Submission to the Savings Working Group

Reserve Bank of New Zealand
November 2010

Executive Summary

An increase in New Zealand residents' (firms, households, and government) savings preferences would be likely to improve New Zealand's medium-term economic performance by reducing pressure on real interest rates and the real exchange rate, and also reduce the risks associated with the current very heavy dependence on borrowed international capital.

National savings – the savings of New Zealand residents – are, of course, not a policy lever; something that governments can simply adjust at will. Nor is a specific rate of national savings an appropriate target for governments to set. National savings (in aggregate) are the outcome of a whole series of individual choices by people and firms acting in pursuit of their own best interests and their sense of the economic opportunities and risks they face.

Microeconomic policies can affect the climate for private savings, and the government's own savings and investment choices are also part of the mix. Policy measures that inadvertently discourage private savings should be kept to a minimum. For the most part, the New Zealand policy framework appears to do that job relatively well – our welfare system, for example, is less distorting of private choices than those in most other advanced countries. There are, nonetheless, a number of areas of public policy where we think that reforms that are probably desirable on their own terms would also be likely to lift national savings. These include:

- A faster return to government operating surpluses. In the relatively short-term (perhaps 3-5 years) a faster move to a better fiscal position is the measure most likely to result in a material increase in national savings.

- Considering a move towards a Nordic tax system (in which income earned on capital is taxed at a lower rate than the maximum marginal tax rate levied on labour). This approach recognises that capital (savings and investment) is typically more responsive than labour to changes in after-tax returns.

- Inflation-indexing the tax treatment of interest (both earnings and deductions).

- There may be opportunities to refine Kiwisaver in ways which generate much the same private savings outcomes at considerably less fiscal cost (hence improving the national savings outcomes with more cost-effective incentivisation).

Macro-prudential policy tools are likely to become a somewhat more important part in central banks' tool-kits over the coming years. Our judgment, at present, is that such tools would improve the resilience of the financial system in the event of a crisis, and may have some mild

natural counter-cyclical tendencies, but that they are unlikely to materially affect the average national savings picture over long periods of time.

The Bank has not taken a view on the merits of compulsory private savings, beyond the default enrolment provisions that already exist in Kiwisaver. Compulsory schemes have typically been focused on dealing with retirement income issues (which is not the focus of the Savings Working Group). Any position taken on this issue needs to involve a very careful assessment of the extent to which such schemes abroad (notably that in Australia) have, in fact, raised national savings.

Introduction

The Reserve Bank welcomes the opportunity to provide this submission to the Savings Working Group (SWG). The Terms of Reference for the Working Group focus on national savings, which is the dimension of savings most likely to be relevant to overall economic performance, and not on retirement income issues.

The Terms of Reference touch, at times quite closely, on several areas of the Bank's responsibility. As the Terms of Reference recognize, the issues around national savings that are likely to be relevant to New Zealand public policy choices are mostly about the possible implications for:

- macroeconomic or financial vulnerability, and
- achieving the sort of economic growth aspirations (towards narrowing the income gaps with other OECD countries) that successive governments have articulated.

We have been researching, and commenting publicly on, some of these issues for many years.

The Reserve Bank has a variety of statutory responsibilities. Of particular relevance to the ground covered in this submission, we have formal responsibility for the conduct of monetary policy to maintain medium-term price stability, and are responsible for the regulation of deposit-taking financial institutions to promote the efficiency and soundness of the financial system. Analysis of issues around macroeconomic stability and imbalances, including the role of possible policy distortions or weaknesses, falls naturally into this territory.

The New Zealand national savings picture

As the Working Group will appreciate, the New Zealand data available to analyse savings, and to make economic sense of what even good data on savings flows might mean, are far from ideal. New Zealand's consistent under-investment in providing and maintaining a rich array of top quality economic statistics makes it more difficult than it should be for officials, researchers, and groups such as the SWG to provide incisive and compelling analysis and advice on economic issues of the sort the Working Group is grappling with. The magnitude of New Zealand's economic challenges means that this under-investment is not something that should be treated lightly. Collection and dissemination of good economic data is a core public good and needs to be much better funded.

In measuring savings the biggest weaknesses are probably in the sectoral breakdown of savings and particularly around the, always slightly artificial, split between business and household saving. We look forward to the new institutional sector accounts Statistics New Zealand will be producing. However, even these new series will not include financial accounts and balance sheets for each sector. The Reserve Bank is keen to see such data being produced and is willing to consider working jointly with Statistics New Zealand to achieve this. A full set of sectoral accounts would enable a far richer analysis and better understanding of issues related to saving and wealth.

Our focus in this submission, and the focus of the SWG, is on national saving and on the breakdown between public and private savings. We also focus on saving in a conventional national accounts sense. Saving is that portion of a year's factor incomes (wages, profits, interest, rents etc) not used for final consumption in that year. Revaluations in the prices of existing assets may, in some circumstances, represent a genuine change in real national wealth. And savings choices may well be influenced by asset price changes and expectations of them, but changes in asset values are not themselves saving.

The measurement issues are generally regarded as being less severe in respect of national savings and public (ie government) savings data. We accept that judgment. Thus, in comparing national savings rates across countries - the focus of much of the analysis – New Zealand official data are a reasonable starting point. Measurement issues are a challenge for every country to some extent. In some respects, consistency of measurement across time and across countries is as important as anything.

To briefly recap on what those international data show, in the 10 years prior to the recession (1998 to 2007), New Zealand's annual national savings rate averaged 17.1 per cent of output produced in New Zealand (GDP). New Zealand's average national savings rate was above those in the United States and the United Kingdom (both averaged 15.4 per cent) and below those in Australia (21.8 per cent) and Canada (22.4 per cent). New Zealand's savings rate was well above the lowest in the OECD (Greece, Iceland, and Poland) but even further below the highest saving countries in the OECD (Korea, Norway, and Switzerland).

Inflation can distort the measurement and interpretation of national savings across time and across countries. A portion of any interest payment is simply compensation for the reduction in the purchasing power of the underlying financial instrument because of inflation. The full extent of nominal interest payments is recorded as an expense, but the inflation compensation component is better thought of as a repayment of principal. Although inflation rates among the countries we typically compare ourselves with are now quite similar over time, New Zealand's high net dependence on external debt means that this issue still affects the cross-country interpretation of our savings data. For a country with no net dependence on foreign debt, all the interest payments and receipts are (net) between residents, and net out for the purposes of national savings statistics. But New Zealand has net foreign debt of just over 80 per cent of GDP and survey measures of expected medium-term inflation are around 2.5 per cent. That combination means that the real national savings rate for New Zealand is understated by up to 2 percentage points. The inflation distortion works in the other direction for countries with large net foreign assets (such as Switzerland or Norway or Singapore). Correcting for this factor tends to narrow international differences in reported national savings rates a little.

One other factor relevant to New Zealand comparisons is the gap between GDP and GNI (gross national income). GDP is the value of all income generated in New Zealand, while GNI is the value of incomes accruing to New Zealand residents. In most countries the two are very similar. That is not so in New Zealand, because of our large negative IIP position and the relatively high cost of servicing that position (that is, our typically relatively high real interest rates). National

savings are the savings of New Zealand residents[1]. But national savings rates are usually calculated relative to GDP - the measure of all income generated in New Zealand - even though a significant portion of that GDP accrues to residents of other countries. For some purposes a GDP-based comparison makes sense, but if we want to better understand the choices New Zealand residents are making, it is preferable to look at GNI-based comparisons. Doing so would raise the national savings rate by around 1 per cent.

Taking account of these two factors suggests that the national savings rate of New Zealand residents (government and private sector) from New Zealand residents' incomes may have been less far below the typical or median OECD country's national savings rate over the last decade or so than is commonly understood.

Of course, none of that changes the fact of the large negative net international investment position. But much of the gap between New Zealanders' savings and the real investment (gross fixed capital formation), and the resulting increase in the net stock of foreign liabilities, occurred in the 1970s and 1980s. By 1990, the negative net international investment position was already around 60 per cent of GDP. Thus, although what New Zealand residents now save from the incomes left over after we have serviced our debts looks a little low by international standards, as important is the effect of the large accumulated overhang of debt that needs to be serviced year after year. In effect, New Zealand as a whole is borrowing to service the debt.

Against that backdrop, a higher national savings rate which was closer to, or above, that typical in advanced countries would have limited the further deterioration in the NIIP position over the last 10-15 years. Alternatively, a higher savings rate might have been associated with a somewhat higher rate of investment, which could have been expected to have lifted future living standards.

How should we think about national savings?

Nations, as such, do not have savings preferences and do not make savings choices. A national savings rate is the aggregation of a series of individual choices made by firms and households, and by the government in respect of its own finances, each responding to their own perceived opportunities, risks, and constraints.

The point may seem obvious but it is important. "The national savings rate" is not a policy lever that can, or should, be adjusted or set in the way that, say, an interest rate or a tax rate can. It is, rather, an outcome of a series of mostly private choices. In that sense, understanding national savings behaviour should centre on (a) the aggregate economy-wide implications of such choices, and (b) material policy distortions or obstacles that might be inappropriately skewing savings behaviour one way or the other.

At an individual level, deferring consumption today, and taking advantage of a positive interest rate (or rate of profit) earned on the savings, lifts future income and consumption prospects.

[1] In the remainder of this document the term "New Zealanders" is used interchangeably with "New Zealand residents", to encompass individuals resident in New Zealand, firms operating in New Zealand, and the New Zealand government.

Each individual will have a different view on the weight they put on the value of future consumption relative to today's consumption. There are reasons to think some people are more short-sighted in making such decisions than might really be in their own long-term interest, but that is just as true of other advanced economies as it is of New Zealand. The default enrolment provisions in a scheme like Kiwisaver are partly a response to that sense – no one is compelled to do anything, but through that low cost provision people are given a nudge to consider choices that they might, on reflection, find to be in their own interests.

The focus of the SWG is, rightly, more macroeconomic in nature. At a macroeconomic level, it is also important not to consider national savings rates in isolation. The focus should be on the possible implications of New Zealanders' savings choices for macroeconomic or financial vulnerability, and for the achievement of a better medium-term economic growth performance. Both of those in quite different ways have to do with the linkage, or otherwise, between national savings and the capital formation that is occurring in New Zealand.

To illustrate this briefly, consider two hypothetical stylised economies. An economy with a very low savings rate and a correspondingly low investment rate (gross fixed capital formation as a share of GDP) might be quite poor or growing only very slowly. But such an economy would also be in balance, there would be no net accumulation of liabilities to the rest of the world, and there would little risk of nasty corrections. On the other hand, an economy with a very high investment rate and a much lower national savings rate might be growing quite strongly, but would have a growing dependence on external finance. Depending on the form that external finance took, that might involve some material macroeconomic or financial risks. And as the experience of Japan from the late 1980s helps illustrate, even a high national savings rate is, in isolation, no guarantee that an economy will not face different types of macroeconomic or financial risks.

Long-term growth connections

The "need" for additional investment (and, hence, capital stock), to support any anticipated path of per capita income, differs from country to country.

The implications of a relatively low national savings rate in the United Kingdom, with slow population growth, could be quite different from the implications of the same savings rate in New Zealand and Australia which have experienced quite high immigration and, hence, quite rapid population growth. More new people means a need for new houses, schools, roads, shops, factories etc, all of which need to be financed, from local or foreign savings. Rapid population growth means that a larger share of GDP needs to be devoted to investment simply to maintain a base level of capital stock per person.

Different industry structures probably also matter. For example, Australia and the United Kingdom have similar per capita incomes but whereas the financial and business services sector (critical in the UK) needs relatively little physical capital (per employee), the mining sector (critical in Australia) needs a lot of physical capital. In that sense, what is likely to matter much more than the national savings rate per se is the gap between national savings and the intended or

actual rate of investment. And the gap that matters is not usually that for a single year, but rather the accumulation of such gaps, on average, over quite long runs of time.

Over the last two decades, New Zealand's real interest rates have averaged consistently higher than those of the countries we typically compare ourselves with. That appears to be linked to gap between the amount of consumption we are happy to defer until tomorrow (ie the amount of saving we New Zealanders are willing to do) and the amount of investment that should, in some sense, be taking place to take advantages of the opportunities New Zealand offers. When those differences are persistent, a persistently higher New Zealand interest rate will be needed to consistently maintain domestic price stability. The persistently higher interest rates tend to hold the cost of capital to domestic investors higher than otherwise, which deters some of the investment that would otherwise take place in New Zealand. Investment deferred in turn holds back, to some extent, the full realization of New Zealand's longer-term growth prospects.

Domestic considerations (local saving and investment preferences) have resulted in persistently high real interest rates (across the entire yield curve). That has tended to bias New Zealand towards an overvalued real exchange rate relative to the medium to long-term fundamentals, such as trends in relative productivity performance. It is striking that over 30-40 years there has been no sustained decline at all in New Zealand's real exchange rate, despite the marked deterioration in our relative productivity performance and the large gap that has opened up between New Zealand incomes and those in other advanced countries. Through this channel the large *ex ante* imbalance between national savings and domestic investment has also tended to reinforce a skew towards economic growth that is concentrated in the non-tradables sectors of the economy, something that has become increasingly apparent since around 2004.

In an elementary textbook account of a globalised economy, national savings do not matter for medium to long-term economic growth prospects. But the nature of elementary textbooks is that they over-simplify for expositional clarity, and miss important features of the real world. Of particular importance here is way that real interest rates can stay away from some stylized "world real interest rate" for surprisingly long periods of time, and the way in which those surprisingly persistent interest rates divergences can be reflected in protracted misalignment of the real exchange rate.

A higher desired or *ex ante* national savings rate would be likely, on average over time, to lower New Zealand's average real interest rate (relative to those abroad), and lower the real exchange rate. A lower cost of domestic capital and a lower real exchange rate would provide a better platform for faster, better-balanced and hence more sustainable, growth in potential per capita GDP.

Vulnerabilities

The nature of the vulnerabilities that can arise from large gaps between desired savings and investment, and from large accumulated net external liability positions, depends on a variety of factors.

An economy that is drawing in mainly more stable foreign direct investment, and achieving rapid growth in export and domestic sectors, is likely to be relatively less vulnerable even if it accumulates substantial net foreign liabilities for a time. In many respects, that description fitted Singapore as it lifted GDP rapidly in the 1960s and 1970s and ran persistently large current account deficits. It is not a model that describes New Zealand at present.

On the other hand, if most of the capital inflow takes the form of debt denominated in foreign currencies, assumed by borrowers with no natural hedges, the danger can be quite marked. That was the situation in various heavily indebted countries, including Hungary in the last few years, and was also an aggravating factor in Iceland. But, again, it is not an issue in New Zealand. The net external debt of New Zealanders is mostly hedged back into New Zealand dollars.

When an economy has gone through a debt-fuelled asset price boom and a period of strong consumption, as New Zealand has, there would be significant macroeconomic adjustment risks even in a closed economy. Those challenges would be all the greater when the government budget had been allowed to move from surplus into quite significant structural deficit. When much of the financing has been from foreigners, and much of it for relatively short-terms (albeit longer than before the global crisis) the vulnerabilities are heightened. No one is quite sure how much vulnerability a net international investment position of around 90 per cent of GDP implies. But we are not aware of any other advanced country having had an NIIP position that high in modern times without some fairly difficult subsequent transitions (many of which are underway at present, in countries such as Portugal, Iceland, Spain, Greece, and Hungary). Any transition is, of course, made easier for New Zealand by our floating exchange rate and well-hedged debt.

There is an important distinction between macroeconomic and financial vulnerabilities. Accumulated imbalances and materially overvalued asset prices, of the sort that face New Zealand, can be followed by a prolonged period of relatively weak GDP growth, and little or no growth in consumption. Living standards may improve only slightly over quite long periods of time. Adjustments of that sort are likely to be costly and very uncomfortable, but need not of themselves threaten financial stability. (As just one, rather extreme, historical example, through the period of the Great Depression, GDP and living standards contracted very markedly in New Zealand and in the United Kingdom, Canada, and Australia, and none of those countries experienced the collapse of a major financial institution.)

The costs of a serious financial crisis are often much greater. Our judgment is that New Zealand banks, and their Australian parents, are well-capitalised to cope with economic shocks. Rating agencies appear to agree. But banks in both New Zealand and Australia are heavily dependent on foreign wholesale funding. Despite significant improvements over the last year or so, much of that funding is still relatively short-term in nature, and banks' confidence in their ability to continue to access foreign funding in future is almost as important to their behaviour as the ability to roll over any particular funding line. At present, Australasian banks find it relatively easy (although not cheap) to raise term funding, apparently because many lenders believe that collateral values (house, farm and commercial building prices) in Australia and New Zealand are relatively robust and that banks can readily cope with any falls in asset values. If that confidence were to be materially undermined, or if global markets were to seize up again on wider concerns

about adjustment pressures in Western countries, that could result in a substantial disruption to the flow of credit and risk a rather nastier real economic adjustment.

Managing vulnerabilities once the net external debt has accumulated and the large increases in domestic debt and asset prices have occurred is no simple matter. The Bank's core funding ratio requirement will progressively reduce rollover risk and the higher levels of capital banks are now holding also help to increase the resilience of the financial system. But even a voluntary increase in private savings, or the sorts of measures that would probably be required to lift public savings, would themselves be likely to help bring about the sort of, perhaps inevitable, adjustment in asset prices that could itself increase perceived risks. There are no fail-safe ways through a period of the sort of macroeconomic vulnerability New Zealand faces.

Given the likely investment needs of a thriving New Zealand economy, the patterns of national savings apparent in New Zealand in the last decade or so would, if continued, be likely to act as something of a drag on our growth prospects, and to pose risks of some difficult economic adjustments. The adjustments could be particularly problematic if external funders were to become more concerned about our imbalances (or the somewhat similar ones in Australia). Although the composition of national savings has changed over the last couple of years (in particular, large fiscal deficits have re-emerged), Treasury, Reserve Bank, IMF and OECD forecasts all show a return over the next year or two to quite large continuing current account deficits. If the exchange rate remains at around the levels experienced recently, it would be difficult to avoid either such a current account outcome, or - at some stage - a period of much more subdued economic growth (and private domestic demand) than we are currently projecting.

What might explain relatively weak national savings?

It is difficult to be definitive about why desired private savings appears to run below the investment needs of a growing New Zealand economy. And without that definitive diagnosis it is wise to be modest in advocating significant policy measures that might affect private behavior.

It is sometimes argued that our retirement income system, or the welfare system more generally, acts as a deterrent to private savings (not fully compensated for by government savings). There is no doubt some truth to this, but it sheds no light on the cross-country comparisons among advanced economies. Our welfare system is no more generous than those in most other countries, and in important respects may deter private savings less than models used in other countries (because in New Zealand neither unemployment nor superannuation benefits are linked to the recipients' prior earnings but instead are paid at a flat rate).

In its 2007 report on New Zealand, the OECD highlighted a sense - also noted in the documents for the Henry review in Australia - that in New Zealand taxes on income on capital are more important than they are in most countries, which may discourage both investment and private savings. The private savings rate appear to have fallen materially following the change in the tax treatment of superannuation and life insurance in the late 1980s, but whether there is a causal connection needs a more in-depth examination. This area probably warrants more investigation, but it is difficult at this stage to identify major underlying causes of the modest national savings performance that are grounded in tax issues. Moreover, although it is very difficult to properly

test, the international evidence on the responsiveness of private savings to changes in real after-tax returns suggests the effects are typically fairly muted.

Our relatively poor overall economic performance itself may help explain savings outcomes. Much of the discussion of saving quickly tends to drift back to the saving behavior of wage and salary earning households. In fact, trends in business savings and retained earnings are likely to be at least as important. New Zealand's economy has done poorly relative to the OECD as a whole, or to Australia, for 30-40 years. In that environment it is likely that there are fewer growing business than there otherwise would be, and perhaps firms and their owners have seen less basis for retaining profits and ploughing them back into expanding the business than they might in a stronger and more dynamic economy.

Overall, a variety of factors may have been at work, and none individually may explain very much. Indeed, it may be that, as the numbers quoted earlier suggested, our national savings rate has not, in effect, been quite as unusually low as is often thought. But the investment needs of an economy with aspirations to catch up with the rest of the world, and to sustain strong population growth at the same time, might point to the desirability of a national savings rate a bit higher than is typical in richer countries with slower-growing populations. Our current vulnerabilities and accumulated imbalances suggest that the ongoing gap between savings and investment will narrow for a sustained period at some point. It is likely that in a successful economy per capita investment would be rising, suggesting that desirably adjustment would come in the form of choices that result in higher national savings.

Policy options

The Terms of Reference the government has set for the Savings Working Group is rightly focused on policy issues and options; things that governments can sensibly and usefully do. It is important here to focus on making a difference over the medium to longer-term. Imbalances that have built up over years and, in some cases, decades cannot be removed overnight, and nor can the associated vulnerabilities. In the shorter-term, however, some of the pressures can be relieved and the risks be better managed. In providing your recommendations we encourage you to focus on getting the policy framework right for the long term, focusing on first-best policy options and eschewing short-term measures that focus on symptoms rather than underlying distortions or causes. Taken together, we believe there are a number of areas where policy measures could improve the climate for national savings.

Aggregate fiscal policy

New Zealand ran structural fiscal surpluses for around 15 years, which greatly strengthened the government's own balance sheet, and acted as a healthy counterweight to the growing private sector domestic and external indebtedness. Very rapid expenditure growth and tax cuts in the last five years, and a belated recognition that the permanent tax base was not as large as it may have appeared at the peak of the boom, mean that New Zealand now has large and structural deficits. Deficits will not go away as the effects of the recession pass. Even in terms of the Crown's own balance sheet these deficits are not sustainable in the medium to long term, especially as the ageing population pressures are already beginning to mount (the first baby

boomers turn 65 next year). The 2010 Budget includes projections showing the government's intention to return to operating surplus by 2015/16, although the specific measures that would make that possible have not been determined or implemented.

There is no strong or obvious case for the New Zealand government to be running a structural fiscal deficit for a prolonged period. Indeed, the large deficits are now probably exacerbating the overvaluation of the exchange rate, simply because they are providing support for domestic demand in ways that mean the OCR is set higher than it otherwise would be. Against this backdrop, a faster return to significant surplus would also be the single most effective change the government could make to the national savings outlook for the coming five years. Raising government savings would, to some extent. be offset by a cut in private savings, but reasonable estimates suggest no more than around a 50 per cent offset even taking a medium to long-term perspective. If the structural fiscal deficit is now around 5 per cent of GDP, closing that deficit quite quickly could also quite quickly add 2.5 percentage points to the national savings rate, with a commensurate reduction in the current account deficit. No other plausible policy changes could reasonably be expected to have effects on that scale over, say, the next five years.

The precise way in which an accelerated fiscal consolidation would affect the economy and national savings depends on a number of specific factors. These include the composition of the consolidation package, the extent to which it was well-signalled in advance, public sentiment at the time, and to some extent the response of monetary policy. The monetary policy framework operates in a way that means that if fiscal consolidation looked like dampening overall economic activity and lowering the inflation outlook, the OCR would be set somewhat lower than otherwise.

One argument sometimes mounted against the case for expecting an improved fiscal position to lift the national savings rate is that New Zealand had fiscal surpluses for 15 years but also a rapid run-up in private debt. It is likely that higher private debt was, in part, a substitute for lower public debt. However, the rise in household debt and rapid asset price growth was seen in a wide range of OECD countries, including many with fiscal positions that were much inferior to that in New Zealand. In other words, there is good reason to suppose that much of the increase in private debt was quite unconnected to national fiscal developments. Moreover, the widespread sense that there is now a large overhang of private debt (especially household and farm debt) suggests that there is little likelihood of a new generalized private credit boom if the fiscal deficit were to be closed more rapidly. Of course, the lower interest and exchange rates could be expected to result in additional investment and borrowing by firms in the tradables sector in particular.

Taxation

We noted in our submission to the Finance and Expenditure Committee's inquiry on monetary policy and associated issues in 2007 that there was likely to be merit in looking in more depth at some changes in the tax system.

In thinking about tax issues, we urge that full consideration be given to the insights of the economic literature about how taxes on different types of income affect behavior in different

ways. Simplicity of tax administration is an important consideration in tax design, but it should not be the dominant one.

Of particular relevance given New Zealand's growth and imbalance challenges is the literature suggesting that business investment (and saving) typically responds more aggressively to tax changes than the willingness of people to work does. Linked to this, it is important to look at the economic incidence of taxes, not just at which entity or sector legally pays the tax. Research evidence is clear that the bulk of the taxes that are levied on owners of capital are actually, in economic effect, borne by wage and salary earners. Less private investment means, over time, less productivity and less wage growth.

In its 2007 survey of New Zealand, the OECD also suggested that the Nordic approach to income tax warranted consideration. In the Nordic tax system, capital income (profits, rent, interest, dividends etc) is taxed at a rate lower than the maximum marginal rates on labour income. Norway, for example, has much higher overall tax rates than New Zealand does, but differentiates quite starkly between the quite progressive tax rates on labour income (a maximum marginal rate of 56 per cent) and the tax rate on capital income (28 per cent). There are, of course, significant operational issues associated with Nordic systems but these appear to have been effectively managed, without appropriate resourcing of the tax authorities, in the countries which have adopted this approach.

A more Nordic system would align well with meeting the longer-term growth challenges facing New Zealand. Investment appears to be more sensitive to changes in tax regimes than national savings does. That means the increase in investment might exceed the increase in national savings, at least for a time. However, the improved longer-term growth prospects would help to support investor perceptions of New Zealand's prospects and the creditworthiness of New Zealand borrowers.

Although somewhat unwieldy, to some extent the PIE regime introduced a few years ago already recognizes a difference between labour and capital income (income earned in a PIE faces a maximum final tax rate of 28 per cent, while other income is subject to a maximum marginal tax rate of 33 per cent). There could be scope to generalize this system somewhat. One other option would be to consider ear-marking some of the current rate of taxation of labour income as a social security tax. New Zealand and Australia are the only OECD countries without a social security tax[2]. These taxes apply only to labour income, and the choice not to use a social security tax means that, compared with others countries, income from capital is taxed more heavily relative to labour income in New Zealand than it sometimes appears.

We have also long considered that when interest is either assessed for tax or deductible against other income for tax purposes, only the real component of interest (and not the inflation compensation component) should be assessed/deducted. At present, the marginal tax rate on the real income earned on a pensioner's modest bank deposits may well be considerably higher than that on a wealthy business person's labour or entrepreneurial income. That seems neither fair nor efficient, and the case for taxing nominal interest fully is not compelling on any grounds.

[2] Other than the ACC earners' levies.

There is some reason to think that allowing full deduction of nominal interest in respect of investment properties may have exacerbated the recent housing boom. Change in this direction would be unambiguously beneficial for the economy in the longer-term We would not expect this change in isolation to result in a material change in national savings behavior in the foreseeable future, although the current account deficit might narrow to some extent because of the removal of the subsidized tax treatment of debt-financed business investment.

Structural policy changes

A better performing real economy would itself lift the attractiveness of investment in New Zealand, whether undertaken by New Zealand firms or by foreign entrants bringing new equity. As discussed above, if firms and their owners see improving long-term growth and investment opportunities here, it is likely that their own savings will increase. If households really anticipated much better times ahead, they might well look to spend the gains in anticipation. However, that risk seems considerably less than usual given the overhang of high debt and unsustainable asset prices to be worked through over the next few years.

Kiwisaver

The Kiwisaver programme has been in place for only a few years, and its impact on savings behavior (private and national) is uncertain. There is now a considerable volume of funds accumulating in Kiwisaver accounts, but what is less clear is how much of that represents additional total savings, as distinct from a change in the vehicle within which the funds are held. It is clear, however, that the tax subsidies are quite generous, and it is likely that any gains in private savings could be achieved at rather less fiscal cost.

We do not have strong views on the details in this area but, for example, considering putting a time limit on the eligibility for the tax credits, sufficient to allow people to establish a savings habit, could result in large fiscal savings and, hence, improve the national savings outcomes of the Kiwisaver programme. In general, more cost-effective methods of incentivizing savings should be considered. Any gains in changing long-term cultural attitudes towards saving are likely to be realized only gradually over many years but should not be discounted for that reason.

Compulsion

The Terms of Reference rule out discussion of issues around the parameters of New Zealand Superannuation. As we noted above, it is probable that New Zealand Superannuation deters private savings less than many state pension schemes abroad do. Moreover, New Zealand Superannuation already handles basic income adequacy needs in retirement (reflected in the low elderly poverty rates reported for New Zealand in OECD comparisons). Compulsory private savings schemes in other countries have typically been linked to retirement income considerations.

Thus in considering the possible costs and benefits of a compulsory private savings scheme careful consideration would have to be given to a full assessment of the microeconomic efficiency effects, and the scale of any increase in the national savings rates that such schemes

have generated elsewhere. That is not easy to do well, and we are aware that views differ widely on the overall economic impact of the Australian scheme.

Macro-prudential policy

In the wake of the recent recession and international financial crises, there has been intensified interest in the possible scope for the use of macro-prudential tools by central banks to improve the resilience of the financial system and, perhaps, to dampen big swings in credit and asset prices. Work in this area is likely to continue for some considerable time, both here and abroad, and we will learn better over time what potential, and what limitations, such instruments have.

At present, our judgment is that the macro-prudential tools may offer the prospect of improving the resilience of the financial system (and hence limiting the macroeconomic costs) in the event of a crisis. We are more sceptical that such instruments could materially dampen the very strong credit-driven upswings that occur in market economies from time to time. From the perspective of the Savings Working Group's remit, we do not think that macro-prudential instruments, however they were deployed, would be likely to materially affect the medium-term national savings and investment patterns in New Zealand.

Conclusion

An exogenous and sustained change in private savings preferences would improve New Zealand's overall economic performance. A faster improvement in the government's own savings (a quicker return to fiscal surplus) would be similarly beneficial. We would expect to see a reduction in the cost of capital, a fall in the real exchange rate towards something more in line with New Zealand's longer-term productivity performance, and a reduction in asset prices and internal debt levels. Those changes would be expected to assist medium-term growth prospects and reduce the risk of the current vulnerabilities crystallizing under external pressure.

The national savings rate is an outcome of a series of, mostly private, choices. The national savings rate is neither a policy lever, nor something that public policy can simply deliver. We have, however, outlined a number of areas of reform that would be efficiency-enhancing and would be likely to lift national savings rates over the medium term. Many of the likely gains would become apparent quite gradually over a period of years as the overall climate for savings and investment shifted. Over the shorter-term, faster fiscal consolidation offers the best prospect of relatively quick gains in lifting national savings, better-positioning New Zealand against the risk of future adverse shocks, reducing some of the pressure on the real exchange rate, and assisting in a transition to stronger and better-balanced growth.