New Zealand Superannuation is not akin to a Ponzi Scheme

by Keith Rankin, 30 March 2012

New Zealand Superannuation is nothing like a Ponzi scheme, as Brian Fallow claims (Now is the time to de-Ponzi our pensions, 29 March).

To appreciate this we need to know what Ponzi finance actually is, and what part of Ponzi finance can appropriately be called a scheme.

The simplest example of Ponzi finance relates to the use of credit cards. If, for whatever reason, a person cannot service their credit card debt from earnings, then the principal alternative is to service it by adding to their debt; that is, by further borrowing.

A person might have credit cards with two different banks, using each credit card to service the other. Once the credit limits are reached, that person borrows more by accepting offers of higher credit limits, applying for higher credit limits, or applying for another loan or credit card, possibly from a third bank.

In itself there may be nothing wrong with this; for example if a person is between jobs and has a reasonable expectation of gaining future employment sufficiently well-paying to enable him or her to service the debt in future out of income.

In a society where Ponzi finance becomes commonplace, the financial system becomes unstable, and a financial crisis becomes probable. The year 2008 has been labelled a “Minsky moment” by some, in honour of the economist who described the links between Ponzi Finance and financial instability.

Ponzi finance is named after the American spendthrift, Charles Ponzi, who in 1920 ran up huge debts to satisfy his own high maintenance lifestyle, and was able to service his debts by persuading both new creditors to lend to him, and existing creditors to leave their money in his care, rewarding them with high returns.

Because Ponzi had intentionally defrauded his creditors, knowing that default was only a matter of time, he was running what is now known as a Ponzi scheme.

There is a valid argument that much inter-country finance is Ponzi in nature. It must be emphasised, however, that such finance is generally transparent, and is undertaken by creditor countries with full awareness of its Ponzi-like nature.

Thus we see countries from East Asia, the Middle East, and northern Europe, who, by running large and ongoing current account surpluses lend to countries with long histories of borrowing (current account deficits), enabling debtor countries such as New Zealand and Australia to spend more than they earn on a seemingly indefinite basis.

Repayment to these creditor countries can only take one form, imported goods and services. There remains little evidence that these creditor countries have any interest in such repayment, given that they continue to try harder than ever to run surpluses. So, these creditor nations, while participating in something akin to Ponzi finance, can hardly be said to be the victims of any Ponzi scheme.

There are also claims that the world's principal financial centres are operating global Ponzi schemes. Nicole Foss made such a claim in a Kim Hill interview on Radio New Zealand on 24 March.

The argument here is that those creditors who are generally more interested in accumulating money than spending it, are receiving financial returns from a whole range of "investment" activities that fall far short of meeting an appropriate economic definition of investment. If so, then there would be few actual returns from productive investment to pay out those creditors, should they in sufficiently large numbers opt to go on the spending spree that their savings entitle them to.

So, what of New Zealand Superannuation? This is a taxation-based scheme, that involves some distributive correction, and that employs the life-cycle principal that working age generations run surpluses (disposable incomes less than their gross earnings) so that non-working-age generations can run deficits. It's not a financial scheme at all.

From time to time, changing demographics means that the ratio of working-age to non-working age people may be unusually low, or unusually high. In the 1950s and 1960s, that ratio was unusually low, with both many elderly people from the late 19th century baby boom, and many children. In the 1980s and 1990s that ratio was unusually high. We anticipate that the ratio will be low again in the 2020s to 2040s, especially if we maintain tight immigration restrictions.

In the 1950s and 1960s we managed by not needing to pay many benefits other than pensions and family benefits. And we managed then by levying higher marginal tax rates on those of working age who, due to their higher incomes, faced the least burdens.

From the 2020s, the principle of transferring disposable income from working-age to non-working age generations will remain intact. It will be eased, if the 2020s' labour market turns out to be tight, by many older people choosing to be net taxpayers. This has nothing whatsoever to do with Ponzi schemes.

If, in the 2020s, the labour market is not tight, then our problem will not be the affordability of public pensions. Rather, the problem will be as it is now, finding productive employment for those of working age.

In the 2020s it is likely that any actual Ponzi schemes will be exposed, as large numbers of retirees wishing to withdraw their private savings will find themselves disappointed. The good news is that, for New Zealanders at least, there will be New Zealand Superannuation to fall back on.