# The Treasury

## Budget 2011 Information Release

## Release Document

## June 2011

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[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[3] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Inland Revenue
Te Tari Taake
Policy Advice Division

THE TREASURY
Kaitohutohu Kaupapa Rawa

Date: 18 March 2011 SH-11-1-3-3

PAD BN 2011/36

To: Minister of Finance and Minister of Revenue

**AIDE MEMOIRE: KIWISAVER – A 3% MEMBER CONTRIBUTION RATE**

Further to our earlier advice on amendments to KiwiSaver[1], you expressed a concern that members that continue to contribute 2% would both see reductions in Government subsidies and miss out on increased matching employer contributions. Such members would see a fall in their KiwiSaver balance at retirement compared to what it would be under present settings. You asked whether a 3% rate would provide a middle ground for these members, particularly those on low income, who do not want or cannot afford to contribute 4%.

The cap on Government contributions already means that lower income earners have a stronger incentive to contribute 4%, and initial experience suggests that default settings and inertia rather than affordability are the main determinants of contribution rates. Nonetheless, there is some evidence that low income members are more likely to choose lower contribution rates, and additional costs to both IRD and employers of introducing a further option would be very modest.

**We recommend a 3% contribution rate be offered to members from 1 April 2012 to enable more members to get the most they can from KiwiSaver**. The default contribution rate for new members would also increase from 2% to 4% from 1 April 2012. The 3% contribution rate would need to be included in Budget night legislation if introduced from 1 April 2012.

**Analysis**

***Would low income individuals stay on 2%?***

Prior to 1 April 2009 the minimum contribution rate was 4% and employer contributions were expected to rise to 4% by 1 April 2011. Since then only 25 per cent of members joining before 1 April 2009 have reduced their rate to 2% despite employer contributions remaining at 2%. Furthermore, since 1 April 2009, when the minimum and default rate was set at 2%, almost 80 per cent of new members contribute at 2%. Thus default settings and inertia seem to be a strong driver for contribution rates, with the result that around half of current members now contribute at 2%, with the other half contributing 4% or (rarely) 8%.

The cap on Government contributions means that incentives are already stronger for low income members to contribute 4%. To maximise the MTC members earning $26,000 need to contribute 4%, and those earning between $26,000 and $52,000 need to contribute more than 2%. A 3% contribution rate would enable members earning between $35,000 and $52,000 to maximise the MTC; those earning less would still need to contribute 4%. Matching employer contributions would reinforce the incentive to contribute 4% and help to ensure that there is little movement the other way (from 4% to 3%).

Nevertheless, there is some evidence that lower income members may opt for lower contribution rates. The members noted above who joined before 1 April 2009, when the minimum contribution rate was reduced to 2%, and subsequently reduced their rate tend to have lower incomes than

[1] *Tax Policy Report: Making KiwiSaver more cost-effective*, T2011/223 and PAD2011/018

those members who have not changed their rate.  Also within the core public sector the 11 per cent of SSRSS members contributing less than 3% (the maximum employer matching level) have lower average incomes (65k vs 70k for other SSRSS members).  However, among KiwiSaver members in the core public sector there is little difference in income between those contributing 2% or 4% (58k vs 59k).

***Impact on household savings from a 3% contribution rate***

Increasing member contributions from 2% to 3%, with employers matching at 3%, should be sufficient to offset the reduction in expected retirement balances from reducing Government subsidies. A member increasing contributions to 4% with matching employer contributions would see a significant increase in their expected retirement balance.  Worked examples are provided in the annex.

The cost of the member tax credit will increase marginally where members do choose to contribute 3% rather than staying on 2%.  Our modelling for the KiwiSaver Budget package assumes that introducing employer matching up to 4% would result in around 75 per cent of members contributing at least 4%.  Given this assumption, even if half of those members remaining on 2% choose the new 3% rate this would cost less than $10 million in additional member tax credit, so would have a limited impact on overall savings from the package.

***Administrative and compliance impact***

An additional member contribution rate should have limited impact on Inland Revenue.  Members only inform their employer or provider of their desired contribution rate; this rate information is not recorded by IR.  Although contribution rates are included in some B2B messaging with providers, such that the change might require some IT changes, we expect these to be small.  Given lead times, changes to forms and information packs should be manageable with limited cost.  This should fall within the $2-3m implementation costs for KiwiSaver changes that IR will be seeking new funding for.

Employers may see a marginal rise in compliance costs, as there would be an additional rate at which employee and employer contributions are made.  Those using commercial payroll systems should have no difficulty with this and would be done alongside other KiwiSaver changes.

To the extent that members do choose 3% rather than 2% this will increase labour costs for employers in the short term.  But this is consistent with your objective to increase the share of private contributions to KiwiSaver.

**Given compliance costs are minimal and the potential benefits for lower income members we recommend members have the option of a 3% contribution rate from 1 April 2012.**

**However, given that members can always make voluntary contributions and the desire to maintain the schemes simplicity, we would not recommend introducing new rates beyond the 3% rate.**

A 3% rate could be introduced from 1 April 2013 to align with employer matching contributions. But some low income members would benefit from a 3% rate now, so an earlier start date of 1 April 2012 would be preferable.

Note that John Boscawen introduced an SOP last year to add 6% and 10% contributions rates.  At the time this was voted down on the basis that members could make voluntary contributions.

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## ANNEX 1: WORKED EXAMPLES OF KIWISAVER RETIREMENT BALANCES

The following tables provide retirement balances at age 65 in today's dollars for new members under the following scenarios:

- **Current KiwiSaver settings** with both employees and employers contributing 2%
- The **Budget 2011 package** (fully implemented) with reduced MTC, ESCT exemption removed, and employer matching contributions with employees and employers contributing 2%, 3% and 4%.

**Retirement balances for a 30 year old joining KiwiSaver at different starting income levels ($30,000, $50,000 and $75,000):**

| | $30,000 | $50000 | $75000 |
|---|---|---|---|
| *Current Settings:* | | | |
| **Member 2%, Employer 2%** | **$140,000** | **$192,000** | **$264,000** |
| *Budget 2011 Package:* | | | |
| Member 2%, Employer 2% | $110,000 | $149,000 | $206,000 |
| **Member 3%, Employer 3%** | **$158,000** | **$211,000** | **$296,000** |
| Member 4%, Employer 4% | $202,000 | $272,000 | $387,000 |

**Retirement balances for a 45 year old joining KiwiSaver at different starting income levels ($30,000, $50,000 and $75,000):**

| | $30,000 | $50000 | $75000 |
|---|---|---|---|
| *Current Settings:* | | | |
| **Member 2%, Employer 2%** | **$61,000** | **$89,000** | **$121,000** |
| *Budget 2011 Package:* | | | |
| Member 2%, Employer 2% | $49,000 | $69,000 | $94,000 |
| **Member 3%, Employer 3%** | **$71,000** | **$97,000** | **$134,000** |
| Member 4%, Employer 4% | $89,000 | $123,000 | $174,000 |

Underlying assumptions:

- Real wage growth of 1.5% per annum
- Funds earn a real return of 4% per annum
- PIE and ESCT thresholds are indexed to inflation