Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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30 April 2018

Submission to the Tax Working Group

Executive Summary

The Ministry of Social Development's (MSD) submission covers a small set of issues focused on the impact of the tax system on our clients, raised in response to the Tax Working Group's (TWG) Submissions Background Paper.

While MSD's clients are many and varied, one of the key differences in the current welfare system is between the targeted working-age benefit system and the universal New Zealand Superannuation (NZS) system. While NZS is available to almost all New Zealanders who are over 65, the working-age benefit system is subject to income tests to limit its availability to those without any other means of support (and maintain incentives to work).

This means that the working-age benefits are generally only accessed by people on relatively low incomes. The welfare system also includes a significant amount of other 'supplementary' assistance to help meet costs such as housing, disability and/or childcare. This supplementary assistance is available to people of all ages, but it is subject to income and asset tests, in order to target it those with few other resources. Supplementary assistance is available to people also receiving a main benefit or NZS, and people who are working on relatively low incomes[1].

There are also important 'life-course' differences between people of working age and those in retirement. Working-age people are generally trying to accumulate savings and assets, while those in retirement may be decumulating previous savings or selling assets to support their retirement.

For these reasons, MSD's submission is split into two parts to illustrate the particular opportunities to improve wellbeing through taxation for lower-income working-age people (Part One) and retired people (Part Two).

Part One concerns working-age people on lower incomes and suggests that the Tax Working Group considers:

- The overall balance of the tax system in relation to redistribution, including considering increasing the reduction in income (and wealth) inequality caused by the tax system; and

[1] While MSD pays students loans and allowances, policy responsibility for student financial support sits with the Ministry of Education.

- The impact on those on the lowest incomes of any changes to tax, particularly any impacts on effective marginal tax rates and key costs for low-income households such as rent, power and food.

Part Two concerns people in retirement and suggests that the Tax Working Group considers:

- Better aligning the tax rules that apply across different types of investments to support households to increase long-term savings; and
- Improving the tax rules for annuities to improve options for the decumulation of retirement savings.

We note that the Group's Terms of Reference exclude consideration of "the adequacy of the personal tax system and its interaction with the transfer system". In our view, this is a missed opportunity to consider the significant interactions between the systems, particularly as these disproportionately impact people on the lowest incomes.

It is also a missed opportunity to consider the trade-offs across the tax and transfer system. Our current system has created a relatively simple and broad-based tax system with limited redistributive powers. This has been paired with a targeted welfare system which 'takes the weight' of redistribution, requiring high effective marginal tax rates and considerable complexity for clients and MSD to manage.

In MSD's view, even fiscally-neutral changes to the composition of the tax system should consider any key impacts on the transfer system in order to be able to assess the 'fairness' of the changes, particularly for lower-income people who are likely to be affected.

MSD officials would be happy to meet with the Tax Working Group if desired.

Part One: Taxation and Improving Wellbeing for Lower-Income People of Working Age

Who are MSD's working-age clients?

Financial support	Numbers[2]		
Main benefit	273,000	Around 10% of the NZ labour force (16-64 years)	168,000 (or around 15%) of children in NZ
No main benefit (only supplementary payments)	58,000		

- Using a low-income measure that identifies 15% of the overall population as below the threshold or 'poor'[3], around 80% of those who live in households whose main source of income is a main benefit are below this threshold ('poor') and they make up around 40% of all such individuals[4].
- Just over 40% of those who live in households whose main source of income is from a main benefit experience material hardship, compared to around 13% of the overall population[5].

Consider of the overall balance of the tax system in relation to redistribution

Current tax settings, particularly the reliance on GST and income taxes (and relatively low top income tax rates) mean that low-income people are likely to pay a higher share of tax than in other countries, and contribute to "the inequality-reducing power of New Zealand's tax-benefit system (being) currently relatively low compared with that for other OECD countries"[6].

The current tax system's structure means that the transfer system bears a greater weight to decrease inequality. While the targeted approach to welfare is significantly determined by affordability (linked to the overall level of taxation and out of scope), there is scope for the tax system to increase its redistributive power within the current fiscal envelope.

Given the Government's child poverty reduction targets and the comparatively lower level of redistribution of NZ's tax and transfer system, consideration could be given to reducing the relative tax burden on those on lower incomes, particularly if this is achieved through more comprehensively taxing sources of income from assets that are currently untaxed.

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[2] Benefit fact sheet, numbers as at 31 March 2018, http://www.msd.govt.nz/about-msd-and-our-work/publications-resources/statistics/benefit/index.html#Latestbenefitfactsheetsrelease1
[3] Income below 60% of the median, after housing costs, constant value (2007 reference year)
[4] Perry, Bryan "Household Incomes in NZ: Trends in indicators of inequality and hardship 1982-2016", July 2017
[5] Ibid
[6] "Future of Tax: Submissions Background Paper", Tax Working Group, March 2018, p. 36

Taxes on assets and wealth

A way to increase the overall redistributive power of the tax system could be to reduce the reliance on income tax and/or GST, and shift to taxes that target currently untaxed income from assets or wealth, such as a comprehensive Capital Gains Tax (excluding the family home) or a Land Tax. These taxes are much less likely to impact on lower-income people who tend to have fewer (or no) assets. Applying taxes more comprehensively across different sources of income and wealth can reduce distortions in the incentives people have to invest and structure their affairs in particular ways, and also have strong equity arguments.

Consider the impact on low-income people of any changes to the tax system

Effective marginal tax rates for those on lower incomes

While interactions with the transfer system are outside the scope of the TWG's consideration, MSD's view is that it is difficult to assess the 'fairness' of the tax system without considering the impacts of any changes on lower-(and middle) income people who are navigating across both the tax and welfare systems.

The provision of targeted income support necessarily requires the creation of higher Effective Marginal Tax Rates (EMTRs), where the combination of tax and the withdrawal of transfer payments as income rise means that people retain less from an increase in income. High EMTRs can create 'poverty traps' whereby the gap between benefit and work is insufficient to meet the additional costs of working, and entering employment is discouraged. High EMTRs can also discourage increasing incomes when in work.

It is worth noting that the impact of the tax system on EMTRs is modest compared to the impact of welfare settings, given the relatively low tax rates on incomes below $48,000. However, it is worth briefly summarising the key settings in the welfare system, so that any changes to tax are mindful of this context.

For all main benefits, there is a modest amount of income that can be earned before the benefit payment begins to reduce – this is known as the 'abatement-free threshold' and varies from between $80 and $100 a week for different benefit types.

Above this abatement-free threshold, main benefit payments reduce sharply and people face abatement rates of either 30 percent or 70 percent for each dollar earned, resulting in EMTRs of between around 40 percent to 90 percent (once tax and ACC levies are included). It is important to note that a small number of people will be directly experiencing these EMTRs.

However, while only a relatively small number of people will be directly experiencing these EMTRs, any beneficiary who moves into work (whether or not they are still entitled to any main benefit payments) will experience these EMTRs over their additional income. This means the gap between their benefit income and their income from work will be relatively small, particularly if their wages are low.

High EMTRs also impact on working people receiving supplementary payments. Working for Families payments are reduced by 25 percent for each dollar earned over $42,700 of family income, and Accommodation Supplement reduces by a further 25 percent for each dollar earned above the relevant benefit cut-out point.

This means some lower-income families, while significantly benefitting from this supplementary assistance, face EMTRs that are 25-50 percent above their marginal tax rate. For example, a family with two children and a single earner on $50,000 a year, receiving Working for Families and the Accommodation Supplement, would retain around 20 percent of a modest pay rise. This compares to a similar family earning $150,000 who would retain around two-thirds of such an increase.

Secondary tax – out of scope

The current approach to secondary tax results in many beneficiaries who earn additional income being over-taxed on their employment income, as only their benefit income is able to be taxed on the lowest income tax threshold. We understand that improving/abolishing secondary tax is not included in the work of the TWG.

Costs for lower-income households

Some of the other taxes discussed in the Submissions Background Paper could have significant impacts on low-income people and the costs they face. MSD provides considerable financial support to low-income people, and any significant changes in cost will impact on both the wellbeing of these people and the demand for this support. Note that while this section is inside the 'working-age' part of the submission, many of the recommendations will be relevant for low-income superannuitants as well.

Housing Affordability

Housing costs, and particularly rents, are a key cost for many low-income people. Housing costs have grown considerably faster than incomes for those on lower incomes for a significant period of time, and this has resulted in a large group of low-income households with low residual (after housing costs) incomes. For households in the bottom income quintile, average housing costs have increased from 29% to 51% of their average income between 1988 and 2016[7].

These increased housing costs have put increased pressure on MSD's provision of social housing, and on the costs of the Accommodation Supplement and hardship assistance such as Temporary Additional Support.

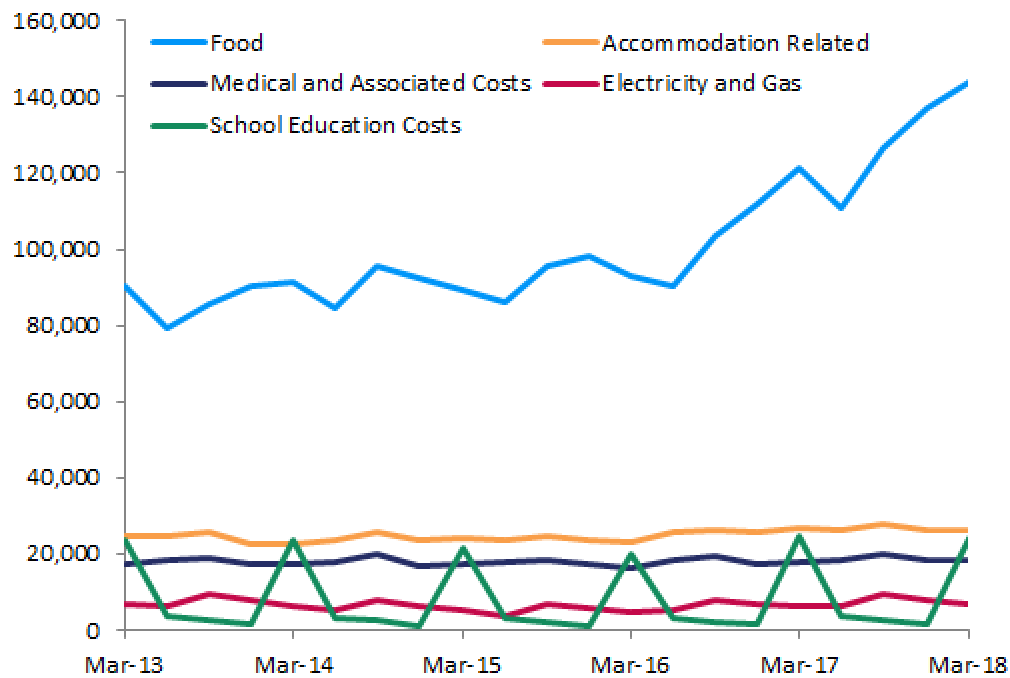
MSD's view is that changes to tax should support an increase in housing affordability, particularly for renters, and should seek to minimise any potentially negative impacts on housing supply.

GST and a Sugar Tax

Exemptions to GST are also raised in the Background Paper. While recognising the complexity that these exemptions create and their relatively high cost, MSD has seen significant pressure on hardship assistance, particularly grants for food, over the last few years, as shown in the figure on the next page.

[7] Perry, Bryan "The material wellbeing of NZ households: Overview and Key Findings", July 2017

Figure 1: Selected quarterly hardship assistance reasons, March 2013 to March 2018



Any exemptions that would support low-income people to better afford food may reduce pressure on hardship assistance, and improve the health and wellbeing of low-income people who are struggling to get sufficient (and high-quality) food on the table. However, there are potentially most cost-effective solutions within the welfare system to address pressure on hardship assistance. Solutions within the welfare system would be unlikely to be able to provide a targeted incentive to increase consumption of particular products.

Conversely, taxes that may increase costs for low-income families, such as a tax on sugar, may flow through to higher demand for MSD support, depending on the extent to which higher costs encourage substitution for other (non-taxed) products.

Part Two: Taxation and Improving Wellbeing in Retirement

The Submissions Background Paper highlights changing demographics, particularly the ageing population and the fiscal pressures it will bring. The use of dependency ratios, however, over-emphasises the impact of population ageing for two reasons:

- More people are remaining in paid work beyond pension age. At around 24 percent, New Zealand currently has one of the highest labour force participation rates in the OECD for people aged 65 years or over. By 2038, it is projected that people aged 65 or over will make up 10 percent of New Zealand's total workforce. Older people also make an additional economic contribution through unpaid work, volunteering and caregiving.
- Older people pay tax – the combination of tax on earnings from paid work, New Zealand Superannuation (NZS), consumption (GST) and investments is significant and growing. The Ministry of Social Development projects that by 2061 people aged 65 or over will pay $25.1 billion in tax, up from around $5.5 billion today (real 2016 dollars)[8].

In terms of future government expenditure associated with the ageing population it is important to remember that while expenditure on public pensions is increasing, New Zealand spends less on public pensions as a percentage of GDP than the average across OECD countries and this is expected to remain the case. It is also important to remember that NZS is taxable and taxed at a recipient's marginal tax rate – as a result around 14.8 percent of expenditure on NZS is retained by the Crown as income tax. While health expenditure increases with the ageing population, Treasury estimates that from 2025, around 25 percent of the future increase in health spending will be directly attributable to the ageing population[9].

Compared to other age groups, New Zealanders aged 65 years or over are currently less likely to experience material hardship, have low incomes (after deducting housing costs) and live in houses that are hard to heat, damp or mouldy. This is attributable to universal NZS and a high level of mortgage-free home ownership. However, this may not continue for future generations of older people. We anticipate that more people will be reaching the age of 65 with debt and many will still be paying mortgages or living in rental accommodation. For many retirees, NZS will be insufficient to meet their weekly costs and these people will need to rely on accumulated savings or additional financial support from the Government (e.g. Accommodation Supplement, Temporary Additional Support or state housing).

Therefore, encouraging savings and the tax rules applicable to household savings is of growing importance as we face an ageing population and the growing diversity amongst our older population. We need to lift the level of retirement savings, particularly by people who have a modest income over their working life and who are unlikely to own their home in retirement, and ensure that these retirees have a range of appropriate options for decumulating their savings.

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[8] http://www.superseniors.msd.govt.nz/documents/publications/business-of-ageing-factsheet-update-osc116.pdf

[9] *2016 Statement on the Long-term Fiscal Position*, Treasury, Wellington, p 61.

In the context of improving wellbeing in retirement, we suggest that the Tax Working Group consider:

- Better aligning the tax rules that apply across different types of investments; and
- The tax rules for annuities.

When improving the alignment of the tax treatment of different investments, tax changes that would support wellbeing in retirement should be considered

It is important that both retirement income policy and tax policy support long-term saving, particularly for those who during their working life have a modest income.

In general, New Zealand's current tax rules discourage saving. The biggest issue is that current tax rules encourage the diversion of savings into residential property, away from long-term savings vehicles that increase the level of national savings.

While not advocating for 'concessions' for retirement savings, the tax treatment of locked-in superannuation funds, including KiwiSaver could be considered in the context of 'levelling the playing field' across different types of investments. These types of investments are particularly important for people who have a modest income and can therefore save only a modest amount over their working life.

In addition, the issue regarding taxation of interest income from bank deposits is of particular relevance to the many retirees who hold their retirement savings in bank accounts.

It makes sense for older people who have reached the decumulation stage to look for a conservative/low-risk investment vehicle for their retirement savings and as a result, holding savings in savings accounts with major banks is common practice. While low interest rates becoming embedded is positive for younger people taking on a mortgage, it is not good news for retirees who rely on low-risk investments to generate a portion of their retirement income.

In the context of the different tax treatment of different investments, it has been suggested that gains that are solely due to inflation should not be taxed and in particular this should apply to household savings held in bank accounts. This is discussed on pages 39 to 41 of the Tax Working Group's Submissions Background Paper – Future of Tax – the graph on page 40 highlighting the high effective marginal tax rate of bank account savings compared to other types of savings, particularly housing.

Current tax policy in New Zealand significantly advantages investment in owner-occupied housing and rental property and has contributed to house price increases. While the Tax Working Group may consider changes to the tax rules for housing, we suggest that part of 'levelling the playing field' for savings should include considering the tax rules applicable to:

- Locked-in retirement funds (e.g. KiwiSaver); and
- Household savings in bank accounts.

Benefits associated with reducing the tax liability of these investments could include reducing the relative attractiveness of investment in residential housing, increasing the

level of national savings, and improving the wellbeing in retirement of people who are able to save only a modest amount over their working life.

Consider options that would tax annuities in a similar manner to other substitutable investments, to remove a tax distortion that may be discouraging the development of the New Zealand annuities market and contributing to the growing 'decumulation problem'

KiwiSaver balances are continuing to grow (with around $40 billion of funds currently invested) and so is the number of KiwiSavers eligible to withdraw them. Limited decumulation options mean that financial wellbeing in retirement is potentially less than it could be. For example, lack of options for decumulation could contribute to poor decision-making at age 65 (including using KiwiSaver funds for immediate consumption) which could undermine the purpose of the KiwiSaver scheme – to increase individuals' well-being and financial independence, particularly in retirement. The Government has a vested interest in this, given the level of subsidies provided to KiwiSavers – over $8 billion since the scheme commenced in 2007 and forecast expenditure of over $900 million in the current financial year (including the housing deposit subsidy).

Annuities are an obvious and potentially efficient way to convert a lump sum of savings into an income stream in retirement. Annuities are popular in overseas jurisdictions for this reason. While the relatively small size of the New Zealand market and uncertainty around longevity risk may be barriers to the provision of annuity products, the New Zealand tax system also treats annuities adversely relative to other forms of investment. The result is that there is only one annuity product on the market at present[10].

The tax issue regarding annuities has three aspects. First, the concessionary PIE investment tax treatment applicable to many other financial investments is not available to annuities. Second, the whole nominal interest component of annuity payments is taxed even though part of it represents inflation and not a real return. Third, other competing investment options can generate tax-free capital gains that make fully-taxed annuities unattractive.

The 2009 Capital Market Development Taskforce[11] and the 2010/2011 Savings Working Group[12], among others, have criticised the tax treatment of annuities as adverse and non-neutral and have advocated reform. We suggest that the Tax Working Group consider the tax rules applicable to annuities to support an environment where people reaching retirement have access to greater range of options for decumulating their savings.

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10 *Lifetime Income* was launched in 2015 and claims to be managing around $100 million of retirement assets. https://www.lifetimeincome.co.nz/

11 See '*Capital Markets Matter*' (2009):http://www.med.govt.nz/business/economic-development/pdf-docs-library/cmd-capital-markets-matter-full-report.pdf p 107.

12 See '*Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity*' (2011):http://media.nzherald.co.nz/webcontent/document/pdf/20116/swg-report-jan11.pdf p 102.