MICHAEL JONES

REFORMING NEW ZEALAND WELFARE

INTERNATIONAL PERSPECTIVES

THE CENTRE FOR INDEPENDENT STUDIES

Policy Monographs 37

MICHAEL JONES

REFORMING NEW ZEALAND WELFARE

INTERNATIONAL PERSPECTIVES

THE CENTRE FOR INDEPENDENT STUDIES

1997

Published June 1997 by

The Centre for Independent Studies Limited.

Views expressed in the publications of The Centre for Independent Studies are those of the authors and do not necessarily reflect the views of the Centre's staff, Advisers, Directors or officers.

National Library of Australia

Cataloguing–in–Publication Data:

Jones, M.A. (Michael Anthony).
Reforming New Zealand welfare : international perspectives.

Includes index.
ISBN 1 86432 024 9

1. Welfare state. 2. Social service - New Zealand. 3. Public welfare - New Zealand. I. Centre for Independent Studies (Australia). II. Title. (Series : CIS policy monographs ; 37).

361.993

Book cover and design by Daryl-Anne Le Roux
Printed by Merino Lithographics, Moorooka, Queensland.
Typeset in Garamond 10pt.

Contents

Tables

Figures

Key Points

- there is intense worldwide debate about the future of welfare states
- the debate is driven by concern about rising costs and the social consequences of long term dependency

- welfare systems develop incrementally in response to particular problems
- reform also tends to be incremental, with major reforms being rare in any country
- market ideas are less influential in welfare policy because of problems in their application and the opposition of strong vested interests
- there has been a shift to governments wanting to be 'developmental states' rather than 'welfare' states, with an emphasis on equipping people for self-sufficiency

- New Zealand has not given enough consideration to long-term welfare issues
- New Zealand's welfare system has been generous by world standards
- it has given the aged particular preference by not linking retirement income to work history and by paying them more than other welfare recipients

- poverty is a concept with many meanings
- how living standards are assessed, whether absolute or relative standards are used and where poverty lines are drawn significantly affect the proportion of the population classified as being in poverty

- perceptions of inequality are an obstacle to economic change
- rising inequality is a worldwide phenomenon
- explanations include downsizing and unemployment, globalisation, technological change, the shift to a service economy, immigration and family break-up
- income inequality in New Zealand rose in the late 1980s, probably due mostly to unemployment
- wage inequality also rose, though it has been declining for female workers since the early 1990s

- New Zealand, in common with other western countries, has an ageing population
- the aged in the population as a proportion of those in the workforce is projected to more than double between 1980 and 2040
- the number of very elderly people requiring expensive care is increasing
- costs could be reduced by increasing the age of retirement and more means testing
- a more fundamental way of dealing with financing the aged is to privatise retirement
- each individual provides for his or her own retirement through an individual retirement account, as in current superannuation schemes

- solutions to the problems of non-aged dependency are less clear
- there is an increasing tendency to put time limits on receiving benefits
- improving the skills possessed by those on welfare is important

Foreword

Around the world there is deep dissatisfaction with the welfare state. This dissatisfaction has several sources. There is worry that for many of the worst-off life is not improving; that to the contrary the rise of an underclass is evidence that the worst-off are falling further behind. There is concern at the rising costs of social security systems, and especially the long-term implications of a large class of people – especially single parents, the unemployed, and the elderly – heavily reliant on public sector income support for extended time periods. There are fears that issues of intergenerational justice will create divisions between the generations, with younger people being taxed so heavily to assist the elderly that they will be unable to provide adequately for themselves and their families.

These dissatisfactions are present in New Zealand, but less discussed than in other parts of the world. While New Zealand has been an international leader in economic reform, it has not moved so quickly on welfare issues. As Michael Jones' *Reforming New Zealand Welfare* demonstrates, New Zealand, in common with other western countries, faces major problems financing its elderly. He suggests that New Zealand moves to a system of self-funded retirement, with each individual contributing to a personal retirement account over their working lives. While on libertarian grounds a voluntary system is clearly preferable, Jones argues that a compulsory scheme, up to a certain proportion of annual income, is necessary to minimise the number of people who will have to rely on tax-supported state pensions. Self-funded retirement may end up being the biggest privatisation of them all, giving average citizens, via superannuation funds, a stake in New Zealand's private sector prosperity instead of an interest in state-sponsored wealth redistribution.

While *Reforming New Zealand Welfare* pays particular attention to the problems of ageing in New Zealand, its subtitle – *International Perspectives* – is important. Michael Jones draws on a wide reading of the world literature on welfare, poverty and inequality in discussing the New Zealand situation. Despite important differences between countries, there is much they can learn from each other.

In New Zealand, as elsewhere, there is concern that despite the success of economic reforms they have come at a high price. How high that price might have been is very hard to tell in New Zealand, because its statistics are not good by international standards. It is likely, though, that the long term negative effects have been exaggerated. Any transition will cause disruption, but the important issue is how does the situation in New Zealand now compare with what it would have been had governments continued with the old anti-market policies?

The likely result would have been not the good growth of the last few years, but continuing decline, with lower living standards for all and limited resources available to assist the dependent. Throughout the transition period New Zealand's welfare system has been more generous than in most other countries. This generosity is possible only in a growing economy.

The Centre for Independent Studies is committed to encouraging thinking about the future in Australia and New Zealand. *Reforming New Zealand Welfare* has a particular proposal for New Zealand, but analysis of welfare relevant to both.

Greg Lindsay
Executive Director

About the Author

Michael Jones teaches in the Faculty of Management at the University of Canberra. He is the author of many books on social policy, including *The Australian Welfare State: Evaluating Social Policy* (1996), now in its fourth edition; and about local government, including *North Sydney 1788-1988* (1988) and *Transforming Australian Local Government: Making it Work* (1993).

Chapter One

Introduction

'Germany's unity has developed so much new energy and created new interests and points of view. But oh! The social question! It makes all governments shudder.'

Otto von Bismarck, German Chancellor, founder of the modern welfare state, circa 1889.[1]

There is intense debate in western countries about the future direction of welfare states. Existing welfare systems were designed in a very different era, to deal with social problems at a particular point in time. This book aims to apply the rich recent international literature on social policy issues to the New Zealand situation. Simple solutions to complex social problems are not available. New Zealanders need a renewed discussion about justice, rights, and deserts; and the generations have to negotiate an equitable balance between receipt of and payment for benefits.

Balancing economic change with social welfare is a central issue in all western countries. The pursuit of a more efficient economy is compatible with the pursuit of equity so long as social policies are carefully designed. If social issues are neglected, there is a real possibility that powerful groups will reverse economic reforms.[2] Stagnant or declining economies eventually face pressures to reduce welfare benefits or face a fiscal crisis. Only expanding economies can create the new wealth that is the basis for higher living standards for all, including those on government benefits, and quality public services, especially for education and health. Welfare systems have to become positive, promoting human and social capital, national savings, and international competitiveness. In the past, the New Zealand cash benefit system has been largely reactive, responding primarily to the consumption needs of those considered in distress.

New Zealand has been admired for its economic reforms over the past decade. While other western countries, especially in Europe, stagnated, New Zealand implemented major changes: it transformed the tax system, liberalised financial markets, promoted low inflation, reduced subsidies to industry and lowered tariffs, downsized the public sector through privatisation or greater competition, and deregulated the wage-setting system. It now has the tenth most competitive economy in the western world, well ahead of Australia which was rated seventeenth.[3] The New Zealand reforms are now being adopted, or at least studied, in many countries around the world.[4]

New Zealand's reforms have been focused on improving economic efficiency to increase the rate of economic growth. Changes in social policy have been designed primarily to reduce government spending and to strengthen the incentives to work for those potentially in the workforce. Critics both in New Zealand and overseas have claimed that these economic changes, however necessary, created high levels of social distress: economic gain was accompanied by social pain.[5] Some groups have been hurt by reforms, but many have also benefited from the return to a rapidly growing, high employment, economy. We can never prove what would have happened had the major reforms not been introduced. It is likely, however, that living standards would have declined if New Zealand had failed to implement its extensive economic reforms.[6]

The debate about New Zealand's extensive reforms misses the main point if it focuses only on social distress. The distribution of the costs and benefits of radical economic change is essentially a short term issue, a problem of managing a transition to a more open, competitive economy. Those who lose in the short term can be compensated. Long term, large scale social dependency, that can persist even in a growing economy, is a far more complex question that has not been addressed in the New Zealand debate so far. Complex economic changes require a reexamination of central social policy issues: how to define a minimum 'poverty line', the basis of an adequate 'social safety net'; how to reduce long term dependency of the unemployed and single parents; and, probably most importantly, how best to provide for long periods of retirement of an ageing population

While New Zealand has become a far more free market economy in the past decade, it still has an elaborate and comprehensive system of programs to assist a wide range of specific groups in need. In 1996, with a growing economy, there was still a high level of social dependency in New Zealand. There were 1,076,078 (30 per cent of the population) men, women, and children on government-funded benefits for retirement, unemployment, domestic purposes, invalidity and other needs.[7] Some of these people had other resources – especially those on retirement benefits – but a surprisingly high proportion were dependent mainly on government payments.

Benefit cuts and a growing economy have reduced the recent cost of welfare state cash benefits (excluding health) in New Zealand to around 10 per cent of gross national product in 1996, a significant reduction from the 13.4 per cent of 1991. Cash benefits amounted to 8.1 per cent in 1949, 7.3 per cent in 1963, 6.2 per cent in 1971, 9.12 per cent in 1980, and were 10.7 per cent in 1984, before the period of radical reform in New Zealand's economy.[8] Of course, the composition of this expenditure has changed significantly over the period since 1949. Expenditure on the aged in 1949 was close to outlays for family allowances designed to raise children's living standards. In more recent decades, outlays on the unemployed, single parents, and the aged dominated. New Zealand now spends comparatively little on cash benefits for working families with children. The *level* and *nature* of modern dependency are the disturbing issues to be addressed here.

New Zealand social welfare arrangements – especially for the retired, the single most expensive group on benefits – have largely been quarantined from much of the major transformation of the rest of the economy and the public sector. New Zealand Superannuation was means tested lightly through the last decade via an income tax surcharge, though even this has now been abandoned once again. Since 1992, the retirement age has been raised from 60 to eventually be 65 by the year 2001, reducing the numbers eligible for New Zealand Superannuation by about 24 per cent. Other benefits, especially for unemployment and single parents, were reduced in 1991. But the changes were in many ways merely a reversion to the relativities between the aged and other groups that had existed in the past. A recent comprehensive review of western welfare states found that New Zealand's non-contributory benefits, even after the reductions in 1991, were still among the more generous of affluent western countries, partly because they were not related to past work history or present work requirements.[9]

The level of social dependency in New Zealand may have little direct relationship to comparatively recent economic reforms. Most western countries with sophisticated public welfare systems have experienced similar growth in dependency, even though most have not yet introduced comprehensive economic reforms on the New Zealand model. Many countries seem complacent about the long term ageing of western societies. This highly significant development – and its serious cost implications – is something that will not dominate until the second and third decades, or even later, of the next century.

Reforming welfare systems is more difficult than changing many other parts of the economy. Privatisation and deregulation initiatives had a solid, if controversial, foundation in economic and political theory. These reforms have now been systematised, and are being applied to both rich and poor countries. Governments may have largely exited from many other parts of the economy, but is still the dominant source of expensive programs in social welfare. Pro-market strategies such as privatisation and competition have had remarkably little impact on central income maintenance welfare programs in New Zealand, although such ideas have had more influence in health policy.

One important strand in the western welfare state emphasises some minimum standard of living that no one should be allowed to fall below. This minimum changes over time and is interpreted differently by each country. Poverty thresholds are far more generous in Sweden, for example, than in the United States. The best known aspects of the welfare state are the specific cash payment programs designed for the aged, the disabled, the sick, the unemployed, single parents, and other social groups deemed to be in need of significant government assistance. New Zealand, like other western governments, has also placed particular emphasis on intervening in private markets for housing and health to ensure more equitable outcomes. This book focuses on cash benefit payments, especially for the aged, unemployed, and single parents because these programs account for most social expenditures and these groups pose the most difficult problems of long term reliance on government benefits.

Readers need an overview of the complex differences between welfare systems in different countries. The book begins in Chapter Two by developing a framework for examining alternative welfare state designs. Each western country has developed a unique welfare state that defies credible classification. Every country has problems with its welfare system. Each has some lessons to offer – sometimes on what *not* to do. The term 'welfare state' – which means something different in each country – is used in this book to refer to the many government strategies that effect income distribution and standards of living, especially, but not entirely, for the lower income members of the society.[10]

New Zealand has a unique welfare state, and, in some respects a particularly generous one, because benefits are in no way related to specific work contributions. In particular, few other western countries are as generous to their aged who receive benefits not conditional on work histories. New Zealand and Australia are the only western countries not to have formal two tier governmental welfare systems –

that is one set of benefits related to past work history and income, and another more basic set available to all upon a means test. New Zealand has, at various times, had two tier benefits with a universal superannuation for all of the aged together with a means tested old age pension. But a single tier system with a flat-rate of age benefit has always been a strong underlying philosophy. In Western Europe and North America where two tiers are common, the lower tier, usually called 'social assistance' is means tested, and is paid to those in need because of inadequate incomes.[11] It is designed to alleviate poverty. The level of assistance varies but is well below the second tier of contributory social insurance benefits which usually pay out earnings-related sums to those who have worked for decades and have paid more in contributions.

In Europe and North America, the second and higher benefit tier – usually called social insurance or social security – is financed from employee and employer contributions and rewards those with long work histories with pensions that are a high proportion of former earnings. The two tier system that dominates western welfare arrangements with the exception of New Zealand and Australia has its problems, and these will be discussed at various points in the book. But the one tier system in New Zealand and Australia is the source of many of the dilemmas in social policy in recent times. Relatively high and often long term unemployment, and increasing levels of single parenthood, create new problems in western countries. The New Zealand single tier system with benefits paid regardless of work histories was designed when these latter problems of long term dependency were largely absent.

Because welfare systems are dominated by incremental decision making a knowledge of their history is important and this is covered in Chapter Three. New Zealand's welfare arrangements have been remarkably resilient and resistant to major change. The existing welfare system still bears a striking resemblance to that created by Prime Minister Michael Savage in 1938. New Zealand can only reform its welfare system if it allows itself to become more critical of its past efforts.[12] The Savage welfare state, we may have to realise, was a mistake or an attempt to create a 'utopia', that was quite unsuited to postwar New Zealand.

As stated earlier, New Zealand leads the world in applying free market economic ideas to improve efficiency and promote economic growth. Chapter Four examines thinking by economists around the world on how to reform social policy to promote efficiency and equity.

Economists dominate research and debate on welfare systems and this chapter examines the recent iconoclastic world debate on welfare problems. Economists are examining welfare systems with more rigour than in the past, and make interesting points about the varieties of social protection, how to provide against market failure, the complex trade-off between efficiency and equity, and the role of globalisation, technological change and human capital in explaining poverty and inequality. Almost all economists stress the importance of investment in human capital to reduce dependency and create an adaptable workforce. The 'welfare' state is being replaced by the 'developmental' state, as governments have to maintain a high level of international competitiveness in a ruthless world economy. Welfare benefit systems can be a major source of uncompetitiveness, because they require high taxes that can drive business away, and can weaken incentives to work, save, and honour family responsibilities. Further, New Zealand's welfare benefits for the unemployed, single parents and the sick and invalids are means tested, and this creates incentive problems that are difficult to overcome. It can become economically 'rational' for some low income people not to work. Other social scientists than economists are also developing some useful models for understanding modern social problems, and these are also discussed in this chapter.

Trends in poverty and inequality over the past decade, and the issues and the complex debates about them are tackled in Chapters Five and Six. There is a widespread international belief that modern structural economic reforms that emphasise greater use of the market inevitably increase poverty and inequality. In a number of countries, especially Britain and the United States, both the numbers and proportions living in 'poverty' have risen over the past few decades, while the gap between the rich and the poor has widened. These trends are well documented. There is evidence – although the information is not extensive – that similar if less marked trends have emerged in New Zealand. These chapters also examine the recent extensive world research on the causes of increasing inequality in western countries.

Some economists place most of the blame on global labour markets, arguing that now only the highly skilled segments in western labour markets can compete with the far lower wages in developing Asian countries. Footloose global firms search out the most profitable locations, and can obtain low skilled labour far more cheaply in some developing countries than they can in more developed countries such as New Zealand.

Others blame large scale technological change for increasing inequality and high levels of dependency in western countries. Modern technology means that corporations and governments can manage downsized operations with fewer employees than in the past. Technological change does not only affect the unskilled, for many large organisations have removed entire layers of management which have been made obsolete by new information technologies. Displaced labour is not always employable without expensive retraining, and some European countries have forced workers over 50 to take early retirement on the assumption they have no role in new industrial economies. American economists, in particular, blame increasing inequality on the service industries that now dominate western economies. Service employment, so the critics claim, is poorly paid, produces limited career structures, and has low rates of productivity improvement.

Another cluster of explanations centre upon deregulation of wages and more competitive industry environments which can lower wages, as firms compete with new entrants not handicapped by the high costs of older firms. Unions lose much of their power to hold up wages in a deregulated global economy. Modern technology may create 'winner take all' markets where vast rewards go to a few individuals. Large scale low-skilled immigration is blamed by some for lowering wages and increasing social dependency.

The most pessimistic welfare researchers, found among economists in the United States in particular, argue that the nature of dependency has changed in western countries because dependency is frequently a long term experience. Long term dependents have formed an 'underclass': they have become accustomed to not working, develop deviant lifestyles, have unstable family patterns, and pass these habits on to their children. Governments have few tested ideas on how to solve the problem. In 1996, the United States passed significant legislation to 'end welfare' by allowing the States to implement new systems that limit the time on welfare and require beneficiaries – mainly single parents – to work. This policy experiment has important implications for all western countries that face similar problems.

Not all agree with the underclass theory, and optimists claim that the high level of dependency in western countries today is merely a transitional problem. Rapidly changing western economies have created a temporary surplus of lower skilled workers, who will eventually retire from the workforce, which will then absorb more highly qualified and younger labour market entrants. The book focuses on the relevance of these extensive international debates to New Zealand social policy.

But the greatest concern among western welfare analysts is perhaps about the effects of population ageing on future welfare spending and this is the subject of Chapters Seven and Eight. In New Zealand, men at 65 can now expect to live an average of fifteen years while women can expect nearly nineteen years. If the age of eligibility for New Zealand Superannuation was adjusted to equal average periods on the aged pension in 1900, the eligibility age would now be 75 for men and 80 for women.[13] This extension of life spans for many people means that policies designed late last century cannot be the basis for the next century. New Zealand, like most western countries, has done little to prepare for the radically different age-dominated society of the next century. Old age can be an opportunity for a new 'third age' in life, not a problem, if funding systems are changed to ensure most of the aged are largely financially self-supporting through a system of contributions while in the workforce.[14] A society that places emphasis on employment can scarcely then arbitrarily define age 65 as the end of the working life. The aged may not want to work to age 65 or even 70, but it is difficult to see why a younger generation should or can pay for their elders' decades of leisure. Our notions of 'retirement', like savings and pensions, all need to be reconsidered.

Social insurance systems in most of the rest of the world face large financial deficits now or in the near future because they have been too generous in levels of payment to the aged. New Zealand faces similar problems, but as yet is more relaxed about them. This complacency may be misplaced, because in the future, the aged may well live longer and retire earlier than any government anticipates and both these trends have been apparent internationally for the last 25 years. Moreover, ageing is expensive not only because of government pension costs, the sole concern in this study. The aged are major users of expensive health care facilities. Some will also need long term and expensive social care and, while not in need of hospital care, they often require assistance with daily tasks.

In the face of these escalating costs of the aged, New Zealand urgently needs to examine whether it should move towards a fully funded defined contribution pension scheme, a variant of which is now being implemented in Australia.[15] Some economists claim that such a scheme has major benefits for the economy now, as well as coping with the ageing crisis next century: others are more sceptical. The issue is particularly urgent in New Zealand which has a serious population ageing problem, very low levels of household savings, and treats its aged relatively generously, at least in comparison with Australia. Chile is the only long term working example of self-funding retirement though it is very different from New Zealand, and the true testing of the success of those policies will not come for some decades yet. It will be decades before the new Australian scheme can be evaluated comprehensively. Potentially, self-funding retirement can provide dignity, self-reliance and adequate living standards for the aged who will predominate in New Zealand and other western countries.

New Zealand has received worldwide praise for its innovations in fiscal responsibility, and for honesty about its government's real financial position and future liabilities. But the true state of government fiscal health cannot be determined without examining the costs of future welfare benefits, particularly to the aged. It is a logical next step to develop and publish generational accounts that clarify who benefits and who pays for welfare state programs. The New Zealand Treasury has prepared intergenerational accounts, although accurate generational accounts are very difficult to prepare and subject to serious inaccuracies.[16] It is difficult enough to prepare generational accounts for the past, although the historian David Thomson had made courageous attempts to do so for New Zealand.[17] It is far more difficult to prepare such accounts for the distant future, and yet they are important to all good planning.

The book concludes with an examination of some recent proposals for welfare state reform. Controversial reform ideas from the United States are discussed as well as more constructive strategies that focus on developing human capital. These reforms may be relevant to the several groups in New Zealand society of serious concern to social policy makers. Economic growth has reduced the numbers of unemployed, but longer term unemployment may help create a dependent 'underclass' – often with children – who may be largely uninvolved in the mainstream economy. New Zealand has a comparatively high number of single parents, dependent on government support. Single parenthood may become a permanent lifestyle amongst certain groups and be transmitted between generations.

New Zealand is soon to have a referendum on whether to move towards a greater degree of self-funded retirement to raise national savings and ensure a higher and more secure standard of living for the aged next century. The book argues that New Zealand's current policies provide no coherent strategies to cope with a rapidly ageing population. Under present arrangements, many of the New Zealand aged will lead uncertain, high-risk lives, reliant on handouts from government that can be changed at any time. It is difficult for New Zealanders to plan for their retirement five years ahead, let alone decades ahead as should be possible in a well-planned welfare state.

Thrift was once one of the great western social virtues, and higher savings are still the key to reducing the scale of western welfare states. Very low savings levels mean that most households in trouble have become totally dependent on government assistance. To maintain high living standards, New Zealand must continue to reform its welfare system and to reward those who save, work, and maintain responsibilities to dependents.[18]

Policy makers who created the foundations of the modern New Zealand welfare state in 1938 would probably have been horrified at the thought of having 30 per cent of the population – the figure in 1996 – dependent on government benefits. Dependency expanded gradually without precipitating any distinct national crisis that might have focused attention on systematic reform and New Zealand's social policy remains dominated by piecemeal changes. The neglect of social policy is in part a result of the sheer scale and complexity of the other reforms carried out in New Zealand. Structural economic reforms have largely been completed: it is now time to apply the same systematic scrutiny to social policy.

References

1 Quoted in Hugh Heclo 'The Social Question', in Katherine McFate, Roger Lawson, William Julius Wilson eds *Poverty, Inequality and the Future of Social Policy*, Russell Sage Foundation, New York, 1995, p. 666. Originally from Ernst Engelberg *Bismarck*, Siedler Verlag, Berlin, 1990.

2 This reaction against capitalism is the main theme in Robert Skidelsky *The World After Communism: A Polemic For Our Time*, Macmillan, London, 1995.

3 Fred Brenchley 'Australia rises to 17th in global competitiveness', *Australian Financial Review*, March 27, 1997, p. 10. This article reports on the latest world competitiveness report compiled by IMD, the Swiss business school.

4 The intense international interest in New Zealand's reforms is shown by the comprehensive article by Lewis Evans, Arthur Grimes, Bryce Wilkinson, and David Teece 'Economic Reform in New Zealand 1984-95: The Pursuit of Efficiency', *Journal of Economic Literature*, vol. xxxiv, December 1996, pp. 1856-1902.

5 Excellent summaries of two major researchers of the social effects of New Zealand's economic reforms are Robert Stephens 'Social Services' and Brian Easton 'Income Distribution' in Brian Silverstone, Alan Bollard and Ralph Lattimore eds. *A Study of Economic Reform: The Case of New Zealand*, Elsevier, Amsterdam, 1996, pp. 451-95 and 101-38.

6 There are similarities to the continuing debate about what happened to living

standards in Britain during the industrial revolution in the nineteenth century. The debate still rages, but there is some consensus that while many people were hurt, the alternative was greater poverty in a poorer, less industrialised country. See Jeffrey G. Williamson *Did British Capitalism Breed Inequality?*, Allen and Unwin, Boston, 1985.

7 This figure is taken from the *Annual Statistics Report of the Department of Social Welfare, 1996*, Wellington, 1996, pp. 4 and 10.

8 The 1996 figure is from *Annual Statistics Report of the Department of Social Welfare 1996*, Wellington, 1996, p. 1. The 1991 figure is from Statistics New Zealand *New Zealand Official Yearbook* 1996, Wellington, p. 135. This statistic has been published in the Yearbook for the period since 1945, although the detailed basis of the measure has changed over time. It is a useful general measure of the scale of welfare payments. Earlier year figures are from the various Yearbooks.

9 Tony Eardley, Jonathan Bradshaw, John Ditch, Ian Gough and Peter Whiteford *Social Assistance in OECD Countries: Country Reports*, HMSO, London, 1996, p. 315.

10 Nicholas Barr, a leading welfare state economist, said 'Defining the welfare state continues to baffle writers and, as with poverty, much high-grade effort has been wasted in the search'. Nicholas Barr 'Economic Theory and the Welfare State: A Survey and Interpretation, *Journal of Economic Literature*, vol. xxx, June 1992, p. 742. See also Robert E.Goodin *Reasons For Welfare: The Political Theory of the Welfare State*, Princeton University Press, Princeton, 1988, pp. 6,7,10,11.

11 See Tony Eardley, Jonathan Bradshaw, John Ditch, Ian Gough and Peter Whiteford *Social Assistance in OECD Countries: Country Reports*, HMSO, London, 1996.

12 New Zealand had two Royal Commissions on its welfare state: in 1972 and 1988. Both accepted the basic soundness of existing policies and recommended marginal changes. In fairness, overseas critical research on welfare states has largely been published after 1988. See *Royal Commission on Social Security in New Zealand*, Wellington, 1972. *The Royal Commission on Social Policy*, Government Printer, Wellington, 1988.

13 These figures are discussed in a later chapter. The information on 'survival rates' by age group are available in New Zealand Statistics *Demographic Trends 1996*, Wellington, 1996, p. 88 while figures on comparable survival rates at the turn of the century are in *The New Zealand Official Year book, 1915*, Wellington, 1915, pp. 195-7.

14 The 'third age' is from Peter Laslett *A Fresh Map of Life: The Emergence of the Third Age*, Harvard University Press, Cambridge, 1991.

15 A fully funded scheme for New Zealand is analysed in Roger Douglas *Unfinished Business*, Random House, Auckland, 1993, pp. 155 ff.

16 See Laurence J Kotlikoff *Generational Accounting: Knowing Who Pays, and When, for What We Spend*, Free Press, New York, 1993; Alan J. Auerbach, Bruce Baker, Laurence J.Kotlikoff and Jan Walliser *Generational Accounting in New Zealand Is There Generational Balance,?* Treasury, Wellington, 1995; Congress of the United States Congressional Budget Office *Who Pays and When? An Assessment of Generational Accounting*, Washington, 1995.

17 David Thomson *Selfish Generations? How Welfare States Grow Old*, The White Horse Press, Cambridge, 1996 (2nd. edition).

18 David Green has detailed many useful specific reform ideas in his recent book *From Welfare State to Civil Society*.

Chapter Two

Alternative Welfare System Designs

Each country has developed it own mix of approaches to social welfare over the past century, and this confuses debate when comparisons are made. This chapter examines different types of welfare arrangements in an attempt to understand the New Zealand system and the range of alternatives available in the future. A clear appreciation of different welfare arrangements is crucial to any debate about the future shape of a New Zealand welfare system. Recent books on welfare systems describe a sense of crisis in most countries, as schemes designed for an immediate post 1945 – or even earlier – world, face serious problems because of high unemployment, increasing income inequality, ageing populations, and weakening family structures. Fiscally pressed governments opportunistically cut where they can, but few are taking the long view. Incremental downsizing is likely to be ineffective in the long term.

Welfare systems reliant mainly on the family

The family was the main source of social assistance before the development of modern welfare systems. Families – and especially women – still provide most caring services in modern economies through looking after children, older people and others who need assistance. 'Family welfare' in the European past varied widely over place and time, but in the later nineteenth and early twentieth centuries was usually organised around a clear division of labour between men and women: the man was the wage earner and the woman looked after the children, the aged parents (less commonly) and other household matters. To be viable, family based welfare systems require women to be content with their housewife role, need relatively small families so that large numbers of children do not cause poverty, and wage systems that ensure that the male earner can support a family above a poverty level. Family welfare systems also need stability in relationships to ensure that one parent is not left to raise children alone.

Family-based welfare systems have weakened in many western countries. Most women work outside the home for pay, divorce levels are high, and substantial numbers of children are raised in poor, single parent households. Further, feminist writers are often hostile to family welfare systems which are usually designed by men who regarded women primarily as housewives.[1]

Family-reliant welfare, however, is still very important in some parts of the world, and constitutes the main form of social support in poorer countries where western-style welfare systems are generally non-existent.

Western researchers are now taking more interest in the strong family-based 'Confucian' states in Asia, especially those of Japan, Hong Kong, Singapore, South Korea and Taiwan.[2] These countries are (Japan and Singapore for example) either richer than much of the west, or have strong economic growth. They benefit from high rates of national savings and investment, in part because state welfare expenditures are low. Governments there can focus on physical and social infrastructure spending because they are able largely to avoid the massive consumption expenditures of western welfare systems.[3]

Strong family systems there provide the social supports expected from the state in western countries. In 1990, for example, around six in every ten elderly persons in Japan resided with their children or other relatives, a far higher percentage than in New Zealand or other western countries.[4]

In 1996, Singapore created a Parents Claims Tribunal to examine cases of need amongst the aged, and to order children to pay for the upkeep of their parents. Although 95 per cent of the aged in Singapore already live with or receive other help from their children, the government is intent on forcing the remaining five per cent to honour their responsibilities.[5] New Zealand, like other western countries, has mechanisms for making delinquent absentee parents pay towards the upkeep of their children, but has been reluctant to press similar obligations on children towards their parents, at least since World War Two. Countries such as Singapore see little difference in the principle of reciprocity between parents and children and children and their parents.

Communitarian welfare systems

Even strong families cannot always cope with every contingency, and through history a variety of community responses have emerged. One group of such can be called communitarian welfare systems based upon voluntary support of fellow citizens. Voluntary organisations once provided major resources to those in need and still do in more limited ways.[6] Those who began creating western welfare state systems around the turn of the century claimed that the existing voluntary agencies could not cope with new sources of social needs, such as the growth in the numbers of the dependent aged. State aid, it was charged in turn, weakened voluntary agencies.[7] Voluntary agencies are still important, but their resources are modest in comparison with the vast scale of social transfers through government or occupational welfare systems. Western welfare systems are usually managed by central governments, remote from local communities. Switzerland, a country with an unusually strong civil society, is the major exception, and has retained local government control of social assistance, with 3,000 different systems for its seven million people.[8] Of late, there has arisen a renewed 'communitarian' movement in western societies that aims to strengthen voluntary organisations as sources of community support.[9] There is now growing interest in writers such as David Green, and a revival of the 'civic community' of family, community, churches, local authorities, private enterprises and voluntary associations.[10]

Communitarian ideas, with the stress on voluntary action and personal responsibility, may not be immediately practical, but they provide a valuable intellectual foundation for longer-term reappraisal and reconstruction of western welfare systems.[11] Empirical evidence suggests that local communities, once the source of much social assistance, are now weak in western countries, and cannot always carry a heavy welfare burden.[12] Moreover, the American conservative historian Gertrude Himmelfarb, while sympathising with communitarians who want to strengthen 'civil society', points out that 'civil society has been infected by the same virus that has contaminated the entire culture: irresponsibility, incivility, a lack of self-discipline and self-control'. Indeed, the family itself, the keystone of civil society, is in disarray, insists Himmelfarb, while pointing to the prevalence of divorce, single parent families, fatherless children, illegitimacy, and promiscuity (especially among teenagers).[13]

Further, most western societies have a strong individualist base that counters moves towards more communitarian approaches. Even so, government reforms can encourage self-help, and provide incentives to strengthen local communities and voluntary activity.[14] These new programs, however, often require coercive government action, quite different to the softer 'grassroots' movements supported by communitarians. In the United States, the widespread adoption of 'community policing', based on the ideas of American academic James Q. Wilson, appears to be the most significant example of applied communitarian thinking. Fear of crime means that local community organisation is becoming stronger, but often in coercive ways.[15] By all accounts, however, community policing has been very effective, showing that communitarianism can be practical.

Both the ideas of family-based Confucian welfare states and the communitarians have been influential over the past decade, because they focus on personal responsibilities as well as rights. John Gray, a leading western philosopher, claims that the superiority of Confucian philosophies of responsibility has destroyed the credibility of the western emphasis on rights. Gray advises post-Communist states to ignore western welfare models and perhaps look to East Asia for more viable models to copy.[16] Gray thinks Western welfare states have proved to be expensive, perpetuate dependency, and weaken families and communities.

Western welfare systems, the communitarian critics argue, have only emphasised the rights of people to benefits. But families and communities are all about the balancing of individual rights with reciprocal responsibilities. Strong communitarian values in affluent countries such as Japan mean that poverty is still socially shameful. The Japanese poor keep a low profile and obtain only minimal assistance from the state. More than 200,000 government-appointed neighbourhood 'welfare commissioners' monitor those in need, ask employed relatives to help and may even ask employers to pressure the employed relatives if they are reluctant to help. The number of Japanese receiving poverty relief from governments has fallen by a third since 1985 and is now only one per cent of the population, well below the level in western countries.[17]

There are signs that Japan is moving slowly towards adopting more of the features of western welfare states as social and economic conditions change, and a younger generation emerges with weaker family-orientated values. Divorce rates are still only one-third the level in the United States but are rising, as are the number of single parents.[18] But Japan's modest welfare system – despite the country's high level of economic development – shows that elaborate welfare state arrangements and weak family and community responsibility are not an inevitable result of industrialisation, urbanisation, and globalisation.

Social insurance welfare systems

Social insurance welfare systems are the dominant model in Western Europe and North America.[19] Schemes differ but are based on a number of fundamental principles. The schemes should be compulsory, and individuals must contribute to the cost via a special tax, usually shared between employees and employers. Coverage should be comprehensive, providing for a range of needs especially old age and invalidity. Individual benefits are to be 'earnings related', that is linked in some way to the size and particularly length of time of individual contributions through taxes. These schemes have existed in Europe and North America at least since World War Two, and sometimes for much longer.[20] Originally, social insurance schemes were based on strict actuarial principles. Risks would be pooled, but the benefits received, especially in retirement, were to be closely related to the size of one's personal or employer's contributions. The clear contributory nature of the plans meant that there was no stigma attached to receipt of the non-means tested benefits.

Social insurance schemes on the long established model in Europe and North America differ fundamentally from the newer self-funded compulsory occupation schemes being implemented in Australia and being considered in other countries. Long-established social insurance schemes are based on 'defined contributions'. Eligibility for pensions is based on employees and employers having paid defined amounts into a fund for a designated period of time – say 30 or 40 years. Benefits paid on retirement are defined as a percentage of final salary or some averaged measure of salary, say over the last ten years of employment. The sum paid is in no way related to accumulated funds invested. The schemes operate on a pay-as-you-go system. Payments to the retired come directly from deductions from those currently in the workforce.[21] In contrast, the newer self-funded schemes – called 'defined benefits' pay final benefits that are directly related only to the invested sums accumulated in an individual's account.

Social insurance systems, first developed in Germany last century, are inherently conservative – inequalities are preserved, as the higher paid usually get higher benefits in old age. Social insurance schemes had complex internal redistributive patterns both intended and accidental. Early beneficiaries, for example, obtained generous benefits because they had not contributed for the 30-40 years required in most schemes to fully fund benefits. The long lived, often the more affluent, also benefit disproportionately. Women mainly engaged in child rearing accumulated few claims to benefits in their own right.

A second tier of social poverty assistance was maintained alongside social insurance to take care of those who for whatever reason had not accumulated rights in the social security system. Individuals sometimes collect both types of payment at once, although poverty assistance is usually means tested. Australia and New Zealand, in contrast to most developed nations, did not develop social insurance since they made no link between personal contributions and benefits paid. Benefits are usually means tested and depend on current income (and sometimes assets) but not past contributions: in New Zealand the exception is the age pension, which is paid at one rate to everyone regardless of past or present income or assets. Poverty assistance programs are normally paid out of general tax revenue.

Social insurance appealed through much of the twentieth century to fiscally conservative governments because it appeared to be risk free, and its costs were separate from the main government budget. Cost escalations would be controlled, so it was felt, because any cost increases were imposed at once on employees and employers who would scrutinise the scheme's operations and moderate their demands. Social insurance was usually well supported by a wide section of society – including employers – because it gave employees security. Structural change in the economy and labour market adjustment was supposedly easier to achieve because workers would be protected from income interruption through substantial benefits.

Later parts of the book will examine the current problems associated with social insurance. It is now criticised because of wildly escalating costs, the inability to cope with ageing populations, unjust transfers between generations, and assuming a male breadwinner lifetime employment pattern that increasingly does not occur.

Social insurance on the United States or Western European model is not a realistic model for New Zealand's future. But while social insurance has its problems, it at least reinforced the idea that welfare state benefits were linked to work effort. Significant retirement benefits were only payable to those with long employment histories. Whatever the success or failure of social insurance to date, this issue has to be confronted by all.

Occupational welfare systems

'Occupational welfare' has long been a key part of western welfare systems, although often neglected in examination of policy options. Many people in western countries rely on pensions and other benefits such as health care that are provided by their employers in place of or in addition to direct public pensions or services. Japan is the most sophisticated example of occupational welfare, although even there only a segment of the population works for companies providing generous benefits. In 1990, 50 per cent of Japanese firms provided pension plans, and Shinkawa and Pempel say in a recent book that

> Many Japanese firms spend considerable sums to create, if

> not cradle-to-grave socialism, at least its hiring-to-retirement equivalent. They provide subsidised housing, housing allowances, and/or loans for new homes; transportation allowances; medical facilities for employees and their families; in-plant canteens, barber shops, nurseries, and discount shopping centres; organised company vacation spots at ski centres or hot springs; child care allowances and often on-site nurseries; as well as company picnics, athletic clubs, marriage brokerage facilities, cultural clubs and libraries. In addition, the best programs provide generous insurance schemes and retirement plans.[22]

Singapore is an example of compulsory occupational superannuation. Employers pay 18 per cent of employees' wages into the Central Provident Fund, established in 1953, and employees pay another 22 per cent. Eighty per cent of the Singapore workforce is forced to pay into the Central Provident Fund for retirement. Those without accumulated retirement funds have to rely on assistance from families, or from very low means tested benefits.[23]

Occupational welfare was attacked by the leading designers of postwar welfare states – especially Richard Titmuss in Britain – for being socially divisive by favouring only a more affluent group and for relying on expensive and regressive tax subsidies.[24] Western governments are now reviewing the role of occupational welfare. In the past, the aim was to remove the special concessions for occupational welfare. Now it is to spread the benefits of occupational welfare to all employees, and so to ease claims for direct state benefits.

In the 1980s and 1990s, privatisation of government activities became a popular idea. Social insurance and other welfare state schemes, especially for retirement, accounted for a very significant proportion of government outlays in most countries so it was inevitable that privatisation ideas would influence social policy. Some governments have become interested in extending occupational pension schemes, making them compulsory, and regulating their activities to reduce risks and to ensure that accumulated funds are actually used for retirement. Most people, it was argued, could pay for their own retirement in this way. Government provision would only be needed for the relatively small group who were unable to accumulate sufficient contributions through employment.

Such a comprehensive employer/employee mandated system is similar in some ways to social insurance in that it requires government compulsion, both in terms of membership and minimum levels of contribution. It is different, however, in that members of an occupational scheme have ownership rights to their accumulated funds. This system is a way in which individuals can adjust their income over their own life cycle.

New generation social security ideas in the 1990s emphasise the benefits of creating individual retirement funds. Each generation builds up a fund from its own or employer contributions. These funds are invested and the benefits payable depend on the return on the funds. The fund members, not the government, bears the risk if returns are disappointing and may also receive high returns if they have been lucky on the stockmarket or in other investments. Individual benefits are purely a result of individual and employer contributions plus fund earnings. This trend could be termed the *privatised retirement state.*

Employers can become disillusioned with their contributions to superannuation systems. Increased international competition means that employers are reluctant to provide expensive benefits which do not have to be provided by competing firms. Many companies have downsized and outsourced some activities to smaller firms unable to provide generous benefits. Generous employer provided benefits depend on the continued prosperity of the employer, add to labour costs, and create gaps in benefit provision.

Private superannuation coverage in New Zealand is difficult to document but around half the workforce contribute to occupational superannuation schemes.[25] The incentive to contribute to private schemes is weakened because state payments to the aged in New Zealand have been relatively generous, although this has been reduced since 1985. When introduced in 1977, New Zealand National Superannuation provided a means test free gross weekly payment to married couples aged 60 and over at a rate equal to 80 per cent of the gross average wage: the single pension rate was 60 per cent of the married rate. Applicants only needed to have resided in New Zealand for ten years to be eligible.[26] Furthermore, New Zealand abolished tax concessions for private superannuation schemes in 1987, making such schemes less attractive than in Australia with its substantial tax concessions.

Tax expenditure welfare systems

Tax expenditure welfare systems – providing designated groups with tax concessions and thereby boosting their net incomes – were once extensive in New Zealand, but have gone out of favour here as in most western countries. Tax expenditures are, however, still important in many modern welfare states, especially those with high marginal tax rates. Comparative information on tax expenditures in advanced countries is difficult to obtain, but it appears that tax concessions on superannuation are the single most important tax expenditure in most countries.[27] The Australian compulsory superannuation system is particularly attractive to contributors because of the major tax advantages it offers to the individual. The highest income groups benefit from a concessional tax rate on fund earnings that is lower than the common marginal tax rate of around 50 per cent of earnings. Australian tax expenditures – concessions on social security programs – are very large. In 1994-5, tax expenditure revenue costs were A$12,876 million, equal to 30 per cent of the direct social security outlay costs that appear in the budget documents. These outlays have been criticised for favouring upper income groups, being too complex, and too hidden from budget scrutiny.

Tax concessions on housing are another major tax expenditure in many western countries. The United States has generous tax deductions for mortgage and consumer loan interest. In the economist's ideal world, equity in owner occupied housing would be taxed as income, to make it identical to other investments. An agreed interest rate, possibly the long-term bond rate, would be applied to housing equity and added to taxable income. This is rarely done, however, with the result that countries such as New Zealand and Australia tend to build a lot of housing. Home ownership is enjoyed by a wide range of income groups, but the tax subsidy is most valuable to those with expensive homes and high income tax rates. It would not be politically feasible to impose an imputed income tax on owner occupied housing in New Zealand. Such a tax is imposed in some European countries such as Sweden and the Netherlands but generous exemptions dilute the impact of the tax on all but the very wealthy.[28] Such tax expenditures vary from country to country, are difficult to calculate, and are often unpublished if available. This makes accurate welfare state spending comparisons between countries difficult. Generally, comparisons between countries in this study do not include tax expenditures.

Universal program welfare systems

Universal programs provide benefits without means tests to defined benefit categories such as the aged or families with dependent children.[29] They are easy to administer, and remove the social stigma of means testing. Universal benefits are also supposed by some to strengthen social solidarity because all classes are eligible. The idea of universal benefits developed most strongly in late 1940s Britain, where elites felt that means tests would increase social divisions in an already highly structured class-ridden society.

New Zealand's universal retirement benefits, since the 1970s at least, have been generous in world terms because benefits are comparatively high, are not means tested (tax surcharges have been used but then abolished), and are not in any way dependent on prior workforce participation or tax payment. Universal pensions are popular because they benefit the middle and upper income groups who are politically influential, and this makes them very resistant to change. In the United States, interfering with the broadly targeted social insurance for the aged has been likened to the electrified central rail of the New York underground railway: 'touch it and you are dead'.

Non-contributory universal benefits such as New Zealand Superannuation are unpopular amongst policymakers in most western countries because of their high costs. Means tested benefits can be targeted to those in need and if tightly 'targeted' to the most needy are usually far less expensive and more effective than universal payments in alleviating poverty.

Means tested welfare systems

Most western countries, eager to reduce social welfare outlays, are moving towards a greater use of means testing, although there are major political obstacles. Means testing appeals to those who want to reduce the role of the state to assisting those unable to make use of market mechanisms. It also appeals to government budget-cutters because the benefits are immediate while the possible negative effects – and they are debatable and difficult to prove – are long term. Financially strapped countries look on Australia as a model, even if they idealise the system and ignore its deficiencies.[30] Australia, and to a lesser extent, New Zealand, have some of the most means tested welfare systems in the western world. In part this may be because both lacked the despised Poor Law systems, closely identified with means testing in the United States and Western Europe.

There is remarkably little criticism of means testing in Australia, but New Zealand has always been more suspicious and has stronger universalist traditions.

The means testing process was once thought to be stigmatising, expensive to administer, and created perverse incentives not to work, save, or stay married. Stigmatisation (a sense of shame) it was felt, is more likely when only a small proportion of the population are on targeted benefits.[31] But the growth in dependency in New Zealand since 1973 means that means tested benefits are now paid to a significant proportion of the population, and this has lowered the stigma. Moreover, the rights movement, popular in the 1970s and 1980s, reduces or even eliminates any sense of shame at being in receipt of benefits.

Stigma is stronger in two tier systems, such as in the social insurance states in the United States and Western Europe. Being dependent on means tested benefits defines a person as having a weak contributions and work history. People in this category are not regarded as having the same degree of rights to benefits as those in social security schemes. This strong sense of shame operates in Germany, and prevents up to half of eligible single parents from claiming benefits.[32] Local governments deliver means tested benefits in Germany, and are not welcoming to clients, who are encouraged to keep quiet about their needs.

Means tests create very difficult incentive problems. A well-informed public soon learns about means tests, and people may change their behaviour to ensure their eligibility. It is perhaps not surprising that household savings are so low in Australia and New Zealand since household savings will simply make a household less eligible for a benefit. Means tests have other unhealthy incentive effects. The aged in Australia, for example, have an incentive to invest heavily in housing which is exempt from the means test.

Means tests also create 'poverty traps'. Those on targeted benefits have little or no incentive to retrain and work more hours, because they will lose a high proportion – of perhaps 100 per cent or more – of the increased earned income. Poverty traps are complex because there are often numerous means tests faced by a particular beneficiary. Australia, for example, has means tested arrangements for cash benefits, health care, housing assistance, child care, transport, education, and many other services. It is difficult to harmonise these benefits.

Policy makers are well aware of poverty traps, and often allow beneficiaries to earn a significant amount before they lose part of their benefit payment. But Australia has found that this may encourage the creation of a large part-time workforce of those who have discovered that it is best to earn half of their income from benefit and half from paid work.

Australia has also found that well informed clients, especially middle class students at university, are very difficult to means test effectively. Many families have tax-efficient investments that minimise taxable income to levels below the low benefit eligibility level. Their real standard of living can be far higher. The means test had to be changed to measure real resource levels, yet this is complicated, expensive to administer, and leads to many disputes. Australian experience suggests that assets as well as income have to be means tested, and an imputed income earning rate has to be applied to all assets to ensure means tests are not avoided. Such policies carry heavy political costs.

Means tested benefits can also create an incentive for the growth of an underground economy where workers are hidden from the tax system. Welfare payments plus proceeds from the black economy can provide attractive living standards. The modern service economy creates many opportunities for 'hidden' employment. While it is difficult to research the scale of the underground economy in western countries, one study in the United States found that income not reported to the tax department was large and increasing rapidly.[33]

Targeted means tested systems may only be effective if benefits are kept at low levels, possibly well below the poverty line. The United States has this policy in most states: American social assistance rates for groups such as single parents are far below New Zealand levels. This creates a work incentive by increasing the income gained from entry to the workforce. Means tested benefits may also require coercive workfare programs to monitor beneficiary behaviour closely, and impose strong incentives to work despite the limited financial benefit of doing so. Countries like New Zealand are reluctant to do this, because low benefits create problems with malnutrition, especially for dependent children, may increase crime, and generally create social unrest and resentment.

The employment-workfare state

Forcing the poor to work, enforcing absent parent's responsibilities for child support, reducing benefits for 'undeserving' groups, and tough policies against crime are recent policy initiatives in many western countries that are based on a new moralistic attitude towards social welfare. Influential 'moralistic' writers now view elaborate welfare state systems as symptoms of moral disorder, and social problems such as crime, illegitimacy, and single parenthood dependency as the results. Gertrude Himmelfarb, the American historian, says 'for most people, reality has asserted itself. We now know that what we have been experiencing cannot be denied, belittled, or explained away as anything but the moral crisis that it is'.[34] The Social Affairs Unit in the United Kingdom supports the reintroduction of guilt, shame, ostracism, disgrace and punishment.[35] Himmelfarb clearly wants a return to the values of the Victorian era. She says

> Today the word 'stigma' has become odious, whether applied to dependency, illegitimacy, addiction, or anything else. Yet stigmas are the corollaries of value. If work, independence, responsibility, and respectability are valued, then their converse must be devalued, seen as disreputable. The Victorians, taking values seriously, also took seriously the need for social sanctions that would stigmatise and censure violations of these values.[36]

Many western countries are now best described as employment-workfare states, so far as the non-elderly are concerned. Governments are increasingly reluctant to allow non-elderly beneficiaries to remain on unemployment, single parent, or some invalidity benefits for long periods of time, and require work for benefit. But workfare of a sort is also being applied to the elderly. Eligibility for New Zealand Superannuation is rising from age 60 to 65 and may rise to 70 in the future as the definition of retirement changes. The workfare state focuses on making benefits less attractive by reducing benefit levels, tightening eligibility, imposing time limits, and, above all, requiring clients to work or undergo training that leads to work.

The United States is the most radical 'workfare' state in the western world so far as the non-elderly are concerned. American public opinion appears to support programs that make welfare payments for unemployment and especially for single parents conditional on work, education and training aimed at eventual workforce participation.[37] The workfare model is also gaining some popularity in Britain, New Zealand and Australia, especially for the long-term unemployed. Implementing these ideas is not easy. However, 'Workfare' in the United States often seems to be more about popular political rhetoric than effective programs, and such programs can become coercive and vindictive.[38] Workfare is expensive to administer and requires additional training, education and child care costs to the state. Cash benefits may have long term negative consequences, but they can be cheap and easy to provide, compared to workfare. Greater control over the poor increases the coercive powers of the state, a power that can spread to other parts of society.[39] Institutionalised vindictiveness offends philosophers' ideas of social justice in modern societies.[40]

Trends

There are some clear trends in worldwide preferences for welfare program design. Social insurance on the European model is increasingly being questioned, although it is important to realise that these schemes are still by far the dominant form of social security in the modern world. They have not been able to cope well with modern life cycle patterns, an ageing population, early retirement, high unemployment, high inflation in the past two decades, and persistent decisions by governments to be overly generous to the present aged at the expense of future generations. Social insurance schemes have long since abandoned the supposedly scientific actuarial foundations that were so attractive to conservative governments earlier in the century. These schemes rely on compulsion, and require large government bureaucracies now out of fashion in a privatising world. Very high social insurance taxes in Europe make it difficult to expand economic activities: firms have a strong incentive to migrate to low tax environments with minimal welfare states.

The second trend in social policy is a powerful worldwide movement to privatise, or partially privatise the welfare state, especially for retirement.[41] Privatisation perhaps better called 'individualisation' – enables an individual to accumulate his or her personal fund from employer and employee contributions. This approach has already been described earlier in this chapter.

Australia, normally a slow innovator, is changing to a privatised system where contributors accumulate individual sums in funds of their choice. The age pension will still be required for those who fail to accumulate enough life-time contributions. Even Sweden, the land of social solidarity and inclusion, has adopted a partially privatised system for next century. A later chapter will examine the feasibility of privatising New Zealand retirement.

In the meantime, there are clear trends towards more means testing of benefits. Even Britain, the one-time bastion of universalism, has retreated to means testing, because of persistent dependency levels caused by high levels of unemployment, single parenthood and disability.

Means testing was once assumed to be linked only with the implementation of low level benefits linked to preventing poverty. What some commentators call the 'new means testing' is becoming more widely discussed. The 'new' means testing approach admits the problems of harsh means tests on the lowest income groups.[42] Instead, it focuses on means tests that reduce or abolish benefits for higher income groups, perhaps those in the top third or so of the income distribution. In recent years, Australian social policy has been moving in this direction with means tests for superannuation tax benefits, family allowances, and child care benefits. This approach appeals to middle income groups and may be politically more popular than harsher means testing of the poor. The idea attracts those who believe that higher income groups have gained excessive increases in relative incomes in recent years. The problem with the plan is that means testing may not save much by focusing on only a relatively small proportion of the population. The incentive problems with means tests, described above, may apply to means tests at any level of income.

The rising interest in means testing is being combined with a renewed emphasis on programs to increase workforce participation amongst the long term dependent. The Clinton administration has handed single parents benefit back to the States and abandoned uniform national administration, and the Canadians are moving in the same direction. State governments are allowed to implement experimental programs, based on two year continuous time limits on benefits with a maximum lifetime limit of five years for the receipt of benefit.

While cash social welfare benefits account for a high proportion of government outlays, few western countries now care to be described as 'welfare states'. They desperately want to be regarded as 'developmental states' or 'employment creation states' on the Japanese or East Asian model. Policy makers realise that only revitalised economies and higher growth rates will cure the underlying causes of high dependency levels, and provide the extra resources needed to modernise industry, upgrade human and physical infrastructure, and meet ever-rising public expectations for a high standard of living.

At century's end, no welfare system in the developed world is a model of impressive adaptation to radically changing social, economic and political circumstances. Change is difficult because there are no unblemished models to follow, and New Zealand will have to work through the issues by itself, learning what it can from experiences in other countries.

References

1 Vic George and Paul Wilding *Welfare and Ideology*, Harvester Wheatsheaf, New York, 1994, pp. 130-160; see also Gillian Pascall *Social Policy: A New Feminist Analysis*, Routledge, London, 1997.

2 Catherine Jones 'The Pacific Challenge: Confucian welfare states' in Catherine Jones ed. *New Perspectives on the Welfare State in Europe*, Routledge, London, 1993; there

is disagreement among specialists about the nature of past and present family arrangements in Asia; see Jack Goody 'Comparing Family Systems in Europe and Asia: Are There Different Sets of Rules?', *Population and Development Review*, vol. 22, no. 1, March 1996, pp. 1-20.

3 An excellent analysis is in World Bank *The East Asian Miracle: Economic Growth and Public Policy*, Oxford University Press, Oxford, 1993.

4 Fumie Kumagai *Unmasking Japan Today: The Impact of Traditional Values on Modern Japanese Society*, Praeger, Westport, 1996, pp. 147-8; see also Arthur Gould *Capitalist Welfare Systems: A Comparison of Japan, Britain and Sweden*, Longman, Harlow, 1993.

5 'Dad's Day in Court', *The Asian Wall Street Journal*, 14-15 June 1996, p. 10.

6 Peter L Berger and Richard John Neuhaus *To Empower People: The Role of Mediating Structures in Public Policy*, American Enterprise Institute, Washington, 1977.

7 Marvin Olasky *The Tragedy of American Compassion*, Regnery Publishing Co, Washington, 1992.

8 Tony Eardley, Jonathan Bradshaw, John Ditch, Ian Gough and Peter Whiteford *Social Assistance in OECD Countries: Country Reports*, HMSO, London, 1996, p. 372.

9 David Green *Reinventing Civil Society: The Rediscovery of Welfare without Politics*, IEA, London, 1993, was one of the first of the many books on communitarianism or 'civil society'. See also Amitai Etzioni *New Communitarian Thinking: Persons, Virtues, Institutions and Communities*, University Press of Virginia, Charlottesville, 1995 and Paul Hirst *Associative Democracy: New Forms of Economic and Social Governance*, University of Massachusetts Press, Amherst, 1994. Socialist writers are also now very interested in communitarian ideas. See Erik Olin Wright ed. *Associations and Democracy The Real Utopias Project*, vol.1, Verso London, 1995.

10 David Green *From Welfare State to Civil Society: Towards Welfare that Works in New Zealand*, New Zealand Business Roundtable, Wellington, 1996.

11 Amitai Etzioni *Rights and the Common Good: The Communitarian Perspective*, St Martins Press, New York, 1995; David G Green *Reinventing Civil Society: The Rediscovery of Welfare Without Politics*, Institute of Economic Affairs, London, 1993.

12 See Robert D. Putnam 'Bowling Alone: America's Declining Social Capital', *Journal of Democracy*, vol. 6, no. 1, January 1995, pp. 65-78.

13 Gertrude Himmelfarb 'Preface' in Digby Anderson ed. *This Will Hurt: The Restoration of Virtue and Civic Order*, Social Affairs Unit, London, 1995, p. x.

14 See Mai Wann *Building Social Capital: Self help in the twenty-first century welfare state*, Institute for Public Policy London, 1995.

15 George Kelling and Katherine M. Coles *Fixing Broken Windows: Restoring order and reducing crime in our communities*, Free Press, New York, 1996; see also Gordon Hughes 'Communitarianism and Law and Order', *Critical Social Policy* vol. 16, no. 4, November 1996, pp. 18-41.

16 John Gray 'From Post-Communism to Civil Society: The Reemergence of History and the Decline of the Western Model', in Ellen Frankel Paul, Fred D. Miller Jr, and Jeffrey Paul eds. *Liberalism and the Economic Order*, Cambridge University Press, Cambridge, 1993, pp. 26-50.

17 'Poverty amid plenty', *Economist*, 21 December 1996, p. 28.

18 Roger Goodman and Ito Peng 'The East Asian Welfare States: Peripatetic Learning, Adaptive Change, and Nation Building', in Gosta Esping-Andersen ed. *Welfare States*

in Transition: National Adaptations to Global Economies, Sage, London, 1996, pp. 192-224.

19 Details of these schemes are summarised in US Department of Health and Human Services *Social Security Programs Throughout the World – 1993*, Government Printer, Washington, 1994.

20 The rest of this chapter relies heavily on the typology developed in Lawrence H. Thompson 'The Advantages and Disadvantages of Different Social Welfare Strategies', *Social Security Bulletin*, vol. 57, no.3, Fall 1994, p. 7.

21 Some schemes such as in the United States, invest short term surpluses which develop when social security taxes exceed short term payouts. These surpluses which are only a small proportion of total payouts in a given year are invested in government bonds.

22 Toshimitsu Shinkawa and T.J. Pempel 'Occupational Welfare and the Japanese Experience' in Michael Shalev *The Privatization of Social Policy? Occupational Welfare and the Welfare State in America, Scandinavia and Japan*, Macmillan, London, 1996, p., 281. The information on the extent of pension coverage is on page 325.

23 M. Ramesh 'Social Security in Singapore: The State and the Changing Social and Political Circumstances', *Journal of Commonwealth and Comparative Politics*, vol. 31, no.3, November 1993, p. 111. The interest in comparing East Asian welfare policies with the west is detailed in the article by Larry Elliott 'Turning Back the Welfare Clock', *Guardian Weekly* September 1, 1996, p. 19.

24 See the chapter on Titmuss in Vic George and Robert Page eds. *Modern Thinkers on Welfare*, Prentice Hall, London, 1995, pp. 149-165.

25 T. Ashton and S. St John *Superannuation in New Zealand: Averting the Crisis*, Institute of Policy Studies, Wellington, 1988 and S. St John and T. Ashton *Private Pensions in New Zealand Can They Avert the 'Crisis'*, Institute of Policy Studies, Wellington, 1993. The literature on private and public superannuation is reviewed in David Thomson 'The Future of New Zealand's National Superannuation', *Agenda*, vol. 3, no.3, 1996, p. 299.

26 David Thomson 'The Future of New Zealand's National Superannuation', *Agenda* vol. 3 no. 3, 1996, p. 297.

27 *OECD Tax Expenditures: Recent Experiences*, OECD, Paris, 1996. The publication presented information on 14 OECD countries. New Zealand was not included. OECD countries have no consistent ways of defining or measuring tax expenditures.

28 Gavan A. Wood *Taxation and Housing*, National Housing Strategy, AGPS, Canberra, 1991, p. 66.

29 A recent discussion of universalism is Simon Thompson and Paul Hoggett 'Universalism, selectivism and particularism: towards a postmodern social policy', *Critical Social Policy* vol. 16, no.1, February 1996, pp. 21-43

30 The Australian means tested system is being used in partisan debates on the future of the American social security system . See Eric R. Kingson and James H. Schultz 'Should Social Security be Means Tested?', in Eric R. Kingson and James H. Schultz eds. *Social Security in the 21st Century*, Oxford University Press, New York, 1997 p. 153.

31 Paul Spicker *Stigma and Social Welfare*, Croom Helm, Beckenham, 1984; the hatred of the means test in British social policy is documented in Alan Deacon and Jonathan Bradshaw *Reserved for the Poor: The Means Test in British Social Policy*, Blackwell,

Oxford, 1983.

32 Roger Lawson 'Germany: Maintaining the Middle Way', in Vic George and Peter Taylor-Gooby eds. *European Welfare Policy: Squaring the Welfare Circle*, Macmillan, London, p. 44.

33 Edgar L. Feige 'Overseas Holdings of U S Currency and the Underground Economy', in Susan Pozo ed. *Exploring the Underground Economy*, Upjohn Institute for Employment Research, Kalamazoo, 1996, pp. 5-62.

34 Gertrude Himmelfarb 'Preface' in Digby Anderson ed. *This Will Hurt: The Restoration of Virtue and Civic Order*, Social Affairs Unit, London, 1995.

35 Digby Anderson ed. *This Will Hurt: The Restoration of Virtue and Civic Order*, Social Affairs Unit, London, 1995.

36 Quoted in Jacob Weisberg 'The Family Way', *New Yorker*, October 21 and 28 1996, p. 187.

37 See Fay Lomax Cook and Edith J. Barrett *Support for the American Welfare State: The Views of Congress and the Public*, Columbia University Press, New York, 1992.

38 Joseph Dillon Davey *The New Social Contract: America's Journey from Welfare State to Police State*, Praeger, Westport, 1995.

39 Liberal justice as the removal of fear is the key theme in Bernard Yack ed. *Liberalism without Illusions: Essays on Liberal Theory and the Political Vision of Judith N. Shklar*, Chicago University Press, Chicago, 1996.

40 Avishai Margalit *The Decent Society*, Harvard University Press, Cambridge, 1996.

41 The privatisation movement is strongest in the United States where the massive government role in retirement seems at odds with the nation's pro-free-market philosophies. The social security establishment in the United States is very much on the defensive. See Eric R. Kingson and James H. Schultz eds. *Social Security in the 21st Century*, Oxford University Press, New York, 1997. Critics of privatisation claim that moves to dismantle social security are a result of a greedy Wall Street trying to gain access to the vast funds involved. See the November/December 1996 issue of *Mother Jones* especially the article by Robert Dreyfuss *The End of Social Security as We Know It?* and Theda Skocpol *Deja Views*.

42 The term 'new means testing' is used to describe an influential movement in America by Eric R. Kingson and James H. Schultz 'Should Social Security be Means-Tested', in Eric R. Kingson and James H. Schulz eds. *Social Security in the 21st Century*, Oxford University Press, New York, 1997, pp. 47-56.

Chapter 3

The Unique New Zealand Welfare System

New Zealand has a welfare system that is different to that of any other western country. It is most like Australia's, but there are important differences even between these two countries with similar histories. A reexamination of New Zealand's welfare history is important for current policy analysis. Welfare programs are notoriously incremental. Current problems can be products of decisions made decades ago, or, in the case of age pensions, almost a century ago. Programs are implemented in response to particular problems at various points in time and often become more generous and expensive over time. Welfare reform now – when it happens at all – usually focuses on small scale changes, a sort of incrementalism in reverse. Welfare systems are rarely examined comprehensively.

The following is a brief introduction to the New Zealand system of state cash social benefits. It is not intended to be comprehensive but to highlight the features which shape and constrain the reform of welfare from here on.

The beginnings of a welfare system for the aged

New Zealand, like Australia, was forced to deal with an ageing population late last century. New Zealand had a particular problem because its high standard of living and healthy climate meant that New Zealanders often lived to ripe old ages. In 1896-1900, New Zealand males of 65 years of age had an average life expectancy of another 12.19 years, while females had 13.29 years.[1] A second, even more important source of rapid ageing was the sudden inrush in the 1850s and 1860s and 1870s of young settlers, who reached old age together at century's end. There was an additional problem of how to deal with the 'old old' or those over 75 who often need more care.

Charities could only do so much, and in New Zealand's case not much at all since they were so small, and they needed a high level of government subsidy. New Zealand was already a mobile society, with high levels of internal and international migration which limited support by way of neighbourhood and kin. Even though many of the married aged had large families that might have been expected to care for them, there were also large numbers of single males, a result of a sex imbalance common to Australia and New Zealand last century.

New Zealand had at least four main practical choices in developing policies for the aged: to expand the role of charities; create Poor Law administrative structures; establish a simple, means tested aged pension; or develop a comprehensive social insurance scheme on the German model. There were of course other options in theory, though they lay beyond the realms of serious consideration at the time.

The State could fund charities to care for them, but this was expensive and often stigmatising because the respectable aged poor resented charity. Moreover, 'charities' is rather a misnomer in the New Zealand context, for there were very few of any size or independence from the state. There was, too, a high level of respect for the ageing pioneers at the turn of the century. They were seen as having worked hard and raised large families with little help from government, and so as deserving of something better than charity. Although life expectancy for those who reached 65 was reasonable, around 12 years, many did not reach 65, the age of eligibility for the aged pension. Around 1900, for example, only 52 per cent of each 100 of the male population born had survived to 65 while only 57 per cent of each 100 females born survived to that age. In contrast, in 1995, in New Zealand, 80 per cent of males and 86 per cent of females survived to 65.[2]

A second option – similar to the English Poor Laws – to cope with ageing was to expand the existing system of 23 Charitable Aid Boards, elected by the various local bodies in their districts and funded by a mixture of central government subsidies, local rates, subscriptions and bequests. For centuries, the English poor law schemes had granted outdoor relief – similar to the aged pension – to those such as the aged deemed unable to work.[3] Charitable Aid in New Zealand did much less, but might have been enlarged and so have duplicated the large scale systems existing for many years in Europe. This would have taken some time to establish, making it difficult to deal urgently with the ageing problem.

Nor was it clear that local bodies were up to the task. The mostly small local governments in New Zealand had their own problems coping with building physical infrastructure. They had little interest in the low status role of administering poor laws, especially if this required revenue from local rates. Moreover, the poor law in Europe had a dreadful reputation and was hardly a model to copy, with local administration of welfare often harsh and unfair. Australia and New Zealand nationalism included the belief that the new countries were so rich they had no 'paupers', nor a need for a poor law, and especially not for the respectable aged.

Charitable Aid administrators at the time were often tough minded about poverty, and favoured no extensions providing for the growing numbers of the elderly. In 1889, Dr Duncan MacGregor, the Inspector of Hospitals and Charitable Institutions and perhaps the most extreme man in New Zealand in his opposition to public assistance, complained that the Charitable Aid Boards were not very effective. Once locals knew that the central government was providing significant funds, said MacGregor, it was difficult to raise funds locally – a 'Poor Law dries up the springs of private charity'. He supported an American move to abolish outdoor relief, because only by keeping paupers in institutions could they be prevented from reproducing, and so society could 'cut off the entail of hereditary pauperism and crime and insanity and idiocy'.[4] Provision for the poor was steered elsewhere because of such attitudes.

The third option, the one adopted, was to establish a means-tested aged pension that would provide a small subsistence income that would mask the worst symptoms of old age poverty. The pension established in 1898 was unusual in at least one respect. The subsistence amount of £18 a year would be barely adequate for those with no other income. But pensioners were allowed to have another £34 a year in income before the pension was reduced. There was much mention at the time of the moral superiority of the 'deserving' poor over the 'undeserving' poor, and the generous income limit for private income was aimed at helping the deserving poor, who had saved to fund at least some of their own retirement. For the first few decades, however, most home owners were excluded under the income and assets test, a tough measure in a high home-owning society.

New Zealand was not original in creating the aged pension. When Sir George Turner, the Victorian Premier, introduced the legislation for the first aged pension into Victoria in 1899, he listed the numerous schemes being discussed around the world. Turner said 'When we look back over the last 50 years of our history, we find that there has gradually arisen throughout the whole civilised world an almost unanimous recognition of the fact that there is an absolute necessity for making some better provision for our aged deserving poor. Many schemes have been brought forward in that direction.'[5]

Turner tabled the details of schemes operating or proposed in New Zealand, Germany, Denmark, Austria, Iceland, Italy, France, and nine alternative schemes proposed in Great Britain. The first proposal in Britain for compulsory insurance for old age was introduced into the Parliament in 1722, and was passed by the House of Commons but rejected by the House of Lords. In 1794, legislation for a universal pension scheme was brought into the British Parliament but never implemented. A scheme for a welfare state remarkably like the modern versions was detailed in Thomas Paine's popular *Rights of Man,* published in 1791.[6]

Copying policies from other countries occurred widely late last century. Germany had established a social insurance scheme in the 1880s, and alternative systems for coping with ageing populations were intensively debated in Europe and North America in the last two decades of the century. Another age pension scheme – possibly the model for New Zealand – had been established in Denmark in 1891.[7] New Zealand in turn was viewed as an innovator in its own right, and its scheme was much discussed elsewhere and was probably the model for the first Australian schemes at the turn of the century, in New South Wales and Victoria, and taken over by the Commonwealth in 1908.

The old age pension proposals in New Zealand met with fierce resistance in Parliament, suggesting that New Zealanders had principled objections to welfare without work at this early stage in social policy development. Pember Reeves noted that there were 1,400 speeches in Parliament on the Old Age Pension Bill – with one member speaking 93 times. Most of the speeches were against the proposal. Those opposed to the pension claimed it was 'likely to burden the colony needlessly and increasingly, sap the springs of self reliance and tax the thrifty for the benefit of the improvident'.[8]

The extraordinary debate on the pensions bill showed that New Zealanders had a highly developed and informed understanding of the contemporary worldwide debate on poverty alleviation. The opposition to the bill was based largely on the fact that it was an unconditional benefit, available to the 'undeserving' as well as to the 'deserving' poor. The means test would stigmatise the recipients, while failing to reward the industrious and the thrifty who had saved for their retirement. The bill's opponents wanted pensions to be contributory, among other things, and government to supplement the insurance payments of those who had saved for retirement. Critics pointed out that contributory requirements would mean that benefits could not be paid for decades, and that the pioneers often had little opportunity to save through their difficult lives.

The aged pension, as introduced in 1898, was hardly a major fiscal commitment. By 1902, there were only 12,776 eligible pensioners (including 1,055 Maoris) – about one third of the aged – out of a total population of 840,000, and thereafter the proportions fell to around one quarter of the aged. Those 65 years and older accounted for only four per cent of the New Zealand population. Concern over possible deception by the aged was common in early years of the scheme – only one in 20 of those applying for pensions had documentary proof of age – but the system soon settled into an accepted routine. There were strong pressures to minimise administrative costs, and beleaguered administrators soon gave up trying to be moral policemen.

The state learnt that redistribution of income was easy, did not require many bureaucrats, and was politically popular. There were few scandals in pension administration, certainly far fewer than with asylums and homes for the destitute. There was no special tax for social welfare outlays, so the cost side of the equation was hidden. Those who benefited were grateful, and those who paid were not even aware they were paying.

In 1905, the Prime Minister R.J. Seddon said that if you did away with the property qualification (on owner occupied homes) on the pension you might as well just have the universal pension. The rule on the value of the owner-occupied home that would count in the means test was challenged constantly by the aged, was liberalised progressively, and was totally abolished in 1925. (The value of the owner occupied home ceased to count in the Australian aged pension means test in 1912). Only in rich countries such as Australia and New Zealand could those who owned at least their own homes be considered 'poor'. In neither country were early policy makers clear whether they were assisting the poor, or the aged, or the aged poor or only the 'deserving' among them. Liberalisation of the means test meant that the policy soon became one of assisting the aged as a broad social group.[9]

The significance of these early aged pensions was not lost on bewildered overseas experts, who noted that the Australian and New Zealand aged pensions were really extensions of the poor law, not social insurance, and yet that the benefits paid were more generous than for contributory social insurance in Europe. One leading expert, I. M. Rubinow, could not understand how the Australian aged pension system (and soon the New Zealand pension) exempted the owner occupied home, enabling pensioners to be supported by the state, often for many years, then to bequeath their homes to their children on their deaths.[10]

By 1913, about one third of the aged population in New Zealand was eligible for the pension, about the same proportion as in Australia, and this would create a dangerous precedent for the future.[11] Many of the aged could expect to be supported by the State in retirement; and private savings would only make them ineligible. The politicians who created the New Zealand aged pension did not realise that the modest outlay and small program would establish the fundamental nature of the New Zealand welfare system for at least the next century, and probably longer.

Would social insurance have been better?

Australia and New Zealand took the easy way out in their early social welfare policy-making. While European countries were examining the needs of their population systematically, Australia and New Zealand started a process of social policy patchwork, introducing new piece-meal programs once a awkward new group became troublesome. European social insurance, by comparison, evolved more slowly and thoroughly. International congresses in the 1890s discussed what was considered to be the new scientific way to overcome the problem of economic insecurity.[12]

Once non-contributory pensions were established in Australia (1908 nationally) and New Zealand (1898), it became very difficult to introduce social insurance. It is hard in a democracy to convince people that they should contribute over a lifetime for a retirement pension, when they observe existing programs that give sometimes generous benefits with no requirement for workforce effort or specific individual contribution by those now elderly. Australia did develop an interwar guilt complex about its lack of social security programs, and social insurance ideas were discussed in a number of major inquiries, the recommendations of which were never implemented. New Zealand showed little interest in social insurance at any stage.

Social insurance was far more difficult to implement than means tested benefits, especially when the latter were initially quite limited and so inexpensive to taxpayers. It was hence perhaps no accident that social insurance was first implemented in 1883, in Germany, then a non-democratic country. Bismarck, the Chancellor, was able to dictate terms to German employers and employees, who shared the cost. Bismarck was attracted to social insurance because he believed that social insurance encouraged work, thrift, and gave the working class an interest in preserving the status quo. Socialism – then a threat in Europe – was felt unlikely to flourish in a social insurance state where workers were protected against poverty caused by sickness, accident, and old age.

Almost all European countries implemented social insurance schemes either late last century or in the first half of this century. Recent scholarly work shows that the policies differed greatly from country to country.[13] What is clear, however, is that the demand for broad social insurance schemes did not come only from the working class. Powerful social movements in favour of comprehensive social insurance often came from usually conservative farmers, and other middle class white collar and skilled labour groups, who wished to be protected from economic insecurity. These social insurance schemes often gained wide support even when financed by workers (via wage levies or forgone wages in the form of employer contributions).

The weakness of social insurance in Australian and New Zealand welfare history was also due partly to the adoption of alternative methods to ensure class security and social peace. Australia and New Zealand initially did not see themselves as potentially social insurance states, because they believed they had changed the laws of classical economics. Australia and New Zealand were famous earlier in the century, not for their aged pensions or for other means-tested poverty-relieving benefits, but because of their control over market forces in the labour market.[14] Overseas visitors marvelled at their prosperity that seemed to be due to high minimum wages, high wages generally, and unusually high levels of protection against imports. Exports were also closely controlled through producer boards, some of which are still in existence. Public service employment was also extensive, adding another form of security for workers. Social solidarity through shared contributions and benefits was not seen as necessary in the Antipodes.

The Utopia of 1938

By the mid-1930s the New Zealand cash benefit system was a confusing patchwork of specific programs that had been created to help particular groups who had become vocal, or who were creating a burden on charities. The main cash benefits up to 1938 are listed in Table 3.1.

By 1939, total expenditure on the pre-1938 legislation programs amounted to about three per cent of gross national product, a modest sum and less than one third of the proportion in 1996. Most of the programs were means-tested and were predominantly directed to the aged, either in the form of old age pensions, and those on invalid pensions (who tended to be close to pension age). Fiscal conservatism meant that no general right to cash unemployment benefits was created before 1938, despite high levels of social distress in the then world-wide depression of the 1930s. Australia had introduced a means tested invalid pension in 1909; similar legislation had not been created in New

Table 3.1

Main welfare benefits in New Zealand 1898-1936

Year enacted	Nature of non-contributory benefit	
	Means tested	Not means-tested
1898	Old age pension	
1911	Widow's pension	
	Maori War pension	
1915		Miner's pension
1924	Blind pension	
1926	Family allowances	
1936	Deserted wives and invalid pension	

Zealand until 1936. New Zealand was more attentive to widows, creating pensions for them that were not matched in Australia until 1942.

In 1938 New Zealand introduced legislation for a new Social Security Act that would enlarge the welfare system considerably, though leave its central non-contributory nature unchanged. The result was what New Zealanders, and a good few observers from outside as well, liked to call the most comprehensive and possibly most generous welfare system in the world at the time. The 1938 legislation did include the appearance of a special revenue-raising measure to pay for social security in New Zealand. A five per cent charge on all income (including companies) and a per capita registration fee were paid into a new Social Security Fund. The tax was increased to 7.5 per cent in 1946. When pay-as-you-go taxation was introduced in 1958, an apportionment was made from total revenue at the rate of 7.5 per cent of all income and this was paid into the Social Security Fund. The separate funding was abolished in 1964 and all the costs of social security were met from consolidated revenue, as they had been in effect all the time. This short lived 'contributory' system was artificial because, unlike social insurance schemes in other countries, an individual's payment was in no way linked with eligibility for a benefit. New Zealanders with weak work histories and low or non-existent contributions were eligible for the same benefits as those who had contributed significant amounts. Nor did the Social Security Fund ever meet all social security claims. The special contributory tax, however, may have created some sense amongst the generation who paid the tax that they had 'paid their contributions' and so deserved the universal superannuation promised in the 1938 legislation and enhanced in later years, long after the Fund was abolished.[15]

The main details of the 1938 legislation are shown in Table 3.2. A range of new benefits for the sick and unemployed were created, and those for the aged extended. The means tested age benefit, for example, was paid to 50 per cent of the aged in 1950, compared with 34 per cent in 1935. This expansion together with the start of a new means test free superannuation scheme, pushed forward yet further the growth of the distinctive New Zealand non-contributory system of cash benefits.

The origins of the 1938 legislation were mixed and have been studied by numerous historians.[16] They include the general worldwide interest in social security experiments in the 1930s, the ferment of ideas on social protection being debated in Britain based in part on strong elements of religious duty and socialist sympathies, and the inevitable compromises between wants and costs that were fought out within the Labour Party caucus. The influence of Michael Savage, the Labour Prime Minister from 1935 to 1940, was also important. With attitudes formed in the 1890s depression in Australia, Savage believed strongly in the exceptional nature of New Zealand and New Zealanders. Nothing was to be too good for them in his new utopia.

Savage's sympathies, shared widely with Labour colleagues, are evident in the following two examples in his own words,

> The luxuries of today were the necessities of tomorrow and there was nothing too good for the people of New Zealand ... The best music, the best means of travel, the best education, the best of everything ... that is our objective.[17]
>
> I want to know why people should not have decent wages, why they should not have decent pensions in the evening of their days or when they are invalided. What is there more valuable in our Christianity than to be our brother's keepers in reality? I want to see that people have security ... I want to see humanity secure against poverty, secure in illness in old age.[18]

The strange economics of New Zealand in the later 1930s and 1940s also helped underpin the Labour experiment. New Zealand experienced what would prove to be a temporary export boom from the mid-1930s, and Labour built the 1938 legislation on the basis of a few years of improving performance. Many, including the leading

Table 3.2

Main features of the Social Security Act, 1938, New Zealand

Title of benefit	Main features
Universal superannuation	A benefit payable without means test after ten years residence for those aged 65 and over. To be phased in to equal age benefit.
Age benefit	A means tested benefit payable to men and women at 60 (previously only to women at 60, men at 65).
Invalid benefit	Continued the 1936 scheme. Same level as the age benefit.
Widows benefit	Means tested benefit payable to widows with and without children (previously children were required for widows). Also payable to deserted wives with children. No children required for deserted wives from 1945. Rate slightly below the level of the age benefit.
Orphans benefit	Means tested benefit for orphans.
Family benefit	Means tested benefit. No means test after 1946, increasing number of benefits from 42,637 to 230,021.
Sickness benefit	New means tested benefit for the sick. Worth two thirds of the age benefit.
Unemployment benefit	New means tested benefit for the unemployed. Same as sickness benefit, one-third less than age benefit.
Emergency benefit	Means tested benefit payable to those in need but not fulfilling other eligibility criteria.
National health scheme	Means test free benefits, usually without charge to all. Unique in the world at that time.

Sources: A. M. Finlay *Social Security in New Zealand: a simple guide for the people*, Whitcombe and Tombs, Christchurch, 1943; Elizabeth Hanson *The Politics of Social Security: The 1938 Act and some later developments*, Auckland University Press, Auckland, 1980, pp. 154-5; New Zealand Year Books.

international commentators, shared this view at the time, that New Zealand was indeed a very wealthy country. For example, the influential work *The Conditions of Economic Progress* by the Australian economist Colin Clark, published in 1940, pioneered new measures of comparative economic growth.[19] The book found that New Zealand was the third wealthiest country in the world for the period from 1925 to 1934, exceeded in per capita wealth only slightly by the United States of America and Canada. New Zealand was twice as wealthy per head as Sweden, Germany and Norway and was 20 per cent more wealthy than Australia. New Zealanders were proud to read that by the late 1930s, 'The world's highest level of real income per head has now been reached by New Zealand, which already had a high income per head at the beginning of the century and has shown an almost uninterrupted upward trend'.[20]

New Zealand had by far the most productive agricultural sector of any country in the world, with productivity per head nearly twice the level of Australia – the next most productive, and five times greater than most countries in Europe. Clark also noted that Australia and New Zealand had the least dispersed incomes of all modern countries: skilled workers earned comparatively little more than the less skilled, a legacy of elaborate wage fixation systems and national egalitarian sentiment.

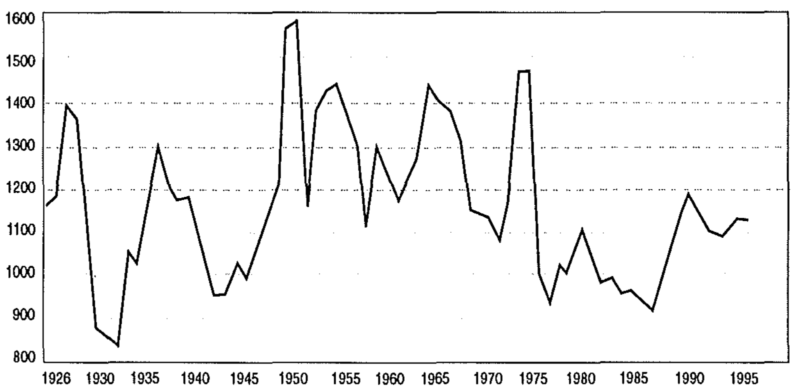
Clark's figures showed that the New Zealand welfare system, expanded and systematised in 1938, was not the creature of a poor country. It was the humanitarian creation of a country that had reason to believe that the problem of economic scarcity had been solved. They could afford, or so it was argued, the most generous welfare system in the world. Walter Nash, the Minister of Finance, could proudly state in the New Zealand Parliament in 1946 that real income per head in New Zealand had expanded by 60 per cent between 1935 and 1945.[21] It was clear that New Zealand had created a welfare system for a rich country. Few, perhaps understandably if now regrettably, asked why outlays on cash benefits should be growing so fast in such a rich country, or what sort of system might better suit a poorer New Zealand with a stagnant economy, falling terms of trade, and escalating dependency.

The result was that at the end of the 1940s, New Zealand had cemented in place its unusual system of non-contributory cash benefits, which were paid without relation to an individual's work or tax-paying history. It was also an array of benefits predicated upon continuing good economic performance, but this did not eventuate. Most importantly, the late 1930s reversal in the long-term fall in export terms of trade proved temporary, and from the mid 1950s this long term decline reappeared, as Figure 3.1 makes clear. New Zealand has had more favourable terms of trade than Australia in the past few decades, but, like Australia, it is subject to severe fluctuations caused mainly by swings in commodity prices. Few New Zealanders, or their leaders, recognised the significance of this, and for the next 40 years the country alternated periods of restraint in spending on welfare benefits with periods of expensive expansion.

The 1950s and 1960s generally saw restraint enforced on cash benefit outlays. By 1949, New Zealand had one of the higher international levels of spending on cash benefits, as indicated in Table 3.3. Across the next 15 years, however, the New Zealand rate of increase was the lowest of all. This was partly because it started from a high base and reflects a youthful demography, but it is also evidence of some fiscal discipline. There are, of course, numerous reasons to question such international league tables – in particular, what one country chooses to deliver by way of direct cash benefits (the thing measured

Figure 3.1

Terms of trade index-ratio of export prices to import prices, New Zealand 1926-1995. (index numbers-base: average of ten years ended June 1989=1000)



Source: Statistics New Zealand *New Zealand Official Yearbooks, 1990, 1996.* Wellington, 1990 and 1996.

here) another gives by way of tax expenditures, low cost housing or free medical services. Yet the general trends suggested remain sound: New Zealand started the post-war era with high non-contributory cash benefit spending, and kept outlays limited in the following decade or so. But in other periods this restraint was abandoned and spending grew rapidly. Most striking, in the mid 1970s, even as the economic storm clouds were gathering, New Zealand extended greatly its universal non-means tested old age pensions, and introduced a new domestic purposes benefit, largely for sole women raising children.

Table 3.3

Trends in social security expenditures in selected countries 1949-1966

Country	Social security spending as a percentage of GDP		
	Percent *1949*	Percent *1966*	Percent increase *1949-1966*
New Zealand	9.5	11.8	24.2
Australia	4.3	9.0	52.2
Austria	11.6	21.0	81.0
Belgium	11.8	18.5	56.8
Canada	6.1	10.1	65.6
Denmark	7.8	13.9	43.9
Finland	6.2	13.1	111.3
France	11.0	18.3	39.9
Germany(West)	13.7	19.6	43.1
Ireland	7.2	11.1	54.2
Italy	8.2	17.5	113.4
Japan	4.2 (1952)	6.2	47.6
Netherlands	8.1	18.3	125.9
Norway	6.5	12.6	93.8
Sweden	9.1	17.5	92.3
Switzerland	5.8	9.5	63.8
United Kingdom	10.6	14.4	35.8
United States	4.4	7.9	79.5

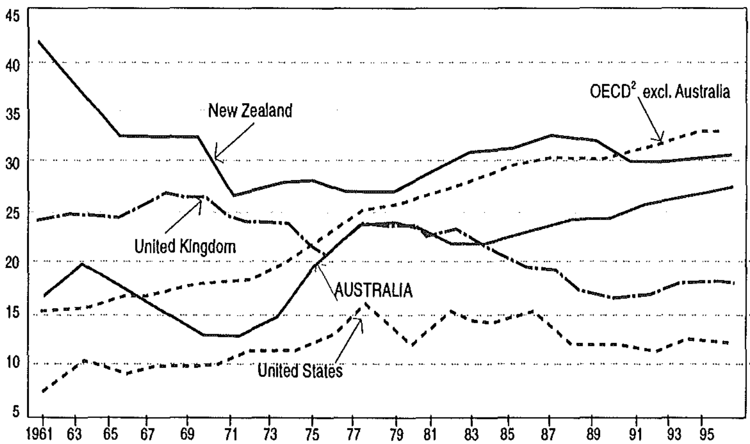
Source: Mainly from the International Labour Organisation *The Cost of Social Security 1964-1966*, Geneva 1972. The figures were also published in Harold L. Wilensky *The Welfare State and Equality: Structural and Ideological Roots of Public Expenditures*, University of California Press, Berkeley, 1975, p. 30-31.

Figure 3.2 shows that, in the 1960s, so far as unemployment benefits were concerned, New Zealand benefits were high compared to other OECD countries shown. While cash benefits for unemployment have been reduced in recent years, the figure shows that New Zealand levels are still amongst the highest as a proportion of average earnings, and are far higher than in the United States or Great Britain.

In short, the New Zealand welfare benefit system became trapped in its past. Universal, non-means tested benefits for all of the aged, at levels that are generous by comparison with a number of countries, and non-contributory but means-tested benefits for the non-aged that were paid without time limits, became its distinctive and expensive features. These did not leave the country ready to face the country's erratic international economic performance through the 1950s and 1960s, even less the swift end to growth and the deepening problems of the 1970s and 1980s. Dependency figures rose to levels unimagined

Figure 3.2

Summary measure of benefit entitlements 1961- 1995 (1)



Source: *OECD Economic Surveys, Australia, 1996*, Paris 1996, p. 91. Note: (1) Unemployment benefits before tax as a proportion of the average across two earnings levels-average earnings and two thirds of average earnings – and three sets of family circumstances – single; with a dependent spouse; and with a spouse in work. (2) Excludes the Czech Republic, Hungary, Iceland, Luxembourg, Mexico, Poland, Portugal and Turkey.

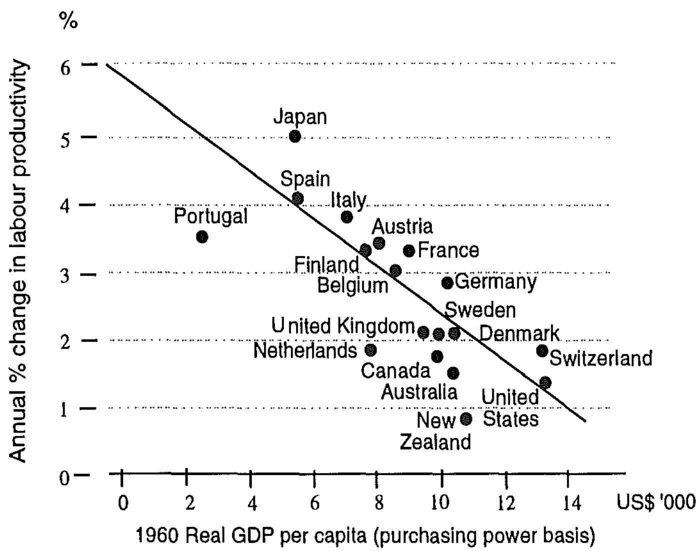
in the past, while New Zealanders continued to express broad satisfaction with their benefit arrangements. The Royal Commission on Social Security in 1972 captured this optimism and complacency well. New Zealand remained proud of its welfare state, including its cash benefit arrangements, and saw little reason to question its fundamentals.

The increasing strains brought about by the events of the last 20 years can be seen in numerous indicators. New Zealand's poor economic performance by international standards is well known, and its weak increase in labour productivity is just one symbol of this. As Figure 3.3 makes clear, since 1960 New Zealand's achievements in this have been at the bottom of the table, and far outstripped by high and low spending welfare states alike.

New Zealand's per capita income grew by only 1.4 per cent per annum between 1950 and 1985, compared to an OECD average of 2.9

Figure 3.3

Labour productivity growth and initial income, selected countries, 1960-1990



Source: I. J. Macfarlane 'Pessimism and Optimism About Australia's Future', *Reserve Bank of Australia Bulletin*, March 1994, p. 2.

per cent. Further, half this low level of New Zealand's per capita income growth was due to increasing inputs of labour and capital rather than improvements in efficiency.[22]

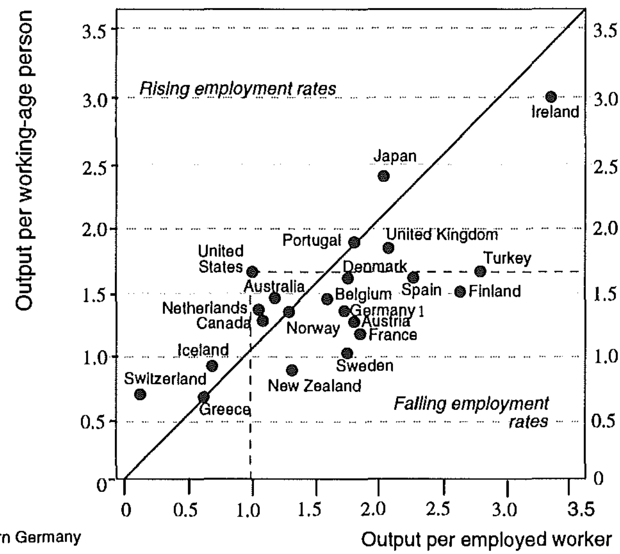
Figure 3.4 shows the poor New Zealand performance in terms of output per employed worker and per working age person from 1980 to 1995. New Zealand not only has had poor productivity per worker, but has also had a weak record on employment growth. The United Kingdom, for example, generally considered to have a lacklustre economy, had greatly exceeded New Zealand's performance. Few of the countries in the figure have been outstanding performers: Japan and Ireland are the notable high performers.

All this coincided with very sharp rises in the numbers on benefits and the costs to the Treasury. Figures 3.5 and 3.6 trace the course of the major cash benefits paid to those under age 60.

The numbers on social benefits in New Zealand is some guide to the scale of dependency and poverty. At the end of June 1996, New Zealand had 1,076,078 men, women and children on income support

Figure 3.4

Output per working-age person and per employed worker 1980-1995: average annual growth rates

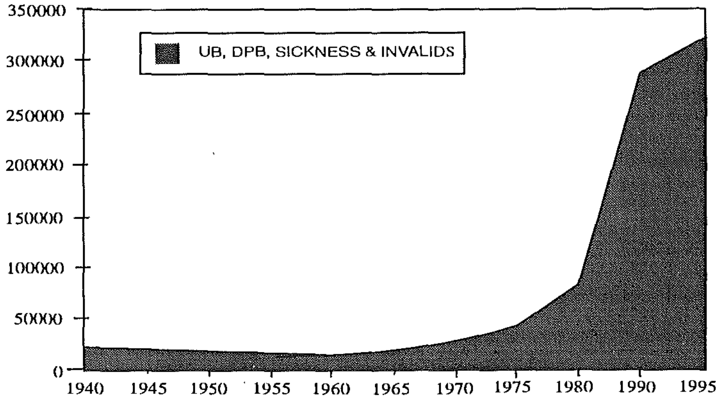


1. Western Germany

Source: OECD *Economic Outlook*, no. 59, 1996, p. 22.

Figure 3.5

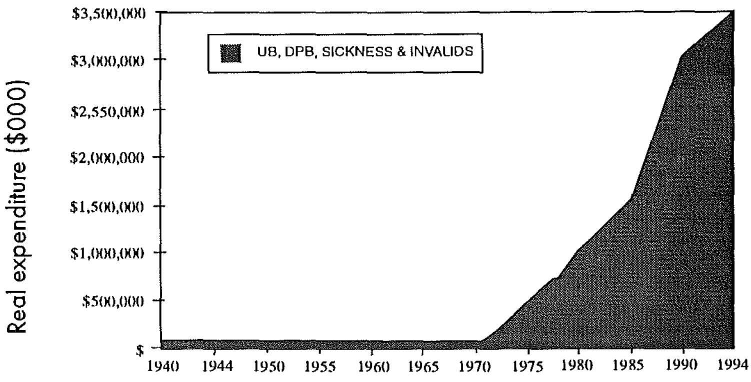
Numbers of people on major benefits (non-aged) New Zealand 1940-1995 (excluding family benefit)



Source: Minister of Finance, *Investing in People*, Wellington, October 1995. This graph includes those on unemployment, domestic purposes (largely single parent benefit) and sickness and invalidity benefit.

Figure 3.6

Total real government expenditure on major benefits (non-aged) New Zealand 1940-1994 (1994 dollars, excluding family benefit)



Source: Department of Social Welfare, reproduced in unpublished Treasury paper. Note: This graph includes those on unemployment, domestic purposes (largely single parent benefit) and sickness and invalidity benefit.

schemes designed to support a household without other assistance (unemployment, training, sickness, invalidity, domestic purposes, orphans, and retirement benefits). Some of the group on benefit had significant other resources, especially those in New Zealand Superannuation, but many were dependent on the pension as their sole source of income. This was 30 per cent of the population. On the same date, there were 1,688,000 New Zealanders employed in the paid workforce (including part timers) For every 100 people on benefit, there were 156 people in employment. The 30 per cent of the population on benefit cost about 9.9 per cent of gross domestic product. About 57 per cent of this amount was for New Zealand Superannuation, about half for the other benefits.

Table 3.4 includes the numbers of children in dependent families in the calculations, because this gives a different perspective than simply the number of adults on welfare benefits.

When dependent children are included, domestic purposes benefit becomes a major source of dependency, accounting for 27 per cent of the benefit population in 1996 (or 292,152 adults and children).

Table 3.4

Numbers on benefit and pensions, New Zealand, 30 June 1996

	Adults	Children	Total	Percent	Percent cost
Unemployment	134,133	53,754	187,887	17.5	14.1
Training	11,389	1,978	13,367	1.2	1.1
Sickness	33,386	11,224	44,610	4.1	4.2
Invalidity	42,450	8,502	50,952	4.7	5.5
Domestic purposes	108,789	183,363	292,152	27.1	15.9
Unsupported child/ orphans	–	4,991	4991	0.5	0.3
Widows	9,047	4,477	13,524	1.3	0.9
Transitional retirement	7,870	405	8,275	0.8	1.0
NZ Super.	459,901	419	460,320	42.8	57.1
Total	806,965	269,113	1,076,078	100.00	100.00

Source: Department of Social Welfare *Annual Report, 1996,* Wellington.

Unemployment also becomes more important, with the unemployed and their children accounting for 17.5 per cent of the benefit population. Those on domestic purposes benefits, and the unemployed and their families, account for 44.5 per cent of the dependent. The aged on New Zealand Superannuation and their children account for 42.8 per cent of the population on benefits. Payments to this group form 57 per cent of the total.

The unemployed and single parents now represent a major proportion of cash benefit outlays. This represents an important historic shift in the spread of benefits, for those who established the modern cash benefit system in the 1930s thought they were providing benefits primarily for the aged, who were regarded widely as 'deserving'. The post-1970 growth in benefits and outlays, however, were for groups with more dubious social standing, so far as being given cash benefits is concerned. The unemployed and single parents in particular were not regarded as being as worthy as the aged, and the 1991 cuts in benefits to the non-aged emphasised this.

Conclusion

As New Zealand approaches the end of the century, its cash benefit system, a central element in its welfare state, has features that make it different from any other western country. For most of this century, Australia and New Zealand had similar cash benefit systems: benefits were flat rate, means tested, non-contributory, focused on the needy, and the majority of the population were assumed to take care of their own retirement and other social contingencies. Nevertheless, New Zealand has long treated its aged as a more 'deserving' group than, say, the unemployed or single parents. Australia has maintained a strict equality, paying the same benefits to all dependent groups.

By the mid 1990s, Australia had joined the mainstream of social security in western countries and established a compulsory, universal, contributory plan for retirement, albeit on a privatised individual account basis that is different from the long established social security schemes in North America and Western Europe. The aims of the Australian scheme, however, were not very different from the historical aims of social security: governments force everyone to save for their own retirement, since individuals cannot be trusted to provide for their own needs. The fully funded Australian scheme is designed to overcome the excessive costs of social security in the United States and parts of Europe. In Australia, the retired next century will only retire on the investment returns of what they and their employer have paid into a fund. They have to accept the risk that governments will not change the rules in the meantime and reduce tax subsidies to saving or raise taxes on fund benefits. The Australian capitulation to a comprehensive and compulsory scheme means that New Zealand was now alone among western countries in not having a compulsory, contributory retirement scheme.

New Zealand's social welfare history has also been very different in another key respect. Comprehensive contributory social security such as exists in most western countries has created powerful vested interests against change, especially against reducing benefits. Compulsory contribution social security creates a moral and political contract between government and beneficiaries that is extraordinarily difficult to change, even in time of severe fiscal crisis. Contributory schemes for all income groups establish a strong idea that social security entitlements are an 'earned right' and not to be manipulated by politicians to suit annual budgetary situations. New Zealand, in contrast, has had no such 'contract' with its population, especially the retired. Cash social welfare payments in New Zealand have been altered, drastically at times, for all groups, including the retired, although they have been treated more preferentially than the unemployed or single parents. The New Zealand cash benefit system may please economic policy makers who want budgetary flexibility, but that can create a vulnerability that is the antithesis of a fundamental aim of the western welfare state: the reduction in risk and the creation of certainty, especially for retirement living standards.

No western country has been able to solve the problems of long term dependency amongst the non-aged. The unemployed and single parents now create a serious and relatively recent expensive social dependency problem. Many children now live in families on low benefits and little prospect of rejoining the workforce. New Zealand, like other western countries will have to develop new ways to alleviate this problem.

References

1 *The New Zealand Official Year-Book, 1915,* Government Printer, Wellington, 1915, pp. 194-6.

2 These figures are from *The Official New Zealand Year Book 1915,* Wellington, 1915, pp 189-93.

3 David Thomson 'The Welfare of the Elderly in the Past: A family or community responsibility?', in Margaret Pelling and Richard M. Smith eds. *Life, Death, and the Elderly,* Routledge, London, 1991, pp. 194-221.

4 James Edward Le Rossignol and William Downie Stewart *State Socialism in New Zealand*, Harrap and Co, London, 1911, pp. 181 ff.

5 Sir George Turner *Debate on Old Age Pensions Bill, 22 August 1899*, Victorian Parliamentary debates, vol. xci, 1899-1900, p. 754.

6 Thomas Paine *Rights of Man*, Heritage Press Norwalk, 1961 (first published 1791).

7 Dietrich Rueschemeyer and Theda Skocpol eds. *States, Social Knowledge, and the Origins of Modern Social Policies*, Princeton University Press, Princeton, 1996.

8 This section relies heavily on the superb analysis in W. Pember Reeves *State Experiments in Australia and New Zealand*, 1902, republished 1969, Macmillan, Melbourne, vol. 2, p. 243 ff..

9 A thorough study of the pension is Gavan Whyte *Old Age Pensions in New Zealand 1895-1938*, MA thesis, Massey University, 1993.

10 I.M. Rubinow *Social Insurance*, Williams and Norgate, London, 1913, p. 379.

11 G.H. Knibbs *Report on the Old Age and Invalid Pension*, Government Printer, Canberra, 1913.

12 In 1910, George Knibbs, the Australian Commonwealth Statistician published a long report on the result of his overseas research on social insurance, G.H. Knibbs *Social Insurance*, Government Printer, Melbourne, 1910.

13 Two examples of the very high quality research on the evolution of the European welfare state are Peter Baldwin *The Politics of Social Solidarity: Class Bases of the European Welfare State 1875-1975*, Cambridge University Press, Cambridge, 1990; George Steinmetz *Regulating the Social: The Welfare State and Local Politics in Imperial Germany*, Princeton University Press, Princeton, 1993.

14 See Francis Castles *The Working Class and Welfare*, Allen and Unwin, Sydney 1985.

15 Details of the Social Security Fund are taken from Statistics New Zealand *New Zealand Official Yearbook 1990*, Wellington, 1990, p. 212.

16 The standard work is Elizabeth Hanson *The Politics of Social Security: The 1938 Act and some later developments*, Auckland University Press, Auckland, 1980; a contemporary work by a Labour politician is John A. Lee *Socialism in New Zealand*, T. Werner Laurie, London, 1938; recent comparative studies include Alexander Davidson *Two Models of Welfare: The Origins and Development of the Welfare State in Sweden and New Zealand, 1888-1988*, Almqvist and Wiksell International, Stockholm, 1989; Raymond Richards *Closing the Door to Destitution: The Shaping of the Social Security Acts of the United States and New Zealand*, Pennsylvania State University Press, University Park, 1994.

17 Barry Gustafson *From the Cradle to the Grave: A Biography of Michael Joseph Savage*, Penguin Books, Auckland, 1988, p. 229.

18 Department of Social Security *The Growth and Development of Social Security in New Zealand*, Government Printer, Wellington, 1950, p. 17.

19 Colin Clark *The Conditions of Economic Progress*, Macmillan, London, 1940.

20 Colin Clark *The Conditions of Economic Progress*, Macmillan, London, 1940, pp. 41 and 148.

21 Ronald Mendelsohn *Social Security in the British Commonwealth*, University of London, The Athlone Press, London, 1954, p. 172.

22 OECD *Economic Surveys: New Zealand, 1993*, Paris, 1993, pp. 11-12.

Chapter 4

The Theory of the Welfare State

Supporters of the free market have been successful in convincing governments to sell public enterprises, deregulate the economy, reduce tariff protection, and introduce competition into most of what remains of government activity, except, that is, for most welfare state programs. Free market doctrines have had limited practical influence on the welfare state. Britain, for example, maintains an elaborate welfare state, based on principles that are the antithesis of free market ideas. Free market supporters have been arguing against the fundamental structures of the western welfare state for two decades, but have had little influence on practical policy.[1]

This chapter reviews the theoretical framework for the welfare state. It asks whether welfare states continue substantially unreformed because of fundamental faults with the private market, because of political processes, or because they meet needs that cannot be met by alternative strategies. The welfare state, in New Zealand or elsewhere, did not develop from sophisticated social and economic theory: it developed historically, from state responses to specific problems, especially population ageing, and the poverty created by the 1930s worldwide depression. No simple framework from one particular scholarly discipline can provide all the insights needed to understand social issues, and this chapter does not try to develop any 'grand' theory of the New Zealand welfare system. Rather, its examines the perspectives available from the world research literature by economists and others, and picks out what seems useful in understanding the unique New Zealand situation. The recent interest in the welfare state by social scientists has exposed the weak theoretical foundations of large scale, publicly organised welfare systems, a fact admitted even by its supporters.[2]

Some may object that economics – the basis of the chapter – is too narrow a perspective to adopt. But whether one approves or not, economists have dominated welfare state research since the 1970s.[3] They are experienced at measuring poverty and inequality, evaluating the effects of public programs, studying social mobility and long term income dynamics, and they understand the labour market better than other social scientists. Economics offers invaluable perspectives on welfare systems because it focuses on who pays and who benefits. This is a valuable antidote to the moralisms and good intentions of welfare reformers, who have created social programs based on simple faiths, only to see them have quite different and often perverse impacts. Economics, and the other social sciences, tell us that any intervention in social and economic systems has complex and often unpredictable effects.[4] Social programs are experiments, not final solutions.

Economists are, of course, fallible, and cannot explain fully the disturbing patterns of social exclusion, racism, and other forms of discrimination and poverty.[5] Often, non-economists deeply resent the domination of 'economic fundamentalism' and the imperial ambitions of economists to monopolise policy analysis.[6] The later parts of the chapter examine some of the interesting perspectives from sociologists and political scientists.

The durability of welfare states

Rising dependency and tax levels since 1973 have increasingly focused the attention of economists on welfare outlays, and in recent times many mainstream economists have become pessimistic about the western welfare state.[7] They cannot see how a generous western welfare system, with high income guarantees for those who do not work, can be compatible with a globalised economy with unprecedented international competition from low-wage countries.

Modern welfare systems were established by those with little understanding of social and economic dynamics. Welfare systems were viewed in static terms and programs were established to meet existing needs. There was little conception that the welfare system was an independent force that could change behaviour, create new needs, and could change incentives and so even perpetuate poverty and inequality.

Economists now understand that welfare systems can create powerful vested interests in existing programs. In the past decade it became clear in all countries that it is extremely difficult to implement major changes to comprehensive, contributory social security arrangements, at least in the short to medium term. Selective, means-tested programs were easier to retrench or dismantle.[8] Change is generally only possible if it is phased in over long periods, often decades, and existing benefits are 'grandfathered', that is, protected from short term change.

Pessimism about the possibility of radical reform is the main message of a recent book on the limited welfare reforms of the Reagan and Thatcher administrations in the United States and the United

Kingdom. In his book, Paul Pierson said, after examining the failures to limit social spending in Britain and the United States:

> Welfare states have created their own constituencies. If citizens dislike paying taxes, they nonetheless remain fiercely attached to public social provision. That social programs provide concentrated and direct benefits while imposing diffuse and often indirect costs is an important source of their continuing vitality. Voters' tendency to react more strongly to losses than equivalent gains also gives these programs strengths.[9]

Pierson makes the important point that we know little about how governments can retrench welfare systems successfully. Politicians found it easy to expand entitlements in times of economic expansion, but are often reluctant to face the political costs of retrenchments in troubled economic times. Pierson notes that Sweden was unable to make significant changes to its elaborate welfare state in the period of severe economic crisis between 1991 and 1994, despite being governed by a right wing coalition, which was sympathetic to privatisation and fiscal retrenchment. Even Britain, with a radical Conservative government for over a decade, has made only incremental rather than radical changes to its welfare system.[10]

Contributory social security in the United States has remained largely unchanged and generous to the retired, despite dire predictions of impending bankruptcy, severe budgetary problems, and drastic retrenchment to the means-tested benefits for single parents.[11] In the United States, a recent, high quality study found that 'Today, seventy-year-olds are consuming, on average, roughly one-fifth more than thirty-year-olds; in the early 1960s, they were consuming slightly more than two-thirds as much. The increase in the relative consumption of the elderly is dramatic, even if one considers only non-medical consumption'.[12] This generous treatment of the elderly is primarily due to expensive health care programs, and expensive social security benefits, paid for by those currently in the workforce. The American aged have much to lose from changes to social security and fiercely resist any erosion in benefits.

The sharp reductions in cash benefits for single parents and the unemployed in the New Zealand welfare system in 1991 are so rare an occurrence internationally that a leading welfare researcher has stated recently that changes in New Zealand were a 'truly exceptional case that hardly warrants generalisation'.[13] And even here, benefit reform has been limited, with governments unwilling to reduce benefits significantly to the aged, the most costly long term group. The New Zealand aged receive significantly more than other groups such as the unemployed and single parents. The New Zealand government in the 1990s also abolished family benefits, which supports the argument that western welfare states increasingly favour the aged over children.

The need for transparency

Some economists argue that the modern western 'welfare state' has to be defined far more broadly than just government social programs of cash benefits and assistance for housing and health care. One of the issues to which economists draw increasing attention is the various and complex ways in which social protection can be delivered and to the significant importance of 'transparency' or clarity of decision making in whatever is pursued. Their preference is always for political systems to be clear and open about spending and taxation or who gains and who loses. This perspective is useful, because it suggests that the radical changes to the New Zealand state over the past decade – perhaps unmatched by any other country – has meant a major cutback in indirect 'welfare state' aspects of the New Zealand economy: tariffs and other subsidies to industry and public employment have been reduced, and health, housing and education programs made more subject to competition and user charges.

It is possible to develop various typologies of welfare or resource transfer systems. One, based upon relations to employment, suggests four types of transfer or benefit regimes. (The discussion here is of benefits or transfers of a wider variety than simply the cash benefits component which is the principal concern of this study).

The first of the four types refers to hidden transfers to workers from consumers and investors, via such things as trade protection. High tariffs, foreign exchange controls, wage regulation and other forms of protection boost incomes for those occupying certain jobs, at the expense of others. These Type One transfers, a fundamental part of New Zealand and Australia policy for much of this century to the 1980s at least, obscure the true level and nature of transfers, limit structural change in the economy and lower international competitiveness.[14] Workers, unions, and owners of capital will usually resist any reduction in these subsidies, arguing they will reduce employment and living standards.

Type Two transfers are contingent on the continuation of employment. Sweden is an unusually advanced welfare system, because it has generally had an open economy and has not therefore relied on protection to maintain employment. Instead, Sweden pioneered Type Two transfers through active manpower programs of retraining, and especially through the expansion of public sector employment. This requires significant public expenditures and high taxes. Type Two transfers can assist an economy to adjust to structural change, but they can also act as a major distortion in the economy. Public sector employment can expand significantly, and the expansion of retraining schemes can become a costly permanent feature of the economy, influencing employee behaviour and wage levels, especially at the bottom level of income distribution. High levels of public employment can become a base for powerful and demanding unions, and form a political basis for opposition to significant changes in the welfare system.[15] Like Type One transfers, those of Type Two obscure costs and benefits and distort markets, and are increasingly disfavoured by economists.

Transfers of Type Three are more transparent than those of Types One and Two, but can still be highly distorting. Type Three social transfers are contingent on past employment. The social insurance states, the dominant form of welfare provision in Western Europe and North America, have two tier welfare systems, as we have noted before. Those with long work histories are guaranteed high levels of income replacement to cover periods of sickness, invalidity, unemployment, and especially retirement. These forms of social insurance can, in theory, be based on strict actuarial principles without cross subsidy. The schemes often in fact involve significant cross-subsidisation and redistributions to the lower income group within the workforce. They can often also result in significant cross-subsidisation between generations.

Type Three social transfers are difficult to maintain in modern advanced economies. Many large corporations and government authorities are reluctant to commit themselves to employment for life (the key prerequisite for individuals building life histories of contributions, and most widespread in Japan). They prefer to downsize and rely on outside contractors for an increasing proportion of production. These contractors usually cannot offer employees long-term employment and significant non-wage benefits. Part-time employment is becoming more widespread in New Zealand and other western countries, reducing the ability of workers to accumulate significant contributions to enable independent retirement and other benefits. Employers object to the high cost of employer funded benefits for long term workers, a subject discussed elsewhere in the book.

Increasing competition between countries means that businesses can often make valid claims that high business welfare costs decrease their competitiveness and can induce them to move to lower tax locations.

Type Four transfers are usually contingent on low incomes and are administered via a means test or via membership of a particular deprived category, such as a minority ethnic group. These transfers might also be allocated on the basis of membership of a favoured category such as the aged without a means-test (as in New Zealand). Australia and New Zealand favour Type Four means-tested transfers more than do other affluent countries. Means-tested benefits can create 'poverty traps' and alter behaviour in client groups. Those on benefits are often reluctant to take employment which would mean only minor increases in net income, and sometimes can even lead to a reduction

Figure 4.1

Main forms of social transfers

Type 1	Transfers contingent on stable job structure. Minimise structural change, maintain employment in traditional sectors, control wage levels. High levels of protection against imports and government subsidies to maintain existing industries. Australia and New Zealand are good examples in the past.
Type 2	Transfers contingent on continued employment. Open economy but with extensive active manpower programs and public employment to maintain high levels of employment. Sweden the best example. More open economies make this model increasingly relevant.
Type 3	Transfers contingent on past employment. This is the model for the social insurance state that predominates in Europe and North America. Benefits are generous to those with long work histories.
Type 4	Transfers contingent on low income, allocated according to a means tests, or to membership of a particular social group, such as the aged.

Source: Adapted from Deborah Mabbett *Trade, Employment and Welfare: A Comparative Study of Trade and Labour Market Policies in Sweden and New Zealand 1880-1980*, Clarendon Press Oxford, 1995, p. 178-9.

in household resources. High levels of dependency require high taxes which can distort economies. Means-tested benefits can be relatively easy to reduce, especially if they are only given to a small proportion of the population who have little political influence. Universal benefits, such as New Zealand Superannuation, have proven to be far more politically resilient and the scheme has been maintained over the long term despite attempts to means test through the tax system. These various transfer classifications are summarised in Figure 4.1

New Zealand ended up in economic difficulties, partly because it mixed Type One (heavy protection), Type Two, with a high level of public sector employment, and Type Four (means-tested welfare state).[16] International pressures and slow growth caused a significant reduction in Type One protection in the 1980s, and public sector efficiency improvements and the privatisation of much of public enterprise lead to structural changes, and employment losses in particular sectors. This greatly increased dependency on Type Four, which has serious incentive problems. The deregulation of wages and international competition leads to uneven wage growth and falling incomes for some. Deregulated wages require a controversial reduction in social protection benefits to ensure work incentives are maintained by a gap between welfare benefits and employment income. An alternative is Type Two policies that emphasise expensive retraining and the growth of government employment, although this often also has its problems, as Sweden is now making clear.

Mancur Olson has specialised in what makes economies grow and decline.[17] According to Olson, over time countries become ossified, growth slows and a crisis develops because interest groups become more powerful and fight to maintain special benefits for themselves. Olson has reminded economists that, while Sweden has been in serious economic difficulties in recent times, it did manage to maintain astonishingly high public spending – 72 per cent of gross domestic product in 1993 – by far the highest amongst affluent countries. Its lavish welfare system only coexisted with a sophisticated economy for so long because it had an open, competitive, high-value-added economy for a lengthy period. Its subsidies were clearly concentrated in explicit assistance to selected groups via social insurance and social assistance programs.

New Zealand, in contrast, had the worst of all possible worlds: a complex and distorting mixture of explicit subsidies via welfare programs, and implicit subsidies through highly protected domestic industries and high levels of public employment. Olson, like many other theorists, makes a strong case for clear and explicit subsidies: direct income support for social welfare is preferable to indirect assistance such as tariffs because it can be monitored more easily, targeted to specific sub-groups, and should reduce allocative inefficiency. For him, the Swedish experience shows that a strong open economy can, at least for a time, support extremely high levels of transfer spending. A static or declining uncompetitive economy with little history of structural change can face a crisis at quite low levels of welfare state spending. Sweden entered a period of severe economic crisis in the 1990s because its taxation levels and generosity of benefit became too onerous in a declining economy. Transfers of all types have their costs, especially in the long-term, and there are no shining examples of success with any policy mixes which New Zealand might now adopt with confidence. Indeed, New Zealand is now used by the OECD as one of the few examples of a western government that has actually implemented significant structural economic reforms.[18]

Market failure and the revival of private insurance

The case for government provision or at least regulation of social security benefits has been justified on a number of grounds that are summarised below.[19] All these justifications are debatable and many will be discussed in this chapter and later in the book.

- The nature of modern society and the decline of the extended family makes it difficult to rely on family care for the aged. Changing demographics, especially the decline in the birth rate and increased life expectancy means that, in the future, there will be a higher proportions of the aged to be supported and a smaller proportion of people in the workforce to pay for their support. Only government, say its supporters, can take the long view to plan for these demographic trends.
- Governments have to be paternalistic and provide compulsory social security plans because individuals are myopic about the future, and most think only of the short term, not the decades they are likely to spend in retirement.
- Governments can reap information efficiencies, by providing a basic minimum floor for retirement without having to gather information on the complex, precise nature of each individual's preferences.
- Compulsory social insurance schemes can overcome the adverse selection problems in private insurance markets (discussed later).

With adverse selection, only good risks are likely to take advantage of insurance for lifetime annuities. Compulsion can ensure that individuals do not run out of retirement savings before they die.

- Only government can cover its populations against major uninsurable shocks such as destructive wars, serious inflation, and major depressions such as in the 1930s.
- Governments can overcome 'free rider' problems, called 'moral hazard' problems by economists – where individuals refuse to save because they know society will not let them die in poverty. Social security forces everyone to contribute to the social safety net.
- Governments, via the power to tax can offer inflation – and income-linked benefits over the long term, a difficult task for private insurance firms which rarely provide such guarantees.
- Governments can use social security to redistribute a minimum income to those on low incomes who are unable to save enough for a lifetime.
- Governments can gain economies by minimising administrative costs, particularly for low earners, that may consume a disproportionate share of funds in private schemes.
- Government social security schemes provide a form of risk-sharing across generations that is difficult for the private sector, whose returns may be determined by booms and busts in certain types of assets, especially the stockmarket.

The early supporters of welfare programs claimed government provision on a massive scale was necessary because of obvious market failures such as these. Market failure was supposed to prove the case for government intervention on the assumption that government was not subject to failures. In recent times, however, extensive welfare state research documents in turn the failure of many government attempts to solve welfare problems.[20]

Government failures in welfare are discussed in many parts of this book. Briefly, government is supposed to have failed because of escalating costs of welfare systems in western countries. Welfare programs have ended up costing far more, as a proportion of gross national product, than even their most enthusiastic supporters or fiercest critics believed possible. High costs mean high taxation, internationally uncompetitive economies, and a crowding out of investment by welfare consumption expenditures. Welfare systems are also blamed for encouraging a wide range of negative behaviour. Generous benefits may discourage work effort, poor lifestyles, low levels of private savings, and an incentive to form or remain in single parent families. Such broad costs, known to economists as 'externalities', are now very influential in government policy analysis.

What is now provided by government welfare programs, was until the last century or even more recently, provided by private markets. Education and public health – the first areas of governmental intervention last century – often have positive externalities for society, which benefits from a better educated workforce. Public health measures such as the control of infectious diseases also benefit the broad society: deadly diseases did not always distinguish between the rich and the poor. The first welfare system was created in Germany by Bismarck in the 1880s because he felt it would provide positive externalities in the form of a more conservative working class, and one less interested in socialist revolution.

But modern welfare states involve government compulsion and often direct service provision in a far wider range of programs than just health and education, where most economists agree that the failure of private markets requires government intervention. The bulk of people, so the argument went, lacked adequate information about risks and failed to plan for the future. Left to their own devices, they would leave school too early, fail to save to cover periods of unemployment – let alone distant retirement – and would fail to take preventative measures to ensure good health. They would often smoke, drink, and gamble to excess. Welfare state paternalism – government knows what is best for you – is most developed in the Swedish model. Gunnar Myrdal, one of its creators, said 'Like domesticated animals, people growing up in a western type of regulated national communities have no real conception any longer of a wilder life. To the reflecting social scientist the adaptability of the human animal to new conditions will never cease to be one of this world's wonders.'[21]

Welfare states arose in part too because of another form of market failure: private insurance was unable or unwilling to provide adequate cover for the bulk of the population. If insurance is voluntary, only bad risks will seek insurance. Premiums will rise to prohibitive levels, or an insurance market will not exist for the particular risk. Insurers are often cautious because they lack in-depth information about clients, who may have an incentive for 'moral hazard', that is to overuse the insurance because once they are covered they have an incentive to take advantage of the cover.

Comprehensive and compulsory social insurance systems such as exist in western Europe and less comprehensively in the United States are based on the idea that coverage for retirement and other social conditions has to be compulsory to allow lower premiums and coverage of those with high levels of needs, who often cannot afford risk-based premiums.

Compulsion and even total provision by government does not overcome moral hazard problems, as of course the cost explosions in national social insurance schemes illustrate. New Zealand has struggled to control spending by the Accident Rehabilitation and Compensation Insurance Scheme, a compulsory insurance scheme established in 1974. Benefits were related to previous earnings and are more generous than in the social security system. Clients had an incentive to misrepresent claims and resist reentering the workforce – moral hazard problems common in insurance schemes. Those unable to work as a result of injuries, however caused, were paid an amount equal to 80 per cent of pre-injury income. This level of payment was far more generous for most than anything available under the rest of the New Zealand welfare system. The scheme has been reformed, with most clients forced to rely on the lower level benefits in the mainstream social welfare system.

In 1995, there were 1,439,000 claims under the accident compensation scheme, making the scheme a major program given New Zealand's total population of 3.64 million. The scheme cost $912.7 million in 1994-5, equal to nearly ten per cent of social welfare outlays.[22] The difficulties of controlling claims and costs in the accident scheme may be one reason why New Zealand policy makers are now wary of other social insurance schemes.

If free markets work – and this has been accepted in many areas of public policy – it seems reasonable to suggest that private insurance could become the basis of a newly privatised welfare state. Private insurance has many attractions to reformers. The role of the state will be diminished, people can assess their particular risks, and there are rewards for responsible behaviour. Government paternalism and compulsion will disappear and liberty will be enhanced. But many modern economists, on the other hand, have all but rejected private commercial insurance as a basis for replacing state welfare programs. Private insurance needs five preconditions to be effective.[23]

Precondition 1 'The probability that the event insured against will occur for individual citizens must be independent of the probability that it will occur for any other citizen.'

According to this precondition, it is not possible, for example, for citizens to insure against inflation because inflation would affect the whole population. Originally, social insurance schemes were based on the idea that individuals' contributions would be pooled and invested and then repaid to them when they retired, together with interest. This 'funded' social security was soon abandoned because high rates of inflation eroded the returns on investment. Instead, social insurance generally moved to a pay-as-you-go system. Retirees' incomes were paid directly from the pay packets of those currently in the workforce. Wages generally rise with inflation so the risk of inflation appeared to be solved, but only by a comprehensive, compulsory government managed scheme.

Insurance for support against old age is possible, if the problem of inflation is ignored. New Zealand and most other western countries have controlled inflation over the past few years, but there is no guarantee that this low inflation pattern will continue. Capital markets have become smarter, and interest rates now rise rapidly in inflationary periods to ensure real rates of returns to lenders. This issue is discussed in more detail in Chapter Nine on self-funding retirement. The difficulties of insuring against inflation does create a real problem in private insurance markets for retirement. Supporters of privatising social insurance claim that investing savings in the stockmarket is, in effect, a way of insuring savings against inflation because stock markets at least keep up with inflation, in the long term. This issue is discussed in more detail in Chapter Nine.

Coverage against premature death is insurable, at least at younger ages when such death is rare. Insurance is viable against the need for intensive social care when old, but only if premiums are payable over a lifetime. As age progresses, it becomes apparent to some that they have a higher probability of needing old age care, and only they will tend to take out insurance: compulsory coverage of all would be necessary.

Premiums, even so, would be high because long life expectancy is common in western countries. Germany has recently introduced a compulsory social care system based on contributions of two per cent of wages by all the workforce. This is a substantial lifetime payment, showing the high costs of social care, mainly for the aged. American insurers have been reluctant to offer long term care insurance because of the difficulty in defining who is in need of assistance, and because of the 'moral hazards' in policy holders claiming on policies when not really in need. Administration of these policies would require expensive case management that adds to policy costs.[24]

Precondition 2 'The probability that the event will occur must be less than 1.' It is not profitable for a company to sell insurance if the event is likely to occur to everyone. It would not be possible, for example, to insure against death at all ages because it will eventually happen to everyone.

Precondition 3 'The probability that the event will occur must be known and subject to estimation.' Lloyds of London has serious financial problems of late partly because of costs caused by previously unknown conditions, such as the long term deadly effects of asbestos and other toxic substances. This requirement makes insurance companies reluctant to insure against new diseases such as AIDS. Insurance against unemployment was thrown into a crisis by the 1930s depression, when unprecedented and so unpredicted large scale unemployment soon exhausted reserve funds.

Precondition 4 'Individual citizens must not be capable of concealing from the insurance company which risk group they are in.' This can be a major problem for insurance companies, but they can overcome it in part by developing sophisticated risk profiles by age, past history, type of car (with car insurance), locality, and so on. Modern laws on privacy can make it difficult for an insurance company to find the information it needs for proper risk assessment, and anti-discrimination laws can make proper risk-based policies illegal. Risk analysis, for example, may suggest high premiums for a particular ethnic or lifestyle minority. Ignorance of risk group membership, however, often leads to premium averaging or 'community rating' as in Australian private health insurance. These premiums will be too high for low risk groups and only high risk groups will find insurance attractive. Healthier Australians have been withdrawing from private health insurance and premiums are rising because most remaining policy holders are higher risk, likely to be older, and to make expensive claims. In the United States, governments have had to force insurance companies to offer insurance to those who live in high risk, low income neighbourhoods. Insurance companies, left to the free market, may neglect the higher risk, lower income groups, even though these groups may have a wide range of needs.

Health insurers in the United States have similarly become very cautious because very high health care costs can be incurred by small percentages of the population. It has been found there that one per cent of the population is so sick as to consume 30 per cent of medical expenses in a given year, and the sickest five per cent 58 per cent of health outlays. Private companies, without government regulation, have a strong incentive to refuse to insure this group, and million of Americans have been denied health insurance.[25]

Precondition 5'It must not be possible for individual citizens to influence the probability of the event insured against occurring.' This is the major 'moral hazard' problem of both public and private insurance. Those with high levels of health insurance coverage, for example, have a strong incentive to make extensive use of available services. This is a major cause of spiralling health costs, especially in the United States where there is extensive non-government health insurance. The United States spends 15 per cent of national product on health care, nearly twice the proportion in New Zealand. For example, the insurance system means that individuals have a strong incentive to seek expensive care, provided by doctors who also have a vested interest in providing more care. The individual faces little or no additional cost for the service, other than the insurance premium which remains the same whether services are used or not.[26] High unemployment levels in recent decades are partly linked to the generosity of unemployment benefits. The OECD reported in 1996 in its survey of structural change in OECD countries that 'There is a wide consensus that the generosity of unemployment and other social benefits, in terms of both duration and level, raises structural unemployment by reducing the incentive to find and keep a job'.[27]

It is difficult for most social needs to meet all these conditions for the application of actuarially-based insurance that could be provided privately. Sickness benefit is one example where private cover should be possible. People – or most at least – do not know when they are going to be sick (excluding epidemics), and medical verification should eliminate cheating.

Long-term chronically ill people may have difficulty obtaining insurance.

The trade-off between efficiency and equity

Those who support increased private insurance and market approaches to social welfare usually also claim there is a trade-off between social expenditures and economic growth. This is a controversial question because some countries in Europe, especially the former West Germany and Sweden and other Scandinavian countries, have been very strong economies through the postwar decades despite very high levels of social spending which would be considered unsustainable by many policy makers and interest groups in New Zealand and Australia. But despite such evidence to cause doubt, economists and policy makers have long assumed that there is a trade-off between income equality and economic efficiency. High levels of equality require high taxes which reduce incentives for entrepreneurs, generally lower work incentives, encourage leisure, reduce savings, lessen the return on investment, and lead to lower economic growth rates.[28] Any insistence on carving the economic pie into equal slices shrinks the size of the pie.

Michael Savage and the other architects of the New Zealand welfare system in the 1930s did not believe there was any trade-off between higher welfare spending and economic growth. Many of their successors have thought otherwise and New Zealand's social policy decisions over the past decade have been designed to reduce public outlays. Family benefits have been abolished, age benefits were subject to a tax surcharge (now abolished once more), user pays has been applied at least partially to many health and educational services, and a range of welfare benefits were reduced in 1991. The underlying assumption appears to be that a smaller welfare system, and therefore lower taxes, will make New Zealand more competitive and increase the rate of economic growth. The larger economic pie can then help finance social welfare benefits.

Economists have long been fascinated by the problem of measuring the exact nature of the trade-off between equality and efficiency.

Recent theoretical work on welfare outlays offers some tantalising suggestions on the topic. Sinn, for example, argues that welfare programs may not always weaken incentives to work and innovate, even with significant progressive income taxation and extensive social welfare assistance to those who suffer income loss from a wide variety of causes. Welfare programs increase individuals' willingness to take risks, thus stimulating the economy and increasing the rate of economic growth. Sinn acknowledges that high taxes to finance a welfare state can make an area uncompetitive and create an incentive for capital to migrate. However, this dilemma can be overcome in part by financing the welfare state by personal income taxes, not taxes on mobile businesses. [29] Sinn summarises his argument:

> Protected by the welfare state, people engage in risky and profitable activities which they otherwise would not have dared to undertake. Risky occupations might not be chosen without the protection of the welfare state, and it would be difficult to find entrepreneurs willing to supervise risky

> investment if debtor's prison were all that society provided in the case of failure. Perhaps the most important function of the social welfare net is that it makes people jump over the dangerous chasms which would otherwise have put a halt to their economic endeavours. It may, in fact, make them too eager to jump. Protected by the welfare state, people may neglect to take necessary care, may take too much risk, and end up in a worse situation than without such protection. This is the moral hazard problem that an overwhelming majority of policy advisers seems to fear.[30]

But others do not agree. Sinn's optimism about the positive risk-enhancing side of elaborate welfare systems is a minority view popular only in parts of Europe. Most European economists are disillusioned with European welfare systems that are viewed as comfortable and non-risk enhancing, and contribute to sluggish economic performance.

There has also been recent sophisticated empirical research on the equality-efficiency trade-off. The work on affluent countries between 1974 and 1990, which included New Zealand, showed no evidence that greater income equality impairs efficient economic performance in advanced industrialised countries. High levels of income equality are compatible with high levels of economic growth, although it is more difficult to argue that high levels of income equality enhance economic performance.[31]

The link between inequality and economic growth may, then, be an illusion. It seems more likely that countries that experience rapid growth, for a complex array of reasons, are more likely to be generous in redistributing income. This argument fits some of New Zealand's history. Its booming economy between 1935 and 1950 was easily able to afford major redistributions. The level of redistribution only became a problem when the rate of economic growth faltered.

Attempts to seek broad laws of equality-efficiency trade-offs have not been very successful, usually focusing on a few countries that may be special cases.[32] Recent World Bank research suggests that the equality-efficiency trade-off is now mostly relevant to poorer, non-western countries, noted for their very high levels of inequality. In contrast, inequality in western countries appears modest.[33]

It may be more productive to focus on the history of individual countries rather than on broad patterns. Japan, for example, has a very high level of income equality, but this may have had little to do with its high rate of economic growth, at least until recently. Japan achieves equality through a high level of equalisation of primary workforce incomes, not through government taxation and social programs. It seems that each country develops for itself criteria of what is fair and reasonable in terms of income equality. A high level of income equality in Sweden, for example, is accepted because of Swedish culture and history and political agreements. The same level of income equalisation might be politically and socially unacceptable in Australia, New Zealand, and the United States.

To summarise, it seems reasonable to say, in terms of ensuring minimum income protection for the lowest income groups, that countries can overshoot targets (Sweden) or undershoot (United States). Some sort of middle ground seems the most sensible. Welfare systems need to be flexible and responsive to changing needs, economic conditions, and the global economic environment. The Swedish approach was once called the 'middle way,' but after egalitarian policies are commenced it seems difficult to stop the momentum. Swedish public expenditure in 1993 at 72 per cent of national product is hardly a middle way. Eminent Swedish economists such as Assar Lindbeck now argue that such spending removed fundamental incentives for growth, and so undermined that country's longer term economic and social success.

The research for the period from 1990 to 2000 and beyond might look very different. The highly inegalitarian United States economy is growing rapidly and creating a high level of employment. The British economy, also becoming highly inegalitarian, is also growing respectably, in contrast to continental Europe where growth is minimal, job creation stagnant, and there is disillusionment with traditional equalising welfare states. The boom in East Asian economies that mostly have minimal welfare states and growing inequality also suggests that patterns of the past may have changed.

Human and social capital

The theory of human capital is perhaps the most important contribution of economics to the development of modern welfare systems. Human capital theory was popularised by the American economist Gary Becker in 1964.[34] The human capital of a nation is 'the sum of the skills embodied in its people, with the value of that capital dependent on the opportunities people have to use those skills'.[35] Human capital does not depend simply on formal qualifications, but includes skills learnt in the workplace. Economists had long been familiar with the importance of physical capital to economic growth, but Becker applied similar techniques to understanding the role of investment in people through training and education: higher levels of human capital are the key to productivity. Influential research published in 1967 found that the level of investment in human capital was a key to understanding why some economies grew faster than others.[36]

The Organisation for Economic Cooperation and Development (OECD) stresses the need to improve the level and quality of human capital in its recent reports on the New Zealand economy. Affluent countries like New Zealand have to improve their productivity to maintain their competitive edge over low wage countries in Asia with minimal levels of human capital. Highly educated and trained workforces are flexible and able to adapt to new technologies and changing markets.

The relatively poor quality of human capital in New Zealand is shown in Table 4.1, where New Zealand is compared to two other small economies, Denmark and Singapore, and to the highest level country in the OECD. New Zealand, according to the OECD, has real problems in its poor level of human capital development which adversely affects New Zealand's productivity performance. Moreover, human capital levels are not raised quickly. New Zealand, like many other countries, has large numbers of older workers with low levels of human capital and industries are often reluctant to invest in retraining for older workers because it is believed they will soon retire.

Table 4.1

Indicators of the quality of labour, 1992
0=low-100=high

	New Zealand	Denmark	Singapore	OECD high
Skilled labour	58	79	46	81
Qualified engineers	63	80	57	83
Worker motivation	51	67	63	81
Receptiveness to learning	58	66	70	77
Education	42	65	76	75
Training	50	69	69	82

Source: The World Competitiveness Report 1992, taken from OECD *Economic Survey New Zealand, 1993*, Paris, 1993, p. 71.

Human capital theory has key implications for anti-poverty policies. Those dependent on social welfare benefits for longer periods are increasingly being pressured to undertake retraining, often with government subsidies. The success of these programs globally is mixed, but they do send a strong message that long term dependency is not favoured and that efforts have to be made to gain extra skills. Human capital programs for the poor are part of the recent emphasis on raising the asset levels of the poor, whether it be via home ownership or education and training.[37]

Recently, there has been intense interest in 'social capital'. This idea is linked closely with the growing interest in communitarianism, discussed earlier in the book. 'Social capital' concepts were developed by the American sociologist James Coleman who argued that peoples' behaviour is 'shaped, redirected, constrained by the social context: norms, interpersonal trust, social networks, and social organisation'. These forces are important for the functioning of both society and the economy.[38] Social capital – the relations among persons – can have positive or negative effects. Human capital investment is more likely to be productive, if it is supported by positive social capital: strong families and well functioning and supportive communities. Coleman was a leading American researcher on educational outcomes, and his studies show powerful links between educational success and positively functioning families and communities. The American analyst Francis Fukuyama has helped popularise the idea of social capital, claiming that a high level of positive social capital in the form of 'trust' is a key to successful economies.[39]

Social capital in the family and the community can affect the level of social dependency and how it is managed. Families can encourage children to succeed in education, or may discourage achievement. Strong families do not necessarily create positive social capital. The American economist George Borjas has shown that strong families, in some ethnic groups which are living in tightly integrated neighbourhood communities, can have marked negative effects on achievement by their children. The strong ethnic traditions in such places make it difficult for the children to advance socioeconomically in the broader society.[40]

Family background is a key influence on many social problems and there is a controversial movement in the United States to license parents: only those functional families with a licence can have children. Jack Westman, an American psychiatrist, argues that the main source of juvenile violence and crime is the 'cycle of child abuse and neglect when parenting fails. Incompetent (defined in legal terms as unfit) parenting is the most important factor in adult outcomes. Competent parenting protects even biologically vulnerable and socioeconomically disadvantaged children from these outcomes' [41]

While most admit the importance of social capital, it is not clear how it can be strengthened by specific actions. Coleman argues that it is a 'public good' that affects everyone, but that it is not created by individual, isolated actions, instead being largely the product of voluntary and spontaneous social organisation. Social capital is created by obligations and expectations which depend on trust and norms accompanied by sanctions. Governments know little about how to change these broad social forces. Fukuyama summarises his view of the importance of increased social capital, but without offering obvious solutions. He says

> The traditional argument between left and right over the appropriate role of the state, reflected in the debate between the neomercantilist and neoclassical economists, misses the key issue concerning civil society. The left is wrong to think that the state can embody or promote meaningful social solidarity. Libertarian conservatives, for their part, are wrong to think that strong social structures will spontaneously regenerate once the state is subtracted from the equation. The character of civil society and its intermediate associations, rooted as it is in non-rational factors like culture, religion, tradition, and other pre-modern sources, will be key to the success of modern societies in a global economy.[42]

Fukuyama's model for high levels of social capital is Japan, while Robert Putnam, an American political scientist, has become well known for his support for parts of northern Italy as an example of where there is strong and effective social capital, based on strong local governments.[43] It is difficult to transfers these models to countries with weak social capital or even to be clear about the essence of these models: parts of Italy, for example, may have high levels of social capital but it is not clear what caused it to develop.[44]

Marketisation

Most western countries have accepted that the idea that government programs should be exposed to free market pressures. Privatisation combined with deregulation encourages the use of competitive markets, and ranges from the outright sale of government enterprises to contracting out of government services, and the use of simulated purchaser-provider mechanisms. Not all economists support large scale privatisation, but the case for privatisation depends on classical economic concepts: competitive markets are more effective than government bureaucracies in providing a wide range of services. Free market principles in government have been applied in New Zealand with probably more enthusiasm than in any other western nation, a fact now well documented in the New Zealand and international literature.[45]

An idea that underpinned the postwar welfare state was that government should provide 'universal' services in housing, health and income security. Universal government provision was supposed to eliminate stigma for the poor, who would obtain the same services as the rich. Universal services were also supposed to minimise administrative costs by avoiding means testing, eliminating 'wasteful' competition, providing services in a compassionate non-commercial way, encouraging voluntarism, and promoting citizenship and social inclusion.[46]

By the 1970s there was growing disillusionment with the idea that government was the most effective provider of universal welfare services. Research showed that the middle class benefited the most because they were more competent in dealing with the welfare bureaucracies and were more aware of their rights.[47] Large centralised monopolistic government bureaucracies were likely to be unresponsive to client needs. Service costs were often high because of lack of competition. Large public housing estates had become social disaster areas because the poor were concentrated in the most unattractive and dangerous large estates. The middle class increasingly preferred to purchase private schooling, private hospital care, private housing and so on. Economists increasingly argue that the poor might be better served by different and more competitive service delivery systems. Government would have a role as a regulator, setting minimum standards and possibly enforcing compulsion, and would provide subsidies. But there was a need to create competition in the supply of housing, health, and retirement benefits.

This new market-based movement saw the adoption of quasi-markets in health, education, public housing and other parts of the welfare system.[48] Quasi-markets usually require government services to be restructured along purchaser-provider lines. One group plans service provision while those who supply services form into 'provider' units and compete for contracts, often with competing units from other organisations or the private sector. Rudolf Klein, a researcher of the long term quasi-market innovations in the British National Health System, claims that the new market movement can be compared to the changes from a model based on the 'church' to that based on the 'garage'. The 'church' model, once the basis of government's role in health, relied on paternalistic professionals and centralised planning, responding to 'needs' with little attention to costs, priorities, trust, universalism and stability. The 'garage' or market model emphasises consumer choice, responsiveness, demand (and ability to pay), contract, targeting and adaptability.[49] New Zealand adopted these policies for housing and health services in the late 1980s. But all Western countries, including Britain, have proven reluctant to establish quasi-markets in the educational sector, even though they were urged to do so by many reformist free market economists.

There is now considerable research on the effectiveness of market-based reforms for health and social care, especially in the United Kingdom. This research points out that market-based systems often do not have positive effects, either in terms of consumer satisfaction or economic efficiency. Those working within the health care industry can distort the intentions of the reforms, create higher administrative costs and perpetuate expensive professional empires. Competition in health care is not a simple solution to rising health costs. In its 1996 report on the New Zealand economy, the OECD – a strong supporter of quasi-market reform – was critical of the market reforms to the New Zealand health care system. The changes appeared to have created confusion, reduced accountability, and failed to improve productivity.[50] User pays and other elements of the market-based approach are difficult to apply to health care services, especially when the public have been accustomed to free services for decades. Health services have always occupied a special place in welfare state thinking. Western publics – even in the normally pro-market United States, demand a high degree of access and even equality between income groups in health services, while often tolerating marked inequalities in income, housing and other goods: even pro-market supporters find it hard to deny treatment to a person facing pain or death because of inability to pay market prices for health care.[51]

Governments, it now appears, may introduce complex quasi-market reforms that merely create an appearance of reform, without implementing reform in substance. Quasi-market reforms, especially in health care, may avoid the hard political decisions about service reductions that may well be the only way to achieve cost savings. Much modern health care is very expensive, and western governments may have to accept inevitable increases in the proportion of national product spent on health, especially as the population ages. Spending restraints may require significant rationing, longer waiting lists, and controls on cost increasing medical treatments: market-based reforms alone will not resolve these.

The issue is particularly controversial in New Zealand, where public sector health costs as a proportion of national product are one of the lowest in the OECD area, and have fallen since 1990-91. Since 1971, New Zealand per capita health costs (adjusted for inflation) have remained modest in comparison with the trends in other OECD countries, and were, in 1994, about one third of the level of the United States in comparative purchasing power. In 1994, New Zealand's overall health spending (public and private) was only slightly above the level in the United Kingdom, the lowest spender, noted for its frugality and long waiting lists.[52]

A welfare safety net as a form of 'social control'

Western welfare states are based on a complex mixture of values and social and economic theories and practical responses to problems at a specific point in time. The first, and longest standing is the concern to relieve poverty and destitution. Most societies have had some idea of a basic minimum standard of living.

Another longstanding concern has been for 'social control' and is rooted in pragmatism: if left without help the poor will clog hospitals, fill mental asylums, commit crimes, and generally become a public nuisance. The values of some of the poor – especially their criminal behaviour, high illegitimacy, lack of a work ethic, and alcohol and drug abuse – can also be seen as a threat to the broader values of the dominant social groups. In this view, governments' task is to provide an austere minimal safety net, create social controls to limit the effects of the deviant poor, and perhaps help some of the poor, especially children, to become part of mainstream society.

Welfare in the United States is often seen as the clearest modern example of this social control and minimal safety net in practice. The United States has very high levels of crime, with over a million people in prison, by far the highest ratio in the developed world. Prisons are expensive and may perpetuate the cycle of poverty and deprivation. The United States also spends an unusually high proportion of national product on domestic security personnel, police, prison guards, and in supervising an often untrusted workforce.[53] In 1980, for example, the

State of California spent two per cent of its budget on prisons but this has grown to 10 per cent by 1996 and was projected to grow to 18 per cent by 2002. Much of this increase in funding has been taken from the higher eduction budget.[54] About 28 million Americans, more than ten per cent of the population, live in expensive-to-administer walled, gated and guarded residential communities, and the proportion is increasing rapidly.[55] Visitors to the United States are often shocked by the glaring poverty, often adjacent to plush shopping areas, and beggars and the homeless roam the streets.

A minimal, safety-net welfare system, then, is often justified on the grounds that it will save money and reduce the level of nuisance.[56] The evidence that this works in practice is not good, and leads many to the counter argument that the 'social costs' of poverty demand a more expansive welfare state: if we do not treat the poor well they will continue to plague us. However, this 'social costs of poverty' justification for significant public spending in turn attracts many critics. Powerful groups in society do not like to be held to ransom, to be told that if you do not help the poor, they will rob or kill and destroy your neighbourhood. Dominant social groups are likely instead to adopt the American solution: move to walled residential areas and incarcerate the troublesome underclass in prison. The social costs approach also gives little guidance about what types of programs and what level of poverty line is required to produce any given level of social benefit. Social science gives very little specific guidance on how to overcome social problems in lower income groups. Attempts to make the poor work are expensive, often fail, and create yet another downward cycle of despair that leads to more extreme solutions.[57]

Critics of this argument for substantial spending on the poor also insist that social benefits in themselves underpin a self-destructive poverty culture amongst the lower class, creating a permanent 'underclass', now one of the most common terms in American social policy debate, and increasingly being used in Europe.[58] In this view, only an austere, subsistence safety net, or even perhaps none at all, will create the incentives for the underclass to change their behaviour. The social costs argument was based on the argument that poverty was caused by social and economic conditions. There is now strong support in the United States for the argument that those in poverty are largely responsible for their own situation, a return to the 'blaming the victim' approach popular through most of history. This view of minimal welfare now dominates much thinking in America, and is gaining support in Britain. It is not favoured in Australia, New Zealand, and western Europe.

In conclusion, economists do not have all the answers on how to devise an optimum welfare system. They have no competence on deciding the core political and social values which are at the foundation of social policy: what should be the minimal poverty line for the social safety net; and what degree of income inequality is acceptable. But economists' tools are valuable for evaluating existing arrangements and suggesting alternatives for the future. In recent times, sociologists and political scientists have become more interested in the welfare state and their perspectives are a useful balance to excessively narrow economic views.

References

1 A recent iconoclastic anti-welfare state book based on free market principles is David Marsland *Welfare or Welfare State? Contradictions and Dilemmas in Social Policy*, Macmillan, London, 1996; in March 1997, the British Conservative Party announced a radical plan to privatise social security on a model similar to the Australian plan. See 'Who needs a state pension?', *The Economist* March 8, 1997, p. 16.

2 See the extensive review by Nicholas Barr 'Economic Theory and the Welfare State: A Survey and Interpretation', *Journal of Economic Literature*, vol. xxx, June 1992, pp. 741-803. Barr admits the thin theoretical foundations for welfare states on page 749.

3 The vast economics research on poverty generated in the United States is reviewed in Robert H. Haveman *Poverty Policy and Poverty Research: The Great Society and the Social Sciences*, University of Wisconsin Press, Madison, 1987.

4 See the complex models described in G.M.M. Gelauff and J.J. Graafland *Modelling Welfare State Reform*, North Holland, Amsterdam, 1994.

5 A recent interesting attempt by a sociologist to explain new trends in poverty is Bill Jordan *A Theory of Poverty and Social Exclusion*, Polity, Cambridge, 1996.

6 See the powerful critique by lawyer Jane Kelsey *Economic Fundamentalism: The New Zealand Experiment-A World Model for Structural Adjustment*, Pluto Press, London, 1995.

7 Agnar Sandmo 'Economists and the Welfare State', *European Economic Review*, vol. 35, 191, pp. 213-39; Assar Lindbeck 'Hazardous Welfare-State Dynamics', *American Economic Association, Papers and Proceedings*, vol. 85, no.2, May 1995, pp. 9-15; Edward M. Gramlich 'Economists' View of the Welfare System', *American Economic Association Papers and Proceedings*, vol. 79, no. 2, May 1989, pp. 191-6.

8 See the analysis in Fay Lomax Cook and Edith J. Barrett *Support for the American Welfare State: The Views of Congress and the Public*, Columbia University Press, New York, 1992; see also Paul Pierson 'The New Politics of the Welfare State' *World Politics*, vol. 48, no.2, January 1996, p. 175.

9 Paul Pierson *Dismantling the Welfare State? Reagan, Thatcher, and the Politics of Retrenchment*, Cambridge University Press, Cambridge, 1994.

10 See Paul Pierson 'The New Politics of the Welfare State' *World Politics*, vol. 48, no.2, January 1996, p. 171-3; see also Richard B. Freeman 'The Large Welfare State as a

System', *American Economic Review*, vol. 85, no.2, may 1995, p. 16-21.

11 See James Midgley and Martin B. Tracy eds. *Challenges to Social Security: An International Perspective*, Auburn House, Westport, 1996.

12 Jagadeesh Gokhale, Laurence J. Kotlikoff and John Sabelhaus 'Understanding the Postwar Decline in U.S. Savings: A Cohort Analysis', *Brookings Papers on Economic Activity*, no. 1 1996, p. 381.

13 Gosta Esping Anderson 'Positive-Sum Solutions in a World of Trade-Offs?', in Gosta Esping-Andersen *Welfare States in Transition: National Adaptations in Global Economies*, Sage, London, 1996, p. 266.

14 Adapted from Deborah Mabbett *Trade, Employment and Welfare: A Comparative Study of Trade and Labour Market Policies in Sweden and New Zealand 1880-1980*, Clarendon Press Oxford, 1995, p. 178-9. Mabbet has created this typology from a wide range of sources which are given in her book.

15 Sherwin Rosen 'Public Employment and the Welfare State in Sweden', *Journal of Economic Literature*, vol. xxxiv, June 1996, pp. 729-40.

16 See the extensive sources in Deborah Mabbett *Trade, Employment and Welfare: A Comparative Study of Trade and Labour Market Policies in Sweden and New Zealand 1880-1980*, Clarendon Press Oxford, 1995. This typology of distortions is standard in the extensive literature published by the Organisation for Economic Cooperation and Development in Paris, especially their annual reviews of the New Zealand economy. For a recent overview, which praises New Zealand for its extensive reforms see OECD *Economic Outlook* no. 59, June 1996, Paris, 1996, especially pp. 42-57.

17 Mancur Olson *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, Yale University Press, New Haven, 1982; On Sweden see Desmond Lachman et. al. *Challenges to the Swedish Welfare State*, International Monetary Fund, Washington, 1995; Mancur Olson *How Bright are the Northern Lights? Some Questions About Sweden*, Lund University Press, Lund, 1990.

18 See OECD *Economic Outlook* no. 59, June 1996, Paris, 1996, especially pp. 42-57.

19 This section relies heavily on E. Philip Davis *Pension Funds: Retirement-Income Security, and Capital Markets: An International Perspective*, Clarendon Press, Oxford, 1995, p. 31. This book is one of the best recent works on private retirement systems, although it does not contain specific information on New Zealand arrangements.

20 Dennis J. Snower 'The Future of the Welfare State', *Economic Journal*, vol. 103, May 1993, pp. 700-17.

21 Gunnar Myrdal *Beyond the Welfare State*, Duckworth, London, 1960, p. 62. Quoted in Agnar Sandmo 'Economists and the welfare state', *European Economic Review*, vol. 35, 1991, pp. 213-9, p. 221.

22 The figures are from Statistics New Zealand *New Zealand Official Yearbook 1996*, Wellington, pp. 174-5.

23 The following section is adapted from the excellent treatment in Niels Ploug and Jon Kvist *Social Security in Europe: Development or Dismantlement?*, Kluwer Sovac Series on Social Security, The Hague, 1996, pp. 39-42; This treatment in turn relies on work by Nicholas Barr *The Economics of the Welfare State*, Stanford University Press, Stanford, 1993.

24 See Norman Daniels, Donald W. Light and Ronald L. Caplan *Benchmarks of Fairness for Health Care Reform*, Oxford University Press, New York, 1996, p. 43.

25 See Norman Daniels, Donald W. Light and Ronald L. Caplan *Benchmarks of Fairness for Health Care Reform*, Oxford University Press, New York, 1996, p. 48.

26 The cost increasing and market distorting role of insurance in health care is a theme of most American literature on the health 'crisis'. See for example, Henry J. Aaron *Serious and Unstable Condition: Financing America's Health Care*, Brookings, Washington, 1991, pp. 8-16; the figures on health expenditures as a proportion of national product are from OECD *The Reform of Health Care Systems: A Review of Seventeen OECD Countries*, Paris, 1991-1994, p. 37.

27 OECD *Economic Outlook* no. 59, June 1996, Paris, 1996, p. 44.

28 The classic work is Arthur Okun *Equality and Efficiency: The Big Tradeoff*, Brookings, Washington, 1975.

29 Hans-Werner Sinn 'A Theory of the Welfare State' in Torben M. Andersen, Karl O. Moene and Agnar Sandamo eds. *The Future of the Welfare State*, Blackwell, London, 1995, pp. 27-58.

30 Hans-Werner Sinn 'A Theory of the Welfare State' in Torben M. Andersen, Karl O. Moene and Agnar Sandamo eds. *The Future of the Welfare State*, Blackwell, London, 1995, p. 28-9.

31 Lane Kenworthy 'Equality and efficiency: The Illusory Tradeoff', *European Journal of Political Research*, vol. 27, 1995, pp. 225-254.

32 Rebecca Blank ed. *Social Protection and Economic Flexibility: Is There a Trade Off?*, University of Chicago Press, Chicago, 1994.

33 Klaus Deininger and Lyn Squire 'A New Data Set Measuring Income Inequality', *The World Bank Economic Review*, vol. 10, no.3, 1996, pp. 565-91.

34 Gary S. Becker, *Human Capital*, third edition, University of Chicago Press, 1993 (first published 1964).

35 OECD *Economic Surveys, New Zealand, 1993*, Paris, 1993, pp. 69-70.

36 Edward F. Denison *Why Growth Rates Differ: Past Experience in Nine Western Countries*, Brookings, Washington, 1967.

37 Michael Sherraden *Assets and the Poor: A New American Welfare Policy*, M.E. Sharpe, Armonk, 1991.

38 James S. Coleman 'Social Capital in the Creation of Human Capital', *American Journal of Sociology*, vol. 94, supplement, p. S96.

39 Francis Fukuyama *Trust: The Social Virtues and the Creation of Prosperity*, Hamish Hamilton, London, 1995.

40 George J. Borjas 'Ethnicity, Neighbourhoods, and Human-Capital Externalities', *The American Economic Review*, vol. 85, no.3, June 1995, pp. 365-90.

41 See the special issue of the journal *Social Science and Modern Society* vol. 34 no. 1 November/December 1996 on licensing parents. See especially Jack C. Westman 'The Rationale and Feasibility of Licensing Parents', *Social Science and Modern Society*, vol 34., no.1, November/December 1996, p. 46.

42 Francis Fukuyama 'Social Capital and the Global Economy', *Foreign Affairs*, vol. 75, no. 5, Sep/Oct 1995, p. 103.

43 See Robert D. Putnam *Making Democracy Work: Civic Traditions in Modern Italy*, Princeton University Press, Princeton, 1993; Robert D. Putnam 'The Prosperous Community: Social Capital and Public Life', *The American Prospect*, no. 13, Spring 1993, pp. 35-42; Robert D. Putnam 'Tuning In, Tuning Out: The Strange Disappearance of Social Capital in America', *PS: Political Science and Politics*, vol. xxviii, no.

4, December 1995, pp. 664-83.

44 See the powerful critique of Putnam's Italian research in Sidney Tarrow 'Making Social Science Work Across Space and Time: A Critical Reflection on Robert Putnam's *Making Democracy Work*'. *American Political Science Review*, vol. 90, no.2, June 1996, pp. 389-97.

45 See the excellent recent work by Jonathan Boston, John Martin, June Pallot and Pat Walsh *Public Management: The New Zealand* Model, Oxford University Press, Auckland, 1996; the domination of the market model in the public sector in western countries is discussed in B. Guy Peters *The Future of Governing: Four Emerging Models*, University Press of Kansas, Lawrence, 1996 and Colin Campbell and Graham K. Wilson *The End of Whitehall: Death of a Paradigm?*, Blackwell, Oxford, 1995.

46 A useful source for the main postwar thinkers on welfare is Vic George and Robert Page *Modern Thinkers on Welfare*, Prentice Hall, Hemel Hempstead, 1995.

47 R. Goodin and J. Le Grand eds. *Not Only the Poor: the Middle Class and the Welfare State*, Unwin Hyman, London, 1987.

48 Julian Le Grand and Ray Robinson eds. *Privatisation and the Welfare State*, George Allen and Unwin, London, 1984; Julian Le Grand and Will Bartlett eds. *Quasi-Markets and Social Policy*, Macmillan, London, 1993.

49 Rudolf Klein *The New Politics of the NHS*, 3rd ed. Longman, London, 1995, p. 248.

50 Criticism of quasi-markets in health care are in Ewan Ferlie, Andrew Pettigrew, Lynn Ashburner and Louise Fitzgerald *The New Public Management In Action*, Oxford University Press, Oxford, 1996, pp. 74-87; OECD *Economic Surveys New Zealand 1996*, Paris, 1996, pp. 114-121.

51 The special place of health in definitions of social justice is a theme of Michael Walzer *Spheres of Justice: A Defense of Pluralism and Equality*, Basic Books, New York, 1983.

52 The trends in health care outlays as a proportion of national product are in OECD *Economic Surveys New Zealand 1996*, Paris, 1996, p. 118; the comparisons from 1981 are in 'Health Expenditure', *Health Expenditure Bulletin*, no. 12, December 1996, p. 24.

53 Samuel Bowles and Herbert Gintis 'Escaping the efficiency-equity trade-off: productivity -enhancing asset redistributions', in Gerald A Epstein and Herbert M Gintis eds. *Macroeconomic Policy After the Conservative Era: Studies in investment, savings and finance*, Cambridge University Press, Cambridge, 1995, p. 411.

54 Robert Reich 'Secession of the Successful', *New Perspectives Quarterly*, vol. 13, no. 2, Spring 1996, p. 18.

55 Larry Elliot 'The Return of the Feudal Barons', *Guardian Weekly*, June 30 1996, p. 14.

56 This is the major tradition in scholarly work on the American welfare state. See Frances Fox Piven and Richard A. Cloward *Regulating the Poor: The Functions of Public Welfare*, Vintage Books, New York, 1993 (second edition).

57 Kent Weaver 'Old Traps, New Twists: Why Welfare is So Hard to Reform in 1994', *The Brookings Review*, Summer 1994, pp. 18-21.

58 Herbert J. Gans *The War Against the Poor: The Underclass and Antipoverty Debate*, Basic Books, New York, 1995.

Chapter 5

Poverty

This chapter examines poverty, with inequality being the subject of the following chapter. It examines the link between levels of poverty and economic reforms to promote efficiency, and the difficulty of assessing these links because of inadequate information. Poverty statistics often lack credibility because of disputes over the definition of poverty, especially the level of the 'poverty line', the problems of using income alone as a valid poverty measure, and the failure to take into account longer term dynamic processes rather than just point-in-time snapshots of poverty.

The level of social welfare benefits has a major effect on the extent of poverty, since most of those on welfare benefits, including New Zealand Superannuation, are reliant primarily on the benefit and had only limited other income.[1]

If benefits are below an agreed 'poverty line', then many will, by definition, be in income poverty. A higher level of benefits, above the 'poverty line', should remove eligible households from income poverty. Some groups such as those households with children but receiving low incomes may not be eligible for any benefits but may also be poor.

Recent debate in New Zealand has focused on the effects of a more open and free market economy on poverty and social equality. Economic reforms have been openly directed towards creating a 'developmental' rather than a 'welfare' state. The reduction in the top income tax rate to 33 per cent was one of many changes aimed at stimulating enterprise, work effort, and employment. It is assumed that changes to incentives will increase the rate of economic growth, and will tend to lift employment, raise productivity, and improve living standards, especially for those in the workforce. This process has been termed the 'trickle down' effect of economic growth: a rising tide is supposed to lift all boats.

Critics claim that the reforms of the past decade have increased poverty and inequality, a claim that has also been made in other western countries. A major 1996 international study of poverty in western countries, however, could only refer to impressionistic, journalistic evidence on New Zealand poverty.[2] In the words of Bob Stephens, a leading poverty researcher, New Zealand in 1992 'does not have any satisfactory, independently determined poverty line'.[3] The difficulty is that researchers continue to use poverty lines in policy debate, although few agree on what these might be. Brian Easton, another leading poverty researcher, talks of an approximate 40 per cent increase in numbers below the poverty line in recent years (using the 1972 Royal Commission on Social Security measure).[4] In a more recent article, Easton is sceptical of the quality of New Zealand's current poverty measures. He said 'Unlike the 1970s, poverty research over the past decade has not been one of New Zealand social science's great achievements'.[5] Krishnan made the best of available methods and data in a 1995 survey, and found significant evidence of increases in poverty.[6]

Better poverty statistics will not automatically lead to more generous benefits for the poor: the United States, as policy researcher Hugh Heclo says, now has the best data and economic analysis of poverty in the world, but has the worst record of all industrialised nations in reducing poverty.[7] Even so, New Zealand's social policy debate would be far more enlightening if it was built on better statistics, based on a sophisticated understanding of the long-term dynamics of poverty.

Over the past two decades, poverty measurement in western countries has been captured by economists, who have applied increasingly sophisticated statistical methods to income distribution data. Despite this, poverty lines are not fashionable in social policy discussion in the mid 1990s. Australian social policy has been much influenced by one poverty line since the early 1970s, but there is now widespread disillusionment, partly because eminent researchers find wildly varying proportions in poverty. According to Peter Whiteford 'the literature provides a bewildering array of contradictory results and trends.'[8] Most researchers argue that the major technical and philosophical problems and high costs of developing poverty lines and poverty surveys make them a matter for academic discussion, not practical policy. It is difficult enough to measure poverty at a point in time, but is far more challenging to measure poverty over time or to study poverty as a dynamic process. Many people may move in and out of poverty while some may be in poverty over the long term.

But a central dilemma remains: what minimum living standard should form the basis for New Zealand's welfare system and how can it be adjusted over time?

Measuring poverty

It is difficult to determine whether poverty has increased in New Zealand over the past decade. Research by Stephens and Waldegrave measures poverty in New Zealand between 1984 and 1993. If an absolute view of poverty is taken to be 50 per cent of median income, Table 5.1 shows that poverty in 1992-3 was at the same 4.3 per cent

Table 5.1

Trends in the incidence of poverty, New Zealand,1984-93, per cent. (Income as poverty measure before adjusting for housing costs)

	50% Income Level						
Household Type	1983/4	1985/6	1987/8	1989/90	1990/91	1991/2	1992/3
1 adult	3.7	3.0	2.9	2.0	2.1	3.7	4.2
1 adult + children	11.8	10.7	12	9.5	11.7	9.0	14.3
2 adults	1.7	1.0	1.2	1.6	1.7	1.8	1.2
2 adults + 1 child	4.1	2.3	1.7	1.6	1.7	1.8	1.2
2 adults + 2 children	6.6	3.1	3.6	2.8	4.1	7.3	4.1
2 adults + 3 children	14.0	10.1	6.8	5.5	12.7	10.5	13.9
3+ adults	1.3	1.2	1.8	1.6	1.1	0.5	1.9
3+ adults + children	2.7	3.5	2.1	2.6	6.5	5.2	6.1
Total	4.3	3.1	2.9	2.5	3.7	4.1	4.3
($) Real Poverty Level 50%	16,032	15,442	15,717	14,971	14,677	13,763	13,696

	60% Income Level						
Household Type	1983/4	1985/6	1987/8	1989/90	1990/91	1991/2	1992/3
1 adult	27.5	31.7	31.2	33.6	25.9	8.6	9.1
1 adult + children	37.8	30.3	32.8	41.8	35.8	48.6	46.2
2 adults	6.4	2.7	7.3	3.8	4.0	3.4	3.7
2 adults + 1 child	9.3	5.3	7.1	12.4	11.0	12.3	14.0
2 adults + 2 children	12.4	8.9	8.9	12.2	13.3	15.2	12.4
2 adults + 3 children	28.1	25.6	21.2	20.1	21.8	22.0	24.1
3+ adults	2.7	2.7	2.4	2.8	3.3	1.0	4.2
3+ adults + children	5.5	9.4	6.2	6.3	12.9	8.0	13.3
Total	13.7	12.6	13.9	14.4	13.7	10.1	10.8
($) Real Poverty Level 50%	19,242	18,533	18,861	17,612	17,612	16,510	16,366

Source: Robert Stephens and Charles Waldegrave 'Measuring Poverty in New Zealand', *Social Policy Journal of New Zealand*, no. 5, December, 1995, p.107. Note BDL= benefit datum line developed by the 1972 Royal Commission on Social Security.

level as in 1983-4, having never surpassed this level throughout the period. If a relative, more generous poverty line of 60 per cent of median income is taken as the poverty line, poverty is much higher, at 10.8 per cent in 1992-3, compared to 13.7 per cent in 1983-4, having peaked at 14.4 in 1989-90. Brian Easton, however, points out that because of major changes in income distribution over the past 15 years, the median income level has fallen relatively, meaning that it may not be an accurate measure of long term poverty trends.[9]

Stephens and Waldegrave conclude that the highest rates of poverty over the period were amongst single parents and those intact families with three children. These two groups show high levels of poverty (46.2 per cent and 24.1 per cent respectively in 1992-3) when a poverty line of 60 per cent of median income is used.[10] Their research suggests that children, rather than the elderly should be the main target for increased social benefits. New Zealand now has relatively meagre benefits for children, compared with Australia or most other western countries, even though many children (269,113 in June 1996) live in households dependent on social welfare benefits. The deregulated wage system no longer ensures that wages are sufficient to support a family: children in low income families with a full time earner may also be living in poverty. Brian Easton claims in 1997 that 'by far the largest group of the poor is children'.[11]

Poverty lines based on average wages or disposable income fail to deal with a key issue. Work incentives for those on benefits depend not on average wages but on wages in the lower part of the income structure. For many on welfare benefits, wage trends for the lower fifth of wage earners in New Zealand is the crucial indicator on the gap between benefits and wages. The deregulation of wages in New Zealand has made this issue more important, because lower level wages are not as clearly defined as when the poverty line first became popular. Poverty surveys should compare welfare benefit rates with lower-end wage movements, as well as against other indicators. In 1996, the minimum wage for those aged 20 and over was $255 for a 40 hour week. This is close to the benefit levels paid to couples on unemployment benefits.

If benefit levels represent political and social values as expressed through the political system, there may be a case to revise feasible poverty lines downwards. Brian Easton claims that the unemployment benefit was reduced in 1991 to exactly the level developed by New Zealand Treasury, using what Easton considered to be outdated and minimal standards.[12] Some critics would say that there is a need to revise benefit levels upwards. In Australia, welfare benefit levels exceed the semi-official poverty line by significant amounts. The Australian poverty definition is not particularly rigorous and is different to those used in New Zealand so comparisons between the countries are not possible.

Measures of poverty in New Zealand are based on one off 'snapshot' cross-sectional sample surveys of those poor at a particular point in time, according to a selected poverty line, or series of lines. This method has been discredited as an accurate measure of poverty over time. Periodic surveys give an impression that the poverty measurements can give an indication of poverty over time. This is false, because the poor in a particular survey may be quite different persons from the poor at a later date, even as soon as one year afterwards. People may be merely moving in and out of poverty, and the snapshot measure can be a poor measure of their longer term welfare. A fixed poverty line tells little about the extent or persistence of poverty amongst those below the poverty level and merely provides a 'head count'.

'Poverty gap' analysis is more promising, but still gives only a point-in-time 'snapshot' of poverty, and is little help in understanding long-term poverty dynamics. Poverty gap analysis measures the gap between the poverty line and the incomes of particular individuals and groups, enabling researchers to develop a ranking of the marginally poor to the 'truly poor'. Poverty gap analysis usually gives a very different and more accurate picture of the composition of the poor than simple head counts.[13]

Britain has far better quality income statistics than New Zealand. A recent survey of poverty dynamics in Britain, using high quality information, found that 'results from current statistics on the income distribution may conceal a great deal of the fluidity in personal financial circumstances. There is not a single homogeneous group who are the "poor" and whose lot is permanently to remain poor. Rather, fluctuations in personal circumstances lead to considerable variations in living standards even from one year to the next'.[14] This is a perhaps surprising result, because Britain is reputed to be a rigid, class based society, with limited social mobility and hardcore patterns of income inequality.

Surveys of poverty should adopt a number of key strategies if they are to be credible and valuable in policy discussion. Income, in itself, is not an effective measure even though it has been the predominant measure used in the past. There is now a broad consensus amongst poverty researchers that four central indicators must be available as the basis for a useful measure of poverty:

- A sensible poverty measure based on the distribution of real expenditure (not just current income) covering all market goods and services, preferably over a period of time (at least a year).
- Indicators of access to non-market goods and services for which meaningful prices can be assigned, especially education and health care services, and personal care services such as child care.
- Indicators of distribution within households including measures of gender disparities and child nutritional status. Poverty amongst women and children is now a central issue in western countries.
- Indicators of certain personal characteristics which entail unusual constraints on the ability to escape poverty, such as physical handicap or impairments, racial discrimination, inadequate human capital, or low levels of social capital in poor quality 'ghettoes' which creates a 'spatial poverty trap'.[15]

The respected Institute of Fiscal Studies (IFS) in London has found that expenditure measures, in particular, are much better indicators of income distribution and poverty than are measures of income.[16] An expenditure approach has the strong advantage that it allows for the fact that households may smooth consumption over time, while their income is often variable. The rise in inequality in expenditure was not as rapid as the rise in inequality in income. While income distribution figures show an increasing poverty and inequality, an expenditure approach shows that the poorest households have increased their spending substantially in real terms over the 1979-1992 period.

The IFS said in its report

> There are many households throughout the population who are ranked differently by expenditure than by income. A significant proportion of those in the bottom income decile group are to be found higher up in the expenditure distribution than others with higher incomes. The expenditure of the poorest tenth by income is considerably higher than that of the income decile group above it. An increasing number of those in the bottom income group have shown relatively high expenditure since 1979 ... Income is a particularly poor indicator of living standards for households reporting negative incomes. In some years, these households have shown expenditure which is higher than that of the average expenditure of the population as a

whole.[17]

The IFS study, using high quality data, is disturbing for countries that rely on income distribution surveys that measure only income, not expenditure. The under-reporting of income information compared with expenditures is not due to any increase in debt levels, which have remained constant through the study period. Some people may be lying, but the main explanatory factor seems to be that some people live off past income and assets. Many self-employed are in this category: their incomes may fluctuate, so that the point-in-time single measures are highly misleading.

New Zealand has published reports of household expenditure surveys for some time. This publication is too broad to be considered a poverty survey but does have some interesting material because it publishes expenditure patterns for ten different income groupings, from the lowest, under $12,400, to the highest, $81,700 and over. The lowest income group includes those generally accepted to be at risk of being poor. The 1995 survey showed that the spending patterns of the lowest income category (under $12,400) were not very different to the pattern of the other nine income categories.[18] The survey, limited as it is, does not support those who argue that New Zealand has severe poverty in its lowest income group.

Developmental states, trying to compete with low tax, low wage minimal welfare benefit Asian economies, seem to be more interested now in rediscovering the absolute poverty line such as that accepted in the United States, than in measuring poverty according to relative, rising poverty lines. They may prefer to spend the benefits of economic growth on rewarding those who work, and in upgrading education and training and improving private and public infrastructure, while keeping the poorest up to a fixed (linked only to price increases) rather than a rising (linked to average income increases) minimum.

As well as traditional income and expenditure-based measures of poverty, there are a number of alternative approaches. The American poverty line is based on the proportion of food in a family budget. Generally, families there are regarded as being in poverty if more than 35 per cent of family income is spent on food. This method takes account of family size, because larger families will spend more on food than smaller families.

Another measure of poverty extends the food ratio approach and focuses on the ratio of fixed costs of 'necessities' to total income. Necessities normally include housing, energy, food, clothes and public transport. The list can be expanded according to conceptions of what is a luxury and what is a necessity. Households spending more than 60 per cent of income on housing, energy and food are regarded as being in poverty. Another related poverty measure is to measure the number of families on incomes close to the mean whose expenditure exceeds their incomes.[19]

A more controversial approach to poverty measurement develops an index of relative deprivation that defines poverty as those who lack resources which are common to the society of which they are a part. This measurement changes over time, and includes access to public services such as health care and an adequate social environment. This measure usually engenders strong arguments about what is a luxury and what is a necessity. It can also be criticised for accepting the materialistic, consumption-obsessed nature of modern western society. If the mass of people watch low quality video movies or sport on cable television, is someone relatively deprived in not having access to such things?

In all, Bradshaw, Bouwknegt and Holmes identify 12 alternative approaches for measuring poverty amongst the 20 main categories of household types used in poverty surveys. They omit another respected method: subjective poverty, based on perceptions of the poor and others as to what constitutes 'poverty'. The range of poverty levels for Britain in 1990 for these 12 is shown in Table 5.2. The table shows that reputable poverty measures produce an amazing range of poverty estimates for most types of households. The measurement of poverty has a long way to go before it can produce credible figures that are useful for social and political debate.

Bradshaw, Bouwknegt and Holmes conclude their survey of with the grand understatement that 'poverty is not easy to measure'. One is reminded of the statement in the English Poor Law Report in 1834 of the 'Mischievous ambiguity of the word *poor*'.[20] It is risky to use only one poverty measure, and the choice of measure will produce markedly different pictures of the particular groups in poverty. Poverty is an ambiguous notion – relative, gradual and multi-dimensional. In poverty research, 'the measure determines the result'.

Benefit levels and poverty

The New Zealand cash benefit system has always had an underlying purpose of eliminating absolute poverty and deprivation by providing a minimum income floor for groups defined as being in need. Cash benefits for the aged have in more recent decades been provided at higher levels than other benefits and free of strict means tests. But even

Table 5.2

Proportion of families defined as poor according to different measures, Britain, circa 1990

Household type	Percent found in poverty by different measures range
Elderly, single	1-74
Elderly, couple	9-45
Single, working	3-34
Single, not working	6-76
Couple, 1 earner	5-28
Couple, 2 earners	1-16
Couple, no earners	10-38
Lone parent, 1 child, working	7-40
Lone parent, 2+ children, working	17-48
Lone parent, 1 child, not working	23-84
Lone parent, 2 children, not working	36-92
Couple, 1 child, one earner	8-56
Couple, 2 children, one earner	3-68
Couple, 1 child, two earners	0-47
Couple, two children, no earners	15-90
All households	10-29

Source: Jonathan Bradshaw, Laura Bouwknegt and Hilary Holmes 'In Search of a Representative Measure of Poverty', in Peter Smith ed. *Measuring Outcomes in the Public Sector* Taylor and Francis, London, 1996, p. 148. Note: for space reasons not all household types are included.

here, the aim has been to ensure that the poorest aged are lifted above the level of destitution, even if the benefits are spread to include those who would have an adequate income without government assistance.

The Social Security Act in 1938 – the moment when New Zealand focused on its evolving welfare system systematically – showed a clear focus upon alleviation of poverty, based undoubtedly on fresh memories of absolute, subsistence poverty in the 1930s. A.M. Finlay, a Labour politician, summed up the approach in 1943 when he said: 'We may define Social Security as **a policy, which, by redistributing some of the rewards of capitalist society, aims to provide at least a healthy subsistence for all** (his emphasis).'[21] Finlay emphasised that the New Zealand welfare system in 1943 promised 'nothing not strictly necessary – no frills, no luxuries, no more than healthy subsistence'.

Social security aimed to remove the privations and undernourishment and actual starvation which had formerly threatened the lower economic strata of society. He emphasised that social security was evolutionary, not revolutionary. It is set, he stated, in the 'framework of existing capitalist society'. Social security would not change the essential economic characteristics of the capitalist system 'in the slightest'.[22]

Benefit levels in New Zealand, as elsewhere, have not been created or adjusted according to any scientific definition or measurement of poverty, but are usually linked to some mix of earnings levels and price movements. Social security benefit rates have to be compared with some benchmark for them to have any meaning as a coherent anti-poverty policy.[23] For decades after the 1938 Social Security Act cash benefits were adjusted roughly in line with movements in average weekly earnings (AWE). This measure is a reasonable way of ensuring that those on benefit have a standard of living that moves in line with average increases in living standards, as measured by wages. In times of growing average earnings (exceeding inflation) indexing welfare benefits only by price increases results in slower benefit growth. Britain, for example, has only increased the basic state aged pension by prices since 1979, when the pension was equal to 20 per cent of average earnings. By 1997, the pension had fallen to 15 per cent of average earnings and it is estimated that it will be just eight per cent in 2030.[24]

In New Zealand, welfare cash benefits as a proportion of average earnings were published each year (and compared with the past five years or so) in the *New Zealand Year Book*. In 1946, when statistics were first available, the unmarried standard benefit rate was equal to 31.6 per cent of average weekly earnings while the married benefit was equal to 63.1 per cent of AWE. This benchmark was maintained generally for the unmarried benefit rate, although it did decline to a low of 24.7 per cent in 1971 and then returned to the approximate figure of 30 per cent in the seventies.

The *Royal Commission of Inquiry into Social Security in New Zealand* in 1972 renewed interest in the need to benchmark cash benefits to average earnings. The Royal Commission did not advocate the establishment of a poverty line. Instead, it advocated a 'scale of living standards' index to measure benefit adequacy. This incorporated a relative poverty measure that was supposed to ensure that beneficiaries were 'able to feel a sense of *participation in and belonging to* the community' (italics in original). These are vague concepts, and extremely difficult to measure and promote as credible poverty indicators. The Royal Commission recommended that the married rate of benefit be set at 80 per cent of either the ruling rate of wages paid to building and engineering labourers, or the lower quartile level of adult male earnings. This was a different measure from average weekly earnings but was still an attempt to link benefit levels with changes in wages of a specified group, not price movements.

Average earnings is not very useful as a consistent long term benchmark because it is affected by tax changes and changes in workforce composition that change the meaning of the statistic over time. The relationship of benefits to average earnings is no longer published in the annual *Statistics New Zealand Year Book*. From 1977 until 1989, superannuation was linked to the average weekly wage (gross, then net) with the couple rate set at 80 per cent. Benefits were not indexed between 1990 and 1993, and non-aged benefits were reduced in 1991. In 1995-96, benefits for unemployment, sickness, invalidity and other non-aged benefits were increased by 2.92 per cent, the same as the increase applied to New Zealand Superannuation. This increase was about fifty per cent above the two per cent increase in the consumer price index over the year.

The cash benefit paid to the unemployed, single parents, widows and the sick are below that paid to the aged who are eligible for New Zealand Superannuation and these benefit levels in 1996 are shown in Table 5.3. The sick are paid more than the unemployed, invalids get a higher amount, single parents are also lowly paid and the aged are treated the best. Australia, in contrast, generally pays the same rate regardless of a particular benefit category. The aged receive the same cash benefits as other groups. The magnitude of the differences in benefits between categories in New Zealand is difficult to explain, but it does reflect common ideas on 'deservingness'.

Ruth Richardson, the Minister of Finance, introduced major benefit reductions for the non-aged in 1991. She made it clear that the changes were designed to halt the growth in dependency and to reduce the incentives to stay on unemployment and single parents (domestic purposes) benefit. Richardson has stated that she saw the cuts largely in moralistic terms, as 'a statement about the types of lives people should be encouraged to lead, about the types of activities that should be more highly valued, about personal responsibility and integrity'. She also claimed that the welfare state had set out to reduce poverty but had created a dependent underclass and ghettoes where lawlessness and hopelessness were rife, with more poverty and inequality.[25]

Table 5.3

Social welfare cash benefits, weekly rates, 1 April 1996 (after deduction of tax at G rate)

Couple	**Weekly benefits $**
Unemployed	$237.48
Sickness	$269.90
Invalids	$296.86
Domestic purposes (mainly single parents)	$251.25 (sole parent two children)
NZ Superannuation	$313.12
Single	**Weekly benefits $**
Unemployed (25+)	$142.50
Sickness (25+)	$148.43
Widow adult	$148.43
NZ Superannuation	$203.53

Source: Benefit levels are from Department of Social Welfare *Statistical Information Report*, Wellington, 1996, pp. 12-13.

The 1991 benefit reductions in New Zealand signified a major shift in thinking about poverty lines, the causes of and remedies for poverty. The Royal Commission on Social Security in 1972 has talked in terms of rights, participation, and belonging to a community. Poverty lines and benefit levels are now viewed as merely part of the strategy to adjust incentives to a globalised, far more competitive and market based New Zealand economy. If this view is accepted, wage deregulation required a reduction in benefit levels so that the less skilled had an incentive to work: work had to be made to pay and benefits therefore had to be significantly below after tax wages. A recent sophisticated study has found that the benefit reductions in New Zealand in 1991 did lead to higher levels of employment amongst certain groups, although the increases are very small, ranging from a decline of 0.2 per cent to an increase of 0.1 percentage points.[26] The study, however, admits there are major problems in assessing the effects of these reforms.

Critics of the 1991 cash benefit cuts claim that many New Zealanders faced hardship. The poverty researcher Bob Stevens said in 1992 that

> Social security has ceased to permit beneficiaries to be able to belong to and participate in the average standards of living of the rest of the population. It has now become a safety net, with increased reliance upon family and private provision, strict work tests and eligibility criteria, and benefit levels just sufficient to avoid destitution. Poverty has been redefined in absolute terms, with reference to a minimum budget required for subsistence, rather than being relative to the standards of living of the rest of the population. No wonder that beneficiaries are in strained financial circumstances and are increasingly resorting to food parcels and charitable relief.[27]

The reduced benefit levels may well have caused distress to certain groups. But the cuts were arbitrary and were not related to a 'subsistence' budget or any formal idea of a minimum safety net as Stevens claims. New Zealand, like most western countries just does not have the information to link current benefit levels with 'subsistence'. The 1991 cuts almost certainly meant that relative poverty increased, because benefits declined as a proportion of average wages, but this measure is only an approximate indicator of relative poverty. New Zealand has little accurate information on trends in relative poverty.

Comparing the generosity of cash benefit levels internationally faces severe information problems. However, in the most ambitious comparative work to date, a recent study has compared New Zealand's cash benefit levels with other OECD countries. The report concluded that 'Benefit levels for some groups remain relatively generous. Overall, before housing costs, social assistance benefit levels are four per cent above the OECD average value, even though national income per head is 11 per cent below the average. For single pensioners New Zealand benefits rank as the seventh highest in the OECD and for couples they are the ninth highest, although only five OECD countries have lower levels of national income' [28]

The process of trying to define and measure poverty is a useful process in itself. Alternative measures clarify different value positions and assumptions about the causes of poverty. New Zealand urgently needs more sophisticated studies on the nature and extent of poverty: there is still too much reliance on the now dated and simplistic ideas developed in the *Royal Commission on Social Security* in 1972. The debate on the effects of economic policy changes on standards of living has been shallow because neither side of the debate – the optimists and the pessimists – have been able to document their arguments with convincing statistics or models of the long term dynamics of poverty. Social policy is expensive, with cash benefits costing around ten per cent of national income. It would surely be cost effective to spend more on high quality studies on the dynamics of poverty. Long term studies are needed to track the composition of poverty, and to measure the extent of the permanent 'underclass', if such a group exists. The New Zealand Treasury has attempted to measure the dynamics of poverty, but statistical sources for this are inadequate. The limited research does show considerable income mobility in New Zealand, thus weakening the underclass thesis.[29] Alleviating poverty and designing effective programs demands better information. Until New Zealand's statistics on poverty are improved, observers will have to remain sceptical about claims of increasing or decreasing poverty.

Agnosticism about the validity of poverty measurement is intellectually honest, but it does leave a major gap in social policy making. Imagine the state of modern economies, if economists said they could not measure economic parameters because it was too difficult! Most measures used in economic policy also have serious technical and philosophical problems, but are nevertheless used as a basis for major decisions. An indicator may have problems, but trends usually have meaning even if the absolute measure is faulty. It is now widely agreed in the United States, for example, that the consumer price index is flawed and probably overestimates price increases by around 50 per cent.[30] This criticism could be made of the index in all western countries who use similarly flawed methodologies. The artificially high figure has major implications for government outlays, many of which are indexed. But no one suggests nations abandon the consumer price index.

New Zealand has numerous competent poverty researchers. Perhaps it is time for a new, wide-ranging inquiry into the meaning, causes and extent of poverty. Resistance to this idea may come from those who feel that documenting poverty is a sign of policy failure in a country. This is not the appropriate attitude. The New Zealand economy and society, like other western countries, is undergoing dramatic and sometimes traumatic change, caused by some of the trends discussed in the next chapter. These changes can create stresses and indeed absolute destitution for particular groups in the population. New Zealand was a pioneering welfare state because it cared about how some groups – initially the aged – were being hurt by changes. With the limited information available, it now seems that children are the group most likely to be in poverty: they are innocent victims, as deserving of help as the aged at the turn of the last century. Desirable large-scale economic change is more likely to gain political support if social casualties are monitored and assisted. Ignoring poverty can lead to an emotional reaction against the economic change necessary to provide the increases in real income per head that fund social services.

References

1 See the figures in Department of Social Welfare *Statistics Report*, Wellington, 1996, p. 11. The figures show a remarkably high dependence by beneficiaries on welfare payments, with the vast majority reporting limited other income.

2 Tony Eardley, Jonathan Bradshaw, John Ditch, Ian Gough and Peter Whiteford *Social Assistance in OECD Countries: Country Reports*, OECD, HMSO, London, 1996, p. 311; recent literature on poverty in New Zealand is discussed in Jane Kelsey *Economic Fundamentalism-The New Zealand Experiment-A World Model for Structural Adjustment*, Pluto Press, London, 1995, pp. 273-96.

3 Bob Stevens *A New Zealand Poverty Measure*, Foundation for Research Science and Technology, Wellington, 1992, p. 4.; The *Report of the Review Committee on Income and Wealth Statistics* published by the Department of Statistics, Wellington in 1991 admitted New Zealand had no official poverty line but gave little attention to the matter. See p. 76.

4 Brian Easton 'Economic and Other Ideas Behind the New Zealand Reforms', *Oxford Review of Economic Policy*, vol. 10, no. 3, 1994, p. 89.

5 Brian Easton 'About Time We Had Some Facts', *New Zealand Books*, March 1997, p. 16.

6 Vasantha Krishnan 'Modest but Adequate: An Appraisal of Changing Household Income Circumstances in New Zealand', *Social Policy Journal of New Zealand*, no. 4, July, 1995, pp. 76-97.

7 Hugh Heclo 'Growing Income Inequalities in America? A Review Essay', *Political Science Quarterly*, vol. 111, no. 3, 1996, p. 523.

8 For a critique of poverty measurement in Britain see Richard Pryke *Taking the Measure of Poverty: A Critique of Low-income statistics: Alternative Estimates and Policy Implications*, IEA, London, 1995; the disillusionment with Australian poverty measurements is discussed in Peter Whiteford 'Measuring Poverty and Income Inequality in Australia', *Agenda*, vol. 4, no. 1, 1997, p. 39.

9 Brian Easton 'About Time We Had Some Facts', *New Zealand Books*, March 1997, p. 15.

10 Robert Stephens and Charles Waldegrave 'Measuring Poverty in New Zealand', *Social Policy Journal of New Zealand*, no. 5, December 1995, pp. 88-112; see also Robert Stephens 'Social Services' in Brian Silverstone, Alan Bollard and Ralph Lattimore eds. *A Study of Economic Reform: The Case of New Zealand*, Elsevier, Amsterdam, 1996, pp. 451-95.

11 Brian Easton 'About Time We Had Some Facts', *New Zealand Books*, March 1997, p. 15; see also Mike Moore *Children of the Poor: How Poverty Could Destroy New Zealand's Future*, Canterbury University Press, Canterbury, 1997.

12 Brian Easton 'About Time We Had Some Facts', *New Zealand Books*, March 1997, p. 15.

13 See Deborah Mitchell and Ann Harding *Changes in Poverty Among Families During*

the 1990s: Poverty Gap versus Poverty Head-count Approaches, National Centre for Social and Economic Modelling, University of Canberra, Discussion paper no.2, October 1993.

14 Steven Webb *Poverty Dynamics in Britain: Preliminary Analysis from the British Household Panel Survey*, Institute for Fiscal Studies, London, 1995, pp. 17-18.

15 See Martin Ravallion 'Issues in Measuring and Modelling Poverty', *The Economic Journal*, vol. 106, no. 438, September 1996, pp. 1332-3.

16 Alissa Goodman and Steven Webb *The Distribution of UK Household Expenditure, 1979-92*, Institute for Fiscal Studies, commentary no. 49, London, 1995.

17 Alissa Goodman and Steven Webb *The Distribution of UK Household Expenditure, 1979-92*, Institute for Fiscal Studies, commentary no. 49, London, 1995, p. 32.

18 Statistics New Zealand *Consumer Expenditure Statistics, 1995*, Wellington, 1996.

19 These measures are discussed in J. Bradshaw, Laura Bouwknegt and Hilary Holmes 'In Search of a Representative Measure of Poverty', in Peter Smith ed. *Measuring Outcomes in the Public Sector*, Taylor and Francis, London, 1996, p. 142.

20 Quoted in Gertrude Himmelfarb *The Idea of Poverty: England in the Early Industrial Age*, Knopf, New York, 1984, p. 523.

21 A.M. Finlay *Social Security in New Zealand: A Simple Guide for the People*, Whitcombe and Tombs, Christchurch, 1943, pp. 52-3.

22 A.M. Finlay *Social Security in New Zealand: A Simple Guide for the People*, Whitcombe and Tombs, Christchurch, 1943, pp. 45-7.

23 Information on trends in Australia is from Department of Social Security *Developing a Framework for Benchmarks of Adequacy for Social Security Payments*, Policy Discussion paper no. 6, May 1995.

24 'Who needs a state pension?', *The Economist*, 8 March, 1997, p. 16.

25 Ruth Richardson *Making a Difference*, Shoal Bay Press, Christchurch, 1995, p. 208.

26 Tim Maloney *Benefit Reform and Labour Market Behaviour in New Zealand*, Institute of Policy Studies, Wellington, 1997, p. 65.

27 Bob Stevens 'Budgeting with the Benefit Cuts', in Jonathan Boston and Paul Dalziel eds. *The Decent Society: Essays in Response to National's Economic and Social Policies*, Oxford University Press, Auckland, 1992, p. 122.

28 Tony Eardley, Jonathan Bradshaw, John Ditch, Ian Gough and Peter Whiteford *Social Assistance in OECD Countries: Country Reports*, OECD, HMSO, London, 1996, p. 315; see also John P. Martin 'Measures of Replacement Rates for the Purpose of International Comparisons: A Note', *OECD Economic Studies*, no. 26, no. 1, 1996, pp. 99-114.

29 See for example John Creedy *Income Dynamics over the Life Cycle: New Evidence for New Zealand*, Treasury, Wellington, 1995; the benefit levels paid in New Zealand are shown in Table 5.1; for criticisms of Treasury research see Brian Easton 'About Time We Had Some Facts', *New Zealand Books*, March 1997, pp. 14-16.

30 See Robert D. Hershey Jr. 'New Price Index Expected to be Pushed to Reflect Buying', *New York Times*, December 1, 1996, p. 40.

Chapter 6

Inequality

In the past decade, a wide range of commentators have claimed that fundamental trends in western countries are leading to greater inequality in income and wealth. Robert Reich, the former United States Secretary of Labor and a leader of those pessimistic about inequality, claims that, since 1979, almost all the income growth in the United States went to the wealthiest fifth of American households: the poorest fifth saw their real income fall dramatically. Free market reforms in New Zealand have been blamed by some for creating greater inequality.[1] This chapter reviews the complex arguments on what is still an unresolved matter. The issue is vitally important because, if left unexamined, it could lead to resistance to the changes necessary for the long term vitality of western economies. Western welfare systems will have to be redesigned to cope with increasing inequality, if this is indeed an inevitable consequence of economic change in advanced economies.

A strategy that focuses on ensuring that no household falls below a minimum poverty line is very different from emphasising the reduction in lifetime inequality. A society could, if it desired, have a well designed safety net, based on a sophisticated poverty line to eliminate most deprivation such as hunger, poor housing, inadequate health care and so on. This same society could also have a high degree of income inequality, with the top ten per cent of households earning vastly more than the bottom ten per cent.

Understanding inequality, like poverty, poses complex challenges.

Critics in New Zealand claim that inequalities persist, in part, because New Zealand (and Australia for that matter) refused to develop comprehensive welfare states on the Scandinavian model. The means-tested 'residual' New Zealand welfare system ignores inequality, focusing instead on an austere safety net.[2] Reducing inequality, so the critics say, requires major structural changes in social and economic institutions. Sweden is one of the most equal societies in the western world.[3] This has required complex institutional arrangements to control wages, provide a wide range of subsidised public services, create many government jobs and, above all, maintain very high tax levels that fund highly redistributive income support programs.

'Equality of opportunity' is a central idea in western countries. While admitting that inequality exists, many believe that those from all income groups, even the lowest, should have the opportunity to climb the income ladder. Subsidised government educational provision, and especially higher education, is supposedly a key mechanism for achieving social mobility for even the poorest. Equality of opportunity is difficult to measure, and may be a myth in many countries because of discrimination on the basis of social class, race and gender, but it is nevertheless an important underlying value. Groups may resist changes needed for economic growth if they perceive the changes to be unfair. Economic change is more likely in the long run, if it increases equality of opportunity.

The debate on the effects of widespread New Zealand economic reforms over the past decade has focused on events within New Zealand. But the past decade has witnessed powerful global movements that influence poverty and inequality within particular countries. Changes in standards of living within New Zealand may often be more a result of these broad global patterns. This chapter surveys the main arguments. Robust conclusions are difficult to make because the world debate is in a state of flux. There is, however, some modest consensus that the trends towards inequality are not the inevitable result of global forces, but reflect particular political, social and institutional choices.

Inequality in New Zealand

Whether recent changes have altered income distribution is a complex issue. But it is important to realise that New Zealand before the reforms in the 1980s and 1990s was not a particularly egalitarian society, in terms of income and wealth equality. New settlers in Australian and New Zealand have tended to romanticise egalitarianism in these different societies. While wealth ownership in early New Zealand was more equal than countries like the United States and Britain, in 1912 one per cent of New Zealanders owned 36 per cent of total wealth (the comparable figure in the United States was 56 per cent; for England and Wales 66 to 69 per cent). By 1939, the top one per cent in New Zealand owned 25 per cent, similar to the levels in the United States of 31 per cent and was slightly more equal than Victoria from 1912 to 1939.[4]

Measuring inequality within one country over time is extremely difficult and international comparisons are even more complicated. Ideally, one requires information on after tax household income, and also information about the supply of government services, especially health care, education, housing, and other significant services that alter comparative living standards.

In 1996, the World Bank published the results of the most ambitious and thorough comparison of current gross income inequality in most countries in the world. The series applied sophisticated methods to standardise information, and is the best general guide yet to comparative inequality. The 'Gini coefficient' is widely used in inequality research and is 'equal to half the expected absolute difference in incomes, relative to the mean, between any two tax units drawn at random from the population: for example, a value of 36 means that, on average, the absolute difference between the incomes of any two tax units is equal to 72 per cent of the mean'.[5] In short, the lower the Gini level, the more equal the society, the higher the level, the greater inequality.

Table 6.1 shows that New Zealand had an average level of current gross income inequality over the 1970-1990 period that was about average for affluent countries. It was more egalitarian than Australia, which was, apart from France, the most unequal society shown in the table, and was similar to Japan. Inequality in affluent countries was generally far less than in countries in Sub-Saharan Africa and Latin America.

While the World Bank study is useful in giving a long term comparative view of inequality in New Zealand, it is of little use in answering the question of whether income equality increased over the past decade or so, when New Zealand was engaged in widespread economic reform. The Organisation for Economic Cooperation and Development (OECD) in Paris is the main source of comparable international statistics on this question because it standardises measures to ensure international comparability.

The 1996 OECD report on the New Zealand economy published figures on trends in disposable income distribution for full time workers between 1980 and 1993, shown in Figures 6.1 and 6.2. Real disposable income is a more accurate guide to changes in inequality because it takes account of changes to taxation (real disposable income in this table refers to gross wages and salaries minus taxes, adjusted for inflation). Part time work is becoming increasingly important in New Zealand so the focus on full time workers limits the value of the information. The information takes no account of changes in the level of cash benefits or subsidised government services such as health care and education. This information, obtained from Statistics New Zealand,

Table 6.1

Inequality in industrial and high income developing countries circa 1960-1990 (with selected comparisons)

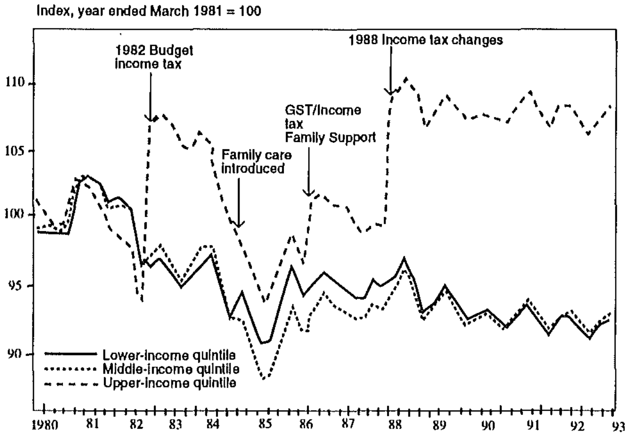
Country	Average Gini	Minimum Gini	Maximum Gini	Ratio of top quintile share of income to bottom quintile's share
New Zealand	34.36	30.04	40.21	6.78
Australia	37.88	32.02	41.72	8.32
Canada	31.27	27.41	32.97	5.54
Denmark	32.09	30.99	33.20	6.29
France	43.11	34.85	49.00	6.31
Germany	31.22	28.13	33.57	5.35
Ireland	36.31	34.60	38.69	8.91
Italy	34.93	32.02	41.00	4.94
Netherlands	28.59	26.66	29.68	4.43
Norway	34.21	30.57	37.52	7.39
Sweden	31.63	27.31	33.41	5.64
United Kingdom	25.98	22.90	32.40	4.03
United States	35.28	33.50	38.16	8.46
Total (21 countries)	33.19	22.90	56.00	6.63
Japan	34.82	32.50	37.60	7.06
Sub-Saharan Africa	44.71	28.90	63.18	11.61
Latin America/ Caribbean	50.15	37.92	61.88	16.02

Source: Klaus Deininger and Lyn Squire 'A New Data Set Measuring Income Inequality', *The World Bank Economic Review* vol. 10, no.3, 1996, pp. 574-7.

The information from New Zealand is taken from twelve observations from 1973 to 1990. The top quintile is the top fifth of income earners while the bottom quintile is the lowest fifth of the population. The ratio in the right hand column is a measure of the wealth of the top 20 per cent of earners as a multiple of the lowest 20 per cent.

Figure 6.1

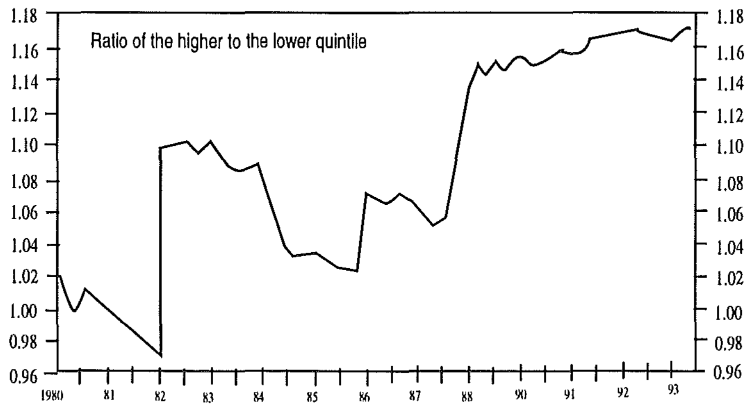
The evolution of real disposable income: full time wage and salary earners, New Zealand 1980-93.



Source: *OECD Economic Surveys, New Zealand, 1996*, Paris, 1996, p. 71.

Figure 6.2

The evolution of real disposable income: full time wage and salary earners, New Zealand 1980-93: ratio of the higher to the lower quintile.



Source: *OECD Economic Surveys, New Zealand, 1996*, Paris, 1996, p. 71.

is no longer published, so it is not possible to update the Figures.

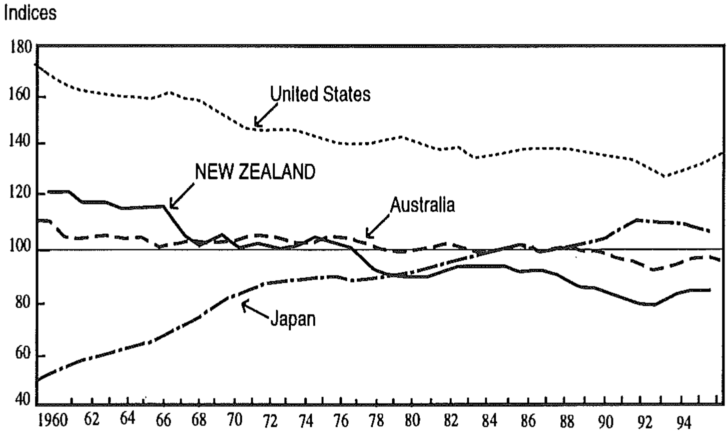
Figures 6.1 and 6.2 show a clear pattern of a widening share of income for the top quintile (fifth) of income earners. From 1980 to 1993 the upper quintile have increased their ratio of real net income to the lower quintile by about 15 per cent, and from the 1982 peak to the 1993 peak by between five and six per cent. The figures are somewhat erratic, suggesting the influence of specific government decisions on taxes and benefits, and possibly the influence of recessions, booms, and stock market prices and dividends. The diagram also shows the decline of the middle quartile over most of the period from 1981 to 1985, followed by a rise and then a settling down to a generally declining plateau. The real disposable income of the middle income group has declined over the 1980 to 1993 period by about five per cent. While income inequality often looks at just the top and bottom of the income distribution, trends in middle income quintiles are also very important, because many households are in this group and the maintenance of their standard of living is important in gaining political support for economic changes.

The trend in lower quintile incomes is the most intriguing feature of the graph. The lower income quintile trend closely followed the middle income trend and exceeded it in some years, particularly between 1985 and 1988. The lower quintile has matched the middle income trend since 1988 – albeit with both on a gradually declining curve – suggesting that wage reduction in New Zealand has not been particularly dramatic for those in full time employment, despite labour market deregulation and that inequality among wage earners has not risen markedly.

Declining real incomes for some groups in New Zealand are in part a result of the overall poor performance of the New Zealand economy. The debate over economic change and inequality in New Zealand has often been dominated by the argument that affluent groups have benefited more significantly than less well-off groups. The overall poor performance of the New Zealand economy, at least until the past few years, however, means that often most groups were in absolute decline in terms of living standards. Stephens and Waldegrave show that from 1984 to 1993, all but the ninth and tenth income deciles (tenths) experienced declines in real incomes over the period, with the greatest falls being in the lowest five income deciles.[6] Figure 6.3 shows the general decline between 1960 and 1995 in gross national product per head for New Zealand in purchasing power parities between 1960 and 1995. New Zealand real incomes have declined dramatically

Figure 6.3

Gross National Product per head in selected OECD countries. Current purchasing power parities OECD=100



Source: *OECD Economic Surveys, New Zealand, 1996*, Paris, 1996, p. 4.

between 1960 and 1992, with only modest exceptions in some years. Real income has increased since 1992. The figure shows the rapid increase in real income per head in Japan; even the sluggish Australian economy has performed better than New Zealand's over the period. The figure also shows the large gap in incomes per head in 1995 between the low figure in New Zealand and the higher figures in Japan and especially the United States.

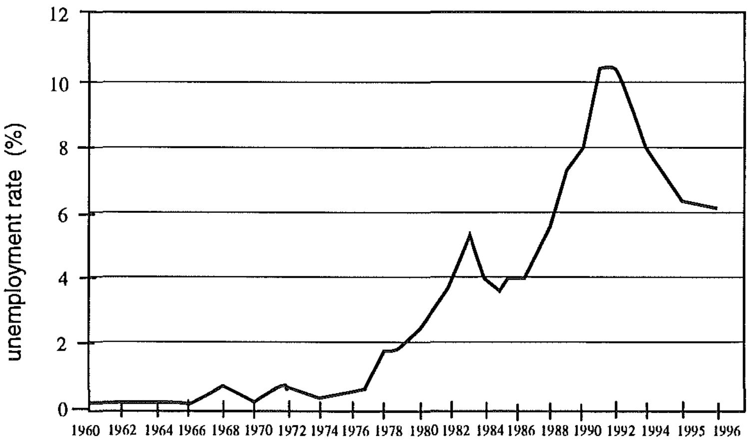
The information to this point in this chapter has focused on broad indicators of trends in inequality over relatively long periods of time. The New Zealand Treasury has made its own summary measures of trends in inequality, again using the Gini coefficient. The measure is useful, not so much as for what it means in absolute terms, but in movements over time. Treasury found that current disposable income inequality, as shown by the Gini index, increased by five per cent between 1981-2 and 1987-8 (after dipping about four points in 1985-6). Inequality then increased by a significant 14 per cent between 1987-8 and 1989-90.

It is likely that the massive increase in unemployment was the major source of this trend. Unemployment rose particularly steeply in New Zealand, and many of those who once had workforce income were reduced to relying on minimal means-tested welfare benefits, leading to an increase in income inequality.[7] The steep rise in the New Zealand unemployment rate is shown in Figure 6.4. The income was more significant than in many other countries because New Zealand's rate was extremely low in the sixties and most of the seventies. The rapid decline in unemployment in the past few years should be reducing inequality as more low income households, formerly dependent on minimal welfare benefits, receive higher wage and salary incomes.

Significant increases in the numbers of single parents on welfare benefits is also another important factor in increasing inequality, although these women and children could well have been suffering low or declining incomes when they lived in intact families. The New Zealand welfare system, in common with other western countries, contributes indirectly to increased inequality in household income. Welfare benefits enable people to live independently, as separate, often low-income, households where earlier these people would have either stayed in their relationship, or lived with parents or other relatives. The welfare system has weakened two-or even three-generation households by paying benefits to individuals or small households.

Figure 6.4

New Zealand unemployment rate 1960-1996

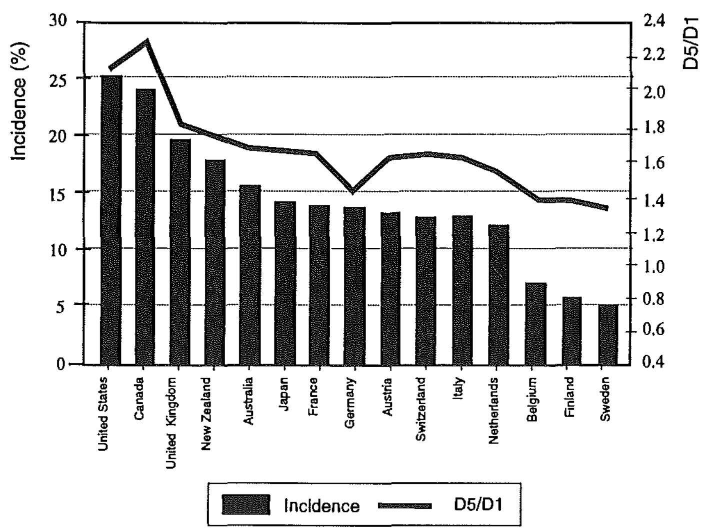


Source: New Zealand Treasury, unpublished data on income distribution and Statistics New Zealand.

Figure 6.5 shows the incidence of low pay and earnings inequality for a range of countries, using the latest information from 1993 to 1995. The graph shows that New Zealand has the fourth highest incidence of low pay out of the 15 countries examined. The United States and Canada have by far the highest incidence of low pay, and New Zealand is only three per cent above the level in Australia and a wide range of European countries such as France, Germany and Italy. New Zealand, however, has a very low level of unemployment compared to most other countries in the chart, which have reduced the incidence of low pay by maintaining high minimum wages and high unemployment. New Zealand has followed OECD recommendations and changed the tax and benefit and wage setting systems to make work 'pay'. For some groups this means lower pay, and this will emerge in statistics as a trend

Figure 6.5

Incidence of low pay and earnings inequality: selected OECD countries, 1993-5



Source: OECD *Employment Outlook* July 1996, Paris, p. 70. Note: The incidence of low pay refers to full time employment only. Low pay is defined as less than two thirds of median earnings for all full time employees. The D5/D1 ratio refers to earnings of all full time workers and is the earnings of the fifth income decile divided by the lowest income decile.

towards greater earned income inequality. Leaving these groups on long term unemployment benefit reduces the level of earned income inequality but may be less desirable in the long term.

Figure 6.6 show long term comparative trends in earnings dispersion (the incomes of the highest income decile divided by the lowest) in a range of advanced countries from 1970 to 1994-5. The graph shows, once again, the remarkably different trends in the United States which has experienced the most marked increase in earnings inequality. Wage inequality amongst men has been increasing in New Zealand in the 1980s and early 1990s, but the trend is decreasing, especially amongst female workers where inequality has decreased since 1990.

The international trends show marked differences between countries, although there is a general upward trend apparent in earnings dispersion (the ratio of the top ten per cent of earners to the bottom ten per cent) in some countries since around 1980. Of the countries listed, the United States has seen a much steeper downward slide for the lowest income quintile, caused by a complex range of factors including a low minimum wage, a strong shift away from the poorly educated in the labour market, and an uneven and austere social welfare system that varies significantly between states.[8] New Zealand has also seen significant rises in income dispersion for men, although the increase has not been as dramatic as in the United States or Britain. The increase in income dispersion in New Zealand since the mid 1980s has not been all that different from Australia, even though the latter had not implemented major economic reforms over that period.

Explanations for increasing inequality in western countries

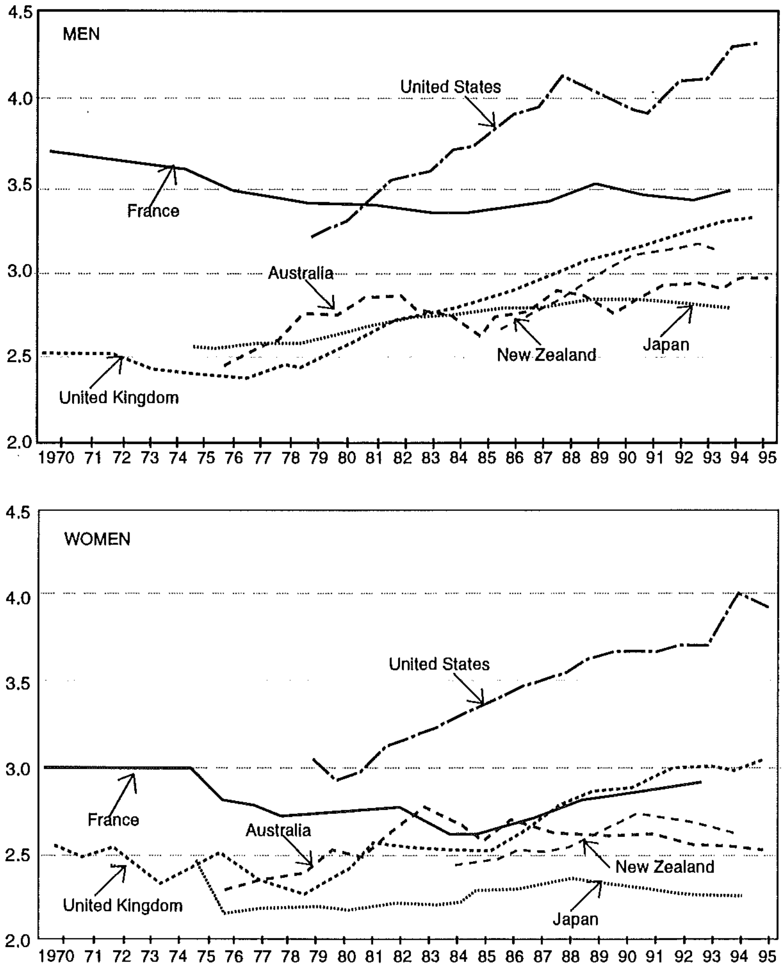
There are many possible explanations for a general increase in inequality in western countries. The extensive literature on the complex range of influences rarely specifically mentions New Zealand but is useful to the New Zealand situation because it looks beyond internal policy changes. The factors used to explain increasing inequality are summarised in Table 6.2.

(a) Globalisation

The New Zealand welfare system was designed at a time when the nation-state was more relevant than it is today. Small countries like Australia, New Zealand, and the Scandinavian nations believed that they could control their destiny through Keynesian economic management, protective tariffs, and generous welfare states. The formula worked for a long time, making it difficult to convince current

Figure 6.6

Trends in earnings dispersion: incomes of the top decile divided by the bottom decile (D9/D1) 1970-circa 1995



Source: OECD *Economic Surveys, Australia*, Paris, 1996, p. 86. Note: Data for New Zealand is from 1984 and data have been interpolated for missing years. D1 and D9 refer to the upper earnings of respectively, the first and ninth deciles of employees ranked in order of their earnings from the lowest to highest i.e. 10 per cent of employees earn less than the D1 earnings limit and 90 per cent earn less than the D9 earnings limit.

Table 6.2

Main factors believed to be responsible for increasing inequality in western countries

Trend	Main characteristics
Globalisation	Open world economies causes a 'race to the bottom' as companies seek out the lowest cost location. High labour cost western economies disadvantaged.
Technology and downsizing	Reduces labour demand, especially for the downsized non-computer literate. New telecommunications make globalised economies more likely.
Service-based economy	Skilled part requires highly educated employees; unskilled part has low productivity that pays low wages, offers no career opportunities. A few top performers may obtain most of the rewards.
Immigration	Large numbers of low skilled immigrants reduce low skill wages.
Underclass dynamics	A wide range of factors has created a permanent 'underclass' in western countries that is difficult to integrate into the mainstream economy.
Transitional problems	The shift to a service economy and the increased demand for skilled workers has left a large pool of workers, many older, who need retraining or early retirement.

Source: Adapted, in part, from the ideas in Barry Bluestone 'The Inequality Express', *The American Prospect*, no. 20, Winter 1995, pp. 81-93.

generations that circumstances are now very different. The 'Golden Age' from 1945 to 1973 is still the dominant idea for most New Zealanders of what is 'normal'. Past successes lead to persistent nostalgic efforts to recreate the past.

Globalisation is given considerable attention here because it is a very important topic, even though many of the debates on the issue are annoyingly inconclusive. New Zealand's economic reforms have been underpinned by a commitment to open up the once heavily protected and regulated economy to international competition. The process still has some way to go, with plans to move to zero tariffs on imports by early next century. Internationalisation is a radical step for a small economy and there are worries that there may be resistance to liberalisation. The Australian Labor Party, for example, has, in opposition, reversed its free-trade stance and now supports the maintenance of considerable protective barriers. Globalisation engenders fear that can be mobilised politically, at possibly high long run costs and reduced economic growth rates in the future.

The New Zealand economy has become rapidly internationalised. In 1994, exports accounted for 23.8 per cent of gross national product in New Zealand, and exports have increased by an average of 6.5 per cent a year over the past five years. In contrast, exports account for only 7.7 per cent of gross national product in the United States and 8.6 per cent in Japan.[9] The openness of the New Zealand economy – the ratio of imports plus exports as a percentage of GDP increased by 42 per cent between 1983 and 1993.[10] The growing role of foreign trade in New Zealand is not in itself evidence of growing inequality and could indeed be a sign of increasing national wealth for all. It all depends on the nature of the trends in trade and their influence on employment and wages. This information is not available at the moment.

Many now argue that the nation state has limited relevance to modern economic and social policies. National governments have a shrinking ability to control their destinies because collective action and public goods now overlap national borders and footloose corporations search for the most profitable locations.[11] To some writers, the modern world is returning to a Social Darwinist era of ruthless international competition, with the strongest countries winning the battle.[12] Sachs and Warner, after reviewing global economic trends and the opening up of most economies to global competition, argue that

> The world economy at the end of the twentieth century looks much like the world economy at the end of the nineteenth century. A global capitalist system is taking shape, drawing almost all regions of the world into arrangements of open trade and harmonised economic institutions. As in the nineteenth century, this new round of globalisation promises to lead to economic convergence for the countries that join the system. In this paper we have provided strong evidence of convergence among open economies during 1970-89, as well as evidence of accelerating growth in the countries that have recently undertaken market reforms.[13]

The Japanese writer Kenichi Ohmae is the most iconoclastic, arguing that the nation-state has come to an end.[14] Benjamin Barber refers to 'McWorld' to describe the relentless spread of American lifestyles and corporations across the world.[15] Information, technology, capital, and goods and services are now highly mobile. Immigration between countries is still highly restricted, but large scale tourism and illegal immigration makes it increasingly difficult to control the international movement of people.

The new globalisation creates an obsession with becoming internationally competitive. Nations must adjust their tax levels, labour costs, and a wide range of other elements in competitiveness, it is held, if they are to attract capital and continue to develop economically, enhancing productivity, improving human capital, and serving the needs of a growing economy.[16]

A failure to be internationally competitive will mean a slowly growing economy, reduced job opportunities especially in emerging industries, and increasing inequality.

Globalisation places a premium on mobility. Hans-Werner Sinn, an economist at the University of Munich, has adapted the well known public choice location theory made famous by Charles Tiebout in 1956, according to which households and firms are mobile over time and seek out low tax locations. This leads to concentrations of the wealthy and of the poor in different, contrasting areas.[17]

New York City is a good example of this polarising effect. The rich households and cost-conscious firms leave the high tax city, which then faces an impossible spiral of ever higher taxes to service its growing poor population. To Sinn, this location competition will see the death of the high tax social insurance states such as Germany, the Netherlands, France and Sweden. Sinn's article has been influential in policy discussion in the European Community, because he emphasised that the movement of industry is responsive to different tax levels in various countries.

Industries located in Europe or thinking of locating there, ruthlessly seek out the best deal, and are attracted to countries with low taxes, low wages, and low social security benefits. Western European countries are engaged in frantic competitive efforts to attract industries. The owners of capital now have enormous power over governments, and economic development agencies in Western Europe routinely pay subsidies to attract employment. In 1996, the grants per new job attracted ranged from UK £12,000 to £20,000.[18] The Irish economy is booming because of generous grants and a low ten per cent company tax rate. Britain is also attracting a large share of incoming investment, perhaps because it has lower wages and lower employer financed social security taxes, in comparison with continental European countries such as Sweden or Germany. Korean companies are investing in Britain on a large scale, claiming that wages are often lower than in Korea.

Globalisation is leading to 'competitive deregulation', defined as the 'possibility that firms in areas with low social wages may be able to undercut the prices of competitors, causing firms in areas with high social wages to either go out of business, relocate, or pressure local public officials and workers to reduce social wage costs. In extreme scenarios, these actions could fuel a downward spiral in social provision, eventually producing rudimentary, lowest-common-denominator social policies.'[19]

Firms that locate in low cost areas such as Ireland or Britain are accused of 'social dumping'.

The academics who not so long ago admired the wonders of corporatism in European countries – the comfortable unity of industry, labour and government to push up wages, prices and social benefits – now accept the inevitability of ruthless international and even interregional competition. Streeck says that

> The outcome of regime competition is biased in favour of capital. This effect need not, and probably will not, arise in one or two years, given, for example, the interests of national governments in retaining a modicum of control over their domestic political economies. But in the long run, unless national social policy regimes can somehow generate the political resources for strengthening their capacity to contain competition among them, their character will be fundamentally altered by market constraints on national initiatives to expand social protection: successful rollbacks of overextended national systems exposed to competition; the difficulty of developing innovative policies under strict international compatibility requirements; subtle power shifts inside national systems due to exit threats from mobile participants; the need to turn social policies into incentives for investors; and, not least, the response of business firms to the market incentives offered by regime competition.[20]

Recent events in Germany suggest that a national crisis over uncompetitiveness can develop very quickly. While the problems of the Swedish welfare state have been well known for some time, Germany was thought to be invulnerable to the effects of globalisation.

It has a very large, highly productive economy, with widely admired education and training systems and envied prowess in technologically sophisticated products. Nevertheless, in 1996, German was facing an economic crisis, with sluggish growth, high unemployment, uncontrollable budget deficits, and high taxes which encouraged companies such as BMW and Mercedes Benz to build new plants in Eastern Europe or the United States. In 1993, welfare expenditures in Germany accounted for 34 per cent of national product, requiring very high taxes on both employers and employees.[21]

In early 1997, *The Economist* reported that almost a third of manufacturers in Germany planned to shift some production abroad in the next three years, mostly to Eastern Europe. German companies almost doubled their investment abroad in 1995 to record levels. Employers, fearing industrial unrest, have defied government directions to reduce sick pay below 100 per cent replacement of wages. Workers who lose their jobs still get close to two-thirds of their previous wage for a year (almost three years if they are over 54) and half thereafter, which could well be forever. Germany has taken a number of steps to become more competitive and cope with the unemployment rate, expected to be nearly 12 per cent of the labour force in early 1997, but is facing fierce resistance from workers.[22]

Competition for industry is not only between nations. The state governments in Australia and the United States offer generous subsidies to attract industry to their particular locations. In the United States, this competition has created a 'race to the bottom', as states reduce welfare outlays to cut taxes, make themselves less attractive to the poor, and attract industry.[23] Special subsidies to industry are costly and wasteful and usually end up being matched by other areas. It is far more effective to copy the New Zealand policy of reforming the economy to change the fundamentals such as taxation and regulation that reduce competitiveness. This is the strong argument in a recent report on wasteful state and local industry assistance in Australia.[24]

The globalisation perspective can produce very pessimistic views on the future of high wage, high social benefit western economies. The economist Michael Jensen argues that western countries can only survive the competition from the vast labour pool in developing countries by downsizing their organisations, substituting capital for labour, and ensuring that their small workforces are highly skilled. To Jensen, the new globalisation is so significant he calls it the 'modern industrial revolution'.[25]

Jensen is convinced that western economies will have great difficulty in competing with the vast pool of labour in non-western countries. Labour in the poorer Asian countries, such as India, China, and Indonesia, costs only about US$2 per day, in contrast to an average of US$84 per day for the United States and Europe. These vast differentials in labour costs require a new wave of economic restructuring in western economies. Jensen summarises his views:

> While the changes associated with bringing a potential 1.2 billion low cost labourers onto world markets will significantly increase average living standards throughout the world, they will also bring massive obsolescence of capital (manifested in the form of excess capacity) in western economies as the adjustments sweep through the system. Western managers cannot count on the backward nature of these economies to limit competition from these new human resources. Experience in China and elsewhere indicates the problems associated with bringing relatively current technology on line with labor forces in these areas is possible with fewer difficulties than one might anticipate.[26]

The new competitive western enterprises will require highly educated 'symbolic analysts,' who use technology and new information technologies to create high-value-added but low cost enterprises. Those who do not increase their level of human capital will be condemned to low wages. Employers will move labour intensive, low productivity activities to poor countries.

Western countries will continue to experience widening inequality, as the highly skilled benefit from higher wages, while the less skilled suffer falling wages or are supported by welfare state benefits. In a globalised world, the unskilled person in Auckland cannot expect to earn much more than the unskilled person in Beijing. This analysis is widely accepted, and was popularised by Robert Reich, in his book *The Work of Nations: Preparing Ourselves for 21st Century Capitalism*, published in 1991.[27]

The economist Adrian Wood has presented the most pessimistic argument for the effects of free trade on the lower skilled in western economies. Wood's research suggests that imports from low wage countries have caused a substantial decline in the demand for unskilled labour in the developed countries – by about 20 per cent up to 1990.[28] He recommends massive investment in training and education in western countries to develop the human capital advantages of the the less skilled. Wood maintains his commitment to free trade, because the developing countries offer important new markets for western countries, and low cost imports from low wage countries improve the living standards of all income groups in western countries. There is very strong intellectual support for the benefits of free trade.[29] An exhaustive study of most countries in the world found a strong causal relationship between an open economy and higher rates of long term economic growth.[30]

The American economist Paul Krugman is the major critic of what he calls 'pop internationalism', or the attempt to blame globalisation for the increasing inequality in incomes in the United States and Europe and the collapse in the demand for unskilled labour. Krugman writes from an American perspective, and points out that the United States, despite appearances to the contrary, is not a major trading nation. Exports in 1994 accounted for only 7.7 per cent of the American economy, about the same percentage as in 1890.

Krugman attacks pop internationalism from many perspectives. He claims that there is little that is new in all this. The world economy was in fact more internationalised last century. Economies were then far more dominated by primary production and manufacturing, and as he says, 'a century ago, Chicago meatpackers were acutely aware of their competition with New Zealand'.[31]

The attack on the social effects of modern globalisation is based on an admiration – or even fear – of the incredible growth rates of Japan and the 'Asian Tigers' such as Singapore over the past few decades. Many feel that western nations just cannot compete with these Asian economies, which are pure 'developmental' states without the responsibilities of welfare systems that burden western economies.

Krugman denies that these high growth Asian countries are particularly efficient. Japanese growth has slowed, and much of Asia's growth has been a result of increases in inputs of land, labour, and capital. Krugman draws chilling parallels with the American fear of Russia's rapid growth in the 1960s. Krugman's main point is that any country can grow rapidly up to a certain point just by increasing inputs: by taking unemployed or underemployed labour from the farms or families and putting them into factories or into mechanised agriculture. But, he argues, at some time the supply of inputs will be exhausted, and these apparently high growth economies will stagnate at a level of per capita income that is well below the richest western countries. They will then only grow by becoming more efficient, producing more output for a given level of input. Improvements in efficiency will then require massive investments in physical and social infrastructure, especially in the human capital levels of the population.

The globalisation argument may also be based upon misunderstood fundamental trends in modern western economies. Krugman argues that 'the kinds of jobs that grow over time are not the things that we do well but the things that we do badly'.[32] For example, western economies have become very efficient at producing food, so few people are employed in food production. A similar argument can be made for modern, internationally competitive manufacturing plants. In 1995, only 28.4 per cent of the New Zealand workforce were employed in agriculture, hunting, fishing, forestry and manufacturing. As Krugman says, western countries are efficient at producing goods, but are not very good at increasing productivity in services, even though services now dominate employment in modern economies.

If Krugman is correct, western economies will only grow in the future by improving productivity in the services sector, even though much of this is not internationally tradeable, at least not in the short term. There are signs that the service sector is becoming globalised, as shown by the spread of global firms in food (McDonalds etc.), waste disposal, and financial services such as insurance. Child care, restaurants, banking, education, and hospital and aged care services are increasingly dominating modern economies. Growth will require improvements in these activities. Productivity growth in modern New Zealand is not impressive, after adjusting for the influence of cyclical movements in economic activity. The OECD claims in its 1996 report that 'labour productivity gains have not been outstanding, averaging one and a half per cent per annum'. [33]

The debate on the effects of imports from low wage countries continues to rage in the United States, and elsewhere, with indeterminate results. It is agreed that trade with poorer countries in the past decade did reduce the proportion of the developed world's population employed in manufacturing by 1 to 2 percentage points.[34] This does not appear to be very significant in comparison with other structural changes occurring in economies, such as the downsizing of the government sector. A survey of interested economists at a 1995 conference in New York found that the economists blamed foreign trade for only 11 per cent of the increase in income inequality in the United States.[35]

More worrying for small economies such as Australia and New Zealand is the trend towards industrial specialisation and outsourcing by large international corporations. This has been identified as another source of wage inequality because companies are attracted to low cost producers, whether they be in low wage countries or in large scale, highly efficient plants in developed economies.[36] Increasingly, component parts for manufactured products are being sourced from many countries, including developed economies. Scale economies may make it uneconomic for large companies to manufacture for the small markets in New Zealand. Australia, albeit with significant help from tariffs, is developing some important niches in motor vehicle component manufacture, mainly for export, that are typical of trends in world trade. Some economists argue that such a return to an emphasis on scale economies may damage the interests of small economies.[37]

On the other hand, 'post-Fordist' production trends are contrary to such a return to scale economies. Post-Fordist theory claims that the mass production era is over.[38] New computer technologies and rapidly changing tastes mean that flexible production has replaced mass production. Product markets, even for significant items such as cars, are dominated by short model-life products that require great workforce and production flexibility. Firms will locate in higher cost areas with well trained, flexible workforces that can produce high-value-added products for rapidly changing markets. Well-known examples of this trend include New Zealand's exports of yachting equipment and Australia's flourishing export trade in sophisticated, large catamarans for ferry services in Europe and Asia. Innovative design, capital-intensive manufacturing, and speedy production of custom items overcomes the disadvantage of high labour costs and distance from markets.

Post-Fordism suggests that small countries such as Australia and New Zealand will have to specialise more in the future.[39] This specialisation is contrary to the self-sufficiency and import replacement that was the basic policy premise for most of this century. Specialisation involves some risks, because the economies become more vulnerable to changes in a small range of industries. Specialisation requires structural changes in the economy, perhaps well in excess of those in the past decade.

The effects of globalisation are obviously an important element in modern government. Paul Krugman's sceptical arguments may well be correct because the sheer size of the American economy reduces the effects of globalisation there. But Australia, and especially New Zealand, are far smaller economies, and are dependent on what happens elsewhere in the world. Paranoia about globalisation, competition from low wage countries, and outsourcing by large multinationals, could well lead to strong pressures for retaining existing protection or even increasing tariffs in the future. New Zealand currently is rated quite highly by international competitiveness agencies.[40] But some industries are still comparatively highly protected, and there remain significant problems in the economy, as shown by the 1996 OECD economic survey.

The literature on post-Fordism and globalisation always concludes by insisting on the primacy of human capital investments in western countries. Poor countries have vast populations with low wage costs, but they rarely have well trained and educated labour forces. New Zealand is criticised by the OECD for its inadequate human capital programs, and its rate of economic growth now is being constrained by a shortage of skilled workers. New Zealand will probably have to increase spending on well planned human capital programs in the future if it is to avoid increasing inequality.

The debate on globalisation is confusing but some tentative conclusions can be made on the implications for New Zealand. Krugman's arguments attacking globalisation as a cause of inequality may be relevant to the vast American economy but are probably less relevant for New Zealand. The small New Zealand economy is vulnerable to global trends because its small size means it will become increasingly dominated by trade: imports plus exports will almost certainly grow as a proportion of national product. New Zealand does not have a welfare system anything like the high cost examples in western Europe that are a major problem in international competitiveness for major industrial powers such as Germany. But New Zealand does have a far higher level of dependency than in the past, and faces significantly higher outlays in the future for major dependency groups such as single parents and the aged. New Zealand also has a very low rate of household savings, a major disadvantage because competing Asian economies typically save and invest high proportions of income. New Zealand will have to reduce the scale of welfare dependency if it has to lower taxes in the future to improve international competitiveness.

(b) Technology and downsizing

Research on inequality in western countries now emphasises the role of massive technological change in modern economies. The low price, extraordinary sophistication, and high productivity of modern technology accelerate the pace of adaptation needed to adjust to new technology. Paul Krugman argues that the effect of technological change is a far more important explanation of growing inequality than the more popular emphasis on foreign trade.[41] Few argue that technological change should be slowed down, because it is the key to improved productivity and higher living standards. Technological change, however, requires a more adaptable human capital system that retrains workers made redundant by technological change. This 'skills mismatch' is much discussed in western economies.

Economists in the past were usually optimistic about the employment effects of technology, arguing that technology improved productivity, raised real incomes, and had no significant implications for overall unemployment in a mobile workforce.[42] Joseph Schumpeter emphasised that capitalists who survive must participate in the 'perennial gale of creative destruction. The problem that is usually being visualised is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.'[43]

There is widespread concern, in the United States and Europe especially, with the extensive wave of 'downsizing' in larger organisations in the public and private sector. In a major series of articles in 1996 *The New York Times* claimed that American firms had shed 43 million jobs through downsizing since the early 1970s.[44] This downsizing is supposed to be destroying the past pattern of long-term careers, and reducing the proportion of the population with employer-funded benefits such as superannuation. Some of this downsizing is the result of new technologies which allow companies to operate with fewer staff, especially at the middle management and supervisor level. Downsizing is now part of modern management philosophy with a recent book from Harvard Business School even being called *Creative Destruction*.[45]

There is major debate on the validity of the downsizing argument. It is possible that many of the former employees who have been displaced are employed by dynamic new smaller firms that are expanding in other parts of the economy. A recent book on wage inequality in the United States argues that wage inequality is not a result of technological change or foreign trade. It is primarily a product of American corporate philosophies that pay managers and supervisors very high wages and cut lower level staff or reduce their wages. It is a result of intra-firm distribution of income, caused in part by declining union membership.[46]

Wage fixing deregulation weakened unions in New Zealand, although unions are also declining in many western countries for a wide variety of other reasons: union membership in New Zealand has declined from 43.5 per cent of the workforce in 1985 to 23.4 per cent in 1994.[47] Deregulation and globalisation of the broader economy weakens unions and reduces or destroys the premium wages previously enjoyed in protected industries. This process is most obvious in the United States. New airlines like Southwest grow rapidly because they offer lower fares based on much lower labour costs – even for pilots – than the older airlines. The older airlines must in turn reduce their costs through wage reduction or other methods, or establish new low cost airline subsidiaries to compete with other low cost carriers.

The effects of technology on inequality are still very debatable. Rapid technological change has happened in the past without apparent effects on inequality. No western country is prepared to limit technological change, which is considered essential to improved competitiveness. All affluent countries have responded to technological change by improving training and education, or by encouraging the exit from the workforce of older workers with few skills or skills unsuited to the modern economy.

A recent study of employment creation in the United States has claimed that most of those who lost their jobs in downsizing in recent years have been quickly reabsorbed into the workforce – at salaries on average 14 per cent lower. This is much less than the 40 per cent reduction claimed by some.[48] The same study found that 68 per cent of new jobs created in the United States in the past two years have been in industries paying above average wages, such as high technology and finance. There is now a growing recognition that it is senseless to protect labour in inefficient sectors. Companies in the United States shed 17.4 million workers from 1990 to 1995 but the economy created 28.4 million net new jobs over that period.[49]

The new mood in western countries recognises that pessimism about growing inequality, and the extension of low skill, low-paid 'hamburger flipping' jobs, was a product of an economy in transition and a major recession in the early 1990s. The United States economy, once the example of escalating inequality, is now creating employment at very high levels. Great Britain is one of the more rapidly growing economies in Europe. New Zealand is also one of the most rapidly growing western economies. Restructuring is obviously working: the lasting effects upon inequality remain very unclear. The United States example may be misleading for countries like New Zealand. The United States is fortunate in leading the world in major growth industries such as software, multi-media, films, and other parts of the knowledge and information sector.

(c) The service-based economy

New Zealand, like all modern economies, has experienced a rapid growth in service industries. Some claim that the shift from manufacturing to services is a key cause of inequality because service jobs are usually menial, poorly paid, part-time, and offer little career advancement. Services now account for around 80 per cent of paid jobs in the United States.[50] Nor are service jobs necessarily low skill. Advances in information technology allow the development of computer software that makes many service industries as capital intensive as many parts of manufacturing industry. Hospitals, for example, are far more information technology intensive than in the past. Four-fifths of information technology sold in the United States is now purchased by service providers. This increasing sophistication increases the case for better staff retraining and education. The service sector can no longer be a dumping ground for low skilled labour. This may increase inequality for the unskilled, at least until they are retrained.

The increasing capitalisation of the services sector should improve productivity and raise wages. Sluggish productivity in many service industries has been blamed for poor income growth in western countries. If 80 per cent of modern economies are based on services, high rates of economic growth must depend on improvements in service industry productivity.

The growth of the service sector has been female friendly. In the past the manufacturing and agricultural economy favoured male workers rather than females. But most service industries use female labour heavily and could prefer women, who may be more skilled in dealing with the public. Some of the service sector growth is in industries that replace activities formerly carried out in the home by women. Child care and aged care services are two clear examples of female based occupations. Sweden has very high levels of female workforce participation rate in welfare state activities such as child care. New Zealand's female workforce participation has risen significantly over the past few decades and is above the OECD average, but it is still well below the level in other countries such as Sweden.

Increased female workforce participation changes the nature of the New Zealand welfare state. The New Zealand welfare state was based historically on the assumption that most households would have a single income – that of a male breadwinner. Pensions for widows were introduced in 1911, far earlier than in most other countries in recognition of the importance of the loss of such an income. The rise of the two income family changes the pattern of income distribution.

Many households have two incomes, while some have no income apart from social welfare. This trend may explain part of the increase in inequality in household income, noted in many western countries.

Germany has taken a deliberate policy decision to discourage the two earner household and increase the number of positions available for male breadwinners.[51] Incomes of couples in Germany have to be added together for tax purposes, creating a substantial disincentive for female workforce participation. Germany also does little to provide child care services, a further discouragement for female workforce participation. Women receive recognition for being mothers and gain points towards contributory social insurance. The suppressed female labour force is a major obstacle to the flexibility of the German economy. Female workforce participation seems certain to rise in New Zealand, encouraged by the tax system and the changing service economy. Inequality in household income may well grow with this.

The growth of the service sector may create what some economists call 'winner-take-all' labour markets. These economists have argued that modern labour markets tend to reward a few with vast payments, while the mass of employees suffer low or declining rewards. The earnings of top movie actors, recording artists, lawyers and entrepreneurs do indeed seem to have soared in the United States.[52] These new trends in labour markets are made possible by modern technology. Bill Gates, the owner of Microsoft, has a vast income because software, although expensive to develop, is cheap to reproduce. Similarly, a pop star can flood the world with his latest record, reproduced cheaply. It is not clear what can be done about this trend. People often want the best product: they do not want the second best software or a second tier record. Massive incomes, such as are not uncommon in the United States, can be taxed, but there is no guarantee that the income earners will not move to a low tax area in another country.

(d) Immigration

Immigration can influence the pattern of inequality.[53] In the United States, large numbers of often unskilled legal and illegal immigrants increase competition and depress wages in low-skill labour markets. New Zealand's immigration program is modest, and it difficult to argue that immigrants reduce wages and increase inequality.

Modern immigration is different to that in the past. Open economies and flexible wage systems mean that unskilled migrants will either work for low wages or become dependent on social welfare, both of which may encourage greater income inequality in a society. This process is most apparent in the United States, where service industries such as food and hospitality have a high labour content because of very low wages. Los Angeles, which has a high proportion of immigrants, has been called the 'capital of the Third World'.[54] Those on middle and upper incomes are able to employ maids, gardeners, and child carers for a few dollars an hour, far below the rates payable in New Zealand or Australia. Welfare benefits are either very low, or more likely, not available. Countries like New Zealand, with a long history of minimum wages and social safety nets, would not support the American arrangements.

New Zealand has to be cautious about immigration in the future. Large scale immigration of unskilled or low skilled people could increase inequality because of the difficulty of absorbing these migrants into the economy. Most western countries have reduced migrant intakes or, like Australia, are about to reduce the levels. This may have more to do with social resentment, scapegoating, and even racial prejudice than any rational economic argument. The radical right in western Europe is very strongly opposed to immigration. This opposition is based, in part, on the fear that new immigrants will reduce the viability of welfare state benefits for longer term residents.[55] The United States and Australia have recently implemented laws that restrict immigrant access to welfare benefits for some years, creating potential social distress amongst some groups.

However, the OECD argues that New Zealand's economic growth is restricted because of severe shortages of skilled labour.[56] Local education and training cannot overcome these shortages quickly so there may be a need for small scale, targeted, skilled immigration.

(e) Underclass dynamics

In all discussions of inequality today, there is growing attention to the 'underclass', especially in American and British literature. Definitions of the 'underclass' usually stress the persistence of multiple deprivations, often transmitted between generations. There is a fear that renewed economic growth is bypassing a hardcore poverty group, drawing new labour force entrants from the young, others without previous workforce experience, or immigrants. The underclass is usually concentrated in inner-city ghetto areas, and displays high levels of dysfunctional behaviour such as welfare dependency, dropping out of school, drug addiction, crime, weak labour force attachment, and early out-of-wedlock child bearing.[57]

The underclass approach to poverty and inequality is valuable because it focuses on asset deficiencies. The underclass are of course deficient in financial assets, but also physical capital (poor housing and low quality neighbourhoods), social capital (family instability and high crime levels), and human capital (poor levels of skills, education and earning capacity). Most poverty surveys give little attention to assets beyond housing costs. Sherraden argues that when people have assets they behave differently, and the world responds differently to them as well. Assets can improve household stability, create a viable and hopeful future, stimulate the development of other assets, especially human capital, allow people to focus and specialise, provide a foundation for risk taking, increase social influence, self-confidence, and political participation and enhance the welfare of offspring.[58]

There are some dangers that Maoris in New Zealand could form an American style underclass. Figure 6.7 shows the dramatic recent increase in unemployment amongst Maoris (13 per cent of the population) and Pacific Islanders (four per cent of the population) and the even more disturbing decline in workforce participation levels amongst these two groups. Because Maoris and Pacific Islanders have young populations which should have a high participation rate compared to Europeans/Pakehas, age adjusted participation rates are really ten per cent lower than non-Maori.[59]

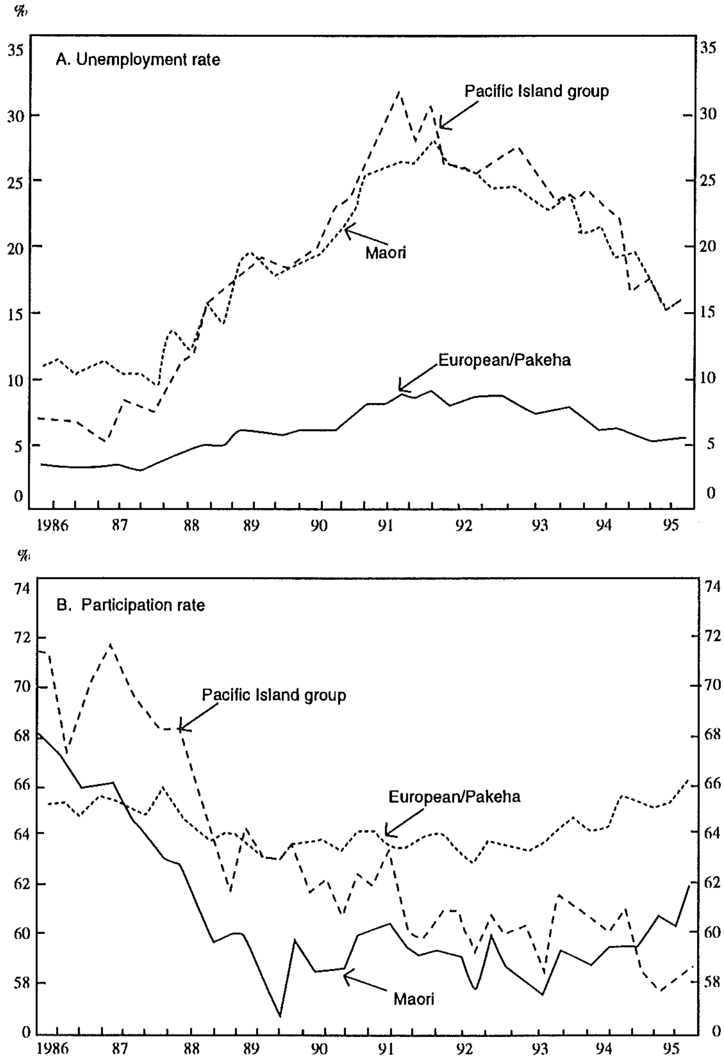
Unemployment amongst Maoris and Pacific Islanders has declined considerably from the peak in 1991, but it is still high – around 15 per cent – which is far higher than the 4.5 per cent rate amongst Pakehas. The decline in unskilled jobs has reduced Maori employment. The decline in employment amongst Maoris and Pacific Islanders is now a major problem in the New Zealand welfare state, of which policy makers are very aware.

Maoris have a disturbingly high level of single parent families, and receive single parents benefit (domestic purposes) at more than three times the rate of non-Maoris. Maori teenage child bearing, a key indicator of underclass behaviour according to American research, is still about three times the level for non-Maoris, but has almost halved between 1966 and 1993.

There are interesting comparisons between Australian Aboriginal people and the Maoris. Maoris appear on a wide range of indicators to be vastly more advantaged than Australian Aboriginals, which can be explained by early New Zealand policies to include Maoris in mainstream society. The Maori have had equal citizenship rights to all social welfare benefits from the time of the first aged pension in 1898.

Figure 6.7

Unemployment and participation rates by ethnic group



Source: *OECD Economic Surveys New Zealand, 1996*, Paris, 1996, p. 52.

Australian Aboriginal people, partly because of constitutional provisions and of racism, were not allowed access to Commonwealth social service benefits until the 1940s, and did not receive full welfare state recognition until 1967.[60] The Maoris are far more urbanised than Australian Aboriginal people, 72 per cent of whom lived outside capital cities in 1991. Maoris, too, had full voting and citizenship rights from last century, while Aboriginals did not gain these rights until the 1960s.

Aboriginal people have low levels of workforce participation and high levels of unemployment, ranging up to 41 per cent in some areas; the overall rate in 1991 was 32 per cent for males and 28 per cent for females. Aboriginal incomes are low and those employed are concentrated in lower-level jobs. A high proportion of Aboriginal people have been employed in government-funded employment schemes which are not very effective.[61] Aboriginal life expectancies are around 20 years below non-Aboriginal levels in Australia, while Maoris have a life expectancy that is only 5.4 years for men and 6.2 years for females below Pakehas.[62]

Despite their disadvantage, it is unlikely that the Maoris will become an underclass on the American model. Importantly, New Zealand's comprehensive social welfare policies cover Maoris. In contrast, the underclass in American cities often have inadequate welfare benefits, if these are available at all, have no comprehensive health care cover, and live in highly segregated poor quality ghettoes, isolated from many facilities. New Zealand has disadvantaged residential areas but few, if any, compare with the extensive ghettoes in major American cities. All the evidence suggests that the Maori population is undergoing a major demographic transition that will weaken underclass processes. The birth rate has fallen dramatically, and the Maori demographic profile will be similar to the non-Maori pattern in the next century.[63]

(f) Transitional problems

Critics of market-based economic reforms sometimes mistake transitional problems for long term patterns. New Zealand's economy and society has undergone great change over the past two decades. The pace of social and economic change has been dramatic even for unprotected, open economies such as Sweden and Germany. But New Zealand had to undergo multiple internal and external changes, probably more than any other western economy. The world economy is changing rapidly and New Zealand has been transformed from an insular, highly protected, indebted country to an outward looking society and economy that is far more internationally competitive. The economy has changed, and service industries are now far more important than in the past. The male breadwinner-based labour force is now far more complex and diversified.

It will be ten years or more before the long term patterns in inequality in the new world economy are clear. Trends in inequality were affected by the severe world recession in the early 1990s; New Zealand patterns were also affected by the need to be more open to the world economy and to downsize the large public sector. New public policies can be developed if inequality appears to be increasing, and especially if extremes of wealth and poverty become apparent. Premature action on the basis of unclear short term 'fuzzy' trends is a recipe for major and expensive policy failures.

Welfare state researchers differ in their diagnosis and prescriptions for the future. There is unusual consensus, however, that it is pointless to use welfare state programs to try to maintain past social and economic patterns that are no longer viable. Continental Europe is trying to do this, and is stagnating. Economic growth is the only way New Zealand can create the new resources to assist those in need. It is politically very difficult and divisive to reduce the real standard of living of any group in order to help another group. It is easier to alter the distribution of income in a growing economy, because no one then need suffer an absolute decline in their real standard of living.

There is also an unusual consensus amongst welfare researchers and policy makers, both on the left and right, over the importance of raising the level of human capital through better education and training.[64] Welfare states inadvertently encouraged long term dependency, trapping many people in a dismal cycle of idleness, loss of skills, and isolation from the broader society and economy. These programs may have been created with the best of intentions. But they too often lead to a persistent form of officially created inequality and segregation of significant proportions of the population.

This chapter has surveyed some of the vast literature on trends in inequality in western countries. Much of the literature necessarily comes from the United States where increasing inequality is best documented and is an important political issue. New Zealand may well be different, but the available high quality information – and it is not extensive – does suggest that many of the trends described in this chapter are observable in New Zealand, and indeed, to varying degrees, in most western countries.

There is a strong feeling among many recent researchers that the trends described in this chapter are inevitable, the result of complex deep-seated social and economic forces, beyond the capacity of government to alter: the implication is that the United States is only so extreme in its inequalities because it is the most 'modern' capitalistic and individualistic economy and society.[65] It would be wrong, however, to assume that New Zealand will follow the United States, with inevitable increases in inequality. Inequality in the United States is a result of particular political, social and institutional choices, especially the serious racial divisions, large scale legal and illegal immigration, and the lack of any national 'safety net' for income support or health care. America has chosen to do little about these issues.[66]

In comparison, New Zealand is still a far more interventionist society. It has institutions, especially a strong central government, that can monitor the trends discussed in this chapter and take action where serious deep-seated inequalities persist. Sensible policies can allow the economy to expand without creating a divided, income and class segregated society on the United States model. Paradoxically, the United States has vast amounts of high quality information that documents its worsening inequality, yet decides to do little to alleviate the problem. New Zealand probably has more underlying will to prevent extremes of inequality but as yet has little high-quality information to form the basis of a coherent strategy.

References

1 Robert Reich has written extensively about the effects of modern economic change on inequality and his works are referred to later in the chapter. A brief statement is Robert Reich 'Succession of the Successful' *New Perspectives Quarterly*, vol. 13, no. 2, Spring 1996, p. 18. A recent statement of these arguments on New Zealand is Jane Kelsey *Economic Fundamentalism: The New Zealand Experiment - A World Model for Structural Adjustment*, Pluto Press, London, 1995; a popular journalistic statement is Will Hutton *The State We're In*, Vintage, London, 1996 (revised edition).

2 See Pat Shannon *Social Policy*, Oxford University Press, Auckland, 1991; Chris Rudd 'The New Zealand Welfare State: Origins, Development, and Crisis', in Brian Roper and Chris Rudd eds. *State and Economy in New Zealand*, Oxford University Press, Auckland, 1993, pp. 226-45.

3 See Deborah Mitchell *Income Transfers in Ten Welfare States*, Avebury, Aldershot, 1991; Sweden has developed sophisticated theories to support their elaborate welfare state. See Tim Tilton *The Political Theory of Swedish Social Democracy: Through the Welfare State to Socialism*, Clarendon Press, Oxford, 1990; a recent optimistic defence of social democracy, despite Sweden's economic crisis is Henry Milner *Social Democracy and Rational Choice: the Scandinavian experience and beyond*, Routledge, London, 1994; for the massive role of social security in redistributing income in Europe see Pierre Hausman 'The impact of social security in the European

Community', in Jos Berghman and Bea Cantillon eds. *The European Face of Social Security*, Avebury, Aldershot, 1993, pp. 109-121.

4 See M.N. Galt 'Wealth and its distribution in New Zealand, 1893 to 1939', *Australian Economic History Review* vol. xxxv, no. 2, September 1995, p. 78.

5 A.B. Atkinson *Incomes and the Welfare State: Essays on Britain and Europe*, Cambridge University Press, Cambridge, 1995, p. 17; See also the highly technical comments in OECD *Income Distribution in OECD Countries: Evidence from the Luxembourg Study*, OECD, Paris, 1995.

6 Robert Stephens and Charles Waldegrave 'Measuring Poverty in New Zealand', *Social Policy Journal of New Zealand*, no.5, December 1995, p. 105.

7 New Zealand Treasury, unpublished data on income distribution.

8 For income trends in the United States see Sheldon Danziger and Peter Gottschalk eds. *America Unequal*, Harvard University Press, Cambridge, 1995; Sheldon Danziger and Peter Gottschalk eds. *Uneven Tides: Rising Inequality in America*, Russell Sage Foundation, New York, 1993; for Britain see John Hills ed. *New Inequalities: The changing distribution of income and wealth in the United Kingdom*, Cambridge University Press, Cambridge, 1996.

9 OECD *Economic Surveys New Zealand 1996*, Paris, 1996, attachment.

10 OECD figures quoted in Lewis Evans, Arthur Grimes, Bryce Wilkinson and David Teece 'Economic Reform in New Zealand 1984-95: The Pursuit of Efficiency', *Journal of Economic Literature*, vol. xxxiv, December 1996, p. 1883.

11 Philip G. Cerny 'Globalization and the changing logic of collective action', *International Organization*, vol. 49, no. 4, Autumn, pp. 595-625; Richard Rosecrance 'The Rise of the Virtual State', *Foreign Affairs* vol. 75, no. 4, July/August 1996, pp. 45-61; see also Gary Teeple *Globalization and the Decline of Social Reform*, Humanities Press, New Jersey, 1995.

12 Robert Harvey *The Return of the Strong: The Drift to Global Disorder*, Macmillan, London, 1995.

13 Jeffrey D. Sachs and Andrew Warner 'Economic Reform and the Process of Global Integration', *Brookings Papers on Economic Activity*, no.1, 1995, p. 62-3.

14 Kenichi Ohmae *The End of the Nation State: The rise of regional economies*, Free Press, New York, 1995; see also Susan Strange *The Retreat of the State: The Diffusion of Power in the World Economy*, Cambridge University Press, Cambridge, 1996.

15 Benjamin R. Barber *Jihad vs McWorld*, Times Books, New York, 1995.

16 Gary Teeple *Globalisation and the Decline of Social Reform*, Humanities Press, New Jersey, 1995.

17 See the influential article by Hans-Werner Sinn 'Tax Harmonization and Tax Competition in Europe' *European Economic Review*, vol. 34, 1990, pp. 489-504.

18 John Waples 'Welsh raise stakes in jobs war', *Sunday Times*, London, 19 May, 1996, p. 7.

19 Paul Pierson and Stephen Leibfried 'Multitiered Institutions and the Making of Social Policy', in Stephen Leibfried and Paul Pierson eds, *European Social Policy: Between Fragmentation and Integration*, Brookings, Washington, 1995, p. 27.

20 Wolfgang Streeck 'From Market Making to State Building? Reflections on the Political Economy of European Social Policy', in Stephen Leibfried and Paul Pierson eds, *European Social Policy: Between Fragmentation and Integration*, Brookings, Washington, 1995, p. 423; Streeck and other corporatist writers expand their views on the

loss of national power in J. Rogers Hollingsworth, Philippe C. Schmitter and Wolfgang Streeck *Governing Capitalist Economies: Performance and Control of Economic Sectors*, Oxford University Press, New York, 1994.

21 Richard Hauser 'Problems of the German Welfare State After Unification', *Oxford Review of Economic Policy*, vol. 11, no.3, Autumn 1995, p. 47.

22 'Gimme a job', *The Economist*, January 4, 1997, pp. 50-51.

23 Paul Peterson *The Price of Federalism*, Brookings, Washington, 1995, p. 108 ff.

24 Industry Commission *State, Territory and Local Government Assistance to Industry*, Draft Report, Canberra, 1996; see also Daphne A. Kenyon and John Kincaid eds. *Competition among States and Local Government: Efficiency and Equity in American Federalism*, Urban Institute, Washington, 1991.

25 Michael C. Jensen 'The Modern Industrial Revolution. Exit, and the Failure of Internal Control Systems', *The Journal of Finance*, vol. xlviii, no.3, July 1993, pp. 831-80.

26 Michael C. Jensen 'The Modern Industrial Revolution. Exit, and the Failure of Internal Control Systems', *The Journal of Finance*, vol. xlviii, no.3, July 1993, p. 844.

27 Robert B. Reich *The Work of Nations: Preparing Ourselves for 21st Century Capitalism*, Knopf, New York, 1991. Reich popularised the term 'symbolic analysis'.

28 Adrian Wood *North-South Trade, Employment and Inequality: Changing Fortunes in a Skill Driven World*, Clarendon Press, Oxford, 1994, p. 388 ff.

29 The benefits of free trade are reiterated in Economic Planning Advisory Commission *Tariff Reform and Economic Growth*, Canberra, 1996. The increase in protectionist sentiment in the world is discussed in John Lloyd 'Let Goods be Homespun', *Prospect*, July 1996, p. 22 ff.

30 Jeffrey D. Sachs and Andrew Warner 'Economic Reform and the Process of Global Integration', *Brookings Papers on Economic Activity*, no.1, 1995, pp. 1-118.

31 Paul Krugman *Pop Internationalism*, MIT Press, Cambridge, 1996, p. 207.

32 Paul Krugman *Pop Internationalism*, MIT Press, Cambridge, 1996, p. 212.

33 *OECD Economic Surveys, New Zealand, 1996*, Paris, 1996, p. 10.

34 Jeffrey D. Sachs and Howard J. Shatz 'U.S. Trade with Developing Countries and Wage Inequality', *American Economic Review Papers and Proceedings*, vol. 86, no. 2, May 1996, p. 237.

35 Gary Burtless 'International Trade and the Rise in Earnings Inequality', *Journal of Economic Literature*, vol. xxxiii, June 1995, p. 815.

36 Robert C. Feenstra and Gordon H. Hanson 'Globalization, Outsourcing and Wage Inequality', *American Economic Review Papers and Proceedings*, vol. 86, no. 2, May 1996, pp. 240-5.

37 James M. Buchanan and Yong J. Yoon eds. *The Return to Increasing Returns*, University of Michigan Press, Ann Arbor, 1994.

38 There is a vast literature on Post Fordism. A useful recent work is Roger Burrows and Brian Loader eds. *Towards a Post-Fordist Welfare State?*, Routledge, London, 1994.

39 Paul M. Romer 'Growth Based on Increasing Returns Due to Specialisation' in James M. Buchanan and Yong J. Yoon eds. *The Return to Increasing Returns*, University of Michigan Press, Ann Arbor, 1994, pp. 275-286.

40 *OECD Economic Surveys, New Zealand 1996*, Paris, 1996, p. 110.

41 Paul Krugman *Pop Internationalism*, MIT Press, Cambridge, 1996, pp. 189 ff.

42 Chris Freeman, Luc Soete eds. *Technical Change and Full Employment*, Blackwell,

Oxford, 1987.

43 Joseph A. Schumpeter *Capitalism, Socialism and Democracy*, Allen and Unwin, 1976, p. 84. (first published 1942).

44 Quoted in Alex Brummer 'There is life after downsizing', *Guardian Weekly*, June 2 1996, p. 14.

45 Richard L. Nolan and David C. Croson *Creative Destruction: A Six Stage Process for Transforming the Organization*, Harvard Business School Press, Cambridge, 1995.

46 David M. Gordon *Fat and Mean: The Corporate Squeeze of Working Americans and the Myth of Managerial Downsizing*, Free Press, New York, 1996.

47 Statistics New Zealand *New Zealand Official Yearbook 1996*, Wellington, 1996, p. 304.

48 The study by Joseph Stiglitz, head of the Council of Economic Advisers is summarised in Alex Brummer 'There is Life After Downsizing', *Guardian Weekly*, June 2 1996, p. 14.

49 'Big Payoffs From Layoffs: How the Downsizers Fared', *Business Week*, 24 February 1997, p. 10.

50 This section draws on Andrew Wyckoff 'The Growing Strength of Services', *OECD Observer* no. 200, June 1996, pp. 11-16.

51 Details of the German situation relies on Gosta Esping-Andersen 'Welfare States without Work: The Impasse of Labour Shedding and the Familialism of Continental European Social Policy' in Gosta Esping-Andersen ed. *Welfare States in Transition: National Adaptations in Global Economies*, Sage, London, pp. 66-87.

52 Robert H. Frank and Philip J. Cook *The Winner-Take-All Society*, Free Press, New York, 1995.

53 A survey of the extensive American research is in George J. Borjas 'The Economics of Immigration', *Journal of Economic Literature*, vol. xxxii, December 1994, pp. 1667-1717; also see Michael Jones *The Australian Welfare State: Evaluating Social Policy*, 4th edition, Allen and Unwin, Sydney 1995, for a discussion of evidence for these trends.

54 David Rieff *Los Angeles: Capital of the Third World*, Orion Books, London, 1993.

55 Herbert Kitschelt *The Radical Right in Western Europe: A Comparative Analysis*, University of Michigan Press, Ann Arbor, 1995, pp. 260 ff.

56 See *OECD Economic Surveys, New Zealand, 1996*, Paris, 1996.

57 William Julius Wilson *The Truly Disadvantaged: The Inner City, the Underclass, and Public Policy*, University of Chicago, Chicago, 1986.

58 Michael Sherraden *Assets and the Poor: A New American Welfare Policy*, M.E. Sharpe, Armonk, 1991.

59 *OECD Economic Surveys New Zealand, 1996*, Paris, 1996, p. 53.

60 Tom Clarke and Brian Galligan 'Aboriginal Natives and the Institutional Construction of the Australian Citizen: 1901-1948', *Australian Historical Studies*, vol. 26, no. 105, October 1995, pp. 523-43.

61 Australian Bureau of Statistics 1994 *National Aboriginal and Torres Strait Islander Survey Employment Outcomes for Indigenous Australians*, Cat. 4199.0, Canberra, 1996.

62 Aboriginal death rates depend significantly on location. See Australian Institute of Health and Welfare *Australia's Health 1994*, AGPS, Canberra, 1994, p. 26-7.

63 This information is from Statistics New Zealand *New Zealand Now: Maori*, Wellington, 1994.

64 The disillusionment with the welfare state by both the left and right is well argued in sociologist Anthony Giddens *Beyond Left and Right: The Future of Radical Politics*, Polity Press, Cambridge, 1994.

65 See for example, Douglas S. Massey 'The Age of Extremes: Concentrated Affluence and Poverty in the Twenty-First Century', *Demography*, vol. 33, no. 4, November 1996, pp. 395-412.

66 See Paul Krugman 'The Spiral of Inequality', *Mother Jones*, November/December 1996, pp. 44-9.

Chapter 7

An Ageing Society

Many western countries now fear the future costs of the welfare state for the aged. Cash benefits for the aged continue to be the dominant form of expenditure, but long life and improvements in health technology mean that health costs are now also a prominent concern. In the future, the 'old old', those 75 and over will be a higher proportion of the aged and some will need 'social care' such as government-supported accommodation in nursing homes or specialised residential accommodation. This third type of expenditure, different to short term health care in hospitals, is attracting increasing concern. Long term care in institutions is expensive and can sometimes exceed health care costs for the aged.[1] This book does not deal with health and social care issues in any depth – they are complex enough to warrant a separate book – but this is an important element in the economic effects of the ageing population. Indeed, the 'ageing' crisis that is now a major topic of discussion in the United States often bases its case as much on escalating medical costs of ageing as the costs of providing cash assistance to the elderly.[2]

Democratic governments find it difficult to control health and social care spending on the aged. Paul Krugman says that 'The budgets of advanced countries are in large part engines that transfer money from workers to retirees...'. He blames spending on the aged for the high debt levels in most western countries. If governments, he asks, have not been willing to control the aged problem over the past twenty years, with modest aged proportions in the population, how can we expect them to deal with the demographic time bomb of rapidly ageing populations next century?[3]

New Zealand is experiencing demographic trends similar to those in other western societies. Fertility rates have fallen to half of the high levels in the 1960s and life expectancies have risen in the past few decades and continue to increase. The population, therefore, is ageing and this trend will accelerate next century, especially when the post 1945 'baby boom' generation retires. These trends will have a profound impact on social policy, the level of taxation, and, if current policies are maintained, suggest an increased role for the state. The low fertility rate and longer life expectancies mean that the slowly expanding or even static workforce will have to finance a growing aged population.

All western countries are concerned with the impact of ageing populations on their welfare arrangements. In the United States at least, public opinion has began moving from seeing the elderly as 'frail, poor, and deserving to viewing them as hedonistic, prosperous, and selfish'.[4] The fear of the ageing of western populations is reasonable, because elaborate social insurance schemes in the United States and Europe have been unable to cope with even modest ageing over the past few decades, without major increases in taxes. Under existing generous and expensive government subsidy schemes, a higher proportion of the aged means escalating outlays for pensions, and health and social care.

The demographic crisis

The modern ageing 'crisis' in western countries is a product of the post 1945 baby boom and bust after 1970, improvements in cash benefits for the elderly in many countries, and increases in health and other costs that accompany improved life expectancies. New Zealand, Australia, Canada and the United States experienced the most significant tidal wave of births.[5] The postwar baby boom will cause a crisis when its members start to retire after 2010. The low birthrate since the early 1970s means there will be relatively fewer workers than in the past to support the larger numbers of retirees after 2010. In the United States, with a similar demographic profile to New Zealand, it is estimated that the cost of supporting the retired will increase in real terms by 67 per cent over the 20 years from 2010 to 2030, or at an annual compound rate of 2.6 per cent.[6] Projections show that New Zealand will have one of the most rapidly growing aged populations next century. These figures are shown in Table 7.1.

The table shows that France, the United Kingdom and Sweden already had high aged dependency ratios in 1980 and will experience the lowest rates of increase through the next few decades. New Zealand, in contrast, has one of the highest rates of projected increase of all the countries listed. Even Australia, with an anticipated increase of 117 per cent, is well below New Zealand. Only Canada and Japan will likely face higher rates of increase than will New Zealand. The accuracy of these projections are dependent on three main trends. A lower than projected birth rate will escalate ageing while a higher birth rate will reduce it. Longer life expectancies will also increase the number of the aged while shorter lives will reduce it. Large scale immigration is perhaps the most significant policy issue. Large numbers of younger immigrants in child bearing years could reduce ageing,

Table 7.1

Aged dependency ratios in OECD countries 1980-2040

Country	Aged dependency ratio (a) 1980	2020	2040	Per cent change 1980-2040
New Zealand	15.4	23.0	34.8	132
Canada	14.1	28.9	35.8	168
France	21.9	30.6	37.6	74
Germany	23.4	33.5	41.6	106
Italy	20.8	29.3	37.9	97
United Kingdom	23.2	25.5	30.0	43
Japan	13.5	33.6	37.0	180
United States	17.1	25.0	32.3	108
Australia	14.8	23.6	31.7	117
Sweden	25.4	33.1	35.3	47
OECD average	18.9	27.6	35.1	98

Source: OECD *Ageing Populations: The Social Policy Implications*, Paris, 1988, p. 32. Note: (a) the aged dependency ratio is the population 65+ divided by the population aged 15 to 64. The figures for 2020 and 2040 are projected.

especially if continued over the long term. There is an unusual consensus amongst experts, however, that populations in western countries are on an inevitable ageing path.[7]

The demographic effects of expected population ageing have been detailed by Statistics New Zealand up to 2031 and are shown in Table 7.2. The projections show that those aged 65 and over are expected to increase in numbers from 416,000 in 1994 to 940,000 in 2031 or from 11.7 per cent to 21.3 per cent of the population. The table also shows that the numbers in the age group 60 to 65 also rises rapidly and this group could raise dependency levels if, as now, the workforce shows a bias in favour of younger workers and unemployment or invalidity is high in this age group. The group aged 75 and over will increase very rapidly over the period and create special problems in requiring additional outlays for health and social care. Those aged 85 and over show the most dramatic rates of increase, even from 1994 to 2011 and up to 2031 – an increase 1994-2031 of 237.8 per cent. This group is the most dependent on health and social care services. The number of children up to 14 years will actually decline modestly over the 1994 to 2031 period, freeing up some public resources to help the aged. But the cost of children is primarily a responsibility of families while the aged are heavily dependent on public outlays for pensions, and health and social care. Table 7.2 shows the issue of most concern to policy-makers: between 1994 and 2031, the workforce (15 to 64) is projected to increase by only 17 per cent, while those 65 and over will increase by 126 per cent.

To some, these projections of an ageing population up to 2031 show a situation that is manageable, especially if the economy grows at a reasonable rate.[8] But longer term population projections are more frightening and are shown in Table 7.3: they show an accelerating ageing, especially for the higher cost group aged 75 and over. If birth rates remain low and length of life continues to increase, then the real impact of ageing populations will be felt in the second half of next century: the Japanese population, for example is expected to fall to 55 million by 2100, from 125 million in 1996.[9] These long term projections

Table 7.2

Population projections New Zealand 1994-2031

Age group	1994	2011	2021	2031	percent change 1994-2031
0-14	820,000	807,000	771,000	782,000	-4.6
15-64	2,306,000	2,682,000	2,758,000	2,697,000	+17.0
60-64	141,000	219,000	275,000	274,000	+94.3
65+	416,000	543,000	717,000	940,000	+126.0
70+	279,000	382,000	498,600	676,600	+142.5
75+	168,000	250,900	309,500	435,800	+159.4
85+	37,300	75,400	93,600	126,000	+237.8
Total	3,542,000	4,031,000	4,246,000	4,418,000	+24.9

Source: Statistics New Zealand *New Zealand Official Yearbook, 1996*, Wellington, 1996, p. 100 and Statistics New Zealand *Demographic Trends, 1996*, Wellington, 1996, p. 129. Note: these figures are based on the 'medium' estimates of fertility, mortality with long term immigration of 5,000 per annum. Statistics New Zealand has prepared 11 alternative series of population projections and nine alternative series of labour force projections.

may appear fanciful, but unexpected major falls in fertility in Japan, Germany and Italy have made the World Bank's projections published in 1994 look far too optimistic: lower fertility in recent years, if continued, has dramatic implications for population ageing.

All the projected populations detailed here for New Zealand assume a continuation of fertility at about present levels of around 2.0, a relatively high figure when compared to some western countries. A fall in New Zealand fertility to the levels now current in Japan, Germany and Italy would accelerate population ageing significantly. New Zealand, like other western countries faces a difficult choice: changing social welfare systems requires long lead times and largely self-funding retirement systems on the Australian model require 30 to 40 years to be fully operational. Population projections, however, are

Table 7.3

Population projections for New Zealand 1994-2150

	1994	2050	2100	2150
0-14	820,000	816,000	819,000	819,000
15-64	2,306,000	2,681,000	2,685,000	2,696,000
65+	416,000	958,000	1,132,000	1,186,000
75+	168,000	527,000	635,000	681,000
Total	3,542,000	4,455,000	4,636,000	4,701,000

	1994 %	2050 %	2100 %	2150 %
0-14	23.2	18.3	17.7	17.41
15-64	65.1	60.2	57.9	57.3
65+	11.7	21.5	24.4	25.2
75+	4.7	11.8	13.7	14.5
Total	100.00	100.00	100.00	100.00

Source: The 1994 and 2031 figures are from Statistics New Zealand *New Zealand Official Yearbook, 1996*, Wellington, 1996, p. 100 and Statistics New Zealand *Demographic Trends, 1996*, Wellington, 1996, p. 129. The projections for 2050, 2100 and 2150 are from Eduard Bos et al. World *Population Projections 1994-95 Edition: Estimates and Projections with Related Demographic Statistics*, World Bank, John Hopkins University Press, Baltimore, 1994, p. 369. The projections assume a fertility rate of 2.062, about the 1995 level, net migration of zero after 2000, and some improvement in life expectancy.

uncertain and Statistics New Zealand does not publish any projections past 2031 even though the longer term projections are the most relevant for major policy changes.

Life expectancy in New Zealand has been improving this century, as shown in Table 7.4. In 1993-5, life expectancy at age 65 for the total population was 15.13 years for men and 18.87 years for women, with Maori levels being about three years less. A high proportion of New Zealanders now survive to older ages, as shown in Table 7.5. Those over 75 – sometimes called the 'old old' are now more numerous as a proportion of the population than in the 1950s and this trend will accelerate in the future as shown later in this chapter. The survivor rates

Table 7.4

Expectation of life at age 65, New Zealand, selected years

Years	Expectation of life at ages 65 and 70, New Zealand, total population			
	Life expectancy at age 65			
	Total population		Maori population	
	Male	Female	Male	Female
	Years	Years	Years	Years
1896-1900	12.19	13.29	not available	
1950-52	12.84	14.80	10.47	12.16
1970-72	12.56	15.95	10.72	12.14
1993-95	15.13	18.87	12.67	15.45 (1990-92)
	Life expectancy at age 70			
	Total population		Maori population	
	Male	Female	Male	Female
1896-1900	9.53	10.37	not available	
1950-52	10.02	11.44	8.39	9.98
1970-72	9.80	12.44	8.72	9.90
1993-5	11.88	15.10	10.17	12.56 (1990-92)

Source: Statistics New Zealand, *Demographic Trends, 1996*, Wellington, 1996, and earlier issues. Note: 1990-92 are the latest figures available for Maoris.

The figures for 1896-1900 are from *The New Zealand Official Year Book 1915*, Government Printer, Wellington, 1915, pp. 193-7.

– the proportion surviving out of 100,000 at various ages have improved significantly between 1896-1900 and 1993-5. When the first aged pension was created in New Zealand in 1898, only 52.7 per cent of males and 57 per cent of females have survived to 65, the pension eligibility age. By 1993-5, 79.7 per cent of males and 86.1 per cent of females had survived to 65. The table shows significant improvements in survivor rates even between 1955-7 and 1993-5, especially at older ages. Improved survivor rates until older ages creates problems for public finances, not only for pension outlays but also for health costs,

Table 7.5

Numbers surviving until specified ages out of each 100,000 of the population, New Zealand, selected years

	Numbers surviving out of 100,000 born 1896-1900	
Age	Males	Females
0	100,000	100,000
65	52,695	57,028
70	42,377	47,754
75	30,200	36,174
80	17,942	23,137
85	8,641	11,682
90	3,044	4,127

	Numbers surviving out of 100,000 born 1955-57		1993-5	
Age	Male	Female	Male	Female
0	100,000	100,000	100,000	100,000
65	69,131	78,940	79,717	86,134
70	56,998	70,062	69,986	80,122
75	42,268	57,550	56,620	71,084
80	26,644	41,021	39,600	57,923
85	13,102	23,019	23,123	40,815
90	4,357	8,919	9,905	22,522

Source: Statistics New Zealand, *Demographic Trends, 1996*, Wellington, 1996.

The figures for 1896-1900 are from *The New Zealand Official Yearbook 1915*, Government Printer, Wellington, 1915, pp. 189-93.

which increase steeply at older ages, and social care which often requires public funding. If National Superannuation in New Zealand was adjusted to equalise survivor rates to when the benefit was first introduced in 1898, the eligilibity age would now be 75 for men and 80 for women.

In 1994, the Social Security system in the United States was thrown into a state of panic because of unexpected increases in life expectancy, due largely to longer life spans for the aged. New models of social security viability in the United States found that its financial health was 'surprisingly sensitive with respect to the mortality variable'.[10] People were living longer after retirement than many had predicted, and Australia has shown the same. It is possible, indeed, likely, that life expectancies may continue to increase, to rise to levels as yet unimaginable, with major implications for government pension and health costs for the elderly. Some researchers in the United States predict that life expectancy for those born after 1982 will approach 100 years during the next century, but others predict western countries are already approaching the upper limits.[11]

In 1996, the Australian Bureau of Statistics published revised population projections for Australia.[12] Male life expectancies at birth are projected to rise from 75.3 in 1996 to 81.1 in 2051. Male life expectancies at age 65 are also assumed to rise from 15.8 years in 1996 to 19.1 years in 2051. Female life expectancies at birth are expected to rise from 81.1 in 1996 to 86.5 in 2051, while female life expectancies at age 65 are projected to increase from 19.6 in 1996 to 23.1 in 2051. These are very significant increases that would, if they do eventuate, impose major burdens on retirement funding systems. The increases could be greater still, since all projections of the life expectancies made during the past 30 years, especially for the very old, have proven consistently conservative. Government pension systems were never intended to fund retirement for an average of 21 years – the expected average length of life in Australia for those aged 65 in 2051. These life expectancies from 65 are about twice the level when aged pensions were first introduced into Australia at the turn of the century.

Those who believe that death rates will fall further point to the major decline in deaths from vascular diseases in western countries in the past 25 years, and predict similar improvements for a range of diseases in the future. Educated western populations often readily adopt medical recommendations to reduce risk factors, as shown by the decline in heart disease. Reductions in smoking would improve life expectancy substantially because deaths from lung cancer (80 per cent of which are thought to be linked to smoking) are still a significant cause of earlier death in New Zealand.

Those sceptical of significant future extensions in life expectancy at older ages view population mortality from an evolutionary perspective over the past 200 years. Mortality patterns in the past 200 years have been very different to the trends over the previous 100,000 years of human existence. Until about 200 years ago, people died at much younger ages, especially as infants. Natural selection operated to eliminate sicker and weaker members of the population. Only the healthy or the lucky survived to 30, let alone 60 or older.

The demographer Jay Olshansky says

> Although humans have been able to achieve remarkable mortality declines by modifying physical environments, altering lifestyles, and introducing modern, medical technology, the one factor that remains beyond current control is the genome (genetic structure) itself. At the individual level, humans who survive beyond the ages required by our species' life history to ensure reproductive success cannot escape accumulated DNA damage and inevitable declines in somatic maintenance and repair that lead to death. At the population level, basic population genetics implies that once extended survival into older ages is achieved for almost everyone, genetic heterogeneity is increased, thus enhancing the opportunity for the expression of new or infrequently observed diseases.[13]

Long life, from this perspective, is an unnatural extension of the body's controlled maintenance and repair functions that have evolved to ensure reproductive success. The evolutionary approach to life expectancy sets the upper limit of life expectancy at birth to 85 years.

Those who support the evolutionary approach to human mortality reject the 'compression of morbidity' hypothesis. This term has been used to describe the pattern where most people are healthy until shortly before death at an advanced age, usually around 85.[14] This has relevance for the debate over the health care cost implications of an ageing population. Health costs increase with age. In New Zealand in 1993, for example, those aged 65 and over were 11.3 per cent of the population but accounted for 33 per cent of health costs. Those aged 75 and over were 4.6 per cent of the population but accounted for 21.2 per cent of health costs.[15]

If most health costs were incurred shortly before death, it does not matter if people live longer – in terms of health outlays, but not pension costs – because the same costs are involved. The death of someone at 85 should not cost more than a death at 50. Increasing concerns about rising health and social care costs of the aged suggest that it is simplistic to argue that most older people are well until just before they die at advanced ages. Older populations are likely to develop higher rates of non-fatal but disabling conditions, especially arthritis, osteoporosis, depression, and dementia.

The increases in life expectancy for those aged 65 and over is a central element in demographic projections for the effects of an ageing population. Table 7.6 shows some interesting trends. Life expectancy at age 65 increased markedly from 1940 to 1990. The improvement from 1960 to 1990 was greater than from 1940 to 1960. American researchers forecast continuing rapid increases after 2010. The projected improvements in life expectancies shown in the table may not appear large (three years or so from 1990 to 2070) but they frighten the actuaries who plan the financing of the American social security system, who recommend increased contributions to cope with the development. As already stated, increased life expectancy, especially at older ages also has major implications for cost increases in public outlays for health and social care. Pension costs cannot be considered in isolation from these other outlays. An American researcher calculated, that, in the United States, the cost of government social security benefits for the elderly consist of 50 per cent for cash benefit pensions and fifty per cent for government health costs.[16]

Table 7.6

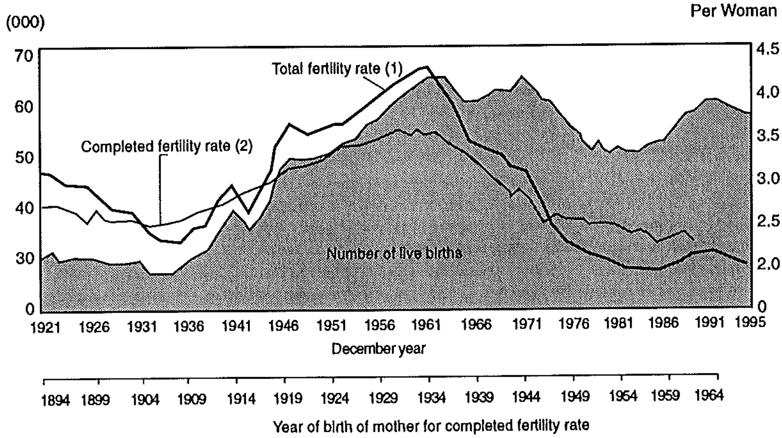
Unisex life expectancy at retirement, United States 1940-2070

Retirement	Retirement age life expectancy		
Year	65	70	75
1940	12.71	9.92	7.56
1960	14.52	11.53	8.88
1990	17.09	13.85	10.90
2010	17.92	14.51	11.43
2040	19.22	15.70	12.50
2070	20.44	16.82	13.52

Source: Stephen C. Goss 'Comment' in Peter A. Diamond, David C. Lindeman and Howard Young, eds. *Social Security: What Role for the Future*?, National Academy of Social Insurance, Washington, 1996, p. 76.

Figure 7.1

Live births and fertility rates, New Zealand, total population, 1921-1995



Source: Statistics New Zealand *Demographic Trends 1996*, Wellington, 1996, p. 39. Note (1): The total fertility rate in a particular year is the average number of births a woman would have during her reproductive life if she was exposed to the fertility rates characteristic of various child bearing age groups in that year. Note (2): The completed fertility rate is the average number of children a woman born in a particular year has had during her reproductive life.

Fertility rates

The ageing problem in western countries is partly a result of longer life expectancies and high rates of survivorship until old ages. But population ageing is also due to the dramatic fall in the fertility rate in New Zealand and other western countries in recent decades: this trend for New Zealand is shown Figure 7.1.

Table 7.7 shows New Zealand fertility rates in comparison with other countries. The New Zealand fertility rate of 2.0 is above some other affluent countries, and is slightly above Sweden which has very generous and expensive pro-natal policies specifically designed to encourage child bearing. Italy, with a fertility rate of 1.2, now has the lowest fertility rate ever recorded in modern history, and Germany, with 1.3, is not far behind. In 1996, Japan's fertility rate fell to 1.4.[17] Few western countries have a fertility rate that will ensure long term population growth.

Table 7.7

New Zealand fertility rates in comparison with selected countries, c1995

Country	Fertility rate
Argentina	2.8
Australia	1.9
Canada	1.7
France	1.7
Germany	1.3
India	3.4
Iraq	6.6
Ireland	2.0
Israel	2.8
Italy	1.2
Japan	1.4
New Zealand	2.0
Sweden	1.9
Switzerland	1.5
Uganda	7.3
United Kingdom	1.8
United States	2.1

Source: Population Reference Bureau, Washington, data published in Bureau of Immigration, Multicultural and Population Research, *Australia's Population Trends and Prospects 1995*, AGPS, Canberra, 1996, pp. 110-12. Note: The fertility rate is the average number of children a woman would have during her lifetime if she experienced the age specific fertility rates of a particular year. The fertility rate is more accurate than the birth rate which can be distorted by changes in the number of women in child bearing age groups.

Future fertility rates are notoriously difficult to predict. The assumptions of today can appear very foolish in retrospect. Western countries in the 1930s were in a state of panic because a declining birth rate supposedly meant an ageing population by the 1980s.[18] For reasons still unexplained, the post 1945 birth rate soared to high levels in New Zealand and Australia, most markedly, until 1970, and this particular feared disaster never occurred. Western countries struggled instead to absorb high numbers of young people; high youth unemployment suggests they still have not solved this unanticipated problem.

New Zealand fertility rates in 1995 are less than half the 1962 figure of 4.19. They rose again slightly in the late 1980s and have been declining since 1990: from 2.18 in 1990 to 2.04 in 1995. Maori fertility has been declining even more significantly in the long term, from a high 6.18 in 1962 to 2.38 in 1995. Maori fertility, however, increased from 2.19 in 1990 to 2.38 in 1995.[19] There is always the possibility of a repetition of the unexpected resurgence in births that occurred after World War Two in most western countries, including New Zealand.

Some researchers support the cyclical approach to long term birth rates. Easterlin suggests that history shows that large cohorts have small birth rates themselves as parents, and that small cohorts have larger birth rates.[20] The cohort approach is valuable, because it emphasises that each cohort has a unique set of historical circumstances that shapes its attitudes throughout its life course. Easterlin's countercyclical theory is regarded as a reasonable explanation of the unexpected post-1945 baby boom. Low birth rates in the 1930s meant that workers were in demand, wages rose, and optimistic parents decided to have more children. If Easterlin is correct, we can expect the low-birth cohort born since the seventies in New Zealand to have a high birth rate as parents, especially if the economy expands at a reasonable rate. But other evidence throws doubt upon the general applicability of Easterlin's thesis.

Easterlin's view is based on a theory of relative income, defined as the recent income experiences of young men and women compared to the past income of the young person's parents. The theory has not been tested for New Zealand or for other countries with any depth. The high birth rates in the 1950s and 1960s meant this generation felt 'crowded' in the workforce and had to compete with many others in their birth cohort. Unemployment rose and this made them feel pessimistic about income expectations, leading to a reluctance to marry and have children.

However, this cyclical theory overlooks the profound social changes of the past few decades, especially in the attitudes of women to career, marriage and children. These structural changes may well overwhelm any changes in relative income expectations due to different cohort sizes.

Easterlin suggests that fertility rates will rise again: many demographers argue the very opposite. Fertility in western countries may decline in the future because of the instability of marriage. The number of single parents in New Zealand and other western countries has increased significantly in the past decade, mainly because of rising divorce rates. Many of these single parents are poor, and are heavily dependent on government benefits. This suggest that a cautious attitude towards having children may develop in the future. Marriage is now a risky activity: divorce usually means that a woman is left in charge of children, and will have difficulty in gaining employment and further education. Olsen believes the growing instability of marriage is a key factor in his prediction of falling fertility levels.[21] Hugo has shown that, as female income rises in Australia, birth rates fall among this more affluent group, and an increasing number remain childless.[22]

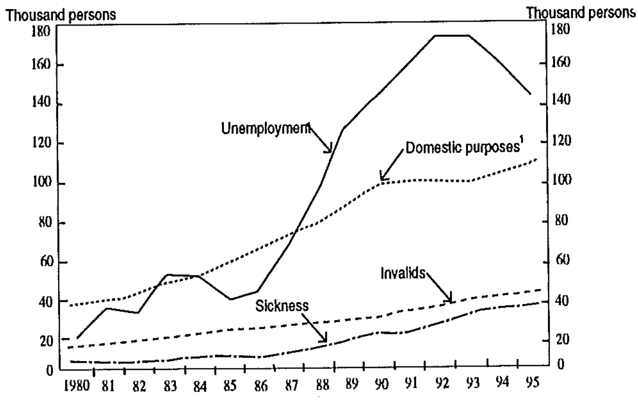
Immigration is often mentioned as a way to overcome low birth rates and ageing populations in western countries. There are, however, major problems with this strategy. If fertility continues to decline immigration levels would have to be very high and way beyond past levels if an ageing of the population is to be halted. Moreover, immigrants often adopt the same small family size as the host society in their new environment. Migrant selection processes, especially family reunion, can mean that immigrant populations have a similar age structure to the receiving country. Large scale immigration can cause demographic bulges as the particular group of immigrants ages, sometimes aggravating ageing problems because of the irregular trends. Australia, for example, admitted large numbers of immigrants after World War Two. These immigrants are now largely in older age groups, and form a part of a surge in ageing. Immigration would need to be massive and to increase in scale proportionately to population growth to have any real long term effect on population ageing. Yet immigration by its nature tends to be cyclical, and dependent on conditions in the source as well as the receiving countries.[23]

New Zealand has little interest in a rising fertility rate if these children are to be part of single parent households dependent on government social welfare. A recent comparative study found that 'the level of receipt of benefits by single parents in New Zealand is very much higher than in either Australia or the United Kingdom'.[24] Figure 7.2 shows the rapid increase in the numbers of beneficiaries of domestic purposes benefits since 1980. The numbers have risen from 37,040 in 1980 to 108,797 in 1996. Of these 103,644 were sole parents, either an unmarried parent (33,431) or separated or divorced. Expenditure has risen over this period from $169.4 million to $1,440.1 million. Direct cash benefit outlays on single parents in 1996 exceeded the outlays on unemployment benefits. In 1996, there were 183,363 children of those dependent on Domestic Purposes benefit. The rise in single parents shows no sign of abatement, despite significant benefit reductions in 1991. The numbers on benefit increased by more than eight per cent between 1992 and 1995.

An analysis of single parent benefit recipients (excluding dependent children) in 1994 shows that they were 4.8 per cent of the population in the United Kingdom, 1.6 per cent in Australia, and 2.8 per cent in New Zealand and Canada. This group was only 0.7 per cent in Sweden, 0.1 per cent in Japan and 0.2 per cent in France.[25] Single parents on benefits in the United Kingdom and Australia were increasing at roughly the same rate as in New Zealand in the 1990s. The relatively high New Zealand figure is due, in part, to the proportionately higher incidence of single parenthood amongst Maori households. The very high figures in the United Kingdom and the United States show that single parent numbers on benefit could well rise above existing levels in New Zealand. The very different proportions of the population on benefit in different countries is partly a result of varying proportions of single parents in the population as well as differing eligibility conditions. Sweden and France, for example, insist that single parents seek work when children are quite young. Other countries like Australia and New Zealand do not require work effort until the youngest child is 16.

Figure 7.2

Numbers of persons claiming selected benefits New Zealand 1980-1995



1. Domestic purposes benefit is primarily paid to single parents.

Source: OECD *Economic Surveys New Zealand 1996*, Paris, 1996, p. 68.

There is a concern that the single parent benefit in itself encourages irresponsible behaviour among certain groups. Tougher policies towards unemployment benefit recipients may make single parent benefit appear more attractive. Single parents do not have to face a work test, and receive more money if they have more children. McLanahan et al. summarise the results of numerous recent studies in the United States on the effects of single parenthood:

> The new research shows that, on average, offspring from disrupted or never married families are less likely to complete high school and are more likely to have low earnings as adults than are offspring of intact families. There is also evidence that living with a single mother is related to the reproduction of female-headed families through teen-marriage, teen fertility, premarital fertility, and marital disruption. Finally, the research shows that adolescents in female-headed families have higher rates of delinquency and are more likely to use alcohol and drugs than two-parent families. In most of these studies, the association between family structure and offspring's behaviour remains significant even after controlling for race and family socio-economic status.[26]

Policy options for this problem will be discussed in a later chapter. To summarise, all the available evidence suggests that New Zealand fertility rates will remain at low levels and could decline to average European levels of around 1.7. The Italian, German and Japanese experience shows that birth rates can fall to very low levels in advanced western countries: about 25 per cent lower than now exist in New Zealand. It is very likely that the New Zealand population will age rapidly next century, in common with all other western countries. The effects of ageing on population decline will become very marked by the end of the next century.

Policy options for an ageing population

1. Increase age of eligibility for retirement benefits

Much of the fear of ageing is due to the high cost to government of supporting the retired with income assistance and subsidies for health and social care. There is a real concern that current pay-as-you-go pension and health financing systems will impose an intolerable burden on future workers who will have to pay taxes far higher than now to finance the enlarged proportion of aged in the population.

These cost problems are solvable by a number of policy changes, some of which are discussed in later chapters. The so called 'ageing crisis' could be managed in part, by raising the retirement age next century to at least 70. This would reduce governments cash benefit costs substantially. In 1997, for example, making 70 rather than 65 the retirement age for New Zealand Superannuation would have reduced the number of claimants by 31 per cent. Raising the retirement age to 70 saves so much because many of the aged at 65 will survive until 70 whereas the survival rate declines more rapidly after 70. Governments influence – but by no means determine – retirement ages by setting a fixed age for eligibility for government age benefits. Formal retirement ages in western countries are generally the same or even lower than the 65 years first adopted in the aged pensions established around the turn of the century. New Zealand, like only Japan, France and Italy among western countries, until recently had a pension eligibility age of only 60 rather than the more common 65. New Zealand's retirement age is being raised gradually to 65 from 1992 to 2001. Actuaries in the United States are recommending an increase to 70, as a way of coping with the soaring cost of aged benefits. [27]

The retirement age of 65 became a benchmark when the British Civil Service adopted it as their pensionable age in 1859. New Zealand adopted 65 as its pension age in its first scheme in 1898. The first German aged pension scheme in 1891 and the first British scheme in 1908 fixed a retirement age of 70.[28] The United States is phasing in a retirement age of 67 and 70 is likely to be the retirement age next century. The Australian government in 1996 changed the laws to enable people to contribute to superannuation and gain tax concessions until age 70 and compulsory retirement at age 65 has been abolished in many western countries.

Retirement ages as institutionalised by eligibility for government pensions can have many different justifications although governments rarely spell out their reasons for adopting a particular age. There are a number of perspectives. Physical degeneration was the first rationale, and probably the most influential last century when retirement ages were specified in the age pension in 1898. Ageing is accompanied by physical decline which makes workforce participation difficult if not impossible. This argument had appeal when the first pension schemes were being debated late last century. New Zealand was still primarily an agricultural country and work was often arduous. The argument is less persuasive now because most jobs in a predominantly service and mechanised economy are not physically arduous. Moreover, people physically decline at different rates: those unable to work because of old age can be provided with an invalid pension. Most western countries have now abolished compulsory retirement ages because the image of ageing as inevitable physical and mental decline and incapacity offends many. A retirement age at 70 would mean that the total New Zealand population would now have an average life expectancy of 11.88 years for men, and 15.10 years for women (10.17 and 12.56 years for Maoris). These are considerable periods of retirement, although some of the aged will experience long periods of incapacity. Longer life expectancies creates difficulties on the meaning of benefit eligibility at 65. Financially troubled governments could just as easily take 70 as the age for benefit eligibility, using extended life expectancies as the justification.

Eligibility ages for government aged pensions have also been influenced by the level of unemployment. Eligibility for the aged pension was lowered to 60 in the 1938 social security legislation. While it is difficult to document the reasons for this, it is likely that the high unemployment in the 1930s depression was one consideration. Allowing the aged to access the pension at 60 rather than 65 was one way to improve the employment opportunities of the young. In recent times, countries in Europe such as Germany and the Netherlands have encouraged surplus workers to retire at age 50 (called 'baby pensioners') as a way to deal with high and persistent unemployment. Employers who reduce their employment levels often induce older workers – those 50 and over – to take early retirement. This argument is now less relevant in New Zealand which has relatively low levels of unemployment.

Table 7.8 shows the wide disparity of the proportions of the populations on early retirement or invalidity schemes in selected western countries in 1990. New Zealand had the lowest proportion of its population on invalidity benefits: 0.8 per cent. This New Zealand figure is probably artificially low because of the role of the Accident Rehabilitation and Compensation Insurance scheme. Many other countries were using invalidity as a 'dumping ground' for surplus workers, usually aged 50 and over. Some European countries had high proportions on invalidity benefits or publicly funded early retirement schemes. Finland had 8.8 per cent in this category. Italy was also very high with 7.6 per cent, as were Austria, Denmark, Norway, Sweden, France, Germany, and the Netherlands.

The figures on early retirement and invalidity schemes are highly significant. Many European countries have retired significant propor-

Table 7.8

Invalidity benefits, all schemes, proportion of population 1990

Country	Numbers on invalidity benefits – percentage total population	Number on early retirement schemes – percentage total population	Total per cent
Australia	1.8	na	1.8
Austria	4.9	1.5	6.4
Belgium	1.7	1.7	3.4
Canada	0.9	0.9	1.8
Denmark	3.0	2.9	5.9
Finland	6.0	2.2	8.8
France	0.9	3.7	4.6
Germany	3.0	neg.	3.0
Greece	3.4	na	3.4
Ireland	1.3	neg.	1.3
Italy	7.6	na	7.6
Japan	1.4	zero	1.4
Netherlands	5.9	0.6	6.5
New Zealand	0.8	zero	0.8
Norway	5.5	na	5.5
Portugal	3.3	na	3.3
Spain	1.7	0.6	2.3
Sweden	4.2	neg	4.2
Switzerland	2.3	zero	2.3
United Kingdom	2.1	zero	2.1
United States	1.2	0.1	1.3

Source: Sveinbjorn Blondal and Mark Pearson 'Unemployment and Other Non-employment Benefits', *Oxford Review of Economic Policy*, vol. 11, no. 1, Spring 1995, p. 138; Note: early retirement schemes are official public sector schemes.

tions of their workforces well before the age of 65. Many have been retired in their early fifties. The proportions of the population figures above can be roughly doubled to obtain a figure for the proportion of the labour force. The Netherlands, for example, has retired around 12 per cent of its workforce early, and many other European countries have done the same. The proportions on early retired schemes and disability benefits rose well above the 1990 figures, as European countries tried to cope with the recession in the early 1990s, and with their rigid social insurance schemes.[29]

Inducing early retirement amongst older workers may not be an efficient way to raise the overall level of employment.[30] Current early retirement schemes in western countries can be explained by the need to adjust to the massive structural changes in recent decades, in response to changes in technology, freer trade, and a shift to a more complex information based economy. Many older workers are relatively poorly educated to cope with what is a transitional problem. In the future, the workforce will be more educated and more capable of adapting to major structural changes in the economy.

Retirement ages can be established on the basis of a 'reward' for long periods in the workforce. Contributory social insurance or occupational schemes often set a retirement age not at an arbitrary age limit of 60 or 65, but after a set number of years as a contributor: 30 or 35 years is a common figure. If someone starts full time work at, say 15, he or she can retire at 45 or 50, having 'earned' the pension from decades of contributions. This argument is strongest in fully funded, actuarially based retirement systems where the pension can be linked directly to funds in the individual's account. Governments often give generous tax concessions to these funded schemes, and, in the case of Australia, set 55 as the minimum retirement age where benefits can be taken without tax penalties.

Retirement as a 'reward' for long periods in the workforce is difficult to implement in New Zealand because there is no separate social security tax. Everyone who satisfies residency requirements is granted the pension at 60 (progressively being raised to 65). Some have worked in the paid workforce since 14, while others may have only intermittent work histories. The pension as a reward for years in the paid workforce also discriminates against women, many of whom have been absent from the workforce for many years as they raised families.

Raising retirement ages is a way of coping with the affordability problem, but this affordability argument is difficult to assess. Its validity depends, in part, on future rates of increase in real living standards per head. A real growth rate per head of say, three per cent per year over the next three decades would create the surplus resources necessary to make ageing less of an affordability problem. A slowly growing or static economy, on the other hand, would make the higher costs of ageing populations a more significant economic problem.

In democracies, retirement ages for government pensions can also be viewed as simply a result of political conflict. The aged have votes, while children do not, although of course their parents vote. As the proportion of the aged increases in a society, their political power increases, especially if they are politically aware and well organised. Over time, as the proportion of children falls, and the aged become more numerous, welfare systems can be expected to favour the aged, possibly at the expense of outlays on children. If this view is correct, and it is difficult to document, eligibility ages for government benefits will become more generous over time, despite increased life expectancies.

The aged could be persuaded or forced to pay for their own retirement and health and social care by some system of compulsory contributions through their lifetimes. Each generation could pay for itself. A change to generational self-funding would require major policy changes in New Zealand and some options are discussed in later chapters. A movement towards generational self-funding would take decades to implement and would be easier to achieve if high rates of economic growth could be sustained. High growth rates would mean that the younger generation would not have to sacrifice current consumption levels to provide for their own retirement: the contributions could come from the increases in real incomes that come from economic growth.

(2) Reducing the level of New Zealand Superannuation and/or means-testing

Sweden is discussing and politicians have agreed in principle on a system whereby the level of social security benefits for the aged are indexed according to mortality rates as well as wage rates: pensions are reduced or increased according to wage growth moderated if mortality rates fall amongst the aged, and their life expectancy therefore increases.[31] These proposals inject yet another uncertainty into retirement income: benefits to the aged increase or decrease according to how many die per year. Increased longevity, once praised, now becomes a negative factor for the retired and it is outside the control of the individual.

New Zealand could reduce the cost of supporting the aged in the future by cutting benefits below present levels or by means-testing, perhaps on the Australian model. As shown earlier in the book, New Zealand Superannuation is paid at significantly higher rates than unemployment or domestic purposes benefits, and, unlike almost all other cash social welfare benefits, is not means-tested. The cost of future aged cash benefits could be reduced significantly, depending on the level of the benefit and the severity of the means test.

The favoured treatment of the aged in the New Zealand cash benefit system can be explained, in part, by the old distinction between the deserving and the undeserving poor. However, there are likely to be political difficulties with this strategy. The aged are seen as being deserving and therefore more entitled to welfare. Deservingness has been extensively researched in the United States; the same issues obtain in New Zealand.[32] The level of deservingness depends, firstly, on the level and extent of the beneficiary's need. Many of the aged are not potentially in the workforce, and have a need for some non-work source of income. They are often frail and need assistance in everyday tasks. Need alone, however, is not an indicator of deservingness. Many single parents and the unemployed have greater needs than the aged as they are often supporting children and have high housing costs.

The level of deservingness also depends on whether there are sources of assistance other than state funded benefits. Children are a potential source of assistance for the aged, but this is problematic in western societies where children are encouraged to be independent as young adults. The aged often desire independence and do not favour reliance on children, who may be married and have their own family commitments. Non-western countries, by contrast, still regard children as the basic support group for aged parents.

Deservingness is also linked with the cause of need. Physical decline with ageing is not regarded as having been caused by the individual. By contrast, the unemployed and single parents are often regarded, however unfairly, as contributing to their own condition, especially in times of low unemployment.

Those who strive towards independence and at least try to help themselves are often regarded as more deserving. The aged usually have accumulated some assets, especially their owner-occupied residence, which is interpreted widely as a sign that they have tried to gain some independence. Some of the current aged have saved for their own retirement.

Lastly, deservingness is linked with how responsibly recipients are seen to use money allocated to them. The aged are usually viewed as being responsible spenders, not wasting their incomes on smoking, alcohol, or gambling.

Another factor creating political support for the aged is everyone realises that they will be old and possibly needy some day, and this creates support even amongst the young.

(3) Adopt a social insurance scheme

New Zealand could adopt a social insurance scheme, the most common way of providing assistance in western countries even though New Zealand has never in the past century shown any serious interest in them. Social insurance schemes have proven to be high cost and will become even higher cost as western populations age next century. The OECD has estimated the future costs of social security payments for the aged for its member countries and these are shown in Table 7.9. The estimates are presented for current projections, without policy changes, for cost containment that contains costs after 2015 and for extension of the retirement age to 70, introduced gradually after 2005. The figures are particularly useful in showing relative costs of aged benefits between countries. The table shows that, with no major policy changes, the net present value of New Zealand's National Superannuation scheme to 2070 is equal to 213 per cent of 1994 gross domestic product. This is well above the Australian figure of 97 per cent, and is also above the United Kingdom, Iceland, Ireland, and the Netherlands. The level, however, would be well below the more generous schemes in Germany, Sweden, Finland and Italy. Cost containment by freezing pension expenditures as a proportion of gross domestic product after 2015 would reduce the net present value of New Zealand's pension outlays to 178 per cent of GDP, still well above the 78 per cent for Australia. Later retirement after 2005 would further reduce the New Zealand figure slightly to 171 per cent of GDP, still well above the Australian figure of 79 per cent. The table shows that only Australia, Iceland and Ireland have aged pension costs far below most other countries listed.[40]

All long term projections should be regarded with caution, but these OECD estimates are frightening for many countries. The table shows the very different paths being taken by New Zealand and Australia. In the next century, Australia will have the lowest outlays in the OECD for aged cash benefits while New Zealand will have outlays over double the Australian level. This difference will be a major factor in the varying role of the state in the respective countries: the state in New Zealand will be far more dominated by outlays for the aged than will be the case in Australia.

Social insurance as a model for organising social welfare has declined in popularity over the past few decades. The unemployed,

Table 7.9

Net present value of social security payments[1]
Percentage of 1994 GDP

	Baseline	Cost containment[2]	Later retirement[3]
United States	163	142	142
Japan	299	269	263
Germany	348	313	309
France	318	289	253
Italy	401	348	347
United Kingdom	142	147	122
Canada	204	174	166
Australia	97	78	79
Austria	298	268	246
Belgium	300	260	252
Denmark	235	211	179
Finland	384	341	304
Iceland	106	83	91
Ireland	107	106	90
Netherlands	214	181	179
New Zealand	213	178	171
Norway	230	189	201
Portugal	277	228	236
Spain	323	283	298
Sweden	**370**	**354**	**258**

1. The net present value refers to the value today of future payments. The calculation assumes a discount rate of 5 per cent per year over the period 1994-2070 and a productivity growth of 1.5 per cent.
2. Pension expenditures are kept unchanged relative to GDP from 2015.
3. Starting after 2005, the retirement age is raised by 0.5 year annually to reach 70 years.

single parents and other dependent groups have become more numerous. They are usually not covered by social insurance schemes, which were designed to provide incomes for the retired with long work histories. Some countries, such as the United Kingdom, Denmark, and Ireland have emphasised means-tested social assistance rather than social insurance. Occupational superannuation outside the formal social insurance scheme has also become important in some countries, especially the United Kingdom.

Table 7.10

Social security and total taxes as a percentage of gross domestic product, selected years

Country	Social security taxes as a percentage of GDP 1965	Social security taxes as a percentage of GDP 1994	Total taxes as a percentage of GDP 1994
Australia	–	–	29.9
Austria	7.8	13.8	42.8
Belgium	9.2	14.5	46.6
Finland	2.1	11.6	47.3
France	11.0	17.6	44.1
Germany	8.3	14.5	39.3
Italy	na	11.5	41.7
Japan	3.0	8.7	27.8
Netherlands	9.1	15.5	45.9
New Zealand	–	–	37.0
Norway	3.4	9.4	41.2
Sweden	3.7	13.6	51.0
Switzerland	3.2	7.5	33.9
United States	3.0	6.7	27.6
OECD Europe	5.0	10.6	40.8

Source: OECD *Revenue Statistics of OECD Member Countries 1965-1995*, Paris, 1996, pp. 74, 82-3. Notes: Total tax revenues include social security taxes. Australia and New Zealand do not have separate social security taxes.

Table 7.10 shows the trends in social insurance in the OECD countries that still rely on social insurance for provision of retirement benefits. New Zealand and Australia are included in the proportion of taxation column for comparison purposes. The table shows that Austria, Belgium, France, Germany, Italy, Finland, the Netherlands, and Sweden are the main social insurance states, with social security taxes (shared between employer and employees) over 10 per cent of gross domestic product. These taxes have risen significantly between 1965 and 1994, reaching high levels at France at 17.6 per cent, the Netherlands at 15.5 per cent and Sweden at 13.6 per cent. Japan, Switzerland, and the United States have social security taxes that are well below these levels: these countries emphasise occupational superannuation outside the formal social security system and have tighter eligibility requirements.

The key problems in implementing social insurance in New Zealand are now discussed. The first problem is high cost. Table 7.10 above shows that social insurance schemes became very expensive in the past three decades: social security taxes for a comprehensive scheme require taxes that averaged 10.6 per cent of gross domestic product in Europe and were far higher in some European countries. In 1996, New Zealand Superannuation (the main program that would be replaced by a social insurance scheme) cost around 5.7 per cent of gross domestic product, far below the fully developed European social insurance states. Table 7.10 shows that in 1994, New Zealand had a level of taxation – 37 per cent of gross domestic product, that was well above the United States (27.6 per cent), Japan (27.8 per cent), or Australia (29.9 per cent) and was similar to Germany (39.3 per cent) which has a sophisticated social insurance scheme. A social insurance scheme in New Zealand would raise taxes to levels that may be politically unacceptable.

The second problem with a social insurance strategy – and perhaps the critical factor, is that social insurance may only be able to work effectively when a country has a favourable demographic situation: there needs to be a reasonable balance between the numbers in the workforce and the numbers in retirement. Existing social insurance schemes in Europe and North America were created when demographic conditions were favourable and the workforce could be taxed modestly to finance the relatively small proportion of the population who were retired. Ageing populations in New Zealand and other western countries will create a demographic imbalance. Taxes on workers would have to rise to levels far higher than exist even in some countries in Europe to finance the cost of benefits to the retired, assuming that retirement ages and benefit levels are unchanged.

Thirdly, social and economic changes in the past few decades have meant that social insurance states such as Sweden and the Netherlands have found that increasing proportions of their populations require assistance but are not eligible for social insurance benefits. This second tier is referred to as 'social assistance' providing 'social transfers'. These social transfers have increased to an average of around 7.3 per cent of GDP in 1992, a significant increase from the average of 2.5-3 per cent of GDP in 1960 and 6 per cent in 1980.[34]

Social insurance schemes assumed a long working life of 30 or 40 years (until 65 usually), low unemployment and stable families. These conditions weakened in the past two decades. Social insurance states faced high and persistent unemployment, a decline in full time employment, and the rapid growth of single parent numbers. A smaller proportion of the population was eligible for full social insurance benefits because they had not spent long enough in the workforce. Social insurance states often received many immigrants who had minimal accumulated contributory rights. Disability rates also soared.

New Zealand faces many of these problems. In 1996, for example, benefits for non-aged benefits such as unemployment, training, sickness, invalidity and domestic purposes amounted to 5.2 per cent of gross domestic product, almost as much as outlays on New Zealand Superannuation (5.7 per cent). Social insurance, even if implemented, would only solve half the problem, albeit the most expensive part with the greatest long term potential for escalation. A social insurance scheme for retirement would require the maintenance of a parallel system for a wide range of other non-aged benefits.

There is a fourth objection to a social insurance scheme for New Zealand. Social insurance schemes require very long lead times for their introduction because members are required to build up contributions over thirty or forty years before being eligible for full benefits. Social insurance schemes in western countries were able to reduce the eligibility periods during the phase in of their schemes because, as stated earlier, retirees were only a modest proportion of population compared to the working population, especially in the first few decades of the schemes. A recent study of Social Security in the United States concluded that

> Almost all individuals who have retired in any year between 1940 and today – no matter what their income level or family type – have received large positive transfers from Social Security beyond the sum of their contributions to the system and a reasonable rate of return on those contributions.[35]

The ageing of populations in countries like New Zealand in the next few decades would make it extremely expensive to grant full eligibility for benefits before 30 or 40 years because this would impose heavy additional tax burdens on the workforce.

New Zealand may not need social insurance because of its apparent continuing success in reducing inflation to modest, manageable levels. Social insurance schemes were well suited to the high inflationary periods in western countries from the early seventies to the late eighties. Workers' wages were generally rising with inflation, allowing the transfer of adequate resources to the retired. Fully funded schemes would have found it difficult to survive the erosion of capital in these inflationary times. Continuing low inflation in New Zealand strengthens the case for a fully funded scheme, to be discussed in the next chapter.

Future schemes to fund retirement are likely to consist of three main elements: the first level, funded from general taxation, will provide a means-tested minimum income floor to provide a basic safety net to prevent poverty amongst the aged.[36] The Australian aged pension is the closest example of this model. New Zealand Superannuation also provides an example, although it is now not means tested. It is paid at a flat rate, not related to an individual's earning levels and is designed as a safety net for the aged: general taxation provides a minimum guaranteed income.

The second level of retirement provision will be an extension of long-standing occupational welfare schemes. Individuals will be encouraged or even forced to contribute to their own individual retirement fund and the income in retirement will depend on the years of contributions, the wage level during the working life, the performance of investment strategies, and the length of retirement. Government regulation is required to prevent abuse and to ensure that savings are invested wisely. This 'defined contribution' model is the subject of the next chapter. The third tier is entirely voluntary. People are free to save additional resources to ensure a desired standard of living in retirement.

Conclusion

This chapter has outlined the 'ageing crisis' that is the central issue in welfare planning for the next century and is a subject of intense debate in most western countries. Demographic projections – for all their uncertainty – suggest that New Zealand's population, in common with all other western countries, will continue to age. The higher proportions of the aged next century pose difficult issues.

Raising the age for eligibility for New Zealand Superannuation to 70 from 65 would certainly go some way to reducing the cost of public support for ageing next century: it could reduce the cost by about one third. But this approach is feasible only if those aged 65 to 70 can find employment. Large scale early retirement schemes in many western countries suggest that, at least in recent history, this has not been easy. Raising the eligibility age for pensions to 70 may be unfair to those who have contributed to taxation revenue through long working lives. The possibility of a 70 age for eligibility creates uncertainty in New Zealand's retirement benefit system.

New Zealand could also reduce the future cost of aged benefits if these benefits were reduced, possibly by making them the same as current benefits for unemployment. This may mean that poverty rates amongst the aged will raise. Comprehensive means testing on the Australian model would also reduce costs, but New Zealand has a strong bias against such a policy as shown by the rejection of even indirect means testing through a tax surcharge in 1997.

It is unlikely that New Zealand would introduce a social insurance scheme on the European model. It would be high cost, take decades to phase in, and would not be suited to the demographic imbalances between the aged and the workforce that will be a central feature in the next century.

The rapid ageing of the population next century in New Zealand will require major intergenerational transfers under existing funding arrangements. The workforce after 2020 will be paying high taxes to support an aged population at a relatively high standard of living – if current arrangements for indexing benefits to wages continue. The aged will be benefiting from the work efforts of the then workforce. We cannot assume that the workforce at the time will be any more altruistic than it is now. They have a right to benefit from their own workforce efforts, not to see their taxes rising because of forced transfers to the aged, who may have paid lower taxes throughout their lifetimes.

References

1 Information on these costs in New Zealand was not available. Britain, which already has a more aged population has developed much information on the high costs of health and social care for the aged. See Anthea Tinker 'The Role of Housing Policies in the Care of Elderly People', in OECD *Caring for Frail Elderly People: New Directions in Care*, Paris, 1994, p. 74.

2 See Peter G. Peterson *Will America Grow Up before It Grows Old?*, Random House, New York, 1996, pp 30 ff,

3 Paul Krugman 'First, Do No Harm', *Foreign Affairs*, vol. 75, no. 4, July/August 1996, p. 168-9.

4 David C. Lindeman 'Introduction', in Peter A Diamond, David C. Lindeman and Howard Young, eds. *Social Security: What Role for the Future?*, National Academy of Social Insurance, Washington, 1996, p. 15.

5 Robert Brown 'An Actuary's Perspective', in Peter A. Diamond, David C. Lindeman and Howard Young, eds. *Social Security: What Role for the Future?*, National

Academy of Social Insurance, Washington, 1996, p. 21.

6 Robert Brown 'An Actuary's Perspective', in Peter A. Diamond, David C. Lindeman and Howard Young, eds. *Social Security: What Role for the Future?*, National Academy of Social Insurance, Washington, 1996, p. 29. ,

7 See for example *OECD Ageing in OECD Countries: A Critical Policy Challenge*, Social Policy Studies, no.20, Paris, 1996.

8 This is the essential argument of Diana Cook and John Savage *The Fiscal Impacts of an Aging Population*, New Zealand Institute of Economic Research, Wellington, 1995.

9 *Economist* October 12 1996, p. 24.

10 Robert Brown 'An Actuary's Perspective', in Peter A. Diamond, David C. Lindeman and Howard Young, eds. *Social Security: What Role for the Future?*, National Academy of Social Insurance, Washington, 1996, p. 36.

11 Jay S. Olshansky 'Demographic Perspectives on Human Senescence', *Population and Development Review*, vol. 20, no.1, March 1994, p. 57.

12 Australian Bureau of Statistics *Projections of the Populations of Australia: States and Territories, 1995-2051*, cat. 3222.0, Canberra, 1996, p. 14.

13 Jay S. Olshansky 'Demographic Perspectives on Human Senescence', *Population and Development Review*, vol. 20, no.1, March 1994, p. 72.

14 David W.E. Smith *Human Longevity*, Oxford University Press, New York, 1993, p. 127.

15 OECD *Ageing in OECD Countries: A Critical Policy Challenge*, Social Policy Studies no. 20, Paris, 1996, p. 54.

16 C. Eugene Steuerle 'Social Security in the Twenty-First Century', in Eric R. Kingson and James H. Schulz eds. *Social Security in the 21st Century*, Oxford University Press, New York, 1997, p. 243.

17 *Economist* October 12 1996, p. 24.

18 W.G.K. Duncan ed. *Social Services in Australia*, Angus and Robertson, Sydney, 1939.

19 Statistics New Zealand *Demographic Trends 1996*, Wellington, 1996, p. 50.

20 Richard A. Easterlin *Birth and Fortune: The Impact of Numbers on Personal Welfare*, Basic Books, New York, 1980; Richard A Easterlin 'The Birth Dearth, Aging and the Economy', in Sisay Asefa and Wei-Chiao Huang (eds). *Human Capital and Economic Development*, W.E. Upjohn Institute for Employment Research, Lamamazoo, 1994, pp. 11-34.

21 Randall J. Olsen (1994) 'Fertility and the Size of the U S Labour Force' *Journal of Economic Literature*, vol. xxxii, March, p. 76.

22 Graeme Hugo, 'Recent Trends in Fertility Differentials in Australia', *People and Place*, vol.1, no.2, 1993, pp. 1-5.

23 A more detailed discussion of these issues in Michael Jones *The Australian Welfare State: Evaluating Social Policy*, Allen and Unwin, Sydney, 1996.

24 Tony Eardley, Jonathan Bradshaw, John Ditch, Ian Gough and Peter Whiteford, *Social Assistance in OECD Countries: Country Reports*, London, HMSO, 1996, p. 292.

25 Tony Eardley, Jonathan Bradshaw, John Ditch, Ian Gough and Peter Whiteford *Social Assistance in OECD Countries: Synthesis Report*, OECD, Paris, 1996, p. 42.

26 Sarah S. McLanahan et al. 'The Role of Mother Only Families in Reproducing Poverty', in Aletha C. Huston ed. *Children in Poverty: Child Development and Public*

Policy, Cambridge University Press, Cambridge, 1994, p. 53.

27 Robert Brown 'An Actuary's Perspective', in Peter A. Diamond, David C. Lindeman and Howard Young, eds. *Social Security: What Role for the Future?*, National Academy of Social Insurance, Washington, 1966, p.34,

28 Sol Encel 'Retirement Ages and Pension Ages-A Complex History', *Social Security Review*, June 1996, p. 7-11.

29 The OECD report on the Netherlands for 1994 gives a detailed account of the Netherlands explosion in these categories; *OECD Economic Surveys, Netherlands 1994*, Paris, 1994.

30 See OECD *The Labour Market and Older Workers*, Paris, 1995.

31 Peter A. Diamond 'Proposals to Restructure Social Security', *Journal of Economic Perspectives*, vol. 10, no. 3, Summer 1996, p. 69.

32 This section summarises the extensive research reported in Fay Lomax Cook and Edith J. Barrett *Support for the American Welfare State: The Views of Congress and the Public*, Columbia University Press, New York, 1992.

33 Similar pessimistic figures were arrived at by simulations by the OECD. See E. Philip Davies *Pension Funds: Retirement-Income Security and Capital Markets. An International Perspective*, Clarendon Press, Oxford, 1995, p. 48.

34 Maitland MacFarlan and Howard Oxley 'Reforming Social Transfers', *OECD Observer*, no. 199, April/May, 1996, p. 28.

35 C. Eugene Steuerle and Jon M. Bakija *Retooling Social Security for the 21st century: Right and Wrong Approaches to Reform*, Urban Institute Press, Washington, 1994, p. 108; similar transfers from the poor to the more affluent are a feature of most social insurance schemes. See Estelle James 'Providing better protection and promoting growth: A defence of *Averting the old age crisis*', *International Social Security Review*, vol. 49, no. 3, 1996, p. 9.

36 See the detailed discussion of a three tier system in Estelle James 'Providing better protection and promoting growth: a defence of *Averting the Old Age Crisis*', *International Social Security Review*, vol. 49, no.3, 1996, pp. 3-16; a three tier system is also recommended in Assar Lindbeck. et al. eds. *Turning Sweden Around* MIT Press, Cambridge, 1994, p. 113.

Chapter 8

The New Option: Fully Funded Retirement?

Retirement welfare programs have been found to be increasingly wanting and there is now a growing movement in favour of compulsory occupational superannuation: most of the working population can provide for their own retirement by contributing (with help from employers) to their own retirement fund throughout their working life. Gosta Esping-Andersen, a social policy specialist reported in 1996 that

> Individual retirement accounts are mushrooming everywhere. In an immediate sense, their growth has been fuelled by government tax concessions, but behind this lies a more complex change. Governments, be they of conservative, liberal or socialist persuasion, are keen to shift the financial responsibilities for welfare into the market. With population ageing, public sector deficits and heightened financial strain, even the most robust welfare state faces the spectre of financial crisis.[1]

The Advisory Council on Social Security in the United States released a report in January 1997 that recommended at least a partial move to turn America's retirement social security system into a funded plan, based on stockmarket investment, with some members of the Council recommending individual retirement accounts on the Chilean and Australian model.[2] New Zealand is to have a referendum in 1998 on a compulsory savings scheme to form the basis of a different, funded, retirement system. The details of the scheme are still to be decided.

Retirement is one of the last major areas of government activity which might yet be privatised. The effects of social security privatisation would be far more widely distributed than any other modern privatisations. Virtually everyone in the society becomes a shareholder, or a 'stakeholder' in popular terminology.[3] There has been very widespread acceptance of the idea in Australia, and little or no criticism, despite the phasing in of a 15 per cent contribution required from each worker or employer to fund the scheme.

Current policies, if continued, are a recipe for severe intergenerational conflict after 2030, when New Zealand's population ageing will accelerate. Potentially, the aged will have a great deal of political power because they will be more numerous. The New Zealand electoral system now allows groups such as the aged, or any age group, to form age based parties more easily than before. Even now, governments are reluctant to reduce benefits to the aged because of the political difficulties in doing so. Future numbers of the aged will be such as to make governments even more reluctant. In 1997, for example, the New Zealand government removed even the modest means testing of New Zealand Superannuation, even though the aged are a small proportion of the electorate now, when compared to projections for next century. The workforce, however, will be the wealth creators and they will face high taxes to finance retirement under existing pay-as-you-go arrangements: they will have a strong incentive to organise to protect their interests. The owners of capital will also have a role. They may move from countries with high taxes and intergenerational conflict to countries that had taken the steps in earlier decades to ensure that each generation would fund its own retirement through fully funded, compulsory schemes.

Funded, defined contributions superannuation

The worldwide momentum for funded, defined contributions, privately managed superannuation was due largely to the 1994 publication by the World Bank *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*.[4] The idea has promoted vigorous debate in many countries. The shift to defined contributions away from defined benefits has many appeals to governments. In the past, as shown in earlier chapters, governments have created major fiscal problems by generous defined benefit schemes. In defined benefit schemes, benefits are paid according to some formula such as a per cent of final salary and there is no specific link with contribution levels or returns from invested funds.[5] There has been a temptation for politicians to become more generous over time. Benefits are usually indexed according to prices or movements in average earnings. Defined contribution schemes, on the other hand are very different in nature. In these schemes, benefits depend entirely on an individual's contributions plus earnings on the funds invested. Benefits are usually not indexed for inflation or increases in earnings: on retirement the individual has to search the market for investments that will provide some indexation. In defined benefit schemes, the government takes the financial risk; in defined contribution schemes, the individual takes the risk. This is a major potential problem in defined contribution schemes that will be discussed later. If investment schemes failed or performed poorly, there would be pressures on government to 'top-up' benefits to reasonable levels, negating the advantage of fully funded-schemes: they are supposed to not call on public funds to pay benefits.

The idea of defined benefit retirement schemes has been given theoretical support by the eminent American economist Martin Feldstein. Feldstein and his colleagues at Harvard University and the National Bureau of Economic Research are not known for bold policy proposals. Feldstein, however, has published a recent paper arguing that the funding and design of social security systems is the most important gap in modern policy analysis.[6] Social security expenditures account for a significant proportion of government outlays in many western countries and future commitments – especially for retirement – dominate government financial forecasts.

New Zealand has received widespread praise for its legislation on fiscal openness and clear reporting. Yet, as noted in the recent OECD report on the New Zealand economy, New Zealand has avoided publishing information on its future fiscal commitments on social welfare. Governments do publish the unfunded liabilities of public service pensions, and these significant costs have contributed to an understanding of the poor fiscal condition of many western countries. The OECD notes that, if governments are to be consistent, they should also publish unfunded pension liabilities for general social welfare programs.[7]

Economists argue that a country should include social security wealth in any measures of population, poverty, wealth, and fiscal health. The aged in New Zealand often have low incomes but they have massive future drawing rights – some economists call it a 'property right' – on future government resources. It can be changed at any time, but benefits to the aged have been able to survive the major economic turmoil that has reduced benefits to other groups. The aged become more numerous with each passing year, so there is no reason to think that they will not continue to be treated as a privileged group.

New Zealand has no separate social security tax and all pensions are paid from general taxation. New Zealand Superannuation is not paid from special earmarked funds with money invested. It is transferred directly from taxpayers – primarily workers – to pensioners.

In 1995, the cost of New Zealand Superannuation was $5,083 million, equal to 75 per cent of receipts from the goods and services tax. If the health costs of the aged were included, all GST revenue is probably needed to fund the New Zealand retired. Notionally, then, one can regard the GST as really a social security tax. Coincidentally, the GST is about the same level as American social security tax. The American social security tax, like the GST, is a proportionate and not a progressive tax. One could just as easily regard a proportion of income tax as a social security tax. In 1995, the costs of National Superannuation were equal to about a third of income tax.

The Americans have the advantage that the social security tax must rise as the costs of retirement increase, creating a 'transparency' much valued by economists. There is a vigorous and high level debate in the United States on the future of the social security scheme and this debate focuses on the increases in the social security tax needed to fund the ageing population next century.[8] New Zealand's growing retirement costs can be concealed in the general budget. The social security crisis in the United States has developed because the tax has risen so many times. Social security was sold to the American people in the 1930s on the basis of an original combined employer-employee tax of only two per cent of payroll. The rate rose to three per cent in 1950, six per cent in 1960, 10 per cent in 1980 and 12 per cent in 1988. The tax is expected to increase to 18 per cent over the next 50 years and possibly to 23 per cent. The public has been assured on each occasion of an increase that the expert actuaries have 'fixed' the system for the long term.

Feldstein criticises American unfunded social security taxes partly because of their deadweight costs. Social security tax, or, in New Zealand, a third of income tax, is earmarked (formally in the United States, informally in New Zealand), to fund retirement. Most of this money is not invested in stocks and bonds but is transferred directly to the incomes of the retired. The rate of return on this money is dependent on the rate of increase in average earnings of those in the workforce, around two to three per cent a year in a good year, in real terms (2.6 per cent per year average in the United States over the past 35 years).

Feldstein argues that the two to three per cent return on unfunded social security is far lower than the average real pre-tax return of 9.3 per cent on non-financial corporate capital in the United States over the past 35 years of 9.3 per cent. The difference between this 9.3 per cent and the 2.6 per cent referred to earlier is considered by Feldstein to be a key component of the deadweight costs of unfunded social security. This is a very substantial difference in rates of return. Feldstein gives an example. Consider an employee aged 50 who contributes $1,000 to unfunded social security to buy a benefit that will be paid at 75. With a 2.6 per cent yield this will be worth $1,900 after 25 years. A yield of 9.3 per cent from funded social security would mean the person could have purchased the same $1,900 at age 75 for only $206. Even a return of 5.4 per cent would enable the same amount to be purchased for $510, about half the cost of social security.

The deadweight cost of unfunded social security should perhaps be added to the traditional deadweight costs of income taxes. New Zealand has reformed its tax system, but there are still the substantial deadweight costs of the third of income taxes that are notionally used to fund retirement. Income taxes discourage work effort, savings, and create notorious poverty traps for those on social security benefits. In 1992, despite many reforms to public spending, taxes in New Zealand were still 36.1 per cent of gross domestic product (on a three year moving average), well above the level of many OECD countries and similar to the OECD average of 38.4 percent. The New Zealand level is well above the tax level in dynamic Asian economies.[9] A recent study estimated that the deadweight costs of labour taxation in New Zealand have risen rapidly over the past 20 years and are now equivalent to about 18 per cent of taxation of the tax raised.[10] The deadweight costs of the third of income taxes needed to fund National Superannuation could even be higher than this. Marginal tax rates could be much lower if overall income taxes were to be reduced by one third.

Feldstein argues that the deadweight costs of taxes are higher when taxpayers cannot see any direct benefit from paying taxes. American social security offers only very indirect linkages between social security taxes paid by contributors and benefits received. Taxes are redistributed by complex administrative measures that increasingly cap benefits to the middle and higher income earners, and redistribute income within the system to those on lower incomes.

The situation in New Zealand is even worse. There is no rational link whatsoever between lifetime taxes paid and benefits received from National Superannuation. In the United States, social security benefits are only paid to those with decades of paid contributions as a result of long periods of employment. In contrast, full National Superannuation rights in New Zealand are payable to a person with minimal lifetime employment, or even no paid employment at all. Social security systems without accounts for each individual do not give individuals any incentive to work more, or to earn higher wages in the expectation that the higher tax paid will mean better retirement benefits.

Feldstein argues that social security systems are one important reason for the decline in national savings in western countries. Household savings differ between countries and explanations of these differences are complex.[11] The low level of household savings in New

Zealand are shown in Table 8.1. Fully funded compulsory superannuation on the Australian model is supposed to increase national savings and this argument is discussed later in this chapter.

This low level of household saving does need to be qualified. Household savings, of course, does not include the building up of assets in an owner occupied dwelling which is a key element in savings strategy in most western countries. Widespread home ownership certainly helps the aged in retirement, and reduces the amount that would be required if the aged household was paying market rents or trying to finance a substantial mortgage in retirement. But home ownership is not a sufficient financial base in retirement for most households. Aged households also need an income stream to provide a reasonable standard of living and to help finance the health care and perhaps social care that are disproportionately needed in retirement. In theory, the aged could dissipate their housing wealth by selling the family home and moving to rental properties at older ages, thus freeing up resources for general expenses. These possibilities, however, have their limits. Many of the aged have an attachment to the family home and wish to will it to children on their death. Also, the age of death is uncertain, and this makes optimum disinvestment of owner occupied housing a difficult choice. Long life expectancies means that, for many aged people, the realised value of the owner occupied dwelling would

Table 8.1

Household savings in New Zealand 1985/6 to 1994/5, savings as per cent of household disposable income

Year	Household savings as per cent of household disposable income
1985-86	5.6
1986-87	4.7
1987-88	7.4
1988-89	6.1
1989-90	5.7
1990-91	2.7
1991-92	4.7
1992-93	2.1
1993-94	1.4
1994-95	0.7

Source: Supplied by Statistics New Zealand July 1996.

not be nearly high enough to finance many years of retirement.

The failure to develop a funded social security system in most western countries has, Feldstein claims, serious economic consequences. Feldstein estimates that the unfunded social security system in the United States causes an annual loss to the American economy of about $730 billion, or ten per cent of gross domestic product. The loss is vast, even if the actual rate of return on funded retirement is only half of that assumed. The loss would still be five per cent of national product. Feldstein claims that, in the United States, social security depresses private savings by about 60 per cent, although this is a controversial assessment and other economists have disputed this estimate.[12]

Towards the end of his paper, Feldstein becomes more conservative and assumes that the real rate of return on invested income in funded social security would be more like five per cent after tax. This may not appear to be a great return, but is significant over a long period. Feldstein points out that existing systems index linked with wage increases in the working population is a risky policy in the long term. This arrangement can change at any time, in the same way as the New Zealand government reduced other social benefits in 1991.

The new Australian model for funded retirement

The growing popularity of fully funded, compulsory defined contribution retirement plan may appear radical at first examination, but in many ways it can be viewed as a conservative, incremental change. There is nothing really new in principle about private superannuation, that is schemes that are outside formal, comprehensive government schemes. Public servants have had such schemes since at least last century and private sector employees, especially in larger companies have also enjoyed these benefits for decades. In Australia, about 40 per cent of the workforce were members of occupational plans before the scheme was made compulsory in 1991. Private, occupational superannuation is very significant in many advanced countries: at the end of 1991, occupational pension schemes had assets equal to 70 per cent of gross domestic product in Switzerland, 60 per cent in the United Kingdom, 51 per cent in the United States, 32 per cent in Canada, 46 per cent in the Netherlands, 33 per cent in Sweden, and 22 per cent in Australia.[13] Occupational superannuation has been popular even in countries with generous welfare states. Non-legally obligated occupational pensions and health care benefits in the United States have been estimated in a recent study to account for more than 30 per cent of all annual social policy expenditures and represent about 7.5 per cent of gross national product.[14]

Public service schemes have usually been defined-benefit plans and this meant that, at least in Australia, governments found in the 1980s and 1990s that they faced massive unfunded pension liabilities because they had not created funded systems: they had paid superannuation to the retired out of contributions from those currently contributing in the workforce. A number of inquiries at the State and Federal level clarified the unfunded liabilities and the public sector schemes are being reformed to make them fully funded, defined contribution schemes which are considered more financially responsible. This move transfers the risk to the superannuant rather than the government. The compulsion to join these schemes, greater public regulation, and the move away from defined-benefits to defined-contributions are the key innovations in current plans for fully-funded superannuation.

Australia has moved to a fully funded scheme, expanding the long established and politically popular, tax-advantaged funded private superannuation system. The new scheme has extended this system to the broad population, at the same time rationalising its administration. The Labor government in power which created the scheme had close relations with the union movement and business through an 'Accord'. Union and business support was needed for the significant sacrifice in future wage increases — 15 per cent – needed to make the scheme viable. The main details of the scheme are shown in Table 8.2.

The Australian publicly mandated but privately managed, defined contribution fully funded superannuation scheme will eventually require 15 per cent employer-employee contributions. It was made easier to implement because of some specific features of existing retirement arrangements. The scheme is made particularly attractive by the generous tax concessions available to contributors to approved superannuation schemes. In the past, higher income earners were the main beneficiaries of these concessions: a high proportion had generous superannuation, and this group also had the highest tax rates. The scheme was viewed as the democratisation of what was formerly an executive fringe benefit.

The Australian scheme was introduced, in part, as a way to boost national savings from very low levels. Mandatory superannuation alone is unlikely to turn Australia or New Zealand into high savings economies on the East Asian model, even though the high savings in these countries was a powerful influence on the Australian introduc-

Table 8.2

Main details of compulsory superannuation in Australia

Membership	Compulsory for all employees. Those already in schemes that fulfil the contributory and regulatory requirements do not have to contribute any additional funds.
Contributions	15 per cent of earnings by year 2002; mix of employee (3 per cent) and employer (9 per cent minimum) contributions.
Coverage	87 per cent of workers in 1995 (in 1983 only 40 per cent covered). The new scheme has meant far higher coverage for female workers (from 24 per cent in 1988 to 85 per cent in 1994) and for part time workers (from eight per cent in 1983 to 67 per cent in 1994).
Portability	Fully portable between employers
Preservation	Tax penalties if cashed in before age 55. Contributions can be made until age 70, to encourage later retirement. Proposals to raise preservation age to 60.
Payment form	Can be taken as lump sum or pension or mixture of both. Tax free up to A$400,000 (lump sum) and $800,000 (life pension or annuity) in 1994, indexed by average earnings. Excess amounts taxed at marginal tax rates.
Taxation	Contributions and fund earnings taxed at concessional rate of 15 per cent. Proposals for 30 per cent tax on high income earners currently before parliament to lessen advantages to the more affluent. Tax concession on pension.
Regulation	Extensive controls on investment funds but many competitive funds with wide range of freedom to invest.
Effect on savings	Expected four per cent increase in national savings rate by 2020.
Effect on retirement	Person on average weekly earnings and 40 year income contribution could expect 68 per cent higher income than age pension alone.

Source: Ralph Willis *Saving for Our Future*, AGPS, Canberra, 1995; Peter Costello *Recognising Older Australians*, AGPS, Canberra, 1996.

tion of compulsory savings.[15] Compulsory national superannuation contributions may merely be a substitute for other forms of savings. In Australia, it is estimated that between 30 and 50 per cent of compulsory superannuation contributions are substitutes for other forms of saving. The net effect, nevertheless, is still a worthwhile increase to national savings.[16] Economists disagree about the effects of tax incentives and compulsory savings on the level of savings but *The Economist* noted in 1997 that over a savings period of 22 years, a one dollar tax break that generated a mere 26 cents in new savings would still generate an impressive two dollars and nine cents of new private capital.[17] In theory, governments can save through fiscal surpluses, but in democracies such surpluses often lead to pressures for tax cuts or higher spending.

The 15 per cent superannuation guarantee charge in Australia is similar to a tax and reduces work incentives. The problem is more acute in Australia because marginal tax rates are relatively high, compared to New Zealand which reformed its tax system, lowered marginal income rates and introduced a consumption tax. The superannuation charge, when added to the top tax rate means that some people will be paying a marginal rate of around 65 per cent. Individuals have an incentive to avoid the contributory systems – by becoming unemployed, working fewer hours, self employment or other means – to take advantage of the indexed aged pension. There is no guarantee that key elements of the scheme will remain stable over the long term. Already, in the 1996 Australian budget, the government announced major changes to tax concessions for more affluent contributors.

The Australian scheme is inflexible and not well adapted to life cycle income and expenditure needs. Contributors have to pay the same percentage throughout their lifetimes, perhaps limiting the ability to purchase homes early in life. A more flexible scheme would allow individuals to vary payments – for example, contributing higher proportions after the peak expenditure demands of home purchase and child rearing. It may be more efficient to allow individuals to cease making contributions once an adequate fund has been accumulated. This flexibility would, however increase scheme complexity and increase administrative costs.

The new Australian national superannuation scheme was easy to market and gained bipartisan political support, because of the high level of Australian concern with the effects of an ageing population next century. Government statements, research papers, and popular commentators disseminated information about – and usually exaggerated – the problem of population ageing. This process of propaganda and indoctrination went on for well over a decade. By 1990, most Australians were aware of the 'ageing crisis,' and believed that the age pension would not exist next century. Surveys in the United States show that the American public support Social Security but have a low confidence that it will be able to fund their retirement adequately.[18] New Zealanders, in contrast, appear far more relaxed about ageing as a problem. Publications on the issue from respected research institutes are technical, detached, and view ageing as a problem – but not a catastrophic development – that can be accommodated in future government budgets.[19] New Zealand historian David Thomson kept up what was a lone voice raising the issue of the 'selfish aged,' but he seemed to gain more notice and respect in Europe than in New Zealand. The second edition of his book on the aged was published in 1996 in the United Kingdom.[20]

Tax concessions on superannuation

Fund contributions on superannuation earnings in Australia are generally taxed at a concessionary rate of 15 per cent, well below the level of marginal tax rates for most Australians. Most Australian workers are on marginal income tax rates of between 40 and 50 per cent. This tax concession is an expensive loss to government revenue. The cost rose from A$3,825 million in 1988-89 to $7,275 million in 1994-5.[21] The cost of this concession will rise rapidly and probably double, as the scheme becomes fully operational, if income tax rates are not altered. The outlays on the age pension in 1994-5 were A$11,853 million. The superannuation tax concession in that year of $7,275 million was equal to 61 per cent of aged pension outlays.

New Zealand is in a more difficult position with regard to using tax concessions as an inducement to move towards a fully funded superannuation scheme. New Zealand has no significant tax concessions on superannuation.[22] The exemption of half the income from superannuation from taxation is just a recognition that roughly half is the return of contributor's capital. Tax concessions are less necessary in New Zealand, because marginal income tax rates are far lower than in Australia. The lack of tax concessions, though, is a major problem in convincing people to accept a compulsory government superannuation scheme. At the moment, there is no incentive to abandon voluntary private savings arrangements.

The Australian tax concessions are not unusual, and most western countries give significant tax concessions for funded superannuation.

New Zealand is a notable exception, abolishing tax concessions in the 1980s. This decision has been blamed for the collapse or winding back of many pension schemes and the decline in national savings.[23] Taxation systems in a range of advanced countries are listed in Table 8.3.

Generous tax concessions on superannuation in western countries have undoubtedly been an important factor in explaining the boom in private superannuation arrangements: workers who make optimum use of pensions can reduce their lifetime tax liability by between 20 and 40 per cent. Tax concessions may be justified by the reduction in the burden to the state from fully funded retirement. Fully funded retirement at reasonable levels of income should reduce the burden on government in many ways other than pensions: the well funded aged can be expected to pay more towards health, social care, and other services. Tax concessions are also justified because they encourage a higher level of private savings and this benefits the economy, especially, some argue, if the funds are invested in competitive pension funds, not a government monopoly. Tax concessions for superannuation makes compulsion more acceptable.

There may be a case for significant tax concessions during the thirty year phase-in period of mandatory, fully-funded retirement plan on the Australian model. Phasing in a fully funded individual retirement system in New Zealand would not be easy and would take at least two to three decades. International experience suggests that 15 per cent of wages (assuming average wage) is needed over 30 years to create a reasonable pension, equal to about two-thirds of the average wage. This is a significant amount of contribution and there is some concern in Australia that it will lead to lower levels of owner occupation by reducing disposable income. The scheme will be a burden for the current working generations, especially those in younger age groups. The generation from age 20 onwards are being asked to fund their own retirement, and also to pay for the retired for the next 20 to 30 years. This is a double taxation that will substantially reduce real living standards for this group. They should benefit from lower taxes when they are retired although this is not guaranteed: governments have a tendency to find other uses for income saved from one area of spending. There may be an argument for imposing a tax surcharge on those retiring over the next few decades, to overcome the favourable expenditure by their continuing reliance on aged pensions, in Australia, or government superannuation in New Zealand. This double taxation of a generation may be an argument for generous tax concessions, to be phased out in 2020-30 when the phase in period of the new scheme ends.

Compulsion

The move to compulsory superannuation in Australia was made easier than in New Zealand because of the much harsher nature of the Australian aged pension. The Australian aged pension is means tested both for income and assets. This requires intrusive administrative arrangements that cause resentment, fear, and anxiety in the aged. New

Table 8.3

Taxation of funded pension schemes in selected advanced countries

Country	Details
United States of America	Contributions and asset returns tax free. Benefits taxed.
United Kingdom	Contributions and asset returns tax free. Benefits taxed except for tax-free lump sum.
Germany	Employer's contributions taxed as wages; employee's contributions and asset returns tax free. Benefits taxed at a lower rate.
Japan	Contributions tax free. Tax on asset returns. Benefits taxed, except for free lump sum.
Canada	Contributions and asset returns tax free. Benefits taxed.
Netherlands	Contributions and asset returns tax free. Benefits taxed.
Sweden	Contributions tax free in some schemes, subject to social security tax in other schemes. Asset returns taxed. Benefits taxed at lower rate.
Denmark	Contributions tax free. Tax on real asset returns. Benefits taxed including 40 per cent of lump sum.
Switzerland	Contributions, asset returns tax free. Benefits taxed.
Australia	Contributions, asset returns and benefits taxed at concessional rates within benefit limits.
Italy	Contributions and asset returns tax free, benefits taxed.

Source: Adapted from E. Philip Davis *Pension Funds: Retirement-Income Security, and Capital Markets. An International Perspective*, Clarendon Press, Oxford, 1995. p. 83.

Zealand Superannuation is now far less intrusive, simpler, and ignores the complex issue of income or asset testing. New Zealand has firmer commitments to indexing aged pensions for movements in average wages. Australian aged pensions, by contrast, are automatically indexed for rises in prices, but links to wage movements are more tenuous.

In Australia, aged pensioners generally receive the same amounts per week as single parents and the unemployed, lumping the aged in with the general 'welfare' group. New Zealand, in contrast, treats the aged as higher class citizens than single parents and the unemployed, both of whom receive considerably lower pensions. The Australian aged are stigmatised and humiliated by the very nature of the comprehensive means test on the aged pension. The Australian aged pension, even with competent and courteous administration, is still the 'pauper's pension,' as it was described around the turn of the century. New Zealand's National Superannuation is best described as a 'citizen's pension'.

New Zealand policy makers often express reservations about whether contributory superannuation arrangements should be made compulsory. Modern libertarian philosophers and free market economists also dislike government compulsion. Compulsion means less individual liberty, intrusive government, and an increase in state power. The rapidly ageing New Zealand population will need extensive assistance through compulsory taxation if existing policies are continued. Compulsory contributions into an individual's superannuation account may be considered by libertarians to be the lesser of two evils. At least the payments are directly assisting the contributor, not paid to someone else as in social insurance or non-funded schemes. It could be argued that the compulsory contribution level should be established only to provide a minimum floor for retirement income, say the 25 per cent of average weekly earnings institutionalised in Australia. One aim of the Australian scheme, however, is to raise the living standards of the aged over what is often a long retirement.

Appallingly low private savings levels in Australia and New Zealand – some of the lowest in the developed world – strengthen the case for compulsion if a funded superannuation system is to be adopted. New Zealand, after all, already has compulsion; individuals have to pay taxes that finance the generous New Zealand Superannuation scheme. No individual is able to 'opt out' from tax payments because he or she has adequate private superannuation. Those who oppose compulsion should logically support a move to abandon existing government New Zealand Superannuation arrangements. Individuals would be told there will be a major tax reduction, but each individual is to be left to save for his or her own retirement. Few adopt such a position.

Costs, benefits and risks of privatised retirement

When social insurance was established earlier this century, few of its supporters predicted the negative effects that would emerge in late century as deep, perhaps fatal flaws. Democratic governments have a strong tendency to overpromise benefits and underestimate costs. Privatised, funded retirement is now being proposed without balanced attention to the likely pitfalls. This section discusses some of the main points. Fortunately, there has been a vigorous debate between supporters of the new scheme and its detractors. Much of the debate has to remain uncertain because Chile provides the only example of a long established (1980) mandatory retirement system on the World Bank model. Chile is not an advanced liberal democracy – the scheme was established by a military dictatorship and criticisms of the scheme's operations are more often than not criticisms of the undeveloped nature of the Chilean stockmarket, weak administrative structures, poor tax compliance and unstable and inflationary economic policies. It now appears that the spectacular increase in Chilean national savings from 8.2 per cent of gross national product in 1981 to 27.6 per cent in 1995 had more to do with government budget cutting than with the new pension scheme. The government cut existing pension programs drastically while the scheme was being implemented, partly to give an incentive to join the new plan.[24] Australian experience will be a far more relevant model for New Zealand, but the scheme is very new and will not even be implemented fully until 2002.

The major criticism of privatised retirement is that, in search of high returns, competing funds will invest heavily in the stockmarket, and therefore face high risks. Ajit Singh, an economist at the University of Cambridge, is a major sceptic about trusting retirement funds to the stockmarket.[25] Investment in the stockmarket, according to the World Bank is supposed to produce high returns, increase national savings and investment and therefore provide contributors with a higher standard of living in retirement.

Singh is sceptical that stockmarkets are necessarily rational and doubts that stockmarkets even in advanced economies necessarily perform an efficient monitoring, screening and disciplinary function on private firms. He cites research to show that even fully developed stock markets such as London and New York are dominated by speculators – casino capitalists – subject to whims and fads and interested in short term gains, not long term values. Takeovers, the main theoretical mechanism for improving market efficiency are also flawed, with many being motivated by power rather than a search for efficiency. Singh also notes that stockmarkets are noted for their high volatility and can decline dramatically: in the United States, for example, the real value of the stock market approximately halved after the oil shock of the early 1970s and stayed at this level for the rest of the decade. Such a trend would cause major problems for those who retired – or who were close to retirement – just as the stock market slumped. Singh also claims that stockmarket expansion in the past two decades has had little if anything to do with economic growth.

Estelle James of the World Bank has replied to these and other criticisms.[26] She claims that supporters of existing social insurance (defined benefit) schemes neglect the impact of these schemes on the economy: the World Bank regards these effects, especially the weakened incentive to work and save, as a central problem in western countries. The many defects of existing social insurance schemes in Europe and North America have been discussed in many different parts of this book. Only more rapidly growing western economies will be able to provide the additional resources to support ageing populations at adequate levels of income, health care and other services. James regards existing social security schemes as incapable of fundamental changes to align benefits received more closely with individual contributions. Reform schemes are made difficult if not impossible because of overpromising by politicians in the past.

The World Bank is surprised that its emphasis on stockmarket investment of savings is regarded as a negative factor by many critics. Fully funded superannuation does not necessarily require any investment in the stockmarket: the funds could be invested in government bonds, property, or a range of other safer, if usually lower yielding, investments. Stock markets could account for one third of investment, property one third, and government bonds one third, a common low risk portfolio in Australian superannuation investments.

The expansion and increased sophistication of stockmarkets in many countries allows savers from one country, with competent advice, to diversify investment risks that were previously not available. Prudent diversification, would reduce the impact of inflation in one country or a slump in the stockmarket in another. International investment also enables the retired in an ageing country to invest abroad and gain the benefit from higher growth rates in a country with a higher proportion in the workforce. They regard diversification as 'very important for programs with a long term horizon in a very uncertain world'. While there are certainly risks in stockmarkets, publicly financed social security relies entirely on tax revenue which may be difficult to increase in a slow growth environment.

The existing New Zealand Superannuation scheme is not risk free. Over the past decade or so, the New Zealand aged have seen an effective means test via a tax surcharge (removed in 1997), the phasing in of an increased age of retirement (60 to 65), and a freeze on indexation for price and wage increases at one point. In a severe recession or other economic crisis, there may be moves to reduce payments under New Zealand Superannuation to the lower levels now paid to the unemployed, a long standing policy in Australia. Governments cannot make binding intergenerational agreements that are needed to ensure security in retirement.[27] The New Zealand system of government, with no upper House and no States, allows governments to change policies more easily than many other countries which have more checks and balances. Only a very optimistic New Zealander could believe that existing policies for retirement will remain largely unchanged in a decade – let alone three decades. Policies on indexation, retirement ages, and means testing can be changed at any time.

'Transparency' is a key value in World Bank support for mandatory, funded retirement schemes. Existing social insurance schemes in advanced economies have been the opposite of transparent. Who pays and who benefits has been hidden, with systematic and massive transfers to rich and poor who joined the schemes early and received benefits without a lengthy contribution period. An American expert on their social security system claims that 'for most of Social Security's history, the system has been regressive within generations. That is, within a given cohort of retirees, net transfers have been inversely related to need: people with the highest lifetime incomes have tended to receive the largest absolute transfers above and beyond what they contributed'.[28]

The World Bank regards existing social insurance schemes as an intergenerational conspiracy, with the retired from early next century paying the price because their benefits will be less than the present value of their contributions. Although existing social insurance schemes are often referred to as an 'intergenerational contract', the World Bank regards this as a sham. Contracts are supposed to be voluntary between two agents, both of whom benefit. In this case, however, the 'contract' was voted into existence by the 'winners' (the working generation generally from 1940 to 1980) at a time when the 'losers' were not even born or were certainly not old enough to be politically articulate.[29]

In contrast, fully funded retirement is transparent: benefits are a result of contributions plus investment returns. Funded individual retirement accounts may be the only truly effective way of ensuring clarity in intergenerational justice. Existing arrangements make it virtually impossible to determine whether one generation is being unfairly advantaged over another. Fully funded retirement should allow each generation to benefit from its own efforts and productivity, and provide a strong incentive for maximum work effort.

Fully funded individual retirement accounts on the Australian model may offer more flexibility on retirement ages. In Australia, those with fully funded pensions can retire and receive preferential tax treatment at any age from 55 onwards. The value of the pension, of course, will be lower at 55 than at later ages. The early retiree, of course, could combine part time work with pension income. The Australian system allows greater flexibility than the fixed retirement ages normally applied in formal government pension plans such as in Australia and New Zealand. The funded, contributory model allows those who start work at relatively young ages to retire earlier than under alternative schemes. The less skilled may well commence work at 16 or 18, and could have a work-history of 30 years by fifty or so, and could well have accumulated enough capital in their fund to enable early retirement. Fully funded superannuation removes the widely documented 'poverty trap' problems with means-tested aged pensions and other benefits where clients have an incentive not to work in order to remain eligible for the benefit. The self-funded retiree can combine work, possibly part time or intermittent, without affecting his or her pension entitlement.

Supporters of government social insurance schemes or even non-contributory plans such as New Zealand Superannuation argue that only government can protect long lived retirees against the ravages of inflation and ensure that the retired benefit from increases in real wages that accompany economic growth. Pay-as-you-go schemes allow governments to fund inflation and/or average wage indexed aged pensions by raising revenue from those currently in the workforce. Wages, in the long term, tend to increase in line with inflation and economic growth so those in the workforce need not necessarily pay higher proportions of income to support the retired.

With fully funded retirement on the Australian model, the retired may not be protected against the loss of their relative income position, because of general improvements in the level of real income and wages in the community due to higher real economic growth rates. A growth in real wage levels of two and a half per cent per year means a doubling in real wages in 28 years. A retiree would experience a decline in relative living standards, even assuming he or she received a normal rate of return on investment in the annuity. This decline could become a real problem given that many retirees can expect to live for two decades or longer after retirement. Self-funded individual retirement accounts do not necessarily solve the problem of the relative living standard of the proportion of the aged who live long after retirement. The problem becomes even greater if, as is now common, many retire earlier than 65. Long lived retirees have the option of using the minimum safety net – presumedly updated for wages and/or general living standards – as their private retirement income declines. Governments may, of course, refuse self-funded retirees access to the general safety net but may allow access if the self-funded retiree has managed the retirement fund prudently and its decline is no fault of the member.

Supporters of fully funded retirement schemes do not see a problem with maintaining living standards of the retired. Lawrence Thompson, a Commissioner of Social Security in the United States argues that 'widespread ownership of defined contribution retirement accounts may create a political constituency for fiscally responsible government policies. If so, the pension institution itself may facilitate improved macroeconomic policies. The positive economic effect is transmitted through the political process.' [30]

New Zealand – without pension fund pressure but with encouragement from overseas lenders – has become a world leader in responsible fiscal behaviour in the past decade and low inflation is a key political and economic objective. Global financial markets now punish countries with high inflation and interest rates tend to rise to ensure reasonable real rates of return on investments. It is too soon to tell if low inflation is a permanent feature of western economies. The discipline of the past decade is in great contrast to the high rates of inflation, budget deficits, and high levels of government borrowing over the previous three decades. Supporters of fully funded retirement also claim that stock markets tend to rise according to inflation.

If New Zealand rejects a funded individual retirement scheme, it will probably have to make its retirement benefit system less attractive. There will be strong pressures to make the benefit similar to the

Australian aged pension, which is significantly less generous as a proportion of average earnings and far more rigorously means tested, with controls on both income and assets. A non-compulsory system is likely to be successful only if the alternative is less attractive than at present. Tighter means tests, the equalisation of the aged benefit with unemployment and other benefits – as in Australia – and the gradual raising of the retirement age to 70 would create far stronger incentives for the next generation of New Zealanders to provide for their own retirement.

To conclude, despite reservations about the Australian scheme, the writer believes that New Zealand should look seriously at introducing a fully funded individual retirement system in the near future. Even Sweden, the home of socialised welfare, has introduced a form of generational accounting in its reformed retirement system.[31] The idea is the most popular innovation in 50 years of social security. The plan rewards work, clarifies intra and intergenerational subsidies, and could provide major benefits to the economy. Feldstein says 'shifting from an unfunded program to a funded one is an application of the general principle that, when you discover you are in a hole, the first thing to do is to stop digging'. New Zealand, to use Feldstein's term, is 'in a hole' with its unfunded superannuation system for its aged. In the writer's view, it is too generous and inequitable, and it deserves to be modified, even if there were no future problem of a dramatically ageing population. A fully funded retirement system should help the economy, improve equity, and cope with an ageing crisis next century.

The financial crisis in the retirement system in the United States and in Europe shows that, despite the best research, in the final analysis, the aged always seem to cost far more than anyone ever predicts. This chapter has only examined the issue of retirement income. The aged are also very costly because of the high costs of their health and social care. Few democratic countries have devised ways of coping with these two growing areas of government outlays, even though they could become more costly next century than the provision of retirement income. If New Zealand continues its present policies, it could find itself facing crises in all three areas.

References

1 Gosta Esping-Andersen 'Conclusion: Occupational Welfare in the Social Policy Nexus' in Michael Shalev *The Privatisation of Social Policy? Occupational Welfare and the Welfare State in America, Scandinavia and Japan*, Macmillan, London, 1996, p. 335.

2 The report is discussed in 'How to Fix Social Security', *Business Week*, January 20, 1997, pp. 26-8.

3 'Stakeholder' has become a popular term in the British Labor party. See Brian Burkitt and Frances Ashton 'The Birth of the Stakeholder Society', *Critical Social Policy*, vol. 16, no. 4, November 1996, pp. 3-16; the emphasis on asset ownership by broad sections of the population is also a key theme in the views of the socialist economist John Roemer. See the debate on his ideas in Erik Olin Wright ed. *Equal Shares: Making Market Socialism Work*, Verso, London, 1996.

4 World Bank *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, Oxford University Press, Oxford, 1994.

5 Definitions for defined benefits and defined contributions are from E. Philip Davis *Pension Funds: Retirement-Income Security, and Capital Markets. An International Perspective*, Clarendon Press, Oxford, 1995, pp. 300-301.

6 Martin Feldstein 'The Missing Piece in Policy Analysis: Social Security Reform', *American Economic Association, Papers and Proceedings*, vol. 86, no. 2, May 1996, pp. 1-14; see also Martin Feldstein 'Fiscal policies, capital formation, and capitalism', *European Economic Review*, vol. 39, 1995, pp. 399-420.

7 OECD *Economic Surveys New Zealand 1996*, Paris, 1996, p. 1643.

8 See for example Eric R. Kingson and James H. Schulz eds. *Social Security in the 21st Century*, Oxford University Press, New York, 1997; of course, intense debate and major reforms on social security can arise even when there is no separate tax. Australia is a good example. The Australian Treasury spent many years educating the population about the cost implications of an ageing population.

9 *Revenue Statistics of OECD Member Countries 1965-1994*, OECD, Paris, 1995, p. 74.

10 W. Erwin Diewert and Denis A. Lawrence 'The Excess Burden of Taxation in New Zealand', *Agenda*, vol. 2, no. 1, 1995, p. 31; more detail is in W. Erwin Diewert and Denis A. Lawrence *The Marginal Costs of Taxation in New Zealand*, Swan Consultants, Canberra, 1994.

11 See *Economic Roundup* Summer 1995 for a review of the OECD report on Taxation and Household Savings.

12 Edward M. Gramlich 'How Does Social Security Affect the Economy?', in Eric R Kingson and James H. Schulz eds. *Social Security in the 21st Century*, Oxford University Press, New York, 1995, p. 152.

13 E. Philip Davis *Pension Funds: Retirement-Income Security, and Capital Markets. An International Perspective*, Clarendon Press, Oxford, 1995, p. 6. Estimates for New Zealand are not available.

14 Martin Rein 'Is America Exceptional? The Role of Occupational Welfare in the United States and the European Community', in Michael Shalev ed. *The Privatization of Social Policy? Occupational Welfare and the Welfare State in America, Scandinavia and Japan*, Macmillan, London, 1996, p. 41.

15 See World Bank *The East Asian Miracle: Economic Growth and Public Policy*, Oxford University Press, Oxford, 1993.

16 Vince Fitzgerald *An Assessment of Current Superannuation Arrangements*, CEDA Information Paper no. 44, March 1996, p. 18.

17 'Of politicians and piggybanks', *Economist*, January 11, 1997, p. 72. The article reviews numerous articles on the role of incentives in savings and notes the conflicting evidence.

18 This is just an observation about Australia from personal conversations. The government often stated that this was not so, that the pension would remain intact, but this seems to increase public suspicion. The American data is from Virginia P. Reno and Robert B. Friedland 'Strong Support but Low Confidence' in Eric R. Kingson and James H. Schulz eds. *Social Security in the 21st Century,* Oxford University Press, New York, 1997, pp. 178-94.

19 See, for example, Diana Cook and John Savage *The Fiscal Impacts of an Ageing Population,* NZ Institute of Economic Research, Wellington, 1995.

20 See the detailed discussion of Thomson's work in Alan Walker ed. *The New Generational Contract: Intergenerational relations, old age, and welfare,* University College London Press, London, 1996; see also the collection (including an interesting paper by Thomson in Peter Laslett and James S. Fishkin eds. *Justice between Age Groups and Generations,* Yale University Press, New Haven, 1992.

21 The Treasury *Tax Expenditures Statement,* AGPS, Canberra, 1995, p. 46.

22 Toni Ashton and Susan St John *Superannuation in New Zealand: Averting the Crisis,* Institute of Policy Studies, Wellington, 1988.

23 This claim is difficult to prove. See the references in E. Philip Davis *Pension Funds: Retirement-Income Security and Capital Markets. An International Perspective,* Clarendon Press, Oxford, 1995, pp. 87-8.

24 See the summary of research by the International Monetary Fund in 'Retirement Revolution', *Economist,* 23 November 1996, p. 105; more detail on the Chilean scheme is in Barbara E. Kritzer 'Privatizing Social Security: The Chilean Experience', *Social Security Bulletin,* vol. 59, no.3, Fall 1996, pp. 45-55.

25 Ajit Singh 'Pension reform, the stock market, capital formation and economic growth: a critical commentary on the World Bank's proposals', *International Social Security Review,* vol. 49, no.3, 1996, pp. 21-44.

26 Estelle James 'Providing Better Protection and Promoting Growth: a defence of *Averting the Old Age Crisis*', *International Social Security Review,* vol. 49, no. 3, 1996, pp. 3-16.

27 See Joseph E. Stiglitz et al. *The Economic Role of the State,* Blackwell, Oxford, 1989.

28 C. Eugene Steuerle and Jon M. Bakija *Retooling Social Security for the 21st century: Right and Wrong Approaches to Reform,* Urban Institute Press, Washington, 1994, p. 108; similar transfers from the poor to the more affluent are a feature of most social insurance schemes. See Estelle James 'Providing better protection and promoting growth: A defence of *Averting the old age crisis*', *International Social Security Review,* vol. 49, no. 3, 1996, p. 9.

29 David Thomson has documented the intergenerational injustice under the tax-funded New Zealand retirement and public spending system. See David Thomson *Selfish Generations? How Welfare States Grow Old,* The White Horse Press, Cambridge, 1996 (2nd ed.).

30 Lawrence H. Thompson 'Principles of Financing Social Security Pensions', *International Social Security Review,* vol. 49, no 3, Summer 1996, p. 60.

31 Desmond Lachman et al. *Challenges to the Swedish Welfare State,* International Monetary Fund, Washington, 1995.

Chapter 9

Conclusion

The welfare state was once described as a 'safety net' but A.B. Atkinson points out that this is an inaccurate metaphor.[1] A safety net in a trapeze act is designed to catch one or two persons at a time, and is designed for life-saving purposes on rare occasions. Atkinson suggests that 'lifeboat' is a better term. By law, lifeboats on a sinking ship have to have sufficient capacity to carry all ship passengers to safety. Even this is not all that accurate a metaphor, because many on the welfare lifeboats stay on board for years: some never reach land. American critics of the welfare state claim that modern benefits have created an excessively comfortable 'hammock' for the poor. Welfare reformers want to transform the 'hammock' into a 'trampoline'. The poor will 'bounce' on and off welfare quickly.

By 1997, it appears that a growing and internationally competitive economy has limited impact on the scale of social dependency. New Zealand has found, like most western countries, that economic growth does not solve the problem of large scale social dependency. Dependency has risen during recent recessions and rarely falls to former levels even when the economy is growing rapidly. Unemployment has fallen since the peaks in the 1990s recession, but the six per cent level is well above the 3.9 per cent rate in 1986. In June 1996, there were still 187,887 men, women and their dependent children on unemployment benefits. The proportion unemployed for long periods has fallen over the past few years but is still substantial. Single parents, the main group receiving domestic purposes benefits, also remain a serious problem. Those adults receiving domestic purposes benefits have almost trebled in numbers from 1980 and have increased by eight per cent between 1994 and 1996. In 1996, 292,152 adults and dependent children were reliant on domestic purposes benefits (108,789 adults and 183,363 children). The growth and persistence of social dependency in New Zealand is better understood by studying longer term trends than by just focusing on the recent past. Excluding dependent children, the numbers on unemployment benefit in 1996 have grown by 6.4 times since 1980. Those on sickness benefits have increased by 4.4 times, invalids by 2.7 times and domestic purposes by 2.9 times. These levels are far above the population increase over the period of only 13 per cent.

The continuation of large numbers of the non-aged on welfare benefits would be less serious if most of the unemployed and single parents – both potentially in the workforce – were only on benefits temporarily. Receiving benefits for a few months to cope with a short term crisis is very different from long term welfare dependency: the longer the period on benefit, the more likely skills will become obsolete, self-esteem decline, and employability reduced. Statistics on stocks and flows of those on benefits are not readily available in New Zealand. Overseas experience suggests that researchers should look at dependency patterns over a five-year period.[2] Patterns over five years make a major difference to our view of the composition of the poor. Current snapshot, cross-sectional measures of poverty – and even these are inadequate in New Zealand – do not record the dynamics of movements in and out of poverty. They seriously exaggerate the importance of those who are merely on benefits for a short time. What may appear to be short terms on benefits may in fact be frequent benefit 'spells' by largely the same group. Two or three years on benefit over five years in a number of episodes is seriously dependent, even if individual spells are only of a few months' duration.

There are no simple solutions to continuing high levels of long term social dependency amongst the non-aged in New Zealand. Economic growth on its own is not likely to be enough. Many of the non-aged dependent on benefits seem strangely insulated from broader economic changes and expanding employment opportunities. New Zealand, like other western countries may have developed some form of dual economy and society where 'outsiders' on benefit have little to do with the mainstream economy or society. New approaches call for more active strategies to reduce dependency. New Zealand has to examine other options such as time-limited benefits for unemployment and single parenthood and more systematic human capital strategies.

Single parents

New Zealand, Australia, Ireland, and the United Kingdom have long had the most liberal approaches to single parents on benefits, as none require the single parent to seek work until the youngest child is at least 16. Continental European countries have generally been more demanding of work effort by single parents. Single parents on benefit have to seek work when the youngest child reaches five years in the

Netherlands, and three years in Austria, Sweden and Finland. In some ways the liberal approach in New Zealand is unusual since so many women with children are in the workforce so staying at home until the child is 16 is no longer a dominant social norm. The European approach may be more draconian, but helps the single parent maintain workforce experience, essential to preventing long-term dependency. In Sweden, 90 per cent of single mothers work, usually at reduced hours.[3]

There is now an emerging consensus in the United States that there should be time limits to single parent benefits. In 1996, President Clinton implemented a plan to devolve 'welfare' mainly for single parents, back to the States who were encouraged to 'experiment' with programs to end social dependency by forcing single mothers into the workforce.[4] This dramatic action, by a Democratic President, shows how welfare state thinking has become very radical, at least in the United States. The new plan is based on a maximum continuous limit of two years on single parent benefit. The single parent must then find a job, undertake approved training, or work at a government-created position. Single parents are limited to a lifetime maximum five years on benefit.

Some welfare specialists are sceptical of the new tough policy. Financially pressured governments may want single parents to work, but retraining, job placement, and child care and special job creation schemes are expensive. Only a minority of these programs are effective, and they require extraordinary abilities and commitment by skilled staff. High program costs can make single parent benefit payments look like a bargain: single parents on benefit provide low cost child care. An expansion of well-designed programs to assist children of those on benefits may be the most appropriate short term response to the problem.[5]

Human capital

Human capital is undoubtedly the most popular solution to long term dependency problems in the welfare state. Better education and training can reduce long term welfare dependency by increasing employability and can raise incomes for vulnerable groups, thus increasing the opportunities for higher savings and greater self-reliance. Each report by the Organisation for Economic Cooperation and Development (OECD) on the New Zealand economy exhorts New Zealand to spend more on developing its human capital. Sophisticated economic research supports a human capital strategy as a significant independent factor in economic growth.[6]

However, it is not easy to implement human capital improvements in western countries. Australia has spent very large sums on expanding education and training over the past decade. There is now disillusionment with parts of this strategy.[7] Unemployment in Australia is still high – around twice the level of the Pakeha in New Zealand, if account is taken of those on government-created jobs and in official training schemes. Australia spent A$1.9 billion on labour market programs in 1995-6 (Working Nation), but unemployment was only slightly below what was expected at that stage in the economic recovery cycle in 1996. In its 'Working Nation' program, Australia followed the Swedish example of an 'active manpower policy', promoted by the OECD for many years. The Swedish model is expensive – requiring one government employee per 15 unemployed – and can alter labour markets in negative ways.[8] The success of the Swedish model required continually expanding government employment, which was also expensive and unsustainable in the long term.[9] Human capital strategies are most likely to be effective if they are well planned, based on changing incentives and major structural changes to existing dominant educational and training institutions.

The aged

As Chapters 7 and 8 show, the problems of the aged are quite different. Old age is a predictable event for which most people, over their lifetimes, can make appropriate provision. The opportunity exists to put in place a system that will deal with many of the problems of an ageing population, but self-funded retirement requires a long phase-in period and so a debate on the matter is needed now.

While controversial, proposals for self-funded retirement are capable of broad appeal. The Right like the emphasis on markets, competition and self-reliance. The Left sees the possibility of dispersed stock-ownership as a way to increase working class assets in a similar way to home ownership and to influence the capitalist decision-making process: it can be substitute for nationalisation of industry, now out of favour.[10] The prospect of dealing with important issues of intergenerational justice also appeals to political thinkers. Already we are seeing large transfers of wealth from the young to the elderly, who will on average receive back from government more than they contributed in taxes over their working lives. As the population ages problems of intergenerational justice will become more acute, and the young could become resentful that their own capacity to have an adequate standard of living and support a family is restricted by the high taxes needed to fund the needs of the dependent elderly.

For the vast majority of people who will, due to increased life expectancy, enjoy long years of retirement, self-funded retirement can offer more security and more choices. While retirees will be subject to the uncertainties of investment, they will be less vulnerable to changes in government policy. At present governments can change benefit levels and eligibility rules, including retirement age. As fiscal pressures increase over time they will have stronger reasons for making these changes. Self-funded retirement removes these dangers, and enables people to plan better for their old age.

Conclusion

Despite its wage deregulation and benefit cuts in 1991, New Zealand still has a comprehensive income support system, reasonably generous by world standards. It has evolved incrementally and it will be difficult to make transformational changes in the same radical spirit that has changed so many formerly valued institutional arrangements. But the debate over what is feasible in social welfare reform is becoming more radical as governments become frustrated at continuing high dependency and apparent lack of progress. Other countries such as Australia and the United States provide some useful examples of policy changes, although many of these innovations such as self-funded superannuation in Australia and the new policy towards single parents in the United States are still too new to be assessed as successes or failures.

The Swiss business school IMD compiles a world competitiveness report each year that rates New Zealand economic reforms highly, as a leader in the 'Anglo-Saxon' restructuring model also used in the United States, the United Kingdom, and Australia. Criticisms of the social costs of this model – justifiable or not – have created new interest in some Northern European models, especially the Netherlands which is combining rapid growth and restructuring with more attention to the social consequences of economic change and the need for greater investment in human capital. The next decade will see competition between the Anglo-Saxon, Dutch, and Asian models. Each approach has advantages and disadvantages and the Anglo-Saxon model's long-term success will depend increasingly on the success in adapting dated welfare state structures to new demands.[11]

New Zealand has always been an innovator, and, once it gives the welfare state enough critical attention, will undoubtedly develop a reform strategy suited to its history, values, and particular social and economic circumstances. It will develop reforms that preserve the compassionate basis of its almost century old welfare state with the need to alter incentives to reward those who work, save, and preserve family structures, while helping those in genuine need.

References

1 A.B. Atkinson *Incomes and the Welfare State: Essays on Britain and Europe*, Cambridge University Press, Cambridge, 1995, p. 276.

2 Mary Jo Bane and David T. Elwood *Welfare Realities: From Rhetoric to Reform*, Harvard University Press, Cambridge, 1994.

3 Gosta Esping-Andersen 'Conclusion: Positive-Sum Solutions in a World of Trade-Offs?', in Gosta Esping-Andersen ed. *Welfare States in Transition: National Adaptations in Global Economies*, Sage, London, 1996, p. 261.

4 Rebecca M. Blank 'Policy Watch: Proposals for Time-Limited Welfare', *Journal of Economic Perspectives*, vol. 8, no. 4, Fall 1994, pp. 183-93.

5 A recent discussion on children's programs is Sheila B. Kamerman and Alfred J. Kahn *Starting Right: How America Neglects Its Youngest Children and What We Can Do About It*, Oxford University Press, New York, 1995.

6 Norman Gemmell 'Evaluating the Impacts of Human Capital Stocks and Accumulation on Economic Growth: Some New Evidence', *Oxford Bulletin of Economics and Statistics*, vol. 58, no. 1. 1996, pp. 9-28.

7 See Economic Planning and Advisory Commission *Future Labour Market Issues for Australia*, AGPS, Canberra, 1996; see also the critical review of training in western countries in 'Training and Jobs: What Works', *The Economist* April 6 1996, pp. 19-21.

8 The high level of staff required in active manpower policies is detailed in Jukka Pekkarinen, Matti Pohjola, and Rob Rowthorn eds, *Social Corporatism: A Superior Economic System?*, Clarendon Press, Oxford, 1992, p. vi.

9 Lars Calmfors and Per Skedinger 'Does Active Labour-Market Policy Increase Employment? Theoretical Considerations and Some Empirical Evidence from Sweden', *Oxford Review of Economic Policy*, vol. 11, no. 1, 1995, pp. 91-109.

10 In the British context see Andrew Gamble and Gavin Kelly 'The New Politics of Ownership', *New Left Review*, no. 220, November-December 1996, pp. 62-97.

11 See the discussion in Fred Brenchley 'Australia rises to 17th in global competitiveness', *Australian Financial Review*, March 27, 1997, p. 10. This article reports on the latest world competitiveness report compiled by IMD, the Swiss business school and the comments by Professor Stephane Garelli.

Index