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Universal New Zealand Superannuation and tax: implications for sustainability

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New Zealand has a universal state pension for all residents from age 65 who satisfy minimal residency tests.[1] The simplicity and efficiency gains of paying a relatively generous universal pension without any income test comes with a high fiscal cost. The *quid pro quo* of universal provision is usually high marginal taxes on the well-off. In light of the ageing of the population and recent tax changes, including KiwiSaver and PIEs, the coherence of universality may need to be revisited.

Background to the modern New Zealand Superannuation

The modern state pension, originally called National Superannuation, was introduced in 1978 by the National government as a universal taxable pension, funded on a PAYG basis from general taxation. The gross rate of 80% of the gross average wage for a married couple was revised in 1979 to a net rate of 80% of the net average wage. The generosity of the relative to the average wage, was further reduced by indexation to prices alone from 1989. The Accord of 1993 changed the name to New Zealand Superannuation (NZS) and cemented in the married couple rate to be between 65-72.5% of the average wage. Following a 'side agreement' between the Labour and New Zealand First parties in 2005, the floor for NZS was raised to 66% of the net average wage. A more detailed historical summary is available here.

Rates of NZS vary depending on whether the person is married, single or living alone. From 1 April 2009, NZS at the married rate is $14,229 p.a. gross each or $28,458 in total. NZS is taxed on an individual basis and is paid without regard for other income or assets.

The historical treatment of the top income superannuitants

In recent years, the highest income earning superannuitants have significantly increased the net amount of NZS they keep. The gain, i.e. how much better off each superannuitant is *because* they get NZS, is gross NZS after tax at the highest tax rate applicable to that superannuitant. Table 1 sets out the amounts that high income earners could historically retain after tax.

When National Superannuation was introduced, the top tax rate was 60% and in the early 1980s, this was increased to 66%. Thus in 1982, a wealthy high income couple could retain only 34% of the gross payment, if both were on the top tax rate.

[1] Unless they have a qualifying state pension from another country in which case a deduction may apply.

In the period between 1985 and 1998, a surcharge was applied to other income and effectively reduced the net gain from NZS to zero for the top earners. During the 1990s the Effective Marginal Tax Rate (EMTR) with the surcharge ranged between 53% and 58% until NZS was fully abated. While there was evidence that the surcharge was avoided by some, it reduced the net payment to zero for most in the full-time workforce.

The imposition of the surcharge had a bitter history as described in St John (1999). Nevertheless it was supported by the 1992 Task Force on Private Provision for Retirement and was a key part of the 1993 Accord. The Alliance Party was reluctant to concede that a special extra tax on the retired was fair. It favoured universal provision with a much more progressive tax rate. It was persuaded, however, that the surcharge was similar in its effect to progressive taxation. On that basis the Alliance Party agreed in the Accord that there should be a surcharge or progressive tax that has equivalent effect (St John, 1999).

Table 1. Historical changes in the net amount of NZS retained by top earners

NZS	1978	1982	1985	1988	2000	2009
Top tax rate	60%	66%	66%	33%	39%	38%
% of gross retained in top deciles	40%	34%	0% Surcharge 1985-98		61%	62%, With planning 70%, 79%

The surcharge was in place for 13 years, but was removed in 1998 following an all-party agreement[2]. In 2000, the top tax rate was raised to 39%, but in terms of the Accord, this was scarcely the progressive tax scale that the Alliance Party had in mind (see St John, 1999, p. 285). Now the high earner couple, each on the top rate, could retain 61% of the gross as compared to 0% with the surcharge.

In 2009, the top tax rate is 38% so that retention by high earners has increased to 62%. Assuming the income is equally earned, a couple with total gross income, including NZS, of up to $96,000 retains 79% of gross NZS, and up to $140,000 retains 67% of gross NZS. It is only for total gross incomes of above $168,000 well into the top decile of the household income distribution[3], that the retention falls to 62% of gross NZS. However, as discussed below and as Table 1 indicates, in 2009, with tax planning, retention rates can be further enhanced for even these very highest earners.

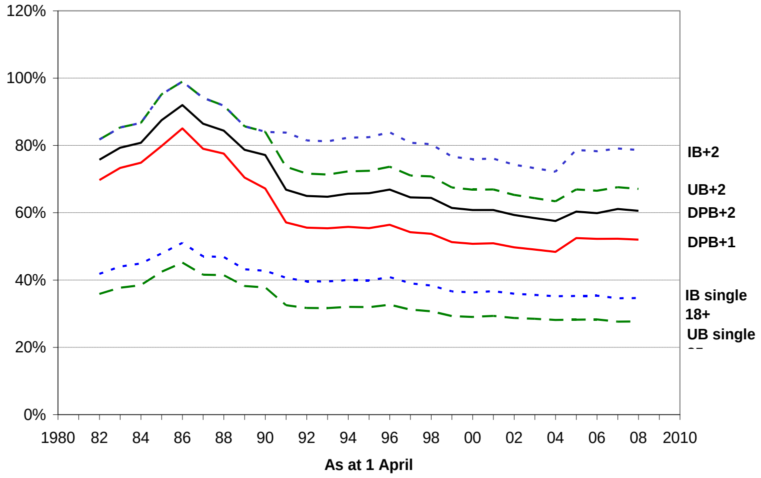
Indexation of state benefits

The formula for the indexation of the NZS has improved the generosity of NZS relative to other social welfare benefits such as the Unemployment Benefit, Sickness and Invalid Benefits, and the Domestic Purposes Benefit. Most core welfare benefits were cut in 1991 and 2005, and the net amounts have been adjusted over the years only for changes in the Consumer Price Index (CPI). Figure 1 shows the steady decline relative to net average wages in the 28 years to from 1980 to 2008.

[2] This was against the recommendation of the Periodic Report Group 1997.
[3] Couples in the top decile of the equivalised household distribution have $89,000 or more of total disposable income (Perry 2009, p 30).

The effect of the tax cuts of October 2008 and April 2009 was to push up the net average wage so that net social welfare benefits have fallen even further relative to net wages. This is because benefits are adjusted only from their current net level by the CPI and then grossed up using the new tax rates. This is in contrast to the formula for NZS which is linked to the net average wage.

Figure 1. Benefits relative to the net average wage



Source: Perry (2009)

Marginal and effective marginal tax rates

In 2009, the Sickness Benefit for a couple is $317 net a week. The couple can earn only $80 gross a week between them before facing an EMTR of 92.7% on every additional dollar earned. Other hardship assistance is means-tested and stigmatising, and has high administration costs and particular disincentive effects, none of which apply to NZS.

In contrast, a married couple whose only income is NZS each receive a net $239 a week (or $12,438 a year). As a couple they receive $478 net a week, or $161 net per week more than the couple on a Sickness Benefit. For total income of up to $48,000 p.a. each, the marginal tax rate for the NZS couple is only 21%, for incomes between $48,001 and $70,000 p.a., their marginal tax rate is only 33%, and for incomes over $70,000 p.a. it is 38%.

If each of a married couple is on a tax rate of 38%, they gain a total net $17,644 ($339 a week) from NZS. If all of the 'other' income is earned by only one of the couple so that the second party is taxed largely at 12.5%, their total NZS net payment is $21,250 ($409 a week).

These calculations highlight the generosity of the pension payment to high income couples, and show that, even in the example where both are on the top tax rate, perhaps because both are still working, their net NZS exceeds the net payment to a couple supported by the Sickness or Unemployment Benefits. As discussed below, the changes brought in with tax-paid funds lets them reduce their taxable income still further, and gain from an effective lower tax rate on their NZS.

The latest changes – KiwiSaver and PIEs

Between 2007 and 2009, the environment for the payment of a universal pension changed markedly with the introduction of KiwiSaver and the Portfolio Investment Entity (PIE) regime (St John, Littlewood, & Meehan, 2008). A further change is now proposed to PIE taxation in the Taxation (Consequential Rate Alignment and Remedial Matters) Bill currently before a select committee. The current regime allows wealthy investors to manipulate their taxable income, and the Bill's proposals further enhance tax planning opportunities (see RPRC submission on the Taxation (Consequential Rate Alignment and Remedial Matters) Bill, August 2009, available here).

The proposals in the new Bill are to expand the Portfolio Investor Rate (PIR) in PIEs from 19.5% and 30%, to 12.5%, 21%, and 30% as set out in Table 2. These proposed rates are used in the calculation of the net gain from NZS below.

Table 2 – Proposed replacement regime for PIEs (CRA&RM Bill 2009)

#	Taxable Earnings	Taxable + PIE income	PIE tax rate
1.	$0 – $14,000	$0 – $48,000	**12.5%**
2.	$0 – $14,000	$48,001 – $70,000	**21%**
3.	$14,001 – $48,000	$0 – $70,000	**21%**
4.	$48,001 and over	n.a.	**30%** **(on PIE income)**
5.	**n.a.**	**$70,001 and over**	**30%**

Adapted from (Inland Revenue Department, 2009, p. 6)

The example above discussed how a couple on a gross income of $140,000 (including NZS), well into the top decile of the household income distribution, effectively retain 67% of NZS when taxed using the ordinary PAYE tax rates. Their total disposable income is $107,700. Furthermore if their other income is investment income and they utilise line #3 in Table 2, they can retain 79% of the gross NZS. Their disposable income rises to $113,018, and their net NZS is $22,592 or $434 a week.

Now consider an extreme of a Couple A with a combined gross investment income of $300,000 ie $150,000 each. Under ordinary PAYE, they would each pay $46,550 or $93,100 in total tax. Their disposable income is $206,900. If they qualify for NZS, their gross income increases by $28,458 and disposable income rises by 0.62 of the gross NZS to a total of $224,544. The gain from net NZS is or $17,766 or $339 a week.

Couple B, also has $300,000 of investment income and additional gross NZS engages in the optimal tax planning position based on Table 2 line #3. Now income is arranged with $14,229 gross NZS each taxed as primary income, $55,771 each from PIEs taxed at 21%, and the balance of $94,229 each taxed at 30% in a registered superannuation scheme. Disposable income of the couple rises to $244,900. Retention of NZS is now 70% of gross. This is a net NZS of $19,920 or $383 a week.

Compared to Couple A on $300,000 without NZS and without tax planning, Couple B is $38,000 better off. This is due to tax planning which has given them $20,356, and the high retention of NZS which has given them $19,920 of net NZS.

Thus the very highest income retirees, ie those in the top income decile and with very substantial assets, are not only able to reduce their taxes artificially and gain from tax-paid vehicles, but they can also retain 70-79% of net NZS, well above the amount currently paid to the poorest sickness beneficiary couple. The couple on a social welfare benefit is far less likely to own their own home or to have any additional financial wealth.

Over the next 20 years, as better-off baby boomers enter retirement with increasing amounts of tax-subsidised KiwiSaver lump sums, retirement incomes for those in the top deciles will be further enhanced.

Issues of principle

There are two issues that arise: firstly, policy about the tax scale has been made without an eye to the distributional consequences for the wealthiest NZS recipients. These are unintended and to date, have been somewhat second order consequences. If the top personal rate tax is to be further reduced, these implications need to be considered.

The second question is whether allowing better-off over-65s to retain such a high proportion of NZS after tax is sustainable on either fiscal or moral grounds as their numbers swell and the pressure from pensions and health spending increases. The calculations above show that the combined gain from net NZS and diversion to tax-paid vehicles allows the highest income couple to benefit from a tax-funded subsidy ($38,000) which is over twice the net value of the Sickness or Unemployment Benefit ($16,484).

Perhaps New Zealand has two stark options: pay universal benefits and enforce a properly progressive tax scale, or be forced to abandon universality.

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