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Does KiwiSaver improve the unique New Zealand mix of retirement policies?[1]

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Abstract

New Zealand has enjoyed a very simple set of retirement policies that, to date, have proved effective in preventing poverty in retirement. A universal, wage-linked, basic income is paid to everyone from age 65 who meets a minimal residency criterion. Beyond that, there are no tax incentives and no compulsion for the accumulation of retirement savings and consequentially there are few onerous regulations. The theory has been that tax neutrality in the treatment of saving is the most economically efficient. The practice has been an ongoing programme of tax reform designed to ensure tax neutrality in financial saving is actually achieved. Educated and fully informed individuals are supposed to exercise choice and save in ways that are the most beneficial both to them and consequentially to the economy. In an apparent loss of faith in this purist philosophy, and an apparent concern about the high Current Account Deficit, the New Zealand Government has recently announced that a new work-based savings scheme, KiwiSaver, will be introduced in 2007. The concern has been that too many people do not save enough, and that they need motivation to save more. While there will be no tax incentives of the kind customary in other jurisdictions, the government will contribute a lump-sum of $1,000 to each KiwiSaver account, and will subsidise the membership fees. KiwiSaver has many elements of choice built into its design, drawing on theories of behavioural economics and the notion of the fully informed investor. This preliminary assessment analyses the genesis of KiwiSaver and outlines some concerns of theory and practice with this new initiative.

1. Introduction

New Zealand has enjoyed a very simple set of retirement policies to date. More recently, the New Zealand Government has indicated a concern about both national saving and individual saving. Arising from this concern, a new work-based savings scheme, KiwiSaver, will be introduced in 2007. KiwiSaver has many elements of choice built into its design, drawing on theories of behavioural economics and the notion of the fully informed investor. This paper outlines how KiwiSaver fits in the overall retirement policy mix and outlines some concerns in theory and practice with this new initiative.

2. Retirement income provision in New Zealand

New Zealand has taken an unusual path both internationally and in comparison with Australia. Compulsory private saving has been eschewed with a universal flat-rate state pension at a level significantly above welfare benefits forming the basis of retirement income. In the terminology of the World Bank, New Zealand has a very successful first pillar that largely meets the poverty prevention goal, no second pillar of either earnings-related pensions or compulsory private saving, and a purely voluntary, non-subsidised third pillar. It is into this environment that KiwiSaver will be introduced in 2007.

Public provision

The parameters of New Zealand Superannuation (NZS) are set out in Part 1 of the New Zealand Superannuation (and Retirement Income) Act 2001. While the retirement income system in New Zealand has been subject to intense political debate over many years, the Act now enjoys wide political support. Its significance is that it provides legislative support for the continuance of a universal pension at age 65 at a rate for a married couple that does not fall below 65% of the net average wage.[3] There are minimal residency requirements of 10 years' residency since the age of 20 years and not less than 5 years' residency since attaining the age of 50.

Each person is taxed on total gross income including the gross pension, providing some degree of income testing. With mildly progressive income tax rates, (see Table 1) the top income pensioner effectively receives a pension worth approximately 72% of the pension of the lowest income pensioner.

[3] Policy is often referred to in summary as '65 at 65'.

Box 1 Rates of New Zealand Superannuation

The calculation basis

- The net rate of payment for a couple is legislated to be within the band of 65% and 72.5% of net Average Ordinary Time Weekly Earnings averaged for male and female (AWE).
- The rate for a single pensioner who shares accommodation is 60% of the married rate, or a minimum of 39% of AWE. The rate for pensioners living alone is 65% of the married rate or a minimum of 43.25% of AWE.
- Each year there is an annual adjustment to reflect movements in the Consumer Price Index, unless the floor of 65% is breached at which point wage indexation restores the floor.

Weekly Rates as at April 2006

Pension type	gross	After tax at ordinary rate
Single- living alone	$320.13	$283.90
Single- sharing	$294.37	$243.60
Married couple	$243.06	$203.00

Source: www.winz.org.nz

The attractive and/or unusual features of New Zealand Superannuation (NZS) are:

- Each person over 65 receives the pension in his or her own right. While there are different rates depending on marital status, each individual is taxed as an individual and there is no account taken of a spouse’s income. The pension is gender-neutral and non-contributory and thus recognises both paid and unpaid contributions to society. Women in particular have been advantaged (St John, 2005b).
- The payment is indexed to living standards by the provision of a floor-related to average wages so that protection is afforded not only for inflation but also for a growth in living standards generally. For New Zealanders of modest means and with limited lifetime earnings, New Zealand Superannuation provides a replacement income sufficient in most cases to keep pensioners out of the poverty statistics.[4]

[4] Using the Ministry of Social Development’s definition of the poverty line, 51.2% of economic units supported by an income-tested benefit are in poverty but only 7.6% of those reliant on New Zealand Superannuation (Ministry of Social Development, 2005).

- The pension is very simple to understand and apply for. Administration costs are minimised and there are no inherent disincentives to work, save, retire early or disguise (or dispose of) assets because the pension is not means-tested.
- The general tax base is wider than wage income, as it includes taxes on investment income and on consumption. Thus some of the burden of the PAYG scheme is spread from the working age population to include tax contributions from the old as well.

In terms of sustainability, the net cost of paying New Zealand Superannuation is currently 3.6% of GDP and expected to increase to around 7.5-8% of GDP by 2050.[5] While the fiscal pressures of an ageing population are real, the size of the problem seems modest in comparison with other OECD countries many of whom already who face much higher pension/GDP ratios.

Additionally, other countries provide subsidies in the form of tax expenditures for private provision that are not reflected in their pension/GDP ratios. Ireland for example has a regime of tax expenditure for retirement incomes that if counted as part of the state's pension costs for 2000/1 would increase the pension/GDP ratio by 1.7 percentage points (Hughes, 2005). Thus it may be argued that the lack of tax incentives assists in the affordability of the relatively generous, tax-funded, universal New Zealand Superannuation.

The New Zealand Government partially prefunds NZS by allocating part of the fiscal surplus each year to the New Zealand Superannuation Fund. The Fund will partially smooth the increase in tax required over time and begins to be drawn down from approximately 2028. Contributions are determined each year on a forty year rolling horizon so that, with higher returns, contributions can be lower. The Fund began investing in September 2003 with $2.4 billion in cash.

> *As at 31 May 2006 the Fund's assets stood at $9.8 billion, and are expected to grow to around $120 billion by 2025, making it one of the largest funds in Australasia. (http://www.nzsuperfund.co.nz/)*

The Fund is managed at arms length by a board of appointed 'Guardians' of the Fund who use professional fund managers to invest the money both domestically and abroad. This precludes the government using the Fund for other purposes or directing the portfolio mix. To date there have been no major controversies over the governance of the Fund with a clean bill of health pronounced in late 2004 in the first audit of the Fund (Eriksen, 2004).

In the mid 2000s New Zealand is enjoying a period of unprecedented political stability round superannuation policy, in no small part due to the success of the Fund and the emerging political consensus around the New Zealand Superannuation Act.

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[5] See http://www.retirement.org.nz/

Private provision

New Zealand has a simple system of voluntary, unsubsidised supplementary provision for retirement saving. In theory, an individual is free to save in any way that is appropriate, whether that be in acquiring equity in housing, repaying debt, investing in financial assets or in education.

The tax reforms in the late 1980s that gave rise to this system were designed to treat all saving in the same way as it would be treated if the money were placed in a bank. On this basis, contributions are out of after-taxed income, earnings are taxed in the fund at the marginal rate of the investor, and when withdrawn, savings are capital and thus tax free. This bank model treatment is known as Taxed/Taxed/Exempt (TTE).

While a personal flat income tax was also to be part of the reforms, it never eventuated. Instead, the tax regime has four effective marginal tax rates for earners as shown in Table 1. Employer contributions (under a withholding tax called SSCWT) and superannuation fund earnings have been taxed at 33% making the regime tax relatively penal for anyone on only a 21% tax rate.[6]

Perversely however, significant tax advantages from saving in employer-sponsored schemes for high-income superannuation fund members were introduced when the top personal tax rate was lifted to 39% in 2000. Nevertheless the ‘salary sacrifice’ option for high-income earners to exploit these advantages was not widespread. The Taxation (FBT, SSCWT and Remedial matters) Act 2000 imposed a fund withdrawal tax (FWT) to reduce the attraction for high-income people to use superannuation vehicles as a short term means of avoiding the 39% rate.

In another tilt to the playing field, superannuation funds have to pay tax on capital gains where such funds are deemed to be trading rather than ‘passive’. Individuals who invest on their own account usually do not pay such a tax, in practice, if not in law. In 2004, a report commissioned by government to determine an acceptable tax treatment of investment in New Zealand recommended the removal of capital gains tax on non-passive managed funds to address this anomaly (Stobo 2004). The Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill 2006 currently before the House seeks to address this issue.

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[6] However some middle income earners whose marginal tax rate is effectively much higher than 21% due to the abatement of family assistance payments, and income-tested benefits (including students whose obligations in respect of student loan repayments are also income-tested) are actually favoured in this regime.

Table 1: New Zealand Tax Schedule for Personal Income Tax

Bracket	Effective marginal tax rate* 1988-1996	Effective marginal tax rate* from 2000
$0-9,500	15	15
$9,501-30,895	28	21
$30,895-38,000	33	21
$38,001-60,000	33	33
$60,000+	33	39

Note that the statutory rate of 19.5% for incomes $1-38,000 is modified by the low income rebate.

Despite the best endeavour of a working party (TOLIS, 1997) to resolve the marginal tax rate issues, there were no easy answers. In 2004 a partial solution was introduced so that employers could use the marginal tax rate of the employee for the tax on employer contributions. The option was voluntary and did not address the over-taxation of fund earnings for employees on tax rates of less than 33%[7].

In 2005 it was announced that schemes could also, if they chose, impute investment income to individual members, but again this was voluntary and could not easily apply to defined benefit schemes. The Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill before the house in 2006 also attempts to address this problem. Taxation of Portfolio Investment Entities (PIEs) will use a proxy rate of 19.5% for those on incomes of under $48,000 and 33% for other members[8]. However, there are compromises and complexities in finding the average proxy rate in this manner. At present, it is not clear whether the proposed legislation will be passed in its current form.

The New Zealand experience shows that the pursuit of tax neutrality in the treatment of savings has not only been difficult to achieve in the absence of flat tax, but is also illusory when other savings vehicles such as housing are taken into account. Significant biases towards investment in housing arise from the non-taxation of the imputed rent in owner-occupied dwellings, the tax-free nature of most capital gains by individuals deemed not to be traders, and the tax regime for rental property income that allows deductibility of full nominal mortgage interest and other write-offs such as depreciation.[9]

New Zealanders have proportionately more of their savings tied up in housing than in other countries (Skilling & Waldegrave, 2004). Since the tax changes in 1990, the value of housing assets has increased markedly relative to net financial assets as shown in Figure 1 (Bollard, 2004)

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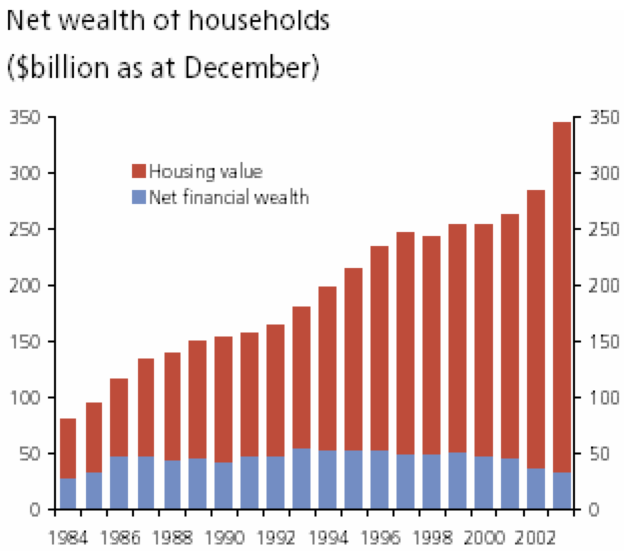
[7] Anecdotally it appears that, employers have not used this option.

[8] See the submission on this aspect from the Retirement Policy and Research Centre (St John & Littlewood, 2006)

[9] Though the depreciation claimed may eventually become taxable on the sale of the rental property.

Figure 1: Net wealth of households ($billions as at December)



Source: Reserve Bank of New Zealand (2004).

Nevertheless it should be noted that this picture is somewhat misleading as it nets off financial liabilities, including those related to housing, from financial assets. The Reserve Bank's numbers as of 31 December 2005 in Table 2 show the position more clearly:

Table 2: Household assets, liabilities and wealth as % of personal disposable income – 1979 to 2005

	1979	1989	1999	2005
Gross financial assets	138%	156%	182%	181%
Financial liabilities	n.a.	n.a.	15%	22%
Net financial assets	n.a.	n.a.	167%	159%
Gross housing assets	192%	259%	337%	567%
Housing liabilities	n.a.	n.a.	93%	137%
Net housing assets	n.a.	n.a.	244%	430%
Net wealth	282%	360%	411%	588%
% p.a. increase since 1979	-	2.5%	1.9%	2.9%

Note - The financial liabilities for 1979 and 1989 were not divided between housing liabilities and other liabilities. Total financial liabilities were 48% of disposable income in 1979 and 55% in 1989. Equivalent numbers in 1999 were 108% and 159% for 2005 (up from 146% in 2004).

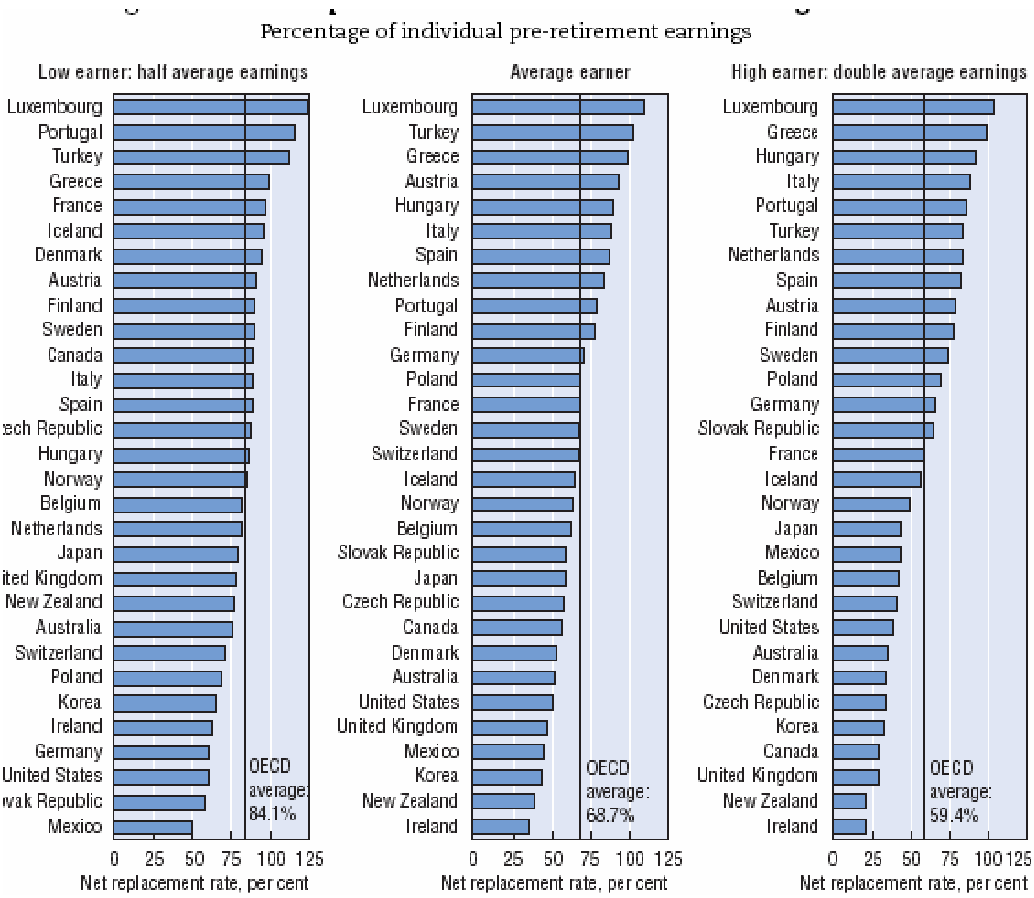
While the OECD has consistently endorsed the New Zealand approach to tax reform, it has criticised the lack of a capital gains tax. Those who trade assets, in theory, must pay tax on the gains, but there has there been little attempt to enforce this particularly for residential assets. Despite the best endeavours of the McLeod Committee that discussed advantages that might flow from a Risk-Free Return Method (RFRM), there has been no political interest in levelling the playing field for housing (McLeod, 2001).

3. The New Zealand model in international context

Currently, the implicit policy goals of New Zealand's retirement policies do not include an income replacement objective for middle income New Zealanders. The New Zealand scheme has been particularly successful enabling people with no other saving to feel they can participate and belong to society. Implicitly there has been a judgement, at least until the recent moves on KiwiSaver, that any additional income provision for retirement should be entirely a private matter. In most other OECD countries, income replacement is a much more explicit goal, both in state schemes and in additional private pensions.

The OECD (2005b) compared the 'pensions promise' across the OECD. This includes not just the public pensions provided by the first tier and earnings-related PAYG schemes, but also mandatory, second tier saving. While the difficulties of such international comparisons are acknowledged, some conclusions about New Zealand's relative position can be drawn. Figure 2 shows the relatively high rate of replacement in New Zealand for low income earners in contrast to the low rate for middle and high income earners (OECD, 2005b).

Figure 2 Net replacement rates at different earnings levels



Source: OECD (2005b)

Low income earners, on less than one half average wages in New Zealand would fare even better in an international comparison, due the relatively generous flat rate state pension. However under current regimes, workers on average earnings in the OECD will receive about 69% net of their earnings on average, in contrast to only 39% in New Zealand (OECD, 2005a).[10] The replacement rates decline as income increases much more quickly in New Zealand than in other countries including Australia. It is likely that the picture understates New Zealand as an outlier as other countries have a much higher state involvement in the third pillar of additional private pensions. Generous tax concessions in both the second and third pillars are common in countries other than New Zealand but are not counted as part of pension expenditure.

4. Concerns about private saving

Review taskforces during the 1990s and 2000s supported the voluntary, tax unsubsidised retirement savings regime in New Zealand (Periodic Report Group, 1997, 2003; Report of The Taskforce on Private Provision for Retirement, 1992). Nevertheless, there has been widespread anxiety about whether New Zealanders are saving enough, both individually for retirement and as a nation. The decline in workplace schemes has been particularly marked with only about 16% of the labour force in an employment-based scheme of any kind in 2004 down from 23% in 1990 (Government Actuary, 2005).

A net worth survey in 2002 (Table 3) showed that mean assets for individuals over 65 was only $186,000 and the median was $113,000 so that the distribution is highly skewed (Statistics New Zealand, 2002). A similar picture (also Table 3) is shown for those in the pre-retirement group aged 45-64 so that New Zealanders appear less well prepared for retirement than their counterparts elsewhere.

Table 3: The net worth of those over 65 and those aged 45-64

Individuals Age	% Under $20,000	% $20,001-$100,000	% $100,001-$500,000	% Over $500,000	Mean $	Median $
Over 65	15.9	29.6	47. 3	7.2	186,400	112,800
45-64	14.5	25.5	50.8	9.2	220,900	140,000

Source: Statistics New Zealand *(2002), Table 9.01*

Some preliminary Treasury research has argued however that, given the substantial wealth implied by the New Zealand Superannuation pension itself, *on average*, people are likely to already be saving enough for optimal income smoothing (Scobie, Gibson, & Le, 2004) The

[10] It should be noted that the OECD takes the living alone rate for the NZ calculations.

results are tentative and based on limited data. Also, they are based on averages and rely on particular definitions of what constitutes savings and a range of assumptions such as perfect annuitisation of financial savings[11]. They do not, however, endorse the popular view that people are not saving enough for retirement and raise the concern that it may be suboptimal to force or cajole extra saving in order to make people better off in retirement than they are now.

Reflecting concern about private saving during the early 2000s, there were many discussions and reports about the basis on which private savings should be taxed (St John, 2005a). A major, concurrent review of the tax system examined the case for tax incentives in depth, and recommended that they not be reintroduced (McLeod, 2001). A report of officials noted that it was difficult to ascertain the exact goals government wanted to achieve and that none of the options being examined were able to meet all the objectives the government sought (The New Zealand Treasury, 2001). As in the past when tax incentives have been considered, it has been difficult not to conclude that the advantages are likely to go to the people who least need an incentive to save, and that overall savings are unlikely to be enhanced. The skewed distribution of financial saving persuaded the committee that tax concessions would be both highly regressive and ineffective (The New Zealand Treasury, 2001). International evidence also shows that incentives greatly influence the composition of savings but probably do not increase national saving.[12]

In 2002, the Labour government endorsed the status quo of no upfront tax incentives.

> *The government is not considering upfront tax incentives. These are likely to have to be very large - with fiscal costs running to many hundreds of millions of dollars a year - before they have any desirable effect on overall savings. Their abolition in the mid-1980s represented sensible tax policy on both equity and efficiency grounds. (Minister of Finance, 2002a)*

Along with a sharp decline in occupational schemes generally, 'total remuneration' packages became more common in the 1990s. In these, income is grossed up and the employee chooses the nature of the savings instrument and how much to save in it, while the employer's role may be limited to facilitation and/or administration only. However, the Minister of Finance signalled some dissatisfaction with this approach portending changes discussed below:

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[11] The report assumed that the main home would be passed on to the next generation as an inheritance.

[12] See, for example, A report by the Pensions Policy Institute (UK) for Age Concern, October 2004 at http://www.pensionspolicyinstitute.org.uk/news.asp?p=95&s=2&a=0

> *I do detect a change of attitude. The 1990s were a high watermark for individualism. A part of that was the rise of the idea of the total remuneration package. Employers recruited on a set fee for service and the worker did what he or she decided they wanted to with the wage. While this is fine in theory, there is a growing body of research that suggests that the hands-off approach works against some of that total remuneration going into long term saving.(Cullen, 2003)*

New initiatives for private provision

In the state sector itself, a new 'State Sector Retirement Savings Scheme' commenced in 2004 as a portable defined contribution scheme in which the government as employer matches contributions up to a net 3% of gross salary. There is a wide choice of investment styles, risk/return options and fee structures.

Employees of government departments and teachers who are not part of an existing employer-subsidised scheme may join.[13] By 2004, the take-up by more than 45% of eligible employees had surpassed expectations, raising the possibility that the scheme would be extended to other public sector employees.

In mid 2004 the government appointed a working group to report on the design of a generic workplace savings product. It was taken as given that it was desirable to have such a product even though there were to be no tax incentives involved (Savings Product Working Group, 2004). Submissions were invited on the group's recommendations and many of these questioned the need for such a product. There were many difficult issues, such as whether there should be automatic enrolment, how part-time and casual workers might be included, rules around early withdrawal, management and approval of schemes and how all this could be achieved in a tax neutral environment.

While the working group assumed that the government would not introduce any tax incentives for the generic product, it was clear that 'sweeteners' as they were called in the report were likely to be necessary[14]. Private providers argued that any such incentives would undermine existing employment-based schemes and would be a costly mistake, both ineffective in substantially increasing saving and cumbersome to administer.

[13] Existing schemes that were set up to replace the old Government Superannuation Fund scheme will integrate over time with the new scheme.

[14] In substance, the difference between a 'sweetener' and a 'tax incentive' reflects the lump sum nature of the former. Both come effectively at the cost of higher taxes for all, including non-savers.

5. KiwiSaver

The 2005 budget finally announced a work-based generic scheme, the KiwiSaver, to be introduced in 2007 (see Box 2). This scheme is based on the premise that people are more likely to commit to saving regularly if they are automatically enrolled rather than deciding whether to opt in.

What are the goals?

When KiwiSaver was first announced, the problem was seen to be one of low national saving. New Zealand is heavily reliant on foreign saving with persistently large current account deficits and accumulated overseas debt.[15]

> *[The CAD], and a range of other indices, point to a low level of household savings in New Zealand. We are left highly dependent on foreign capital, which means a substantial proportion of our national income is reclaimed by foreigners as theirs. Hence our Gross National Product is significantly less than our Gross Domestic Product. New Zealanders often bemoan the consequences of low saving, such as high levels of foreign ownership. But, if we are to own, literally, more of our future we must lift our level of savings.* (Budget Speech, 2005).

However it was not clear that the KiwiSaver was capable of lifting national saving.[16] By the time the Bill was introduced, there was little mention of the problem: The Bill is introduced thus:

> *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 individuals' well-being and financial independence, particularly in retirement. KiwiSaver is designed to complement New Zealand Superannuation (NZS) for those who wish to have more than a basic standard of living in retirement.*

Only on p36 was there a reference to the hope that national saving will improve:

> *If the behavioural changes flow through into increased domestic saving, then economic growth may increase as more funds may be available to fund domestic investment and reduce New Zealand's reliance on borrowing offshore.*

[15] The March 2006 figures suggest that New Zealand is heading towards a CAD of 10% of GDP, net overseas liabilities are 86% of GDP (http://www.stats.govt.nz/).

[16] The best thing that the government has done to improve national savings is to staunchly run surpluses during the upswing of the last six years.

Box 1 KiwiSaver Design

- KiwiSaver is a voluntary, work-based savings scheme administered by the Inland Revenue Department using the existing PAYE (pay as you earn) tax system. Employees will be automatically enrolled into KiwiSaver when they start a new job. They will have six weeks to 'opt-out' and must advise Inland Revenue of their decision. Scheme enrolment is not automatic for workers under 18, or for existing employees. They will be able to join if they wish. Self-employed people and beneficiaries will also be able to join but need to make payments directly to Inland Revenue.

- Employees' contributions will start from the next pay day after 11 weeks with an employer. Deductions from wages are at a rate of 4 percent of gross pay, unless the individual opts for the higher rate of 8 per cent. These are held by Inland Revenue for an initial three month period during which the employee can seek financial advice and select a fund provider. Savers will be able to select their own fund and can change fund providers, but can only have one provider at any time. Those who do not specify a fund will be randomly allocated to a default provider.

- Savings are primarily for retirement and 'locked in' (i.e. will not be accessible) until the age of eligibility for NZ Superannuation, currently 65, except in cases of: financial hardship, permanent emigration, or after a minimum of three years, to contribute toward a deposit on a first home. However savers can stop contributions for up to five years at a time by applying for a 'contributions holiday'. Contributions resume at the end of the five years unless the individual applies for a further 'contributions holiday'.

- Employers do not have to (but may) choose a 'preferred' KiwiSaver scheme for their employees but will have responsibility for deducting employees' contributions and forwarding them to Inland Revenue along with PAYE.

- Existing superannuation schemes will have the option of converting to KiwiSaver, subject to certain criteria. Members of other schemes may choose to open a KiwiSaver account, instead of or as well as, their existing scheme.

- The automatic enrolment provisions will not apply in workplaces where the employer is already running a work-based scheme, provided the scheme is: portable open to all permanent employees, and has a total contribution rate (employer plus employee) of at least 4 per cent. The employer's scheme has to obtain 'exempt' status.
- The Government will: make an upfront contribution of $1,000 per saver, to be locked in until the recipient reaches the age of eligibility for New Zealand Superannuation or for five years, whichever is the greater; provide a fee subsidy; after three years of saving, offer a first home deposit subsidy of $1,000 per year of membership in the scheme, up to a maximum of $5,000 for five years subject to an income test.

Source: derived from http://www.ird.govt.nz/kiwisaver/summary/

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In information released on the detail on KiwiSaver, there seemed to be some recognition that middle income people were not well catered for in the simple New Zealand system as is also suggested by the OECD data (see Figure 2):

> *Saving and investing is the foundation of the future wealth of New Zealanders as individuals and as a country. While New Zealand Superannuation (NZS) provides a base level of income, middle income New Zealanders will have to provide for their own savings to avoid a potentially significant drop in income during retirement.*

KiwiSaver however does not ensure extra *income* for middle income New Zealanders, as it is a lump sum scheme. It will not have much impact on the imminent baby boomer's retirement nor, indeed, can it be expected to increase aggregate national saving.

Confusingly, KiwiSaver is also intended to achieve social objectives for first home buyers as detailed below. Thus there are two goals and they may be contradictory.

A flat $1,000 government contribution is provided as set out in Box 1. This 'sweetener' limits the problems of the regressivity of tax concessions and enables the TTE tax regime to remain largely unaffected.

The consultation phase

Draft legislation is currently under review, with passage of the Act expected in October 2006 and full implementation in April 2007. Many concerns were raised in the select committee hearings: Among these are several themes that relate to choice and the administration of the KiwiSaver schemes:

The Association of Superannuation Funds of New Zealand (ASFONZ) [17] for example noted:

- **Number of default providers:** It is expected that there will be only 4-6 default providers. ASONZ expressed the view that this might "allow the government bargaining power to negotiate administration fees down to a level that will provide a barrier to entry to non-default providers". ASFONZ stated that, if this is the case, "driving fees to an uncompetitive level may force default providers to cross-sell aggressively to justify a product that in itself does not meet the necessary return to the providers' shareholders."

- **Dual goals**: the concepts of retirement saving with saving for a first home are likely to be confusing.

- **Contributions rates:** There are only two choices for the contribution rate, 4 and 8% of an employee's taxable pay. More choice here would arise from one rate of 4% with an alternative that saw contributions increasing gradually over four years. Allowing the increasing contribution to come out of future pay rises also accords with the principles of behavioural economics on which the Bill is founded.

- **Exempt employer**: Criteria for an employer to become an 'exempt employer' are restrictive and if they remain in their current form, may result in a decline in the participation in and operation of workplace savings arrangements other than KiwiSaver.

The industry (ASFONZ) also believes that KiwiSaver may lead to: reduced employer-subsidised superannuation provision (including the winding up of current schemes); costly administering thousands of inactive accounts with less than $3,000 to their credit; reduced provider choice as smaller providers that fail to obtain 'default' status withdraw from the market; barriers to entry for new providers in the face of large, favoured, incumbent default providers; higher costs for other superannuation-related services (voluntary member savings, employer subsidies, insurance and advisory services) as providers seek to recover costs from loss-making KiwiSaver accounts (Association of Superannuation Funds of New Zealand, 2006).

Choice and the KiwiSaver

New Zealanders can exercise choice at several levels in KiwiSaver:

- First, they have the fundamental choice of opting out as this is a voluntary not a compulsory scheme.
- They have the choice of 2 levels of contribution.
- They can take contributions holidays for five years at a time.
- They may cash in their saving for a first home, if they qualify.
- They can choose their provider.
- They can choose their investment strategy.
- They have complete freedom of choice as to what to do with the lump sum at age 65.
- If their employer offers an employment based scheme that is exempt they do not have to belong to both. (The industry does not however expect that many employers will seek exempt status)

New Zealand's public policy on KiwiSaver has been influenced by the results of studies from the US based on behavioural finance[18]. These studies show that most employees do not understand what decisions to make about saving schemes (whether to join; how much to contribute; what investment strategy to choose).[19] Too much choice is seen as preventing employees from making any decisions, let alone making appropriate decisions. The research typically shows higher rates of joining if employees are guided to join; to pick a 'realistic' contribution level and an 'appropriate' investment strategy – but then to give employees the opportunity to change those decisions. The research typically shows that employees tend not to move away from the default selections.

The applicability of such studies to New Zealand is unclear. In the US, it is not hard to demonstrate that an employee who does not join a scheme will be worse off financially than one who does. That is particularly the case where the employer subsidises contributions to the scheme, as is often the case. If the employee did not join, (s)he would miss out on a piece of the available remuneration. Despite that, many make the seemingly irrational decision not to join or, more accurately, fail to make the decision to join.

New Zealand on the other hand has none of the generous tax concessions available in the US, nor are schemes always employer subsidised. There is to be no requirement for employers to subsidise their employees' contributions to KiwiSaver (as has been recommended for the equivalent arrangement in the UK[20]). In fact, the only subsidies will come from taxpayers in the shape of the 'sweetener' (the opening $1,000) and on-going administration fee subsidies.[21]

All who chose to join or who fail to opt out must contribute for a 12 month minimum period. While it is reasonable to require the 12 months' contributions for savers to be entitled to the $1,000 government contribution, the process may accidentally capture some who should have opted-out. It will be too late to make that choice after the 6 week opt-out period and once the contributions have been deducted (starting after 11 weeks).

managed funds is desirable either from an individual or a societal point of view is debateable.

[18] See, for example, Mitchell and Utkus (2003).

[19] One of the reasons the decisions seem so complex in countries like the US is the plethora of rules created by increasingly complex tax and regulatory environments. That is a problem New Zealand savers do not face.

[20] The report issued by the UK Turner Commission recommended that, if employees join, they must contribute the equivalent of 4% of their pay above a threshold and the employer must then contribute 3% to a new "National Pension Savings Scheme". A benefit worth about an additional 1% of pay will come from tax relief (Pensions Commission, 2005).

[21] The government has estimated that *KiwiSaver* will cost about $167 million in each of the first three years (0.1% of GDP) and $100 million a year after that (*Budget 2005 Savings Package: Work Based Savings Scheme*, Budget paper 6 April 2005). No survey work has been done on the likely take-up or on-going cost.

Many potential low income contributors have significant debts including student loans and mortgage debt. While contributions holidays are possible, these add a further raft of complexity. The government will subsidise fees but whether saving minimal contributions in

Once the initial 12 month contribution period to qualify for the government's subsidy has been completed, New Zealand's tax treatment of savings means that it will make financial sense for all employees with any kind of personal debt to stop contributing as soon as possible. That raises the potential of hundreds of thousands of dormant accounts with, perhaps, less than $3,000 in contributions.

6. Discussion

It is too early to assess KiwiSaver but some speculative comments can be made. The attractive features of KiwiSaver include its portability and relatively low employer compliance costs. But employers do not have to contribute so that the KiwiSaver may be no better than a low return bank deposit for many low income savers.

Under the tax-neutral TTE regime, an employee is almost always better off repaying private debt, such as house mortgages (where, again, there are no tax preferences for interest payments) rather than saving through an employment-based scheme. The only exception to this general rule is where the scheme is subsidised. That is relatively uncommon in New Zealand. So, it should be possible to measure the financial loss to employees each year by joining KiwiSaver rather than repaying debt.

Unsophisticated investors may struggle to exercise choice appropriately. The role for advisors and precisely who has fiduciary responsibility are as yet unclear, although the employer is absolved in its role. The scheme is best described as 'soft compulsory' with the compulsion limiting choice rather than enhancing more rational behaviour.

KiwiSaver may be good for some employees but that will come at a large cost to employers, financial service providers and taxpayers. KiwiSaver may attract many members who join just for the up-front $1,000 taxpayer-provided subsidy, then go on a perpetual contribution holiday leaving taxpayers to pay the administration fees for inactive KiwiSaver accounts. While this may be good business for financial service providers, there is a possibility that KiwiSaver may be a retirement saving failure like equivalent schemes in the UK (Stakeholder Pensions) and Ireland (PRSAs)[22].

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[22] Despite very generous tax incentives in both countries. *KiwiSaver*, by contrast, proposes an extremely modest "sweetener".

Nevertheless, the scheme has avoided the worst of tax concessions, and there is some indication that some employers will contribute if not match employee contributions. The impact on existing schemes is unclear however, and the offsets that will occur suggest there will be little new saving and little impact on the national saving problem itself. Whatever the emerging problems KiwiSaver encounters, it is unlikely that even eventually making it fully compulsory would solve any of these problems. To make KiwiSaver compulsory would also raise a raft of difficult administrative problems, around who should be exempt from the scheme, what earnings would be covered, and what the role of the employer would be.

The lingering concern about KiwiSaver is both a failure to define clearly what KiwiSaver's objectives might be along with a seeming reluctance to discuss the policy issues related to its introduction. Those gaps may create further uncertainty and change rather than settle the debate about private provision for retirement.

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