

Setting and adjusting the rates of New Zealand Superannuation

A Submission to the Commission for Financial Literacy and Retirement Income on the 2013 Review of Retirement Income Policies

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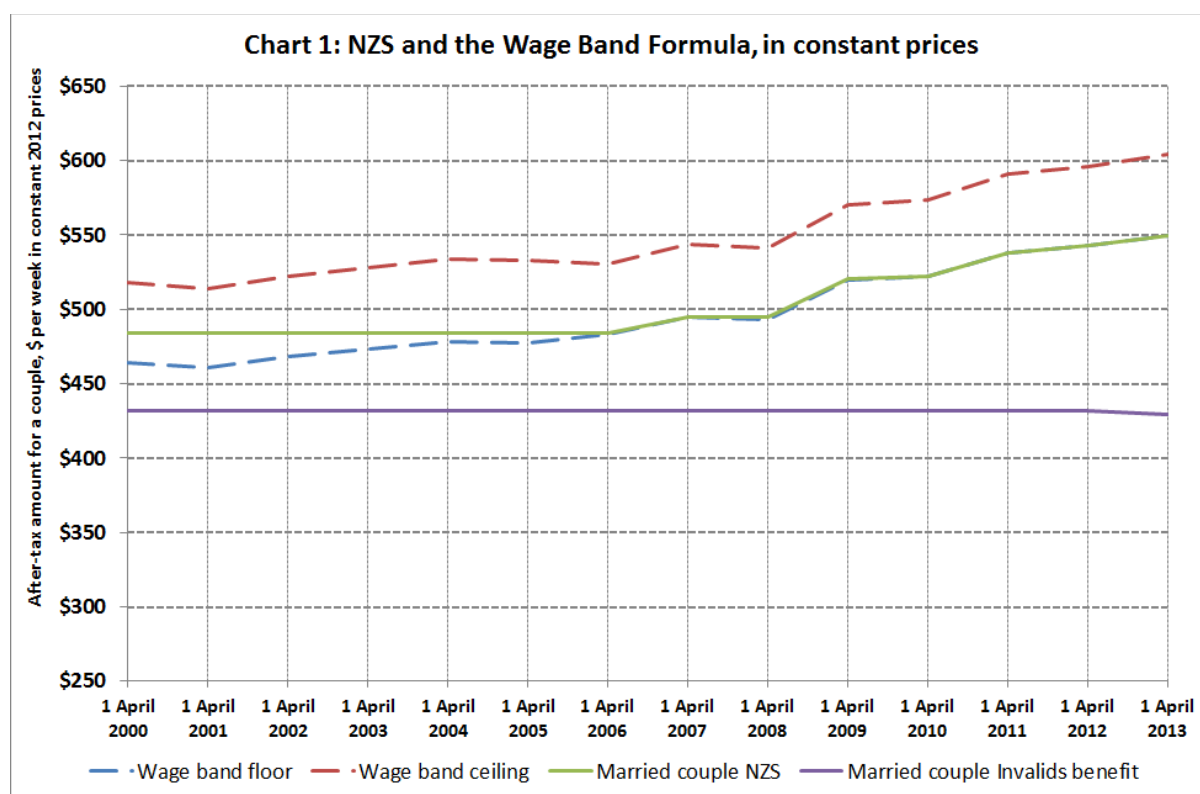
This submission argues that

- The present annual adjustment formula for New Zealand Superannuation (NZS) will soon become a serious pressure point affecting the long term sustainability of the retirement income system and that modifying this formula should therefore form part of any package of changes designed to keep the system fiscally affordable.
- The rationale for the current formula is based on a misplaced view of the best way to provide security in old age, because NZS is paid at standard rates irrespective of individual circumstances and whether people have access to other assets and income. If spending on NZS continues to rise, this could crowd out more effective programmes of assistance to seniors tailored to areas of greatest need.
- Modifying the formula can and should be done in a way that continues to recognize the critical contribution of NZS as an annuity that covers longevity risk, particularly for women, and its feature of not penalizing people for continuing in paid work beyond the age of eligibility for NZS.
- Adjusting the formula would be a complementary policy to raising the age of eligibility as its incidence is broader and it would reduce the need for a more extreme change using just one instrument.

The rising real value of the NZS pension

Rates of NZS are increased with effect from April each year using the “wage band” indexation formula that is set out in legislation. Essentially this formula performs two functions: it adjusts the pension for any increases in the cost of living, as indicated by rises in the Consumers Price Index (CPI), and it can also increase the pension amount when average weekly earnings in the economy rise faster than the cost of living.

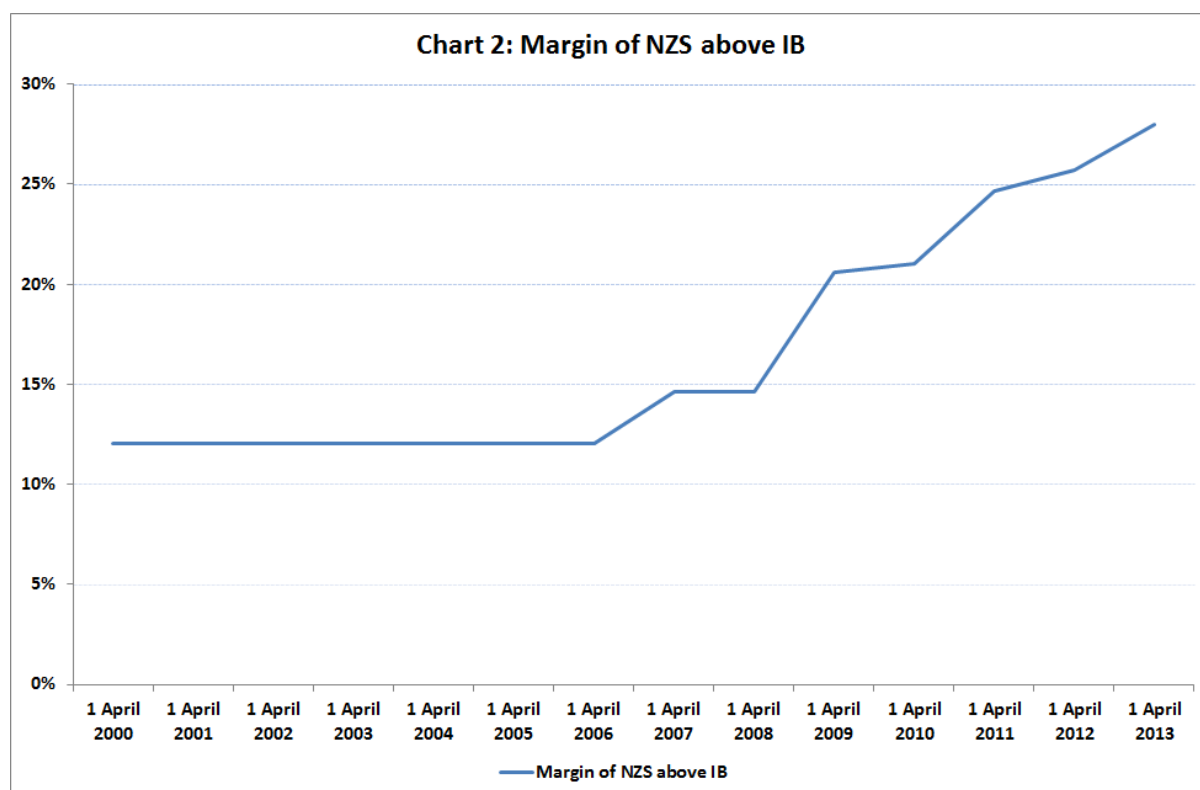
The effect is that the real value of the NZS pension (i.e. after compensating for inflation) is trending upwards, as shown in the Chart 1. This is because, since 2007, the “wage floor” in the annual pension adjustment formula has risen to a level where, in most years since then it has required that NZS be adjusted by more than just the rate of inflation. In fact, the NZS pension, after tax, is **13.7 percent higher** in 2013 (in real purchasing power terms) than it was in 2006.



Other government welfare transfers are not adjusted in the same way. Chart 1 also shows for comparison the amount paid to a couple where one partner is eligible for invalids benefit (IB) and the other partner has little or no income, usually because he or she is caring for the invalid partner. IB, like other income-tested benefits, is adjusted solely for CPI inflation each year, which is why Chart 1 shows IB as a flat line in constant price terms¹. Historically this benefit has been below the amount of NZS, but IB does not get the same upward adjustment when real average weekly earnings increase. As a result, the margin between NZS and IB has widened significantly in recent years, from

¹ Slight variations can arise because the CPI movement is taken as over a calendar year, while benefits are set for the year commencing 1 April.

12 percent to 28 percent for a couple, as seen in Chart 2, and will widen further in the future under current policies.



In constant 2013 price terms, a couple who were both qualified for NZS used to receive \$52 per week **more** than a couple relying on Invalids Benefit would receive. That margin was steady up until 2007. Today, that margin has opened out to \$120 per week (\$60 per partner).

Note that other income-tested welfare benefits such as Sickness Benefit, Domestic Purposes Benefit for Women Alone and Unemployment Benefit are paid at lower rates than Invalids benefit. Therefore the margin of NZS income support above these other benefits is even greater, as shown in Table 1.

Table 1: Differences between NZS maximum weekly pension amounts and selected income-tested benefit rates, as at 1 April 2013 (net of tax).

	NZ Super pension	Invalids Benefit	DPB Women Alone Benefit	Sickness or Unemployment Benefit
Single person, living alone	\$357.42	\$257.75	\$214.79	\$206.21
<i>NZS margin above Benefit</i>		<i>\$99.67 (39%)</i>	<i>\$142.63 (66%)</i>	<i>\$151.21 (73%)</i>
Single person, sharing accommodation with others	\$329.93	\$257.75	\$214.79	\$206.21
<i>NZS margin above Benefit</i>		<i>\$72.81 (28%)</i>	<i>\$115.41 (54%)</i>	<i>\$123.72 (60%)</i>
Person who is married or in defacto relationship	\$274.94	\$214.79	Not applicable	\$171.84
<i>NZS margin above Benefit</i>		<i>\$60.15 (28%)</i>		<i>\$103.10 (60%)</i>

The rise in other income sources

By definition, income-tested benefits are paid only to people with very limited amounts of other income, but this is not the case with NZS. NZS entitlements are not clawed back from people who have assets or other sources of income².

Remember that an NZS pension forms only part of the total income of many older people. Table 4.1 in the 2010 Review of Retirement Income Policy set out the proportion of people aged 65 plus who received various types of income, and the average amount of that income. Table 2 below updates that information to 2012 and shows that a growing proportion of older people are receiving income from non-pension sources and that the average amount received from most of those sources is also growing.

Table 2 re-confirms that almost all people over 65 receive NZS and that the average rate of NZS is rising in real terms, as described earlier. It also shows however that the proportions of older people receiving investment income, salary or wages and income from self-employment have all increased over the past two years, possibly because of the influx of the post-War “baby boomer” generation into this age bracket. We may expect this trend to continue as more “baby boomers” reach pension age.

It is worth noting that the number of older people who are self-employed has risen sharply over the past two years, from 28 thousand to 43 thousand. Furthermore, the average amount of income from self-employment among this group has risen by over 30%, even after inflation is taken into account.

Table 2: Number of people aged 65 and over who receive income from various sources, changes between June quarters 2010 and 2012.

Income source	Number receiving this source (thousands)		Percent of all people aged 65+		Average weekly amount for those receiving that source		
	2010	2012	2010	2012	2010	2012	Real change
Government transfers (mainly NZS)	517.8	562.1	96.8%	97.8%	\$294	\$322	3.1%
Investment income	280.9	329.6	52.5%	57.3%	\$143	\$151	-0.6%
Wage or salary income	61.0	70.0	11.4%	12.2%	\$641	\$694	1.9%
Of which:							
Full-time employment	31.6	36.6	5.9%	6.4%	\$955	\$991	-2.4%
Part-time employment	29.0	32.7	5.4%	5.7%	\$299	\$357	12.3%
Other transfers	53.0	56.9	9.9%	9.9%	\$272	\$310	7.2%
Self-employment income	28.4	42.9	5.3%	7.5%	\$448	\$629	32.1%
Total people aged 65+	535.0	574.8					

Source: Statistics New Zealand, *New Zealand Income Survey*, Supplementary tables 4 and 5

² The direct deduction of overseas pension income and the income test that applies to the alternative rate of NZS for somebody with a non-qualifying partner are special situations and are not discussed here.

Another indicator of rising incomes among the 65+ age group can be obtained from the NZ Income Survey, using information published on the distribution of personal income, by quintile, i.e. the characteristics of people in each quintile of personal income.

We know that people who are solely reliant on NZS, or who have very modest amounts of additional income, usually fall in the second quintile of personal income and this shows up clearly in the data; people aged 65+ are heavily over-represented in that particular quintile, see Table 3.

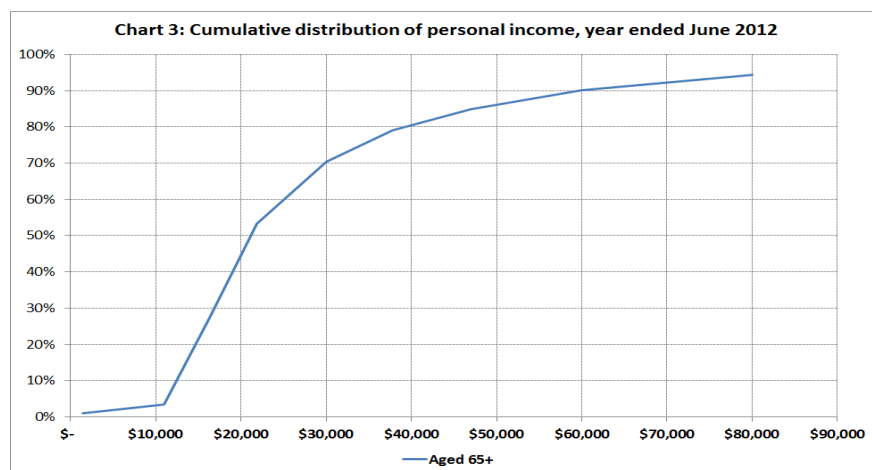
Table 3: Personal income of people aged 65+; proportion in each quintile for the total adult population.

	Quintile 1 (Bottom 20%)	Quintile 2	Quintile 3	Quintile 4	Quintile 5 (Top 20%)
June 2009	2.8%	55.3%	20.5%	9.0%	7.3%
June 2010	3.0%	53.6%	20.3%	10.0%	6.5%
June 2011 ³	2.7%	49.3%	27.2%	9.2%	8.6%
June 2012	1.9%	53.4%	23.6%	10.7%	8.9%

Source: Statistics New Zealand, *New Zealand Income Survey*, Table 8

However, the data also shows that, in recent years, an increasing proportion of 65+ people are placed in the top two quintiles (from 16.3% in 2009 to 19.6% in 2012). In other words, more people in this age group have incomes that are notably higher than just the standard rates of NZS. A further 24 percent have personal incomes that place them in Quintile 3, still above the standard rates of NZS.

The Household Economic Survey (Income) provides another source of information on the incomes of people aged 65+. Chart 3 plots the proportion of older people with incomes below certain levels.



Source: Statistics New Zealand, *Household Economic Survey (Income)*, table 9.

Chart 3 shows that about 50 percent of people aged 65+ have personal incomes up to \$20,000 (the highest rate of NZS in that year), while the other 50% have incomes above this level.

³ In June 2011 the income threshold for Quintile 3 dropped slightly and this resulted in one of the rates of NZS (single, living alone) falling into Quintile 3, which explains the jump in the proportion of 65+ in quintile 3 in that year. In June 2012 however the Quintile 3 threshold increased and all the rates of NZS once again fell within the bounds of the second quintile.

Other factors affecting living standards

Personal income is only one aspect of an older person's capacity to attain and maintain a decent and comfortable standard of living. The 2010 Review (Chapter 4) pointed to a number of additional factors, including whether someone has a debt-free home, other physical and financial assets, and access to various forms of support from family and friends.

Among the financial assets available as a cushion against emergencies or as a regular future source of income are KiwiSaver balances. IRD estimates that 72,000 KiwiSaver members became eligible to withdraw their savings during the year to 30 June 2013. However the monthly flow of account closures suggests that more than half of these members have chosen not to withdraw from KiwiSaver at this stage and instead may be keeping their balances intact in the meantime.

Although the accumulated savings balances of those eligible to withdraw are relatively small, typically between \$5000 and \$20,000, the size of available balances can be expected to increase year by year as successive cohorts reach NZS eligibility age.

On the downside, of course, there are factors that can act to limit a person's ability to cope, even with personal income above the standard pension.

In his very useful review of the range of policies and programmes for older New Zealanders, David Preston notes that the great majority of the current cohorts have adequate or comfortable living standards, with a relatively small percentage experiencing hardship. This can be put down to the mix of a modest universal pension, access to a range of publicly funded services provided to all age groups and targeted supplements and services for those older people with particular needs⁴.

Preston also notes, however, that there are some disparate trends that suggest that later cohorts of people reaching NZS eligibility age will be more diverse than in the past. There will be both more poor and more affluent proportions.

For example a greater proportion of today's working age population will reach age 65 without owning a home debt-free, and having experienced periods on a benefit. They will have had little opportunity to accumulate a financial nest-egg for their retirement and may also have fragile family support networks. At the same time, other trends point to growing future affluence in old age among those who were two-income earning households, gained from owning their homes when house prices were booming, are accumulating savings from high paying work and are capable of continuing to earn beyond age 65.

If this is correct, then it would seem sensible to re-balance policy so that a relatively lesser proportion of taxpayer-funded transfers are committed to increasing the universal flat rate pension and a relatively greater proportion to funding programmes that address the key areas of vulnerability among older people.

⁴ Preston (2013), *The Contribution of Wider Policies and Programmes to Living Standards of Older New Zealanders*, a paper commissioned for the 2013 Review of Retirement Income Policy by the Commission for Financial Literacy and Retirement Income. Section C.

It is important not to throw out the baby with the bath water. The case for having a universal, flat-rate NZS pension remains very strong. It provides efficient longevity risk protection by guaranteeing a minimum real level of income for as long as a person lives. It avoids the disincentives to save and to continue earning and employment beyond eligibility age (unlike most overseas pension designs). It is simple to administer because it does not require lifetime earnings or contributions records to be kept. Its clear set of individual, unconditional entitlements by virtue of citizenship fosters social cohesion and is part of our sense of national identity. Finally NZS, together with a range of other supporting programmes, provides a really effective safety net and is the means by which New Zealand has achieved the lowest rates of poverty among older people in the OECD⁵ (even while poverty remains noticeably higher among younger age groups).

But none of these merits is significantly threatened if the real level of the entitlement is maintained but is constrained from expanding and the fiscal savings from doing this are channeled to other programmes and/or to debt reduction.

Such rebalancing can be done in a straightforward way by changing the NZS indexation formula so that only a portion of any “real earnings growth” dividend is passed on to pension rates. This change was suggested in the 2010 Review (Recommendation 6.1) but, like most of the recommendations of that review, it has not been acted upon.

Summary of the argument

1. NZS payment rates have increased by 13.7 percent in real terms since 2006, while income-tested benefit rates have not changed. The gap between an Invalids Benefit and NZS is now approaching 30 percent (or 40 percent for single people living alone).
2. NZS is paid without an income test and a growing number of older New Zealanders (at least half) have other sources of income and savings in addition to their NZS. This means that measures of “income adequacy” should not look solely at the size of the NZS pension.
3. Living standards among older New Zealanders are generally comfortable (2010 Review, Chapter 4), but there are vulnerable groups at risk of hardship. There are also indications that the range of living standards will become more diverse, with increasing proportions of both vulnerable and well-off older people.
4. In light of these developments, it would seem sensible to change the indexation regime for NZS so that pension rates are fully protected against inflation but are not increased to maintain relativity with future real growth in average weekly earnings. This change would help ease pressures on NZS cost rises. It would also help fund programmes addressing areas where older people are most vulnerable, such as home rentals, insulation, healthcare and disability support.
5. More generally, social investment in families’ capabilities, networks and opportunities to earn and save prior to retirement age would help reduce the prevalence of vulnerability in old age.

⁵ See for example OECD “Pensions at a Glance, 2011” Part II, Chapter 3.