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**AN ECONOMIC ANALYSIS OF COMPULSORY
SAVINGS**

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1 Introduction

This paper focuses on the economic effects of a compulsory savings scheme. It looks first at some of the economic relationships between savings, economic growth, and national sovereignty. Section 3 presents empirical evidence on savings performance in New Zealand and some countries with compulsory savings schemes. Section 4 considers some policy issues from the perspective of the business sector, including the financial services industry, and section 5 makes some concluding comments. An annex contains some more detailed material on these issues.

2 Consumption, savings and economic growth

What are we trying to maximise?

Material standards of living, including in retirement, are basically dependent on consumption opportunities. Consumption is the end-purpose of economic activity; it is the aggregate we want to maximise. Savings is deferred consumption; it is simply a means to an end. We save in order to spread consumption over time or to increase consumption in the future through profitable investments. The sustainable consumption opportunities of the community, including people in retirement, are essentially determined by the productivity and growth performance of the economy.

Do higher savings lead to higher growth?

Fifty years ago economists were concerned about excessive saving - the so-called Keynesian problem of under-consumption. Today some people fret about countries saving too little. In fact, excessive savings and investment are as damaging to welfare (consumption possibilities) as the reverse. A successful effort to raise national savings and investment ratios might have little effect on the rate of economic growth. A basic growth model suggests the sustainable growth rate would not be altered. Instead there would be a one-off increase in per capita income. At the same time consumption per head could fall because of the greater burden of capital depreciation. Policies for growth need to be broadly based.

Can governments change national savings ratios?

National savings comprise savings by households, firms and governments. Firms and governments have no money of their own: their assets and liabilities are owned by individuals. Given people's consumption plans, it is plausible that changes in one component of savings would be offset to some extent by changes in others. Furthermore, attempts to increase one form of household savings (retirement savings) by regulation would be likely to result in reductions in other forms of household savings (e.g. home ownership). Most economists believe the main influence the government can exert on national savings is through

its own savings or dissavings (operating surpluses or deficits). Taxes and welfare policies may be additional influences.

Would higher domestic savings reduce reliance on foreign investment and increase New Zealand's sovereignty?

If domestic savings are lower than domestic investment, the result by definition is a current account deficit and, if maintained over time, an increase in both foreign liabilities and domestic assets to service them. There is nothing untoward about this situation if overall policy settings are sound. Nor is there any automatic relationship between domestic savings and the current account balance. As shown in the annex, higher domestic savings could be offset by changes in investment or net imports which would leave the current account position unchanged. Any problem of external indebtedness is best addressed by sound stabilisation (monetary and fiscal) policies and microeconomic reforms to improve international competitiveness. The net stock of claims by foreigners on New Zealand can only be reduced by running current account surpluses, not by restrictions on asset sales or foreign investment. Economic sovereignty is primarily a matter of whether a country's overall economic framework is sound and robust, and its economy flexible and competitive.

What is the 'right' level of saving?

The answer to this question is straightforward. Central planners do not have the information to know. Instead it is the level that emerges if households are free to divide their income between current and future consumption in accordance with their own preferences in a relatively undistorted economic environment, free of inflation and fiscal imbalances. It is likely to be futile, if not counter-productive, for governments to try to interfere with the sum of the decisions of all the units making up the community as they go about their affairs.

3 Empirical evidence on savings

General

As theory suggests, there is no close relationship between national savings (and investment) ratios and economic performance. The US savings ratio has been low for many decades. The savings ratios in the former Eastern bloc countries were among the highest in the world. The theory was that 'primitive socialist accumulation' would enable them to pay for rapid industrialisation in the absence of foreign capital and allow the Soviet Union to overtake the West. New Zealand's savings and investment ratios have been around or above the OECD averages but until recently our growth rate has been the lowest in the OECD area. Clearly other factors, including the efficiency of savings and investment, are more important determinants of economic growth.

Moreover, studies suggest that the causal connection between savings and growth may not run in the direction that is commonly supposed. The World Bank in its report *The East Asian Miracle* concluded that "growth drives savings rather than the other way around". In a separate examination of four Asian countries, other researchers came up with a fairly unambiguous finding: "In all four countries [Japan, South Korea, Singapore and Hong Kong] growth was high early and savings was high later". In South Korea, for example, growth averaged 6.1 percent during the period 1960-74 while the average savings rate was only 10.4 percent. In the subsequent period, 1977-87, savings averaged 27.8 percent and growth only 5.3 percent.¹

Some of the economic relationships considered thus far can be studied for three countries that have adopted compulsory savings schemes.

The Case of Australia

Australia has had a compulsory superannuation scheme since the early 1990s. Despite this, household savings have been falling steadily, and are now less than 3 percent of disposable income. The national savings rate has fallen too: at 16.7 percent of GDP in 1994, it was well below the average for the first half of the 1980s. New Zealand's savings rate in 1994 was 20.4 percent, nearly four percentage points higher than Australia's. What has clearly happened in Australia is that there has been a massive switch in savings into superannuation and life insurance and away from forms such as repayment of home mortgages, but no increase in the total. Moreover, compulsory savings has not prevented large current account deficits and a build-up of external debt.

The Case of Chile

Chile introduced a compulsory savings scheme against a background of astronomical rates of inflation, a collapse of private savings and an inadequate and unaffordable public safety net. Its domestic savings rate has risen from under 5 percent to around 25 percent. However, contrary to the common belief about the effects of pension reform, empirical research suggests that its contribution to private saving was small or even negative.² The important contributions to Chile's higher savings rate appear to be the increase in disposable income with economic growth and the increase in public saving resulting from sounder fiscal policies.

The Case of Singapore

Similar evidence exists for Singapore. Its Central Provident Fund (CPF) was established in 1955 and Singapore has had one of the highest savings rates in the world. However, while the

¹ See 'Savings equals growth? Ain't necessarily so', *Australian Financial Review*, March 13 1997.

² Holzmann, Robert, 'Pension Reform, Financial Market Development, and Economic Growth : Preliminary Evidence from Chile', IMF Working Paper, August 1996.

CPF may have been a factor in Singapore's rising savings rate until the early 1980s, recent research suggests that the more important explanations are demographic factors, the rapid growth of private disposable income and the high level of budgetary saving.³ Withdrawals are allowed from the CPF for a range of purposes. Only 15.9 percent of withdrawals are at age 55 (the age at which funds may be withdrawn for retirement purposes), and housing investments account for the bulk (66.6 percent) of the withdrawals. CPF saving is clearly highly substitutable for voluntary private saving and there appears in recent years to have been a full offset between CPF and non-CPF saving.

4 Implications for business and the financial services industry

General

Because compulsory savings schemes do little or nothing to increase overall national savings, they cannot make any significant contribution to economic growth even if there were a positive and causal link between total national savings and growth. Moreover, such schemes clearly distort savings and investment patterns in a number of ways, and are therefore likely to have negative effects on growth, and on welfare more generally. The interests of the business sector are in the development of a dynamic economy with increasing output and incomes per capita. These interests are the same as those of the retired elderly, who require access to a growing volume of real goods and services as their numbers increase. Interventionist policies such as compulsory savings reduce economic growth.

Implications for capital raising

In order to reduce administrative complexities and lock-in savings until retirement, approved forms of compulsory savings have to be confined to a relatively narrow range of institutions, principally superannuation funds, life offices and banks. Investments in small businesses, farms, and property, for example, are unlikely to be approved. Large superannuation funds are able to invest in major publicly listed companies, whose access to capital may therefore be improved with a compulsory regime, but they find it difficult to cope with the transactions costs of investments in small businesses, farms or direct property. Capital raising in these cases, and others such as venture capital, would be likely to become more difficult. Compulsory savings would almost certainly lead to pressures to re-regulate the financial sector, resulting in higher costs for all raisers of capital.

Implications for savings institutions

At first sight a compulsory savings scheme might be thought to benefit approved financial institutions by channelling a higher proportion of national savings through them, although it would disadvantage other financial intermediaries. However, providers of retirement income

³ Carling, Robert and Oestreicher, Geoffrey, 'Singapore's Central Provident Fund', IMF Paper on Policy Analysis and Assessment, December 1995.

products are likely to experience significant growth in any case given the growing recognition of the need for private provision. Moreover, a reduction in economic growth under a compulsory scheme might reduce the volume of savings attracted by such institutions despite their higher market share. They would also be subject to the costs of increased regulation, high levels of transfers between schemes, a good deal of marginally profitable or unprofitable business, and frequent changes to the rules of the scheme. The last are inevitable with changing economic and political circumstances - some 2,000 changes to Australia's scheme have been reported since its inception. Changes in tax rates and inflation also affect scheme costs and benefits. Future governments could not be relied upon to maintain a hands-off attitude to fund investments - the proportion invested overseas, for example, could well become a political issue. There would also be political pressures to depart from an actuarially fair basis for provisions such as annuities, which would have no justification on commercial or efficiency grounds. All these factors would create an uncertain environment both for savers and institutions, contrary to the intentions of the policy.

5 Conclusion

The analysis in this paper suggests that proposals for compulsory superannuation to pursue the goals of national savings, sovereignty, economic growth and retirement income provision are misconceived. New Zealand does not have a savings problem by OECD standards. The environment for savings has been improved substantially in recent years with lower inflation, deregulation of the financial system, lower income taxes and the introduction of GST, moves towards a more restricted welfare safety net, and an end to public sector dissavings. These moves should be maintained or extended: the government's proposals to increase spending, reduce the need for self-provision of health, education and retirement income savings, and reduce its own savings are moves in the wrong direction. Similarly, it is surely egregious in itself and of dubious efficacy in terms of providing security in retirement to take away or reduce people's freedom to apply their savings to such purposes as:

- education;
- investments in a business or a farm;
- buying a home or repaying a mortgage; and
- consumption at times of great need.

Instead of a narrow focus on savings, the focus of retirement income policies should be on economic growth. As one study put it:

The key to providing high incomes in retirement is the pursuit of policies promoting high economic growth. Policies to this end rarely are focused just on retirement and superannuation issues but cover taxation, government spending, government regulations, labour market arrangements, and the incentive and reward structures facing individuals, private business enterprises and governments. With an expanding economy, most people should be able to self-provide for their retirement income, and

should face incentives to save and to consume which are level and fair across their lifetime: the basic role of a government pension is to provide a bottom safety net against the problem of aged poverty.⁴

There are no grounds for arguing that the present public safety net is 'unsustainable'. The available studies indicate that it would require only quite modest increases in tax rates to sustain it even in the long term. Moreover, what matters for sustainability is not the increase in the proportion of elderly in the population but its relationship to the productivity of the economy. The central scenario of the NZIER's 1995 assessment was based on the conservative assumption of a long-term growth rate of 1.8 percent per annum.⁵ This is far below the medium-term growth rates - of 3.5-5 percent in the case of National and 6 percent in the case of New Zealand First - targeted by the Coalition government. In the long term, the economy ought to have the potential to achieve an annual growth rate considerably higher than that assumed by the NZIER, given sound policies. Those calling the present scheme unsustainable seem to lack confidence in the country's future economic management.

Of course to argue that the present safety net is sustainable is not the same as arguing that the current policies are the best possible ones. A good case can be made, for example, for allowing the eligibility age to rise as life expectancy increases, for the adoption of targeting on Australian lines, and for aligning the rate to the lower level of other long-term benefits for a future cohort of retirees, as the Royal Commission on Social Policy recommended. Similarly, private superannuation planning would be encouraged by general growth-oriented policies including reductions to income tax rates, which would reduce the current tax bias against savings and towards tax-favoured investments such as home ownership and higher education. Such policies should be pursued in the period ahead, within the Accord framework, if the September referendum on compulsory superannuation fails.

⁴ Anstie, R, Freebairn, J and Porter, M, 'Superannuation and government aged pension schemes for a dynamic economy', Centre of Policy Studies, Melbourne, May 1989.

⁵ New Zealand Institute of Economic Research, 'The Fiscal Impacts of an Aging Population', Office of the Retirement Commissioner, 1995.