Retirement Income Policy in New Zealand: Lessons for Australia

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LIKE other OECD countries, New Zealand has an ageing population, with serious consequences for the future financing of retirement incomes. Unlike other OECD countries, however, New Zealand has chosen not to make saving for retirement compulsory, not to fund it through earmarked taxes, and not to encourage it with tax incentives. Are these choices wise?

New Zealand's Current Policies

New Zealand Superannuation. New Zealand provides a state pension, New Zealand Superannuation (NZS). Like Australia's age pension, it is financed on a pay-as-you-go basis from general revenue; unlike the Australian pension, it is not means-tested. It is generally available to people who have been resident in the country for at least ten years at the time of application

The age of eligibility (which is the same for men and women) is in the process of being raised from age 60 to age 65 over a nine-year transition period that ends in 2001. NZS is indexed annually to the movement in the CPI. At the time of this CPI adjustment, if the post-tax amount of NZS paid to a couple lies outside a 'wage-band' of between 60 per cent and 72.5 per cent of after-tax ordinary-time average weekly earnings, it is adjusted to bring it within the range. This adjustment ensures that NZS maintains a fair relationship with incomes of people in the paid labour force.

Private provision for retirement. The provision of private income for retirement is entirely voluntary in New Zealand. Savings of all kinds are regarded as potential savings for retirement. The main policy emphasis is to ensure that the financial sector is competitive and efficient and that consumers are well-informed about savings and related issues. It is assumed that this will result in the strongest possible private savings environment, at minimal economic cost.

New Zealand is unique in treating savings in a tax-neutral manner. This approach was adopted in 1988 in the context of an overall tax reform programme

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designed to make the entire tax system more efficient by broadening tax bases and lowering tax rates (New Zealand Government, 1988). Income tax is levied comprehensively on the income from which savings are made and on the earnings of those savings, but withdrawals of savings are tax-exempt. By contrast, Australia taxes superannuation at every stage of the saving process, but at reduced rates.

Neutral tax treatment of all forms of savings has been difficult to achieve in practice, for mainly administrative reasons (Periodic Report Group, 1997:60-4). Nevertheless, New Zealand has one of the world's least distorting and simplest tax systems.

Demographic Change

While the total New Zealand population is not forecast to grow appreciably by the mid-21st century, the average age is likely to increase rapidly.

Other developed countries commonly show earlier and more marked ageing of their populations than New Zealand (Table 1). New Zealand is in a slightly better position than even Australia, which also compares favourably with OECD trends.

**Table 1: Percentage of elderly population and dependency ratio:
New Zealand and selected countries, 1950-2050**

Year	NZ	Australia	Canada	Japan	Sweden	UK	USA
<i>Percentage of population aged 65+</i>							
1950	9.0	8.1	7.7	4.9	10.3	10.7	8.1
1970	8.5	8.3	7.9	7.1	13.7	12.9	9.8
1990	11.1	11.2	11.2	12.0	17.8	15.7	12.5
2010	12.0	12.6	13.3	20.5	17.9	15.7	12.9
2030	18.0	18.9	21.0	26.1	21.9	20.9	19.6
2050	20.3	22.4	21.7	30.2	22.3	22.6	20.8
<i>Elderly dependency ratio (aged 65+/aged 15-64)</i>							
1950	0.15	0.12	0.12	0.08	0.16	0.16	0.13
1970	0.14	0.13	0.13	0.10	0.21	0.21	0.16
1990	0.17	0.17	0.17	0.17	0.28	0.24	0.19
2010	0.18	0.19	0.20	0.32	0.28	0.24	0.19
2030	0.29	0.31	0.35	0.44	0.37	0.34	0.32
2050	0.33	0.38	0.36	0.56	0.37	0.38	0.34

Source: United Nations, *World Population Projections* (revised ed.), New York, 1994.

NZS Expenditure Projections

Based on projections by the New Zealand Treasury (Periodic Report Group, 1997), in the absence of any policy change NZS will more than double its share of GDP over the next 50 years from 5 per cent to 11 per cent (or from 4 per cent to 9 per cent in net terms). Many OECD countries already spend nearly 10 per cent of GDP on their public pensions; in Japan, Germany, France and Italy, government pension expenditures are projected to rise to between 14 per cent and 20 per cent

of GDP in the first few decades of the 21st century (OECD, 1997:38-40). New Zealand is thus relatively well placed in terms of projected expenditure on public pensions. Australia is in an even stronger position, with expenditure on public pensions expected to be only about half of that for New Zealand over the period to 2050 (OECD, 1997:38-9). However, NZS accounts for less than half of the increase in projected ageing-related government expenditure, which also includes general health expenditure, aged and long-term care and disability services (Periodic Report Group, 1997a). According to the NZIER (1997:15), financing future government spending, including the costs of an ageing population, will require tax revenues to rise to nearly 40 per cent of GDP by 2050. This compares with the historical peak of just over 35 per cent of GDP reached in 1990 and an average of slightly above 30 per cent over the past 25 years. Yet a rise to 40 per cent would not necessarily represent a crisis: many OECD countries already have tax burdens at levels beyond 40 per cent of GDP.¹

That said, like all OECD countries New Zealand needs to compete with low-tax countries, such as those in Asia. As well, considerable uncertainty surrounds projections over a 50-year period.

Financing Future NZS Costs

If current arrangements remain unchanged, the tax burden imposed by expenditure on NZS could constrain the growth of the economy. The options for reducing future expenditure on NZS comprise raising the age of eligibility for NZS beyond age 65; changing the indexation formula for NZS; and converting NZS from a universal to a targeted benefit.

The Periodic Report Group's (1997) modelling indicated that raising the age of eligibility and targeting the benefit would allow for a fiscally sound response to the economic changes that will occur over the coming 50 years, without compromising the assurance of an adequate retirement income for all New Zealanders. It also concluded that, if the voluntary regime delivered adequate retirement incomes for the population at reasonable fiscal cost, then compulsion should be rejected, since the benefits of compulsion in terms of retirement income or national savings outcomes would not outweigh the costs of a compulsory regime (this is discussed in detail below).

In contrast, Australia undertook no modelling before introducing compulsory superannuation. Yet the OECD (1997:38-9) projects Australia's share of GDP on expenditure on age pensions to be about half that for New Zealand.

Compulsion versus Voluntary Provision

In September 1997, New Zealanders voting in a referendum rejected overwhelm-

¹In 1995, Denmark, Sweden, Belgium, Finland, France, the Netherlands, Luxembourg, Greece, Austria and Norway all had tax/GDP ratios above 40 per cent. New Zealand's comparative position would be different if non-OECD countries were included.

ingly a proposed compulsory and fully-funded private Retirement Saving Scheme (RSS). As well as doubts about the need to add the scheme to the existing savings mechanisms, a multitude of other reasons played a part in its rejection.² The main issues raised by compulsion are summarised below.

Should governments decide how and when people save? By design, compulsory schemes restructure the choices made by individuals to ensure that they save more for retirement in a particular form than otherwise would be the case. But is it reasonable to assume that governments know better than their citizens about desirable living standards in retirement?

The view that private choices about saving will be inferior to government induced choices is not widely accepted in New Zealand. Jenny Shipley, then Minister for Social Welfare, now Prime Minister, stated on *Sky News* on 17 August 1997: 'it is not the role of the Crown to tell people how to manage their net worth. ... New Zealanders are quite able, given the choice, to make decisions about what to do with the money that will fund them in retirement without laws or compulsion or limited frames of investment'.

Is compulsion necessary to prevent myopia and free riding? The main economic arguments cited to justify compulsion are that people are either myopic or will choose to 'free ride' on the state. These arguments were probably in the mind of John Dawkins, Australia's Treasurer when compulsion was introduced there, when he said: '... like most other people, Australians generally undervalue savings for their own future retirement. Private voluntary savings cannot be relied upon to provide adequate retirement security for most Australians' (Dawkins (1992:1).

In New Zealand, it is generally held that myopia, to the extent that it exists, is best addressed by attacking the problem directly through information and education.

As for 'free riding', it is helpful to divide the population into three broad groups:

1. those who have limited capacity to save and will be reliant on public provision in retirement;
2. those who could save, but choose instead to rely on NZS in retirement (the 'free riders'); and
3. those who save privately, even with NZS.

²The referendum was held at the behest of the New Zealand First Party that had campaigned for a compulsory savings scheme prior to the 1996 election and subsequently became the National Party's partner in a coalition government. Over 80 per cent of the population voted; of those, over 90 per cent voted against the compulsory scheme. Exit polls suggested that only about 12 per cent of those who voted against the scheme were influenced by its close association with Winston Peters, Treasurer and Leader of the New Zealand First Party.

Voluntary provision does not adequately deal with the second 'could save but don't' group. But how big is this group compared with the other two? Research undertaken in New Zealand for the proposed RSS indicated that, even with a mature compulsory saving scheme which required that annuities be taken at retirement age, around 40 per cent of RSS income would continue to be funded by the government (New Zealand Government, 1997:64), which suggests that the first group is relatively large.

An element of free riding will doubtless remain, irrespective of how well-informed people are about their retirement income needs. However, the alternatives to voluntary provision impose significant costs themselves, and these have to be weighed against the shortcomings of a voluntary regime.

The welfare costs of compulsion. In contrast to voluntary arrangements, which may miss one of the three target groups identified above, compulsory regimes affect all three groups when they are aiming to modify the behaviour of only the 'could save but don't' group. Because this group cannot be readily identified in practice, compulsory regimes generally force everyone to save in a particular way and at a particular time. This imposes large welfare costs on the entire community, through distortions to individual preferences and forgone opportunities.

In Australia, the most comprehensive published estimates of the gains in retirement incomes from the compulsory Superannuation Guarantee Charge (SGC) (Willis, 1995:10-14) take no account of welfare costs. These costs arise from the forgone opportunities to choose between consumption and saving during one's working life. Even if compulsion increases *retirement* income, it may reduce *life-time* welfare by limiting the uses to which current income can be put.³

The patterns of saving are likely to vary a great deal between individuals, reflecting their different circumstances. The 'one size fits all' requirement of a compulsory arrangement cannot cope with this diversity. New Zealanders tend to save more as their incomes grow and as they get older, and many people prefer to accumulate assets (in particular, to buy a house), rather than rely on financial assets when they save (Periodic Report Group, 1997:159-66).

Much of the Australian literature on retirement saving reflects the trade-off between the flexibility of a voluntary regime and the constraints of a compulsory one. Advocates of reforms directed at tightening the rules often also call for more flexible arrangements for some parts of the community. For example, Mack (1996) supports the restriction of lump sums and an acceleration in the increase in the preservation age to 60 so that 'retirement savings are used for retirement purposes only' (1996:80), but at the same time she criticises the system for 'fail[ing] to address the other savings needs of individuals' (1996:77). Similarly, while supporting compulsion, Davidson and McClelland (1996:90) suggest that people should be able to reallocate their compulsory saving to other life-cycle purposes. Implicit in these calls for access to superannuation prior to retirement is the view that the welfare

³See Freebairn (1996:49).

losses from forced retirement saving are not matched by the welfare gains from those savings in retirement.

Sinha and Sinha (1994:27) estimate that compulsory levy rates of 9 per cent to 12 per cent impose deadweight losses of between \$200 and \$400 per worker per year. In aggregate, they estimate that the SGC imposes a welfare cost of \$0.9 - \$1.9 billion per year (or some 10-20 per cent of the cost of the age pension).

The impact of compulsion on the financial sector. In New Zealand, it is argued that a voluntary framework for private savings is more conducive to growth than compulsion because:

- when industry participants are competing equally for the saver's dollar, and where there is no assurance of a constant flow of 'contributions', those participants are likely to provide the best allocation of resources, in order to offer the best returns;
- compulsory schemes alter behaviour (and hence resource flows) throughout the economy, even though their real 'target' is only one group. So compulsion is likely to reduce the efficiency of investment in aggregate. There was a particular concern in New Zealand that if compulsion resulted in more savings being directed to managed funds, it would starve the small business sector of self-generated finance;⁴ and
- compulsory regimes generally apply to the rate at which people save from current income, and ignore the returns to household wealth that can be gained from more efficient investment. It is possible that the return on investment could be lifted while the rate of saving remained unchanged, so increasing the benefits from that saving.

Administration and compliance costs. Compulsory private provision entails general administration and regulatory costs that a voluntary system would avoid. Such costs can be very large.

Compulsory regimes also impose high compliance costs. They generally involve a plethora of reporting mechanisms that require savers, employers and the industry to generate sometimes very detailed information and to provide it on a regular basis to a number of agencies. Where compulsory arrangements are linked to tax bases, they can be very costly in terms of revenue forgone. This has been the case in Australia, where the SGC 'tax' has created an added incentive to escape the income-tax net.

When saving is not entirely voluntary, particular groups are likely to resist modi-

⁴One answer to this problem is to exclude self-employed people from the compulsory arrangements, as in Australia. In the proposal put to the referendum in New Zealand on the RSS, the self-employed were included on equity grounds: it did not seem just to force only part of the community to save.

fying their behaviour in the required way, thus making such schemes vulnerable to pressures for change. For example, Duval (1996:54-7) has said of Australia's superannuation system that

... there is general agreement that the system is too complex ... and changes too frequent. ... Everyone says that we need a system which is simple and stable ... but all the pressure is for change, and most of that change would make the system more complex. ... There are around 50 to 60 public servants in Canberra ... whose only job is to change the rules for superannuation. These people are not idle — on the contrary they are all working very hard.

By contrast, New Zealand has had a much more settled and stable regime over the last ten years at least. This allows people to make their retirement income arrangements confident that the rules will not be frequently changed.

The inflexibility of compulsory regimes. It is difficult to design a system today that will be appropriate in 40 or 50 years' time. A voluntary regime, with its relative freedom from rules and regulations, leaves people free to use their ingenuity in solving unforeseen future problems. Political processes characteristically lag behind rather than lead pressures for change, so that changes to regulations often come too late.

Compulsion and fiscal savings. However, even if people do save enough voluntarily, they may do so in ways that elude means tests, and so do not reduce the future fiscal costs of public pensions.

This issue is not easily resolved. As income and assets tests become more sophisticated, so too do the techniques used to get round them. Compulsion may seem to provide an easy answer to this problem. As was proposed with the RSS, it could be mandatory to preserve savings to the age of eligibility for the public pension. But just as people lobby for special concessions in means tests, they will lobby for early access to their funds. As well, serious technical difficulties emerged as the notion of such a large pool of mandatory annuities was investigated in a small country like New Zealand.

Compulsion and national savings. On the other hand, the aggregate level of savings could be lower under a voluntary regime than under a compulsory one.

Certainly, the SGC is likely to increase national saving in Australia. It has generally been assumed that around 50 per cent of the saving undertaken as a result of the SGC is additional retirement savings resulting from compulsion, but with variations of between 33 per cent and 60 per cent.⁵ But whereas the increase in the

⁵See, for example, Brown, 1993:19; Harper & FitzGerald, 1992:28; Tulip & Stott, 1994; Covick & Higgs, 1995; Goode, 1994:13.

amount of savings can be estimated, the *efficiency* of such saving cannot. Granting one sector of the financial market an effective guaranteed market could impose considerable efficiency losses, as would government direction of superannuation funds (though calls for this have so far been resisted in Australia). The contingent liability that a compulsory scheme imposes on a government must also be taken into account. So it remains uncertain whether the SCG will provide a net benefit to the community.

The quality of investment is likely to be more important to a country's future capacity to cope with an ageing population than the amount that citizens save. The contrast between the present economic situations of Japan (historically a high-saving nation) and the US (low historical savings measured on a traditional basis, despite generous tax incentives) can be at least partly explained by the quality of the resulting investments.

The most direct way that governments can contribute to national savings is by making additional savings itself. Compulsion and tax incentives lead to some degree of substitution, and can detract from national savings in the short term. This would have happened in New Zealand under the RSS, since the fiscal costs would have been higher under the compulsory regime than under the voluntary regime until around 2017 (New Zealand Government, 1997:14).

Tax Incentives under a Voluntary Savings Regime

A unique feature of the New Zealand retirement income system is that it does not offer tax incentives to encourage retirement income provision.

Tax concessions were rejected largely because it was judged highly unlikely that they would reduce fiscal costs. Revenue impacts for even the most well designed tax incentives were shown to produce a net loss to national savings (Task Force on Private Provision for Retirement, 1992a:93-4). Such findings are consistent with an OECD report on taxation and household saving, which concluded that the net effect on total national saving may be negative in so far as the tax revenue lost is greater than the additional household saving (reported in Commonwealth Treasury, 1995:57). Similarly, the World Bank (1994:201) stated 'it is not clear whether tax incentives have increased aggregate saving, and most of the tax benefits have gone to high-income households, many of which would have saved in any event'.

In considering how to increase savings rates in the US, Kotlikoff (1990:245) found that useful measures included: providing information to all employees about their current retirement benefits and the additional savings required to reach an adequate retirement income savings level; adopting a value added tax; and tightening fiscal policy. This is consistent with the New Zealand policy framework. He concluded that tax concessions 'have critical shortcomings that are as likely as not to exacerbate our national savings problems'.

Tax concessions have been rejected in New Zealand also because, as the World Bank (1994:201) observes, they are typically regressive: since higher-income earners have the highest capacity to save, they generally do best out of concessions for saving.

It is very difficult to design tax concessions that target saving at the margin. Where concessions relate to all savings, much of their cost is wasted in subsidising behaviour that would have occurred anyway. Tax incentives cannot be designed to target only that group that can save but don't. Designing tax concessions generally means favouring some forms of saving at the expense of others. This has economic costs. Neutral taxation treatment is important if the voluntary savings market is to be truly competitive. One commentator has noted that much of the material used to inform potential savers on the best options for retirement saving in Australia focuses almost solely on tax at the expense of issues such as investment quality, diversification between and within markets, flexibility and the other important factors that should be taken into account in determining an appropriate retirement savings plan.⁶

Tax incentives commonly impose high compliance and administration costs. New Zealand's tax-neutral retirement schemes are administered by the Government Actuary under the Superannuation Schemes Act 1989, which contains a mere 20 pages (Littlewood, 1997:119).

New Zealand's tax treatment is straightforward and has changed very little over more than a decade. This relative simplicity and stability in the system arguably creates a greater incentive to save than complex subsidies involving constant change and uncertainty.

What Has Happened to Savings in New Zealand?

No clear-cut answer can be given to the question of what has happened to savings in New Zealand under its present retirement income policies. There are severe data problems.⁷ The full impact of many policies will involve time lags that are often the subject of debate, and distinguishing the impact of retirement income policy on savings from other factors is very difficult.

The assets and liabilities held by households are accounted for mainly by housing. More than 80 per cent of people over the age of 65 own their own home in New Zealand. The percentage of financial assets held by asset type has remained relatively stable since the early 1990s, with around 70 per cent in housing, 13 per cent in banks and non-bank financial institutions, 7 per cent in superannuation funds, and the remainder shared between life insurance, private shareholdings, unit trusts and other financial investments. Unfortunately, this information fails to cover many asset types. It is thought that far more household net worth is held in assets such as rental and commercial property, capital equipment and equity in businesses than in financial products traditionally associated with saving. With the exception of housing, very little information is available about how much households have invested in these assets, although saving in the form of business equity is likely to be very significant in New Zealand.

Unofficial estimates suggest New Zealand's household net worth may not be

⁶Personal communication, Michael Littlewood, October 1997.

⁷See Periodic Report Group (1997a:157-67).

markedly different from that of at least some of the major OECD countries (see Figure 1).

Figure 1: Household net worth as a per cent of household disposable income

Note: 1994 data were not available for Italy or for the large OECD countries.

Source: OECD, *Employment Outlook*, Paris, June 1996. New Zealand data are drawn from the Westpac•FPG New Zealand Savings Indicators.

Statistics New Zealand's measure of household saving is low at roughly between NZ\$1,000 and NZ\$3,000 per household per year over the last decade. In gross terms, business sector saving is around 12 per cent of GDP (or just under 4 per cent after allowing for depreciation). The government has substantially increased its saving efforts in recent years, and has run budget surpluses since 1993-94. National saving in New Zealand has risen to a level comparable to that of other OECD countries, and higher than Australia's since 1993 (Figure 2).

Lessons for Australia

Perhaps the biggest difference between the retirement income arrangements in New Zealand and Australia lies in the complexity of the latter. In Australia it has become conventional wisdom that retirement income policy cannot be simple: every attempt to simplify it appears to add yet more rules and regulations. Australia is not alone in this respect. For example, in the US a new company specialising in auditing the calculation of beneficiary's entitlements claims to find mistakes in half of the cases it investigates (Littlewood, 1997:119). Yet New Zealand shows that there is a simple alternative. Without tax incentives or compulsion, the rules can be kept to a minimum, the saving environment is much more certain and stable, and individual savers have flexibility and choice.

Figure 2: Gross national saving rates for Australia, New Zealand and OECD, per cent of GDP

Note: Year ending December for Australia and OECD, March for New Zealand.

Sources: OECD, Statistics New Zealand.

If Australia nevertheless persists with compulsion, it is essential that reforms are undertaken to make it a truly effective mechanism to reduce fiscal costs. Such reforms include bringing the self-employed into the compulsory regime, synchronising the age of eligibility for the old-age pension with the vesting age, and requiring that all benefits that emerge from the compulsory scheme take the form of lifetime annuities. In addition, Australia could follow New Zealand in abolishing tax concessions for superannuation. This would immediately sweep away much of the system's complexity. In any case, there is no sound rationale for allowing concessions on compulsory saving.

In New Zealand, it remains to reform NZS. Without any targeting mechanism, NZS may become so costly as to limit future growth prospects. In this respect, New Zealand can learn from Australia, where the assets and income tests are now well established. A targeting mechanism would make the system more complicated, but this seems a small price to pay for keeping the rest of the retirement income framework as simple and as efficient as New Zealand's is. That said, means testing does impose a disincentive to save that can be particularly damaging under a voluntary saving regime. Other changes, such as increasing the age of eligibility or altering indexation arrangements, could also be considered to minimise such impacts.

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