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Future proofing New Zealand Superannuation for a changing world

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Introduction

Under existing policy settings, the costs of retirement income, health, and welfare for the rapidly growing older population in New Zealand lift markedly over the next decades both in absolute terms and relative to other state spending. Society must adapt to the inevitable demographic changes and may be willing to bear the costs without policy change. But 'affordability' is a loaded term. While there may be debates about whether the increasing costs are manageable, they may entail the opportunity cost of other more desirable spending, at least at the margin. If there is a reluctance to tax or borrow for the growing cost, then the 'affordability' of New Zealand Superannuation (NZS) may be improved by using one or more of three main levers: the qualifying age, the level of the payment, and the degree of targeting.

Lifting the age of eligibility for NZS has been the most discussed lever and is widely seen as necessary for fiscal sustainability. The Retirement Commissioner has reinforced this view in the last two three-yearly reviews of retirement incomes policy (Retirement Commission, 2010, 2013). Yet this is not the only policy lever available to improve affordability, nor is it necessarily the most equitable. The qualifying age could be raised gradually to reflect improved longevity but the long lead-in times likely to be needed preclude immediate savings. Reducing the level of NZS for everyone is the least favoured option, carrying the likelihood of increasing poverty among the aged population.

This paper revisits the third lever of means testing. While the contemplation in New Zealand of such policy reforms is greeted in many quarters, including the political one, with suspicion if not outright rejection, there are good reasons to scrutinise potentially viable options. This paper suggests that the current modest degree of clawback provided through the tax system could be enhanced by taking a basic income approach. In doing so, better alignment of retirement incomes policies over time between Australia and New Zealand may be possible.

By saving money with an increased clawback as described in this paper, the best features of a universal, adequate, unconditional retirement income floor are retained. Without recreating poverty among the old, the pressure on the working age population can be reduced, and perceptions of intergenerational enhanced. If the rates of NZS are aligned over time especially the single sharing and married rates, greater rationality is introduced and further saving is possible.

Background[2]

Among developed countries, New Zealand has taken a unique approach to the provision of retirement income that 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, along with high rates of home ownership, in preventing 'after housing costs' poverty among most of those over 65. The over 65s in fact have the best living standards profile of any age group in New Zealand with low rates of significant hardship:

> *In 2013, the 60% [After Housing Costs] AHC fixed line poverty rate for the 65+ age group was 7%, compared with 13% for 45-64 year olds, 16% for 18-44 year olds, and 22% for children (aged 0-17 years)…. For example, using MSD's Economic Living Standards Index (ELSI), 5% of older New Zealanders and 17% of children were identified as "in hardship" (2011-12 HES), using a fairly stringent threshold which gave a population hardship rate of 13%.*
> *The lower AHC income poverty and low material hardship rates for older New Zealanders reflects the mix of universal public provision (mainly NZS) and the private provision built up by most of the current cohort over their lifetime. A key component of this private provision is mortgage-free home ownership which is relatively high among the current cohort.* (Perry, 2014, pp. 28 - 29)

The fiscal cost of NZS, in net terms, is relatively low in international terms at around 4.1% of GDP today rising to 6.1% in 2050 and just 6.7% by 2060.[3] While this appears to be a modest increase,[4] there are associated fiscal pressures from an ageing population, including healthcare costs, that make this picture less benign (New Zealand Treasury, 2013a).

NZS does not discourage saving or working since it is not income- or asset-tested, and there is no requirement to actually retire from work. Wealthy recipients of NZS may still be in well-paid work[5] and/or have other large private incomes and assets. Some of this group may have accumulated their wealth with tax-free capital gains and may have gained substantially from the 2010 income tax cuts and lower Portfolio Investment Entity (PIE) rates of tax. The amount of NZS retained after-tax by individuals taxed at the top rate, perhaps because they still work full-time, is more than the net Jobseeker Support benefit rate paid to an unemployed adult (Table 1).

Working age 'welfare' benefits are indexed to inflation alone so that over time the gap between these and NZS will continue to grow. Projections show that under current policy settings spending on welfare benefits and other provisions that affect the working age population such as Working for Families tax credits decline markedly as a proportion of GDP while spending on NZS and health increases (New Zealand Treasury, 2013a p16). When working-age families are taxed to pay universal pensions to many who are still working and appear much better-off than they are, intergenerational equity and fairness may be questioned.

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[2] The arguments in this paper are explored more fully in (St John, 2013)
[3] These percentage changes rely on assumptions about GDP growth and labour market participation rates as projected in the Half Year Economic and Fiscal Update (HYEFU) *NZS Fund model, worksheet NZS expense - History & Future.*
[4] See PensionBriefing 2013-6 *New Zealand Superannuation's real costs – looking to 2060.*
[5] See PensionBriefing 2014-4*, Updating data on older workers***.**

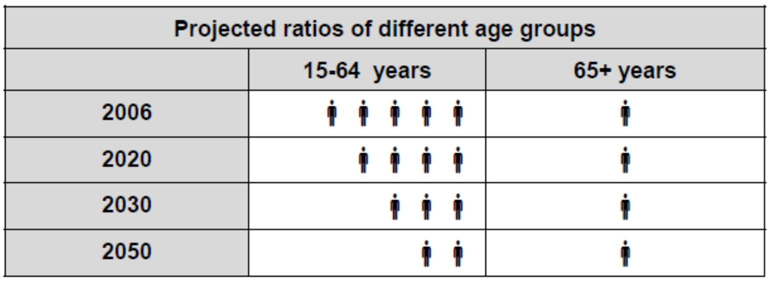
Table 1: New Zealand Superannuation (NZS) and Jobseeker Support rates at 1 April 2014

Category	% Net average wage	Annual rate	Annual Net	Annual Net
		NZ$ (gross)	Primary Tax	33% Tax
NZS Single, living alone	43%	$21,932	$19,080	$14,692
NZS Single, sharing	40%	$20,154	$17,612	$13,503
NZS Married person or partner in civil union or de facto relationship (each)	33%	$16,600	$14,677	$11,121
Jobseeker Single, 25+ years		$12,147	$10,871	
Jobseeker Married, civil union or de facto couple (with or without children) (each)		$10,122	$9,059	

Source: Work and Income website: http://www.workandincome.govt.nz/

The argument for cost containment may become compelling in the next two decades as increasing numbers of baby boomers reach retirement with ever larger, subsidised KiwiSaver lump sums (St John, Littlewood, & Dale, 2014) and qualify for NZS which under the pay-as-you-go system must be funded by current taxpayers. NZS is partially prefunded, but the New Zealand Superannuation Fund (NZSF) in itself does not itself make the cost of NZS any less, and the accumulation in the NZSF has opportunity costs.[6] A simplified visual picture of the scale of demographic change is provided in Table 2.[7]

Table 2: Structural Ageing in New Zealand 2006 to 2050



Source: New Zealand Treasury (2013b)

Future pension payments may be reduced through the use of one or more of the three main levers: 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 carefully considered mix of the three levers might most effectively maintain the best features of NZS. The first two levers are briefly discussed next, followed by a more detailed proposal for use of the third lever: income-testing. This third lever has been seldom discussed seriously in New Zealand since the late 1990s when the surcharge was abolished (see discussion below).

Lever 1: increase the qualifying age for NZS

The New Zealand Treasury (2013a) has, amongst other options, investigated the possibility of raising the eligibility age for NZS. This may appear inevitable in the face of

[6] While the NZSF's rate of return has been higher to date than the rate of interest on government borrowing, the working age population will have to pay for the assets when they are liquidated.
[7] Table 2 simplifies the true demographic picture but is used because this is a common international measure. In fact, the 'working age' population should exclude many at the youngest ages (because they are still in education) and include many at the oldest ages because increasing numbers of those age 65+ are still working.

an ageing population and ever improving longevity: average life expectancy at age 65 for 25 year olds today is expected to be 25 years for men and 27 years for women, compared to the current 20 years (men) and 23 (women) at age 65 (Commission for Financial Literacy and Retirement Income, 2013 p.36).

Nevertheless, caution is advised. An important disadvantage of relying on raising the age of eligibility to improve NZS sustainability is that many people with physically demanding jobs are disabled or sick by age 65 and unable to work further. Others lack the required skills or education to meet market requirements. The cost saving from raising the age would have to take account of the costs of supporting people who could not work past 65 and would require another form of state assistance. The use of conventional welfare benefits with stringent income tests may mean those who cannot continue to work exhaust their private retirement resources before reaching the new higher age of eligibility.

While New Zealand increased the state pension age rapidly by 5 years over the period 1992-2002 with little warning, the current consensus is that raising the age needs to be well-signalled. The Retirement Commissioner's Review of retirement incomes (2010) proposed a modest rise from 65 years to 67 by 2 months per annum from 2020 to 2033. With this proposal, savings would be minimal until almost the end of the period when the last of the babyboomers reach retirement age, in about 2030. The proposals by the Retirement Commissioner in the 2013 Review were even more modest: that the proportion of life over the age of 20 after the state pension age be kept at a minimum of 32%, its current projected level for today's average 65 year-old. Immediate savings will not be achieved with this proposal either as the illustrative schedule used in the Review shows no impact until 2027 when the 1962 cohort would be the first to receive NZS later than age 65 (Commission for Financial Literacy and Retirement Income, 2013 p38).

New Zealand runs some fiscal risk by being out of step internationally. In Australia for example, the increase to age 67 for the Age Pension will begin in 2017 and be achieved over only six years, by 2023, with talk of a further extension to age 70 by 2035.[8] New Zealand's current reciprocity agreements with Australia and other countries mean individuals' residency there can be used to qualify for NZS if they emigrate to New Zealand. This potential for people from other countries with higher qualifying ages and higher residency and/or contribution requirements for the age pension to benefit from our less stringent conditions is another risk to the future affordability of NZS (Dale & St John, 2012). Nevertheless, both major political parties have shown a lack of political will to signal a timetable for a rise in the age.

In summary, some raising of the age is inevitable to reflect improved average longevity, greater participation in the workforce and to align with other countries such as Australia. However, if the only way to do this politically is to give a long lead-in time, there will be little or no potential for immediate savings from using this lever.

[8] In the United Kingdom, Under the Pensions Act 2011, the State Pension age for women will increase to 65 by December 2018, when the State Pension age for both men and women will start to increase to reach 66 by October 2020. Unlike the UK, where access to the State Pension is based on a person's National Insurance contribution record, New Zealand only requires 10 years residency, with 5 of those years after age 55. See UK State Pension Age Timetables at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/310231/spa-timetable.pdf.

Lever 2: decrease the amount of NZS

A second lever to reduce the cost of NZS is to reduce the payment level. One approach to achieving this is to change the indexation basis for NZS. Projections show that fiscal savings from indexing the annual payment of NZS to inflation rather than wages would lead to significant long-term savings (The New Zealand Treasury 2009, pp. 57-58). The real spending power of NZS would be protected but the rate of NZS would fall relative to average wages.

However, the baby boomers now aged 49-69 are very diverse in both health status and resources. Many are not well-off, and some have lost money in New Zealand's finance company meltdown and/or the leaky home fiasco. Others have suffered through divorce and ill health. As Perry (2014, p170) reports, the great majority of older New Zealanders (aged 66+) are very dependent on NZS and other government transfers for their income:

- *40% have virtually no other income source*
- *the next 20% have on average around 80% of their income from NZS and other government transfers.*

The level of NZS needs to be high enough to prevent hardship and it does that for most, particularly for those who are home-owners, though some pensioners clearly still struggle. For a healthy retirement that allows participation in society, O'Sullivan & Ashton (2012) calculated that about another $8,000 net a year per person (2012 dollars) is needed. This suggests that the current level of NZS as a long term support for people over 65 with no other income is far from generous.

Therefore, reducing either the level of NZS or the relativity to wages over time may undermine the desirable achievement of low hardship rates for the 65+ group. Nevertheless the Retirement Commissioner (2013, p. 90) has suggested there is a case for a moderation of the indexation formula and recommended that:

> *…the Treasury be directed to develop a model by December 2014 that will show the likely impacts on living standards among older New Zealanders of a new method of indexation of NZS, based on the average of percentage change in consumer prices and earnings but no less than price inflation in any year. The model will need to take into account projected growth in KiwiSaver balances and transfer of a proportion of any fiscal savings being applied to measuring and maintaining the real living standards of less-well-off New Zealanders.*

Another approach to decreasing the amount of NZS is to rationalise the three different rates for NZS. As shown in Table 1, 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 in net terms. As previous Retirement Commission or Periodic Report Groups Reviews (eg, 1997, 2007, 2010) have noted, these differences are hard to justify.

The different rates are historical and they are unsuited to a modern world of flexible living arrangements and relationships (St John, MacLennan, Anderson, & Fountain, 2014). There is a case therefore to pay the same flat rate to everyone, set somewhere between the married person and single sharing rate, and have an additional means-tested payment where high housing costs are demonstrated.[9]

[9] The means-tested Accommodation Supplement is currently already accessed by 5.6% of those over 65. (Ministry of Social Development, 2013). This payment could be further adapted for the over 65 group.

The elimination of the living alone rate would reduce the cost of NZS somewhat although it may create additional complexity for some. Importantly, the Accommodation Supplement could be adapted to assist with high housing costs independently of whether superannuitants are sharing or living alone.

As shown in Table 3 around 27% of superannuitants live alone and possibly the majority would still need accommodation assistance. Nevertheless savings here can be made without affecting the living standards of those dependent solely on the pension. Whether or not there is a separate rate for living alone the alignment of the married and single rates appears justified.[10] To save costs without direct cuts the single sharing rate could be frozen until the married rate catches up with normal annual adjustments.

Table 3: NZS and Veterans' Pension recipients as at 31 March 2014

	NZ Super		Veterans		
	female	**male**	**female**	**male**	**total**
Married, civil union, de facto couples, both qualify	159,891	208,839	2,625	3,288	374,632
Single sharing	58,562	26,905	1,109	551	87,122
Single living alone	122,459	51,128	3,433	1,218	178,227
Non-qualified partner	13,113	1,608	310	0	15,030
TOTAL	354,025	288,480	7,478	5,056	655,011

Source: estimated from data provided for 2010 MSD regulatory statement.[11]

In summary, apart from modernising and improving simplicity by aligning the rates of NZS, there appears little justification for reducing NZS costs by lowering the level of NZS payments as this approach entails the risk of increasing old age hardship.

The third lever: a means test

This leaves the 'third rail'[12] of superannuation policy: some form of means test. This has been a politically unattractive option because of New Zealand's history, summarised below. Yet this Working Paper suggests there is a way to apply a means test that could be seen as fair and acceptable with enough useful savings to take the pressure off relying solely on raising the qualifying age or reducing the rate of NZS as the principal levers.

In Australia the means test on the Age Pension takes account of both income and assets (see Appendix, St John, 2013). The means test in Australia is well accepted (Chomik and Piggott, 2014) but is likely that New Zealanders would find that kind of a means test a step too far. This paper concentrates on an income-based means test, but that does not preclude an attempt to include as much imputed income from assets as feasible over time.

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[10] The Retirement Commissioner's Review (2010, p. 13) endorsed the alignment of the single sharing and married person rates In the interests of simplicity it suggested that the living alone rate remained unchanged.

[11] https://www.msd.govt.nz/documents/about-msd-and-our-work/publications-resources/regulatory-impact-statements/ris-living-alone-payment.pdf

[12] *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).

History of income tests on NZS for high income earners[13]

When the National government introduced 'National Superannuation' in 1977, it was much more generous than the previous age pension arrangements. Between 1977 and 1985, 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 the rate for 'welfare' benefits.

While there was no income test for National Superannuation, the top personal tax rate was 60%, and then 66% between 1982-86 when a 10% surcharge was imposed. This meant that top income retirees could retain net, only 34-40% of the gross pension with the tax system effectively clawing 60-66% of it back from those who were still in well-paid jobs, or in receipt of substantial other income. Universal pensions and progressive taxation went hand in hand.

In 1985, in a very controversial move and despite its pre-election promise not to reduce the state pension, the Labour government imposed a surcharge of 25% on all other income over an exempt amount. This surcharge had the effect of recovering the full amount of the state pension from high earners. When the top tax rate was reduced to 48% in 1986 and later to 33% in 1988, the surcharge effectively acted as a substitute for more progressive taxation for those in receipt of the universal pension.

The National government was elected in 1990 and, despite promising to repeal the surcharge, instead effectively intensified means-testing of the pension. As 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 (St John, 1992). 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 more 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 (Periodic Report Group, 1997).[14]

While the surcharge was complicated and contentious, it performed a useful cost-saving function without imposing hardship. Some better-off retirees did not bother claiming the state pension, and most of those still in high-paid work received little after-tax benefit from it.

The fiscal cost of abolishing the surcharge in 1998 was estimated to be $400m or 10% of the net cost of NZS. This indicates that the surcharge created a 10% fiscal saving on the net cost of NZS (Periodic Report Group, 1997 p48). By the end of the 1990s, the state 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.[15]

On 1 October 2010, the National government reduced the top personal tax rate back to 33%. Figure 1 shows the current disposable income of a married superannuitant compared to an ordinary taxpayer (using the tax rates post 1 October 2010). In 2014, if

[13] For more detail see St John (2013).

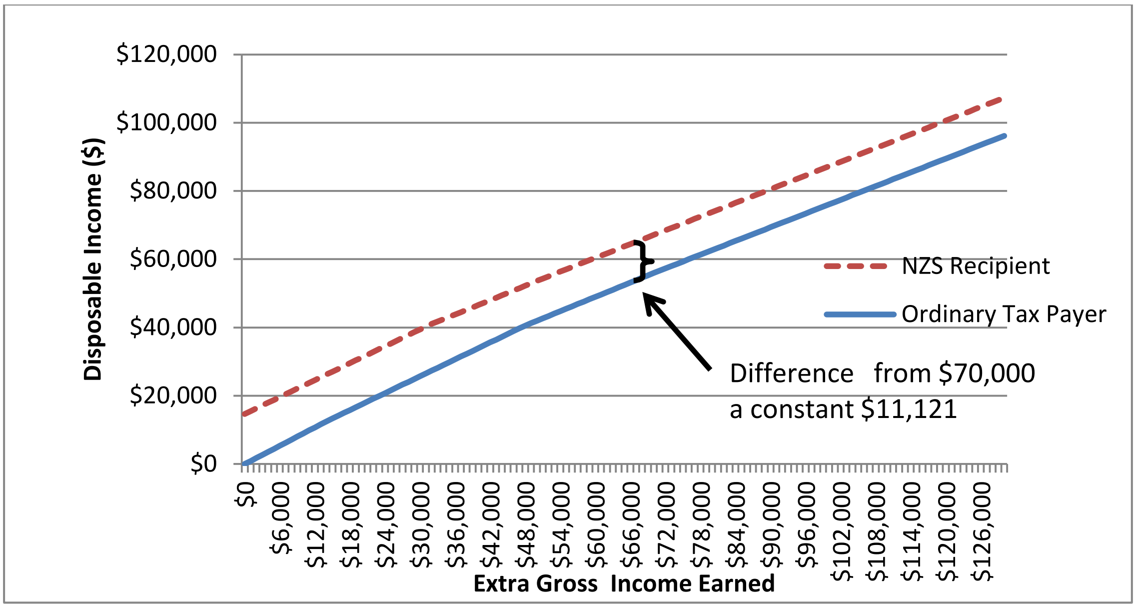
[14] In some cases, the surcharge was avoidable for those not on a salary; some commentators called it a 'voluntary tax'.

[15] 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.

there is no other income, the gross amount of NZS is taxed at the lowest tax rate and net disposable income is $14,677 for a married person (see intercept on vertical axis in Figure 1). For a superannuitant with enough other income to be in the top tax bracket, disposable income is increased by $11,121, the net amount of NZS after tax at 33%. Thus high-income superannuitants retain at least 67% of their gross NZS: at all high income levels, a married NZS recipient receives $11,121 more disposable income than other high income taxpayers.

In the context of the overall population, the net $11,121 of NZS paid to the wealthiest married superannuitant is more than the net Jobseeker Support of $9,059 (annualised) paid to an unemployed married adult. The current net gain to single sharing and single living alone wealthy superannuitants is even greater: $13,503 and $14,692 respectively, compared to $10,871 (as an annual rate) for a single person on Jobseeker Support.

Figure 1: The current situation for a married superannuitant: disposable income with NZS



Using the tax system

Finding a way for the top line to meet the bottom line in Figure 1 by reducing the generosity of net NZS at the top end is one approach to cost saving. It may reduce the degree to which the other two main levers of raising the qualifying age state pension age or reducing the rate of payment must be employed. As suggested above, both of these mechanisms may impact unfairly on those least able to manage. In contrast only those with significant 'other' income will be affected much by using this tax lever for reform.

To 'make the lines meet' in Figure 1, 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) and discussed further in St John (2013). This reform option means that the flow of tax to the IRD on gross NZS and other income, and the surcharge paid by a superannuitant, is offset against the gross NZS payment from the IRD. Money would flow one way only. The value of this approach is a simplification compared to the very confusing way the surcharge operated.

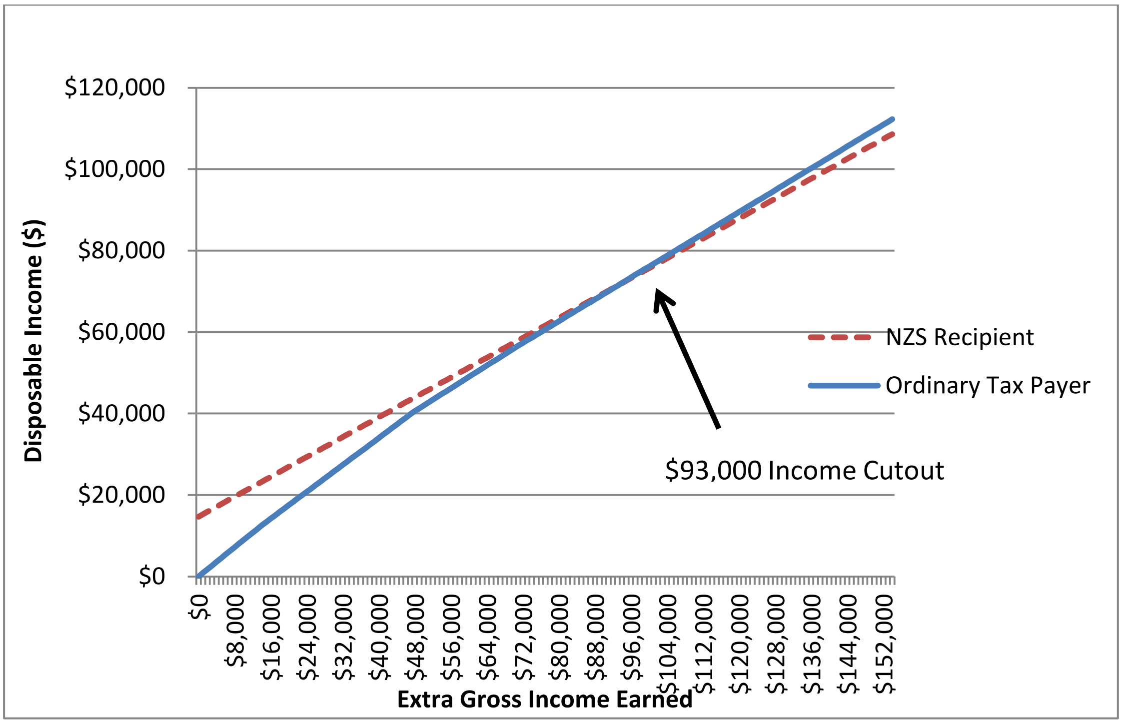
This Working Paper suggests a 'basic income' approach may be simpler to implement and understand. The basic income, named here the 'New Zealand Superannuation Grant'

(NZSG), would be paid to all superannuitants as a weekly non-taxable grant.[16] Then, for any other gross earnings or other income, a separate tax scale would apply for each additional dollar. For illustrative purposes it is proposed that the NZSG is the same for everyone (married; single sharing; single living alone) and any extra supplement for high housing costs would be part of the welfare system.[17] While the NZSG could be set at any level, Figure 1 shows it as equal to the current (after-primary tax) rate of NZS: i.e. $14,677 for a married person.

A break-even point exists (Figure 2) where the NZSG, plus extra income from work or investment, net of the new 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 gain from the NZSG has been effectively clawed back or offset by the new tax. Any over-payments of tax by high income people could be claimed back at the end of the income tax year.

This proposal is technically different to the surcharge of 1985-1998 because the NZSG payment is not part of taxable income. The surcharge was exceedingly complex, applying until the net advantage from NZS was equal to the surcharge paid and could mean different end points (when NZS had been fully clawed back) for different taxpayers. Few could follow the calculations. The surcharge was also perceived as an additional, discriminating tax that could result in marginal rates of tax exceeding 50% (see St John, 1991 for further discussion of how the surcharge worked).

Figure 2: Scenario 1. Flat tax of 39% on other income



NZSG has the further advantage that as a non-taxable grant it is consistent with receiving a private annuity that is also not considered to be taxable income under the

[16] Paying the pension as a non-taxable grant and a progressive tax on other income makes the pension analogous to other universal payments or provisions such as the old Family Benefit.

[17] As shown in Table 3 around 178,000 superannuitants get the single, living alone rate. Of these, many would continue to require a supplementary payment to reflect higher costs. A suitably modified accommodation supplement may be required.

TTE[18] regime for saving for retirement that New Zealand has adopted. If future-focussed decumulation policies require encouraging the translation of KiwiSaver lump-sums into an annuity or into an add-on to NZS, the NZSG approach provides a consistent treatment.

Under the NZSG, an individual could either opt for the NZSG and the new tax scale for all other income, or wait until end of the tax year and take any NZSG due as a rebate. About 40% of retirees who have no additional income would notice no difference. For high-income earners, whether that income is earned from paid work or from investments, the new tax scale would not remove their right to the basic income floor of the NZSG if other income reduces or disappears. Thus the NZSG is the prototype of a basic income that provides automatic income security as of right.

The breakeven point is very sensitive to the tax rate chosen, or in the case of a tiered tax schedule, to the highest rate of the schedule. An example scenario is depicted in Figure 2 with a flat tax at 39% on other income. The breakeven point occurs when the NZSG recipient's 'other' income is $93,000. If a recipient of NZSG receives more than $93,000 then it would be rational for them to either forego the NZSG and be treated as an ordinary taxpayer, or to apply for a refund of any tax overpaid on income above $93,000 at the end of the year.

Given that for 80% of NZS recipients, NZS provides at least 55% of their income (Perry, 2009), a tiered structure may be useful to give some relief to those with limited extra income. Figure 3 illustrates a tiered scenario; with rates of 17.5% for the first $15,000 of other income, and 39% on each dollar above that. The break-even point in this case would be much higher than in Figure 2, at $147,000.

Figure 3: Scenario 2. Two-tiered rate of 17.5% (for first $15,000 earned) and 39% above $15,000

[18] TTE refers to the tax regime New Zealand has adopted for all saving contributions made out of after tax income (T), earnings taxed in the fund (T), and withdrawals tax-free (E).

As with the flat rate example, at an end-of-year adjustment, a rebate would arise if an individual earned less income than the break-even or cut-out point, and did not choose to take weekly payments of NZSG. It is likely that some wealthy people would not bother to receive the NZSG, as happened with the surcharge, however they would have automatic entitlement if they needed it at any point.

The breakdown of annual losses in disposable income relative to current settings is shown in Table 4 for the two scenarios depicted in Figures 2 and 3, at bands 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 of scenario 2.

Table 4: Losses in annual disposable income (rounded)

Other taxable income	Scenario 1	Scenario 2
$5,000	$1,070	$0
$10,000	$2,150	$0
$15,000	$3,220	$0
$20,000	$4,300	$1,070
$25,000	$5,370	$2,150
$50,000	$8,420	$5,220
$75,000	$10,020	$6,800
Around $93,000 cut out for scenario 1	$11,120	$7,900
Around $147,000 cut out for scenario 2		$11,120

Features of the New Zealand Superannuation Grant

The NZSG would be far less complicated than other forms of clawback such as the surcharge, a welfare-type means-test directly on NZS, or even a negative income tax approach. As with any targeting regime, an increase in the degree of targeting will result in some avoidance activity. New Zealand's past experience shows that opportunities and incentives for tax avoidance were features of the history of the surcharge. It must be noted here however that the NZSG proposal is not nearly as harsh as the welfare means-test that applies to rest home care subsidies or welfare benefits. It provides a gentle clawback using the principle of progressive taxation which, it can be argued, is the natural counterpart of universal provision.

Another concern may be that the NZSG would need to be carefully packaged so as not to adversely influence the decision to save. This of course would be much more of a problem with a full means-test including an asset-test rather than the proposed income-test operated through the tax system.

The integrity of the NZSG approach would require that the top PIE rate be aligned so that for the two scenarios given, the top NZSG PIE rate would be 39%. Alternatively, gross PIE income could be included as 'income' to be taxed at 39% less the tax already paid by the PIE on the member's behalf (similar to the imputation regime).[19] The same

[19] There is a case for using a consistent definition of taxable income for everyone, not just superannuitants. Thus extensions to the definition of taxable income, such as apply in Working for Families, might capture other possible avoidance activity.

argument applies to income earned through trusts, companies and overseas vehicles.[20] Treatment of current annuities and defined benefit pensions raise other complex but not insoluble problems. In the past, such annuities were apportioned 50% as income for surcharge purposes. There may also be opportunities. If for example there was desire to encourage annuitisation, an annuity to a limited value could be treated the same as the NZSG grant instead of apportioned 50% as income as a means of making it attractive to middle income people in the absence of compulsory annuitisation (St John, 2015).

Costing

The fiscal saving possible by using the NZSG depends on the decision about the alignment of rates and critically on the tax rates chosen. If the degree of targeting was similar to the surcharge as it operated at the end of the 1990s, savings of the order of 10% or more could be expected (currently $1.2 billion of gross NZS or around $1 billion net NZS).

In modelling the saving from scenarios one and two, costings by the New Zealand Treasury are presented as a percentage of aggregate net NZS expenditure under current NZS regime in that year. Scenario One assumes the alternative tax regime is a flat tax rate of 39% on non-NZS taxable income. Scenario Two assumes a tax of 17.5% on the first $15,000 of taxable income and 39% above that. Costings are run over three consecutive March-end years 2010/2011, 2011/2012 and 2012/2013 to ensure consistency.

The assumptions used by the Treasury are that:

- All eligible people elect the option that delivers the higher disposable income, even if only by $1 per annum. In other words, the only people who turn down the NZSG are those whose non-NZS income exceeds the 'break even' point, where they would end up with the same disposable income under either option.
- There are no behavioural responses, in particular, no change to labour supply or average hours worked by eligible superannuitants.

The true cost to the government of providing the public pension is the aggregate net (after-tax) NZS expense. Relative to its value in each year, costed under the NZS and personal tax regime existing in that year:

- Scenario One (39% tax on all other income) produced overall savings of 22%, 23% and 26%, in the 3 consecutive years respectively; and
- Scenario Two (17.5% of first $15,000, 39% on balance) produced overall savings of 14%, 16% and 18%, in the three consecutive years respectively.

These figures assume an immediate adjustment of all rates to the married rate of NZS. In practice the alignment of the rates would be phased in over time and the savings would increase more gradually. The costings also take no account of the additional supplements required by many of those living alone with high housing costs. Over time, as the baby boomers swell the numbers over age 65, savings will likely increase. This will be reinforced in Scenario Two if the threshold for the second tax rate is unadjusted for inflation.

The rate of NZSG could be set anywhere between the single sharing and married rate. If the rates were immediately aligned to the single sharing rate by raising the married rate

[20] The issues around the need for an overall reform of these vehicles so that they are taxed at the individual's appropriate marginal tax rate are explored in Chamberlain & Littlewood (2010).

there would be much less saving. However there would be little justification for taking this more expensive route to align the rates. A range of costings for each tax scenario using different assumptions about the rate of the NZSG is summarised in Table 5.

Table 5: Costing the savings of using different assumptions for the rate of NZSG paid to all NZS-eligible individuals.

a. The NZSG is the net married person annual amount for all		
Tax year	**Scenario One**	**Scenario Two**
2010/11	22%	14%
2011/12	23%	16%
2012/13	26%	18%
Average of three tax years	**24%**	**16%**
b. The NZSG is the net married person annual amount for all married individuals and the net single sharing NZS annual amount for all single individuals		
Tax year	**Scenario One**	**Scenario Two**
2010/11	16%	8%
2011/12	17%	9%
2012/13	20%	12%
Average of three tax years	**18%**	**10%**
c. The NZSG is equal to the rate that the individual is eligible for under current system i.e. married person, single sharing or single alone rate		
Tax year	**Scenario One**	**Scenario Two**
2010/11	13%	6%
2011/12	14%	7%
2012/13	17%	10%
Average of three tax years	**15%**	**8%**

The comparisons in Table 5 suggest that even if the single and married rates are not aligned so that no-one has a reduction in their net payment (Option c in Table 5), worthwhile savings are possible even with Scenario Two that provides the more gentle clawback.

If the living alone rate is reduced to single sharing rate (Option b in Table 5), more savings are possible (3 and 2 percentage points under Scenario One and Two respectively) but there are extra costs of accommodation assistance to account for. Options a and b have no separate living alone rate: savings are 6 percentage points higher when the single sharing rate is eliminated as in Option a.

The large saving under either tax scenario suggested by Option a would only materialise once the married and single rates were aligned to the married rate, and this may take some time. Nevertheless this may be the appropriate longer term strategy.

Conclusion

This preliminary analysis suggests that the combined approach of: adopting the two-tiered tax scenario, freezing the single sharing rate so that over time there is alignment with the married rate, eliminating the living alone rate, and increasing supplementary assistance for accommodation costs where needed, will give worthwhile and immediate savings of over 10% of net NZS. Savings should then increase gradually over time.

These fiscal savings are possible without imposing hardship or affecting those with modest amounts of additional income and can be achieved relatively sooner compared to raising the eligibility age with an appropriate lead-in time. The inevitable increase in the eligibility age to reflect improved longevity could be more gradual which would reduce the disadvantages for individuals who, given the arduous nature of their employment, may expect to retire from work earlier than others.

The proposed NZSG simplifies the treatment of relationship status by paying a single rate of NZSG for all – a tax-free grant equal to the net amount now paid to a married person. Once phased in, that will simplify the current payment rates and reduce the cost of NZS, although additional payments for those with high accommodation costs would be required.

The NZSG approach does not unduly penalise extra income, depending on the parameters. Given that for the bottom 60% of NZS recipients, as measured by gross incomes, NZS payments comprise at least 80% of their total income, and for the bottom 80% of recipients it comprises at least 55%, the majority of over 65s will face little if any reduction in disposable income, especially in scenario Two. It is consistent with the current arrangements that do not require any retirement test.

As with any targeting regime, efforts to maximise returns will lead to some tax planning activity. However those who should be paying the top rate of tax of 33% already have an incentive to reduce their taxable income and some already pay little or no tax. It is debateable as to whether a marginal 39% tax rate would substantially change behaviour but there is the possibility that it could provide the impetus for a full investigation into, and exposure of, current and potential tax avoidance activities by wealthy individuals. Under the proposed NZSG, a wealthy person would have to reduce taxable income to under $15,000 to avoid the 39% rate completely.

The proposed change would decrease the fiscal cost of NZS through reductions in payments to high income superannuitants and thus allow more spending or lower taxes for younger New Zealand taxpayers. It may therefore lead to improved perceptions of inter-and intra-generational equity.

If it is agreed that the cost of net NZS should be reduced by increasing the degree of targeting, using the tax system and the proposed NZSG has a number of potential advantages compared to other targeting regimes:

- **Relatively simple**: Simplicity in administration when compared to other income tests and the old surcharge.
- **Flexibility**: The choice of tax rates for other income allows flexibility and clarity in reaching a desired breakeven point and required fiscal savings. It also provides

choice and clarity for very high-income superannuitants who are not denied access to the basic income floor of NZSG if their situation changes.

More work is required to determine the scope of income to be included and to limit opportunities for avoidance. NZSG is one of a range of possible reforms to NZS to be considered as a means of enhancing the sustainability of an already world-class retirement system. It moves New Zealand's age pension closer to Australia's age pension. A similar reform in Australia has potential for more harmonisation of state pensions policy.

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