Tax Incentives for Retirement Saving

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Introduction

Let me begin with a comment that each one of us probably has a fairly firm view of the role that taxation incentives should play in developing and promoting savings for retirement. Some of us have experience in an environment where contributions and fund investment income are fully exempt from tax but the benefits are subject to full taxation. In contrast, others have experience of the exact opposite, with full taxation on contributions and investment income but with benefits exempt from tax. And then, some of us have experience within a hybrid environment where there are taxes paid on contributions, investment income and benefits. We all come with our own pre-conceived ideas, perceptions and experience.

In addition, there is no clear picture as to the correct or best system. It is reasonable to say that it is a controversial topic around the world.

Further more, this controversy has increased in recent years as some countries have moved away from the traditional system of only taxing end benefits. New Zealand and Australia are good examples and indeed, Australasia is watched with interest around the world. Although it is controversial, it is an important topic for macroeconomic reasons and within the context of an ageing population.

So, to begin, what can we say? Let us begin with some general, and hopefully, non-controversial, statements

Some framework statements

- *Changes in taxation change behaviour*. Perhaps this statement is obvious but it needs to be said. If a Government introduces a worthwhile incentive or concession, behaviour will be changed. The extent of the change can be debated and is often difficult to measure, but people do change behaviour and more money in the pocket tends to be a great motivator. To take an analogy, many of us will go to a cheaper petrol station, two or three kilometres down the road to save _ a cent a litre. Different prices cause different behaviour.
- *Governments needs revenue to operate*. Most Governments also operate within a short term political cycle. Governments do not have the luxury of being able to defer income indefinitely or to borrow into the longer term to a significant extent. Recent economic events and increased monitoring by analysts and the markets have, in fact, encouraged Governments to borrow less.
- *Our current social context is very different from 10, 20 or 30 years ago.* We have a much stronger focus on the shorter term. As investors, there is a much greater focus on short term results and the value to shareholders this year. As consumers we tend to act and live for today and Generations X and Y highlight the trend. Furthermore our labour markets are much more mobile. Individuals are no longer expecting to stay in the same job or even work in the same country for their whole career. There is a much stronger global view in terms of employment, in terms of living standards, in terms of the future. In short, these trends drive a focus on the shorter term and not the longer term.
- *Equity issue remains important*. Equity is difficult to define but most people know when something is unfair. Equity also needs to be considered both within a generation (e.g. within an income tax system) and between generations. Inter-generational equity is particularly important when we look at taxation for long term savings as in retirement.

What are the tax options for super?

Now turning to the topic at hand. Most of us are aware that superannuation can be taxed at any or all of the stages — contributions, investment income and benefits. The following table sets out the major options.

Options	Taxation on Contributions	Taxation on Investment Earnings	Taxation on Benefits
New Zealand	Taxed	Taxed	Exempt
Many Developed Countries (a deferred approach)	Exempt	Exempt	Taxed
Australia	taxed	taxed	taxed

As we consider this table we immediately recognise that there are considerable differences between the three options. The New Zealand (TTE) model of taxing contributions and fund earnings is the exact opposite to the deferred (or EET) approach adopted in many developed countries.

Deferring taxation from contributions to the benefits can have the same result under certain conditions. In other words, if the tax rate on contributions is the same as the tax rate on benefits, the net result can be the same. However, as is often noted, the tax rate on benefits is normally much lower than the tax rate on contributions because income levels are generally reduced in retirement. Deferring tax from contributions to benefits can raise important equity issues.

However, it should also be noted that deferring taxation can provide a long term advantage to the Government. In effect, the Government is borrowing extra dollars today to fund the concessions, is investing these borrowed dollars into a superannuation fund and is receiving the taxation on the benefits. If the superannuation fund is earning at a rate higher than the Government bond rate, the Government s long term revenue position can be improved.

Within the context of an ageing population there is much to be said for deferring taxation, as the revenue will increase when some of the pressures from health, age care and pension costs increase in two or three decades time. That is, the deferring of taxation on superannuation provides future revenue for the Government. Of course, it is also recognised that there are many other social and economic drivers that

will determine the financial position of future Governments. However, there will be financial pressures on the Government within an ageing population which will be difficult to address through the income tax or broad based consumption tax options. Future taxation revenue emerging from superannuation benefits represents a possible increasing source of revenue for some countries.

Although coming from the Western Island, I do not recommend the Australian model! It is complicated, it has taxation at three stages and it provides very oblique messages. Furthermore it adds significant compliance costs.

The following table shows the present value of future taxation from a Government perspective under half a dozen options. For this purpose, I have assumed that the Government bond rate is 6% and the pre-tax fund earning rate is 9%. These figures are for an individual over a 35 year working career and highlight the fact that deferring tax can increase the present value of taxation for a Government. In addition, it is clear that exempting investment income from taxation can be costly.

Options	**Present value of Revenue from a Government perspective**
TTE at 33%	100.0
ETT at 33%	127.9
ETT at 21%	94.9
ET at 21%, T at 33%	116.5
ET at 33%, T at 21%	110.3
EET at 33%	85.9

So returning to the fundamental question - which is the best system? It depends on what you want the system to do; what are the motives - from both the Government and community perspectives. I will return to the question in a moment, but let me give you some fundamental requirements.

First, the system should be simple and transparent. It should be able to be understood clearly by all participants and not add significant compliance costs. This suggests that a multi-stage system does not have an advantage.

Second it should be clear that any incentive to encourage certain behaviour is clear and non-ambiguous.

Third, it is a system for the long term and should have bipartisan political support. This may difficult to achieve within a democratic society but in an ideal world it is an important criteria. Constant changes will encourage instability and lack of long term confidence.

Fourth it should be fair over the long term. In that context, the level of income one earns in a particular year may be much less relevant than the level of income earned over several years or decades. Furthermore, within a changing labour market, individuals will have increasingly flexible work patterns. In terms of fairness, I suggest that it is best achieved when benefits are taxed at the end. That is, at the point we know the full superannuation benefit received over the full working career.

In addition, as mentioned earlier, future taxation on benefits can be an important advantage to the financial revenue needs of future governments. Taxing benefits also increases the funds available within the funds for investment purposes.

Last year, eighteen Australian organisations, ranging from unions to employers, from actuaries to the farmers federation, signed a statement entitled Framework Principles for the Australian Retirement Income System. It noted, that the taxation of superannuation,

- ensures that superannuation is taxed in a manner that maintains community support and confidence and recognises the costs to individuals of its long term perspective and high level of preservation;
- should be designed to provide a clear incentive to save, preferably at the point of contribution, and have a focus on taxes on benefit payments, as this provides the simplest method of achieving equity, provides increasing revenue in future years and is consistent with international practice;
- is simple to understand
- can be operated transparently and efficiently.

However, we must also recognise that we do not start with a clean sheet of paper. Each country has its own current system and therefore any shifts must take into account transitional issues and grandfathering clauses. We ve had the problem in Australia of significant grandfathering problems which complicates the system and adds to compliance costs. These grandfathering clauses also inhibit future governments taking appropriate action.

Why might the Government give support

Taxation incentives for savings have been around for many decades. In fact, within many countries they were part of the first income tax system and deductions were given for life insurance savings. But why is a government interested in developing such a behaviour? Many reasons have been put forward but let me suggest the ones that I think have some merit.

- *to change behaviour within a community and to generate a positive social or economic outcome.* Governments introduce measures across the board to change behaviour whether it be in terms of research and development, education, health, or in other fields. Saving for future economic security should be no different. It is appropriate that government sets up a structure to encourage appropriate behaviour and generate a positive outcome for the society.
- In terms of most voluntary savings, individuals continue to have access to their saving. Individuals save for a particular purposes such as children s education, holidays, or as security for rainy day. However, in each case there is access to these savings, as needed. In terms of superannuation savings, this is not the case. The savings are preserved or locked away for several decades. This means that these savings are different from other forms of shorter term savings and if this behaviour is to be encouraged, it is reasonable to reward this lack of access.
- Retirement incomes are not just about superannuation. Retirement incomes come from four sources of income including a public pension, a compulsory system (in the public or private sector), voluntary savings and employment income during retirement. In some countries, voluntary savings for superannuation can offset future social security costs. The actual extent of this offset will depend on the system and the political and social history of the country. However, it is important to note that if one is to encourage savings to offset future social security costs, then there must be clear integration between the pillars. I can certainly note from the Australian experience that this is not always the case.
- Traditionally savings for superannuation have been encouraged as they would increase the level of national savings. This can be a somewhat simplistic argument as one must also take into account the cost of government support (or the loss of national savings) as well as the extra private sector savings. It is worth noting that in an economy such as New Zealand there is heavy reliance on overseas investments. This places pressure on the country from the international perspective. Greater local savings gives a country greater economic independence.

So which of these arguments have some merit? Let me concentrate on two.

The long term social benefit

I suggest that the strongest argument for a government incentive for retirement savings is that it can establish a mindset and infrastructure within the community for saving. In particular, such a savings mindset within the younger generations can be particularly advantageous in the longer term.

Incentives for savings also raises the questions within the community as to who is responsible for a person s future financial security in their retirement. Is it the government, the individual or somebody else? It may be considered paternalistic if the government encourages certain behaviour but I suggest it can have significant positive social outcomes. If the government does not send these signals clearly, there can be an assumption that we can all rely on the government for the future. Governments within a civilised society will always play a role in providing aged income. However, it is important that this burden is shared between governments and individuals. That message must be clearly portrayed.

To use another example, most governments encourage certain behaviour in the health sector. For instance, vaccinations which are now compulsory for many children were encouraged for many years through government support. In addition, certain medical prescriptions are financially supported by the government in the interests of the public health system. I suggest that financial support for long term savings is, in fact, supporting our future economic health. Such incentives can indeed change behaviour to the benefit of both the individual and the community.

Of course, it could be considered somewhat paternalistic to encourage certain behaviour that individuals can do voluntarily. However, I think it is unreasonable to suggest that all individuals within the community can fully understand the long term risks associated with longevity, inflation and future economic conditions. This is particularly the case within a generation that tends to focus on the shorter term. A government with longer term views can in fact encourage longer term benefits.

Of course, such behaviour also raises the issue as to the philosophy of the government, and the level of individual responsibility for their own future being. I want to suggest that it is a partnership where the individual must play his or her role, but the government must establish the framework. Without the framework, there is no environment for the individual to operate with an appropriate level of confidence. Of course, the extent of any government support also depends on priorities within government expenditure. However, long term economic health must be a priority for all governments.

Finally, let me make a brief comment on the compulsory versus voluntary savings debate. As you are aware the Australian system is compulsory and will reach its contribution maximum of 9% of earnings next July. New Zealand rejected the compulsory route through a referendum. I think both systems have their merits and ideally I m quite happy with a mixed system. However, they represent different philosophies and they do send different messages.

In terms of the level of savings, it is reasonable to suggest that the compulsory system has a stronger effect on savings although there is also significant offset. Even within the compulsory system not all money that is saved will be new savings. There will be substitution or reallocation. Furthermore it has been suggested that as the level of compulsory accounts within the Australian Superannuation System increases, individuals will reduce saving that they would otherwise have done. This leads us on to the next issue, What is the evidence? .

The evidence of savings

There has been considerable discussion on the evidence relating to incentives for long term savings. Firstly, let s note that most of the studies have been carried out in the US and the context there is quite different from New Zealand or Australia. Nevertheless, there are lessons that can be learnt. In general, let me summarise the evidence as I see it.

1. The level of private sector savings increases as incentives are provided; that is behaviour is changed. However, as may be expected, much of the savings is reallocation from other forms of savings. There is new savings but there is also reallocation.
2. Total savings, allowing for the cost of the loss of revenue from the government, may be positive or negative. It is difficult to be conclusive.
3. The quality of savings is important. How does one compare greater savings within the private sector providing money for development capital with a reduction in the government deficit or borrowings. They are different in terms of quality and this must be realised. Within an economy savings should encourage wealth creation and, in general terms, I suggest that happens better within the private sector.
4. Generally speaking, incentives favour those on higher incomes who receive the greater benefit. It should also be noted that many of these high income earners will already save and will be reallocating from other savings. Hence, the equity of some of these outcomes can be questioned.

Finally there is the impact of inflation and the timing of taxation of the tax payments that need to be considered. So what do we conclude? In the long term there are benefits to the community and to the individual for encouraging long term savings. However, these incentives must be clearly targeted to receive the best results. So let us look at some of the criteria that we might use to develop such an outcome.

Some criteria for establishing an incentive for Long Term Savings

Here is a list of some criteria that could be used to develop a savings incentive.

- It must be simple with a clear incentive to participate in the savings system.
- The benefits produced from the retirement savings system must be able to be integrated with other pillars within the retirement income system.
- It should provide some positive benefit for the lack of access to the savings.
- It should build on the current system so there are limited transitional issues.
- It should not provide major windfalls to winners who are already in the system.
- It should be fair for members in the one generation and between generations.

With these criteria in mind, let me suggest one way forward for New Zealand.

A Member Rebate

In view of the desire for a savings framework and the importance of a partnership I recommend that New Zealand could consider introducing a rebate for member contributions from after tax money, that is both linked to the age of the contributor and capped.

For example, let us look at a cash refundable rebate of 21% of the contributions paid by those under the age of 35, 14% for those aged between 35-45 and 7% for those aged 45-55. There could be an annual cap of $4,000 per annum. In addition, there would an opportunity for some catch up over a period of years for those who have been out of the workforce. For instance, one could look over a five year period and permit people to contribute an extra 50% if they have not

been contributing at the maximum rate in recent years. Such a proposal has a number of advantages.

- It is immediate as it provides cash in the pocket as a refund for those participating. That is, it changes behaviour.
- It is biased towards the younger members of the community; that is, it helps establish a savings mindset.
- It is targeted.
- It does not provide a windfall to those already in the system.
- It is simple to understand and implement.
- It has very limited compliance costs
- It could be broadened beyond the workforce to include spouse and other members of the family.
- Its costs to Government revenue are predictable and known year by year. The rebate rate could be reduced for large contributions if it was felt that higher income earners were receiving larger benefits. However, such an adjustment would remove some of the simplicity.
- It allows for changing labour market involvement as people come into and out of the workforce.

I am also suggesting that certain conditions be established for the system, such as the funds be preserved to at least age 60 and some limits in the format of benefits.

Some other Comments

The conditions in which we are operating are changing continually so we therefore need flexibility. However, we must also have immediacy in the value of the concession. A value in the future is perceived to be a much lower value than an immediate value.

I have not made a comment on the taxation of fund earnings. I have assumed for the moment that fund earning taxes will continue. However, it should be noted that such taxes can be unfair for lower income earners, as their funds can be taxed at a rate in excess of their marginal tax rate. However, the only

feasible option for taxing fund earnings is a flat rate on all funds. Any other proposal is much too complicated.

We must also remember that we must keep compliance costs low. Some of you would be familiar with the surcharge introduced into Australia 5 or 6 years ago for high income earners. It is an incredibly complicated tax with court cases still pending. It has added compliance and system costs that are significant and which all fund members bear. Here is an example of a tax which New Zealand ought not follow!

Conclusion

As I said at the outset there are different views on the tax system for savings. However, let us conclude by asking the question — what is the desired behaviour within the community? I suggest that it is desirable that people are encouraged to save for their retirement. We recognise that some people will do that anyway. However, I suggest that it is appropriate for the Government to establish a framework to encourage such behaviour. It should be a partnership between the Government and individuals. This raises the issue as to how much the Government contributes to such a framework through the loss of taxation revenue.

My recommendation in this paper is that the introduction of rebates on member contributions that are capped and targeted is one way forward for New Zealand. They provide a clear incentive and can be adjusted in the longer term. However, they should be agreed by all parties to encourage confidence within a stable long term system.