THE UNIVERSITY OF AUCKLAND
BUSINESS SCHOOL

Retirement Policy and Research Centre

Pension Policy Research Group

School of Business, Aras an Phiarsaigh

Trinity College Dublin

KiwiSaver

The first three years: lessons for Ireland?

2 June 2010

Susan St John, Michael Littlewood, Claire Dale[1]

Working Paper 2010/2

Retirement Policy and Research Centre

Economics Department
Business School
The University of Auckland
Private Bag 92019
Auckland, New Zealand
www.rprc.auckland.ac.nz

1. Associate Professor Dr Susan St John and Michael Littlewood are co-directors, Dr M.Claire Dale, Research Fellow, of the Retirement Policy and Research Centre, the University of Auckland, with assistance from Andrew Familton, RPRC.

Table of Contents

1. Introduction 3
2. The New Zealand pensions framework: 5
  2.1. Background 6
3. KiwiSaver: 2007-2010 8
  3.1 KiwiSaver I 8
  3.2 KiwiSaver II 9
  3.3 KiwiSaver III as at March 2010 11
4. The underpinning theory 15
  4.1 Influence from the US behavioural studies 15
  4.2 Investment fund strategy- the default option 16
  4.3 Default strategy and the savings environment 16
5. KiwiSaver design 16
  5.1 Soft compulsion 16
    5.2 Exempt employers 17
  5.3 Role of incentives 18
  5.4 Choice and competition 19
  5.5 The default schemes 19
    5.5.1 Default scheme rules 20
    5.5.2 Effect of default settings on members 20
  5.6 Fees and returns 21
  5.7 Lock-in 23
    5.7.1 First home 23
    5.7.2 Contributions holidays 24
    5.7.3 Mortgage diversion 24
6. Assessing the KiwiSaver experience 24
  6.1 Distributional effects of KiwiSaver: 24
    6.1.1 Impact of inflation 25
  6.2 Financial knowledge 26
  6.3 Aggregate effects on saving 26
  6.4 Income or lump-sum? 28
  6.5 Implications for New Zealand Superannuation 28
7. KiwiSaver: lessons from the first 3 years 29
  7.1 Confused objectives 29
  7.2 Constant change 29
  7.4 Distributional concerns 29
  7.5 Why children? 30
  7.6 Too many providers? 30
  7.7 Too little regulation? 30
  7.8 Calls for compulsion 31
  7.9. Choice, default and opt-out 31
  7.10 Auto-enrolment 31
  7.11 Housing 32
  7.12 Mis-application of lessons from studies on behavioural finance 32
8. The lessons in summary 33
References 34

1. Introduction

KiwiSaver is the world's first auto-enrolment opt-out national saving scheme. It runs alongside New Zealand's basic universal Pay As You Go (PAYG), partially prefunded pension, New Zealand Superannuation (NZS). The design, implementation and outcomes of KiwiSaver are of potential interest to countries such as Ireland and the UK that are implementing similar schemes.

KiwiSaver was introduced in July 2007 and in 2010, after its first three years, is being hailed in many financial circles in New Zealand as a great success:

> *KiwiSaver has proved to be a huge success, far beyond the Government's expectations. At the end of March [2010] the scheme had a phenomenal 1,369,609 members, net of opt outs and closures, compared with the Treasury's projections of 680,000 members by June 2014.* (Gaynor, 2010)

Other commentators have been similarly adulatory, with few, if any, arguing for a reversal of policy or questioning the fundamental design of KiwiSaver:

> *NZ Superannuation is simple. KiwiSaver is rather less so, but nonetheless no more intrinsically complicated than voluntary private savings schemes encouraged in some places and compulsory ones mandated in others – and having both PAYG and fully funded approaches operating together is now seen as optimal. The auto-enrolment method adopted for KiwiSaver is arguably more complicated than either the voluntary or compulsory approaches, but preserves an element of choice seen as highly desirable.*(Rashbrooke, 2009)

It is timely to ask however: a success for whom? Is it a numbers game? Has it had the effect on the economy that was originally desired? What are the macro implications as opposed to the micro effects of providing for some citizens to have more resources in retirement? Will they in fact have more, or will members simply reduce other savings to compensate? In the long term, what are the implications for New Zealand's overall pensions framework and in particular the very successful universal state pension?

The New Zealand economy, while not as badly affected by the Global Economic Crisis as many European countries and the US, is in the unenviable position of having one of the highest net international liabilities/GDP ratios in the OECD[2] (Bedford, 2009; Statistics New Zealand, 2010). While the Current Account Deficit (CAD) has fallen sharply in the recession from the unsustainable levels of 8-9% of GDP in recent years, the structural issues relating to New Zealand's external accounts have not been addressed. New Zealand has persistently run a tight monetary policy to contain inflation at the cost of a high real interest rate and large CAD. There is no indication that this policy will change and projections in the 2010 Budget show further deterioration in the CAD and international indebtedness is expected (Minister of Finance, 2010).

Repeatedly in the media, the lack of household savings is held to be the culprit (see for example Bollard, Hodgetts, Briggs, & Smith, 2006; Fallow, 2010; Gaynor, 2008). The good fortunes of New Zealand's closest neighbour, Australia, whose economy is much stronger and productivity higher, is often attributed to its compulsory superannuation scheme. This has reportedly added to Australia's capital base and encouraged domestic investment and strong growth (The NZ Institute, 2010).

2. 90% of GDP in December 2009 (Statistics New Zealand, 2010).

On the eve of the introduction of KiwiSaver, the Minister of Finance said:

> *KiwiSaver now presents the chance for a new beginning for New Zealand in terms of saving and investing. It is the individual's equivalent to the New Zealand Superannuation Fund – the opportunity for greater security in retirement. At the same time it will significantly increase the flow of funds in New Zealand for investing both here and overseas. The effects of such funds can be seen in Australia. By some measures Australia is now the world's fourth largest offshore investor. We, on the other hand, are one of the world's largest borrowers relative to our size.* (Cullen, 2007a)

In 2010, New Zealand's Labour Party Opposition is suggesting that the solution to New Zealand's economic problems is for more household saving. It proposes to achieve this by making KiwiSaver compulsory and by restarting contributions to the New Zealand Superannuation Fund (NZSF). These contributions, running at NZ$2 billion pa, had been put on hold in 2008 when the government's fiscal position deteriorated. With assets of NZ$16.6 billion as at 31 March 2010, the fund can be viewed as a way in which the government has saved on behalf of New Zealand households (New Zealand Superannuation Fund, 2010).

Following the Government of Ireland's Green paper (2007), the Irish Government signalled a desire to introduce a savings scheme similar to the UK's personal pension accounts (Government of Ireland, 2010). The driver is the concern that the state pension costs will rise unsustainably as the population ages. Projections indicate that public spending on pensions, health and long-term care will increase from around 12% of GDP (14% of GNP) today, to 26% (31% of GNP) by 2050 (Government of Ireland, 2007, p. 25). A rise in the state pension age to reach 68 by 2028 is proposed, along with a new national auto-enrolment, opt-out, defined contribution scheme. Unlike KiwiSaver in New Zealand, however, it appears that there will be sufficient lead-in time for the detail to be carefully developed.

In summary, the main features of the proposed new auto-enrolment 'supplementary pension plan' as set out in the National Pensions Framework (2010) to be administered by the Irish government are:

- Defined contribution;
- A start date of 2014 if economic conditions permit;
- Employees aged 22 or older automatically enrolled on starting work;
- Opt-out possible after three months with re-enrolment after two years;
- Contributions locked-in after six months;
- A one-time bonus to those who contribute to the new plan for more than 5 years without a break;
- Employees must contribute at least 4% of qualifying earnings (The floor and ceiling for contributions is to be decided closer to the date of introduction of the auto-enrolment scheme);[3]
- Employers must contribute 2% of qualifying earnings;
- A standard tax break on the total contributions of 33% (equivalent to another 2% of qualifying earnings) but possibly paid to the scheme rather than reducing other tax;
- Employers who sponsor defined contribution schemes with higher contributions, or offer defined benefits, do not need to auto-enrol employees;

3. The National Pensions Framework (footnote 14, p.31) indicates as an example that the limits would lie between €18,304 and €51,740.

- The state delivers the saving options from providers chosen by 'competitive tender' so that members will choose from a range of funds (including a low risk default option);
- There will be no government guarantee on the returns.

Some key comparisons between Ireland and New Zealand are given in Table 1.

Table 1. Ireland and New Zealand comparisons

	Ireland	New Zealand
GDP per capita (US$) 2009	$61,000	$29,500
Population (million)	4.46	4.36
Life expectancy at birth - at age 65 males - at age 65 females	79.7 years 16.6 years 19.8 years	80.2 years 18.0 years 20.6 years
65+ Poverty Rate (50% median threshold)	31%	2%
Pension funds in economy (% of GDP) 2005	52.8%	11.3%
Unemployment rate % (Dec 09)	12.5%	7.1%

Sources: Perry (2009), OECD, (2009), (2006);New Zealand Life Tables: 2005-2007, Statistics New Zealand, Irish Life Tables 2005-2007, Central Statistics Office 2009.

One key lesson from New Zealand is that it is very important to be clear about what problem is to be addressed. In the case of KiwiSaver, there has been some slippage from the original view that it ought to be a means of increasing national savings, to the view that it should augment retirement income savings and provide a higher standard of living than the state pension alone can provide. Lacking from the analysis to date has been discussion of whether KiwiSaver actually improves national saving and even if it does, whether that necessarily influences the growth of the economy through higher and better investment. The second goal of improving retirement incomes is inherently contradictory both in light of the first goal and in light of the increased fiscal pressures in pensions and healthcare brought about by an ageing population (Bell, Blick, Parkyn, Rodway, & Vowles, 2010). Unless there is attention to decumulation issues and some integration with the universal pension, KiwiSaver may simply facilitate extra consumption by the larger retired population.

This paper sets out the nature of the New Zealand pension system and how KiwiSaver has become a major part of it. Some statistics are reported along with a discussion of emerging problems with KiwiSaver's design, and the implications for other countries contemplating auto-enrolment schemes .

2. The New Zealand pensions framework:

In brief, the retirement income framework in New Zealand has, at its foundation, NZS, a flat-rate, universal, taxable benefit, which is paid out of current taxation with some pre-funding provided by the NZSF as set out in the 2001 New Zealand Superannuation and Retirement Income Act. Until 2007, when KiwiSaver was introduced, New Zealand had been unique in offering little or no tax concessions for additional private retirement saving (St John, 2005). Until then, only about 14% of the working age population was covered in traditional retirement saving schemes subsidised by the employer (Government Actuary, 2008).

2.1.Background

New Zealand introduced the old-age pension in 1898 to provide some protection for the deserving poor aged over 65. Strict eligibility conditions included income and asset tests, good moral character and sober habits, and 25 years' residency. Over the course of the 20th century, this pension was extended and by the early 1970s, there was a universal taxable pension payable from age 65, and a means-tested age pension payable from age 60. Responding to concerns that occupational superannuation had very limited coverage, a state-run, compulsory, contributory, defined contribution (DC) savings scheme was set up in 1974. This was abandoned in 1977 in favour of National Superannuation, a more generous basic universal state pension (Ashton & St John, 1988).

National Superannuation was a flat-rate, taxable benefit financed out of general taxation, payable from age 60, indexed to net average wages, with eligibility determined by age and residency. Originally set at 80% of the gross average wage for a couple, its generosity was reduced over time and in 1985 a surcharge was imposed on other income providing a de-facto income test (Ashton & St John, 1988, p. 24). Private superannuation schemes, largely the preserve of long-serving, high-income male employees, remained tax-subsidised (Ashton & St John, 1988, p. 27). The favourable tax treatment of retirement saving was removed between 1987 and 1990, from which point, New Zealand became the first and only country to treat private retirement saving in the same way as other forms of financial saving (St John, 2007).

In 1993, the three main political parties signed up to an 'Accord' on retirement incomes policy. The Retirement Commission was established and the basic pension renamed New Zealand Superannuation (NZS). While the Accord did not endure, the basic parameters of NZS as set out in the legislation (New Zealand Government, 2001) retain broad political support.

The net rate of NZS for a couple is at least 66% of the net average wage (33% each married person). Indexation is annually via the Consumer Price Index until the floor of 66% is reached and then pensions rise with the net average wage. The dollar amounts are set out in Table 2.

Table 2. New Zealand Superannuation rates at 1 April 2010

Category	Percentage of net average wage*	Annual rate	Annual Net	Annual Net
		NZ$ (gross)	(Primary Tax)	(Tax at 38%)
Single, living alone	42.9%	$19,425	$16,542	$12,044
Single, sharing	39.6%	$17,814	$15,270	$11,045
Married person or partner in a civil union or de facto relationship	33%	$14,592	$12,725	$9,047
Married or in a civil union or de facto relationship, both qualify	Total 66% Each 33%	$29,184 $14,592	$25,450 $12.725	$18,094 $9,047

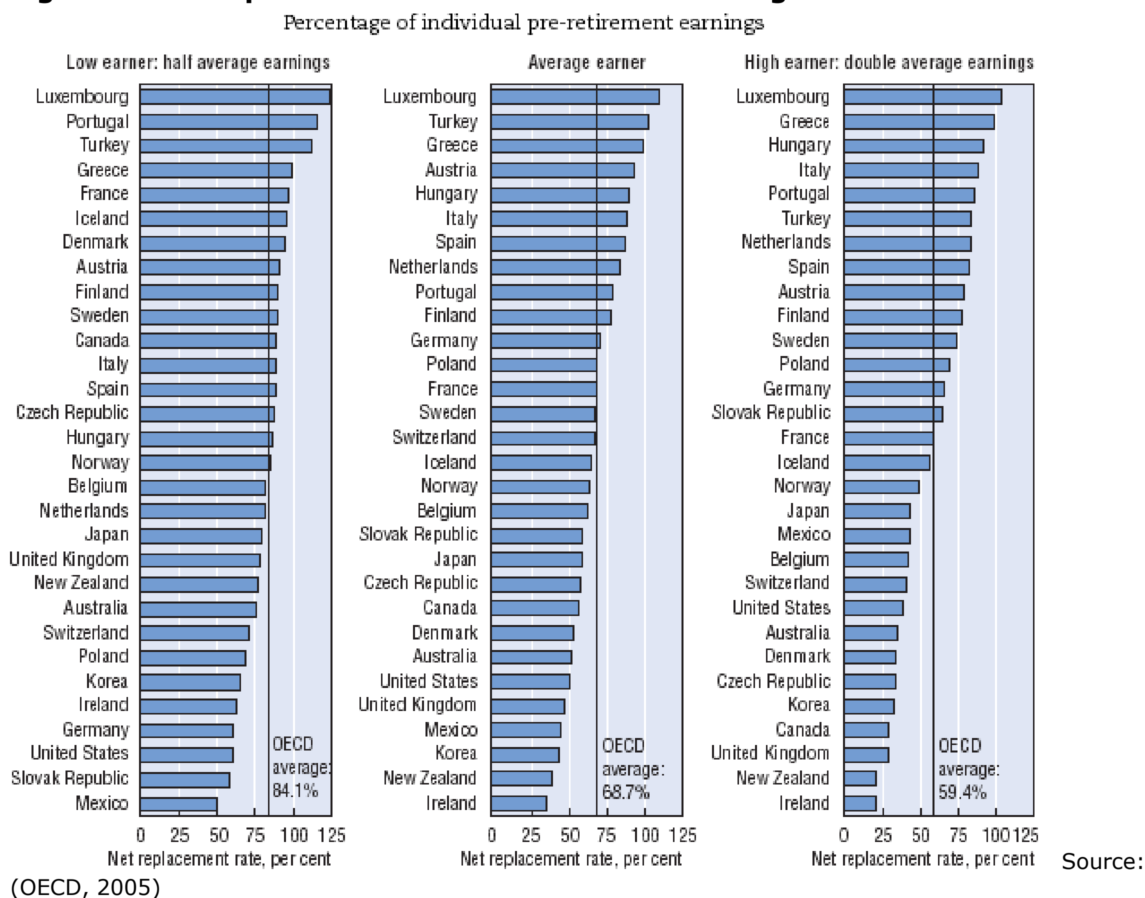
Source: Work and Income website: http://www.workandincome.govt.nz/. Note: supplementary income-and asset-tested benefits may also be paid.*NZ $38,546 ($48,609 before tax). 1NZ $ = €0.54 24.05.10.

Only 10 years' residence in New Zealand after age 20 are required, with at least five of those after age 50 (the 10(5) Residency Requirement). The residence requirements can also be achieved after the State Pension Age of 65 years. NZS is unique internationally

for its simplicity and effectiveness in providing a basic standard of living to everyone over 65. Although there is a specified 'couple rate', it is payable to each pensioner in his/her own right (individual entitlement), and each partner of a married couple receives an individual pension that is taxed along with other individual income.

NZS is best seen as a sophisticated yet simple variant of social insurance; it is neither earnings-related nor contributory but fulfils the role of a basic income. The Retirement Commissioner has described NZS as "a remarkably effective, simple and secure foundation for retirement income. It means that New Zealanders - and especially women – are less at risk of hardship in later life than people in many developed countries" (Crossan, 2007, p. 4). When compared with basic age pensions internationally, and with other welfare benefits domestically, NZS is relatively generous. As a consequence, New Zealand has very low rates of pensioner poverty and hardship in contrast to many other countries, and in New Zealand compared to those on welfare benefits (Perry, 2009). Nevertheless, while low-income earners do well in an international comparison of public pensions, as shown in Figure 1, workers on average earnings or above have relatively low replacement rates (OECD, 2005).[4]

Figure 1. Net replacement rates at different earnings levels



Source: (OECD, 2005)

Ireland shows a similar pattern to New Zealand. The replacement rates decline as income increases much more quickly in New Zealand than in other countries including Australia. It should be noted that Figure 1 reflects only the mandatory state-provided pension arrangements, ignoring private provision; and that high replacement rates in countries at the top of the league are usually only for those with a full contributions

4. It should be noted that the OECD takes the living alone rate for the NZ calculations.

record. Generous tax concessions in both the second and third pillars of retirement provision are common in many countries but are not included as part of state pension expenditure in Figure 1.

3. KiwiSaver: 2007-2010

Until the advent of KiwiSaver, saving for retirement in New Zealand had been a voluntary, unsubsidised activity. The tax regime for private and occupational superannuation schemes was the same as for saving in a bank. Contributions, whether by employer or employee, were out of after-tax income (T), fund earnings were taxed at a rate that proxied the individual's marginal rate (T), but withdrawals were like a return of capital and hence tax-exempt (E). This TTE tax treatment contrasts with the EET treatment conventional for retirement savings in other countries.

The first tax break for private saving in New Zealand since 1990 was introduced in 2000 when the top personal marginal tax rate was raised to 39% and the rate applied to employers' contributions for employees remained at 33%. This however was a modest concession and did not indicate a loss of faith in the doctrine of tax neutrality (TTE) with respect to saving (St John, 2007).

> *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, 2002)

There was still a concern that many workers did not have access to an occupational saving scheme and that New Zealanders were not saving 'enough'. It was in this context that KiwiSaver, a contributory, employment-based, retirement-saving scheme, was conceived.

3.1 KiwiSaver I

In the scheme as announced in the 2005 Budget, KiwiSaver members were to contribute 4% or 8% of their gross income to a KiwiSaver account. At this point, the scheme looked modest. While employers could contribute, there was no compulsion to do so. The key premise of KiwiSaver I was that people are more likely to commit to saving regularly if they are automatically enrolled rather than deciding whether to 'opt-in' as discussed in section 5.4.

In KiwiSaver I, the government subsidies were a flat $1,000 'sweetener' (the Kickstart) paid on joining, and an annual fees subsidy of $40. These subsidies avoided the problems of the regressivity of tax concessions and left the TTE tax regime for saving unaffected. At this point, New Zealand looked like it was offering the world a natural experiment to ascertain the pure effect of an opt-out policy, uncomplicated by significant other incentives.

But the climate was about to change. In August 2006 (only ten months before KiwiSaver's start date), the Government announced that matching contributions by employers up to 4% would be tax-exempt. Cabinet papers released under the Official Information Act show alarm bells were ringing:

Officials do not recommend exempting employer contributions to KiwiSaver from SSCWT.[5] *On the one hand, this would create benefits for an employee to sacrifice his/her salary or wages in exchange for an employer contribution, higher amounts could be saved and compliance costs for employers would be reduced. On the other hand, this would create a tax distortion in favour of employer contributions to KiwiSaver relative to existing schemes, could have a fiscal cost of up to $330 million, could lead to pressure to exempt all employer contributions, and would lead to no tax on employer contributions under the taxed/taxed/exempt (T/T/E) model.* (Inland Revenue Department, 2006)

Concerns were echoed by the OECD:

Over the years, there has been a move toward granting more exceptions, constituting a break with the "broad base, low rate" policy endorsed in the 2001 Tax Review (McLeod et al., 2001). Non-neutral tax policies that are unevenly applied to various activities encourage New Zealanders to devote resources to less-taxed activities, rather than to those that generate the greatest economic returns. …The tax exemption for employer contributions to registered superannuation schemes is a further departure from the comprehensive income approach. In the latter system, any employer contribution to a superannuation fund for the benefit of an employee is liable for tax. The exemption was introduced in the context of KiwiSaver to incite employers to invest in superannuation schemes and give them more choice in the way they remunerate their workers. While this might seem attractive by providing some tax advantages to savings, it nonetheless introduces non-neutrality by only favouring one particular type of savings and can induce switching between savings instruments. Over the life cycle, it can be seen as a tax exemption for employees and to erode the tax base. (Mourougane, 2007)

As might have been predicted, the employer contribution tax-break was the thin end of the wedge. The Association of Superannuation Funds of New Zealand argued that there was a serious risk that many existing superannuation schemes would be wound up, undermining the government's goal of increased saving. Thus almost immediately, a further Supplementary Order paper extended similar tax privileges to all employer superannuation schemes that met lock-in provisions. Cabinet papers acknowledged that the extension to other schemes had little to do with the goal of increasing new saving as it essentially subsidised existing saving.

While there appeared to be little, or no, in-depth analysis of the regressivity of the reintroduction of tax incentives, the IRD was concerned about the potential costs, noting that the higher the employee's salary the higher the benefit. The IRD also noted that:

…the benefit of the $1000 government contribution to KiwiSaver and the fee subsidy pale over time in comparison with the benefit of the tax exemption. (Inland Revenue Department, 2006)

3.2 KiwiSaver II

On the eve of the introduction of KiwiSaver, in the May 2007 Budget, dramatic changes were announced to take effect on 1 July 2007. The extensions of the scheme, named here KiwiSaver II, may have reflected a concern that the uptake would be low. More importantly, healthy fiscal surpluses had emerged in a strongly growing economy and the government desired to limit the demands for tax cuts. Along with contributions to the NZSF, KiwiSaver offered a way to lock up these surpluses. The very significant

5. SSCWT was the Specified Superannuation Contribution Withholding Tax applied to employer contributions as a proxy for the tax that the employees would have paid if the contributions had been treated as their income.

changes introduced with very little warning only six weeks before KiwiSaver started, imposed large compliance costs on employers, on scheme providers, and on the Inland Revenue Department that was required to administer the scheme.

There were three elements to the significant enhancements:

- First, a member tax credit (MTC) to savers to match their contributions into KiwiSaver (or a complying superannuation fund) up to a maximum of $20 per week from 1 July 2007;
- Second, compulsory matching employer contributions for employees, starting at 1% from 1 April 2008, and then rising by a further 1% each year, until reaching 4% from 1 April 2011;
- Third, an employer tax credit that reimbursed contributions at a rate of 100% up to $20 per week per employee from 1 April 2008. (Cullen, 2007b)

The new matching MTC which applied to the first $20 contributed by employees and the tax offset to employers were less regressive than pure tax exemptions, however the cost was still high. The New Zealand Treasury estimated that by 2011, the fiscal cost would be NZ$1.2 billion a year, while the positive effect on household saving was expected to be only NZ$1.1 billion (The New Zealand Treasury, 2007). The MTC was not limited to those in employment and could be accessed by beneficiaries, unpaid caregivers, and the self-employed, for contributions up to $20 a week.

The compulsory employer contributions of 1% to rise to 4% of employees' gross pay by 2011 applied only to those employees in the scheme, leaving much confusion as to what would happen with remuneration packages and wage negotiations. Nevertheless, the quasi-compulsory employer contribution was clearly expected to play a part:

> *There is no doubt that employer contributions will create a greater sense of employee loyalty.[6] The accumulation of savings funds in this way will also create greater incentives for workers to stay in New Zealand. The Government expects that the phase-in of the compulsory matching employer contributions will be taken into account in wage and salary bargaining.* (Cullen, 2007b)

The employer costs were offset by a matching $20 tax credit, so that in the first two years when the compulsory rate was 1% and 2% the cost to the employer, even for higher waged employees, was to be minimal.

A housing subsidy had been made available through KiwiSaver for first-home buyers, but in addition, a mortgage diversion scheme was introduced late in the piece despite its rejection by the select committee. Under this scheme, after one year, up to half of the employee's own KiwiSaver contributions could be directed to mortgage repayments. Given that a key concern that promoted KiwiSaver in the first place was over-investment in housing, providing mortgage repayments and a first-home deposit subsidy from what was intended to be retirement savings appeared counterintuitive (OECD, 2007).

Mortgage diversion was quietly dropped in 2009. According to the Revenue Minister, the Hon Peter Dunne, mortgage diversion:

> *... goes against a basic principle of KiwiSaver to lock in savers' funds until they are 65, thus helping them to accumulate assets for their retirement years. Someone*

6. An odd contention, given that the employer's contribution was compulsory.

using mortgage diversion could, for example, sell the house before he or she is 65, thus gaining access to funds. (Dunne, 2009)

However this 'difficulty' also applies to the first home deposit and subsidy scheme that remain a feature of KiwiSaver III as discussed in section 5.7.

The introduction of KiwiSaver II was timed to coincide with the reform of the taxation of collective investment vehicles including superannuation schemes. The intent was to retain the tax-paid nature of superannuation schemes, but to align the proxy tax rate on the scheme's investment income more closely with the tax rate of the individual investor. Superannuation schemes (and other collective vehicles) can become 'Portfolio Investment Entities' (PIEs), and the effect for most was that investment income in the fund was taxed preferentially. Advantages were greatest for taxpayers on the top marginal income tax rate of 38% because the maximum PIE rate was only 33% (30% from 1 April 2008) and many could re-organise their affairs to qualify for a PIE rate of only 19.5%. PIEs have continued to offer considerable rewards for restructuring the way in which earned income is received (Chamberlain & Littlewood, 2010).

3.3 KiwiSaver III as at March 2010

The newly elected National-led government had never really supported KiwiSaver or the NZSF policies, and in late 2008 significant changes were made to KiwiSaver to provide the revenue to reduce income taxes. The chief justification was to make KiwiSaver more affordable, to both the individual and the state. With effect from 1 April 2009, the state-provided $40 p.a. fee subsidy was abandoned; the minimum employee contribution was reduced to 2%; the employer's compulsory contribution was capped at 2%; the tax-free employer contribution was limited to 2% of the employee's gross salary or wages; and the employer tax credit was abolished. The government also halted contributions to the NZSF, arguing that emerging fiscal deficits implied that they would have to borrow to maintain contributions.

There had been concern that, under KiwiSaver II, some wage-earners could be penalised on joining by being offered a lower gross wage than others:

The KiwiSaver Act will be amended to make it clear that upon joining KiwiSaver, no employee can have their gross pay reduced as a result of employer contributions. This will ensure that when employees join KiwiSaver, the compulsory contributions from their employer are a genuine addition to their existing pay. The changes will also provide employers and employees with the ability to negotiate their own arrangements in good faith.[7] (English, 2008)

Box 1 sets out the dimensions of the current KiwiSaver III scheme. While very much watered down, in 20 or so years, KiwiSaver is likely to be an important component of retirement income for many. The implications are discussed below.

The scheme is open to all New Zealand residents under the age of 65 (3.7 million people), of whom about 1.7 million out of a total labour force of 2.29 million, are potentially entitled to tax-subsidised employer contributions. Those not entitled to that contribution include employees under age 18 and over age 64, temporary employees, domestic staff and some employees in seasonal agricultural work. The 31 December 2009 data shows that 35% of the eligible population (under age 65) have joined.

7. In fact, this mis-stated the true position: while employers could not reduce pay directly, they could eventually incorporate the employer's 'compulsory' contributions into future pay rises.

Box 1. KiwiSaver III (as at March 2010)

- 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 are automatically enrolled into KiwiSaver when they start a new job. They have the 2nd to 8th week of employment to 'opt-out' and must advise their employer or the Inland Revenue of their decision. Having opted-out, they cannot be auto-enrolled again until they change jobs.
- Scheme enrolment is not automatic for workers under 18 or over 64, or those employed less than 4 weeks, or for existing employees when KiwiSaver started in 2007. They may join if they wish. Self-employed people and beneficiaries and non-workers can also join but make payments directly to the scheme provider.
- A maximum $20 a week matching subsidy is paid by the government for the member's contributions.
- Employees' contributions start from the first pay day with an employer. Deductions from wages are at a rate of 2% of gross pay, unless the individual opts for the higher rate of 4% or 8%. If the employee contributes, the employer must match that to 2% of the employee's pay but is not obliged to contribute more. Matching contributions up to 2% by the employer are deductible to the employer but are tax-free to employees.
- Funds are held by the Inland Revenue for an initial three month period after auto-enrolment 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 provider, but can only have one provider at any time. Those who do not specify a fund will be randomly allocated to one of, currently, six default providers that have been chosen by the government.
- Savings are 'locked in' until the age of eligibility for New Zealand Superannuation, currently 65, except in cases of: financial hardship, permanent emigration, serious illness or after a minimum of five years (for those first joining after age 60) or to contribute toward a deposit on a first home. However, after a minimum 12 month contribution period, employees can apply for a 'contributions holiday'. Contributions resume at the end of the five years unless the individual applies for a further 'contributions holiday'. Individuals (including employees on contributions holidays) can contribute what they wish, when they wish.
- Existing superannuation schemes may convert 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 "exempt" i.e. running a scheme that is portable, open to all new permanent employees, with a total contribution rate (employer plus employee) of at least 2%.
- After three years' membership, the government will also 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.

Source: derived from http://www.treasury.govt.nz/kiwisaver/

Table 3 shows that a significant proportion (37.4%) of the 1,369,609[8] total members, net of opt-outs[9] had been automatically enrolled. However, nearly one third of those who were automatically enrolled had opted-out during the 8 week opt-out period.

Table 3. Membership as at 31 March 2010

Method of joining KiwiSaver	Members	Percentage
Opt-in via provider (active choice)	649,745	43.2%
Opt-in via employer	207,873	15.2%
Automatically enrolled	511,991	37.4%
Total membership (net of opt outs and closures)	**1,369,609**	**100%**
Opt-out	240,559	
Closed (left country, died, mistakenly enrolled)	112,092	
Active contributions holidays (includes financial hardship holidays)	40,517	

Source:(Inland Revenue Department, 2010)

A small but growing proportion of members are on a contributions holiday in which both the member contributions and the compulsory employer contributions are halted. As at 31 March 2010, 40,517 KiwiSaver members (about 4.8% of employee members) had taken an active contributions holiday, perhaps reflecting heightened financial hardship during the recession.[10]

As at March 2010, there was around $5 billion held in KiwiSaver funds. The annual inflow, including the government's contribution, was around $2.14 billion.[11]

Table 4 provides the age profile of KiwiSaver members, showing a surprisingly even spread of members across the age bands. However, there are substantial differences in membership as a proportion of age bands, as shown in Figure 2.

Table 4. Age profile as at 31 March 2010

Age band	Members	% of total members
0-17	245,538	17.9
18-24	215,457	15.7
25-34	219,242	16.0
35-44	221,892	16.2
45-54	222,753	16.3
55-65	236,887	17.3
No Information	7,840	0.6
Total	1,369,609	100.0

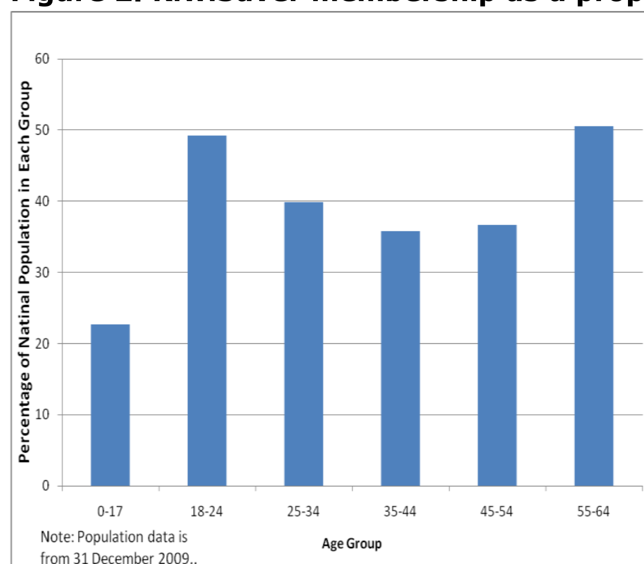
Source:(Inland Revenue Department, 2010)

There are 245,538 members between the age of 0 and 17 (22.7% of all New Zealanders under age 17). Given that only a small proportion would have part-time jobs or have left school by age 17, most of these members have opted in, or were joined up by their parents to KiwiSaver by active choice.

8. Of these, 245,538 members are aged under 18.
9. See: http://www.kiwisaver.govt.nz/statistics/ks-stats-09-07-31.html.
10. A private communication with the Inland Revenue indicates that at 31 March 2010, there were approximately 806,000 KiwiSaver members in respect of whom employers were contributing, or 58.8% of all KiwiSaver members.
11. See http://www.kiwisaver.govt.nz/statistics/ks-stats-10-03-31.html.

Children under 18 are not entitled to the member tax credit, but may benefit later from the housing subsidy and may be able to access their own saving in the scheme as a deposit for their first home.

Figure 2. KiwiSaver membership as a proportion of age-group population



Source:derived from (Inland Revenue Department, 2010)

As Table 5 shows, around 77% of members have incomes less than the average wage (around $50,000). The aggregate figures show little gender-based difference (slightly more females than males), but female membership is greater at lower income ranges.

Table 5. Membership by income and gender 2008-9

Income $NZ pa	Total	Male	Female
0-10,000	17%	14%	19%
10,001-20,000	18%	15%	22%
20,001-30,000	16%	13%	18%
30,001-40,000	15%	15%	15%
40,001-50,000	11%	13%	10%
50,001-60,000	8%	9%	6%
60,001-70,000	5%	6%	4%
70,001-80,000	3%	4%	2%
80,001-90,000	2%	3%	1%
90,001-100,000	1%	2%	1%
100,001-110,000	1%	1%	0%
110,001-120,000	1%	1%	0%
120,000+	2%	4%	1%
Total	100%	100%	100%

Source: Inland Revenue Department (2009)

4. The underpinning theory

4.1 Influence from the US behavioural studies

The rationale for KiwiSaver I was influenced by the results of studies from the US based on behavioural finance (see, for example, Mitchell & Utkus, 2003). 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.[12] 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, and to pick a 'realistic' contribution level and an 'appropriate' investment strategy, but then given the opportunity to change those decisions. The research also shows that employees tend not to move away from the default selections.

Such studies were reviewed in the KiwiSaver design process, but the applicability to New Zealand was unclear (Toder & Khitatrakun, 2006). 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 evident 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 part of the available remuneration and valuable tax concessions. Despite that, many appear to act against their own best interests and choose not to join or, more accurately, fail to make the decision to join.

KiwiSaver I had none of the generous tax concessions available in the US, nor was it intended that it would be employer-subsidised (as has been decided for the equivalent arrangement in the UK).[13] In fact, the only subsidies were from taxpayers in the shape of the 'sweetener', the opening $1,000, and on-going administration fee subsidies.[14] Nevertheless, it was believed that the design of a savings scheme and the regulatory environment in which it exists can have a significant effect on both participation rates and the decisions that savers make during their membership.

One of the key concepts, particularly for an unsubsidised opt-out scheme, is that of the default settings. Such defaults can have:

> *...a tremendous influence on realized savings outcomes at every stage of the savings lifecycle: savings plan participation, contributions, asset allocation, rollovers, and decumulation. That defaults can so easily sway such a significant economic outcome has important implications for understanding the psychology of economic decision-making. But it also has important implications for the role of public policy towards saving. Defaults are not neutral - they can either facilitate or*

---

12. 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.
13. The UK's 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). What is now called the National Employment Savings Trust (NEST) administered by the Personal Accounts Delivery Authority (PADA) starts in 2012 (see: www.padeliveryauthority.org.uk). The contribution requirements recommended by the Turner Commission will apply to incomes between £5,000 and £35,000 a year (2009 values) unless the employer offers an alternative 'qualifying' scheme that is at least as generous.
14. The government estimated that KiwiSaver I would 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).

hinder better savings outcomes. Current public policies towards saving include examples of both. (Beshears, Choi, Laibson, & Madrian, 2006)

4.2 Investment fund strategy- the default option

In terms of the default investment strategy, there can be no single default setting that is appropriate for all. The issues are not clear-cut (Toder & Khitatrakun, 2006). The first observation is that the default option is bound to be the popular choice, for example see Beshears et al. (2006) and Madrian and Shea (2001). One possibility is to have a default option that is diversified across shares, property, bonds, and cash and where the proportion invested in 'riskier' assets (shares and property) automatically reduces with the member's age. In that way, savers who made no decision would be given a strategy that was at least age-appropriate. However, the issue is more complex than first appears as people differ in their risk aversion or exposure to human-capital risk.

This illustrates one of the difficulties with using behavioural research as a way of informing regulatory intervention: the intervention may be assumed to imply that the regulator (or employer, or scheme trustee, as the case may be) is effectively standing in the place of the investor and inevitably will be held responsible for the outcomes. Getting it wrong at least some of the time seems inevitable. Despite the fact that, in most cases, investors can move away from the default settings, evidence shows that most do not even if moving appears in their best interests. The design of the default option is therefore important both in itself (its effect) and also for the 'signal' it sends members as to what might be a 'good' strategy (Tapia & Yermo, 2007).

4.3 Default strategy and the savings environment

Specifically, it is clear that participation increases considerably if enrolment is made default and opt-out, instead of a non-participation default but with an option to opt-in (Beshears, et al., 2006). But care is needed when transplanting 'solutions' that may be helpful in a US context (such as for 401(k) saving schemes) into an environment that has different economic drivers, such as tax and public pension provision. The US regulatory environment for both public and private provision is very complex and the so-called lessons from behavioural research may be no more than regulatory intervention that is really designed to help savers make sense of complexity. The regulators may be better served with policies that simplify the pension and savings landscapes.

5. KiwiSaver design

5.1 Soft compulsion

While the underpinning rationale for KiwiSaver's 'auto-enrolment, opt-out' approach is that people ought to save for their retirement, most people need to be nudged into that decision. The principle is that people are affected by inertia and once opted-in, they are unlikely to opt-out even if they would not have made the initial active decision to join.

Under KiwiSaver I, and because of the tax-neutral treatment of formal retirement saving schemes, there was a strong case to suggest that some employees, 'defaulted' into KiwiSaver, would have been better off to use those required contributions to reduce debt. The significant tax subsidies given to employer and employee contributions in

KiwiSaver II changed that economic equation.[15] As with the US's 401(k) schemes, joining KiwiSaver II would usually leave the member in a better economic position than not joining. The reduction of these subsidies in the current KiwiSaver III makes it more ambiguous.

Under the KiwiSaver rules, members who are auto-enrolled and do not exercise the 8 week opt-out provision must contribute for a 12 month minimum period to be entitled to the $1,000 government contribution and the matching 'member tax credit' for the first $1,043 of the member's own contributions. While that might be a reasonable requirement, the process will accidentally capture some people who should have opted-out for reasons of affordability or appropriateness.

Many potential low income contributors have significant debts including student loans and mortgage debt. While contributions holidays are possible (but only after the full initial 12 months of contributions), these add further complexities. Whether saving minimal contributions through managed funds is desirable either from an individual or a societal point of view is debateable.

As noted, once the initial 12 month contribution period to qualify for the government's subsidy has been completed, an employee can take a contributions holiday for 5 years renewable. That raises the potential of hundreds of thousands of dormant accounts with, perhaps, $3,000 or less in contributions.

5.2 Exempt employers

The engagement of KiwiSaver with existing schemes has been complex and problematic. If an existing scheme offered KiwiSaver-equivalent conditions, they may be classified as 'complying' funds and attract government subsidies but not the kickstart. An 'exempt' scheme must comply with the normal KiwiSaver contribution requirements, and must be available to all new employees, but does not qualify for the government-provided subsidies. An employer with an exempt scheme does not however have to comply with the auto-enrolment conditions. Employees can still be KiwiSaver members however, and exempt employers must comply with KiwiSaver conditions for those employees. If the employer offers an employment-based scheme that is exempt, employees do not have to belong to both. As of 30 June 2009, only 483 employers had been granted exempt status but no new exempt schemes are possible after 6 October 2009. A further 29 employers offered 'complying funds' that offered KiwiSaver-equivalent conditions.

Some very large employers such as the universities have been 'exempt' so that the auto enrolment feature has not been universally applied. Overall, the provisions have probably had an adverse effect on existing schemes. The Government Actuary (the regulatory authority for occupational schemes) stated in 2009:

> *It is too early to look for significant signs of substitution from Registered Superannuation into KiwiSaver Schemes. Trends may be beginning to emerge. There has been a continuation of Registered Schemes winding-up or moving to a Master Trust structure as a participating employer within a Master Trust. There are*

15. Whether the employer's contributions are an economic advantage to employees depends on the employer's remuneration strategy. If the employer's contributions to KiwiSaver are taken into account in setting the member's remaining taxable pay then the only net advantage to the employee-member would be the fact that the employer's contributions, under KiwiSaver III, are tax-free to a maximum of 2% of the employee's pay.

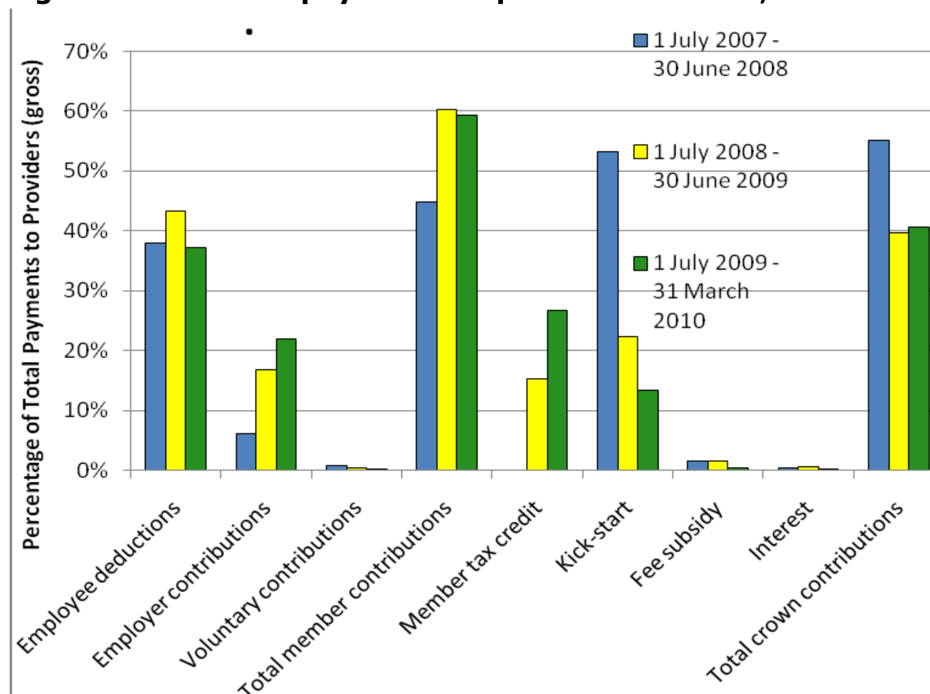
also examples of employers closing schemes in favour of KiwiSaver. (Government Actuary, 2009a p. 12)

5.3 Role of incentives

Figure 3 shows funds paid to providers during each year according to the source of the funds, including government incentives. There are often suggestions in the media that these government incentives are too good to ignore (Gaynor, 2010). Indeed, that contributions from the Crown have totalled 40% of payments to providers for each of the three years implies that stronger than forecast uptake can be linked to the level of government-provided incentives. Throughout the three years of KiwiSaver, there has been a change in relative weighting of each government incentive in the makeup of members' funds. The kickstart one-off $1,000 payments represented over 50% of funds contributed in the first year to June 2008, but they have since declined in importance as members' and employers' contributions have flowed in. This trend can be expected to continue. However, the member tax credit which took effect from 2007 has increased to represent 26.7% of payments to providers since July 2009. Not accounted for in Figure 3 is the tax expenditure implied in the tax exempt status of the employer contribution, the most regressive of the tax subsidies.

After joining KiwiSaver, the tax subsidies for an employee member are limited to the maximum member tax credit of $1,043 a year and the employer's required tax-exempt contributions[16] of 2% of pay. Members who qualify for the first home subsidy (see paragraph 5.7 below) also receive $1,000 for each of the first five years' contributions. For non-employees (other than children) the member tax credit is the only ongoing subsidy, first home subsidy aside.

Figure 3. Source of payments to providers in 2008, 2009 and 2010



Source:(Inland Revenue Department, 2010).

16. That may be an addition to remuneration if the employer has not incorporated them into all employees' remuneration, referred to in New Zealand as a 'total remuneration' approach to compensation.

These rules will probably see employees contributing no more than 2%, as long as that is at least $1,043 a year so the matching MTC of $1043 can be paid. For those earning less than $52,150 a year, a top-up voluntary contribution can be made before 30 June to ensure a contribution of at least $1,043. Non-employees should contribute no more than $1,043 a year in order to maximise the subsidy. Given that KiwiSaver benefits are locked up until age 65, it may be preferable for any additional retirement savings to be made to an accessible scheme. In New Zealand, other than under KiwiSaver, there are no regulatory age-based restrictions on access to retirement benefits.

5.4 Choice and competition

New Zealanders can exercise choice at several levels in KiwiSaver. They can choose:

- to opt-out as this is a voluntary not a compulsory scheme;
- one of three levels of contribution: 2%, 4% or 8% of gross taxable pay;
- unlimited contributions holidays for five years at a time;
- from a range of 54 providers[17] and change their initial decision at any point;
- to cash in savings for a first home and receive a government subsidy for the deposit on their first home, if they qualify;
- the investment strategy. Most providers offer many different options including varying levels of shares cash property and bonds in the mix;
- what they do with the lump sum at age 65.

Offering too much choice, for example as in Australia and Sweden, is not necessarily a good thing. The OECD concluded that it can create:

> *...information overload, resulting in greater confusion and complexity, and, consequently, in greater use of the default option. This is confirmed by the international evidence, as the percentage of contributors who exert choice is higher in Chile (approximately 74%) and especially in Central and Eastern European countries (over 85%) than Australia or Sweden (less than 10%).* (Tapia & Yermo, 2007)

The 'lessons' derived from studies of behavioural finance suggest that savers need help to navigate their choices through the setting of default options that they can change if they wish. The rules governing KiwiSaver use this principle in a number of ways. There remains a tension between offering choice, based on the premise that the informed individual will know what is best for them, and more directive policy based on the need to maximise advantages for society. Thus for example, the individual currently has a wide choice as to how to use KiwiSaver funds in retirement, but the choice to run these savings down early in retirement may not be in society's best interests.

5.5 The default schemes

New employees are auto-enrolled into KiwiSaver and the Inland Revenue Department allocates them randomly to one of six 'default providers'.[18] The six providers were chosen following an "open competitive tender process where ministers were assisted by advice from independent external experts who carried out detailed evaluation of

---

17. Although there were a total of 54 KiwiSaver schemes at 3 May 2010 (see http://www.isu.govt.nz/templates/ISU/KiwiSaverSchemesRegister.aspx?id=22800), membership of at least 15 of those was limited to employees of a particular employer or members of a group or society.

18. The default scheme providers are: AMP Services (NZ) Limited; ASB Group Investments Limited; AXA New Zealand (National Mutual Corporate Superannuation Services Limited); ING (NZ) Limited; Mercer (NZ) Limited; Tower Employee Benefits Limited. If the employer has a 'chosen scheme', new employees are first allocated to that scheme, but may transfer to a provider of their choosing.

potential providers."[19] The government suggested that it had "…followed a fair, consistent and transparent process which ensured all potential default providers were assessed on an equal basis." The original six default providers' appointment in 2006 has not been reviewed.

5.5.1 Default scheme rules

A default scheme must have a default investment option: a portfolio with no more than 25% invested in 'growth' assets (shares and property). The six default providers dominate the membership and asset statistics, showing the commercial value of default status to the incumbents. At 30 June 2009, default memberships[20] totalled 32% of all members and 33% of assets (Government Actuary, 2009, p. 22). While providers of default schemes are required to offer a suite of other investment products, during the 12 months to 30 June 2009, only 4,081 members or 0.7% had switched out of a default investment option.

One of the difficulties with the current default provider process is that it assumes a static market in financial service providers. The current re-structuring of the market in New Zealand has already seen the full takeover of one default provider by another provider (not default) and will probably see the merger of two of the current six providers and the sale of a third, yet there has so far been no suggestion that the original six appointments will be reviewed.

There is little doubt that default provider status was of commercial value to the original appointees. It now seems appropriate to review the process for their appointment. One approach would be to require a provider to comply with a number of conditions. All providers that continuously met the conditions could have default status.

This approach would automatically accommodate changes in the markets and provide the government the relative certainty it needs before conferring a privileged economic position on a private business. It would also distance the government from any suggestion that it will stand behind the failure of a default provider.

5.5.2 Effect of default settings on members

> *At June [2009], most members were contributing at 4% of their salary or wages to their accounts; 12% were contributing at the lower 2% rate. However, of those who joined KiwiSaver since the changes were in place, approximately half were contributing at 2% and just less than half had chosen to contribute at a higher rate (either 4% or 8%). Of those who joined before 1 April 2009, most have not changed their previous contribution rate. This suggests that most individuals are being influenced by the default arrangements in place at the point that they join KiwiSaver, although the early figures for those joining after 1 April suggest that members are exercising some choice over their contribution rate.* (Inland Revenue Department, 2009)

It is too early to be confident that members are in fact exercising a free choice to save more than the minimum 2% of pay. There is a significant incentive for the mainly

19. According to a contemporary press release from the Minister responsible. See http://www.med.govt.nz/templates/MultipageDocumentTOC____24456.aspx.
20. Defined as members who had been enrolled under the default scheme process rather than actively joining the default provider.

commercial providers of KiwiSaver schemes to persuade members to contribute more than that, particularly where commissions are payable to advisers.

5.6 Fees and returns

In introducing KiwiSaver, the government recognised that financial service providers would benefit from a government-endorsed initiative. Accordingly, it gave a supervisory role to the regulatory authority for superannuation schemes, the Government Actuary. As well as registering new KiwiSaver schemes, the Government Actuary has oversight of existing schemes.

> *For any new KiwiSaver Scheme my role is to ensure and enable eligible schemes to be registered in a timely manner. This requires a review to ensure that the trust deed complies with the requirements of the legislation, that matters covered in Schedule 2 of the Act are adequately disclosed and that fees are not unreasonable as identified in Schedule 1 of the Act and the KiwiSaver Regulations 2006….(Government Actuary, 2009, p. 3)*

The requirement with respect to fees is set out in Schedule 1 to the Act. Clause 2 of that Schedule states that the following persons must not charge a fee that is "unreasonable":

- *the trustees of the scheme;*
- *the administration manager of the scheme;*
- *the investment manager of the scheme;*
- *the promoter of the scheme;*
- *any other person who charges a fee for services in relation to the provision of a KiwiSaver scheme.*

The KiwiSaver Act, in section 189B, requires any increase in the fees to be notified to the Government Actuary. In fact, understanding the fees is not straightforward even before addressing the issue of whether they are 'reasonable' (or, 'not unreasonable').

The main difficulties centre around the number of different parties that may potentially charge a fee (the list above). In addition, a KiwiSaver scheme may not own most of its assets directly but rather may hold investment products that may be commercially linked to the scheme's promoter. It is also possible for a scheme to create entities to fill each of the roles listed above, and charge a 'not unreasonable' fee at each point. A total fee charged by the KiwiSaver provider that would be deemed 'unreasonable' may appear 'reasonable' when broken down into various 'sub-provider' charges, even if they are linked commercially to the provider. This merely disguises the 'unreasonable' fee.

Then there is the difficulty of deciding what issues can be taken into account in assessing 'reasonableness'. Might, for example, the low uptake of membership justify higher fees because many costs are unrelated to membership size? The Government Actuary looked specifically at this but essentially avoided the issue:

> *After considering both legal and technical advice, I concluded that KiwiSaver was designed as a low cost work place savings scheme and that the pattern of fees developed covered the range of fees likely to be regarded as "not unreasonable". I use a small technical panel to help me review the "unreasonable fee" process and this panel provided my technical advice above.* (Government Actuary 2009, p. 6)

A relatively simple scheme like KiwiSaver should, in theory present fewer problems of fee comparison than other retirement saving vehicles. The Retirement Commission

provides an on-line calculator that attempts a fees comparison. However, fees associated with the management of investment assets vary with the type of asset managed. Of the 21 KiwiSaver providers for whom published investment performance data are available, there are more than 165 investment options, stretching across the risk spectrum from those invested wholly in cash to those with 100% in shares. It is not possible to directly compare the fees of all those options because, for example, cash-based investments require less skill and knowledge and are (or should be) less expensive to manage than shares-based alternatives. When investment options combine asset classes, then fees will naturally vary between those with more share-based assets than those with fewer.

As the Retirement Commission's web site states:[21]

> *Fees are charged so your scheme can pay for investment, management and administration costs. A more active investment policy usually means higher fees but also provides the potential for higher returns and greater variation in those returns. A greater proportion of equity investments (like shares) also provides the potential for higher and more variable returns. It's important to note that fees are just one factor to consider when selecting a KiwiSaver product or provider. The level of risk (and associated return), service level and communication offered by the fund provider should also be considered.*

In other words, given the difficulties of comparisons and of even identifying all the possible fees and their amounts, the attempts to control fees through legislation are fraught. It may be more useful to require full disclosure, including the amounts charged by sub-providers and sub-sub-providers, and to require that members be informed of what the total dollar amount charged to their individual saving accounts were for the year. There may also be an advantage in requiring providers to disclose fees on the basis of common opening and contribution values. That would give commentators (and the Government Actuary, as regulator) basic comparative data in similar markets across all providers. The government's role could even extend to funding ongoing research on comparative costs by an independent group.

Investment return comparisons are equally problematic. What matters to a KiwiSaver member is the after-tax and after-fee investment returns. The key drivers for any investment return are the before-tax sector returns (cash, local bonds, overseas bonds, local shares etc.), investment strategy (what proportions of the total invested there is in cash, bonds, shares etc), income tax, and fees.

Looking at just the after-tax investment returns, the central issue is investment strategy (for a given set of gross returns across all the sectors) and tax. It is therefore impossible to directly compare returns across providers unless the investment strategy (and its implementation) is identical. In a rising share market, one provider may appear to have done better than another but that may be due to the proportion of shares held in the apparently better performer.

This difficulty does not prevent comparisons being made. There are at least four different comparisons that purport to directly compare KiwiSaver investment returns. For example, the Morningstar Australia report for 31 March 2010 attempts to compare like with like, by grouping options with similar investment strategies, such as all 'Multi-sector, conservative' funds. Of the 18 products listed under 'Multi-sector, conservative', the benchmark investment strategies show 'growth' assets (shares and property)

21. http://www.sorted.org.nz/calculators/kiwisaver-fees/page2.php.

varying from as little as 0% (for both the Fisher Funds Conservative KiwiSaver Fund and the Grosvenor KiwiSaver Enhanced Income Fund) to as much as 23.2% (AMP KiwiSaver (Default) Fund).

It is difficult to interpret and compare returns from such widely dispersed strategies, even when they have similar, low risk objectives. A difference in returns might simply indicate the difference in asset mix and provide no indication of the manager's skills. It is no coincidence that, of the 16 funds that stated their growth asset proportions under the heading 'Multi-sector, conservative', those with the highest proportion of shares did best over the 12 months to 31 March 2010 (in a growth market) while those with the smallest proportion were at the bottom of that comparison.

This does not diminish the importance of investment comparisons to members, particularly over the long timeframes involved with KiwiSaver. It does suggest, however, that New Zealand has some way to go before there are reliable, transparent, comparative reports comparing KiwiSaver schemes for the purpose of informing scheme members. It is one thing to legislate disclosure requirements; quite another to make that disclosure meaningful and helpful to members. Again, the government's role could extend to funding ongoing research and regular publication on comparative costs by an independent group.

Overall, it is fair to indentify a lack of rigorous monitoring to date. The Securities Commission recently raised an alarm at the lax regulation of KiwiSaver schemes and the potential for deception and bad practice. In 2010, for example, a provider was found to have inflated returns by putting in personal money (Bridgeman, 2010). In addition, some providers have recruited students to promote KiwiSaver accounts to children, and to enrol members on a commission basis.

Other issues arise when some providers regularly write for the newspapers on investment matters and may advertise their funds in the same papers. Overall the existence of so many competing providers and products has been confusing for the public, and the lines of responsibility for regulatory oversight have been obscure. The Securities Commission has noted the "tangled web of jurisdictions overseeing KiwiSaver schemes" including the Government Actuary, the Companies Office, the Securities Commission, and the National Enforcement Unit, each with its own role to play.[22]

5.7 Lock-in

The premise of KiwiSaver is that it is a long-tem savings scheme so that in general it is not accessible until the age of 65. As shown below, there are some provisions for hardship and a member's own savings may be exported when they leave New Zealand permanently. The lock-in can be subverted however by the provisions for housing. There are also generous provisions for contributions holidays that do not give access to the money but stop the future automatic deductions by the employer.

5.7.1 First home

In line with the view that owning a home is a "critical part of long term financial security" (Cullen, 2006), after 3 years, KiwiSaver members can qualify to withdraw some or all of their saved funds, excluding the kickstart and MTC, to buy their first home. KiwiSaver

22. See Securities Commission website: http://www.seccom.govt.nz/invest/articles/260310.shtml.

members who have previously owned a home and seek to use their saved funds to purchase again can, through their providers, request Housing New Zealand to assess their financial situation. If it is the same as a 'first home-buyer', they may also qualify.

In addition to the ability to withdraw funds to put towards purchasing a first home, a member may qualify for a government subsidy of $1,000 for each year they have been in KiwiSaver, up to an individual maximum of $5,000. Members of employer superannuation schemes exempt from the KiwiSaver automatic enrolment can also qualify for this home ownership deposit subsidy.

5.7.2 Contributions holidays

All employee members of over 12 months' standing are entitled to take a contributions holiday of between 3 months and 5 years, while new members experiencing or expecting to experience financial hardship can apply to take an early contributions holiday, even during the initial mandatory 12 months' contributory period. Such situations of financial hardship are assessed by the KiwiSaver schemes according to legislated criteria and must be due principally to circumstances outside the members' control.

During a contributions holiday, a member's employer will also cease compulsory employer contributions. As at 31 March 2010, 40,517 KiwiSaver members (just under 3% of total members) had taken an active contributions holiday, perhaps reflecting heightened financial hardship during the recession. The member, while on a contributions holiday, may chose to contribute independently and has an incentive to do so up to a level that maximises the government's member tax credit of $20 a week.

5.7.3 Mortgage diversion

With the intention of further aiding New Zealanders' home-ownership aspirations, KiwiSaver originally included a mortgage diversion facility, enabling members to direct up to half of their contributions towards mortgage repayment. This was based on the idea that repaying the mortgage is an effective way of saving. Under changes introduced in September 2008 to make the facility more broadly applicable, the range of qualifying mortgages was extended to include flexible mortgages. Despite these efforts, only 600 members had taken advantage of the facility as of May 2009.

The mortgage diversion scheme added compliance costs for providers and banks and was abolished by the National Government from 1 July 2009, although members who had previously signed up were able to continue. As discussed in section 3.2, the Minister of Revenue also noted at this time that the diversion scheme offered members an opportunity to bypass the lock-in of their funds, since by selling the home they would gain access to diverted contributions. He suggested that this contradicted the principle of accumulating assets for retirement, a fundamental objective of KiwiSaver (Dunne 2009).

6. Assessing the KiwiSaver experience

6.1 Distributional effects of KiwiSaver:

The taxpayer-funded subsidies to KiwiSaver are distributed to members based on the contributions made by individuals and their employers. Over time, the subsidies relating to the employers' contributions become relatively more important as the real value of the fixed-dollar MTC and the original kickstart diminish (Retirement Policy and Research Centre, 2009).

The RPRC analysis shows that changes made to the KiwiSaver scheme in 2009 (KiwiSaver III) will have a major impact on the total value of the lump sum benefit members can expect at age 65 assuming 40 years membership. The most significant impact resulted from the 2009 reduction in the compulsory, tax-exempt employer contribution from 4% to 2% of employee's pay. The loss of the $40 pa fee subsidy results in a $2,416 reduction in the lump sum benefit at age 65.

Table 6. Changes in lump sum benefit KiwiSaver II to KiwiSaver III (assuming 4% contribution rate; 40 years' membership, 2% p.a. net real return)

Income pa	KiwiSaver II	KiwiSaver III	Difference
$20,000	$197,910	$123,012	-$74,898
$30,000	$275,587	$173,931	-$101,657
$40,000	$323,909	$210,172	-$113,737
$50,000	$372,231	$246,413	-$125,817
$60,000	$420,552	$282,654	-$137,898
$70,000	$468,874	$318,896	-$149,978
$80,000	$517,195	$355,137	-$162,059
$90,000	$565,517	$391,378	-$174,139

Source: (Retirement Policy and Research Centre, 2009)

Overall, changes made to KiwiSaver resulted in an average benefit reduction of 34%. While the highest income earners had the largest dollar reduction, the highest percentage reduction (38%) was experienced by those on the lowest incomes, $20,000 a year; and the smallest reduction (31%) was experienced by those earning $80,000 p.a. and above.

The 2009 changes also had an impact on the taxpayer-funded proportion of lump-sum benefit, with the greatest change to the proportions due to discontinuing the employer tax credit. Other factors contributing to lower member returns were cessation of the $40 fee subsidy, and reduced total value of the tax-exempt employer contribution.

6.1.1 Impact of inflation

There is no statutory requirement for the real value of the MTC and the $1,000 kickstart to be maintained by the government. Without indexation their real value will reduce each year by the rate of inflation. This has an impact on the distributional effects of KiwiSaver. Members who joined in the first year of the scheme received the full value of the kickstart, while future members will receive less in real terms. Once the payment is invested, the interest rate earned on the investment should cover the rate of inflation. Thus the MTC is the only future benefit negatively affected by inflation for members joining in the first year.

Limiting the tax-exemption of the employer contribution to 2% of the member's income has reduced the regressivity of KiwiSaver; that is, it has improved the distributional nature of the scheme as it existed under KiwiSaver II. However, from a distributional point of view, the most progressive change the government could make to KiwiSaver is the elimination of the tax-exempt nature of the employer's contribution. This concession is regressive: the benefit associated with the exemption is highest for those in the highest income tax brackets. Also, because the benefit is proportional to members' incomes, the real value of the exemption is not affected by inflation (to the extent that

incomes are protected from inflation). The exemption is a tax expenditure costing approximately $170 million a year in forgone tax revenue (Policy Advice Division of Inland Revenue Department & Treasury, 2009). It is unclear why taxpayers should give greater retirement-saving assistance to the highest paid KiwiSaver members.

By removing the exemption for the employer contribution, the government would both improve the distributional nature of the scheme, and reduce the tax burden associated with government financing of benefits predominantly captured by higher-income members. It would also move KiwiSaver closer to the original design as announced in the 2005 Budget. The gain in revenue could be applied to indexation of the kickstart and MTC to improve intergenerational equity.

6.2 Financial knowledge

One of the intentions of KiwiSaver is to encourage the spread of financial literacy. According to a report prepared for the Capital Markets Taskforce (O'Connell, 2009), New Zealand has an active and well-supported National Strategy for Financial Literacy led by the Retirement Commission, and is one of the few countries to have completed a survey of financial literacy levels in the population. While this report found that New Zealand is a world leader in the delivery of financial education in terms of organisation, cost-effectiveness and mode of delivery; it also found education about investing, in particular, could be improved. While most New Zealanders appear to understand the basic concepts of risk, return and diversification, and appreciate that investing is a way to achieve financial goals, they are sceptical about share market returns over the long term (O'Connell, 2009).

Financial education about capital market investment tends to be focussed around retirement savings products, including KiwiSaver. The Retirement Commission's *Sorted* website and the Securities Commission's website both provide some information about investing directly in capital markets. Interestingly, numbers on the *Sorted* website peaked when these services were advertised on television. Currently however, there is a relatively low demand for this type of information. The high and stable percentage of KiwiSaver memberships suggests that once they have joined a scheme, New Zealanders do tend not to seek further advice.

In terms of KiwiSaver helping improve the financial literacy of the young, (as may have been the goal of allowing children to participate), there are reasons to suspect the impact has been negative. Children have little incentive to contribute to a scheme that locks-up their saving until they reach age 65. They may also observe that their kickstart either grows very slowly or even diminishes over time in nominal terms now that fees are not subsidised. This may in fact provide a perverse object lesson that managed funds are not to be trusted, and for providers, a multiple of small inactive accounts may prove to be a headache to administer.

6.3 Aggregate effects on saving

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

[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. (Cullen 2005, p. 4)

However it was not clear that KiwiSaver was capable of lifting national saving.[23] By the time the Bill was introduced, there was little mention of the problem. The purpose of the Kiwisaver Act 2006 is described 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. (KiwiSaver Act 2006)

Only on p.36 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.

It is too soon to assess KiwiSaver's impact on either national or household saving. Gibson, Hector and Le (2008) provided a preliminary estimate of household saving and show the 'shift' effect, "...[i]t appears that out of every dollar in KiwiSaver accounts, only 9-19 cents is new saving" (Gibson, Hector, & Le, 2008, p. 27). The eight year longitudinal Survey of Family Income and Employment (SoFIE) currently being carried out by Statistics New Zealand, may eventually shed light on KiwiSaver's impact. Every two years, starting in 2004 and continuing until 2010, financial data is collected from SoFIE's participants that allow analysis of households' savings.

The first pre-KiwiSaver SoFIE data are now available. Scobie & Henderson (2009) have estimated that, before KiwiSaver started in 2007, New Zealand households saved an average 16% of their gross incomes in the two years 2004-2006. Taking property revaluations out of that estimate reduced the saving rate to 5%. When the next tranche of SoFIE's financial data is available from 2008, it might be possible to see if KiwiSaver has affected households' saving patterns. However, separating out the specific impact of KiwiSaver is likely to be problematic, especially in times of changing economic conditions.

Even if there is an impact on household saving, there is no guarantee that national saving (the sum of private and public saving) will improve. KiwiSaver is not the only change since 2007: a combination of reduced contributions to the NZSF; lower income taxes; a rebalancing towards the tax on goods and services; lower rates of tax on investment earnings and the impact of the recession are but a few of other contemporaneous influences. Moreover, while some of the rhetoric suggests that more KiwiSaver savings equals more investment and growth, in practice more saving from any source does not 'cause' more or better investment.

---

23. 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.

6.4 Income or lump-sum?

In other countries, tax incentives usually have one clear redeeming feature: they may allow prescription of the nature of the final benefit. Provision of income via a pension or an annuity can, in an EET environment, give society some pay-back for foregoing tax revenue in the accumulation process. While the annuity provides longevity protection for savings supplementary to the state pension and thus protects the longest-lived individuals, society also gains because there is certainty of an income stream that can in principle be used to pay for the additional costs of long-term care and other health costs. Given the personal nature of the concessions, pensions are not easily disguised by the use of trusts, nor can the underlying capital sum be dissipated too early in retirement

New Zealand had a unique opportunity with a tax neutral TTE regime to design an explicit subsidy to recognise the gains to society from annuitisation with few of the disadvantages of traditional tax incentives (St John, 2006). One possibility was the provision of a limited value, inflation-adjusted, gender neutral annuity to supplement NZS, purchased out of lump-sum saving and a suitable share of home equity. This annuity would require subsidisation to be viable but may have also included a cost-effective insurance rider for long-term care. This opportunity is now passing while New Zealand runs the dangers of an EtE regime, with unregulated lump sums coming out of KiwiSaver (and other tax-advantaged schemes). In the meantime, private home equity release schemes are aimed at younger old-age groups for consumption, not for long-term retirement income purposes.

The provision of tax-funded subsidies in KiwiSaver might have been used to impose restrictions on spending of KiwiSaver lump-sums in retirement. Unfortunately New Zealand's annuities market is almost non-existent and under current tax rules and the lack of inflation indexing annuities, are rarely purchased voluntarily. A more careful development phase for KiwiSaver might have allowed some attractive options, such as the purchase of a top-up to NZS to be developed (St John, 2009).

6.5 Implications for New Zealand Superannuation

NZS is defined as 'universal' because it is not means (income or asset) tested; and every New Zealander over the age of 65, after meeting the residency requirement, is eligible to receive it.

However those who have entitlement to an overseas pension analogous to NZS find that it is offset by these pensions dollar for dollar. Many immigrants to New Zealand believe they are unfairly treated when their second-tier state pensions from their home country are deducted. Other payments are exempt, including those from compulsory private saving schemes such as in Australia and Chile. Since 2007, New Zealand residents can save for extra retirement income in KiwiSaver, so that the deductions of some overseas pensions can appear anachronistic and anomalous (Dale, St John, & Littlewood, 2009).

NZS itself is effectively taxed at the top marginal tax rate applying to the individual. Until 1985, there was a more progressive income tax scale, then for the period 1985-1998, a surcharge applied that provided a modest degree of clawback from higher income people. Today, erosion of the tax base, and calls for lower top tax rates in addition to generous KiwiSaver subsidies for the better-off savers may undermine the integrity and fiscal sustainability of the universal payment (St John, 2009). New Zealand can

eventually expect pressure for an income- and asset-tested approach similar to that in Australia.

7. KiwiSaver: lessons from the first 3 years

7.1 Confused objectives

The current design of KiwiSaver does not appear to be the outcome of any research-based policy development process. After three years, it is still unclear what problems KiwiSaver was to address, and how they would be addressed. Where was the evidence that New Zealanders were under-saving for retirement, and KiwiSaver would provide the solution? What impact is there on national saving? If KiwiSaver was to ensure more income in retirement, why was there no attention to decumulation of the lump-sum? How does KiwiSaver help moderate the fiscal pressures of an aging society?

7.2 Constant change

The time-frames around KiwiSaver's introduction were unreasonably short and New Zealand continues to pay the price with poor quality regulation and constant change.

As explained in section 3, KiwiSaver's introduction was a copybook illustration of how not to go about such a major change to a retirement savings environment. KiwiSaver III (the current version) is still undergoing change, including the removal of mortgage diversion from 1 July 2009, and closing the 'exempt scheme' option on 6 October 2009. These constant and significant shifts over such a short period (KiwiSaver started on 1 July 2007) perpetuate the opaque way in which the original design and subsequent re-design was conceived and developed. It also illustrates the point made in paragraph 7.1: because there was no clear vision and widely agreed purpose for KiwiSaver, it has become a hostage to politics. Further change is now to be expected.

7.3 Implications for New Zealand Superannuation (NZS)

Demographic change implies that the cost of NZS in its current form will double over the next 40 years, from about 4% of GDP to 8%. The costs of healthcare will also reflect the changing age structures of New Zealand's population. Although there is currently no sign from the government that this is under consideration, given the contribution that taxpayers will be making to the accumulation of KiwiSaver benefits, it would seem logical that a future government might link NZS through a means test to KiwiSaver. A similar link applies in Australia to its equivalent of NZS, the 'Age Pension' (but applies to all assets and income, not just those derived from Australia's compulsory saving scheme).

7.4 Distributional concerns

Until KiwiSaver, New Zealand's tax treatment of retirement savings was relatively neutral and had been so since 1990. That changed with KiwiSaver II in 2007 with the introduction of a range of subsidies and tax-exempt, compulsory employer contributions of 4%. Although that significant concession was halved with KiwiSaver III, what remains raises concerns that apply to all pay-based interventions in retirement saving schemes. Those workers who for whatever reason do not belong to KiwiSaver, effectively subsidise those that do belong, both from higher taxes to fund the MTC, kickstart, tax exemption and from wages that grow more slowly over time because of the employer contributions

for those who do belong. The gender imbalances in retirement savings are reinforced to the extent that subsidies favour higher paid workers.

Distribution across generations depends on whether the Kickstart and the MTC are maintained in real terms. Once a person has joined KiwiSaver, the generosity of the subsidy appears to matter less, as inertia leads to them maintaining their membership.

7.5 Why children?

It seems difficult to justify the eligibility of children for a national, subsidised *retirement* saving scheme. Although care was taken to exclude them from the auto-enrolment conditions that apply from age 18, the payment of the $1,000 kickstart (and previously the $40 a year administration fee) in respect of children, seems anomalous.

Most members under age 18 are not contributing to their accounts. For the 2008/09 year, 6% of the more than 180,000 members who are children contributed through Inland Revenue to their accounts at a total value of $2 million (an average of only $11 each). It is likely large numbers of accounts managed by providers contain nothing more than the $1,000 kickstart payment. Of the contributing children, almost all are contributing through salary or wage deductions (Inland Revenue Department, 2009).

From a financial education point of view, the messages about the point of saving given to children in KiwiSaver may be quite perverse. The lock-in rules are very unattractive to the young and with no fees subsidy, these high cost small accounts may not generate a sufficient return to maintain even the nominal value of the original kickstart. From a distributional perspective, most of the benefits are likely to flow to the children of higher income, more financially literate families.

7.6 Too many providers?

Most observers expect that the total number of providers (currently 53, including employer-specific schemes) will reduce substantially. It is difficult to understand why employers would set up KiwiSaver arrangements specific to their own employees, and those are likely to disappear. Of the remaining 35 or so 'public' schemes, possibly half will merge with other schemes.

The question is whether the remaining 20 to 25 KiwiSaver providers is too many; or, would the single scheme approach chosen by, for example, the UK and Sweden be preferable? Having more than one provider means that disclosure and regulatory oversight needs greater care and there are emerging problems in New Zealand. At very least a reformed regulatory framework and an informed business press that is capable of assessing competing claims and providing reliable information to the general public is required.

7.7 Too little regulation?

The regulatory regime overseeing KiwiSaver schemes is relatively light-handed, relying more on registration and filing than on approval and oversight. KiwiSaver has been slotted into the existing regime that applies to all other 'superannuation schemes'. Although it has its own legislation, the KiwiSaver Act 2006, it remains to be seen whether this delivers the protection that a government-mandated regime requires. As noted, the Securities Commission has raised issues with the behaviour of some providers and the unsatisfactory regularity environment.

The current environment is best described as self-regulation, but the industry has failed to provide an authentic mechanism whereby schemes' investment performance, fees and costs can be compared. Full disclosure, such as for commissions, is supposed to provide the requisite member protection. But firms gain financial advantage from sales, and disclosure does not impose an obligation to explain the range of alternatives (Sheather, 2010). The global financial crisis may call into question the robustness of a regulatory regime founded largely on the 'prudent person' requirement that trustees to act in the best interests of their beneficiaries. It is clear that different trustees have different views as to how to interpret this provision.

7.8 Calls for compulsion

KiwiSaver is a form of 'soft compulsion'. Most KiwiSaver schemes by volume of members are owned by Australian-based financial service providers that have profited by Australia's compulsory retirement savings scheme. Despite the fact that KiwiSaver has been in place only since 2007, there are many calls, especially from the industry, to make it compulsory. The framework is in place; the only change needed would be to remove the opt-out. Concerns about compulsion include the forcing of those who cannot afford to contribute to be in the scheme and the inevitable need to integrate KiwiSaver with NZS.

7.9. Choice, default and opt-out

In a defined contribution environment where the benefits from a given set of contributions depend on the investment returns, it is almost inevitable that members should say where their money is invested. That implies that they should have the right to decide who manages that money. But too much choice in a small country can be costly for individuals, providers and regulators. The balance between individual choice and what is sensible and what is cost effective has yet to be reached.

As mentioned in section 5.5, the rationale for conferring a commercial advantage on the six default KiwiSaver providers is unclear. Equally, it is difficult to see why the government would impose investment restrictions on the default investment option of only the default providers. If there were any justification for such rules, why might they not apply to all KiwiSaver schemes? An auto-enrolment regime necessarily requires default providers but not default investment options. The flawed structure of default provider selection, another by-product of the haste and secrecy that accompanied KiwiSaver's introduction, requires review.

7.10 Auto-enrolment

Most new employees must be joined up to KiwiSaver if they are not already members. 'Soft compulsion' is justified on the grounds that it is relatively easy to opt-out and that it is a means of making sure people have a chance to do what is in their best interests. Exempt schemes undermine the intent of auto-enrolment. Whether it is a 'successful' strategy depends on how employees react and then what happens to their other savings behaviour. KiwiSaver's success cannot be properly measured for one or more decades and then only if it can be established that KiwiSaver has helped employees to achieve what they might not have been otherwise able to do on their own. Such an outcome will be difficult, if not impossible, to demonstrate. That may undermine the justification for auto-enrolment, and all the compliance costs that it entails for the employer.

7.11 Housing

Many New Zealanders still make most of their 'retirement' savings through owning a mortgage-free home by the time they reach retirement age. Requiring someone who is not already a home-owner to save through KiwiSaver, rather than use those savings to purchase and pay off a home, was antithetical to New Zealanders.[24] KiwiSaver accommodated that by the concessions and subsidies for first home purchases, and the now defunct mortgage diversion facility. However, it compromised KiwiSaver's fundamental objective: to increase financial savings for retirement. The lesson here is that a government's intervention needs a clear, unambiguous focus. It would perhaps have been better to restrict the auto-enrolment requirement to employees who were over age 35 or 40, and then to give no concessions to home ownership.

7.12 Mis-application of lessons from studies on behavioural finance

Most of the research relating to behavioural finance focuses on the relationship between scheme members, their market incomes (usually just from the employer that sponsors the scheme), and financial assets directly invested in the scheme itself for retirement. It does not usually include other assets that a scheme member might own (such as housing, entitlements to the state pension and other assets, including direct investments and the household's capacity to earn income during the period to retirement) all of which must have a significant bearing on a member's willingness (or need) to take on the risks associated with investing financial assets in shares and/or property in the particular savings scheme under review (or even joining the scheme at all).

Not all employees need to save for retirement; on the other hand, they may need to save for retirement but not now because they have more pressing financial commitments such as completing their education, starting a family, buying a house or paying off debt. The lessons from behavioural finance do have direct implications for framing choices within complex saving schemes but what seemed like a 'simple' answer to the problem of, for example, investment choice for defined contribution scheme providers and sponsors may turn out to be simplistic.

From a public policy perspective, the question is whether governments should be designing a regulatory framework that influences private behaviour to save particular amounts of money for retirement at particular times and in a particular way. It is one thing for the principles of behavioural finance to help employers, for example, to design a workplace retirement saving scheme and influence the choices the scheme offers. The employer's saving scheme is part of its remuneration strategy and one of the objectives should be that the scheme's design 'works' in the way the employer wants. It is another step for governments to force employers to intervene directly in a particular way in the compensation framework offered to employees, as has been illustrated by KiwiSaver.

There is a final problem with the evaluation of soft compulsion: auto-enrolment is supposed to nudge people to behave in the 'right' way; in this case, to save more for their retirement. It is impossible to assess whether the 'nudge' has been successful if at the same time there are significant monetary incentives to change behaviour.

---

24. While employees could opt-out, they then lost the advantage of the significant tax breaks and employer's contributions that were part of KiwiSaver II and remain, in reduced form, in KiwiSaver III. Also, everyone's taxes (including non-homeowners) are higher to pay for the incentives.

8. The lessons in summary

This paper has discussed a number of public policy issues posed by KiwiSaver in its current form. Based on the events of the last five years, New Zealand can expect KiwiSaver to continue to 'evolve' but it is hoped that evolution is informed by careful research and debate rather than more knee-jerk reaction.

There may be a number of lessons for other countries such as Ireland in the KiwiSaver experience. Despite the apparent instability of the many changes to KiwiSaver, it has been well accepted, so far, by the public. Employers and the IRD have experienced extra compliance costs in the auto-enrolment processes but there has been only mild opposition from employers.

While it is dangerous to draw lessons after only 3 years, the experience may suggest that large incentives to get the scheme off the ground and entice people to remain opted-in may be then reduced significantly ex post with little impact on membership. Moreover, non-indexation of core tax-funded subsidies may allow the real value of fixed incentives to reduce over time.

Opening the scheme to children has little justification, and most young adults need help today to pay debts and mortgages before they save for tomorrow. Compensating them by offering housing subsidies only muddies the waters and adds complexity.

New Zealand's experience shows that too many providers is wasteful, and it is important to get the default arrangements right. Tax-funded subsidies may insulate members from the impact of poor returns and high fees, and reduce the market demands for adequate protections and policing of provider behaviour. It is therefore important to get the regulatory framework right from the beginning.

The New Zealand experience also shows the danger of setting up a tax-subsidised scheme without attention to decumulation. It is difficult to change the rules some years into the scheme, when people joined on the understanding they would have free choice over their accumulated lump-sums.

Finally, to the extent that the scheme is evaluated against its objectives, the objectives must be clear: Is KiwiSaver's purpose to benefit the individual in retirement? Is it to reduce the pressures on the economy of an ageing population? Or, is KiwiSaver supposed to solve the national saving problem? As long as the purposes are unclear, the scheme is vulnerable to the industry determining the design of the scheme to meet its own objectives.

References

Ashton, T., & St John, S. (1988). *Superannuation in New Zealand. Averting the Crisis*. Wellington: Institute of Policy Studies.

Bedford, P. (2009). The global financial crisis and its transmission to New Zealand - an external balance sheet analysis. *Reserve Bank of New Zealand Bulletin, 71* Retrieved from http://www.rbnz.govt.nz/research/bulletin/2007_2011/2008dec71_4bedford.pdf

Bell, M., Blick, G., Parkyn, O., Rodway, P., & Vowles, P. (2010). *Challenges and Choices: Modelling New Zealand's Long-term Fiscal Position*

Beshears, J., Choi, J. J., Laibson, D., & Madrian, B. C. (2006). The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States. *National Bureau of Economic Research Working Paper*(no. 12009.).

Bollard, A., Hodgetts, B., Briggs, P., & Smith, M. (2006). *Household savings and wealth in New Zealand*. Wellington: The Reserve Bank Of New Zealand.

Bridgeman, D. (2010). Huljich withdraws investment statement, Sec Com investigates. *The National Business Review, 20 May*.

Chamberlain, M., & Littlewood, M. (2010). *Working Paper 2010-1. Towards a more rational tax treatment of collective investment vehicles and their investors*. Auckland: Retirement Policy and Research Centre, Department of Economics, University of Auckland.

Crossan, D. (2007). *Executive Summary. 2007 Review of Retirement Income Policy*. Wellington: Retirement Commission.

Cullen, M. (2006). KiwiSaver - security and choice. from http://www.beehive.govt.nz/release/kiwisaver+-+security+and+choice

Cullen, M. (2007a). Budget Speech 2007. 2010, from http://www.beehive.govt.nz/?q=node/29338

Cullen, M. (2007b). Budget Speech 2007. from http://www.beehive.govt.nz/?q=node/29338

Dunne, P. (2009). KiwiSaver mortgage diversion to be closed. Retrieved from http://www.beehive.govt.nz/release/kiwisaver+mortgage+diversion+be+closed

English, B. (2008). *Changes make KiwiSaver more affordable for all*. Retrieved from http://www.beehive.govt.nz/release/holding+kiwisaver+release.

Fallow, B. (2010, April 1, 2010). Borrowers exposed under debt mountain. *The New Zealand Herald,*. Retrieved from http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=10635708

Gaynor, B. (2008, Mar 29, 2008). Current account shows holiday is over,. *The New Zealand Herald,*. Retrieved from http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10500788&pnum=0

Gaynor, B. (2010). KiwiSavers need to be more adventurous. *24th April*. Retrieved from http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10640441

Gibson, J., Hector, C., & Le, T. (2008). *The distributional impact of KiwiSaver* (Working paper): University of Waikato.

Government Actuary. (2008). *Report of the Government Actuary for the year ended 30 June 2008*. Wellington: Ministry of Economic Development.

Government Actuary. (2009). *Report of the Government Actuary (in respect of the KiwiSaver Act (2006)*. Retrieved from http://www.parliament.nz/NR/rdonlyres/844F274F-E406-499C-9B8F-F34AD320DA31/114903/DBHOH_PAP_18814_GovernmentActuaryinrespectoftheKiw.pdf.

Government of Ireland. (2007). *Green Paper on Pensions*. Retrieved from http://www.pensionsgreenpaper.ie/downloads/GreenPaper.pdf.

Government of Ireland. (2010). *National Pensions Framework*. Retrieved from http://www.pensionsgreenpaper.ie/downloads/NationalPensionsFramework.pdf.

Inland Revenue Department. (2006). Tax policy report: Fiscal implications of the SSCWT exemption for KiwiSaver (pp. Released under the Official Information Act 17 July).

Inland Revenue Department. (2009). *Kiwisaver Evaluation: Annual Report 2: July 2008 - June 2009*. Retrieved from http://www.ird.govt.nz/resources/2/3/236969804fea97e9881ceb53c1fd2485/ks-ar-2009.pdf.
Inland Revenue Department. (2010). Kiwisaver Statistics as at 31 March 2010. Retrieved 29/04/2010, 2010, from http://www.kiwisaver.govt.nz/statistics/ks-stats-10-03-31.html
Minister of Finance. (2002). December economic and fiscal update 2002. from http://www.treasury.govt.nz
Minister of Finance. (2010). *Budget 2010*: http://www.treasury.govt.nz/budget/2010
Mitchell, O., & Utkus, S. (2003). *Lessons from behavioral finance for retirement plan design* (Pension Research Council Working Paper).
Mourougane, A. (2007). *Toward a more efficient taxation system in New Zealand* (OECD Economics Department Working Papers No. 557): OECD Publishing.
New Zealand Superannuation and Retirement Act (2001).
New Zealand Superannuation Fund. (2010, 20 April 2010,). Investment Performance. Retrieved 14 May 2010, from http://www.nzsuperfund.co.nz/index.asp?PageID=2145855927
O'Connell, A. (2009). *Financial Literacy in New Zealand, A Report Prepared for the Capital Market Development Taskforce*. Wellington.
OECD. (2005). *Pensions at a glance*. Paris: OECD.
OECD. (2006). *OECD in Figures 2006-2007*: OECD.
OECD. (2009). *OECD in figures*. Paris: OECD.
Pensions Commission. (2005). *A New Pension Settlement for the Twenty-First Century*.
Perry, B. (2009). *Non-income measures of material wellbeing and hardship:first results from the 2008 New Zealand Living Standards Survey, with international comparisons*. Wellington: Ministry of Social Development.
Policy Advice Division of Inland Revenue Department, & Treasury, N. Z. (2009). *Background paper for Session 3: Other base broadening and revenue raising ideas*. Wellington: Victoria University of Wellington Tax Working Group.
Rashbrooke, G. (2009). Simple, Effective and (Relatively) Inexpensive: New Zealand Retirement Provision in the International Context. *Social Policy Journal of New Zealand*(36), 97 - 110.
Retirement Policy and Research Centre. (2009). *Modelling the distributional aspects of KiwiSaver: methodology and results* (PensionBriefing 2009-6.). Auckland: Retirement Policy and Research Centre, Department of Economics, The University of Auckland.
Sheather, B. (2010, 22 May 2010). Ban on commissions is a must. *The New Zealand Herald*. Retrieved from http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10646641
St John, S. (2009). The Annuities Market in New Zealand: Ministry of Economic Development, For the Capital markets Taskforce Report. .
St John, S. (2005). Retirement income policy in New Zealand. *The Economic and Labour Relations Review, 15*(2), 217-239.
St John, S. (2007). Farewell to tax neutrality: the implications for an aging population. *Economic and Labour Relations Review, 18* (1), 27-52.
Statistics New Zealand. (2010). Balance of Payments and International Investment Position: December 2009 quarter. *Hot Off The Press*, from http://www.stats.govt.nz/browse_for_stats/economic_indicators/balance_of_payments/balanceofpayments_hotpdec09qtr.aspx
Tapia, W., & Yermo, J. (2007). *Implications of Behavioural Economics for Mandatory Individual Account Pension Systems*: OECD.
The New Zealand Treasury. (2007). *Budget Economic and Fiscal Update*. Wellington: The New Zealand Treasury.
The NZ Institute. (2010). NZ Ahead. from http://www.nzinstitute.org/Images/uploads/nzahead-pdfs/NZahead_Full_report.pdf
Toder, E., & Khitatrakun, S. (2006). *KiwiSaver Evaluation Literature Review*. Retrieved from http://www.treasury.govt.nz/publications/informationreleases/kiwisaver/background.