Tax Working Group Public Submissions Information Release

Release Document

September 2018

taxworkinggroup.govt.nz/key-documents

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How to Fix the Over-taxation of Long-Term Savings in New Zealand: A Submission to the 2018 Tax Working Group (TWG) by Peter Neilson on behalf of Annuity, KiwiSaver and Term Deposit Investors April 2018

The Author

The author of the submission is Peter Neilson an economist who was Minister of Revenue and Associate Minister of Finance when the 1989 changes to the taxation of superannuation and the 1990 Budget changes were being promoted. He is currently the pro bono Chair of the Simplicity Trust which "owns" the low fee, passively managed, not-for-profit KiwiSaver provider called Simplicity. He is also a former CEO of the Financial Services Council (FSC) the industry body for KiwiSaver and personal insurance providers. In 2013 while at the FSC he led the team that produced the report "The Tax Barrier to Retirement Prosperity in New Zealand" I would be interested in meeting with the TWG if that would assist with understanding the issues I raise and the proposed remedies.

The Disclaimer

The views expressed in this submission are my own and should not be read as representing the views of any other organisation.

1 Executive Summary

This submission addresses the tax issues preventing low to middle income New Zealanders from achieving a comfortable retirement through long-term savings and recommends some practical and fairer solutions.

Our current tax system encourages retirement savers to bid up the price of urban land suitable for housing, an existing asset. It also diverts capital flows away from investments that create new wealth, new jobs or could improve labour productivity by increasing the amount of capital used by each worker. What economists call capital deepening. It would be desirable to have a tax regime which helps lift wages rather than bidding up the price of land, which also makes us less competitive.

Research reported on back in 2011, by the Savings Working Group revealed that taking reasonable assumptions some 90% of a KiwiSavers retirement nest egg would come from earnings within their KiwiSaver fund and only 10% from their initial contributions and the contributions made by their employer and the taxpayer.

New Zealand is currently the OECD country with the most hostile tax environment for long-term savings in financial products earning compound returns (KiwiSaver, bank term deposits and standard annuities). These are the savings vehicles typically used by low and medium income earners in preparation for retirement.

The tax penalty on long term savings arises from two drivers;

Income tax inherently overtaxes the part of your income you save, because taxing income today, unlike an expenditure tax such as GST, taxes future consumption more than current consumption and,

The impact of taxation is particularly severe when the subsequent earnings on those savings within your fund, from compound returns (interest on interest) occurs over a long period of time, such as the 40-45 years prior to your retirement. The tax imposed on KiwiSaver earnings within your fund, effectively halves the earnings that will be added to your nest egg over 40-45 years.

The bias in tax treatment creates a huge wedge between the after-tax returns of compound interest products like KiwiSaver and those of investors in residential rental properties even when the pre-tax profitability is the same.

The three drivers of the relative over-taxation of compounding interest financial products relative to residential rental investments are as follows;

- all interest income is taxed on a comprehensive economic income basis
- interest income is taxed on an accrual rather than realisation basis
- the part of nominal interest that is just compensation for inflation and so is a return of capital, rather than a return on capital is taxed as if it were income.

For someone in the top 33% income tax bracket, the effective tax rate on residential rental property (with gearing being maintained as more rental properties are purchased), is close to 0% while the effective tax rate on KiwiSaver fund earnings is over 50% if you save for 30 years or more.

For the well informed this is a powerful disincentive to invest in KiwiSaver above the level that will be matched by the employer's contribution of 3%. It is a very strong incentive to invest in residential rental property where the effective tax rate could be only around 2% over a 20-year period. If you can gear your residential rental property to 100% the effective tax rate becomes negative. In effect other taxpayers subsidise your investment, the tax system pays you to make the investment.

In most OECD countries as in New Zealand owner occupied homes are not subject to tax on the value of the imputed rentals (the tax on the income you don't need to earn as you are not paying rent) so the equity you have in your home becomes in effect a tax-free bank account, but in contrast,

- ownership of rental properties is not encouraged by their tax systems, capital gains are taxed at least on realisation if not as they accrue and rental income is treated as any other corporate income and any losses are not deductible against other, non-rental income, and
- typically, in these countries for retirement savings, made through locked-in superannuation schemes you do not pay income tax on the contributions you make into your fund, inside the fund your earnings are not taxed but you do pay tax on the income you receive from your fund in retirement.

This type of regime is called **EET** short for, your contributions into your fund, are **E**xempt from tax, inside the fund the earnings are **E**xempt from tax and the withdrawals are **T**axed. This was the tax treatment for superannuation savings in New Zealand prior to 1989 and is in line with what optimal tax theory would recommend.

The current regime in New Zealand is **TTE,** that is your contributions into KiwiSaver are out of already **T**axed income, the income your contributions earn within the KiwiSaver fund itself, are **T**axed but your withdrawals after age 65 are **E**xempt from income tax.

The existing tax regime has provided rental property investors with an almost costless option to buy access to future capital gains that are unlikely to be ever taxed in practice under current tax settings. This is all perfectly legal under current New Zealand tax law.

The tragedy we have is that the savings products most easily used by low and middle-income earners (KiwiSaver and bank term deposits) have the highest effective tax rates. That is the people who need of save over a long term face the biggest tax penalties for doing so.

As a result of these tax distortions we are poorer as a country than we should be, fewer families own their own homes and wealth inequality has increased. These are self-inflicted injuries that we could have avoided.

In the UK investors own some 18% of the housing stock, in Australia the proportion is 27% whereas, in New Zealand no strictly comparable statistics appear to be available. A recent April 2018 Horizon Research Poll reported that 47.5% of New Zealand adults own their own home, 32.8% say they are currently renting, a further 4.3% are currently flatting, another 4.8% have other living arrangements and pay rent or board and 1.4% don't own a home but live rent free. In recent years more than 30% of new mortgage lending has been to investors. As rental properties on average are less expensive than the average owner-occupied home that is sold, this suggests the proportion of investor owned residential property in New Zealand could be higher than 30%.

In 1989 in order to increase tax revenue and reduce the fiscal deficit the tax incentives to save in superannuation schemes were removed and the **EET** superannuation regime was switched to a **TTE** regime. In the 1990 Budget other changes were made which reduced the effective tax rates paid on income from investments in residential rental properties.

As is so often the case, a tax policy, that was thought fiscally helpful in the short term has been disastrous for our social well-being, the housing of our population, our social cohesion and economic growth over the longer term. The last election result was in part a revolt of the renter generation against the home owner and rental property owner generation.

A very good description of the problem and an outline of the issues with the 1989 changes to the taxation of superannuation savings and possible solutions, is contained in Dr Andrew Coleman's University of Otago Economics Discussion Paper No 1709 Housing, the 'Great Income Tax Experiment', and the intergenerational consequences of the lease. He recommends moving back to **EET** from the current **TTE** superannuation tax regime.

My suggested solutions

In order of preference I would recommend that;

1)As Optimal Tax Theory would suggest we move back to an Expenditure Tax treatment for Retirement Savings, EET

or failing that,

2) Reduce the PIE rates to zero to create a level playing field between compound return financial products and residential rental property investments

or failing that,

3) Move to a Comprehensive Economic Income (Haig-Simons definition) for all forms of investment income to the degree feasible and then offset any residual advantages for rental property investments by reducing the PIE rates to ensure a level playing field with them and also ensure no investor will pay an effective tax rate higher than the marginal income tax rate they pay on their other income.

It should be noted that none of these recommendations provides a tax advantage for locked-in savings. They merely offset the current tax disadvantages retirement savings in compound return financial products suffer relative to investments in residential rental property and with the income tax rates they would pay on their other wage and salary income.

The least financially sophisticated and lowest income earning savers are paying our highest effective tax rates, over 50% yet nothing has happened to fix these issues to date.

The overtaxed middle and lower-income earner savers, in particularly those in default conservative KiwiSaver funds are much more likely to be, young, female, Maori and Pasifika and renters. In contrast those higher income earners, who are leveraging the equity in their own homes to invest in highly geared residential rental properties are paying effective tax rates of 0-10%, much lower than the marginal tax rates they would pay on their other wage and salary income. This group is far more likely to be older, richer, male, already own their own homes and not be Maori or Pasifika. These tax expenditures represent a massive redistribution of wealth from poorer to richer New Zealanders. The tax expenditures for rental property investors and home owners, benefiting mainly the wealthiest 40% of New Zealanders were in 2013 estimated to be cost $4b a year. That is almost twice the value of all public expenditure on housing assistance (rent subsidies and accommodation benefits) provided in 2013, mainly to the poorest 20% of New Zealanders.

While KiwiSavers are locked in till age 65 and term deposit investors for the term of their investment the Government of the day has a captive tax stream paid for by people who do not usually know they are being overtaxed.

The TWG can make recommendations to stop that.

2 Introduction and Comments on the Terms of Reference (ToR)

The TWG has been asked to report to the Government on:

Whether the tax system operates fairly in relation to taxpayers, income, assets and wealth,

Whether the tax system promotes the right balance between supporting the productive economy and the speculative economy,

Whether there are changes to the tax system which could make it more fair, balanced and efficient, and

Whether there are other changes which could support the integrity of the income tax system, having regard to the interaction of the systems for taxing, companies, trusts and individuals.

3 This Submission

This submission will specifically address the tax issues preventing low to middle income New Zealanders from achieving a comfortable retirement through long-term savings and recommends some practical and fairer solutions.

To this end the submission will also respond to the request in the Terms of Reference for the TWG to consider whether a system of taxing capital gains or land (not applying to the family home or the land under it) or other housing tax measures, would improve the tax system.

Our current tax system encourages retirement savers to bid up the price of urban land suitable for housing, an existing asset. It also diverts capital flows away from investments that create new wealth, new jobs or could improve labour productivity by increasing the amount of capital used by each worker. This is what economists call capital deepening. It would be desirable to have a tax regime which helps lift wages rather than bidding up the price of land, which also makes us less competitive.

4 What is the Problem we should be trying to fix?

Research reported on back in 2011, by the Savings Working Group revealed that taking reasonable assumptions some 90% of a KiwiSavers retirement nest egg would come from earnings within their KiwiSaver fund and only 10% from their initial contributions and the contributions made by their employer and the taxpayer.

New Zealand is currently the OECD country with the most hostile tax environment for long-term savings in financial products earning compound returns (KiwiSaver, bank term deposits and standard annuities). These are the savings vehicles typically used by low and medium income earners in preparation for retirement.

The tax penalty on long term savings arises from two drivers;

1)Income tax inherently overtaxes the part of your income you save, because taxing income today, unlike an expenditure tax such as GST, taxes future consumption more than current consumption. (This is always the case as long as people would rather spend today rather than to wait to spend later.)

2)The impact of taxation is particularly severe when the subsequent earnings on those savings within your fund, from compound returns (interest on interest) occurs over a long period of time, such as the 40-45 years prior to your retirement. The tax imposed on KiwiSaver earnings within your fund effectively halves the earnings that will be added to your nest egg over 40-45 years.

The tax you pay within your KiwiSaver fund reduces the amount of net interest, after tax has been deducted, reinvested to earn further interest. On existing tax policy settings, over 40 years of saving you retain only 45.3% of the potential earnings, you would have earned in the absence of tax. This is despite the so-called concessional **P**ortfolio **I**nvestment **E**ntity "**PIE**" rates (10.5%,17.5% and 28%)which give the impression you will pay lower than normal income tax rates on your KiwiSaver earnings in the fund over the time you are saving.

Similar discriminatory tax treatment exists for other compound return financial saving products including bank term deposits and is a major reason why, standard annuities are both unattractive and not supplied by any New Zealand based organisation.

The bias in tax treatment creates a huge wedge between the after-tax returns of compound interest products like KiwiSaver and those of investors in residential rental properties even when they both have the same pre-tax profitability.

5 Understanding the Power of Compound Interest & the Rule of 72.

How can taxing the earnings, or interest on savings, as you earn them make much of a difference to your retirement nest egg?

Most people would think intuitively that paying tax in your fund could not possibly make a big difference to the amount of money that ends up in your KiwiSaver nest egg at retirement.

A simple example might help explain the impact of paying tax on your returns, as you earn them, has on your retirement nest egg. Suppose your Grandmother for your 17th birthday gives you $10,000 but on condition that you don't spend it. You must invest the amount for the next 48 years. She wants you to spend it only after you reach age 65. You have a fund to invest it in, that pays 6% interest each year, but the fund has to pay a 50% tax on each year's earnings, on your behalf.

To calculate the time, it takes to double your money you can use the Rule of 72. That is divide 72 by the interest rate you are being paid and it tells you how many years it will take to double your money, from compound returns (earning interest on interest).

If you paid no tax on your 6% interest, the Rule of 72 tells us that 72 divided by the interest rate of 6% means your initial $10,000 of savings will double in value every 12 years. Over 48 years your initial $10,000 investment would double 4 times. So, your initial $10,000 becomes a retirement nest egg worth $160,000 by the time you reach 65 (if you pay no tax on your 6% interest income). If, however you need to pay a 50% tax on your annual interest earnings, the after-tax rate of return drops to only 3%. This means only half the earnings can be reinvested each year to earn compound returns (interest on interest).

You can use the Rule of 72 to calculate the time it takes to double your money if the after-tax return is only 3% each year. 72 divided by 3 gives the answer 24 years. Your fund now doubles only every 24 years. This means that over 48 years, earning 3% each year your savings only double twice so your initial $10,000 only grows to produce a $40,000 nest egg at age 65. So, compared to the tax free 6% return, the 3% net, after-tax interest return (after paying the 50% marginal income tax rate), on your annual interest earnings, the marginal **E**ffective **T**ax **R**ate (the **ETR**) over 48 years of saving is 75%.

For New Zealanders with above average incomes who already own their own home there are two main avenues for investing their retirement savings one is in KiwiSaver and the other is by investing in residential rental property. Some more risk averse savers invest in bank term deposits.

For those on middle or lower incomes, particularly if they do not own their own homes it is almost impossible, on current tax settings, to save for a comfortable retirement by putting a little away each week for a long time, to get the benefit of compound returns (earning interest on interest).

In the UK investors own some 18% of the housing stock, in Australia the proportion is 27% whereas, in New Zealand no strictly comparable statistics appear to be available. A recent April 2018 Horizon Research Poll reported that 47.5% of New Zealand adults own their own home, 32.8% say they are currently renting, a further 4.3% are currently flatting, another 4.8% have other living arrangements and pay rent or board and 1.4% don't own a home but live rent free. In recent years more than 30% of new mortgage lending has been to investors. As rental properties on average are less expensive than the average owner-occupied home that is sold, this suggests the proportion of investor owned residential property in New Zealand could be much higher than 30%.

6 What causes such a big difference in the Effective Tax Rates?

The three drivers of the relative over-taxation of compounding interest financial products relative to residential rental investments are as follows;

- All interest income products are taxed on a comprehensive economic income basis (any change in capital value is treated as income). There is no tax-free capital gain in contrast to investments in residential rental accommodation held for longer than the "bright line" test period.
- Interest income is taxed on an accrual rather than realisation basis (income from interest is taxed annually as it is earned) whereas capital gains on rental properties are only taxed on realisation that is when sold. When interest income is taxed on an accruals basis, only the smaller after-tax amount of interest is re-invested each year so grows much more slowly than when tax is deferred until realisation, and
- The part of nominal interest that is just compensation for inflation and so is a return of capital rather than a return on capital is taxed as if it were income.

Calculating an Effective Tax Rate

With a 6% tax free return your nest egg grows to $160,000 over 48 years

With an after-tax return of 3% (after paying a 50% tax rate) this drops to only $40,000 over 48 years

So, the effective tax rate over 48 years is 160,000-40,000 = 120,000 divided by 160,000 which is 75% compared to the marginal tax rate of 50%.

The effective tax rate increases the longer the period of saving continues.

This means taxing compound returns in KiwiSaver, particularly hits those who are on lower incomes who need to save a little each year for a very long time to build up a large retirement nest egg.

Longer term investments in rental property particularly when heavily geared (mainly financed by debt) are strongly favoured by our current tax system. As a result, New Zealand stands out compared to most OECD countries in having the biggest tax bias in favour of investing in residential rental properties and against investing in compound return financial products such as standard annuities, bank term deposits and KiwiSaver conservative funds, which are mainly invested in bonds. It should be noted that KiwiSaver investments in Australian and New Zealand equities (shares) are not taxed on their capital gains. However equally it should be noted that default KiwiSaver members who remain in conservative funds have portfolios that are mainly in bonds, a fixed interest compound interest product. These investment products are both subject to tax on any capital gains and suffer the highest effective tax rates.

7 I thought we had a tax system that taxed all forms of income equally, a low rate wide base approach am I wrong?

How is New Zealand's tax system different for the most common forms of retirement savings?

Most forms of income in New Zealand such as wages, salaries and fringe benefits. are taxed on a uniform basis but not so for income from capital.

In New Zealand as in most countries the imputed income from owner occupied homes is not currently and is not proposed to be taxed.

There is however a big difference in the tax treatment between different forms of savings used to prepare for retirement. For someone in the top 33% income tax bracket, the effective tax rate on residential rental property (with gearing being maintained as more rental properties are purchased), is close to 0% while the effective tax rate on KiwiSaver earnings is over 50% if you save for 30 years or more. At over 50% the effective tax rate on KiwiSaver earnings is not only massively higher, than for investments in residential rental properties. They are also much higher than the standard marginal income tax rates paid by a KiwiSaver investor on their other income. The marginal **E**ffective **T**ax **R**ate, (**ETR**) of 54.7% over 40 years of saving in KiwiSaver, is for the case of a 33% marginal tax payer. That means the effective tax rate for KiwiSaver or term deposit investors, is nearly twice as high as the so-called concessional PIE rate of 28% for someone in that income tax bracket.

For the well informed this is a powerful disincentive to invest in KiwiSaver above the level that will be matched by the employer's contribution of 3%. It is a very strong incentive to invest in residential rental property where the effective tax rate could be only around 2% over a 20-year period. If you can gear your residential rental property to 100% the effective tax rate becomes negative. In effect the other taxpayers subsidise your investment, the tax system pays you to make the investment. Some will say that with bank lending restrictions you cannot gear up your rental properties to 100%. This is not in fact the case. A partner in a law or accounting firm or medical specialist owning a debt free home worth $1m can borrow $4m to purchase rental properties and each rental property can be geared to 100% because the average gearing overall, on their real estate holdings including the family home is only 80%.

8 What is the tax treatment for retirement savings in most other OECD countries?

In most OECD countries as in New Zealand owner occupied homes are not subject to tax on the value of the imputed rentals (the tax on the income you don't need to earn as you are not paying rent) so the equity you have in your home becomes in effect a tax-free bank account, but in contrast,

- ownership of rental properties is not encouraged by their tax systems, capital gains are taxed at least on realisation if not as they accrue and rental income is treated as any other corporate income and any losses are not deductible against other, non-rental income, and
- typically, in these countries for retirement savings, made through locked-in superannuation schemes you do not pay income tax on the contributions you make into your fund, inside the fund your earnings are not taxed but you do pay tax on the income you receive from your fund in retirement.

This type of regime is called **EET** short for your contributions into your fund, are **E**xempt from tax, inside the fund the earnings are **E**xempt from tax and the withdrawals are **T**axed. This was the tax treatment for superannuation in New Zealand prior to 1989 and is in line with what optimal tax theory would recommend.

The current regime in New Zealand is **TTE,** that is your contributions into KiwiSaver are out of already **T**axed income, the income your contributions earn within the KiwiSaver fund itself are **T**axed but your withdrawals after age 65 are **E**xempt from income tax.

This tax change has been highly distortionary for earnings between different forms of long term retirement savings. The effective tax rate on an owner-occupied home is 0%, for an investment in a residential rental property held for 20 years with 80% gearing it is about 2% and on a term deposit or other debt instrument over 50%. (A conservative KiwiSaver scheme, mainly invested in bonds and cash is fairly close to this at 54.7% over 40 years of saving, (Source 2013 Financial Services Council, report, "The tax barrier to retirement prosperity in New Zealand")

The effective tax rates on bank term deposits and the bonds which dominate the conservative KiwiSaver fund portfolios held by default investors are much higher than the marginal income tax rates they would be paying on their other wage and salary income.

9 How do New Zealanders save for retirement?

For New Zealanders with above average incomes who already own their own home there are two main avenues for investing their retirement savings one is in KiwiSaver and the other is by investing in residential rental property. Some more risk averse savers invest in bank term deposits.

For those on middle or lower incomes, particularly if they do not own their own homes it is almost impossible, on current tax settings, to save for a comfortable retirement by putting a little away each week for a long time, to get the benefit of compound returns (earning interest on interest). This is because on an income of $70,000 or less you need to save steadily for a long time to build up your retirement nest egg you need to fund a comfortable retirement (about $300,000-450,000). On that sum you can earn about $300 a week on top of your NZ Super. However, the longer the period over which you need to save, the higher is your effective tax rate on your fund earnings. This is because of the impact paying tax within your fund, has on slowing the growth of your savings, from only, the lower after-tax earnings being reinvested into your fund. That difference makes a huge impact, significantly reducing your retirement nest egg over 40-45 years of saving.

If they do own their own home the best after tax return comes from paying off their mortgage and then using the equity in their home to invest in residential rental properties. This is particularly so when you have sufficient income to fund the tax losses, your highly geared rental property will incur while you benefit from the lift in value of your investment, when property prices increase faster than general inflation. While your investment properties remain highly geared, the interest and other ownership costs are likely to exceed the rents received. In that position you are able to deduct those losses against your other income. Provided you have sufficient other income to deduct the losses against you can keep purchasing more rental properties and gearing up the debt levels they carry. The value of these tax deductions increases the higher is your marginal tax rate. This is a strategy that is really only available for people who have an income above $120,000. Unlike KiwiSaver this form of retirement savings can be accessed well before you turn 65.

I would not claim that the tax treatment of residential rental properties is the only reason why residential property prices have increased much faster than prices generally. Rapid population growth from migration particularly into Auckland, super low interest rates since the Global Financial Crisis (GFC) and regulatory constraints on urban land release for home construction have been the prime drivers. However, the current tax regime has provided rental property investors with an almost costless option to buy access to future capital gains that are unlikely to be ever taxed in practice under current tax settings. This is all perfectly legal under current New Zealand tax law. My point is that our current tax treatment of retirement savings is neither fair nor helpful for our social and economic development.

10 Why is it so hard for low and medium earners to achieve a comfortable retirement?

To achieve a comfortable retirement most New Zealanders consider they will need an income of $250-300 a week in addition to National Super.

To do so, a low or middle income New Zealander would need to save $300-450,000 over their working lives, in addition to paying off their home so that it was freehold by the time of their retirement.

There are different ways you could accumulate a nest egg of $450,000.

You could save about $4,000 a year for 40 years, a challenging but not impossible task for someone earning $70,000 or less each year but the effective tax rate on the earnings from their savings would be 54.7% if they were in the 33% tax bracket.

That effective tax rate would be lower, closer to 40% if they could save $40,000 a year over just the last 10 years prior to retirement at age 65.

Unfortunately, almost no one earning $70,000 a year or less could save $40,000 each year, for 10 successive years.

Under the current tax settings that nest egg of $300,00-450,000 is almost impossible to save for, in a KiwiSaver account or in term deposits for someone on a low or even median income.

The tragedy we have is that the savings products most easily used by low and middle-income earners (KiwiSaver and bank term deposits) have the highest effective tax rates. That is the people in most need of saving over a long term face the biggest tax penalties for doing so.

People who have been unable to save to create the deposit to purchase their own first home are also likely to have insufficient incomes to save for a deposit on a rental property. It is also unlikely that they could also service the tax losses, from highly gearing a rental property or properties, to minimise tax. The tax savings from deducting the tax losses when interest costs exceed the rental income are greater, the higher is your marginal tax rate. So again, this feature is of most benefit to higher income earners. Provided you have sufficient income to deduct the interest costs against and can continue to gear up your properties there is little reason why this retirement income saving strategy won’t work for high income earners. The reality is we have a tax system that is creating a wedge between the home ownership aspirations of low and middle income New Zealanders while providing large tax subsidies to those residential property investors, on higher incomes who usually already own their own homes. If the marginal home buyer is the residential rental investor then the low and medium income earner wanting to purchase a first home is being out competed by an investor able to deduct the mortgage interest expense against their non-investment income.

In the UK investors own some 18% of the housing stock, in Australia the proportion is 27% whereas, in New Zealand no strictly comparable statistics appear to be available. A recent April 2018 Horizon Research Poll reported that 47.5% of New Zealand adults own their own home, 32.8% say they are currently renting, a further 4.3% are currently flatting, another 4.8% have other living arrangements and pay rent or board and 1.4% don't own a home but live rent free. In recent years more than 30% of new mortgage lending has been to investors. As rental properties on average are less expensive than the average owner-occupied home that is sold, this suggests the proportion of investor owned residential property in New Zealand could be higher than 30%. The only practical ceiling in New Zealand on this proportion is that every investor owned home needs a tenant.

11 What are the consequences of the tax regime we currently have?

The regime we have has contributed to;

- Average house prices having gone from 3 to more than 7 times average earnings over the past 30 years
- Housing costs and rents being a much higher proportion of household incomes than they were in the past
- Declining home ownership as more New Zealanders find it difficult to get onto the property ladder by purchasing a first home in competition with residential rental property investors
- Unlike many countries with more neutral tax treatments for residential rental property investments we have no corporate providers of quality, secure, long-term rentals for low and medium earners as they cannot compete with private investors who unlike the shareholders in corporates are able to deduct their tax losses in rental property investments against their other income
- Higher interest rates, as the demand for borrowing increases, to obtain the tax advantages of owning highly geared residential rental property to access substantially tax-free capital gains
- Those higher interest rates help push up our currency reducing the profitability of exporting

- As a consequence of making KiwiSaver, annuities and term deposits less attractive, capital particularly long-term capital is more expensive than it would otherwise be.
- This is also manifested in an underdeveloped capital market in New Zealand particularly when fast growing enterprises need early risk capital.
- Our NZX stock exchange market capitalisation is much smaller than it could be if we removed tax discrimination against financial long-term, compound return saving products.

As a result of these tax distortions we are poorer as a country than we should be, fewer families own their own homes and wealth inequality increases. These are self-inflicted injuries that we could have avoided.

12 How did this Problem arise?

In the 1980's attempts were made to ensure all forms of economic income were taxed on the same basis to create a level playing field for investment and taxpayers. It was initially applied to most forms of remuneration and along with the introduction of GST widened the tax base which enabled income tax rates to be reduced. Greater reliance on wide based expenditure taxes and less reliance on income taxation is consistent with what optimal tax theory would suggest to assist economic growth and improve economic welfare.

In 1989 in order to increase tax revenue and reduce the fiscal deficit the tax incentives to save in superannuation schemes were removed and the EET superannuation regime was switched to a TTE regime. In the 1990 Budget other changes were made which reduced the effective tax rates paid on income from investments in residential rental properties.

In 1990 the previous $10,000 annual cap on the losses in investment property that could be claimed, against other income was removed. The other change was, to no longer require investors in property other than in farms, to repay the tax losses they had claimed if they on-sold the property within 10 years. These changes meant that rather than a Mom and Pop owning a single rental property the possibility existed to keep on adding rental properties to your portfolio. This required you to have sufficient income, to gear up each property you purchased and fund the tax losses while the expected capital gains, increased your net worth.

When the then, recently deregulated banks started providing 100% loans on residential investment properties the access to these types of investments was greatly enhanced. At that point residential rental property investment became the retirement savings plan of choice for those in the professions and other higher income earners.   These changes combined to create in New Zealand the largest gap between the effective tax rates on residential real estate investments which are highly concessionary and the taxation of superannuation savings which had become the most punitive of any OECD country.

As is so often the case, a tax policy, that was thought fiscally helpful in the short term has been disastrous for our social well-being, the housing of our population, our social cohesion and economic growth over the longer term. The last election result was in part a revolt of the renter generation against the home owner and rental property owner generation.

Our current divisions over immigration policy have also been partially driven by the different interests of those who do not own a home but aspire to do so and those who already own one or more homes. For the person who already owns land or houses, immigration, increasing the number of people competing for the same amount of land, thereby boosting house prices, produces largely untaxed capital gains and is wealth enhancing. For the young and homeless increased immigration makes it harder and more expensive to buy a first home, increases rents and may provide competition for entry level jobs reducing their incomes, all of which for them is wealth reducing.

13 What are some Solutions that could fix the problem?

A very good description of the problem and an outline of the issues with the 1989 changes to the taxation of superannuation savings and possible solutions, is contained in Dr Andrew Coleman's University of Otago Economics Discussion Paper No 1709 Housing, the 'Great Income Tax Experiment', and the intergenerational consequences of the lease. He recommends moving back to EET from the current TTE superannuation tax regime.

These are alternative approaches to create a level playing field between rental property investments and compound return financial products such as KiwiSaver, standard annuities and bank term deposits.

In order of preference I would recommend that;

1)As Optimal Tax Theory would suggest move back to an Expenditure Tax treatment for Retirement Savings, EET

Move from our current **TTE** system to an **EET** regime that most OECD countries use. (A comprehensive expenditure tax, Kaldor approach is consistent with optimal tax theory and as recommended by Dr Andrew Coleman), or

2) Reduce the PIE rates to zero to create a level playing field between compound return financial products and residential rental property investments

If you cannot agree to recommend a move to an EET regime then at least fix the over-taxation within superannuation funds by moving the "middle **T**" to an **E**. Move to a TEE regime by reducing the PIE rates (currently 10.5%, 17.5% and 28%) all to 0% for retirement savings locked in till age 65 and continuing if an approved annuity or other approved savings product is purchased at retirement. Any withdrawals at 65 or later that were taken as a lump sum and not used to purchase an approved annuity would be taxed at 15%. (A pragmatic approach to give a result that would create a level playing field with investments in residential rental property under its existing tax treatment), or

3) Move to a Comprehensive Economic Income (Haig-Simons definition) for all forms of investment income to the degree feasible and then offset any residual advantages for rental property investments by reducing the PIE rates to ensure a level playing field with them and also ensure no investor will pay an effective tax rate higher than the marginal income tax rate they pay on their other income.

This would require removing the tax deductibility of interest against other income for rental property investors so that the deductibility can be only against the income being generated by the investment property. (This has been proposed by the current Government but has not yet been enacted.)

Only allow the deductibility of the real part of interest rates as the part of nominal interest paid to compensate the lender for inflation is a return of capital and is not income that should be taxed.

Pay income tax on any annual real capital gain or deduct any annual real loss against other income on real estate, other than the family home and the land under it or have an annual land tax of 1% on land other than the land under the family home based on an annual self -declaration of value. To help keep the system low cost and effective IRD should be able to purchase any property for later resale at auction, at its declared value plus 20% to discourage the under-reporting of values. If the TWG cannot agree to recommend either an annual land tax or an annual capital gains tax it should at least recommend that the owner-occupied home exemption be capped at a dollar amount say $1m.

With those changes in place adjust the PIE rates so they create a level playing field with rental property investments and effective tax rates no higher than the marginal income tax rates investors would pay on their other income. This is a level playing field-based approach built on a close to comprehensive economic income measure, using a Haig-Simons definition of economic income.

It should be noted that none of these recommendations provides a tax advantage for locked-in savings. They merely offset the current tax disadvantages retirement savings in compound return financial products suffer relative to investments in residential rental property and with the income tax rates investors would pay on their other wage and salary income.

14 Can these provisions be ring-fenced effectively?

These tax treatments could be restricted to products where the investor was locked in, for at least 2 years for the term deposit and annuity products. In the case of KiwiSaver where you are locked in until age 65 apart from for a withdrawal, as under the current rules, for either the purchase of a first home or under the existing extreme hardship conditions. To stop high income individuals backloading income into KiwiSaver as a tax shelter very close to retirement, you could increase the PIE rates after age 55 for late KiwiSaver enrolees so they were neutral with the tax treatment of other earned income.

15 Why has the problem not been solved before?

We currently have some 2.7m KiwiSaver, and 750,000 bank term deposit investors that are overtaxed because of the existing tax arrangements.

Since 2008 Governments have known that residential rental property investors have an advantage over first home buyers.(Source Final Report of the House Prices Unit: House Price Increases and Housing in New Zealand, March 2008, Department of Prime Minister and Cabinet, New Zealand) Since the 2011 Savings Working Group reported, Governments have known that the effective tax rates for KiwiSaver type conservative assets and bank term deposits are much higher than what KiwiSavers would pay on their other income. In the case of KiwiSaver they are also much higher than the nominal single year PIE tax rates which are often described as concessional.

The least financially sophisticated and lowest income earning savers are paying our highest effective tax rates, over 50% yet nothing has happened to fix these issues to date. While I do not think anyone set out to make it this way, the existing tax benefits for rental property investments and the tax penalties for long term savings in annuities, bank term deposits and KiwiSaver have been an engine for increasing wealth inequality in New Zealand. The overtaxed middle and lower-income earner savers, in particularly those in default conservative KiwiSaver funds are much more likely to be, young, female, Maori and Pasifika or renters. In contrast those higher income earners, who are leveraging the equity in their own homes to invest in highly geared residential rental properties and paying effective tax rates of 0-10%, much lower than the marginal tax rates they would pay on their other wage and salary income. This group is far more likely to be older, richer, male, already own their own homes and not be Maori or Pasifika. These tax expenditures represent a massive redistribution of wealth from poorer to richer New Zealanders. The tax expenditures for rental property investors and home owners, benefiting mainly the wealthiest 40% of New Zealanders in 2013 were estimated to be cost $4b a year. That was almost twice the value of all public expenditure on housing assistance (rent subsidies and accommodation benefits) provided in 2013, mainly to the poorest 20% of New Zealanders.

While KiwiSavers are locked-in till age 65 and term deposit investors for the term of their investment the Government has a captive tax stream paid for by people who do not usually know they are being overtaxed.

16 Conclusion

The Tax Working Group has an opportunity to recommend solutions for these issues. Be bold and brave in making your recommendations to address these issues.