Income support

Introduction

This position paper is about the objective of income support to alleviate poverty and hardship in old age. It focuses on income derived from New Zealand Superannuation (NZS) or other pension schemes, accumulated savings and assets – although some people will also derive income from working past the age of eligibility for NZS. The adequacy of retirement income is influenced by the extent of other support available, for example through the health system or housing or transport policies and programmes. These additional matters are discussed in the position paper on “Wellbeing”.

History

An income-tested Age Benefit, introduced in New Zealand in 1938 for people aged 60 and over, was a classic example of a policy focused on poverty alleviation[1]. However, the Age Benefit was accompanied by a separate universal benefit for people aged over 65 years. Over time, these two benefits effectively merged at age 65 (Preston, 2008). The 1972 Royal Commission of Inquiry into Social Security in New Zealand first spelled out that an adequate benefit should allow people to belong to and participate in the community, and proposed setting all benefit rates at a percentage of the ruling rate of wages paid to building and engineering labourers, or of the lower quartile of adult male earnings (Crossan, 2010).

The income support element of retirement income policy recognises that people with little or no savings, who cannot earn an income or who face particularly high and unavoidable costs, are unable to support themselves financially. The social welfare system exists to help in such situations by providing a basic level of income support funded out of general government revenue. NZS is very effective in keeping poverty rates low among older people but it also has several features which are not normally associated with a programme focused exclusively on alleviating poverty. In particular, NZS is not targeted solely at those on low incomes (Crossan, 2010; Perry, 2010).

Assessing levels of need for income support

There are a number of possible ways for determining needs for income support in retirement:

- As a proportion of individual pre-retirement income (a *replacement rate*).

  For example, an individual might aim at accumulating assets that together with other entitlements will generate 60% of their pre-retirement income;

- As a proportion of median or average income.

  This is the approach taken in New Zealand, where New Zealand Superannuation is currently set for couples at 66% of average ordinary time earnings after tax (i.e. 33% per partner in the relationship). For single people living alone, the pension is about 40% of

[1] As was the first public pension, introduced in 1898.

that average wage. The level of payment is reviewed each year and adjusted to take account of increases in cost of living (inflation) and wages (see position papers on "Citizenship dividend" and "Fiscal restraint and investment" for more discussion on this indexation)[2];

- As an absolute amount required to maintain a certain standard of living.

  Although this approach is not generally used in public provision of retirement income, there is a trend towards calculating what people will need to be able to pay for in retirement (Davey, 2009; Perry, 2009; Matthews, 2012; O'Sullivan & Ashton, 2012)[3] and this may feed into policy development in the future.

Provision of income support

Once needs have been established, different countries use various combinations of "tiers" of income support for people in retirement (OECD, 2011)[4]:

1. A first tier to ensure a minimum standard of living and prevent poverty. This first tier is always publicly funded and often "means tested" so that it is targeted to poorer pensioners and benefits to better-off retirees are reduced. In other words, first tier provision is often used to *redistribute* wealth from those who are richer at the time of retirement to those who are poorer;
2. Second tier provision is based on individual savings, often compulsory and related to workplace earnings (as in Australia). Even when compulsory, the second tier may be associated with incentives such as lower taxation rates. Second-tier savings are designed to achieve some target standard of living in retirement compared with that when working (the replacement rate mentioned above);
3. Third tier provision comes from an individual's private, voluntary savings in addition to the first two tiers.

Second and third tiers can also be divided into two broad types, depending on the way they are accumulated then paid out in retirement:

- As their name implies, **defined benefit** schemes pay out a pre-determined level of retirement income, usually based on the number of years of contributions to a pool of savings and level of income while in employment;
- In **defined contribution** schemes, contributions flow into an individual account. The accumulation of contributions and investment returns is then paid out as a lump sum or more often, converted into a pension-income stream at retirement.

---

[2] As of 1 April 2012, the weekly rates of NZS were $348.92 for a single person living alone ($18,143.84 per annum) and $536.80 for a couple ($27,913.60 per annum). See https://www.sorted.org.nz/a-z-guides/nz-super-rates

[3] See also http://www.superannuation.asn.au/resources/retirement-standard/ and

http://www.msd.govt.nz/about-msd-and-our-work/publications-resources/monitoring/living-standards/index.html

[4] OECD: The Organisation for Economic Cooperation and Development, consisting of 34 of the world's wealthiest or most "developed" countries.

In New Zealand and across the world, the number of defined benefit schemes is declining (John and Levine, 2009; Kahn & Rafaloff, 2009; Dwyer, 2011). This is largely because such schemes created sizeable liabilities for their owners – usually employers – and attendant financial risks that the liabilities would not be able to be met when they fell due. However, it could be argued that NZS is a form of defined benefit scheme as today's taxpayers contribute throughout their working lives (to the previous generation of workers' retirement income) in the expectation that they will also receive the same amount of gross retirement income when their turn comes. This approach to funding NZS is described as *PAYGO* (Pay as you go).

Defined contribution schemes have become more the norm as financial risk has been shifted to individual members, i.e. the actual amount available to fund their retirement income is affected by investment outcomes. The "pre-funding" of retirement income represented by defined contribution schemes is an example of *SAYGO* (Save as you go). KiwiSaver is such a scheme.

The tendency towards direct contribution schemes increases the degree to which each cohort of retirees funds their own retirement income (see position paper on "Intergenerational equity (cohort self-funding)"). This can be a good thing, but there is also a temptation for governments facing budget pressures to increasingly shift the responsibility for funding retirement income from:

- Public to private provision (tier one to tiers two and three)
- PAYGO to SAYGO

While superficially attractive, such shifts can create distortions in savings behaviour and compromise objectives relating to wellbeing, risk pooling and citizenship dividend (see relevant position papers). The impact on the "transition generation" can be unfair – if they end up paying for two retirements – and threatens the political sustainability of retirement income policy. Policy based on a workplace-based tier two also disadvantages workers in lower paid or "marginal" jobs and women, who are more likely to take breaks in employment and earn less while they are employed.

New Zealand's system performance

New Zealand's retirement income framework is very unusual. Along with Ireland, it is one of only two OECD countries not to have a mandatory, tier-two provision. The universal, non means-tested nature of NZS is also unusual, as is the lack of any special tax treatment for superannuation payments.

Nevertheless, New Zealand has the lowest old-age income poverty rate (1.5%) in the OECD (because NZS is paid above the OECD poverty benchmark)[5] compared with an OECD average of 13.5% and Australia at 26.9% (because the Australian Age Pension comes in below the OECD benchmark). By comparison, poverty rates among the whole population are 10.8% in New

[5] The way that levels of NZS are set virtually guarantees this result.

Zealand, 10.6% in the OECD and 12.4% in Australia (OECD, 2011; Perry, 2011)[6]. According to Perry (2011) "the lower hardship rate for older New Zealanders reflects the mix of universal public provision (mainly NZS) and the private provision built up by most of the current cohort over their lifetime. A key component of this private provision is mortgage-free home ownership which is relatively high among the current cohort". Housing is a key non-monetary component of retirement income and there is a much lower poverty rate among older New Zealanders who own their own home (Crossan, 2010). However rates of home ownership in New Zealand are declining (New Zealand Productivity Commission, 2012) and this trend may have an impact on retirement incomes in the future.

A majority of older New Zealanders remain heavily dependent on NZS for their income: 40% have next to no other income, and the next 20% receive 85% of their income from NZS. Around half of older New Zealanders receive less than $100 per week from non-government sources such as employment, private super and other investment returns (Perry, 2012). Because it is paid at a flat rate, NZS replaces a higher proportion of lower incomes and in that sense is redistributive[7].

The average total value of NZS payments received by New Zealanders throughout retirement also compares favourably with OECD averages (OECD 2011) and because NZS is universal and paid out for the whole of retirement, it provides a degree of protection from the market risks associated with savings and investments, and from the risk of outliving income (see position paper on longevity risk pooling).

So NZS has a number of positive features, but the level of income it provides is very close to the OECD poverty benchmark. Small changes in income can show up as large apparent shifts in poverty levels, but these shifts simply reflect the existence of the strong clustering of household incomes for older New Zealanders at and just above the level of NZS (the "pensioner spike") in the New Zealand income distribution (Perry, 2012). New Zealand's system of income support for retirees is therefore finely balanced and very sensitive to changes in policy. It has for example been mooted that there be an option to take up NZS entitlements at an earlier age but at a lower rate (or defer payments to a later age at a higher rate). While the motivation for this proposal is laudable – to address the shorter average life spans of some groups – it is highly likely that if it were adopted, rates of poverty among younger superannuitants would increase.

Over time, income from KiwiSaver will augment NZS but at current enrolment and contribution rates, is not likely to match NZS. Approximately half of eligible New Zealanders are members of KiwiSaver (Matthews, 2011). The OECD estimates that a total contribution rate of 4% over a working life would eventually replace 14.6% of individual annual earnings (OECD, 2011). At present, 59% of KiwiSaver members are contributing at the rate of 2% of salary or wages and

[6] Note: income poverty measures ignore wealth, home ownership and provision of public services.

[7] Although one peer reviewer pointed out that NZS' redistributive features may be deceptive; it may be that on average richer old people get more because of their longer lifespans.

36% at the rate of 4%. 89% of employer contributions are at the rate of 2% (Inland Revenue, 2012). KiwiSaver will be an increasingly important component of retirement income policy but NZS is likely to continue to be the mainstay.

Summary and conclusions

While New Zealand's retirement income policy is centred on New Zealand Superannuation, well being in retirement is also affected by other aspects of public policy and expenditure – especially in health but also in areas such as housing and transport. NZS stacks up well against other countries' approaches to income support and is very effective in keeping poverty rates low among older people, although it has several features that are not normally associated with a programme focused exclusively on alleviating poverty. In particular, NZS is a universal entitlement rather than being targeted solely at those on low incomes.

A large proportion of retirees depend on NZS and the overall system is finely balanced, highly interconnected and very sensitive to changes in policy.

KiwiSaver will in time make an important contribution to retirement income but any temptation to make this a substitute for the support provided through NZS should be resisted. New Zealand Superannuation is a national treasure. It has served older New Zealanders very well for several decades, and must be retained – although some changes will be required if it is to remain sustainable. If these changes to NZS are to be made in the future, they must be derived from thorough analysis and debate, and introduced incrementally with long lead times.

References

Crossan, D. (2010). *Review of Retirement Income Policy.* Wellington, Retirement Commission: 144.

Davey, J. (2009). *Expenditure in Retirement.* Wellington, Retirement Commission: 28.

Dwyer, M. (2011). *Raising women's future retirement prospects: To what extent do individual superannuation schemes in New Zealand address needs for retirement income in a gender-neutral manner?* Wellington, Commission for Financial Literacy and Retirement Income: 16.

Inland Revenue (2012). *KiwiSaver Evaluation: Annual Report July 2011 to June 2012.* Inland Revenue, Evaluation Services: 32.

John, D. C. & Levine, R. (2009). National Retirement Savings Systems in Australia, Chile, New Zealand and the United Kingdom: Lessons for the United States. Washington, The Retirement Security Project: 35.

Kahn, M. & Rafaloff, R. (2009). "Replicating the Guaranteed Income of DB Plans in a DC World." *Benefits Quarterly 25*(2): 23.

Matthews, C. (2011). *Kiwisaver and Retirement Savings.* Sydney and Wellington, Financial Services Institute of Australasia: 16.

Matthews, C. (2012). *New Zealand Retirement Expenditure Guidelines.* Wellington, Workplace Savings New Zealand.

New Zealand Productivity Commission (2012). *Housing Affordability.* Wellington, New Zealand Productivity Commission: 329.

O'Sullivan, J. & Ashton, T. (2012). "A minimum income for healthy living (MIHL) - older New Zealanders." *Ageing and Society 32:* 20.

OECD (2011). *Pensions at a Glance.*

Perry, B. (2009). *Non-income measures of material wellbeing and hardship: first results from the 2008 New Zealand Living Standards Survey, with international comparisons.* Wellington, Ministry of Social Development: 76.

Perry, B. (2010). *The material wellbeing of older New Zealanders.* Background papers of the Retirement Commissioner's 2010 Review, Ministry of Social Development: 37.

Perry, B. (2012). *Household incomes in New Zealand: Trends in indicators of inequality and hardship 1982 to 2011.* Wellington, Ministry of Social Development: 186.

Preston, D. (2008). *Retirement Income in New Zealand: the historical context.* Wellington, Retirement Commission: 63.

Royal Commission of Enquiry (1972). *Social Security in New Zealand.*