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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: Taxation of Retirement Savings

*Background Paper for Session 13 of the Tax Working Group
July 2018*

Purpose of discussion

This paper provides information on the taxation of retirement savings and follows on from the more general discussion on taxation of capital income in session 5. It provides an overview of the regimes involved in taxing savings – income tax, portfolio investment entity (PIE) tax, and KiwiSaver. It discusses anomalies in how the portfolio investment entity (PIE) tax rates are determined and a number of issues related to private savings and investment decisions and how taxation could influence those. It raises for consideration changes in the PIE tax rates and some specific changes to taxation of KiwiSaver funds.

Key points for discussion

- Is the current taxation of savings appropriate within the context of fairness, maintaining a robust capital income tax base, and other policy objectives?
- Are there anomalies in the way PIE tax rates are set that should be addressed?
- Would the group like any of the options raised for KiwiSaver to be further explored and discussed in the interim report?
- Should the interim report have general comments, directions for reform, or specific ideas for development?

Recommended actions

We recommend that you:

- a **note** the taxation of savings involves the interaction of the income tax, portfolio investment entity tax regime, and KiwiSaver;
- b **note** additional information on the impact of inflation on the tax system, and options to address it, will be presented in Session 14;
- c **indicate** subjects the Group would like considered for the interim report:
 - i. changing how the PIE tax rates are set;
 - ii. any of the specific reforms discussed for KiwiSaver taxation.
- d **indicate** how the Group would like discussion of retirement savings to be framed for the interim report.

Taxation of Retirement Savings

*Discussion Paper for Session 13
of the Tax Working Group*

July 2018

Prepared by Inland Revenue and the New Zealand Treasury

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Executive Summary

Tax and savings policy

In practice, individuals save for a variety of reasons. They accumulate funds for future investments or purchases of consumer durables. They set aside funds to cover unexpected losses of income or sudden expenses. And they smooth their consumption patterns over their lives – that is, they save for retirement. Regardless of the purpose of saving, however, all savings are affected by the tax system.

New Zealand's taxation of savings involves the interaction of four main aspects:

- The TTE system for taxing capital income (other than capital gains);
- Owner-occupied housing (not taxed);
- The portfolio investor entity (PIE) tax regime; and
- The KiwiSaver regime.

The tax treatment of retirement savings is typically set with regard to two broad aims:

Retirement income adequacy and equity

New Zealand's primary policy tool for achieving this aim is New Zealand Superannuation (NZS), which is supplemented by voluntary private saving through the KiwiSaver scheme and other saving vehicles. Unlike other OECD countries, New Zealand does not have a significant tax-assisted system for retirement savings. A key question examined in this paper is whether it might be sensible to do so.

Reducing distortions

Tax policy generally aims to enhance efficiency by minimising distortions in the treatment of different types of saving vehicles and investments. Comprehensive approaches to taxation can achieve this goal. In cases where a comprehensive approach is not feasible, reducing the taxation of a particular saving vehicle may reduce some distortions, but increase others.

Policy issues

Effectiveness of tax incentives

There are difficult trade-offs involved in the design of tax incentives for saving. International evidence suggests that tax incentives do not necessarily generate significant increases in private saving, because individuals may simply reallocate existing saving into the tax-favoured vehicle. Tax incentives for saving tend to be regressive, and can have high fiscal costs (which, all else equal, will reduce public saving). The most common way of managing fiscal and regressive impacts is to impose restrictions on contributions into tax-favoured accounts; tighter restrictions have the downside of reducing the additional private saving generated by the incentives.

Treatment of housing

Equity in owner-occupied housing is the most tax-favoured form of saving. Some commentators believe this treatment distorts the allocation of saving and inflates house prices. Tax-favoured retirement savings vehicles would reduce the bias in favour of owner-occupied housing, but create a new distortion between retirement savings and other forms of saving. The degree to which tax-favoured retirement saving vehicles would reduce house price appreciation is also uncertain (not least because KiwiSaver allows withdrawals for first home purchases).

Treatment of inflation

There is a general issue in the tax system regarding the treatment of inflation. The real effective tax rate on interest is high because the inflation component of interest is taxed. This treatment reduces the incentive to save through debt instruments. Removing tax on the inflation component of interest for retirement saving vehicles alone would have a high fiscal cost and create new distortions in the tax system. The Secretariat suggests instead that the Group consider this issue in a broader discussion of the treatment of inflation across the tax system. The Group is scheduled to discuss the treatment of inflation at its next meeting.

Increasing the integrity and fairness of non-locked-in PIEs and enhancing KiwiSaver

The tax rate on income accumulating within PIEs is typically lower than the marginal tax rate of the individual investors. The paper seeks the Group's views on exploring options that better reflect the investor's tax rate in their PIE tax calculations for non-locked-in PIEs. Although this is not consistent with a narrow objective of promoting savings, such an approach would be consistent with increasing fairness and the Group's broader objective of ensuring that high income individuals cannot use closely-held companies to avoid the top personal tax rate.

A number of options for enhance the KiwiSaver regime are also discussed. While some reforms have a high fiscal cost and a regressive distributional impact, there are some reforms that could be targeted at low income savers and improve savings outcomes for them. They have a progressive distributional outcome and a modest fiscal cost. These include having an exemption from tax on the employer's contribution available for low income employees only, and reducing the lower KiwiSaver PIE tax rates by five percentage points each.

Other savings issues

There has been a long-running policy debate about New Zealand's national savings rate – which is low compared to many OECD economies – and whether it is associated with weak productivity performance, macroeconomic vulnerabilities, and a risk of inadequate future retirement incomes. There have also been long-running concerns about distortions in the treatment of different forms of saving, and whether these

distortions may be reducing productivity. Some commentators have argued that the taxation of income from savings should be reduced in order to increase saving rates.

Next steps

This paper seeks the Group's views regarding the coverage of savings policy in the Interim Report. Savings policy is a large and complex area, and there is little time for the detailed design of options before the production of the Interim Report.

Given these constraints, the Group might wish to consider whether it intends to use the Interim Report to lay out a broad direction of reform only, or whether it wishes to go further and float a number of illustrative options for reform. An indication of the options of interest to the Group will allow the Secretariat to begin programming work and form a view on what can feasibly be delivered in time for the Interim Report.

1. Introduction

1.1 Purpose

1. This paper follows on from the paper on the *Taxation of Capital Income and Wealth* that was discussed at session 5. That paper gave a broad overview of how New Zealand taxes capital income. The focus of this paper is on the taxation of the capital of domestic savers that is primarily intended to fund their retirement. A number of broader questions about the taxation of capital income are discussed in chapter 4.

1.2 Content and scope

2. This paper discusses:
 - a. Issues and concerns related to retirement savings;
 - b. How New Zealand taxes retirement savings compared to how other countries tax retirement savings;
 - c. How taxation of retirements savings relates to broader issues concerning the taxation of income from capital;
 - d. Options to address concerns and resulting impacts;
 - e. Conclusion and summary of options.

2. Savings Issues

2.1 Policy objectives

3. Taxation of retirement savings can have a significant effect on the four capitals that contribute to wellbeing. These effects can be direct, or more indirect to the extent that they affect parts of the society and the economy outside of retirement savings. In addition, changes to the tax system designed to address retirement savings objectives raise the standard criteria of efficiency, fairness and revenue adequacy.

Retirement income objectives

4. The overall objective of retirement income policy is to minimise economic insecurity in old age. This is a concern for both social and human capital. New Zealand achieves this objective through three main policy planks:
 - New Zealand Superannuation manages core old age poverty alleviation goals.
 - The KiwiSaver scheme supports private saving to maintain a standard of living in retirement over and above the level guaranteed by New Zealand Super.
 - Private decision-making on retirement saving is supported by various measures to improve the financial literacy of New Zealanders.
5. From a retirement income policy perspective, the key savings question is whether individuals are saving sufficiently to provide themselves with an ‘adequate’ income in retirement relative to their pre-retirement income.¹ In the mid-2000s, research undertaken by The Treasury found that household saving behaviour was broadly consistent with smoothing consumption into retirement, suggesting that private saving for retirement was generally adequate. However, this conclusion was conditional on existing superannuation eligibility being maintained for all future retirees, which may not be the case given long-term fiscal pressures.
6. We do not have more recent evidence to determine whether households’ savings are likely to be adequate for retirement. Rising housing costs could pose a threat to the adequacy of retirement savings for younger households, as more people are getting shut out of home ownership for their whole lives. If they retire without owning a home to live in it is more questionable whether superannuation alone would be sufficient.
7. About an equal number of women and men are members of KiwiSaver (as of June 2017, 1.4 million women and 1.3 million men were members of KiwiSaver) (see Appendix B for information on KiwiSaver). However, a recent Westpac survey found that men have much more savings in KiwiSaver and elsewhere. Only 4% of women have more than \$50,000 saved in KiwiSaver, compared to 13% of men. In addition, 24% of women contribute more than 3% of their salary to KiwiSaver and

¹ Not all individuals are better off saving. Some low-income individuals will actually be better off if they do *not* save now, because they will earn more in the future as recipients of New Zealand Superannuation.

31% of men do. 52% of men also have additional savings outside of KiwiSaver, as do 39% of women. Given that women live on average three years longer than men, they may face more difficulty in maintaining an adequate income throughout their retirement (Westpac (2018)). These results are likely due to the fact that women, on average, have lower incomes during their working years and so would have less income available to save. Tax changes focused on lower income savers may help reduce gender gaps in savings.

Economic performance objectives

8. Saving behaviour matters for overall economic performance, through its effects on investment, resource allocation, capital market development and macroeconomic imbalances. Retirement saving is one element of New Zealand's overall saving. As outlined in Appendix A, New Zealand's national savings rate is lower than in most other OECD countries. This stems from lower private savings, since public saving has tended to be higher than other jurisdictions. There has been concern that low national saving is associated with New Zealand's weak productivity performance and macroeconomic vulnerabilities.
9. The reasons behind New Zealand's level of saving are complex and not fully agreed. Saving outcomes are likely to reflect the interaction of a range of policy settings and economic signals rather than any single policy. Any policy option that supports higher national saving will only be warranted if the changes provide net benefits other than just increased saving, which requires careful consideration of the details of any proposed policy. It suggests a focus on removing distortions, where they can be identified. Consideration should be given to fairness as well as efficiency impacts.
10. Taxation can have a significant effect on the incentives on how and how much to save. Taxation of income from savings raises significant design and policy issues, which are briefly outlined in section 2.2. Policies directed at retirement savings, which form a significant part of overall savings, could also have an effect on the overall savings rate.
11. The effect of retirement income policy settings on saving rates depends upon the nature of the policy intervention. For example, the rise in the age of eligibility for New Zealand Superannuation during the 1990s is estimated to have increased the household saving rate by around 2.5 percentage points. On the other hand, the introduction of tax-favoured retirement accounts may affect the composition of savings more than the overall rate of private savings, as funds are shuffled from taxable to non-taxable accounts. Depending upon the parameters, there may also be some increase in private savings. However, even if private savings increase, national savings may not because reduced tax revenues reduce national savings, potentially offsetting any increase in private savings.

Capital markets development objectives

12. Capital markets are financial markets that facilitate the buying and selling of long-term debt and equity instruments. By channelling the wealth of savers to those that are seeking to raise long-term capital, these markets complement the intermediation role played by banks and other financial institutions. Well-developed capital markets also enhance the capacity of economic agents to manage and price risk. This is a concern about financial and physical capital.
13. Cross-country literature has found a positive relationship between the level of financial system development and long-run economic growth. Underdeveloped banking and capital markets can hamper economic growth by preventing the financial system from effectively performing its vital functions, such as allocating resources across time and space, and managing and pricing risk.
14. In New Zealand, there has been a long-standing concern that financial system development, and broader economic welfare, has been inhibited by the relatively underdeveloped nature of New Zealand's corporate bond and equity markets. A greater pool of domestic savings could deepen domestic capital markets, although the net benefits are uncertain.
15. Other important considerations include the allocation of private saving and the tax treatment of different types of investment entities. There are also concerns that the favourable taxation of owner-occupied housing compared to financial assets is contributing to housing price appreciation and intergenerational inequity.

Macroeconomic stability

16. Increasing national saving could reduce New Zealand's level of external indebtedness and current account deficits. New Zealand's external indebtedness exposes households and firms to risk. For example, external bank funding needs to be rolled over in international debt markets which can be disrupted during times of global financial stress.

Cost of capital, investment and productivity

17. Higher saving rates should in principle enable greater investment and, therefore, also higher economic growth. Higher saving could reduce the cost of capital, providing greater incentives for firms to invest. As new capital also brings with it new technology, higher investment may increase the productivity of both labour and capital.
18. Higher national saving would reduce upward pressure on interest and exchange rates over the business cycle, supporting export growth and the productivity benefits it brings. That may also support an increased share of investment in the tradable sector, particularly if accompanied by changes in tax and regulatory settings to reduce differential impacts on investment incentives across sectors.

19. Policies seeking to raise retirement savings may not further these last two objectives (macroeconomic stability and investment and productivity) unless national savings (which includes government saving or dissaving) were also to increase. Using tax reductions or incentives as a lever for increasing retirement savings may run counter to these objectives if they reduce national savings. Reducing tax on retirement savings may cause national savings to fall unless tax revenue is made up elsewhere, and reducing the taxation of capital income more broadly (i.e., all forms of income from capital, including business income) will have more direct impacts on the cost of capital and investment than tax preferences that only apply to particular types of investments (financial assets).

Inflation and efficiency of investment

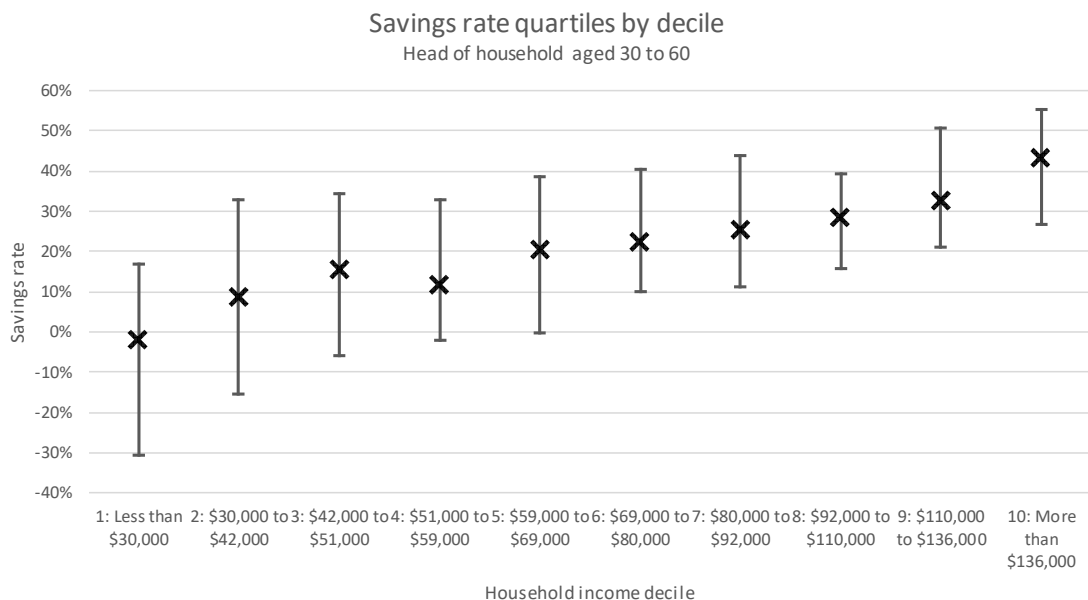
20. Ideally, the marginal effective tax rates on different investments should be as uniform as possible so that taxation does not distort taxpayer choices into making inefficient investments. Since tax is calculated on nominal income, and inflation has different effects on different investments and how the tax rules apply to them, inflation is a source of distortion of effective tax rates. In addition, inflation accounts for a high effective tax rate on debt, which would reduce the accumulation of savings invested in debt. These concerns about inflation and investment biases are, in principle, a reason for considering comprehensive indexation of the tax base as will be examined in a later session. A separate question that we discuss, however, is whether there should be any consideration of indexation purely for retirement savings accounts.

2.2 Policy considerations and trade-offs

21. There are costs as well as benefits in any tax measures to increase retirement saving rates. Costs will include:
- The sacrifice of current consumption (which may generate significant welfare costs, particularly for low income individuals).
 - The creation of new (and possibly unintended) distortions in saving and investment patterns.
 - Fiscal costs.
 - Compromises to the efficiency and/or coherence of other policy regimes.
22. The benefits of additional saving would need to be weighed against these costs in each policy domain. In discussing the role of taxation on savings, the secretariat will discuss two broad issues which impact the list of policy objectives above:
- How tax affects the level of private and national savings; and
 - How tax affects the choice of investments for savers.

3. Who are the savers?

23. As mentioned earlier, for individual and household savings there is a strong life-cycle pattern, with households saving during their working lives, and saving generally increasing later in working life. After retirement, households often move into dissaving, consuming more than their income. Some may have some net savings remaining when they die, which is left as a bequest, but not all do. New Zealand Superannuation and means-tested benefits, such as for retirement homes, act as a stipend for people who have consumed all of their savings.
24. At all age levels, higher income households save more than lower income households. The x marks in the graph below show the mean savings rates for each decile. The bottom of the lines shows the savings rate for the bottom quartile and the top of the lines shows the savings rate for the top quartile within each decile:

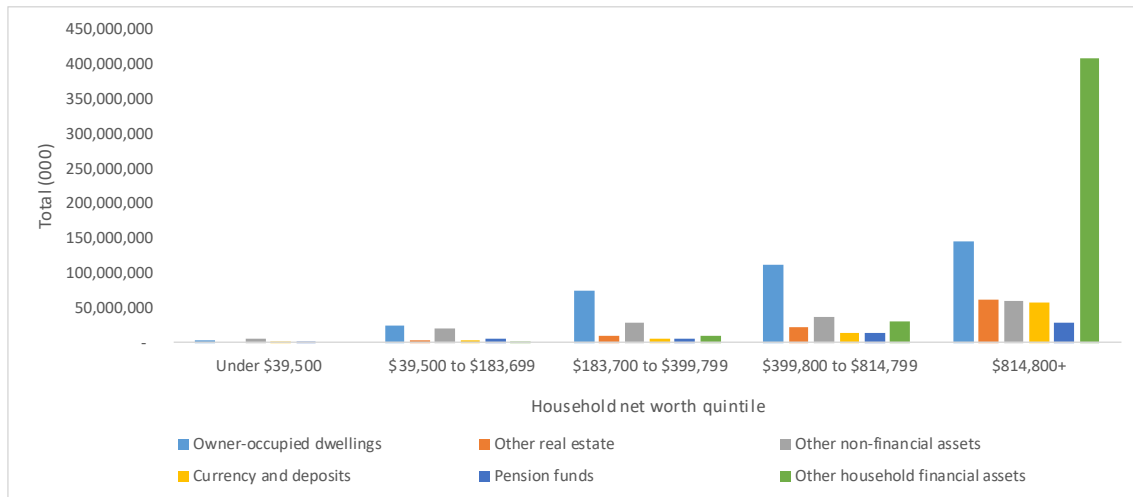


Decile	Median	Upper Quartile	Lower Quartile	Mean	Decile lower boundary	Mean household disposable income (unequalised)	Mean household expenditure (unequalised)
1: Less than \$30,000	-2.1%	17.1%	-30.6%	-6.3%	*	\$21,000	\$23,000
2: \$30,000 to \$42,000	8.7%	32.8%	-15.3%	6.2%	\$30,000	\$36,000	\$33,000
3: \$42,000 to \$51,000	15.7%	34.3%	-6.0%	10.7%	\$42,000	\$47,000	\$42,000
4: \$51,000 to \$59,000	11.8%	33.0%	-2.2%	9.7%	\$51,000	\$55,000	\$50,000
5: \$59,000 to \$69,000	20.3%	38.7%	-0.1%	15.1%	\$59,000	\$64,000	\$54,000
6: \$69,000 to \$80,000	22.3%	40.6%	9.9%	20.9%	\$69,000	\$74,000	\$59,000
7: \$80,000 to \$92,000	25.4%	44.0%	11.2%	27.2%	\$80,000	\$86,000	\$62,000
8: \$92,000 to \$110,000	28.4%	39.2%	15.9%	27.7%	\$92,000	\$100,000	\$72,000
9: \$110,000 to \$136,000	32.7%	50.8%	21.1%	32.4%	\$110,000	\$122,000	\$83,000
10: More than \$136,000	43.2%	55.3%	26.7%	39.7%	\$136,000	\$210,000	\$112,000

Source: Household Economic Survey (2012/13) with subsequent Treasury calculations

25. Tax reductions for savings will have distributional effects which will depend on the categories of assets that are affected. The distribution of ownership of these assets is very skewed, as illustrated by the following chart:

Distribution of Assets by Household Net Wealth Quintile



Source: Statistics New Zealand 2015 Household Economic Survey

26. Because of this, any change to the taxation of income from savings (capital income) is likely to have distributional consequences. Tax reductions for savings in financial assets that are not targeted are likely to strongly favour higher income and higher wealth households. For example, 84% of financial assets are owned by the top quintile (20%) of households in wealth distribution. It may, however, be possible to make changes which are less regressive or progressive with appropriate targeting.

4. New Zealand's taxation of savings

4.1 Taxing Savings is Taxing Capital Income

27. When we talk about taxing “savings,” we are really talking about taxing domestic savers on income from capital. Domestic savers invest their savings, sometimes passively (such as putting it in a bank) and sometimes actively (such as investing in their own business). We tax the income resulting from the investment.² A description of how we tax capital income was provided in the previous paper on the *Taxation of Capital Income and Wealth*.
28. As the population ages, a smaller proportion of people will be in the workforce earning labour income compared to older people earning primarily capital income from savings. As government spending pressures will also increase in areas such as superannuation and elderly care, it will be important to maintain a robust system of taxing capital income.

4.2 Description of Income Tax

29. How New Zealand taxes savings was described in the paper on the *Taxation of Capital Income and Wealth*. It is generally by way of an income tax which is described as TTE (investment is made from taxed income, the capital income is taxed as it is earned, and there is no tax when the proceeds of the investment are withdrawn or used).
30. The main exceptions to TTE taxation in New Zealand are equity in owner-occupied housing (the benefit of imputed rental income is not taxed, so it is TEE), and investments earning significant capital gain, since capital gains are generally not taxed. An example of this is investment property, which could be described as TtE (the lower-case “t” symbolising the partial taxation of total income).
31. The taxation of New Zealand household capital investments was categorised in the *Taxation of Capital Income and Wealth* paper:³

² Although imputed income of owner-occupied housing is not taxed. This is discussed later.

³ This table is a little different from the one presented in session 5 to show more nuance in the tax treatment of some investments, as described in paragraph 32.

New Zealand Household Investments

Financial Assets	Cash and Deposits	Debt Securities	Domestic Shares (listed companies)	Foreign Shares	Investment Funds	Super Funds	Financial Assets subtotal
Gross Amount NZ\$ Billions	\$170	\$5	\$121	\$8	\$62	\$95	\$460
% of Total Investments	10%	<1%	7%	<1%	4%	6%	27%
Allocated Liabilities	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net Amount NZ\$ Billions	\$170	\$5	\$121	\$8	\$62	\$95	\$460
% of Total Investments	12%	<1%	8%	1%	4%	6%	31%
Tax Treatment	TTE	TTE	TtE	TTE equivalent (FDR)	TtE (PIE)	ttE (some KiwiSaver)	Mixed

Other Investments	Owner-Operated Business	Investor Housing	Owner-Occupied Housing	Other Investments Subtotal	Total Investments
Gross Amount NZ\$ Billions	\$201	\$265	\$786	\$1,253	\$1,712
% of Total Investments	12%	15%	46%	73%	100%
Allocated Liabilities	\$0	\$68	\$173	\$241	\$241
Net Amount NZ\$ Billions	\$201	\$197	\$614	\$1,012	\$1,472
% of Total Investments	14%	13%	42%	69%	100%
Tax Treatment	TtE	TtE	TEE	Mixed	Mixed

Source: Reserve Bank of New Zealand series C22 and Treasury

32. The small “t”s for domestic shares, owner-operated business, and investor housing reflect the fact that they often have some portion of capital gain in the return, which is not taxed under current rules. If we were to tax capital gains at full marginal rates, domestic shares, owner-operated business and investor housing are likely to shift towards TTE and make most of the categories in the table above TTE. The small second “t” for investment funds and superfunds reflects the lower PIE tax rate structure. The small first “t” for super funds reflects the member tax credit for KiwiSaver, which is an offset to full taxation of the contributions.

4.3 PIE tax rules and KiwiSaver

33. The portfolio investment entity (PIE) regime has the main tax rules applying to managed funds in New Zealand – the most common example of which are KiwiSaver funds. The main PIE rules apply to managed funds, such as unit trusts, that invest in diversified portfolio financial assets. KiwiSaver is generally used for investments in managed funds that may not be accessed until reaching the age of 65

(subject to limited exceptions). There is also a listed company PIE regime which is used mostly for investing in commercial property.

PIE Taxation

34. The PIE regime came into effect on 1 October 2007, to coincide with the taxation of KiwiSaver schemes. Unlike KiwiSaver the PIE regime is not limited to the taxation of funds locked-in until age 65. It could be used for non-retirement savings and investment more generally.
35. The premise of the PIE regime is to remove barriers to savers investing in managed funds. Smaller savers may get the benefit of diversified investments, without facing some of the previous tax disadvantages of investing in a managed fund. This was mainly having trading gains taxed, since individual investors usually held shares on capital account and so were not taxed on trading gains. A feature of the PIE regime is that New Zealand and Australian share gains are generally not taxed, despite managed funds normally being treated as holding shares on revenue account.

PIE taxation rules

36. PIE taxation is quasi-transparent. Tax is calculated and applied as if the investors earned their share of the PIE income directly. However, to reduce compliance and administrative burdens, the PIE must calculate all of its investors' tax and pay it to the IRD. The fund is reimbursed for the investors' tax by cancelling their units in the fund equal to the amount of the tax.

Investor tax rates

37. The maximum PIE tax rate is 28%. When the PIE rules were put in place an important consideration was New Zealand's lack of a capital gains tax. There were other entities where income could be taxed at the company tax rate and where this ended up as a final tax. This included investment in unit trusts. The same was arguably true for investment in companies when shareholders were able to sell their shares and generate tax free capital gains.
38. Rather than basing PIE tax rates on taxpayers' marginal tax rates in the year that income was earned, PIE investors were able to nominate tax rates from one of the prior two years. This was to allow as many PIE investors as possible to not have to file income tax returns, and to know their relevant income information with certainty. There was not the possibility that arises under Business Transformation for there to be automatic square-ups without taxpayers needing to file returns.
39. For investors on tax rates below the capped rate there are also generous rules, as illustrated in the table below. This was aimed at ensuring there was no overtaxation of those with income just below a tax threshold. This allowed investors to choose the PIE tax rate for them that was equivalent to their personal marginal tax rate based just on their taxable income (disregarding amounts earned in PIEs). In order to limit the benefit of earning significant PIE income at a low tax rate, there is a

separate threshold based on taxable plus PIE income. It means there will be numerous cases where an investor's taxable plus PIE income would put them in a higher marginal tax rate if they earned investment income directly instead of through the PIE.

Marginal tax rate	Individual tax rates – for the current year	PIE Tax Rates – For either of the two prior years:	
	Taxable Income	Taxable Income	Taxable + PIE Income
10.5%	<=\$14,000	<=\$14,000 AND	<=\$48,000
17.5%	\$14,001 - \$48,000	<=\$48,000 AND	<=\$70,000
28%	NA	>\$48,000 OR	>\$70,000
30%	\$48,001 - \$70,000	NA	NA
33%	>\$70,000	NA	NA

Share trading

40. The other feature of PIE taxation is that gains on selling shares in New Zealand and Australian companies are exempt from tax (even if they would otherwise be on revenue account). Other capital gains, such as on land, are not automatically exempt and the general provisions apply.
41. Since most individual investors would not pay tax on gains on shares anyway, the main advantage of PIE taxation compared to individual taxation is the lower tax rate schedule.

KiwiSaver

42. KiwiSaver came into effect on 1 July 2007, although KiwiSaver funds were first held by Inland Revenue until 1 October 2007 when they became held and managed by private funds and taxed under the PIE regime. KiwiSaver is aimed at encouraging savings for retirement, with funds locked-in until age 65, unless some hardship withdrawal requirements are met, and some early withdrawal is allowed for some home purchases. The purpose of KiwiSaver, as described in Section 3 of the KiwiSaver Act 2006, is to “encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement.”
43. KiwiSaver provides a mixture of non-tax incentives and incentives delivered through the tax system to encourage saving in the scheme. These incentives have been changed over time, with the general trend being to reduce their fiscal cost and so reducing subsidies to savers.
44. The incentives of the scheme at the time it was introduced in 2007 include:
 - New employees were automatically enrolled in the scheme, so employees would have to take action to opt out of the scheme;
 - New members were given \$1,000 (kick-start) in their account to sign up;

- Members entitled to a member tax credit of one dollar contributed to the scheme for each dollar they contributed during the year, up to \$1,042;
 - Employers must make a matching contribution, phased in over four years, from 1% per year to 4% per year of total wages (note the employer contribution rate was subsequently frozen at 2% at the end of 2008);
 - Employers entitled to an employer tax credit, paid to them, calculated in the same way as the member tax credit, dollar-for-dollar for up to \$1,042 of annual contributions;
 - Employer contributions exempt from employer superannuation contribution tax (ESCT);⁴ and
 - A fee subsidy for scheme management fees of up to \$40 per year.
45. Since the initial scheme many changes have been made in order to reduce the cost of subsidies that were considered not to be very effective:
- The employer tax credit was repealed (2009);
 - Minimum employee contribution and employer contributions set at 2% (2008);
 - Annual \$40 management fee subsidy repealed (2009);
 - ESCT exemption repealed (2012);
 - Member tax credit reduced from dollar-for-dollar to \$.50 per dollar of contribution (maximum annual credit now \$521) (2012);
 - Minimum employee (and employer matching) contribution raised from 2% to 3% of wages (2013);
 - \$1,000 kick-start repealed (2015).
46. Withdrawals have been allowed for some low-income housing purchases and these have generally been liberalised over time.
47. See Appendix C for more detail on changes that have been made to KiwiSaver since it has been introduced.

4.4 Other Countries – Concessionary retirement savings schemes

48. Almost all OECD countries except New Zealand have concessionary tax regimes for retirement savings. Most are EET (Exempt-Exempt-Taxed – the contribution is made out of income which is not taxed, the investment income is not taxed as it is earned, and the withdrawal of the capital and accumulated earnings are taxed when withdrawn) or a variation (such as a low tax rate at some points instead of exempt).⁵ New Zealand is shown as having the lowest tax subsidy (near zero) for savings in retirement accounts compared to its general system for taxing investment income.⁶

⁴ Since PAYE does not apply to amounts contributed by an employer to an employee retirement scheme, ESCT applies instead. This generally applies the employee's marginal tax rate (from 10.5% to 33%) to be withheld from the contribution and paid by the employer to the IRD.

⁵ See Yoo and de Serres (2005) for a full cross-country survey.

⁶ Yoo and de Serres (2005) show New Zealand as having a modest subsidy for retirement savings because its withholding tax on employer contributions was less than the maximum personal tax rate, making it tTE. The member tax credit of KiwiSaver would also have this effect. The article states that Mexico has

49. Other countries generally do not have a universal superannuation scheme for the elderly like New Zealand does. They often have means-tested schemes instead. Therefore, they gain a fiscal benefit if their residents accumulate more retirement savings. This does not apply to New Zealand.
50. A discussion of the effectiveness of such schemes is in chapter 6 and Appendix D.

no subsidy for retirement savings because all investment income is not taxed in Mexico. Other information shows this not to be the case.

5. Reducing capital income taxation

51. Although the focus of this paper is on reducing taxation on retirement savings only, it is useful to consider issues with regard to reducing taxes on capital income more generally. Any moves to reduce taxes on savings to boost economic performance, develop capital markets, or reduce distortions between different forms of investment would be much more consistently addressed by cutting taxes on capital income more generally than just on retirement savings.
52. The tax rates on labour income and capital income are aligned partly for simplicity. The personal tax scale is designed to tax income at different marginal rates without regard to whether it is capital income or labour income. That makes it simpler for compliance and administration. Separating capital and labour income would require two separate tax calculations. The biggest complexity is when capital income and labour income are combined, such as income from an owner-operated business. Which amount is from capital and which is from labour would have to be determined.
53. A strong reason for taxing labour income at the same rate as capital income is fairness. Capital income is earned mostly by higher income households, and so any shift to taxing capital income lighter than labour income would be likely to be regressive (refer to the discussion in chapter 3).
54. From a purely efficiency point of view, economists think there is no compelling reason why capital income and labour income need to be taxed at the same rate. In fact, many think that, for efficiency, capital should be taxed at a lower rate.
55. Some countries have a Nordic income tax system with lower taxes on capital income than on labour income. The capital income tax rate reduction is not confined to income from financial assets in retirement savings accounts, but it applies to capital employed in active businesses also. This means the country can collect some tax on capital income while reducing efficiency costs associated with distortions caused by taxing capital income. However, it is a complex system to reduce the tax on capital income, since rules are needed to separate capital income from labour income in terms of owner-operated businesses (Sorensen 1998).
56. Retirement savings account incentives, such as EET or TEE, are another way of reducing the tax on capital income – but only for investments that are locked into retirement savings accounts. In most countries, there are caps on the maximum annual contributions in order to manage the fiscal costs of such schemes. These have many of the same disadvantages as the more general ways of reducing the tax on capital income (i.e. high fiscal costs and regressive distributional impacts), but have much weaker benefits in terms of reducing the allocative efficiency costs of investment. This is because the retirement savings plans themselves introduce new distortions. And many individual savers save amounts above the annual contribution limits, so the accounts do not affect their marginal investment decisions at all.

57. Unlike a Nordic income tax system, tax incentives for retirement savings may reduce biases between some types of savings but will increase tax biases between other forms of savings. They can, for example, increase biases between whether people save in retirement savings accounts or more liquid ways which allow them to adapt to unforeseen changes (like health care costs, or helping children study or buy a house). It would mean lower taxes on those investing in retirement savings accounts than for those investing in their own businesses, which generally would not qualify as an investment in a retirement savings account.

6. Questions for Consideration Regarding Retirement Savings

6.1 Overview

58. This chapter discusses some topical issues with regards to retirement savings in particular. It is followed by a chapter which discusses whether it would be desirable to make changes to the tax rate structure for PIEs (outside of KiwiSaver) and a chapter discussing possible changes to KiwiSaver settings in order to address retirement savings and distributional objectives.
59. The issues discussed and the description of the PIE and KiwiSaver regimes raise a number of issues:
- Whether it would be desirable to change the taxation of savings for retirement income reasons;
 - Whether it would be desirable to change the taxation of retirement savings for the purpose of improving the allocation of investments;
 - Whether some adjustment should be made to address (remove) the taxation of the inflation component of interest in retirement savings accounts; and
 - Whether the determination of the PIE tax rates or possibly locked-in-PIE rates only should be simplified and rationalised.

6.2 Using tax incentives to fund retirement income

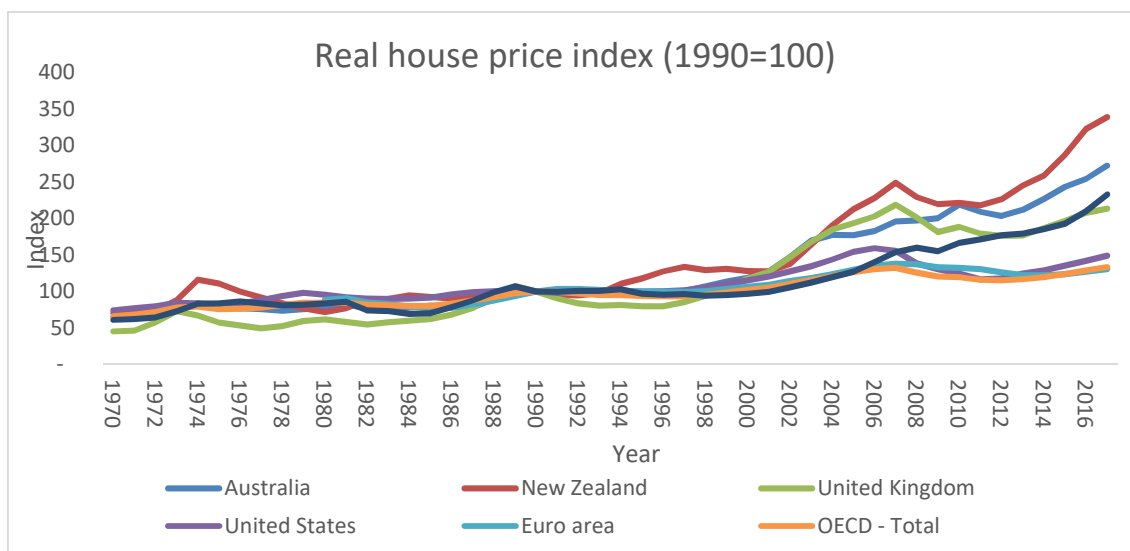
60. As indicated in chapter 2, the amount of savings will be an important factor in achieving a higher level of retirement incomes.
61. The main policy intervention for assuring retirement income adequacy is universal superannuation from age 65. This policy has led New Zealand to have one of the lowest levels of elderly poverty in the OECD. It is an adequate but not generous level of retirement income and people accustomed to a high standard of living during their working life would have to supplement it with savings if they are to maintain that. KiwiSaver is a second plank in achieving retirement income adequacy. Section 3 of the KiwiSaver Act 2006 states that one of its objectives is to “encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement.” A key question is whether there should be further measures.
62. There is obviously the question of fiscal cost. From a perspective of preventing elderly poverty, universal superannuation and our current KiwiSaver scheme are already important safeguards. At the same time, it will be important to maintain a strong revenue base in order to fund adequate superannuation and other spending programmes.
63. Using tax incentives for retirement savings as a lever to increase private savings is may be limited in its effectiveness. Overseas studies have not reached a consensus on how much savings in retirement savings account is additional and how much is a

replacement of other savings. But many overseas studies as well as studies in New Zealand have suggested some increase in private savings but also a significant degree of replacement (see Appendix D). Even if the incentives promote private saving, they are unlikely to promote national saving if they end up adding to the fiscal deficit. Increased private savings when young will often be balanced by increased dissaving when older. Over a lifetime there need be no increase in saving. At the same time there will be ongoing fiscal costs in providing these incentives which will tend to reduce government saving. Thus, tax incentives are unlikely to promote national saving (see Gravelle (1994) at 191).

64. There are also distributional issues to consider. If tax incentives were provided through a general cut in taxes in retirement saving much of the benefit is likely to be captured by those with high incomes and high wealth (refer to the distributional information in chapter 3. If there were no restrictions on the amounts that could qualify for the special treatment, about 84% of the tax reductions would likely flow to the top 20% of households in terms of wealth).
65. A number of specific proposals for changing tax treatment of retirement savings are discussed in chapter 8.

6.3 Allocation of investments

66. Some commentators have said New Zealanders save much more in housing than financial assets compared to other countries. The comparative data on this is not clear as different countries have different ways of calculating stocks of wealth. Comparing New Zealand and Australia, the two countries used to have a similar ratio of housing values compared to net household wealth. Since 2012, New Zealand housing shares have grown more quickly than Australia's due to higher house price growth. New Zealand now has housing at about 73% of household net worth, while Australia is at 64% of household net worth.
67. Coleman (2017) suggests that New Zealand's removal of EET taxation of retirement savings in 1989 has contributed to rising house prices since then, creating an intergenerational wealth transfer with older homeowners benefitting from the price increase while younger buyers must pay more to buy an average house. Comparative OECD data also shows that New Zealand house prices appreciated at about the same rate as for the OECD from 1970 until 1993, but then started to appreciate more quickly than the rest of the OECD from 1994 and then more quickly still from about 2002.



68. Equity in owner-occupied housing has TEE taxation (the purchase is paid out of taxed income, and neither imputed rents nor capital gains are taxed). Other countries provide some EET tax treatment for retirement savings, which is largely equivalent. New Zealand does not offer EET taxation, so equity in owner-occupied housing is the only highly tax-preferred form of investment.⁷
69. The extent to which the current tax rules encourages owner occupiers to invest in houses that are larger than they otherwise would is an open question. The tax benefits of investing in owner-occupied housing applies only to the equity invested. For the 50% of owner occupiers who own a house without a mortgage, there will be some bias encouraging more housing than otherwise. For the 50% of owner-occupiers who have a mortgage, however, a bigger house would mean a larger mortgage. Because mortgage interest is not deductible there should be little or no tax incentive to acquire an excessively large house. Thus, an EET for retirement saving would have little effect in discouraging overinvestment in owner-occupied housing for these households.
70. Could an EET or TEE for retirement savings reduce demand pressures for housing and so reduce price appreciation? This is not clear:
- With limits on contributions, the tax favoured accounts may not be available for marginal savings decisions.
 - KiwiSaver offers withdrawal for first home purchases in some cases, so the account proceeds could be diverted to buy housing. Using KiwiSaver to fund a first home purchase has become increasingly significant as restrictions on withdrawals for this use have been loosened (see Appendix B).
71. In addition, while bringing superannuation to an EET system would reduce the bias of the superannuation investments versus owner-occupied housing, it would

⁷ Although owner-occupied housing is subject to local and regional council rates.

increase the bias between superannuation and most other forms of saving. For example, investing in your own business would be disadvantaged compared to other investments.

72. There is a significant transitional cost to adopting an EET regime. In order to prevent unfairness to current investors (who have already been taxed on savings contributions and income), current savings balances would still be able to be withdrawn tax-free. This results in a significant initial fiscal cost as discussed below.

6.4 EET and TEE Accounts

73. A way to reduce the tax on retirement savings commonly used overseas is an EET account (Exempt-Exempt-Tax). The contributions would be deductible if made by an employee, and exempt from ESCT if made by an employer. There would be no tax on accruing investment income as it is earned by the fund.
74. Another way to reduce the tax on retirement savings is through TEE accounts (Taxed-Exempt-Exempt). The contributions are made from taxed income, but there is no tax on the investment income or the withdrawal. The effect of reducing the tax on investment income is similar to EET. However, the fiscal cost is much lower for starting a new regime because the first “T” is still taxed.
75. The analysis of whether a TEE account or an EET account would increase savings or change the allocation of investment was discussed in section 6.2 and 6.3.
76. If we ignore behavioural changes, the initial fiscal cost of a TEE regime would be about \$200 million to \$300 million per year, and for an EET it would be about \$2,500 million per year. (The higher initial cost for an EET regime arises from the fact that there will be a substantial deferral period before significant amounts are withdrawn from the scheme, and thus taxed under the third “T”). Although these are very different initial costs, the costs will be the same in the long run on a net present value basis.⁸
77. These estimates of the fiscal costs assume there is *no increase* in KiwiSaver balances compared to historical trends. This is important because either of these schemes would substantially increase their attractiveness, and so would attract much

⁸ The standard analysis is that the effect of an EET regime is that it has the same cost to the investor as if labour income was taxed (at the rate of the final T) at the time the labour income was earned and contributed to the fund (the time of the first E). If the investor was taxed on the amount contributed to the fund immediately (as with TEE), then the investor would invest the post-tax amount and earn investment income on that. If, say, the tax rate was 20%, when the fund was accessed, the investor would receive the 80% of the labour income that was contributed to the fund (net of the 20% tax on that), and the investment income on the 80% post-tax contribution. If instead the fund is EET, the investor could make a contribution of 100% of labour income (no tax on contribution) and earn 100% of the investment returns as long as it remained in the fund. When amounts are withdrawn, 20% tax is imposed on the original contributed capital, and the investment earnings. The result is the investor receives the same amount whether the tax is imposed at the beginning or at the end. The government is a silent co-investor with the investor. If the investor's return is the same as the government's discount rate, then the revenue value to the government is equivalent under either system.

more diversion of savings into them, potentially attracting almost all forms of financial savings. If no limits were put on contributions, the fiscal costs would be much higher, and would flow almost entirely toward wealthy households. Under an EET or a TEE scheme, it would be likely that many older and wealthier households would pay very little tax on their investment income. Under either an EET or a TEE scheme, putting tight limits on KiwiSaver balances would be necessary, but then the goal of attracting more savings into KiwiSaver wouldn't be achieved. The looser the restrictions on investing into an EET or TEE KiwiSaver, the higher the fiscal cost and the more regressive the distributional outcome will be.

78. An EET scheme would require time and effort to operationalise for Inland Revenue and fund providers. It could require IRD to prioritise implementing this with other changes in the Business Transformation process. For individuals, it would require them to have more interaction with IRD after their retirement than they would under the current rules.

6.5 Inflation

79. Inflation raises the real effective tax rate on debt investments. Higher effective tax rates reduce the rate of accumulation of savings. If the real interest rate is 3% and inflation is 2% then the real effective tax rate is about 55%.
80. Although inflation has remained at a low 2% for many years, nominal interest rates have fallen. This has made inflation a larger component of the nominal interest rate and has increased the real effective tax rate on debt:



Source: RBNZ and Secretariat

Note: Expected inflation is annual CPI inflation expected in one year from now from the Reserve Bank of New Zealand Survey of Expectations. The interest rate is the weighted average advertised interest rate paid for a new six month term deposit of \$10,000.



Note: Real effective tax rate is calculated assuming the taxpayer faces the top statutory individual marginal tax rate, expected inflation is annual CPI inflation expected in one year from now from the Reserve Bank of New Zealand Survey of Expectations, and the interest rate is the weighted average advertised interest rate paid for a new six month term deposit of \$10,000. The calculation is sensitive to assumptions.

81. Although inflation is clearly increasing the real effective tax rate on debt and other investments, it is not clear what the response should be.
82. As this paper has a focus on retirement savings, it will discuss only the option of indexing interest for inflation when the interest is earned in a KiwiSaver account.
83. As KiwiSaver is intended to provide some concessions for retirement savings, this treatment would be a concession for retirement savings only within a general context of a tax system that taxes nominal income (no indexing for inflation). This makes the scheme a ttE scheme. In this case, the middle “t” is not an arbitrary discounted tax rate, but is based on the principle of taxing the real return.
84. Even if the intent is to limit the indexation to KiwiSaver interest only, it would still be necessary to index some interest expense to avoid creating an unacceptable tax arbitrage risk. That risk is that a taxpayer should not be able to borrow and deduct full interest, and then invest in KiwiSaver where the interest would only be partially taxable. Indexing some interest expense would then have to be required.
85. In addition, indexing itself may be complex, especially as interest may be earned on complex debt instruments, such as in foreign currencies with different underlying inflation rates. These rules would add complexity and compliance costs.

86. Indexing interest only would add new distortions (such as between investing in debt versus shares and real property). It would be less distortionary to comprehensively index the tax system for inflation, but that would be very complex. More information will be provided on this in the paper on revenue-negative and productivity-enhancing reforms.

6.8 Questions for discussion

87. Does the group want more information on tax concessions for saving in general?

7. Options for changes to the PIE regime

88. The PIE tax regime applies to managed fund investments such as unit trusts. It applies both for KiwiSaver and for general investment purposes, not just for locked-in retirement savings. As discussed in chapter 3, there are anomalies in the PIE tax rates that apply compared to personal income tax rates. Questions to consider are:

- Whether the top tax rate should be aligned with the top personal tax rate for non-KiwiSaver PIEs; and
- Whether the lower PIE rates should have a five percentage point discount (same as for the top rate) for locked-in KiwiSaver funds.

A. Remove the 28% capped rate and allow 30% and 33% rates to apply to PIE investors. Also apply individuals' actual tax rates for the lower incomes

Discussion

89. The reason the top PIE tax rate is aligned with the company tax rate is the fact that it was difficult to make a higher rate “stick”. There was a concern that companies could be used to avoid the higher personal tax rates. Taxing capital gains could mitigate this concern. In the absence of a capital gains tax, other changes such as mandating PIE tax treatment for managed funds may achieve this.

90. The terms of reference do not allow the group to recommend an increase in an income tax rate. Something to consider is whether this would prevent the group from recommending an increase in the capped PIE rate, or whether the PIE regime may be considered a tax base regime within the wider context of a personal tax system with a maximum tax rate of 33%.

Fairness

91. The current PIE rate structure favours higher income savers more than lower income savers. It also favours savers through PIEs relative to savers making direct investments and ordinary wage earners. Removing the cap of the top rate would end this.

Coherence

92. The tax system will be more coherent if the capital income earned through a PIE is taxed at the investor's personal tax rate. Without doing this, the capped PIE rate will become more anomalous in an environment where we tax capital gains and make it more difficult to achieve other ways of avoiding the top-up tax, such as with dividend stripping transactions. It raises the question of why we tax active businesses that take risks and employ people at 33% (after dividends and if capital gains are taxed), but allow passive investments to be taxed at lower rates.

93. Simplifying the way we determine the lower rates will also improve coherence. The changes being made by Inland Revenue through Business Transformation may allow investors' current marginal tax rates to apply, with the PIE paying a withholding tax to ensure compliance, similar to interest RWT withheld by banks.

Revenue

94. Removing the cap will raise about \$43 million annually if applied to all PIEs, and \$16 million annually if applied only to PIEs that are not part of KiwiSaver.

B. Keep the 28% capped rate and allow a 5 percentage point benefit for the lower tax rates as well.

Discussion

95. If it were thought desirable to provide a more consistent incentive for retirement savings accounts than at present, one option would be to give a five percentage point discount on all marginal tax rates as suggested by the Savings Working Group (2011). This would allow lower-income earners to generally accumulate savings in retirement savings accounts more rapidly. However, non-locked in PIEs are a close substitute for other forms of saving so we would see little reason for providing a five percentage point discount for non-locked in PIEs. For that reason we think this change should only be considered for PIEs that are KiwiSaver accounts, and therefore are discussed in the following chapter on possible KiwiSaver changes.

7.1 Question for discussion

96. Does the group want more information on removing the 28% maximum tax rate cap for PIEs and determining the lower rate?

8. Options for Changes to KiwiSaver

97. This chapter discusses a number of options for reducing the overall tax on KiwiSaver. These options all have some common impacts:

- **Savings.** The international research on taxation and saving suggest that these changes are unlikely to lead to substantial increases in the overall rate of private savings when post-retirement consumption is taken into account. However, they should increase the rate at which retirement savings grow leaving more for the taxpayers when they retire. In addition, taken alone they are likely to reduce national savings.
- **Revenue and efficiency.** All of the options reduce revenues. Depending on how replacement revenues are raised, there could be a reduction in efficiency and productivity.
- **Distribution and fairness.** Unrestricted tax benefits for saving are likely to be very regressive, with about 84% of the benefit flowing to the top 20% of households. Even with strong limits for eligible treatment, some will still be regressive. A few options with strict income conditions for eligibility will be progressive. These are illustrated at the end of the chapter.

Options for reducing tax/increasing subsidies for KiwiSaver contributions (reducing the first “t” of ttE).

Description	Fiscal Cost	Private Savings	Distribution
Raise member tax credit from \$0.50 per dollar back to \$1.00 per dollar capped at \$1,042 total.	\$800 million	Some increase in the rate of wealth accumulation in KiwiSaver accounts.	Progressive
Remove the ESCT exemption for employer contribution only for taxpayers earning less than \$48,000.	\$150 million	Probable increase. Survey information of KiwiSaver investors show that they had little awareness of this benefit from investing in KiwiSaver. Some increase in the rate of wealth accumulation in KiwiSaver accounts.	Progressive
Remove ESCT on all employer contributions to KiwiSaver.	\$650 million	Probable increase. Survey information of KiwiSaver investors show that they had little awareness of this benefit from investing in KiwiSaver. Some increase in the rate of wealth accumulation in KiwiSaver accounts.	Regressive

Reducing the second “t” – ttE

98. These options would reduce the effective tax rate on the investment income of the fund as it is earned.

Description	Fiscal Cost	Private Savings	Distribution
Reduce all of the lower PIE tax rates in KiwiSaver accounts by five percentage points, and simplify rate schedule.	\$23 million if limited to KiwiSaver only.	Probable increase. Some increase in the rate of wealth accumulation in KiwiSaver accounts.	Progressive
Do not tax the inflation component of interest earned in KiwiSaver accounts.	\$185 million (assumes limited to KiwiSaver only – balance growth no higher than current plus trend)	Probable increase. Some increase in the rate of wealth accumulation in KiwiSaver accounts.	Regressive
Move to TEE (current treatment for contributions, not deductible for individuals and subject to ESCT for employers) and exempt investment income from tax.	About \$200 million to \$300 million per year assuming restrictions on contributions are in place so KiwiSaver balances do not grow any faster than historical trends. If these restrictions are not in place or are not effective fiscal costs will be very much higher.	Probable increase. Some increase in the rate of wealth accumulation in KiwiSaver accounts.	Regressive

Moving to EET

99. Estimates the cost of changing KiwiSaver to an EET scheme. Assumes annual KiwiSaver contributions would be limited to just the employee 3% plus the employer 3% annual contributions.

Description	Fiscal Cost	Private Savings	Distribution
Move KiwiSaver to EET. Limit annual contributions to KiwiSaver to the 3% employee contribution plus the 3% employer contribution to manage fiscal cost.	About \$2,100 million to \$2,500 million per year over the forecast period. Assumes investors will initially withdraw funds that have been subject to TTE, so they will not initially face tax on withdrawal. Over time, withdrawals will become taxable, reducing the annual cost to about \$200 million but it may take about 30 years for this to fully work through. By this time, the steady state fiscal cost will be much higher than \$200 million because KiwiSaver balances will likely be much larger then. Fiscal cost assumes strict rules on maximum contributions are in place. If not, fiscal costs will be much higher.	Probable increase. Some increase in the rate of wealth accumulation in KiwiSaver accounts..	Regressive

Further information on distributional impacts

100. Uncapped tax benefits for savings are likely to strongly benefit wealthier households given the skewed distribution of ownership of financial assets which could potentially be held in KiwiSaver accounts. However, even if eligibility for KiwiSaver is limited to a low level of savings (assumed to be a 3% employee contribution plus a 3% employer matching contribution) some of the options are still regressive. Some, however, are progressive.
101. The following table shows the approximate change in accumulated savings after 30 years for the policy options above for taxpayers earning \$48,000, \$100,000, and \$200,000 per year.
102. The savings are calculated by assuming everyone saves in KiwiSaver the same proportion of their annual salary, which coincides to the amount people would save now in order to maximise the benefit of the 3% employer matching contribution. That is – the employee contributes 3% of their pre-tax salary (so if they make \$100,000, they contribute \$3,000), and the employer contributes 3% before the deduction for ESCT, which is withheld from their contribution and not contributed to KiwiSaver.
103. KiwiSaver is assumed to earn a pre-tax return of 5% (nominal). Inflation is 2%. Net returns are reinvested. Total net savings after 30 years are determined. For the inflation indexing of interest distribution, all of the return is assumed to be interest income.
104. In the case of EET, the employee is presumed to contribute the amount before tax that would equal an after-tax amount of 3% of their salary, on order to reflect the fact that they would be allowed a deduction for their contribution. For EET, the member tax credit is assumed to be grossed-up by the tax rate. This is because EET is the only option that would tax the member tax credit (when it is distributed). As the member tax credit is currently an untaxed benefit, it would have to be grossed-up to retain its value in an EET account.
105. The following table shows the change in after-tax savings accumulations (compared to the current income tax, PIE, and KiwiSaver rules) under the different options shown above.

Change in Total Savings over 30 Years under different KiwiSaver Reform Options

Option	% change in accumulated net savings after 30 years by annual salary per option			Annual fiscal Cost
	\$48,000	\$100,000	\$200,000	
Increase member tax credit from \$.50 per dollar to \$1 per dollar	+16%	+9%	+5%	\$800 million
Remove ESCT for the employer contribution only for employees earning up to \$48,000 per year.	+8%	0%	0%	\$150 million
Remove ESCT for all employer matching contributions.	+8%	+18%	+19%	\$650 million
Reduce all of the lower PIE tax rate by five percentage points.	+5%	0%	0%	\$23 million
Do not tax the inflation component of interest	+6%	+10%	+10%	\$185 million assuming strict restrictions on maximum contributions
TEE for KiwiSaver	+17%	+28%	+28%	\$210 million assuming strict restrictions on maximum contributions.
EET for KiwiSaver	+17%	+28%	+28%	\$2,500 million per year in the early years, assuming strict restrictions on maximum contributions.

106. While these options may not significantly increase levels of private savings, some have fairness or distributional benefits and a modest fiscal cost. These are reducing the lower PIE tax rates for KiwiSaver PIEs (to match the five percentage point reduction of the top PIE tax rate) and providing a limited ESCT exemption, capped at an amount such as \$48,000. Tax reductions focused on benefitting lower income savers are also likely to reduce gender gaps in savings, given that women generally earn less and save less than men.

Questions

107. Does the group want more information on any of these options?

9. Conclusion

108. Maintaining an adequate income for the elderly is an important government policy, and universal superannuation is the primary tool for this. This is supported by KiwiSaver. With these in place, there is a question of whether there is a need for further across-the-board interventions to support adequate income in retirement. Maintaining a robust capital income base into the future will be increasingly important as the population ages given likely growing fiscal pressures.
109. There is unlikely to be national savings benefit from across-the-board cuts in taxes on retirement savings such as an EET or a TEE retirement savings scheme. While tax incentives may boost private savings in some circumstances, the most immediate outcome will be to shift savings from outside the scheme into the scheme. If there are caps on these schemes there will be many cases where the schemes are not an option for some marginal savings decisions, so the impact of increasing private savings would then be limited. The ongoing fiscal cost is likely to reduce national savings. Caps would nevertheless be critical to manage fiscal cost and reduce the extent to which most of the benefit goes to those with higher income and wealth.
110. If the concern is primarily with the savings of low-income groups, there are targeted measures like the ESCT exemption for lower income employees or extending the five percent discount on locked-in PIE income to those on lower tax rates. These could limit the fiscal costs of intervention while directing the benefits to those most in need.
111. This paper has explained how the tax system deals with retirement savings, and has canvassed a range of options for reforming the system and encouraging greater saving behaviour. The Secretariat would now like to seek the Group's views on how best to cover retirement savings policy in the Interim Report.

9.1 The broad approach for the Interim Report

112. Retirement savings is a large and complex policy area, and there is little time for the detailed design of options before the production of the Interim Report. Given these constraints, the Group might wish to consider the following approaches for the drafting of the Interim Report:

- Use the Interim Report to lay out a broad direction of reform, and then begin work on fleshing out the direction and options after September.

and/or

- Use the Interim Report to float a number of illustrative, high-level options for reform, to gauge the level of public interest or concern about types of options.

9.2 Options of interest to the Group

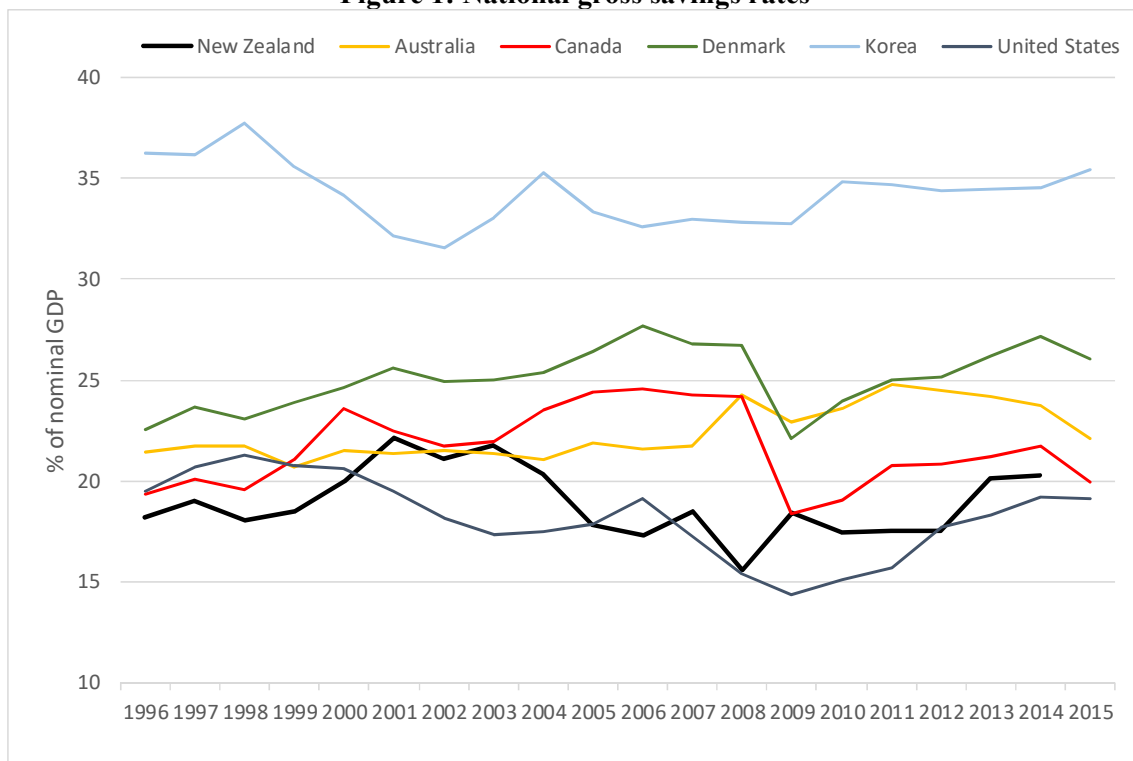
113. It would also be helpful if the Group could highlight options of particular interest for further work. This will allow the Secretariat to begin programming work and develop a view on what can feasibly be progressed in time for the Interim Report, and what will need to be delivered on a longer timeframe.

Appendix A: Savings data

Indicators of saving in New Zealand

1. Savings is the difference between income and consumption. Saving rates can be measured for individuals, the Government ('public' saving), and households and businesses (which are often grouped together as 'private' saving).
 - The saving rate of individuals varies greatly over time, with individuals typically saving the most during their working life (especially towards the end when their incomes are the highest). Later in life, after retirement, individuals will often consume more than their income (dissaving) (Vink 2014).
 - National saving patterns will be more consistent over time, but will vary with macroeconomic conditions and government policy.
2. New Zealand's national saving rate is low relative to many OECD economies. The relatively low national saving rate mainly results from New Zealand's low rate of private saving; public saving has been consistently higher in New Zealand than in most other advanced economies over the past two decades.

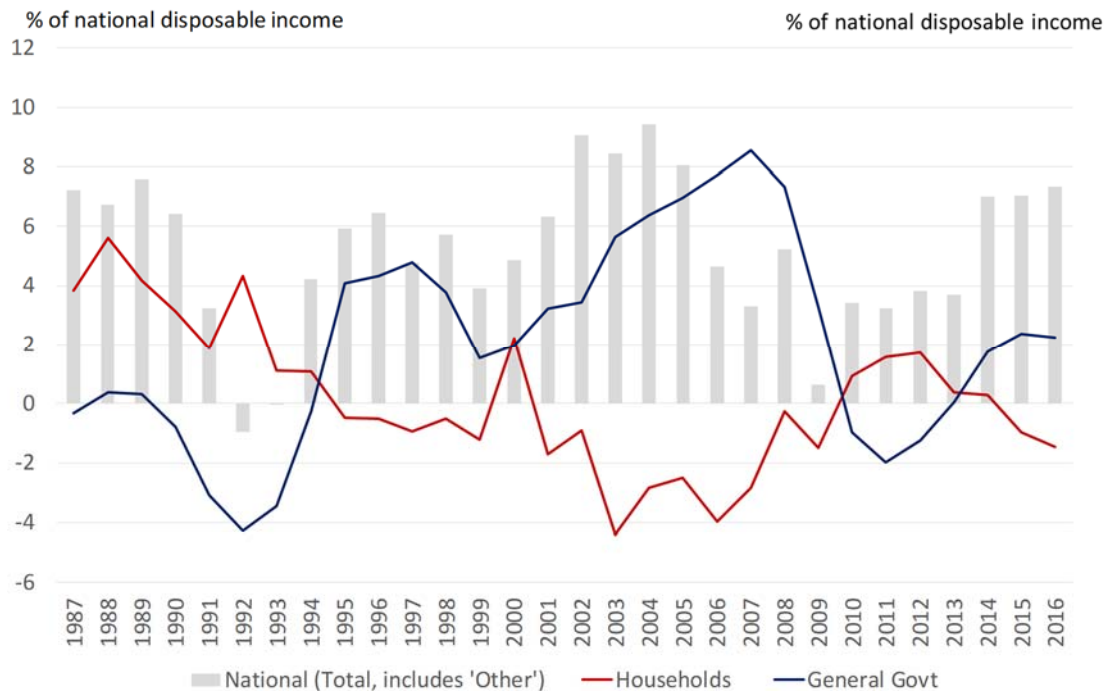
Figure 1: National gross savings rates



Source: OECD.

3. New Zealand's gross national saving rate has fluctuated between 15% and 20% of GDP over the past 40 years. However, there have been significant shifts in the sources of saving, with low public saving and higher private saving in earlier periods, and high public saving and low private saving since the early 1990s.

Figure 2: Government vs Household net saving rate

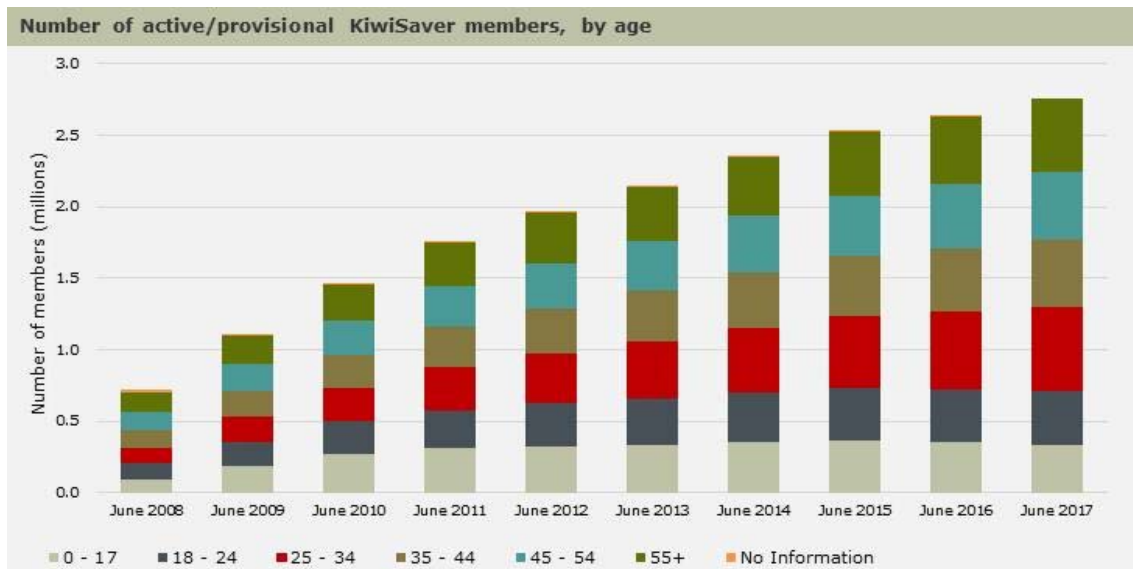
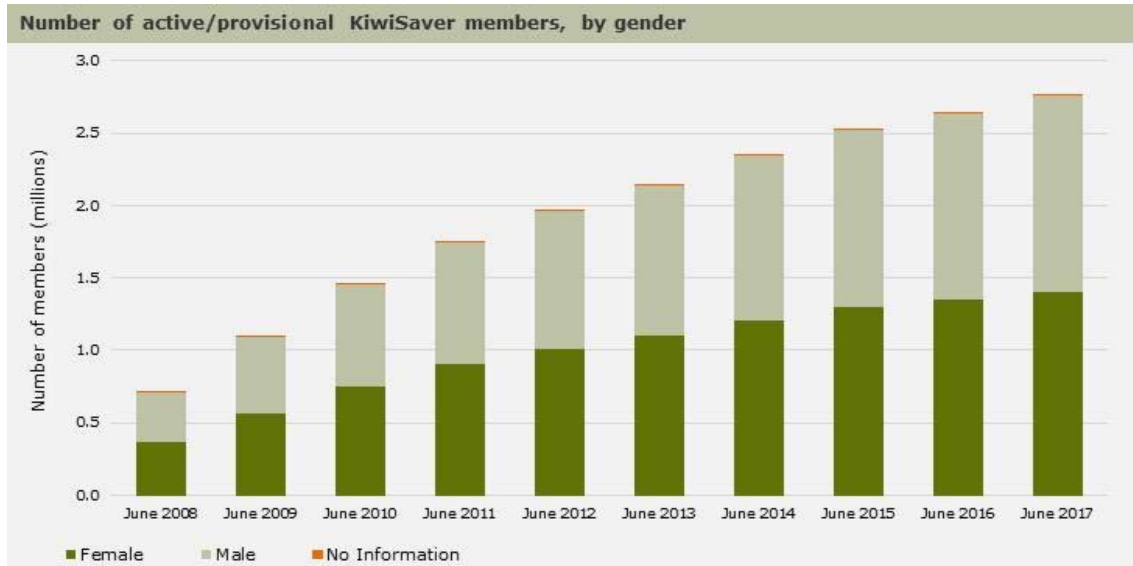


Source: Statistics NZ

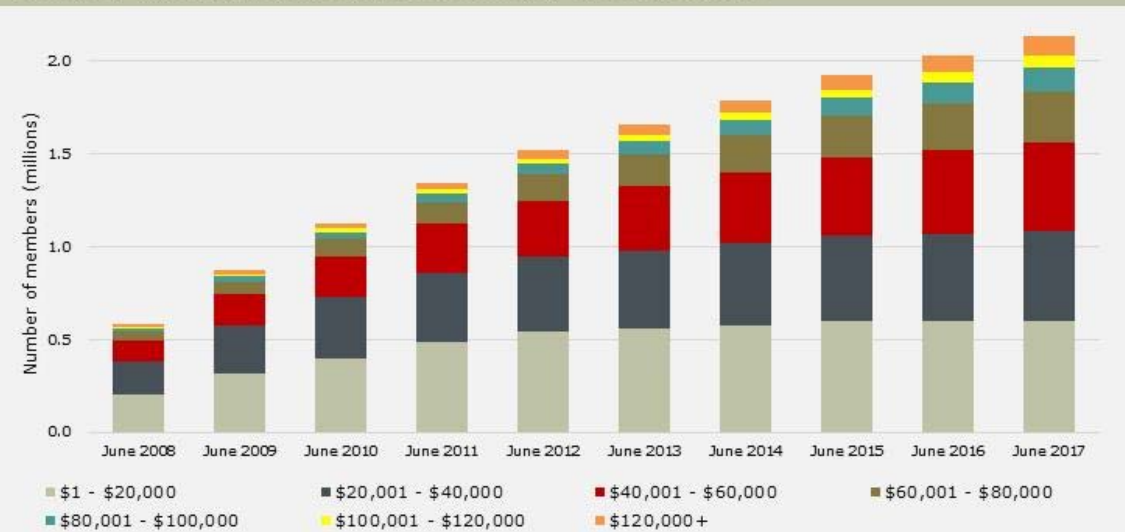
4. The inverse relationship between public and private saving rates is probably driven, at least in part, by common factors. For example, an increase in private consumption (and hence lower national saving) typically results in higher government saving because tax revenues are strong.
5. The reasons for New Zealand's low saving rates are not fully understood. Saving outcomes are likely to reflect the interaction of a range of policy settings and economic signals, rather than any single cause.

Appendix B: KiwiSaver statistics

The source for all of these statistics is Inland Revenue's KiwiSaver website:
<http://www.kiwisaver.govt.nz/statistics/annual/>



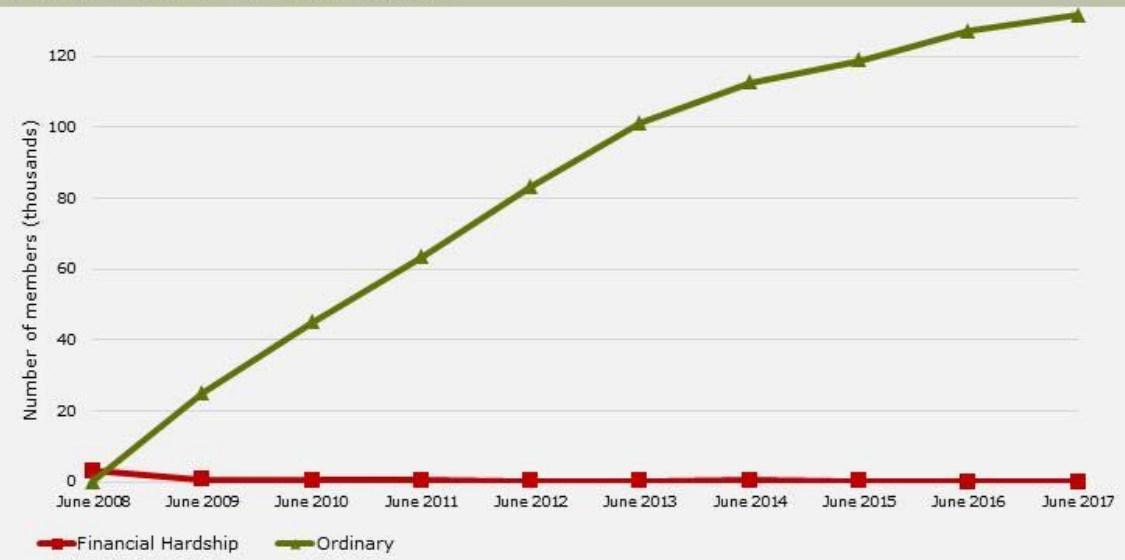
Number of active/provisional KiwiSaver members, by annual income



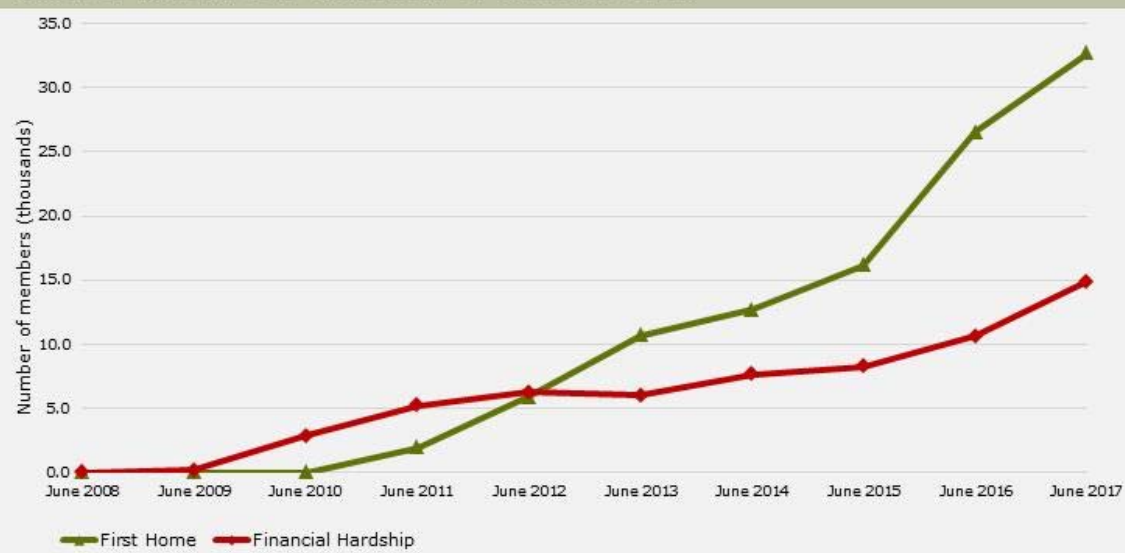
Payments to Scheme Providers, by category



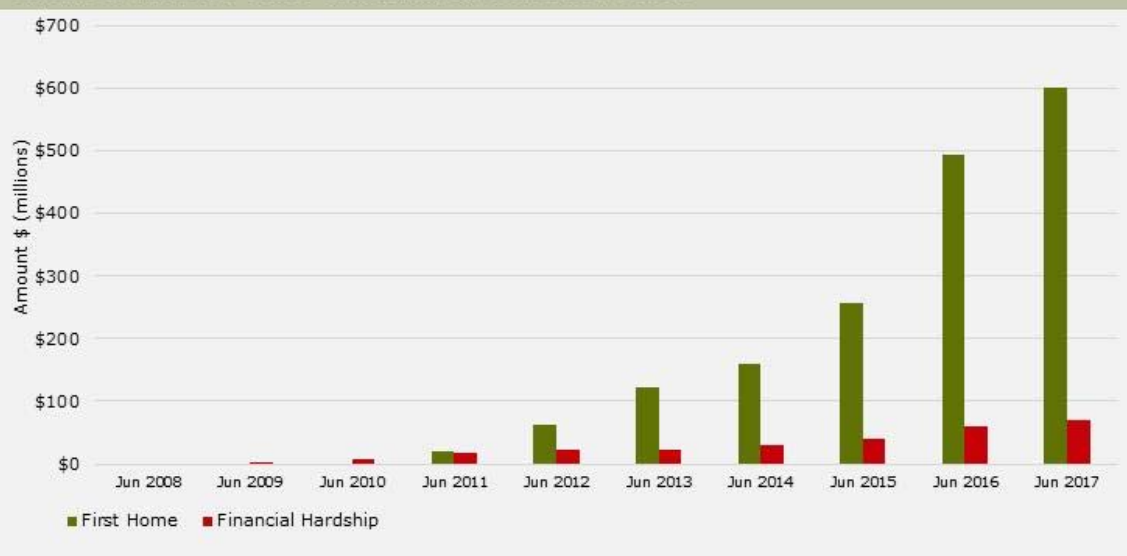
Number of contribution holidays, by type



Number of KiwiSaver Fund Withdrawals, by withdrawal reason



Amount of KiwiSaver Funds Withdrawn, by withdrawal reason



Appendix C: Timeline of changes to KiwiSaver since 2006

Change	Date
KiwiSaver Act 2006 passed	September 2006
Scheme came into force	July 2007
Contribution rates	
Compulsory employer contributions introduced (1%, rising to 4% by 1 April 2011).	April 2008
Minimum employee contribution rate reduced to 2% of gross salary/wages	April 2009
Compulsory employer contribution capped at 2% of employee's gross salary/wages	
Minimum employee and employer contribution rose from 2% to 3%	April 2013
Tax	
Employer tax credit introduced	April 2008
Employer tax credit discontinued	April 2009
Exemption from employer superannuation contribution tax capped at the employer's minimum compulsory contribution rate of 2%	
Tax-free status of employer contributions to KiwiSaver and other complying superannuation funds ended. All employer contributions will be subject to Employer Superannuation Contribution Tax (ESCT) paid at the employee's marginal tax rate.	April 2012
Home purchase	
KiwiSaver first home deposit subsidy can be treated as a social assistance suspensory loan for tax purposes.	April 2010
KiwiSaver withdrawal for first home purchase may include member tax credits.	April 2015
KiwiSaver homestart package replaced KiwiSaver first home deposit subsidy <ul style="list-style-type: none"> • Doubled support for first home buyers purchasing a newly built home; • Increased house price caps • Expanded eligibility for Welcome Home Loans (underwritten by Housing NZ) 	
Homestart scheme: income limits removed for second home buyers (previously Homestart was only available to first home buyers and people who had previously owned property but had low assets and earnings).	July 2016
Homestart scheme: <ul style="list-style-type: none"> • Income caps for first home buyers increased from \$80,000 to \$85,000 for a single person and from \$120,000 to \$130,000 for a couple. • House price caps increased. 	August 2016

Government contributions	
Member tax credit introduced (enhancement announced in Budget 2007)	July 2007
Member tax credit reduced from \$1043 maximum to the current \$521 maximum.	July 2012
\$1,000 tax-free "kick start" government contribution removed	May 2015
Fees	
Annual \$40 member fee subsidy discontinued.	April 2009
Requirements for providers	
New disclosure rules required fund managers to report their performance and returns, fees and costs, assets and portfolio holdings, liquidity and liabilities, and key personnel, along with any conflicts of interest, in a standardised format on their websites.	April 2013
Changes to minimum content requirements for annual statements (including the requirement that fees be stated in dollar terms, rather than as a percentage).	2018
Other	
Total remuneration approach to employer contributions allowed as long as negotiated in good faith. Otherwise, employer contributions had to be paid over and above existing salary and wages.	November 2007
Amendment to the Employment Relations Act amendments made it illegal to treat otherwise comparable KiwiSaver and non KiwiSaver employees differently (effectively banning the total remuneration approach in most work places).	September 2008
Employment Relations Act amendments outlined above repealed, allowing total remuneration approach again.	December 2008
Mortgage diversion option removed (a proportion of employee contributions can be used to make mortgage repayments instead of going towards KiwiSaver). Those already using it could continue to do so.	June 2009
Trans-Tasman portability of retirement savings introduced (KiwiSaver and Australian superannuation funds can be transferred between the two schemes); New Zealanders could no longer withdraw their KiwiSaver funds in cash on the basis of permanent emigration to Australia.	July 2013
KiwiSaver schemes lost their "qualified recognised overseas pension scheme" (QROPS) status.	6 April 2015

Appendix D: Using tax measures to increase private savings

1. There has been substantial theoretical and empirical analysis of tax measures intended to increase private savings.

Theoretical Analysis

2. Individuals have an incentive to save to smooth consumption or defer consumption in order to manage risks of fluctuation of their income. Saving for retirement is a special case of this as people know their income will be lower after they retire.
3. Another benefit of saving is that by saving people will generally be able to consume more over their lifetime than if they consumed all of their current income. For example, assume someone earns \$1,000 in a given year. If they consume it all, they will have \$1,000 of consumption. But if instead they consume 90% of it and save 10%, then they will consume \$900 immediately. If the \$100 earns a 10% return, then the next year they could have \$110 to spend on consumption, so they will have consumed \$1,010 in total. However, this is affected by the tax on the investment income. The higher the tax, the less the return to savings. So lowering the tax rate on investment of savings should increase the incentive to save. This is called the substitution effect and it is the primary rationale behind providing tax incentives for savings.
4. However, there is also the income effect which tends to have the opposite impact and cause some people to reduce savings if the return on savings is higher. If the return on investment of savings is higher, then people feel wealthier and may choose to increase current consumption as well as future consumption. So economists generally say reducing the tax on savings has an ambiguous theoretical impact on the level of private savings (Gravelle 1994).
5. In practice, many countries that have tax incentives for savings limit the maximum contributions in order to manage the fiscal cost and reduce the regressive distributional impact. However, most private savings are made by people with savings that exceed the limits (i.e. people contribute the maximum into the tax-favoured accounts, and they have savings outside of the accounts as well). This means the tax incentives may have no effect on marginal savings decisions, nullifying the substitution effect in many cases, but they still have an income effect. Theoretically, these types of schemes should result in a *reduction* of private savings (Gravelle 1994, OECD 2007).

Empirical Studies

International Studies

6. A number of empirical studies have tried to identify if there is a correlation between saving rates and returns to savings in general, and tax incentives for savings in particular. Many of these are summarised in the OECD's study on tax-preferred savings accounts (OECD 2007, and also Gravelle 1994). Although they have tried a

variety of different methodologies, most studies have identified only weak correlations between returns to savings or tax incentives and amounts saved, including some negative correlations.

7. Assuming that intervention to encourage savings is warranted, a general conclusion regarding the design of a savings scheme is if they are to have any effect, they should be targeted at middle income taxpayers (OECD 2007). Low income taxpayers generally will not save regardless of incentives, and high income taxpayers will save anyway. Middle income taxpayers seem to be a “sweet spot”, but if the benefits of savings contributions are capped at a low level, many high income savers may experience an income effect without a substitution effect, and so reduce savings.
8. The OECD survey of tax preferred accounts show that high income taxpayers by far tend to dominate participation in the schemes, so it appears clear these schemes are distributionally regressive.

New Zealand Studies

9. There have been two major studies of KiwiSaver published as The Treasury working papers since it was established in 2007.
10. KiwiSaver is not an EET scheme. It relies on behavioural economics (new employees are automatically enrolled, so the employee must take action to opt out) and incentives to contribute directly rather than incentives on the taxation of the income. Also, KiwiSaver was more generous initially than it is now, with some of the incentives phased out.
11. The main KiwiSaver incentives have been:
 - Automatic enrolment for new employees
 - A \$1,000 government contribution to the scheme for opening a KiwiSaver account (since phased out)
 - Employer matching contribution, phased in and now at 3% of salary
 - No income tax on the employer matching contribution (since phased out) (for a time KiwiSaver was a very generous tTE scheme), and
 - A government matching contribution of the employee’s first \$1024 of contributions per year, initially matched dollar per dollar, reduced now to \$.50 per dollar.
12. A 2011 working paper used surveys to ask people how much of their KiwiSaver contributions were diversions of existing savings versus new savings (Law, Meehan and Scobie 2004). The response was 36% was new savings. However, most participation (93% of investments) was from people outside of the target group (defined as people who would not otherwise adequately fund their retirement). Additionally, even with that level of self-reported additional savings, the contribution to national savings was estimated to be marginal or maybe negative.

13. A 2014 working paper did not rely on self-reporting, but instead used linked sources of data, the Survey of Family Income and Employment and IRD data to compare net wealth data for KiwiSaver members and non-members (Law and Scobie 2014). The result was no higher accumulation of net wealth for KiwiSaver members compared to non-members. (In fact, there was a slower accumulation of net wealth for KiwiSaver members compared to non-members).

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