A review of:

A report from the Treasury for the Savings Working Group:

Saving in New Zealand – Issues and Options

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Background to my analysis

I thought it might be helpful for there to a clear statement of my own position on a number of issues covered in the Treasury's report *Saving in New Zealand – Issues and Options* of September 2010 (the Report[1]) with respect, at the least, to retirement saving issues. That may help set the scene for the comments that follow.

I also want to make it clear at the outset that what follows are my own comments, rather than those of the Retirement Policy and Research Centre.

With respect to retirement income provision, governments tend to over-estimate their ability to require or encourage their citizens to behave in particular ways. There are several players in decisions about whether, how, and how much, to save for retirement: taxpayers, the government, employers, providers of financial products, advisers, employers and, the focus of all this effort, the individual saver. Policy (both public and private) should be informed by a clear understanding of who can add value and where.

In a modern democracy, the government has an obvious, fundamental role to limit, or even perhaps prevent, poverty in old age. With ageing populations and increasing numbers of elderly voters, that is as much a political as a philosophical strategy. Adopting that as the driver for *public* provision has consequential implications for the design of state-provided pensions. A universal, PAYG, Tier 1 pension is a logical consequence for a number of reasons.

On *private* provision, financial preparation for retirement is not just about financial savings. The government has a role to establish the general framework within which all interactions take place (e.g. system of justice and the enforcement of contracts) and a 'consumer protection' role with respect to financial service providers and their products. There are also statistical and research roles because only the government has the power to enforce disclosure of relevant information. That information is essential to encourage an informed debate on the efficacy of an increasingly important part of policies that relate to both public and private provision for retirement. But should the government do more? This is effectively the question the Savings Working Group (SWG) has been asked to address.

The evidence[2] shows that, of the three main strategies available to a government with respect to *private* financial provision for retirement (tax incentives, compulsion and voluntary), tax incentives are the least desirable. They are regressive, inequitable, complex, distortionary and expensive but, worst of all, seem not to 'work' (raise saving). Compulsory private provision is potentially 'better' but suffers from many of the same faults as tax incentives. Compulsion should not be combined with tax incentives and inevitably involves intrusive regulation, complexity and cost. Despite forcing people to

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1 Extracts from the Report and references to it are styled 'Report, page number'.

2 I am curious to understand why this report makes no reference to the work of the following: the Task Force on Private Provision for Retirement (1992), The Periodic Review Group's reports of 1997 and 2003; the published work of the Super2000 Taskforce and the Retirement Commissioner's review of 2007. A number of these made significant references to saving-related issues in the retirement saving context. The 2001 McLeod tax review also covered tax-related issues that deserve re-airing in a report of this nature. The consistent themes of these reports were to endorse New Zealand's retirement income settings and to reject both tax incentives and compulsory private provision as policy options for private retirement provision.

behave in a particular way, the impact on saving levels seems equivocal. Savers can, and logically should respond by reducing other savings they might otherwise have made.

This suggests that the optimal strategy with respect to *private* financial provision for retirement is to let individuals (and their employers, where relevant) decide whether, when, where and how much to save for retirement. That policy has significant potential implications for the roles of the government, employers, financial service providers and, of course, for savers themselves. Significant transitional arrangements will usually be necessary because of the arrangements currently in place (such as, for New Zealand, KiwiSaver, Portfolio Investment Entities (PIEs), the New Zealand Superannuation Fund, the special tax treatment for superannuation schemes etc).

I think that many advocates of compulsion and/or tax concessions for retirement savings of an approved kind do not, seemingly, trust their fellow citizens to behave rationally when left to make their own decisions. New Zealand is the only developed country to have tested that 'experiment' over the 20 years 1987 (roughly) to 2007. Based on research now surfacing (and discussed later) it seems that we can probably trust most citizens (and their employers) to make appropriate retirement saving decisions in the context of a relatively settled public policy framework. Perhaps the better question to ask in this context is 'why wouldn't citizens/employers behave rationally? Those who support change (including supporters of KiwiSaver) have, in my view, failed to address that most fundamental question.

What follows comments directly on the Report. It draws from issues raised in the order in which they appear in the Report itself, using the same paragraph headings for ease of reference.

Comments on Section A of the Report– Saving policy in context

National saving issues are about more than whether New Zealanders save enough for retirement. Given my particular interests, many of my comments on the Report will have a retirement savings focus. I think they also illuminate the wider 'savings' issues that this report covers. Or rather, they cannot be dismissed just because they focus on retirement saving issues.

I agree with the Report, 6 that "Individual private saving decisions reflect personal circumstances, with a myriad of choices that change over time. Individuals generally make the best choices for themselves."

Whether the sum of the individual decisions have 'negative implications for economic performance' (Report, 6) isn't really the overriding issue as individuals could easily make decisions that are for their individual and/or aggregate benefit but which have nothing to do with good (presumably) "economic performance". For instance, a person may respond to an income tax reduction by working fewer hours; or to tax subsidies for retirement saving by retiring earlier. His/her overall welfare may rise but the volume of output might fall. Is that a bad thing?

The Report presumes there is a problem with national saving. It rightly raises doubts as to whether national saving "...could contribute to a stronger, more balanced economy" (Report, 6). The qualifier "could" seems appropriate because there seems little international evidence to support the case that high national saving does 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.

Does increasing saving matter?

I agree with the Report that lifting the level of national saving is not a goal in its own right. Higher saving may mean there is more money for local investment (or investment in overseas economies) but, in the context of the Report, there should be some qualifier which questions the links between savings, investment and growth. In fact, there wasn't any comment along these lines. I think it is very important in the national discussion that everyone is clear those connections are not necessary consequences. More savings do not necessarily mean more investment and more investment does not necessarily mean higher growth.

Also, there seems to be a confusion between the static issue of increasing the proportion of domestic saving while holding investment constant (which could reduce the current account balance other things being equal) and increasing domestic saving to increase the level of investment that may be associated with no change in the current account or even an increase.

As to evidence for New Zealand's current 'problems', the Report, 7 states that household balance sheets are "over-extended". The most recent direct evidence of households' total assets and liabilities comes from reports on 2006 data from the Survey of Family, Income and Employment (SoFIE). SoFIE 2006 data show that New Zealanders have borrowed only 13.9% of gross assets (RPRC *PensionBriefing* 2010-5 here). Expressed another way, households had gross assets that were 7.2 times their liabilities.

The Report, 7 also said that "property prices ... are over-extended" as a result of the apparent "imbalances". It isn't immediately apparent why property prices might rise as a consequence of the "imbalances". And, can we be sure that these imbalances are all directly linked to poor levels of savings? Evidence and a discussion about these were missing in the Report.

Figure 1 (Report, 8) was given in support of New Zealand's vulnerability. It 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." However, of the countries circled on Figure 1 with New Zealand, four of them (Portugal, Ireland, Greece and Spain) all have fixed exchange rates (the Euro). New Zealand does not face that. Australia and New Zealand seem to be outliers in Figure 1 and I wonder if that says more about the internal structures of both countries that make them both less comparable to the Spains and Irelands of Figure 1. Perhaps a more relevant issue as to why the two countries seem to have weathered the global financial crisis more successfully is that both New Zealand and Australia had low levels of asset short-selling and, more significantly, low levels of short-selling within the banks.

It would also be interesting to produce another version of Figure 1 with net government debt on the Y-axis. I suspect New Zealand would look relatively better than Figure 1 shows. Finally, it would be helpful to see some comments on Japan's position as it is among those countries with the highest net foreign assets (with Norway and Luxembourg) but with by far the largest level of gross government debt. There are probably lessons to be learned from the 'top, right-hand' position on the chart of Figure 1 as well as from the 'bottom, left-hand position' that New Zealand occupies (with Australia).

As a more general observation, New Zealand is a relatively 'young' country by comparison with some OECD countries. Younger citizens tend to have more debt than older ones so the country's overall debt position probably at least partly reflects the capital needs of people who are at that younger end of their life cycles.

The often-quoted international debt situation does make New Zealand more vulnerable to a change in international sentiment and that can happen quickly. The size of the debt is almost certainly influenced by the fact that New Zealand's banks are almost all overseas owned, a point noted later in the Report. The size of the debt itself at the moment seems less of a worry. Of greater importance to New Zealand is whether the borrowed money is

being used productively. There isn't much recognition of this crucial issue in the Report. If the borrowings are being put to productive use, do we need to be concerned about the amounts borrowed?

The Report presumes that New Zealand's capital markets are in an unspecified way, "under-developed". It wondered whether New Zealand's relatively low saving rate contributed to that:
"There is also some evidence that a higher national saving rate is associated with the development of capital markets." (Report, 8)

I think it is more likely to be the other way around. A development of capital markets may be associated with ('help promote') *higher* national saving rates. That would make more sense. Anyway, does it follow that growth necessarily follows lower interest rates. The more logical causation is investments that return greater returns than the cost of capital. Driving interest rates down (as an objective) may well lead to less efficient use of capital and so suboptimal growth.

The Report then suggests that "[p]olicies to address imbalances through increasing national saving are mostly complementary with growth-focused policies over the medium-term." (Report, 8)

Again, this may be the wrong way round. Perhaps we should instead focus on growth-focused policies and let the national saving rate 'fall-out', so to speak. In other words, should 'national saving' (as conventionally defined) be the specific target of policy initiatives?

I agree though that "[p]romotion of national saving, depending on how it is done, may have adverse short-term growth impacts"[3] (Report, 8).

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[3] See **A Penny Saved May Not Be a Penny Earned - Thinking Hard About Saving and the Creation of Wealth** A 'fallacy of composition' says that what's good for one person isn't necessary good for a group. So it is with saving: that's because $1,000 saved is $1,000 not spent. Saving might raise the saver's wealth but not necessarily the country's. Spending may be more important than saving. more
Note: this is the first of many direct links to abstracts posted on www.PensionReforms.com – this, in each case, is a summary of the report that is accessible from the web site's abstract.

New Zealand's saving picture

National saving

I think the Report includes confusing references to two separate concepts:

- 'Saving' – what I think should instead be called the 'flows difference' as it does not measure what might ordinarily be regarded as savings;
- 'Savings' a net increase in wealth of individuals or groups.

The definitions section isn't very helpful (Report, 46); nor is the explanation in the box "Statistics and measurement" – Report, 10. In particular, what are the strengths/weaknesses of 'flows difference' numbers in illuminating the topic that is the subject of the Report?[4] It is notable that there are no citations to papers that have examined the relevance of 'flows difference' numbers when thinking about 'savings'. Here are some suggestions from www.PensionReforms.com (in each case, the 'more' link goes straight to the PR abstract):

1. **Are Americans Saving "Optimally" for Retirement?** There is no substitute for looking at stocks of wealth (rather than flows of 'saving') to assess the adequacy of retirement saving. This US study re-proves that eloquently. more
2. **Saving in New Zealand: measurement and trends** Strongly negative household 'saving' might tell us something about the behaviour of New Zealanders but not whether they are saving for retirement, let alone saving enough. A 'stocks' measure of wealth is much more useful than the 'flows' of income and spending. more
3. **Selected Issues in the Measurement of New Zealand's Saving(s)** Wealth at and in retirement is the only thing that really matters to a household's economic welfare in retirement. That can be measured only at the household level. So, what can we tell from aggregate, so-called 'household saving' numbers? Not a lot. In fact they tend to distract rather than illuminate. more
4. **Household saving and wealth** The macro-economic numbers appear to show New Zealand's household saving has plummeted since 2000. Are the numbers wrong or are households getting poorer at an alarming rate? Statistics may not give the full picture - missing information doesn't help. more
5. **Evaluating Micro-Survey Estimates of Wealth and Saving** In the US, micro-economic measures of wealth have diverged in recent years from macro-economic measures of saving. There seem to be signs of greater decumulation at older ages but 'saving' and wealth seem less connected now than they were. more

The Report, 10 describes the net national saving measure in Figure 2 as 'conventional' (the 'flows difference' number). It may be 'conventional' (an

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[4] For example, "'Saving' numbers for both the government and households are drawn from the 'System of National Accounts' (SNA) that make some seemingly arbitrary decisions about what counts as 'current consumption'." Claus, I. & Scobie, G, (2002) *Saving in New Zealand: measurement and trends,* New Zealand Treasury.

interesting expression) but, in the context of this paper, how useful is 'conventional'? Not very, I suggest. The stock measure, apart from looking more like an ordinary definition of 'savings', is probably more useful.

The Report, 9 suggests that the difference between the two sets of numbers is because the 'flows difference' measure excludes changes in asset values. But that is not the only reason for the difference – the other reasons should also be explained. And anyway, the stock figures show somewhat higher levels of savings after removing asset revaluations so this cannot be the defining difference.

The box headed "Statistics and measurement" (Report, 10) presents a number of difficulties.

First, the explanations tend to confuse the 'flows difference' measure with the stocks measure and did not clearly state which one it was describing, in some cases. Referring to the 'flows difference' measure as 'conventional' is also unhelpful as that implies the alternative (better, in my view) measure is less well-regarded.

It then suggests that the 'stocks measure' was "indirect" What is "indirect" about the stock measure? That seems a bit of a put-down. I think stock measures are much more direct (counting actual assets and liabilities) than the alternative that tries to measure what is not spent by comparing all the income that can be measured with all the money spent that can be measured (missing out, for example, the informal economy) and then assuming that the difference between these two very large numbers is 'saved' or set aside in some way that cannot, seemingly, be verified. That this difference is saved, in the ordinary sense of that word is a questionable assumption no matter how 'conventional' the concept may be.

There is no mention in the Report that the 'household saving' number is labelled experimental by Statistics New Zealand. Also, that the OECD seemingly has difficulties with New Zealand's measure and, as far as I know, will not use it.

Next, if the 'flows difference' numbers measure what is actually happening at the household level then, as implied by Iris Claus and Grant Scobie, New Zealand's households would have exhausted all their assets by now. The growth in the capital value of assets isn't enough to explain the present wealth of New Zealanders.

Then, there was a reference to wealth measurements by the Reserve Bank of New Zealand. The Report pointed out that the RBNZ numbers excluded "equity held by households in unincorporated businesses and farms...". That is an understatement of the true position. The RBNZ numbers do not miss just 'unincorporated' businesses; they actually miss all *unlisted* businesses; a much wider exclusion. However, those are not the only exclusions – directly held commercial property is missing, along with, probably, most overseas, directly-owned assets. In the absence of credible data on the extent of overseas assets, we do not know the extent of this gap.

The RBNZ numbers also count all debt, including debt raised on family homes to finance business investment. Estimates of the size of this part of debt put the amount at upwards of 20% of all household debt. Finally, the RBNZ debt numbers count the amounts borrowed for the development of human capital (student loans), but not the asset acquired as a consequence. Calculating that asset would be difficult but the absence of that asset from the numbers should at least be noted whenever the concomitant debt is mentioned.

Under the "Cautions" the Report, 10 concludes that the difference between the 'flows difference' and 'savings' numbers "...is a puzzle that may never be fully settled given the data sources and conceptual differences." However, that then leaves open, in the context of the Report, which is the more useful set of numbers?

Intuitively, the stocks measure seems the more relevant. The flows measure may tell us something about the country as a whole and its relationship with the world but that message seems disconnected from the fundamental subject of the Report. Calling the difference a "puzzle" is not good enough. Even if we decide that the macro numbers are more important than the micro (in the context of the topic of the Report, that seems unlikely) we really need to better understand the significance of the macro data. What has actually happened to the apparent 'deficits' (the 'flow differences')? Can public policy measures of the kind raised in the Report really change things? The ultimate conclusion may be that New Zealand should focus its public policy attention on getting the settings 'right' (for example, consistent tax treatment across all forms of 'income') and allow the macro numbers to lie where they fall.

The Report correctly raises the "caution" that care is needed when comparing international numbers. This is a health warning that should be repeated whenever these international comparisons are used.

I note, again, that all measures exclude the asset of human capital but count the debt incurred to obtain that (student loans).

I will end these comments on the numbers with a thought experiment – let us say that every country wanted to increase its saving(s) rate and somehow succeeded in doing that. Unless there are suitable investments to absorb those extra savings, asset prices will increase by the extra amounts saved but growth doesn't then follow (not from that anyway). To continue a point already made, new investment opportunities are more likely to lead growth, not more savings. That applies to governments just as much as to individuals and firms.

Saving in New Zealand by sector

The Report then attempts to draw conclusions from the 'flows differences' and, in particular from what it called "dis-saving" by households and firms, suggesting that, overall, "...they have been consuming more than they earn..." (Report, 11) That is indeed where the 'flows difference' numbers

take us but that runs counter to the alternative 'savings' measure. Can we really accept that households are spending more than they earn, and have been doing that since 1993? Intuitively, that does not seem credible, particularly over the extended period that characterises New Zealand's negative 'household saving' data. That intuition seems supported by recent reports on stocks-based measures of 'savings' – covered later.

The Report, 11 suggests that 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." But absolute interest rates should not directly affect 'savings' except to the extent that the cost of debt to individuals affects the amounts they have left over after meeting their mortgage payments and putting food on the table. It would be nice to see evidence for the Report's suggestion.

Again, the 'flows difference' numbers suggest that the "government is now a net dis-saver, while the private sector has become a net saver." The Report misses noting the connections between these trends. Higher-than-needed income tax makes the government a 'saver' and the households (and other taxpayers), dissavers. The reverse is now being demonstrated. So, what might we learn from this seemingly obvious connection? Who *should* be the savers – the government or the private sector? In other words, given a choice, should taxes be lower?

When addressing the issues surrounding household assets the Report, 12 used Reserve Bank data purporting to show that around 70 percent of net household wealth was accounted for by housing. This is a truly misleading number: see here for the explanation. Because the RBNZ's numbers miss entirely direct business investment (and other assets), the proportion of net household wealth accounted for by housing is somewhat overstated. SoFIE 2004-06, by contrast, measured all net housing (including holiday homes and residential investment properties) at a net 46% of all net assets in 2006. See here for a fuller analysis of SoFIE's 2006 asset position[5].

To illustrate the gap created by 'missing' business investments, the net value in SoFIE 2006 of business assets was 19.8% of total net assets. By contrast, total measured debt[6] was 13.9% of total assets. The 'missing' assets were actually larger than all (counted) debt.

But Figure 4 presents an even more misleading picture. It purports to show New Zealand's ratio of housing to total net wealth as the highest among comparator countries. However, New Zealand's 95% or so number (housing as a proportion of net wealth) is even more seriously misleading than the "around 70 percent of net household wealth" analysed above.

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5 Derived from Scobie, G. & Henderson, K, (2009). *Saving Rates of New Zealanders: A Net Wealth Approach* New Zealand Treasury.

6 Unfortunately, SoFIE did not ask for the amount that businesses themselves had borrowed. We know only the net value of business assets.

Here is how it was obtained: the RBNZ wealth number (as already mentioned this misses entirely all business investment, amongst other things) is the denominator. The numerator is created by deducting gross housing (so effectively netting house mortgage debt off against other net financial assets) from net measured assets. So-called 'net financial assets' are therefore the 5% difference between gross housing in Figure 4 and total net wealth.

What should happen is that housing debt should be deducted from gross housing to create 'net housing'. What would be even better would be to use a fuller measure of assets and liabilities than the RBNZ statistics offer. If that means we can't compare New Zealand against other countries (because they also inexplicably net house mortgages against total financial assets), so be it. Figure 4 tells us nothing about what is actually happening in New Zealand households so the comparison is not useful.

In any event, Figure 4 may illustrate a different underlying picture. Perhaps there are lower levels of home ownership in, say, Japan that seemingly appears in a better light than New Zealand in Figure 4. I understand that isn't the explanation for somewhat lower US number (the answer there may be the level of disposable incomes rather than the value of the homes) but it will certainly explain the seemingly better (than New Zealand's) German number. According to Japan's Housing and Land Survey, home ownership in 2005 was 61.2%[7]. The German home ownership rate in 2002 was only 43%. According to the US Census Bureau's *Housing Vacancies and Home Ownership*, home ownership was 69%.

Great care needs to be taken with putting these numbers together but home ownership rates will certainly explain some of the differences in Figure 4.

The RBNZ's relatively lower stock of financial assets compared with other countries may be what the unhelpful RBNZ analysis shows for New Zealand's households but avoiding any mention of 19.8% business assets and 18% of financial assets that SoFIE 2006 demonstrates gives a slightly different impression of household balance sheets. It was surprising that the Report made no mention of the two tranches of data now gathered for SoFIE (2004 and 2006) and the analyses that are now available on those.

The Report, 13 referred to households' "high debt" and that New Zealand's household debt levels doubled in the last 15 years as a fraction of disposable income. Again, it might have been appropriate to mention that, according to SoFIE 2006, total financial liabilities of respondents were 13.9% of gross assets. Incidentally, according to Australia's equivalent survey (HILDA), Australian households had borrowed 14.4% of gross assets in 2006 – see the RPRC *PensionBriefing* 2010-5 here for a fuller comparison between the two sets of results.

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[7] And we need apparently to be quite careful about that number. In Japan, multi-generational occupations of homes count as 'owner-occupied' which is true for the actual owner but not for the younger generation that also lives there.

Although much of this additional borrowing has indeed been secured against property not all was used to buy that property because business loans are often secured in that way.

A recently released report[8] looked at data for SoFIE at both 2004 and 2006 and found that average saving per adult (over two years) was:

– total: $29,900;
– excluding housing gains: $12,600 (18% gross incomes);
– excluding property & durables: $9,700.

The report also concludes that "…passive saving from the property boom did not crowd out other forms of saving". Given the positive saving levels found here, it seems that households did not 'consume' property, at least over 2004-2006. Also, it wasn't just property assets that increased in value up to the onset of the global financial crisis – so did shares.

The Report, 14 then notes that a large proportion of total overseas debt is private and is "intermediated via the banking system, and shows up in national statistics as high offshore corporate debt". It was not apparent what the apparent problem is here. Presumably the overseas lenders to the private sector expect borrowers to be able to service their loans and have taken the appropriate steps to secure the ultimate repayment of their capital, after allowing for the economy-wide risks (inflation, exchange rate changes etc) and the business/credit risks of the borrowers. Why would we expect foreign private lenders to advance money to businesses and/or individuals without a high expectation of repayment?

Government debt is a bit different. Governments may borrow to pay for current spending or low quality capital expenditure, all secured by its ability to tax, not by the commercial or social viability of the projects on which the government spends that borrowed money so lenders do not need to engage on due diligence in that regard. The key risks to lenders here are that governments may choose inflation to reduce the cost of debt denominated in domestic currency (not applicable to foreign lenders in foreign currency) or they may default on repayment. This is very different from lending to private borrowers. If private projects fail, lenders may not be repaid. In those circumstances wouldn't we expect private lenders to private businesses to take some care? Why would such borrowing generally be unrelated to expected income and the value of security? This general point seemed to be missing entirely from the Report.

Implications of low saving for the New Zealand economy

The Report, 15 then tries to draw some conclusions from the above analyses.

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[8] *Household Wealth and Saving in New Zealand: Evidence from the Longitudinal Survey of Family, Income and Employment* Trinh Le, John Gibson and Steven Stillman (2010).

Implications of low saving for capital market development

For example it suggested that "[t]he low rate of national saving appears to be a contributing factor" to an apparent "under-development" of New Zealand's financial system. The Report misses a connection here – the correct relationship in this regard is not with the 'flows difference' numbers as "conventionally measured" but rather with financial savings into direct investments or pooled investment products. This is a much narrower issue. Intuitively, this 'under-development' is not necessarily something that should directly concern policy-makers. Why can't the financial system fix itself?

It then suggests (Report, 15):
"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."

This is all so tentative and without any real research findings to support the suggestions that I wonder about its value. Where is the evidence of the 'apparent' link between the "low rate of [flows-based] national saving" and an apparently 'under-developed' financial system? Given the real difficulties with the practical application of any findings from those measures, can we really be confident of any connection at all? And where is the evidence that businesses are actually constrained by this seeming under-development? Is there evidence that the cost of capital to New Zealand's business is higher than might be explained by factors other than the apparent "under-development" (such as the quality of the investment offerings, market size, distance to main financial centres, risk free rate of return etc)? What precisely characterises New Zealand's "under-development" and how precisely might whatever those characteristics are, fix whatever is wrong with New Zealand's capital markets?

Unlike the conclusions reached in the cited report of the Capital Markets Development Taskforce, 2009, a sustained increase in "national savings" (presumably still the 'flows difference' numbers) may not "strengthen New Zealand's financial system." The international evidence indicates a lower level of confidence in these kinds of connections. See, for example, *When Does Domestic Saving Matter for Economic Growth* Aghion, Comin & Howitt (2006). The authors' conclusions? More savings seem to matter for 'poor' rather than 'rich' countries; open capital markets disrupt theories based on closed economies and local savings matter for innovation in 'poor' countries – they seem not to be significant for 'rich' countries.

High interest rates and exchange rates

The Report, 16 refers to the link between strong growth in government and private spending and a shrinking tradeable sector (including exports) relative to the non-tradeable sector, noting that all of the growth in the economy since 2004 has been in the non-tradeable sector.

It would have been helpful for the Report to show what the relative contributions made by each of the government and households were to this shift. Given the significant relative increase in government spending, despite fiscal surpluses, might that not be a major component? More importantly, a reduction in international competitiveness may be misdiagnosed as a saving problem.

It may be true that the premium on New Zealand long-term interest rates is necessary to attract foreign funds to New Zealand to finance the saving shortfall but it will also be affected by the use of the interest rate mechanism by the RBNZ to control local inflation.

It is also true that "[f]oreign investors seeking a higher return on their investment shift capital from lower interest rate countries to New Zealand. These capital inflows then drive up the exchange rate." (Report, 17) But this then seems to be somewhat self-fulfilling. The real question is whether the prevailing interest rates are higher than can be explained by other New Zealand factors – size, distance to markets, dependence on agriculture etc. The Report does not discuss those possibilities. Saving rates may also be an influence but probably only one among many.

The Report, 17 states:
"A permanent increase in national saving will take pressure off domestic resources which will allow, on average, lower interest rates to maintain low inflation."

But this assumes everything else remains static; that is, as domestic savings replace foreign-sourced savings, investment is unchanged. There may be other possible outcomes. The world sets the basic cost of money; local rates are surely not determined solely, or even predominantly, by domestic saving rates because that money can just as easily be invested elsewhere.

The report offers no evidence of any connection between saving, savings, interest rates and inflation. A comparison between New Zealand and Australia would be useful, given that we have similar institutions and dependencies. In any event, a "permanent increase in national saving", assuming this leads to a 'permanent increase in the size of claims that local savers have on local output' may lead simply to a rise in the price of assets that are suitable investments; that is, unless there is an improvement in the number/scale of such opportunities.

The Report, 17 then suggests that "[l]ower 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 that is not the only driver. What about innovation that may require no additional capital stock (or even a reduced amount of capital stock – Trademe, for example)? And do we count human capital as 'investment'?

Eventually, the Report, 18 backs away from any conclusion on the amount by which "... saving rates would have to rise to achieve lower interest and

exchange rates, particularly since both are dependent on many domestic and global factors...". In fact, there are probably too many other factors to demonstrate whether saving or savings might contribute to lower interest rates, for example. And, as a domestic investor, why should I want to accept lower interest rates just because my fellow countrymen have behaved 'more sensibly'? And does New Zealand really have a shortage of capital that a higher national saving rate might help to resolve?

So more savings without an increased demand for the savings could potentially do nothing but change the point of equilibrium and make credit easier and businesses less disciplined. The Treasury (Report, 18) suggests that it needed to do more work before it "...would confidently attribute significant growth gains to this role of saving in the economy..." The SWG needs to see that work.

High current account deficits

The Report, 18 confidently asserts that "[l]ow rates of national saving relative to domestic investment are reflected in New Zealand's persistent current account deficits…"

Here is an alternative view:

> "Furthermore, all of the variables in the above equations [which involve income, expenditure, investment, national savings and the CAB] are endogenous according to standard macroeconomic theory. This means that their values are simultaneously determined by more fundamental considerations. A high saving rate cannot cause a low investment rate or a low [current account deficit]. Instead the levels of investment and saving depend diversely on the underlying causative factors such as preferences, new technologies, taxes, government spending and regulation, and world interest rates and prices (the overseas terms of trade). As a result, any observed correlation might be positive, negative, or zero depending on the nature of the dominant joint causes during the observation period." Wilkinson, B. & Le, T, (2008). *Is Poor Household Saving the Cause of New Zealand's High Current Account Deficit?* New Zealand Institute of Economic Research.

Again (Report, 19):
"Current account deficits in New Zealand are associated with average levels of investment (relative to other OECD countries) but low saving."

An alternative view:

> " …most of the variation in the CAB could be attributed to favourable shocks in technology, a cheap world cost of capital, and external valuation shocks (reflecting terms of trade and exchange rate developments) at longer time horizons." Wilkinson, B. & Le, T, (2008) *Op cit.*

In fact, Wilkinson and Le show that there is no correlation internationally between the current account balances and household saving rates of 21

OECD countries over the period 1970-2000. As that report notes, this disconnect is entirely consistent with mainstream economic theory.

The Report, 19 notes that the current account deficit has improved as investment has fallen with the recession and economic uncertainty has increased household saving rates but warns that "...most forecasts show these trends to be temporary...". The Report's reader is then left with the central question in this context: are they 'trends' or simply 'outcomes' based on trends in a combination of other factors?

The Report, 21 then lists a number of factors that suggest New Zealand is at risk of "falling foreign investor confidence". Perhaps New Zealand cannot afford to rely "...solely on offshore investors' confidence in macroeconomic and financial institutions."

Until this point in the Report, the authors have been trying to convince the reader that there is a problem with the level or rate of domestic saving. Now that seems abandoned and the focus is on a 'loss of confidence or sudden stop'. While this may be a valid concern, it seems disconnected from the Report's main theme.

National debt levels are a "problem" according to the Treasury (Report, 21). It cites "the fragility of household and farm balance sheets" as evidence. But this needs to be put in some perspective. For all households, total debt was 13.9% of total gross household assets, according to SoFIE 2006. That doesn't seem to make households' balance sheets too 'fragile' (asset coverage of 7.2 times debt) but perhaps the Report's reference here is to the relationship between the cost of debt-servicing to net household income. There should be some evidence on that. We need to know much more about the relationship between incomes and debt servicing than is apparent in the Report before concluding that household balance sheets are 'fragile'. On the face, that seems to be the only possible source of the 'fragility'.

A general conclusion is drawn (Report, 21) that New Zealand should not "...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." It then cites in support "...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."

This was the theme of *A Synopsis of Theory, Evidence and Recent Treasury Analysis on Saving* The Treasury (2007):

> "However, in the light of the recent data, evidence and analysis mentioned above, on balance we think that further or stronger pro-saving action is now justified...This judgement for further or stronger action rests on a least-regrets approach in the light of data uncertainties, persistent macroeconomic imbalances and the

possibility that individuals are basing saving decisions on long-run expectations that could turn out to be mistaken."

In other words: we understand that some indicators about retirement saving seem to suggest that New Zealanders are saving 'enough' for retirement. However, because those statistics seem disconnected from 'conventional' macro measures (the so-called "puzzle"), we can't really be sure about that. So, the significant tax concessions granted to KiwiSaver in the 2007 Budget can somehow be justified.

Questions

This section of the Report, 22 concludes with three (of five) "questions" on which I want to comment:

- **Do you agree that New Zealand's level of national saving is too low?** Comment: Are we talking about the 'flows differences' or the 'savings' measure? It does not seem apparent that 'savings' are too low. And, in any event, does either constrain the level of investment that New Zealand needs?
- **Why is the national saving rate in New Zealand comparatively low?** Comment: We have not seen evidence of a 'savings' shortfall; and the connection between the 'flows difference' measures and growth has not been made.
- **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?** Comment: According to SoFIE 2006, the business assets of all households were 19.8% of all net households' assets while the total financial assets were a net 18% of total net assets according to SoFIE 2006. It does not seem clear that these levels are "relatively low"

Section B - The policy options

A possible policy package to boost national 'saving'

The Report, 23 suggests three considerations the SWG would need to take into account in considering its recommendations:

- One was what the report calls "fiscal consolidation". I think this means 'returning the government's accounts to a fiscal surplus'. It might have been nice to say that. In some international literature, this expression is actually code for 'more transparency in the government's accounts'. That is not an issue with New Zealand.

- Another consideration was the identification of issues that might "...hinder people saving". Before we do that, however, we need clearer evidence than the Report presents as to whether people are in fact "hindered". So we need to understand what those 'hindrances' might be. I can't think of any, apart from low incomes. One the problems with the two key alternative strategies that might address the supposed 'hindrances' (specific saving incentives or compulsion) is that international evidence seems not to support the proposition that either of these actually increase 'saving' or even, perhaps 'savings'. There is more on this below.

The Report, 24 notes that the reasons "...household and business saving might be low... is something that needs to be better understood so that policy choices address factors that are behind individuals' choices to save."

I suggest, first that we do not really seem to know whether household and business saving is 'low', never mind 'too low' but if, as well, we seem not to understand the "factors that are behind individuals' choices to save", research should be a pre-condition to any discussion about change. Do we actually know that household/business saving is *too low*? We cannot have a sensible discussion on this issue without understanding what this might mean and whether New Zealand suffers from it.

The Report, 24-25 lists a number of possibilities:

- **Lower incomes** that limit our ability to save.
- **Incentives to save** – the Report suggests that "...taxes may be distorting people's saving and investment decisions..." It is clear that taxes of any kind distort those decisions: that is inevitable. The question is whether the distortions can be justified in the presence of the government's need to finance its agreed objectives, such as by providing a safety net.
- **Capital market development** – without explanation, the Report, 25 suggests that "New Zealand has less developed capital markets than many other countries." In what particular regard is this the case? There is an assumption that savers are somehow denied choices that are available to savers in other markets. Even if that were true, one explanation might be that savers do not need a

"more developed capital market" because more of households' assets are in directly owned businesses that aren't suitable for listing or debt options? And anyway, wouldn't overseas' investment opportunities attend to whatever the problem is here in New Zealand? It isn't clear why this issue, even if demonstrated, should be a concern to be addressed by changes in public policy.

- **The need for precautionary saving.**
- **Retirement income settings** – The Report, 25 suggests that "[m]any OECD countries have a large component of superannuation met from save-as-you-go compulsory savings schemes." We need to be clear on this issue – I assume the Report is referring to pre-funded SAYG schemes. Singapore is an OECD country that has a SAYG scheme that fulfils a similar role to NZS, but at Tier 2; which are the others? There is any number of PAYG Tier 1, even PAYG Tier 2 schemes but there were no examples given in the Report of other countries with pre-funded SAYGO schemes at Tier 1[9]. New Zealand is no different.
- **Behavioural factors** – While it may be true 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)", where is the evidence that New Zealanders are saving less than they should, for retirement or any other purpose? It might nice to cite that without reference to 'conventional' macro measures that seem to have little connection to the reasons that households might choose to save.

The Report, 25-26 suggests four direct ways that changes in the government's policies might change the savings environment:

- **Higher saving through higher growth.**
- **Government as saver** – The future of the New Zealand Superannuation Fund, the Accident Compensation Fund and the Government Superannuation Fund should be high on this particular agenda. In all cases, those financial assets are effectively 100% leveraged on the government's balance sheet. I have examined the case for the abolition of the NZSF and how, to 30 June 2009, the presence of the NZSF had diminished the government's wealth by $2.6 billion (Littlewood, 2010).
- **Getting the saving environment right** –The current tax environment is an inconsistent mess at the moment because of the 'silo approach' to the taxation of different types of investment income and their disconnection from different income-tested welfare benefits. The recently announced proposals to widen the definition of 'family scheme income' will apply some sticking plasters to this but will create their own distortions and will not address the tax inconsistencies themselves, only the relationships

[9] The closest other countries to the Report's statements are Chile, Mexico and Poland, all of which have SAYG Tier 2 schemes with a minimum Tier 1 pension.

between some of those 'incomes' and the welfare system. The current tax treatment of investment income (including the 11 different ways an Australian share and the 13 different ways an overseas bond can be owned) and the different tax consequences of many of those options was examined by Chamberlain and Littlewood (2010).

What is actually needed here is a principles-based approach to the definition of 'income' and a shift away from the current rules-based approach.

- **Options to subsidise or compel saving** –The international evidence seems to conclude that governments are relatively powerless to fundamentally change household behaviour and that any connections between micro and macro outcomes seem poor. Here are some suggested references from www.PensionReforms.com (again, the 'more' goes straight to the PensionReforms' abstract):

  1. **Pensions and Saving: New International Panel Data Evidence** Any positive impact on gross national saving that might be attributable specifically to increased pension saving is low. Reforming countries (those with compulsory schemes) do not seem to have attained higher saving rates than others. more
  2. **What Drives Private Saving Across The World?** An analysis in 2000 of 30 years' data from 150 countries shows what seems to really matter if improving savings is a national objective. Growth seems important but private reactions are slow to appear. Faith in the good sense of citizens also probably matters. more
  3. **Pension Reform and Saving** So does pre-funding government pension systems increase national saving? That depends on who's in charge of the money and how it's run. The case for private pre-funding to increase national saving seems lost because of the substitutionary effect. more
  4. **Global Imbalances: a Savings and Investment Perspective** The things that seem to be linked to increased saving include higher output growth, "fiscal consolidation" (greater transparency in the government's accounts) and better terms of trade. Private credit increases and ageing populations tend to reduce saving. Increased credit may mean firms invest more while a higher cost of capital seems associated with lower investment. more
  5. **How Much Is The Working-Age Population Saving?** Countries angst over their citizens' saving behaviour (typically awful). Public policy decisions seem to hinge on inadequate data. Aggregate saving measures in the US seem particularly unhelpful. Most of the downward trend seems attributable to changes in the saving rates of those over 65. Why might that be a concern? more

Broader options

I agree that good institutional settings are a necessary condition for household saving (Report, 26). What seems less clear is the assertion (Report, 27) that "New Zealand's capital markets are relatively shallow" This makes some presumptions that were unsupported in the Report.

Again, while it may be true that "...many New Zealanders are unsophisticated investors" I have seen no evidence that they are, as claimed, relatively less sophisticated than investors in other countries.

New Zealand was, in 2006, the only country to have carried out a national survey of financial literacy. A 2009 update for the Retirement Commission found the following difference from the earlier study:

> "There has been a significant improvement in New Zealanders' overall financial knowledge. An increase of 10 percentage points in the size of the High knowledge group means that 43% of New Zealanders are now scoring highly in respect to financial knowledge. Of particular interest, the Advanced knowledge group, that in 2006 was measured at 15% (1:7 New Zealanders), has increased significantly to 20% (1:5 New Zealanders). However, whilst the overall improvements are positive, the Lowest knowledge group (measured in 2006 at 9%) has not changed significantly (10% in 2009)." (Colmar Brunton, 2009, p. 2)

Government as saver

The Report, 27 suggests that the "...quickest way for the Government to improve national saving and reduce imbalances would be to improve its own saving position." In fact, that is probably the only way the government can directly affect 'national saving' ("as conventionally measured").

The Report, 28 then provides the first of its "Pros and Cons" tables that are intended to provoke discussion. They run the risk, however, of being directly unhelpful. To take the first 'pro' on page 28: "Increased national saving" through a return to surpluses in the government's accounts means that the government collects too much tax to meet its outgoings. That will be at the expense of taxpayers and may create equivalent deficits in their accounts. That is a "Con" in terms of the table.

Getting the saving environment right

The Report, 29 states:

> "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."

And how might we measure what constitutes "good saving decisions"?

Removing tax distortions

I agree that "[t]axes introduce a number of distortions that affect individuals' decisions, including decisions to save and invest." (Report, 29) Also that "[i]nternational 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."

In fact, tax changes might reduce national saving once all the costs of incentives (both direct and indirect) are accounted for.

Of current interest in this overall regard is an analysis the RPRC has done that compares households' assets and liabilities in Australia and New Zealand: see the RPRC *PensionBriefing* 2010-5 here. After 15 years of compulsion and generous tax breaks for retirement savings, the total assets that all Australians could convert to cash for retirement income purposes as of 2006 (i.e. excluding the home, car and contents) were worth 54.5% of net household assets; the corresponding figure in New Zealand for the same year was 51.2% after more than 15 years of no compulsion and negligible tax breaks. The relative similarity of those proportions seems striking in the context of such different savings' policies.

The Report, 30 notes that the "...current tax system distorts saving and investment decisions in two main ways:

- Different forms of saving and investment are taxed in different ways and at different rates. For example, capital gains are not taxed..."

But capital gains are taxed if received by 'traders' unless they are trading New Zealand and some Australian shares for a PIE. The Report did not mention, however, that different ways of receiving income have a direct impact on Effective Marginal Tax Rates (EMTRs). Only some of these will be attended to by the proposed changes to 'Family Scheme Income'[10].

The Report, 30 then suggests that "...returns on saving that accumulate over a long period are taxed at high effective rates." That may be so but that is consistent with an income, rather than an expenditure-based approach to the taxation of savings (TTE vs. EET). The question therefore is whether we should have the TTE, income-based system. I think we should. Once that decision is taken, everything practical should be done to ensure that the TTE playing field is as level as practicable.

The example cited in the Report, 30 also assumes that the savings are in fact held for 60 years - a highly unlikely scenario. An average 15-20 years is actually more realistic in the New Zealand environment.

It is also true that inflation is significant but not *all* inflation as suggested in the Report, 30. Investments already price into their nominal returns the *expected* inflation rate. Investors take account of expected pre-tax returns,

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[10] Notably, income earned in KiwiSaver schemes will be further favoured because it will not feature in the member's EMTR. It is difficult to understand why that can be justified.

expected tax and expected inflation. Investors do not like unexpected inflation.

I agree that "[t]he simplest way to reduce the distortionary impact of inflation is to keep inflation low.

The Report, 31 then suggests that the tax system "... may have played a part in New Zealand households holding a large proportion of their assets in houses...". According to data from SoFIE for 2006, New Zealand's households in total held a net 46% in all property assets, including rental investment property, holiday homes etc. Is that a "large proportion"? In Australia, the equivalent proportion in 2006 was, according to HILDA, 50.3% (again, including other property). In the UK, net '*housing* wealth' was 40% of total net worth in 2007 – see here. New Zealand's proportion does not seem too different between the three countries mentioned. And, I repeat, the tax system does not treat directly owned property assets any differently from directly-owned equities.

The features the Report describes are by no means the only distortions as pointed out by Chamberlain & Littlewood (2010). I do not have the information needed to calculate the impact of introducing the comprehensive, principles-based taxation of investment income explained in that report but, along with a more logical system of defining 'income' for the purpose of calculating income-tested benefits, I would expect that to produce higher tax revenue and/or lower welfare costs than now. As well, the system will be easier to understand, fairer and less subject to 'planning' techniques.

I suggest that a more comprehensive system would have similar outcomes to simply lowering tax rates, an option offered in the Report, 32.

Inflation indexation is, perhaps, logical but too complicated. Keeping inflation low seems the better alternative.

Partial exclusion of interest income (Report, 32) seems in conflict with the principles of TTE. Once we have agreed on TTE, *ad hoc* exclusions should be avoided.

On complexity grounds, a dual income tax system (Report, 32) should also be avoided. There are, in fact, very large practical problems in segregating capital income from labour income so New Zealand should not follow the lead of others. If the concern is that savings and investment are too highly taxed, then we should further reduce income tax relative to GST e.g. favour further income tax cuts but GST increases. However, as the rate of GST rises, the base will come under increased threat, e.g. Labour's just announced fresh fruit and vegetables policy.

A capital gains tax has been rejected previously by the 2001 McLeod Review, as well as the Tax Working group, referred to in the Report, 32. In any event, it might be reasonable to wonder how a higher tax rate on capital income will increase savings.

What's missing from this section, and the table of 'Pros and cons' (Report, 32-33) is the possibility of a full review of the income tax and income-tested welfare benefits. As mentioned, this issue has been described in detail (Chamberlain & Littlewood, 2010). The aim should be to move away from the current 'silo-based' approach to the definition of 'income' and calculations of income tax. There are significant reasons for doing that, aside from savings-related considerations.

The effect of transfers and government expenditure on saving

As the Report, 34 notes, the SWG is not to review the role of New Zealand Superannuation (NZS). Even though the government says it is committed to retaining the current settings of NZS, I strongly suggest that the SWG should comment on NZS's significance to its brief.

The Report, 34-37 then offers comments on both student loans and NZS, as though the Treasury does expect the SWG to comment.

Student loans

I have two comments on the material that discusses the role of student loans:

- Interest-free student loans provide students with a subsidy to take on debt and probably encourage an over-investment in human capital, to the extent that it is not in the national interest for that to continue.

- Figure 12 (Report, 35) needs further analysis. Are the increases in loans and debt illustrated connected with an increase in student numbers and was that increase in part fuelled by the change to the interest rate policy? It would be helpful to use 'same student' numbers as the base for a consideration of the impact of public policy changes.

New Zealand Superannuation

There are several observations on the comments made (Report, 36) about NZS:

- It is, of course, true that NZS will become more costly as the population ages but the numbers cited in the Report ("4.4 percent of national income and is expected to rise to about 8 percent a year by 2050") are before-tax numbers . The more useful after-tax cost is currently a net 3.4% in 2004 growing to 6.7% by 2050.

- The Report, 36 seems to suggest that a PAYGO method of financing is, in some unstated way, inferior to a 'Save As You Go" alternative. Apart from the fact that only one other country (Singapore) uses a pre-funded, SAYGO approach[11], I think that PAYGO is the only way that a government-funded programme

[11] And three others (Chile, Poland and Mexico use pre-funded Tier 2 schemes that are linked to minimum benefit provisions under Tier 1.

like NZS should be financed. Considerations as to whether that might directly affect 'saving' or 'savings' rates should not be relevant to that discussion.

- The Report, 36 says that "New Zealand is unique in having a flat-rate universal pension". That is not the case although New Zealand is the only *developed* country in that position. If all countries were included, the following also have universal state pensions that are equivalent to NZS: Mauritius, Samoa, Nepal, Lesotho, Namibia, Botswana, Bolivia, Brunei, Kosovo and Mexico City[12].

The Report, 36 suggests two broad ways that NZS could change:

- **Changes to the age of eligibility** – I support this being a topic that is part of the SWG's considerations. A workforce that stays employed for longer, whether or not the state pension age increases, is likely to produce more, save more and pay more taxes. It may also reduce the costs of ageing as older people who work may stay healthier for longer. Of the two possibilities suggested (shifting the age to a new older one or increasing the age with improving life expectancies), the former is preferable. An unknown possibility (based on expectancies) would be more difficult to understand and plan for.

- **Changing the level of NZS** – several possibilities were mentioned here, all with the apparent intention of "encourage[ing] individuals to save more for their retirement":
  - **Indexing increases to inflation instead of wage increases.** This is a bad idea as the UK has so clearly demonstrated. A lower pension that is linked to wages is better even if it has the same NPV as the inflation-adjusted alternative. Again, the objective should be to keep NZS as simple as possible.
  - **Some form of means testing.** This may be logical in theory but impractical in practice unless New Zealand moves to the principles-based taxation of income that is recommended in Chamberlain & Littlewood (2010). A brief look at the Australian experience should demonstrate why this should be off the agenda. Financial planners receive a large proportion of their fee income devising techniques to avoid the income/asset tests that apply to the Age Pension.

Options to subsidise or compel saving

The Report, 37-43 looks at two policy options "...where the Government specifically encourages or compels individuals to save."

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[12] Information about most of these can be found on www.PensionReforms.com - go to the 'Sort & options' tab and sort the abstracts by country.

Tax subsidies for saving

While it is true that all countries (not "many") have some "form of subsidised savings accounts and these are often linked to retirement savings" (New Zealand now has KiwiSaver) what is notable is how so few have examined whether or not they 'work'. That also applied to KiwiSaver (during its development phases).

However, it is questionable, as suggested in the Report, 38 that KiwiSaver aims to provide "...an accumulation of financial assets by people who would not otherwise be able to maintain their standard of living in retirement". In fact, the level of taxpayers' subsidy is related to opening the account and the amount saved – not to the level of retirement income or standard of living in retirement.

The Report also suggests that "KiwiSaver may also assist financial literacy". It seems that this is an extremely expensive experiment. I have seen no evidence that Australians have a markedly different level of financial literacy than New Zealanders; and they have had full compulsion for 18 years and a lesser version for a further six years.

Then, it is suggested that KiwiSaver may "assist ... capital market development generally." However, if the Australian experience is anything to go by, the most likely outcome will be an inefficient fund management industry that spends time lobbying (successfully as it turns out) for more subsidies. The Australian industry's latest 'success' is to persuade the government to increase the compulsory contributions from 9% to 12% of pay. Its next target is seemingly to lift that to 15%.

I agree that "[i]t is timely to review the effectiveness of [the KiwiSaver incentives] now that the Government is no longer saving."

Based on overseas evidence relating to tax-incentivised saving, we should expect not much more than 20-30% of KiwiSaver contributions to be 'new' savings. As I have already stated, whether or not that was a 'necessary' addition seems a moot point.

Figure 14 (Report, 39) gives an almost complete picture of the amounts contributed to KiwiSaver. However, it misses the amounts paid directly by employers and individuals. It would be helpful to know what those amounts are.

The Report, 39-40 suggests some things the SWG might want to examine:

1. **Boost automatic enrolment**: The Report cites KiwiSaver's aim "...to overcome behavioural factors (such as procrastination)" through automatic enrolment. However, given that KiwiSaver is about retirement saving, there is actually no evidence of inappropriate procrastination in that regard. A 2009 report (Le, Scobie, & Gibson, 2009) concludes that about one third of New Zealanders are not saving 'enough' on conservative assumptions. Another 2009 report (Scobie & Henderson, 2009) compares net wealth at 2004 and 2006 from SoFIE data "…at the

individual level and computing the implied real saving rate on an annual basis. This yielded an overall median estimate of 16% of gross income…".

The Report, 39 then cites an Inland Revenue Department survey that apparently "...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."

It is not possible for a survey of the kind cited to establish whether that is a significant reason; significant enough to change the current automatic enrolment arrangements. Do we know whether the non-members needed to save for retirement? Unless we know that, we cannot conclude the non-members were behaving inappropriately. Also, we should really stop asking people what they think about retirement saving issues and whether they might do, or not do, something about it, or even whether they are (or are not) saving for retirement[13]. Past surveys of this kind have been extremely unhelpful. We should instead concentrate on what people do, rather than what they say they might do.

The Report, 39 suggests the possibilities of "...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 contributions holidays." I suggest an alternative: remove all current tax concessions given to KiwiSaver. In fact, if behavioural economics were the only consideration for KiwiSaver's existence, why should there be any tax concessions at all?

That aside, the whole issue of public policy decisions founded on the principles of behavioural economics is problematic. Here are some papers through www.PensionReforms.com that cast a different light on this issue:

a. **The Importance of Default Options for Retirement Savings Outcomes: Evidence From the United States** Saving plans designed to reflect the principles of behavioural economic principles will 'improve' outcomes - raise joining and saving rates and increase benefits. However employers and taxpayers might wonder whether these 'improvements' are all good. more
b. **Why Some Workers Don't Take 401(k) Plan Offers - Inertia versus Economics** Why do workers give up the possibility of being paid to save for retirement? It seems irrational not to receive the employer's subsidy and the usually significant tax breaks given to retirement saving. Evidence from the US and the UK gives some insights. more
c. **Behavioral Background for Economic Policy** Behavioural

[13] For example, the recent RaboDirect survey (see here) was, on its face, useless because, according to the survey, reducing debt is not 'saving'. The fact that surveys of this kind are often carried out by financial service providers (including, now, the IRD with respect to KiwiSaver) means that their findings should usually be regarded with considerable scepticism.

economics may help to explain why people behave as they do. It may also help employers and suppliers frame employees' and consumers' choices. Moving choice into the framing of public policy is another step. more

d. **Having One's Cake And Eating It Too - An Analysis Of Behavioural Economics From A Consumer Policy Perspective** Behavioural economics seems to offer guidance leading only to winners without losers but the mistakes of proxy decision-makers replace those of decision-makers. The further proxies are from the decisions, the larger those mistakes are likely to be. more
e. **Literacy, Trust And 401(k) Savings Behavior** Employees in the US seem irrational when contemplating 401(k) Tier 3 saving schemes. They do not seem to do what is clearly in their best interests. There are many reasons for this but financial literacy and trust (or a lack of those) seem important. more

2. **Better targeting of incentives:** The Report wonders whether KiwiSaver incentives should be aimed at "...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." But arguably, in the presence of NZS, these are the people who need to save the least, certainly those on 'lower incomes'. Unless we contemplate a contemporary introduction of an income/asset test for NZS, it was unclear what this possibility might achieve overall.

3. **Remove ongoing incentives**: The original design of KiwiSaver was more closely aligned to the testing of theories based on the principles of behavioural economics. However, they were never given the chance to demonstrate whether procrastination and/or inertia are in fact significant impediments. Stocks-based measures of 'savings' suggest not.

The international evidence seems to be that tax incentives for retirement saving do not 'work'. Here are some references from www.PensionReforms.com:

a. **The Effects Of 401(k) Plans On Household Wealth** Do tax breaks for US 401(k) schemes increase household wealth? This complex question has a surprising answer - possibly. But by a whole lot less than might be expected and perhaps not at all. more
b. **Current taxation of qualified pension plans: has the time come?** In a seminal 1992 paper, Alicia Munnell argued for the removal of tax breaks for retirement saving in the US. The logic still stands and things have got worse since. more
c. **The Effects of the Introduction of Tax Incentives on Retirement Savings** Spain introduced tax incentives for retirement saving in 1988. Contemporary data show how they affected consumption behaviour. New saving is at best less than a quarter of money contributed. There are some differences in the impact on consumption at different ages. The oldest show most signs of rearranging existing savings. more
d. **Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts** Tax incentives encourage people to save for retirement, don't they? They may not actually do that but that's

not their only problem. Most tax benefits go to richer savers, rewarding them for what they may have done anyway. What should the US do about that? more

e. **Reforming Australia's Hidden Welfare State - tax expenditures as welfare for the rich** All developed countries give concessionary tax treatment to retirement savings. In some cases, like Australia, the concessions' cost is very large but at least Australia counts it - most don't. Do the recipients of this middle class welfare need it? Might there be a better way of organising it? more

f. **The Evolution of Aggregate Stock Ownership---A Unified Explanation** The way households own assets, like shares and housing is unsurprisingly related to the way they are treated for tax. High marginal rates seem to shift assets from direct to indirect ownership. Inflation seems to decrease direct ownership where marginal rates are high and gains are taxed. more

If we have EET for retirement savings, taxpayers will inevitably attempt to exploit weaknesses in the tax system so that they actually get EEE on their investments. They should not be criticised for that but it would be better if the tax system did not need to 'think' about gaming issues and the need to devise complex rules to prevent savers from maximising their after-tax benefits.

There are some other things that should, perhaps be considered ahead of tax breaks and hardening up the auto-enrolment arrangements. KiwiSaver could be improved with increased flexibility, transparency, fee disclosure etc. KiwiSaver has to be re-designed so that people want to join and, if they join, it is beneficial for them.

Compulsory private saving

Next, the Report, 41-43 looks at the possibility of compulsory private provision. Compulsion may not raise national saving.

Evidence suggests that compulsory schemes will probably increase household savings, but not by anything approaching the full amount of compulsory contributions. That's because savers respond by reducing other forms of saving.

The Report, 41 suggests that "[m]any OECD countries, such as Australia, have compulsory saving schemes". I think the Report is confused - apart from Singapore and Australia, which other OECD countries have pre-funded, compulsory saving schemes?[14] The Report also says that these unnamed countries also have "...a means-tested, state-funded, safety-net pension". Again, there is confusion - Australia is the only country that income/asset-tests a significant Tier 1 pension (similar to NZS). The US does that to the extremely modest SSI[15] but not to the much more significant (and arguably more equivalent benefit to NZS) 'Social Security' benefit.

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[14] Apart from countries that are rather unlike New Zealand – Chile, Mexico and Poland.

[15] That is payable in full or in part to only 11% of Americans over age 65.

The table in the Report, 41 repeats the confusion.

The report, 42 lists some of the potential broader implications of compulsory saving – I comment on some of the points made:

- Saving by repaying a mortgage is, almost without exception 'best' for all given the need for debt-free accommodation at retirement[16].
- Some might also think that if they save in the compulsory scheme, this will be adequate and they may therefore save less than would otherwise be the case.
- Many would view the compulsory savings as a form of tax and look to minimise its impact on them.
- The experience from Latin America indicates that compulsion grows numbers of both the self-employed (usually exempt from membership) and informal sectors of the economy.
- If we are concerned about the increasing cost of the ageing population, increasing the future claims on the economy through compulsion without a commensurate reduction in state provision doesn't make any sense. Income/asset-testing NZS would be essential.
- In any event, all the evidence we have at present shows that the elderly are not amongst the groups in society that are facing hardship. On that basis, we can be reasonably confident that this piece of overall government policy is actually working in its current, pre-KiwiSaver guise. For evidence of this, see the following from www.PensionReforms.com:

    1. **Growing Unequal? Income Distribution and Poverty in OECD Countries** Retirement income systems should aim to eliminate poverty amongst the old. Amongst the rich countries, the OECD finds that poverty levels can be very high for those "of retirement age". Poverty levels may not be correlated with the amount of a country's "social spending". The data need careful handling. more
    2. **Household Incomes in New Zealand - trends in indicators of inequality and hardship 1982 to 2008** A New Zealand government report looks at poverty measures based on household incomes both before and after housing costs. Despite having little income other than the Tier 1 pension, the old are faring relatively better than other groups. more
    3. **Non-income measures of material wellbeing and hardship: first results from the 2008 New Zealand Living Standards Survey with international comparisons** A new look at New Zealand wellbeing and hardship numbers show that the old are relatively well-off by comparison with other groups. They also fair well in international comparisons so local retirement income policies seem to be 'working'. more

- It is unclear why changes to KiwiSaver should be seen as a way of fixing whatever might be wrong with New Zealand's capital markets. That should be an issue for capital markets to resolve. The picture in

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[16] However, significant KiwiSaver incentives can change this 'bargain'. I have suggested that these be abolished.

Australia on the fees charged by financial service providers for the development of capital markets there seems an unnecessary cost for savers to bear.

- The Report, 43 (footnote) cites with implied approval an Irish review of compulsory and quasi-compulsory schemes. Here is PensionReforms view of the Irish Green Paper; and here are PR's views of the Irish government's decisions.

The following are references from www.PensionReforms.com to reports that have looked at different compulsory saving arrangements. In many respects, they paint a relatively unflattering picture of compulsion as a policy option (as before, the 'more' link goes straight to the PensionReforms' abstract):

1. **Reassessing Pension Reform in Chile and Other Countries in Latin America** Chile and other Latin American countries give us lessons about what (and what not) to do; what (and what not) to expect. Intricately detailed regulation is inevitable – 'success' isn't obvious. more
2. **Pension Funds, The Financing Of Transition Costs And Financial Markets Development. Lessons From The Chilean Privatization Reform** Privatising Tier 1 in Chile carried large, long-tail transition costs as this 1998 paper amply illustrates. That's not the only problem with a compulsory Tier 2. The advantages are less obvious. more
3. **Macroeconomic Effects of Pension Reform in Chile** This 20 year review of Chile's pension arrangements identifies its achievements and quantifies its contribution to key economic indicators. However, looking at the past doesn't mean it should be the future. more
4. **The Australian Approach to Retirement Income Provision** Australia's retirement income environment is complex during both the accumulation and retirement phases. Complexity necessarily accompanies compulsory private saving and there are gaps that seemingly need fixing. Whether it is 'successful' has a number of possible answers. more
5. **Pension Systems in Latin America: Concepts and Measurements of Coverage** If you compel citizens to save for retirement then you might expect that everyone will be saving for retirement. Well, no; not once the data from 17 South American countries are analysed. Partly successful 'compulsory' regimes might actually do more harm than good. more
6. **The Effect of the Australian Superannuation Guarantee on Household Saving Behaviour** It's natural that government agencies find support for their government's own retirement income strategies. This report one from Australia suggests the compulsory Tier 2 savings scheme seems to be working. But all of the costs of compulsion need to be counted first. more
7. **Australia's National Saving Revisited: Where do we stand now?** Australia forces its citizens to save for retirement, so they save more don't they? Perhaps but perhaps not; and anyway, seemingly not enough. Sterner measures are indicated. more
8. **Pension Reform in Latin America - Design and Experiences** The World Bank reviews the Latin American experience of compulsory

Tier 2 retirement saving schemes. As a principal proponent of the now "five pillar" pensions solution, including compulsion, it seems a pity the World Bank can't find more encouraging evidence. more

9. **Pension Reform and Macroeconomic Stability in Latin America** The IMF has reviewed the progress of pension reforms in Latin America. In many ways, they have not been as successful as had been hoped. Chile may be an exception but then again, may be not. more
10. **Personal Retirement Accounts and Saving** When a country introduces a compulsory retirement savings scheme, 'new' saving might be at least partly at the expense of 'existing' saving. For Mexico, so it turns out. More rules seem needed. more
11. **Implications of Behavioural Economics for Mandatory Individual Account Pension Systems** Compulsory Tier 2 schemes need lots of rules, especially if the scheme partly replaces the state's pension obligations. Defined Contribution Tier 2 schemes face an additional hazard - the investment risk. The OECD wonders whether more rules might be necessary. more
12. **Social Security Coverage and the Labor Market in Developing Countries** Most studies attribute non-participation in Tier 2 schemes to labour market characteristics (informal/part-time employment) or employers' decisions. But workers might choose not to join and take jobs where 'mandatory' contributions are easily evaded. 'Compulsory' may in fact mean 'if I want to'. more
13. **Choosing Not to Choose - Making superannuation work by default** Compulsory Tier 2 schemes (like Australia's) need thickets of regulations to make everyone do as they are told. Another thicket now seems needed to protect savers from their apparent lack of interest in outcomes. Do employers need to be forced to make choices for them? And so it goes on.... more
14. **Superannuation - the right balance?** Australia's retirement income system will produce post-retirement replacement rates of 80% plus for home-owning, low income earners. Middle and high earners will be less well off as will those who do not own their homes. Time for them to do more. Really? more
15. **Reform of the Australian Retirement Income System** Australia's mix of a Tier 1 income- and asset-tested pension along with a compulsory Tier 2 pension and expensive tax breaks for all retirement saving produces patchy outcomes, at best. After 18 years of full compulsion, 60% of pensioners have less than $20 a week in private income. more
16. **Saving Tomorrow - the savings and spending patterns of Australians** Australians are forced to save for retirement through Tier 2's SG accounts that are funded largely by employers' contributions. A longitudinal wealth study (HILDA) shows they didn't save a lot in the four years to 2009: A$300 a year on average, despite compulsion. more

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