

Mandatory Savings the saviour of New Zealand's welfare state

Abstract

New Zealand faces an impending cost spiral of public spending on healthcare and pensions, as well as ongoing and substantial payments to those out of work. None of the solutions conventionally proffered, such as generating markedly higher productivity growth or levying significantly higher taxes, seems plausible. Mandatory savings accounts, however, offer more promise. Ending unnecessary transfer payments to businesses and wealthy individuals would allow health, out-of-work and retirement savings accounts to be set up and funded for all individuals. This policy change could secure the future welfare needs of low earners, enhancing opportunity, dignity, choice and fair treatment. It would also alleviate fiscal pressures, encourage efficiency gains and reduce wealth inequality.

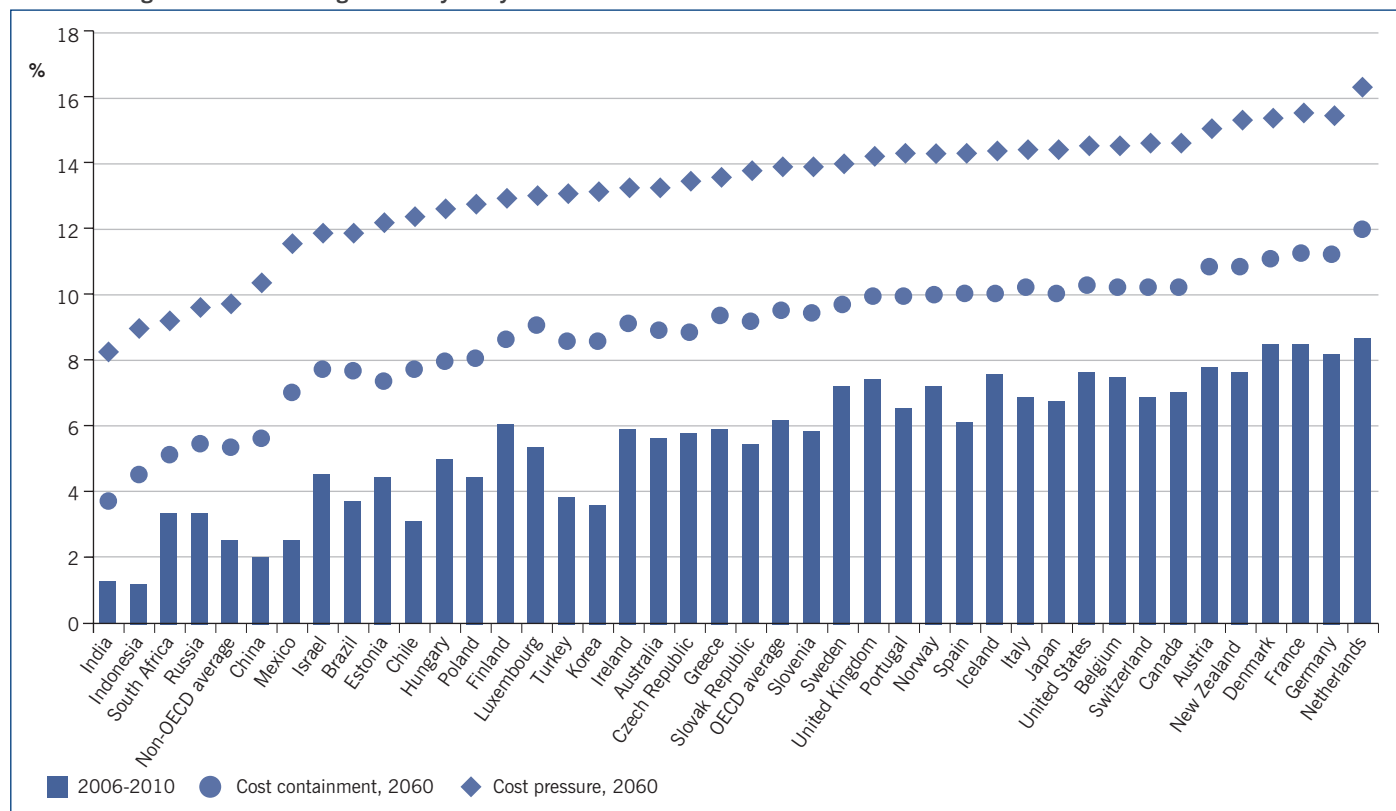
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Almost 80 years since the establishment of New Zealand's welfare state, it faces an unprecedented crisis. There is widespread agreement that it is failing to deliver on its objectives. Welfare payments make up the single largest portion of public spending. Yet significant numbers of children grow up in poverty, most adults do not retire with enough capital to live in comfort, and homelessness is on the rise, among other social issues.

Future cost trends will only exacerbate these problems. Given current policy settings, future New Zealand governments will not have sufficient funds to ensure that their citizens can access high quality healthcare. In a 'cost-pressure' scenario, public health and long-term care spending in New Zealand is forecast to increase from 7.6% of GDP in 2015 to 15.3% by 2060. In addition, spending on government superannuation, equal to 5.1% of GDP in 2015, is forecast to rise to 8.1% by 2050.¹ In other words, these two areas alone will require an increase in funding of over ten percentage points of GDP over the next 30–40 years. This change is due to a forecast doubling of the retired population and, in the case of healthcare, to costs per person rising faster than GDP.

Figure 1: Total public health and long-term care spending ratio to GDP in 2006–10 and forecasts to 2060: range of estimates using sensitivity analyses for individual countries



Source: OECD, 2013

As well as these projected increases in public spending, New Zealand also suffers from low productivity growth. Yet the view that welfare costs can be met by relying on high future rates of economic growth has little merit. Higher productivity growth is notoriously hard to achieve, and far richer countries than New Zealand will struggle to afford their welfare states. Indeed, we already see moves, especially on the political right, to constrain health spending, leading to rationing and lower quality services. Lower income earners will bear the brunt of these changes, as they are least able to access private care. Such an outcome is unacceptable in an age when economic inequality is such a pressing issue (see, for example, Rashbrooke, 2017).

Some would argue for greater public funding of the welfare state via higher taxes. But to the extent that those taxes fall on capital, New Zealand's poor savings record is likely to be weakened further. Lower incentives to invest and build capital in a country already short on it will likely lead to lower wage growth and a reduced ability to fund welfare provision.

This article offers an alternative vision for not only the healthcare system, but also superannuation and out-of-work income

provision, based around the creation of mandatory individual savings accounts. First, to set the New Zealand debate in context, a brief discussion of the global debate on the future of the welfare state is given. Second, a proposed policy outline, using New Zealand as a case study, is provided. Third, the impacts of the reform on representative New Zealanders, the nation's fiscal position, inequality and economic incentives are discussed.

Since this article sketches how the reform works at a high level, the detail given is necessarily less than it would be in a more narrowly focused contribution. However, versions of the proposals herein have been elaborated elsewhere (see Douglas and MacCulloch, 2016).

Background

Large publicly funded welfare states are under pressure all over the world. The dependency ratio, which is the proportion of elderly to younger, economically active workers, is expected to rise in most nations. Severe pressures will be exerted on pensions and public health systems. The ratio of public health and long-term care expenditures to GDP has already been steadily rising. Under the OECD's 'cost-

pressure' projections, these expenditures will almost double, reaching 14% of GDP by 2060 (see Figure 1). Furthermore, public pension spending is forecast to grow from 9.5% of GDP in 2015 to 11.7% of GDP in 2050 (OECD, 2013).

One of the countries that has best managed these kinds of pressures is Singapore, which provides universal healthcare coverage at a lower cost than any other high-income nation. Total health spending, by both government and private sources, is 4.8% of GDP in Singapore (compared to 17.2% in the United States, 9.3% in the UK and 9.5% in New Zealand).² The cornerstone of Singapore's system is the mandatory MediSave medical savings account. Although MediSave funds belong to the contributing worker, the government has guidelines as to how the money can be spent and holds the accounts within its Central Provident Fund.

Efficiency gains have arisen from the use of MediSave accounts due to more transparent pricing of healthcare services, less third-party funding, and encouragement of personal responsibility. By most measures, excellent health outcomes have resulted (Haseltine, 2013). For large bills that could otherwise drain

an individual's MediSave funds, insurance schemes are available. The government offers a low-cost scheme, known as MediShield, under which individuals are automatically insured unless they choose to opt out. A multi-billion dollar endowment fund (the MediFund) also exists so that low-income people can receive a level of care they otherwise could not afford, even in the most highly subsidised wards of public hospitals. It is a safety net for those who have used up their MediSave money and MediShield coverage.

One feature of the reform proposed in this article is the establishment of mandatory savings accounts to help individuals fund the purchase of health services, similar to Singapore. While this system may lead to efficiency gains, our calculations for New Zealand do not rely on any being made. Note that the US, which has a high proportion of private spending on healthcare, has not successfully contained costs. This can be partly attributed to the subsidy which (third-party) employer-purchased health insurance plans receive. Martin Feldstein, for example, argues that 'because employer payments for health insurance are tax-deductible for employers but not taxed to the employee, current tax rules encourage most employees to want their compensation to include the very comprehensive "first dollar" insurance that pushes up health-care spending' (Feldstein, 2009).

Funding the new system

Finding the funds

Under our proposed reform, the government would fund mandatory savings accounts for all workers, from which people would then be able to pay for many of their welfare needs. (However, substantial provision of government welfare services – including New Zealand Superannuation – would remain in place.) Rather than increase taxation, the most sensible way to fund this spending is to seek savings elsewhere in the government budget.

Unnecessary subsidies

Existing public spending could be reduced by eliminating a range of subsidies that disproportionately benefit more

affluent New Zealanders. These include subsidies to the production of films that are internationally focused and produced in New Zealand; offshore market development assistance to business; the Provincial Growth Fund; accelerated depreciation tax allowances available to businesses in the forestry, farming, bloodstock and research industries; and favourable treatment of rental housing.³

While some of these schemes may be argued to create benefits in terms of promoting economic growth, a core proposition of this article is that social welfare would be enhanced if instead the

the subsidised fee system and introduces a means test to restrict interest-free loans and grants to students from low-income, low-capital families. The aim is to target assistance where it is needed and release funding for the savings accounts of all workers.

In addition, government subsidies would be eliminated for the KiwiSaver automatic enrolment scheme for employees, the biggest recipients of which are better off New Zealanders who tend to make the largest contributions. Working for Families tax credits and power subsidies would be limited to less affluent families. (Some

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money was used to fund health, out-of-work and retirement savings accounts for all workers. This alternative purpose would secure the long-term survival of a high-quality healthcare system and enable a transformation of the level of retirement wealth (see below). Put another way, there are many kinds of unnecessary subsidies which may appear small, yet add up to create a large opportunity cost. Part of the reason turns out to arise from the so-called miracle of compound interest, as the flow of funds into the individual savings accounts which would be released by ending these schemes compounds up over time.

The reform proposed in this article also changes spending on tertiary students. In 1992 the Student Loan Scheme was introduced by the government to help pay for tuition fees, course costs and living expenses. In 2006, student loans were made interest-free (while students continued to pay a subsidised fee). Subsequently, the present Labour-led coalition announced a free-fees policy for one year of full-time study, ultimately intended to cover three years. The reform proposed here reverts to

more affluent families may therefore experience a fall in disposable income, though they would also enjoy the benefits of their mandatory saving accounts, as detailed below.) The government would also stop making contributions to the Cullen Superannuation Fund, freeing up around \$1 billion – the projected contribution in the present financial year – to be paid into the individual accounts. (The existing balance in the Cullen Fund could be retained for its current purpose of helping to pre-fund future government superannuation payments.)

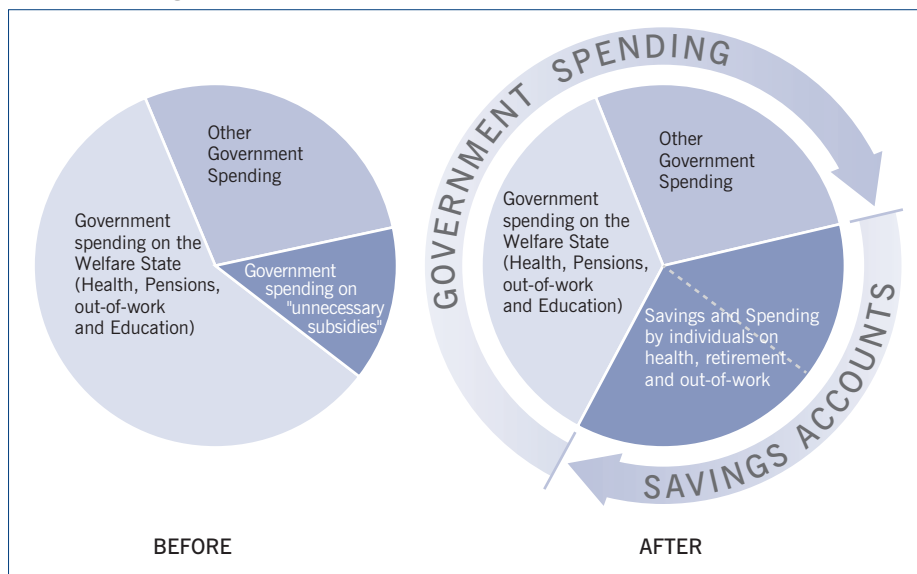
A total of around \$10 billion becomes available upon ending all of these kinds of payments.

Redirected spending

Several other forms of government spending would become unnecessary once individual savings accounts for health, out-of-work and retirement provision are introduced. Our reform instead gives priority to redirecting this funding into the individual accounts.

We can redirect a substantial amount of current welfare spending, including \$11

Figure 2: How government spending changes: before and after the 'savings-based' reform



billion of public health and out-of-work expenditure.⁴ In addition, a total of around \$9 billion is currently paid by employers and employees to the Accident Compensation Corporation (ACC) and to KiwiSaver. Our mandatory accounts would replace the ACC scheme. Another \$1 billion of funds would be required from individuals as a personal contribution to the accounts. Taken altogether, these savings (and contributions) amount to \$31 billion (\$10 billion + \$11 billion + \$9 billion + \$1 billion).⁵

Allocating the funds

The allocation of the above funds to our new savings accounts is guided by a set of principles:

- medium-term quality decisions take precedence over quick-fix solutions;
- decisions relating to welfare should identify and exploit economic and social linkages, so that every action will improve the working of the system as a whole;
- only large-scale reform packages provide the flexibility needed to demonstrate that losses suffered by a group of people from one policy would be offset by gains for the same group in some other area.

Retirement provision

First, a fresh approach to retirement policy would take place. To ensure that individuals prepare properly for retirement, it is proposed that the government create new

retirement savings accounts for every New Zealand worker, which would replace the KiwiSaver scheme.⁶ Into these accounts the government would place an amount equal to 9 cents in every dollar of an individual's earned income up to \$54,000 (indexed), generating a maximum of \$4,860 per year.⁷ These savings could be accessed only at the legal age of retirement (currently 65). Note that the existing government pension remains and continues to be paid out at its current rate (with the same yearly adjustment).

Given that those in the bottom half of the income distribution have few savings, this reform would represent a major turnaround in their fortunes. Although the savings would be funded from existing general taxation and be paid into dedicated personal accounts over which their owners exercise responsibility, it has some aspects in common with the contributions-based national insurance levies used in other nations. A key feature of the present proposal is that the new contributions to the savings accounts have little effect on most workers' disposable incomes.

The cost to government of the new policy would be around \$9 billion, which would come from the \$31 billion pool of funds detailed above, leaving \$22 billion available.

Health and out-of-work provision (sickness, unemployment and accident)

Second, a fresh approach to healthcare and out-of-work policy could be implemented.

Benefit levels and other assistance for the out-of-work would stay at present levels and be adjusted on the same basis as currently. But parallel to the above, the government would create mandatory accounts dedicated to supporting an individual's health and out-of-work costs. Into these accounts it would place an amount equivalent to 24 cents in every dollar of an individual's earned income up to \$54,000 (indexed). This would generate a maximum of \$12,960 per year. In the case of healthcare, in particular, rules would be set governing how the funds are spent. Annual payments into these accounts would total \$22 billion. Individuals could then use them to meet the following costs:

- insurance to cover healthcare costs of over \$20,000 (indexed) per year;
- insurance to cover the costs associated with falling out of work;
- a chronically-ill fund contribution; and
- direct payments for smaller healthcare and out-of-work bills.

These estimated withdrawals would add up to \$13 billion annually, of which \$10 billion would be for healthcare and \$3 billion for out-of-work costs. This would leave \$9 billion annually as savings (\$22 billion – \$13 billion), a sum which would accrue interest and could be spent on future healthcare and out-of-work costs. Within that \$9 billion, around \$2 billion would be secured as savings dedicated for spending on healthcare costs in retirement.

For those people who cannot afford to pay for their healthcare, which include the long-term unemployed, the government acts as 'insurer of last resort'. Our proposed budgets retain ample public funds for this purpose (which is served by the MediFund in Singapore).⁸ Note that this safety net may come at a cost of undermining work incentives, due to increasing marginal effective tax rates. On the other hand, the new funding paid into the health, out-of-work and retirement savings accounts of workers leads to a large build-up of wealth and provides a greater incentive to become employed (see below).

Due to these offsetting effects, the number unable to support themselves from their savings accounts and entirely dependent on the state may be about 5–6% of the population, although firm estimates are hard to make.

How the reform works: some diagrams

Figure 2 shows how the reform affects spending by the government. Public expenditure on ‘unnecessary subsidies’ is ended. Instead these funds are put into the savings accounts. In addition, these accounts receive a part of the funds that were previously spent by the government on welfare, which now become available for spending directly by individuals.

Strikingly, the flow of funds into the health and out-of-work accounts enabled by the ending of ‘unnecessary subsidies’, and the subsequent accumulation of interest, would be sufficient to absorb the increases in healthcare spending forecast over the next decades. This result is based on assuming that the capital in the accounts accumulates at a compound rate of about 4%, which matches the rate of increase of per capita public health spending since 1980.⁹ The flow of funds into the retirement accounts also provides a rapidly compounding balance, available at 65.

Figure 3 shows financial flows under the new system. Detailed full government budget forecasts to 2035 are presented in Douglas and MacCulloch (2016), which shows the transition to the new scheme.

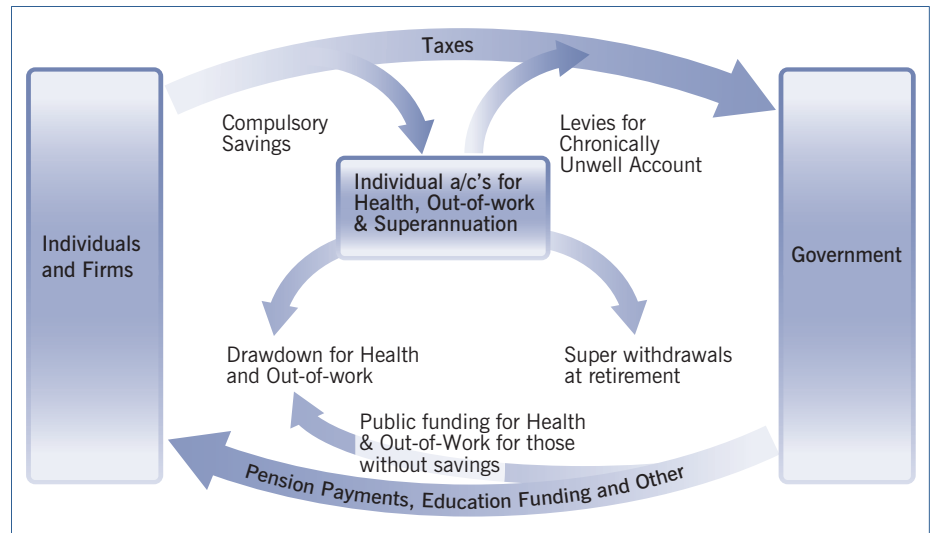
Outcomes of the reform

Individual outcomes and wealth inequality

This reform enables most workers, but especially low- and middle-income earners, to acquire their own savings accounts, without much affecting disposable incomes. Current levels of total healthcare spending would be retained, and could be increased more in the future, compared to the existing system. Payment for services can now be made out of the individual accounts.

More specifically, a 20-year-old may expect to retire after 45 years with between \$500,000 and \$1 million in their retirement savings account (or between \$1 and \$2 million for a couple) in 2018 dollars.¹⁰ New Zealanders not falling within the chronically ill category would retire with about \$150,000 in their health and out-of-work account after 25 years in the workforce (as well as holding a healthcare insurance policy). A greater level of security would result. The system should also work more fairly in a broader sense. Around 70% of those in the workforce would be able to accumulate

Figure 3: Financial flows in the new ‘savings-based’ system



savings of \$17,820 per year (\$4,860 in the retirement account plus \$12,960 in the health and out-of-work account) to help meet their current and future welfare needs (and the other 30% a little less).

Since the build-up in savings enabled by this reform can be achieved by low- to middle-income earners (who previously had little or no savings), the potential exists for more equitable outcomes. For example,

Exhibit A: Outcomes of the ‘savings-based’ policy on representative New Zealanders

1. Existing retired

The current retired will see little change in their income under the new system.

- a. The government pension remains (with the same yearly adjustment).
- b. Low-income, low-capital retirees receive a yearly grant into their health a/c which enables them to buy a catastrophic health insurance policy and have funds to supplement their normal health expenditures.

2. Impact on working New Zealanders

- a. The government pension equal to what is paid today and on the same terms will continue.
- b. Individuals will also hold capital in their health/out-of-work and retirement savings accounts. The level of capital depends on the number of years to retirement and earnings.
- c. An increase in retirement income.

3. Impact on out-of-work New Zealanders

- a. Benefit levels and other assistance remain at present levels and are adjusted on the same basis.
- b. Increased support by way of specialist training with the aim of improving life skills, putting jobless New Zealanders in a position where they have the skills to get a job, together with one-on-one support systems.
- c. Responsibility of those who are out-of-work (where required) to attend practical training sessions.

Table 1: New Zealand's existing government budget, plus ACC and KiwiSaver, compared to a savings-based budget: 2019 forecast

	(1) Existing budget (\$ billions)	(2) Savings-based budget (\$ billions)
Revenues		
Taxation (personal, corporate, GST) – <i>government</i>	86.7	
Taxation and contributions to health, out-of- work and retirement savings accounts		96.7
Contributions to fund mainly ACC and KiwiSaver accounts by employees and employers	9.0	
Total	95.7	96.7
Expenditures		
Health, pensions, out-of-work, education and other – <i>government</i>	76.7	65.7
'Unnecessary subsidies' to high earners – <i>government</i>	10.0	
Healthcare and out-of-work savings accounts		13.0
Payments from ACC fund	4.0	2.0
Total	90.7	80.7
• Government cash balance	0	0
• Health, out-of-work and retirement savings accounts balances		18

Notes: In column (1) the change in government cash balance is 0 (= \$86.7bn – \$76.7bn – \$10bn). In column (2), total contributions to health, out-of-work and retirement savings accounts equal \$31bn (out of \$96.7bn revenues). Hence the change in the government cash balance is 0 (= \$96.7bn – \$31bn – \$65.7bn) and the change in the savings accounts balances is \$31bn – \$13bn = \$18bn. The \$1 billion difference in revenues between the Existing and the Savings-based budgets reflects the additional funds, outlined above, which are required from individuals as contributions to their savings accounts.

Source: Treasury, 2018

a young household of two working adults, sitting in the bottom quintile of the distribution of net household wealth, would likely see their new level of wealth upon retirement lift them into the top quintile.¹¹ Much of the explanation as to how this outcome is achieved arises from the compounding returns on the capital in the savings accounts.

Note that rising inequality in nations like the US and UK (led by the 'top 1%') has recently been blamed on the return to capital exceeding the economic growth rate, together with a high concentration of capital among the rich. It has consequently been suggested that capital taxes should be raised (see Piketty, 2014). The present article offers an alternative: namely, the removal of unnecessary subsidies to release a flow of funds into savings accounts over the lifetime of all workers, enabling them to establish their own compounding source of wealth.

Furthermore, individuals would gain more power to decide when, where and by whom they get medical help and how

much capital and income they have in retirement, instead of those decisions being made by politicians. These choices would be constrained by rules governing the workings of the savings accounts (one would expect people to be given full freedom to draw down their retirement account once they reached 65). In this way the reform should bring a greater level of choice, and with it more independence, opportunity and fair treatment, compared to the present system.

Since individuals would now purchase their own services it becomes harder for institutions (e.g., hospitals) to capture resources, since different providers would need to compete harder. The income of providers, whether public or private, would depend more on their services than on meeting third-party reimbursement formulas. Price information and negotiation become a vital part of the healthcare and insurance marketplaces. To help facilitate this outcome, there necessarily would be strong regulations governing the healthcare insurance market

place (to avoid the problems prevalent in the US system). The present article does not, however, assume that private provision leads to more efficiencies. In Singapore, public and private hospitals coexist, although most healthcare is directed by the government to the public side. The public hospitals are dominant in the sense of offering an extremely high quality of care at affordable prices and setting the ethos for the entire system, though the private system is seen as necessary to challenge it. The public system, in turn, serves to keep private costs in check.¹²

Funding the shift in New Zealand to the new system would create winners and losers. Losers comprise special interest groups that presently benefit from the 'unnecessary subsidies' (as listed above). These include the beneficiaries of film subsidies and high-income/high net wealth families in receipt of interest-free student loans and free tertiary fees. Winners are the recipients of the savings accounts, which are set up for every New Zealand worker. If efficiencies result from the new system, and are sufficiently large, then of course the number of losers would be reduced. Exhibit A provides more details of how the reform affects different types of people.

Fiscal outcomes

Table 1 shows figures from the government budget, and adds in the KiwiSaver and ACC schemes. In the forecast 2019 financial year, the New Zealand government expects to receive \$86.7 billion in tax revenues. In addition, individuals and employers make \$9 billion of other payments (levied to support health costs, ACC and KiwiSaver), yielding a total of \$95.7 billion of available funds.

At present, \$76.7 billion is spent by the government on mainly welfare-related purposes (like health, out-of-work, education and superannuation), whereas \$10 billion is spent on purposes that are referred to as 'unnecessary subsidies' in this article. The total of (non-unnecessary subsidies-related) spending is \$80.7 billion (\$76.7 billion + \$4 billion of ACC payments). Under the new regime, funds are allocated differently. Of total revenues, \$31 billion is transferred into the savings accounts for health, out-of-work and retirement. Government spending reduces

to \$65.7 billion. However, \$13 billion is spent from the accounts, made up of \$11 billion to compensate for the drop in government funding of health and out-of-work costs, plus another \$2 billion previously spent from the ACC fund (which is phased out).

Under the new policy, a total of \$80.7 billion continues to be spent on (mainly) welfare-related activities (\$65.7 billion + \$13 billion, plus an additional \$2 billion from the old ACC fund). In all, \$18 billion becomes savings in the personal accounts, available for future spending on health/out-of-work and retirement.

Over time, the reform would lead to improvements in the government's fiscal position, due, in particular, to the build-up of interest earned on the savings accounts, which enables people to cover rising healthcare costs without putting pressure on the government's budget constraints.

Conclusion

Many nations are forecast to struggle to fund their welfare states over the coming decades. Although governments will be hard pressed to maintain present levels

of (per capita) welfare generosity, private savings rates have been falling. In this article, a reform is proposed that would enable the government to fund savings accounts of individuals with little effect on disposable incomes. We use a case study of New Zealand, although our reform could be applied to other places. It would especially help low- and medium-income earners to establish significant levels of (non-housing) capital. It may even lead to productivity gains, especially in healthcare. The fiscal viability of the welfare state would be secured, while ample public funds are retained to ensure universal coverage.

- 1 For a lower projected increase, calculated on a different basis, see Rosenberg, 2017.
- 2 The healthcare expenditure figure of 7.6% of GDP quoted for New Zealand in the Introduction refers to public spending. Once private expenditures are also included, the figure rises to 9.5%.
- 3 The 'favourable treatment' to the owners of rental housing arises from the tax deductibility of their expenses and mortgage interest payments.
- 4 Current public spending on health and out-of-work redirected into the accounts would focus on types of funding where individuals were better placed to spend the funds directly themselves, rather than the State doing so on their behalf.
- 5 These figures are based on Treasury (2018) forecasts for 2019.
- 6 The balances in existing KiwiSaver accounts would simply be added to the new mandatory retirement accounts.
- 7 This cut-off is chosen since it is close to average earnings.

The proposed reform in this article is designed to help all workers establish significant personal savings. However, such help stops at \$54,000. If higher income earners wish to spend additional funds on their welfare needs, above what is held in the mandatory accounts, then it would be out of their own pockets.

- 8 For the 2018/19 year, healthcare spending by the New Zealand Government is forecast to be about \$19 billion. Since \$10 billion of this budget now goes into health savings accounts, it still leaves \$9 billion of public spending, which would have a high redistributive component, for subsidising the health-care of those unable to pay out of their accounts.
- 9 See Ministry of Health, 2010. Public health spending increasing at a greater rate than GDP is associated with an increasing proportion of GDP spent on healthcare. Provided the return on our savings accounts is higher than the growth rate of GDP (and is close to the rate of increase of health spending), the present proposal is able to help resolve the potential future funding crisis in the health system. For evidence that the return on capital has typically exceeded the growth rate, see Piketty, 2014.
- 10 These figures depend on the rate of return of capital held in the savings accounts. For example, if it accrues at a real rate of 4% per annum, then the balance upon retirement at 65 years old for someone who is presently 20 would be \$612,000 (or \$1.2 million for a couple), given a retirement account which receives annual funding of \$4,860. If the rate of return is assumed to be 5% per annum then the amount is \$815,000.
- 11 As noted earlier, a working couple in their 20s would retire with \$1.2 million in their retirement account (assuming a 4% rate of return). At present, households in the bottom quintile of the net wealth distribution in New Zealand have less than \$43,000, with a median of \$9,000 (mostly held in mortgaged real estate). Since the cut-off point for the top wealth quintile is \$1.07 million, such a couple would retire with a net wealth that placed them in the top quintile given this reform (see Statistics New Zealand, 2018).
- 12 On whether health services should be publicly or privately provided see, for example, Besley and Coate, 1991.

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