The SAYGO mirage: why the government should not pre-fund New Zealand Superannuation, not even partially

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1. Summary

This paper makes the following points:

1. A SAYGO public pension cannot be less expensive, fiscally, than a PAYGO pension of the same size.
2. The fairest way to finance a public pension (like New Zealand Superannuation) is on a PAYGO basis: today's taxpayers decide what proportion of the government's claims on economic output should be spent on today's public pensions. The same should apply tomorrow.
3. Even with very modest levels of growth, tomorrow's taxpayers will be somewhat richer than today's. A SAYGO pension proposes to tax today's relatively poorer earners to subsidise tomorrow's richer equivalents. Over time, SAYGO is regressive because it favours tomorrow's richer taxpayers over today's poorer equivalents.
4. Intergenerational (or temporal) equity is irrelevant to the financing of a PAYGO NZS. Only vertical inequity is relevant; benefit changes can resolve vertical inequity most directly and, if necessary, overnight.
5. The New Zealand Superannuation Fund has not justified its existence fiscally after nine years. Taxpayers have not been properly compensated for the investment risks involved.
6. A research-led discussion should begin now on the size and shape of NZS over coming decades.

2. The case for SAYGO

Andrew Coleman[2] ('Coleman (2013)') introduces a reduced version of an earlier proposal to fully pre-fund New Zealand Superannuation (NZS) through what would become a greatly extended version of the New Zealand Superannuation Fund (NZSF)[3]. Rather than aiming to build a government-controlled pool of financial assets that would grow to about twice GDP ($400 billion), Coleman now raises the possibility of pre-funding just the increases in the cost of NZS that are attributable to the ageing population and improvements in pensioner mortality. That could lead eventually to a fund of about half the size of the original proposal.

Investment wisdom states that over the long-term, money invested in shares and other investments should achieve a positive *net real* rate of return (i.e. after tax, inflation and expenses). For it to be otherwise might undermine the reason for saving at all. Putting money aside only to see it reduce in real value over time isn't sensible; better to buy assets that will keep their purchasing power. It then seems a short step to suggest that the cost of a retirement benefit of $1 in 40 years will be less than $1 by the value of the compounded net, real return over the 40 years.

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[2] Coleman, A (2013) *To Save or Save Not: intergenerational neutrality and the expansion of New Zealand Superannuation*, accessible here.

[3] Coleman, A (2012) *The economics of PAYGO and SAYGO retirement schemes in New Zealand*, a presentation to a debate organised by the Retirement Policy and Research Centre in March 2012 (presentation is accessible here).

Some proponents of a 'save-as-you-go' (SAYGO) approach to paying for a state pension think that, because of the expected net, real returns, a SAYGO pension is less expensive for taxpayers over the long-term than its pay-as-you-go (PAYGO) equivalent. This means that less money has to be set aside for the public pension over the long term in a SAYGO environment than under its PAYGO equivalent.

They test this argument in economic models by holding the SAYGO replacement as being payable on exactly the same terms as the current PAYGO benefit. They also assume the SAYGO pension remains payable by the government so the government must own the assets that underpin the SAYGO financing[4]. These are two generous (and unrealistic) assumptions for reasons explained below but, for the sake of the discussion, we shall temporarily take them as givens.

Even if we accept that a fully or partially pre-funded state pension is a desirable aim, there is the almost insurmountable political and fiscal objection that the generation of workers in the transition to a SAYGO pension must pay twice for about 35 years: once for the current pensions in payment and a second time to meet the amounts needed to put aside for their own pensions. SAYGO proponents argue that this is a necessary consequence of righting the shortcomings of past policies; of putting us back on track, fiscally. That makes the 35-year transition from PAYGO to SAYGO a difficult political message especially if, at the end of the process, tomorrow's retirees end up with no more than current pensioners.

We do not need detailed mathematical equations to explain the difference in financing a state pension like New Zealand Superannuation (NZS) by putting money aside today.

The financing argument is, in essence, a simple one. This paper suggests that the SAYGO thesis is, however, simplistic[5] when applied to state pensions. What may be appropriate for a private individual or an employer (the pre-funding principle) does not apply to a government. The reasons that individuals (and their employers) finance retirement benefits by pre-funding them have nothing to do with cost or equity and cannot justify the adoption by governments of a similar strategy. The simple investment argument is irrelevant, even if a government could guarantee a net real return on the financial assets (it cannot).

Adopting SAYGO as the basis for financing the age pension will not reduce the cost of NZS by a single dollar. It will alter the incidence of that cost but, without a change in NZS benefits, does not change it.

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[4] Having the state own the underpinning assets in an extended NZSF slides by the very real difficulties associated with pre-funding NZS through individual accounts and a compulsory Tier 2 arrangement, such as in Chile and, to a large extent, in Australia. An equivalent New Zealand proposal was defeated in the 1997 Referendum by 92:8. Many think that Australians have greater proportions of their assets in financial wealth than New Zealanders as a result of the Australian compulsory SG arrangements. However, the evidence suggests otherwise – see here for a 2006 comparison of household wealth. Australia is a richer country but Australians had (in 2006) about the same proportion of their households' net assets in accessible forms to pay for their retirement needs: 50.5% in Australia vs. 49.4% in New Zealand.

[5] '***Simplistic'*** *adjective* - "characterised by ... [t]he tendency to oversimplify an issue or a problem by ignoring complexities or complications." (source: *Dictionary.com*).

3. The intergenerational mirage

SAYGO proponents see virtue in each generation's paying for its own pensions, even if only partly; a nod to self-help, Calvinistic principles. That necessarily involves pre-funding – workers should save while they have work-related income to pay for their own retirement income needs once they stop working. Each generation of workers should pay for its own pensions (sharing the costs within that generation) rather than look to the next generation of workers to support their retirement income needs. A full SAYGO replacement seemingly lets current workers set their own pensions, once the 35-year transition is complete. It suggests that, over a worker's lifetime, the 'lifetime taxes less lifetime benefits' is, on average, zero. Discrete generations of taxpayers get back what they have paid.

The case for a SAYGO public pension on the grounds of intergenerational equity is a mirage; it poses a question that need not be asked and provides a 'solution' for a misdiagnosed problem.

There is no case even to justify each so-called 'generation' meeting its own pension costs. With respect to just pensions, there are inevitable 'inequities' within each generation – between those with longer or shorter lifespans in retirement; between those who survive until retirement and those who do not; between those with higher lifetime taxes and those who have paid less tax or even none; between males and females; between the sick and the able; between Asians and Maori etc., all of the same generation and with the same annual NZS pension. Even if we could put fixed boundaries around particular generations (that isn't possible), the justification for 'sharing' risks of any kind within those boundaries, including NZS, is less than obvious.

The case for 'fixing' those inequities *within* a generation is no stronger than the case for fixing lateral inequities[6] *between* generations. In fact, the financing argument (how we pay for NZS) has nothing to do with lifetime taxes[7], health, sex, race or longevity. It even misrepresents the fundamental nature of claims on economic output.

4. Future fiscal challenges

The demographic statistics associated with New Zealand's ageing population are well-known. The net cost of NZS[8] will about double in real terms over the next 40 years. SAYGO proponents argue that pre-funding is a way to make NZS affordable in the face of the increasing numbers of pensioners. Such a proposition misrepresents the nature of these kinds of claims on the economy. The SAYGO 'solution' rests on that mischaracterisation.

The material living standards of people in retirement depend largely on their ability to consume goods and services. Many of those goods and services, but not all, will be

[6] The more natural expression to contrast 'vertical equity' (sharing risks amongst today's taxpayers) might be 'horizontal equity'. However, because that is usually used in a taxation context to suggest that taxpayers with equivalent incomes should pay equivalent amounts of tax, 'lateral equity' is used as a contrast to 'vertical equity' for the financing of pension promises. Lateral equity shares risks amongst taxpayers over time. This avoids having to characterise generations as being fairly or unfairly treated.

[7] Coleman, A. (2012) makes an elaborate attempt in *Intergenerational transfers and public policy* (accessible here) to notionally allocate the share of lifetime taxes attributable to the financing of NZS over past generations. It is only notional because, for the reasons explained here, PAYGO outgoings of all kinds, not just pensions, do not work like that. Forcing a notional allocation of taxes on past generations of workers just isn't helpful, even for the purposes of illustration.

[8] NZS is taxed in the hands of superannuitants. The after-tax cost is the only cost that matters. Currently, that net cost is about 3.7% of GDP; by 2050, the net cost is expected to be about 6.7% of GDP.

purchased by retirees from financial savings made before *or* after retirement. Saving does not necessarily stop at retirement.

Retirees cannot directly consume the money represented by those savings; they must be used to buy goods and services that are produced by New Zealand's future working-age population or by workers of other countries (imports).

From an economic perspective, other things held equal, it does not much matter whether $1 of pension is provided privately or publicly. The pension is a claim by non-producers on producers' *current* economic output. If the pension is to be paid by the state, tax must be higher (than otherwise) to meet that claim; if the pension is private, the owner of that claim must find a buyer for that claim (or its underlying assets) to meet the pension commitment. As Nicholas Barr once memorably put it, "Pensioners do not eat pound note 'butties' – they use the pound notes to purchase consumption, and it is consumption that matters."[9]

An increasing elderly population can continue to be supported at current real income levels only by, broadly (after Barr):

- increasing output today and tomorrow, or
- restricting consumption today and tomorrow, or
- improving the productivity of the relatively smaller workforce we expect to have.

All that can happen through:

- immigration (increasing the labour force);
- raising the state pension age (that both reduces the value of pension claims and also increases the labour force through later retirements);
- reducing the annual pension (again, reducing claims by the retired);
- increasing the labour force participation rate of current non-workers, both before and after the state pension age (that need not mean a reduced pension);
- improving productivity through technology (to allow a diminishing workforce to maintain or even improve production), or
- alternatively, higher taxes today on the *working age* population might limit their consumption and 'free up' resources for today's old *non-workers*.

For current levels of NZS to be sustainable in, say, 2050, what really matters is the strength of the 2050 economy to meet that claim. Even with exceptionally modest growth, tomorrow's per capita income will be somewhat higher than today's[10]. In simple terms, the SAYGO proposal asks today's relatively poorer producers to subsidise tomorrow's richer producers through the switch from PAYGO to SAYGO.

That makes a public SAYGO pension regressive: higher taxes today impose costs on low income individuals who would be required to further reduce their consumption now to fund the NZSF. The benefits may be captured through lower taxes subsequently (that is not certain for reasons explained below) but most of those benefits would be captured by those in higher income brackets who pay most of the tax anyway.

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[9] Barr, N A (1979), *Myths My Grandpa Taught Me*, Three Banks Review, No 124, pp. 27-55 at p 35.

[10] Growth of only 1% p.a. will increase the real value of output by 49% over 40 years. Improving the future growth rate to just 2% p.a. will see output grow by 121%. The total population is expected to grow: Statistics New Zealand's 'median projection' will see a total population of 6 million by 2061 (*Could New Zealand reach 7 million people by 2061?* Statistics New Zealand article accessible here). That is an increase of 34% from the estimated December 2012 population of 4,435,000 (see here). Even at economic growth of just 1% p.a., per capita output will increase by 11% in real terms.

It is surely better to let each generation of taxpayers decide on the 'fair' share of economic output of the day should be devoted to supporting older non-producers. That decision should be made at the time, not now.

Shifting the financing of NZS to SAYGO will undoubtedly produce a higher stock of savings in government ownership but those will come at a cost. Reducing consumption today (given that either higher taxes will be needed to meet SAYGO savings or other government expenditure reduced) will be contractionary. If higher tax today is the 'price' of each year's contribution, that will come at the expense of private 'saving' (the macro number) as Coleman (2013) acknowledges. If government services are cut to meet the SAYGO contributions, private replacements can only reduce other private consumption.

Whether the change means higher 'savings' over the whole economy (stocks) will depend rather on the 'Ricardian equivalence' effect on private decisions about saving for retirement. Citizens will look at the enormous and growing NZSF and might reasonably decide to reduce their own private savings. That would be illogical (their state-financed retirement incomes will not be increased by those NZSF savings) but understandable. Some suggest that New Zealanders might offset their own savings by as much as 50% of the government's savings[11].

There also seems to be an assumption that a large proportion of those savings will remain in New Zealand. That is unrealistic because a $200 billion stock (say) of financial assets must be invested somewhere[12]. The current New Zealand Superannuation Fund (NZSF) is only $21 billion and, at 30 September 2012, 65.6% was invested overseas (see here). The proportion invested within New Zealand with a fund more than nine times greater is more likely to be smaller than larger than the current 24.4%[13].

Another fundamental assumption is that higher levels of SAYGO savings for retirement necessarily produce greater growth than in the absence of those savings. This rests on the proposition that greater savings produce more investment and that, in turn means higher levels of economic growth. It is true that an economy with a greater proportion of productive assets (than in another similar economy) should, though may not, grow faster. But will the additional pension savings proposed in a SAYGO environment lead to higher national savings and further, will any additional savings finance investment and

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[11] For example, "…there are important links between household and government saving that policies need to take into account. One relationship is that of partial Ricardian equivalence whereby around one half of any increase in government saving could be offset by lower household saving…": Savings Working Group (2011) *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity*, at p.144, accessible here. A chart in Gorman, E., Scobie, G.M., and Paek, Y. (2013) *Measuring Saving Rates in New Zealand: An Update* at p.12 illustrates neatly the substantial negative correlation between government and private saving rates over the 40 years 1972-2012. Using three-year moving averages, the correlation rate is -0.67 (where -1.0 represents perfect negative correlation).

[12] That does not include buying New Zealand government bonds, nor bonds issued by state-owned enterprises. There is no point in pre-funding if the money is simply cycled through the government's own accounts in the same way as happens with the US Social Security contributions. That amounts to a pre-funding illusion.

[13] The NZSF Guardians acknowledge the existing difficulties of lifting the current proportion of New Zealand-based investments even with the current, relatively small, pool of assets: "The Fund already has significant investment in New Zealand (18% of the Fund or 27% including cash) that goes well beyond New Zealand's weight in the global investment market." (NZSF's response of 2 June 2009 to the Minister of Finance's request to increase the proportion over time to 40% accessible here). The Guardians said they would "actively consider those [extra] investment opportunities" but that "…the Fund will expect an additional return (when compared with more diversified global investments) to reflect the risks associated with asset concentration, the relative illiquidity of New Zealand assets, and other idiosyncratic risks associated with investing in any single location."

so lead to greater growth? Standard economic theory is silent on these questions. Anything can happen.

Of the list of potential policy solutions listed above to cope with a rising retired population, only one (improving productivity through technology) may, but need not be related to larger pools of SAYGO savings, as long as those are invested in New Zealand to improve output from the relatively smaller proportion of workers. The NZSF's assets should in fact be invested where the best long-term returns are more likely, commensurate with other investment considerations (expected returns, concentration, diversification, volatility etc.). The assets will be 'owned' by the New Zealand economy, regardless of their geographic location but the question is whether that will improve the productivity of New Zealand's workers.

The remaining solutions listed above are unrelated to SAYGO savings.

Simply stating the investment truism described above (that SAYGO savings should achieve net real returns over the long term) is not relevant to the questions about the future fiscal sustainability of NZS.

5. $1 of pension costs $1 regardless of pre-funding

The cost of any future retirement benefit calculated on whatever basis (defined benefit, defined contribution, pension or lump sum, public or private, pre-funded or PAYGO) is the benefit actually paid.

The cost of a state pension *in 2050* of $1 a year is unaffected by the way in which the pension is financed. Pre-funding NZS might change the incidence of that cost but it does not affect the cost at the time the benefit is paid. The true cost (the amount actually paid plus the costs of administration) is what matters when we consider the implications of the future fiscal challenges faced by an ageing New Zealand in, say 40 years. Having a SAYGO fund that partly pre-funds NZS makes no difference to the cost of NZS when it is actually paid. However, the presence of something like the NZSF is not costless.

Any new tax creates a 'deadweight cost' that must be added to the obvious amounts raised to pay for its intended use. Economists disagree on the scale of that cost but it is not trivial[14]. Coleman (2012)[15] refers generally to this issue, noting that a SAYGO framework imposes those costs during the 35-year build-up rather than when the PAYGO alternative becomes payable. Coleman (2013) does not raise the issue.

For the reasons explained next, *tomorrow's* taxpayers should surely make the trade-offs that are necessary in deciding the merits of increasing taxes to meet any of the rising costs associated with an aging population; or anything else they decide to spend. One of those trade-offs is the deadweight costs associated with any increase in taxes.

6. The political implications of a SAYGO pension

Coleman (2013) suggests that the government should greatly extend the New Zealand Superannuation Fund (NZSF) so that, instead of making a contribution to the future

[14] A 2006 article here (Kerr, R. *The deadweight costs of taxation*) suggests that it might be at least 18%. "What this means is that, for it to be justified, a government project financed by increased labour taxation would need to return $1.18 net of collection costs for each dollar spent on it. If it returned only $1, roughly speaking 18 cents of national income would be sacrificed."

[15] Coleman, A. (2012) *Intergenerational transfers and public policy* (accessible here).

NZS outgo, currently expected to be about 10% of future outgo, the NZSF should aim to significantly increase that. By 2050, expected increases in the future costs of NZS would be pre-funded on a SAYGO basis so that, by 2050 costs of about half of each year's NZS should be met by drawdowns from the NZSF with the balance coming directly from taxpayers. So of each $1 of NZS in 2050, about 50 cents will come from the NZSF (effectively from the higher taxes paid by today's taxpayers) and the other 50 cents from tomorrow's taxpayers.

Some suggest there is an implied intergenerational 'bargain' that if current earners support today's NZS, tomorrow's earners will support the current style of NZS payments to tomorrow's retirees. This could be characterised as 'temporal equity' rather than intergenerational.

In fact, there is no such 'bargain' and there never has been one. To suggest this ignores the many changes to the value of NZS (both improvements and reductions) that have taken place over the 115 years since the first age pension started in 1898[16]. If we straight-lined the change in value of the pension from 1898 to 2013, there has been a significant improvement in both the annual amount and the terms on which it is paid, not least because of the improvement in pensioner longevity over the 115 years (a given state pension is worth more at the state pension age if it is payable for longer). However, if we confined the comparison to just the last 25 years since 'National Superannuation' was fully implemented in 1978, today's pension is somewhat less generous, despite improving mortality experience[17].

Recognising the past processes for setting NZS, the better way to describe the annual amount payable to each superannuitant in a year is as follows:

$$\frac{T}{R}$$

Where:
- 'T' is the total amount that taxpayers of the day are prepared to spend in that year on NZS;
- 'R' is the total number of people entitled in that year to receive NZS.

This way of distributing the government's income for pensions is governed by vertical equity because it looks at the claims on the public purse by different groups in each year, rather than temporal equity that considers claims by different groups over time.

In theory, the T/R calculation could produce a different annual amount of NZS in each year as economic, fiscal and political pressures affect the calculation and distribution process. In practice, there are good reasons why the annual amount of NZS should be relatively stable over decades. Private saving programmes to supplement the Tier 1 state pension are, by their nature, long-term commitments. It must be possible, for example, to tell today's 45 year olds what we expect their Tier 1 pension might be in 20 years.

We could, alternatively, re-express the annual NZS benefit as 'y% of GDP per capita' per annum. That would change the emphasis to something that is more directly linked to

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[16] A summary of the many changes made between 1940 and 2008 is given in *PensionBriefing 2008-5*, *A condensed history of public and private provision for retirement income in New Zealand – 1975-2008*, Retirement Policy and Research Centre (2008) accessible here.

[17] In 1978, 'National Superannuation' for a couple was *80%* of the *pre-tax* national average wage, payable from *age 60*. NZS, by contrast, is a net 65% of the net national average wage (grossed up for tax), payable from age 65.

economic fundamentals and to the case made in this paper. New Zealand's ability to pay NZS in 2050 (or to meet dividend payments or pay interest instalments or convert any of the other claims on the 2050 economy) depends not on what happened before 2050 but rather on the strength of the economy in 2050. It is, in fact, the ability of the 2050 economy to convert claims to cash that will determine the pensioners' standard of living in 2050; and for everyone else.

The stylised T/R distribution process has always been, and will continue to be, the way this happens. In other words, (apart from the reasons already explained) how NZS is financed or how 'entitlements' are described is irrelevant. Regardless of the NZSF's presence, taxpayers of, say, 2050 will effectively set the proportion of government expenditure ('claims') that is attributable to age pensions and the government will set the eligibility conditions to distribute that total so as to achieve the benefit's then current objectives, such as alleviation of poverty or even its prevention.

It does not matter, in this context, whether the NZS benefits are 'promised' with the conditions of payment being enshrined in the New Zealand Superannuation and Retirement Income Act 2001. Legislation of all kinds is there until it is changed by a new set of political leaders[18]. Again, that has always been the case. Any analysis that tries to identify the supposed past share of taxes that have gone to meet PAYGO-financed pension 'entitlements' is therefore pointless. That tries to impose a SAYGO framework where none has existed. The same applies to 'overlapping generation' (OLG) models that attempt to track the claims by cohorts over time. Forcing a cohort-style analysis on the issue does not help us to understand how PAYGO financing works.

PAYGO financing is best described as 'of the time' rather than 'over time'.

Past political leaders found it relatively easy to improve PAYGO pensions on a rising tide of baby-boomer workers because future pension promises do not have to be paid for today. Facing up to the fiscal implications of increasing numbers of baby-boomer retirees will be more difficult politically but is no justification for a change to SAYGO financing. It will just be more difficult. In fact, tomorrow's taxpayers could conclude that a SAYGO framework was intended to lock in the scale of today's pension against the possibility that tomorrow's economy might not be able to support that pension. That should be an unacceptable proposition.

If, on current guesses, the expected net 6.7% of GDP for NZS proves unacceptable to 2050 taxpayers, a new (presumably lower) number will be set and the T/R, PAYGO distribution process will apply to that new lower number. Whether part of that 6.7% is met from government-owned financial savings (the NZSF) does not change the 6.7%.

7. The state should not emulate private provision

Some SAYGO proponents misunderstand the reason that private pensions tend to be pre-funded and so reach the mistaken conclusion that governments should emulate the private sector's behaviour on the financing of retirement benefits.

In the private sector, personal (not occupational) retirement saving provision is, by definition pre-funded. The idea of an unfunded *personal* savings arrangement is a

[18] For the same reason, it does not matter whether taxpayers have paid identified 'social security contributions' to 'purchase' their pension 'entitlements' (the case, for example in the US and the UK). Those 'entitlements' are still effectively PAYGO-financed and are subject to the same kinds of changes that have afflicted NZS since 1977.

contradiction in terms. If an individual wants to save for retirement, current consumption must be reduced by the value of assets put aside in financial saving instruments. Alternatively, consumption of increases in the value of existing assets must be deferred.

Occupational retirement savings (workplace pensions; KiwiSaver and other superannuation schemes) are different. They can be unfunded. For example, the promise in an employment contract to pay a 'golden parachute' at its end is usually unfunded and depends on the employer's financial position, or even the employer's existence, at the time it falls to be paid. More formal schemes that cover many employees are almost always pre-funded: the employer's contributions are set aside in the year in which the commitment accrues, usually in a trust or paid to a financial service provider that invests the assets.

Without getting too involved in the various possibilities[19], a key reason for pre-funding an occupational scheme, particularly a defined benefit scheme, is that the employer may cease to exist. Money should be set aside from the employer's current activities to cover the possibility that the employer will not be there to meet the commitment in 20 or 30 years time.

That argument does not apply to the state pension. The government will not disappear. In 2050, it will be making the same kinds of trade-offs between revenue and expenditure; between the desirable and the possible, as it makes today. Pre-funding of a government pension cannot be justified on the grounds that support the financing of private occupational pension promises[20].

8. Why is the PAYGO/SAYGO discussion just about NZS?

Why do just public pensions deserve debate about the merits of SAYGO financing of future government obligations? The trajectory of the expected health care costs looks very similar to NZS; in fact, probably worse. So, why might we not consider pre-funding them as well? We could even add to that list future education, policing, security or any other costs that we can be certain will still be the state's responsibility in 2050 and beyond.

The likely explanation is that state pensions look and feel like private pensions and so the state should be seen to be behaving similarly to its private counterparts. Many other countries are having similar discussions about just pensions.

However, there is no difference in principle between a 'promised' pension (that is in truth no more promised than the future education services that will delivered to the young) or the guessable but unknown costs of, say, policing from 2050 on.

We seem willing to allow tomorrow's taxpayers to determine what they are prepared to pay in each year for health, education and policing and that's as it should be. This rejoinder suggests that NZS can and should be added to that list. We should understand long-term expenditure trends and that is the point of the Long-Term Fiscal Model that

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[19] That discussion could cover: the differences between defined benefit and defined contribution schemes; the intervention of accounting standards that effectively control the way employers can make pre-funding decisions; the particular case of Germany where occupational schemes are often unfunded etc. These, however, do not affect the central point being made here.

[20] On similar grounds, the government need not pre-fund the occupational pensions for its own employees.

the Treasury updates on a regular basis[21]. This shows what 40-year trends in government expenditure might look like on different bases but they have nothing to do with the financing of those expenditures. We need those projections on NZS and other expected government outlays to assess the likelihood that they might be acceptable, or not, to future taxpayers.

The fact that we can predict the trajectory of expected NZS costs does not mean we have to pay for them now, not even partly.

We do not set today's public policy on, say, the education of school children based on how taxpayer-financed school services were offered to pupils in the 1960s. Instead, we make those decisions based on what we would like to achieve in 2013 in relation to the amount of money available in 2013. The same should apply to pensions in 2050.

9. SAYGO's political risk

SAYGO advocates assume that today's taxpayers, by paying more and partially pre-funding the expected NZS liability, will pay less (or collect more) in the future. That seems unlikely.

Including the annual amount drawn down from the greatly enlarged NZSF, it is in fact more likely that *total* government expenditure (including the NZSF's annual drawdown) will be higher in the presence of that contribution than in its absence.

That is because there is no commitment in the SAYGO framework to reduce the future tax-take in each year by the value of the annual drawdown to be received from the NZSF in that year. That applies to the NZSF now and will probably also be the case for the SAYGO proposal. Politics being what they are, the pressure to lower pension payments in the face of fiscal austerity would be constrained by the presence of the NZSF. In a way, that is the point of pre-funding. Equally, the ability to resist pressure to increase pensions beyond those currently 'promised' would be reduced in the presence of the NZSF, notwithstanding the formal pre-funding arrangements. Even if there were a formal commitment to reduce taxes by the amount of the NZSF's drawdown in each year, it would be easy to circumvent it.

In fact, a case could be made in which an NZSF-look alike of up to $200 billion would worsen the potential intergenerational 'conflict'. It could even raise, rather than lower the risk of changes to NZS though those changes would be more difficult initially to make, given the presence of the fund and the feeling (but not the reality) that 'entitlements' had been paid for.

10. The NZSF has not justified its existence

The government has about $100 billion of gross debt (bonds, Treasury bills and other borrowings) on its balance sheet at 30 June 2012[22] or about 49% of GDP.

On the other hand, the NZSF (an operational arm of the government) was worth about $19 billion at 30 June 2012. The RPRC has looked at the NZSF's investment performance in two *PensionBriefings*[23], based on a detailed analysis in Littlewood (2010)[24].

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[21] The Treasury's model is accessible here.

[22] The Treasury (2012) *A Snapshot of the 2012 Financial Statements Government of New Zealand*, accessible here.

[23] The most recent analysis is Retirement Policy and Research Centre (2013) *Updating the NZSF investment performance numbers to 2012*. That is accessible here.

Those reviews argue that the NZSF's returns have first to exceed the cost of debt before the government has made *any* economic gain from the presence of the NZSF. That is because the government could, at any time, sell the NZSF's assets and repay $19 billion of its debt (as of 30 June 2012). In fact, over nine years to 2012, the NZSF's accumulated returns exceeded the cost of debt by just $346 million (2% of the NZSF's closing assets at 30 June 2012).

However, the more relevant 'hurdle rate' should allow for the risk of an investment portfolio that is effectively 100% leveraged, looking at the government's overall balance sheet in a 'total accounting context'. The *PensionBriefings* suggested this allowance for risk should be a margin of at least 2.5% a year over the cost of debt, though a higher rate could be justified. On this test, the NZSF has cost taxpayers an accumulated $2.8 billion as of 30 June 2012 (15% of the closing assets at 30 June 2012).

The NZSF has not justified its existence in the nine complete financial years since it began and illustrates the kind of risks that a much-enlarged fund would run in the proposed SAYGO environment.

11. The real question

As explained, the cost of a pension in the year of payment is unrelated to the way in which it is financed. Given the SAYGO proponents' assumption that NZS will remain payable by the state then, based on current projections, a net 6.7% of GDP will still be the cost, other things held constant.

We must therefore conclude that Coleman's underpinning thesis is that a net 6.7% of GDP in 2050 will be unacceptable to taxpayers of tomorrow. What then might be acceptable? 6.0%? 5.5% or 5.0%? That is the 'affordability' question we should be addressing – the 'T' of the T/R distribution process.

If the electorate 'says' it is happy to accept the expected increase to a net 6.7% of GDP, there is no purpose in pre-funding NZS. On the other hand, if that level of increase is seen to be unacceptable then addressing the benefit design of NZS is the simplest, most direct way of addressing the issue.

12. What should we be talking about?

This is not to suggest that the design of NZS should stay 'off limits' as a current topic for public debate until 2050; quite the contrary.

Given the link between benefit design and the cost of any superannuation scheme, New Zealand must develop a consensus about the long-term shape of NZS. Despite a 40 year history of policy instability on superannuation issues, including the much-amended KiwiSaver, the summary below states when we last had any sort of a proper, research-led discussion about each of the key design parameters that define the annual NZS amount paid:

- State pension age of 65: the last full discussion on this was held in 1898, with some fiddling between ages 60 and 65 between 1977 and 2002 (the reduction to age 60 was undebated; the increase back to age 65 was also undebated);
- Residential qualification for entitlement – never;

[24] Littlewood, M. R. (2010) *Pre-funding a government's future financial obligations - the New Zealand Superannuation case study* New Zealand Economic Papers Volume 44 (Issue 1, April 2010): 91 – 111.

- Pension of a net 65% of the net national average wage for a married couple – never;
- Pension to singles who share accommodation at 60% of the married couple's rate – never;
- Pension supplement for singles who live alone – never;
- Inflation linkage to national average wage – never;
- Review process – never.

New Zealand needs a research-led discussion on each of these elements. In the current political climate, that discussion is unlikely. Just to take the state pension age of 65 as one example of the seven key cost drivers of NZS:

- The National Party says that it will not discuss any aspect of the design of NZS. On the age, National's leader John Key states:

  > "National will also maintain the age of eligibility at 65 years. We will keep this pledge, and I will resign as a member of our Parliament rather than break it."[25]

- The Labour Party, by contrast, suggests an increase in the state pension age from 65 to 67:

  > "Labour will gradually lift the age of NZ Super eligibility from 65 to 67 starting in 1 April 2020 and taking 12 years to phase in."[26]

- The Green Party will "maintain universal New Zealand Superannuation for all New Zealanders 65 years and older…"[27]

- New Zealand First has reaffirmed "…its "unequivocal" position for the age of entitlement for Government Superannuation to remain at 65."[28]

- "The Maori Party has always advocated lowering the age of entitlement to New Zealand superannuation to 60 years for groups whose life expectancy is lower than average…"[29]

- The Act Party's leader, John Banks (11 June 2012) stated:

  > "Increasing the age by two months a year, every year, until the age of eligibility reaches 67 – an adjustment over 12 years – is a fair way of introducing the change and will give people time to adjust…"[30]

The Labour Party suggests that it is prepared to discuss NZS with other parties[31] but that is not what New Zealand needs. Agreement amongst political leaders must be the ultimate objective because they control the legislative process. However, an essential first step is to gather the information New Zealanders need to discuss all the implications of a shift in the state pension age before we make that change; and then to have that discussion.

The expected cost of NZS is just one of those implications; the impact on the labour force of a change in the state pension age is another example. With quality information on all the implications, parties can form policies that fit their particular political

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[25] Key, J. (2013) *John Key's Commitment to Seniors*, National Party website accessible here.
[26] Labour Party Manifesto 2011 *Own Our Future*, at p. 234 accessible here.
[27] Green Party of Aotearoa (2013) *Income Support Policy*, Green Party website accessible here.
[28] Peters, W. (2012) *Entitlement Age for Superannuation To Stay at 65*, New Zealand First website accessible here.
[29] Maori Party (2011) *Kawanatanga: Superannuation*, Maori Party website, accessible here.
[30] Banks, J (2012) *National Should Reconsider NZ Super Position*, accessible here.
[31] Shearer, D. (2012) *Genuine debate on Super affordability needed now*, Labour Party website, accessible here.

ambitions; the absence of that data condemns us to repeat the mistakes of the last 40 years.

New Zealand needs to start that research-led, national debate now. Tomorrow's retirees need plenty of notice as to what they might expect from NZS so they can make appropriate decisions about private provision for retirement.

In the absence of a research-led, national debate on the design of NZS, it seems at best premature to discuss how to pay for a pension when we do not know what that pension might look like, even if we accepted that SAYGO-financing is a good idea. Coleman effectively assumes an NZS status quo. That might be done to illustrate a point but is the wrong place to start.

13 'Mixed ownership model' another distraction

Coleman (2012)[32] analyses another version of the SAYGO model – the so-called 'FSC supplementary scheme'[33].

Instead of having the government manage the assets underpinning the 'purchase' of the higher NZS costs associated with an aging population, the 'mixed ownership model' sees the state:

- For the Tier 1 NZS, fix a somewhat higher state pension age (say, age 73) that the FSC argues will be related to mortality improvement over coming decades;
- Require citizens to bridge the income gap for the eight years between ages 65-73 by compulsory private savings at Tier 2 that are used to buy a fixed term annuity[34].
- If the Tier 2 savings are insufficient to fully cover the income gap, the government would top them up to the required level.

It is easy to see why an organisation representing fund managers might want to promote a compulsory or 'semi-compulsory' top up to a reduced NZS but the question is whether what the FSC calls 'KiwiSaver Plus' might be sensible public policy. The answer must be no.

It is for the government to set the terms of NZS and, as already described, to balance its policy objectives with available resources. If the government decided that a net 6.7% of GDP in 2050 was unaffordable, it must reduce the expected cost through changes to the NZS pension. It makes no sense to shift part of those costs into the private sector and force citizens to make up the reductions – that does not change the overall cost to the

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[32] Coleman, A. (2012) *Intergenerational transfers and public policy*, accessible here.

[33] As detailed in Financial Services Council (2012) *Pensions for the Twenty First Century: Retirement Income Security for Younger New Zealanders*, accessible here.

[34] The Financial Services Council says it is "agnostic" as to whether the private supplement should be compulsory or voluntary (Financial Services Council (2012) at page 8). That is disingenuous and may be intended to sidestep comparisons with the 'Retirement Savings Scheme' proposal that was defeated decisively in the 1997 Referendum. It may even be intended to insulate the proposal from claims of self-interest because the FSC's members would administer the KiwiSaver Plus schemes. If, as the FSC suggests, public policy should have a view on retirement income support between ages 65 and 73, some form of compulsion is inevitable for the private savings 'gap filler'. The proposals to top up inadequate savings if they are insufficient to buy the bridging annuity and even to require that voluntary savings must purchase an annuity to fill the 'gap' between ages 65 and 73 are both anathemas to the notion of a voluntary supplement. The FSC supplementary scheme will not work in the way it proposes unless the so-called KiwiSaver Plus arrangement is compulsory.

economy of the NZS-associated claims; it simply re-distributes that cost between publicly and privately administered claims on tomorrow's economy.

Instead, after setting the qualification and benefit conditions for NZS that it believes are appropriate, the government should let individuals (and employers) decide how to reshape their decisions about work, retirement, retirement income, housing needs and the other things that ease the transition from full-time work to full-time retirement.

14. In conclusion

The SAYGO proposal to partly pre-fund NZS over 35 years is a policy red herring that has the potential to massively disrupt the future political and budgeting process affecting the most expensive single item of government expenditure. It also has the potential to see large swathes of the economy under the political control of future governments, all the while failing to address the key issue: the size and shape of NZS itself. With a SAYGO public pension, the government will undoubtedly end up larger than it is now but the real question is whether the economy itself will be larger.

With even modest levels of growth over the next 70 years, the grandchildren and great-grandchildren of current workers will be significantly wealthier than those workers. So, why might public policy determine that today's workers reduce consumption over the next 35 years (akin to another form of taxation) to produce higher levels of incomes when a stronger future economy might easily deliver minimum standards of living more effectively through NZS? Workers may decide to do that for themselves but there seems no public policy justification to insist on that or even encourage it. Incentivising or forcing workers to do this today (with the consequential impacts on today's economy) seems misplaced when tomorrow's incomes are likely to be so much higher in real terms than today's.

SAYGO proponents think that governments should emulate private behaviour and make advance provision for expected future pension obligations. In fact, they misunderstand the true nature of those obligations and should instead be thinking about the real issue – improving New Zealand's economic performance today and into the future. They should then leave the producers of tomorrow's economic output to decide what proportion of that should go to non-producers (including the retired).

A SAYGO-financed NZS is the answer to a question that should not have been asked. On that basis, it is simply a distraction.

On balance, the current PAYGO public pension seems appropriate now and into the future, leaving workers to make supplementary SAYGO decisions on a voluntary, unsubsidised basis (or through subsidised KiwiSaver arrangements[35]) in ways that best suit their individual circumstances as those unfold through their working lives.

[35] We could start another equivalent discussion about the public policy merits of tax subsidies for KiwiSaver savings (and requiring employers to match members' contributions) or even the auto-enrolment, opt-out framework that is central to KiwiSaver. There are policy echoes with the arguments that underpin the SAYGO public pension suggestion.