*Forthcoming* New Zealand Economic Papers

# How to Change the Welfare State from a Taxation to a Savings Based Model

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**Abstract**

The future of public welfare states is in doubt as costs trend up due to population ageing. Yet there is little agreement about how to reform them. We show how tax cuts can be designed to establish mandatory savings accounts so that a (mostly) publicly funded and provided welfare system can be changed into one that relies largely on private funding and private suppliers. Greater competition in the provision of health-care services offers the potential for significant efficiency gains. The government retains sufficient revenues to act as 'insurer of last resort' for those individuals unable to meet welfare costs out of their savings accounts. To our knowledge, showing how both a tax and welfare reform can be jointly designed to enable the transition to this new type of system to occur in a potentially politically feasible way has not been done before.

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## 1. Introduction

Across many nations, the cost of health-care and retirement welfare programmes are projected to put rising pressure on government budgets. The causes are lower fertility rates and improvements in life expectancy, which have together led to an increasing proportion of elderly. For example, 26% of the New Zealand population is projected to be over 65 years old by 2060, compared to just 16% in 2021.[1]

As a consequence, many countries are seeking to reform their welfare states so that the costs to the government can be reduced, quality of outcomes increased, and the plight of low earners, who are most vulnerable to public cuts, improved.

However there are at least three significant hurdles to overcome. First, disagreements are often focused around two opposing ideologies. One demands welfare spending cuts and lower taxes, whereas the other argues for higher welfare and more taxes to fund it. Second, even when economists propose a reform that is promising in theory, designing the transition to be politically feasible is overlooked. Third, the debates are narrow. They seldom focus on a comprehensive reform that rewrites the rules governing the entire tax and welfare system, with the aim of making them both work more fairly and efficiently.

The novel "Savings not Taxation Reform" we propose is an attempt to resolve the above problems. It keeps total welfare funding, from both public and private sources, at least as high as pre-reform levels, whilst creating opportunities for higher quality and efficiency by opening up more choice and competition in the supply of health-care services. These features potentially help make our proposed reform desirable to a majority of voters.

This article shows how a country can change from having a primarily publicly funded and provided welfare system to one that relies largely on private funding from mandatory savings accounts and privately supplied health-care services. The reform takes a unified approach to the funding of health, retirement and risk-cover for job-loss. We use New Zealand, a country with which we are familiar, as a case study, although the reform can be adapted to other nations with large publicly-funded systems.

[1] See the NZ Treasury's "Long Term Fiscal Projections" (2021). The next set are due in 2026.

How does it work? All income taxes currently paid on personal earnings up to a certain threshold go directly into the accounts. Low earners are thereby given the money to save. A drop in corporate taxes helps fund employer contributions. The government retains sufficient tax revenues to act as 'insurer of last resort', paying for people who can't meet their welfare costs out of their own savings accounts. Corporate welfare and subsidies to wealthy families are ended, and a levy put on the accounts. These funds help low earners build savings, and pay for the welfare needs of the chronically unwell.

Our Savings-not-Taxation reform offers scope for efficiency gains in health-care. It does so opening up choice for individuals. Rather than the government dictating where to go, people can choose their preferred public or private supplier. Consequently, a higher level of quality competition is promoted than under single public provider systems, which becomes the driver for higher quality outcomes at lower costs.

A reason for optimism on this front is that Singapore uses mandatory accounts and has one of the highest quality services in the world, yet spent only 5.6% of GDP on health-care in 2021 (including both public and private). By comparison, New Zealand spent 10.1% that same year (see World Health Organization, 2024).[2] Potential efficiency gains may, however, be constrained due to NZ's population being much more geographically dispersed than Singapore's, meaning, at least in small provincial towns and rural locations, having competing health-care suppliers may be less achievable.[3]

Consequently, although efficiency gains will probably be realizable upon implementation of our reform, they have not been factored into our estimated current and projected national budgets due to uncertainty over their size. As such, our estimates are likely to understate the overall benefits of the changes that we advocate.

## 2. The "Savings not Taxes" Reform: An Example

*The Problem and its Background*

Large publicly funded and provided welfare states are under threat. The 'dependency ratio', which is the proportion of elderly to younger, economically active, workers is

[2] Furthermore, the US spent 16.6% of GDP, and United Kingdom 11.3% of GDP, on health-care in 2021.
[3] For example, Gadiel and Sammut (2014) argue that *"it may be unwise for Australia to borrow a model found simply to work in Singapore's unique social and city-state geographical setting"* (see page 16).

expected to rise all over the world. Severe pressures will be brought to bear on public pensions, as well as health-care systems. Having recognised the welfare state problems faced by almost all developed nations, we ask ourselves, "What can we do about it?"

First, we need to quantify the problem in a way that politicians, economists, the news media and others cannot ignore. One way is to forecast public pensions and health spending over the next several decades. The Organization for Economic Cooperation and Development (OECD) reports rising trends. Its member nations spent 8.9% of GDP on pensions in 2022, which is projected to increase to 10.3% by 2060 (OECD, 2023). Health spending is forecast to increase from 9.2% of GDP in 2022 to over 12% by 2050, a rise of 3 percentage points under a "cost-pressure scenario" (OECD, 2024).[4]

New Zealand faces greater pressures on pension spending, which is projected to rise from 5.0% of GDP in 2021 to 7.7% of GDP by 2060, as well as on public health-care spending, than the OECD average. A combination of both public health and pensions expenditures is projected to increase by 6.4 percentage points of GDP per annum in NZ from now to 2060, a staggering figure (NZ Treasury, 2001).

Another way of quantifying the problem is to measure the size of future welfare state net liabilities using the concept of the "fiscal gap", which is defined as the present value of projected future government expenditures, net of the present value of future taxes. Using this approach, Kotlikoff (2023) estimates that the gap in the U.S. is around $41 trillion, implying that the government needs to immediately and permanently increase taxes in the current year by 41%, or cut welfare spending by 35%, to bring its long-term fiscal position into balance, changes which are of unimaginable sizes.[5]

Second, we need to return to fundamentals. This involves adopting principles related to successful structural change: (a) Only medium to long-term quality decisions, not quick-fixes, make a difference. Our aim is to get the framework right to help ensure everyone acts more effectively; (b) Quality decisions relating to welfare must exploit economic and

[4] See also OECD (2006) and OECD (2013) for more long-term projections.
[5] The Public Finance Act (1989) in NZ promotes the use of accrual accounting, which should have meant that estimates relating to measuring the fiscal gap were provided by the government, under the heading, Unfunded Future Welfare Liabilities. However they have not been supplied. Including an allowance for the accrued cost of health and pensions due to the increasing numbers of retirees implies a fiscal deficit of 5 percentage points of GDP higher than the one reported by the Treasury in 2024. See also Kotlikoff (2013).

social linkages, so every action improves the working of the system as a whole, instead of treating problems separately; (c) Only packages provide the flexibility to demonstrate that any losses suffered by a group of people from the policy would be offset by gains for the same group in another area. Opportunity, incentive and choice are vital to win support.

*An Overview of the Solution: The "Savings not Taxation" Reform*

To get the framework right, we need to adjust the tax system so the vast majority of New Zealanders of working age can provide for themselves.[6]

The first step is to build mandatory savings accounts for health, pensions and risk-cover via the transfer into them of current taxes paid on income up to $NZ 60,000 (close to 2024 median earnings).[7] These payments are supplemented by employer contributions, whose corporation taxes are cut in lieu. Note that part of this new payroll tax may be "passed through" and borne by workers in the form of wage cuts. Estimates of the size of such cuts vary widely across studies in different nations, maybe due to differences in labour market competition, and so are subject to much uncertainty.[8]

The result is that individuals would have savings of around $NZ 21,000 per year, enough to look after their own welfare needs. Of this total, $9,450 is paid into a health account, $7,350 goes toward superannuation and $4,200 is paid into a risk account. Mandatory health insurance is funded from the savings accounts. Higher earners must pay for welfare costs incurred above what has been set aside from their first $60,000 of income out of their own pocket. In countries like Singapore, out-of-pocket expenses are, in the case of health-care, directed towards increasing one's comfort, like having one's own room or better meals, rather than influencing the quality of medical care received.

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[6] Mainly due to inflation during and after the pandemic from 2021-24, the new National-led government upped income tax thresholds in its first May 2024 budget to adjust for bracket creep. For income up to $14,000 that had been taxed at 10.5%, the threshold was raised to $15,600; for income up to $48,000 that was taxed at 17.5%, it was raised to $53,500; and for income up to $70,000 that was taxed at 33%, it was raised to $78,100. The top threshold of $180,000, at which the rate rises to 39%, was left unchanged.

[7] See Statistics NZ (2024): http://www.stats.govt.nz/topics/income/

[8] Unresolved debates about this aspect of our reform could affect its level of voter and political support. Jinyoung, Seonghoon and Kanghyock (2022) summarize studies in which the pass-through rate, which is defined as the proportion of an increase (decrease) in employer payroll taxes that is passed onto workers in the form of a wage cut (rise), ranges from below 10% to over 80%. They state how *"heterogeneity in labor market competitiveness might be one reason for the inconsistent findings on the labor market impacts of payroll taxes"*.

The second step is to end government subsidies to the wealthy by removing "privilege" (corporate welfare and high earners' grants). In addition, a levy is charged on the savings accounts. Our reform retains the NZ State Pension, but makes a significant change by raising the retirement age, albeit gradually from 65 to 70 years old over a 20 year period (i.e., 3 months per year). These funds are re-directed to support the mandatory savings of low earners and guarantee health-care for the chronically unwell.[9]

The public grants that are ended include fee subsidies and interest-free loans to tertiary students from wealthy families. Instead a means-test is introduced so only students from low income, low capital families receive aid. Grants to the movie industry, winter energy subsidies to wealthy households, KiwiSaver subsidies to high earners, favorable tax treatment to owners of rental housing, and accelerated depreciation allowances to industries like forestry, fishing and bloodstock, are all ended.

Although the groups affected by these changes form a minority of the population, the political feasibility of such cuts could, of course, be threatened by lobbying. For example, interest-free tertiary student loans were first offered in the lead-up to a tight NZ election in 2005. They were regarded as a factor that helped swing victory in favour of former Prime Minister Helen Clark's Labor Party. Upon the National Party subsequently gaining power, the policy was not unwound, remaining in place even to this day, perhaps due to a political wish not to anger student groups. In addition, ending movie subsidies has met with industry threats to relocate elsewhere. The world's second richest man, Jeff Bezos, and Director James Cameron, have together received grants totaling around $300 million to shoot an Amazon series of Lord of the Rings, and Avatar films, respectively, in NZ.

Political constraints may also affect the viability of increasing the pension eligibility age. For example, a National-led government announced in 2017 that it would raise the age from 65 to 67 years old, with the change only being phased in after 2037. However, the Party lost the upcoming election to Labour, which dropped the policy. The 65 year old retirement age remains in place to this day.

[9] The current elderly with little or no market income, whilst not losers, are not winners under our reform, since they have not accumulated the wealth in the mandatory accounts over their lifetimes that the younger generation will be able to build.

The alternative to resisting our proposals of establishing mandatory savings accounts and ending privilege is to give way to lobbying pressures from these kinds of special interest groups, sending one down the path of spiraling fiscal deficits and public debt levels. The NZ Treasury's Long Term Fiscal Position (2021) confirms how, in such a case, higher taxation, or welfare cuts, or both, become necessary. Our plan has neither, making it a superior one in our view, offering higher social benefits, achieved at lower costs.

In the aftermath of the 2020-22 pandemic, NZ's media has increasingly highlighted the costs of the ageing population and declining health-care system, occurring in the context of a double-dip recession. For example, in a widely reported 2024 speech, Treasury's Chief Economist noted, *"Higher than anticipated ... structural fiscal deficits have accentuated the long-term fiscal challenge .. According to the OECD, New Zealand has the highest basic pension paid out of general taxation relative to gross earnings .. [It] is currently running a fiscal deficit of 2.4% of GDP .. our fiscal settings are not sustainable over the long run, given the impact of population ageing."*.[10] The nation is now experiencing a two-tier health-system in which people who cannot afford private insurance are not able to access the same quality of care as those who can afford it. The former group of voters will increasingly benefit from our reform, whereas the losers will be the firms and high earners identified above who are currently receiving subsidies. We believe that rising pressures on the public purse are already strengthening the hand of the majority who will benefit, and weakening the hand of interest groups.

Figure 1 shows the financial flows under a "Savings not Taxation" system and Table A summarizes the changes using our NZ case study. For the financial year ended June 2024, the government received $NZ 167.3 billion in tax revenues and spent $NZ 180.1 billion, of which $12.7 billion was paid on corporate welfare and grants to high earners.[11] In the first year of our reform, tax revenues would fall to $120.6 billion. Meanwhile $46.7 billion of those tax cuts is paid into mandatory savings accounts, which becomes directly available for welfare spending by private individuals. The funds not spent out of the accounts in the present year become savings for future welfare expenditures.[12]

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[10] See NZ Treasury (2024), Dominick Stevens, "Fiscal and Economic Impacts of Increasing Longevity", https://www.treasury.govt.nz/sites/default/files/2024-09/sp-longevity-public-purse.pdf

[11] The NZ Treasury financial accounts use accrual accounting methods to measure revenues and expenses, which are the figures reported here. They also report cash flows alongside the accrual figures.

[12] For a more detailed explanation of how a "savings not taxation" policy change affects the government accounts and individual savings, see Douglas and MacCulloch (2020).

When compared to the trajectory of fiscal deficits based on current NZ policy settings, which are set to increasingly expand starting in 2030, rising to 8% of GDP by 2060, our reform offers the prospect of balanced long-term future budgets. That balance is enabled by the welfare payments made by individuals out of their own savings accounts, which are funded by tax reductions, cuts in privilege, the gradual increase in pension age, and compounding interest on private savings. Perhaps more than any other feature of our reform, it is the "miracle of compound interest" that governments like New Zealand's is not taking proper advantage of, and which can help eliminate long-run fiscal challenges.

## 3. Reform Outcomes and Conclusion

What kinds of outcomes can we expect from the new regime? First, consumers spend their own money for health-care and save for their own retirement. A culture of personal responsibility should develop, helping to control costs. Consumers become the principal buyers of welfare services, as they are for other goods and services, instead of third-party government agencies. Choice from competing suppliers becomes available for people, not just the rich, creating a sense of empowerment. More transparent price comparisons become possible for health-care services, which should also improve efficiency.

Second, the role of government changes from primary funder and health-care provider to regulator, information-provider and insurer of last resort. Its fiscal accounts show an improvement of revenues over expenditures compared to the current system. Over time, a greater proportion of welfare becomes funded by the compound interest accruing on the savings accounts, allowing people more money than at present to pay for such needs.

As a consequence, a reform of this mandatory-savings type should help secure the future of a high quality welfare state. Equity is ensured since it retains a significant redistributive role for the State to ensure that a minimum standard of living is maintained for everyone, which includes universal coverage of health-care services.

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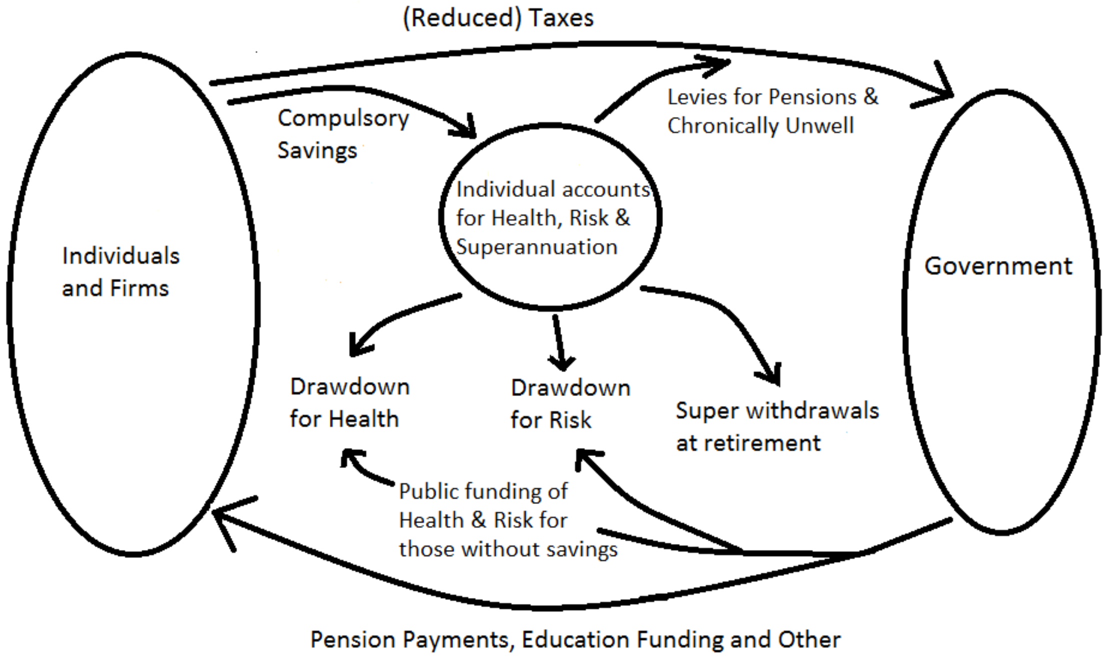
## Figure 1

## Financial Flows in the "Savings not Taxation" System.




*Note:* Taxes are cut and payments made to Mandatory Savings Accounts, which are funded out of those cuts, as well as cuts in corporate welfare and transfers to wealthy families. Part of these funds are paid into health accounts, part to retirement accounts, and part to risk-cover accounts. A levy is put on the accounts to help those with insufficient savings to pay for health-care and risk-cover.

## Table A

## NZ Government and Proposed Savings-Based Budgets for Year-ended June 2024

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

| | (1) Government Budget ($ millions) | (2) Savings-Based Budget ($ millions) |
|---|---|---|
| **Revenue Budget** | | |
| Taxation (Personal, Corporate, Goods and Services Tax) - *Government income for year* | 167,347 | 120,647 |
| Payments into Health, Superannuation & Risk-cover Mandatory Savings Accounts (to cover current and future spending) | | 46,700 |
| **Total Income (In taxes and payments into Savings accounts)** | **167,347** | **167,347** |
| **Expenditure Budget** | | |
| Health, Super, Risk-cover, Education & Other - *Government* | 167,311 | 156,457 |
| - *Ex savings accounts* | | 23,604 |
| Corporate Welfare and Grants to High Income Earners | 12,750 | |
| **Total Expenditure** | **180,061** | **180,061** |

*Source:* NZ Treasury (2024). "Financial Statements of the Government of New Zealand for Year Ended 30 June 2024"