
The sustainability of New Zealand's retirement income framework

Introduction

The 2010 review of retirement income policy identified eight different objectives for retirement income policy which are supported to varying degrees by New Zealand's current framework. A short paper on each of these objectives can be found at <http://www.cflri.org.nz/retirement-income/policy-positions>.

Other means of assessing retirement income policies are also available and one of these has been developed by the New Zealand Treasury, based on its living standards framework¹. Richard Hawke and Len Cook have between them identified a number of criteria for assessing retirement income policy: adequacy, efficiency, simplicity, flexibility, stability, certainty, equity, fairness and overall sustainability (Hawke, 2005; Cook, 2006). Several of these criteria refer to the same attribute in a slightly different way, and as with the eight objectives, there is considerable overlap between them.

All of these frameworks reflect the complexity of retirement income policy. There are tradeoffs to be made, and it is impossible to empirically determine the "correct" policy setting. Values, perceptions and political judgment also play their parts so public understanding and "buy in" to decision making processes and outcomes are essential.

Overall sustainability of retirement income policy depends on a thriving economy, an affordable cost and political acceptance across generations. New Zealand's economic prospects may be uncertain, but its retirement income framework is inexpensive and fundamentally works well. Notwithstanding a turbulent prior history and the introduction of two major new schemes since the year 2000, the last 15 years have seen a high level of support for current settings.

However, challenges are clearly emerging. In particular, the rapidly ageing and longer-lived population will generate fiscal pressures through increased demands on New Zealand Superannuation (NZS) and the health system. The Retirement Commissioner's 2013 review will need to address these issues.

It will be important for the review to keep a broad view, and to not recommend hasty action. While superficially simple in comparison to those of other countries, New Zealand's system of retirement income is actually sophisticated and finely balanced. There are clearly fiscal problems to be faced but the fiscal lens is not the only one that should be used. This brief paper includes other perspectives to be taken into account and canvasses a suite of measures

¹ See <http://www.treasury.govt.nz/government/longterm/externalpanel/pdfs/lrfep-s2-01.pdf>

likely to be required if the long-term sustainability of retirement income policy is to be assured.

Fiscal sustainability

...fiscal sustainability can refer to whether the government can maintain its policies without major adjustments in the future or whether its policies would lead to excessive accumulation of debt that the government would eventually need to take action to address. (Pradelli, 2012, cited in Buckle & Cruickshank, 2012)

Treasury projections prepared for the long term fiscal statement show that the cost of NZS is set to almost double as a percentage of GDP (from 4.4% to 8%) by the middle of the 21st century. This would be a return to mid-1970s proportions, which were at that time regarded as unsustainable and required a tumultuous process of readjustment. It has to be said however, that there remains a view that 8% in 2050 is affordable.

In one sense, “affordability” is not the question. Rather, it’s a matter of priorities. After all New Zealand could afford an aircraft carrier if it really wanted one, but we’d have to do without a lot of other things. Similarly, we can pay for any level of NZS if taxes are raised, or we take on more debt or government spending is redirected from other areas. But such measures would sooner or later exacerbate economic and fiscal problems or create resentments which threatened the political sustainability of NZS.

What is more, the Treasury has shown that the New Zealand Government is faced with burgeoning debt and a growing “fiscal gap” – to which NZS is projected to be a major contributor (Bell, 2012). The real problem is not so much the absolute cost of NZS to the Government, but the *doubling* of that annual cost in four decades. At 4-5% of GDP, NZS is sustainable in its current form. At 8% of GDP it’s probably unsustainable as a cost to Government.

But we can’t simply wish that cost away. The population is definitely ageing and the future economy will have to meet the costs of retirement income somehow, whether from the Government purse or from private savings. One option is to grow the economy faster, so that there is sufficient extra wealth to meet future costs. Unfortunately, most projections are for modest rates of economic growth at best, and in any case the current indexation of NZS means we can’t grow our way out of the problem. Ways will have to be found to reduce the fiscal burden while preserving the best features of the current system.

Some have argued for cutting the cost of NZS through means testing and a more targeted system of payment. But this approach would create distortions in the system by penalising those who have done the right thing by saving and incentivising the kinds of game playing we don’t want. It would also be costly to implement and quite possibly not save very much.

Often in tandem with means testing, compulsory saving is also mooted as a means of boosting national savings and reducing fiscal risks. But in New Zealand’s relatively low-income economy

not everyone can afford to save, and compulsion would mean some savers having to sacrifice investment in, say, home ownership or education. Australia has also found that compulsion removes competitive pressures from the marketplace (Cooper & Review Panel, 2010). A better approach is for a financially literate population to voluntarily choose to save in ways that meet their own individual or household needs. It is also important to focus on policies that grow incomes and to ensure that savers are getting good value from the schemes they already have (Scobie, Gibson et al., 2004; Coleman, 2006).

Raising the age of eligibility for NZS, as recommended in the 2010 review of retirement income policy, would ultimately lead to savings of around 0.7% of GDP – \$1.5 billion dollars a year in today's dollars. Raising the age by two years would not create undue hardship for most older New Zealanders, and seems fair given that life expectancy for 65-year old men has increased by about five years in the last 50. For women the increase in life expectancy at pension age has been ten years (OECD, 2011). Indeed it could be argued that an increase of two years in the age of eligibility is not enough, although there will still be some people who need to retire at 65 (or even earlier) and allowance will need to be made for them.

It is clear from the 2010 review and Treasury's 2012 papers that the biggest potential savings are from changes to the indexation of NZS (Kirkup & Kengmana, 2012). Unlike welfare benefits, NZS is indexed to wages so that recipients maintain relativity with the working-age population. This formula has helped to ensure low official rates of poverty among the over-65s. Any change to a lower indexation, such as to price inflation, would risk increases in levels of old-age poverty unless retirees were managing additional sources of income or there was a supplementary system of needs-based, targeted assistance. Other programmes and policies that have traditionally contributed to well-being in retirement would also have to be factored in.

The Retirement Commissioner's 2010 review recommended a "halfway house" change to indexation, to an average of wages and the consumer price index. This would have maintained superannuitants' purchasing power while still giving them a (reduced) share of increased national wealth. The combination of raising the age of eligibility and changing indexation was projected (by 2035) to have produced a saving of around \$3 billion per annum in today's figures.

These changes would have retained the essential simplicity and efficiency of NZS while reducing the Government's fiscal risk and providing more certainty in planning. The long lead time for change would also have allowed time for New Zealanders to adjust their own preparations for retirement, thus protecting the political sustainability of the retirement income framework.

Political sustainability

In many ways the situation has remained unchanged since the Retirement Commissioner's 2010 review, but the growth of KiwiSaver has added a crucial new dimension to the overall

retirement income framework. There has also been a continued decline in the affordability of home ownership (New Zealand Productivity Commission, 2012) which has always been an essential foundation for New Zealanders' wellbeing in retirement, and increases in workforce participation among the over-65s. Indeed, it could be said that New Zealand has a system based on far more than the three pillars or "tiers" traditionally recognised by the World Bank and OECD, i.e.:

1. *NZS* which provides a basic income sufficient to prevent poverty in old age. 40% of older New Zealanders rely entirely on NZS, and another 20% depend heavily upon income from this source (Perry, 2012);
2. *KiwiSaver* which now has two million members and nearly \$15 billion under management. KiwiSaver "nudges" people into membership but is not compulsory, unlike the Superannuation Guarantee in Australia;
3. *Other superannuation schemes and private savings which are voluntary*. Balances from these sources (and from KiwiSaver) will need to be well managed if they are to last through increasingly longer periods of retirement;
4. *Home ownership*. Rates of poverty among retirees who own their home outright are much lower than among those who are still paying a mortgage or rent (Perry, 2012). Unfortunately, housing affordability has declined to the point where now a house costs around five times salary compared to two-and-a-half times during the 1990s, and rates of home ownership are declining (New Zealand Productivity Commission, 2012);
5. *Employment*. One of the advantages of raising the age of eligibility for NZS is that it sends a signal for older New Zealanders who are able to keep working – whether full time or part time – with consequent benefits to individuals and the wider economy (Buckle & Cruickshank, 2012). An extra year or two's savings can make a huge difference to net worth, health and well being. Older workers contribute to economic growth and their income taxes help meet the costs of NZS. However there continue to be problems with stereotyping and discrimination against older workers (McGregor & Gray, 2002; Wilson & Kan, 2006; Wilson, Parker et al., 2007). There is also a common misperception that older workers are "taking the jobs of the young" and potential for resentment directed at those working while also receiving NZS;
6. *Other public services*, especially in health care. The extent to which these costs are met by the public purse has an impact on the amount of income available for other consumption in retirement. Informal support, such as from other family members or friends, might also be included in this tier.

There has been recent research which aims to establish the absolute cost of different lifestyles in retirement, the expectations that New Zealanders have and the degree of planning they are undertaking (Matthews, 2012; O'Sullivan & Ashton, 2012)². It is difficult to be conclusive about the findings of this research, but there are indications that the "baby boomers" and following generations will have higher expectations for consumption in retirement than did their forbears. There is little doubt that if they are to meet those expectations, they will need to

² See <http://www.stuff.co.nz/business/money/7937650/Retirement-saving-needs-a-target>

save more. But they also need fair warning, and sufficient financial literacy to make the right decisions.

Reforms are more successful where the public understand why fiscal adjustment is needed, and where there is public support for debt or deficit reduction and measures for it to be achieved. (Buckle & Cruickshank, 2012)

Summary

Ultimately, decisions about older people's entitlements to income support from the rest of the community will be influenced by shared values and political judgement. But political sustainability and fiscal sustainability intersect. There is clearly a need for more private saving to enable individuals to meet their expectations of retirement income on top of what NZS can provide, and for the Government to hold down the cost of NZS as the population ages.

However, private savings must not be used as a total offset against the cost of NZS. Rather, a raising of the age of eligibility of NZS, along with a change in indexation, could reduce costs while still ensuring an income "floor" to prevent poverty. The gap between the floor and expected lifestyles could be met from private savings, particularly from increasing KiwiSaver balances. The real challenge will be to phase in any transition so as to not create hardship or inequity within or between generations.

Other measures will need to be implemented in parallel:

- Improve housing affordability to increase levels of ownership
- Protect access to public health and other services
- Change employment practices to enable older New Zealanders to continue to participate in the workforce
- Improve financial literacy at all ages, including among older kiwis
- Carry out research to establish the absolute costs of living in retirement, and individual and aggregate impacts of KiwiSaver balances on retirement income prospects
- Provide products and services that will enable the effective management of financial resources throughout retirement
- Target assistance to meeting new needs arising from changes in policy settings
- Involve the public in debate and communicate changes well in advance.

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