Tax Working Group Public Submissions Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

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

CFFC
Commission for Financial Capability
Building wealthy lives

Hon Sir Michael Cullen
Tax Working Group

By email

30 April 2018

Dear Sir Michael

Re: Future of Tax

Taxes - uninteresting and opaque?

Firstly, I would like to acknowledge the Tax Working Group and the important work underway.

Unprecedented demographic change, combined with the globalization of trade and automation of jobs, is changing the structures of our societies and economies. The time for review is now.

For most people the mechanics of how governments fund transfers and public services is uninteresting and opaque. It falls behind the important stuff such as our marriages, mortgages, children, jobs, health and hobbies. That can make change difficult because it is not understood.

During the 2016 Review of Retirement Income Policies we listened to people in shopping malls, community halls, WINZ offices, churches, maraes and workplaces across New Zealand and heard myths and misunderstandings about who pays for what. People were avoiding conversations with lenders because they believed overdue debts would be written off after 5 years, Superannuitants stated that NZ Super is paid out of a central fund they contributed to across their working lives, and others explained that KiwiSaver accounts had been combined and become something called the Super Fund.

At CFFC we have invested time and resource in simplifying and explaining complex and dry subjects to help people be better equipped and informed to understand some of these issues. We will be rolling out a short and hopefully compelling video series in the second half of 2018 that seeks to present the mechanics of 'tax in and tax out' in a clear and meaningful way.

An ageing population

As with many other OECD countries, New Zealand is undergoing unprecedented demographic change. Our population is ageing due to increased longevity and a lower fertility rate. The change is not a bump or a blip. It is anticipated to be a long term structural shift.

Preparation for an older population needs to be active and intentional, and problematically it needs to start before the changes ahead are apparent to the taxpayer. To understand the need for those changes we are asking people to 'see what they can't see', which brings with it some tensions between generations and between the needs of today and tomorrow.

Health expectancy is increasing alongside life expectancy, meaning we are healthier for longer, extending our working lives and our expectations of what we can do in our 'third age'. As health expectancy increases our view of ageing has evolved, and for many New Zealanders 65 is no longer considered old. As more of us live into our nineties (and beyond) retirement can extend to thirty years or more. It cannot best be described as one period of life but rather several, extending from 'young-old' through to 'old-old'. A CFFC competition to name the three stages of retirement gave us: Discovery, followed by Endeavour and then Reflection. The last phase is where we draw our friends and family close because they hold our history.

As future generations become accustomed to a hundred-year life span, it won't be just the end years that we will do differently, we will make whole-of-life changes. We may dip in and out of education across our lives as we train and retrain for multiple careers. We will live in more houses, juggle blended families and live life with diseases that would once have killed us.

Increased life expectancy is a positive trend, but it raises the question: how will we pay for the additional years we live? What are our expectations of how life will be after 60, 70, 80 and 90 and who will fund it?

How many of those years will be healthy and lived independently, and how many will be spent in aged care? An increase in elderly New Zealanders with higher health needs will put pressure on government funds.

The role of private provision will increase

Present and future governments will need to navigate the choices around reduced spend, increased taxation or higher debt but irrespective of what policy changes occur, the role of private provision will increase and the jeopardy of reaching retirement with little or nothing will be greater. This is often referred to internationally as a 'shift in responsibility' from governments to individuals. In reality it is complicated and funding our retired years is a complex mix of the government, individuals and families. We know from the work completed during the 2016 Review that beliefs about the right balance of responsibility varies across individuals and cultures.

At the risk of sounding bleak, the ageing population and reduced dependency ratios, combined with decreasing rates of home ownership and the need for infrastructure investment, presents us with a perfect storm.

There are many questions on taxation across the system that will be reviewed in response to these issues. The one we are seeking to highlight here is the tax treatment of savings. When we talk about savings we include short term savings and retirement savings (many of which are investments).

'You'd be a mug not to'

In a nutshell and to cut to the chase, if the role of private provision is going to increase, we need to ensure that saving makes sense. At all ages. To put it colloquially, it needs to be considered a 'no-brainer'. Financial advisers need to be able to recommend savings products over and above rental property investments without reservation. Young people need to view it as 'the smart thing to do' or 'you would be a mug not to'. The wisdom of savings needs to be in the social narrative, a social norm. Our conversations at dinner, with friends, at work, need to marvel at the simple logic of it.

Based on our work at CFFC and what we hear from New Zealanders, New Zealand is not there yet. In fact, for many, we seem to be some way off.

While acknowledging the role of low interest rates and therefore low yield as a deterrent, the longer-term issue is the tax treatment of savings. Savings are accompanied by some resentment and a lingering suspicion that 'you are paying several times over', that it is 'an uphill struggle'. This is compounded when a colleague or a friend makes more money on property. By comparison savings doesn't 'feel active' or an ambitious way to grow your money because 'it gets eroded on the way in and eroded again on returns'.

One of the challenges we face in building financial capability and asking people to forego something today to save for tomorrow is our present bias. It is that same present bias that causes resentment towards the TTE nature of KiwiSaver because we upweight the importance of the money paid today and award less importance to the tax exemption on draw down.

People are not always driven by rational and detailed calculations when it comes to money decisions. (It's worth noting that the Tax Working Group members and much of Treasury are likely to be a small and unique sub-set of numerate planners, not necessarily representative of the broader population.) Our spending can be driven by FOMO, fear of ageing, peer pressure, status anxiety, cultural and social norms. The bad news is that our savings and investments are a complex mix of assumptions and beliefs, stories combined with advice and hearsay and the occasional use of a calculator. So our views on what's smart and where we are getting short -changed matter, they impact our decisions.

Recently in the US a 29-year-old outlined to me why she saved into her 401k account. She saw it as a way to 'stash cash and avoid tax' and therefore a way of keeping more of her income. She also kept the income on the income. She wasn't yet thinking about the tax taken on the way out, that was years away. In the meantime, her and her friends viewed it as a 'no-brainer'. It was something for nothing and everyone wants something for nothing.

Extensions of KiwiSaver

One scenario is that a revised tax treatment relates only to KiwiSaver.

If that were the case, it would be worth also considering the idea under construction at CFFC, a form of KiwiSaver Lite which is a short-term emergency savings account that is automated to reach a pre-set amount and then further savings divert into a main KiwiSaver account. The product is designed for those who don't save long term because they don't want to lock up valuable funds they may need to cover an unexpected cost or cover a redundancy or sudden drop in income. Having built up a buffer, they are more likely to save for the long term. The mechanics of how they access the buffer account and under what terms needs work. There would need to be some criteria in place. The automation of the original saving, then switching across to long term savings and switching back if the buffer is raided, delivers the cognitive ease needed to make it work. Clearly offering a tax-free path for income to move into a buffer account would be highly contentious and may be considered prohibitively expensive but in the interests of innovation in the face of sizeable challenges it shouldn't be dismissed too easily. There may be a variation of it that works and 'expensive' is relative. If tax breaks are to be given to low income families that can be done in a number of ways.

Short term savings or the buffer or rainy-day account make a significant difference to financial wellbeing. Unexpected costs or a drop in income are expensive if they cannot be covered by savings. The poverty premium kicks in and people borrow, often using the short term high cost credit provided by payday or second and third tier lenders with interest rates of over 30%. The snowball effect of that kind of credit reduces a family's ability to meet their living costs which leads to more borrowing and a debt spiral.

The recent ANZ report based on the Kempson model confirmed the findings of previous research locally and internationally that our ability to save is less about income and more about our habits. Regular saving even at low income levels increases financial wellbeing.

KiwiSaver providers have been broadly supportive of the idea. We know that half of members don't get the full MTC and half of that group contribute nothing. Our research tells us that's not always an affordability problem, it's also an access problem. While at first glance KiwiSaver Lite might pose a risk of cannibalizing funds, it has the potential to grow them and build savings habits.

Housing and KiwiSaver and retirees

If KiwiSaver had a favourable tax treatment relative to other saving's products, it would also be a tax supported flow through of funds to housing as people withdraw funds for first homes. As with the buffer, while contentious I can think of worse things. There is the argument that it fuels house price increases but it probably has to join the queue behind other contributing factors.

Addressing the housing question is multifaceted including increased supply, cost of credit, employment and wage growth. While prices remain high and LVR's are in place it all also requires a deposit. In the absence of parents who can assist that requires savings and KiwiSaver has a role to play. While it depletes long term savings in the short term, it sets that individual or family up long term.

Declining home ownership is a serious headwind for our retirees of the future. Paying down a mortgage over time is a brutal discipline that sucks money out of our pay-packets and slowly but surely pays down a house. At CFFC we hear from young New Zealanders who, convinced they are 'locked out of the housing market' and renting, spend their remaining disposable income on other things. There is not enough going into savings to compensate for home ownership.

More people will reach retirement as renters at a time when the number of taxpaying workers has reduced relative to retirees. Even with an investment in affordable rental housing stock suitable for retirees, and improved tenancy laws, reaching retirement renting is problematic. In addition to the financial challenge it presents, the prospect of packing up a house and finding a new place to live because a landlord needs to sell, is daunting. As we age we value constancy, we like to know where things are, knowing our neighbours provides connections and a greater feeling of security and community.

New Zealand looks healthy in aggregate but at a household level, not so much

To wrap up, in aggregate New Zealand is looking healthy. Over a trillion dollars of housing assets and only 250 B in (direct) housing debt would suggest 750 B plus in equity, on paper at least. But the CFFC barometer of 11,000 interviews suggests that while around 50% of New Zealanders are doing ok and will make it to retirement with a mortgage free home and savings, the remaining 50% are broken down into varying levels of financial ill-health with 13% (of the total pop) in 'intensive care'. It is the second 50% I am the most concerned about because future governments simply will not have the funds to plug the gap between what people can provide for themselves and what they need.

To repeat the earlier statement, the jeopardy of reaching retirement with little or nothing will be greater.

This is an important moment in time to consider the fundamentals needed to improve the prospects of that 50% and their children.

Yours sincerely

Diane Maxwell
Retirement Commissioner