Brent Sheather's RESEARCH

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TAX INCENTIVES FOR RETIREMENT SAVING: MOVING THE DIAL OR SUBSIDIZING THE FINANCE SECTOR? – Part 2

In the last column we briefly looked at some of the lobbying from the local investment management industry: advocating for tax incentives for retirement saving along with making KiwiSaver compulsory. Fund managers invariably point to the "success" of the Australia and US retirement savings systems as a reason for NZ taxpayers to subsidise their asset gathering endeavours. But, as we saw last week, many independent experts in Australia aren't convinced that the Aussie solution has been a "success". Today we will look at a recent paper by two US academics which is equally sceptical about the "success" of the American saving for retirement system. The paper "The Case For Using Subsidies For Retirement Plans To Fix Social Security," was written by Andrew Biggs and Alicia Munnell of The American Enterprise Institute and The Centre For Retirement Research at Boston College respectively. It estimates that the tax breaks for both employer sponsored and individual retirement accounts (like KiwiSaver, but much more "successful"), despite costing tax payers about US$185 bn a year, actually do little to increase retirement saving. The authors conclude that the tax incentives should be scrapped and that the extra tax raised, about 1% of US GDP, should be used to plug the deficit in Social Security (SS) – the US version of NZ Superannuation.

First off though let's see what the big deal is with SS. As noted above the Social Security system is basically the US version of NZ Superannuation and as such about 94% of individuals in paid employment in the US can expect to get payments from SS when they retire. In 2022 Social Security payments to about 246 million individuals totalled about US$1.2 trillion, equivalent to 5.2% of US GDP. Unfortunately payments from SS to retired Americans' greatly exceed the revenue generated from tax. Therefore each year the deficit is funded by selling down some of it's investment portfolio. Somewhere around 2030, if nothing gets done, it's investment portfolio will have been completely liquidated which will mean that benefits need to be cut to 80% of current levels. Obviously very big numbers are involved with SS so progressive US governments have opted to "kick the can down the road" rather than risk their re-election prospects. The Biggs/Munnel paper provides a potential solution, without raising taxes, and their analysis should be essential reading for NZ politicians and Treasury so that they can adequately respond to the local finance sector's lobbying for retirement saving tax incentives.

The paper starts by explaining how the tax incentives apply to retirement savings in the US: "They arise because employees can defer taxes on compensation that they receive in the form of retirement savings. In traditional defined contribution (DC) plans, employees are not taxed either on their own or their employer's contributions in the current year or on the investment earnings on their balances. Instead, participants are allowed to defer taxes until benefits are received in retirement, at which time both contributions and investment earnings are taxed as ordinary income."

The report highlights the fact that the tax advantages mainly accrue to high-earners because, obviously, they earn more and are more likely to have access to an employer sponsored retirement plan. It quotes a Brookings Centre study that showed that 59% of the tax incentives accrue to the top 20% of income earners and a massive 84.5% of the tax incentives are enjoyed by the top 40% of income earners. It doesn't take much in the way of common sense to realise that people earning large incomes don't need much in the way of an incentive to save for retirement: if people are earning large incomes they are likely to be intelligent and if they are intelligent they will save for retirement. Therefore it is highly likely that US tax-payers would get much better value for money if these funds were deployed elsewhere.

The report then looks at the question as to whether the tax incentives actually increase saving – "The tax subsidy for retirement saving may be justified if it promotes national capital formation. The increase in national capital formation is the sum of government saving – revenues less expenditures – and saving by individuals. Since the loss of revenues produced by the tax expenditure reduces government saving, the question is whether people covered by retirement plans increase their saving by enough to make up for this loss. The weight of the evidence indicates that they do not. It might initially seem that tax preferences do indeed increase national saving. After all, the tax preferences make retirement saving more attractive to the savers and massive amounts have been accumulated in retirement plans. But the economists' lifecycle model suggests that people may simply shift savings from ordinary taxable investment accounts to tax-favored retirement accounts in order to reap the benefits of the tax preference."

Professors Biggs and Munnell also looked at the impact of automatic enrolment in retirement plans and whether that increased total household savings. The paper cites a 2022 study which found that the automatic enrolment of Department of Defence employees in a government savings plan, whilst significantly increased amounts saved in the plan, actually had little or no effect on the participants total saving. They also cite a Danish study which looked at a reduction in tax subsidies for retirement contributions in 1999: "The results show that, for some, pension contributions declined. But the decline was nearly entirely offset by an increase in other types of saving. The tax subsidy, in other words, had primarily induced individuals to shift their saving from taxable to tax-advantaged retirement accounts, not to increase overall household saving. The authors concluded that tax incentives had virtually no impact on retirement saving".

The main objective of the Biggs etc paper is to provide a rationale for US politicians to redirect their tax subsidies more productively. However their summary of the research on the topic and in particular the conclusion that tax incentives simply move savings from taxable to tax free vehicles without actually increasing the level of overall savings provides NZ politicians and independent retirement experts with an unbiased, expert exposé as regards the substantial costs and illusory benefits of tax incentives. The predictable response from KiwiSaver providers and their cheerleaders will no doubt be similar to the pushback expressed to the authors in the US: dismissing the findings without providing evidence to the contrary. Professor Biggs in another paper responded to his critics, quoting Winston Churchill: "There is nothing so nice as to be shot at and missed".

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.