Farewell to tax neutrality: the implications for an ageing population

The 15th Australian Colloquium of Superannuation Researchers: Financial Consequences of Longevity
UNSW Sydney
19th 20th July 2007

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9th May 2007
The twenty year experiment and its ending

- New Zealand has been a leader in tax policy since the late 1980s
  - Principles-based approach
  - Coherent
  - Simple

- Changes in 2007
  - Framework abandoned

- Implications for an ageing population
  - Higher fiscal costs
  - Longevity risk unaddressed
  - Retirement incomes regime left unstable
Tax base choices

- Income Y
  - *Annual* income tax discriminates against saving

- Expenditure Y-S
  - DET *neutral* to saving but higher rate?

- Hybrid system- some types of income given an expenditure tax treatment. Typical of most OECD countries
## Different tax treatments - superannuation

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1987 Treasury found New Zealand tax treatment of saving to be:

- Distortionary, anti-growth
- Unfair
- Costly - 1.2% GDP
- Suggested TTE
  - All saving treated the same as putting money in a bank savings account
1988 comprehensive income tax reforms

- Broad base
  - Elimination of exemptions
  - Imputation
  - Fringe benefits
- Low rate
- Supplemented by broad-based 10% GST
- Flat tax
- Capital gains
TTE and all that 1988-1990

Roger was right! *(At least about super)*

EET to TTE - a dramatic world first
- Part of whole package
- Industry rolled over

But was Roger only partially right?
- Brash Committee dissent
- They recommended ETT
  - Also tax neutral
  - Less tax revenue foregone
  - More natural to have a final T
Comprehensive income tax
1988-2007

- Broad base and low rates of income tax
- GST a supplemental tax
- OECD waxes lyrical

"After the radical reforms undertaken in the 1980s, the NZ tax system has long been regarded as one of the most efficient within the OECD."

OECD 2007
The simplest and most cost effective retirement scheme in the world?

Public provision
- New Zealand Superannuation
  - New Zealand Superannuation Fund

Private provision
- Voluntary unsubsidised
- TTE tax treatment
Flies in the ointment?
Tax neutrality hard to achieve

1. Housing remained TEE
   • no capital gains tax
   • no imputed rental tax
   • traders scot-free

2. TTE does not fit well with progressive taxation
1988 statutory rates 24% and 33%

Actual scale was not flat
3 effective rates with low income earner’s rebate

Effective Marginal Tax Rate (%)

Income ($)
Current personal tax scale less flat than in 1988

Big tax reductions in 1996 and a new top rate in 2000

Effective Marginal Tax Rate (%) vs. Income ($ p.a.)
The TOLIS committee - 1998

- Failed to reconcile ‘tax paid’ funds with taxing the individual at their appropriate marginal tax rate
- Various half-hearted policy changes
What have reviews said?

- Hard won consensus around TTE
  - Brash Committee 1988
  - Task Force 1992
  - Accord 1993
  - Periodic Report Group 1997
  - Super Taskforce 2000
  - McLeod Review 2001
  - Periodic Report Group 2003
  - Retirement Commission Review 2007?
“We generally conclude that the reform programme has been a success and should not be reversed”

“There is little evidence that changes to the tax system will induce higher saving other than by redistributing from those who are less likely to save (typically poorer households) to those who are more likely to save (typically wealthier households)”

McLeod Review 2001
What did Treasury have to say?

Saving Incentives Paper 2002

- Have tTE if you must! But rich gain most

Annual Household Financial Saving by Income Decile - 1997-98
What Labour said

December Economic and Fiscal Update 2002

“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.”
“I do detect a change of attitude. The 1990s were a high watermark for individualism. A part of that was the rise of the idea of the total remuneration package. … While this is fine in theory, there is a growing body of research that suggests that the hands-off approach works against some of that total remuneration going into long term saving.”
Enter KiwiSaver - 2005 Budget

- TTE but with $1,000 “sweetener”
  - Lump sum
  - Progressive
  - Limited

- Cabinet papers 2006
  - Don’t go there with anything else!
“V. Whether employer contributions to KiwiSaver should be exempt from specified superannuation contribution withholding tax (SSCWT):

[Comment: Officials do not recommend exempting employer contributions to KiwiSaver from SSCWT. On the one hand, this would create benefits for an employee to sacrifice his/her salary or wages in exchange for an employee 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.]

Recommendation:

g. Agree that employer contributions to KiwiSaver are subject to SSCWT;” (July 2006 IRD paper released under the OIA)
The end of the 20 year experiment

The progression:

- 1988 “the ideal” TTE with flat tax
- 1996 TTE ‘penal’ for low income earners below 33% Housing remains TEE
- 2000 TTE “advantaged” for high earners on 39%
- 2005 TTE KiwiSaver announced
  - PIE taxation regime solves MTR problem
  - $1000 sweetener
- 2006 tTE Employer contributions tax-free
- 2007 ETE Budget 2007
Budget 2007: Farewell to tax neutrality

- Matching tax credit of $20 a week for member contributions KiwiSaver
- Matching employer contributions made compulsory (for members) rising to 4% by 2011
- Tax credit up to $20 paid to employers
- Matching employer contributions to 4% tax free
“There are a number of costs of increased saving including the fiscal cost to government and sacrifices in current consumption. There may also be economic efficiency costs of incentives or regulations to promote saving that significantly distort behaviour."
However...

“... in the light of the recent data, evidence and analysis ..we think that further or stronger pro-saving action is now justified.

This judgement … rests on a least-regrets approach in the light of data uncertainties, the economy’s tendency to macroeconomic imbalances and the possibility that individuals are basing saving decisions on long-run expectations that could be mistaken. “
Two options for NZ:

- Comprehensive income tax
- Dual system
  - Income and capital treated differently

“Future changes to the tax system need to be consistent with the approach ultimately adopted”

NZ country report 2007
The next experiment?

Tax treatment is now complex and lacks:

- Transparency
- Consistent principle
- Will cost more to administer
- Boundaries will be constantly tested

Amounts in superannuation will rise but not necessarily ‘saving’

Tax planning will re-emerge
Unresolved issues

- Universal New Zealand Superannuation does not fit with tax-subsidised private saving
  - High earners get two bites of the cherry
  - What then the future of NZS?
- Will KiwiSaver be made compulsory?
- How can lump-sum tax-free payments from KiwiSaver be justified?
  - The longevity risk not addressed
- How does KiwiSaver help the saving problem?
How will the OECD react?

“Tax policy in New Zealand is grounded within a coherent overall strategy and the changes for various parts of the system are generally scrutinised with a view to how these might affect the efficiency equity and simplicity of the system as a whole”

Dalsgaard OECD 2001

Yeah right!
KiwiSaver II– interim judgement

Positive
- Portability
- Extends workplace saving options

Negative
- Objectives unclear, rushed introduction; chaotic implementation
- Tax breaks unjustified, expensive, regressive
- Future instability in retirement policy
- Does not protect for longevity risk