Inland Revenue
Te Tari Taake
Policy Advice Division

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Treasury/IRD Report: Overview of Enhanced KiwiSaver Package

Date:	30 March 2007	**Treasury Priority:**	HIGH
Security Level:		**Report No:**	PAD2007\079 T2007/450

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	**Agree** to the recommendations	3 April 2007
Minister of Revenue (Hon Peter Dunne)	**Agree** to the recommendations	3 April 2007

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Peter Martin	Director, Economic Performance Group, the Treasury	*[information deleted in order to protect the privacy of natural persons, including deceased people]*	✓
Mike Nutsford	Policy Manager, Inland Revenue Department		

Enclosure: **No**

Overview of Enhanced KiwiSaver Package

Executive Summary

- As a policy to improve private savings, the enhanced KiwiSaver package stacks up well. Its design combines a number of the more successful elements of international saving schemes, such as automatic enrolment, lock in and matching contributions (from the employer and government). Further, the tax incentives are targeted at those that are least likely to be saving to start with i.e., low to moderate-income earners. As a result, we consider that the package will have a material impact on private savings and that any potential impact on consumption will be limited.

- The key risk is the fiscal impact of the package. Implementing the package in a manner that is consistent with the government's current fiscal strategy will require slower growth in other spending than would have otherwise been the case. *[information deleted as it includes 'draft' estimates only which have been superseded by final estimates*
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- In the forthcoming Fiscal Strategy Report (FSR), the Minister will need to credibly explain how the costs of the enhanced KiwiSaver package can be met without undermining the government's long-term fiscal strategy. How the fiscal impact of the package is managed will also be a key determinant of its impact on national savings.

- To facilitate a Budget day announcement, Cabinet agreement on the package will need to be secured at the 19 April meeting of the Cabinet Business Committee (CBC). Further work that needs to be completed prior to this meeting includes finalising the costings of this proposal and assessing its impacts on the Crown as an employer. Ministers will also need to consider the extent to which they would like to consult on the package prior to the CBC meeting.

Recommended Action

We recommend that you:

1 **agree** that on Budget day the following enhancements to KiwiSaver will be announced:

A member tax credit matching member contributions into KiwiSaver (and other complying funds) at a rate of 100% up to a maximum of $20 per week effective from 1 July 2007

An employer tax credit reimbursing employers for matching contributions they make into their employees' KiwiSaver (and other complying funds) accounts at a rate of 100% up to a maximum of $20 per week for each employee, effective from 1 April 2008.

Compulsory matching employer contributions to KiwiSaver funds phased in as follows (as a percentage of salary):

2008/09: 1%
2009/10: 2%
2010/11: 3%
2011/12: 4%

Agree/disagree. *Agree/disagree.*

2 **agree** that the package will be implemented as follows

Member tax credits

- the scheme provider submits an annual return to the Inland Revenue Department (IRD) showing each member's details and the amount of contributions eligible for the tax credit;

- IRD pays the tax credit to the provider to be deposited to the member's KiwiSaver account.

Employer tax credits

- reimbursed to employers leveraging off existing systems such as PAYE to minimise compliance costs and cashflow issues.

Compulsory matching employer contributions

- IRD can be the collection agency for contributions into KiwiSaver funds. Scheme providers will collect contributions into complying and non-complying funds.

Agree/disagree. *Agree/disagree.*

3 **agree** that the legislation to give effect to the member tax credit will be introduced on Budget night under normal urgency.

Agree/disagree. *Agree/disagree.*

4 **agree** that the changes to give effect to compulsory matching employer contributions and the employer tax credit will be made in a separate bill to be enacted later in 2007,

Agree/disagree. *Agree/disagree.*

If you agree to 1, 2, 3 and 4:

5 **note** that implementing this package in a manner that is consistent with the government's current fiscal strategy will require significantly slower growth in other spending than would have otherwise been the case

6 **note** the economic implications of the enhanced package outlined in this report.

First home subsidy

7 **agree** that officials should report back by 5 April 2007 on whether the first home subsidy provided as part of the original KiwiSaver package should also apply to complying funds.

Agree/disagree. *Agree/disagree.*

If you agree to 7:

7a **agree** that officials can consult with officials at Housing New Zealand in terms of this issue.

Agree/disagree. *Agree/disagree.*

Fee Subsidy

8 **agree** that

EITHER

- officials report back on options for the fee subsidy by 5 April 2007 for consideration by relevant Ministers;

Agree/disagree. *Agree/disagree.*

OR

- Ministers will defer the decision and provide Cabinet with two options for the subsidy, these being:

Agree/disagree. *Agree/disagree.*

Option One:

- Set the fee subsidy at $40 to fully cover the most expensive administration fee charged by a default provider for a default investment product; and

Option Two:

- Set the subsidy at $55, the amount budgeted under the original KiwiSaver package.

Agree/disagree. *Agree/disagree.*

9 **note** that the Minister of Finance has requested that Cabinet grant CBC power to act on all budget related issues at its meeting on 19 April 2007.

10 **agree** that officials will start to prepare a Cabinet paper for consideration by CBC on 19 April 2007 broadly based on the contents and structure of this report and provide the Minister of Finance and Minister of Revenue with a draft of this paper by 11 April 2007.

Agree/disagree. *Agree/disagree.*

11 **note** that the following issues still need to be finalised before submitting the Cabinet paper: costings of the package; fiscal implications based on these costings and impact on the Crown as an employer.

12 **agree** that in preparing the Cabinet paper:

EITHER

- Consultation will be limited to officials in Treasury, IRD and the Ministry of Economic Development (MED) who are already aware of the content of the proposal;

Agree/disagree. *Agree/disagree.*

OR

- Officials are permitted to consult more widely with officials in relevant departments whose input is required to finalise advice.

Agree/disagree. *Agree/disagree.*

13 *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials*

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14 **note** that you will be receiving three additional reports on 30 March 2007, seeking agreement on:

- detailed design issues;
- the treatment of existing schemes; and
- the KiwiSaver communication plan and changes to this plan to accommodate the enhanced KiwiSaver package.

Peter Martin
Director, Economic Performance Group
for Secretary to the Treasury

Mike Nutsford
Policy Manager
Inland Revenue Department

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Overview of Enhanced KiwiSaver Package

Purpose of Report

1. This report seeks Ministerial approval for undertaking further work on the enhanced KiwiSaver package in the lead up to a Budget day announcement. This includes preparing a Cabinet paper to be considered by the Cabinet Business Committee on 19 April 2007.

2. The report provides a broad overview of the package, as well as assessing its potential economic and fiscal impact. In doing so, the report provides an indication of the type of issues that officials consider should be covered in the Cabinet paper. The paper also highlights some of the key risks associated with implementing the package and outlines what further work will need to be done in preparing a Cabinet paper.

3. You will be receiving additional reports on more detailed policy design issues and the KiwiSaver communication plan at the same time as this report. Some of the content of these reports will also be incorporated into the Cabinet paper.

Analysis

I Overview of Package

Core Features

4. The enhanced KiwiSaver package builds on the core KiwiSaver model by offering tax incentives for employees and non-employees such as the self employed to save on an ongoing basis, as outlined in the table below. It has three key aspects: individual (member) tax credits; matching employer contributions; and employer tax credits. Key features of the original KiwiSaver model have been maintained, including automatic enrolment, portability, the Specified Superannuation Contributions Withholding Tax (SSCWT) exemption, lock in and vesting.

Table 1: Key features of Enhanced KiwiSaver Package

Tax credit for member contributions (member tax credits)
The member tax credit matches member contributions into KiwiSaver (and other complying funds) at a rate of 100% up to a maximum of $20 per week ($1040 per year). Direct contributions into a KiwiSaver account (e.g., for the self employed) will also be eligible for the tax credit. This will come into effect from 1 July 2007. From 1 April 2008, any employees that are new members to KiwiSaver will need to contribute a minimum 4% of their salary.
Tax credit for employer contributions (employer tax credits)
The employer tax credit reimburses employers for matching contributions they make into their employees' KiwiSaver (and other complying funds) accounts at a rate of 100% up to a maximum of $20 per week for each employee.

This would come into effect from 1 April 2008.

In addition, matching employer contributions would become compulsory to the extent that the employee contributes. The compulsory matching employer contributions would be phased in as follows:

2008/09: 1%
2009/10: 2%
2010/11: 3%
2011/12: 4%

Implementation of Package

5. To ensure that IRD can deliver these changes[1], officials propose that implementation of the tax credits would proceed as follows:

Member tax credits

- the scheme provider submits an annual return to IRD showing each member's details and the amount of contributions eligible for the tax credit;

- IRD pays the tax credit to the provider to be deposited to the member's KiwiSaver account or complying fund on an annual basis.

Employer tax credits

- reimbursed to employers, leveraging off existing systems such as PAYE to minimise compliance costs and cashflow issues.

Compulsory matching employer contributions

- IRD will be the collection agency for contributions into KiwiSaver schemes. Scheme providers will collect contributions into complying and non-complying funds.

6. *[information deleted as disclosure would prejudice the maintenance of the law]*

7. Legislation to give effect to the package will be passed in two stages: legislation relating to the member tax credit will be introduced on Budget night for a launch date of 1 July 2007; the remainder of the legislation (relating to compulsory matching employer contributions and employer tax credits) will need to be passed by late 2007 and take effect on 1 April 2008.

How Does the Package Stack Up for Household Savings?

8. A key objective of the package is to address the household sector's poor savings record. New Zealand's household saving rate is negative and has been for some time. It is also among the lowest household saving rates in the OECD.

9. Household saving decisions are influenced by a number of interacting factors including income levels, the relative price of consuming now versus consuming later (reflected in

[1] More detail on the way in which the changes will be implemented by IRD is contained in the joint IRD/Treasury report – Enhanced KiwiSaver Package – Detailed Design Issues.

after-tax interest rates) and households' own preferences. While the interactions between these factors are complex, there are still some interventions that the government can use to encourage greater private-sector savings such as:

- policies aimed at increasing incomes i.e., economic growth, flowing through to higher wages, is good for savings;

- policies aimed at increasing the return to savings e.g., through tax incentives; and

- investment in programmes, like education campaigns, which are designed to influence savings preferences.

10. Internationally, governments have experimented with a number of these interventions with mixed success. Although participation in saving schemes generally increases in response to government interventions, the overall impact on private savings depends on the behaviour of individuals. The enhanced KiwiSaver package is unique in its approach, combining the more successful elements of these approaches. Unlike other schemes, which are typically compulsory or voluntary, KiwiSaver is a mixture of the two. Matching employer contributions are compulsory, but only to the extent that the employee wishes to contribute to a KiwiSaver scheme. Purely compulsory schemes have tended to encounter a high degree of switching, as those households who already perceive that they are saving sufficiently will simply replace their existing savings with the 'compulsory' form. Where tax concessions are offered, this behaviour can also result in an increase in consumption i.e., households can save less for the same after tax return.

11. Under the enhanced KiwiSaver package, the combination of participation being voluntary, lock in until the age of eligibility for NZS and a minimum 4% employee contribution limit the scope for tax credits and employer contributions being used to fund higher consumption rather than saved. Further, over and above the tax credits, KiwiSaver funds are not substantially tax advantaged relative to other savings instruments i.e., returns are taxed in broadly the same way as for other portfolio investments.

12. Targeting savings schemes at lower income earners is also likely to have a greater pay off for household savings than schemes targeted at high-income earners, which are the international norm. High-income earners are the individuals most likely to be saving already. As a result, the extent of switching that occurs under a scheme targeted at these individuals is likely to be higher than for a scheme targeted at lower-income households who are less likely to be saving in the first place. In the enhanced KiwiSaver package, the cap on the tax credits mean that households with low to moderate incomes will benefit relatively more from the credits than higher-income earners e.g., an individual earning $26,000, who saves 4% of his/her salary in KiwiSaver ($20 per week) will receive an additional $20 from their employer and $20 from the government (i.e., an additional $2 for every $1 saved). As the government contribution is capped at $20 per week, the pay off for an individual earning $50,000 falls to 1.5:1.

13. Officials note that the change from the original KiwiSaver package to not allow employer contributions to count towards an employee's minimum contribution, and the subsequent increase in minimum contributions for these employees, will impose an additional liquidity constraint on low-income earners. A minimum contribution of 4% potentially equates to a reasonably significant portion of disposable income at relatively low income levels and therefore could make participation difficult. However the introduction of compulsory employer contributions and tax credits provide added incentives for employees who do not currently receive an employer contribution and would not have joined KiwiSaver, to join.

14. KiwiSaver is also based on an automatic enrolment regime with opt out facility, which is not widely used. In the US, where enrolment in the 401(K) programme was made the default i.e., opt out rather than opt in, participation rates were found to be particularly high.

15. Higher savings can lead to stronger growth, which in turn can feed back into higher savings, creating a virtuous cycle. A key way in which higher savings can lead to stronger growth is through financial market development. If the increase in private savings is not offset by a decline in government savings, it could also contribute to a reduction in the cost of capital. All else equal, a lower cost of capital would improve the growth potential of the New Zealand economy over time.

16. Taking into account the way in which the package has been designed, we have derived preliminary estimates of its likely impact on private saving[2]. Overall, we estimate that the consumption impact is likely to be between a reduction of 15% and an increase of 25% of the total fiscal cost of the saving tax credit (with a mid-point of perhaps 5% to 10%). As a result, the package is likely to result in an increase in private saving of close to (or perhaps more than) the full fiscal cost of the package. Further information on the assumptions underpinning this modelling is included in appendix one. However, we note that these estimates are subject to some uncertainty. The Reserve Bank of Australia, for example, estimates that around 35 to 50 cents in the dollar of compulsory superannuation in Australia was offset by switching from one form of saving to another.

II Take Up Assumptions

17. To estimate the likely take up of the enhanced KiwiSaver package, officials have drawn on overseas evidence relating to broad comparators, the State Sector Retirement Savings Scheme (SSRSS) experience and have also revisited some of the assumptions underpinning KiwiSaver. Table two sets out the current range of take-up estimates, and the cost of the package associated with these take up rates. The modelling assumes that take up varies in different income brackets, but that it builds relatively quickly to these levels i.e., levels off after five years. Further analysis on the assumptions underpinning this modelling is outlined in appendix one.

Table 2: Additional Cost of Enhanced KiwiSaver Package Using Different Take-Up Rates ($m)

	2007/08	2008/09	2009/10	2010/11	2011/12	*2016/17*
Lower estimate [overall 40% take up]	100	300	600	700	900	*1300*
Mid estimate [overall 50% take up]	200	500	900	1200	1300	*1600*
Higher estimate [overall 65% take up]	400	800	1300	1500	1800	*2200*

Note figures are rounded to the nearest $100 million.

18. There is substantial uncertainty regarding the level and profile of take up over time. Depending on perceptions of whether everyone else is joining (or not), overall take up could be higher (or lower). In preparing final Budget (BEFU) forecasts, officials are reviewing the assumptions underpinning these costs to ensure that they are as robust as possible.[3]

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[2] These estimates assume that business savings is not impacted by the proposal. For further information on the impact of the package on businesses refer paragraphs 34 to 36.

[3] Key adjustments that have already been identified include adjusting the cost of the employer tax credits so that they are on a June year basis and accommodating any potential behavioural responses from employers to the announcement (i.e., introducing matching employer contributions at a more quickly than required by the package in order to fully access the tax credits).

III Fiscal Impact

19. Assumptions on the take up of the enhanced KiwiSaver package are key to modelling the fiscal implications. In particular, the speed of take up could have a significant impact on the affordability of the scheme in the earlier years. In the analysis below, the mid estimate outlined in table two is the focal point, but the analysis also highlights the risks of higher or faster take up. In the modelling, the costs of the enhanced KiwiSaver package are assumed to be in addition to the $1.9 billion operating allowance and business tax package.

20. *[information deleted as it includes 'draft' estimates only which have been superseded by final estimates*

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23.

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24. Accommodating the enhanced KiwiSaver package within the government's current fiscal objectives will therefore require considerable fiscal discipline, including slower expenditure growth than would have otherwise been the case. Fiscal restraint will help

to ensure that debt does not continue to track upwards and the government is not borrowing to make its contributions to NZSF. *[information deleted as it includes 'draft' estimates only which have been superseded by final estimates*

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25. Ongoing monitoring of take up levels will help to ensure that appropriate adjustments to spending growth can be made if take up is higher than expected, particularly in early years. This will assist the government in maintaining sufficient fiscal headroom to cope with an adverse shock. It is possible that this monitoring could be incorporated into the existing monitoring and evaluation programme for KiwiSaver.

26. The modelled impacts will also have implications for the drafting of the forthcoming Fiscal Strategy Report (FSR). In particular, the Minister will need to credibly explain how the costs of the enhanced KiwiSaver package can be met without undermining the government's long-term fiscal strategy.

Additional Costs

27. There are a number of additional costs associated with the enhanced KiwiSaver package that have yet to be incorporated into our forecasts. These include:

- IRD implementation costs relevant to these changes; and

- additional costs imposed on the Crown as an employer from compulsory matching employer contributions.[4]

28. *[information deleted as disclosure of the information would prejudice or disadvantage commercial negotiations and it includes 'draft' estimates only which have been superseded by final estimates*

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29. Our initial view is that the remaining costs are likely to be modest relative to what we have already modelled. Full details of these costings will be outlined in the Cabinet paper and they will be incorporated into the final BEFU forecasts.

4 Although the cost of the credits is estimated across the labour force, including the state sector, additional costs to the Crown that have not been taken into account include compulsory matching employer contributions for state sector employees who are not currently eligible for SSRSS or another superannuation scheme provided by the Crown. By 2011/12, the matching employer contributions that the Crown has to pay will also exceed its current 3% contribution to SSRSS.

IV Economic Impact

Impact on National Saving

30. The impact on national saving of savings schemes depends on the way in which they are financed by the government. Higher levels of private saving will lead to an improvement in national saving if the debt accrued by the government to fund the package is smaller than the resulting increase in private savings. In other words, although the enhanced KiwiSaver package is designed in a way that raises the likelihood of an improvement in private savings, and a change in the composition of national savings, this on its own may not lead to an improvement in national savings.

31. A disciplined fiscal strategy is therefore also important for fully realising the potential gains of the enhanced KiwiSaver package. The actual impact of the package on national saving will not be clear for some time. As such, clarity around the longer-term fiscal and macroeconomic implications of the package will be important in managing external perceptions. For example, in its latest review of New Zealand, Standard and Poors confirmed New Zealand’s credit rating on foreign currency debt at AA+ with a stable outlook. However, it was noted that this rating could come under pressure if the government’s fiscal position was to weaken or if there was no medium-term improvement in the current account deficit.

32. If an increase in national saving can be maintained over the longer term, then this is likely to lead to an improvement in the current account deficit, reducing New Zealand’s reliance on foreign capital to fund domestic investment.

Impact on Housing Market

33. The impact on the housing market of the enhanced KiwiSaver package is unlikely to be significant. The package itself does not impose any additional liquidity constraints on individuals as it is not compulsory and individuals will be able to withdraw funds for the purchase of a first home (but not for the purchase of an investment property). However, individuals will not be able to withdraw member tax credits in this situation, reducing the risk that the government will be perceived as subsidising housing market activity. As the package provides additional incentives to save in financial assets, it also reduces the relative tax advantage of housing.

Impact on Businesses

34. Unlike for a ‘pure’ compulsory superannuation scheme, the impact on employers from the enhanced KiwiSaver package are likely to vary, particularly in the short term. For those employers who already offer workplace superannuation schemes with contributions of 4% and above, and who can switch to KiwiSaver schemes, the actual impact may be a reduction in labour costs as they will be eligible for an employer tax credit.

35. For other employers, the compulsory matching contributions will increase cost, although less so than if employer contributions were compulsory for all employees, not just those making contributions to KiwiSaver, and if there were no employer tax credits. Because of tight labour markets, these employers will bear the majority of the increased in costs in the short term, potentially offsetting some of the positive impact of the parallel reduction in corporate taxes.

36. Over the longer term, research on payroll taxes suggest that the majority of the incidence of compulsory employer contributions will be passed on to the employee through a combination of higher inflation from increases to the cost of production and lower nominal wage growth. For employers who employ a large number of low-skilled workers, contributions to KiwiSaver funds could credibly be used as a bargaining chip

in wage negotiations. This would be more difficult for employers whose workforce is dominated by highly-skilled labour. However, these employers are more likely to be already making contributions to workplace superannuation schemes.

37. Transitioning to the ‘new’ KiwiSaver environment may impose some additional compliance costs on employers, mostly around changes to the payroll systems, which could be incorporated into the annual payroll update. However, as per the current KiwiSaver scheme, these are expected to be minimal. The costs on providers are likely to be somewhat higher and will include system changes to facilitate the member tax rebate claim.

Impact on Monetary Policy

38. In recent statements, the Governor of the Reserve Bank has noted that fiscal policy has become more stimulatory. Given that the focus of the enhanced KiwiSaver package is on improving savings, our view is that he is likely to be less concerned about this particular proposal than the possible alternatives e.g., additional government spending or a personal income tax cut. Our preliminary modelling also indicates that the impact on inflation of the package is minimal. However, the way in which it is factored into any subsequent interest rate decisions and/or statements will depend on how the Governor views the overall fiscal package for Budget 2007.

Impact on Financial Market Development

39. Australian experience shows that compulsory superannuation has helped to enhance financial markets by increasing the financial asset holdings of Australian households and expanding and deepening financial markets and institutions. This effect appears to be over and above the effect of increases in asset values.

40. The enhanced KiwiSaver package is expected to generate new savings that will largely flow into managed funds. According to our preliminary estimates, these flows will build up quickly at first and then stabilise at around one per cent of GDP after five years. In the case of Australian compulsory superannuation, household flows into superannuation grew from an average 2.8% of GDP in 1989-95 to 4.6% over 1996-2002. [5]

41. The increased flow of funds would be allocated to various sectors based on the investment strategies and diversification targets of each fund. Portfolio allocations depend on many variables including the economic situation both domestically and abroad, industry performance and emerging risks, the size of the total portfolio, etc. On average, New Zealand fund managers invest around half of their funds in foreign assets, mostly equities. Equities and fixed interest assets each account for around a third of funds invested domestically, with the remainder in property and cash.

V Wider Policy Implications

Housing Subsidy

42. Housing New Zealand has reported to Ministers on the eligibility criteria (income and house price caps) for the housing deposit subsidy separately (BN/06/131 refers). As part of this report, officials noted that the extension of the SSCWT exemption to complying funds raised the question as to whether access to the housing deposit subsidy should also be extended to these funds.

43. Currently the deposit subsidy is available to KiwiSaver members and members of work-based schemes that are exempt from automatic enrolment. In light of the wider policy

[5] Connolly & Kohler, Impact of Superannuation on Household Saving, March 2004, Reserve Bank of Australia

decisions on the access of non-KiwiSaver schemes to the tax credits and other benefits of the enhanced KiwiSaver package, it is timely to reconsider the rules of access to the housing deposit subsidy. Officials propose that we report back to Ministers on the issue of access to the housing deposit subsidy by 5 April 2007.

Fee Subsidy

44. The process for paying the KiwiSaver fee subsidy has been agreed by Cabinet (EDC Min (07) 5/1 refers), but a decision on the level of the fee subsidy was deferred by Ministers and remains outstanding. Cabinet previously agreed that the fee subsidy be set at a flat dollar amount per member per annum, and that the amount should aim to cover the administration fee of the default schemes (CBC Min (06) 3/7 refers). Funding for the fee subsidy was set aside in the savings allocation at $55 per member per annum, prior to any information being available on fees charged by default providers. It is now estimated that the most expensive fee to be charged by a default scheme (for a default investment product) is $37 per member per annum.

45. Officials see two broad options for the fee subsidy:

<u>Option One:</u>

- Set the fee subsidy at $40 to fully cover the most expensive administration fee charged by a default provider for a default investment product

<u>Option Two:</u>

- Set the subsidy at $55, the amount budgeted under the original KiwiSaver package.

46. If required, officials can provide further information on these two options by 5 April 2007 to facilitate a decision by the relevant Ministers prior to the Cabinet paper being submitted. Alternatively, Ministers could choose to defer the decision and present both options, with their associated costs, to Cabinet.

Impact on Crown as an Employer

47. As an employer, the government has a number of workplace schemes already in existence across the state sector, including SSRSS. The government will therefore face similar issues to the private sector in respect of these schemes once the tax credits are introduced and employer contributions become mandatory. Assuming KiwiSaver is the preferred vehicle through which the government could realise its savings goals in the state sector, the key issues to address will be the speed of the transition and the nature of any further consultation before the government finally decides its approach.

48. Transitioning to KiwiSaver could be complex for some employers, particularly those offering deferred salary arrangements that currently allow employees in high-stress occupations to retire mid career e.g., New Zealand Defence Force. These issues are being worked through by the State Services Commission (SSC) and Treasury officials, so that ministers will be in a position to give guidance to State sector employers in a timeframe consistent with advising employers generally of the impact of this proposal.

Impact on Small Businesses

49. Small businesses are among those employers most likely to be affected by the compulsory matching employer contributions. It is unlikely that many of these will already be offering workplace superannuation schemes. Corporate tax cuts and the phasing in of the compulsory employer contributions will mitigate some of the pressure. However, unincorporated employers and employers exempt from tax will not benefit from the company tax reduction. Further, by virtue of being self employed, the

principals in these businesses will only be eligible for the member tax credits and not the employer tax credits.

Supervision of Superannuation Industry

50. As the enhancements to KiwiSaver will encourage some individuals with limited financial expertise to start saving, the proposed changes are likely to have implications for the analysis on appropriate supervisory arrangements. In particular, consideration may need to be given to greater regulation of the superannuation industry given that, over time, KiwiSaver funds and superannuation funds with complying funds status are likely to dominate the industry. The Ministry of Economic Development (MED) is already examining the supervisory arrangements of non-bank financial institutions, including superannuation providers, in its review of non-bank financial products and providers. Officials have indicated that work on superannuation schemes could be brought forward if the enhanced KiwiSaver package is endorsed by Cabinet.

Core Design Features

51. IRD has prepared two reports, in consultation with the Treasury, seeking agreement on the core design features of the package and the treatment of existing schemes. These reports will also propose that the Minister seeks delegated authority from Cabinet to make decisions on key features, to ensure that the package can be implemented and legislation drafted within current timeframes.

VI Further Work

52. To accommodate a Budget day announcement, a Cabinet paper will need to be prepared for consideration by CBC, alongside other Budget initiatives, on 19 April 2007. We understand that the Minister of Finance has written to the Prime Minister requesting that Cabinet grant CBC the power to act at this meeting on all Budget-related issues.

53. The final Cabinet paper will therefore need to be submitted to the Cabinet office by 10am, Monday 16th April. We propose basing the Cabinet paper on the content of this report, albeit with updated information on costings, the long-term fiscal implications and the impact on the Crown as an employer.

54. In terms of consultation on this Cabinet paper, we see two broad options:

- Officials will provide the Minister of Finance and the Minister for Revenue with a draft copy of the Cabinet paper by 11 April 2007 for comment by 13 April 2007. In preparing this paper, we will consult with officials in Treasury, IRD and MED who are already aware of the package; or

- Officials will distribute a draft of the Cabinet paper to key officials in government departments with an interest in the package by 5 April 2007. Officials will provide the Minister of Finance and the Minister for Revenue with a draft copy of the Cabinet paper by 11 April 2007 for comment by 13 April 2007.

55. If the member tax credits are to be launched from 1 July 2007, work on drafting the legislation will need to commence prior to any Cabinet decisions being made. Officials propose following the process outlined in table four.

[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

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Consultation

56. IRD has provided input to the design and implementation issues discussed in this report. Key officials in MED have also been consulted.

APPENDIX ONE

Savings tax credits – fiscal costs and impacts on consumption

This note provides more detail on the basis for the current provisional range of fiscal costs and the range of impacts this may have on consumption. These numbers are uncertain and will be subject to further change after the current round of fiscal modelling. This note also documents the basis for the assumptions made in this process.

Fiscal Costs

Table 1 reproduces our current range of fiscal costs, it also shows the unrounded version of these numbers for information. The mid-estimate has been used in the preliminary BEFU modelling.

[information deleted as it includes 'draft' estimates only which have been superseded by final estimates

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Within these numbers, we are aware of several issues around the costing of the employer tax credit which are likely to increase the overall costs somewhat. Specifically:

- The current costing for the employer tax credit needs to be adjusted to a fiscal year basis – roughly one quarter of the employer tax credit (e.g. from 1 April 2008 to 30 June 2008) would fall in the earlier fiscal year (e.g. in this case 2007/08). This is likely to increase the fiscal cost in each of the first three years (2007/08 to 2009/10) by around $40m to $50m, and then tails off thereafter.

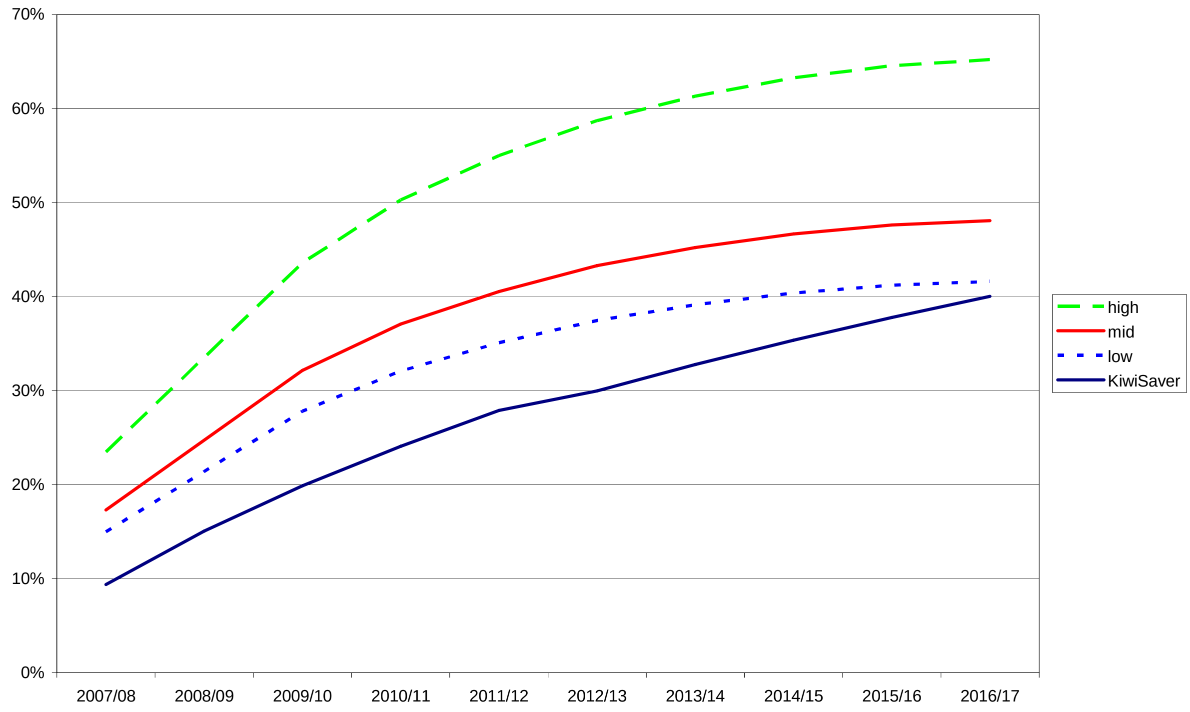
- The current costing for the employer tax credit needs to reflect possible employer behaviour while the compulsory matching is phased in – we have assumed all employers only match contributions at the compulsory rate during the phase-in, however some already match at higher rates (for existing schemes) and some may be more generous, in particular to the extent that they would receive the employer tax credit and hence they face no net cost as a result of this more generous matching. This will also increase the fiscal cost in the first four years, at most by perhaps $100m in 2008/09 and 2009/10 and by somewhat less in 2007/08 and 2010/11.

The tax credits could be phased in, so that the individual's savings tax credit is $10/week in 2007/08 and 2008/09 and the employer tax credit is $10/week in 2008/09, before both increase to $20/week thereafter. On the assumption that take-up is unchanged, this phasing would reduce the cost in the first two years to $174m and $370m, respectively. It is likely that take-up in the initial years would be somewhat lower as a result of this phasing, so the fiscal cost would be correspondingly lower.

Note, a significant part of the fiscal cost in the first year is the cost of higher take-up of KiwiSaver and the greater volume of first year $1,000 contributions from the government, so lower assumed take-up would affect the whole of this cost (whereas the phasing of the tax credits only affects part of the cost).

Take-up Assumptions

These costings are the product of an assumed profile of take-up levels across the income distribution, and an assumed path for how take-up builds up to these levels. We assume that take-up builds up relatively quickly over time, before settling at a steady state level. International experience supports this profile over time.



The modelling here estimates the level of take up of the savings tax credits. This is different to the original KiwiSaver modelling that sought to estimate the number of accounts opened. Our mid-estimate has take up of the tax credits of around 50% of the labour force within ten years. This is equivalent to around 170% of the take-up of KiwiSaver alone. KiwiSaver in its current form was estimated to have take up of 40% after ten years, of which around one-quarter were inactive accounts (mainly as a result of people taking contributions holidays). The tax credits and matching employer contributions should result in both higher take-up and fewer inactive accounts, so that active accounts are around 70% higher under the enhanced KiwiSaver package.

Steady state take-up levels

	Less than $26,000	$26,000 to $38,000	$38,000 and over	total
Lower estimate	30%	45%	60%	40%
Mid estimate	35%	50%	70%	50%
High estimate	50%	70%	90%	65%

These take-up rates are informed by two main factors.

First, we have HES data on current contributions to superannuation across different income bands, which has been calibrated against the Government Actuary data on the total active superannuation accounts currently in existence. There are over 600,000 current superannuation accounts. There is scope for an individual to be a member of more than one superannuation scheme, however, this does suggest that around a quarter of the labour force are currently contributing to superannuation schemes. The HES data also provides a tentative income distribution for these current contributors.

Table: Individuals contributing to superannuation schemes – by income

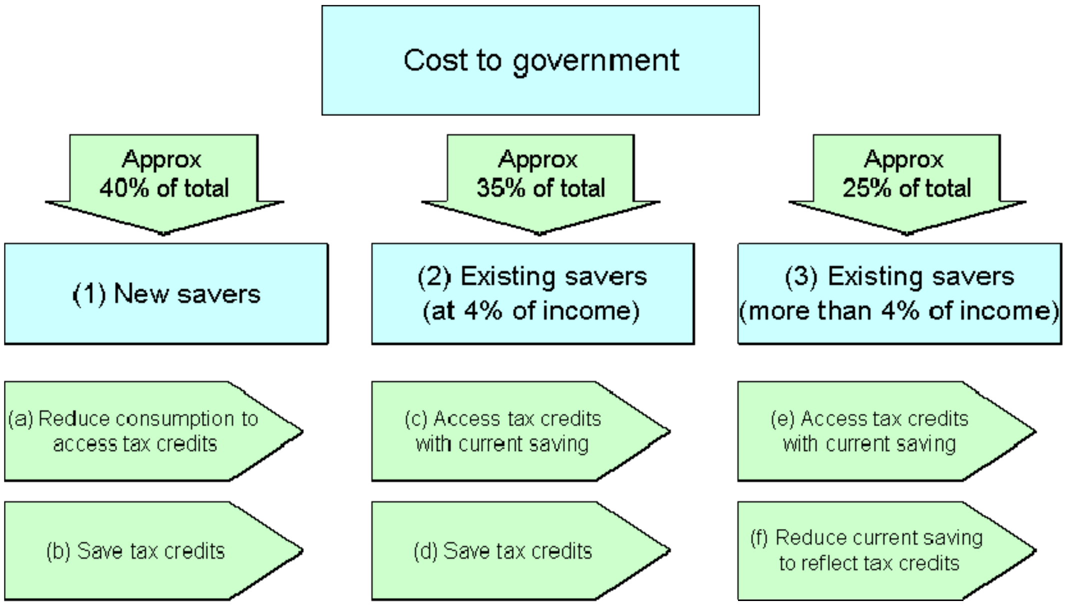
HES data (2004)	$0 to $15,000	$15 to $26,000	$26 to $38,000	$38 to $60,000	$60,000+	Total
Proportion contributing to super schemes	9%	21%	33%	42%	47%	27%

Second, we know (from Inland Revenue's employer monthly schedules) that around 40% of individuals with incomes of less than $26,000 work for less than six months of the year. It is unlikely that many of these casual and seasonal workers would want to contribute to a superannuation scheme. We also know that NZ Superannuation will provide a similar level of consumption in retirement for individuals with incomes of less than $26,000, suggesting that many of those with incomes in this range may have little need to save for retirement. At the same time, we also know (from the HES) that around 20% of individuals with incomes less than $26,000 are part of a couple with a joint income over $60,000, suggesting that many of these couples may chose to make their joint retirement savings (at least in part) against the lower of their incomes (given the structure of the tax credits).

This analysis suggests that there are limits to the overall take-up of the tax credits. It also suggests that these limits will be lower at lower incomes.

Impact on consumption

The impact on consumption reflects a number of assumptions and factors. The flow chart below illustrates the broad shape of the proposed tax credits and their effects. A number of assumptions are needed to develop an impact on consumption.



A key factor driving this structure is the data we have on individuals who are currently undertaking superannuation savings. There are three broad situations that individuals receiving the savings tax credits could face:

1) They are not currently saving (in any substantial way, long term towards retirement) – as a result, (a) they need to reduce their level of consumption to make their own contribution to their fund, in order to access the tax credits; and (b) they are also likely to save the value of the tax credits.

2) They are currently undertaking superannuation saving of around 4% of salary – as a result (c) they can access the tax credits with this current saving (by switching into KiwiSaver or into a qualifying section of their fund); and (d) they are also likely to save the value of the tax credits.

3) They are currently undertaking superannuation saving of more than 4% of salary – as a result (e) they can use their existing saving to access the tax credits; and (f) they may choose to reduce their level of contribution to take account of the tax credits (as they will be able to save more than before in their fund at a lower cost to them in term so consumption foregone).

Government Actuary data suggests that there are approximately 230,000 people in defined contribution employer schemes currently, saving on average $4,000 per annum (note this is the total contribution, so it is likely to include the employer matching contributions). There are approximately 330,000 people in retail schemes currently, saving on average $2,400 per annum.

Assumption 1: we have assumed that most people with current superannuation schemes will chose to access the savings tax credits, and that they will do so with the contributions they are currently making. As a result, approximately 40% of the total take-up is people without current superannuation saving, and the remaining 60% of total take-up is people who are already making superannuation contributions.

Assumption 2: we have assumed that the majority of those with current superannuation saving are only contributing around 4% of salary at present – equating to approximately 35% of the total take-up. This reflects the proportion of people with retail schemes, who are not currently receiving employer contributions and so are likely to find it difficult to reduce their contributions enough to offset the tax credit and compulsory employer contribution.

Assumption 3: we have assumed that approximately 25% of the total take-up will be people with current superannuation schemes who are contributing significantly more than 4% of salary at present. This reflects the proportion of people with employer schemes, as they (and their employer) have more scope to adjust these contributions to reflect the tax credits.

These assumptions generate a distribution of people accessing the tax credits. Some people will need to reduce their consumption[6] in order to make their contributions that are then matched by the tax credit and the employer, while others will be able to use existing superannuation contributions to access the tax credits. In addition, some people will have the scope to reduce their existing contributions to reflect the value of the tax credits, while others will not.

Assumption 4: the people who need to reduce their consumption to make their contributions – box (a) – may choose to borrow, to some extent, to maintain their level of consumption. We have assumed this may be relatively modest (20% of the total) or that they are fully finance-constrained (and so can borrow 0% of the total).

Assumption 5: the people who are not currently making contributions of more than 4% to superannuation saving – boxes (b) and (d) – cannot reduce these contributions to reflect the value of the tax credits, because the 4% contribution is a minimum. They may choose to borrow, and/or they may choose to reduce other saving[7], and/or they may choose to accumulate less housing equity – in order to consume part of the value of the tax credits. We have assumed this may be relatively modest (20% of the total) or that they are fully finance-constrained (and so can borrow 0% of the total).

[6] At least relative to what it would otherwise have been, e.g. if they join KiwiSaver through auto-enrolment on changing job, and their new job has a higher salary.

[7] This other saving would be shorter term than retirement saving – e.g. precautionary saving – and so greater retirement saving may not be a good substitute.

Assumption 6: the people who are currently making contributions of more than 4% to superannuation saving – box (f) – can reduce these contributions to reflect the value of the tax credits. This is a simple income effect – as they can make the same or larger contributions to superannuation saving in total, by foregoing a smaller part of their income. We have assumed that they are likely to consume most of this increase in income and have applied marginal propensities to save of 0.2 and 0.4.

At this stage, our analysis has abstracted from the way that people determine their appropriate level of superannuation saving. In situations (1) and (2), we have assumed that people will choose to make substantially larger superannuation contributions than they are currently, and that the majority of the value of the tax credits will be saved. In situation (3), we have assumed that people currently saving 8% or 12% of their salary as superannuation contributions will choose to continue contributing at around this level. The tax credits make it easier for them to contribute at this level, freeing up some income. We have assumed they will consume most of this extra income. Depending on how people determine their level of superannuation saving, it is possible that a higher proportion of this increase in income could be saved by people in situation (3); it is also possible (but perhaps less likely) that a lower proportion of the value of the tax credits would be saved in situations (1) and (2).

The following table summarises the range of possible impacts on consumption of these different assumptions around consumption and savings/borrowing behaviour. The table also varies the proportion of people whose existing superannuation savings are sufficiently above 4% of salary so that they could reduce their contributions to reflect the tax credits, i.e. box (f). The Government Actuary data suggests that perhaps 40% of current superannuation savers would be in this position – this generate the 25% of total take-up assumed above. Varying this 40% gives a larger or smaller proportion of total take-up that is in a position to reduce their current contributions.

Table: Impact on consumption – sensitivity analysis

Assumptions			Proportion of current super savers who reduce their contributions to reflect the value of the tax credits			
Box (a) ability to borrow to mitigate lower consumption	Box (b) & (d) ability to reduce other saving	Box (f) marginal propensity to save	50%	40%	30%	20%
0.2	0.2	0.2	**25**	**20**	**15**	**10**
0	0.2	0.2	**10**	**5**	**0**	**-5**
0	0.2	0.4	**5**	**0**	**-5**	**-10**
0	0	0.4	**0**	**-5**	**-10**	**-10**

Combining variations of these assumptions suggests that the impact on consumption would be between a reduction of 10% and an increase of 25% of the total fiscal cost of the savings tax credits (with a mid-point of perhaps 5% to 10%). As a result, the package is likely to result in an increase in private saving of close to (or perhaps more than) the full fiscal cost of the package.

The last assumption that influences this impact on consumption is the overall level of take-up. If overall take-up were higher, it is likely that current superannuation savers would form a smaller part of the total take-up. As a result, it is likely that the impact on consumption would be lower/more negative and the increase in savings would be larger – as long as this higher take-up was not the result of widespread rorting of the tax credits.