

## Treasury Report: Savings Incentive Options, Consultation and Analysis

<b>Date:</b>	7 December 2001	<b>Priority:</b>	Medium
<b>Security Level:</b>	In Confidence	<b>Report No:</b>	T2001/1967

### Action Sought

	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance	Read and select amongst recommended alternatives	None
Associate Minister of Finance and Revenue (Hon Paul Swain)	Note contents	None
Associate Minister of Finance (Hon Trevor Mallard)	Note contents	None

### Contact for Telephone Discussion (if required)

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## Treasury Report:

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### Executive Summary

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Following the Budget announcement regarding incentives for private savings, you instructed officials to consult with industry representatives to obtain their views. This report discusses the results of those consultations and officials' analysis of options for increasing private savings.

This report focuses on three tax incentive designs, tTE, TET and TEt treatment. Officials' view is that none of these schemes will be able to meet all of the objectives of a savings incentive. This is because of inherent contradictions between these goals. As a result, officials have endeavoured to outline these contradictions, along with the assumptions that guide them. Like nearly every analytical constraint, these can be resolved. The best way to proceed is for officials to receive guidance on which objectives are most important and which can be considered secondary. Such guidance would allow officials to move forward toward designing a savings incentive regime.

If Government did wish to proceed with tax incentives for private savings, the general consensus of those consulted is for a tTE system, implemented using rebates and subject to a cap on contributions. Consulted parties most broadly supported the incentive in a tTE regime because of the upfront nature of the incentive relative to a TEt or TET regime. These parties believe that an incentive would be most effective if it were immediate. Many felt that TEt or TET may be effective at increasing the level of savings for those who already save over the long term, but that in order to increase the number of new households saving, tTE would be more effective.

Officials too suggest a tTE scheme, but one that would include a cap on contributions much lower than consulted parties have likely envisioned (approximately \$1000-\$2000). Officials do not suggest that an upfront incentive is likely to make savings more realistic for many low to middle income households. Such an incentive scheme is simpler to promote and explain however, which may increase its utilization amongst households with little to no current savings. While no incentive may be likely to appreciably increase savings, Officials prefer a tTE scheme to a TET or TEt incentive because it would result in fewer harmful distortions to investment patterns, it would have a lower fiscal cost and it would create less room for avoidance and tax planning behaviour.

### Recommended Action

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We recommend that you:

- a **note** that officials have consulted the following agencies on options to increase private retirement savings - ASFONZ, Business New Zealand, CTU, ISI, Office of the Retirement Commissioner and the Government Actuary;
- b **note** the following broad themes from the consultation:
  - i. Concerns about the need for, and efficacy of, tax concessions for retirement savings;

- ii. If tax incentives were to be introduced, the preferred option of the majority of those consulted was for an upfront incentive, in the form of a tTE model;
- c **note** that summaries of each consultation session are attached as Annex 2;
- d **agree** that officials either:
  - i. Further develop the use of incentives on returns to savings via a TEt or TET approach with the purpose of increasing savings;  
*Agree/disagree*
  - ii. Further develop the use of upfront incentives via a tTE approach with the purpose of increasing savings;  
*Agree/disagree*
- OR
- iii. Cease further work on development of a tax incentive for private savings.  
*Agree/disagree*
- e **meet with** officials to discuss this report.

**Paul Stocks**  
for Secretary to the Treasury

**Hon Dr Michael Cullen**  
Minister of Finance and Revenue

## Treasury Report:

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### Background

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1. Officials last reported on this issue on June 21, 2001. After that report you asked us to consult with ASFONZ, Business New Zealand, CTU, ISI, Office of the Retirement Commissioner and the Government Actuary on industry issues raised in the provision of tax incentives for savings. In particular this consultation was to focus around the options of tTE and TET. The difference between TET and TEt may not have been clear to some consulted parties. Analysis of officials and consultation were expected to be the basis for advice on the relative merit of these options. We have performed that consultation and analysis and are reporting on the results.
2. The current regime for taxing superannuation, and the various options considered have the following general characteristics<sup>1</sup>:

#### TTE (the current regime)

- The saver makes contributions to a fund from income that has been taxed at ordinary rates,
- Earnings are taxed in the hands of the fund as they are earned (at 33%),
- Neither earnings nor contributions are taxed in the hands of the saver when they are distributed,

#### tTE

- The saver makes contributions to a fund from income that has been taxed at a reduced rate,
- Earnings are taxed in the hands of the fund as they are earned,
- Neither earnings nor contributions are taxed in the hands of the saver when they are distributed,

#### TEt

- The saver makes contributions to a fund from income that has been taxed at ordinary rates,
- Earnings are not taxed while they are held by the fund,
- Earnings are taxed in the hands of the saver when they are distributed,

#### TET

- The saver makes contributions to a fund from income that has been taxed at ordinary rates,
- Earnings are not taxed while they are held by the fund,
- Earnings *and the contributions* are taxed in the hands of the saver when they are distributed.

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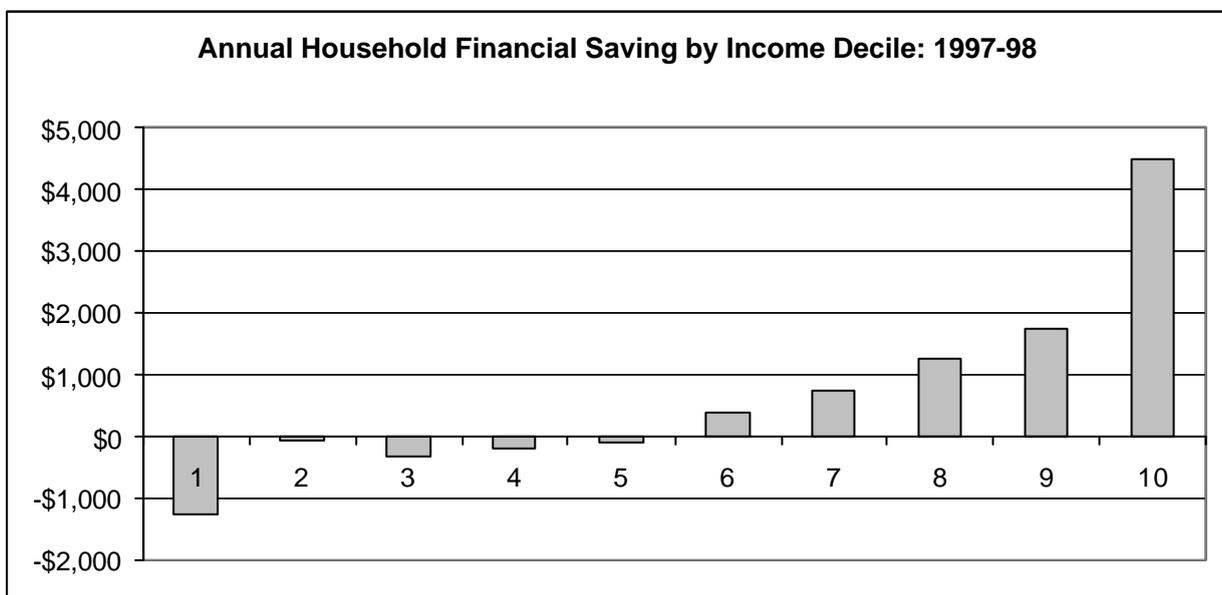
<sup>1</sup> More background on these schemes has previously been provided by officials in reports T2000/289, PAD2000/044 and PAD2001/160, T2000/988.

### Benchmarks for a Successful Savings Incentive

3. While priorities differ amongst the consulted parties, each of them agreed that the list of concerns noted below were the central points on which to evaluate a savings incentive. Therefore, tTE, TET and TEt are evaluated along the following lines<sup>2</sup>:
  - Effectiveness in increasing savings (Net National, Private, Retirement, etc.);
  - Fiscal Implications;
  - Neutrality of the tax system (Investment Distortions);
  - Administrative Simplicity;
  - Compliance Costs; and
  - Equity.
4. The ability to attain these objectives is affected by the current savings environment (detailed in the Data and Implications Sections) and the competition amongst them (detailed in the Constraints Section).

### Savings Data and Context

5. The broad pattern of household saving by income is shown in the figure below. This figure separates households into ten deciles by income level. These figures should not be thought of as representing retirement savings, as people accumulate financial savings for many reasons beside retirement.



6. On average, most saving is conducted by high income households, while the bottom half of the population are net-dissavers. Within each decile there are households that save and households that dissave<sup>3</sup>.

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<sup>2</sup> Portability has also been raised as an important factor for the vehicles resulting from an incentive regime. tTE, TEt and TET options can all be designed to accommodate portability and thus it has not been further considered here.

7. Comparing the net savings position of each decile shows that the top 20% of households by income undertake 70% of savings. The top 30% represent 85% of savings. As a result of these differences in savings patterns an incentive will have a different effect on households of varying income profiles.

### Implications of Savings Data on the Response to an Incentive

8. Households of different current income and savings levels will be affected in different ways by a savings incentive. A description of how any particular household might be affected by a savings incentive provides a context to demonstrate these differences. Assumptions about the relative sizes of these effects can help determine what type of incentive is likely to be most effective.
9. The first response to a savings incentive will be for those currently with accessible retirement savings to direct that savings toward the incentive. Households would only be willing to subject a portion of their financial savings to restrictions on pre-retirement withdrawal (lock in).
10. A savings incentive may further affect savings behaviour and may generate new savings in two ways. In economic terms these are the **income effect** and the **substitution effect**<sup>4</sup>.
  - Reducing the cost of savings may induce some people to save more. When savings is less expensive, that is, it requires less current consumption to be foregone, then those who prefer to save will increase their savings. In economic terminology this effect is called the **substitution effect**. It is the outcome that, all other things equal, occurs because a tax incentive makes savings less costly relative to consumption.
  - Increasing people's incomes increases the amount of money they have to save. Increasing the value of a household's savings allows them to consume more now and later. A tax incentive provides those who save with additional income by reducing their taxes and increasing the value of their savings<sup>5</sup>. In economic terminology the combined result from this change is called the **income effect**. The **income effect** experienced by high and low income households is likely to be quite different. The impact of this effect on saving may actually be positive or negative and will vary in size, however for those high income households that are currently saving this effect is much more likely to be positive and it will be larger relative to low and middle income households.

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<sup>3</sup> Some of the lower income dissaving reported here is the result of retirees amongst that group and the fact that retirees are more likely to dissave than save. That fact does not affect the outcome of this analysis however. Even if the bottom 50% of the population were assumed to save at the same level as the fifth decile, or even as much as the sixth decile, income constraint would still prevent the bottom half of the population from saving for retirement at any meaningful level.

<sup>4</sup> Academic work on the subject of estimating the income and substitution effects from savings incentives has not been able to produce reliable figures. The best available estimate is that between 0-30% of balances resulting from incentives are new savings, while the remainder of these balances represent funds redirected from other current savings. That 30% of balances would represent new savings is then a very optimistic assumption. This paper assumes that a tTE, TET or TET incentive can all attain such an optimistic increase in savings. This does not mean that there are no reasons to believe that one option might be more successful than the others. Estimation of these differences is beyond the scope of this analysis however. Further the assumption of equivalent effectiveness is useful as a basis for comparison between and analysis of expected differences in effectiveness between incentive schemes.

<sup>5</sup> Those who already save now they get money back for it and they have higher lifetime earnings. Permanent increases in income may also cause a reduction in the amount of hours worked as more leisure is consumed along with more consumption and savings.

11. Taxes also have *income effects* and *substitution effects*, which reduce saving (and consumption). Savings incentives are financed by taxes. The income and substitution effects of the taxes at least partially offset the same effects of the saving incentive. This is detailed in a later section, after the foundation is laid here for how incentives themselves affect behaviour.
12. The *income effect* and *substitution effect* will vary by household income level (in a manner detailed below). One's assumptions about the size of each effect by income level are central to decisions about the type of incentive and the size of any contribution cap.
13. The total level of savings generated by the bottom 70% of households, even were it to increase dramatically is unlikely to have a large effect on total private savings.
14. The most promising avenue to generate additional savings is in stimulating high income households to direct a greater share of disposable income toward savings (*substitution effect*). These households have the most disposable income, and as they consume the most financial planning advice are, in the main, more likely to have a strictly rational response to an incentive.
15. If a cap is placed on retirement savings eligible for an incentive then households whose current retirement savings are in excess of that cap will not change their behaviour to increase savings (*substitution effect*). This is because they can receive the full value of any incentive by merely redirecting their current savings and thus they are not induced to change current behaviour.
16. Households with high current income will receive the bulk of any increases in income from a savings incentive, and will have the highest propensity to save that income (*income effect*). Contribution caps will not limit this effect. The amount of new savings induced will depend on the amount of money returned by an incentive, by the propensity of high income earners to save new income and by their likelihood of reducing labour supply (e.g. early retirement) in response to increased income.
17. Increasing the incomes of savers outside the top 10-20% of households will not induce a great deal of new savings (*income effect*). These savers will not receive a great deal of increased income from savings incentives because their current retirement savings are not large. Also their propensity to save new income may be much less than the highest income earners. Increasing the savings in this group requires changing their behaviour.
18. Low to middle income households may be encouraged to change their saving behaviour (*substitution effect*), but may not be able to increase their savings due to income constraint. Those households that are currently income constrained would generally need to provide for their current consumption before making meaningful efforts to provide for future consumption.

### **The Effects of Funding an Incentive Through Taxes**

19. While returning funds to savers via tax incentives can increase incomes and thus savings (*income effect*), it must be recognized that the taxes that pay for an incentive reduce incomes on the whole and thus reduce savings. For the sake of clarity, this paper considers the effect of a savings incentive delivered as a reduction in taxes (increasing the incomes of those who currently save) noting the effects of changing this assumption where appropriate.
20. In a conceptual sense an incentive must be funded by taxes. At any particular point in time however, decreasing other spending or reducing government surplus may fund a tax incentive. In this case a tax incentive is generally compared with the effect of a tax cut, the size of the expenditure required to fund that incentive. In a circumstance where much of tax revenue is raised on high income earners and those households are

the most likely to save, taxation seems to be a difficult vehicle by which to deliver increased savings.

21. A tax incentive, may represent a tax cut on those who have a track record of saving, increasing their incomes and inducing more savings (*income effect*). Because 100% of the tax incentive will be provided to current or new savers, while the fiscal cost of that incentive is distributed over savers and non-savers alike, the combined income effect may be positive, but because all of the income returned will not be saved, the effect on national savings will still be negative.
22. As a result, no system passes the hurdle of high savings per dollar of government expenditure (the objective of national savings). For example, assuming that a very generous level of substitution is stimulated, that goal is best reached by a tTE system with a cap of \$2500 and a rebate of \$0.25. The ratio of government spending to increased savings is still approximately 3-1 however.

### Constraints Underlying Analysis

23. Officials understand that your view is that current savings levels are too low and that it may be desirable and effective to use the tax system to attempt to increase savings<sup>6</sup>. In an attempt to design an incentive system based on that assessment, officials have encountered several analytical constraints. No single savings incentive scheme can meet all of the criteria of a successful savings policy (as outlined in this paper). This is because fundamental trade offs exist between these criteria, and because each of the broader objectives of savings policy (i.e. increasing retirement savings, increasing national savings, etc) can be undermined by a focus on one or more of these criteria. The inconsistency between the broader objectives of savings policy themselves is considered in Annex 1 to this paper.
24. Officials can suggest the best available incentive design given existing constraints if you provide the relative level of importance that should be given to each objective. Officials can also outline those objectives that would be compromised by the resulting incentive design. The particular constraints are outlined below.
25. **Redistribution through taxes creates a trade off amongst savings objectives.** It is clear that most saving is done by those with high current incomes and that a savings incentive is unlikely to have much of an effect on those with low incomes. Taxing those with high incomes to provide a savings incentive for those with low incomes will reduce aggregate private saving, and will reduce net national savings more still. Taxing those with low incomes to provide a savings incentive for high income earners may increase saving, but is problematic from an equity perspective. Taxing those with high incomes to fund an incentive for high incomes is circular. Any incentive generates the costs of taxation to fund it, and only a regressive tax and incentive combination appears to have much chance to increase national saving. Reducing the taxation on high income earners is the least cost approach with the greatest likelihood of increasing net national savings.
26. **Implementing savings incentives raises serious equity considerations.** Assuming an optimistic response at all income levels to a tax incentive for savings, a savings incentive is largely a tax break for the top 10-20% of income earners. Roughly 70% of the cost of an incentive would be directed at the top 20% of households by income. Over 50% of that cost is directed at the top 10% of households. Addressing these concerns can result in decreasing the effectiveness of an incentive.
27. **Contribution caps do not remove equity problems, but they improve equity.** With a contribution cap of \$1000 and a rebate of \$.10 on the dollar (tTE), approximately 56% of the spending on an incentive is still directed toward the top 20% of households.

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<sup>6</sup> Either Private, Net National or Retirement Savings.

28. **Caps reduce the effectiveness of an incentive.** Compared with a focus on other income groups, new savings are most likely to come from encouraging high income earners to save rather than consume (*substitution effect*). A contribution cap largely eliminates any such effect. If a contribution cap is below the level of current retirement savings for any household then that household will not change its behaviour in response to an incentive, instead it will gain the full value of the incentive without changing its behaviour.
29. **Caps increase the subsidy for current savings.** Under even the most optimistic credible assessments, 75% of the spending on a savings incentive would subsidize savings that would have been made without any incentive. As a result, the bulk of the cost of any incentive is in financing benefits to current savers. The smaller the level of new savings encouraged by an incentive, the higher the proportion of spending that is directed toward current savings. Because a contribution cap dramatically reduces new savings from high income earners, the outcome is that a cap increases the proportion of an incentive directed at current savings. A cap of \$1000 would result in 90% of an incentive funding current savings (with generous assumptions about new savings).
30. **Without a contribution cap, an incentive must be less generous (for the same cost), decreasing its ability to change behaviour.** As any contribution cap becomes smaller, less and less savings are eligible for an incentive. With less qualifying savings it becomes increasingly affordable to provide generous incentives on the remaining eligible savings. A more generous incentive is more likely to generate new savings. In practice the generosity of incentives is reduced either through the use of clawback provisions (TET/TEt) or lower rebates (tTE). Without a cap, lower generosity reduces the likelihood that an incentive will result in new savings, particularly for low and middle income earners.
31. **Targeting new savers may be self-defeating.** Using progressive contribution caps or income testing eligibility for an incentive might be considered as a way to improve the equity of an incentive (by targeting lower income earners). The expense of targeting will decrease the likelihood that national savings will be improved. Further, progressive caps or income testing must often be policed at the point of contribution, which generally means by employers. Such requirements would increase the administrative costs of employer offered incentives and reduce the chance that employers will offer them. For those who have difficulty saving (those for whom targeting was undertaken in the first place) employer schemes may have the most impact.

## Evaluation of tTE, TEt and TET

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### Characteristics of tTE, TEt and TET

32. When a tTE, TEt or TET regime is implemented, there are a number of design parameters that can alter the impact of the scheme. Representative policies have been outlined for the purpose of consideration in this report.
33. The tTE regime
  - The concession is delivered as a flat rebate on contributions to designated savings vehicles, and is delivered at the end of the year or at the time of contribution,
  - An annual cap on rebate eligible contributions ranging from \$1000 to \$4000,
  - Fund withdrawals would be restricted (“locked in”), until retirement,
  - Additional contributions above the cap level could be made to the same retirement savings account without tax benefit.

34. The TET regime
- After-tax contributions up to an annual cap ranging from \$1000 to \$4000,
  - Accumulated interest on deposits avoids taxation until withdrawal,
  - Withdrawals would be taxed on principal and interest at the marginal rate,
  - Savings will be long term in nature without withdrawal restrictions, because it is only rational to invest in a TET regime if that investment is expected to be at least 8-12 years in length (depending on the expected rate of return). A TET incentive would still require “lock in” provisions to ensure that saving is for retirement and not merely long term,
  - Additional contributions above the cap would not be allowed.
35. The TEt regime
- Similar to TET, but taxation upon withdrawal would apply only to the accumulated interest and not to contributions to the fund,
  - Contributions would be after-tax up to an annual cap ranging from \$1000 to \$4000,
  - TEt would require that fund withdrawals be restricted (“locked in”), until retirement
  - Additional contributions above the cap would not be allowed.

### Evaluation of TEt/TET

36. **The benefit of a TEt or TET regime is realized over very long term savings profiles.** Such a benefit will primarily appeal to those who save already and are familiar with the important effect of compound interest. Because the top 20% of households undertake the vast majority of savings, these households may be more likely to respond to such an incentive.
37. Relative to a TET system, TEt primarily benefits those who are saving for the short term. The additional benefits of a TEt system, for those who have saved in such a system for the long term, are a very small percentage of their total retirement savings. This difference is small because over long profiles, the accumulated interest becomes the vast majority of the amount to be taxed. While this disparity may be small per person, it does have a large effect in aggregate on the cost of the incentive.
38. **Factors influencing the effectiveness of a TET or TEt incentive.** The success of a TET or TEt incentive in increasing savings will be determined in the same framework as savings incentives generally, but several specific assumptions will establish the relative superiority of TET/TEt as opposed to tTE incentives.
- If very long term incentives can motivate low and middle income earning households to change their behaviour (*substitution effect*), then a TET/TEt incentive may have a meaningful impact on retirement income (though not necessarily private savings).
  - If high-income households respond to lifetime income increases by increasing savings more than by reducing their labour supply (*income effect*), this would increase the impact of a TET/TEt incentive on long term private savings<sup>7</sup>. Retirement savings will increase, but may be withdrawn sooner. If *substitution effects* are thought to be very small and *income effects* much larger then TET or TEt would increase private/national savings more than tTE.

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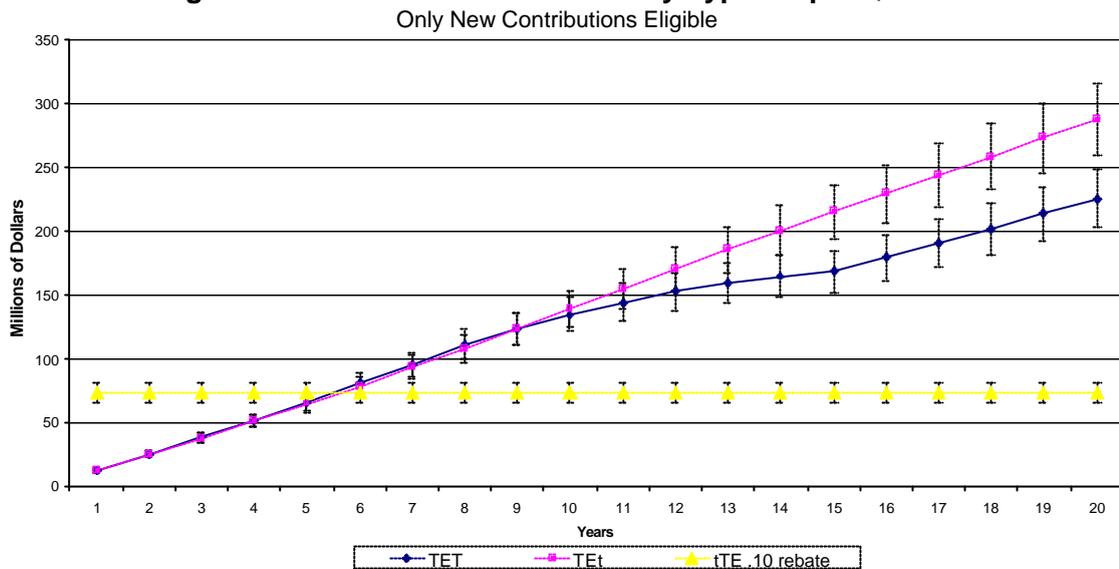
<sup>7</sup> If labour supply reductions were primarily promulgated through early retirement then savings would still be increased for a number of years before labour supply reductions balanced this out.

- The impact of TET/TEt is dependent on the rate of return to savings. The Office of the Retirement Commissioner suggests that the long run average return to private retirement savings will be approximately 8% nominally before taxes. At this level, saving for one's entire working life, under a TET system, generates substantial additional retirement income compared to saving under a tTE system, but at a much higher cost to Government. If this rate were reduced to 5% the lifetime benefit of TET relative to tTE or even TTE is very low. At such low levels one might expect no appreciable increase in savings to arise due to the lifetime spreading of this increase in return and its relative uncertainty.
  - Saving in a TET or TEt environment depends on the belief that future government will maintain the same tax treatment of savings as the one under which a household chose to save. If change is suspected then households are unlikely to invest much in a TET or TEt scheme.
39. **Fiscal costs are likely to require that TET or TEt incentives be subject to a cap and not extended to current savings.** If TEt or TET treatment were extended to the current stock of savings a significant and immediate tax revenue loss would be created without stimulating any additional savings. These losses will be recovered to some extent when funds are withdrawn at retirement, but the first year losses of such a policy have been estimated at \$500 million and the recovery of much of these funds would be deferred for many years. A TEt or TET regime with a cap on yearly contributions that excludes current savings balances has a much more controllable fiscal cost<sup>8</sup>.
40. **Contribution caps are more problematic in a TET or TEt environment.** In a TET/TEt system, a cap represents the maximum total contribution to a retirement account. In a tTE system a cap only represents the level of contribution subject to tax incentives (i.e. savers can add more to a tTE system, they will simply get no additional tax benefit). A TET or TEt scheme requires the opening of an additional fully taxed account to save more than the level of a contribution cap, a result which is likely to interrupt any momentum to savings generated by an incentive (depending, of course, on the size of the cap).
41. **The tax cost of TET or TEt is not high in early years.** If contributions are capped and current balances are not eligible then the expense of TET or TEt, while still very high, only reaches this height after several years. This cost continues to rise rapidly until taxation from fund withdrawals begins to ease the cost of ongoing savings incentives. A TEt system is more costly because, upon withdrawal, it taxes only the accumulated interest and not the original principal contributed to the fund. It is after the first 10 years that the higher cost of a TEt incentive is observed, but this cost becomes much higher over time.
42. **Figure 1** depicts relative fiscal costs of TET, TEt and tTE incentives. These are not final cost estimates but do serve to highlight representative likely costs and comparisons amongst options. Costs are expressed in constant real dollars. A ten percent margin for error either way has been highlighted for each option. These costs explicitly assume that current savings are not given TET or TEt treatment, either of which would result in costs over \$500 million (off the top of the chart) in year one.

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<sup>8</sup> While balances currently saved in other accounts may be transferred to TET or TEt accounts, in any given year the level of transfer would be limited by that year's contribution cap. Allowing current retirement savings balances in their entirety to be eligible for incentives would be very costly.

**Figure 1: Estimated Incentive Cost by Type: Cap of \$2000**



43. **Fiscal cost figures are very sensitive to the rate of return**, as is the case with a TET/TEt scheme's effectiveness. Here again the nominal rate of return is assumed to be 8%. Lower rates of return increase the size of the principle relative to accumulated interest and make a TEt regime more attractive to savers. However, such lower rates of return, while they reduce the cost differences between TET and TEt, do not change the fact that in percentage terms, a TEt system is much more expensive than a TET system in the long term.
44. If the nominal rate of return were lowered to 5% the costs of a TEt or TET system at a cap of \$2000 would remain roughly similar for the first ten years, with a cost of approximately \$60 million per year at that point. While the cost of a TET system would increase more slowly after that point, TEt's cost would continue rising to roughly half again that of TET at twenty years.
45. **TET/TEt exemptions will create a base maintenance risk.** An exemption for retirement savings will create a base maintenance risk through strong incentives to redefine other activities as qualifying superannuation funds. A TET/TEt policy risks creating onshore tax havens.
46. **Policing this risk will create compliance costs to Government.** A TET/TEt regime would require qualifying savings vehicles to be maintained separately from other savings vehicles. All funds within segregated vehicles would need to be monitored to insure that they were qualifying funds and could not be intermingled with other funds. Policing this separation will require additional Government resources.
47. A tTE or TEt based tax incentive for savings will also require a lock-in provision to prevent contributors taking advantage of the tax incentive and then shortly thereafter withdrawing saved funds to be used for current consumption. The TET system provides an inherent incentive to allow funds to accumulate in the long term because the advantage of saving in a TET regime only exists for long term savings. Primarily TET encourages those who begin saving to continue saving.
48. **TET or TEt schemes have substantial investment distortion risks.** By advantaging certain methods of saving (e.g. financial savings vs. education and business investment) or by advantaging specific financial vehicles (e.g. superannuation funds vs. shares, etc.), tax incentives can introduce further investment distortions. Whenever the choice of investment deviates from the basis of the balance of risk and return the total

portfolio held by New Zealanders deviates from its optimal value. This deviation creates financial risks and may decrease long-term productivity and economic growth.

49. TET/TEt treatment of savings affects the selection of investment vehicle and would leave superannuation savings separate from other saving. TET or TEt appears to require stringent ring fencing by funds. Increased administrative costs would generally be passed on to the funds themselves reducing returns. A risk exists that qualifying funds may perform more poorly than alternatives if ring fencing is onerous. More difficult vehicles to administer will result in a more narrow range of options in which funds are invested. This will increase the likelihood of lower returns and a substantially affected pattern of investment.
50. In a TET or TEt framework funds will not have a use for imputation credits provided by some investment options. As a result, such funds will be biased toward holding debt and assets in particular, which will serve to skew New Zealand investment, potentially undermining growth. Changes to the imputation system (along the lines considered in relation to charities), would be needed to accommodate a TET/TEt incentive system.

### Evaluation of tTE

51. **The benefit of a tTE regime is realized in the year a decision to save is made.** A rebate oriented tTE system returns benefits to savers in the same year that the decision to save is made. Essentially tTE is simple to understand and to promote to potential savers and offers immediate versus deferred financial benefits. These assumptions are most likely to hold for lower to middle income earners, while high incomes households receive more professional financial planning and may be more influenced by the long term impact of incentives. The response to a tTE incentive will vary amongst higher and lower income households as a result of these differences.
52. **Factors influencing the effectiveness of a tTE incentive.** The success of a TET or TEt incentive will be determined in the same framework as savings incentives generally, but several specific assumptions will establish the relative superiority of tTE as opposed to TET/TEt incentives.
  - If low and middle income households will only respond to an upfront incentive then tTE would be preferred. Many of those who advocate savings incentives have done so under the premise that the savings of low and middle income earners is too low and this is driven by what they describe as “irrational behaviour”. This raises the possibility that to cause these households to change their behaviour (a *substitution effect*) an incentive must be upfront in nature.
  - There is reason to believe that no incentive can cause lower and middle-income households to change their savings behaviour in a significant way. Returning \$100 to those who save \$1000 will not do much to ease consumption constraints. Much of the available analysis focuses on the US context with comparatively large incentives (and with easier access to accumulated funds), in which the effect on private savings is still unclear. This assumption would diminish the viability of tTE incentives.
  - A tTE solution will still increase the incomes of those who currently save by returning a rebate to them for current savings, some of that rebate would be saved (*income effect*). The propensity to save increased earnings is high for those households that currently do the most saving. In order to maximize this effect the highest affordable rebate level would be provided on whatever level of retirement savings was eligible.
  - Because the benefit in any given year is entirely transferred within that year, time consistency and certainty about future government policy are less important to

savings decisions than TET/TEt. Time consistency issues are still relevant in a tTE framework however.

53. **Increasing the savings of low income earners is a problematic objective.** A tTE regime is often cited as a method to increase the savings of low and middle income households. If these households lack the ability to fund current consumption, tax incentives are unlikely to create the ability to save. If these families have pressing consumption needs, even if they could be encouraged to save, saving may not make them better off over the course of their lifetimes.
54. **A capped tTE rebate system would allow a better limitation of financial risk to the crown than a TET system,** as it is more predictable in the resulting expenditure, it has more flexibility for adjustment over time and it is simply less expensive in absolute terms, given roughly equal cap sizes.
55. **Figure 2 depicts tTE costs.** The cost of a tTE system is largely constant in real terms from the year of implementation, though there may be a transition period while behaviour adjusts. These are not final cost estimates but do serve to highlight representative likely costs and comparisons between options.

**Figure 2: tTE Cost**

Incentive	\$.10 Rebate	\$.15 Rebate	\$.20 Rebate
tTE-\$1000	\$50 Million/Year	\$77 Million/Year	\$103 Million/Year
tTE -\$2000	\$73 Million/Year	\$109 Million/Year	\$145 Million/Year
tTE -\$3000	\$85 Million/Year	\$128 Million/Year	\$171 Million/Year

56. **tTE schemes, have substantial investment distortion risks, though fewer than TET/TEt systems.** By advantaging certain methods of saving (e.g. financial savings vs. education and business investment) or by advantaging specific financial vehicles (e.g. superannuation funds vs. shares, etc.), tax incentives can introduce further investment distortions. Whenever the choice of investment deviates from the basis of the balance of risk and return the total portfolio held by New Zealanders deviates from its optimal value. This deviation creates financial risks and may decrease long-term productivity and economic growth.
57. A tTE vehicle by contrast to TET/TEt appears to be simpler to set up and administer and could be nearly any kind of financial device, as long as withdrawals were limited by a lock-in provision. Because the refund component is discrete year-to-year the need for high levels of ring fencing would be decreased. This fact would decrease the risk of investment distortion.
58. **Compliance costs to Government of a tTE system are lower than those for a TET/TEt system.** The central compliance issue in a tTE regime is preventing excess rebates if a cap is implemented and ensuring that funds given incentives are not withdrawn before allowed. However, this regime does not require that savings vehicles be treated separately as additional contributions can be made to locked-in funds.
59. A tTE system that provides rebates back during the course of the year to improve the savings of income-constrained households was raised in consultation, but such a system is likely to cause higher administrative costs. Another tTE option suggested was the use of progressive rebate levels by income. This too would likely increase administrative costs. While some tTE solutions can increase administrative costs, this is not an inherent feature of tTE in general.

60. A tTE or TEt based tax incentive for savings will also require a lock-in provision to prevent contributors taking advantage of the tax incentive and then shortly thereafter withdrawing saved funds to be used for current consumption.

## Comparison Summary

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61. As you are aware, Officials view is that a TTE regime, while not without drawbacks, provides the best treatment of savings amongst the options considered here. If you wish to alter this regime to increase savings (net national, private or retirement savings), Officials advise that it be a tTE system with a low cap (perhaps \$1000-\$2000) and with a relatively generous rebate (depending on financial constraint).
62. While a tTE regime may be preferable to a TET/TEt system, it would not be preferable to acting within a TTE framework (that status quo). This advice is rooted in an assessment that the benefits of the advised tTE system do not outweigh its costs in compliance, fiscal expenditure and investment distortion risk.
63. This advice is based on the following assumptions:

Assumption	Conclusion
<ul style="list-style-type: none"> <li>An upfront incentive may be no better than a long term incentive at making savings more affordable for low to middle income earners.</li> </ul>	TET
<ul style="list-style-type: none"> <li>A tTE rebate system may be easier than TET/TEt to explain and promote to households with little to no current savings.</li> </ul>	tTE
<ul style="list-style-type: none"> <li>Increasing the income of households with high current income may best increase private savings.</li> </ul>	TET, tTE with high rebate
<ul style="list-style-type: none"> <li>TET schemes are much more expensive relative to the benefits they provide than tTE schemes.</li> </ul>	tTE
<ul style="list-style-type: none"> <li>High cap sizes combined with generous incentives are overly expensive relative to their benefit</li> </ul>	low cap size
<ul style="list-style-type: none"> <li>The compliance costs and investment distortion risks of savings incentives are important. TET schemes magnify these risks relative to their benefits.</li> </ul>	tTE
<ul style="list-style-type: none"> <li>Retirement income is a problematic objective, but it is preferable to private or national savings, which are unlikely to be reached by an incentive. Those who currently save little to nothing should thus be the focus of any incentive.</li> </ul>	Low cap size
<ul style="list-style-type: none"> <li>A larger incentive (not a larger cap size) would best encourage households to change their behaviour.</li> </ul>	High rebate level.

## Consultation Feedback

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64. A number of consulted parties raised the need for clarity in the primary objective of savings incentives (e.g. retirement income, private savings, etc.). Some parties expressed concern that if objectives are not clearly defined and communicated that the value of any policy will be reduced.
65. The opinions of consulted parties on the ability of incentives to generate new savings were mixed. Consulted parties broadly supported the incentive in a tTE regime over

TET or TET because of its upfront nature. These parties believed that an incentive would have the best chance for success with low and middle-income households if it were more immediate. Many felt that while TET or TET is effective at increasing the return for saved funds over the long term, in order to increase the number of households saving, tTE would be more effective.

66. Some industry representatives were in support of an EET system, and a tTE system was several steps removed from their ideal savings regime. If tTE were adopted they preferred a higher rebate level. A preference about cap size was not expressed, but contribution caps on the order of \$1000-\$2000 were likely not envisioned by consulted parties.
67. Some consulted parties expressed concern that the benefits of a tax incentive might accrue only to high income earners and that they would like to see any incentive designed in such a way as to avoid this result. Further, many consulted parties felt that the success of an incentive would be represented by its ability to bring new households into the practice of saving for retirement. Concern that the design of any savings incentive would not imperil benefit eligibility was also raised.
68. Consulted parties were very concerned that any incentive scheme not saddle employers with high administrative costs. They pointed out that participation in superannuation schemes by employers has steadily declined in recent years as a result of compliance costs with an absence of returns to these costs.
69. Compliance costs to Government were not the focus of concern by consulted parties, though they were acknowledged as important.
70. Some parties expressed concerns over investment distortions existing as a result of current tax policy. Some were concerned about incentives raising additional distortions while others thought incentives were needed to counter current distortions.
71. Some consulted parties expressed concern that savings incentives might displace other potential Government spending. It was expressed that this trade-off would be of particular concern if incentives were not successful in increasing retirement savings.

## Inland Revenue comment

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72. Under a TET scheme, Inland Revenue considers that a cap on contributions is not necessary to limit the fiscal cost. This is because a TET scheme will only provide an incentive to long-term savings – long enough for the benefit of exempt earnings to outstrip the retaxing of the contributions. Savings would not be put into funds just for the short term.
73. Furthermore, a contribution cap for a TET or TET scheme would be problematic from an enforcement perspective. A cap would be needed on the amount that each person could contribute each year, but institutions would not be able to monitor whether a person had already made contributions with another institution. Only the person would have the necessary information.
74. Inland Revenue agrees that a tTE scheme is the preferred option for the reasons set out in the report. Consultation showed that an up-front concession is the most likely way to encourage new and increased saving. However, Inland Revenue notes that overseas evidence suggests that it is unlikely that incentives would raise the overall level of national savings.

## Annex 1: Competing Objectives of Tax Incentives for Savings

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1. In addressing the issue of savings, it must be acknowledged that there is not one way to address all of the potential objectives with regard to savings policy, as these objectives often compete with one another. An incentive that may best meet a goal such as increasing retirement savings or increasing the savings of low and middle income earners may not be the same incentive that best increases national or private savings as a whole.

### ***National Savings***

2. For a tax incentive to increase national savings, the increase in private savings as a result of any incentive must be larger than the revenue foregone as a result of the tax reduction. However, international experience is not supportive of the ability of incentives to raise total national savings.
3. If an optimistic assessment of the ability on an incentive to cause substitution toward savings is made then a capped tTE solution with a high rebate level best increases savings per dollar of government expenditure.

### ***Private Savings***

4. If increasing long-term private savings were the goal, TET or TEt may be the better solution, particularly if one is sceptical about the ability of savings incentives of any sort to change the decision making of low and middle-income earners. This option may be more expensive relative to the savings generated, but may increase the total level of private savings by the highest degree.

### ***Retirement Savings***

5. The recent report *The Living Standards of Ordinary New Zealanders*, by the Office of the Retirement Commissioner may diminish the need to address retirement income for the general population, suggesting that retirees may be no worse off than many in the working age population.
6. In addition to savings, a strong economy will be needed to meet the financial strain accompanying an aging population. Any policy that attempts to address retirement income becomes self-defeating if it results in investment distortions that reduce the economic capacity needed to shoulder the upcoming burden.
7. Because the success of a policy focusing on retirement savings as an objective will be closely tied to increasing the savings of low and middle income earners, officials suggest that these two goals be considered in tandem.

### ***Low and Middle Income Savings***

8. Currently the bottom 50% of households by income, on average do not have financial retirement savings. If these households lack the ability to fund current consumption, tax incentives are unlikely to create the ability to save. If these families have pressing consumption needs, even if they could be encouraged to save this may not make them better off over the course of their lifetimes.
9. Some argue that the displacement of non-superannuation benefits for future retirees is one rationale for increasing savings particularly among lower income earners. The argument is that relatively small increases in savings might reduce government support in addition to superannuation consumed by future retirees by lifting their incomes just above eligibility levels. Those targeted by such a policy would be decreasing current consumption for the benefit of foregoing future government support. Over a lifetime people would be made economically worse off by such a policy.

10. Further, if savings incentives carry a risk of undermining economic growth, such an outcome would be as likely to hurt low and middle income earners as an incentive is to help them.
11. While benefit displacement may not be a good rationale for savings incentives, increasing the savings of households who currently do not save will be a necessary component of raising the retirement incomes of those who are most likely to be at economic risk in their later years.

### **Changing the Composition of Savings**

12. It could be argued that increasing Private Savings while decreasing Government Savings was worthwhile if the return to Private Savings was thought to be higher than the return to Government Savings. Many have also said that Residential Investment (private homes) represents too high a percentage of Private Savings in New Zealand. Some industry parties consulted would like to see an incentive to “balance against housing incentives”.
13. Altering the composition of savings comes with the risk of unforeseen changes however. It is very likely that funds would be transferred from other financial assets rather than housing, and it is quite possible that assets could be redirected from other uses such as small business or education.
14. Among the objectives listed, this one is the most likely to be attainable via tax incentive, subject to the concerns listed. A capped tTE rebate system has the best opportunity to achieve such an end while creating fewer investment distortions than a TET or TET system.

## Annex 2: Records of the Process of Consultation

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1. For each group with which consultation was conducted, the key positions expressed in that consultation are listed below. Parties include ASFONZ, Business New Zealand, CTU, ISI, Office of the Retirement Commissioner and the Government Actuary

### **Business New Zealand**

2. TET (or really any system with a T at the end) has the potential to be politically difficult because big lump-sum tax payments could be seen as taking away from savings that people have “already worked for”, despite the poor rationale behind such an argument.
3. Upfront rebates are the preferred method of incentive if an incentive is to be offered, favouring the tTE approach. The lack of neutrality to other potential methods of retirement provision such as small business and education is a concern however. Whatever is done should attempt to avoid distorting investment incentives.
4. If rebates put money back in the hand of those who save, the incentive is likely to be more effective than if the money is merely directed back in to a fund. This is because the overall additional donation is likely to appear small.
5. A complicated system will further risk alienating employers and will lower firm participation rates. A simple rebate system might not require very much additional effort for employers however.
6. Incentives would best be focused on those who currently save less, and a flat rate cap on contributions would appear to be one good way of achieving this. Lower income earners will be concerned about income saved counting against benefit eligibility and this may make SSCWT more attractive. A tTE system could have better equity implications than a flat rate SSCWT however.

### **CTU**

7. CTU approaches issues such as this one as part of a broader concern for the position of working people and the benefits offered to them by their employers. CTU would like to see any initiative by companies that would lift the low percentage of New Zealanders in employer based savings schemes.
8. CTU express the concern that any incentive such as this would carry an opportunity cost and they would not like to see other taxes increased or important funding cut to fund a tax incentive.
9. The viability for employers is important to take in to account; otherwise history has shown that participation in plans dies out. CTU would like to get employers interested in savings plans again.
10. CTU was positive about the ability of incentives to lift savings levels of some groups with education and particularly if those incentives were upfront (tTE).
11. Investment incentives and neutrality were important concerns and though TET has some favourable reaction, tTE would be preferred.
12. Low-income earners would probably most benefit from a high benefit and a low yearly cap on contributions.

### **ISI**

13. ISI argues that some sort of tax scheme for savings is important if only to balance against the inequities of the current tax system and its impact on incentives to save.
14. There is a distinction between a focus on long-term savings and a focus on retirement savings and the goal should be clear before proceeding.
15. EET at the marginal rate is the ideal structure according to ISI and is their starting point in discussions. In an ideal world, ISI would like a significant rethinking of the proper

way to tax retirement income. Philosophically, ISI believes that income which is saved for retirement is currently taxed too high and should be taxed at the appropriate marginal rate of income in retirement.

16. A concern about the long-term viability of superannuation was expressed and they feel it would be beneficial if people were informed that they would not likely be able to have a comfortable standard of living relying on superannuation.
17. In general upfront incentives are preferred with an E upfront and the deferral of taxation until retirement.
18. Another suggestion would be an ETT with a cap on contributions and a 21% proxy rate on withdrawal. The 33% rate would be a second best alternative in an ETT system.
19. ISI wonders if a “small t upfront” would “capture people’s imaginations”. However this option would be the next most desirable according to ISI. In this case a \$0.06 reduction for each marginal tax rate would be requested.
20. Employer deduction schemes are likely to work best and should direct withheld monies directly to a fund to reduce temptation to spend. Capping eligible contributions would be supported, but it is important to keep an incentive plan as simple as possible if it is likely to succeed. Portability between employers and plans would be needed as well as a lock in provision. These requirements all raise administration issues that will require close consideration.
21. TET is not generally supported because it doesn’t create any motivation for those not otherwise inclined to save.

## **ASFONZ**

22. In general tax incentives might not be supported as good government policy, but it is possible that such incentives might increase private retirement savings, though likely not national savings. In designing such incentives however, avoiding skew in investment generally should be a priority. Neutrality is an important goal, remembering that the status quo itself is not neutral however.
23. A policy intended to increase savings should also be concerned with the maintenance of savings.
24. A balance between administrative simplicity and effectiveness is important with respect to all savings incentives. There is a concern that many more employers will discontinue their involvement in savings schemes if they are difficult to administer.
25. An important concern for low income savers will be the way in which income that is saved under locked-in vehicles counts against benefit eligibility. This is a current advantage of SSCWT. A very high proportion of the saving by low and middle income earners stems from employer savings plans.
26. A rebate scheme would be a good way to assist the self employed as well.
27. ASFONZ is supportive of the idea of capping contributions eligible for rebate on a yearly basis.
28. Incentives would ideally be designed to allow the broadest range of appropriate savings vehicles to qualify if they meet certain criteria. In this way banks and others would be allowed to participate.
29. If a TET regime was considered, ASFONZ notes that there would be imposing transition issues.

## **Office of the Retirement Commissioner**

30. A concern was put forward that any policy change be driven by clear objectives. These objectives should cover both the national level effects desired (i.e. increasing retirement savings, national savings, etc.), and the population to whom an incentive is

being delivered (i.e. low or middle income groups or the broader population). Without such grounding any policy will be more troublesome for organizations such as the ORC who serve an educational role.

31. The ORC does not have a public view on the efficacy of tax incentives, but tends to agree with the tax review that incentives are unlikely to increase national savings. The ORC would echo concerns over compliance costs, etc potentially undermining the value of any incentive.
32. If incentives are offered ORC believes they will have the greatest effect if they are upfront. Though it is acknowledged that different groups will have different reactions to incentives; if getting new savers started is the goal upfront incentives are likely to work best. A rebate as per charitable contributions is one such option.
33. ORC would favourably view a flat rate incentive or other such progressively minded actions. While the ORC does think that caps on contributions are needed, caps based on age are likely to be overly complicated in practice.
34. Because quality of savings is an important concern the effects on investment incentives should be closely considered, as should the type of savings vehicle to which incentives would qualify.
35. Lock-in provisions will be necessary under both tTE and TET options. The design of lock-in provisions should also reflect the goals of the incentive policy. For example there are a number of long-term savings goals in addition to retirement, such as education etc., and these may be just as important nationally as retirement savings. If lock in is focused on retirement this will certainly put off some people with other long-term savings goals.
36. Fees for managed funds may also be a concern if certain funds become preferred vehicles due to incentives. ORC would not like to see a large portion of the incentive eaten up in fees. ORC would support the regulation of fees as per the U.K. system and would also like to see improved disclosure regulations.
37. Finally, tax incentives might make more sense if retirement benefits were income tested. The ORC is not opposed to some clawback provisions in incentives.

#### **The Government Actuary – Geoff Rashbrooke**

38. Geoff believes that if incentives are implemented that upfront incentives are best positioned to increase savings. He tends to believe that it is possible to influence household savings behaviour with tax incentives and that a form of ETT arrangement could be devised to meet that goal.
39. He supports the idea of greater taxation on retirement savings withdrawal (the “final T”) to encourage slower disbursements of money on the presumption that people will not be very accustomed to managing large amounts of capital and that they may be disposed to make poor decisions.
40. He was concerned that exemptions on earned interest for savings (“middle T”) would result in the misuse of savings vehicles for avoidance, distortion in investment behaviour and that compliance costs could be high.
41. Geoff would like ultimately to move to an ETT arrangement, but would be supportive of some tTE regimes as a model for transition toward “something broader.”
42. He was in favour of an upfront (tTE) rebate scheme, particularly one designed to allow cash flow from tax benefits to be accessed quickly by lower income individuals in order to maximize the incentive for lower income individuals. He also appreciates the ability to cap such rebates.