WELFARE: INDEPENDENCE NOT DEPENDENCY

A 'SAVINGS NOT TAXES' REFORM

Roger Douglas and **Robert MacCulloch** show how individual compulsory savings accounts can be established using tax revenues so that a publicly-funded welfare system can be replaced by one that promotes independence instead of dependency.

For almost 80 years, New Zealanders have experimented with the welfare state. What have the consequences been? Do all children receive a decent education? No. Do most people retire with enough capital to live in comfort? No. Does everyone receive health treatment when they need it? No. Have we eradicated poverty? No.

On the very goals that the welfare state has sought to achieve, no-one could genuinely argue that it has succeeded. Even the modern-day proponents of the welfare state, no matter which political party they belong to, all know that it has failed. But they all think they have the solution. They think the solution is more money.

That is why the welfare state budget has shown an inexorable growth, regardless of who has been in power. That is why our proposal offers an alternative vision of the way that healthcare, superannuation, out-of-work income, housing and education could be.

In particular, we look at how we can best help low-income earners help themselves. In this we are driven by the belief that until we do, there will be no satisfactory solution to the country's problems, including political class warfare.

Everywhere we have found that people have not behaved as the designers of the welfare system expected and needed them to in order to fulfil the system's stated purpose. Instead of fostering altruism and a sense of mutual obligation we have ended up with capture and welfare dependency.

One of the principal purposes behind the policies outlined in this article is therefore to change the system's incentives, to wean people away from benefits that they don't need and, in the words of President John F. Kennedy, to give the disadvantaged a hand-up, not a hand-out.

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In doing so, the gains we expect to achieve are not just economic. Our policies aim to give low-income earners the opportunity, encouragement and incentive to make some real progress for themselves by themselves. In helping low-income earners to win independence, their future is transformed and everyone else's improved.

We believe current problems can be turned into opportunities if we focus on the fundamental underlying linkages between all of the key policy areas including unemployment, healthcare, retirement, education, welfare, housing and the economy.

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We believe:

- One cannot solve these problems by seeking short-term answers as we have for the past 30 to 40 years. None of them can be solved unless we place them in a medium-term context.
- Because the issues are fundamentally linked we cannot deal with each area in isolation; we need a package of measures to do so.

The article is structured as follows. It begins by providing a clear set of principles and objectives, before giving the detailed policy outline using New Zealand as a case study. It then describes the outcomes flowing from our reform which show how it impacts representative New Zealanders, the nation's fiscal position and incentives. The last section shows how it can be applied to Australia.

Principles and objectives

Our reform follows from the application of a set of principles and objectives, namely that:

1. Each generation should pay for themselves (i.e., not continue to run up massive unfunded debt for future generations, currently $NZ 10 billion a year).
2. Each person, or family, should, as far as possible, look after themselves.
3. Individuals, or families, should only pay personal tax on income above what they need to look after their basic needs (including provision for retirement).
4. Taxpayers should have an obligation to save the taxes no longer payable to the government.
5. Government policies should be fiscally sound.
6. The role of government should, over time, become one of information provider (to ensure transparency of prices), underwriter and guarantor that low-income families are left no worse off by the reform.
7. There should be the opportunity to compare prices.
8. There should be a structure of incentives that encourages self-sufficiency.
9. As much as possible, power should be transferred from large institutions and government bureaucracies to individuals.
10. There should be competition via market-based institutions.
11. The tax-benefit system should be simplified.
12. Privilege to 'special' groups should be removed.

Designing the shift to a 'savings-not-taxes' welfare system

To achieve the above objectives, we need to adjust the tax system so that most people of working age can provide for themselves. The essence of the reform is as follows. The first step is to build up individual compulsory savings accounts (for health, pensions and risk-cover) via the transfer into them of current tax paid on income up to $NZ 50,000 per annum, supplemented by employer contributions.

Specifically, employers contribute to the savings accounts an amount equal to 12½% of each taxpayer's income up to $NZ 50,000 per annum (in lieu of ACC, superannuation contributions and lower tax rates). A personal contribution to the accounts (in lieu of current welfare expenditures) of 5% of income up to $NZ 50,000 per annum is also made.

For someone earning $NZ 50,000 per annum or more, these savings equal $NZ 17,500 per annum. These savings are split as follows: the Health account receives 45%, the Super account 35%, and the Out-of-Work (or 'Risk-Cover') account 20%. Mandatory 'catastrophic' health and risk-cover insurance is funded from these funds.

Box A below and overleaf gives a detailed summary of the reform and Figure 1 (page 13) explains the changes in terms of a diagram. For a full description, see our University of Auckland working paper *Welfare: Savings Not Taxation*.[1]

Box A: Summary of the 'Savings-Not-Taxes' Policy: NZ Case Study

1. Taxation and Compulsory Savings: Objectives and Policy

a. The corporate tax rate on profits is cut from 28% to 17.5%.

b. The goods and services tax rate (GST) is raised from 15% to 17.5%.

c. A tax free personal income up to $50,000 per annum for a person classified as a single taxpayer (single/couple with two incomes). Current taxes paid on the first $50,000 of income, including Accident Corporation Compensation (ACC), equals $8,750. This sum goes directly into the personal saving accounts.

d. A tax free income of $65,000 per annum for a one income family with dependants. (Current taxes paid including ACC equal $13,250).

These tax savings are supplemented by individuals' own, and employers', contributions as follows:

e. An individual contribution of 5% on any earned income up to $50,000 per annum and an employer contribution of 12½% on income up to $50,000 brings the total savings level to $17,500 a year for those on an income of $50,000 (or above) and $22,750 for a one income family with children on $65,000.

f. An individual's savings to be allocated on the following basis: Superannuation savings account 35% (i.e., $6,125); Health savings accounts 45% (i.e., $7,875); Risk savings account 20% (i.e., $3,500)

g. Income savings and contributions to be indexed to an appropriate inflation index (e.g., superannuation indexed to wage increases).

h. Personal Income greater than $50,000 per annum is to be taxed as follows:

$50,001–$70,000	17.5c in the dollar (currently 30c, so a reduction of 42%)
$70,001+	23c in the dollar (currently 33c, so a reduction of 30%)

2. Healthcare: Objectives and Policy

a. Base Case: $7,875 savings per year (inflation adjusted) to go into each individual's 'Medi-Health Cover Savings Fund'. This figure applies to more than 1 million NZers and varies around this base for nearly 1m more.

b. Variances from Base Case: For one income families with dependants, $12,375 to go into their savings account per year (inflation adjusted) (i.e., $4,500 over and above base case which goes to the partner's healthcare savings or in the case of single parent family towards child care).

c. A prescribed level of savings set for each person (i.e., a Medi-Health Savings Fund, equal to 1.5 times a contributor's current age, measured in '000s of 2015 dollars). For example, for 40 year olds, the savings objective is $60,000 + inflation).

d. Once the Medi-Health Savings Fund objective is achieved, the level of required savings is reduced by 40% (i.e., $3,150 = 40%*$7,875 per year) thereby increasing a contributor's disposable income by that amount.

e. A 12½% per annum levy is charged to the fund, as a contribution to the health costs incurred by the retired, beneficiaries and chronically ill (i.e., $988 inflation-adjusted).

f. A catastrophic insurance policy to be taken out each year to cover medical costs above $20,000 (inflation adjusted) in any one year.

g. A government underwrite.

Box A: Summary of the 'Savings-Not-Taxes' Policy: NZ Case Study (continued)

3. Superannuation

a. Base Case: $6,125 savings per year (indexed to wages) to go into each person's 'Superannuation Fund'.

b. A 25% tax on the size of the Superannuation Fund on the date of retirement.

c. Moving the date of retirement from 65 to 70 over 20 years (i.e., by three months a year). Individuals can still retire at 65 provided they drawdown the equivalent of the government pension from their own fund.

d. A government pension equivalent to what is paid today plus a Superannuation Fund the size of which will depend on the number of years' contributions and income earned.

4. Risk-Cover (Unemployment, Sickness, Invalid and Accident Cover): Objectives and Policy

a. Base Case: $3,500 savings per year (indexed to wages) to go into each person's Risk-Cover Fund.

b. A prescribed level of savings is set for the Risk Cover Fund, equivalent to what each individual would currently be paid if unemployed, plus 10% of that amount, for 40 weeks.

c. Once the above level is reached, individual contributions are reduced by 70% (or $2,450=70%*$3,500) thereby increasing a contributor's disposable income by that amount.

d. A catastrophic insurance policy to cover being out of work for more than 26 weeks.

e. A government underwrite (if funds insufficient to cover the first 26 weeks of being out of work).

f. An insurance policy to cover the next 130 weeks and government underwrite beyond three years.

5. Education: Objectives and Policy

a. An education tax credit for every child whose family would like one (in order to have individual choice) for their children's education.

b. Reformed management structure for education.

c. Loans only available to students from low-income, low-capital families

6. Housing: Objectives and Policy

a. Primary objective of housing policy is to greatly increase the supply of housing lots in areas of New Zealand where lots are in short supply. Secondary objective is to assist low-income families.

b. Investment in housing of 10% of yearly welfare savings of $28 billion over the next 5 year period.

c. Policies which ensure that sufficient land is zoned for lot development.

d. Once zoned, levy rates on estimated number of lots to be provided after six months.

e. Impose penalties if action to develop lots is not started within the first year.

f. Residential housing: losses can only be offset against future residential housing profits.

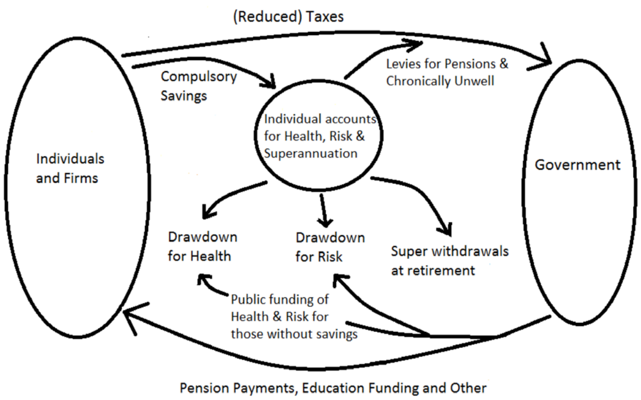
7. Out-of-Work Beneficiaries including Domestic Purposes: Objectives and Policy

a. Ensure every domestic purposes beneficiary or out-of-work person is in a position where it is possible to look after themselves (i.e., they have the skills to do so).

b. For those who don't have the skills, specialist training will be provided (up to 15 hours a week). Penalties for non-attendance.

c. Children will be provided with pre-school care while training is taking place.

Figure 1: Financial Flows in the 'Savings not Taxes' System:
Taxes are reduced and contributions made to Compulsory Savings Accounts in lieu. Funding for Healthcare and Risk is publicly supported for those with insufficient savings.



Source: Douglas and MacCulloch (2016), *Cato Journal* (forthcoming).[2]

Outcomes of the 'savings not taxes' reform

In this section, we describe how the reform affects the income and savings of different types of individuals, how it affects incentives and also the overall impact on the fiscal position of the government. Our estimates do not assume efficiency gains. However, particularly for healthcare services, such gains may be expected. A reason for optimism is that total health spending, by both the government and private sector, in Singapore, which uses compulsory health savings accounts, is 4.8% of GDP, compared to 17.2% in the US, 9.3% in the UK, 8.8% in Australia and 9.5% in NZ.

Impact on the income and savings of representative individuals

Whilst our reform does not systematically seek to favour any particular income group, a necessary feature is to help low and middle income earners establish their own private savings accounts, with minimal impact on their disposable income.

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 the savings accounts.

First, tax rates are reduced most for lower income earners, who pay zero taxes under the new regime. Second, employer contributions to savings accounts become voluntary for high income earners so likely start declining (as a proportion of income). Third, for those people who cannot afford to pay their healthcare bills, and the long-term unemployed with no insurance cover, the government acts as 'insurer of last resort'. Fourth, embedded in our reform is a guarantee that the disposable income of low income working families with dependants does not decline once it is implemented.

Those individuals on low incomes obtain additional savings of 35 cents for every extra dollar earned up to $NZ 50,000. Higher income earners (on more than $NZ 50,000) get a tax saving of at least 10 cents for every extra dollar earned. Companies receive a tax saving of 10½ cents in the dollar of profit. More details of how the reform affects a set of representative agents is given in Box B overleaf.

Impact on incentives

As a consequence of the reform, there are strong incentives to stay employed and stay healthy. Once a person's Health fund exceeds 1.5 times their age (in '000s of dollars) and their Risk fund exceeds 40 times the unemployment benefit, required savings drop by $NZ 107 per week (or $NZ 5,600 per year) which constitutes a huge increase in disposable income for those on a low wage.

As for producers, their income will depend primarily on service to consumers rather than meeting the policies of third-party reimbursement formulas. Since consumers now spend their own money, rather than someone else's, any cost-plus systems that exist should quickly disappear. Price information and negotiations become a vital part of the healthcare and insurance marketplaces. Family networks are also likely to be strengthened.[3]

Impact on fiscal outcomes

Table A shows the existing government budget. In the 2015-16 financial year, the government received $NZ 75.2 billion in taxes and spent the same amount of cash, mainly on the welfare state. Under the new regime, tax revenues fall to $NZ 53.4b. However $NZ 20.6b of the tax cuts is paid into savings accounts, yielding $NZ 74b of funds available for welfare spending by government and private individuals.

Box B: Outcomes of the 'Savings-not-Taxes' Policy on Representative New Zealanders

1. Existing Retired

The current retired (of 700,000 people) will see little change in their income as a result of the move from a tax-based system to a savings-based one:

a. The government pension remains (i.e., with the same yearly adjustment).

b. Low-income, low-capital retirees will receive a yearly grant into their Medi-Health Fund Account. This grant enables them to take out a catastrophic health insurance policy and have additional funds available to supplement their normal expenditure on health.

2. New Zealanders Within 20 Years of Retirement

a. The government pension equal to what is paid today and on the same terms will continue.

b. In addition, individuals will hold capital in their Medi-Health and Superannuation savings accounts upon retirement.

c. The level of capital depends on number of years to retirement and earnings.

d. A more efficient healthcare system with higher quality outcomes.

e. An increase in retirement income.

3. New Zealanders More Than 20 Years From Retirement

a. The government pension will continue.

b. In addition, individuals will hold capital in their Medi-Health and Superannuation savings accounts.

4. Impact of a Savings Based Welfare System on Out-of-Work New Zealanders

a. Benefit levels and other assistance remain at present levels and will be adjusted on the same basis.

b. Increased support by way of specialist training for all that need it, with the aim of:

   (i) Improving life skills.

   (ii) Putting jobless NZ'ers in a position where they have the necessary skills to get a job and maintain it.

   (iii) New support structure (one-on-one).

c. Responsibility of those who are out of work (where required to attend practical training sessions).

d. Improved incentive to find a job.

5. Employers

a. Corporate tax rate reduced from 28 cents in the dollar of profit to 17½ cents.

b. Reduction in compulsory employer support for: (i) Employee Superannuation on income > $50,000 (ii) Employee Accident Cover beyond the basic level to all those employees on income > $50,000.

c. Increase in existing costs due to 12½% contribution on income up to $50,000 for super, healthcare and risk cover of employees. These costs are offset by reductions in existing costs (see (a) and (b)).

In the first year of the reform $NZ 58.0b of mainly health, pensions, risk and education spending is funded by the government and $NZ 8.8b is private. The funds that are not spent out of the accounts in the current year become savings for future welfare expenditures.

The savings-based budget improves the overall balance by $NZ 7.2b (or 3% of GDP) in the first year of the reform. This change is made possible by the removal of corporate welfare (i.e., grants and tax breaks), ending of middle class capture and subsidies, savings for future spending on healthcare, superannuation and joblessness, individual expenditures on these areas, and more GST revenues.

Over time, the 'savings not taxes' reform leads to large improvements in the government's fiscal position due, in particular, to increasingly large reductions in government superannuation expenditures and greater personal spending on welfare, aided by the build-up of interest earned on the savings accounts. As a result, a huge reduction in government debt occurs.

After 40 to 50 years, the government would pay less than 25% of annual healthcare, super and out-of-work expenditures with 75% or more of all expenditures being paid by individuals. Furthermore, savings held by New Zealanders, primarily for welfare expenditures in retirement, would exceed $600 billion, compared with close to zero under the current pay-as-you-go system.

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 taxes' system is reported in Column 2.

Row		(1) Government Budget ($ millions)	(2) Savings-Based Budget ($ 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	75,200	74,000
	Expenditure Budget		
3	Health, Super, Risk, Education & Other – *Government*	68,800	58,000
4	– *Ex savings accounts*		8,750
5	Corporate Welfare and Grants to High Income Earners	6,400	
	Total Expenditure	75,200	66,750
	Government Cash Balance (=row 1 - row 3 - row 5)	**0**	**(4,650)**
	Savings Based Budget Balance (=row 2 - row 4)		11,900
	Overall Balance	**0**	**7,250**

Sources: NZ Treasury (2016); Douglas and MacCulloch, *Cato Journal* (forthcoming).[4]

Other outcomes

A number of other desirable outcomes stem from the reform. For example, nearly 80% of New Zealanders would likely retire after 45 years with $NZ 500,000 in their Super Fund and $NZ 100,000 in their Health Fund (both in 2016 dollars) as well as holding a catastrophic healthcare policy. A greater level of security than presently exists would be created.

Although our focus has been on NZ, the question arises as to whether this kind of reform would be possible in Australia. Our answer is 'yes'.

The system should also work more fairly in a broader sense. For example, there should be a virtual elimination of waiting times for elective surgery. Most New Zealanders are given the means to save due to the payment of zero taxes on the first $NZ 50,000 of their income. As a consequence, around 70% of those in the workforce can accumulate savings of $17,500 per year (and the other 30% a little less) to help meet their current and future welfare needs.

More generally, individual New Zealanders, not politicians, decide when, where and by whom they get medical treatment, how much capital and income they have in retirement, what cover they receive if they find themselves out-of-work, and where their children are educated. Privilege, conferred by politicians on corporates and other producers, is removed. Middle class capture is also avoided.

Since individuals now purchase their own services it becomes almost impossible for institutions (for example, hospitals) to capture resources the way they have in the past. Around 80% of people would pay for themselves with only 5-6% entirely dependent on the government.

Welfare: 'savings not taxes' reform for Australia

Although our focus has been on NZ, the question arises as to whether this kind of reform would be possible in Australia. Our answer is 'yes', provided there is the political will to do so, and the necessary policies are packaged and presented in an appropriate way.

But why do we answer with a simple 'yes'? Because Australia has a great deal of room to move in the personal and business tax area. It would be relatively easy to lower tax rates dramatically in return for the removal of privilege. A reform of this nature has features that should appeal to both Liberal and Labor parties. Since it replaces mandatory taxes and purchases of welfare services by third parties with mandatory savings that can be spent directly by individuals, personal responsibility and freedom of choice are expanded. Whilst we do not claim to be experts on the Australian government's budget, we can provide an outline of how the reform could be applied in this context.

First, contributions to the personal savings accounts would be slightly higher than NZ. For a person earning $A 60,000 there would be a total of around $A 21,000 contributions each year. Of this total, the Health Fund receives $A 10,500, the Super Fund $A 6,500 and the Risk Fund $A 4,000. Annual catastrophic health and risk insurance policies would be taken out by each person, with smaller bills paid directly from one's savings account.

How would these savings, equal to 35 cents in the dollar for a person earning $A 60,000, be funded? Around $A 10,500 comes by way of personal income tax cuts, $A 3,000 from individual contributions and $A 7,500 from employers (totalling $A 21,000). Although the government loses $A 10,500 in tax revenues (for our base-case individual) this loss is offset, in the main, by a cut in current and future health, retirement and out-of-work public expenditures.

The individual contributions of $A 3,000 would be paid in lieu of existing out-of-pocket health and super contributions. As for the employer contributions of $A 7,500, these are offset by the transfer of existing super payments which are no longer required. The reform also includes significant tax cuts for employers (including corporations).

There still remain important roles for the government, both as 'insurer of last resort' in the healthcare and out-of-work areas, and also as provider of vital information (for example, prices for health services).

We believe Australia has the opportunity to cut taxes well beyond what is necessary to fund the savings accounts, as set out above. One way to achieve this goal, whilst reducing the fiscal deficit, would be to cut government spending on privileges for special interest groups. These include grants to individuals, such as tax credits, as well as corporate welfare (for example, subsidies to small businesses, large corporations and industry organisations).

In other words, Australia has a choice. It can maintain its somewhat complex tax code with all sorts of exemptions or have a tax system along the following lines: zero taxes on 0 to $A 60,000, a 20% rate from $A 60,000 to $A 120,000 and a 25% rate on incomes greater than $A 120,000.

In NZ, most 'corporate welfare' was abolished in the 1980-90s, partly based on a view that individuals are better investment managers than the state. The ending of these business and individual concessions also helped to balance the government budget.

The savings (and corresponding extra government income) that followed these changes allowed a key political strategy to be implemented in the form of large cuts in tax rates (for example, the top personal income tax rate was halved from 66% to 33%). Whilst corporate rates were also cut dramatically the package proved to be politically popular, with the government of the time increasing the number of seats it held at the next election.[5]

A similar package, as outlined above, for Australia would also prove, in our opinion, to be equally popular. Why? Because the decisions would be quality ones. Significant efficiency gains likely arise from the changes to healthcare and risk-cover, the removal of corporate welfare and other forms of privilege, as well as the tax cuts. These changes also allow individuals to accumulate large balances in their savings accounts to meet future super and healthcare payments in retirement. The fiscal gap of the Australian government can be closed and the system is able to become fully funded.

Conclusion

Many countries are forecast to struggle to publicly fund their welfare states over the coming decades. Although governments will be hard pressed to maintain present levels of (per-capita) welfare generosity through taxation, private savings rates have been falling. Inefficiencies have also become rife. In this article 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.

We believe Australia has the opportunity to cut taxes well beyond what is necessary to fund the savings accounts.

We use a case study of New Zealand, a country with which we are familiar, although our proposed reforms could also be applied to other nations as we show with regards to Australia. A reform of this type has the potential to lead to long-run efficiency gains, especially with respect to healthcare and other forms of risk cover. It may also help to secure the fiscal viability of the welfare state, whilst at the same time retaining ample government resources to ensure universal coverage and equitable outcomes.

Endnotes

1 Roger Douglas and Robert MacCulloch, 'Welfare: Savings not Taxation', *Department of Economics Working Paper No. 286* (University of Auckland, 2016), https://ideas.repec.org/p/auc/wpaper/31890.html
2 New Zealand Treasury, New Zealand: Economic and Financial Overview 2016 (Wellington: NZ Treasury, 2016); Roger Douglas and Robert MacCulloch, 'Welfare: Savings not Taxation', *Cato Journal* (Washington: forthcoming 2017).
3 Rafael Di Tella and Robert MacCulloch, 'Informal Family Insurance and the Design of the Welfare State', *Economic Journal* 112 (2002), 481-503.
4 NZ Treasury; Douglas and MacCulloch (forthcoming).
5 Roger Douglas, 'The Politics of Successful Structural Reform', *Policy* (Autumn 1990), 2-6.