Robert Stephens

Focusing on the Future

a summary and critique of the 2013 retirement income report

Introduction

Every three years, under the New Zealand Superannuation and Retirement Income Act 2001 the Commission for Financial Literacy and Retirement Income is required to conduct a review of retirement incomes, to be submitted to the government. This article presents a summary and discussion of their 2013 report, entitled *Focusing on the Future.*

The commission is funded by the government, but operates and comments as an independent organisation. However, the terms for the triennial review are determined by agreement between the government of the day and the commission. Between reviews the commission's work focuses on improving New Zealanders' financial literacy, ensuring that there is free and independent financial information available, and monitoring retirement villages legislation, with the overall objective of improving the financial well-being of New Zealanders throughout their lifetimes.

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Retirement income policies cover both public provision via New Zealand Superannuation (NZS) and the veteran's pension, and private provision through KiwiSaver, occupational pensions, and private savings through bank deposits, shares etc. The split between public and private is not clean. Public provision is largely funded from current government revenue, predominantly taxation revenue on a pay-as-you-go basis, although the New Zealand Superannuation Fund, built up from tax revenue (plus accumulated interest), is largely invested in the private sector and can be used to smooth NZS expenditure flows (Guardians of the New Zealand Superannuation Fund, 2013). KiwiSaver is operated on a save-as-you-go basis to individual accounts, accumulating interest throughout the contribution period, based on contributions from employees (who are automatically enrolled, with an opt-out provision), with employers required to provide a matching contribution. There is a government tax offset of $1000 upon enrolment in the scheme, plus a 50% tax credit for contributions to a maximum of $521 per annum. This government contribution to KiwiSaver amounted to $1.05 billion in 2012, or about 12% of the current costs of NZS (Dwyer, 2013). Other private savings receive no tax assistance, and the interest and dividends

from the private savings are taxed at the individual's personal income tax rate.

The 2013 report was able to draw upon nine policy position papers and a variety of background papers prepared for the commission. Each paper related to particular aspects of the terms of reference, as well as past reviews and government responses to those reviews. The terms of reference, and the wider context surrounding the report, were discussed at a workshop held by the Institute of Governance and Policy Studies. The papers and workshop fed into a peer-reviewed discussion document. The final report was tabled in Parliament in December 2013.

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The report

While the report is a stand-alone document, it really should be read in conjunction with the background and position papers. The majority of the report relates to future challenges facing both the private and public provision of retirement income, set in a global and historical context. Seventeen recommendations were made, covering NZS, KiwiSaver, the New Zealand Superannuation Fund, financial literacy, taxation, age-friendly housing and workplaces, and international pensions. The executive summary provides a succinct abstract of the report.

The global context

The report's chapter on the global context shows that most countries have developed distinctive programmes to provide income in retirement, with different emphasis on the three tiers of pension income – with government provision of a universal superannuation at age 65, occupational pensions and voluntary savings.

The chapter provides limited comparative data on trends in the number of pensioners, pension expenditure and labour force participation rates. Knowledge that most OECD countries have an average ratio of government pension expenditure relative to national output of 9.3% in 2010, which exceeds the projected ratio in New Zealand of 7.2% in 2050, would have been vital contextual material. NZS is affordable by international standards: the real issue is whether we want to spend that amount of money on pensions. The level of expenditure is thus a matter of intergenerational equity, and thus social (and political) choice, based on what the alternative uses are for the fiscal expenditure saved if the cost of NZS is reduced.

Instead, the chapter concentrates on different scenarios based on the level of future economic growth and social cohesion, set in a context of likely and uncertain global economic, demographic, health and societal trends. Economic progress and a lack of social cohesion could lead to a situation of winners versus losers, while economic growth and social cohesion should lead to success. A failure in economic growth could result in a fall in social cohesion or all of us struggling together. To be useful, this matrix needed to establish the framework for the remainder of the document.

The framework for retirement income

Much of this section of the report is a descriptive history, along with information on the outcomes of the current framework for older New Zealanders. One interesting feature is the wide range of programmes in existence for pensioners, ranging from NZS and KiwiSaver to the SuperGold Card, the means-tested assistance of the Community Services Card, housing, transport and mobility assistance, special needs grants, disability support and rates rebates. There is little analysis of how these programmes developed, how they link together, or their fiscal costs and distributional effects.

The report shows that two key features of retirement income policy – lack of compulsion for savings and a lack of policy to replicate working income levels into retirement – have persisted. The report does not state the dominant policy objective, which is the adequacy of income levels in retirement. Another feature overlooked is the constantly changing use of the tax system in regard to savings, especially in regard to occupational pensions: until 1986 contributions to superannuation funds received a tax reduction, but receipt of the pension was taxed; between 1986 and 2006 there were no tax advantages from entering occupational pensions (leading to a substantial drop in participation in occupational pensions), but pension receipt was tax free; and post 2006, KiwiSaver has provided a $1000 inducement to enter into voluntary schemes and a small tax reduction on contributions. Given the report's stress on intergenerational equity, some analysis should have been made of the idiosyncratic nature of the winners and losers from these different tax treatments.

The report provides eight objectives, which cover the adequacy of income support; ensuring financial and social well-being; personal responsibility for managing of finances; risk-pooling if individuals live longer than they expect to; a citizenship dividend based on past contributions to society; lifetime consumption smoothing, due to a mismatch through the life cycle between needs and income; equity between generations so that each generation pays taxes roughly equivalent to its pension receipt; and the government having a sound fiscal position that can permit payments of NZS. While the report identifies the need to 'find a balance between the [eight] objectives that is both politically and fiscally sustainable for a long period' (p.18), it does not cover the trade-offs between these objectives. For example, improving the adequacy of

income comes at a fiscal cost; an adequate NZS reduces the need for personal responsibility to provide adequate savings; the baby-boomer bubble reduces equity between generations, as current pensioners have paid less in tax than pension receipt, with the reverse for future generations (although the New Zealand Superannuation Fund was designed to offset this imbalance).

History has shown how politicians have constantly meddled with the policy framework and parameters, probably because of the simplicity of NZS and KiwiSaver. Past retirement income reports have not led to certainty and confidence in the framework, and recommendations on raising the age of entitlement for NZS have not been politically welcomed. The recommendations in this report are relatively modest: to raise the age of entitlement only in line with increased longevity. But this change will not start until 2027, meaning that any fiscal savings will be very small, especially if offset by income-related benefits for those unable to remain in employment.

NZS, plus private provision, has generally resulted in very low deprivation and income poverty rates for those 65 and over. However, NZS is only just above the 60% of median income poverty threshold, so that the very low level of additional income most pensioners have puts them at risk of poverty, especially for non-home owners. As the non-home owner group is likely to rise significantly in the near future, the adequacy of NZS is going to come under increasing pressure, with consequential impacts on fiscal expenditures, or private savings: all of these issues are considered in section 3 of the report, 'Future challenges'.

Future challenges

Addressing population ageing is the major challenge ahead, but the decline in home ownership and the increasing expectations for rising living standards for those aged over 65 should be added to the policy mix. Raising tax rates on the working-age population to pay for the baby boomers' pensions may result in new political configurations due to perceived intergenerational inequity: for example, how willing will a young Māori population be to support an ageing European population, especially if the current differential in income and living standards continues?

Fairness of the system

The report states that the key achievement of the pension system is social inclusion and cohesion. A universal system overcomes the stigma from targeting; reduces administration costs due to complex and ever-changing eligibility rules; stops gaming of the pension through the formation of trusts and hiding income; and encourages the continuation of work and savings. The report could have indicated how past issues in regard to fairness have had political impacts. Raising the age of eligibility from 60 to 65 caused limited resentment, and reducing the pension level from 80% of earnings to 66% was also seen as fair; but the introduction of the tax surcharge on non-pension income led to tax avoidance, especially via trusts.

Population ageing

The future cost of population ageing is a function of the dependency ratio of the working-age population to those over 65. The report indicates the substantial potential impact of increasing labour force participation rates among both those in the 15–64 age group and the 65-plus age group. The experience of a substantial rise in the labour participation rates of those aged 60–64 following the rise in NZS entitlement age in the 1990s could have been used as an example of behavioural responses to policy change. This example would also have provided support for the recommendation of increasing the age of eligibility as longevity increases. By international standards the proposed rate of increase in the age of eligibility is very slow, and starting at a far later date than for most of the OECD: the policy work has been done, most of the population are familiar with the population ageing issues, and the slow rate of change in the age of eligibility means that fiscal savings will be relatively low. This recommendation seems to stem from critical responses to previous, more speedy age-raising recommendations, as well as political expediency.

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Affording retirement income

Table 9 of the report (p.41), which shows the gross public pension expenditure as a percentage of GDP for a selection of OECD countries, demonstrates the relatively low cost of NZS. It would have been useful to have had the data in net (after tax) figures rather than the gross figure which is entered into the national accounts. The difference is just under one percentage point. Other OECD countries (except Australia) have much higher expenditure due to an older age structure, mainly because of the earnings-related nature of most OECD pension schemes, where higher pension levels go to those who had larger incomes while in work. The low cost of NZS is a further reason for having a universal, flat-rate pension. While the data indicates that there is no need for New Zealand to panic, and could be used to justify the slow rate of raising the age of eligibility from 2027, the report states that 'it makes sense to take steps now' (p.41).

Figures 5 and 6 (pp.42 and 43) compare current expenditures on health, NZS, education and non-NZS welfare expenditures, with three alternative scenarios:

1. cost-pressure increases based on past growth rates;
2. net debt stabilised at 20% of GDP;
3. the current population age structure maintained into the future: this scenario shows how much of the cost increase is due to age structure changes.

The cost pressure increase is large for health and NZS and downward for the other items of social expenditure. The ageing population impact explains most of the estimated four-percentage-point increase in health and NZS expenditures to 2050.

2. *Changing the method of indexation*. In the 1990s, when adjustments to the pension were based on movements in the consumers price index (CPI) rather than average income, income poverty quickly emerged for pensioners with limited additional income. (The post-1999 Labour-led governments raised pensions back to 66% of average wages.) The report recognises this possibility and recommends using the average of wage growth and CPI movements. This approach should maintain current living standards and provide for some of the benefits of economic growth. The report also recommends greater use of targeted second-tier benefits, but this would reduce the desired level of fiscal savings.

The New Zealand evidence indicates that only a third of contributions to KiwiSaver represent additional savings (p.66), as many private occupational pension schemes have been rolled into KiwiSaver.

Options for reducing the cost of NZS

The options need to be seen in relation to other aspects of retirement income, especially KiwiSaver.

1. *Raising the age of eligibility*. The report argues that '[r]aising the age will also *save money*' (p.44, italics added) – presumably this means fiscal savings, as individuals just turning 65 will lose money. The cumulative impact is a significant fiscal saving on pensions, especially with increases in labour force participation, but the savings need to be offset by greater expenditure on income-related benefits. The proposal to raise the eligibility age in line with changes in longevity seems logical, but does not give certainty to individuals or fiscal forecasters, and would have high administration costs with constant changes in the eligibility age.

3. *The impact of KiwiSaver*. The report correctly indicates that 'KiwiSaver is additive to NZS, not a substitute' (p.46) and represents the second tier of pension schemes. But the report requests further research on how KiwiSaver could impact on the method of indexation. Using KiwiSaver to lower the rate of adjustment of the pension level could be seen as a back-door method of means-testing for NZS.

5. *Varying the age of eligibility*. People could delay the time of receipt of NZS and receive a higher pension as a result. There should be no future fiscal impact if pension levels are actuarially calculated. Compared to raising the age for all, it would assist those retiring early or with a lower life expectancy. It would increase the risk for those making an incorrect estimate of their longevity, making them more vulnerable to income poverty.

The proceeds from the New Zealand Superannuation Fund can be used as a form of intergenerational transfer of the cost of NZS. Current working baby boomers are paying less tax than required to sustain their NZS, and making contributions to the Super Fund. The fund provides a useful mechanism to spread the tax burden fairly across generations, thus improving the affordability of NZS. The fund improves the level of savings, and, if it continues to be sensibly invested, can increase the rate of economic growth. But additions to the fund are only sensible if the return on the fund is greater than the interest cost of government debt. The report recommends that the fund's returns be made tax exempt, which would treat them similarly to those of ACC and EQC, but be out of line with the additional tax burden that is placed on the returns from private savings.

The report's conclusions on the options are appropriate: 'the issue that arises is not so much one of affordability as of future generations' ability and willingness to pay the additional cost' (p.47).

New Zealand's saving performance

There is considerable concern and debate as to whether New Zealanders are saving sufficiently to supplement NZS and maintain their pre-retirement income. Macroeconomic data shows that aggregate savings are potentially negative. The macro data looks at economy-wide savings, including public, external and individual debt as well as personal savings. The data does not allow an assessment of whether individual savings are adequate for a desired retirement income, nor the extent to which KiwiSaver accounts are offset by reductions in other private savings. Overseas evidence suggests that the extent of transference between forms of savings is substantial. The New Zealand evidence indicates that only a third of contributions to KiwiSaver represent additional savings (p.66), as many private occupational pension schemes have been rolled into KiwiSaver.

The microeconomic data indicates a general adequacy of savings to maintain pre-retirement income. There are substantial differences in the level of household savings by gender, age, ethnicity, income levels when in work, home ownership etc., with adverse events such as poor health, redundancy, divorce or death of a spouse also exacerbating individual differences in savings levels. Maintaining the level of NZS is a necessary safety net to offset these risks and lifestyle events.

Savings are not necessarily beneficial for an economy. Savings reduce consumption levels, and thus production and employment. Savings have to go into new productive investment to make a contribution to economic growth, but are often invested overseas, or into housing as a rental investment, which can raise house prices and rents. Reduced levels of home ownership in future will affect the adequacy of NZS for renters. The report provides limited direct recommendations to address this issue.

Further, aggregate savings only increase while the fund is building up: when mature, the savings fund will remain constant, or, with an ageing population, fall. Some 72% of those aged 65 and over intend to withdraw their savings from KiwiSaver over the next five years, generally in a lump sum (Dwyer, 2013). The impact of this on aggregate savings depends on whether these funds are used for current consumption (overseas trip, payment of debt, etc.) or reinvested.

KiwiSaver

KiwiSaver, which started in 2007, is a 'voluntary' occupational pension scheme designed to increase individual retirement income. Contribution rates are relatively low at 3%, though 36% of members have a 4% contribution rate. The report states that only half of eligible New Zealand residents are members, but this includes those aged over 65 or who are not in the workforce. 67% of people aged 18–24 are members, indicating a degree of acceptance among the younger generation, possibly due to a belief that NZS will no longer exist when they retire (Pinkerton, 2010), and the potential use of KiwiSaver funds as a deposit for home purchase.

KiwiSaver has become a political football, with changes to the employee and employer contribution rates and tax liabilities. The report does not advocate compulsory membership, but would like to see a more active approach to enrolment, with greater financial education. The report supports the administrative, compliance, enforcement and monitoring aspects of KiwiSaver developed since 2007. It supports maintaining the use of a single account for each member whenever members change employment.

Adequacy of income in retirement

The amount of income from savings in retirement is partly a function of the ability to save and desired standards of living in retirement, complicated by unknown longevity, the after-tax interest rate on savings, and the degree to which assets are run down in retirement. This latter feature is overlooked in the report. The commission's Sorted website concentrates on the level of current savings for that adequate income, but not possible means of asset rundown (decumulation) to maintain post-retirement income levels (Rashbrooke, 2014). Scenarios can be done on an actuarial basis (requiring costly financial advice) or by self-help. The Sorted website could indicate that, with a portfolio of assets, one bundle could be set aside for the rainy day, greater-than-expected longevity or for inheritance. Then, with different net interest rates and varying amounts of drawdown, it could indicate how long the other assets would last; if too short or long, then the decumulation rate can be adjusted. The report recommends only the development of an Ministry of Social Development discussion document on decumulation.

Housing

The report covers the impact of home ownership and housing costs on the adequacy of retirement income. Those who own their homes generally have a higher standard of living, are able to maintain their independence longer, and have a better standard of accommodation. Those in rental accommodation tend to have a high rate of income poverty (Perry, 2013).

Home owners have an asset which could be used to enhance current living standards, through equity release schemes, where the asset value is converted to an income stream or lump sum, or by downsizing into a smaller property (Davey, 2005). The report indicates the limitations of both approaches. Equity release has issues with estimating longevity and high interest rates. Downsizing may be restricted by a lack of availability of smaller dwellings with ready access to transport, and the capital released may be too small to generate a satisfactory income stream. Movement into retirement villages may release some financial capital, but incurs regular fees and complex legal issues.

The recommendation is for yet another review, to find ways of increasing the supply of age-friendly housing, presumably covering issues of design, transport and access to amenities.

Continued employment

Adequacy of income can be maintained by continuing to work beyond the age of eligibility for NZS. The universal nature of the pension, with no income test, along with the absence of a compulsory retirement age encourage labour force participation. Over the 22-year period from 1991 to 2013 the proportion of people 65 years and over participating

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in the labour force has increased from 5.8% to 22.5% (Statistics New Zealand, 2014). This rise in the participation rate reflects reduced employer discrimination against older workers, skill shortages and a willingness of employees to continue working (Davey, 2014). Not all are able or wish to. Attitudinal change needs to start when a worker is younger. Other factors are a possibility of retraining, part-time work, adjustment for health status or job change (e.g. going from being a builder to a building inspector).

The report is neutral on the 'lump of labour' theory, which posits that employment of older workers reduces employment for younger people. The majority of research rejects the hypothesis.

The report's recommendation is weak. It calls for the Ministry of Business, Innovation and Employment to 'work with employers, industry associations and unions to implement ways to encourage the recruitment, retention, retraining and mobility between jobs of older workers' (p.83).

Financial literacy

The report agrees with the trend towards greater individual responsibility for retirement income, provided that responsibility is underpinned by NZS. Making KiwiSaver compulsory reduces the risk for workers, but compulsion is not recommended due to compliance costs, savings substitutions, greater financial burdens for low-income earners, and lack of incentives for financial advisers. Greater financial literacy is seen as the preferred mechanism, giving individuals the ability to make appropriate savings decisions, rather than compulsion.

The Sorted campaign certainly tries to provide financial advice, but there is limited discussion here about how many people actually use the service and act on its information. The report would like to see financial advice provided through the workplace as well as its own programmes to increase financial literacy. However, most people receive information from banks, which tend to push their own products; family or friends, who are not always well informed; or financial advisers who are not always well known or trusted. The recommendation to give the commission 'an explicit mandate to lead the provision of financial education' (p.87) would probably have limited impact on the status quo.

The report fails to consider issues round the appropriate timing of savings. It assumes that saving from a young age is the best option, due to the impact of accumulated interest. Taking account of the life cycle could provide greater flexibility for savings levels, with high savings rates before the arrival of children (and thus a base from which interest can accumulate), low savings when equivalent income falls because of the extra costs associated with children and often a shift to one income, then higher savings rates when the children have left home. Of course, many do not fit this picture, but at least acknowledging the benefits of flexibility in savings rates, with some instructive guidance, may help even out income and expenditures and provide for greater income adequacy over the whole life cycle, not just when over 65.

Future directions

This section covers the recommendations made in the body of the report, on keeping NZS fair and affordable; KiwiSaver; the New Zealand Superannuation Fund; financial literacy; taxation; age-friendly housing; age-friendly workplaces; and international pensions. When the recommendations are put in one place, the document seems very conservative, which is probably because past reports have been largely ignored by governments. Being published just prior to Christmas 2013, the report received limited media coverage and probably had limited influence within government circles. This lack of coverage and influence should be of grave concern to policy makers who have to consider long-term fiscal impacts from population ageing. Individuals should be concerned, as the lack of detailed policy development gives politicians too many opportunities to alter both NZS and KiwiSaver. The hard decisions are left for other reviews, but the commission has been around long enough to have done the required analysis themselves.

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