Inland Revenue
Te Tari Taake
Policy Advice Division

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Update of the Savings Allocation

Date:	11 November 2005	**Priority:**	High
Security Level:	IN-CONFIDENCE	**Report No:**	PAD2005/200 T2005/2075

Action Sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations Refer to Ministers of Housing and Commerce	Friday 18 November 2005
Minister of Revenue	Agree to recommendations Refer to Ministers of Housing and Commerce	Friday 18 November 2005
Associate Minister of Finance (Hon Phil Goff)	Note	None
Associate Minister of Finance (Hon Trevor Mallard)	Note	None
Associate Minister of Finance (Clayton Cosgrove)	Note	None

Contact for Telephone Discussion (if required)

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11 November 2005 SH-13-0-7

Tax Policy Report: Update of the Savings Allocation

Executive Summary

Officials have previously committed to undertake a broad review of the estimates underlying the Savings Allocation, including incorporating the impact of policy changes since the Budget and improving the model used to estimate the cost of KiwiSaver. This follows concerns previously signalled to you that the model was overly complicated due to it being developed in parallel to the policy process and in a short space of time. You have been invited to report back to the Cabinet Policy Committee if this review suggests that the current Savings Allocation is not adequate.

The review has led to a change in the profile of participation in KiwiSaver, with fewer participants in early years and additional participants in subsequent years. This change results primarily from the review of the model used to cost KiwiSaver, not from policy changes since the Budget (which have a minimal effect on the fiscal costings).

The change in profile of KiwiSaver participants affects the fiscal cost of the government contributions ($1000 upfront payment per person, fee subsidy), and of the home ownership deposit subsidy. The costs of the government contributions to KiwiSaver are now expected to be less front-loaded, with lower costs in 2006/07 and 2007/08, and higher costs in future years. In total over the forecast period (2006/07 – 2009/10) these changes lead to a net decrease in costs of $55 million. In the outyears, the average costs of the fee subsidy and government contribution are expected to be higher by $8 million per annum, which is more than offset by a lower expected cost for the home ownership deposit subsidy.

The nature of these changes is forecast changes, and therefore they can be included in the forecasts for the Half Year Economic and Fiscal Update with the agreement of joint Ministers. Because the Savings Allocation is likely to be adequate overall, we do not think you need to inform Cabinet of these changes.

The revised model leads to the assumption that around 25% of the eligible population will have joined KiwiSaver by 2013/14, which is marginally higher than that assumed in the Budget model. As we have previously reported, these estimates are highly uncertain and depend on assumptions around take-up, which is difficult to predict. However, we now have more confidence in the model underlying these costings.

A Cabinet paper seeking appropriations for some of the operational funding in the Savings Allocation is likely before the end of 2005. In addition, there is pressure on some of the other areas of the Savings Allocation, with a risk that costs will be higher than previously allocated for a generic financial education programme, operational costs for MED, and administration of the fee subsidy.

Any proposals for additional funding have not yet been scrutinised by Treasury. Officials will report further on whether additional funding is required, either later this year or as part of the Budget 2006 process. There is some scope within the operational contingency in the Savings Allocation to fund minor increases. Officials will also be looking to alternative sources for any additional funding sought. We do not recommend making changes to the Savings Allocation to reflect these pressures.

Recommended Action

We recommend that you:

a **note** that officials have previously committed to undertake a broad review of the estimates underlying the Savings Allocation, including incorporating the impact of policy changes since the Budget and improving the model used to cost KiwiSaver;

b **note** that this review suggests a change in the profile of participants, and therefore less front-loading of the costs, as a result of changes in the model used to cost KiwiSaver;

c **note** that agreement by joint Ministers is required to include these revised costs in the fiscal forecasts for the Half Year Economic and Fiscal Update (HYEFU);

d **agree** to include the following revised costs for KiwiSaver government contributions in the fiscal forecasts for the HYEFU, with a corresponding impact on debt:

	$m – increase/(decrease)					
Operating (GST excl)	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**Outyears**
Revised KiwiSaver government contributions Budget KiwiSaver government contributions						
Change		**(35)**	**(63)**	**32**	**11**	**8**

Agree/disagree. *Agree/disagree.*

e **note** that the home ownership deposit subsidy is expected to cost less than the amount previously agreed to in the Savings Allocation of up to $35 million per annum, with the following expected costs:

	$million			
Operating (GST excl)	**2010/11**	**2011/12**	**2012/13**	**Outyears** **(average 13/14 – 16/17)**
Total cost(p.a)	9	16	18	17

f **note** that these changes will not affect the HYEFU because they are beyond the forecast period;

g **agree** that the revised costs in recommendation 'e' above will form the basis of future baseline updates as additional years are rolled out;

Agree/disagree. *Agree/disagree.*

h **note** that a Cabinet paper seeking appropriations for some of the operational funding needed for KiwiSaver is likely before the end of 2005;

i **note** that there is pressure on other parts of the Savings Allocation, with a risk that costs will be higher for a generic financial education programme, operational costs for MED, and administration of the fee subsidy, and that officials will report further either later this year or as part of the Budget 2006 process;

j **note** that the model used to cost KiwiSaver will be passed from Treasury to Inland Revenue; and

k **refer** this report to the Minister of Housing and Minister of Commerce.

	Mike Nutsford
Senior Analyst, Tax Policy	Policy Manager
for Secretary to the Treasury	Inland Revenue

Minister of Housing
Minister of Commerce

Referred: Yes/No	Referred: Yes/No

Hon Dr Michael Cullen	**Hon Peter Dunne**
Minister of Finance	Minister of Revenue

Tax Policy Report: Update of the Savings Allocation

Purpose of Report

1. This report provides an update on the state of the Savings Allocation. Officials have previously committed to undertake a broad review of the estimates underlying the Savings Allocation, including incorporating the impact of policy changes since the Budget and improving the model used to estimate the cost of KiwiSaver.

2. The bulk of this paper discusses revised costings for the government contributions ($1000 upfront contribution per person and fee subsidy) and the home ownership deposit subsidy.

Analysis

Background

3. The Savings Allocation was set as part of Budget 2005 to fund the 'Securing Your Future' package. Some funding has already been appropriated against Votes Housing, Revenue, and Commerce as part of Budget 2005. Items that remain to be funded out of the Savings Allocation include:
   - generic financial education;
   - home ownership deposit subsidy; and
   - KiwiSaver (operational costs and government contributions).

4. Since the Savings Allocation was finalised in Budget 2005, there have been some policy changes, and further work has been undertaken in a number of areas (including a redevelopment of the model used to cost KiwiSaver). This has led to a change in pressures on different parts of the Allocation. The following sections provide an update of the estimated cost of government contributions, the home ownership deposit subsidy, and other components of the Savings Allocation.

KiwiSaver government contributions

5. We have previously signalled that we will undertake a broad review of the estimates underlying the Savings Allocation, incorporating the impact of policy changes since the Budget. We have also redeveloped the model used to cost KiwiSaver. This follows concerns earlier signalled to you that the previous model was overly complicated, in part because the model was developed in parallel to the policy process and in a short space of time [Aide memoire, Savings Package Costing and Modelling, 4 April 2005]. We now have more confidence in the model underlying the costings. The main changes include:
   - incorporating existing registered superannuation scheme (RSS) members into the model to allow some of these members to convert to KiwiSaver (previously these members were outside of the model but were still included in the costings);
   - explicitly modelling the interest paid by Inland Revenue during the 3-month holding period[1]; and
   - simplifying and improving the internal consistency of the model.

[1] We have only considered interest payable by Inland Revenue during the 3-month holding period, not any interest payable on unclaimed money that may occur beyond the holding period.

6. The main results of these changes are that:
   - the cumulative number of people participating in KiwiSaver is marginally higher than that assumed in the Budget model by the end of the modelled period;
   - the composition of people participating has changed (with more people entering via automatic enrolment and fewer via the opt-in mechanism); and
   - the time profile of participation has changed, with less participants initially and more participants in later years.

7. We assume a similar number of existing RSS members join KiwiSaver over the modelled period, but the profile is more spread out (previously we assumed they all joined in first 3 years).

Figure 1: New participants

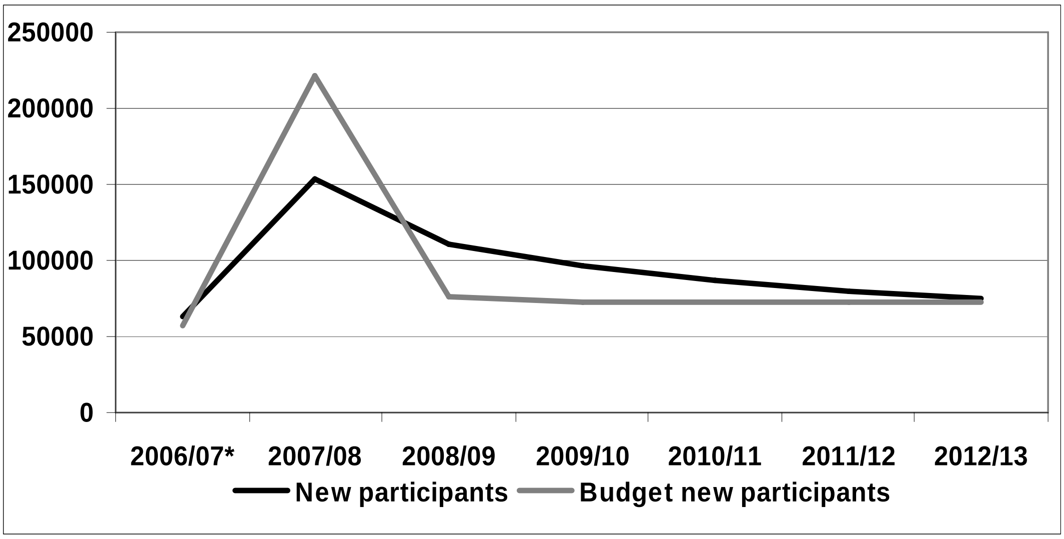
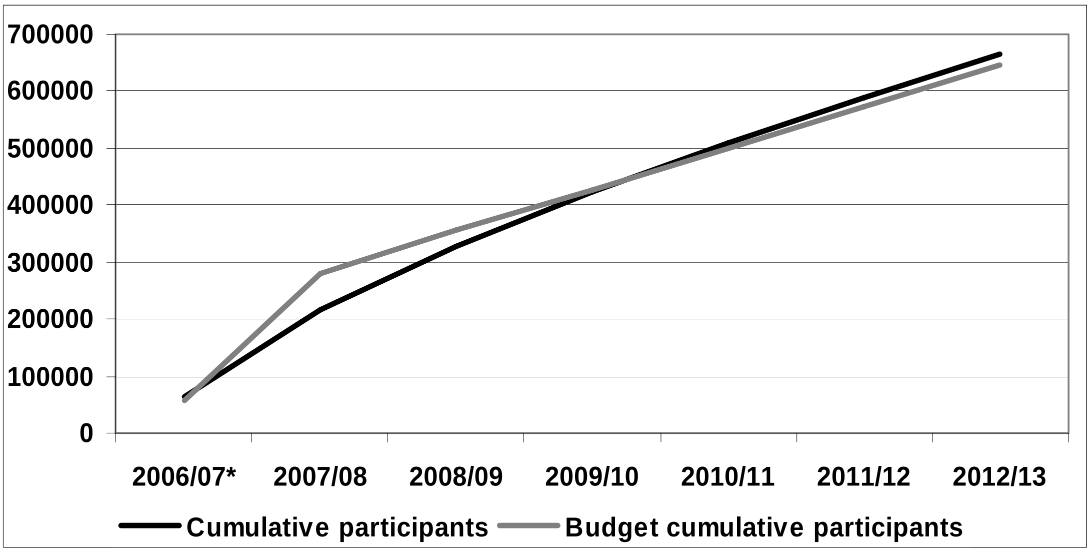


Figure 2: Cumulative participants



* Participants are assumed to join KiwiSaver from 1 April 2007, so 2006/07 is a quarter of a fiscal year. In practice, most of these people may become KiwiSaver members in the 2007/08 fiscal year, due to the delays associated with the 8-week consideration period and the time delay between funds being deducted from an employee's pay and forwarded to Inland Revenue. These delays mean the fiscal cost is likely to be delayed to 2007/08, and this has been taken into account for the purposes of estimating the fiscal cost in table 1 and figure 3.

8. These changes result in a shift in the profile of the costings, with lower costs initially and higher costs in future years. The costs in 2006/07 are lower because of fewer initial participants, and because the period where funds are held at IRD is now 3 months (previously 8 weeks), which delays more of the costs to the 2007/08 fiscal year. In total over the forecast period (2006/07 – 2009/10) there is a net decrease in costs of $55 million. In the outyears, costs are projected to be higher by $8 million per annum. This is the result of changes to the profile of participants, with slightly higher numbers of cumulative participants by the end of the modelled period.

Table 1: Fiscal cost of KiwiSaver government contributions

	$million – increase/(decrease)				
Operating (GST excl)	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**Outyears**
KiwiSaver					
$1000 upfront contribution					
Fee subsidy					
Total[2]					
Total in Budget Savings Allocation					
Change	(35)	(63)	32	11	8

9. The driver of costs changes over time. Initially, the $1000 upfront contribution is the main contributor to costs, as higher numbers of people join the scheme but have low balances. Over time, the fee subsidy becomes more significant as members balances grow, and the upfront contribution declines as fewer new members join KiwiSaver each year (see figure 3).

Figure 3: Composition of fiscal cost

[2] The total includes interest paid by IRD on balances in the holding account, at less than $1 million per annum.

10. The costings are based on a number of simplifying assumptions. These are detailed in the appendix. In particular, these costings assume:
    - the scheme is fully rolled out to all potential members on 1 April 2007; and
    - the upfront government contribution of $1000 per person will be recognised as an expense to the Crown at the time a member's first contribution is paid to Inland Revenue, even though the $1000 is not paid to a member for another 3 months. In practice, the timing of recognition of the expense will depend on the wording in the legislation. If the $1000 were recognised at the end of the 3 months, the fiscal costs would be further reduced in the initial years.

11. As we have previously reported, these estimates are highly uncertain and depend on assumptions around take-up, which is difficult to predict. Changes in participation assumptions have a large impact on overall costings, and there is a wide margin of error around the participation assumptions. At this stage, we have kept our assumptions similar to those used in the Budget model, as there is no new information on which to base any changes to assumptions (the participation assumptions are outlined in the appendix). However, we now have more confidence in the model underlying these costings.

12. The redeveloped model was designed to estimate the number of KiwiSaver participants in the short term (i.e. out to about 2013/14). By 2013/14, the cumulative participation rate is assumed to be marginally higher than the level in the Budget model at 25% of the eligible population[3]. Beyond this point, we are less confident in the ability of the model to produce accurate projections. At some point, we would expect cumulative participation to level off as a percentage of the eligible population.

13. To give an idea of the sensitivity of the estimates to the participation assumptions, table 2 shows the impact if participation through automatic enrolment were higher by 10 percentage points[4]. This would increase costs by around million in 2007/08 and almost million per annum in outyears. If participation through automatic enrolment were lower by 10 percentage points, costs would be lower by a similar magnitude.

Table 2: Increase of 10 percentage points in participation through automatic enrolment

	$million increase				
change in fiscal year costs	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**Outyears (average 10/11 – 13/14)**
KiwiSaver					
$1000 upfront contribution - increased cost					
Fee subsidy - increased cost					
Total - increased cost					
as a percentage					

3 Previously this was given as 25% of the labour force by 2012/13, but as some participants are outside of the labour force, it is more accurate to quote the figure as a percentage of the eligible population, which lowers the quoted ratio slightly.

4 This results in an increase in take-up from 20% to 30% for employees who change job for the first time, or those who start a job having previously been unemployed, and from 15% to 25% for those who start a job having previously been outside of the labour force.

14. The model used to cost KiwiSaver will be passed from Treasury to Inland Revenue. However, Treasury will continue to be responsible for monitoring the overall Savings Allocation.

Home ownership deposit subsidy

15. The home ownership deposit subsidy was also part of the overall Savings Allocation in Budget 2005. Because the deposit subsidy is only available to KiwiSaver members, KiwiSaver participation is an input into the modelling of deposit subsidy uptake and costs. Therefore changes to the KiwiSaver model lead to changes in the number of deposit subsidy recipients and associated costs. This section outlines the key results from this modelling.

16. The assumptions underlying this modelling are outlined in the appendix. This model applies the same assumptions used in the earlier Cabinet paper [CAB Min (05) 13/10 refers], but with the revised KiwiSaver participation numbers, as discussed in paragraph 8.

Estimated Costs and participation numbers for the Deposit Subsidy

17. Table 3 below outlines the results of the revised modelling. The figures rely on an estimated take-up rate of 15% of those households who are both eligible for the deposit subsidy and can afford to access home ownership. However, there is a wide margin of error in estimating the participation numbers and associated costs, since the take-up rate could be quite different from the assumed one.

18. The calculations allow for a $100,000 household income cap restriction placed on applicants for the deposit subsidy. They do not include the proposed house price cap restriction, which would limit the price of the house purchased, and potentially reduce the number of deposit subsidy recipients and the fiscal cost.

19. The amount received by each individual will vary between $3,000 - $5,000 (KiwiSaver members are eligible for a deposit subsidy of $1,000 a year, after 3 years in the scheme, up to a maximum of $5,000). The revised costing figures apply a weighted average, which estimates the likely size of the deposit subsidy that each eligible KiwiSaver will receive.

20. Table 3 estimates the number of individual KiwiSaver members that are assumed to access a deposit subsidy in any given year. However, to calculate whether or not an individual KiwiSaver will be able to afford a house and be eligible for the deposit subsidy (i.e. have a household income less than $100,000), the housing model converts individual KiwiSaver members into households.

Table 3: Costs and participation numbers for the Deposit Subsidy

	$million			
Operating (GST excl)	**2010/11**	**2011/12**	**2012/13**	**Outyears** **(average 13/14 – 16/17)**
No. individuals receiving deposit subsidies (p.a)	2,952	4,295	4,153	3,698
Total cost(p.a)	8.86	16.23	18.44	16.59

21. The KiwiSaver model estimates that 1% of all of the people participating in the KiwiSaver scheme will use the home ownership withdrawal each year, leading to an increasing number of home ownership withdrawals over time.

22. By contrast, after a general increase in deposit subsidy recipients, reaching 4,454 in 2013/14 at a cost of $19.85 million, the figures begin to decrease in outyears, falling to 1,341 in 2019/20 at a cost of $6.02 million. This decrease is primarily due to the increasing impact of the $100,000 household income cap in limiting the number of households eligible for the subsidy. The decrease in recipients over time may also be partly attributed to the increasing number of participants that have received a subsidy in previous years. The costing figures display a similar pattern to the trend in participant numbers, indicating a similar steady decrease in costs in outyears.

23. The estimated number of recipients, and therefore the cost, is lower than in the Cabinet paper on the home ownership package [CAB Min (05) 13/10 refers]. These changes are due to the changed profile of participants in KiwiSaver. These costs are also less than the funding set aside as part of the Savings Allocation of up to $35 million in outyears.

24. Housing New Zealand Corporation will seek appropriation for the administration of the deposit subsidy and actual payments as part of the broader savings package. Once actual participation rates for KiwiSaver are available, officials will be able to provide a better estimate of the costs of the deposit subsidy.

Other components of the Savings Allocation

25. A paper seeking appropriations for some of the operational funding for KiwiSaver is likely before the end of 2005.

26. Further work undertaken since the Budget suggests additional funding (over and above that set aside in the Savings Allocation) may be needed for:

- **Generic financial education**. Officials are in the process of developing options for a proposed financial education programme (which will be separate to a KiwiSaver specific information campaign to be coordinated by IRD), and intend to report back early next year seeking decisions on the proposed programme and to appropriate the associated funding as part of Budget 2006.

- **MED operational funding**. The Savings Allocation in Budget 2005 included funding for the costs of running a tender for the selection of default providers, and MED are due to report to the Minister of Commerce and Minister of Finance on the details of a tender process in November 2005. MED may also seek funding for additional policy and legal resource to devote to KiwiSaver, and implementation and operational costs for the Insurance and Superannuation Unit.

- **Administration of the fee subsidy**. It has not yet been determined which department will be responsible for ongoing administration of the fee subsidy, and costs for this function were not explicitly included as part of the Savings Allocation in Budget 2005. The exact requirements of administering the fee subsidy are not yet known, as the policy around the fee subsidy is still being developed. Until the role of the administering agency is clear, it is not clear how much this function will cost.

27. Additional funding required for these areas has not yet been scrutinised by Treasury. Officials will report further on whether additional funding is required, either later this year or as part of the Budget process. There is some scope within the operational contingency in the Savings Allocation to fund minor increases in funding. Officials will also be looking to alternative sources for any additional funding sought.

28. The Savings Allocation also contains operational funding for IRD, and IRD are intending to seek appropriation of the funding during the Budget 2006 process. Officials from the Treasury will work with IRD to see whether all of the funding set aside in contingency is required.

Overall allocation

29. You have been invited to report back to the Cabinet Policy Committee if this review of the estimates underlying the Savings Allocation suggests that the current Savings Allocation is not adequate [CBC Min (05) 12/1 paragraph 15]. At this stage, our analysis suggests:

- The change in profile of KiwiSaver participants has an impact on the Savings Allocation in each year, and this will have a corresponding impact on debt (see table 4). This is largely a change in the profile of costs within the Savings Allocation. In the outyears, the increased cost of KiwiSaver is more than offset by the decreased cost of the home ownership deposit subsidy. The nature of these changes is forecasting changes, and therefore can be included in the HYEFU forecasts with the agreement of joint Ministers. Because the Savings Allocation is likely to be adequate overall, we do not think you need to inform Cabinet of these changes.

- There may be pressure on other parts of the Savings Allocation, as discussed in paragraph 26. However, we do not recommend making changes to the Savings Allocation to reflect these pressures because: the costs are not yet finalised; there may be some scope to fund minor increases in funding from the operational contingency within the Savings Allocation or alternative sources; and the magnitude of any increase is likely to be small.

Table 4: Overall Savings Allocation

	$million – increase/(decrease)					
Operating (GST excl)	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**Outyears**
Items remaining in Savings Allocation	4	82	272	135	181	181
Changes:						
KiwiSaver		(35)	(63)	32	11	8
Home ownership deposit subsidy						(18)
Revised items remaining in Savings Allocation	4	47	209	167	192	171

Appendix – Modelling assumptions

KiwiSaver

1. The costings of the government contributions are based on a number of simplifying assumptions, including:

Participants

- The eligible population is assumed to be all those aged 18-64 years;
- People withdraw their balance and close their account in the year the fund ceases to be locked in (the later of when they turn 65 or have had an account for five years);
- After the first year, people aged over 60 do not open an account;
- There are no age-specific or income-specific assumptions;
- Job turnover is assumed to be 25%.

Participation rates

- 20% for employees that change job for the first time, or those who start a job having previously been unemployed (including those with an existing registered superannuation scheme (RSS));
- 15% for those who start a job having previously been outside of the labour force (including those with an existing RSS), recognising that this is a diverse group and is likely to include those people entering temporary/part-time employment, who are assumed to be less likely to participate in KiwiSaver;
- 10% for employees with an existing RSS who opt in during the first year, and 1% in subsequent years;
- 6% for employees without an existing RSS who opt in during the first year, and 1% in subsequent years;
- 5% for self-employed with an existing RSS who opt in during the first year;
- 3% for self-employed without an existing RSS who opt in during the first year;
- 2% for those who have previously opted out, enabling people in this group to either opt in or join through automatic enrolment if they change jobs again. This includes those with an existing RSS. From year 2 onwards, self-employed are also assumed to opt in at this rate;
- 0.5% for those unemployed or outside of the labour force who opt in.

Savings balances and fees

- Product provider fees do not change over the modelled period;
- Participants stop contributing when they withdraw for housing or turn 65 years of age. These accounts become inactive;
- All participants with active accounts contribute 4% of the average gross taxable income for the labour force (approx $40,000. This is an average, and implicitly takes into account the fact that some people will contribute at 8%, some will have employer contributions, some will take contribution holidays, and those not employed may have lower average incomes);
- 1% of members withdraw for housing each year (after three years participation). People who have withdrawn for housing do not resume contributions during the modelled period;
- The gross rate of return is assumed to be 7%, and members are taxed at 33%. The net return (calculated on the balance net of fees) is credited annually;
- Fees are credited back to individual's accounts;
- Fees are assumed to be the average of a conservative and a balanced product;

- Wage growth is assumed to be 3.5% per annum.

Existing RSS members

- This group has the same average income and income growth as members who start with no scheme;
- This group has the same probability of housing withdrawal as members who start with no scheme;
- This group is assumed to be more likely to opt-in in the first year than people with no RSS;
- This group is assumed to transfer an average balance of $2000 to the KiwiSaver component of their account when they convert.

Self-employed

- The self-employed are less likely to participate in year one than other employed, because it is not as easy to make contributions (i.e. employees have an employer make deductions along with PAYE, whereas self-employed must make payments themselves);
- From year 2 onwards, they are grouped with job-changers who have faced automatic enrolment and chosen to opt out, and have a participation assumption of 2%. Note that this participation assumption is higher than the 1% opt-in assumed for non-self-employed. This allows for a few self-employed who move into a non-self-employed job and face automatic enrolment.

Home ownership deposit subsidy

2. The deposit subsidy model uses the total estimated participation numbers in KiwiSaver in any given year as the starting point and applies the following assumptions to estimate deposit subsidy recipients and total fiscal cost:

    - KiwiSaver participants are distributed according to the general population in terms of their propensity to own a home;
    - Non-home owning KiwiSaver participants are distributed by income band, territorial authority and household composition according to the distribution of the current renting population, as approximated by 2001 Census data;
    - The same income distribution statistics are applied to both home owners and non-home owning participants;
    - In any one year, 15% of households who are eligible for the deposit subsidy and can afford to access home ownership would take it up; and
    - All households that access the deposit subsidy purchase lower quartile houses;
    - 5% of eligible households are assumed to fail credit checks.