Intergenerational equity (cohort self-funding)

Introduction

This position paper explores the model of intergenerational equity (cohort self-funding) which seeks to ensure equal cost sharing across different generations. In the context of retirement income policy, this means that the government services (such as New Zealand Superannuation or NZS) received by each generation throughout its lifetime match in some way the amount of taxes that generation has paid[1].

However, consideration might also be given to the extent to which living standards are equalised over time (McDonald, 2005) or to the wider economy's long-term sustainability[2]. Current expenditure on retirement income is not available for investment in other areas such as education which mainly benefits the young, or physical infrastructure which has a payoff well into the future. Alternatively, spending might be shifted to an area such as health services, which are disproportionately accessed by older people – an intra-generational transfer rather than an intergenerational one. In New Zealand and across the world, pensions policy has tended to favour present over future generations (Thomson, 1991; Evans and Quigley, 2012).

Any public expenditure which incurs debt or delays its repayment is effectively "an obligation passed from one generation of taxpayers to the next" (Buckle and Cruickshank, 2012). This may not be a bad thing if the economy grows consistently over time so that better off future generations are more able to afford the cost of repaying the debt they have inherited (McDonald, 2005). Future obligations may also be met by a generation accumulating assets such as the New Zealand Superannuation Fund (NZSF)[3], to pre-fund the payments they will ultimately receive.

Decisions about the extent to which debt is shared across generations are very complex. In making them, value judgments can be just as crucial as economic analysis[4] (Auerbach, 2008; Guest, 2008). The intergenerational sharing of fiscal burdens needs to be considered in a very broad context.

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[1] In this context a "cohort" is a group of New Zealanders who were born in a specific time period, e.g. the 1920s or the "baby boomers" born between 1946 and 1964.
[2] Intergenerational equity is also affected by degrees of environmental protection and other policies that influence generational "shares", e.g. of education and health services or living standards in general (McDonald 2005, Whitehead 2012). These matters are outside the scope of this short paper, but not forgotten.
[3] Note the NZSF and NZS are completely different instruments. NZS is the universal government pension, while NZSF (www.nzsuperfund.co.nz) invests money, on behalf of the Government, to help pay for the increased cost of superannuation entitlements in the future.
[4] See position paper on "Citizenship dividend".

History

Older New Zealanders may recall the social security contribution of "one and six in the pound" that used to be paid up until it was fully incorporated into income tax rates in 1969. Many believed that their contribution was pre-funding their future old age pension entitlements, but this was never the case. The revenue was used by the governments of the day to help finance social security and health spending at the time. In fact, today's NZS entitlements are much greater than could have been financed by placing all the social security contributions in a fund and investing it (Crossan, 2010).

The 1970s was a time of much upheaval in New Zealand's retirement income framework. A compulsory superannuation scheme introduced in 1975 was replaced in 1977 by the forerunner of NZS. The cost of the new scheme proved to be fiscally unsustainable and intergenerational equity was compromised. Over the next two decades a number of measures were put in place to recalibrate the system.

In 1989 and 1990 an attempt was made to publish pension cost projections, to signal when in the future NZS entitlements might need to be trimmed back to keep the tax burden fair for future taxpayers[5]. This mechanism was overtaken in 1991 by a series of budget initiatives that directly reduced the cost of NZS ahead of the timetable suggested by demographic pressures alone (Crossan, 2010). More recently, governments have issued analyses of long term fiscal trends and options and to varying degrees these have fed into decisions about future spending[6].

The NZSF was established in 2001 with the intention of smoothing the projected future rise in NZS costs associated with the ageing of the baby boomers. It was seen to be cross-generationally fair as it reduced the requirement for future taxpayers to pay for the previous generation's superannuation. The introduction of KiwiSaver in 2007 also had implications for intergenerational equity, as will be discussed below.

Identifying causes of inequity

> *In comparing the wellbeing of different generations, a considerable degree of complexity arises because at any point in time the population is comprised of a number of over-lapping generations. Furthermore, within any generation people will live for different lengths of time (Whiteford, 2010).*

To the complexity referred to in the above quotation may be added uncertainties about the nature and size of the future economy from which pensions will be paid. Absolute equity between generations may be impossible to achieve but it remains an important objective to

[5] This cost, expressed as a percentage of the income tax base, was to have been shown as a "retirement tax" separately identified as a component of the existing income tax payable by each taxpayer (Caygill, D., 1989).

[6] See http://www.treasury.govt.nz/publications/research-policy/wp/2010/10-01 and http://archive.treasury.gov.au/igr/default.asp. The next Long-Term Fiscal Statement from the New Zealand Treasury is due to be published in March 2013.

ensure that respective generations will continue to support a stable system of retirement income. Support is more likely if those contributing can see that other people on similar incomes also give a similar share – implying the need for some intervention to ensure that this is the case (McDonald, 2005)[7].

Some of the same principles apply to intergenerational equity as to fairness or equity within generations. For example there are obligations, expectations and reciprocity between generations and sustainability is extremely important (Healy, 2004; Whiteford, 2010). Equitable distribution of wellbeing between generations might be seen in terms of a level of consumption of goods and services available to each person (McDonald, 2005), a notion that resonates with "lifetime consumption smoothing" for an individual[8]. Daniels (1983; 2008) goes so far as to argue for "prudential savings accounts" whereby provision is made by each individual for his/her old age (and other needs) thus eliminating the need for transfer of resources between persons or generations.

Thomson (1991) claims that there is more redistribution between generations than within generations, However he also argues that the welfare state is premised on collectively managing shared risk rather than humanitarian objectives, in order to get the buy in of (basically self-interested) people. There is therefore a need for sustainable institutions and policies so that people can believe in the insurance they are being taxed to pay for[9]. Such institutions and policies have emerged over the last century or so, and have gradually replaced more traditional means of ensuring intergenerational equity, where the aged are supported by younger family members. Traditional expectations still exist in some communities within New Zealand, although there is anecdotal evidence to suggest that younger generations' adherence to the assumed social contract is becoming progressively weaker (Wood, 2012).

State-mandated, pay-as-you-go systems use the taxes paid by people of working age to pay the pensions of those who are retired. This process continues as each successive generation retires and their children start to pay taxes. The system works well enough if each cohort is more or less the same size, and no generation uses its political power to vote itself a pension that is unsustainably large, i.e. unreasonably increases the funding burden for the following generation. We have already seen how the latter problem arose in 1975, and took many years to undo. A far greater challenge will arise from the permanent ageing of the population in the 21st century.

Along with many other countries (though not as badly as some) New Zealand's system of retirement income faces a major demographic change. Whereas in 2011, there were

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[7] It's worth noting here that NZS is paid out of taxation to all New Zealanders who meet age and residency criteria. Because of Goods and Services Tax (GST) it is virtually impossible for residents to not pay at least some tax, even if they have never been in the workforce.

[8] See position paper on "Lifetime consumption smoothing".

[9] The 1942 "Beveridge Report", which was the forerunner of the Welfare State in the UK, was premised on the provision of social insurance. Interestingly, Beveridge's "Plan for Social Security in Britain follows the precedent of New Zealand": see http://www.sochealth.co.uk/public-health-and-wellbeing/beveridge-report/

approximately five people in the 15-64 age group for every person aged 65 or over, by 2036 the ratio will be halved, to about 2.6:1. Some commentators refer to this as an increase in the "dependency ratio" or the number of workers available to support each superannuitant, but nobody knows for sure the extent to which over 65s (or indeed 14-64 year olds) will continue to participate in the economy[10]. Superannuitants themselves pay tax and there may also be changes in fertility or migration which will impact on the structure of the population. Nevertheless as things stand, it is highly likely that in future a relatively smaller pool of workers will be taxed to pay for the NZS of the previous generation[11].

It is also more or less certain that the number of people aged 65+ is likely to double from 600,000 (14% of the population) to around 1.2 million (approaching 25%) in 2036. Within the 65+ age group, the number of people aged 85 and over (85+) is expected to increase significantly. From 76,000 in 2012, there will be 180,000–210,000 people aged 85+ in 2036, and 290,000–430,000 in 2061. By 2061, about 1 in 4 people in the 65+ age group will be 85+, compared with 1 in 8 in 2012[12].

The gross cost of NZS is projected to increase as a proportion of GDP from 4.7% to nearly 8% by 2050 (Crossan, 2010). Furthermore Coleman (2012) has calculated that most New Zealand taxpayers aged over 35 in 2012 have contributed only about half of what they receive back as pension payments. Increasing longevity means that later-born generations are spending longer in retirement than did their parents, and more funding of retirement income will needed. Taxation policy is therefore of prime importance:

> *Tax concessions to private retirement saving schemes are an additional aspect of the retirement system and since the tax incentives affect people when they are working, they are a major part of the intergenerational equity issue whose ramifications extend across the whole economy. It is likely to be the case that the structure of the taxes we have to fund public pensions and to provide incentives to accumulate private savings affect the structure of the capital stock and the productivity of the economy … anything that reduces the quantity of capital available to working age people in the economy lowers their wages and contributes to intergenerational tension (Coleman, 2010).*

Some possible responses

All of these factors point to increasing intergenerational inequity but there are also a number of possible responses. These could be implemented separately or in combination and include introducing a self-funded contributory pension system, changing the way increases in NZS are

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[10] Numbers of over 65s in the New Zealand workforce have almost quadrupled since 1986, and the employment rate among that age group has doubled (Callister 2012).

[11] This shrinkage in the workforce is exacerbated by high rates of emigration among younger age cohorts, as has recently been the case (see http://www.stats.govt.nz/browse_for_stats/population/migration/permanent-long-term-departure.aspx)

[12] See http://www.stats.govt.nz/browse_for_stats/population/estimates_and_projections/NationalPopulationProjections_HOTP2011/Commentary.aspx#dependency

calculated and changing the age of eligibility for NZS. The 2010 review of retirement income policy (Crossan 2010) recommended a gradual increase – starting in 2020 – in the age of eligibility for NZS from 65 to 67; and changing indexation from wages alone to a combination of wages and price increases (but not less than inflation in any year). This changed method of calculating annual increases would guarantee some real increase in the purchasing power of NZS, but slow down growth in the cost of the scheme. Retired generations would thus have a share in the economic growth generated by the succeeding generation of workers, but not as much of a share as is currently the case. Officially-calculated levels of poverty may also increase.

Whether or not these proposals are fair to individual superannuitants is a matter for debate, but the aggregate effect would be to reduce the total amount of retirement income paid out of taxes, and to increase the need for complementary private savings. This implies a shift in balance between the currently dominant Pay As You Go (PAYGO) from taxes and Save As You Go (SAYGO) through vehicles such as the NZSF, KiwiSaver or other superannuation schemes[13]. The questions that then arise are, what should be the balance between PAYGO and SAYGO, and what path should be taken to get there? A switch to fully SAYGO-based system is possible and might ultimately be less costly than PAYGO (Feldstein, 2005; Coleman, 2012) but would have to be carefully managed if a "transition" generation were not to be called on to pay twice – once for their parents' NZS and once for their own pensions (Feldstein, 2005). On one level this would be fair, given that taxpayers have effectively been underfunding NZS, but it would not be equitable between generations.

It should be noted that whether retirement income comes from a PAYGO or a SAYGO approach, it has to be paid out of the future economy. Savings are not "cans of beans" that are stored in the pantry for later consumption. Rather, money saved is used in the present day and there is an expectation that in the future someone will pay it back. The ultimate guarantor of retirement income is a healthy economy.

Conclusions

If New Zealand's system of retirement income is to remain stable and credible, future generations will need to meet the terms of a social contract they had no part in negotiating.

This will be more likely to happen if the cost of the system is fiscally sustainable, and the burden has been fairly spread through time. Sustainability will also be enhanced by a sharing of costs between the (public) Pay As You Go New Zealand Superannuation scheme and (private) Save As You Go schemes such as KiwiSaver. A shared approach would not be inconsistent with an insurance-based orientation for social welfare, as long as other objectives for retirement income policy continued to be observed. For example the basic level of income support from NZS could be complemented (not substituted) by private savings for those who require a "top up" in order to fully meet their expectations of retirement income.

[13] See position paper on "Income support".

There remain the questions of what the balance should be between PAYGO and SAYGO, and what should be the path towards achieving that balance, so that no generation carries an unfair burden. These questions need to be debated, because the answer to "what is fair?" is ultimately a question of values. The mechanisms for setting the balance already exist, in New Zealand Superannuation, the New Zealand Superannuation Fund and KiwiSaver – along with formulae for taxation and indexation which can be adjusted as required.

Whatever mix is chosen, future retirement income will be paid out of the future economy, and retirement income policies cannot be treated in isolation. They are inextricably tied up with those policies and programmes which more generally promote economic growth.

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