

Providing for Retirement: Some Key Issues

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Introduction

This topic has become one of the most problematic areas of policy debate around the world. The onset of a marked demographic transition, combined with debate about the role of government and the efficiency of public provision, has provided both a trigger and a platform for debate. In New Zealand, retirement income policy has been a volatile and unresolved issue since the 1970s. During the 1980s and 1990s there was considerable debate about the long-term policy settings. Following the passage of the New Zealand Superannuation Act (2001) the issue appeared to drop off the political radar. However, it has been revived more recently as a result of political and other contributions – such as New Zealand First’s proposal for a “golden age card” and the New Zealand Institute’s discussion papers on an “Ownership Society”. This flow of ideas, combined with the shifting demographic profile, should ensure that retirement income will remain a live issue in the minds of the electorate.

The framework for retirement income

While the term ‘retirement income’ is commonly used and there is general acceptance of its meaning, the specifics are less clear. Retirement income does not exist to increase national savings or to provide jobs for actuaries, tax lawyers, accountants, fund managers, or regulators. The purpose is to help the elderly live in dignity.

Within this objective there are a number of tensions for the simple reason that there are many influences on individual behaviour and a number of needs to be met when designing schemes for retirement income. There is also a wide and diverse range of stakeholders (individuals of various ages, government and a group of agencies), so that any alternative arrangements should at least be tested against a common set of criteria. In

1999, the Super 2000 Taskforce suggested the following headings for this purpose:

Policy stability

When making provision for retirement, people only get one chance and there is no possibility for “learning by doing”. Also, the time frame is far longer than for almost any other decision they will make, and most people are risk-averse in such situations. Therefore policy stability is, essentially, the need for policy changes to take place only after careful deliberation and in a manner which allows individuals to adjust to any consequences.

No government can provide certainty, but it can attempt to reduce instability, e.g. from rapid or unanticipated shifts of policy. But the desire for stability must be carefully distinguished from a desire to maintain the status quo. It would be dangerous to use the status quo as a hurdle that has to be overcome before change can even be proposed (let alone implemented). A key difficulty is that policy stability implies different treatment according to age. In this area of policy, as in others, risk factors will change over time and will require constant re-assessment. As always, innovation and progress require change.

Sustainability

The Periodic Report Group noted in 1997 that any retirement income scheme must pass the test as to whether it can be sustained over a long period. If a scheme is unsatisfactory, in terms of adequacy, efficiency, equity or fiscal cost, it will come under pressure for change or replacement. For these reasons, the Group suggested that any scheme requires mechanisms to accommodate adjustments without requiring large, frequent or radical changes. In addition, this would allow successive governments to incorporate changes prompted by new research or changes in economic, demographic or social conditions; changes

in conditions, such as demographics, have the potential to upset a previously sustainable scheme.

Adequacy

Perhaps the core objective of retirement income is adequacy. Modern societies demand that people have a level of income in retirement sufficient to provide for a basic standard of living. What constitutes an adequate standard of living is debatable: values, ideals and attitudes have changed in the past and will continue to do so. While New Zealand and Australia have tended to focus on the need to prevent old age poverty and provide for a minimum standard of living, European countries have tended to relate retirement income to lifetime earnings; hence, 'adequacy' can be understood in a range of ways.

Equity

Equity is a contentious issue; it is a concept implying relativity, but without any clear basis for actual measurement. In the debate on retirement income, equity is most often judged by inter-temporal effects, i.e., allocation between generations. But equity also relates to intra-temporal issues – for example, equity in terms of the tax treatment of alternative savings vehicles. It is also related to fairness in relation to individual preferences. A person who chooses to spend more freely prior to retirement will end up with less income than one who spends more prudently – which clashes with some notions of equity.

Efficiency

All retirement income systems are costly. However, it is desirable for unnecessary costs to be avoided. The distribution and allocation of costs will also affect individual behaviour, and any judgements to be made under the other headings listed above. One measure of policy might be the degree to which adequacy and equity are achieved while minimising total cost. Of course, a system designed around these criteria alone may not lead to a sustainable solution.

Why is reform needed?

In common with many other countries, New Zealand is experiencing a rise in the proportion of older people as a result of increased life expectancy and lower birth rates. Analysis of census data suggests that the proportion of the

population aged over 65 will rise from the current 12% to 25% by 2050. But the changes are far more profound than the simple ageing of individuals. The shift in demographic structure is associated with an increase in 'age dependency'; i.e. the ratio of people of retirement age relative to those of working-age. Under present arrangements, annual payments under NZ Superannuation will rise from current levels of 4% of GDP to around 9% over the next 50 years. This trend has the potential to affect the stability of the whole economy.

The demographic change will also extend further the length of time people are expecting to be 'retired'. In 1900, the average life expectancy for both men and women was less than the qualifying age for the old age pension; in 1938, when 'universal superannuation' was introduced for those over 65 the average life expectancy was 65 for men and 68 for women. While the qualifying age for National Superannuation is currently 65 life expectancy has increased substantially; therefore, the period over which the government is expected to contribute to retirees' income is considerably longer. Over time, as the New Zealand population ages, the nature of this population will change (both in terms of age and ethnicity). At present, the over 65 year age group is dominated by Europeans while the Maori and Pacific Island population is generally much younger; however, over time Maori and Pacific peoples will form an increasingly significant component of the older age groups.

In general, it is expected that retired people in New Zealand will continue to become more diverse in many ways: marital status, employment history, asset holdings and educational profile. This diversity must be accommodated. Recent research reveals both the lack of financial wealth among New Zealand retirees and the fact that, relative to other countries, asset ownership in New Zealand is much more heavily weighted towards housing. As a result, the retired population is particularly sensitive to changes in the rate of New Zealand Superannuation.

All these changes in demographics, population structure, the labour market and the status of New Zealand's retired population provide good reasons to rethink the way in which New Zealand makes provision for retirement income. The central question is; precisely what changes should be introduced?

What are the options?

Pension reforms initiated around the globe have tended to have common ingredients: retaining a state-run distributive pillar in support of the old-age poor; a complementary pillar of fully-funded savings based on personal accounts (which may be run by either the public or private sector); and a pillar of voluntary private savings. For the majority of reforming countries, these changes represent a radical departure in three ways:

1. A more explicit separation out of the redistributive component of retirement provision;
2. The substitution for a pay-as-you-go arrangement (PAYG) by a fully-funded arrangement (at least in part) of old age saving; and
3. The frequent use of private management for the collection of contributions, the investment of pension funding savings, and/or the payment of pension benefits.

Despite the move away from PAYG schemes one of the goals of public pensions is to reduce poverty among the elderly and so, even with a fully funded scheme, some form of public pension scheme is likely to be necessary. Therefore, the debate over pensions should be concerned with the relative merits of arrangements implemented in addition to the state-run distributive pillar.

PAYG schemes: For an individual, PAYG schemes rely on an implicit contract: i.e., a contribution now ‘guarantees’ a pension in the future. These schemes are a direct transfer of the right to consume from younger to older people and are usually run by the state because they have the ability to tax current income earners and use the proceeds to pay current pension demands and do not need to accumulate funds over time.

These schemes require the output per worker to exceed the sum of the growth rates in the retired population and in real pensions, otherwise changes in the contribution rate, in coverage or in the payout must be made. In times of real income growth and with a population that isn’t ageing, there is an incentive to provide a PAYG scheme as everyone gains.

Contrary to popular belief, these schemes are not risk-free: governments can, and historically have, discounted, defaulted and changed the rules of entitlement and pension provision. In doing so, they may violate the

previously agreed commitments to provide predictable, stable, long-lasting and comprehensive coverage. In addition, they cannot cope with a diversity of time preference.

Funded schemes: These rely on the investment of current income into financial assets that are then used for the provision of a future pension. Thus, these schemes are a mechanism for accumulating financial claims, which can be exchanged at a later date. While there are many variations on funded schemes there are two main types of funded schemes, ‘defined benefit’ or ‘defined contribution’. They possess the following distinguishing features:

In defined contribution schemes (DC) the individual’s pension (or entitlement) is determined only by the sum of the accumulated financial assets of the individual and the fund’s earning rate. That is, the ultimate benefit depends on the individual’s contributions and planning success so that their pension benefit is funded in advance. Historically, these systems have been highly focussed on the individual; however, the exact nature of this type of scheme is becoming more blurred as notional defined contribution schemes have been enacted in countries such as Sweden.

In defined benefit schemes (DB) the pension paid out is determined by the employee’s previous wages (over some nominal period). Historically, DB schemes were designed to help solve contracting problems between workers and firms. Firms often want to reduce worker mobility because hiring is costly or because new workers need firm-specific training. However, workers do not want to commit to remaining with one firm. A rising wage profile and back-weighted pension accruals induce a worker to stay. However, the benefits of these schemes were distributed very unevenly: some employees did very well while most did not benefit.

Reform options: While the path taken by many countries follows a template provided by the World Bank in 1994, leading to similarities across the world, each country starts from a different position and has a different set of ideals and norms. Many argue that the natural policy response to population ageing is to find ways to increase self-provision for retirement, normally in the form of compulsory savings by employees or their employers.

New Zealand has not followed this path. Interestingly New Zealand adopted it for a brief time in the early 1970s with the contributory scheme of the Labour Government; however, the election of the 1975 National Government resulted in this scheme being changed to universal New Zealand Superannuation (NZS). Hence, private provision for retirement relies on voluntary savings and the New Zealand 'solution' to the fiscal pressures on its publicly provided pension programme has been the creation of the New Zealand Superannuation Fund (NZSF).

However, this is not a structural change or an increase in the private provision of retirement income; rather it is a mechanism intended to change when the burden of increased future pension payments occurs. This 'solution' does not change the balance between the roles of the government and the individual; its objective is to maintain the government's financial ability to continue to provide a universal public pension. In considering the future options a number of key issues must be addressed.

Key issues

Economic growth

Real income growth is critical for all retirement income schemes. PAYG schemes have relied on income growth to enable current pensions to exceed past contributions; i.e. the sum of the growth rates in the working population and labour productivity must exceed the sum of the growth rates in the retired population and the real pension. Similarly, DB schemes rely on the ability of future generations to fund the retirement of past generations. DC schemes rely on the individual's contributions and success in asset allocation; therefore, the economic growth rate affects individuals' views of future economic conditions and, by extension, their willingness to forgo current consumption for the benefit of future consumption.

Uncertainty and risk

One of the major reasons for the New Zealand Superannuation Act (and the New Zealand Superannuation Fund) was the desire for certainty. However, certainty in state provision does not imply certainty for the individual. The recent AMP Superannuation survey notes that of all those surveyed,

45% (49% in July 2000) were saving for their retirement; when told the rates for NZS 76% said that was not enough money; and 62% said they did not think a similar level of pension would be available for them on retirement.

Uncertainty and risk are two different core issues that pension schemes face. With risk, the probability distribution of potential outcomes can be estimated; with uncertainty it cannot. Therefore, while insurance can deal with risk, it cannot deal with uncertainty. For pensions there are at least three sources of uncertainty:

1. Macroeconomic changes. For example, a decline in real output has adverse effects on pension schemes. Inflation affects pensions, but tends to affect funded schemes more e.g. the effect on German private savings due to hyperinflation in the 1920s;
2. Demographic changes. Changes such as population ageing affect all types of schemes; however, changes in demographics have played the most significant role in placing the PAYG schemes under pressure to change; and
3. Political changes. The enforceability of the inter-generational contract, for example, requires effective government, while there is no 'higher court' to appeal to if the government of the day changes the nature of pension provisions.

Pension schemes also face sources of risk:

1. Management risk. Pension funds can be affected by fraud and incompetence (e.g. The Maxwell Group of Companies in the UK)
2. Investment risk. The choice and behaviour of any pension plan manager affects the returns to the fund, and fluctuations in fund value.

One of the reasons for any pension scheme is to distribute and apportion risk and uncertainty.

New Zealand: can we continue to be special?

New Zealand is similar to other developed countries in having a significant public pension scheme. However, New Zealand is unique in its complete reliance on taxation funding and its focus on universal benefits; this reflects New Zealand's social and political history. Despite New Zealanders' desires for policy stability it is important to note that since the introduction of NZS the level of payout has been adjusted a number of times,

including changes to the indexation regime; a taxation surcharge has been introduced (and removed); the age of entitlement has changed; and the system has been characterised as unsustainable (by the 1988 Royal Commission on Social Policy).

The comparison with Australia: With the increasing emphasis on closer economic relations between New Zealand and Australia, we have seen a closer integration of the Australian and New Zealand labour markets. In both countries there has been a move towards more flexible labour markets for both sexes, and more transparent remuneration policies. In these circumstances, New Zealand's ability to maintain a separate approach from Australia in relation to retirement income is questionable.

Until 1986, Australia relied on its Age Pension (a universal, but means-tested, benefit payment) for retirement income provision. When a Labour Government was elected in 1983, a major part of its economic strategy was a continuing contract with the union movement. This set the scene for the introduction of a compulsory superannuation scheme – this was seen as a deferred wage and salary arrangement, rather than as a significant change in social security.

In any country, structural reform of retirement income is complicated politically and economically. Many of the expected benefits are long-term, uncertain and will largely accrue to younger people. Faced with limited resources and pension costs that have become the largest single item of public expenditure, most governments will change some aspect of the pension system (such as increasing the age of entitlement or changing the indexation regime). Thus, reform is not a case of weighing the interests of the young against those of the old but rather a question of community, and ideally cross-party, consensus. One mechanism for encouraging this is to use institutional structures to focus the debate. In Australia the strong union and employer groups had a century-long history of bargaining before the arbitration courts. This helped to develop an incomes policy within which a trade-off between a wage increase now and retirement income later became workable.

Stocktaking for the future

The extensive liberalisation of the New Zealand economy in the 1980s and 1990s did not include any overhaul of the country's approach to retirement income. We have

seen that the current scheme attempts to cover three major objectives: relief of poverty, recognition of the aged, and deferral of income - so that living standards in retirement can be closer to those enjoyed during working life.

True, NZ Superannuation does offer one measure of stability, i.e. all New Zealanders, regardless of lifetime earnings or other variables, such as illness, can be comfortable in the knowledge that they will have an income when they retire. The aim of the scheme is that this should be at an "adequate" level. This depends in turn on an overall societal view on what constitutes an adequate standard of living.

We see in effect that the appearance of stability is deceptive; the system results in an inter-generational transfer which is large and increasingly burdensome for the working-age cohort. The NZSF was set up to meet some of these problems, but there are many "ifs and buts" which suggest that, despite broad political acceptance, it is in itself not a solution. It is not too hard to see it failing the test of sustainability. Before that happens, we should make use of the current good health of the economy to explore how other elements could be brought into the overall design.

In a different world...

Over a period of 25 to 30 years, the world has been changing quite fundamentally for New Zealand and for New Zealanders. As individuals, we have much more freedom to travel, see the world and change our place of employment or residence. The country's economy is itself more closely integrated with the world economy. New Zealanders are increasingly able to compare our standard of living with what is available elsewhere (particularly on the other side of the Tasman).

Another significant trend, and one which has been reinforced by this greater exposure to the outside world, is the move towards a more diverse society inside New Zealand. Ageing of the population is not the only factor which might influence future policies. Society is also changing; in particular, there is an ongoing growth in the Maori and Pacific Island populations. Historically, these groups have had quite different experiences in terms of the way they provided for old age. Home ownership rates have been lower, as has life expectancy. The precise composition of population growth thus becomes more relevant to policy.

Changes in New Zealand society, in family structure

and in the nature of households has already altered the type of housing required. Although housing investment in New Zealand has traditionally been as 'safe as houses', past trends may not be a good indicator of the future. No longer is population growth driven by a high birth rate and no longer is the nuclear family the standard model for home ownership. A standard pattern for housing tenure, career, and early family formation has given way to a wide range of lifestyle pathways. Therefore, investing income in the housing market may become less desirable as an avenue of providing for retirement.

Finally, changes in the profile of a "working life" have already become substantial. One feature of PAYG schemes is that they maintain a link between the 'age of entitlement' and the 'age of retirement'. Given the decreasing size of the workforce, increased longevity, loss of skills and decline in well-being when people retire, and the desire for many people to work during at least their early years of retirement, breaking this link would be valuable. Increasing the age of entitlement in the 1990s demonstrated how sensitive the New Zealand labour force participation rates can be. A move to a more flexible, and individually focussed, retirement age would be advantageous to both older workers and employers.

Adding to the choices

Not only does the current New Zealand system of retirement income provision fail the equity test in terms of intergenerational equity, but it also fails in terms of intra-temporal equity. Is it equitable to have a system which removes incentives to achieve higher earnings during one's working career in order to improve one's post-retirement standard of living? Intra-temporal equity is also important for other reasons. For example, people naturally expect it in the tax treatment applied to different ways of saving. Currently, owner-occupier housing in New Zealand is tax-favoured. This leads to distorted investment patterns, which may also affect the potential for economic growth.

Given that the PAYG scheme is both inequitable and potentially unsustainable, something else is obviously needed to spread the risk to the individual. This could be designed as another pillar alongside the universal pension and need not be publicly provided. The DB arrangement can be quickly discounted: in its time, it

was part of a deliberate strategy to keep workers locked into employment. This strategy runs counter to current (and foreseeable) patterns. A scheme based on direct contributions by individuals is required.

The Australian system is based around individual accounts, as is the current Canadian system, and the same mechanism has been promoted as a key element in the recent United States reforms. Arguably, this type of account can have two main benefits for a nation's economy. First, the accumulation of investments will add to private and national saving and thus aid the rate of domestic capital formation (or the accumulation of the nation's overseas assets). Second, this structure provides better incentives for older workers to decide as individuals how to structure their pattern of employment. Crucially, this arrangement makes it very difficult for governments to break commitments previously entered into.

In order to minimise risk, it would be advisable not to rely on an implicit contract; however, reliance on one source of income is also risky. Instead, the aim should be to receive income from a range of sources (a portfolio approach) – and so we return to the three pillars. The public pension will still provide a floor to protect against old age poverty. The mandatory private savings will establish a link between retirement income and employment history (as well as various consumption/lifestyle choices). It will also reduce the incentive to free-ride, and will reduce the taxation advantage of domestic housing. The third pillar, voluntary savings, would also exist for those who wish to pursue this option.

It can be seen that the argument for pre-funding through individual accounts becomes very powerful. It responds to the importance of economic growth and the need to avoid too great a gap between old-age income in this country and that accessible in other nations, especially those where New Zealanders can easily migrate during their working life. Possibly, the objective of this pillar should be defined as "providing the mechanism that is most likely to provide retired people with optimal ability to consume"; rather than link it to the maintenance of a minimum standard of living (the first pillar). Economic and financial changes in the last 20 years have compelled people to become more discerning about consumption choices, and this in turn is associated with the growing importance of self-regulation.

Conclusion and postscript

To sum up, the current arrangement may be acceptable to today's pensioners and may not result in a substantial decline in income for many New Zealanders in the short term. In the medium to long term, its defects will become more obvious – it will not do enough to promote economic growth, nor will it improve the ability of future retirees to consume. The economic future of New Zealand, its households and its individual citizens is quite different from that experienced since 1970. It is, therefore, timely to restructure retirement income provision in New Zealand in order to provide for the living standards of tomorrow's retired population.

The creation of a scheme where the eventual payout is in part a function of previous contributions should appeal to our notion of equity for the individual. The accounts would provide a transparent instrument, similar to that used in many other areas of policy. They would represent a shift away from hidden transfers and unequal treatment for different groups. The creation of the NZSF was essentially the creation of a mandatory savings programme and its existence now provides New Zealand with an opportunity to effect real structural change. This change could reflect the increased diversity of the New Zealand population, together with evolving patterns of lifetime employment and the need for the individual to manage risk and responsibility.

It is normal for structural change to occur in times of extreme budget pressure. The greater challenge for today's policymakers is to recognize that the extremely healthy state of the economy offers the country a singular opportunity. They may not again enjoy the budgetary flexibility to seize it.

Postscript: The 2005 Budget was released as this article was in the final stages of going to press. In effect, it provided little for those interested in retirement savings in New Zealand. The KiwiSaver scheme attempts to encourage savings for a number of reasons, one of which is retirement. However, the policy focus of the scheme is blurred. First, it is an attempt to encourage "savings" as such, and second it is facilitating home ownership. Which goal does it really target?

One has to ask; who will benefit from the scheme in practice? Unfortunately, the main beneficiaries will be those close to retirement. But there is a

small glimmer of hope... an optimist could suggest that the real benefit of KiwiSaver will be the indication it provides that the Government has finally zeroed in on the issue of savings. If so, then maybe – just maybe - the scheme is testing the water for some more definitive action in the near future. Which brings us back to the need to clarify the key policy objective.

Richard Hawke carried out extensive research on this topic at IPS during his tenure of the Henry Lang Fellowship from 2003-4 and the Institute published his detailed study early this year, under the title "Retirement Income Provision in New Zealand: A Way Forward". This article draws on the original study and on more recent contributions to the debate. A full bibliography is contained in the main publication (pp.147-162). Both IPS and the author would welcome any comment on the suggested approach to future policy on retirement income.