What is the most pressing intergenerational challenge facing our tax system

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Introduction

"In the long run we're all dead". The infamous words of acclaimed economist John Maynard Keynes highlights the fact that we often fail to see the bigger picture. Majority of the public only plan for the imminent weeks and months, with only a few considering events a year or two into the future. It is therefore only to be expected that pensioners are struggling financially with the burden falling upon the current workforce to provide additional funding.

The most pressing intergenerational problem facing our tax system today is that majority of the public have failed or are failing to save enough for a comfortable retirement. While programmes such as KiwiSaver and the New Zealand Superannuation Fund do provide support for retirees, changes must be made to ensure that the public is adequately prepared for retirement. This essay will outline how our current tax system is hindering NZ's long-term development and what changes can be made to align tax policies with the treasury's living standards framework.

Aging Population

New Zealand's aging population has brought with it a variety of fiscal consequences. Revenue growth from the labour force has slowed, while increased demand for healthcare and superannuation has led to higher government spending[1]. Evidently, the current system is unsustainable as while the government can afford to continue providing N.Z super in the long term, taxes would either have to rise or spending in other sectors would have to fall in order to compensate for the cost. Currently NZ Super consists of approximately 4% of NZ's GDP, with forecasts estimating that the cost could almost double to 7.9% over the next 40 years[2]. There are also concerns in regard to whether future generations will have the capacity to afford sustaining NZ super, given that the amount of youth in NZ is shrinking, in contrast to the growing amount of elderly in New Zealand[3]. However, the burden of paying for the rising costs of retirement inequitably falls on those working today. This conflicts the treasury's living standards framework which aims to sustain and improve social capital, such as social connections that provide emotional support[4]. Our current system promotes intergenerational inequity as those working may feel that it is unfair for them to pay for the shortcomings of previous generations. Government intervention is therefore required to ensure retirees today and, in the future, will be able to enjoy a reasonable standard of living.

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[1] (Tax working group, 2018)
[2] (Parker, 2018)
[3] (Tax working group, 2018)
[4] (New Zealand treasury, 2017)

Taxation of Savings

Retirees today feel that they don't have enough to maintain a reasonable standard of living. While this is partly due to a lack of savings by the public in the past, the blame does not solely fall on the retiree. The way that New Zealand Taxes savings is based on a T.T.E tax system which taxes the initial contribution as well as the interest earned[5]. No tax is charged however when savings are drawn out. Our tax system is distinctively different to that of other countries as it does offer large concessions for retirement savings. Concessions are normally achieved through an E.E.T tax system in which the initial contribution and interest are exempt from tax, however tax is charged when savings are drawn out. As a result, New Zealander's are receiving far lower returns from their savings, than what they would get under other tax regimes. The Savings Working Group analysed that 90% of a person's retirement income came from compounding interest, and 10% from initial contributions[6]. However, after tax, retirees lose up to 57% of their savings[7]. While the governments KiwiSaver incentives and superannuation payments do alleviate the loss, retirees are still receiving relatively weak returns on their investments. Perhaps this why there is a disparity between retirees actual and expected income. On average retirees currently earn $437 a week, however many expect that $655 a week is needed to ensure a comfortable retirement[8]. While many argue that simply saving more is the solution, the taxes on retirement savings disincentivise savers given the relatively low rate of return in comparison to other investments. Under the human capital section of the Treasury's living standards framework, life expectancy is one of the factors that treasury aims to sustain and improve[9]. The standard of living for the elderly must therefore be improved to ensure that they can live out their lives comfortably without having to worry about making ends meet.

Housing vs Savings

The current tax regime also promotes investment in housing and rental properties, rather than financial assets. Saving in financial assets yields relatively low returns in comparison to investing in housing and rental properties which is taxed relatively lightly in comparison to financial assets. For example, the tax rate on equity funded owner occupied housing is essentially 0%, and capital gains for housing are also tax free[10]. As a result, investment into housing generates far higher returns for the investor, in comparison to investing into financial assets. The main problem however is that houses are unproductive assets. Private savings in a bank can be lent out to businesses which will often be used to purchase capital assets and improve productivity and productive capacity which helps improve the economy in the long term. Currently however, it is estimated that up to 60% of household wealth is tied up in housing, since current tax policies favour housing far more than capital assets[11]. As a result, land prices are increasing which is unproductive since it does not help New Zealand's ability to earn higher incomes. Another problem is that the mortgages lent out by banks are often funded by offshore borrowing, making New Zealand more susceptible to the adverse effects of foreign economies[12]. The

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[5] (Guest, 2013)
[6] (Finances Services Council, 2014)
[7] (Finances Services Council, 2014)
[8] (Klipin, 2017)
[9] (New Zealand treasury, 2017)
[10] (Finances Services Council, 2014)
[11] (Finances Services Council, 2014)
[12] (Finances Services Council, 2014)

fact that housing is taxed relatively lightly means that the government are receiving less tax, which affects their ability to fund public sectors, particularly healthcare and superannuation funds. Given that New Zealand's savings rate is already relatively low[13], it is important that our current savings are used productively in order to ensure the long-term sustainability of our economy. The treasury aims to improve and sustain financial capital, which includes the financial assets of households[14]. While it is expected that housing continues to be the highest valued household asset, changes must be made to promote investment into savings to ensure growth in the economy's long-term GDP through investment in productive assets.

Changes for the future

Looking to the future, it is evident that changes must be made to our current tax system in order to secure a comfortable retirement for both present and future generations. Our current tax policy is made to ensure that government has sufficient funds to cover their expenditure, which is usually approximately 30% of GDP[15]. However as outlined earlier in the article our aging population has caused intergenerational inequity. In order to improve quality of life for the elderly, the present generation must endure higher taxes or less government funding in other sectors. Any changes however must conform to the living standards framework as well as the goal of improving and sustaining the four capitals.

In terms of the tax revenue criteria, the intergenerational nature of retirement means new policies will be based on horizontal and vertical equity[16]. In regard to improving the standard of living for retirees, this will likely mean that the fiscal cost of continuing to provide healthcare and superannuation will spread, to reduce the cost on the present workforce.

One of the problems outlined earlier is the T.T.E savings regime which takes up to 57% of an individual's savings[17]. While arguments have been made for a more concessionary savings regime such as E.E.T, the government are likely significant fiscal costs which will only add further long term fiscal pressure on the economy. Forecasts have also shown that taxes on capital income and consumption are likely to become more relevant in the future in comparison to labour income taxes[18]. The decreasing amount of youth in New Zealand suggests a smaller workforce in the future, making the proportion of income gained from investment income relatively more relevant in the long term[19]. As a result, a lower tax rate on capital income seems to be a possible way to encourage saving, particularly for retirement. It is important however to remember that savings will still be competing with housing for investors interest, which means that tax policy on housing will also need to be considered.

The savings working group have suggested that lowering the tax on capital income will result in a higher standard of living for the future retirees. However, it is estimated that the tax on investment income would need to fall from 28% to 1% in order to yield comparable returns with investment in housing

[13] (Finances Services Council, 2014)
[14] (New Zealand treasury, 2017)
[15] (Tax working group, 2018)
[16] (Tax working group, 2018)
[17] (Finances Services Council, 2014)
[18] (Tax working group, 2018)
[19] (Parker, 2018)

rental properties[20]. While this would likely incur significant fiscal costs, an argument can be made that this cost could be alleviated by removing the government funded incentives for KiwiSaver which would save up to 740 million per year[21]. The main disadvantage of this idea however is that as the population continues aging, more tax will be required to sustain the current level of payments for healthcare and superannuation. Furthermore, the increase in savings is unlikely to be felt in the short term, which means that those expecting to retire soon will suffer from relatively low levels of savings as well as a lack of KiwiSaver incentives. Additional fiscal costs will therefore be incurred in the short term as the government will need to provide additional support to upcoming retirees, in order to ensure that they can receive the same quality of life as both previous and future generations. This will likely need to be funded through additional taxes or decreased funding in other sectors which will be unpopular with voters, discouraging governments from adapting this option. An increase in savings however is also likely to lead to increased investment which will increase wealth and real income levels which could potentially alleviate long term fiscal costs. In the short term however, additional funding will be needed to improve the standard of living for present retirees.

Lowering the tax on capital income will also indirectly affect house prices. By making the returns on capital income comparable to that from investments in housing and rental property, consumer confidence will fall leading to a decrease in consumer spending. The decreases however will mostly be from investment demand, as the shortage in Auckland[22] means that house prices are unlikely to fall much relative to prices in other parts of country. Low interest rates however offset the decreases in investor demand, as it will be relatively cheaper for households to take out mortgages to buy houses. However, the combined effect of lowering the tax on capital income and building additional houses will likely be greater than that of low interest rates so we can expect house prices to cool down.

From analysing the proposed policy of the Savings Working Group we can see the complexity behind designing a retirement income policy that will please everyone. The treasury's living standards framework however has provided a guideline for how policy changes will affect the wellbeing of New Zealanders. While it's inevitable that sacrifices will have to be made when designing tax policies, the living standards framework helps to identify key issues which require greater consideration. Former government statistician Len Cook used the framework to identify that tax policy will need to be equitable and sustainable[23]. The strengths and weaknesses of tax policies will also be addressed to ensure that the governments proposed tax policies will provide the best possible outcome for the greatest number of retirees.

Conclusion

Evidently, the most pressing intergenerational problem facing our tax system today is the fact that retirees today aren't receiving enough income to make ends meet. The onus of providing additional funds for retirees however falls on the next generation making equity a key issue when deciding how to improve the standard of living for retirees. Government involvement however is required to ensure that

[20] (Tax working group, 2018)
[21] (Tax working group, 2018)
[22] (Rutherford, 2018)
[23] (Commission for Financial Literacy and Retirement Income, 2010)

our tax system does not hinder the quality of life for retirees, but instead provides the necessary support needed to ensure that retirees have a comfortable standard of living.

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