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Farewell to tax neutrality: the implications for an aging population[1]

Susan St John [2]

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[2] Susan St John Senior Lecturer Economics, Department of Economics, University of Auckland; co-director of the Retirement Policy & Research Centre, Business School, the University of Auckland.

Abstract

In the light of the financial consequences of longevity, the potential for widening of living standards as the population ages, and the perception of an increased burden by the working age population, recent policy changes in New Zealand appear far from ideal.

For nearly twenty years, the retirement system has comprised just a universal state pension, called New Zealand Superannuation, and voluntary unsubsidised private saving. The decision in the late 1980s to promote tax neutrality for saving was critical to cost-effective, adequate, secure, equitable and sustainable income for all in an uncertain future. Strident calls to promote saving for retirement gradually undermined the accord around tax neutrality in the 2000s, leading in 2007 to the reintroduction of tax incentives for certain types of saving, and other types of state intervention in private provision. This paper examines how the twenty year experiment with tax neutrality is coming to an end and the implications this has for the support of an aging population experiencing increased longevity.

Key words: tax neutrality, tax concessions, longevity, risk, retirement saving, annuities, retirement policies.

1. Introduction

New Zealand has often been described as a social laboratory; nowhere more so than in the case of retirement provision. For nearly twenty years, New Zealand adhered to the principle of tax neutrality in private saving for retirement. Voluntary unsubsidised private saving together with a universal state pension, New Zealand Superannuation, appeared to be a well-supported, cost-effective, adequate, secure, and highly equitable approach.

When tax neutrality for saving was first introduced between 1988 and 1990, along with other wide ranging reforms to the tax system, it took many by surprise (St John & Ashton 1993). This paper revisits the nature of the dramatic experiment to abandon conventional tax treatment of such saving. Along with other lurches in retirement provision, it provoked some international bemusement (Johnson, 1999). Was it a successful experiment? What was the purpose? Did it have potential advantages in the light of an ageing population?

In 2007, the nearly twenty-year experiment has been brought to an abrupt end, providing yet another opportunity for scientific observation of international interest. What happens to saving when tax incentives are introduced? While the goals of these recent changes, which will be fully phased in by 2011 (see Box 1), are ostensibly to enhance retirement saving as well as to solve the national saving problem, a bigger question concerns whether they are suitable reforms in the light of the ageing population and increasing longevity.

The twenty-year experiment in New Zealand demonstrates that a comprehensive income tax approach to retirement saving requires that the principle be implemented *comprehensively* so that housing investment, in particular, does not remains tax advantaged More recent experience also shows that opening the door, even just a little to tax breaks leads quickly down the slippery slope towards an expenditure tax treatment for retirement saving and the complexities of a hybrid approach for taxing capital thought to be so damaging in the 1980s in many OECD countries (Hagemann, Jones, & Montador, 1987).

This paper suggests a framework for evaluating the success of the two New Zealand experiments using the economic criteria of equity, efficiency and administrative simplicity; their capacity to meet stated goals; and their suitability in the face of an ageing population.

2. Background: The retirement policy mix 1988-2007

Private Provision

For the period 1988-2007, New Zealand had a uniquely simple system of voluntary, unsubsidised provision for retirement saving to supplement the basic state pension. In theory people were free to save in any appropriate way, whether that be in acquiring equity in housing, repaying debt, investing in businesses or financial assets or even in furthering their own education or that of their children. This section discusses the theoretical underpinnings that gave rise to this tax reform in New Zealand and the context of the difficult transition to tax neutrality.

Between 1990 and 2005, defined contribution employment-based schemes steadily replaced defined benefit schemes as risk was shifted from employers to employees, and overall employee participation in occupational superannuation schemes declined (Table 1).

Table 1: The membership and assets of occupational superannuation schemes (private and public) 1990-2005

Year	% coverage of the labour force	Assets $NZm
1990	22.6%	9,508
2005	14.7%	11,452

Source Report of the Government Actuary for the Year Ended 30 June 2006, accessed at **http://www.isu.govt.nz/**

This process had the extra negative factor of the change in the tax regime described below impacting on private pension and annuity provision. This means fewer new retirees have either an annuity or a private pension to supplement the basic state pension, and far fewer again have pensions that offer full protection from the risk of inflation.

The state pension

The state pension, New Zealand Superannuation (NZS),[3] is a basic income, payable at age 65 to all New Zealanders living in New Zealand who meet the minimal residency requirements of 10 years' residency since the age of 20 years and not less than 5 years' residency since attaining the age of 50. There are offsets for some overseas pensions.

It has several unusual features as a first pillar. It is non-contributory and thus recognises both paid and unpaid contributions to society. Women in particular are well-treated (St John & Gran, 2001). NZS protects against the risk of inflation, the risk of poor investment and the risk of a growth in living standards generally. It is very simple to understand, apply for and administer. There are no inherent disincentives to work or save because the pension is neither income- or asset-tested.

As social insurance, the scheme does not require any guarantee period or return of capital on death, so that it functions as a cost-effective pure, gender neutral, life annuity, providing longevity protection. The general tax base is wider than wage income, as it includes taxes on investment income and on consumption. Thus some of the burden of the PAYG scheme is spread from the working-age population to include tax contributions from the old as well.

The net rate of payment for a couple is legislated to be within the band of 65 percent and 72.5 percent of net Average Ordinary Time Weekly Earnings (AWE). Each year there is an annual adjustment to reflect movements in the Consumer Price Index, unless the floor of 65 percent is breached at which point wage indexation restores the floor (under MMP arrangements the floor is currently agreed at 66%). Table 2 sets out the current rates. The level has been effective in largely preventing poverty for the elderly, so that there is little need for supplementary welfare payments. A comprehensive survey in 2004 showed that those over 65 enjoy the best profile of living standards of any age group (Ministry of Social Development, 2006)

In terms of sustainability, the net cost of paying New Zealanders the NZS is currently 3.6 percent of GDP and expected to increase to around 8 percent of GDP

[3] As set out in Part 1 of the New Zealand Superannuation and Retirement Income Act 2001

by 2051.[4] While the fiscal pressures of an ageing population are real, the size of the problem seems modest in comparison with other OECD countries many of which already face much higher pension/GDP ratios and which provide subsidies in the form of tax expenditures for private provision that are not reflected in pension/GDP ratios.[5]

Table 2 New Zealand Superannuation Rates 1 April 2007

Pension type	% couple rate	Net weekly at primary tax	Gross weekly
Single Living alone	65	$277	$336
Single sharing	60	$256	$310
Couple, each person	50	$213	$256

Source: WINZ http://www.workandincome.govt.nz/

Was this a sensible arrangement for retirement policies?

One outcome has been less reliance on superannuation assets in household net worth. In contrast to Australia, New Zealand has pension funds/GDP of only 11 percent. The OECD weighted average is 87.6 percent, while Australia has 58 percent. However, there are 16 OECD countries whose ratios are lower then New Zealand, including high growth countries such as Norway and Korea. Iceland's percentage is 123.2%, yet its Current Account Deficit has been of the order of 10% of GDP, showing that a high pension assets/GDP is no guarantor of solving the national savings problem.

It may be argued that the lack of tax incentives has justified the relatively generous tax-funded universal New Zealand Superannuation. The universal pension together with the tax-neutral regime for private financial saving has cost advantages, favourable equity implications, and enjoys relative simplicity. Each person in receipt of the pension is taxed in their own right as an individual on total gross income including the gross pension, so that with New Zealand's mildly progressive income tax rates, the top income pensioner effectively receives a pension worth approximately 72 percent of the pension of the lowest income pensioner. If there is

[4] See http://www.retirement.org.nz/

[5] Ireland for example has a regime of tax expenditure for retirement incomes that if counted as part of the state's pension costs for 2000/1 would increase the pension/GDP ratio by 1.7 percentage points, (Hughes, 2005).Also see Yoo et al (2004) for a comparison of the costs in OECD countries.

a deficiency, it is in the lack of assistance to enable middle income people to achieve an adequate income replacement rate that offers them protection from the longevity risk including the risk of increasing average longevity (St John, 2006b).

3. Comprehensive Income Tax

In the 1980s, special tax advantages in the tax system were supposed to achieve all kinds of objectives. Sometimes interventions were based on desirable aims, such as to encourage savings for retirement, increase business investment and exports, or to expand the coverage of private health insurance. Often however, tax privileges resulted from the activities of pressure groups. The process narrowed the base on which taxes could be levied which implied a higher required rate on the smaller base. In turn, higher tax rates increased the incentive to evade and avoid or otherwise find loopholes, and for interest groups to lobby for further protection.

In this environment the tax system (as in other OECD countries) was widely perceived to be complex and administratively cumbersome, to have high efficiency costs and to be inequitable. Many people were able to avoid their fair share of the tax burden, while others resorted to illegal actions to evade theirs (Hagemann, Jones, & Montador, 1987; McCaw Committee, 1982; McLeod, 2001b). Dramatic tax reforms to address these problems were announced in the late 1980s as outlined below.

Tax reform 1987-1990[6]

In December 1987, the Minister of Finance, Roger Douglas, announced wide tax reforms including a low flat rate of personal tax aligned with the company rate. Tax subsidies for saving were to be removed, imputation credits introduced for dividend income and the tax base broadened by the closure of loopholes of all kinds. The rationale was largely economic and there did not appear to be any particular concerns about the effects on retirement incomes. The intent was to ‘level the playing field’ so as to remove, or minimise, the economic cost of distortions that arose from treating different income streams differently. Douglas argued that tax concessions had allowed savings to flow to favoured financial institutions that had not necessarily invested the money in the best ways possible for growth. He

[6] This section draws on (St John S, 2007)

claimed that a low, flat tax rate was necessary to encourage saving, reward work and minimise avenues for income splitting. The intent was clearly to underpin the other economic reforms of the 1980s in New Zealand that had emphasised the role of the free market in the allocation of scarce resources (Easton, 1997a; , 1997b).

A consultative document reviewed the arguments for comprehensive income tax underlying these reforms, particularly as they affected saving, and considered the merits of an expenditure tax treatment of saving. A direct expenditure tax (DET) has theoretical advantages by not imposing a penalty on saving. All increases to savings are deducted and reductions to savings are added to income to give the DET base (Y-S). It was noted that if savings are positive the DET base is smaller than the income base (Y), necessitating higher rates of tax to achieve the same revenue.[7] In turn, higher rates of tax carry higher disincentives to work and save (Douglas, 1988).

A comprehensive income tax rather than a DET was chosen in light of the difficulties of the transition to DET and the lack of DET in the rest of the world (Douglas, 1988, p. 38).

The equity argument

While flat tax itself is not progressive, improving fairness was another strong rationale for the changes. Tax avoidance and tax exemptions had rendered the old tax system of the 1980s far less progressive than the stepped up marginal schedule appeared:

> *[Flat tax] in conjunction with enhanced income support for low income people in the workforce and the abolition of tax concessions that favour the better-off will also make our tax-benefit system more truly progressive (Douglas,1987).*

Higher income people under flat tax would pay more tax, first because they would no longer benefit from a lower rate on the first part of their income and second because of the removal of the major tax concessions and the closing of tax loopholes.

[7] Alternatively it could be argued that if all bequests are counted as expenditure, the DET is equivalent to a Lifetime Income Tax, in turn, superior to an annual income tax.

The Minister of Finance claimed that the concessions on life insurance and superannuation schemes alone were worth 2.5 percentage points on basic tax rates, or about 1.2 percent of GDP (Douglas, 1987).The rate of the flat tax was not announced in the tax package although later it was revealed that a 23 percent rate was contemplated and would have been accompanied by the cuts to government expenditure by the introduction of user pays for state provision of many kinds.

Saving for retirement

As in many other countries, tax-subsidised private pensions were originally the preserve of employees in large companies and the government sector. The chief beneficiaries in the private sector were characteristically white, male, high-income, long-term employees. In the state sector, a defined benefit scheme (The Government Superannuation Fund) with its inflation-adjusted pensions enjoyed wide coverage in the 1960s and 1970s.

Prior to the tax reforms of the late 1980s, pension schemes had received preferential tax treatment on both employee and employer contributions and on fund earnings. While pensions were taxed as income, up to 25 percent of pension savings in these schemes could be taken as a tax-free lump sum. Pure lump-sum schemes were also tax subsidised, but less generously since the early 1980s.[8]

Under the tax regime introduced in 1987 and applying until 2007, contributions to savings plans were made out of after-tax income so that contributions may be described as ‘taxed’ (T). Income accruing as fund earnings is taxed (T) at the company rate of 33%, while withdrawals from the fund are exempt from tax (E). The traditional expenditure tax treatment involves an Exempt/Exempt/Taxed (EET) regime while the New Zealand income tax treatment of savings involved a Taxed/Taxed/Exempt (TTE) regime.

By 1st April 1990, the new tax regime was fully operational with the Income Tax Amendment Act 1989 and the Superannuation Schemes Act 1989 providing the necessary taxation and supervisory legislation. Schemes became ‘registered’ by the Government Actuary rather than ‘approved’ as previously for tax concession purposes. The regime emphasised the responsibilities of trustees and applied

[8] For a discussion of the pre-reform tax treatment see St John & Ashton (1993, pp. 23-24).

equally to schemes sponsored by employers and those offered to the public via retail schemes.

From this point New Zealand's tax regime for retirement income saving no longer distinguished between pension and lump-sum schemes. A tax neutral approach precludes the right to regulate retirement saving for social purposes, for example, to legislate for the purchase of an annuity from the retiree's lump-sum savings. Thus with no tax concessions, no restrictions could apply as to how scheme benefits were to be received, although the trust deed could specify such details. Also there was no restriction on the amount of the employer's contribution. Rather than tight regulation, the disclosure requirements of the Securities Amendment Act 1996 and the Investment Advisors (Disclosure) Act 1996, were imposed, consistent with free market reforms that assume full information (Periodic Report Group, 1997, p. 191).

These far-reaching reforms made New Zealand the only OECD country, except perhaps Mexico, not to treat private savings for retirement differently from other forms of saving (Yoo & de Serres, 2004). While the intent of removing privileges from certain classes of saving was to encourage investment in more productive areas, the idea of tax neutrality in the treatment of saving was difficult to realise in practice as discussed below. The transition period was also difficult and involved a considerable cost to government revenue as described in Appendix 1.

Backtracking from flat tax

The tax regime adopted by New Zealand (TTE) for retirement saving works best if the tax rate system is fairly flat. That way, the contributions tax rate applied to employer contributions, the tax rate on fund earnings (the company rate) and the marginal tax rate of contributors will be similar. No end of year reconciliation is required nor is the imputation of income from tax-paid funds. However Douglas's radical and unexpected announcement in late 1987 caused much political bickering within the government, and the full package was never implemented the way it was conceived. The flat tax proposal was abandoned and instead, two statutory rates with a low income rebate were introduced giving three effective marginal tax rates (see Table 3).

Table 3 New Zealand Tax Schedule for Personal Income Tax

Bracket	Effective marginal tax rate 1988-1996	Effective marginal tax rate 1997-2000	Effective marginal tax rate 2001-
$0-9500	15*	15*	15*
$9501-30895	28	21	21
$30,895-38,000	33	21	21
$38,001-60,000	33	33	33
$60,000+	33	33	39

* Includes the low income earner's rebate

Nevertheless until the mid-1990s, the tax scale was fairly flat and the tax regime of TTE worked tolerably well. But once the second tax band was lowered from1997/8 to 21 percent and extended, there were big disparities between taxes paid in superannuation funds and the marginal rates actually faced by low and middle income earners. Employer fund contributions (under a withholding tax, the SSCWT[9]) and earnings in the fund were taxed at 33 percent making the regime tax penal for anyone on only a 21 percent tax rate.

Perversely however, significant tax advantages from saving in employer-sponsored schemes for high-income superannuation fund members were introduced when the top tax rate was lifted to 39 percent in 2000/1 (see Table 3). Nevertheless the ‘salary sacrifice’ option for high-income earners to exploit these advantages by reducing their gross income in exchange for employer contributions was not widespread. The Taxation (FBT, SSCWT and Remedial Matters) Act 2000 imposed a fund withdrawal tax (FWT) to reduce the ability of high-income people to use superannuation vehicles as a short term means of avoiding the 39 percent rate.

Despite the best endeavour of the Taxation of Life Insurance and Superannuation working party, TOLIS (1997), to resolve the marginal tax rate issues, there were no easy answers in determining a suitable proxy rate for either employer contributions, or for the taxation of fund earnings. In 2004 a partial solution was introduced so that employers could use the marginal tax rate of the employee (15%, 21%, 33%) for the tax on employer contributions. The option was voluntary and did not address the over-taxation of fund earnings for employees on tax rates of less than 33

[9] Specified Superannuation Contribution Withholding Tax

percent. It was not until 2007 that the issue was finally addressed in the raft of Dramatic changes described below. In another tilt to the playing field, superannuation funds paid tax on capital gains where such funds are deemed to be trading assets rather than investing 'passively'. Individuals who invest on their own account are usually exempt from such a tax. In 2004, a report commissioned by government to determine an acceptable tax treatment recommended the removal of capital gains tax on non-passive managed funds to address this anomaly (Stobo, 2004). The government included this as part of the overall tax changes for investment vehicles to take effect in 2007 as discussed further below.

The 'level playing field'?

> *After the radical reforms undertaken in the 1980s, the NZ tax system has long been regarded as one of the most efficient within the OECD (OECD, 2007).*

While the OECD has consistently endorsed the New Zealand approach to tax reform, in recent years it has criticised the lack of a capital gains tax. Housing, especially, has remained tax favoured. The New Zealand experience shows that the pursuit of tax neutrality in the treatment of savings is not only difficult to achieve in the absence of flat tax, but is also illusory when other savings vehicles such as housing remain tax favoured. There are measurement issues of 'missing assets' but New Zealanders appear to have proportionately more of their savings tied up in housing than in other countries. Since the tax changes in 1990, the value of housing assets has increased markedly relative to net financial assets (Bollard, 2004).

Significant biases towards investment in housing arise from the non-taxation of the imputed rent in owner-occupied dwellings, the tax-free nature of most capital gains by individuals deemed not to be traders, and the tax regime for rental income that allows deductibility of full nominal mortgage interest and other write-offs such as depreciation[10], while capital gains are largely untaxed. Despite the best endeavours of the 2001 Tax Review (McLeod, 2001a, 2001b) that examined the case for taxing imputed rent and discussed advantages that might flow from a tax on net housing equity the Risk-Free Return Method (RFRM), there has been little political interest

[10] Recovered on resale

in levelling the playing field for housing. In 2007 the OECD suggested that New Zealand needed a new strategic direction:

> *There are at least two broad options: adapting the system within a comprehensive income approach or moving to a dual income tax system, in which capital income is taxed at a lower rate than earned income. These options should be evaluated against the criteria of efficiency, equity, simplicity and transition costs within an inter-temporal economy-wide framework. In any case, weak points within the current tax bases should be re-examined, recognising the merits of a "broad-base, low-rate" approach. Any actions taken in the near-term should avoid adding to domestic demand and be consistent with the long-term direction eventually adopted. Reforms should also not put long-term fiscal sustainability at risk: a higher GST rate could help achieve this objective (OECD, 2007).*

Re-introduction of tax incentives?

Numerous retirement policy review taskforces during the 1990s and 2000s supported the voluntary, tax unsubsidised retirement savings regime in New Zealand.[11] The 2001 Tax Review, the first since 1982, also recommended that tax incentives for saving should not be introduced (McLeod 2001). Nevertheless, anxiety persisted about whether New Zealanders save enough, either individually for retirement, or as a nation. New Zealand is heavily reliant on foreign savings with a persistently large current account deficit and accumulated overseas debt.[12] While the national saving problem involves more than just the household sector, New Zealanders' poor personal savings habits came under increasingly scrutiny.[13]

A 2002 net worth survey showed that mean assets for individuals over 65 was only $186,000 (Statistics New Zealand, (2002). With a median of only $113,000, the distribution is highly skewed, and on the surface New Zealanders appeared less well prepared for retirement than their counterparts elsewhere. However Treasury research argued that given the substantial wealth implied by the New Zealand Superannuation pension itself, *on average*, people were saving enough for optimal income smoothing (Scobie, Gibson, & Le, 2004). A later paper refined this

[11] Periodic Report Group (Periodic Report Group, 1997, 2003; Report of The Taskforce on Private Provision for Retirement, 1992).

[12] The current account deficit for the year ended March 2007 was $13.9 billion (8.5 percent of GDP), New Zealand's net international liability position at 31 March 2007 was $145.0 billion, 85% GDP (Statistics NZ, http://www.stats.govt.nz/default.htm

[13] See, for example, Skilling, (2005).

research, but still found little evidence of widespread undersaving, (Le, Scobie, & Gibson, 2007).

In 2001 the Government reviewed the basis on which private savings are taxed or otherwise encouraged within the parameters that:

> *...any incentives would have to meet the requirements that they were fiscally affordable, did not crowd out other government spending and added to overall savings levels, rather than merely shifting the form of savings' (Cullen, 2001).*

A range of complex suggestions was made. The Minister of Finance, Dr Cullen initially proposed a 'parallel option' to the current taxation regime for superannuation, under which contributions continue to be paid from taxed income, investment earnings are tax free, and benefits are partially taxed. This was referred to as TEt (or Taxed, Exempt, and partially taxed) compared to the current TTE. There was to be a limit on the annual contributions and a limit on the amount that could accumulate within the scheme. The scheme would be required to lock in the benefits for a period or until a specified age is attained and to provide a portion as a pension.

There were concerns in the industry that compliance would be difficult and would require new schemes distinct from existing schemes. As noted above, a major, concurrent review of the tax system examined the case for tax incentives in depth, and recommended that they not be reintroduced (McLeod,2001b).

A report of officials noted that it was difficult to ascertain the exact goals the government wanted to achieve and that none of the options examined (tTE,TET,Tet) was able to meet all the objectives the government sought, (The New Zealand Treasury, 2001). As in the past when tax incentives were considered, it has been difficult not to conclude that the advantages are likely to go to the people who least need an incentive to save, and that overall savings are unlikely to be increased. The skewed distribution of financial saving towards the higher income end persuaded the committee that tax concessions would be both highly regressive and ineffective.

On balance the Treasury report indicated that if a tax incentive were to be reintroduced then a very limited one (with a cap on contributions of $1000-2000) with an upfront incentive was best:

> *Officials do not suggest that an upfront incentive is likely to make savings more realistic for many low to middle-income households. Such an incentive scheme is simpler to promote and explain however, which may increase its utilization amongst households with little to no current savings. While no incentive may be likely to appreciably increase savings, Officials prefer a tTE scheme to a TET or TEt incentive because it would result in fewer harmful distortions to investment patterns, it would have a lower fiscal cost and it would create less room for avoidance and tax planning behaviour (The New Zealand Treasury, 2001, p. 1).*

In other words, Treasury was not enamoured of the idea of reintroducing tax incentives at all. The government continued to discuss saving incentives, but in January 2002 it decided that tax incentives for private saving would not proceed in the current year after all, citing reasons of fiscal tightness.

In February 2002, the National opposition announced its policy to reintroduce tax incentives. The shape of these would appear to reflect the minimal tTE model proposed by Treasury. But in the May Budget, the Labour government endorsed the status quo of no upfront tax incentives, and later went on to win the election.

> *The government is not considering upfront tax incentives. These are likely to have to be very large - with fiscal costs running to many hundreds of millions of dollars a year - before they have any desirable effect on overall savings. Their abolition in the mid-1980s represented sensible tax policy on both equity and efficiency grounds (Minister of Finance, 2002).*

4. The un-levelling of the level playing field

While it appeared that tax concessions were not on the agenda, by 2003 there were calls for a more proactive state intervention in private savings. The Minister of Finance signalled his dissatisfaction with the ‘total remuneration’ packages that had become more common:

> *I do detect a change of attitude. The 1990s were a high watermark for individualism. A part of that was the rise of the idea of the total remuneration package. Employers recruited on a set fee for service and the worker did what he or she decided they wanted to with the wage. While this is fine in theory, there is a growing body of research*

> *that suggests that the hands-off approach works against some of that total remuneration going into long term saving (Cullen, 2003).*

A new ‘State Sector Retirement Savings Scheme’ commenced in 2004 as a portable defined contribution scheme in which the government as employer matched contributions up to an after-tax 3 percent of salary. A wide choice of investment styles, risk/return options and fee structures was offered from a limited list of providers. The government appeared to consider the new scheme as a role model for private sector employees, but how private sector employers could match a subsidy sourced from the general taxpayer was not clear, and employment-based superannuation schemes continued to decline. In mid 2004 the government appointed a working group to report on the design of a generic workplace savings product (Savings Product Working Group, 2004). There were many difficult issues, such as whether there should be automatic enrolment, how part-time and casual workers might be included, rules around early withdrawal, management and approval of schemes and how all this could be achieved in a tax neutral environment.

While the working group assumed that the government would not introduce any tax incentives for the generic product, it was clear that ‘sweeteners’ as they are called in the report were likely to be necessary. Critics such as the Association of Superannuation Funds of New Zealand argued that any such incentives would undermine existing employment-based schemes and would be a costly mistake, both ineffective in substantially increasing saving and cumbersome to administer.

5. KiwiSaver Mark 1

The predicted economic slowdown of the mid-2000s failed to materialise as the sustained housing boom, fed by the willingness of banks to borrow abroad, kept confidence high. A worrying scenario of a tight monetary policy to contain the economic boom leading to high interests and high exchange rates exacerbating the current account deficit, and overseas debt was being played out, leading to evermore strident calls for households to save more.

The 2005 budget announced that a work-based scheme KiwiSaver, requiring a 4% or 8% employee contribution, would be introduced in 2007. The key premise of

KiwiSaver (Mark1) was that people are more likely to commit to saving regularly if they are automatically enrolled rather than deciding whether to 'opt in' (see for discussion of this feature St John & Littlewood, 2006).

In KiwiSaver (Mark 1), the only government subsidies were a flat $1,000 'sweetener', and an annual fees subsidy of $40. These subsidies eschewed the problems of the regressivity of tax concessions thus enabling the TTE tax regime to remain unaffected. The legislation was subject to the normal submissions through the select committee process but when the bill was finally reported back, some key features of KiwiSaver had been changed. Of particular significance, it had been decided that employer contributions that matched employee contributions up to 4 percent of gross income would be exempt from the withholding tax (SSCWT). The legislative effect for this was not in the KiwiSaver Act 2006 itself but in the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill, going through the House at the same time, and appeared to be the result of compromise in a Mixed Member Proportional (MMP) parliamentary system.

Cabinet papers released under the Official Information Act show alarm bells were ringing:

> *Officials do not recommend exempting employer contributions to KiwiSaver from SSCWT. On the one hand, this would create benefits for an employee to sacrifice his/her salary or wages in exchange for an employee contribution, higher amounts could be saved and compliance costs for employers would be reduced. On the other hand, this would create a tax distortion in favour of employer contributions to KiwiSaver relative to existing schemes, could have a fiscal cost of up to $330 million, could lead to pressure to exempt all employer contributions, and would lead to no tax on employer contributions under the taxed/taxed/exempt (T/T/E) model (Inland Revenue Department, 2006).*

Concerns were echoed by the OECD:

> *Over the years, there has been a move toward granting more exceptions, constituting a break with the "broad base, low rate" policy endorsed in the 2001 Tax Review (McLeod et al., 2001). Non-neutral tax policies that are unevenly applied to various activities encourage New Zealanders to devote resources to less-taxed activities, rather than to those that generate the greatest economic returns …The tax exemption for employer contributions to registered superannuation schemes is a further departure from the*

comprehensive income approach. In the latter system, any employer contribution to a superannuation fund for the benefit of an employee is liable for tax. The exemption was introduced in the context of KiwiSaver to incite employers to invest in superannuation schemes and give them more choice in the way they remunerate their workers. While this might seem attractive by providing some tax advantages to savings, it nonetheless introduces non-neutrality by only favouring one particular type of savings and can induce switching between savings instruments. Over the life cycle, it can be seen as a tax exemption for employees and erode the tax base (Mourougane, 2007).

Exactly as would be predicted, the employer contribution tax break was the thin end of the wedge. The Association of Superannuation Funds of New Zealand argued that there was a serious risk that many existing superannuation schemes would be wound up, undermining the government's goal of increased saving. Thus almost immediately, a further Supplementary Order paper extended similar tax privileges to all employer superannuation schemes that met lock-in provisions. Cabinet papers acknowledged that the extension to other schemes had little to do with the goal of increasing new saving as it essentially subsidised existing saving.

While there appeared to be little, or no, in depth analysis of the regressivity of the reintroduction of tax incentives, the IRD noted that the higher the employee's salary the higher the benefit, and that:

'…the benefit of the $1000 government contribution to KiwiSaver and the fee subsidy pale over time in comparison with the benefit of the tax exemption (Inland Revenue Department, 2006).

Officials were clearly concerned about their potential cost:

The fiscal risks of a wide extension of the SSCWT exemption and other KiwiSaver incentive are very considerable (Inland Revenue Department, 2006).

A housing subsidy had been made available through KiwiSaver for first home buyers (see Box 1), but in addition a mortgage diversion scheme was also introduced late in the piece despite select committee scrutiny that had rejected it. Under this scheme, after one year, up to half of the employee's own KiwiSaver contributions can be directed to mortgage repayment. Given that a key concern that promoted KiwiSaver in the first place was overinvestment in housing, providing mortgage repayments from what was intended to be retirement savings appeared somewhat counterintuitive (OECD, 2007).

The introduction of KiwiSaver was timed to coincide with the reform of the taxation of collective investment vehicles including superannuation schemes. The intent was to retain the tax paid nature of superannuation schemes, but to align the proxy tax rate more closely with the tax rate of the individual investor. Unfortunately as the previous TOLIS exercise showed, there is no easy way to do this accurately without imputation and an end of year reconciliation. The final legislation reflected this dilemma- erring on the side of generosity to the individual and thus opening the gates to avoidance activity.

Superannuation schemes (and other collective vehicles) can, from 1 October 2007, become ‘Portfolio Investment Entities’ (PIEs), where a member who earns under $38,000 from other sources but whose total income including PIE income is under $60,000 can opt for a 19.5 percent rate.[14] In effect this could mean $60,000 of PIE income can be taxed at only 19.5 percent. If the member earns more than $38,000 in taxable pay, or more than a combined $60,000 including the PIE income, the whole of the PIE income is taxed at the alternative higher PIE rate, set at 33 percent, (30% from 1 April 2008). Thus there are not inconsiderable rewards for restructuring the way in which earned income is received.

The avenues for avoidance of tax have other ramifications which are likely to emerge over time. For example, the ability and incentive for employees to salary sacrifice into superannuation schemes generally, together with the lack of full accounting for PIE income, means that eligibility for income-tested supplements may be enhanced. For instance, an extensive programme of Families Tax Credits now applies a long way up the income distribution,[15] providing a further 20% return on a salary sacrifice arrangements. A lower repayment of student loans which are now interest free gains another 10%.

[14] KiwiSaver schemes as a whole do not have to be PIEs but the government appointed “default schemes” must be PIEs.

[15] see St John (2006a)

Box 1 KiwiSaver (as at July 2007)

- KiwiSaver is a voluntary, work-based savings scheme administered by the Inland Revenue Department using the existing PAYE (pay as you earn) tax system. Employees are automatically enrolled into KiwiSaver when they start a new job. They have the second to eighth week of employment to "opt-out" and must advise their employer of their decision.
- Scheme enrolment is not automatic for workers under 18, or those employed less than 4 weeks, or for existing employees. They may join if they wish. Self employed people and beneficiaries can join but make payments directly to the scheme provider.
- Employees' contributions start from the first pay day with an employer. Deductions from wages are at a rate of 4 percent of gross salary, unless the individual opts for the higher rate of 8 percent. Matching contributions up to 4 percent by the employer are tax-free.
- There is a matching tax subsidy of $20 a week for employees' contributions and a compulsory 4% contribution from employers to be phased in over four years from 2008, matched with a $20 a week tax subsidy paid to the employer.
- Funds are held by the Inland Revenue for an initial three month period during which the employee can seek financial advice and select a fund provider. Savers will be able to select their own fund and can change provider, but can only have one provider at any time. Those who do not specify a fund will be randomly allocated to a default provider.
- Savings are "locked in" until the age of eligibility for NZ Superannuation, currently 65, except in cases of: financial hardship, permanent emigration, serious illness or after a minimum of three years or to contribute toward a deposit on a first home. However, after a minimum 12 month contribution period, savers can stop contributions for up to five years by applying for a "contributions holiday". Contributions resume at the end of the five years unless the individual applies for a further "contributions holiday".
- Existing superannuation schemes have the option of converting to KiwiSaver, subject to certain criteria. Members of other schemes may choose to open a KiwiSaver account, instead of or as well as, their existing scheme.
- The automatic enrolment provisions will not apply in workplaces where the employer is "exempt" i.e. running a scheme that is portable, open to all new permanent employees, and has a total contribution rate (employer plus employee) of at least 4 per cent.
- A mortgage diversion option is available whereby one half of the employee's contribution can be allocated to their mortgage costs.
- The Government will also make an upfront contribution of $1,000 plus $40 for fees per person, to be "locked in" until the recipient reaches the age of eligibility for NZS or for five years, whichever is the greater; provide a fee subsidy; offer a first home deposit subsidy of $1,000 per year of membership in the scheme, up to a maximum of $5,000 for five years.

Source: derived from http://www.treasury.govt.nz/kiwisaver/

In early 2007 it was clear that the pressure to extend tax concessions further would intensify. In the May Budget (Just 6 weeks before KiwiSaver was to begin) tax subsidies were dramatically extended so that the first $20 a week of individual contribution attracts a matching $20 ‘tax credit’. This corresponds to a 100% subsidy on 4 percent contributions from gross pay up to $26,000 per annum. The tax credit is not limited to those in employment and can be accessed by beneficiaries, unpaid caregivers and the self employed for contributions up to $20 a week.

From 1 July 2008 compulsory employer contributions of 1% rising to 4% of employee’s gross pay in 2011 will apply. This is only for those employees in the scheme, leaving much confusion as to what will happen with remuneration packages and wage negotiations. The employer costs are offset by a matching $20 tax credit, so that in the first two years the cost to the employer is minimal, even when employees are earning more than $26,000. The current (July 2007) version, KiwiSaver (Mark 2) is outlined in Box 3, but aspects are still to go through the legislative process. Meanwhile, the top rate of the PIE regime reduces to 30% from 1 April 2008, creating an ever bigger gap between the top income tax rate and the tax on investments in PIEs.

The new matching tax subsidies which apply to the first $20 contributed by the employee and the tax offset to the employer are less regressive than pure tax exemptions, however the cost is high. The New Zealand Treasury estimates that by 2011, the fiscal cost will be $1.2 billion, while the effect on household saving is expected to be only $1.1 billion (The New Zealand Treasury, 2007).

These projections are likely to serious under-estimates of the tax foregone in KiwiSaver as the extensive nature of the tax subsidies become apparent and take-up increases (see Table 4 for some ballpark estimates). The scheme is open to all NZ residents under the age of 65 (3.7 million people), of which about 1.7million are potentially entitled to tax-subsidised employer contributions.

Table 4 The fiscal cost of KiwiSaver (Mark 2)

	One-off sweetener $1000	Fees subsidy $40 pa	Annual cost of employee subsidy 2011	Annual cost of employer subsidy 2011	Cost of 30% PIE rate
Cost $ Billion					
100% uptake	3.7	0.15	2.4	1.2	0.18
50% uptake	1.85	0.08	1.2	0.5	(estimate)

Notes: These are estimates by author

6. Evaluation of tax neutrality, and KiwiSaver II in light of the ageing of the population

Box 2 shows the timeline of the changes to the tax treatment of superannuation in New Zealand. Gains from the post-2007 regime are likely to be largest for the 45-64 age group, who are the most likely to have other savings that they can shift into KiwiSaver, have the least time to wait before getting access at 65, and will still receive a universal benefit. The net present value of the upfront $1000 and the $40 subsidy on the first $20 saved is much lower for those aged 18-45, who except under limited conditions cannot access this until age 65. This group is far less likely to join KiwiSaver and enjoy access to the subsidies.

Box 3 uses some conventional criteria for evaluation of the old and new tax regimes: economic efficiency, horizontal equity, vertical equity, administrative simplicity and fiscal cost. The implications for the use of principle in tax policy; political stability of the state pension and the implications for the ageing population increasing longevity risk are summarised.

In terms of addressing the stated problem of national saving or the Current Account Deficit (CAD) little can be expected. The impact on the goal of reducing consumption is in seeming conflict with tax-subsidised lump-sums paid out at 65. It is also likely that employers will eventually close existing work-based superannuation schemes or shift them into KiwiSaver, so that there may be little actual increment in total saving.

Some positive features of KiwiSaver include full portability, choice of provider and the likelihood of increased financial literacy in the population over time. But there are several reasons to support the claim that KiwiSaver is ‘seriously regressive’[16] despite the use of a tax credit approach rather than a tax incentive:

- At any given income level, the two-earner family gains the most.
- High-income one earner families are more likely to have the non-earner in KiwiSaver and accessing the upfront $1000 and the matching annual $1040 subsidy.
- High earners are more likely to benefit from the advantageous PIE regime and from salary sacrifice options (Retirement Policy and Research Centre, 2007).
- Older, wealthier baby boomers are more likely to join and have less time to wait to get the upfront incentive. Returns on savings, ignoring the actual investment returns are high.
- Subsidised KiwiSaver contributions overturn the old rule that reducing debt was the first main preparation for retirement. It now makes financial sense to either not reduce debt, especially student loan debt, or even to increase debt to join KiwiSaver.
- Younger debt-laden workers, those on benefits and those with children are less likely to join because of the initial 4 percent contribution hurdle.

In terms of the impact in an ageing society, the new regime offers no retirement decumulation product that might protect against the longevity risk. There is no constraint on the use of tax-subsidised lump-sums. The fiscal costs of an ageing population have been exacerbated without any social advantage such as requiring an annuity that could be used to help pay for health and long-term care (St John, 2006b). It is hard to see now how annuity products can be made attractive in a voluntary regime without further state spending. The state pension has offered a basic level of protection to date, but its universal generous level at age 65 may be under increasing threat.

[16] As claimed by some, see for example CPAG researcher (Wynd, 2007). While matching tax credits are supposed to be less regressive than tax incentives, a detailed distributional analysis has not been released by Treasury or the IRD.

Box 2 Timeline of tax changes to saving for retirement in New Zealand

Years	Employer Contributions	Employee Contributions	Fund earnings	Final withdrawals
Pre 1988	Lump sum – tax free to ceiling Pension - tax free (E)	To ceiling, tax free (E)	Tax-free (E)	Lump-sum tax free (E) Pension taxed (T)
1990- for standard superannuation scheme	Taxed 33% (T) (15%/21%/33% also possible from 1.4.06)	Taxed at MTR (T)	Taxed 33% (30% from 1.4.08) (T)	Tax-free lump-sum or pensions (E)
1 July 2007 KiwiSaver or complying fund only	Tax-free to 4% employee’s gross pay (voluntary)	Taxed at MTR but matching tax subsidy up to $20 a week	Taxed at 19.5% or 33% as a proxy for MTR of employee	Tax-free lump-sum
1 July 2008 KiwiSaver or complying fund only	Tax-free to 4% employee’s gross pay. 1% (compulsory) Employer gains matching tax subsidy up to $20 a week	Taxed at MTR but matching tax subsidy up to $20 a week	Taxed 19.5% or 30% as a proxy for MTR of employee	Tax-free lump-sum
1 July2009 KiwiSaver or complying fund only	Tax-free to 4% employee’s gross pay. 2%(compulsory) Employer gains matching tax subsidy up to $20 a week	Taxed at MTR but matching tax subsidy up to $20 a week	Taxed 19.5% or 30% as a proxy for MTR of employee	Tax-free lump-sum
1July 2010 KiwiSaver or complying fund only	Tax-free to 4% employee’s gross pay 3%(compulsory) Employer gains matching tax subsidy up to $20 a week	Taxed at MTR but matching tax subsidy up to $20 a week	Taxed 19.5% or 30% as a proxy for MTR of employee	Tax-free lump-sum
1 July 2011 KiwiSaver or complying fund only	Tax-free to 4% employee’s gross pay 4%(compulsory) Employer gains matching tax subsidy up to $20 a week	Taxed at MTR but matching tax subsidy up to $20 a week	Taxed 19.5% or 30% as a proxy for MTR of employee	Tax-free lump-sum

Box 3 Assessing the tax regimes for saving

years	Pre 1988	1990-2007	2011-
Tax regime 1.Private saving 2.Housing	 EET TEE	 TTE TEE	 ETE TEE
State pension NZS	Universal pension until 1985, when the surcharge (income test) came in	Surcharge 1984-1998 (low impact) NZS fully universal from 1999	Universal NZS unlikely to remain
Economic Efficiency 1. saving 2. state pension 3. tax system	Poor. 1.Highly distortionary inconsistent treatment 2.Surcharge distorts 3.Overall tax system a hybrid of income and expenditure. High DWL	Good. 1. Consistent treatment of saving except for housing 2. Low distortions from universal NZS 3. Comprehensive income tax basis Moderate DWL	Poor. 1.Highlydistortionary inconsistent treatment 2.Return to efficiency costs of income tested NZS? 3.Overall tax system a hybrid of income and expenditure. High DWL
Horizontal equity	Poor Savers in superannuation and housing advantaged	Good except for lack of capital gains tax	Poor. Savers in superannuation and housing advantaged
Vertical equity	Poor	Better	Poor
Administration simplicity	Poor	Excellent	Poor
Use of principles approach in tax policy	Poor	Excellent	Poor
Fiscal costs of pensions	High. Tax breaks add 2.5 percentage points to tax rates	Sustainable	Potentially explosive
Stability state pension	Poor	Settled - Accord 1993- 2000	Under threat
Protection of longevity risk (annuities market)	Good basic state pension Some private pensions and annuities	Good basic state pension Lump-sum saving Few annuities and pensions	State pension under threat Lump-sum saving No annuities
Impact on national saving	n/a	Neutral – except for housing	Negative Encourages spending with lump sums at 65 Reduces government saving

7. Farwell to tax neutrality and the voluntary regime

Tax incentives for saving for retirement have been traditional in western societies. Their negative effects have been well documented,[17] including their regressivity; their ineffectiveness in increasing saving; their complexity and the costs of their regulation and administration; their gender bias, and their lack of transparency. New Zealand alone experimented with a different way.

The direct and indirect costs of moving to a TTE regime in the late 1980s were high as has been outlined earlier, and in Appendix 1. The rewards of simplicity and fairness were only partially realised however, largely because of the failure to deal with housing. Investment in housing remained tax-advantaged, while saving in superannuation schemes was often treated inappropriately at the individual level. Speculation in housing contributed to current account worsening and a high overseas indebtedness, fuelled in turn by high interest rates and an overvalued exchange rate. In a scramble to address this problem, together with an unwillingness to confront the housing market directly, the previous highly principled approach to tax matters was relegated to second place.

In 2001 a tax paper from the OECD could claim

> *Tax policy in New Zealand is grounded within a coherent overall strategy and the changes for various parts of the system are generally scrutinised with a view to how these might affect the efficiency equity and simplicity of the system as a whole (Dalsgaard, 2001).*

Even as late as 2005, a government discussion document stated:

> *…it is important that the tax rules for investment income operate efficiently and that investors' decisions are not distorted by different tax treatments for income from investments that are similar in nature (New Zealand Government, 2005).*

But the policy direction had taken New Zealand a long way from this ideal just two years later. The departures from tax neutrality were accelerated by compromises in an MMP environment and have appeared easy to sell to an unsophisticated public. The financial services industry has been buoyed by the prospect of new business

[17] see for example Sinfield (2000)

and has perpetuated the popular illusion that such tax concessions will help to solve the ‘saving problem’.

The 2007 OECD report on New Zealand offered two clear alternative directions for tax reform: either comprehensive income tax or a Dual Income Tax DIT in which capital is taxed less than income to overcome the savings disincentive of an annual income tax (Mourougane, 2007). Both require a consistent comprehensive definition of capital income and a uniform rate of tax. Neither of these two approaches is now the basis of tax policy in New Zealand.

While the original reforms that promoted tax neutrality were part of an overall coherent package, recent changes have been introduced in a piecemeal process and illustrate the dangers of opening the floodgates even a little. As discussed, KiwiSaver led to the series of subsequent undebated, unsupported adjustments including the introduction of direct tax subsidies, and has opened avenues for tax avoidance through collective investment vehicles.

As one concession leads to demands for another, it is likely the process is far from over. There seems little reason to exempt employer contributions from the SSCWT and not allow employee contributions to be tax-free also. Compulsory employer contributions for employees enrolled in KiwiSaver complicate remuneration policy and may lead to demands for full compulsion over time. Concessions on fund earnings in PIEs for 39% marginal taxpayers are likely to lead pressures for similar tax breaks for lower marginal tax payers. Finally, there is a case to be paid for encouraging annuities, again with costly implications as the opportunity for a trade-off with the KiwiSaver introduction has not been exploited.

The longevity risk

In other countries, tax incentives usually have one clear redeeming feature; they may allow prescription of the nature of the final benefit. Provision of income via a pension or an annuity can give society some pay-back for foregoing tax revenue in the accumulation process. While the annuity provides longevity protection for savings supplementary to the state pension and thus protects the longest lived individuals, society also gains because there is a certain income stream that can in principle be used to pay for the additional costs of long term care and other health costs. Given the personal nature of the concessions, pensions are not easily disguised by the use of trusts, nor can the underlying capital sum be dissipated too early in retirement

New Zealand had a unique opportunity with a tax neutral regime to design an explicit subsidy to recognise the gains to society from annuitisation with few of the disadvantages of traditional tax incentives St John,(2006b). One possibility was the provision of a limited value, inflation-adjusted, gender neutral annuity to supplement NZS, purchased out of lump-sum saving and a suitable share of home equity. This annuity would require subsidisation to be viable but may have also included a cost-effective insurance rider for long-term care. This opportunity is now passing while New Zealand runs the dangers of an ETE regime, with unregulated lump sums alone coming out of KiwiSaver and other tax-advantaged schemes. In the meantime, private home equity release schemes are aimed at younger age groups for consumption, not for long term retirement income purposes.

The New Zealand retirement system has been built on the provision of a generous universal pension for all without any means test. If the private savings of the well-off become tax-subsidised however, such largesse may be called into question. The advantages of a simple, fully universal pension that secures a sound basic level of longevity protection for all may eventually be a casualty of the reversal in tax policy. The hard won gains of the twenty year experiment have been lost, not with ‘a bang but with a whimper’.

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Appendix 1 The transition to tax neutrality[18]

A complex and uncertain time for private superannuation followed the December 1987 announcement of TTE. Arguments that changes to existing schemes involved retrospective legislation fell on deaf ears. The Government could point to many other reforms undertaken in the 1980s that entailed a measure of retrospectivity. A transitional regime for previously tax-favoured schemes was supposed to be sufficient to allow the smooth adjustment to the new tax environment.

A consultative committee was set up under the chairmanship of Dr Donald Brash to hear submissions. While the reforms themselves were not supposed to be up for debate, the overwhelming majority of submissions to the committee voiced strong opposition to the direction that the Government had chosen. The Brash committee was however in sympathy with the concept of neutral treatment of all forms of savings, but recommended that an approach that exempted contributions from tax, but fully taxed fund earnings and emerging pension benefits (Exempt/Taxed/Taxed) would be more appropriate (Report of the Consultative Committee, 1988).

Under certain assumptions, such a regime was tax neutral although the committee was in favour of some degree of concession which they argued could be offset by a lower entitlement to the state pension. Amongst the arguments for this alternative treatment were:

- lower windfall gains for existing pensioners and those close to retirement;
- less disruption to schemes in the short term with implications for the stability of capital markets;
- better ability to impose regulations, especially those relating to preservation, portability and the requirement to take a pension.

The committee claimed that the Government’s proposed TTE regime would be more fiscally costly than the equivalently neutral ETT regime that they recommended. This extra cost would arise despite the short-term gains that would accrue to the Government’s budget by bringing the tax liability forward to contributions. Not only would the possibility of increased numbers of schemes being wound up mean greater calls on the state pension in the future, but they also foresaw the possibility of a significant loss of tax revenue when all end benefits were paid tax-free compared to their recommendation in which all benefits would be taxed as they emerged (Report of the Consultative Committee, 1988, p. 21).

The committee also argued that its preferred tax regime would be perceived to be the more natural by taxpayers rather than the artificial situation where the emerging pension is tax-free. If pensions were tax-free, people were bound to worry that some future government could impose a tax again even though logically this does not reflect the capital nature of such flows.

In the event, the Government made only minor changes in line with the committee’s recommendations and indicated the intention to proceed with the TTE treatment of superannuation saving.

[18] Derived from St John & Ashton (1993)

There was little over two years between the announcement of the new regime and its full implementation. The absence of any grandfathering clauses to ease transition meant that the impact of the changes on private superannuation schemes was dramatic. All pension schemes had to be reviewed, and pension levels could be reduced to reflect their new tax-paid status and to allow for the tax on investment income. Many occupational schemes were closed to new members, while others were wound up and the funds distributed. Some were changed from a defined benefit basis to a defined contribution basis.

Existing schemes had until January 1990 to submit proposals to the Government Actuary if they wished to reduce accrued benefits to compensate for the new tax regime. This once-only legislative provision over-rode the trust deed which would not ordinarily permit this to happen without the consent of all affected members. Existing and newly retiring pensioners were to be compensated for the tax on fund earnings and the subsequent reduction in their pensions by being able to take the pension tax-free.

There was widespread misunderstanding concerning the effect of tax-free pensions on final disposable incomes and why pensions had to be reduced. The renegotiation of the defined benefit state sector scheme, the Government Superannuation Fund, was particularly acrimonious, with many members seeing the reductions in their benefits as a unilateral attack on their living standards and contractual rights. There were unprecedented marches on Parliament by the police and strikes by prison officers.

Any renegotiated reductions to accrued superannuation benefits were required to be fair between members and to provide no financial advantage to the superannuation scheme. Those near or in retirement were to be protected as far as possible. While, strictly speaking, those in retirement or close to retirement would require a much lower reduction in pension benefits than younger members of schemes to compensate for the tax changes, it was deemed to be equitable to have a uniform rate of reduction across the board if the trustees were so to choose.

As it turned out, many schemes in actuarial surplus did not reduce the pensions already being paid much if at all so that pensioners received an immediate increase of disposable income from their pensions of up to 49 percent depending on their marginal tax rate. The Government Superannuation Fund (GSF) was also required to reduce benefits, despite being largely PAYGO. In this case, existing pensions were reduced as if the pension was taxed as primary income ignoring all other forms of income. There were considerable windfall gains for those on the highest marginal tax rate and with the largest pensions (St John & Ashton, 1993, p.39).

Not only were the distributional consequences of adopting TTE unfortunate, but the loss of tax revenue was scarcely appropriate in the light of the fiscal problems the Government was facing. It was estimated that the revenue forgone over time by the granting of tax-free benefits to those who had saved under a highly tax concessionary regime was of the order of around $3-4,000 million in present value terms (Report of the Consultative Committee, 1988).

The net result of the renegotiation period was that many of those who had already benefited from the concessionary regime of the past benefited yet again – what had been an EET regime became, effectively EEE for some. The losers were taxpayers generally, and future and current members of existing schemes whose entitlements would be considerably less generous. Ironically, the lost revenue may have eliminated any time advantage that there might have been in bringing forward the receipt of tax from the receipt of the pension to the contributions and fund earnings stages. A one-off tax on accrued capital might have been effective in reducing the windfall gains, as was suggested when similar possible reform was considered in the US (Munnell, 1992).

Douglas argued that long drawn out transitional arrangements are seldom fair, they are usually complex, and they defer the benefits of the changes being implemented. He believed that any dramatic change in which there are winners and losers was best presented as part of an overall package where personal losses in one area are offset by gains in other areas. But political factors disrupted the reform process so that many of the changes originally envisaged by Douglas were not implemented [TTE is in fact the only survivor of the December 1987 Economic Statement]. The full reduction in personal taxes never eventuated as the government backtracked from flat tax, and some other significant features of the wider reforms, including a capital gains tax were also abandoned. By the time superannuation schemes were renegotiated to allow for the imposition of tax on investment earnings and contributions, the connection between the lower personal tax rates introduced in 1988 and the removal of concessions was largely lost.

The timing of the reforms could hardly have been worse. The December 1987 announcement came just after the New Zealand share market crash and at the beginning of what was to be a prolonged and deep economic recession. Reduced cash flows and the attempts to shift towards more liquid portfolios on the part of major long-term savings institutions intensified the downturn in the property and equities market. Unlike many other countries, share prices were slow to recover after the share market crash, and the share price index (Barclays Index) fell from a peak of 3,800 in October 1987 to around 1,200 by the end of 1990. Attempts to sell assets by institutions in this period may have contributed to the damagingly high interest rates that persisted despite a rapidly reducing rate of inflation. The Consultative Committee had certainly foreseen this possibility as a consequence of the new tax regime (Report of the Consultative Committee,1988, p 26).