

Welfare: Savings not Taxation

Sir Roger Douglas and Robert MacCulloch

Minister of Finance, NZ, 1984-1988, Roger Douglas Associates; Graduate School of Management University of Auckland

Many nations are seeking to reform their welfare states so that costs to the government can be reduced and the quality of outcomes improved. As a potential way to achieve these aims, there has been a surge of interest in the Singaporean model which features compulsory savings accounts and transparent pricing of health services. It has achieved some of the best health-care outcomes in the world at a cost that is the lowest amongst high income countries. In this paper we show how tax cuts can be designed to help establish compulsory savings accounts so that a publicly funded welfare system can be changed into one that relies largely on private funding in a politically feasible way. To our knowledge, showing how both a tax and welfare reform can be jointly designed to enable this transition to occur has not been done before. Our policy reform creates institutions that have features in common with Singaporean ones, especially for health-care. However there are also key differences. We present a new unified approach to the funding of health, retirement and risk-cover (for events like unemployment) through the establishment of a set of compulsory savings accounts. A case study of New Zealand is used as an illustration. The fiscal impact of our proposed reform on the government's current and future budgets is reported, as well as its effect on low, middle and high income individuals.

1. Introduction

Across many countries publicly funded health-care and retirement programmes are forecast to put rising pressure on government budgets. For health and finance ministries, the search for ways to treat and prevent illness more cheaply without sacrificing quality is becoming urgent. Even in those nations where private funding has been relied on more heavily, as in the United States, health-care costs have been rapidly rising.

Pension systems that are funded by taxing the young are also being threatened due to ageing populations and declining birth rates. This paper presents a detailed and practical budgetary reform plan that offers a way to relieve these kinds of strains through the establishment of a new set of welfare institutions. The reform seeks to lessen dependency on the State and expand choice, whilst at the same time improving the efficiency of the system and quality of services, particularly for lower and middle income earners.

In 1960, the total of both public and private health spending accounted for under 4% of GDP, on average, across OECD countries.¹ By 2009, this proportion had risen to 9.6%. The rise was particularly rapid in the United States, where the total grew from about 5% of GDP in 1960 to around 17% today. Projections of public health spending by the OECD forecast an increase of another 7.7 percentage points of GDP by 2060.² The cost of public pension schemes are also forecast to rise significantly over this period, by around 2.2 percentage points of GDP.

Many different reasons have been proposed to explain why health-care costs, in particular, have been rising faster than output across much of the world. Some commentators blame the rapidly expanding population of the elderly, compared to the population of the young who must support them, pointing out that the cost of caring for the elderly far exceeds that for the young. Others blame the use of more expensive technologies. Another reason may be the relatively slow productivity growth experienced by the health-care sector, possibly due to it needing a continuing labour content in which labour-saving innovation is difficult to achieve.³

1 See "Health at a Glance", OECD Indicators (2011).

2 The OECD (2013) calculates this figure using a 'cost-pressure' scenario in which health expenditures unrelated to demographics or income are assumed to continue growing at the same average rate as in the past.

3 This phenomenon has been referred to as the "Cost-Disease-Effect", as outlined by William Baumol (2012).

Some argue that the rise in health-care costs has been exacerbated by the fact that the users of health-care services often rely on a third party to fund their expenses, whether it be the government or their employer. Ensuring that there are adequate mechanisms to contain rising costs in the absence of direct monitoring by the users can be fraught with difficulty. In this instance, a single government payer might have the advantage of preventing differential pricing for the same services, and may even be able to drive down prices, especially for purchases of drugs, through the use of its own single-buyer (or 'monopsony') power.⁴ Due to these kinds of raging debates, reform of the welfare state, and in particular health-care, has become fraught with controversy, making change politically difficult.

One of the few countries that has successfully controlled health-care costs, whilst also maintaining one of the highest quality services in the world, is Singapore. The cornerstone of its system is the compulsory 'Medisave' account. Workers pay a percentage of their wages into their individual accounts. Employers also make contributions. The size of the contributions is set by the government. The funds are used to help pay for services, in addition to funding health insurance plans. Medisave has kept national costs low by helping health services to become more transparently priced to the users and by shifting a portion of expenses to individuals and their employers.⁵ On the delivery side, services are provided by a mix of both publicly and privately owned hospitals, competing with one another. Government assistance is provided for those who are unable to pay. In terms of performance, Singapore's universal health-care system was rated 6th out of 191 nations by the World Health Organization, ahead of most high-income economies.⁶ A recent influential book by William Haseltine, a Founder of Human Genome Sciences, has lauded the Singaporean model for its remarkable success.⁷

In this paper, we present a policy reform which uses tax cuts to help establish compulsory savings accounts to enable a publicly funded welfare system to be replaced by one that relies largely on private funding. Some of the new regime's features borrow from the Singaporean system.⁸ We show how the transition can be achieved in a politically feasible and practical way which, to our knowledge, has not been done before.

The paper seeks a unified approach to the funding of health, retirement and risk-cover. Our reform relies primarily on establishing a set of accounts that give individuals choice over how their funds are spent, replacing many of the complex and diverse public schemes that have been developed over the past century.

We use a case study of New Zealand, where most welfare spending is funded by the government from general taxation on a "pay-as-you-go" basis, to show how the reform works. However, there is no loss of generality, in the sense that changes similar to the ones that we propose could also be designed for many other nations. Current and future budgets under both the existing system and proposed new regime are calculated. The design of our reform seeks to overcome concerns that these kinds of changes may cause too many groups, especially low income earners, to lose out compared with the existing system, and, also, that institutions in a nation like Singapore reflect factors unique to its culture that cannot be replicated.

First, we show how tax cuts weighted towards lower earners can enable the funding of individual compulsory savings accounts. These accounts can be used to pay directly for medical expenses, cover events related to job-loss or accidents, purchase mandatory catastrophic insurance plans, as well as build up retirement savings. Taxes currently paid on earnings up to \$NZ 50,000 for single tax-payers go directly into the accounts. They are supplemented by contributions from employers, whose taxes and levies are reduced as compensation, as well as from individuals in lieu of other existing levies. These changes allow for privately funded welfare payments to substitute for many public ones. Total spending levels can be maintained across most welfare categories and transparent pricing of health-care services introduced.

Second, provided that subsidies are discontinued to two groups, namely businesses in receipt of 'corporate welfare' and university students from wealthy families, who will enjoy a cut in their income tax rates under the reform, then most people can establish significant savings balances (whilst retaining their pre-reform disposable incomes).

4 See Kenneth Arrow's Stigler Centre Blog, courtesy of the University of Chicago's Booth School of Business, 15 March, 2016.

5 Private health-care expenditures accounted for 65 per cent of total national health expense in Singapore in 2008.

6 See World Health Organization (2000). Other rankings are, for example, 37th for the US, 18th for the UK and 41st for NZ. France was top of the rankings.

7 See *Affordable Excellence: The Singapore Health-care Story* by William Haseltine (2013).

8 Other aspects of our reforms, like the establishment of an individual risk-cover account for events like unemployment, and the retention of a tax-financed state pension, differ from Singaporean institutions.

Third, even in the presence of our sizeable aggregate tax reductions, the government can still retain sufficient revenues to fulfil the role of ‘insurer of last resort’, helping to pay for those individuals who cannot meet their own welfare expenses out of their savings accounts.

More broadly, our reform is aimed at changing beliefs away from a culture of dependency to one of independence, whereby lower income earners are given the means and opportunity to build up their own capital, from which they can choose to fund a range of affordable services and make progress for themselves. Our estimates of the reform’s impact do not assume efficiency gains. However, particularly for health services, such gains may be expected. The reason for optimism is that total health spending in Singapore, by both the government and private sector, is about 4.8% of GDP, compared to 17.2% in the US, 9.3% in the UK and 9.5% in NZ.⁹ Yet Singapore’s relatively low cost system has managed to produce high quality health-care outcomes, better than even most of the developed nations of the world. Consequently, efficiency gains may not only be achievable, but also large enough to compensate for any small drop in current consumption due to the creation of the compulsory savings accounts.

The paper is structured as follows. Section II summarises some of the literature that has pointed to the threats faced by publicly funded welfare states. We discuss how Singapore has circumvented many of the problems faced by other systems. Section III describes our policy reform using a case study of New Zealand. It estimates both the aggregate-level impact of the reform on the fiscal position of the government, now and in the future, and also the individual-level impact on disposable income and wealth held in savings accounts. Section IV concludes.

II. The long run viability of publicly funded welfare

A substantial literature has described the looming challenges faced by many nations with publicly funded welfare states. In this section, we discuss some of the challenges faced by health, pensions and other welfare schemes.

II. a. Health-care

The ratio of public health and long-term care (LTC) expenditure to GDP has already been rising steadily for several decades. The latest projections for the next 50 years highlight the growing pressures. In the OECD’s “cost-pressure” scenario, average health and LTC public expenditures are projected to almost double, reaching approximately 14% of GDP by 2060.¹⁰

An alternative: affordable health-care and the Singapore model

Singapore provides universal health-care coverage at a lower cost than any other high-income nation. By most measures, such as infant mortality and life expectancy, outcomes are excellent.¹¹ Singapore’s adult mortality rate (the probability of dying between 15 and 60 years old) is the lowest in the world. The cornerstone of the system is a compulsory medical savings account called “MediSave”. It was the first of its kind in the world and is based on the idea that people should be helped to save for their own health-care expenses. The Singaporean government regards MediSave as a way to ensure that everyone has the funds to do so. Workers and their employers are required to contribute a specified portion of wages into each individual’s account. The accounts are held within the government-managed Central Provident Fund (the ‘CPF’).

Although funds put into a MediSave account belong to the contributing worker, the government has guidelines as to how the money can be spent. Its aim is to balance affordable health-care against over-consumption and prevent premature depletion of funds. People can choose between five ward classes in the public hospitals. Aside from amenities, care quality remains the same. Patients in wards with the least amenities receive up to 80% of their charges. Financial means-testing is used to determine eligibility for subsidies.

⁹ See OECD (2014a, b and c) and the World Health Organization’s Global Health Expenditure Database (2015). These percentages are the sum of both private and public health expenditures.

¹⁰ For the ‘BRIIC’ countries (i.e., Brazil, Russia, India, Indonesia, China and South Africa) public health spending is presently at a much lower level than for the OECD, at around 2.5% of GDP (in 2010). However, under the “cost-pressure” scenario, it is forecast to increase by around four times, on average, across these countries, to become 10% by 2060.

¹¹ Public spending on health-care was less than 1% of GDP in Singapore until recently (it broke through this barrier in 2010 to reach 1.5%) compared with 8.1% for the US, 7.8% for the UK and 8.3% for NZ. See Haseltine (2013).

For large bills that could otherwise drain one's MediSave funds, insurance schemes are available. The government offers a low-cost one called 'MediShield' under which individuals are automatically insured unless choosing to opt out. As a catastrophic health insurance, MediShield focuses its benefits on helping people pay for serious illnesses. There is also the option of purchasing private insurance, especially if one wishes to stay in the higher ward classes.

The third 'M' of Singapore's system is 'MediFund', which is a government safety net. It is a multi-billion dollar endowment fund to help the lowest income earners receive a level of care that they otherwise could not afford, even in the most highly subsidised public hospital wards.

The Health Ministry in Singapore publishes prices on its website for medical conditions, procedures, ward classes and more. The aim is to empower patients with transparent information for making informed decisions regarding high-quality, low-cost care and encourage competition between institutions. Our paper shows how a largely publicly funded health-care system, like the New Zealand one, can be changed into a savings-based system with similarities to Singapore.

II. b. Retirement (or "Superannuation")

Aside from the challenges arising from funding a high-quality health-care service, a large literature has also discussed the looming challenges faced by public pension schemes due to population ageing. Public pension spending is forecast to grow from 9.5% of GDP in 2015 to 11.7% of GDP in 2050, on average, across OECD countries.

When the number of welfare recipients rises, governments often reduce the per capita generosity of publicly funded programmes to help fit their budget constraints.¹² To prepare for this future, one might expect that private savings would have been rising in those countries with large publicly funded systems. However, this trend does not appear to be happening. To the extent that the decline in the savings rate in many Western countries has been viewed as a policy problem, various ways of increasing savings in these countries have often been debated.¹³

For example, some economists advocate changes to the tax system to encourage savings (e.g., Feldstein, 1983). Others argue that there is a self-control problem biasing people toward over-consumption.

¹² See, for example, Di Tella and MacCulloch (2002) who focus on unemployment benefit programmes.

¹³ Attention has also been focussed on the apparent 'excess' of desired saving over investment, coming especially from China and other Asian economies, resulting in a large flow of foreign saving into the US. See Bernanke (2005, 2015).

¹⁴ Nudging people in a 'desirable' direction is sometimes referred to as 'libertarian paternalism'. See Thaler and Sunstein (2003).

¹⁵ In 1992, the Australian government introduced individual retirement savings accounts to which contributions were made compulsory for employers and voluntary (though tax deductible) for employees.

In this case, automatically enrolling an individual in a savings plan, whereby one is joined up unless specifically electing to opt out, may be a solution.¹⁴ An example of such a scheme is NZ's "Kiwi-Saver" accounts that help to supplement retirement income.

Another policy response is to introduce compulsory retirement savings accounts, which are a feature Singapore.¹⁵ Our new regime also introduces compulsory "superannuation" accounts although it differs from Singapore by retaining the NZ state pension.

II c. Risk-cover: Unemployment, sickness, invalid and accidents

The two biggest categories of welfare spending are health and pensions. However, the welfare state in most Western countries also covers a range of situations that include unemployment, or being unable to work due to sickness, disability or accident. Different schemes with different payments have typically been designed for each of these events.

A feature of the Singaporean system is that the government provides no unemployment benefits. The zero benefit policy appears to stem from a belief in the country that progress is determined mostly by a person's own efforts and abilities. Consequently, the jobless are expected to use their own endeavours, as well as family support, to get back to work.

On this dimension, our new regime differs from Singapore. It continues NZ's tradition of maintaining an unemployment benefit scheme, although makes changes to the existing system. A 'risk-cover' compulsory savings account is established to help pay expenses for up to 26 weeks should one become out-of-work, regardless of cause. A catastrophic insurance policy is also funded out of this account to help cover expenses if still out-of-work after that time, with the government acting as 'insurer of last resort'.

III An economic reform package: Designing the shift to a “savings- not-taxes” welfare system

We now address the question of how to design a policy reform that allows a publicly funded welfare system to be changed into one that relies increasingly on private funding. A distinguishing feature of our new regime is that it proposes a unified approach to the funding of health, retirement and risk-cover through the establishment of a set of compulsory savings accounts. A case study of New Zealand is used to illustrate a tax and welfare reform of a type that could enable the transition to take place in a politically feasible way.

III. a. A New Zealand case study: Background

Otto von Bismarck created the first ‘modern’ welfare state in Germany in the 1880s, including an old age pension programme in 1889. New Zealand was an early follower, introducing its own legislation in 1898, which was expanded in 1938. In the early 1950s New Zealand was one of the most prosperous places in the world, with a GDP per capita ranking of 3rd out of 24 OECD countries. It then began a steady decline to reach a position of 18th in the early 1980s, culminating in a constitutional and foreign exchange crisis.¹⁶

In 1984 the newly-elected Labour Party embarked on “supply-side” reforms which encompassed both macro-economic stabilisation and structural change. These included the cutting of personal income tax rates, introduction of a Goods and Services Tax, privatisation of state-owned enterprises, deregulation, elimination of agricultural subsidies, dropping of trade tariffs and independence of the central bank (which was given a price stability objective under a new act of parliament). The welfare state underwent few changes during this period.¹⁷

In the 1990s the National Party reduced the generosity of several classes of benefits and introduced a greater degree of means-testing for welfare services. However, most welfare spending in NZ remains funded out of general tax revenue on a non-contributory “pay-as-you-go” basis. In 2015, taxes and government spending each represented about 31.4% of GDP.¹⁸

III. b. A New Zealand case study: The ‘welfare: savings-not-taxes’ reform

This section describes how tax cuts can be designed to help people build up funds in their own compulsory savings accounts, which they can then use to either spend on welfare purchases or save for future use. One of the main aims of the reform is to enhance individual responsibility, though the government still retains a role in terms of helping to fund those who are unable to pay for their welfare needs out of their own savings.

The tax reform

Under the new regime, the corporate tax rate in NZ is cut from 28 to 17.5 cents in the dollar of profit and the Goods and Services Tax (“GST”) rate is increased from 15% to 17.5%. With respect to Personal Income Taxes (“PIT”) the rate is presently set at 10.5% for incomes from 0 to \$14,000 and 17.5% for incomes between \$14,000 and \$48,000. Tax rates rise to 30% for incomes between \$48,000 and \$70,000. The top rate of PIT is 33% which applies to incomes over \$70,000. Under the new regime, the PIT falls to zero for single tax-payers (i.e., a single person or couple with two incomes) earning less than \$50,000. It becomes 17.5% for incomes between \$50,000 and \$70,000, and 23% on income beyond \$70,000. For one-income families with dependent children, PIT rates fall to zero for incomes less than \$65,000. In total, taxes are cut by \$21.9 billion, comprising a \$21.0 billion cut in personal taxes, \$4.1 billion cut in company taxes and \$3.2 billion rise in GST (see Figure 1, label 1, “(Reduced) Taxes”).

The welfare reform

At present, the NZ government funds its welfare state out of general taxation. In addition to health and risk-cover (for unemployment, sickness and disability) it also pays a pension and makes grants to corporations and high-income earners. Under the new “Savings-Not-Taxes” regime, the funds from the above tax cuts on income below \$50,000 (or \$65,000 for one-income families with children) go directly into the compulsory accounts. They are supplemented by an individual’s own, and their employer’s, contributions. Single tax-payers contribute 5% of earned income up to \$50,000. Their employer pays another 12½% of income up to \$50,000. These add up to savings of \$17,500 per year for each person earning \$50,000 or more (and \$22,750 for a one-income family with children on \$65,000 or more).

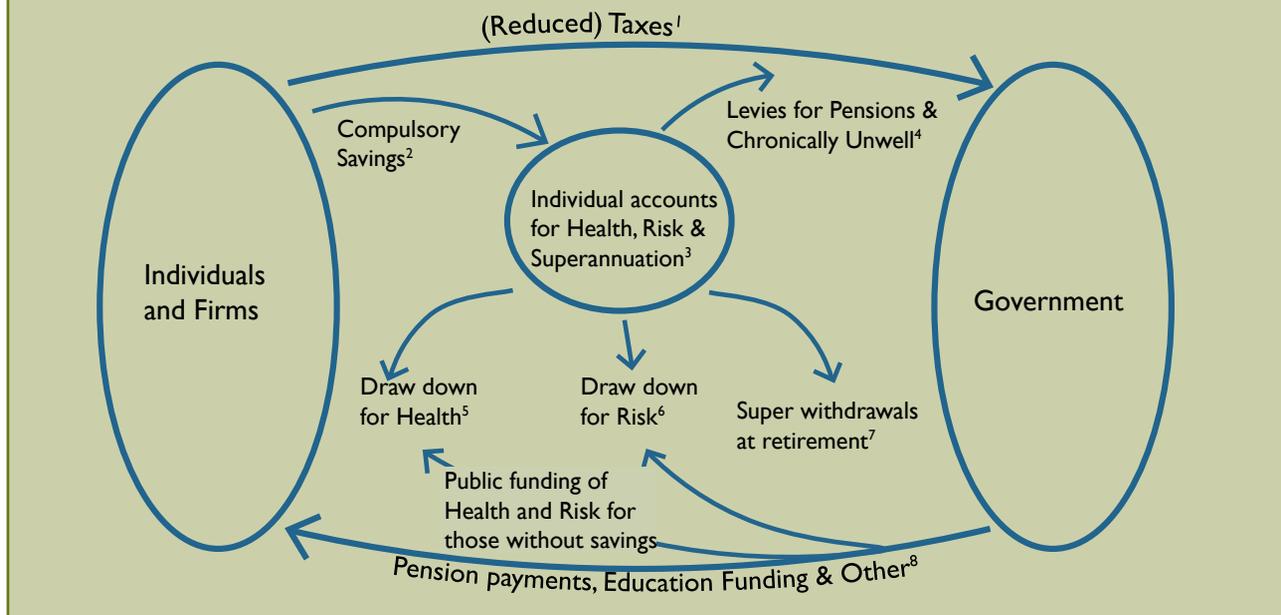
These funds are used to help meet current health and risk-cover payments, as well as build up savings balances for future superannuation payments.

¹⁶ See Maddison (2001) for GDP per capita rankings.

¹⁷ See Douglas (1993).

¹⁸ See Executive Summary of the New Zealand 2015 Budget by the Minister of Finance, Hon. Bill English.

Figure 1. Financial flows in the “savings not taxation” system:
Taxes are reduced and contributions made to Compulsory Savings Accounts in lieu. Funding for Health-care & Risk is publicly supported for those with insufficient savings.



Smaller health and risk bills are paid directly whereas larger ones are funded by the purchase of catastrophic insurance plans. The government continues to pay a pension to retired New Zealanders. It also underwrites the health-care and risk-cover payments of those with insufficient savings. Summed across all individuals, compulsory savings equal \$28 billion (see Figure 1, label 2, “Compulsory Savings”).

Health-care

The share of public health-care spending in NZ has remained relatively constant over the last decade at around 80% of total spending (well above the average of 72% in OECD nations).¹⁹ In the OECD’s upside ‘cost-pressure’ scenario, public health and long-term care spending is forecast to increase to 15.3% of GDP by 2060. Even in their ‘cost-containment’ scenario, spending is forecast to rise to 10.8% of GDP over this period (See OECD, 2013).

Under our new regime, changes to the health system’s source of funding and transparent pricing of health-care services are introduced. Each person now builds up a ‘Medi-Health Savings Account’ which receives 45% of their compulsory savings. It is out of this account that most of one’s medical expenses are paid. A prescribed level of savings is set for each person and after it is achieved, the level of required savings is reduced,

increasing one’s disposable income. Total contributions to the health savings accounts are \$12.6 billion (=45%*\$28 billion) each year (see Figure 1, label 3, “Individual accounts”).

An annual catastrophic health insurance policy must also be taken out to cover medical events costing more than \$20,000 in any one year (in 2015 dollars) and is paid for out of one’s savings account. Individuals have the choice to insure themselves at a higher level than the basic cover. Those earning more than \$65,000 are expected to pay for part of their own health-care, before drawing down on their savings accounts. A 12.5% levy on the yearly health savings contributions (of \$1.6 billion=12.5%*\$12.6b) is made to help pay for the chronically ill, retired and beneficiaries (see Figure 1, label 4, “Levies”). In practice, the levy, as well as a proportion of the public underwrite, may be paid into a fund from which it would be dispersed to beneficiaries.

On the expenditure side, estimated drawdowns on the private health accounts in the first year of the reform equal \$7.5 billion.²⁰ The government funds a further \$8.1 billion (see Figure 1, label 5, “Drawdown for Health”). As a result, the total amount spent on health-care remains the same at \$15.6 billion. In other words, the reduction in public spending is fully offset by additional spending from the compulsory savings accounts.

¹⁹ About 20% of health spending in NZ is privately funded, mainly through out-of-pocket payments. The private health insurance market is small, funding 5% of total spending and supporting a limited range of services. See OECD (2015).

²⁰ Included in the \$7.5b of spending out of the private accounts is the levy of \$1.6b for the chronically ill, retired and beneficiaries, which reduces over time as these groups (especially the retired) become more able to meet health bills out of their own savings.

To the extent that efficiency gains are achieved (as pricing becomes more transparent, third-party funding is reduced and responsibility is encouraged) we expect gains in service provision for this same level of funding.

Retirement (or “Superannuation”)

At present, NZ pays a ‘universal’ pension to nearly everyone over the age of 65 who has completed quite modest residence requirements. It is “flat rate” (i.e., does not depend on a person’s previous income and is not means-tested). The pension cost 5.1% of GDP in 2015 and is forecast to rise to 8.1% by 2050.²¹ The Labour government also introduced the “Kiwi-Saver scheme” in 2007, which is a voluntary retirement savings scheme. Employees are automatically enrolled, unless they choose to opt out, and they contribute a percentage of their gross earnings. Employers and the government also make contributions.²²

Under the new regime, each person builds up their own ‘Superannuation Fund’ account, which receives 35% of their total compulsory savings. For many people their contributions will replace their existing Kiwi-Saver payments. Our new regime extends the retirement age from 65 to 70 years old over the next 20 years (i.e., by 3 months per year) and retains the government pension, although its source of funding changes. At the start of the reform the pension continues to be funded out of general taxation, though it will be increasingly covered by the 25% tax levied on the size of an individual’s Superannuation Fund on the date of their retirement.

Total contributions to the Super Fund accounts are \$9.8 billion (=35%*\$28 billion) per year (see Figure 1, label 3, “*Individual accounts*”). Of this total, a pension levy of \$2.5b (in 2015 values) is paid upon retirement (see Figure 1, label 4, “*Levies*”). The remaining \$7.3b becomes savings that one is free to spend after retiring. In year 1 of the reform there are no super withdrawals from the accounts, whereas the government spends \$10.6b on the pension (see Figure 1, labels 7 and 8, “*Super withdrawals*” and “*Pension Payments*”). As the retirement age starts to rise, public spending on the pension falls under the new regime, compared to the present one.

Risk-cover: Unemployment, sickness, invalid and accident cover

Unemployment benefits in NZ are currently paid out of general taxation and are of unlimited duration. The government provides support for people with a health condition, injury or disability. It also sponsors the Accident Compensation Corporation (“ACC”) that pays 80% of net wages to employed people who are unable to work due to accidents. As a result of these different schemes for unemployment, sickness and accidents, the size of payments to an individual who is out-of-work depends, at present, on what is the cause.

Under the new regime, each person has a ‘Risk-Cover Fund’, which receives 20% of their total compulsory savings. A prescribed level of savings is set for the fund. Once reached, required contributions drop sharply. Should one become out-of-work, a drawdown occurs. If still out-of-work after 26 weeks, then a weekly payment is received from a catastrophic risk insurance policy (purchased by the fund). If one has insufficient funds in the savings account, or is jobless for more than 156 weeks, leaving one without insurance cover, then government assistance is given.

Total contributions to the risk accounts are \$5.6 billion (=20%*\$28 billion) per year (see Figure 1, label 3, “*Individual accounts*”). Estimated drawdowns in the first year of the reform equal \$1.5 billion and the government funds a further \$8.4 billion which includes out-of-work benefits (see Figure 1, label 6, “*Drawdown for Risk*”). Note that the payments which each person receives no longer vary depending on the reason for being out-of-work.

Education

Primary and secondary schooling in NZ is presently funded out of general taxation, unless families elect to pay for private education. The government also helps to fund “Early Childhood Education”. There are no changes to the budget allocations for these programmes under the new regime, although an education tax credit now becomes available for any child whose family would like one.

University students, on the other hand, currently pay a subsidised fee for their degrees, and are also eligible for public grants.

21 Although the pension is paid out of general taxation, the Labour government established a ‘Superannuation Fund’ in 2001 to help partially pre-fund future payments. Contributions to this fund are financed out of tax revenues but were suspended in 2009. The latest estimates suggest that up to about 8% of the expected cost of [the government pension] in 2050 will come from the Super Fund.

22 In addition to these personal contributions, there are also employer and government contributions to Kiwi-Saver. See the Financial Markets Authority (NZ) (2015). Total Kiwi-Saver assets were \$28.5 billion in 2015. The savings are privately managed in funds chosen by each individual.

In 1992, the government introduced a ‘Student Loan Scheme’ which provides students with the opportunity to borrow for tuition fees, course costs and living expenses. In 2006, student loans were made interest-free.²³ Our reform retains the subsidised fee, though it introduces a means-test to restrict interest-free loans and grants to only those students who come from low income, low capital families. Note that this is the group who gain the most from lower personal taxes under the new regime. The reduction in these grants equates to \$NZ 3.3 billion. As a consequence, education funding falls to \$11.9 billion (see Figure 1, label 8, “Pension Payments, Education Funding and Other”).

Other welfare expenses: Subsidies to business, Kiwi-Saver and “Working for Families”

The government presently engages in a range of subsidies to business, sometimes called “corporate welfare”. It also subsidises the Kiwi-Saver scheme and funds the “Working for Families” programme. In the budget accounts, these are referred to as “Other Expenses”.

Corporate welfare includes a range of subsidies for Ultra-Fast Broadband and fibre connections, movies that are “internationally focused and produced in NZ”, “offshore market development” assistance to business, and support to ‘Callaghan Innovation’ which maintains the “strategic capabilities” of industry. The total cost of these kinds of programmes was \$1.35 billion in 2015.²⁴ In addition, a range of ‘accelerated depreciation’ tax allowances are available to businesses in the forestry, farming, bloodstock and research industries, as well as favourable treatment of rental housing. These subsidies and allowances are generally discontinued under the new regime.

The Working for Families (“WFF”) programme, meanwhile, consists largely of earned income tax credits. Since our new regime cuts taxes for lower income earners and helps people to establish their own savings accounts, both WFF tax credits and Kiwi-Saver subsidies are no longer necessary. Even so, the WFF budget is still largely retained and instead reoriented to guarantee low and middle income working families with dependent children that their disposable income does not fall while their savings accounts are being established.

²³ Interest-free student loans are included in the public accounts under the heading ‘Social Welfare’. See Statistics NZ (2008).

²⁴ See “Estimates of Appropriations 2015/16 - Economic Development and Infrastructure Sector”, B5, Vol.1, NZ Treasury (2015). These programmes are administered by the Ministry of Business, Innovation and Employment.

²⁵ This total includes the \$2.45 billion levy on the size of people’s super funds on the date of their retirement. It is included in the accounts, not as cash revenue in the current year, but instead as an accrual. Although accruals are not generally included in public sector accounts, for our purposes they help to show the extent to which future liabilities are being funded. The NZ Public Finance Act 1989 gave requirements for accrual reporting by government departments. Note that a further \$7.35b is paid into compulsory super accounts though is not included in Table A since people spend these funds as they choose upon retirement. We include only those payments into private savings accounts for which the government mandates a specific purpose.

Of these different types of public spending, there is a \$2.4 billion cut in subsidies to business and a drop in Kiwi-Saver subsidies of \$720 million under the new regime (i.e., \$NZ 3.1 billion in total). As a result, “other” welfare spending falls to \$19 billion (see Figure 1, label 8, “Pension Payments, Education Funding and Other”).

III c. A NZ case study: Budgetary and economic impact of the ‘savings-not-taxes reform’

In this section, we estimate the impact of our new policy regime on the government’s budget and discuss its economic consequences at an aggregate level. We also estimate how people will be affected at an individual level, according to whether, for example, they are on a low or high income, are working, jobless, or retired. In addition, some long-term forecasts are provided.

Impact on the government’s 2015-16 budget

Under the present taxed-based system, revenues equal \$75.2 billion. The government spent the same amount of cash, mainly on the welfare state, representing 31.4% of GDP (= \$239.5 billion). The first major impact of the new savings-based system is to cause tax revenues to fall to \$53.4 billion. This comprises lower personal income tax revenues, lower company taxes and lower interest and dividend taxes. These reductions are to a small extent offset by a rise in GST revenues. Table A below reports the NZ Budgetary accounts which summarise these changes.

The second major impact of the new regime is the funding of personal savings accounts. A total of \$20.65 billion goes into these accounts to help contribute to each individual’s current and future personal health expenses, out-of-work income and pay for catastrophic health and risk-cover insurance.²⁵

In the first year of the reform \$58.0 billion of spending is funded by the government, comprised of \$8.1b on health, \$10.6b on pensions, \$8.4b on risk-cover, \$11.9b on education and \$19.0b on other expenses. By contrast, a total of \$8.8 billion of welfare spending is funded by the compulsory accounts, comprised of \$7.5b on health and \$1.3b on risk-cover.

Table A. New Zealand government and savings-based budgets for 2015-2016:

The Existing "Taxes Only" System is reported in Column 1 and the effect of the "Savings not Taxation" System is reported in Column 2.

Row		(1) Government Budget (\$NZ millions)	(2) Savings-Based Budget (\$NZ millions)
	Revenue Budget		
1	Taxation (Personal, Corporate, Goods and Services Tax) - Government cash income for year	75,200	53,350
2	Current & Future spending for Health, Risk-cover & Super from private savings accounts	-	20,650
	Total Income	<u>75,200</u>	<u>74,000</u>
	Expenditure Budget		
3	Health, Super, Risk-cover, Education & Other - Government	68,750	58,000
4	- Ex savings accounts		8,750
5	Corporate Welfare and Grants to High Income Earners	6,450	
	Total Expenditure	<u>75,200</u>	<u>66,750</u>
	Government Cash Balance (=row 1 - row 3 - row 5)	0	(4,650)
	Savings Based Budget Balance (=row 2 - row 4)		<u>11,900</u>
	Overall Balance	0	7,250

Source: NZ Treasury (2016): "Financial Statements of the Government of NZ for the year ended 30 June 2015".

A total of \$6.45b of subsidies to businesses and students from wealthy families are dropped, which helps allow the tax cuts to be deep enough to enable most people to establish significant savings balances.

Macroeconomic impact of the "savings-not-taxes" reform

Our estimates of the government's current budget under the new "Savings-not-Taxes" policy regime assume that GDP remains at a similar level to the previous policy regime. In this section we determine how the introduction of compulsory savings accounts may affect a small open economy with a flexible exchange rate, like New Zealand. The policy change features a cut in both taxes and public welfare spending. Government cash expenditure outlays are reduced by \$17.2 billion and tax revenues are cut by \$21.9 billion, producing a small cash budget deficit in the first year of the reform (equal to \$4.65 billion, or 1.9% of GDP) which subsequently reduces over time.

What is the estimated overall effect of the new regime on private consumption? Of the \$21.9 billion total drop in taxes, \$2 billion comes from no longer taxing welfare transfer payments which is offset by an equivalent cut in gross transfers.

Hence average incomes, net of taxes and transfers, rise by \$19.9 billion, taking that factor into account. Offsetting this rise is the additional required level of compulsory savings of \$28 billion. Since the (automatic enrolment) Kiwi-Saver scheme (which received contributions of \$4.5 billion in 2015) is largely subsumed into the new regime, the net increase in gross savings should be around \$23.5 billion (= \$28b - \$4.5b).

Consequently, there will be an expected drop of about \$3.6 billion, on average, in after-tax-and-compulsory-savings incomes (= \$23.5b - \$19.9b, or 1.5% of GDP). In other words, since compulsory savings are mostly funded out of tax cuts, private consumption, on average, is not affected much. Where does the \$23.5 billion in additional gross savings go? A total of \$8.8b is spent by individuals, out of their personal accounts, on health and social security. Hence net private savings rise by around \$14.7b (= \$23.5b - \$8.8b). Subtracting the government's dis-saving of \$4.7b (due to its deficit) yields an increase in total national savings of \$10.0b (= \$14.7b - \$4.7b, or 4.2% of GDP). A large part of these savings (= \$6.4b) can be traced back to the tax cuts made possible by the government's ending of subsidies to business and Kiwi-Saver (= \$3.1b) as well as interest-free loans and grants to university students from wealthy families (= \$3.3b).

In other words, our paper highlights the extent to which just two existing government programmes (i.e., 'corporate welfare' and transfers to students from wealthy families) may stand in the way of implementing a "Savings-not-Taxes" type of reform. The tax cuts arising from the discontinuation of these schemes allow for the funding of a significant part of the annual savings held in an individual's Medi-Health, Risk Cover and Superannuation Funds.

As mentioned above, these estimates assume that GDP remains largely unchanged before and after the new regime is implemented. But how realistic is this assumption? Our reform yields a sizeable decrease in the share of government spending in GDP. Furthermore, the associated drop in taxes enables compulsory savings accounts to be funded, from which a significant portion of welfare purchases can be made directly.

The macroeconomic consequences of the new regime include the following: (a) To the extent that the funds in the compulsory accounts which remain after spending on welfare lead to increases in national savings then capital outflows may increase; (b) Downward pressure may be exerted on the exchange rate which in turn increases net exports; (c) The level of GDP may not be much changed, at least in the short run, to the extent that the drop in government consumption is replaced by more private purchases of welfare services and a trade surplus.

Impact of the "savings-not-taxes" reform on representative individuals and firms

In this section we estimate how the new "Savings-not-Taxes" policy regime affects different kinds of individuals and firms. For our purposes, 'disposable income' is defined as being net of taxes, transfers and contributions to one's compulsory savings account. Our reform has different consequences across various groups. Its aim is to secure the long-term viability of the welfare state, improve efficiency and ensure equitable outcomes. The existing level of welfare services is largely retained, and potentially increased over time, compared to the existing system. The main change is that payment for many of these services now comes from private savings accounts.

Whilst our reform does not systematically seek to favour any particular group, a feature is to help low and middle income earners establish their own accounts, with minimal impact on disposable incomes. At the same time, the reform aims to promote more responsibility for welfare needs and stronger work incentives.

First, tax rates are reduced most for lower income earners, who pay zero taxes under the new regime (i.e., for single tax-payers on less than \$50,000 and one income families with dependent children on less than \$65,000). The size of the cuts to their marginal tax rates range from 10.5 to 30 percentage points. Middle income earners get a 12.5 percentage point reduction and high income earners (i.e., those on more than \$70,000) get a 10 percentage point cut.

Second, employer contributions to workers' savings accounts equal 12.5% for single tax-payers on incomes less than \$50,000 (and \$65,000 for those with dependents). Contributions become voluntary at this point so will thereafter likely start declining as a proportion of income.

Third, the government makes a payment to compensate low income earners for the rise in GST (equal to \$1 billion, or 0.4% of GDP). Fourth, for those people who cannot afford to pay their health-care bills, and the long-term unemployed with no insurance cover, the government acts as 'insurer of last resort'. Fifth, embedded in our reform is a guarantee that the disposable income of low income working families with dependents does not decline once it is implemented.

The main losers stemming from the reform are university students coming from high income, high capital families who no longer qualify for grants and interest-free loans. The other group who may lose are those firms who receive subsidies from the government.

Estimates of how the new regime affects the retired, out-of-work and low, middle and high income earners are reported in Douglas and MacCulloch (2016). For example, working low income families with dependents (on <\$50,000 a year) become better off, since not only is their disposable income guaranteed by the government to stay at least as high as under the present system, but they also start building wealth in their savings accounts. For working low income earners without dependants who have a Kiwi-Saver scheme, their disposable income is about 1% less than at present, on average, although again their savings rise significantly.²⁶

Long-term forecasts of the impact of the "savings-not-taxes" regime on the government budget (to 2035)

Over time, our reforms avoid the large predicted fiscal deficits associated with funding the welfare state based on the present tax settings. For example, under the existing system, the government's cash deficit is forecast to rise to \$19.3 billion by 2035.

²⁶ However, for those working low-income families without dependents and with no Kiwi-Saver scheme, their disposable income will be reduced by about 5%, for the reason that they will need to start making contributions to build up their own savings accounts without being able to make any offsetting reduction to their existing private (voluntary) contributions.

However, it reduces to a \$2.7 billion deficit under the “Savings-not-Taxes” regime (in 2015 values). Furthermore, the overall budget balance (combining government and compulsory accounts) goes into a surplus of \$6.4 billion due to the excess of income paid into the accounts over expenditures made out of them.

Most of the long-term reduction in government spending under the “Savings-not-Taxes” regime comes from the following sources. First, pension spending drops from \$28.1b (under the existing system) to \$17.4b (under the new regime) due mainly to the rise in the retirement age from 65 to 70 years old between 2015 and 2035. Second, there are the cuts in ‘corporate welfare’ and interest-free loans and grants to students from high-income, high-capital families.²⁷

In summary, the introduction of compulsory savings accounts and associated reduction in taxes can be done in a way that maintains total funding for most categories of welfare, compared to the present system. Combined with small changes to the retirement age (phased in over many years) and a cut in subsidies (to students from wealthy families and private corporates) the long-run fiscal challenges largely disappear. A large proportion of the population who today have little savings would also retire with substantial capital due to our changes in superannuation.²⁸

IV Conclusion

Many countries are struggling to fund their welfare states. Although they will be hard pressed to maintain present levels of (per-capita) welfare generosity through taxation, private savings rates have been falling. As a potential way to pre-empt these looming problems, recent attention has been paid to the Singaporean model. It features compulsory savings schemes and transparent pricing of health services which have yielded some of the world’s best health-care outcomes delivered for a cost that is the lowest amongst high-income nations.

In this paper we present a policy reform that uses tax cuts to help fund compulsory savings accounts to enable a publicly funded welfare system to be replaced by one that is largely privately funded. To our knowledge, the paper is the first to show how this transition can be achieved in a politically feasible way. We use a case study of NZ, a country with which we are familiar, although our proposed reforms could also be applied to other nations.

A reform of this type has the potential to lead to long-run efficiency gains, especially with respect to health-care and other forms of risk cover. It may also help to secure the viability of the welfare state, whilst at the same time retaining ample government resources to ensure universal coverage and equitable outcomes.

References

- Arrow, Kenneth (2016), “There Is Regulatory Capture, But It Is By No Means Complete”, Interview with Asher Schechter, Stigler Centre Blog at the University of Chicago Booth School of Business.
- Baumol, William (2012), *The Cost Disease: Why Computers Get Cheaper and Health Care Doesn't*, with Contributions by David de Ferranti, Monte Malach, Ariel Pablos Méndez, Hilary Tabish and Lilian Wu. New Haven, Connecticut: Yale University Press.
- Bernanke, Benjamin (2005), “The Global Saving Glut and the U.S. Current Account Deficit”, *Sandridge Lecture*, Virginia Association of Economists, Richmond, Virginia. Washington: US Federal Reserve Board.
- Bernanke, Benjamin (2015), “Why Are Interest Rates So Low? Part 3: The Global Savings Glut”, *Ben Bernanke's Blog*, Washington: The Brookings Institution.
- Di Tella, Rafael and Robert MacCulloch (2002), “The Determination of Unemployment Benefits”, *Journal of Labour Economics*, vol. 20, no. 2, pp. 404-434. Chicago: The University of Chicago Press.
- Douglas, Sir Roger (1993), *Unfinished Business*, Auckland: Random House New Zealand.
- Douglas, Sir Roger and Robert MacCulloch (2016), “Welfare: Savings not Taxation”, Department of Economics Working Paper no. 286, Auckland University, New Zealand.
- English, Hon. Bill (2015), New Zealand 2015 Budget, Executive Summary. Wellington. NZ Government.
- Evans, Lou, Grimes, Arthur, Bryce Wilkinson, and David Teece (1996). “Economic Reform in New Zealand 1984-95: The Pursuit of Efficiency”, *Journal of Economic Literature*, Vol. XXXIV (December), pp. 1856-1902.
- Feldstein, Martin and Daniel Feenberg (1983), “Alternative Tax Rules and Personal Saving Incentives: Microeconomic Data and Behavioral Simulations” in *Behavioral Simulation Methods in Tax Policy Analysis*, Ed: M. Feldstein, Chapt. 6, pp. 173-210, Chicago: University of Chicago Press.
- Financial Markets Authority (New Zealand) (2015), *KiwiSaver Annual Report: 30 June 2014-30 June 2015*, NZ Government.

²⁷ Detailed forecasts of the impact of the new policy regime on the government budget, as well as on the compulsory savings accounts, leading up to 2035, are reported in Douglas and MacCulloch (2016).

²⁸ The new policy regime that we propose may also help resolve a major political dispute regarding wealth inequality (where the bottom 40% of income earners held just 3% of NZ household net wealth in 2015). See Statistics NZ (2015).

- Haseltine, William (2013), *Affordable Excellence: The Singapore Health-care Story*, Brookings Institution
- Maddison, Angus (2001), *The World Economy: A Millennial Perspective*, Development Centre Studies, OECD: Paris.
- OECD (2013). “Public Spending on Health and Long-Term Care: A New Set of Projections”, OECD *Economic Policy Papers*, No. 6. OECD: Paris.
- OECD (2014a), *OECD Health Statistics. How does the United Kingdom compare?* OECD: Paris.
- OECD (2014b), *OECD Health Statistics: How does the United States compare?* OECD: Paris.
- OECD (2014c), *OECD Health Statistics*. OECD: Paris.
- OECD (2015), *OECD Health Statistics: How does Health Spending in NZ Compare?* OECD: Paris.
- Statistics New Zealand (2008), *Measuring Government Sector Productivity in NZ: A Feasibility Study*, Statistics NZ: Wellington.
- Statistics New Zealand (2015), *Household Net Worth Statistics: Year Ended June 2015*. Statistics NZ: Wellington.
- Thaler, Richard and Cass Sunstein (2003), “Libertarian Paternalism”, *American Economic Review*, vol. 93, no.2, pp. 175-179.
- World Health Organization (2000), *The World Health Report 2000. Health Systems: Improving Performance*. WHO: Geneva.

About the authors

Roger Douglas, as Minister of Finance in New Zealand, won an international reputation as the strategist and driving force responsible for the reform of the country's economy, from 1984 to 1988. Sir Roger entered Parliament in 1969. He first became a Cabinet Minister in 1973, in the term of the Third Labour Government from 1972 to 1975. He held the portfolios of Broadcasting and Post Office and later Housing. His period as Finance Minister saw major deregulation of New Zealand financial markets. After leaving Parliament in 1990, Sir Roger was the Managing Director of Roger Douglas Associates, an international consulting firm, specialising in advice on economic restructuring and structural adjustment. He is a founder member of ACT NZ and re-entered Parliament as an ACT MP between 2008 and 2011.

Robert MacCulloch holds the Matthew S. Abel Chair of Macroeconomics at Auckland University. A native of New Zealand, he worked at the Reserve Bank of NZ, before he travelled to the UK to complete a PhD in Economics at Oxford University. Robert was awarded a Royal Economic Society Junior Fellowship and pursued research interests at London School of Economics and Princeton University. He joined Imperial College London Business School as Director of their PhD Program, where he was awarded Best Teacher Prizes and the Rector's Award for Distinguished Research Excellence. Robert subsequently returned to his alma mater in NZ. He has published in journals including *American Economic Review*, *Review of Economic Studies*, *Review of Economics and Statistics*, *Journal of Economic Perspectives* and *Brookings Papers in Economic Activity*.

The **Centre for Economic Policy Research (CEPR)** is a network of over 1,000 research economists based mostly in European universities. The Centre's goal is twofold: to promote world-class research, and to get the policy-relevant results into the hands of key decisionmakers. CEPR's guiding principle is 'Research excellence with policy relevance'.

A registered charity since it was founded in 1983, CEPR is independent of all public and private interest groups. It takes no institutional stand on economic policy matters and its core funding comes from its Institutional Members and sales of publications. Because it draws on such a large network of researchers, its output reflects a broad spectrum of individual viewpoints as well as perspectives drawn from civil society.

CEPR research may include views on policy, but the Trustees of the Centre do not give prior review to its publications. The opinions expressed in this report are those of the authors and not those of CEPR.