Long-Term Fiscal External Panel

Summary: *Session Three – Retirement Income and Tax Policy Analysis and Choices*

25 October 2012 (9:30am-4:30pm), Victoria Business School, Level 12, Rutherford House

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The third External Panel session considered policy options that might improve the long-term fiscal position by managing the spending pressures arising from expected demographic changes. The options were in the areas of education, retirement income, taxation and working-age welfare. The policy areas of health care, justice, natural resources and the Crown's balance sheet will be considered in the next session.

The policy options presented to the panel were generally considered through the lens of the various dimensions of the Treasury's *Living Standards Framework.* The dimensions are: fiscal sustainability, economic efficiency, risk and uncertainty, equity, and social infrastructure.

The analysis in this summary is based on draft work. The analysis may be refined, amended or strengthened in the 2013 *Statement on the Long-Term Fiscal Position*.

Draft research papers which informed the discussion at the third panel session, and which will inform discussion at the fourth session to be held on November 29, will be put online with the summary of the fourth session.

HIGHLIGHTS – PANEL DISCUSSION

There was support for the Treasury's approach of considering a wide range of tax and spending policy options that might address long-term fiscal pressures. In each case, the Treasury should be clear about the rationale for the policy change being considered. Apart from fiscal savings, potential policy changes need to be articulated on the basis of clear principles and address how any transition to altered policy settings might be managed.

The following points emerged from discussion. Not every member of the External Panel necessarily agrees with every point:

- An enduring response to managing the long-term fiscal pressures will likely involve a package of subtle policy changes implemented gradually. An ageing voting population and the MMP environment mean that one-off or abrupt policy changes may be inappropriate.
- The impacts of policy changes on all New Zealanders, and especially those of lower incomes, should be carefully considered - in terms of fairness and of securing policy responses that will endure.
- The panel raised questions about the merits of some of the tax options and were concerned to ensure the efficiency, distribution and administrative cost, sustainability and coherence features of tax options were considered and well founded and that there was a clear rationale for choosing an option, especially if there were proposals to consider introducing a new tax base. For example, if the rate of GST rises, there may be greater risk of political pressure for exemptions to be introduced, reducing GST revenue and adding to complexity, thereby reducing the efficiency and integrity of GST.
- The panel also discussed the merits of broadening the tax system by means of either a land tax or more comprehensive capital gains tax. Concerns were raised over the interpretation of the purported economic efficiency properties of a land tax. Some argued that re-introduction of a land tax could have adverse implications for investment and may also mean pressure for the sorts of exemptions that contributed to it being discarded in the 1980s. While some acknowledged that in principle a capital gains tax may be attractive from the point of view of improving the integrity of the tax system, revenue from a capital gains tax may prove to be volatile and there are administrative challenges in administering a sound capital gains tax.
- Treasury's base projections fix the Crown's tax revenue at a set ratio to GDP from 2020. Some members suggested that Treasury consider an alternative projection of revenue based on the indexation of personal tax rate thresholds to consumer price inflation, from a certain point in the future. Doing this would still prevent "bracket creep' to some extent while securing more revenue to the Crown over the long term than would occur in the Treasury's base projections. On the basis of current Treasury projections, this could generate extra revenue equivalent to about 2% of GDP by 2060.
- Retirement income policy settings have been changed many times since the 1970s and some argued that any further changes should be based around the existing broad framework. Concerns were expressed about options that would result in greater levels of poverty among older people or that would be complex and inefficient to administer. Treasury should focus on fewer options, with detailed analysis of the trade-offs, and a clearer rationale for why they had been chosen.
- On modelling welfare spending, there was support for the Treasury projections in the next Statement to no longer assume that welfare benefits will grow at only the rate of inflation indefinitely. The assumption seems implausible, given expected wage growth.
- Some members suggested analysis into why the improvement in New Zealand's labour quality is not leading to material improvements in labour productivity. This could inform the discussion of priorities for state spending over the long term, including how best to invest resources freed from the "demographic dividend" within education spending. (The demographic dividend arises from a smaller proportion of the population being young and involved in formal education).

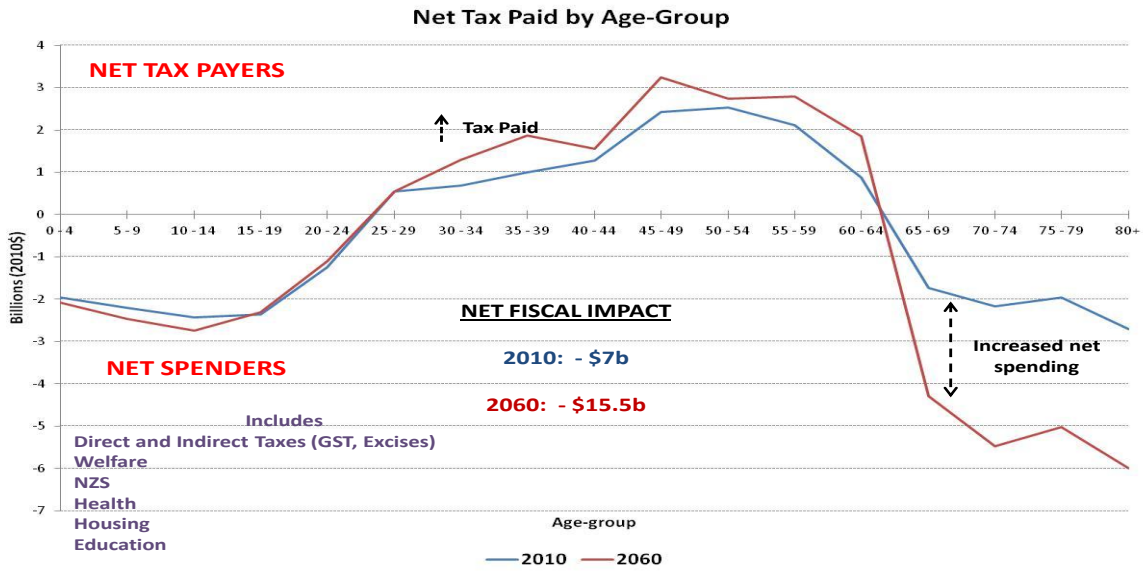
GENERAL OVERVIEW

- For a long-term fiscal strategy to be credible, it needs to build on prudent fiscal strategies in the short-to-medium term (the next 5-10 years).
- Long-term fiscal statements tend not to focus on the specifics of short-to-medium term fiscal strategies. The general assumption at the Treasury, even as it prepares its next *Statement*, is that governments over this decade will work to return to an operating surplus and reduce debt to sustainable levels. In moving to restore a fiscal buffer to deal with future shocks, they will also be helping to manage the initial cost pressures from demographic ageing. The starting point for debt will be lower, possibly at or close to a long-term net debt objective.
- Beyond the current fiscal strategy, further policy action will be needed to deal with the significant cost pressures arising from demographic ageing. These pressures become particularly evident from the late 2020s. While delaying policy change enables policy makers to learn more about the impact of demographic change, delay can be costly in terms of the political feasibility of introducing sustainable policy adjustments, particularly if delays necessitate larger and more abrupt policy changes.
- The third and fourth panel sessions cover the key policy choices that will be presented in the next *Statement on the Long-term Fiscal Position* for managing long-term cost pressures and achieving fiscal sustainability. Treasury is not presenting a preferred option at the sessions; nor will the *Statement* identify a preferred option. Instead the *Statement* will present a range of potential options for public discussion along with key judgments, effects and trade-offs.

KEY MESSAGES FROM PRESENTATIONS

Distributional Impact of Population Ageing

- There are many possible drivers of change in the income distribution over long periods of time, including changes in technology, skill levels in the population, the ongoing impact of globalisation, household formation rates, demographic change and changes in labour force participation rates. Two of the most critical assumptions underpinning Treasury's long-term projections are the last two issues, demographic change and changes in labour force participation.
- Treasury's analysis shows that demographic and labour force participation rate changes, in isolation, can be expected to have little material impact on standard high-level measures of intra-generational income inequality (Gini coefficients, Lorenz curves), although they would have some impacts on relative poverty levels among different population groups (e.g. such as those aged 65 years and over, households and households with dependents), at particular points in time, over the next fifty years (e.g. 2020, 2030, 2040, 2050 and 2060).
- Treasury's analysis also showed how the burdens of taxation and spending are expected to change across different age-groups of individuals as a consequence of population ageing. The analysis showed an increase in net taxes paid by the 25-64 age-group and a significant increase in the net spending – due to NZS and healthcare costs - received by those over the age of 65.



- While population ageing, and expected changes in labour force population should not, other things equal, unduly affect intra-generational (or cross-sectional) income inequality over the next 50 years, other things **will not be** equal.
- The extent to which any future policy decisions might affect intra-generational income inequality and relative poverty measures and inter-generational (future generations) outcomes will depend on the design of those future decisions.
- What this means is that the timing of when and how governments take policy action to address the fiscal challenges matters in terms of the intra-generational and inter-generational distributional impacts.
- Policy action to significantly reduce the fiscal gap over a short period, via an increase in taxes and/or a decrease in spending, may have an immediate effect on measures of household income inequality and poverty. Compared with current policy settings, such action would involve future taxpayers bearing less of the burden of current spending.
- Alternatively, if policy action occurs over a longer period, income inequality and poverty levels may not be affected much, but future taxpayers will continue to fund higher levels of spending over the transition period.

Retirement Income Policy

- NZ Superannuation, the basis of our current retirement income policy, has been world-leading in combating poverty among older people. It also has low administrative and compliance costs. However, it performs less well on other dimensions of the *Living Standards Framework*, particularly on fiscal sustainability. It also performs relatively poorly at replacing income from work.
- Population ageing will drive an increase in the cost of NZ Superannuation. This is because a larger proportion of people will be entitled to receive this pension and the average time in receipt of the pension will increase. Under current settings, the gross cost of NZ Superannuation will rise from 4% to nearly 8% of GDP in 2050.
- Treasury presented its analysis of four stylised options against the *Framework*:
  (1) Increase the age of eligibility for national superannuation;
  (2) Slow the rate of increase in superannuation payments (via less generous levels of wage or CPI indexation);
  (3) Compulsory private saving (Private SAYGO, or save as you go, where private savings would no longer be additional to NZ Superannuation but would instead part-fund it);

(4) Communal savings in a retirement scheme such as the NZ Superannuation Fund (Public SAYGO).

All options help manage the long-term fiscal cost in different ways.

- Some or all of these options are likely to be evaluated in the *Statement* in one form or another; but Treasury will not be recommending a preferred policy package.
- Depending on the precise design, preliminary analysis from the Treasury indicated that individuals could receive the same level of NZ Superannuation from options that involve either raising the age of entitlement or a public SAYGO approach as they would under existing settings; in either option, the pension rate would remain aligned with average income; relative poverty among older people, similarly, would not likely change (compared with present levels). It is noteworthy, however, that an option that involved raising the age would mean that people who still decide to retire at 65 would need to fund their earlier years in retirement. Pensioners unable to do this might have to rely on working-age benefits (which are less generous than NZ Superannuation). Also, under a public SAYGO approach, the level and distribution of the costs of funding NZ Superannuation would be different (compared with under existing settings).
- Under a slower rate of wage/CPI indexation option, NZ Superannuation alone would no longer be sufficient to keep all pensioners out of relative poverty.
- A private SAYGO option would have significantly different implications for people on different incomes, since higher-income earners would have higher retirement savings.The full impact would depend on individual circumstances and those who already save may be worse off in retirement, as their private savings would no longer be additional to their NZ Superannuation but would instead part-fund it.
- The base case highlights that younger generations do better in terms of total NZ Superannuation received over a lifetime as they are expected to live longer than older generations. The option of raising the age of entitlement might be expected to leave those aged 60 unaffected (because any change to age of entitlement would be phased in over a period of time), while 40-year olds would be slightly more affected than younger people in terms of their total lifetime receipt of NZ Superannuation.
- Under CPI indexation, younger generations would be more at risk of relative poverty than older generations if they do not take steps to compensate – although there would be reduced costs of superannuation and hence scope for governments to lower taxes or increase spending on other areas. Under a private SAYGO approach, younger people have more time to accumulate savings and so might be increasingly well off in retirement, although they would have borne the costs of that throughout their lives.

Dr Susan St John: Adapting Universal Provision

- If future fiscal pressures bring into question the affordability of maintaining current NZ Superannuation settings, then all policy options to reduce the Crown's NZ Superannuation costs need to be examined; raising the age of eligibility for universal New Zealand Superannuation is one policy lever available to improve affordability, but not necessarily the most equitable one.
- Some of the arguments advanced for means-testing include: that it would take pressure off the need to consider other policies to fund NZ Superannuation or to reduce the cost of NZ Superannuation; issues of alignment with Australian's retirement income provision; and, to enhance inter-generational equity.
- There are different ways that a means-testing framework could be put together to avoid some of the pitfalls of the surcharge adopted in the 1980s; a negative income tax approach could be used; alternatively, New Zealand Superannuation could be paid out as a regular non-taxable payment or grant where individuals' additional earnings would be subject to a separate tax scale.
- Dr St John will address the *Affording Our Future Conference* on the topic of means testing.

Tax Policy

- Treasury presented a range of options for raising more tax revenue, including: raising personal income tax rates, raising GST rates, raising the company tax rate, taxing capital gains on a realisation basis and a tax based on unimproved land.
- Treasury argued that the most economically efficient option would be a land tax, as there would be minimal reduction in economic performance. A GST rate increase would have some efficiency cost by discouraging labour force participation, but would be the least inefficient rate increase among existing tax bases.
- If distributional impact is the primary concern, changes that increase the tax burden on capital income, eg, introducing a capital gains tax or increasing the company rate, would increase the progressivity of the tax system.
- If the sustainability of revenue is the primary concern, Treasury considered it most likely that increases to personal income tax or GST rates, or introduction of a land tax, would be the most stable sources of future tax revenue.
- Treasury noted that historically most major tax changes are made as part of broader packages of reform. It is unclear whether using one particular tax measure alone to close the fiscal gap would be durable, or efficient, over the long-term.

Working-Age Welfare Policy

- Spending on welfare has broadly increased as a percentage of gross domestic product since the late 1970s. This has largely been driven by substantial increases in recipient numbers of main benefits. The level of main benefits (eg, unemployment, sickness, invalid's and the domestic purposes benefit) has been linked to inflation and so has not risen in real terms. The level of supplementary benefits has risen at a faster rate.
- In previous *Long-Term Fiscal Statements*, the Treasury's base case may have under-estimated the upward cost pressures in welfare, by assuming that main and supplementary benefits would continue to be indexed to consumer price inflation. Because GDP and wages grow faster than inflation, welfare spending would fall significantly as a proportion of GDP. It may be implausible in the long run to have beneficiaries' income continuously falling below wage earners' income.
- The Treasury is therefore looking at adjusting base case projections of benefits to include more than just the future inflation rate. Two options are being considered:
    - A "GDP approach" which is broadly based on a historical average welfare-to-GDP ratio of approximately 5% of GDP
    - A "CPI plus" approach, which indexes the Family Tax Credit and housing assistance payment rates to wage growth.

Education Policy

- Education spending is critical to living standards because access to quality education has profound implications for every aspect of people's private and social lives while the quality of the skills of the workforce have such wide-ranging implications for economic performance and social cohesion.
- Education spending has increased significantly in recent years and is currently equal to around 5.8% of GDP. Treasury's initial modelling suggests nominal spending per student will continue to rise, while education spending settles at around 5.2% of GDP over the long term (reflecting demographic change).
- Treasury anticipates that higher numbers of adults moving into tertiary education (driven by up-skilling) will increase spending on higher education as a share of GDP. On the other hand, the pre-school and school age population is expected to grow more slowly than the employed

labour force over the long term. This should lead to less spending on pre-school and school age education as a proportion of GDP even as nominal spending per student continues to increase.

PANEL DISCUSSION AND FEEDBACK

Following each presentation, Panel members asked questions of the presenter and offered comments and suggestions. The key points are summarised below.

On the Distributional Impact of Population Ageing

- Some panel members suggested that the *Statement* should more clearly acknowledge other factors that may impact on equity, such as technological change and household formation.
- In addition to analysing relative poverty among household income deciles, Treasury should consider measuring absolute poverty at different points in time in the future.
- The *Statement* should be explicit about its assumptions and to acknowledge where data gaps prohibit further analysis, eg, projections of lifetime income distribution.
- The *Statement* should clearly define terms such as "inter-generational equity" and acknowledge that there may be alternative views on how to frame and measure complex inter-generational equity issues.
- Stylised scenarios may help demonstrate the potential trade-offs that might be involved should future governments adopt different measures to secure fiscal sustainability. For example, how would different revenue-raising measures affect income distribution and poverty measures between household types and between generations?

On the Cost Projections of Retirement Income Policy

- There was support for focusing on fewer options for managing the future cost of NZ Superannuation, with more detailed analysis on the expected trade-offs. The rationale for the policy changes needs to be brought out clearly. For example, if increases in longevity are expected to drive the cost of NZ Superannuation, what is the logic of increasing the age of entitlement versus changing the rate of entitlement?
- Some panel members would like to see more discussion on the underlying principles for NZ Superannuation, such as whether it is a right that is earned or a welfare payment to prevent poverty.
- Some members suggested that the option of linking the increases in Superannuation payments to inflation rather than the average wage is implausible, given the adverse implications for poverty among older people.
- Noting that New Zealand has experimented with retirement income policy settings since the 1970s, some Panel members suggested that reform options be based around gradual changes to the broad existing framework.
- Some members expressed concern about picking arbitrary years for increasing the age of entitlement of NZ Superannuation. The alternative is to get public support for a longevity index, so that there is agreement on whether the age should increase, by how much, and how often.
- Some members raised the point that when NZ Superannuation entitlements were reduced in the past, or when the entitlement age has been raised, there was no visible effect on national savings performance.
- The panel also discussed how past efforts at means testing NZ Superannuation proved to be unpopular, administratively complex and resulted in unintended consequences such as providing disincentives to save or work. Doubt was cast on the net level of savings potentially

available to the Crown and queried whether it would be worth losing the benefits of universality for what would likely to be a small cost saving, as means-testing would likely be acceptable only if it cut in high up the income scale.

On Tax Revenue Options

- There was agreement that the international context will continue to inform consideration of expenditure and tax settings. The mobility of labour and capital are important considerations. On the other hand, population ageing is an international issue and other governments are also likely to consider tax increases as they meet the fiscal and economic challenges presented by demographic change.
- Future tax policy changes would need to be gradual and done in the context of international developments, to ensure New Zealand is moving in the direction of international trends and that changes do not adversely affect the relative competitiveness of our economy.
- The panel was generally supportive of maintaining a broad-base low-rate approach to tax policy design in New Zealand. However, it was less supportive of some of the individual tax policy options being presented, in terms of their usefulness as a response to spending pressures arising from demographic change and there were contrasting views amongst members of the panel concerning Treasury's interpretation of the distributional effects of some taxes, including GST.
    - It was acknowledged that an increase in GST has less adverse efficiency implications than increases in income taxes. However, a rise in GST may raise the likelihood of exemptions that would reduce revenue raised and reduce the efficiency of New Zealand's GST system; the sustainability of an effective GST system in the face of emerging information technologies and globalisation was discussed, developments which suggest caution may be warranted when assuming GST a stable source of long term revenue.
    - Similarly, some panel members challenged the purported efficiency properties of a land tax. Land usually requires some form of investment to render it productive. If the introduction of a tax that targeted just one form of wealth created uncertainty over future tax policy this could adversely impact on investment and further increase the efficiency costs of the tax. The panel also considered that its re-introduction may lead to pressure for the sorts of exemptions that contributed to its being discarded in the 1980s.
    - While a capital gains tax could enhance the integrity and distributional properties of the overall tax system, it is administratively challenging and it may prove to be a volatile source of revenue. More specifically, the introduction of a capital gains tax on owner-occupied housing would have implications for lower and middle income individuals as relatively more of their wealth tends to be held in their homes.
- Some members of the panel noted that these tax changes may still form part of an overall tax strategy for reasons other than long-term fiscal pressures.
- Treasury's base projections fix the Crown's tax revenue at a set ratio to GDP from 2020. Some members suggested that Treasury consider an alternative projection of revenue based on the indexation of personal tax rate thresholds to consumer price inflation, from a certain point in the future. Doing this would still prevent "bracket creep' to some extent while securing more revenue to the Crown over the long term than would occur in the Treasury's base projections. On the basis of current Treasury projections, this could generate extra revenue equivalent to about 2% of GDP by 2060.

On the Working-Age Welfare Projections

- There was support for Treasury to move its base case projection away from assuming that welfare benefits will continue to grow at only the rate of inflation indefinitely. There was agreement that this seems implausible, given expected wage growth.

- Panel members recommended more analysis into how sensitive welfare spending projections are to assumptions about the unemployment rate over time.

On Education Policy Options

- Some members of the panel suggested analysis might be useful into why the improvement in New Zealand's labour quality is not leading to material improvements in labour productivity. This could inform a wider discussion on New Zealand's relative productivity performance and inform discussion also of priorities for state spending over the long term, including how best to invest resources freed from the "demographic dividend" within education spending