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Saving and investment in New Zealand, and the Super Fund
occasional paper

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Executive summary and conclusions[1]

Over recent years, the adequacy of saving in New Zealand has been a key area of policy debate. The general view is that saving rates in New Zealand are too low and hence there is a shortage of saving. In this occasional paper, we challenge the view that New Zealand lacks saving. Rather, we argue that the economy suffers more from poor performing investment.

While the saving rate remains low at the household level, many forms of saving are unaccounted for – including government expenditure on health, welfare, education, and retirement income. In addition, households have access to considerable savings – or wealth – which are not included in a lot of the policy analysis, especially when it comes to retirement income provision. New Zealand also has an open capital market, providing access to the world's pool of savings. New Zealand's national saving rate is also comparable to other, successful, economies such as the US and Australia. On balance, it is hard to claim New Zealand lacks access to capital.

However, we argue that when it comes to the use of savings (i.e., investment), New Zealand performs poorly. Many of New Zealand's investments have below international rates of return, with New Zealand's per-capita income slipping behind that of most OECD countries. Pursuing policies that improve the incentive structure for individuals to invest and work smart – raising the *quality of investment* - appears more rewarding than policies that concentrate on *raising the stock of savings*.

Public retirement income and the proposed Super Fund

Recently the savings debate has focused on the impact that New Zealand's aging population will have on government retirement income expenditure in the future. New Zealand Superannuation (NZS) policy has thus increasingly been seen as a tool for dealing with the perceived inadequacy of private saving.

In this occasional paper, we highlight that the government has significant budget concerns approaching - given the demographic trends and generosity of the current NZS. The cost of publicly funding NZS is set to increase steeply over the next 50 years.

The Government's proposed 'Super Fund' is an effort to pre-finance some of the rising cost of NZS in future years. However, at its peak, the Fund will only cover 14% of the entire cost of New Zealand superannuation if all goes well. Meanwhile, the total cost of NZS will rise from 4% of GDP now to around 9% over the next couple of decades, irrespective of the Fund being established.

Importantly, the Super Fund will not alter the *design* of NZS and so does little to improve longer-term investment incentives, and in fact could be detrimental. Alternative uses of government revenue exist, such as reducing the tax rate or government debt, or increasing spending on education. All of these policies support economic growth and can be managed while still providing NZS to those in need.

Other concerns about the Fund are also raised. For example:

- The proposed Fund will not raise the pool of savings in New Zealand. Instead, it is only likely to alter the form of saving and possibly dent individual's willingness to save and invest smart.
- The Government is taking more financial risk onto their balance sheet for no *risk-adjusted* gain on the use of tax revenues. And,
- It is difficult to see how or why the proposed Fund could be modified to include individual accounts. The incentives for individuals to save and invest would remain the same.

Overall, higher economic growth and more labour force participation remain the key to NZS being affordable in the future. Public discussion is thus necessary on the *design* of NZS, rather than its *funding*.

[1] The authors would like to thank Paul Conway, Nick Tuffley and Richard Sullivan for their useful assistance and comments. Also thanks to Natalie Denne and Jill Watson for their diligent publication effort. The views expressed in this paper, and any errors, are those of the authors and not those of the institution they work for.

The way forward?

In this occasional paper we argue that there is a combination of policies that better encourages wealth creation and labour force participation, while also providing an adequate retirement income to those in need.

For example, the design of NZS could be altered as its costs rise with New Zealand's aging population. The design issues include the state pension age, qualifications for payment, the dollar amount paid, and its inflation linkage. The 'Todd Taskforce' canvassed these issues in the 1990s, and the Retirement Income Commission is more than capable of leading the debate in a bipartisan fashion.

Moreover, there are many variations of public retirement income provision that may be more cost effective, efficient, and equitable than both the proposed Super Fund and the current NZS.

One option discussed in this paper is the Government providing a retirement-income subsidy for middle and low-income New Zealanders. The government could match dollar-for-dollar retirement income savings in individual accounts, mimicking the current employer-based schemes for those in work. Meanwhile, NZS can remain as is for those who do not earn an income. Amongst many benefits, such a scheme strengthens the incentives to save and invest smart, is less costly and better targeted, and les susceptable to future political interference.

In Section I we highlight various measures of saving and discuss whether New Zealand has a shortage. Section II highlights that New Zealand's economic fortune is more related to the *quality* of investment, not the *quantity* of savings. Section III outlines the role of, and reasoning for, government intervention in the provision of retirement income. It also discusses the impact of an aging population on NZS. Section IV provides a critique of the proposed Super Fund, while Section V outlines the evolving partnership between business and government, and offers a way forward.

I. What is saving and does New Zealand have a shortage?

The view that New Zealand lacks saving comes from many statistics. New Zealand's national saving is low by international standards; the aging population implies an increasing saving requirement; the low level of household saving; New Zealand's persistent current account deficits; and the level of public and national debt.

In this section we discuss these various measures and comparisons of saving, and refute the generally held view that there is a generic saving shortage. Instead, we highlight that saving is a very difficult concept to measure accurately and that there is no optimal level of saving for an economy with an open capital market. Overall, it is very difficult to claim New Zealand lacks access to capital.

Nevertheless, we do highlight that many investments are earning low rates of return. We discuss the investment dilemma and role of retirement income in Sections II and III.

Defining saving

Saving is the use of income for any purpose other than consumption. In other words, saving is 'gratification deferred'. As such, it is generally measured by the difference between the *flow* of current income and the *flow* of current expenditure. Current expenditure or consumption refers to purchases of goods that deliver immediate benefits.

Saving, therefore, can be thought of as investing in anything that provides a flow of services into the future, rather than providing instant gratification. In other words, *saving* is simply the mirror image of *investment*.

Unfortunately, when it comes to measuring savings, definitional problems are significant and lead to many spurious conclusions. For example, in the national accounting framework that much of the income and expenditure data is taken from, spending on education is considered 'consumption', while buying a cell phone is considered 'investment'. However, it is not difficult to imagine that the future returns to education will more than outstrip the returns on a cell phone.

Typically, saving is measured as an annual flow, and is commonly expressed as a saving rate (i.e. the amount saved as a percentage of total income). Saving can be undertaken by households, business and government (where national saving is the sum of all three) and can come in many forms. At the household level examples include taking out life insurance, paying off debt, increasing equity in a house or business, and/or capital gains on shares, antiques, or art. However, these examples only represent saving if they are not offset by borrowing or selling assets.

Note also that the term *saving* is different from the term *savings*, which is usually used to describe the *stock* or accumulation of wealth that results from the act of saving. The stock of savings can be thought of as net wealth or net worth.

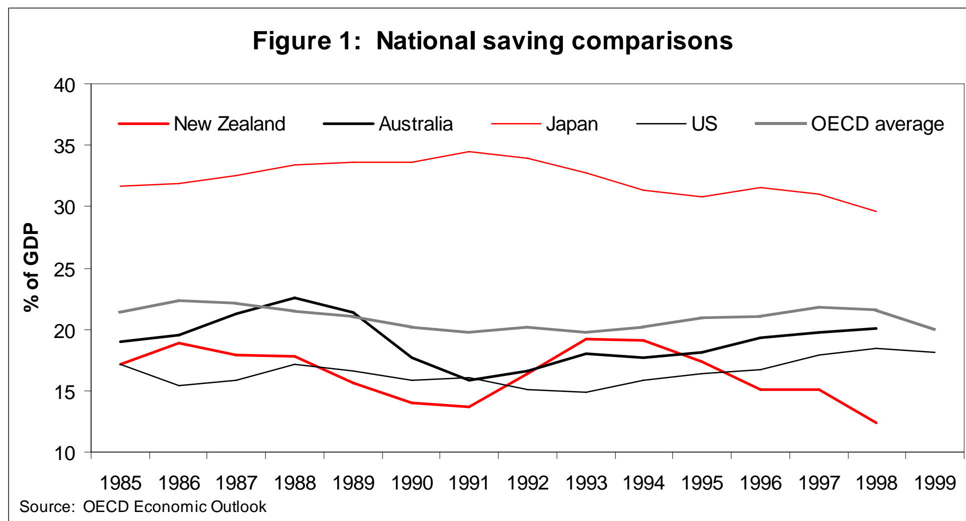
Does New Zealand lack saving?

Having defined saving, the next question is does New Zealand lack saving? To answer this question we look at international comparisons, various forms of saving, and the stock of savings. We also consider what an open capital market means for saving and the price of capital in New Zealand.

Although New Zealand can not fund all of its investment, it is very hard to argue that New Zealand lacks access to capital.

International comparisons – national saving rates

Standard international comparisons of national saving suggest that New Zealand has about an average level of saving relative to GDP (Figure 1). New Zealand's saving performance puts it on par with countries such as the United States and Australia – two economies that have performed well over the last 10 or more years.

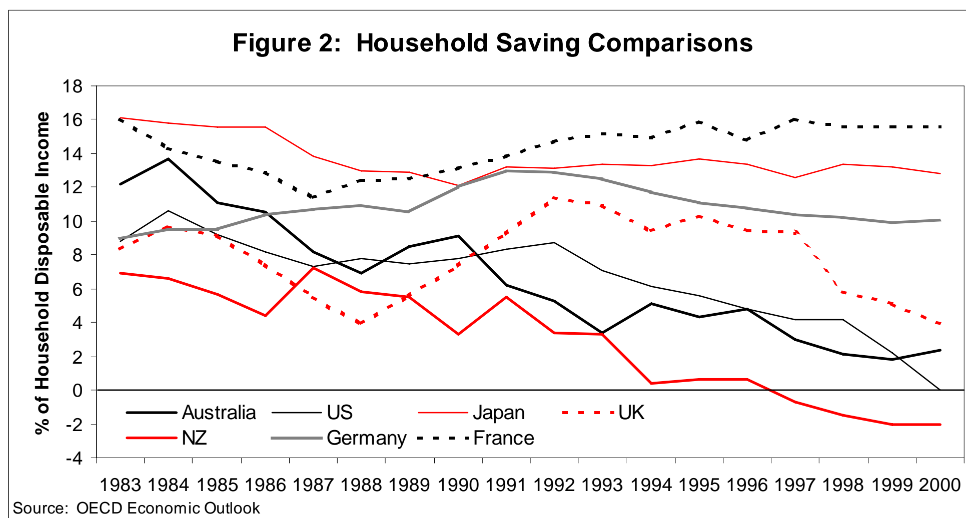


The extent that New Zealand's national saving lags that of some OECD countries can be explained by recent growth rates and business cycle developments. In addition, factors such as the past level of real interest rates, inflation, the particular type of taxation prevalent in a country (i.e., direct versus indirect tax), and demographic trends[2] all assist in explaining the varied saving rates across countries.

Household saving

Even if people are satisfied with the national level of saving, there has been much discussion in the past about who is doing this saving - businesses, households, or the government.

New Zealand households have been shown to have a declining and low rate of saving. This pattern of reduced household saving has also been witnessed in the United States, Australia, the United Kingdom, and Canada – to name just a few countries (Figure 2). The declining household saving rates in these countries has been put down to many things, including better access to debt, improved property rights, high income growth expectations, and increased household wealth.



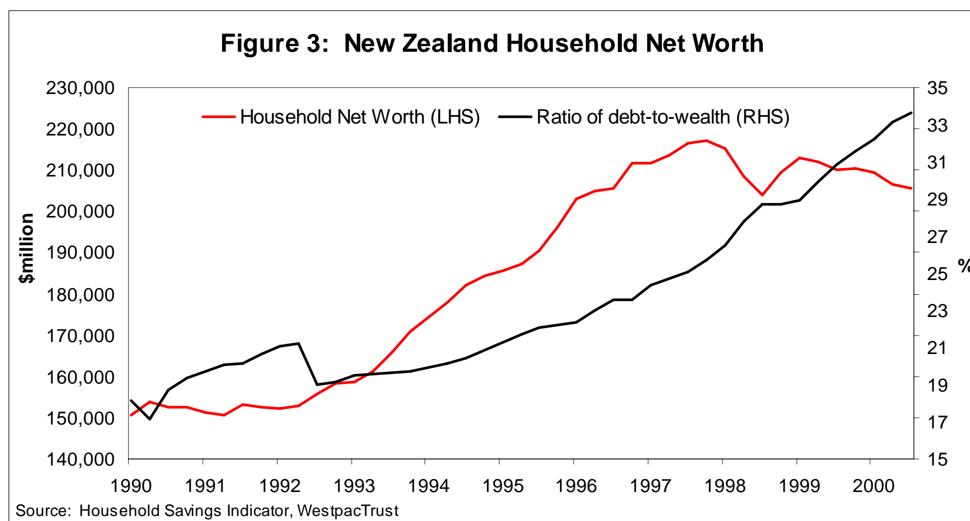
[2] On the demographic front, for example, a country could have a national saving rate of zero and still be able to meet its retirement income commitments. The zero saving rate may simply reflect that on aggregate, those retired and running down their level of saving are simply being offset by those working and building their saving up.

More importantly, such a narrow "flow" measure of household saving is a misleading means by which to assess the ability of households to meet their future commitments, such as providing an income during retirement.

Savings – the stock

Stock or balance sheet measures provide a more accurate measure of household savings. Net worth, for example, is defined as the stock of assets less the stock of liabilities, and as such offers an alternative and conceptually broader measure of saving to the flows measure, as it includes capital gains.

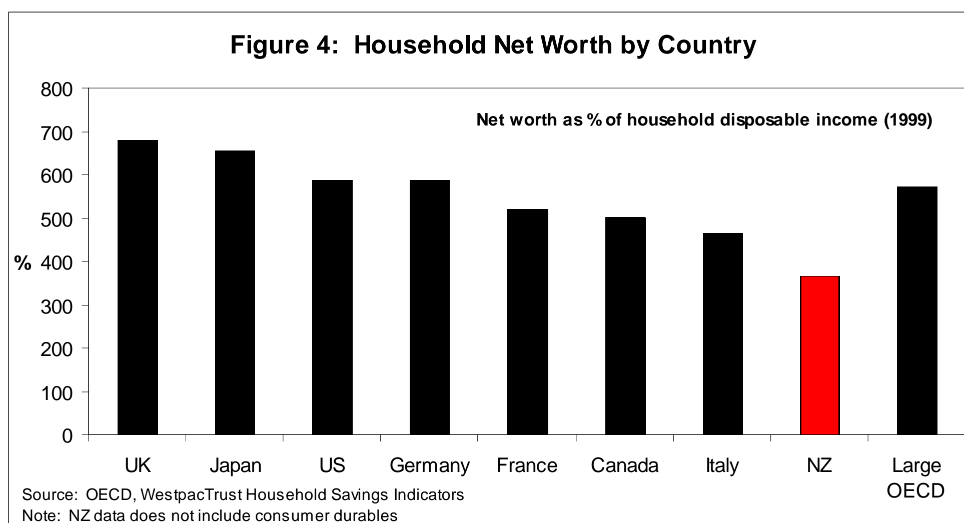
New Zealand households have fared reasonably well over the last decade in terms of wealth accumulation, which may explain in large part their declining saving rate (as measured in income flow terms above). Figure 3 shows an estimate of the rise in household net worth over the last decade or so, as measured by WestpacTrust's Household Savings Indicator.



The growth in household wealth includes money in the bank, insurance, growth in managed funds, and house prices. The rise in wealth throughout the 1990s was mostly driven by the rise in house prices. Houses make up around two-thirds of total household wealth as measured by the survey from which this data is taken.

The net worth measure deducts household debt from the growth in household wealth. The increase in household debt over the 1990s was significant, with the ratio of household debt-to-wealth rising strongly once house prices stopped their rapid growth from 1997 onward. Over the last couple of years, many of the factors that led to a rise in household's propensity to accumulate debt have since receded. The factors reducing the demand for debt include higher inflation-adjusted interest rates, the current stock of debt, and reduced expectations about New Zealand's potential growth rates after the euphoria of the mid-1990s.

The WestpacTrust' estimate of household net worth still misses significant parts of household wealth, such as equity in small businesses (e.g., farms) and the purchase of durable commodities. The international comparisons in Figure 4 include these sources of household wealth for all countries except New Zealand, thereby biasing downward New Zealand's household wealth estimate.



Human capital

One of the most important components of household wealth that is not included in the above statistics is the rise in human capital – or education. Since the 1960s, the increase in education has been exceptional across most OECD countries, including New Zealand. Table 1 below shows the increase in the working age population with some form of education. Table 2 highlights the increase in earnings capacity due to the increase in education.

Table 1: Educational Qualifications

Highest Attainment (% of population aged 15 and over)

	1966	1986	1996
Secondary	9	26	26
Other school	3	1	7
University	2	6	9
Other tertiary	12	26	25
No formal qualification	74	41	33

Source: Conway and Orr (2000).

Table 2: Gross Percentage Increase in Income Above No-Qualification Income Due to Schooling in New Zealand

	All Employed Males		All Employed Females	
	1986	1996	1986	1996
School Certificate	11.5	17.0	13.6	17.9
UE or Sixth Form Certificate	27.3	26.9	23.9	32.0
Bursary	22.4	23.3	16.5	14.2
Diploma	40.3	47.3	41.4	56.3
Bachelors Degree	97.6	103.8	78.2	107.8
Postgraduate Qualification	109.4	133.4	99.6	157.8

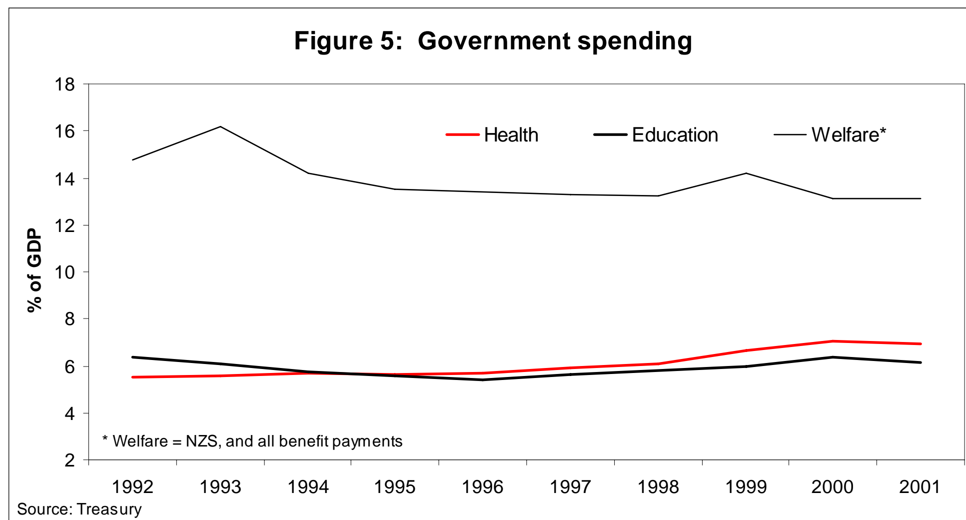
Source: Adapted by Treasury's Joint Working Group (2000) from Winkleman, R. *The Economic Benefits of Schooling in New Zealand: Comment and Update.*

As is evident, investing in education is one of the most important forms of household savings. As our stock of knowledge grows, so does our future earning potential – often over and above the earnings potential of some physical form of capital.

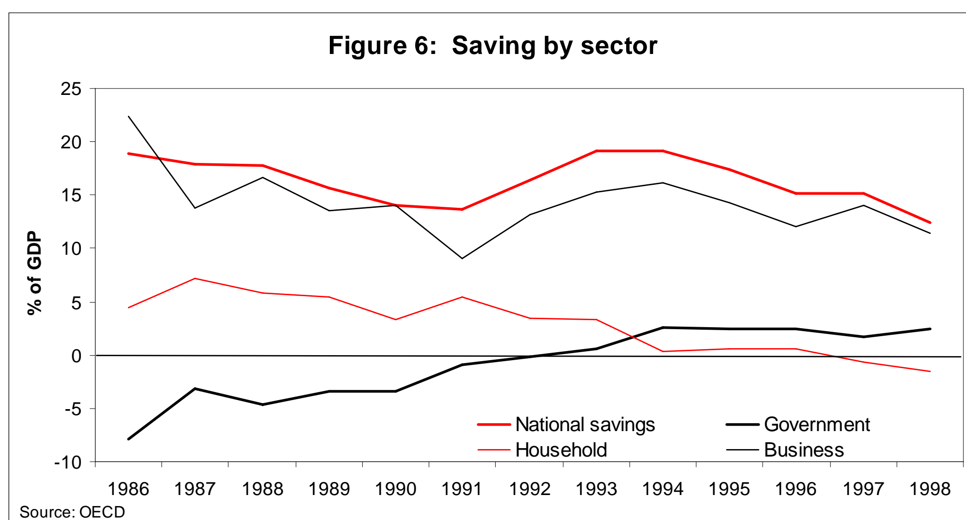
Government spending

Another important component missing from measures of saving are various forms of government spending. Precaution is one of the key reasons for saving. This is 'insurance' that shelters people from the impact of unexpected events such as poor health, an accident, or loss of income. In addition, government expenditure on education and research and development are also important components of national saving, given the expected returns to individuals going forward.

In New Zealand, the government accounts for a large proportion of 'social insurance'(Figure 5). This insurance includes public spending on health, education, and various forms of welfare (including retirement income). Such public expenditure is funded through the tax system for household consumption and should be accounted for whenever saving statistics and policies are being considered. When people pay their taxes, they assume they are purchasing services, one of which is social insurance.



Countries with significant government provision of social insurance will also generally have low private sector saving rates. This close relationship between household and government saving has long been evident in aggregate saving statistics (Figure 6).



Efforts by government to raise their saving are often only met by a reduction in private saving, leaving the national saving rate largely unchanged. Offsetting behaviour between private and public saving is witnessed throughout the OECD, where over recent years the decline in household saving (as measured by income flows) has in part mirrored the rise in government saving. Overall, it is very important to understand that government policies aimed at *increasing* saving are generally only effective at *redistributing* them. Meanwhile, raising income growth is the best means by which to increase savings.

An open capital market

In an open capital market such as New Zealand's, there is no such thing as an 'optimal' level of domestic saving or debt. Total investment can (and often should) exceed total saving, with New Zealand's current account *deficit* being the difference.

Hence, when assessing if New Zealand is in someway constrained in its access to capital, many factors have to be considered. Most importantly, a high debt level and a persistent current account deficit do **not** immediately imply that there is a structural fault in the economy.

For example, a country's demand for capital is dependent on its stage of economic development and natural resources. New Zealand has been a net capital importer for several decades as the 'catch up' in technology has continued, and its comparative advantages remain dominated by primary resources. In addition, the use of foreign capital for investment brings many advantages, including access to foreign skills, markets, ideas, and opportunities.

As long as foreign borrowing is invested productively, then there is no shortage of capital. The returns on the debt-funded investment both generate sufficient income to meet debt repayments and provide additional income for the person who made the borrowing.

Meanwhile, investors will continue to lend to domestic residents at rates that encourage ongoing borrowing. The cost of borrowing in New Zealand is the global interest rate plus some 'risk premium' related to specific features of the New Zealand economy relative to other destinations. These fundamentals may include New Zealand's economic policy settings, relative inflation performance, debt level, and/or expected future growth rate (reflecting the ability to meet interest payments).

One issue possibly concerning policymakers is that the returns to the investment (i.e., profit or interest payments) go to the foreign owners of the capital. However, we have to remember that New Zealanders also get access to foreign investment opportunities, as well as the many other advantages that the use of foreign capital brings.

Figure 7, for example, compares New Zealand and Ireland's use of foreign capital. Both countries have significant investment income deficits, highlighting the degree of foreign capital invested in both economies. Ireland, the 'growth miracle' economy of the 1990s, made more use of foreign capital than New Zealand by a significant degree. However, given that Ireland's GDP grew more strongly than over the 1990s than compared to New Zealand – averaging 6.9% as opposed to 2.2% - it appears, on the face of it, that they made more productive use of their imported capital.

A big proportion of foreign investment in Ireland was used in the 'tradeable' sectors of the economy, as reflected in their strong net export performance. By contrast, a big proportion of New Zealand's foreign borrowing was either invested in domestic utilities that were previously government-owned, and/or invested in housing

Over more recent years, a lot of investment capital has left New Zealand shores in search of better risk-adjusted relative returns. However, the recent sale of New Zealand assets (e.g., bonds and stocks) relates more to the *quality* of investment opportunities, rather than the *quantity* of domestic savings.

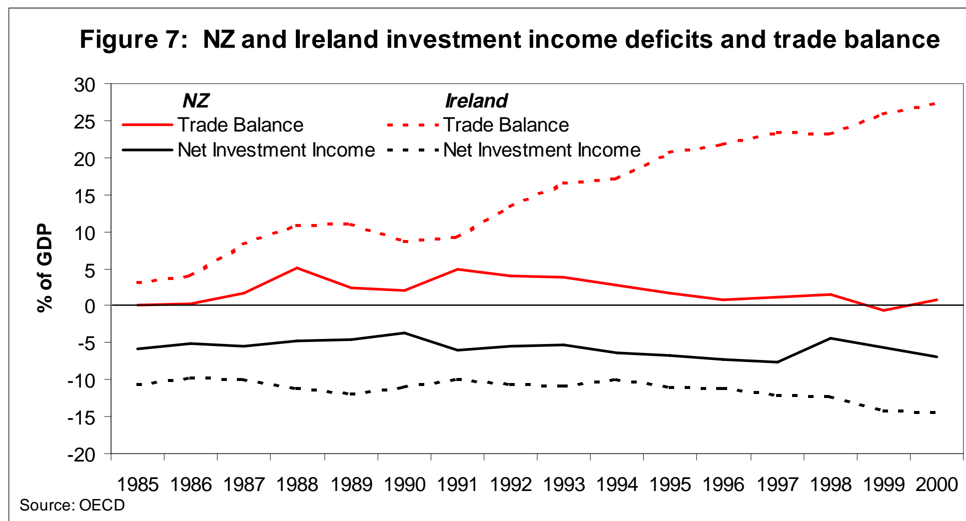


Figure 7: NZ and Ireland investment income deficits and trade balance

Source: OECD

Summary

When considering the volume of saving in New Zealand, as distinct from its form, it becomes evident that:

- Defining and measuring saving is fraught with difficulties;
- New Zealand does not appear 'capital constrained';
- Government policies aimed at raising total saving are often futile, with offsets occurring between sectors of the economy; and
- New Zealand has access to global capital as long as it pursues reasonable economic policies and quality investment opportunities.

II. New Zealand's investment challenge

The claim that New Zealand has a savings shortfall, or is capital constrained, is difficult to make. However, growth in the New Zealand economy has struggled to keep pace with many of its OECD comparator countries. These concerns suggest that rather than New Zealand having a saving *quantity* shortfall, it has an investment *quality* issue.

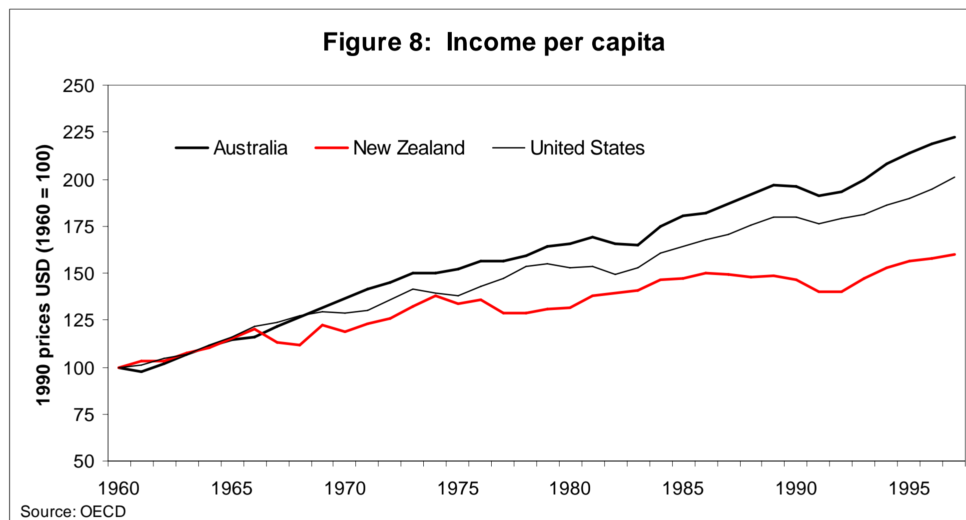
This section provides evidence that New Zealand lacks quality investment, with many of the assets held by the country producing below international rates of return.

If the Government wants to assist in generating wealth then it should concentrate mostly on improving the incentive structure for individuals and businesses to invest wisely, rather than on policies aimed at raising the quantity of saving.

It's not what you've got, it's what you do with it

New Zealand's per-capita income has struggled to keep pace with many OECD countries (Figure 8). The relative economic decline was halted for a while during the 1990s following a period of strong growth. However, the absolute per-capita income gap remains stark.

Figure 8: Income per capita

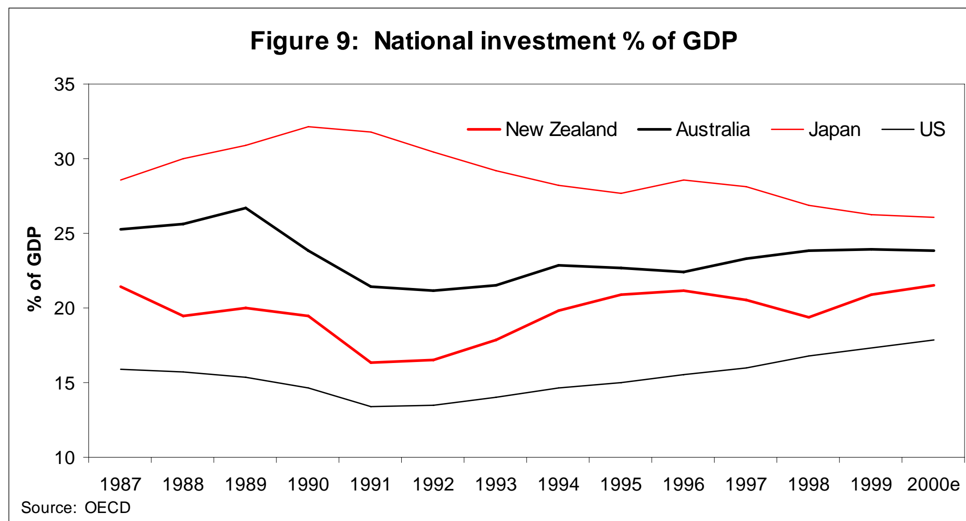


Source: OECD

Economic growth comes from increasing the inputs into the production process and using these inputs more productively. When it comes to increasing the inputs, New Zealand's labour force growth rate and investment levels have been around the OECD average. There has been no obvious shortage of investment in New Zealand over recent decades (Figure 9).

However, when it comes to returns on this investment and the growth in productivity, New Zealand has lagged many OECD countries. In short, economic growth is as much about the quality of investment as it is the quantity of investment (or saving).

In fact, a country can have a very high domestic saving rate, yet still generate almost no economic growth (e.g., Japan over the last decade). Just as a country can have a low domestic saving rate yet grow very wealthy (e.g., the United States over recent years).

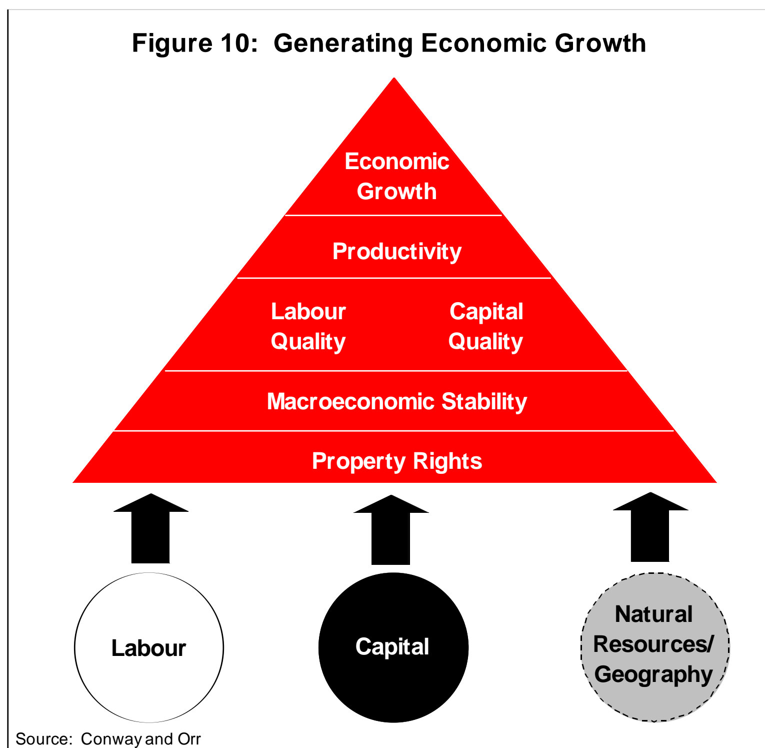


What's behind the poor relative growth performance?

There are many factors that influence economic growth including:

- Increases in the size of the labour force and the capital stock.
- Improvements in the quality of the labour force and the capital stock.
- And, improvements in the general level of macroeconomic productivity, which stem from a wide range of potential sources.

Figure 10 captures some of the features of the economic growth process, with the pyramid structure primarily indicating that economic growth is the ultimate goal of economic policy (Conway and Orr, 2000). Although Figure 10 trivialises the complexity of the growth process and the inter-relationships between the various factors, we feel that it captures the main factors.



Stable property rights underpin the working of a market economy, while a stable macroeconomic environment assists in the allocation of resources. Meanwhile, the microeconomic environment and individual incentive structures also determine the dynamics of an economy, thereby generating productivity and sustained growth.

In New Zealand, a big component of policy effort in the 1980s and 1990s has been spent debating and implementing macroeconomic reform, such as anchoring low inflation and ensuring predictable levels of government spending and taxation. However, although such macroeconomic stability may be *necessary* for generating sustainable economic growth, it is not *sufficient*. Macroeconomic stability will provide a stable platform on which to build – but it will not tell you much about what to invest in, or when.

It is in the area of microeconomic incentives that New Zealand still has considerable work to be done. Microeconomic incentives are the crucial ingredient to long-run economic growth. These include issues such as education, the regulatory and competition environment, openness to international trade, the migration of people and ideas, tax levels and type, and factors that motivate innovators and entrepreneurs.

Summary

New Zealand's economic fortunes are more linked to the *quality* of investment than the particular *stock* of saving that is available. The focus of policy should thus be as much on what creates the individual incentive structure to invest wisely.

With average resources and a geographical disadvantage, New Zealand can not afford average economic policies. Exceptional policies are all that will see New Zealand climb higher on the OECD per-capita income ladder.

III. Public retirement income provision and the aging population

The adequacy of savings has been a key area of policy debate in New Zealand. We have challenged the view that there is a lack of saving, and argued that the economy suffers more from poor performing investment. In this section we focus on the more specific issue of ensuring an adequate retirement income is available for all New Zealanders.

We agree that the government has significant budget concerns approaching, given the aging population and generosity of the current NZS. However, we argue that the Government's proposed 'Super Fund' does little to improve New Zealand's longer-term saving, investment, or economic growth performance.

Given that it is improved economic growth and labour force participation that will ultimately secure future retirement incomes, there is plenty of thinking left to be done on the design of NZS and supporting policies.

Public provision of retirement income

Like governments in most OECD countries, New Zealands' governments for several decades have had the vision of ensuring that there is an adequate income for all of its citizens in retirement. Various schemes have emerged across countries, and evolved over time.

In general terms, government involvement in the provision of retirement income is necessary and justified by '*market failure*', where people will not provide sufficiently for their retirement due to 'short-sightedness' or myopia. That is, individuals often fail to save sufficiently to meet their income needs when they are no longer earning. This failure leaves a role for government to provide – via the tax system – at least some 'income of last resort' for those who can't, or haven't, saved.

However, the promise of a government pension also generates its own '*moral hazard*', potentially leading to less private saving. If the general public strongly believes that the government will adequately provide them with a retirement income, then the private incentive to save for retirement has been significantly reduced.

Striking a balance between providing a retirement income for those in need, while maintaining incentives to invest as an individual, is not easy. This balance is generally referred to as the 'first tier' of retirement saving provision.

The *first tier* of retirement income means that the government must provide:

- A pension level which the genuinely needy can survive on, and interest groups will accept; while
- Ensuring private saving and investment incentives remain strong.

However, if this balance is wrong then, because of moral hazard, government involvement can lead to under and even over-funding for retirement income, and poor private-sector investment decisions.

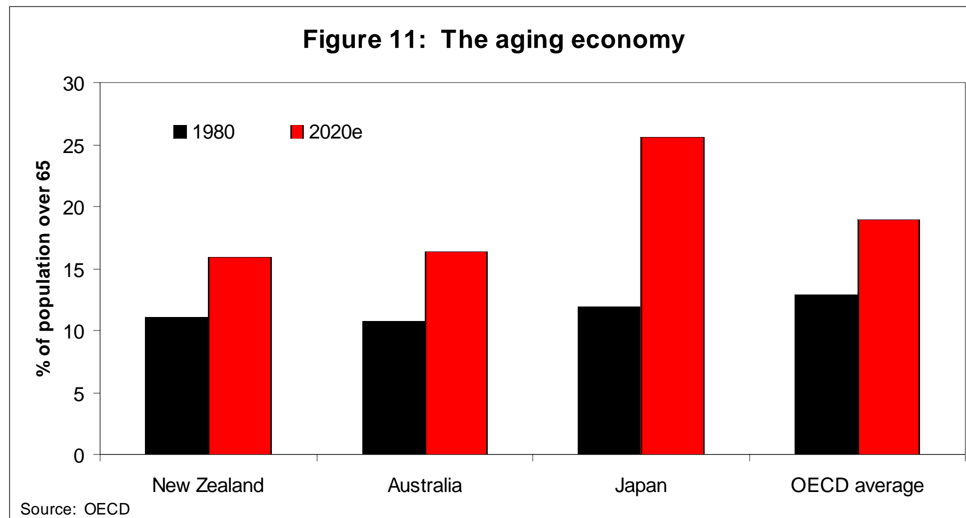
The aging population and New Zealand Superannuation

The first tier of public retirement income in New Zealand is known as New Zealand Superannuation (NZS). NZS is a 'pay as you go scheme', with retiree's income funded out of current tax revenue. NZS is universally available to those over 65 years of age and is not 'needs-tested'. Full details of the NZS can be found on the New Zealand Treasury website: www.treasury.govt.nz.

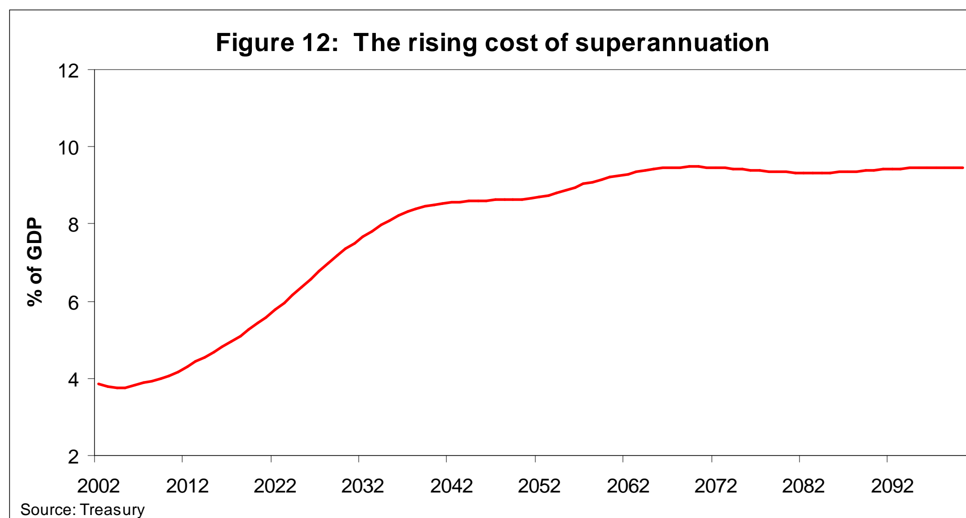
In New Zealand people are also urged through public education and a host of other activities to generate other forms of long-term savings - i.e., create a second-tier of savings. However, the capacity for this to happen is reasonably limited outside of higher income groups.

Meanwhile, New Zealand's rising life expectancy and aging population implies a rising burden on the tax base pay for NZS. The age profile of New Zealand - and most other OECD countries - highlights that a demographic 'bubble' is approaching, where a smaller proportion of the total population will be of working age (see Figure 11).

It is estimated for New Zealand that the proportion of the population aged 65 years and over is to increase from 12% now to 27% over the next 50 years. The total dependency ratio - i.e., retired + youth as a proportion of the working-age population - increases from 50% now to 70% in 2050, which was about the same as it was in the 1950s when the youth population included the baby boomers.



In New Zealand, the demographic 'bubble' is set to arrive from about 2015 onward. The bubble comes later in New Zealand and is somewhat less than other OECD countries are set to experience. Given this rising dependency ratio, the current retirement income arrangements suggest a rapidly growing inter-generational transfer of income from the working age population to the retired (Figure 12). It is estimated that the cost of the government's NZS will rise from 4% of GDP now to over 9% in 2020.



Such a large inter-generational transfer of wealth may prove unsustainable in both an economic and political sense in the future. Future taxpayers may be unprepared to meet the high cost of NZS and vote with their feet. Under the current level of generosity, the cost of completely pre-funding the future liability of NZS is already too great for the economy to manage.

Summary

In order to meet the growing NZS either:

- Future generations will need to have sufficient income or wealth to meet their own retirement needs;
- More people will need to remain in the labour force;
- NZS will need to become less generous; and/or
- More saving will need to be made now to partly pre-fund the future costs.

In other words, there is a need to find the best combination of policies that encourage wealth creation and labour force participation, while also increasing the incentive to save as individuals. Of the options outlined above, only one policy is directly related to raising the quantity of saving now for retirement income purposes in the future.

IV. The Government's proposed Super Fund: Panacea or Placebo?

The Fund

Given the projected rise in the cost of providing NZS associated with New Zealand's aging population, the Government has proposed the establishment of a new Fund to part finance the provision of NZS. The full details of the proposed fund can also be found on the New Zealand Treasury website. Some of the key features of the proposed fund are as follows.

- Tax receipts are to be set aside annually to establish a fund to partially meet the future costs of NZS. At its peak, the fund will cover only 14% of the entire cost of NZS. The fund should thus be regarded as smoothing the 'pay-as-you-go' public retirement income system.
- The annual contributions into the fund will be determined by government acting on advice from Treasury.[3] The Government will have the ability to alter the annual contributions – over and above the Treasury advice - but will be required to offer a rigorous explanation as to why it was necessary and the resulting fiscal implications.
- The funds' assets are expected to peak at around 50% of GDP sometime between 2023 and 2029.
- The fund will not be able to be drawn upon to assist in the superannuation payments until 2020 – when the demographic bubble is upon New Zealand. After about 2025, the annual NZS payments are expected to begin to exceed the annual required contribution to the fund, and the fund will start being drawn on to help finance the cost of NZS.
- The exact year the draw down starts on the fund will depend on the growth of the fund over time and on future expectations about the relative cost of NZS. The fund's balance is expected to gradually approach zero toward the end of the 21st century.
- A Board will be set up to govern the assets of the fund. The Board will be independent of government, and will be responsible for establishing the management structure of the fund and managing its assets. The funds assets will be used only for the purpose of meeting the future cost of New Zealand Superannuation.
- There will be costs for establishment of the Board during 2000/01. These have not been provided for in the 2000/01 Budget. This will be in the region of $1-2 million. Beyond 2000/01, there will need to be an annual appropriation for the expenses of the Board and its secretariat.

On balance, the Fund will aim to assist meeting the future cost of retirement income by part financing it now.

Panacea or Placebo?

The government's proposed 'tax smoothing' retirement income scheme is designed to build up a large 'ear-marked' retirement income fund which creates more certainty about whether sufficient funds will be available to meet retirement payments. While increased certainty about the level of future retirement income is excellent, it can also be misleading if people feel that the retirement income issue is fully resolved.

First, even with the introduction of the fund, the retirement income savings issue is far from resolved. The total burden of retirement income still rises from around 4% of GDP now, to 9% in the next 20 or so years. The burden on future taxpayers remains large, with their ability to pay dependent on the size of the tax base at the time. The super fund can at best be described as a start, and even then with significant risk and opportunity costs.

[3] Each year, as part of the Budget preparation, Treasury will be required to calculate the level of annual funding required. The calculation will be on the basis that if the contribution rate were to be held constant as a proportion of projected GDP, it will be sufficient to finance the expected costs of NZS entitlements (after PAYE tax) over a rolling forty-year timeframe. According to work undertaken by the Treasury, in the early years this contribution is estimated to be about NZ$2 billion.

Second, with regard to opportunity cost, it is unclear if the proposed will boost economic growth or labour force participation by more than the alternatives of:

- Reducing the tax rate as the government's operating surplus builds;
- Paying down government debt and reducing New Zealand's investment risk premium; or
- Increasing spending on education or other wealth generating schemes.

Lower taxes could increase labour force participation. And, increased spending on education could raise individual's earning potential. A reduction in public debt would reduce interest rates and promote investment.

These policy alternatives can be managed while still providing the current government superannuation. Meanwhile, an open debate or discussion on these policies has yet to occur.

Third, it is also doubtful that the proposed retirement income scheme will raise the pool of savings in New Zealand. Instead, it is only likely to alter the form of saving. Government saving will remain the same, with no increase in revenue or reduction in expenditure made obvious. In fact, the rise in the fund can only be achieved by either reducing government's capital expenditure or having higher than otherwise gross public debt. There is nothing in the proposed scheme that commits the government to raising their overall level of saving.

Meanwhile, the visibility and magnitude of the proposed scheme may create a mirage that government retirement income is guaranteed. This mirage of wealth may generate 'moral hazard' amongst the wider economy and dent people's willingness to save and invest as individuals.

Fourth, with the creation of the fund, the Government is also taking more financial risk onto their balance sheet for no obvious *risk-adjusted* increase in returns. Rather than paying back government debt, the proposed fund will diversify tax revenue into other domestic and foreign assets. The additional cost of establishing and operating the fund includes parliamentary time and attention, publicity, printing, management and salary costs, and other compliance costs.

Fifth, the incentive structures for the funds' managers will also be reasonably weak, as retired peoples' incomes are set independent of the fund's performance. Instead, retirement income remains underwritten by the government's ability to raise tax revenue. Meanwhile, issues such as governance, retirement income generosity, ethical investment, and the size of annual fund contributions will remain live political issues.

Sixth, the magnitude of the inter-generation transfer of income implicit in the current NZS – even with the proposed fund - will ensure that retirement income policy remains a political issue. For example, it is unclear how the proposed fund might ensure that future taxpayers will be willing or able to pay the tax bill, and will not instead start looking for alternative places to work or store their wealth. One of the fastest growing businesses at present is the creation of Family Trusts.

Seventh, it remains unclear both how or why individual names could be attached to this particular Fund in the future.

On the *why*, including individual accounts will not alter the incentives for individuals to save and invest. The amount that individuals would pay into the account remains unrelated to their savings situation, while the amount people receive when retired remains the same irrelevant of their needs. Overall, NZS will be neither better targeted nor related to needs.

On the *how*, practical issues remain such as who qualifies for an account, when can people get access to these funds, and what would happen if someone leaves the country or dies early?

Summary

The proposed fund has positive intentions and is a start towards smoothing the tax transition to a higher level of NZS commitments. However, it appears both costly and risky. The Fund does not build on the relative advantages and competencies of the public and private sectors as well as it could, and, important questions remain unanswered. In particular,

- How will the fund influence private sector behaviour? And,
- How is it superior to other options such as reduced taxes or public debt?

If the issue of retirement income is to be properly addressed, a key requirement going forward is to assess the design of NZS, rather than its funding. Otherwise, the future tax burden will continue to rise.

Moreover, given that the retirement income issue mostly affects voters who have yet to be born or are not old enough to vote, a bipartisan agreement on retirement income is necessary.

V. Moving forward – a partnership solution

The Government's vision for retirement income is admirable and one that most governments within the OECD share. That is, to ensure that there is an adequate level of income for all citizens in retirement.

However, nowhere in this vision does it mean that the government need be the sole provider of a retirement income. Instead, a partnership appears the only practical means by which to attain the goal of ensuring an adequate retirement income for all citizens. The partnership can take many forms, most notably between:

- The public and private sector;
- Various political parties to ensure a bipartisan policy approach; and
- The current working generation and the future taxpayers, to ensure that the future tax burden is affordable.

This section discusses some of the ways in which this partnership can continue to evolve, with each interested group using their relative expertise.

A partnership solution

The various groups that have been working towards a sustainable public retirement income include the government, various government agencies, the private sector, and the funds management industry. Over recent years a partnership has been increasingly forged between these groups that exploits the comparative advantages of both the public and private sectors.

The focus of public policy on superannuation over recent years led the Retirement Income Commission, has been on creating the necessary conditions to ensure that private individuals generate a sufficient quantity and quality of savings. These efforts have revolved around: public education, ensuring a competitive funds management industry and an adequate range of savings products, improving the neutrality of the tax system, and building on the credibility of public policy and private sector funds management.

This work has been excellent and led to a significant improvement in the integrity of the savings industry. Funds under management have risen strongly over recent years, although equity in the family home continues to dominate New Zealand's savings statistics.

Focusing policy on those in need

There is no reason or justification to dilute or compromise past good work. However, there is a strong reason to supplement it. For example, the key focus of private funds management companies is on the upper end of the income scale. However, from a public policy perspective, middle and low income New Zealanders need to be the focus of efforts. These income groups are well aware of the need for long-term savings, but are neither well informed about the options, nor able to afford it.

In order to fill this gap, several policy options are possible. For example, the NZS could persist as is. However, the generosity of the NZS would need to decline over time as it becomes increasingly expensive with an aging population.

Rather than debating the *funding* of retirement income, more discussion is needed on its *design*. The issues related to the design of NZS include the:

- State pension age,
- Dollar amount paid,
- Inflation linkage, and,
- Qualifications for payment.

The Todd Taskforce on Retirement Income covered all of these issues. And, the Retirement Commissioner is capable of leading this debate in a bipartisan fashion. However, if design changes prove necessary, then they should be confronted as early as possible. The current working population should be given every opportunity possible to prepare for their retirement with adequate information and well-formed expectations.

The same with a twist?

If we are interested in a modification to NZS then there are many variants more efficient than the Super Fund.

For example, the government could provide a retirement-income subsidy for middle and low-income New Zealanders. This would create a more efficient first-tier of saving for those most in need, albeit being more difficult to set up initially.

For every dollar saved by an individual below a certain income level, the government could match it dollar-for dollar until a long-term savings level is reached that provides an annuity in retirement. The savings would not be accessed until retirement age, and the payment would be as an income, rather than a lump sum. Meanwhile, the current NZS could be left purely for those people not in the labour force for whatever reason.

In such a system, individual names are attached to the first tier savings, and the private sector is competing to manage the funds and calculating the annuities actuarially correctly.

Meanwhile, government retirement income support is better targeted, and moral hazard, in terms of saving and investment decisions is minimised. The overall retirement income system would also be more affordable.

The benefits of such a system are clear. The public and private sectors are both using their relative expertise. The funds are privately managed and long-term savings goals are met accordingly. And, fund managers are left with very strong incentive structures to perform well – as future retirement income levels will depend on them.

Meanwhile, the system remains flexible for future changes to generosity of the scheme and there is no need to create an independent government structure. The system can be implemented using the current tax collection system. Finally, those who do not earn any income for whatever reason will not be disadvantaged since the current NZS could still be available as a retirement income of last resort. The most important outcome is that incentives to save and invest smart remain.

Summary

No matter what the final system, there will be several levels of retirement income provision. These may include:

- Some form of needs tested public retirement income;
- Possibly a government supplemented individual retirement scheme; and
- Various forms of private savings.

However, amongst the combination of public policy options discussed, the proposed Super Fund is neither the make nor break of future retirement income provision.

VI. Conclusions

New Zealand's long-term economic wellbeing and its ability to fund a 'pay as you go' retirement income is determined by future economic growth and labour force participation. These factors are determined by the *quality of investment* in both physical and human capital, not the *quantity of saving*.

The influence of fiscal policy on an individual's investment intentions goes well beyond the government's ability to build a savings fund for retirement. The level and type of taxation, the provision of social services, the Government's role in education, and the credibility of their regulatory policies all alter private saving and investment decisions.

It is not clear that the proposed Super Fund will increase New Zealand's future wealth or national savings. The proposed Super Fund is, *at best*, only a part solution to meeting the future burden of retirement income, while adding significant risks and costs. Irrespective of the Fund being created, the inter-generational transfer of wealth between future workers and future retirees remains large and growing.

The creation of the Fund must be compared to alternative uses of government revenue, such as reducing the income tax rate, paying down government debt, or increasing spending on education and/or research and development. These policy alternatives can be managed while still providing a government retirement income *for those in need*.

With regard to the future of NZS, discussion must continue about its *design* features, more so than it's funding. The key design parameters of NZS include the state pension age, dollar amount paid, inflation linkage, generosity of the NZS compared to other forms of welfare, and qualifications for payment - including some form of needs testing. Meanwhile, there are other methods of delivering government retirement income assistance that is more efficient, and less costly and distorting on private incentives to save.

Given that it is future taxpayers that will bear the brunt of NZS decisions made now, a bipartisan approach to NZS changes appears necessary. A bipartisan approach will depoliticise retirement income decisions, and reduce the temptation and/or ability for the current generation to continue to vote to 'take the candy from the baby'.

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