RETIREMENT INCOME PROVISION

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RETIREMENT INCOME PROVISION

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EXECUTIVE SUMMARY

* The key to our ability as a society to provide a reasonable standard of living for the future elderly will be the future performance of the New Zealand economy. If our economy continues to perform as badly as it has over recent decades, the prospects for the future elderly are dim. That applies irrespective of any decisions made now as to the form of retirement income policy.

* The first priority of any government should therefore be to implement general policies which would lay a foundation for sustained high rates of economic growth with negligible inflation.

* Any retirement income policy needs to be consistent with the general policies required if we are to be able to support tomorrow's elderly. A burdensome or poorly structured policy will undermine the economy's growth potential.

* Retirement income policy also needs to be credible and sustainable in the longer term. If this is not achieved, further changes will be required in the future. The area of retirement income involves long-term decision making and therefore demands a stable policy environment. However, more than most, it has suffered from frequent and abrupt policy changes.

* Current policies for state provision incur high economic costs and are not consistent with the sort of economic policies required to secure the economic growth we need. They were designed to meet the problems of a particular period in our history when alternatives to state provision were less feasible. They have now become more questionable from an equity point of view and less sustainable from an economic efficiency viewpoint.

* Greater reliance on private retirement provision would be more consistent with the income, wealth and work profile of tomorrow's elderly, and with the sort of economic policies needed to sustain a relatively large elderly population.

* It is recognised that people may not make the best possible decisions as individuals in respect of private retirement provision. However, decision making subject to political and interest group pressures can also be poor in this, as in other areas, and intervention to 'correct' for 'poor' decisions by some is likely to impose costs on others.

* Greater reliance on private provision is a viable option if general policies are more conducive to savings and to labour market opportunities. In addition, reduced public provision will provide the incentives for people to save for their retirement in the same way as they save for other future events.

* Within an environment in which greater reliance is placed on private retirement provision, there will continue to be a need for state-provided income support for those who are unable to make provision for themselves or who fail to do so.

* The state programme should be based on principles of income support, not income maintenance. The government's role is to ensure the elderly are not left without the means to provide themselves with a reasonable standard of living and to provide a minimum benefit consistent with that standard.

* The retirement income support programme should have a higher eligibility age, be more closely targeted and should provide less generous benefit levels than the current national superannuation programme.

* Within the context of a broad approach to retirement income provision, such a programme corresponds most closely to Scheme I of the Department of Social Welfare's December 1988 discussion paper.

* None of the other options outlined in that paper would be consistent with the sort of policies required to provide a sound form of income security for the future elderly. In particular, the social insurance schemes which seem to be favoured amount to universal income maintenance schemes with more generous benefit levels. They would result in a move in the opposite direction to that required and impose high effective marginal tax rates on today's working population.

* Any move to alter retirement income policy will require detailed consideration of transitional issues. Careful judgements should be made as to how quickly the reforms can be implemented without unfairly affecting those who cannot be expected to adjust to the changes.

* A review of retirement income policy would be incomplete without a review of the government's role in providing superannuation benefits to its own employees. Taxation and public sector reforms make such a review, based on the same criteria as the government has used elsewhere, an urgent priority.

* Provided the preconditions of sound economic management and a stable planning horizon are met, the approach recommended will progressively facilitate greater self-reliance and help break down artificial notions of compulsory retirement for participants in the workforce, while protecting those currently dependent on state support.

* The fiscal and economic problems which New Zealand is facing are acute, and the current and future burden of the national superannuation programme is an important element in them. The area of retirement income policy has been plagued by changes and uncertainty, with damaging consequences for individuals, institutions and capital markets. It is imperative that priority is now given to establishing a sound, sustainable environment for long-term retirement planning.

1 INTRODUCTION

1.1 Purpose of the Paper

The form of future government retirement income policy has become a critical issue. The government has progressively withdrawn the taxation concessions for private retirement saving. Recently it has sought comment on the future of national superannuation. The Opposition has also announced changes to national superannuation which it considers desirable.

This paper is a contribution to the discussion of retirement income policy. It is not solely concerned with the future of national superannuation. It is argued that that is far too narrow a focus. Indeed "retirement" is itself a misnomer since continuing workforce participation may, in some cases, be a desirable means of obtaining a "retirement" income.

While the paper does suggest desirable changes to government retirement income programmes, the emphasis is on the importance of sound general economic policies and the need for consistency between a retirement income programme and those economic policies.

1.2 Social Responsibilities to the Elderly

It is accepted that a society has a basic responsibility to ensure that all its members can, if they so wish, participate fully in economic and social activities. That basic principle would be transgressed if vulnerable sections of society were denied access to a reasonable level of material support. The elderly is one group which may be vulnerable. It would not be considered acceptable for that section of society to experience inadequate living standards.

Present policies aim to achieve that objective by providing a generous level of income support in the form of national superannuation which is effectively, but very loosely, income-tested. However, there is a general recognition that that response may not be entirely appropriate and indeed may not be possible to sustain.

1.3 Analytical Framework

There seems to be less of a recognition of how narrowly focused the debate on retirement income policy tends to be. It seems to operate within the following assumptions:

a most, if not all, people should withdraw from the labour force and retire at or around 60 to 65 years of age;

b as a substitute for the labour income which the retired no longer receive, the government should provide a pension to maintain a reasonable standard of living;

c that pension can be supplemented (to some extent) by earnings from past savings so as to increase the standard of living of the retired.

Retirement income policy tends to be discussed within the bounds set by those assumptions. What should be the age of retirement? What is an appropriate pension level? Should benefits be targeted to those in greatest need and, if so, how?

Those are relevant questions. However, there are important prior questions such as: What economic environment is most conducive to sensible retirement planning? Can any retirement income system operate successfully if economic policies do not generate growth in the output of real goods and services? When such questions are asked, not all the above assumptions may be found necessarily to apply.

By widening the focus of debate, it is argued that the objectives of the government's retirement income policies can be seen as often confused and misplaced. It is submitted that in this area the government should aim to:

- a put in place wider economic policies which are conducive to economic growth and thus to private retirement provision; and

- b put in place an income support programme for those whose retirement income would otherwise be inadequate.

The retirement support programme needs to be consistent with wider economic policies and should be designed according to the normal criteria of efficiency, equity, simplicity and certainty.

1.4 Structure of the Paper

The paper first considers past and current responses to retirement income issues. It notes how those were designed to meet past needs, and how the current response is narrowly conceived and appears to incur high costs while becoming increasingly questionable on equity grounds.

The next section reviews policy issues in this area and highlights the importance of general economic policies, and the need for a retirement income support programme which is consistent with those objectives. The form such an income support programme should take is discussed in the fourth section. The conclusion is that it should be closely targeted and provided on similar lines to other targeted benefits. In that regard there seems to be room for reducing the level of individual benefits over time. Once the desirable end-point of policy reform is settled, careful consideration should be given to the transitional issue. That and the government's role in this area as an employer is considered in the fifth section. The final section provides a summary of the paper.

2 A REVIEW OF PAST AND CURRENT RESPONSES TO RETIREMENT INCOME NEEDS

2.1 Introduction

This section reviews the manner in which the government has in the past formulated its policies with respect to the income of the elderly. It is argued that the policy framework has been considered narrowly in terms of the provision of retirement income. That response reflects the late nineteenth century need, both here and overseas, to provide material support for those who, in old age, would otherwise be left destitute.

The social and economic adjustment that many societies experienced as they became urbanised and industrialised provided limited opportunities for alternatives to state income support for the elderly. A century later the opportunities for people to provide for their old age by way of accumulated savings and/or continued workforce participation seem much greater. It would therefore be a mistake to remain locked into policy responses which, while they may have been appropriate in the past, have become less justifiable today.

The existing response of a state-provided retirement income is costly in terms of tax revenue which must be raised to fund the programme. That inevitably has resulted in high economic costs being incurred. Moreover, the fairness of the system becomes more suspect as the elderly become more affluent and/or otherwise more capable of making their own income provision. Economic and demographic trends indicate that the cost of the existing response is likely to increase in the future at the same time as the justification for it diminishes.

2.2 The Initiation of Government Retirement Income Schemes

Direct, large-scale public intervention specifically aimed at providing the elderly with substantial retirement incomes is a relatively recent twentieth century phenomenon. It is also largely confined to the more advanced urban, industrialised societies. Throughout history, most societies have operated successfully without the state assuming responsibility for providing the elderly, as a group, with material support. The more common response has been programmes to avoid destitution. It should not, therefore, be assumed that retirement income programmes are a necessary aspect of every society. They may nevertheless be desirable. In that regard, there were good reasons for the development of such programmes in the late nineteenth and early twentieth centuries.

Pressure for old age pensions and other forms of state retirement provision developed initially in nineteenth century Europe. That pressure was a result of important social and economic developments.

In a traditional agrarian society, life expectancy was low. For those fortunate enough to live until old age, there was no "retirement" as such. As working ability decreased, people moved from more to less strenuous activities. To the extent that they could not then fully support themselves, they were supported by the extended family networks within which they continued to live and work, or by their local communities.

By the late nineteenth century, life expectancy in the western world had lengthened to the point where attaining old age became an increasing possibility. At the same time the urban exchange economy developed. The population became more mobile with the nuclear, two-generational family replacing the traditional extended, multi-generational family networks. Within such a society, people required cash incomes which were generally obtained by selling labour services.

These developments disrupted traditional patterns of old age support. For the elderly, the option of moving from more to less strenuous activities became more difficult. The option of building up capital income to replace labour income was often not viable in a period of rapid economic change and relatively low wages.

The third option of reliance on extended family networks (a form of inter-generational contract) became in theory more viable, but in practice less so. As children remained out of the workforce for longer periods, the investment by parents in their upbringing, education and training increased. In principle, this provided the basis for extending the traditional inter-generational contract whereby parents supported their children in the latter's non-productive years and, in return, children would support their parents in old age. However, the demands of the industrialising economy and resulting labour mobility undermined extended family networks, making any such inter-generational contract difficult to enforce.

The result was that social and economic change broke down the structures which had previously supported the elderly. Many were left in destitution. Moreover, because of economic growth, destitution was less tolerable at the end of the nineteenth century than it had been at its beginning.

Essentially the state then intervened to enforce the implicit inter-generational contract between parents and their children by providing old age pensions funded out of forms of taxation. An early example was the German Law of Insurance against Old Age and Infirmity of 1889. The United Kingdom introduced an old age pension in 1909.

New Zealand faced pressures similar to those of other western countries. Indeed the pressures here were probably greater since, as a country of immigrants, there was clearly less opportunity for people to rely on extended family networks. Possibly for that reason New Zealand was one of the first countries to institute a state retirement income programme - the Old Age Pensions Act 1898. That was a tightly targeted (income and asset tested) programme of modest generosity. Benefits reached about 20% of the average wage by the mid-1920s.

Another reason for the institution of government retirement income schemes was to reduce competition in the labour market at a time when the population and the labour force were growing rapidly. Many industrial awards have provided for compulsory retirement at the pension age. And earlier retirement has sometimes been suggested as a "cure" for unemployment. Because of the current and expected aging of the population, these arguments carry less force for the present generation than for previous ones.

2.3 Extensions to Government Retirement Income Schemes

The establishment of government retirement income programmes in most western countries was followed by a period of expansion of such schemes. That ran from the early 1930s to the immediate post-war period.

The economic downturn of 1929 to 1938 (which reduced many people's savings and their ability to save for retirement) followed by the Second World War (which in Europe also eliminated the lifetime savings of many individuals and increased the sense of social unity) created the basis for the establishment of new retirement programmes or the expansion of existing ones. For example, this period saw the establishment of a public retirement income programme in the United States (1935). Programmes in Europe and the United Kingdom were expanded and/or re-established.

The New Zealand initiative, in line with international trends, was the the Social Security Act 1938. That legislation established the basic structure of state-provided retirement incomes for the next thirty-five years. It provided for an income and asset tested benefit from the age of 60 years, with the benefit rate for a qualifying couple being about 60% of the average wage. A universal (i.e. non-targeted) benefit from the age of 65 years was also provided for, but the benefit was initially set at a relatively low level (less than half that of the old age benefit).

2.4 Post-war Expansion

A third general period of government retirement income policy lasted from the 1950s to the late 1970s. That was a period of rapid economic growth combined with slow growth in the elderly age cohorts of western populations. That provided governments with the fiscal ability (at least in the short term) to expand the coverage and generosity of existing retirement income programmes. Three particular trends can be discerned.

First, there was a move away from **funded schemes** (under which present-day taxes or contributions are set aside to meet liabilities in the form of promised future benefits) towards **pay-as-you-go** (PAYG) schemes (under which present-day taxes or contributions are used to pay present-day benefits). Of the OECD countries, only Canada and Japan retained a funding element as part of their public retirement income programmes. One effect of the move away from funded schemes was that there was not the same need for governments to account for the cost of future benefits. That could disguise the real costs of making the terms of schemes more generous.

A second trend over this period was a move from **flat rate schemes** (which pay a set benefit to all beneficiaries) to **earnings related schemes** (which pay a benefit based on past contributions or earnings). Earnings related schemes tended to be more generous than flat rate schemes, offering higher benefits to upper income earners without any reduction in other benefits. However, the tendency was also to offer benefits which would not mature for a number of years. An example was the United Kingdom's State Earnings Related Pension Scheme (SERPS) which came into effect in 1978. It promised a pension based on a contributor's best twenty years indexed earnings on top of a universal basic entitlement. Because it was a PAYG scheme, with pension entitlement based on years of contribution, its initial cost was negligible. However, as benefit entitlements matured, contribution levels would have had to reach high levels.

A third trend was a move towards indexation of pensions to wage levels. On the basis that real wages would increase over time, that also increased the real cost of the programmes.

When combined with general increases in the generosity of programmes, the end result of these trends was a sharp increase in the current and future costs of public retirement income programmes. Between 1960 and 1980, the annual growth rate of real public expenditure on pensions in the OECD countries ranged between 5.3% in the United Kingdom and 13.2% in Japan (OECD 1988a). That compared with an annual growth rate in the number of people aged over 65 years of between 1.5% in the United Kingdom and 3.5% in Japan (ibid). There was therefore a substantial increase in the real costs of such programmes per beneficiary.

Until the mid-1970s, the programme established in New Zealand in 1938 showed remarkable stability. Within the structure the programme became more generous. The major change occurred in 1960 when the universal benefit level was raised to the same level as the age benefit and the asset test on age benefits was removed. The increased generosity of the scheme resulted in an increase in real public expenditure on the programme. Between 1959/60 and 1974/75 the average annual rate of real increase was about 4%. As a percentage of GDP, expenditure increased from about 3% in 1959/60 to 3.8% in 1974/75.

The apparent political consensus on the structure of public retirement income programmes was broken in the mid-1970s. The Third Labour Government introduced a new structure in 1975 centred on an earnings related funded scheme paid for by contribution levels of, eventually, 8% of earnings. That scheme was replaced in 1977 by the national superannuation scheme introduced by the Third National Government. Its key features, compared to the pre-1975 arrangements, were:

a) a more generous benefit level set, for a couple, at 80% of average earnings; and

b) more generous eligibility criteria with a universal (i.e. non-targeted) benefit available from the age of 60 years.

2.5 Recent Trends

A fourth period in the history of public retirement income programmes can be traced from the late 1970s. This coincided with a period of reduced economic growth in most economies, placing most western governments under considerable fiscal pressure. In addition, concern increased over demographic projections which indicated that the costs of schemes would rise sharply in the future. That led many governments to the conclusion that existing programmes could not be sustained.

From the late 1970s, therefore, many countries have proposed or put in place measures to reduce the generosity and/or scope of existing programmes. An example is the United Kingdom which decided to reform the SERPS programme with the aim of reducing its future costs. Other countries (such as Germany, the United States, and Japan) have decreased future benefit entitlements and/or increased the age of eligibility (scheduled in the United States and proposed in Japan).

So far, New Zealand has only tentatively followed the trend towards more restrictive public retirement provision. Benefit levels were reduced slightly in 1979 and a form of targeting (via the national superannuitant tax surcharge) introduced in 1985. However, benefit levels (at around 80% of the average wage) remain generous relative to the position before the mid-1970s (around 60% of the average wage - although the difference is slightly exaggerated by the impact of income tax). The surcharge is an extremely loose form of targeting, recouping only an estimated 4% of the gross cost of the scheme (Treasury 1987).

By way of comparison, it may be noted that Australian benefit levels are considerably lower. The single pension rate is around 34 percent of net earnings and the combined married rate is around 54 percent of net earnings (figures for the September quarter 1988).

2.6 The Cost of National Superannuation

There are three ways of measuring the cost of a state retirement income scheme:

- fiscal cost;
- cost in terms of other government objectives foregone;
- cost in terms of reduced economic output.

2.6.1 The Fiscal Cost of National Superannuation

The more generous provisions introduced in the mid-1970s, and the lack of moves since to significantly recoup that expansion, when combined with an increasing number of elderly, have resulted in a continuing increase in the costs of the programme. National superannuation now consumes some 50% of social welfare expenditure and 17% of total government expenditure. In 1986/87 its cost was some $3,650 million (current annual cost about $3,900 million). Allowing for tax paid (including the surcharge) of some $950 million, the net cost in 1986/87 would have been about $2,700 million (Royal Commission 1988). On that basis, the average annual rate of increase in real expenditure since 1974/75 has continued to run at just under 4%. With lower economic growth over the period (compared to the pre-1974 period), public expenditure on retirement incomes has increased from about 3.8% to about 5% of GDP. By comparison, Australian spending on age pensions was around 2.4 percent of GDP in 1987/88 (with minor additional benefits increasing this figure to perhaps 3 percent of GDP).

The fiscal cost of national superannuation is not in itself a reason for reducing the level of provision. However, the burden which is thereby imposed needs to be recognised and judged against the value (in terms of meeting social objectives) obtained from the expenditure.

2.6.2 The Fiscal Cost of National Superannuation as an Equity Concern

The fiscal cost of national superannuation can be measured in terms of other social objectives the government cannot pursue because a high proportion of a given expenditure budget is allocated to retirement income provision. The cost of national superannuation is being borne at a time when the government is under considerable budgetary pressure which is forcing it to review and control its expenditure. There is thus an equity concern that, to keep within a given budgetary constraint, the government is forced to restrict expenditure on areas such as health and education which may have higher social values.

A related equity concern arises from viewing the fiscal cost as a substantial transfer of resources from the younger to the older generations. In general, throughout the western world, state retirement income programmes have been successful at significantly reducing the extent to which poverty is prevalent amongst elderly sections of the population. However, there is growing international recognition that poverty, to the extent that it exists, has become centred on low income (particularly single parent) households with children (the low income group).

It should be appreciated that one potential effect of programmes such as national superannuation is to transfer resources from the low income group to the elderly. That can occur because the government might have to forgo, for fiscal reasons, other measures aimed at improving the position of the low income group and/or because the low income group is itself taxed in order to finance the retirement income programme.

Such inter-generational transfers can be viewed as particularly inequitable if the elderly recipients are themselves relatively affluent. As previously noted, when retirement income programmes were initially introduced many elderly were without a means of support once they were no longer able to participate in the workforce. Economic disruption and war have meant that that position remained for significant numbers until relatively recently. However, the generation who are now retiring, after having spent most of their working lives in the relatively prosperous and stable post-war period, can be expected to have been in a better position to accumulate non-labour wealth prior to retirement.

2.6.3 The Cost of National Superannuation in Terms of Reduced Output and Welfare

A third, and probably the most important, method of assessing the burden represented by the fiscal cost of a scheme such as national superannuation is to measure the cost in terms of the economic loss incurred. Generous benefit levels reduce incentives to work, save and invest. Such benefit levels must be financed out of current or future taxes, which further distort incentives.

(a) Benefit Levels

Available New Zealand data (see New Zealand Government 1988, and New Zealand Planning Council 1988) suggest that only a relatively small proportion of those aged over 60 have substantial amounts of non-labour income. However, the proportion of elderly households with relatively high incomes is still significant. On the basis of the 1986 New Zealand Census, 40% of two-person households aged 60 to 64 years had incomes over $20,000 per annum (for the 65 years-plus age group that figure was 32%), and 33% of one person households in the same age bracket had incomes over $12,000 per annum (for the 65 years-plus age group that figure was 22%). These figures are significantly higher than the counterpart figures for Australia.

There are a number of possible reasons why non-labour income (excluding national superannuation) is not higher for this age group:

a the post-war workforce generation is just reaching the retirement age cohorts;

b compulsory retirement provisions in employment contracts have limited additional earnings;

c the long-term existence of relatively generous state retirement income programmes has lessened the need for the accumulation during working life of income-earning assets (or encouraged early retirement, asset rundown and subsequent reliance on state pensions);

d other government economic policies, such as policies leading to high and variable inflation rates, have discouraged savings;

e a principal form of saving has been owner-occupied housing which produces no cash income;

f the national superannuation surcharge (although only relatively recently introduced) has encouraged superannuitants to hold their wealth in forms which do not produce surchargeable income - such as assets producing capital gains - or through entities which shelter income from the surcharge.

Although the non-labour income of superannuitants is on average relatively low, available data do suggest that this section of the population is relatively affluent in terms of asset holdings. This is especially true of home ownership with over 65% of the 60 to 64 years age group, and nearly 75% of the 65 years plus age group, owning a mortgage-free house.

In the future, a growing proportion of the elderly is likely to have substantial capital resources. That is especially likely to be the case of the children of the current retiring generation. Not only would many in this group have benefited in full from post-war prosperity and have had greater access than their parents to retirement savings vehicles (such as occupational superannuation), but they will also be likely to inherit substantial assets from their relatively wealthy parents. In other words, many of those born from about 1945 onwards are likely to be the beneficiaries of the compounding effect of two generations of relative affluence.

It would seem that a state funded retirement income programme which attempts to transfer resources to an elderly population, significant numbers of which are becoming increasingly well-off financially and thus increasingly capable of supporting themselves, is likely to come under pressure for being inequitable.

In the preceding discussion it has also been assumed that those in the over-60 years age group are unable to continue working and thus derive labour income. That assumption is unjustified. In addition to, or in partial or total substitution for, capital income from past savings, those aged over 60 years can and do derive income from work.

Nevertheless, a characteristic of OECD countries in the post-war period has been a marked decline in the labour force participation rates of the elderly. This is evident from the following data (OECD 1988a):

Labour Force Participation Rates Of Those Aged Over 65 Years - Selected OECD Countries

	Male		Female	
	1965	1985	1965	1985
Australia	23.3	8.9	4.4	2.0
Canada	26.3	12.3	6.0	4.2
Germany	24.0	5.2	7.8	2.5
Japan	56.3	37.0	21.6	15.5
UnitedKingdom	23.7	7.6	6.5	3.2
United States	26.6	10.3	9.4	6.8

A similar trend has been evident in New Zealand as shown in the following data (Royal Commission 1988):

Labour Force Participation Rates Of The Aged - New Zealand

(For 1966, those aged 65 to 69 years. For 1986 those aged over 65 years.)

	Male		Female	
	1966	1986	1966	1986
New Zealand	42.1	8.8	6.5	1.9

As can be seen, New Zealand had relatively high labour force participation rates in the mid-1960s, but the decline has since been dramatic. New Zealand participation rates are now average to low. Thus New Zealand's means test-free but generous pension has not been very successful in generating labour force participation among the elderly - although this has not been its objective. That trend is particularly evident in the participation rates of males aged 60 to 64 years which have been as follows (Royal Commission 1988):

1966	72%	
1971	69%	
1976	58%	
1981	47%	
1986	39%	(c.f. Australia 48%, January 1989)

In other words, in the mid-1960s almost three quarters of males aged 60 to 64 years were still actively engaged in the workforce. Today just over a third are so employed. It is questionable whether that is an outcome the elderly want or one that other sections of society can reasonably be expected to pay for.

There are a number of explanations for the trend towards much lower workforce participation rates by the elderly. To the extent that the trend reflects retirement preferences and an

increased ability (because of affluence) to realise those preferences, it can be seen as a desirable advance from the point of view of the elderly. However, the ability to retire early may be the result of retirement income available from the state and funded by working age taxpayers at a level which is generous in relation to the incomes that older people could expect to enjoy from continued employment.

The issue is then whether the economic cost to society (as a result of the increased tax burden) of providing people with the ability to retire at an historically early age can be justified. On equity grounds, it is questionable whether it is fair to tax those who are struggling within limited incomes to raise families in order to enable older, but still physically capable, persons to withdraw completely from the labour force at increasingly early ages.

The 1988 New Zealand Royal Commission also found evidence to suggest that the trend to early retirement may not necessarily reflect the personal preferences of the elderly. In some cases institutional factors may be forcing people into premature retirement. That is likely to relate to rigidities in the labour market which cause wage rates to be set at above the market rate so that available jobs have to be rationed. One rationing method is to regard the qualifying age for age-related benefits to be a form of statutory retirement age. Labour market rigidities also increase the time and cost involved in finding jobs. That is likely to force older workers out of the labour market since they have a shorter future working life and thus a more limited return from the effort involved in finding a job.

Whether early retirement is voluntary or involuntary, it seems reasonable to conclude that a generous national superannuation scheme has had a major impact. The acceleration in the trend towards early retirement by the 60 to 64 year olds between 1976 and 1981 seems to have been at least partly attributable to the more generous benefit entitlements available from 1977. Overseas research on the relative importance of state retirement schemes on elderly labour force participation rates is not conclusive. However, the weight of evidence does seem to suggest that the existence and nature of such schemes is one of the most important factors determining retirement ages (see Pechman et al. 1968). Moreover, state pension schemes can also induce early retirement and asset rundown prior to the statutory pension age.

Clearly it is difficult to give credence to the view that the trend to earlier retirement is the result of declines in health standards or higher health requirements to remain in the workforce. Life expectancy has increased in recent decades and is expected to increase further with higher living standards. The weight of available evidence suggests that in general there is little net decline in a person's labour productivity as a result of aging - at least before age 70-plus. In many cases any reduced physical and mental capacity, together with increased resistance to innovation, is likely to be offset by increased experience and skill which enhances human capital. (For a survey of the literature on this issue, see Clark et al. 1978.)

Paradoxically, at the same time as medical advances and a decline in the proportion of the workforce engaged in physically demanding activity makes a longer working life possible, that working life is becoming shorter. It seems difficult to view this as a trend which the general taxpayer should subsidise or which the government should specifically encourage.

(b) Taxes

Treasury has estimated (Treasury 1987) that (assuming national superannuation were funded entirely from personal income tax), in net terms a personal tax rate of over 8% would be required to pay for it. On the basis of a current average personal tax rate of 23% to 24%, a theoretical reduction of government expenditure equivalent to the cost of national superannuation would enable the government to reduce all personal income tax rates to an average 15% rate. Alternatively, assuming net annual expenditure on national superannuation is $2,700 million, a reduction in expenditure requirements by that amount would enable the government to reduce GST to about one third of its present level (statistical source: 1987 Budget, Annex 3).

The cost of national superannuation can in part be measured in terms of the additional economic wealth which such lower tax rates would generate. All taxes reduce net national wealth. They impose costs on society over and above the costs to each individual taxpayer of tax payments and the costs of calculating and collecting the tax. These hidden but nevertheless real costs are economic efficiency costs. They are a measure of the loss in output and welfare caused by the fact that taxes detrimentally affect decisions on work, investment and savings. Flaws in the tax system increase those costs. But even the best designed tax system incurs substantial costs.

Income taxes reduce incentives to work and save. Taxes on expenditure, such as GST, do not distort savings decisions but they impose disincentives on work which are even higher than income taxes that raise the same amount of revenue. The higher the marginal rate of tax (the tax rate on the last dollar of income or expenditure) the higher the economic costs incurred with respect to the particular taxpayer affected. Conversely, as marginal rates of tax are lowered, the economic costs associated with the tax system decline.

In the past the efficiency costs associated with raising tax revenue have been significantly underestimated. That contributed to the view which was prevalent until the 1970s that a relatively large public sector did not adversely affect economic performance. However, more recent research has altered that assessment. The magnitude of the costs incurred by taxes are now more widely appreciated.

It still remains difficult to quantify the efficiency costs of taxes with any precision. Overseas results produced from economic models (which are of necessity highly simplified models of complex economic interactions) are sensitive to assumptions on the responsiveness of work and savings decisions to taxes, as well as to marginal tax rates arising in individual tax systems. Early estimates of the marginal costs of raising one dollar of public funds in the United States ranged between $1.09 and $1.16 (Browning 1976). Later studies have increased these estimates to between $1.25 and $1.75 (Stuart 1984 and Topham 1984), while an Australian study estimated the marginal cost for that country at $1.65 (Findlay and Jones 1982). Hansson and Stuart (1985) conclude that the social cost of a marginal unit of tax revenue can vary considerably according to the types of taxes, initial tax rates and the expenditure programme they fund. Nevertheless, they find that for Sweden the marginal cost of taxes could easily exceed $3. Moreover, Slemrod and Sorum (1984) estimate that United States individual taxpayer compliance costs were 5-7% of total Federal and State income tax revenue. Although Burtless and Haveman (1987) have argued that some of the new estimates of excess burdens are "overdrawn and highly uncertain", on balance they appear significant enough to be of concern to policy.

Given a net national superannuation cost of about $2,700 million, and assuming New Zealand's marginal cost of public funds over that range is $1.25, that would mean that national superannuation incurs an efficiency cost of some $675 million per annum. That is equivalent to more than the annual sale of a state asset of the size of Postbank and more than the amount spent each year by the government on university education. This is not wealth which is redistributed to superannuitants or anyone else. It represents a potential welfare sacrifice by each and every New Zealander. This income could be available to individual New Zealanders but is instead lost because of the costs incurred in raising the revenue to pay for national superannuation.

While that cost may be considered warranted - a sacrifice we are prepared to make in order to meet social objectives - it is nevertheless a sacrifice which should be subject to rigorous justification.

2.7 The Demographic Issue

As previously noted, the recognition that the fiscal cost of state retirement income programmes would increase considerably in the future if left unchanged, because of the growing proportion of the population reaching qualifying ages, was a major factor leading a number of western countries to reduce the generosity of their programmes from the mid-1970s onwards.

The populations of Europe and North America have been aging from at least the start of the present century but the rate of change has accelerated since the mid-1960s as a result of increasing life expectancies and decreasing fertility. The over-65 year age group had grown from 8.5% of the OECD population in 1950 to 12% in 1980 (OECD 1988a). However, the initial impact on government expenditure was favourable. That was because the increasing proportion of the population out of the workforce because of old age (the "elderly dependent") was offset by a rapid reduction in the proportion of the population which was out of the workforce because of youth (the "young dependent"). As noted, public expenditure on retirement incomes rose markedly in the twenty-five years from 1960 but demography was not a major contributing cause.

However, projections showed that this offset would not continue to apply. The critical issue with respect to dependency ratios is the extent to which dependent groups receive resources which can be produced only by the working age population. In that regard a number of studies have suggested that the elderly require twice the resources of the young (Jones 1984). Thus an increase in the proportion of elderly dependents exactly offset by a reduction in the proportion of young dependents would produce an increased net burden on the working age population. This is seen as the likely scenario between 1980 and the end of the century with the elderly dependency ratio (the ratio of dependent to working age population) rising from 19 to 22 while the youth dependency ratio is projected to decline from 33 to 29. Into the twenty-first century the youth dependency ratio is expected to remain relatively constant while the elderly dependency ratio is expected to climb steadily to 24 in 2010 and more sharply to 34 in 2030 and 35 in 2050 (OECD 1988a).

New Zealand demographic projections show a similar pattern to other OECD countries. Its elderly dependency ratio is expected to climb from 16 in 1980 to 23 in 2010 before reaching 36 in 2030 and then falling slightly to 35 in 2050 (OECD 1988a). The government has estimated

that the result would be a doubling of the fiscal cost of national superannuation by the middle of next century (New Zealand Government 1988). Thus the fiscal burden and the economic costs it generates would rise significantly.

Demographic projections are no more accurate than the mortality, fertility and migration assumptions upon which they are based. Nevertheless, it seems likely that New Zealand will experience a significant increase in the elderly proportion of its population, the impact of which should not be ignored. That point is reinforced by the likely increase in the political pressure for generous state-provided retirement incomes as the electorate ages. As the Brash Committee Report on Superannuation Taxation (1987) noted, the proportion of the electorate which is entitled to national superannuation under existing criteria is expected to increase from a current 22% to 32% by the year 2030 (Consultative Committee on Superannuation and Life Insurance 1988).

Changes in the structure of the population can be expected to have other economic impacts which need to be taken into account. These are likely to include:

- a more mature workforce, with increased skill levels but possibly lower mobility;
- capital deepening associated with slower population growth and resulting higher returns to labour with offsetting lower returns to capital;
- reduced rates of saving as the older population draws on past savings to fund present consumption; and
- changes in expenditure patterns with an increasing demand for services such as health care.

2.8 The Costs of Constant Policy Changes

The likely high future cost of current retirement income policy - if that policy is left unchanged - has resulted in a number of calls for reform. However, retirement income planning is of necessity long-term in nature. Many people begin preparing for their retirement twenty or thirty years out from their desired retirement age. This makes predictability and stability in this area particularly important.

Unfortunately retirement planning in New Zealand has, over recent years, been subject to numerous government policy changes. As noted by the Consultative Committee on Superannuation (Consultative Committee 1988), since the mid-1970s there have been five major changes in the policy framework relevant to superannuation. That amounts to one major change every two to three years.

Since many retirement-related decisions (such as how much of one's working age income should be saved for retirement) are not easily reversed, each policy change imposes costs on people who are forced to adjust to it. For example, less generous public pensions may result in people under-saving for their retirement. A more predictable and stable policy framework should therefore be a central objective of any consideration of this area.

This is not an argument for no policy change. The perceived unsustainability of national superannuation itself undermines the desirable predictability of future policy. On the other hand, these considerations make it important that any policy developed should be economically and socially credible and sustainable. The problem with past policies is that they have not met that criteria. This issue is addressed further in section 5 of this paper.

2.9 Conclusion

Past and current government policies with respect to retirement income have centred on state provision of such an income, paid for out of current taxes. That has been on the basis that the recipients were generally unlikely to have significant other resources, income or capital, on which to draw.

However, that policy response was largely a reaction to past economic and social conditions. The result is already a heavy fiscal cost which is imposing high economic costs. Those costs would increase significantly in the future. Moreover, the conditions which precipitated that response do not apply to the same extent today and are likely to apply even less in the future. In particular, a significant proportion of the elderly population is likely to become relatively affluent and sufficiently active to be able to continue in employment well after the age of 60 years. It does not seem reasonable that younger taxpayers should be required to subsidise those who may be more affluent than themselves.

On the other hand, a proportion of the elderly will be likely to continue to require assistance as is the case with other sections of the population. To achieve that result as efficiently and fairly as possible, the government's policies in this area should be reviewed. That review should not be blinkered by the policies of the past. Objectives should be clearly specified within the context of overall economic and social policies, and the most efficient means of achieving the objective identified.

A lesson from the 1970s, both here and overseas, is that ill-considered reforms may later need to be reversed at the cost of considerable uncertainty. There is currently a widespread belief that national superannuation in its present form is unsustainable. That view has been reinforced by frequent policy changes. A policy response which is, and which is perceived to be, longer term in nature is highly desirable. The only policy response which is likely to be sustainable in the longer term is one which is seen as being logical and consistent with the government's broader economic and social policies, and which is perceived to be fair from an inter-generational viewpoint.

3 POLICY ISSUES WITH RESPECT TO RETIREMENT INCOMES

3.1 Introduction

This section identifies the main policy issues involved in reviewing the government's appropriate response to securing adequate income provision for the elderly. It is argued that this must be considered in the context of the government's overall economic policies. It is those policies which will determine our ability to provide for the future elderly, irrespective of the manner in which that provision is made. Thus, the government's prime responsibility in the retirement income area is to ensure that its overall economic policies are consistent and well-directed.

If that is achieved, there is considerable scope for increasing the extent to which people can become less reliant on government income provision than has been the case in the past. That would result in major benefits to New Zealand society as a whole, New Zealand taxpayers and the elderly. It seems nevertheless unlikely that social objectives would be achieved without a substantial programme which would provide for those who would be unable to provide for themselves.

In determining the nature of such a programme, it is necessary to clearly define its objectives. Past and current policies have been confused as to whether they aim to maintain people's incomes to a level comparable with pre-retirement income levels, or whether the objective is limited to supporting people at a minimum but adequate level of income. The last option is seen as the appropriate role for the government in this area.

3.2 The Government's Prime Responsibility With Respect to Retirement Provision

The government's prime responsibility in this area is not specific to the retired or the elderly. It should be to ensure that general economic and other policies are pursued which advance overall national welfare by being conducive to economic growth, price stability, full employment and an equitable distribution of incomes and wealth. As a result of such policies, everyone benefits from a higher standard of living whether they be elderly, middle-aged or young. A wealthier country would also be in a better position to support (at least in absolute terms) any dependent groups within the population such as the dependent elderly.

Economic growth, and the increased national welfare which results from such growth, are the products of an efficiently operating economy and an environment where effort and initiative are not stifled but are appropriately rewarded. An environment of uncertainty over future government policy increases the risks associated with undertaking wealth-creating activities and thus impacts adversely on national welfare.

The government should therefore ensure that it pursues a set of policies which are understood by the public and which are maintained in a consistent and predictable manner. For the same reasons, price stability should remain a prime objective of the government's economic policies. The efficiency of the economy can be enhanced by removing barriers to competition in capital, labour and product markets, and by reducing the role of government-backed enterprises which do not face normal market disciplines and incentives.

Policies which advance overall national welfare have a particular relevance for the elderly and those saving for their retirement. Past government policies have impacted particularly harshly on this group by considerably reducing their ability to provide for themselves in their old age. Specifically:

- high tax rates, and especially high income tax rates, have reduced the ability and incentives for people to save for their old age;

- inflation, especially unanticipated inflation, has resulted in income being redistributed from savers to borrowers, reducing the effective accumulated savings of those near retirement. Fear of future inflation has made it difficult for individuals to adequately plan for their retirement and has hindered the ability of private sector institutions to provide the services people want - e.g. an annuity which has a reasonably certain purchasing power;

- high and unpredictable inflation combined with high marginal income tax rates have combined in a particularly adverse way for savers. Labour income is effectively a real return since human capital values are not eroded by inflation. Capital income, on the other hand, is often a nominal return since a return in the form of interest includes an element to compensate for inflation. Thus, high marginal income tax rates have been imposed on the inflation-compensation element of returns on savings;

- restrictions imposed by the government on returns from capital income have severely hit the retired and those saving for retirement. For example, those saving for retirement at times when the government has imposed artifical controls on interest rates have been effectively forced to subsidise younger borrowers. Similarly, those saving through superannuation schemes or life offices which were forced to hold certain levels of government stock subsidised the general taxpayer;

- labour market laws and practices have forced people out of the workforce before they would otherwise have wished to leave. This has hindered one of the avenues open to people to provide for themselves in their old age - continued work, perhaps on a part-time basis. As discussed in the previous section, rigidity in the labour market is one possible explanation for the perverse situation where elderly labour participation rates are falling, the potential working lifespan of people is increasing, and some elderly are expressing dissatisfaction that they are prematurely being retired and unable to continue in the labour force. Moreover, government policies which have increased the cost of labour have forced the labour market to adjust by leaving many people unemployed. Those who are thereby made unemployed have usually not been in a position to provide for contingencies such as their old age;

- government policies (including policies specifically relating to superannuation and retirement provision) have been inconsistent, changeable and lacking in long-term credibility.

Thus, the most important set of policies which would enable people to provide for their old age would comprise policies which ensured zero (or at least low) inflation, higher rates of economic growth, low tax rates (especially on income), returns on capital income which are not artificially constrained, and flexible labour markets. These are the same policies which promote general economic welfare. In the longer run, the interests of those saving for their

retirement, the elderly and the rest of the population are all therefore best promoted by the same set of policies. (Many currently retired people, of course, have little alternative but to continue to rely on government support.)

What is remarkable is that governments have not pursued such policies in the past. For the sake of short-term objectives, economic growth has been depressed, inflation has been allowed to reach high and variable levels, returns on capital income in past years were often artificially low, the flexibility of the labour market has been constrained and income tax rates have been set at confiscatory levels. The difficulties thereby imposed on private retirement provision have increased the need for the government itself to compensate this group by way of state-provided retirement income support.

A useful adjunct to the major economic policies listed would be an expanded immigration programme. The acceptance of a larger number of immigrants with skills, capital, ideas and a strong work ethic would help foster entrepreneurship and innovation and assist the transformation to a more outward-looking economy. By increasing the proportion of the working age population to the elderly dependent, it would also ease the demographic problem for a period of time (although it would not provide a long-term solution).

The adoption of a more reasonable and rational set of economic policies would put people in a much better position to provide for their old age. Moreover, higher economic wealth would make it easier for the government to offer support for those who, for various reasons, may have no alternative means of support available.

The high fiscal cost of national superannuation as it is presently structured, and particularly the projected future fiscal costs, would make the achievement of a desirable set of economic policies difficult. In particular, the fiscal pressure which governments would be under would require stringent economies elsewhere if tax rates were to be kept to tolerable levels. Thus, constraining the cost of national superannuation would be an important foundation for achieving the economic policies which would enable people to obtain a high standard of living in their old age.

To be compatible with overall economic policies which are conducive to economic growth, any retirement income programme should, as far as possible, minimise fiscal costs as well as disincentives to save and work. That would open a possibility of entering a virtuous circle. Constraining fiscal costs and allowing taxes to fall would provide people with a greater ability to provide for their own retirement. This would in turn reduce the pressure on the retirement income programme which would then allow fiscal costs to be constrained further. On the other hand, failure to adopt this strategy could produce the opposite result of increasing reliance on taxpayer assistance.

The need to ensure that the former result is achieved is made critical by the demographic trends discussed in the preceding section. An increased elderly population can continue to be supported at current income levels only by:

a severely constraining current consumption and investing overseas so as to be able to draw upon overseas resources in future years; and/or

b severely constraining the consumption of the working age population in future; and/or

c significantly increasing future domestic productivity and therefore output.

The first option would seem to be extremely difficult to achieve in the light of New Zealand's past economic history. The second would be clearly undesirable. It could also require the future working age population to sustain a significant drop in their living standards so as to provide the growing numbers of elderly with a reasonable standard of living. That may prove difficult to sustain politically as the future working age population may refuse to accept such an outcome. That is often overlooked by those who see institutional solutions (whether by way of promises of future state benefits or the establishment of specific superannuation funds) as a method of guaranteeing future benefit levels for the elderly. Without a significant increase in future output, such responses are likely to be unsustainable. Under such a scenario the expectations of the future elderly are likely to be unfulfilled.

The one and only option which appears to be socially desirable, likely to be sustainable, provide a reasonable degree of long-term security and thus make it possible to meet the expectations of the future elderly is the last of the three listed options - a policy framework which provides for the achievement of sustainable economic growth. That in turn must involve a stable environment for retirement income planning.

Other economic consequences of the projected demographic change are also likely to be important. For example, if the labour force becomes less mobile as it matures, the costs of existing labour market rigidities would be likely to increase, thereby damaging the prospects for the economic growth necessary to sustain a larger elderly population. As another example, the economy must retain the flexibility to react appropriately to changes in overseas consumer demands as the populations of our major trading partners age. In addition, changes in expenditure patterns towards greater consumption of service goods such as health care make it critical for our future economic performance that those goods are supplied efficiently and effectively.

3.3 Policies Targeted at Increasing Savings

Since sustainable economic growth (and a higher level of future economic output) is the prerequisite for any stable and viable means of providing for the future elderly, it may be argued that specific policies are necessary in order to promote such growth. In particular, policies specifically aimed at increasing the rate or level of savings have sometimes been seen as desirable.

It is necessary to recognise that a pool of monetary savings cannot itself enable society, in aggregate, to provide for the elderly who are no longer actively engaged in the productive process. Money is a convenient unit of account, but it can never be more than a claim upon the total available social resources. To provide for the future elderly, the focus must be on increasing future available resources, not on increasing future monetary funds. As one economist has put it: "Pensioners do not eat pound note 'butties' - they use the pound notes to purchase consumption, and it is the consumption that matters" (Barr 1979 at page 35). Consumption in turn can only be provided out of available social resources.

Nevertheless, future available resources may be increased by forgoing current consumption (i.e. by saving) and increasing investment so as to increase future potential productive capacity. By such a process of capital deepening it can be expected that more output can be achieved for any future labour force of a particular size. That increased level of future output could then be transferred to tomorrow's elderly.

However, the relationship between capital formation and future output is not automatic. High investment may give rise to a potential for higher future output, but that potential will not be realised if investment is poorly directed. Many centrally planned economies (China, the Soviet Union, Eastern Europe) have had relatively high savings rates, yet their economic performance compared with countries at comparable stages of development has been dismal. Conversely, successful countries like the United States and South Korea have had relatively low savings rates.

New Zealand savings rates have tended to be around if not above the OECD average, as the following tables show:

NET SAVING AS A PERCENTAGE OF GDP

	1960-86	1980-86
New Zealand	13.2	12.7
OECD average	11.4	8.2
US	7.7	3.9
Japan	20.6	17.5
United Kingdom	8.5	6.1
Germany	14.1	9.1
Australia	9.1	3.7
Sweden	11.1	5.2

Source: OECD 1988b

GROSS SAVING AS A PERCENTAGE OF GDP (1985)

New Zealand	21.9
OECD average	20.2
US	16.5
Japan	31.4
United Kingdom	19.2
Germany	22.2
Australia	20.1
Sweden	17.8

Source: OECD 1986

New Zealand's relatively poor economic performance over a period in which we maintained relatively high savings rates can be attributed, at least in part, to poor investment and poor

utilisation of resources. That in turn can be attributed to government policies which have not been conducive to economic growth.

The message is that if we are to achieve the higher future output required to support the future elderly, it is not savings policies as such which we require but policies which will assist in establishing an environment supportive of maximising our economic potential. In other words, sound economic policies along the lines previously outlined.

Specific policies aimed at enforcing savings through particular institutions or investment activities, or specific incentives to achieve the same effect, would be inconsistent with the required general economic policies and would thus be counter-productive. Programmes which attempt to force individuals to maintain a certain savings rate are not necessarily effective. The forced savings, if different from the level, pattern and form of voluntary savings, are likely to be offset, at least to some extent, by a reduction in discretionary savings or by discretionary dissaving.

To the extent that such programmes are effective, they will distort individual savings decisions. The desired level of individual savings is likely to vary considerably between individuals. Some individuals will wish to maintain a high level of consumption in retirement. Others will have lower retirement requirements. Those differences will be reflected in savings decisions. Similarly, intra-family transfers are likely to vary considerably, affecting savings requirements. In some cases, younger family members will support older non-working members (reducing savings requirements) while in other cases older members will bequest resources to younger members (increasing savings requirements). Choices made here will depend upon a number of factors including wealth levels and cultural preferences.

Even if individuals have a uniform desired level of savings, their rate of savings in any particular year is likely to vary considerably. That is because people in general have different consumption requirements and varying access to income at different stages of their lives. Savings behaviour tends to be tailored to those factors. Under the generally accepted life-cycle savings model, for which there is considerable empirical evidence (see EPAC 1988), savings are low for younger age groups (during pre-employment and family establishment periods), reach a peak in later middle age, and fall during retirement as savings are drawn upon as a substitute for lost labour income. Thus, the rate of a person's savings can be expected to vary significantly over his or her lifetime.

Finally, the form in which people voluntarily undertake savings will vary considerably. Savings can take a variety of forms including human capital formation, the accumulation of financial assets, home ownership, and the acquistion or expansion of farms and businesses. The type of financial assets acquired can also vary considerably as to risk and liquidity. The actual form of an individual's savings at any particular time will be dependent on a multitude of factors including his or her attitude towards risk. If it is desired to introduce policies which encourage or enforce savings without distorting the form in which those savings are held, such policies would need to take into account all types of savings.

Any successful attempt by the government to impose on individuals a requirement to maintain any set level of savings and to require those savings in a set form would disrupt these complex decisions as to the level, pattern and form of savings. As a result, savings decisions would be

distorted with high economic costs being thereby incurred. Moreover, to the extent that the form of those savings is set by government fiat, a sub-optimal result is likely. For example, a person may be forced by government policy to invest in financial assets when that person, and society in general, would receive a higher return by investing in a business or in further education. That would lower overall wealth.

If instead of relying on compulsory savings schemes the government were to rely on providing incentives to save at a particular level, in a particular manner and in a certain form, the results would be similar. The non-compulsory nature of such a scheme would recognise the complex nature of savings decisions and give greater latitude to personal decision making. On the other hand, the incentives to operate such a scheme would of necessity involve a fiscal cost. That fiscal cost would need to be funded out of tax revenue which, as previously argued, involves a high economic cost.

The conclusion is that savings decisions are, in general, best left to the judgement of individuals. Individuals have incentives which governments do not to make sound decisions. In addition, unlike governments, they can fine-tune their decisions to their specific circumstances. It is true that in making such savings decisions people will sometimes make mistakes. The costs of such mistakes will largely be limited to, and directly affect the individual concerned. Governments also make mistakes. The costs of such mistakes are typically larger and are borne by everyone. Moreover, individuals are normally better placed to identify and correct their mistakes more rapidly than is the government.

The government should therefore generally restrict its role to limiting the extent to which its actions distort savings decisions and create disincentives to saving. In that regard, as previously noted, high income tax rates, especially in inflationary periods, have discriminated against savings. All efforts should be made to keep income tax rates low and to constrain inflation to negligible levels. Consideration could also be given to moving more of the taxation burden towards GST and away from income tax. In addition, any policy specifically targeted at the provision of retirement income should, as far as feasible when other considerations are taken into account, minimise the extent to which people are discouraged from saving.

Should the government desire to further increase the rate of domestic savings, it is likely that that could most efficiently be achieved by constraining its current expenditure and running a real fiscal surplus. That may, for instance, be appropriate when the level of national debt is running at what is considered to be an unsustainable level. Poorly justified government expenditure programmes and associated taxation and borrowing requirements have crowded out household savings which could have been allocated to higher quality uses. Improved fiscal policy could make a significant contribution to national returns on savings and investment. Such a broad approach to saving avoids the need to excessively interfere in individual decisions as to the appropriate form and pattern of savings. It may be particularly important for governments to keep under control those items of their expenditure which are substitutes for savings to some extent - such as social security payments.

3.4 A Move to Greater Reliance on Private Retirement Provision

If the government does not maintain general economic policies which are conducive to economic growth, it is condemning the retired of the future to a lower standard of living than would otherwise be possible. That is the case irrespective of the extent to which, and the

form in which, it also offers policies specifically aimed at providing the elderly with the means of obtaining a reasonable standard of living.

If appropriate economic policies were adopted and maintained, greater reliance than in the recent past could be placed on private retirement provision. With efficient capital markets unconstrained by inappropriate government interventions, negligible levels of inflation and realistic tax rates, it would be much easier for people to save for their own retirement. Such savings, in an economy with efficient product markets and with capital and other resources being allocated to their most productive use, would in turn help the economy to expand so as to meet the demands of the future. An efficiently operating labour market would reduce the risk of unemployment and the resulting inability to save, as well as providing the elderly with the alternative of continued employment, perhaps on a part-time basis, up to an older age than at present. The increased participation rate of women in the workforce is also a factor which is conducive to a higher level of self-provision than was feasible for many women in the past.

By placing greater reliance on private provision of retirement income, the cost of any public provision would be lower. That in turn would reduce the need to raise taxation revenue, reducing disincentives to save and work. These desirable incentive effects would be reinforced if benefits were allowed to decline in relation to earnings as real income growth takes place.

Such an approach would recognise that past levels of public retirement income provision were designed for a period in which the ability of most people to provide for themselves was much more constrained than it should be in the future. There is always likely to be a need for state support for those who, for a variety of reasons, are unable to support themselves. However, provided the economic environment is right, the argument that private provision is not a viable option for the vast majority of the population because their lifetime income is insufficient, and that they must therefore be dependent on the next generation, will become even less tenable.

In that regard it should be recognised that programmes to provide incomes through the mechanism of the state are means of transferring income, not of creating it. The key question is: What is the more efficient means of effecting an inter-generational transfer of income from younger to older members of society? The private mechanism largely relies on accumulated voluntary savings, continued workforce participation and intra-family arrangements. The state mechanism tends to rely on enforced taxation imposts with their associated high economic costs. Prima facie, it seems clear that primary reliance should, as far as possible and as far as equity considerations allow, be on the private option.

Against that view, it is often argued that individuals are not in fact in a position, or at least are not in as good a position as the government, to make arrangements for their old age. That is contrary to the generally accepted view that individuals are normally better placed than the government to make decisions with respect to other arrangements such as what goods to buy and to produce.

If the government were to reduce its involvement in this area, private provision would assume a much larger role than it has in the past. In other words, a reduced role for the government does not imply a lower standard of living for the elderly. Even under existing arrangements involving considerable reliance on government provision of retirement incomes, which is

likely to have crowded out private provision to some extent, private retirement provision is nevertheless significant. This can be seen in the considerable assets held in superannuation schemes (over $12 billion as at March 1988) and in life insurance policies. Such levels of savings cannot be attributed primarily to concessional tax arrangements.

Furthermore, people are currently making a number of other savings decisions which are long-term in nature and which, to a greater or lesser extent, have as an objective the spreading of income from high to lower income earning years. The most obvious example is housing. It is common for people to purchase a house and begin paying off the mortgage almost immediately. The aim is a mortgage-free house on retirement, an objective often pursued from a relatively early age. Another example of such income-spreading is medical insurance. This has grown as an industry because people are concerned to ensure that they are not totally reliant on what is perceived to be a level of public provision which does not meet all their personal requirements.

If private provision for retirement is common under a system with generous public retirement income provision, less generous provision can be expected to result in a significant increase in the extent to which people will save or otherwise provide for their old age. This was, after all, how middle income people provided for their retirement before state pension schemes grew to their present levels and undermined an ethic of private responsibility.

A number of grounds for questioning the ability of individuals to make reasonable decisions with respect to their old age provision have been advanced.

First, it has been argued that private capital markets limit private savings by failing to provide the scope for small investors to hold a sufficiently diversified range of assets (Nektarios 1984). However, a number of financial institutions and instruments (such as pooled investment funds) are in fact available to do just that. There is no evidence to suggest that economies of scale are such that the government would be more efficient at handling investment funds.

Secondly, it has been argued that unanticipated inflation can inhibit the ability of people to save for old age with any degree of certainty (Hemming 1979). Individuals can take a number of steps to hedge against such an event. Perhaps the most common is home ownership. Nevertheless, this is an issue of concern and, as previously argued, the maintenance of sound economic policies (including avoidance of inflation) is a prerequisite for any policy geared to the needs of the future elderly. If the need were demonstrated, the government could consider issuing inflation-indexed bonds, thereby assuming the risk of any unanticipated inflation which its policies may induce.

A third argument which has been advanced for public provision is that insurance markets are unable to provide appropriate insurance against events such as an unanticipated shortening of one's working life - which increases retirement income requirements while reducing one's ability to save for retirement. The argument is that individuals have a better knowledge of the risk of such an event happening to them than insurers, thus making insurance contracts non-viable (Diamond 1977). However, such problems are common to all forms of insurance. Well-developed mechanisms are available to limit the problem, as is evident in the area of health insurance. In any case there is little reason to believe that the government is any better at handling such problems than are private insurers.

Fourthly, Samuelson (1958) has suggested that governments may be able to produce a better retirement income scheme than private organisations because they can, through the taxation system, ensure that the elderly share in any overall growth in national income. However, the elderly should be able to benefit from such growth if capital markets are operating efficiently and if inflation and taxation rates on capital income are minimised. Again, the prerequisite for greater reliance on private retirement provision (or any alternative to it) is the maintenance of sound economic policies.

Finally, it is often argued that individuals, if left to themselves, are likely to under-provide for their old age. This may be because of a lack of information of what adequate provision entails. However, there is a considerable industry which derives its income from educating people on such matters. Retirement is not an unexpected event which people cannot reasonably anticipate. Indeed, far more than, say, accident or sickness, it is an event which most people can anticipate relatively accurately many years before it occurs. For that reason there is an established history of private provision. If information were indeed the problem, the preferable government response would be to produce and disseminate appropriate information.

A contrary argument is that, irrespective of the information available to them, people are myopic and make irrational decisions particularly with respect to long-term matters such as future old age. This may be true. People will not necessarily make the best possible decisions in this or any other area. However, the real issue is whether the government is likely to make better decisions. To the extent that the government reflects the views of the general electorate, it is difficult to see why people are likely to be less myopic in their voting decisions than they are said to be in their retirement saving behaviour. Governments generally do not have the same incentives as individuals to try to make the right decisions, and may often make worse ones.

The conclusion is that the case for the government taking the leading role in the provision of retirement income provision is no stronger than the case for the government taking the leading role in the provision of most other goods or services. In assuming that role the government is unable to tailor provision to the requirements of particular individuals (for example, the person who prefers a lower level of savings but a longer working life) and it generates high costs in doing so which inhibit economic performance.

3.5 Specific Government Policies to Provide Incomes for the Elderly

Even if greater reliance were to be placed on private retirement provision, there would still be a continuing requirement for a programme providing some form of state provision of retirement income. The alternative would be to accept the likelihood of a degree of elderly destitution, an outcome which New Zealanders are unlikely to find acceptable. The issue is what the objective of such a programme should be.

In a previous paper on unemployment benefit policy (New Zealand Business Roundtable 1988), a distinction was drawn between government policies which aimed to provide income support (the provision of a minimum income when out of the workforce) and income maintenance (the provision of income when out of the workforce which is commensurate with income when in

employment). That is a useful distinction for defining the objectives of the government's retirement income programme.

While the case for maintaining an equitable distribution of incomes and wealth, and for preventing people from falling into poverty, often leads governments to intervene to provide individuals with income support, governments generally do not assume responsibility for maintaining a person's past income level. The general rule is that governments accept a responsibility for providing income support but leave any income maintenance up to individuals and the private sector to arrange, for example by taking out insurance.

There is no strong case for rebutting this general rule with respect to retirement provision. Primary reliance should be on private provision with the government assuming a role as a provider of income support for the elderly who have insufficient private resources, that support being aimed at a level which would prevent such people from falling into poverty.

3.6 Conclusion

As emphasised in this section, the government's prime responsibility with respect to retirement income provision is to ensure that the economic setting is such that people can realistically and reasonably plan and provide for their own retirement. Primary reliance can then be placed on private retirement provision with the expectation that that provision will vary between individuals as to its level and form. The government will need to maintain a programme of income support for the elderly so as to ensure a minimum adequate standard of living for such people. The programme would have as its objective the prevention of old age poverty. It should not attempt to ensure the maintenance of an income level commensurate with pre-retirement incomes. Should the government assume a lesser role, there is ample evidence to suggest that people will react by increasing the extent to which they provide for their own retirement.

4 THE FORM OF INCOME SUPPORT

4.1 Introduction

This section considers the issues that arise in designing an income support programme. It is considered that the key criteria for such a programme are that it should be consistent with:

- the poverty alleviation objectives of income support;
- the set of economic policies which are required to enable New Zealand to have a level of output which would support our future elderly population; and
- primary reliance for retirement income being on private provision.

Where these criteria are in conflict, some trade-offs will be required.

The conclusion is that the programme should be aligned more closely to other income support benefits. That suggests a tightly targeted benefit available at a much later age than is currently the case for national superannuation. There would also appear to be a justification for reducing, over time, the level of benefit below that which currently applies under national superannuation.

In December 1988, the Minister of Social Welfare released a discussion document with five options for the future of government-provided retirement income support (Department of Social Welfare 1988). The option preferred in this paper most closely corresponds with Scheme I of that discussion document. The other options in that document are considered and the reasons why they do not meet the criteria set out in this paper are outlined.

4.2 Criteria for an Income Support Programme

An income support programme should aim to provide an adequate but modest level of benefit to recipients. The benefit should be adequate so as to meet the objective of preventing those elderly who have minimal alternative means of support from falling into unacceptable poverty. On the other hand, as an income support programme it should be based upon the premise that most people will, given time, be able to provide for their own old age. Thus the programme should not be designed to replace other forms of market income. It should be sufficiently modest as to not be a substitute for private provision, and should therefore ideally be set at a level below that which most people would provide for themselves.

Since the purchase of state retirement income support is to provide a floor for those who have inadequate provision, in line with its poverty alleviation objective, it should not act as a supplement to private provision any more than it should be a substitute. That suggests that the benefit should be tightly targeted.

The second key criterion for the programme is that it should be consistent with achieving the higher economic output which will be required in the future to maintain and improve

standards of living. That requires the programme to be supportive of the type of economic policies advocated in this paper.

One requirement here is to constrain the fiscal and therefore the economic costs associated with the programme. That would be achieved by keeping the level of benefit modest, the age of eligibility high and the benefit tightly targeted. Raising the age of eligibility would also reduce the extent to which existing benefits appear to have encouraged people to retire at a much earlier age than was prevalent some years ago. That would be consistent with achieving adequate economic output in the face of the demographic trends previously outlined.

A targeted benefit, on the other hand, would be likely to result in high marginal tax rates on those who fall within the range in which the benefit is abated or reduced. That would be likely to act as a disincentive for the elderly to work and save. Such disincentives conflict with the incentive structure which broader economic policies should aim to achieve.

This is an inherent conflict in any welfare programme. Targeting is desirable in order to constrain costs and the economic damage caused by the high tax rates required to finance those costs. On the other hand targeting itself is not costless. In general, however, the costs of targeting have been found to be less than the costs of an unconstrained expenditure programme. The economic costs associated with targeting can be minimised by reducing the government's overall expenditure commitments (and thus revenue requirements), by restricting the generosity of benefits, by imposing benefit criteria (such as a high eligibility age), and by abating benefits across a relatively narrow range of income and/or wealth.

4.3 The Level of Benefit

The criterion here is a benefit which is adequate enough to relieve poverty but modest enough not to be a substitute for private provision. In that regard there appears to be considerable room to reduce, over time, the current level of benefits as provided under the national superannuation scheme. The current net rate of national superannuation for a married couple is running at just under 75% of the net average ordinary time wage. By comparison, the comparable sickness/invalids benefit is running at some 70% of the net average ordinary time wage, and the unemployment benefit at under 60% of that wage.

On the basis that the unemployment benefit rate does meet some minimum level of adequacy (indeed our unemployment benefit rates are relatively generous when compared, for instance, to Australia) there would seem to be room to lower our retirement income support rate to such a level. The unemployment rate would also be a rate closer, relative to wages, to the level of old age benefit applying until the 1970s. A move to reduce the level of benefits along these lines would produce a significant reduction in the fiscal costs of the programme. This would be in line with the government's recent benefit reform proposals which involve a reduction in the relative generosity of national superannuation and a compression in the differentials between different benefits.

The actual level of the benefit would need to be determined in accordance with more information on the consumption requirements of the elderly - which should be the subject of a greater statistical research effort - and in the light of other subsidised services provided to them such as health care. Because the health status and requirements of elderly people vary

considerably, however, the direct provision of health services, or targeted provision of the means to finance them, rather than general income support, appears to be the most efficient and equitable response, as the report of the Officials' Committee on Income Security for the Elderly (New Zealand Government 1988, p18) points out.

4.4 The Age of Eligibility

The current age of eligibility of national superannuation (60 years) is relatively low when compared with the practice in comparable countries. For males, eligibility ages tend to be between 65 years and 67 years, and there are proposals to increase eligibility ages in the United States and Japan. The Australian age pension is paid to men at 65 and women at 60. The Royal Commission on Social Policy suggested that a universal element in pension arrangements should not be introduced until age 68.

A rise in the eligibility age would:

- be consistent with the increase in potential working life discussed in section 2;
- reduce incentives to early retirement, thus reducing the pressure from demographic trends;
- result in significant fiscal savings. The Officials Committee on Income Security for the Elderly (New Zealand Government 1988) estimated that an increase in the eligibility age to 65 would reduce the fiscal cost of retirement benefits by between 15% and 18%; and
- reduce the extent to which the programme remained a substitute for private provision and thereby also reduce the disincentive effects from targeting the benefit.

An increase in the eligibility age would appear to be the most critical move in any redesign of public retirement income provision. Other ordinary benefits, such as sickness or unemployment, would be available below the age of eligibility for those who qualify. It is suggested that the age of eligibility be one at which, for those who meet targeting criteria, qualification for those other benefits could normally be assumed. This would suggest an eligibility age of around 70 years. An increase in eligibility age could be phased in over a number of years (e.g. by increasing this age by one year every two years).

4.5 Targeting the Benefit

The existing national superannuation scheme is very loosely targeted. Closer targeting would reduce the extent to which the scheme became a supplement for private provision. It would be a corollary of the view that primary reliance for retirement income should be on private provision that the benefit should be payable only to those who most need it.

It could also effect significant fiscal savings. For example, the Officials Committee on Income Security for the Elderly (New Zealand Government 1988) estimated that income testing without a threshold could reduce the cost of national superannuation by about 8% at a 20% abatement rate and by over 25% at a 70% abatement rate.

Since the 1960s, New Zealand benefits have tended to be targeted almost exclusively on the basis of income. However, if the primary purpose of targeting is to limit qualifying beneficiaries to those who are in most need of assistance, it seems dubious to argue, especially in the case of retirement income support, that income is the sole appropriate parameter to target. Instead the better measure of people's need is their ability to consume.

Consumption can be financed out of accumulated wealth. In the case of the elderly, that is likely to be the common case because, under the life-cycle savings model, people will have accumulated savings during their working career which can then be run down to finance consumption in retirement.

The most obvious example of this is housing, in which the elderly have, in general, a high investment. Ownership of a house which is fully or substantially equity-financed provides considerable income in the form of imputed rent. If that effective income is not included within the targeted base, benefits will not be targeted to those most in need. As a result, the provision of an adequate benefit level for those without such an asset requires the provision of very generous benefits to those who do.

Moreover, non-inclusion of assets or wealth in the targeted base results in avoidance of the targeting rules and distortions in investment behaviour. Assets are held in forms which produce high imputed income but low or no measured income. Housing is again the clearest example. Income can also be sheltered from the targeting procedures by holding income-earning assets in separate entities such as trusts, life offices and companies.

It was for such reasons that the Consultative Committee on Superannuation and Life Insurance (Consultative Committee 1988) recommended that consideration be given to targeting public retirement income provision on the basis of assets. An assets test integrated with an income test so as to more correctly measure ability to consume may pose some administrative problems. For example, some forms of assets are notoriously difficult to value. Nevertheless, assets tests are successfully operated in some overseas countries. The introduction of an asset test in Australia has significantly reduced expenditure (the percentage of the relevant age group not receiving the age pension has increased from 17 percent to 22 percent). A feature of the Australian scheme is that, against the recommendations of the Gruen Committee, the family home is excluded from the test. This seems dubious on equity grounds, and must also contribute to an inefficient use of the housing stock. The assets test has gained a reasonable measure of political acceptance, with the Federal Opposition having dropped an earlier commitment to abolish it.

The economic cost of targeting is the high effective marginal tax rates which result over the abatement range. It is sometimes argued that targeting would have limited economic costs in the case of the elderly because they are outside the workforce and as such do not face disincentives to work. However, this overlooks their ability to continue working into old age, at least on a part-time basis. Moreover, targeting acts as a disincentive to those in pre-retirement years who are saving for their retirement and who would be likely to derive retirement capital income within the abatement range.

In general, it has been seen as most efficient to abate benefits out relatively quickly over a relatively narrow abatement range. That is because high effective marginal tax rates are

then limited to those within that range. This group normally has a prospect of moving outside the range within a reasonable time-frame. Given the existing structure of national superannuation and the income profile of the existing elderly, that could be difficult to achieve - income appears to be relatively small and narrowly spread. Inclusion of assets in the target base may help in that regard.

More generally, the less generous the benefit levels and the higher the age of eligibility, the lower the concerns which result from targeting. For example, if the eligibility age were 70 years, a targeted benefit would have a less severe impact on incentives to work.

One form of targeting which is sometimes suggested is to restrict benefits to those who are no longer in the workforce. However, that approach seems unacceptable from both economic efficiency and equity viewpoints. It would discourage workforce participation and result in benefits being received by wealthy capital income earners but not by poorer labour income earners.

Targeting is sometimes seen as being demeaning for recipients. People do not wish to be seen as the beneficiaries of charity which "means testing" is associated with. However, the government provides numerous forms of assistance to various groups in the community. Such assistance is normally targeted to those most in need. If assistance were not so targeted it would be fiscally unsustainable and help could not be provided to those who need it. Income support for the elderly should be viewed along these lines with targeting being a means of more adequately providing for those who require support.

A second objection to targeting sometimes raised is that the elderly are said to have paid for their support by way of taxes. As noted by the Consultative Committee on Superannuation (Consultative Committee 1988) the view that people are entitled to national superannuation is "totally erroneous". Past taxes have never been sufficient to fund the level of benefits that the scheme purports to offer the future elderly.

4.6 Alternative Retirement Programmes

Four retirement income provision programmes were outlined in the Department of Social Welfare's discussion document of December 1988 (Department of Social Welfare 1988) as alternatives to a targeted programme. Two involve schemes which are along traditional income transfer lines (with no linkage between benefits available to individuals and the amount contributed to the scheme by way of taxes) and are partly or fully universal and thus partly or fully non-targeted. Such schemes would not meet the criteria outlined in this paper to the same extent as the programme previously outlined. That is because of the higher fiscal and therefore efficiency cost associated with reduced targeting.

The other two schemes advanced operate on general insurance principles. By this it is meant that a linkage is established between an individual's contributions to the scheme and the benefits which will be available to that individual under the scheme. The general insurance scheme alternatives which are suggested differ as to the method of their funding. The "social insurance" scheme is funded on a PAYG basis, and the "compulsory funded scheme" is fully funded.

This raises the issue of whether one method of funding a scheme is to be preferred over another - whether it is better to operate a scheme on a PAYG or on a fully funded basis. Private superannuation schemes in most, but not all, western countries are generally operated on a fully funded basis. It is therefore often argued that any state scheme should be financed in the same way. However, private superannuation schemes have tended to be fully funded for two reasons:

a they have received taxation concessions which make full funding advantageous; and

b fully funded schemes tend to offer beneficiaries greater security that the retirement benefits will be forthcoming. For example, future retirees are not then left as unsecured creditors of an insolvent employing company. Where private schemes operate on a PAYG basis, as is often the case in West Germany, future benefits are normally insured.

Neither potential taxation concessions nor greater security against bankruptcy of an employer sponsoring company are relevant considerations where the scheme is provided by the government. Probably for that reason, government retirement insurance schemes in the western world have generally operated on a PAYG basis. That has been seen as offering greater flexibility with respect to benefit levels than is the case with fully funded schemes.

Nevertheless, there has been some pressure for a move to operating government schemes on a funded basis. The benefits seen from such a move are that:

a it could increase the level of domestic savings by creating a pool of what are effectively compulsory savings. Martin Feldstein is a leading advocate of this argument (Feldstein 1974);

b it would impose greater fiscal discipline on governments by forcing them to recognise the present value of benefit increases at the time any such increase is promised.

The savings argument is not particularly persuasive. Retirement income policies should attempt to minimise any distortionary effects on savings but there is little reason to suggest that such policies should have the inducement of any particular savings behaviour as an objective. If the government does wish to make a change of savings behaviour a policy objective, it should advance that policy outside the context of approaches to retirement income. For example, it should make a general policy decision to reduce its budgetary deficit or increase its surplus. It is not clear that increasing what are effectively taxes in order to fund a retirement income programme would necessarily lead to the optimal budgetary position.

Moreover, the economic evidence is inconclusive on whether moving to a fully funded retirement income programme would increase domestic savings. The impact on overall domestic savings would be determined by the extent to which the change in financing method was offset by other changes in the behaviour of governments and individuals (Danziger et al. 1981). For example, the government could operate a retirement income programme on a fully funded basis by issuing a retirement income fund with an appropriate level of government debt instruments. In such cases, there is no economic distinction between PAYG and fully funded schemes.

The second argument is also not a strong one. The fiscal restraint which a fully funded scheme imposes on a government can be replicated under a PAYG scheme by accounting for government expenditure on a basis which more closely approximates normal accrual accounting methods.

This leaves the argument for fully funded financing somewhat dubious. Moreover, there is a significant potential problem associated with the fully funded approach. By definition, full funding requires the accumulation of a substantial pool of savings for investment. If that investment were to be subject to government direction, it would not necessarily be directed to areas producing the highest possible social rate of return. It would also give rise to fears about the nationalisation of industry.

If the savings pool were to be managed by the private sector there would be substantial problems in ensuring that the investments were not, implicitly or explicitly, guaranteed by the government. Even without such a guarantee, a government would be likely to find it difficult not to regulate the types of investment which private sector fund managers could undertake. There would therefore be the danger that full funding would lead to investment distortions which would in turn reduce New Zealand's overall economic performance. An economy operating at a less than optimal level would undermine the prospects of providing adequately for the future elderly.

It is concluded that there is no overwhelming case for preferring fully funded financing methods over PAYG methods with respect to retirement income policies (or any other income transfer programme). It would nevertheless be desirable to account for retirement income programmes on an accruals basis so as to impose greater fiscal discipline on governments. Government expenditure on retirement income programmes would then be measured in terms of the present value cost of providing future benefits. A fiscal balance measured in this way would indicate more precisely whether or not the government was maintaining the level of savings which would otherwise prevail.

However, this approach does not require particular taxes to fund measured retirement income expenditure. Indeed, the experience of the United States suggests that it would be preferable to include the accrued costs of retirement income programmes in normal government accounts. In the United States, the social welfare programme is essentially costed on an accruals basis, requiring more revenue to be raised by way of taxes than is required to fund current payments. However, the resulting "surplus" is usually used to reduce the measured overall federal fiscal deficit position. In that way some of the potential advantages of moving to accrual measurement do not materialise.

The more important issue is not how a social insurance-type scheme should be financed, but whether that is a more appropriate form of government policy than the more traditional type of income transfer programme advocated in this paper. This is particularly important since the Minister of Social Welfare has indicated that he favours a move to a social insurance approach.

The apparent reason for favouring this option is that it is seen as a method of avoiding, or at least mitigating, "free-rider" problems. A "free-rider" problem is seen as occurring where a person does not save for his or her own retirement but instead relies upon state provision.

The "free-rider" problem seems to be little understood. To the extent that a retirement income scheme is not targeted, the economic costs associated with the disincentives to work and save are entirely the product of the high marginal tax rates required to finance such a scheme.

It is true that under such a scheme people are likely to save less of their own income since a government-provided retirement income will require a lower stock of private savings in order to fund any desired level of retirement consumption. However, that is saying no more than that a person can be expected to attempt to save enough to provide a desired level of retirement consumption. If an individual already has a sufficient expected retirement income to meet expected requirements, that person has no reason to increase the income available to him or her in retirement. There is clearly no reason why the government should attempt to force people to so over-provide. Provided that the costs of a retirement income programme are appropriately measured on an accruals basis, the government's impact on overall savings should be determined by explicit fiscal policy decisions.

It is also true that any change in benefit levels which is not financed by taxes or contributions from those who will eventually receive the benefits will alter savings behaviour. That is because such a change will result in an inter-generational transfer of wealth and, under the life-cycle savings model, different generations can be expected to exhibit different savings behaviour. However, that is a pure income effect which, while it may cause equity concerns, should not raise efficiency concerns.

The "free rider' problem changes its nature where the retirement income programme is targeted. It may be argued that, because of the disincentive effects from the high effective marginal tax rates produced over the abatement range, it is necessary that people should be forced to save. Were this to occur, high marginal tax rates for some beneficiaries (as a result of the targeting) would be replaced by high marginal rates for contributors (as a result of enforced savings). This is contrary to the purpose of targeting.

The scheme which appears to be favoured by the Minister is a social insurance-type scheme which is not targeted and which would provide more generous benefit levels than existing arrangements in order to link "contributions" to benefit levels. It would be funded by ordinary tax revenue or by a special tax called "contributions". The report of the Officals' Committee on Income Security for the Elderly (New Zealand Government 1988, Annex 5) indicates that the increase in effective marginal tax rates to fund such a scheme would be of the order of about sixteen percentage points, before allowance is made for government subsidies for those who have inadequate incomes during their working lives. In other words, a person currently on a 33% effective marginal tax rate would then face a 49% effective marginal tax rate.

It is true that this rise in tax rates would in part reflect a decision to account for the accrued costs of the retirement income in the government's budgetary position. However, part of the rise would reflect the more generous nature of the benefits. A reduced cost from closer targeting and/or increasing qualifying age levels would be rejected.

An argument is put forward that these higher effective marginal tax rates are not real effective marginal tax rates to the extent that any benefits are actuarially fair. Similarly, it is argued that enforced savings through private superanuation schemes would not amount to

taxation. These arguments are dangerous. They suggest that if a taxpayer is receiving a good return from taxation in the way of services or income support, the economic costs of taxation are removed. The same argument could be presented in favour of any form of government expenditure. Moreover, the fact that a government expenditure programme is a "good deal" - even if true - does not mean that a taxpayer would choose to take advantage of it in the absence of compulsion. Only if this were the case would the associated levy be regarded as a price, not a tax. The fact that the public may get a good return from a government-provided service may be a reason for providing that service. However, the economic costs incurred because of the need to pay for the service should not be wished away or ignored.

The distinguishing feature of a tax is that it is a compulsory levy. Economic costs are incurred as a result of raising taxes because it is practically impossible to levy a tax impost without distorting savings or work decisions. That applies to an income tax dressed up as a compulsory superannuation contribution as much as it does to any other form of income tax. As one writer has summarised the argument in the United States context:

> "If Social Security were to go only to the elderly poor, Social Security taxes could be folded into the income tax system. When all pretense is dropped that Social Security is an annuity system, separate taxes to finance benefits make as little sense as separate taxes to finance the food stamp programme" (Becker, 1989).

A contrary argument in favour of a social insurance-type scheme is that it might impose no costs on those who do undertake the target level of retirement savings. Their behaviour would be unaltered. The behaviour of those who "under-save" would be altered, but that is the desired policy result. There are a number of problems with such an argument.

It assumes that the government is a better judge than individuals as to the optimal level of their savings, an argument which has previously been rebutted. Furthermore, it ignores the costs of altering the form, manner and timing of optimal savings decisions. Finally, it ignores the problems of accurately measuring "income", a proportion of which would be required to be saved. For example, in the absence of an accrued capital gains tax, accrued capital gains would not be required to be saved whereas a proportion of economic income in other forms would be. This reinforces the general point that the government cannot costlessly impose its will on the general populace.

There are also practical problems of implementing a social insurance-type programme. It would not come fully into effect for a generation and there are major problems in covering non-income earners under such a scheme. It has been suggested that non-income earners could be covered by general tax revenue. However, that would imply very high marginal tax rates on those who move from the benefit system back into the workforce. In addition a social insurance-type scheme could potentially restrain and undermine general taxation reform. That is because "contributions" would be based upon income. An effective increase in the income tax impost would restrict the extent to which the tax base could be weighted further away from income and towards expenditure. It has also been suggested that part of the "contributions" could be paid by employers. That would amount to a distortionary "payroll" tax which would undermine the thrust of recent taxation reforms and, at least in respect of the initial incidence, increase labour costs and reduce employment growth.

A social insurance-type option would imply an acceptance of the view that the appropriate role for the government is income maintenance rather than income support. That is contrary to

the arguments presented in this paper. However, no reason for the government adopting an income maintenance approach has been put forward. Any such approach would entail a more generous retirement income programme which is universally available. The high costs of such a programme would necessarily create a financing burden which would require higher effective marginal tax rates.

4.7 Conclusion

There will be a continuing need for some form of retirement income support to be provided to the elderly who have not provided for themselves or who are unable to do so. The form of income support which most closely meets the criteria advanced in this paper is one which is less generous than existing measures, more tightly targeted, and with a higher age of eligibility. That corresponds to Scheme I of the Department of Social Welfare's discussion document of December 1988. The other options in that document do not meet these criteria. In particular, social insurance-type arrangements would be a move in the wrong direction. Such options would be less sustainable than the existing programme.

5 OTHER ISSUES

5.1 Introduction

The preceding sections have reviewed government retirement income policy. This section covers two related issues. The first is the transition to any revised form of retirement income support. The second is the government's role in the field of superannuation as an employer rather than as a provider of income transfer payments on behalf of the community as a whole. Both of these issues are important. They are considered here relatively briefly. The aim is to set down the principles which should guide policy decisions in these areas.

5.2 Transitional Issues

The preferred approach to public retirement income policy set out in previous sections involves the recognition of the primary importance of general economic policies in setting an environment in which the elderly will be able to be supported in the future. A continuing need is seen for a programme offering a minimum adequate level of retirement income support. Such a programme would differ from existing arrangements by being more tightly targeted, having a higher eligibility age and offering less generous benefits relative to prevailing wage rates. The transitional issue is how such a policy change should be implemented in a way which is acceptable to the community and fair to those who are likely to be affected.

Those who have made retirement and savings decisions on the basis of existing government policies should be protected from any sudden disruption to their plans as a result of a change in those policies. People have made decisions on the basis of past policies and should not be unduly penalised because these policies may have been unwise.

Nevertheless, it would clearly be impossible to implement a policy change along the lines advocated without adversely affecting some people in the short term. If the future fiscal costs of retirement income programmes are to be reduced, the present value of the future benefits of such programmes will need to be constrained below the level which people may currently expect. The objective of transitional measures should not be to avoid any such adverse impact, but to minimise it for those who cannot reasonably be expected to adjust, and would have difficulty in adjusting, to the new arrangements.

Transitional measures should also attempt to bring forward to the earliest possible date the efficiency gains from the reforms. In this case that means reducing the fiscal costs and disincentive effects of the existing arrangements as soon as possible. However, that should not be achieved at the expense of imposing losses on those who can least cope with them.

This requires some difficult judgements to be made. In general the desirable result would be likely to be a phasing-in of reforms over a period of time so that the burden of adjustment is minimised for those in or near retirement. The desirable phase-in period would allow a person to adjust savings and work decisions in line with the revised policy. Those who have already retired are the least able to adjust and therefore should face the smallest possible change to their circumstances. On the other hand, given the implications of the retirement of the "baby boom" generation from about 2005, it is important that those who are now middle-aged should have a suitable basis on which to plan.

It would also seem desirable to vary the transitional arrangements according to the extent to which different aspects of any reform package are likely to adversely affect those who are most in need and who have the most difficulty in making adjustments. In that regard, an increase in the age of eligibility is likely to be the most sensitive issue. The concerns here could be met by a gradual increase in the age of eligibility along the lines adopted in the United States (where the eligibility age is to increase from 65 years to 67 years between the years 2000 and 2027) and advocated in New Zealand by the National Party. However, a twenty to forty year phase-in period as adopted by the United States seems excessive. A person should be able to adjust to a requirement for a longer working life or a larger retirement provision over a much shorter time-frame.

Benefit levels may also require a phased reduction. A sudden reduction in the level of income enjoyed by the elderly would be difficult to sustain. The preferred approach would be to gradually reduce benefit levels relative to wage levels. To be successful that requires a period of rising real wage rates. That in turn relies upon the success of the government's general economic policies and the degree to which individuals are prepared to make use of the foundations laid by those policies. Increased emphasis could also be placed on additional (means-tested) payments directed to those with particular needs (e.g. private renters). Although the preferred approach is to constrain benefit levels by reducing them in relative but not absolute terms, reductions in the real levels of those benefits may be required if the economy continues to perform poorly. The retired should not necessarily be immune from the consequences of a poorly performing economy any more than any other section of society.

A move to closer targeting of benefits would require a shorter phase-in period than other changes. That is because targeting aims to protect those most in need. Nevertheless, close targeting may adversely affect those who have already retired and are unable to make any adjustment to new benefit criteria (by, for instance, increasing savings while still in employment). The extent to which a phase-in of targeting is required will be a matter of judgement. For example, targeting probably offers the most potential to bring about a significant early reduction in the fiscal costs of retirement income support, and early introduction may therefore be seen as justifiable in order to contribute to a better economic performance and thus help avoid a need to reduce the level of benefits in real terms. Experience elsewhere, including Australia, suggests that the withdrawal of assistance for the better-off aged is acceptable to the community. The adoption of an income and assets test would replace the present national superannuation surcharge.

One of the difficulties of any transitional path along the lines outlined is that it is, of necessity, spread out over a number of years and is therefore subject to changes in the political environment. The advantages of a decision to alter the age of eligibility, benefit levels and/or the level of targeting at some time in the future will be lost if people believe that political changes will result in the decision not being implemented or subsequently being reversed.

It is not possible to completely exclude future policy changes. A non-partisan approach to policy reform in this area might be useful in cementing any policy change in place. Even so, current party leaders cannot bind their successors. The key to minimising the uncertainty of future policy changes is a policy which is, and is seen to be, credible. That requires a policy which is economically sustainable in the longer term and which is consistent with other economic and social policies.

Possible mechanisms for increasing the credibility of long-term retirement income programme reform have been suggested. Some of these involve, as a transitional measure, issuing the public with bonds (which may or may not be transferrable) equal to the present value of existing benefit entitlements which would no longer be available under the revised programme (see Buchanan 1968, and Browning 1973). In other words, accrued benefit rights would be protected. Those in or near retirement would have a high entitlement while younger people would have a low entitlement. While such an approach has a number of practical difficulties, it should be given serious consideration. In the final analysis, informed public opinion is the main safeguard against ill-conceived and unstable policies.

5.3 The Government as Employer

This paper focuses on the government's actual and potential role in providing for the retirement income of the general public by way of general and specific policies. However, the government also has a role in this area as an employer. As such it offers its employees generous superannuation provision through the Government Superannuation Fund (the GSF). The government's superannuation arrangements have had flow-on effects to local authorities and state enterprises which have tended to adopt similar arrangements. The private sector has also had to compete with those arrangements.

In an environment in which greater stress is placed on private and employer-sponsored retirement provision, it will become even more critical than in the past that the government adopts an appropriate role as an employer in this area. Moreover, the arrangements adopted are likely to have an effect on the efficiency of the public sector and thus on overall economic performance. For those reasons, the government's role as an employer should not be overlooked in any review of retirement income policy.

There are a number of reasons why a review of the GSF is critical at this stage.

First, the withdrawal of taxation concessions for private superannuation cover generally requires a review of GSF benefits in order that GSF beneficiaries do not receive more favourable treatment than beneficiaries of private schemes. As noted by the Consultative Committee on Superannuation and Life Insurance (Consultative Committee 1988 at p. 14):

> "In the context of the proposed changes in the tax regime applicable to the private provision of retirement income, changes which will of necessity mean significant reductions in the post-tax benefits received by many members of private superannuation schemes, it would be quite intolerable if the members of the GSF were insulated from changes of that kind simply by virtue of the Government's ability to 'write a cheque on the taxpayer'."

Secondly, current GSF arrangements involve a high fiscal cost. The estimated 1988/89 fiscal cost was just under $600 million (source: 1988/89 Estimates), making it one of the government's larger expenditure items. Since the GSF is not fully funded, the real cost on an accruals basis would be significantly higher. At a time when the government is reviewing other expenditure areas, such a large expenditure item should not be ignored. For example, as also noted by the Consultative Committee, the offering of inflation-indexed pensions which private schemes cannot offer should be questioned.

Thirdly, recent public sector reforms have substantially altered the traditional form of public sector employment contracts. The ambit of the core public service has been reduced and departments have been given greater flexibility in negotiating employment terms and conditions. Existing GSF arrangements are largely based upon employment terms which are uniform across departments. The GSF in its present form thus tends to be at odds with public sector employment reform.

Finally, public sector reforms have been based upon a recognition that private sector incentive structures are often more appropriate for management decision making than are public sector incentive structures. The GSF is one of the larger investment funds in the country. The question should be raised as to whether it could not be better administered by the government or individual departments making arrangements with private sector institutions in the same manner as private sector employers.

It is understood that the government is reviewing the GSF both in the light of the removal of taxation concessions and for more general reasons. Past reviews of the GSF have been a disappointment. They have been dominated by the interests of potential beneficiaries and have tended to result in more generous entitlement provisions being made available. The current review should be established with clear criteria. The following are the essential questions which should be asked:

a do superannuation provisions produce more efficient public service employment contracts?

b can future superannuation arrangements be made compatible with recent public sector reforms?

c are the arrangements on the same basis as the private sector would and could agree to?

d what is the most efficient way of implementing and administering the government's superannuation arrangements?

e how is the transition to new arrangements to be made?

5.4 Conclusion

Two issues have been raised in this section which should be considered in any review of the government's retirement income policy. The first is the transition to any revised public income support programme. With respect to this issue, the desirable future reform should be clearly specified, and a judgement then made as to the best transitional path. The judgement involves a trade-off between early implementation with resulting early efficiency gains and deferred implementation so as to protect the position of those who are least able, and can least afford, to adjust to the new policy. Consideration will need to be given to how any transitional path can be made credible and therefore effective.

The second issue raised in this section is the government's role in superannuation as an employer. It is argued that current arrangements have never been properly analysed. Taxation changes and changes to the public sector itself make such a review an urgent priority.

6 CONCLUSION AND SUMMARY

6.1 The Critical Issue

The critical issue with respect to retirement income policy is how to provide a decent standard of living for the elderly of the future. This is often seen in terms of the type of benefits the government should be offering for the elderly. However, as argued in this paper, that focus is too narrow. It ignores the importance of ensuring that wealth is available to be distributed to the elderly, and it ignores the important role of private retirement provision.

The only way in which New Zealand will be able to ensure that the growing proportion of the population which is elderly has the security of a decent standard is for the economy to perform well enough to provide a decent standard of living for everyone. That requires a return to the high and sustainable economic growth rates which New Zealand has experienced in the past and which other countries, but not New Zealand, have enjoyed in more recent years. If the economy performs as poorly as it has over the past few decades, the prospects for the future elderly are dim. That is the case irrespective of how generous present governments may appear in promising future state benefits for the retired.

The government's first priority must therefore be to maintain general policies which produce a climate conducive to high and sustained economic growth. Reform of current government retirement income programmes should be seen as part of the reforms necessary to cultivate a high economic growth climate.

6.2 Greater Reliance on Private Provision is a Viable Option

Past government policy in this area has not been consistent with achieving the necessary economic environment. Those saving for their retirement have suffered from penal tax rates, discriminatory government interventions, and unanticipated inflation. Private retirement provision has consequently been made difficult with the result that people have relied heavily on state provision. Generous state provision has not only "crowded out" private provision, but has also had to be financed out of taxes. Those taxes are a burden which result in strong disincentives to work and save, undermining the health of the economy.

If we are to reverse this vicious circle, greater reliance will need to be placed on private retirement provision. Given the right incentives and the right economic conditions people will, to a much greater extent than recently, be able to save for their retirement and/or extend their working lives. Critical to this is a reduction in the level of state benefits. That would both reduce disincentives to private provision and reduce the fiscal costs of the current retirement programme. Reduced fiscal costs will in turn allow the tax burden to be reduced, thereby further improving the incentives for, and ability of, people to make their own retirement provision.

6.3 The Continuing Role of Income Support

Total reliance on private provision would maximise incentives and minimise fiscal costs. However, it is an unacceptable approach because it would leave those who cannot or have not made their own retirement provision without adequate means of support. The government therefore needs to adopt the role of guaranteeing support for those who have no private retirement provision. In line with other income support programmes the government operates,

that should be a tightly targeted programme with benefits set at the minimum levels necessary to provide a reasonable, albeit not generous, standard of living for recipients.

There are economic costs involved in providing such support. However, those costs must be borne if we are to maintain the sort of society New Zealanders have indicated that they want. The costs cannot be avoided, but they can be minimised by tightly targeting benefits and by constraining benefit levels. In addition, economic costs can be reduced by increasing the age of eligibility for retirement benefits with other benefits (sickness and unemployment) being available for those below the eligibility age.

Social insurance or compulsory saving schemes along the lines set forth in Department of Social Welfare's discussion document of December 1988 are inconsistent with the policies needed to provide income security for the future elderly. Such schemes would amount to a method of increasing taxes to fund programmes more generous, more poorly targeted to those in need, and even less sustainable in the longer term than national superannuation.

6.4 The Importance of Policy Stability and Transitional Measures

Reforms to the method of providing for the elderly are necessary. That inevitably means another change in government policy in this area; an area which has been subject to too many abrupt policy changes in recent years. This makes it essential that the changes decided upon be credible in the longer term and that they be perceived to be fair. It will thus be necessary to phase in any reforms so as to protect those who are least able to make the required adjustments.

6.5 Concluding Comment

The approach to retirement income provision proposed in this paper differs from policies currently in place in most comparable countries. In many of them, as in New Zealand, decisions taken by past governments have been motivated not by efficiency and equity objectives but by political considerations and interest groups. Many governments are now finding that economic and demographic trends are not consistent with past commitments. Reform of public pension schemes is a major policy issue in the OECD area. As a leading United States authority has noted:

> "Sooner or later budgetary deficits and tax burdens will force the United States and other countries to do what has been until now politically unthinkable - to replace Social Security systems in their present form with systems of benefits only for the needy elderly" (Becker, 1989).

The country whose current policy most closely approximates the approach recommended in this paper is Australia. The Australian government has reduced, but not eliminated, concessional tax treatment for private superannuation schemes. Its pension policy is based on a higher age of eligibility for males than is the case in New Zealand, and rates of benefit in relation to wages are lower. Its scheme is also targeted by means of an income and assets test. In view of the common labour market between New Zealand and Australia, there are some advantages in retirement income policies in the two countries being operated on similar lines.

The approach recommended is not unfamiliar in the New Zealand context. Income and assets tests have been features of retirement income programmes in the past, eligibility ages have been higher and benefit levels lower in relation to wages. The modifications to these parameters in the past 2 - 3 decades have been among the main reasons for the difficulties in retirement income programmes now being faced. Earlier arrangements enjoyed widespread community support over long periods of time and provided a stable and practicable basis for private retirement planning.

The economic and fiscal problems which New Zealand has been grappling with in recent years are acute. Over the past fifteen years a massive burden of public debt, unsupported by equivalent assets, has been accumulated and will be a burden on the next generation. Unfunded national superannuation liabilities are an addition to this burden. In effect, recent cohorts of voters have been living at the expense of their children. While there will be political resistance to any changes from some quarters, the unsustainable nature of the present arrangements is such that, without change, tax burdens will become even more oppressive, forcing a poorer economic performance and a migratory response on the part of the most productive New Zealanders. Such a scenario would be completely counter to the long run interests of present and future retirees.

A recurring theme of this paper has been the necessity for New Zealand to achieve a superior economic performance if the interests of its future elderly are to be properly safeguarded. The size of the economic 'pie' to which they will have access is more important for their welfare than the existence of financial claims on the output of the working population.

The approach proposed in this paper will only work if the necessary broad economic policies are adopted and maintained consistently over time. The same is true of any alternative approach to retirement income provision. A key factor is a lower government expenditure burden which will enable a reduction in tax rates, facilitate self-provision from after-tax income, and encourage economic growth. Given the continuing debt servicing burden and other pressures on government spending, containment and reduction of the relative cost of national superannuation is now imperative. Combined with a low inflation environment, lower barriers to employment and more efficient capital markets, such an approach offers scope for greatly expanding the volume of real goods and services on which the welfare of retired people will depend. Of all the specific retirement income schemes available, the option advocated in this paper would make the greatest contribution to an economic growth scenario. It is a relatively simple and familiar approach, and would pose the fewest transitional problems. As a cost-effective means of meeting widely-shared equity objectives, it also holds out the best prospects of sustained political support and long-term stability.

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