The Role of Taxation in New Zealand's Retirement Income Policy

A short background paper presenting both information and personal perspectives intended to provoke discussion amongst those wishing to participate in the consultation process for the 2013 review of New Zealand's retirement income policy.

Prepared for the Commission for Financial Literacy and Retirement Income's triennial review of retirement income policy.

Paul Mersi[1]
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Relevance of tax to retirement income

Tax has multifarious potential and actual effects on retirement incomes through the combination of: what is and isn't taxed, the rate of tax, and the timing of the crystallisation of any tax liability.

At an individual and household level these effects include:

- the capacity to save (tax on income);
- the desire to save (tax on spending, incentives);
- the eventual size of the retirement nest-egg to the extent to which returns on savings contribute to accumulated savings (tax on investment income and gains, both during accumulation and decumulation phases) – the impact of this effect is surprisingly large[i];
- the real value of the retirement savings (tax affecting the decumulation itself eg via annuity, and tax on spending);
- what assets to invest in (differential tax treatments, base, rate, liability timing).

At a national level the tax system impacts: the country's fiscal position (the net result of overall tax revenues and government income & spending); the nature and adequacy of corporate investment (rates of depreciation, treatment of R&D costs etc); economic growth, efficiency, and productivity.

When considering tax in any policy context, it is critical to look beyond the legally prescribed base, rates and timing, and pay due regard to how tax is applied in practice;

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1 Paul Mersi (www.paulmersi.com) is an independent consultant and company director; he was a member of the Savings Working Group and has had a long-standing involvement as an advisor and commentator on savings and investment-related issues; the views expressed in this paper are his personal views and they should not be inferred as necessarily representing those of his clients or any company of which he is a director.

itself a combination of implementation and policing by Inland Revenue, taxpayer and advisor attitudes (critical in a regime dependent upon 'voluntary compliance'), and technical uncertainties.

It is stating the obvious that tax is not the be-all and end-all for retirement incomes, and does not exist in a vacuum (either nationally or internationally); thus tax cannot be a panacea for all ills impacting saving, investment, and retirement incomes.

It is sobering to reflect on some of the other things that can impact on retirement incomes, even if we had an ideal tax system (whatever that is):

- Level of personal incomes;
- Global and NZ economies;
- interest rates & inflation;
- asset values;
- aged health policies;
- NZ Superannuation policy (including the manner in which governments fund future NZ Superannuation liabilities);
- Saver and investor confidence;
- Availability of appropriate saving and decumulation products;
- Media quality and mood;
- Quality and availability of good data, information, and analysis;
- Often conflicting messages from both genuine experts and so-called 'experts';
- Regulation;
- Trust (intermediation failures have been acute in some areas of investment, and still dribble on [eg Ross Asset Management]);
- Skepticism re value added by intermediaries

...and all this in a context of an imperfect non-economic-model world, where saver's and investor's perceptions are their reality in terms of the decisions that they make.

So can we at least do some things to improve the tax system from the perspective of retirement income?

The tax policy legacy

New Zealand has a rich legacy of major tax-specific policy reviews: McCaw[ii], Valabh[iii], McLeod[iv], and, most recently, the Tax Working Group[v] (TWG). In addition, there have been many other major reviews conducted in which tax policy has been a material feature, including most recently the Capital Markets Development Task Force[vi] and the Savings Working Group[vii] (SWG). The nature of this paper precludes even summarising this legacy, however most of their reports (and in many cases also background and research papers) are readily available on-line (refer to respective endnotes).

By international standards New Zealand has been served comparatively well by a strongly principled and genuine best-efforts approach to tax reform and administration by central government officials, successive Ministers and governments, and a largely supportive advisor community; especially since the mid-1980's. Many of the reforms and regimes introduced over the last 30 years are recognised as world exemplars (eg GST, financial arrangements accrual regime).

The perception might be that as time goes on, reviews are completed, changes are made, and our tax system has been improved to the point where each new review is dealing with issues of diminishing importance. The reality though is that there are still major issues out there and to be resolved; and now extant in a local and global environment that is very different from even 10 years ago.

It is notable that the major policy reviews of the past few years are still identifying gaps in the tax base and inconsistencies of treatment as being of major concern, and have been relatively consistent in identifying both the issues and the nature of the tax changes that should occur (and there is very little in these issues and solutions that are new).

Most of these identified gaps and inconsistencies are very relevant when viewing tax policy from the perspective of retirement incomes.

Tax and saving & investment

Many potential savers are hamstrung predominantly by relatively low incomes, often exacerbated by high effective marginal tax rates (income tax rates plus the effect of reduced benefit-support through income-testing). Being predominantly an income rather than a tax issue, this paper takes this point no further.

How well served have savers and investors by tax reform thus far? The reform trend has generally been largely beneficial: reducing personal income tax (both marginal rates and overall) and corporate tax, increasing tax collected via GST, and the KiwiSaver-driven PIE regime.

However, even in the context of what is essentially a broad-base low-rate (ie 'good') tax system, a large component of economic income and gains are not taxed or are taxed in an ad hoc manner (ie 'bad'). Just how differently various investments are taxed is well illustrated in the SWG's report; with 'real world' effective tax rates on rental housing being only half of those applying to debt instruments (and only between about 40%–60% of those applicable to domestic and foreign shares respectively)...and effective rates on residential housing being nil[viii].

In this context, the main areas for reform insofar as they are important in the context of retirement incomes are:

<u>More GST and less Income Tax</u>

It is generally accepted that personal and corporate income taxes are prima facie most harmful (distortionary) to economic growth and saving, and taxes on consumption (eg GST) are among the least harmfull[ix].

It is thus fundamentally beneficial to retirement savings over the long term for total taxation to be low, and for a greater proportion of that tax to be on consumption spending (ie GST) rather than on income (ie Income Tax). The quid pro quo of shifting more towards reliance on GST is a reduction in income tax rates, and that of itself has the added benefit of reducing the impact of any shortcomings in the income tax base, rates, and/or timing (eg differences in the taxation of various investments, discussed below).

There has been a high degree of consistency over time (and particularly in recent years)

for tax policy reviews to advocate for a continuation of the shift over the past 20 years towards a greater reliance on GST and away from Income tax (most recently advocated by both the TWG and SWG)[x].

However such further shifts are not all good news in the context of retirement income; those who are close-to or already retired would suffer from the increase in GST as they spend their retirement income, however they would benefit (potentially significantly) from the lower rates of income tax on their investment earnings, even during retirement, and presumably also indirectly from enhanced growth in the economy.

The SWG also identified potential benefits from shifting further towards GST in terms of a positive effect on New Zealand's level of national savings, something that should also be of indirect benefit to savers[xi].

Taxing land

The perennial thorny issue of each of the various tax policy reviews is appropriately taxing changes in asset values; most frustratingly, land. Even though there are circumstances where capital gains from land are currently technically taxable, in practice this is the exception rather than the rule, particularly with respect to rental properties and most private holders (including owner-occupiers).

NZ has made ground-breaking advances since the 1980's in moving the tax base towards comprehensive coverage of all forms of income; the single most radical change being the Financial Arrangement accrual regime, which not only ensured that 'capital' gains from the widest range of financial instruments was taxable in all circumstances, but also provided that the liability crystallised on an accrued rather than realised basis.

This 'advance' certainly leveled the playing field with respect to income from labour (ie salary and wages), and it had not only technical but popular appeal because of that. However, that regime actually exacerbated the after-tax difference in returns on a range of investment choices for investors – most significantly with respect to investment in land (and, to a lesser degree, in shares).

In the words of the TWG:

> “this inconsistent treatment breaches all the principles of a good tax system”[xii], and, “investment in property...is being significantly influenced by tax effects”[xiii].

The SWG reinforced this view, stating:

> “the large differences in effective rates distort the way people hold their savings and are likely to have played a part in New Zealanders' attraction to owner-occupied and rental housing since these asset classes are tax preferred over shares and debt instruments.[xiv]“

Land as a directly-held investment asset does not need any further encouragement from the tax system; in most New Zealanders' eyes it is seen as holding a multitude of advantages over other assets: a long and largely consistent history of increasing in value (in both real and nominal terms), tangible (not just represented by a 'unit' or piece of paper), easy availability of highly geared funding via pre-packaged readily-available loans

(simply unavailable to the saver for other investment assets), and with a minimal risk of intermediary failure (eg Ponzi-type outcomes).

It is to New Zealand's economic detriment to be distorting investment decision-making, and it is accepted[xv] that tax is distorting decision-making in this regard in favour of an asset class that, while potentially wealth creating at an individual level, in aggregate makes a minimal contribution to national growth and wealth.

From the perspective of retirement incomes, though, there is another dilemma: land (predominantly in the form of a homeowner's main residence) has been most people's way of accumulating and storing their retirement nest-egg. Accordingly, any tax changes which may affect the value of land will be detrimental to many retired people, and many close to it. At an individual level, it may be of little solace that the economy as a whole (and therefore investors generally) should be better off in the long term as a result of such changes.

Despite these concerns, the need to deal with issue has been consistently recommended by various reviews (except where it has been specifically excluded from their scope, eg SWG). The issues and 'complications' of a Capital Gains Tax (CGT) and its potential substitutes have been fully canvassed numerous times; most recently by the TWG which recommended:

> "The most comprehensive option for base-broadening with respect to the taxation of capital is to introduce a comprehensive capital gains tax (CGT). While some view this as a viable option for base-broadening, most members of the TWG have significant concerns over the practical challenges arising from a comprehensive CGT and the potential distortions and other efficiency implications that may arise from a partial CGT"; and
>
> "The other approach to base broadening is to identify gaps in the current system where income, in the broadest sense, is being derived and systematically under-taxed (such as returns from residential rental properties) and apply a more targeted approach. The majority of the TWG support detailed consideration of taxing returns from capital invested in residential rental properties on the basis of a deemed notional return calculated using a risk-free rate.."[xvi]

Neither recommendation has thusfar been taken forward in any government policy programme (the cause probably not enhanced by what seems to be a negative view amongst some officials regarding the 'practicalities or desirability" of such base-broadening options[xvii]).

One obvious political (and potentially administrative) bug-bear is whether to subject an individual's primary residence to a capital gains tax (exempting the primary residence is a key feature of the 'partial CGT' referred to above). It is interesting to note that New Zealand has been experiencing a trend of declining home ownership (standing at less than 65% in June 2010, and forecast to decline further); the absence of such a potentially complicating and compromising exemption impliedly being of concern to declining numbers of people – and in particular to few of those in the younger age groups[xviii].

It is a major disappointment that when it comes to taking on the challenge of dealing adequately with the taxation of land, the last great bastion of untaxed income, we seem to lose our bottle; there is little if any sign of either the resoluteness and bravery of approach

or the confidence to create a world-leading design that were manifest in both our accruals regime and our GST (and perhaps also more recently in the taxation of off-shore non-portfolio-investment income).

Reducing the inherent overtaxation of 'compounding'-type investment income

I noted previously the distortionary effects of the high effective rates of tax faced by the simplest savings products (bank deposits and bonds) relative to other forms of investment; being twice those applicable to rental housing. These high relative rates arise from a combination of: taxing interest on an accrual (rather than as-received) basis, taxing the inflation element of interest, and comprehensively taxing debt instruments in terms of 'capital' gains.

SWG was in favour of the indexation of interest income (and expense); that is, tax interest only to the extent it exceeds a notified standard rate that reflects the rate of inflation (eg 2%)[xix].

Such reform would go some way towards tilting the tax playing field in the right direction (in terms of reducing the distortion between different types of investment assets); particularly absent the prospect, at least imminent, of a comprehensive CGT raising the effective tax rates on other investments.

Putting aside potential growth benefits from reducing tax distortions on investment decision-making, from the perspective of retirement income, any such reform resulting in a material (and appropriate) reduction in the effective rate of income tax on income from debt instruments should prima facie be of significant benefit, even to those already retired.

It is relevant to note here the SWG's observation, in respect of retirement income generated from private savings, that:

> “90% of retirement income is generated by (compounding) investment income”[xx].

A retirement income perspective on tax policy principles

The various tax policy reviews referred to at start of this paper have been conducted under the now mantra-like 'normal principles of good tax policy', which in essence require that a tax system is: efficient (in economists' sense of the term), effective in funding government spending, sustainable over time, minimising of both compliance and administration costs, and robust (minimising avoidance)[xxi].

However when viewing tax reform from the perspective of saving and investment, one could question whether enough emphasis has been given to the economic efficiency (investment allocation) benefits, and whether there has been an over-emphasis on both an inability of potential reforms (especially CGT) to generate material new tax revenue and concerns over potential administration and compliance costs; all combining to stifle potential reform to further improve the tax system (as it happens, in a way that is beneficial to saving/investment and thus retirement incomes).

We should reflect on whether a well-designed, principle-based CGT (or indexation regime for that matter) would be any more intimidating to design and comply with than was the

case with our still best-in-class GST regime (created all of 30 years ago). We should back ourselves to be able to repeat that feat.

Getting higher up the tax reform agenda

We seem to be in a political environment where appetite for and tolerance of major change is relatively low. A further, and not unreasonable, constraint on future reform is the country's fiscal/budget position.

This environment poses a challenge to the prospect of imminent change of the kind consistently recommended from the past reviews of New Zealand's tax system; changes that would both further improve the system and be overall positive in a retirement income context.

Changes along the lines of those highlighted in this paper do not seem to have a high policy priority at present; the government's latest Tax Policy Work Programme[xxii] lists, as one of over 25 areas of potential work, this rather non-specific reference:

> "Savings and investment taxation review; Examine the effects of different possible tax reforms on savings and investments (such as whether the tax treatment of PIEs and direct investors should be aligned)".

Getting traction in this area (particularly off the back of the TWG and SWG recommendations) will require the profile and importance of these issues to be driven by the public, to create political pressure to get them pushed them higher up the reform queue.

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i **Savings Working Group Report** , section 7.2.3, Box 5 ("Tax on investment income has the greatest effect on retirement income");
http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

> "The most important tax from the saver's point of view is tax on investment income. This has a far greater effect on retirement income than a tax on contributions or a tax on retirement income...Ezra *et al* (2009, p44) derived the "10/30/60 rule." They use the example of a 35-year-old worker who saves a fixed percentage of an increasing payroll stream until retirement at age 65, and then draws down an inflation-indexed pension until age 90. Using reasonable assumptions with no tax on investment income, they calculate that the total retirement income from age 65 to 90 is financed just 10% from contributions, 30% from investment income before retirement, ***and a surprising 60% from investment income after retirement***. Thus ***90% of retirement income is generated by (compounding) investment income***. This is why taxing investment income has a much greater effect on net retirement income than taxing contributions or gross withdrawals." [Emphasis added]

ii The **McCaw Committee** (formally "Task Force on Tax Reform") reported in 1982.

iii The **Valabh Committee** (formally "Consultative Committee on the Taxation of Income from Capital") reported over the course of a number of years until 1996.

iv The **McLeod Review** (formally "Tax Review 2001") reported in October 2001; final report and other material available on-line:
http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001

v The (Victoria University of Wellington) **Tax Working Group** reported in January 2010; final report and other material available on-line:
http://www.victoria.ac.nz/sacl/cagtr/twg

vi **Capital Market Development Task Force**, reported in December 2010; final report and other material available on-line:
http://www.med.govt.nz/business/economic-development/capital-market-development-taskforce

vii **Savings Working Group**, reported in January 2011; final report and other material available on-line:
http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup

viii **Savings Working Group Report**, Section 7.2.7, tables and explanation in "Box 6" "Effective tax rates on different classes of investments", page 83, final report available on-line:
http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

- Additional detail contained in **SWG Background Paper** "Inflation Adjusting the Tax Base: Policy & Design Issues" by Inland Revenue, 27 October 2010, available on-line:
http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/pdfs/swg-b-ir-iatb-27oct10.pdf

ix **Tax Working Group Report**, Chapter 2.1, page 22, final report available on-line:
http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf

> "A major efficiency concern with the current structure of the New Zealand tax system is the impact that personal and corporate taxes have on productivity and GDP growth. International evidence suggests that these two taxes are among those taxes which are most harmful to growth. On the other hand, taxes on consumption and annual property taxes such as rates, are among those taxes which are the least harmful to economic growth."

- **Savings Working Group Report**, Section 7.2.2 "Current structure of the New Zealand tax system", pages 75 to 77 [especially illustration in "Box 4" on page 76], final report available on-line:
http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

x **Tax Working Group Report**, Recommendations 2, 4, & 11, pages 10 & 11, final report available on-line:
http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf

- **Savings Working Group Report**, 6th Tax Policy recommendation, page 15, available on-line: http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

xi **Savings Working Group Report**, Section 7.2.4 “Increasing the level of national saving by changing the structure of the tax system”, pages 79 & 80, final report available on-line: http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

xii **Tax Working Group Report**, page 49, final report available on-line: http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf

xiii **Tax Working Group Report**, Section 4.1, page 59, final report available on-line: http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf

xiv **Savings Working Group Report**, from “Box 6”, page 83, final report available on-line: http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

xv **Tax Working Group Report**, Section 2.1 “Problems with the structure of the New Zealand tax system” , page 21, and “Taxation of capital income”, pages 25 & 26, final report available on-line: http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf

> “There is a major hole in the tax base for the taxation of capital, which is manifest, for example, in high investment and low taxable returns in the property market.”

xvi **Tax Working Group Report**, Recommendations 6 & 7, page 11, final report available on-line: http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf

xvii **Tax Working Group, Notes from 1st Session**, 5 June 2009, available on-line: http://www.victoria.ac.nz/sacl/cagtr/twg/publications/twgfirstmeeting-summary.pdf

> “Broadening the tax base. This could involve the addition of new taxes such as a capital gains tax (which, in theory, should be based on accrual grounds, although this is difficult to achieve in practice), death, wealth, land, and Tobin taxes, or stamp duties. Inland Revenue is doubtful about the practicalities or desirability of any of these major base broadening options but agrees that they should be explored.”

xviii **Savings Working Group Report**, Section 7.3.7 “Declining home ownership””, pages 103 & 104, final report available on-line: http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

xix **Savings Working Group Report**, Section 7.2.7, pages 82 to 84, final report available on-line: http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

xx **Savings Working Group Report**, section 7.2.3, Box 5 (“Tax on investment income has the greatest effect on retirement income“); http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup/finalreport/swg-report-jan11.pdf

xxi **Tax Working Group Report**, Section 1.2 “The Role of Taxes”, pages 13 & 16, final report available on-line: http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf

> “The ideal tax system would be efficient (meaning that it would not distort people’s behaviours) and provide the necessary revenue to finance the Government’s spending at the least cost. It would also raise revenue in a way that people agree is fair. In practice, there can often be tradeoffs between fairness and efficiency. The tax base also needs to be sustainable over time. This is particularly important in a more globalised world (where taxing labour and capital income may be more difficult) and with population aging (which may increase the need for robust tax bases). Another essential

element of design, and sustainability, is choosing a tax system that is less vulnerable to interest group pressure and political temptation to change, and does not encourage avoidance."

"To minimise inefficiency effects, economic theory argues that if the information is available, tax should be levied on those tax bases where there is least likely to be any behavioural change from the imposition of a tax – what are termed 'inelastic' (or unresponsive) bases. In the absence of perfect information, however, it is difficult to reliably identify and target the most inelastic bases of tax, and there can also be associated equity issues (for example, whether it is fair to tax some areas and where that tax burden falls). For these reasons, the approach in New Zealand over the last twenty years has tended towards a broad-base low-rate approach."

xxii Government's Tax Policy Work Programme 2012-13, released 16 March 2012, available on-line: http://taxpolicy.ird.govt.nz/work-programme