Improving the affordability and equity of New Zealand Superannuation

RPRC PensionBriefing 2010-7

14 December 2010

Raising the age of eligibility for New Zealand Superannuation is widely seen as necessary for fiscal sustainability. The Retirement Commissioner has reinforced this view in her 2010 Report. Yet this is not the only policy lever available to improve affordability, nor is it the most equitable. A subtle mix of the three possible parametric changes: the age, the level and the degree of targeting may be preferable. The Retirement Commissioner has also suggested a moderation of the indexation of NZS. This PensionBriefing examines the way in which increasing the degree of targeting might also contribute to reducing the fiscal cost while also addressing some of the current intergenerational inequities of New Zealand Superannuation.

Introduction

Among developed countries, New Zealand has taken a unique approach to the provision of retirement income which has put universal New Zealand Superannuation (NZS) at the centre. As a basic income, provided on residency grounds not contributions or work periods, it has been outstandingly successful in preventing hardship among those over 65.\(^1\) The over 65s in fact have the best living standards profile of any age group in New Zealand with very low rates of severe and significant hardship (Perry, 2009).\(^2\) NZS does not discourage saving or working since it is not income or asset-tested, and there is no retirement test.\(^3\) The fiscal cost in net terms, ignoring GST, is relatively low at around 3.5% of GDP today rising to just over 7% in 2050.\(^4\) While this appears to be a modest increase (see PensionBriefing 2010-4) there are associated fiscal pressures from an aging population, including healthcare costs that make this picture less benign.

When working age families are taxed to pay universal pensions to many who may be better off than they are, intergenerational equity issues may arise. Wealthy recipients of NZS, which is set at a rate higher than the unemployment benefit, may still be in well-paid work, and/or have other large private incomes and assets. Many accumulated their wealth with tax-free capital gains in the boom years. They are also the group likely to have gained substantially from the income tax cuts and lower Portfolio Investment Entity (PIE) and company rates of tax.

\(^1\)New Zealand’s over-65 poverty rate is not low when measured by the standard EU median household poverty line (60% before housing costs) and even on the OECD 50% line the New Zealand rate is now as high as 22% (Perry, 2010, p. 129). However, these measures are sensitive to small changes in the median, and do not reflect the lower costs of housing of this group. The RPRC intends to look at this issue more closely in a future PensionBriefing.

\(^2\)Requirement to retire from work.

\(^3\)To understand the actual cost of NZS the gross cost should be adjusted both for income tax and GST. Otherwise a tax shift, such as the GST/income tax shift in 2010, can make the net cost of NZS look greater than it actually is.
This Pension Briefing argues for more intra-generational sharing of the costs so that the wealthy, younger retired contribute more to the costs of the older, low income and less wealthy retired. By doing so, the pressure on the working age population can be reduced and intergenerational equity enhanced. Improving the affordability of NZS requires immediate debate as the large baby boom cohort reaching age 65 between 2010 and 2030 has already begun to receive NZS. The issue will become acute quite quickly, especially if the New Zealand economy recovers only slowly from the recent recession.

Options for reform

To reduce the costs of the baby boomers’ retirement, there are three levers to adjust – the age of eligibility, the level of payments, and means-testing. While raising the eligibility age is often discussed as if it were the only option, a subtle mix of the three levers could most effectively maintain the best features of NZS. The argument for cost containment may become more compelling as increasing numbers of baby boomers reach retirement with ever larger subsidised KiwiSaver lump sums (Retirement Policy and Research Centre, 2009; St John, Littlewood, & Dale, 2010).

The New Zealand Treasury has, amongst other options, also signalled the possibility of raising the eligibility age and, while this may be inevitable in the face of an ageing population, caution is advised. Raising the state pension age needs to be well-signalled, an issue that the Retirement Commission has reflected in its modest proposal to raise the age from 65 to 67 in 2-months-a-year increments from 2020 to 2033. In Australia, the increase to 67 will take place over only six years from 2017 to 2023. Immediate savings are therefore not possible and with the Retirement Commission’s proposal, savings will be minimal until almost the end of the baby boomers’ retirements (2010-2030). Moreover, it does not address the intergenerational inequities that arguably result from the top 20-25% accessing a universal benefit at the same time as they expect to pay low taxes.

In a recent speech, Don Brash raised the possibility of flexibility in the age at which NZS is accessed (Brash, 2010). He suggested that those who take the pension at age 65 could receive an actuarially-adjusted lower level than those who waited to age 67 or later. Potentially, this might encourage some to stay in the workforce for longer while maintaining choice for others. However there are currently few impediments to people continuing to work and arguably people have as much choice as they need about when to retire and whether to work full or part-time. This is one of the great advantages of NZS being universal and Table 1 shows how employment in the older age group has already increased significantly (Statistics New Zealand, 2009).

Table 1: Labour Force Participation – population aged 65 years and over

<table>
<thead>
<tr>
<th>Census year</th>
<th>Population aged 65+ in the labour force</th>
<th>Labour force participation rate of all age 65+</th>
<th>Proportion of the total labour force aged 65+</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Increase</td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>21,828</td>
<td>-</td>
<td>6.4%</td>
</tr>
<tr>
<td>1991</td>
<td>22,632</td>
<td>804</td>
<td>6.0%</td>
</tr>
<tr>
<td>1996</td>
<td>37,719</td>
<td>15,087</td>
<td>9.2%</td>
</tr>
<tr>
<td>2001</td>
<td>50,745</td>
<td>13,026</td>
<td>11.6%</td>
</tr>
<tr>
<td>2006</td>
<td>82,545</td>
<td>31,800</td>
<td>17.1%</td>
</tr>
</tbody>
</table>

Source: Statistics New Zealand (2009, p. 9)

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Another important disadvantage to relying on raising the state pension age to improve sustainability is that many people with physically demanding jobs are disabled or sick by age 65, and should not be expected to work past this age. The cost saving from raising the age would have to factor in the costs of supporting people who could not work past 65 and require another kind of benefit.

The second lever is the level of NZS. Projections show that fiscal savings from indexing the annual payment to inflation rather than wages would lead to significant long-term savings (The New Zealand Treasury 2009 p57-58). However, the baby boomers now aged 45-65 are very diverse in both health status and resources. Many are not well-off, and many have lost money in the financial meltdown and leaky home fiasco. Others have suffered through divorce and ill health. The level of NZS should be high enough to prevent hardship and it does that for most, though some clearly still struggle. Therefore, reducing either the level of NZS or the relativity to wages over time may undermine the desirable achievement of low poverty for the over 65 year old group. Nevertheless the Retirement Commission has suggested that if wages grow strongly there is a case for a moderation of the indexation formula (Retirement Commission, 2010).

However, the current three different rates for NZS, as previous Retirement Commission reports have said, cannot be justified. Their existence is historical and they are unsuited to a modern world of flexible living arrangements and relationships. It would make good sense therefore to pay the married person rate to everyone and have a living alone payment only where the need is demonstrated. This change would also improve the fiscal costs somewhat. The 2010 review again endorses the alignment of the single sharing and married person rates, but in the interests of simplicity suggests that the living alone rate remains unchanged. (Retirement Commission, 2010).

In summary, there are no immediate savings from raising the state pension age if an appropriate lead time is given. It could be a blunt tool with equity consequences. And, apart from aligning the rates of NZS, there appears little justification for saving costs by lowering the level of annual payments. This leaves the ‘third rail’ of superannuation policy: some kind of means test. This has been a politically unattractive option because of New Zealand’s history, summarised below. Yet this PensionBriefing suggests there are ways to do it that may be acceptable and perceived as fair so that this option should not be dismissed without careful consideration.

5 While the 2010 GST/income tax adjustments have increased the gap between NZS and other social welfare benefits, the issue here is more that these other benefits have been left behind, not that NZS is too high.
6 See for example the Periodic Report Group 1997. There is a married rate, a single sharing rate at 60% of the married rate, and a single living alone rate at 65% of the married rate. With diverse living arrangements possible there is far less justification for the second two higher rates to be paid.
7 Touch it and you die. The phrase ‘third rail’ is a metaphor in politics to denote an idea or topic that is so ‘charged’ and ‘untouchable’ that any politician or public official who dares to broach the subject would invariably suffer politically. The third rail in a railway is the exposed electrical conductor that carries high voltage power. Stepping on the high-voltage third rail usually results in electrocution. The use of the term in politics serves to emphasise the ‘shock’ that results from raising the controversial idea, and the ‘political death’ (or political suicide) that the unaware or provocative politician would encounter as a result. (Wikipedia).
Our history of NZS for high income people

Under the National government in the 1970s, there was much talk about the generosity of the pension. Between 1977 and 1985 the state pension (then called National Superannuation) was fully universal, as now, and while the relativity to the average wage was reduced from its initial 80% for a married couple, it was always higher than for so-called ‘welfare’ benefits. However, while there was no income test, the top personal tax rate was then 60%, and even as high as 66% in the early 1980s. This meant that top income retirees could retain only a net 34% of the gross pension—the tax system effectively clawing it back in larger part from those who were still in well-paid jobs or in receipt of substantial other income.

In 1985, in a very controversial move and despite its promise not to reduce the pension, the Labour government imposed a surcharge of 25% on other income over an exempt amount. Then in 1990, the newly elected National government, although it had promised to repeal the surcharge, instead effectively intensified means-testing of the pension with changes announced in the 1991 Budget.

NZS was to be made into a welfare benefit, with a strict income test as applied to other welfare benefits. However, the policy was deeply unpopular and was abandoned before it began. In a policy U-turn, the surcharge was again reinstated, but at a more stringent level. However, by its last year, 1998, the threshold of exempt income for the surcharge had become generous and the rate of clawback was only 20%. By that point, only 16% of people were affected and only the top 5% of earners had all of their net NZS clawed back. While the surcharge was complicated and contentious, it performed a useful function. Some better-off retirees did not bother claiming the pension, while most of those still in high-paid work received nothing. The fiscal cost of abolishing the surcharge in 1998 was estimated to be $400m or 10% of the net cost of NZS (Periodic Report Group, 1997).

Thus by the end of the 1990s, the pension was again fully universal and for a brief time, the better-off paid only a maximum of 33% tax on it. When Labour was elected in 1999, the top tax rate was raised to 39%, but even so, the top earners retained 61% of the gross NZS.

On 1 October 2010, National returned the top personal rate to 33%. Figure 1a shows the current disposable income of a superannuitant compared to an ordinary taxpayer (using the tax rates post 1 October 2010). If there is no other income, the gross amount of NZS is taxed at the lowest tax rate and net disposable income is around $13,300 for a married person. For a superannuitant with enough other income to be in the top tax bracket, disposable income is increased by $9,995, the net amount of NZS after tax at 33%. Thus top earners who may still be working, now can retain at least 67% of gross NZS, and enjoy perks such as the Super Gold Card and subsidised health care. The top line remains higher by $9,995 and parallel to the disposable income line for other taxpayers at all high income levels.

This means that the wealthiest superannuitants in 2010 are better off by more than the net unemployment benefit for a single person. In addition, of course, they may also have benefited from the 2010 GST/income tax shift.

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8 In some cases, the surcharge was avoidable for those not on a salary.
9 Though the increasing prevalence of tax avoidance in the decade following the increase in the top marginal personal tax rate suggests that many top income earners would have retained more than 61%. See (Inland Revenue Department, 2008) for a discussion of this trend.
Reducing NZS for high income people

Finding a way to make the two lines meet (Figure 1a) by reducing the generosity of net NZS at the top end might be an equitable way to save costs. It may reduce the degree to which the state pension age needs to be raised or the rate of payment reduced. As suggested above, both of these last two mechanisms may impact unfairly on those least able to manage. Only those with significant ‘other’ income will be affected much by the suggested change.

To achieve this, a negative income tax approach could be used. In the past, when the surcharge operated, such an approach was suggested as a sensible rationalisation (St John, 1991). This reform would have meant that the flow of tax to the IRD on gross NZS and other income, and the surcharge paid by a superannuitant, would have been offset against the gross NZS payment from the IRD. Money would flow one way only. The value of this approach would have been the much improved simplification for those affected by the very confusing way the surcharge operated.

Today, the picture is a little different and this PensionBriefing suggests a different option for consideration. This approach, called here the ‘Superannuation Grant’, would mimic the old surcharge in effect by making the two lines meet (see Figure 1a). From age 65, a superannuitant would receive a weekly non-taxable grant. Then, for any additional earnings, a separate tax scale would apply. The grant for all superannuitants would be the current rate of NZS taxed at the primary rate: i.e. $13,300 for a married person as shown in Figure 1a. Any extra supplement for living alone would be part of the welfare system. For all who claim NZS, the Superannuation Grant would be the non-taxable amount with each extra dollar of other income taxed on the separate tax code.

A break-even point would exist where the Superannuation Grant plus extra income earned from work or investment net of the flat tax rate is equal to the disposable income of an ordinary
taxpayer paying the usual rates of income tax. This point is effectively where the benefit of NZS payments has been clawed back by the flat tax.

This is technically different to the surcharge of 1985-1998 because the NZS payment is the same for everyone (married; single sharing; single living alone) and is not part of taxable income. It is much simpler in concept as the surcharge was exceedingly complex, applying until the net advantage from NZS was equal to the surcharge paid. Few could work it out themselves. The surcharge was also hated because it was perceived as an additional, discriminating tax that could result in rates of tax exceeding 50%.

In this new approach, an individual could either opt for the NZS grant and the NZS tax scale for all additional income, or wait until end of the tax year and take any NZS due as a rebate. About 40% of retirees who have no additional income would notice very little difference. But it would reduce or remove NZS for high income earners, many of whom will still be in the workforce, without removing their right to the income floor if needed. The perception of NZS as a retirement pension (that is, payable once employment ceased) would be enhanced.

The breakeven point is very sensitive to the flat tax rate chosen, or in the case of a tiered tax schedule, to the highest rate of the schedule. An example is depicted in Figure 1b with a flat tax at 38% on other income. The breakeven point occurs when the NZS recipient’s other earned income is $84,150. A recipient of NZS who earns less than $84,150 would pay a flat rate of 38% tax on this other income. If they earned more than $84,150 then it would be rational for them to forego NZS payments and be treated as an ordinary taxpayer. For a flat rate of 40% the breakeven point is lower at $63,075 of other income.

Figure 1b: Flat tax of 38% on other income

Given that for 80% of NZS recipients, NZS provides at least 55% of their income (Perry, 2009), a tiered structure may be useful. Building in an exemption is another approach to give some relief to those with limited extra income. Figure 1c illustrates a tiered approach; with rates of
20% for the first $25,000 of other income and 38% on each dollar above that. The break-even point in this case would be much higher, at $174,150.

**Figure 1c: Two tiered rate of 20% (for first $25,000 earned) and 38% above $25,000**

In an end of year adjustment, a rebate would arise if an individual earns less income than the break-even point but did not choose to take the weekly NZS. Many wealthy people would simply not bother to apply for NZS, as happened with the surcharge.

The breakdown of annual losses in disposable income relative to current settings is set out in Table 2 below for the two scenarios depicted in Figures 1b, and 1c, at bands from $5,000 to $100,000 of extra income earned. There are losses for people with small amounts of additional income, but these may be compensated in other ways, or minimised as in the two-tiered tax approach suggested in Figure 1c.

**Table 2: Losses in annual disposable income**

<table>
<thead>
<tr>
<th>Other taxable Income</th>
<th>1b</th>
<th>1c</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000</td>
<td>$1,125</td>
<td>$125</td>
</tr>
<tr>
<td>$10,000</td>
<td>$2,250</td>
<td>$250</td>
</tr>
<tr>
<td>$15,000</td>
<td>$3,375</td>
<td>$375</td>
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<td>$20,000</td>
<td>$4,500</td>
<td>$500</td>
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<tr>
<td>$25,000</td>
<td>$5,625</td>
<td>$625</td>
</tr>
<tr>
<td>$50,000</td>
<td>$9,135</td>
<td>$3,635</td>
</tr>
<tr>
<td>$75,000</td>
<td>$9,995</td>
<td>$5,038</td>
</tr>
<tr>
<td>$100,000</td>
<td>$9,995</td>
<td>$6,288</td>
</tr>
</tbody>
</table>
Features of the Superannuation Grant

As with any targeting regime, an increase in the degree of targeting may result in some avoidance activity. Opportunities and incentives for tax avoidance were features of the history of the surcharge. Other concerns are that it needs to be carefully packaged so as not to influence the decision to save. It would however be only slightly more complicated in administration than the current universal payment, which is exceedingly simple. Behavioural changes will make it somewhat more complicated though less complicated than the old surcharge.

The proposed Superannuation Grant as a new way for over 65s to receive NZS has a number of potential advantages:

1. **Flexibility**: The choice of tax rates allows flexibility in reaching a desired breakeven point and required fiscal savings.

2. **Fiscal savings**: According to modelling by the Treasury, targeting would be one of the most effective ways of achieving fiscal savings (The New Zealand Treasury, 2009, p. 59). The savings depend on the tax rate, but if the degree of targeting was similar to the surcharge savings of the order of 10% or more would be expected. Moreover, these fiscal savings could be achieved relatively sooner than raising the eligibility age with appropriate lead-in time.

3. **Simplifies the design of NZS**: The proposal envisages a single rate of an NZS Superannuation Grant for all – a tax-free grant equal to the net amount now paid to a married person. That will simplify the current payment rates and cut the cost of NZS once phased in.

4. **Simplicity in administration** compared to other income tests and the old surcharge.

5. **Maintains the level of payments for those in need**: This ensures old-age poverty is kept relatively low.

6. **Does not unduly penalise extra income, depending on the parameters**: Given that for the bottom 60% of NZS recipients, as measured by gross incomes, their NZS payments comprise at least 80% of total income, and for the bottom 80% of recipients it comprises at least 55%, the majority of over 65s will face minimal reductions in disposable income.

7. **Allows for a smaller increase in the eligibility age**: A smaller increase in the state pension age would reduce the disadvantaging for individuals who, given the arduous nature of their employment, may expect to retire from work earlier than others; and avoids the introduction of any retirement test.

8. **Improved inter and intra-generational equity**: Perhaps most importantly, the proposed change would decrease the fiscal cost of NZS for younger New Zealand taxpayers through reductions in payments to older, higher income earners.
This *PensionBriefing* has been compiled by Susan St John and Andrew Familton.

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**References:**

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*A speech given to the Asset Allocation Summit at the Hilton Hotel in Auckland, 21st July 2010.*


