NEW ZEALAND BUSINESS ROUNDTABLE

Submission to the Savings Working Group

September 2010

1. Introduction

1.1 The Business Roundtable welcomes the establishment of the Savings Working Group. We think there has been much mistaken analysis around savings over the past decade, especially by the Treasury, and that as a result, costly policies have been based on false premises.

1.2 The over-arching context of the Savings Working Group (SWG) must be the government's top priority goal of achieving income parity with Australia by 2025. This is simply infeasible with current policies. Major changes are needed. We agree with the statement of the SWG chairman, Kerry McDonald, that:

> Success will require a full-blooded unqualified commitment, based on an astute, strategic, and well executed approach, linked with unequivocal political leadership.[1]

We think this view should inform the SWG's approach to savings issues.

1.3 The group needs to take a broad approach to its work. Many government policies have an effect on savings. We accept that the government has ruled out changes to some of them, but this should not prevent the SWG commenting broadly in the interests of public understanding.

1.4 We think it should base its advice on standard public policy principles, particularly liberty, economic efficiency and equity. The level or form of saving is not a public policy issue in its own right. We do not think it is the role of the government to attempt to engineer particular savings outcomes. Rather, it should aim to minimise policy distortions that influence New Zealanders' decisions about saving. It is not in fact clear that the government can significantly influence aggregate savings (as distinct from the forms savings takes). Most economists think its main leverage is over its own savings or dis-savings.

1.5 We have long been sceptical of the mantra that New Zealanders are

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[1] Excerpt from a submission to the 2025 Taskforce.

poor savers. We see no reason why the aggregate savings decisions of New Zealanders – decisions they make about what to consume out of current income and what to save in order to consume more in the future – are likely to be very different from, say, citizens of other Anglo-Saxon countries. Empirical evidence (see below) seems to bear out this intuition. International comparisons of savings need to be carefully interpreted. For example, fast-growing countries tend to save at high rates whereas it can be expected that countries with aging populations will save relatively less. Adjustments for relevant factors narrow the range of savings rates.

1.6 A number of other considerations need to be borne in mind when analysing savings issues:

- All components of saving – government, business and household – need to be taken into account.

- This distinction between households and firms is fuzzy at best – households are the owners of firms (along with foreign capital). Thus retained earnings by corporates are arguably part of household saving.

- Household liabilities in part represent investment in small and medium enterprises.

- Flow measures of savings often include as consumption expenditure items that are really investment – eg public education expenditure is treated as consumption expenditure.

- A major missing element in the savings/wealth story is investment in human capital; our measures of net wealth, while showing positive aggregate saving rates for households, understate those savings as they count the liabilities (student loans) and make no allowance for human capital on the asset side of the household balance sheets. So net wealth measures *understate* implied saving rates.

- New Zealand Superannuation essentially represents a stock of retirement wealth – its impact is to drastically reduce the inequality of net wealth holdings by individuals.

- Inflation distorts flow measures of savings; earlier work by Iris Claus and Grant Scobie showed that, once corrected for inflation, there is no downward trend in household savings.

- Lifetime savings patterns must be taken into account. Leaving aside bequests, in the long run what is saved by households will eventually be consumed.

- There are numerous ways of measuring savings and statistical difficulties abound. Upgrading savings data would be useful.

1.7 It is also important to be clear that the linkages between savings, investment and economic growth are complex. Some countries with high domestic savings and investment rates have done poorly while others with lower rates have done well. Also relationships are two-way: while savings may facilitate growth, growth also facilitates savings. Thinking about development has long since moved away from ideas about enhancing savings propensities to close the gap with a desired investment rate in order to achieve faster growth. Institutions and policies which are conducive to economic freedom and entrepreneurship are recognised as more fundamental.

1.8 SWG members will be well aware of all these issues. We think the group could perform a valuable service by discussing them carefully in its report.

2. Previous inquiries and studies

2.1 The findings of some previous inquiries and studies are worth noting (those mentioned below are not comprehensive).

The 2001 Tax Review

2.2 The 2001 McLeod Tax Review found that:

- it was not apparent that New Zealanders save too little
- there is little evidence that changes to the tax system would induce higher saving
- the current account balance is the result of many influences (such as New Zealand's international competitiveness), not just saving
- most New Zealanders are making adequate provision for their retirement, given New Zealand Superannuation, and
- higher private savings would lower the cost of NZS only if it were means-tested.

The McLeod Review was a high quality exercise. It provides a useful starting point for the SWG.

NZIER Working Paper 2007/01: Does New Zealand have a household savings crisis?

2.3 This study was co-funded by the Business Roundtable. Its executive summary is worth quoting in full:

> **Is there a household saving crisis?**
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> Data from the Household Income and Outlay Accounts (HIOA) show that the ratio of household saving to disposable income has been negative since the early 1990s and has declined steeply since 2000. These data have led many people to believe that New Zealand has a household saving crisis which will result in a crisis in retirement incomes in due course. These concerns have been expressed by certain key politicians. The upshot has been the enactment of several policies, notably:
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> - the New Zealand Superannuation Fund (2003), a scheme under which the government runs budget surpluses to invest in a fund to be able to cater for the costs of the universal pension when the population ages;
> - the State Sector Retirement Savings Scheme (2004), an employer subsidised saving scheme for state sector employees; and
> - Kiwisaver (2007), an employment related superannuation scheme in which the government provides inducements for joining, on-going subsidies for fund managers and tax breaks for participant employees and their employers. From April 2008 employers will be required to make contributions to the saving of their employees who are members.

A review of the existing measures of household saving in New Zealand shows little evidence of a saving problem. Indeed, the data that the proponents of saving policies have used poorly reflect the true household saving performance. Other data sources indicate that household saving is not only positive but has also been rising considerably in recent years.

Problems with the data

There are several reasons to believe the frequently-cited HIOA saving data inadequately capture true household saving. Firstly, being based on the national accounts statistics framework, HIOA overlooks hidden economic activity. Because tax evasion is an important motivation for this activity, it tends to be greater on the income side than the consumption side. Since saving in HIOA is the difference between income and consumption, omitting the informal economy understates saving. The size of the informal economy tends to rise with the effective tax rate so the increase in the top personal tax rate (from 33% to 39%) in 2000 since then is likely to have caused an accelerating understatement of household saving.

Secondly, HIOA takes no account of income from assets that New Zealanders hold directly in other countries. Given the lack of a full capital gains tax, no exchange controls, the very small local equity market, large inflows of migrants, and the global focus of many New Zealanders, the wealth held directly overseas is potentially large. Therefore, omitting this source of income understates saving.

Thirdly, the sharp drop in the household saving rate from 2000 seems a sensible response to a fiscal policy change. In 2000, the top personal tax rate was raised by 18% from 33% to 39%. This shifts saving from households to the government by raising government revenue at the expense of household disposable income. Moreover, the fiscal surplus has expanded and households may have interpreted this as the government saving on their behalf, reducing their need to save.

The increase in the top tax rate applies to personal income but not to corporate and trust income and this has induced a change in the form of household saving. The income earned from trusts has grown steeply since 2000. Unincorporated businesses have been incorporated to reduce the tax burden. Shareholders of closely held companies have restricted their drawings to reduce their liability for personal income tax at the higher rate. In New Zealand, it is very cheap to set up and operate a company; thus cost and inconvenience do not much constrain incorporation and retaining savings to avoid the highest personal tax rate.

It is noteworthy that while household saving as recorded in the national accounts has fallen sharply since 2000, government and business saving have risen just as markedly so that aggregate saving as a percentage of GDP has been reasonably stable.

The current situation

The current situation can be summarised as follows:

- many believe New Zealand has an ever-worsening saving crisis which will lead to problems with the adequacy of retirement incomes;

- this belief has led to the introduction of several policies to correct an apparent failure of a hands-off approach to produce the optimal level of saving;

- the data upon which this belief is based are very suspect, and other data indicate that household saving is positive and rising sharply;
- a significant factor as to why the HIOA household saving rate has trended downward since 2000 is fiscal policy, specifically the increase in the top marginal tax rate by 18% in that year; and
- we have significant policy responses to statistical aberrations attributable largely to households' legal reaction to a sharp increase in the top personal income tax rates imposed a few years ago.

Are pro-saving policies a safe bet?

If saving is already high, more saving will depress consumption and weaken growth. If saving is low, external borrowing can be used to fill the shortfall. Saving is costly since it reduces current consumption.

Whether investment is financed by borrowing or saving does not matter. The crucial question is still how wisely invested the funds are. As long as the loans are used in profitable investments, indebtedness is not a problem. If New Zealand has difficulty sustaining foreign debt, it is because it has a growth problem, not a saving shortage.

Moreover, pro-saving policies like KiwiSaver are inefficient and inequitable. These policies entail subsidies, which will result in higher taxes (or lower government saving). The collection of tax to finance the subsidies creates a deadweight loss equivalent to the administrative resources involved in the money-go-round. Much of the saving is unlikely to be new saving but merely the reallocation of saving from other forms to the tax-favoured vehicle. The subsidies will also induce some people to borrow or delay loan repayment to fund their 'saving' contributions.

2.4 The then minister of finance Dr Michael Cullen criticised the study on the grounds that New Zealanders "spend more than we earn". This is simply untrue: annual net national savings have been overwhelmingly positive. He also confused national savings with the current account balance. These are two quite different things: the sum of all current account balances in the world is zero, so that even if all countries had the same savings rate there would be positive and negative current account balances because investment rates differ.[2] Besides investment, the current account reflects many other factors, including international competitiveness and the stance of monetary policy. In our view Dr Cullen misdiagnosed the large current account deficits of the last decade as a savings issue. We think they were much more the result of a loss of international competitiveness due to excessive

[2] For further details, see Bryce Wilkinson and Trinh Le, 'Is poor household saving the cause of New Zealand's high current account deficit?', NZIER Working Paper 2008/01.

government spending and regulation which drove up real unit labour costs and the real exchange rate.[3]

2.5 Further confusion was evident in Dr Cullen's 2007 budget statement that the household saving trend was "a movement into negative household saving". Experts on saving have long pointed out that this claim is implausible – it would mean that the value of New Zealanders' net household assets was actually declining when plainly it is not. The point is that the flow measure of HIOA does not take account of changes in the value of the stock of savings. When these are taken into account, household savings were not declining as implied by the flow measure.[4] It is also important to note that an economy could have measured household savings of zero and yet individuals could be saving adequately for their retirement. For example, the working age population in the workforce could be saving 50 percent of their incomes while retirees were dis-saving at the same rate.

Capital Market Development Taskforce

2.6 The 2009 Capital Market Development Taskforce examined capital formation and the functioning of New Zealand's capital markets. It did not suggest that New Zealand has a savings problem.

2025 Taskforce report

2.7 In its November 2009 report the 2025 Taskforce said that:

> New Zealand's national savings rate – the share of each year's GDP not consumed – has averaged 17 percent since 1990. That is among the lower national savings rates in OECD countries. Australia's national savings rate has averaged 20 percent of GDP over the same period – also a little below the savings rate in the average OECD country. But there is quite a range of advanced country experiences. For example, national savings rates in the United States and the United Kingdom (averaging around 15.5 percent) have been lower than those in New Zealand. However, because US and UK incomes are so much higher than those in New Zealand the real dollars saved per person are still lower here than in the US and the UK.

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[3] An IMF Paper by Werner Schule on New Zealand's imbalances found that reducing government consumption spending by 1 percent of GDP would reduce the balance of payments deficit relative to baseline by about 0.5 percent of GDP.

[4] This result holds even after removing the effect of asset revaluations via house prices.

2.8 The Taskforce went on to say:

> National savings can be analysed as the sum of public saving (what the government saves) and private savings. Over most of the last 15 years, New Zealand's public savings rate was among the highest in the OECD. For the time being that has changed: the rapid expansion in government spending and the unfunded tax cuts undertaken in the last five years mean that New Zealand now faces a reasonably extended period of operating deficits.
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> Private saving and consumption choices are just that: private. The government is not directly responsible for those choices. However, government policies can affect those choices, consciously or inadvertently, and can influence households to save less than they otherwise would do. Government surpluses themselves can encourage the private sector to save less – they have less reason to worry about the risk of future tax increases.
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> At least two broad classes of specific government policies are also likely to influence private savings choices, even if the government's own books are balanced:
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> - Welfare policies. Government-provided retirement incomes are likely to materially influence incentives for the private sector to save. Generous state assistance for tertiary education, state-funded health services, and social welfare benefits are also likely to have somewhat similar effects. The New Zealand welfare system is more generous than the systems in Australia and the United States and our universal non-contributory New Zealand Superannuation is among the most generous anywhere in the developed world.
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> - Tax policies. Taxing both the income earned on capital (eg interest) as well as the labour income that first generated the income that was saved is widely regarded as, in effect, double-taxing savings and hence potentially quite costly. New Zealand obtains a relatively high proportion of its tax revenue from the taxation of capital (as does Australia), and until recently had a comprehensive approach to income tax, in which all domestic income earned on savings was taxed at the individual's maximum marginal personal tax rate. That is very unusual internationally. Taxation of income on capital would be expected to adversely affect both domestic investment and domestic private savings.
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> Australia also typically has had among the highest real interest rates among OECD countries. In Australia's case, it is plausible that desired rates of investment at any given domestic interest rate may be a significant part of what underpins the relatively high neutral level of interest rates. Over recent decades, on average, a consistently larger share of Australia's GDP has been devoted to investment than any other longstanding OECD country. That is consistent in part with the fact that Australia has had among the most rapid population growth in the OECD and with the rather capital intensive nature of the mining sector.

2.9 Based on this analysis the Taskforce made the following recommendations:

> 7 Ambitious welfare reform measures should be undertaken as a matter of priority to reduce the very large number of people of working age currently receiving welfare benefits.

> 8 Early steps should be taken to lower the actual and prospective costs (as a share of GDP) of New Zealand Superannuation. The eligibility age should be increased progressively, with increases linked to ongoing improvements in life expectancy, and for some years payments should be indexed to the CPI rather than to after-tax wages.
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> 9 Remaining KiwiSaver subsidies should be abolished.
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> 18 The New Zealand Superannuation Fund should be wound up and its assets used to reduce gross government debt.

Motu study Household Wealth and Saving in New Zealand: Evidence from the Longitudinal Survey of Family, Income and Employment

2.10 The abstract of this recent study by Trinh Le, John Gibson and Steven Stillman, to which the Business Roundtable made a financial contribution, reads as follows:

> This paper uses data from the Survey of Family, Income and Employment (SoFIE) to estimate household saving in New Zealand between 2004-2006. Comprehensive data on wealth is collected biannually in SoFIE and we calculate household saving by examining how wealth has changed over time. We find that even the most conservative estimate of household saving was at least 14% of gross income during this time period. On the other hand, the indirectly derived Household Income and Outlay Accounts (HIOA) indicate (net) household saving was -12.5% per year over the same period. We also find no evidence that capital gains in housing during this time period crowded out saving or that the composition of household wealth in New Zealand differed from that in other developed countries.

2.11 The paper concluded:

> Policies such as the State Sector Retirement Savings Scheme (SSRSS) and KiwiSaver, and the introduction of other tax-favoured savings vehicles, including Portfolio Investment Entities (PIEs), were developed by policymakers because of the belief that New Zealand currently has negative levels of household saving. However, our results indicate that, on average, people were already saving one-eighth to one-sixth of their income prior to the introduction of KiwiSaver and PIEs. While we do not attempt to ascertain whether the level of household saving we estimate is 'optimal', the fact that actual saving appears to be strongly positive while policymakers have (wrongly) perceived it to be negative likely undermines some of the rationale for why these distortionary pro-savings policies were needed.
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> Clear evidence is needed in the area of public policy settings towards household savings because decisions based on incorrect evidence can be very costly for individuals and society. For example, direct government expenditure on KiwiSaver and foregone tax-revenue on income earned in SSRSS, KiwiSaver and PIEs comes at the cost of other publicly provided goods and services. Given that the government operating balance, which was strongly positive until 2008 ($2.38 billion in 2008), was -$10.5 billion in 2009 and is forecast to remain negative for a decade (Treasury, 2009) and that larger than anticipated KiwiSaver costs are an important contributor to these anticipated deficits (Treasury, 2008, Table 2.5, p. 30), these pro-savings policies

may be at best unnecessary and at worst counterproductive for promoting future economic growth.

It has also been argued that New Zealanders hold too high a proportion of their wealth in property and that the property boom that was occurring in the 2000s potentially distorted saving decisions. In particular, it is believed by some that a potential negative side-effect of this boom was that high levels of passive saving may have crowd out active saving. For example, Hull (2003) and De Veirman and Dunstan (2008) both report evidence of a negative correlation between passive and active saving and argue that this evidence is consistent with the "target saver" theory where people save to achieve a target dollar amount and hence different forms of saving are substitutes for one another.

However, our preliminary results using SoFIE provide no support for this hypothesis. Not only do individuals with higher passive saving between 2004 and 2006 have higher total active saving, but they also have higher active non-property saving. While further work needs to be done to allow these results to have a causal interpretation, they strongly suggest that passive saving from the property boom did not crowd out other forms of saving. In other words, journalistic stereotypes about irresponsible New Zealanders cashing in on their rising house values to go and buy big screen TVs appear have little basis in statistical fact. Furthermore, an international comparison shows that New Zealanders hold a similar proportion of their net worth in property as do individuals in other OECD countries.

In economic downturns, as in the past two years, policies that distort saving decisions actually work against the desire to stimulate consumption. In particular, while KiwiSaver is voluntary, once enrolled, individuals cannot withdraw contributions and can only take contribution holidays under restricted circumstances. Including 'lock-in' devices in KiwiSaver was done intentionally in response to arguments from behavioural economics about people lacking commitment to save. To the extent that such lock-in makes it harder for households in future to access their savings in times of need there may be a considerable welfare cost to this misreading of the evidence about lack of household saving in New Zealand.

2.12 This study highlights the extent to which recent savings interventions may have been based on false premises. We think the SWG should review empirical findings on savings in New Zealand and, if necessary, seek expert advice. We would be happy to suggest suitable advisers.

3. Treasury paper *Saving in New Zealand*: *Issues and Options*

3.1 We do not regard the background paper prepared for the SWG as a high quality analysis. It does not report or engage with the findings of many of the studies and inquiries cited in the previous section. It reflects some of the poorly substantiated analysis that led Treasury to recommend 'least regrets' savings interventions to the last government, despite the views of some of its own savings experts.

3.2 The argument in the Treasury paper appears to run as follows:

(i) New Zealand has had large balance of payments deficits for so many years that the negative net foreign asset position "makes New Zealand more vulnerable to an unforeseen change in investor sentiment", putting us at risk of future fiscal and economic stress.

(ii) Balance of deficits reflect investment being persistently higher than savings (I>S).

(iii) New Zealand's savings to GDP ratio is low relative to the OECD average and this is contributing to (1) relatively undeveloped capital markets, (2) inflationary pressures (too much private and public consumption), and high real interest rates and a high real exchange rate (p 15). This is the reason for the shrinking of the traded goods sector (p 16). "A permanent increase in national saving will take the pressure off domestic resources which will allow, on average, lower interest rates to maintain inflation" (p 17).

(iv) Past high government savings (the difference between tax revenue and government spending (T-G)) have contributed positively to national savings by around 4 percent of GDP but net private savings has been around -1 percent of GDP. The problem seems to be that New Zealanders are less willing to save than their OECD counterparts (p 11).

(v) Six possible reasons for New Zealanders' apparent reluctance to save are listed on pp 24-25.

(vi) The remedy is to raise the savings ratio S/Y (raising S by raising Y is acknowledged to be a better goal but is outside the scope of the Treasury paper). The hope is that a savings policy will raise savings and economic growth (p 25).

(vii) One option is to raise T-G, and the effects of tax structure and welfare incentives could be looked at. There are also options to subsidise or mandate private savings.

3.3 The weak points in this chain of logic include the following:

(i) The argument does not note that relatively low savings rates are an Anglo-Saxon country phenomenon, yet the economic performance of Anglo-Saxon countries compares favourably with that of most other OECD countries. Moreover, Anglo-Saxon countries historically have the best developed equity markets.

(ii) There is no convincing evidence that inflationary pressures are related to the national savings rate in an open economy. The critical issue is the commitment of a central bank to a non-inflationary monetary policy.

(iii) The points in paragraph 3.2 (iii) above look like low quality armchair theorising. Is there any real empirical evidence to back them up?

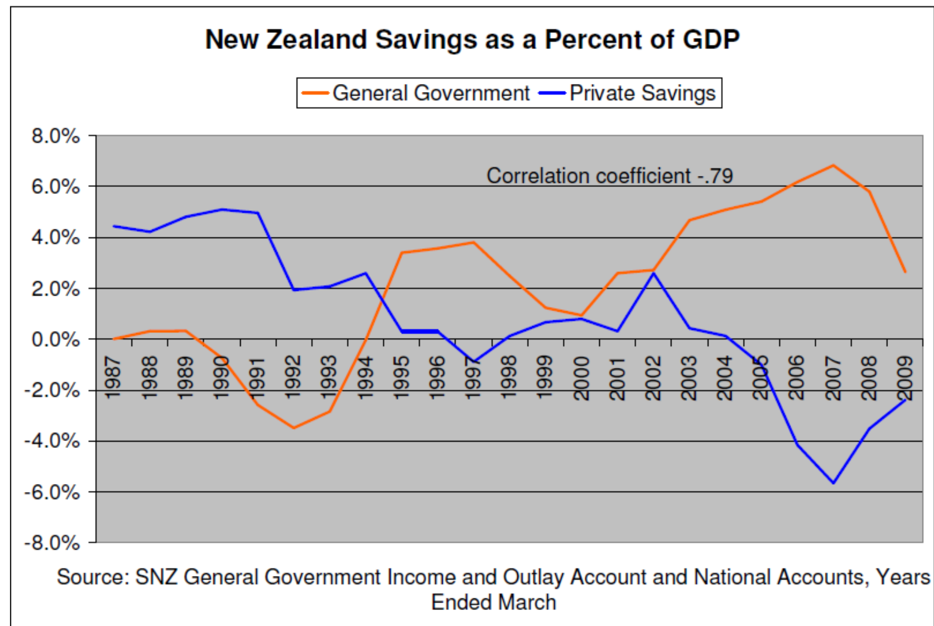
(iv) The balance of payments analysis does not consider other possible explanations or contributing factors. For example, disproportionate spending on low quality investment I or G could force up I relative to S with a poor overall growth rate and serious crowding out of the traded goods sector by the non-traded goods sector.

(v) The interest rate premium argument does not consider a myriad of other risk factors that bond markets can be expected to price. These include expropriation risk, tax rate risk, interest rate risk, reinvestment risk, liquidity risk, and currency risk.

(vi) The argument that domestic savings and foreign savings are not perfect substitutes does not establish that they are so imperfect as to create a real problem for finding investment

capital in New Zealand – independently of the risk factors mentioned above, or undesirable constraints on overseas investment in New Zealand.

(vii) The analysis does not mention confounding investment/capital stock/capital intensity data which indicate that New Zealand has grown capital intensity so fast in recent decades as to be both (1) a major contributor to labour productivity growth in OECD comparisons and (2) a major contributor to New Zealand's poor multifactor productivity growth according to the same data series. (For given output per capita growth, MFP growth is smaller the larger is capital intensity growth).



(viii) The argument ignores the tendency for private savings to move inversely to public savings. The chart above shows this tendency in New Zealand during the last 20 years. An extensive 1999 cross-country study for the Bank of Chile found that an increase in public savings of 4 percent of Gross National Disposable Income might raise national savings by only 1.2 percent in the long run. This purely illustrative finding would imply that the 4 percent figure in the paragraph 3.2 (iv)

above might be more like 1 percent compared with the counterfactual of general government balance.

(ix) Perhaps most significantly, the reliance on the national savings flow estimate for household savings cherry-picks the data. There are at least three other ways of getting estimates of household savings: stock data on a national basis, flow data from household survey information, and stock data from household surveys. All three of these measures point to increasing household net worth. This implies that households are not dis-saving. Moreover, the differences are massive. It is odd that the Treasury paper does not cite the December 2009 Scobie and Henderson Treasury Working Paper that finds a median savings rate for individuals of 16 percent. After removing capital gains from owner-occupied housing it estimated the median was 5 percent. This compares with the negative figures for household savings in the national income account flow data. The Motu paper cited above supports the Scobie/Henderson findings, including the doubt cast on the conventional wisdom that New Zealanders invest too heavily in housing.

3.4 In summary, the Treasury paper loses credibility by not reporting and engaging with recognised alternative theories and conflicting evidence on saving.

3.5 We do not in any way wish to minimise the concern about the imbalances in the New Zealand economy and the build-up of external debt in the last decade. This makes New Zealand vulnerable to developments such as the recent global financial crisis. Contrary to the previous government's view, we see this problem not primarily as a savings issue but rather one related to the allocation of resources between the traded and non-traded goods sectors of the economy. A shift in favour of the traded goods sector is badly needed. This calls for a focus on export and import-competing industries and measures to improve their profitability which was severely damaged by the last

government's policies. Policy action across a broad front is needed to reduce domestic costs and increase the flexibility of the economy to facilitate resource switching. Policy adjustments in areas such as government spending (so that fiscal policy is more supportive of monetary policy), tax, privatisation, regulations that impose excessive costs on business activity, employment law, the emissions trading scheme, tariffs, local government and port reform, among others, need to be considered. Many of these issues would appear to be outside the SWG's terms of reference but we suggest they should be highlighted as fundamental to a strategy for reducing New Zealand's external vulnerability. We think there is a lack of urgency around these issues at present.

4. Savings Working Group's terms of reference

4.1 We comment below on several issues under the three headings in the SWG's terms of reference.

1. Fiscal policy: The role of Government savings as part of the national savings picture, including long-term savings/debt targets and any offset between government and private savings.

4.2 We support the government's plans to return the budget to a surplus position. This would be positive for government savings. Desirably the timetable for doing so should be shortened. We see spending discipline rather than tax increases, combined with growth-enhancing policies, as by far the most satisfactory way of achieving surpluses. There is enormous scope for reducing wasteful and poorly targeted spending. Unless major reductions in the government share of the economy occur, the 2025 target will not be reached. Lower levels of government spending and policy reforms in areas such as education (tertiary student fees and loans), health and ACC (including moves to greater private insurance) and the welfare system would also encourage private saving.

4.3 The government has ruled out changes to New Zealand Superannuation. We think that raising the eligibility age for NZS is the most obvious way of increasing private savings for retirement and containing future fiscal costs and support the 2025 Taskforce

recommendations. There is also compelling evidence that raising the age of eligibility has a major effect on labour force participation rates, which are already rising among older workers.

4.4 We support the continued use of debt targets in the Public Finance Act. To reinforce spending disciplines, we favour the introduction of limits on spending and taxation in the Act. A Taxpayer Rights Bill which would introduce a top-down limit was foreshadowed in the National-ACT Confidence and Supply Agreement and commended in the 2025 Taskforce report.

4.5 It is not clear to us whether the SWG is to look at the New Zealand Superannuation Fund. We note the 2025 Taskforce's recommendation that the Fund should be wound up and its assets used to repay debt. Our position has been that ongoing debt reduction is a preferable strategy compared with the establishment of a dedicated Fund. The summary of our submission on the bill establishing the Fund was as follows:

- The pre-funding proposal is largely an accounting exercise with no direct economic impact on the retirement income problem. As now spelled out, it is essentially a tax-smoothing scheme. At their peak, capital withdrawals would cover no more than 14 percent of the annual cost of New Zealand Superannuation (NZS).[5] Because the level and conditions of access to NZS remain unchanged, the long-term burden NZS imposes on the government's finances and the economy's capability to produce the goods and services needed by people in retirement remain unaltered.

- From a financing point of view, the more logical approach would be to reduce debt further in the period ahead and/or cut taxes rather than establish a massive government-directed investment fund. Any benefits from pre-funding in terms of discipline on other elements of government spending could be largely achieved by publicly reporting future NZS liabilities.

- By promoting the notion that NZS can be maintained in its present form and that the Fund will solve the superannuation problem, the government is undermining past attempts to highlight the gravity of demographic trends and to encourage people to assume personal responsibility for their income in retirement. A significant change in behaviour will not occur if the form of NZS remains unaltered. The key requirement in any sound approach to retirement income is to extend the process of reducing the generosity of NZS and making access to it more restrictive for the next generation of retirees, while protecting those currently in retirement.

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5 The figure is now less than 7 percent.

- It follows that the pre-funding proposal contained in the Bill is a distraction from the central issues in retirement income policy which are the performance of the economy, which underpins the living standards of the elderly and is undermined by high spending and tax burdens, and the form of the public safety net. The debate should be refocused on these issues through a process designed to facilitate public and inter-party support for a stable long-term policy.

2. Taxation: The impact of the tax system, particularly taxation of income from savings and investment, on the level and composition of national savings and investment decisions. This will include:

- The case for moving to a dual income tax system, where labour and income from savings and investment might be taxed at separate rates.
- Indexation/part-indexation of the tax system so that real, rather than nominal, income from savings and investment is taxed.

4.6 We have been frustrated by what we see as a series of repeated diversions on tax policy issues, often originating in the Treasury, over the past 15 years. These include ideas of a cash flow tax, capital gains tax, land tax and a Nordic (dual income) tax system. They have consumed a lot of time and energy that could have been devoted to higher priority tasks such as spending reforms.

4.7 The Business Roundtable has consistently favoured moves to a broad-based, low-rate tax system comprising two main tax bases, with more emphasis on taxing consumption and less on taxing income. Such a strategy encourages savings. We supported the GST/income tax switch in this year's budget. We would like to see further reductions in income tax, with an alignment of top rates, achieved through spending reductions. The next move, which would benefit savings, might logically be to a 28 (personal), 28 (trust) and 28 (company) percent tax scale. This would also remove many of the distortions of the PIE regime. Further moves towards a low, flat scale would reduce the tax bias in favour of housing and other non-taxation of capital gains.

4.8 We are not attracted to a dual income tax system. In the New Zealand context labour mobility is important as well as capital

mobility. Such a system would very likely require the introduction of a capital gains tax (as in Norway). We discussed this issue in our March 2001 submission to the McLeod Tax Review as follows:

Why not introduce a 'Nordic' dual income tax?

If income from capital is highly mobile, why not reduce rates of tax on that income, while continuing to subject income from labour to higher progressive rates of tax?

Such a 'dual' income tax regime was introduced in Norway in 1992 and similar systems have been introduced in Denmark, Sweden and Finland. The Netherlands is also currently considering the implementation of such an approach (see Van den Noord (2000) for a discussion of Norway's dual income tax system).

In Norway, the dual income tax system involves imposing:

- a 28 percent flat rate of tax on the total net income of individuals (including realised capital gains and imputed rental income from owner-occupied housing) at the company tax rate of 28 percent;
- an additional surtax of 13.5 percent on income that is not eligible for deductions (labour, self employed labour, and pension income);
- an additional social security contribution levy of:
    - 7.8 percent on labour income;
    - 10.7 percent on self-employed labour income; and
    - 3 percent on pension income.

This system produces:

- a flat rate of tax of 28 percent on income from capital; and
- the following top marginal tax rates on labour income:
    - 49.3 percent for a salaried worker;
    - 52.2 percent for a self-employed worker; and
    - 44.5 percent for a pensioner.

At first sight, a dual income tax system appears to have a number of advantages. In particular, it appears to provide a means of:

- encouraging savings and investment by lowing the rate of tax applying to income from capital in the hands of individuals;
- reducing the extent to which the tax system:
    - distorts patterns of investment, since it applies a uniform flat rate of tax to all forms of income from capital; and
    - encourages individuals to invest directly rather than via intermediaries, since the income from capital derived by a company

is taxed at the same rate as the income from capital of an individual investor.

On closer inspection, however, a dual income tax system has a number of major problems.

A dual system encourages tax planning and distorts individuals' decisions regarding the manner of organising their business activities.

For example, a dual income tax system provides an incentive for individuals to recharacterise their labour income as income from capital. This is particularly easy for individuals who are either self-employed or who own and operate small businesses. Such individuals are able to reduce their taxable income by:

- paying themselves relatively low wages (ie understating the value of the labour services they supply to the business); and
- deriving most of their income in the form of distributions of profit which are taxed at the lower rate.

Norway seeks to deal with this problem through the use of a 'split model' which divides the business income of the self-employed and individuals who own and run small businesses (ie 'active' shareholders) into:

- ordinary income (ie gross business income less deductions for interest expense and depreciation) which is taxed at the flat rate of 28 percent; and
- imputed personal income, which is taxed at more progressive rates.

Imputed personal income is estimated by calculating total business income and subtracting:

- imputed capital income, which is calculated at an assumed rate of return set by parliament of 10 percent (the average government bond rate of 5 percent plus a risk premium of 5 percent); and
- an allowance for capital income arising from goodwill that is not quantified in the balance sheet, which is calculated at a rate of 20 percent of salaries paid to employees.

At best, such a 'split model' produces a rough estimate of the value of the labour services supplied by the individual to the business. The accuracy of that estimate is dependent on the accuracy of the assumptions it makes about:

- the rate of return being earned on the physical assets used by the firm – such a presumed rate of return will not be accurate for businesses that are in loss, just starting up, or in the process of restructuring. In such cases, the value of labour services provided may be understated; and
- the assumed value and rate of return on goodwill not recorded in the accounts.

Even in the presence of such a 'split model', there is still considerable scope and incentive for individuals to transform their labour income into income from capital.

For example, under the 'split model' individuals can reduce their tax liability by overvaluing their assets in order to derive a greater proportion of their income in the form of income from capital. The scope for such tax avoidance is greater for those businesses that use large quantities of capital than it is for businesses comprising groups of professionals providing labour services.

The 'split model' also provides an incentive for the owners of small businesses to dilute their shareholding to escape the provisions of the split model. The 'split model' only applies to 'active' shareholders, that is, individuals who own more than two thirds of the shares in the business or who are entitled to more than two thirds of the dividend income it distributes. As a result, 'active' shareholders can escape the additional surtaxes on 'labour' income by issuing shares to family members to dilute their shareholding below that threshold to become 'passive' shareholders.

In order to address this problem, Norway introduced 'identification' rules which define the types of individuals who may or may not be considered to be 'passive' shareholders. In particular, it restricts 'active' shareholders from avoiding additional tax on their labour income by issuing shares to their relatives.

A dual income tax system also provides incentives for individuals who derive most of their income from the provision of professional services (eg lawyers, accountants, dentists etc) to incorporate and qualify as 'passive' company owners in order to reduce their tax liabilities.

We conclude that a dual income tax system is an unattractive option for New Zealand. Its chief merit of reducing taxation on capital income and the high deadweight costs associated with such taxation is better pursued by reducing the top personal and company tax rates. Such an approach is more feasible in New Zealand than in Nordic countries which still have very high levels of government spending.

4.9 We understand that the McLeod Tax Review examined the dual tax system and concluded that it did not have merit in the New Zealand context. It was not included as an option in the Review's Issues Paper or discussed in its final report. New Zealand and Australia are the only developed countries that now have imputation systems. Most studies that examine the harmful effects of company tax reflect the classical system whereby income earned through a company is taxed once at the level of the company and again when it is distributed. The focus should be on cutting all income tax rates – the company tax is not the only tax on capital income, and indeed personal and trust rates are more important for domestic investors. We note that although there have been changes to Norway’s tax system since our submission was written, the 28 percent rate still applies. From 1 April 2011 New Zealand will have a company tax rate at that level.

4.10 We are sceptical about the case for indexation or part-indexation of the tax system to take into account inflation. This was considered and rejected when inflation rates were much higher in the past. There is no doubt that even low rates of inflation have significant economic costs, as Andrew Coleman has demonstrated. We are concerned that the Reserve Bank has not kept prices stable in recent years as required by the Reserve Bank Act – in the five years to 2009, annual CPI inflation averaged 3 percent. Such a rate of inflation implies an increase in the price level approaching 35 percent over a decade. Our preferred approach would be for the Reserve Bank or the government to undertake research on the measured inflation rate that is consistent with stable prices, having regard to statistical measurement issues. We suspect it would be in the region of 1 percent per annum. The Reserve Bank Policy Targets Agreement should then be centered around that mid-point. We would be pleased to see the SWG make such a recommendation.

4.11 We are not against considering tax indexation options. The Henry tax review in Australia suggested partial indexation might have merit. Indexation arrangements would, however, introduce further complexity, and higher administration and compliance costs, into a tax system that we would like to see simplified. A lower and flatter income tax scale would also reduce the inflation distortion.

4.12 Our main point on tax issues is that the SWG's work should be guided by standard tax policy criteria of efficiency, equity and simplicity. It would not be in the interests of overall community welfare if it were simply driven by a goal of increasing savings.

4.13 The idea has sometimes been raised of issuing inflation-indexed bonds in the context of providing an instrument for savings and a hedge against inflation. Our preference, as indicated, is for a firmer focus by the Reserve Bank on maintaining price stability. We think the key principle for debt issuance should be the minimisation of cost to the taxpayer. Prima facie the use of inflation-indexed bonds may not be least-cost if there is not a liquid market for them. If there are

other arguments for introducing such an instrument the SWG could consider them.

3. KiwiSaver: The role of KiwiSaver in improving national savings, such as:

- Improving the operation and outcomes of KiwiSaver – including options where KiwiSaver is either voluntary or compulsory.

- The fairness and effectiveness of current KiwiSaver subsidies.

4.14 The Business Roundtable did not support the introduction of KiwiSaver. The summary of our submission on the KiwiSaver Bill read as follows:

- The Bill is the culmination of work started by the Savings Product Working Group (the SPWG) and continues to exhibit the effects of poor problem identification and analysis …

- For example, there is no compelling evidence that people, on average and over time, make irrational savings decisions. The best New Zealand evidence on the adequacy of savings for retirement suggests that there is no widespread under-saving. It was ignored by the SPWG and the 2005 background papers issued in association with the 2005 Budget (the Budget Papers) and now in the Bill's Regulatory Impact Statement (the RIS).

- The Bill is founded on ideas from so-called behavioural economics that purport to 'guide' people into decisions about, in this case, retirement saving that are deemed by the government to be better for them than alternative uses of their money. Insufficient attention is paid to the costs and benefits of government action. It is implausible to suggest that politicians make better judgments about long-term savings than do individual savers who are the same people that vote them into office.

- The current broad approach to the provision of income in retirement, comprising New Zealand Superannuation (NZS) and benefit support funded from general taxation, together with voluntary provision, has been extensively examined and endorsed, for instance by the 1992 Task Force on Private Provision for Retirement and the 1997 and 2003 Periodic Report Groups, and commands wide public support. Some of the parameters of NZS will need to be changed over time, as advocated by the Organisation for Economic Cooperation (OECD) and other organisations, and the process of those changes requires debate.

- A principled argument for abandoning a voluntary approach to private savings for retirement, including workplace superannuation, has not been made by the government in support of the Bill, and we do not believe that such an argument could be sustained.

- Employers and employees should be permitted to agree voluntarily on pay and conditions of work, including whether to provide workplace superannuation. There is no evidence that either employers or employees have difficulties in formulating such mutually agreed arrangements and, even if they did, employees have considerable

opportunity to contribute to superannuation schemes independently of their employer.

- Most of the potential members of the proposed "compulsory, opt-out" KiwiSaver scheme would be in debt. In such cases, a strategy of paying off debt would almost certainly yield a higher return than putting money into a superannuation scheme, and it would be less risky.
- The Bill's compulsory KiwiSaver scheme is likely to put at risk existing workplace superannuation schemes, be excessively costly and impose higher compliance costs on employers. We are concerned that there has been no attempt to quantify those risks and costs, nor to justify them.
- The KiwiSaver scheme will generate much costly activity that savers will eventually have to pay for and has the potential to create market distortions that are likely to be more costly than any costs associated with possible under-provision for retirement income.

4.15 We think the SWG should review experience with KiwiSaver to date. The Treasury considered it was unlikely to lead to higher national savings. The subsidies that were added to the original scheme now amount to a large fiscal cost. Even though the government has reduced them, they are still running at around $1 billion a year. This makes KiwiSaver an attractive investment for many – although returns to date have been poor – but does not constitute a public policy justification for it. We note that the 2025 Taskforce recommended that remaining KiwiSaver subsidies should be abolished. The subsidies are almost certainly regressive in the sense that middle and higher income earners benefit more from them than low income earners. We think the SWG should examine the international evidence on whether tax subsidies for retirement saving actually increase national saving.

4.16 If the removal of subsidies were favoured by the SWG, a remaining issue would be whether the original scheme is justified on behavioural economics grounds. On this point Richard Epstein of the University of Chicago Law School had this to say in response to a question at a talk he gave at Treasury in 2004:[6]

> Question: *My understanding is that small changes in arrangements can lead to large changes in behaviour, and these changes cannot be predicted by the rational choice approach. Take the example of a savings scheme and default settings. Is the default arrangement that one opts out or opts in? That seems to make a big difference. Assume that people have a tendency to save too little. Individuals only have one*

[6] Richard A Epstein, *Behavioural Economics*, New Zealand Business Roundtable, May 2005.

> *opportunity to save for their retirement – there is no opportunity for learning. Why not take that insight from behavioural economics and use it to inform policy?*
>
> I believe that it is a mistake to over-generalise the impact of default rules or their stickiness.
>
> Start with Thaler's work on this default issue, which is subject to one fairly serious criticism. Consider the situation where an employer is deciding whether to make a contribution to retirement savings part of a remuneration package. As explained earlier, the employer is willing to pay $100 all up, and the choice is whether to pay the entire sum in salary, or $90 in salary and $10 into a pension fund. The employer would surely provide default terms that maximised the value of the package in the eyes of the employee. After all, the same amount is involved either way. To attract and retain staff the employer will set the opt-in or opt-out default in a way that is calculated to give the highest net compensation. So this is not an arbitrary setting; it is a considered judgment by the employer. If it turns out the employer is not making such a calculation, there is a serious disconnect. The appropriate response, that many employers have taken, is to spend a little more time considering the options.
>
> I think it is simply bad management to assume that the only thing you do is to flip the opt-in or opt-out default in the opposite direction when there are information shortfalls. The right thing to do is to start educating your employees: send them a pamphlet or run a workshop to outline ways people could plan for their retirement, explain what the pitfalls are, and so forth. The University of Chicago gives employees a sum of $3,000 to let faculty and staff hire a financial advisor. This individual approach makes sense because asset allocation becomes a much more difficult issue with age. At age 60 you would not want to rely completely on investments in equities, because there could be a 10-year stretch of negative returns.

4.17 The remaining issue in the SWG's terms of reference is whether KiwiSaver should be made compulsory. In terms of public policy criteria, this would be an infringement of liberty. The issues here are similar to those associated with the compulsory scheme proposed by New Zealand First that was put to a referendum and defeated by a large majority in 1997. The conclusions of our assessment of that proposal were as follows:

> The New Zealand First proposal should not be adopted (preferred option) or it should be subjected to scrutiny by relevant experts and the public through an open consultative process. This conclusion rests on the following main points:
>
> - a key feature of retirement income policy should be the promotion of economic growth which alone can deliver the real goods and services needed by a growing number of elderly. Interventionist policies reduce economic growth;
> - provision for retirement should be a private responsibility for the vast majority of New Zealanders, as is the case in many other countries;

- the government should provide a safety net. Policy on New Zealand Superannuation has been heading in the right direction (gradual increases in the age of eligibility, reductions in the generosity of support and, until recently, a genuine commitment to targeting);

- there is no evidence that the voluntary approach is not working. To the contrary, there are encouraging signs that New Zealanders are becoming more conscious of the need to plan for their own retirement and are acting accordingly. The accord framework can be used to build on these developments and maintain a stable political consensus. Another change to policy would be highly disruptive to many individuals, taxpayers and institutions;

- an increase in untargeted support for the elderly is a step in the wrong direction;

- compulsory superannuation involves an unjustified intrusion into people's lives. The welfare of savers would be reduced;

- concerns about savings deficits and risks to national sovereignty from foreign investment are misplaced. They do not justify compulsory superannuation;

- government assistance would still be required for people on low incomes and non-earners who are not supported in other ways, such as people with little attachment to the work force, recent immigrants and care givers, and for those whose savings were lost following the failure of a financial institution;

- compulsory superannuation is equivalent to a tax increase for all citizens who would not otherwise save at the prescribed level. A large rise in the effective rate of tax would be imposed on many citizens. Incentives to work, save and invest and a host of other choices would be adversely affected; and

- the introduction of a compulsory scheme would be a massive and vastly expensive undertaking. Substantial resources would be committed to the design an operation of the scheme. Ongoing regulation and litigation can confidently be expected. Its implementation would require detailed attention by the government and involve ongoing political controversy as changing circumstances forced amendments to it over time.

4.18 The last point has been borne out by subsequent experience in Australia. There have been literally thousands of legislative amendments to the Australian scheme. Recently it has also been reported that:

> The federal government is set to collect a $10 billion windfall from unclaimed superannuation as industry executives admit it is almost impossible to track down the owners of the lost accounts.[7]

The risks associated with the scheme have also been exposed by the global financial crisis. Many superannuation fund members lost money and, as a respected financial journalist recently wrote:

[7] 'Labour to reap $10 bn in lost super', *Australian Financial Review*, 18 June 2010.

> … another major global financial meltdown could place governments under intense pressure to pay tens of billions of dollars in compensation to superfund members who experience a zero real return over a protracted period.[8]

Compulsion carries the risk of an implicit government guarantee, reduced incentives for efficiency in the funds management industry, and increasing regulation of savings and investment vehicles.

4.19 Perhaps the most important point to make in this context is that making KiwiSaver compulsory would only make sense if the government abandoned the universal New Zealand Superannuation scheme and introduced means-testing (by income and assets), as in Australia. Otherwise there would be no reduction in future fiscal costs. Also, unless those forced to save through compulsory channels made offsetting reductions in their other forms of saving, the result would be even greater future claims on the economy's production by the retired elderly. This would not help the adjustment of the economy to an aging population and could be a source of inter-generational warfare. We are unaware of any evidence that would suggest that additional income support for the retired is a priority. In fact, the best evidence we have is that New Zealanders over age 65 have the lowest levels of deprivation in New Zealand.[9]

5. Funding of New Zealand Superannuation

5.1 Lastly, an idea that may be put to the SWG is that New Zealand Superannuation should be funded on a pay-as-you-go (PAYG) basis. We examined this issue in a 1989 study.[10] The relevant section of the report reads as follows:

> This raises the issue of whether one method of funding a scheme is to be preferred over another – whether it is better to operate a scheme on a PAYG or on a fully funded basis. Private superannuation schemes in most, but not all, western countries are generally operated on a fully funded basis. It is therefore often argued that any state scheme should be financed in the same way. However private superannuation schemes have tended to be fully funded for two reasons:
>
> a they have received taxation concessions which make full funding advantageous; and

8 Brian Toohey, *Australian Financial Review*, 11 September 2010.

9 Ministry of Social Development: *New Zealand Living Standards 2004*, (2008); Bryan Perry, *Non-income measures of material wellbeing and hardship: first results from the 2008 New Zealand Living Standards Survey with international comparisons* (2010).

10 *Retirement Income Provision*, New Zealand Business Roundtable, 1989.

b fully funded schemes tend to offer beneficiaries greater security that the retirement benefits will be forthcoming. For example, future retirees are not then left as unsecured creditors of an insolvent employing company. Where private schemes operate on a PAYG basis, as is often the case in West Germany, future benefits are normally insured.

Neither potential taxation concessions nor greater security against bankruptcy of an employer-sponsoring company are relevant considerations where the scheme is provided by the government. Probably for that reason, government retirement insurance schemes in the western world have generally operated on a PAYG basis. That has been seen as offering greater flexibility with respect to benefit levels than is the case with fully funded schemes.

Nevertheless, there has been some pressure for a move to operating government schemes on a funded basis. The benefits seen from such a move are that:

a it could increase the level of domestic savings by creating a pool of what are effectively compulsory savings. Martin Feldstein is a leading advocate of this argument (Feldstein 1974);

b it would impose greater fiscal discipline on governments by forcing them to recognise the present value of benefit increases at the time any such increase is promised.

The savings argument is not particularly persuasive. Retirement income policies should attempt to minimise any distortionary effects on savings but there is little reason to suggest that such policies should have the inducement of any particular savings behaviour as an objective. If the government does wish to make a change of savings behaviour a policy objective, it should advance that policy outside the context of approaches to retirement income. For example, it should make a general policy decision to reduce its budgetary deficit or increase its surplus. It is not clear that increasing what are effectively taxes in order to fund a retirement income programme would necessarily lead to the optimal budgetary position.

Moreover, the economic evidence is inconclusive on whether moving to a fully funded retirement income programme would increase domestic savings. The impact on overall domestic savings would be determined by the extent to which the change in financing method was offset by other changes in the behaviour of governments and individuals (Danziger *et al* 1981). For example, the government could operate a retirement income programme on a fully funded basis by issuing a retirement income fund with an appropriate level of government debt instruments. In such cases, there is no economic distinction between PAYG and fully funded schemes.

The second argument is also not a strong one. The fiscal restraint which a fully funded scheme imposes on a government can be replicated under a PAYG scheme by accounting for government expenditure on a basis which more closely approximates normal accrual accounting methods.

This leaves the argument for fully funded financing somewhat dubious. Moreover, there is a significant potential problem associated with the fully funded approach. By definition, full funding requires the accumulation of a substantial pool of savings for investment. If that investment were to be subject to government direction, it would not necessarily be directed to areas producing the highest possible social

rate of return. It would also give rise to fears about the nationalisation of industry.

If the savings pool were to be managed by the private sector there would be substantial problems in ensuring that the investments were not, implicitly or explicitly, guaranteed by the government. Even without such a guarantee, a government would be likely to find it difficult not to regulate the types of investment which private sector fund managers could undertake. There would therefore be the danger that full funding would lead to investment distortions which would in turn reduce New Zealand's overall economic performance. An economy operating at a less than optimal level would undermine the prospects of providing adequately for the future elderly.

It is concluded that there is no overwhelming case for preferring fully funded financing methods over PAYG methods with respect to retirement income policies (or any other income transfer programme). It would nevertheless be desirable to account for retirement income programmes on an accruals basis so as to impose greater fiscal discipline on governments. Government expenditure on retirement income programmes would then be measured in terms of the present value cost of providing future benefits. A fiscal balance measured in this way would indicate more precisely whether or not the government was maintaining the level of savings which would otherwise prevail.

5.2 We remain attracted to the accrual accounting idea.

6. Conclusion

6.1 We suggest the SWG could usefully focus on:

- empirical evidence on savings in New Zealand
- the relationship of savings, investment, international competitiveness, government spending, monetary policy and other factors to New Zealand's external balance of payments and external debt
- whether the role of the government should be to minimise policy distortions affecting private savings or to actively promote private savings
- government savings and dis-savings, including targets for debt
- the case for reducing the government spending share of the economy to facilitate further income tax reductions and thereby reduce the double taxation of savings

- whether there is a case for departing from general tax policy principles on savings grounds.
- whether to reinforce price stability as a monetary policy target or to adjust the tax system for inflation
- whether the New Zealand Superannuation Fund should be wound up and a debt reduction strategy pursued instead
- the case for KiwiSaver subsidies and for the underlying scheme, and
- the relationship of welfare and other social policies to savings.