

Saving in New Zealand – Issues and Options

September 2010



THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Government

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Foreword

The Government has appointed an independent Savings Working Group (SWG) to provide it with advice on how New Zealand can improve its national saving.

The topic of saving has been a long-standing area of interest within the Treasury. This document follows work in 2005 when we recommended the adoption of a suite of policies that took account of macroeconomic vulnerabilities and supported private saving. In 2007, the Treasury released a further report outlining its position on New Zealand saving.

In providing advice to the Government, the SWG will need to grapple with some complex issues. First, it will need to decipher a clear picture of New Zealand's national saving performance. Different approaches to measuring saving tell different stories. Second, evidence about the effectiveness of possible interventions to lift saving is often ambiguous. Third, even those interventions that are effective in achieving one objective usually have downsides when measured against other objectives.

Government plays a role in determining the level of saving in an economy. A significant component of national saving in any society simply reflects the direct effects of the fiscal policy of its government. At the same time, government policies affect the incentives of individuals and firms when they decide the extent to which they will save or dis-save at any particular point in time.

The aim of this discussion document is to assist the SWG to start its work. Options set out in the second section identify possible courses of action, plus associated costs or benefits, to help the SWG formulate its advice to the Government.

The Treasury also hopes this document facilitates public discussion, with questions included for this purpose, and encourages public submissions to the SWG in the weeks ahead.

The work of the SWG will build upon the previous work of the Capital Market Development Taskforce and the Tax Working Group.

A handwritten signature in black ink that reads "John Whitehead". The signature is written in a cursive, flowing style.

John Whitehead
Secretary to the Treasury

Executive summary

The New Zealand economy faces two key challenges.

The first is to lessen its vulnerabilities ahead of the next economic or financial shock that impacts on New Zealand.

The second is to raise per capita economic performance to achieve future higher living standards for New Zealanders.

No single policy lever is available to comprehensively address these twin challenges.

A successful strategy will come only from a broad set of co-ordinated policies. This document highlights the possible role that saving policy can play in addressing these challenges.¹

The Government has appointed an independent Savings Working Group (SWG) to provide it with advice on how New Zealand can improve its national saving. This document will be used by the SWG as a basis for discussion and development of its advice.

New Zealand as a whole appears to save less than other countries in the Organisation for Economic Co-operation and Development (OECD). One measure of saving performance, our net national saving rate, has been consistently and significantly below the median of countries in the OECD. Government has contributed positively to national saving over the past 15 years (around 4 percent of GDP on average). By contrast, net private saving (business and households) as a percentage of GDP averaged around negative 1 percent over the same period, suggesting that New Zealand households and firms have been “dis-saving”.

In the wake of the global financial crisis, these trends have recently reversed: general government has become a net dis-saver, reflected in its annual fiscal deficits, while the private sector has become a net saver. Overall, our net national saving rate has remained low throughout the period.

We have a good understanding of the drivers of government saving and dis-saving. The drivers of individual and firm saving decisions are less clear.

What seems uncontroversial is that government policies can have intended as well as unintended impacts on individuals’ saving decisions. There may be scope for policy reform to limit distortions arising from government policies that act to encourage private dis-saving.

Lifting the level of national saving should not be seen as a goal in its own right. Improved saving performance would help address economic imbalances, reduce New Zealand’s indebtedness and possibly contribute to improved economic growth.

¹ This document follows on from earlier Treasury work which can be found at: <http://www.treasury.govt.nz/publications/informationreleases/saving/synopsis> and <http://www.treasury.govt.nz/publications/informationreleases/saving/securingyourfuture>

Low rates of national saving relative to domestic investment are reflected in New Zealand's persistent annual current account deficits, but these are not of themselves a concern. Foreign investment is a necessary and important source of funding given that national investment exceeds saving. However, persistent current account deficits over many years mean that the shortfall in saving has led to a significant accumulation of overseas liabilities.

The country's net foreign asset position (also referred to as the net international investment position) – what it owes the world – is now relatively more negative than elsewhere in the developed world.

Heading into the recent global financial crisis in 2008/09, New Zealand's net foreign asset position stood at around negative 84 percent of GDP while the government had been running surpluses.

Today, the net foreign asset position stands equal to around negative 89 per cent of GDP. By 2014, it is projected to exceed 100 percent of gross domestic product (GDP). Projections are for general government to be dis-saving until 2016.

The Treasury's view is that this outlook leaves New Zealand more vulnerable to an unforeseen change in investor sentiment. Many countries in similar positions to New Zealand are now experiencing fiscal and economic stress.

A key role for the SWG will be to assess the extent of New Zealand's and New Zealanders' vulnerability, and to make recommendations on practical measures that will reduce that.

A package based on some of the options outlined in this report could, over the long-term, be expected to improve New Zealand's national saving which would, in turn, diminish the risk of any future downturn in investor confidence.

This suggests the following continuum of policy choices.

Higher saving through higher growth

The SWG needs to form a view about the relationship between people's income levels and their saving performance. A focus on economic growth (output per worker) is vital to any successful effort to strengthen national saving. Also, higher growth rates increase the capacity of the New Zealand economy to service larger current account deficits while stabilising the net foreign asset position.

Policies to support economic growth are a much broader area of debate and are not covered in this discussion document. However, the link between the Government's growth agenda and improving national saving should be noted. It is important that any package of policies to improve national saving should support rather than undermine the Government's growth agenda.

Government as saver

The clearest policy lever is any government's fiscal strategy, which determines how much it can save. Policy choices that lead to a significant change in government saving could take effect within a couple of years. There are a number of choices for the Government: how quickly it can move back to surpluses; the extent to which its saving can be sustained over a longer period; and how changes around individual spending areas will influence household saving decisions.

Getting the saving environment right

Existing government policies have intended and unintended effects on individual saving choices. The SWG may want to consider areas where current government policy creates distortions against individual saving:

- ▶ Tax distortions – international evidence suggests that tax is likely to have only a modest impact on *how much* people save and invest, but that it can have a very significant impact on *how* people save and invest. The tax system contains two main types of distortions. First, different forms of saving and investment are taxed at different rates. Second, savings income that accumulates over a long period is taxed at high effective rates exacerbated by inflation. This document sets out several options for possible tax reform aimed at reducing saving and investment distortions: reduce income taxes; index the tax base for inflation; provide a discount on interest income; a dual income tax; or introduce a capital gains tax.
- ▶ The impact of government expenditure and transfers on saving – these affect how much individuals need to save. The two areas considered most likely to reduce the need for household saving are student loans and New Zealand Superannuation (NZS). The Government is committed to retaining the current settings of NZS and it has been excluded from the terms of reference of the SWG. The Government has also said it is committed to retaining interest free student loans and the Group is unlikely to consider the student loan scheme in detail. These two areas are discussed in order to cover the full suite of options as part of the broader debate.

Options to subsidise or compel saving

The SWG may also consider options for the Government to incentivise or compel individuals to save. Many governments provide some form of subsidised savings accounts; these are often linked to retirement savings. New Zealand subsidises retirement saving through KiwiSaver, which includes an automatic-enrolment mechanism and a fairly significant subsidy. Some other countries subsidise forms of saving through tax-preferred savings accounts.

Depending on how it is designed, compulsory saving could raise national saving though there may be trade-offs against other objectives. Compulsory saving raises difficult wellbeing and fairness issues. Reaching a view on compulsion will therefore require careful discussion and consideration.

Section A – Saving policy in context

This paper focuses on how increased national saving can reduce risks to the economy and improve growth prospects

The implications of national saving for economic growth and risks to the economy are the focus of this paper. It does not explicitly address other saving-related objectives such as retirement income adequacy. However, policy options to raise national saving should be considered in the context of not only growth and rebalancing objectives but also in terms of the potential interplay with other objectives, such as equity. This paper will partially address some of these issues as policy options are laid out.

Individual private saving decisions reflect personal circumstances, with a myriad of choices that change over time. Individuals generally make the best choices for themselves. What seems uncontroversial is that government policies can have intended as well as unintended impacts on individuals' saving decisions.

The choices people make at an individual level can affect New Zealand's overall indebtedness, the composition of economic activity, and growth prospects

These individual saving decisions add up at the national level and may have negative implications for economic performance, especially if they have been biased by poor policy or information. These negative implications include distortions in the type of economic activity that takes place, imbalances in the economy represented by the accumulation of high levels of economy-wide debt, and a reduced capability of the economy to grow over time.

This document is interested in the role that government can play in improving national saving. This can be: directly, whether by raising its own saving or by encouraging saving through subsidisation or compulsion; or indirectly, through overall government policy settings (such as tax) that might negatively impact on private saving decisions.

Saving policies are part of a broader package of growth-enhancing policies within the Government's growth agenda

Finally, it is important to consider saving as just one part of a very complex economy. While increased national saving could contribute to a stronger and more balanced economy, there are many other – potentially more significant – factors that should also be considered. For example, the quality of New Zealand's capital stock, the efficiency of the overall tax system, and the quality of government spending and regulations all have significant influence on the economy.

Why increasing saving matters

Higher national saving would reduce the amount New Zealand needs to borrow offshore

Lifting the level of national saving is not a goal in its own right. Higher national saving means that more domestic funds are available to invest in productive activity at any given interest rate. By increasing the proportion of funding from domestic sources, it also has favourable implications for the nature and extent of imbalances in the economy. This is especially the case given the government's objective to grow the economy more quickly, which is likely to require higher levels of investment.

Three imbalances stand out for New Zealand:

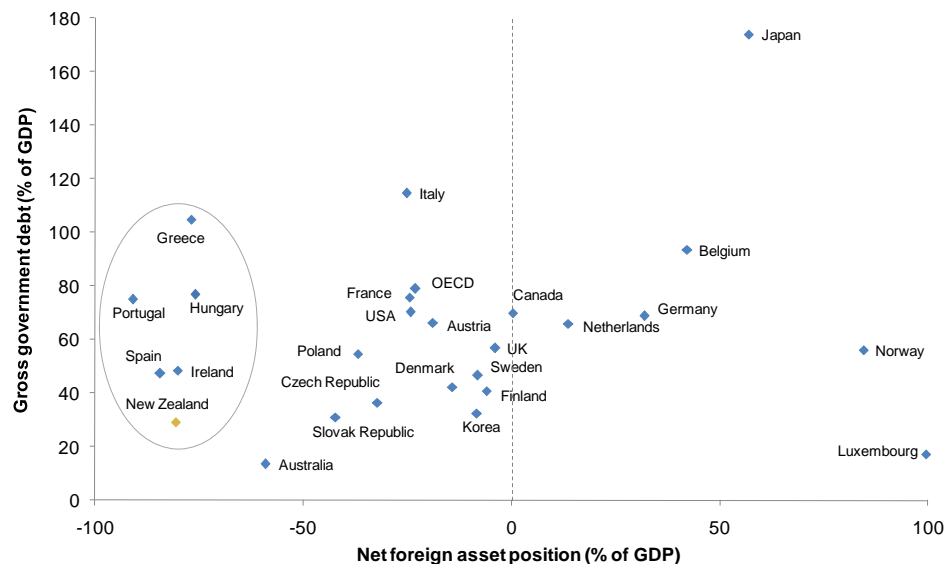
- ▶ high and persistent current account deficits
- ▶ high private sector debt – particularly household and farm debt, and
- ▶ a significant structural fiscal deficit.

These imbalances are reflected in New Zealand's net foreign asset position, which is one of the most negative in the developed world, while property prices and household balance sheets are over-extended.

New Zealand's level of international debt is one of the highest in the developed world, and is similar to that of countries facing significant economic stress

Many countries with similar imbalances to New Zealand are now experiencing severe fiscal and economic stress. It is fair to say that New Zealand's strong institutions have to date contributed to the resilience of the economy, helping to prevent it from experiencing similar stress. For example, Figure 1 shows that New Zealand's low government debt going into the global financial crisis was likely to have been an important differentiating feature from other countries struggling to cope with high international imbalances. But since the start of 2008, New Zealand's net foreign asset position has deteriorated further from negative 84 percent of GDP to negative 89 percent. Moreover, New Zealand now has a high structural fiscal deficit, and increasing public sector debt.

Figure 1 - Government debt and net foreign asset position (2008)



Source: OECD, IMF, Treasury

International debt cannot continue to grow indefinitely

If these imbalances and trends are not arrested, the potential future loss of investor confidence may grow.

- ▶ The risk to the economy associated with these imbalances can also weigh against economic confidence which, if significant, would reduce investment, further holding back the economy's potential growth.

It is not just through imbalances that national saving can impact on growth. Growth may be indirectly influenced through lower interest rates and linked to lower interest rates, a lower exchange rate. There is also some evidence that a higher national saving rate is associated with the development of capital markets.

Policies to address imbalances through increasing national saving are mostly complementary with growth-focused policies over the medium-term. Promotion of national saving, depending on how it is done, may have adverse short-term growth impacts. Lower consumption demand may not be immediately offset by growth in investment and exports, which can be expected to occur over the medium-term. Promotion of growth itself can also lead to a medium-term trade-off with imbalances. For example, higher investment growth, if not accompanied by higher saving, would need to be financed from abroad, increasing international liabilities, at least temporarily.

New Zealand's saving picture

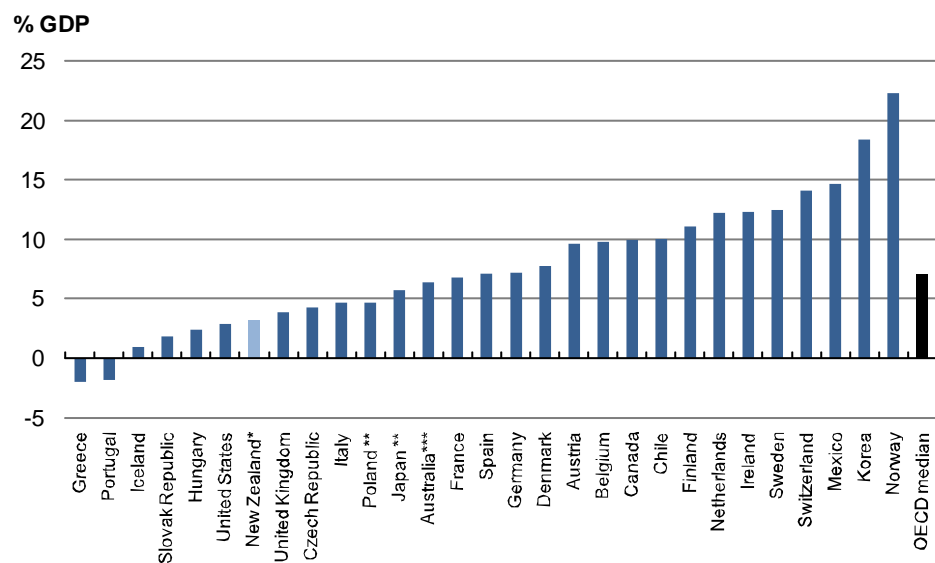
The evidence and interpretation of New Zealand's saving can be broken down in several ways.

National saving

New Zealand appears to save less than most other OECD countries

It appears that New Zealand's net national saving is low compared to most other OECD countries (Figure 2).

Figure 2 - Net (of depreciation) national saving (percent of GDP, average 2000 - 2008)



* Based on March year data
 ** Average for 2000-2007
 *** For fiscal years beginning on 1 July of the year indicated

Source: OECD

In 2009, New Zealand's net national saving was about 0.3 percent of gross domestic product (GDP), significantly below its average of 3.2 percent for the 2000 to 2008 period. Over the last 10 years, net national saving has fluctuated between 0 and 6 percent of GDP.

There are different approaches to measuring saving. The net national saving measure in Figure 2 is based on the conventional approach, which defines saving as income not spent on current consumption. Estimates of saving (the stock measure) that incorporate changes in asset values show a higher level of saving than the conventional approach, which excludes changes in asset values (refer to the following box on *Statistics and measurement*).

Statistics and measurement

Savings are a stock built up from a saving flow each period. There are two approaches to measuring saving:

- ▶ The direct flow measure used by Statistics New Zealand, which is more conventional, defines saving as income not spent on current consumption.
- ▶ The indirect stock measure based on the change in an individual's net worth (total assets minus total liabilities).

The main difference between these measures is asset revaluations. They are included in the stock measure, but not in the flow measure.

Statistics New Zealand uses the flow measure for estimating national saving, calculated as the difference between national disposable income and private and government consumption.

National saving can be broken down by sector. The national accounts measure of household saving shows rates have been declining since the early 1990s, becoming strongly and increasingly negative since around 2001.

An alternative stock measure of household saving can be calculated using Reserve Bank of New Zealand data on changes in the annual Household Balance Sheet, excluding equity held by households in unincorporated businesses and farms, and consumer durables.

A number of estimates of household saving have been made using the Household Balance Sheet data with different exclusions and deflators. All show higher levels than the national accounts flow measure of household saving, although the Reserve Bank estimate shows a similar trend of falling saving.

Cautions

- ▶ Despite allowing for methodological differences (different treatments of asset revaluations), the inability to fully reconcile the stock and flow measures is a puzzle that may never be fully settled given the data sources and conceptual differences.
- ▶ One of the reasons that the national accounts data may not accurately reflect the split between household and business saving is the high degree of cross-over between business and household saving in New Zealand. The current approach is to typically combine them into a single private sector group when analysing saving behaviour and outcomes.
- ▶ Though there is an internationally accepted methodology for measuring saving, caution is still needed when comparing saving rates across countries, due to the variation in the actual way saving is measured and the differences in the timeframe over which data has been collected. However, such comparisons are useful to illustrate broad trends.

The following section breaks national saving down by sector to identify drivers of saving in the aggregate picture.

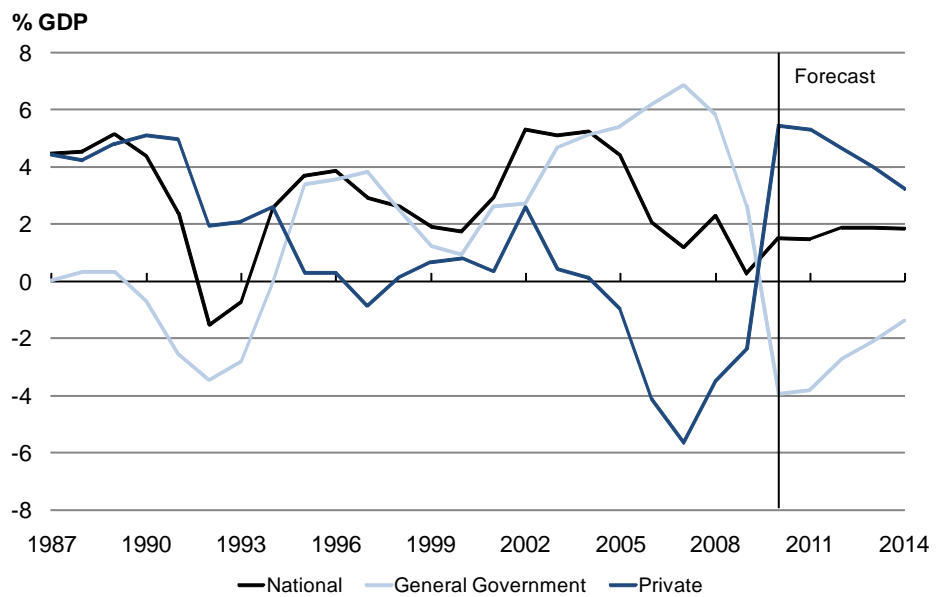
Saving in New Zealand by sector

Over the past 15 years, government saving in New Zealand was mostly positive, while private saving was negative on average

General government has contributed positively to national saving over the past 15 years (around 4 percent of GDP on average). By contrast, net private saving (business and households) as a percentage of GDP averaged around negative 1 percent over the same period, suggesting that New Zealand households and firms have been “dis-saving”. That is, overall, they have been consuming more than they earn. This is despite New Zealand typically having higher interest rates than most other countries in the OECD, suggesting that New Zealanders are less willing than most of their OECD counterparts to save at a given interest rate, or to put it another way, more willing to spend.

These trends have reversed partly in response to recent challenging economic circumstances (Figure 3). The government is now a net dis-saver, while the private sector has become a net saver.

Figure 3 - Net (of depreciation) saving by sector



Source: Statistics NZ, Treasury

Private sector

The private sector is made up of businesses and households.

Business debt levels have increased in recent years

Debt levels in the business sector increased as a share of GDP through the mid-2000s. Strong earnings growth and rising asset values helped support this level of debt. However, over the past two years, declining asset values and weaker earnings have increased the burden of this debt, leading many businesses to try to reduce debt (lending to businesses has been contracting since mid-2009).² A similar pattern has been observed in the household sector, but on a larger scale. Since households ultimately own most New Zealand businesses, the following sections will focus on household saving and their balance sheets.

Household assets are made up of two main elements: financial assets (such as bank accounts, shares, superannuation funds etc.) and non-financial assets, mainly housing.

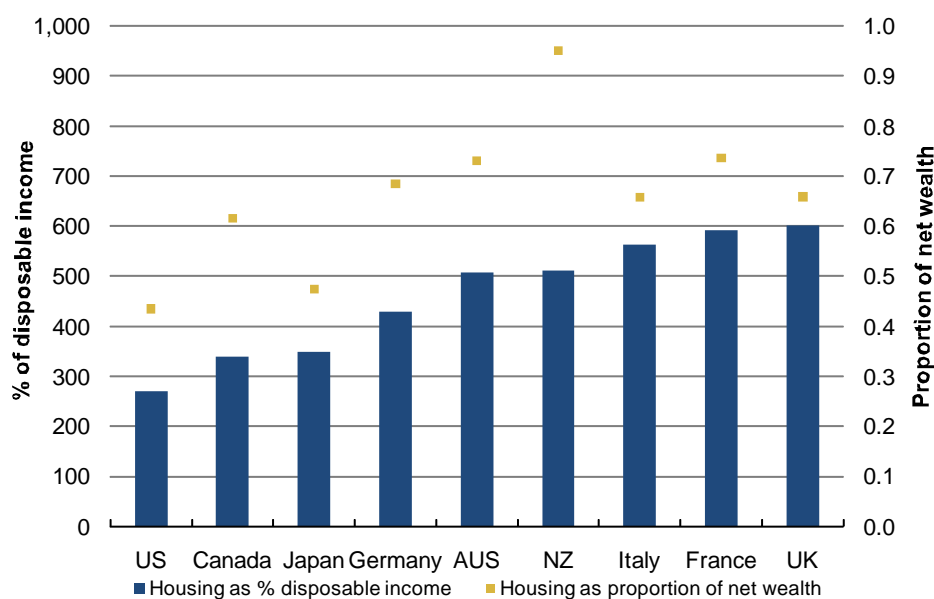
Relative to financial assets, housing is a very important component of household balance sheets.³ In 2009, using Reserve Bank data, around 70 percent of net household wealth was accounted for by housing. This was up from 58 percent in 1992 and is likely to reflect the increase in house prices that occurred over that period. Property prices over the past decade have risen significantly (more than 50 percent in real terms during the last 10 years).

Comparing New Zealand to other countries is difficult because of differences in data collection and presentation. Figure 4 uses OECD data to show the share of gross housing to household net wealth (the sum of financial and non-financial assets less liabilities) across several countries, as well as gross housing as a percent of household disposable income.

² Reserve Bank of New Zealand (May 2010), *Financial Stability Report*.

³ The extent to which housing represents national saving depends on a number of circumstances. An increase in the value of the house is 'saving' using a stock measure, but it is not 'saving' in a flow sense, such as paying off the mortgage funded from offshore.

Figure 4 - Cross country household wealth data (2007)



Source: OECD, RBA, RBNZ

Figure 4 shows that in New Zealand, the ratio of housing to total net wealth is the highest among comparator countries. It is also worth noting the lower share of housing seen in those countries that did not experience a significant house price boom over the period, such as Japan. Figure 4 also shows that at about five times disposable income, New Zealand's housing to disposable income ratio is comparable to Australia and below that of Italy, France and the UK. New Zealand households hold a relatively lower stock of financial assets compared with other countries.⁴

Household debt levels are high and have doubled in the last 15 years

High debt is the counterpart to very low levels of private saving over a considerable period of time and high property prices. New Zealand's household debt levels doubled in the last 15 years as a fraction of disposable income. They are now around 160 percent of disposable income. That means for every dollar earned, we each owe on average \$1.60.

Much of this additional borrowing has been secured against property. Furthermore, as rising property prices have led consumers to feel wealthier, debt has also been used by households to fund increased consumption, while property vendors have also consumed some of the

⁴ Figure 4 suggests that New Zealand households' relatively low stock of financial assets does not reflect an 'over investment' in housing (because the stock of housing wealth is not unusually high). Rather it is more a reflection of the low rate of household saving more generally. Later sections in this paper illustrate the fact that investment in housing has been tax preferred over investment in debt or equities, and this helps explain New Zealand preferences for holding wealth in the form of housing rather than financial assets. Even so, these tax distortions do not explain New Zealand's low rate of national saving, other than to the extent that the wealth (or collateral) effect from rising house prices encouraged more consumption at the expense of saving.

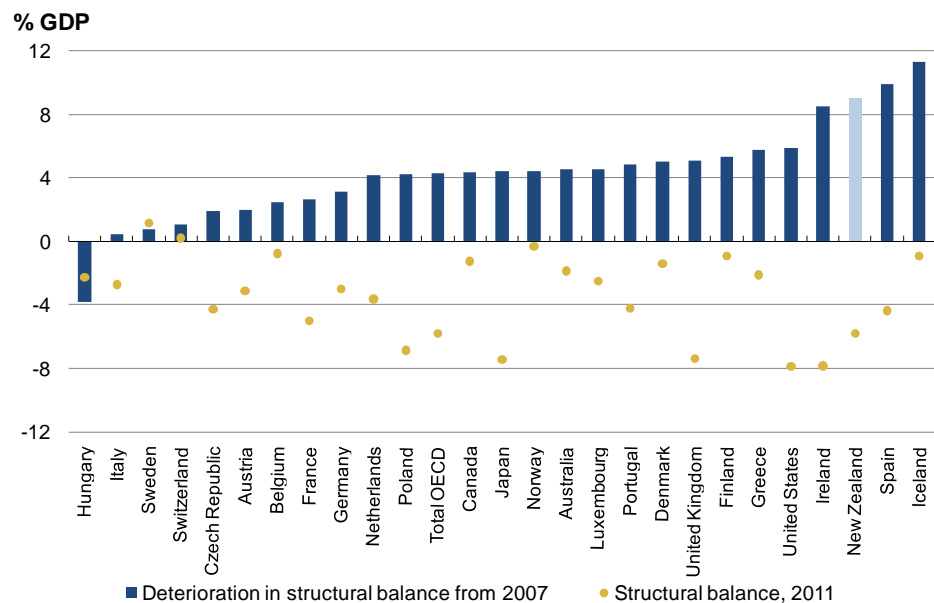
proceeds of their sales. Government and private overseas debt totals around \$244 billion (130 percent of GDP for the March quarter 2010). A vast bulk (\$219 billion or 117 percent of GDP) of total overseas debt is intermediated via the banking system, and shows up in national statistics as high offshore corporate debt.

Government sector

Saving by general government has declined sharply, increasing the level of government debt

The recent decline in saving by both central and local government has led to increasing levels of government debt. New Zealand now faces a significant structural fiscal deficit that the Government has committed itself to reducing. Although New Zealand's public debt levels are relatively low by OECD standards, the change in the structural fiscal balance – from surplus to deficit – has been large by OECD standards (Figure 5).

Figure 5 - General government structural budget balances in OECD economies



Note: Source is the OECD's cyclically-adjusted estimates in Economic Outlook 2010. The New Zealand estimate has been adjusted by Treasury to reflect the latest Budget. The deterioration is measured by comparing the 2007 CAB with each country's lowest CAB over 2009-2011.

Source: Treasury, OECD

Most of the fall in government saving reflects policy-driven spending increases and tax reductions, rather than the temporary effects of the economic cycle

Most of the deterioration in the Government's fiscal position has been driven by underlying structural factors including:

- ▶ increased government expenditure, and
- ▶ falling government revenue as a result of income tax cuts in 2008 and 2009.

It also partly reflects the impact of New Zealand's recession over 2008 and early 2009, plus subsequent sluggish economic growth.

Implications of low saving for the New Zealand economy

New Zealand's national saving performance is low relative to its investment. This has implications in terms of risks to future economic growth and the mix of current economic activity.

Implications of low saving for capital market development

The low rate of national saving may also be contributing to the lack of development of New Zealand's capital markets

The Capital Market Development Task Force identified that New Zealand's financial system is under-developed relative to other countries. The low rate of national saving appears to be a contributing factor. As a result of this under-development, businesses are unlikely to have access to a full range of financial services throughout all stages of their development, which could have some implications for investment.

Based on international experience (discussed more fully in the report of the Capital Markets Development Taskforce, 2009), a sustained increase in national saving (for example over 10 to 15 years) could strengthen New Zealand's financial system, with positive knock-on effects to business growth and labour productivity.

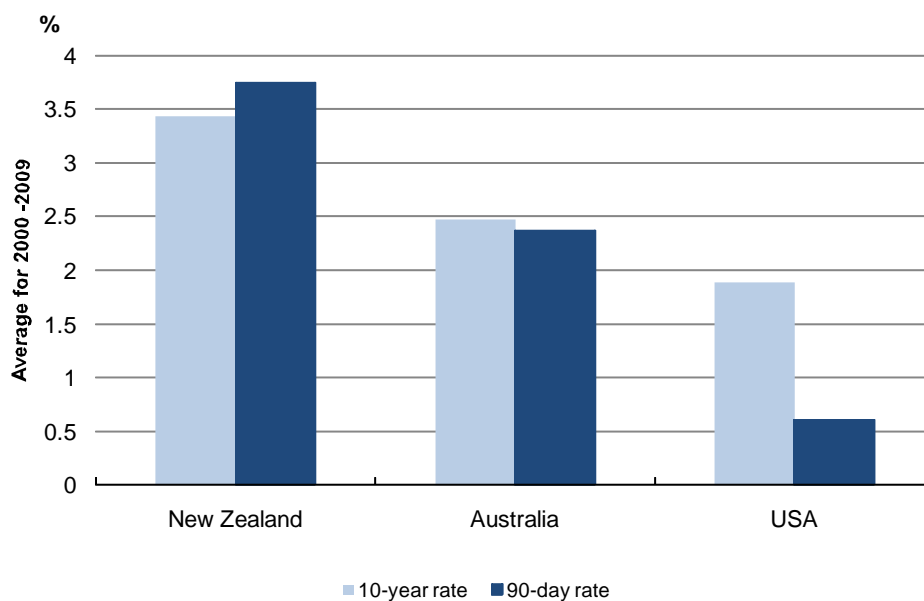
High interest rates and exchange rates

Strong growth in spending may be increasing the level of New Zealand interest rates, putting upward pressure on the exchange rate

Over the past decade, strong growth in government and private spending has increased competition for scarce resources in the economy, so that there has been:

- ▶ increased underlying inflation pressure, requiring New Zealand interest rates to be high relative to comparator countries like Australia and the United States (Figure 6), and
- ▶ an elevated exchange rate level driven in part by the interest rate premium.

Figure 6 - Average real interest rates (deflated using CPI)

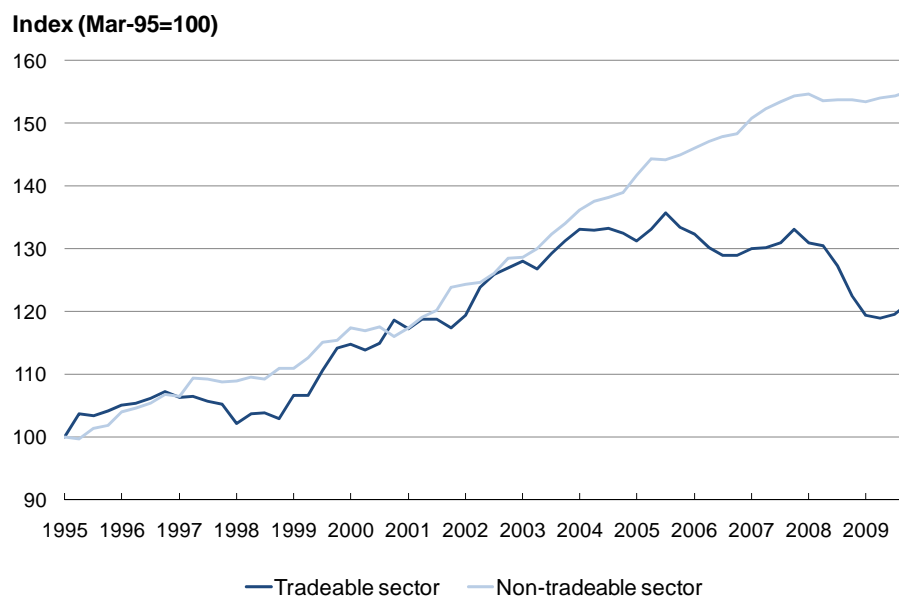


Source: OECD, Treasury

Overall, these factors have combined to shrink the tradeable sector (including exports) relative to the non-tradeable sector. All of the growth in the economy since 2004 has been in the non-tradeable sector (Figure 7).⁵ To put it another way, domestic resources have shifted from investment and exporting to supplying non-tradeable output to satisfy government and household consumption. Higher imports have also been necessary to meet this demand.

⁵ The tradeable sector is estimated as the volume of output (ie, real GDP) in primary and manufacturing industries (highly exposed to overseas trade) combined with the volume of services exports (as it is difficult to estimate what services are tradeable). Non-tradeable output is estimated as a residual with total real GDP.

Figure 7 - Relative performance of the tradeable and non-tradeable sector



Source: Statistics NZ, Treasury

The premium on New Zealand long-term interest rates is often cited as necessary to attract foreign funds to New Zealand to finance the saving shortfall. That is, investors will lend to New Zealand only at those higher rates. Another view is that higher interest rates are necessary to maintain low inflation in the face of higher household and government consumption.

Foreign investors seeking a higher return on their investment shift capital from lower interest rate countries to New Zealand.⁶ These capital inflows then drive up the exchange rate.

A permanent increase in national saving will take pressure off domestic resources which will allow, on average, lower interest rates to maintain low inflation. As the premium on New Zealand interest rates relative to interest rates elsewhere would be smaller, it would be expected that the exchange rate would be lower on average too – at least for a few years.

Higher national saving will allow for lower interest rates, which will be beneficial for investment

Lower interest rates would be beneficial to investment without increased reliance on foreign borrowing. Investment not only adds to the capital stock (which determines labour productivity) but investment itself can help to drive additional productivity growth through improvements in technology and business practices that enable labour and capital to be combined more effectively.

⁶ This is not to say that investors do not demand a risk premium but rather, that the risk premium is not the driver of the margin on New Zealand's long-term rates.

Higher national saving could indirectly benefit the export sector through a lower exchange rate

A free-floating exchange rate remains an important part of New Zealand's sound macroeconomic institutions. Increased national saving would likely facilitate a lower exchange rate than otherwise, at least for a few years. This would be beneficial to the export and import-competing sectors. Whether a sustained increase in exports will itself enhance productivity depends on a number of micro-economic factors, but the evidence suggests that a lower exchange rate creates opportunities for high productivity firms to grow and achieve scale through exporting.

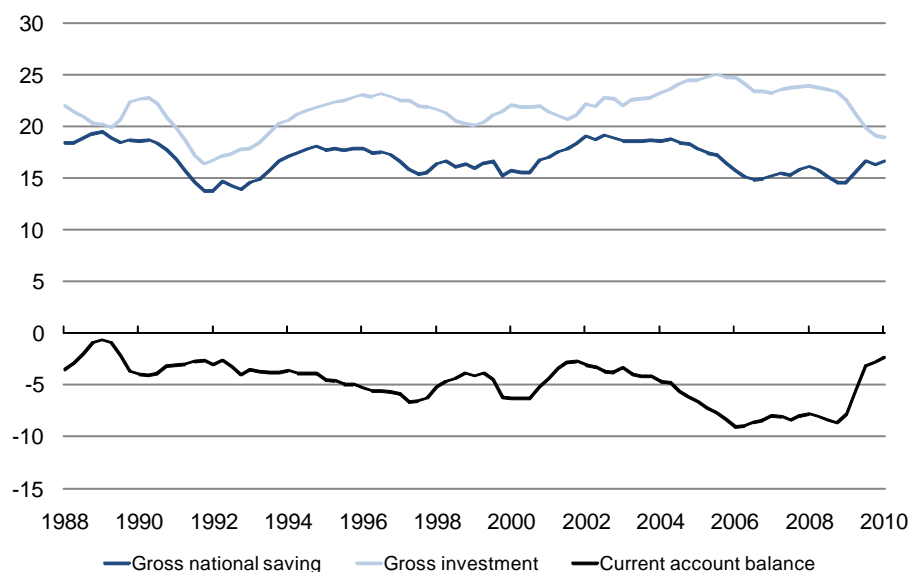
It is not clear exactly how much saving would have to rise to achieve lower interest and exchange rates, particularly since both are dependent on many domestic and global factors. Further work is needed before the Treasury would confidently attribute significant growth gains to this role of saving in the economy.

High current account deficits

The persistent saving-investment gap is reflected in New Zealand's on-going current account deficits

Low rates of national saving relative to domestic investment are reflected in New Zealand's persistent current account deficits (Figure 8).

Figure 8 - Gross saving and investment flows

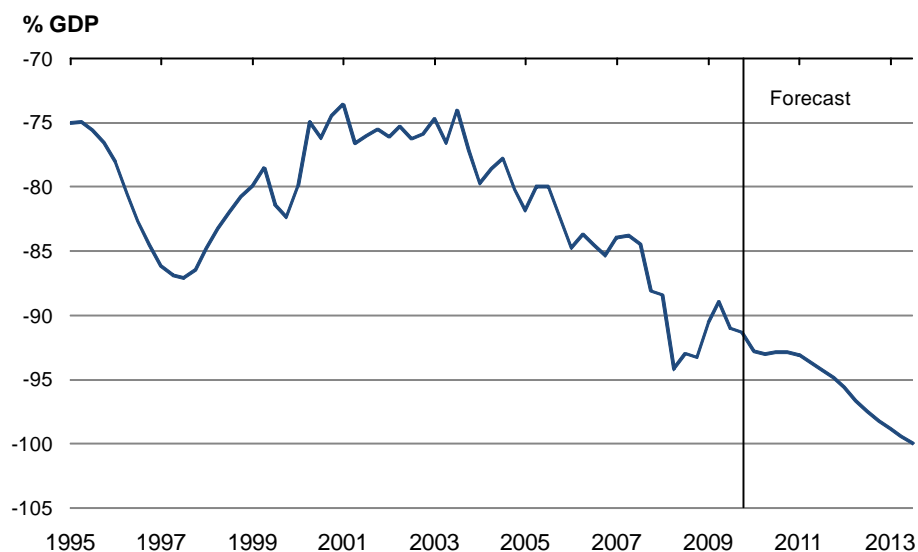


Source: Statistics NZ, Treasury

Over many years New Zealand has borrowed a significant amount from overseas

A long period of current account deficits has led to a significant deterioration in New Zealand's net foreign asset position (the difference between what New Zealanders owe and what they own overseas), to about negative 90 percent of GDP. The Treasury's forecast is for New Zealand's net foreign asset position to widen to around 100 per cent of GDP by 2014 (Figure 9). New Zealand has tended to attract foreign capital in the form of debt and direct equity investment. However, the net foreign asset position is predominantly made up of net debt rather than net equity, which is indicative of New Zealanders *owing* a lot, rather than *being owned*.

Figure 9 - Net foreign assets



* Figures prior to June 2000 quarter interpolated from annual series.

Source: Statistics NZ, Treasury

This resulting stock of foreign funds must be serviced. The cost of this servicing has averaged around 6 percent of GDP but of late has dropped to 4 percent with falling interest rates and lower returns to foreign investment in New Zealand.

The cost of servicing offshore debt would be more manageable if New Zealand had faster growth and higher investment

For a given level of current account deficit, a faster growing economy can service its obligations more easily than a slower growing economy. This is because, on average and over time, investment can be expected to more than cover its funding costs and help increase growth. Current account deficits in New Zealand are associated with average levels of investment (relative to other OECD countries) but low saving.

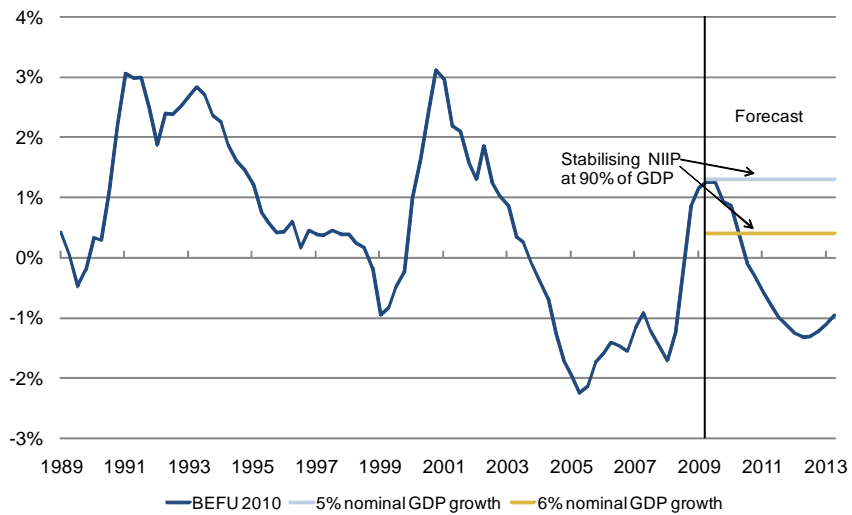
The current account deficit has improved as investment has fallen with the recession and economic uncertainty has increased household saving rates. However, most forecasts show these trends to be temporary.

An increase in national saving would be required to stabilise New Zealand's net foreign asset position

Stabilising the net foreign asset position

It is possible to estimate the increase in national saving that is required to stabilise New Zealand's external imbalances. To stabilise the net foreign asset position at current levels (around negative 90 percent of GDP), requires a 1.3 percent of GDP surplus on the trade balance (Figure 10). The associated increase in national saving (on forecast levels – refer to Figure 3) would need to be around 2 percent of GDP.⁷ If GDP growth were to be higher, this would allow New Zealand to stabilise vulnerabilities at a lower saving rate. For example, a higher nominal GDP growth rate of 6 percent would require a smaller trade surplus and as a result, a smaller increase in national saving on forecast levels.

Figure 10 - Trade balance



Key assumption: Interest rate = 7%, Transfer balance = 0.4%

Source: Treasury

To reduce New Zealand's external imbalances, would require an even larger increase in national saving. To reduce the net foreign asset position to negative 70 percent of GDP (over 10 years) would require a trade surplus of around 3 percent of GDP. This is significantly above average historic levels (since 1989) and would likely be associated with a lower exchange rate on average. The associated increase in national saving (on forecast levels – refer to Figure 3) would need to be around 4 percent of GDP.

⁷ Modelling is based on an assumed nominal GDP growth of 5 percent (3 percent real GDP growth and 2 percent inflation). It also assumes 7 percent interest rates on net liabilities, which results in a net investment income deficit of 6 percent of GDP. This would be consistent with an on-going current account deficit of around 4.3 percent of GDP (assuming a 0.4 percent of GDP transfer surplus).

Now that government debt levels are rising, New Zealand is at greater risk of falling foreign-investor confidence, with potentially harmful effects on the economy

Overall, New Zealand has robust macroeconomic and financial institutional arrangements that individually and collectively provide significant financial and economic resilience, despite New Zealand's sizable imbalances. Effects of the recent global financial crisis were lessened because:

- ▶ Public debt was low, by international standards, which allowed for accommodative fiscal policy when GDP was contracting.
- ▶ A credible monetary policy framework allowed for looser monetary policy. Lower interest rates eased the burden on debtors.
- ▶ The lower exchange rate acted as a buffer for exporters when commodity prices dropped. This is evidence of the advantages of a floating exchange rate regime. Floating exchange rates automatically adjust, which enable a country to dampen the impact of shocks and foreign business cycles.
- ▶ Financial institutions are sound. Major financial institutions were characterised by little foreign currency exposure, strong credit ratings and funding lines from strong parent owners, and balance sheet strength and transparency.

However, given that current forecasts show that government debt levels are again rising quickly, it may be a risky strategy going forward to rely solely on offshore investors' confidence in macroeconomic and financial institutions.

The Treasury's view is that action should be taken now to reduce national debt levels

There are two key concerns: whether these imbalances continue to build to a level at which New Zealand is perceived by creditors as being too risky; and the degree to which the economy can weather another significant shock given the current state of imbalances. Financial confidence is at risk to any event that would trigger:

- ▶ a material decline in property prices, commodity prices, or increase in unemployment, given the fragility of household and farm balance sheets, or
- ▶ fresh attention on the overall extent of net foreign indebtedness.

The Treasury considers it desirable to reduce imbalances through policy reform, rather than risk the inevitable forced adjustment that would occur if New Zealand were to continue down the current path of spending and debt accumulation. Policy reform would help the prospects for an orderly and controlled adjustment, reducing the welfare costs that would occur if the adjustment was forced upon the economy.⁸

⁸ This judgement rests on a "least-regrets" approach in light of data uncertainties, persistent macroeconomic imbalances and the possibility that individuals are basing saving decisions on long-run expectations where the environment could change.

A rebalancing economy would see a reversal of long-term trends. That would mean lower debt, an improvement in New Zealand's net foreign asset position, and incomes and rents catching up with house prices and debt servicing requirements. The box on *Stabilising the net foreign asset position* shows what is required to control and reduce international liabilities.

Questions

- ▶ Do you agree that New Zealand's level of national saving is too low?
- ▶ Why is the national saving rate in New Zealand comparatively low?
- ▶ Is New Zealand households' relatively low stock of financial assets a reflection of an 'over investment' in housing or a reflection of the low rate of household saving more generally?
- ▶ How exposed is the New Zealand economy given its internal and external imbalances, and how could higher national saving help to ease these vulnerabilities?
- ▶ To what extent could increased national saving increase economic growth?

Section B - The policy options

Forming a policy package to boost national saving

A number of complementary policy changes are likely to be needed to achieve a significant and sustained increase in national saving

A package containing a number of the options outlined in this report could, over the medium to long term, add up to significant desirable changes in the structure of the New Zealand economy and national saving. In forming such a package, the SWG will need to consider how the package fits together, in particular:

- ▶ The timing of change – fiscal consolidation is an option with more immediate effects. Most of the other options would lead to gradual changes in individuals' saving habits that would build up over time.
- ▶ How to form a package of reinforcing elements to change entrenched saving behaviour. This is likely to require a change to government saving, changes to policies that currently hinder people saving, and may require specific saving incentives or compulsion.
- ▶ The fiscal impact of the overall package has to be considered; cost reductions in other areas could provide fiscal room for initiatives designed to increase national saving. However, lower spending overall is an essential ingredient in achieving higher government saving that boosts national saving.

Guidelines for change

In weighing up and comparing policy options for inclusion in a reform package, it is worth referring to a set of principles or guidelines. There is no one “right” set of guidelines to use. The following are suggested as a starting point:

- ▶ **Objectives:** The package should reduce New Zealand’s vulnerability to externally generated economic or financial shocks – especially by reducing the current account deficit and/or net external liabilities. It should also lift New Zealand’s long-term rate of growth, or at least not harm it.
- ▶ **Effective:** The package should have a high probability of leading to an increase in net national saving and overall, should be welfare-enhancing taking its broad social costs and benefits into account. Each component of the package should be mutually reinforcing for the package to be effective in increasing net national saving.
- ▶ **Efficient:** The package should allow resources to flow to their most productive use in ways that minimise compliance, administrative and “deadweight” costs, and must not introduce new, unintended distortions between different saving and investment classes.
- ▶ **Fair:** The package should take into account distributional impacts, ie, it should avoid negative impacts on groups of people that would disadvantage them relative to others given their particular circumstances.
- ▶ **Predictable:** The package should be easily understood by the public and its effects transparent, so that individuals and firms can plan for their futures with confidence.
- ▶ **Stable and enduring:** The package should be expected to receive a high degree of public support so that it can realise its benefits over the medium to long term.
- ▶ **Affordable:** The package should be affordable to individuals, families, businesses, taxpayers and the Government.

No one policy option is likely to satisfy all such conditions simultaneously –a package of measures that can do so will be required.

There are a number of possible reasons why household saving is low

Expenditure and revenue drive government saving. It is more difficult to understand why New Zealand household and business saving might be low. This is something that needs to be better understood so that policy choices address factors that are behind individuals’ choices to save. It is likely that overall household and business saving in New Zealand could be low due to a combination of the following factors:

- ▶ Lower incomes – New Zealanders have, on average, lower incomes than people in many of the countries we typically compare ourselves with. This limits our ability to save. New Zealand households may also be seeking to emulate a higher standard of living than our incomes allow.

- ▶ Incentives to save – taxes may be distorting people’s saving and investment decisions.
- ▶ Capital market development – New Zealand has less developed capital markets than many other countries. This means that people have more limited domestic investment options. Many of New Zealand’s largest firms are not publicly listed as they are State Owned Enterprises, in local government ownership, or are held in restrictive forms, eg, co-operatives.
- ▶ The need for precautionary saving – for unexpected events such as sickness or unemployment. New Zealand has a comprehensive safety net, which means people might feel less of a need to save.
- ▶ Retirement income settings – New Zealand provides near-universal publicly-funded superannuation. Many OECD countries have a large component of superannuation met from save-as-you-go compulsory savings schemes.
- ▶ Behavioural factors – these are not unique to New Zealand, but literature suggests that there are a number of behavioural factors that may lead to individuals saving less than they would otherwise choose to (such as inertia and dislike of complexity).

Government policy choices clearly form a key part of the environment that influences how individuals save. The following sets out a potential spectrum of government policy options, which need to work together to drive a change in national saving.

Policies to increase national income should help raise national saving

- ▶ **Higher saving through higher growth** – income levels are a significant determinant of how much individuals save. If the Government wants to achieve a significant increase in national saving, the broader policy agenda should support this goal. Likewise, the Government’s saving policy package should have a positive impact on economic growth as well as boosting national saving.

The Government’s growth agenda

The Government’s **medium-term agenda** is designed to lift the long-term trend rate of growth. It is based around six policy drivers and aimed at delivering the following medium-term shifts:

- ▶ A **public sector** that is substantially more effective with fewer resources than at present, where stronger commercial disciplines are imposed on both existing and new spending, where new forms of delivery are actively tested to ensure that the right things are done and done well, and where the balance sheet is actively managed.
- ▶ A **tax and welfare system** that gives stronger support to productive investment and saving, removes barriers to participation in work, and encourages people and capital to shift to more productive activity.

- ▶ A world-class **regulatory environment** that opens up more business opportunities to individuals and firms, and enables resources to flow freely to their most productive uses.
- ▶ Investment in economic and social **infrastructure** – public and private – that is more responsive to economic demands, user-pays is applied where practical, and infrastructure is better managed.
- ▶ A supply of **skills** from the school system that show improvements in overall skill levels over time, including a significant reduction in the rates of poorly-achieving school leavers, and a tertiary system that meets the skill needs of a growing economy on an affordable basis.
- ▶ A stronger international focus on **science, innovation and trade** policies with increasing international flows of people, goods, ideas and capital, stronger linkages between researchers and firms, and a shift of resources from the non-tradeable to the competition-exposed sectors.

The clearest way for government to increase national saving is to increase how much it saves

Government can reduce unintended impediments to private saving caused by other government policies

Saving subsidies or compulsion could increase private saving but raise wellbeing and fairness issues

- ▶ **Government as saver** – the most direct choice the Government has is how much it saves. Fiscal policy changes may take effect more quickly than other elements of a policy package to boost national saving. Fiscal policy changes should be consistent with the broader package, as some areas of expenditure are positive for household saving or economic growth.
- ▶ **Getting the saving environment right** – government policies can distort individuals' decisions about how much or how to save. In particular, the tax system can distort saving decisions and some areas of government expenditure can have a significant impact on private saving.
- ▶ **Options to subsidise or compel saving** – the government can subsidise or compel individuals to save. Depending on design, subsidies and compulsory saving may increase national saving. However, compulsory saving raises difficult wellbeing and fairness issues. This means that coming to a view will require careful consideration.

Broader options

Finally, there are broader areas that have the potential to influence the saving environment. These are noted as part of the broader context but are not discussed further in this document:

- ▶ **Macroeconomic prudential and monetary policy settings** – good institutional settings are a necessary condition for household saving.

- ▶ **Investment options and financial literacy** – New Zealand’s capital markets are relatively shallow and many of our largest companies are owned by central or local government, or owned in restricted forms (by co-operatives or iwi). Surveys suggest that many New Zealanders are relatively unsophisticated investors. The Capital Market Development Task Force provided recommendations aimed at improving the range and quality of investment options, and improving the quality of financial information available to investors.⁹ The Government has developed an Action Plan to respond to these recommendations.¹⁰ The Retirement Commission is also currently co-ordinating a National Strategy for Financial Literacy.
- ▶ **Regulation of household debt** – many New Zealand households find management of debt challenging. This can be especially significant for low-income households and those with low levels of financial literacy. The Ministry of Consumer Affairs is currently reviewing the Credit Contracts and Consumer Finance Act 2003, which regulates debt provision.¹¹

Government as saver

The quickest increase in national saving may come from an increase in the Government’s own saving

The quickest way for the Government to improve national saving and reduce imbalances would be to improve its own saving position. The Government has moved from being a significant saver to a significant dis-saver with deficits forecast to continue for the next five years.¹²

Policy changes designed to accelerate the return to surplus could take a number of years to be implemented and take effect, but this can happen more quickly than most of the other policy levers outlined in this document. This suggests that fiscal policy is an important part of a saving policy package designed to have an early impact. It would also provide a buffer in the event that the economy is hit by a negative shock.

⁹ Capital Market Development Taskforce (2009) *Capital Markets Matter: Report of the Capital Market Development Taskforce*. For example, the Taskforce recommended: the partial listing of state owned enterprises; improving the governance and disclosure of managed funds; developing the bond market (ie, long-term government bonds and inflation-indexed bonds); and investigating the development of the annuities market.

¹⁰ Capital Market Development Taskforce – *Government Action Plan*. The Government is reviewing financial regulation to improve the quality of information and advice available to investors.

¹¹ Ministry of Consumer Affairs (2009) *Review of the Operation of the Credit Contracts and Consumer Finance Act 2003*. The areas being covered by the review include: credit fees and charges; providing better information to consumers (eg, on mortgage prepayment, and the implications of not paying off credit cards); not allowing the unsolicited extension of credit without the consumer’s express agreement; and fringe lending practices.

¹² Net core Crown debt is forecast to increase to 25.3 percent of gross domestic product in 2013, up from a low of 5.6 percent in 2008. This dis-saving is forecast to continue until 2016, when the Government’s budget is projected to return to surplus.

The extent to which improved government saving can be sustained over a longer period depends on the durability of policy choices underpinning it and ongoing government commitment, noting that fiscal challenges also become harder over the long term.¹³ To ensure a significant and enduring lift in national saving, options to increase private saving should also be considered as part of a saving package.

The way the Government increases its saving will determine whether private saving rises or falls

The policy choices to increase government saving may also have an impact on private saving. Reductions in government spending in areas that are currently reducing private saving will have the most impact on national saving. Some of these options are discussed in the following sections (for example, interest-free student loans). Conversely, reductions in government spending in some areas (such as compulsory education) would likely be, at least partly, offset by increased spending by individuals, such that national saving would be largely unchanged.

Finally, reduced government spending in areas where there are significant inefficiencies would likely further assist economic growth and rebalancing by freeing up resources for use in the tradeable sector, and allow interest rates and the exchange rate to be lower than otherwise. Conversely, reductions in spending in growth-enhancing areas or tax increases would be likely to slow economic growth and could add to New Zealand’s imbalances.

	Pros	Cons
Speed up the return of government surpluses (projected for 2016)	<ul style="list-style-type: none"> ▶ Increased national saving ▶ Assist the rebalancing of the economy through lower interest rates and exchange rates ▶ Greater government fiscal flexibility in economic shocks ▶ Reduce finance costs by lowering government debt ▶ Move earlier to manage costs of ageing population ▶ Provide increased scope for new initiatives in later years 	<ul style="list-style-type: none"> ▶ Expenditure reductions may include areas that add to peoples wellbeing or are growth enhancing ▶ Risk of slower economic growth in the short term ▶ Households/businesses may increase spending (reduce saving) to maintain services that would otherwise have been provided by the Government

¹³ New Zealand Treasury (2009) *Challenges and Choices: New Zealand's Long-term Fiscal Statement*.

Questions

- ▶ Are there pros and cons not considered here? On balance, is an earlier return to surpluses a good option that the Government should consider to increase national saving?
- ▶ Once the Government is in surplus, does more need to be done to ensure that it continues to save?

Getting the saving environment right

Some government policies may be acting as a disincentive to private saving.

Any government's policies will have both intended and unintended impacts on individuals' saving choices. It is worth considering whether the Government should change any policies to support rather than hinder good saving decisions by individuals, households and businesses.

Removing tax distortions

Taxes introduce a number of distortions that affect individuals' decisions, including decisions to save and invest. The 2010 Budget reduced tax distortions to saving and investment by switching away from taxes on income, saving and investment toward taxes on spending. This switch was achieved through reductions to personal and corporate income tax rates and an increase in the rate of goods and services tax (GST).¹⁴

Taxes tend to have more impact on *how* people save, rather than *how much* people save

International evidence suggests that tax is likely to only have a modest impact on *how much* people save and invest, but tax can have a very significant impact on *how* people save and invest.¹⁵ This means that tax changes may have a part to play in a wider package of reforms to promote increased and more efficient national saving, but are unlikely to on their own deliver a significant increase in the level of national saving.

¹⁴ New Zealand Treasury (2010) *Technical Note on the Basis of Assumptions Regarding the Effect of the Tax Package on Forecast and Projected Economic Growth* expected that the increase in GST would reduce non-housing consumption by 3%; and that the decrease in the personal income tax rates would boost household savings by approximately 1.5%.

¹⁵ OECD (2007) *OECD Tax Policy Studies No. 15: Encouraging Savings through Tax-Preferred Accounts*; Bosworth, B. & Burtless, R. (1992) *Effects of Tax Reform on Labor Supply, Investment, and Saving*, *Journal of Economic Perspectives*.

The New Zealand tax policy framework

The overall aim of New Zealand's tax policy is to finance government expenditure at the lowest possible economic cost while meeting the government's distributional objectives.

A key goal of tax policy is to make the tax system as efficient as possible. For this reason, successive governments have applied a broad-based, low-rate (BBLR) tax policy framework. The Tax Working Group also endorsed the BBLR framework as a means to reduce the economic distortions created by the tax system.

Tax policy principles suggest focusing on minimising negative tax effects on saving and investment decisions, rather than on providing targeted incentives to increase the level of private saving. This section considers options that have the potential to remove tax distortions, although the extent to which each option does this will need to be carefully considered by the SWG.

A later section considers tax subsidies for saving. The broader impacts of moving away from tax neutrality would need to be carefully considered; it would need to be clear that the benefits outweighed the costs.

The current tax system distorts saving and investment decisions in two main ways:

Different forms of saving are taxed differently

- ▶ Different forms of saving and investment are taxed in different ways and at different rates. For example, capital gains are not taxed and PIE investments are taxed at a lower rate than direct investments.

Savings held for long periods may face higher tax

- ▶ Returns on saving that accumulate over a long period are taxed at high effective rates. For example, an interest-bearing account taxed at 33 per cent and held for 60 years would face a effective tax rate on future consumption of 68 per cent when the taxes on interest earned over that period are taken into account.¹⁶

The effect of inflation on tax

Even a modest rate of inflation can significantly increase the effective tax rate for some forms of savings. This is because the tax system taxes nominal rather than real returns. Real returns are nominal (actual) returns that have been adjusted for inflation.

A tax system that does not adjust for inflation has differential effects on different forms of income, for example:

- ▶ Interest income is overtaxed.

¹⁶ Assumes an initial investment of \$100, no withdrawals, and a consistent nominal return of 6% over 60 years and a marginal tax rate of 33%.

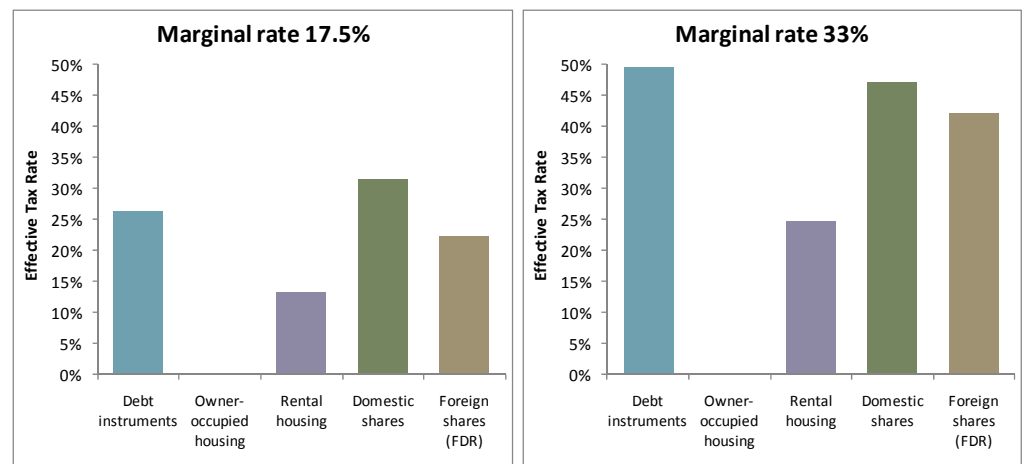
- ▶ The deduction for interest expenses is overly generous. This creates an incentive to fund investment largely through foreign debt rather than equity.
- ▶ Inflation also creates an inbuilt tax bias favouring investment in longer-lived assets ahead of shorter-lived plant and equipment.

The simplest way to reduce the distortionary impact of inflation is to keep inflation low using monetary policy. Other options are outlined on the next page.

New Zealanders' preference for housing may be partly explained by current tax rules

These tax features can distort the way people hold their savings and may have played a part in New Zealand households holding a large proportion of their assets in houses, as it is tax preferred over debt or equity. Figure 11 illustrates different real effective tax rates (taxes as a percentage of real income) for investors on 17.5% and 33% marginal tax rates:¹⁷

Figure 11 - Real effective tax rates



Options to reduce tax distortions

To address these distortions requires consideration of some tax changes. The broader efficiency and equity impacts of these options would need to be carefully considered by the SWG due to the pervasive impacts of the tax system. Several of the options have a fiscal cost; in the absence of expenditure reductions, base-broadening options would also need to be considered as part of a saving package to offset any negative fiscal impacts. Some base-broadening options also have the potential to reduce distortions.

¹⁷ Assumptions include: true inflation is 2 percent per annum; investments are financed with an individual's own capital; all investments provide a nominal return of 6 percent. For rental housing, 50 percent of the return is assumed to be in rents and 50 percent in non-taxable capital gains.

- ▶ *Lower personal tax rates* – distortions in the tax system are created because different forms of savings and investment are taxed at different effective rates. Reducing personal tax rates would lower the tax rate on savings, reduce the difference in effective rates and could have broader growth benefits.
- ▶ *Inflation indexation* – inflation is one reason why different forms of savings and investment are taxed at different effective rates. Inflation indexation is complex in practice but aims to tax real returns, ie, taxing the returns to savings or investment that have been adjusted for the impact of inflation.
- ▶ *Partial exclusion of interest income* – an option proposed by Australia's Future Tax System Review, to partially address the impact of inflation on interest income, was a 40 percent exclusion rate for certain forms of capital income (interest, residential rental income and capital gains). This could be extended to interest expense deductions to more comprehensively proxy for inflation compensation.
- ▶ *Dual income tax* – a number of countries have a dual income tax system that taxes capital income at a low flat rate and labour income at higher progressive rates. A dual income tax system would cap the rate of tax payable on capital income (similar to an extension of the current PIE regime) to ensure that those on lower personal tax rates do not pay more tax. A dual system could make the taxation of different forms of savings and investment more neutral and would lower the tax rate applied to most savings and investment.
- ▶ *Capital gains tax* – introducing a capital gains tax would help to reduce tax distortions between investments in debt, inventories and real property including those caused by inflation. A capital gains tax is also a base-broadening measure that could be used to fund other tax cuts. The Government has asked that the SWG not consider a capital gains tax or land tax. These areas were recently considered by the Tax Working Group.

	Pros	Cons
Reduce income taxes	<ul style="list-style-type: none"> ▶ Lowers impact of tax on saving decisions ▶ Potential increased labour force participation ▶ Most simple measure to reduce impact of tax system on savings 	<ul style="list-style-type: none"> ▶ Fiscal cost (size of cost dependent on level of reductions) ▶ Distributional consequences depending on rate structure

	Pros	Cons
Index tax base for inflation	<ul style="list-style-type: none"> ▶ Improves neutrality of debt, inventory and equity investment ▶ Removes distortions to financing through borrowing/equity from non-residents ▶ Net reduction in tax on domestic savings 	<ul style="list-style-type: none"> ▶ Net increase in tax on domestic investment funded by debt ▶ Fiscal cost (correlated to level of inflation) ▶ Complex to administer and comply with
Discount on interest income and expense	<ul style="list-style-type: none"> ▶ Partially reduces impact of inflation on the tax system ▶ Reduces tax rates on debt capital 	<ul style="list-style-type: none"> ▶ Fiscal cost (although this will be lower if extended to interest expense) ▶ Ad hoc method of reducing impact of inflation and not consistent with a neutral tax framework ▶ If extended to interest expense, increases tax on investment and cost of debt financing
Dual tax system	<ul style="list-style-type: none"> ▶ Lower rate of tax applied to all capital income, applied to both savings and investment ▶ Could improve the integrity of the tax system 	<ul style="list-style-type: none"> ▶ Fiscal cost ▶ As higher income earners earn disproportionate amount of capital income, decreases progressivity of the tax system ▶ Complexity in separating labour and capital income
Capital gains tax	<ul style="list-style-type: none"> ▶ Improves neutrality between debt, equity and real property; and decreases the distortions caused by inflation ▶ Improves the integrity of the tax system ▶ Fiscal gains 	<ul style="list-style-type: none"> ▶ By itself, increases tax on savings (unless paired with one of the tax cut options)

Questions

- ▶ To what extent is the tax system distorting saving and investment decisions? Do these distortions need to be addressed?
- ▶ Which of these options (and any others) are the most likely to reduce tax distortions to saving and investment (bearing in mind other objectives of economic growth, equity and meeting revenue needs)?

The effect of transfers and government expenditure on saving

Government provision of transfer payments and publicly provided services impacts on individuals' saving choices by:

- ▶ *Reducing the need for lifecycle saving* – for example, NZS and student loans reduce the need to save in advance for well-known lifecycle events.
- ▶ *Reducing the need for precautionary saving or insurance* – for example, social welfare benefit payments, and subsidised health services.¹⁸

A number of areas of government expenditure could reduce household saving for lifecycle or precautionary reasons. Households generally build up and draw down on savings over long periods of time. This means that the largest impact on household saving is likely to be from policies that affect the need for lifecycle saving.

The two areas considered the most likely to reduce the need for household saving are student loans and New Zealand Superannuation (NZS). The Government is committed to retaining the current settings of NZS and it has been excluded from the SWG's terms of reference. The Government has also said it is committed to retaining interest-free student loans and the SWG is unlikely to consider the student loan scheme in detail. Nonetheless, these two areas are discussed in order to cover the full suite of options that could have a significant impact on national saving as part of the broader debate.

Student loans

Subsidised student loans reduce incentives to save and encourage debt

The Government has a student loan scheme to facilitate students' funding of their tertiary education course and living costs. It currently involves a significant Crown subsidy through interest-free student loans. In 2009/10, the Government lent \$1.5 billion in student loans: this borrowing is expected to cost the Crown \$728 million, ie, nearly half of the value of the loan is written off when it is drawn down.¹⁹

As noted above, the Government has stated that it is committed to retaining interest free student loans. Notwithstanding that, Treasury considers that the student loan scheme is likely to be having a negative impact on household saving in several ways:

- ▶ it removes the incentive for individuals or their parents to save for tertiary education

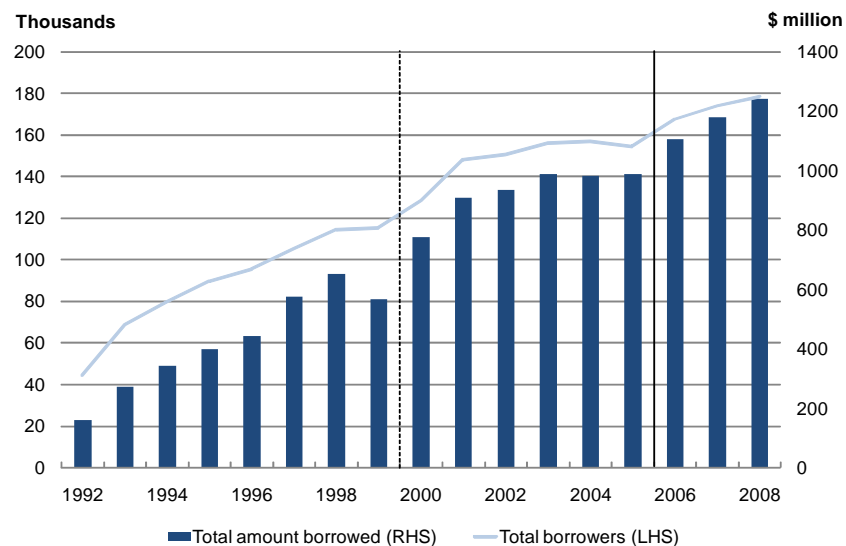
¹⁸ See for example Callen & Thimann (1997) *Empirical determinants of household saving: evidence from OECD countries*; and Hawke (2005) *Retirement income provision in New Zealand: A way forward*.

¹⁹ Ministry of Education (2009) *Student Loan Scheme Annual Report October 2009*.

- ▶ interest-free student loans provide students with a subsidy to take on debt. This is likely to encourage some to take on more debt than they would in the absence of interest-free loans, and
- ▶ encouraging students to take on debt could have an ongoing impact on their saving behaviour. For some people, taking on large amounts of debt when young could acclimatise them to continue funding consumption through debt rather than saving.

The following graph illustrates total borrowing via the student loan scheme and highlights two periods of policy change. The 2005-2006 period shows that the introduction of interest-free student loans was associated with an 8.4% increase in the number of borrowers and a 12% increase in borrowing. The 1999-2000 period has several explanations, one of which is the 'no-interest-while-studying' policy introduced in 2000.²⁰

Figure 12 - Total student loan borrowing



Source: *Student Loan Scheme Annual Report 2008/09*

One option to arrest these trends could be to reduce the subsidy element of the student loan scheme. This could involve charging interest on student loans or further changes to the eligibility criteria to receive a student loan. Changes to student loan settings could both increase household saving and speed up the Government's return to surplus. Changes to the conditions of the student loans scheme could also be combined with the introduction of a saving product to encourage parents and/or individuals to save for tertiary education.

²⁰ The 1999-2000 period has a number of explanations, including: the amount that could be borrowed for course-related costs was reduced in 1999 leading to a fall in total borrowing. This policy was reversed in 2000 and the 'no-interest while studying' policy was introduced.

NZS settings may be contributing to lower household saving

New Zealand Superannuation

A second area of government expenditure that reduces the need for lifecycle saving for many households is NZS. This reduces national saving through a number of channels:

- ▶ it significantly reduces how much households need to save to maintain the same standard of living in retirement. This is particularly true for households on lower incomes, who need to save very little for their retirement to maintain their standard of living²¹
- ▶ it reduces the opportunity for government saving as it is a significant fiscal cost and is becoming more costly as the population ages. NZS currently costs around 4.4 percent of national income and is expected to rise to about 8 percent a year by 2050,²² and
- ▶ it is largely funded on a pay-as-you-go basis rather than save-as-you-go, which means neither the government nor individuals are saving enough to fund future pensions.²³

Different countries have adopted quite different models of pension payments. New Zealand is unique in having a flat-rate universal pension. NZS has a number of advantages but it may also be reducing national saving compared with alternative regimes characterised by save-as-you-go or less generous schemes.

Over the long term, there are two broad ways that NZS could change:

- ▶ Changes to the age of eligibility – could have benefits both in terms of increasing national saving and encouraging elderly people to stay in the workforce. This could involve providing a payment at a later date for those who remain in the workforce longer and delay receiving NZS; or it could involve increasing the age of eligibility as life expectancy increases.
- ▶ Considering the level of NZS – this would encourage individuals to save more for their retirement. There are a variety of ways that the level of NZS could be adjusted, for example, indexing increases to inflation instead of wage increases to maintain a constant standard of living for the elderly, or some form of means testing.

²¹ Gibson, Le and Scobie (2004) *Saving for retirement: New evidence for New Zealand*.

²² New Zealand Treasury (2009) *Challenges and Choices: New Zealand's Long-term Fiscal Statement*.

²³ The New Zealand Superannuation Fund (NZSF) is an exception but is simply intended to help smooth the transition to the costs associated with an older population, and is not a full solution. Capital withdrawals from the NZSF are projected to begin in 2030/31. If the returns from the fund were solely allocated to funding NZS, the fund would be expected to finance around 6.3% of annual NZS expenditure over the decade beginning in 2036/37, which is a relatively small percentage (estimated by the Treasury).

The following table outlines some policy options for government expenditure changes that would encourage private saving.

	Pros	Cons
Change student loan scheme (eg, charging interest or further changes to eligibility criteria)	<ul style="list-style-type: none"> ▶ Raise household saving by removing an incentive to take on debt ▶ Potential to change some students' ongoing attitude to debt (ie, culture or habit) ▶ Increase Government saving <p><i>Tertiary education saving product</i></p> <ul style="list-style-type: none"> ▶ Could potentially lift household saving if combined with student loan changes 	<ul style="list-style-type: none"> ▶ May discourage participation in tertiary education ▶ Less of an incentive for graduates to remain in New Zealand <p><i>Tertiary education saving product</i></p> <ul style="list-style-type: none"> ▶ Risk of low uptake, which is why it has not been progressed. May have sufficient uptake if combined with student loan changes and a subsidy ▶ Needs to be compatible with tertiary policy settings and purpose of KiwiSaver
Modify NZS settings	<ul style="list-style-type: none"> ▶ Could raise national saving ▶ More affordable for the Government ▶ Incentives for older people to work (could be a pro or con depending on the change) 	<ul style="list-style-type: none"> ▶ Raises issue of fairness between different groups ▶ Adequacy of retirement income ▶ Possibly increased administrative complexity

Some Government policies may be acting as a disincentive to private saving

Questions

- ▶ Are these approaches to reducing policy-created disincentives to save the right ones? Are there other approaches that should be considered?
- ▶ Could changes to the student loan scheme increase national saving?
- ▶ Should a tertiary education savings product be designed to supplement the student loan scheme?

Options to subsidise or compel saving

This final section sets out policy options where the Government specifically encourages or compels individuals to save.

Subsidies for saving

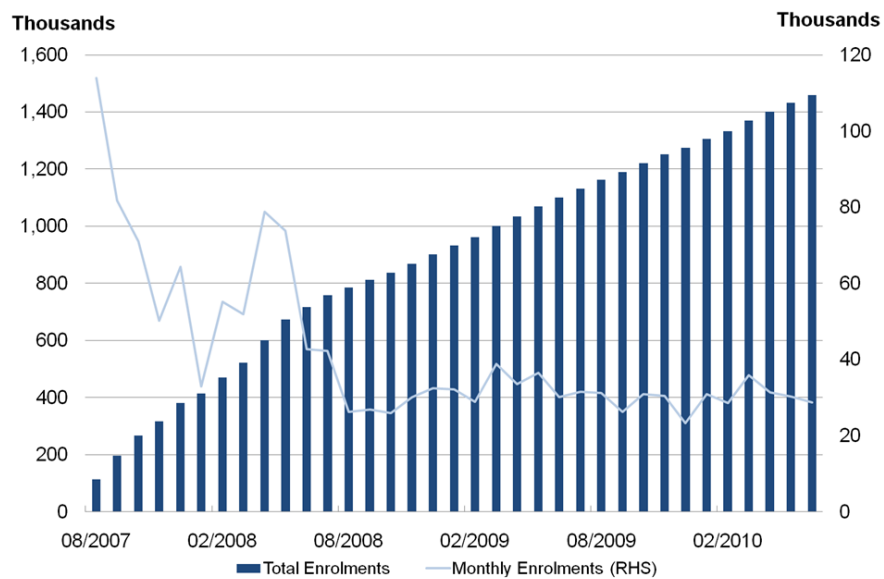
Many countries provide some form of subsidised savings accounts and these are often linked to retirement savings. In New Zealand, the Government subsidises retirement saving through KiwiSaver, which includes an automatic-enrolment mechanism and a fairly significant

subsidy. Some other countries subsidise forms of saving through tax-preferred savings accounts.

KiwiSaver aims to encourage a long-term saving habit

The KiwiSaver scheme aims to encourage a long-term saving habit and an accumulation of financial assets by people who would not otherwise be able to maintain their standard of living in retirement. KiwiSaver may also assist financial literacy and capital market development generally, and has generated public debate on retirement saving. KiwiSaver has had strong uptake as illustrated below.

Figure 13 - KiwiSaver enrolments 2007 - 2010



Source: Inland Revenue administrative data

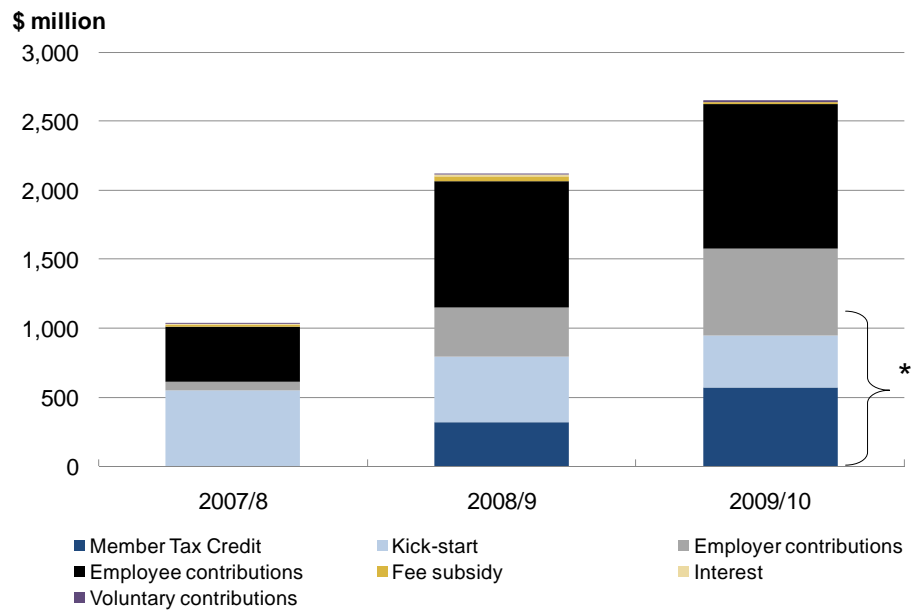
KiwiSaver subsidies were introduced at a time when the Government was saving strongly, but households were not. It is timely to review the effectiveness of these now that the Government is no longer saving.

International evidence suggests subsidies have a significant impact on *how* people save and a modest impact on *how much* people save

It is too early to draw definitive conclusions on the impact of KiwiSaver on national saving in New Zealand, with the scheme introduced in 2007. There is no hard evidence of the impact of KiwiSaver on national saving. It seems likely that KiwiSaver has encouraged some household savings that would not otherwise have occurred, but that some proportion of KiwiSaver contributions would have been saved anyway. KiwiSaver also involves the Government saving on behalf of households through subsidies. KiwiSaver incentives currently cost the Government about \$1 billion per annum. The international evidence on the impact of subsidies on household saving varies, but tends to suggest that subsidies have a significant impact on *how* people save and only a modest impact on *how much* people save.²⁴

²⁴ Attanasio, O., Banks, J., Wakefield, M. (2007) *Encouraging Savings through Tax-Preferred Accounts*; Attanasio, O. and Banks, J. and Wakefield, M. (2004) *Effectiveness of tax incentives to boost (retirement) saving: Theoretical motivation and empirical evidence.*

Figure 14 - KiwiSaver money paid to providers, 2007 - 2010 (\$ million)



* *Employer contributions include a tax exemption from Employer Superannuation Contribution Tax (ESCT) at a cost to the government of around \$230 million p.a. Employers also received the Employer Tax Credit until 31 March 2009.²⁵*

Source: Inland Revenue administrative data

There are reform options that may improve the impact of KiwiSaver

The SWG may wish to consider a number of options to reform KiwiSaver in order to improve its likely impact on national saving:

- ▶ **Boost automatic enrolment** – KiwiSaver's automatic enrolment of new employees was designed to overcome behavioural factors (such as procrastination) which mean that individuals save less in practice than they might otherwise choose to. However, automatic enrolment only applies only to new employees. An Inland Revenue Department survey found more than a quarter of non-members said the main reason they had not joined KiwiSaver was because they had not yet got round to it.²⁶ There is scope to extend KiwiSaver automatic enrolment further, for example: a one-off automatic enrolment of all non-members; an extension of automatic enrolment to people who have been in their jobs for more than five years; or a reduction in contribution holidays.

²⁵ Employers used to be reimbursed for proportion of their compulsory contributions through the Employer Tax Credit at a cost to the Government of \$37.5 million in 2007-2008 and \$206 million in 2008-2009.

²⁶ Colmar Brunton (2010) *KiwiSaver evaluation: Survey of individuals*

- ▶ *Better targeting of incentives* – target KiwiSaver incentives to those on moderate or lower incomes; these individuals are the most likely to increase their level of saving because of the availability of KiwiSaver subsidies. While evidence is not yet clear, incentives are unlikely to be having a significant effect on how much is saved by wealthier individuals, as the benefit of the subsidy can be captured by diverting funds from other forms of saving.
- ▶ *Remove ongoing incentives* – KiwiSaver was originally designed with a \$1,000 kick-start but no ongoing government contributions. This design relies on contributions continuing to be made due to peoples desire to save for retirement and inertia.

KiwiSaver provides one form of subsidy for retirement saving. Other countries use a variety of tax subsidies that could be considered as alternatives.

Many countries offer tax subsidies that move toward exempt-exempt-tax (EET) treatment of retirement savings, which substantially reduces the effective tax rate on savings. Taxation of savings in New Zealand is currently based on a tax-tax-exempt (TTE) approach, under which tax applies to income before it is saved and on income earned; but not on savings when they are withdrawn. An EET approach involves allowing a deduction for (or not taxing) income applied to saving, exempting qualifying interest or other savings income from tax, and taxing distributed savings at marginal income tax rates.

	Pros	Cons
Boost automatic enrolment	▶ Increase KiwiSaver membership	▶ Increased uptake will increase the cost of incentives
Target KiwiSaver incentives	▶ Reduced fiscal cost (and extent of government dis-saving)	▶ Likely to reduce uptake of KiwiSaver
Remove ongoing KiwiSaver incentives	▶ Could increase national saving through significant reduction in fiscal cost	▶ Likely to reduce household saving
Targeted tax incentives (eg, EET)	▶ Reduced tax rates on some long-term savings	▶ Reduces efficiency of the tax system ▶ High fiscal cost ▶ Likely to make the tax system less progressive ▶ May result in “switching” toward tax-preferred savings forms rather than increase in level of savings

Questions

- ▶ Should the Government be subsidising household saving?
- ▶ If so, what would be the most effective way to do this?

Compulsory private saving

Compulsory saving raises difficult wellbeing and fairness issues

The government can require individuals to save compulsorily. In New Zealand, this could be done by changing the law to make it obligatory for individuals to participate in the KiwiSaver scheme. Depending on how it is designed, compulsory saving could raise national saving. Compulsory saving raises difficult wellbeing and fairness issues. Coming to a view on compulsion will require careful discussion and consideration.

Compulsory saving generally increases household saving to some extent

Evidence suggests that compulsory schemes generally increase household saving, but not by the full amount of compulsory contributions. Households typically respond by reducing other forms of saving to some extent.²⁷ The success of compulsory schemes in raising national saving is heavily dependent on the nature of the design of the schemes. There are potential trade-offs against other objectives, for example, an exemption for low-income workers may reduce the impact on national saving but improve wellbeing and fairness.

A modest compulsory savings scheme might have only a limited effect on New Zealand's national saving. This is partially because many workers are already contributing to KiwiSaver. The effects of compulsory saving on national saving may depend on how it fits with the broader policy package.

Many countries have a compulsory savings scheme, but not alongside a universal pension system like New Zealand Superannuation

Many OECD countries, such as Australia, have compulsory saving schemes along with a means-tested, state-funded, safety-net pension. New Zealand would be unique were it to introduce a compulsory saving scheme in addition to a near-universal retirement income provision, particularly given the relative generosity of NZS compared to other countries' safety-net pensions. The typical OECD country pension model is sometimes referred to as the three-tier system and is set out in the table below.

Tier 1: Mandatory, adequacy	Tier 2: Mandatory, savings	Tier 3: Voluntary, savings
Typical OECD pension system		
Safety net pension, means tested and state funded.	Compulsory savings accounts.	Tax subsidies for pension savings.
New Zealand current pension system and potential additions		
Universal New Zealand Superannuation (NZS).	New Zealand doesn't have a compulsory saving scheme.	KiwiSaver, predicted to rise to 1.4 million members.

²⁷ The available empirical evidence for the impact of compulsory superannuation on household saving varies significantly between the studies, with the impact dependent on design of the study, the key features of the retirement income system as a whole, and the particular economic circumstances of the country. See for example in Australia: Connolly & Kohler (2004) *The impact of superannuation on household saving*; and Connolly (2007) *The effect of the Australian superannuation guarantee on household saving behaviour*.

The following lists some of the potential broader effects of compulsory saving:

- ▶ *Effects on households* – some people may feel better off with compulsory saving and might welcome an imposed discipline requiring them to save. Others, in contrast, may feel financially worse off because their choices on how much, when best, and how best to save would be constrained by law. Saving by repaying a mortgage, investing in a business or farm, or by acquiring financial assets may be the best saving choice for some people. Others may be better off by not saving at that point in their lives.
- ▶ *Labour market effects* – compulsory saving may be viewed partially as a tax by people who would prefer not to save, or who would prefer to save in a different form. In particular, compulsory saving risks creating an unintended disincentive to engage in the labour market, particularly for low-income workers, as they are generally less able to set funds aside for retirement.
- ▶ *Retirement income options* – over the longer term, compulsory saving could link to other retirement income policies.
- ▶ *Capital market development* – compulsion could have a positive influence on New Zealand's capital market development by raising the availability of domestically-sourced funds available for long term investments.²⁸
- ▶ *Government intervention in capital markets* – compulsion would substantially increase the level of government intervention and direction in the market. Compulsion would likely require increased regulation to reduce financial market risk and could increase pressure to introduce some form of guarantee, which would have implications for the Crown's exposure to potential liabilities.

²⁸ The empirical evidence of the effect of compulsory saving on financial market development is mixed, with the results influenced by the existing level of capital market development. One of the main areas of study has been analysis of Chile's experience following the introduction of compulsory retirement savings accounts in the early 1980s. See for example Iglesias-Palau (2009) *Pension reform in Chile revisited: What has been learned?* For general discussion of the link between retirement income system design and capital market development, see for example Vittas (2000) *Pension reform and capital market development*, and for a recent cross country analysis, see Rocholl & Niggemann (2010) *Pension funding and capital market development*.

- ▶ *Economic impact* – the overall economic impact of compulsory saving schemes is design dependent. Specific compulsory saving schemes would need to be assessed for their overall economic impact.²⁹

	Pros	Cons
Introduce compulsory saving (there are many different models)	<ul style="list-style-type: none"> ▶ Positive impact for capital market development ▶ Modest increase in national saving 	<ul style="list-style-type: none"> ▶ Substantial increase in government intervention ▶ Not the best option for all individuals ▶ Negative labour market effects

Questions

- ▶ Would the pros of New Zealand having a compulsory savings scheme outweigh the cons?
- ▶ Would compulsion be a better option than others that direct individuals into long-term savings?

²⁹ This was the approach taken by the Irish Pensions Board in 2006 when it undertook analysis of compulsory and quasi-compulsory pension systems with a view to recommending the most appropriate system for Ireland at a practical level. For their report “Special Savings for Retirement”, the Pensions Board commissioned work to quantify the macro-economic effects of a range of alternative pension systems.

Definitions

Base broadening: Options to widen the tax base through the inclusion of currently untaxed income or assets; the removal of existing exemptions.

Broad-base, low rate: An approach to tax policy that involves ensuring that the tax base is as wide and comprehensive as possible, and applying low tax rates to the base. The wide tax base increases revenue gained at lower rates, and reduces distortions caused by different items being taxed at different/exempt rates.

Capital gains tax: Extending the income tax rules to tax income derived from increases in the value of assets (or to allow losses to be offset against other taxable income). Capital gains taxes can apply to a range of assets including real property and shares, and can apply on an accrual basis or on the sale of the asset (realisation basis).

Capital market: A market for securities (debt or equity), where business enterprises (companies) and governments can raise long-term funds.

Consumer Price Index: Statistics New Zealand's official index to measure the rate of change in the prices of goods and services bought by households.

Consumption: Income that is not saved.

Core Crown: Consists of the Crown, departments, Offices of Parliament, the Reserve Bank, and the NZS Fund.

Current account: The current account includes all the transactions (other than those in financial items) that involve economic values and occur between New Zealand and the rest of the world. The major classifications are:

- ▶ Goods and services
- ▶ Income
- ▶ Current transfers.

Dual income tax system: A tax system that taxes capital income at a low flat rate and labour income at high progressive rates. Mechanical rules separate labour and capital income.

Effective tax rate: Tax paid as a percentage of pre-tax income.

EET (Exempt-exempt-tax): A method of taxing savings income whereby tax is not levied on income that is saved (an alternative approach is to allow a deduction for income saved); no tax on interest or other savings income earned; distributed savings are taxed at marginal income tax rates.

Fiscal Strategy: Fiscal policy is one tool a government has to achieve its economic and social objectives. In New Zealand, the operation of fiscal policy is governed by the Public Finance Act 1989 (PFA), which requires the government to outline its fiscal policy intentions in the annual Fiscal Strategy Report (FSR). This fiscal strategy is undertaken through the setting of long-term fiscal objectives relating to expenses, revenue, the operating balance, debt and net worth over a period of at least 10 years.

The current Government's fiscal strategy - set out in the [FSR 2010](#) - aims to deliver a fiscal position that is sustainable in the long term, contributes to economic stability and advances key priority policies.

General Government: Central, state (where applicable) and local government sub-sectors.

Gross Domestic Product: A measure of the value of all goods and services produced in New Zealand; changes in GDP measure growth or contraction in economic activity or output. Real GDP is measured as the value of goods and services excluding the effects of price changes over time.

Gross National Product: GDP less primary incomes payable to non-resident units plus primary incomes receivable from non-resident units.

Gross National Saving: The sum of government, business and household saving, excluding capital gains.

Household Debt: Debt incurred by households including: personal loans, credit sales, hire purchase, credit cards, long-term leases, mortgages and housing buy-back schemes.

Inflation Indexation: Indexing the tax base to adjust for the impact of inflation. Indexation would most likely apply to inventories, depreciation allowances, available subscribed capital, and interest deductions and income.

Investment: The amount of goods purchased, not for consumption but to be used for future production. It can also reflect the amount of funds used to purchase financial assets.

Labour productivity: Measures output per input of labour (where labour inputs might be measured as hours worked or people).

Modified Dual income tax system: This term is used in this report to refer to a dual income tax system where capital income is taxed at a capped rate and labour income is taxed at progressive rates. The capped tax rate for capital income means that a taxpayer facing a lower marginal rate for their labour income would pay that lower rate on their capital income; whereas those facing a higher labour tax rate would pay the capped tax rate on their capital income.

Monetary policy: The Reserve Bank implements its monetary policy decisions by adjusting its official cash rate (OCR) in an effort to maintain stability in the general level of prices within a defined annual CPI target range. Tightening monetary policy means raising the level of the OCR in order to moderate aggregate demand pressures and to reduce inflationary pressures, while easing monetary policy has the reverse effect.

National accounts: Also known as System of National Accounts (SNA), a comprehensive, consistent and flexible set of macroeconomic accounts to meet the needs of government and private sector analysts, policy makers, and decision takers.

Net Core Crown debt: All debt issued by the core Crown less core Crown financial assets (excluding advances and financial assets held by the NZS Fund). Advances and financial assets held by the NZS Fund are excluded as these assets are less liquid and are made for public policy reasons rather than for the purposes associated with government financing.

Net foreign asset position: Also referred to as the net international investment position (NIIP), this measures the stock of New Zealand's external assets minus the stock of New Zealand's external liabilities.

Net national saving: Gross national saving less depreciation of fixed capital.

Portfolio investment entity (PIE) regime: PIEs are collective investment vehicles for passive investments. PIEs must have a minimum of 20 investors, with no more than a 20% interest in the PIE. PIEs can invest in equity (with some restrictions), debt, other PIEs, or real property. They can also be listed on the stock exchange. Investments in PIEs are effectively taxed either at the individual's marginal tax rate, or at the 28% capped rate.

Productivity: The amount of output (eg, GDP) per unit of input.

Real effective tax rate: Tax paid as a percentage of real pre-tax income (pre-tax income adjusted for inflation).

Saving (flow): Disposable income less final consumption expenditure. Saving can be calculated for each institutional sector or for the whole economy.

Structural fiscal balance: An estimate of the fiscal balance (eg, operating balance before gains and losses) adjusted for short-term fluctuations of actual GDP around trend GDP. The estimate provides a picture of the underlying trend fiscal position. Because it is based on a number of assumptions and is sensitive to new information, the estimate is subject to some uncertainty.

Trade Balance: The trade balance is the difference between exports and imports of goods and services.

TTE (Tax-tax exempt): A method of taxing savings income whereby tax applies to income before it is saved; interest or other savings income is taxed at marginal rates; distributed savings are not taxed.

Total Crown: The reporting entity as specified in Part III of the Public Finance Act 1989, and includes the core Crown, state-owned enterprises and Crown entities.

Tradeables/non-tradeables: The tradeable sector is the part of the economy particularly exposed to foreign competition. It includes primary, manufacturing and tourism industries. Non-tradeable output is estimated as a residual with total real GDP.

Transfer payments: Welfare benefits (eg, unemployment, invalids, sickness, domestic purposes benefit) and other assistance (eg, accommodation).

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