested. The rate of NZS is indexed annually. Practically everybody over the age of 65 receives NZS[3]. Currently the annual fiscal cost of NZS is equivalent to around 4.5% of New Zealand's GDP.

In terms of the World Bank's multi-pillar pension taxonomy of pension systems[4] NZS is a zero-pillar programme providing a basic or social pension funded from general revenues. But it is a much more significant programme than the means-tested or residual zero-pillar programmes typically found in other countries. New Zealand has no mandated contributory pension scheme of pillar 1 or 2 type.

[2] These include short-lived attempts to introduce a compulsory savings scheme in 1975 and again in 1997, the application of modest and indirect targeting via a special superannuitant tax surcharge between 1985 and 1998, and a failed attempt to introduce very tight income testing of New Zealand Superannuation in 1991.

[3] Eligibility is based simply on age and on having at least 10 years of legal residence in New Zealand since age 20, including five years since age 50. The Ministry of Social Development estimates that 94% of New Zealand residents aged 65 and over receive NZS (or the equivalent Veterans Pension).

[4] For example Holzmann and Hinz (2005)

A number of third pillar-type voluntary occupational and personal pension schemes provide a structured means for individuals to top-up their income for retirement should they choose to. Among these schemes KiwiSaver, which was introduced in 2007, is of particular interest for this paper because it was the first government-promoted scheme to offer such significant savings incentives.

2.1 1992: A voluntary, tax-neutral regime for retirement savings

Until 5 years ago retirement savings policy in New Zealand was underpinned by a rationale that had been clearly articulated in the report of a task force set up in the early 1990s to review private saving for retirement[5]. That review recommended against both a compulsory saving scheme and the use of tax incentives or subsidies to achieve a sustainable improvement in long-term national savings. Instead it advocated a tax-neutral, unsubsidized voluntary saving regime supported by a programme of enhanced financial education and information[6], regulation and financial product disclosure, together with a savings ombudsman and dispute resolution service. The future stability and sustainability of the new system was to be supported by a series of six-yearly reviews of the overall retirement income regime by a group drawn from the private and public sectors under an independent Chair.

The 1992 Task Force's view was that the primary focus of the government's public pension programme needed to be on protecting the most vulnerable in society[7]. In other words the government should not be in the business of mandating or directly providing anything above a basic retirement income. Rather, its role was to raise living standards generally by ensuring well-functioning markets and creating the preconditions for economic growth through sound economic, monetary and fiscal policies. It was up to individuals to choose whether and how to save and invest for a higher than basic income in retirement.

> *"…we approach private provision for retirement as ultimately a personal responsibility, within a wider context which includes public provision…while a person may derive part or all of their private retirement income from an employment-based scheme, this does not alter our views on the ultimate responsibility for private provision." Op cit p 23*.

The key recommendations of the Task Force were accepted by all the parliamentary parties of the day[8] and were incorporated in a negotiated Accord on Retirement Income Policies that was signed in August 1993. The explanatory note on the purpose and principles of that political document stated:

---

5 Task Force on Private Provision for Retirement (1992).

6 The Retirement Commission, which promotes retirement savings education and information, was established as a direct consequence of the Task Force's recommendations.

7 At that time the public pension was indirectly income tested via a tax surcharge on superannuitants' other income. The Task force supported extending this arrangement because they feared that the public and political consensus in favour of an adequate level of income support for the genuinely needy would be weakened under universal entitlement (op cit p25).

8 These were the National Party in Government and the Labour and Alliance Parties in Opposition.

"The purpose of the Accord is to achieve consensus on retirement income policies so that people can plan with certainty for and during their retirement. While people should be encouraged to save for their retirement, they should not be compelled by law, or given tax incentives, to do so. Retirement income will continue to be provided in an integrated way from both private savings and from public funds."

The broad political consensus represented by the Accord enjoyed only a relatively short life. Over the ensuing five years, new parties entered Parliament, not all of which were prepared to sign up to the Accord, and the key targeting instrument under the Accord (the highly controversial and politically sensitive New Zealand Superannuitant surcharge) was completely phased out, restoring NZS to a universal flat rate pension.

Despite this setback, the other central features of the Accord – the timetable for raising the age of NZS eligibility to 65 by 2001, the annual indexation formula for NZS[9] and the neutral tax treatment of voluntary private saving- were preserved. These components, together with the restoration of the universal pension, appeared to have achieved broad public approval and acceptance[10].

2.2 2007: The new game – savings incentives

It was not until, motivated by concern at low levels of household saving, the Labour-led Government introduced the KiwiSaver scheme, that the principle of no tax incentives for saving began to be challenged. The government wished to maintain a voluntary approach and drew on the behavioural finance literature to design an opt-out system in place of traditional opt-in schemes. The central idea was that a higher rate of participation would be achieved through "the power of inertia to encourage people to save": automatic enrolment in a savings scheme at the workplace for new employees, with the ability for them to opt out within eight weeks of enrolment.

When KiwiSaver was first announced in the 2005 Budget Speech it was made clear that the fiscal costs of the new policy had to be moderate, with minimal compliance costs for employers and employees. The standard employee contribution rate would be 4% (with the option of 8%), deducted through the tax system and passed on to a private sector fund provider of the employee's choice. Employees who failed to choose were assigned randomly to one of six authorized "default fund" providers. Employers were not required to make any

---

9 The after-tax amount is adjusted by the annual increase in the Consumers Price Index, but may be increased by a further amount to ensure that amount does not drop below a set minimum percentage of an average weekly after-tax earnings measure. Effectively this means that, in a growing real wage economy, NZS is indexed to wages rather than prices.

10 The overwhelming rejection of a compulsory retirement saving scheme proposal in a 1997 public referendum may have served to cement in the new status quo and help remove pension reform from the political stage for the next ten years.

contribution, but could choose to do so. Savings were to be locked in until age 65[11]. The Government would support KiwiSaver financially in three ways:

- meeting the administration cost of collecting contributions via the Inland Revenue Department;
- An upfront contribution of $1000 for each new account
- Negotiating a subsidy on the fees charged by fund providers up to a capped level.

With this modest level of subsidization and a forecast moderate rate of take-up, the scheme was expected to cost the Government $667 million in total over the first three years of the scheme.

But in the period leading up to its enactment the government added significant additional incentives to the KiwiSaver scheme and announced them in the 2007 Budget Speech, barely six weeks before the scheme was due to start. These new incentives were:

- A government funded dollar for dollar "tax credit"[12] on individual contributions up to a maximum of $20 per week;
- Compulsory matching employer contributions of 4% phasing in over four years. The cost of this to employers would be substantially offset by another matching tax credit up to a maximum of $20 per week.

The Minister of Finance, noting that fiscal surpluses were projected, framed his decision as a choice between modest personal tax cuts that might add to demand pressures, or "bolder moves to strengthen KiwiSaver and build greater economic and social strength for the future". Within a year, the global financial crisis would dramatically change the economic and fiscal environment.

Not only did these additional subsidies clearly break the old consensus against the use of incentives for savings, but the fiscal cost of the scheme suddenly became much greater and risked ballooning further as a result of a higher than anticipated take-up of the scheme because of its enhanced attractiveness. Later that same year the Retirement Commission noted that the additional incentives were forecast to increase the 2016/17 cost of the total incentive package to over $2 billion, or 32 times the cost of the incentives originally envisaged in the 2005 Budget. At that stage it would be around one-fifth of the net cost of NZS. The Commission went on to comment:

> *"We have lost the chance to see how well lower incentives (at a lower fiscal cost) would have worked. If the original KiwiSaver had been left as planned to run for*

[11] People saving for a first home deposit were, however, to be permitted to withdraw their savings plus an additional subsidy within 3-5 years. There were also provisions for a person's own contributions to be accessed in cases of severe hardship.

[12] Although this was presented as a tax credit it was actually a subsidy.

some years, then we would have gained some understanding of the effectiveness of the unique KiwiSaver design, including the major innovation of automatic enrolment, but without the generous incentives of KiwiSaver II."
- Retirement Commission (2007) p 55.

Following the change of government in 2008 and in the face of a sharply deteriorating fiscal position following the recession, a series of changes have been made to trim back the costs of the scheme, most recently in this year's Budget (Table 1).

Table 1: Changes to KiwiSaver rules since its enactment

	Introduction July 2007	**December 2008 changes**	**Budget 2011 changes**
	Highly subsidised	Modest cost trimming	Shift more cost to employers
Employee contribution • Default • Other rate choices	 4% 8%	 2% 4% or 8%	 3% (from 2013) 4% or 8%
Employer compulsory contributions	1% from 2008, rising to 4% from 2011	Set at 2%, with no further rise	3% (from 2013)
Employer tax relief on compulsory contributions	Matching Employer Tax Credit (ETC) up to $20 per week	ETC removed; employer contributions up to 2% made tax exempt	Tax free status removed; tax to be paid at employee's marginal tax rate.
Govt contributions • Kick-start on joining • Annual member contribution subsidy • Annual fee subsidy	 $1000 $1:$1 up to $1042 $40	 $1000 $1:$1 up to $1042 None	 $1000 50c:$1 up to $521 None

The effect of the latest set of announced changes has been to shift some of the cost from the government back on to employers and members. However, the emphasis on promoting KiwiSaver as a way to raise overall savings seems to have remained, while the government continues to assure the public that it will not change NZS.

3 Juggling multiple conflicting objectives

The changes made to the KiwiSaver scheme rules in just four years since its inception have been significant. They suggest that there is no broad political consensus on the primary purpose of the scheme, its optimal size or the relative role of individual members, the taxpayer and employers in financing. Arguments for and against the scheme frequently appeal to a number of different considerations.

Sometimes the case for KiwiSaver reform is argued from a macroeconomic perspective. For example, a Savings Working Group (SWG) was set up by the government to stimulate public discussion and understanding on issues of national saving in the New Zealand economy and to recommend improvements to specific saving and saving-related policies. In its final report the SWG called for decisive steps to increase the rate of national saving and lift productivity. It made 11 recommendations specific to the design of KiwiSaver, with a further four options to be considered (Savings Working Group (2011)). Some, but not all, of these suggestions were picked up in the 2011 Budget announcement.

It is worth noting that the objectives of KiwiSaver as set out in its legislation make no reference to national saving, productivity growth or debt reduction goals. Instead they refer to encouraging individuals' long-term savings habits, consumption smoothing and financial independence in retirement.

The SWG's case for change was not based on any concern that low saving rates were causing poverty in old age. They noted that the level of retirement savings appears to be high enough – at least for people over 45 – to avoid an increase in elderly poverty rates.

> *"However, the emphasis here is not so much on looking at whether saving for retirement of different cohorts is adequate at the individual or household level (since this is not a focus for the SWG), but in assessing whether mechanisms to provide retirement income might also be used to lift household and national saving. In effect, we look at whether a second objective – lifting national saving – can be added to the primary objective of providing adequate retirement incomes. It seems likely that any success with respect to this second objective could also have positive consequences for the first objective. That is, it may result in retirement incomes being provided on a more sustainable basis." (Op cit p 73)*

Other commentators argue that KiwiSaver subsidies and universal NZS are poorly targeted from a social point of view and their high and growing fiscal cost risks compromising the important public policy goal of protecting vulnerable people against poverty in their old age.

Clearly, the assessment of whether KiwiSaver and NZS are successful programmes is influenced by different expectations of what they should be seeking to achieve and whether their costs represent good value for money.

The latest 3-yearly independent review of New Zealand's retirement income policies (Retirement Commission (2010)) included an analysis and discussion of the many legitimate objectives that may be of concern when policy is being designed and debated. These are summarized in Table 2. Overarching the concentration on specific policy objectives and the selection of policy instruments is the need for any changes to the system as a whole to be accepted by all stakeholders as both fair and sustainable over an extended period of time.

Table 2 focuses on the attainment of a range of outcomes from retirement income policy. These outcomes are not confined to income flows or wealth accumulation, although these are clearly important for many of the models. They encompass a range of important psychological and social as well as economic outcomes. Outcomes such as high subjective well-being, the absence of social conflict, a sense of community cohesion and support, fulfilling work, skill acquisition, control over one's destiny and avoiding sudden shocks and surprises are all part of the picture alongside the more conventional policy goals of rising material living standards and poverty relief.

Table 2: Multiple retirement income policy objectives and design foci

Model name	Objective or concern	Design focus	NZ historical examples
Voluntary saving	Personal responsibility, choice and control	Financial literacy, financial market regulation, transparency, trust, tax-neutral environment	1992 Todd Task Force and 1993 Multi-party Accord; advocated a non-subsidised, voluntary saving regime.
Income support	Old age poverty and hardship alleviation	Needs-tested income support to enable community participation, not portable outside NZ.	1938 Age Benefit; 1972 Royal Commission on Social Security's measure of hardship
Citizenship dividend	Social inclusion and cohesion	Standard payments and equal entitlement by virtue of general social contribution	1938 Universal Superannuation; 1977 National Superannuation; SuperGold Card for discounts and concessions
Wellbeing	Positive and active ageing	Employment and education opportunities for older people, flexible work; protection against elder abuse	Government Positive Ageing Strategy; absence of work/income test for NZS
Lifetime consumption smoothing	Maintain individual living standards into retirement	A compulsory or highly incentivised saving programme with annuitisation; off-shore portability	1975-76 New Zealand Superannuation Scheme; 1997 Referendum on new compulsory retirement savings scheme (defeated); 2007 version of KiwiSaver
Cohort self-funding	Intergenerational equity	Equal cost-sharing across generations; partial pre-funding or fully self-funded DC scheme or Notional DC.	2001 NZ Superannuation Fund - partial pre-funding of future NZS costs
Risk pooling	Protection against longevity risk	Well-functioning annuities market, inflation proof bonds	Mixed wage/price indexation of NZS standard rates.
Fiscal restraint and investment	Productivity and growth to raise living standards	Limits on government pension spending; raise age of eligibility for NZS; drop wage indexation	1991 fiscal retrenchment package froze NZS rates and raised the eligibility age.

3.1 Initiating policy reforms

Each objective or concern is valid, but at a given time some assume greater importance than others. The retirement income policies operating during periods of relative stability can perhaps be considered a fairly simple combination of instruments that focuses on satisfying the more important concerns of the day and discounts other concerns that are seen as less pressing or would require additional policy instruments and complexity.

Reform initiatives commonly arise when the existing policy package is seen to be failing. Typically this happens when demographic, economic, social and political conditions are changing rapidly. The "failure" may be because

- Policies are no longer achieving the outcomes they were primarily intended to achieve, or
- Objectives and concerns that had not been given much attention are assuming greater importance and existing policy designs are not addressing these adequately.

New Zealand's recent experience with retirement income policy reform initiatives is mixed. Some succeed, in the sense of setting a new balance and direction that is maintained over the course of several years and different administrations. Other initiatives have failed, either by not being implemented or by being substantively reversed within a short period, or by a new administration (for examples see footnote 2).

The frequency of failed initiatives may reflect the structure of incentives under New Zealand's political system. With a three year electoral cycle and no second chamber providing legislative checks and time for mature consideration, it is tempting for an incoming administration to quickly design and pass new legislation, relying on its electoral mandate for public acceptance of the changes after the event. The use of broadly based community consultation, public referenda, commissions of inquiry or bi-partisan groups to advise on new policy is relatively rare.[13]

For these reasons it is difficult to determine, at the time a major new policy is introduced, whether it will enjoy broad public understanding and consent and settle in as a permanent and stable part of the retirement income policy framework.

It appears that introducing KiwiSaver as an adjunct to NZS will eventually be seen as one such successful policy initiative, despite the amount of modification it has had in its first four years. These modifications may be thought of as a progressive clarification of the relative roles to be played by NZS, KiwiSaver and other forms of individual wealth accumulation

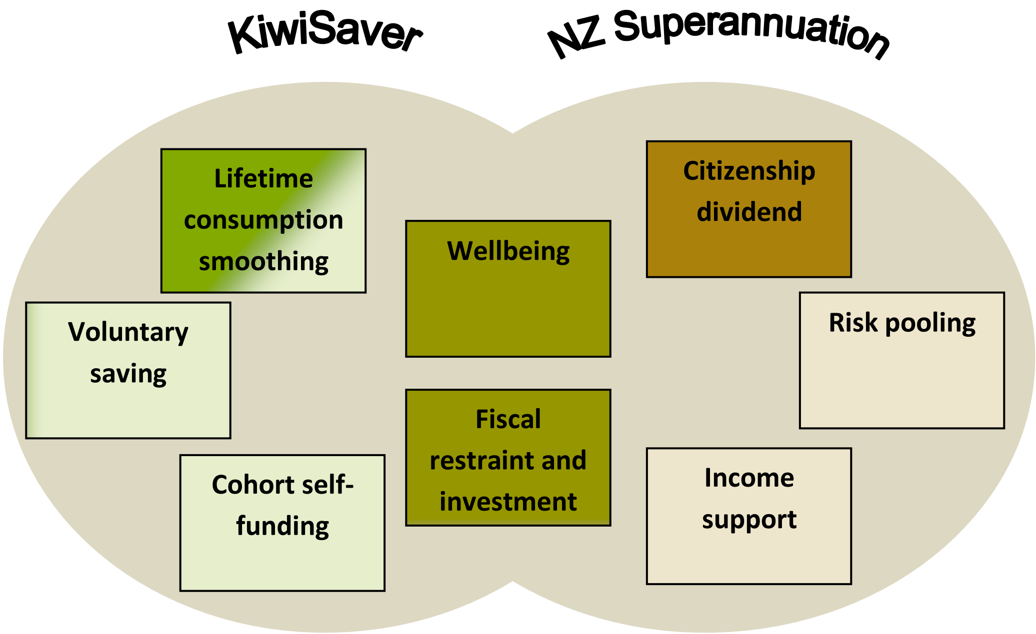
[13] The current government has appointed a number of technical groups to advise on issues such as the reform of capital markets, taxation, welfare and saving, but their terms of reference tend to be constrained, which arguably restricts the extent to which linkages can be made to other related areas of policy.

(including home ownership) and the degree to which long-term saving should receive special attention from the government.

Returning to the eight objectives listed in Table 2, the 2010 Review of Retirement Income Policy noted that NZS, as the flagship policy, addresses many, but not all of those objectives:

> *The introduction of KiwiSaver in 2007 addresses a number of the objectives that are beyond the primary focus of NZS. For this reason, KiwiSaver can be seen as a useful complement to NZS since, in combination they help address all eight policy objectives." (Op cit p 94)*

Chart 1: How KiwiSaver and NZS address different retirement income policy concerns



Source: From Retirement Commission (2010) Chart 5.7

Chart 1 illustrates the argument. Each policy helps address a different set of concerns while, arguably, both promote wellbeing and have some characteristics that help promote fiscal restraint and investment. The ways in which NZS and KiwiSaver help satisfy some policy concerns (and not others) are discussed in the following two sub-sections.

3.2 New Zealand Superannuation: objectives and strengths

The concerns of "citizenship dividend" and "income support" in New Zealand can be traced back more than 100 years to the Old Age Pensions Act of 1898, which stated:

> *"It is equitable that deserving persons who during the prime of their life have helped to bear the public burdens of the colony by the payment of taxes, and to open up the resources by their labour and skill, should receive from the colony a pension in their old age."*

Several elements in the rationale for an old-age pension – merit, contribution, belonging and need – were alluded to in the 1898 legislation[14]. Forty years later the 1938 the introduction of a "universal superannuation" entitlement that was distinct from income-tested Age Benefit served to explicitly separate the elements of merit and contribution from those of belonging and need. This matching of different concerns with different policy objectives has twice been confirmed by commissions of inquiry, in 1972 and 1988, as a sensible way to proceed. Both commissions argued that, provided there was an income-tested age benefit sufficient to protect against poverty and allow older people to participate with dignity, then a universal payment in old age that recognizes merit and general contribution (i.e. a citizenship dividend) does not necessarily need to be set at the same level.[15]

Instead of continuing with a dual system to address the two concerns – citizenship dividend and income support – New Zealand has since 1977, with brief exceptions, adopted a single policy instrument to deal with both. NZS has been presented as recognition of older people's past contributions as citizens irrespective of their current financial needs, while at the same time being set high enough to provide a basic standard of living for someone with no other income.

This combination of universal entitlement and a relatively high payment rate has created concern that NZS imposes too great a burden on taxpayers and is fiscally unsustainable. Chart 2 shows the potential for the cost of NZS to escalate unless measures are taken to adjust some of the entitlements from time to time.

The annual cost of the universal pension was 6-7% of GDP in the decade following its introduction but this was under considerable upward pressure and was maintained only by reducing its amount relative to wages and applying a moderate income test via a special superannuitant surcharge[16].

In 1991 the incoming National government embarked on an extensive programme of policy reforms that included measures to substantially reduce government spending on a range of social welfare and pension programmes. As a result, over the following decade annual spending on NZS was reduced substantially to around 4–5% of GDP, mainly through a rise in

---

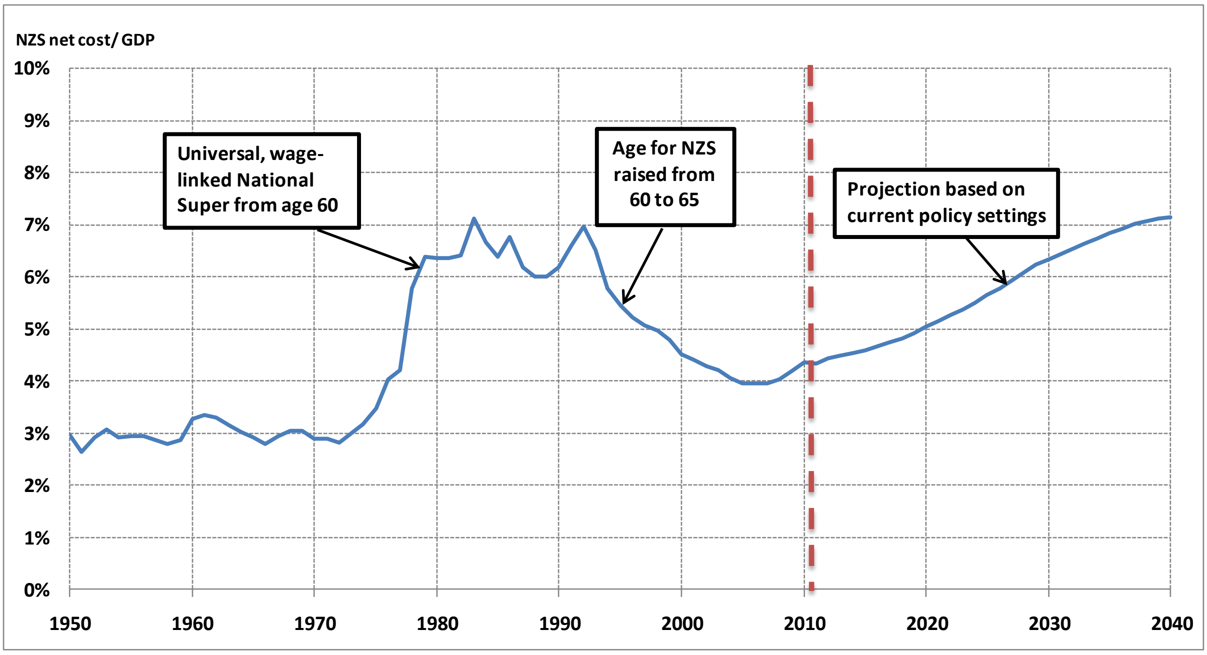
14 Royal Commission on Social Policy (1988), Volume III, Part 2, p 498.

15 The 1972 Royal Commission noted that although the gross payment rates of age benefit and universal superannuation were the same, the later was taxable, giving a lower amount in the hand. They supported retaining rough parity but only as long as the adequacy of age benefit and other benefits were not thereby prejudiced. The 1988 Commission went much further, recommending that the rate of universal superannuation should be set at half the rate of an income-tested benefit.

16 This surcharge applied at varying rates between 1985 and 1998 and covered between 20 and 30% of NZS recipients. In effect NZS was withdrawn at a taper rate of between 20 and 25% against other income in excess of a relatively low exemption threshold. The surcharge reduced the net cost of the public pension by around $300 million per year.

the NZS eligibility age from 60 to 65. However that adjustment has served mainly to delay the onset of one of the real drivers of future cost: the post-WW2 “baby boom” generation who will start qualifying in increasing numbers over the coming 20 years. Chart 2 suggests that future costs could increase to more than 7% of GDP over the coming decades.

Chart 2: Variations in public pension cost



Source: NZ Treasury projections and Retirement Commission (2010)

Although financing such an expansion will be a challenge, it needs to be recognised that today New Zealand is better placed than many other countries. OECD average pension expenditure is forecast to grow from 8.4% to 11.4% in 2050.

Notwithstanding the challenge of keeping it affordable, NZS has a number of design features that are attractive.

- It is extremely low cost in an administrative sense because it is funded out of general revenue, requires no individual contribution records to be kept and places no compliance costs on employers. There is no cost in administering an income test or monitoring changes in financial or employment circumstances;
- The absence of an employment or income test means that there are no built-in penalties from earning additional income beyond NZS eligibility age. The present value of future pension wealth embodied in NZS is unaffected by when a worker chooses to retire. This feature helps to explain why New Zealand has one of the highest rates of labour force participation of older people in the OECD (Hurnard (2005)).
- Knowing well in advance how much NZS will be worth proves a secure basis for people to judge how much additional income they need to plan for in order to achieve their own desired standard of living in retirement.

- Standard amounts for each person signals fairness and promotes social cohesion.
- NZS covers longevity risk efficiently by providing a known, fully indexed gender-neutral annuity.

3.3 The KiwiSaver scheme: objectives and strengths

KiwiSaver brings greater focus to those objectives and concerns that are not adequately dealt with by NZS. Chart 1 suggests that these concerns are to do with lifetime consumption smoothing, valuing voluntary saving and the problem of unequal cost-sharing across different generations.

The standard life-cycle model of saving treats saving and dis-saving as the means towards the objective of smoothing consumption, since maintaining a uniform rate of consumption is deemed to be the way rational decision makers can maximize the utility of their consumption over a person's expected lifetime. An indication of the success of this process is a net pension replacement rate[17] that is around 70% across a range of earnings profiles[18].

There is considerable variation in net pension replacement rates, both across countries and according to relative earnings levels. A comparison of New Zealand with the OECD average (Table 3) shows that the replacement rate provided by NZS is comparable with OECD levels only for people with a low level of pre-retirement earnings. For those with earnings 50% higher than the national average, the replacement rate in New Zealand (29.4%) is less than half the OECD average for such earners.

Table 3: Net pension replacement rates by pre-retirement earnings

	50% of average earnings	Median earnings	Average earnings	150% of average earnings
New Zealand	79.4%	49.6%	41.5%	29.4%
OECD	82.8%	72.0%	68.8%	63.4%

Source: OECD (2011) p125

This result follows directly from its structure. The level of NZS equates to 33% - 43%[19] of national average after-tax ordinary-time weekly earnings. This can be thought of as the net pension replacement rate for someone on the average wage, but of course the universal flat-

17 The net pension replacement rate is defined in OECD (2011) as the individual net pension entitlement divided by net pre-retirement earnings, taking account of personal income taxes and social security contributions paid by workers and pensioners.

18 This figure is only an indicative judgment of how much income is required to preserve utility. Factors to consider include working expenses, changes in spending patterns after retirement and whether people have additional sources of retirement income besides their pension.

19 This variation depends on a person's partnership status and whether he/she lives alone or with other adults. It is independent of the individual's income or employment status.

rate structure of NZS translates this into a higher replacement rate for an individual with low pre-retirement earnings and a lower replacement rate for someone on higher earnings.

In this context KiwiSaver can be seen as a future means of increasing the pension replacement rates of New Zealand's higher income earners towards the OECD average, thereby contributing to the objective of lifetime consumption smoothing for these individuals.

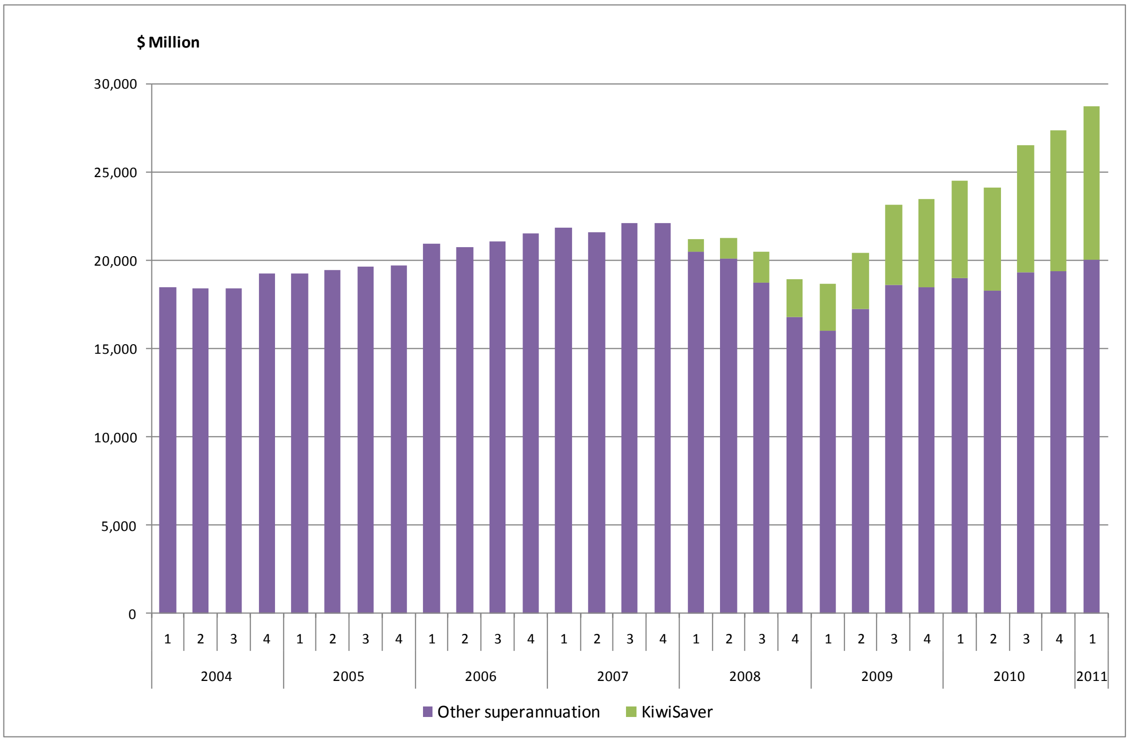
This is clearly a central purpose of KiwiSaver, as set out in the KiwiSaver Act 2006:

> *"To encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement…"*

It is too early to judge whether KiwiSaver will have a major impact on future pension replacement rates or be a cost-effective instrument for achieving life-time consumption smoothing. A number of concerns have been raised:

- There is some indicative evidence (for example Chart 3) that KiwiSaver has diverted some savings that would otherwise have been placed in other forms of superannuation. If this diversion is sizeable and has been motivated by the subsidies provided by the government, this raises questions about the public interest value of such subsidies.

Chart 3: Total balances in KiwiSaver and other superannuation funds



Source: Reserve Bank and New Zealand Managed Funds Survey

- Given the basic annuity provided by NZS and a range of other saving options, many of the people who could be assumed to be automatically enrolled in KiwiSaver may have already been making adequate provision for their retirement (see for example the earlier modelling work of Scobie et al (2004)).

- Currently there is no policy requiring KiwiSaver balances to be converted into annuities when savers reach age 65, or at any future time. Members are free to choose whether to carry on accumulating, draw down balances at a rate that suits them or to splurge. In fact, the annuities market in New Zealand is almost non-existent. It is therefore highly unlikely that any target pension replacement rate would be realised in practice.

A second objective associated with KiwiSaver's role as shown in Chart 2 is voluntary saving. The concern to improve long-term saving through non-compulsory schemes sees voluntary schemes as a way in which people can take personal responsibility for managing their own financial affairs by exercising choice and control. Compulsion is seen as watering down this responsibility. By using automatic enrolment with an opt-out provision, KiwiSaver has succeeded in creating a large number of new savers while still allowing individual choice.

The success of KiwiSaver in stimulating members to increased levels of confidence, financial literacy, better general budget management skills and informed investment decision-making will depend to a large extent on the quality of the financial advice, fund reporting, education and information resources made available to them. New regulatory initiatives have recently been taken to improve some of these areas.

A third objective that KiwiSaver might be said to help meet is more equal pension cost-sharing across generations. This objective fails to be met under NZS as a PAYG system, particularly when there are big differences in the size of cohorts. The taxes required to pay today's NZS entitlements (and provide other services to the 65-plus age group) are quite unrelated to the amount of tax that today's recipients actually contributed.

A defined contribution pension scheme should theoretically ensure that the benefits it pays are directly linked to the contributions of individual members and there is no cross-subsidy. In the case of KiwiSaver, however, the injection of additional funds from the government to individual accounts has the effect of transferring income among different age groups of taxpayers and members.

Despite this, KiwiSaver can claim to offer some movement towards improving intergenerational equity.

4 Two generations; two messages

Section 3 made a case for regarding the combination of NZS and KiwiSaver as reasonably effective in addressing all of the concerns that were listed in Table 2 because each focused on its own subset of concerns, as illustrated in Chart 1.

The real problem is related to the longer-term stability and sustainability of the present combination of policies.

> *"KiwiSaver and NZS are complementary policies in terms of meeting a diverse range of policy objectives, so offer a simple solution to the overall design challenge. Unfortunately they are also both serious competitors for funding and public support from a range of stakeholders. For this reason, in combination they add to the overall pressure on financial affordability and political sustainability of the retirement income system." – Retirement Commission (2010) p 96*

Concerns have been raised by several independent commentators about the long-term fiscal sustainability of NZS in conjunction with the subsidisation of the KiwiSaver scheme. The Retirement Commission's 2010 Review went to some lengths to set out the case on demographic and fiscal grounds for gradual and moderate changes in NZS via the indexation formula and the age of eligibility, starting from 2020, while suspending judgment on the merits of KiwiSaver until a thorough evaluation of it is completed in 2013.

The April 2011 OECD Survey of New Zealand also argued on fiscal grounds that NZS entitlements should be trimmed in a similar way. In addition, the OECD recommended reforming KiwiSaver by removing subsidies, especially to high income earners who are most likely to have shifted their savings from other sources, and extending the automatic enrolment programme.

The question arises: how will the competition between NZS and KiwiSaver for government (i.e. taxpayer) funding eventually be resolved, given that each policy addresses a different set of objectives? This section attempts to cast some light on this question by focusing on two aspects of the design problem that have already been alluded to:

- Insecurity – the risk that basic pension entitlements may have to be trimmed or targeted because of the projected rising fiscal cost of NZS payments and KiwiSaver subsidies in combination.

- Savings inadequacy – the risk that the KiwiSaver scheme will fail to generate enough assets to satisfy the living standards expectations of future retirees and the investment needs of the economy.

These are essentially economic and political problems because they require the balancing of demands and expectations of two broadly different groups – younger workers and older retirees - in an environment of uncertainty, mistrust and constrained resources.

These two groups tend to see the issue of retirement income policy from quite different perspectives. They are at different life-stages, with different life experiences, values and expectations and facing a different set of options.

4.1 Older people: concerns and messages

For those approaching or at the stage of retirement, income security and a “no surprises” approach are important because, once they have left the paid workforce permanently, many will have restricted options to adapt to any sudden rule changes or unexpected expenses.

The great majority of the current generation of retired New Zealanders are very dependent on NZS and other government support. Two-fifths of those aged 65 and over have little or no other income, while a further fifth receive on average around 20% of their income from other sources[20].

Despite this, older people score higher in terms of material living standards and subjective wellbeing than the total adult population and the overall poverty rate[21] among older people is remarkably low (9% compared with 15% for the total population and 22% among children).

Within this broad picture, however, there are significant pockets of hardship and vulnerability among the elderly. Mortgage-free home ownership is an important contributory factor in helping retired people manage on a basic pension and those who are living in rental accommodation show up as having much higher incidence of poverty (Table 4).

Table 4: Poverty rates of people aged 65+ by tenure, 2009

Tenure of household	Share of each tenure type	Poverty rate
Owned, or in a family trust, no mortgage payments	79%	3%
Owned, or in a family trust, with mortgage payments	11%	20%
Paying rent (private, state or local authority housing)	10%	47%
All aged 65 and over	100%	9%

.
Source: Perry (2010) Table 2

As discussed in Section 2, the dual-purpose universal pension has been New Zealand’s flagship policy for more than 30 years, along with its justification as a citizenship dividend and protection against old age poverty. Many retirees and older workers therefore regard

20 Retirement Commission (2010), p 65.

21 In this section and in Table 4 the poverty rate is measured as the proportion of individuals who live in households with an equivalised income, after deducting housing costs, which is less than 60% of the median.

NZS in its current form as part of an implicit social contract[22] and would see any significant government initiatives to change NZS rules and entitlements as an unfair breaking of that contract. The major concern publicly expressed by elder support and lobby groups is to ensure that NZS entitlements are preserved and, if possible, enhanced. KiwiSaver is an almost irrelevant consideration for older people[23].

Those who are most vulnerable are particularly concerned at the prospect of cuts to other forms of elder support programmes, such as disability and accommodation assistance, public health services and rest-home care subsidies.

In the face of such strong feelings and despite growing pressure from some economic commentators, both the major political parties have stated publicly that they support the continuation of NZS in its current form, with no income testing or change in the payment formula or age of eligibility, for the foreseeable future. Most notably, the current Prime Minister has staked his political credibility on not changing the system:

> *"National will maintain Super at 66% of the average wage from the age of 65, or I will resign" - Rt. Hon John Key, Prime Minister, on the National Party's official website.*

The reference to "…Super at 66% of the average wage…" illustrates the tendency of political parties to use attractive short-hand references when articulating their positions. Until it was increased a few years ago, the benchmark amount paid to a married/partnered **couple** was guaranteed to be no less than 65% of the average wage. With the age of NZS eligibility also set at 65 years, some media, parties and lobbyists were fond of using a snappy slogan that summed up the pension entitlement commitment and conveyed a sense of balance and fairness:

"*Sixty-five at sixty-five*".

Referring casually to the amount of NZS paid to two individuals rather than one, can convey the false impression that, at retirement, the average worker can expect NZS to replace about two-thirds of his or her earnings, whereas the reality (as was seen in Table 3) is that it would replace much less than this.

This can spell trouble for people who have misinterpreted the slogan's promise and assumed that very little additional saving is required to achieve a comfortable retirement, in particular, those who experience separation or death of a spouse.

[22] Hurnard (2007) p 15-16 attempts to describe the attitudes and values of New Zealanders that go to make up an implicit social contract with the government on retirement income policies.

[23] KiwiSaver membership was not open to people who were aged 65 or over at the time the scheme was introduced.

4.2 Younger workers:- concerns and messages

Young adults face having to make financial decisions affecting their futures in an environment of uncertainty, mistrust and confusion.

- **Uncertainty** relates to their own future employment and earnings prospects and the timing of family formation and first home purchase[24].
- **Mistrust** of the finance sector generally has risen in the wake of a series of finance company failures since 2006 and other more recent economic setbacks. A consumer financial confidence survey earlier this year[25] revealed that fund managers, financial advisers and share brokers are still poorly perceived relative to banks. Following February's major after-shock in Christchurch, confidence in insurance companies has also declined sharply.
- **Confusion** arises when people hear mixed messages about what they should do to achieve better outcomes for themselves and their families. This is especially problematic when they lack access to factual information, the financial literacy to sort out good advice from poor advice and the confidence to initiate action.

The general response to the 2008/09 recession has been a significant flight to security back to bank deposits and a much more cautious approach to borrowing.

KiwiSaver was launched at a time when people were seeking greater security and its take-up has grown rapidly. The concern of this paper is that the absence of a consistent signal about the future roles of NZS, KiwiSaver and other components of retirement income policy is exacerbating the uncertainty, mistrust and confusion of New Zealanders with regard to how much they need to save for their retirement.

The ANZ-Retirement Commission Financial Knowledge Survey 2009 reported that most respondents believed that NZS alone would not provide them with the sort of standard of living they would like to have in their retirement and they expected to have additional income for this purpose. A key motivator in individuals' decisions to join KiwiSaver was a desire to secure their retirement income and have more than the basic pension[26].

What is unclear, however, is how well informed people are about the practical implications of these aspirations. Many people have no idea of the present level of the NZS pension[27], let alone how much their KiwiSaver balance might be worth at the time of their retirement.

---

[24] The proportion of 25–29 year olds who own or party own their residence fell 13% between 2001 and 2006. Among 30–34 year olds the decline was 9%. (Source NZ Census analysis by age of "tenure holder")

[25] RaboDirect Financial Confidence Index, March 2011

[26] Reported in Retirement Commission (2010) p 93.

[27] A recent Nielsen survey done for the Retirement Commission found that more than 80% of people aged 45-59 were unable to correctly identify the rate of NZS from a prompted list of ranges.

Over and above the arithmetical challenge of calculating an individual's future retirement income under a host of technical and forecasting assumptions, there is a degree of scepticism that NZS in its current form will still be available when the next generation reaches retirement age.

The current government's commitment not to change the existing policy settings for NZS has, arguably, transferred pressure on to some future administration to make the adjustments necessary to keep it affordable. This may in turn have increased uncertainty among younger people about how much they need to save for a comfortable retirement. More than half of people aged 20-25 years now have a KiwiSaver account, but there is a clear split of opinion over whether even this will be sufficient to give them an adequate income in their retirement[28].

Recent changes to the KiwiSaver rules must also create doubt as to when contribution rates, subsidies and other conditions will finally settle, if ever. People may naturally resist committing a higher percentage of their current income to be locked in until age 65. In the absence of compulsory annuitisation, savers approaching retirement will also need to devise a KiwiSaver decumulation strategy that, in combination with NZS generates a balance of steady income and precautionary funds for unforeseen emergencies. This may, however, be a less critical factor in New Zealand compared with other countries because of the relatively greater significance of NZS as an annuity[29].

A further source of uncertainty lies in the declining rates of home ownership among younger New Zealanders mentioned earlier. Owning a house is viewed as important for the wellbeing of retired people. Both the quantum of saving and its allocation to home equity or other financial assets are key decisions to be made and require a considerable degree of financial literacy or guidance from a trusted adviser.

Adding to the potential confusion for younger savers will be the marketing activities of the financial services sector (both savings product providers and lenders) and sellers of consumer goods.

Assessing the situation facing younger workers, the 2010 Report on Retirement Income Policy commented:

> *"The message for younger people that KiwiSaver will give extra income in retirement is reassuring but unless it is backed up by good financial education and advice it risks confusion and complacency… It is tempting … for a young person to believe that someone else (i.e. the government or their KiwiSaver provider) is taking responsibility for their long-term financial security for them" – Retirement Commission (2010) p 94*

[28] Colmar Brunton (2009) reported a clear split of opinion in responses to the statement "people with KiwiSaver will have an adequate retirement income", with 21% agreeing, 32% disagreeing, 36% neutral and 11% unsure.

[29] Hurnard (2007)

This attitude may also be prevalent among older workers. A recent survey reported that 42% of people aged 45-59 had not started to financially plan for their retirement by working out how much money they would need to have saved by the time they retire[30].

Furthermore, recent research found that, unlike the experience of several other OECD countries, New Zealand shows no statistically significant link between higher levels of financial literacy and the likelihood of thinking about financial planning for retirement[31]. The authors speculate that one reason could be that New Zealand's public pension system already provides a considerable degree of income security, thus reducing people's need to make investment decisions or manage their own pension plans, although this could change in the future.

5 Drawing the threads together

This final section offers some suggestions on how New Zealand's pension system design and messaging needs to be improved to avoid a future period of instability, "crisis management" and the risk of later policy reversals.

It is tempting to include the consideration of long-term pension system design alongside today's more pressing government concerns, such as earthquake recovery planning, fiscal consolidation and the search for improved economic performance. Indeed, few would deny that there are important linkages between them and ideally they should all be considered together, with the responses to each policy area tied back to a broad and coherent strategy so that they all work in consort.

Nevertheless, some caution needs to be exercised because of the different time frames involved. As discussed in Section 3, the system appears to be basically sound and enjoys broad public support. There is a risk that, by linking pension reform too closely with the need to solve more immediate economic problems, the case for such reform is justified and presented as an urgent fiscal imperative rather than being a carefully planned and communicated investment in long-term stability and social protection.

This is not to argue for delaying action to improve the operation and sustainability of retirement income policy. There are several steps that are currently being taken to improve the financial literacy of savers, consumer protection and the regulation of financial markets and financial advisers. The point is that future intentions to alter any pension rules or entitlements need to be more clearly signalled and well in advance so that people have time to consider, propose modifications and absorb the implications without being presented with a fait accompli.

30 Neilsen survey of 400 New Zealanders aged 45-59.
31 Crossan et al (2011)

Pension policy potentially affects the financial wellbeing of everyone, but in several different ways depending on their gender, life-stage, earnings potential, wealth and so on. It can also be a matter of considerable psychological and social significance, affecting individual employment, saving and voting decisions in some cases.

To date, the policy pronouncements of most political parties appear to have been aimed at assuring older people that their NZS entitlements will not be changed and are guaranteed for the foreseeable future. While the motivation for providing this assurance is clear, indirectly it risks increasing the uncertainty and scepticism of younger people who are trying to make decisions about their own long-term retirement savings.

The importance of saving is constantly being stressed, but it is often unclear whether the concern is with national saving (which includes public sector deficit reduction) or personal saving for retirement. At the same time, the financial incentives for voluntary long-term saving continue to be changed, along with the mix of responsibilities for making contributions to KiwiSaver.

These mixed messages serve to highlight the tension between the two concerns that were introduced in Section 4 - insecurity and savings inadequacy – and the different generations for whom they are most relevant.

> *"Public statements regarding the future of NZS risk sending mixed messages because they are aimed at two distinct audiences: those who are at or near retirement age who seek reassurance that their entitlements are safe, and younger people who wish to know how much they need to save for their retirement" – Retirement Commission (2010) p 94*

The aging of the population and challenges to New Zealand's future growth prospects and economic management all suggest that retirement income policies will be revisited, in some form or other, within the coming decade. It is impossible today to predict the outcome of the future public debates over whether to modify the present system or move to another system.

This paper has painted a picture of retirement income policy at a given time reflecting a public consensus that assigns greater importance to some objectives and concerns than others. It sees the mix of policy objectives and concerns being re-weighted and re-evaluated from time to time in light of changing social values, economic conditions and the emerging life experiences of each generation as it ages.

Based on New Zealand's history with retirement income policy experiments and the nature of recent national and international debates, one can envisage (at least) three ways in which policy might evolve:

A. Convert KiwiSaver into a compulsory saving scheme that would eventually phase out NZS

B. Return NZS to a dual system: an income-tested age benefit with a smaller universal pension available at a higher age

C. Continue universal NZS broadly as it is, but with a somewhat higher eligibility age and lower indexation, a targeted supplementary assistance programme for need, plus voluntary KiwiSaver, but with few incentives.

Whichever new direction eventuates, it is likely to have resulted from a process of public debate and analysis that reflected the concerns of the day. In terms of Table 2, direction A could be said to emphasise cohort self-funding and lifetime consumption smoothing, direction B emphasises income support, while direction C is closest to the status quo and emphasises the citizenship dividend, risk pooling and income support.

Solution C is essentially that proposed in the 2010 review of retirement income policy.

References

Colmar Brunton Research (2009), *ANZ/Retirement Commission Survey of Financial Knowledge, 2009* , Wellington

Crossan, Diana, David Feslier and Roger Hurnard (2011), Financial Literacy and Retirement Planning in New Zealand, (forthcoming)

Holzmann, Robert, and Richard Hinz (2005), *Old-Age Income Support in the Twenty-first Century: An International Perspective on Pension Systems and Reform*. World Bank

Hurnard, Roger (2005), *The effect of New Zealand Superannuation eligibility age on the labour force participation of older people*, New Zealand Treasury Working Paper 05/09

Hurnard, Roger (2007), *Managing assets and income in retirement*, An issues paper prepared for the Retirement Commission, May 2007, available at http://www.retirement.org.nz/node/187

New Zealand Government (1997), *You and your retirement savings: the proposed compulsory Retirement Savings Scheme*, Wellington ISBN 0-478-10638-6

OECD (2011), *Pensions at a Glance, 2011: Retirement Income Systems in OECD and G20 Countries*, OECD Publishing

Perry, Bryan (2010), *The Material Wellbeing of Older New Zealanders: background paper prepared for the Retirement Commission's 2010 Review*, Ministry of Social Development, Wellington, available at http://www.retirement.org.nz/files/retirement-files/RIR/2010Review/2010-review-background-paper-wellbeing-of-older-people.pdf

Retirement Commission (2007), *2007 Review of Retirement Income Policy*, Retirement Commission, Wellington

Retirement Commission (2010), *2010 Review of Retirement Income Policy*, Retirement Commission, Wellington, available at www.retirement.org.nz/retirement-income-research/policy-review/2010-review/2010-review-report

Royal Commission of Inquiry (1972), *Social Security in New Zealand*, Report March 1972, Government Printer Wellington

Royal Commission on Social Policy (1988), *Report of the Royal Commission on Social Policy: The April Report*, Government Printer, Wellington, April 1988

Savings Working Group (2011), *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity*, Savings Working Group Final Report to the Minister of Finance, January 2011, New Zealand Government, Wellington

Scobie, Grant, John Gibson and Trinh Le (2004), *Saving for Retirement: New Evidence for New Zealand*, New Zealand Treasury Working Paper 04/12

Task Force on Private Provision for Retirement (1992), *Private Provision for Retirement: The Way Forward*. Final Report of the Task Force, Chair: Jeff Todd, Wellington, December 1992