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THE NEW ZEALAND INSTITUTE

SUBMISSION TO THE FINANCE & EXPENDITURE SELECT COMMITTEE

ON THE KIWISAVER BILL

27 APRIL 2006

EXECUTIVE SUMMARY

The New Zealand Institute welcomes the introduction of the KiwiSaver scheme as a step in the right direction. The introduction of a scheme to encourage household savings is a long overdue addition to the New Zealand policy landscape.

However, the KiwiSaver scheme is likely to have only a modest effect on household savings and will not be close to sufficient to address the savings challenges facing New Zealand.

New Zealand's household savings rate is the worst in the OECD at -7% of household income. As a consequence, New Zealand is heavily reliant on importing foreign capital to finance domestic spending and investment. This is reflected in a current account deficit of 9% of GDP, among the highest in the OECD, and an external liability position that is among the worst in the OECD.

This situation weakens New Zealand's capital markets, reduces the capital available to New Zealand firms for expansion, and means that the New Zealand economy is increasingly foreign owned. And because few New Zealanders have significant holdings of financial assets, there is not a broadly shared domestic ownership stake in New Zealand's future economic prosperity.

In response to these substantial challenges, this submission recommends that the KiwiSaver scheme be implemented as scheduled on 1 April 2007, but that an expanded KiwiSaver scheme be introduced by 1 April 2008 that will generate a much more significant increase in New Zealand's household savings.

This submission outlines a proposal to expand KiwiSaver through a combination of required employer and voluntary employee contributions. In this proposed KiwiSaver Plus scheme, employers would be required to contribute 4% of each employee's income into the employee's savings account. This employer contribution would be financed, at least in part, by a compensating company tax rate cut.

In addition, employees can elect to contribute an additional 4% of their income into the scheme. There will be automatic enrolment into this part of the scheme, with an opt-out clause. These contributions would be made out of pre-tax income, with tax only being paid on withdrawal from the accounts. The ability to contribute pre-tax income makes participation in the scheme much more likely than in the current KiwiSaver scheme.

This submission also proposes the introduction of a kids' savings account so that New Zealanders are assisted and encouraged to save from an early age.

To make this happen, we propose that the KiwiSaver legislation be amended to allow such an expansion of the KiwiSaver scheme and to include an explicit schedule for the introduction of a KiwiSaver Plus scheme. This submission proposes an introduction date for the expanded scheme of either 1 April 2008 or 1 April 2009.

There is currently a window of opportunity to take meaningful action to increase savings with a healthy fiscal position, low rates of unemployment, and strong corporate profitability. If action is not taken now to raise household savings, it will likely be many years before we have another opportunity like this. This discussion therefore represents an historic opportunity to strengthen the New Zealand economy and to move New Zealand forward.

1. INTRODUCTION

The New Zealand Institute is a privately funded, independent, and non-partisan think-tank that is committed to generating new and creative debate, ideas, and solutions that contribute to building a better and more prosperous New Zealand for all New Zealanders. The Institute's members are leaders from the business, community, and education sectors.

The New Zealand Institute undertook a substantial programme of research on issues related to personal savings and asset ownership during 2004 and 2005. This submission uses this 'Ownership Society' research as the basis for commenting on the KiwiSaver Bill.[1]

This submission focuses on the adequacy of the KiwiSaver scheme to raise New Zealand's savings rates substantially, rather than on the specific design features of the KiwiSaver scheme.

The New Zealand Institute welcomes the introduction of the KiwiSaver scheme as a step in the right direction. The introduction of a scheme to encourage household savings is a long overdue addition to the New Zealand policy landscape.

The major argument made in this submission is that the KiwiSaver scheme will not be close to sufficient to address the savings challenge that New Zealand faces. The priority now is to make the KiwiSaver scheme considerably more ambitious so that it will have a much more significant effect on the level of household savings. This submission outlines why a more ambitious scheme is needed and makes recommendations as to how the KiwiSaver scheme can be expanded.

This submission is structured as follows. Section 2 outlines New Zealand's current savings performance, and makes the case that an increased savings rate is important for New Zealand's economic and social future. Section 3 evaluates the adequacy of KiwiSaver in this context, and concludes that it will not generate a material increase in New Zealand's savings rate. Section 4 outlines a proposal for an expanded version of KiwiSaver – KiwiSaver Plus – and makes recommendations on the process going forward. Section 5 concludes.

2. THE IMPORTANCE OF INCREASED SAVINGS

The commentary accompanying the KiwiSaver legislation correctly identifies the benefits that will be generated through increased personal savings in terms of retirement income adequacy and personal financial security.[2] The New Zealand Institute's research describes the financial and non-financial benefits that individuals obtain through personal savings and asset ownership.[3]

In addition to the benefits that occur at the individual and household level, increased savings generates two types of national-level benefits. First, increased household savings is a vital part of strengthening the New Zealand economy and enhancing its prospects.[4] Second, increasing

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[1] Copies of the Institute's publications are available at www.nzinstitute.org or on request.

[2] The general policy statement that prefaces the KiwiSaver Bill notes that "The purpose of KiwiSaver is to encourage a long-term savings habit and asset accumulation by individuals who are not currently saving enough, with the aim of increasing individual well-being and financial independence, particularly in retirement".

[3] It's Not Just About The Money: The benefits of asset ownership, New Zealand Institute Discussion Paper, 2004/2.

[4] These issues are discussed in more detail in Home is where the money is: the economic importance of savings, New Zealand Institute Discussion Paper, 2005/1.

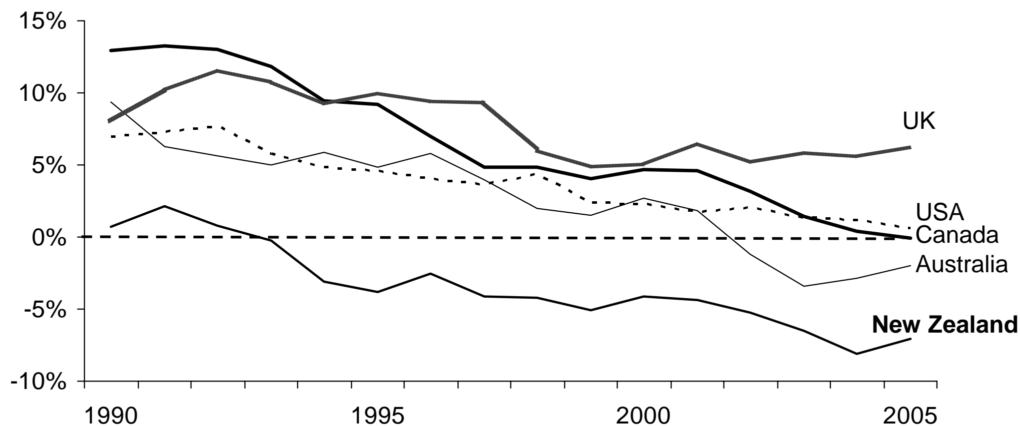
the number of New Zealanders who have an ownership stake in the New Zealand economy will generate a range of social and attitudinal benefits.

The individual benefits generated by increased savings are clearly important, but there needs to be real urgency around addressing these national-level savings issues. Unless these issues are addressed meaningfully and in short order New Zealand will be exposed to some serious economic risks and, even more importantly, will not be well positioned to improve its economic performance in a substantial and sustained way. It is these national-level issues that are the focus of this submission.

Savings and economic growth

On most measures, New Zealand's savings performance is among the worst in the OECD by a substantial margin. The OECD estimate New Zealand's household savings rate to be -7% of household disposable income in 2005, the lowest in the OECD. This is a more conservative estimate than the Reserve Bank of New Zealand who calculate household savings to be -14% of household income. New Zealand's level of household savings has been negative for over a decade and has been the lowest in the OECD for longer than this.

Figure 1: Household saving as a % of household disposable income



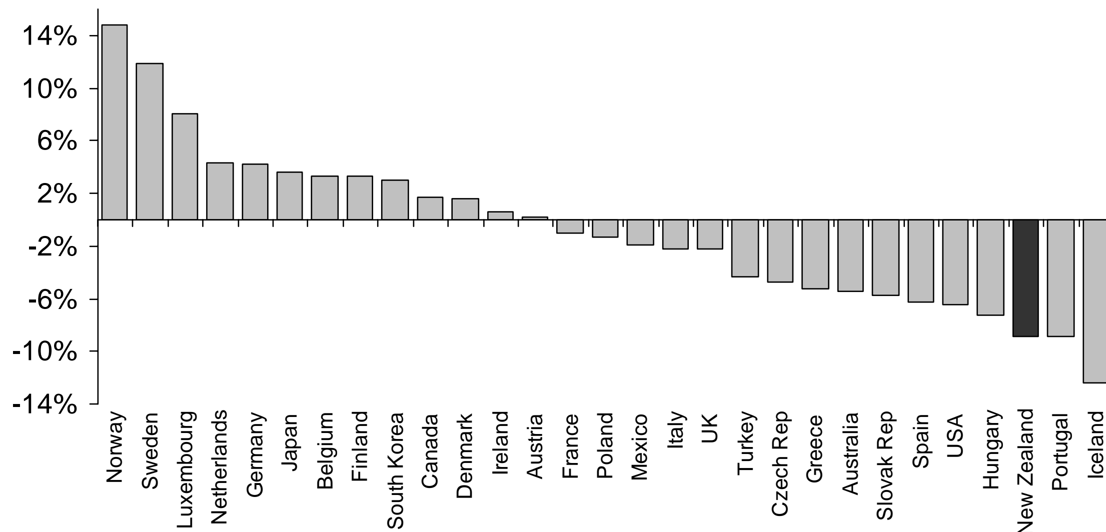
Source: OECD.

The negative savings rate indicates that New Zealand households are borrowing to consume, often on the strength of rising real estate values. Indeed, strong private consumption growth has been a key driver of New Zealand's economic growth over the past 15 years, with business investment playing a much less significant role in the growth process.

This low level of household savings is offset by positive government savings (fiscal surpluses) and business savings (retained earnings). But it remains the case that New Zealand is heavily reliant on importing capital from foreign savers to finance domestic spending and investment.

The extent of New Zealand's reliance on foreign capital is measured by New Zealand's current account deficit. The deficit for the year ended December 2005 was about 9% of GDP, one of the largest in New Zealand's history, and close to the largest in the OECD as described in Figure 2.

Figure 2: Current account as a % of GDP, 2005



Source: OECD; Statistics New Zealand.

This is a long-term issue. New Zealand has run large current account deficits consistently for the past three decades. Historically this was due to large fiscal deficits that required the government to borrow from international lenders. But New Zealand's borrowing is now driven by the private sector and in large measure by household borrowing.

Indeed, most of the foreign capital that New Zealand has imported over the past decade has financed residential real estate investment and private consumption growth, neither of which do much to strengthen the productive base of the New Zealand economy.[5]

New Zealand's large, persistent current account deficits have led to New Zealand accumulating one of the highest levels of net external liabilities (debt and equity claims) in the OECD as a share of the size of the economy. As at 31 December 2005, New Zealand's international investment position was -$137 billion or 89% of GDP, among the largest in the OECD as described in Figure 3. This equates to about $33,000 of net external liabilities for every resident New Zealander.

This consistent sale of debt and equity claims on the New Zealand economy to foreign investors translates into a high degree of foreign ownership of the productive New Zealand economy. New Zealand has a relatively high stock of inward FDI as a share of the economy by OECD standards at 54% of GDP in 2005.

As a consequence of this substantial foreign ownership position about $12.9 billion, or over 8% of New Zealand's GDP, was exported to foreign investors in 2005 as the return on their New Zealand investments. A significant portion of New Zealand's economic growth therefore benefits the foreign savers who have invested their capital in New Zealand. New Zealand is increasingly becoming a nation of employees rather than of owners. This matters because ownership is what generates wealth – countries cannot spend their way to prosperity on the back of foreign credit.

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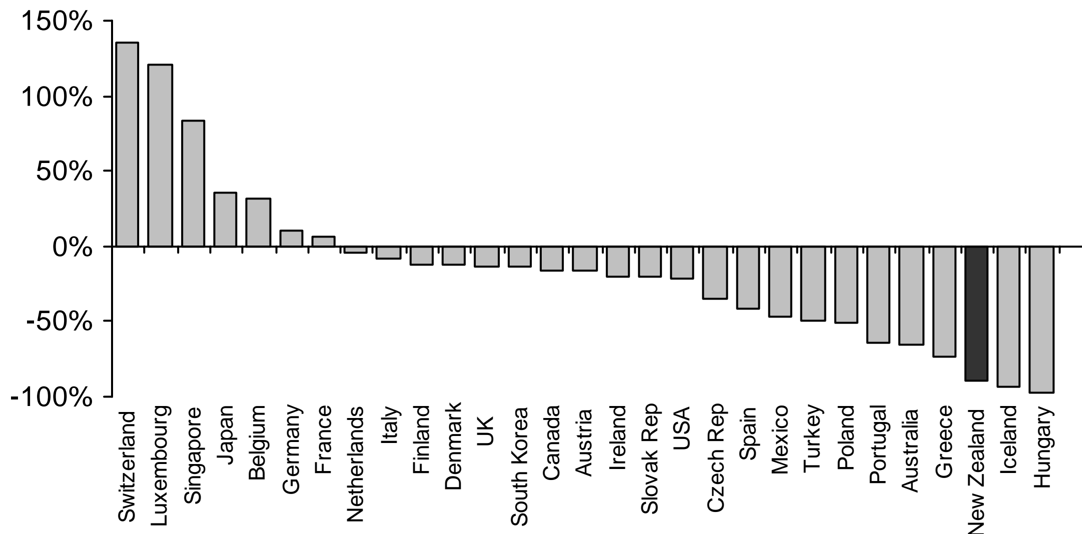
[5] Don Brash, 'An Indebted People', speech to the Canterbury Employers' Chamber of Commerce, 25 January 2002.

Figure 3: Net external liabilities as a % of GDP



Source: IMF; Statistics New Zealand.

On current course and speed the extent of foreign ownership of New Zealand companies is likely to increase, because of New Zealand's consistently low household savings rates and a relatively small pool of capital compared to other countries. The Reserve Bank report that superannuation funds under management in New Zealand are currently NZ$31 billion, and that these funds have increased by about NZ$4 billion over the past five years.

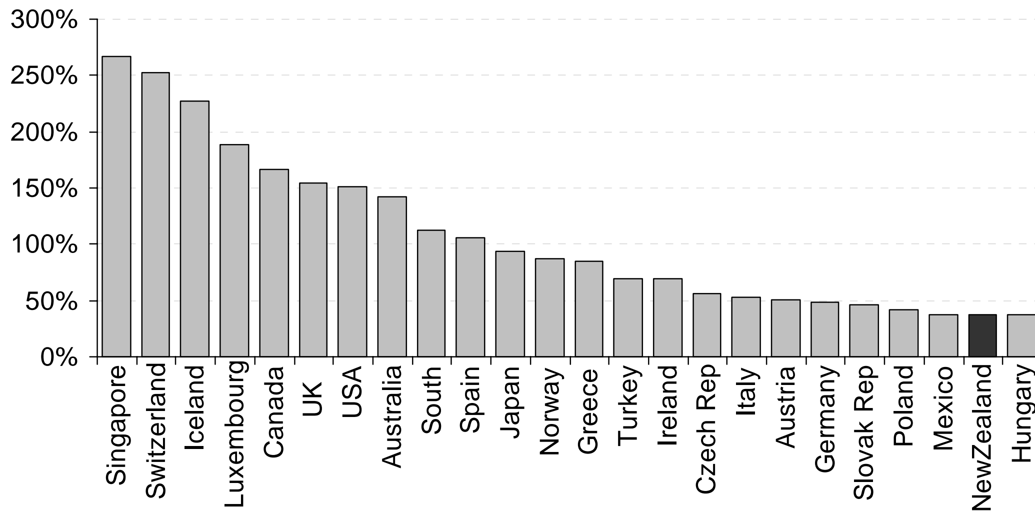
This contrasts sharply with the Australia situation, where there is a large and growing pool of capital as a consequence of its compulsory superannuation scheme. Private sector pension funds under management in Australia are forecast to rise from about NZ$840 billion in 2004 to about NZ$3.0 trillion in 2015.[6] Indeed the pension fund asset increased by about NZ$130 billion in 2005 alone. Recent Australian media commentary has focused on the increased difficulty of finding domestic investment opportunities because of the scale of the inflow of funds.

So pension funds under management in Australia are about 27 times larger than pension funds under management in New Zealand, despite the Australian economy being only about six times larger. And the increase in pension funds in Australia in 2005 was about four times the size of the total pension funds under management in New Zealand.

The small pool of domestic capital is reflected in the small size and relative illiquidity of New Zealand's capital markets, with relatively little capital raising taking place, as indicated in Figure 4. There is a demonstrated link between the strength and vitality of a country's capital markets and economic performance. Strong capital markets enable growing companies to efficiently access the capital they need to grow. Indeed, Australia's capital market strength is widely thought to have been an important factor in its strong economic performance over the past decade.

[6] Presentation by Andrew Mohl to an AMP conference, January 2006.

Figure 4: Market capitalisation of national exchange as a % of GDP, 2006



Source: IMF; Deutsche Bank; relevant national exchange for Iceland, Canada, Slovak Rep, and Czech Rep.

The availability of capital in Australia, together with the associated effects of larger and more liquid capital markets and more aggressive pricing, also makes Australia an attractive destination for New Zealand companies. This is often referred to as 'hollowing out', in which New Zealand companies are systematically purchased by Australian companies and often transfer their listing and focus to Australia. Table 1 gives a sense of the type of changes in the composition of the Top 10 listed New Zealand companies over the past decade. There has been much recent media coverage of this topic.[7]

This process will continue for as long as New Zealand's household savings rates remain low. Senior figures in New Zealand's capital markets regularly point to the risk of more departures of major New Zealand companies unless meaningful action is taken on savings. This has serious economic consequences, as well as posing a serious risk to the government's tax base.

The relative lack of savings also means that New Zealand ownership of successful New Zealand companies will continue to decline, as there will not be sufficient New Zealand capital available to fund the expansion of these companies. If large New Zealand companies want to access substantial amounts of capital to fund new projects, they will have to rely in large measure on foreign investors. Being able to access foreign capital is obviously a good thing, but it would be even better if New Zealand capital were available to fund a greater share of this expansion.

The exit of New Zealand companies also means that there will be erosion in the infrastructure that surrounds capital markets, in terms of the professional advisory services that lawyers and bankers offer. This is likely to make future capital raising more difficult for New Zealand companies.

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[7] 'NZX at risk as raiders eye vulnerable firms', Dominion Post, 6 March 2006, 'Sharemarket at risk of losing biggest firms', New Zealand Herald, 9 March 2006, 'Editorial: New Zealand business like branch of Australia', New Zealand Herald, 30 March 2006, 'Fletcher looks to jump ditch', New Zealand Herald, 4 April 2006.

Table 1: Top 10 listed companies

April 7, 2006	December 31, 2001	December 31, 1996
1) Telecom: $11.45 billion.	1) Telecom: $9.3 billion.	1) Telecom: $13.64 billion.
2) Contact Energy: $4.7 billion, could soon delist.	2) Carter Holt Harvey: $2.96 billion, delisted.	2) Carter Holt Harvey: $5.5 billion, delisted.
3) Fletcher Building: $4.40 billion.	3) Contact Energy: $2.3 billion, majority owned by Origin, could soon delist.	3) Brierley Investments: $3.9 billion, now primarily Singapore-based UK hotel owner.
4) Vector: $2.75 billion.	4) Lion Nathan: $2.20 billion, Japanese-owned, now listed in Australia.	4) Fletcher Challenge Paper: $2.15 billion, now owned by Norske Skog.
5) Sky TV: $2.54 billion.	5) The Warehouse: $2.01 billion.	5) Fletcher Challenge Forestry: $1.9 billion, now stripped of trees, trades as Tenon.
6) Auckland International Airport: $2.48 billion.	6) Fisher & Paykel Healthcare: $1.75 billion.	6) Lion Nathan: $1.86 billion, now Japanese owned and Australian listed.
7) Sky City: $2.28 billion.	7) Independent Newspapers: $1.54 billion, wholly owned by Fairfax.	7) Fletcher Challenge Building: $1.61 billion.
8) Fisher & Paykel Healthcare: $2.08 billion.	8) Sky Network TV: $1.54 billion, majority owned by News Corp.	8) Fletcher Challenge Energy: $1.52 billion, now owned by Anglo Dutch Shell.
9) The Warehouse: $1.35 billion.	9) Auckland International Airport: $1.52 billion.	9) Wilson & Horton: $1.13 billion, now owned by Australia's APN.
10) Fisher & Paykel Appliances: $1.16 billion.	10) Sky City: $1.29 billion.	10) Air New Zealand: $1.06 billion, bailed out by the taxpayer but still listed.
Source: The New Zealand Herald		

An increased household savings rate is a vital element in strengthening New Zealand's capital markets, providing New Zealand funds to finance the expansion of New Zealand companies, developing the venture capital industry, and creating new asset classes like infrastructure funds. An increased weight of New Zealand capital will give companies a reason to use New Zealand as a base from which to take on the world, and will help to counteract the agglomeration pressure to move to markets like Australia.

Increased savings will also help to reduce New Zealand's high cost of capital, which is partly due to the risk premium paid on capital raised here because of New Zealand's high level of external indebtedness. On average over the 1990-2005 period, New Zealand's 90 day interest rates have been about a percentage point higher than in Australia and three percentage points higher than in the US.

Analysis at the Reserve Bank estimates that a 10 percentage point reduction in New Zealand's external liabilities to GDP ratio would reduce its long term real interest rate by 25 basis points and other New Zealand research estimates that a percentage point reduction in the current account deficit/GDP ratio would reduce the real interest rate by 19 basis points.[8] These estimates are consistent with international research.[9]

The high cost of capital has a significant deterrent effect on investment, and means that New Zealand companies have to pay more to raise capital than the companies that they compete with in international markets. This reinforces the tendency for New Zealand companies to relocate to markets like Australia.

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[8] Chris Plantier, 'New Zealand's economic reforms after 1984 and the neutral real rate of interest', Reserve Bank of New Zealand, 2003, and Paul Conway and Adrian Orr, 'The GIRM: The Global Interest Rate Model', Westpac, September 2002.

[9] Maurice Obstfeld and Kenneth Rogoff, 'The Six Major Puzzles In International Macroeconomics: Is There A Common Cause?', NBER Working Paper 7777, July 2000.

And for New Zealand to continue to attract significant amounts of foreign capital into the future, we will likely need to offer higher interest rates and an increasingly low exchange rate. There are limits to New Zealand's ability to continue to sell debt and equity claims on the New Zealand economy to finance the current account deficit. New Zealand already has one of the highest stocks of inward FDI as a share of GDP in the OECD, with many large New Zealand companies already significantly foreign-owned, and the household sector is already heavily indebted.

Certainly the outcomes that New Zealand has generated make the New Zealand economy more vulnerable. This does not mean that an external crisis is imminent or likely. But neither is New Zealand's current course and speed conducive to strong economic performance going forward.

Increasing household savings is also a valuable part of reducing the extent of the interest rate and exchange rate cycles as it will take the heat out of domestic spending. By removing a key driver of the exchange rate cycle, increased savings will have a significant effect on encouraging international engagement by New Zealand firms and thereby on New Zealand's productivity growth. Increasing the level of household savings is an important part of shifting the New Zealand economy from a consumption led economy to an investment and productivity led economy.

Taking meaningful action to significantly raise the level of household saving will act to address the costs and risks associated with New Zealand's external imbalance over time. But more importantly, increased household savings will strengthen the New Zealand economy through strengthening the capital markets, reducing the cost of capital, and providing New Zealand capital to finance the expansion of New Zealand firms so that a greater share of the returns benefit New Zealanders. An increased pool of domestic capital is a vital part of creating a strong New Zealand economy.

Creating an ownership society

Asset ownership provides people with a stake in the future economic prosperity of New Zealand. The benefits from economic growth tend to be capitalised into asset values like share prices or the value of real estate. As a consequence, people who own assets benefit to a greater extent from economic growth than those whose income comes only from wages. An ownership society in which asset ownership is broadly distributed within the population is likely to lead to the benefits of higher rates of economic growth being more broadly shared.

For this reason, societies in which most people have an ownership stake in economic progress are much more likely to favour investment in the future of the country as opposed to consumption that does not generate a future return on their assets. This is likely to increase the support base for policies and actions that will generate higher rates of economic growth.

The intuition is the same as that which motivates employee share ownership plans. If employees have an ownership stake in the firm where they work, they have an added interest in the commercial success of the firm in addition to their wage income. Such ownership schemes are commonly linked to improved firm performance, worker productivity, and workplace morale.

In a New Zealand context, then, broad-based financial asset ownership is likely to increase the public's commitment to the success of New Zealand firms and the overall performance of the New Zealand economy. One likely reason that New Zealanders appear ambivalent about business and economic growth in general is that many do not believe that they will benefit personally from improved economic performance. A survey undertaken by the Growth & Innovation Advisory Board in 2003 on the attitudes of New Zealanders to economic growth found that while respondents were generally supportive, over 40% couldn't identify personal benefits that they would receive from economic growth.

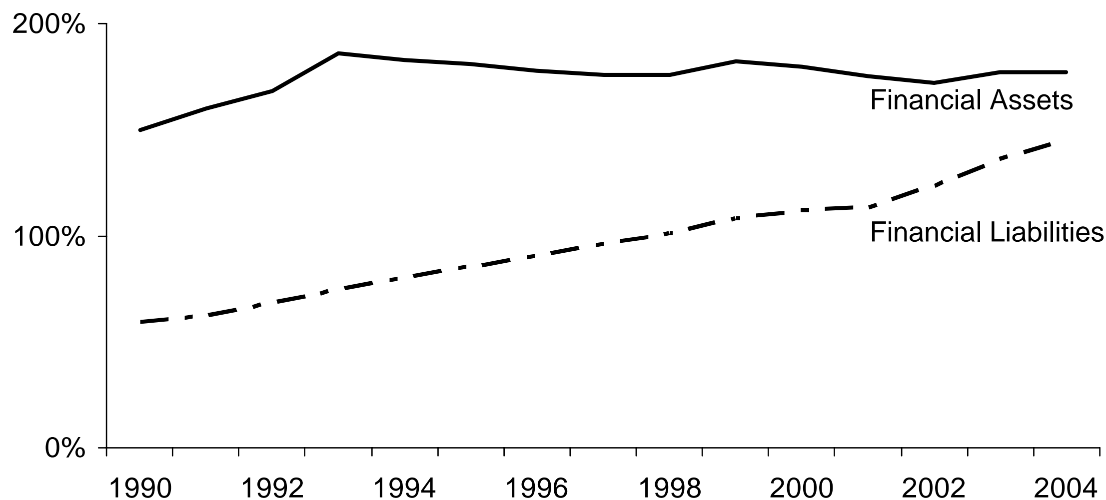
Changing these attitudes has been one of the important benefits from the introduction of compulsory savings in Australia. Over 50% of Australians now report that they own equities.[10] As many more Australians have accumulated meaningful asset ownership positions, often with a heavy representation of Australian companies, it is not surprising that Australians seem to have more positive attitudes towards commercial and economic success.

Recent Australian Treasury analysis of private sector wealth showed that real estate wealth increased by about $4,000 per person during 2005 while business assets – mainly shares in superannuation and other funds – rose by $23,000 per person.[11] The significant contribution from financial assets is a long-standing trend; since 1995, real estate wealth has risen by a little under $100,000 per person while business assets rose by over $75,000 per person.

Because personal wealth is now driven to a large extent by Australian corporate performance, attitudes to business are likely to have changed. People understand that they have a personal interest in economic success. It is common to hear claims that Australia's saving scheme has been an important factor in creating a culture of success and aspiration in Australia.

This is very different to the New Zealand situation, where only about 20% of people own financial assets and these assets represent a small share in household balance sheets. And there has been no significant increase in household ownership of financial assets over the past decade, as described in Figure 5. New Zealand is much more a nation of employees and consumers than a nation of owners. This is much less likely to lead to positive attitudes to business and to economic success.

Figure 5: Household financial assets and liabilities as a % of household disposable income



Source: Reserve Bank of New Zealand.

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[10] ASX, 2004 Australian Share Ownership Study, February 2005.

[11] Economic Roundup, Australian Treasury, Summer 2006; Sydney Morning Herald, 27 March 2006.

Policy Implications

Increasing New Zealand's savings rates is an important part of raising New Zealand's economic growth potential, and moving New Zealand from a consumption led economy to an investment and productivity driven economy. New Zealand cannot spend its way to prosperity, but rather needs to increase investment in the productive base of the economy. Raising household savings rates and ensuring that many more New Zealanders have an ownership stake in the New Zealand economy is a vital part of this process.

Governments have a clear policy interest in improving New Zealand's savings outcomes, both to address the costs and risks associated with a heavy reliance on foreign capital and also to secure New Zealand's economic future by investing in the future. And given the scale of these challenges, deliberate, sustained, and ambitious government action is needed.

Because New Zealand is a small, remote economy, we need to fight hard to avoid becoming economically peripheral. Building a pool of domestic capital is a vital part of this task, as Australia and Singapore have shown. New Zealand cannot keep on relying on foreign investors to write the cheques for us.

It is not sufficient to hope that income growth will provide the basis for increased savings. Although higher incomes are an important input into raising household savings, the fact that household savings have dropped in New Zealand over the past decade despite strong rates of economic growth suggests that the link is not automatic. Just as some low income people save more than those on much higher incomes, so there is no direct link between income and savings at a country level.

The missing factor in New Zealand has been policy to encourage or require people to save a portion of any income growth. Australia introduced its compulsory superannuation scheme when its income was substantially lower than New Zealand's income level is today, and this has ensured that a significant proportion of its strong economic growth over the past decade has been saved. The appropriate response for New Zealand, then, is to establish policies to encourage savings.

3. EVALUATION OF THE KIWISAVER BILL

New Zealand has been distinctive among OECD countries over the past 15 years in terms of the absence of policies directly aimed at encouraging household savings. Developed countries widely recognise the importance of personal savings to both individuals and the country, and have consistently implemented, and then expanded, policies to encourage savings. It is unlikely to be a coincidence that New Zealand has the worst household savings outcomes in the OECD and the most hands-off policy approach to savings among these countries.

In this context, the KiwiSaver Bill is a welcome addition to the New Zealand policy landscape, in combination with other measures designed to encourage savings such as the introduction of the State Sector Retirement Scheme and various tax changes. The introduction of the KiwiSaver legislation marks an important shift from a completely passive policy approach with respect to encouraging household savings to a situation that provides some policy encouragement to save.

However, although KiwiSaver is a step in the right direction, it is unlikely to generate an increase in the savings rate that is sufficient to address the challenges describe above.

It is difficult to be precise about the increase in household savings that will be generated by the KiwiSaver scheme because participation is voluntary, and the take-up rate will depend on a myriad of factors such as individual behaviour, the way that the scheme is promoted in the workplace, the schemes that are offered, and the nature of financial education programmes.

Some of the design features of the scheme are likely to increase participation to a greater extent than a standard voluntary scheme, such as the inclusion of automatic enrolment. A number of US studies have found that the introduction of automatic enrolment into 401(k) retirement savings schemes raised participation rates very substantially.[12]

But it is not clear whether automatic enrolment into the KiwiSaver scheme will have a similar effect on participation. In the 401(k) schemes, there are ongoing financial incentives to contribute to these accounts, such as tax concessions and frequently a matching contribution from the employer. In the KiwiSaver scheme, there is no financial incentive for ongoing saving (just an up-front $1000 contribution). This is likely to reduce the impact on participation.

Similarly, the ability to withdraw for a deposit on a first home will likely increase the attractiveness of the scheme to younger New Zealanders who may not have participated had it simply been a retirement savings vehicle. But the risk is that many people will contribute for the purposes of home ownership and then may not contribute thereafter.

And for many on low and modest incomes, a minimum contribution of 4% of gross income, which may be 5-6% of post-tax income, may also act as a disincentive to participate particularly in the absence of any ongoing financial incentives.

The only estimate provided in the KiwiSaver legislation is that 25% of the eligible population (presumably those employees who have joined a new employer over this period) will be participating by 2013/2014. For the reasons outlined above, this estimate may turn out to be optimistic.

But even if this estimate is correct, the KiwiSaver scheme will not have a significant impact on savings. If the 25% of the workforce who participate each contribute 4% of their income, a maximum of about 1% of employee income will be saved through this scheme. This is likely a higher figure than would otherwise have been saved, but it will not make a material impact on a current account deficit of 9% of GDP, the strength of New Zealand's capital markets, or the extent of foreign ownership of the New Zealand economy. Neither is this likely to make substantial contribution to creating an ownership society, particularly in terms of broadening asset ownership among New Zealanders on low and modest incomes.

Overall, it is likely that KiwiSaver will have positive effect on household savings. Savings is largely about habit formation, and making it easier for people to form the habit may have some long-term effects. But in the absence of any required savings component or any ongoing financial incentive to save, KiwiSaver is unlikely to lead to a substantial lift in household savings.

In summary, although the KiwiSaver scheme is a welcome step in the right direction, it must be regarded as only a modest start. Much more is required.

4. KIWISAVER PLUS

This section outlines how the existing KiwiSaver scheme could be scaled up and used as a base for a more ambitious personal savings policy. Indeed, many of the administrative arrangements in terms of default accounts and the use of the tax system to deduct the contributions can be used in an expanded KiwiSaver scheme.

This submission outlines a KiwiSaver Plus scheme that incorporates a required employer contribution of 4% of the employee's income, which will be financed, at least in part, by a cut in

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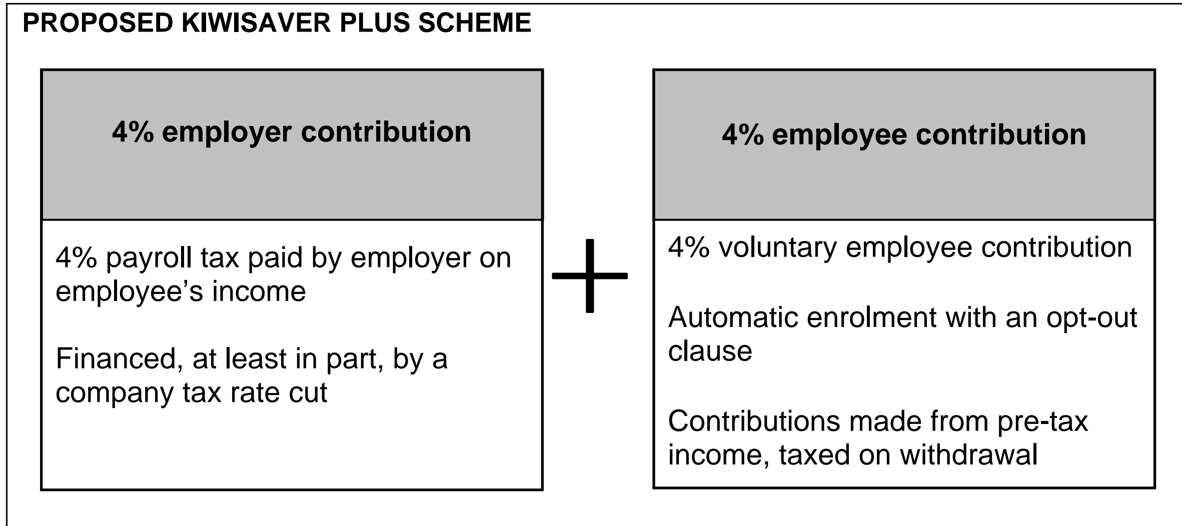
[12] James J. Choi, David Laibson, and Brigitte Madrian, 'Plan Design and 401(k) Savings Outcomes', NBER Working Paper 10486, May 2004.

the corporate tax rate, together with an incentivised voluntary employee savings contribution of an additional 4% of pre-tax income.

In addition, this submission recommends introducing a kids' savings accounts to assist young New Zealanders to save from a very early stage.



Required employer contribution

This submission recommends that employers be required to contribute 4% of each employee's income into the employee's KiwiSaver account. KiwiSaver accounts will be opened automatically on the opening day of the expanded scheme for everyone earning employment income.

These employer contributions can be offset, at least in part, by providing company tax rate cuts. The scope of these tax cuts should be considered as part of the business tax review that is currently underway.

Some employers may also choose to offset these required contributions through lower wage growth over the next few years. Indeed, diverting a portion of future wage growth into the employee's savings account is a non-inflationary way of delivering wage growth, and has worked successfully in a range of other countries.

Employer contributions are standard in similar schemes internationally, such as Australia. This approach means that individuals will not be required to save on their own account, which for low and modest income earners will be a significant advantage relative to the current KiwiSaver scheme.

An alternative approach is for the required 4% contribution to be split evenly, with employees and employers each required to contribute 2% of the employee's income. This could be financed through a mix of company tax rate cuts together with personal tax rate cuts, particularly for those on low incomes.[13]

[13] Personal tax cuts to finance contributions to the KiwiSaver account is a pragmatic way to provide tax cuts, returning money from the state to individuals, without any of the economic risks associated with over-stimulating the domestic economy through increased private consumption growth.

The international evidence shows clearly that these required contributions to the employee's KiwiSaver Plus accounts will act to substantially increase the overall level of household saving. Recent Australian evidence suggests that about two thirds of the compulsory savings in the Australian superannuation scheme represents new savings.[14] This is consistent with estimates from the US and the UK, where the proportion of new savings is generally estimated between a half and three quarters.[15] Indeed some studies have found that compulsory savings 'crowds in' new savings, where people save additional amounts because they develop a savings habit.

This means that the argument that required savings will not have a significant impact because individuals will respond by reducing their voluntary savings by a matching amount is not strong. In reality, of course, many New Zealanders – even those on middle and high incomes – have little existing savings that could be reduced.

Incentivised voluntary savings

The voluntary savings component of an additional 4% of income is modelled on the existing KiwiSaver scheme. There would be automatic enrolment into this part of the scheme, in which it is assumed that people will contribute 8% of their income into the KiwiSaver account. People can choose to opt out if they wish in the same way as with the current KiwiSaver scheme.

To encourage people to choose to make these voluntary contributions, it is important that a financial incentive be in place to reward savings. Probably the simplest way of providing this incentive is to allow people to contribute 4% of their pre-tax income to the account, and avoid tax on this portion of their income until it is withdrawn from the account. This is common practice internationally. This ought to have a powerful effect on participation by giving people an immediate incentive to contribute – the choice is to either make a contribution of 4% of gross income or have this amount taxed at the individual's marginal tax rate.

The pre-tax contributions into the account would only be taxed on withdrawal, which creates an incentive to keep the money in the account for longer so as to increase the value of the tax benefit.

An alternative way of providing a financial incentive is for the government to provide an annual contribution of, say, $1000 to the accounts of people who make the voluntary 4% contributions. For someone earning $50,000 a year, the 4% voluntary savings contribution is $2000 a year and so the $1000 government match would represent a 50 cents on the dollar contribution. Because of its flat nature, the government contribution will be a more powerful financial incentive to save for those on low and middle incomes than for those on higher incomes.

Additional voluntary contributions can be made, but these additional contributions would not attract any further incentive.

Kids savings accounts

The KiwiSaver scheme is aimed at encouraging people in work to save. But in addition, we recommend that a kids' savings accounts be introduced alongside the KiwiSaver scheme to encourage savings from a young age. This will ensure that young people start adult life with an asset, and will also assist in encouraging a savings habit from a young age.

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[14] Ellis Connolly and Marion Kohler, 'The Impact of Superannuation on Household Saving', Research Discussion Paper 2004/01, Reserve Bank of Australia, 2004.

[15] Douglas Bernheim, 'Taxation and Savings', NBER Working Paper 7061, 1999; Martin Feldstein and Jeffrey B. Liebman, 'Social Security', NBER Working Paper 8451, September 2001.

The basic elements of these accounts are as follows.[16] The account would be opened automatically at birth, with the government making an initial endowment of $500 with repeat $500 contributions at ages 5 and 10. These accounts are open to contributions from family and other sources and the government will match these contributions dollar for dollar up to $200 a year. The funds will accumulate tax free until age 18, and the funds cannot be withdrawn until age 18.

On conservative return assumptions, the account balance will be sufficient to allow many people to finance tertiary education without taking out a student loan. This is a better approach to assisting young New Zealanders than the decision to make student loan debt interest free, which is likely to encourage more young New Zealanders into debt. And the cost of these kids' savings accounts – about $300 million a year – is about the same as is currently spent writing off student loan debt and interest.

When the individual commences full time work, the employer and voluntary employee contributions will be made into this account in the manner described above. So this is a savings account that follows people over a lifetime.

This is different from the proposal that the government put out last year and that was subsequently shelved because of a lack of interest from providers. This is because the scheme outlined in this submission is universal, because the accounts will have considerably larger balances, and because the funds cannot be withdrawn until the individual is at least 18. These factors will make the scheme much more commercially attractive to providers.

Withdrawals from the accounts

The KiwiSaver scheme currently allows people to withdraw for a deposit on a first home or on retirement. These are both reasonable categories of withdrawal. One additional category of withdrawal class that the New Zealand Institute recommended last year was for the repayment of the student loan debt that was due to tuition fees. This is particularly important if the kids' savings accounts are also introduced.

Other Features

Creating a comprehensive system of accounts opens up options for the government in terms of fiscal management. For example, the government will be able to make one-off payments – or 'special dividends' – into these accounts in times of fiscal surplus, which may be preferable to giving tax cuts that may not be fiscally sustainable when economic conditions change. The establishment of these accounts also allows for the proceeds of privatisations to be distributed to individual accounts rather than into the consolidated fund. Such an approach has been used successfully in Singapore.

These accounts also open up some options in terms of economic management of the business cycle, to supplement the role of monetary policy. The Treasury and the Reserve Bank recently released a report on the Supplementary Stabilisation Instruments project, finding that there were few instruments available to take the heat out of the domestic economy when it is booming.

But with a universal system of accounts, it would be possible to levy a temporary required contribution on the employee of say 1% of income, to reduce the amount being spent in boom times. To avoid hardship, this requirement could be restricted to those earning higher income. This is better than some proposals to levy variable rates of tax to manage the cycle, because the increased contributions go into the individual's account rather than to the government. Something similar to this has been used in Singapore.

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[16] These accounts are discussed in more detail in Opportunity for a Lifetime: Creating an ownership society in New Zealand, New Zealand Institute Discussion Paper, 2005/2, 2005

Materiality

KiwiSaver Plus will have a much more material impact on household savings than the planned KiwiSaver scheme. Immediately on implementation of KiwiSaver Plus, 100% of the workforce will be participating and saving at least 4% of their income. Assuming that half of the workforce participates in the voluntary savings component, the increase in household saving will be about 6% of household income. Additional savings will occur through the kid's savings accounts.

RECOMMENDED NEXT STEPS

This submission supports the passage of the KiwiSaver legislation with implementation on 1 April 2007, but in the context of a clear commitment to significantly scale up the commitment to significantly expanding the KiwiSaver scheme in the next couple of years.

Implementing the KiwiSaver Bill on schedule will have an immediate positive effect on savings, even if modest, and will mean that any operational issues can be identified and resolved before an expanded scheme is implemented. But it is important that the KiwiSaver scheme is passed into legislation with a commitment to expansion within the next couple of years.

To achieve this, the KiwiSaver Bill will need to be amended to allow for it to be readily expanded. This will involve writing the legislation in such a way that it anticipates the requirement for employers and employees to make contributions to this scheme. The government will also need to consider how to manage the fiscal implications of providing tax cuts to help finance the required savings contribution.

The amended KiwiSaver Bill should also incorporate an explicit timeline for the shift to an expanded scheme. We propose 1 April 2008 as the start date for the expanded scheme to be implemented – or if this is not thought practical then by 1 April 2009.

5. CONCLUDING REMARKS

The introduction of the KiwiSaver scheme is a welcome development. But it is important to understand that the KiwiSaver scheme is a very modest first step, and by itself is unlikely to have a material impact on the overall level of savings in New Zealand.

Increasing New Zealand's level of household savings is a vital part of strengthening the New Zealand economy and enhancing New Zealand's economic prospects. Increased savings will strengthen New Zealand's capital markets and make New Zealand a more attractive place for companies to locate, provide the capital for New Zealand firms to expand, and ensure that New Zealanders benefit from this process.

Creating an ownership society will also generate significant attitudinal changes, by giving many more New Zealanders a stake in the future success of the New Zealand economy.

The challenges are well understood. The priority now is to respond with meaningful action that is proportionate to the scale of the savings challenge. This is an opportunity to make a significant contribution to strengthening the New Zealand economy and moving New Zealand and New Zealanders towards a more secure future.

This is not the time for half measures. These issues have been discussed for a long time, and we have not taken advantage of previous opportunities to address these issues. Now is the time to act with boldness, determination, and real seriousness of purpose. We also strongly urge bipartisan support on this issue. Broadly shared, bipartisan agreement on the way forward is vitally important because of the long-term nature of savings policy.