Tax Working Group Public Submissions Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

A Submission to the 2018 Tax Working Group

Introduction

my**super** Superannuation Scheme (**mysuper**) welcomes the opportunity to contribute a submission on the future tax treatment of pre and post retirement savings. my**super** is a registered workplace saving scheme and is also a complying superannuation fund that was established in 1991.

What is the problem we should be trying to fix?

New Zealand is currently the OECD country with the most hostile tax environment for long-term savings in financial products earning compound returns (workplace saving schemes, KiwiSaver, superannuation schemes (each a **Managed Investment Scheme**) bank term deposits and standard annuities) typically the savings vehicles used by low and medium income earners in preparation for retirement.

The tax penalty on long term savings consists of two parts.

Income tax inherently overtaxes the part of your income you save, because taxing income today unlike an expenditure tax such as GST, taxes future consumption more than current consumption.

The impact of taxation is particularly severe when the subsequent earnings on those savings from compound returns (interest on interest) occurs over a long period of time, such as the 40 years prior to retirement. The tax imposed on Managed Investment Scheme earnings in the fund effectively halves the earnings that will be added to your nest egg over 40-45 years.

The tax members pay within a Managed Investment Scheme reduces the amount of interest after tax has been deducted, reinvested to earn further interest over 40 years to the point that you retain only 45.3% of the potential earnings in the absence of tax. This is despite the so-called concessional Portfolio Investment Entity (**PIE**) rates (i.e. 10.5%,17.5% and 28%) which give the impression members will pay lower than normal tax on their Managed Investment Scheme earnings in the investment fund they have chosen.

Research undertaken back in 2010 by the Savings Working Group revealed that taking reasonable assumptions some 90% of a Managed Investment Scheme retirement nest egg would come from earnings within their Managed Investment Scheme and only 10% from their initial contributions and the contributions made by their employer and the taxpayer. Note this is even with the currently highly discriminatory tax treatment in place.

Similar discriminatory tax treatment exists for other compound return financial saving products including bank term deposits and is a major reason why, standard annuities are both unattractive and not supplied by any New Zealand based organisation.

How can taxing the earnings or interest from savings as you earn make much of a difference to New Zealanders retirement nest egg?

Most New Zealanders would think intuitively that paying tax in your fund could not possibly make such a big difference to the amount of money that ends up in your KiwiSaver nest egg at retirement.

A simple example might help explain the impact of taxation on your returns, as you earn has on your long-term savings. Suppose your Grandmother for your 17 birthday gives you $10,000 but on condition that you invest the amount for 48 years. She wants you to spend it only after you reach age 65. You have a fund to invest it in, that pays 6% interest each year, but the fund has to pay a 50% tax on each year's earnings on your behalf.

To calculate the time it takes to double your money you can use the Rule of 72. That is divide 72 by the interest rate you are being paid and it tells you how many years it will take to double your money from compound returns (earning interest on interest).
If you paid no tax on your 6% interest, the Rule of 72 tells us that 72 divided by the interest rate of 6% means your initial $10,000 of savings will double in value every 12 years. Over the next 48 years your initial $10,000 investment would double 4 times. So, your initial $10,000 becomes $160,000 by the time you reach 65 if you pay no tax on your 6% interest income. If however you need to pay a 50% tax on your annual interest earnings, the after-tax rate of return drops to only 3%. This means only half the earnings can be reinvested each year to earn compound returns (interest on interest).
You can use the Rule of 72 to calculate the time it takes to double your money if the after-tax return is only 3% each year. 72 divided by 3 gives the answer 24. Your fund now doubles only every 24 years. This means that over 48 years earning 3% each year your savings only double two times so your initial $10,000 only grows to $40,000. So compared to the tax free 6% return, the 3% net after-tax interest (after paying a 50% marginal income tax rate), on your annual interest earnings, the marginal Effective Tax Rate (**ETR**) over 48 years of saving is 75%.

Calculating the Effective Tax Rate

With a 6% return your nest egg grows to $160,000 over 48 years. With an after tax return of 3% this drops to only $40,000 over 48 years. So the effective tax rate over 48 years is 160,000-40,000 = 120,000 divided by 160,000 which is 75% compared to the marginal tax rate of 50%.

The effective tax rate increases the longer the period of saving continues. This means taxing compound returns in Managed Investment Scheme, particularly hits those who are on lower incomes who need to save a little each year for a long time to build up a large retirement nest egg.

What is the tax treatment for retirement savings in most other OECD countries?
In most OECD countries by contrast, these countries for retirement savings made through locked in superannuation schemes you do not pay income tax on the contributions you make into your fund, inside the fund your earnings are not taxed but you do pay tax on the income you receive from your fund in retirement. This type of regime is called **EET** short for your contributions into your fund, are Exempt from tax, inside the fund the earnings are **E**xempt from tax and the withdrawals are **T**axed. This was the tax treatment for superannuation in New Zealand prior to 1989.

The current regime in New Zealand is **TTE**, that is your contributions into Managed Investment Schemes are out of already Taxed income, the income your contributions earn with in the KiwiSaver fund itself are Taxed but your withdrawals after age 65 are Exempt from income tax.

This tax change has been highly distortionary for earnings between different forms of long term retirement savings. The effective tax rate on an owner-occupied home is 0%, for an investment in a rental property held for 20 years with 80% gearing can be about 2% and on a term deposit or other debt instrument over 50%. (A conservative Managed Investment Scheme is fairly close to this at 54.7% over 40 years of saving).[1]

The effective tax rates on bank term deposits and the bonds which dominate the conservative Managed Investment Scheme investment funds are much higher than the marginal income tax rates they would be paying on their other wage and salary income.

How do New Zealanders save for retirement?
For New Zealanders the main avenue for investing their retirement savings one is via a Managed Investment Scheme. and the other is by investing in residential rental property. Some more risk averse savers invest in bank term deposits.

For those on middle or lower incomes particularly if they do not own their own homes it is almost impossible to save for a comfortable retirement by putting a little away each week for a long time to get the benefit of compound returns (earning interest on interest).
This is because – based on the low employer contribution rates (i.e. 3%) – on an income of $70,000 or less you need to save steadily for a long time to build up your retirement

[1] Source 2013 Financial Services Council, report, “The tax barrier to retirement prosperity in New Zealand.

nest egg you need to fund a comfortable retirement (about $300,000-450,000). On that sum you can earn about $300 a week on top of your NZ Super. However, the longer the period over which you need to save, the higher is your effective tax rate because of the impact paying tax within your fund has on slowing the growth of your savings, from the lower after-tax earnings being reinvested into your fund.

To achieve a comfortable retirement most New Zealanders consider they will need an income of $250-300 a week in addition to NZ Super.

To do so a low or middle income New Zealander would need to save $300-450,000 over their working lives in addition to paying off their home so that it was freehold by the time of their retirement.

There are different ways you could accumulate a nest egg of $450,000. You could save about $4,000 a year for 40 years, a challenging but not impossible task for someone earning $70,000 or less each but the effective tax rate on their savings would be 54.7% if you are in the 33% tax bracket.

That effective tax rate would be lower, closer to 40% if you could save $40,000 a year for the last 10 years prior to retirement to age 65 but almost no one earning $70,000 a year or less could save $40,000 a year.

Under the current tax settings that nest egg of $300,00-450,000 is almost impossible to save for, in a Managed Investment Scheme or in term deposits for someone on a low or even median income.

The tragedy we have is that the savings products (i.e. Managed Investment Schemes) most easily used by low and middle income earners have the highest effective tax rates. That is the people in most need of saving for the long term face the biggest penalties for doing so.

How did the Problem arise?

In the 1980's attempts were made to ensure all forms of economic income were taxed on the same basis to create a level playing field for investment. It was initially applied to most forms of remuneration and along with the introduction of GST widened the tax base which enabled income tax rates to be reduced. Greater reliance on wide based expenditure taxes and less reliance on income taxation is consistent with what optimal tax theory would suggest to assist economic growth.

In 1989 in order to increase tax revenue and reduce the fiscal deficit the tax incentives to save in superannuation schemes were removed and the EET superannuation regime was switched to a TTE regime. This created the largest gap between the effective tax rates on residential real estate investments which were highly concessionary and the taxation of superannuation which became the most highly punitive of any OECD country. As is so often the case, a tax policy, that was fiscally helpful in the short term was disastrous for our social well-being, housing our population and economic growth in the longer term.

What are some Solutions that could fix the problem?

These are alternative approaches to create a level playing field which are:

1. **Optimal Tax Theory would suggest moving to an Expenditure Tax treatment for Retirement Savings EET**

   Move from New Zealand's current TTE system to an EET regime that most OECD countries use. (A comprehensive expenditure tax, Kaldor approach is consistent with optimal tax theory).

2. **Reduce the PIE rates to zero to create a level playing field**

   Move to a TEE regime by reducing the PIE rates (and other tax for non-PIE Managed Investment Scheme) all to 0% for retirement savings locked in till age 65 and continuing if an approved annuity or other approved savings product is purchased. Any withdrawals at 65 or later that were taken as a lump sum and not used to purchase an approved annuity would be taxed at 25%.

   A variation could be any withdrawals at 65 or later, the first 30% could be taken tax free, but any amount over the first 30% not used to purchase an approved annuity would be taxed at 30%.

3. **No options for income in retirement**

   Between 2021 and 2060 KiwiSavers reaching age 65 will have combines nest eggs of some $468b to spent or invest. At the moment there is nothing in place to encourage the KiwiSavers with maturing balances to invest any of that money is products to provide a reliable amount of ongoing income.

   We would suggest that tax policy should encourage retirees to save some of their Managed Investment Scheme nest egg, in a way to provide a steady income stream in addition to NZ Super in retirement. The current tax settings actively discourages this approach. If retirees blow all their Managed Investment Scheme balances and then become soon dependent on NZ Super then pressure will mount for NZ Superannuation to be increased.

We would suggest that Managed Investment Scheme withdrawals that are not transferred to an approved annuity be subject to a 25% withholding tax. Note the offsetting benefit is that your new post retirement savings product would continue to have access to the zero PIE tax rate on earnings reinvested within the fund. If this is not done then a new anomaly would be created. Someone who elected to stay in their KiwiSaver fund after 65, using it to draw down regular withdrawals would continue to enjoy the lower PIE rates but those who moved to another locked in savings product such as an annuity or term deposit would not.

4. **Remove Employer Superannuation Contribution Tax**

Move to regime where PIE rates remain the same (or are increased) but Employer Superannuation Contribution Tax is completely removed for all employer contributions to all Managed Investment Scheme. This would also need to be combined with any withdrawal at 65 or later that were taken as a lump sum and not used to purchase an approved annuity would be taxed at 25%.