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SUBMISION ON TAX REVIEW APRIL 2018

TO THE TAX WORKING GROUP

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SYNOPSIS

EXECUTIVE SUMMARY

This submission considers concepts of wealth and capital adequacy from the perspective of retirees who have saved for retirement under the 1988 TTE tax regime (rationalised as the 'level playing field ') which has resulted in dismal levels of savings for retirees basically dependent on Universal National Superannuation that is pitched on an OECD scale as 'poverty alleviation'.

Concepts of capital adequacy are considered and a model used to examine in particular the effects of currency depreciation even at the 'benign' inflation targets imposed by government policy on the Reserve Bank, over long timeframes such as working lives and retirement.

The submission questions whether it is appropriate to consider retirement savings of TTE regime workers that are clearly inadequate to generate sufficient income for well-being (OECD concept) in retirement, as 'wealth' that should be subject to further tax attack under any newly imposed superstructure of 'wealth' taxes including capital gains taxes.

While Kiwisaver is a nod in the right direction, the government has a responsibility to try harder to encourage and give hope that saving for retirement is a worthwhile goal. Further 'wealth' taxes by whatever name, most certainly will not achieve that.

INTRODUCTION:

1. Tax and fairness are mutually exclusive concepts:

   Every one of us has a position on tax swayed by ideology, income, wealth, age, and circumstances, including economists and academics massaging some favoured economic theory , and no doubt those on the Tax Review Group who will protest their determination to strive for equity or fairness.

   There is nothing 'fair' about tax[1] – it is possible to rationalise all final solutions (which simply represent another view on how to pluck the goose so as to *obtain the largest amount of feathers with the smallest possible amount of hissing*) and in the process, scratch whatever personal itches need soothing.

   Whether the selected "solution" is acceptable is finally an issue for the electorate.

2. Credibility of the Tax Working Group:

   Sir Michael Cullen has taken broad measures to promote the review and encourage the widest possible participation, and has

[1] The IRD discontinued its slogan "we aim to be fair" when this anomaly was clarified by Judge Anthony Willy who argued there is no equity or fairness about a tax which the government ordains shall be levied on the subject. The IRD conceded the point and discontinued the promotion.

taken care in his 2nd March 2018 overview to the NZ IFA conference in Queenstown and the 14th March 2018 Submissions Background Paper to outline a wide ranging framework of imperatives, theory, principles and issues, intended to enhance confidence in the process, add legitimacy to the review, and credibility to the Group's final report, but the process is tainted by his appointment as Chairman of the Group, as The Press editorial 25/11/17 (and other editorials) so succinctly point out.[2]

DECLARATION OF INTEREST:

1. Pre-retirement status:

   With the above allusions to integrity, it is clearly necessary for me to state my position and perspective:

   I held a management position with a NZ-based private manufacturing and importing company for most of my working life and saved over that time to provide a supplementary income

[2] The Christchurch Press editorial in the 25th November 2017 edition of the paper made a number of points such as "Cullen is many things but a politically independent voice on taxation policy he is not…..so the tax working group will no doubt deliver what the Labour-led Government wants….The tax working group will not be seen to be and independent group of experts…it will be seen to be an in-house Labour-led think tank – regardless of who the other appointees are…The chairman is decisive… terms of reference are selective' and so forth. This damning indictment makes a charade of the whole exercise, yet in hope, I offer this submission.

base to augment National Superannuation (clearly necessary to provide any realistic prospect of reasonable comfort and well-being in retirement years).

On that basis I believe the case I make to be representative of a large group of retirees and those who will retire over the next few years.

2. Pre-retirement tax regime:

With the more recent exception of Kiwisaver, and some tax tinkering, for example with PIE entities, saving for retirement since the Labour Government taxation review of 1988 has attracted no tax concessions (in contrast with every other OECD country) with the 'level playing field' rationale promoted as the justification. So for some thirty years, the only tax incentive workers saving for retirement have had to look forward to was the quid pro quo that the accumulated capital (wealth) would be tax exempt in retirement. Until retirement, tax has been paid at marginal rates on the income from which the savings were derived, and tax has been paid and continues to be paid on the income from those savings - including capital gains taxes at income tax rates if taxpayers are deemed to be traders or tax on deemed dividends from certain investments whether such dividends are declared, paid or not, and we pay GST and other taxes (e.g. petrol/road user, and local body taxes that escalate outrageously every year – all with another dollop of GST on top) on much of whatever we spend from those savings, including spending from the 'exempt' tax-paid capital sum.

3. Scope of submission:

   The emphasis and scope of this submission is therefore to review the tax environment for retirement savings (wealth) and the plight of the retirement sector.

ADEQUATE LEVELS OF SAVINGS FOR RETIREMENT:

1. Concepts of capital adequacy:

   It is a fundamental concept of finance that capital should be nurtured. Capital is the goose that lays the golden eggs. In today's parlance it should be 'sustainable'. To draw down on it to meet or help meet living expenses in retirement will diminish it at an increasing rate as its income earning base depletes. Perhaps that is OK if you know how long you are going to live, but otherwise it represents a financial stress not conducive to comfort and well-being, a situation I am sure none of the Tax Working Group would like to contemplate personally. **Sustainability of capital requires that it generate sufficient surplus to meet required (living) expenses while maintaining the purchasing power of the capital sum.**

Reference to statistics of household net worth in NZ makes clear that only a relatively small proportion of households could realistically claim at the date of retirement to have that scale of capital, but it should be a valid parameter in deciding at what level and to what extent the goose might be plucked.

2. Model to test capital adequacy:

   (i) Assumptions and rationale for displayed iteration:

Appendix 1 displays a model that examines capital adequacy in relation to a selection of variables and illustrates important issues impacting on retirees.

The model takes a selected level of investable funds at retirement for a couple who own their own home without debt (a relatively representative situation), and adjusts that sum each year by adding the gross return it achieves to gross income from Universal National Superannuation (less tax on that combined income) and deducts the post-tax scale of living expenses required to meet a standard of comfort and well-being that is related in an internationally relevant way to the pre-retirement income of the couple.

The example shown in appendix 1 depicts savings of $500,000 each available to a couple to start a retirement investment fund of $1m. This sum is statistically high when compared with NZ household wealth data and indeed in relation to the preretirement salaries (and potential to save therefrom) attributed to the couple in the displayed iteration, but serves to reinforce the point very clearly that further taxes on 'wealth' will not be well received by a large number of taxpayers since a considerable amount of it is required to realistically provide for a morally acceptable level of comfort and security in retirement.

The example in the displayed iteration assumes that couple were each earning $60,000pa prior to retirement (a figure around the national average for wages and salaries) and in accordance with conventional financial advice that an income of 70% of preretirement earnings should be sufficient in retirement to provide for a comparable level of comfort and well-being, they set a budget for drawings in the first year of retirement of $70,000, being the tax-paid equivalent of 70% of their preretirement pre-tax salaries. Their budget includes allowance for the essentials – food, clothing, dentist and medical, power and energy costs, fuel and travel costs, rates, property insurance, medical insurance, property and vehicle maintenance, provision for periodic home and property renovation maintenance and periodic vehicle replacement, TV and internet, pets, etc. plus entertainment, holiday costs, and so forth - provided the $70,000 proves sufficient.

Rate of Return selected in the displayed model iteration is based on conventional financial wisdom that people in retirement should have a high proportion of investment in monetary assets for reasons of liquidity and risk, etc. (one such criterion, for example, suggests that the age of the retirees indicates the percentage of their retirement fund that should be held in monetary assets but many retirees feel more secure without the risk of holding equities real estate or other 'risk' assets). An examination of bank term deposits over the last five years shows averages like 3.58%pa[3]. for 6-month terms, 3.75%pa[4]. for 1-year terms, and 4.17%pa.[5] for 2-year terms. The displayed iteration takes the 3.75% rate.

The opening value of Universal Superannuation in the model is the current published pre-tax rate paid to a married couple i.e. $35,443. The sum is CPI inflation adjusted (as a simplified expedient) in subsequent years.

The CPI rate of inflation has run at historic lows over the last 5-year period, but official government policy has required the Reserve Bank to engineer monetary policy so as to generate an inflation rate between 1 and 3%pa.- ideally an average of 2.0%pa. For modelling purposes, this iteration gives the bank credit for succeeding in the years to come.

Assuming the Reserve Bank does succeed in maintaining the average required inflation rate, the displayed iteration adds a margin to that rate to recognise that the basket of outlays facing retirees is subject to more pronounced price rises than the basket

[3] This figure is the an average of the monthly averages in Table B3 RBNZ statistics over the last 5 years to March 2018

[4] Figure derived from historical chart over a 5-year timeframe to March 2018 from Interest.co.nz web-site

[5] Figure derived from historical chart over a 5-year timeframe to march 2018 from interest.co.nz web-site

that comprises the general CPI. This delightful refinement is taken directly from our city council that claims its annual rate increases of several times the inflation rate are caused by this problem[6], and of course, things like rates, energy, insurance, travel, and medical costs that form a comparatively large component of retirees' expenses, typically escalate at rates higher than the CPI. You might want to test that assumption but I am sure you will acknowledge in principle the inconvenient rationale for such an adjustment.

(ii) Results:

The values selected for this iteration of the model result in the capital sum being exhausted within 26 years, so our retirees will be in trouble if they live beyond 90 years of age. You can muck around with changes to the variables (sensitivity testing) but the guts of the problem here is the impact of inflation (even at very low rates) on monetary assets.

[6] Average weekly residential rate increases for Christchurch ratepayers have increased by 39.3% over the last five years in comparison to CPI increases of 5.9% over the same period.

Inflation has not been tamed but the ability of central banks to control it is limited. We have become complacent about inflation in recent years.

In my early working career, a senior manager retired in 1974 after a 40-year lifetime of diligently saving for retirement –including up to 15% of salary into a fixed contribution superannuation scheme after that facility was introduced by the company. The sacrifices made to accumulate this nest-egg made him risk adverse, so his savings including the lump-sum pay-out from the superannuation scheme were invested in bank term-deposits.

In the first five years of his retirement, inflation ran at an average 15%pa. On a compound basis, the effect of that inflation was to halve the buying power of 40 years of his saving. Another five years down the track his retirement dollars (if anything was left of them) would buy only 29% of what they could buy at the time of his retirement because the value of the legal tender of the Crown had been depreciated by that extent over that timeframe. The reality was that the viability of his retirement fund had long been decimated. On the other hand, borrowers at the time of his retirement, including the government, had the value of their debts effectively discounted to 29% of their opening value. Depreciation of the nation's currency is effectively a redistribution of wealth from savers to borrowers without invoking the taxation system. The responsibility for managing the value of the nation's legal currency rests with the government, though its agent the Reserve Bank.

I resolved never to forget that lesson nor underestimate the insidious effects of even modest levels of inflation over longer timeframes. Neither should the Tax Working Group.

Real assets on the other hand, in contrast to monetary assets, usually increase in value (as measured by the official legal tender of the realm) so some further discussion of inflation will continue in the following sections of this submission dealing with capital gains and wealth taxes.

'WEALTH' AND CAPITAL TAXES OF SPECIAL CONCERN FOR RETIREES:

1. Capital Gains Taxes:

   Capital gains are an anathema to those of socialist persuasion who would rather see such gains redistributed to labour, and they present an opportunity for economists and academics to argue that prices on assets with untaxed capital-gain potential will be bid higher than for (productive) assets that generate taxable returns. Nowhere does the capital gains tax debate become more inflamed than with the issue of property, where gains on sale seem to be regarded as fortuitous and not the result of honest endeavour (although the property may well have been purchased with the savings from tax-paid income). Both parties are happy to claim that property booms are stimulated by the absence of capital gains taxes. Both positions are overexposed and overrated. Of course, those bleating about the theory of tax advantage wouldn't utilise that insight for altruistic reasons, but to my knowledge, many retirees prefer property investment to other options simply because it is a tangible investment they feel more familiar with than they do the capital markets where interest returns are too low and equity investment too risky given their comparative lack of expertise in those areas.

The reality is that property booms are basically driven by population growth and demand for property exceeding the available supply on the market at that time, driving prices up.

There is no evidence that in jurisdictions with capital gains tax regimes, property booms are avoided.

There are a lot of administrative and technical difficulties in implementing a capital gains tax regime and to date, thankfully, common sense has prevailed in New Zealand by not introducing such a tax. The 'pros and cons' have been rehearsed in many forums over the years and summarised in what is clearly intended to be a 'definitive' paper published by the Policy Advice Division of the IRD in conjunction with the New Zealand Treasury, in September 2009. This paper affects an impartial stance but the 'cons' are disingenuously tossed off. The issue of the impact of inflation over time on asset prices, for example, which is absolutely at the core of the credibility of a capital gains tax, is accorded half a page in a document of 58 pages:-the difficulties of indexing inflation are noted, some red herrings thrown in, the practical suggestion of some sort of arbitrary exemption offered as a palliative if indeed it was considered necessary to recognise inflation at all.

That report (like the current review) was written during a time of relatively benign inflation, and no doubt there would have been moral outrage at that time to discover a property selling for, say, $2,350,000 that had been purchased only five years earlier for $2,000,000, generating a tax-free realised gain of $350,000 without a stitch of honest work having been done for it.

An examination of the facts might tell another story. Most important, the “benign’ annual inflation rate over that timeframe nevertheless cumulated to 15.6%, so $312,000 of the $350,000 capital ‘gain’ is solely down to a depreciation in the value of the legal tender of the realm - required by law to be used as a measure of value and exchange - and is not a real gain at all. It would be dishonest and morally reprehensible to tax it as though it was. The responsibility for managing the value of the legal tender of the realm as previously noted, rests with the government through its agent the Reserve Bank.

A more wide-ranging and instructive assessment on the merits or otherwise of a capital gains tax is set out in a paper first published in September 2014, written by Judge Anthony Willy and Anthony De Reeper, both eminently qualified to do so, and I have included that paper as part of this submission: refer to Appendix 2.

2. Other 'wealth' taxes:

Wealth (property, retirement savings, etc.) is accumulated by most people over their working life and determines the level of comfort and wellbeing they are able to experience in retirement.

Most OECD countries provide tax incentives to encourage saving for retirement. As noted in the 'Future of Tax' submissions paper issued by the Tax Working Group, taxation on savings for retirement is considered under three headings: contributions, investment earnings, and withdrawals. These components are accorded the symbols 'T' for fully taxed, 't' for concessional tax, 'E' for exempt. Twelve OECD nations have an EEt regime; ten have an EET regime; three have an ETT regime; Australia has a ttE regime and New Zealand has a TTE regime.

Australian retirement policy has as its aims firstly ensuring all Australians have an adequate and secure income in retirement and secondly, encouraging those in the workforce to save for their retirement to have a higher standard of living than that which would be achieved on the state provided age pension alone. The second objective, while having moved away from 'income maintenance' continues to emphasise the importance of ensuring an adequate standard of living in retirement. However, '*it appears from policy tools adopted since 1988 (the absence of tax incentives together with a universal pension) that the primary object pursued in New Zealand is that of poverty alleviation.*[7]

There is no doubt that the Australian policy approach has increased household wealth[8]

New Zealand's retirement savings figures and participation in occupational superannuation are among the lowest in the OECD. Australian retirees can expect to have an income of 70 – 80% of their ***final retirement income,*** *after 40 years of Superannuation Guarantee participation. New Zealand retirees will, assuming National Superannuation continues unchallenged, at a minimum receive 60 – 65% of the* ***average wage.*** *The difference in the standard of living that these amounts will support is significant. Australian retirees will be advantaged with some relationship between their pre-retirement and retirement income, a benefit which retirees in New Zealand will not have. What also cannot be ignored are the economic impacts that are likely to result from*

[7] Extract from a doctoral thesis by Lisa Marriott entitled 'The Politics of Retirement Savings Taxation: A Trans-Tasman Comparison' Victoria University, Wellington, 2008.
[8] ibid

this, such as the impact of reduced consumption on economic growth, and greater reliance on the state in such areas as health and housing'.[9]

So much for the 'level playing field' rationale!

The absence of tax concessions on retirements savings that 25 other OECD have considered good policy, will of course have increased tax available to NZ governments in the short-term to meet other priorities over most of the three decades that New Zealand has taken advantage of this rationale, while deferring a moral dilemma about its responsibility to facilitate what most advanced economies would consider reasonable levels of comfort and dignity for its retired community.

Little wonder, then, that in spite of demographic statistics forecasting an increase in the number of retirees per worker, some politicians retain sufficient embarrassment about that history to insist that the Universal Superannuation entitlement policy not be ambushed, and since its funding has been assisted by the absence of tax concession on the marginal income of all workers but particularly higher paid workers, and its value is

[9] Ibid.

judged to be at 'poverty alleviation' level, it is little wonder there is also a reluctance by those politicians to consider removing its universality. This is particularly pertinent when the dismal statistics of the median level of personal net worth of the 55 to 64 year age group (i.e. those about to start their retirement years) shows a median couple to have a wealth of $556,000 (including the family home)[10]. The 65+ group is higher at $576,000 and since this is a group that would include many who exhaust their savings, it is fair to acknowledge that the median wealth of people age 64 and about to retire at 65 would be considerably higher, but the model results shown in Appendix. 1 suggest that even a starting retirement fund of $1m for a couple (above the value of the family home) may well not be sufficient to support an annual draw-down that provides for a standard of living that relates in any accepted way to the level of income earned prior to retirement.

It should be no surprise then, that those employees who saved under the TTE savings regime who consider the 'exempt' promise to be a social contract that requires now to be honoured, will not expect to see a superstructure of tax caveats (wealth taxes by

[10] Fig.18 page 37 'The Future of Tax' Submission background paper.

whatever name) superimposed by the government on their retirement savings - and rightly so, whatever the definition of 'exempt' is argued to be.

Chairman Cullen raises the spectre of wealth taxes in his Queenstown speech[11] but clearly there is an issue as to whether a fund of savings at retirement that is arguably insufficient to support a standard of living at 70% of pre-retirement income (that includes the universal superannuation entitlement) should be referred to as 'wealth'.

Perhaps the Working Group might agree that wealth is a concept best associated with…..well, rich people.

CONCLUSION:

The heavily prescribed terms of reference to be considered by the Tax Working Group nevertheless leaves a wide range of issues to consider and this submission deals with only a small though exceptionally important part of that.

[11] See for example, 'Thinking outside our current system' last para p.9

What it seeks to do is to ensure the Tax Working Group is reminded of important considerations that relate to retirement savings and assessment of wealth. In particular, it seeks to remind the Group, with examples, of the enormous impact that even benign rates of inflation (including government policy to change the value of the realm's currency) have over long timeframes such as retirement.

It further questions concepts of wealth and the dismal results generated by the 'level playing field' retirement savings regime. Compared with almost every other OECD country where parameters for retirement are considered a priority responsibility of government facilitated through tax policy, in New Zealand, governments since 1988 (with a nod to Kiwisaver and a bit of tax tweaking at the edges) have been satisfied with a policy of poverty alleviation.

It raises concern about any proposal to impose further tax drain on retirement capital including capital gains tax and other wealth taxes by whatever name, where that capital is clearly at risk of being unable to provide for internationally recognised levels of comfort, well- being and dignity in retirement.

Given the limited scope of this submission there is little utility in suggesting how these issues might be addressed in a balanced way except to note the following concluding comment:

The Tax Working Group has effectively been instructed what solutions it is required to rationalise, including a requirement to lift the tax load over a decade from 30% to some 35% of GDP. The National Party on the other hand is proposing to drop it from 30 to 25%. My submission calls for a reordering of government priorities, but within a budget that does not threaten to stuff the goose - say 30% of GDP.

Donald G Foster

April, 2018.