pensionbriefing

THE UNIVERSITY OF AUCKLAND BUSINESS SCHOOL

A briefing paper from the retirement policy and research centre

KiwiSaver, compulsory employer contributions and remuneration

RPRC Briefing Paper 03/2008

This briefing paper analyses the latest change to KiwiSaver as the government tries to limit employers' capacity to set pay for members and non-members.

In summary

The latest change to KiwiSaver attempts to force employers to pay KiwiSaver members more than non-members. The change seems philosophically unsupportable. The process by which the change was made was also inadequate and may be unworkable. Had there been proper consultation, the change might have been different.

Background

Virtually overnight in 2007, the government introduced compulsory employer contributions to KiwiSaver for employees who chose to join. The first announcement was in the 2007 Budget (17 May 2007) and was accompanied by a tax incentive for KiwiSavers that started only five weeks after that announcement.

None of the major changes to KiwiSaver (Kiwisaver II) was subject to economic analysis, independent review or even a proper debate. The very large question as to whether New Zealand actually needed KiwiSaver II was not addressed.

For employers, these changes marked the start of a legislative intervention into employers' agreements with employees about how much, in total, employees are paid. KiwiSaver I required employers to offer KiwiSaver but they did not have to contribute. The contributions to KiwiSaver I were to come only from members and taxpayers (though employers could contribute if they wished).

KiwiSaver II changed that. Not only were taxpayer subsidies to members increased somewhat (the "Member Tax Credit") but employers had to start contributing from 1 April 2008. The member's contributions of 4% of taxable pay were to have added employer contributions that started at 1% of pay in 2008/9. They will rise to 4% by 2010/11. The government will subsidise those employer contributions by 1% of pay (the "Employer Tax Credit") so that employers' costs will not increase in the 2008/09 year. That changes in the second and subsequent years.

The new, much more complex KiwiSaver II was fully operational only 11 months after the first announcements and only less than four months after Parliament passed the legislation itself.

What the KiwiSaver Act's changes used to say

Based on submissions made to the draft legislation in 2007, the amended KiwiSaver Act 2006 recognised that contributions by an employer to a superannuation scheme were part of an employee's overall remuneration.

The 2007 changes to the 2006 Act first swept away any agreements between employers and employees concerning superannuation subsidies. The government effectively said that it did not want its intentions frustrated by employers that had obtained agreements with employees before the full details of the compulsory employer contributions were known.

Here is section 101B of the KiwiSaver Act 2006 that was passed on 13 December 2007, 109 days before the law required the employers' compulsory contributions to start:

"101B Compulsory contributions must be paid on top of gross salary or wages except to extent that parties otherwise agree after 13 December 2007

(1) The purpose of this section is to ensure that, for contractual arrangements of parties to an employment relationship (as defined in section 4(2) of the Employment Relations Act 2000), compulsory contributions are paid in addition to an employee's gross salary or wages described in section 101D(3).
(2) The contractual arrangements of parties to an employment relationship must not have the effect of defeating the purpose of this section described in subsection (1).
(3) A contractual term or condition has no effect to the extent to which it is contrary to the purpose of this section described in subsection (1).
(4) However, on and after 13 December 2007,—
   a. parties to an employment relationship are free to agree contractual terms and conditions that ignore the purpose of this section described in subsection (1); and
   b. to the extent of such agreement described in subparagraph (a), subsections (1) to (3) do not apply.
(5) For the avoidance of doubt, the duty of good faith described in section 4 of the Employment Relations Act 2000 always applies when parties to an employment relationship bargain for terms and conditions relating to compulsory contributions and associated matters.
(6) In this section, compulsory contributions means an amount of employer contributions equal to the amount of compulsory employer contributions that would be required by this subpart in the absence of section 101D(5)(a)."

In summary:

- The principle of section 101B was that the employer's contributions were to be added to pay (sub-section (1));
- Previous agreements between employers and employees were annulled (sub-section (3));
- After 13 December 2007, the employer could agree with employees how the contributions might be treated, even if that agreement was contrary to the specific intention of sub-section (1) (sub-section (4));
- The "good faith" provisions of the Employment Relations Act applied to any agreement made under sub-section (4) (sub-section (5)).

Given the large changes in the remuneration landscape introduced by KiwiSaver II, section 101B seemed a reasonable attempt to allow employers and employees to agree how the employer's contributions were to be treated once the full details of KiwiSaver II were known. Though the employers' contributions started only three months later (on 1 April 2008), agreements could be made at any time, as long as they complied with the "duty of good faith".

What the law now says

Following the passing of the Employment Relations (Breaks and Infant Feeding and Other Matters) Amendment Act 2008 on 2 September 2008, the following is now the position. Sub-section 101B(5) of the KiwiSaver Act as above was replaced by the following:

"(5) For the avoidance of doubt,—

(a) the duty of good faith described in section 4 of the Employment Relations Act 2000 always applies when parties to an employment relationship bargain for terms and conditions relating to compulsory contributions and associated matters; and

(b) sections 103(1)(h) and 110A of the Employment Relations Act 2000 apply in relation to the contractual terms and conditions of the parties to an employment relationship, subject to section 4A of the Employment Relations (Breaks, Infant Feeding, and Other Matters) Amendment Act 2008."

Paragraph (a) of the new section (the "duty of good faith") repeats the old sub-section (5). Paragraph (b) is new and refers to extra provisions inserted into the Employment Relations Act by the new Act. Here they are:

"**110A Membership of KiwiSaver scheme or complying superannuation fund**

(1) For the purposes of section 103(1)(h)[of the Employment Relations Act], an employee's employment is adversely affected if—

(a) the employee is a member of a KiwiSaver scheme within the meaning of section 4 of the KiwiSaver Act 2006 or a complying superannuation fund within the meaning of section YA 1 of the Income Tax Act 2007; and

(b) the employee's employer refuses or omits to offer or afford to that employee the same terms of employment, conditions of work, fringe benefits, or opportunities for training, promotion, and transfer as are made available for other employees of the same or substantially similar qualifications, experience, or skills (**comparable employees**) employed in the same or substantially similar circumstances; and

(c) the reason (wholly or in part) for the employer doing any of those things is that the employee is a member of a KiwiSaver scheme or a complying superannuation fund.

(2) Without limiting subsection (1), an employee's employment is adversely affected if—

(a) the employee's salary or wages are less than the salary or wages of other comparable employees employed by the employee's employer; and

(b) the reason (wholly or in part) for the situation described in paragraph (a) is that the employer has taken into account the compulsory contributions (within the meaning of section 101B(6) of the KiwiSaver Act 2006) the employer is required to make in relation to the employee.

(3) To avoid doubt, for the purposes of subsection (2)(a), an employee's salary or wages—

(a) do not include any amount that recognises (wholly or in part) compulsory contributions (within the meaning of section 101B(6) of the KiwiSaver Act 2006) made by the employer in relation to the employee; but

(b) do include deductions made by an employer on behalf of the employee, being the employee's contributions to a KiwiSaver scheme or a complying superannuation fund."

In summary, the new legislation creates a personal grievance if a KiwiSaver employee's "salary or wages" are less than those of a non-KiwiSaver employee because the employer has taken the compulsory employer contributions into account in setting the KiwiSaver member's "salary or wages".

Purpose of this briefing paper

We do not propose to analyse the new legislation in detail[1]. Whether or not employers might be able to work their way around the new legislation, the purpose of this briefing paper is to draw attention to some serious philosophical and procedural objections to the latest KiwiSaver changes.

Before looking at those objections, we need to explain the two main remuneration strategies available to employers. It is only in the context of these two options that the full implications of the changes can be appreciated.

'Total remuneration' vs 'pay + benefits'

There are two main ways to think about the treatment of an employer's contributions to a workplace superannuation scheme, including KiwiSaver:

- **'Pay + benefits'**: employees receive taxable pay[2] and, if they join the subsidised superannuation scheme, the employer also contributes. Employees who join therefore get more in total remuneration than those who do not. Employees who do not join are not compensated for their 'loss'.
- **'Total remuneration'**: the employer sets a total 'price' for the job. If the employee joins the subsidised superannuation scheme, the total remuneration stays the same but the amount of regular take-home pay reduces for members. Both members and non-members who are otherwise equivalent employees will receive the same total remuneration.

In practice, most employees in New Zealand were paid under the 'total remuneration' approach because most employees received no subsidised employee benefits, including superannuation. That means most employers had not probably not addressed the issue of remuneration philosophy.

The government has now effectively tried to force employers' hands with respect to KiwiSaver – the government intends that employers must apply the 'pay + benefits' approach to the compulsory employer contributions. Even if the employer had thought through the implications of employee benefit subsidies and had decided on a 'total remuneration' approach, it will now have no apparent choice with regard to KiwiSaver. That seems a backward step.

We suggest that governments should not try to second-guess what might suit employers and employees in every possible situation. There does not appear to be a compelling community benefit in such regulation. Also, based on past experience, such a detailed level of intervention is likely to lead to unintended consequences.

---

1 For example, it seems unclear how an agreement in "good faith" between an employer and employee that incorporates the employer's KiwiSaver contributions into remuneration and that is specifically permitted under section 101B(4) of the KiwiSaver Act can be overturned as the result of a personal grievance claim because of the effects of section 110A of the Employment Relations Act.

2 For consistency in this briefing paper, "pay" is the regular amount an employee receives each week or month and excludes indirect benefits such as superannuation, the value of medical insurance or motor vehicle etc. Pay is subject to tax under the PAYE regime. The new legislation refers to this as "salary or wages". "Total remuneration" refers to the combined value of all the direct cash and indirect benefits an employee receives from the employer. Indirect benefits are, in most cases, subject to either FBT or Employer Superannuation Contribution Tax (ESCT). However, there is no ESCT on the employer's KiwiSaver contributions.

'Total remuneration' and the Employer Tax Credit

One of the apparent reasons for the latest change was that some employers were effectively using the total remuneration approach (paying less in direct pay for KiwiSaver members) and as well, keeping the Employer Tax Credit of 1% of pay (to a maximum of 4% or the amount the employee was contributing). It was suggested that, while not illegal, those employers breached the spirit of the reason for the Employer Tax Credit ("ETC").

The first point to make is that an employer's keeping the ETC in these circumstances was not illegal. The KiwiSaver Act, as amended in 2007, did not require the employer's KiwiSaver contribution to be on top of other pay before the employer qualified for the ETC. It only required that the employer was making contributions to KiwiSaver. In a total remuneration environment, employer contributions that are derived from 'salary sacrifice' are legally (and for tax purposes) exactly the same as employer contributions in a pay + benefits environment.

If the original intention of the ETC was to reward employers that increased an employee's total remuneration by the amount of the employer's KiwiSaver contributions, the legislation could have said that but did not.

However, employers that have a total remuneration philosophy (where the amount the employee receives in total should be unaffected by the employee's decision to join KiwiSaver) should not, in principle, keep the ETC if the employee joins KiwiSaver. Instead, the after-tax equivalent of the ETC should be added to the employee's remuneration. On the face, that makes it seem as if the employer is paying the KiwiSaver member more. That is not the case.

The total pre-tax cost of the employee *to the employer* should, under total remuneration, be the same between otherwise equivalent members and non-members. The after-tax value of each employee's total remuneration will certainly be different. Not only will the member receive the subsidies that KiwiSaver directs at members (see below) but members will also receive the ETC. That is because of the public policy decisions made through the KiwiSaver Act. It has nothing to do directly with the employer's decisions on total remuneration. Both employees' total remuneration will be the same.

Philosophical objection – regressive intervention

The most serious objection to the latest KiwiSaver change is that it will magnify the already regressive nature of KiwiSaver.

New Zealand has a progressive system of personal taxation. Those who earn more must pay higher proportions of their pay in tax – not just in dollar terms but also as a proportion of the higher slices of their pay.

That progressive principle has already been undermined by the tax subsidies that characterise KiwiSaver II. More highly paid employees are better able to afford the 4% employee contributions because they have higher disposable incomes. Also, as they are probably already saving, they are able to re-arrange existing saving arrangements to capture the tax concessions available through KiwiSaver at no (or at a lesser) loss in take-home pay.

The following lists the KiwiSaver II tax concessions:

- Tax-free employer's contributions (no ESCT on contributions to 4% of pay). This is potentially the most generous concession of all and exceeds the value of the Member Tax Credit for all employees paid more than $67,000 a year.
- Member Tax Credit of a tax-free $1,043 a year.
- Tax-free 'kick-start' of $1,000.
- Tax-free administration fee subsidy of $40 a year.
- PIE tax savings on investment income earned in the KiwiSaver scheme[3].

As should be expected, international evidence shows that most of the tax concessions given to retirement saving in other countries accrue to the highest paid. Here are two examples:

> "In short, pensions [in the US] benefit a relatively privileged minority of the population, while all taxpayers face higher rates to cover the preferences accorded qualified plans."[4]

> "[In the UK and Ireland, a]bout two-thirds of the benefits accrue to the top two income deciles in both countries and 3 per cent or less to the bottom two deciles."[5]

There are no Inland Revenue statistics yet that show the pay of KiwiSaver members. A recent report based on a direct survey[6] indicates that those who have joined KiwiSaver are paid more than average:

> "In terms of [survey participant] characteristics, the results in Table 1 indicate that KiwiSaver members are older, richer and better qualified than non-members."

The reason for this pattern is easy to understand – to qualify for the KiwiSaver II concessions, employees must contribute a net 4% of their pay[7]. That imposes a significant affordability hurdle for many employees to jump and may exclude them from accessing the value of the KiwiSaver II concessions and other benefits.

Allowing employers to adopt a total remuneration approach to the treatment of the compulsory employer contributions would reduce that distortion, but not eliminate it – the regressive tax concessions would remain. The total remuneration of employees in that case is not affected by whether employees can afford to join KiwiSaver. All employees doing the same job would receive the same total remuneration.

---

3 The investment income in a "Portfolio Investment Entity" (PIE) is taxed on a concessional basis by comparison with the tax that would have applied had the PIE member received that income directly. The value of the concession can be as much as 13.5% (33% less 19.5%) but could also be 3% or 6%, depending on the mix of PIE income and pay. A further concession derives from the tax-free treatment of trading gains from New Zealand and most Australian shares. Paradoxically, members who have very low pay (less than $9,500) pay more tax on the PIE income than had they received it directly (15% less 19.5%). That penalty worsens to 7 percentage points from 1 October 2008 when the bottom tax rate falls to 12.5% on pay below $14,000 a year.

4 *Current taxation of qualified pension plans: has the time come?* Alicia Munnell, 1992 – see here.

5 *Private Pensions and Equity in Ireland and the UK* Gerald Hughes, 2002– see here.

6 *How much new saving will KiwiSaver produce?* John Gibson and Trinh Le, 2008 – see here.

7 With the employer's agreement, there is an alternative contribution regime that starts at 2%/2% in 2008/09 but will be 4%/4% from 1 April 2011. There is no evidence as to the number of KiwiSaver members who are on this basis. We expect that number to be quite small.

The latest changes to KiwiSaver try to magnify that element of material unfairness. The KiwiSaver Act is now effectively telling employers that they must pay KiwiSaver members more in total than non-members. So those who cannot afford to join KiwiSaver are now to be materially worse off *with respect to total remuneration from their employer* than their otherwise equivalent colleagues who can afford to find a net 4% of their pay. It is unrealistic to suggest that the low paid can join KiwiSaver to collect the concessions.

That is not the only disadvantage suffered by non-members. As already explained, those who do not join-KiwiSaver are now directly discriminated against with respect to the total remuneration they receive from the employer but they will also be worse off in two other regards:

- **Taxes higher**: KiwiSaver II means that everyone's taxes will be higher by about $2 billion a year once KiwiSaver II is fully implemented (from 2011). All employees will pay more tax, including those who cannot afford to join. So those who do not join will be helping to pay for the taxpayers' subsidies to those who do join. Members will be compensated by the value of the concessions (and the employer's contributions – more on those next) but, by definition, they will receive more through KiwiSaver than they pay through taxes.
- **Lower future pay rises**: The compulsory employer contributions must come from the employer's remuneration budget. The new law seems to suggest that this budget is an elastic pot – that somehow employers will find the extra amounts needed to make the compulsory KiwiSaver contributions from their 'other income'. However, that is not what will actually happen. Employers will treat the KiwiSaver-imposed costs as a charge on the total available remuneration pot. That means future pay rises must be lower for all employees, including for non-members. All employees will 'pay the price' of those lower increases but, as with the issue of higher taxes for everyone, KiwiSaver members will be more than compensated by the value of the employer's contributions to KiwiSaver in respect of them. The will be further advantaged by the tax-free treatment of those contributions.

The higher taxes and their inequitable distribution are features of any tax concession. The lower future pay rises are a direct consequence of the compulsory employer contributions.

In summary, those who cannot afford to join KiwiSaver (or who choose not to join) will suffer directly and indirectly for the lost opportunity. The already regressive tax characteristics of KiwiSaver II have been magnified by the latest remuneration changes.

Procedural objection

The way in which this latest change was introduced also deserves comment. The KiwiSaver changes came by way of a late change to an Employment Relations Act amendment that had already been considered through the Parliamentary process. The original Employment Relations (Breaks and Infant Feeding) Amendment Bill had nothing to do with KiwiSaver.

However, when the Bill reached its final reading in Parliament, the KiwiSaver changes were added by way of a Supplementary Order Paper of 2 September 2008. The changes received no examination by either the parliamentary opposition, the normal internal regulatory checks, nor even from outside experts and other interested parties (like

employers) who might have been able to make submissions on the proposed changes. The KiwiSaver changes were passed by Parliament on the day they were introduced.

In a non-urgent matter like KiwiSaver, the way the latest change was made seems almost a subversion of the parliamentary process.

This is not the first time that the KiwiSaver Act has been changed in this way. When the original legislation was passed in November 2006, the following unannounced major changes were made at the last moment:

- The exemption of employer contributions to tax (previously SSCWT; now ESCT);
- The mortgage diversion scheme, the difficulties with which are only now being discussed.

In fact, the Select Committee that considered the KiwiSaver Bill specifically recommended against the mortgage diversion scheme. Despite that, the Third Reading process was used to insert the change unannounced and essentially undebated.

There is a serious issue of principle here. Changes to KiwiSaver are not matters of urgency or of national significance. The latest change is essentially a procedural issue though, perhaps, one of greater significance than its designers understood.

It is now almost surreal to see that advertised objections to the possible (but at that stage unannounced) changes from the Employers and Manufacturers Association might even be illegal under the Electoral Finance Act 2007. It seems that, in an election year, it is not possible to even draw attention publicly to the difficulties with a potential change.

Conclusion

New Zealand has a long and not very proud history of poorly thought out changes to both public and private provision for retirement. There are many cases of rushed, secretive amendments to legislation that have made unexpected changes that might have been avoided had time and a robust examination been built into the process.

The latest change seems to have no sound superannuation or economic underpinning and seems to be been inadequately considered.

For comments on this briefing paper and for further information contact:

Michael Littlewood
Co-director, Retirement Policy and Research Centre
University of Auckland
Private Bag 92 019
Auckland 1142
New Zealand

E Michael.Littlewood@auckland.ac.nz
P +64 9 92 33 884 DDI
M +64 (21) 677 160
http://www.rprc.auckland.ac.nz
http://www.PensionReforms.com