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The Turner Report (with a UK version of KiwiSaver)

Introduction

New Zealand is heading for a year of major superannuation activity with the proposed introduction of the Kiwisaver Scheme from April 2007. The outlined timetable includes:

- February 2006: KiwiSaver Bill introduced into Parliament.
- August 2006: Final stage of Select Committee process.
- October 2006: KiwiSaver legislation expected to be passed.

The timetable for Kiwisaver will also drive changes to the taxation of investment income by the introduction date of April 2007.

It is therefore relevant to review the overseas superannuation development that has arisen in the work of the Pensions Commission in the United Kingdom. On 30 November 2005 the Commission published a report "A New Pension Settlement for the Twenty-First Century ", which sets out conclusions on the likely evolution of the UK pension system if the policy is unchanged, as well as recommendations for a new policy direction.

This article comments on the points in the report which we consider have relevance to New Zealand. Full details on the report (and on the earlier first report of the Commission) are at www.pensionscommission.org.uk.

Outline of the current UK system

The Basic State Pension (BSP) amounts to £79.60 per week and is not means tested. This is supplemented first by a Pensions Credit system and secondly by an earnings related pension, known as the State Second Pension (S2P), the value of which depends both on earnings and period of membership, and is funded on a pay as you go basis.

An average earner who has a fully paid up S2P receives a pension of 37% of their salary. This compares to 70% in Holland, 76% in Sweden and 71% in France. For a person earning twice the average income, the pension drops to 24% of income, while in Holland the rate is 70%, in Sweden the rate is 72% and in France the rate is 54%.

The State Pension Age (SPA), the age of entitlement to the benefit, is 65 for men and 60 for women, but rising for women to 65 by 2020.

Employers can contract out of S2P if their own scheme provides sufficient benefits.

Participation varies significantly in the workforce, from 85% in the Public Sector, 59% in Manufacturing, 41% in Wholesale and Retail, to 14% in the Hospitality industry.

Analysis of current position and trends

The report makes a number of comments.

1. The current generation of UK pensioners is on average doing well. Many pensioners have reasonably generous pensions from defined benefit schemes.

2. The cost outlook to the State is seen as too high, given demographics and increasing age longevity.

3. The State is planning to play a reduced role in pension provision for the average pensioner, on the assumption that private provision will grow to meet any reduction. However, employer-based provision is seriously reducing and is probably in irreversible decline, both in number of employees covered and in the level of benefits provided, primarily due to the switch from defined benefit to defined contribution schemes. The Commission has commented that there is a decreasing belief in good pensions helping retention and recruitment.

4. People are ambivalent in their attitude to compulsion. Many who want to save react adversely to the idea of compulsory saving.

5. Saving through housing may be appropriate for some but not all.

6. Major gaps arise in the provision for those who have had interrupted paid working lives and caring responsibilities, in particular, for women.

7. Rising life expectancy and falling fertility rates impose higher costs in the support of pensioners. The rate at which the SPA is increased will determine whether it is the pensioners or the taxpayers that pay the costs.

Summary of recommendations

The Commission notes that the UK is in a specific group with Ireland, New Zealand and Canada, where the state pension is primarily designed to prevent poverty rather than provide income replacement.

The Commission wants to create a National Pension Savings Scheme, the objectives are which are to:

- strongly encourage individuals and their employers to provide for a pension which will deliver earning replacement income in retirement, and
- enable people to save through low cost savings vehicles.

The Commission also wants to reform the current State pension to underpin private saving through policies which will:

- focus the limited available tax resources on providing as generous a non-means tested flat rate State pension as possible,
- improve the position of people with interrupted paid work histories and caring responsibilities, and
- face the reality of the long-term expenditure and State Pension Age trade-off.

National Pension Savings System proposal

The proposal is to have all employees automatically enrolled into either a high quality employer scheme or a newly-created National Pension Savings System, with the right to opt out.

Minimum contributions above a threshold level (around NZ$12,000) and below an upper level would be an after-tax 4% earnings contribution from members, tax relief equivalent to 1%, and a compulsory employer contribution of 3%.

Contributions would be collected through the PAYE system or a new similar system.

There will be provision for individual savings accounts, with member choice of investment options (default options will be provided).

Additional voluntary contributions will be allowed.

A targeted maximum annual fee for expenses has been set at 30 bps (0.3% of assets).

The expected income level arising for an average earner is 15% of salary on top of the 30% of salary which the Basic State Pension should provide.

Measures will be put in place to ensure that employers can easily continue with their current schemes.

Proposed State income reform

The preferred approach is to:

- move from the current two-tier approach, to a single-tier, non-means-tested benefit, and
- increase the State Pension Age gradually from 65 in 2020, to 66 in 2030, to 67 in 2040 and to 68 in 2050.

While the State Pension Age is planned to rise after 2020 to account for increasing life expectancy, the suggestion is made that the entitlement age for the S2P could be later than that for the Basic State Pension.

Tax relief

The cost of the current regime is significant at £12.3 billion in 2004/05, but no major reforms are proposed by the Commission, due to the complexities that the existing predominantly defined benefit schemes create.

The Commission recommends the creation of a separate tax relief regime for the proposed National Pension Savings Scheme, based on a single rate of tax relief (at 25%), delivered as an upfront matching Government contribution.

Annuity market

The UK system relies on annuities to convert lump sum savings into pensions at retirement. The difficulties of this market are recognised in an environment of increasing longevity and low interest rates. The Commission notes that tax changes may be necessary to encourage the development of annuity products, and that Government needs to continue to issue long-term debt.

An interesting comment is the mention of longevity bonds - presumably instruments under which the Government might assume some of the risk for people living too long when they purchase certain financial products.

Relevance for New Zealand

While the Commission has looked at overseas models for ideas, it does not appear to have adopted any specific New Zealand initiatives, although some concepts are consistent with the design of KiwiSaver.

The first report notes that the United Kingdom is like New Zealand, in that the State provides a flat income level independent of earnings. But the New Zealand benefit level is at a similar level to the total benefit provided by Continental Europe for the average earner, of around 70% of income.

The Commission proposes a model that has a combination of a Basic State Pension, with an earnings-related component delivered through funded private savings schemes linked to individual accounts. The proposal to use the State to collect contributions to such schemes has similarities with KiwiSaver and is made in the context of delivering cost-effective savings schemes to employees.

Of particular interest is the way that the compulsory enrolment idea is combined with tax relief at a flat 25% level and a compulsory 3% employer contribution. These incentives would suggest that employees will initially join and then be willing to remain in a funded private savings scheme.

Initial criticisms of the proposed UK reform are that the proposals for change are not radical enough and that the period for the introduction of the changes is just too long. In contrast, New Zealand has historically shown good ability to make effective changes over reasonable time spans.

It may be that the current KiwiSaver concept needs to consider the UK proposals. It does seem that there is a growing recognition that KiwiSaver is being too ambitious with its housing component and should be redefined solely as a savings scheme. Perhaps the ideas of compulsion and tax relief should also be revisited.

Summary information on the United Kingdom Pension System

Basic State Pension (BSP)

The BSP is a contribution based, non-means-tested weekly pension, payable currently at the rate of £79.60 for a single person and £127.25 for married couples.

The married couple's pension is payable when the spouse has an insufficient contribution record to receive more than 60% of the full amount in their own right.

The BSP is currently payable at age 65 for men and 60 for women, with the women's age rising to 65 by 2020.

Eligibility is based on National Insurance contribution history, not on citizenship or residency.

Contributions are 11% of employee earnings between the Primary Earnings Threshold and the Upper Earnings Limit and 1% above the Upper earnings Limit.

The self-employed make contributions of £2.05 each week together with 8% of annual profits between £4,745 and £31,720 plus 1% of annual profits above £31,720.

The BSP can be deferred, in which case the pension increases by 7.5% for each year of deferral. A proposal to have the pension increase at 10.4% has been made.

Pension Credit

Pension credit is a means-tested benefit available to people aged 60 and over. It has two elements:

Guarantee Credit – increases income up to a particular level (£105.45 per week for a single person in 2004/2005).

Savings Credit – available to people aged 65 and over. A further top-up that matches pre-benefit income but tapers away as income increases.

The pension credit serves to encourage saving for lower earners while discouraging saving for higher earners.

State Second Pension (S2P)

The S2P is a mandatory, earnings-related second tier pension for employees.

An employee earning between the lower earnings and the upper earnings threshold (£5,200 and £11,400) accrues an annual pension increasing linearly from £60 to £90.

A person earning between the lower earnings limit and the lower earnings threshold (£4,200 and £11,400) accrues an annual pension of £60.

A person earning between the upper earnings threshold and the upper earnings limit (£26,500 and £32,200) accrues an annual pension increasing linearly from £90 to £110.

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