How the proposed tax incentives for household savings may actually disincentivise savings: A comment on treasury's proposed changes.

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National treasury recently released two papers concerning the promotion of household savings through amendments to the saving and investment taxation guidelines for public comment and consultation purposes (see below for information on the papers). The papers suggest specific amendments to current taxation exemptions on discretionary retirement and non-retirement savings through predefined collective investment vehicles, in order to stimulate savings amongst domestic households that are traditionally not too fond of saving. This short comment is intended to highlight the perils of exposing individuals with low financial literacy to uncertain returns in equity and property markets through such investment vehicles.

Even though tax benefits seldom excite serious economists, the proposals by Treasury to amend its current taxation structures in order to promote savings through pre-specified investment vehicles should be assessed with an open mind. The purpose of these amendments is to organically cultivate a domestic household savings culture. If successful, the benefits are clear. Stimulating household savings would decrease the financial vulnerability of households, particularly the lower- and middle-income segment, which the proposed amendments specifically target. Such increased financial resilience will provide lower income households with a much needed hedge against possible job losses and cyclical or even longer-term real income declines. It could also stunt the dramatic growth in recent years of unsecured debt-funded expenditure by low-income households.

The benefit to the economy of increased household savings is clear as well. According to Standard Bank analyst, Bruce Donald (refer to the Business Report, 16 October 2012), South Africa needs R16 billion to R17 billion worth of capital

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inflows each month to fund the deficit on its current account (which currently looms at 6.4% of GDP). This deficit confirms South Africa's status as a developing, capital-importing country in the sense that high investment spending needs exceed its comparatively low national savings level. An overreliance on foreign capital inflows to finance the current account deficit might not, however, be sustainable in the light of current political and economic turmoil, nor be sufficient or available to the same extent to finance the country's growing investment needs in the longer term. In fact, the strong momentum which drove foreign capital inflow into the bond market following the recent inclusion of SA government bonds into the influential WGBI index, tracked by billions of dollars globally, could very well end up being an early Christmas present with an expiry date before the festive season even arrives. The "sugar rush" of bond inflows in excess of R80 billion for the year to date (more than double the inflows in 2011) might well turn sharply, as the recent credit rating downgrade by Moody's, labour unrest in key mineral and agricultural sectors, underlying inflationary pressures and uncertainty over political transition gets priced in. The pressure exerted on the rand lately is also not helping government's cause in convincing foreign investors to invest their yield-starved, yet cautiously allocated funds in South Africa.

In this light, the need for increased domestic household savings is clear. Discussion Paper D (p.15) suggests that the current savings-incentivising measures, in the form of tax-free interest income thresholds and co-contribution schemes implemented in 2000, are not sufficient and have not delivered their intended results. To this end, National Treasury has suggested a more visible approach to stimulating household savings in the form of clearly specified tax exempted financial products.

The paper suggests two types of savings account vehicles that can be used to achieve this goal: an interest-bearing - and an equity account. I will now briefly focus on the feasibility of the latter proposed collective investment vehicle, which will be exposed to JSE listed equities and property assets, with all earnings and capital growth in the funds exempted from taxation.

The problem with using such equity investment vehicles to breed a culture of savings amongst low- to middle-income households, is that share- and property-market investments can and do experience periods of dramatic volatility in returns, as was seen on a global stage in the past few years. Treasury's intended tax incentivised savings vehicles will thus facilitate the exposure of lower-income

savers' capital to variable returns, potentially leading to unwanted and unforeseen variation in their consumption ability. This exposure to volatility, which some may only realise once they have experienced it, may have a counter-productive result, that is, actually depress the already fragile state of saving amongst low-income households.

This follows as most lower income South Africans (the group specifically targeted by the proposed amendments) can rather safely be regarded as less financially informed than their European lower income counterparts, where such strategies have been tested before with varied success, as indicated in Discussion Paper D (p.12). The main contention is that this intended savings enhancement measure may well carry the seeds of its own demise, if potential exposure to negative returns on volatile equity markets cause widespread distrust in the savings system among financially less informed individuals.

In this regard, National Treasury's (or, for that matter, any other public institution's) ability to monitor the thoroughness and transparency of information provided by investment intermediaries to lower income households regarding the potential volatility and downside risk to which such collective investment vehicles are exposed, might be severely limited. This follows as such intermediaries have an incentive to downplay investment risk, creating a low-income investment market rife with exploitation opportunity.

Added to this, National Treasury's implicit endorsement of such pre-defined savings vehicles, through its taxation amendments and proposed communication regarding its potential benefits, may create an unmerited overconfidence in the ability of such savings vehicles to generate continued positive real returns and safely secure near-term future consumption stability (much like the notorious mortgage-backed securities in the US, which managed to garner unmerited support across the financial spectrum prior to its financially debilitating demise in 2008). A deviation from this unrealistic expectation of continued real returns growth may create a costly sense of distrust amongst lower income households, particularly as their savings goals might not always be longer-term oriented, as these savings vehicles are specifically proposed for discretionary, non-retirement savings.

One needs to consider, though, that lower income individuals have in the past been largely excluded from exposure to financial markets, shown to yield the highest return over longer periods. The measures proposed by National Treasury

therefore also seem to address the serious issue of inequality, by facilitating the exposure of lower income groups to equity market returns. The problem is, however, that short-term volatility may erode the longer-term benefit from being exposed to such assets, as savers can shift funds between the proposed investment vehicles or extract funds completely, thereby realising short-term losses. To ensure an equitable investment outcome from this perspective, Treasury should perhaps consider only facilitating the exposure of longer-term oriented discretionary investments (such as in the form of defined retirement savings) to equity market returns, while ensuring shorter-term discretionary savings incentives are limited to clearly specified fixed-income returns (like that of the popular RSA retail savings bond).

Another issue to consider before implementing the proposed measures is whether it would be an effective tool in stimulating new savings. A likely outcome would be that higher income individuals, who mostly already utilise the financial market's investment platforms effectively, will be the main beneficiaries of these amendments. This need not be regarded a problem, *per sé*, if it still achieves the goal of ensuring higher net national savings. Where it can become an inefficient, rent-seeking exercise is where the majority of beneficiaries of the proposed amendments are such individuals who then merely shift some part of their savings portfolio into these vehicles. Such shifting of already invested (or investment bound) funds to savings vehicles with lower taxes would not achieve Treasury's intended goals of stimulating new savings. Such a scenario would then, by inference, imply a tax benefit incidence which does not have the desired savings creation or equity outcome. As tax incentives also entail the forfeiture of tax revenue, the end result of these proposed amendments may well be a significant loss in fiscal revenue with very little benefit in terms of increased net household savings. Unless other taxes are increased or expenditure is reduced to compensate for this revenue loss, the budget deficit may actually increase. Although the papers recognise these possibilities, they are not sufficiently dealt with and the question of how they will ensure that **new** household savings are effectively stimulated through these tax amendments remain unanswered.

Despite the contentions raised in this comment, it cannot be disputed that higher household savings is vital to the continued well-functioning of our economy and that means should urgently be sought to ensure it is stimulated sufficiently. National Treasury should, however, carefully consider the net impact and possible

unintended consequences of its proposed amendments, and also consider other avenues that may complement its efforts to stimulate household savings. While Treasury's efforts to stimulate savings through capped tax-free interest income measures have not delivered its intended results, adding this newly proposed dimension to savings-stimulus through tax amendments may be unlikely to solve the low household savings problem in isolation. Any efforts to achieve this end must be done with great emphasis on educating and informing lower income households of the benefits to saving, while in turn ensuring that effective and low cost micro-savings platforms are available and fixed returns are clearly communicated up front. Exposing reluctant savers to variable returns using tax incentives may not be the savings panacea we are desperately in need of.

National Treasury's Papers: (Made available by Sabinet)

Incentivising non-retirement savings (Paper D) and *improving tax incentives for retirement savings (Paper E).*