

**The ISI Report
on
RETIREMENT SAVINGS:
A WAKE-UP CALL**

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“A mere continuation of the status quo would fail to address the problems we face today, and would totally fail to prepare New Zealand for the challenges that lie ahead.”

The Way Forward, the Task Force on Private Provision for Retirement, December 1992

RETIREMENT SAVINGS: A WAKE-UP CALL

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1 Executive Summary

- 1.1 The Investment Savings and Insurance Association (ISI) represents institutions serving more than 1.5 million New Zealand investors and policy holders. The ISI is concerned that previous studies of retirement income policy - notably the Todd Task Force report and the two reports last year of the Periodic Report Group - have been overly optimistic about the country's ability to cope with the impact of demographic change. Both last year's PRG Reports identified the future need to change present policies. But the inference drawn from the Reports was that we have time to discuss this challenge and to obtain community agreement before the next review is carried out in 2003, and before the 'baby boomers' start to retire, around 2015. The ISI is concerned that if we wait until this demographic bulge is upon us then drastic action, such as a sudden hike in tax rates or a fall in superannuation benefits, will be unavoidable.
- 1.2 To confirm or allay its concerns, the ISI set up a Project Team to examine the Todd Reports and the potential role of increased savings. The Project Team consisted of Dr Gareth Morgan, principal of Infometrics, a leading New Zealand economics consultancy; Jonathan Eriksen, a senior New Zealand actuary; and Hon. David Caygill, a former Minister of Finance.
- 1.3 Infometrics' full report is attached as an appendix to this document. The Report expands on the model used by Treasury to plot the future fiscal cost of New Zealand Superannuation (NZS). Whereas the Treasury model looked narrowly at the issue of fiscal cost, the expanded model considered the wider impact on the economy of both higher government expenditure and the resulting higher tax rates needed as greater numbers of retirees qualify for present levels of NZS. The research indicates that more than just fiscal cost is at stake. Without preventive action, fiscal pressures are likely to lead to unacceptably high levels of inflation, public debt and an imbalance of external payments, in addition to higher tax rates.
- 1.4 The Project Team also looked at what measures could help avoid such unfortunate outcomes. They looked at the role higher private savings might play, as well as the most obvious ways (ie raising the age of entitlement and lowering the pension amount) of reducing the gross cost of NZS. They found the greatest impact will be achieved where a number of policy approaches are pursued in combination. The Project Team also found that greater benefits are achieved for less cost, the earlier remedial action is commenced.
- 1.5 The research also looked at the impact of higher savings on different groups within the community. Here again the conclusion echoes that earlier reached by Todd and the Periodic Report Group: Future retirees will need to be able to use the equity in their homes in their retirement years, or ensure that less of their savings is tied up in their homes on retirement.
- 1.6 The conclusions which flow from this research seem stark and obvious. If we are to significantly reduce the fiscal and economic problems arising from an ageing population we must address a number of policy areas without delay. In particular there is a need:
 - To raise economic growth;
 - To avoid distortions in the conditions which influence private savings and improve private savings rates;

- To enhance the efficiency of private sector investment;
 - To limit government spending;
 - To pursue a consistent approach to immigration; and
 - To enhance access to an adequate retirement income for those in greatest need.
- 1.7 Above all, research suggests that the present policies in these areas are not sufficient to avoid future problems. The longer we wait to address them, the more drastic the action which would be required.
- 1.8 Further research is needed in the following areas:
- to establish society's welfare preferences;
 - the factors which influence the quality of saving and investment decisions;
 - the role of housing as a vehicle for retirement saving;
 - universal entitlement versus targeting;
 - the growth of government spending.

2 Introduction

- 2.1 The Investment Savings and Insurance Association (ISI) represents investment and life insurance companies in New Zealand. Member companies manage over \$20 billion in savings on behalf of more than 1.5 million New Zealand investors and policy holders.
- 2.2 The ISI was formed in 1996 from the former Investment Funds Association and the Life Office Association. It provides a voice for the investment, life insurance, superannuation, savings and managed fund industries.
- 2.3 One of the key objectives of the ISI is to work to secure the future of New Zealanders. The ISI does not just represent the interests of its member companies, but works to ensure that New Zealanders are provided with the best options to secure their futures through savings, investment and the protection they receive from insurance. The ISI sees itself as part of the education process which, in our view, needs to occur with respect to the key issue of future retirement income policy.
- 2.4 Last year the Periodic Report Group reported on the state of retirement income policy. The Group reviewed the existing system of policies and looked to the future. In its Interim Report, published in July, the Report Group concluded:

“We need to find a means of getting community involvement in designing a policy change mix that could be agreed at the time of the next periodic review in 2003.”
- 2.5 This Report is a contribution to that debate.

3 Background

3.1 The Present System of Retirement Income Provision

3.1.1 Public retirement income is provided through New Zealand Superannuation (NZS). This is a flat-rate universal entitlement.¹ It is funded out of general taxation on a pay-as-you-go basis. Individuals qualify for NZS on attainment of the eligibility age (currently increasing from 60 to 65, the transition being completed in 2001), if criteria relating to residency in New Zealand are satisfied.

3.1.2 The present gross annual levels of NZS are:

<i>Married Couple</i>	<i>\$19,710.00</i>
<i>Single Person (living alone)</i>	<i>\$13,147.00</i>
<i>Single Person (sharing)</i>	<i>\$12,049.00</i>

3.1.3 NZS rates are reviewed each year with a view to their adjustment. Government policy has focused on two potentially conflicting objectives. First, it is felt that the purchasing power of the NZS benefit should be protected. Second, it is felt that public retirement income should be linked to the level of income earned by the working population. In order to achieve these two objectives, NZS is increased each year in line with the rise in the Consumers Price Index (CPI), but subject to an after-tax wage band test. The test dictates that the increase must be such that the revised NZS for a married couple lies within the range of 65% to 72.5% of average, ordinary-time after-tax weekly earnings, which, as a result, can be above or below the rise in the CPI.

3.1.4 Up until the current fiscal year, NZS payments have been “targeted”. Whilst the level of NZS itself was independent of an individual’s financial situation, those with other sources of income were liable to additional tax payments through the application of the New Zealand superannuitants’ surcharge. In effect, the surcharge clawed back through the tax system part or all of the NZS payments to superannuitants with moderate to high other income. In the previous fiscal year (1997/98), the surcharge applied at the rate of 25 cents in the dollar for income above a threshold of \$10,296 for a single person and \$15,444 for a couple.

3.1.5 The surcharge was abolished with effect from 1 April 1998. Since its introduction in 1985 and during the frequent structural changes since then, it has been accompanied by controversy. Many, if not most of those who have been affected or thought they were likely to be affected by it, have believed the surcharge to be unjust. The inconsistent approach to the treatment of income from different sources made avoidance of the surcharge possible, creating a thriving market for “surcharge friendly” investment products. Although only approximately 25% of superannuitants were affected by the surcharge, a great deal of time and money was spent on avoidance.

¹ The question as to whether NZS is an entitlement or a benefit has proved highly controversial. In a sense, it is both. NZS is an entitlement in that the law provides payment on the basis of age (and residential qualifications) alone, ie without proof of need. But NZS is also a benefit in the sense that it is paid by the State from taxes to a particular group in society, just as other groups are supported for similar public policy reasons.

- 3.1.6 On the other hand, NZS itself has proved controversial, at least from its inception as National Superannuation in 1976. It is easily the largest single expenditure programme undertaken by the Government. This is less a reflection of the level at which NZS is paid and more a reflection of the average number of years for which it is paid to each recipient (currently approximately twelve years compared to four years on a Domestic Purposes Benefit or 6-12 months on an unemployment benefit). Put another way, in the year ending 30 June 1997 more than 450,000 people received NZS, compared to 112,000 who received the DPB and 140,000 who receive the unemployment benefit.
- 3.1.7 Comparisons with the domestic purposes and unemployment benefits are themselves controversial and rejected by many as inappropriate. This reaction, as well as the scale of the NZS programme, raises the question: what is the purpose of NZS?
- 3.1.8 The range of purposes for which state retirement income may be provided has been described in work by St John and Ashton (1993)² as follows:
- (a) Alleviation of poverty
 - (b) Prevention of poverty.
 - (c) Belonging and participation so that retired people feel part of the community.
 - (d) Continuance of economic status so that the standard of living relates to pre-retirement levels.

Level (a) could be operated by a welfare system which provides benefits only on demonstrated need. Level (b) might be achieved by a low universal entitlement; level (c) by a high universal entitlement; and level (d) by a generous salary-related state pension.

- 3.1.9 Different people will have different views as to where NZS currently fits into this scale. Whilst some of the working population may believe that it is near level (c), superannuitants with no other income and higher than average costs would probably claim that it lies at the lower end of this range. Whatever the situation, society must decide the appropriate level of future provision. But that decision must be made bearing in mind the consequences for taxation and the future standard of living of society as a whole.

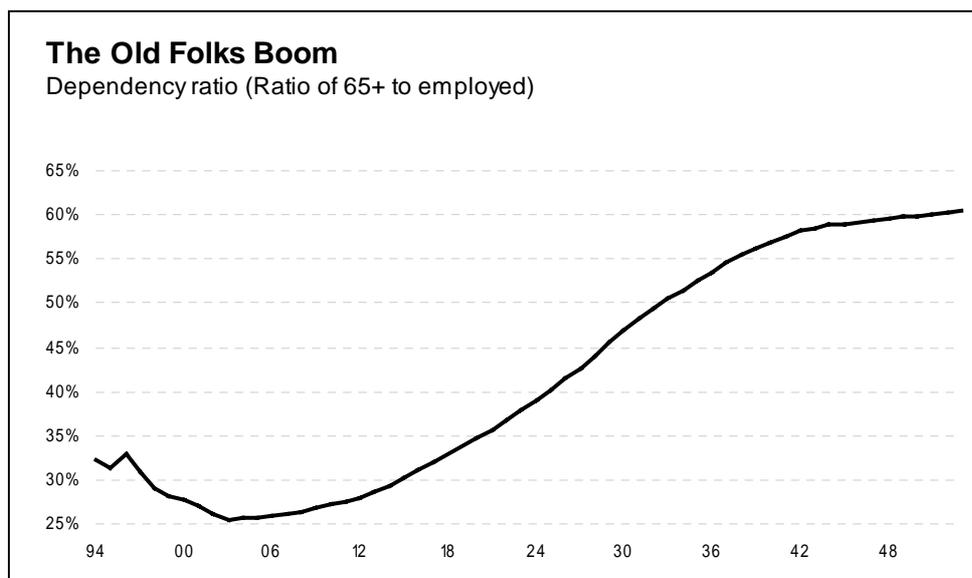
3.2 The Need for Change

- 3.2.1 There are two main, related reasons why the present system needs review. The first is that like other western countries, New Zealand's population is ageing. That is, its composition is changing in a way which will increase the cost of publicly-provided retirement incomes. The rising cost of retirement income will place economic pressure on the nation as a whole. We now briefly outline each of these factors.

² Private Pensions in New Zealand: can they avert the crisis?

- 3.2.2 **Demographic Pressures:** *“New Zealand has an ageing population. Over the coming decades an increasing number and proportion of the total population will enter the retirement ages. This trend will be particularly marked after 2010 when people born in the post-World War II baby boom begin reaching sixty-five years of age . . . over the same period the labour force will become older but stay steady in number, while the dependent young will decline in number.”*³
- 3.2.3 Population trends are a function of three factors: fertility, mortality and migration. Each of these factors contributed to the so-called post-war “baby boom”. Each is described in detail in ‘Ageing and Retirement in New Zealand’. We briefly summarise that material here. In essence, the overall result of these trends has been a “demographic bulge” as “baby boomers” move up the age scale.
- 3.2.4 As to fertility: between 1946 and 1965 over 1.1 million babies were born in New Zealand, over 77% more than in the preceding twenty years. The fertility rate peaked at 4.3 births per woman in 1961. By the mid-1960s however the “baby boom” had lost its momentum as effective contraception became more widely available. By 1978 fertility had fallen below the replacement level of 2.1 births per woman. It has only exceeded that level for a brief period in the early 1990s.
- 3.2.5 On the other hand, increasing life expectancy is contributing to population growth in older age groups. Medical advances, improvements in preventative health care and lifestyle changes are resulting in people living longer. Before the mid-1960s much of the improvement in life expectancy was due to declining infant mortality rates. However, in the past three decades most of the gains in life expectancy have been due to falling death rates at older ages.
- 3.2.6 Life expectancy is projected to increase further over the next fifty years or more. By 2051, life expectancy at birth could increase to 81 years for males and over 85 years for females. Men who reach the age of sixty-five in 2051 will probably be able to expect a further twenty years of life, while women may expect a further twenty-four years.
- 3.2.7 With the decline in fertility that followed the baby boom, and with the baby boomers themselves growing older, the proportion of children in the population proceeded to fall. This fall is projected to continue in the future, with children making up just 16% of the population by the year 2051.
- 3.2.8 The proportion of the total population who were of working age fell slightly until the early 1960s, then increased as the baby boomers began to reach this age. 15 to 64 year olds now make up 65% of the population. This figure is projected to increase slightly to 67% by the year 2010, but, as baby boomers begin to reach retirement, it will fall to around 59% by 2040 and then level off.
- 3.2.9 The consequence of these trends is that there will, in future, be proportionately fewer people of working age available to generate the resources to support the increasing numbers of retired people. This could be illustrated in the form of a dependency ratio as shown below:

³ ‘Ageing and Retirement in New Zealand’, Statistics New Zealand, August 1997



- 3.2.10 Another way of considering the dependency ratio is this: If we were to raise the retirement age so as **to maintain the current ratio of beneficiaries to earners, then the age of eligibility for NZS would need to increase to 77 years by the year 2051**, all other things being unchanged. Of course all other things are not likely to remain unchanged. The increased numbers of those in retirement mean there will be increased demands by the aged for health care in particular. Assuming a continuation of present trends in age-related health expenditure, **total health costs are expected to rise from 5.9% of GDP to 11% by 2050**.
- 3.2.11 It is true that other countries face similar, if not greater, pressures. Many of these countries begin with higher standards of living per capita and therefore have greater resources to bring to bear on these challenges - though a number are also taking actions such as raising the age of entitlement to publicly funded retirement income in order to reduce future fiscal costs. Perhaps the simplest point to be borne in mind is that the pressures facing other countries do not make it any easier for us to resolve our own problems.
- 3.2.12 **Fiscal Consequences:** Past modelling work has suggested that, under reasonable population, economic and fiscal policy assumptions, Government expenses could increase from 32% of GDP in 1996/97 to around 40% of GDP in the 2040s.⁴ Funding such an increase in the size of government would imply a one-third increase in the taxes paid by our children or grandchildren. Raising taxes today to fund this projected increase could alleviate this future problem, but at the expense of today's generation of taxpayers.
- 3.2.13 These fiscal consequences have been considered in detail in a variety of publications, notably the reports of the Task Force on Private Provision for Retirement (the 'Todd Task Force'). For several reasons, which we set out in this document, the ISI considers that this analysis does not go far enough. Nevertheless, it is clear that considerable efforts have gone into addressing the issue of retirement incomes - especially the publicly funded component. Indeed, at times over the last 25 years it has seemed that New Zealand has debated little else. Before setting out our view on the current challenges facing the nation it is worth recalling recent efforts to address the issue of retirement income policy.

⁴ Polackova 1997, Population Ageing and Financing of Government Liabilities in New Zealand, World Bank Research Paper 1703.

3.3 The Todd Task Force Reports

- 3.3.1 In 1991 the Government appointed a Task Force to research and recommend how people could be encouraged to save more towards their retirement. The Task Force was set up in a highly charged political atmosphere. The year before the Government had been elected on a platform which included the commitment to abolish the superannuation surcharge. Instead, the Government was persuaded by the economic and fiscal position to take dramatic action in almost the opposite direction: retaining the surcharge and increasing, over time, the age of eligibility for NZS.
- 3.3.2 Despite these actions it was clear that doubts remained as to the long term affordability of publicly provided retirement incomes. In addition, many questioned the fairness of the superannuation surcharge and the equity of treatment as between different generations of New Zealanders. In this environment the Task Force conducted its examination of retirement issues. Although it was described as the Task Force on **Private** Provision for Retirement, it saw its task as “*how to find the best mix of continuing public provision (National Superannuation) and increased private provision*”.⁵
- 3.3.3 The Task Force began by drawing up a statement of ‘*The Issues*’, which was released in December 1991. This report identified three ways of promoting private provision:
- retain and facilitate voluntary private provision
 - introduce compulsory private provision
 - reintroduce tax concessions for private provision
- 3.3.4 Over the next 10 months the Task Force did further work on these three options. In August 1992 it published an extensive report which explored and analysed the three options in detail. Then in December 1992 the Task Force produced its final report entitled: “*Private Provision for Retirement: The Way Forward*”. The Task Force unanimously recommended what it described as “*the improved voluntary private provision of retirement income, its integration with continuing public provision paid on an income-tested basis, plus agreed rules for reviewing the preferred regime every six years, reinforced by public and political consensus and a much improved public understanding of retirement provision issues*”.⁶
- 3.3.5 One might immediately observe that 6 years later a number of these conditions are not being met. As from 1 April this year publicly-funded retirement incomes are not being paid on an income-tested basis. The partial political consensus which was established by the Accord on Retirement Income Policies seems to have eroded, and it is questionable whether there is a much improved public understanding of retirement income issues.
- 3.3.6 The following paragraph from the Task Force’s final report is also noteworthy:
- “We recognise the risk that the improved voluntary option may not achieve the required changes in people’s saving behaviour. If, at the time of the first review in 1997, there has been insufficient improvement in long-term savings indicators, we think it inevitable that the review team would need to give serious consideration to a compulsory savings regime.”*⁷

⁵ The Options: an outline, p.1

⁶ The Way Forward, p.11

⁷ *ibid.*, p.11

3.4 The Accord and the Retirement Income Act 1993

- 3.4.1 Following the Todd Task Force's report, in August 1993, three of the four political parties then represented in Parliament, ie National, Labour and the Alliance, entered into what they called an Accord on Retirement Income Policies.
- 3.4.2 The Accord declared the parties' view that retirement income policy should be "*stable, certain and sustainable, so that people can plan properly for their retirement*". The parties endorsed a voluntary approach to private provision, declaring that "*people should be encouraged to save for their retirement through the availability of appropriate savings products, supported by education and the provision of information about retirement matters; but should not be compelled by law, or given tax incentives, to do so*". The parties also declared that "*retirement income should continue to be provided in an integrated way from both private savings and public funds*".
- 3.4.3 Although the parties differed about the best means of achieving this, they also agreed that "*the net amount provided from public funds for a retired person should reduce as that person's total income increases*".
- 3.4.4 The Accord led to the Retirement Income Act 1993. This created the office of Retirement Commissioner whose functions include:

To develop and promote methods of improving the effectiveness of the retirement income policies from time to time implemented by the Government in New Zealand, ...

To monitor the effects of retirement income policies that are being implemented in New Zealand...."

- 3.4.5 The Act also provided, as the Task Force had recommended, for periodic reports on retirement income policies. The first was to be by December 1997 and thereafter six yearly.

3.5 The Interim Report of the Periodic Report Group

- 3.5.1 Last year the government appointed the first Retirement Income Policies Periodic Report Group. Once again, the government asked Jeff Todd, the chairman of the 1992 task force, to chair the review group. He was joined by Susan St John, an academic who has written extensively in the area of retirement income policy and by Colin Blair, the Retirement Commissioner. These three were also assisted by officials from the Department of the Prime Minister and the Cabinet, Treasury, and the Department of Social Welfare.
- 3.5.2 In July the Group presented an interim report. They did so in order to provide information to assist voters who in September last year faced a referendum on the Coalition Government's proposed Compulsory Retirement Savings Scheme. As it turned out, the referendum overwhelmingly rejected the proposed scheme. 80% of those who were eligible actually voted and of those who voted, 92% voted "No". Although strictly a vote on a particular scheme, the outcome has been widely interpreted as a rejection of the compulsory approach to the provision of retirement income.

- 3.5.3 The Periodic Report Group's interim report reached a number of significant conclusions. These included:
- "Substantial progress has been made in the last five years in improving the existing system"⁸
 - "The overall economic climate looks more positive than it did in 1992" (eg the fiscal position looks much healthier) - but the current account deficit is an area of potential concern"⁹
 - "Data on savings trends are still inadequate"¹⁰
 - "With one proviso, the current system can provide New Zealanders, now and in the future, with an adequate standard of living in their retirement. The proviso is the need to reestablish a consensus on the best way to manage NZS in the long term"¹¹
- 3.5.4 In its interim report the Group examined the living standards of those receiving NZS. The Group made several findings:
- Households dependant on NZS now have an average equivalent disposable income about 20% higher than households who receive social welfare benefits as their main source of income.
 - The standard of living of the majority of superannuitants is close to that of the average New Zealand household, but this finding was particularly dependent on housing costs.
 - More than three quarters of those over 65 own their homes mortgage free. Where deprivation does exist, low levels of asset ownership are an important factor.
- 3.5.5 The Group regretted the impending abolition of the surcharge but they sought to make the best of the inevitable, eg "*The abolition of the surcharge will provide a breathing space in which we can inform and educate the community about the future shape of public provision and explain why some kind of targeting mechanism will be needed in future*".¹²
- 3.5.6 Looking forward, the Group identified four key considerations affecting the development of a long term consensus and the evolution of retirement income policy:
- The need for fiscal responsibility;
 - The need for realistic individual assurance;
 - The shift in the stance of public policy and of social attitudes towards greater individual and family responsibility;
 - Differences between cohorts (mini-generations).
- 3.5.7 A key finding was that, as a proportion of GDP, NZS will double over the next fifty years. But it will not exceed the level of the early 1990s until after 2020. Using Treasury's long-term fiscal model to update the Task Force's previous fiscal projections, the Group examined the percentage of GDP that would need to be collected as tax revenue if the Government is to keep its budget in balance. This percentage was around 36% in 1996, will fall to 30% in 2000 and then rise steadily to reach nearly 40% by 2050.

⁸ 1977 Retirement Income Report, July 1997, p.1

⁹ *ibid.*, p.9

¹⁰ *ibid.*, p.21

¹¹ *ibid.*, p.27

¹² *ibid.*, p.47

- 3.5.8 The Group noted that these projections suggested a higher tax take will be needed than the 1992 projections had suggested. This situation permits of three options:
- We pay more now;
 - We pay more later;
 - We reduce expenditure on NZS or some other policy area.
- 3.5.9 The Group noted that by deferring change to, say, 2015 we are foregoing lower tax rates in the meantime that could promote growth in the intervening period.
- 3.5.10 The Group identified three ways of reducing NZS expenditure:
- Raising the age of the eligibility;
 - Changing the indexation formula;
 - Targeting NZS, rather than paying it universally.
- 3.5.11 The Group reached the following conclusions:
- *“At present . . . expenditure on NZS . . . is manageable, but this . . . is projected to rise over the first half of the next century as a result of population ageing . . . These fiscal pressures could result in historically high tax revenue requirements, approaching 40% of GDP in 2050”;*
 - *“We need to find a means of getting community involvement in designing a policy change mix that could be agreed at the time of the next periodic review in 2003”;*
 - *“It is essential that both the need for change and the nature of that change have broad acceptance well ahead of when the baby boomers start retiring around 2015”.*¹³

3.6 The Periodic Report Group’s Concluding Report

- 3.6.1 In December 1997 the Periodic Report Group presented its final report. The Group began this report by observing that *“New Zealand’s current institutional structures and policy settings appear to score well in terms of growth promotion”*. (This surprising observation does not square with what others were saying at almost exactly the same time. For example, the International Monetary Fund: *“growth has slowed, the structural fiscal surplus has been reduced, private saving is low, competitiveness has deteriorated and the current account deficit has widened”*. The IMF went on to advise that authorities should reduce the cost of the public pension scheme (and move quickly to implement health care reform).
- 3.6.2 The Group offered some discussion on the importance of private provision of retirement savings. For example they claimed the following:
- Poor savings performance is reflected in the current account deficit (the gap between savings by New Zealanders and investment in New Zealand);
 - Pressure on public provision is less if people have saved privately especially if there is some form of targeting, as the Group favoured;

¹³ Todd Task Force Report, pp145/6

- Private savings allow incomes closer to working life earnings which encourages social cohesion;
 - Private savings allow individuals to better manage risks, eg changing needs.
- 3.6.3 The Group also recorded the strongly held view that the tax system presently distorts investment in favour of housing (contributing, amongst other things, to the current account deficit). They noted that the removal of the surcharge has made it more difficult to strike a rate of payment that is consistent with social participation, because the same amount now has to be paid to everyone over 65. They asserted that agreement about a policy change mix is needed well ahead of 2015.
- 3.6.4 The Group developed five examples of public provision structures that could apply in, say, 2020:
- (a) *A universal amount indexed to wage growth (in effect the current system now that the surcharge has been abolished);*
 - (b) *An amount indexed to wage growth abated away at higher income levels;*
 - (c) *A universal amount linked to inflation but with a targeted top-up;*
 - (d) *A choice of a low universal pension, linked to inflation, or an income-tested age benefit;*
 - (e) *An income-tested age benefit only, as in Australia. (Though their income test is slightly less stringent than New Zealand's standard benefits, Australia also has an assets test).¹⁴*
- 3.6.5 In the Group's view, any scheme for the public provision of retirement income needs to achieve equity between generations and needs to be sustainable over a long period as the population ages. The Group reiterated its previous warning: long term fiscal pressures on the cost of health services and retirement income could result in a high tax revenue requirement, approaching 40% of GDP by 2050.
- 3.6.6 Nevertheless the Group's conclusions were essentially optimistic. These included:
- *"The current retirement income framework is sound. It has the capacity to serve New Zealanders well into the future.*
 - *While a new multi-party agreement is desirable, the integration of public and private provision (ie means-testing) should be reinstated by 2015.*
 - **Consideration** (our emphasis) *should be given to integrating public and private provisions before then."*¹⁵

¹⁴ NZS is paid at a relatively higher rate than the Australian equivalent, but concessions are more common in Australia.

¹⁵ 1997 Retirement Income Report, December 1997

4 Our Research

4.1 Why We Commissioned Further Research

4.1.1 At the risk of over-simplifying the Task Force and PRG reports, they concluded:

- (a) *New Zealand's system of retirement income provision is basically sound; and*
- (b) *Although adjustment will be necessary - especially by "reintegrating public and private provision" (ie restoring some form of means-testing) - we don't need to do this immediately. There is time to adjust.*

For a number of reasons the Association thinks that these are dangerously comfortable conclusions. **In our view there is no room for complacency.** While greater public awareness of the issues is important, it is not in our view sufficient to ensure that the right decisions will be made.

4.1.2 Moreover, since it is already clear that New Zealand faces a fiscal problem, it makes sense to act sooner rather than later. Early action is likely to be less drastic than later action will need to be.

4.1.3 In order to ensure that our own conclusions are soundly based we commissioned Infometrics, a leading economics research firm, to review the Periodic Report Group's findings, including the Treasury model on which they were based, and to provide advice accordingly. The full research report is included as an appendix to this document. What follows is essentially a summary of its rationale, its methodology and its conclusions.

4.2 Research Agenda

4.2.1 The Infometrics research sought to address a number of questions:

- (a) *To establish the critical issues which determine the adequacy or otherwise of retirement savings;*
- (b) *To construct a framework or model to more adequately analyse those issues;*
- (c) *To recommend a policy approach to best ensure that these issues are adequately catered for; and*
- (d) *To take cognisance of the substantial amount of work already done in the area, particularly that done in New Zealand under the auspices of the various Todd Reports, and to build on those foundations.*

4.2.2 Infometrics first canvassed the economic theory on the provision of personal savings for purposes including retirement and then considered whether the state of this theory was adequately reflected in the analytical framework used by the Todd Committee(s).

4.2.3 The framework used by Todd was primarily the Treasury's fiscal model. This is particularly suited to answering questions on fiscal solvency, eg what the changing demographics imply for Government expenditure, taxes and public sector borrowing. However the Treasury model does not incorporate the impact on the Government's accounts of different consumption or savings decisions by households, nor the impact of the budget deficit on inflation and the balance of payments, all of which define the sustainability of any economic growth path. Infometrics therefore enhanced the Treasury model with these features so that it was a less partial analytical framework

than was used in the Todd analysis. It is worth noting that the model is still limited in a number of ways and Infometrics have recommended a number of enhancements which would further improve its usefulness.

- 4.2.4 Equipped with a more suitable model, Infometrics then examined the key drivers that will determine whether New Zealanders make adequate provision, so that the incomes of those retiring in the middle of the next century meet their expectations. The influences examined include economic growth, government spending, the incidence of taxation and population growth.
- 4.2.5 Finally, the research augments the Treasury model with a microsimulation model which considers the distributional aspects of any particular growth scenario. The rationale for this is that a particular set of circumstances may give rise to a macro result which suggests that private and public sector retirement savings will together adequately provide for the overall needs of the retired cohort. But this may be an inadequate description of the outcome if there are particular sectors of the cohort who are inadequately catered for. The distributional model specifically considers the numbers of people who would remain in need of public sector assistance in their retirement.

4.3 The Role of Savings

- 4.3.1 **Why do people save?** In his famous 1936 treatise *'The General Theory of Employment, Interest and Money'* John Maynard Keynes identified eight reasons for saving:

Precaution	To be prepared for the unexpected, eg unemployment
Foresight	To prepare for the expected, eg retirement
Calculation	To enjoy the income gains from saving, eg interest and capital appreciation
Improvement	To improve one's lifestyle, eg to own a car
Independence	To do the things you want, eg not be reliant on the bank manager
Enterprise	To provide the means for business projects
Pride	To bequeath a fortune
Avarice	To be miserly

To this list of eight, we would add two other potential reasons:

Custom	Being a creature of habit
Accident	Saving unintentionally, eg if there is nothing to spend all your money on.

- 4.3.2 A factor common to many of these reasons for saving is that we all eventually face credit limits. In the end we need to put some of our own resources into the activities we are interested in.

- 4.3.3 This leads on to the reason **why saving is important** for economic performance. Economic growth depends on expanding the amount we, as a nation, produce. This can be achieved by:
- using more labour (ie. either using more workers or working longer hours);
 - using more capital; or
 - working harder or smarter.
- 4.3.4 Thus one way of increasing economic output is through increasing the size of the nation's capital stock, which in turn requires a level of investment in excess of the existing stock's depreciation. Investment in turn depends on domestic savings and/or our ability to borrow from abroad. Thus individuals' preferences to save or spend today will influence the future rate of economic growth and hence lifetime wealth prospects.
- 4.3.5 But there is a limit to the benefits that accrue from saving more for tomorrow as distinct from spending today. By reducing the amount spent today, saving also reduces today's demand for goods and services, and so also today's economic activity. In other words, there are costs associated with too much saving, as well as too little. In a market economy, interest rates provide the pricing signal to savers and borrowers that ensures that the split between saving and spending reflects society's preferences. A rise in interest rates provides an incentive to save, but a disincentive to borrow. Capital markets tend to be self-correcting, as the increase in saving resulting from an increase in interest rates and the lack of willingness of borrowers to borrow at higher interest rates eventually bring interest rates down.
- 4.3.6 In addition to the trade-off between consuming today or tomorrow there is a trade-off between the provision of public and private goods and services. Individuals and the nation as a whole benefit from the services provided by the Government. Yet providing these services has a cost - in particular the larger the government, the higher the average rate of taxes. Thus private wealth prospects reduce with increases in the size of government.
- 4.3.7 The Infometrics research presents a theoretical model that focuses on the impacts of interest rates, risk perceptions, the level of government activity, government policy and life expectancy on aggregate saving behaviour. The influence of each of these is examined in the full research document.

4.4 The Role of Public Pension Policy

- 4.4.1 A public pension provides the following benefits to society:
- It provides a safety net for the unfortunate;
 - It addresses market failures related to the uncertainty of life expectancy and any adverse selection problems in annuity markets. (The prices sought by those willing to sell annuities may not match the price that buyers are willing to pay, if sellers are unwilling to take on the risk of the people who are most likely to live longest).¹⁶
- 4.4.2 But like any other area of government activity there are also costs associated with state provided pension schemes (**especially tax-funded pay-as-you-go schemes**):

¹⁶ There has been considerable debate, reflected in the Todd Reports, as to the potential role of annuities in future retirement income policy. The simple point might be made that they seem to work in other countries.

- The more generous the state pension, the more private wealth accumulation will decrease because more taxes will need to be collected. And by providing for retirement the Government is removing one of the incentives for private saving. Both of these factors imply that the amount of capital accumulation, and ultimately economic growth, will be less.
- A tax-funded, pay-as-you-go, pension scheme implies a redistribution of wealth across generations. This can raise issues of intergenerational fairness and moral hazard and increases the risk of future governments renegeing on the implied social contract.

4.4.3 These arguments suggest that the net enhancements to national welfare from a tax funded, pay-as-you-go, state pension scheme will decrease once the scheme goes beyond addressing purely safety net and market failure issues (by reducing private wealth accumulation prospects). Its generosity and universal entitlement provisions mean that the current New Zealand scheme does go beyond these criteria. New Zealand in general will be better off with a less generous state provided scheme - **irrespective of affordability issues**. Options Infometrics modelled include:

- Reducing the generosity of the weekly pension allowance (this would maintain a safety net, increase the incentive for those who can to save, and ease medium term fiscal pressures);
- Raising the age of entitlement - eg from 65 to 75 (this would do the same as reducing the weekly amount, but also provide some certainty in setting saving targets, would be relatively simple to administer, and may offset some of the prospective demographic pressures by encouraging even greater workforce participation).

Infometrics did not attempt to model:

- Targeting;
- Full funding of a Government scheme (because this will not of itself address safety net issues, and can distort saving and investment behaviour).

4.4.4 **Measuring Key Drivers of Adequate Retirement Income Provisions:** The focus on superannuation policy in recent years has largely come from an awareness that we are sitting on a fiscal time bomb. The ageing of the baby-boomers means that the number of retirees in New Zealand is likely to increase from about one for every four workers today, to one for every two workers from the 2030s on. It has been this prospect, rather than welfare issues, that has highlighted the “over generosity” of the current scheme.

4.4.5 Past modelling work has suggested that under reasonable population, economic and fiscal policy assumptions government expenses could increase from 32% of GDP in 1996/97 to around 40% of GDP in the 2040s.¹⁷ Funding such an increase in the size of government would imply a one third increase in the taxes paid by our children or grandchildren. Raising taxes today to fund these projected expense increases could alleviate this but, as discussed below, this would bring other costs. The problem is that there is no certainty that the fiscal problem will eventuate - because future governments might take other forms of remedial action - so raising taxes today may just provide an unnecessary burden on today's tax-payers.

¹⁷ Polackova 1997

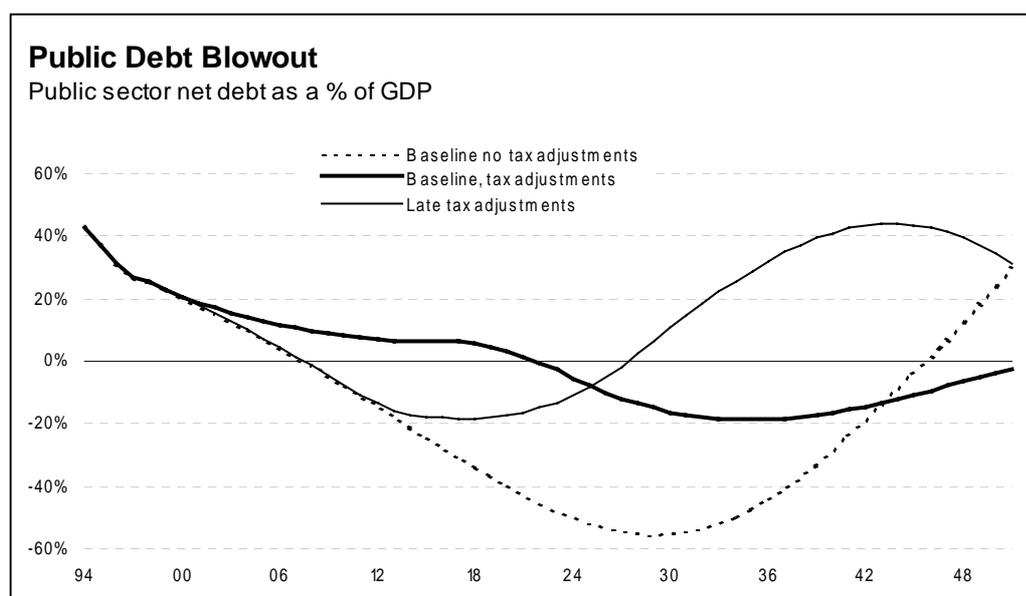
- 4.4.6 **Sensitivity to Projection Assumptions:** One might well ask: How seriously can you use fifty-year forecasts? How accurate were post-war forecasts of the 1990s? The answer must be that these models cannot tell us what is going to happen. But they can help us examine what potential pressures could arise and how best to manage those pressures.
- 4.4.7 In this respect the work carried out by World Bank economist, Hana Polackova when she visited the New Zealand Treasury in 1996 is illuminating for its examination of the sensitivity of fiscal outcomes to different demographic, growth and policy assumptions. The fiscal problem facing New Zealand is likely to reduce with:
- higher growth;
 - a slower pace of government spending;
 - more immigration; and even
 - different birth and death assumptions.
- 4.4.8 **Limitations of the Treasury Model:** Virtually all the macro modelling work that has been done in this area to date has been based on the Treasury's Long Term Fiscal Model, or variants of this model. Infometrics have done the same but extended their model to incorporate a partial interaction between government and the private sector. By ignoring interactions between government and the private sector, past modelling has focused too narrowly on looking at the issue from the Government's perspective. But the ageing population is a national issue irrespective of Government policy.
- 4.4.9 Ignoring interactions with the private sector also means that the full consequences of a fiscal policy stance are not truly addressed. For example, an excessively loose fiscal stance would tend to increase interest rates and inflation, which in turn would influence consumption and investment decisions. The current Treasury model ignores the possibility that fiscal policies could generate inflation or current account problems that would make those policies unsustainable. Adding just five behavioural equations (relating to inflation, interest rates, private investment and private consumption) allows an examination of this interaction with the private sector.
- (NB: Economic growth remains exogenous to the model and so the interactions modelled remain only partial. Infometrics see this as simply an incremental improvement to the modelling framework).
- 4.4.10 **Pressures on Government spending:** As has been identified in past modelling work, fiscal pressures generated from an ageing population are derived from expected increases in the cost of NZS (from 5.3% of GDP in 1996/97 to 10.7% in 2050/51) and in health (from 5.9% to 11.0% of GDP). The baseline scenario implies that government spending will reach 41.3% of GDP by 2050. This is similar to previous modelling work.
- 4.4.11 The adjustments to the model require the operation of a fiscal rule to ensure that fiscal policy does not generate major economic imbalances. The rule Infometrics used allowed the effective income tax rate to adjust by up to one cent in the dollar a year to ensure that net public debt does not exceed 20% of GDP, and net assets do not exceed 20% of GDP. Tax decisions are made on the basis of 20 year forecasts of the net debt/net asset position.

4.4.12 The implication of this rule applied to the baseline scenario is that the average effective income tax rate would need to increase to 30 cents in the dollar by 2050. This compares with an expected average effective rate (ie taking into account abatement of benefits) of 23 cents in the dollar after the 1 July 1998 tax cuts. In other words, **to meet the rising cost of NZS, taking both fiscal and economic consequences into account, tax rates would need to increase by one third.** Such an increase implies a very large intergenerational wealth transfer which not only seems unfair but is likely to be economically inefficient and also poses significant risks that future governments will renege on retirement income policies.

4.5 Consequences of Inaction

What are the consequences of inaction to these fiscal pressures?

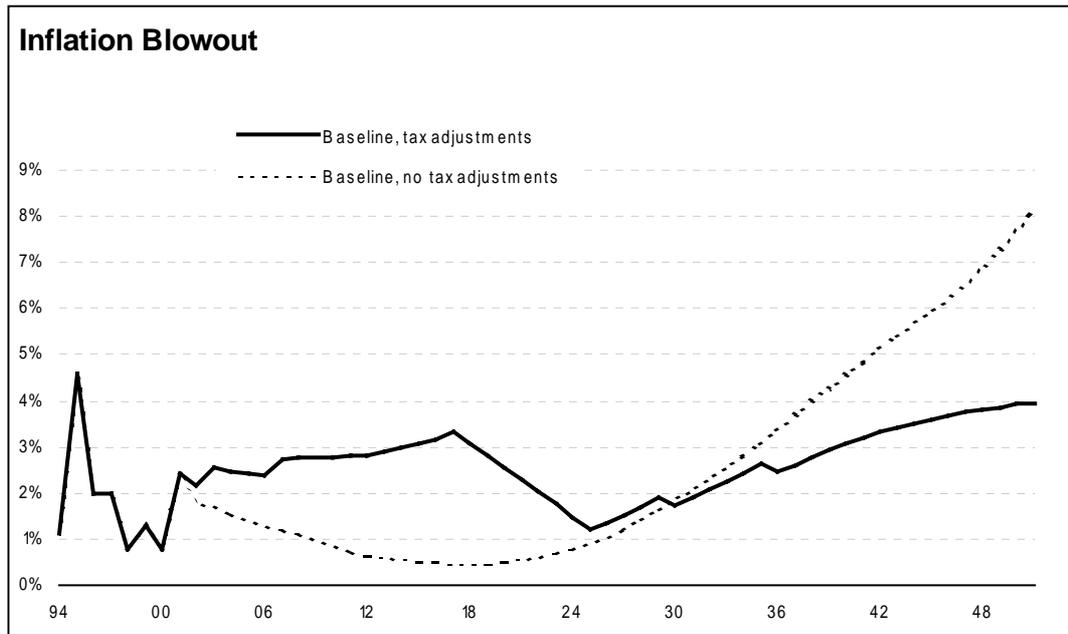
4.5.1 **Public Debt Blowout:** If there are no tax adjustments (eg as stipulated by the tax rule Infometrics have used), then there are likely to be very large swings in the Government's net debt (asset) position. During the favourable demographic window (up to, say, 2010), the Government could potentially build up a very strong asset position, but this would quickly reverse beyond 2030.



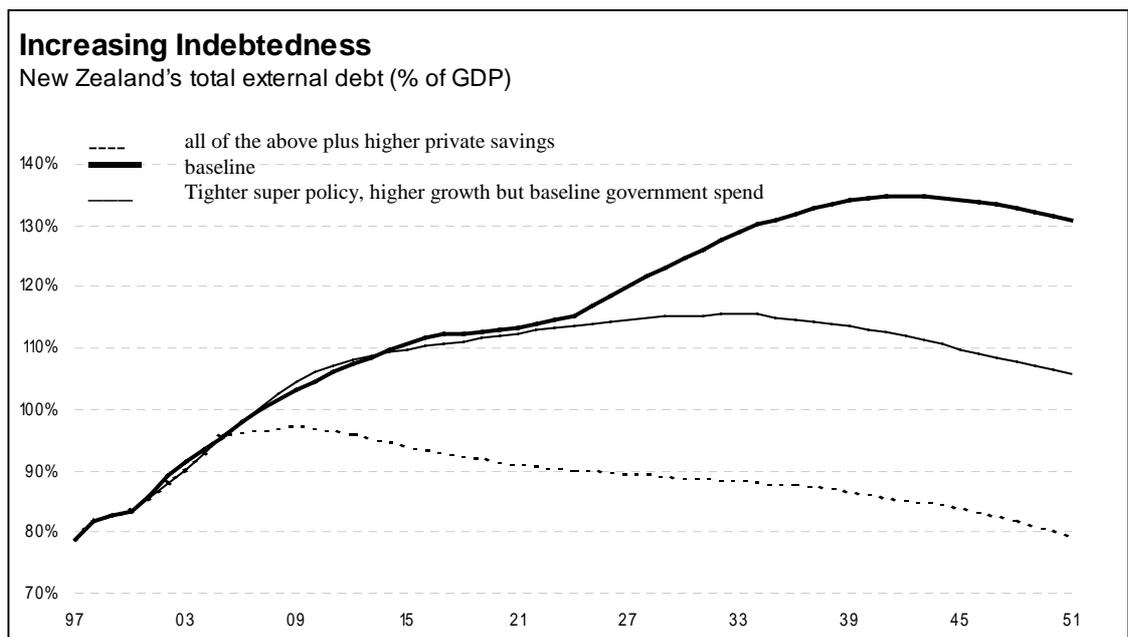
4.5.2 A late adjustment could be as costly as well. Just changing the forecast horizon in the tax rule from the 20 year horizon to a three year forecast horizon (as used in the Treasury's fiscal forecasts) not only means that net debt could still go up over 40% of GDP, but the effective income tax rate would need to go up to 42 cents in the dollar to bring the fiscal position back into control.

4.5.3 In other words, **a delayed reaction to fiscal problems requires far more drastic fiscal adjustments than pre-emptive action that prevents the development of a crisis.**

4.5.4 **Inflation Blowout:** In Infometrics' model inflation is dependent on the size of the fiscal balance. This means that as the tax rule used in the baseline keeps the fiscal position near balance, inflation does not get excessive. **Without the tax rule the deteriorating fiscal position from the 2030s would lead to an exploding inflation track.**



4.5.5 **Balance of Payments Blowout:** In the baseline the current account fails to improve significantly - implying that the national debt position deteriorates to 130% of GDP by 2050. (It is currently 78.8% of GDP).



This graph illustrates the progressive improvement in NZ's foreign indebtedness from:

- (i) a tighter superannuation policy plus higher economic growth and government spending as in the base line;
- (ii) as in (i) above plus greater private savings.

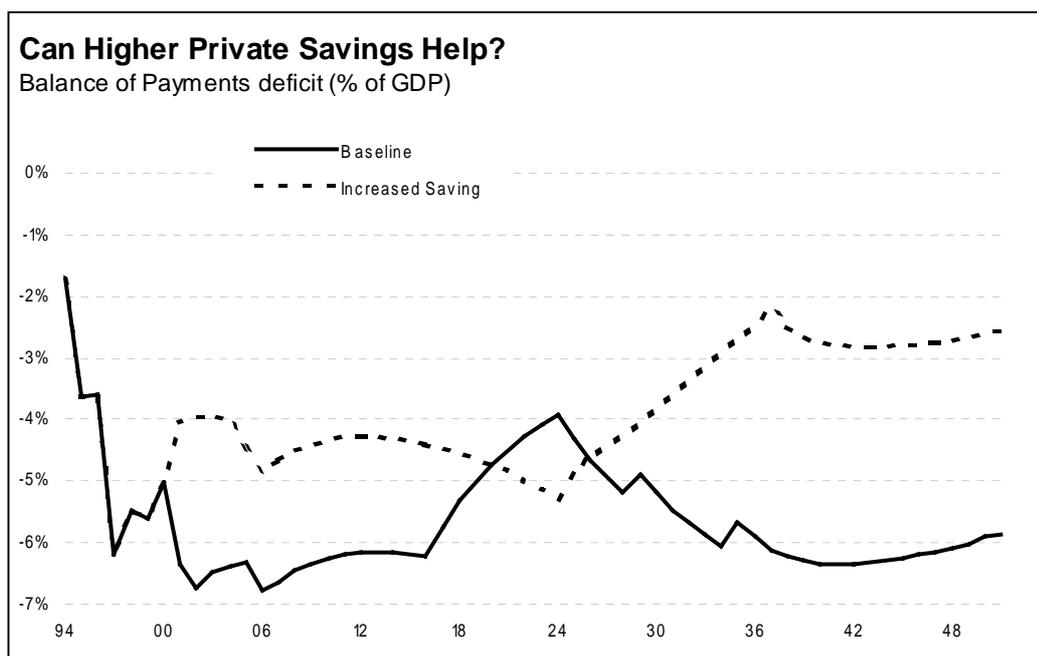
Significantly, even these changes only return the debt burden to where it is currently.

4.5.6 To sum up: none of the inputs into the baseline scenario are likely to generate a significant improvement in New Zealanders' savings behaviour. The model is not a comprehensive guide to future savings behaviour. However, the macro factors modelled do not suggest that fiscal policy will be sufficient to encourage the necessary savings.

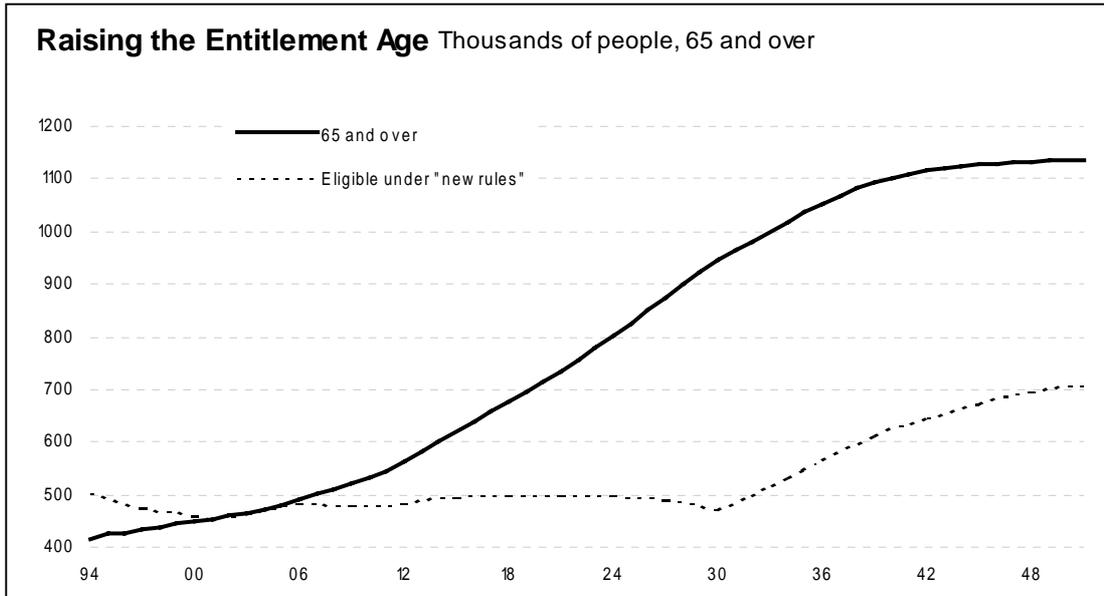
4.6 What Can Help?

4.6.1 **Does economic growth help?** Yes, but only if Government spending is checked. If trend economic growth is increased by 0.5% pa, but Government spending is fixed at baseline levels, government spending in 2050 is projected to be 37% of GDP (cf baseline 41.3%). In other words, to fund the current superannuation scheme without excessive increases in the tax burden will require future governments to restrain the growth in spending in other areas. Bearing in mind expected pressures on health spending in particular, from the same ageing population, this will not be easy.

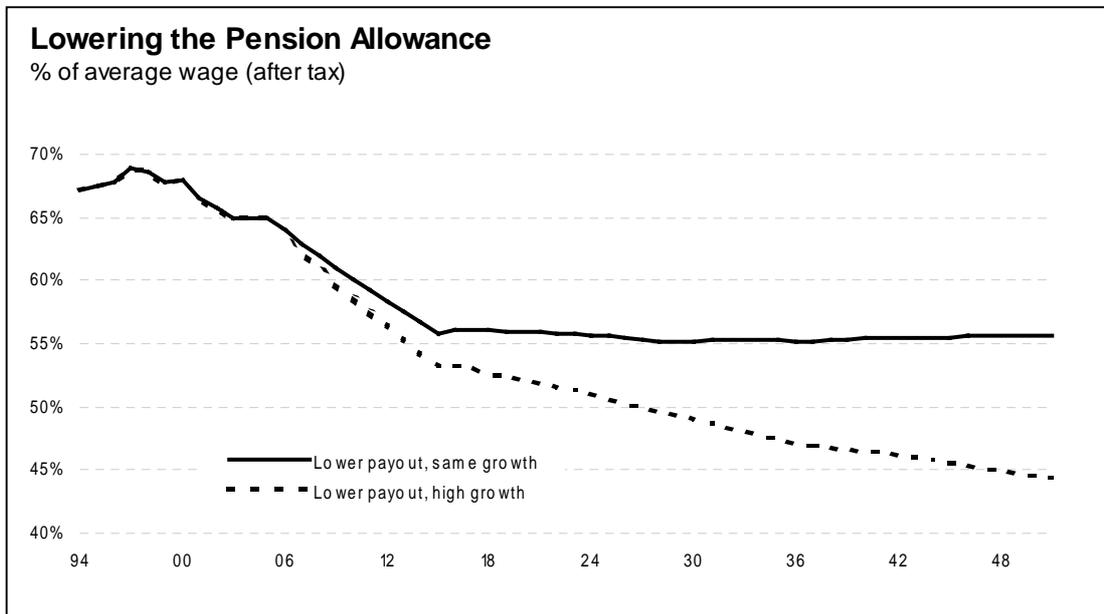
4.6.2 **Higher Savings?** Increasing private savings does not necessarily address the public provision of superannuation and so will not have a very large impact on the fiscal position. But **an increase in private savings will improve the national debt position**, and in this sense makes the fiscal spending on superannuation more affordable. Reducing the size of private consumption as a share of GDP by 2 percentage points would result in a more sustainable current account profile. National debt in 2050 would be 74% of GDP, compared with 130% in the baseline and 78% today.



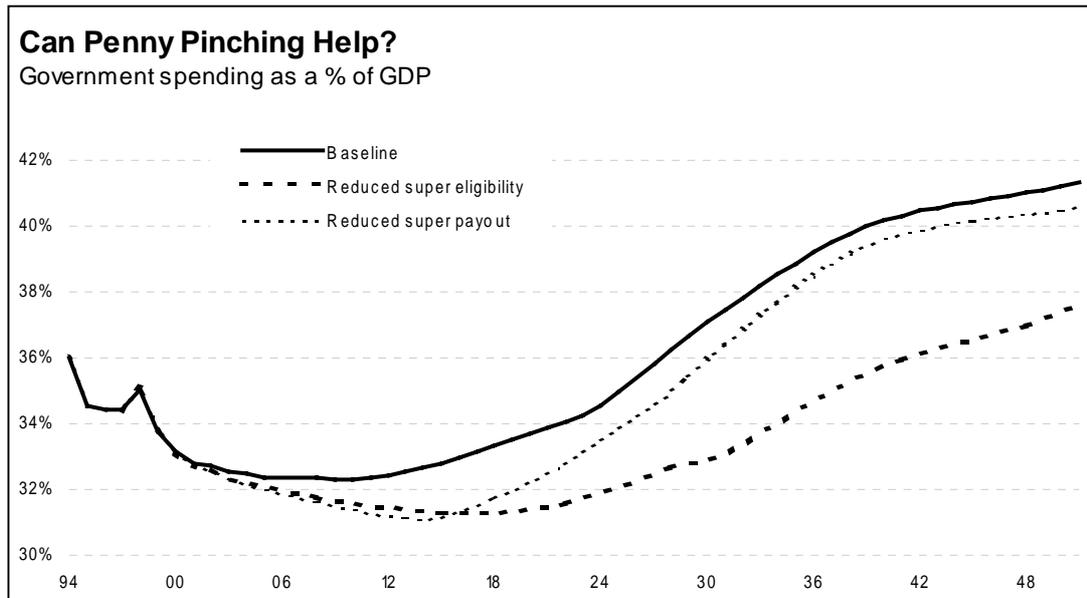
4.6.3 **Pension Pinching: Raising the Age of Entitlement:** Two methods of reducing the Government's superannuation liability were modelled. The first was to assume that the age of entitlement to NZS is gradually raised to 75. The way it is modelled assumes that the process begins in 2005 and takes until 2030 to be fully implemented, and that the "hard-up" over 64s still receive NZS (assumed to be 35% of those aged between 65 and 74).



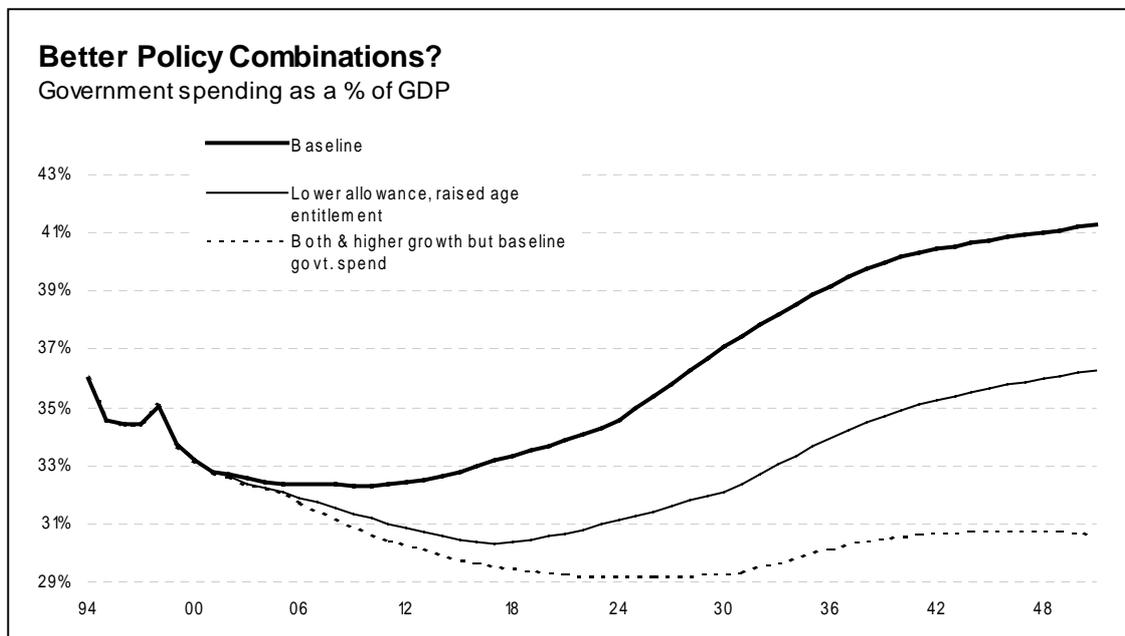
4.6.4 **Pension Pinching: Lowering the Pension Allowance:** The other method considered was to return NZS indexation to the CPI in 2005 (rather than to the average wage) until the average weekly NZS payment was equivalent to the unemployment benefit (which would occur in 2015). The fiscal savings from this approach increase with increases in economic growth, as adjustments to the unemployment benefit are not expected to keep up with wage growth in a high growth environment.



4.6.5 Raising the age of entitlement to NZS appears to be a potent approach to reducing the fiscal costs of the public pension. Government spending is modelled to be 37.6% of GDP in 2050 by raising the entitlement age (compared with 41.3% in the baseline). This one policy approach has almost as much impact as the high growth/fixed expenses scenario (36.8% of GDP).



4.6.6 **Policy Combinations:** Most of the effects of the different policy approaches compound when combined. Combining the two public pension-reducing policies implies Government spending at 36.3% of GDP in 2050. If this was accompanied by higher growth/lower Government spending in other areas, Government spending would be just 30.7% of GDP. This would allow an average effective income tax rate of just 17 cents in the dollar.



4.6.7 Conclusions from Macro Research

The status quo is likely to impose large and probably unacceptable costs on future generations.

We have some time, but the costs of delaying action can be very large.

A multi-faceted approach is likely to have a greater chance of success.

It should include policies that:

promote growth and returns on investment and savings;

restrain increases in the size of government;

reduce tax-funded government pensions.

4.7 Research on Distribution

4.7.1 Infometrics' MIDAS Model (Microsimulation of Income Dynamics and Accumulation of Savings) is a dynamic model of individual wealth accumulation incorporating:

- age - by 5 year age groups from age 19;
- sex;
- ethnicity - European, Maori, other;
- marital status - single (never married + separated + widowed), married including de facto;
- income - by deciles;
- savings - a function of age, sex, ethnicity, marital status, income;
- inheritances;
- capital gain.

4.7.2 The MIDAS model examines the probability of individuals moving from one income decile to another over a period of 5 years. In general, relative income varies substantially over peoples' lifecycles. However, there are marked differences for different sex/ethnic groups. For example, European males aged 35-39 are mostly upwardly mobile and are more likely to stay put if they are already in a higher income decile. There is about an 80% chance of this for those in decile 10. On the other hand, Maori females aged 35-39 are mostly downwardly mobile and are much less likely than European males to stay in higher income deciles.

4.7.3 Another way of using this data (which is set out in full in the appendix) is to compare wealth by age for two cohorts, one representing the generation which is just starting its working life and one which is two-thirds of the way through, ie:

- the cohort aged 15-19 in 1996;
- the cohort aged and 45-49 in 1996.

- 4.7.4 For both cohorts the fastest increase in wealth occurs in the two decades preceding retirement. Wealth continues to rise, but at a slower rate up to age 55-59. Beyond this age wealth declines for males, but hardly at all for females. More women inherit their husband's share of the couple's assets than the other way around.
- 4.7.5 The younger cohort accumulates more wealth by the age of retirement than the older cohort simply because of the projected economic growth. Each generation tends to be better off than the preceding one. In other words, **the younger you are, the better off you will be.**
- 4.7.6 For each of these two cohorts the model illustrates the distribution of wealth at age 64, allocated into deciles. Again the profiles for each sex and cohort are similar, with the younger cohort attaining more wealth by age 64 than the older cohort, and with males accumulating more than females. Apart from the lowest two deciles, it is evident that wealth rises at an increasing rate. For example, there is a bigger difference in wealth between the sixth and seventh deciles than between the fifth and sixth deciles.
- 4.7.7 Another issue we can examine is the proportion of retirees who will not be able to provide for their own retirement. That is, we can ask the question, how many would need Government support? We define this as having net worth at age 64 which is less than the net present value of an annual income stream equal to NZS. The proportion is calculated for males and females, for the two age cohorts defined above, including and excluding wealth tied up in owner occupied dwellings - (This is assumed to be 70% of total wealth, which is equal to the current share).
- 4.7.8 For the younger cohort, about 18% of males and 46% of females will have insufficient wealth to provide entirely for their own retirement. If, however, wealth tied up in housing is for some reason not accessible for consumption, the proportions rise to 78% and 93% respectively.
- 4.7.9 Another way of interpreting these figures is that an asset test for NZS based on this criteria would remove about two-thirds of those aged 64 if owner occupied housing is included in the test, compared to only about 14% if it is excluded. For the older cohort, the corresponding figures are about 52% and 11%.
- 4.7.10 Infometrics then asked the question: Do higher growth and savings help? This time their results were confined to the younger cohort, ie those aged 15-19 in 1996. They again showed the proportion of people aged 64 who could not provide for their own retirement, defined as before, under:
- higher economic growth;
 - higher economic growth and higher savings;

for alternative proportions of wealth tied up in owner-occupied dwellings.

Under the most favourable scenario - higher growth and greater savings - 3% of males and 14% of females would accumulate insufficient wealth to provide for their own retirement. Excluding housing, even with a greater diversification of investment, the proportions rose to 46% and 67% respectively.

With an asset test for NZS, excluding housing (under greater portfolio diversification), 43% of those aged 64 would be ruled ineligible, compared to 91% if housing is included.

- 4.7.11 **Conclusions of Research on Distribution:** There is a high level of dependency on the state pension. Excluding their houses, over 85% of today's 15-19 year olds are unlikely to have accumulated a sum at retirement age equivalent to the present value of NZS. Even under the higher economic growth and higher private sector savings scenario examined above, the majority of people will still not have accumulated a sum in excess of the capital equivalent of NZS.
- 4.7.12 If the equity in the house is considered as well as other accumulated savings, then in the baseline scenario two-thirds of retirees will have accumulated sufficient savings to obtain annually as much in real terms as the state pension currently offers. Under the high growth high savings scenario this figure rises to over 90%. This suggests that **it is important for retirees either to access the equity in their house over the retirement years, or to have less of their savings in this asset class on retirement.**

In the Infometrics baseline scenario the state pension bill will double (relative to the size of GDP) by the year 2050. If targeting is introduced so that only those with savings (excluding the house) less than the present value of NZS qualify for the pension, then the pension bill will rise by 86% (rather than 100%) over that period. If economic and savings performance is improved as specified earlier, and the pension is reduced to the level of the unemployment benefit, then the real rise in the state pension can be reduced to 57%. If housing assets were captured by the means test then the rise in the pension bill would be reduced to 9%.

4.8 Policy Implications

- 4.8.1 There is opportunity, by virtue of the window presented in the age distribution of the population, for policymakers to improve the chances of adequate provision. But equally on offer from this window is the danger that a 'time-is-on-our-side' attitude will lull policymakers into complacency. That complacency will then raise the likelihood of insufficient provision being made and compel either macro economic blowouts (inflation, balance of payments, public debt), or necessitate large and sudden adjustments to tax rates or state pension entitlements. Such belated changes will hit later generations of taxpayers unfairly.
- 4.8.2 Pre-emptive policy action would enable policymakers to manage the risk and reduce significantly the chances of sudden, large swings in policy settings after 2015.
- 4.8.3 The suggestion that voluntary provision is best and that there is adequate time to adjust things if provision departs from a course of adequacy, is a **high-risk strategy** not unlike the approach the Government took to the 'Think Big' projects to solve the oil crisis of the 1970s. In that case the problem disappeared and the Government was left with expensive white elephants. In this case the equivalent risk is to be left with either an impoverished elderly cohort or a high, economic welfare-retarding level of intergenerational transfers. The implied changes in tax rates given that eventuality are large and impose unnecessary costs on private sector certainty and efficiency.
- 4.8.4 It is basic to market theory that participants make better quality decisions the better the quality of information they have available. In this regard it is important for today's policymakers to avoid both overly promoting a view that the current policies will be adequate or that huge changes will be necessary. Rather, the onus is on providing a clear enunciation of what the status quo economic, regulatory and taxation policy is likely to deliver and what changes are necessary to significantly improve the chance of adequacy.

5 Policy Conclusions

- 5.1 The most important policy conclusion we reach on the basis of all this research is the simple point that the issue of retirement savings cannot properly be considered in isolation from other policy issues. The Government needs to raise its performance or outcomes in a number of policy areas if it wishes to significantly reduce the fiscal problem arising from the ageing population. We summarise these now.
- 5.2 **Economic Growth:** The most potent way to reduce the risk of failure and either large intergenerational transfers or reduced retirement incomes for the elderly is to improve economic growth. What matters here is the growth rate that can be maintained without inflation or balance of payments disequilibria. Any examination of savings policies needs to assess why the economy is not operating to its full potential. At present it is clearly not, with an unsustainable balance of payments deficit coinciding with unemployed labour resources.
- 5.3 **Private Savings Rates:** The policy goals should be to ensure that savings rates are as close as possible to those which citizens would maintain if they had perfect information on their economic circumstances at retirement age, and over their retirement years. The Government should not send signals today which suggest that a particular savings rate is appropriate unless it has clear grounds for doing so. Clear plans for the long term future of NZS will provide people with better information on which to base their own savings decisions. The role of the state pension should be as a safety net rather than as a non-contributory insurance scheme of questionable tenure (at least in its current form), which then distorts the signals people receive with respect to their need to save for themselves.
- 5.4 **Efficiency of Private Sector Investment:** Investors need clear sustainable signals that do not seek to influence the allocation of investment resources. If investment funds are flowing into particular areas primarily because of taxation or regulatory reasons (farming, films, orchards being past examples; housing, fishing, forestry, passive index funds and offshore investment trusts all being current examples) then overall returns are lowered. Institutional factors that encourage a biased pattern of investment need to be reviewed so that the economy can maximise its potential.
- 5.5 **Government Spending:** There is a considerable body of economic analysis that suggests there is an optimal size of government. Once government gets over a certain size the benefits to economic welfare and social equity which flow from government delivery are offset by the losses in allocative efficiency within the economy. The problem is that taxpayers are compelled to pay for and consume a range of goods and services supplied by government by virtue of its regulatory and taxation monopolies. This set of goods and services is different from those that would be chosen given free choice and hence there is a loss of consumer benefit.
- 5.6 Government spending should be restricted to those instances where it can be proved that the outcome is superior to market failure. Adherence to this rule has implications for the Government's role in all areas including the major sectors of health, education and retirement insurance. An example may be the recent trend in the health bill. Currently this is lifting rapidly even though the demographics suggest it should not be. As the population ages, as incomes rise, and as technologies expand, pressures for health spending will increase even further. There will continue to be a clash between a seemingly insatiable demand for health services and a limited capacity to provide. Pricing mechanisms are needed to cap this demand. A coherent health policy whose

direction is known to future retirees will be an important driver of adequate retirement income provision.

- 5.7 **Immigration:** Over recent years New Zealand has had a volatile immigration policy. Consistent policy could assist to raise the per capita growth rate and the sustainability of publicly-funded retirement support. A coherent immigration strategy could improve the inter-generational balance in the population, thus lowering the aged dependency ratio as well as improving the country's skill base. It is therefore important to ensure that immigration policy has clear long term objectives.
- 5.8 **Retirement Pensions:** Finally, the distributional analysis indicates that higher growth, even with greater private savings, will not remove the need for a public pension of some sort. This is even more significant if housing assets are not counted as part of retirees' potential retirement funds. The proportion of the cohort currently aged 15-19 with net worth (excluding a house) at retirement (ie, age 65) less than the net present value of a reduced NZS pension is over 50% - even if we can assume a higher growth, higher private savings path.
- 5.9 In order to reduce this dependency, retirement policy needs to address how the equity in houses can be accessed for retirement needs. With access to the wealth tied up in housing the proportion of 65 year olds who would then require a state funded pension could fall to just 9%.
- 5.10 In summary, a suite of economic performance indicators and policy implications will jointly determine the retirement savings outcome. The sooner the performance in each area approaches its potential, the sooner we can reduce the risk of failure of adequate provision for the retired generation to an acceptably low level. Present policy settings do not meet this objective. Rather, they imply either a major lift in intergenerational transfers, or a reduction in future retirement incomes of the elderly. Work must begin now to avoid either outcome.

6 Where to From Here?

- 6.1 Given the policy directions in which the current research is pointing, the next logical step will be to focus individually on those areas of policy from which specific outcomes can be drawn.

6.2 Establishing Society's Welfare Preferences

- 6.2.1 The research saw a clear role for the Government in providing security of retirement support to those who are disadvantaged or for whom the period of retirement will be longer than usual. The resource costs associated with public provision may trade off increased security gains with the cost of foregone private wealth creation.
- 6.2.2 It is important to establish society's relative preferences on this issue to improve the likelihood of retirement income policy meeting the aspirations of New Zealanders and thus reducing the potential pressure for future policy reversal.

6.3 Factors Influencing the Quality of Investment and Saving Decisions

- 6.3.1 Much of the analysis of retirement income issues to date has focused on the adequacy of saving from a quantitative point of view, rather than looking at the quality of saving and investment decisions which offer returns that reward savers for foregoing immediate consumption.
- 6.3.2 More research could usefully be undertaken on the distribution of saving and investment across the full range of savings options, and to compare the New Zealand mix and performance of saving and investment decisions with international benchmarks.

6.4 The Role of Housing as a Vehicle for Retirement Saving

- 6.4.1 New Zealanders have historically had a strong preference for home ownership as a means of retirement saving. The debate on the merits of this preference has focused on whether the regulatory, taxation and legal frameworks encourage an over-investment in home ownership.
- 6.4.2 There would be considerable value added to this debate by looking at the reasons why individuals seek home ownership and what role this should ideally play in a retirement savings strategy. Regard must be given to the risks of having residential property as the primary asset in a savings portfolio. It would also be useful to compare a typical New Zealand savings portfolio with the optimal portfolio choice.

6.5 Universal Entitlement versus Targeting

- 6.5.1 The research to date suggests that economic efficiency and fiscal affordability could both be offered as reasons why a reduction in the amount of publicly funded superannuation could be considered.
- 6.5.2 The investigation of social preferences referred to in Section 6.2 above might offer some indication of the desirable amount for total spending on NZS but further work is needed on the relative merits of targeted versus universal entitlements.

6.6 Growth of Government Spending

- 6.6.1 The affordability of NZS will be influenced by the growth in spending commitments in other areas of government activity.
- 6.6.2 Research in this area is needed to examine historical trends, identify drivers of demand for any growth in spending, assess the ability of Government to meet this demand and look at ways of meeting demand while minimising spending pressures. Some consideration should also be given to determining the net benefit of Government spending.
- 6.6.3 The existing models for assessing the fiscal and economic cost of demographic pressures and the distributional aspects of retirement income provision would both benefit from enhancement to allow more in-depth analysis.

6.7 Conclusions

- 6.7.1 This paper has sought to demonstrate the broad economic framework within which effective retirement saving policy can be established, the consequential threads of research which need to be woven into the development of that policy and the urgency with which these issues need to be addressed.
- 6.7.2 The challenge now facing Government is to make a commitment to buy in to the process and to provide the momentum and resources needed to achieve the objective of long term, stable and effective policies in this vital area.

