

3 November 2005

New Zealand as a Case Study

Evolving public and private sector retirement income provision

Louis Boulanger

Actuary

Presentation in Saipan at the APAFS 5th Annual Pacific Region Investment Conference

Outline

■ Historical context

- 1898-1974: progressive social policy
- 1975-2004: public pension policy instability
 - 1984: beginning of major economic reforms
 - 1987: removal of tax ‘concessions’ (EET to TTE)
 - 1996: major electoral reform (FPP to MMP)

■ Contemporary public provision policy (post 1984)

1. for employees: from pension (DB) to retirement savings (DC) policy
2. for citizens: state pension as the supreme political football
 - **NZSF**: a decent attempt to address ageing population problem

■ Contemporary ‘private’ provision for retirement (post 1990)

- from DB to DC to ‘No B or C’ from employers
- new government initiative: **KiwiSaver** (from April 2007)

■ Reflections on the New Zealand case

1. Historical Context

1898-today

Brief overview of past 107 years

First, the old days (before PCs...)

- NZ boasts one of the oldest systems of public pensions in the world
 - Old Age Pension introduced in 1898
 - modest (£18/yr); means-tested; for those aged 65+
 - Social Security Act 1938
 - introduced a two-tier public pension system that was to last nearly four decades
 - OAP became the Age Benefit; £78/yr; entitlement age reduced to 60
 - those not entitled to Age Benefit received small (£10/yr) Universal Superannuation
 - by 1947, the Age Benefit for a couple was now equal to 72% of the average wage
 - by 1970s, pensioners' situation had gone from marginal to very favorable
 - 1974: Labour Party's first attempt at pension reform
 - introduce government-run contributory second-tier (to replace Age Benefit)
 - 1975: National Party's 'biggest election bribe in country's history'
 - scrap Labour's scheme and move to a one-tier universal flat rate pension (called 'National Superannuation') payable from general revenue from age 60 equal to 80% of the average wage

Historical context continued

Picking up the pieces and creating a mess

1984: Labour back in government and country facing economic crisis

- 2 major innovations in pension policy from reformist government:
 1. Introduction of a 'surcharge' on incomes of better-off pensioners
 - very important development in the historical context
 - similar effect to Canada's Old Age Security claw back
 - but honored election campaign pledge to leave pension benefit same (except in name; now called 'New Zealand Superannuation'...)
 2. Change in tax treatment of 'retirement savings' (pension plans)
 - from exempt contributions/exempt earnings/taxed benefits (E/E/T)
 - to taxed contributions/taxed earnings/exempt benefits (T/T/E)
 - not done as result of deliberate retirement income policy

1996: population votes in favor of new electoral system (like Germany)

Final leg of history

Pension policy under MMP

Winston Peters (NZ First) and the balance of power under MMP

- 1996 Coalition Agreement with National Party
 - abolition of the surcharge
 - even if National was opposed
 - this made the NZ Super (pension) benefit universal
 - referendum on compulsory retirement savings scheme (CRSS)
 - CRSS was nothing like what NZ First had promoted in election campaign:
 - instead of a 2nd-tier add-on plan to NZ Super with individual accounts
 - actual CRSS proposed was designed to gradually phase out NZ Super
 - CRSS was neither a DC nor a DB; more like 'old vinegar in bright new bottle'
 - rejected by a staggering 91.8% of those who voted (smart Kiwis!)

1999: enter Michael Cullen (Labour) to save the day

- first senior politician (Finance Minister) to take problem seriously
- succeeds in creating the New Zealand Superannuation Fund (NZSF)

2. Contemporary Public Provision

a. DB → DC

b. NZ Super Fund

Government as employer

Outlawed DB plans

- State Sector Act 1988 (s.84B)
 - closed the Government Superannuation Fund (DB) to new members
 - required State sector employers who wished to offer new plans to ensure:
 - that all benefits are fully funded as they accrue; and
 - that the sum of all benefits payable to a member will not exceed funds actually held by or on behalf of the scheme in respect of that member
- Result?
 1. significant reduction in cost of public sector pensions
 2. no new DB plans since (and virtually no new DC plans either)
 3. now considered 'unwise' to amend s.84 (would remove effective protection)
- State Sector Retirement Savings Scheme launched in July 2004
 - simply a menu of selected retirement savings vehicles (DC)

Government as State

The NZ Super Fund

- Fund established in 2003 to:
 - receive and pay out current year's benefit entitlements (pay-as-you-go)
 - receive and invest additional capital contributions
 - only intended to *partially* pre-fund future cost of the benefit
 - amount required to be paid into Fund calculated annually by Treasury
 - formula based on level funding cost over rolling 40-year horizons
- Government is making the required capital contributions (to date)

\$ billion (June year end)	2003	2004	2005	2006	2007	2008	2009
Required contribution	N/A	1.879	2.107	2.207	2.213	2.343	2.528
Actual/Budgeted contribution	1.200	1.879	2.107	2.207	2.213	2.343	2.528

- Fund pays tax as a body corporate

The benefit (pension)

New Zealand superannuation (NZS)

- Standard annual pension entitlement: “65 at 65”
 - 65% of average earnings paid to a *couple* from age 65 (‘net’)
 - no income or asset test to determine eligibility
 - CPI adjustment annually (on 1 April)
 - resulting pension benefit must remain between 65% and 72.5% of average earnings (currently just under \$40,000)
- NZS entitlements are currently (*after ‘standard’ tax):

NZ Superannuation	Annually*	Weekly*
Couple (both partners qualify)	\$19,927.44	\$383.22
Couple (one partner qualifies)	\$19,000.80	\$365.40
Married Person	\$9,963.72	\$191.61
Single (living alone)	\$12,952.68	\$249.09
Single (sharing)	\$11,956.36	\$229.93

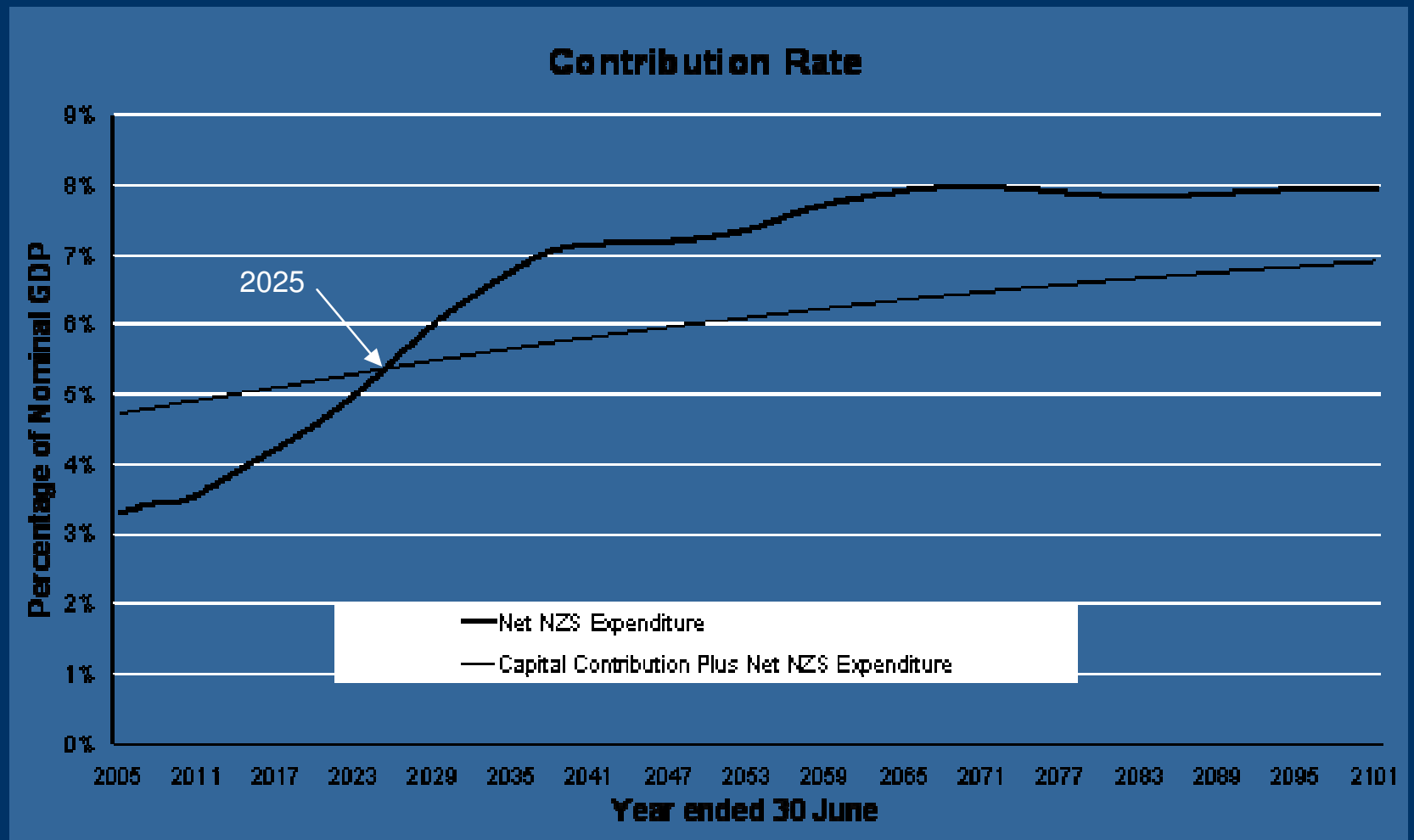
The governance of the Fund

Guardians of New Zealand Superannuation

- Crown entity established by New Zealand Superannuation Act 2001
- Separate entity operating at arms length from Government
- Elaborate nomination process for Fund's governing board (GNZS)
 - intended to shield the board (and fund managers) from political interference
- Function is to manage and administer the Fund in accordance with Act
- Must invest the Fund “on a prudent, commercial basis”
 - maximise return “without undue risk to the Fund as a whole”
 - no controlling interest in any other entity permitted under the Act
- Focus on pre-tax returns given Government is a shareholder

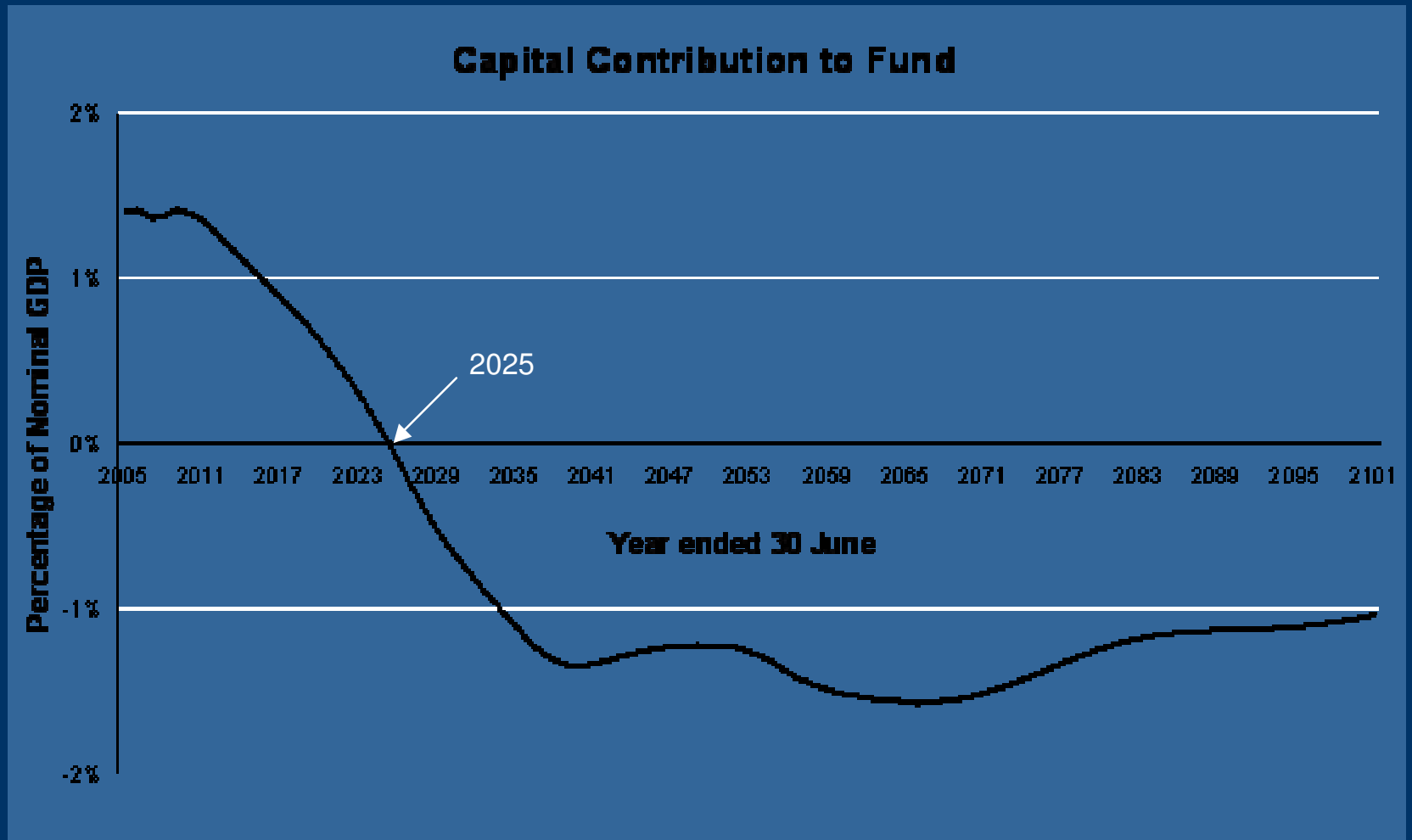
Cost of NZS with and without the Fund

Source: New Zealand Treasury



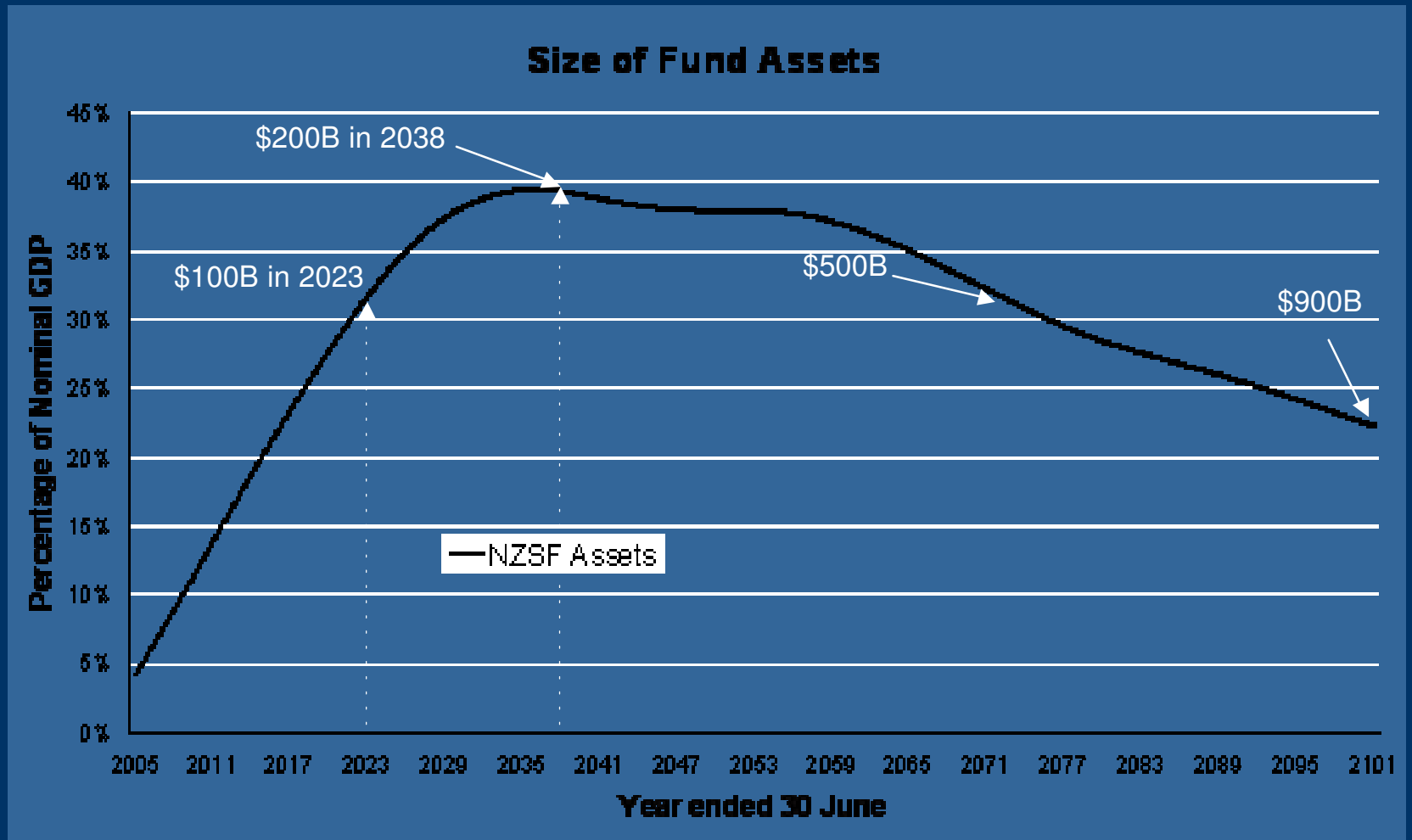
Capital contributions

Over and above pension payouts



Projected Fund size

Exceeds \$900 billion after year 2100



3. Contemporary 'Private' Provision

DB → DC → No B or C

KiwiSaver to the rescue

Workplace pension plans

Died with the tax changes

- Transition from E/E/T to T/T/E regime
 1. painful for DB plans
 - benefits had to be reduced to maintain same value and funding position
 - reductions had to be explained to members
 2. natural for DC plans
 - reduction of benefits automatic
 - usually much greater than those suffered by DB plan members
- Most DB plans converted to DC plans or wound up
- Huge payouts → birth of 'retail' industry (savings schemes)
- No new DB plan since 1990
- No longer considered employers' responsibility
 - 'Voluntary Private Provision' (from total cash compensation)
- Increasing reliance on home ownership and other property

Voluntary provision not working well

KiwiSaver to the rescue

- Cumulative effect of bad (or no) policy
 - participation in work-based plans declined from 23% (in 1990) to 13%
 - no sign yet of any improvement or a reversal of that trend
- Officials now (!) recognize the importance of work-based savings
- KiwiSaver announced in Budget 2005 (due to start April 2007)
 - designed to complement the NZ Super Fund
 - already praised by *The Economist* and *Pensions Policy Institute* (UK)
 - a national retirement savings work-based scheme run by the tax authority
 - automatic enrolment, but workers can opt-out (*based on behavioral finance*)
 - employees contribute 4% or 8%; employers do not have to contribute
 - government contributes \$1,000 up front and provides a fee subsidy
- Blurring of 'public' and 'private' provision in store (any precedents?)

4. Reflections on the New Zealand case

Lessons to be learned?

Some observations

Good and bad

- We started with a modest, means tested, 'old age' pension
 - we now have a universal benefit still payable from age 65
- Politicians use pension policy as a political football, so:
 - 75% majority in the House should be required for changes
- Unique policy mix: voluntary private provision + universal pension
 - could work, but needs refinement and invigoration
- Unique in providing no tax concessions for retirement savings
 - is New Zealand right and the Rest of the World wrong?
- Innovative solutions: NZ Super Fund and KiwiSaver
 - greater role of central government?

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