SAVINGS WORKING GROUP

Interim Report

Saving New Zealand: Reducing Vulnerabilities and Impediments to Growth

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1 Vulnerabilities mean stark choices

High foreign debt puts New Zealand in a difficult economic situation. The country is vulnerable – some say "highly vulnerable". And continued increases in debt are unsustainable.

There is an urgent need for both the government and household sectors to lift productivity and national savings, and to strengthen our international competitiveness and tradable (export and import-substituting) goods and services industries.

What caused this situation?

New Zealand has run current account deficits in every year since 1974. This has made us continually reliant on foreign finance, particularly debt, to fund domestic investment. Put simply, we've spent more money than we have, so we've borrowed the rest from overseas. As a result, net foreign liabilities (government plus private foreign debt and inward foreign investment in New Zealand, less our foreign assets) rose to a worryingly high 90% of GDP - in the same zone as the troubled European countries, Ireland, Greece, Spain and Portugal.

The bottom line is that New Zealanders collectively have been spending too much and saving too little, using large amounts borrowed offshore to fund new investment. Its credit is about maxed out. It's time to get real. We need less consumption by both government and households, more savings, better quality investment, more exports and increased import substitution.

Although the government's share of these net foreign liabilities is relatively small (but growing rapidly), it is the total that counts. Significantly, about 90% of the net liabilities are in the form of debt rather than equity.

The private sector share of the debt is largely brought in through the banks, subject to their prudential requirements and hedged to the New Zealand dollar. But these funds tend to be short-dated so New Zealanders are vulnerable to the risk that foreign lenders will not roll over the loans except on unfavourable terms. Moreover, a significant proportion of the funds ended up in house and farm price bubbles.

A net foreign liability-to-GDP ratio above 60% is considered risky, raising the likelihood of a sudden and destructive economic shock. Ireland, Greece and the UK have all suffered sudden shocks, as did New Zealand in 1987. Typically, a shock means a shrinking economy, large job losses, constrained government spending (eg reduced pensions, benefits, and public sector wages), and services, and falling asset values. A ratio above 60% also reduces the headroom for the country to cope with sudden disasters, such as a foot-and-mouth outbreak or a major earthquake.

Critically, the higher the level of net foreign liabilities, the more upward pressure there is on interest rates. In addition, continuing current account deficits and a high exchange rate are also linked. This combination discourages investment and exports. To the extent that the liabilities are government-held, the supply of government goods and services (such as pensions and health services) can be constrained by rising government debt and interest payments.

New Zealand's vulnerability is heightened by the sensitivity of international capital markets to high debt, weak balance sheets and crumbling fiscal positions in the wake of the global financial crisis. It has also been reflected in Standard and Poor's recent decision to put New Zealand's foreign currency rating on negative outlook, itself a reflection of the nervousness of others about our vulnerabilities.

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It's akin to standing on top of a crumbling cliff, uncertain of the exact risk and needing to step back quickly to reduce the risk.

The Savings Working Group strongly recommends the pre-emptive, progressive policy option, at the very least as insurance to avoid the economic and social damage of an externally imposed shock.

The position has improved slightly in recent months, but this largely reflects the weak economy and lower consumption, investment and imports, and lower profit remittances offshore. This is no reason for complacency though as this seems likely largely to reverse when growth resumes.

Basically New Zealand has two options:

- We can adopt policies, now, that progressively address the problem, first by preventing further growth in net foreign liabilities and then by gradually reducing them;
- We can do nothing, or very little, and wait for the inevitable shock. This is a serious and increasing risk in a world sharply focussed on high debt, and poorly managed countries.

This is akin to a choice between taking unpleasant but effective medicine now, or rejecting the medicine and taking the risk of life-threatening surgery in the future. The Savings Working Group (SWG) strongly recommends the first option, at the very least as insurance to reduce the risk of the economic and social damage of an externally imposed shock, which would probably be managed under the guidance of the IMF.

An important contributor to the problem has been the adverse consequences of inappropriate and poorly managed policies, including policies more oriented to short-term political gains than longer-term national interest. More of this would be disastrous.

How would the adjustment process work? If we – the government and the people – save more, we will consume less, import less and, over time, export more. This will reduce the current account deficit. If we can eliminate the deficit net foreign liabilities would stop rising. Current account surpluses would reduce the liabilities progressively over time and at the same time lower interest rates and, probably, the exchange rate.

The bottom line, though, is we've had the fun, the big spend-up, bought overpriced houses and farms, and a lot of bling. Now, unfortunately, it's time to pay and lay a more secure foundation for future sustainable wealth.

What the necessary policies will look like in detail needs more work than the SWG has had time for but some comment is possible at this stage. Consumption, both government and private, needs to be reduced and saving increased. A reduction in total consumption of around 3% of GDP would appear appropriate.

This will lower the interest rates New Zealand pays foreigners, encouraging private investment. It should also lower the value of the NZ dollar, encouraging exports. Modelling indicates that the investment and export responses could mean only a small and brief dip in GDP and a strong and sustainable expansion path thereafter, but there are no guarantees here. This is potentially tough stuff - but astute, agile policy will give the best prospects of success. The bottom line, though, is we've had the fun, the big spend-up, bought overpriced houses and farms, and a lot of bling. Now, unfortunately, it's time to pay and lay a more secure foundation for future sustainable wealth.

It's the same for people, households, companies and countries!

Saving, however, also takes place in the government sector and another sobering issue is the government's position. Its current spending level is unsustainable. It is borrowing heavily week by week and running large deficits.

The Treasury's long-term fiscal projections show that if the government keeps its borrowing within a sustainable level, as it must, then there are two options:

- Maintain current spending policies and increase the annual tax take by around 9% ; or
- Maintain current tax settings, and shrink the supply of goods and services (excluding transfer payments) below current levels for the next 20-plus years. The modelling shows the reduction peaks at about 8% below current levels in real terms in 2022 before slowly climbing back to reach the starting point around 2042.

Both options are unpalatable. However, they assume that productivity in the government sector increases by only 0.3% each year and it can undoubtedly do better than that. If it increases annually by 1%, then the period of shrinkage falls substantially. If it increases for five years at 2% a year and 1%

thereafter, then there is no shrinkage and strong growth is sustainable. This opens up important options. The government could make a substantial contribution to reduced consumption and increased savings while still growing its supply of goods and services.

Unfortunately, the government sector has a very poor record on productivity growth and performance improvement. But there are some encouraging examples of what can be achieved. Also, it will be faster to raise savings through government, and those savings could bridge the short term until the private sector can make a more significant contribution.

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Finally, it is important to understand that the SWG is not talking about "nice to do" options. We have our backs to the wall. It will not be easy, but failure to act decisively risks much greater pain in future.

2 Where the SWG is heading in its recommendations

Purpose

The SWG is independent of government. Its role is to recommend to the Minister of Finance, economic strategies and policies for New Zealand from a savings perspective as well as specific policies in relation to savings; and to stimulate public debate and understanding of New Zealand's economic situation and policy options.

The terms of reference include exploring the connections between national saving and fiscal policy, taxation and the future role of KiwiSaver. The terms of reference exclude consideration of changes to NZ Superannuation, welfare settings and several other areas.

This report briefly outlines some important views of the SWG and touches on a number of other issues. The final report is due at the end of January 2011.

Issues

Identifying the underlying state of New Zealand saving (the "flow" of income not spent by the nation each year) and savings (the accumulated stock of saving over the years) is complicated by:

The SWG concludes that New Zealand has a national savings problem and that this is linked to a number of serious problems in the economy.

- Discrepancies in the macro and micro data and differences between different measures (stocks and flows) of savings.
- The economic cycle and weak economy.
- Current changes in related areas (e.g. the rebalancing of tax from income to GST, the introduction of KiwiSaver and new banking regulations, household concerns about high debts, and an uncertain outlook) are too recent for firm conclusions about their longer-term impacts.

However, the SWG's role includes making judgments in the face of uncertainty, suggesting options and identifying where further work should be undertaken.

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Some of the SWG's main work areas are:

National savings

- The nature and extent of New Zealand's vulnerability.
- Comparisons with other countries.
- The nature and probability of an external market shock.
- The particular character and implications of net foreign liabilities, including higher interest and exchange rates.
- How much, if any, of the recent increase in household saving is a longer term shift?
- Policy options to lift national saving and some of their implications.
- The implications of doing nothing.
- How did we get where we are and can we discourage a return in the future to the present vulnerable position?
- The situation by sector – household, business and government.
- Is there a coherent and sound national policy on saving?
- Is the government's fiscal contribution to saving adding value? Could its effectiveness be improved?
- Why has output and employment in the vital tradable goods sector (ie exports and import-substitution) been declining since 2004 while the rest of the economy is growing?
- Issues affecting productivity and the low capital-to-labour ratio.
- The role of the New Zealand Superannuation Fund.

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Household savings

- The data on household saving are very uncertain and considerable work is needed to differentiate household and business savings. There are large differences in the measures of the saving rate (new savings) and the stock of wealth.

- Age and income distributions have important implications for household saving which are hidden by averages. Compared to most OECD countries, New Zealand has a young population which reduces average per capita measures. Measures of wealth suggest many middle-aged and older New Zealanders have adequate savings to enable similar levels of consumption in retirement as when they were working, but this may not be true for younger generations.
- Many New Zealanders have very unbalanced portfolios of savings. Low stocks of wealth can be caused by low saving levels or poor investment decisions.
- There are many reasons for people to save and accumulate assets other than retirement. While households' choices between spending their money earlier in life and accumulating higher levels of wealth should largely remain private, they are influenced by current government policies and expectations of future government policies. Low savings make households vulnerable to individual shocks or to national-level shocks that force changes to government policies. Tax policy can change the incentives to delay consumption, and can affect the types of assets New Zealanders choose to accumulate.
- Compared to most OECD countries, New Zealand has a small mandatory retirement saving scheme, and provides relatively few incentives for voluntary saving. The SWG is not opposed to this overall framework, although it is investigating whether the differences between New Zealand's approach and the approach on other countries is responsible for our saving levels and asset composition. If this approach is continued, however, there are some modifications that would likely improve saving levels and the mix of assets that are accumulated.
- The pros and cons of making KiwiSaver compulsory. Would compulsion increase national savings? Evidence from Australia suggests it might, at least to some degree. Putting in thresholds (eg compulsory only for those above a certain income level or age) could ameliorate some of the major concerns with compulsion.
- "Soft compulsion" (such as the automatic enrolment of everybody with a choice to opt out) is another option.
- How would compulsion fit with New Zealand Superannuation?

- There are no rules on how KiwiSavers should withdraw their savings in retirement, and there is a shortage of suitable investment products for retirees who are not financially savvy. Should the government issue tax-free, inflation-indexed bonds with, say, a 2% real rate of return, so that individuals can inflation-proof their own retirement investments. Or should there be an option for individuals to use part of their KiwiSaver funds to buy a higher level of NZ Super? Or should the government provide annuities, on a full-cost basis, to remove the risk of institutional failure?
- There are some serious disincentives to save. How can these be removed or mitigated?
- A number of important KiwiSaver-related issues, including fees and costs, the whole question of disclosure, more effective regulation, investor confidence, lower-cost options and additional default options. How can the efficiency of the process and structure be improved and the returns to savers increased?
- New Zealand Superannuation can be paid from government savings ("save as you go") or from current tax revenue ("pay as you go"). The SWG is looking at the advantages and disadvantages of both and how to improve the balance between the two. Public or private savings could also help address future health costs, as is being done in Singapore.

The SWG also favours at least some inflation-indexation in the taxation of income from savings and an extension of tax rates applying to the current PIE regime. Lower taxes on saving may not have a large effect on the total quantity of savings, but should materially improve the allocation of saving across different classes of investment.

- Financial literacy affects both the quality and quantity of savings. The SWG encourages further work and better coordination in this area.

Tax

- Income can be taxed when it is earned ("income taxes") and when it is spent ("expenditure taxes"). The difference largely concerns the way the returns to savings are taxed. Compared to expenditure taxes, income taxes tax the returns to saving more heavily and provide an incentive to select tax-advantaged investments such as owner-occupied property. New Zealand provides fewer opportunities to have savings taxed on an expenditure basis than most other OECD countries. Thus, while New Zealand's broad based, low rate tax system has many advantages, it provides greater disincentives to save than most other OECD countries.
- The tax system has many anomalies and distortions – the wide variation in effective marginal tax rates on various forms of savings is an important example. For example, differences in effective marginal tax rates strongly favour owner-

occupied housing and investment housing. Simple savings products, such as bank term deposits, are seriously penalised. These distortions, and their associated bias in market pricing signals, need to be reduced, although this does raise wider issues for the tax system. It is important that the tax system is oriented to the best outcomes for the economy and the community.

- Further shifts over time towards expenditure taxation (GST) and away from income tax are favoured because of the resulting improved incentive to save. This would include compensation for those most adversely affected.
- The SWG also favours at least some inflation-indexation of taxes on savings as well as an extension of tax rates applying to the current PIE regime. Lower taxes on saving may not have a large effect on the total quantity of savings, but should materially improve the allocation of saving across different classes of investment.
- The SWG does not support the adoption of a full Nordic system since a move towards the desired outcome can be achieved in other ways.
- In most countries, earnings on retirement savings are tax-exempt, but not in New Zealand. This taxation of returns on retirement income over time heavily cuts back the returns to saving. The SWG considers that there should be a close examination of this issue, in a more comprehensive policy context.

State sector management

- Lifting the growth rate of productivity in the government sector, both central and local, would increase government savings and help cap the growth of public debt (and therefore national debt). Doubling productivity growth, from its present low level would halve the level of government debt by 2050, while delivering the same volume of services. A considerable amount of work is already under way on this issue, but real progress will depend on astute and effective leadership, which is not always evident.

- The information provided in the government's recently released *Investment Statement* is designed to lead to better management of the state's public assets and liabilities and may produce a more effective allocation of assets. As local government holds roughly the same value of assets as central government, a similar process there could improve that sector's capital management.

Faster return to surplus

- The SWG urges government to increase its savings sooner than signalled in Budget 2010. Faster fiscal consolidation will more quickly build a buffer against future shocks and reduce vulnerability, discourage growth in low-value spending, and will help to lower both interest rates and the exchange rate.

- In the Treasury's long-term fiscal projections, the cost pressures from the ageing population and rising health spending are growing, the window for changing policy settings is closing and the no-change option is not viable. Younger New Zealanders should understand this and also not bank on house-price booms to lift their net wealth.

Process

- Over 30 submissions have been received and all of the significant points raised will be addressed.
- The submissions and a lot of other material are on the SWG website. http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/index.htm
- The final report will be completed by 31 January.

Secretariat

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